MOTILAL OSWAL

the Corner Office
Interaction with the CEO

Capitalizing leadership position in secular growth business

Strong operating performance; return ratios to remain superior

Over the last decade HDFC has delivered a PAT CAGR of 22%. Impeccable asset quality, growth and profitability performance has led to market cap CAGR of 30%. We met Mr Keki Mistry, Vice Chairman and CEO of HDFC for a Q&A session. Our discussion largely centered around (1) the outlook for the housing finance industry, and (2) the way forward for HDFC as a financial conglomerate, besides a standalone housing finance entity. Our key takeaways:

- **Despite strong growth in the last few years, the Indian housing finance industry remains fairly underpenetrated. This coupled with changing demographics offers strong growth potential for housing finance companies. HDFC is confident of achieving 18-20% asset growth over the next 5-10 years.**
- **Subsidiaries /associates have grown sizable and have become self-sufficient. The life insurance business has turned profitable and should not need further capital infusion. HDFC does not need to dilute capital to fund subsidiaries; strong core RoE will help fund own growth. Value unlocking through listing of insurance subsidiary could provide capital for infusion in HDFC Bank, as and when needed.**
- **HDFC largely maintains its guidance on its four core parameters - (1) consolidated RoE to improve by 100bp (except for FY13, due to warrant conversion) every year for the next three years, (2) growth to be maintained at 18-20%, (3) spreads to be in the 2.15-2.35% range, and (4) cost-to-income ratio may not improve in FY13 due to acquisition of new office building and change in taxation-related provisions on certain services.**
- **We believe valuations are attractive, considering the growth potential (FY12-14E earnings CAGR of ~20%), sound business fundamentals, and substantially improved performance of subsidiaries. Buy with an SOTP-based TP of INR800 (17% upside).**

HDFC

Mr Keki Mistry
Vice Chairman & CEO

Mr Keki Mistry has been associated with HDFC for over three decades now. He joined HDFC in 1981, was appointed Managing Director in 2000 and re-designated as Vice Chairman & CEO in 2010. He is a Fellow of The Institute of Chartered Accountants of India.

Stock Info

CMP (INR) - 20 July 2012	684
Bloomberg	HDFC IN
Equity Shares (m)	1,477.0
52-Week Range	726/601
1,6,12 Rel.Perf.(%)	5/-4/5
MCap.(INRb)/(USDb)	1,015/18

Financial summary (INR b)

Y/E March	2012	2013E	2014E
Op. Inc.	57.5	69.6	83.5
Net Inc.	62.0	75.1	90.2
PAT	41.2	49.2	59.2
EPS (INR)	27.9	32.1	38.6
EPS Gr. %	15.8	15.1	20.2
AP/AE (x)	**19.3**	**16.2**	**12.5**
ABV (INR)	100.5	105.9	125.8
Adj P/ABV(x)	**5.0**	**4.5**	**3.6**
Core RoE %	27.3	29.4	30.9
RoA %	2.8	2.9	2.9

Q: After growing your asset base at a 23% CAGR over the past decade, what is the size of opportunity that HDFC is looking at over the next 5-10 years?

A: The housing finance industry in India has witnessed secular growth over the last few years, led by (1) strong economic growth, resulting in higher job creation and expansion of the salaried class population, and (2) lower mortgage penetration, which drove demand for housing finance. **Despite such high growth, the market remains highly underpenetrated and there is ample scope for growth, going forward.**

India's young population is sizable. The average age of the home buyer for HDFC was 38 years in FY12, down from 42-43 years a few years ago. The demographic shift - increasing share of a young working population - will help the secular growth trend for the housing finance industry to continue. A lot will also depend on what steps the government takes for job creation. **Mortgages is now a mature business and barring brief periods of slowdown in economic growth, 18-20% growth is achievable over the next 5-10 year period.**

