



## HDFC Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,631	HDFCB IN
	REUTERS CODE
S&P CNX: 3,942	HDBK.BO

11 January 2007

Neutral

Previous Recommendation: Neutral

Rs999

Equity Shares (m)	313.1
52-Week Range	1,150/620
1,6,12 Rel.Perf.(%)	-5/3/-11
M.Cap. (Rs b)	312.9
M.Cap. (US\$ b)	7.1

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)
3/06A	36,698	8,708	27.8	29.5	35.9	5.9	11.4	17.7	1.4	6.0
3/07E	52,008	11,407	36.4	31.0	27.4	5.0	11.0	19.8	1.3	5.1
3/08E	68,120	14,916	47.6	30.8	21.0	4.2	10.5	21.7	1.3	4.2

HDFC Bank's earnings grew by 31.6% YoY, in line with estimates. Margins improved to over 4%, while NII growth was 39% YoY in 3QFY07. Slowdown in other income during the quarter to 26% YoY was the surprise, as core fee income growth slowed down to 20% YoY. Business (deposits and core customer assets) growth has slowed down to 29% YoY in 3QFY07 from 37% YoY in 2QFY07 and 50% YoY in 1QFY07. The bank has added 48 new branches during the quarter. Asset quality has been maintained at 0.4% of customer assets.

- Business growth slows down, a conscious strategy since last couple of quarters
- NII growth at 38% YoY; margins improve to >4%
- Operating expenses increase by 35% led by 71% increase in staff expenses
- Provisions increase by 35% YoY, as retail assets grow fast

While we have no concerns regarding the growth prospects of the bank over the medium term, current valuations at 21x FY08E EPS and 4.2x FY08E BV of HDFC Bank are on the higher side and leave little room to expand. We expect HDFC Bank to report EPS of Rs36 in FY07 and Rs48 in FY08. The book value would be Rs199 (FY07) and Rs239 (FY08). We maintain **Neutral**.

### QUARTERLY PERFORMANCE

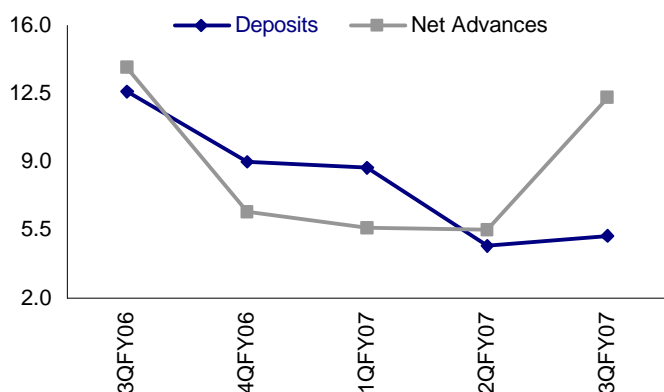
									(Rs Million)	
	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Interest Income	8,941	10,229	11,798	13,785	15,043	16,357	17,593	18,630	44,753	67,622
Interest Expense	3,704	4,108	5,092	6,391	6,867	7,901	8,307	8,741	19,295	31,815
<b>Net Interest Income</b>	<b>5,237</b>	<b>6,121</b>	<b>6,706</b>	<b>7,394</b>	<b>8,176</b>	<b>8,456</b>	<b>9,286</b>	<b>9,889</b>	<b>25,458</b>	<b>35,808</b>
Growth (%)	31.3	43.8	52.4	44.0	56.1	38.1	38.5	33.7	43.2	40.7
Other Income	2,636	2,602	2,961	3,042	3,508	3,977	3,733	4,982	11,240	16,200
<b>Net Income</b>	<b>7,872</b>	<b>8,723</b>	<b>9,667</b>	<b>10,436</b>	<b>11,684</b>	<b>12,433</b>	<b>13,019</b>	<b>14,871</b>	<b>36,698</b>	<b>52,008</b>
Growth (%)	55.3	59.1	50.9	42.2	48.4	42.5	34.7	42.5	51.1	41.7
Operating Expenses	3,580	4,016	4,491	4,823	5,527	5,791	6,050	6,843	16,911	24,212
<b>Operating Profit</b>	<b>4,292</b>	<b>4,706</b>	<b>5,176</b>	<b>5,612</b>	<b>6,157</b>	<b>6,642</b>	<b>6,969</b>	<b>8,028</b>	<b>19,787</b>	<b>27,796</b>
Provisions and Contingencies	1,659	1,806	1,972	1,816	2,639	3,057	2,664	3,140	7,252	11,500
<b>Profit Before Tax</b>	<b>2,634</b>	<b>2,900</b>	<b>3,205</b>	<b>3,796</b>	<b>3,518</b>	<b>3,585</b>	<b>4,305</b>	<b>4,888</b>	<b>12,535</b>	<b>16,296</b>
Provision for Taxes	799	904	961	1,164	1,125	955	1,349	1,459	3,827	4,889
<b>Net Profit</b>	<b>1,835</b>	<b>1,996</b>	<b>2,244</b>	<b>2,632</b>	<b>2,393</b>	<b>2,629</b>	<b>2,956</b>	<b>3,428</b>	<b>8,708</b>	<b>11,407</b>
Growth (%)	31.1	31.1	31.3	30.1	30.4	31.7	31.7	30.3	30.8	31.0
Cost to Income Ratio (%)	45.5	46.0	46.5	46.2	47.3	46.6	46.5	46.0	46.1	46.6
Interest Expense/Interest Income (%)	41.4	40.2	43.2	46.4	45.6	48.3	47.2	46.9	43.1	47.0
Other Income/Total Income (%)	33.5	29.8	30.6	29.1	30.0	32.0	28.7	33.5	30.6	31.1

