HDFC: Comments dated 15-06-2012 on Research Report of Macquaire dated 14-06-2012

The main basis of the report to downgrade HDFC is by cutting its Price to book ratio of standalone operations from 4 to 2 on account of various factors. I disagree with the above for the following reasons:

1. The report states that there has been a steady rise in the corporate loan book i.e. loan given to real estate developers and hence Price to book of 4 cannot be assigned. However since last 3 years from FY 2010 there is no rise in the allocation to corporate loan book and it is steady at around 36 – 37 %. Keki Mistry has himself stated in various forums that the management would like to maintain a balance of 2/3rd Retail Loans and 1/3rd Corporate Loans. I feel this is very comfortable considering there have been no bad debts for the past 20 years in Corporate loans given. HDFC has a stringent appraisal system for corporate loans and which has withstood over 20 years. Hence this is a very naïve excuse for cutting the price to book from 4 to 2.

2. LIC Housing has been reporting a higher spread on corporate loans given by them as its lending policies are more liberal than HDFC and hence the yield on such loans will be higher as they are perceived to be more risky.

3. The analyst has wrongly calculated the expense ratio at around 30 % of the spread as the cost to net income ratio is around 8 %. For FY 2012 as per the Annual Report, the net interest income is around Rs. 5,906 crores (17,062 – 11,156 Interest earned – Interest expended). The other expenses are only around 531 crores. Hence the cost income ratio comes to only 8 % of the spread. Refer page 4 of the report where the analyst claims that out of spread of 1.35 % for retail loans, operating expenses is 0.35% and that out of spread of 4 % for corporate loans, operating expenses is 0.30%. This clearly shows that the table on Page 4 does not reflect the actual facts.

4. The analyst has mentioned the ROE has come down from 27 % to 20 %. However the annual report mentions the ROE as 22 %. Keki Mistry has stated the company is comfortable in maintaining ROE between 20 % to 22 %. I feel that this a very healthy ROE for a financial company and along with the growth in demand for housing loans at around 20 % the PAT and EPS of the company can continue to grow at a CAGR of 20 % p.a. for the foreseeable future.

5. As regards routing of the provisions viz. the regulatory norms through the Reserves, I would like to mention the following points:

    A. The management has stated time and again that this provisioning was a one time affair which was necessitated as per new Regulatory Norms and HDFC had additional provision in the earlier years which was in excess of what was required at that time and hence it was routed through the reserves. The Annual Report for FY 2011-12 also states the same fact that an amount of Rs. 349.93 crores has been utilized from the Additional Reserve under Section 29C of the National Housing Bank Act, 1987. This provisioning covers the existing "back book" and incremental provisions will be debited to the P & L Account. The routing provision through the Additional Reserve is transitory in nature and is not going to be an annual affair.

B. LIC Housing Finance had to make additional provisions and route it through the P & L Account because it had not provided anything in addition to the regulatory provisions in the earlier years. Hence there is no Additional reserve in place. Hence when these new provisions were introduced by the regulatory authority it had to rote it through P & L unlike HDFC.

6. As regards to the Zero Coupon Bonds I would like to mention the following points:

   A. The amount raised via the Zero Coupon Bonds is for investments in subsidiaries and associate companies primarily HDFC Bank and HDFC Life. HDFC only recognizes dividend income received from the subsidiaries and associate companies in its standalone accounts. The share of profit of HDFC in its subsidiaries and associate companies is not allowed to be recognized as per Indian Accounting Standards. Hence the interest on zero coupon bonds should not be debited to the P & L Account if the income from the funds raised via the Zero Coupon Bonds is not recognized on the credit side of the P & L Account. If interest cost is debited to the P & L Account, it will go against the Matching Concept of Indian Accounting Standard.

   B. This is not a new point found out by the analyst. I have to state that the management have stated many times in several interviews with the media and various analysts about the same. All Analysts are aware of the facts that have been highlighted by the management several times. I am enclosing an Edelweiss Report dating back to January 2012 wherein the accounting treatment is clearly mentioned.

   C. Even Macquarie was aware of the fact as can been seen from their report dated 23-06-2011 attached herewith.

   D. The Annual Report for FY 2011-12 also discloses the Zero Coupon Bonds Issue on Page No.: 66 Para 3.5 wherein interest cost are mentioned as being charged to the Reserves. Hence adequate disclosures have been made to the shareholders.

Conclusion:

1. What intrigues me is the timing of release of this report. Vested interests are at play at a time when Warrants are due for conversion on or before 23rd August 2012.

2. From the errors seen in the report it is clearly understood that it is prepared in haste and seniors at Macquarie have not vetted this report which clearly shows staff was instructed to prepare this report. The analysts have not even tried to reach out to the management for clarifications or referred to their earlier reports.

3. The report is based on biased presumptions & assumptions. I am not happy with the manner in which the Report is made out. My advice to investors is not to rely on this report.

4. The audited accounts of HDFC present a true & fair opinion on the Companies Accounts. There is no violation of any Law of the Land according to me.

5. The management of HDFC is transparent and from the various research reports it can be clearly seen that they have been adequately disclosing various facts and figures from time to time. This report clearly negates the legacy of the management of HDFC which has a blemish free record.

Analyst Disclosure :

I hold shares of HDFC Ltd.

About the Analyst :

I, Mr. Rajesh Desai am a practicing Chartered Accountant and doing equity research as a hobby.