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HDFC Bank Ltd.

July 2, 2015

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HDFC Bank Ltd. is India's largest private sector lender engaged in providing a range of banking and financial services. The bank operates in four segments: treasury, retail banking, wholesale banking and other banking business. With capital adequacy of 16.8% (tier-1 capital: 13.7 %) by the end of FY15, the bank is well-capitalized to meet its capital requirements to support its future business growth. As on 31st March, 2015, the bank has customer base of ~3.2 crore with a nationwide network of 4,014 branches and 11,766 ATM's in 2,464 towns and cities across India.

Investment Rationale

Expects 21-22% loan book growth in FY16-17E

HDFC Bank continued to witness strong loan growth of 20.6% YoY, outpacing the industry growth of ~9% YoY in FY15. The bank's loan growth was driven by wholesale segment rather than retail segment. Despite of healthy growth in corporate loans, the bank's loan mix remain tilted towards retail segment, with 51% share of total loan portfolio. With healthy growth in corporate segment and pick up in retail loan growth, we expect advances of the bank to grow in the range of 21%-22% in the coming two years.

Well positioned to deliver consistent profitable growth

HDFC Bank continues to maintain its strong growth trajectory with net profit growing at a CAGR of ~28% over FY10-15. During FY15, the bank posted strong growth of 20.5% YoY in its net profit at ₹102.2 billion on account of 21.2% YoY growth in net interest income (NII) in FY15. Further, non-interest income of the bank also grew by ~13% YoY aided by ~20% YoY healthy fee income growth. Given its strong fundamentals and consistent profit growth over the past five years, we expect the lender to sustain its strong earnings performance, with net profit expected to grow at a CAGR of ~23% over FY15-17E.

Betting big on healthy loan book & asset quality

Given the improvement in the profitability led by strong NII & non-interest income, sustained NIM growth, healthy asset quality and better operating metrics, we believe that HDFC Bank is well poised to continue its growth momentum. Being the country's largest private lender, we expect the lender to reap significant benefits out of the policy changes.

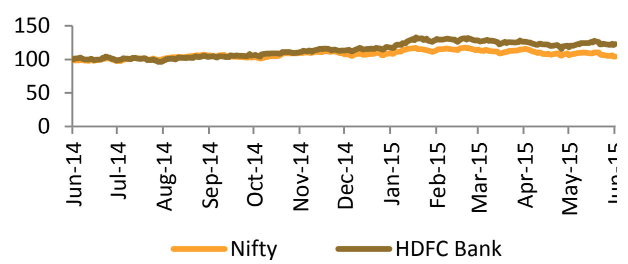
Market Data

Rating	**BUY**
CMP (₹)	1,062
Target (₹)	**1,253**
Potential Upside	~18%
Duration	Long Term
Face Value (₹)	2.0
52 week H/L (₹)	1,109.3/791.4
Adj. all time High (₹)	1,109.3
Decline from 52WH (%)	4.3
Rise from 52WL (%)	34.2
Beta	1.2
Mkt. Cap (₹cr)	2,66,190.3
Book value (₹cr)	62,009.4

Fiscal Year Ended

Y/E	FY14A	FY15A	FY16E	FY17E
NII (₹cr)	18,483	22,396	26,614	32,317
Net Profit (₹cr)	8,478	10,216	12,416	15,401
Cost/income (%)	45.6	44.6	44.1	43.4
EPS (₹)	35.3	40.8	49.5	61.4
P/E (x)	30.1	26.1	21.4	17.3
P/BV (x)	5.9	4.3	3.7	3.1
ROA (%)	1.9	1.9	1.9	2.0
ROE (%)	21.3	19.4	18.5	19.4

One year relative price chart



Shareholding Pattern	Mar 15	10 Feb 15	Diff.
Promoters	21.7	21.7	0.0
FII	32.6	32.6	0.0
DII	9.7	10.0	-0.3
Others	36.0	35.7	0.3

