HDFC Bank Ltd – BUY

'Quality growth to continue'

Sector: Banking	
Sensex:	18,446
CMP (Rs):	2,139
Target price (Rs):	2,475
Upside (%):	15.7
52 Week h/l (Rs):	2,540/1,629
Market cap (Rscr) :	100,315
6m Avg vol ('000Nos):	935
No of o/s shares (mn):	465
FV (Rs):	10
Bloomberg code:	HDFCB IB
Reuters code:	HDBK.BO
BSE code:	500180
NSE code:	HDFCBANK

Prices as on 01 Mar, 2011

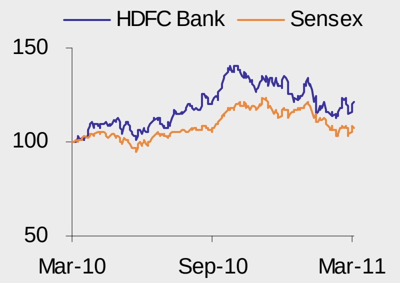
Shareholding pattern

September '10	(%)
Promoters	23.4
Institutions	40.2
Non promoter corp hold	8.5
Public & others	27.9

Performance rel. to sensex

(%)	1m	3m	1yr
HDFC Bk	5.5	(1.7)	13.1
ICICI Bk	(1.8)	(7.1)	2.6
Axis Bk	1.6	(1.7)	2.1
Yes Bk	0.9	(9.7)	(0.1)

Share price trend



Research Analyst
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Our recent interaction with HDFC Bank reaffirmed our belief that the bank is comfortably placed to deliver industry leading loan and earnings growth. The bank has been witnessing robust credit demand in both retail and corporate segments. Given its profile of assets, HDFC Bank has been largely serving a more enduring credit demand. With Tier-1 capital at 12%, bank is well capitalized to support robust growth for next three years.

While migration to TDs is happening, management is hopeful of retaining CASA at 46-48%. HDFC Bank is confident of sustaining NIM in a narrow range of 4-4.3% aided by its matched asset-liability duration and relatively strong pricing power. Though asset quality is expected to remain sanguine, the provisioning charge is expected to increase in FY12 due to resumption of general provisioning. RoA would stay at industry-best levels of 1.5-1.6%. Retain BUY on HDFC Bank with 9-month target of Rs2,475.

Loan growth to be in the range of 26-29%

HDFC Bank expects system loan growth to moderate from current 23% to near 20% by the end of the year due to higher base. With the bank's loan book expected to remain stable or marginally decline sequentially in Q4 FY11, FY11 credit growth would likely be in the range of 26-29%. In FY12 also, bank would strive to grow 4-7% ahead of the system. With a small ~4% market share, the bank has ample headroom to grow faster and gain market share. However, the bank does not prefer to grow significantly higher (more than 10%) than system as that would entail compromise on asset quality or margins. HDFC Bank intends to keep the loan book mix near 50:50 between retail and wholesale segments.

Working capital loans driving growth in corporate segment

Within the wholesale credit segment (~45% of loan book), bank has been witnessing strong demand for working capital loans (~75% of corporate book) being driven by inflation and higher commodity prices. Bank expects robust demand to continue with the overall economic activity anticipated to remain buoyant. The demand for long term loans (~25% of corporate book) especially from the infrastructure and industrial sector has not seen the extent of revival as was expected. Higher levels of capacity utilization and strong order book suggest that demand for term loans should pick up. However, HDFC Bank is least dependant on revival in this segment as it comprises minority portion (10-15%) of the overall loan book.

Financial summary

Y/e 31 Mar (Rs m)	FY10	FY11E	FY12E	FY13E
Total operating income	121,942	147,282	180,856	231,350
Yoy growth (%)	13.8	20.8	22.8	27.9
Operating profit (pre-provisions)	64,297	76,840	92,804	121,284
Net profit	29,487	39,437	45,571	60,066
yoy growth (%)	31.3	33.7	15.6	31.8
EPS (Rs)	64.4	84.9	98.1	129.4
BVPS (Rs)	470.2	531.0	605.8	705.9
P/E (x)	33.2	25.2	21.8	16.5
P/BV (x)	4.5	4.0	3.5	3.0
ROE (%)	16.1	17.1	17.3	19.7
ROA (%)	1.5	1.6	1.6	1.6
CAR (%)	17.4	15.6	13.5	11.6

Source: Company, India Infoline Research

Witnessed robust demand across products till date

As lending rates are likely to increase in near term, bank expects marginal slowdown in some pockets

Robust demand across products in the retail segment

In the retail segment (~55% of loan book), the bank has witnessed robust demand across products till date. However, till December most of the deposit rate hikes were not transmitted on the retail side. As the lending rates are likely to increase in the near term, bank expects marginal demand slowdown in the segments of mortgages (due to higher ticket size), CV loans (as it is linked to business) and auto loans (especially for premium cars). HDFC Bank is one of the leading players in most products in the retail segment. Its market share in auto loans is estimated at 22-25%, in CV financing at 15-20% and in incremental personal loans and credit cards at much higher.

