kotak Institutional Equities

HDFC Bank (HDFCB)

Banks/Financial Institutions

BUY

FEBRUARY 10, 2010

CHANGE IN RECO.

Coverage view: Attractive

Price (Rs): 1,594

Target price (Rs): 1,800

BSE-30: 15,922

Best bank to own in the current environment. We believe that banks with strong retail and CASA deposit franchisees are best placed at times of rising rates. HDFC Bank has been the best bank in terms of CASA growth and asset quality over the past few quarters. We believe that above-industry loan growth (20%+), 4%+ margins and lower provisioning should drive 30% PAT growth over the next 6-8 quarters. Upgrade our recommendation on HDFC Bank to BUY (from ADD earlier).

Company data and valuation summary

HDFC Bank

Stock data			
52-week range (Rs) (high,low)			1,839-774
Market Cap. (Rs bn)			720.4
Shareholding pattern (%)			
Promoters			19.3
FIIs			47.0
MFs			4.6
Price performance (%)	1M	3M	12M
Absolute	(7.1)	(6.5)	68.3
Rel. to BSE-30	2.0	(3.2)	2.0

Forecasts/Valuations	2010	2011E	2012E
EPS (Rs)	64.8	84.4	107.7
EPS growth (%)	30.5	30.2	27.6
P/E (X)	24.6	18.9	14.8
NII (Rs bn)	85.1	102.6	121.4
Net profits (Rs bn)	29.3	38.1	48.7
BVPS	472.0	537.7	621.5
P/B (X)	3.4	3.0	2.6
ROE (%)	16.1	16.7	18.6
Div. Yield (%)	0.8	1.0	1.3

Upgrade to BUY, notwithstanding expensive valuations

While valuations for stock remain expensive at 19XFY2011E PER and 3XFY2011E, we believe that likely strong earnings growth of 28-30% over the next couple of years coming from core operational earnings, improving asset quality and better than industry growth is likely to sustain these high valuations. The stock has underperformed by 3% over the last 3 months and outperformed marginally over the last month. Given the strong economic outlook, on the backdrop of high government deficit, we expect interest rate environment to remain challenging. HDFC Bank is one of the best banks to own in such an environment given its strong core liability franchisee; upgrade our recommendation to BUY.

Quality operational performance; will trade at a premium to others

We are extremely impressed by HDFC Bank's recent operational performance—excelling on all key parameters. Margins improved sequentially by 10 bps to 4.3%, driven by strong traction in CASA deposits (up 38% yoy and CASA percentage now is 51%). We expect margins could further improve if interest rates rise as HDFC Bank's high CASA franchisee would ensure lower deposit costs. The pace of new NPL formation has peaked, which is likely to result in lower absolute NPLs (only bank to report absolute lower NPLs, both at gross and net level over last couple of quarters) and credit provisioning requirement going forward. Quality of earnings has improved considerably as earnings now are being driven by core performance with negligible treasury contribution.

Superior CASA franchisee—would ensure strong margins in a rising rate environment

One of the key positives of HDFC Bank has always been its strong CASA franchisee. Over the last few quarters, CASA deposit growth has been spectacular for the bank; savings deposits grew by 41% yoy to Rs467 bn and current deposits grew by 34% yoy to Rs333 bn as of December 2009—this is the best in the industry. Reported CASA ratio has increased to 51%, while the core CASA ratio was at 49%, up from 40% last year. With interest rates set to rise, the power of CASA franchisee is likely to be reflected in superior margins and a steady loan growth. We expect margins to improve by 20 bps in FY2011E over FY2010E (as per our model). This is despite a likely increase of 15bps in deposit costs due to daily average working for savings deposits.

