

CREDIT RATING REPORT

Gruh Finance Limited

June 2010



INSTRUMENTS RATED					RATINGS
Rs.8 Billion Commercial Paper Programme (Enhanced from Rs.5 Billion)					P1+
Non-Convertible Debentures Aggregating Rs.1.5 Billion					AA/Stable (Withdrawn)
Fixed Deposit Programme					FAA+/ Stable (Reaffirmed)
RATING HISTORY					Analytical Contacts at CRISIL:
Date	Long-Term	Fixed Deposit	Short-Term	Rating Watch/Outlook	Pawan Agrawal Tel: +91-22-3342 3301 Email: pagrawal@crisil.com Rupali Shanker Tel: +91-22-3342 1952 Email: rshanker@crisil.com CRISIL Rating Desk: Tel: +91-22-3342 3047/ 3342 3064 Email: CRISILratingdesk@crisil.com
No rating change in the last three years					
<p>CRISIL has reaffirmed its ratings on Gruh Finance Ltd's (GRUH's) fixed deposit and commercial paper programmes at 'FAA+/Stable/P1', and has withdrawn its 'AA/Stable' rating on the company's non-convertible debentures, which have been fully redeemed.</p>					<p><i>Disclaimer:</i></p> <p>CRISIL has taken due care and caution in compilation of data for this rating rationale, based upon the information provided by the issuer and also upon information obtained from sources it considers reliable. However, CRISIL does not guarantee the accuracy, adequacy or completeness of any information. CRISIL especially states that it has no financial liability whatsoever to the subscribers / users / transmitters / distributors of the rating or the rationale. No part of this rationale may be published / reproduced in any form without CRISIL's prior written approval.</p> <p>A CRISIL rating reflects CRISIL's current opinion on the likelihood of timely payment of the obligations under the rated instrument and does not constitute an audit of the rated entity by CRISIL. A CRISIL rating is not a recommendation to buy, sell or hold the rated instrument; it does not comment on the market price or suitability for a particular investor. All CRISIL ratings are under surveillance. Ratings are revised as and when circumstances so warrant. CRISIL Ratings' rating criteria are generally available without charge to the public on the CRISIL public web site, www.crisil.com. For the latest rating information on any instrument of any company rated by CRISIL, please contact CRISIL RATING DESK at CRISILratingdesk@crisil.com, or at (+91 22) 3342 3000 - 09.</p>
Rating Drivers					
Strengths					
<ul style="list-style-type: none">Strong linkages with parent, Housing Development Finance Corporation Ltd (HDFC, rated 'AAA/FAAA/Stable/P1+' by CRISIL)Adequate asset qualityComfortable capitalisationHealthy earnings profile					
Weaknesses					
<ul style="list-style-type: none">Modest asset-liability management (ALM) profileLimited market share, and geographic concentration in revenue profile					
Rating sensitivity factors					
<ul style="list-style-type: none">Change in degree and type of support from HDFCChanges in CRISIL's view on HDFC's credit risk profileVolatility in earningsChanges in asset quality					

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Outlook: Stable

CRISIL believes that HDFC will retain its majority stake in GRUH and continue extending financial and management support to the company. GRUH is expected to maintain its comfortable capital adequacy and asset quality levels over the medium term. The outlook may be revised to 'Positive' in case of improvement in GRUH's market position or if there is a material increase in the degree of integration of the company's operations with HDFC. Conversely, the outlook may be revised to 'Negative' if there is a significant deterioration in GRUH's asset quality, or a substantial decline in its earnings profile.

Rationale

GRUH was promoted in 1986 as Gujarat Rural Housing Finance Corporation Ltd by HDFC and the Aga Khan Fund for Economic Development. As of March 31, 2010, HDFC held a stake of 61.36 per cent in GRUH, which amounts to a book value of Rs.540 million.

GRUH primarily extends housing loans in rural and semi-urban areas, which is a lower-income group market segment. This is distinct from, and complements, HDFC's target market segment. For 2009-10 (refers to financial year, April 1 to March 31), GRUH reported a net profit of Rs.690 million on a total income of Rs.3.09 billion, compared with a net profit of Rs.503 million on a total income of Rs.2.95 billion for 2008-09.

