

HDFC Bank

Hold (from Buy)

Absolute performance

n/a

Short term (0-60 days)
Overweight
Market relative to region
Banks
India
Price

Rs1130.95

Target price

 Rs1181.00 (from Rs1303.10)
Market capitalisation

Rs400.84bn (US\$9.35bn)

Avg (12mth) daily turnover

Rs280.09m (US\$6.89m)

Reuters

HDBK.BO

Bloomberg

HDFCB IN

Rising to the challenge

The integration of CBOP becomes visibly harder for HDFC Bank in this tough operating environment. While we expect HDFC Bank to rise to the challenge, the valuations and uncertainties lead us to downgrade our rating to Hold.

Key forecasts

	FY06A	FY07A	FY08F	FY09F	FY10F
Reported PTP (Rsm)	12535.6	16391.2	22810.3	32513.2▲	41452.1▲
Reported net profit (Rsm)	8708.3	11414.2	15901.3	23409.5▲	29016.5▲
Reported EPS (Rs)	27.8	35.7	44.9	50.6▼	60.4▼
Normalised EPS (Rs)	27.8	35.7	44.9	50.6▼	60.4▼
Dividend per share (Rs)	5.50	7.00	9.00	11.5▲	14.5▲
Normalised PE (x)	40.7	31.6	25.2▼	22.3	18.7▲
Price/book value (x)	6.68	5.62	3.49	3.02	2.52
Dividend yield (%)	0.49	0.62	0.80	1.02	1.28
Return on avg equity (%)	17.7	19.5	17.7	16.2	14.9▼

Accounting Standard: Local GAAP

Source: Company data, ABN AMRO forecasts

year to Mar, fully diluted

CBOP acquisition: an opportunity and a challenge

In the near term, we believe EPS growth will be under pressure, due in part to the merger with Centurion Bank of Punjab (CBOP) and the proposed dilution to HDFC Ltd. According to CBOP, the ROA in 9MFY08 was 0.71%, in contrast to HDFC Bank's ROA of 1.3% in FY08F. In the medium term, we expect HDFC Bank's ROE to fall from 17.7% in FY08 to 14.9% in FY10 (vs our earlier estimate of 17.1%). That said, we see upside potential over the longer term.

Focus turns to integration; asset quality potentially under stress...

With the merger of two banks with vastly different profitability, the focus has turned to integration. We believe HDFC Bank has its work cut out improving the low-cost deposits proportion of CBOP to the levels of HDFC Bank. CBOP's legacy is evident from the fact that of its 404 branches, 91 are in the state of Kerala (erstwhile Centurion Bank and Lord Krishna Bank) and 78 in the state of Punjab (erstwhile Bank of Punjab). The ability of HDFC Bank management to effectively leverage this network will be a key determinant of the benefits of the merger. Furthermore, the merger between these two mainly retail banks comes at a time when retail asset quality across the system seems to be under stress.

...but we believe in management's ability to deal with the challenges

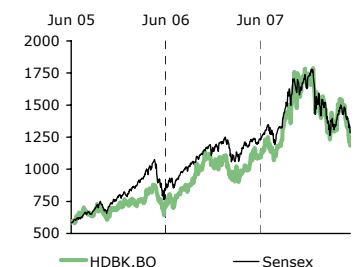
We believe HDFC Bank management will be able to deal with the challenges posed by integration, asset quality and business growth. We think asset quality will remain better than peers despite the merger. We estimate loan-loss provisions will decline from 2.7% of average loans in FY08 to 2.2% in FY09-10.

Valuations seems fair; we downgrade because of uncertainty

We value HDFC Bank using a discounted EVA™ model and lower our target price to Rs1,181 (from Rs1,303). At our new target, the stock would trade at 3.2x FY09F book value, adjusted by writing off 100% of pre-tax NPLs, and 23.3x FY09F EPS. The operating environment has turned challenging and, thus, we increase the estimated COE by 50bp to 13.5% to reflect the uncertainties of the merger. We downgrade our recommendation to Hold.

