

# 1QFY14 earnings update

## Robust retail loan growth

July 19, 2013

<b>Rating</b> Remains	<b>Neutral</b>
<b>Target price</b> Increased from 780	INR 860
<b>Closing price</b> July 19, 2013	INR 803
<b>Potential upside</b>	+7.1%

### Action: Maintain Neutral with a revised TP of INR860 as we roll forward our valuation base

HDFC reported PAT of INR11.7bn for 1QFY14, marginally lower than our estimate of INR12bn (Street: INR12.1bn) – up 17.1% y-y. PAT came in lower than our estimate as net interest income was lower than our expectation as spread compression was somewhat offset by higher non-interest income. Loan growth was 19.4% y-y (24% including loans sold), with retail loans contributing the bulk of the growth. The proportion of retail loans increased q-q to 67.1%, from 65.6%. Including loans sold, retail loans grew 31% y-y. Retail lending spreads improved 5bps q-q to 2.01% and non-retail spreads compressed 12bps q-q to 2.82%. On an aggregate basis, spread was down 1bps q-q to 2.29%. Asset quality deteriorated on the corporate book, with GNPL % increasing by 17bps q-q to 1.08%, while retail asset quality held up relatively better (retail GNPL % increased by 3bps q-q to 0.61%).

**Outlook for FY14:** With the recent spike in market borrowing costs on account of liquidity tightening by the RBI, the key factor to watch would be funding strategy in the year ahead. Given the uncertainty surrounding the policy stance on this, it is too early to take an active view on the funding strategy. On loan growth, we are building in 18.9% for FY14F, with the retail loan mix expanding to 67.5%, from 67.1% currently.

**Valuation: On a standalone basis, HDFC currently trades at 2.5x our FY14/15F ABV of INR195.3. Our revised TP of INR860 implies a P/ABV of 2.8x our FY14/15F ABV**

31 Mar	FY13		FY14F		FY15F		FY16F	
	Actual	Old	New	Old	New	Old	New	
Currency (INR)								
<b>PPOP (mn)</b>	67,178	73,381	73,854		87,971		100,896	
<b>Reported net profit (mn)</b>	48,483	52,170	52,855		62,071		71,089	
<b>Normalised net profit (mn)</b>	48,483	52,170	52,855		62,071		71,089	
<b>FD normalised EPS</b>	31.44	33.65	33.75		39.63		45.39	
<b>FD norm. EPS growth (%)</b>	14.2	16.6	7.3		17.4		14.5	
<b>FD normalised P/E (x)</b>	25.5	N/A	23.8	N/A	20.3	N/A	17.7	
<b>Price/adj. book (x)</b>	5.0	N/A	4.4	N/A	3.9	N/A	3.4	
<b>Price/book (x)</b>	5.0	N/A	4.4	N/A	3.9	N/A	3.4	
<b>Dividend yield (%)</b>	1.8	N/A	1.7	N/A	2.1	N/A	2.4	
<b>ROE (%)</b>	22.0	20.0	19.8		20.6		20.9	
<b>ROA (%)</b>	2.8	2.6	2.6		2.6		2.5	

Source: Company data, Nomura estimates

**Key company data:** See page 2 for company data and detailed price/index chart.

### Anchor themes

Housing finance continues to be a key growth segment in India and we expect retail mortgages to grow relatively faster than the non-retail segment due to stable asset quality and more resilient demand.

### Nomura vs consensus

Our PAT for FY14F is 5-6% below consensus as we build in compression in spreads due to higher retail loan share.