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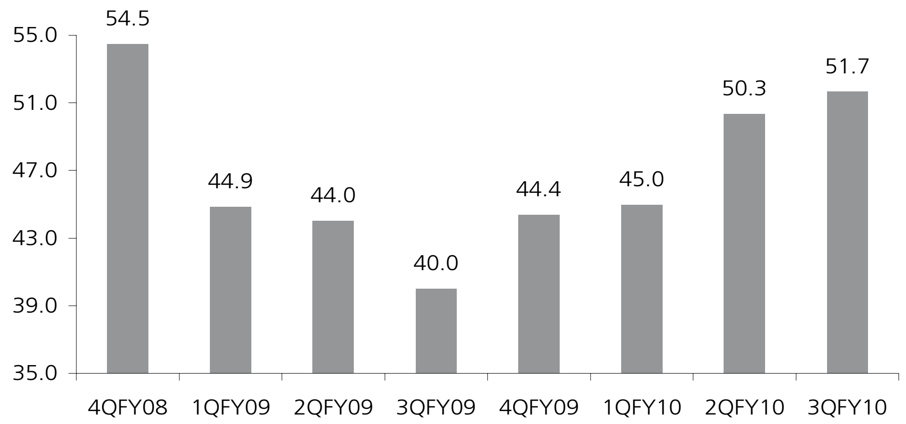
CASA ratios have seen a sharp increase over the last few quarters
CASA % as proportion of deposits, March fiscal year-ends, 4QFY08 – 3QFY10 (%)



Source: Company, Kotak Institutional Equities

HDFC Bank has been gaining market share in CASA deposits
YoY market share of CASA deposits growth, March fiscal year-ends, 2QFY09-3QFY10E (%)

	3QFY09	4QFY09	1QFY10	2QFY10	3QFY10	Mkt Share gain (bps)
Public banks						
Andhra Bank	2.1	2.1	2.1	2.1	1.9	(21)
Bank of Baroda	7.6	7.5	7.7	7.6	7.7	53
Bank of India	5.8	5.4	5.7	5.4	5.6	2
Canara Bank	6.5	6.2	6.0	6.0	6.1	(74)
Corporation Bank	1.9	2.6	1.9	1.8	1.9	(0)
Indian Bank	2.7	2.5	2.5	2.5	2.6	(10)
IOB	3.3	3.4	3.3	3.4	3.1	(22)
OBC	2.9	2.5	2.7	2.6	2.6	(11)
PNB	9.1	9.1	9.3	9.1	8.8	(25)
State Bank of India	31.5	32.2	32.6	32.2	32.2	153
Union Bank	4.9	4.6	4.9	5.0	4.8	(3)
Old private banks						
Federal Bank	0.9	0.9	0.9	0.9	0.9	5
J&K Bank	1.4	1.4	1.3	1.2	1.3	(7)
New private banks						
Axis Bank	5.0	5.6	4.9	5.0	5.1	(12)
HDFC Bank	7.2	7.0	7.3	7.7	7.8	44
ICICI Bank	7.2	7.0	7.1	7.4	7.6	(73)
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	

Source: Kotak Institutional Equities

HDFC Bank has been the fastest growing bank on CASA front
CASA Deposits for last 6 quarters (Rs bn)

	3QFY09	4QFY09	1QFY10	2QFY10	3QFY10	YoY gwth (%)
Public banks						
Andhra Bank	171	186	185	201	200	17
Bank of Baroda	609	671	697	750	795	31
Bank of India	463	486	513	530	571	23
Canara Bank	521	562	538	586	627	20
Corporation Bank	156	233	168	181	196	26
Indian Bank	217	226	227	248	264	22
IOB	266	303	295	337	319	20
OBC	235	224	241	255	271	15
PNB	729	818	839	889	901	24
State Bank of India	2,535	2,894	2,936	3,166	3,311	31
J&K Bank	115	126	114	120	138	21
New private banks						
Axis Bank	401	506	442	495	519	29
HDFC Bank	579	634	655	754	800	38
ICICI Bank	576	627	639	727	783	36
Total	**8039**	**8991**	**9010**	**9817**	**10272**	**28**

