

## Earnings slowing down

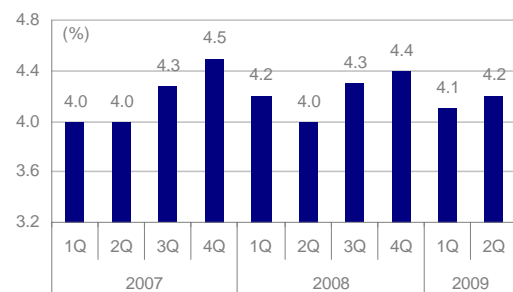
HDFC Bank reported a healthy 43% YoY growth in 2QFY09 net profit, in line with expectations. Adjusted for CBOP merger w.e.f. 1 April 2008, net profit grew 29% YoY. While key ratios like NIM, fee income/assets and NPL ratios remain healthy, profitability ratios ROA/ROE have declined from last year. Deposit growth has moderated more than loan growth and LDR has risen to 76%. We expect slower earnings growth of 19% CAGR during FY08-10, compared to 28% during the previous three years and also expect peak ROE at 17%. Despite its expensive valuations of 2.4x FY10ii book, the stock has been relatively resilient and we expect it to continue outperforming its peers and the broader market, in the current environment of flight to safety. ADD.

**Higher LDR is a cause for concern:** Loan growth was 34% YoY (on a like-to-like basis), but deposits grew by only 21% YoY. Consequently, loan/deposit ratio rose from 63% in end-FY08 to 74% in 1QFY09 and further to 76.4% in 2QFY09. This is well above the system average LDR of 74% and is a cause for concern in the current environment, in which banks want to reduce their dependence on market borrowings. The LDR is likely to come down in future quarters, which would put pressure on the NIM.

**No material deterioration in key ratios:** NIMs expanded by 10bps QoQ to 4.2% despite a slight drop in CASA and due to higher LDR. CASA declined to 44% of deposits (from 54.5% in end-FY08), which is still much higher than other banks. Cost/income ratio at 55% is higher compared to pre-merger level of 50% in FY08, but we expect it to decline gradually.

**Gross NPLs went up by 11% QoQ:** NPL coverage ratio dropped to 65% from 67% in the previous quarter. GNPL ratio at 1.6% and NNPL ratio of 0.6% were also slightly higher compared to the previous quarter. However, the bulk of the rise has come from the erstwhile Centurion Bank of Punjab's portfolio (primarily retail and SME) of ~Rs130bn, as credit losses in HDFC Bank's standalone portfolio remain within tolerable limits.

### Rising net interest margins



Source: Company, IIFL Research

### Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Op income (Rs m)	49,847	75,110	100,919	132,296	165,945
Net profit (Rs m)	11,415	15,902	21,566	28,444	37,018
EPS (Rs)	35.7	44.9	50.8	63.1	82.1
Growth (%)	28.5	25.5	13.2	24.2	30.1
PER (x)	30.6	24.4	21.5	17.3	13.3
Dividend yield (%)	0.6	0.8	0.8	0.9	0.9
Price/Book (x)	5.4	3.4	3.2	2.4	2.1
ROA (%)	1.4	1.4	1.3	1.3	1.4
ROE (%)	19.5	17.7	16.5	16.3	17.0
CAR (%)	13.1	13.6	11.0	11.8	11.0

Price as at close of business on 16 October 2008

12-mth Target price (Rs) 1265 (16%)

