

Morgan Stanley Asia Limited+

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July 21, 2013

Stock Rating  
**Overweight**

Industry View  
**Cautious**

## HDFC

### Good Results; Attractive Multiples + Strong Retail to Drive Performance

#### What's Changed

Price Target	<b>Rs1,125 to Rs1,050</b>
F14e / F15e / F16e EPS	<b>-3.4% / -3.4% / -2.6%</b>

**F1Q14 PAT at Rs11.7bn, 17% Yoyo, was in line with MSe. Consol PAT was up 34% YoY. Individual AUM growth was strong at 24% YoY even as spreads expanded. NII was 3% below MSe owing to lower corporate spreads. Reduce EPS/TP given the pickup in interest rates. OW.**

**Individual AUMs grew 24% YoY, 6% QoQ:** Individual loan disbursements were up 26% – HDFC continues gaining market share. Non-individual AUM growth was low at 11% YoY (13% last qtr). Overall AUMs grew 20%. The quality of HDFC's balance sheet continues to improve with decreasing reliance on non-retail business.

**Headline NII grew 17% YoY:** Individual loan spreads were higher at 2.04% vs. F2013 (1.96%) and F4Q13 (1.99%, implied). Non-individual spreads were lower at 2.82% vs. 2.94% for F2013, likely due to interest income reversals on an NPL. Overall GNPL ratio is still low at 0.77% and improved YoY on lower retail GNPLs. No capital gains were booked this quarter. Fees were weak.

**Reduce EPS / TP.** Given sharp rise in rates following RBI moves, we are trimming our NIM and EPS est. (we were earlier expecting spreads to expand in F14 following the drop in wholesale rates in Apr-June). Our TP declines more due to sharp rise in risk-free rate and hence cost of equity -- but still implies 31% upside.

**Maintain OW.** We find valuation attractive at 3.0x F14e BV (adjusted for subs) and 15.8x F14e P/E in the context of strong earnings outlook – ~20% EPS CAGR in F13-15e; 20%+ ROE – coupled with a strong balance sheet – 0.77% NPL ratio and 14.0% Tier I ratio.

#### Key Ratios and Statistics

Reuters: **HDFC.NS** Bloomberg: **HDFC IN**  
India Financial Services

Price target	Rs1,050
Up/downside to price target (%)	31
Shr price, close (Jul 19, 2013)	Rs803.20
52-Week Range	Rs929.50-600.85
Sh out, dil, curr (mn)	1,546
Mkt cap, curr (bn)	US\$20.9

Fiscal Year ending	03/13	03/14e	03/15e	03/16e
ModelWare EPS (Rs)	29.1	35.2	43.0	52.4
Prior ModelWare EPS (Rs)	-	36.4	44.5	53.8
ModelWare net inc (Rs mn)	44,915	54,675	66,883	81,497
P/E	28.2	22.8	18.7	15.3
P/BV	5.1	4.5	4.0	3.5
Return on avg eqty (%)	20.4	20.7	22.7	24.5

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).  
e = Morgan Stanley Research estimates

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## Financial Summary

Profit and Loss Statement				
Rs Mln (Year end March)	F2013	F2014E	F2015E	F2016E
Interest Income	198611	231868	273495	321950
Interest Expense	138909	160000	187018	218334
<b>Net Interest Income</b>	<b>61798</b>	<b>74201</b>	<b>89276</b>	<b>106975</b>
---Fee Income	2413	2341	2809	3371
---Capital Gains	3156	4000	4800	6000
---Dividend Income	4807	6345	7931	9914
---Other non int. income	394	468	557	664
<b>Total Non Interest Income</b>	<b>10769</b>	<b>13154</b>	<b>16097</b>	<b>19948</b>
<b>Total Income</b>	<b>72567</b>	<b>87355</b>	<b>105373</b>	<b>126924</b>
---Employee Expenses	2462	2967	3501	4131
---Other Operating exp	2927	3527	4162	4911
Total Operating Expenses	5389	6494	7662	9042
<b>Operating Profit</b>	<b>67178</b>	<b>80861</b>	<b>97710</b>	<b>117882</b>
Provisions for Contingencies	1450	1496	1795	2155
<b>Pre-tax Profit</b>	<b>65728</b>	<b>79365</b>	<b>95915</b>	<b>115727</b>
Tax	17245	20823	25165	30363
<b>Net Profit</b>	<b>48483</b>	<b>58542</b>	<b>70750</b>	<b>85364</b>
Extraordinary (post-Tax)	0	0	0	0
<b>Reported Profit</b>	<b>48483</b>	<b>58542</b>	<b>70750</b>	<b>85364</b>
ZCB Impact (net of tax)	3568	3867	3867	3867
<b>Modelware PAT</b>	<b>44915</b>	<b>54675</b>	<b>66883</b>	<b>81497</b>

Balance Sheet Data				
Rs Mln (Year end March)	F2013	F2014E	F2015E	F2016E
Total Assets	1838280	2205755	2643140	3162029
Total Loans	1700460	2040034	2448409	2938090
Total Earning Assets	1838779	2222291	2680045	3223642
Total deposits	519330	649163	811453	1014316
Shareholder's Equity	250000	277417	311572	353977
No. of shares	1546	1554	1554	1554
<b>Average Assets</b>	<b>1709866</b>	<b>2022017</b>	<b>2424448</b>	<b>2902585</b>
<b>Asset Quality</b>				
Gross NPL's	11903	14280	17139	20567
Loan Loss Reserve	17923	19419	21214	23369
Gross NPL Ratio	0.7%	0.7%	0.7%	0.7%
Coverage Ratio (including all loan)	150.6%	136.0%	123.8%	113.6%
<b>Capital Ratios</b>				
Tier 1 Ratio	13.9%	13.5%	13.3%	13.2%
Tier 2 Ratio	2.5%	2.5%	2.5%	2.5%
Capital Adequacy ratio	16.4%	16.0%	15.8%	15.7%

Per Share Data and Valuations				
Year end March	F2013	F2014E	F2015E	F2016E
<b>Per Share Ratio (Rs)</b>				
Modelware EPS	29.1	35.2	43.0	52.4
Book Value	161.7	178.5	200.5	227.8
Core Operating Profit	41.5	49.5	59.8	72.0
DPS	12.5	15.0	18.0	21.5
<b>Valuations</b>				
P/E	27.6	22.8	18.7	15.3
Price to Book	5.0	4.5	4.0	3.5
Price to Core Op. Profit	19.3	16.2	13.4	11.2
Dividend Yield	1.6%	1.9%	2.2%	2.7%