### Research analysts

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

# Key data on HDFC

## Profit and Loss (INRmn)

Year-end 31 Mar	FY12	FY13	FY14F	FY15F	FY16F
Interest income	161,551	198,184	229,099	267,180	314,596
Interest expense	-110,934	-137,998	-160,083	-185,441	-220,789
Net interest income	50,618	60,186	69,015	81,739	93,807
Net fees and commissions	2,684	2,413	2,550	3,815	4,875
Trading related profits	2,702	3,156	1,230	1,915	2,298
Other operating revenue	6,606	7,724	8,473	8,745	9,464
Non-interest income	11,992	13,293	12,254	14,476	16,638
Operating income	62,609	73,479	81,269	96,215	110,444
Depreciation	-205	-236	-223	-228	-233
Amortisation					
Operating expenses	-2,890	-3,602	-4,265	-4,767	-5,566
Employee share expense	-2,058	-2,462	-2,927	-3,250	-3,750
Op. profit before provisions	57,456	67,178	73,854	87,971	100,896
Provisions for bad debt	-800	-1,450	-1,050	-1,761	-2,161
Other provision charges					
Operating profit	56,656	65,728	72,804	86,210	98,735
Other non-operating income					
Associates & JCEs					
Pre-tax profit	56,656	65,728	72,804	86,210	98,735
Income tax	-15,430	-17,245	-19,949	-24,139	-27,646
Net profit after tax	41,226	48,483	52,855	62,071	71,089
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	41,226	48,483	52,855	62,071	71,089
Extraordinary items	0	0	0	0	0
Reported NPAT	41,226	48,483	52,855	62,071	71,089
Dividends	-18,868	-22,517	-21,644	-25,418	-29,111
Transfer to reserves	22,359	25,966	31,211	36,653	41,978

## Valuation and ratio analysis

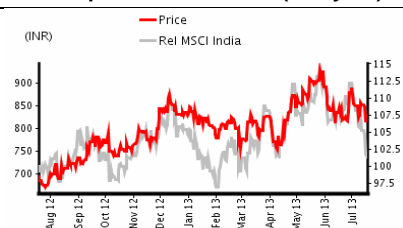
Reported P/E (x)	28.7	25.3	23.4	19.9	17.4
Normalised P/E (x)	28.7	25.3	23.4	19.9	17.4
FD normalised P/E (x)	29.2	25.5	23.8	20.3	17.7
FD normalised P/E at price target (x)	31.2	27.4	25.5	21.7	19.0
Dividend yield (%)	1.6	1.8	1.7	2.1	2.4
Price/book (x)	6.2	5.0	4.4	3.9	3.4
Price/adjusted book (x)	6.2	5.0	4.4	3.9	3.4
Net interest margin (%)	3.60	3.58	3.46	3.46	3.34
Yield on interest earning assets (%)	11.47	11.80	11.47	11.33	11.21
Cost of interest bearing liabilities (%)	8.72	9.26	9.24	9.02	8.94
Net interest spread (%)	2.76	2.54	2.23	2.30	2.27
Non-interest/operating income (%)	19.2	18.1	15.1	15.0	15.1
Cost to income (%)	8.2	8.6	9.1	8.6	8.6
Effective tax rate (%)	27.2	26.2	27.4	28.0	28.0
Dividend payout (%)	45.8	46.4	41.0	41.0	41.0
ROE (%)	22.7	22.0	19.8	20.6	20.9
ROA (%)	2.83	2.84	2.64	2.63	2.53
Operating ROE (%)	31.2	29.9	27.3	28.6	29.1
Operating ROA (%)	3.90	3.84	3.64	3.66	3.51

## Growth (%)

Net interest income	17.5	18.9	14.7	18.4	14.8
Non-interest income	12.0	10.9	-7.8	18.1	14.9
Non-interest expenses	16.7	24.7	18.4	11.8	16.8
Pre-provision earnings	16.4	16.9	9.9	19.1	14.7
Net profit	16.6	17.6	9.0	17.4	14.5
Normalised EPS	15.7	13.6	7.9	17.4	14.5
Normalised FDEPS	16.4	14.2	7.3	17.4	14.5

Source: Company data, Nomura estimates

## Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-4.7	-1.8	15.8
Absolute (USD)	-6.2	-11.2	7.1
Relative to index	-9.1	-7.6	-1.7
Market cap (USDmn)	20,720.2		
Estimated free float (%)	90.1		
52-week range (INR)	931.4/631.25		
3-mth avg daily turnover (USDmn)	45.77		
Major shareholders (%)			
Citigroup Strate	8.8		