The rating is driven by GRUH's following strengths:

Strong linkages with parent, HDFC

HDFC holds a 61.36 per cent stake in GRUH. GRUH enjoys strong equity and management support, in the form of help in formulation of guidelines and policies, from HDFC. In the past, HDFC has also invested in GRUH's subordinated debt programme and funded its securitised portfolio.

HDFC's vice-chairman and chief executive officer, and managing director are GRUH's chairman and non-executive director, respectively; GRUH's managing director is a former HDFC employee. GRUH's operating policy, sanctioning norms, and loan schemes are also modelled on those of HDFC. Although GRUH is in the same industry as its parent, the company operates in a niche segment, and caters to the lower-income group in rural and semi-urban areas, which is distinct from HDFC's target segment; this rules out direct competition with the parent. GRUH is also involved in cross selling of HDFC products, such as insurance. At present, GRUH is a referral agent for HDFC Standard Life. However, the quantum of business generated through this channel remains small.

CRISIL believes that GRUH will continue to receive the required support from HDFC to achieve profitable growth.

Adequate asset quality

GRUH has adequate asset quality, underpinned by strong risk management systems and an efficient credit approval and recovery mechanism. As on March 31, 2010, the company's gross non-performing assets (NPAs) were low at 1.1 per cent of total assets, an improvement from 2.03 per cent as on September 30, 2009, on account of higher recoveries; however, there was a marginal increase from 0.9 per cent as on March 31, 2009. GRUH has extended complete cover for its NPAs, and therefore, had zero net NPAs as on March 31, 2010.

GRUH caters mainly to the low-risk individual segment; however, of late, the company has begun issuing builder-developer loans. In 2009-10, it made disbursements of Rs.0.8 billion to builders, against

total disbursements of Rs.7.8 billion for the year. The company has also progressively increased its exposure to the non-salaried individual segment. Despite the inherent weakness of this segment, GRUH has enjoyed good asset quality (gross NPAs in this segment stood at 0.5 per cent as on March 31, 2010, as compared with 0.3 per cent a year earlier). GRUH has maintained its asset quality across asset classes by strictly adhering to its conservative appraisal process, and by strengthening its monitoring and recovery processes. The average loan-to-cost ratio of the company stood at around 73 per cent for 2009-10, compared with 70 per cent for 2008-09. The company has set up a special team for follow-up and recovery of over-dues. In 2009-10, Rs.7.4 million was recovered from written-off accounts.

CRISIL believes that the asset quality performance of loans to non-salaried individual and builder segments needs to be monitored closely over the medium term, especially in light of the increased disbursements to this segment. The credit profile of customers in these segments is inherently weaker than that of salaried individuals; this could result in higher credit risks. However, given GRUH's strong risk management systems, high provisioning and stringent credit appraisal processes, CRISIL expects the delinquencies from these riskier segments to be low. The company's asset quality is, therefore, expected to remain adequate over the medium term.

Comfortable capitalisation

GRUH is comfortably capitalised. The company reported an overall capital adequacy, as a proportion of risk-weighted assets, of a healthy 16.6 per cent as on March 31, 2010 (16.2 per cent as on March 31, 2009). Its Tier I capital coverage for un-provided weak assets (two-year lagged NPA net of provisions) was high at 26 times as on March 31, 2010. Its gearing stood at 8.8 times on March 31, 2010. The company's capitalisation is supported by its adequate asset quality, healthy accruals to net worth, and flexibility to raise additional capital if required.

CRISIL believes that GRUH's Tier I capital is adequate, and that the company will maintain its capitalisation at comfortable levels and sustain a stable growth rate over the medium term.

Healthy earnings profile

GRUH has a healthy earnings profile, driven by its low cost of borrowings, efficient treasury management, and ability to pass on increasing interest rates to borrowers, which result in good interest spreads as compared with those of its peers. The company's earnings profile is marked by an adequate net profitability margin (NPM¹; 3 per cent for 2009-10, compared with 2.1 per cent for 2008-09 and 2.5 per cent in 2007-08) and return on average assets (2.7 per cent for 2009-10, compared with 2.2 per cent in 2008-09). Significant reduction in cost of borrowings during 2009-10 on account of raising higher short-term funds was the key contributor to improvement in GRUH's NPM. Moreover, the company's presence in far-flung rural markets, where competition is less, provides flexibility to generate above-average yields. The company has also increased its focus on non-salaried and builder loans, generating higher yields for the company. Floating rate loans account for 97 per cent of GRUH's existing portfolio, giving the company flexibility to pass on the increase in cost to its borrowers, and partially shielding the company's interest rate risks.

