

HDFC

Demystifying forex equation

India Equity Research | Banking and Financial Services

We recently met the HDFC management for better understanding of the company's foreign currency exposure, hedging policies and related accounting adjustments in Q3FY12. We also gained clarity on utilization of excess reserves/networth due to adjustments pertaining to interest on zero coupon bonds and standard asset provisioning. We maintain our PAT estimate of 18% CAGR and RoEs of 23-24% over FY11-13. However, due to utilization of reserves, as discussed above, book value accretion will be 18-19% (refer table 6). Our SOTP fair value is INR664/ share (FY13E) (valuing the core book at 4.2x and investments at INR 224) and we maintain 'HOLD'.

Forex exposure: Adequately hedged

- HDFC had USD1.1bn of foreign currency denominated liabilities (refer table 1), which were completely hedged as of FY11. Over and above forex denominated liabilities, the company had entered into USD697mn cross currency swaps and interest rate swap converting its fixed rate INR liability into floating rate forex liability to trim the overall cost of borrowing (refer table 2). Besides using principal only swaps, currency option, forward contracts and cross currency swaps for hedging (refer table 3), it has build USD denominated assets of USD500-600mn to create a natural hedge against currency movement risk.
- The net open position on forex exposure in FY11 was USD304mn (on cross currency swaps). However, due to sharp INR depreciation in 9mFY12, limit on ~USD300mn currency options (European) got triggered and if the INR /USD rate continues to remain above the trigger limit, it will also be classified as an open position.
- HDFC accounted for cross currency swaps at fair value, i.e., incorporating MTM on both currency movement and interest rate differentials. As per management, historically the moves often offset each other, leading to minimal MTM hit. Q3FY12 onwards, an accounting policy change has been effected whereby outstanding liability will be marked to spot rates, but the benefit on interest rate differentials will be excluded.

Financials

Year to March	FY10	FY11	FY12E	FY13E
Net Interest Income(INR mn)	33,875	42,471	50,886	60,597
Net profit (INR mn)	28,265	35,350	41,871	49,452
Shares outstanding (mn)	287.1	293.4	294.3	305.9
EPS (INR)	19.7	24.1	28.5	32.3
EPS growth (%)	22.7	22.4	18.1	13.6
PE (x)*	31.2	24.5	19.5	16.9
Price to book (x)*	10.2	8.0	6.8	4.4
ROE (%)	20.0	21.7	23.3	23.1

* Adj. for subs.

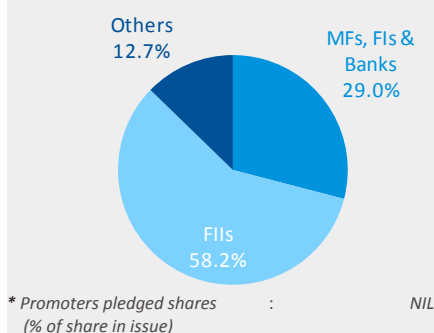
EDELWEISS 4D RATINGS

Absolute Rating	HOLD
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Equalweight

MARKET DATA (R: HDFC.BO, B: HDFC IN)

CMP	: INR 683
Target Price	: INR 664
52-week range (INR)	: 738 / 582
Share in issue (mn)	: 1,473.6
M cap (INR bn/USD mn)	: 1,006 / 19,960
Avg. Daily Vol.BSE/NSE('000)	: 369.3

SHARE HOLDING PATTERN (%)



PRICE PERFORMANCE (%)

	Stock	Nifty	EW Banks and Financial Services Index
1 month	5.4	1.4	3.9
3 months	2.9	(4.2)	(4.7)
12 months	4.3	(15.4)	(13.8)

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- Due to INR depreciation of 8% in Q3FY12, HDFC has created INR4.14bn (INR/USD rate of 53) of forex translation reserves after taking INR1.03bn hit on P&L.
- With the INR appreciating ~4% post December 2011, the overall forex translation reserves will come off by INR1.5-2.0bn. However, management indicated that it will be conservative in amortizing reserves and reducing volatility in earnings due to sharp currency movements. Forex translation reserves will be classified under 'Current Assets' and we are not adjusting it against the networth as equivalent interest rate differential benefit on cross currency swaps will flow through P&L.