Source: Kotak Institutional Equities

Management's intent is to grow faster than the industry

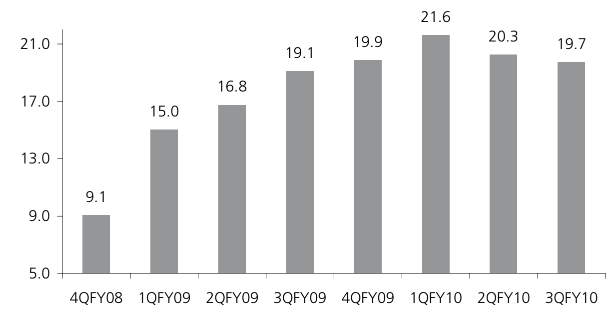
The management has highlighted their strategy of growing loans by 3-5% higher than industry growth. In FY2010E, HDFC Bank is likely to grow its loans by about 20% and we expect a 25% growth in FY2011E. The bank has been gaining market share in the secured retail products segment as most other banks had slowed down. Buyback of mortgages from HDFC will also drive incremental loan growth in this segment. Further, HDFC Bank has limited presence in project lending and has largely focused on working capital-related business in the past. With a pick-up in economic activity, the management now finds sufficient opportunities to grow at a rapid pace on the low base for project-related activities as well. We believe that the proportion of mortgages and project-related loans will increase over the time although retail and working capital loans will continue to dominate its loan book.

NPLs have peaked—expect positive traction

The bank has managed its asset quality in the best possible manner with sustaining its net NPLs at 0.4%-0.6% and gross below 2%. Incremental delinquencies are already declining and absolute NPLs (both gross and net) are declining over the last couple of quarters. Delinquency rates have declined from 2.1% in 1HFY10 to 1.2% in 3QFY10. The total restructured assets for HDFC Bank were just at 0.4% of the loan book.

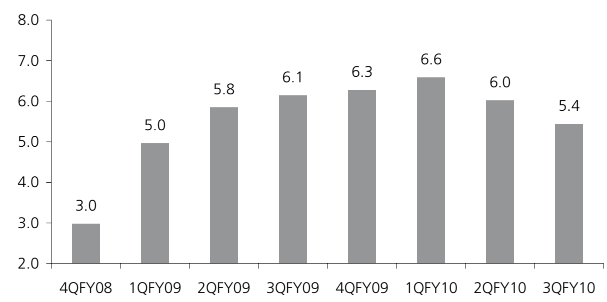
The declining delinquency rates would result in much lower provisioning requirement over the next few quarters and this could support earnings significantly. The bank historically has been providing about 200 bps loan loss provisioning, which we expect to decline now, also aided by the fact that loan book composition is changing towards more secure assets.

Absolute levels of gross NPLs are declining
Gross NPLs, March fiscal year-ends, 4QFY08 – 3QFY10 (Rs bn)



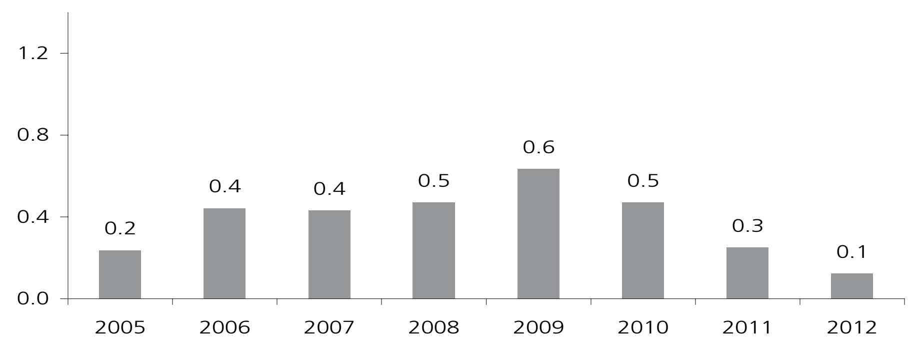
Source: Company, Kotak Institutional Equities estimates

