



HDFC Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,884	HDFCB IN
	REUTERS CODE
S&P CNX: 3,715	HDBK.BO

17 October 2006

Neutral

Previous Recommendation: Neutral

Rs1,009

		YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROAE	ROAA	P/ABV
		END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
Equity Shares (m)	309.9	3/06A	36,698	8,708	27.8	29.5	36.3	6.0	11.4	17.7	1.4	6.1
52-Week Range	1,068/603	3/07E	51,204	11,378	36.3	30.7	27.8	5.1	11.0	19.7	1.3	5.2
1,6,12 Rel.Perf.(%)	8/12/-3	3/08E	66,380	14,766	47.2	29.8	21.4	4.2	10.5	21.5	1.3	4.3
M.Cap. (Rs b)	312.7											
M.Cap. (US\$ b)	6.9											

HDFC Bank's earnings grew by 31.7% YoY, in line with estimates. Although margins were sustained at 4%, NII growth slowed to 38% YoY and 3% QoQ to Rs8.5b in 2QFY07 from 56% YoY and 11% QoQ growth reported in 1QFY07. Other income growth was strong at 53% YoY in 2QFY07. Business (deposits and core customer assets) growth has slowed down to 37% YoY in 2QFY07 from 50% YoY in 1QFY07. Provisions have increased YoY on the back of rising retail asset book. Asset quality has been maintained at 0.4% of customer assets.

- ✍ Business growth slows down, a conscious strategy
- ✍ NII growth slows; margins however maintained
- ✍ Fee income maintains continued traction
- ✍ Provisions increase by 70% YoY on back of higher NPA provisions

While we are not concerned regarding the growth prospects of the bank over the medium term, we believe that delays in branch licensing, to some extent, will start impacting the bank. Bank's reliance on term loans has increased in last couple of quarters. While, we expect margins to be maintained at near 4% in the medium term, as it benefits from the high CASA, we believe this leverage might be on a declining trend, should new branch licenses not come by in the near term. Current valuations at 21.4x FY08E EPS and 4.2x FY08E BV of HDFC Bank are at its best and we expect no further expansion to multiples. We expect HDFC Bank to report EPS of Rs36 in FY07 and Rs47 in FY08. The book value would be Rs199 (FY07) and Rs239 (FY08). We maintain **Neutral**.

QUARTERLY PERFORMANCE

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Interest Income	8,941	10,229	11,798	13,785	15,043	16,357	16,871	17,564	44,753	65,835
Interest Expense	3,704	4,108	5,092	6,391	6,867	7,901	7,994	8,020	19,295	30,781
Net Interest Income	5,237	6,121	6,706	7,394	8,176	8,456	8,877	9,544	25,458	35,053
Growth (%)	31.3	43.8	52.4	44.0	56.1	38.1	32.4	29.1	43.2	37.7
Other Income	2,636	2,602	2,961	3,042	3,508	3,977	4,215	4,450	11,240	16,150
Net Income	7,872	8,723	9,667	10,436	11,684	12,433	13,092	13,995	36,698	51,204
Growth (%)	55.3	59.1	50.9	42.2	48.4	42.5	35.4	34.1	51.1	39.5
Operating Expenses	3,580	4,016	4,491	4,823	5,527	5,791	5,973	6,337	16,911	23,628
Operating Profit	4,292	4,706	5,176	5,612	6,157	6,642	7,119	7,658	19,787	27,575
Provisions and Contingencies	1,659	1,806	1,972	1,816	2,639	3,057	2,920	2,934	7,252	11,550
Profit Before Tax	2,634	2,900	3,205	3,796	3,518	3,585	4,199	4,724	12,535	16,025
Provision for Taxes	799	904	961	1,164	1,125	955	1,260	1,307	3,827	4,647
Net Profit	1,835	1,996	2,244	2,632	2,393	2,629	2,939	3,417	8,708	11,378
Growth (%)	31.1	31.1	31.3	30.1	30.4	31.7	31.0	29.8	30.8	30.7
Cost to Income Ratio (%)	45.5	46.0	46.5	46.2	47.3	46.6	45.6	45.3	46.1	46.1
Interest Expense/Interest Income (%)	41.4	40.2	43.2	46.4	45.6	48.3	47.4	45.7	43.1	46.8
Other Income/Total Income (%)	33.5	29.8	30.6	29.1	30.0	32.0	32.2	31.8	30.6	31.5

