April 17, 2012

Housing Development Finance Corporation Limited
"Bluest of blue chip"

Nirmal Bang Research (Division of Nirmal Bang Securities Pvt. Ltd.)
B-2, 301/302, 3rd Floor, Marathon Innova, Off Ganpatrao Kadam Marg,
Lower parel (W), Mumbai - 400 013.
Tel - 3027 2300/01/02 (Fax) 3027 2303
Website : www.nirmalbang.com

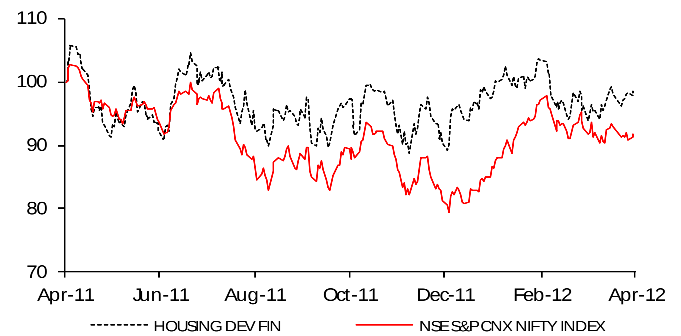
Initiating Coverage — HDFC Warrants

Present Price	Rs.84
Rating	Outperformer
Upside	20-25%
Sector	Finance

Stock Details

BSE Code	961682
Bloomberg Code	HDFC IN
Market Cap (Rs. cr)	100442
Free Float (%)	100
52- wk HI/Lo (Rs)	155/60
Avg. Volume BSE (Monthly)	100240
Face Value (Rs)	10.0
Dividend (FY 11)	N.A
Shares o/s (Crs)	N.A

Relative Performance	1Mth	6Mth	1Yr
HDFC(%)	2.3	1.2	(3.5)
NIFTY(%)	(1.1)	2.8	(9.7)



Shareholding Pattern as of 31 March 2012	
Promoters Holding	0%
Institutional (Incl. FII)	86.1%
Corporate Bodies	2.9%
Public & others	10.9%

Vishal Jajoo - Sr. Research Analyst
(+91 22 3926-8136)
Email id: vishal.jajoo@nirmalbang.com

Snapshot

Housing Development Finance Corporation Ltd. (HDFC) is India's premier housing finance company. The corporation's main business is to provide loans for the purchase or construction of residential houses. The distribution network of the company spans across 289 outlets, which include 71 offices of the wholly owned distribution company, HDFC Sales Private Limited.

Investment Rationale

- Bluest of blue chip share: The company's earnings have grown at a CAGR of +20% even in the toughest of economic environments. The same has been reflected in the stock price which has generated positive returns compared to other blue chip stocks generating negative returns since January 2008, (when the Sensex was at its peak levels).

- Delta impact much higher in quasi instruments like warrants compared to shares: The delta impact in case of quasi instruments is much higher compared to the movement in the share prices, thereby, generating a higher ROI for an investor.

- Risk-reward ratio much favourable: Even if the warrant price fails to generate higher returns, the same can be converted into equity shares by paying an amount of Rs.600 per share (acquisition cost: Rs.684). We expect the share price of HDFC Limted to quote at Rs.840 over the next 12 months.

- Excellent asset quality: HDFC Limited has an excellent asset quality backed by more than 30 years of experience of the Indian real estate market. The company has managed to reduce the NPAs continuously over the last several quarters.

- Lowest cost/income ratio: HDFC Limited has the lowest cost/income ratio at 8%. The same is attributable to the fact that the Balance Sheet size of more than Rs.1.3 lakh crore is managed by less than 1700 employees!

- SOTP value: HDFC Limited with its stake in HDFC Bank, HDFC Ergo, HDFC Standard, other investments has a much higher value than what is reflected in the present price.

Recommendation

We recommend a buy on warrants of HDFC Limited with an expected return of 20-25% in the short to medium term.

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INVESTMENT RATIONALE

Bluest of blue chip; *must have* in the portfolio

It is more than 50 months but the Sensex is yet to breach the levels of +21000 levels that it had touched in January, 2008.

We are comparing the share price performance of a couple of large heavy weights in the SENSEX along with HDFC Limited. The share price performance has clearly outperformed not only the benchmark indices but also the peers in the SENSEX. We expect this trend to continue going forward also for the stock.

One of the bluest of blue chip stocks to have outperformed the benchmark indices

Scrip	Price in January 2008	Price on April 17, 2012	% Change
Sensex	21000 plus	17200	-20%
RIL	3200 (ex-bonus price of 1600)	745	-53%
L&T	4200 (2100 at present)	1300	-38%
HDFC Ltd.	**3175(634, post-split)**	**680**	**+7%**

(Source: Capitaline)

'Improving scenario' going forward

Housing Development Finance Corporation(HDFC)'s financial performance during Q3FY'12 was marginally muted on account of lower Net Interest Income growth at 15 per cent y-o-y. However, the asset quality continues to be robust.

