

COMPANY UPDATE

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HDFC BANK

PRICE: Rs.1021
TARGET PRICE: Rs.1200

RECOMMENDATION: BUY
FY17E P/E: 17.2x, P/ABV: 3.1x

We expect HDFC bank to retain premium valuation vis-à-vis its peers on back of consistent earnings growth, superior liability franchise, robust NIM and healthy asset quality. We expect bank to report healthy return ratios (RoE: 18-19%; RoA: 1.9-2.0%) during FY16/17E. As stock is currently trading at reasonable valuation (3.1x FY17E ABV), we retain BUY rating on the stock with unchanged TP of Rs.1200 based on 3.6x FY17E ABV.

Stable earnings growth despite marginal weakness in NIM

HDFC bank has reported stable earnings growth during recent quarters despite marginal pressure on its margin. Net revenue growth has been broadly in line with the overall loan growth. Moreover, robust growth in non-interest income during three out of last four quarters has aided in the strong traction in revenue line. We believe there is some pressure on underlying margins in both retail as well as corporate segments which can be explained by 1) Competitive pressure on retail lending products 2) Increase in CPs for large corporates given the difference in base rate and lower yielding market instruments for similar risk profile customers 3) Faster growth in FDs vis-à-vis CASA 4) Reduced base rate (70bps during 9MFY16).

Trends in the drivers of earnings growth

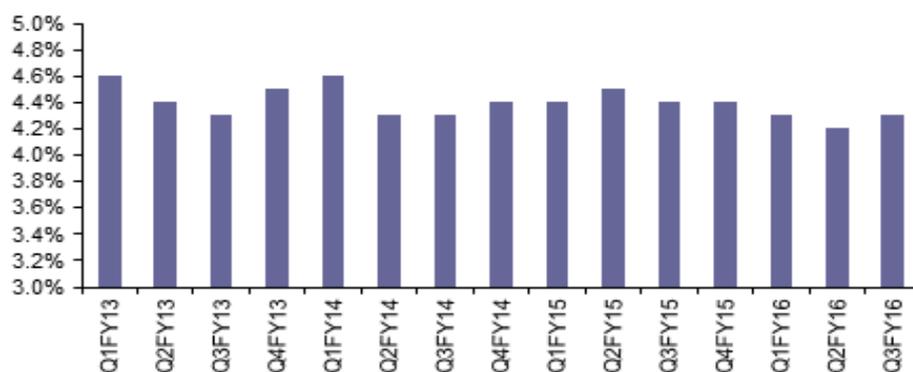
(%)	Q1 FY14	Q2 FY14	Q3 FY14	Q4 FY14	Q1 FY15	Q2 FY15	Q3 FY15	Q4 FY15	Q1 FY16	Q2 FY16	Q3 FY16
NII	21.0%	15.3%	16.4%	15.3%	17.0%	23.1%	23.0%	21.4%	23.5%	21.2%	24.0%
Other Income	16.7%	25.3%	11.4%	11.0%	-3.9%	11.0%	18.0%	28.1%	33.0%	24.7%	13.3%
Fee Income	11.7%	11.0%	11.4%	10.0%	9.5%	13.4%	14.7%	20.6%	21.8%	21.6%	11.0%
Net Revenue	19.7%	18.1%	14.8%	14.0%	10.7%	19.6%	21.4%	23.4%	26.0%	22.2%	20.7%
Opex	15.7%	9.3%	3.8%	1.2%	4.6%	19.2%	19.4%	21.4%	25.9%	19.8%	21.7%
PAT	30.1%	27.1%	25.1%	23.1%	21.1%	20.1%	20.2%	20.7%	20.7%	20.5%	20.1%
Deposits	17.8%	14.2%	22.9%	24.0%	22.7%	24.8%	18.6%	22.7%	30.1%	29.7%	26.5%
Advances	21.2%	16.0%	22.9%	26.4%	20.7%	21.8%	17.0%	20.6%	22.4%	27.9%	25.7%
Balance Sheet	15.6%	14.3%	22.0%	16.9%	18.0%	18.3%	14.3%	20.1%	28.1%	29.4%	28.6%

Source: Company

Nonetheless, fall in NIM has been partly cushioned by rise in the share of unsecured portfolio (PL & credit cards) from 24.4% in Q3FY15 to 25.5% in Q3FY16. Its base rate is lowest amongst SCB at 9.30% (since Dec 28, 2015) which is likely to impact its lending yields. However, it would facilitate HDFC bank in maintaining its leadership position in the highly competitive retail segment along with some market share gains in corporate segment.

