Daiwa Capital Markets

Sector

Diversified financials / India
2 August 2011

The 10-second briefing

Bulk of pain may already be over

- We believe that the bulk of the interest-rate hikes are already over, and interest rates should peak in the next 2-3 months
- Spread between loan and deposit growth has narrowed to 1.5% from 6-8% for FY11, reflecting improvement in structural liquidity
- High interest rates leading to depressed valuations, but medium-to-long-term upside potential in stocks substantial, in our opinion

NBFC Sector

- **Positive** (unchanged)
- Neutral
- Negative

How do we justify our view?

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What's new

While the interest-rate cycle may take some more time to turn, we believe that the bulk of the rate hikes have already occurred and the spread between loan and deposit growth is narrowing, which we see as positive for the non-banking financial companies (NBFCs).

What's the impact

We believe the NBFC Sector is facing multiple headwinds. Apart from concerns in the market related to high interest rates, Power-Sector-related woes have further depressed the valuations of Infrastructure Development Finance (IDFC), Power Finance Corp (PFC) and Rural Electrification (REC). Similarly, increased regulatory risk and fears about a possible slowdown in sales of commercial vehicles have affected the valuations of Shriram Transport Finance (Shriram). Mortgage-related risks, however, are low at present, in our opinion, as housing-finance companies (HFCs) have not seen any significant slowdown in loan growth so far, and have also been able to pass on the rate hikes to existing customers, thereby helping to protect lenders' interest spreads. Hence, we see Housing Development Finance (HDFC) and Dewan Housing Finance (Dewan) as attractive plays, even in the current interest-rate scenario.

What we recommend

We believe the derating of NBFC stocks can be attributed mainly to the sharp rise in interest rates. We also believe that interest rates should peak in another 2-3 months, which would help these NBFCs to outperform the market significantly over the next 6-12 months or so. We recommend buying PFC, REC, IDFC and Shriram at current levels, and HDFC on any share-price weakness. While we have downgraded our rating on HDFC to Outperform (2), as it now offers less upside potential after having outperformed other financial stocks we cover, it remains our most defensive pick in the sector.

We have also lowered our six-month target price for PFC, as we believe a substantial rerating is unlikely over the next six months given the current sentiment toward the Power Sector.

How we differ

In contrast to the market, we do not expect the NBFCs' NIMs or interest spreads to face any significant pressure from here. We also believe that fears regarding large-scale defaults or the restructuring of loans to the Power Sector offer an opportunity to buy PFC and REC, as the government has already started taking some commendable steps, which may take time but give us comfort that it has already started moving in the right direction. A slowdown in loan growth is one of the key risks, but we believe this is factored largely into valuations currently, and that the downside potential from this is limited for most NBFC stocks. The market also appears too concerned about the financing prospects of the Power Sector, which is facing various challenges. We, however, believe the government will be forced to take some unpopular and drastic steps in the Power Sector, which may lead to an improvement in sentiment toward stocks like PFC, REC and IDFC over the next 6-12 months.

Key stock calls

	New	Prev.
Housing Development Finance (HDFC IN)		
Rating	Outperform	Buy
Target price	Rs754.00	Rs754.00
Up/downside	▲ 10.1%	
Power Finance Corp (POWF IN)		
Rating	Buy	Buy
Target price	Rs280.00	Rs391.00
Up/downside	▲ 56.0%	
Rural Electrification (RECL IN)		
Rating	Buy	Buy
Target price	Rs265.00	Rs265.00
Up/downside	▲ 27.6%	
Infrastructure Development Finance (IDFC IN)		
Rating	Buy	Buy
Target price	Rs158.00	Rs190.00
Up/downside	▲ 25.8%	
Shriram Transport Finance (SHTF IN)		
Rating	Buy	Buy
Target price	Rs898.00	Rs898.00
Up/downside	▲ 45.0%	

Source: Daiwa forecasts
Note: Please refer to page 3 for details.

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

- **Positive** (unchanged)
- Neutral
- Negative

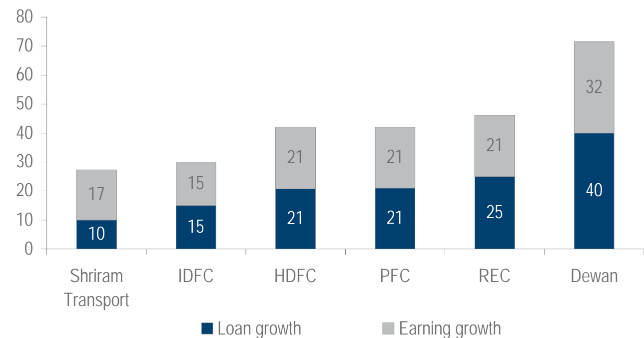
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We see the loan-growth outlook for most NBFCs as strong. While we forecast Shriram to record the lowest loan growth among its NBFC peers of 10% YoY for FY12, including securitisation, we expect its assets under management (AUM) to expand by around 15% YoY. We expect NBFCs such as HDFC, PFC, REC and Dewan to record very strong loan growth, and most of them to record around 18-20% YoY EPS growth for FY12.

NBFC Sector: FY12E loan and earnings growth (YoY %)

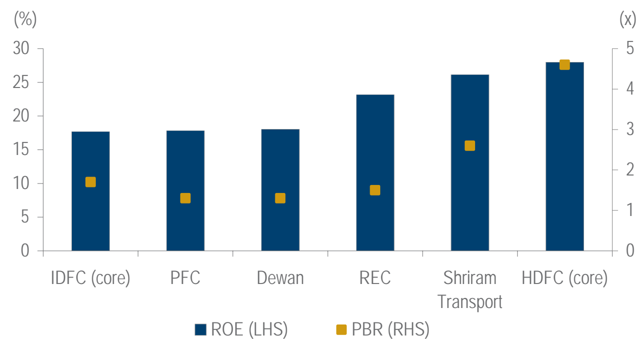


Source: Daiwa forecasts

Valuation ✔✔✔✔✔

We see the valuations of NBFCs like IDFC, PFC, REC and Dewan as attractive. Also, considering Shriram's high FY12-13E ROE, its valuations are not very demanding, in our opinion. In the case of IDFC, although its consolidated FY12E ROE is quite low, at 13%, its lending ROE is 17.3%. As we believe that the bulk of the interest-rate hikes is already behind us, the valuations of most of the NBFCs we cover are attractive, and that they have the potential to trade at one-year-forward PBRs of more than 2x once interest rates start to fall.

NBFC Sector: FY12E ROEs (%) versus PBRs (x)



Source: Daiwa forecasts

Earnings revisions ✔✔✔✔✔

We have made only slight revisions to our earnings forecasts for the NBFCs we cover, and believe that many of those for FY12 could be exceeded, especially in the case of Shriram, whose earnings forecasts we expect to be revised up by the market over the next few quarters.

NBFC Sector: Daiwa versus Bloomberg-consensus forecasts (FY12E)

Rs m	Daiwa earnings forecast	Consensus earnings forecast	Difference (%)
HDFC	42,881	41,381	4
PFC	31,589	31,840	(1)
REC	31,047	29,731	4
IDFC	14,739	15,705	(6)
Shriram Transport	14,427	14,938	(3)
Dewan	3,020	2,876	5

Source: Bloomberg, Daiwa forecasts

Executive summary

Bulk of pain may already be over

An improvement in liquidity in the banking system could stop banks from raising deposit rates aggressively. Around US$300bn worth of projects are already at various stages of implementation, which will limit the downside risk of a slowdown in loan

■ Investment thesis

Structural liquidity in the banking system is improving; ongoing projects supporting loan demand

Against a backdrop of multiple concerns in the market, such as a possible large-scale default or restructuring of loans to the Power Sector, a slowdown in commercial-vehicle sales growth and continued interest-rate hikes by the Reserve Bank of India (RBI), we believe the market is ignoring the improvement in structural liquidity in the banking system.

While there has been a slowdown in the number of projects announced, there are already around US$300bn worth of projects at various stages of implementation, which we believe should keep demand for loans high.

■ Valuation

Risk-reward profiles for most NBFCs favourable; trading currently at lower ends of past-two-year valuation ranges

Most NBFCs are trading currently at the lower ends of their past-two-year valuation ranges, due to high interest rates and concerns in the market about a slowdown in loan growth. Infrastructure-financing NBFCs, such as IDFC, PFC and REC, are trading currently at an average PBR of 1.3x on our FY12 BVPS forecasts, compared with last year's peak level of around a 2.5x one-year-forward PBR.

■ Profit outlook

We forecast decent net-profit growth of 18-20% YoY for FY12 for most of the NBFCs we cover

We forecast net-profit increases for most of the medium-to-large-sized NBFCs we cover of 18-20% YoY for FY12 and similar ROE growth. We believe our FY12 earnings-growth forecast of around 17% YoY for Shriram, due to some uncertainty about the regulatory environment and our concerns about a slowdown in its loan disbursements, may prove conservative. Also, the market is factoring in flat loan-disbursement growth for FY12, in line with the company's guidance, but we believe it could surprise on the upside.

Key stock calls

		Rating		Target price (local curr.)			EPS (local curr.)					
							FY1			FY2		
Company Name	Stock code	New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
Housing Development Finance Corp	HDFC IN	Outperform	Buy	754.00	754.00	0.0	29.23	29.23	0.0	34.35	34.35	0.0
Power Finance Corp	POWF IN	Buy	Buy	280.00	391.00	(28.4)	23.13	23.45	(1.4)	25.60	26.69	(4.1)
Rural Electrification Corp Ltd	RECL IN	Buy	Buy	265.00	265.00	0.0	31.44	31.48	(0.2)	38.19	38.29	(0.3)
Infrastructure Development Finance	IDFC IN	Buy	Buy	158.00	190.00	(16.8)	9.926	10.79	(8)	11.54	13.47	(14.4)
Shriram Transport Finance	SHTF IN	Buy	Buy	898.00	898.00	0.0	63.78	65.17	(2.1)	76.94	77.24	(0.4)
Reliance Capital Ltd	RCAPT IN	Outperform	Outperform	599.00	944.00	(36.5)	9.284	15.63	(40.6)	27.94	18.05	54.8
Dewan Housing Finance Corp Ltd	DEWH IN	Buy	Buy	339.00	339.00	0.0	28.92	28.92	0.0	38.42	38.42	0.0

Source: Daiwa forecasts Note: figures for POWF IN and RCAPT IN are for FY1 and FY2, respectively; FY1 = FY11, FY2 = FY12 and FY3 = FY13

Table of contents

Both lending and deposit rates appear close to peaking 5
We believe most of the interest-rate hikes have occurred 5
Structural liquidity is improving 5
Leverage of many NBFCs at past-five-year lows; likely to improve 6
Power Sector: the biggest challenge, as well as the biggest opportunity 8
Power Sector: government's push for reforms – a step in the right direction for PFC, REC & IDFC 8
State power ministers in unanimous agreement over reforms 8
Restructuring loans may not be the solution, in our view, as it sets a wrong example for others 9
While the financial condition of the SEBs is serious, states' fiscal-deficit conditions have improved 9
Shunglu Committee's recommendations could lead to more serious and positive action by the government 9
Recent cabinet reshuffle may address coal-shortage problems over the medium term 10
Power demand-supply gap may be here to stay 10
Infrastructure-financing stocks: more of a rerating story 11
Home-loan financing remains a safe option 12
Less competition from banks after discontinuation of teaser-rate loans 12
HFCs appear better placed than other NBFCs in a high-interest-rate environment 12
Low operating costs likely to keep HFCs' return ratios high 12
Strong demand drivers in place for robust disbursement growth 13
Tax benefits keep effective rates low in a high-interest-rate environment for home loans 13
HFC stocks: strong earnings-growth visibility for HDFC and rerating potential for Dewan 14

Company Section
Housing Development Finance 16
Power Finance Corp 24
Rural Electrification 33
Infrastructure Development Finance 41
Shriram Transport Finance 48
Reliance Capital 58
Dewan Housing Finance 65

Both lending and deposit rates appear close to peaking

We believe most of the interest-rate hikes have occurred, structural liquidity is improving, and deposit rates may have already peaked. The leverage of most NBFCs is at past-five-year lows, and appears likely to improve.

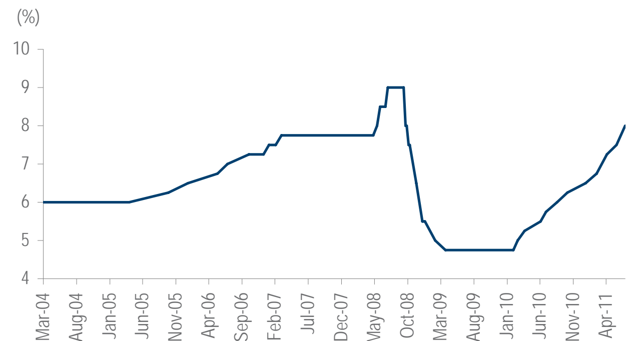
We believe most of the interest-rate hikes have occurred

We believe that most of the interest-rate hikes have already happened, and that interest rates may only rise by a further 0.25-0.5% over next to 2-3 months in a worst-case scenario. The RBI has hiked interest rates aggressively (11 times since March 2010). The Repo rate has been raised by 3.25% and stood at 8% in July 2011, up from the low of 4.75% in February 2010. Against this backdrop, deposit rates have already risen by around 3.5%, and lending rates are up by around 2.75-3%.

In the latter part of this cycle (ie, from May 2011 onwards), banks have been raising only lending rates and have left peak deposit rates untouched. We believe that given the improvement in deposit growth, the banks may refrain from raising deposit rates despite the RBI raising interest rates. Also, further hikes in lending rates could lead to a slowdown in loan growth, and hence the banks may also avoid raising lending rates as well. However, in order to protect their NIMs, the banks may be more inclined to raise their lending rates than deposit rates in the future.

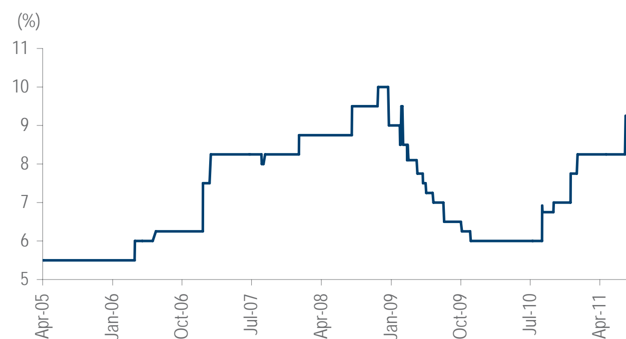
During the previous rate-hike cycle (2006-08), the one-year deposit rate for State Bank of India (SBI) (SBIN IN, Rs2,440, Hold [3]) peaked at around 10%. During the current interest-rate cycle, the bank has hiked interest rates aggressively, by 3.25pp, from a low of 6% in November 2009 to 9.25% currently. However, during the previous cycle, much of the tightening was due to the RBI hiking the cash reserve ratio (CRR), which has not been the case this time. Hence, we believe that deposit rates may be very close to peaking now.

■ RBI Repo rate



Source: RBI

■ SBI: one-year deposit rate



Source: Bloomberg

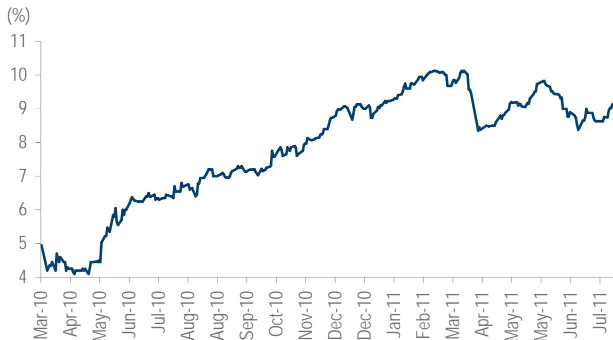
Structural liquidity is improving

Short-term lending rates have fallen by almost 40bps since April 2011, which we believe indicates that the liquidity situation has improved slightly. Certificate-of-deposit rates had increased by 4.5pp, from 5% in April 2010 to 9.5% in April 2011. The three-month certificate-of-deposit rate stands currently at around 9.1%, compared with about 9.5% in April 2011.

More importantly, the difference between loan growth and deposit growth for the banking system so far this fiscal year is only around 1.5%, compared with about 6-8% in FY11. This may lead to banks not resorting to deposit-rate hikes should the RBI hike the Repo rate.

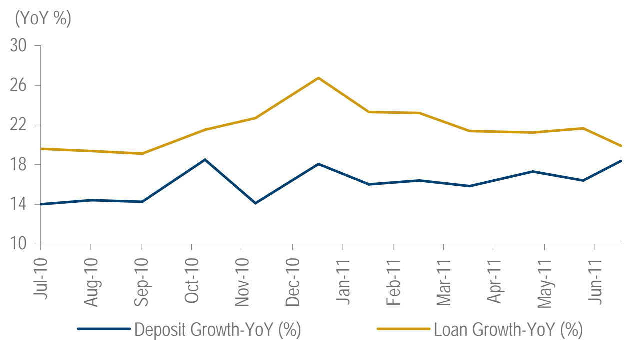
The rate of increase in credit advanced by the banking system moderated to 19.3% YoY because of the relatively low demand for funds, whereas the high deposit rates resulted in deposit growth improving to 17.9% YoY as at 15 July 2011.

■ Three-month CD rate



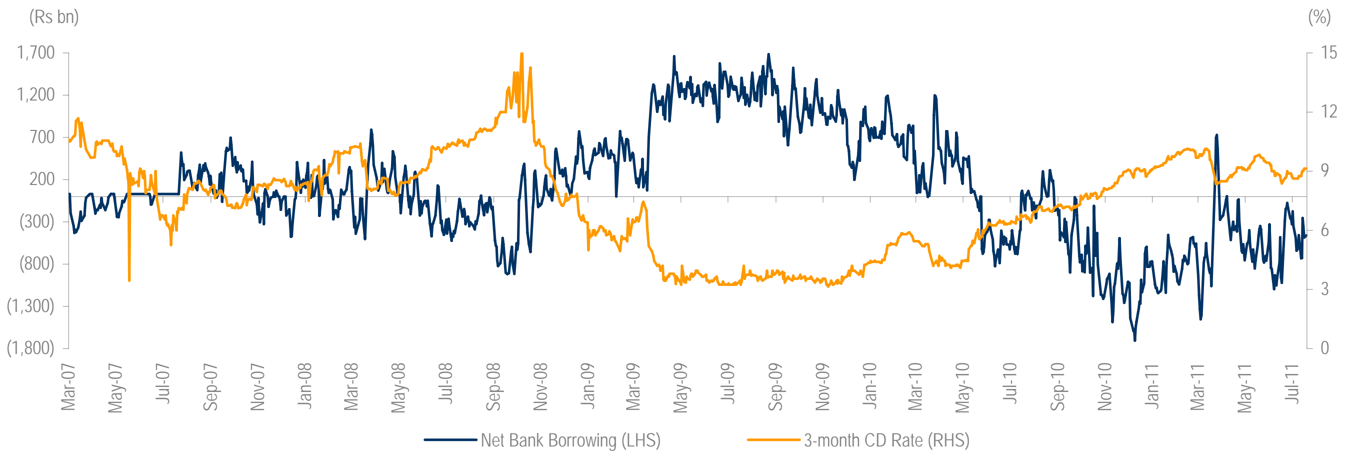
Source: Bloomberg

■ Loan and deposit growth



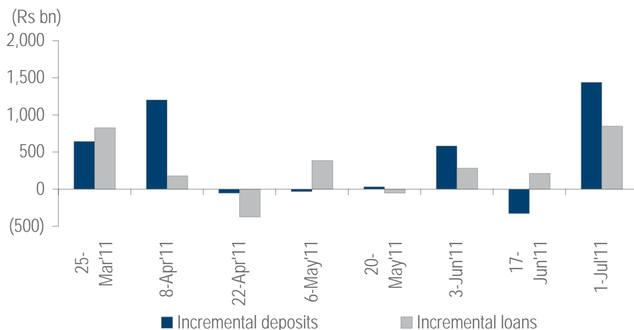
Source: RBI

■ Net bank borrowing versus certificate-of-deposit rate



Source: Bloomberg

■ Fortnightly incremental loans and deposits (Rs bn)



Source: RBI

Leverage of many NBFCs at past-five-year lows; likely to improve

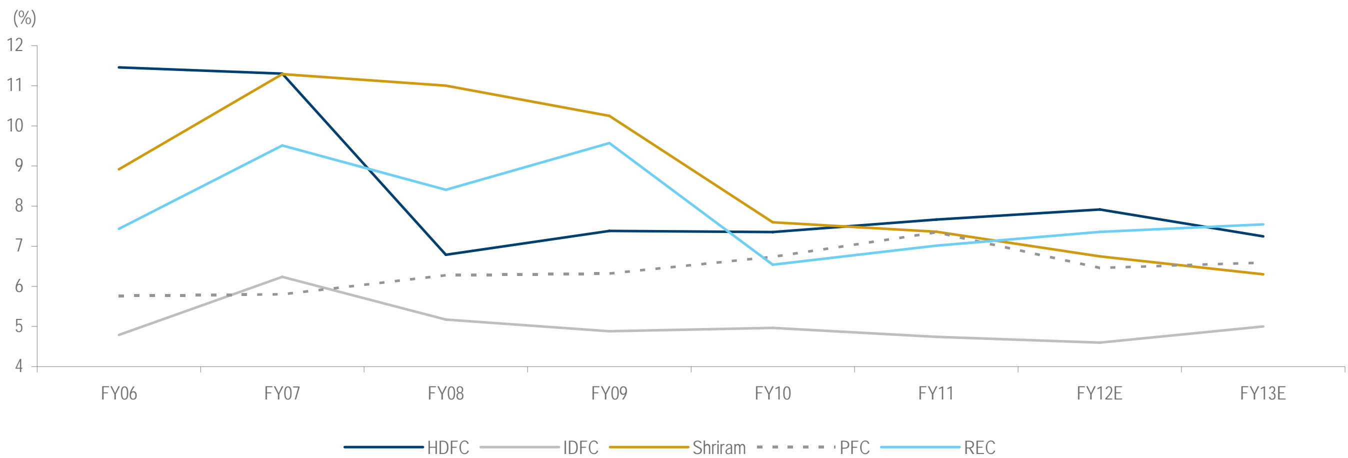
The leverage of most infrastructure-financing NBFCs declined in FY11, due largely to equity dilution, which we believe is positive in a high interest-rate scenario. Low leverage means that a higher proportion of the financing of loans happened through owned funds, rather than borrowed funds, which helps support NBFCs' NIMs at a time when the interest spread (the difference between loan yields and borrowing costs) typically comes under pressure.

We expect the leverage of most of the NBFCs we cover to increase over the next two years, which we again see as a positive, as interest rates now appear to us to be close to peaking and likely to fall in the future.

, we see Shriram as an exception to the trend of increasing leverage, as we believe its leverage may remain flat or decline, given that we forecast its AUM growth to lag its ROE growth significantly over the FY12-13 period.

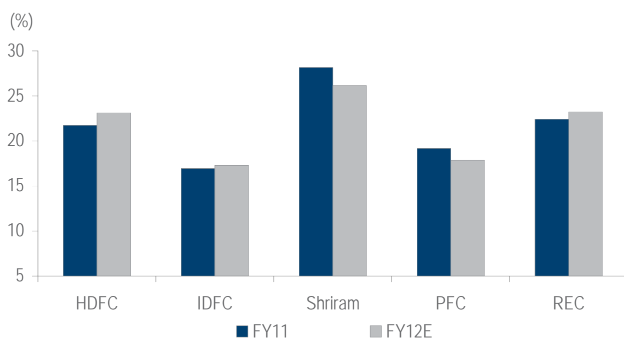
HDFC is another company that we believe should see its ROE improve slightly in FY12. However, the conversion of warrants in FY13 may again lead to a slight drop in its leverage. However, as we forecast Shriram and HDFC to record high ROEs of 26% and 23%, respectively, for FY12, any improvement in their leverage may be less significance to them. Also, despite improvements in their leverage and higher costs of funds, we don't expect any of the NBFCs we cover to record any material NIM compression in FY12.

■ NBFC Sector: leverage



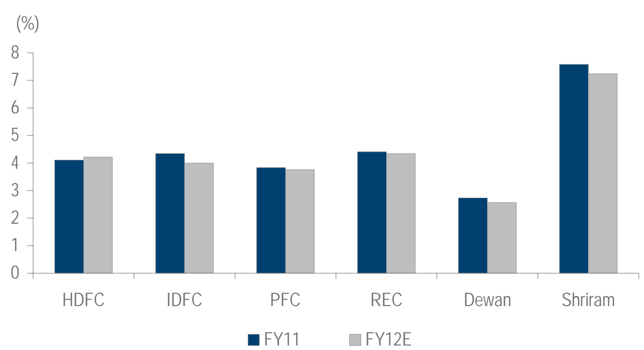
Source: Companies, Daiwa forecasts

■ NBFC Sector: ROEs



Source: Companies, Daiwa forecasts

■ NBFC Sector: NIMs



Source: Companies, Daiwa forecasts

Power Sector: the biggest challenge, as well as the biggest opportunity

The Power Sector – one of the major drivers of GDP growth over the past 4-5 years

Power Sector: government's push for reforms – a step in the right direction for PFC, REC & IDFC

Over the past several months, the Power Sector in India has been facing many issues, with losses for power-distribution companies and problems relating to coal shortages being the main ones. When the cost of purchasing power was rising, many state utilities did not increase their power tariffs, which led to burgeoning losses for the state distribution companies (DISCOMs). The power-transmission and distribution losses only added fuel to the fire. The government has taken to forcing some state regulators to hike tariff rates. Over the past 12 months, 8-9 state-owned power-distribution companies have raised tariff rates. However, such rate hikes have still been insufficient to reduce the DISCOMs' losses materially.

State power ministers in unanimous agreement over reforms

Recently, the power ministers of all states met with the Union power minister, and agreed unanimously on some of the key initiatives to be implemented by the states, with the main ones being:

- The state governments would consider **converting loans due from the state governments to the distribution utilities as state government equity** to ensure capital infusions and improvements in the net worth of utilities.
- The state governments would **ensure the payment of all outstanding dues** from various departments of state governments and institutions to the distribution utilities, or release payments from state budgets directly.
- The state governments would not only **clear all the outstanding subsidies to the utilities, but ensure advance payment of subsidies**.
- The states would ensure that the **distribution utilities file their Annual Tariff Revision Petitions every year**.
- The Annual Tariff Revision Petitions would be filed before the Central Electricity Regulatory Commission (CERC), keeping in mind the increase in the power-purchase cost (which accounts for nearly 70-80% of the cost of supply) and **states will ensure that the difference between the average revenue realised (ARR) and the average cost of supply (ACS) is not only bridged, but is positive to generate internal surpluses** that can be used for network expansion and maintenance.
- The state governments would **ensure the automatic pass-through of tariffs following increases in fuel costs** by incorporating the same into the regulations.
- The state governments would ensure that the **accounts of the utilities are audited up to 2009-10**, and also ensure that the accounts for each financial year are audited by September of the following financial year.
- The state governments would take effective steps to **reduce aggregate technical and commercial losses (AT&C) losses to less than 15%** by administrative measures, curbing the pilferage of electricity and by setting up special police stations and special courts to deal exclusively with cases of power-related thefts.

While the implementation of these steps, in our opinion, would take time and involves ironing out some technicalities, we still see this as a significant development. In the past, there have been many meetings involving state chief ministers and bureaucrats to chart out a plan to resolve the problems being faced by the Power Sector. **However, this is the first time that all states have agreed unanimously to implement the steps enumerated above, which we believe is a positive step.**

Some states, such as Madhya Pradesh, have already started implementing aggressive policy reforms. Feedback from members of the CERC suggests that Madhya Pradesh increased the power tariff recently by 10%, which would help bring down the cumulative

losses for the state's utilities from Rs54bn to Rs34bn. The state government has also allowed power-distribution companies to convert fixed-rate term loans to low-cost perpetual loans, thus lowering their interest-cost burden. In our opinion, other states can be expected to implement similar state-electricity-board (SEB)-friendly measures in a gradual manner.

Restructuring loans may not be the solution, in our view, as it sets a wrong example for others

While the market appears concerned about the possible large-scale restructuring of some states' DISCOM loans in order to avoid defaults, **we believe that the formation of regulatory assets and converting the cumulative losses into regulatory assets and then recovering them through small tariff hikes may be the only long-term solutions for state power-distribution companies to lower their losses.** This would also help the DISCOMs to avoid imposing any tariff-rate hike shocks on end consumers. In our view, the recent meeting of the state power ministers achieved a good breakthrough, as all the state ministers agreed unanimously to act on a set of measures to reduce the distribution losses.

While the financial condition of the SEBs is serious, states' fiscal-deficit conditions have improved

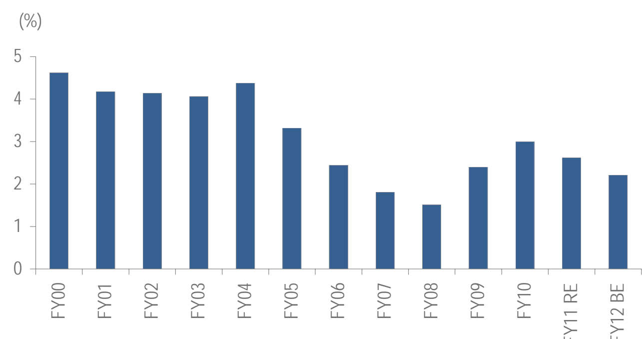
While there have been concerns in the market about the financial health of the SEBs and its impact on the asset quality of the power financers, we believe the recent correction in the share prices of power-finance companies is due mainly to the tight monetary policy followed by the RBI. Issues relating to the poor health of the state-owned distribution companies and scarcity of coal for power-generation projects have added fuel to the fire, in our opinion.

While none of the states have defaulted on their loan repayments, REC's management has indicated that certain north-eastern states have faced temporary cash-flow problems. SEBs in the states of Tamil Nadu, Uttar Pradesh, Madhya Pradesh, Punjab and Rajasthan are facing financial problems. There are, however, no signs of a possible default on interest payments by these states.

Also, as a measure to strengthen the credit worthiness of these SEBs, loans granted to them by PFC and REC and other financial institutions are either guaranteed by the respective state governments or have an escrow mechanism that is backed by a first charge on the revenue of these SEBs. As it is very difficult to check the credit-worthiness of such state distribution companies, most financial institutions rely on the escrow mechanism, which assures them that the borrower has sufficient cash flow to pay the lender, even if it is making operating or cash losses.

The combined losses of the SEBs in FY11 were estimated at 1% of GDP (source: Economic Survey FY11). However, the combined fiscal deficit of all state governments is estimated to have come down to 2.6% in FY11, from around 3% in FY10. Hence, if we look at the performances of the SEBs on the back of the fiscal performances of the state governments, the situation does not look so grim.