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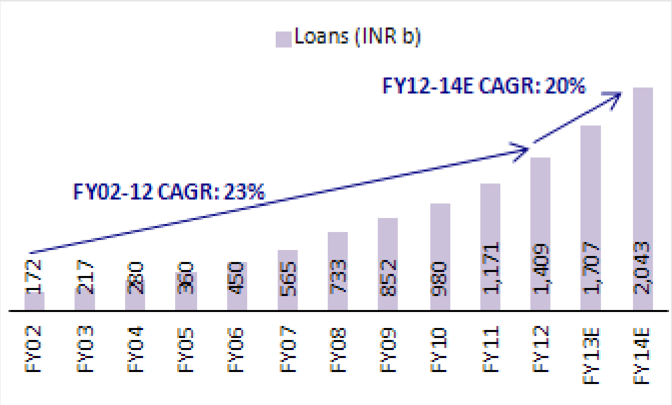
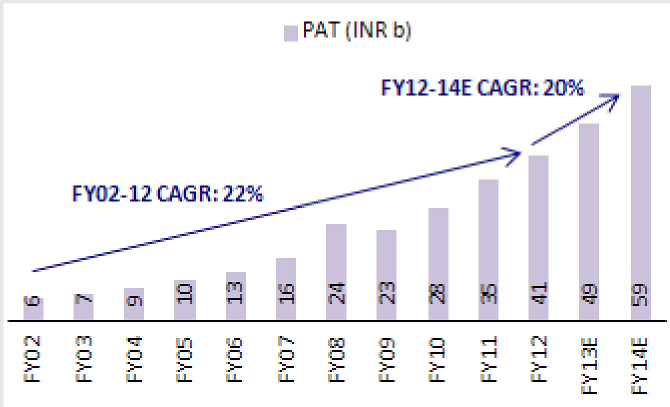
Expect healthy loan growth to continue



Profitability intact; profits have grown in line with asset growth



Source: Company/MOSL

> Currently, one has to focus on centers that are not growing, as most parts of the country are witnessing buoyant demand

Q: How do you see the housing finance market evolving over the next five years?

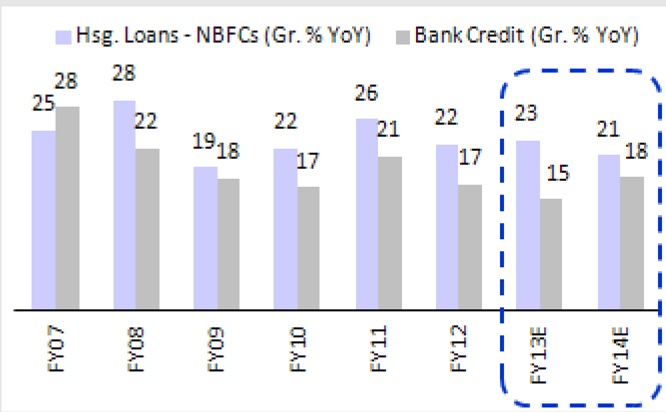
A: The housing finance market has been dynamic, and apart from macro factors like growth and interest rates, **a lot depends on the dynamics of different states.** Mortgage growth typically follows economic growth of that state. Currently, one has to focus on centers that are not growing, as most parts of the country are witnessing buoyant housing demand. For example, currently the NCR is the biggest growth contributor for HDFC, followed by Chennai, Mumbai, Pune and Bangalore. This is contrary to the trend a few years ago, when Mumbai and NCR were the major growth drivers. **Many new markets will evolve over the next few years and different centers will drive growth during different time periods**.

> We do not expect any disruptive activity by any market participant

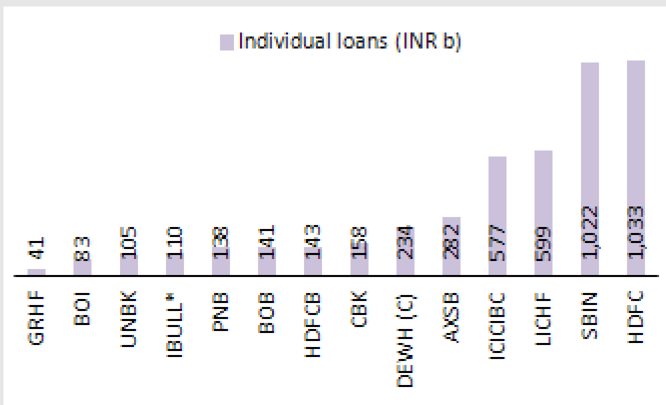
Q: Is sluggish growth in the corporate / infrastructure segments leading to intense competition in the housing finance segment?

