HDFC BANK

Edelweiss
Ideas create, values protect

Gathering momentum

December 18, 2009

Reuters : HDBK.BO Bloomberg : HDFCB IN

We recently met the management of HDFC Bank to discuss the bank's growth strategy and to understand the current business environment. Overall, HDFC Bank believes that it remains in a strong position, despite the short-term challenge of business growth witnessed by the industry.

Business growth to remain ahead of industry; margins at ~4%

Credit growth for HDFC Bank was at 15% YTD (11% Y-o-Y), well above the industry growth of ~5% (~13% Y-o-Y). The bank maintained that it remains well-positioned to grow above industry average growth for FY10 and maintain margins at ~4%. Both retail and corporate segments are growing, driven by improvement in business environment. Management has indicated that it is looking to build selectively longer duration portfolio in its book. The bank reaffirmed that factors such as - 1) surplus liquidity, giving borrowers an arbitrage to borrow cheaply through non-banking channels; 2) repayment by specific industries; 3) low inflation/low inventory environment; and 4) fill-up of capital by equity markets – have resulted in subdued credit growth for the industry.

Asset quality risks have peaked; provisions likely to decline

As mentioned in the previous two quarters, the bank believes that concerns of asset quality have significantly abated. It is witnessing lower NPA formations against FY09. Further, in the past one year, it has aggressively worked on Centurion Bank of Punjab's (CBoP) portfolio to bring the overall portfolio coverage to ~70%, as mandated by RBI.

Outlook and valuations: Gathering momentum; maintain 'HOLD'

Overall, the meeting gave us positive insight into credit growth for the bank, despite being disappointing in the near term for the sector. Going forward, we maintain that the quality of earnings will continue to improve strongly for the bank on the back of credit growth. We have maintained our numbers for FY10/11.

Post capital infusion, the bank has little concern for balance sheet growth and will work towards improving RoEs from near-term levels of ~16-17%. The stock is trading at rich valuations of 3.3x FY11E adjusted book and 21x FY11E earnings, justifying higher premium for its attractive business franchise. However, we see limited upside from current valuations and maintain '**HOLD'** on the stock. On relative basis, we rate it **'Sector Performer'**.

EDELWEISS 4D RATINGS

Absolute Rating	HOLD
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Overweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 1,664
52-week range (INR)	:	1,836 / 774
Share in issue (mn)	:	427.4
M cap (INR bn/USD mn)	:	712 / 15,205
Avg. Daily Vol. BSE ('000)	:	1,544.6

SHARE HOLDING PATTERN (%)

Promoters*	:	19.3
MFs, FIs & Banks	:	12.5
FIIs	:	28.2
Others	:	40.1
* *Promoters pledged shares (% of share in issue)*	:	*Nil*

Note: As of 30th September 2009

PRICE PERFORMANCE (%)

	Stock	Nifty	EW BFSI Index
1 month	3.1	(0.4)	(6.3)
3 months	17.5	1.5	3.3
12 months	81.9	70.7	84.3

Financials

Year to March	FY08	FY09	FY10E	FY11E
Revenues (INR mn)	75,110	107,118	124,153	143,756
Rev growth (%)	*50.0*	*42.6*	*15.9*	*15.8*
Net interest income (INR mn)	52,279	74,212	82,282	98,411
Net profit (INR mn)	15,902	22,449	29,831	34,756
Shares outstanding (mn)	354.4	425.4	451.6	451.6
Diluted EPS (INR)	44.9	52.8	66.1	77.0
EPS growth (%)	*25.5*	*17.6*	*25.2*	*16.5*
Diluted PE (x)	37.1	31.5	25.2	21.6
Price to book (x)	5.1	4.8	3.6	3.2
Price to PPOP (x)	16.7	14.8	12.3	10.2
ROAE (%)	17.7	17.2	16.8	15.6

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Marginal shift in asset book

In the corporate segment, the bank, which is mainly into working capital lending, is witnessing an increase in long-term proposals. For HDFC Bank, participation in the infrastructure segment, which has been the biggest consumer of credit for the banking sector, has been mainly through working capital loans to suppliers of the vertical. Given the current liability structure, the bank believes that it would be able to take a slightly higher duration corporate assets in its portfolio from current levels. It has indicated that going forward, it is willing to participate in a few of the long-term projects (infrastructure mainly in telecom, power and other CAPEX related investments), provided pricing of credit risk and duration is appropriate.

