

Company Focus

28 July 2008 | 9 pages

HDFC Bank (HDBK.BO)

 Results

Buy: 1Q09 Results – Merger Done, Time to Run

- Profits up 45%, 2% below expectations** — HDBK's profit and quality performance is largely along expected lines. So once again, no real surprises. More importantly, the acquisition of Centurion is now done, and the impact on financial measures, operating matrices and final cost is largely along expected lines. Delivering on the acquisition is what lies ahead.
- Merged matrices a step lower, but on expected lines with few surprises** — The merged entity is a step lower on operating matrices: margins are down to 4.1%, cost to income ratio is up, fee proportion is down, and NPLs are at the top end of HDBK's pre-merger level. But they all remain healthy and largely within guided and expected levels. HDBK has also taken a balance sheet charge of about Rs7b, only a little ahead of the Rs6b we had factored in.
- Asset growth momentum, but there is some fee erosion** — HDBK continues to grow aggressively. Loan book is up almost 15% qoq (ex-centurion), and asset behaviour beyond acquired NPA's remains in line with historical trends. While headline fees are relatively strong at 29%, there is apparent erosion in Centurion's fee pie; grossed up, fee growth is only single digit. This, along with cost rationalisation/leverage, is key to reverting to strong return ratios.
- Time to make the acquisition work** — Centurion's acquisition has been expensive – in the actual price paid, the step down in operating and profit measures and the time consumed. With the merger behind, we believe now is the time for management to generate returns on this investment and justify what continues to be viewed as an expensive acquisition.

Buy/Low Risk	1L
Price (28 Jul 08)	Rs1,127.05
Target price	Rs1,450.00
Expected share price return	28.7%
Expected dividend yield	0.8%
Expected total return	29.4%
Market Cap	Rs478,808M
	US\$11,357M

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



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	11,414	35.23	29.1	32.0	5.6	19.5	0.6
2008A	15,900	45.59	29.4	24.7	3.5	17.7	0.8
2009E	22,995	55.42	21.6	20.3	2.6	15.1	0.8
2010E	33,153	72.17	30.2	15.6	2.3	16.2	0.8
2011E	46,424	101.06	40.0	11.2	1.9	19.4	0.8

Source: Powered by dataCentral

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¹Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	32.0	24.7	20.3	15.6	11.2
P/E reported (x)	32.0	24.7	20.3	15.6	11.2
P/BV (x)	5.6	3.5	2.6	2.3	1.9
P/Adjusted BV diluted (x)	5.7	3.6	2.7	2.4	2.0
Dividend yield (%)	0.6	0.8	0.8	0.8	0.8
Per Share Data (Rs)					
EPS adjusted	35.23	45.59	55.42	72.17	101.06
EPS reported	35.23	45.59	55.42	72.17	101.06
BVPS	201.42	324.39	428.87	493.74	588.00
Tangible BVPS	201.42	324.39	428.87	493.74	588.00
Adjusted BVPS diluted	196.68	310.38	413.93	476.54	567.52
DPS	7.00	8.50	8.50	9.00	9.50
Profit & Loss (RsM)					
Net interest income	37,096	49,591	76,300	100,876	133,183
Fees and commissions	12,924	17,145	29,050	37,184	47,596
Other operating Income	2,179	4,901	6,575	7,690	9,277
Total operating income	52,198	71,637	111,925	145,749	190,055
Total operating expenses	-24,846	-37,456	-61,262	-76,183	-96,610
Oper. profit bef. provisions	27,353	34,181	50,663	69,567	93,445
Bad debt provisions	-8,610	-11,376	-14,929	-20,812	-25,174
Non-operating/exceptionals	-2,352	0	0	0	0
Pre-tax profit	16,391	22,805	35,735	48,754	68,271
Tax	-4,977	-6,905	-12,739	-15,601	-21,847
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	11,414	15,900	22,995	33,153	46,424
Adjusted earnings	11,414	15,900	22,995	33,153	46,424
Growth Rates (%)					
EPS adjusted	29.1	29.4	21.6	30.2	40.0
Oper. profit bef. prov.	31.7	25.0	48.2	37.3	34.3
Balance Sheet (RsM)					
Total assets	912,356	1,331,765	2,036,356	2,634,531	3,419,812
Avg interest earning assets	791,714	1,079,843	1,626,386	2,269,589	2,964,217
Customer loans	551,451	707,199	1,156,610	1,583,044	2,149,535
Gross NPLs	6,576	9,068	15,907	20,294	28,081
Liab. & shar. funds	912,356	1,331,765	2,036,356	2,634,531	3,419,812
Total customer deposits	682,979	1,007,686	1,579,274	2,127,668	2,849,339
Reserve for loan losses	8,104	10,413	17,541	21,472	27,556
Shareholders' equity	64,332	114,972	190,139	218,903	260,694
Profitability/Solvency Ratios (%)					
ROE adjusted	19.5	17.7	15.1	16.2	19.4
Net interest margin	4.69	4.59	4.69	4.44	4.49
Cost/income ratio	47.6	52.3	54.7	52.3	50.8
Cash cost/average assets	3.0	3.3	3.6	3.3	3.2
NPLs/customer loans	1.2	1.3	1.4	1.3	1.3
Reserve for loan losses/NPLs	123.2	114.8	110.3	105.8	98.1
Bad debt prov./avg. cust. loans	1.7	1.8	1.6	1.5	1.3
Loans/deposit ratio	80.7	70.2	73.2	74.4	75.4
Tier 1 capital ratio	8.1	9.5	10.6	10.2	10.0
Total capital ratio	12.7	12.6	13.7	13.3	13.1

