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INITIATING COVERAGE
HDFC BANK

Banking on the hinterland

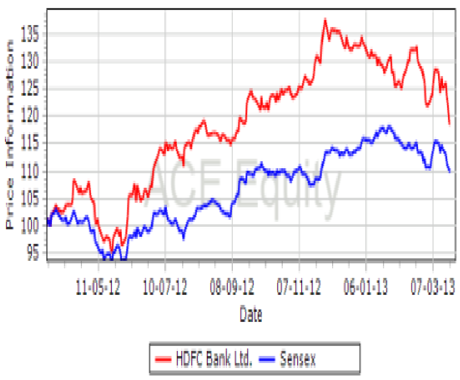
CMP:	**Rs.614**
Target Price:	**Rs.697**
Recommendation:	**HOLD**

Stock Info	
BSE Group	A
SE Code	500180
NSE Symbol	HDFCBANK
Bloomberg	HDFCB IN
Reuters	HDBK.BO
BSE Sensex	18736
NSE Nifty	5651

Market Info	
Market Capital	` 143951 cr
Equity Capital	` 469 cr
Avg. Trading Vol. (NSE Qtly)	3373981
52 Wk High/ Low	705/482
Face Value	2

Shareholding Pattern (%)	(31st Dec 2012)
Promoters	22.9
Domestic Institutions	8.9
Foreign Institutions	33.6
Public & Others	32.4
Govt. Holdings	NA

Financials	FY12	FY13E	FY14E	FY15E
PAT (Rs in Cr)	5167	6730	8560	10843
EPS (in Rs)	21.8	28.5	36.2	45.9
PE (x)	27.8	21.5	16.9	13.4
PABV (x)	4.9	4.6	3.6	2.8



March 28, 2013

HDFC Bank, the second largest private bank (in terms of asset base) and the preferred provider for banking services, is expected to maintain the upbeat growth momentum both on the business as well as earnings front. The bank is expected to clock 28% CAGR on the bottom-line and 22% CAGR on the business front for the period FY12-FY15E. While most of the goodies stand priced in; we initiate coverage on HDFC Bank with HOLD rating on the stock for a target price of Rs 697 valuing the bank at 3X P/BV FY15E.

Superior liability franchise- key enabler

HDFC bank's liability-driven growth strategy has resulted in high CASA, lower cost of funds and therefore, stable margins. The bank's strong liability franchise will help arrest the significant slide in its sector-leading NIMs, particularly at a time when the sector is confronted with pressures on account of slower loan growth and falling share of high yielding assets. The management is confident to maintain ~ 47-48% CASA levels in medium term.

Healthy branch network- key strategy

HDFC bank's unique and high quality franchise backed by banking on rural India as the Bank's expansion plans take into account the need to have a presence in all major industrial and commercial centres. As of March 31, 2011, 793 of HDFC bank branches were in semi-urban or rural areas as compared to 1,159 as of March 31, 2012 and we only expect the branch expansion strategy of the bank to provide impetus to the widening of low-cost deposit base and fee income.

Margins stability- positive

Higher CASA floats coupled with increased traction in retail loan book (up 6.8% qoq) and run-down of some of the short-term low-yielding corporate loans led to higher margins (4.2%) for the bank. We expect the bank to clock healthy margins in the range of 4.3-4.4% for the next two years; however, moderate pressures stand imminent.

Impeccable asset quality

HDFC Bank enjoys one of the best asset quality in the financial sector space with GNPAs stabilizing at 1.0%. The restructured assets stood at 0.4% of total advances as at the end of third quarter FY13. Given the tough macros, stressed assets would surface in certain sectors resulting in slippages for the bank in coming quarters. That said, adequate provisioning and resilient book may keep the quality under control. While the credit costs may slightly move up for the bank, the recoveries are expected to be manageable.

Operating metrics remain healthy, Earnings momentum positive

Superior asset quality and faster than systemic credit growth has enabled HDFC Bank to maintain the earnings momentum. We expect bank to register 28% CAGR over FY12-15E (vs historical average of >30%) which we believe is indicative of strong earnings growth at a time when most banks are likely to face significant stress. We expect RoEs to fall in the range of 18-21% over FY13-15E and RoAs in the range of 1.8-2.0% for the same period which stands as one of the best in the industry.

Fairly priced, Hold

We expect HDFC Bank's valuation premium to the sector to continue primarily due to Selective lending and diversified exposure, focus on low-cost savings deposits and adequate provisioning. We value HDFC Bank at P/ABV of 3.0X FY15E to arrive at a price target of Rs 697 and recommend HOLD on the stock.

