Update

SECTOR: BANKING

HDFC Bank

STOCK INFO.		BLOOMBERG
BSE Sensex: 12,938		HDFCB IN
		REUTERS CODE
S&P CNX: 3,745		HDBK.BO
Equity Shares (m)	313.1	
52-Week Range	1,150/620	
1,6,12 Rel.Perf.(%)	-3/-1/2	
M.Cap. (Rs b)	292.0	
M.Cap. (US$ b)	6.6	

28 February 2007 **Buy**

Previous Recommendation: Neutral Rs933

YEAR END	NET INCOME (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	CAR (%)	ROAE (%)	ROAA (%)	P/ABV (X)
3/06A	36,698	8,708	27.8	29.5	33.5	5.5	11.4	17.7	1.4	5.6
3/07E	52,008	11,407	36.4	31.0	25.6	4.7	11.0	19.8	1.3	4.8
3/08E	68,120	14,916	47.6	30.8	19.6	3.9	10.5	21.9	1.3	4.0
3/09E	87,237	19,513	62.3	30.8	15.0	3.2	10.5	23.6	1.4	3.3

Best placed bank in a rising rate scenario: With deposit cost on a rise, we believe that banks with strong retail franchise, higher proportion of CASA deposits and thus lower cost of funds would be best placed. HDFC Bank emerges as our preferred bank on all these fronts. HDFC bank's cost of funds remains relatively insulated as more than half of its deposits are contracted at fixed rates (CASA deposits) of ~2.5%- 2.8%.

Margins set to improve: HDFC Bank has the highest CASA ratio in the industry (55% in 3QFY07). While this will result in lower rise in deposit cost, it has been hiking loan rates consistently in line with other banks. With yields likely to rise faster than cost of funds for HDFC Bank, we expect margins to improve marginally going forward.

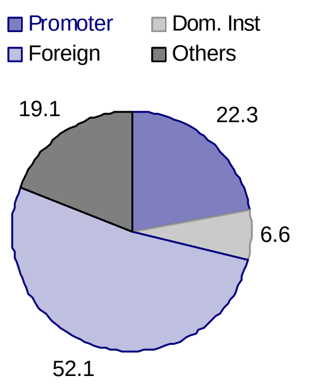
New branch additions - would ensure growth: After a long gap of one year due to regulatory issues, HDFC Bank has added 48 new branches during 3QFY07. We expect similar number of additions during 4QFY07. As the regulatory impediment on branch expansion is removed, concerns on long term growth has reduced significantly.

Asset quality - low risks, already carrying adequate provisions: HDFC bank's risk assessment and management systems are time tested. HDFC Bank follows a more strict policy for making provisioning towards specific NPAs when compared to requirements laid down by RBI. We believe that net NPAs will remain ~0.3-0.5%.

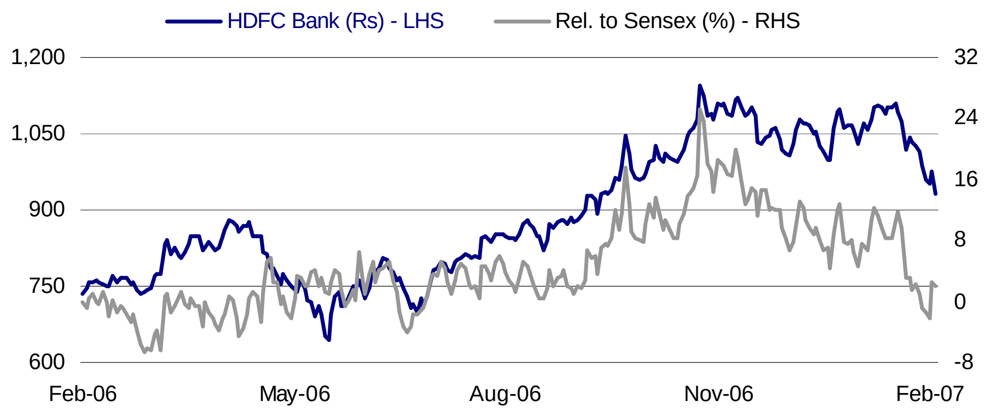
Equity dilution in FY08 - likely to be book accretive: We expect capital raising in FY08/FY09, which will again happen at a signficant premium to book. Based on the past experiences, such dilution can improve the book value by almost 20%. While RoE will also decline subsequently, we believe that strong growth rates would ensure rise in ratios thereon. Our current estimates factor an RoE of 24% in FY09 (without dilution).