Table 1: Classification of loans according to nature of lending

(%)	FY05	FY06	FY07	FY08	FY09
Working capital loans	39.9	26.4	23.7	26.9	26.8
Term loans*	17.1	16.4	17.8	12.5	11.9
Retails loans	43.0	57.2	58.5	60.6	61.4

Working capital loans includes Bills/CC/OD and others. Difference in retail and working capital classified under term loans

Source: Company, Edelweiss research

In the retail segment, it has started witnessing net growth with the pace of run-off of CBoP's portfolio reducing, which was earlier offsetting disbursements made in the previous quarters. On the increase in mortgage in the past few quarters, the bank indicated that it is consciously taking some portion of the loans originated for HDFC under its existing arrangement, as it helps satisfying PSL requirements. It also stated that it is comfortable taking longer duration portfolios. In the unsecured portfolio, the bank is witnessing growth, but remains cautious on pace of growth. The bank believes that improvement in the underlying demand of specific products (like commercial vehicles) as well as increase in branch network (1,500 branches in H1FY10 against 760 in FY08) will deliver loan growth in the retail book. On competition, the bank believes that strong turnaround time gives it an edge that can protect its market share despite PSU and other private banks stepping up their lending.

Table 2: Break-up of retail loans

(%)	FY05	FY06	FY07	FY08	FY09	Q210
Auto loans	18.7	22.3	27.5	29.9	25.2	27.3
CV	19.5	19.0	16.3	15.4	13.0	12.6
Two wheeler	9.2	12.8	7.0	4.2	3.1	2.8
Personal loans	18.2	20.8	18.0	16.3	14.5	13.4
Credit cards	6.1	6.0	6.3	7.2	6.3	6.0
Business Banking	9.8	8.6	17.1	19.5	21.3	19.5
Housing					8.2	10.2
LAS	11.0	7.7	4.0	3.0	1.2	1.2
Other retail	7.5	2.8	3.7	4.5	7.2	7.0

Source: Company, Edelweiss research

The bank is still not looking at building an international book, and prefers looking to gain higher market share in the remittances business. It is meeting most of the foreign currency requirements through its current representative offices. We are maintaining our credit growth estimates for FY10 at 21% and FY11 at 25% and stable margins (calc.) for the bank at ~4.4%.

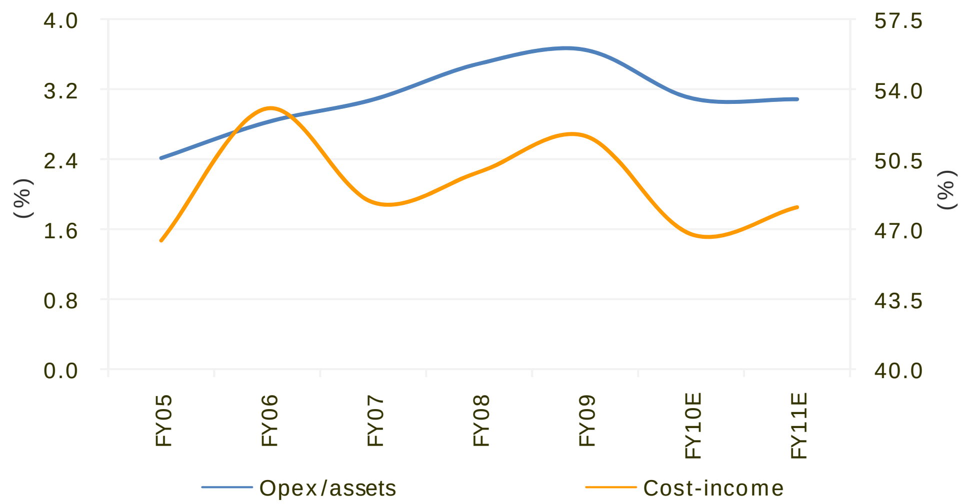
Chart 1: Lending yields of wholesale led to stable margins

Source: Company, Edelweiss research

- **Cost improvement ahead of expectations; synergies gaining traction**

Cost-income ratio, which had increased to ~56% during the time of merger, has declined significantly in the past few quarters. Productivity improvement expectation, a key rationale for the merger is coming well, and ahead of the banks estimates, leading to lower cost-income ratio. Experience from the CBoP acquisition has been positive, given the productivity improvement achieved in a relatively short period. Going forward, the bank believes that there is further scope to improve its productivity, mainly from CBoP's branches through a two-fold mechanism: new origination of assets/liabilities and cross-sell of the suite of HDFC Bank's products. On new branch expansion, the bank is looking to add ~200 branches yearly (FY10 target at ~1,650 branches). For FY10/11, we are keeping cost-income ratio at ~47% levels.

