

HDFC (Housing Development Finance Corporation)

As Good as Gold

- HDFC reported pre-extraordinary earnings in-line with our estimates, up 30% yoy. The stock significantly outperformed in a market down almost 6% today, ending down 1.3%. Retain OW rating on the stock.
- All-round strength in disbursement growth, spreads and asset quality; However, incremental trends reflect some impact of the tight liquidity conditions as 2Q disbursements slowed to 23% vs. 28% in 1Q09, although retail disbursements remained healthy at 31%; Spreads slipped sequentially to 2.24% but remained above the guidance range of 2.15-2.20%; NPL ratio at 1.04% was the lowest in 10 years of any 2Q.
- We fine tune our earnings 7-8% this year and next conservatively factoring in the current tight conditions despite remaining confident of a robust demand pipeline at the company and continued ability to maintain spreads. In fact, HDFC is a key play on potentially lower interest rates given its wholesale funded nature even while it has remained fairly insulated from the recent rate spike.
- We cut our normalized ROE from 30% to 24% and fair book multiple to 4x from 5.6x mainly on the back of a higher required minimum Tier 1 of 9.5% vs. 8% assumed earlier. Consequently our sum-of-parts based target price for Sep09 is cut 11% to Rs2,900 yet offering a substantial upside of 60%. Stock catalysts are likely to be any rate cuts in the system and easier liquidity conditions leading to a recovery in growth.
- Stock trades at 3.2x FY10E book but the mortgage parent at just 1.6x after stripping out subsidiary values, - clearly undervalued. Key risks include continued tightness in money markets and interest rates and property prices remaining at elevated levels.

Reuters: HDFC.BO, Bloomberg: HDFC IN
Rs in millions, year-end March

	FY07	FY08	FY09E	FY10E			GDR	NA
Net profit	15,704	24,363	24,318	30,514	52-week range	Rs3262-1586.25	Reuters	NA
Basic EPS (rep'd) (Rs)	62.5	90.7	85.1	106.1	Market cap	US\$10.5B	Bloomberg	NA
Basic EPS growth (%)	23.9	45.2	-6.2	24.7	Shares outstanding	284MM shares	52-wk range	NA
P/E (basic) (x)	28.5	19.6	20.9	16.8	Price	Rs. 1,782.05	Ratio	NA
BVPS (Rs)	219.4	420.6	487.2	557.4	Date of Price	17 Oct 08	Avg daily volume	NA
P/BV (x)	8.1	4.2	3.7	3.2	Free float	74%	Current prem (%)	NA
ROE (%)	31.3	27.8	18.7	20.3	Avg daily value	US\$74.98MM	13-wk avg prem (%)	NA
Tier 1 ratio (%)	7.6	14.6	12.4	11.3	Avg daily volume	1.69MM shares	52-wk avg prem (%)	NA
DPS (Rs)	22.0	25.0	27.0	31.8	BSE Sensex	9,975.3		
Dividend yield (%)	1.2	1.4	1.5	1.8	Exchange rate	Rs48.5 / US\$1		

Source: Company reports and J.P. Morgan estimates

Overweight

HDFC.BO, HDFC IN

Price: Rs1,776.55

▼ Price Target: Rs2,900.00
Previous: Rs3,240.00

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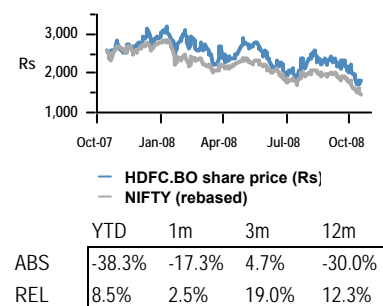
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Price Performance



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HDFC's solid performance in each successive quarter keeps us surprised positively, particularly given the deteriorating environment. In fact, the fact that they reported their lowest NPL ratio this quarter for the last 10 second-quarter earnings seasons while maintaining growth and profitability is a revelation of their superior management and operations.

