JM FINANCIAL

HDFC Bank | BUY

On top of its game – raising TP to INR 2000

We raise our target price for HDFC Bank from INR 1800 to INR 2000 as we build the valuation for HDB Financial Services and HDFC Securities in our target price. We value these companies at INR 132/share, contributing 7% of our target price for HDFC Bank (bank valued at 4x FY19E BVPS vs 3.9x earlier). Our recent meetings with the bank's top management and various business heads give us further comfort that the bank remains in its usual solid shape with respect to growth, risk and profitability. Market share gains continue to accelerate on both corporate as well as retail loans aided by the bank's pricing advantage, solid product suite and shift from the churn at its key corporate clients. In our view, the bank's investments in technology and shift towards digital banking will come to fruition over the next 18-24 months and reflect in lower opex ratios; we forecast a cost-income ratio of <40% by FY20. Given the strong tailwinds on growth, HDFC Bank could look to raise capital in FY19E - in our scenario analysis, HDFC Bank's CET1 could drop to sub 12% levels by 1HFY19, which could mean a capital raise over the next 12 months. We marginally raise our earnings estimates for FY18/19, factoring lower opex and better loan growth. Under our scenario analysis (see Exhibit 15), HDFC Bank's FY19E BVPS could increase by 10-12% depending on quantum and pricing of the capital issuance. HDFC Bank remains our top pick in the Indian banking space.

- **Building efficiencies for a medium-term competitive edge:** HDFC Bank has been at the forefront of the digital banking onslaught and continues to invest heavily to drive future efficiencies. Its focus on proportionately higher investments in technology vs. peers (partially exhibited in capex spends on software, see Exhibit 7), slower physical network addition than past trends (Exhibit 5) is likely to provide further cost levers going ahead. Management indicated that over the medium term, it intends to generate incremental efficiencies of up to 1.5% of assets on a pre-tax basis, part of which in our view, will need to be passed on to customers. However, even part of it, if retained, could lead to sizeable gains on profitability given that the bank is already at the top end of profitability. We build FY20E RoAs of 2% and there could be upside risks to it.
- **Growth to stay robust and all-round:** HDFC Bank is gaining market share by a huge margin; it formed 35% of incremental industry credit growth during 1QFY18. Within the retail space, it formed 34% of incremental industry growth. While these numbers look high from a market share perspective, as industry growth normalises over the next 12-18 months, we could see incremental market share dropping, but HDFC Bank's own growth momentum staying robust. Importantly, management indicated that profit growth could accelerate as the efficiencies come to fruition over next 18 months, which means that the bank could eventually go back to ~25%+ YoY earnings growth. We forecast earnings CAGR of 21.5% over FY17-19E.
- **Possible capital raising in the next 12 months; could act as a trigger:** HDFC Bank's CET1 currently stands at 12.44% as of 1QFY18. HDFC Bank would need to raise equity capital in FY19E given that CET1 could drop to 12% by Sep-18E/Mar-19E, which we believe is a lower threshold looking at past instances of capital raise. A book accretive capital issuance, in our view, could act as a trigger to drive further outperformance.

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Recommendation and Price Target	
Current Reco.	BUY
Previous Reco.	BUY
Current Price Target (12M)	2,000
Upside/(Downside)	8.6%
Previous Price Target	1,800
Change	11.1%

Key Data – HDFCB IN	
Current Market Price	INR1,842
Market cap (bn)	INR4,754.5/US$74.3
Free Float	79%
Shares in issue (mn)	2,562.5
Diluted share (mn)	
3-mon avg daily val (mn)	INR2,465.9/US$38.5
52-week range	1,849/1,158
Sensex/Nifty	32,186/10,079
INR/US$	64.0

