

CREDIT RATING REPORT

Gruh Finance Limited



March 2009

INSTRUMENTS RATED					RATINGS
Non-Convertible Debentures Aggregating Rs.1.5 Billion					AA/Stable (Reaffirmed)
Fixed Deposit Programme					FAA+/ Stable (Reaffirmed)
Rs.5 Billion Commercial Paper Programme					P1+ (Reaffirmed)
RATING HISTORY					Analytical Contacts at CRISIL: Pawan Agrawal Tel: +91-22-6691 3301 Email: pagrawal@crisil.com Suman Chowdhury Tel: +91-22-6691 3293 E-mail: schowdhury@crisil.com CRISIL Rating Desk: Tel: +91-22-6691 3047/6691 3064 Email: CRISILratingdesk@crisil.com
Date	Long-Term	Fixed Deposit	Short-Term	Rating Watch/Outlook	
No rating changes in the last three years					

Rating Drivers

Strengths

- Strong linkages with parent, Housing Development Finance Corporation Ltd (HDFC, rated 'AAA/FAAA/Stable/P1+' by CRISIL)
- Healthy asset quality
- Comfortable capitalisation levels
- Adequate earnings profile

Weaknesses

- Stressed asset-liability management (ALM) profile
- Limited market share, coupled with geographic concentration

Rating sensitivity factors

- Extent of support from HDFC
- Changes in CRISIL's view on HDFC's credit risk profile
- Volatility in earnings
- Asset quality

Outlook: Stable

CRISIL believes that HDFC will retain its majority stake in Gruh Finance Ltd (Gruh Finance) and will continue extending financial and management support to the company. Gruh Finance 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 Finance'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 Finance's asset quality or a substantial decline in its earnings profile.

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Rationale

Established in 1986 as Gujarat Rural Housing Corporation Ltd, Gruh Finance was promoted by HDFC and the Aga Khan Fund for Economic Development, with the objective of providing an institutional structure to rural housing. HDFC has a stake of 61.85 per cent in Gruh Finance, which amounts to a book value of Rs.607¹ million as on March 31, 2008.

Gruh Finance primarily extends housing loans to individuals 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.

The rating is driven by Gruh Finance's:

Strong linkages with parent, HDFC

HDFC had a 61.85 per cent stake in Gruh Finance as on March 31, 2008. Gruh Finance 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 Finance's subordinated debt programme and funded its securitised portfolio.

HDFC's Managing Director and Vice Chairman is Gruh Finance's Chairman and HDFC's Executive Director is Gruh Finance's Non-Executive Director. Gruh Finance's Managing Director is a former HDFC employee. Gruh Finance's operating policy, sanctioning norms, and loan schemes are also modelled on those of HDFC. Gruh Finance 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. In addition, Gruh Finance is involved in cross selling of HDFC products, such as and insurance policies. At present, Gruh Finance is a referral agent for HDFC Standard Life. However, the proportion of business generated through this channel remains small.

Although Gruh Finance is in the same industry as its parent, the market segment that the company caters to is distinct from that of HDFC, thus ruling out direct competition with the parent. CRISIL believes that Gruh Finance will continue to receive the required support from HDFC to achieve profitable growth.

Healthy asset quality

Gruh Finance has strong asset quality, underpinned by its strong risk management systems, and efficient credit approval and recovery mechanisms. As on March 31, 2008, the company's gross non-performing assets (NPAs) were low at 1.1 per cent, as against 1.4 per cent as on March 31, 2007. Gruh Finance has extended complete cover for its NPAs, and therefore, had zero net NPAs as on March 31, 2008.

Although Gruh Finance caters mainly to the low-risk individual segment, the company has recently begun issuing builder-developer loans. In 2007-08 (refers to financial year, April 1 to March 31), it made disbursements of Rs.0.65 billion to builders, as against total disbursements of Rs.6.32 billion for the year. The company has also increased its exposure to the non-salaried individual segment where it has enjoyed good asset quality (Gross NPA to this segment as on March 31, 2008 stood at 0.7 percent). Gruh Finance 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 68 per cent for 2007-08, compared with around 70 per cent for 2006-07. The

¹ As per HDFC Annual report

company has set up a special team for follow up and recovery of over-dues. In 2007-08, Rs.7.3 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. The credit profile of customers in these segments is inherently weaker than that of salaried individuals; this could result in higher credit risks, especially in the light of the current slowdown in demand in the housing sector. However, given Gruh Finance's strong risk management systems 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 healthy over the medium term.