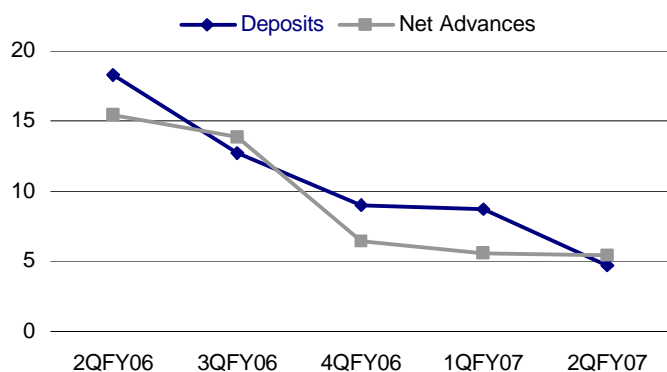
E: MOST Estimates

HDFC Bank's earnings grew by 31.7% YoY, in line with estimates. Although margins were sustained at 4%, NII growth slowed to 38% YoY and 3% QoQ to Rs8.5b in 2QFY07 from 56% YoY and 11% QoQ growth reported in 1QFY07. Other income growth was strong at 53% YoY in 2QFY07. Business (deposits and core customer assets) growth has slowed down to 37% YoY in 2QFY07 from 50% YoY in 1QFY07. Provisions have increased YoY on the back of rising retail asset book. Asset quality has been maintained at 0.4% of customer assets.

Business growth slows, a conscious strategy

During the quarter, business (deposits and core customer assets) growth has slowed down to 37% YoY in 2QFY07 from 50% YoY in 1QFY07. Deposits grew by 40%, while core customer assets grew by 34% YoY in 2QFY07 (YoY growth of 58% and 40%, respectively in 1QFY07). The management believes this is in line with its target of a moderation in overall growth rates from the earlier growth rates which were very high and not sustainable.

INCREMENTAL GROWTH (%) SLOWING DOWN



Source: Company/ Motilal Oswal Securities

CASA growth remains strong

With 27% and 17% YoY savings and current deposit growth in 2QFY07, HDFC Bank has been able to maintain its CASA QoQ at 52% in 2QFY07, as incremental (QoQ) CASA to incremental deposit at 42% in 2QFY07 (compared with incremental 20% QoQ in 1QFY07). However, growth

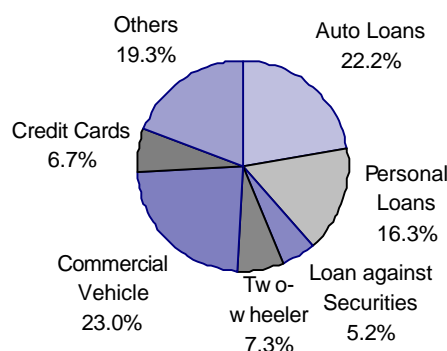
in term deposits on a YoY basis was stronger at 66% in 2QFY07, although of the total incremental deposit mobilization in 2QFY07 the incremental share of term deposits was only 58% compared with 80% in 1QFY07.

Retail continues to drive asset growth

HDFC Bank has recently entered the corporate loan and loan syndication business. So far, the bank was concentrating more on disbursing loans for working capital. Sequential growth in corporate loans in 2QFY07 was 6.5% versus <2% growth reported in the last couple of quarters. Overall, core customer assets grew by 34% YoY in 2QFY07.

Retail has been the key growth driver for the bank. Retail loans grew 44.4% YoY (down from 57% YoY growth in 1QFY07), and now constitute 58.9% of net advances. In retail, the main growth driver has been personal loans, auto/two-wheeler loans and credit cards. Loans against shares growth YoY was modest at 8%, as the bank has consciously decided to be cautious with these loans.

