

HDFC (Housing Development Finance Corporation)

Getting better all the time

- **4Q beat our estimates; we raise our price target:** Profit was 7% higher, mainly from better fee growth and a lower cost-to-income ratio. We raise our May08 price target is Rs1,824, which implies 9% upside from the current price. We retain our OW rating given firm business dynamics and defensive nature of the stock.
- **Positive business trends but lower fair multiple:** Higher market share, rock-steady margins, improving fees and better asset quality as competition slows down are positives. However, given the lower tax break under sec.36 (i)(viii), we are marginally lowering our normalized ROE by 84bp to 28.8% and the fair book multiple for the core business to 3.7x from 4x earlier.
- **Subs add 30% to sum of parts:** 56% of subs value from HDFC Bank, 31% from the life company, and 10% from the mutual fund. Stock catalysts are likely to be continued market share increases at the expense of competitors, as well as value unlocking in ICICI's insurance holding company.
- **Equity issue—not yet:** given relief on risk weights for home loans under Rs2MMMM; Also, likely to maintain stake in the bank at 20% even after assuming an equity issuance up to Rs2B this year.
- **Key risks:** Further rate hikes, property prices continuing to rise, and significantly worsening asset quality.

Reuters: HDFC.BO, Bloomberg: HDFC IN

Rs in millions, year-end March

	FY07	FY08E	FY09E	FY10E		GDR	NA	
Net profit	15,704	18,943	23,005	28,667	52-week range	Rs1825-962	Reuters NA	
Basic EPS (rep'd) (Rs)	62.1	74.9	90.9	113.3	Market cap	US\$10.2B	Bloomberg NA	
Basic EPS growth (%)	23.2	20.6	21.4	24.6	Shares outstanding	252.95MM shares	52-wk range NA	
P/E (basic) (x)	26.6	22.1	18.2	14.6	Free float	74%	Ratio NA	
BVPS (Rs)	219.4	264.7	323.9	402.6	Avg daily value	US\$24.4MM	Avg daily volume NA	
P/BV (x)	7.5	6.2	5.1	4.1	Avg daily volume	0.62MM shares	Current prem (%) NA	
ROE (%)	31.3	30.9	30.9	31.2	BSE Sensex	14,078	13-wk avg prem (%) NA	
Tier 1 ratio (%)	7.6	7.6	7.4	7.5	Exchange rate	Rs41.15/US\$1	52-wk avg prem (%) NA	
P/COPS (x)	26.0	21.1	16.6	13.2	Performance	1 mth	3 mths	12 mths
DPS (Rs)	22.0	26.2	28.2	30.6	Absolute (%)	16.6	-4.8	28.1
Dividend yield (%)	1.3	1.6	1.7	1.9	Relative (%)	9.8	-2.1	11.2

Source: Company, Bloomberg, JPMorgan estimates.

Overweight

Rs1,679.20

04 May 2007

Price Target: Rs1,842.00

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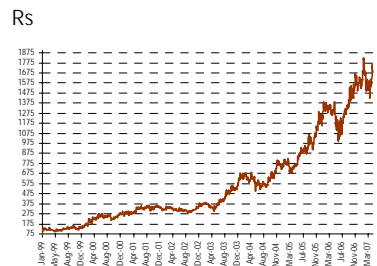
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Figure 1: HDFC- Price performance



Source: Bloomberg

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Getting better all the time

We were pleasantly surprised by HDFC's 27% disbursement growth in 4Q – no mean achievement in an environment in which interest rates and property prices are near recent peak levels. That, along with rock steady spreads, improving fee income trends, and better asset quality helped the 34% yoy growth in operating profits and 29% growth in net profits.

We are revising earnings up 6% for the current year given better prospects for property gains (represented under lease income) and reasonable prospects for further capital gains bookings from its significant equity portfolio (listed and unlisted).