Market cap (US\$ m) 9,515

52Wk High/Low (Rs) 1825/890

Diluted o/s shares (m) 425

Daily volume (US\$ m) 52.6

Dividend yield FY08ii (%) 0.7

Free float (%) 80.6

#### Shareholding pattern (%)

HDFC 19.4

FII's 48.1

Domestic MFs/Insurance cos 19.9

Others 12.6

#### Price performance (%)

1M 3M 1Y

HDFC Bank -11.1 21.0 -27.5

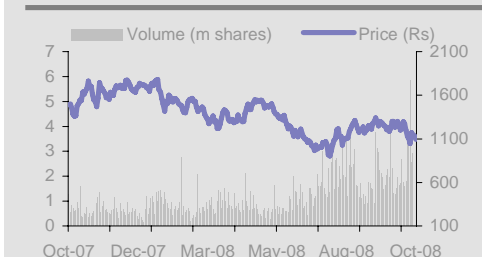
Rel. to Sensex 10.6 36.9 17.0

Axis Bank -10.0 7.2 -29.4

ICICI Bank -29.7 -19.9 -64.1

SBI -2.5 35.6 -15.3

#### Stock movement



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## Earnings slowing down

**Significant additions to distribution network:** In 2QFY09, the bank added 183 branches (taking the total up to 1,412) and 364 ATMs (total 2,890). It also added 84 new cities to its coverage, taking the total up to 528 cities. With these additions, HDFC Bank's network is almost as large as ICICI Bank's (1,388 branches and 4,233 ATMs in July 2008).

**Outperformer in a falling market:** The stock price has been resilient and fallen 37% YTD compared to the 48% decline in the Sensex and 49% fall in the BSE Bankex. The 20% equity dilution in the current year due to share-swap with Centurion Bank of Punjab shareholders and 6% next year due to issue of new shares to HDFC will moderate earnings growth to only 19% during FY08-10, compared to 28% earnings CAGR during the previous three years. This will also cap the ROE at 16.5-17.0% over the next 2-3 years. While near-term upside is capped as valuations are still expensive at 2.4x FY10ii book, the stock should continue to outperform due to flight to quality.

**Figure 1: HDFC Bank – key ratios pre and post merger**

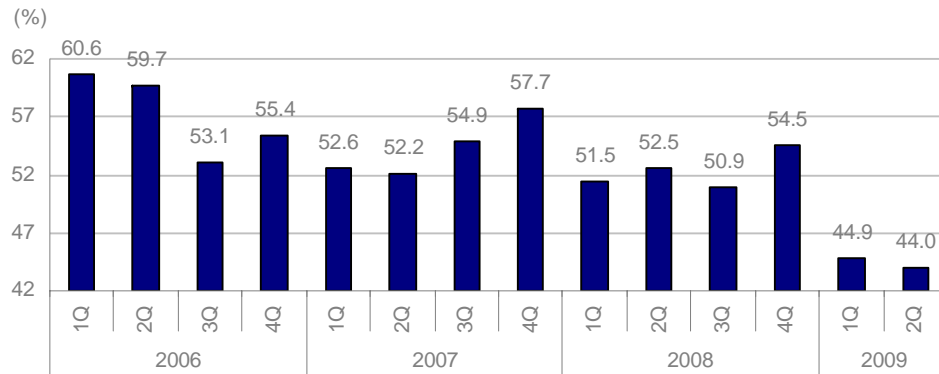
	Pre-merger (FY08)	Post-merger	
		1QFY09	2QFY09
NIM (%)	4.2	4.1	4.2
CASA (%)	54.5	44.9	44.0
Fee income/assets (%)	1.3	1.2	1.4
Cost/income (%)	49.9	55.7	55.3
Gross NPL (%)	1.4	1.6	1.6
Net NPL (%)	0.5	0.5	0.6
Tier-I CAR (%)	10.3	9.3	8.8
LDR (%)	62.9	73.9	76.4
ROE (%)	17.7	15.0	15.5
ROA (%)	1.4	1.2	1.2