~75-80% of bank's advances are retail loans and WC loans

Therefore, the credit demand served is more secular in nature

Largely consumption bank; less affected by business cyclicity

Bank believes that it is largely a consumption-driven bank given its profile of assets (~75-80% is retail loans and WC loans) and therefore the credit demand it serves is more secular in nature. This is in contrast to most PSBs who face cyclical credit demand as they have significant exposure to term financing. An observation that supports this argument is that HDFC Bank typically witnesses stronger growth in the first nine months while PSBs witness robust credit pick-up in H2.

In Q1 FY11, Bank had disbursed short-term loans to the tune of Rs80-90bn

By the end of Q3 FY11, all these loans ran-off

The core YTD growth stands at robust 26.5%

Short-term opportunistic assets have run-off

In Q1 FY11, HDFC Bank had disbursed short-term loans to the tune of Rs80-90bn mainly to telecom companies for payment towards 3G and BWA spectrum. These loans had tenure of 6-9 months. So, whereas the bank reported yoy loan growth was 40% and 37% at the end of Q1 FY11 and Q2 FY11, the core growth (excluding these assets) was actually 30% and 32% respectively. At the end of Q3 FY11, both the reported and core growth converged to 33% as all these advances ran-off. Adjusting for the significant run-off witnessed during Q3 FY11, the core qoq loan growth stood strong at 6%. Further, the core YTD growth stands at robust 26.5%, significantly ahead of the system which has witnessed 16% credit expansion.

Bank does some sell-offs or participates out during the last quarter

This adjustment mainly happens in the corporate segment

Bank typically slows down growth in Q4 to have a lower PSL target for the next year

Generally, the bank grows strongly in the first three quarters of the year and does some sell-offs or participates out during the last quarter so that year-ending advances are either marginally lower or in-line with Q3. This adjustment mainly happens in the corporate segment with the bank transferring some working capital loans to other banks. The closing advances form the basis of the priority sector lending target for the next year.

Rate hike has been disparate across maturities; sharper at the shorter end and lower at longer end

Average deposit rate hike has been 150bps

The average deposit rate hike implemented over the past 5-6 months has been 150 bps. Across maturities, however, rate hike has been disparate with it being more sharper at the shorter end (175-200 bps for 1-2 year deposits) and lower at longer end (~100-150 bps for 3-5 year deposits). Bank feels that it would be too early to gauge the impact of rate hikes on deposit mobilization as material hikes were implemented near December 2010.

Deposit growth would be in-sync with advances keeping C/D ratio elevated

Significant increase in deposit rates implemented was mainly to retain deposits coming up for renewal

In the near term, bank feels there is no need to shore-up deposits.

The bank sees deposits growth continuing to track the growth in advances in the medium term. The significant increase in deposit rates implemented was mainly to retain deposits coming up for renewal. Peer banks were raising rates fast and HDFC Bank could not have afforded to keep its rack rates significantly different from the market. The bank is not intending to mobilize deposits materially in Q4 FY11 also as the loan book is expected to remain stable. In the near term, bank feels there is no need to shore-up deposits.

CASA to Term Deposit migration taking place

HDFC Bank has the industry best CASA ratio of 50%

Bank is confident of sustaining CASA in the range of 46-48% in the medium term

Plans to add 150-170 branches in the current year and 170-200 branches in FY12

HDFC Bank has the industry best CASA ratio of 50%. Further, within term deposits (TDs), retail/wholesale mix is 80:20. The wholesale deposits are essentially relationship deposits kept by corporate banking clients and are less interest rate sensitive in nature. With significant increase in TD rates, the bank has been witnessing migration from CASA since the month of December. However, the core CASA growth remains strong and bank is confident of sustaining CASA in the range of 46-48% in the medium term. The key to sustaining CASA would be network expansion and the bank plans to add 150-170 branches in the current year and 170-200 branches in FY12. The branch addition would be across geographies and location would be a fair mix of Metros, Tier-2, Tier-3 and Rural. Presently, ~68% of the bank's branches are outside the Top 9 cities.