E: MOST Estimates

**NII growth rate at 38%; margins maintained at 4%+**

NII growth was maintained at the 2QFY07 level of 38% YoY. On a sequential basis, NII growth was strong at 10% QoQ to Rs9.3b in 3QFY07 from 38% YoY and 3% QoQ growth reported in 2QFY07 owing to increased interest expenses during the quarter.

QOQ TREND IN NII (%)



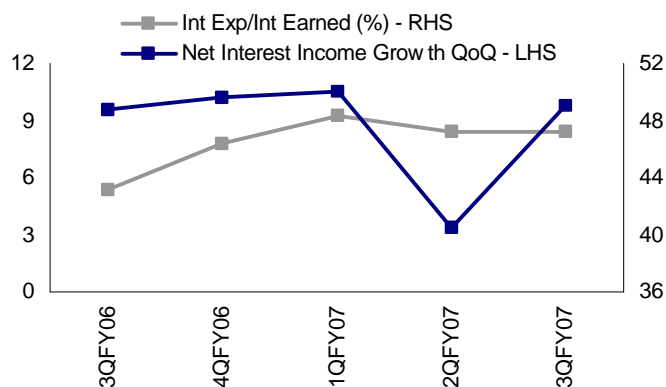
Source: Company/ Motilal Oswal Securities

With 280bp improvement in CASA QoQ, HDFC Bank’s margins improved marginally during the quarter and was above 4%. With CASA being at 55% and permission by the RBI to open new branches, we expect HDFC Bank to maintain margins in the forthcoming quarters.

**Other income growth slows down from historical levels**

While other income, ex-treasury growth was at 33% YoY in 3QFY07, driven by rising fee income growth (20% YoY) as well as other income, this growth rate has come off the pace of the last few quarters, wherein the growth in core other income was as high as 45%-50%. Treasury reported losses of Rs211m in 3QFY07, versus a loss of Rs6m in 3QFY06. The key contributors to fee income growth have been retail products such as credit cards, debit cards, third party distribution, POS terminals etc. The share of retail in fee-based income is maintained at 75%. As a percentage of assets, fee income constitutes 1.8% of assets.

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 net NPAs at 0.4% as at end-3QFY07. It has continued to make general provisions and holds specific general provisions for its standard customer assets that are higher than the regulatory requirements.

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

**Operating expenses up 35% led by 71% increase in staff expenses**

Operating expenses increased by 35% YoY led by 71% rise in staff expenses. Increase in staff expenses was on account of rising salaries and significant manpower addition since the last nine months. The bank has been recruiting heavily over the last few quarters in anticipation of newer branches and for generating fee based revenues.

**Branches – strong additions**

This is the first quarter, after almost more than a year, that HDFC Bank received approvals for new branch openings from the RBI. HDFC Bank opened 48 new branches in 3QFY07 and now has 583 branches spread across 263 cities and 1,471 ATMs. In fact, these branches were opened within 45 days after receiving approvals from the RBI.