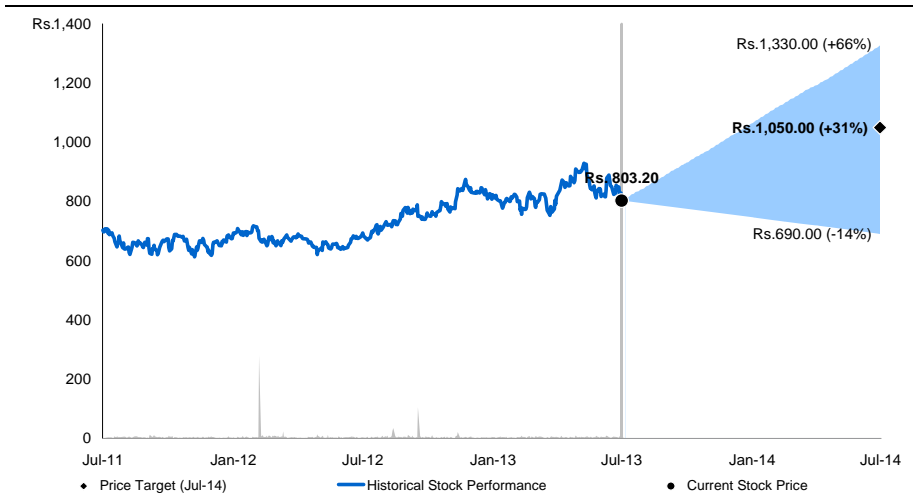
Ratio Analysis				
Year end March	F2013	F2014E	F2015E	F2016E
<b>Spread Analysis</b>				
Avg. Yield on Earning Assets	11.7%	11.4%	11.2%	10.9%
Cost of Earning Assets	8.2%	7.9%	7.6%	7.4%
Net Interest Margin	3.5%	3.5%	3.5%	3.5%
NIM (with Off B/S Items)	3.3%	3.3%	3.3%	3.3%

Growth Ratios				
Year end March	F2013	F2014E	F2015E	F2016E
Net Interest Income	16%	20%	20%	20%
Non Interest Income	22%	22%	22%	24%
Operating Expenses	19%	21%	18%	18%
Operating Profit	17%	20%	21%	21%
Reported Net profit	18%	21%	21%	21%
Modelware Net Profit	16%	22%	22%	22%
EPS (Modelware)	16%	21%	22%	22%
Total Loans	21%	20%	20%	20%
Total Assets	16%	20%	20%	20%
<b>Profitability Ratios</b>				
Return on Equity	20.4%	20.7%	22.7%	24.5%
Return on Assets	2.6%	2.7%	2.8%	2.8%
<b>Efficiency</b>				
Cost Income Ratio	7.4%	7.4%	7.3%	7.1%
Expenses/average assets	0.3%	0.3%	0.3%	0.3%

Source: Company Data, Morgan Stanley Research; E=Morgan Stanley Research Estimates

## Risk-Reward Snapshot: HDFC (HDFC.NS, Rs803.2, OW, PT Rs1,050)

### Risk-Reward View: Relative Positioning + Attractive Multiples



<b>Price Target Rs1,050</b> Derived from a probability-weighted sum-of-the-parts analysis (we use separate probability weights for the insurance business and HDFC Bank – see valuation section for details).		
<b>Bull Case</b> <b>Rs1,330</b>	6.6x Base Case 15e BVPS	<b>Loan growth picks up more than expected, and margins remain elevated:</b> Volume growth is stronger than the 20% we have built into our base case. Wholesale funding costs remain low, implying margins stay higher for longer. We value the insurance business at 2.3x F2015E EV (implying a value of Rs84/share) and HDFC Bank at Rs990/share.
<b>Base Case</b> <b>Rs990</b>	4.9x Base Case 15e BVPS	<b>Loan growth of 20% in F2014-15E:</b> Top-line growth of 20% in F2014-15E. We value the insurance business at 1.85x F2015e EV (implying a value of Rs65 per share) and HDFC Bank at Rs860/share.
<b>Bear Case</b> <b>Rs690</b>	3.4x Bear Case 15e BVPS	<b>Pressures on loan growth and margins:</b> We estimate loan growth of around 10% for F2014. Margins compress relative to our base-case estimate, owing to greater competition and sharp rise in short rates. We value the insurance business at 1.25x F2015e EV (implying a value of Rs34 per share) and HDFC Bank at Rs585/share.

Source: Thomson Reuters, Morgan Stanley Research

### Investment Thesis: Why OW

- Strong brand presence and management.
- One of the largest players in the mortgage loan segment.
- Leverage to various businesses in the financial sector: life insurance, asset management, etc.
- Despite noise around competition over the last 12 months or so, individual AUM growth continues to be strong at 24% YoY, with HDFC likely gaining market share. We expect top-line growth of 20% over the next two years.
- Asset-quality trends remain robust, with NPLs at 0.77%.
- One of the best-capitalized institutions in India, with a Tier I ratio of 14.0%, which is likely to improve by over 2% points when NHB announces lower risk weights in line with recent RBI guidelines.
- Further, given 22% EPS CAGR in F2013-15e, 22% average ROE and strong balance sheet, valuations (adjusted for subsidiaries) appear attractive at 3.0x F2014e P/BV, 2.6x F2015e P/BV, 15.8x F2014e P/E and 12.9x F2015e P/E.

### Key Value Drivers

- Loan growth and spreads
- Valuation of life insurance business and HDFC Bank

### Upside Catalysts

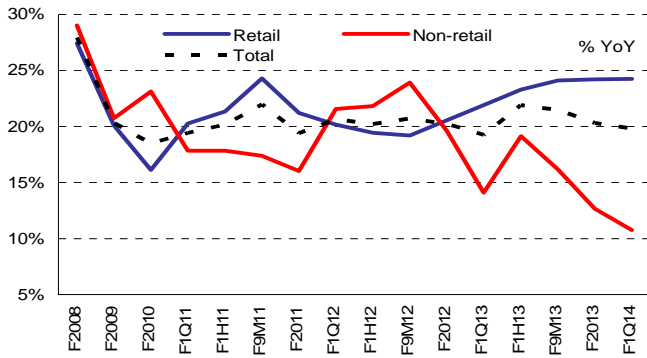
- Corporate loan growth momentum – resulting in lower mortgage competition from SOE banks
- Beneficial moves in short rates
- Trend in asset prices, esp. housing

### Downside Risks

- Spike in wholesale funding rates
- Sharp cuts in base rates by banks which would pressure yields/spreads
- Sharp rise in developer NPLs