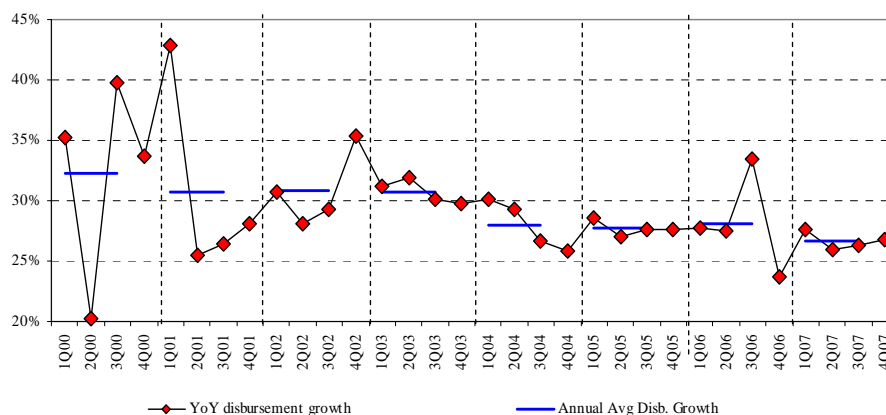
However, we are cutting our normalized ROE forecast by 84bp to 28.8% - still impressive - given halving of the 40% tax-free reserve in the recent Budget. Accordingly, our fair book multiple for HDFC's core business falls to 3.7x vs. 4x earlier. But higher contribution from its subsidiaries where we look for Rs530 per share adds up to a May08 target price of Rs1,824, representing a 9% upside, and prompting us to maintain our Overweight rating on the stock.

Stock catalysts include a) continued pace of new loan growth in the face of slowing competition, and b) any potential value unlocking in ICICI Bank's insurance holding company will likely benefit most Indian listed holding companies like HDFC.

Highlights of 4Q were:

1. Continued healthy disbursement growth trends

Figure 2: HDFC disbursement growth



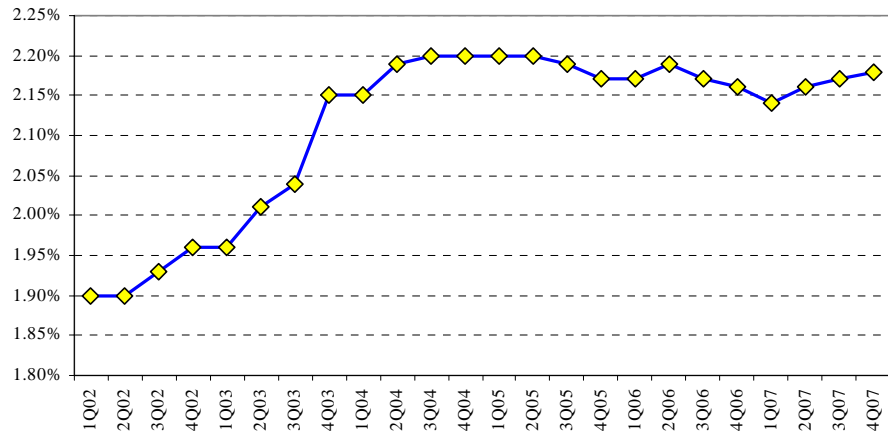
Source: Company data, JPMorgan

Floating rate loans continue to be at 85% of total loans, both incrementally and on a portfolio basis. Fixed rate loans have not really picked up despite a steep rise in interest rates.

In fact sanctions (i.e. new loan approvals) reflect a spike in 4Q to 36% reflecting the wide national presence and origination capability of HDFC.

2. Housing loan spreads firm at 2.18% as reported by the company.

Figure 3: HDFC: Quarterly margin trends



Source: JPMorgan estimates, Company data.

3. Fees showed a smart pickup to 0.31% of new approved loans vs. 0.16% in 3Q07.
4. Cost-to-income ratio further improved 188bp to 8.7% in 4Q07.
5. Operating profit growth of 34% after excluding income from leases which is typically in the nature of capital gains from property sales.
6. Continued healthy growth in equity gains up 29% yoy from its unlisted and listed equity portfolio.
7. Further improvement in asset quality with gross NPLs declining to 0.92% vs. 0.96% last year.
8. 29% growth in net profits.