HDFC bank has been reporting strong NIM vis-à-vis its peers. We are of the view that HDFC bank earns higher margin on retail portfolio (NIM at ~5%) while wholesale book generates <2% of NIM. So, any normalization in asset portfolio mix (reduction of retail share) or shift towards lower yielding mortgage book in near future could negatively impact its margins. The aggressive cut in base rate in recent quarters would definitely impact its lending yield but the quantum would be moderate as its fixed loan portfolio is bigger than other players while aggressive cut on deposit rates in recent quarters would also cushion the margin compression. Hence we are modelling 10-15bps NIM compression and expect it to come at 4.2-4.3% during FY16/17E as compared to 4.4% in FY15.

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Trend in NIM (%)

Source: Company

Peer comparison (Trend in NIM)

	Q1FY15	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16
ALB	3.25%	3.05%	3.27%	2.85%	2.91%	2.95%	2.55%
Andhra	2.14%	2.93%	3.43%	3.48%	2.87%	3.20%	3.24%
Axis	3.88%	3.97%	3.93%	3.81%	3.81%	3.85%	3.79%
BoB	2.35%	2.40%	2.20%	2.17%	2.26%	2.08%	1.72%
DCB	3.71%	3.72%	3.70%	3.75%	3.81%	3.79%	3.96%
HDFC Bk	4.40%	4.50%	4.40%	4.40%	4.30%	4.20%	4.30%
ICICI Bk	3.40%	3.42%	3.46%	3.57%	3.54%	3.52%	3.53%
Indian Bk	2.44%	2.67%	2.47%	2.48%	2.36%	2.26%	2.31%
J&K	3.63%	4.01%	3.66%	3.92%	3.93%	4.02%	3.85%
PNB	3.42%	3.18%	3.21%	2.79%	2.90%	2.97%	2.75%
SBI	3.13%	3.09%	3.14%	3.28%	2.99%	3.03%	2.77%
Union Bank	2.60%	2.53%	2.50%	2.37%	2.39%	2.34%	2.22%

Source: Company

Strong balance sheet growth continues; focus on unsecured portfolio remains

Despite challenging macro environment, HDFC bank has been reporting strong balance sheet growth which grew at faster pace (28.6% YoY in Q3FY16) on back of strong build-up in investment book (partly due to reclassification). The retail segment continued to grow at faster pace (30.4% YoY) vis-à-vis wholesale book (20.6% YoY), as per the regulatory definition, on back of strong performance in Mortgage, Kisan gold card, PL, 2 wheelers, Credit cards, Business banking and Auto loans. The share of unsecured portfolio (PL + credit cards) improved from 24.4% in Q3FY15 to 25.5% in Q3FY16, which in our view has partly cushioned the fall in lending yield.

Break-up of retail book

(Rs. Bn)	Q1FY15	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Mkt Share
Car Loans	347.9	377.8	400.1	405.3	434.6	460.1	497.6	23.2%
Loan against Securities	9.7	10.5	11.9	13.5	9.8	10.8	11.3	0.5%
Personal Loans	214.6	231.4	248.0	258.2	288.3	318.8	350.7	16.3%
Two Wheelers	34.3	36.2	39.6	41.6	43.9	47.3	52.1	2.4%
Credit Cards	132.7	140.1	153.6	161.5	168.7	180.0	196.9	9.2%
CV	133.2	138.6	132.1	127.9	133.9	148.0	149.5	7.0%
Business Banking	222.6	219.6	213.4	188.3	240.2	272.9	269.4	12.5%
Mortgage	195.7	195.6	199.8	241.3	268.9	284.8	284.2	13.2%
Gold Loan	38.5	38.6	39.0	40.6	42.2	43.1	43.6	2.0%
Kisan Gold Card	110.2	129.0	136.3	161.8	166.6	192.1	197.2	9.2%
Others	62.9	64.0	74.4	88.5	75.7	86.7	96.3	4.5%
Total retail loan	1502.5	1581.3	1648.3	1728.4	1872.7	2044.6	2148.7	100.0%

Source: Company

HDFC bank has been building its mortgage portfolio primarily on account of loans bought from HDFC Ltd to meet its PSL obligations. We expect HDFC bank to continue focussing on unsecured portfolio and select secured portfolio like mortgage etc, given the weak investment cycle negatively impacting the loan demand in the corporate segment. For HDFC bank, share of mortgage is still lower vis-à-vis its peers.

