HDFC Bank (HDBK.BO)

Results

Buy: 4Q Results – Cannot Pick a Hole in the Quarter

- **Profits up 34% yoy; qualitative reinforcement** — Qualitatively, the quarter was ahead, while quantitatively (i.e. net profit), it was just a little behind. The key takeaway is that HDBK continues to stand out in the troubled crowd with its asset book holding comfortably, profitability remaining stable and outlook good enough for it to maintain 20%+ loan growth. We believe HDBK is making significant franchise (and market share) gains in these relatively uncertain times – and doing so profitably.
- **Asset quality: Continues to defy and widens the gap** — The pace of deterioration remains stable (comfortably covered by operating profitability). The restructuring phenomenon appears to have passed it by (0.1% of loans), and 20-25% loan growth looks achievable. Mgmt has a cautiously optimistic growth and quality outlook (consistent through Oct-Nov 2008 lows), and its track record for working through the cycle builds. The risks are the economy and the now-rising expectation that HDBK is immune to asset quality issues.
- **P&L: Fees and costs impress, while trading one-offs provide provisioning cushion** — The P&L is fundamentally the upside surprise – fees have accelerated (bolstered by a strong bounce-back in derivative revs), costs are showing signs of moderating (almost a first among peers), and margins continue to hold at 4%+ levels – significant stability in varying interest rate environments. A surprise trading gain (second quarter running now, though) provides the cushion for a provisioning boost, which is otherwise too high for a normal earnings cycle.
- **Maintain Buy (1L)** — While HDBK becomes even more expensive, we find that we cannot pick a hole in its quarter or business strategy, and until that happens, valuations will likely remain high.

Buy/Low Risk	**1L**
Price (23 Apr 09)	Rs1,092.50
Target price	Rs1,100.00
Expected share price return	0.7%
Expected dividend yield	0.8%
Expected total return	**1.5%**
Market Cap	Rs464,732M US$9,312M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	11,414	35.23	29.1	31.0	5.4	19.5	0.6
2008A	15,900	45.59	29.4	24.0	3.4	17.7	0.8
2009E	23,020	57.29	25.7	19.1	3.0	17.4	0.8
2010E	28,497	65.79	14.8	16.6	2.6	17.5	0.8
2011E	38,048	87.84	33.5	12.4	2.2	19.9	0.9

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	31.0	24.0	19.1	16.6	12.4
P/E reported (x)	31.0	24.0	19.1	16.6	12.4
P/BV (x)	5.4	3.4	3.0	2.6	2.2
P/Adjusted BV diluted (x)	5.6	3.5	3.1	2.7	2.3
Dividend yield (%)	0.6	0.8	0.8	0.8	0.9
Per Share Data (Rs)					
EPS adjusted	35.23	45.59	57.29	65.79	87.84
EPS reported	35.23	45.59	57.29	65.79	87.84
BVPS	201.42	324.39	360.35	418.76	499.52
Tangible BVPS	201.42	324.39	360.35	418.76	499.52
Adjusted BVPS diluted	196.68	310.38	347.04	403.30	481.07
DPS	7.00	8.50	8.50	9.00	9.50
Profit & Loss (RsM)					
Net interest income	37,096	51,494	74,458	93,010	116,234
Fees and commissions	12,924	17,145	25,621	32,026	40,033
Other operating Income	2,179	4,901	6,434	7,806	9,316
Total operating income	**52,198**	**73,541**	**106,513**	**132,842**	**165,583**
Total operating expenses	-24,846	-37,456	-56,485	-67,596	-81,058
Oper. profit bef. provisions	**27,353**	**36,085**	**50,028**	**65,247**	**84,525**
Bad debt provisions	-8,610	-11,376	-16,245	-23,947	-29,384
Non-operating/exceptionals	-2,352	-1,904	0	0	0
Pre-tax profit	**16,391**	**22,805**	**33,783**	**41,300**	**55,141**
Tax	-4,977	-6,905	-10,763	-12,803	-17,094
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**11,414**	**15,900**	**23,020**	**28,497**	**38,048**
Adjusted earnings	11,414	15,900	23,020	28,497	38,048
Growth Rates (%)					
EPS adjusted	29.1	29.4	25.7	14.8	33.5
Oper. profit bef. prov.	31.7	31.9	38.6	30.4	29.5
Balance Sheet (RsM)					
Total assets	**912,356**	**1,331,765**	**1,947,972**	**2,367,391**	**2,947,937**
Avg interest earning assets	791,714	1,079,843	1,583,001	2,095,736	2,605,089
Customer loans	551,451	707,199	1,158,225	1,458,274	1,896,556
Gross NPLs	6,576	9,068	25,716	39,101	49,889
Liab. & shar. funds	**912,356**	**1,331,765**	**1,947,972**	**2,367,391**	**2,947,937**
Total customer deposits	682,979	1,007,686	1,543,684	1,924,227	2,451,843
Reserve for loan losses	8,104	10,413	19,157	27,674	41,628
Shareholders' equity	**64,332**	**114,972**	**150,322**	**174,689**	**208,378**
Profitability/Solvency Ratios (%)					
ROE adjusted	19.5	17.7	17.4	17.5	19.9
Net interest margin	4.69	4.77	4.70	4.44	4.46
Cost/income ratio	47.6	50.9	53.0	50.9	49.0
Cash cost/average assets	3.0	3.3	3.4	3.1	3.0
NPLs/customer loans	1.2	1.3	2.2	2.7	2.6
Reserve for loan losses/NPLs	123.2	114.8	74.5	70.8	83.4
Bad debt prov./avg. cust. loans	1.7	1.8	1.7	1.8	1.8
Loans/deposit ratio	80.7	70.2	75.0	75.8	77.4
Tier 1 capital ratio	8.1	10.5	8.6	7.7	7.1
Total capital ratio	12.7	13.9	11.8	10.7	9.9