Table 1: HDFC: 4Q07 results

Rs in millions, year-end March

	4Q07A	Y/Y	Q/Q
Income from Operations	15794	42%	16%
Total Interest Expenses	10042	48%	6%
Net Interest Income	5752	32%	39%
Fees	328	23%	162%
Total Operating Income	6080	32%	43%
Operating Expenses	526	8%	-20%
Operating Profit	5554	34%	54%
Capital Gains	1207	29%	63%
Others	0	NM	NM
Total Other Income	1207	20%	42%
Pre-tax Profit	6761	32%	52%
Tax	1261	44%	41%
Net Profit	5501	29%	55%
Int Exp/Int Income	64%		
Fees/Total Oper. Income	5%		
Cost Income Ratio	8.7%		
Balance Sheet			
Loans	565,124	25.6%	7.1%
Sanctions	106,660	35.8%	34.4%
Disbursements	87,130	26.8%	40.9%

Source: Company data, JPMorgan

Consequently, we are raising our earnings estimates by 6% for FY08 and introducing our FY09 and FY10 estimates.

Table 2: HDFC: Changes to earnings estimates

Year-end March

	FY08E
Net Interest Income	-4.3%
Fee Income	75.8%
Operating Cost	6.8%
Operating Profit	-4.0%
Other Income	191.4%
Provisions	64.7%
PBT	8.9%
Tax	20.4%
Net profit	6.2%
Loans	-9.0%
Earning Assets	-2.8%
Deposits	90.4%
Borrowings	-9.2%
Net Interest Margin	-0.05%
ROA	0.25%
ROE	1.38%
Tier 1 Ratio	-1.06%

Source: JPMorgan estimates

Table 3: HDFC: Earnings outlook

Year-end March

(% growth)	FY07A	FY08E	FY09E	FY10E
Profit & Loss				
Net Interest Income	21%	23%	26%	26%
Fee Income	2%	11%	13%	20%
Operating Expenses	10%	20%	18%	18%
Operating Profit	22%	23%	27%	26%
Pre-tax Profit	26%	22%	25%	25%
Profit after Tax	25%	21%	21%	25%
EPS	23%	21%	21%	25%
Balance Sheet				
Loans	26%	26%	25%	25%
Assets	23%	25%	24%	23%
Book Value per share	23%	21%	22%	24%
Tier 1 Ratio (%)	7.6%	7.6%	7.4%	7.5%
Ratios (%)				
ROE	31.3%	30.9%	30.9%	31.2%
ROA	2.76%	2.68%	2.61%	2.63%
Net Interest Margin	3.05%	3.04%	3.06%	3.11%
Cost/Income Ratio	12.8%	12.5%	11.8%	11.1%

Source: Company data, JPMorgan estimates

We value HDFC's stock on a sum-of-the-parts basis valuing the parent on a 3.7x book multiple based on a 28.8% normalized ROE and long-term growth of approx. 9% arriving at a 12-month forward parent value of Rs1,294. In addition, we value its subsidiaries/associate company holdings at Rs530 as outlined below.

Table 4: HDFC: Sum-of-the-parts valuation

Rs	12 month forward	Methodology	Contribution to subsidiary total
HDFC Parent (a)	1294	Gordon Growth Model - 3.7 x book	
Subsidiaries/Associates			
Listed Subsidiaries	307	Market Value of HDFC Bank's share	56%
Asset Management	57	7% of AUM	10%
Call Center	16	1.5x forward revenues	3%
Life Assurance	149	Appraisal Value	31%
Total Subsidiaries	530	Total	100%
Fair Value	1824		

Source: JPMorgan estimates

This leads to our 12-month forward target price of Rs1,824, which implies 9% upside from the current level. We view this as adequate to merit an Overweight rating on the stock.