Comfortable capitalisation levels

Gruh Finance is adequately capitalised in relation to the size of its current business and growth plans. Its gearing improved to 9 times as on March 31, 2008, from 12 times as on March 31, 2006. This improvement was largely due to a capital infusion of Rs.596.2 million, through a rights issue, concluded in December 2006. The capitalisation levels are also supported by healthy asset quality and healthy accruals to net worth.

The company reported an improvement in its overall capital adequacy, as a proportion of risk-weighted assets, to 18.1 per cent as on March 31, 2008, from 16.3 per cent as on March 31, 2007. The company's Tier I capital coverage for un-provided weak assets (Two year lagged NPA net of provisions) at around 14 times remains robust, backed by its healthy asset quality and flexibility to raise additional capital if required.

CRISIL believes that Gruh Finance'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.

Adequate earnings profile

Gruh Finance has maintained an adequate earnings profile, driven by low overall 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 that of its peers. The company's earning profile is marked by a healthy net profit margin (NPM; 2.5 per cent for 2007-08, as compared with 2.0 per cent in the previous year) and return on average assets of 2.47 per cent for 2007-08 (2.25 per cent 2006-07). 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. However, floating rate loans comprise around 93 per cent of Gruh Finance'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.

However, in an effort to reduce borrowing costs, the company has relied on short-term borrowings. This, in an increasing interest rate scenario, has increased the company's borrowing costs, especially in the nine months ended December 2008. 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 Finance's profitability in the near term.

CRISIL expects Gruh Finance's earnings to remain subdued as a result of reduced lending in the currently sluggish housing finance segment. Moreover, the company is enhancing its branch network, adding to its operating expenditure. Given the company's ability to manage its interest spreads, CRISIL expects Gruh Finance to maintain an above-average earnings profile over the medium term.

The abovementioned rating strengths are partially offset by the following weaknesses:

Stressed ALM profile

Gruh Finance has favoured high short-term borrowings, resulting in a higher ALM mismatch than other housing finance companies (HFCs), although it has helped contain borrowing costs. Short-term asset-liability mismatches are an inherent characteristic of the housing finance business. The company resorts to short-term debt to take advantage of the lower interest rates and significant pricing differential that exists between short- and long-tenure loans. However, short-term borrowings cannot be easily refinanced in times of tightening in liquidity in the money markets.

CRISIL believes that Gruh Finance's ALM profile is likely to remain stressed over the medium term. However, the degree of asset-liability mismatches has reduced, driven by the company's increasing recourse to long-term bank finance (Unutilised credit lines (Bank lines and NHB refinance available) as on December 31, 2008 stood at Rs. 5.3 billion). Besides, the company's longstanding relationships with bankers and flexibility to take recourse to securitisation transactions with its parent will help Gruh Finance manage its current ALM mismatches. However, the degree of mismatches remains a key monitorable over the medium term.

Limited market share, coupled with geographic concentration risks

Gruh Finance has a very small market share in the housing finance segment; as on March 31, 2008, its outstanding loan portfolio (Rs. 17.7 billion) accounted for less than 1 per cent of the overall individual housing loan outstanding in the industry, comprising banks and HFCs. Gruh Finance also operates primarily in the rural and semi-urban areas of Gujarat and Maharashtra. Around 84 per cent of the company's outstanding portfolio is concentrated in these two states.

The company is improving its geographical diversity, with around 31 per cent of fresh disbursements (to individuals) being made in Madhya Pradesh, Rajasthan and Karnataka in FY 2007-08. It also plans to begin operations in Chhattisgarh and Tamil Nadu. In 2007-08, the company set up 10 offices, most of them in new states, taking its network of retail offices to 82 as on March 31, 2008. The company has opened another six branches in 2008-09. Its high geographic concentration in asset portfolio is expected to reduce only gradually over the medium term.

