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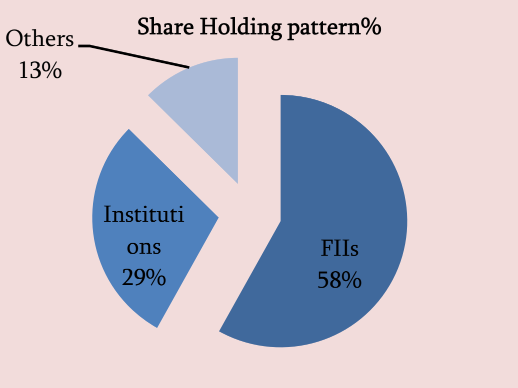
HDFC
HOUSING DEVELOPMENT FINANCE CORPORATION LTD.

Recommendation – BUY , Target Price – INR 746

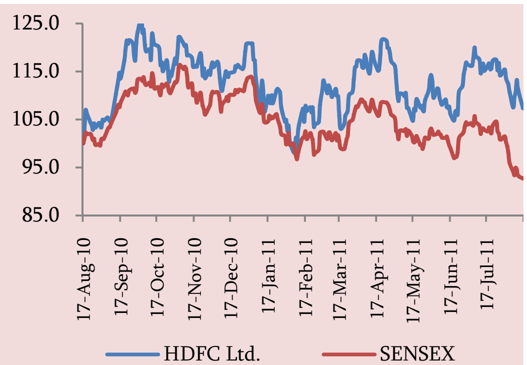
Analyst – Abhisek Sasmal
asasmal@microsec.in

BUY

Market Data	
Current Market Price (INR)	646
Target Price (INR)	746
Upside Potential (annualized)	~ 10.3%
52 Week High / Low (INR)	780/582
Market Capitalization (In INR Mn)	950711



STOCK SCAN	
BSE Code	500010
NSE Code	HDFC
Bloomberg Ticker	HDFC IN
Reuters Ticker	HDFC.BO
Face Value (INR)	2
Equity Share Capital (INR. Mn.)	2930
Average 3 Year P/E/PBV	27.2/4.64
Beta vs Sensex	1.13
Average Daily Volmes (6 M)	2856000
Dividiend Yield (%)	1.39
Stock Return (1 Yr)	8.70%



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HDFC Limited – "Safe as Houses"

HDFC has delivered superior profitability and consistent growth across the economic cycles. This ability to steer the business through volatile times and rate hike cycles makes it a relative safe haven. Experienced management also lends credibility to our call. **Key risks** – Demand slowdown in Domestic Housing market, Increased competition from banks.

Key Rationale

- ✓ Market leader in the Mortgage Finance Industry.
- ✓ Resilient margins due to high pricing power, funding mix flexibility & minimal ALM gaps.
- ✓ Strong Asset Quality with adequately capitalized books.
- ✓ Good Dividend paying history.
- ✓ Strategic investments yielding good returns.

Q1'12 Result Review

HDFC Ltd. has reported first quarter FY12 net profit of INR 8445.3 Mn, a 21.6% jump as compared to INR 6945.9 Mn in same quarter the previous year. Net Sales & Other Operating Income went up by 35.88% YoY to INR 38006.7 Mn. As on June 30, 2011, the loan book stood at INR 1241.7 Bn as against INR 1016.3 Bn in the previous year, registering a YoY growth of 22.2%. Loan spread was marginally down to 2.30% from 2.33% in Q4FY11. The Capital Adequacy Ratio stood at 13.8% whereas Tier I capital stood at 12.2%.

Valuation & Recommendation

At INR 646, the stock is trading at 4.3x FY13 core book value and 18.6x FY13 core earnings justifying consistent and quality of earnings. We valued the mortgage business at INR 497 per share (5x on FY13e core book). We initiate on **HDFC ltd** with a **BUY** rating on the stock with price target of **INR 746** arrived at by SOTP valuation.

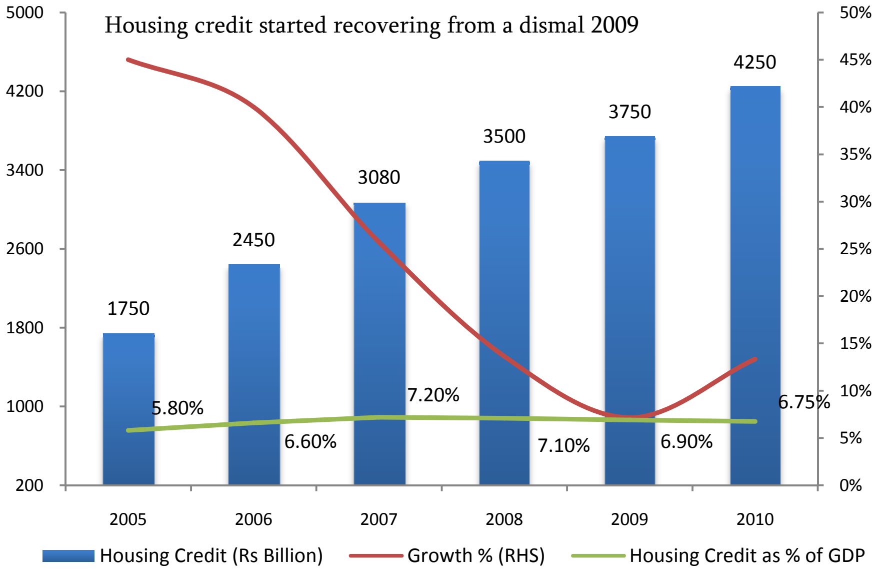
Description	FY10	FY11	FY12E	FY13E
Net Interest Income (NII)	34860	44460	55540	70850
Pre-provision profits	39740	49370	59080	74770
Net profit	28260	35350	42060	53230
Net interest margin (NIM)	**3.13%**	**3.47%**	**3.60%**	**3.80%**
EPS (Rs)	19.7	24.1	28.7	34.6
Book value per share (Rs)	106	118	135	151.3
Adjusted book value per share (Rs)	49	64.2	81.2	99.3
PE (x)	32.8	26.8	22.5	18.6
PB (x)	6.1	5.5	4.8	4.3
ROE%	19.95	21.74	21.73	20.06
D/E	6.35	6.66	6.7	6.8