A: Healthy growth momentum, stable profitability and relatively low risk nature of the business has attracted a number of players into the mortgage business. **We are not unduly worried about the current competitive landscape. HDFC has never tracked market share percentages, as they are misleading**. Some private sector banks are getting aggressive in this space, though public sector banks have not been too aggressive post 2008-09. However, we do not expect any disruptive activity by any market participant.

Expect growth in housing loans to outpace credit growth



HDFC and SBIN the largest mortgage players in India



Source: Company/MOSL

Q: What are your expectations from the government / regulator for the housing finance industry?

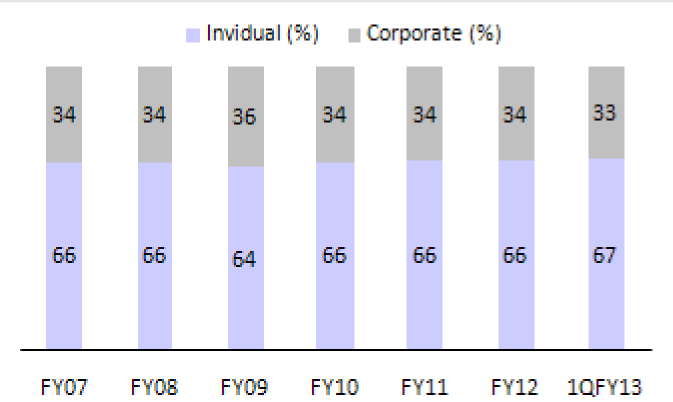
A: It is absolutely impossible to predict what the regulator can do. However, we do not foresee any major regulatory changes that can disrupt the industry. In fact, a few days ago, the chairman of **NHB has put to rest rumors about expected increase in capital requirements for housing finance companies, as proposed for banks and other asset financing NBFCs.**

As of June 2012, spreads on individual loans are 1.93% and corporate loans are at 2.81%

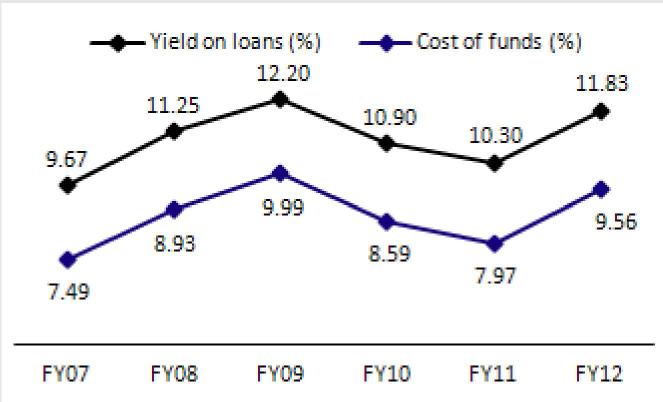
Q: Has there been any change in the profitability of your retail business, resulting in higher share of the corporate book in your profitability?

A: Spreads in retail loans are lower than in corporate business. However, risk weights and provisioning requirements are lower in retail loans (40bp) than in corporate business (100bp). Relatively lower RoA in retail loans is compensated by higher leverage. Thus, we have tried to maintain our internally targeted RoE in each of our businesses. Typically, people look at yields on a specific retail product along with the blended cost of funds. However, **the products that have lower yield are matched with a relatively lower cost liability. Hence, the spread on that particular product is largely similar to that on other retail products.** In the individual mortgage business, we have been able to maintain our spreads in our targeted range. As of June 2012, spreads were 1.93% for the on-balance-sheet individual portfolio and 2.81% for the corporate loan portfolio. Additionally, we also earn 1.53% spreads on the sold-down portfolio, which are not recognized while reporting blended spreads (2.27% as of 1QFY13).