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Powered by: dataCentral

Figure 1. HDBK: 4Q09 Results – Key Highlights (Rupees Million, Percent)

	4Q09	4Q08	YoY %	3Q09	QoQ%	CIRA Comments
Interest Income	42,508	29,562	43.8	44,685	-4.9	
Interest Expense	(23,988)	(13,141)	82.5	(24,893)	-3.6	
Net Interest Income	**18,520**	**16,421**	**12.8**	**19,793**	**-6.4**	**A little lower than expectations, though maintains trend line growth**
Fee-Based Income	8,676	5,508	57.5	7,068	22.8	Strong show - an acceleration in growth, boosted by a strong revival in the derivatives business
Other Non-Interest Income	2,471	(15)	NM	2,326	6.2	Strong trading and valuation gains - key boost to profitability, but a one-off
Non Interest Income	11,147	5,493	102.9	9,394	18.7	
Operating Income	**29,667**	**21,914**	**35.4**	**29,186**	**1.6**	
Operating Expenses	(13,962)	(11,027)	26.6	(14,606)	-4.4	Significant pull-back in cost increase, and potentially a key leverage to growth ahead
Pre-Provision Profit	15,705	10,887	44.3	14,581	7.7	
Pre-Provision Profit ex-trading gains	13,234	10,902	21.4	12,255	8.0	
Charges for Bad Debts	(6,000)	(4,651)	29.0	(4,654)	28.9	Increased provisioning, reflecting some asset pressures, but also profit cushion
Other Operating Items	(574)	0	NM	(664)	-13.5	
Pre-Tax Profit	9,131	6,236	46.4	9,263	-1.4	
Tax	(2,822)	(1,525)	85.1	(3,046)	-7.3	
Net Profit	**6,309**	**4,711**	**33.9**	**6,217**	**1.5**	
EPS	14.8	13.3	11.2	14.6	1.4	
DPS	10.0	8.5	17.6	0.0	NM	
Customer Loans	988,831	634,270	55.9	1,000,789	-1.2	Degrowth in balance-sheet, largely reflecting a run off in bulky large oil co loans - retail continues to show momentum
Customer Deposits	1,428,116	1,007,690	41.7	1,448,620	-1.4	Degrowth QoQ, reflecting reduced asset growth, but bolstered by an improving mix
AIEA	1,605,585	1,492,818	7.6	1,841,163	-12.8	
AIBL	1,474,352	1,053,568	39.9	1,446,537	1.9	
Total Assets	1,832,710	1,331,766	37.6	1,831,853	0.0	
Avg Assets	1,832,281	1,323,080	38.5	1,774,751	3.2	
Non-Performing Loans (NPL)	19,881	9,070	119.2	19,114	4.0	Relatively moderate increase compared with peers and the environment; well ahead of expectations and primary highlight of the quarter. Restructured loans at about 0.1% of loans, a major positive surprise
Loan Loss Reserves (LLR)	(13,605)	(6,085)	123.6	(12,971)	4.9	Provisioning coverage continues to be high, bolstered by high general provisions
Shareholders' Funds	150,806	114,972	31.2	144,497	4.4	
Book Value Per Share	354.7	325	9.3	340	4.4	Cap Ad at 15%+ and Tier 1 at 10% rise as management switches to Bale 2 - significant cushion, in absolute and relative terms
Key Ratios (%)	**4Q09**	**4Q08**	**Bps ∆ YoY**	**3Q09**	**Bps ∆ QoQ**	
ROAA (annualized)	1.38	1.42	-5	1.40	-2	
ROAE (annualized)	16.73	16.39	34	17.21	-48	
Net Interest Margin (bps)	420	440	-20	430	31	Margins remains robust, but moderate from previous year, and recent quarter - overall trends, and insensitivity to rates, continues to remain impressive
Fee Inc/Operating Income	29.2	25.1	411	24.2	503	
Other Non-Interest Inc/Op Inc	37.6	25.1	1251	32.2	539	
Op. Cost/ Operating Income	47.1	50.3	-326	50.0	-298	Bolstered by trading gains, though absolute cost control remains impressive
Loan-to-Deposit Ratio (LDR)	69.2	62.9	630	69.1	15	
NPL/Loan Ratio	2.0	1.4	58	1.9	10	Highlight of the quarter
LLR/NPL Ratio	68	67	134	68	57	