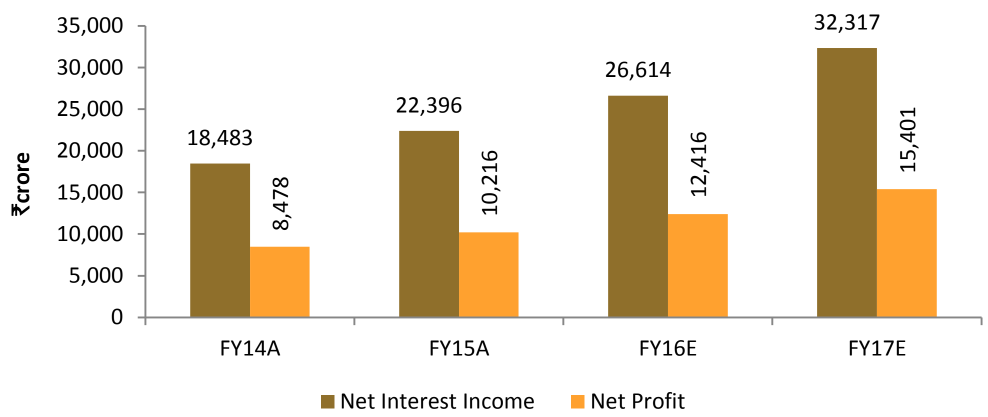
Healthy financial performance

Non-interest income of the bank, which contributes ~29-30% of net total income, grew also 14% to ₹8,996 crore in FY15, aided by healthy fee income growth and robust trading gains.

On standalone basis, HDFC Bank earned an interest income of ₹48,470 crore on its lending in FY15, which is 18% higher from a year ago. Meanwhile, the bank paid 15% higher interest, worth ₹26,074 crore on its deposits during FY15. As a result, the net interest income (NII) recorded a growth 21.2% YoY at ₹22,396 crore. Robust traction in NII growth came on account of healthy loan growth and better retail mix (healthy growth in auto loans, personal loans, loan against shares and credit cards). In Q4FY15, NII of the bank rose by 21.4% YoY to ₹6,013 crore.

Non-interest income of the bank, which contributes ~29-30% of net total income also grew 14% to ₹8,996 crore in FY15, aided by healthy fee income growth and robust trading gains. While in Q4FY15, the bank's non-interest income rose by 23.3% YoY on account of robust improvement in fees & foreign exchange revenue. Fee & commission income rose by 20.6% YoY in Q4FY15 marked by pick up in volume across segments. We expect that robust business growth to continue with the fee income is likely to gain traction in the coming years. The bank expects fee income to grow by ~15% in FY16E.

NII & Net Profit trend



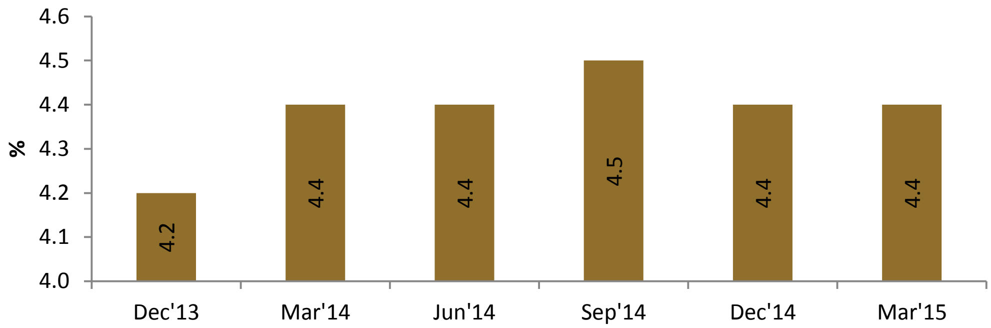
Given its strong fundamentals and consistent profit growth over the past five years, we expect the lender to sustain its strong earnings performance, with net profit to grow at a CAGR of ~23% over FY15-17E.

The bank has been on an expansion spree with focusing more in the semi-urban and rural places over the last couple of years and hence higher set up cost and growing employee remuneration fuelled up the operational expenses by 16% to ₹13,988 crore in FY15. Provisioning against contingencies grew by 31% YoY to ₹2,076 crore in FY15. However, in Q4FY15, operating expenses rose 21.5% YoY to ₹3,855 crore and provision rose more than twice at ₹576.7 crore in Q4FY15. Thus, after providing taxation of ₹1,338 crore and ₹51,128 crore in Q4FY15 and FY15 respectively, the net profit of the bank grew 20.7% YoY and 20.5% YoY to ₹2,807 crore and ₹10,216 crore in Q4FY15 and FY15, respectively. Given its strong fundamentals and consistent profit growth over the past five years, we expect the lender to sustain its strong earnings performance, with net profit to grow at ~23% CAGR over FY15-17E.