YoA has been improving; easier to pass on higher cost in wholesale segment vis-à-vis retail

Finding it easier to transfer the higher cost of funds in the wholesale segment

On the retail side, intensified competition has marginally diluted pricing power

Bank is confident of passing at least partial hike in the retail segment going ahead

Bank's yield on advances has been increasing aided by 75 bps PLR and 50 bps Base Rate hike implemented over the past five months. The bank has been finding it easier to transfer the higher cost of funds in the wholesale segment as CP rates have increased considerably. On the retail side, intensified competition has marginally diluted pricing power and thereby the ability to pass on despite the bank's dominant presence in most segments and strong brand equity. As per the bank, new players are entering the retail credit market and few old players have returned. However, post December 2010, the retail rates have become less sticky. Bank has implemented two rate hikes in the Auto loans segment, which was followed by the competition. Bank is confident of passing at least partial hike in the segment going ahead.

Lending rate hike need not be as sharp to sustain margins

As per the bank, even though the TD rates have risen by 150-175 bps, the bank does not need to raise lending rates by that extent to sustain margin. 50% of the bank's deposits is CASA and the higher rates are only applicable to the incremental TDs and the ones that are coming up for renewal. So for the entire deposits book, the cost doest not increase by the extent of rate hike. Therefore, lending rates hike need not be as sharp to sustain margin at least in the short term.

Shorter duration of assets imply quicker transmission

Around 20% of the bank's loan book is floating and gets re-priced immediately

Around 20% of the bank's loan book is floating and gets immediately re-priced post rate hike. This portion mainly includes 25-30% of the corporate book (non working capital loans having average maturity of ~3 years) and few pockets of the retail book such as home loans (linked to HDFC's PLR) and a part of business banking. The residual 70-75% of the wholesale book is working capital loans with average maturity of less than 1 year and the average duration of the residual retail portfolio is about 18 months.

NIM to be maintained in the range of 4-4.3%

NIM to remain stable (most likely slip marginally by 5-7bps) in the near term

Bank has been running matched books thereby immunizing its margin from extreme interest rate movement

The significant deposit rate hike implemented would increase CoD in the next two quarters as existing deposits come for renewal and TD accretion accelerates. On the other side, YoA is expected to improve. Bank expects NIM to remain stable (most likely slip marginally by 5-7bps) in the near term. The key reason behind the bank's ability to sustain NIM in a narrow range of 4-4.3% has been superior asset-liability management (ALM). HDFC Bank has been running matched books ie average duration of assets and liabilities have been similar at near 18 months thereby immunizing its margin from extreme interest rate movement. Further, despite other headwinds in the past such as significant slowdown in credit demand, integration of relatively low-margin CBoP book, savings interest re-calculation and change in loan mix, the bank has commendably sustained NIM above 4%.

Deposits rate increases to halt in the near term; retail lending rates to increase further

Bank expects no deposit rate hikes in the near term but further lending rate increases on the retail side

Estimates RBI to raise policy rates by 50-75 bps in the remainder of calendar year

Bank expects no deposit rate increases in the near term but possibly 25-50 bps increase in the medium term. On the retail side, bank sees headroom for further lending rate increases in the range of 50-75 bps in different product categories. Wholesale lending rates are expected to remain steady in the near term. Bank expects RBI to raise policy rates by 50-75 bps in the remainder of calendar year. As per the bank, though the expected increase in policy rates would be successful in containing inflation, it may also moderate economic growth to near 8% in FY12.

Tight liquidity conditions to ease in the next couple of months

Bank comfortably placed with respect to liquidity therefore enabling it to exert strong pricing power

HDFC Bank has been comfortably placed with respect to liquidity therefore enabling it to exert strong pricing power. Even during the previous liquidity crunch in 2008, the bank did not resort to borrowing from RBI under the LAF window. As per the bank, RBI would like to have liquidity deficit in the range of Rs500-700bn and this is likely to be achieved by the start of next fiscal mainly driven by a more forceful government spending.

Core fee income to grow behind loan growth

Fee income mainly transaction driven; 80% comes from the retail segment and 20% from the corporate segment

Regulatory changes in the past 1-2 years have lowered the fee income growth trajectory

The core fee income growth would continue to lag advance growth for some time, according to the bank. The fee income of the bank is mainly transaction driven (branch banking, sale of TPPs, fees on Debit/Credit cards, ATM charges, etc). About 80% of the fee income comes from the Retail segment and the rest 20% from the Corporate segment. The regulatory changes in the past 1-2 years such as removal of ATM fees, entry load on MFs, IRDA capping the expenses of insurance companies, etc have lowered the fee income growth trajectory to 15-20% in the medium term. In the longer term though, the fee income would track the loan growth.