Price Performance

%	1M	6M	12M
Absolute	5.3	31.6	43.9
Relative*	2.1	18.3	26.8

* To the BSE Sensex

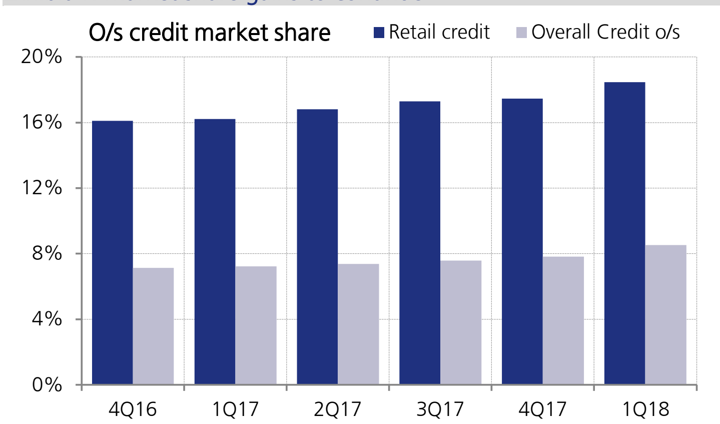
Financial Summary					(INR mn)
Y/E March	FY15A	FY16A	FY17E	FY18E	FY19E
Net Profit	1,02,159	1,22,962	1,45,497	1,74,660	2,14,578
Net Profit (YoY) (%)	20.5%	20.4%	18.3%	20.0%	22.9%
Assets (YoY) (%)	20.1%	20.0%	21.9%	19.3%	20.1%
ROA (%)	1.9%	1.9%	1.9%	1.8%	1.9%
ROE (%)	19.4%	18.3%	17.9%	18.2%	19.3%
EPS	40.8	48.6	56.8	68.2	83.7
EPS (YoY) (%)	15.3%	19.3%	16.7%	20.0%	22.9%
PE (x)	**45.2**	**37.9**	**32.4**	**27.0**	**22.0**
BV	247	287	349	401	466
BV (YoY) (%)	36.5%	16.2%	21.4%	15.0%	16.2%
P/BV (x)	**7.45**	**6.41**	**5.28**	**4.59**	**3.95**

Source: Company data, JM Financial. Note: Valuations as of 13/Sep/2017

Growth trends to remain robust – current pace could accelerate gradually

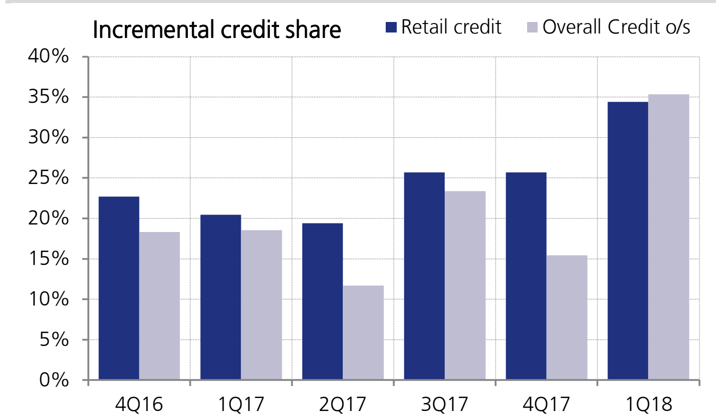
- HDFC Bank's management is confident of sustaining strong growth rates (>20% in assets) quite comfortably. Growth is likely to remain well-balanced, on account of three key drivers: 1) greater share of existing customers, 2) market share shift from PSU banks that will add new customers and 3) growth into newer geographies.
- Given PSU banks' structural issues with respect to capital and impaired assets, the gradual market share shift for HDFC Bank (and some other private banks) has only accelerated and is likely to persist over the next couple of years before PSU banks look to get their act together. Its balance sheet strength has allowed HDFC Bank to capture a disproportionate market share among well-rated corporates, leading to an incremental market share gain of 25-35% in the past three quarters.
- On the corporate lending book, management emphatically stated the perception that HDFC Bank has completely steered away from term loans/infrastructure projects is misplaced. HDFC Bank remains a participant on assets where management believes the risk-reward is favourable and policy risk lower. This continues to be the strategy, especially with respect to wholesale lending.
- Incrementally though, HDFC Bank is looking to be one of the top 3 banking relationships for large corporates and hence more closely involved in refinancing opportunities, working capital financing as well as opportunities such as transaction banking. This is complemented by the fact that large corporates, too, are looking to partner with banks that offer a complete bouquet of products at a competitive price. This is reflecting in the bank's strong market share gains despite overall muted credit growth in the system.
- On the retail assets side, continued system-wide growth and HDFC Bank's dominant position in the space with diverse retail offerings has allowed it to capture high incremental market share. With both engines firing, growth momentum (which picked up meaningfully in 4QFY17) is likely to sustain or accelerate from hereon.
- Notably, the proportion of self-employed customers (especially in the bank's retail asset mix) is likely to go up over the medium term as the portfolio grows at the current robust pace. The proportion of salaried individuals, primarily on unsecured assets and some in the vehicle finance business, is ~60%, according to us. Over the medium term, this could get evenly balanced between salaried and self-employed individuals. Importantly, this bodes well for NIMs, given the relatively high yields in the self-employed segment.