Source: Company, IIFL Research

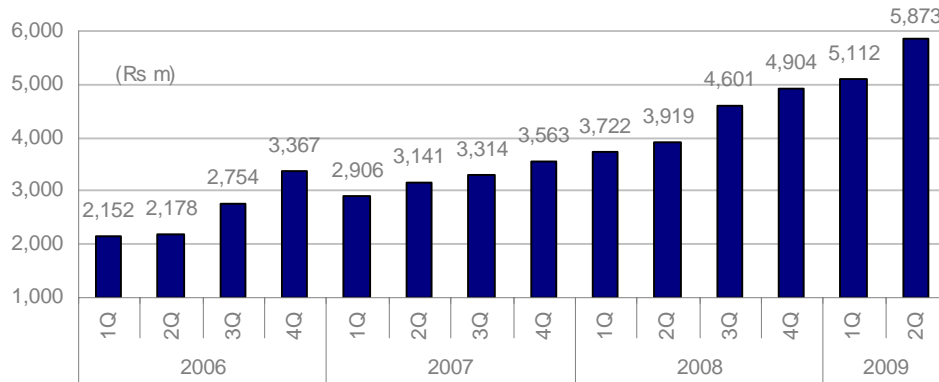
**Figure 2: Results at a glance**

(Rs m)	2QFY09	1QFY09	QoQ (%)	2QFY08	YoY (%)
Interest Income	39,912	36,216	10	23,628	69
Interest expenses	21,248	18,983	12	12,001	77
<b>Net interest income</b>	<b>18,665</b>	<b>17,234</b>	<b>8</b>	<b>11,627</b>	<b>61</b>
<b>Other income</b>	<b>6,431</b>	<b>5,934</b>	<b>8</b>	<b>4,824</b>	<b>33</b>
<b>Total income</b>	<b>25,096</b>	<b>23,168</b>	<b>8</b>	<b>16,451</b>	<b>53</b>
Other expenses + Dep	13,867	12,894	8	8,184	69
Provisions	3,460	3,446	0	2,894	20
<b>Profit before tax</b>	<b>7,768</b>	<b>6,828</b>	<b>14</b>	<b>5,373</b>	<b>45</b>
Taxation	2,488	2,187	14	1,688	47
<b>Net Profit</b>	<b>5,280</b>	<b>4,641</b>	<b>14</b>	<b>3,685</b>	<b>43</b>
<b>Business parameters (Rs bn)</b>					
Loans	1,022	968	5.6	623	64.1
Deposits	1,338	1,309	2.2	911	46.9
CASA Deposits	589	587	0.3	478	23.2
CASA (%)	44.0	44.9	(0.8)	52.5	(8.5)
<b>P&amp;L ratios (%)</b>					
Net Interest margins	4.2	4.1	0.1	4.0	0.2
Cost/Income ratio	55.3	55.7	(0.4)	49.7	5.5
Non-interest income/Total income	25.6	25.6	0.0	29.3	(3.7)
Prov-to-inc	13.8	14.9	(1.1)	17.6	(3.8)
<b>Asset quality</b>					
GNPL (Rs m)	16,759	15,028	11.5	7,683	118.1
NNPL (Rs m)	5,841	4,961	17.7	2,437	139.6
GNPL (%)	1.6	1.6	0.0	1.2	0.4
NNPL (%)	0.6	0.5	0.1	1.2	(0.6)
NPL coverage ratio (%)	65.1	67.0	(1.8)	68.3	(3.1)
<b>Capital Adequacy (%)</b>					
CAR	11.4	12.2	(0.8)	14.9	(3.5)
Tier I	8.8	9.3	(0.5)	11.3	(2.5)