Valuations reasonable on FY09 basis, Upgrade to 'Buy': The stock has declined 18% from its high and now trades at PE of 15x and P/B of 3.2x on FY09. We upgrade our recommendation to **Buy** with a price target of Rs1,162.

SHAREHOLDING PATTERN DEC-06 (%)



STOCK PERFORMANCE (1 YEAR)



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Best placed bank in the current scenario – Would see margin improvement

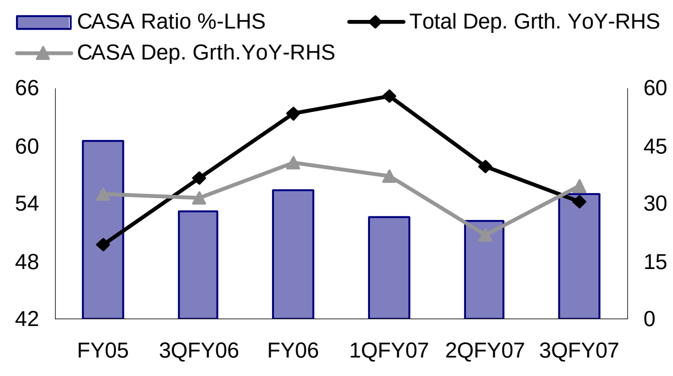
With deposit costs on a rise, we believe that banks with strong retail franchise, higher proportion of CASA deposits and thus lower cost of funds would be best placed. HDFC Bank emerges as our most preferred bank on all these fronts.

HDFC Bank's business model is superior on both assets and liabilities. It has lower cost of funds due to strong retail deposit franchise and higher yields on advances due to higher proportion of retail advances. The CASA ratio of 55% against the banking sector average of ~35% is its key strength. Also in its term deposits, the dominant portion comes from retail customers, where rates are lower compared to bulk deposits. Though interest rates on term deposits have increased by 200-300bp in last 12 months, HDFC bank's cost of funds remains relatively insulated (increased by 80-90 bps YoY only) as its CASA deposits have a blended cost of 2.5%- 2.8%, which is fixed.

Consistently maintaining high CASA deposits

HDFC Bank has the highest CASA ratio in the industry. The bank has a network of 583 branches, strong technology capabilities, focus on capital markets and strong established brand name. These factors have enabled it to maintain the highest CASA deposits in the system. In fact over the last 5 quarters, despite no new branches, HDFC Bank has maintained its CASA deposits over 50%. A high CASA proportion means that the increase in cost of deposits would be the lowest as compared to other banks in the system.

TREND IN CASA DEPOSITS QOQ



Source: Company/ Motilal Oswal Securities

Yields have increased in line with the market

While deposits cost increases would be slow, HDFC Bank has hiked loan rates consistently in line with the markets. However as most of the loans are fixed in nature (6m-24m), increases in yields is likely to be a consistent feature for the bank every quarter.

INDICATIVE YIELDS AND INCREASE IN LOAN RATES OVER LAST ONE YEAR

RETAIL LOANS	% RISE IN (YOY) LENDING RATE	CURRENT LENDING RATE%
Auto	2-3	13-13.5
CVs	2-3	12-14
2Ws	2-4	18-20
Personal loans	2-4	15-18
Loans against securities	2-3	14-18
Credit cards	-	18-36

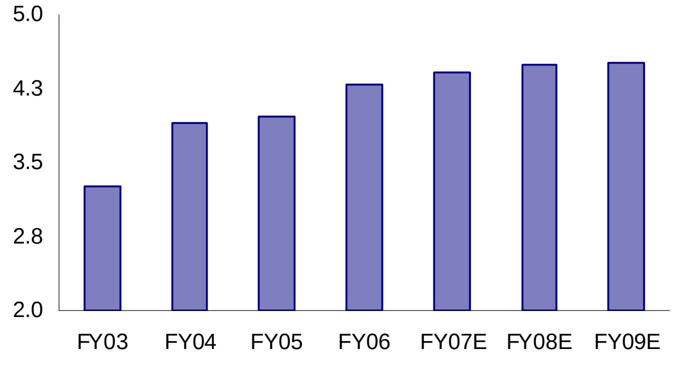
Source: Company/ Motilal Oswal Securities

… Thus margins set to improve

The blend of low cost deposits and higher yields enables the bank to earn one of the highest NIMs of 4% in the industry, which we expect to increase marginally in the current scenario. On the corporate loans, the bank is focused on working capital requirements, thereby avoiding any asset liability mismatches. With yields likely to rise faster than cost of funds for HDFC Bank, we expect margins to improve by ~10bp in FY08.