Exhibit 1. Market share gains to continue



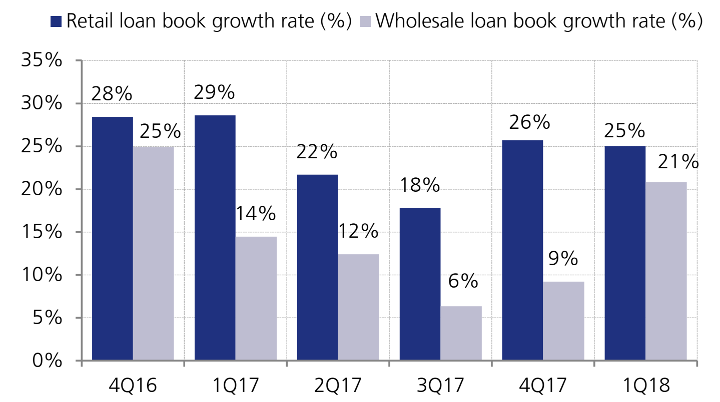
Source: Company, RBI, JM Financial

Exhibit 2. Market share in incremental credit has accelerated



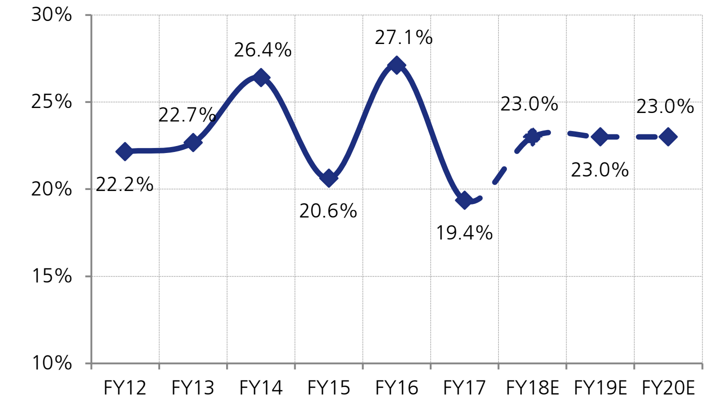
Source: Company, RBI, JM Financial

Exhibit 3. Wholesale book has picked up growth recently



Source: Company, RBI, JM Financial

Exhibit 4. We estimate higher growth over FY17-20E

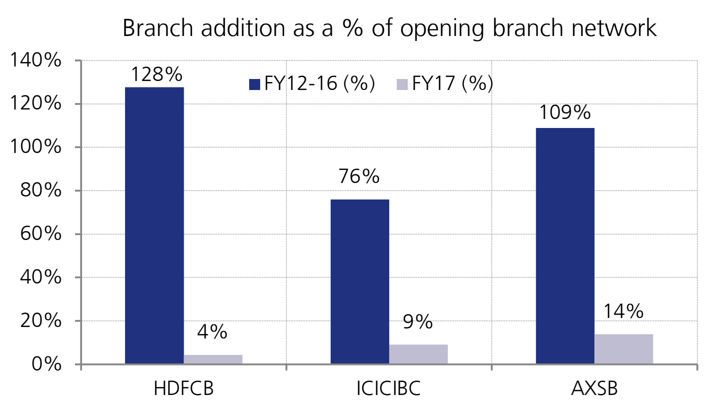


Source: Company, RBI, JM Financial

Cost efficiencies to come through as past investments start sweating:

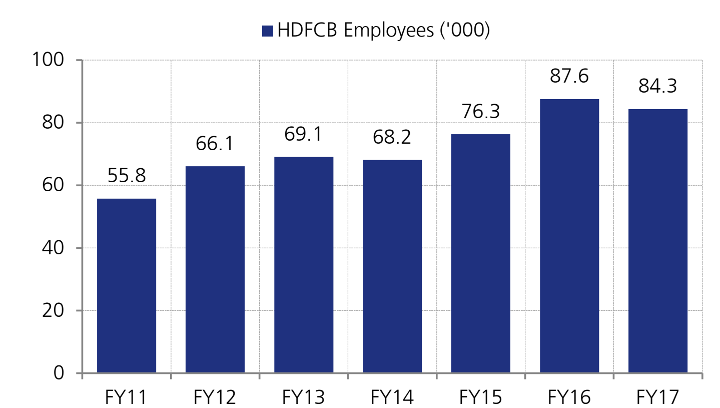
- HDFC Bank successfully drove down its cost-to-income ratios by 620bps from 49.6% in FY13 to 43.4% in FY17.
- A large part of the expansion in its branch network took place during FY12-FY16 (branch network increased 2.2x during this period). In comparison, ICICI Bank and Axis Bank saw its network grow to 1.75x and 2.09x during the same period.
- In FY17, HDFC Bank meaningfully slowed down its branch expansion and in our view that is likely to be the trend over the next 2-3 years. A large part of the incremental growth is likely to be driven by digital acquisition and sweating the existing network.
- Employee addition has markedly slowed down owing to efficiencies being extracted through technology, especially back-end operations. The bank's employee base, in fact, declined in FY17 and addition is likely to be slow going forward.
- With c.30% of the bank's personal/unsecured retail loans originating through online channels in FY17 (vs. 15-17% in FY16) and most other retail products in their mid-to-low teens for digital origination, investments made by the bank on the digital front have started yielding results.

