

**HDFC**

**Edelweiss**  
 Ideas create, values protect

Quality performance

### Quality of earnings improves

Quality once again has come to the fore. HDFC reported 23% growth in PAT in Q1FY11, led by improved spreads (Y-o-Y) and robust individual disbursements. Dependence on treasury income has come off – zero investment profits (against 6% to income in Q1FY10). As anticipated, margins have come off Q-o-Q - a seasonal impact. Asset quality and operating efficiency continue to be remarkable.

### Building traction; individual segment driving growth

HDFC stepped up momentum in the individual loan segment via attractive special home loan schemes, which resulted in 62% Y-o-Y growth. Overall disbursement growth is closer to the historical average of 25% due to limited focus on corporate loans. Adjusting for sell-downs of individual loans to HDFC Bank (INR 12.6 bn), loan growth improved to 23% Y-o-Y. We believe HDFC is on track to achieve targeted growth of 20-25% and we expect disbursements and loan book to post 22-23% CAGR over FY10-12E.

### Spreads to sustain; well matched asset liability profile

Spreads (rep) this quarter improved by 11bps Y-o-Y, to 2.34%, led by decline in cost of funds and spreads sustained at 2.3% in special schemes. Q-o-Q, NIMs (calc.) came off more than 100bps - more of a seasonal impact. We believe HDFC will be able to maintain spreads at 2.3% over FY11-12E in a rising interest environment, led by special schemes and well matched asset liability profile.

### Dividend income higher; fee income lower than expectations

HDFC booked dividend income of INR 1.2 bn, including dividend of INR 980 mn from HDFC Bank (pertaining to its direct holding). Dividend on indirect holding through HDFC Investments will accrue in Q2FY11. Fee income at INR 234 mn was lower than expectations as it waived charges on non-individual loans. Profit on sale of investments in IL&FS will be booked once it receives FIPB approval.

### Outlook and valuations: Positive, valuations fair; maintain 'HOLD'

Core earnings were strong in Q1FY11 with disbursement growth driven by individual loans and spreads sustaining at 2.3%. We expect the company to grow disbursements 22% and maintain interest margins at ~3.4% over FY10-12E. We maintain our EPS estimates at INR 118.5 for FY11 and at INR 141.6 for FY12. The stock is currently trading at 4.1x FY12E book and 21.7x FY12E earnings. Our SOTP fair value for FY12E stands at INR 3,110. We maintain 'HOLD' recommendation and rate it 'Sector Underperformer'.

July 14, 2010

Reuters: HDFC.BO Bloomberg: HDFC IN

**EDELWEISS 4D RATINGS**

Absolute Rating	<b>HOLD</b>
Rating Relative to Sector	<b>Underperformer</b>
Risk Rating Relative to Sector	<b>Low</b>
Sector Relative to Market	<b>Overweight</b>

Note:  
Please refer last page of the report for rating explanation

**MARKET DATA**

CMP	:	INR 3,077
52-week range (INR)	:	3,145 / 1,950
Share in issue (mn)	:	287.1
M cap (INR bn/USD mn)	:	895 /19,171
Avg. Daily Vol. BSE/NSE ('000):	:	774.7

**SHARE HOLDING PATTERN (%)**

Promoters*	:	0.0
MFs, FIs & Banks	:	29.8
FIIIs	:	57.9
Others	:	12.3
* Promoters pledged shares (% of share in issue)	:	NIL

**PRICE PERFORMANCE (%)**

	Stock	Nifty	EW BFSI Index
1 month	9.3	5.5	4.0
3 months	11.7	1.5	7.7
12 months	38.8	35.9	51.9

**Financials**

Year to March	Q111	Q110	Growth (%)	Q410	Growth (%)	FY10	FY11E
Inc. from oper. (INR mn)	10,775	8,301	29.8	12,873	(16.3)	40,658	48,843
PAT (INR mn)	6,946	5,649	23.0	9,258	(25.0)	28,265	34,030
BV per share (INR)						529	660
Adj book value*						262	386
Diluted EPS (INR)	23.5	19.2	22.9	31.3	(24.8)	98.4	118.5
Price/ Book (x)						5.8	4.7
Price/ Adj. book (x) *						9.1	5.9
Diluted P/E (x)						31.3	26.0
Price/ Adj. earnings (x) *						27.7	21.6