Chart 2: Cost-income ratio has fallen below 50%

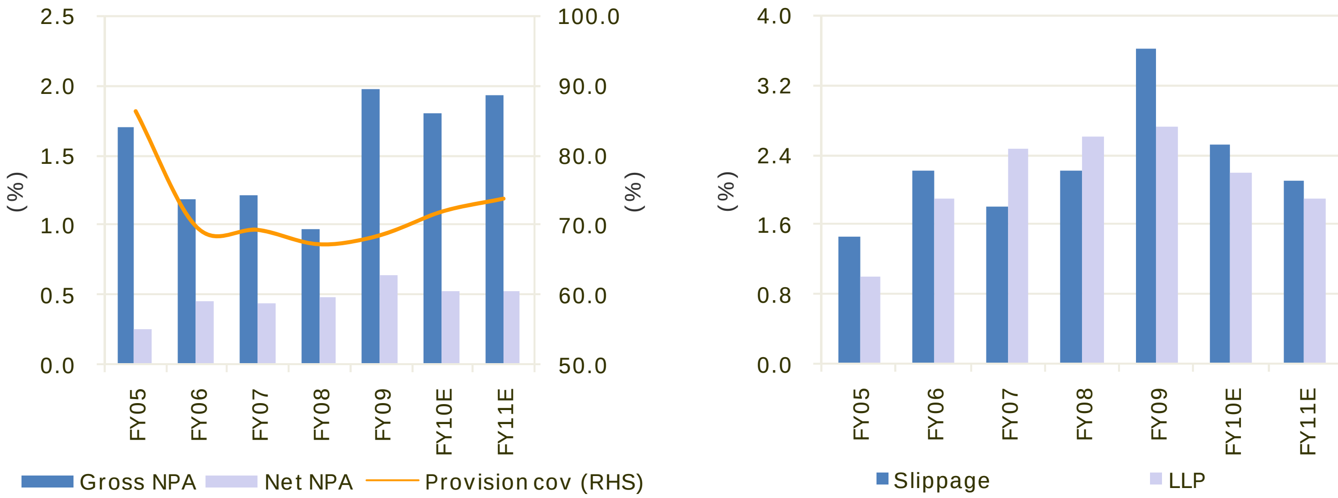


Source: Company, Edelweiss research

- **Asset quality risks have peaked; loan loss provisions likely to decline**

As mentioned in the previous two quarters, the bank believes that concerns of asset quality have significantly abated. It is witnessing lower NPA formations against FY09. Further, in the past one year, it has aggressively worked on the portfolio of CBoP to bring the overall portfolio coverage to ~70%, as mandated by RBI. CBoP portfolio will see a complete run-off by FY11 as some of the longer duration loans like personal loans still exist in the book. Overall, the bank believes that its loan loss provisions will gradually decline over the next few quarters. We are building loan loss provisions at 2% for FY10/11, similar to FY06 levels.