Price performance (1M) (3M) (12M)

	1M	3M	12M
Price (Rs)	1453	1311	1091
Absolute %	-22.1	-13.7	3.7
Rel market %	-13.5	-8.5	-3.2
Rel sector %	-19.9	-17.5	1.7



Stock borrowing: Difficult

Volatility (30-day): 37.35%

Volatility (6-month trend): ↓

52-week range: 1825.00-1050.30

Sensex: 15066.10

BBG AP Banks: 176.87

Source: ABN AMRO, Bloomberg

Priced at close of business 10 June 2008. Use of ▲ ▼ indicates that the line item has changed by at least 5%.

Researched by
**ABN AMRO Institutional
Equities Team**
www.abnamrobroking.co.in

Table 1 : SWOT analysis of CBOP acquisition

Strengths	Weaknesses
<ul style="list-style-type: none"> ▪ A 404-branch network - a substantial proportion of which is complementary, gives an early entry advantage in over 91 cities. ▪ Trained workforce and strong fee income orientation ▪ SME base of 3,000 customers, 250 relationship managers, product offered in 70 locations and a total loan book of Rs28bn (Dec-07). 	<ul style="list-style-type: none"> ▪ Exposure to predominantly retail assets including personal loans and two-wheeler loans, where asset quality has come under stress across the industry ▪ Acquisition, although paid for in stock, was made when valuations were rich ▪ Near-term impact on profitability with return on equity slated to decline
Opportunities	Threats
<ul style="list-style-type: none"> ▪ Not many banks were available for acquisition. For HDFCB, this is an opportunity to gain size ahead of competition expected from foreign banks in 2009. ▪ Low proportion of low-cost deposit ratios of CBOP is an opportunity, the redressing of which would improve profitability significantly ▪ Potential for fee income growth by hawking financial products through the expanded branch network 	<ul style="list-style-type: none"> ▪ Possible increase in loan losses in case of retail asset quality deterioration ▪ Integration may prove challenging - vastly different bank in terms of costs and profitability ▪ Slower economic growth may affect retail banking, leading to a period of stagnation for the merged entity

Source: ABN AMRO forecasts

Table 2 : FY09F - HDFC Bank + CBOP

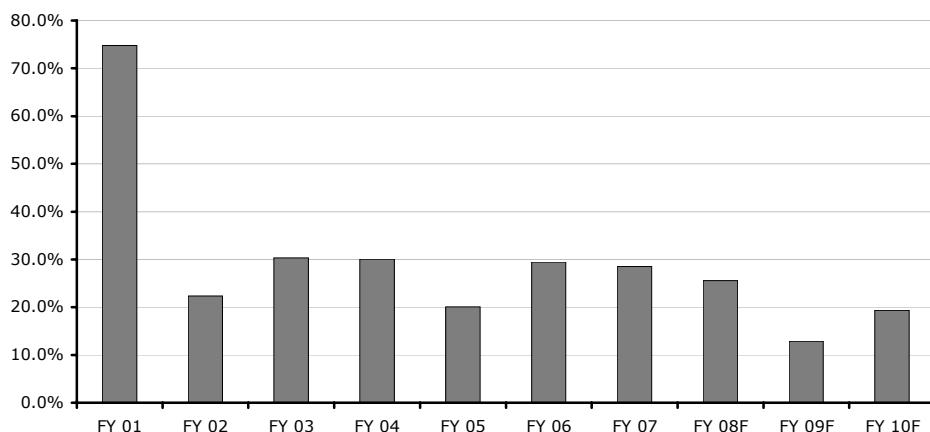
Rs bn	FY08F	FY09F	% growth
Loans			
CBOP	158.3	182.1	15.0%
HDFC Bank	634.3	824.5	30.0%
Total	792.6	1,006.6	27.0%
Deposits			
CBOP	217.1	255.1	17.5%
HDFC Bank	1,024.4	1,229.3	20.0%
Total	1,241.5	1,484.4	19.6%

Note: HDFC Bank figures for FY08 are close to actuals as preliminary figures have already been released.

