

HDFC Bank

 BSE code: 500180
 NSE code: HDFCBANK

CMP: Rs 1,093
Target: Rs 1,331 ↓

BUY

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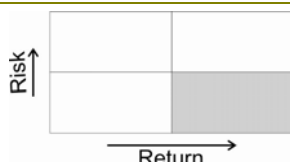
Company data

Particulars	
Market cap (Rs bn / US\$ bn)	463.9/ 10.8
Outstanding equity shares (mn)	424.6
52-week high/low (Rs)	1,825/ 890
3-month average daily volume	170124

Financial snapshot

Particulars	FY08	FY09E	FY10E
NII (Rs bn)	52.3	74.7	103.3
Growth (%)	50.7	43.0	38.3
Adj net profit (Rs bn)	15.9	20.7	26.8
Growth (%)	39.3	30.1	29.7
FDEPS (Rs)	44.9	48.7	59.5
Growth (%)	25.5	8.6	22.2
P/ABV (x)	3.5	3.4	2.5
ROE (%)	17.7	16.1	15.6

Risk-return profile



Shareholding pattern

(%)	June-08	Mar-08
Promoters	19.4	23.3
FIIIs	47.0	47.5
Banks & FIs	7.8	7.5
Public	25.8	23.7

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
HDFC Bank	1,093	13.1	(27.9)	(30.3)
Sensex	14,287	6.1	(17.4)	(19.0)
BSE Bankex	6,523	10.3	(26.0)	(39.1)

 Company website: www.hdfcbank.com

Growth remains robust, merger impact to show by end of FY09

HDFC Bank's Q1FY09 results were largely in line with our expectations. On a reported basis, the numbers are not exactly comparable as Q1FY09 results are for the merged entity. On a like-to-like basis, the NII growth remained robust. However, growth in non-interest income was muted as a certain area of business of the erstwhile CBoP was discontinued resulting in lower fee income growth. The merger related issues - improvement in CASA deposits and asset quality and rationalization of cost/income ratio - would take at least 2-3 quarters to be addressed and following that, the full impact of the merger would be visible.

We have revised our estimates to include the impact of the merger and have changed our target price for the stock. We now value HDFC Bank at Rs 1331 using the DDM model. We have also changed the assumption of the risk-free rate from 8.7% to 9.1%. At this price, the stock would trade at a P/ABV of 3.1x. We reiterate our Buy recommendation on the stock.

Actual vs estimated performance

(Rs mn)	Actual	Estimated	% Variance
NII	17,234.7	18,115.2	(4.9)
Total Income	23,168.9	23,843.7	(2.8)
PPP	10,275.1	11,060.9	(7.1)
PAT	4,643.5	4,540.2	2.3
EPS (Rs)	10.9	10.7	2.3

Source: Company, Religare Research

Quarterly results

(Rs bn)	Q1FY09	Q1FY08	% Chg YoY	Q4FY08	% Chg QoQ
Int on Advances	26.4	14.5	81.4	20.1	31.2
Inc on Investments	9.5	5.6	69.7	8.8	8.4
Int on Bal with RBI etc.	0.3	0.6	(38.0)	0.7	(51.0)
Interest income	36.2	20.7	75.0	29.6	22.5
Interest expenses	19.0	10.8	75.2	13.1	44.5
Net interest income	17.2	9.9	74.9	16.4	5.0
Other income	5.9	5.7	3.6	5.5	8.0
Total Income	23.2	15.6	48.7	21.9	5.7
Operating expenses	12.9	7.7	66.5	11.0	16.9
PPP	10.3	7.8	31.1	10.9	(5.6)
Provisions and W/off	3.4	3.1	12.2	4.7	(25.9)
PBT	6.8	4.8	43.3	6.2	9.5
Taxes	2.2	1.6	40.8	1.5	43.5
PAT	4.6	3.2	44.6	4.7	(1.4)
Cost/ Income Ratio (%)	55.7	49.7		50.3	

Source: Company, Religare Research

Result highlights

Merger to accrue benefits by end of FY09

We believe that HDFC Bank results should be analyzed after taking into account the impact of the merger with CBoP. Though RBI gave approval on May 23, 2008, the effective date of the merger was April 1 2008. The main highlights of the merger were:

- ❖ The merger was effected using the 'pooling of interest' method. The bank's main task was to harmonize the accounting policies and, as a result, HDFC Bank took a hit of Rs 7 bn to streamline the policies of erstwhile CBoP with itself. Of this Rs 7 bn, around 70% went towards the harmonization of accounting policies relating to loan-loss provisioning and depreciation of assets, and the balance 30% reserves write-offs were towards the merger-related restructuring costs like stamp duty, HR and IT integration expenses.
- ❖ The loan book size of the erstwhile CBoP was close to Rs 150 bn, largely constituted by retail loans with only around 15% of corporate loans. In terms of asset quality, the gross NPAs at the end of Mar 2008 were around 3.8% and net NPAs at around 1.7%. The harmonizing was done to bring in more stringent provisioning requirements for identifying NPAs as the existing norms of the erstwhile CBoP were comparatively more relaxed. The duration of CBoP's lending portfolio is around 18-20 months so the risk of incremental slippage would continue in near future, however the bank is confident of its recovery management process and anticipates lesser pain.
- ❖ The CASA ratio at the end of June 2008 was 45%. This is in line with our expectations as CBoP had a much lower CASA ratio of around 25% compare to 56% for pre-merged HDFC Bank. By the end of the year, the target CASA ratio is around 47-48%. This would primarily be driven by an increasing contribution of low-cost deposits from the erstwhile CBoP's branches.
- ❖ Of the total non-interest income of CBoP, fee income constituted around 50%, which was generated mainly through distribution of insurance products (Aviva) and from processing fees. In line with regulatory and operational issues, these streams of income have temporarily been discontinued. This aspect acted as a drag on the 'other income' of the merged entity and it would take 2-3 quarters for the issues to be addressed. Till these issues are resolved positively, the 'other income' growth (primarily the fee income) would remain muted for the merged entity.
- ❖ The cost/income ratio of the merged entity has increased to around 56% from 50% levels for standalone HDFC Bank. The increase was expected as CBoP's C/I ratio was around 60%. HDFC Bank has retained almost all the employees of CBoP and expects to achieve full synergies and efficiencies, in terms of the restructured HR and IT processes, in the next 2-3 quarters. This means that by Q4FY09, the entire workforce would be working at full efficiency levels as that of the existing bank and the technology and IT-platforms would be completely integrated to support efficient performance. The aim is to reduce the C/I ratio to around 52-53% by the end of FY09.

Highlights of the merged results

Q1FY09 Results (Merged)

Rs bn	Q1FY09	Q1FY08	% chg
NII	17.2	11.3	52.5
Total Income	23.2	18.4	25.6
PPP	10.3	8.7	17.5
PAT	4.6	3.5	31.1

Source: Company, Religare Research

NII on the adjusted basis has improved 52.5% to Rs17.2 bn whereas net profits were up 31.1% to Rs 4.6 bn.

Non-interest income, for the reasons mentioned earlier, has de-grown by 17% to Rs 5.9 bn. Also, revaluation loss of Rs 776 mn on the investment portfolio for the quarter muted the growth.

Provisions expenses for the quarter comprised mainly of specific provisions towards NPAs and general provisions for standard assets. The realignment of provisioning policies on the loan portfolio of the erstwhile CBoP also resulted in increased provisioning expenses.

On a like-to-like basis, the net profit was up 31.1% to Rs 4.6 bn.

Outlook and Valuation

Business to grow at robust rate; Buy

We believe that the full positive impact of the merger would be visible only by Q4FY09. The higher contribution to CASA deposits from the erstwhile CBoP branches would add to the NII growth, while a focus on the recovery mechanism would keep the asset quality strong. Muted growth in fee-income would, however, continue to be a drag. Business growth would continue at a robust rate.

With changes in key rates/ratios in the monetary policy, both lending and borrowing rates might harden in a range of 50-100 bps. NIMs are likely to shrink but the bank is still confident of maintaining it above 3.8%.

We have revised our estimates for HDFC Bank taking into account the merger of CBoP and related factors. As a result, we have revised our estimates for NII upwards by 8% and 15.9% respectively for FY09 and FY10. However, on the back of muted fee income growth and high provisioning requirement, the upwards revision in profits have been limited to 1.1% and 2.9% respectively.

Revision Table

(Rs bn)	FY09E			FY10E		
	Revised	Earlier	% ch	Revised	Earlier	%ch
NII	74.7	69.2	8.0	103.3	89.1	15.9
Total Income	102.4	96.3	6.3	139.1	124.3	12.0
PPP	48.4	47.9	1.1	66.7	60.9	9.5
PAT	20.7	20.5	1.1	26.8	26.1	2.9
ROE (%)	16.1	16.6		15.6	18.4	

Source: Religare Research

HDFC group, the promoter, has been granted warrants, post-merger, to maintain its shareholding at 23% of the bank. These were issued at a conversion price of Rs1,530 per share. The price was based on the market price and conditions existing at the time of merger discussions during Jan - Feb 2008. The warrants expire by December 2009. However, in view of the current share price and the uncertainty surrounding the future of the financial sector performance, infusion of money into the bank is not anticipated in the immediate future. However, we have assumed the conversion later in FY10, as we believe that HDFC group would not lower its holding in the bank.

We have valued HDFC Bank using the DDM model. We have now factored in the dilution and also assumed the conversion of warrants given to the HDFC group. We have changed the assumption of risk-free rate from 8.7% to 9.1%. As a result, we have now revised our target price for the stock to Rs 1,331 from the earlier price target of Rs 1,879. At this price, the stock would trade at a P/ABV of 3.1x. We reiterate our Buy recommendation on the stock.