Exhibit 5. Pace of branch addition should slow down meaningfully



Source: Company, RBI, JM Financial

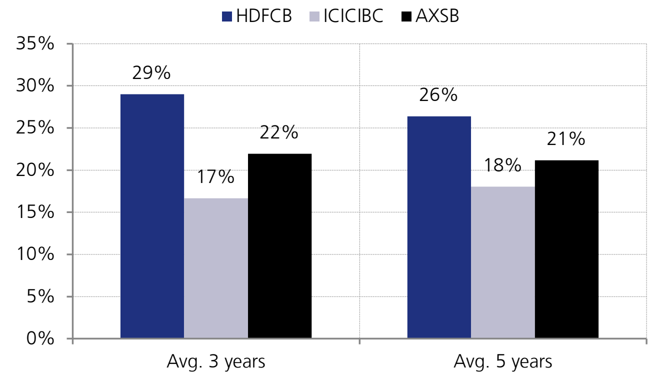
Exhibit 6. Pace of employee addition to come off too



Source: Company, RBI, JM Financial

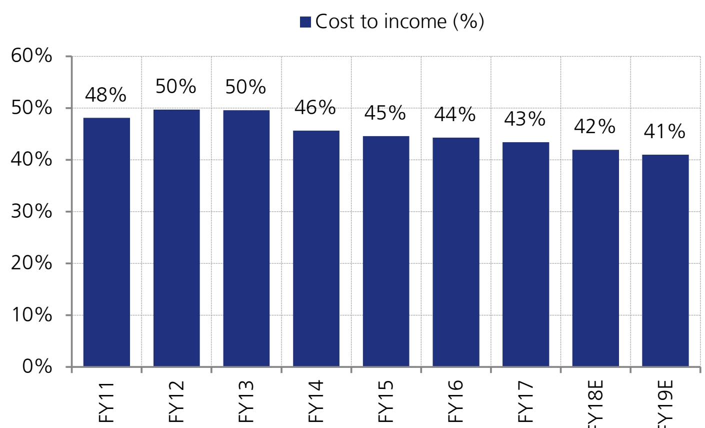
- The bank's greater thrust on technology investments is partly also reflected in its greater expenditure on software. Software expenses (that are capitalised) have formed an average of 29%/26% of the total fixed asset addition base in last 3yrs/5yrs respectively. In comparison, ICICI Bank and Axis stand between 17-22%.
- We are not making comparisons with KMB, IIB and YES given that these banks are in a different stage of their growth lifecycle with respect to network, size and business focus.

Exhibit 7. Share of software capex spend (as a % of gross fixed asset additions)



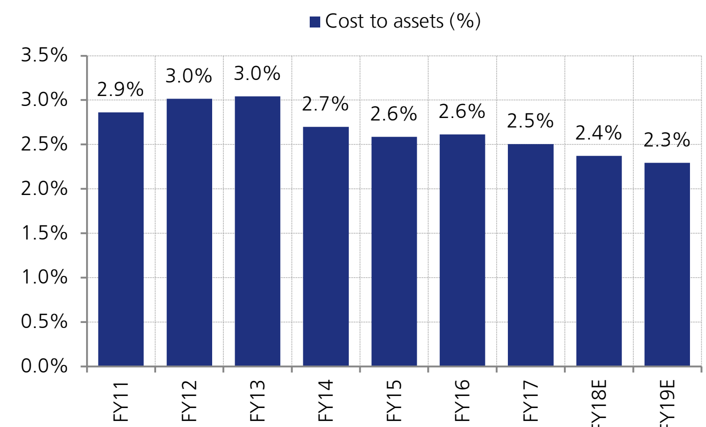
Source: Company, JM Financial

Exhibit 8. Focus on digitisation will lead to cost efficiencies



Source: Company, RBI, JM Financial

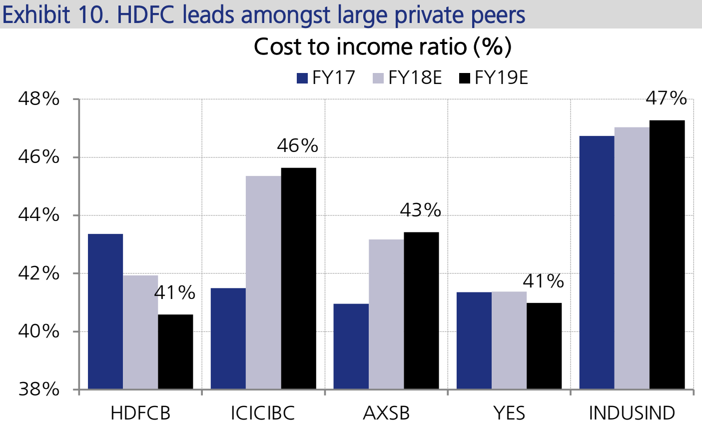
Exhibit 9. Cost-to-assets has been steadily improving