NIM to remain stable in FY16-17E

HDFC Bank has been maintaining a superior NIM of above 4% for over 2 years. During Q4FY15, NIM of the bank remain stable at 4.4% as reducing money market rate helped in containing lower cost of funds. We expect this stability to be maintained as retail loans continue to be in the high interest segment and growth is mainly happening in the same for all banks. The lender expects its NIM at the end of FY16E to stay in 4.1-4.5% range. However, with rising pressure of increased competitive intensity, we expect NIM to remain in the range of 4.1-4.4% in the coming years.

NIM trend

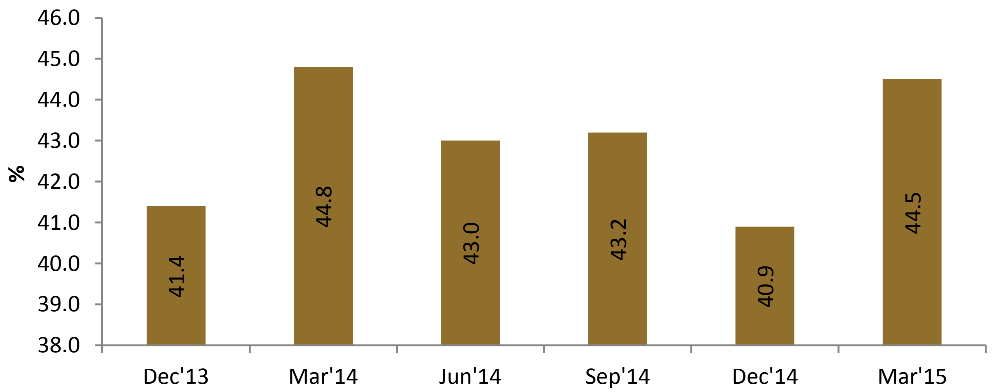


Higher focus towards low cost borrowings to build strong liability franchise

We believe strong branch network will help the bank to grow deposits at a CAGR of 21% over FY15-17E, with healthy low cost deposits base, which may help it to keep NIM in 4.1-4.4% range in the next two years.

HDFC Bank has maintained strong liability franchise, with deposit growth of 22.7% YoY at ₹543,660 crore in FY15, which is one of the best among peers. This has been due to constant investment in branches & ATMs, strong brand recognition and quality services. Persistent focus on the retail segment has always paid off well for HDFC Bank in its endeavor to mobilize strong CASA share of ~44% over the years. The bank posted 6 bps YoY expansion in net interest margins (NIM) at 4.43% at the end of FY15 as reducing money market rate and uptick in low cost CASA deposits helped in containing lower cost of funds. We believe strong branch network will help the bank to grow deposits at a CAGR of 21% over FY15-17E, with healthy low cost deposits base, which may help it to keep NIM at healthy levels in the next two years.

CASA ratio trend



Expects loan book to grow by 20-21% in FY16-17E

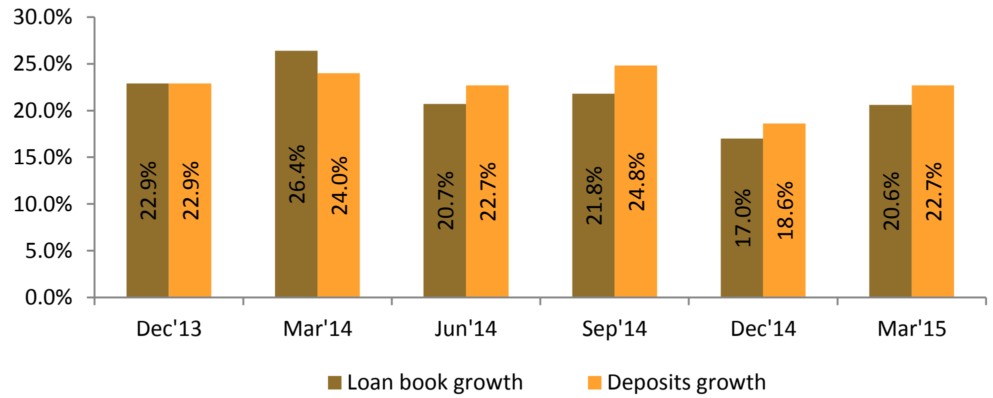
HDFC Bank has registered a strong loan growth of 20.6% YoY with over ₹365,495 crore of advances, once again outpacing the industry credit growth rate by ~9% in FY15. Loan growth remained impressive on broad based, with retail book growing at 21.8% while, wholesale book growing at 17.6% in FY15. Retail loan portfolio rose on continued traction in auto loans, home loans and personal loans, which grew at 20-25% each. While, lending across credit cards (31% YoY) and retail agri-loans (52% YoY) also fuelled the retail loan book growth. Growth in wholesale loan book was driven by marginal uptick in working capital loans, brownfield Capex and refinancing.