C/I ratio to remain stable; almost all efficiencies from CBoP squeezed

C/I ratio expected to remain stable near 47%

From the acquired CBoP, all the possible efficiencies have been squeezed out. Though the general productivity improvement measures would continue, the C/I is expected to remain stable near 47%.

Asset quality to stay strong; however, provisioning charge to increase in FY12

NPL levels have been consistently improving over the past six quarters

Bank does not foresee any deterioration in asset quality in the medium term

MFI is the only concern area, however, bank's exposure to is negligible at 0.6% of the book

HDFC Bank has one of the strongest asset quality in the industry. NPL levels have been consistently improving over the past six quarters and presently the GNPL% and NNPL% stand at 1.1% and 0.2% respectively. The bank does not foresee any deterioration in asset quality in the medium term. As per the management, almost all products in the retail segment are displaying lower levels of stress than what has been priced in. Even the cheque bounce rate, which is typically the lead indicator for NPAs has been stable. On the wholesale side also, the asset quality has been steady and barring any 'system shocks' it is unlikely to slip. Total restructured assets remain at insignificant 0.3% of the bank's gross advances. MFI is the only concern area, however, bank's exposure to it is negligible at 0.6% of the book (~Rs10bn) and about 1/3rd of it is in Andhra Pradesh. The bank has already taken a provision equivalent to 10% of exposure unlike some other banks who have been restructuring these loans.

Provisioning charge to increase to ~1.4-1.5% from Q1 FY12 with resumption of general provisioning

However, the provisioning charge that had declined in the past two quarters to ~1.2% is expected to increase to ~1.4-1.5% from Q1 FY12 with resumption of general provisioning (GP). Bank estimates the surplus GP cover to exhaust by Q4 FY11. PCR (core specific loan-loss provisions) at 83% stands significantly higher than required.

RoA to remain at industry best levels of 1.5-1.6%

Lower treasury gains (due to higher interest rates) could marginally pull-down the RoA to near 1.5%

RoA improvement over the past two quarters was driven by handsome treasury gains and material decline in provisioning charges. Going ahead, lower treasury gains (due to higher interest rates) could marginally pull-down the RoA to near 1.5% from the current 1.6%. As regards the impact of resumption of general provisioning on RoA, it is likely to get offset by the absence of counter-cyclical floating provisions that the bank is making currently.

Well-capitalized for brisk growth over the coming three years

Well-capitalized with a CAR of 16% and Tier-I capital of 12%; adequate to support growth over the next 3 years

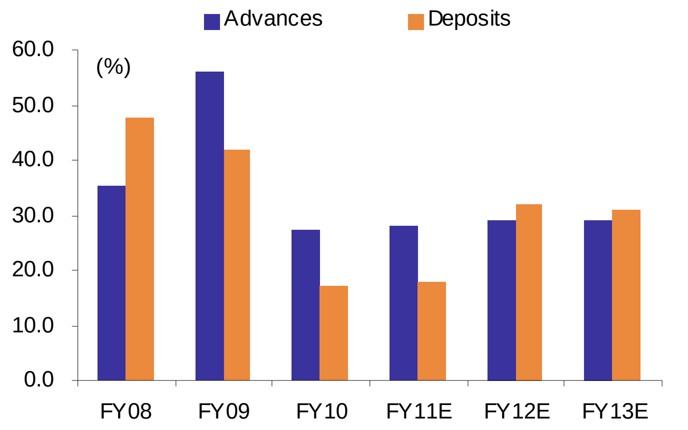
At the end of Q3 FY11, HDFC Bank was well-capitalized with a CAR of 16% and Tier-I capital of 12%. Bank estimates that that approx 1% of the capital would be consumed pa based on the targeted loan growth rate. Therefore, the bank seems adequately capitalized to meet the growth requirements over the next three years.

Premium valuation for the bank to continue; Retain BUY with 9-month target of Rs2,475

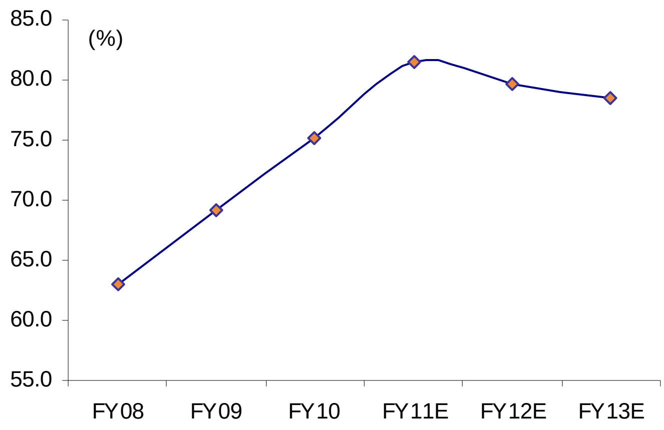
HDFC Bank is set to deliver an industry-best loan and earnings CAGR of 29% and 27% respectively over FY10-13