Normalised ROE and fair multiple

Table 5: HDFC: Normalised ROE

HDFC	NORMALISED	FY07	FY08E	FY09E	FY10E
Net Margin (as % of avg. IEA)	3.21%	3.14%	3.13%	3.17%	3.23%
Non-IR/Asset	0.12%	0.16%	0.14%	0.13%	0.12%
Non-IR/Revenues	3.7%	4.8%	4.3%	3.9%	3.7%
Fees/Revenues	3.7%	4.8%	4.3%	3.9%	3.7%
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	3.30%	3.27%	3.24%	3.26%	3.30%
Cost/Income	10.9%	12.7%	12.4%	11.7%	11.0%
Cost/Assets	0.36%	0.42%	0.40%	0.38%	0.36%
Pre-Provision Profits	2.94%	2.86%	2.84%	2.88%	2.94%
LLP/Loans	-0.04%	-0.05%	-0.04%	-0.04%	-0.04%
Prov/Writebacks on Sec.	0.50%	0.64%	0.60%	0.55%	0.51%
Pre-Tax	3.40%	3.45%	3.40%	3.40%	3.42%
Effective Tax Rate	23.00%	20.2%	21.0%	23.0%	23.0%
ROAA	2.62%	2.76%	2.68%	2.61%	2.63%
Equity / Assets	9.10%	8.8%	8.7%	8.5%	8.4%
RoE	28.79%	31.3%	30.9%	30.9%	31.2%
Adjusted NAV	421.4				
PV of Adj NAV	285.6				
COE	14.30%				
RFR	8.00%				
Equity Prem	6.00%				
Beta	1.05				
Growth	9.0%				
CURRENT PRICE	1679.20				
Fair P/BV	3.73x				
Terminal Value	1066.6				
Sum of PV of Dividends	65.78				
Current Fair Value	1614.5	12 Month (May 2008)	Fair value = Rs 1824		

Source: JPMorgan estimates

Risks to our rating and price target

Key risks to our rating and price target include a substantial rise in interest rates and property prices impacting mortgage demand adversely or significantly worsening asset quality.

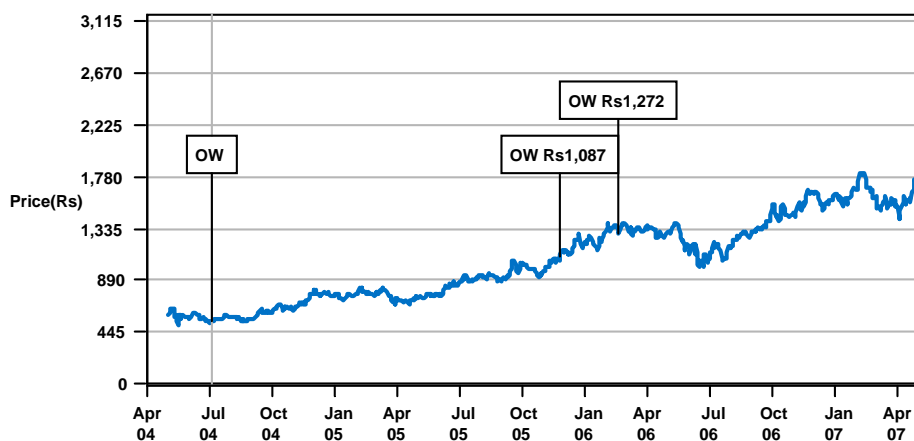
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HDFC (Housing Development Finance Corporation) (HDFC.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
03-Jul-04	OW	532.45	--
25-Nov-05	OW	1086.05	1087.00
18-Feb-06	OW	1300.05	1272.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
 Break in coverage Feb 27, 2004 - Jul 03, 2004. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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Revised March 30, 2007.