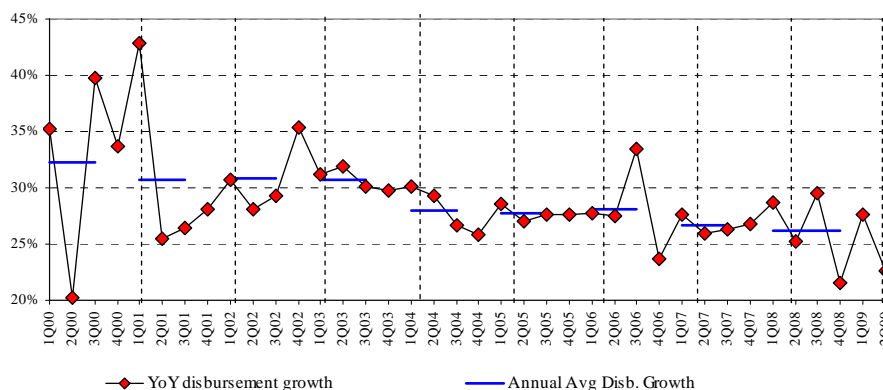
While we did see some signs of cyclical weakness in slower disbursement growth, most of it was due to staying away from bulk disbursements as money markets remained tight. Retail disbursement growth continued at a brisk pace of 31%.

However, in the current environment where investors' risk appetite has reduced considerably, we trim earnings by 7-8% for the next 2 years taking into account some permanence of this slowdown and tightness and also reduce our fair multiple to 4x book for the parent's mortgage business assuming a higher required Tier 1 ratio of 9.5% vs. 8% assumed earlier. Accordingly, we cut our Sep09 target price by 11% to Rs2,900 implying a significant 60% upside from current levels.

An easing rate environment is likely to be the key stock catalyst as wholesale funded entities like HDFC are likely to benefit relatively more and also would alleviate some of the growth slowdown recently observed. Consequently, we reiterate our Overweight rating on the stock.

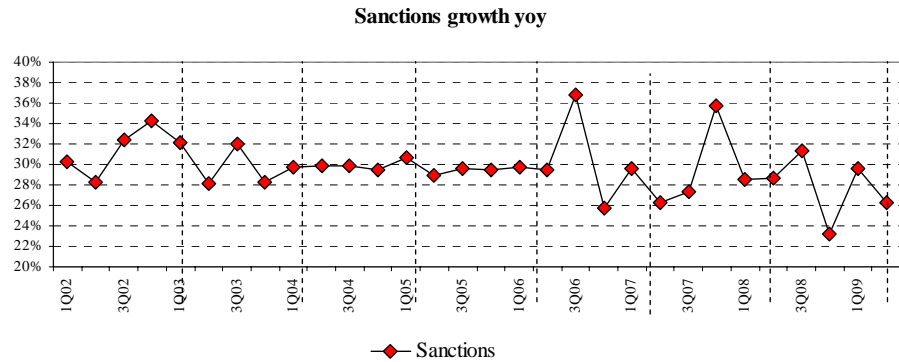
A pictorial summary of 2Q09 results follows:

Figure 1: HDFC Ltd: Disbursement growth trend, yoy



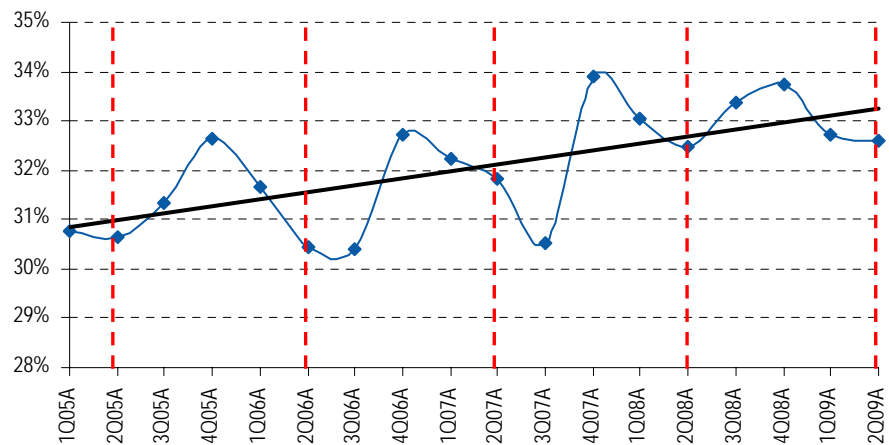
Source: Company data, J.P. Morgan estimates