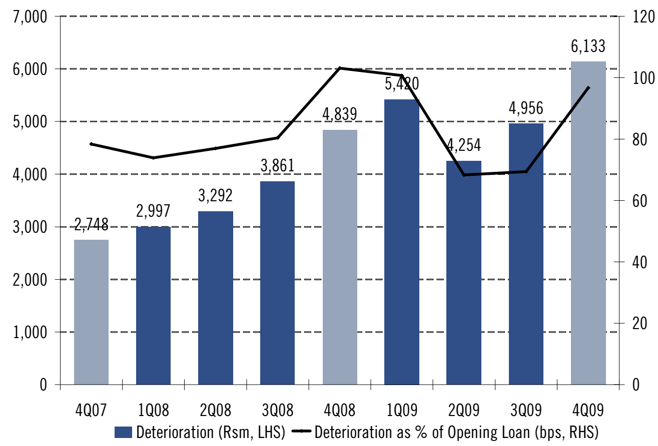
Source: Company Reports and CIRA Estimates

Figure 2. HDBK: Key Business Parameters (Rupees Million, Percent)

	4Q09	4Q08	YoY %	3Q09	QoQ%	CIRA Comments
Expense Profile						
Others	8,923	7,571	17.9	8,784	1.6	
Employee Expenses	5,039	3,456	45.8	5,821	-13.4	Some rationalization in external costs
Total Operating Expenses	**13,962**	**11,027**	**26.6**	**14,606**	**-4.4**	
Fee Income Profile						
Fees and commissions	7,148	4,904	45.8	6,440	11.0	
Forex / Derivatives	1,528	604	153.0	628	143.3	Significant bounce-back - possibly easier given competition likely to have vacated
Total Fees	**8,676**	**5,508**	**57.5**	**7,068**	**22.8**	**Acceleration in growth - impressive, particularly given moderation in growth**
Deposit Profile						
Savings	349,150	261,540	33.5	330,810	5.5	Momentum comes back, with easing rates the likely reason
Current	284,450	287,600	-1.1	242,580	17.3	Bounce-back, though management cautious and sustained revival just yet
Term	794,516	458,550	73.3	875,230	-9.2	
Total Deposits	**1,428,116**	**1,007,690**	**41.7**	**1,448,620**	**-1.4**	
CASA Ratio	44%	54%		40%		Very positive in improvement in mix