ZCBs: Blended cost of 9.6% to be adjusted against network

HDFC carries zero coupon bonds of ~INR72bn (refer table 4 for details) equivalent to the value of its investments in HDFC Bank and insurance companies (refer table 5). ZCBs of INR24bn that matured in June-July 2011, were refinanced at 9.3-9.5%. Another INR17.5bn of ZCBs issued at 9.5-10.0% will be refinanced in Q4FY12.

The blended cost of ~9.6% on these INR72.2bn of ZCBs will be knocked off from securities premium account as per its accounting policy—INR7bn (INR4.5-5.5 per share), of which the proportionate amount of INR5.13bn has been charged in 9mFY12.

Standard asset provisioning adjusted against special reserves

The company has been carrying excess reserves (under the head provisioning for contingencies) of INR3bn in FY11. It has further provided INR3.7bn towards standard assets on H1FY12 outstanding loan book and revised provisioning requirement on doubtful assets (notified by NHB). On incremental loans, it will be providing for 40bps standard asset provisioning by primarily utilizing the excess reserves it has been carrying.

Other highlights

- HDFC has outstanding loans under Dual Rate Home Loan scheme of INR223bn and this entire portfolio will be converted into floating rate loans on April 1, 2012.
- Of the 36% lending exposure to non-individual segment, developer loans account for 12% while lease rental discounting constitutes 13-14%.
- Other interest income grew 50% YoY and QoQ partially due to increase in corporate deposits (now at INR35bn compared to INR20bn in Q2FY12) and government securities exposure.

Table 1: Details of HDFC's forex denominated liability (as of FY11)

	USD mn	INR equivalent (mn)	Interest rate	Maturity	Hedging
FCNR (B) loans from dom banks	744	33,086		< 3 years	
Asian Development Bank	72	3,312	LIBOR + 40 bps	Dec-22	Handed over USD deposit to BOI overseas and obtained INR fund thereby protecting exchange risk
International Finance Corp	100	4,473	6 mths LIBOR + 100 bps	Retired in Jun, '11	
KfW of Germany	9	390			
DEG - member of KfW	5	224			
Short term Forex borrowings	175	8,310	< 6 mths LIBOR + 200 bps	FY13	Hedged via principal only swaps
Total	1,104	49,795			

Source: Company

Note: Entire foreign currency denominated liability is hedged including FCNR (B) loans and KfW/DEG loans

Table 2: Besides forex borrowings, HDFC has exposure to interest rate and cross currency swaps (as of FY11)

	USD mn	Nature of transaction
Principal related forex exposure		
Foreign currency denominated borrowings	1,104	Details in Table 1
Cross currency swaps	698	To convert fixed rate rupee liabilities into forex liabilities and interest rates linked to benchmarks of respective currencies
Total	1,802	
Interest related forex exposure		
Interest rate swaps on forex liability	15	To hedge interest rate risk on foreign currency borrowings

Source: Company

Note: HDFC also has interest rate swaps where it has converted fixed rate rupee liability of notional amount of INR 232 bn into floating rate

Table 3: Instruments used to reduced cost of borrowings and protect currency risk

Entire principal hedged via	USD mn
- principal only swaps	175
- currency options	300-400
- forward contracts	300-400
- dollar denominated assets	500-600
- open position	300

Source: Company

Table 4: Zero coupon bonds issued by HDFC

Descriptor	Date of issue	Redemption date	Issue size (INR mn)	Yield (%)
HDFC 0% 2012 (Series-205 (H-009))	27-Jul-10	27-Jan-12	7,500	9.48
HDFC 0% 2012 (Series-187 (G-006))	8-Feb-10	8-Feb-12	5,000	10.03
HDFC 0% 2012 (Series-191 (G-010))	9-Mar-10	9-Mar-12	5,000	
HDFC 0% 2012 (Series-194 (G-013))	8-Apr-10	28-Jun-12	1,000	
HDFC 0% 2012 (Sr-I-011)	4-Jul-11	5-Jul-12	5,000	9.48
HDFC 0% 2012 (Series-202 (H-006))	13-Jul-10	13-Jul-12	2,250	9.52
HDFC 0% 2012	24-Aug-09	24-Aug-12	20,000	9.93
HDFC 0% 2013 (Sr-I-008)	10-Jun-11	10-Jun-13	5,000	9.48
HDFC 0% 2013 (Sr-I-010)	21-Jun-11	21-Jun-13	7,000	9.42
HDFC 0% 2013 (Series-207 (H-011))	30-Aug-10	30-Aug-13	5,000	9.47
HDFC 0% 2014(S-120(E002))	16-May-07	16-May-14	2,000	8.09
HDFC 0% 2016 (Sr-I-009)	14-Jun-11	14-Jun-16	7,500	9.39
TOTAL			72,250	