■ Fiscal deficits of all states (%)



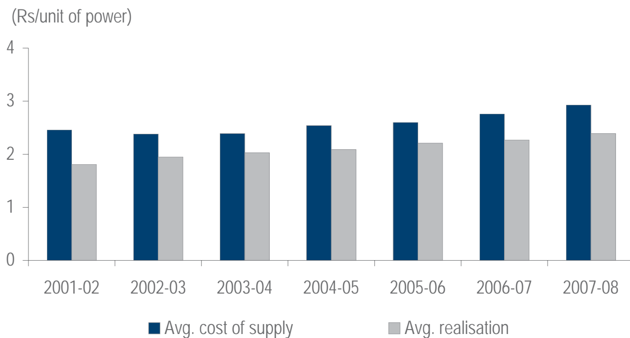
Source: Planning Commission Note: RE = revised estimates; BE = budget estimates

Shunglu Committee's recommendations could lead to more serious and positive action by the government

The Shunglu Committee, which was appointed by the Government of India to suggest ways of improving the financial conditions of the SEBs, is widely expected to come out with its report in a month or two, and media reports suggest that the committee is of the view that the state power regulators that have not performed should be removed. As power is the responsibility of individual states in India, policies are set by the respective state governments, and each state appoints its own power regulator.

Some state utilities have not only failed to hike tariffs over the past few years, but have also failed to audit their financial accounts. To meet the widening gap between power revenue and the cost of supplying power, we believe the states will have to raise power tariffs.

■ Average tariff rate vs. cost of power purchases in India



Source: Central Electricity Authority

Some states, like Uttar Pradesh and Rajasthan, which have also not increased their power tariffs for a long time, have started to raise them recently. We believe other states could follow suit, although the quantum of the tariff hikes could be small. Implementing the suggestions made by the committee could take time and political will. In our opinion, while the reduction of transmission and distribution (T&D) losses could provide some relief for the SEBs, the long-term solution lies in raising tariff rates in line with the rise in cost of power purchased by the distribution companies.

Recent cabinet reshuffle may address coal-shortage problems over the medium term

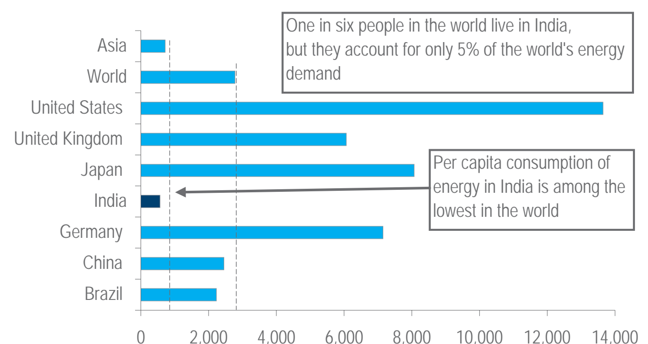
The Government of India announced a reshuffling of cabinet ministers recently. We expect the change of minister for the environment to speed up the approval process for mining. This should benefit the power generators (especially private companies) that are facing coal shortages, and alleviate some of the concerns in the market about the availability of coal, in our view.

While the supply of coal is dominated by government-owned Coal India Ltd, we believe that in the event of the power sector facing severe coal shortages, the government could intervene. Currently, power tariffs are not being raised by the state utilities, and hence they cannot afford to buy fuel at higher prices. However, once the utilities are able to raise tariffs, the power generators may feel more comfortable about buying fuel at slightly higher prices – if the fuel supply is ensured. The tariff hikes depend a lot on the political landscape, but the recent unanimous agreement of the states shows that the conditions are slowly but surely changing.

Power demand-supply gap may be here to stay

Demand for power and power funding seems strong. India's energy consumption is among the lowest in the world, and demand for power in the country can only rise, in our opinion. However, in India, the problem stems from AT&C losses, which are among the highest in the world (about 28% over each of the past couple of years). These transmission and distribution losses have been a considerable drain on the SEBs, and have contributed to the losses arising from low tariff rates for end consumers. The concerns about the financial health of the SEBs have led to concerns about the viability of loans made by the power-financing companies to the SEBs. The government has formulated policies, like the Restructured Accelerated Power Development and Reform Programme (R-APDRP), to provide assistance to states undertaking distribution reforms in an effort to cut AT&C losses.

■ India: power consumption per capita



Source: IEA

There are concerns in the market that the unwillingness of DISCOMs to buy more power (as every time they buy power, they make losses) could lead to surplus power capacity, which would actually add to the woes of the power-generating companies. Our contacts in the power and related industries suggest that the power surplus is due largely to the lack of demand from the DISCOMs and not from ultimate consumers. Hence, there is surplus as the power producers are not producing at full capacity. Over the next five years, the Planning Commission expects about 88GW of power capacity to be added to the current installed base. However, despite this, we expect demand to still far outstrip supply, and the power deficit to remain at over 7%.

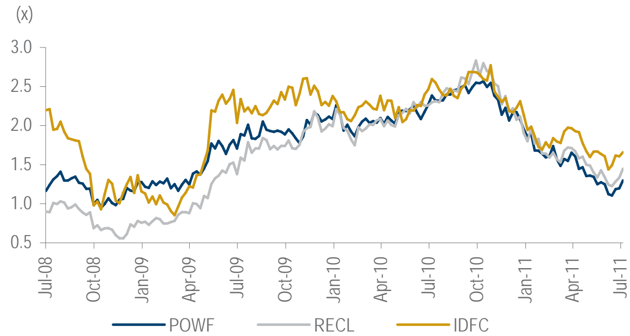
We believe the financing requirements of the Power Sector will remain substantial over the next five years. We estimate that it could need at least US$100bn of additional funding over the period. We arrive at this figure by assuming only two-thirds of the *12th Five-Year Plan* targets are met, and that the funding requirements for transmission and distribution are equivalent to that for the generation segment (although they could turn out to be even higher).

We estimate REC and PFC combined account for around 35-40% of the Power Sector's lending requirements. We estimate the lending opportunity over the next five years for REC and PFC alone is almost 1.3x their combined current loan-book size, and that their assets could more than double over the next five years. Our main concern, therefore, is not about loan growth, but the uncertainty surrounding the health of the SEBs (REC's and PFC's borrowers) and any delays in the reform of the Power Sector.

Infrastructure-financing stocks: more of a rerating story

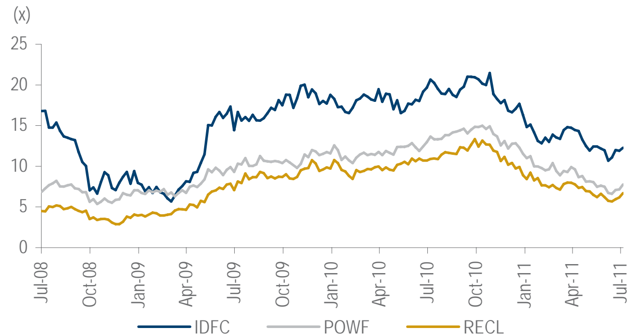
We regard companies that focus on infrastructure lending, such as like IDFC, PFC and REC, more as re-rating stories, as their earnings have not suffered much even when the stocks have been derated. While a big rerating may still take time, we still believe these stocks are valued very attractively on a six-month view, and offer a good investment opportunity with 20-30% upside potential for their share prices over the next six months.

■ PFC, REC and IDFC PBR



Source: Bloomberg, Daiwa forecast

■ PFC, REC, IDFC PER



Source: Bloomberg, Daiwa forecasts

Home-loan financing remains a safe option

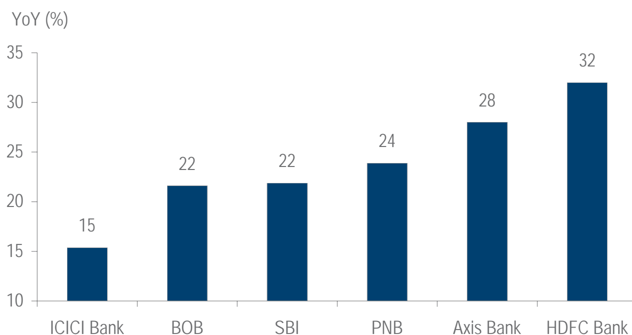
Relatively low ticket sizes, strong asset quality, and the ability to pass on higher rates to existing customers are the main reasons that HFCs are doing so well in the current high-interest-rate environment; the recent withdrawal of teaser rates by the SBI has also helped.

Less competition from banks after discontinuation of teaser-rate loans

Banks took an aggressive approach to expanding their home-loan portfolios by introducing teaser-rate loans (fixed-rate loans for first 1-3 years and floating rates thereafter) in FY11. Teaser-rate loans accounted for almost 75-80% of incremental disbursements in FY11 for banks such as SBI. The HFCs faced severe competition, which resulted in them losing market share to the banks in FY11.

However, the banks discontinued teaser-rate loans after the RBI introduced the 2% provisioning on all teaser-rate loans in November 2010, as it perceived these loans as being at higher risk. We believe that the discontinuation of teaser-rate loans by banks will result in less competition for HFCs, thereby boosting their disbursement growth.

■ Housing loan growth



Source: Companies

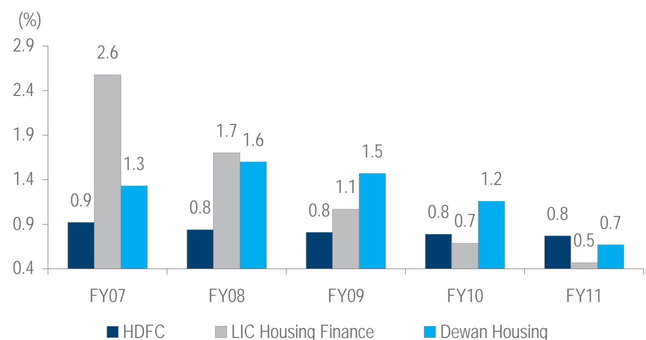
HFCs appear better placed than other NBFCs in a high-interest-rate environment

We believe the HFCs are better placed than other NBFCs in the current high-interest-rate environment. In most cases, when raising interest rates, HFCs raise the tenor of loans for existing customers, and keep the equated monthly instalment (EMIs) at the same level, in contrast to other NBFCs, which tend to increase the equated monthly or quarterly instalment.

Hence, HFCs can potentially pass on the increased borrowing cost to borrowers easily, and thereby keep interest spreads constant, even in a high-interest-rate environment, which is not the case for other NBFCs.

Also, the borrower of a housing loan is not affected directly, as the cash outflow remains constant when the interest rate is hiked, and hence is less likely to default, which is a major concern whenever interest rates increase. That is also one of the reasons that HFCs have maintained healthy asset quality, even in a high-interest-rate environment.

■ Gross NPLs



Source: Companies

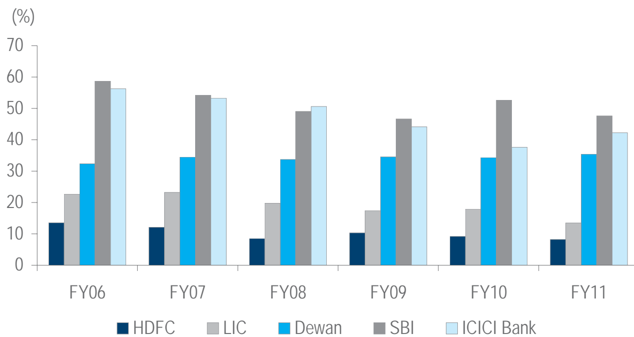
Low operating costs likely to keep HFCs' return ratios high

HFCs have the advantage of lower operating-cost structures than the banks, as they outsource the loan-origination process to direct selling agents (DSAs), and hence need fewer employees. The bulk of salary payouts is also linked to their performance, and hence their costs do not necessarily increase during a slowdown.

The DSAs are paid a fixed commission percentage on the total amount of disbursements. Also, banks have

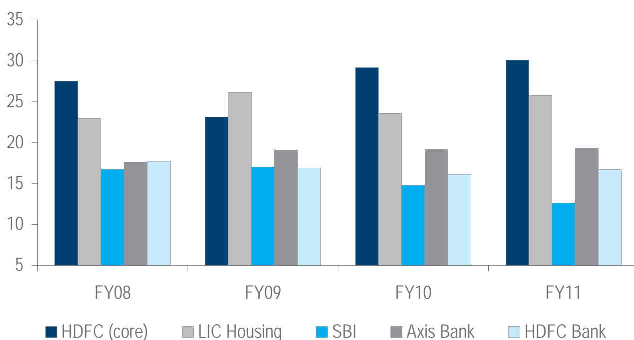
wider distribution networks, which results in higher cost-to-income ratios as compared with HFCs. HDFC's and LIC Housing Finance's cost-to-income ratios were in the 8-20% range from FY08 to FY11, compared with 38-51% for SBI and ICICI Bank over the same period.

■ Cost-to-income ratios (%)



Source: Companies

■ ROE comparison (%)



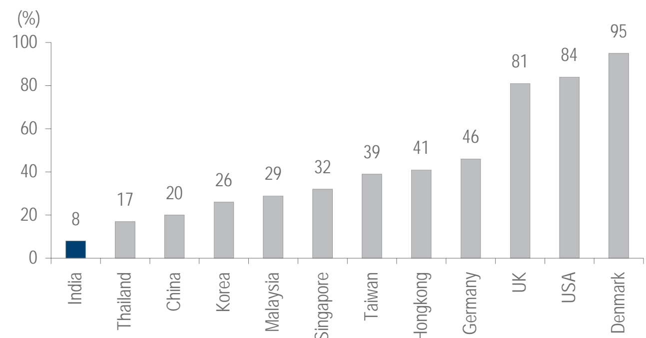
Source: Companies

Strong demand drivers in place for robust disbursement growth

We believe there are strong drivers in place for demand for housing loans to remain robust. With the improvement in the economic environment, we would expect affordability levels to improve against the backdrop of favourable demographics, the easy availability of finance, increasing urbanisation, the shift towards a nuclear-based family system, and the government's focus on low-cost housing. Also, despite the rise in property prices and increase in interest rates, loan disbursements for housing have remained strong, which illustrates the inherent demand for housing and housing loans in the country.

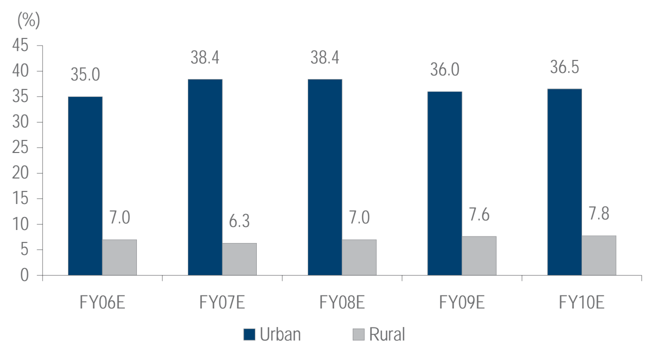
National Housing Bank estimates that India requires a total of Rs2tn per year to meet the increasing demand for homes, given the shortages of more than 24m housing units in urban areas and 577m housing units in rural areas. India remains one of the most underpenetrated countries globally in terms of mortgages as a percentage of GDP, at around 8-10% in FY11, compared with around 25-40% in developed countries in Asia, and around 80-95% in other developed countries.

■ Mortgages as a % of GDP



Source: Industry sources

■ Mortgage penetration in urban and rural areas (%)



Source: Industry sources, compiled by Daiwa

Tax benefits keep effective rates low in a high-interest-rate environment for home loans

The effective interest rate for the borrower of a housing loan is around 2.9pp lower than what a HFC charges because of the tax incentives of Rs150,000 for the interest payment and Rs100,000 for the principal payment. Hence, an individual generally prefers to take out a loan to fund the purchase of a home, resulting in strong disbursement growth.

We estimate the effective cost of a typical Rs2m home loan for a borrower with an annual income of Rs1m would be around 7.6% in FY12, compared with 5.5% in FY11, which we still see as very attractive despite the rise in interest rates.

■ Effective cost of home loans (Rs)

	FY12E	FY11E
Annual income	1,000,000	1,000,000
Effective tax rate (%)	30.9	30.9
Total tax payable	253,380	259,560
Deduction for interest allowed (A)	150,000	150,000
Deduction on principal allowed	100,000	100,000
Tax-free annual income	180,000	160,000
Net taxable income (B)	820,000	840,000
Loan amount	2,000,000	2,000,000
Interest (%)	10.5	8.5
Tenor (years)	20	20
Total EMI per month	19,968	17,356
Total amount paid per year	239,616	208,272
Interest component paid for the year (C)	208,533	168,473
Principal (D)	31,079	39,805
Net taxable income (B-A-D)	638,921	650,195
Total tax paid	197,427	200,910
Tax amount saved (E)	55,953	58,650
Effective interest paid on home loans (C-E)	152,580	109,823
Effective interest on home loans (%)	7.63	5.49

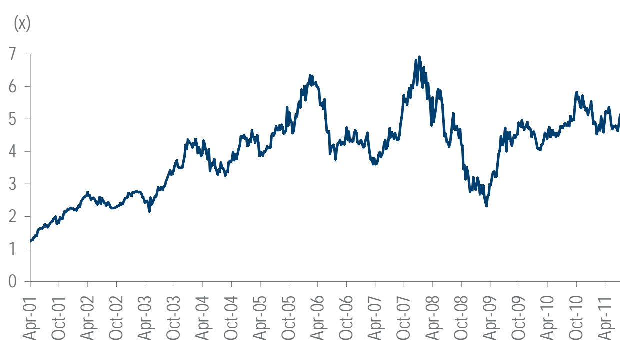
Source: Daiwa estimates

HFC stocks: strong earnings-growth visibility for HDFC and rerating potential for Dewan

We believe that HDFC has the highest earnings-growth visibility for the next 2-3 years among all NBFC stocks. However, due to its proven ability to remain unaffected – in terms of loan growth, NIM compression or asset quality in any part of the loan cycle – the valuations of HDFC are not affected much by rising interest rates, in our view. Given the fact that HDFC holds various investments on its books, and also because of the non-equity dilutive nature of the mortgage business, we continue to value HDFC on a PER basis. Given that we forecast HDFC's earnings to rise at a CAGR of 22% over the next two years, and our FY12 ROE forecast of 28% for its mortgage business, we believe that the stock will discount the earnings at a faster rate than any other NBFC under our coverage. However, as the stock has already outperformed other financial stocks under our coverage substantially over the past couple of months, we believe its rerating potential is limited. We have an Outperform (2) rating on the stock.

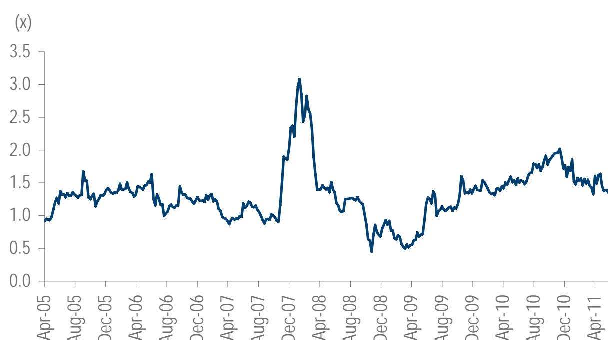
We believe Dewan offers a strong earnings-growth and potential rerating opportunity, although the risk is relatively higher when compared with HDFC. Also, as the company increases in size, we believe its valuations will improve. We have a Buy (1) rating on the stock.

■ HDFC: PBR



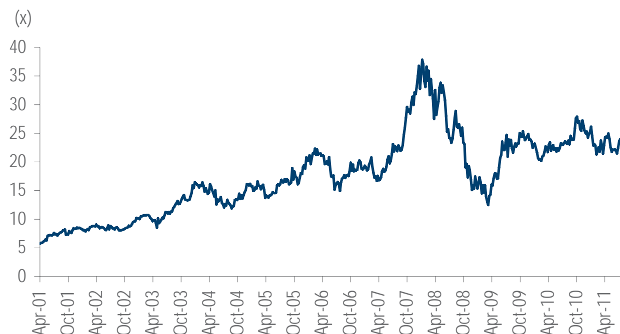
Source: Bloomberg

■ Dewan: PBR



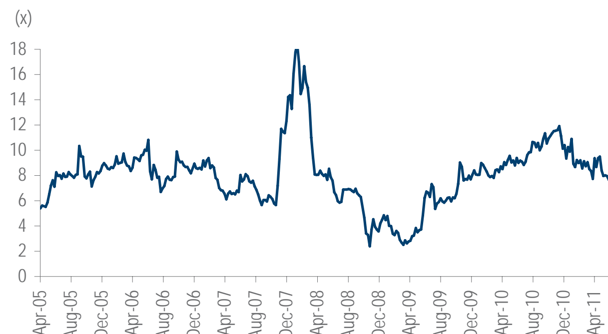
Source: Bloomberg

■ **HDFC: PER**



Source: Bloomberg

■ **Dewan: PER**



Source: Bloomberg

■ **Non-banking financial companies: peer valuations**

Company	Stock code	Price (Rs) 2 Aug 11	Target price (Rs)	Rating	PBR			PER			ROE	
					FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY12E	FY13E
Housing Development Fin.	HDFC IN	684.7	754.00	Outperform	5.3	4.5	4.0	21.9	17.4	14.8	28.0	29.0
Power Finance Corp	POWF IN	180.1	280.00	Buy	1.4	1.1	1.0	7.8	7.0	6.1	17.9	17.7
Rural Electrification Corp	RECL IN	208.05	265.00	Buy	1.7	1.4	1.2	8.0	6.6	5.4	23.2	23.8
Infrastructure Development Fin.	IDFC IN	125.25	158.00	Buy	1.8	1.5	1.3	11.8	10.0	8.7	17.3	16.1
Shriram Transport Fin.	SHTF IN	616.95	898.00	Buy	2.8	2.3	1.8	11.3	9.7	8.0	26.2	25.3
Dewan Housing Fin.	DEWH IN	210.25	339.00	Buy	1.4	1.2	1.0	7.5	7.3	5.5	18.0	20.4

Source: Daiwa forecasts
Note: Valuations for HDFC and IDFC are based on their core lending business

Disclaimer

When a report covers six or more subject companies please access important disclosures for Daiwa Capital Markets Hong Kong Limited at http://www.daiwacm.com/hk/research_disclaimer.html or contact your investment representative or Daiwa Capital Markets Hong Kong Limited at Level 26, One Pacific Place, 88 Queensway, Hong Kong.

The 10-second briefing

Housing Development Finance
HDFC IN

Target price: **Rs754.00 → Rs754.00**
Up/downside: **+10.1%**
Share price (2 Aug): **Rs685.00**

No signs of a slowdown

- There have been no signs of a slowdown in loan growth
- The low proportion of negative amortisation should help HDFC raise rates for existing borrowers without effecting EMI
- Loan demand is strong in cities where property prices have risen less

1 Buy
2 **Outperform** (from Buy)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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■ What's new
Despite a slowdown in some of the major cities, demand for mortgages remains strong in those cities where prices are more affordable. We expect HDFC to benefit from this.

■ What's the impact
At a time when there is concern in the market about a slowdown in overall loan growth in the banking system, we forecast HDFC's loan disbursements to rise by more than 20% for FY12. Pre-payment rates have remained stable so far this financial year at about 11%.

HFCs are able to pass on increases in lending rates more quickly than NBFCs, as HFCs can increase the tenure rather than the EMI, as a way of factoring in interest-rate hikes. In addition, HDFC has the ability to change its borrowing mix to control the cost of funds.

Cities where prices have risen less are driving new loan demand for HDFC. Management has said that customers are more sensitive to increases in property prices than rises in interest rates, and there is always a strong latent demand when property prices are low.

■ What we recommend
We maintain our SOTP-based six-month target price of Rs754. However, given the upside potential, we have lowered our rating to Outperform (2) from Buy (1).

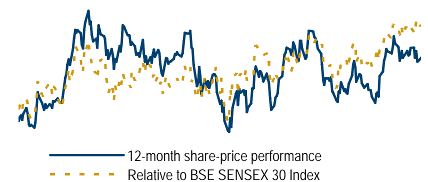
■ How we differ
We differ from the market in the way that HDFC should be valued. We believe that since it is a non-dilutive play with a track record of earnings growth, it should be valued on a PER basis rather than PBR. The stock may appear expensive on a mortgage PBR basis, but is trading currently at a mortgage PER of 17.4x on our FY12 forecast (after deducting the value and cost of investments), which we believe remains attractive, given our forecasts of high mortgage ROEs of 28-30% for the next three years.

Forecast revisions (%)

Year to 31 Mar	12E	13E	14E
PPOP change	0.0	0.0	0.0
Net-profit change	0.0	0.0	0.0
EPS change	0.0	0.0	0.0

Source: Daiwa forecasts

Share price performance



12-month range	589.15-760.35
Market cap (US$bn)	22.80
Average daily turnover (US$m)	40.25
Shares outstanding (m)	1,467
Major shareholder	Citigroup Strategic Holdings Mauritius ltd (8.8%)

Financial summary (Rs)

Year to 31 Mar	12E	13E	14E
Total operating income (m)	65,543	78,948	96,624
Pre-provision operating profit (m)	60,557	73,295	89,741
Net profit (m)	42,881	51,332	62,814
Core EPS (fully-diluted)	29.233	34.353	41.280
EPS change (%)	20.0	17.5	20.2
Daiwa vs Cons. EPS (%)	4	4	6
PER (x)	23.4	19.9	16.6
Dividend yield (%)	1.4	1.5	1.5
DPS	9.500	10.000	10.000
PBR (x)	5.1	4.0	3.5
ROE (%)	23.1	22.4	22.4

Source: Bloomberg, Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

- **1** Buy
- **2** **Outperform** (from Buy)
- **3** Hold
- **4** Underperform
- **5** Sell

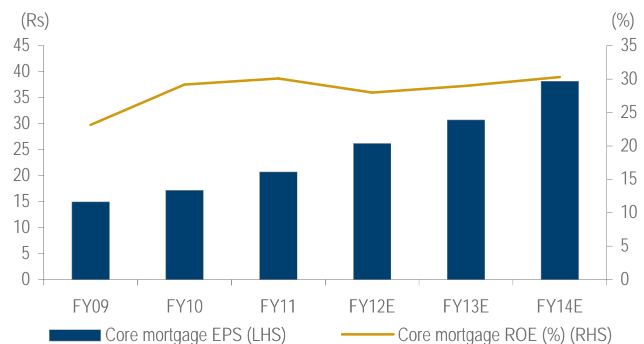
How do we justify our view?

- Growth outlook ✔ ✔ ✔ ✔ ✔
- Valuation ✔ ✔ ✔ ✔ ✔
- Earnings revisions ✔ ✔ ✔ ✔ ✔

Growth outlook ✔ ✔ ✔ ✔ ✔

We expect HDFC's loan growth to remain high over the next few years due to the company experiencing strong loan demand in cities where property prices have remained stable or are seeing some moderation. For FY11-13, we forecast a 20% CAGR in loan growth and core mortgage EPS to increase at a CAGR of 22%. We forecast the company's core mortgage ROE to average 28.5% over the next two years, and expect it to be among the best in the industry.

HDFC: core mortgage EPS and ROE



Source: Daiwa forecasts

Valuation ✔ ✔ ✔ ✔ ✔

HDFC's core mortgage business is a non-dilutive play with a track record of stable balance sheet and earnings growth. Thus we value the mortgage business on a PER basis rather than PBR. The core business is trading currently at a mortgage PER of 17.4x on our FY12 mortgage-EPS forecast. In our view, a stable earnings-growth and high-ROE play such as HDFC warrants a premium valuation. We value the mortgage business at a PER of 20x on our FY12 mortgage-EPS forecast. Our target price of Rs754 is based on an SOTP valuation.

HDFC group: SOTP (FY12E)

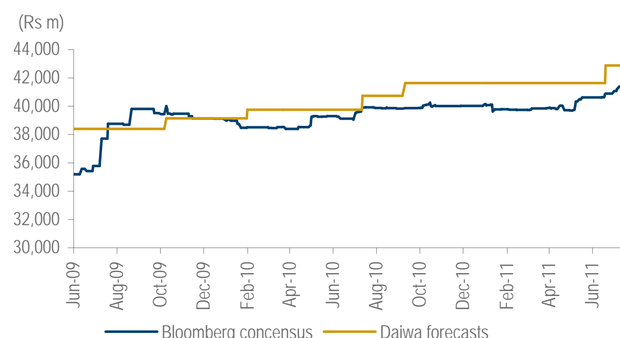
	Holding (%)	Total value (Rs m)	Value assigned to HDFC (Rs m)	Value/share for HDFC	Note
HDFC	100	768,322	768,322	524	Based on 20x FY12E core mortgage EPS, given high projected core mortgage ROE over the next two years
HDFC Bank	23	1,096,980	200,377	137	Based on the current market price of HDFC Bank
HDFC Standard Life	72	120,235	72,050	49	Based on a 14% NBAP margin and 14x NBAP
HDFC AMC	60	45,298	27,179	19	Valued at 5% of total AUM
Others investments	-		37,770	26	
Fair value of the group			1,105,699	754	

Source: Daiwa estimates

Earnings revisions ✔ ✔ ✔ ✔ ✔

Our earnings forecast for FY12 is 4% higher than that of the Bloomberg consensus. We believe the consensus is likely to move closer to our forecast as the market starts to factor in stable loan growth and interest spreads.