AUM mix has remained stable for few years



Yields and costs have moved in tandem leading to stable spreads



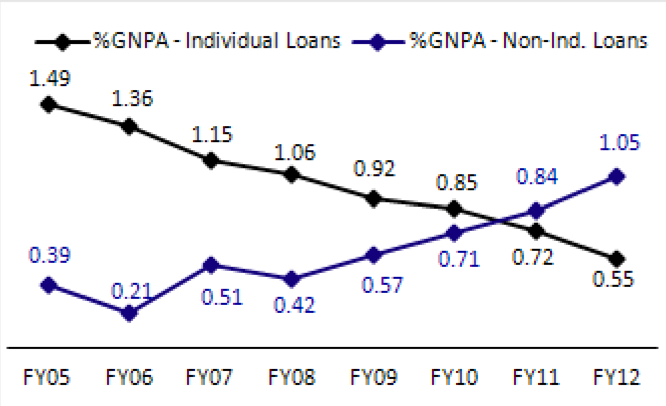
Source: Company/MOSL

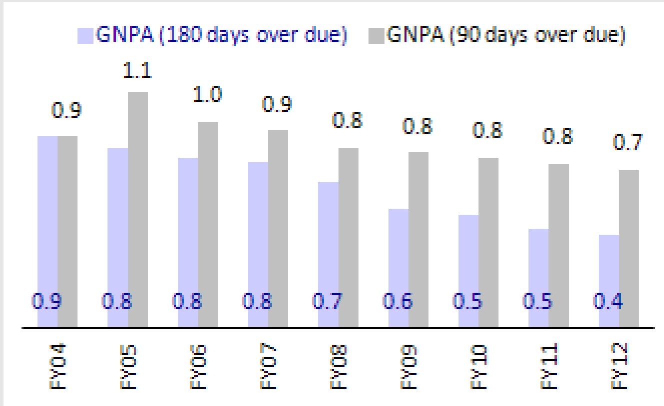
To mitigate the emerging risks, we first build processes and then build size

Q: How does HDFC manage risks, given the rapidly changing economic environment and its growing size?

A: HDFC has been proactive in managing its risks, which has resulted in robust asset quality for the company. **Managing risk is a dynamic thing - we need to keep on updating processes, as the risks (e.g. regulatory risks, currency risks, macro risks, etc) keep changing.** As risks change, the ability/perceived ability to manage risks also changes. To mitigate the emerging risks, we first build processes and then build size. Asset quality is a fundamental factor in determining processes and **HDFC's processes have always been asset quality oriented and not market share oriented.**

Despite steep increase in GNPAs in the corporate book, asset quality has improved considerably due to substantial improvement in quality of the individual loans portfolio





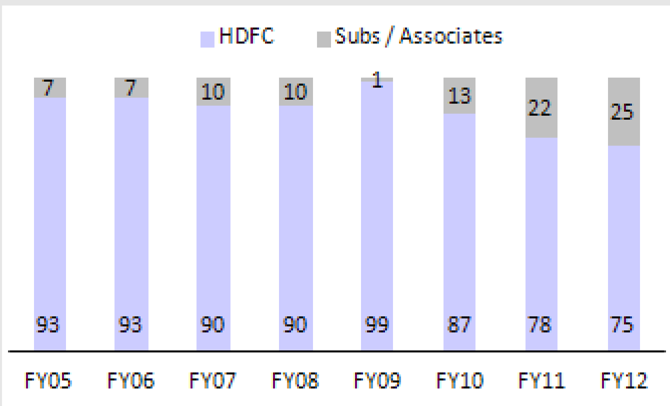
Source: Company/MOSL

Q: What is your view on unlocking value from other businesses?

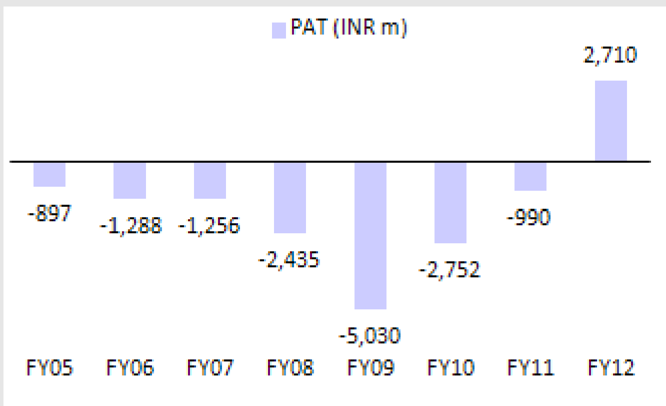
A: Over the years, HDFC has seeded many businesses, invested in them and nurtured them to grow into sizable and independent institutions. **Our ideology of building successful businesses has been of giving authority to the right people and not interfering in their decision-making.** Some of our associates have acquired companies and successfully integrated operations. Only in case of the general insurance business, significant help has been taken from the foreign partner for an understanding of the underwriting and risk associated with the business.