We believe that HDFC Bank is set to deliver an industry-best loan CAGR of 29% over FY10-13 despite its higher base. With NIM management, operating efficiency and asset quality being top-class, a robust headline growth would translate into strong earnings CAGR of 27%. We expect HDFC Bank to outperform the Bankex in the medium term. Using our proprietary valuation model for banks, *Bank 20*, and an adjudged premium, we assign FY13 P/BV multiple of 3.6x and arrive at 9-month price target of Rs2,475.

Business growth to remain brisk over FY10-13

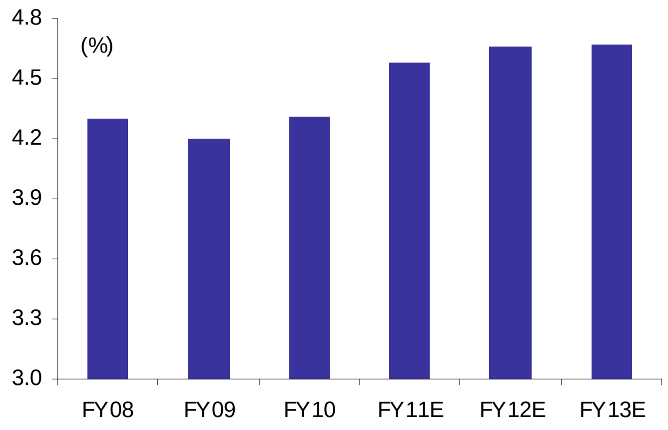


C/D ratio to remain elevated as deposits would closely track advances

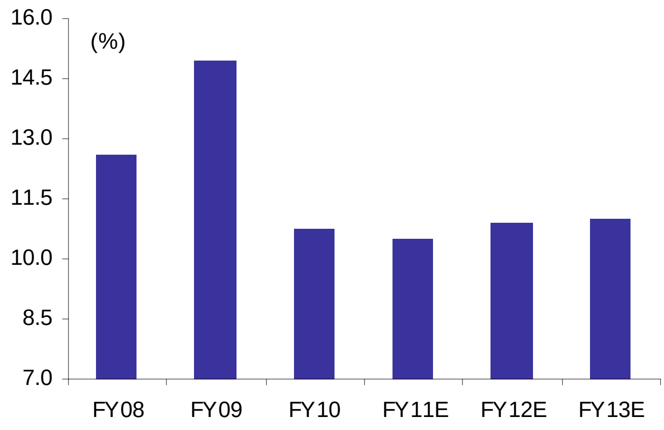


Source: Company, India Infoline Research

NIM* to remain robust (reported margin to remain in the range of 4-4.3%)