Trends in Mortgage

RS. Bn	FY10	FY11	FY12	FY13	FY14	FY15	Q1FY16	Q2FY16	Q3FY16
SBI	711.9	899.1	1027.4	1194.7	1407.4	1592.4	1636.8	1709.0	1796.8
HDFC Ltd	613.0	736.5	887.8	1113.2	1332.8	1556.9	1596.0	1656.2	1737.4
LIC Housing	339.5	467.3	599.6	752.4	885.6	1056.3	1077.0	1110.8	1143.1
ICICI Bank	474.0	539.0	486.8	575.7	706.2	891.0	938.2	992.9	1045.3
Axis Bank	147.4	188.8	281.8	388.5	509.0	615.6	645.1	668.9	691.9
Indiabulls Housing	170.7	198.2	275.2	344.3	411.7	522.4	540.2	582.2	622.7
DHFL	87.6	141.1	255.0	339.0	406.0	510.4	538.0	563.1	589.9
HDFC Bank	87.3	114.9	142.6	167.8	193.0	241.3	268.9	284.8	284.2

Source: Company, Individual loans for HDFC & LIC Housing; mortgage loan for Indiabulls Housing; Reclassification of loans since FY14 in Axis bank ; Reclassification of loans since FY12 in ICICI Bank

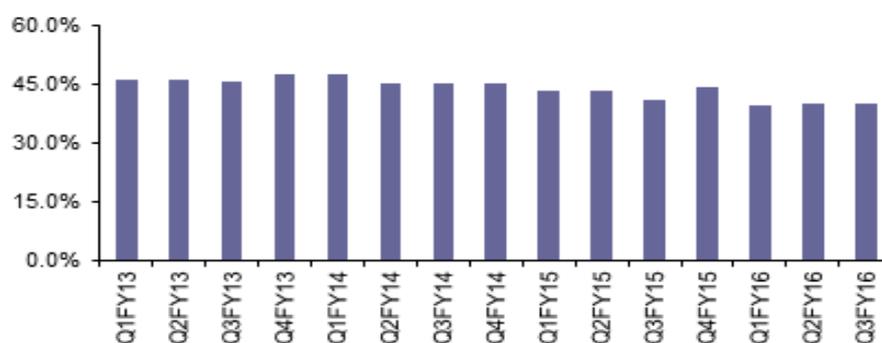
Mortgage (Peer Comparison)

% of loan bk	Q1FY14	Q2FY14	Q3FY14	Q4FY14	Q1FY15	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16
Axis Bank	22.2%	22.6%	24.2%	24.1%	21.0%	20.6%	19.1%	19.1%	19.4%	19.2%	18.8%
HDFC Bank	6.6%	6.1%	5.4%	6.4%	6.3%	6.0%	5.8%	6.6%	7.0%	6.8%	6.5%
ICICI Bank	19.8%	19.8%	20.0%	20.9%	21.4%	21.9%	22.5%	23.0%	23.5%	24.2%	24.0%
Andhra	6.1%	6.3%	6.5%	6.6%	6.6%	7.4%	7.2%	7.7%	8.0%	7.6%	8.2%
BoB	7.7%	7.6%	7.7%	7.2%	7.8%	8.1%	8.3%	7.7%	8.3%	8.5%	9.4%
PNB	4.8%	4.9%	4.9%	4.9%	5.1%	5.2%	5.5%	5.7%	5.9%	6.2%	6.4%
SBI	11.4%	11.4%	11.4%	11.3%	11.7%	12.0%	12.1%	11.9%	12.5%	12.5%	12.6%
Union Bank	6.3%	6.1%	6.3%	6.6%	6.8%	7.0%	7.2%	7.1%	7.6%	7.9%	7.9%

Source: Company

HDFC bank continues to have robust liability franchise, despite competition coming from several mid-size private banks which are offering attractive rates on saving deposits. Its CASA franchise continued to grow at healthy pace - SA/CA grew at 20.6%/23.0% (excluding one-off), respectively, with CASA share remaining stable at 40% at the end of Q3FY16. Although there is slight moderation in CASA mobilization (Rs.105 bn in 9MFY16 as compared to Rs.216 bn in FY15), its liability franchise remains one of the best in the industry.