Going forward, the share of profits from subsidiaries should increase substantially. This is not only because HDFC Bank is growing at a strong pace. The life insurance business has turned profitable and recorded its maiden profit in FY12. The general insurance business too has been profitable, barring the motor pool losses, which affected the whole industry and not just HDFC Ergo. **Over the next 5-10 years, we should see release of capital from the businesses that we have set up and there should be need of capital infusion only in the event of acquisitions**.

Share of subsidiaries/associates in cons. PAT has increased (%)



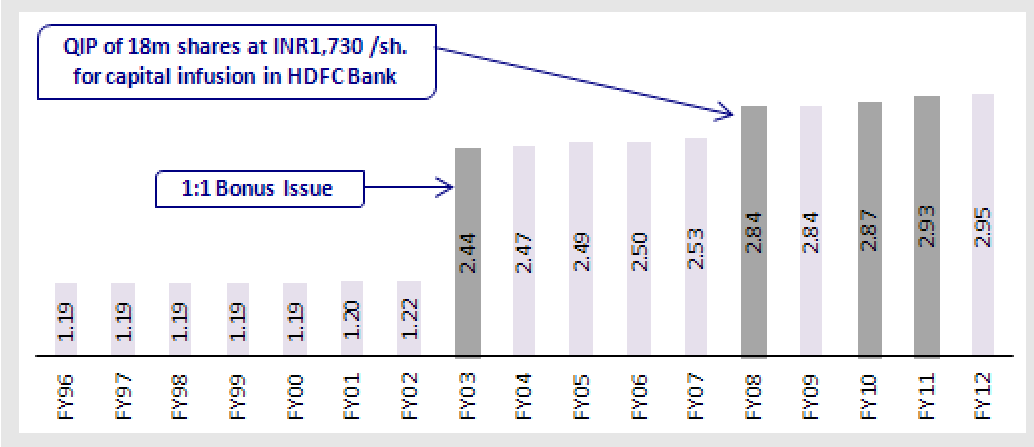
Life insurance business turned profitable in FY12



Source: Company/MOSL

HDFC has historically diluted equity for funding its subsidiaries/associate companies; going forward, the life insurance business can throw capital for funding capital needs of HDFC Bank

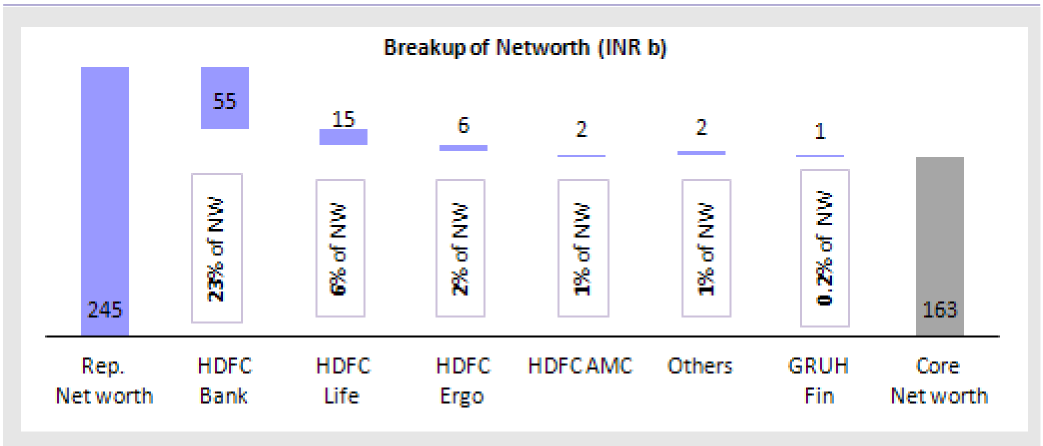
Outstanding equity share capital (INR b)



Source: Company/MOSL

A third of HDFC's net worth is invested into subsidiaries/associate companies

Break-up of FY13E net worth within subsidiaries/associate companies and core business