Company Background

HDFC Bank Ltd is a major Indian financial services company based in India, incorporated in August 1994, after the Reserve Bank of India allowed establishing private sector banks. The Bank was promoted by the Housing Development Finance Corporation, a premier housing finance company of India. HDFC Bank is one of India's premier banks; both on the domestic and international grounds; providing a wide range of financial products and services to its 21 million customers across hundreds of Indian cities using multiple distribution channels including a pan- India network of branches, ATMs, phone banking. As of December 31, 2012, the Bank's distribution network was at 2,776 branches and 10,490 ATMs in 1,568 cities. HDFC Bank, the World class Indian bank with sound customer franchise is the preferred provider for banking services for target retail and wholesale customer segments. The Bank had a market share of 3.9% in total system deposits and 4.3% in total system advance and the Bank's Credit Deposit (CD) Ratio was 79.2% as on March 31, 2012. The bank enjoys rich track record of healthy profitability growth, strong liability franchise and impressive risk appetite since historical times.

Key Management Personnel

Name	Designation	Previous Assignment
Aditya Puri	Managing Director	Chief Executive Officer of Citibank, Malaysia
Harish Engineer	Executive Director	Bank of America
Paresh Sukthankar	Executive Director	Citibank
Sashi Jagdishan	Head-Finance	-

HDFC Bank's product bouquet

Wide Range of Products and Customer Segments			
Retail Banking	**Loan Products:** Auto Loans Retail Business Banking Personal Loans Credit Cards 2-Wheeler Loans Commercial Vehicles Finance Construction Equipment Finance Home Loans / Mortgages Loans against Securities Tractor and Agri loans Education Loans Gold Loans	**Deposit Products:** Savings Accounts Current Accounts Fixed / Recurring Deposits Corporate Salary Accounts	**Other Products / Services:** Depository Accounts Mutual Fund Sales Private Banking Insurance Sales (Life, General) NRI Services Bill Payment Services POS Terminals Debit Cards Gold Sales Foreign Exchange Services Broking (HDFC Securities Ltd)
Wholesale Banking	**Commercial Banking:** Working Capital Term Loans Bill Collection Forex & Derivatives Wholesale Deposits Letters of Credit Guarantees	**Transactional Banking:** Cash Management Custodial Services Clearing Bank Services Correspondent Banking Tax Collections Banker to Public Issues	**Key Segments:** Large Corporate Emerging Corporates Financial Institutions Government / PSUs Supply Chain (Suppliers and dealers) Agriculture Commodities
Treasury	**Products / Segments** Foreign Exchange Debt Securities Derivatives Equities	**Other Functions:** Asset Liability Management Statutory Reserve Management	
Complete Suite of Products to Meet Diverse Customers' Needs			

Investment Rationale

Strong and one of the best liability franchise – a key strength

HDFC Bank enjoys superior liability franchise and scores on one of the highest CASA ratio in the financial space. Historically, the bank has pursued liability-driven growth strategy resulting in higher CASA (>50% in the past), low cost of funds and thus higher sustainable margins.

Table 1: Liabilities Management

Particulars (Rs crs)	FY11	FY12	FY13E	FY14E	FY15E
Deposits	208586.4	246706.4	301787.9	368181.2	449181.1
CASA	109908.0	119405.9	129768.8	150954.3	184164.3
Demand Deposits	46460.0	45407.8	46716.8	49814.9	60774.2
Saving bank deposits	63448.0	73998.0	83052.0	101139.4	123390.0
Term deposits	98678.4	127300.6	172019.1	217226.9	265016.8
CASA Ratio	**49.0%**	**48.4%**	**43.0%**	**41.0%**	**41.0%**

Source: Company, Arihant Research

CASA to be maintained with intermittent hiccups

Despite the savings rate deregulation by RBI in October 2011 and the consequent increase in savings rates by few private peers, HDFC bank was least affected given the dominant pan-Indian presence supported by wide branch network. In spite of price based competition, the Bank witnessed a strong growth of 16.6% in its savings deposits.

Banking on rural India: Aditya Puri- "We are well placed to offer services to India's growing semi-urban and rural population – the mechanic and the baker, and the customer in the town's movie hall."

The bank has well demonstrated the fact that SA pricing does not prove as a CASA driver; but (a) strong branch set-up with wide product range and quality service, (b) adequate branch network and (c) focus on increasing balances in existing accounts through cross-selling activities boost the low-cost deposit base. CASA today stands at levels lower than the past mainly on account of higher term deposit rates that prompted customers to move their money from current and savings account to fixed deposit schemes. That said, the current CASA ratio for the bank stands at 45% levels and is expected to be maintained on the back of aggressive branch expansion strategy followed by the bank. The management is confident to maintain ~ 47-48% CASA levels in medium term. In addition to this, the bank plans to add 250-300 branches per year in next 3-5 years which will support CASA mobilization strategy & priority sector requirements.