HDFC: net-profit forecasts (FY12E)



Source: Bloomberg, Daiwa forecasts

Financial summary

■ Key assumptions

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan growth (%)	25.6%	29.2%	16.7%	15.0%	19.6%	20.7%	20.2%	20.9%

■ Profit and loss (Rs m)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	17,235	27,858	32,714	36,567	45,257	55,902	68,587	85,446
Net fees & commission	2,182	1,670	3,482	5,110	4,938	6,141	7,111	8,178
Trading and other income	3,253	7,695	252	2,094	3,597	3,500	3,250	3,000
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**22,670**	**37,223**	**36,448**	**43,771**	**53,792**	**65,543**	**78,948**	**96,624**
Personnel expenses	(913)	(1,178)	(1,386)	(1,467)	(1,755)	(2,001)	(2,281)	(2,760)
Other expenses	(1,829)	(1,990)	(2,372)	(2,564)	(2,667)	(2,985)	(3,373)	(4,123)
Total expenses	**(2,742)**	**(3,168)**	**(3,758)**	**(4,031)**	**(4,423)**	**(4,986)**	**(5,654)**	**(6,883)**
Pre-provision operating profit	**19,928**	**34,055**	**32,690**	**39,740**	**49,370**	**60,557**	**73,295**	**89,741**
Total provision	(250)	(320)	(500)	(580)	(700)	(1,000)	(2,000)	(2,500)
Operating profit after prov.	**19,678**	**33,735**	**32,190**	**39,160**	**48,670**	**59,557**	**71,295**	**87,241**
Non-operating income	0	0	0	0	0	0	0	0
Profit before tax	**19,678**	**33,735**	**32,190**	**39,160**	**48,670**	**59,557**	**71,295**	**87,241**
Tax	(3,974)	(9,373)	(9,365)	(10,895)	(13,320)	(16,676)	(19,962)	(24,427)
Min. int./pref. div./other items	0	0	0	0	0	0	0	0
Net profit	**15,704**	**24,363**	**22,825**	**28,265**	**35,350**	**42,881**	**51,332**	**62,814**
Adjusted net profit	**15,704**	**19,428**	**22,825**	**28,265**	**35,350**	**42,881**	**51,332**	**62,814**
EPS (Rs)	**12.499**	**18.146**	**16.061**	**19.782**	**24.359**	**29.233**	**34.353**	**41.280**
EPS (adjusted) (Rs)	**12.499**	**14.470**	**16.061**	**19.782**	**24.359**	**29.233**	**34.353**	**41.280**
EPS (adjusted fully-diluted) (Rs)	**12.499**	**14.470**	**16.061**	**19.782**	**24.359**	**29.233**	**34.353**	**41.280**
DPS (Rs)	**4.400**	**5.000**	**6.000**	**7.200**	**9.000**	**9.500**	**10.000**	**10.000**

■ Change (YoY %)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	30.0	61.6	17.4	11.8	23.8	23.5	22.7	24.6
Non-interest income	10.4	72.3	(60.1)	92.9	18.5	13.0	7.5	7.9
Total operating income	24.7	64.2	(2.1)	20.1	22.9	21.8	20.5	22.4
Total expenses	11.5	15.5	18.6	7.3	9.7	12.7	13.4	21.7
Pre-provision operating profit	26.7	70.9	(4.0)	21.6	24.2	22.7	21.0	22.4
Total provisions	66.7	28.0	56.3	16.0	20.7	42.9	100.0	25.0
Operating profit after provisions	26.4	71.4	(4.6)	21.7	24.3	22.4	19.7	22.4
Profit before tax	26.4	71.4	(4.6)	21.7	24.3	22.4	19.7	22.4
Net profit (adjusted)	24.9	23.7	17.5	23.8	25.1	21.3	19.7	22.4
EPS (adjusted)	23.9	15.8	11.0	23.2	23.1	20.0	17.5	20.2
Gross loans	25.5	29.1	16.8	14.9	19.9	20.8	20.2	20.9
Deposits	18.8	8.8	71.5	19.1	6.7	20.0	21.0	19.0
Total assets	28.1	28.7	20.4	14.7	19.7	18.1	18.9	19.6
Total liabilities	28.5	20.7	22.1	14.5	20.5	18.7	17.0	20.4
Shareholders' equity	24.2	115.2	10.0	15.7	13.9	14.0	32.2	14.4
Avg interest-earning assets	23.3	30.4	19.7	10.1	19.9	20.6	20.1	20.7
Avg risk-weighted assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & equivalent	6,858	19,691	43,793	6,549	7,345	13,084	14,512	15,973
Investment securities	29,804	49,459	60,895	100,725	110,979	113,425	121,199	130,678
Net loans and advances	565,124	729,980	851,981	979,670	1,171,266	1,414,221	1,700,005	2,054,604
Fixed assets	2,131	2,085	2,034	2,221	2,340	2,390	2,440	2,490
Goodwill	0	0	0	0	0	0	0	0
Other assets	51,796	42,990	57,866	76,489	103,092	104,191	119,722	137,583
Total assets	**655,712**	**844,205**	**1,016,569**	**1,165,655**	**1,395,021**	**1,647,310**	**1,957,877**	**2,341,327**
Customers deposits	103,844	112,963	193,747	230,811	246,251	295,501	357,556	425,492
Borrowing	242,242	211,998	253,719	321,369	424,898	501,380	616,697	740,037
Debentures	225,844	366,552	391,096	413,473	482,956	569,206	657,355	775,679
Other liabilities	28,268	33,220	46,634	48,025	67,751	83,730	65,117	101,279
Total liabilities	**600,198**	**724,732**	**885,195**	**1,013,678**	**1,221,856**	**1,449,816**	**1,696,725**	**2,042,486**
Share capital	2,530	2,840	2,844	2,871	2,934	2,934	3,043	3,043
Reserves & others	52,984	116,633	128,529	149,106	170,231	194,560	258,109	295,797
Shareholders' equity	**55,514**	**119,473**	**131,374**	**151,977**	**173,165**	**197,494**	**261,152**	**298,840**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**655,712**	**844,206**	**1,016,569**	**1,165,655**	**1,395,021**	**1,647,310**	**1,957,877**	**2,341,327**
Avg interest-earning assets	582,656	760,020	909,997	1,002,123	1,201,712	1,449,234	1,740,269	2,100,908
Avg risk-weighted assets								
BVPS (Rs)	43.88	84.13	92.37	105.87	118.05	134.64	171.62	196.39

Key ratios (%)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan/deposit	548.1	650.4	442.9	427.3	480.2	483.5	480.4	488.0
Tier-1 CAR	7.6	14.6	13.2	12.8	12.2	12.0	13.7	13.0
Total CAR	12.9	16.8	15.1	14.6	14.0	13.8	15.7	15.0
NPLs/gross loans	0.9	0.8	0.8	0.8	0.8	0.9	0.9	0.9
Total loan-loss prov./NPLs	78.8	76.7	88.6	83.7	124.4	114.8	116.6	117.7
ROAA	2.7	2.6	2.5	2.6	2.8	2.8	2.8	2.9
ROAE	31.3	22.2	18.2	20.0	21.7	23.1	22.4	22.4
Net-interest margin	3.0	3.7	3.6	3.6	3.8	3.9	3.9	4.1
Gross yield	9.2	10.4	11.7	10.6	10.0	10.8	10.7	10.8
Cost of funds	7.0	8.1	9.6	7.7	7.1	8.0	7.8	7.9
Net-interest spread	2.2	2.3	2.1	2.9	2.9	2.8	2.9	2.9
Total cost/total income	12.1	8.5	10.3	9.2	8.2	7.6	7.2	7.1
Effective tax	20.2	27.8	29.1	27.8	27.4	28.0	28.0	28.0
Dividend-payout	35.2	27.6	37.4	36.4	36.9	32.5	29.1	24.2

Source: Company, Daiwa forecasts

Company profile

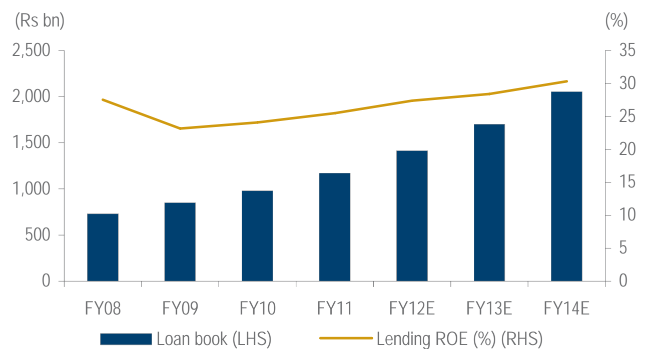
Incorporated in 1977, Housing Development Finance is the largest Housing Finance Company in India, with an asset base of Rs1416bn (US$31bn). The company had 294 outlets as at 30 June 2011, with a presence in more than 2,400 cities and towns in India. The company is owned predominantly by foreign institutional investors (about 75%) and is one of the best-managed companies in the financial sector.

Valuation premium likely to be sustained

We expect a high sustainable ROE for the lending business

We have constructed a separate P&L statement for the lending business, in which we forecast HDFC's core EPS from the lending business to increase at a CAGR of 22% for FY11-13 compared with a 20% CAGR over the period for the combined entity. We expect the ROE from the lending business to be much higher than that for the combined entity. HDFC has demonstrated its ability to maintain a high ROE: its lending P&L recorded an ROE of 27% over the past four years. Our forecast for the ROE of the core lending operation of 28-29% over the next two years, which we expect to be among the best in industry and therefore warrants a premium valuation, in our view.

■ HDFC: loan book and mortgage-business ROE



Source: Company, Daiwa forecasts

■ HDFC: core mortgage ROE

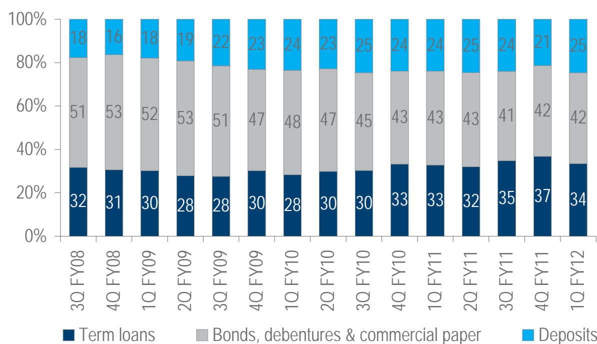
	ROE breakdown of HDFC					Core ROE breakdown of HDFC's mortgage business				
Rs m	FY10	FY11	FY12E	FY13E	FY14E	FY10	FY11	FY12E	FY13E	FY14E
Net interest income	36,567	45,257	55,902	68,587	85,446	36,567	45,257	55,902	68,587	85,446
Other income	7,204	8,535	9,641	10,361	11,178	2,783	2,686	3,438	4,003	4,604
Dividends	2,327	2,252	2,703	3,108	3,575	nil	nil	nil	nil	nil
Profit on sale of investments	2,094	3,597	3,500	3,250	3,000	nil	nil	nil	nil	nil
Fees and other charges	2,317	2,204	2,688	3,253	3,904	2,317	2,204	2,688	3,253	3,904
Other Income	466	482	750	750	700	466	482	750	750	700
Net income	43,771	53,792	65,543	78,948	96,624	39,350	47,942	59,340	72,590	90,050
Operating expenses	4,031	4,423	4,986	5,654	6,883	4,031	4,423	4,986	5,654	6,883
Operating profit	39,740	49,370	60,557	73,295	89,741	35,319	43,520	54,355	66,936	83,166
Provision & contingencies	580	700	1000	2000	2500	580	700	1,000	2,000	2,500
PBT	39,160	48,670	59,557	71,295	87,241	34,739	42,820	53,355	64,936	80,666
Tax	10,895	13,320	16,676	19,962	24,427	10,074	12,418	14,939	18,182	22,587
PAT	28,265	35,350	42,881	51,332	62,814	24,665	30,402	38,415	46,754	58,080
Reported net worth	151,977	173,165	197,494	261,152	298,840	-	-	-	-	-
Lending net worth	-	-	-	-	-	75,281	126,814	147,643	174,801	208,489
ROE (%)	20.0	21.7	23.1	22.4	22.4	-	-	-	-	-
Core mortgage business ROE (%)	-	-	-	-	-	29.2	30.1	28.0	29.0	30.3
Reported EPS (Rs/share)	20	24	29	34	41	-	-	-	-	-
Core EPS (Rs/share)	-	-	-	-	-	17	21	26	31	38
Reported BV (Rs/share)	106	118	135	172	196	-	-	-	-	-
Core mortgage BV (Rs/share)	-	-	-	-	-	52	86	101	115	137

Source: Company, Daiwa forecasts

Lending-rate hikes and flexible borrowing plan protect spreads

We believe HDFC has been able to move swiftly from one borrowing source to another depending on movements in interest rates. From April 2006 to April 2007, when the cost of borrowing from banks started rising, HDFC reduced its proportion of bank borrowing quite significantly. Bank loans as a percentage of total borrowing declined from 43% for 4Q FY06 to 34% for 1Q FY08, and to 28% for 1Q FY10. Starting in 1Q FY10 when bank lending rates started to soften, HDFC increased its borrowings from banks. Once again, as the banks have increased their lending rates recently, HDFC has lowered its dependence on bank loans and the share of bank loans in HDFC's total borrowings has declined from 37% for 4Q FY11 to 34% for 1Q FY12.

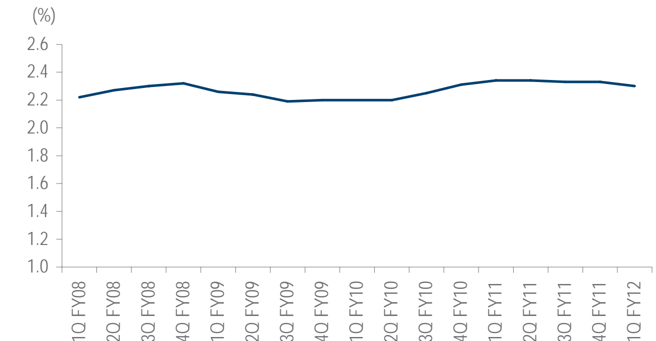
▪ HDFC: borrowing mix



Source: Company

Another factor that keeps interest spreads stable for HDFC is the company's ability to raise the interest rates of its existing borrowers without affecting the equated monthly instalment (EMI). HDFC's cost of funds has risen for the past three quarters, but the company saw a very modest 4bp fall in its interest spread. We believe that the company will be able to improve its loan yield for FY12, as it has been increasing its lending rates over the past six months and maintain interest spreads at the current level.

▪ HDFC: interest spread



Source: Company

Pre-payment rates have remained stable

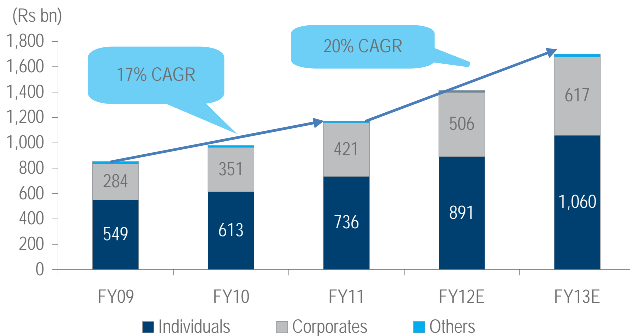
Even though interest rates have risen pre-payment rates have remained stable at about 11%. On average, about 18-20% of loans are repaid in a year, with the normal pre-payment level at about 11% and the normal principal payment at about 7%. In the current high-interest-rate environment, negative amortisation (where the monthly interest amount payable exceeds the EMI) is only about 4-5% of total loans.

The impact of likely new guidelines on standard asset provisioning of 0.4% on retail home loans will be about Rs1.2bn, which the company proposes to deduct directly from its reserves.

Cities other than Mumbai driving loan demand

Property prices in cities such as Mumbai and Delhi have risen much more than those in cities such as Chennai and Hyderabad over the past few years. HDFC is seeing an increase in loan demand from such cities. Management suggests loan demand is most sensitive to property prices, and that there is always a rise in demand when property prices fall, even marginally. We do not expect the current high-interest-rate environment to affect loan demand adversely, as loan demand is less sensitive to interest rates. We forecast HDFC's loan book to increase at a CAGR of 20% over the next two years, with strong increases in the individual-loan and lease-rental segments.

■ **HDFC: loan book (Rs bn)**



Source: Company, Daiwa forecasts

Valuations and SOTP

HDFC's loan disbursements and interest spread have remained stable over the past 10 years or so, reflecting its track record of unhindered loan growth throughout different credit cycles. The company's strong loan-growth visibility, stable interest spreads, its superior asset quality compared with its peers, and a sustainably high ROE warrant a premium valuation, in our view. Our forecast of a core mortgage business ROE of 28.5% over the next two years would be one of the best in industry, we believe. We remain bullish on the company's ability to deliver a strong financial performance. However, the share price has risen by more than 10% over the past month and is trading currently at a PER of 17.4x on our FY12 core mortgage EPS forecast, providing less scope for large upside potential. Hence, we have downgraded our rating to Outperform (2) from Buy (1). Our SOTP-based target price is still Rs754, and assumes an unchanged PER for the core mortgage business of 20x for FY12.

Risk

The main risk to our target price and rating would be a fall in loan disbursements due to high interest rates.

■ **HDFC: core mortgage ROE**

	ROE breakdown of HDFC					Core ROE breakdown of HDFC's mortgage business				
Rs m	FY10	FY11	FY12E	FY13E	FY14E	FY10	FY11	FY12E	FY13E	FY14E
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Dividends	2,327	2,252	2,703	3,108	3,575	nil	nil	nil	nil	nil
Profit on sale of investments	2,094	3,597	3,500	3,250	3,000	nil	nil	nil	nil	nil
Fees and other charges	2,317	2,204	2,688	3,253	3,904	2,317	2,204	2,688	3,253	3,904
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Reported net worth	151,977	173,165	197,494	261,152	298,840	-	-	-	-	-
Lending net worth	-	-	-	-	-	75,281	126,814	147,643	174,801	208,489
ROE (%)	20.0	21.7	23.1	22.4	22.4	-	-	-	-	-
Core mortgage business ROE (%)	-	-	-	-	-	29.2	30.1	28.0	29.0	30.3
Reported EPS (Rs/share)	20	24	29	34	41	-	-	-	-	-
Core EPS (Rs/share)	-	-	-	-	-	17	21	26	31	38
Reported BV (Rs/share)	106	118	135	172	196	-	-	-	-	-
Core mortgage BV (Rs/share))	-	-	-	-	-	52	86	101	115	137

Source: Daiwa estimates and forecasts

■ HDFC group: SOTP (FY12E)

	Holding (%)	Total value (Rs m)	Value assigned to HDFC (Rs m)	Value/share for HDFC	Note
HDFC	100	768,322	768,322	524	Based on 20x FY12 core mortgage EPS, given our high forecast core mortgage ROE of 28-29% over the next two years
HDFC Bank	23	1,096,980	200,377	137	Based on the current market price of HDFC Bank
HDFC Standard Life	72	120,235	72,050	49	Based on a 14% NBAP margin and 14x NBAP
HDFC AMC	60	45,298	27,179	19	Valued at 5% of total AUM
Others investments	-		37,770	26	
Fair value of the group			**1,105,699**	**754**	

Source: Daiwa forecasts

Daiwa Capital Markets

Company

Diversified financials / India
2 August 2011

The 10-second briefing

Power Finance Corp
POWF IN

Target price: **Rs391.00 → Rs280.00**
Up/downside: **+56.0%**
Share price (2 Aug): **Rs179.45**

Government action should help

- Recent relaxation of environmental index and cabinet reshuffle should ease concerns about coal availability for power projects
- PFC's likely overseas borrowing and tax-free bond issuance should help to protect its NIM in the high-interest-rate environment
- With a projected ROE of around 18% for the next two years, we believe the stock can potentially trade at a 1.7x PBR for FY12E

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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What's new
India's recent change of Minister for the Environment has boosted the market's hopes of a speed-up in clearances for coal mining, which we believe should ease market concerns about coal availability for power projects in the medium-to-long term. India has the world's third-largest coal reserves and the current shortage relates more to government inability to act fast rather than any structural shortage of coal in the country, in our view. In addition, we believe the formation of a coal regulator is a key to solving the country's coal shortages in the long term. Aside from this, PFC's recent proposal to issue tax-free bonds of Rs50bn should help it to protect its NIM in the current high-interest-rate environment.

What's the impact
PFC's exposure to power-distribution companies is only 5% of its total loans, and in our view the company should not be affected directly by concerns about the financial health of SEBs. PFC has not faced any loan-collection problems from SEBs so far, and is protected well by its escrow mechanism with its borrowers and bankers, which it has had to resort to only once in the past decade.

What we recommend
We have lowered our six-month target price to Rs280 (from Rs391), as we now derive a lower PBR from our Gordon Growth Model of 1.7x (formerly 2.5x) on our FY12 BVPS forecast to reflect the concerns over the power sector and about high interest rates, which we believe could lead to a slowdown in PFC's loan growth in FY12. We maintain our Buy (1) rating on PFC. Despite 15% equity dilution following the capital raising in 1Q FY12, we forecast PFC to deliver a ROE of 18.2% on average for the next two years.

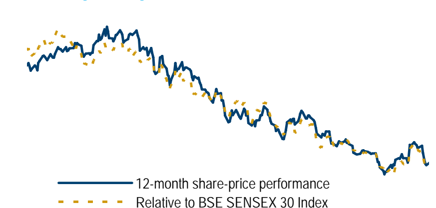
How we differ
The market is concerned about the shortage of coal, which could affect India's power projects, and in turn affect PFC's asset quality adversely. We believe the government will take progressive steps to resolve the power sector's current problems.

Forecast revisions (%)

Year to 31 Mar	11E	12E	13E
PPOP change	(2.2)	4.1	2.6
Net-profit change	(1.4)	3.1	1.6
EPS change	(1.4)	(4.1)	(11.7)

Source: Daiwa forecasts

Share price performance



12-month range	170.95-380.60
Market cap (US$bn)	4.67
Average daily turnover (US$m)	23.27
Shares outstanding (m)	1,148
Major shareholder	Government of India (73.7%)

Financial summary (Rs)

Year to 31 Mar	11E	12E	13E
Total operating income (m)	36,650	44,647	55,040
Pre-provision operating profit (m)	35,673	43,588	53,829
Net profit (m)	26,548	31,589	39,093
Core EPS (fully-diluted)	23.130	25.602	29.618
EPS change (%)	13.1	10.7	15.7
Daiwa vs Cons. EPS (%)	0	(1)	2
PER (x)	7.8	7.0	6.1
Dividend yield (%)	2.8	3.3	3.9
DPS	5.000	6.000	7.000
PBR (x)	1.4	1.2	1.0
ROE (%)	19.7	18.4	18.1

Source: Bloomberg, Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

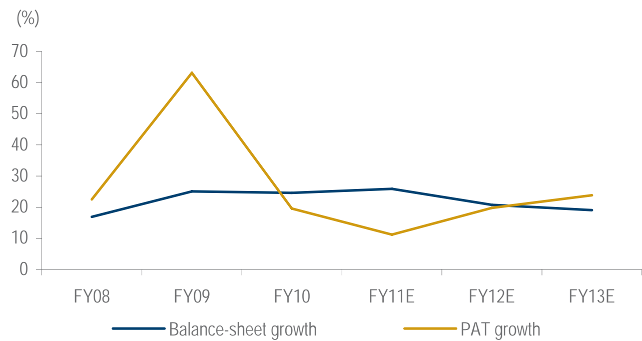
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

PFC's outstanding loans authorised to the power sector represent around 1.7x of the size of its current loan book, which we believe provides good visibility for high growth in the company's balance sheet over the next two years. We forecast a balance-sheet CAGR of 20% from FY11-13, driven by a CAGR of about 20% in loans over the same period.

PFC: growth in balance sheet and net profit

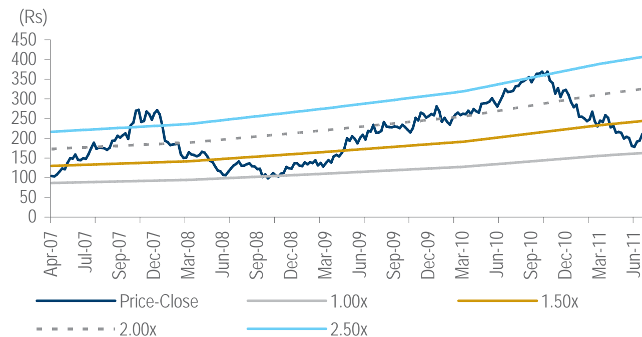


Source: Company, Daiwa forecasts

Valuation ✔✔✔✔✔

The stock's one-year forward PBR has corrected from a peak of 2.5x in October 2010 to 1.1x currently (on our FY12 BVPS forecasts), due largely to high interest rates and market concerns about the power sector. We believe the bulk of the interest-rate hikes are over and that there is only a small increase left to go now. We also believe the market's concerns about the power sector's issues should subside as the government has already started taking actions to improve the availability of coal and reduce losses in the power sector. Given our expectations for PFC to record strong loan and earnings growth and a solid ROE of around 18% for FY12 and FY13, we believe the stock has the potential to trade at a PBR of 1.7x based on our FY12 BVPS forecast.

PFC one-year forward PBR bands



Source: Bloomberg, Daiwa forecasts

Earnings revisions ✔✔✔✔✔

We have revised up slightly our FY12 and FY13 net-profit forecasts. As the company has raised capital in 1Q FY12, we expect its NII growth to remain strong for FY12, despite our expectation for its interest spread to fall in FY12.

PFC: Daiwa vs. Bloomberg-consensus net-profit forecasts

(Rs m)	FY12E	FY13E
Daiwa	31,589	39,093
Bloomberg consensus	31,841	38,400
Difference (%)	(1)	2

Source: Bloomberg, Daiwa

Financial summary

■ Key assumptions

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Loan growth (%)	20.6%	23.3%	17.5%	24.9%	23.9%	24.7%	21.0%	20.0%

■ Profit and loss (Rs m)

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Net-interest income	11,241	14,130	18,118	22,503	29,231	35,230	42,302	52,845
Net fees & commission	11	57	363	173	(37)	990	1,835	1,635
Trading and other income	248	303	345	506	934	430	510	560
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**11,500**	**14,490**	**18,826**	**23,182**	**30,127**	**36,650**	**44,647**	**55,040**
Personnel expenses	(232)	(248)	(497)	(442)	(736)	(671)	(738)	(812)
Other expenses	(267)	(270)	(357)	(464)	(355)	(306)	(321)	(400)
Total expenses	**(499)**	**(518)**	**(855)**	**(906)**	**(1,091)**	**(977)**	**(1,059)**	**(1,212)**
Pre-provision operating profit	**11,001**	**13,972**	**17,971**	**22,276**	**29,036**	**35,673**	**43,588**	**53,829**
Total provision	142	49	100	(37)	21	(320)	(900)	(1,000)
Operating profit after prov.	**11,143**	**14,021**	**18,071**	**22,240**	**29,057**	**35,353**	**42,688**	**52,829**
Non-operating income	1,521	1,044	(201)	2,059	1,070	80	0	0
Profit before tax	**12,664**	**15,064**	**17,870**	**24,299**	**30,127**	**35,433**	**42,688**	**52,829**
Tax	(2,909)	(5,202)	(5,796)	(4,594)	(6,575)	(9,246)	(11,099)	(13,735)
Min. int./pref. div./other items	0	0	0	0	0	0	0	0
Net profit	**9,755**	**9,862**	**12,074**	**19,705**	**23,552**	**26,188**	**31,589**	**39,093**
Adjusted net profit	**9,212**	**10,831**	**13,251**	**17,646**	**23,482**	**26,548**	**31,589**	**39,093**
EPS (Rs)	**9.467**	**9.055**	**10.520**	**17.168**	**20.520**	**22.816**	**25.602**	**29.618**
EPS (adjusted) (Rs)	**8.939**	**9.945**	**11.545**	**15.374**	**20.459**	**23.130**	**25.602**	**29.618**
EPS (adjusted fully-diluted) (Rs)	**8.939**	**9.945**	**11.545**	**15.374**	**20.459**	**23.130**	**25.602**	**29.618**
DPS (Rs)	**3.508**	**2.263**	**3.500**	**4.000**	**4.500**	**5.000**	**6.000**	**7.000**

■ Change (YoY %)

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Net-interest income	(7.1)	25.7	28.2	24.2	29.9	20.5	20.1	24.9
Non-interest income	9.2	39.4	96.7	(4.1)	32.0	58.3	65.1	(6.4)
Total operating income	(6.8)	26.0	29.9	23.1	30.0	21.7	21.8	23.3
Total expenses	8.5	3.8	65.0	6.0	20.5	(10.5)	8.4	14.4
Pre-provision operating profit	(7.4)	27.0	28.6	24.0	30.3	22.9	22.2	23.5
Total provisions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	181.3	11.1
Operating profit after provisions	(4.4)	25.8	28.9	23.1	30.7	21.7	20.7	23.8
Profit before tax	(9.7)	19.0	18.6	36.0	24.0	17.6	20.5	23.8
Net profit (adjusted)	(3.6)	17.6	22.3	33.2	33.1	13.1	19.0	23.8
EPS (adjusted)	(3.6)	11.3	16.1	33.2	33.1	13.1	10.7	15.7
Gross loans	20.5	23.3	17.4	24.9	23.9	24.7	21.0	20.0
Deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	20.4	24.5	16.9	25.0	24.6	23.1	21.0	19.2
Total liabilities	23.8	24.9	19.0	28.6	26.1	25.0	17.8	20.1
Shareholders' equity	8.4	22.8	8.1	9.2	16.8	12.7	41.1	14.6
Avg interest-earning assets	19.8	22.2	20.3	21.5	24.7	25.1	22.9	20.2
Avg risk-weighted assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Company, Daiwa forecasts; Note: annual report for FY11 has not yet been released

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Cash & equivalent	3,648	5,077	6,745	7,420	13,943	23,503	25,853	28,438
Investment securities	165	589	660	360	310	539	539	539
Net loans and advances	356,025	439,028	515,660	644,290	798,560	995,707	1,204,806	1,445,767
Fixed assets	847	814	770	750	740	767	775	783
Goodwill	0	0	0	0	0	0	0	0
Other assets	14,211	21,160	21,643	29,271	36,222	25,820	33,628	33,161
Total assets	**374,896**	**466,667**	**545,478**	**682,090**	**849,775**	**1,046,336**	**1,265,600**	**1,508,687**
Customers deposits	0	0	0	0	0	0	0	0
Borrowing	269,248	335,838	406,480	521,600	671,080	855,988	1,006,583	1,208,757
Debentures	0	0	0	0	0	0	0	0
Other liabilities	30,888	39,016	39,717	52,040	52,035	47,549	57,577	69,171
Total liabilities	**300,136**	**374,854**	**446,197**	**573,640**	**723,115**	**903,537**	**1,064,160**	**1,277,928**
Share capital	10,305	11,478	11,478	11,478	11,478	11,478	13,199	13,199
Reserves & others	64,456	80,336	87,804	96,972	115,182	131,322	188,241	217,561
Shareholders' equity	**74,760**	**91,814**	**99,282**	**108,450**	**126,660**	**142,800**	**201,440**	**230,760**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**374,896**	**466,668**	**545,478**	**682,090**	**849,775**	**1,046,336**	**1,265,600**	**1,508,687**
Avg interest-earning assets	328,394	401,432	483,029	586,717	731,591	915,431	1,124,623	1,352,121
Avg risk-weighted assets								
BVPS (Rs)	72.55	79.99	86.50	94.49	110.35	124.42	152.62	174.83

Key ratios (%)

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Loan/deposit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tier-1 CAR	18.2	18.3	16.8	16.1	17.0	15.3	17.7	17.0
Total CAR	18.2	18.3	16.8	16.1	17.0	15.3	17.7	17.0
NPLs/gross loans	0.3	0.1	0.0	0.0	0.0	0.2	0.1	0.1
Total loan-loss prov./NPLs	23.3	40.0	66.7	53.8	53.8	15.6	40.0	50.0
ROAA	2.7	2.6	2.6	2.9	3.1	2.8	2.7	2.8
ROAE	12.8	13.0	13.9	17.0	20.0	19.7	18.4	18.1
Net-interest margin	3.4	3.5	3.8	3.8	4.0	3.8	3.8	3.9
Gross yield	8.9	9.3	10.1	10.9	10.7	10.7	11.2	11.2
Cost of funds	7.1	7.4	8.1	8.8	8.2	8.2	9.0	8.8
Net-interest spread	1.8	1.9	2.1	2.1	2.6	2.5	2.3	2.3
Total cost/total income	4.3	3.6	4.5	3.9	3.6	2.7	2.4	2.2
Effective tax	23.0	34.5	32.4	18.9	21.8	26.1	26.0	26.0
Dividend-payout	37.1	25.0	33.3	23.3	21.9	21.9	23.4	23.6

Source: Company, Daiwa forecasts Note: annual report for FY11 has not yet been released

Company profile

Power Finance Corporation was incorporated in 1986 and was given the status of a Nav-Ratna public-sector unit by the government in June 2007. It is a leading power-finance company in India with a balance-sheet size of Rs1,090bn as at 30 June 2011. Power Finance Corporation is also a nodal agency for awarding ultra-mega power projects and for implementing Accelerated Power Development and Reforms Programme schemes to reduce the aggregate technical and commercial losses of state power utilities.