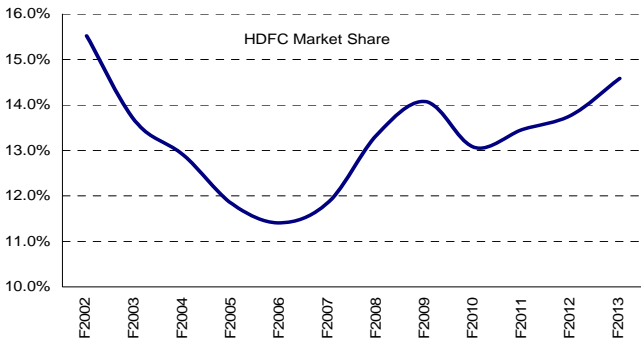
## HDFC – Fundamentally on a Strong Footing

**Exhibit 1**  
Individual AUM\* growth was strong at 24% YoY;  
Non-individual AUM growth slowed to 11% YoY



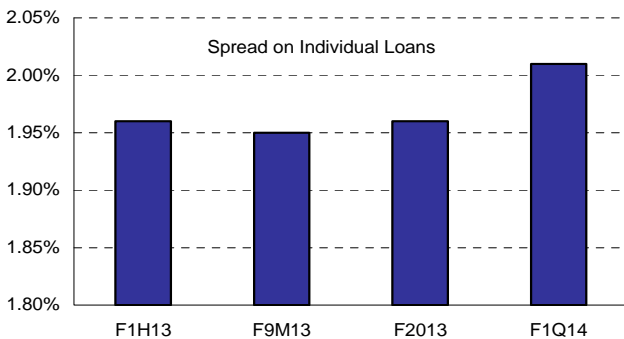
Source: Company data, Morgan Stanley Research \* Including securitized loans

**Exhibit 2**  
Market share in individual mortgages has risen



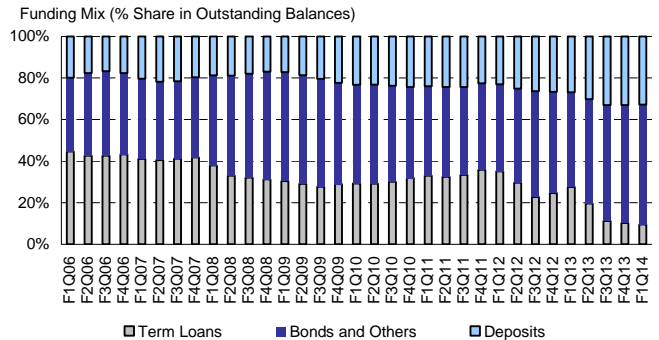
Source: Company Data, RBI, NHB, Morgan Stanley Research  
Note: We use HDFC's on-balance-sheet loans for this exercise.

**Exhibit 3**  
Reported individual loan spreads improved to 2.01% from 1.96% for F2013 and 1.99% for F4Q13 (implied)



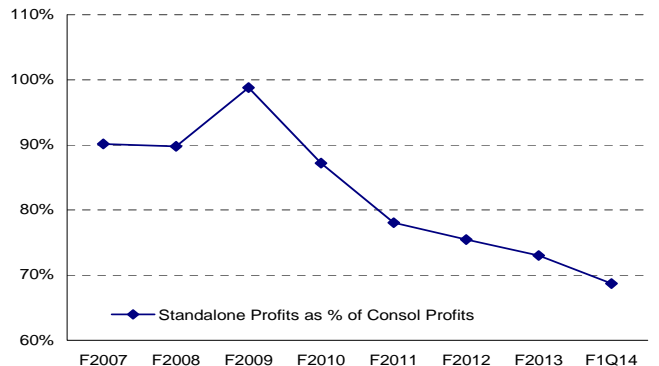
Source: Company Data, Morgan Stanley Research

**Exhibit 4**  
Good ALM has helped HDFC maintain spreads in a tight range across cycles; rising share of retail deposits imparts more stability to funding franchise



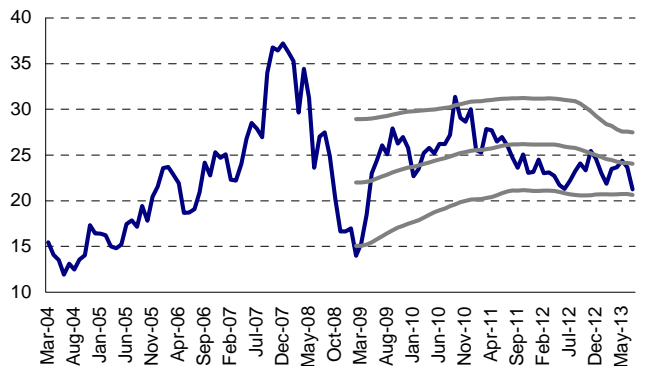
Source: Company data, Morgan Stanley Research

**Exhibit 5**  
% Contribution of parent has been trending lower



Source: Company data, Morgan Stanley Research

**Exhibit 6**  
HDFC 1-year Forward P/E



Source: Company Data, Thomson Reuters, Morgan Stanley Research

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Exhibit 7

## F1Q14 Results Summary

	F1Q13	F4Q13	F1Q14	YoY	QoQ
Interest income	46464	53392	52198	12%	-2%
---Loans	44019	50985	50351	14%	-1%
---Investments	2445	2407	1847	-24%	-23%
---Surplus from deployment of Cash	460	514	646	41%	26%
Interest Expenses	33882	34398	37633	11%	9%
---Expense	33672	34174	37382	11%	9%
---Charges	210	224	251	19%	12%
<b>Net Interest Income</b>	<b>13042</b>	<b>19508</b>	<b>15211</b>	<b>17%</b>	<b>-22%</b>
Non Interest Income	2499	2871	2806	12%	-2%
---Capital Gains	202	1049	0	NA	NA
---Fees	618	879	544	-12%	-38%
---Dividend	1596	814	2171	36%	167%
---Other Income	83	129	90	8%	-30%
<b>Total Income</b>	<b>15541</b>	<b>22379</b>	<b>18016</b>	<b>16%</b>	<b>-19%</b>
<b>Expenses</b>	<b>1342</b>	<b>1132</b>	<b>1635</b>	<b>22%</b>	<b>44%</b>
Staff Expenses	609	590	744	22%	26%
Establishment Expenses	176	183	260	48%	42%
Other Expenses	510	286	576	13%	102%
Depreciation	48	73	55	16%	-24%
<b>Operating Profits</b>	<b>14199</b>	<b>21247</b>	<b>16381</b>	<b>15%</b>	<b>-23%</b>
Provisions	400	250	300	-25%	20%
<b>PBT</b>	<b>13799</b>	<b>20997</b>	<b>16081</b>	<b>17%</b>	<b>-23%</b>
Tax	3780	5445	4350	15%	-20%
<b>PAT</b>	<b>10019</b>	<b>15552</b>	<b>11731</b>	<b>17%</b>	<b>-25%</b>
EPS (computed)*	6.5	10.1	7.5	16%	-25%