Source: Company, RBI, JM Financial

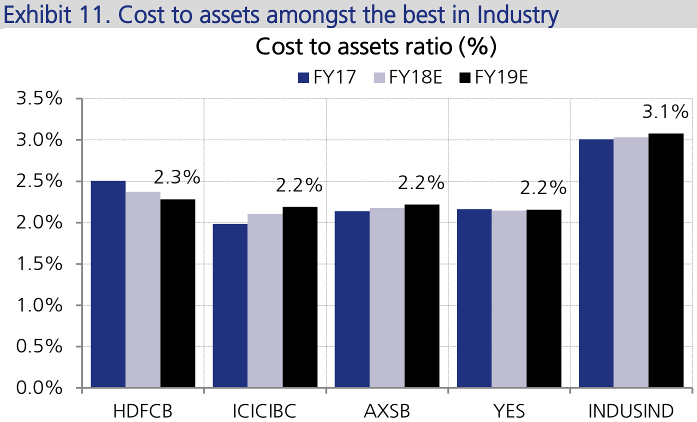
We expect these investments to drive a 440bps decline in cost-to-income ratio by FY20E. Cost-assets should dip to 2.2%, in our view.

Exhibit 10. HDFC leads amongst large private peers



Source: Company, RBI, JM Financial

Exhibit 11. Cost to assets amongst the best in Industry



Source: Company, RBI, JM Financial

HDB Financial Services

HDFC Bank's NBFC subsidiary - HDB Financial Services - continues see robust growth. In FY17, the bank's other BPO subsidiaries were merged with HDB Financial services and thus the lending business now forms ~75% of the total revenue mix of this entity.

HDB Financial services primarily lends to customers that are one notch below HDFC Bank's typical customer profiles and involves small business lending, asset-backed lending (including CVs) and more recently, consumer loans.

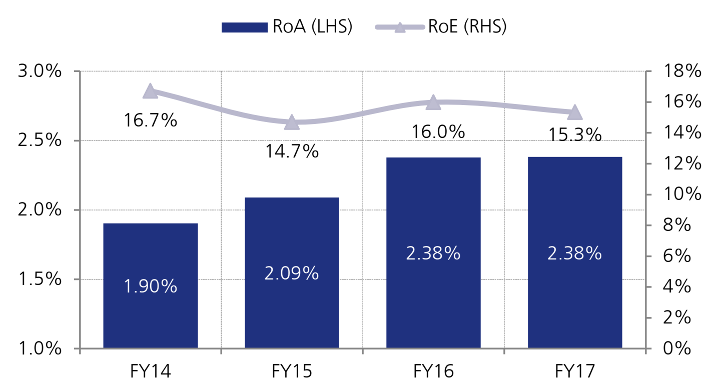
Even with this client risk profile, its GNPA ratio (90dpd basis) was only 1.9% as of 1QFY18 and ~80% of its loans are secured.

It is a rapidly growing business (41% loan book CAGR in FY13-17), consistently delivering RoAs of ~2.4%. HDB is present in 815 cities across India, with 1,151 branches and 65,906 employees (~46000 in BPO). As of FY17, its loan book stood at INR 323 bn and AUM stood at INR 343 bn.

The NBFC operates a completely separate risk and credit architecture as well and there is no overlap with respect to technology backend for the bank and HDB Financial Services.

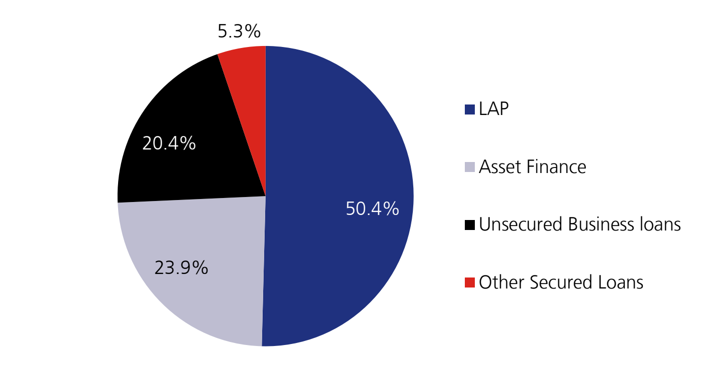
Management indicated that they are gradually scaling up newer businesses such as consumer-durable lending, etc. and the overall asset mix will undergo a material change over the next 3-4 years though the target customer segment will remain the same.