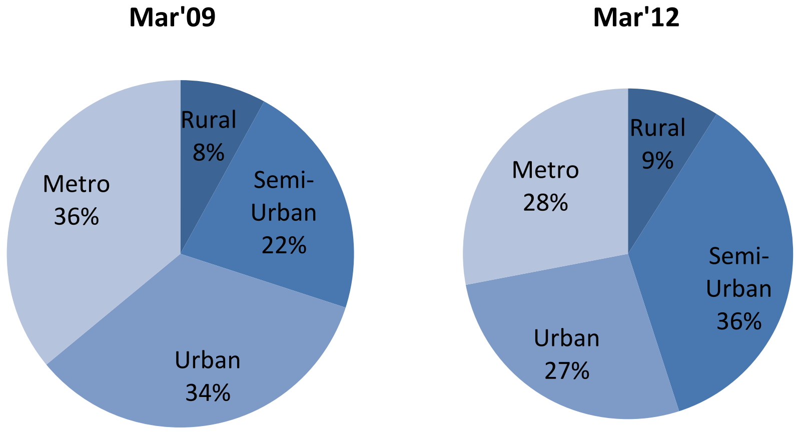
…supported by the strategy of - *Banking on the hinterland*

Rural economy, which was pre-dominantly agriculture dependant, has undergone huge metamorphosis with significant government and private investments. Improving income levels and consumption patterns in these areas provide ample opportunities for financial intermediaries, particularly banks. While PSU banks tend to be active in rural markets, HDFC Bank from the private sector has successfully executed rural strategy.

HDFC Bank hopes to grow market share and is charging into India's hinterland, where millions still have no bank accounts. HDFC Bank has added 558 branches in the last year. Broadly newly open branches start to contribute to profitability in two years from the commencement.

HDFC bank's unique and high quality franchise backed by banking on rural India provides huge customer clientele that in turn forms the potential base for ongoing cross-selling through branches particularly falling in rural and semi-urban areas. Much of the branch addition in the past three quarters has happened in Tier III- Tier VI cities.

Chart 1: Branch distribution mix-strategy banking



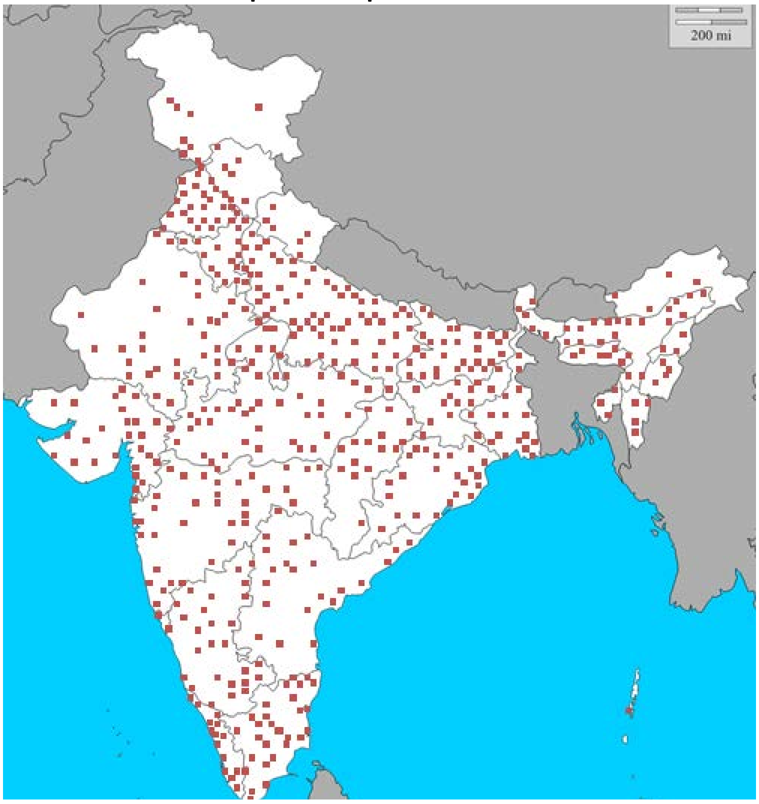
Source: Company, Arihant Research

The Bank's expansion plans take into account the need to have a presence in all major industrial and commercial centres where its corporate customers are located backed by a strong retail customer base for deposits and loan products as well as adequate rural presence to reach out to the unbanked areas. The Bank at present has an enviable network of 2,776 branches spread in 1,568 cities spread across the length and breadth of the country - from Leh in the north to Port Blair in the south and Tawang in the east.

Focus on India's hinterland is visible - 90% of branches opened in last 2 years are outside top 9 cities of India.