BREAK-UP OF RETAIL LOANS (%)

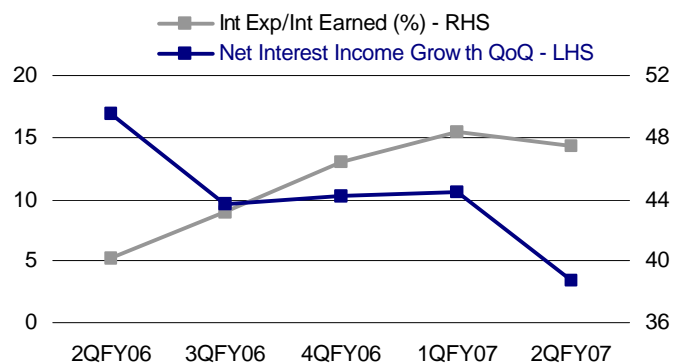


Source: Company/ Motilal Oswal Securities

NII growth slows, margins however maintained

NII growth slowed to 38% YoY and 3% QoQ to Rs8.5b in 2QFY07 from 56% YoY and 11% QoQ growth reported in 1QFY07 on increased interest expenses during the quarter. This was first quarter for the bank wherein CRR interest was absent, which would have resulted in NII being higher by ~1.5%.

COQ TREND IN NII



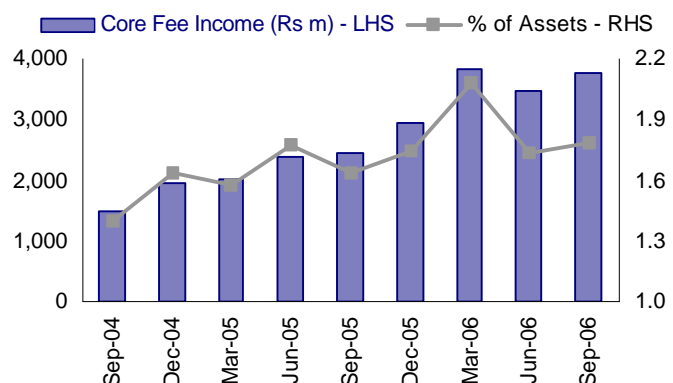
Source: Company/ Motilal Oswal Securities

During the quarter, NIMs have remained stable at ~4%, despite the fact that incremental loan growth has largely been fueled by term deposits for the last couple of quarters. With CASA being at 52%, we expect HDFC Bank to maintain margins in forthcoming quarters.

Fee income maintains continued traction

Other income growth was strong at 53% YoY in 2QFY07 driven by strong fee income growth (44% YoY) as well as other income, ex-treasury, growth of 122%. Treasury income also grew by 73% YoY in 2QFY07. The key contributors to fee income growth have been retail products such as credit cards, debit cards, third party distribution, POS terminals etc. The share of retail in fee-based income currently is 75%. Fee income now comprises 1.8% of assets.

TREND IN FEE INCOME



Source: Company/ Motilal Oswal Securities

Asset quality consistent, with net NPAs of 0.4%

HDFC Bank's asset quality remains the best in the Indian banking sector notwithstanding the bank's aggressive growth over the past several quarters. The bank has maintained its net NPAs at 0.4% as at end-2QFY07. It has continued to make general provisions and holds specific general provisions on its standard customer assets that are higher than the regulatory requirements.

Over the last couple of quarters, the bank has increased its provisioning levels in line with the higher growth in retail loans (two-wheelers, credit cards and personal loans, where delinquencies are higher).

Branch licenses - no communication from the RBI

In terms of getting new branch licenses, the RBI has released no communication yet. As a result, HDFC Bank has not added any branch in the last quarter. The bank expects to get some visibility on this in the next few months.

Provisions increase by 70% YoY

Provisions for NPAs increased by 80% YoY to Rs2.2b due to increased business, primarily retail loans, which now constitute 51% of customer assets, as opposed to 48% in 2QFY06. Other provisions increased too, by 48%, to Rs851m in 2QFY07 primarily due to amortization for investments of Rs576m.

Tax rate of 27%

HDFC Bank's tax rate declined to 27% in 2QFY07 from its historical average of 30%-32%. This is largely due to the bank having a significant amount of tax-free income from mutual funds.

Capital adequacy at 12.1%

The bank's capital adequacy currently is at 12.1%, with Tier-I at 8.2%. While implementation of Basel-2 norms could be positive, as it would release additional capital on retail loans, we believe that in order to sustain 30%-40% loan growth, the bank might require capital over the next 12-18 months. During 2QFY07, the bank has raised Rs2.4b

of subordinated debt qualifying as Lower Tier II capital, Rs3b as Upper Tier II capital and Rs2b of perpetual debt qualifying as Hybrid Tier I capital.

