

HDFC Bank

Asian Banks

HDFCB IN - INR1,089

17 October, 2008

Company Rating:
IN LINE

Second Quarter Earnings

Sector Ranking:
Marketweight

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Steady as she goes

HDFC Bank's 2Q FY09 (3M to 30 September) net income of INR5.28bn came in 1.5% ahead of our estimate of INR5.19bn (CNBC estimate was INR5.15bn). PPOP, at INR11.2bn, was 5% below our estimate of INR11.8 bn. As 2Q08 numbers are taken at the standalone level, it would be incorrect to compare 2Q09 results (which are for the merged entity, HDFC Bank and Centurion Bank of Punjab – Centurion Bank of Punjab [CBOP] whose merger became effective on 23 May, 2008) with the prior period. **With 1H earnings coming in at 45% of the full-year estimate, we do not see any case for revising our estimates.**

- **Margins lower on a sequential comparison.** While HDFC Bank appears to have done well to stem its funding costs, lower loan yields (down 80bp QoQ to 12.3%) have led to NIMs contracting 18bp QoQ to 4.39%. We believe this may be a part of an intentional strategy to shift focus to lower risk assets in a tighter credit environment.
- **Liquidity advantage exploited in a tighter funding environment.** Despite the significant surge in systemic deposit rates, HDFC Bank's liquid asset profile provided it with the flexibility to fund its loan growth, as opposed to boosting higher-cost deposits to the greater detriment of margins. That said, with loan deposit ratios rising to 76%, HDFC Bank has lost much of its liquidity advantage.
- **Marginal rise in delinquency ratios.** One of our prime concerns about the merger with CBOP was related to negative surprises on the NPL front. However, the bank has negotiated this fairly well, with gross and net NPLs on a merged basis rising a mere 30bp to 1.6% and 20bp to 0.6%, respectively. That said, we remain vigilant, CBOP's gross delinquencies were as high as 3.7% in December 2007 and we had envisaged a merged delinquency ratio of 2.2% as at March 2008.
- **CASA ratios sequentially constant at 44%.** With over 500 branch additions, distribution reach is a positive. Nevertheless, HDFC Bank appears to be struggling to push up its current account-savings account (CASA) ratio. We believe further CASA gains are critical in order for HDFC Bank to reap gains from synergies.
- **Valuations not low enough to call a buy.** On the back of the recent de-rating, we warming to the story, although we maintain our In Line rating as the stock's valuation, at 2.8x FY09e P/B, is not cheap and the probability of a further macro-led de-rating is still high.

Fundamental data for HDFC Bank (price as at close on 16 October)

Financial data for HDFC Bank (Price as at close on 16 October)									
	Net income (INRmn)	EPS (INR)	P/E (x)	BVPS (INR)	P/BV (x)	Dividend (INR)	Yield (%)	ROA (%)	ROE (%)
March 2006	8,816	27.62	39.4	170	6.4	5.50	0.5%	1.41%	17.90%
March 2007	11,510	34.93	31.2	203	5.4	7.00	0.6%	1.40%	19.51%
March 2008	15,951	45.50	23.9	326	3.3	8.94	0.8%	1.42%	17.72%
March 2009e	21,580	50.55	21.5	393	2.8	9.72	0.9%	1.27%	14.34%
March 2010e	29,499	60.72	17.9	492	2.2	11.86	1.1%	1.27%	14.13%
Price (INR):	1,089	Shares outstanding (mn): 471.9					Market cap (USDmn): 10,536		
Normalised ROE			Firm value				P/E-based valuation		
NIM (on average assets)	4.65%	Mar-09e Tier 1 capital ratio			9.0%	Fair P/E (x)		17.2	
Non-IR/revenues	28.2%	Excess capital per share (INR)			49	12M fwd. EPS (INR)		53.3	
Costs/income	-53.1%	Cost of capital			13.9%	Fair value (INR)		915	
Operating ROA	3.10%	Long-term growth			12.5%	Implied value of growth			
LLP/loans	-1.95%	Fair P/B (x)			2.84	12M fwd EPS (INR)		53	
Net ROAA	1.36%	Adj. NAV (INR)			445	Capitalised value (INR)		595	
Equity/assets	8.18%	Value of operations (INR)			1,265	Value of growth (INR)		494	
Normalised ROE	16.6%	Total value (INR)			1,315	Attrib. to growth		45.4%	

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Figure 1: Quarterly financials