With the GoI's focus on reviving the investment demand, we expect the demand for corporate loan book to improve further in next two years.

The bank's management believes that if economy picks up, the Indian banking industry to peg its loan book growth at ~13-14% in FY16E, which in turn would lead to higher demand for term loans and project loans. The lender also expects lending growth in the corporate space to move in line with retail lending growth as it sees good opportunity in refinancing some of the completed projects.

The ongoing structural reform by the government to push infrastructural development in the country also provides good lending visibility to the bank. With the GoI's focus on reviving the investment demand, we expect the demand for corporate loan book to improve further in next two years. We expect the bank's loan book to grow in the range of 20-21% in FY16-17E. Thus, we believe that higher economic activity, inflation target of 6% and falling interest rates is likely to support credit growth in FY16E.

Business growth trend



Better risk management to keep asset quality at comfortable level

We expect the bank to maintain stable asset quality in the coming quarters, with further improvement in commercial vehicles and construction equipment segment, which account for about ~12% of the bank's retail loan book.

With one of the best asset management practices in the industry, HDFC bank has succeeded in maintaining best asset quality, with gross NPA and net NPA ratio remaining at a level as low as ~0.9% and 0.3% for the past three years, respectively, lower than that of its peers such as Axis Bank and ICICI Bank. In Q4FY15, HDFC Bank witnessed strong asset quality as its gross NPAs and net NPAs declined to 0.9% and 0.2% as against as against 1.0% and 0.3%, respectively at the end of Q4FY14, allowing the bank to even lower its provision coverage ratio from 82.4% to 79.9% during the same timeframe. The bank's total restructured loans as a proportion of loan book also declined to 0.1% at the end of March 2015 versus 0.2% a year back.

Going further, we expect the bank to maintain stable asset quality in the coming quarters, with further improvement in commercial vehicles and construction equipment segment, which account for about ~12% of the bank's retail loan book. We believe that the bank's focus on boosting its share in unsecured loan book to provide adequate cushion against probable asset quality risks. The management of the bank expects to maintain credit cost at current levels of 50-60bps in the coming quarters. Thus, with better provisioning policies, HDFC Bank is likely to maintain its present asset quality standard.

As of March 31, 2015, the Bank's distribution network reached at 4,014 branches and 11,766 ATMs in 2,464 cities / towns.

Sustained branch expansion to boost business prospects

Over FY12-15, HDFC Bank expanded its reach by adding ~1,470 branches or ~33% of its existing branches. As of March 31, 2015, the bank's distribution network reached at 4,014 branches and 11,766 ATMs in 2,464 cities / towns as against 3,403 branches and 11,256 ATMs in 2,171 cities / towns a year ago. The increased branch franchise has enabled the bank improve its retail franchise through branch expansion.

The bank's focus on semi-urban and unbanked markets continued, with ~55% of the bank's branches in semi-urban and rural areas. Going further, the bank intends to continue with its drive to penetrate deeper into these geographies with new customized products, giving an intense competition to State Bank of India, the country's largest rural lender. The expected increase in incremental contribution from these branches as they ride through the cycle of maturity, will not only empower qualitative balance sheet growth but would also boost the CASA base of the bank, providing the much needed cushion against the NIM.

HDFC Bank has market share of ~31-32% in the car loan segment, and 22-23% in the two-wheeler segment.

With digitization, HDFC Bank will continue to maintain its dominance in the Indian private banking sector

Addressing customer needs, HDFC Bank plans to use biometrics technology to disburse automobile loans in 30 minutes. Earlier, the lender had launched a loan product to disburse personal loans in 10 seconds. The biometrics technology will be linked to applicants' Aadhaar card number, which will pull out the customer profile. The loan will then be approved with additional details. The product is available for HDFC Bank's depositors, as well as others. With this technology, loans for two-wheelers can be approved within 10-15 minutes, whereas the time taken for car loans will be around 30 minutes.

