

HDFC BANK

Core strong, one-off rise in asset quality

India Equity Research | Banking and Financial Services

HDFC Bank's Q1FY18 PAT of INR38.9bn (up >20% YoY) came lower than our estimate on higher credit cost, while revenue maintained momentum and limited the overall impact. Uncharacteristically, GNPLs rose by 19bps QoQ to 1.24% (still best-in-class), but >60% of the contribution was from agri portfolio (effects of farm loan waiver) which seemingly is non-recurring and slippages should normalise henceforth. Having said that, key highlight was the bank's continued traction in core operating profitability (up >25% YoY). Also, NIMs settling at upper end of the guided range at 4.4% coupled with better traction in loan growth led to 20% plus NII growth. Improvement in core fee income (up >30% YoY) and contained opex (up <13% YoY) lent further support. Liability franchise continued to strengthen - CASA stood at 44% (savings accounts (SA) moved up >26% YoY). Best-in-class liability franchise and marginal stress baggage places HDFC Bank in a sweet spot to capitalise on emerging opportunities. Maintain 'BUY'.

Uncharacteristic one-off rise in GNPL

GNPLs rose to 1.24% (up 19bps QoQ), with >60% of slippage driven by agri (effects of farm loan waiver), excluding this, slippages were broadly in line with historical trend. Bank conservatively chose to provide higher (~50%) on this agri portfolio leading to elevated credit cost. Low restructured book (0.1%), nil 5:25 & SDR and > INR12bn floating provisions lends comfort. Marginal stress baggage places HDFC Bank in a sweet spot to capitalise on emerging opportunities (personal loans, credit cards, etc).

Growth momentum building up

Loan growth exceeded our estimate growing >23% YoY (>4x industry growth, an indication of market share gains with strong traction in business banking and unsecured segments). Taking cue from strong operating performance even amid such challenging times, in our view, places HDFC Bank as a frontrunner to seize growth opportunities.

Outlook and valuations: Strong franchise; maintain 'BUY'

Best-in-class liability franchise, expansion of rural/semi-urban branches and improvement in productivity owing to digital focus will ensure that the bank delivers above-industry earnings growth — 18-20% CAGR over FY17-19E, albeit lower than trend — and sustains superior return ratios (RoA of 2%). At CMP, the stock is trading at 3.8x FY19E P/ABV and 20.9x FY19E P/E. We maintain 'BUY/SO' with TP of INR1,958 (4.2x FY19E P/ABV).

Financials

(INR mn)

| Year to March | Q1FY18 | Q1FY17 | Growth % | Q4FY17 | Growth % | FY17 | FY18E | FY19E |
|--------------------|----------|----------|----------|----------|----------|----------|----------|----------|
| Net revenue | 1,28,874 | 1,05,881 | 21.7 | 1,25,014 | 3.1 | 4,54,357 | 5,39,497 | 6,34,641 |
| Net profit | 38,938 | 32,389 | 20.2 | 39,901 | (2.4) | 1,45,496 | 1,76,159 | 2,12,977 |
| Dil. EPS (INR) | 15.0 | 12.6 | 19.0 | 15.4 | (2.6) | 56.8 | 68.7 | 83.1 |
| Adj. BV (INR) | | | | | | 344.1 | 397.0 | 461.7 |
| Price/Adj book (x) | | | | | | 5.0 | 4.4 | 3.8 |
| Price/Earnings (x) | | | | | | 30.5 | 25.2 | 20.9 |

EDELWEISS 4D RATINGS

| Absolute Rating | BUY |
|--------------------------------|------------|
| Rating Relative to Sector | Outperform |
| Risk Rating Relative to Sector | Low |
| Sector Relative to Market | Overweight |

MARKET DATA (R: HDBK.BO, B: HDFCB IN)

| | |
|------------------------------|------------------|
| CMP | : INR 1,735 |
| Target Price | : INR 1,958 |
| 52-week range (INR) | : 1,748 / 1,158 |
| Share in issue (mn) | : 2,573.9 |
| M cap (INR bn/USD mn) | : 4,466 / 68,023 |
| Avg. Daily Vol.BSE/NSE('000) | : 1,966.6 |

SHARE HOLDING PATTERN (%)

| | Current | Q4FY17 | Q3FY17 |
|--|---------|--------|--------|
| Promoters * | 21.1 | 21.2 | 21.3 |
| MF's, FI's & BK's | 11.1 | 10.6 | 12.4 |
| FII's | 34.3 | 34.4 | 31.9 |
| Others | 33.5 | 33.8 | 34.4 |
| * Promoters pledged shares (% of share in issue) | | | NIL |

PRICE PERFORMANCE (%)

| | Stock | Nifty | EW Banks and Financial Services Index |
|-----------|-------|-------|---------------------------------------|
| 1 month | 3.4 | 4.1 | 3.8 |
| 3 months | 13.2 | 8.1 | 11.7 |
| 12 months | 41.0 | 16.7 | 29.3 |

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Banking and Financial Services

