



HDFC Bank

STOCK INFO.	BLOOMBERG
BSE SENSEX: 15,010	HDFCB IN
	REUTERS CODE
S&P CNX: 4,406	HDBK.BO

10 July 2007

Buy

Previous Recommendation: Buy

Rs1,148

Equity Shares (m)	319.4
52-Week Range	1,274/693
1,6,12 Rel.Perf.(%)	-2/3/7
M.Cap. (Rs b)	366.6
M.Cap. (US\$ b)	9.1

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROAE	ROAA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
3/07A	49,847	11,419	35.8	28.3	32.1	5.7	13.1	19.5	1.4	5.8
3/08E	67,413	15,328	42.8	19.7	26.8	3.5	13.4	16.7	1.4	3.5
3/09E	89,332	20,997	58.6	37.0	19.6	3.0	11.5	16.5	1.5	3.1

HDFC Bank's earnings grew by 34% YoY, in line with estimates. However NII growth was merely 28% YoY in 1QFY08 (v/s estimated 44% growth), as margins decreased QoQ to 4.2% (4.1% in 1QFY07). HDFC Bank aggressively built up its term deposits during 1QFY08 recording QoQ growth of 37%. This faster deposit growth (putting pressure on margins) is a "catch up" as the bank had not grown its term deposits for the past three quarters. Loan growth was 33% YoY, above the industry growth of 25%. Asset quality has been maintained with gross NPAs at 1.3% and net NPAs at 0.4% of customer assets.

- ✍ Strong business growth; higher v/s industry
- ✍ CASA ratio and NIMs decline QoQ, as bank builds up term deposit base
- ✍ Other income grew by 77% YoY as fees maintain strong growth
- ✍ Aggressive branch openings continue; 218 branches opened during last 9 months

With the aberration of a slow balance sheet growth and high margins now getting corrected, we expect balance sheet growth to be faster with margins in the range of 4.2-4.3%. Rapid branch expansion would ensure core deposit growth as well as sustainability of its relatively higher CASA ratio. On a post-diluted basis, we expect HDFC Bank to report EPS of Rs42.8 in FY08 and Rs58.6 in FY09. The book value in these years would be Rs332 and Rs379. RoE in FY08-FY09 is likely to be ~17%. The stock currently trades at 19.6x FY09E EPS and 3x FY09E BV. Maintain **Buy**.

QUARTERLY PERFORMANCE

	(Rs Million)									
	FY07				FY08				FY07	FY08E
	1QA	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Interest Income	15,043	16,357	17,593	19,898	21,259	23,063	24,542	27,883	68,890	96,747
Interest Expense	6,867	7,901	8,307	8,721	10,836	11,456	11,630	13,088	31,795	47,009
Net Interest Income	8,176	8,456	9,286	11,177	10,422	11,607	12,913	14,795	37,096	49,737
Growth (%)	56.1	38.1	38.5	51.2	27.5	37.3	39.1	32.4	45.7	34.1
Other Income	2,909	3,977	3,733	3,944	5,158	3,894	4,326	4,297	12,751	17,675
Net Income	11,086	12,433	13,019	15,121	15,581	15,501	17,239	19,092	49,847	67,413
Growth (%)	40.8	42.5	34.7	44.9	40.5	24.7	32.4	26.3	45.6	35.2
Operating Expenses	5,527	5,791	6,050	6,839	7,744	8,000	8,894	9,946	24,208	34,583
Operating Profit	5,558	6,642	6,969	8,282	7,837	7,501	8,345	9,146	25,639	32,829
Provisions and Contingencies	2,040	3,057	2,664	3,303	3,071	2,300	2,400	2,518	7,309	10,289
Profit Before Tax	3,518	3,585	4,305	4,979	4,766	5,201	5,945	6,629	18,330	22,540
Provision for Taxes	1,125	955	1,349	1,544	1,553	1,664	1,902	2,093	6,912	7,213
Net Profit	2,393	2,629	2,956	3,436	3,212	3,537	4,043	4,536	11,419	15,328
Growth (%)	30.4	31.7	31.7	30.5	34.2	34.5	36.7	32.0	30.8	34.2
Cost to Income Ratio (%)	49.9	46.6	46.5	45.2	49.7	51.6	51.6	52.1	48.6	51.3
Interest Expense/Interest Income (%)	45.6	48.3	47.2	43.8	51.0	49.7	47.4	46.9	46.2	48.6
Other Income/Total Income (%)	26.2	32.0	28.7	26.1	33.1	25.1	25.1	22.5	25.6	26.2