The Bank's branch network is deeply entrenched across the country with significant density in areas conducive to the growth of its businesses. The Bank's focus on semi-urban and under-banked markets continued, with over 75% of the Bank's branches now outside the top nine Indian cities. As of March 31, 2011, 793 of HDFC bank branches were in semi-urban or rural areas as compared to 1,159 as of March 31, 2012. By integrating financial inclusion across its various businesses, the Bank has brought over five million households into the banking system as on March 31, 2012. The Bank's branch footprint, forty six percent of which is located in semi urban and rural areas, has been key to these endeavours.

Chart 2: HDFC Bank's pan-India presence



..best in class NIMs to sustain during FY14-15E

Focus on India's hinterland is visible - 90% of branches opened in last 2 years are outside top 9 cities of India.

Given HDFC Bank's strong liability franchise and in turn higher proportion of retail deposits proves a key differentiator for operational performance to contain cost of funds. HDFC Bank has maintained >4% margins over last few years driven by higher CASA base and its unique loan book positioning. Higher CASA base has ensured lower cost of funds in turn maintaining margins at higher levels. Moreover, given the fixed nature of the loan book with relatively matched funding book (on deposit side), the bank's margin profile is relatively stable and the bank's current focus on the high yielding retail portfolio is likely to provide support to margins. Moreover, in a falling interest rate scenario, higher proportion of fixed rate loan and CASA deposits will provide cushion to margins.

Higher CASA floats coupled with increased traction in retail loan book (up 6.8% qoq) and run-down of some of the short-term low-yielding corporate loans led to higher margins (4.2%) for the bank. The higher proportion of retail loans in the bank's portfolio has aided in maintaining the net interest margins even as market yields in the overall economy were falling. We expect the bank to clock healthy margins in the range of 4.3-4.4% for the next two years. However, moderate pressures stand imminent on account of anticipated fall in yields with softening interest rates and loan mix tilting towards low risk corporate loans.

Table 2: Spread Analysis-sustained performance

Particulars	FY11	FY12	FY13E	FY14E	FY15E
Yield on advances	10.6%	11.6%	11.6%	11.9%	12.0%
Yield on Investments	7.2%	7.7%	8.4%	8.6%	8.6%
Yields on advances and Investments	9.5%	10.3%	10.6%	10.9%	11.0%
Yield on earning assests	8.4%	9.5%	9.9%	10.2%	10.2%
Cost of deposits	4.3%	5.6%	5.8%	5.8%	5.8%
Cost of Borrowings	9.8%	11.8%	10.6%	10.9%	12.4%
Cost of funds	4.7%	6.1%	6.3%	6.3%	6.4%
Gross Spread	**3.7%**	**3.4%**	**3.6%**	**3.8%**	**3.8%**

Source: Company, Arihant Research

Impeccable asset quality; loan-mix favorable

Impeccable asset quality with lower restructurings

HDFC bank's asset quality trend continues to be relatively stronger in challenging macro environment largely attributable to benefits of CIBIL ratings, stringent credit origination practices after global financial crisis and adequate provisioning.

The bank managed to retain its asset quality with the gross non-performing assets stabilizing at 1%; reporting almost the same gross NPA ratio since last five quarters. Net NPA ratio too remained unchanged at 0.20% which indicates that the asset quality for the bank has stabilized.

However, there has been a marginal uptick in bad retail loans quarter-on-quarter basis, but the Management is not expecting any significant strain from the retail assets and the book remains healthy.

During the current year, the bank has restructured 0.40% of total asset book, that stood at 1.95 lakh crore. The lender has referred 3 or 4 cases to corporate debt restructuring cell but there is no case for internal restructuring. Slippage ratio and credit cost are at the decade low of 1% and 0.4% respectively.

Table 3: Asset quality Summary-healthy

	FY11				FY12					
Particulars (Rs crs)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	FY13E	FY14E	FY15E
Gross NPA	1833.1	1894.9	2020.6	1999.4	2086.3	2133.4	2432.2	2291.9	2799.2	3401.3
Net NPA	318.5	355.3	398.0	352.3	396.0	386.9	495.8	504.9	745.7	1053.5
Gross Advances	175516.0	188502.2	194302.7	195420.0	213338.3	231648.6	241493.3	240376.8	293037.0	357373.8
% of Gross NPA to Gross Advances	1.0%	1.0%	1.0%	1.0%	1.0%	0.9%	1.0%	1.0%	1.0%	1.0%
% of Net NPA to Gross Advances	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.3%	0.3%
%Provision coverage ratio (calculated)	82.7%	80.0%	80.6%	82.4%	79.4%	78.0%	80.0%	78.0%	73.4%	69.0%

Source: Company, Arihant Research

Retail loan book expansion- key focus; corporate loan book to moderate marginally….