Table 1: Summary of Q1FY18 financials

| (INR mn) | Q1FY18 | Q1FY17 | Growth (%) | Q4FY17 | Growth (%) | Comments |
|-------------------------------|--------|--------|------------|--------|------------|---|
| Net interest income | 93,707 | 77,814 | 20.4 | 90,551 | 3.5 | NIMs settling at upper end of the guided range at 4.4% coupled with better traction in loan growth led to 20% plus NII growth. |
| Other income | 35,167 | 28,066 | 25.3 | 34,463 | 2.0 | Core fee income showed strong traction , registering > 30% growth. Sustainability will hold key |
| Operating expenses | 53,675 | 47,689 | 12.6 | 52,220 | 2.8 | Lower opex supported core profitability, we anticipate some rise in opex. |
| Staff expense | 16,575 | 15,852 | 4.6 | 16,527 | 0.3 | |
| Other opex | 37,100 | 31,837 | 16.5 | 35,693 | 3.9 | |
| Pre prov op profit (PPP) | 75,199 | 58,192 | 29.2 | 72,794 | 3.3 | Core profitability growth sustained momentum, with second consecutive quarter of >25% growth. |
| Provisions | 15,588 | 8,667 | 79.8 | 12,618 | 23.5 | Higher slippages (in agri portfolio) and higher general provisions (INR1.2bn, on account of provisions towards stressed sectors) fed into higher credit cost. |
| Profit before tax | 59,612 | 49,525 | 20.4 | 60,176 | (0.9) | |
| Provision for tax | 20,673 | 17,136 | 20.6 | 20,275 | 2.0 | |
| Profit after tax | 38,938 | 32,389 | 20.2 | 39,901 | (2.4) | |
| EPS (INR) | 15.0 | 12.6 | 19.0 | 15.4 | (2.6) | |
| Balance sheet (INR bn) | | | | | | |
| Advances | 5,810 | 4,706 | 23.4 | 5,546 | 4.8 | Loan growth impressive at > 23%, indicating market share gains. The growth driven by business banking and unsecured segments. |
| Deposits | 6,714 | 5,738 | 17.0 | 6,436 | 4.3 | |
| Investments | 2,161 | 2,063 | 4.7 | 2,145 | 0.8 | |
| Asset quality (INR bn) | | | | | | |
| Gross NPA | 72.4 | 49.2 | 47.2 | 58.9 | 23.1 | Uncharacteristic rise in GNPLs, with > 60% being contributed by agri portfolio. Slippages likely to normalise henceforth |
| Gross NPA (%) | 1.2 | 1.0 | | 1.1 | | |
| Net NPA | 26.3 | 14.9 | 76.0 | 18.4 | 42.5 | |
| Net NPA (%) | 0.4 | 0.3 | | 0.3 | | |
| Provision coverage (%) | 63.7 | 69.7 | | 68.7 | | |

Source: Company, Edelweiss research

Table 2: Advance growth at ~23% YoY, CD ratio rise to ~86%

| | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 |
|---------------------------|--------|--------|--------|--------|--------|
| Advances (INR bn) | 4,706 | 4,944 | 4,950 | 5,546 | 5,810 |
| Advances growth Q-o-Q (%) | 1.3 | 5.1 | 0.1 | 12.0 | 4.8 |
| Advances growth Y-o-Y (%) | 23.2 | 18.1 | 13.4 | 19.4 | 23.4 |
| Deposits (INR bn) | 5,738 | 5,917 | 6,347 | 6,436 | 6,714 |
| Deposit growth Q-o-Q (%) | 5.0 | 3.1 | 7.3 | 1.4 | 4.3 |
| Deposit growth Y-o-Y (%) | 18.5 | 16.7 | 21.1 | 17.8 | 17.0 |
| CD ratio (%) | 82.0 | 83.6 | 78.0 | 86.2 | 86.5 |

Source: Company

Table 3: Core fee income gains traction

| (INR bn) | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 | Y-o-Y (%) |
|--------------------|--------|--------|--------|--------|--------|-----------|
| Fees & commissions | 19.8 | 21.0 | 22.1 | 25.2 | 25.8 | 30.3 |
| Forex & deri. rev. | 3.1 | 3.0 | 3.0 | 3.6 | 3.0 | (5.6) |
| Total fee income | 22.9 | 24.0 | 25.0 | 28.8 | 28.7 | 25.4 |
| % of revenue | 26.5 | 26.6 | 27.4 | 27.6 | 27.3 | |

Source: Company

Table 4: GNPLs rise led by slippages in agri portfolio

| | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 |
|--------------------|--------|--------|--------|--------|--------|
| Gross NPA (INR mn) | 49,209 | 50,690 | 52,323 | 58,857 | 72,429 |
| Gross NPA (%) | 1.0 | 1.0 | 1.1 | 1.1 | 1.2 |
| Growth Q-o-Q (%) | 12.0 | 3.0 | 3.2 | 12.5 | 23.1 |
| Net NPA (INR mn) | 14,934 | 14,889 | 15,643 | 18,440 | 26,282 |
| Net NPA (%) | 0.3 | 0.3 | 0.3 | 0.3 | 0.4 |
| Growth Q-o-Q (%) | 13.1 | (0.3) | 5.1 | 17.9 | 42.5 |
| Prov. cov. (%) | 69.7 | 70.6 | 70.1 | 68.7 | 63.7 |

Source: Company

Table 5: NIMs witness 10bps expansion to 4.4% (upper end of guidance)

| (%) | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 |
|-----------------|--------|--------|--------|--------|--------|
| NIMs (rep) | 4.4 | 4.2 | 4.1 | 4.3 | 4.4 |
| ROA (quarterly) | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |

Source: Company

Table 6: Cost-to-income ratio at <42%

| (%) | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 |
|-------------------|--------|--------|--------|--------|--------|
| Cost-income ratio | 45.0 | 44.7 | 42.3 | 41.8 | 41.6 |
| Tax rate | 34.6 | 34.5 | 34.4 | 33.7 | 34.7 |

Source: Company

Table 7: Liability franchise continues to strengthen

| | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 | Y-o-Y (%) |
|--------------------------------|--------------|--------------|--------------|--------------|--------------|------------|
| Savings account (INR bn) | 1,527 | 1,600 | 1,866 | 1,936 | 1,931 | 26.5 |
| Current account (INR bn) | 761 | 792 | 1,012 | 1,156 | 1,020 | 34.1 |
| CASA % | 39.9 | 40.4 | 45.4 | 48.0 | 44.0 | |
| Time deposit % | 60.1 | 59.6 | 54.6 | 52.0 | 56.0 | |
| Total deposits (INR bn) | 5,738 | 5,917 | 6,347 | 6,436 | 6,714 | 1.4 |

