

HDFC BANK

INR 1,150

On a firm wicket

BUY



HDFC Bank's Q1FY08 numbers were in line with our estimates. Net profit for the quarter grew by 34% Y-o-Y to INR 3.2 bn while net interest income grew by 28% Y-o-Y.

Key highlights of the quarter were: (1) net interest margins improved Y-o-Y to 4.2%; (2) non-interest income increased by 46%; (3) the proportion of low-cost deposit declined slightly to 52%; (4) operating expenses increased 40% Y-o-Y due to expansion in branches; (5) higher general provisioning led to overall provision growth of 50% Y-o-Y; and (6) balance sheet grew by 32% Y-o-Y.

We are maintaining our EPS estimate for FY08 at INR 43 and reducing EPS estimate for FY09 by 2.15% to INR 56.6. We are: (1) incorporating actual FY07 numbers; (2) reducing our margin expectations; and (3) increasing fee income growth expectations to 30% from 27.5% in FY08E.

We like the bank for its liability franchise and asset quality. We believe HDFC Bank is a safe bet compared to its peers on the back of its stable and predictable growth. The stock currently trades at 3.1x FY09E book and 20x FY09E EPS. We maintain 'BUY' recommendation.

* Strong growth in balance sheet continues

After slowing down in Q4FY07, the bank grew its balance sheet by a strong 32% in Q1FY08. Advances grew by 33% Y-o-Y to INR 538 bn. On the retail side, advances grew by 33% with growth in car, credit card, and personal loans, while CV and two-wheeler financing declined. Retail credit as a percentage of total loan book was at 57%, similar to Q1FY07 levels. Deposits also grew by a strong 35% to INR 816 bn. CASA proportion declined to 52% on a sequential basis due to high transactional float of low-cost deposits in Q4FY07 (55% previous quarter). We expect 32% growth in loan book over FY07-09E.

* NIMs improve by 10bps Y-o-Y, but dip by over 30bps Q-o-Q

NIMs improved by 10bps on a Y-o-Y basis. However, on Q-o-Q basis, margins declined by over 30bps due to: (1) absence of interest on CRR balances; and (2) absence of transactional float.

Financials

Year to March	Q1FY08	Q1FY07	growth %	Q4FY07	growth %	FY07	FY08E
Net int. inc. (INR mn)	10,422	8,176	27.5	11,177	(6.8)	44,550	56,254
Net profit (INR mn)	3,212	2,393	34.2	3,436	(6.5)	15,400	20,388
B/V per share (INR)						332.6	377.0
EPS (INR)	10.0	7.6	31.6	10.1	(1.0)	42.8	56.6
Price/ Book (x)						3.5	3.1
Price/ PPOP (x)						12.3	9.3
Price/ Earnings (x)						26.9	20.3

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Bloomberg : HDFCB IN

Market Data

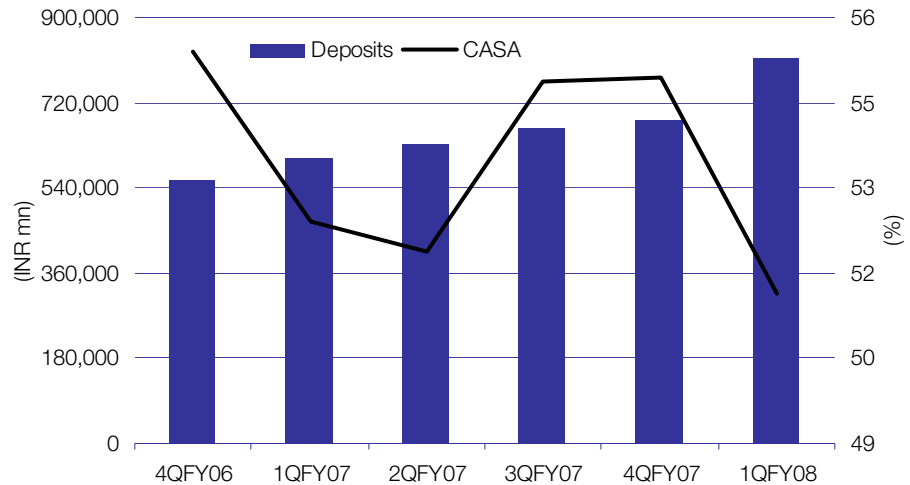
52-week range (INR) : 1,274 / 693
Share in issue (mn) : 319.3
M cap (INR bn/USD mn) : 367.3 / 9,085.4
Avg. Daily Vol. BSE/NSE ('000) : 661.4