Exhibit 12. HDB Financial Services: Return profile



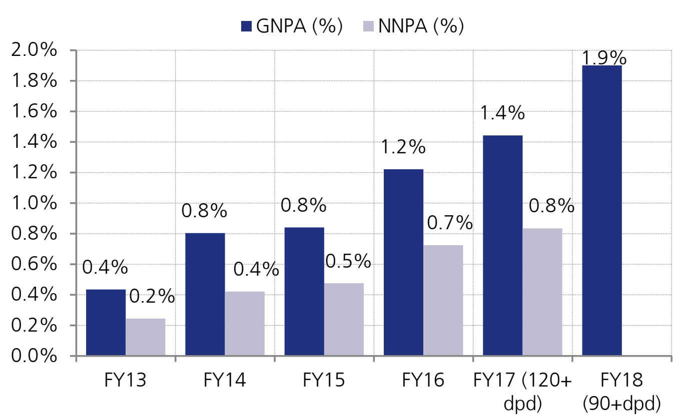
Source: Company, JM Financial

Exhibit 13. HDB Financial Services: Loan book mix (%)



Source: Company, JM Financial

Exhibit 14. NPA trends are encouraging even as book grows rapidly



Source: Company, JM Financial

Capital raise may come through over the next four quarters

- With a CET1 ratio of 12.44% as on 1QFY18E and the average annual CET-1 consumption rate of c.50bps, HDFC Bank may need additional capital over the next four quarters.
- Last capital raise of HDFCB to the tune of nearly c. INR 100bn with a 3.5% dilution was done in 4QFY15 when its CET1 had dropped to 11.97% the previous quarter. Since then, the bank consumed 44bps / 43bps of CET1 capital in FY16 / FY17 when the loan book growth was 27% and 19% respectively.
- Assuming a 24% RWA growth in FY18, HDFCB's CET1 may fall to 12.00% (just above the point of the last capital raise) and hence, we believe the bank will have to opt for an additional capital raise to sustain the growth momentum.
- A book accretive capital raise at 10% premium to CMP will add c.INR 56/share in the book value of the company. We have outlined multiple capital raise scenarios and subsequent BVPS for the bank in FY19E.

Exhibit 15. Scenario for capital raise and post-raise potential 12M TP

Capital Raise scenarios (in 1QFY19E)	At 'x' premium to CMP		
	5%	10%	15%
Expected Issue price (INR)	1,927	2,019	2,110
Assuming a dilution of 3.5 %	89.7	89.7	89.7
Capital raise (INR mn)	1,72,808	1,81,037	1,89,266
Shareholder's equity (INR mn)	13,68,223	13,76,452	13,84,681
BVPS (INR)	**516**	**519**	**522**
CET 1 capital (INR mn)	12,91,893	13,00,122	13,08,351
CET 1 ratio (%)	**13.02%**	**13.11%**	**13.19%**
Potential TP (post-capital raise) (INR)	**2,196**	**2,208**	**2,220**

Source: Company, JM Financial

Valuation and TP

- **Subsidiaries to add c.7% to our 12M TP of INR 2,000:** We value HDFC Bank using the SOTP method, valuing standalone bank at 4x FY19E BVPS and two of its major subsidiaries at INR 132/share.

Exhibit 16. SOTP

HDFC Bank SOTP	Holding (%)	Valuation Methodology	Value per Share	Contribution to TP (%)
HDFC Bank - Parent	100.0%	4x fwd FY19E BV	1,882	94%
HDB Financial Services	96.2%	3.3x FY19E BV	94	5%
HDFC Securities	97.9%	25x FY19 EPS	38	2%
Less: Cost of investments			-15	-1%
Total (INR.)			**2,000**	**100%**

Source: Company, JM Financial

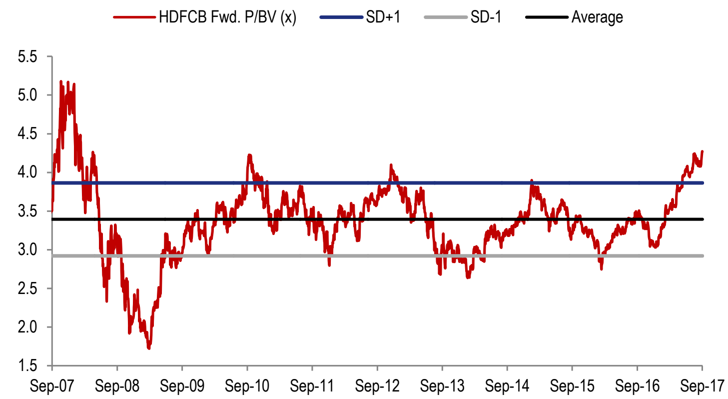
We value HDFC Bank on a two-stage Gordon Growth Model. Our assumptions are as follows:

Exhibit 17. Valuation Summary for Banking business

Initial no of years	10
Growth rate for the first 10 years (%)	18%
Payout ratio for the first 10 years (%)	15%
Perpetual growth rate (%)	4%
Perpetual payout ratio (%)	80%
K1	2.01
K2	17.13
Fully adjusted FY19E BVPS (Rs)	467.1
Target P/BV (x)	4x
Fair value (rounded off)	**1882**