Recommendation history

Date	Event	Reco price	Tgt price	Reco
25-Apr-07	Results Update	1,014	1,132	Hold
4-Jun-07	Company Update	1,159	1,287	Hold
11-Jul-07	Results Update	1,148	1,287	Hold
5-Oct-07	Quarterly Preview	1,404	1,510	Hold
15-Oct-07	Results Update	1,430	1,585	Buy
7-Jan-08	Quarterly Preview	1,697	1,879	Buy
23-Jan-08	Results Update	1,470	1,879	Buy
27-Feb-08	Company Update	1,450	1,879	Buy
31-Jul-08	Results Update	1,093	1,331	Buy

Source: Religare Research

Stock performance



Source: Religare Research

Standalone financials

Profit and Loss statement

(Rs bn)	FY07	FY08E	FY09E	FY10E
Interest earned	66.5	101.2	155.7	218.8
Interest expended	31.8	48.9	81.0	115.4
Net interest income	34.7	52.3	74.7	103.3
Growth (%)	36.2	50.7	43.0	38.3
Non-interest income	15.2	22.8	27.6	35.8
Comm, Exchange & Brokerage	12.9	17.1	23.1	30.1
Growth (%)	34.9	50.6	21.1	29.5
Operating expenses	24.2	37.5	53.9	72.4
Pre-provisioning profits	25.6	37.7	48.4	66.7
Growth (%)	29.6	46.9	28.7	37.7
Provisions & contingencies	9.3	14.8	18.7	28.1
PBT	16.4	22.8	29.8	38.6
Income tax, Interest tax	5.0	6.9	9.1	11.8
Net profit	11.4	15.9	20.7	26.8
Growth (%)	31.1	39.3	30.1	29.7

Source: Company, Religare Research, Merged from FY09 onwards

Balance sheet

(Rs bn)	FY07	FY08E	FY09E	FY10E
Cash in hand & bal with RBI	50.8	125.5	168.3	213.0
Balance with banks, Money at call	39.7	22.3	33.4	38.4
Investments	305.6	493.9	589.3	743.4
Advances	469.4	634.3	1,127.1	1,499.0
Fixed assets (net)	9.7	11.8	16.1	18.5
Other assets	37.1	44.0	46.2	61.6
Total assets	912.4	1,331.8	1,980.4	2,573.9
Equity capital	3.2	3.5	4.2	4.5
Reserves & surplus	61.1	111.4	137.9	198.0
Net worth	64.3	115.0	142.1	202.5
Deposits	683.0	1,007.7	1,568.9	2,063.1
Current deposits (a)	198.1	287.6	395.6	520.2
Savings bank deposits (b)	195.8	261.5	371.5	492.3
Term deposits (c)	289.0	458.5	801.7	1,050.5
Borrowings (incl sub-ord bonds)	61.0	77.3	108.5	117.2
Other liabilities & provisions	104.1	131.8	160.9	191.1
Total liabilities	912.4	1,331.8	1,980.4	2,573.9

Source: Company, Religare Research, Merged from FY09 onwards

Key ratios

Year-end March	FY07	FY08E	FY09E	FY10E
Per share data				
Shares outstanding (bn)	0.3	0.4	0.4	0.5
FDEPS (Rs)	35.7	44.9	48.7	59.5
DPS (Rs)	7.0	8.5	10.0	12.5
Book value (Rs)	201.4	324.4	334.8	449.1
Adjusted book value (Rs)	195.0	316.0	321.5	431.7

Valuation ratios

Market price	1092.5	1092.5	1092.5	1092.5
P/E (x)	30.6	24.4	22.4	18.4
P/BV (x)	5.4	3.4	3.3	2.4
P/ABV (x)	5.6	3.5	3.4	2.5

Earnings quality (%)

Net interest margin	4.7	5.3	5.2	5.2
Yield on advances	10.6	12.6	13.0	12.9
Yield on investments	7.0	7.2	7.2	7.1
Cost of funds	4.3	5.2	5.8	5.9
Cost/Income	48.6	49.9	52.7	52.0
Return on average net worth	19.5	17.7	16.1	15.6
Return on average assets	1.4	1.4	1.2	1.2

Growth ratios (%)

Net interest income	36.2	50.7	43.0	38.3
Other income	34.9	50.6	21.1	29.5
Total income	35.8	50.7	36.3	35.9
Pre-provisioning profit	29.6	46.9	28.7	37.7
Net profit	31.1	39.3	30.1	29.7
Advances	33.9	35.1	77.7	33.0
Deposits	22.4	47.5	55.7	31.5

Asset quality

Proportion of low-cost deposits (%)	57.7	54.5	48.9	49.1
Credit-Deposit ratio (x)	68.7	62.9	71.8	72.7
Investment/Deposit (%)	44.8	49.0	37.6	36.0
Net NPA ratio	0.4	0.5	0.5	0.5
CAR	13.1	13.6	13.3	12.9
Tier-I ratio	8.6	10.3	10.1	9.6

Source: Company, Religare Research, Merged from FY09 onwards

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Recommendation parameters

	Returns	Absolute
Large-caps*	> 10%	< - 5%
	BUY	SELL
Mid-caps**	> 25%	< 10%

*Market cap over US\$ 1bn **Market cap less than US\$ 1bn

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