Industry Prospects

The housing finance industry, comprising both banks and housing finance companies, grew at an average rate of 33 per cent per annum from 2004 to 2007. This was driven by improved affordability of home buyers on account of rising income levels, falling borrower age profiles, demand exceeding supply, tax concessions, low home loan rates, and increase in the number of double-income households. However, CRISIL estimates that the industry will not be able to sustain this growth over the next three to five years, and the growth in housing loan disbursements will fall to 20 to 25 per cent. The slowdown is expected to occur primarily due to the reduced affordability for the average salaried employee in light of the sharp increase in property prices across major cities relative to the average increase in salary levels in the past 24 months.

Nevertheless, in addition to the aforesaid reasons for the growth in the last three years, housing finance growth will continue at over 20 per cent levels over the medium term, supported by improved penetration into the self-employed category, continuing competitive pressures in the industry, keeping

loan-to-value (LTVs) and instalment-to-income ratios (IIRs) at high levels, increasing home prices, leading to higher ticket sizes, and thrust on rural housing.

Commercial banks command over 75 per cent of the market share in terms of fresh originations in housing loans, with HFCs accounting for the balance. Commercial banks have the natural advantages of wide reach, lower cost of funds, and ability to cross-sell products to existing customers. CRISIL expects that only strong HFCs, with wide reach and national presence, access to low-cost funds, strong credit assessment and underwriting skills, and those catering to niche segments, will profitably sustain over the long term. The industry, which has already witnessed some consolidation, will continue to see further amalgamations. Small players, who are unable to attract, or raise capital for growth, would be especially vulnerable to takeovers. Most small bank-promoted HFCs, such as Vibank Housing Finance Ltd, Andhra Bank Housing Finance Ltd, and CorpBank Homes Ltd, have already merged with their parent banks. BoB Housing Ltd is also in the process of merging with its parent, Bank of Baroda.

Housing finance is a low-margin, high-volume business. With high growth rates, especially of the kind shown by banks, whose housing loan portfolios are still unseasoned, it is critical that both banks and HFCs tighten their appraisal and monitoring systems to mitigate asset quality-related risks and their impact on profitability. CRISIL estimates that 'weak assets' - defined as gross non-performing loans lagged by two years to account for high growth and seasoning - of banks and HFCs had reduced to 4.15 per cent as on March 31, 2006, from around 5 per cent as on March 31, 2005. However, underwriting indicators such as LTVs, IIRs, and original tenures, have continued to move to riskier zones, on an overall basis. Also, there have been some players, including a few public sector banks, that have showed deteriorating asset quality. However, CRISIL estimates that the move towards high tenures and high IIRs is unlikely to lead to significant increase in delinquencies, as borrowers tend to prepay part of their loans regularly over the tenure of the loan from salary increments/bonuses. Prepayments reduce overall tenures and reduce the risks of long tenures and high IIRs taken by originators at the time of disbursements.

Although the housing finance sector has seen six rate hikes by lenders since November 2004, the core profitability of HFCs continues to be under pressure due to rising borrowing costs. A CRISIL study reveals that in spite of the rise in interest rates, the incremental core profitability of the HFCs (excluding the market leader HDFC) is low at around 0.2 per cent (pre-credit costs and taxes). The core profitability is expected to improve as lending rates rise and scale benefits accrue to the companies in the form of reducing operating expenses. Some HFCs, in an effort to release the stress on their margins, are increasingly resorting to short-term funding to reduce the overall cost of borrowing. As a result, these HFCs run higher mismatches in their ALM profiles. This stress on ALM profiles could lead to potential liquidity problems if the trend continues.