In an effort to reduce borrowing costs, GRUH often resorts to short-term borrowings, which, in an increasing interest rate scenario, can increase the company's borrowing costs and constrain the spreads. Lower-than-average fee income levels also constrain the company's earnings. Moreover, as the company seeks to expand its outreach to other states, operating expenditure is likely to inch upwards, muting GRUH's profitability in the near term.

¹ CRISIL uses NPM as its measure of core profitability. NPM is defined as (Yield on funds deployed) - (Borrowing costs) - (Operating expense ratio) + (Fee income levels).

CRISIL expects GRUH's NPM to marginally reduce from current levels as the company enhances its branch network, thus adding to its operating expenditure. However, given the company's ability to manage its interest spreads, CRISIL expects GRUH to maintain an adequate earnings profile over the medium term.

The above-mentioned rating strengths are partially offset by GRUH's following weaknesses:

Modest ALM profile

GRUH has favoured short-term borrowings, to take advantage of the lower interest rates and significant pricing differential that exists between short- and long-tenure loans; this has resulted in a higher ALM mismatch than other housing finance companies (HFCs). Short-term ALM mismatches are, however, an inherent characteristic of the housing finance business. Also, short-term borrowings are difficult to refinance during tight liquidity conditions.

However, the extent of ALM mismatches has reduced in 2009-10, driven by GRUH's increasing recourse to long-term finance. Long-term refinance from National Housing Bank (NHB) stood at Rs.9.69 billion as on March 31, 2010. Also, existing liquidity in the form of unutilised NHB limits, unutilised bank lines, and fixed deposits with banks stood at Rs.5.8 billion as on March 31, 2010. Besides, the company's longstanding relationships with bankers, and flexibility to take recourse to securitisation transactions with its parent, will help GRUH manage its current ALM mismatches. Although the cumulative mismatches in the zero to one-year bracket have consistently reduced in the past three years, the extent of mismatches remains a key monitorable over the medium term. CRISIL believes that GRUH's ALM profile is likely to remain modest over the medium term.

Limited market share and geographic concentration in revenue profile

GRUH has a marginal market share: as on March 31, 2010, its outstanding loan portfolio stood at Rs.24.5 billion, accounting for less than 1 per cent of the overall individual housing loan outstanding in the industry consisting of banks and HFCs. GRUH operates primarily in the rural and semi-urban areas of Gujarat and Maharashtra. The company's outstanding portfolio is concentrated in these two states (76 per cent of portfolio outstanding as on March 31, 2010), exposing it to a significant level of regional concentration in its revenue profile.

However, GRUH is improving its geographical diversity; in 2009-10, it made around 28 per cent of fresh disbursements (to individuals) outside Gujarat and Maharashtra. The company set up six offices, most of them in new states in 2009-10, and started operations in Chhattisgarh and Tamil Nadu. GRUH had a network of 95 retail offices as on March 31, 2010. It plans to set up 10 to 12 retail offices in 2010-11, primarily in Maharashtra and Madhya Pradesh. However, GRUH's high geographic concentration in its asset portfolio is expected to reduce only gradually over the medium term.

Industry Prospects

Housing-finance disbursements increased by 3 per cent year-on-year in 2007-08, a plunge from the average 34 per cent increase per annum in the preceding five years. For 2008-09, the increase was by 4 per cent. Although high property prices and increasing interest rates were the primary causes for the decline, with the slowdown in the economy, and the fear of the uncertain job market conditions in the sunrise sectors, financiers too became more cautious and tightened their underwriting norms. All these factors together had a negative impact on the psyche of prospective home buyers, who, in turn, began to defer their purchase decisions.

CRISIL estimates the growth in housing finance to remain subdued, at under 10 per cent, in 2009-10, given the continued downtrend in the credit cycle and the expected further slowdown in the economy. The growth rate is nonetheless expected to be better than in 2008-09, following the recent decline in interest rates, and expectations of a correction in property prices. Moreover, the coordinated efforts of the Government of India (GoI) and the Reserve Bank of India (RBI) have also helped revive the growth in the housing finance segment to some extent: measures such as the reduction in interest rates by the public sector banks for loans up to Rs.2 million, and the special refinance facility of the NHB, at a concession rate of 8 per cent, for HFCs, have been directed towards reducing the interest burden on borrowers. However, CRISIL believes that, given the uncertain economic environment, unless there is a sharp reduction in property prices, the sector may not see a significant revival. While property prices in metropolitan cities remain high, CRISIL believes that housing finance growth in metropolitan cities, over the medium term, will be higher than that in Tier-II and smaller cities because of higher incomes and continued demand for affordable housing.