Maintain Neutral

While we are not concerned regarding the growth prospects of the bank over the medium term, we believe that delays in branch licensing, to some extent, will start impacting the bank. Bank's reliance on term loans has increased in last couple of quarters. While, we expect margins to be

maintained at near 4% in the medium term, as it benefits from the high CASA, we believe this leverage might be on a declining trend, should new branch licenses not come by in the near term. Current valuations at 21.4x FY08E EPS and 4.2x FY08E BV of HDFC Bank are at its best and we expect no further expansion to multiples. We expect HDFC Bank to report EPS of Rs36 in FY07 and Rs47 in FY08. The book value would be Rs199 (FY07) and Rs239 (FY08). We maintain **Neutral**.

HDFC Bank: an investment profile

Company description

HDFC Bank, incorporated in 1994 by HDFC Ltd, is the second largest private sector bank, with a balance sheet size of Rs797b. Rated as one of the best banks in India; it has network in 228 cities, with 535 branches. The bank has been consistently growing its loan book and earnings at over 30% for the last several quarters.

Key investment arguments

- ✍ Strong focus on retail loans (now 51% of net advances) and high proportion of low-cost funds (52.2% of total deposits) enables consistent growth of over 30% in core earnings.
- ✍ Management quality is rated as amongst the best.
- ✍ Net NPAs of 0.4%, despite being an aggressive lender, indicates superior risk management skills.
- ✍ Ability to raise capital at 3-4x book along with strong earnings visibility enables significant value accretion to existing owners.

Key investment risks

- ✍ Inability to open new branches could hurt CASA growth and increase cost of deposits hurting margins.

COMPARATIVE VALUATIONS

		HDFC BK	ICICI BK	UTI BK
P/E (x)	FY07E	27.8	20.7	18.2
	FY08E	21.4	16.8	14.2
P/ABV (x)	FY07E	5.2	2.7	3.6
	FY08E	4.3	2.5	3.0
RoE (%)	FY07E	19.7	13.4	20.2
	FY08E	21.5	15.0	21.8
RoA (%)	FY07E	1.3	1.1	1.1
	FY08E	1.3	1.0	1.1

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	21.9	22.0	22.1
Domestic Institutions	6.6	5.2	5.7
FII's/FDIs	53.4	53.6	52.7
Others	18.1	19.2	19.5

Recent developments

- ✍ During 2QFY07, the bank has raised Rs2.4b of subordinated debt qualifying as Lower Tier II capital, Rs3b of Upper Tier II capital and Rs2b of perpetual debt qualifying as Hybrid Tier I capital.

Valuation and view

- ✍ Strong loan growth with greater concentration on the retail segment, high proportion of low cost deposits, high fee-income would enable HDFC Bank to maintain its earnings growth momentum.
- ✍ We expect earnings to grow by 31% in FY07 and 30% in FY08. The stock is trading at 21.4x FY08E EPS and 4.2x FY08E book value.
- ✍ We maintain **Neutral** rating on the stock.

Sector view

- ✍ YTD loan growth of 30%, highest in the last 12 years.
- ✍ Volatility in interest rates would impact bond gains.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

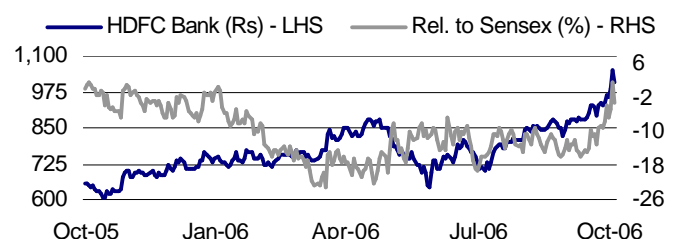
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	36.3	37.1	-2.0
FY08	47.2	47.3	-0.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,009	900	-	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Interest Income	30,935	44,753	65,835	90,047	118,247
Interest Expended	13,156	19,295	30,781	43,868	59,152
Net Interest Incom	17,779	25,458	35,053	46,179	59,095
Change (%)	32.9	43.2	37.7	31.7	28.0
Other Income	6,513	11,240	16,150	20,200	25,363
Net Income	24,293	36,698	51,204	66,380	84,458
Operating Expenses	10,854	16,911	23,628	31,436	41,765
Operating Income	13,439	19,787	27,575	34,944	42,693
Change (%)	33.3	47.2	39.4	26.7	22.2
Other Provisions	3,643	7,249	11,550	13,850	15,000
PBT	9,796	12,538	16,025	21,094	27,693
Tax	3,140	3,830	4,647	6,328	8,308
PAT	6,656	8,708	11,378	14,766	19,385
Change (%)	30.6	30.8	30.7	29.8	31.3
Proposed Dividend	1,401	1,722	2,035	2,349	2,349