\* adjusted for the value of subsidiaries

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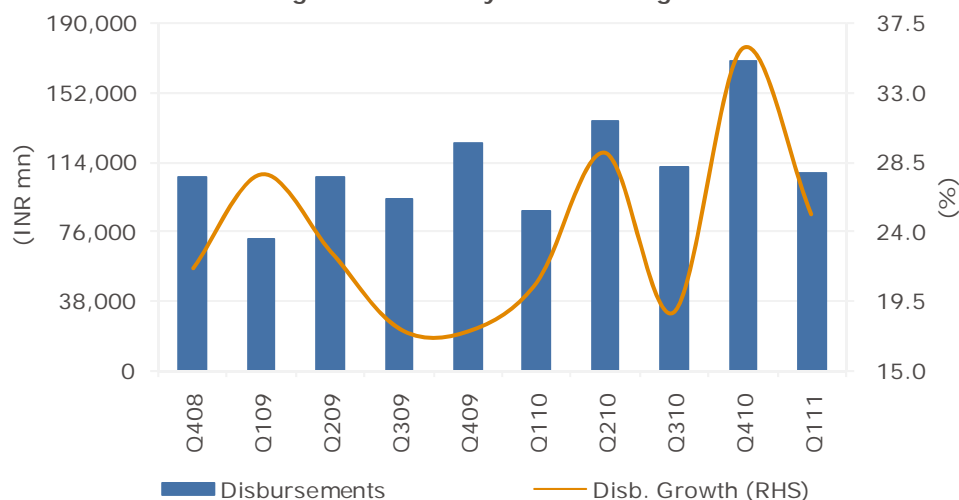
- Individual loans driving growth; sold down INR 13 bn of loans

HDFC stepped up momentum in the individual loan segment via attractive special home loan schemes, resulting in 62% Y-o-Y growth. Overall disbursement growth is closer to the historical average of 25% to INR 109 bn due to limited focus on corporate loans. Sanctions were also strong with 30% Y-o-Y growth, to INR 160 bn; individual loan sanctions have grown 56%.

In Q1FY11, HDFC sold down INR 12.6 bn of loans; cumulative sell downs in the past one year were INR 56.4 bn (INR 10.9 bn in non-individual category). Adjusting for these sell downs, the company's loan book would have grown 23% Y-o-Y (against reported growth of 17%), as was guided by the management. The company earns 1.25% spreads on these sell downs. Going forward, the quantum and trend in sell downs will be dependent on HDFC Bank's priority sector lending requirement and credit offtake for the industry, in general, and the bank, in particular.

The outlook on mortgage growth has improved and we expect disbursements to post 22% CAGR over FY10-12E.

**Chart 1: Disbursements growth driven by individual segment**



Source: Company, Edelweiss research

- Spreads to sustain; well matched asset liability profile

Spreads (reported) during the quarter improved by 11bps, to 2.34%, led by decline in cost of funds and spreads sustained at 2.3% in special schemes through back-to-back funding arrangements. Q-o-Q, NIMs (calc.) have come off more than 100bps, to 3.3% - more of a seasonal impact. The company's net interest income (including surplus from investments in MFs) grew 29% Y-o-Y (down 20% Q-o-Q), to INR 9.3 bn.

HDFC continued with its special home loan scheme by **launching Dual Rate Home Loan in July 2010**, under which, customers will get a fixed rate of 8.25% up to March 2011, 9.25% for April 2011-March 2012, and floating rate thereafter. It has arranged for a back-to-back funding at annualised cost of ~6.4%, which will help it sustain spreads at ~2.3%. The incremental borrowing cost in the past couple of months has jumped ~25-40bps and, therefore, fixed rate under the new scheme in the second year has been increased to 9.25% (from 9.0% and 8.25% under the previous schemes). Yield on advances, following historical trend, has come off Q-o-Q to 10% from 10.9% in Q4FY10.

We believe HDFC will be able to maintain spreads at 2.3% over FY11-12E in a rising interest environment, led by special schemes and well matched asset liability profile.