Source: NSE, Edelweiss research

Table 5: Dividend yield on investments in HDFC Bank and insurance entities is lower

	Investment (INR mn)		Dividend (INR mn)		Dividend yield (%)	
	FY10	FY11	FY10	FY11	FY10	FY11
HDFC Bank	55,497	55,497	824	1,304	1.5	2.3
HDFC Standard Life Insurance	14,281	15,456				
HDFC Ergo General Insurance	3,083	4,378				
Total	72,861	75,332	824	1,304	1.1	1.7

Source: Company

Table 6: Book value accretion after adjusting for interest on ZCBs and provisioning

(INR mn)	FY09	FY10	FY11	FY12E	FY13E	FY14E
Networth (Opening)	119,473	131,374	151,977	173,165	186,718	242,105
Add: Profits	22,825	28,265	35,350	41,871	49,452	58,476
Add: equity/warrant issuances	552	6,316	9,776	2,709	34,968	2,709
Less: Dividend	9,805	11,905	15,516	18,066	20,760	24,548
Less: Utilization						
Std asset prov	1,188		2,986	5,540	3,061	3,252
Interest on zero coupon bonds	431	1,988	5,321	7,322	7,502	7,682
Utilized from Shelter assistance reserve	52	85	115	100	100	100
Reversal of teaser loan provisioning					(2,389)	
Networth (Closing)	131,374	151,977	173,165	186,718	242,105	267,709
Book value per share	92.4	105.9	118.1	126.9	158.3	174.5

Source: Company, Edelweiss research

Note: 1) We have not adjusted Foreign Currency Translation reserves from networth as benefit of interest rate differential will flow through P&L
2) Equity issuances from FY12-14E include 1) ESOPs being exercised; and 2) warrant conversion in FY13

Table 7: SOTP valuations

FY13E	Method	AUMs/book /earnings (INR mn)	Multiple (x)	Value of business (INR mn)	HDFC holding(%)	Value of HDFC's interest (INR mn)	Value per share (INR)
HDFC core mortgage business	PB	158,754	4.2	673,117	100.0	673,117	440
HDFC Bank	Fair value	1,273,090	1.0	1,273,090	23.2	295,357	193
Asset management	% of AUM	1,091,467	5.0	54,573	60.0	32,744	21
Venture Capital	% of AUMs	57,609	10.0	5,761	100.0	5,761	4
HDFC Life Insurance	Appraisal value	3,635	30.3	110,101	72.4	79,680	52
Others						13,530	9
Value of subs						427,072	280
Value (at 20% holding company discount)						341,657	224
Total						1,014,774	664

Source: Edelweiss research

Company Description

HDFC is India's largest provider of housing finance, primarily focusing on retail housing. The company has widened its distribution network to 304 offices in India. It also covers over 90 locations through its outreach programme, which has helped the corporation disburse housing loans in more than 2,400 towns and cities in India. It has also supplemented the distribution channel through the appointment of direct selling agents (DSA). As on December, 2011, 59% of the shares are held by foreign institutional investors/foreign direct investments and 12% by individuals. Besides the core business of mortgages, HDFC has evolved into a financial conglomerate, diversifying into other businesses through its subsidiaries viz., HDFC Standard Life Insurance (73%), HDFC Asset Management Company (60%), HDFC Bank (23.2%), and HDFC General Insurance Company (74%).

Investment Theme

HDFC is the strongest and the most venerable play on Indian mortgages over the long term. We expect the company, with its strong brand recall, superior real estate knowledge, and revamped distribution strategy, to attain 20% CAGR in loan disbursement over FY11-13E. Besides the core business, HDFC's insurance, AMC, banking, BPO, and real estate private equity businesses are also growing at a rapid pace and the estimated value of its investments/subsidiaries explains HDFC's ~35% market capitalisation. Value of stakes in HDFC Bank and HDFC Standard Life form a significant portion of its unrealised gains. The stock has always traded at a premium to other financial stocks due to its stable earnings profile, superior asset quality and strong management.

Key Risks

Increase in competition and sustained slack in the mortgage market can lead to lower growth than our estimates.

Higher-than-expected increase in funding cost and inability to pass the cost to customers in the current tightening monetary environment will adversely affect margins and profitability. Risk of fraud and NPA accretion due to increase in interest rates and fall in property prices is inherent to the mortgage business.