### Key Metrics Adjusted For ZCB Impact

NII (Headline)	13042	19508	15211	17%	-22%
Cost of ZCB Issuances (Pre-tax)	2086	1156	1354	-35%	17%
NII (post ZCB costs)**	10956	18351	13857	26%	-24%
ZCB Costs (post tax)	1489	826	967	-35%	17%
PAT (post ZCB costs)	8530	14727	10764	26%	-27%
EPS (post ZCB costs)**	5.5	9.5	6.9	25%	-27%

### Other Key Metrics

Cost Income Ratio	8.6%	5.1%	9.1%		
Cost to Core Income Ratio	8.7%	5.3%	9.1%		
PBT ex Cap Gains	13597	19948	16081	18%	-19%
PPOP ex Cap Gains	13997	20198	16381	17%	-19%

Loans On B/s	1,482,623	1,700,460	1,769,928	19%	4%
Loans (incl. securitized loans)	1,621,343	1,870,100	1,942,848	20%	4%
Tier I Ratio	11.8%	13.8%	14.0%		

	F1Q13	F2Q13	F1Q14
Spreads	2.27%	2.30%	2.29%
-- Individual Loans	NA	1.96%	2.01%
-- Non Individual Loans	NA	2.94%	2.82%
GNPL Ratio	0.79%	0.70%	0.77%
-- Individual Loans	0.67%	0.58%	0.61%
-- Non Individual Loans	1.00%	0.91%	1.08%

Source: Company Data, Morgan Stanley Research

\* EPS have been computed using fully diluted share count.

\*\* This pertains to the interest cost on zero coupon bonds (ZCBs) that is being run through the reserves.

Exhibit 8

## F1Q14 Results: Actuals vs. Estimates

Rs Mn	F1Q13	F4Q13	F1Q14e	F1Q14a	Act vs Est	%YoY	%QoQ
<b>Net Int Inc</b>	<b>13042</b>	<b>19508</b>	<b>15736</b>	<b>15211</b>	<b>-3%</b>	<b>17%</b>	<b>-22%</b>
Non-Int Inc (ex trsry)	2297	1823	1898	2806	48%	22%	54%
Profit on sale of Inv	202	1049	0	0	NA	NA	NA
Total Non Int Inc	2499	2871	1898	2806	48%	12%	-2%
<b>Total Income</b>	<b>15541</b>	<b>22379</b>	<b>17634</b>	<b>18016</b>	<b>2%</b>	<b>16%</b>	<b>-19%</b>
<b>Total Expenses</b>	<b>1342</b>	<b>1132</b>	<b>1476</b>	<b>1635</b>	<b>11%</b>	<b>22%</b>	<b>44%</b>
<b>Pre Prov. Profit</b>	<b>14199</b>	<b>21247</b>	<b>16158</b>	<b>16381</b>	<b>1%</b>	<b>15%</b>	<b>-23%</b>
Total Provisions	400	250	436	300	-31%	-25%	20%
<b>PBT</b>	<b>13799</b>	<b>20997</b>	<b>15722</b>	<b>16081</b>	<b>2%</b>	<b>17%</b>	<b>-23%</b>
Tax	3780	5445	4085	4350	6%	15%	-20%
<b>PAT</b>	<b>10019</b>	<b>15552</b>	<b>11637</b>	<b>11731</b>	<b>1%</b>	<b>17%</b>	<b>-25%</b>

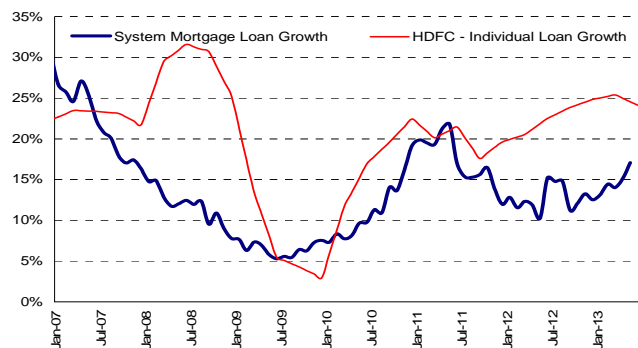
NII (ex ZCB interest costs)	10956	18351	14432	13857	-4%	26%	-24%
PAT (ex ZCB interest costs)	8530	14727	10706	10764	1%	26%	-27%

Source: Company Data, Morgan Stanley Research

## Loan Growth

Exhibit 9

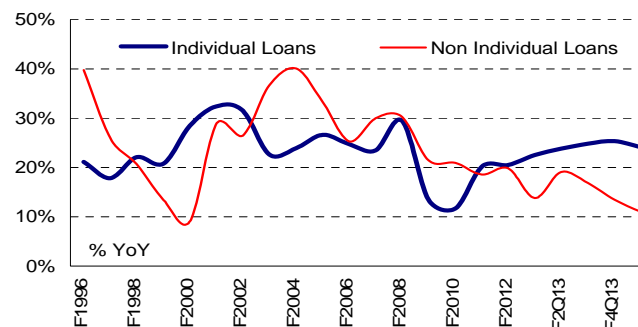
## HDFC's Individual Loan Growth\* vs. Banking System Mortgage Growth



Source: Company Data, RBI, Morgan Stanley Research \* Using HDFC's On B/Sheet loans

Exhibit 10

## HDFC: Long-term loan growth\*

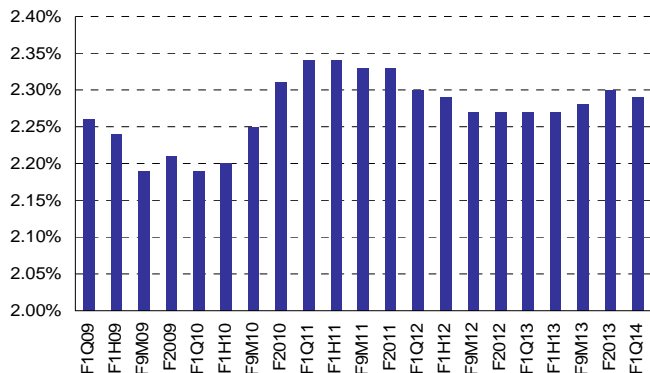


Source: Company Data, Morgan Stanley Research \* Using HDFC's On Balance Sheet loans

