

17 October 2011

**HDFC***Stable lending business; we maintain a Buy*Rating: **Buy**

Target Price: ₹835

Share Price: ₹673

Led by higher net interest income (NII) and stable cost-to-income, HDFC's 2QFY12 profit rose 20.2% yoy. We favour HDFC as we expect its RoE over FY12-14 to hold above 20%, supported by business growth opportunities, the improving credit cycle and subsidiaries' robust operating performance.

- **Robust disbursements and loan growth; spreads improve.** With loan growth of 19.5% yoy (24% yoy on adjusting for "sell-down" in loans), loan disbursements grew 19% yoy. Robust loan growth, coupled with stable spreads of 2.29%, led to 17.5% yoy NII growth. We expect a 19.8% CAGR in loans over FY11-14.
- **Healthy fees and robust treasury profits.** Fees grew 15.9% yoy (37.7% qoq); its share in non-interest income has inched up from 26.2% in 1HFY11 to 26.7% in 1HFY12. Treasury profits grew 47.4% yoy and comprised 6.5% of profits before tax, compared to 5.2% in 2QFY11.
- **Stable asset quality, incremental provisions from reserves.** Asset quality is the best in class, with gross NPAs at 0.82% of loans. In 2QFY12, ₹2.55bn was utilized from reserves to meet the additional provision, set by the National Housing Board, for standard assets. We expect HDFC's prudent growth and high NPA provision buffer to keep credit costs low over FY11-14.
- **Introducing FY14 estimates.** We introduce FY14 estimates and expect a 19.8% CAGR in HDFC's loan book over FY11-FY14, and a 17.8% CAGR in net profit over the same period.
- **Valuation and Risk.** Our sum-of-parts valuation price target is ₹835. We value the mortgage business at ₹563 (3.7x FY13e BV) & subsidiaries at ₹271. Risk: Significant slowdown in the mortgage market, leading to slower-than-estimated loan growth.

Key data	HDFC IN / HDFC .BO
52-week high / low	₹764 / ₹582
Sensex / Nifty	17025/5118
3-m average volume	US\$35.8m
Market cap	₹991bn/US\$20.25bn
Shares outstanding	1472m

Shareholding pattern (%)	Sep-11	Jun-11	Mar-11
Promoters	23.2	23.3	23.4
- of which Pledge	-	-	-
Free float	76.8	76.7	76.6
- Foreign Institutions	29.3	29.2	28.5
- Domestic Institutions	11.0	11.1	11.6
- Public	36.5	36.4	36.5

Financials year-end: Mar	FY12e	FY13e
Net interest income (₹m)	55,677	67,938
Net profit (₹m)	41,068	49,349
EPS (₹)	27.8	33.2
Growth (%)	17.4	19.6
PE (x)	24.2	20.3
PABV (x)	5.2	4.6
RoE (%)	22.2	21.8
RoA (%)	2.8	2.6
Dividend yield (%)	1.5	1.8
Net NPA (%)	0.5	0.5

Source: Anand Rathi Research

Quarterly results (YE Mar)	2QFY11	2QFY12	% yoy	1HFY11	1HFY12	% yoy
Net interest income (₹m)	1,189	1,387	16.6	3,344	3,958	18.4
Non-interest income (₹m)	64	92	44.6	73	134	82.7
Operating expenses (₹m)	104	124	19.0	306	350	14.6
Cost-Income (%)	8.3	8.4	7bps	8.9	8.6	(39)bps
Pre-provisioning profit (₹m)	1,149	1,355	17.9	3,112	3,742	20.2
Provisions (₹m)	15	17	13.3	45	53	17.8
PBT (₹m)	1,134	1,338	18.0	3,067	3,689	20.3
Tax (₹m)	326	367	12.6	870	1,029	18.3
PAT (₹m)	808	971	20.2	2,197	2,660	21.1
EPS (₹)	5.5	6.5	19.0	10.2	12.1	18.6

Source: Company, Anand Rathi Research

Anand Rathi Share and Stock Brokers Limited does and seeks to do business with companies covered in its research reports. Thus, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Disclosures and analyst certifications are located in Appendix 1

## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	36,014	44,876	55,677	67,938	80,241
NII growth (%)	11.6	24.6	24.1	22.0	18.1
Non-interest inc	6,963	8,305	6,540	6,819	7,556
Total income	42,978	53,181	62,217	74,757	87,797
Total income growth (%)	19.9	23.7	17.0	20.2	17.4
Op. expenses	3,238	3,812	4,355	5,382	6,497
Operating profit	39,740	49,370	57,862	69,374	81,300
Operating profit growth (%)	21.5	24.2	17.2	19.9	17.2
Provisions	580	700	823	833	1,003
PBT	39,160	48,670	57,038	68,541	80,298
Tax	10,895	13,320	15,971	19,191	22,483
PAT	28,265	35,350	41,068	49,349	57,814
PAT growth (%)	23.8	25.1	16.2	20.2	17.2
FDEPS (₹/share)	19.7	24.1	27.8	33.2	38.7
DPS (₹/share)	7.2	9.0	10.0	12.0	14.0

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	2,871	2,934	2,956	2,971	2,985
Reserves & surplus	149,106	170,231	193,901	222,303	255,558
Bonds & Debentures	354,973	445,706	536,423	636,343	762,775
Term Loans	379,869	462,148	536,423	636,343	772,555
Deposits	230,811	246,251	302,598	358,963	420,504
Total Liabilities	1,117,630	1,327,270	1,572,300	1,856,923	2,214,378
Advances	979,670	1,171,266	1,403,514	1,682,112	2,016,324
Investments	107,275	118,324	136,169	143,585	168,202
Cash & Bank Bal	25,607	30,859	25,357	22,624	19,482
Fixed & Other Assets	5,078	6,821	7,260	8,602	10,370
Total Assets	1,117,630	1,327,270	1,572,300	1,856,923	2,214,378
No. of shares (m)	1,436	1,467	1,478	1,485	1,493
Deposits growth (%)	n/a	n/a	n/a	n/a	n/a
Advances growth (%)	15.0	19.6	19.8	19.9	19.9

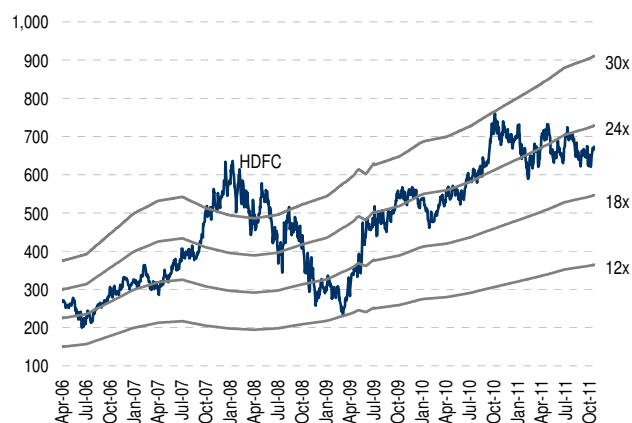
Source: Company, Anand Rathi Research

**Fig 3 – Key Ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	3.4	3.6	3.8	4.0	3.9
Other inc / Total inc (%)	16.2	15.6	10.5	9.1	8.6
Cost-Income (%)	7.5	7.2	7.0	7.2	7.4
Provision coverage (%)	36.6	37.3	36.0	36.1	36.1
Dividend Payout (%)	6.4	6.7	7.0	7.2	7.6
Credit-Deposit (%)	424.4	475.6	463.8	468.6	479.5
Investment-Deposit (%)	46.5	48.1	45.0	40.0	40.0
Gross NPA (%)	0.8	0.8	0.8	0.7	0.5
Net NPA (%)	0.5	0.5	0.5	0.5	0.2
BV (₹)	105.9	118.1	133.2	151.7	173.2
Adj BV (₹)	102.7	114.4	128.7	146.4	169.9
CAR (%)	14.6	14.0	13.6	13.0	12.3
- Tier 1 (%)	12.8	12.2	12.2	11.8	11.3
RoE (%)	20.0	21.7	22.2	23.4	23.9
RoA (%)	2.7	2.9	2.8	2.9	2.8