Source: Thomson Reuters, Nomura research

## Notes

**Balance Sheet (INRmn)**

As at 31 Mar	FY12	FY13	FY14F	FY15F	FY16F	Notes
Cash and equivalents	54,729	57,512	41,780	49,488	68,743	
Inter-bank lending						
Deposits with central bank						
Total securities	122,070	136,135	146,542	159,137	174,253	
Other interest earning assets						
Gross loans	1,420,927	1,713,631	2,035,088	2,418,829	2,909,041	
Less provisions	-16,710	-17,923	-19,505	-21,706	-24,407	
Net loans	1,404,217	1,695,708	2,015,583	2,397,123	2,884,633	
Long-term investments						
Fixed assets	2,340	2,379	1,987	1,889	1,787	
Goodwill						
Other intangible assets						
Other non IEAs	-1,904	-53,453	-46,695	-54,098	-61,686	
Total assets	1,581,451	1,838,281	2,159,198	2,553,539	3,067,730	
Customer deposits						
Bank deposits, CDs, debentures	1,391,275	1,588,281	1,876,371	2,234,500	2,707,254	
Other interest bearing liabilities						
Total interest bearing liabilities	1,391,275	1,588,281	1,876,371	2,234,500	2,707,254	
Non interest bearing liabilities						
Total liabilities	1,391,275	1,588,281	1,876,371	2,234,500	2,707,254	
Minority interest						
Common stock	2,954	3,093	3,108	3,108	3,108	
Preferred stock						
Retained earnings	187,222	246,907	279,718	315,931	357,368	
Reserves for credit losses						
Proposed dividends						
Other equity						
Shareholders' equity	190,176	250,000	282,826	319,039	360,477	
Total liabilities and equity	1,581,451	1,838,281	2,159,197	2,553,539	3,067,730	
Non-performing assets (INR)	10,690	11,990	14,623	18,586	23,690	
Balance sheet ratios (%)						
Loans to deposits	na	na	na	na	na	
Equity to assets	12.0	13.6	13.1	12.5	11.8	
Asset quality & capital						
NPAs/gross loans (%)	0.8	0.7	0.7	0.8	0.8	
Bad debt charge/gross loans (%)	0.06	0.08	0.05	0.07	0.07	
Loss reserves/assets (%)	1.06	0.97	0.90	0.85	0.80	
Loss reserves/NPAs (%)	156.3	149.5	133.4	116.8	103.0	
Tier 1 capital ratio (%)	12.1	13.9	14.1	13.5	12.7	
Total capital ratio (%)	13.9	16.4	15.4	14.6	14.0	
Growth (%)						
Loan growth	19.9	20.8	18.9	18.9	20.3	
Interest earning assets	18.4	20.0	18.0	18.2	19.7	
Interest bearing liabilities	20.6	14.2	18.1	19.1	21.2	
Asset growth	19.2	16.2	17.5	18.3	20.1	
Deposit growth	na	na	na	na	na	
Per share						
Reported EPS (INR)	27.97	31.79	34.30	40.28	46.13	
Norm EPS (INR)	27.97	31.79	34.30	40.28	46.13	
Fully diluted norm EPS (INR)	27.54	31.44	33.75	39.63	45.39	
DPS (INR)	12.77	14.61	14.05	16.49	18.89	
PPOP PS (INR)	38.98	44.05	47.93	57.09	65.47	
BVPS (INR)	128.76	162.23	183.54	207.04	233.93	
ABVPS (INR)	128.76	162.23	183.54	207.04	233.93	
NTAPS (INR)	128.76	162.23	183.54	207.04	233.93	