Figure 2: HDFC Ltd: Loans Sanction growth trend, yoy



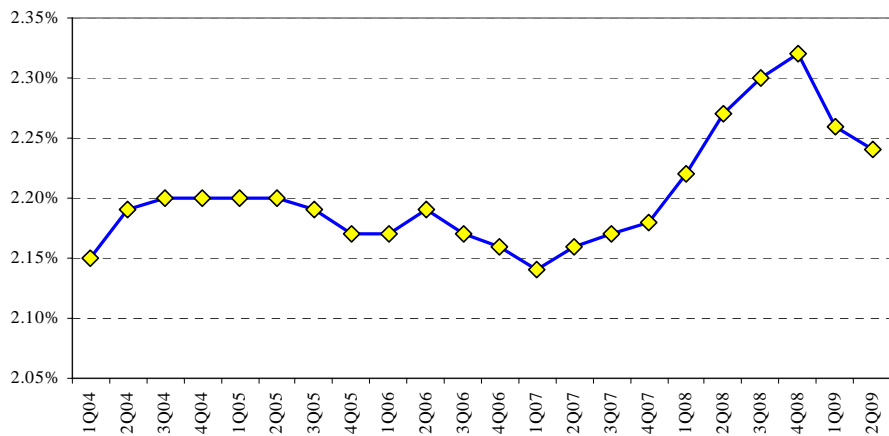
Source: Company reports and J.P. Morgan estimates.

Figure 3: HDFC Ltd: Non-retail disbursement growth trend



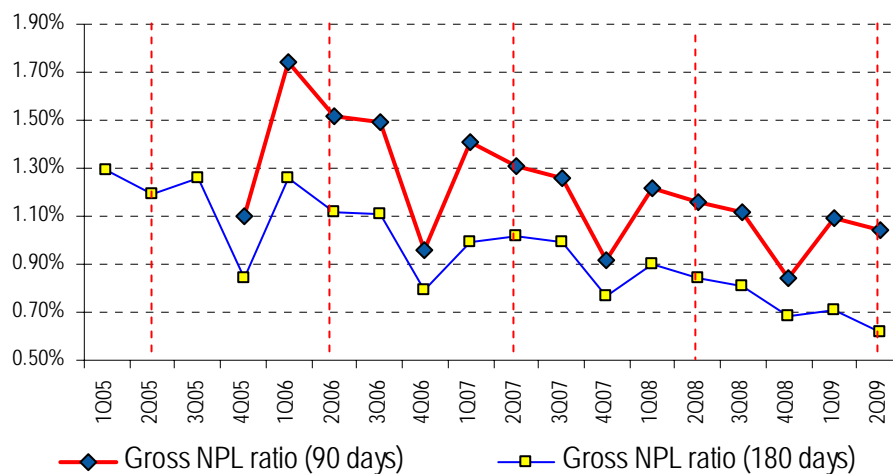
Source: Company reports and J.P. Morgan estimates.

Figure 4: HDFC Ltd: Housing loan spreads



Source: Company reports and J.P. Morgan estimates.

Figure 5: HDFC Ltd: Gross NPL ratio



Source: Company reports and J.P. Morgan estimates.

Table 1: HDFC Ltd: 2Q FY09 Summary

Rs mn	2Q09A	Y/Y	Q/Q
Income from Operations	25,567.1	37.9%	11.9%
Total Interest Expenses	17,572.6	43.8%	12.0%
Net Interest Income	7,994.5	26.5%	11.7%
Fees	112.8	91.5%	94.8%
Total Operating Income	8,107.3	27.1%	12.4%
Operating Expenses	1,033.5	19.7%	2.9%
Operating Profit	7,073.8	28.2%	13.9%
Capital Gains	471.1	75.3%	100.0%
Others	54.9	40.8%	6.8%
Total Other Income	526.0	70.9%	83.3%
Pre-tax Profit (pre-extraordinary)	7,599.8	30.5%	16.9%
Pre-tax Profit	7,599.8	-15.2%	16.9%
Tax	2,257.5	-9.4%	24.2%
Net Profit	5,342	-17.4%	14.1%
Interest Expense/ Income	69%	2.8%	0.1%
Cost Income Ratio	12.7%	-0.8%	-1.2%
Fees/Operating Income	1%	0.5%	0.6%
Disbursements	105,840.0	22.6%	46.9%
Sanctions	141,840.0	26.2%	41.9%
Loans	811,919	30.9%	5.0%

Source: Company reports and J.P. Morgan estimates.