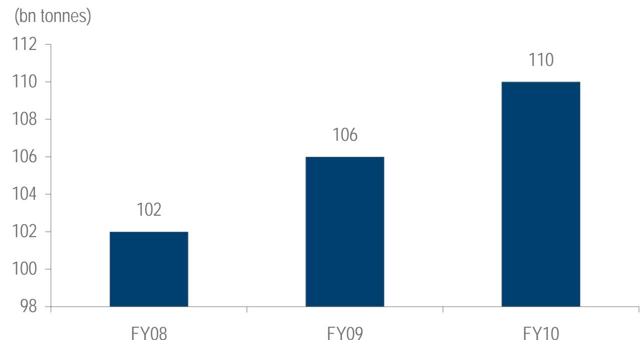
Government action in power sector starts finally

PFC has been derated over the past 4-5 months due to a lack of government action to resolve the power sector's issues, along with high interest rates. The government has already started taking action and we expect more to follow.

Fuel-availability concerns for power-generation companies should abate

Concerns in the market about the availability of coal for India's power plants have increased substantially over the past 4-5 months as power projects of around 32GW are due to be commissioned in the next two years. While there is a gap between coal required and coal available, we believe the expected shortfall over the next two years does not look that alarming. Moreover, we believe the real problem is not coal availability (India has the world's third-largest coal reserves), but rather logistical problems and coal-mining capacity. Coal miners in India can potentially mine coal to greater depths than they are mining currently and should be able to cover the demand-supply gap to an extent. However, we believe the logistical bottlenecks involving the transportation of coal from the mines to the users could take some time to resolve.

■ India: proven coal reserves



Source: Ministry of Power
Note: reserves are as per Indian Standard Procedure (ISP) standards

■ India: coal demand-supply forecasts

m tonnes	2010	2011E	2012E	2013E	2014E	2015E
Coal-demand projections:						
Power (utility)	351	413	473	547	618	687
Power (captive)	35	44	47	50	54	58
Cement	15	16	17	18	19	20
Others (BRK+ sponge iron, etc.)	113	119	124	129	135	138
Power (Import based)	20	21	29	38	48	56
Other imports	48	58	66	72	78	85
Total demand (A)	582	671	756	854	952	1,045
Coal production:						
Coal India	415	423	461	479	499	519
SCCL	49	51	53	55	58	60
Captive	35	39	45	49	57	77
Others	13	13	14	14	14	14
Apparent imports	68	79	95	110	126	142
Total production (B)	583	608	670	710	755	813
Gap based on domestic quality (B-A)	1	(63)	(87)	(144)	(197)	(232)

Source: Planning Commission of India, Daiwa forecasts (India power sector team)
Note: assuming a 75% PLF

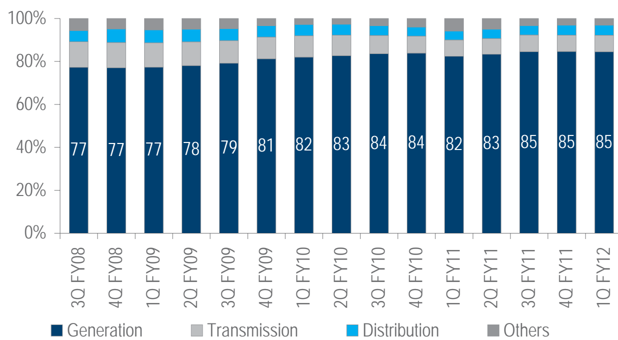
In addition, the Government of India's recent appointment of a new Minister for the Environment has raised expectations that environmental clearances for mines will be speeded up. Also, there is frequent discussion now about the appointment of a coal regulator along the lines of the power-sector regulator, which we believe should augur well for the availability of coal for power-generation companies in the future.

Loans to power-generation companies comprised almost 85% of PFC's loan book as at end of June 2011. Positive news flow about the availability of fuel should boost the outlook for PFC, in our view. We are not overly concerned about PFC's exposure to power-generation companies, since the majority of the power generators to which PFC lends belong to the government (either central or state). We believe that the government is likely to support these companies if they encounter problems of fuel availability.

Exposure to power-distribution companies low at 5% of total loans

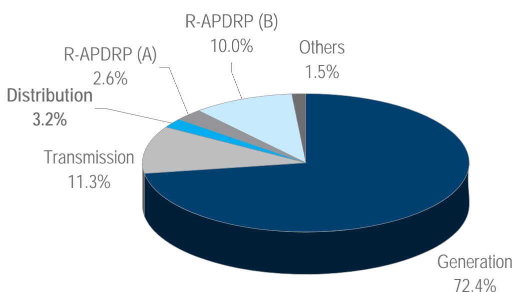
We note that PFC has been financing more projects for power generation than for transmission and distribution projects. In fact, its proportion of loans to distribution companies has declined over the past three years. PFC's total exposure to distribution companies amounted to 5% of its loan book as at the end of June 2011. We believe the share of loans to distribution companies is unlikely to increase substantially even on an incremental basis, as loans authorised to these companies comprised only around 2% of PFC's total loans authorised as at 30 June 2011.

■ PFC: loan mix (%)



Source: Company

■ PFC: mix of outstanding loans authorised (%, June 2011)

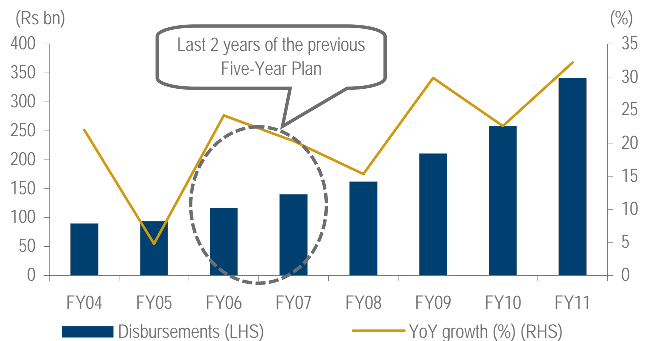


Source: Company

Loan disbursals should remain strong

During the government's previous *Five-Year Plan* (FY03-07), PFC benefitted from the last two years of the plan in terms of an increase in its loan disbursals. FY11 and FY12 are the last two years of the current *Five-Year Plan.* We expect the government to step up its investments in the power sector toward the end of this plan period. PFC recorded a high 32% YoY increase in loan disbursements already for FY11, and we expect the pace of loan disbursals to remain strong going forward, driving a CAGR of 20% in the company's loans over FY11-13.

■ PFC: loan-disbursement record

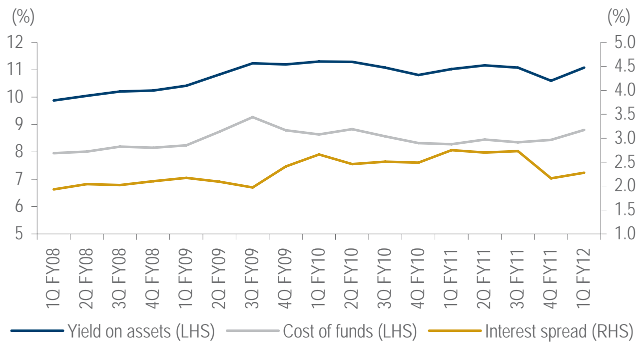


Source: Company

Interest-spread pressure likely in FY12, yet we forecast strong NII growth exceeding 20% YoY

We believe the cost of funds is likely to rise in the next few months, which could exert some pressure on PFC's interest spread in FY12 and we factor in around 30bps YoY fall in its interest spread for FY12. However, we still forecast its NII to rise by more than 20% YoY for FY12, as the positive impact of the equity-capital raising in the first quarter should be visible this year. To match loan growth of around 20% YoY, PFC would need to increase its borrowings at a lower pace, as the capital raised will also help it fund additional loan growth. This should help the company increase its NII at a high rate of more than 20% YoY for FY12 despite interest-spread compression, in our view.

■ PFC: yields, cost of funds and interest spread (%)



Source: Company

Recent restructuring of liabilities should reduce possible asset-liability mismatch

In FY11, PFC moved around 30% of its borrowings from fixed rates to floating rates. The company did this because a large portion (around 70%) of its loan book has a three-year reset clause, and also around 10-12% of its loan portfolio matures every year. Hence, around 30% of its loan book effectively comes up for repricing each year. As such, after this restructuring, PFC has improved its asset-liability management substantially and has brought considerable stability to its NIM and interest-spread management, in our view.

Overseas borrowings: PFC's overseas borrowings of Rs49.6bn comprised 6% of its total borrowings as at June 2011. The company raised US$240m in 3Q FY11 and an additional US$260m in 4Q FY11. Most of these funds are borrowed for long maturities and the company's policy is to keep a significant portion of its overseas borrowings unhedged. The cost of its overseas funds (unhedged) is significantly lower than the overall cost of funds, with a cost differential of around 450bps . Since almost 85% of PFC's overseas borrowings are unhedged, we expect the cost of its overseas borrowings to remain low. However, its overseas borrowings do expose PFC to movements in foreign-exchange rates.

In FY12, PFC plans to borrow between US$500m and US$1bn from overseas markets. We believe the incremental cost of funds could be 50-100bps lower compared with what it would have been if the company did not carry out overseas borrowings, and should support its interest spreads to some extent.

Tax-free bonds: the government has promised to allow PFC to raise Rs50bn as tax-free bonds and we believe these bonds should be issued in FY12. This will help PFC to bring down further its incremental cost of funds.

Current valuations overlook improvement in liquidity and loan/earnings-growth prospects

We believe the market is overly concerned about the scarcity of coal for power-generation companies and rising losses for power-distribution companies. High interest rates have also given rise to concerns in the market about the company's NIM and interest-spread compression, and to fears of a slowdown in announcements of fresh power-sector projects.

We believe the market is overlooking the positive steps taken by the government so far, like the relaxation of the Comprehensive Environmental Pollution Index (CEPI) (the index of India's Environment Ministry, under which clearances for mines are given by the government), the recent cabinet reshuffle, and forcing the state power regulators to put through tariff hikes.

In addition, given that PFC has unrealised loan approvals of around Rs1.7tn, which can be disbursed over a fairly long period, we believe that it does not face an immediate slowdown in fresh loan disbursals as loan demand will continue from the ongoing power projects that are in various phases of completion. Hence, we forecast PFC's loan growth to remain strong at around 20% YoY for FY12, leading to a net-profit increase of almost 20% YoY for the year. We forecast the company's ROE to come down to around 18% for FY12 from about 20% for FY11, due largely to the equity dilution in 1Q FY12. However, we believe an ROE of around 18% is still good enough to value the stock at a PBR of 1.7x on our FY12 BVPS forecast, representing the PBR now derived from our Gordon Growth Model (compared with a 2.5x PBR obtained from our previous model).

We have lowered our six-month target price by almost 28% to Rs280 (from Rs391), on account of the headwinds from the current high-interest-rate environment and to factor in the impact of the equity dilution following the capital raising in 1Q FY12. However, after the recent share-price correction and based on our new target price, we still see around 56% upside potential from the current share price. As such, we maintain our Buy (1) rating on the stock.

■ PFC: one-year forward PBR (x)

Source: Bloomberg, Daiwa forecasts

■ PFC: one-year forward PER (x)

Source: Bloomberg, Daiwa forecasts

Risks

Lower loan disbursals than we expect, along with payment defaults by SEBs, are the key risks to our target price and rating on PFC.

1Q FY12 results: analyst conference-call highlights

- At the analyst call, management said that it has received approval to raise Rs50bn through tax-free bonds for FY12. It has also received approval to raise an additional Rs69bn through infrastructure bonds. However, raising such high amount through infrastructure bonds will be difficult, in our opinion, as the individual size of investing in such bonds is only Rs20,000. Last year, PFC tried to raise Rs50bn through infrastructure bonds, but ended up raising a very small amount. We, however, believe that raising Rs50bn through tax-free bonds will be easier and will help PFC to protect its interest spread and NIMs.
- PFC also explained why the interest spread had fallen sharply for 1Q FY12 to 2.28% from 2.65% for 1Q FY11. Around Rs230bn (27% of total borrowings) of PFC borrowings from banks are linked to base-rate or prime lending rates (PLR) and hence get re-priced upwards as soon as the banks raise their lending rates. However, PFC's assets, which come for re-pricing (around 20-25% of loans get re-priced in a year) get re-priced with a one-quarter lag as there is a fixed date every quarter, when re-pricing happens. Hence, there is a timing lag of around a quarter between re-pricing of borrowings and assets. This is seen as one of the reasons for the compression in the interest spread. The positive impact of a 50bps hike in lending rates by PFC in May will become effective from July 2011 onwards and, hence, should positively impact the NIM.
- PFC's total asset duration stood at 6.32 years and its total liability duration stood at 5.64 years at the end of June 2011. The pure liquidity gap between the maturity of assets and liabilities was only Rs20bn as of June 2011 and is quite small compared with PFC's balance-sheet size of Rs1.09tn.
- On the issue relating to coal-linkages, PFC said that it is not such a big issue as it is made out to be and management does not see any such issue with its forthcoming projects regarding the availability of coal, except for one private project of 700MW which may face some difficulty in getting the full amount of coal. On the coal-linkage front, management said that people have not understood properly the issues regarding the availability of coal for power projects. Earlier the commitment of coal supply from Coal India Limited (CIL) (COAL IN, Rs388, Outperform [2]) was around 70% of the 85% plant-load factor (PLF), which would work out to around 60% of the total field requirement. Against that commitment, CIL is now giving around 50% of the total coal requirement. Also, management feels that agreements are not getting signed because private developers feel that once they sign an agreement, they will lose the right to ask CIL to supply more. Hence, management feels that if the developers are able to import the 10% balance of the coal, there will not be a major issue of any loan default arising from this front.
- PFC has also clarified on the two loan accounts which are currently facing problems. One is the Maheshwar hydro-power project, where PFC's exposure is around Rs7bn. The project was set to be commissioned by November/December of this fiscal year. However, due to issues relating to environmental clearance, the project has been delayed. According to management, the environment ministry has now already given the green light to go ahead and commission the units. The promoter now has to arrange around Rs3bn, for which PFC has also involved The Industrial Finance Corporation of India (IFCI) (Not rated) to help the

promoter to bring in the required equity capital. The company has given the promoters around 45 days time to arrange for the equity capital amount. Management feels that once the promoter is able to arrange the financing, the project will move towards the commissioning stage and once the project starts generating revenue, then it will be easy to fund the remaining units of the projects.

- The other project which is facing problems is a wind-based project where PFC's exposure is around Rs2.3bn. PFC has already treated this account as an NPL in 4Q FY11 and has also provided 10% of the loan amount as provisions for bad loans. The project was delayed by 6-8 months, which is why the interest during construction (INDCO) has gone up. The project is already generating revenue and hence the servicing of loans will not be a problem for the power developer. However, under the RBI guidelines it has to remain a NPL for the next year.
- On losses of the State Electricity Boards (SEB), PFC said that it does not see any signs of defaults from any states so far. For Tamil Nadu (TN), which is considered to be a problem state as far as the SEBs' power-related losses are concerned and where PFC has a loan exposure of Rs50bn, management said that TN imports around 64% of its power requirements from other states and the state cannot afford to default on the suppliers or the lenders as in that case, almost the entire state could find itself without power, which no government in any state can afford. Hence, management believes that the recent statement of the TN's Chief Minister was that cumulative losses of SEBs are so much that unless the state governments provide support, the SEBs will have difficulty making payments to lenders and suppliers, is more of a political statement.
- Management also clarified that PFC was not a part of the 2000-01 restructuring exercise done to reduce the burden of interest payments by SEBs and it never faced any problems related to restructuring of its loans to SEBs.
- Management also said that it may not have to do the 25bps provision on its loan, as required by other NBFCs, because PFC is a government-owned company as per Section 4A, and is exempt from such provisioning requirements. Also, as a matter of conservatism, PFC has been making provisions of up to 5% of its long-term income every year and already has around 1% of its loans as reserves for bad and doubtful debt (RBDD).
- PFC is quite confident of achieving 20%+ YoY loan growth for FY12. As reiterated by management, PFC has substantial outstanding loan approvals (or loan sanctions), which are still not disbursed. As at the end of June 2011, those outstanding approvals stood at Rs1.7tn. Of these unrealised Rs1.7tn of loan approvals, around Rs809bn of approvals are those where the necessary documents have already been executed and loan disbursals have already started. Also, for another Rs253bn of loan approvals, the necessary documents are already executed but disbursals have yet to commence. Hence, around 62% of the unrealised approvals are already in the process of getting disbursed in the coming years. Hence, management is quite confident of achieving 20%+ YoY growth in its loan book for FY12 and also expects high loan growth in the coming years.
- PFC's net interest income rose by 15% YoY in 1Q FY12, driven by 22% YoY growth in its loan book. Management also explained that in 4Q FY11, the company had to reverse interest income of Rs160m relating to a loan which turned into a NPL. It also incurred issue-related expenses of Rs440m, of which expenses related to external commercial borrowings (ECB) were Rs330m and expenses related to infrastructure bonds issuance were Rs110m. These expenses and reversals of interest income affected the interest spread and, hence, the interest spread came down to 2.16% for 4Q FY11 from 2.73% for 3Q FY11. The interest spread in 1Q FY12 remained low at 2.28% as upward re-pricing of borrowings was much faster than upward re-pricing of loans. As we expect loans to be re-priced in 2Q FY12, the interest spread and NIM should see an upward movement, in our opinion.

PFC: 1Q FY12 results

	Quarter ended				
(Rs m)	Jun-11	Jun-10	% Chg	Mar-11	% Chg
Interest income	28,480	23,120	23	25,680	11
Interest expense	18,580	14,540	28	17,250	8
Net interest income	**9,900**	**8,580**	15	**8,430**	17
Other Income	350	650	(46)	80	-
Forex (losses)/ gains	(750)	(620)	-	240	-
Net income	**9,500**	**8,610**	10	**8,750**	9
Operating costs	270	10	-	300	(10)
Provisions	70	0	-	260	-
PBT	**9,160**	**8,600**	7	**8,190**	12
Tax	2,320	2,100	10	2110	10
Provisions	(20)	(30)	-	20	-
PAT	**6,860**	**6,530**	5	**6,060**	13
Balance sheet					
Loans outstanding (Rs bn)	1,041	856	22	996	4
Sanctions (Rs bn)	169	144	17	141	20
Disbursements (Rs bn)	62	81	(23)	119	(48)
Yields and margin (%)			bps		bps
Yield on assets (%)	11.08	10.95	13	10.60	48
Cost of funds (%)	8.80	8.30	50	8.44	36
Net interest margin (%)	3.85	4.06	(21)	3.48	37
Spread (%)	2.28	2.65	(37)	2.16	12
Asset quality (%)					
Gross NPAs	0.23	0.02	-	0.23	-
Net NPAs	0.2	0.01	-	0.2	-

Source: Company

Daiwa Capital Markets

Company

Diversified financials / India
2 August 2011

The 10-second briefing

Rural Electrification

RECL IN

Target price: **Rs265.00** → **Rs265.00**
Up/downside: **+27.6%**
Share price (2 Aug): **Rs207.65**

Reforms could provide a boost

- For the first time, state power ministers have agreed unanimously to bring down the SEBs' losses
- Conversion of losses into regulatory assets, not loan restructuring, should be the key solution for SEBs
- REC is heavily geared to such reforms, with more than 50% of its loan book exposed to DISCOMs, and it should be the major beneficiary

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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■ What's new

The state power ministers' recent unanimous agreement for the first time to adopt resolutions to reduce the losses of India's SEBs has given a boost to the market's expectations of reforms for the power sector, in our view. Also, contrary to widespread concerns about a potential restructuring of loans to the power sector, we believe the key solution to reducing the SEBs' losses lies in converting the losses into regulatory assets, and reducing these assets' losses through tariff hikes. Tariffs have been raised in about eight states over the past year.

■ What's the impact

With more than 50% of its loan book exposed to the power-distribution companies (DISCOMs), we believe REC is likely to benefit from power-sector reforms.

While the current scenario of high SEB losses looks unsustainable to us over the long term, and further tariff hikes will have to be implemented to prevent the SEBs from defaulting on their borrowing from power-finance companies, we believe many state governments, which have seen their fiscal performances improve in FY11, will not let these SEBs default on interest payments in the near term. The fiscal deficits of some of the large states, like Maharashtra, Uttar Pradesh and Rajasthan, improved in FY11 compared with FY10. However, states like Tamil Nadu saw their fiscal deficits deteriorate over the period.

■ What we recommend

We maintain our Buy (1) rating and six-month target price of Rs265. The key risk to our target price is the possibility of default by a SEB which could lead to the stock being derated.

■ How we differ

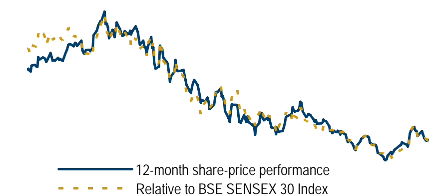
While the market is concerned about possible defaults or loan restructuring by the SEBs, we see this possibility as remote. As the states own these SEBs and give them financial assistance, the SEBs are unlikely to default, provided the fiscal performances of their respective states remain stable.

Forecast revisions (%)

Year to 31 Mar	12E	13E	14E
PPOP change	(0.2)	(0.3)	(0.2)
Net-profit change	(0.2)	(0.3)	(0.2)
EPS change	(0.2)	(0.3)	(0.2)

Source: Daiwa forecasts

Share price performance



12-month range	181.05-399.35
Market cap (US$bn)	4.65
Average daily turnover (US$m)	13.52
Shares outstanding (m)	987
Major shareholder	Government of India (66.8%)

Financial summary (Rs)

Year to 31 Mar	12E	13E	14E
Total operating income (m)	44,732	54,559	65,294
Pre-provision operating profit (m)	42,891	52,485	62,958
Net profit (m)	31,047	37,719	45,337
Core EPS (fully-diluted)	31.441	38.198	45.913
EPS change (%)	21.1	21.5	20.2
Daiwa vs Cons. EPS (%)	4	8	8
PER (x)	6.6	5.4	4.5
Dividend yield (%)	3.9	4.3	4.8
DPS	8.000	9.000	10.000
PBR (x)	1.4	1.2	1.0
ROE (%)	23.2	23.8	24.0

Source: Bloomberg, Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

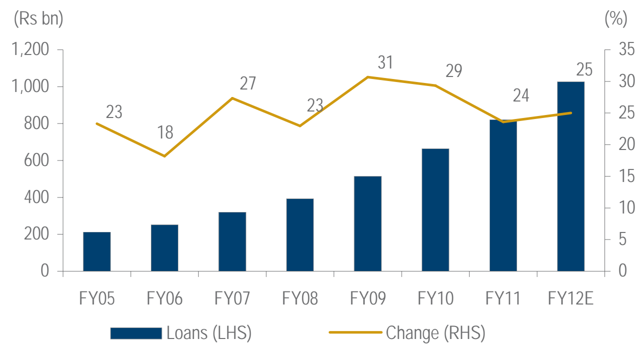
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We expect strong growth in loans and loan disbursements for REC for FY12, as FY12 is the last year of the Government of India's *11th Five-Year Plan*. Data during past plans suggests that loan growth for the power-sector financers is strong generally in the last year of the plan. While we assume a modest narrowing of REC's interest spread in FY12 on a year-on-year basis, we forecast loan-book growth of 25% YoY to drive a 21% YoY rise in the net profit. Lower loan disbursements than we expect would be one of the key risks to our call.

REC: loan growth

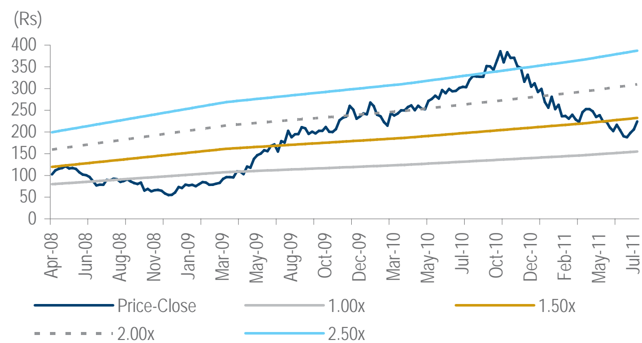


Source: Company, Daiwa forecasts

Valuation ✔✔✔✔✔

The stock is trading currently at a PBR of 1.4x, based on our FY12 BVPS forecast. We believe that the current valuations, which are close to a past-two-year low, provide limited downside risk. At the same time, we believe further delays in reforms of the power sector could lead to a derating of the stock.

REC: historical PBR bands

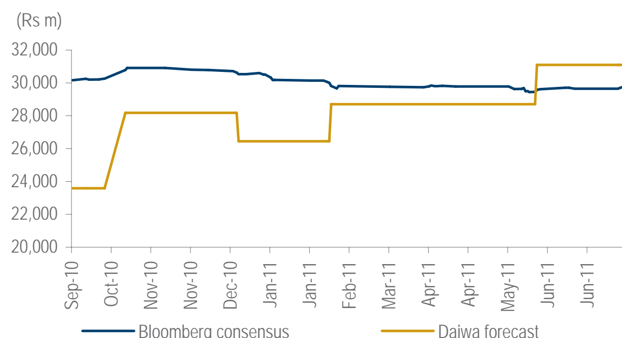


Source: Company, Daiwa forecasts

Earnings revisions ✔✔✔✔✔

We believe our 21% YoY net-profit increase forecast for FY12 is based on fairly realistic assumptions. We forecast loan growth of 25% YoY with a moderate narrowing of the interest spread.

REC: Daiwa vs. consensus net-profit forecasts (FY12E)



Source: Bloomberg, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan growth (%)	26.7%	22.5%	30.7%	29.3%	23.6%	25.0%	22.0%	22.0%

Profit and loss (Rs m)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	11,008	14,444	18,920	26,174	34,059	41,692	51,115	61,681
Net fees & commission	0	46	698	585	1,400	1,540	1,694	1,863
Trading and other income	945	192	723	1,205	984	1,500	1,750	1,750
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**11,952**	**14,682**	**20,341**	**27,964**	**36,443**	**44,732**	**54,559**	**65,294**
Personnel expenses	(501)	(927)	(872)	(1,171)	(1,275)	(1,402)	(1,570)	(1,759)
Other expenses	(155)	(198)	(238)	(298)	(399)	(439)	(504)	(577)
Total expenses	**(656)**	**(1,125)**	**(1,110)**	**(1,469)**	**(1,674)**	**(1,842)**	**(2,074)**	**(2,336)**
Pre-provision operating profit	**11,297**	**13,557**	**19,231**	**26,495**	**34,768**	**42,891**	**52,485**	**62,958**
Total provision	(211)	(400)	(34)	(2)	(2)	(924)	(1,503)	(1,681)
Operating profit after prov.	**11,086**	**13,157**	**19,197**	**26,493**	**34,766**	**41,966**	**50,982**	**61,277**
Non-operating income	0	0	0	0	0	0	0	0
Profit before tax	**11,086**	**13,157**	**19,197**	**26,493**	**34,766**	**41,966**	**50,982**	**61,277**
Tax	(3,322)	(4,532)	(6,480)	(6,478)	(9,075)	(10,919)	(13,263)	(15,940)
Min. int./pref. div./other items	(14)	0	0	0	0	0	0	0
Net profit	**7,750**	**8,625**	**12,717**	**20,015**	**25,691**	**31,047**	**37,719**	**45,337**
Adjusted net profit	**8,913**	**9,399**	**14,113**	**20,020**	**25,637**	**31,047**	**37,719**	**45,337**
EPS (Rs)	**9.928**	**10.523**	**14.811**	**21.683**	**26.017**	**31.441**	**38.198**	**45.913**
EPS (adjusted) (Rs)	**11.418**	**11.468**	**16.437**	**21.689**	**25.963**	**31.441**	**38.198**	**45.913**
EPS (adjusted fully-diluted) (Rs)	**11.418**	**11.468**	**16.437**	**21.689**	**25.963**	**31.441**	**38.198**	**45.913**
DPS (Rs)	**2.270**	**3.000**	**4.500**	**6.500**	**7.500**	**8.000**	**9.000**	**10.000**

Change (YoY %)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	26.3	31.2	31.0	38.3	30.1	22.4	22.6	20.7
Non-interest income	(57.3)	(74.8)	496.9	26.0	33.2	27.5	13.3	4.9
Total operating income	9.4	22.8	38.5	37.5	30.3	22.7	22.0	19.7
Total expenses	35.1	71.6	(1.3)	32.4	13.9	10.0	12.6	12.6
Pre-provision operating profit	8.2	20.0	41.9	37.8	31.2	23.4	22.4	20.0
Total provisions	n.m.	90.0	(91.4)	(93.6)	0.0	n.m.	62.7	11.8
Operating profit after provisions	6.2	18.7	45.9	38.0	31.2	20.7	21.5	20.2
Profit before tax	6.2	18.7	45.9	38.0	31.2	20.7	21.5	20.2
Net profit (adjusted)	0.9	5.5	50.2	41.9	28.1	21.1	21.5	20.2
EPS (adjusted)	0.9	0.4	43.3	32.0	19.7	21.1	21.5	20.2
Gross loans	26.2	22.1	30.6	29.2	23.6	25.0	22.0	22.1
Deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	21.0	18.5	30.4	24.2	24.4	23.6	22.1	21.4
Total liabilities	22.1	16.8	32.9	19.8	26.1	24.6	22.6	21.6
Shareholders' equity	13.3	30.3	14.9	56.1	15.6	17.8	18.9	19.7
Avg interest-earning assets	23.0	20.5	24.2	28.2	25.6	24.1	22.4	21.6
Avg risk-weighted assets	22.2	24.4	27.0	29.9	11.4	14.6	29.7	24.2

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & equivalent	22,973	12,530	18,860	13,903	28,319	24,071	26,478	29,126
Investment securities	11,945	11,473	10,049	9,099	8,124	8,531	8,957	9,405
Net loans and advances	320,991	393,165	513,814	664,526	821,321	1,026,651	1,252,514	1,528,067
Fixed assets	554	703	566	671	881	905	1,023	1,155
Goodwill	0	0	0	0	0	0	0	0
Other assets	3,514	8,663	12,837	2,648	1,103	2,409	8,779	7,485
Total assets	**359,977**	**426,534**	**556,127**	**690,847**	**859,748**	**1,062,566**	**1,297,750**	**1,575,238**
Customers deposits	0	0	0	0	0	0	0	0
Borrowing	302,810	342,828	449,360	559,482	700,038	866,544	1,065,140	1,297,729
Debentures	0	0	0	0	0	0	0	0
Other liabilities	11,700	24,478	38,737	25,149	36,976	51,485	60,752	71,867
Total liabilities	**314,510**	**367,306**	**488,097**	**584,631**	**737,014**	**918,028**	**1,125,892**	**1,369,596**
Share capital	7,806	8,586	8,587	9,875	9,875	9,875	9,875	9,875
Reserves & others	37,661	50,642	59,444	96,341	112,859	134,664	161,984	195,768
Shareholders' equity	**45,467**	**59,228**	**68,031**	**106,216**	**122,734**	**144,538**	**171,859**	**205,642**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**359,977**	**426,534**	**556,127**	**690,847**	**859,748**	**1,062,566**	**1,297,750**	**1,575,238**
Avg interest-earning assets	320,776	386,539	479,946	615,126	772,646	958,508	1,173,601	1,427,273
Avg risk-weighted assets	287,124	357,078	453,490	589,170	656,568	752,319	976,004	1,212,586
BVPS (Rs)	58.25	68.98	79.23	107.56	124.29	146.37	174.04	208.25

Key ratios (%)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan/deposit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tier-1 CAR	14.2	15.1	13.2	16.0	18.5	16.9	15.7	15.5
Total CAR	14.2	15.1	13.2	16.0	18.5	16.9	15.7	15.5
NPLs/gross loans	2.3	0.8	0.1	0.0	0.0	0.0	0.0	0.1
Total loan-loss prov./NPLs	22.3	22.9	69.5	89.8	90.0	80.0	80.0	90.0
ROAA	2.7	2.4	2.9	3.2	3.3	3.2	3.2	3.2
ROAE	20.8	18.0	22.2	23.0	22.4	23.2	23.8	24.0
Net-interest margin	3.4	3.7	3.9	4.3	4.4	4.3	4.4	4.3
Gross yield	8.8	9.1	10.0	10.6	10.7	11.3	11.3	11.2
Cost of funds	6.4	6.4	7.3	7.8	7.7	8.6	8.4	8.3
Net-interest spread	2.5	2.7	2.7	2.9	3.0	2.8	2.9	2.9
Total cost/total income	5.5	7.7	5.5	5.3	4.6	4.1	3.8	3.6
Effective tax	30.0	34.4	33.8	24.5	26.1	26.0	26.0	26.0
Dividend-payout	22.9	28.5	30.4	30.0	28.8	25.4	23.6	21.8

Source: Company, Daiwa forecasts

Company profile

Rural Electrification Corporation was incorporated in 1969 and was conferred with the status of Nav-Ratna public sector unit by the government in 2008.It is a leading power finance company in India with a balance sheet size of Rs 859.7bn as at the end of March 2011.