Share Holding Pattern (%)

Promoters : 24.7
MFs, FIs & Banks : 8.7
FII's : 26.5
Others : 40.1

Cost of funds increased by 60bps, while yields on assets declined by 39bps (mainly due to absence of interest on CRR). Yield on advances have improved by 60bps sequentially as full effect of PLR hikes affected in previous quarters flowed in. The bank opened 69 branches during the quarter, which we believe, will play a pivotal role in improving the bank's retail business, going forward. Along with equity issuance we expect margins to remain stable in FY08E.

Chart 1: Deposits and CASA



Source: Company, Edelweiss research

*** Revising up FY08 fee-based income estimate**

HDFC Bank's non-interest income in Q1FY08 grew higher than expected by 77% Y-o-Y. The bank incurred losses on sale/revaluation of investments of INR 41 mn in Q1FY08 against INR 622 mn in Q1FY07 (please note that consequent to change in guidelines, banks will reduce investment depreciation and amortization from treasury gains instead of reporting it in provisions). Forex and derivatives revenues nearly tripled, whereas fee and commission income grew by 28% Y-o-Y. We are revising our fee-based income estimate to 32.5% in FY08 (27.5% earlier) and to 30% in FY09E (25% earlier).

Table 1: Break up of non interest income

	Q1FY08	Q1FY07	growth %	Q4FY07	growth %
Fees & Commissions (INR mn)	3,722	2,906	28.1	3,563	4.5
Forex & Derivatives revenues (INR mn)	1,465	558	162.5	1,033	41.8
Total fee income	5,187	3,464	49.7	4,596	12.9
Fee to avg assets (%)	2.2	2.0		2.1	
Investment profit/loss (INR mn)	(41)	(662)	(93.8)	(656)	(93.8)

Source: Company, Edelweiss research

*** Other details**

HDFC Bank's operating expenses grew by 40% Y-o-Y due to 70% growth in staff expenses and expansion in branch network. The bank opened 69 branches during the quarter. Provisioning for the quarter was higher by 50% Y-o-Y due to high general provisioning (enhanced general provisioning norms on certain standard assets which were absent in Q1FY07). The bank maintained its net NPA ratio at 0.4%.

The bank has adopted AS-15, consequent to which INR 576 mn will be adjusted against the bank's net worth.

HDFC Bank's capital adequacy ratio as on June 2007 is 13.1%, with tier-1 of 9.2%. The bank has allotted 13.5 mn shares at INR 1023 per share on a preferential basis to HDFC Ltd, aggregating to INR 13.9 bn. It is also planning a USD 700 mn GDR issue in the coming months, which we believe will be at a premium to the current price and hence, will be book accretive.

* **Valuations**

The stock is trading at 3.1x FY09E book and 20x FY09E earnings. We expect the bank to generate 15-16% RoE in FY08-09E and 24% EPS CAGR over FY07-09E. HDFC Bank has always traded at a premium to peer banks due to its growth and earnings quality. We believe the bank, with its stable and predictable growth, is a safe bet compared to its peers. We maintain our **'BUY'** recommendation.