Source: ABN AMRO forecasts

Note that these assumptions may not tally exactly with reported numbers

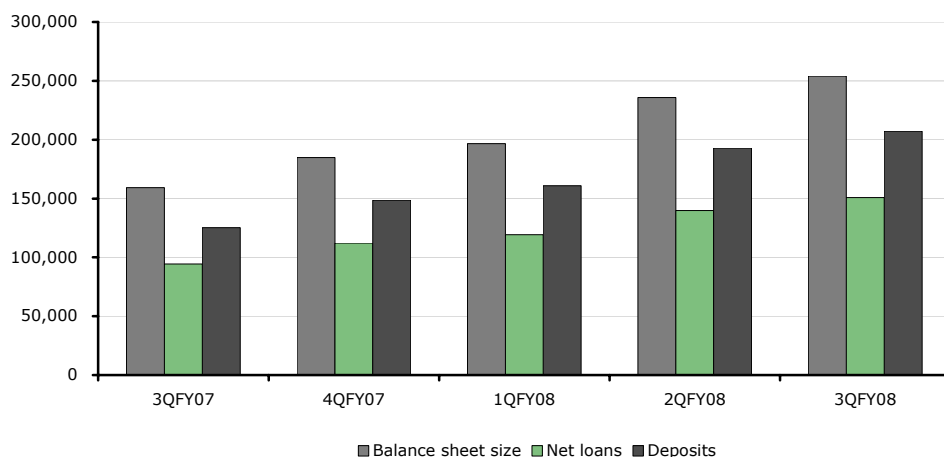
Chart 1 : HDFC Bank EPS growth (yoy)



Note: FY09 and FY10 estimates assume a dilution of 13.1m shares to HDFC in each year.
Source: Company data, ABN AMRO forecasts

A decline in EPS growth warrants a reduction in valuation ratios, in our view

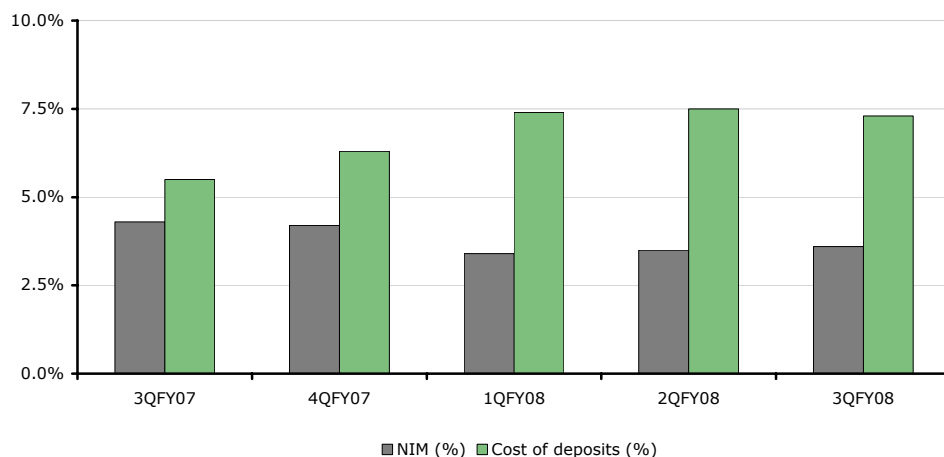
Chart 2 : CBOP – balance-sheet size, loans and deposits (Rs m)



Source: Company data (Dec-07)