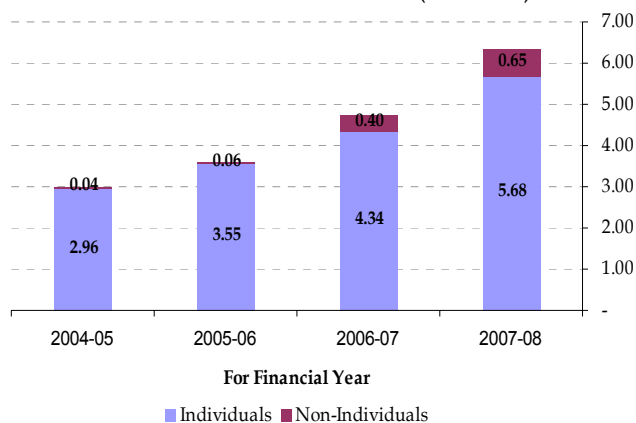
However, the capitalisation (in terms of the capital coverage of weak assets) of CRISIL-rated HFCs is comfortable. The regulatory capital adequacy ratio of most of the HFCs is moderate. In order to sustain higher growth rates, HFCs are expected to shore up their capital adequacy primarily through the issuance of Tier II capital (and hybrid capital once permitted by the regulator - National Housing Bank). CRISIL believes that its rated HFCs have significant flexibility to raise capital, either due to their strong reputation in the capital markets, or due to their strong parentage.

Business Profile

Market position

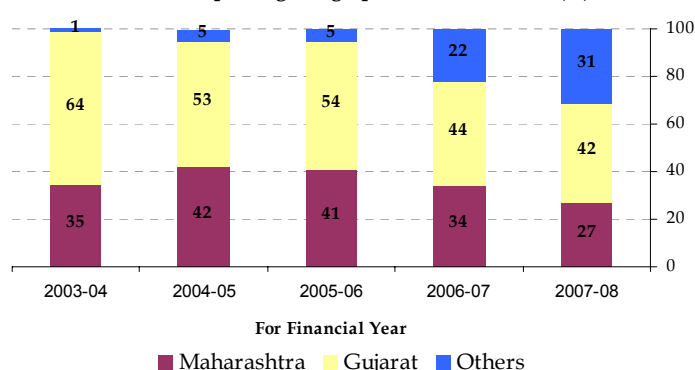
Gruh Finance is a small HFC, with a market share of less than 1 per cent. In 2007-08, the company disbursed loans of Rs.6.32 billion, through a network of 477 associates and 82 branch offices across seven states. During the same period, the company achieved an overall year-on-year growth rate of around 33 per cent in disbursements, which is comparable to that of its peers. Disbursements to non-salaried individuals increased to Rs.2.7 billion in 2007-08 from Rs.1.8 billion in the previous year. The company also extends builder loans: these disbursements increased to Rs.0.65 billion in 2007-08 from Rs.0.40 billion in 2006-07 (See Chart 1). Disbursements in nine months ended December 31, 2008, grew 25 per cent year-on-year and stood at Rs.4.97 billion, as compared with Rs.3.97 billion during the corresponding period last year. The outstanding loan book as on March 31, 2008 stood at Rs. 17.7 billion as compared to Rs 13.8 billion a year ago.

Chart 1: Total Disbursements (Rs Billion)

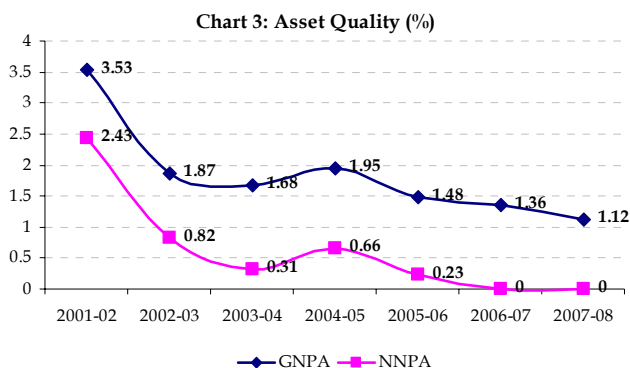


Gruh Finance’s operations are mainly concentrated in the rural and semi-urban areas of Gujarat and Maharashtra. However, the company’s geographical diversity has improved, with around 31 per cent of fresh disbursements (to individuals) being sourced from outside Maharashtra and Gujarat in 2007-08, as against 22 per cent in 2006-07. In 2007-08, the company set up 10 new offices; most of them in new states, taking its network of retail offices to 82 (See Chart 2).