Source: Company

Table 8: Retail book witnesses continued traction (as per RBI classification)

| (%) | Q1FY17 | Q2FY17 | Q3FY17 | Q4FY17 | Q1FY18 |
|-------------------------------|--------------|--------------|--------------|--------------|--------------|
| Retail | 49.5 | 51.1 | 52.7 | 51.2 | 52.1 |
| Non retail | 50.5 | 48.9 | 47.3 | 48.8 | 47.9 |
| Retail loans break-up: | | | | | |
| Auto Loans | 22.4 | 22.4 | 22.4 | 21.9 | 21.8 |
| Personal Loans | 17.4 | 17.7 | 17.8 | 17.6 | 18.3 |
| CVs | 6.6 | 6.6 | 6.7 | 6.8 | 6.5 |
| Loan Against Securities | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| 2-Wheelers | 2.4 | 2.3 | 2.3 | 2.2 | 2.2 |
| Business Banking | 11.0 | 12.5 | 12.3 | 12.8 | 13.4 |
| Credit Cards | 9.1 | 8.5 | 9.1 | 9.2 | 9.6 |
| Housing loans | 14.4 | 13.3 | 13.6 | 13.5 | 12.8 |
| Others | 14.2 | 14.3 | 13.5 | 13.8 | 13.3 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Company

Table 9: Break up of domestic retail advances (as per internal classification)

| (INR bn) | Q1FY18 | Q1FY17 | YoY (%) | Q4FY17 | QoQ (%) |
|---|--------------|--------------|-------------|--------------|------------|
| Auto | 737 | 596 | 23.8 | 701 | 5.2 |
| Personal Loans | 561 | 411 | 36.6 | 505 | 10.9 |
| Home Loans | 388 | 336 | 15.5 | 384 | 1.1 |
| Kisan Gold Card | 281 | 235 | 19.6 | 288 | (2.5) |
| Credit Cards | 291 | 213 | 36.9 | 260 | 11.9 |
| CV/CE | 385 | 315 | 22.2 | 379 | 1.4 |
| Others | 159 | 140 | 13.3 | 157 | 1.3 |
| Two Wheelers | 77 | 66 | 16.8 | 73 | 5.2 |
| Gold Loans | 51 | 49 | 5.2 | 49 | 4.2 |
| Loans against securities | 30 | 19 | 56.7 | 28 | 5.6 |
| Total Retail Advances | 2,960 | 2,379 | 24.4 | 2,826 | 4.8 |
| Add : Business Banking | 881 | 693 | 27.1 | 818 | 7.7 |
| Total Retail Advances (Including business banking) | 3,841 | 3,072 | 25.0 | 3,644 | 5.4 |

Source: Company

Financial snapshot

(INR mn)

| Year to March | Q1FY18 | Q1FY17 | % change | Q4FY17 | % change | FY17 | FY18E | FY19E |
|--------------------------|---------|---------|----------|---------|----------|---------|---------|---------|
| Interest income | 186,687 | 165,160 | 13.0 | 181,144 | 3.1 | 693,060 | 820,127 | 966,911 |
| Interest exp | 92,980 | 87,346 | 6.5 | 90,593 | 2.6 | 361,667 | 423,405 | 498,223 |
| Net int. inc. (INR mn) | 93,707 | 77,814 | 20.4 | 90,551 | 3.5 | 331,392 | 396,722 | 468,688 |
| Other income | 35,167 | 28,066 | 25.3 | 34,463 | 2.0 | 122,965 | 142,775 | 165,952 |
| Net revenues | 128,874 | 105,881 | 21.7 | 125,014 | 3.1 | 454,357 | 539,497 | 634,641 |
| Operating expenses | 53,675 | 47,689 | 12.6 | 52,220 | 2.8 | 197,033 | 228,690 | 265,011 |
| Staff expense | 16,575 | 15,852 | 4.6 | 16,527 | 0.3 | 64,837 | 74,462 | 85,482 |
| Other opex | 37,100 | 31,837 | 16.5 | 35,693 | 3.9 | 132,197 | 154,228 | 179,529 |
| Pre prov op profit(ppop) | 75,199 | 58,192 | 29.2 | 72,794 | 3.3 | 257,324 | 310,807 | 369,629 |
| Provisions | 15,588 | 8,667 | 79.8 | 12,618 | 23.5 | 35,933 | 43,900 | 46,937 |
| Profit before tax | 59,612 | 49,525 | 20.4 | 60,176 | (0.9) | 221,391 | 266,907 | 322,693 |
| Provision for taxes | 20,673 | 17,136 | 20.6 | 20,275 | 2.0 | 75,894 | 90,748 | 109,715 |
| PAT | 38,938 | 32,389 | 20.2 | 39,901 | (2.4) | 145,496 | 176,159 | 212,977 |
| Diluted EPS (INR) | 15.0 | 12.6 | 19.0 | 15.4 | (2.6) | 56.8 | 68.7 | 83.1 |

Ratios

| | | | | | | | | |
|-------------------|------|------|--|------|--|------|------|------|
| NII/GII (%) | 50.2 | 47.1 | | 50.0 | | 47.8 | 48.4 | 48.5 |
| Cost/income (%) | 41.6 | 45.0 | | 41.8 | | 43.4 | 42.4 | 41.8 |
| Provisions / PPOP | 20.7 | 14.9 | | 17.3 | | 14.0 | 14.1 | 12.7 |
| Tax rate (%) | 34.7 | 34.6 | | 33.7 | | 34.3 | 34.0 | 34.0 |

Bal. sheet data (INRbn)

| | | | | | | | | |
|-------------|-------|-------|------|-------|-----|-------|-------|-------|
| Advances | 5,810 | 4,706 | 23.4 | 5,546 | 4.8 | 5,546 | 6,666 | 8,012 |
| Deposits | 6,714 | 5,738 | 17.0 | 6,436 | 4.3 | 6,436 | 7,727 | 9,361 |
| Investments | 2,161 | 2,063 | 4.7 | 2,145 | 0.8 | 2,145 | 2,452 | 2,838 |