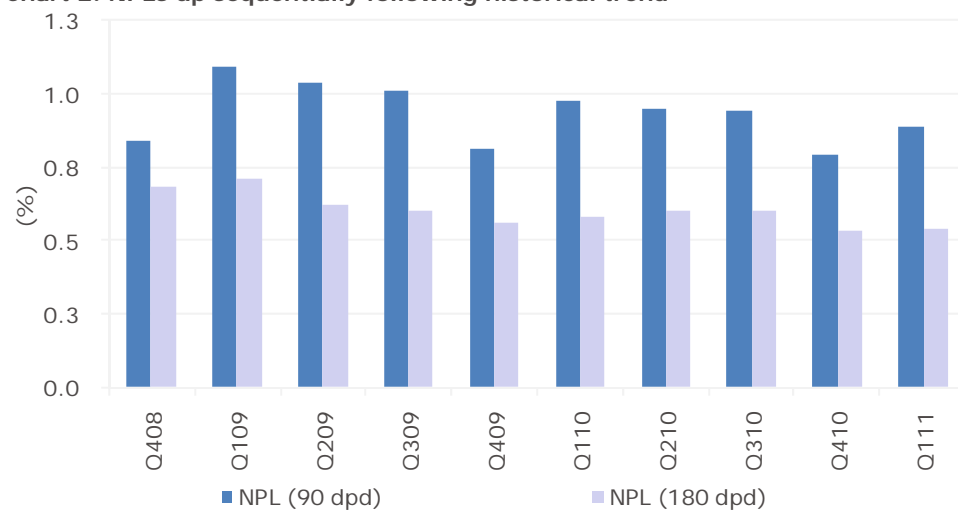
**Table 1: NIMs come off Q-o-Q – a seasonal impact**

(%)	Q1FY11	Q1FY10	change (bps)	Q4FY10	change (bps)
Yield on home loans	10.1	11.7	(159)	10.9	(85)
Yield on assets	9.3	11.1	(175)	10.1	(78)
Cost of funds	7.0	9.4	(236)	6.7	29
Margins	3.3	3.0	29	4.3	(105)

Source: Company, Edelweiss research

- **Following historical trend, NPLs were up sequentially**

Following the historical trend, NPLs (90dpd) have risen Q-o-Q, to 0.89% in Q1FY11, from 0.79% in Q4FY10, though they were lower against 0.98% in Q1FY10. The company has provided INR 150 mn for contingencies, while cumulative provisioning in absolute terms has gone up by INR 412 mn, to INR 6.97 bn. We expect the company to maintain superior asset quality, going forward, as well.

**Chart 2: NPLs up sequentially following historical trend**

Source: Company, Edelweiss research

**Table 2: SOTP valuations**

FY12E	Method	AUMs/book /earnings (INR mn)	Multiple (x)	Value of business (INR mn)	HDFC holding(%)	Value of HDFC's interest (INR mn)	Value per share (INR)
HDFC core mortgage business	PE	35,783	17.7	631,578	100.0	631,578	2,200
HDFC Bank	Fair value	903,168	1.0	903,168	23.7	214,051	746
Asset management	% of AUM	1,225,164	5.0	61,258	60.0	36,755	128
Venture Capital	% of AUMs	52,809	10.0	5,281	100.0	5,281	18
HDFC Life Insurance	Appraisal value	5,394	23.6	127,203	51.0	64,874	226
Others						5,776	20
<b>Value of subs</b>						<b>326,736</b>	<b>1,138</b>
Value (at 20% holding company discount)						261,389	910
<b>Total</b>						<b>892,967</b>	<b>3,110</b>

Source: Edelweiss research

Note: \* Considering stake sale in life insurance

# Core mortgage book will appear distorted for the next two years due to investments in HDFC Bank's warrants; Hence, we are using equivalent P/E multiple.

## Financials snapshot

(INR mn)