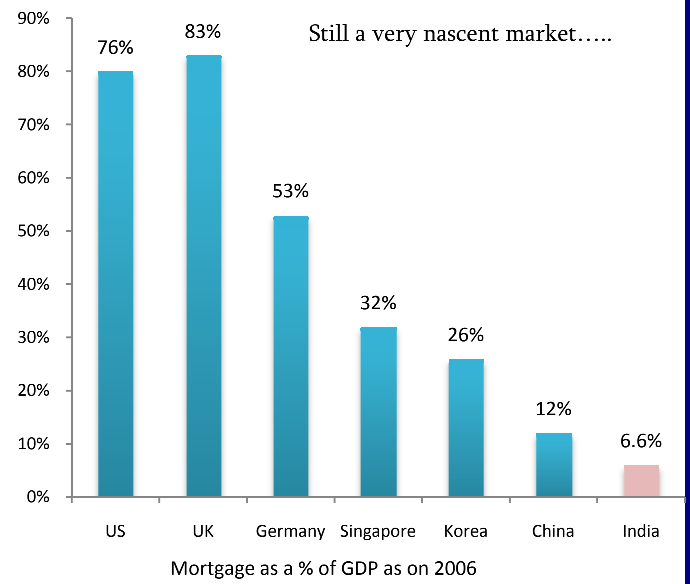
S source: Company, Microsec Research

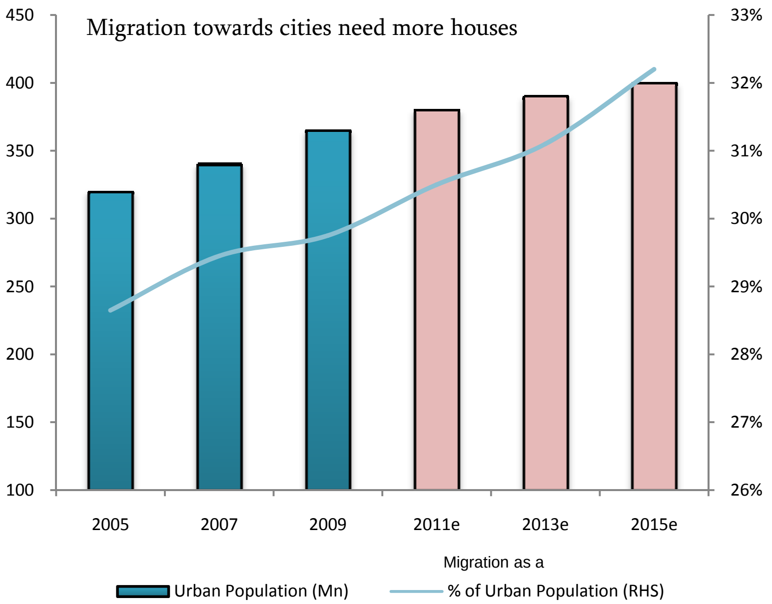
Housing Finance Industry Overview

The mortgage industry in India is at a nascent stage. Long term growth story looks very attractive with all the key factors intact.

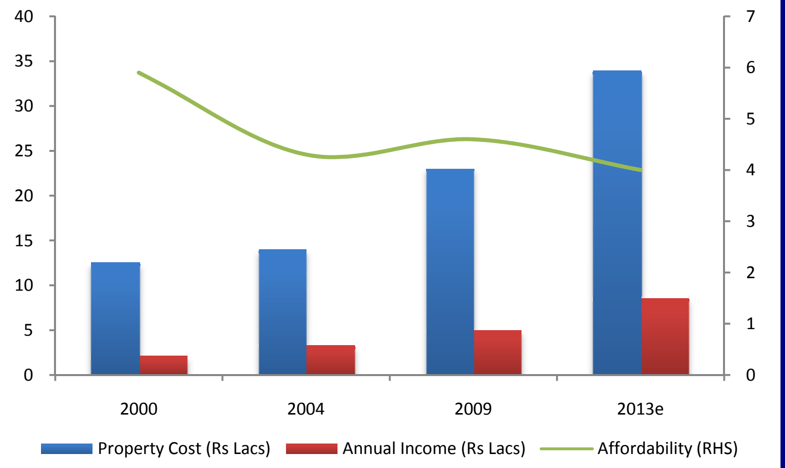
After years of unprecedented price rise, property markets experienced significant price correction in FY09. Very high property prices, a high interest rate scenario coupled with slowing economy had resulted in slowdown in housing demand in 2009. We have bounced back strongly from that phase in 2010. The key factors working in its favor are housing affordability keeping in mind the rising income level (rise in income faster than rise in property prices), increasing urbanization, favorable demography.





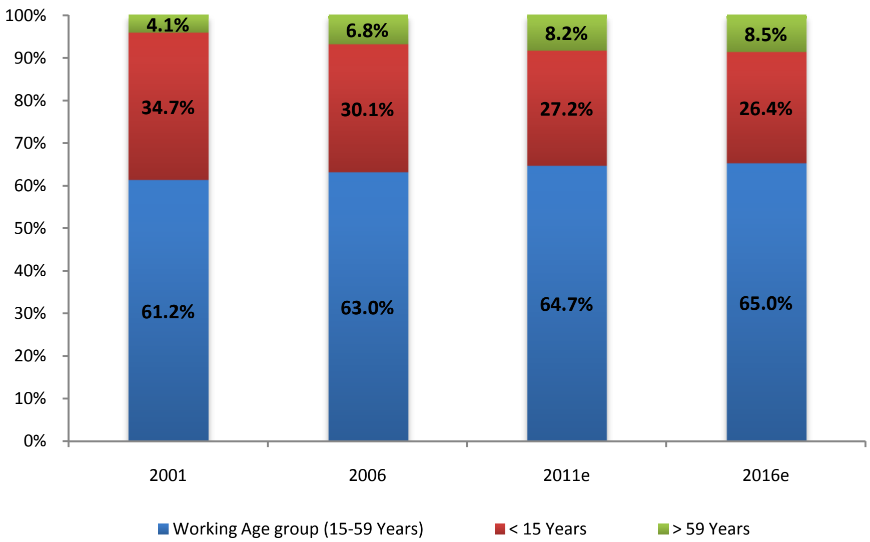


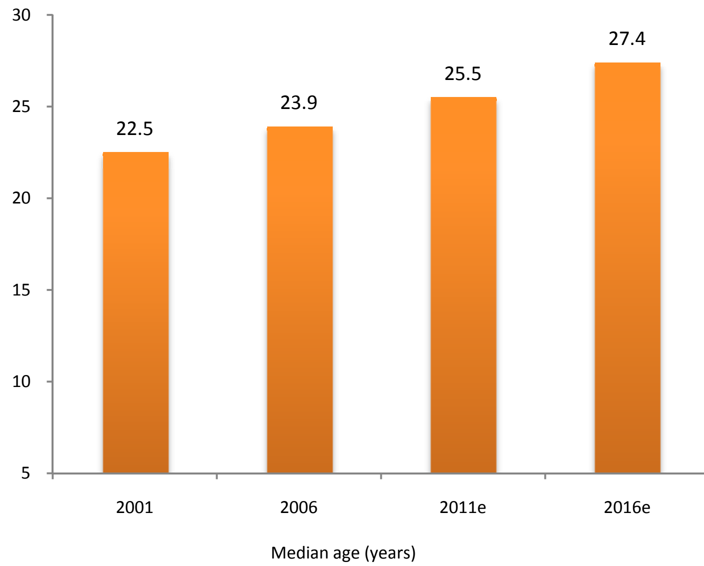
Increase in affordability leads higher equity participation from borrowers which leads to lower LTV