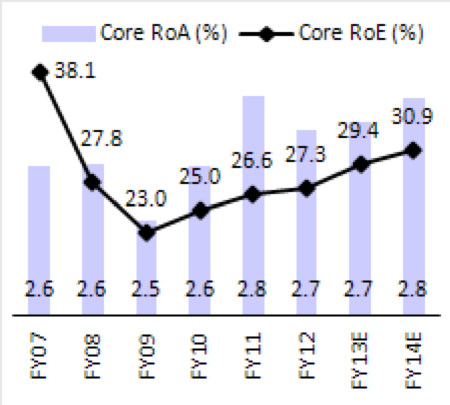


Source: Company/MOSL

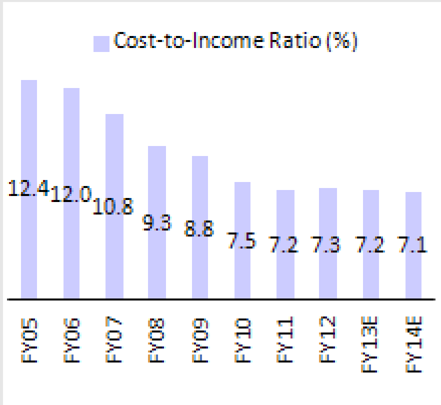
Q: What is your outlook on the four core operating parameters - RoE, cost-to-income, growth, spreads?

A: HDFC has always guided its investors on the four core operating parameters. In FY12, we clocked a consolidated RoE of ~24%. Our endeavour is to improve consolidated RoE by 100bp every year for the next three years. In FY13, RoE is unlikely to improve, due to warrant conversion. On the second operating parameter, **cost-to-income ratio is unlikely to improve this year, as (a) we have bought a new office building, which will take another six months to be ready for occupation, and (b) there have been changes in taxation provisions on certain services**, as a result of which we will get lesser CENVAT credit. Till the new office building is ready for occupation, we will have to bear the cost of two office buildings, which will keep the cost-to-income ratio higher. Growth should be in the region of 18-20%. **On the spreads front, as we have been guiding, we should be able to achieve 2.15-2.35%.**

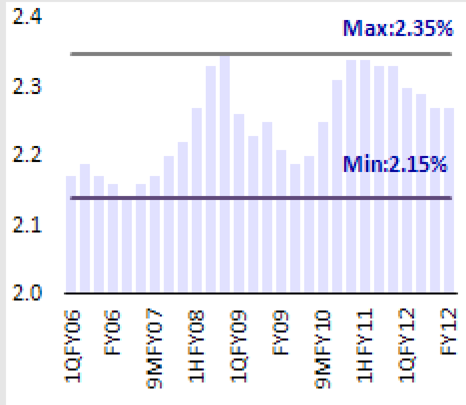
Core return ratios to remain strong



Cost-to-income ratio unlikely to fall substantially



Spreads have remained in a narrow band of 2.15-2.35%



Source: Company/MOSL

We do not account for interest on ZCBs through P&L as we do not account for income generated by subsidiaries

Q: What is your rationale behind accounting for interest payable on ZCBs through reserves?

A: As at June 2012, we had zero coupon bonds (ZCBs) worth INR80b outstanding on the balance sheet. We use these bonds to fund our subsidiaries and associates. Under Section 78 of Companies Act, premium on these bonds can be routed through reserves. **As we have been maintaining, under Indian GAAP, we cannot recognize income generated by subsidiaries. Thus, funding cost for these investments should also not be routed through P&L. We have adopted this method to give a true and fair picture of our business to our investors.** Even in case of consolidated numbers, under Indian GAAP, the treatment followed for standalone numbers has to be followed for consolidated numbers. However, at every point, we have given enough disclosures for the same.

Other highlights

- **HDFC has got an exemption (for maintaining stake above 10%) from NHB for its holding in Gruh Finance**. This is because HDFC has been holding the stake in Gruh Finance before the guidelines capping the equity holding at 10% came in.
- On migration to IFRS, HDFC will be eligible to recognize both income as well as expenses related to subsidiaries/associate companies. It will then account for profits from subsidiaries/associate companies and interest on ZCBs through P&L (currently routed through reserves).