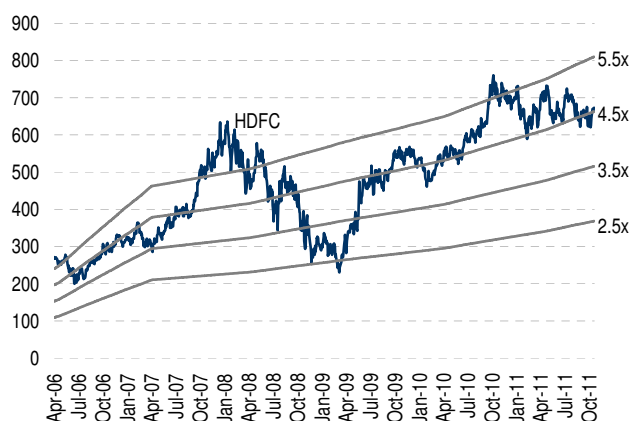
Source: Company, Anand Rathi Research

**Fig 4 – PE band**



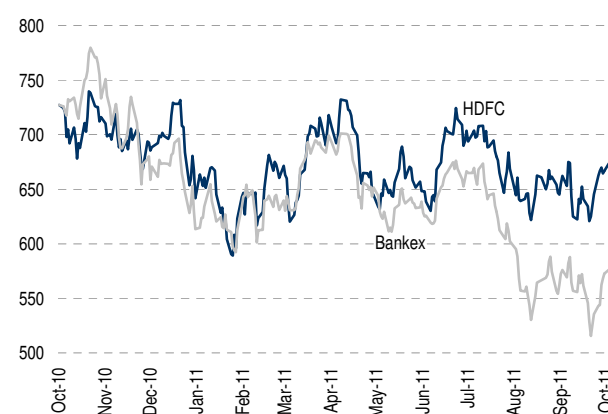
Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-Book band**



Source: Bloomberg, Anand Rathi Research

**Fig 6 – HDFC vs BANKEX**



Source: Bloomberg

## Results review

Led by higher net interest income (NII) and stable cost-to-income, HDFC's 2QFY12 profit rose 20.2% yoy. We favour HDFC as we expect its RoE over FY12-14 to hold above 20%, supported by business growth opportunities, the improving credit cycle and the subsidiaries' robust operating performance.

### Steady approvals and disbursements

In 2QFY12, disbursements grew 19% yoy, to ₹33.8bn; approvals rose 18%, to ₹43.3bn. Cumulative disbursements and approvals in 1HFY12 also grew steadily yoy, up 17.5% and 17.8%, respectively. Loans to corporate bodies comprised 35.5% of loans and grew 23.6% yoy, faster than retail housing loans (17.6% yoy). The continuing growth in approvals augurs well for the outlook on housing loan growth. We expect a 19.8% CAGR in HDFC's loan book over FY11-14.

In the past 12 months, HDFC "sold down" ₹49.9bn of loans. Adjusting for these, its loan book grew 24% yoy. Ahead, we expect these loans to be lower as systemic credit growth revives.

**Fig 7 – Loan-book mix (₹m)**

	2QFY11	2QFY12	Growth %	
			YoY	QoQ
Individuals	682,630	802,680	17.6	3.1
Corporate bodies	365,230	451,440	23.6	0.7
Others	15,010	15,800	5.3	8.3
<b>Total advances</b>	<b>1,062,870</b>	<b>1,269,920</b>	<b>19.5</b>	<b>2.3</b>

Source: Company

**Fig 8 – Loan-book composition (%)**

	2QFY11	2QFY12
Individuals	64.2	63.2
Corporate bodies	34.4	35.5
Others	1.4	1.2

Source: Company

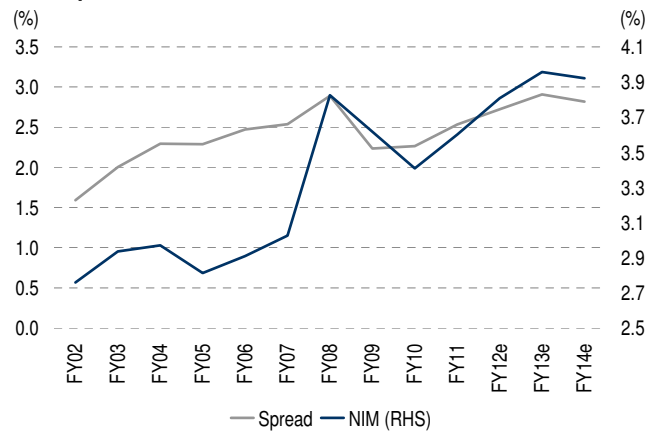
### NIM to gradually improve

HDFC's net interest margin, unlike that of most NBFCs, is less sensitive to changes in overall liquidity and in the interest-rate environment because of its diverse funding mix. We expect the high proportion of floating-rate loans and diversified funding base to help protect its spreads, even in a rising interest-rate scenario. We do not expect any funding hurdles for HDFC with its established credit lines, priority sector status and AAA rating for its bond issues.