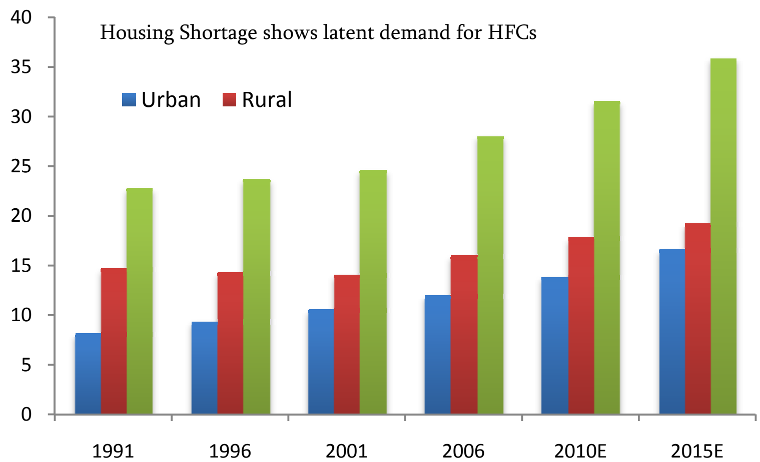
Affordability defined as Property price/ Annual Income **Source: Bloomberg, HDFC,Microsec Research**

Increase in Workable population leads to more aggregate disposable income & higher no of home buyers. Increase in median age results into more mature new home buyer market





Source: National Commission on Population Microsec Research



Source: NBO, NHHP, Microsec Research

If we see the chart carefully, we can easily point out that the housing shortage in absolute number is not decreasing. i.e. existing gap in housing stock from 1991 to 2006 could not be filled up by conventional housing supply system. Whereas, housing shortage in semi-urban areas is increasing. i.e. demand for new housing is growing at a higher pace in semi-urban areas and supply is not adequate. This demand is the main underlying theme for the HFCs (Housing Finance Companies) which not only provide financial support for buying existing home but also lends to builders for creating new homes .

What we are today-US was in 1984, Shows huge market potential for HFCs

Bn USD	**1984**	**1994**	**2006**
US GDP	3902	7018	14000
Mortgage Market	203.7	773	10640
Mortgage as % of GDP	5.2%	11%	76%
Market Share			
Banks	74.1%	46.2%	37%
Mortgage Companies	23.4%	52.8%	60%
Others	2.6%	1.1%	3%

Bn USD	**2006**	**2016**
Indian GDP	906	1811
Mortgage Market	59.8	253.4
Mortgage as % of GDP	6.6%	14%
Market Share		
Banks	72.1%	Huge Market Potential
Mortgage Companies	26.3%	
Others	1.6%	

Source: Federal Reserve Board, US department of Housing & Urban Development, Microsec Research

If we compare US housing finance market with Indian market, although it's a very early stage in development of housing finance industry here, but it is showing all the right trends. With proper regulatory compliances in place (learning from the mistakes of US), we believe HFCs are well capitalized to tap this huge demand for financing housing dreams for millions of people in India. The market for interest rate swaps & mortgage backed securities are not very developed in India. Title due diligence is still lengthy, and mortgage enforcement is still an issue for non-banker lenders in India. However with increasing focus on low to medium income group, the risk profile of some HFCs may probably increase to the extent that new rules regarding securitization of property will become imminent. This will be the inflection point of Indian Housing Finance market. However the caveat is that in US also it took almost 10 years to develop the mortgage backed securities market.

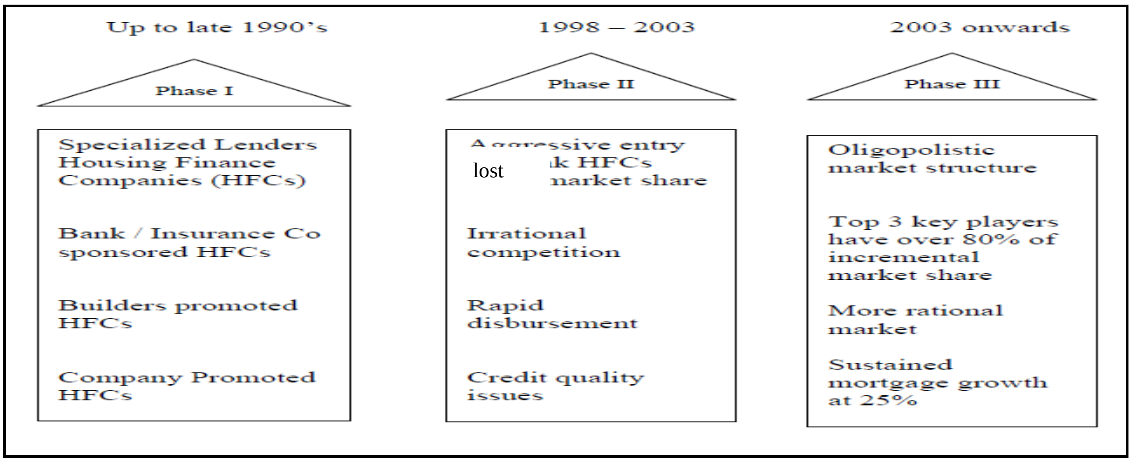
Development of US Housing Finance Market