Chart 3: Asset quality risks have significantly reduced



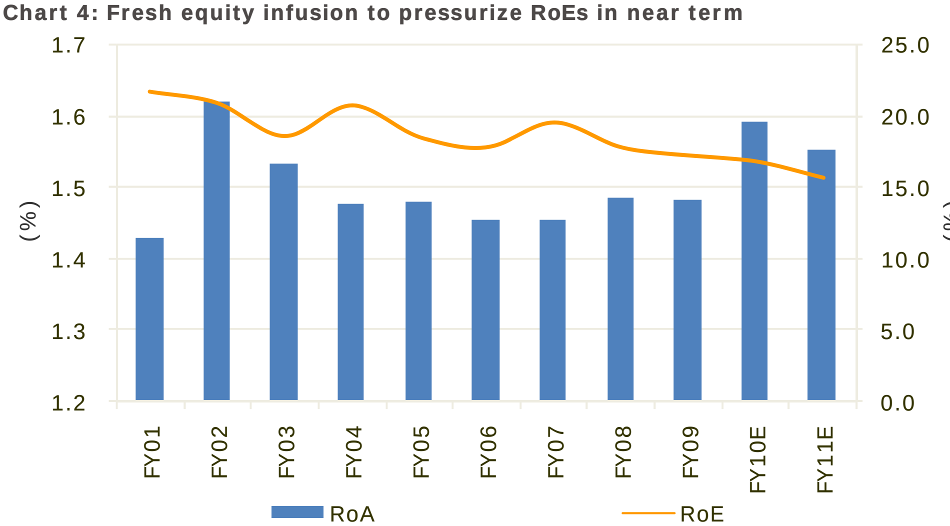
Source: Company, Edelweiss research

- ### Others

  There has been some pressure on retail third-party distribution income (contributes ~15-18% to fee and commission), mainly due to pricing pressure on the mutual fund income. However, management believes that over the next few quarters, volume growth should ease the pricing pressure. The bank has not made any significant changes to its wealth management team.

  The bank is adequately capitalized to fund credit growth for the next few years. The conversion of warrants of HDFC Ltd has resulted in tier-1 capital moving to ~12.5% which could result in lower RoE in the near term. The bank would continue to maintain RoA at ~1.3% levels.

Chart 4: Fresh equity infusion to pressurize RoEs in near term



Source: Edelweiss research

Company Description

HDFC Bank has a balance sheet size stands at INR 1,940 bn as on September 2009. It is amongst the leading private sector banks with a market cap over INR 700 bn. The key promoter, HDFC, holds 20% stake, and FIIs and public hold the balance. The distribution network has got a boost with merger with CBoP with 1506 branches and 3,500 ATMs in 528 cities. HDFC Bank is among the top three players in auto loans, personal loans, commercial vehicles, cash management, and supply chain management. It holds 3.7% share in deposits and 3.6% in loans in the industry among the leading players. The bank's strengths include its brand equity, professional management, distribution reach, high CASA, clean book, and focus on profitability.

Investment Theme

HDFC Bank has a track record of consistent growth in earnings and assets. Earnings have grown at a steady pace of 30% in the past few years. The bank enjoys best-in-class interest margins of ~4% on the back of more retail oriented franchise. Retail advances constitute 57% of its loan book. Even on the liability front, retail deposit (CASA) mix stands healthy of total deposits among the industry. We expect its loan book to grow at 24% CAGR over FY09-11E and CASA ratio to be sustained at these levels. Keeping asset quality healthy would be one of bank's key strengths. The bank continues to create higher loan loss provisions to maintain net NPA ratio at 0.5-0.7% of advances. With largely retail oriented book, we expect higher NPA accretion going forward and gross NPA to rise further to 2.2% by FY010E. With higher provision coverage, net NPAs are likely to be maintained at 0.5-0.7% levels. The merger with CBoP will provide a thrust to its liability franchise with 50% increase in network and CBoP retail concentration will complement HDFCB's loan book.

Key Risks

Higher-than-expected decline in CASA ratio and change in macro environment may impact cost of funds and consequently margins.

Higher then expected delinquencies due to the loan mix and also vulnerable to system-wide deterioration in the quality of retail assets is the key risk.

Valuations de-rating of the stock due to structural changes within the bank (like change in management etc.,).

Lower then expected asset growth.

Financial Statements

Income statement (INR mn)

Year to March	FY07	FY08	FY09	FY10E	FY11E
Interest income	66,690	101,150	163,323	165,562	195,535
Interest expenses	31,795	48,871	89,111	83,279	97,125
Net Interest income	34,896	52,279	74,212	82,282	98,411
Non interest income	15,162	22,832	32,906	41,871	45,345
- Fee & forex income	*14,827*	*19,976*	*30,559*	*36,372*	*43,646*
- Misc. income	*1,030*	*430*	*(1,520)*	*499*	*499*
- Investment profits	*(695)*	*2,425*	*3,867*	*5,000*	*1,200*
Net revenues	50,058	75,110	107,118	124,153	143,756
Operating expense	24,208	37,456	55,328	58,090	69,177
- Employee exp	7,769	13,014	22,382	23,510	28,501
- Other opex	16,439	24,443	32,946	34,580	40,676
Preprovision profit	25,850	37,654	51,790	66,064	74,579
Provisions	9,459	14,843	18,791	22,214	23,491
- Loan loss provisions	8,610	12,160	17,263	21,499	22,491
- Investment depreciation	211	0	0	715	1,000
- Other provisions	638	2,683	1,528	0	0
PBT	16,392	22,811	32,999	43,849	51,088
Taxes	4,977	6,909	10,549	14,018	16,332
PAT	11,415	15,902	22,449	29,831	34,756
Reported PAT	11,415	15,902	22,449	29,831	34,756
EPS (INR)	35.7	44.9	52.8	66.1	77.0
DPS (INR)	7.0	8.5	10.0	13.0	15.0
Payout ratio (%)	22.9	22.2	22.2	23.0	25.9