CBOP has seen strong growth in balance sheet size in recent quarters

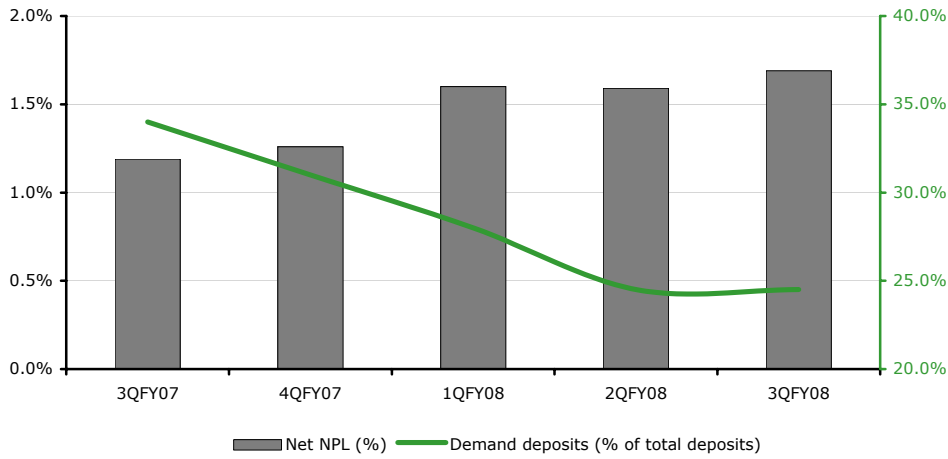
Chart 3 : CBOP – NIMs and cost of deposits (%)



Source: Company data (Dec-07)

In recent quarters, CBOP's cost of deposits has risen sharply, given its reliance on bulk deposits, bringing down NIMs

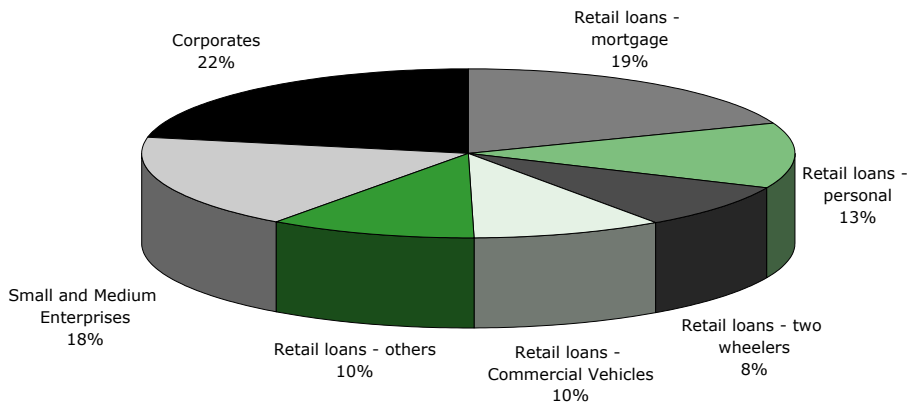
Chart 4 : CBOP – net NPLs and proportion of low-cost deposits (%)



Source: Company data (Dec-07)

HDFC Bank will be hoping that NPLs don't rise and demand deposits from CBOP's branches rise to deliver value from the acquisition

Chart 5 : CBOP – loan mix (%)



Source: Company data (Dec-07)

CBOP is a predominantly retail bank but has a strong SME franchise as well

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HDFC BANK: KEY FINANCIAL DATA

Income statement

Rsm	FY06A	FY07A	FY08F	FY09F	FY10F
Net interest income	23006.8	34684.1	52278.9	73935.6	97977.9
Non-interest income	11240.3	15163.6	22831.8	32460.6	41012.0
Total income	34247.1	49847.7	75110.7	106396	138990
Operating costs	-15125	-22650	-34739	-51639	-66582
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	-1785.9	-2196.0	-2717.2	-3828.6	-4594.3
Pre-prov operating profit	17336.2	25001.7	37654.5	50928.9	67813.1
Provisions charges	-4800.6	-8610.5	-14844	-18416	-26361
Post-prov op prof	12535.6	16391.2	22810.3	32513.2	41452.1
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	n/a	n/a	n/a	n/a	n/a
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	12535.6	16391.2	22810.3	32513.2	41452.1
Taxation	-3827.3	-4977.0	-6909.0	-9103.7	-12436
Minority interests	n/a	n/a	n/a	n/a	n/a
Preference dividends	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	8708.3	11414.2	15901.3	23409.5	29016.5