The asset quality in the housing loan portfolios of banks and HFCs has been improved since 2007, gross NPAs of CRISIL's rated HFCs has declined to 0.9 per cent of their gross advances as on March 31, 2009, from around 1.3 per cent as on March 31, 2007. Over the past couple of years, however, HFCs have progressively increased their exposure to high-yield, high-risk builder segment. Although there has not been any significant delinquency in this portfolio, it continues to be susceptible to downturns in the economy.

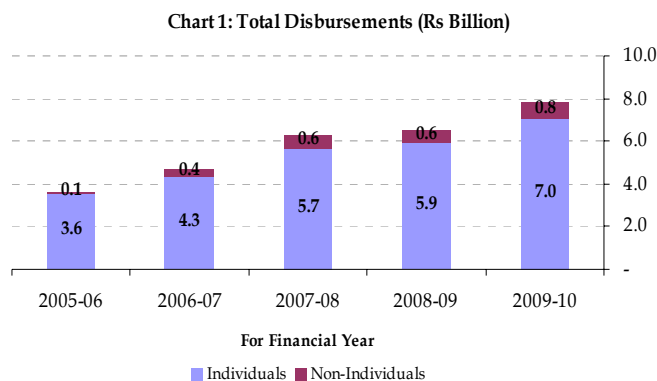
Core profitability, represented by the NPM, for CRISIL-rated HFCs declined in 2008-09 to 1.6 per cent from 2.1 per cent in 2007-08, primarily because of increase in funding costs, without a proportionate increase in yield on housing loans. CRISIL expects NPM of its rated HFCs in 2009-10 to remain stable at 2008-09 levels and improve marginally to 1.8 per cent in 2010-11 as banks withdraw their competitive interest rate schemes.

Asset liability management (ALM) remains a cause for concern for HFCs, as many of them continue to fund significant portions of their assets through short-term borrowings. Most HFCs, nevertheless, maintain large bank lines as a back-up to protect themselves from liquidity-related issues. However, mismatches between assets and liabilities will remain a key risk factor over the medium term.

Business Profile

Market position

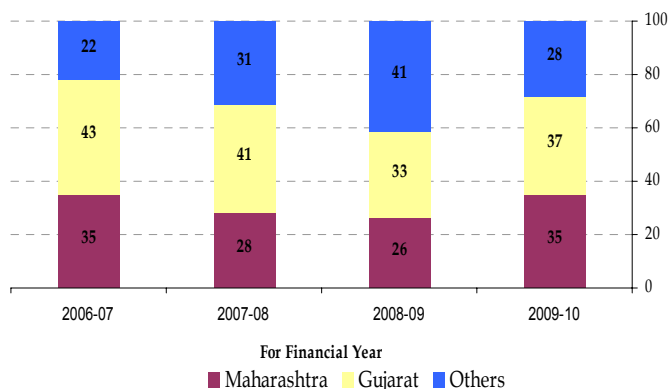
GRUH is a small HFC, with a market share of less than 1 per cent. In 2009-10, the company disbursed loans of Rs.7.80 billion through its 506 associates, and 95 retail offices, spread across seven states. GRUH's disbursements picked up in 2009-10 with a 19 per cent year-on-year growth compared with a 4 per cent growth in 2008-09 when disbursements were adversely affected by the economic slowdown. The disbursement growth, however, remained lower than the cumulative annual growth rate of 30 per cent witnessed between 2004 and 2008. Disbursements to non-salaried individuals increased to Rs.3.2 billion in 2009-10, from Rs.3 billion in 2008-09. Builder loan



disbursements also increased to Rs.0.79 billion in 2009-10 from Rs.0.63 billion in 2008-09 (see Chart 1). The company's outstanding loan book as on March 31, 2010, stood at Rs.24.54 billion, as compared with Rs. 20.86 billion a year earlier.