Year to March	Q111	Q110	Growth (%)	Q410	Growth (%)	FY10	FY11E	FY12E
Interest income	26,168	26,314	(0.6)	26,877	(2.6)	104,506	118,897	150,254
Interest exp	17,196	19,628	(12.4)	15,595	10.3	70,631	77,748	100,786
Net interest income	8,972	6,686	34.2	11,282	(20.5)	33,875	41,149	49,468
Dividend income	1,181	562	110.2	432	173.6	2,327	2,676	3,077
Others	623	1,053	(40.9)	1,160	(46.3)	4,456	5,018	5,783
Net income from ops	10,775	8,301	29.8	12,873	(16.3)	40,658	48,843	58,328
Other income	48	49	(1.0)	65	(25.5)	226	226	226
Net revenues	10,824	8,350	29.6	12,938	(16.3)	40,884	49,069	58,554
Depreciation	40	40	1.0	53	(24.1)	182	192	202
Other expenses	1,118	1,024	9.2	686	62.9	3,635	4,030	4,415
Profit before tax before	9,666	7,286	32.7	12,199	(20.8)	37,066	44,848	53,937
Profit on Sale of Investments		513		454		2,094	2,000	2,000
Profit before tax	9,666	7,799	23.9	12,653	(23.6)	39,160	46,848	55,937
Provision for taxes	2,720	2,150	26.5	3,395	(19.9)	10,895	12,818	15,276
PAT	6,946	5,649	23.0	9,258	(25.0)	28,265	34,030	40,661
Reported net profit (including extraordinaries)	6,946	5,649	23.0	9,258	(25.0)	28,265	51,130	40,661
Diluted EPS (INR)	23.5	19.2	22.9	31.3	(24.8)	98.4	118.5	141.6
NII/GII (%)	34.3	25.4		42.0		32.4	34.6	32.9
Cost/income (%)	10.7	12.7		5.7		8.0	7.4	6.8
Tax rate (%)	28.1	27.6		26.8		27.8	27.4	27.3

## Balance sheet data (INR mn)

Disbursements	108,630	86,880	25.0	168,860	(35.7)	504,130	620,080	750,297
Borrowings	997,517	837,947	19.0	965,653	3.3	965,653	1,155,888	1,428,595
Mortgage assets	1,016,247	870,458	16.7	979,670	3.7	979,670	1,202,272	1,492,728

### ■ Company Description

HDFC is India's largest provider of housing finance, primarily focusing on retail housing. The company has widened its distribution network to 254 offices in India. It also covers over 90 locations through its outreach programme, which has helped the corporation disburse housing loans in more than 2,400 towns and cities in India. It has also supplemented the distribution channel through the appointment of direct selling agents (DSA). As on June 30, 2010, 58% of the shares are held by foreign institutional investors/foreign direct investments and 12% by individuals.

Besides the core business of mortgages, HDFC has evolved into a financial conglomerate, diversifying into other businesses through its subsidiaries viz., HDFC Standard Life Insurance (73%), HDFC Asset Management Company (60%), HDFC Bank (19.4%), and HDFC General Insurance Company (74%).

### ■ Investment Theme

HDFC is the strongest and the most venerable play on Indian mortgages over the long term. We expect the company, with its strong brand recall, superior real estate knowledge, and revamped distribution strategy, to attain 22% CAGR in loan disbursement over FY10-12E.

Besides the core business, HDFC's insurance, AMC, banking, BPO, and real estate private equity businesses are also growing at a rapid pace and the estimated value of its investments/subsidiaries explains HDFC's ~35% market capitalisation. Value of stakes in HDFC Bank and HDFC Standard Life form a significant portion of its unrealised gains. The outlook on mortgage growth and asset quality has improved since January with change in the macro environment. The stock has always traded at a premium to other financial stocks due to its stable earnings profile, superior asset quality and strong management.

### ■ Key Risks

Increase in competition and sustained slack in the mortgage market can lead to lower growth than our estimates.

Higher-than-expected increase in funding cost and inability to pass the cost to customers in the current tightening monetary environment will adversely affect margins and profitability.

Risk of fraud and NPA accretion due to increase in interest rates and fall in property prices is inherent to the mortgage business.

## Financial Statements

<b>Income statement</b>					<b>(INR mn)</b>
Year to March	FY08	FY09	FY10	FY11E	FY12E
Interest income	77,840	104,863	104,506	118,897	150,254
Interest expended	51,429	74,325	70,631	77,748	100,786
Net interest income	26,411	30,538	33,875	41,149	49,468
Non interest income	2,788	5,062	7,009	7,920	9,086
- Fee & forex income	632	1,149	2,317	2,780	3,336
- Misc. income	1,038	2,333	2,794	3,052	3,453
- Investment profits	1,118	1,580	1,898	2,088	2,297
Income from operations	29,199	35,600	40,884	49,069	58,554
Net revenues	29,199	35,600	40,884	49,069	58,554
Operating expense	2,734	3,155	3,237	3,616	3,979
- Employee exp	1,178	1,386	1,467	1,613	1,774
- Depreciation /amortisation	166	175	182	192	202
- Other opex	1,390	1,595	1,589	1,812	2,003
Preprovision profit	26,465	32,445	37,646	45,452	54,575
Profit on sale of investments	1,333	252	2,094	2,000	2,000
Provisions	425	507	580	605	638
Profit before tax	27,373	32,190	39,160	46,848	55,937
Provision for tax	7,931	9,365	10,895	12,818	15,276
Profit After Tax	19,442	22,825	28,265	34,030	40,661
Extraordinaries	4,921	-	-	17,100	-
Reported PAT	24,363	22,825	28,265	51,130	40,661
Basic shares outstanding (mn)	284	284	287	287	287
Basic EPS (INR)	68.5	80.2	98.4	118.5	141.6
Diluted equity shares (mn)	284	284	287	287	287
Diluted EPS (INR)	68.5	80.2	98.4	118.5	141.6
Dividend per share (INR)	25.0	30.0	36.0	35.6	42.5
Dividend payout (%)	34.1	42.9	42.6	23.3	35.0