Source: Company data, Nomura estimates

# 1QFY14 result highlights

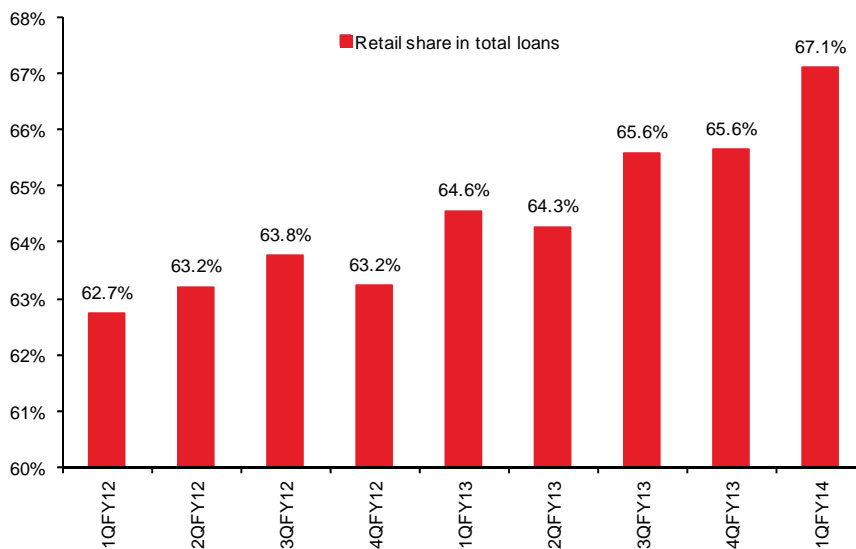
## PAT and NII lower than our estimates

HDFC reported PAT of INR11.7bn, marginally lower than our estimate of INR11.95bn and the Street's estimate of INR12.1bn. PAT miss was largely on account of 4.5% lower NII than our estimate at INR14.8bn (up 15.8% y-y) as NIMs declined by 10bps y-y. The decline in NIM was on account of a higher mix of retail loans in the total loans leading to a compression in spreads, as spreads for retail loans are lower compared to corporate loans (2.01% spread for retail loans in 1QFY14 vs. 2.82% spread for corporate loans). We expect HDFC to make lower spreads for FY14F, as we expect the retail mix to remain high due to lower corporate demand for loans.

## Retail segment drives loan growth

Loan growth of 19.4% was supported by healthy growth in the retail segment. The retail segment grew 24.1% y-y in 1QFY14, compared to 11% y-y growth in the corporate segment. We expect this trend to continue, with the retail segment growing faster than the corporate segment. Currently, the mix of retail loans in total loans is at 67.1%, and we expect this to increase to 68.6% by FY15F. We are building in 22% y-y growth in retail loans vs. 12.6% growth in corporate loans for FY14F.

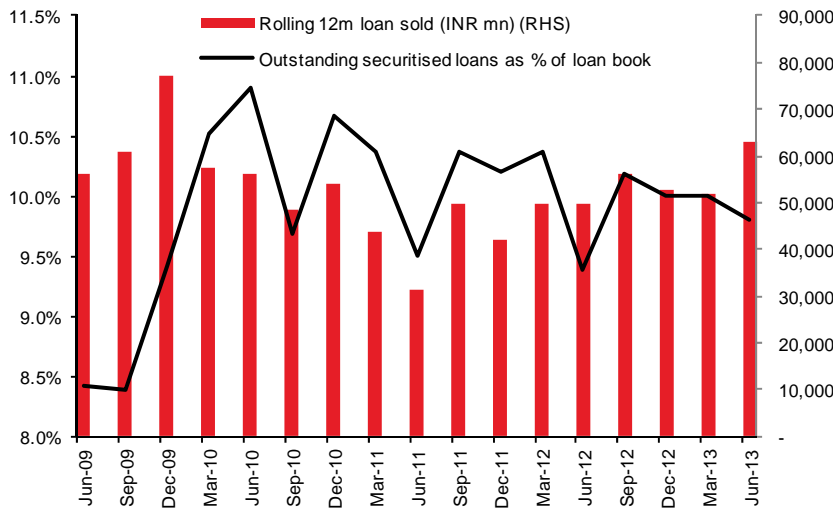
**Fig. 1: Retail mix (of total loans) steadily increasing**



Source: Company data, Nomura research

Loans sold during the past one year stand at INR63.1bn. Including the loans sold, retail loans would have grown 31% y-y and total loans would have grown 24% y-y during the quarter. Outstanding securitised book is at 9.4% of the total loan book.

**Fig. 2: Loans sold vs. securitised book**



Source: Company data, Nomura research

### Higher dividend income supports PAT growth

Non-interest income grew 16.6% y-y in the quarter to INR3.5bn vs. our estimate of INR3.1bn. While, there was no treasury income in the quarter (compared to our estimate of INR4.3bn), dividend income came in higher at INR2.2bn, resulting into 11.2% higher non-interest income than our expectation.