E: MOST Estimates

HDFC Bank's earnings grew by 34% YoY, in line with estimates. However NII growth was merely 28% YoY in 1QFY08 (v/s estimated 44% growth), as margins decreased QoQ to 4.2% (4.1% in 1QFY07). HDFC Bank aggressively built up its term deposits during 1QFY08 recording QoQ and YoY growth of ~37%. This faster deposit growth (putting pressure on margins) is a "catch up" as the bank had not grown its term deposits for the past three quarters. Loan growth was 33% YoY, above the industry growth of 25%. Asset quality has been maintained with gross NPAs at 1.3% and net NPAs at 0.4% of customer assets.

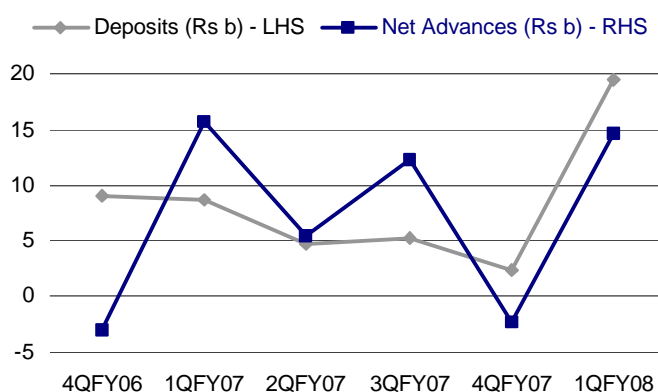
Strong business growth; higher v/s industry

HDFC Bank had slowed down its bulk deposit intake during 2HFY07 as rates were unattractive. This resulted in slower deposit growth of 22% for FY07. Also during 2HFY07, the bank's total term deposits remained almost flat at ~Rs300b. But in 1QFY08, the bank has reversed the trend of the slower growth and has built a strong retail term deposit base. Term deposits grew by 37% QoQ (65% of incremental deposits is from retail sources). As a result, CASA reduced from 58% in 4QFY07 and 53% in 1QFY07 to 52% in 1QFY08. On a QoQ basis, the bank has grown its deposits by 19% vs industry growth of 3%.

Overall, loans as well as retail loans grew by 33% YoY (similar to 33% YoY growth in FY07). The bank has been able to sustain its credit growth during 1QFY08 while credit growth in the system has reduced from 28% in FY07 to ~25% for the period. On a QoQ basis, loans have grown by 15% vs industry de-growth of 1.5%. Retail credit accounted for 57% of its advances, down from 60% in

March 2007. Within retail, credit cards, personal loans and business banking (loans to traders) witnessed the fastest growth, while 2W, CVs and loans against securities saw stagnation/degrowth.

INCREMENTAL GROWTH (%) - STRONG PICK UP IN 1QFY08



Source: Company/ Motilal Oswal Securities

CASA ratio decline QoQ, as bank builds up term deposit base

With 38% YoY growth in term deposits against 21% and 43% YoY growth in savings and current deposits in 1QFY08, HDFC Bank's CASA ratio dropped YoY from 53% to 52% in the quarter. On a QoQ basis, CASA ratio dropped by 620bp as term deposits grew by 37% QoQ. Term deposits had reduced by 4% QoQ in 4QFY07, as the bank consciously abstained from taking bulk deposits as the prevailing rates were unattractive. Term deposits had remained stagnant at around Rs290-Rs300b during 2HFY08. Management cautiously made a "catch up" on deposits growth during 1QFY08.