Asset quality

| | | | | | | | | |
|------------------------|------|------|------|------|------|-------|-------|-------|
| Gross NPA (INR bn) | 72 | 49 | 47.2 | 59 | 23.1 | 59 | 88 | 115 |
| Gross NPA (%) | 1.2 | 1.0 | | 1.1 | | 1.0 | 1.3 | 1.4 |
| Net NPA (INR bn) | 26 | 15 | 76.0 | 18 | 42.5 | 18 | 27 | 35 |
| Net NPA (%) | 0.4 | 0.3 | | 0.3 | | 0.3 | 0.4 | 0.4 |
| Provision coverage (%) | 63.7 | 69.7 | | 68.7 | | 68.7 | 68.8 | 69.4 |
| B/V per share (INR) | | | | | | 349.1 | 404.5 | 471.4 |
| Adj book value / share | | | | | | 344.1 | 397.0 | 461.7 |
| Price/ Adj. book (x) | | | | | | 5.0 | 4.4 | 3.8 |
| Price/ Earnings | | | | | | 30.5 | 25.2 | 20.9 |

Q1FY18 Earnings Call Takeaways

With respect to asset quality

- **GNPLs rose to 1.24% (net addition of INR13.6bn), roughly 60% of the increase (viz. ~INR8bn) was on account of agri segment and the balance is in line with historical trend.**
- **Provision composition:** INR15.58bn of which Specific provision was INR13.43bn and General Provision was INR2.06bn. **Of the incremental provisions of INR6.92bn (compared to Q1FY17), the increase of INR5.1bn in specific provision was driven by agri portfolio (INR3.71bn, i.e. 72% was due to agri NPLs) and of the INR2bn rise in General provisions INR1.2bn was due to provisions on stressed assets (60-100bps of general provisions vs. requirement of 40bps in some stressed segments).**
- GNPLs movement – Slippages –INR31bn , Recoveries – INR17.5bn, upgrades – INR4.9bn, W/O- INR7.37bn , other recoveries – INR5.21bn.
- Large part of the slippages this quarter was related to agri. portfolio (large part of that ~90%, is related only to crop loans and not to the retail segment of the same borrowers). The slippages from the agri. portfolio was largely a reflection of farm loan waiver than their ability to pay. Just to elucidate while ability got impacted post demonetisation but April harvest has been good so as to not significantly impact the ability of the borrower to pay. Thus what has happened is the fact that promises on Farm loan waiver has kept farmers at bay to pay the amount, but with this details being out and clarity on eligibility being by and large there, the bank expects repayments to happen over next harvest.
- **On the agri. segment the bank made higher provisions (provided 50% towards these agri assets) than required by regulatory provisions (increased coverage on the portfolio).**
- No movement of restored book – (remains at 0.1%).

With respect to growth

- Loan growth (>23% YoY) was broad-based, with both domestic retail and wholesale advances growing at healthy rates. **Banks expects the bank to outpace the system growth going ahead**
 - Growth in the wholesale book was driven by working capital demand and market share gains. There is enough opportunity based on relationship, rates and turnaround to see good growth momentum in this segment.
 - As of now haven't seen any immediate impact on business banking side which could lead to asset quality issues or lower demand, Have seen some market share gains (more branches activated in this segment)
 - Growth in the home loan is function of purchase from HDFC which was INR25bn this quarter (versus more normalised growth of INR30bn) which has nothing to do with let up in origination thus adjusting for this the growth is still higher.
- **With respect to core fee growth: there were some one-offs viz a) Strong distribution of MFs (proportion of equity is much higher), b) discussion with Oil minister/OMCs got concluded which resulted into fees (which contributed 4-5% of the growth), adjusting for these the growth is in 18-20% range. Having said that other income saw some**

higher traction in few of the core products which could drive these sort of growth henceforth.

- Overseas loans – INR201bn (INR199bn in FY17, INR330 in Q1FY17)
- Q4FY17 has seen higher level of CASA share, however this quarter there has been higher growth in Fixed deposit during this quarter.

Other highlights

- CET-1: 12.44%, Bank currently have no timeline in mind to raise the equity capital. Raised INR80bn of AT-1 bonds during the quarter.
- Historically, margins have been in the range of 4-4.3%, which seems realistic.
- Of the cases that are being referred to NCLT, bank had an exposure to only one account which was partly sold in FY15 and the balance has been fully provided for.
- Some increase in employee cost will happen under Ind-AS , management expect this to rise by around 5 percentage points. On the credit cost, the bank doesn't expect any major change as general provisions made currently higher which will offset any impact.
- With respect to HDB Financials:
 - Advances: INR329.3bn, AUM- INR350bn ;
 - Moved NPA to 90dpd this quarter for HDB which had impacted profitability, the company reported PAT of INR1.5bn

Q4FY17 Earnings Call Takeaways

With respect to loan book

- **Loan growth was broad-based, with both domestic retail and wholesale advances growing at 26-27%** (as per internal business classification)
 - **Management expects the bank to outpace the system growth going ahead**
 - However, quantum is uncertain as the linkage between GDP growth and banking growth seems to have been fractured
- **Large Corporate:** Despite competition from the bond market, the bank continues to see opportunities for growth in this segment
 - Gaining market share from foreign banks and public sector banks
- **Emerging Corporate:** Well-positioned in terms of customer acquisition, with operations in 100 cities
 - Generates a pipeline from the business banking segment
 - Gaining market share from other private banks and public sector banks
- **Business Banking:** Mostly small business loans, based on a branch-acquisition strategy
 - Saw increase in disbursements post demonetisation, on back of draw-down of limits
 - Gaining market share from public sector banks and some NBFCs
- Unsecured business gaining traction on account of better sales process at front-end
 - Penetration is in early teens and increasing
- Focus is on acquiring customers based on superior product range and service quality
- Proportion of loan book on base rate: ~5-6%

With respect to asset quality

- **Standalone slippages (excluding those related to RBI dispensation) stood at 1.5%**
 - **Recovery from a/cs on which RBI dispensation was sought (~INR2.4bn) was ~25%, with rest slipping into NPAs**
 - Segments which saw higher NPAs partly due to demonetisation include Agri, SLI, and 2-wheelers to some extent
 - Collection ratio in SLI portfolio of ~INR40bn is better-than-system and seeing stabilising trend
 - **While corporate saw few slippages (no large chunky piece), there was nothing owing to RBI divergence guidelines**
- Provisions and contingencies stood at ~INR12.6bn, vs. ~INR8bn (including floating provisions) last year on a like-to-like basis
 - Specific provisions of INR9.8bn saw a spike partly owing to slippage of a/cs on which RBI dispensation was sought
 - General provisions of INR2.8bn was driven by increase in loans and advances during the quarter