Net NPLs are declining even faster
Net NPLs, March fiscal year-ends, 4QFY08 – 3QFY10 (Rs bn)



Source: Company, Kotak Institutional Equities estimates

Net NPLs trend is likely to be better than most other banks
Net NPLs as proportion of loans, March fiscal year-ends, 2005-2012E (%)

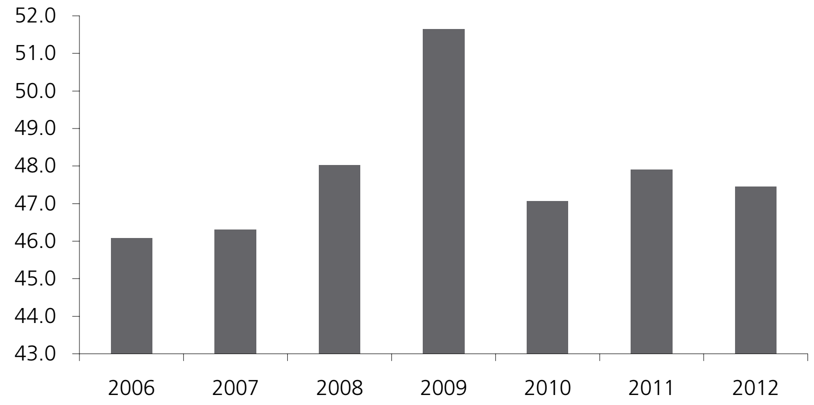


Source: Company, Kotak Institutional Equities

Cost/income leverage is currently playing out

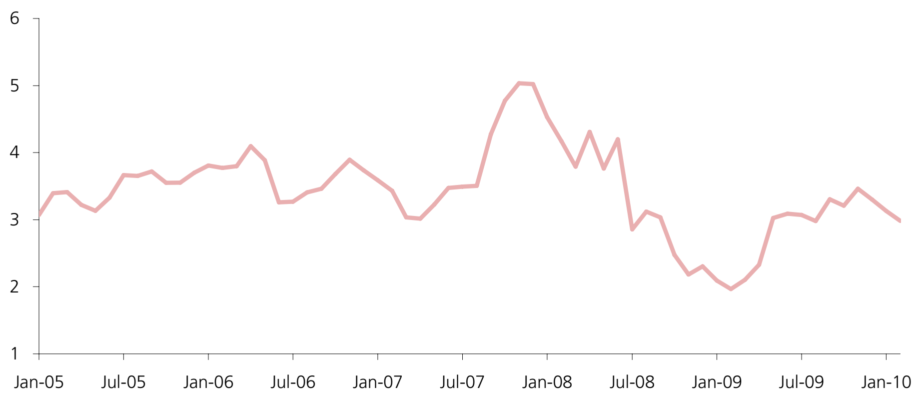
Post the CBoP merger, the management's strategy of right sizing its operations and redeploying manpower more effectively appears to be paying dividends. Better efficiencies in other operations are also contributing to lower cost-income ratio over the last few quarters. While costs are likely to rise on the back of increasing wage and rental costs, we expect cost-income ratios to be maintained at near 47%, as income growth is also likely to gather momentum. We expect this trend of better productivity gains to continue for the next few quarters and drive earnings growth for HDFC Bank.