Reforms could provide a boost

We believe that converting the SEBs' losses into regulatory assets is the only plausible long-term solution

Restructuring the loans of any state DISCOMs is not the solution, as it will send the others the wrong message

Although the market is concerned about the possible large-scale restructuring of some states' DISCOM loans to avoid the DISCOMS from defaulting on their borrowings, **we believe that converting the SEBs' losses into regulatory assets, and then reducing these assets' losses by implementing small tariff hikes on a regular basis, is the only plausible long-term solution.** The state power ministers' recent meeting has led to a breakthrough, whereby they reached a unanimous decision to adopt resolutions to reduce the lossed of India's SEBs.

A few months ago, Madhya Pradesh, one of the states facing high power-distribution losses, set a good example by raising the consumer power tariffs by 10%, which should, according to power sector experts, bring down the combined current losses of the SEB in the state by almost Rs20bn.

While the financial performances of the SEBs are deteriorating, the fiscal performances of many states are improving

While there have been concerns in the market regarding the financial health of the SEBs and the subsequent impact on the asset quality of the power financers, issues relating to the poor health of the state-owned power-distribution companies and scarcity of coal for power-generation projects have exacerbated these issues, in our opinion.

While none of the states have defaulted on their loan repayments, REC's management said that certain states in the north east of the country have been facing temporary cash problems. SEBs in the states of Tamil Nadu, Uttar Pradesh, Madhya Pradesh, Punjab and Rajasthan are facing financial problems. There are, however, no signs of a possible default on interest payments by these states.

Also, as a measure to strengthen the credit worthiness of these SEBs, loans granted to them by REC and other financial institutions are either guaranteed by the respective state government or include an escrow mechanism that will provide a first charge on the revenue of these SEBs. While it is difficult to check the balance sheets of these state power-distribution companies for their credit-worthiness, most financial institutions rely on an escrow mechanism, which assures them that the borrower has sufficient cash flow to pay to the lender, even if the borrower is making operating or cash losses.

If we look at REC's loan exposure across the country, of the five states where it has considerable exposure, Maharashtra's SEB is not facing any major financial problems.

However, SEBs in other states, such as Tamil Nadu, Uttar Pradesh, Rajasthan, and Punjab, are facing severe financial problems. Nevertheless, the fiscal performances of these states (except for Tamil Nadu) are improving, and we believe that as long as the fiscal conditions of these states are strong, they will not allow their respective SEBs to default on their interest payments to REC. The following table shows REC's loan exposure to the SEBs in some of the large states. The fiscal deficits for most states appear to be under control, improving for FY11 compared with FY10.

■ REC's exposure and states' fiscal deficits

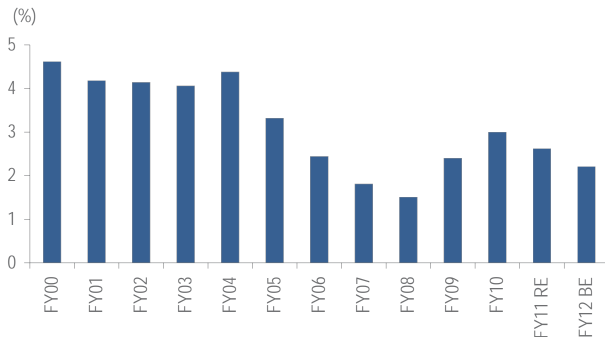
States	REC's exposure (Rs bn)	As a % of REC's total loans	Fiscal deficit		Debt/GDP	
			FY10	FY11	FY10	FY11
Maharashtra	127	16	3.7	2.4	20	20
Tamil Nadu	110	13	3.4	4.2	25	20
Rajasthan	89	11	4.5	2.5	41	n.a.
Uttar Pradesh	62	8	4.9	4.4	36	n.a.
Punjab	55	7	3.4	3.4	34	30

Source: Company, RBI, state governments

Also, as shown in the following chart, the combined fiscal deficit of all of the states in India improved for FY11, compared with FY10, and is set to improve further for FY12, based on estimates by the Planning Commission of India.

According to the *Economic Survey FY11*, the SEBs combined FY11 losses are estimated to be equivalent to 1% of GDP. However, the combined fiscal deficit of all of the state governments is estimated to have fallen to 2.6% for FY11, from about 3% for FY10. Hence, if we look at the financial performances of the SEBs on the back of the fiscal performances of the state governments, the situation does not look that grim.

Combined fiscal deficit for all states (%)



Source: Planning Commission
Note: RE = revised estimate and BE = budget estimate

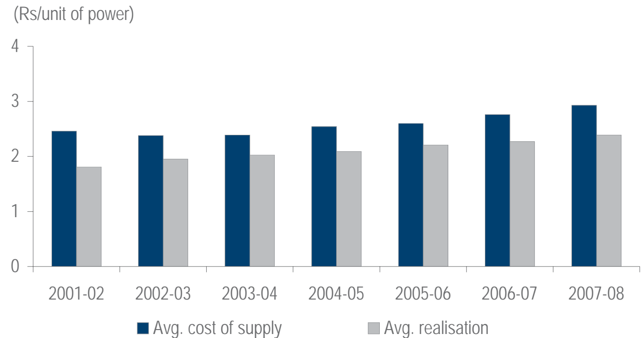
One way to improve the financial performances of the SEBs is to increase power tariffs. Many states have not increased power tariffs for more than five years, even though the cost of purchasing power is rising. However, this is changing slowly, and some states, like Uttar Pradesh and Rajasthan, have raised power tariffs over the past 6-12 months.

Shunglu Committee recommendations could lead to further tariff hikes, a key share-price catalyst for the stock over the medium term

According to recent media reports, the Shunglu Committee, appointed by the Government of India to suggest ways to improve the financial performances of the SEBs, is of the view that the state power regulators that have not performed should be removed from their positions. As power is an area that is governed by the individual states, each state appoints its own power regulator.

Some state utilities have not only failed to hike tariffs over the past several years, but have also failed to audit their financial accounts. To meet the increasing gap between power revenue and the cost of power supply, states will have to increase power tariffs, according to the committee's recommendations.

Average tariff rate vs. cost of power purchases in India



Source: Central Electricity Authority

Some states, like Uttar Pradesh and Rajasthan, which have also not increased their tariffs for a long time, have started to raise tariffs, finally. Other states could also follow suit, although the quantum of tariff hikes could be small. Implementing the suggestions made by the committee could take time and political will. In our opinion, while a reduction in transmission and distribution (T&D) losses could provide some relief, the long-term solution lies in raising tariff rates in line with the rise in the cost of power purchased by the power-distribution companies.

Pressure on the interest spread unlikely to be more than 20bps for FY12

Given REC's asset-liability profile and its ability to raise funds from overseas and via capital-gain bonds, we forecast a narrowing in its FY12 interest spread of not more than 20bps.

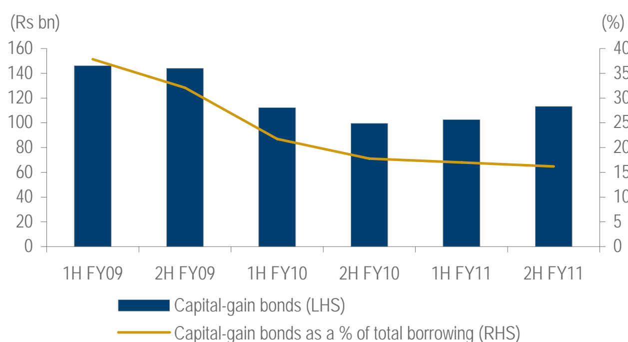
REC's interest spread narrowed by 24bps QoQ to 3.2% for 4Q FY11, driven by a fall in the yield on loans (YOL), which dropped to less than 11% (10.96%), even as the cost of borrowing was flat on a quarter-on-quarter basis. Management attributed the drop in the YOL to the repayment of certain high-yielding loans during the quarter.

Management has clarified that the drop was only temporary and that the YOL rebounded to about 11.6% in May 2011. We expect REC's YOL to improve over the next few quarters as the impact of the rise in lending rates starts to be reflected in yields. REC has become aggressive in passing on interest-cost pressure by increasing its lending rates twice over the past two months (by 100bps in total – 50bps each in April 2011 and May 2011).

Despite the rising interest-rate environment, REC's cost of funds dropped by 4bps QoQ for 4Q FY11. This was largely contributed to by low-cost borrowing from the overseas market and also by raising a high amount of capital-gain bonds (54EC bonds).

The total amount raised from capital-gain bonds for 4Q FY11 rose substantially from Rs11.16bn for 3Q FY11 to Rs19.11 for 4Q FY11. This has also been one of the key factors in keeping REC's cost of borrowing low.

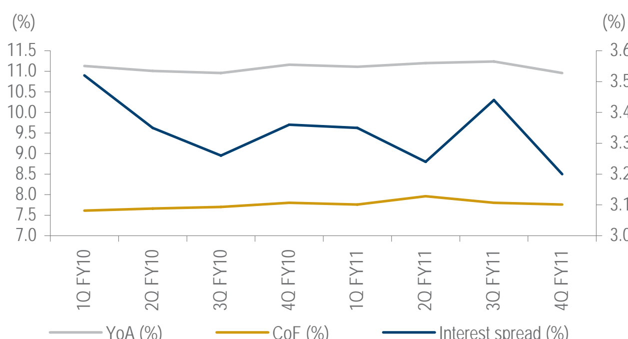
■ **REC: funds raised through capital-gain bonds**



Source: Company

REC raised Rs33bn (US$750m) in foreign-currency borrowing, at a cost of 3.44%, which also contributed to the slight drop in its incremental cost of funds. The company plans to raise about 24% of its total borrowing for FY12 from the overseas market, and has applied to the RBI to raise US$1.5bn through overseas bond offerings. We believe this should ease some pressure on the cost of funds and support the company's interest spread.

■ **REC: yields, cost and spread changes**



Source: Company

REC's asset-liability duration profile looks to be in its favour, as management expects almost Rs129bn of loans to come up for repricing in FY12, as against Rs96.6bn worth of borrowing, as conveyed by management during the recent analyst call.

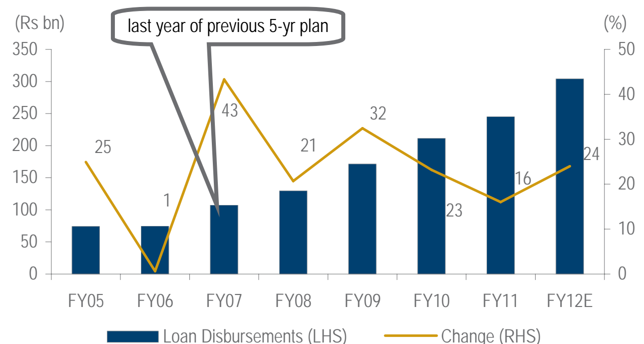
Currently, REC is lending to government utilities at about 12% and to the private sector at about 13%. With the increase in lending rates, we believe the pressure witnessed on loan repricing during 4Q FY11 is unlikely to be repeated in FY12.

In our view, REC should be able to minimise the pressure on its interest spread, and in the worst-case scenario, it may face a 20bp decline for FY12. Any sign of a reversal in the interest-rate cycle would be a big positive for the company's interest spread and NIM, in our view.

Loan disbursements likely to improve for FY12 – the last year of India's current *Five-Year Plan*

FY11 was a year of relatively low loan-disbursement growth. Loan disbursements rose by only 16% YoY for FY11, after witnessing average growth of 25% YoY for the past three years – loan growth tends to pick up in the last year of any five-year plan, based on our observations.

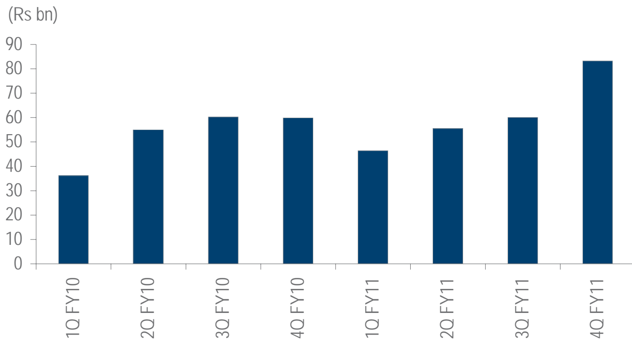
■ **REC: annual loan disbursements**



Source: Company, Daiwa forecasts

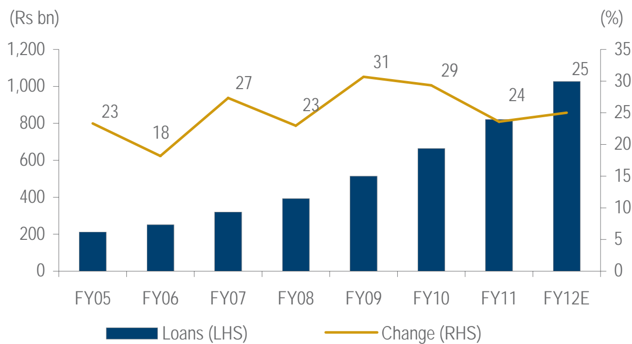
REC's loan disbursements, which remained sluggish until 9M FY11, rising by a mere 7% YoY, witnessed a remarkable improvement for 4Q FY11, pushing up loan-disbursement growth for FY11 to 16% YoY. We expect loan disbursements to remain strong for FY12, leading to loan-book growth of 25% YoY for FY12.

▪ **REC: loan disbursements**



Source: Company

▪ **REC: loans**



Source: Company, Daiwa forecasts

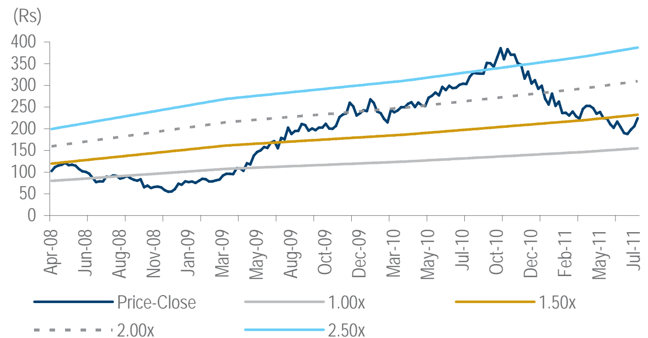
Current valuations seem to discount most concerns

There have been fears in the market of NIM compression for FY12 and the possibility that the SEBs will default on their borrowings from REC due to their poor financial performances. Furthermore, we believe the country's monetary-tightening policy, along with the overhang of PFC's follow-on-public offering (FPO), contributed to REC's share-price correction, as PFC is in the same business as REC, and there was seemingly an oversupply of PFC's stock (post-FPO) at a time when general market sentiment was poor.

In our opinion, while the concerns in the market regarding the power sector (ie, the SEBs and coal linkages) may take some time to abate, REC's current valuations seem to be pricing in these concerns. We believe that if REC is able to show loan growth with a stable interest spread over the next two quarters, its valuations should improve.

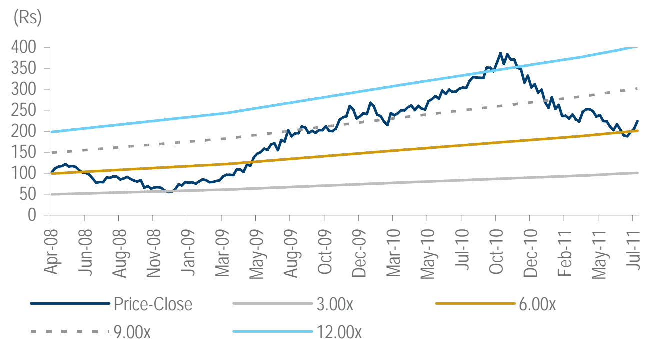
In our view, while the power-sector issues may take time to resolve, the peaking of the interest-rate cycle could alone provide a 25-30% return on the stock. The stock's current FY12E PBR of 1.4x is almost at a two-year low. We maintain our Buy (1) rating and Gordon Growth Model-derived six-month target price of RS265.00, implying an FY12E target PBR of 1.8x.

▪ **REC: PBR bands**



Source: Daiwa

▪ **REC: PER bands**



Source: Daiwa

Risk

The key risk to our target price and rating is the possibility of a default by any SEB, which could lead to the stock being derated.

Daiwa Capital Markets

Company

Diversified financials / India
2 August 2011

The 10-second briefing

Infrastructure Development Finance
IDFC IN

Target price: **Rs190.00 → Rs158.00**
Up/downside: **+25.8%**
Share price (2 Aug): **Rs125.60**

Lending spread close to bottoming out

- We have revised down our FY12 earnings forecast by 7% as management guides for a slowdown in loan growth
- Most of the lending-spread compression is over: we forecast no more than a 10-15bp contraction for FY12
- Target price lowered by 17%; maintain Buy rating as loan-growth slowdown is temporary and valuations attractive

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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What's new
While there has been a slowdown in fresh-loan approvals, the number of infrastructure projects currently being implemented is high and could be sufficient for loan disbursements over the next 3-6 months. However, as per management's guidance, we have revised down our loan-growth forecast to 15% YoY for FY12.

What's the impact
The company saw its lending spread contract by 50bps YoY for FY11. Most of the spread compression is over, in our view, and we forecast it to contract by no more than 10-15bps YoY for FY12. We forecast IDFC's low leveraging of less than 5x to result in an ROE of only 13.0% for FY12, rising to 13.4% for FY13. The consolidated ROE is low as about 26% of the company's net worth is invested in non-interest-bearing assets. Excluding non-interest-bearing assets, we forecast IDFC's lending ROE to average about 16.7% for FY12-13.

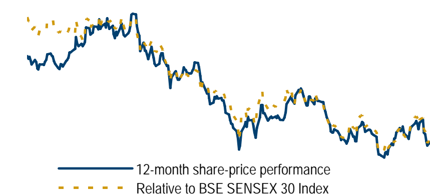
What we recommend
We believe infrastructure continues to offer huge loan-demand potential in India, and that IDFC will continue to benefit from this in terms of high loan growth over the next 2-3 years. We forecast lending EPS to increase at a CAGR of 17% over FY11-13. As about 26% of the company's net worth is invested in non-interest-bearing assets, we assign a value of Rs32/share to those investments. For FY12, we forecast a lending EPS and BVPS of Rs9.3 and Rs63, respectively. Hence after assigning a PBR of 2.0x on our FY12 forecasts and adding Rs32/share for the value of its investments, we arrive at our six-month target price of Rs158. We believe any signs of interest rates peaking will trigger a rerating of the stock.

How we differ
The market is concerned about the low ROE of the company and hence assigns a low PBR to the stock currently. However, we believe it should not be valued on a consolidated ROE basis or on a consolidated book-value basis. In our view, only the lending business should be valued on a PBR basis, and the other businesses, such as asset management and securities, should be valued based on other metrics. The lending ROE is much higher than the consolidated ROE, and we forecast it to average about 16.7% for FY12-13: hence, we estimate the lending book value should be about 2.0x once interest rates start to peak.

Forecast revisions (%)

Year to 31 Mar	12E	13E	14E
PPOP change	(6.8)	(10.3)	n.a.
Net-profit change	(6.5)	(11.5)	n.a.
EPS change	(8.0)	(14.4)	n.a.

Source: Daiwa forecasts



12-month range	118.00-215.55
Market cap (US$bn)	4.30
Average daily turnover (US$m)	26.03
Shares outstanding (m)	1,509
Major shareholder	Government of India (17.9%)

Source: Bloomberg, Daiwa

Financial summary (Rs)

Year to 31 Mar	12E	13E	14E
Total operating income (m)	27,154	32,743	38,194
Pre-provision operating profit (m)	21,843	26,654	31,176
Net profit (m)	14,739	17,411	20,757
Core EPS (fully-diluted)	9.926	11.541	13.759
EPS change (%)	6.9	16.3	19.2
Daiwa vs Cons. EPS (%)	(4)	(4)	2
PER (x)	12.7	10.9	9.1
Dividend yield (%)	1.6	1.6	1.6
DPS	2.000	2.000	2.000
PBR (x)	1.5	1.4	1.2
ROE (%)	13.0	13.4	14.4

Source: Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

- **Buy** (unchanged)
- Outperform
- Hold
- Underperform
- Sell

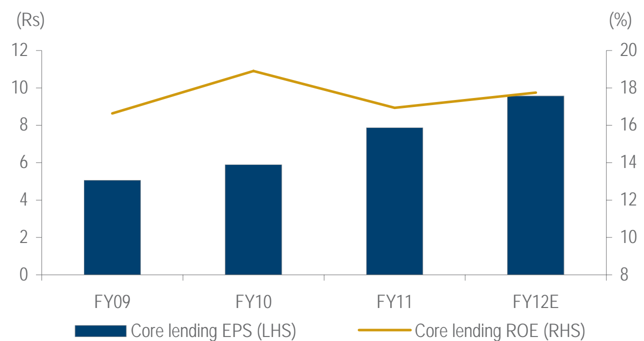
How do we justify our view?

- Growth outlook ✔ ✔ ✔ ✔ ✔
- Valuation ✔ ✔ ✔ ✔ ✔
- Earnings revisions ✔ ✔ ✔ ✔ ✔

Growth outlook

We expect the loan growth to slow for FY12 on account of high interest rates. Despite this, we forecast consolidated net profit to increase by 15% for FY12, driven by a relatively stable lending spread and loan growth of around 15% YoY. Meanwhile, we forecast IDFC's core mortgage ROE to improve from 16.9% for FY11 to 17.3% for FY12.

IDFC: earnings



Source: Daiwa forecasts

Valuation

For FY12, we forecast a lending EPS and book value of Rs9.3 and Rs63, respectively. Based on our Gordon Growth Model, we have assigned a PBR of 2.0x and a PER of about 13.5x on our FY12 forecasts. After adding Rs32/share for the value of its investments, we arrive at our six-month target price of Rs158.

IDFC: SOTP valuation

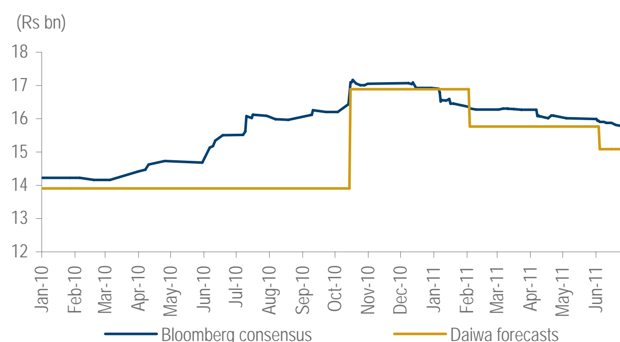
	At cost (Rs m)	Estimated value (Rs m)	Per-share value for IDFC	Note
NSE stake	925	7,400	5	Considering recent transaction valuations
Value of private-equity business	90	7,200	5	7% of AUM
Value of IDFC Mutual Fund	8,142	8,000	5	4% of AUM
Value of IDFC Securities	3,301	6,534	4	10x FY12E earnings
Value of IDFC's investments in private-equity funds	3,000	6,000	4	At almost 2x its cost
Other investments (ARCIL, Athena, L&T Infra, STCI)	8,956	13,434	9	Valued at about double the cost of investments
Total value	24,414	48,568	32	-
Value of the core business at 2x FY12E lending book value		190,108	126	-
Total value of IDFC		238,676	158	-

Source: Daiwa estimates

Earnings revisions

We have revised down our net-profit-growth forecast for FY12 by about 4% following a downward revision to our loan-growth forecast to 20-25%, compared with about 30% previously.

IDFC: FY12E consolidated net profit



Source: Bloomberg, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan growth (%)	38.0%	43.0%	3.5%	21.5%	50.4%	15.0%	25.0%	24.0%

Profit and loss (Rs m)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	4,283	6,940	9,225	11,164	16,447	19,794	24,109	28,283
Net fees & commission	800	1,590	1,110	1,440	1,940	1,959	2,155	2,371
Trading and other income	2,070	4,710	5,222	8,460	7,070	5,400	6,479	7,540
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**7,153**	**13,240**	**15,557**	**21,064**	**25,457**	**27,154**	**32,743**	**38,194**
Personnel expenses	(480)	(1,677)	(1,773)	(3,072)	(2,956)	(2,808)	(3,370)	(4,044)
Other expenses	(340)	(863)	(1,893)	(2,410)	(2,365)	(2,503)	(2,719)	(2,975)
Total expenses	**(820)**	**(2,540)**	**(3,666)**	**(5,482)**	**(5,320)**	**(5,311)**	**(6,089)**	**(7,018)**
Pre-provision operating profit	**6,333**	**10,700**	**11,892**	**15,582**	**20,136**	**21,843**	**26,654**	**31,176**
Total provision	(175)	(700)	(1,532)	(1,298)	(2,346)	(2,250)	(3,450)	(3,450)
Operating profit after prov.	**6,158**	**10,000**	**10,360**	**14,284**	**17,790**	**19,593**	**23,204**	**27,726**
Non-operating income	0	0	0	0	0	0	0	0
Profit before tax	**6,158**	**10,000**	**10,360**	**14,284**	**17,790**	**19,593**	**23,204**	**27,726**
Tax	(1,241)	(2,480)	(2,782)	(3,666)	(4,998)	(4,794)	(5,733)	(6,909)
Min. int./pref. div./other items	120	(100)	(79)	1	26	(60)	(60)	(60)
Net profit	**5,037**	**7,420**	**7,499**	**10,620**	**12,818**	**14,739**	**17,411**	**20,757**
Adjusted net profit	**5,037**	**7,420**	**7,499**	**10,620**	**12,818**	**14,739**	**17,411**	**20,757**
EPS (Rs)	**4.481**	**6.131**	**5.792**	**8.183**	**9.283**	**9.926**	**11.541**	**13.759**
EPS (adjusted) (Rs)	**4.481**	**6.131**	**5.792**	**8.183**	**9.283**	**9.926**	**11.541**	**13.759**
EPS (adjusted fully-diluted) (Rs)	**4.481**	**6.131**	**5.792**	**8.183**	**9.283**	**9.926**	**11.541**	**13.759**
DPS (Rs)	**1.000**	**1.200**	**1.200**	**1.500**	**2.000**	**2.000**	**2.000**	**2.000**

Change (YoY %)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	55.8	62.0	32.9	21.0	47.3	20.4	21.8	17.3
Non-interest income	9.9	119.5	0.5	56.3	(9.0)	(18.3)	17.3	14.8
Total operating income	33.5	85.1	17.5	35.4	20.9	6.7	20.6	16.6
Total expenses	50.3	209.7	44.3	49.6	(2.9)	(0.2)	14.6	15.3
Pre-provision operating profit	31.6	69.0	11.1	31.0	29.2	8.5	22.0	17.0
Total provisions	(54.8)	300.2	118.7	(15.3)	80.8	(4.1)	53.3	0.0
Operating profit after provisions	39.1	62.4	3.6	37.9	24.5	10.1	18.4	19.5
Profit before tax	39.1	62.4	3.6	37.9	24.5	10.1	18.4	19.5
Net profit (adjusted)	28.9	47.3	1.1	41.6	20.7	15.0	18.1	19.2
EPS (adjusted)	21.7	36.8	(5.5)	41.3	13.5	6.9	16.3	19.2
Gross loans	37.9	42.5	3.5	21.5	50.4	15.4	25.0	24.0
Deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	49.5	57.4	4.1	15.5	41.7	14.2	21.2	20.8
Total liabilities	58.7	51.1	2.6	16.1	37.0	15.4	24.2	23.1
Shareholders' equity	14.8	89.7	10.4	13.5	60.4	9.8	10.6	11.4
Avg interest-earning assets	48.2	54.9	3.6	7.2	52.7	13.9	22.9	22.3
Avg risk-weighted assets	49.5	57.4	(10.6)	25.9	37.7	15.3	21.7	21.2

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & equivalent	10,801	18,081	8,255	2,715	11,049	13,259	15,911	19,093
Investment securities	23,903	52,257	64,999	46,417	69,611	74,253	82,691	92,395
Net loans and advances	139,185	199,051	205,962	250,311	376,523	433,002	541,252	671,152
Fixed assets	490	3,850	4,543	4,415	4,469	4,916	5,408	5,948
Goodwill	969	2,943	10,789	11,694	11,638	11,638	11,638	11,638
Other assets	8,494	13,229	6,820	32,545	19,877	26,051	25,689	24,341
Total assets	**183,842**	**289,410**	**301,367**	**348,097**	**493,167**	**563,119**	**682,589**	**824,567**
Customers deposits	0	0	0	0	0	0	0	0
Borrowing	142,528	216,535	223,050	258,939	356,539	413,586	516,982	641,058
Debentures	6,500	6,500	6,500	6,500	6,500	6,500	6,500	6,500
Other liabilities	5,334	10,201	9,779	12,494	17,683	19,434	22,350	24,585
Total liabilities	**154,362**	**233,236**	**239,329**	**277,933**	**380,722**	**439,520**	**545,832**	**672,143**
Share capital	11,260	12,943	12,952	13,006	23,009	15,086	15,086	15,086
Reserves & others	18,220	42,990	48,806	57,095	89,434	108,411	121,469	137,037
Shareholders' equity	**29,480**	**55,933**	**61,758**	**70,101**	**112,443**	**123,497**	**136,555**	**152,123**
Minority interests	0	241	281	63	2	102	202	302
Total equity & liabilities	**183,842**	**289,410**	**301,367**	**348,097**	**493,167**	**563,119**	**682,589**	**824,567**
Avg interest-earning assets	173,889	269,389	279,216	299,443	457,184	520,514	639,854	782,640
Avg risk-weighted assets	199,671	314,328	280,953	353,657	487,015	561,531	683,534	828,738
BVPS (Rs)	26.18	43.21	47.68	53.90	71.22	81.86	90.52	100.83

Key ratios (%)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan/deposit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tier-1 CAR	16.1	17.8	20.0	17.4	21.9	22.0	20.0	18.4
Total CAR	20.4	23.3	23.8	20.5	24.5	27.5	25.5	23.9
NPLs/gross loans	0.5	0.2	0.4	0.3	0.2	0.5	0.5	0.5
Total loan-loss prov./NPLs	100.0	100.0	40.3	46.2	51.2	100.0	100.0	100.0
ROAA	3.3	3.1	2.5	3.3	3.0	2.8	2.8	2.8
ROAE	18.3	17.4	12.7	16.1	14.7	13.0	13.4	14.4
Net-interest margin	2.5	2.6	3.3	3.7	3.6	3.8	3.8	3.6
Gross yield	7.4	8.1	10.8	10.3	8.8	10.7	10.4	10.1
Cost of funds	5.7	6.6	9.1	7.4	6.6	8.6	8.0	7.8
Net-interest spread	1.6	1.4	1.7	2.9	2.2	2.1	2.3	2.3
Total cost/total income	11.5	19.2	23.6	26.0	20.9	19.6	18.6	18.4
Effective tax	20.2	24.8	26.8	25.7	28.1	24.5	24.7	24.9
Dividend-payout	22.3	19.6	20.7	18.3	21.5	20.1	17.3	14.5

Source: Company, Daiwa forecasts

Company profile

Infrastructure Development Finance is a leader in providing financing for long-term infrastructure projects, and also has interests in private-equity funds, asset management, and equity broking and investment banking. The company was incorporated in Chennai by a consortium of public and private investors, and was listed in August 2005. It had a balance sheet of Rs493bn (US$10.4bn) as at the end of FY11.