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Capital	3,099	3,131	3,131	3,131	3,131
Reserves & Surplus	42,104	49,865	59,208	71,625	88,661
Net Worth	45,203	52,996	62,339	74,756	91,793
Deposits	363,482	557,968	736,518	957,473	1,129,819
Borrowings	52,900	45,605	62,039	83,046	110,457
Other Liab & Provisor	52,645	78,495	102,043	132,656	172,453
Total Liabilities	514,229	735,064	957,939	1,237,932	1,565,865
Current Assets	44,740	69,190	75,612	88,826	114,761
Investments	193,438	283,888	374,732	468,415	585,519
Advances	255,663	350,613	483,845	653,191	836,085
Net Fixed Assets	7,083	8,551	9,750	11,500	12,500
Other Assets	13,306	22,823	14,000	16,000	17,000
Total Assets	514,229	735,064	957,939	1,237,932	1,565,865

KEY ASSUMPTIONS					
(%)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Deposit Growth	19.5	53.5	32.0	30.0	18.0
Advances Growth	44.1	37.1	38.0	35.0	28.0
Investments Growth	0.5	46.8	32.0	25.0	25.0
CRR	5.0	5.0	5.0	5.0	5.0
Provision Coverage	86.2	69.1	77.7	86.5	83.7
Dividend per share	4.5	5.5	6.5	7.5	7.5

E: Most Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Spreads Analysis (%)					
Avg. Yield-Earning As:	6.9	7.5	8.1	8.4	8.7
Avg. Cost - Int. Bear. L	3.6	3.9	4.5	4.9	5.3
Interest Spread	3.4	3.7	3.6	3.5	3.4
Net Interest Margin	4.0	4.3	4.3	4.3	4.3

Profitability Ratios (%)					
RoE	18.5	17.7	19.7	21.5	23.3
RoA	14	14	13	13	14
Int. Expended/Int. Earn	42.5	43.1	46.8	48.7	50.0
Other Income/Net Incom	26.8	30.6	31.5	30.4	30.0

Efficiency Ratios (%)					
Op Exp/Net Income	44.7	46.1	46.1	47.4	49.5
Employee Cost/Op.Ex	25.5	28.8	30.5	29.9	30.0
Business per Empl. (R	60.9	51.3	57.2	58.5	56.9
Net Profit per Empl. (F	0.7	0.6	0.6	0.6	0.6

Asset Liability Profile (%)					
Advances/Deposit Ra	70.3	62.8	65.7	68.2	74.0
Invest./Deposit Ratio	53.2	50.9	50.9	48.9	51.8
G-Sec/Investment Rat	58.0	69.2	52.4	41.9	33.5
Gross NPAs to Advan	1.7	1.4	1.5	1.5	1.7
Net NPAs to Advance	0.2	0.4	0.3	0.2	0.3
CAR	12.7	11.4	11.0	10.5	10.5
Tier 1	8.9	8.6	7.5	6.8	6.8

VALUATION					
Book Value (Rs)	145.9	169.2	199.1	238.7	293.1
Price-BV (x)	6.9	6.0	5.1	4.2	3.4
Adjusted BV (Rs)	144.6	166.0	195.7	235.9	288.4
Price-ABV (x)	7.0	6.1	5.2	4.3	3.5
EPS (Rs)	21.5	27.8	36.3	47.2	61.9
EPS Growth	20.1	29.5	30.7	29.8	31.3
Price Earnings (x)	47.0	36.3	27.8	21.4	16.3
OPS (Rs)	43.4	63.2	88.1	111.6	136.3
Price-OP (x)	23.3	16.0	11.5	9.0	7.4

E: Most Estimates

N O T E S

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Disclosure of Interest Statement	HDFC Bank
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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