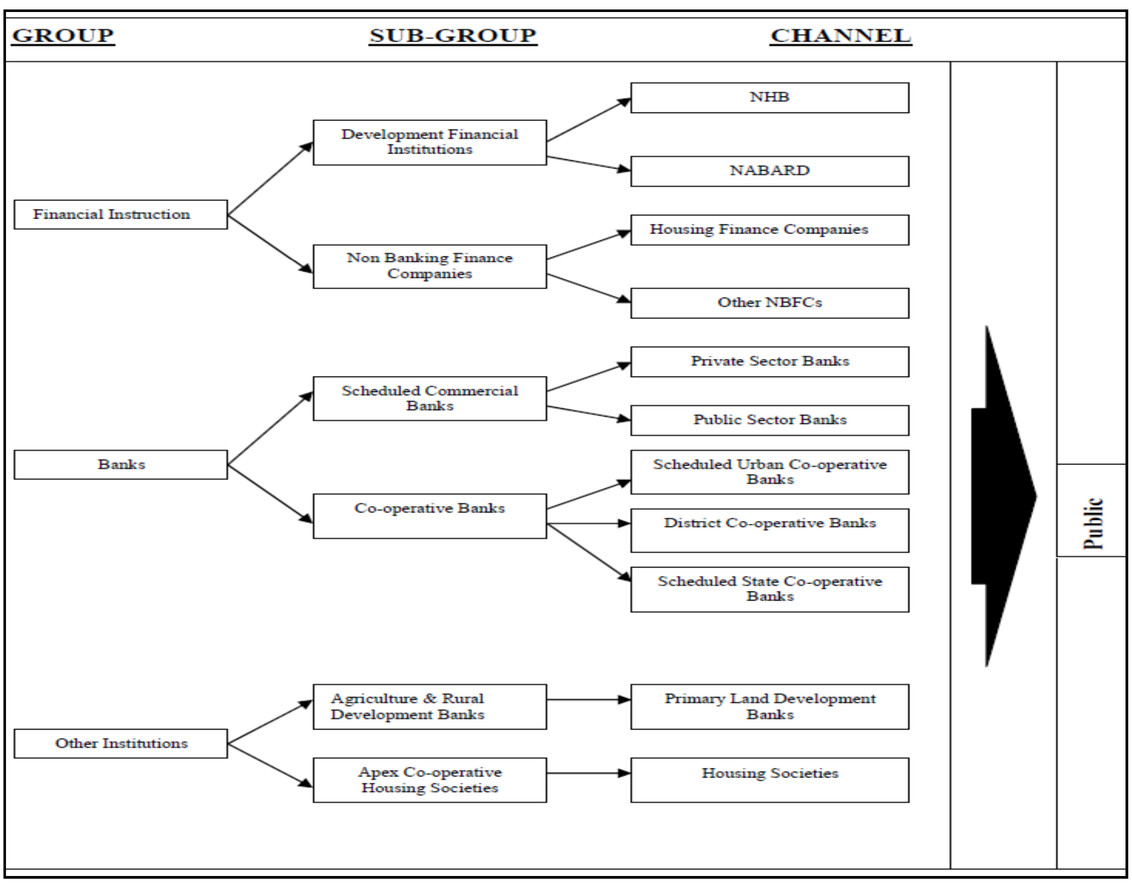
	Institutions	*Products*	*Risk/Shocks*
"Era of Exploration" *Pre-1930s*	• "Terminating" Building Societies (since 1775)	• Nonamortizing; variable rate; semiannual payment	• Peer enforcement and deposit-based funding
	• "Permanent" Building Societies (1850s)	• 6- to11-year loan term and 50 to 60% maximum LTV	• Localized risk management (e.g., 50-mile radius rule)
	• Mortgage companies (1870s)	• MBBs by mortgage companies (1870s to 1890s)	• Recession in 1890s led to demise of mortgage companies; agency problem in pooling
	• Life insurance companies (active in the early 1900s)	• Deposit/investment certificates (1890s)	• Significant growth in 1920s and stock market crash in 1929
"Era of Institutionalization" *1930s to 1960s*	• Creation of HOLC and RFC to liquidate bad loans/banks (1933)	• Fully amortizing loans with leveled monthly payments	• Great Depression (1930s)
	• Creation of FHLBanks (1934) and Fannie Mae (1938) to increase liquidity	• Fixed interest rate and longer than 20-year loan term	• National Housing Act (1934) and Housing Act (1949)
	• Creation of FHA, FDIC, FSLIC, and private mortgage insurance companies (1934) for credit enhancement	• Maximum LTV up to 80%	• Regulation Q (1966)
	• Privatization of Fannie Mae and creation of Ginnie Mae (1968)	• Underwriting guidelines set by Fannie Mae (1954)	• Rising interest rates and inflation (1960s)
Era of Securitization *1970s to 1980s*	• Creation of Freddie Mac (1970)	• Introduction of ARMs (1981)	• First and second oil shocks (1970s)
	• New investors into the market: mutual funds, pensions, foreign investors (1980s)	• MBS issuance: first PC by Freddie Mac (1971), Ginnie Mae tandem plan (1974-76), first private MBS by Bank of America (1977)	• Interest rate hike and mismatch of asset-liability duration of S&Ls (1980s); removal of interest rate ceilings (1980s)
	• S&L Debacle (1980s) and creation of RTC (1989)	• First CMO issuance (1984) and a big increase in MBS issuance (1982–86)	• Oil patch default ramp-up (1980s)
		• Market for interest rate swaps (1980s)	• FIRREA (1989) and Basle I (1980s)
Era of Automation/ Computerization *1990s to Current*	• Creation of OFHEO (1992)—Minimum and Risk-Based Capital Rules for GSEs	• IT revolution—AUS, mortgage score, AVM (since mid-1990s)	• California default ramp-up (early to mid-1990s)
	• HUD affordable housing goals for GSEs (1992)	• Refi booms (mid-1990s to early 2000s)	• Expansion of credit derivatives markets (since mid-1990s)
	• Globalization of MBS markets (ongoing)	• HELOC, second mortgages, and other affordable products (1990s to current)	• House price index-based hedging market (currently under study)

Source: US Department of Housing & Urban Development

Indian Market

With the development CMBS (commercial mortgage-backed securities) market in India, we may see a new era beginning going forward. The creation of real estate special purpose vehicles (SPVs). would remove many issues related to property transfers. With more focus on **inclusive growth & affordable housing**, companies which are targeting or focusing the low to middle income group are probably is in a better place. NHB's refinancing rules for these companies are also expected to relax a bit, which is a big positive.





Source: MPRA, Microsec Research

NHB's initiatives for development of Urban & Rural Housing

Refinance of construction finance for Affordable Housing

The Scheme draws on the National Urban Housing & Habitat Policy 2007 (NUHHP-2007) which has laid stress on measures to respond to the housing needs in the urban areas and the growing pressure on housing and related infrastructure facilities. The Policy seeks to promote various types of public-private partnerships for realizing the goal of "Affordable Housing for All" with special emphasis on the urban poor.

Under this scheme 100% loan sanctioned by HFCs for affordable housing is eligible for refinance for a maximum period of 5 years from NHB.