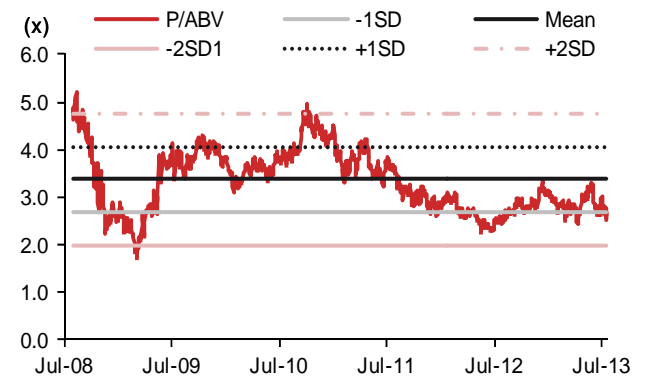
### Asset quality in retail segment stays stable but deteriorates in corporate segment

Asset quality was stable for the quarter, with the GNPL ratio at 0.77% (0.7% in 4QFY13). The GNPL ratio for the retail segment increased by 3bps q-q to 0.61%, while in the corporate segment, the ratio increased by 17bps q-q to 1.08%. HDFC has total provisions of INR18bn vs. GNPLs of INR13.7bn. Of the total INR18bn, INR4.2bn is for specific provisions, INR9bn is for standard asset provisions and INR4.7bn is for excess provisions (over and above requirement as per NHB norms).

## Valuation methodology and risks

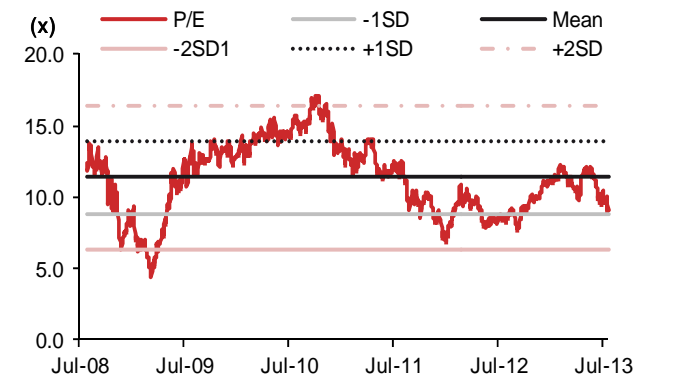
We raise our TP to INR860, from INR780, for HDFC on book roll-forward. We use a sum-of-the-parts methodology (SOTP) to value the subsidiaries. Valuation for the subsidiaries works out to INR320 per share. We value HDFC's core mortgage business using a three-stage residual income valuation method that assumes the following: 1) a 18.5% CAGR for the company's average interest-earning assets during FY13-17F, followed by a CAGR of 12% for FY17-25F and a terminal growth rate of 4% beyond that; 2) average ROE of 21.4% over FY13-25F and a 19.6% terminal value ROE; and 3) discount rates ranging from 13.5% (current cost of equity) for FY13-17F and 12% for FY18-25F with a 10% terminal rate. At our target price, HDFC would trade at 2.8x our avg FY14/15F ABV of INR195.3 and 14.7x avg FY14/15F EPS of INR36.7 for an ROE of 19.8% for FY14F.

Fig. 3: One-year forward P/ABV chart



Source: Company data, Bloomberg, Nomura estimates

Fig. 4: One-year forward P/E chart



Source: Company data, Bloomberg, Nomura estimates

**Key risk:** Higher-than-expected compression in spreads, lower-than-expected loan growth and weak asset quality in the corporate segment.