Lending spread close to bottoming out

Although we expect loan growth to slow for FY12, the bottoming out of interest spreads, an improvement in the ROE, and reforms in the Power Sector should help the stock undergo a rerating

We forecast the lending-business ROE to improve to about 17.3% for FY12

We forecast the ROE of IDFC's core lending operation to increase to 17.3% for FY12, up from 16.9% for FY11. The following table shows a P&L statement for the core lending business that excludes the profit from the sale of investments and income/gains on equity investments. For FY11-13, we forecast an EPS CAGR of about 17% for its core lending business, which we believe should help IDFC to enjoy a higher PBR multiple than its peers.

The company's loan growth of 50% YoY for FY11 was very high, in our view, and as such, we forecast the loan-growth rate to slow to about 15% for FY12, given the recent monetary tightening by the RBI and management guidance for lower loan growth. However, following the strong contraction in the interest spread of 50bps YoY for FY11, we forecast the contraction for FY12 to be no more than 10-15bps YoY.

Also, as about 26% of IDFC's net worth is invested in various non-interest-bearing assets, the consolidated ROE for FY11 was only 13% compared with the lending ROE of close to 16.9%. We forecast a lending ROE of 17.3% for FY12. The company should also see a dilution in its equity of about 3.2% in March 2012, as a result of the conversion of compulsorily convertible cumulative preference share (CCCPS) of Rs8.4bn. As the dilution is due to take place in the last month of FY12, we have deducted Rs8.4bn from the company's lending net worth for FY12 to calculate the lending ROE.

We have factored into our model a moderate increase in leverage for FY11-13. If the company's balance sheet and leverage were to improve at a faster rate than we expect, this would provide upside potential to our current ROE forecast.

■ IDFC: core lending P&L (re-constructed)

	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E	FY14E
Interest earned	12,823	21,595	29,814	30,665	39,828	55,905	66,231	78,795
Interest expenses	8,555	14,802	20,795	19,502	23,865	36,111	42,122	50,512
Net interest income	4,269	6,792	9,018	11,162	15,963	19,794	24,109	28,283
Fee income	904	1,600	1,573	2,080	2,947	3,234	3,599	4,102
Net Income	5,173	8,392	10,592	13,242	18,910	23,028	27,707	32,385
Operating expenses	614	1,133	1,288	1,994	2,084	2,523	3,053	3,695
Operating income	4,559	7,259	9,304	11,248	16,826	20,506	24,654	28,690
Provisions	499	574	564	1,026	1,485	1,800	3,000	3,000
PBT	4,061	6,685	8,740	10,222	15,341	18,706	21,654	25,690
Tax	772	1,471	2,185	2,556	3,835	4,676	5,414	6,422
Net profit	3,289	5,214	6,555	7,667	11,506	14,029	16,241	19,267
Reported net worth	28,820	54,544	60,292	68,229	102,260	121,877	134,564	149,824
Leveraging net worth	22,488	41,517	37,304	43,815	75,963	95,054	107,205	121,918
Core ROE	15.2	16.3	16.6	18.9	16.9	17.3	16.1	16.8
Total interest-bearing assets	157,799	241,172	258,714	283,643	431,300	492,542	605,974	741,513
Leverage	3.7	6.2	6.3	6.7	6.0	5.4	5.4	5.9
Lending/leverage book value	20	32	29	34	52	63	71	81
Core EPS	2.9	4.0	5.1	5.9	7.88	9.3	10.8	12.8

Source: Company, Daiwa forecasts

We believe most of the interest-spread contraction is already over

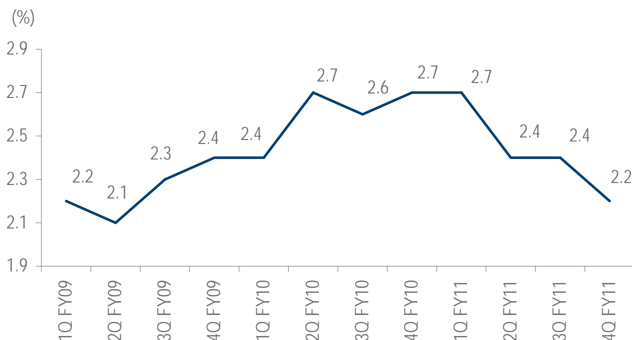
For FY11, IDFC's interest spread, according to the company, fell by as much as 50bps YoY, and was one of the highest contractions seen by the company over the past five years. It was due largely to rises in interest rates, and in particular to the increases IDFC made to lending rates over the year. We believe most of the interest-spread compression is over, and forecast a contraction of 10-15bps YoY for FY12.

Should the interest spread be stable over the next two quarters, we believe it could trigger a rerating of the stock. Looking at the current asset-liability position, as at the end of June 2011, the asset duration stood at 2.0 years while the liability duration was 2.55 years, which suggests that that if interest rates were to remain high, then the company would be well-placed to benefit, as the re-pricing of assets will be faster than the re-pricing of liabilities. This would help the company to protect its outstanding interest spread, even as incremental spreads remained under pressure.

Also, if interest rates were to start falling, the incremental spreads would start improving, which might offset the negative impact of faster asset re-pricing in a falling interest-rate scenario.

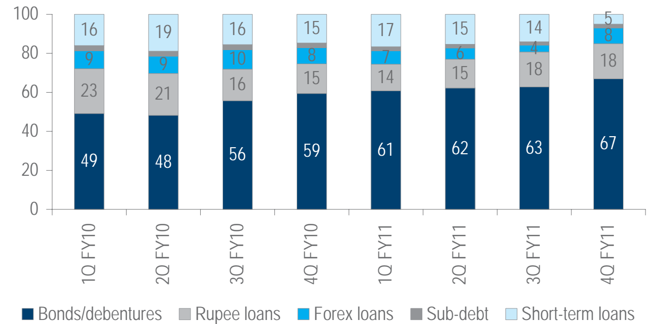
Hence, we believe the company is well-positioned to protect its interest spread for the reminder of FY12 and any further compression, if at all, will be marginal.

■ IDFC: interest spread



Source: Company

■ IDFC: borrowing breakdown (%)

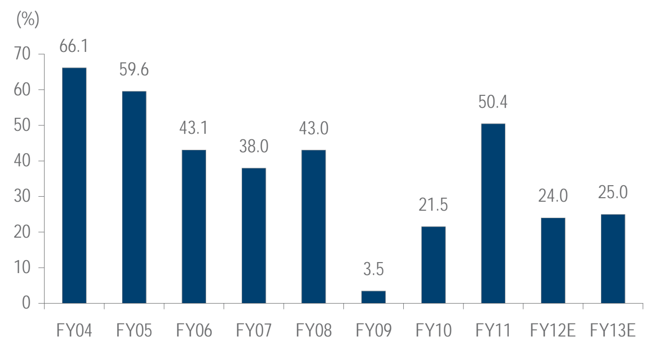


Source: Company

Loan growth may slow for FY12

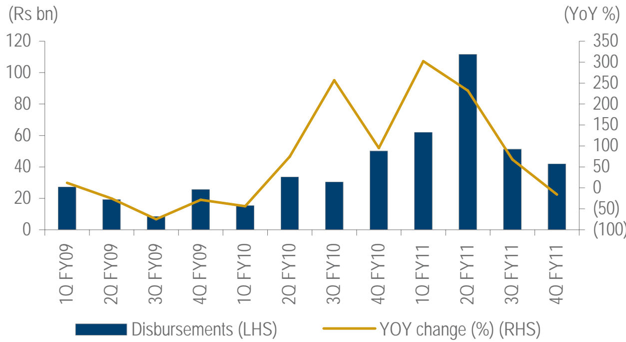
Following IDFC's loan growth of 50% YoY for FY11, we expect it to slow for FY12. However, we forecast loan growth to be around 15% YoY for FY12 as while there has been a slowdown in the approval of fresh loans, the pipeline of disbursements is likely to be strong. According to data from the Centre for Monitoring Indian Economy, US$300bn worth of projects is at various stages of implementation. Hence, we believe that despite the slowdown in fresh-loan approvals, there will still be good demand for loans over the next 3-6 months due to of the ongoing implementation of existing projects. However, if interest rates continue to rise for a longer period than we expect, then we believe the risk of a slowdown in demand for loans will increase.

■ IDFC: loan growth



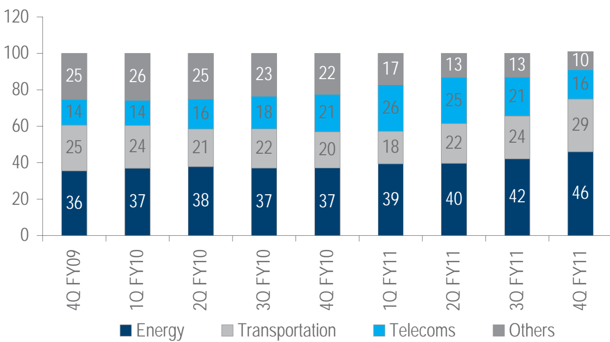
Source: Company, Daiwa forecasts

■ IDFC: loan disbursements



Source: Company

■ IDFC: loan-book breakdown (%)



Source: Company

Valuations attractive after recent share-price correction

We believe that IDFC's valuations are attractive for the following reasons: 1) most of the lending-spread compression is already over, 2) we forecast the lending ROE to improve to an average of about 17.3% for FY12, up from 16.9% for FY11, and 3) we expect the market's concerns about the quality of infrastructure loans to ease on account of the recent steps taken by the government to reform the Power Sector.

The company raised Rs34.94bn worth of capital in 2Q FY11, of which Rs8.4bn was raised as CCPS that will be converted in 4Q FY12 at a conversion price of Rs176/share.

We forecast core lending EPS to increase at a CAGR of 17% over FY11-13. About 26% of the company's net worth is invested in non-interest-bearing assets, and we assign a value of Rs32/share to those investments.

For FY12, we forecast a lending EPS and BVPS of Rs9.3 and Rs63, respectively. Hence after assigning a PBR of 2.0x and a PER of about 13.5x on our FY12 forecasts and adding Rs32/share for the value of its investments, we arrive at our six-month target price of Rs158. We believe that any signs of interest rates peaking will trigger a rerating of the stock. We maintain our Buy (1) rating for the stock.

Risks

A continuation in the high-interest-rate environment, which could lead to a slowdown in loan growth, and an increase in NPLs are the key risks to our target price and rating.

■ IDFC: SOTP valuation

	At cost (Rs m)	Estimated value (Rs m)	Per-share value for IDFC	Note
NSE stake	925	7,400	5	Considering recent transaction valuations
Value of private-equity business	90	7,200	5	7% of AUM
Value of IDFC Mutual Fund	8,142	8,000	5	4% of AUM
Value of IDFC Securities	3,301	6,534	4	10x FY12E earnings
Value of IDFC's investments in private-equity funds	3,000	6,000	4	At almost 2x its cost
Other investments (ARCIL, Athena, L&T Infra, STCI)	8,956	13,434	9	Valued at about double the cost of investments
Total value	24,414	48,568	32	
Value of the core business at 2x FY12E lending book value		190,108	126	
Total value of IDFC		238,676	158	

Source: Daiwa estimates

The 10-second briefing

Shriram Transport Finance
SHTF IN

Target price: **Rs898.00 → Rs898.00**
Up/downside: **+45.0%**
Share price (2 Aug): **Rs619.40**

Should fare well despite cyclical slowdown in the CV industry

- Cyclical CV-industry slowdown unlikely to have large impact on SHTF's profitability. AUM to rise by about 15% for FY12E
- We forecast 30-5obp NIM pressure for FY12. Changes in regulatory environment may lead to a further NIM decline of 50-100bps for FY12
- Average ROE of 26% for FY12-13E the highest among the financials we cover

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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▪ What's new
We believe a cyclical slowdown in commercial-vehicle (CV) sales is unlikely to have a significant immediate impact on SHTF's AUM (unless the slowdown continues for more than two years), as SHTF operates mostly in the used-vehicle segment, the impact on which is felt mostly with a lag. We believe recent concerns in the market about an increase in regulatory risk for priority-sector loans (a significant proportion of SHTF's loan book qualified for priority sector status) have been overdone.

▪ What's the impact
In our view, even if the RBI were to say that securitised loans should be treated as non-priority loans (securitised loans account for about 45% of SHTF's total AUM), the maximum impact on SHTF's FY12E NIM would be a 50-100bp cut. Our talks with management suggest that SHTF could be planning to implement alternative measures to counter the risk of fresh securitised loans not being treated as priority-sector loans, pending the RBI's final decision.

We believe the prolonged high interest-rate environment and slowing industrial and economic growth will have a negative impact on CV sales, and thus SHTF's loan disbursements for FY12. However, even if we factor in zero loan-disbursement growth for FY12, we forecast SHTF to still record about a 15% YoY rise in its AUM over the same period.

▪ What we recommend
SHTF's average ROE of 26% for FY12-13E would be one of the highest in the industry. We maintain our Buy (1) rating, and six-month target price of Rs898, based on FY12-13E PBRs of 3.3x and 2.7x, respectively.

▪ How we differ
Contrary to the market's perception about the increase in regulatory risk, we are less worried as we believe SHTF will always be able to find alternatives to earn interest/fee income, as long as its loan model is sound and loan demand continues to remain high.

Forecast revisions (%)

Year to 31 Mar	12E	13E	14E
PPOP change	(1.6)	(1.9)	(0.8)
Net-profit change	(2.1)	(0.4)	1.6
EPS change	(2.1)	(0.4)	1.6

Source: Daiwa forecasts

Share price performance

12-month range	594.05-893.35
Market cap (US$bn)	3.18
Average daily turnover (US$m)	16.25
Shares outstanding (m)	226
Major shareholder	Shriram Holdings (41.3%)

Financial summary (Rs)

Year to 31 Mar	12E	13E	14E
Total operating income (m)	38,386	46,108	55,086
Pre-provision operating profit (m)	28,078	33,006	38,786
Net profit (m)	14,427	17,403	21,098
Core EPS (fully-diluted)	63.787	76.943	93.279
EPS change (%)	17.1	20.6	21.2
Daiwa vs Cons. EPS (%)	(3)	0	6
PER (x)	9.7	8.1	6.6
Dividend yield (%)	1.1	1.2	1.4
DPS	7.000	7.500	8.500
PBR (x)	2.3	1.8	1.5
ROE (%)	26.2	25.3	24.8

Source: Bloomberg, Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

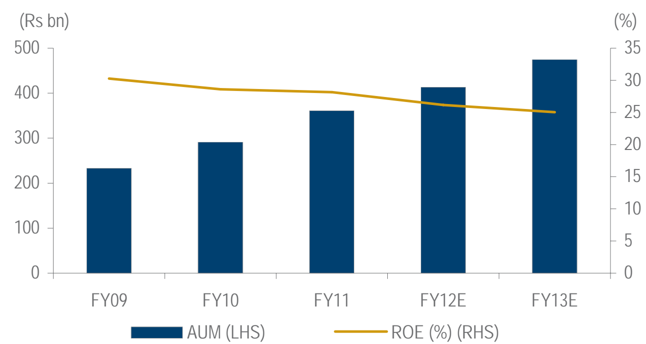
How do we justify our view?

- Growth outlook ✔ ✔ ✔ ✔ ✔
- Valuation ✔ ✔ ✔ ✔ ✔
- Earnings revisions ✔ ✔ ✔ ✔ ✔

Growth outlook ✔ ✔ ✔ ✔ ✔

We forecast an earnings CAGR of 19% for the FY11-13 period, driven by a net interest income CAGR of 21%. While we expect the company's loan disbursement to slow down for FY12, we forecast its AUM to rise by 15% YoY. Unbooked securitised-loan income of Rs30bn as at the end of June 2011 should help SHTF to expand its NII by 21% over the next two years, in our view. However, its average ROE of 26% over the next two years should be among the best in industry.

SHTF: AUM and ROE

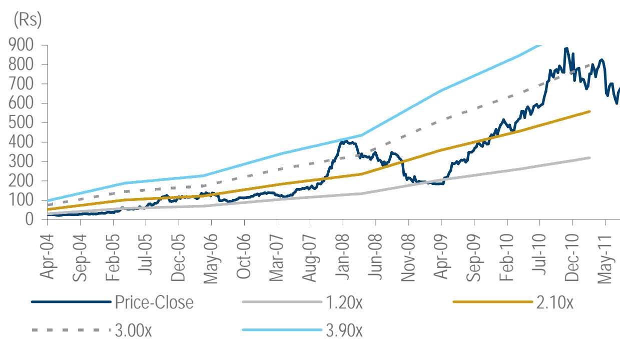


Source: Company, Daiwa forecasts

Valuation ✔ ✔ ✔ ✔ ✔

Over the past 3-4 years, SHTF has commanded rich valuations, given its niche market, high loan growth, stable asset quality, and high ROE. We believe SHTF will continue to capitalise on its inherent strengths, and expect it to deliver one of the best ROEs in the industry over the next two years. Given our expectation of an average ROE of 26% for the next two years, we believe the stock deserves to trade at an FY12E PBR of 3.3x.

SHTF: one-year-forward PBR bands

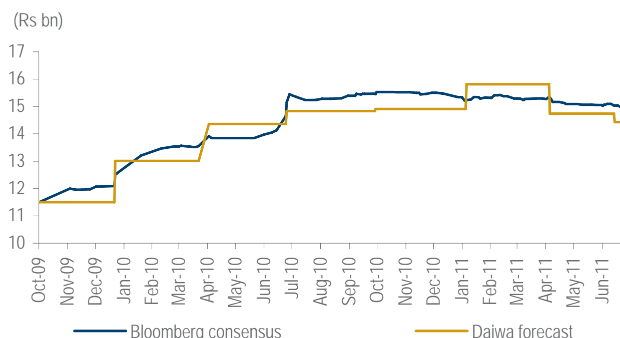


Source: Daiwa forecasts

Earnings revisions ✔ ✔ ✔ ✔ ✔

We have lowered our FY12 net-profit forecasts slightly, as we have factored a slight decrease in the company's net-interest margin compared with our previous forecasts.

SHTF: Daiwa's FY12 net-profit forecast vs. that of the Bloomberg consensus



Source: Bloomberg, Daiwa forecasts

Financial summary

■ Key assumptions

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan growth (%)	54.4%	83.7%	18.8%	0.3%	10.6%	9.5%	14.0%	20.0%

■ Profit and loss (Rs m)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	6,603	11,680	17,098	21,877	30,561	37,372	45,011	53,868
Net fees & commission	146	129	327	351	270	884	962	1,093
Trading and other income	11	166	110	300	749	130	135	125
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**6,760**	**11,975**	**17,535**	**22,527**	**31,580**	**38,386**	**46,108**	**55,086**
Personnel expenses	(725)	(1,252)	(2,005)	(2,251)	(3,582)	(4,836)	(6,287)	(7,858)
Other expenses	(1,490)	(2,348)	(3,265)	(2,926)	(3,958)	(5,471)	(6,816)	(8,442)
Total expenses	**(2,215)**	**(3,600)**	**(5,271)**	**(5,176)**	**(7,540)**	**(10,307)**	**(13,102)**	**(16,300)**
Pre-provision operating profit	**4,546**	**8,375**	**12,264**	**17,351**	**24,040**	**28,078**	**33,006**	**38,786**
Total provision	(1,665)	(2,317)	(3,057)	(4,106)	(5,548)	(6,219)	(6,637)	(6,819)
Operating profit after prov.	**2,881**	**6,058**	**9,206**	**13,244**	**18,492**	**21,860**	**26,368**	**31,966**
Non-operating income	0	0	0	0	0	0	0	0
Profit before tax	**2,881**	**6,058**	**9,206**	**13,244**	**18,492**	**21,860**	**26,368**	**31,966**
Tax	(988)	(2,160)	(3,082)	(4,515)	(6,191)	(7,432)	(8,965)	(10,869)
Min. int./pref. div./other items	0	0	0	0	0	0	0	0
Net profit	**1,893**	**3,898**	**6,124**	**8,729**	**12,302**	**14,427**	**17,403**	**21,098**
Adjusted net profit	**1,893**	**3,898**	**6,124**	**8,729**	**12,302**	**14,427**	**17,403**	**21,098**
EPS (Rs)	**11.308**	**20.127**	**30.115**	**40.689**	**54.467**	**63.787**	**76.943**	**93.279**
EPS (adjusted) (Rs)	**11.308**	**20.127**	**30.115**	**40.689**	**54.467**	**63.787**	**76.943**	**93.279**
EPS (adjusted fully-diluted) (Rs)	**11.308**	**20.127**	**30.115**	**40.689**	**54.467**	**63.787**	**76.943**	**93.279**
DPS (Rs)	**3.000**	**5.000**	**5.000**	**6.000**	**6.500**	**7.000**	**7.500**	**8.500**

■ Change (YoY %)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	41.8	76.9	46.4	28.0	39.7	22.3	20.4	19.7
Non-interest income	(27.6)	87.2	48.0	48.9	56.8	(0.5)	8.2	11.0
Total operating income	38.7	77.1	46.4	28.5	40.2	21.6	20.1	19.5
Total expenses	14.6	62.5	46.4	(1.8)	45.7	36.7	27.1	24.4
Pre-provision operating profit	54.5	84.2	46.4	41.5	38.6	16.8	17.5	17.5
Total provisions	104.5	39.2	32.0	34.3	35.1	12.1	6.7	2.7
Operating profit after provisions	35.4	110.3	52.0	43.9	39.6	18.2	20.6	21.2
Profit before tax	35.4	110.3	52.0	43.9	39.6	18.2	20.6	21.2
Net profit (adjusted)	37.1	106.0	57.1	42.5	40.9	17.3	20.6	21.2
EPS (adjusted)	(1.2)	78.0	49.6	35.1	33.9	17.1	20.6	21.2
Gross loans	70.6	89.2	19.8	1.2	10.7	8.9	13.9	20.0
Deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	73.3	69.5	36.7	7.8	16.8	14.4	14.4	16.2
Total liabilities	79.7	69.9	37.6	1.7	15.1	12.2	12.4	14.5
Shareholders' equity	33.8	66.3	28.0	68.8	27.8	25.0	24.1	23.6
Avg interest-earning assets	176.2	83.7	43.4	29.4	18.4	27.9	20.8	11.7
Avg risk-weighted assets	133.0	71.2	51.8	19.9	7.0	11.7	12.2	13.0

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & equivalent	17,527	13,742	57,849	45,373	36,251	39,876	37,882	35,988
Investment securities	2,246	13,851	6,548	18,560	36,507	47,459	61,697	80,206
Net loans and advances	79,307	150,022	179,031	179,650	198,656	217,528	247,982	297,579
Fixed assets	1,675	1,426	1,343	465	384	453	530	616
Goodwill	0	0	0	0	0	0	0	0
Other assets	7,006	3,636	4,862	24,970	42,380	54,016	62,974	63,332
Total assets	**107,760**	**182,678**	**249,632**	**269,017**	**314,178**	**359,332**	**411,065**	**477,720**
Customers deposits	0	0	0	0	0	0	0	0
Borrowing	86,951	147,863	201,213	184,599	198,817	216,193	236,759	265,833
Debentures	0	0	0	0	0	0	0	0
Other liabilities	10,145	17,076	25,708	46,070	66,722	81,868	98,242	117,890
Total liabilities	**97,095**	**164,939**	**226,921**	**230,669**	**265,539**	**298,061**	**335,001**	**383,723**
Share capital	1,842	2,032	2,035	2,255	2,262	2,262	2,262	2,262
Reserves & others	8,822	15,707	20,676	36,092	46,747	59,010	73,802	91,736
Shareholders' equity	**10,664**	**17,739**	**22,711**	**38,348**	**49,008**	**61,272**	**76,064**	**93,997**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**107,759**	**182,678**	**249,632**	**269,017**	**314,548**	**359,332**	**411,065**	**477,720**
Avg interest-earning assets	99,891	183,482	263,186	340,458	402,932	515,187	622,562	695,213
Avg risk-weighted assets	78,987	135,226	205,230	246,122	263,338	294,135	330,048	372,991
BVPS (Rs)	57.90	87.31	111.58	170.03	216.68	270.90	336.30	415.59

Key ratios (%)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan/deposit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tier-1 CAR	10.3	9.8	11.1	16.0	16.7	17.3	17.6	18.2
Total CAR	13.6	12.8	14.1	21.5	24.9	24.8	24.6	24.7
NPLs/gross loans	2.2	1.6	2.1	2.8	2.6	2.5	2.4	2.4
Total loan-loss prov./NPLs	40.1	56.6	61.9	74.9	85.9	70.0	70.8	70.8
ROAA	1.8	2.7	2.8	3.4	4.2	4.3	4.5	4.7
ROAE	17.7	27.4	30.3	28.6	28.2	26.2	25.3	24.8
Net-interest margin	6.6	6.4	6.5	6.4	7.6	7.3	7.2	7.7
Gross yield	14.0	13.4	14.0	13.0	13.2	12.2	11.6	11.9
Cost of funds	11.3	11.0	11.3	11.6	11.9	12.2	12.0	11.5
Net-interest spread	2.7	2.4	2.7	1.4	1.4	0.0	(0.4)	0.4
Total cost/total income	32.8	30.1	30.1	23.0	23.9	26.9	28.4	29.6
Effective tax	34.3	35.7	33.5	34.1	33.5	34.0	34.0	34.0
Dividend-payout	26.5	24.8	16.6	14.7	11.9	11.0	9.7	9.1

Source: Company, Daiwa forecasts

Company profile

Shriram Transport Finance Company is the flagship company of Shriram Group. It was established in 1979 and has almost three decades of experience in the CV- financing business. As at 30 June 2011, Shriram Transport Finance had a network of 494 branches and 16,486 employees.

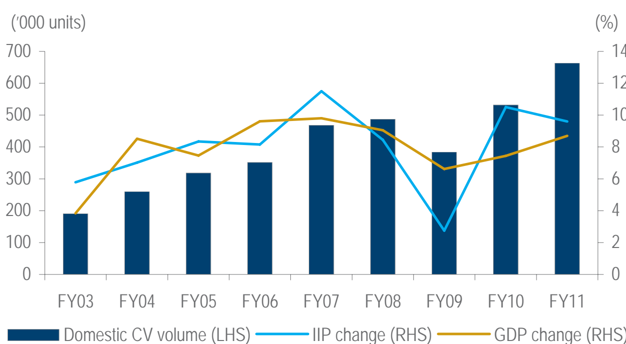
Should fare well despite slowdown in CV financing

We forecast AUM to expand by about 15% YoY for FY12, despite our expectations of a slowdown in the CV-sales cycle and loan disbursements for FY12

CV-industry sales growth sensitive to changes in economic growth

A sustained high interest-rate environment, coupled with lower GDP and industrial-production growth, will have a negative impact on CV-industry sales, in our opinion. In the past, the country's CV sales volume has been negatively affected by declines in GDP and IIP (industrial production as measured by the Index of Industrial Production) growth.

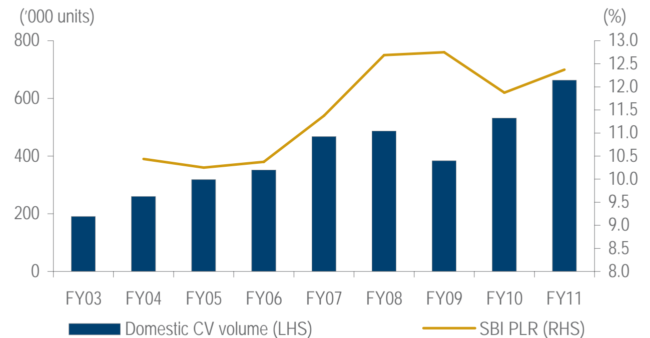
■ CV industry: sales volume vs. GDP and IIP growth



Source: SIAM, Bloomberg

An increase in interest rates tends to have a negative effect on the CV sales volume directly, although the indirect impact of rising interest rates through an economic slowdown tends to have a more obvious effect on the sales volume.

■ CV industry: sales volume vs. interest rates

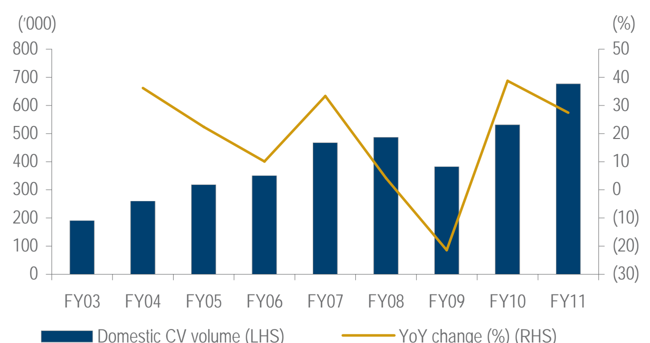


Source: SIAM, Bloomberg
Note: We have used SBI's PLR as a proxy for lending rates

Slowdown in sales for the CV-industry unlikely to be as sharp as for FY09

While the pressures on India's economic growth are evident, we believe GDP and industrial-production growth is unlikely to falter at a rate previously witnessed in FY09. Even if GDP growth were to fall by 100bps for FY12, the negative impact on the CV sales volume, in our view, would not be as sharp as for FY09.