Balance sheet (INRmn)	06/07	09/07	12/07	03/08	06/08	09/08
Cash and balances with the RBI	84,717	120,273	91,379	125,532	158,138	152,556
Interbank assets	36,314	18,241	42,778	22,252	27,012	21,197
Investments	351,654	402,890	417,369	493,935	456,849	441,952
Loans and advances	538,393	622,780	713,868	634,269	967,969	1,022,223
Fixed assets	10,436	10,545	10,651	11,751	14,982	15,590
Other assets	35,439	40,720	38,350	44,027	61,037	64,132
Total assets	1,056,953	1,215,450	1,314,395	1,331,770	1,685,987	1,717,649
Deposits	816,045	910,686	993,870	1,007,690	1,309,176	1,337,805
Borrowings	27,751	48,125	32,717	44,789	66,635	61,539
Subordinated debt	32,826	32,464	32,421	32,491	35,260	35,653
Other	99,362	115,298	141,804	131,828	176,924	143,941
Total liabilities	975,983	1,106,572	1,200,811	1,216,798	1,552,808	1,578,938
Total shareholders' equity	80,969	108,878	113,584	114,972	133,179	138,711
Income statement (INRmn)	06/07	09/07	12/07	03/08	06/08	09/08
Net interest income	10,422	11,627	14,376	16,421	17,235	18,665
Other income	5,158	4,824	6,789	5,493	5,934	6,431
Total revenue	15,581	16,451	21,165	21,914	23,169	25,096
Operating costs	(7,744)	(8,184)	(10,501)	(11,027)	(12,894)	(13,867)
Pre-provision operating profit	7,837	8,267	10,664	10,887	10,275	11,229
Loan loss provisions	(2,997)	(2,732)	(3,501)	(2,930)	(3,244)	(3,373)
Other provisions	(74)	(162)	(730)	(1,721)	(201)	(87)
Pre-tax profit	4,766	5,373	6,433	6,236	6,830	7,769
Income tax expense	(1,553)	(1,688)	(2,139)	(1,525)	(2,187)	(2,488)
After-tax profit	3,212	3,685	4,294	4,711	4,643	5,280
NIM analysis	06/07	09/07	12/07	03/08	06/08	09/08
Loan yield	11.54%	11.28%	11.18%	11.92%	13.16%	12.30%
Total asset yield	8.64%	8.32%	8.62%	8.94%	9.60%	9.38%
Funding cost	-5.35%	-5.14%	-5.03%	-4.90%	-6.08%	-5.97%
Asset – liability spread	3.29%	3.18%	3.59%	4.03%	3.52%	3.41%
DuPont analysis	06/07	09/07	12/07	03/08	06/08	09/08
NIR/average assets	4.23%	4.09%	4.55%	4.96%	4.57%	4.39%
Non-IR/average assets	2.10%	1.70%	2.15%	1.66%	1.57%	1.51%
Non-IR/total revenue	33.1%	29.3%	32.1%	25.1%	25.6%	25.6%
Total revenue/average assets	6.33%	5.79%	6.69%	6.63%	6.14%	5.90%
Cost/income	-49.7%	-49.7%	-49.6%	-50.3%	-55.7%	-55.3%
Cost/average assets	-3.15%	-2.88%	-3.32%	-3.33%	-3.42%	-3.26%
Pre-provision ROAA	3.18%	2.91%	3.37%	3.29%	2.72%	2.64%
Loan loss provisions/average loans	-2.38%	-1.88%	-2.10%	-1.74%	-1.62%	-1.36%
Loans/assets	51.2%	51.1%	52.8%	50.9%	53.1%	58.5%
Other provisions/assets	-0.03%	-0.06%	-0.23%	-0.52%	-0.05%	-0.02%
Pre-tax ROAA	1.94%	1.89%	2.03%	1.89%	1.81%	1.83%
Tax rate	-32.6%	-31.4%	-33.2%	-24.5%	-32.0%	-32.0%
ROAA	1.30%	1.30%	1.36%	1.42%	1.23%	1.24%
Average equity/average assets	7.38%	8.35%	8.79%	8.64%	8.22%	7.99%
ROAE	17.7%	15.5%	15.4%	16.5%	15.0%	15.5%
Balance sheet ratios	06/07	09/07	12/07	03/08	06/08	09/08
Loans/deposits	66.0%	68.4%	71.8%	62.9%	73.9%	76.4%
Investments/assets	33.3%	33.1%	31.8%	37.1%	27.1%	25.7%
Loans/assets	50.9%	51.2%	54.3%	47.6%	57.4%	59.5%
Customer deposits/liabilities	83.6%	82.3%	82.8%	82.8%	84.3%	84.7%

Source: Company data, FPKc

Figure 2: Deviation analysis

INRmn	2Q FY09e	2Q FY09a	Deviation (%)
NII	19,251	18,665	-3.0
Other income	5,968	6,431	7.8
Total income	25,219	25,096	-0.5
Operating profit	11,853	11,229	-5.3
Provisions	4,425	3,460	-21.8
PBT	7,428	7,769	4.6
PAT	5,199	5,280	1.6