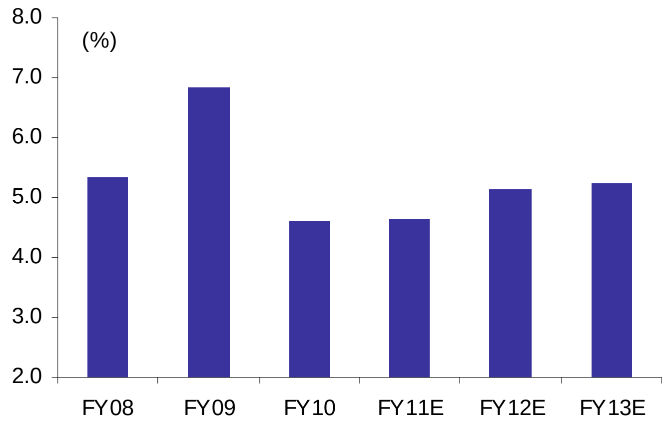


YoA* to improve driven by lending rate hikes

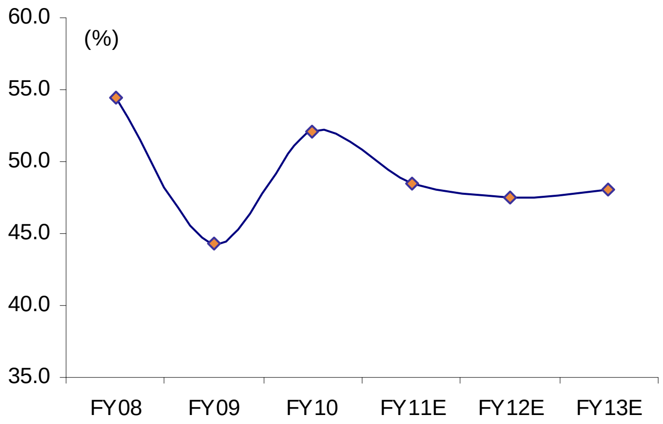


*Source: Company, India Infoline Research; * Computed by us*

CoF* to increase on account of deposit rate hikes

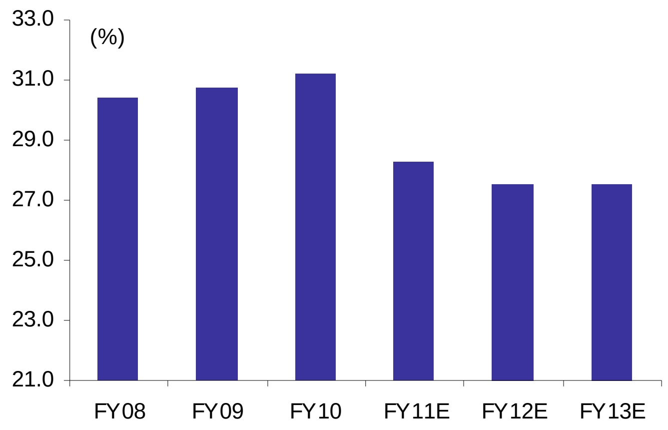


CASA ratio to marginally correct on migration to TDs

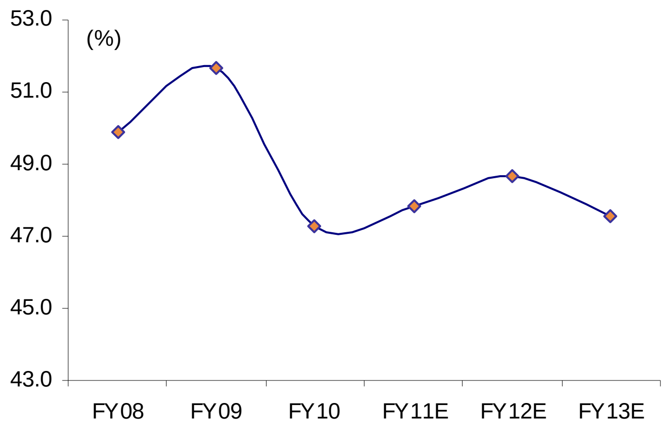


*Source: Company, India Infoline Research; * Computed by us*

Non-interest income % to be impacted by lower fee income growth and treasury gains