■ India: domestic CV sales volume

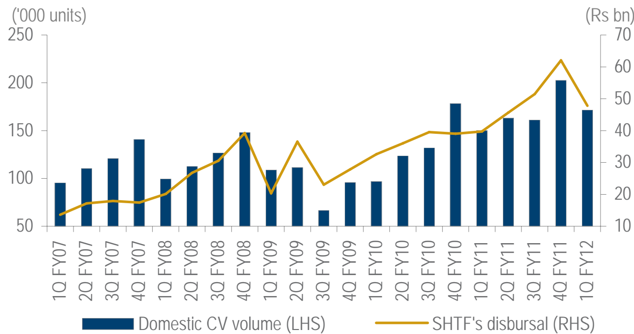


Source: SIAM

AUM forecast to rise by about 15% YoY for FY12, despite flat loan disbursements

A slowdown in the CV sales volume would not have a significant impact on SHTF's fresh-loan disbursements in the used-vehicle segment, unless the slowdown in sales continues for longer than about two years. We believe it will take some time to see the impact of a slowdown in the used-vehicle segment. During FY09, when the CV industry saw its sales volume decline as a result of the global economic crisis, SHTF's vehicle financing and loan disbursements were also negatively affected.

■ CV industry: sales volume and SHTF's loan disbursements



Source: SIAM, Company

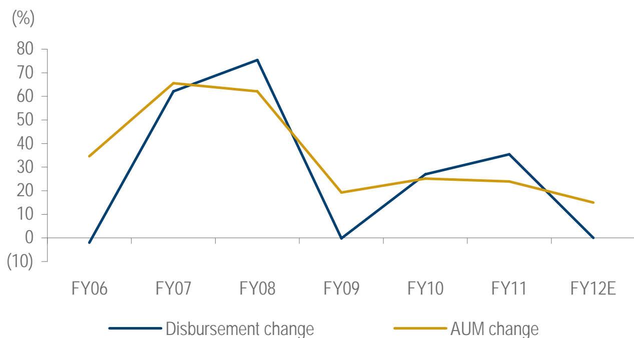
Despite the slowdown witnessed already over the past few months in the CV industry, we forecast the company to expand its FY12 AUM by 15% YoY, even if its fresh-loan disbursements remain flat for the period, based on our forecasts. For example, for FY09, the company recorded zero loan-disbursement growth YoY, but managed to increase its AUM by 19% YoY. We believe that as the signs of the next CV-industry downcycle have started to appear, we could see a slowdown in SHTF's loan-disbursement growth. We have factored in zero loan-disbursement growth for FY12.

■ SHTF: FY12 AUM

	Rs bn
AUM (as at the end of March 2011)	361
Loan disbursements	199
Repayments	143
AUM (as at the end of March 2012)	417
Change in AUM (%)	15

Source: Daiwa forecasts

■ SHTF: AUM and loan-disbursement growth

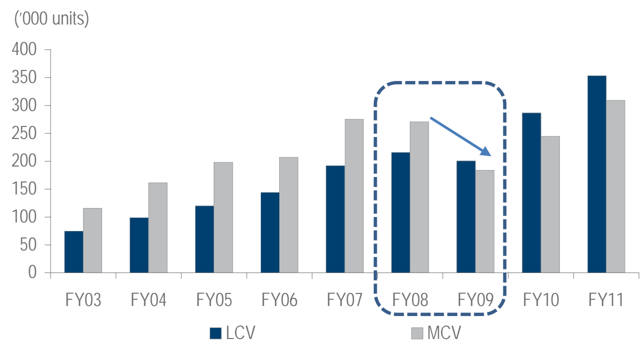


Source: Company, Daiwa forecasts

Less impact on the LCV sales volume than on the MHCV sales volume

Within the CV segment, the negative impact of a slowdown in sales of heavier vehicles – heavy commercial vehicles (HCV) and medium commercial vehicles (MCV) – is worse than for the lighter vehicles – light commercial vehicles (LCV) and small commercial vehicles (SCV). We believe demand for LCVs would be less affected during a slowdown than for heavier vehicles, as the use of LCVs is more flexible. They can be used for multiple purposes, and are priced much lower than MCVs. Also, there is high demand for LCVs in India's rural areas.

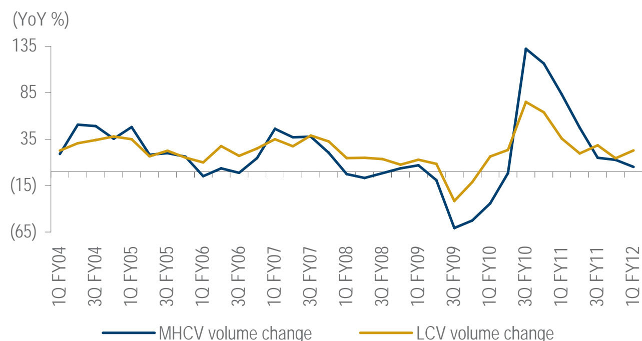
■ LCV vs. MCV: sales volume (FY08 & FY09)



Source: SIAM

Auto industry data for 1Q FY12 reflects a noticeable slowdown in the MCV segment. However, sales for the LCV segment have remained resilient, expanding at 23% YoY for 1Q FY12.

■ MCV and LCV: sales volume YoY (%)



Source: SIAM

Focus on LCV financing should help support SHTF's LCV sales volume

While SHTF provides financing for all kinds of commercial vehicles (HCVs, MCVs, LCVs, and SCVs), a majority of its portfolio, in terms of loan volume, is made up of financing for the MCV, LCV, and SCV segments. Unlike the much heavier vehicles that fall into the HCV category, sales of which fare worse during an economic downturn, the MCV, LCV, and SCV categories comprise lighter vehicles, and hence sales in these segments continue to tick over even during sluggish periods. Flexibility of usage is a big advantage for the LCV and SCV segments.

In terms of value, heavier vehicles (nine tonnes or more) account for only 15% of SHTF's total AUM, with the remainder being taken up with vehicles of nine tonnes or less. The company is also increasingly targeting customers for lighter-vehicle financing, such as the *Tata Ace,* which is still witnessing strong demand.

Automalls to boost sales of repossessed vehicles

SHTF recently opened its *Automalls* operation in Chennai, and plans to open more *Automalls* in a lot of other cities. These malls located on the city outskirts, on arterial road frequented by commercial vehicles. Each *Automall* will cover about 2-3 acres. Through these *Automalls*, SHTF intends to sell repossessed vehicles (it repossess about 6,000- 8,000 vehicles a year, equivalent to about 8% of the total number of vehicles that it finances annually) as well as vehicles from other finance companies.

The *Automalls* will have their own workshops where vehicles will be refurbished and sold through auction. The vehicles will be sold under the brand name *Shriram New Look*, and will have a warranty. Almost all the vehicles in the *Automalls* will be financed by STFL, providing synergies with its core business. The company expects to benefit from building up its expertise in valuing vehicles and an overall improvement in its asset quality.

■ SHTF: the *Automalls* operation in Chennai

Source: Daiwa

■ SHTF: *Automalls* operation auction

Source: Daiwa

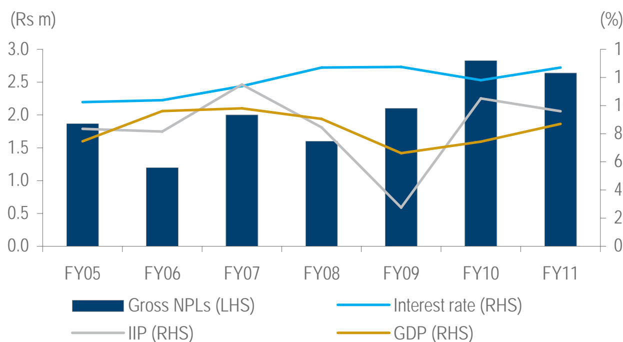
Planning its foray into banking

The company plans to enter the banking business, and will seek a banking licence. We expect the RBI to issue draft guidelines for the company's banking licence, and news flow in the market suggests that the company will be able to meet the RBI's criteria for this licence. The banking company would be housed separately. However, how the banking unit will be structured within the group has yet to be decided (ie, whether it will be a subsidiary of the parent or a subsidiary of SHTF.)

Asset quality should be manageable for FY12

For FY12, we forecast loan disbursements to remain flat on a year-on-year basis, and for the overall loan book to rise by 10% YoY and AUM by about 15% YoY. The ongoing slowdown in the economy (as measured in terms of GDP and industrial-production growth) and sustained high interest rates could have a negative impact on the company's asset quality. However, in the past, the pressure has been well managed by the company. SHTF's follow-up and collection mechanism has helped it contain fresh NPLs. However, we have taken a conservative stance, and factored in an increase in gross NPLs for FY12.

■ SHTF: gross NPLs, GDP, IIP and interest rates



Source: Company, Daiwa, Bloomberg

Construction-equipment financing should become a sizable business over the next two years

Shriram Equipment Finance Company Ltd (SEFC) is a 100%-owned subsidiary of SHTF engaged in the business of financing new and used construction equipment. For FY11, its first year of operation, the company had AUM of Rs6.34bn. Management said the company plans to expand this business aggressively and targets having AUM of Rs50bn by March 2013. While neither we nor the market have factored this business into SHTF's FY12E valuation, we believe that in a year when this business acquires sufficient scale, the market may need to include its value when valuing its parent, SHTF.

■ SEFC: key numbers (as at the end of June 2011)

	Rs m
Capital	1,600
Reserves	85
Net worth	**1,685**
Balance sheet	9,684
AUM	**9,575**

Source: Company

NIM pressure largely priced in, high ROE should sustain its premium valuation

Active securitisation, a high level of cash on the balance sheet, and the ability to pass on the rising cost of borrowing to customers has, to some extent, helped SHTF keep its NIM above the 8% level for the past four quarters. However, we expect the NIM to come under pressure by 30-50bps for FY12, as its cost of borrowing has risen sharply over the past one quarter or so, which the company may not be able to pass on. However, we believe that a NIM compression of 30-50bps is already discounted in the stock's current valuations, and that the market is fully aware of this situation.

We believe that even in the face of the ongoing challenging macro environment, the company should be able to deliver a total asset CAGR of 14% and a 19% earnings CAGR over the FY12-13E period. We forecast an average ROA of 4.4% and average ROE of 26% over the next two years, which we see as the best in the industry. While some regulatory headwinds persist, the company is formulating plans to be better geared to meet any regulatory challenges.

Regulatory risks can be tackled

In May 2011, the RBI said that loans given by banks to the NBFCs, which lend to the priority-sector industries like the CV segment, will no longer be considered priority-sector loans. This has created concerns in the market that SHTF might no longer enjoy lower cost funding from the banks. However, the company has clarified that only a small proportion of its bank borrowing is in the form of priority-sector borrowing (around Rs40-45bn of borrowing from the banks), and that the rest of its bank borrowing was carried out at market rates.

While the market viewed this as a positive clarification, concerns in the market persisted because the RBI did not clarify whether SHTF's securitised loans to the banks would continue to be classed as priority-sector loans. When analysts sought clarification on this during a call with RBI on 4 May 2011, following a

monetary-policy announcement, the RBI said that as of May 2011, there would be no regulatory changes to securitised loans (meaning securitised loans would continue to get priority-loan status), but the final decision had yet to be made. In our view, this has increased SHTF's regulatory risk, because if the RBI stops recognising SHTF's securitised loans on the banks' books as being priority-sector loans, then the banks' appetites for such loans are likely to fall significantly, meaning SHTF is unlikely to be able to securitise loans with the banks as aggressively as it has in the past. This would restrict SHTF's ability to leverage high, achieving a high ROE, and could also affect its NIM.

Although a final clarification is pending, going by what the RBI has done so far (announcing its existing guidelines on NBFCs on 1 July 2011, and keeping the status-quo vis-à-vis securitisation), we do not believe the RBI will remove the priority-sector status from loans securitised by SHTF.

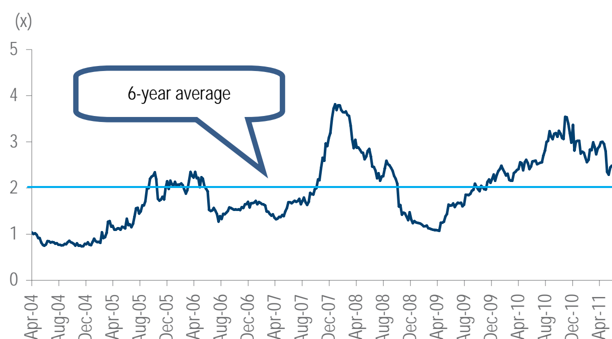
In any case, we believe SHTF is looking to implement alternative measures to counter any regulatory risk. One such alternative could be that SHTF starts originating loans directly on the banks' loan books and earning a fee for doing so. This could help the company maintain its high ROE. Hence, we believe the company will be able to tackle any regulatory risk as long as its business model remains sound, and it continues to record high NIMs and high-quality loans in the used-CV industry.

We believe that as long as SHTF continues to see high-NIM loans and keeps its asset quality under check, the stock should continue to offer strong upside potential, and we see any short-term regulatory impact as an opportunity for investors to buy. The company has one of the highest ROEs in the financial sector and the highest recorded ROE among our covered list of financial stocks. As such, we maintain our Buy (1) rating and Gordon Growth Model-derived six-month target price of Rs898, based on an FY12E target PBR of 3.3x.

Risks

Lower-than-expected loan-disbursement growth, higher-than-expected NIM compression, and a possible change in RBI guidelines on priority-sector loans would be the key risks to our target price and rating.

■ SHTF: one-year forward PBR chart



Source: Daiwa forecast, Bloomberg

■ SHTF: one-year-forward PER chart

Source: Daiwa forecast, Bloomberg

1Q FY12 results: key highlights

- The net-profit increase of 20% YoY was in line with market expectations. The company witnessed an improvement in its NIM on a quarter-on-quarter basis and loan disbursals were also up 20% YoY, which we believe were the key positives.
- The company re-grouped its reported NIM by including the brokerage cost of non-institutional borrowings. Hence, the reported NIM will now be 25-30bps lower compared with what the company was reporting earlier. Fresh NPLs rose by Rs740m for 1Q FY12, slightly higher than expected, though still under control.
- After adjusting for the brokerage costs, the NIM rose to 7.91% for 1Q FY12, compared with 7.65% for 4Q FY11. On a like-for-like basis, the NIM went up to around 8.2% for 1Q FY12, compared with 8.06% for 4Q FY11.
- Of the total loan disbursals of Rs47.84bn for 1Q FY12, the proportion of new CV financing has come down to 22%, compared with 28% on average for the previous two quarters. A slowdown in demand for new CVs, along with seasonal trends, could be the reasons behind the lower proportion of new CVs, which is a positive for the NIM. Also, the high level of securitised loans in 4Q FY11 contributed to the NIM.
- AUM rose by 22% YoY. Cash and bank balances have gone up 72% QoQ, which we see as a positive. The company attributed the rise in the cash to the higher securitisation done in 4Q FY11.
- Management also indicated that the RBI may be looking to implement the draft guidelines on NBFCs which came out a couple of years back. One of the key features was that the loans will require a seasoning of at least 9-12 months before they can be securitised, and also NBFCs may be required to take an additional hit in the capital-adequacy ratio on their securitised loans. The company's CAR stood at around 23% for 1Q FY12 and if the RBI's draft guidelines are implemented, the CAR will come down by 3-4%, which will still be comfortably higher than the required 15% for NBFCs.
- Management also said that as the RBI has put out its guidelines on securitised loans on the RBI website this July without any changes, it is quite hopeful that securitised loans will continue to be recognised as priority sector loans on the banks' loan book, though some level of uncertainty still remains.
- The unrealised income on securitised loans stood at Rs30bn for 1Q FY12, versus Rs36bn for the previous quarter. The company booked around Rs5.5bn of securitisation income in 1Q FY12.
- After the repo rate hike of 50bps by the RBI, the company has not reduced its loan-disbursal target of around Rs200-210bn for FY12, though the downside risk to the target has now gone up, in our view.
- Also, as the company now has a strong non-institutional deposit franchise, it can tap this segment more aggressively if banks hike interest rates aggressively following the monetary-policy announcement.

■ SHTF: 1Q FY12 results

	Quarter ended				
(Rs m)	Jun-11	Jun-10	% Chg	Mar-11	% Chg
Interest income	13,860	12,385	12	13,501	3
Fund based	*8,368*	*8,739*	*(4)*	*9,034*	*(7)*
Securitisation income	*5,492*	*3,646*	*51*	*4,467*	*23*
Interest expense	5,714	5,613	2	5,791	(1)
Net interest income	**8,146**	**6,772**	**20**	**7,710**	**6**
Non-interest income	477	361	32	174	173
Fee-based income	*-*	*60.6*	*(100)*	*62.4*	*(100)*
Other Income	*476.7*	*300.2*	*59*	*111.9*	*326*
Net income	**8,623**	**7,133**	**21**	**7,884**	**9**
Operating expenses	1,678	1,506	11	1,549	8
% of net income	19	21	-	20	-
- Staff costs	*946*	*860*	*10*	*940*	*1*
- Other expenses	*732*	*646*	*13*	*610*	*20*
Operating Income	**6,945**	**5,626**	**23**	**6,335**	**10**
Provisions for NPAs	1,745	1,281	36	1,216	44
Provisions for std. assets					
PBT	**5,200**	**4,345**	**20**	**5,119**	**2**
Tax	1,727	1,456	19	1,713	1
Net profit	**3,473**	**2,890**	**20**	**3,406**	**2**
NIM on AUM (%)	7.91	7.85	-	7.65	-
Interest spread (%)	10.83	10.56		10.40	
Yield on int. earning assets (%)	18.16	18.89	-	17.87	-
Cost of funds (%)	7.33	8.33	-	7.50	-
Disbursements (Rs.bn)	48	40	20	62	(23)
-Used CVs	*37.1*	*33.3*	*11*	*44.8*	*(17)*
-New CVs	*10.8*	*6.4*	*68*	*17.2*	*(37)*
Gross NPLs (%)	2.7	2.5	-	2.6	-
Net NPLs (%)	0.5	0.4	-	0.4	-
AUM (Rs bn)	370	302	22	361	3
On books (Rs.bn)	222	203	9	198	12
Off books (Rs.bn)	148	99	49	163	(9)

Source: Company

Daiwa Capital Markets

Company

Diversified financials / India
2 August 2011

The 10-second briefing

Reliance Capital

RCAPT IN

Target price: **Rs944.00 → Rs599.00**
Up/downside: **+11.3%**
Share price (2 Aug): **Rs538.30**

Focus turns to profitability from growth

- FY12 earnings growth in commercial finance could surprise on the upside, even as AUM stays flat
- The delay in approval of the sale of the stake in life-insurance business could be an overhang
- We forecast earnings to almost triple for FY12, but ROE to remain low

1 Buy
2 **Outperform** (unchanged)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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What's new

We now expect Reliance Capital to focus more on profitability than on revenue growth over the next two years.

What's the impact

Management expects the regulators' approval for the recent stake sale in the company's life insurance business to take place within the next three months, and in the worst-case scenario, it may stretch up to January 2012, when Reliance Life completes 10 years of operation. Reliance Capital had planned to use the cash from the stake sale to reduce its debt and expand various business segments, including the commercial-finance business. The company has been focusing more on non-ULIP (unit-linked insurance plan) products, which have a low average premium ticket size following regulatory changes.

New-business-premium (NBP) income stood at Rs1.54bn for the first two months of 1Q FY12, down 51% YoY. The new-business achieved profit (NBAP) margin has been volatile over the past two quarters. In the asset-management business, we expect the average AUM to remain flat for FY12, but forecast retail AUM to rise by 15-20% YoY, in line with management's guidance.

We think FY12 earnings for the commercial-finance business could surprise on the upside, driven by strong loan growth of about 20%, marginal NIM compression, and stable asset quality.

We forecast a three-fold increase in consolidated net profit for FY12, driven by improving profitability in the lending and life-insurance businesses.

What we recommend

We have lowered our SOTP-based target price to Rs599 from Rs944. This is due largely to the much lower valuations we now assign to the life-insurance business and the investment book. We have increased marginally our value for the lending business in our SOTP valuations. We maintain our Outperform (2) rating.

How we differ

The market seems worried about a slowdown in NBP growth for the life-insurance business. We believe the lending business will see strong earnings growth for FY12, and that this will offset partly the performance of the life-insurance business.

Forecast revisions (%)

Year to 31 Mar	11E	12E	13E
PPOP change	(42.5)	57.7	56.6
Net-profit change	(40.6)	54.8	54.1
EPS change	(40.6)	54.8	54.1

Source: Daiwa forecasts

12-month range	412.15-861.05
Market cap (US$bn)	3.01
Average daily turnover (US$m)	17.43
Shares outstanding (m)	246
Major shareholder	Janus Overseas Fund (5.0%)

Source: Bloomberg, Daiwa

Financial summary (Rs)

Year to 31 Mar	11E	12E	13E
Total operating income (m)	40,365	46,537	50,829
Pre-provision operating profit (m)	2,912	9,238	10,799
Net profit (m)	2,285	6,878	8,050
Core EPS (fully-diluted)	9.284	27.942	32.701
EPS change (%)	(46.7)	201.0	17.0
Daiwa vs Cons. EPS (%)	-	6	2.7
PER (x)	58.0	19.3	16.5
Dividend yield (%)	1.2	1.3	1.4
DPS	6.500	7.000	7.500
PBR (x)	1.7	1.6	1.5
ROE (%)	2.9	8.5	9.3

Source: Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

- 1 Buy
- 2 **Outperform** (unchanged)
- 3 Hold
- 4 Underperform
- 5 Sell

How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

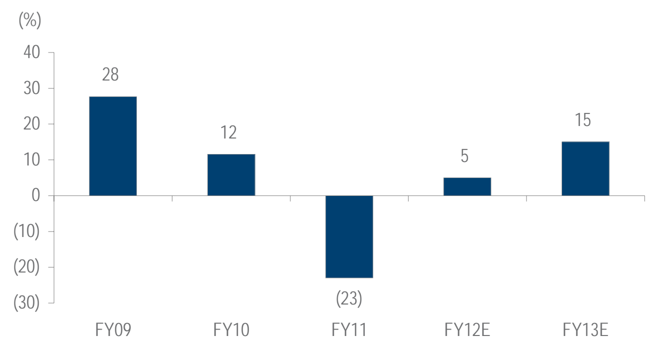
Growth outlook ✔✔✔✔✔

We forecast the NBP in the life-insurance business to increase by only 5% for FY12 as the management is focused on low-ticket-sized traditional products. We also forecast an NBAP margin of 13% for FY12.

For the asset-management business, we forecast the AUM to remain flat for FY12, but with equities accounting for 35% of the total compared with 33% for FY11.

We forecast loan growth of 20% YoY with stable asset quality for the commercial-finance business.

Reliance capital: life insurance – NBP (%)



Source: IRDA, Daiwa forecasts Note: NBP denotes new business premiums

Valuation ✔✔✔✔✔

We value the company on an SOTP basis and have a six-month target price of Rs599. Our value of Rs271/share for the life-insurance business is based on a 10x FY12 NBAP multiple and NBAP margin of 13%. For the asset-management business we assign a value of Rs148/share based on 3.6% of our average AUM forecast for FY12. We have assigned a value of Rs100/share to the commercial-finance business based on a multiple of 10x on our FY12 earnings forecast. For the other business – the general insurance and Reliance Money, and the investments – we assign a value of Rs79/share based on our FY12 forecasts.

Reliance Capital: SOTP

Business	Valuation (by FY12E)	(Rs bn)	(US$bn)	(Rs/share)
Asset management	At 3.6% of AUM	37	0.8	148
Life insurance	Appraisal value	67	1.5	271
Commercial finance	10x FY12 earnings	25	0.5	100
General insurance	At 1x net worth	6	0.1	24
Investments	At 20% discount to cost	15	0.3	49
Reliance Money	5x FY12E earnings	2	0.0	6
Total value of Reliance Capital	-	151	3.3	599

Source: Daiwa estimates

Earnings revisions ✔✔✔✔✔

We have revised up our consolidated-earnings forecasts for FY12 by almost 55% in order to adjust for the increasing profitability in the lending business, and also for the turnaround we expect in the life-insurance business despite the NBP rising at a very slow rate year-on-year for FY12.

Reliance Capital: Daiwa vs. consensus earnings forecasts

Rs m	FY12E	FY13E
Daiwa earnings forecast	6,878	8,050
Consensus earnings forecast	6,336	7,839
% difference	8.6	2.7

Source: Daiwa Forecasts, Bloomberg

Financial summary

■ Key assumptions

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
AUM growth (%)	159.0	75.0	98.6	13.9	31.5	0.8	1.8	2.0
NBP growth (%)	111.9%	381.6%	195.3%	27.7%	11.6%	(22.6%)	5.1%	14.9%

■ Profit and loss (Rs m)

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Net-interest income	1,230	3,022	5,049	5,665	5,834	6,876	8,210	9,862
Net fees & commission	894	1,788	4,271	4,783	6,321	7,333	8,213	9,034
Trading and other income	6,692	16,338	35,735	37,105	35,927	26,156	30,115	31,933
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**8,816**	**21,148**	**45,055**	**47,553**	**48,082**	**40,365**	**46,537**	**50,829**
Personnel expenses	(446)	(1,472)	(4,090)	(5,541)	(5,354)	(4,968)	(5,465)	(6,285)
Other expenses	(1,898)	(11,564)	(28,806)	(29,971)	(36,845)	(32,484)	(31,835)	(33,745)
Total expenses	**(2,344)**	**(13,036)**	**(32,896)**	**(35,512)**	**(42,199)**	**(37,452)**	**(37,299)**	**(40,029)**
Pre-provision operating profit	**6,472**	**8,112**	**12,159**	**12,042**	**5,884**	**2,912**	**9,238**	**10,799**
Total provision	0	0	0	0	0	0	0	0
Operating profit after prov.	**6,472**	**8,112**	**12,159**	**12,042**	**5,884**	**2,912**	**9,238**	**10,799**
Non-operating income	0	0	0	0	0	0	0	0
Profit before tax	**6,472**	**8,112**	**12,159**	**12,042**	**5,884**	**2,912**	**9,238**	**10,799**
Tax	(345)	(1,120)	(2,055)	(1,811)	(1,492)	(579)	(2,309)	(2,700)
Min. int./pref. div./other items	95	35	(12)	(74)	(104)	(48)	(50)	(50)
Net profit	**6,223**	**7,027**	**10,093**	**10,157**	**4,289**	**2,285**	**6,878**	**8,050**
Adjusted net profit	**6,223**	**7,027**	**10,093**	**10,157**	**4,289**	**2,285**	**6,878**	**8,050**
EPS (Rs)	**35.433**	**29.929**	**41.000**	**41.261**	**17.422**	**9.284**	**27.942**	**32.701**
EPS (adjusted) (Rs)	**35.433**	**29.929**	**41.000**	**41.261**	**17.422**	**9.284**	**27.942**	**32.701**
EPS (adjusted fully-diluted) (Rs)	**35.433**	**29.929**	**41.000**	**41.261**	**17.422**	**9.284**	**27.942**	**32.701**
DPS (Rs)	**3.200**	**3.500**	**5.500**	**6.500**	**6.500**	**6.500**	**7.000**	**7.500**

■ Change (YoY %)

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Net-interest income	105.7	145.8	67.1	12.2	3.0	17.9	19.4	20.1
Non-interest income	165.5	138.9	120.7	4.7	0.9	(20.7)	14.4	6.9
Total operating income	155.2	139.9	113.0	5.5	1.1	(16.1)	15.3	9.2
Total expenses	2.7	456.3	152.3	8.0	18.8	(11.2)	(0.4)	7.3
Pre-provision operating profit	451.8	25.3	49.9	(1.0)	(51.1)	(50.5)	217.2	16.9
Total provisions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Operating profit after provisions	451.8	25.3	49.9	(1.0)	(51.1)	(50.5)	217.2	16.9
Profit before tax	451.8	25.3	49.9	(1.0)	(51.1)	(50.5)	217.2	16.9
Net profit (adjusted)	482.5	12.9	43.6	0.6	(57.8)	(46.7)	201.0	17.0
EPS (adjusted)	324.1	(15.5)	37.0	0.6	(57.8)	(46.7)	201.0	17.0
Gross loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	58.6	57.5	148.2	31.2	7.8	22.7	8.4	18.3
Total liabilities	(67.9)	354.3	453.9	41.4	9.7	32.3	8.8	21.6
Shareholders' equity	182.1	25.9	24.7	12.8	3.4	1.1	7.1	7.7
Avg interest-earning assets	18.2	26.4	69.8	78.8	33.2	23.8	11.3	11.4
Avg risk-weighted assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Cash & equivalent	0	0	0	0	0	0	0	0
Investment securities	23,938	28,531	60,564	98,742	119,730	149,300	143,048	182,543
Net loans and advances	0	0	0	0	0	0	0	0
Fixed assets	1,902	1,389	2,020	3,018	2,586	4,520	4,520	4,520
Goodwill	0	0	0	0	0	0	0	0
Other assets	21,345	44,377	121,853	140,214	138,477	166,119	199,147	222,928
Total assets	**47,184**	**74,297**	**184,437**	**241,975**	**260,793**	**319,939**	**346,715**	**409,991**
Customers deposits	0	0	0	0	0	0	0	0
Borrowing	2,419	14,030	84,419	129,268	108,043	128,463	134,186	171,758
Debentures	0	0	8,843	11,819	38,821	45,537	47,537	50,537
Other liabilities	2,264	7,244	24,571	25,521	35,952	67,842	81,395	97,659
Total liabilities	**4,683**	**21,274**	**117,833**	**166,608**	**182,815**	**241,842**	**263,118**	**319,954**
Share capital	2,234	2,462	2,462	2,462	2,462	2,462	2,462	2,462
Reserves & others	39,880	50,562	63,635	72,072	74,578	75,439	80,941	87,381
Shareholders' equity	**42,114**	**53,024**	**66,097**	**74,534**	**77,040**	**77,900**	**83,403**	**89,842**
Minority interests	387	0	507	833	938	197	195	195
Total equity & liabilities	**47,184**	**74,297**	**184,437**	**241,975**	**260,793**	**319,939**	**346,715**	**409,991**
Avg interest-earning assets	20,749	26,234	44,547	79,653	106,074	131,353	146,174	162,796
Avg risk-weighted assets								
BVPS (Rs)	188.51	215.40	268.51	302.79	312.97	316.46	338.82	364.98

Key ratios (%)

Year to 31 Mar	2006	2007	2008	2009	2010	2011E	2012E	2013E
Loan/deposit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tier-1 CAR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total CAR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
NPLs/gross loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total loan-loss prov./NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
ROAA	16.2	11.6	7.8	4.8	1.7	0.8	2.1	2.1
ROAE	21.8	14.8	16.9	14.4	5.7	2.9	8.5	9.3
Net-interest margin	5.9	11.5	11.3	7.1	5.5	5.2	5.6	6.1
Gross yield	8.1	13.1	20.6	23.0	18.1	16.4	18.4	18.8
Cost of funds	5.8	5.2	7.7	10.8	9.3	9.1	10.5	10.3
Net-interest spread	2.3	8.0	12.9	12.2	8.8	7.3	7.9	8.5
Total cost/total income	26.6	61.6	73.0	74.7	87.8	92.8	80.1	78.8
Effective tax	5.3	13.8	16.9	15.0	25.4	19.9	25.0	25.0
Dividend-payout	9.0	11.7	13.4	15.8	37.3	70.0	25.1	22.9

Source: Company, Daiwa forecasts

Company profile

Reliance Capital has interests in asset management, insurance, consumer finance, proprietary investments, stock broking and the distribution of financial products. Management control was given to the Anil Dhirubhai Ambani Group during the de-merger of Reliance Industries in January 2007. Reliance Capital Asset Management, the asset-management arm of the group, is the largest company of its kind in India, and Reliance Life is the fourth-largest life insurer.