Table 2: HDFC Ltd: Changes to earnings estimates, F09E-F10E

	F2009E	F2010E
YoY Growth		
Profit & Loss		
Net Interest Income	-3.8%	-4.7%
Fee Income	0.0%	0.0%
Operating Expenses	4.2%	4.1%
Operating Profit	-4.6%	-5.5%
Pre-tax Profit	-4.4%	-5.5%
Profit after Tax	-7.0%	-8.1%
DPS	-0.8%	2.1%
Balance Sheet		
Loans	-0.7%	-1.6%
Earning Assets	-0.2%	-0.4%
Deposits	0.0%	0.0%
Borrowings	0.0%	0.0%
Tier 1 Ratio (%)	-0.14%	-0.29%
Ratios (%)		
ROE	-1.28%	-1.33%
ROA	-0.20%	-0.23%
Net Interest Margin	-0.14%	-0.17%

Source: Company reports and J.P. Morgan estimates.

Table 3: HDFC Ltd: Earnings Outlook

	F2009E	F2010E
YoY Growth		
Profit & Loss		
Net Interest Income	27%	25%
Fee Income	-32%	10%
Operating Expenses	23%	15%
Operating Profit	26%	26%
Pre-tax Profit	2%	25%
Profit after Tax	0%	25%
EPS	-6%	25%
Balance Sheet		
Loans	26%	25%
Assets	25%	25%
Book Value per share	16%	14%
Tier 1 Ratio (%)	12.4%	11.3%
Ratios (%)		
ROE	18.7%	20.3%
ROA	2.66%	2.68%
Net Interest Margin	3.70%	3.70%
Cost/Income Ratio	10.0%	9.2%

Source: Company reports and J.P. Morgan estimates

Table 4: HDFC Ltd: Normalised ROE

HDFC	NORMALISED	FY2007	FY2008	FY2009E	FY2010E
Net Margin (as % of avg. IEA)	3.72%	3.14%	3.78%	3.74%	3.75%
Non-IR/Asset	0.06%	0.16%	0.12%	0.07%	0.07%
Non-IR/Revenues	1.7%	4.8%	3.0%	1.9%	1.8%
Fees/Revenues	1.7%	4.8%	3.0%	1.9%	1.8%
Dealing/Revenues	0.0%	0.0%	0.0%	0.0%	0.0%
Other Rev/Revenues	0.0%	0.0%	0.0%	0.0%	0.0%
Total Revenue	3.82%	3.27%	3.90%	3.86%	3.85%
Cost/Income	9.2%	12.7%	10.1%	9.9%	9.1%
Cost/Assets	0.35%	0.42%	0.39%	0.38%	0.35%
Pre-Provision Profits	3.47%	2.86%	3.51%	3.47%	3.50%
LLP/Loans	-0.05%	-0.05%	-0.05%	-0.05%	-0.04%
Prov/Writebacks on Sec.	0.33%	0.64%	1.23%	0.32%	0.31%
Pre-Tax	3.76%	3.45%	4.69%	3.75%	3.77%
Effective Tax Rate	29.0%	20.2%	27.8%	29.0%	29.0%
ROAA	2.67%	2.76%	3.39%	2.66%	2.68%
Equity / Assets*	10.93%	8.8%	12.2%	14.2%	13.2%
RoE	24.4%	31.3%	27.8%	18.7%	20.3%
Adjusted NAV	495.6				
PV of Adj NAV	413.0				
COE	13.40%				
RFR	8.00%				
Equity Prem	6.00%				
Beta	0.9				
Growth	9.8%				
CURRENT PRICE	1782.1				
Fair P/BV	4.01x				
Terminal Value	1657.2				
Sum of PV of Dividends	78.86				
Current Fair Value	2600.1				

Source: Company reports and J.P. Morgan estimates

Table 5: HDFC Ltd: Sum of parts valuation

	Fwd Value	Methodology	Contribution to subsidiary total
HDFC Parent (a)	1,969	Gordon Growth Model – 4.0 x book	
Subsidiaries/Associates			
Listed Subsidiaries	270	Market Value of HDFC Bank's share	29%
Asset Management	74	6% of AUM	8%
Life Assurance	368	Appraisal Value	40%
Others	219	Real Estate Funds + unrealised gains (listed & estd unlisted)	23%
Total Subsidiaries	931	Total	100%
Net Value of Subs/Associates (b)	931	Subs to total	32%
Fair Value (a+b)	2,899		