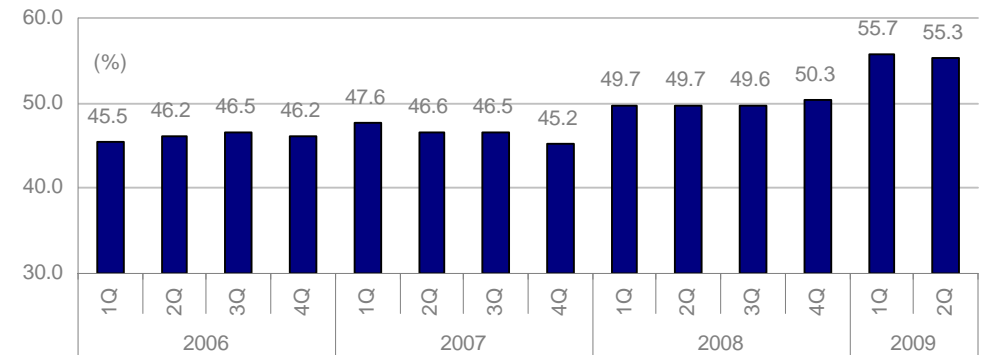
Source: Company, IIFL Research

**Figure 3: CASA ratio has declined but still remains the best amongst peers**


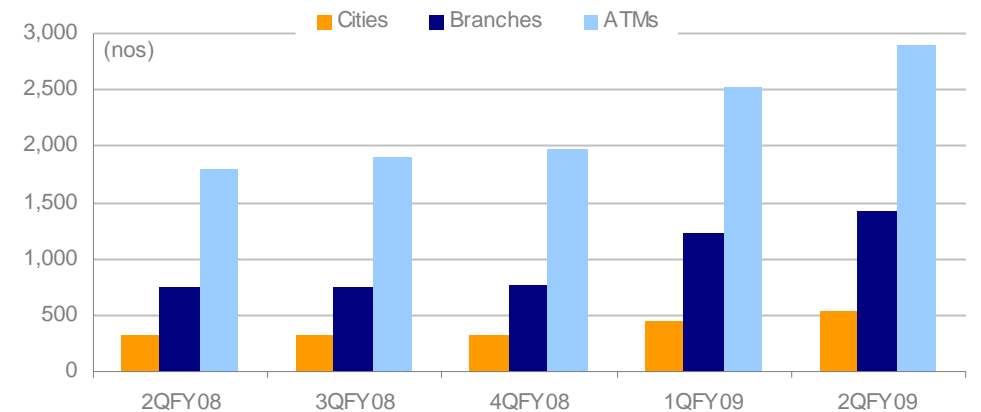
Source: Company, IIFL Research

**Figure 4: Core fee income grew by 13% sequentially**


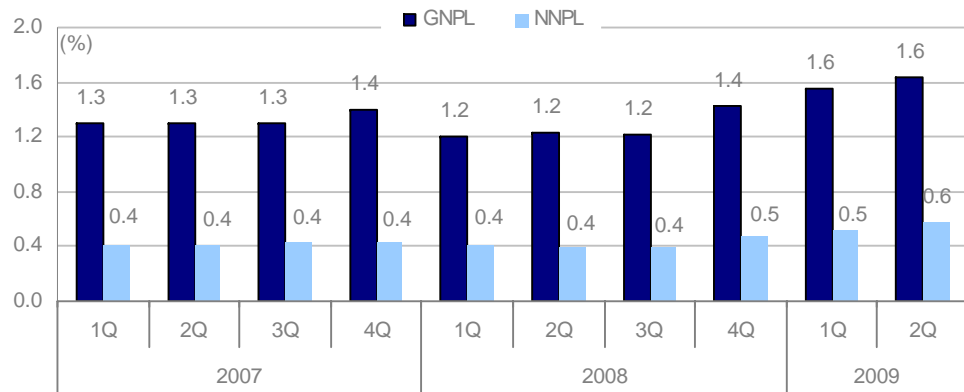
Source: Company, IIFL Research

**Figure 5: Cost/income ratio remains stable owing to branch additions**


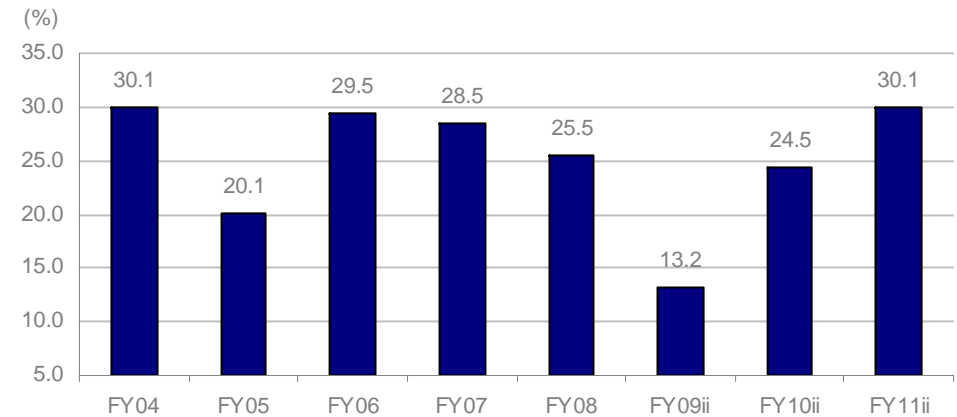
Source: Company, IIFL Research

**Figure 6: Significant expansion in distribution network**


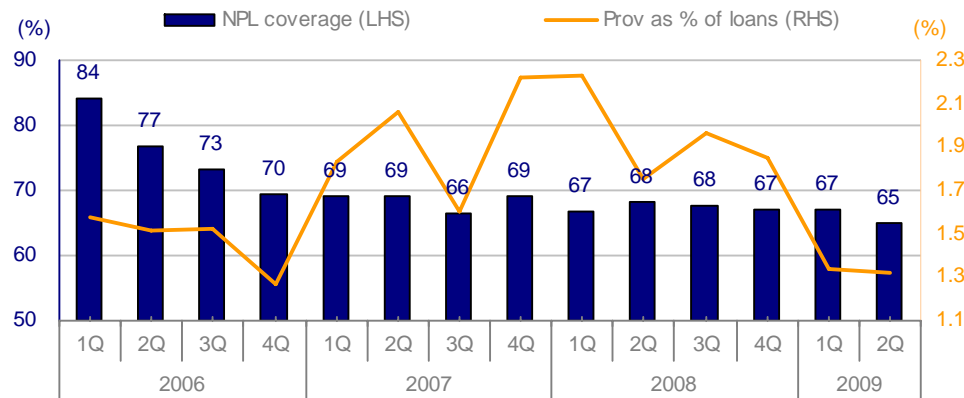
Source: Company, IIFL Research

**Figure 7: Rising NPLs primarily from erstwhile CBOP portfolio**


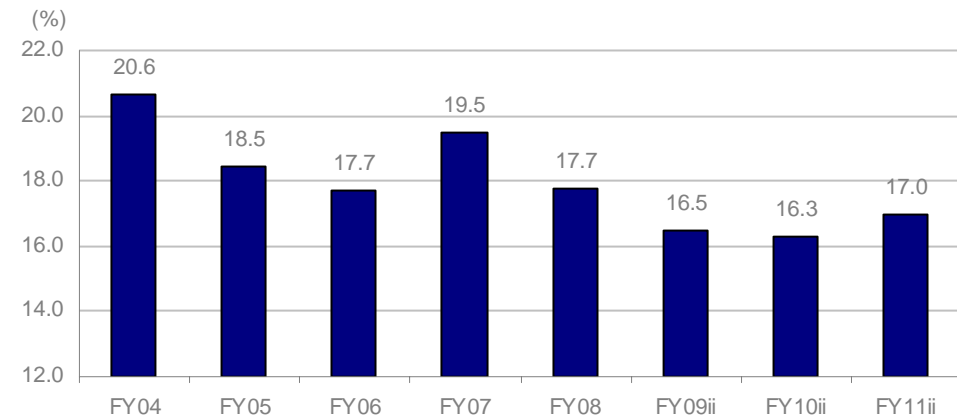
Source: Company, IIFL Research

**Figure 9: EPS growth expected to decline owing to 20% dilution in FY09ii...**


Source: Company, IIFL Research

**Figure 8: Provision coverage remains comfortable**


Source: Company, IIFL Research

**Figure 10: ...pulling down the ROE as well**


Source: Company, IIFL Research

## Financial summary

### Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Interest income	66,479	101,150	157,497	212,356	260,554
Interest expense	31,795	48,871	83,287	113,358	135,734