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Figure 1. HDFC Bank: 1Q FY09 Results – Highlights (Rupees Million, Percent)

	1Q09	1Q08	YoY %	4Q08	QoQ%	Citi Investment Research Comments
Interest Income	36,217	20,692	75.0	29,562	22.5	
Interest Expense	(18,983)	(10,836)	75.2	(13,141)	44.5	
Net Interest Income	17,235	9,855	74.9	16,421	5.0	A little lower than expectation, with a QoQ fall off in margins - was expected to weaken, but a little ahead of expectations
Fee-Based Income	6,686	5,187	28.9	5,508	21.4	A little lower than expected; though core fee is relatively high at 37%, it does appear offset by the drop off on Centurion's own fee pie. Incorporating Centurion fee income in the base, fees are up only marginally, as there appears to have been erosion in Centurion distribution fees.
Other Non-Interest Income	(752)	(29)	2510.4	(15)	5049.3	Largely on account of MTM's on bond portfolio, equally split between the SLR and corporate bond portfolio
Non Interest Income	5,934	5,158	15.0	5,493	8.0	
Operating Income	23,169	15,014	54.3	21,914	5.7	
Operating Expenses	(12,894)	(7,744)	66.5	(11,027)	16.9	Relatively lower increase than anticipated, given the acquisition of the cost heavy Centurion Bank platform - in part explained by lower IPO related costs
Pre-Provision Profit	10,275	7,270	41.3	10,887	-5.6	
Pre-Provision Profit ex-trading gains	11,027	7,299	51.1	10,902	1.1	
Charges for Bad Debts	(3,445)	(2,997)	14.9	(4,651)	-25.9	Charge relatively low compared with historical P&L provisioning levels of HDBK
Other Operating Items	0	493	NM	0	NM	
Operating Profit	6,830	4,766	43.3	6,236	9.5	
Goodwill	0	0	NM	0	NM	
Pre-Tax Profit	6,830	4,766	43.3	6,236	9.5	
Tax	(2,187)	(1,553)	40.8	(1,525)	43.5	
Minorities	0	0	NM	0	NM	
Net Profit	4,644	3,212	44.6	4,711	-1.4	2% lower than expectations
EPS	10.9	10.2	6.9	13.3	-18.0	
Customer Loans	967,969	538,393	79.8	634,270	52.6	Aggressive growth, beyond Centurions acquired assets - in line with managements' suggestion that the growth environment remains fairly comfortable
Customer Deposits	1,309,176	816,045	60.4	1,007,690	29.9	Largely acquisition driven, but it has resulted in a moderation in the mix, which remains within guided levels
AIEA	1,276,512	832,571	53.3	1,492,818	-14.5	
AIBL	1,214,145	777,464	56.2	1,053,568	15.2	
Total Assets		1,056,953	NM	1,331,766	NM	
Avg Assets	665,883	984,654	-32.4	1,323,080	-49.7	
Non-Performing Loans (NPL)	15,027	6,500	131.2	9,070	65.7	Increase largely on account of Centurion Bank; a part of its NPA's have also been offset against the balance sheet, but within anticipated levels. About 8% new deterioration on HDBK's book, which is in line with expectations, and relatively comfortable
Loan Loss Reserves (LLR)	(10,067)	(4,622)	117.8	(6,085)	65.4	Coverage levels in line with historical averages - appear to be limited write-offs, with some provision carry over from Centurion
Shareholders' Funds	133,000	80,969	64.3	114,972	15.7	Management adjusts about Rs7b on merger and asset costs against its book, largely in line with our RS6b expectation
Book Value Per Share	313	253	23.9	325	-3.5	
Key Ratios (%)	1Q09	1Q08	Bps Δ YoY	4Q08	Bps Δ QoQ	
ROAA (annualized)	2.79	1.30	148	1.42	137	
ROAE (annualized)	13.97	15.87	-190	16.39	-242	
Net Interest Margin (bps)	410	420	-10	440	100	Margins dip QoQ on account of acquisition, but remain largely in line with expectations
Fee Inc/Operating Income	28.9	34.5	-569	25.1	372	Relative dip on account of Centurion slowdown, modest YoY fx fee growth; strong performance over the quarter, particularly on the FX side, which in itself might be a little cyclical
Other Non-Interest Inc/Op Inc	25.6	34.4	-874	25.1	55	
Op. Cost/ Operating Income	55.7	51.6	407	50.3	533	
Loan-to-Deposit Ratio (LDR)	73.9	66.0	796	62.9	1099	
NPL/Loan Ratio	1.6	1.2	35	1.4	12	Higher on account of the acquisition - only a little ahead of expectations, with no big surprises on account of the acquisition
LLR/NPL Ratio	67	71	-412	67	-10	Remains at its average levels