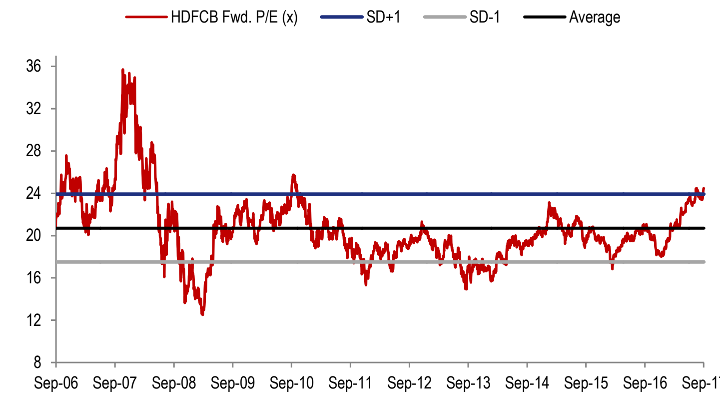
Source: Company, JM Financial

Exhibit 18. One-year-forward Price to Book (P/B)



Source: Company, JM Financial

Exhibit 19. One-year-forward Price to earnings (P/B)



Source: Company, JM Financial

Key takeaways from our interaction with Managing Director, Mr. Puri:

Growth

1. Growth is not a concern at this point for the bank as it is getting enough opportunities in the market without taking any additional risk to chase returns.

2. The bank is not at all getting aggressive on corporate lending. The industry turmoil at PSUs is benefiting the larger incumbents naturally and HDFC Bank is best positioned.

3. At 6-7% GDP growth, the bank can easily grow at current pace. If GDP growth accelerates, HDFC Bank can go back past trend levels.

Costs

4. Management is preparing the bank towards a 100-150bps reduction in cost of credit delivery, which can be passed on to customers from a 3-4 year perspective. This will ensure a cushion for the bank even if there is a medium-term disruption in business due to Fintech players.

5. The bank is working on delivering a totally seamless customer experience comparable to the likes of global e-commerce majors in the next 6 months.

Margins

6. Management is positively surprised by NIMs and is willing to take up to a 30bps hit to chase growth, but will make sure that this comes without sacrificing quality.

Other

7. For the bottom of the pyramid, HDB Financial services will services the segment and the business mix will change for the company materially in 3-4 years. The bank still does not compete with NBFCs and neither does it intend to.

8. Management believes local financialisation of savings is a big theme and continues to remain present in that space through HDFC Securities and by selling insurance and Mutual Funds.

Financial Tables (Standalone)

Profit & Loss (INR bn)

Y/E March	FY15A	FY16A	FY17E	FY18E	FY19E
Net Interest Income	224	276	331	401	483
Profit on Investments	6	7	11	8	6
Exchange Income	10	12	13	14	15
Fee & Other Income	74	88	99	113	134
Non-Interest Income	**90**	**108**	**123**	**135**	**155**
Total Income	**314**	**383**	**454**	**536**	**638**
Operating Expenses	140	170	197	225	259
Pre-provisioning Profits	**174**	**214**	**257**	**311**	**379**
Loan-Loss Provisions	20	26	35	46	54
Provisions on Investments	0	0	0	0	0
Others Provisions	1	1	1	1	1
Total Provisions	**21**	**27**	**36**	**47**	**54**
PBT	**153**	**186**	**221**	**265**	**325**
Tax	51	63	76	90	111
PAT (Pre-Extraordinaries)	**102**	**123**	**145**	**175**	**215**
Extra ordinaries (Net of Tax)	0	0	0	0	0
Reported Profits	**102**	**123**	**145**	**175**	**215**
Dividend paid	24	29	33	40	48
Retained Profits	**78**	**94**	**113**	**134**	**167**

Source: Company, JM Financial

Balance Sheet (INR bn)

Y/E March	FY15A	FY16A	FY17E	FY18E	FY19E
Equity Capital	5	5	5	5	5
Reserves & Surplus	615	722	889	1,024	1,190
Deposits	4,508	5,464	6,436	7,788	9,540
Borrowings	452	530	740	896	989
Other Liabilities	325	367	567	595	655
Total Liabilities	**5,905**	**7,088**	**8,638**	**10,309**	**12,379**
Investments	1,665	1,639	2,145	2,483	2,900
Net Advances	3,655	4,646	5,546	6,821	8,390
Cash & Equivalents	363	526	608	674	791
Fixed Assets	31	33	36	40	45
Other Assets	191	244	303	290	253
Total Assets	**5,905**	**7,088**	**8,638**	**10,309**	**12,379**