YOY GROWTH IN DEPOSITS (%)

	1QFY06	2QFY06	3QFY06	FY06	1QFY07	2QFY07	3QFY07	FY07	1QFY08
Current Deposits	32.3	53.3	22.7	39.2	42.2	16.7	45.0	34.3	43.7
Savings Deposits	48.1	46.8	39.6	41.8	33.4	26.7	26.7	21.0	21.3
Term Deposits	1.6	19.3	43.2	73.4	90.0	65.7	25.4	16.3	37.9
Total Deposits	22.1	35.8	36.8	53.5	58.1	39.6	30.4	22.4	34.6
Term deposits growth - catch up during 1QFY08									
Term Deposits (Rs b)	151	183	240	249	287	304	301	289	396
QoQ Gr. Term Deposits (%)	5.4	21.3	30.9	3.6	15.5	5.7	-0.9	-3.9	37.0
CASA Ratio (%)	60.6	59.7	53.1	55.4	52.6	52.2	54.9	57.7	51.5

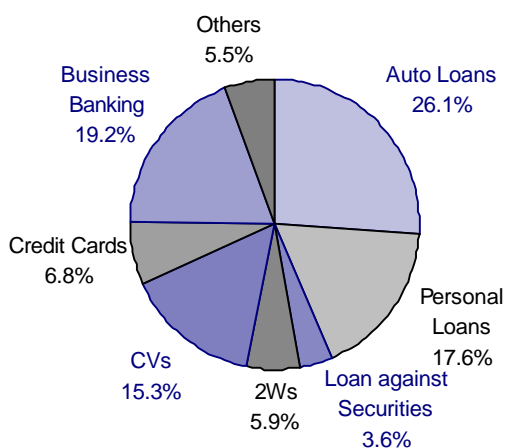
Source: Company/Motilal Oswal Securities

Corporate loans starting to grow faster

Net advances increased by 33% YoY and 15% QoQ. Customer assets registered growth of 29% YoY and 18% QoQ. Retail advances grew in line with total advances growth of 33% YoY to contribute 57% of the total advances of the bank. While during 1QFY08, retail advances grew by a mere 8%, total advances grew by 15%. 2Ws, CVs and loans against securities witnessed a slowdown or stagnation in the retail segment.

Retail has been the key growth driver for the bank, although the pace of growth continues to be slowing down. Corporate loan growth has been picking up for HDFC Bank emanating primarily from SMEs and working capital financing.

RETAIL LOAN BOOK COMPOSITION

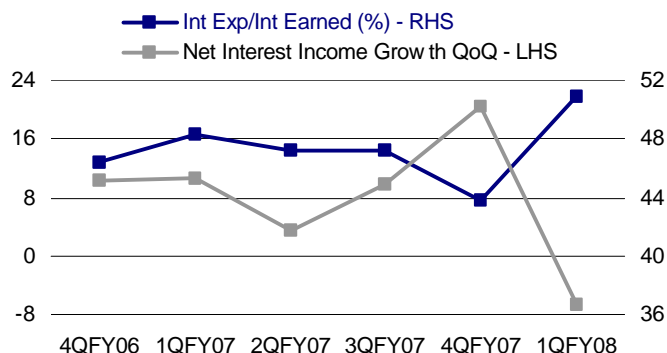


Source: Company/Motilal Oswal Securities

NII growth at 28% YoY; margins improve YoY, but decline QoQ

NII growth was lower at 28% YoY (v/s our estimate of 45%) as balance sheet growth picked up. On a sequential basis, NII declined by 7% to Rs10.4b in 4QFY07 from 51% YoY and 20% QoQ growth reported in 4QFY07. While NIMs have reduced QoQ by 30bp to 4.2%, they have increased 10bp YoY. The higher margins of 4.5% reported in 4QFY07 was an aberration as bank had tactically slowed down asset growth in the period. As the bank moved into the fast asset growth strategy during the quarter and also aggressively built up its term deposits, NII growth and margins came down.