Source: Company data, ABN AMRO forecasts

year to Mar

Balance sheet

Rsm	FY06A	FY07A	FY08F	FY09F	FY10F
Net loans to customers	350613	469448	634269	1053607	1334796
Other int earn assets	292042	321574	505843	581055	673326
Goodwill	n/a	n/a	n/a	n/a	n/a
Oth non-int earn assets	23218.8	29797.0	43873.0	66820.0	79492.9
Total assets	735064	912358	1331769	1906590	2336578
Total customer deposits	566232	700018	1024436	1494668	1841394
Oth int-bearing liab	45604.8	60980.0	77280.0	100552	111858
Non int-bearing liab	70231.5	87029.0	115080	138034	167716
Total liabilities	682069	848027	1216796	1733254	2120967
Share capital	3131.4	3194.0	3544.3	4623.8	4801.1
Reserves	49863.9	61137.0	111428	168712	210810
Total equity (excl min)	52995.3	64331.0	114972	173336	215611
Minority interests	n/a	n/a	n/a	n/a	n/a
Total liab & sh equity	735064	912358	1331769	1906590	2336578
Risk weighted assets	602176	740819	1074480	1712447	2187106
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	n/a	n/a	n/a	n/a	n/a
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, ABN AMRO forecasts

year ended Mar

Capital

Rsm	FY06A	FY07A	FY08F	FY09F	FY10F
Risk weighted assets	602176	740819	1074480	1712447	2187106
Reported net profit	8708.3	11414.2	15901.3	23409.5	29016.5
Opening risk assets	412714	602176	740819	1074480	1712447
Closing risk assets	602176	740819	1074480	1712447	2187106
Change in risk assets	189463	138643	333661	637967	474659
Capital required	13262.4	9705.0	23356.2	44657.7	33226.1
Free capital flow	-4554.1	1709.2	-7454.9	-21248	-4209.7
Ordinary dividend paid	-1722.3	-2235.8	-3189.9	-5317.4	-6961.6
Share buy back/spec div	n/a	n/a	n/a	n/a	n/a
Equity / preference issue	n/a	n/a	n/a	n/a	n/a
Cash flow from financing	-1722.3	-2235.8	-3189.9	-5317.4	-6961.6
Net capital flow	-6276.4	-526.6	-10645	-26566	-11171
Tier 1 capital	52166.7	64115.0	113734	173120	215395
Tier 1 capital ratio (%)	8.66	8.65	10.6	10.1	9.85

Lines in bold can be derived from the immediately preceding lines.