Scheme of 1% Interest Subvention on Housing Loan up to INR.1.5Mn

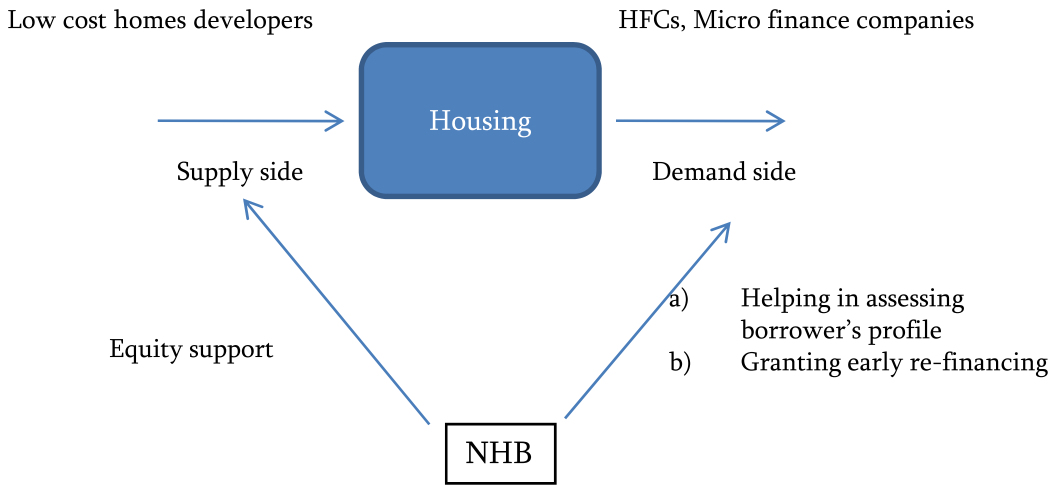
The Government of India has approved a Scheme of Interest Subvention on Housing Loan up to INR.1.5Mn, provided the cost of unit does not exceed INR.2 Mn.

Productive Housing in Rural Areas (PHIRA)

National Housing Bank has launched a new programme called Productive Housing in Rural Areas (PHIRA) under which a composite loan of housing and income generation is extended. Purpose of loan is to provide financial assistance for construction of a decent house and thereafter starting or augmenting income generating activity.

NHB mulls early refinance to housing finance companies

Recently the National Housing Bank is examining the possibility of giving concessional refinance to housing finance companies, set up exclusively to fund the home ownership dream of the households, within a year of commencement of operations. Earlier the rule used to apply after 3 years of operation.



Source: Microsec Research

Key Investment Highlights

• Strong Management team

HDFC has one of the most respected and experienced management teams in the industry. Average tenure of senior management is more than 25 years. Management has conservative and consistent approach to its business and has delivered superior performance across cycles.

• Strong underlying demand growth drivers in place

HDFC is well placed in a business segment where secular growth drivers are intact and capable of supporting loan growth of 22-25%. Key drivers of long term growth for the company include continuation of strong economic growth, higher disposable income, lower penetration of home ownership proportion & penetration in India. *However we believe higher rates could have a negative impact on real estate volumes in near term.*

• Resilient margins due to high pricing power, funding mix flexibility & minimal ALM gaps

Management has a flexible strategy to fund mortgage book growth, depending on prevailing liquidity. HDFC Limited's historical ability to maintain spreads at around 2.2-2.3% and grow business at over 20% YoY across economic cycles gives us comfort. Current funding mix comprises *42% bonds, 32% domestic term loans, 25% deposits and 1% international borrowing.* The bank's excellent management of spreads can be better understood by looking at its asset-liability maturity pattern. HDFC has a tightly matched balance sheet, meaning little mismatch in the duration of its assets and liabilities.

• Strong Asset Quality with adequately capitalized books

HDFC's lending policies are conservative, with an average loan-to-value ratio of 65% at origination and duration of less than six years. 92% of HDFC's mortgages are sourced by themselves or through their affiliates. More than 90% of individual loans are given to salaried employees. *GNPA% & NNPA% as on June'2011 stood at 0.83% & 0.0%.* Since inception, HDFC has disbursed loans aggregating ~ US$ 46Bn of housing loans, while it has suffered loan losses of ~US$ 21Mn (i.e. cumulatively less than 5bps in the last 30 years). The *Capital Adequacy Ratio stood at 13.8% whereas Tier I capital stood at 12.2%.*

• Minimal dilution on account of warrant conversion

HDFC Limited issued 10.95 Mn warrants in August 2009 at an issue price of INR 55 per share (INR 275 pre split). Warrant holders can exchange each warrant for one equity share at any time up to 23 August 2012 at an exercise price of INR 600 per equity share (INR 3,000 pre split). The maximum dilution if all warrants are exchanged for equity shares is 4.65% of the expanded equity share capital. We have built the expected dilution in our model.

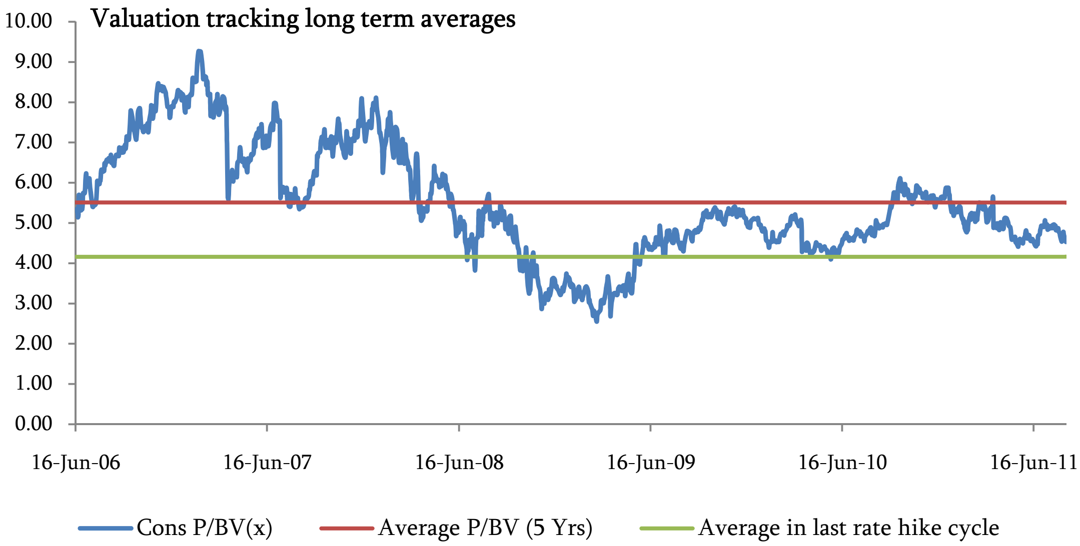
• Strong Dividend paying history

HDFC Ltd. has paid a staggering INR 66.94 Bn as dividend from FY01 to FY11. Last 10 years average dividend % stood at 244% with average dividend yield at 2.01%.