Financial Statements

Income statement						(INR mn)
Year to March	FY10	FY11	FY12E	FY13E	FY14E	
Interest income	104,506	118,070	141,705	166,186	196,090	
Interest expended	70,631	75,599	90,819	105,589	123,982	
Net interest income	33,875	42,471	50,886	60,597	72,108	
Non interest income	7,008	7,113	8,250	9,560	11,092	
- Fee & forex income	2,317	2,204	2,644	3,173	3,808	
- Income from investments	1,898	2,175	2,502	2,877	3,308	
- Misc. income	2,794	2,734	3,104	3,510	3,976	
Income from operations	40,884	49,584	59,136	70,157	83,200	
Net revenues	40,884	49,584	59,136	70,157	83,200	
Operating expenses	3,237	3,811	4,206	4,665	5,175	
- Employee exp	1,467	1,755	1,931	2,163	2,422	
- Depreciation /amortisation	182	192	202	213	224	
- Other opex	1,589	1,864	2,073	2,290	2,529	
Preprovision profit	37,646	45,773	54,931	65,492	78,026	
Profit on sale of investments	2,094	3,597	3,500	3,500	3,500	
Provisions	580	700	750	900	1,050	
PBT	39,160	48,670	57,681	68,092	80,476	
Taxes	10,895	13,320	15,809	18,640	22,000	
PAT	28,265	35,350	41,871	49,452	58,476	
Reported PAT	28,265	35,350	41,871	49,452	58,476	
Basic number of shares (mn)	1,436	1,467	1,471	1,530	1,534	
Basic EPS (INR)	19.7	24.1	28.5	32.3	38.1	
Diluted number of shares (mn)	1,436	1,467	1,471	1,530	1,534	
Diluted EPS (INR)	19.7	24.1	28.5	32.3	38.1	
DPS (INR)	7.2	9.0	10.5	11.6	13.7	
Dividend pay out (%)	42.6	43.4	43.1	42.0	42.0	

Growth metrics (%)

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Net interest income	10.9	25.4	19.8	19.1	19.0
Net revenues growth	19.9	23.7	17.8	17.6	17.7
Opex growth	2.6	17.7	10.3	10.9	10.9
PPP growth	16.0	21.6	20.0	19.2	19.1
Provisions growth	14.5	20.7	7.1	20.0	16.7
PAT growth	23.8	25.1	18.4	18.1	18.2

Operating ratios (%)

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Yield on assets	10.1	9.7	9.9	10.0	10.0
Yield on advances	10.9	10.5	10.8	10.7	10.6
Cost of funds	7.8	7.1	7.3	7.2	7.2
Spread	2.2	2.6	2.7	2.7	2.8
Net interest margins	3.3	3.5	3.6	3.6	3.7
Cost-income	8.0	7.8	7.2	6.7	6.2
Tax rate	27.8	27.4	27.4	27.4	27.3

Banking and Financial Services

Balance sheet					(INR mn)
As on 31st March	FY10	FY11	FY12E	FY13E	FY14E
Liabilities					
Equity capital	2,871	2,934	2,943	3,059	3,068
Share premium	57,796	62,189	57,567	84,917	79,936
Reserves & surplus	91,309	108,043	126,209	154,129	184,705
Net worth	151,977	173,165	186,719	242,105	267,709
Total deposits	230,811	246,251	288,114	339,974	407,969
Secured Loans	636,057	816,415	959,925	1,116,449	1,345,836
Unsecured Loans	98,785	91,439	101,018	111,375	126,620
Total liabilities	1,117,630	1,327,270	1,535,776	1,809,904	2,148,135
Assets					
Loans	979,670	1,171,266	1,378,148	1,646,629	1,978,737
Investments	107,275	118,324	122,393	126,944	131,666
<i>Current assets</i>	74,392	98,610	98,640	100,270	102,599
<i>Current liabilities</i>	48,785	67,751	70,915	72,364	74,440
Net current assets	25,607	30,859	27,725	27,906	28,160
Fixed assets (net block)	2,221	2,340	2,237	2,125	2,001
Other assets	2,857	4,481	5,273	6,300	7,571
Total assets	1,117,630	1,327,270	1,535,776	1,809,904	2,148,135
Balance sheet ratios (%)					
Loan growth	15.0	19.6	17.7	19.5	20.2
Deposit growth	19.1	6.7	17.0	18.0	20.0
EA growth	15.2	18.7	15.7	17.9	18.7
CAR	14.6	14.0	9.6	11.3	10.6