HDFC's spreads expand when interest rates rise, as its assets usually re-price faster than its liabilities. Floating-rate loans are matched by floating-rate liabilities, and HDFC's lending rates are benchmarked to their PLRs, which reflect the cost of funds. Shorter-term borrowings such as commercial paper are used to finance shorter-term corporate loans. Within lending to individuals, ~85% of disbursements are variable-rate; all non-individual (ie, corporate and developer) loans are variable-rate, re-set each time the PLR is altered.

We expect this strategy to help improve margins in an increasing interest-rate scenario – the NIM is likely to improve from 3.6% in FY11 to 4% two years on. So far, HDFC has effectively managed to contain its overall cost of borrowings within 10% through various rising interest-rate periods, and has maintained its spreads within a range of 2.2% to 3%.

**Fig 9 – HDFC's spreads and NIM**



Source: Company, Anand Rathi Research

### Operating costs held in check

HDFC's operating costs were kept in check; its cost-income declined from 8.9% in 1HFY11 to 8.6% in 1HFY12. This is the best in class, comparable with banks and rival HFCs and has been difficult for any bank or bank subsidiary to replicate so far. We expect this cost-income to be sustainable, given our estimate of mortgage growth in the medium term.

Its home-loan arrangement with HDFC Bank is also likely to help keep costs low. The bank has 2,111 branches and over 18m customers. These can be leveraged for more business growth for HDFC, without the need for significant investment in expansion.

### Asset quality stable

HDFC's asset quality improved, with NPAs (beyond 90 days) at 0.82% in 2QFY12 (against 0.86% in 2QFY11). Cumulative provisioning increased by ₹3.52bn qoq to ₹15.25bn, and is still much higher than the regulatory requirement of ₹11.96bn. In 2QFY12, ₹2.55bn was utilized from HDFC's reserves to meet the additional provision, set by the National Housing Board, for standard assets. We expect HDFC's conservative growth and high NPA provision buffer to hold credit costs low over FY11-14. Given its prudent growth and expertise in judging the credit-worthiness of the eventual borrower, we expect HDFC's gross NPAs to be <1% till FY13, with its NPA coverage sustained at +70%.

## Valuation

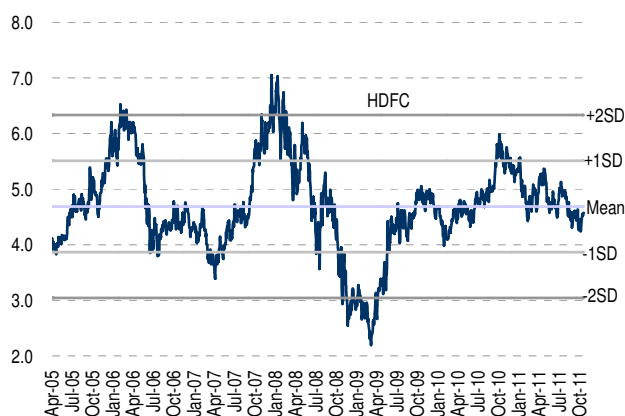
Our sum-of-parts valuation price target stands at ₹835. We value the subsidiaries at ₹271. At our target price, HDFC would trade at 3.4x FY12e and 2.9x FY13e BV (consolidated).