Trend in CASA (%)



Source: Company

Trends in Saving deposit mobilization

(Rs bn)	FY13	FY14	FY15	9MFY16
Axis Bank	121	140	105	45
HDFC Bank	142	149	218	105
ICICI Bank	96	135	157	121
IndusInd Bank	23	29	30	32
Yes Bank	35	33	32	53

Source: Company

As HDFC bank has added almost 1/4 of its total branches in last two years (FY14-15), we believe, this augurs well for the bank in maintaining strong liability franchise, post completion of its gestation period (18-24 months for a typical branch). Its healthy liability franchise has been overriding factor in delivering one of the best NIM in the industry, one of the important characteristics of HDFC bank, which keeps it way above its peers.

Stable asset quality; lower restructured portfolio & healthy coverage ratio provide enough comfort to its future earnings.

Asset quality of HDFC bank has been holding-up well in the prevailing uncertain macro environment. In percentage terms, both GNPA/NNPA stand healthy at 0.97% (0.91% in Q2FY16) and 0.29% (0.25% in Q2FY16), respectively, at the end of Q3FY16. Its provision coverage ratio is also healthy at 70.4% and we believe lower stressed portfolio (net NPA + restructured book) at ~40bps in Q3FY16, provides enough cushion to its future earnings. We are modelling credit costs to remain at current levels and expect headline NPLs to remain in the range of 1.2-1.3% during next two years.

Trends in asset quality

(Rs bn)	Q1 FY14	Q2 FY14	Q3 FY14	Q4 FY14	Q1 FY15	Q2 FY15	Q3 FY15	Q4 FY15	Q1 FY16	Q2 FY16	Q3 FY16
Gross NPA	27.2	29.4	30.1	29.9	33.6	33.6	34.7	34.4	36.5	38.3	42.6
% of Gross Advances	1.04%	1.09%	1.01%	0.98%	1.07%	1.02%	0.99%	0.93%	0.95%	0.91%	0.97%
Net NPA	6.9	7.7	8.0	8.2	10.1	9.2	9.0	9.0	10.3	10.4	12.6
% of Net Advances	0.30%	0.30%	0.28%	0.30%	0.30%	0.28%	0.26%	0.25%	0.27%	0.25%	0.29%
Provision Coverage (%)	74.7%	73.9%	73.6%	72.6%	70.0%	72.7%	73.9%	73.9%	71.9%	72.9%	70.4%

Source: Company

Valuation & recommendations

We believe, its healthy coverage ratio (~70% in Q3FY16) along with lower stressed portfolio (~40bps) provide enough comfort to its future earnings. HDFC bank is likely to retain premium valuation vis-à-vis its peers on back of consistent earnings growth, superior liability franchise, robust NIM and better asset quality.

We retain BUY on HDFC Bank with a price target of Rs.1200

We are modelling C/I ratio to remain in the range of 44-45%, as operating leverage plays out in near term while denominator effect (improvement in revenue) is likely to neutralize the future growth in opex. We are modelling operating expense to grow at 21.2% CAGR during FY15-17E.

We expect PAT to grow 20.9% CAGR during FY15-17E and expect bank to report healthy return ratios (RoE: 18-19%; RoA: 1.9-2.0%) during FY16/17E. As stock is currently trading at reasonable valuation (3.1x FY17E ABV), we retain **BUY** rating on the stock with unchanged TP of Rs.1200 based on 3.6x FY17E ABV.

Key data

(Rs bn)	FY14	FY15	FY16E	FY17E
Interest income	411.4	484.7	602.1	737.2
Interest expense	226.5	260.7	326.3	401.2
Net interest income	184.8	224.0	275.8	336.0
Growth (%)	16.9%	21.2%	23.1%	21.8%
Other income	79.2	90.0	108.2	128.8
Gross profit	143.6	174.0	214.2	259.5
Net profit	84.8	102.2	123.1	149.2
Growth (%)	26.0%	20.5%	20.5%	21.2%
Gross NPA (%)	1.0	0.9	1.0	1.0
Net NPA (%)	0.3	0.3	0.3	0.3
Net interest margin (%)	4.4	4.4	4.3	4.3
CAR (%)	16.1	16.8	16.4	15.6
RoE (%)	21.3	19.4	18.4	19.2
RoA (%)	1.9	1.9	1.9	1.9
DPS (Rs)	6.9	8.0	8.5	9.0
EPS (Rs.)	35.3	40.8	49.1	59.5
Adjusted BVPS (Rs.)	177.8	243.8	280.1	330.1
P/E (x)	28.9	25.1	20.8	17.2
P/ABV (x)	5.7	4.2	3.6	3.1

Source: Company, Kotak Securities - Private Client Research