## Funding Mix, Costs and Spreads

Exhibit 11

**HDFC reported overall loan spreads of 2.29% vs. 2.30% for F2013 and 2.27% for F1Q13**

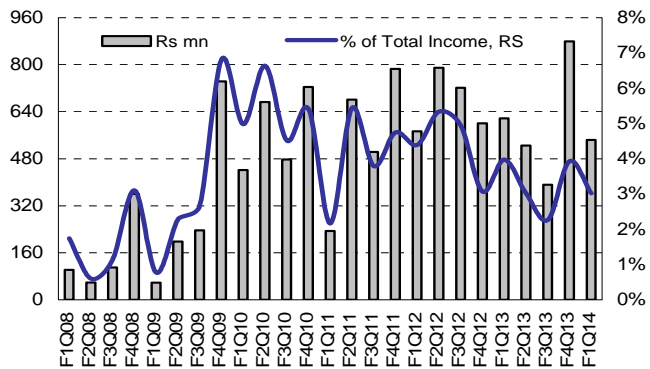


Source: Company data, Morgan Stanley Research

## Non-Interest Income & Costs

Exhibit 12

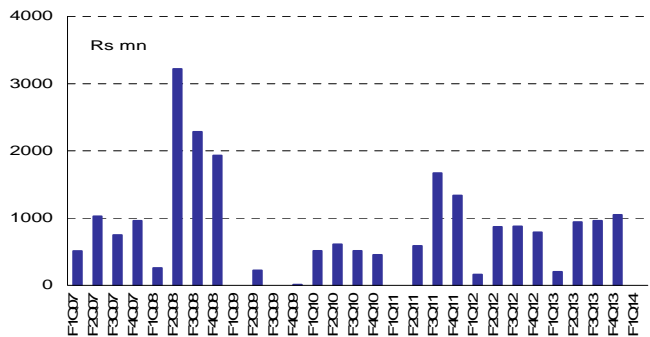
**Fee income was down 12% YoY owing to higher individual disbursements where origination costs are high and are accounted upfront**



Source: Company data, Morgan Stanley Research

Exhibit 13

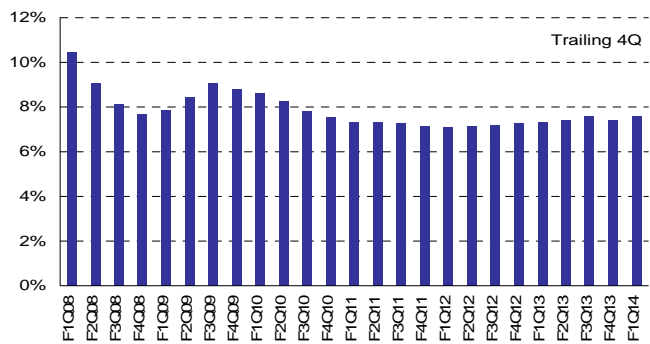
**HDFC did not book any capital gains in the quarter**



Source: Company data, Morgan Stanley Research

Exhibit 14

**Employee Expenses picked up this quarter driven by higher actuarial provisions (as rates softened)**

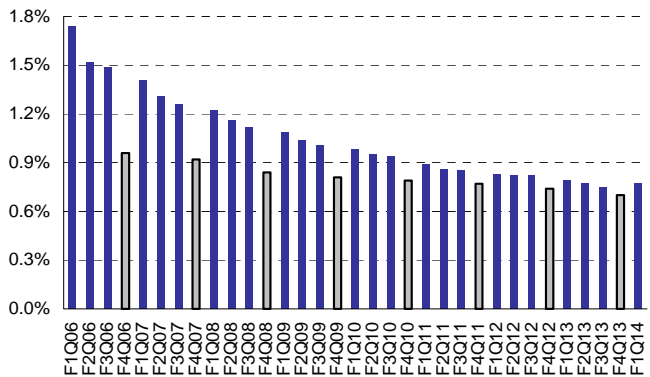


Source: Company data, Morgan Stanley Research

## Asset Quality

Exhibit 15

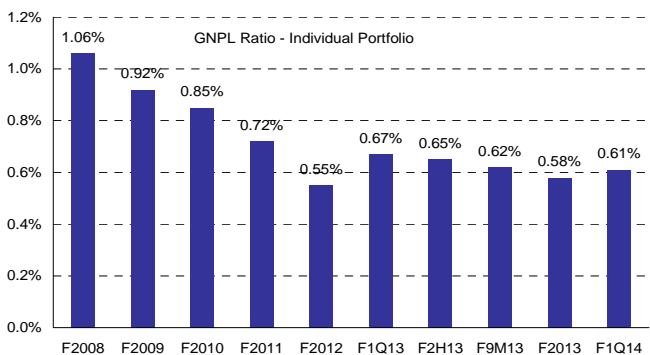
**Overall Asset Quality Was Stable: NPL Ratio (90 d.p.d.) was lower YoY at 0.77% vs. 0.79% (F1Q13)**



Source: Company Data, Morgan Stanley Research

Exhibit 16

**GNPL Ratio for Individual Portfolio was lower YoY**

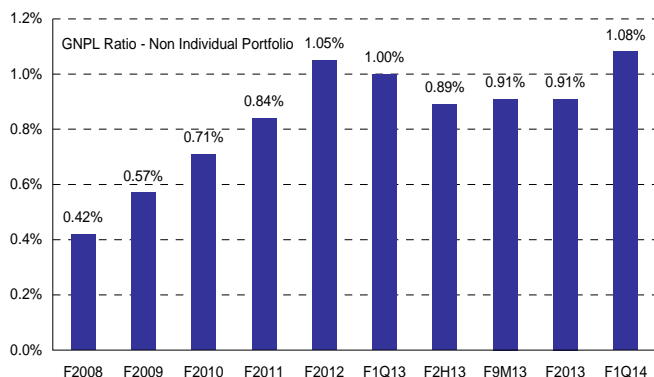


Source: Company Data, Morgan Stanley Research

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Exhibit 17

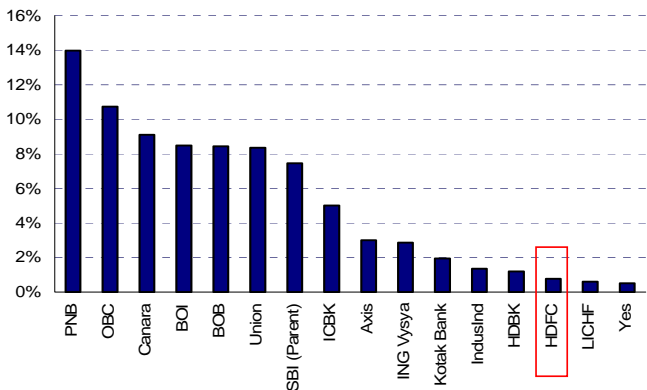
## There was an uptick in the GNPL Ratio for the Non Individual Portfolio – though ratio is still very low