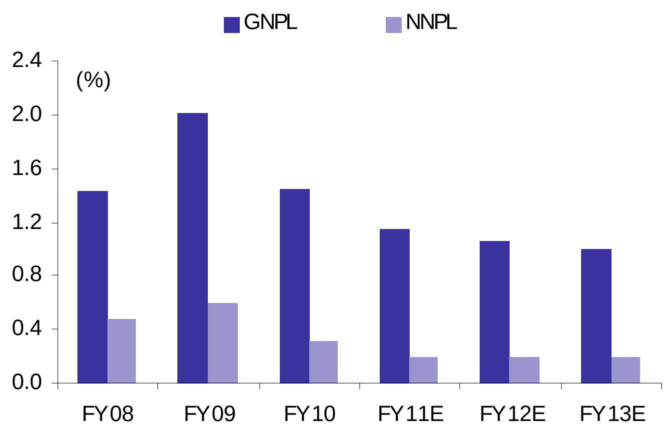


C/I to hover around 47% mark despite decline in non-interest income %

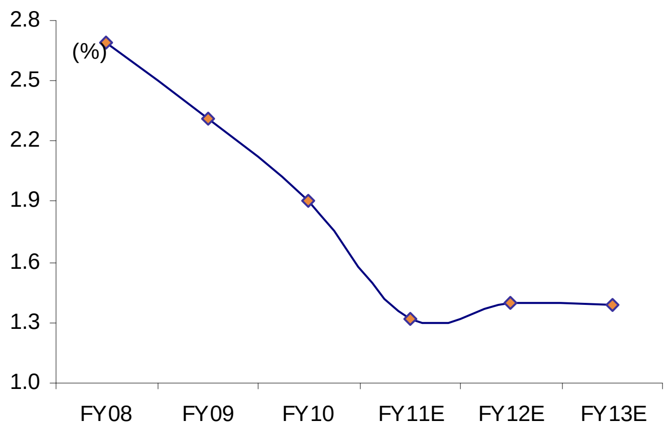


Source: Company, India Infoline Research

Asset quality to gradually improve

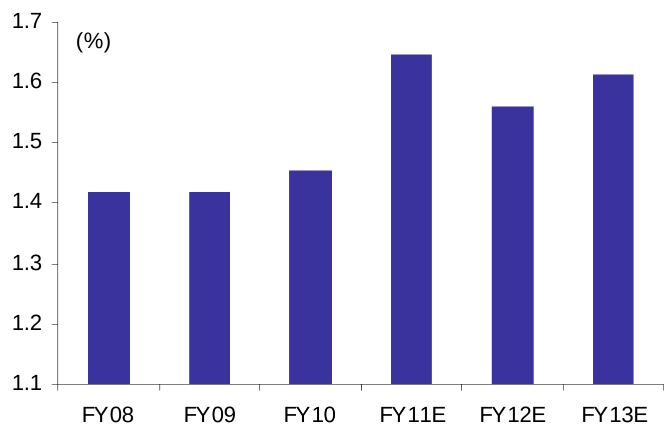


Provision charge to increase in FY12 due to resumption in general provisioning

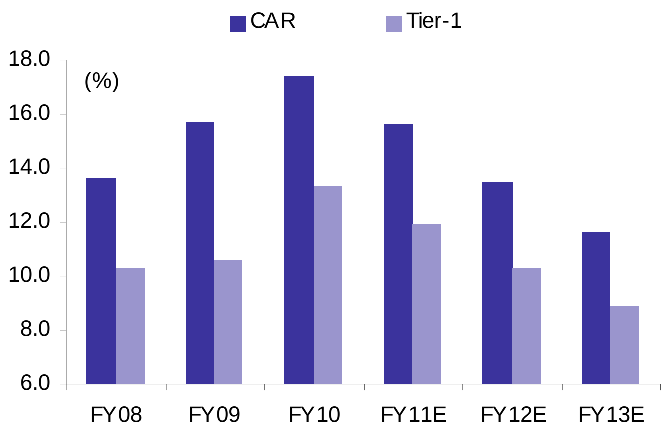


Source: Company, India Infoline Research

RoA to remain at industry-best level of 1.5-1.6%



Adequately capitalized to support growth over the next three years



Source: Company, India Infoline Research

Bank 20 valuation – HDFC Bank (private sector bank)

Valuation Parameters	Indicates/Determines	Star Rating	Nom. Score	Weight	Wght. Score
Loan Book Growth	Medium-term income growth	★★★★★	5.00	0.07	0.35
Loan Book Mix	Business risk	★★★★★	5.00	0.05	0.25
Branch Network	Scale/Reach	★★★★½	4.50	0.04	0.18
CASA Deposits	Cost of Deposits	★★★★★	5.00	0.04	0.20
Cost of Funds	NIM	★★★★★	5.00	0.04	0.20
Credit/Deposit Ratio	NIM	★★★★★	5.00	0.05	0.25
NIM and its management	Profitability/ALM	★★★★★	5.00	0.07	0.35
Core Fee Income/Total Income	Stability of income	★★★★	4.00	0.05	0.20
Treasury Management	Stability of income	★★★★½	4.50	0.04	0.18
Cost/Income Ratio	Operating efficiency	★★★★	4.00	0.05	0.20
Return on Avg. Assets	Operating efficiency	★★★★★	5.00	0.05	0.25
Gross NPL	Asset quality	★★★★½	4.50	0.06	0.27
Provisioning Policy & Coverage	Conservatism	★★★★★	5.00	0.04	0.20
Equity/Net NPL	Risk cover	★★★★★	5.00	0.04	0.20
Capital adequacy	Risk cover	★★★★★	5.00	0.07	0.35
Tier-II/Tier-I Capital	Room for growth w/o dilution	★★★★★	5.00	0.05	0.25
Equity/Total Assets	Leverage	★★★★★	5.00	0.04	0.20
Return on Avg. Equity	Profitability	★★★★½	4.50	0.07	0.32
Management Quality	Long-term income growth	★★★★★	5.00	0.04	0.20
Brand	Long-term income growth	★★★★★	5.00	0.04	0.20
Bank 20 Score		★★★★★			**4.80**

Source: India Infoline Research

 # individual parameter rating is relative to the peer group (ICICI Bank, Axis Bank and Yes Bank)

★ - Worst, ★★- Below Average, ★★★- Average, ★★★★ - Above Average, ★★★★★ - Best

Target Price calculation	Particulars
FY13E Equity (Rs mn)	327,769
Impaired Assets (Rs mn)	4,758
Adj. FY13E Equity (Rs mn)	323,011
Adj. FY13E BVPS (Rs)	696
Avg. FY13E P/BV of Peers (x)	2.0
Bank 20 FY13E P/BV (x)	2.6
(Risk)/Prem. adj. (x)	1.0
Assigned FY13E P/BV (x)	3.6
Target Price (Rs)	2,475
CMP (Rs)	2,139
Upside/(Downside) %	15.7