Financials snapshot								(INR mn)
Year to March	Q1FY08	Q1FY07	Growth (%)	Q4FY07	Growth (%)	FY07	FY08E	FY09E
Interest on advances	14,536	9,058	60.5	12,953	12.2	43,342	59,776	80,250
Interest on investments	6,172	5,195	18.8	6,010	2.7	22,986	23,637	24,647
Interest on other resources	534	782	(31.8)	932	(42.7)	2,563	1,137	1,157
Interest income	21,259	15,043	41.3	19,898	6.8	68,890	84,549	106,054
Interest expenses	10,836	6,867	57.8	8,721	24.3	31,795	39,999	49,800
Net interest income	10,422	8,176	27.5	11,177	(6.8)	37,096	44,550	56,254
Fee income	5,199	3,570	45.6	4,600	13.0	11,761	15,846	20,681
Operating expenses	7,744	5,527	40.1	6,839	13.2	16,911	24,208	31,522
Staff expense	2,839	1,664	70.6	2,153	31.8	4,868	7,769	11,199
Other opex	4,905	3,864	27.0	4,686	4.7	12,043	16,439	20,323
Pre prov op profit (PPOP)	7,878	6,219	26.7	8,938	(11.9)	31,946	36,188	45,413
Investment gains	(41)	(662)	(94)	(656)	(94)	(2970)	(3106)	(2411)
Provisions	3,071	2,039	50.6	3,303	(7.0)	9,248	8,979	12,433
Profit before tax	4,765	3,518	35.5	4,979	(4.3)	19,728	24,104	30,569
Provision for tax	1,553	1,125	38.0	1,544	0.6	4,977	6,919	9,160
Profit after tax	3,212	2,393	34.2	3,436	(6.5)	11,404	15,400	20,388
EPS (INR)	10	8	31.6	10	(1.0)	36	43	57
Ratios								
NII / GII	49.0	54.4		56.2		53.8	52.7	53.0
Cost - income	49.7	49.9		45.2		36.9	42.3	42.3
Provisions / PPOP	39.0	32.8		37.0		28.9	24.8	27.4
Tax rate	32.6	32.0		31.0		25.2	28.7	30.0
Balance sheet data								
Advances (INR mn)	538,390	405,653	32.7	469,448	14.7	469,448	633,755	823,881
Deposits (INR mn)	816,040	606,301	34.6	682,980	19.5	682,979	802,189	1,010,439
Net NPA (%)	0.4	0.4		0.4		0.4	0.1	0.1
Capital adequacy ratio (%)	13.1	11.7		13.1		13.1	16.4	14.2
CASA (%)	51.5	52.6		55.0		57.7	53.2	53.7
Net interets margin (%)	4.2	4.1		4.5		4.7	4.7	4.9

Company Description

HDFC Bank has a balance sheet size of over INR 1000 bn. It is amongst the leading private sector banks with 753 branches in the top 228 cities and over 1,380 ATMs. The key promoter HDFC Ltd holds 22% stake, with FII and public holding the remaining. HDFC Bank is among the top three players in areas of auto loans, personal loans, commercial vehicles, cash management, and supply chain management. The bank's strengths include its brand equity, professional management, reach, high CASA (52%), clean book, and focus on profitability.

Investment Theme

HDFC Bank has a track record of consistent growth in earnings and assets. Earnings have grown at a steady pace of 30% in the past few years and we expect them to grow at a similar pace over FY07-09E. The bank enjoys best-in-class interest margins of ~4% on the back of more retail oriented franchise. Retail advances constitute 57% of its loan book. Even on the asset front, retail deposit (CASA) mix stands healthy at 52% of total deposits. We expect loan book to grow at 32% CAGR over FY07-09E and CASA ratio to be sustained at 50% plus levels. Consequently, NIMs will remain more or less at similar levels. Asset quality remains healthy and is one of the key strengths of the bank. The bank continues to create higher loan loss provisions to maintain net NPA ratio at 0.4% of gross advances. With largely retail oriented book, we expect higher NPA accretion going forward and gross NPA to rise further to 1.9% by FY09E. With higher provision coverage, net NPAs will be maintained at 0.4% levels.