GRUH's operations are concentrated in the rural and semi-urban areas of Gujarat and Maharashtra. Nevertheless, the company has improved its geographical diversity; around 28 per cent of fresh disbursements (to individuals) in 2009-10 were outside Maharashtra and Gujarat, against 41 per cent in 2009-08 (see Chart 2). In 2009-10, the company set up six offices, most of them in new states, taking its network of retail offices to 95.

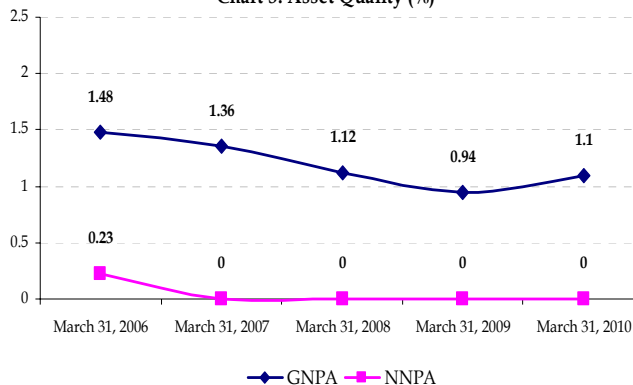
Chart 2: Improving Geographical concentration (%)



Asset quality

GRUH's gross NPAs increased marginally to 1.1 per cent as on March 31, 2010, from 0.9 per cent as on March 31, 2009, but improved from 2.03 per cent as on September 30, 2009. Two-year lagged NPAs, as a percentage of total advances, increased to 1.5 per cent in 2009-10 from 1.4 per cent in 2008-09 (1.8 per cent in 2007-08). To expedite recoveries, GRUH has set up a dedicated team for follow-up and recovery of over-dues. The average ticket size of GRUH's loans is less than Rs.0.5 million, and the average loan-to-cost ratio of the company stood at around 73 per cent for 2009-10, as compared with around 70 per cent for 2008-09 (see Chart 3).

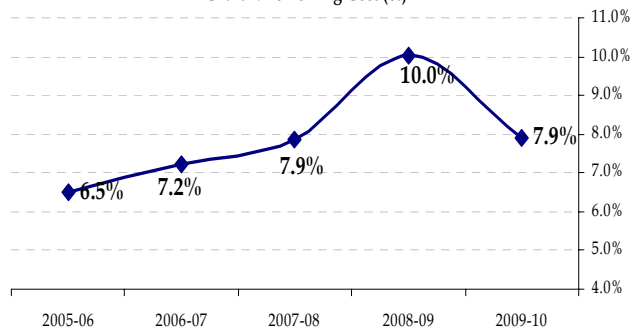
Chart 3: Asset Quality (%)



Resources

GRUH has an adequate resource profile. The company's average cost of borrowings reduced to 7.9 per cent in 2009-10 from 10 per cent in 2008-09, as the company repriced its high-cost borrowings and raised a higher proportion of low-cost short-term debt; (see Chart 4).

Chart 4: Borrowing Cost (%)



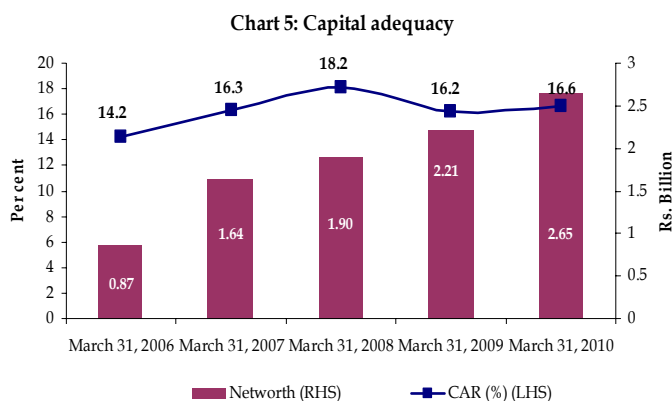
GRUH has a moderately diverse mix of retail and wholesale borrowings. The share of retail borrowings has increased

marginally to 12 per cent in 2009-10. The company enjoys relationships with over 25 banks and also has access to funding from mutual funds and insurance companies. It also has an option of securitisation with HDFC, which further supports its resource profile.