The bank is planning to deploy this technology in 400-500 dealers across the country in the case of two-wheelers in the current financial year. In the same period, the target is to cover 300-400 car dealers. In the past two months, the lender has disbursed about 25,000 car and two-wheeler loans with this technology. Within the retail segment, auto loans make for the largest share with advances worth `46,760 crore at the end of March 2015. HDFC Bank has market share of ~31-32% in the car loan segment, and 22-23% in the two-wheeler segment. With this technology, the bank is confident of wresting more market share. Currently, the device has been deployed in dealership across urban areas. Going ahead, the bank plans to deploy it in semi-urban and rural areas. The increased focus on using technology for speedy loan approval and disbursal is in line with the bank's focus on the digital medium and with an aim to become a 'digital bank'.

Key risks

- Asset quality is showing signs of stability but still at comparatively higher levels. Any deterioration remains the main concern for the bank.
- The bank's high credit to deposit (C/D) ratio is a major concern and is significantly high compared to the industry. In the wake of sluggish deposit growth, high C/D ratio may create capital adequacy and efficient resource utilization issues.
- Any rise in interest rates (though not expected in the near term) could require it to make provisions against its large investment book.
- The deregulation of the interest rates by the RBI has led to strong competition as some of the private sector banks are offering higher rates on savings accounts.

Balance Sheet (Standalone)

Y/E (₹cr)	FY14A	FY15A	FY16E	FY17E
Share capital	480	501	501	501
Total reserve & surplus	42,999	61,508	71,858	86,219
Deposits	367,338	450,796	543,660	663,265
Borrowings	39,439	45,214	45,666	47,492
Other liabilities	41,344	32,484	38,981	46,778
Total Equity & Liabilities	**491,600**	**590,503**	**700,666**	**844,255**
Cash & Balance with RBI	25,346	27,510	27,235	28,325
Money call & short notice	14,238	8,821	9,880	11,065
Advances	120,951	166,460	196,256	235,508
Investments	303,000	365,495	442,249	540,871
Fixed assets	2,940	3,122	3,278	3,671
Other assets	25,125	19,095	21,768	24,816
Total Assets	**491,600**	**590,503**	**700,666**	**844,255**

Profit & Loss Account (Standalone)

Y/E (₹cr)	FY14A	FY15A	FY16E	FY17E
Interest income	41,136	48,470	58,164	70,146
Interest expense	22,653	26,074	31,550	37,828
Net Interest Income	**18,483**	**22,396**	**26,614**	**32,317**
Non-interest income	7,920	8,996	10,616	12,739
Operating income	26,402	31,392	37,230	45,056
Operating expenses	12,042	13,988	16,435	19,558
Profit before provisions & tax	**14,360**	**17,404**	**20,794**	**25,498**
Provisions	1,587	2,076	2,263	2,511
Tax	4,294	5,113	6,115	7,586
Net Profit	**8,478**	**10,216**	**12,416**	**15,401**

Key Ratios (Standalone)

Y/E	FY14A	FY15A	FY16E	FY17E
Avg. cost of deposits (%)	3.6	3.4	3.3	3.2
ROA (%)	1.9	1.9	1.9	2.0
ROE (%)	21.3	19.4	18.5	19.4
Interest Expense/ Intere Income (%)	55.1	53.8	54.2	53.9
Investment/Deposit	32.9	36.9	36.1	35.5
Cost-Income Ratio (%)	45.6	44.6	44.1	43.4
C-D Ratio (%)	82.5	81.1	81.3	81.5
BVPS (₹)	181.2	247.4	288.7	346.0
P/ BVPS (x)	5.9	4.3	3.7	3.1
EPS (₹)	35.3	40.8	49.5	61.4
P/E(x)	30.1	26.1	21.4	17.3

Valuation and view

Over the years, HDFC Bank has outpaced industry growth rates in almost all the operational parameters. But to maintain similar trend and deliver ROA as high as its present 1.9% level despite enlargement in balance sheet, will be a challenge for the bank. However, we believe HDFC Bank will continue its streak of consistent performance and remain one of the safest bets in the banking sector. Further, with strong capital adequacy ratio, healthy asset quality and stable NIM, we believe the HDFC Bank is well positioned to take the advantage of revival in economy, which in turn would lead to higher loan growth in future.

At a current CMP of ₹1,062, the stock trades at a P/BVPS of 3.7x FY16E and 3.1x FY17E, book value. We recommend 'BUY' with a target price of ₹1,253, arrived at FY17E book value which implies potential upside of ~18% to the CMP from a long term perspective.

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