Key Risks

Higher-than-expected decline in CASA ratio from the current high levels may impact cost of Funds and consequently margins as well.

HDFC Bank is also vulnerable to system-wide deterioration in the quality of retail assets.

Valuations de-rating of the stock due to structural changes within the bank (like change in management etc.) is a risk.

Financial Statement

Income statement					(INR mn)
Year to March	FY05	FY06	FY07	FY08E	FY09E
Interest income	30,935	44,753	68,890	84,549	106,054
Interest expenses	13,156	19,295	31,795	39,999	49,800
Net interest income	17,779	25,458	37,096	44,550	56,254
Non interest income	4,635	8,791	12,741	18,270	24,475
- Fee & forex income	6,963	11,447	14,817	19,643	25,535
- Misc. income	208	314	1,030	1,038	1,350
- Investment profits	(2,536)	(2,970)	(3,106)	(2,411)	(2,411)
Net revenues	22,414	34,249	49,837	62,820	80,728
Operating expense	10,854	16,911	24,208	31,522	38,748
- Employee exp	2,767	4,868	7,769	11,199	14,481
- Other opex	8,087	12,043	16,439	20,323	24,266
Preprovision profit	11,560	17,338	25,629	31,298	41,980
Provisions	1,762	4,798	9,248	8,979	12,433
- Loan loss provisions	1,762	4,798	8,610	8,979	12,433
- Other provisions	0	0	638	0	0
PBT	9,798	12,541	16,381	22,319	29,547
Taxes	3,140	3,830	4,977	6,919	9,160
PAT	6,658	8,711	11,404	15,400	20,388
Reported PAT	6,658	8,711	11,404	15,400	20,388
EPS	21.5	27.8	35.7	42.8	56.6
DPS	4.0	5.5	7.0	8.0	11.0
Payout ratio (%)	18.6	19.8	19.6	18.7	19.4

Growth ratios (%)

Year to March	FY05	FY06	FY07	FY08E	FY09E
NII growth	32.9	43.2	45.7	20.1	26.3
Fees growth	76.6	64.4	29.4	32.6	30.0
Opex growth	34.0	55.8	43.2	30.2	22.9
PPOP growth	43.6	44.1	41.5	17.3	31.7
PPP growth	14.7	50.0	47.8	22.1	34.1
Provisions growth	(38.9)	172.3	92.8	(2.9)	38.5
PAT growth	30.7	30.8	30.9	35.0	32.4

Operating ratios (%)

Year to March	FY05	FY06	FY07	FY08E	FY09E
Yield on advances	7.7	8.9	10.6	10.8	11.0
Yield on investments	7.2	7.1	8.0	7.9	7.8
Yield on assets	6.9	7.3	8.8	9.0	9.3
Net interest margins	3.9	4.2	4.7	4.7	4.9
Cost of funds	3.0	3.4	4.2	4.5	4.7
Cost of deposits	3.3	3.4	4.3	4.6	4.7
Cost of borrowings	5.1	7.5	8.6	8.2	8.6
Spread	3.8	4.0	4.6	4.5	4.5
Cost-income	48.4	49.4	48.6	50.2	48.0
Tax rate	32.1	30.5	30.4	31.0	31.0