HDFC Bank, the country's second largest private lender, has been growing its advances faster than the banking system for several years now. The bank's Loan book is healthy mix of retail and wholesale assets (54:46). More than half the bank's revenues come from the retail lending book, which is dominated by commercial vehicle finance, auto loans, personal loans and credit cards. Over the past 8 quarters, the retail loan book has outpaced the corporate loan book mainly due to tactical move to rundown of wholesale book given the turbulent times and strong underlying drivers in retail space. The bank continue to witness strong growth in Auto loans, CVs and business banking segments driving retail loan book growth. The management expects retail loans to continue to grow faster than corporate loans in FY13.

That said, the bank's lending largely forms working capital loans that are fixed in nature. Moreover, the bank do not focus on single segment and carries secured to unsecured ratio of about 80:20 in terms of portfolio size over a sustained period of time. The bank has gone into wider geographies and the distribution strength has grown and the bank is focusing on faster turnaround time while processing loans and personal customisation of products. Nevertheless, the HDFC Bank's priority sector compliance is in-line and has actually increased over the course of past two-three years. The bank is building up the priority sector peace very well into their entire business model and various asset segments.

HDFC Bank aims to grow its loan book 3% or 4% higher than the 17% credit growth projected by the Reserve Bank of India for the industry in FY13. The current domestic credit-deposit ratio at 77% levels stands pretty decent indicating sufficient liquidity to support the loan growth. Both retail and corporate loans would grow at more or less the same pace. In the retail segment, there could be some moderation in auto and commercial vehicle loan that is dependent on the performance of the underlying industry. In the retail space, gold loan portfolio is growing at a faster pace. The bank's gold loan book has doubled from Rs 1,316 crore to Rs 3,018 crore. And while the RBI recently tightened norms for lending against gold, HDFC Bank has not much to worry as the gold loan book forms only 2.8% of total retail advances (at Rs 1.07 lakh crore). Therefore, the bank does not have any concentrated risk on its portfolio.

However, there is no denying the fact that HDFC Bank faces stiff competition in its stronghold retail segment, where the default rate is low, as several lenders including ICICI, SBI and IndusInd Bank Ltd have rushed to expand into home and auto loans. Further, with the central bank planning to issue new banking licenses, the landscape could become even more competitive for HDFC Bank.

Lending to rural/semi-urban market: Profitable initiative, fostering financial inclusion

Table 4: Loan mix-stable

Particulars (Rs crs)	FY11	FY12	FY13E	FY14E	FY15E
Gross Advances	161359	196890	240797	293772	358402
% change Yoy	*26.8%*	*22.0%*	*22.3%*	*22.0%*	*22.0%*
Wholesale advances	81246	89764	108358	132197	161281
% change Yoy	*47.7%*	*10.5%*	*20.7%*	*22.0%*	*22.0%*
Retail advances	80113	107126	132438	161574	197121
% change Yoy	*10.9%*	*33.7%*	*23.6%*	*22.0%*	*22.0%*
Wholesale as % of Total advances	**50%**	**46%**	**45%**	**45%**	**45%**
Retail as % of Total advances	**50%**	**54%**	**55%**	**55%**	**55%**

Source: Company, Arihant Research

…while higher provisioning should keep net NPAs under check

The bank's provisioning policies for specific loan loss provisions remained higher than regulatory requirements. With the increase in retail loans, the bank has increased the unallocated and specific loan loss provisions. The NPA coverage ratio based on specific provisions (no including write-offs, technical and otherwise) was at 80% as on December2012. Including general and floating provisions, coverage ratio is at ~200%.

Average credit costs have been ~ 156bps over FY07-FY11, which went down further to 37bps in FY12, lowest in the bank’s history. We believe superior retail portfolio behaviors and lowest credit costs behind us; the overall credit costs are set to spike up going ahead. That said, given the balance sheet strength and resilient book, the bank stands pretty stable to manage the higher costs maintaining the profitability growth.

Operating metrics remain healthy, Earnings momentum positive

Operating metrics favor earnings momentum, but maintaining remains a challenge

The operating metrics look strong for the bank with the improvement in operating efficiency backed by reduction in cost-income ratio of the bank coming down to 46% (Q3FY13) from higher levels of 50% (Q4FY12). FY13 witnessed cost-income ratio held up on account of full impact of aggressive branch addition, but we expect cost-income ratio to soften as we see the costs stabilizing and the branch network expanding in the rural space wherein the cost matrix stands in favor of the bank. Typically, a branch takes two years to break-even and if the same branch happens to be located in lowers Tier cities (smaller locations); the costs remain under check.

Fee income has been another strong income stream for HDFC bank and fee income growth has on many occasions outpaced balance sheet growth. The growth in the fee income has been fairly broad-based. The growth has come from transaction banking, cash management, trade and merchant banking operations. The bank witnessed volumes picking up in third party sales and loan processing fees and insurance product that added to the fee income.