Source: Company data, FPKe

Figure 3: Annual financial summary (year-end 31 March)

Balance sheet (INRmn)	2006	2007	YoY	2008e	YoY	2009e	YoY	2010e	YoY
Net customer loans	348,998	469,448	35%	634,269	35%	1,020,050	61%	1,333,494	31%
Loans loss reserves	5,378	7,988	49%	13,685	71%	22,282	63%	33,426	50%
NPL	5,089	6,578	29%	15,411	134%	19,688	28%	35,005	78%
Gross loans	354,376	477,436	35%	647,954	36%	1,042,332	61%	1,366,920	31%
Investments	283,907	305,670	8%	492,880	61%	825,018	67%	1,031,273	25%
Other earning assets	69,424	90,734	31%	148,280	63%	165,004	11%	206,255	25%
Total earning assets	707,706	873,840	23%	1,289,114	48%	2,032,354	58%	2,604,447	28%
Average earning assets = (A)	603,084	790,773	31%	1,081,477	37%	1,660,734	54%	2,318,401	40%
Total assets	736,229	913,083	24%	1,331,931	46%	2,062,831	55%	2,578,497	25%
Interbank funding	28,585	26,154	-9%	44,789	71%	69,357	55%	86,696	25%
Customer deposits	557,471	682,643	22%	1,006,314	47%	1,546,909	54%	1,933,636	25%
Long-term debt	17,020	32,826	93%	32,491	-1%	50,314	55%	62,892	25%
Total interest-bearing liabilities	603,076	741,623	23%	1,083,593	46%	1,666,580	54%	2,083,224	25%
Average interest bearing liabilities = (B)	509,759	672,349	32%	912,608	36%	1,375,086	51%	1,874,902	36%
Average assets	624,507	824,656	32%	1,122,507	36%	1,697,381	51%	2,320,664	37%
Shareholders' equity	53,273	64,704	21%	115,351	78%	185,629	61%	232,036	25%
Average common equity	49,238	58,988	20%	90,027	53%	150,490	67%	208,833	39%
Average risk-weighted assets	507,443	671,497	32%	907,650	35%	1,494,766	65%	2,877,492	93%
Income statement (INRmn)	2006	2007	YoY	2008e	YoY	2009e	YoY	2010e	YoY
Margins (% of earning assets)	4.22%	4.38%		4.84%		4.87%		4.73%	
Earning assets/assets	97%	96%		96%		98%		100%	
NIM	4.08%	4.20%		4.66%		4.76%		4.73%	
Interest earned	44,753	66,462	49%	101,170	52%	159,116	57%	214,524	35%
Interest expense	(19,292)	(31,793)	65%	(48,874)	54%	(78,313)	60%	(104,816)	34%
Net interest income	25,461	34,669	36%	52,297	51%	80,802	55%	109,709	36%
Total non-interest revenues	11,556	15,773	36%	23,758	51%	32,321	36%	42,786	32%
Fee income	10,774	13,543	26%	18,299	35%	21,924	20%	27,356	25%
FX/trading gains	473	1,219	158%	5,127	320%	4,374	-15%	6,344	45%
Other operating income	309	1,010	227%	332	-67%	6,024	1717%	9,087	51%
Total operating revenues	37,017	50,441	36%	76,054	51%	113,123	49%	152,495	35%
Operating costs	(17,148)	(24,740)	44%	(38,264)	55%	(61,087)	60%	(80,822)	32%
Operating profit	19,870	25,702	29%	37,791	47%	52,037	38%	71,673	38%
Loan loss provisions	(4,796)	(8,610)	80%	(12,160)	41%	(17,905)	47%	(24,944)	39%
Other provisions	(2,455)	(642)	-74%	(2,689)	319%	(2,686)	0%	(3,742)	39%
Pre-tax profit	12,619	16,450	30%	22,942	39%	31,446	37%	42,987	37%
Tax	(3,860)	(5,016)	30%	(7,020)	40%	(9,906)	41%	(13,541)	37%
Minorities/preference dividends	57	75	31%	29	-62%	39	35%	53	37%
Attributable net income	8,816	11,510	31%	15,951	39%	21,580	35%	29,499	37%
Per share data	2006	2007	YoY	2008e	YoY	2009e	YoY	2010e	YoY
EPS – diluted (INR)	27.62	34.93	26%	45.50	30%	50.55	11%	60.72	20%
Dividend (INR)	5.50	7.00	27%	8.94	28%	9.72	9%	11.86	22%
Payout ratio	19.9%	20.0%		19.7%		19.2%		19.5%	
BVPS (INR)	170.1	202.6	19%	325.5	61%	393.4	21%	491.76	25%
Average shares outstanding – diluted (mn)	321.9	331.3	3%	351.9	6%	428.1	22%	486.9	14%
Year-end shares outstanding (mn)	313.1	319.4	2%	354.3	11%	471.9	33%	471.9	0%
DuPont analysis	2006	2007		2008e		2009e		2010e	
NII/average assets	4.08%	4.20%		4.66%		4.76%		4.73%	
Non-IR/average assets	1.85%	1.91%		2.12%		1.90%		1.84%	
Non-IR/total revenue	31.2%	31.3%		31.2%		28.6%		28.1%	
Total revenue/average assets	5.93%	6.12%		6.78%		6.66%		6.57%	
Costs/income	-46.3%	-49.0%		-50.3%		-54.0%		-53.0%	
Costs/average assets	-2.75%	-3.00%		-3.41%		-3.60%		-3.48%	
Operating ROAA	3.18%	3.12%		3.37%		3.07%		3.09%	
LLP/loans	-1.59%	-2.10%		-2.20%		-2.15%		-2.15%	
Loans/assets	48.4%	49.7%		49.2%		49.1%		50.0%	
Other inc. provs	-0.39%	-0.08%		-0.24%		-0.16%		-0.16%	
Pre-tax ROAA	2.02%	1.99%		2.04%		1.85%		1.85%	
Tax	-30.6%	-30.5%		-30.6%		-31.5%		-31.5%	
Minority & preferred dividends	0.01%	0.01%		0.00%		0.00%		0.00%	
ROA	1.41%	1.40%		1.42%		1.27%		1.27%	
RoRWA	1.74%	1.71%		1.76%		1.44%		1.03%	
Equity/assets	7.9%	7.2%		8.0%		8.9%		9.0%	
ROE	17.9%	19.5%		17.7%		14.3%		14.1%	
Balance sheet gearing	2006	2007		2008e		2009e		2010e	
Loans/deposits	63.6%	69.9%		64.4%		67.4%		70.7%	
Investment/assets	38.6%	33.5%		37.0%		40.0%		40.0%	
Loans/assets	48.1%	52.3%		48.6%		50.5%		53.0%	
Customer deposits/liabilities	81.6%	80.5%		82.7%		82.4%		82.4%	
Long-term debt/liabilities	2.5%	3.9%		2.7%		2.7%		2.7%	
Asset quality/capital	2006	2007		2008e		2009e		2010e	
Loan loss reserves/loans	1.5%	1.7%		2.1%		2.1%		2.4%	
Non-performing loan ratio	1.3%	1.3%		2.2%		1.7%		1.8%	
Coverage of NPLs	105.7%	121.4%		88.8%		113.2%		95.5%	
Growth in NPLs	15.9%	29.3%		134.3%		27.8%		28.9%	
Tier 1 ratio	8.6%	8.6%		10.3%		9.0%		6.9%	
Total CAR	11.4%	13.1%		13.6%		11.6%		10.6%	