- ***With regard to RBI notification on SA provisioning, mgmt. highlighted that some general provisioning may be carried out during Q1FY18***
- No sale to ARCs was carried out during the quarter
- Floating provisions: INR12.5bn

Other highlights

- ***Historically, margins have been in the range of 4-4.3%, which seems realistic***
- ***CASA ratio may come off going forward owing to pick-up in fixed deposit growth***
 - Demonetisation and maturity of FCNR deposits were partly responsible for optically higher CASA ratio
 - Saw one-offs linked to good activity in capital market float-related activities (IPO, dividends, etc.)
- Management see opportunity for improvement in the cost/income ratio
 - Employee re-balancing is something which is being continuously looked at
 - Lower staffing req. on back of digitisation partly offset by higher need due to branch/geography expansion
 - Employee count as of Mar-17: 84,325 (vs. 87,555 in Mar-16)
 - New branch addition should be ~100-200 per year
- IndAS will impact ESOP accounting through higher employee costs as fair value will need to be reflected through the P&L
 - Some tweaking of policy has been carried out and may continue going ahead
- Urban and rural mix stands at ~80:20%
- Investment in subsidiaries: INR36bn
- Net worth of HDB Financial Services: INR53bn
- CET1 ratio: ~12.8%

Company Description

HDFC Bank has a balance sheet size of ~INR8.96tn as at June '17. It is amongst the leading private sector banks with a market cap of over INR4.4tn. The key promoter, HDFC, holds ~21% stake, and FIIs and public hold the balance. The distribution network comprises of 4,727 branches and 12,220 ATMs in 2,666 cities / towns. HDFC Bank is among the top three players in auto loans, personal loans, commercial vehicles, cash management, and supply chain management. The bank's strengths include its brand equity, professional management, distribution reach, high CASA, clean book, and focus on profitability.

Investment Theme

Best-in-class liability franchise, expansion of rural/semi-urban branches and improvement in productivity owing to digital focus will ensure that the bank delivers above-industry earnings growth — 18-20% CAGR over FY17-19E, albeit lower than trend — and sustains superior return ratios (RoAs of 2%). Also, the RBI's directive on recognition & stress reporting divergence may weigh on the sector as a whole, but the bank seems to be better placed than other corporate banks given its superior retail franchise which will drive outperformance in near to medium term.

Key Risks

Higher-than-expected outflow in CASA and change in macro environment may impact cost of funds and consequently margins.

Higher than expected delinquencies due to the loan mix and vulnerability to system-wide deterioration in the quality of retail assets is the key risk.

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

Lower than expected asset growth.

Financial Statements

Key Assumptions

| Year to March | FY16 | FY17 | FY18E | FY19E |
|-------------------------------------|------|------|-------|-------|
| Macro | | | | |
| GDP(Y-o-Y %) | 7.2 | 6.5 | 7.1 | 7.7 |
| Inflation (Avg) | 4.9 | 4.5 | 4.0 | 4.5 |
| Repo rate (exit rate) | 6.8 | 6.3 | 5.8 | 5.8 |
| USD/INR (Avg) | 65.0 | 67.5 | 66.0 | 66.0 |
| Sector | | | | |
| Credit growth | 9.3 | 9.0 | 12.0 | 14.0 |
| Deposit growth | 8.6 | 14.0 | 12.0 | 13.0 |
| CRR | 4.0 | 4.0 | 4.0 | 4.0 |
| SLR | 20.8 | 20.0 | 20.0 | 20.0 |
| G-sec yield | 7.5 | 6.5 | 6.5 | 6.5 |
| Company | | | | |
| Op. metric assumpt. (%) | | | | |
| Yield on advances | 10.8 | 10.2 | 10.1 | 10.0 |
| Yield on investments | 8.5 | 8.4 | 8.3 | 8.2 |
| Yield on asset | 9.7 | 9.3 | 9.2 | 9.2 |
| Cost of funds | 5.6 | 5.1 | 5.0 | 5.0 |
| Net interest margins | 4.5 | 4.5 | 4.5 | 4.4 |
| Cost of deposits | 5.9 | 5.3 | 5.2 | 5.1 |
| Cost of borrowings | 7.0 | 7.6 | 7.5 | 7.4 |
| Spread | 4.1 | 4.2 | 4.2 | 4.2 |
| Balance sheet assumption (%) | | | | |
| Credit growth | 28.0 | 22.2 | 20.3 | 20.3 |
| Deposit growth | 21.2 | 17.8 | 20.0 | 21.1 |
| SLR ratio | 21.5 | 23.1 | 22.2 | 21.5 |
| Low-cost deposits | 43.2 | 48.0 | 46.1 | 47.3 |
| Net NPA ratio | 0.3 | 0.3 | 0.4 | 0.4 |
| Net NPA / Equity | 1.8 | 2.1 | 2.6 | 2.9 |
| Capital adequacy | 15.5 | 14.6 | 14.1 | 13.6 |
| Incremental slippage | 1.6 | 1.5 | 1.8 | 1.7 |
| Provision coverage | 69.9 | 68.7 | 68.8 | 69.4 |