Source: Company reports, Citi Investment Research

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 734 branches and more than 1,471 ATMs in 263 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 Rs1,450. 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 3-4x P/BV band over the longer term, we see it trading at the lower end of its trading band, as it would need to raise ROE from its currently low level, following its acquisition of Centurion Bank, and expected capital-raising from its parent. 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 Rs1,450 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 320bps. 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 3x forward P/BV for a fair value of Rs1,362 - 3x 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.

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) the HDFC Bank-HDFC agreement. 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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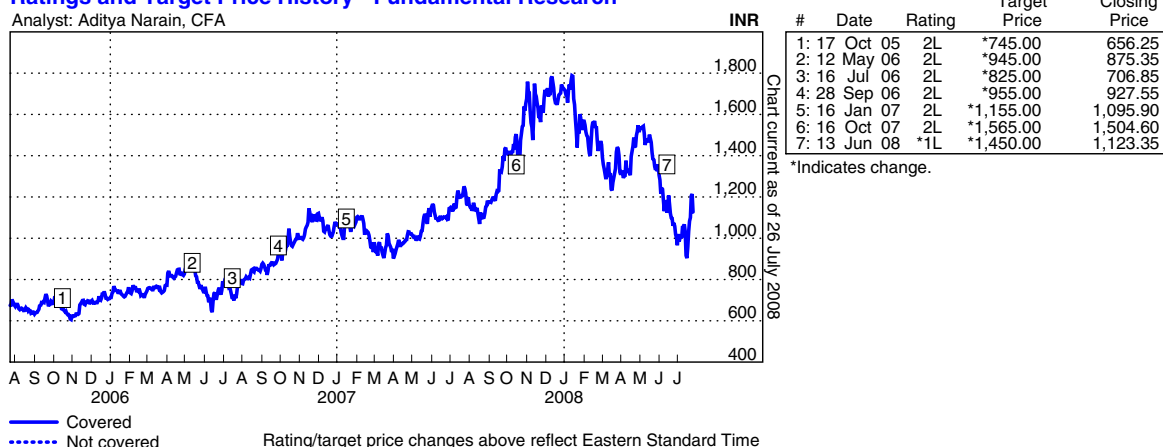
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HDFC Bank (HDBK.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Aditya Narain, CFA



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