QOQ TREND IN NII



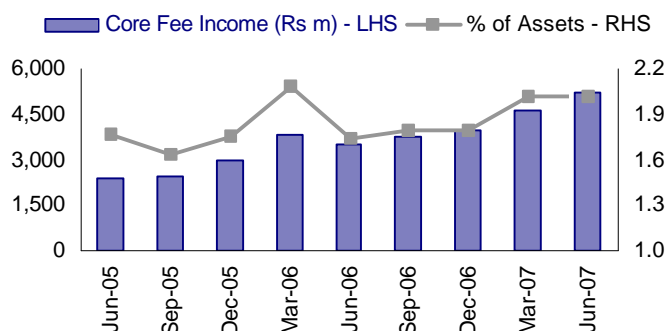
Source: Company/ Motilal Oswal Securities

We believe the bank would be able to sustain margins at the 4%+ level in FY08 given its proven impeccable ALM management.

Other income grew 77% YoY on back of strong forex, derivatives income

Other income grew 77% YoY in 1QFY07 driven by robust fee income growth of 28% (20% YoY growth in 4QFY07) and strong forex and derivative income as well as higher treasury income. Forex and derivatives income grew by 263% YoY to 1.5b. Treasury (including amortization on HTM investments) was impacted by losses of Rs41m in 1QFY08, versus loss of Rs622m in 1QFY07, implying profit of Rs570m from trading in 1QFY08 v/s loss of Rs20m in 1QFY07. Fee income now comprises 2% of assets. The growth in derivatives and forex was on account of executing some big-ticket transactions for corporate clients in the quarter. While this source is sustainable on a yearly basis, its recurrence on a quarterly basis is unpredictable.

TREND IN FEE INCOME



Source: Company/ Motilal Oswal Securities

Asset quality consistent, with net NPAs at 0.4%

HDFC Bank's asset quality remains the best in the Indian banking sector, notwithstanding the bank's aggressive growth over the past several quarters. The bank has maintained its gross NPAs at 1.3% and net NPAs at 0.4% as at 1QFY08. It has continued to make NPA provisions and holds specific general provisions on its standard customer assets that are higher than the regulatory requirements.

Over the last couple of quarters, the bank has increased its provisioning levels in line with the higher growth in retail loans (credit cards and personal loans, where delinquencies are higher).

Operating expenses up 40% led by 71% higher staff expenses

Operating expenses increased by 40% YoY led by a 71% rise in staff expenses. Increase in staff expenses was on account of significant manpower addition to support the rapid branch expansion and rising salaries. Bank aims to maintain the cost to income ratio (adjusting for reclassification of HTM amortization as part other income) at current levels of -49-50% going forward.

Branch network – strong additions continues

The bank opened 69 new branches and 111 ATMs in 1QFY08 and now has 753 branches and 1,716 ATMs. Over the last 9 months, the bank has added 218 branches.

Currently, the bank has exhausted all its licenses in hand, and will have to wait for RBI directions. We estimate an additional 100 branches to be opened during the next 3 quarters.

Capital adequacy at 13.1%

The bank's capital adequacy currently is at 13.1%, with Tier-I at 9.2%. During 1QFY08, it raised Rs13.9b of equity by way of preferential allotment of 13.6m shares at a price of Rs1,013.5 to the parent HDFC Ltd. The bank would be raising an additional Rs28b in equity, probably in 2QFY08, via an international issue as part of its announced equity raising of US\$1b. This capital build-up, apart from being significantly book accretive, would take care of above industry credit growth for the bank in next 3-4 years.

Maintain Buy

With the aberration of a slow balance sheet growth and high margins now getting corrected, we expect balance sheet growth to be faster with margins in the range of 4.2-4.3%. Rapid branch expansion would ensure core deposit growth as well as sustainability of its relatively higher CASA ratio.