**Capital adequacy at 12.8%**

The bank's capital adequacy is currently at 12.8%, with Tier-I at 8.4%. While implementation of Basel-2 norms could be positive, as it would release additional capital on retail loans, we believe that in order to sustain 30%-40% loan growth, the bank may require capital over the next 12-18 months. During 3QFY07, the bank has raised Rs4.8b of subordinated debt qualifying as upper Tier II capital, thereby improving core capital by 20bp QoQ.

**Maintain Neutral**

While we are not concerned regarding the growth prospects of the bank over the medium term, current valuations at 21x FY08E EPS and 4.2x FY08E BV of HDFC Bank leave little room to expand. We expect HDFC Bank to report EPS of Rs36 in FY07 and Rs48 in FY08. The book value would be Rs199 (FY07) and Rs239 (FY08). We maintain **Neutral**.

## 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 Rs897b. Rated as one of the best banks in India; it has a network of 583 branches in 263 cities. 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 52% of net advances) and high proportion of low-cost funds (55% 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 bank's profitability and increase NPA levels during an economic downturn.

#### COMPARATIVE VALUATIONS

		HDFC BK	ICICI BK	UTI BK
P/E (x)	FY07E	27.4	25.3	21.3
	FY08E	21.0	20.1	16.3
P/BV (x)	FY07E	5.0	3.3	4.0
	FY08E	4.2	2.9	3.3
RoE (%)	FY07E	19.8	13.5	20.1
	FY08E	21.7	15.3	22.0
RoA (%)	FY07E	1.3	1.1	1.1
	FY08E	1.3	1.0	1.1

#### SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoters	21.9	21.9	22.1
Domestic Institutions	7.0	6.0	6.4
FII's/FDIs	52.1	53.4	52.4
Others	19.0	18.7	19.2

### Recent developments

- ✍ HDFC Bank has raised its benchmark prime lending rate (BPLR) by 150bp to 13%, simultaneously it has also raised its deposit rates by 50bp-75bp across various maturities.

### 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 31% in FY07 and 30% in FY08. The stock is trading at 21x FY08E EPS and 4.2x FY08E book value.
- ✍ We maintain a **Neutral** rating on the stock.

### Sector view

- ✍ YTD loan growth of 30%, highest in the last 12 years.
- ✍ Volatility in interest rates would impact bond gains.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an Overweight stance on the sector.

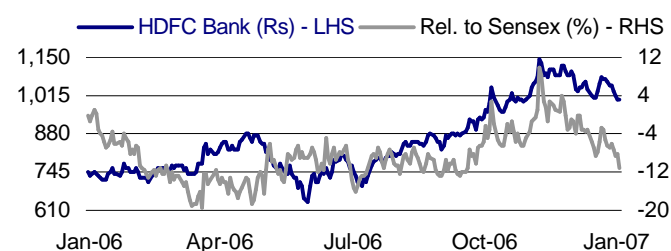
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	36.4	35.4	2.9
FY08	47.6	47.3	0.6

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
999	-	-	Neutral

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Interest Income	30,935	44,753	67,622	94,317	125,255
Interest Expended	13,156	19,295	31,815	46,397	63,381
<b>Net Interest Incom</b>	<b>17,779</b>	<b>25,458</b>	<b>35,808</b>	<b>47,920</b>	<b>61,874</b>
Change (%)	32.9	43.2	40.7	33.8	29.1
Other Income	6,513	11,240	16,200	20,200	25,363
<b>Net Income</b>	<b>24,293</b>	<b>36,698</b>	<b>52,008</b>	<b>68,120</b>	<b>87,237</b>
Operating Expenses	10,854	16,911	24,212	33,112	44,262
<b>Operating Income</b>	<b>13,439</b>	<b>19,787</b>	<b>27,796</b>	<b>35,008</b>	<b>42,975</b>
Change (%)	33.3	47.2	40.5	25.9	22.8
Other Provisions	3,643	7,249	11,500	13,700	15,100
<b>PBT</b>	<b>9,796</b>	<b>12,538</b>	<b>16,296</b>	<b>21,308</b>	<b>27,875</b>
Tax	3,140	3,830	4,889	6,392	8,363
<b>PAT</b>	<b>6,656</b>	<b>8,708</b>	<b>11,407</b>	<b>14,916</b>	<b>19,513</b>
Change (%)	30.6	30.8	31.0	30.8	30.8
Proposed Dividend	1,401	1,722	2,035	2,349	2,349