Income statement

(INR mn)

| Year to March | FY16 | FY17 | FY18E | FY19E |
|--------------------------|---------|---------|---------|---------|
| Interest income | 602,215 | 693,060 | 820,127 | 966,911 |
| Interest expended | 326,299 | 361,667 | 423,405 | 498,223 |
| Net interest income | 275,915 | 331,392 | 396,722 | 468,688 |
| Non interest income | 107,517 | 122,965 | 142,775 | 165,952 |
| - Fee & forex income | 89,868 | 100,749 | 120,520 | 144,107 |
| - Misc. income | 10,159 | 10,909 | 10,454 | 10,845 |
| - Investment profits | 7,491 | 11,307 | 11,800 | 11,000 |
| Net revenue | 383,432 | 454,357 | 539,497 | 634,641 |
| Operating expense | 169,797 | 197,033 | 228,690 | 265,011 |
| - Employee exp | 57,022 | 64,837 | 74,462 | 85,482 |
| - Other opex | 112,775 | 132,197 | 154,228 | 179,529 |
| Preprovision profit | 213,635 | 257,324 | 310,807 | 369,629 |
| Provisions | 27,256 | 35,933 | 43,900 | 46,937 |
| Loan loss provisions | 21,336 | 31,453 | 40,400 | 44,437 |
| Other provisions | 5,768 | 4,557 | 3,500 | 2,500 |
| Profit Before Tax | 186,379 | 221,391 | 266,907 | 322,693 |
| Less: Provision for Tax | 63,417 | 75,894 | 90,748 | 109,715 |
| Profit After Tax | 122,962 | 145,496 | 176,159 | 212,977 |
| Reported Profit | 122,962 | 145,496 | 176,159 | 212,977 |
| Shares o /s (mn) | 2,528 | 2,563 | 2,563 | 2,563 |
| Adj. Diluted EPS (INR) | 48.6 | 56.8 | 68.7 | 83.1 |
| Dividend per share (DPS) | 9.5 | 11.0 | 13.4 | 16.2 |
| Dividend Payout Ratio(%) | 23.5 | 23.3 | 19.5 | 19.5 |

Growth ratios (%)

| Year to March | FY16 | FY17 | FY18E | FY19E |
|-------------------|------|------|-------|-------|
| NII growth | 23.2 | 20.1 | 19.7 | 18.1 |
| Fees growth | 18.1 | 12.1 | 19.6 | 19.6 |
| Opex growth | 21.4 | 16.0 | 16.1 | 15.9 |
| PPOP growth | 22.2 | 19.3 | 21.5 | 19.9 |
| Provisions growth | 31.3 | 31.8 | 22.2 | 6.9 |
| Adjusted Profit | 20.4 | 18.3 | 21.1 | 20.9 |

Operating ratios

| Year to March | FY16 | FY17 | FY18E | FY19E |
|----------------------|------|------|-------|-------|
| Yield on advances | 10.8 | 10.2 | 10.1 | 10.0 |
| Yield on investments | 8.5 | 8.4 | 8.3 | 8.2 |
| Yield on assets | 9.7 | 9.3 | 9.2 | 9.2 |
| Cost of funds | 5.6 | 5.1 | 5.0 | 5.0 |
| Net interest margins | 4.5 | 4.5 | 4.5 | 4.4 |
| Cost of deposits | 5.9 | 5.3 | 5.2 | 5.1 |
| Cost of borrowings | 7.0 | 7.6 | 7.5 | 7.4 |
| Spread | 4.1 | 4.2 | 4.2 | 4.2 |
| Cost-income | 44.3 | 43.4 | 42.4 | 41.8 |
| Tax rate | 34.0 | 34.3 | 34.0 | 34.0 |

Banking and Financial Services

| Balance sheet | | (INR mn) | | | |
|--------------------------|------------------|------------------|-------------------|-------------------|--|
| As on 31st March | FY16 | FY17 | FY18E | FY19E | |
| Share capital | 5,056 | 5,125 | 5,125 | 5,125 | |
| Reserves & Surplus | 721,721 | 889,498 | 1,031,319 | 1,202,783 | |
| Net worth | 726,778 | 894,624 | 1,036,444 | 1,207,908 | |
| Sub bonds/pref cap | 144,279 | 131,820 | 141,820 | 151,820 | |
| Deposits | 5,464,242 | 6,436,397 | 7,726,666 | 9,360,603 | |
| Total Borrowings | 385,906 | 608,469 | 644,969 | 681,469 | |
| Other liabilities | 367,251 | 567,093 | 633,871 | 710,793 | |
| Total liabilities | 7,088,456 | 8,638,402 | 10,183,770 | 12,112,593 | |
| Loans | 4,645,940 | 5,545,682 | 6,665,910 | 8,012,424 | |
| Cash and Equivalents | 389,188 | 489,521 | 524,005 | 620,055 | |
| Gilts | 1,257,106 | 1,624,187 | 1,858,503 | 2,159,045 | |
| Others | 381,752 | 520,446 | 593,407 | 679,106 | |
| Fixed assets | 33,432 | 36,267 | 34,723 | 32,277 | |
| Other Assets | 381,038 | 422,298 | 507,223 | 609,686 | |
| Total assets | 7,088,456 | 8,638,402 | 10,183,770 | 12,112,593 | |
| Credit growth | 28.0 | 22.2 | 20.3 | 20.3 | |
| Deposit growth | 21.2 | 17.8 | 20.0 | 21.1 | |
| EA growth | 19.8 | 20.2 | 20.0 | 18.5 | |
| SLR ratio | 21.5 | 23.1 | 22.2 | 21.5 | |
| C-D ratio | 86.7 | 90.0 | 90.0 | 89.3 | |
| Low-cost deposits | 43.2 | 48.0 | 46.1 | 47.3 | |
| Provision coverage | 69.9 | 68.7 | 68.8 | 69.4 | |
| Gross NPA ratio | 0.9 | 1.0 | 1.3 | 1.4 | |
| Net NPA ratio | 0.3 | 0.3 | 0.4 | 0.4 | |
| Incremental slippage | 1.6 | 1.5 | 1.8 | 1.7 | |
| Net NPA / Equity | 1.8 | 2.1 | 2.6 | 2.9 | |
| Capital adequacy | 15.5 | 14.6 | 14.1 | 13.6 | |
| - Tier 1 | 13.2 | 12.8 | 12.3 | 11.8 | |

| RoE decomposition (%) | | | | | |
|--------------------------|-------|-------|-------|-------|--|
| Year to March | FY16 | FY17 | FY18E | FY19E | |
| Net int. income/assets | 4.5 | 4.5 | 4.5 | 4.4 | |
| Fees/Assets | 1.6 | 1.5 | 1.5 | 1.5 | |
| Invst. profits/Assets | 0.1 | 0.2 | 0.1 | 0.1 | |
| Net revenues/assets | 6.2 | 6.1 | 6.1 | 6.0 | |
| Operating expense/assets | (2.7) | (2.7) | (2.6) | (2.5) | |
| Provisions/assets | (0.4) | (0.5) | (0.5) | (0.4) | |
| Taxes/assets | (1.0) | (1.0) | (1.0) | (1.0) | |
| Total costs/assets | (4.2) | (4.2) | (4.1) | (4.0) | |
| ROA | 2.0 | 2.0 | 2.0 | 2.0 | |
| Equity/assets | 10.9 | 10.9 | 10.8 | 10.6 | |
| ROAE (%) | 18.3 | 17.9 | 18.2 | 19.0 | |