Financial Profile

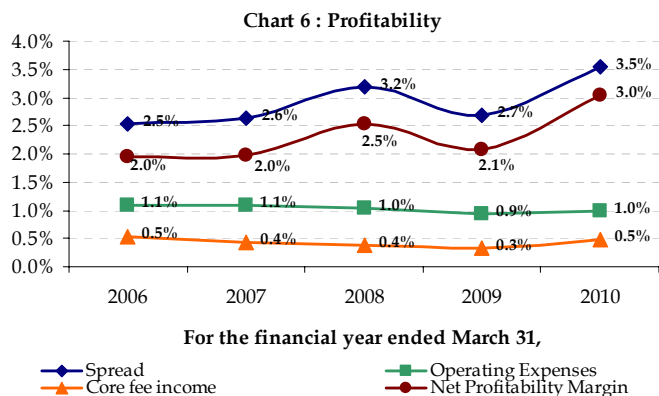
Capital adequacy

GRUH's overall capital adequacy, as a proportion of risk-weighted assets, stood at 16.6 per cent as on March 31, 2010, as compared with 16.2 per cent as on March 31, 2009. The company's Tier I capital adequacy coverage for un-provided weak assets, at 26 times as on March 31, 2010 (28 times as on March 31, 2009, and 15 times as on March 31, 2008), remains robust, and is backed by its healthy asset quality. GRUH's average return on net worth has remained healthy at 25.5 per cent over the past five years. Its gearing stood at 8.8 times as on March 31, 2010, and is comparable to that of its peers (see Chart 5).



Earnings

For the year ended March 31, 2010, GRUH reported a healthy NPM of 3 per cent (see Chart 6). The company has successfully maintained adequate spreads despite reduction in yields by lowering its cost of borrowing. In 2009-10, the return on average assets was 2.7 per cent (2.2 per cent for 2008-09), and return on average net worth was 28.4 per cent (24.5 per cent). GRUH's core fee income has traditionally been low; it was less than 0.5 per cent of total funds deployed in 2009-10. Its operating expenses declined to around 1 per cent of average funds deployed in 2009-10, from 1.03 per cent in 2007-08.



NPM computation (in percentage)	2009-10	2008-09	2007-08
Yield on Average funds deployed	11.44	12.67	11.05
Borrowing Cost	7.89	10.00	7.87
Interest Spread	3.55	2.67	3.18
Operating Expenses/ Average funds deployed	0.99	0.93	1.03
Core fee income/ Average funds deployed	0.48	0.33	0.38
Net Profitability Margin	3.03	2.08	2.53

Liquidity and ALM

GRUH's high reliance on short-term borrowings has resulted in a relatively higher ALM mismatch, as against that of other HFCs. The company contracted short-term debt to take advantage of the significant pricing differential between short- and long-tenure loans. GRUH has consistently run mismatches in the shorter-term buckets; as on December 31, 2009, the cumulative mismatch as a percentage of cumulative outflows was 1 per cent in the zero- to one-month bucket, 24 per cent in the one- to two-month bucket, 7 per cent in the two- to three-month bucket, and 11 per cent in the three- to six-month bucket.

GRUH's short-term borrowings as at December 31, 2009, stood at 28 per cent of its loan assets limit, against the 50 per cent stipulated by its asset and liability committee. GRUH had liquidity in the form of unutilised NHB limits, unutilised bank lines, and fixed deposits with banks of Rs.5.8 billion as on March 31, 2010, which adequately covered the cumulative negative mismatches in the up to one-year maturity bucket. Furthermore, strong parentage and the option of securitisation with HDFC enhance GRUH's financial flexibility.

Past Financial Performance

Year Ended March 31		2010	2009	2008
Equity Capital	Rs. Billion	0.4	0.4	0.4
Net worth (reported)	Rs. Billion	2.7	2.2	1.9
Loans outstanding	Rs. Billion	24.5	20.9	17.7
Investments	Rs. Billion	0.3	0.1	0.2
Total Funds Deployed	Rs. Billion	26.3	24.9	19.9
Total Income	Rs. Billion	3.1	3.0	2.0
Reported PAT	Rs. Billion	0.7	0.5	0.4
Yield on Avg. Funds deployed	%	11.4	12.7	11.1
Interest / Avg. borrowings	%	7.9	10.0	7.9
Overheads / Avg. Funds dep.	%	1.0	0.9	1.0
PAT/Avg. Funds deployed	%	2.7	2.3	2.5
PAT/Avg. Adjusted Net worth	%	28.4	24.5	23.9
Total Debt/Reported Net worth	%	8.8	10.2	9.3

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