Unlike other banks, most of the lending for HDFC Bank is fixed in nature and any increase in PLR does not have any immediate impact on yields on existing loans. Thus, the improvement in yield for the bank is likely to be on a consistent basis over the next few quarters as old loans mature and new loans generate higher yields.

TREND IN NIMS FROM FY04-09 (%)



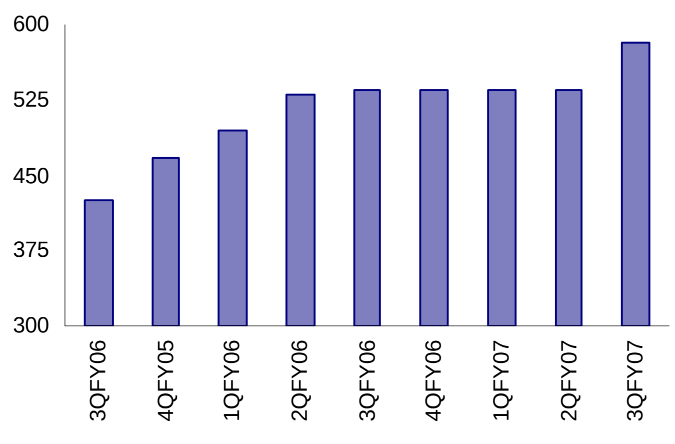
Source: Company/ Motilal Oswal Securities

New branch additions – would ensure rowth

HDFC Bank was unable to expand its branch network for a full year starting 3QFY06 on account of regulatory prohibitions. Also the bank was barred from opening fresh depository accounts during this period.

In our view, the bank's success in creating a core liability franchise is its strong branch network across India and its ability to generate higher business from these branches. Thus, in our view, a prolonged delay to its branch expansion was a serious threat to its successful business model. Nevertheless, throughout during this period management was commendably successful in keeping its core CASA ratio above 50% (and thus retain the cost advantage) by more efficiently utilizing its existing branch network. However, during 3QFY07, RBI has permitted the bank to open new branches, albeit more in semi-urban and rural areas. Bank's readiness in terms of infrastructure and manpower was once again highlighted when it opened 48 branches within mere 45 days. Bank's branch network as on December 2006 stands at 583 spread across 263 cities. It is likely to add another 50 branches in 4Q.

BRANCH NETWORK EXPANSION (NOS)



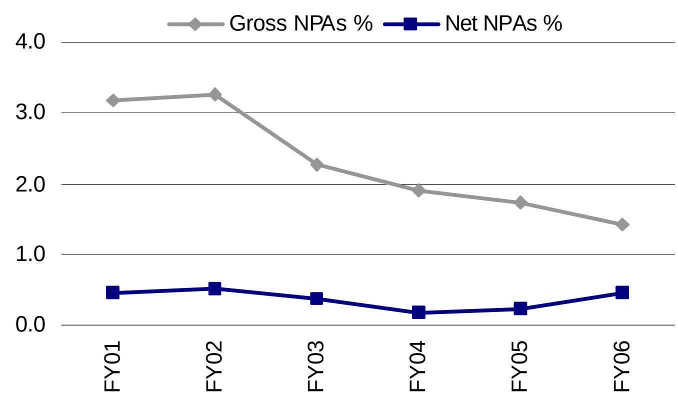
Source: Company/ Motilal Oswal Securities

While we believe that the management is serious about increasing its branch network substantially over the next couple of fiscals, new branch licences however would be subject to RBI approval.

Asset quality – low risks, already carrying adequate provisions

Despite above industry growth in advances, HDFC Bank maintains one of the best asset quality. Its Net NPAs have consistently remained below 0.5% over the last five years. The gross NPA also remain contained at 2-3%, amongst the best in the industry. This asset quality has been maintained despite the change in loan mix towards high yielding and riskier assets (personal loans, credit cards, etc), as the bank has stepped up its provisioning over the last 2-3 fiscals.