Source: Company Data, Morgan Stanley Research

Exhibit 18

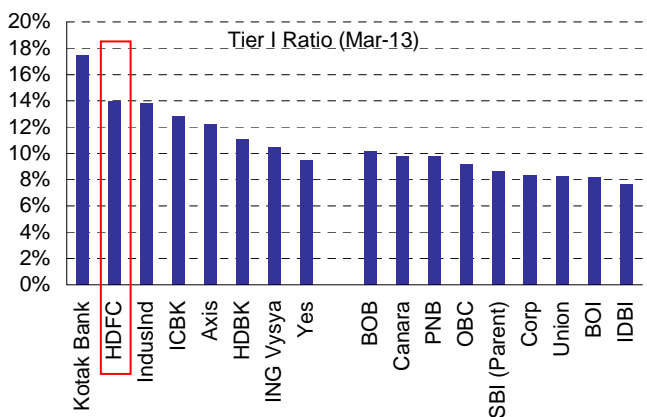
## Impaired Loans Ratio: Indian Banks vs. HDFC



Source: Company Data, Morgan Stanley Research; Note: Impaired loans ratio is as of Mar-13 except for HDFC, HDFC Bank, IndusInd, Kotak and Axis Bank (as of June-13 for these cos.)

Exhibit 19

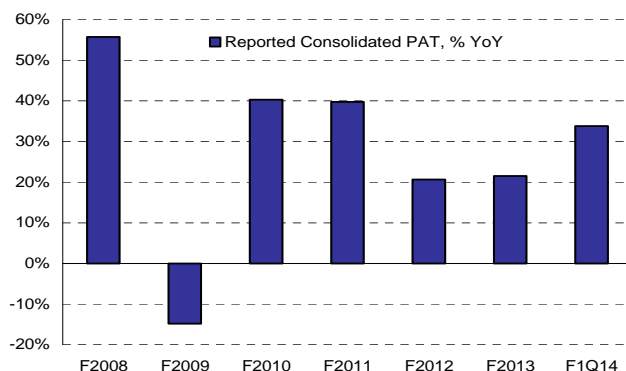
## HDFC Tier 1 Comparison vs. Banks



Source: Company Data, Morgan Stanley Research; Note: Impaired loans ratio is as of Mar-13 except for HDFC, HDFC Bank, IndusInd, Kotak and Axis Bank (as of June-13 for these cos.)

Exhibit 20

## Consolidated PAT is also growing at a healthy rate

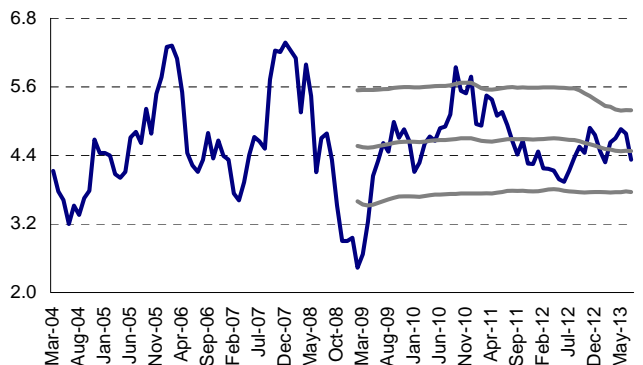


Source: Company Data, Morgan Stanley Research

## Valuations

Exhibit 21

## HDFC – Price/Book (Headline)



Source: Morgan Stanley Research

Exhibit 22

## HDFC – Core Valuations

	F2013	F2014E	F2015E	F2016E
Current Price	804	804	804	804
Value of Sub**	313	313	313	313
Core Value	490	490	490	490
Headline EPS	29	35	43	52
Adjusted EPS	26	31	38	46
Headline PE	27.6	22.8	18.7	15.3
Core PE	18.9	15.8	12.9	10.6
Reported BVPS	162	179	200	228
Adjusted BVPS	145	161	182	208
Headline PB	5.0	4.5	4.0	3.5
Core PB	3.4	3.0	2.7	2.4

Source: Company data, Morgan Stanley Research; \*\* Note: For computing core current valuations, we incorporate the value of HDFC Bank at its current market price. Hence, for the other subsidiaries we use the same assumptions as we do in our base case of the sum of parts

July 21, 2013  
HDFC

## Target Price Discussion

**We value HDFC on a probability-weighted sum-of-the-parts basis:** HDFC has various components – the parent business, the life insurance business, general insurance, asset management, private equity, a stake in HDFC Bank, and Gruh Finance – which we value separately. For the non-banking and non-insurance businesses, we use probability weights of 5% for the bear case (reflects the low probability of a deeper-than-expected economic downturn, resulting in job losses and eventually mortgage delinquencies), 30% for the bull case (reflects the higher possibility of HDFC capitalizing from a starting point of low impaired loans, high capital ratio and relatively low regulatory overhang relative to the banking industry) and 65% for the base case. These weights are unchanged.

We are lowering our price target for HDFC from Rs1,125 to Rs1,050 per share, implying 31% upside from current levels, mainly driven by a reduction in the valuation of the parent to factor in the impact of recent RBI measures and a sharp rise in the risk-free rate and hence cost of equity following the same.

Exhibit 23

## HDFC – Valuation

HDFC - Sum of Parts				
Rs Per Share	Base Case	Bull Case	Bear Case	Value/Share
<b>Probability Weights</b>	<b>65%</b>	<b>30%</b>	<b>5%</b>	
HDFC (Parent)	615	875	450	685
<b>Subsidiaries</b>				
HDFC Asset Management	24	38	13	28
Real estate PE	4	5	3	4
Gruh Finance	15	15	15	15
General Insurance business	4	4	4	4
<b>Probability Weights</b>	<b>80%</b>	<b>5%</b>	<b>15%</b>	
Stake in HDFC Bank	264	311	169	253
<b>Probability Weights</b>	<b>75%</b>	<b>5%</b>	<b>20%</b>	
HDFC Standard Life	65	84	34	60
<b>Sum of Subs</b>	<b>375</b>	<b>455</b>	<b>240</b>	<b>365</b>
<b>Fair value</b>	<b>990</b>	<b>1330</b>	<b>690</b>	<b>1050</b>

Source: Morgan Stanley Research

## Parent business

We value the parent business based on a residual income model with a cost of equity of 13% (12.5% previously) using a higher risk-free rate of 8% vs 7.5% previously. We are lowering our valuation of the parent business by 10% in each of the bull/bear/base scenarios, as we assume a higher cost of equity and reduce EPS estimates (down 3% each in F14/15 and down 2% in F16) owing to lower NIM forecasts. Our base case value is now lower at Rs615 vs. Rs685/share previously. Our bull case value is now Rs875 vs. Rs965/share previously. Our bear case fair value is now Rs450 vs. Rs500/share previously.