We believe that the company's financial performance should improve from here, on account of:

1. Expected fall in interest rates in the economy, leading to improvement in spreads
2. Stability in real estate prices
3. Improvement in the *affordability factor*

1. Interest rates in the economy are expected to soften by atleast 75-100 basis points during the present calendar year. Moreover, with a portion of the company's dual-rate customers getting shifted to floating rates, the spreads are expected to improve going forward. The Banking major, SBI's shift in policy with subdued focus on the *dual rate* home loans augurs well for the company.

2. The stability in real estate prices should augur well for the company. Though prices in certain metro areas like NCR and Mumbai have crossed the highs of 2008 level, resulting into subdued demand, the focus of the company in Tier-II, Tier-III cities has paid-off well.

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Therefore, inspite of poor property registration figures from the metro cities, the company has been able to grow it's asset book by 18-20 per cent on a y-o-y basis. The average ticket size of a client of HDFC is around Rs.18 lakhs. Considering a LTV (loan-to-value) ratio of around 65 per cent, the value of the property comes to Rs.28 lakhs.

Inspite of the fact that the land prices and key inputs in the cost of construction rising significantly over the past several years, the focus of the builders to concentrate on:

1. Flat system in Tier-II and Tier-III cities compared to the traditional row houses and bunglow schemes &
2. Affordable housing schemes in metros focusing on integrated township structure and reduced carpet area

have led to a significant reduction in the affordability factor leading to a demand for housing units

3. Improvement in the *affordability* factor. Affordability factor is calculated as the average price of a house divided by the total annual income of an individual. This figure is much better at present between 4-5 as compared to 7-8x levels, a few years ago. At this level, a home loan borrower's EMI (Equated Monthly Installment) works out to 50% of his salary, providing significant cushion.

   The stability in prices coupled with better earnings potential and the confidence with regard to continuity in earnings in the foreseeable future leads to significant improvement in the risk-taking ability of an individual.

   According to Hewitt, the average annual increment in salary across corporate is expected to be around 12%. With gradual improvement in jobs prospects, as reflected by leading job indicators and fears of job cuts receding, compared to the scenario during Q3FY'12 quarter, we expect things to improve for HDFC going forward.

An old-timer, has witnessed various interest-rate cycles

Incorporated in the year 1977, HDFC has witnessed various interest-rate cycles in the economy. The key task in an NBFC is of recovery, post-disbursal unlike any other manufacturing industry. The company has had witnessed various business cycles and has maintained a strong asset quality. The NPAs of the company have reduced significantly over the last few quarters.

Against the stipulated requirement by the National Housing Bank, HDFC has a much higher provision. This provision figure should improve further with the reversal of *dual rate home loans*.

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Excellent asset quality

The company has an excellent understanding of the residential real estate in the country which has led to the company maintaining an excellent asset quality.

Inspite of various recessionary trends in the economy, the company's asset quality has remained unscathed. This is attributable to various factors:

1. Excellent understanding of the real estate market – The company's experience in the real estate market has helped it to tide over the ups and downs in the real estate segment.

2. Disciplined and prudent approach in loan disbursements – HDFC follows strict procedures and norms while disbursing loans to individuals as well as real estate developers.

   More than 2/3rd of the loan book consists of individual loan borrowers. Majority of the company's home loan borrowers are FTUs (First Time Users) and intend to buy a property for personal use rather than investment purpose. This reduces the speculative element in the real estate transaction. Secondly, the property is kept as mortgage with the company against the home loan and the LTV ratio is capped at a maximum of 80% of the value. However, considering the fact that a significant portion of the real estate deals involve *unaccounted cash*, the actual realizable value of the property is quite high, thereby reducing the LTV ratio to 60-65%, providing significant cushion to the company.

   In case of loans to real estate developers, the acquisition of land is not financed by the company but the constructed structure (along with the land) is mortgaged with the company. The company is very much prudent in approving a project and verifies the data and transactions over the last several years.

   In certain cases, HDFC is working with the second or third generation of real estate developers.

3. Stringent financial and technical feasibility before disbursing the loan - In case of an application by a home loan borrower, the company conducts in-depth verifications before taking a call with regard to the disbursement. These include checks with regard to the company verification/office location of the borrower to salary slips and bank account statements.

   The lower of the below mentioned amount qualifies for a loan application:

   1. 80% of the market value of the property/registration value of the property, whichever is lower
   2. 4x gross total income of the home loan borrower

These processes enable the company to keep a strict tab on the asset quality.

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One of the lowest Cost/Income Ratio

The company has one of the lowest Cost/Income Ratio in Asia. The Balance Sheet size of more than Rs.1.3 lakh crore is managed by a team of less than 1700 employees, translating into a cost/income ratio of ~8%. We expect this ratio to reduce by 100 bps, going forward.