HDFC Limited, INR Mn	FY11	FY12E	FY13E
Equity	2,930	2,930	3,073
Reserves	170,230	195,150	229,427
Net worth (NW)	**173,160**	**198,080**	**232,500**
Less: Amount invested in associate companies / subsidiaries	79,351	79,351	79,351
Adj Net worth	**93,809**	**118,729**	**153,149**
Book value per share	118.2	135.2	151.3
Book value of investments in associate companies/ subsidiaries	54	54	52
Adj BV per share	**64.2**	**81.2**	**99.3**

SOTP Valuation HDFC Limited	Stake	Value/share	Valuation
Mortgage business	100%	497	5x FY13 Core BV
HDFC Bank	23%	166	Target Price
Gruh Finance	60%	6.5	Target Price
Life Insurance	72%	48	15x NBAP Multiple
Asset Management business	60%	22	5 % of AUM
Others		20	
Subsidiary/Associate		262.5	
Adjustment for holding company discount @20%		210	
Mortgage + subs value per share (Rs)		707	
Unrealized gains (assumed)		39.6	
Fair value per share		**746**	

Source: Company, Microsec Research



Source: Company, Microsec Research

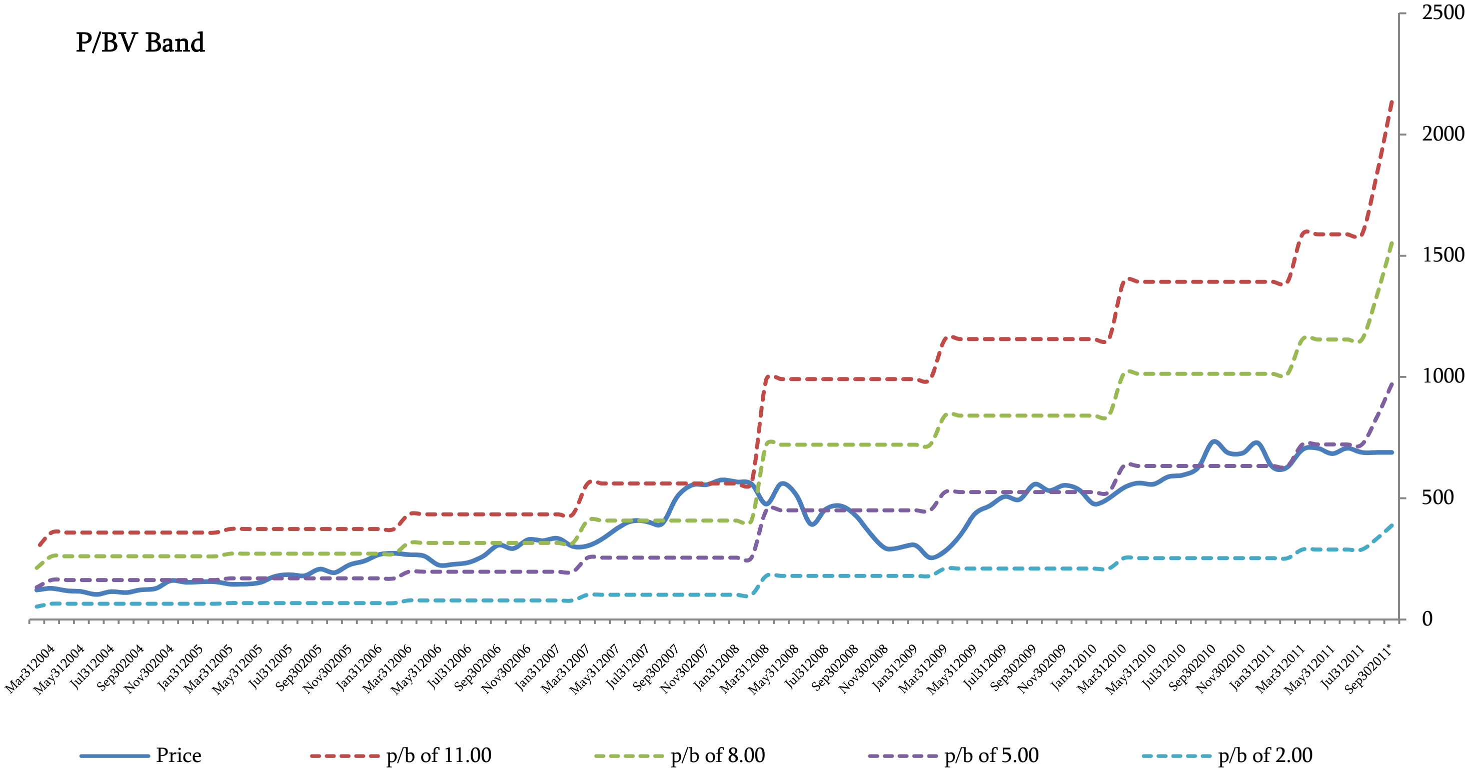
P&L (INR Mn)	FY10	FY11	FY12E	FY13E
Interest earned	105490	120060	153520	197840
Interest expenses	70630	75600	97980	126990
Net Interest Income (NII)	**34860**	**44460**	**55540**	**70850**
Core fee Income	2320	2200	2290	2770
Non interest income	8120	8720	7790	8570
Operating income	**42980**	**53180**	**63330**	**79420**
Operating expenses	3240	3810	4250	4650
Employee Cost	1470	1760	1930	2120
Other Operating exp	1770	2060	2320	2530
Pre-provision profits	**39740**	**49370**	**59080**	**74770**
Provisions	580	700	660	810
PBT	39160	48670	58420	73960
Provision for taxes	10900	13320	16360	20730
Net profit	**28260**	**35350**	**42060**	**53230**

BL (INR Mn)	FY10	FY11	FY12E	FY13E
Equity capital	2870	2930	2930	3073
Reserve and Surplus	149110	170230	195150	229427
Net worth	**151980**	**173170**	**198080**	**232500**
Borrowings	965650	1154100	1413270	1709500
CL and provisions	48780	67750	80180	93530
Total	**1166410**	**1395020**	**1691530**	**2035530**
Loans	979670	1171270	1456970	1799450
Investments	107270	118320	118320	118370
Deferred tax assets	2860	4480	4480	4480
Current assets	74390	98610	109360	110770
Fixed assets	2220	2340	2400	2460
Total	**1166410**	**1395020**	**1691530**	**2035530**