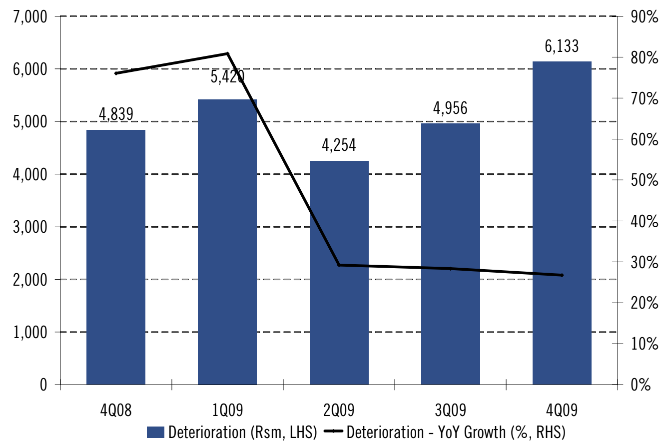
Source: Company Reports and CIRA Estimates

Figure 3. Asset Deterioration (Rsm, LHS) as % of Opening Loans (bps, RHS)



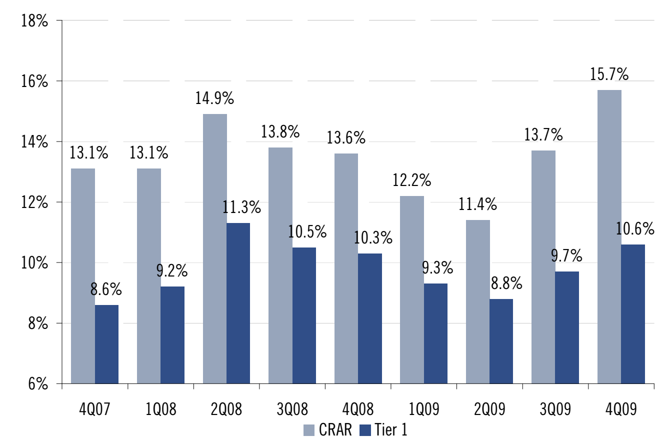
Source: Company Reports and CIRA Estimates

Figure 4. Asset Deterioration (Rsm, LHS) and its YoY Growth (%, RHS)



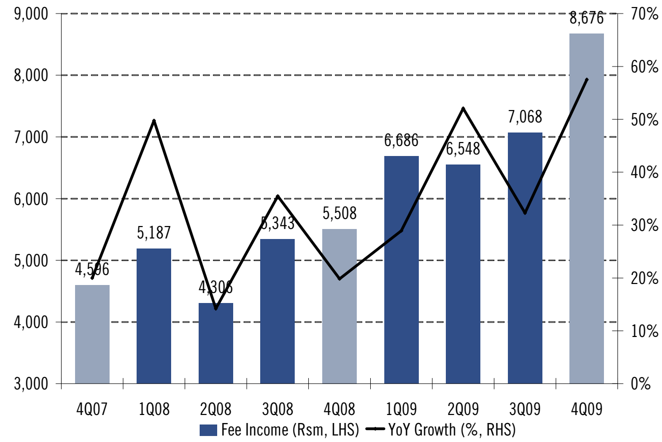
Source: Company Reports and CIRA Estimates

Figure 5. Capital Adequacy and Tier 1 Ratios



Source: Citi Investment Research and Analysis

Figure 6. Fee Income (Rsm, LHS) and its YoY Growth (%, RHS)



Source: Company Reports and CIRA Estimates

HDFC Bank

Company description

HDFC Bank, which began operations in 1994, is 24%-owned by HDFC - India's premier mortgage-finance institution. In 2000 HDFC Bank took over private-sector Times Bank. HDFC Bank is headquartered in Mumbai and has a network of more than 1412 branches and more than 3,177 ATMs in 527 cities. HDFC Bank entered into an arrangement with its parent FY04 through which HDFC Bank sources mortgages for the parent. HDFC Bank pays HDFC for credit appraisal and operations and receives a fee for sourcing. In addition, HDFC Bank buys back 70% of mortgages at a price 125bps lower than the yield of the mortgages. HDFC Bank has had strong and steady growth over the past 10 years and continues to grow at more than 30%. HDFC Bank recently acquired Centurion Bank of Punjab, which should bolster its asset base by about 20% and its branch network by almost 50%. This would also make HDBK the second-largest private sector bank in India, by a relatively large margin.