## Earnings summary

Fig. 5: Earnings summary

Earnings summary (INRmn)	1QFY14	4QFY13	1QFY13	%y/y	%q/q	1QFY14F	Variance %
Interest Earned	52,198.0	53,392.3	46,464.3	12.3	(2.2)	53,313.8	(2.1)
Interest on loans	50,350.7	50,984.9	44,019.0	14.4	(1.2)	51,528.3	(2.3)
Interest from treasury	1,847.3	2,407.4	2,445.3	(24.5)	(23.3)	1,785.5	3.5
Interest expended	37,382.3	34,174.0	33,672.0	11.0	9.4	37,803.9	(1.1)
Net interest income	14,815.7	19,218.3	12,792.3	15.8	(22.9)	15,509.9	(4.5)
Non-interest income	3,451.4	3,384.8	2,958.8	16.6	2.0	3,104.9	11.2
Fee income	544.0	879.4	617.5	(11.9)	(38.1)	520.4	4.5
Surplus from deployment in Cash mgmt schemes	645.9	513.5	459.7	40.5	25.8	190.1	239.7
Treasury income	-	1,048.8	202.4	(100.0)	NM	428.4	NM
Dividend income	2,171.3	814.3	1,595.8	36.1	166.6	1,822.9	19.1
Total Net income	18,267.1	22,603.1	15,751.1	16.0	(19.2)	18,614.9	(1.9)
Operating expense	1,886.1	1,356.0	1,552.0	21.5	39.1	1,780.5	5.9
Employee cost	744.1	590.4	608.7	22.2	26.0	651.5	14.2
Other Finance Charges	251.0	224.3	210.1	19.5	11.9	264.6	(5.1)
Operating & Administrative costs	835.6	468.3	685.3	21.9	78.4	791.1	5.6
Depreciation	55.4	73.0	47.9	15.7	(24.1)	73.2	(24.3)
Pre-prov operating profit	16,381.0	21,247.1	14,199.1	15.4	(22.9)	16,834.4	(2.7)
Provisions & Contingencies	300.0	250.0	400.0	(25.0)	20.0	345.9	(13.3)
PBT	16,081.0	20,997.1	13,799.1	16.5	(23.4)	16,488.5	(2.5)
Tax Provisions	4,350.0	5,445.0	3,780.0	15.1	(20.1)	4,534.3	(4.1)
Adjusted net profit	11,731.0	15,552.1	10,019.1	17.1	(24.6)	11,954.2	(1.9)
EPS	7.5	10.0	6.7	12.1	(24.7)	7.6	(2.0)

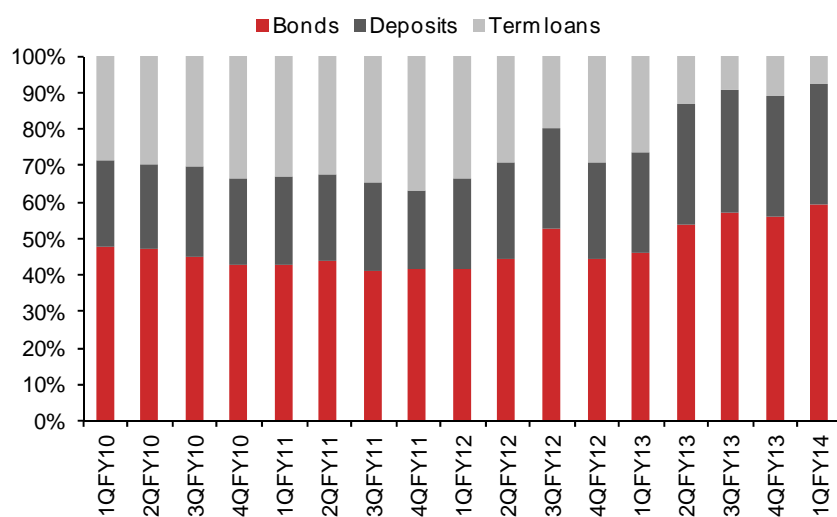
Source: Company data, Nomura estimates

Fig. 6: Loan book breakdown

Loan Break-up (INRmn)	1QFY14	4QFY13	1QFY13	%y/y	%q/q
Retail	1,184,291.2	1,113,210.0	954,129.2	24.1	6.4
Corporate	566,198.4	569,550.0	509,977.3	11.0	(0.6)
Others	14,336.1	12,948.4	18,516.7	(22.6)	10.7
Total Loans	1,764,825.7	1,695,708.4	1,477,777.2	19.4	4.1

Source Company data, Nomura research

Fig. 7: Funding mix



Source: Company data, Nomura research

Fig. 8: Key ratios

Key Ratios	1QFY14	4QFY13	1QFY13	y/y bps	q/q bps
Reported spread, %	2.29	2.30	2.27	2	(1)
Total CAR, %	16.3	16.4	14.6	170	(5)
Tier I, %	14.0	13.9	11.8	220	15
Cost-income ratio, %	10.3	6.0	9.9	47	433
Cost-asset ratio, %	0.40	0.30	0.39	2	10
Gross NPA, %	0.77	0.70	0.80	(3)	7

Source: Company data, Nomura research



# Appendix A-1

## Analyst Certification

We, Vijay Sarathi, Abhishek Bhattacharya and Amit Nanavati, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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### Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
HDFC	HDFC IN	INR 803	19-Jul-2013	Neutral	Not rated	A6,A7,A13

A6 The Nomura Group expects to receive or intends to seek compensation for investment banking services from the issuer in the next three months.