Exhibit 24

## HDFC: Value of Parent Business

HDFC (Parent)	Base Case	Bull Case	Bear Case
RI Based Value	615	875	450
Core BV (F2015E)	182		
Implied P/BV	3.4	4.8	2.5

Source: Company Data, Morgan Stanley Research

Exhibit 25

## What's Changed

	NEW			OLD		
	F2014e	F2015e	F2016e	F2014e	F2015e	F2016e
AUM Growth	20%	20%	20%	20%	20%	20%
NIM (On AUM, computed)	3.3%	3.3%	3.3%	3.4%	3.4%	3.4%
NII Growth	20%	20%	20%	22%	21%	20%
Non Interest Income Growth	22%	22%	24%	26%	18%	22%
Operating Expenses Growth	21%	18%	18%	17%	20%	20%
Operating Profit Growth	20%	21%	21%	23%	21%	20%
Credit Costs	8	8	8	9	9	9
Modelware PAT Growth	22%	22%	22%	25%	22%	21%
Modelware EPS Growth	21%	22%	22%	25%	22%	21%

Source: Company Data, Morgan Stanley Research

## HDFC Bank

We take a pro rata share of 22.8% (to reflect HDFC's stake in HFDC Bank) of our valuation of HDFC Bank's current scenario values. These are based on a probability-weighted residual income model (bull 5% of Rs990; base 80% of Rs860; bear 15% of Rs585).

We use probability weights of 80% for the base case, 15% for the bear case, reflecting a deeper-than-expected economic slowdown resulting in lower loan growth and higher loan delinquencies, and 5% for the bull case, reflecting the low likelihood of an economic rebound accompanied by higher loan growth and higher margins. The bear case weight is much lower than that we ascribe to other banks, given HDFC Bank's low exposure to corporate loans, where we expect a deep asset-quality cycle.

Our residual income model assumes a cost of equity of 13.2% with a beta of 0.95, a risk-free rate of 8.0% and a market risk premium of 5.5%.

**Key risks to our price target include:** Slower-than-expected loan growth, sharp compression in NIMs (owing to greater competition for both retail assets and savings deposits) and significant deterioration in asset quality (new NPL formation



picks up on the retail side). Also, the Reserve Bank of India's final guidelines (when issued) on priority sector and dynamic provisioning could bring down long-term returns.

Upside catalysts include faster-than-expected asset growth, fee income being stronger than expectations, margins remaining elevated for longer, and credit costs being lower than expectations.

## Life Insurance Valuation

We have assigned a value for HDFC life insurance of Rs60/share. Our valuation of Rs127bn (US\$2.3bn) is based on a probability-weighted P/EV method. We assign a 75% weighting to our life insurance base case, 20% to our bear case, and 5% to our bull-case scenario. The higher base-case probability (and lower bear-case probability) is driven by the implementation of regulatory changes in traditional products/NAV guarantee products, which we had factored into our bear-case scenario earlier.

Exhibit 26

### HDFC Life – Valuation

Rs. Mn	Base Case	FY15 Bear Case	Bull Case
Probability Weights	75.0%	20.0%	5.0%
Individual APE	37,804	33,739	45,261
Growth YoY	15.0%	10.0%	25.0%
Expected NBAP Margins, FY15, MCEV Method	17.5%	15.5%	18.0%
Embedded Value (MCEV Method)	78,447	61,411	81,678
Embedded Value (TEV Method, 5% Discount)	74,525	58,340	77,594
Return on EV (Post Cost Overruns)	15.2%	13.9%	18.2%
Price to Embedded Value (x)	1.85x	1.25x	2.30x
<b>HDFC Life Valuation (Rs. Mn)</b>	<b>137,871</b>	<b>72,925</b>	<b>178,466</b>
<b>HDFC Life Valuation (Us\$ Mn, Rs/\$ = 55)</b>	<b>2,507</b>	<b>1,326</b>	<b>3,245</b>
Implied New Business Value	63,346	14,585	100,872
Value of New Business, F2013E	6,616	5,230	8,147
Implied New Business Multiple	9.6x	2.8x	12.4x
HDFC's Stake	72.6%	72.6%	72.6%
No. of Shares (HDFC)	1,546	1,546	1,546
Value Attributable to HDFC	100,095	52,944	129,566
Value Per Share (Rs)	65	34	84
<b>Prob. Weighted Value of HDFC Life (Rs Mn)</b>	<b>126,912</b>		
<b>Prob. Weighted Value (Rs/ Share of HDFC)</b>	<b>60</b>		

Source: Company Data, Morgan Stanley Research

In our base case, we expect new individual business premiums to grow 5% in F2015, weighed down by the negative impact of recent regulatory change disallowing NAV guarantee products. However, part of this decline, in our view, will be offset by the recent launch of pension products. Our F2015 APE growth estimate is 15%. We estimate post-cost new business margins of ~13.5% in F2014-15. We arrive at a base case value of Rs138bn, based on a P/EV of 1.85x.

In our bear case, we factor in a continued adverse macro-economic environment and higher-than-expected negative impact of recent regulatory changes, leading to no growth in APE in F2014 and gradual recovery of 10% in F2015. Further, we estimate post cost overrun margins of 9.5% in F2014-15, compared with ~13-14% for F2013E, mainly due to: 1) proposed higher corporate tax rate under the DTC and 2) higher-than-expected cost overruns.

In our bull case, we expect a quick improvement in the macro environment, leading to individual APE growth of 15% in F2014 and 25% in F2015. We assume post-cost overrun margins of 15% in F2014 and 16% in F2015.

**General insurance:** We value this business based on the last deal price of Rs7.8bn. We apply a similar valuation in our bear case, while for the bull case we include a 10% premium to the business deal price.

**Asset management:** We value this business in terms of assets under management (AUM). We assume 5% in AUM in F2015 in our base case. In our bull case, we assume growth picks up to 20% and we apply a 6% of AUM multiple, while we assume no growth in the bear case and a multiple of 3.5% of AUM.

**Real estate:** We value this business on a percentage of AUM basis. We use 12% in our base case, 14% in our bull case, and 10% in our bear case.

**Gruh Finance:** We value Gruh Finance on the basis of current market cap for this business.

## Risks

**Key downside risks to our price target:** Weak economic growth, resulting in higher competition from SOE banks and thus lower-than-estimated loan growth, and a potential rise in credit costs, following a deep economic slowdown leading to job losses and also delinquencies in the commercial segment.