Chart 2: Improving Geographical concentration (%)

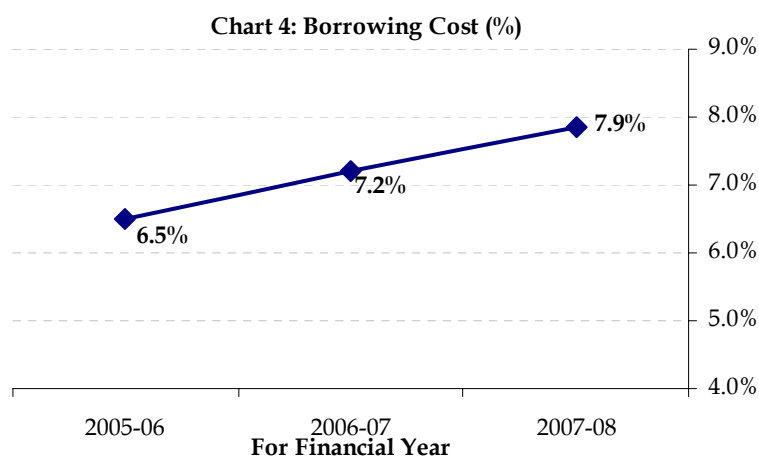


Asset quality



Gruh Finance’s gross NPAs declined to 1.1 per cent as on March 31, 2008, from 1.4 per cent as on March 31, 2007; gross NPAs stood at 1.4 per cent as on September 30, 2008. Weak assets (defined as two-year lagged NPAs), as a percentage of total assets, were low at 1.8 per cent in 2007-08, down from 2.4 per cent in 2006-07. To expedite recoveries, Gruh Finance has set up a dedicated team for follow-up and recovery of over-dues. The average ticket size of Gruh finance’s loans is less than Rs.0.5 million and the average loan-to-cost ratio of the company stood at around 68 per cent for 2007-08, as compared with around 70 per cent for 2006-07.

Resources



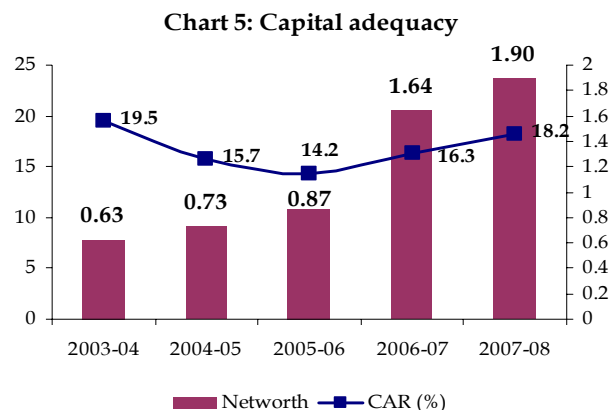
Gruh Finance has an adequate resource profile. The HFC's average cost of borrowings increased to 7.9 per cent in 2007-08 from 7.2 per cent in 2006-07, owing to rise in interest rates in 2007-08; the company has managed to restrict its borrowing costs to levels that are the lowest among HFCs other than HDFC (See Chart 4). The overall weighted average cost of incremental borrowings was 9.0 per cent in 2007-08, as against 8.2 per cent in 2006-07.

Gruh Finance has a moderately diverse mix of retail and wholesale borrowings. The proportion of retail borrowings has remained steady at 11 per cent in 2007-08. The company has also received Rs.1.33 billion of fresh deposits, and experienced a renewal ratio 31 per cent during 2007-08. The company enjoys relationships with over 26 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