Valuation and view: Leader in the best financing business in India; superior return ratios; Buy

- HDFC's execution to withstand competitive pressure without impacting core parameters and profit growth is commendable. Fall in interest rates will reduce cost of funds, resulting in a decline in pressure on spreads.
- Starting April 2012, dual rate home loans (~INR210b, ~16% of loan book) will come up for re-pricing on floating basis, which will help improve yields.
- We expect HDFC to report an EPS of INR32 in FY13 and INR39 in FY14. Core return ratios are likely to remain strong. Adjusted book value (ABV, adjusted for investments in subsidiaries) would be INR106/share in FY13 and INR126/share in FY14. We are not deducting the last equity investment into HDFC Bank (INR40b) from net worth, as it is funded by non-convertible debentures (NCDs) till FY12 and FY13 ABV accounts for conversion of warrants and last investment in HDFC Bank. Key investments, viz, HDFC Bank, HDFC Life, HDFC AMC, General Insurance, etc are valued at INR237/share (post holding discount of 20%) on FY14 basis.
- The stock trades at 3.6x FY14E BV (price adjusted for value of key ventures and book value adjusted for investment in those ventures) and 12.5x FY14E AP/AE. We believe HDFC's valuations are now attractive, considering the growth potential (FY12-14E earnings CAGR of ~20%), sound business fundamentals, and substantially improved subsidiaries' performance. We maintain **Buy** with an SOTP-based target price of INR800.

SOTP FY14E Based (INR)

	Value (INR b)	Value (USD b)	Value/ Sh. (INR)	% of total	Rationale
Core business	**867**	**15.6**	**566**	**70.5**	**4.5x FY14 Adjusted BV (for investments in subs and HDFC Bank, Implied P/E of 16x Core EPS)**
Key Ventures					
HDFC Bank	327	5.9	213	26.5	Valued at INR600/share 3.4x FY14E BV
HDFC Standard Life (72.5% stake)	73	1.3	47	5.9	15x FY14E NBAP; 15% APE CAGR in FY12- FY14E
HDFC AMC (60% stake)	31	0.6	20	2.5	4% FY14E AUM, 15x FY14E PAT
Property Funds	7	0.1	4	0.5	13.3% of total AUM USD1.1b
HDFC General Insurance (74% stake)	7	0.1	4	0.6	Last stake sale value + 20%
Gruh Finance	10	0.2	7	0.8	Valued at 3x FY14E BV
Total Value of Ventures	**454**	**8.2**	**297**	**36.9**	
Less: 20% holding discount	91	1.6	59	7.4	
Value of Key Ventures	363	6.6	237	29.5	
Target Value Post 20% Hold.Co Disc..	**1,248**	**22.5**	**803**	**100.0**	
CMP	1,015	18.3	684		
Upside - %	23	23	17		
Target value w/o 20% Hold. Co. Disc..	**1,339**	**24.1**	**874**		
CMP	1,015	18.3	684		
Upside - %	32	32	27		

Source: MOSL

Income statement

(INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
Interest Income	106,442	106,404	120,431	163,689	203,277	236,504
Interest Expended	74,324	70,631	75,599	111,568	139,426	159,267
Net Interest Income	**32,118**	**35,773**	**44,832**	**52,121**	**63,852**	**77,237**
Change (%)	16.7	11.4	25.3	16.3	22.5	21.0
Fees and Other Charges	1,149	2,317	2,204	2,684	3,419	4,034
Net Int. Income (incl fees)	33,267	38,090	47,035	54,805	67,270	81,271
Change (%)	18.1	14.5	23.5	16.5	22.7	20.8
Other Operating Income	2,356	4,662	5,894	6,957	7,606	8,627
Miscellanous Income	229	226	251	213	250	275
Net Income	**35,852**	**42,978**	**53,181**	**61,975**	**75,126**	**90,173**
Change (%)	17.4	19.9	23.7	16.5	21.2	20.0
Operating Expenses	3,162	3,238	3,812	4,519	5,504	6,647
Operating Income	**32,690**	**39,740**	**49,370**	**57,456**	**69,622**	**83,525**
Change (%)	18.0	21.6	24.2	16.4	21.2	20.0
Provisions/write offs	500	580	700	800	1,958	2,187
Reported PBT	**32,190**	**39,160**	**48,670**	**56,656**	**67,664**	**81,338**
Tax	9,365	10,895	13,320	15,430	18,438	22,165
Tax Rate (%)	29.1	27.8	27.4	27.2	27.3	27.3
Reported PAT	**22,825**	**28,265**	**35,350**	**41,226**	**49,225**	**59,173**
Change (%)	-6.3	23.8	25.1	16.6	19.4	20.2
PAT adjusted for EO	**22,825**	**28,265**	**35,350**	**41,226**	**49,225**	**59,173**
Change (%)	17.7	23.8	25.1	16.6	19.4	20.2