Sanctions and disbursements					(INR mn)
Year to March	FY10	FY11	FY12E	FY13E	FY14E
Sanctions (INR mn)	606,110	751,850	902,220	1,082,664	1,299,197
Disbursements (INR mn)	504,130	603,140	723,768	868,522	1,042,226
Disbursements to sanction ratio (%)	83.2	80.2	80.2	80.2	80.2
Disbursements growth (%)	27.1	19.6	20.0	20.0	20.0
Sanctions growth (%)	23.3	24.0	20.0	20.0	20.0

RoE decomposition (%)					
Year to March	FY10	FY11	FY12E	FY13E	FY14E
Net interest income/assets	3.3	3.5	3.6	3.6	3.7
Non interest income/assets	0.7	0.6	0.6	0.6	0.6
Investment gains/assets	0.2	0.3	0.2	0.2	0.2
Net revenues/Assets	4.1	4.4	4.4	4.4	4.4
Operating expense/assets	0.3	0.3	0.3	0.3	0.3
Provisions/assets	0.1	0.1	0.1	0.1	0.1
Taxes/assets	1.0	1.1	1.1	1.1	1.1
Total costs/assets	1.4	1.5	1.5	1.5	1.4
ROA	2.7	2.9	2.9	3.0	3.0
Equity/assets	13.6	13.4	12.6	12.9	12.9
ROAE	20.0	21.7	23.3	23.1	22.9

Valuation metrics

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Diluted EPS (INR)	19.7	24.1	28.5	32.3	38.1
EPS growth (%)	22.7	22.4	18.1	13.6	17.9
Book value per share (INR)	106	118	127	158	175
Adjusted book value per share (INR)*	52	64	72	104	119
Diluted P/E (x)	34.7	28.3	24.0	21.1	17.9
Price/ BV (x)	6.5	5.8	5.4	4.3	3.9
Price/ Adj. Earnings (x)*	31.2	24.5	19.5	16.9	14.2
Price/ Adj. BV (x)*	10.2	8.0	6.8	4.4	3.7
Dividend yield (%)	1.1	1.3	1.5	1.7	2.0

* adjusted for value of investments in subsidiaries

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Allahabad Bank	REDUCE	SU	H	Axis Bank	BUY	SO	M
Bank of Baroda	HOLD	SP	L	Federal Bank	BUY	SO	M
HDFC	HOLD	SP	L	HDFC Bank	HOLD	SP	L
ICICI Bank	BUY	SO	L	Indian Overseas Bank	HOLD	SU	H
Infrastructure Development Finance Co Ltd	HOLD	SP	M	ING Vysya	HOLD	SP	H
Karnataka Bank	BUY	SO	L	Kotak Mahindra Bank	REDUCE	SU	L
LIC Housing Finance	HOLD	SP	M	Mahindra & Mahindra Financial Services	HOLD	SP	M
Manappuram General Finance	HOLD	SP	M	Oriental Bank Of Commerce	REDUCE	SU	H
Power Finance Corp	BUY	SO	L	Punjab National Bank	REDUCE	SU	M
Reliance Capital	BUY	SO	M	Rural Electrification Corporation	BUY	SO	L
Shriram City Union Finance	BUY	SO	H	South Indian Bank	HOLD	SP	M
State Bank of India	HOLD	SP	M	Union Bank Of India	HOLD	SP	H
Yes Bank	BUY	SO	M				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return



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Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services

Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC, HDFC Bank, ICICI Bank, Infrastructure Development Finance Co Ltd, Indian Overseas Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, Manappuram General Finance, Mahindra & Mahindra Financial Services, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, State Bank of India, Shriram City Union Finance, South Indian Bank, Union Bank Of India, ING Vysya, Yes Bank

Recent Research

Date	Company	Title	Price (INR)	Recos
19-Jan-12	Reliance Capital	AMC stake sale: Raking in the moolah; <i>EdelFlash</i>	318	Buy
16-Jan-12	ING Vysya Bank	Beat on NII, asset quality continues to impress; <i>Result Update</i>	313	Hold
16-Jan-12	South Indian Bank	Growth and profitability intact; <i>Result Update</i>	23	Hold

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	119	47	15	184
* 3 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	111	57	16	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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