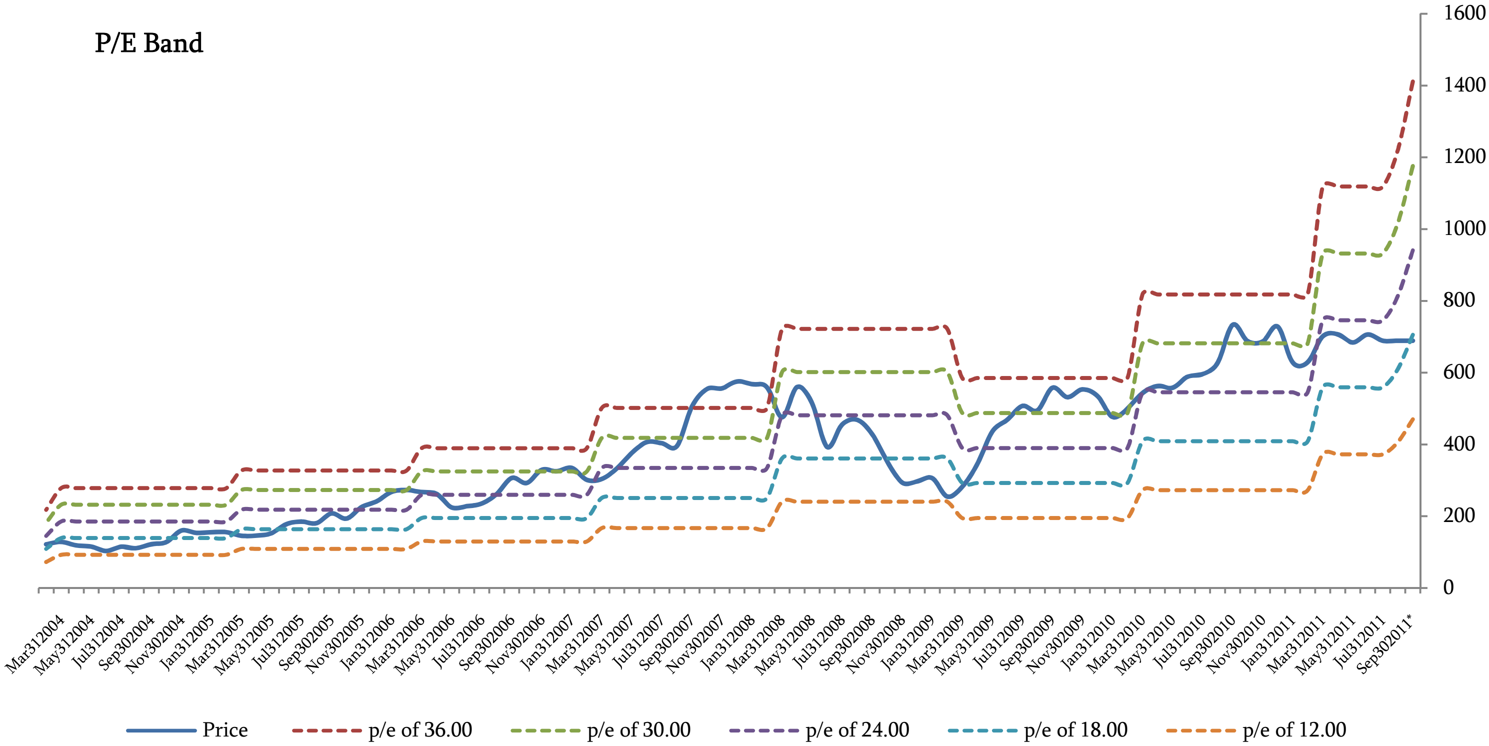
Valuation	FY10	FY11	FY12E	FY13E
EPS (Rs)	19.7	24.1	28.7	34.6
Dividend per share (Rs)	8	10	12	12
Book value per share (Rs)	106	118	135	151
Adjusted book value per share	49	64.2	81.2	99.3
PE (x)	32.8	26.8	22.5	18.6
PB (x)	6.1	5.5	4.8	4.3
Dividend yield (%)	1.20%	1.50%	1.60%	1.80%