| Valuation parameters | | | | | |
|-------------------------|-------|-------|-------|-------|--|
| Year to March | FY16 | FY17 | FY18E | FY19E | |
| Adj. Diluted EPS (INR) | 48.6 | 56.8 | 68.7 | 83.1 | |
| Y-o-Y growth (%) | 19.3 | 16.7 | 21.1 | 20.9 | |
| BV per share (INR) | 287.5 | 349.1 | 404.5 | 471.4 | |
| Adj. BV per share (INR) | 283.8 | 344.1 | 397.0 | 461.7 | |
| Diluted P/E (x) | 35.7 | 30.5 | 25.2 | 20.9 | |
| Price/ Adj. BV (x) | 6.1 | 5.0 | 4.4 | 3.8 | |
| Dividend Yield (%) | 0.5 | 0.6 | 0.8 | 0.9 | |

Peer comparison valuation

| Name | Market cap (USD mn) | Diluted P/E (X) | | Price/ Adj. BV (X) | | ROAE (%) | |
|---------------------------|------------------------|-----------------|-------|--------------------|-------|----------|-------|
| | | FY18E | FY19E | FY18E | FY19E | FY18E | FY19E |
| HDFC Bank | 68,023 | 25.2 | 20.9 | 4.4 | 3.8 | 18.2 | 19.0 |
| Axis Bank | 20,118 | 18.9 | 12.4 | 2.4 | 2.1 | 11.7 | 16.0 |
| DCB Bank | 930 | 23.1 | 19.1 | 2.4 | 2.1 | 11.5 | 11.5 |
| Federal Bank | 3,540 | 16.0 | 13.4 | 2.2 | 1.9 | 13.3 | 14.2 |
| ICICI Bank | 30,059 | 14.4 | 10.1 | 2.3 | 2.0 | 12.1 | 15.8 |
| IndusInd Bank | 14,552 | 25.6 | 20.6 | 4.1 | 3.5 | 16.8 | 17.9 |
| Karnataka Bank | 918 | 8.3 | 6.9 | 0.9 | 0.8 | 10.0 | 11.2 |
| Kotak Mahindra Bank | 29,523 | 32.4 | 26.5 | 4.2 | 3.6 | 14.5 | 14.5 |
| Oriental Bank Of Commerce | 804 | 19.4 | 12.0 | 0.9 | 0.7 | 3.5 | 4.9 |
| Punjab National Bank | 5,226 | 11.5 | 8.4 | 1.6 | 1.0 | 7.7 | 10.0 |
| Yes Bank | 11,200 | 17.0 | 13.1 | 3.0 | 2.5 | 18.0 | 19.9 |
| Median | - | 18.9 | 13.1 | 2.4 | 2.1 | 12.1 | 14.5 |
| AVERAGE | - | 19.3 | 14.9 | 2.6 | 2.2 | 12.5 | 14.1 |

Source: Edelweiss research

Additional Data

Directors Data

| | | | |
|-----------------------|-------------------------------------|--------------------|-------------------|
| Shyamala Gopinath | Part Time Non Executive Chairperson | Aditya Puri | Managing Director |
| Paresh Sukthankar | Deputy Managing Director | Keki Mistry | Director |
| Renu Karnad | Director | Partho Datta | Director |
| Bobby Parikh | Director | A N Roy | Director |
| Kaizad Bharucha | Director | Malay Patel | Director |
| Umesh Chandra Sarangi | Director | Srikanth Nadhamuni | Director |

Auditors - Deloitte Haskins & Sells

**as per last annual report*

Holding - Top 10

| | Perc. Holding | | Perc. Holding |
|-----------------------------------|---------------|-------------------------------------|---------------|
| Capital Group Companies | 8.02 | Life Insurance Corporation Of India | 2.15 |
| FIL | 1.64 | SBI Funds Management | 1.39 |
| ICICI Prudential Life Insurance | 1.31 | Vontobel Holding | 1.17 |
| 50 Sbi - Etf Nifty | 1.03 | GIC | 0.98 |
| ICICI Prudential Asset Management | 0.94 | HDFC Asset Management | 0.92 |

**as per last available data*

Bulk Deals

| Data | Acquired / Seller | B/S | Qty Traded | Price |
|-------------------|-------------------|-----|------------|-------|
| No Data Available | | | | |

**in last one year*

Insider Trades

| Reporting Data | Acquired / Seller | B/S | Qty Traded |
|----------------|-------------------|------|------------|
| 08 May 2017 | Nitin Chugh | Sell | 87284.00 |
| 08 May 2017 | Ravi Narayanan | Sell | 35000.00 |
| 08 May 2017 | Munish Mittal | Sell | 24000.00 |
| 04 May 2017 | Ravi Narayanan | Sell | 60000.00 |
| 02 May 2017 | Ravi Narayanan | Sell | 30000.00 |