Growth ratios (%)

Year to March	FY07	FY08	FY09	FY10E	FY11E
NII growth	68.9	49.8	42.0	10.9	19.6
Fees growth	29.6	34.7	53.0	19.0	20.0
Opex growth	43.2	54.7	47.7	5.0	19.1
PPOP growth	71.2	32.7	36.0	27.4	20.2
PPP growth	72.5	45.7	37.5	27.6	12.9
Provisions growth	285.8	56.9	26.6	18.2	5.7
PAT growth	31.1	39.3	41.2	32.9	16.5

Operating ratios (%)

Year to March	FY07	FY08	FY09	FY10E	FY11E
Yield on advances	10.6	12.6	15.0	11.6	11.3
Yield on investments	8.0	8.5	8.7	6.9	6.8
Yield on assets	8.5	9.4	10.8	8.8	8.7
Net interest margins	4.4	4.9	4.9	4.4	4.4
Cost of funds	3.9	4.4	5.6	4.2	4.1
Cost of deposits	4.3	5.2	6.6	4.9	4.9
Cost of borrowings	9.1	7.2	10.3	9.6	9.2
Spread	4.6	5.1	5.2	4.6	4.6
Cost-income	48.4	49.9	51.7	46.8	48.1
Tax rate	30.4	30.3	32.0	32.0	32.0

Balance sheet **(INR mn)**

Year to March	FY07	FY08	FY09	FY10E	FY11E
Liabilities					
Equity capital	3,194	3,544	4,254	4,516	4,516
Reserves	61,138	111,428	142,210	205,001	230,737
Net worth	64,332	114,972	146,464	209,516	235,253
Sub bonds/pref cap	32,826	32,491	68,842	70,342	71,842
Deposits	682,979	1,007,686	1,428,116	1,592,372	2,022,120
Borrowings	28,154	45,949	26,858	27,867	30,043
Other liabilities	104,065	130,668	162,428	198,401	251,291
Total	**912,356**	**1,331,766**	**1,832,708**	**2,098,498**	**2,610,549**
Assets					
Loans	469,448	634,269	988,830	1,186,597	1,483,246
Investments					
Gilts	*225,449*	*316,662*	*521,578*	*534,691*	*656,705*
Others	*80,197*	*177,272*	*66,595*	*77,446*	*95,310*
Cash & equi	91,539	147,783	175,066	197,601	250,278
Fixed assets	9,667	11,751	17,067	18,260	18,741
Other assets	36,057	44,029	63,571	83,903	106,270
Total	**912,356**	**1,331,766**	**1,832,708**	**2,098,498**	**2,610,549**
Balance sheet ratios (%)					
Credit growth	25.8	28.2	44.7	20.6	25.0
Deposit growth	22.4	47.5	41.7	11.5	27.0
EA growth	31.1	36.4	41.3	23.8	19.6
SLR ratio	31.7	30.1	35.8	33.0	32.0
C-D ratio	79.6	69.1	70.6	76.4	75.2
Low-cost deposits	57.7	54.5	44.4	45.4	47.4
Gross NPA ratio	1.2	1.0	2.0	1.8	1.9
Net NPA ratio	0.4	0.5	0.6	0.5	0.5
Provision coverage	69.2	67.1	68.4	71.8	73.6
Incremental slippage	1.8	2.2	3.6	2.5	2.1
Net NPA / Equity	3.2	2.6	4.3	2.9	0.0
Capital adequacy	13.1	13.6	15.1	16.5	14.4
- Tier 1	8.6	10.3	10.2	12.1	10.8
Book value (INR)	201.4	324.4	344.3	464.0	521.0

Ratios

Year to March	FY07	FY08	FY09	FY10E	FY11E
ROA decomposition (%)					
Net interest income/Assets	4.4	4.9	4.9	4.4	4.4
Fees/Assets	2.0	1.9	1.9	2.0	2.0
Investment profits/Assets	(0.1)	0.2	0.3	0.3	0.1
Net revenues/Assets	6.4	7.0	7.1	6.6	6.4
Operating expense/Assets	(3.1)	(3.5)	(3.7)	(3.1)	(3.1)
Provisions/Assets	(1.2)	(1.4)	(1.2)	(1.2)	(1.0)
Taxes/Assets	(0.6)	(0.6)	(0.7)	(0.7)	(0.7)
Total costs/Assets	(4.9)	(5.5)	(5.6)	(5.0)	(4.9)
ROA	1.5	1.5	1.5	1.6	1.6
Equity/Assets	7.5	8.4	8.6	9.5	9.9
ROAE	19.5	17.7	17.2	16.8	15.6