Source: J.P. Morgan estimates

HDFC (Housing Development Finance Corporation): Summary of Financials

Income Statement						Growth Rates					
Rs in millions, year end Mar	FY06	FY07	FY08	FY09E	FY10E		FY06	FY07	FY08	FY09E	FY10E
NIM (as % of avg. assets)	3.2%	3.1%	3.8%	3.7%	3.7%	Loans	24.7%	25.5%	29.1%	25.7%	24.5%
Earning assets/assets	100.3%	99.3%	100.3%	101.1%	101.0%	Deposits	11.5%	18.8%	8.8%	9.5%	9.7%
Margins (% of earning assets)	3.2%	3.1%	3.8%	3.8%	3.8%	Assets	26.3%	22.6%	29.3%	25.1%	24.9%
						Equity	15.1%	24.2%	115.2%	17.3%	14.4%
Net Interest Income	14,707	17,760	27,252	34,518	43,140	RWA	49.5%	52.8%	12.0%	38.1%	25.6%
Total Non-Interest Income	803	893	829	682	776	Net Interest Income	29.1%	20.8%	53.4%	26.7%	25.0%
Fee Income	803	893	829	682	776	Non-Interest Income	-28.0%	11.2%	-7.2%	-17.8%	13.8%
Dealing Income	0	0	0	0	0	of which Fee Grth	-28.0%	11.2%	-7.2%	-17.8%	13.8%
Other Operating Income	-	-	-	-	-	Revenues	24.0%	20.3%	50.5%	25.3%	24.8%
Total operating revenues	15,511	18,654	28,081	35,200	43,917	Costs	39.4%	10.1%	20.0%	22.9%	14.9%
Operating costs	-2,150	-2,366	-2,839	-3,490	-4,008	Pre-Provision Profits	21.8%	21.9%	55.0%	25.6%	25.9%
Pre-Prov. Profits	13,361	16,287	25,242	31,710	39,908	Loan Loss Provisions	7.1%	66.7%	28.0%	25.0%	15.0%
Provisions	-150	-250	-320	-400	-460	Pre-Tax	37.1%	20.9%	71.4%	1.5%	25.5%
Other Inc/Exp.	3,059	3,640	8,813	2,940	3,529	Attributable Income	37.2%	18.3%	55.1%	-0.2%	25.5%
Exceptionals	697	0	6,363	0	0	EPS	37.0%	16.7%	46.2%	-6.2%	24.7%
Disposals/ other income	-	-	-	-	-	DPS	17.6%	10.0%	13.6%	8.2%	17.6%
Pre-tax	16,270	19,678	33,735	34,251	42,977	Balance Sheet Gearing					
Tax	3,000	3,974	9,372	9,933	12,463	Loan/deposit	519.0%	548.1%	650.4%	746.3%	846.5%
Minorities	0	0	0	0	0	Investment/assets	7.7%	6.0%	8.7%	8.5%	9.0%
Other Distbn.	-	-	-	-	-	Loan/Assets	87.9%	90.1%	90.0%	90.3%	89.9%
Attributable Income	13,270	15,704	24,363	24,318	30,514	Customer deposits/liab.	17.1%	16.6%	13.9%	12.2%	10.7%
						LT debt/liabilities	74.2%	74.6%	71.3%	73.9%	76.3%
Per Share Data Rs						Asset Quality/Capital					
EPS	53.17	62.07	90.73	85.06	106.05	Loan loss reserves/loans	0.8%	0.7%	0.6%	0.6%	0.5%
DPS	20.00	22.00	25.00	27.05	31.82	NPLs/loans	1.0%	0.9%	0.8%	0.8%	0.7%
Payout	38%	35%	29%	32%	30%	Loan loss reserves/NPLs	0.0%	0.0%	0.0%	0.0%	0.0%
Book value	179.05	219.41	420.64	487.20	557.36	Growth in NPLs	8.7%	19.6%	14.9%	16.8%	18.1%
Fully Diluted Shares	0.00	0.00	0.00	0.00	0.00	Tier 1 Ratio	9.4%	7.6%	14.6%	12.4%	11.3%
						Total CAR	15.0%	12.9%	16.8%	14.2%	12.9%
Key Balance sheet Rs in millions						Du-Pont Analysis					
Net Loans	449,901	565,124	729,980	917,971	1,143,172	NIM (as % of avg. assets)	3.2%	3.1%	3.8%	3.7%	3.7%
LLR	-3,805	-4,097	-4,703	-5,300	-6,000	Earning assets/assets	100.3%	99.3%	100.3%	101.1%	101.0%
Gross Loans	453,706	569,220	734,682	923,271	1,149,172	Margins (as % of Avg. Assets)	3.2%	3.1%	3.8%	3.8%	3.8%
NPLs	4,464	5,338	6,132	7,160	8,459	Non-Int. Rev./ Revenues	5.2%	4.8%	3.0%	1.9%	1.8%
Investments	39,537	37,893	70,616	86,084	113,825	Non IR/Avg. Assets	0.2%	0.2%	0.1%	0.1%	0.1%
Other earning assets	3,785	6,096	-7,895	-7,878	-8,609	Revenue/Assets	3.0%	3.0%	3.5%	3.5%	3.5%
Avg. IEA	459,861	565,478	721,506	922,627	1,151,475	Cost/Income	13.9%	12.7%	10.1%	9.9%	9.1%
Goodwill	0	0	0	0	0	Cost/Assets	0.5%	0.4%	0.4%	0.4%	0.4%
Assets	511,897	627,444	810,986	1,014,288	1,266,343	Pre-Provision ROA	2.6%	2.6%	3.1%	3.1%	3.1%
Deposits	87,414	103,844	112,962	123,720	135,748	LLP/Loans	-0.0%	-0.0%	-0.0%	-0.0%	-0.0%
Long-term bond funding	379,799	468,086	578,550	750,391	970,232	Loan/Assets	89.1%	89.8%	90.6%	90.8%	90.9%
Other Borrowings	0	0	0	0	0	Other Prov, Income/ Assets	0.7%	0.6%	1.2%	0.3%	0.3%
Avg. IBL	416,844	519,572	631,721	782,812	990,045	Operating ROA	2.5%	2.5%	3.0%	3.0%	3.1%
Avg. Assets	458,601	569,671	719,215	912,637	1,140,315	Pre-Tax ROA	3.2%	3.2%	4.3%	3.4%	3.4%
Common Equity	44,683	55,514	119,473	141,939	165,036	Tax rate	18.4%	20.2%	27.8%	29.0%	29.0%
RWA	477,889	730,447	818,311	1,129,874	1,418,609	Minorities & Outside Distbn.	0.0%	0.0%	0.0%	0.0%	0.0%
Avg. RWA	398,762	604,168	774,379	974,093	1,274,242	ROA	2.9%	2.8%	3.4%	2.7%	2.7%
						RORWA	3.3%	2.6%	3.1%	2.5%	2.4%
						Equity/Assets	9.1%	8.8%	12.2%	14.2%	13.2%
						ROE	31.8%	31.3%	27.8%	18.7%	20.3%