Source: Company data, FPK

Disclosure information

Global rating system

Outperform (OP)	We expect the stock to outperform its sector over the next 12 months
In Line (IL)	We expect the stock to perform in line with its sector over the next 12 months
Underperform (UP)	We expect the stock to underperform its sector over the next 12 months

Global sector ranking

Overweight (OW)	We expect the sector to outperform the relevant market index over the next 12 months
Marketweight (MW)	We expect the sector to perform in line with the relevant market index over the next 12 months
Underweight (UW)	We expect the sector to underperform the relevant market index over the next 12 months

FPK disclosure information

HDFC Bank

Investment banking

- Neither FPK nor its affiliates intends to seek compensation for financial services from this company during the next three months.
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- Neither FPK nor its affiliates managed or co-managed a public offering of the securities of this company during the past 12 months.
- Neither FPK nor its affiliates received compensation for financial services from this company during the past 12 months.

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Distribution of ratings

	%	With which FPK has had corporate involvement in the last 12 months (%)
Outperform	36.8	2.2
In Line	49.5	2.6
Underperform	13.8	0.2

Valuation methodology

Asia ex-Japan banks sector

Our core valuation methodology is derived from a discounted cash flow. We first take out any capital in excess of an 8% Tier 1 ratio and value this at 1x. We then calculate the value of operations, which we derive based on the relationship between ROE, cost of equity and long-term growth. The sum of the excess capital and the value of operations is our fair value estimate. We also look at earnings momentum indicators and historical trading multiples.

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- Previous rating change in the last 12 months: 22 January, 2008 – In Line to Outperform; 25 February, 2008 – Outperform to In Line.
- This material has not been disclosed to the issuer prior to dissemination.
- This report was prepared by analyst Rajagopal Ramanathan.