Operating efficiency has increased considerable post the CBoP merger
Operational costs-to-average assets, March fiscal year-ends, 2006-2011E (%)



Source: Company, Kotak Institutional Equities

HDFC Bank is trading near the lower end of its valuation band
Rolling P/B (x) for HDFC Bank: Jan 2005 – Feb 2010



Source: Bloomberg, Kotak Institutional Equities

HDFC Bank growth rates and key ratios
March fiscal year-ends, 2008-2012E (%)

	2008	2009	2010E	2011E	2012E
Growth rates (%)					
Net loan	35.1	55.9	22.2	24.8	22.1
Total Asset	46.0	37.6	14.0	16.2	15.2
Deposits	47.5	41.7	14.7	18.0	16.6
Current	45.2	(1.1)	26.7	7.3	10.8
Savings	33.5	73.3	(1.0)	22.9	18.9
Fixed	58.7	33.5	40.8	18.0	16.6
Net interest income	48.7	34.5	14.7	20.6	18.3
Loan loss provisions	41.2	42.0	24.1	(4.9)	(1.4)
Total other income	50.4	44.2	18.1	9.6	16.3
Net fee income	32.7	43.3	16.8	15.2	15.0
Net capital gains	(453.4)	58.2	4.6	(37.5)	40.0
Net exchange gains	48.7	111.4	(5.0)	12.0	14.0
Operating expenses	54.7	47.7	5.5	19.2	16.6
Employee expenses	67.5	72.0	6.2	25.9	19.3
Key ratios (%)					
Yield on average earning assets	9.7	10.8	8.8	9.0	9.2
Yield on average loans	12.6	15.0	11.5	11.2	11.2
Yield on average investments	7.9	7.4	6.2	6.3	6.3
Average cost of funds	5.2	6.7	4.9	4.8	4.9
Interest on deposits	5.2	6.6	4.7	4.6	4.7
Difference	**4.6**	**4.1**	**3.9**	**4.1**	**4.2**
Net interest income/earning assets	5.1	4.9	4.5	4.7	4.8
New provisions/average net loans	2.2	2.1	2.0	1.5	1.2
Interest income/total income	70.7	69.3	68.6	70.7	71.0
Fee income to total income	22.0	22.9	23.1	22.8	22.2
Operating expenses/total income	48.0	51.7	47.1	47.9	47.5
Tax rate	30.3	32.0	32.5	30.0	30.0
Share of deposits					
Current	28.5	19.9	22.0	20.0	19.0
Fixed	45.5	55.6	48.0	50.0	51.0
Savings	26.0	24.4	30.0	30.0	30.0
Loans-to-deposit ratio	62.9	69.2	73.7	77.9	81.6
Equity/assets (EoY)	8.6	8.2	10.2	10.0	10.1
Dupont analysis (%)					
Net interest income	4.7	4.7	4.3	4.5	4.6
Loan loss provisions	1.1	1.1	1.1	0.9	0.8
Net other income	2.0	2.1	2.0	1.9	1.9
Operating expenses	3.6	3.6	3.0	3.1	3.1
Invt. depreciation	0.0	0.0	0.0	0.0	0.0
(1- tax rate)	69.7	68.0	67.5	70.0	70.0
ROA	1.4	1.4	1.5	1.7	1.9
Average assets/average equity	12.5	11.9	10.8	9.9	10.0
ROE	17.7	16.9	16.1	16.7	18.6

Source: Company, Kotak Institutional Equities estimates

HDFC Bank P&L and balance sheet
March fiscal year-ends, 2008-2012E (Rs mn)