Source: Company reports and J.P. Morgan estimates.

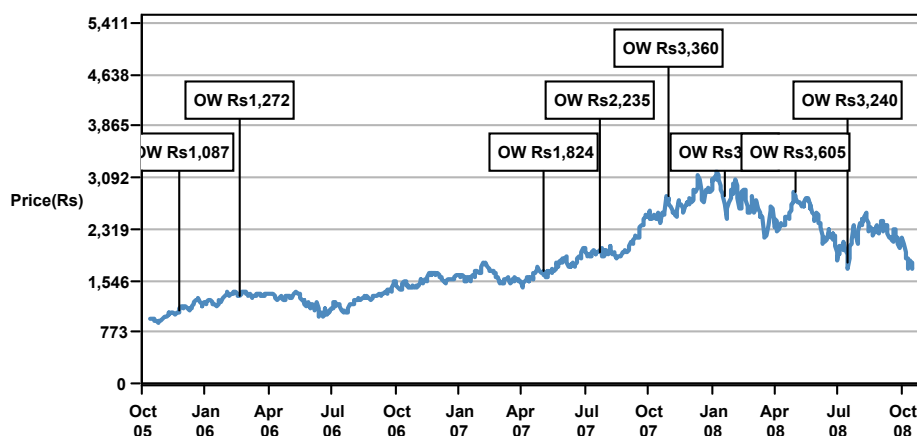
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- An affiliate of JPMSI owns a significant stake in HDFC Securities Limited, a privately held subsidiary of HDFC.

HDFC (Housing Development Finance Corporation) (HDFC.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
25-Nov-05	OW	1086.05	1087.00
18-Feb-06	OW	1300.05	1272.00
04-May-07	OW	1679.20	1824.00
25-Jul-07	OW	1974.70	2235.00
30-Oct-07	OW	2813.05	3360.00
21-Jan-08	OW	2819.80	3709.00
30-Apr-08	OW	2881.45	3605.00
16-Jul-08	OW	1800.30	3240.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Feb 26, 2004 - Jul 02, 2004. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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