Superior asset quality and faster than systemic credit growth has enabled HDFC Bank to maintain the earnings momentum since historical times. While FY13 may not be the year of strong numbers owing to moderation in fee income, limited scope for margin expansion (with slower growth in CA accounts and moderate change in loan mix), the following years to witness stability. Lower provisions, higher fee income, and growth in interest income from advances would aid in maintaining the bank's earnings. We expect the bank to register 28% CAGR over FY12-15E (vs historical average of >30%) which we believe is indicative of strong earnings growth at a time when most banks are likely to face significant stress. We expect moderation in earnings primarily due to the bank’s conscious decision to slow down the pace of loan growth resulting in relatively moderate earnings. We expect the profitability growth to moderate from higher levels of 40% in the past to 27% in FY14-FY15E; that said on relative basis it continues to remain strong.

Strong earnings translate into impressive return ratios

We expect RoEs to fall in the range of 18-21% over FY13-15E and RoAs in the range of 1.8-2.0% for the same period which stands as one of the best in the industry. While increased credit costs may restrict buoyancy in return ratios, it would be conveniently offset by the decent fee income gains expected to consistently flow over next couple of years.

Table 5: Du-pont Analysis - decomposition of RoA

	FY11				FY12			FY13E	FY14E	FY15E
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Mar	Mar	Mar
Particulars	A	A	A	A	A	A	A	E	E	E
NII/avg. total assets	4.0%	3.9%	3.8%	4.0%	4.0%	4.0%	4.0%	4%	4%	4%
Non-Interest Income/avg total assets	1.6%	1.6%	1.7%	1.8%	1.8%	1.5%	1.9%	2%	2%	2%
Treasury income / Avg assets	-0.1%	0.0%	-0.1%	-0.1%	0.1%	0.0%	0.0%	0%	0%	0%
Net Income/avg. total assets	5.6%	5.5%	5.6%	5.8%	5.7%	5.5%	5.9%	6%	6%	6%
Operating Expenses/avg. total assets	-2.7%	-2.7%	-2.7%	-2.9%	-2.8%	-2.7%	-2.7%	-3%	-2%	-2%
Operating Profit /avg. total assets	2.9%	2.8%	2.9%	2.9%	3.0%	2.8%	3.2%	3%	3%	3%
Provisions/Avg. total assets	-0.6%	-0.5%	-0.4%	-0.4%	-0.6%	-0.3%	-0.3%	0%	0%	0%
PBT/ Avg assets	2.3%	2.3%	2.5%	2.5%	2.4%	2.5%	2.9%	3%	3%	3%
(1-tax rate)	31.7%	31.8%	30.2%	31.3%	32.3%	31.5%	31.6%	32%	32%	32%
Return on Assets	1.5%	1.6%	1.8%	1.7%	1.6%	1.7%	2.0%	2%	2%	2%
Avg. total assets/average equity (x)	10.8	11.0	11.3	11.3	11.3	11.4	11.1	11.5	11.4	11.0
Return on Equity	16.7%	17.6%	19.9%	19.6%	18.4%	19.2%	21.6%	21%	22%	22%
Return on Equity	16.7%	17.6%	19.9%	19.6%	18.4%	19.2%	21.6%	21%	22%	22%

Source: Company, Arihant Research

Resilient investment book

HDFC Bank per se does not have any international investment book and hence remains relatively insulated from the global headwinds. The average duration of the bank's total investment book stands at 1.5 and is quite low. Moreover, 62% of the total investment book forms part of HTM category and hence is less vulnerable to MTM losses. However, this restricts to some extent significant trading gains that would arise in a declining yield scenario.

Table 6: Investment book snapshot

Particulars	FY12				FY11				FY10			
Rs. Crs.	HFT	AFS	HTM	Total	HFT	AFS	HTM	Total	HFT	AFS	HTM	Total
Gsec	6,886	22,417	46,915	76,218	103	12,410	41,138	53,651	4,002	5,559	41,489	51,050
Other approved securities	0	0	0	1	0	0	0	1	0	1	0	1
Shares	0	84	0	85	0	94	0	95	7	97	0	104
Debentures & Bonds	443	520	0	963	223	346	53	623	130	946	110	1,186
Subsidiary/JVs	0	0	755	755	0	0	745	746	0	0	155	155
Others	1,955	4,753	12,755	19,463	2,162	13,654	0	15,816	589	5,523	0	6,112
Total	**9,283**	**27,775**	**60,426**	**97,484**	**2,489**	**26,505**	**41,938**	**70,932**	**4,728**	**12,126**	**41,754**	**58,608**
% Total Investments	10%	28%	62%		4%	37%	59%		8%	21%	71%	

High Tier I ratio comforting

The bank has relatively high Tier I capital adequacy ratio, which we believe is comforting in the current stressed environment. Given the higher Tier I ratio, HDFC Bank stands strong in terms of funding growth and absorbing bad loans. The bank can absorb GNPAs up to 10% with provision coverage ratio of 68-70% keeping its Tier I ratio at minimum regulatory requirement. Needless to say, the bank stands comfortable w.r.t. BASEL III norms implementation.