Source: Company, Microsec Research

P/BV Band



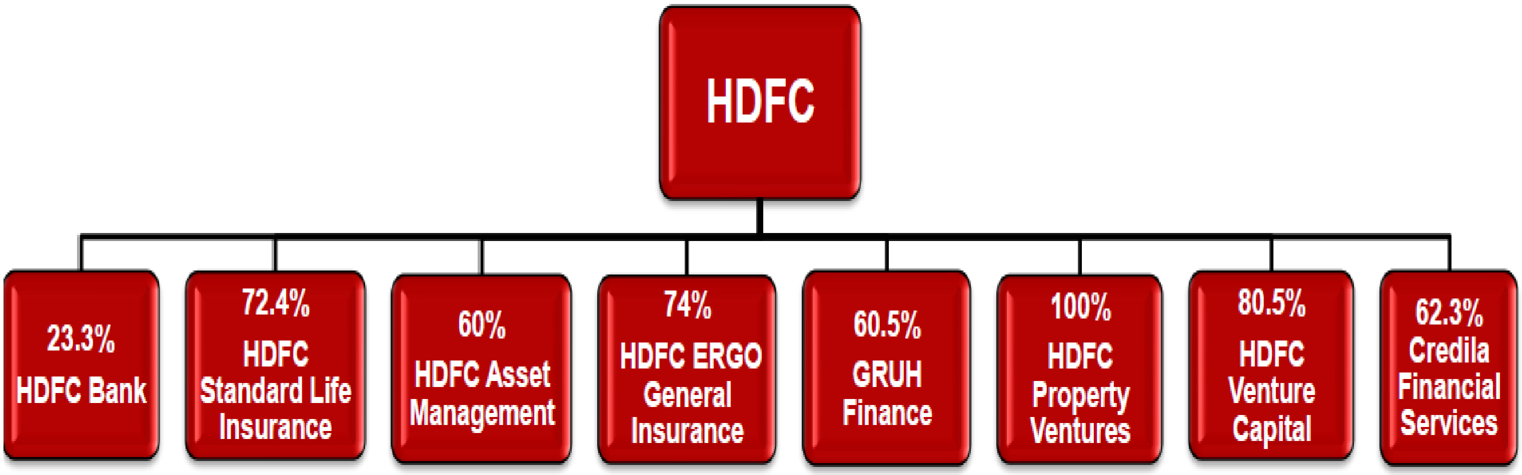
P/E Band



Source: Bloomberg, Microsec Research

Company Profile

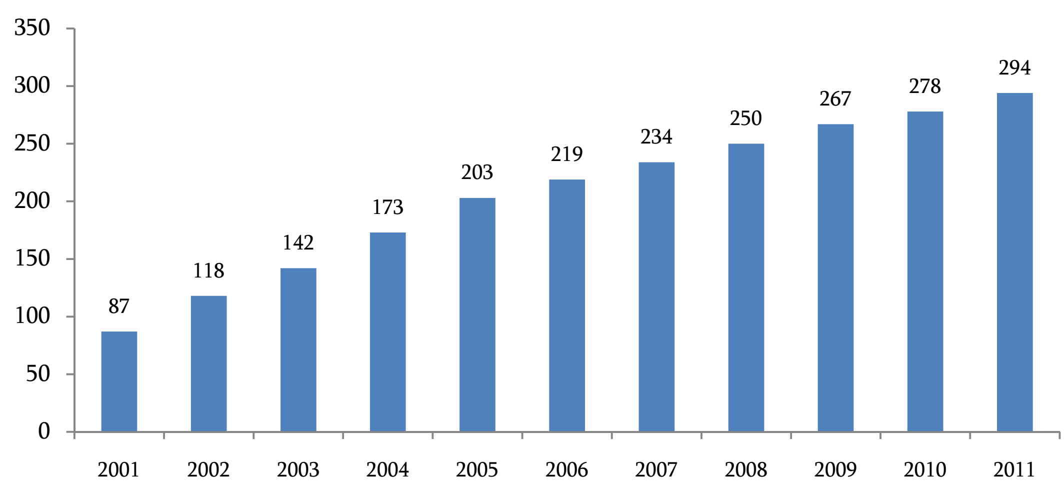
HDFC was incorporated in 1977 with the primary objective of promoting home ownership by providing long-term finance to households for their housing needs. From a specialized mortgage company, HDFC has now grown into a financial conglomerate with interests in banking, asset management, insurance and venture capital.



Experienced Management

Name	Designation	Location
Mr. Deepak. S. Parekh	Chairman	Mumbai
Mr. Keki. M. Mistry	Vice Chairman and Chief Executive Officer	Mumbai
Ms. Renu. S. Karnad	Managing Director	New Delhi
Mr. V. Srinivasa Rangan	Executive Director	Mumbai

no of outlets



Source: Company

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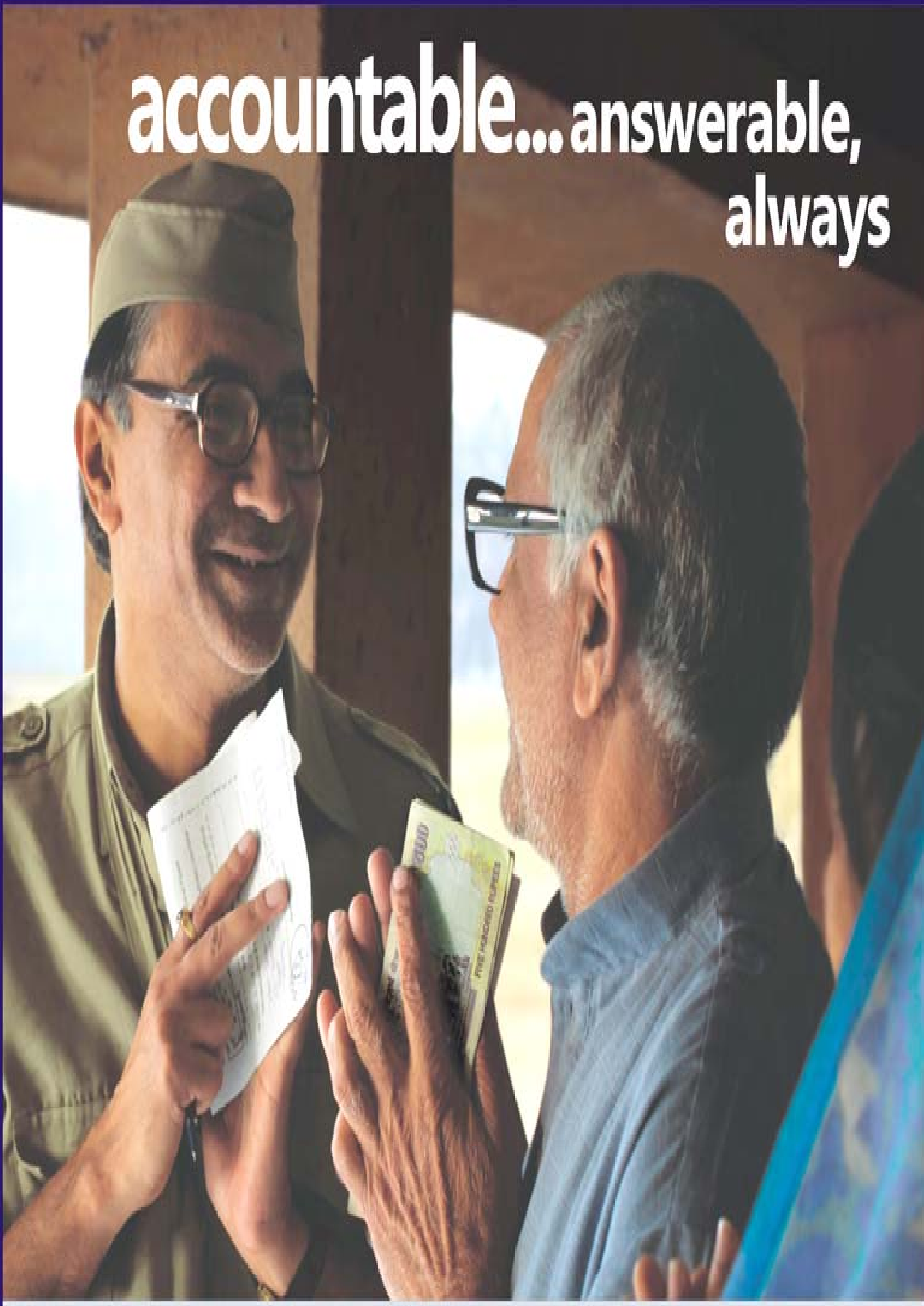
Research-Support			
Subhabrata Boral	Research Support	Executive	sboral@microsec.in

** Rating Scale

Recommendation	Expected absolute returns (%) over 12 months
Strong BUY	More than 20%
BUY	Between 10% and 20%
Hold	Between 0% and 10%
Underperform	Negative return up to -10%
Sell	Less than -10%



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