Valuation metrics

Year to March	FY07	FY08	FY09	FY10E	FY11E
Diluted EPS	35.7	44.9	52.8	66.1	77.0
EPS growth (%)	*28.5*	*25.5*	*17.6*	*25.2*	*16.5*
Book value per share (INR)	201	324	344	464	521
Adjusted book value/share (INR)	197	318	334	454	509
Diluted P/E (x)	46.6	37.1	31.5	25.2	21.6
Price/ BV (x)	8.3	5.1	4.8	3.6	3.2
Price/ ABV (x)	8.4	5.2	5.0	3.7	3.3
Dividend yield (%)	*0.4*	*0.5*	*0.6*	*0.8*	*0.9*
Price to income (x)	16.5	13.1	11.4	10.5	8.9
Price to PPOP (x)	20.0	16.7	14.8	12.3	10.2
No of shares (mn)	319	354	425	452	452

RATING & INTERPRETATION

Company	Absolute reco	Relative reco	Relative risk
Federal Bank	Buy	SO	M
ING Vysya Bank	Buy	SO	H
LIC housing finance	Buy	SO	M
Oriental Bank Of Commerce	Buy	SO	H
Power Finance Corp	Buy	SP	L
South Indian Bank	Buy	SO	H
SREI Infrastructure Finance	Buy	SO	H
Syndicate Bank	Buy	SU	H
Union Bank Of India	Buy	SO	L
Yes Bank	Buy	SO	M
Axis Bank	Buy	SO	M
Allahabad Bank	Buy	SO	H

Company	Absolute reco	Relative reco	Relative risk
HDFC Bank	Hold	SP	L
ICICI Bank	Buy	SO	L
Kotak Mahindra Bank	Buy	SP	M
Punjab National Bank	Buy	SO	L
State Bank of India	Buy	SP	L
HDFC	Hold	SU	L
Indian Overseas Bank	Hold	SU	H
IDFC	Reduce	SU	M
Karnataka Bank	N R	N R	N R
Reliance Capital	Hold	SU	M
Shriram City Union Finance	Buy	SP	H

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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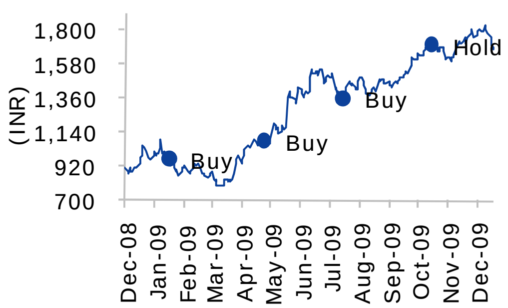
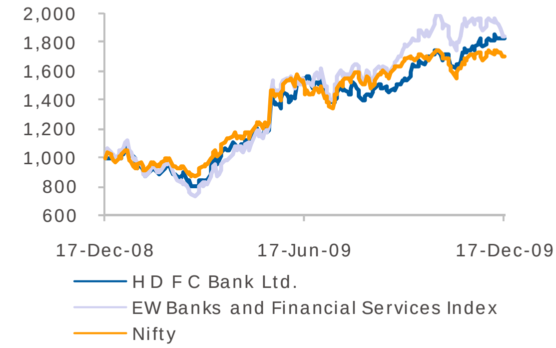
Coverage group(s) of stocks by primary analyst(s): Banking

Allahabad Bank, Axis Bank, Federal Bank, HDFC Bank, ICICI Bank, IOB, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

HDFC Bank



EW Indices



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	70	53	16	142

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	89	38	15

Recent Research

Date	Company	Title	Price (INR)	Recos
20-Nov-09	**ING Vysya Bank**	Stepping up the pace of growth; *Company Update*	307	Buy
31-Oct-09	**State Bank of India**	Margins improve, NPLs rise; *Result Update*	2,191	Buy
30-Oct-09	**Syndicate Bank**	Pressure on margins easing; *Result Update*	87	Buy

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