<b>Net interest income</b>	<b>34,685</b>	<b>52,279</b>	<b>74,211</b>	<b>98,997</b>	<b>124,819</b>
Fee Income	14,827	19,976	25,470	31,747	39,256
Portfolio gains	-684	2,418	604	695	799
Others	1,019	437	634	856	1,070
<b>Non-interest income</b>	<b>15,162</b>	<b>22,832</b>	<b>26,708</b>	<b>33,298</b>	<b>41,125</b>
<b>Total op income</b>	<b>49,847</b>	<b>75,110</b>	<b>100,919</b>	<b>132,296</b>	<b>165,945</b>
Employee cost	7,769	13,014	22,123	30,972	40,264
Other operating expenses	16,439	24,443	31,029	37,927	44,834
<b>Total op expenses</b>	<b>24,208</b>	<b>37,456</b>	<b>53,152</b>	<b>68,899</b>	<b>85,097</b>
<b>Op profit pre prov</b>	<b>25,639</b>	<b>37,654</b>	<b>47,767</b>	<b>63,397</b>	<b>80,848</b>
Provisions for loan losses	6,912	10,264	12,606	18,249	23,286
Other provisions	2,340	4,584	4,353	4,513	4,679
<b>Profit before tax</b>	<b>16,388</b>	<b>22,806</b>	<b>30,808</b>	<b>40,635</b>	<b>52,883</b>
Taxes	4,973	6,905	9,242	12,190	15,865
<b>Net profit</b>	<b>11,415</b>	<b>15,902</b>	<b>21,566</b>	<b>28,444</b>	<b>37,018</b>

Operating cost likely to go up

Higher loan loss provision

EPS CAGR of 19% over FY08-10ii

Loan CAGR of 44% over FY08-10ii

CASA ratio to remain at 45%

### Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Net loans & advances	469,448	634,269	1,046,544	1,308,180	1,602,520
Placements to other banks	39,714	22,252	27,815	34,768	43,460
Cash & equivalents	50,753	125,532	193,916	233,037	282,311
Other int-earning assets	305,648	493,935	595,085	709,300	852,824
<b>Total int-earning assets</b>	<b>865,562</b>	<b>1,275,988</b>	<b>1,863,360</b>	<b>2,285,285</b>	<b>2,781,115</b>
Fixed assets	9,667	11,751	14,395	17,274	20,729
Other assets	37,127	44,027	79,248	103,023	133,930
<b>Total assets</b>	<b>912,356</b>	<b>1,331,766</b>	<b>1,957,004</b>	<b>2,405,582</b>	<b>2,935,774</b>
Customer deposits	682,979	1,007,686	1,511,529	1,844,065	2,268,200
Other int-bearing liabs	60,980	77,280	100,956	115,025	133,171
<b>Total int-bearing liabs</b>	<b>743,959</b>	<b>1,084,966</b>	<b>1,612,485</b>	<b>1,959,091</b>	<b>2,401,371</b>
Other non-int-bearing liabs	104,065	131,828	197,742	244,212	300,380
<b>Total liabilities</b>	<b>848,025</b>	<b>1,216,794</b>	<b>1,810,227</b>	<b>2,203,302</b>	<b>2,701,751</b>
<b>Net worth</b>	<b>64,332</b>	<b>114,972</b>	<b>146,777</b>	<b>202,280</b>	<b>234,023</b>
<b>Total liabs &amp; equity</b>	<b>912,356</b>	<b>1,331,766</b>	<b>1,957,004</b>	<b>2,405,582</b>	<b>2,935,774</b>