Balance sheet					(INR mn)
Year to March	FY05	FY06	FY07	FY08E	FY09E
Liabilities					
Equity capital	3,099	3,131	3,194	3,599	3,599
Reserves	42,100	49,864	61,138	116,096	132,079
Net worth	45,199	52,995	64,332	119,695	135,678
Sub bonds/pref cap	5,000	17,020	32,826	32,826	32,826
Deposits	363,543	557,968	682,979	802,189	1,010,439
Borrowings	47,900	28,585	28,154	34,770	42,592
Other liabilities	52,645	78,495	104,065	63,061	79,432
Total	514,286	735,063	912,356	1,052,541	1,300,966
Assets					
Loans	255,663	350,613	469,448	633,755	823,881
Investments					
Gilts	112,338	196,386	225,449	200,554	202,095
Others	81,160	87,554	80,197	105,454	135,420
Cash & equi	44,740	69,190	91,539	80,692	101,639
Fixed assets	7,083	8,551	9,667	10,237	10,409
Other assets	13,302	22,770	36,057	21,850	27,522
Total	514,286	735,063	912,356	1,052,541	1,300,966
Balance sheet ratios					
Credit growth	31.2	33.4	25.8	35.0	30.0
Deposit growth	19.6	53.5	22.4	17.5	26.0
EA growth	21.5	42.5	23.1	17.7	23.8
SLR ratio	27.3	33.5	31.7	25.0	20.0
C-D ratio	89.0	77.4	79.6	91.5	94.4
Low-cost deposits	60.6	55.4	57.7	53.2	53.7
Gross NPA ratio	1.4	1.2	1.2	1.2	1.2
Net NPA ratio	0.2	0.4	0.4	0.1	0.1
Provision coverage	86.2	74.4	82.2	87.8	92.8
Incremental slippage	1.0	1.8	1.8	1.8	1.9
Capital adequacy	12.2	11.4	13.1	16.4	14.2
- Tier 1	9.6	8.6	8.6	11.6	10.2

Ratios

Year to March	FY05	FY06	FY07	FY08E	FY09E
ROA decomposition (%)					
Net interest income/Assets	3.9	4.2	4.7	4.7	4.9
Fees/Assets	1.6	1.9	2.0	2.2	2.4
Investment profits/Assets	(0.6)	(0.5)	(0.4)	(0.3)	(0.2)
Net revenues/Assets	5.0	5.6	6.3	6.7	7.1
Operating expense/Assets	(2.4)	(2.8)	(3.1)	(3.3)	(3.4)
Provisions/Assets	(0.4)	(0.8)	(1.2)	(1.0)	(1.1)
Taxes/Assets	(0.7)	(0.6)	(0.6)	(0.7)	(0.8)
Total costs/Assets	(3.5)	(4.2)	(4.9)	(5.0)	(5.3)
ROA	1.5	1.4	1.5	1.6	1.8
Equity/Assets	8.0	8.0	7.5	9.8	11.2
ROE	18.5	17.7	19.4	16.7	16.0

Valuation metrics

Year to March	FY05	FY06	FY07	FY08E	FY09E
EPS	21.5	27.8	35.7	42.8	56.6
<i>EPS growth (%)</i>	<i>20.1</i>	<i>29.5</i>	<i>28.4</i>	<i>19.8</i>	<i>32.4</i>
Book value per share	145.9	169.2	201.4	332.6	377.0
Adjusted book value/share	144.5	165.8	197.0	330.6	375.4
Price/Earnings	24.8	27.8	32.2	26.9	20.3
Price/ BV	3.7	4.6	4.7	3.5	3.1
Price/ ABV	3.7	4.7	5.8	3.5	3.1
Dividend yield (%)	<i>0.3</i>	<i>0.5</i>	<i>0.6</i>	<i>0.7</i>	<i>1.0</i>
Price to income	23.4	15.1	11.4	10.1	8.1
Price to PPOP	25.3	17.7	12.8	12.3	9.3

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Gautam Roy - 2286 4305	Airlines, Textile	Rajesh Makharia - 2286 4202
Ashutosh Goel - 2286 4287	Automobiles, Auto Components	Vikrant Oak - 4019 4712
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Harish Sharma - 2286 4307	Infrastructure, Auto Components, Mid Caps	Ashish Agrawal - 2286 4301
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Parul Inamdar - 2286 4355	Information Technology	Swati Khemani - 2286 4266
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Sunil Jain - 2286 4308	Alternative & Quantitative	Harsh Biyani - 2286 4419
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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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