Source: Company, JM Financial

Key Ratios

Y/E March	FY15A	FY16A	FY17E	FY18E	FY19E
Growth (YoY) (%)					
Deposits	22.7%	21.2%	17.8%	21.0%	22.5%
Advances	20.6%	27.1%	19.4%	23.0%	23.0%
Total Assets	20.1%	20.0%	21.9%	19.3%	20.1%
NII	21.2%	23.2%	20.1%	20.9%	20.7%
Non-interest Income	13.6%	19.5%	14.4%	10.1%	14.3%
Operating Expenses	16.2%	21.4%	16.0%	14.1%	15.2%
Operating Profits	21.2%	22.7%	20.4%	20.9%	21.8%
Core Operating profit	18.1%	22.6%	19.2%	23.2%	23.1%
Provisions	30.7%	31.4%	31.8%	29.6%	16.0%
Reported PAT	20.5%	20.4%	18.3%	20.0%	22.9%
Yields / Margins (%)					
Interest Spread	3.62%	3.68%	3.68%	3.72%	3.76%
NIM	4.34%	4.42%	4.39%	4.38%	4.38%
Profitability (%)					
Non-IR to Income	28.7%	28.0%	27.1%	25.3%	24.3%
Cost to Income	44.6%	44.3%	43.4%	41.9%	40.6%
ROA	1.89%	1.89%	1.85%	1.84%	1.89%
ROE	19.4%	18.3%	17.9%	18.2%	19.3%
Assets Quality (%)					
Slippages	1.59%	1.57%	1.54%	1.60%	1.55%
Gross NPA	0.93%	0.94%	1.05%	1.17%	1.11%
Net NPAs	0.25%	0.28%	0.33%	0.34%	0.32%
Provision Coverage	73.9%	69.9%	68.7%	70.9%	71.7%
Specific LLP	0.52%	0.51%	0.62%	0.66%	0.61%
Net NPAs / Networth	1.4%	1.8%	2.1%	2.3%	2.2%
Capital Adequacy (%)					
Tier I	13.66%	13.22%	12.79%	13.43%	12.99%
CAR	16.79%	15.53%	14.55%	14.90%	14.28%

Source: Company, JM Financial

Dupont Analysis

Y/E March	FY15A	FY16A	FY17E	FY18E	FY19E
NII / Assets	4.14%	4.25%	4.21%	4.23%	4.26%
Other Income / Assets	1.66%	1.65%	1.56%	1.43%	1.36%
Total Income / Assets	5.80%	5.90%	5.78%	5.66%	5.63%
Cost / Assets	2.59%	2.61%	2.51%	2.37%	2.28%
PBP / Assets	3.22%	3.29%	3.27%	3.28%	3.34%
Provisions / Assets	0.38%	0.42%	0.46%	0.49%	0.48%
PBT / Assets	2.83%	2.87%	2.82%	2.79%	2.87%
Tax rate	33.4%	34.0%	34.3%	34.0%	34.0%
ROA	1.89%	1.89%	1.85%	1.84%	1.89%
RoRWAs	2.66%	2.58%	2.49%	2.48%	2.54%
Leverage	9.5	9.8	9.7	10.0	10.4
ROE	19.4%	18.3%	17.9%	18.2%	19.3%

Source: Company, JM Financial

Valuations

Y/E March	FY15A	FY16A	FY17E	FY18E	FY19E
Shares in Issue	2,506.5	2,528.2	2,562.5	2,562.5	2,562.5
EPS (INR)	40.8	48.6	56.8	68.2	83.7
EPS (YoY) (%)	15.3%	19.3%	16.7%	20.0%	22.9%
PER (x)	45.2	37.9	32.4	27.0	22.0
BV (INR)	247	287	349	401	466
BV (YoY) (%)	36.5%	16.2%	21.4%	15.0%	16.2%
ABV (INR)	248	287	349	402	467
ABV (YoY) (%)	36.6%	15.9%	21.3%	15.2%	16.3%
P/BV (x)	7.45	6.41	5.28	4.59	3.95
P/ABV (x)	7.43	6.41	5.28	4.58	3.94
DPS (INR)	9.7	11.5	12.9	15.8	18.7
Div. yield (%)	0.5%	0.6%	0.7%	0.9%	1.0%

Source: Company, JM Financial

APPENDIX I

JM Financial Institutional Securities Limited

Corporate Identity Number: U65192MH1995PLC092522
Member of BSE Ltd. and National Stock Exchange of India Ltd. and Metropolitan Stock Exchange of India Ltd.
SEBI Registration Nos.: BSE - INZ010012532, NSE - INZ230012536 and MSEI - INZ260012539, Research Analyst – INH000000610
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Definition of ratings	
Rating	Meaning
Buy	Total expected returns of more than 15%. Total expected return includes dividend yields.
Hold	Price expected to move in the range of 10% downside to 15% upside from the current market price.
Sell	Price expected to move downwards by more than 10%

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