Prabhudas Lilladher

HDFC Bank

Merger benefits to accrue, going forward

Meeting Update

August 25, 2008

Rating	**Outperformer**
Price	Rs1,208
Target Price	Rs1,500
Implied Upside	24.2%
Sensex	14,450

(Prices as on August 25, 2008)

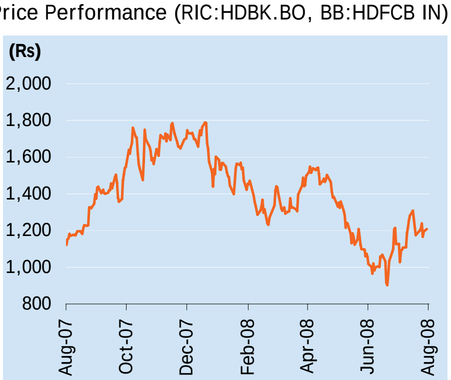
Trading Data	
Market Cap. (Rs bn)	513.0
Shares o/s (m)	424.6
Free Float	80.6%
3M Avg. Daily Vol ('000)	243.7
3M Avg. Daily Value (Rs m)	275.0

Major Shareholders	
Promoters	19.4%
Foreign	28.0%
Domestic Inst.	26.8%
Public & Others	25.8%

Stock Performance

(%)	1M	6M	12M
Absolute	7.2	(15.1)	9.7
Relative	6.0	3.0	9.6

Price Performance (RIC:HDBK.BO, BB:HDFCB IN)



Source: Bloomberg

- **Merger costs on the higher side, long-term benefits to add value:** Merger integration process at HDFC Bank with erstwhile Centurion Bank of Punjab (eCBoP) is on full swing. Employees of eCBoP are being trained, while the systems integration is expected to be completed by CY09. Despite HDFC Bank's fundamentals being far superior to eCBoP, the deal valued eCBoP at 15% premium to HDFC Bank, primarily because of its under-utilized branch network. HDFC bank has significant management bandwidth; the bank has proven in the past that they are capable of making such mergers profitable in the long run.

- **Brief outlook on the sector:** The banking and financial services space has remained under pressure over the past few months mainly due to escalating inflation (latest WPI at 12.6%), primarily driven by higher commodity prices. As a result, RBI has tightened its monetary policy actions giving rise to higher lending and deposit rates. Moderation in credit growth, higher MTM provisions on investment portfolio and risks to higher deterioration in asset quality levels have given rise to earnings risk for the banks in FY09. We would be keenly watching the core earnings performance of banks in Q2FY09, as the impact of higher lending and deposit rates on banks margins will come to the fore.

- **Outlook and valuation:** We believe that the merger, though expensive on valuations, is likely to be positive in the long term. However, there is an execution risk especially in the current economic scenario. At the CMP of Rs1,195, the stock is quoting at 16.0x FY10E EPS, 2.3x FY10E BV and 2.4x FY10E ABV. We maintain our Outperformer rating for HDFC Bank with a price target of Rs1,500.

Key financials (Rs m)	FY07	FY08	FY09*	FY10*
Net interest income	34,685	58,945	78,397	105,837
Growth (%)	*36.2*	*47.3*	*33.0*	*35.0*
Operating profit	25,639	41,747	57,611	77,775
PAT	11,415	17,482	23,567	32,953
EPS (Rs)	35.7	41.4	60.9	77.0
Growth (%)	*28.3*	*16.0*	*47.1*	*26.4*
Net DPS (Rs)	8.2	8.3	9.3	10.3

Source: Company Data; PL Research

Profitability & valuation	FY07	FY08	FY09*	FY10*
NIM (%)	*4.2*	*4.3*	*4.0*	*4.1*
RoAE (%)	*19.5*	*16.3*	*14.6*	*15.2*
RoAA (%)	*1.4*	*1.3*	*1.1*	*1.2*
P / BV (x)	6.0	3.7	3.2	2.4
P / ABV (x)	6.2	3.9	3.3	2.4
PE (x)	33.8	29.2	21.5	16.2
Net dividend yield (%)	*0.7*	*0.7*	*0.8*	*0.9*

Source: Company Data; PL Research
** merged with HDFC Bank effective appointed date 1st April 2008 but effective merger date is 23rd May 2008.*

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Merger related highlights:

All the employees of CBoP have been assigned their new roles in the merged entity and the training processes are underway to bring them at par with HFDC Bank standards.

All systems will be integrated with HDFC Bank platform, i.e. Flexcube. Treasury has already been integrated with the same, while both wholesale banking and retail banking will be fully integrated by October'08 and December'08, respectively.