Source: Company data, IIFL Research

Net interest margins to decline in FY09

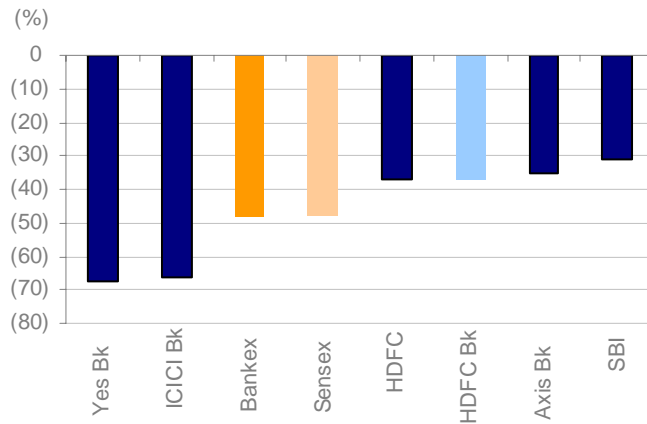
ROE on a decline

### Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
<b>Balance Sheet Structure Ratios (%)</b>					
Loans / Deposits	68.7	62.9	69.2	70.9	70.7
Loan Growth	33.9	35.1	65.0	25.0	22.5
Growth in Deposits	22.4	47.5	50.0	22.0	23.0
Growth in Total Assets	24.1	46.0	46.9	22.9	22.0
<b>Profitability Ratios (%)</b>					
Net Interest Margin	4.4	4.9	4.7	4.8	4.9
Return on Average Assets	1.4	1.4	1.3	1.3	1.4
Return on Average Equity	19.5	17.7	16.5	16.3	17.0
Non-Int Inc as % of Tot Inc	30.4	30.4	26.5	25.2	24.8
Net Profit Growth	31.1	39.3	35.6	31.9	30.1
FDEPS Growth	28.5	25.5	13.2	24.2	30.1
<b>Efficiency Ratios (%)</b>					
Cost to Income Ratio	48.6	49.9	52.7	52.1	51.3
Salaries as % of Non-Int Costs	32.1	34.7	41.6	45.0	47.3
<b>Credit Quality Ratios (%)</b>					
Gross NPLs as % of loans	1.4	1.4	1.8	2.1	2.4
NPL coverage ratio	69.2	67.1	59.5	61.6	67.2
Total prov as % avg loans	2.1	2.2	1.7	1.7	1.7
Net NPLs as % of net loans	0.4	0.5	0.7	0.8	0.8
<b>Capital Adequacy Ratios (%)</b>					
Total CAR	13.1	13.6	11.0	11.8	11.0
Tier I capital ratio	8.6	10.3	8.4	9.4	8.9
<b>Key earnings drivers (%)</b>					
Loan growth	33.9	35.1	65.0	25.0	22.5
Net interest margin	4.4	4.9	4.7	4.8	4.9
Net int income growth	36.2	50.7	42.0	33.4	26.1
Core fee income growth	29.6	34.7	27.5	24.6	23.7
Non-int inc as % of total	30.4	30.4	26.5	25.2	24.8
Operating costs growth	43.2	54.7	41.9	29.6	23.5
Cost/income ratio	48.6	49.9	52.7	52.1	51.3
Gross NPAs as % of loans	1.4	1.4	1.8	2.1	2.4
Total prov as % of loans	2.1	2.2	1.7	1.7	1.7
Tax rate	30.3	30.3	30.0	30.0	30.0

Source: Company data, IIFL Research

### YTD performance – HDFC Bank vis-à-vis peers



Source: Bloomberg, IIFL Research



## Key to our recommendation structure

**BUY** - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

**SELL** - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

**Add** - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

**Reduce** - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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