About Bank 20

Bank 20 is our attempt to minimize the subjective element in assignment of appropriate P/BV for every bank. It is a comprehensive model that takes into consideration 20 key valuation parameters, operational and financial, quantitative and qualitative, to arrive at a more refined book value multiple as compared to that from theoretical return differential (ROE-COE) model. Each of the valuation parameter has been assigned weights in the context of its importance in an objective assessment of a bank. Loan book growth, NIM and its management, capital adequacy, sustainable RoE and asset quality are the Top 5 parameters weighing 34% in Bank 20. Though the parameters may remain constant, individual weights may change with phases in economic growth and concurrent concerns and positives of the industry then.

Financials

Income statement

Y/e 31 Mar (Rs m)	FY10	FY11E	FY12E	FY13E
Interest income	161,729	199,715	260,150	338,229
Interest expense	(77,863)	(94,066)	(129,085)	(170,571)
Net int income	**83,866**	**105,649**	**131,066**	**167,658**
Non-int income	38,076	41,633	49,791	63,691
Total op income	**121,942**	**147,282**	**180,856**	**231,350**
Total op expenses	(57,645)	(70,442)	(88,053)	(110,066)
Op prof (pre-prov)	**64,297**	**76,840**	**92,804**	**121,284**
Provisions	(21,406)	(18,844)	(25,788)	(32,952)
Profit before tax	**42,891**	**57,995**	**67,016**	**88,332**
Taxes	(13,404)	(18,558)	(21,445)	(28,266)
Net profit	**29,487**	**39,437**	**45,571**	**60,066**

Balance sheet

Y/e 31 Mar (Rs m)	FY10	FY11E	FY12E	FY13E
Total cash & equiv	299,424	193,276	215,281	232,046
Investments	586,076	662,266	860,946	1,119,229
Advances	1,258,306	1,610,632	2,077,715	2,680,252
Total int-earn assets	**2,143,806**	**2,466,173**	**3,153,942**	**4,031,528**
Fixed assets	21,228	22,502	28,127	35,159
Other assets	59,552	74,440	89,328	107,194
Total assets	**2,224,586**	**2,563,115**	**3,271,397**	**4,173,880**
Net worth	**215,225**	**246,579**	**281,284**	**327,769**
Deposits	1,674,044	1,975,372	2,607,491	3,415,813
Borrowings	193,935	206,851	228,162	252,669
Total int-bearing liab	**1,867,979**	**2,182,223**	**2,835,653**	**3,668,482**
Non-int-bearing liabs	141,382	134,313	154,460	177,629
Total liabilities	**2,009,361**	**2,316,536**	**2,990,112**	**3,846,111**
Equity + Total liab	**2,224,586**	**2,563,115**	**3,271,397**	**4,173,880**

Key ratios

Y/e 31 Mar	FY10	FY11E	FY12E	FY13E
Growth matrix (%)				
Net interest income	13.0	26.0	24.1	27.9
Total op income	13.8	20.8	22.8	27.9
Op profit (pre-provision)	24.2	19.5	20.8	30.7
Net profit	31.3	33.7	15.6	31.8
Advances	27.3	28.0	29.0	29.0
Deposits	17.2	18.0	32.0	31.0
Total assets	21.4	15.2	27.6	27.6
Profitability Ratios (%)				
NIM	4.3	4.6	4.7	4.7
Non-int inc/Total inc	31.2	28.3	27.5	27.5
Return on Avg Equity	16.1	17.1	17.3	19.7
Return on Avg Assets	1.5	1.6	1.6	1.6
Per share ratios (Rs)				
EPS	64.4	84.9	98.1	129.4
BVPS	470.2	531.0	605.8	705.9
DPS	12.0	15.0	20.0	25.0
Other key ratios (%)				
Credit/Deposits	75.2	81.5	79.7	78.5
Cost/Income	47.3	47.8	48.7	47.6
CASA	52.0	48.5	47.5	48.0
CAR	17.4	15.6	13.5	11.6
Tier-I capital	13.3	12.0	10.3	8.9
Gross NPLs/Loans	1.4	1.2	1.1	1.0
Total prov/Avg loans	1.9	1.3	1.4	1.4
Net NPLs/Net loans	0.3	0.2	0.2	0.2
Tax rate	31.3	32.0	32.0	32.0
Dividend yield	0.6	0.7	0.9	1.2

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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