Source: Company data, ABN AMRO forecasts

year to Mar

HDFC BANK: PERFORMANCE AND VALUATION

Standard ratios	HDFC Bank					Axis Bank			Bank of India		
Performance	FY06A	FY07A	FY08F	FY09F	FY10F	FY08F	FY09F	FY10F	FY08F	FY09F	FY10F
Non-int inc/gr op inc (%)	32.8	30.4	30.4	30.5	29.5	41.0	35.1	34.0	33.4	26.8	26.8
Cost/income (%)	49.4	49.8	49.9	52.1	51.2	49.2	50.0	49.3	41.8	40.1	38.8
Costs/average assets (%)	2.71	3.02	3.34	3.43	3.35	2.41	2.29	2.27	1.67	1.52	1.40
Net income growth (%)	30.8	31.1	39.3	47.2	24.0	62.7	27.3	34.6	78.3	7.97	9.13
Net cust loan growth (%)	37.1	33.9	35.1	66.1	26.7	61.4	39.5	35.1	34.9	22.5	22.0
Cust deposit growth (%)	53.3	23.6	46.3	45.9	23.2	48.9	34.9	36.3	24.4	20.4	20.3
Net interest margin (%)	3.80	4.35	4.82	4.73	4.78	2.98	3.05	3.10	2.72	2.82	2.68
Return on avg assets (%)	1.39	1.39	1.42	1.45	1.37	1.20	1.11	1.13	1.26	1.12	1.03
Return on avg equity (%)	17.7	19.5	17.7	16.2	14.9	17.6	14.6	17.3	27.3	22.2	20.1
RORWA (%)	1.73	1.60	1.51	1.47	1.34	1.67	1.64	1.64	1.76	1.51	1.36
				<i>year to Mar</i>			<i>year to Mar</i>			<i>year to Mar</i>	
Valuation											
Normalised EPS growth (%)	29.5	28.5	25.5	12.8	19.4	27.7	26.7	33.9	65.5	7.97	9.13
Reported PE (x)	40.7	31.6	25.2	22.3	18.7	23.5	18.6	13.9	6.73	6.23	5.71
Normalised PE (x)	40.7	31.6	25.2	22.3	18.7	23.5	18.6	13.9	6.73	6.23	5.71
Price/book value (x)	6.68	5.62	3.49	3.02	2.52	2.87	2.57	2.24	1.53	1.26	1.06
Price/adjusted BVPS (x)	6.88	5.80	3.58	3.08	2.57	2.96	2.66	2.33	1.67	1.37	1.14
Dividend yield (%)	0.49	0.62	0.80	1.02	1.28	0.85	1.07	1.35	1.76	1.95	1.95
				<i>year to Mar</i>			<i>year to Mar</i>			<i>year to Mar</i>	
Per share data	FY06A	FY07A	FY08F	FY09F	FY10F	Solvency	FY06A	FY07A	FY08F	FY09F	FY10F
Tot adj dil sh, ave (m)	313.1	319.4	354.4	462.4	480.1	Tier 1 capital ratio (%)	8.66	8.65	10.6	10.1	9.85
Pre-prov prof/share (INR)	55.4	78.3	106.2	110.1	141.2	Total CAR (%)	11.5	13.1	13.6	12.3	11.8
Reported EPS (INR)	27.8	35.7	44.9	50.6	60.4	Equity/assets (%)	7.21	7.05	8.63	9.09	9.23
Normalised EPS (INR)	27.8	35.7	44.9	50.6	60.4	Net cust loans/dep (%)	61.9	67.1	61.9	70.5	72.5
Book value per sh (INR)	169.2	201.4	324.4	374.9	449.1	Rep NPL/gr cus adv (%)	1.45	1.40	1.43	1.08	1.06
Dividend per share (INR)	5.50	7.00	9.00	11.5	14.5	Tot prov/rep NPLs (%)	69.2	68.9	67.0	66.1	67.7
Dividend cover (x)	5.06	5.11	4.98	4.40	4.17	Bad debts/advances (%)	1.31	1.83	2.34	1.75	1.97
				<i>year to Mar</i>						<i>year to Mar</i>	

Priced as follows: HDBK.BO - Rs1130.95; AXBK.BO - Rs703.10; BOI.BO - Rs256.05
Source: Company data, ABN AMRO forecasts

HDFC BANK: VALUATION METHODOLOGY

Table 3 : Discounted EVA™ valuation

Key Assumptions (Rs m)

NOPAT Terminal Growth Rate (%)	5.0
Terminal NOPAT	555,874
Terminal EVA™	138,969
Terminal Return on NTA Employed (%)	18.0
Cost of Equity (%)	13.5
Terminal Return Spread (%)	4.5
Opening NTA employed	173,120
Adjusted NTA employed	177,468

Terminal Value (Rs)

Terminal EVA™ in Perpetuity	1,029,397
Value of Growth Prospects	605,528
NPV of Terminal Value	220,665

Warranted Equity Value (Rs)

Adjusted Opening NTA employed	177,468
NPV of EVA™	147,967
NPV of Terminal Value	220,665
Equity Value	546,100