This is attributable to various reasons including the fact that:

1. The company invested heavily in technology right from the beginning and therefore, spent less on human resources
2. The word HDFC is synonymous with housing finance. A significant portion of the company's customers are walk-in customers due to the strong brand built by the company over a period of time
3. HDFC's associate company, HDFC Bank (19% stake), generates a significant portion of business for the company with an understanding to keep a portion of the same in its books to meet the Priority Sector Lending (PSL) targets.

Impact of recent announcements by regulatory authority; manageable

The recent announcement by the regulatory authority with regard to excess provisioning and removing the concept of pre-payment penalty did not have any significant impact on the performance of the company. We expect the same trend to continue going forward also.

The company has excess provision in its books. With regard to the waiver of pre-payment penalty, the company has not witnessed any significant increase in clients migrating towards other borrowers considering the fact that the lengthy duration of the loan and therefore, over a period of time the difference in the interest rates charged by both the entities is not significant.

Mortgage to GDP ratio – one of the lowest in the country

The mortgage/GDP ratio is one of the lowest in the country at 8 per cent compared to other developing as well as developed economies. China has a ratio in excess of 30 per cent. Improving demographics, higher numbers of nuclear families and urbanization have not only led to an increase in the demand for housing units but also the corresponding borrowing levels. This scenario should augur well for HDFC Limited.

Tax benefits to promoted housing loan

The tax benefit accruing to an individual home loan buyer augurs very well for the sector as well as the company. The individual tax payer not only gets a deduction of upto Rs.1 lakh u/s 80C of the Income Tax Act, 1961 towards repayment of the principal component but also a claim upto Rs.1.5 lakh towards payment of interest every year.

This reduces the cost of funding significantly for the borrower.

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Focused player in the business

HDFC is the largest player in the mortgage finance business. The other large players in the business are LIC Housing Finance, State Bank of India to name a few.

In case of SBI, the Bank was more aggressive till last year. However, during the present financial year the housing loan book has reduced significantly. SBI has sanctioned Rs.12500 crore of mortgages, a decline of 24% y-o-y compared to Rs.16370 crore in FY'11, attributable to withdrawal of the special home loan product.

Warrants - Delta impact much higher than equity shares

The delta impact in case of quasi-instruments like warrants is very high.

- During December 2011, a warrant of HDFC Limited was quoting at Rs.60 each when the share price of the company was quoting at Rs.600. During the bounce in the markets, the share price touched a high of Rs.700(return of 16%), while the warrant prices almost doubled to Rs.110 levels.

  The delta impact in case of warrants is much higher and the risk-reward ratio is very much favourable considering the fact that the conversion price of the warrant is Rs.600 and the due date for conversion is August 2012(lot size: 1850). In case, the warrants do not appreciate significantly till the date of conversion, if one gets them converted into equity by paying the difference of Rs.600 per share, the cost of equity share of HDFC Limited comes to Rs.684.

  We are bullish on the business model of HDFC Limited and expect the share price to touch Rs.840 over the next 12 months. However, considering the opportunity through the warrants route, there exists significant scope with much lower risk by acquiring warrants of the company compared to the equity shares.

Company Background

Housing Development Finance Corporation Ltd is India's premier housing finance company. The Corporation's main business is to provide loans for the purchase or construction of residential houses. Their distribution network spans 289 outlets, which include 71 offices of the wholly owned distribution company, HDFC Sales Pvt Ltd. In addition, they cover over 2,400 locations through outreach programmes..

The company's subsidiaries include HDFC Developers Ltd, HDFC Investments Ltd, HDFC Holdings Ltd, HDFC Trustee Company Ltd, HDFC Realty Ltd, HDFC Property Ventures Ltd, HDFC Sales Pvt Ltd, HDFC Ventures Trustee Company Ltd, HDFC Venture Capital Ltd, HDFC Ergo General Insurance Company Ltd, HDFC Standard Life Insurance Company Ltd, GRUH Finance Ltd, HDFC Asset Management Company Ltd and HDFC Bank Ltd.

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Housing Development Finance Corporation Ltd was incorporated in the year 1977. The Corporation is established with the primary objective of meeting a social need that of promoting home ownership by providing long-term finance to households for their housing needs. The company was promoted with an initial share capital of Rs 100 million

Risks & Concerns

Any significant negative impact on account of announcement by the regulator

Any significant negative announcement by the regulator should act against the company and may impact the performance in the short term.

Aggressive steps, if any, taken to garner market share by other players in the banking industry

Any significant steps taken to garner market share by the players in the banking industry will impact the business in the short-term. However, considering the leadership status and the various interest rate cycles which the company has witnessed in the past, we are confident that the company should do very well going forward.

RECOMMENDATION

We recommend a buy on the warrants of HDFC Limited with an expected upside potential of 20-25% in the short to medium term. The risk-reward ratio is much favourable in case of warrants of HDFC Limited.

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Note

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