**in last one year*

| Company | Absolute reco | Relative reco | Relative risk | Company | Absolute reco | Relative reco | Relative Risk |
|-----------------------------------|---------------|---------------|---------------|--|---------------|---------------|---------------|
| Allahabad Bank | HOLD | SU | M | Axis Bank | BUY | SO | M |
| Bajaj Finserv | HOLD | SP | L | Bank of Baroda | BUY | SP | M |
| Bharat Financial Inclusion | BUY | SO | M | Capital First | BUY | SO | M |
| DCB Bank | HOLD | SU | M | Dewan Housing Finance | BUY | SO | M |
| Equitas Holdings Ltd. | BUY | SO | M | Federal Bank | BUY | SP | L |
| HDFC | HOLD | SP | L | HDFC Bank | BUY | SO | L |
| ICICI Bank | BUY | SO | L | IDFC Bank | HOLD | SP | L |
| Indiabulls Housing Finance | BUY | SO | M | IndusInd Bank | BUY | SP | L |
| Karnataka Bank | BUY | SP | M | Kotak Mahindra Bank | HOLD | SP | M |
| L&T FINANCE HOLDINGS LTD | BUY | SO | M | LIC Housing Finance | BUY | SP | M |
| Magma Fincorp | BUY | SP | M | Mahindra & Mahindra Financial Services | HOLD | SU | M |
| Manappuram General Finance | BUY | SO | H | Max Financial Services | BUY | SO | L |
| Multi Commodity Exchange of India | BUY | SP | M | Muthoot Finance | BUY | SO | M |
| Oriental Bank Of Commerce | HOLD | SP | L | Power Finance Corp | BUY | SO | M |
| Punjab National Bank | BUY | SP | M | Reliance Capital | BUY | SP | M |
| Repco Home Finance | BUY | SO | M | Rural Electrification Corporation | BUY | SO | M |
| Shriram City Union Finance | BUY | SO | M | Shriram Transport Finance | BUY | SO | L |
| South Indian Bank | BUY | SP | M | State Bank of India | BUY | SP | L |
| Union Bank Of India | HOLD | SP | M | Yes Bank | BUY | SO | M |

ABSOLUTE RATING

Ratings

Expected absolute returns over 12 months

| | |
|--------|----------------------|
| Buy | More than 15% |
| Hold | Between 15% and - 5% |
| Reduce | Less than -5% |

RELATIVE RETURNS RATING

Ratings

Criteria

| | |
|----------------------------|-------------------------------------|
| Sector Outperformer (SO) | Stock return > 1.25 x Sector return |
| Sector Performer (SP) | Stock return > 0.75 x Sector return |
| | Stock return < 1.25 x Sector return |
| Sector Underperformer (SU) | Stock return < 0.75 x Sector return |

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings

Criteria

| | |
|------------|---------------------------------------|
| Low (L) | Bottom 1/3rd percentile in the sector |
| Medium (M) | Middle 1/3rd percentile in the sector |
| High (H) | Top 1/3rd percentile in the sector |

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings

Criteria

| | |
|------------------|-------------------------------------|
| Overweight (OW) | Sector return > 1.25 x Nifty return |
| Equalweight (EW) | Sector return > 0.75 x Nifty return |
| | Sector return < 1.25 x Nifty return |
| Underweight (UW) | Sector return < 0.75 x Nifty return |

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Aditya Narain

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Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services

Allahabad Bank, Axis Bank, Bharat Financial Inclusion, Bajaj Finserv, Bank of Baroda, Capital First, DCB Bank, Dewan Housing Finance, Equitas Holdings Ltd., Federal Bank, HDFC, HDFC Bank, ICICI Bank, IDFC Bank, Indiabulls Housing Finance, IndusInd Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, L&T FINANCE HOLDINGS LTD, Max Financial Services, Multi Commodity Exchange of India, Manappuram General Finance, Magma Fincorp, Mahindra & Mahindra Financial Services, Muthoot Finance, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, Repco Home Finance, State Bank of India, Shriram City Union Finance, Shriram Transport Finance, South Indian Bank, Union Bank Of India, Yes Bank

Recent Research

| Date | Company | Title | Price (INR) | Recos |
|-----------|------------------------------|--|-------------|-------|
| 21-Jul-17 | Dewan Housing Finance | Growth gaining momentum; costs under control; <i>Result Update</i> | 459 | Buy |
| 21-Jul-17 | Bajaj Finserv | Gaining palpable momentum; <i>Result Update</i> | 4910 | Hold |
| 21-Jul-17 | DCB Bank | Gaining momentum; fairly valued; <i>Result Update</i> | 195 | Hold |

Distribution of Ratings / Market Cap

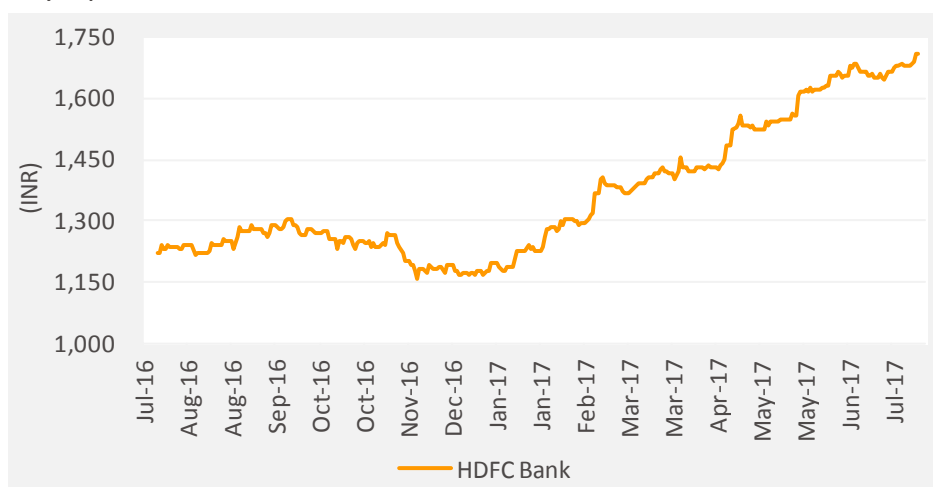
Edelweiss Research Coverage Universe

| | Buy | Hold | Reduce | Total |
|------------------------|--------|------------------------|--------|-------|
| Rating Distribution* | 161 | 67 | 11 | 240 |
| * 1stocks under review | | | | |
| | > 50bn | Between 10bn and 50 bn | < 10bn | |
| Market Cap (INR) | 156 | 62 | 11 | |

Rating Interpretation

| Rating | Expected to |
|---------------|---|
| Buy | appreciate more than 15% over a 12-month period |
| Hold | appreciate up to 15% over a 12-month period |
| Reduce | depreciate more than 5% over a 12-month period |

One year price chart



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