Synergies of the merger is likely to flow over the next 12-18 months, as the bank has added around 400 CBoP branches to its existing 750 branches. However, the addition to the balance sheet size is to the tune of 15-20%. Hence, going forward, the bank expects to improve the productivity of the eCBoP branches, which will help in a robust revenue growth, improvement in CASA and fee income. Simultaneously bring down the cost to income ratio at ~52-53% levels from the current 56% reported in Q1FY09.

Why CBoP branches remained under-utilized?

Aggressive growth and two back-to-back mergers (Bank of Punjab and Lord Krishna Bank) had reduced the productivity to some extent. The bank lacked the product offerings essential to induce customers to maintain higher CASA levels and generate fee income. Also, as compared to other private sector peers, the bank has a lower brand value.

How could things change post merger?

According to the management, eCBoP could not fully leverage its potential due to a weaker brand image and limited product offering, as compared to HDFC Bank. The bank expects to overcome this short coming by providing an array of HDFC Bank products (advisory, wealth management, insurance etc.) and in turn generating higher revenues for the bank.

No asset quality stress witnessed on standalone book:

Although at the system level the retail asset portfolio has been under stress, HDFC Bank has not witnessed any severe stress on its loans. All the losses are within the bank's expectations and it has taken all the corrective actions required to cut down on such loans and address the over-leveraged customers. The bank mainly targets salaried customers in its retail personal loan portfolio, in which the expected loss rate is 3-4%; this is well within the bank's internal estimates. In the credit cards business, on an incremental basis 70-80% of the customer base is internal customers, giving the bank better information regarding their financial position which assists in controlling delinquencies. Current delinquencies are within the bank's expected levels on a portfolio basis. The bank has increased its credit control standards and has adopted innovative steps to identify trends in payment patterns to avoid future losses.

Adopting innovative steps to safeguard future losses

The bank regularly conducts stress testing on its credit portfolios. Over leveraging by customers (single person borrowing from 2-3 different banks) has been one of the main problems for the industry in the small ticket personal loan segment. Hence, the bank with the help of Credit Information Bureau India Limited (CIBIL), has tried to address this issue and take corrective action if needed by informing the collection agents on time.

Some pain likely on eCBoP portfolio

The two wheeler and personal loan segments have been badly hit. Although eCBoP had stopped originating fresh loans post December 2007, there is a portfolio amounting to Rs.20-25bn to run off in the next 12-18 months and is likely to witness deterioration. The bank had taken a hit of Rs.6.5-7bn during Q1FY09 adjusted through reserves, 70% of which is on account of realigning provisioning levels of eCBoP with HDFC Bank's own standards and remaining 30% for merger-related issues and re-branding activities.

Commercial real estate exposure requires a different approach:

In its latest annual report, the bank has reported Rs.59bn as commercial real estate, as on March 2008 (equivalent to 9.3% of FY08 advances). However, real estate developer (only with top corporates) exposure is much lower at ~Rs.10-15bn. Any advance granted against security of office premises, commercial mall and shops etc. and loans to hotels and hospitals also qualify as commercial real estate. However, the cash flows against which financing is done are dependent on the business and not land prices. Hence the loans carry substantially lower risks as compared to normal real estate loans.

RBI tightening not over yet, interest rate risk remains a concern:

The bank has a policy of not carrying excess SLR. Of the SLR book, 85% is in the HTM category with duration of 2.5-3yrs whereas the AFS portfolio duration is ~1yr. However, the loss in MTM will be compensated to some extent by higher interest on investments, going forward.

RoE's to pick up, going forward:

As the benefits of the merger start to contribute in terms of higher earnings from eCBoP branches, the ROE's are likely to pick up in FY10 at ~16.9%. We believe that post the preferential allotment to HDFC bank in December 2009, RoE is likely to remain suppressed. However, the bank would not be required to raise any further equity capital at least till FY11.

Update on forex derivative and MTM cases

No new cases have come up, however, some courts have allowed the banks to continue the recovery process while the case is still under litigation. The number of cases under litigation on a merged basis is in single digits. Post recent appreciation in dollar against other global currencies, the MTM losses have declined significantly.

Steady state growth of 25-30% - achievable:

The bank believes that a 25 to 30% advances and deposit growth is achievable, despite the slowdown. Earlier retail advances grew at a faster pace than wholesale advances. Currently, demand from retail has moderated while that of corporate remains healthy. Hence, on a blended basis, the steady state growth rate of 25-30% is achievable without sacrificing quality.

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Underperformer** (UP)	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			
Not Rated (NR)	:	No specific call on the stock	**Under Review** (UR)	:	Rating likely to change shortly