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HDFC: Summary of financials

Rs in millions, year-end March

Income statement – Rs mn	FY07	FY08E	FY09E	FY10E	Balance Sheet Gearing	FY07	FY08E	FY09E	FY10E
Margins (% of Earning Assets)	3.14%	3.13%	3.17%	3.23%	Loan/Deposit	552%	523%	474%	462%
Earning Assets/Assets	99%	99%	99%	99%	Investment/Assets	6%	6%	5%	4%
NIM (as % of avg. Assets)	3.12%	3.10%	3.14%	3.18%	Loan/Assets	91%	92%	92%	94%
Net Interest Income	17,760	21,906	27,588	34,656	Customer deposits/Liab.	18%	19%	21%	22%
					LT Debt/Liabilities	0%	0%	0%	0%
Total Non-Interest Revenues	893	991	1,124	1,325					
Fee income	893	991	1,124	1,325	Asset Quality/Capital	FY07	FY08E	FY09E	FY10E
FX/Trading gains	0	0	0	0	Loan loss reserves/Loans	0.7%	0.8%	0.6%	0.5%
Other operating income	0	0	0	0	NPLs/loans	0.9%	0.9%	0.9%	0.9%
Total operating revenues	18,654	22,898	28,712	35,980	Loan loss reserves/NPLs	76.7%	86.0%	68.6%	54.8%
Operating costs	(2,366)	(2,840)	(3,356)	(3,946)	Growth in NPLs	19.6%	19.8%	0.0%	0.0%
Operating profit	16,287	20,058	25,356	32,035	Tier 1 Ratio	7.6%	7.6%	7.4%	7.5%
Loan Loss Provisions	(250)	(280)	(310)	(360)	Total CAR	12.9%	13.0%	12.4%	12.2%
Other provisions	3,641	4,200	4,830	5,555					
Exceptionals	0	0	0	0	Per Share Data	FY07	FY08E	FY09E	FY10E
Disposals/ Other income	0	0	0	0	EPS (Rs)	62.07	74.87	90.92	113.30
Pre-tax profit	19,678	23,978	29,876	37,229	Dividend (Rs)	22.00	26.20	28.19	30.59
Tax [rate]	(3,974)	(5,035)	(6,872)	(8,563)	Payout ratio	35%	35%	31%	27%
Minorities/preference dividends	0	0	0	0	NAV	219.41	264.72	323.85	402.64
Attributable net income	15,704	18,943	23,004	28,666	Avg. Shares issued (mn)	253.01	253.01	253.01	253.01
Key balance sheet – Rs mn	FY07	FY08E	FY09E	FY10E	Du-Pont Analysis	FY07	FY08E	FY09E	FY10E
Net Customer Loans	573,317	721,615	902,090	1,126,753	NIR/Avg. Assets	3.12%	3.10%	3.14%	3.18%
Gross Loans	569,220	716,115	896,590	1,121,253	Non IR/Total Rev	4.8%	4.3%	3.9%	3.7%
Investments	37,893	44,904	51,293	48,820	Total Rev/Avg. Assets	3.27%	3.24%	3.26%	3.30%
Other Earning Assets	15,300	15,300	15,300	15,300	Cost/Income	12.69%	12.40%	11.69%	10.97%
Average Earning Assets = (A)	565,478	699,366	869,751	1,074,278	Cost/Assets	0.42%	0.40%	0.38%	0.36%
Total assets	627,444	784,114	975,730	1,201,924	Operating ROAA	2.86%	2.84%	2.88%	2.94%
					LLP/Loans	-0.05%	-0.04%	-0.04%	-0.04%
Interbank funding	0	0	0	0	Loan/Assets	89.78%	91.06%	91.64%	92.66%
Customer deposits	103,844	138,108	190,373	244,013	Other inc:provs	0.64%	0.60%	0.55%	0.51%
Other Interest Bearing Liabilities	468,086	579,029	703,419	856,038	Tax	20.20%	21.00%	23.00%	23.00%
Average Interest Bearing Liab. = (B)	519,572	644,534	805,465	996,922	MI	0.00%	0.00%	0.00%	0.00%
Average Assets	569,671	705,779	879,922	1,088,827	ROAA	2.76%	2.68%	2.61%	2.63%
Shareholders' equity	55,514	66,978	81,937	101,873	RoRWA	2.60%	2.35%	2.32%	2.33%
Risk Weighted Assets	730,447	883,952	1,102,508	1,363,243	Equity/Assets	8.79%	8.68%	8.46%	8.44%
Average Risk Weighted Assets	604,168	807,200	993,230	1,232,875	ROE	31.35%	30.93%	30.90%	31.19%

Source: JPMorgan estimates, Company data.

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04 May 2007