### Growth ratios (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	36.8	17.4	19.9	18.8	18.6
NII growth	60.1	15.6	10.9	21.5	20.2
Opex growth	14.4	15.4	2.6	11.7	10.0
PPP growth	56.9	22.6	16.0	20.7	20.1
Provisions growth	66.1	19.2	14.5	4.3	5.5
Net profit	23.8	17.4	23.8	20.4	19.5

### Operating ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
Yield on advances	11.3	12.5	10.9	10.7	11.0
Yield on assets	10.9	11.8	10.1	9.7	10.1
Net interest margins	3.7	3.4	3.3	3.4	3.3
Cost of funds	8.3	9.7	7.8	7.3	7.8
Spread	2.5	2.1	2.2	2.4	2.3
Cost-income	9.5	9.0	8.0	7.4	6.8
Tax rate	29.0	29.1	27.8	27.4	27.3

**Balance sheet****(INR mn)**

As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital	2,840	2,845	2,871	2,871	2,871
Share premium account	56,391	56,508	57,796	57,796	57,796
Reserves & surplus	60,242	72,022	91,309	128,945	153,409
Net worth	119,473	131,374	151,977	189,613	214,077
Deposits	112,963	193,747	230,811	276,974	332,368
Secured loans	517,367	551,801	636,057	769,643	971,872
Unsecured loans	61,183	93,013	98,785	109,271	124,355
<b>Total liabilities</b>	<b>814,284</b>	<b>969,935</b>	<b>1,117,630</b>	<b>1,345,463</b>	<b>1,642,586</b>
Loans	733,278	851,981	979,670	1,202,272	1,492,728
Investments	69,150	104,687	107,275	110,313	113,890
Total current assets	41,524	55,708	74,392	77,354	81,765
Total current liabilities & provisions	33,220	46,635	48,785	50,112	52,179
Net current assets	8,305	9,074	25,607	27,242	29,586
Fixed assets	2,085	2,034	2,221	2,130	2,028
Other Assets	1,466	2,158	2,857	3,507	4,354
<b>Total assets</b>	<b>814,284</b>	<b>969,935</b>	<b>1,117,630</b>	<b>1,345,463</b>	<b>1,642,586</b>
Loan growth	29.8	16.2	15.0	22.7	24.2
Deposit growth	8.8	71.5	19.1	20.0	20.0
EA growth	29.9	19.1	15.2	20.4	22.1

**Sanctions and disbursements**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Sanctions (INR mn)	425,200	491,660	606,110	739,454	902,134
Disbursements (INR mn)	328,750	396,500	504,130	620,080	750,297
Disbursements to sanction ratio (%)	77.3	80.6	83.2	83.9	83.2
Disbursements growth (%)	25.6	20.6	27.1	23.0	21.0
Sanctions growth (%)	27.6	15.6	23.3	22.0	22.0

**RoE decomposition (%)**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net interest income/assets	3.7	3.4	3.3	3.4	3.3
Non interest income/assets	0.4	0.6	0.7	0.6	0.6
Investment profits/Assets	0.2	-	0.2	0.2	0.1
Net revenues/assets	4.3	4.0	4.1	4.2	4.1
Operating expense/assets	0.4	0.4	0.3	0.3	0.3
Provisions/assets	0.1	0.1	0.1	0.0	0.0
Taxes/assets	1.1	1.1	1.0	1.0	1.0
Total costs/assets	1.5	1.5	1.4	1.4	1.3
ROA	2.7	2.6	2.7	2.8	2.7
Equity/assets	12.2	14.1	13.6	13.9	13.6
ROAE	22.2	18.2	20.0	19.9	20.1