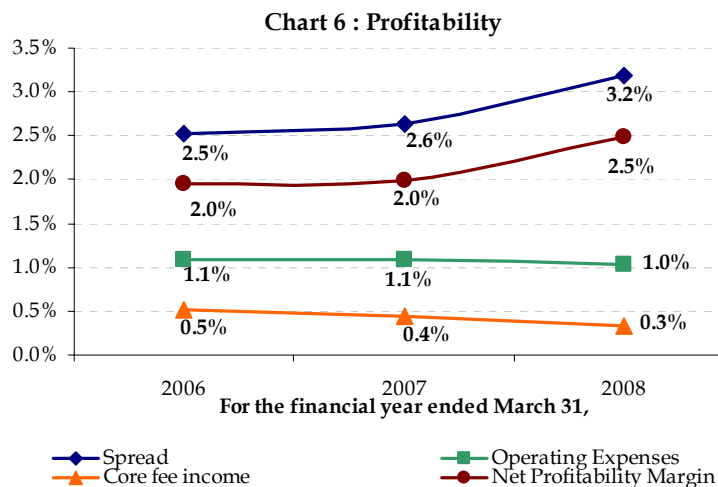
Capital adequacy

Gruh Finance reported a healthy overall capital adequacy, as a proportion of risk-weighted assets, of 18.2 per cent as on March 31, 2008, as compared with 16.3 per cent as on March 31, 2007. The company's Tier I capital coverage for unprovided weak assets, at 14 times as on March 31, 2008 (compared with 11 times last year), remains adequate, backed by its healthy asset quality. Accruals to net worth have been healthy at around 25 per cent for the past five years. Gruh Finance's gearing stood at 9 times as on March 31, 2008, and is comparable to that of its peers. (See Chart 5)



Earnings

For the year ended March 31, 2008, Gruh Finance reported a healthy NPM of 2.5 per cent (See Chart 6). The company's interest spreads improved by 54 bps in 2007-08, indicating the company's ability to pass on increase in borrowing costs to customers. In 2007-08, the return on average assets was 2.47 per cent (2.25 per cent for 2006-07), and return on average net worth was 24 per cent (24 per cent for 2006-07). Gruh Finance's core fee income has traditionally been low; it was less than 0.4 per cent of total funds deployed in 2007-08. Its operating expenses declined marginally to 1.03 per cent in 2007-08 from 1.09 per cent in 2006-07.



Liquidity and asset-liability management

Gruh Finance's high reliance on short-term borrowings has resulted in a relatively higher ALM mismatch, as against other HFCs. Gruh Finance contracted short-term debt to take advantage of the significant pricing differential between short- and long-tenure loans. The company has consistently run mismatches in the shorter term buckets in the past, however of late, the cumulative mismatches have reduced. As of December 31, 2008, the company did not have negative mismatches in the first two buckets.

Gruh Finance's short-term borrowings as on December 31, 2008, stood at 23 per cent (of loan assets) limit, as against the 40 per cent stipulated by its Asset and Liability Committee (ALCO). The company had unutilised credit lines of Rs. 5.3 billion as on December 31, 2008, which adequately cover its cumulative negative mismatches in the up to the one year maturity bucket. Further, strong parentage and the option of securitisation with HDFC enhance Gruh Finance's financial flexibility.

Past Financial Performance

Year Ended March 31		2008	2007	2006	2005
Equity Capital	Rs. Billion	0.4	0.4	0.3	0.3
Net worth (reported)	Rs. Billion	1.9	1.6	0.9	0.7
Housing Loans outstanding	Rs. Billion	16.9	13.8	10.7	8.2
Investments	Rs. Billion	0.2	0.2	0.2	0.2
Total Funds Deployed	Rs. Billion	20.1	15.1	11.9	9.3
Total Income	Rs. Billion	2.0	1.5	1.1	0.9
Reported PAT	Rs. Billion	0.4	0.3	0.2	0.2
Yield on Housing loans	%	12.0	10.3	9.9	10.6
Interest / Avg. borrowings	%	7.9	7.2	6.5	7.3
Overheads / Avg. Funds dep.	%	1.0	1.1	1.1	1.2
PAT/Avg. Funds deployed	%	2.4	2.2	2.0	2.1
PAT/Avg. Adjusted Net worth	%	23.9	23.6	27.0	24.4
Total Debt/Adjusted Net worth	%	9.3	8.0	12.4	11.0

Financials for the nine months ended

Particulars		30/12/2008	30/12/2007
Disbursements	Rs. Billion	5.0	4.0
Total Income	Rs. Billion	2.0	1.4
Operating Expenses	Rs. Billion	0.2	0.1
Interest and Finance Charges	Rs. Billion	1.4	0.9
PAT	Rs. Billion	0.3	0.2

CRISIL Limited

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