Table 7: Capital adequacy Summary

The details of Tier I capital of the Bank are given below :		
Particulars	**March 31, 2012**	**March 31, 2011**
- Paid-up share capital	469	465
- Reserves	29,693	25,054
- Innovative perpetual debt	200	200
(a) Gross Tier I	30,362	25,719
Deductions :		
- Deferred tax asset	-1,465	-1,189
- Securitisation exposures*	-179	-223
- Market risk charge on account of valuation adjustment for illiquid positions of derivatives and non derivative portfolio.	-46	-52
(b) Total deductions	-1,691	-1,465
(c) Total Tier I capital (net of deductions) (a-b)	28,671	24,255
** Principally comprises credit enhancements*		

The details of Tier II capital of the Bank are given below :		
Particulars	**March 31, 2012**	**March 31, 2011**
Upper Tier II capital	3,925	3,862
Lower Tier II capital	6,170	2,925
Provision for standard assets	921	763
Floating provision	1,435	735
Investment reserve account	-	42
Securitisation exposures*	-179	-223
Total Tier II capital (net of deductions)	12,271	8,104

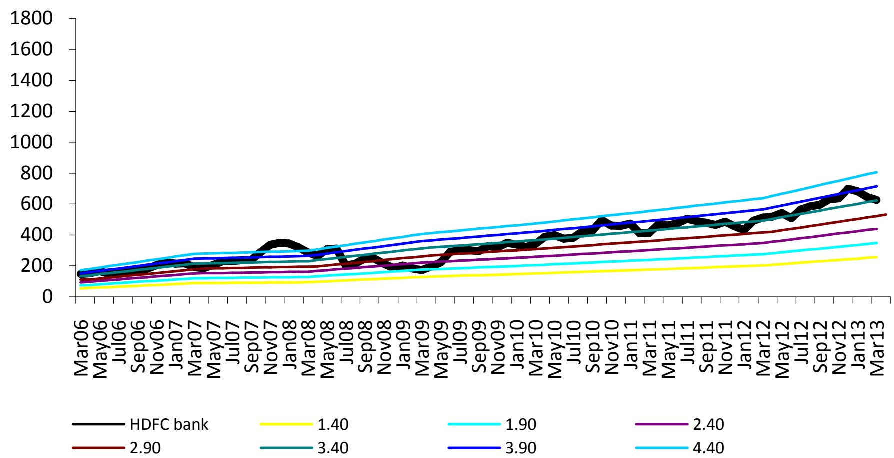
Not cheap, but valuation premium justified, HOLD with price Target of Rs 697

The bank will likely to continue to trade at a premium to the sector due to its reasonably higher earnings visibility (CAGR >26%) over FY13-15E, when earnings growth of few banks are likely to remain stressed during the said period. HDFC bank has the ability to manage any significant deterioration in asset quality; given its higher provisioning.

The bank's strong asset quality, superior return ratios, strong asset growth and adequate capitalization bodes well for its future growth.

Over the years, the bank has created a strong brand name for itself in the banking space by gaining market share (ahead of State Bank of India, the country's largest nationalized lender) and through consistent performance on the operating front (effective branch expansion network and huge low-cost deposit base). HDFC Bank has always commanded premium valuations vis-à-vis its peers due to its track record of consistent growth in earnings and assets. Therefore, there is a reason to believe that HDFC bank shares have been consistent outperformers and has witnessed handsome rally (52-week high: Rs 705). In the recent periods, however, the stock has been trading below its historical average (3.6X P/BV) and we do foresee certain amount of price correction in the interim periods. We recommend HOLD rating on the stock and assign a P/Adj BV of 3.0X on FY15E to arrive at a target price of Rs. 697 based on the 2-stage Gordon growth Model.