On a post diluted basis, we expect HDFC Bank to report EPS of Rs42.8 in FY08 and Rs58.6 in FY09. The book value in these years would be Rs332 and Rs379. RoE in FY08-FY09 is likely to be ~17%. The stock currently trades at 19.6x FY09E EPS and 3x FY09E BV. **Maintain Buy.**

HDFC Bank: an investment profile

Company description

HDFC Bank, incorporated in 1994 by HDFC Ltd., is the second largest private sector bank, with a balance sheet size of Rs1,057b. Rated as one of the best banks in India; it has network in 320 cities, with 753 branches. The bank has been consistently growing its loan book and earnings at over 30% for the last several quarters.

Key investment arguments

- ✍ Strong focus on retail loans (now 57% of net advances) and high proportion of low-cost funds (52% of total deposits) enables consistent growth of over 30% in core earnings.
- ✍ Management quality is rated as amongst the best.
- ✍ Net NPAs of 0.4%, despite being an aggressive lender, indicates superior risk management skills.
- ✍ Ability to raise capital at 4-5x book along with strong earnings visibility enables significant value accretion to existing owners.

Key investment risks

- ✍ High retail loan exposure could hurt banks profitability and increase NPA levels during economic downturn.

Recent developments

- ✍ The bank raised Rs.13.9b of equity by way of preferential allotment of 13.6m shares at a price of Rs1,013.5 to the parent HDFC Ltd.

Valuation and view

- ✍ Strong loan growth with greater concentration on the retail segment, high proportion of low cost deposits, high fee-income would enable HDFC Bank to maintain its earnings growth momentum.
- ✍ We expect earnings to grow by 34.2% in FY08 and 37% in FY09. The stock is trading at 19.6x FY09E EPS and 3x FY09E book value.
- ✍ We maintain **Buy** rating on the stock.

Sector view

- ✍ YTD loan growth of 25% and deposit growth of 23%
- ✍ Macro economic factors remain conducive for strong profitable growth for Indian banks
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

COMPARATIVE VALUATIONS

		HDFC BK	UTI BK	ICICI BK
P/E (x)	FY08E	26.8	25.1	25.0
	FY09E	19.6	18.3	18.7
P/BV (x)	FY08E	3.5	2.6	2.3
	FY09E	3.0	2.4	2.1
RoE (%)	FY08E	16.7	15.0	11.9
	FY09E	16.5	13.6	11.5
RoA (%)	FY08E	1.4	1.0	1.1
	FY09E	1.5	1.1	1.1

SHAREHOLDING PATTERN (%)

	MAR.07	DEC.06	MAR.06
Promoter	22.4	22.3	22.0
Domestic Inst	5.6	6.6	5.2
Foreign	51.5	52.1	53.6
Others	20.5	19.0	19.2

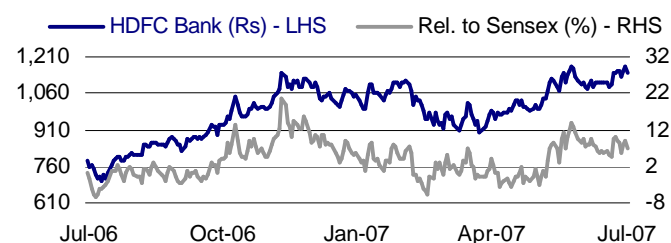
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	42.8	47.6	-10.1
FY09	58.6	60.2	-2.6

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,148	1,373	19.6	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007	2008E	2009E
Interest Income	30,935	44,753	68,890	96,747	129,374
Interest Expended	13,156	19,295	31,795	47,009	63,177
Net Interest Income	17,779	25,458	37,096	49,737	66,197
Change (%)	32.9	43.2	45.7	34.1	33.1
Other Income	4,633	8,788	12,751	17,675	23,134
Net Income	22,412	34,247	49,847	67,413	89,332
Operating Expenses	10,854	16,911	24,208	34,583	45,859
Operating Income	11,558	17,336	25,639	32,829	43,473
Change (%)	26.4	50.0	47.9	28.0	32.4
Other Provisions	1,762	4,776	7,309	10,289	12,595
PBT	9,796	12,559	18,330	22,540	30,877
Tax	3,140	3,830	6,912	7,213	9,881
PAT	6,656	8,729	11,419	15,328	20,997
Change (%)	30.6	31.2	30.8	34.2	37.0
Proposed Dividend	1,401	1,722	2,236	3,045	3,582