No. of Shares (m)	462.4
Warranted Equity Value Per Share (Rs)	1,181.0

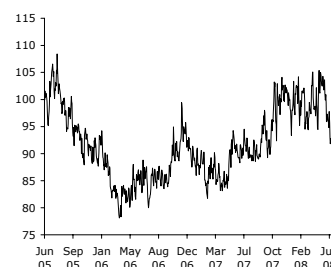
Note: Our target price is based on potential equity size after the dilution to HDFC Ltd of 13.1m shares and 91.3m shares to CBOP, ESOP holders in CBOP and HDFC Bank in FY09F.
Source: ABN AMRO forecasts

HDFC Bank

Company description

HDFC Bank is a new-generation private-sector bank that was issued a banking licence in 1994. Promoted by India's leading housing finance company, HDFC, the bank established itself as one of the most competitive in India within just over a decade. HDFC Bank is known for its technological superiority and strong risk management and an even stronger brand franchise. The bank's strategy is to maintain a low-risk profile of assets, leverage the brand strength, capture market share in the assets market and continuously search for new opportunities to leverage the franchise. In May 2008, the RBI approved HDFC Bank's merger with Centurion Bank of Punjab (CBOP).

Hold Price relative to country



Strategic analysis

Average SWOT company score: 4

Strengths

Strong brand identity derived from its parentage, cost competitiveness achieved through efficient business processes and management's sound execution skills. Access to capital at attractive rates is another positive factor.

5

Weaknesses

A small market share that is unlikely to yield pricing power given the fragmented nature of financial markets. The presence of the bank's parent, HDFC, in housing finance does not allow HDFC Bank to take complete advantage of the opportunities in the housing finance sector.

4

Opportunities

Deepening retail penetration, robust technology backbone and strong brand franchise offers HDFC Bank the opportunity to consistently gain market share in both fund- and non-fund-based revenue streams.

4

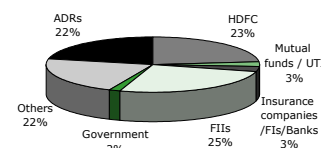
Threats

Competition from foreign banks could intensify. Public sector banks too could become more competitive after the expected strengthening of their technology infrastructure.

4

Scoring range is 1-5 (high score is good)

Shareholding pattern



Source: www.nseindia.com. March 31, 2008

Market data

Headquarters
Sandoz House, Dr. Annie Besant Road, Worli, Mumbai-400018.

Website
www.hdfcbank.com

Shares in issue
354.4m

Freefloat
77%

Majority shareholders
HDFC Ltd. (23%)

India

Country view

Overweight

Country rel to Asia Pacific

We expect Indian growth to remain robust in 2008, driven by domestic demand due to the rise in wages and farm incomes. We see a structural growth story emerging in real estate and agriculture, in line with the government's 11th five-year development plan of redistributing income beyond the city centres. We remain selective buyers of consumer discretionary and consumer staples, especially in upstream industries such as cold chain, agri-businesses and organised retail. We think the IT sector is also worth a fresh look as valuations look increasingly undemanding at present levels and major players have demonstrated an ability to protect their margins.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.



Competitive position

Average competitive score: 4-

Broker recommendations

Supplier power

Banks typically lack pricing power on the liability side in the long term, as consumers can shift preferences among various financial instruments.

4-

Barriers to entry

Distribution access, brand identity and high capital requirements for infrastructure investment, as well as for growing the balance sheet, act as entry barriers.

4-

Customer power

Asset prices tend to be market-driven. Disintermediation in wholesale lending and competition on retail lending renders no pricing power in the asset market for banks.

4+

Substitute products

Alternative financial savings pose a threat to the liability franchise. Similarly, disintermediation poses a threat to the asset franchise.

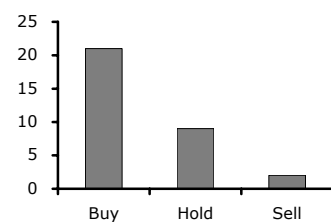
4-

Rivalry

Rivalries tend to be intense due to the fragmented nature of the financial services market. Product innovation is duplicated easily; hence, the lifecycle tends to be short.

4-

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse



Source: Bloomberg