TREND IN GROSS NPAS AND NET NPAS



Source: Company/ Motilal Oswal Securities

Bank's advances profile constitutes mainly of retail loans (excluding home loans) and working capital finance for corporates. The inherent characteristics of these loans are lower average ticket size (but large volume), shorter duration as compared to term lending. These characteristics reduce the overall credit risk of the portfolio. Again HDFC bank's risk assessment and management systems are time tested. and conservative. In our view, the bank is likely to be the least affected in case asset quality deterioration becomes an industry wide phenomenon on back of runaway credit growth observed for last 3 years and steep increase in interest rates.

Conservative provisioning policies

HDFC Bank follows a stringent policy for making provisioning towards specific NPAs as compared to requirements laid down by RBI. On an average, it makes

100% provision for unsecured NPAs within 180 days of recognition; where RBI allows 20% provision for one year period. Such aggressive provisioning policies of the bank further improve the quality of the assets for the bank.

Recently RBI has stepped up provisioning on standard assets for certain asset classes like real estate, capital market, credit cards from 1% to 2%. The bank anticipates a total incremental provision of close to Rs1.5b on this account. This higher provision is likely to be booked in 4QFY07, unless RBI allows it to be staggered.

Equity dilution in FY08 – likely to be book accretive

HDFC Bank's CAR stands at 12.8% as of December 2006 (of which Tier I is 8.4%). While we believe that HDFC Bank can maintain its current growth rates without requiring capital, as it still has room to raise perpetual bonds, the management has intended that it might look at raising capital over the next 12-18 months. We believe that the intention of the bank would be to maintain Tier I in excess of 7.5-8%. Further as new loans for the bank carry higher risk weights (Personal loans, credit cards, capital markets all carry higher than 100% risk weight)

Capital raising is value accretive

HDFC Bank has always raised capital at a substantial premium to its book value in the past. In January 2005 the bank raised equity through ADS at a price ~5.2x its Dec 04 BV. Assuming bank makes a further 7% equity dilution in January 2008 and at a price of Rs 1,152 (5x Dec 07E BV); the issue would be significantly book value additive for the bank. The book value post issue would rise to Rs297 and Rs347 against pre-diltuion book value of Rs237 and Rs291 in FY08E and FY09E BV respectively. The ROE would be around 18% for FY08 and FY09 with this dilution.

IMPACT OF POSSIBLE EQUITY DILUTION

	PRE DILUTION		POST DILUTION	
	FY08E	FY09E	FY08E	FY09E
EPS (Rs)	47.6	62.3	44.5	58.2
BVPS (Rs)	236.9	290.5	296.8	346.8
P/E (x)	19.5	14.9	20.9	16.0
P/BV (x)	3.9	3.2	3.1	2.7
ROE (%)	21.9	23.6	18.5	18.1

Source: Motilal Oswal Securities

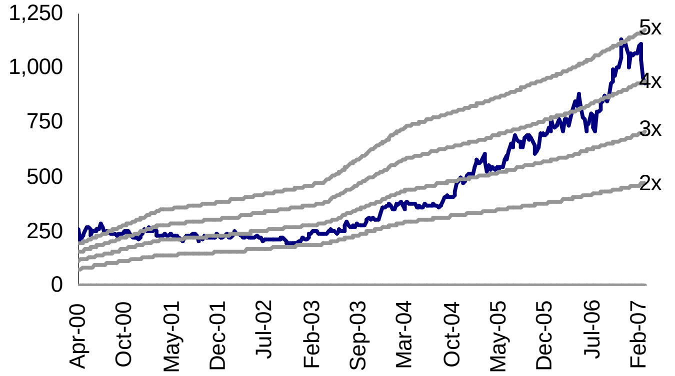
Valuations attractive; Upgrade to 'Buy'

We had downgraded the stock in October 2006, due to concerns on near to medium term growth as new branches were not allowed. Since than, RBI has issued new branch licenses to the bank, which shall mean balance sheet growth is likely to remain robust. Further the sharp rise in the overall interest rates in the system would result in better earnings for HDFC Bank.

We base our valuations now on FY09 earnings. HDFC Bank trades at a P/BV of 3.2x FY09E. On a P/E basis it is quoting at 15x. We expect a CAGR growth in PAT of 31% to be maintained during FY07-FY09 and ROE of 24% in FY09. If HDFC Bank were to raise capital by diluting 7% of its equity in FY08 at 5x its historic book (similar to its previous dilution), then its BV shall expand to Rs347 in FY09 and P/BV reduces to 2.7x FY09E.