Investment strategy

We rate HDFC Bank as Buy / Low Risk with a 12-month target price of Rs1,100. We believe HDFC Bank should be accorded a valuation premium relative to its current trading level as it sustains asset growth, consolidates its distribution, leverages off new capital and stabilizes its business mix with increased retail returns. HDFC Bank should also enjoy increased growth and stability in its fee franchise due to its consistently widening distribution platform. While we expect HDFC Bank to trade in the 2-3x P/BV band over the longer term, we see it trading at the mid end of its trading band, as it is now positioned to raise ROEs from its currently low level, following its acquisition of Centurion Bank, and lowered likelihood of capital raising. We are positive on the bank's prospects and management's ability to deliver; and believe it stands out relative to peers in the currently challenging environment. In addition, its recent acquisition of Centurion Bank likely provides it the platform for strong growth over a sustained period, though there remain near-term challenges and risks in the integration.

Valuation

Our target price of Rs1,100 is based on an EVA model, assuming a loan-loss ratio of 125bps (reflecting the merger with Centurion Bank), a cost/income ratio of 44% and a spread of 300bps. We use the EVA model as our standard valuation methodology for the India banking universe as it dynamically adjusts the economic value of the business. As a secondary benchmark, we apply 2.5x forward P/BV for a fair value of Rs1,047 - 2.5x is a premium to almost all other Indian commercial banks, but is justified we believe by HDBK's structurally higher margin, de-risked earnings and balance sheet mix, as well as by gains in the consumer-lending franchise. This multiple is at the lower end of its historical trading band, and at the lower end of its PBV multiples relative to peers, in previous downcycles.

Risks

We rate HDFC Bank as Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share-price volatility. The downside and upside risks to our target price lie in: (1) any negative/positive news on asset quality; (2) management changes; (3) emergence of high quality and scale competitors; and (4) an increase in risk perceptions of private banks. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

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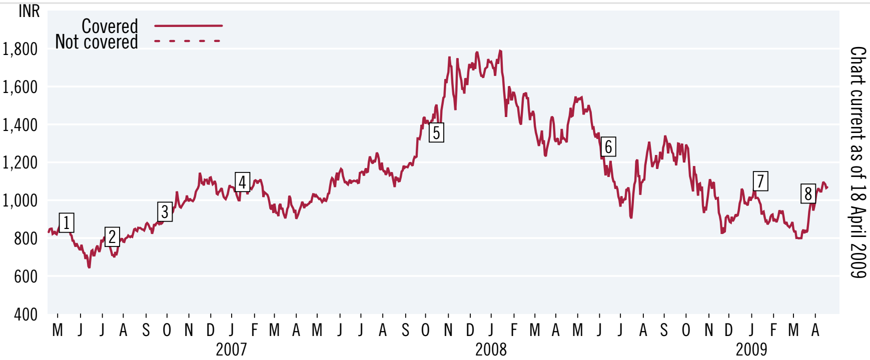
IMPORTANT DISCLOSURES

HDFC Bank (HDBK.BO)
Ratings and Target Price History
Fundamental Research
Analyst: Aditya Narain, CFA



	Date	Rating	Target Price	Closing Price
1	12-May-06	2L	*945.00	875.35
2	17-Jul-06	2L	*825.00	706.85
3	28-Sep-06	2L	*955.00	927.55
4	16-Jan-07	2L	*1,155.00	1,095.90
5	16-Oct-07	2L	*1,565.00	1,504.60
6	13-Jun-08	*1L	*1,450.00	1,123.35
7	14-Jan-09	1L	*1,350.00	977.35
8	23-Mar-09	1L	*1,100.00	884.65

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Mar 2009	**Buy**	**Hold**	**Sell**
Citi Investment Research Global Fundamental Coverage	43%	37%	20%
% of companies in each rating category that are investment banking clients	47%	43%	36%

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