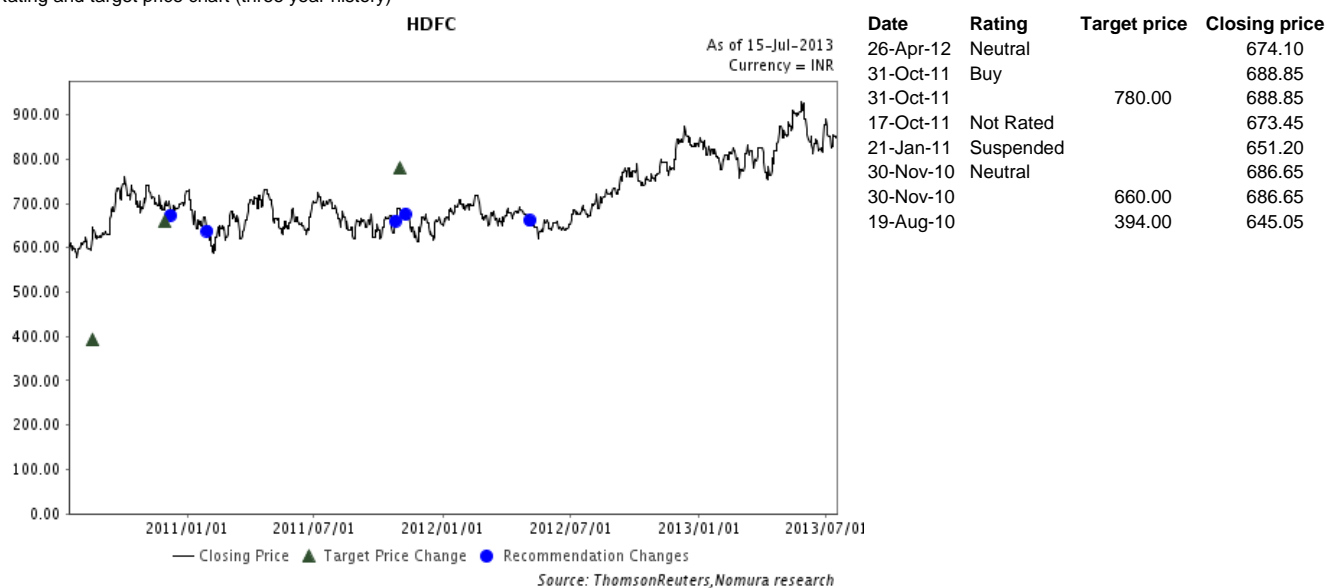
A7 The Nomura Group has managed or co-managed a publicly announced or 144A offering of the issuer's securities or related derivatives in the past 12 months.

A13 The Nomura Group has a significant financial interest (non-equity) in the issuer.

### HDFC (HDFC IN)

INR 803 (19-Jul-2013) Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

**Valuation Methodology** In deriving our TP of INR860, we use a sum-of-the-parts methodology (SOTP) to value the subsidiaries. The valuation for the subsidiaries works out to be INR320 per share. We value HDFC's core mortgage business using a three-stage residual income valuation method that assumes the following: 1) a 18.5% CAGR for the company's average interest-earning assets during FY13-17F, followed by a CAGR of 12% for FY17-25F and a terminal growth rate of 4% beyond that; 2) average ROE of 21.4% over FY13-25F and a 19.6% terminal value ROE; and 3) discount rates ranging from 13.5% (current cost of equity) for FY13-17F and 12% for FY18-25F with a 10% terminal rate. At our target price, HDFC would trade at 2.8x our avg. FY14/15F ABV of INR195.3 and 14.7x avg. FY14/15F EPS of INR36.7 for an ROE of 19.8% for FY14F.

Risks that may impede the achievement of the target price **Key risk: Higher than expected compression in spreads, lower than expected loan growth and weak asset quality in the corporate segment.**

### Important Disclosures

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## STOCKS

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## SECTORS

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## Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

### STOCKS

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