The stock has always enjoyed a valuation premium for the bank's dynamic and proactive management and we believe the same should continue in future as well. We upgrade our recommendation from **'Neutral'** to **'Buy'** with a one year price target of Rs.1,162 (4x FY09E BV and 18.6x FY09E EPS, implying an upside of 25%).

P/B BAND



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
Net Interest Incom	**17,779**	**25,458**	**35,808**	**47,920**	**61,874**
Change (%)	*32.9*	*43.2*	*40.7*	*33.8*	*29.1*
Other Income	6,513	11,240	16,200	20,200	25,363
Net Income	**24,293**	**36,698**	**52,008**	**68,120**	**87,237**
Operating Expenses	10,854	16,911	24,212	33,112	44,262
Operating Income	**13,439**	**19,787**	**27,796**	**35,008**	**42,975**
Change (%)	*33.3*	*47.2*	*40.5*	*25.9*	*22.8*
Other Provisions	3,643	7,249	11,500	13,700	15,100
PBT	**9,796**	**12,538**	**16,296**	**21,308**	**27,875**
Tax	3,140	3,830	4,889	6,392	8,363
PAT	**6,656**	**8,708**	**11,407**	**14,916**	**19,513**
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	58,891	71,059	87,824
Net Worth	**45,203**	**52,996**	**62,022**	**74,190**	**90,955**
Deposits	**363,482**	**557,968**	**736,518**	**957,473**	**1,196,842**
Borrowings	52,900	45,605	62,145	83,152	110,563
Other Liab & Provisior	52,645	78,495	102,043	132,656	172,453
Total Liabilities	**514,229**	**735,064**	**963,074**	**1,248,217**	**1,571,957**
Current Assets	44,740	69,190	80,747	99,111	117,853
Investments	193,438	283,888	374,732	468,415	585,519
Advances	**255,663**	**350,613**	**483,845**	**653,191**	**836,085**
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
Total Assets	**514,229**	**735,064**	**963,074**	**1,248,217**	**1,571,957**

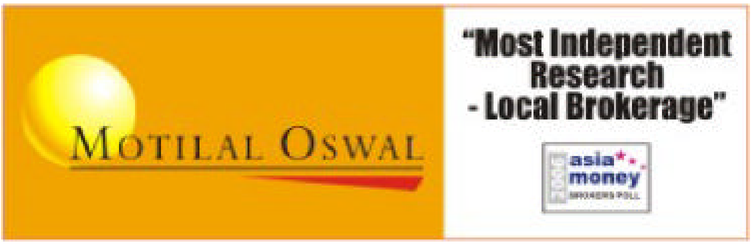
KEY ASSUMPTIONS					(%)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Deposit Growth	19.5	53.5	32.0	30.0	25.0
Advances Growth	44.1	37.1	38.0	35.0	28.0
Investments Growth	0.5	46.8	32.0	25.0	25.0
Provision Coverage	86.2	69.1	77.0	84.6	83.0
Dividend per share	4.5	5.5	6.5	7.5	7.5

E: MOSt Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Spreads Analysis (%)					
Avg. Yield-Earn Asset	6.9	7.5	8.3	8.8	9.1
Avg. Cost-Int. Bear. Li	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	21.9	23.6
RoA	1.4	1.4	1.3	1.3	1.4
Int. Exp./Int. Earned	42.5	43.1	47.0	49.2	50.6
Other Income/Net Inc.	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 Emp. (Rs	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 Advar	1.7	1.4	1.5	1.5	1.7
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*	*8.0*	*7.4*	*7.0*

VALUATION					
Book Value (Rs)	145.9	169.2	198.1	236.9	290.5
Price-BV (x)	6.4	5.5	4.7	3.9	3.2
Adjusted BV (Rs)	144.6	166.0	194.6	233.7	285.5
Price-ABV (x)	6.5	5.6	4.8	4.0	3.3
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)	43.4	33.5	25.6	19.6	15.0
OPS (Rs)	43.4	63.2	88.8	111.8	137.2
Price-OP (x)	21.5	14.8	10.5	8.3	6.8

E: MOSt Estimates



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Disclosure of Interest Statement	HDFC Bank
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