Balance sheet

(INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
Capital	2,844	2,871	2,934	2,954	3,063	3,063
Reserves & Surplus	128,529	149,106	170,231	187,222	240,945	271,410
Net Worth	**131,374**	**151,977**	**173,165**	**190,176**	**244,008**	**274,473**
Borrowings	**838,561**	**965,653**	**1,151,123**	**1,391,275**	**1,623,338**	**1,935,708**
Change (%)	21.3	15.2	19.2	20.9	16.7	19.2
Total Liabilities	**969,935**	**1,117,630**	**1,324,288**	**1,581,451**	**1,867,346**	**2,210,181**
Housing Loans	**851,981**	**979,670**	**1,171,266**	**1,408,746**	**1,726,955**	**2,081,406**
Change (%)	16.2	15.0	19.6	20.3	22.6	20.5
Investments	104,687	107,275	118,324	122,070	128,174	134,582
Change (%)	51.4	2.5	10.3	3.2	5.0	5.0
Total Assets	**969,935**	**1,117,630**	**1,324,288**	**1,581,451**	**1,867,346**	**2,210,181**

E: MOSL Estimates

Ratios

Y/E March	2009	2010	2011	2012	2013E	2014E
Spreads Analysis (%)						
Avg Yield on Housing Loans	12.5	10.9	10.5	11.8	12.1	11.6
Avg. Yield on Earning Assets	12.1	10.2	9.8	11.1	11.6	11.4
Avg. Cost-Int. Bear. Liab.	9.7	7.8	7.1	8.8	9.3	9.0
Interest Spread	2.4	2.4	2.6	2.3	2.4	2.5
Net Interest Margin	3.7	3.4	3.6	3.5	3.6	3.7
Profitability Ratios (%)						
RoE	18.2	20.0	21.7	22.7	22.7	22.8
Adjusted RoE	23.0	25.0	26.6	27.3	29.4	30.9
RoA	2.6	2.7	2.9	2.8	2.9	2.9
Adjusted RoA	2.5	2.6	2.8	2.7	2.7	2.8
Efficiency Ratios (%)						
Int. Expended/Int.Earned	69.8	66.4	62.8	68.2	68.6	67.3
Other Inc./Net Income	10.4	16.8	15.7	15.9	15.0	14.3
Op. Exps./Net Income	8.8	7.5	7.2	7.3	7.3	7.4
Empl. Cost/Op. Exps.	43.8	45.3	46.1	45.5	44.9	44.6
Valuation						
Book Value (INR)	92.4	105.9	118.1	128.8	159.3	179.2
Price-BV (x)				**5.3**	**4.3**	**3.8**
Adjusted BV* (INR)	68.7	80.3	91.2	100.5	105.9	125.8
Adj Price-ABV (x)				**5.0**	**4.5**	**3.6**
EPS (INR)	16.0	19.7	24.1	27.9	32.1	38.6
EPS Growth (%)	17.5	22.7	22.4	15.8	15.1	20.2
Adj Price-Earnings (x)				**18.0**	**15.0**	**11.6**
Adjusted EPS (INR)#	15.2	18.6	22.6	26.0	29.8	35.7
Adjusted EPS Growth (%)	16.9	22.1	21.8	15.1	14.4	20.0
Adj Price-Adj EPS (x)				**19.3**	**16.2**	**12.5**
Dividend per share (INR)	6.0	7.2	9.0	11.0	12.2	14.7
Dividend yield (%)				**1.6**	**1.8**	**2.1**

E: MOSL Estimates; * BV is adj. by deducting investments in key ventures from NW
Adjusted EPS is adjusting for dividend from key ventures

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