**Fig 10 – HDFC subsidiaries: Valuation**

	Stake	Value for	Per share	Valuation
	%	HDFC	value	method
		₹ m	₹	
HDFC Bank	23.2	342,659	232.8	4.3x FY13e BV
HDFC AMC	60.0	29,034	19.7	5% of equity AUM, 1.5% of debt AUM and 8% of PMS AUM
HDFC Life Insurance	72.4	83,162	56.5	12x FY12E NBAP (18% NBAP margin)
HDFC Real Estate Fund	100.0	6,210	4.2	12% of AUM (\$1bn)
Gruh Finance	60.5	9,088	6.2	3.1x FY13eBV
<b>Total value of subsidiaries</b>		<b>470,153</b>	<b>319.4</b>	
Less: Holding company discount (20%)			79.8	
<b>Net value of subsidiaries</b>			<b>271.4</b>	
Value of the mortgage business			563.5	3.7 FY13eBV
<b>Total</b>			<b>834.9</b>	

Source: Anand Rathi Research

**Fig 11 – Past one-year-forward PBV**



Source: Bloomberg, Anand Rathi Research

### Risks to our valuation

- Significant slowdown in the mortgage market, leading to loan growth being lower than we expect.
- Inability to pass on higher funding costs to customers; hence, lower-than-anticipated interest-rate spreads.
- Unexpected increases in credit costs, deviating from HDFC's past asset-quality standards, would trim our earnings estimates.
- Further slowdown in insurance and the asset management sectors would impact our subsidiary valuations and target price.

## Financials

We introduce FY14 estimates and expect a 19.8% CAGR in HDFC's loan book over FY11-FY14, with a 17.8% CAGR in net profit over the same period.

**Fig 12 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Interest income	106,645	120,476	157,236	194,894	240,602
Interest expended	70,631	75,599	101,559	126,956	160,361
<b>Net interest income</b>	<b>36,014</b>	<b>44,876</b>	<b>55,677</b>	<b>67,938</b>	<b>80,241</b>
Growth (%)	11.6	24.6	24.1	22.0	18.1
Non-interest income	6,963	8,305	6,540	6,819	7,556
<b>Total income</b>	<b>42,978</b>	<b>53,181</b>	<b>62,217</b>	<b>74,757</b>	<b>87,797</b>
Non-interest income / total income (%)	16.2	15.6	10.5	9.1	8.6
<b>Operating expenses</b>	<b>3,238</b>	<b>3,812</b>	<b>4,355</b>	<b>5,382</b>	<b>6,497</b>
Employee expenses	1,467	1,755	1,960	2,422	2,924
Other expenses	1,771	2,056	2,395	2,960	3,573
<b>Pre-provisioning profit</b>	<b>39,740</b>	<b>49,370</b>	<b>57,862</b>	<b>69,374</b>	<b>81,300</b>
Growth (%)	21.5	24.2	17.2	19.9	17.2
Provisions	580	700	823	833	1,003
<b>Profit before tax</b>	<b>39,160</b>	<b>48,670</b>	<b>57,038</b>	<b>68,541</b>	<b>80,298</b>
Taxes	10,895	13,320	15,971	19,191	22,483
Tax rate (%)	27.8	27.4	28.0	28.0	28.0
<b>Profit after tax</b>	<b>28,265</b>	<b>35,350</b>	<b>41,068</b>	<b>49,349</b>	<b>57,814</b>
Growth (%)	23.8	25.1	16.2	20.2	17.2
Number of shares	1,436	1,467	1,478	1,485	1,493
Earnings per share	19.7	24.1	27.8	33.2	38.7

Source: Company, Anand Rathi Research

**Fig 13 – Balance sheet (₹ m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	2,871	2,934	2,956	2,971	2,985
Reserves and surpluses	149,106	170,231	193,901	222,303	255,558
<b>Net worth</b>	<b>151,977</b>	<b>173,165</b>	<b>196,856</b>	<b>225,274</b>	<b>258,543</b>
Borrowings	734,842	907,854	1,072,846	1,272,686	1,535,330
Deposits	230,811	246,251	302,598	358,963	420,504
<b>Total loans</b>	<b>965,653</b>	<b>1,154,105</b>	<b>1,375,444</b>	<b>1,631,649</b>	<b>1,955,834</b>
<b>Total liabilities</b>	<b>1,117,630</b>	<b>1,327,270</b>	<b>1,572,300</b>	<b>1,856,923</b>	<b>2,214,378</b>
Advances	979,670	1,171,266	1,403,514	1,682,112	2,016,324
Investments	107,275	118,324	136,169	143,585	168,202
Current assets	22,150	34,558	34,870	39,933	64,893
Cash & bank balances	52,241	64,053	31,422	37,259	44,582
Net current assets	25,607	30,859	25,357	22,624	19,482
Fixed & other assets	5,078	6,821	7,260	8,602	10,370
<b>Total assets</b>	<b>1,117,630</b>	<b>1,327,270</b>	<b>1,572,300</b>	<b>1,856,923</b>	<b>2,214,378</b>