	2008	2009	2010E	2011E	2012E
Income statement (Rs mn)					
Total interest income	**104,034**	**163,323**	**165,818**	**195,281**	**232,263**
Loans	69,667	121,368	125,854	152,226	188,073
Investments	31,604	40,080	38,766	42,287	43,330
Cash and deposits	2,762	1,876	1,199	768	861
Total interest expense	**48,871**	**89,111**	**80,710**	**92,665**	**110,876**
Deposits from customers	43,827	80,155	72,365	82,933	99,469
Net interest income	**55,163**	**74,212**	**85,108**	**102,616**	**121,387**
Loan loss provisions	12,160	17,263	21,418	20,363	20,088
Net interest income (after prov.)	**43,002**	**56,949**	**63,690**	**82,253**	**101,300**
Other income	22,825	32,906	38,878	42,621	49,585
Net fee income	17,145	24,573	28,692	33,052	38,024
Net capital gains	2,418	3,826	4,000	2,500	3,500
Net exchange gains	2,831	5,986	5,687	6,369	7,261
Operating expenses	37,456	55,328	58,358	69,583	81,137
Employee expenses	13,014	22,382	23,776	29,933	35,703
Depreciation on investments	2,884	—	—	—	—
Other Provisions	2,683	1,528	800	800	200
Pretax income	22,811	32,999	43,410	54,492	69,548
Tax provisions	6,909	10,549	14,108	16,347	20,864
Net Profit	**15,902**	**22,449**	**29,302**	**38,144**	**48,683**
% growth	39.3	41.2	30.5	30.2	27.6
PBT+provision-treasury gains	**35,229**	**47,964**	**61,629**	**73,154**	**86,335**
% growth	33.8	36.1	28.5	18.7	18.0
Balance sheet (Rs mn)					
Cash and bank balance	147,783	175,066	144,768	162,580	181,642
Cash	9,401	15,862	18,241	20,065	22,072
Balance with RBI	116,131	119,410	86,733	102,721	119,776
Balance with banks	9,949	9,051	9,051	9,051	9,051
Net value of investments	493,933	588,252	661,473	680,449	694,760
Govt. and other securities	316,656	521,566	594,787	613,763	628,075
Shares	345	397	397	397	397
Debentures and bonds	62,517	19,428	19,428	19,428	19,428
Net loans and advances	634,269	988,830	1,207,914	1,507,135	1,840,834
Fixed assets	11,751	16,989	10,245	10,136	9,547
Net leased assets	—	—	—	—	—
Net Owned assets	11,751	16,989	10,245	10,136	9,547
Other assets	44,027	63,568	64,987	66,547	68,263
Total assets	**1,331,764**	**1,832,706**	**2,089,386**	**2,426,847**	**2,795,046**
Deposits	1,007,686	1,428,116	1,638,550	1,933,937	2,254,765
Borrowings and bills payable	108,852	120,860	117,582	141,957	162,225
Other liabilities	100,256	133,204	119,884	107,895	97,106
Total liabilities	**1,216,794**	**1,682,180**	**1,876,017**	**2,183,789**	**2,514,097**
Paid-up capital	3,544	4,254	4,521	4,521	4,521
Reserves & surplus	111,428	146,219	208,849	238,537	276,429
Total shareholders' equity	**114,972**	**150,473**	**213,370**	**243,058**	**280,949**

Source: Company, Kotak Institutional Equities estimates

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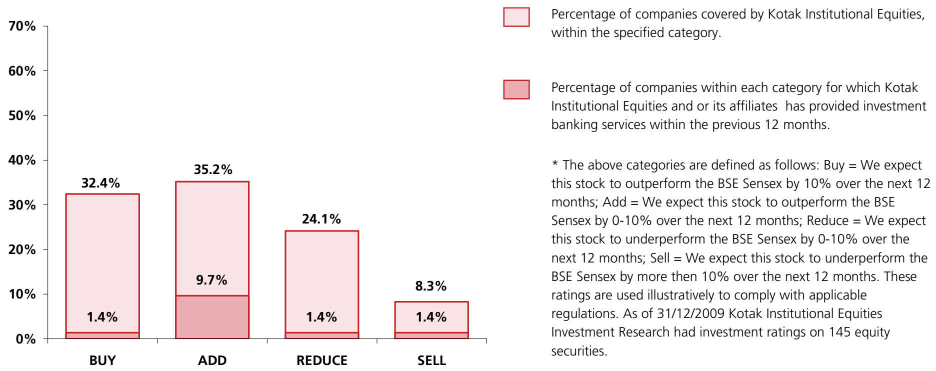

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Source: Kotak Institutional Equities

As of December 31, 2009

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SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

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