Lending business to improve, earnings to improve substantially

Management is guiding for the life-insurance business to turn profitable in FY12 and a substantial improvement in the profitability of the lending business. However, new-premium growth may be subdued

Commercial finance: FY12 earnings could surprise on the upside

For FY12, we expect the earnings of the commercial-finance business to surprise the market on the high side, driven by strong loan growth of about 20% YoY, marginal net-interest-margin (NIM) compression, a year-on-year fall in operating costs, and further decline in credit costs.

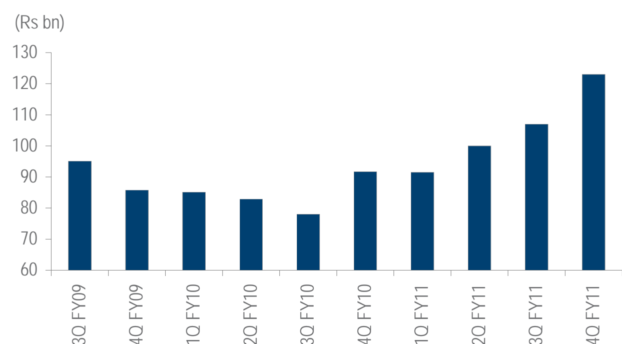
Management expects the loan book in all the key focus segments (SME, home loans, and asset financing) to increase by 20% YoY for FY12.

It is guiding for the NIM to be maintained at about 5% for the lending business over the medium term as the company has had no difficulty in passing on increased borrowing costs to its customers. Almost 65-70% of Reliance Capital's total asset book is based on floating rates, as are 70% of its liabilities. Hence, the asset-liability profile is well matched.

Management expects asset quality to remain stable for FY12. The company is undertaking incremental disbursements from its secured loan book only, with a focus on SMEs, mortgages (in the form of loans against property), commercial vehicles, and construction equipment, and is running down its unsecured loan book. This resulted in the total secured loan book accounting for 97% of the total loan book for 4Q FY11 compared with 88% for 4Q FY10. The total unsecured loan book stood at Rs4bn at the end of 4Q FY11, and management expects it to be run down completely in the next two quarters. The provision coverage ratio was 81% at the end of FY11.

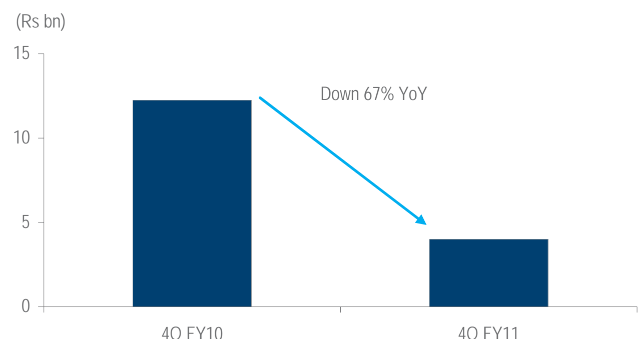
Reliance Capital is now looking forward to entering the infrastructure-financing business in FY12. The company expects the loans to be mainly working-capital loans and to finance mainly suppliers and vendors of its group companies.

■ Commercial finance: total loan book



Source: Company

■ Commercial finance: unsecured loan book



Source: Company

Possible delay in approval of recent stake sale should be an overhang on the stock

Reliance Capital recently sold 26% of its stake in its life-insurance business to Nippon Life Insurance (Not listed), the largest private life insurer in Japan for Rs30.62bn, valuing the total life-insurance business at Rs115bn. However, according to the *Insurance Act*, the main shareholders can dilute the stake only after a company has completed 10 years of operation. The stake sale is likely to be finalised within the next three months, and in the worst-case scenario, it may stretch up to January 2012, when Reliance Life completes 10 years of operation. The company had planned to use the cash from the stake sale to reduce its debt and to

expand various business segments, including the commercial-finance business, and hence this is likely to have a positive impact on Reliance Capital's profitability for FY13.

Also, the company is unlikely to meet the new guidelines on the listing of its life-insurance business. The draft guidelines issued by Insurance Regulator and Development Authority for the listing of life insurance companies, require life-insurance companies to satisfy at least one of the following conditions:

(1) to have recorded a profit in at least three of the preceding five financial years, or
(2) the embedded value (EV) is at least twice its paid-up capital.

We calculate that the EV/paid-up capital for Reliance Life was about 0.9x for FY11 and the company recorded losses for the preceding five financial years and hence it does not meet either of the conditions.

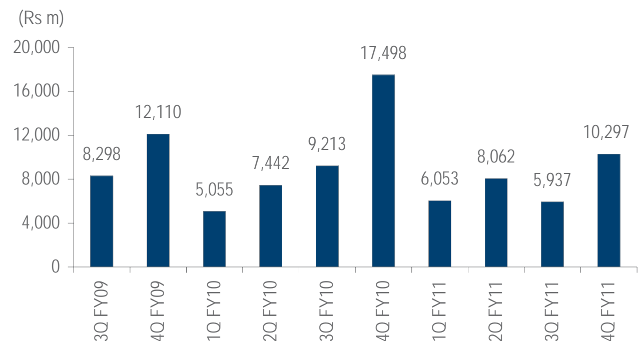
The company is now focusing more on non-ULIP products, with incremental non-ULIP policies accounting for about 60% of total premiums. The participating traditional policies account for about 30% of total premiums and non-participating traditional policies account for 30%, while the ULIP policies account for 40%. We forecast the NBP to rise by no more than 5% YoY for FY12 and be flat for 1H FY12.

Management expects that NBAP margin to be about 16% in a worst-case scenario as it is focused on controlling costs (the company had a cost-to-income ratio of 22% for 4Q FY11) and selling more non-ULIP products, with the focus on the non-participating traditional policies that have high NBAP margins. The NBAP margin of 16.73% for FY11 was significantly lower than the 18.02% recorded for January-September FY11, as the company had a higher proportion of participating policies for 4Q FY11, which generally has a low NBAP margin of about 10%.

The average market share among the private life-insurance players in India declined to 7.2% for 4Q FY11 (based on our calculations) from 11.5% for 4Q FY10. Meanwhile, Reliance Capital has deliberately kept the single-premium contribution target at a lower rate of about 25% compared with the other players, which are aggressive in undertaking single-premium business.

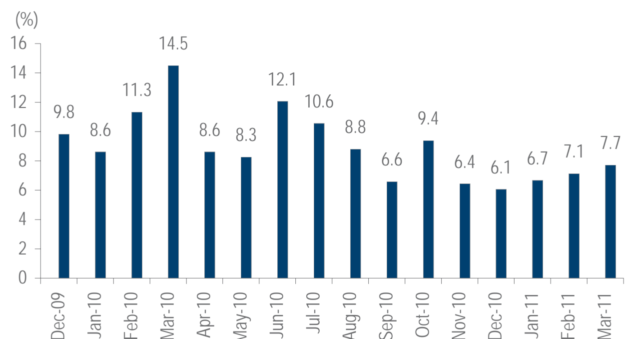
The parent company has injected capital totalling Rs31bn since the life-insurance company, Reliance Life, was established. However, no capital was injected in 4Q FY11. The company's insurance business turned profitable in 2H FY11 and the management expects this to continue for FY12.

■ Reliance Life: NBP



Source: Company, IRDA

■ Reliance Life: market share among the private players



Source: IRDA

Asset management: retail focus to help improve profitability

Management's focus on retail in both the debt and equity segments has helped to improve the profitability of the asset-management business and we expect the company to gain significant traction in the retail business over the medium term.

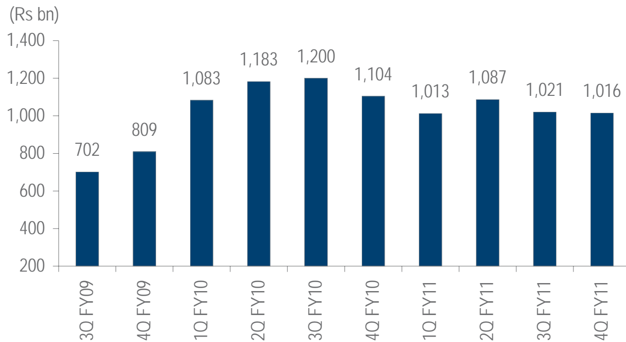
Management expects retail AUM to increase by about 15-20% YoY for FY12, although the overall AUM is likely to be flat year-on-year for FY12.The AUM is typically garnered by three channels namely – banks, investment financial advisors, and third-party brokers – with each accounting for almost an equal proportion (one third) of the incremental AUM. The management on an average pays a commission of 15-20bps to the three channels.

Management expects equity assets as a proportion of total AUM to improve by more than 300bps for 1Q FY12 from 33% for 4Q FY11. It guides for the

proportion of retail assets to total AUM to be about 55% for 1Q FY12 and for this to increase over the medium term as it has been a focus area for the company. Long-term debt as a proportion of total debt increased significantly to about 20% for 1Q FY12, compared with almost zero two years earlier, which should help lead to stable AUM in FY12.

In addition, the company earns a fee of about 80-90bps on the retail debt compared with about 20-25bps on the liquid fund. The profit before tax to average AUM improved to 30bps for FY11 compared with 25bps for FY10 because of the increased focus on retail long-term debt and lower costs.

■ Reliance Mutual Fund: AUM (Rs bn)



Source: Company

Other businesses: focus on profitability rather than growth

Reliance General Insurance

Management expects the combined ratio to fall to about 105% for FY12 from 136% for FY11, as the recent change in provisioning standards for commercial-motor third-party pool resulted in a rise in provisions for FY11.

We believe it will be a big challenge for the general-insurance business to become profitable over the medium term given the high losses in the motor-insurance business. Management expects this business to break even for FY12. It expects to inject about 1.5bn of capital into the business in FY12. The total capital invested in the general-insurance business since its establishment in 2000 has been Rs11bn.

Reliance Money and Securities

The management is seeing improved revenue in the distribution business. The company is now focusing on profit rather than volume growth in these businesses. The main focus area is the distribution of gold coins, which has seen significant demand over the past one year.

Valuation

We have revised up our FY12 consolidated-earnings forecast substantially, by almost 55%, in order to factor in the increasing profitability of the lending business and also to build in our expectation of a turnaround in the life-insurance business, even though we believe the NBP will increase at a very slow rate in FY12.

We value the company on an SOTP basis and have a six-month target price of Rs599. Our value of Rs271/share for the life-insurance business is based on a 10x FY12 NBAP multiple and NBAP margin of 13%. For the asset-management business we assign a value of Rs148/share based on 3.6% of our average AUM forecast for FY12. We have assigned a value of Rs100/share to the commercial-finance business based on a multiple of 10x on our FY12 earnings forecast. For the other business –the general insurance and Reliance Money, and investments – we assign a value of Rs79/share based on our FY12 forecasts.

■ Reliance Capital: SOTP valuation

Business	Valuation (by FY12E)	(Rs bn)	(US$bn)	(Rs/share)
Asset management	At 3.6% of AUM	37	0.8	148
Life insurance	Appraisal value	67	1.5	271
Commercial finance	10x FY12 earnings	25	0.5	100
General insurance	At 1x net worth	6	0.1	24
Investments	At 20% discount to cost	15	0.3	49
Reliance Money	5x FY12E earnings	2	0.0	6
Total value of Reliance Capital	-	151	3.3	599

Source: Daiwa estimates

Risks

The key risk to our target price and rating would be lower-than-expected NBP growth in the insurance business and a lower-than-expected loan growth in the commercial-finance business.

Daiwa Capital Markets

Company

Banks / India
2 August 2011

The 10-second briefing

Dewan Housing Finance
DEWH IN

Target price: **Rs339.00** → **Rs339.00**
Up/downside: **+61.2%**
Share price (2 Aug): **Rs210.30**

Overall business performance remains strong; Buy maintained

- Strong disbursement growth should continue, despite rising property prices and interest-rate hikes
- NIM compression likely to be marginal over the next two quarters
- Current valuation (1.2x FY12E PBR) appears attractive to us

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

Dhiren Shah
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What's new
During our recent talks with DHFL's management, we learned that the company expects its disbursement growth to be strong and NIM compression to be marginal over the next two quarters.

What's the impact
Rising property prices and the recent interest-rate hikes have not had an effect on the current demand for mortgages, and the company's loan disbursements remain strong. DHFL operates in a niche market, and given the strong demand drivers in place, we forecast FY12 disbursement growth of 32% YoY.

Furthermore, the company has been able to pass on its increased cost of borrowing to customers, and has raised its prime lending rate by 75bps since April 2011. Management believes a further 50bp interest-rate hike over the next six months would be passed on easily to borrowers. It expects the NIM to range from 2.9-3% over the next two quarters.

DHFL expects its insurance-distribution income to keep its fee income strong, thereby improving profitability for FY12. Currently, the company earns insurance commission on 65% of its fresh disbursements.

The regulator (NHB) has proposed guidelines to increase the standard provisioning requirement for retail home loans to 0.4%; however this is unlikely to have any impact on the company's profitability, in our view, as it has excess provisions on its books currently.

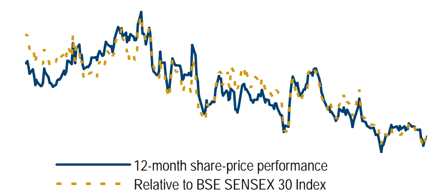
What we recommend
We maintain our Buy (1) rating and six-month Gordon Growth Model-derived target price of Rs339, based on a target FY12E PBR of 2x. The key risk to our target price and rating would be lower-than-expected FY12 disbursement growth and higher-than-expected NIM compression.

How we differ
We are more bullish than the market in that we expect higher disbursement growth and marginal NIM compression for FY12.

Forecast revisions (%)

Year to 31 Mar	12E	13E	14E
PPOP change	0.0	0.0	0.0
Net-profit change	0.0	0.0	0.0
EPS change	0.0	0.0	0.0

Source: Daiwa forecasts



12-month range	198.55-336.95
Market cap (US$m)	498.25
Average daily turnover (US$ '000)	767.66
Shares outstanding (m)	104
Major shareholder	Caledonia Investments PLC (FDI) (7.7%)

Source: Bloomberg, Daiwa

Financial summary (Rs)

Year to 31 Mar	12E	13E	14E
Total operating income (m)	6,540	8,668	10,906
Pre-provision operating profit (m)	4,340	5,831	7,193
Net profit (m)	3,020	4,013	4,948
Core EPS (fully-diluted)	28.921	38.428	47.385
EPS change (%)	17.4	32.9	23.3
Daiwa vs Cons. EPS (%)	5	4	n.a.
PER (x)	7.3	5.5	4.4
Dividend yield (%)	1.9	2.1	2.4
DPS	4.000	4.500	5.000
PBR (x)	1.2	1.0	0.9
ROE (%)	18.0	20.4	21.1

Source: Daiwa forecasts

Important disclosures, including any required research certifications, are provided on the last two pages of this report.

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

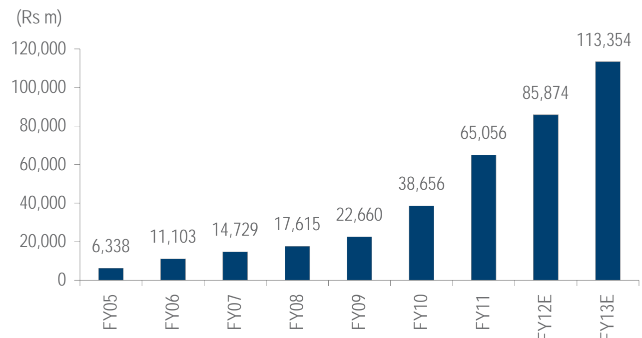
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We forecast a disbursement CAGR of 30%+ over the FY12-14 period, along with healthy asset quality and stable NIMs. We forecast a strong net-profit CAGR of 28% over the same period, with ROEs of 18% and 20.3% for FY12 and FY13, respectively.

DHFL: loan-disbursement growth (Rs m)



Valuation ✔✔✔✔✔

The stock is trading currently at an FY12E PBR of 1.2x, which is at a steep discount to its peers, such as HDFC or LIC Housing (Not rated). We believe this valuation gap should narrow over the next two quarters. We maintain our Gordon Growth Model-derived six-month target price of Rs339, based on a target FY12E PBR of 2x.

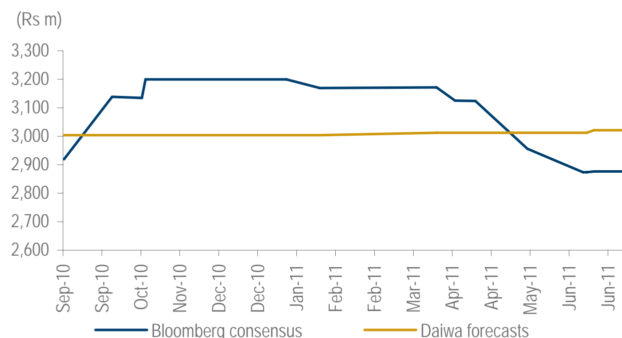
DHFL: PBR bands

Source: Bloomberg, Daiwa forecasts

Earnings revisions ✔✔✔✔✔

We believe the Bloomberg consensus is likely to revise up its FY12-14 EPS forecasts. Our FY12 earnings forecast is 5% higher than that of the Bloomberg consensus. We believe the consensus is likely to move closer to our forecast as the market starts to factor in higher disbursement growth and marginal NIM compression.

DHFL: Daiwa earnings forecasts vs. those of the Bloomberg consensus (Rs m)



Source: Bloomberg

Financial summary

■ Key assumptions

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan growth (%)	44.3%	25.9%	39.6%	50.8%	61.1%	40.0%	25.0%	24.0%
Disbursement growth (%)	32.7%	19.6%	28.6%	70.6%	68.3%	32.0%	32.0%	30.0%

■ Profit and loss (Rs m)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	842	1,097	1,585	2,197	3,393	4,519	6,155	7,940
Net fees & commission	130	126	214	746	1,106	1,666	2,204	2,763
Trading and other income	99	195	208	285	367	355	310	203
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	**1,071**	**1,418**	**2,007**	**3,227**	**4,866**	**6,540**	**8,668**	**10,906**
Personnel expenses	(116)	(176)	(284)	(391)	(614)	(860)	(1,187)	(1,638)
Other expenses	(254)	(302)	(409)	(718)	(1,102)	(1,339)	(1,651)	(2,075)
Total expenses	**(369)**	**(478)**	**(693)**	**(1,108)**	**(1,716)**	**(2,199)**	**(2,838)**	**(3,713)**
Pre-provision operating profit	**702**	**940**	**1,314**	**2,119**	**3,150**	**4,340**	**5,831**	**7,193**
Total provision	(57)	(53)	(73)	(98)	(90)	(203)	(333)	(415)
Operating profit after prov.	**645**	**887**	**1,241**	**2,021**	**3,060**	**4,137**	**5,497**	**6,778**
Non-operating income	0	170	(54)	0	354	0	0	0
Profit before tax	**645**	**1,057**	**1,187**	**2,021**	**3,414**	**4,137**	**5,497**	**6,778**
Tax	(111)	(232)	(324)	(515)	(764)	(1,117)	(1,484)	(1,830)
Min. int./pref. div./other items	0	0	0	0	0	0	0	0
Net profit	**535**	**826**	**864**	**1,506**	**2,651**	**3,020**	**4,013**	**4,948**
Adjusted net profit	**535**	**656**	**918**	**1,506**	**2,296**	**3,020**	**4,013**	**4,948**
EPS (Rs)	**10.668**	**14.931**	**14.274**	**21.136**	**28.438**	**28.921**	**38.428**	**47.385**
EPS (adjusted) (Rs)	**10.668**	**11.857**	**15.167**	**21.136**	**24.637**	**28.921**	**38.428**	**47.385**
EPS (adjusted fully-diluted) (Rs)	**10.668**	**11.857**	**15.167**	**21.136**	**24.637**	**28.921**	**38.428**	**47.385**
DPS (Rs)	**2.500**	**2.500**	**2.500**	**3.000**	**3.500**	**4.000**	**4.500**	**5.000**

■ Change (YoY %)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Net-interest income	71.7	30.2	44.5	38.6	54.5	33.2	36.2	29.0
Non-interest income	(21.5)	40.3	31.6	143.9	43.0	37.2	24.4	18.0
Total operating income	37.0	32.4	41.5	60.8	50.8	34.4	32.6	25.8
Total expenses	46.1	29.4	45.0	59.9	54.9	28.1	29.0	30.8
Pre-provision operating profit	32.6	33.9	39.8	61.2	48.7	37.8	34.3	23.4
Total provisions	12.5	(6.9)	38.6	34.2	(8.2)	125.8	64.1	24.4
Operating profit after provisions	34.7	37.5	39.9	62.8	51.4	35.2	32.9	23.3
Profit before tax	34.7	63.9	12.3	70.2	68.9	21.2	32.9	23.3
Net profit (adjusted)	35.0	22.7	39.9	64.1	52.5	31.5	32.9	23.3
EPS (adjusted)	35.0	11.2	27.9	39.4	16.6	17.4	32.9	23.3
Gross loans	44.3	26.2	39.7	50.8	61.3	40.0	24.9	24.0
Deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	40.5	23.7	45.2	52.8	67.6	28.9	24.6	23.8
Total liabilities	41.1	23.8	48.5	51.3	66.7	30.2	25.2	24.2
Shareholders' equity	35.3	22.7	15.4	70.1	77.3	16.4	18.7	19.4
Avg interest-earning assets	45.9	32.1	36.6	49.4	57.1	42.3	27.4	24.4
Avg risk-weighted assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (Rs m)

As at 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & equivalent	1,425	1,192	4,654	7,303	11,617	2,048	2,338	2,841
Investment securities	963	1,025	1,085	1,314	8,707	9,359	11,676	14,567
Net loans and advances	33,020	41,581	58,066	87,584	141,112	197,557	246,946	306,213
Fixed assets	446	457	498	2,165	2,222	2,445	3,178	4,131
Goodwill	0	0	0	0	0	0	0	0
Other assets	386	556	764	1,028	2,920	3,295	3,470	3,643
Total assets	**36,240**	**44,811**	**65,068**	**99,393**	**166,579**	**214,704**	**267,608**	**331,396**
Customers deposits	0	0	0	0	0	0	0	0
Borrowing	32,147	39,694	58,764	89,268	148,501	193,051	241,314	299,229
Debentures	0	0	0	0	0	0	0	0
Other liabilities	465	666	1,168	1,391	2,594	3,632	4,903	6,618
Total liabilities	**32,612**	**40,360**	**59,932**	**90,659**	**151,095**	**196,682**	**246,216**	**305,847**
Share capital	743	675	635	850	1,044	1,044	1,044	1,044
Reserves & others	2,885	3,775	4,500	7,884	14,440	16,977	20,348	24,504
Shareholders' equity	**3,628**	**4,450**	**5,135**	**8,734**	**15,484**	**18,021**	**21,392**	**25,549**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**36,240**	**44,810**	**65,067**	**99,393**	**166,579**	**214,704**	**267,608**	**331,396**
Avg interest-earning assets	29,229	38,597	52,735	78,792	123,796	176,137	224,410	279,149
Avg risk-weighted assets								
BVPS (Rs)	67.56	72.40	84.38	106.15	148.28	172.57	204.85	244.66

Key ratios (%)

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Loan/deposit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tier-1 CAR	0.0	14.1	14.0	16.1	13.9	12.6	12.0	11.6
Total CAR	14.1	17.0	16.2	17.3	19.4	17.5	16.8	16.4
NPLs/gross loans	1.3	1.6	1.5	1.1	0.7	0.6	0.6	0.6
Total loan-loss prov./NPLs	18.4	27.0	32.4	37.0	85.2	84.6	83.3	83.3
ROAA	1.5	1.6	1.7	1.8	1.7	1.6	1.7	1.7
ROAE	15.8	16.9	19.3	21.8	19.0	18.0	20.4	21.1
Net-interest margin	2.9	2.8	3.0	2.8	2.7	2.6	2.7	2.8
Gross yield	10.8	12.3	12.4	11.3	10.5	12.2	12.1	12.0
Cost of funds	8.5	10.2	10.0	9.0	8.1	10.0	9.7	9.5
Net-interest spread	2.4	2.1	2.3	2.2	2.4	2.3	2.4	2.5
Total cost/total income	34.5	33.7	34.5	34.3	35.3	33.6	32.7	34.0
Effective tax	17.1	21.9	27.3	25.5	22.4	27.0	27.0	27.0
Dividend-payout	23.4	16.7	17.5	14.2	12.3	13.8	11.7	10.6

Source: Company, Daiwa forecasts

Company profile

Dewan Housing Finance ltd (DHFL) is a leading player in the low-and-medium income housing-finance market. It was incorporated in 1984, and as at 30 June 2011, had a loan book of Rs153bn.It had a pan-India presence in 417 locations as at 30 June 2011.

Overall business performance remains strong; Buy maintained

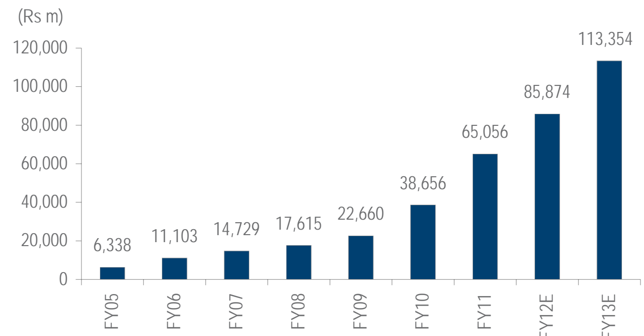
We expect strong disbursement growth, marginal NIM compression, and healthy asset quality for FY12, despite the ongoing challenging macro environment

Strong disbursement and fee-income growth likely to continue

We expect the company's current strong disbursement growth to continue, as we believe rising property prices and the interest-rate hikes have not had an adverse affect on the current demand for the company's mortgages, and its loan disbursements remain strong. The company operates in a niche market, and we believe there are strong demand drivers in place, ie, rising income levels, an increase in the working population, and a shift to the nuclear-based family system. We forecast strong disbursement growth of 32% YoY for FY12, representing a CAGR of more than 30% over the FY12-14 period.

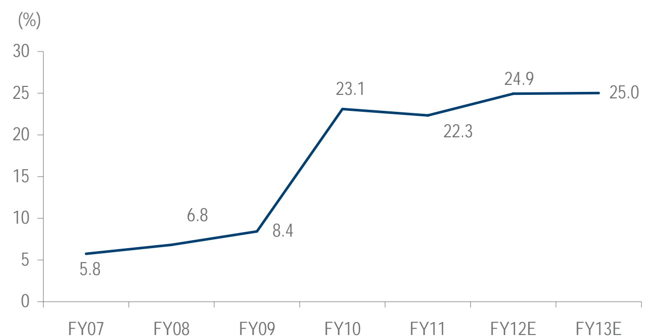
We expect fee-income growth to remain robust, as the company is focused on earning substantial income from the insurance-distribution business that it started in FY09. The company earns insurance commission on 65% of its fresh disbursements to new customers. Its strong disbursement growth, along with higher insurance commission, should lead to higher fee-income growth, for which we forecast a CAGR of 29% over the FY12-14 period.

■ DHFL: loan disbursements (Rs m)



Source: Company, Daiwa forecasts

■ DHFL: fee income as a % of net income

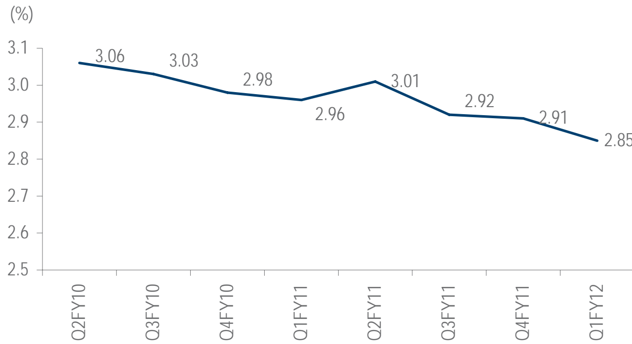


Source: Company, Daiwa forecasts

NIM compression likely to be marginal in the medium term

Management has been able to pass on the increase in the cost of borrowing easily to its customers due to the improved pricing power it enjoys in its niche market segment. It believes that a further 50bp hike in the interest rate over the next six months would be passed on easily to borrowers. The company has increased its prime lending rate by 75bps since April 2011. Management expects the NIM to range from 2.9-3% over the next two quarters.

■ DHFL: quarterly NIM fluctuations (%)



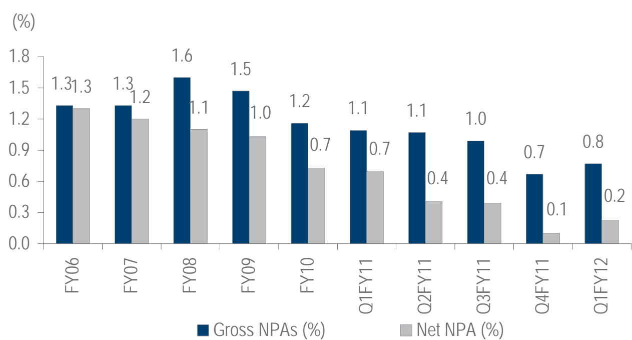
Source: Company

Asset quality likely to remain healthy

The company has always had a conservative approach to lending, which is reflected in the fact that it lends mainly to salaried individuals (more than 70% of its loans go to these individuals), is not dependent on direct sales agents, and has a low instalment-to-income ratio (39% for 1Q FY12). This has led to healthy asset quality, and for 1Q FY12, the company had gross NPLs of 0.77% and net NPLs of just 0.23% (both as a percentage of total loans).

We believe the company's asset quality is likely to remain healthy in FY12, as it has developed strong relationships with its customers over a long period of time and finances mainly end-users.

■ DHFL: gross and net NPLs (%)



Source: Company

Valuations

The stock is trading currently at an FY12E PBR of 1.2x, which is at a steep discount to its peers, such as HDFC and LIC Housing. We believe this valuation gap should narrow over the medium term. We forecast a strong net-profit CAGR of 28% over the FY12-14 period, with ROEs of 18% and 20.3% for FY12 and FY13, respectively. We maintain our Buy (1) rating and Gordon Growth Model-derived six-month target price of Rs339, based on an FY12E target PBR of 2x.

■ DHFL: PBR bands

Source: Bloomberg, Daiwa forecasts

■ DHFL: PER bands

Source: Bloomberg, Daiwa forecasts

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