**Key upside risks to our price target:** Higher-than-expected loan growth, better margins, and lower-than-expected credit costs. A pickup in loan growth in other sectors (such as corporate or infrastructure) could reduce competition, as leading SOE banks could shift their focus away from mortgages.

*We acknowledge the contribution of Paresch Dave to this report.*

### **Company Description**

HDFC is the leader in the Indian mortgage finance market, with a network of ~325 outlets and an outstanding loan book of US\$30bn as of June 2013. It provides housing finance, predominantly to individuals. HDFC also has a presence in commercial banking, insurance, and asset management businesses via its subsidiaries/associates.

### **India Financial Services**

**Industry View: Cautious**



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<b>Equal-weight/Hold</b>	<b>1263</b>	<b>44%</b>	<b>485</b>	<b>47%</b>	<b>38%</b>
<b>Not-Rated/Hold</b>	<b>109</b>	<b>4%</b>	<b>24</b>	<b>2%</b>	<b>22%</b>
<b>Underweight/Sell</b>	<b>469</b>	<b>16%</b>	<b>123</b>	<b>12%</b>	<b>26%</b>
<b>Total</b>	<b>2,861</b>		<b>1042</b>		

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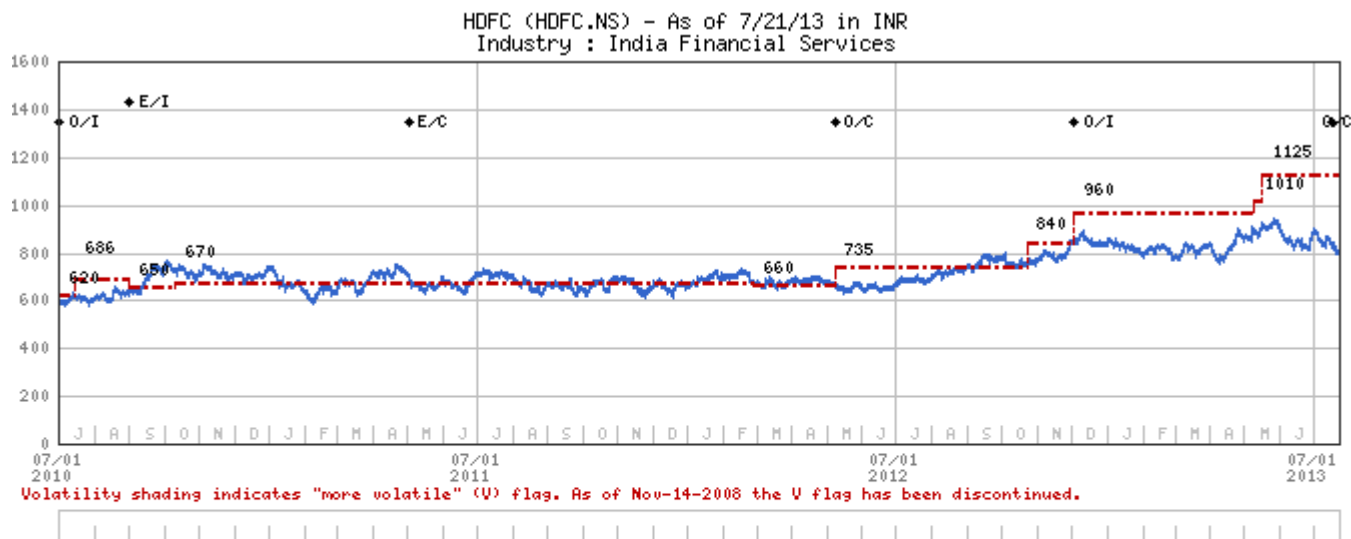
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### Stock Price, Price Target and Rating History (See Rating Definitions)

July 21, 2013  
HDFC



Stock Rating History: 7/1/10 : O/I; 9/1/10 : E/I; 5/2/11 : E/C; 5/8/12 : O/C; 12/3/12 : O/I; 7/16/13 : O/C

Price Target History: 10/14/09 : 620; 7/15/10 : 686; 9/1/10 : 650; 10/11/10 : 670; 2/27/12 : 660; 5/8/12 : 735; 10/23/12 : 840; 12/3/12 : 960; 5/9/13 : 1010; 5/16/13 : 1125

Source: Morgan Stanley Research      Date Format : MM/DD/YY      Price Target --      No Price Target Assigned (NA)  
 Stock Price (Not Covered by Current Analyst) —      Stock Price (Covered by Current Analyst) ■  
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View  
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (U) No Rating Available (NA)  
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**Industry Coverage: India Financial Services**

Company (Ticker)	Rating (as of)	Price* (07/19/2013)
<b>Anil Agarwal</b>		
AXIS Bank (AXBK.NS)	U (09/05/2012)	Rs1,191.9
HDFC (HDFC.NS)	O (05/08/2012)	Rs803.2
HDFC Bank (HDBK.NS)	O (01/18/2010)	Rs680
ICICI Bank (ICBK.NS)	O (04/08/2013)	Rs959.3
Kotak Mahindra Bank (KTKM.NS)	U (07/16/2012)	Rs690.85
State Bank of India (SBI.NS)	U (05/02/2011)	Rs1,811.3
<b>Subramanian Iyer</b>		
IDFC (IDFC.NS)	E (10/28/2012)	Rs125.95
LIC Housing Finance Ltd. (LICH.NS)	O (12/03/2012)	Rs208.35
Multi Commodity Exchange of India Ltd (MCEI.NS)	E (04/10/2012)	Rs739.3
Shriram Transport Finance Co. Ltd. (SRTR.NS)	O (07/25/2012)	Rs659.85
<b>Sumeet Kariwala</b>		
Bank of Baroda (BOB.NS)	E (07/16/2012)	Rs571.3
Bank of India (BOI.NS)	E (07/01/2013)	Rs211.5
Canara Bank (CNBK.NS)	U (05/02/2011)	Rs318.45
ING Vysya Bank Ltd. (VYSA.NS)	E (12/22/2010)	Rs575.55
IndusInd Bank (INBK.NS)	O (12/03/2012)	Rs445
Oriental Bank of Commerce (ORBC.NS)	E (07/01/2013)	Rs173.45
Punjab National Bank (PNBK.NS)	U (05/02/2011)	Rs631
Union Bank of India (UNBK.NS)	E (07/01/2013)	Rs156.55
Yes Bank (YESB.NS)	O (10/20/2009)	Rs424.6

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\* Historical prices are not split adjusted.