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Capital	3,099	3,131	3,131	3,131	3,131
Reserves & Surplus	42,104	49,865	59,237	71,804	88,968
<b>Net Worth</b>	<b>45,203</b>	<b>52,996</b>	<b>62,368</b>	<b>74,935</b>	<b>92,099</b>
<b>Deposits</b>	<b>363,482</b>	<b>557,968</b>	<b>736,518</b>	<b>957,473</b>	<b>1,196,842</b>
Borrowings	52,900	45,605	62,145	83,152	110,563
Other Liab & Provisor	52,645	78,495	102,043	132,656	172,453
<b>Total Liabilities</b>	<b>514,229</b>	<b>735,064</b>	<b>963,074</b>	<b>1,248,217</b>	<b>1,571,957</b>
Current Assets	44,740	69,190	80,747	99,111	117,853
Investments	193,438	283,888	374,732	468,415	585,519
<b>Advances</b>	<b>255,663</b>	<b>350,613</b>	<b>483,845</b>	<b>653,191</b>	<b>836,085</b>
Net Fixed Assets	7,083	8,551	9,750	11,500	12,500
Other Assets	13,306	22,823	14,000	16,000	20,000
<b>Total Assets</b>	<b>514,229</b>	<b>735,064</b>	<b>963,074</b>	<b>1,248,217</b>	<b>1,571,957</b>

KEY ASSUMPTIONS					
(%)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Deposit Growth	19.5	53.5	32.0	30.0	25.0
Advances Growth	44.1	37.1	38.0	35.0	28.0
Investments Growth	0.5	46.8	32.0	25.0	25.0
CRR	5.0	5.0	5.0	5.0	5.0
Provision Coverage	86.2	69.1	77.0	84.6	83.0
Dividend per share	4.5	5.5	6.5	7.5	7.5

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
<b>Spreads Analysis (%)</b>					
Avg. Yield-Earning As:	6.9	7.5	8.3	8.8	9.1
Avg. Cost - Int. Bear. L	3.6	3.9	4.7	5.2	5.5
Interest Spread	3.4	3.7	3.6	3.7	3.6
Net Interest Margin	4.0	4.3	4.4	4.5	4.5

Profitability Ratios (%)					
RoE	18.5	17.7	19.8	21.7	23.4
RoA	14	14	13	13	14
Int. Expended/Int. Earn	42.5	43.1	47.0	49.2	50.6
Other Income/Net Incc	26.8	30.6	31.1	29.7	29.1

Efficiency Ratios (%)					
Op Exp/Net Income	44.7	46.1	46.6	48.6	50.7
Employee Cost/Op.Ex	25.5	28.8	32.5	32.8	33.9
Business per Empl. (R	60.9	51.3	53.0	54.2	53.7
Net Profit per Empl. (F	0.7	0.6	0.6	0.6	0.6

Asset Liability Profile (%)					
Advances/Deposit Ra	70.3	62.8	65.7	68.2	69.9
Invest./Deposit Ratio	53.2	50.9	50.9	48.9	48.9
G-Sec/Investment Rat	58.0	69.2	52.4	41.9	33.5
Gross NPAs to Advdar	17	14	15	15	17
Net NPAs to Advance	0.2	0.4	0.3	0.2	0.3
CAR	12.7	11.4	11.0	10.5	10.5
Tier 1	8.9	8.6	7.5	6.8	6.8

VALUATION					
Book Value (Rs)	145.9	169.2	199.2	239.3	294.1
Price-BV (x)	6.9	5.9	5.0	4.2	3.4
Adjusted BV (Rs)	144.6	166.0	195.7	236.1	289.2
Price-ABV (x)	6.9	6.0	5.1	4.2	3.5
EPS (Rs)	21.5	27.8	36.4	47.6	62.3
EPS Growth	20.1	29.5	31.0	30.8	30.8
Price Earnings (x)	46.5	35.9	27.4	21.0	16.0
OPS (Rs)	43.4	63.2	88.8	111.8	137.2
Price-OP (x)	23.0	15.8	11.3	8.9	7.3

E: MOST Estimates



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**HDFC Bank**

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|---|----|
| 1. Analyst ownership of the stock                       | No |
| 2. Group/Directors ownership of the stock               | No |
| 3. Broking relationship with company covered            | No |
| 4. Investment Banking relationship with company covered | No |

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