Source: Company, Anand Rathi Research

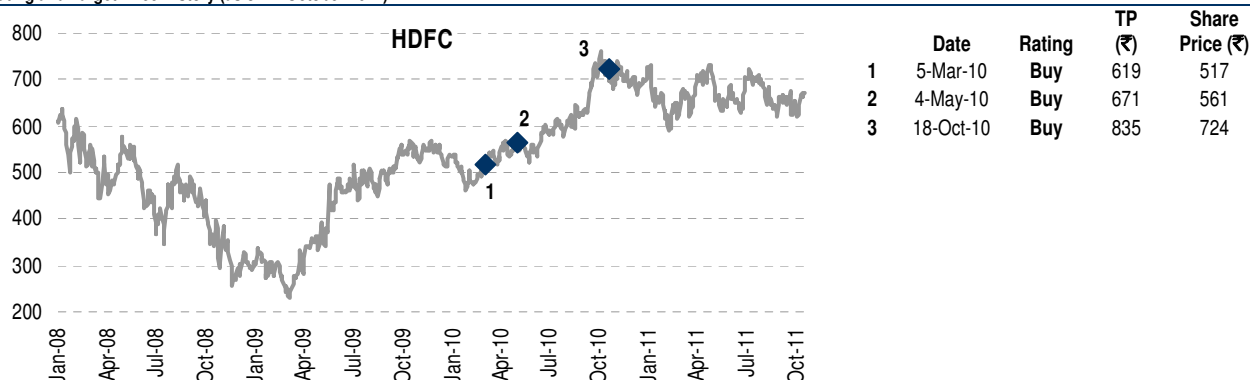
## Appendix 1

### Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

### Important Disclosures on subject companies

#### Rating and Target Price History (as of 17 October 2011)



The research analysts, strategists, or research associates principally responsible for the preparation of Anand Rathi Research have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.

### Anand Rathi Ratings Definitions

Analysts' ratings and the corresponding expected returns take into account our definitions of Large Caps (>US\$1bn) and Mid/Small Caps (<US\$1bn) as described in the Ratings Table below.

#### Ratings Guide

	Buy	Hold	Sell
Large Caps (>US\$1bn)	>20%	5-20%	<5%
Mid/Small Caps (<US\$1bn)	>30%	10-30%	<10%

#### Anand Rathi Research Ratings Distribution (as of 11 March 2011)

	Buy	Hold	Sell
Anand Rathi Research stock coverage (158)	73%	15%	12%
% who are investment banking clients	5%	4%	0%

### Other Disclosures

This report has been issued by Anand Rathi Share & Stock Brokers Limited (ARSSBL), which is regulated by SEBI.

The information herein was obtained from various sources; we do not guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities or any options, futures or other derivatives related to such securities ("related investments"). ARFSL and its affiliates may trade for their own accounts as market maker / jobber and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders. ARSSBL, its affiliates, directors, officers, and employees may have a long or short position in any securities of this issuer(s) or in related investments. ARSSBL or its affiliates may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any entity mentioned in this report. This research report is prepared for private circulation. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Past performance is not necessarily a guide to future performance. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report.

This document is intended only for professional investors as defined under the relevant laws of Hong Kong and is not intended for the public in Hong Kong. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. No action has been taken in Hong Kong to permit the distribution of this document. This document is distributed on a confidential basis. This document may not be reproduced in any form or transmitted to any person other than the person to whom it is addressed.

If this report is made available in Hong Kong by, or on behalf of, Anand Rathi Financial Services (HK) Limited., it is attributable to Anand Rathi Financial Services (HK) Limited., Unit 1211, Bank of America Tower, 12 Harcourt Road, Central, Hong Kong. Anand Rathi Financial Services (HK) Limited. is regulated by the Hong Kong Securities and Futures Commission.

Anand Rathi Financial Services Limited and Anand Rathi Share & Stock Brokers Limited are members of The Stock Exchange, Mumbai, and the National Stock Exchange of India.

© 2011 Anand Rathi Share & Stock Brokers Limited. All rights reserved. This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of Anand Rathi Financial Services Limited.

Additional information on recommended securities/instruments is available on request.