**Valuation parameters**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	68.5	80.2	98.4	118.5	141.6
<i>Y-o-Y growth (%)</i>	<i>8.9</i>	<i>17.2</i>	<i>22.7</i>	<i>20.4</i>	<i>19.5</i>
Book value per share (INR)	420.6	461.9	529.3	660.4	745.6
Adjusted book value per share (INR)	316.7	329.4	262.2	386.3	464.6
Diluted PE (x)	44.9	38.3	31.3	26.0	21.7
Price/ Adj. Earnings (x)	37.9	32.5	27.7	21.6	17.1
Price/ BV (x)	7.3	6.7	5.8	4.7	4.1
Dividend yield (%)	0.8	1.0	1.2	1.2	1.4





Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Allahabad Bank	BUY	SO	H	Axis Bank	BUY	SO	M
Bank of Baroda	BUY	SO	L	Federal Bank	BUY	SO	M
HDFC	HOLD	SU	L	HDFC Bank	HOLD	SP	L
ICICI Bank	BUY	SO	L	Indian Overseas Bank	HOLD	SU	H
Infrastructure Development Finance Co Ltd	HOLD	SU	M	ING Vysya	BUY	SO	H
Karnataka Bank	BUY	SO	L	Kotak Mahindra Bank	BUY	SP	L
LIC Housing Finance	BUY	SO	M	Manappuram General Finance	BUY	SO	M
Oriental Bank Of Commerce	BUY	SO	H	Power Finance Corp	BUY	SP	L
Punjab National Bank	BUY	SO	L	Reliance Capital	HOLD	SP	M
Rural Electrification Corporation	BUY	SO	L	Shriram City Union Finance	BUY	SP	H
South Indian Bank	BUY	SO	H	State Bank of India	BUY	SP	L
Syndicate Bank	BUY	SP	H	Union Bank Of India	BUY	SO	L
Yes Bank	BUY	SO	M				

## ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

## RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

## RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

## SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss  
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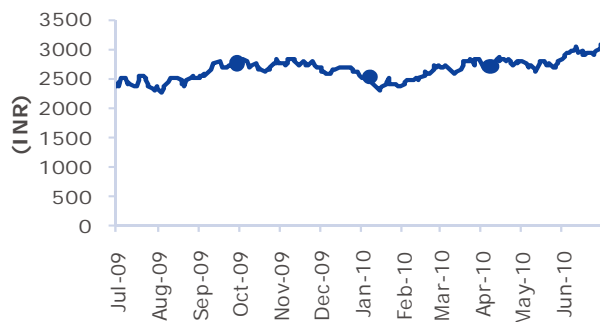


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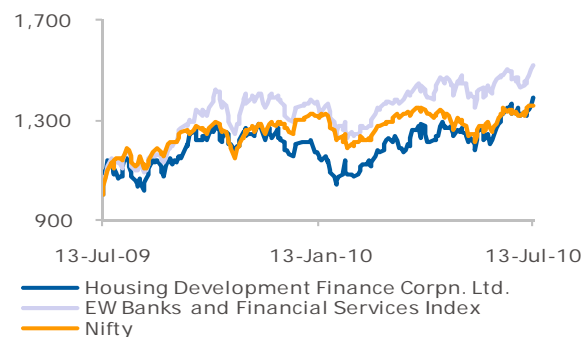
### Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services

Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC, HDFC Bank, ICICI Bank, Infrastructure Development Finance Co Ltd, Indian Overseas Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, Manappuram General Finance, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, State Bank of India, Shriram City Union Finance, South Indian Bank, Syndicate Bank, Union Bank Of India, ING Vysya, Yes Bank

HDFC



EW Indices



#### Distribution of Ratings / Market Cap

##### Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	109	52	12	177
* 4 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	108	54	15	

#### Recent Research

Date	Company	Title	Price (INR)	Recos
9-Jul-10	Banking	Liquidity blues = deposit rates set to move = Positive for margins; <i>Sector Update</i>		
30-Jun-10	United Bank of India	Moving in the right direction; <i>Visit Note</i>	81	Not Rated
29-Jun-10	Banking	Base rate set to roll; <i>Sector Update</i>		

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