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007	2008E	2009E
Capital	3,099	3,131	3,194	3,582	3,582
Reserves & Surplus	42,104	49,865	61,138	115,390	132,196
Net Worth	45,203	52,996	64,332	118,972	135,778
Deposits	363,482	557,968	682,979	887,873	1,118,720
Borrowings	52,900	45,605	60,980	82,089	102,855
Other Liab & Provisions	52,645	78,495	104,065	135,285	175,870
Total Liabilities	514,229	735,064	912,356	1,224,218	1,533,223
Current Assets	44,740	69,190	91,539	119,468	135,147
Investments	193,438	283,888	305,648	412,625	515,781
Advances	255,663	350,613	469,448	633,755	811,206
Net Fixed Assets	7,083	8,551	9,667	11,500	12,500
Other Assets	13,306	22,823	36,055	46,871	58,589
Total Assets	514,229	735,064	912,356	1,224,218	1,533,223

KEY ASSUMPTIONS					
(%)					
Y/E MARCH	2005	2006	2007	2008E	2009E
Deposit Growth	19.5	53.5	22.4	30.0	26.0
Advances Growth	44.1	37.1	33.9	35.0	28.0
Investments Growth	0.5	46.8	7.7	35.0	25.0
Provision Coverage	86.2	69.1	69.2	79.9	79.2
Dividend per share	4.5	5.5	7.0	8.5	10.0

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006	2007	2008E	2009E
Spreads Analysis (%)					
Avg. Yield-Earn Assets	6.9	7.5	8.8	9.7	10.1
Avg. Cost-Int. Bear. Lial	3.6	3.9	4.9	5.7	6.0
Interest Spread	3.4	3.7	3.9	4.0	4.1
Net Interest Margin	4.0	4.3	4.8	5.0	5.2

Profitability Ratios (%)					
RoE	18.5	17.8	19.5	16.7	16.5
RoA	14	14	14	14	15
Int. Exp./Int. Earned	42.5	43.1	46.2	48.6	48.8
Other Income/Net Inc.	20.7	25.7	25.6	26.2	25.9

Efficiency Ratios (%)					
Op Exp/Net Income	48.4	49.4	48.6	51.3	51.3
Employee Cost/Op. Exp	25.5	28.8	32.1	31.4	32.7
Business per Emp. (Rs)	60.9	51.3	51.3	51.2	50.8
Net Profit per Empl. (Rs)	0.7	0.6	0.6	0.6	0.6

Y/E MARCH	2005	2006	2007	2008E	2009E
Asset Liability Profile (%)					
Advances/Deposit Ratio	70.3	62.8	68.7	71.4	72.5
Invest./Deposit Ratio	53.2	50.9	44.8	46.5	46.1
G-Sec/Investment Ratio	58.0	69.2	73.8	71.0	71.0
Gross NPAs to Advances	1.7	1.4	1.4	1.3	1.4
Net NPAs to Advances	0.2	0.4	0.4	0.3	0.3
CAR	12.7	11.4	13.1	13.4	11.5
Tier 1	8.9	8.6	8.6	10.5	9.2

VALUATION					
Book Value (Rs)	145.9	169.2	201.4	332.1	379.1
Price-BV (x)	7.9	6.8	5.7	3.5	3.0
Adjusted BV (Rs)	144.6	166.0	197.3	329.1	374.9
Price-ABV (x)	7.9	6.9	5.8	3.5	3.1
EPS (Rs)	21.5	27.9	35.8	42.8	58.6
EPS Growth	20.1	29.8	28.3	19.7	37.0
Price Earnings (x)	53.4	41.2	32.1	26.8	19.6
OPS (Rs)	37.3	55.4	80.3	91.7	121.4
Price-OP (x)	30.8	20.7	14.3	12.5	9.5

E: MOST Estimates

N O T E S



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HDFC Bank

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|---|----|
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| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
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