Chart 3: HDFC Bank P/ABV Band Chart



Source: Company, Arihant Research

Q3FY13 EARNINGS UPDATE

Reported Quarterly Results						
Particulars (Rs in Cr)	Q3FY13	Q2FY13	YoY	Q1FY12	QoQ	Comments
Interest Earned	8,708	7,203	21%	8,525	2%	
Interest Expended	4,909	4,087	20%	4,793	2%	
Net Interest Income	3,799	3,116	22%	3,732	2%	healthy NII performance on account of strong loan growth at 24% YoY
Other Income	1,799	1,420	27%	1,345	34%	Strong other income performance
Other income / Net Income (%)	*32.1*	*31.3*		*26.5*		
Total income	5598	4536	23%	5077	10%	
Employee Expenses	1,004	867	16%	963	4%	
Non-Employee expenses	1,570	1,291	22%	1,543	2%	
Operating Expenses	2,574	2,158	19%	2,506	3%	Opex inched upwrads YoY
Cost-income Ratio (%)	*46.0*	*47.6*		*49.4*		C/I ratio improving; yet at higher levels
Pre-Prov Profits	3,024	2,378	27%	2,571	18%	
Provisions & Contingencies	307	329	-7%	293	5%	Credit costs moved downYoY; but will spike up going ahead
PBT	2,716	2,049	33%	2,278	19%	
Provisions for Tax	857	619	38%	718	19%	
Effective Tax Rate (%)	*31.6*	*30.2*		*31.5*		
PAT (reported)	1,859	1,430	30%	1,560	19%	**Robust PAT growth supported by healthy NII and lower credit costs**
EPS Basic	7.9	6.1		6.6		
EPS Diluted	7.8	6.1		6.5		
GNPA	2,432.2	2,020.6		2,133.4		
NNPA	495.8	398.0		386.9		
GNPA (%)	1.00	1.03		0.91		
NNPA (%)	0.20	0.20		0.20		
Total CAR (%)	17.00	16.30		17.00		
NIM (%)		4.24		4.41		
Deposits	2,84,119	2,32,508	22%	2,74,130	4%	Deposit base looks strong
Advances	2,41,493	1,94,303	24%	2,31,649	4%	Strong loan growth

Source: Company, Arihant Research

Income Statement				
Year to 31st March (Rs.Cr)	**FY12**	**FY13E**	**FY14E**	**FY15E**
Interest Income	27286	33964	41340	50270
Interest Expenses	14990	19121	23603	28909
Net Interest Income	**12297**	**14843**	**17737**	**21360**
- growth %	*17*	*21*	*20*	*20*
Fee-based Income	4275	5131	6105	7265
Treasury Income	-194	0	0	0
Other Non-interest Income	1163	1723	1907	2285
Operating Income	**17540**	**21697**	**25750**	**30911**
- growth %	*18*	*24*	*19*	*20*
Operating Expenses	8590	9952	11124	12487
- Staff Cost	3400	4491	5380	6444
- Other Operating Exp.	5190	5460	5744	6043
Gross Profits	**8950**	**11745**	**14626**	**18425**
- growth %	*16*	*31*	*25*	*26*
Provisions	1437	1849	2037	2479
Profit Before Taxes	**7513**	**9896**	**12589**	**15946**
Taxes	2346	3167	4028	5103
Profit After Taxes	**5167**	**6730**	**8560**	**10843**
- growth %	*32*	*30*	*27*	*27*

Balance sheet				
As on 31st March (Rs. Cr)	**FY12**	**FY13E**	**FY14E**	**FY15E**
Capital	469	472	472	472
Reserves & Surplus	29455	34297	43554	55695
Deposits	246706	301788	368181	449181
- growth %	*18*	*22*	*22*	*22*
Borrowings	23847	35770	39347	43281
Other liabilities & provisions	37432	35741	40783	65560
TOTAL LIABILITIES	**337909**	**408068**	**492337**	**614190**
Cash on hand & with RBI	14991	21737	30432	42605
Money at call and short notice	5947	6095	6248	6404
Advances	195420	238412	290863	354853
- growth %	*22*	*22*	*22*	*22*
Investments	97483	105626	114136	139246
Fixed assets	2347	2746	3158	3632
Other assets	21721	33451	47500	67450
TOTAL ASSETS	**337909**	**408068**	**492337**	**614190**

Ratio Analysis				
	FY12	**FY13E**	**FY14E**	**FY15E**
Basic Ratio (Rs.)				
EPS	21.8	28.5	36.2	45.9
Book Value per share	127.5	147.2	186.4	237.8
Adjusted Book Value	126.0	145.1	183.3	233.4
Dividend per share	4.3	5.3	6.3	7.3
Asset Quality (%)				
Gross NPAs	1.0	1.0	1.0	1.0
Net NPAs	0.2	0.2	0.3	0.3
NPA Coverage	82.4	78.0	73.4	69.0
Profitability ratios (%)				
RoAE	18.7	20.8	21.7	21.6
RoAA	1.6	1.8	1.9	2.0
NIM	4.3	4.3	4.4	4.3
Operating Profit Margin	51.0	54.1	56.8	59.6
Net Profit Margin	29.5	31.0	33.2	35.1
Cost to Income	49.0	45.9	43.2	40.4

	FY12	**FY13E**	**FY14E**	**FY15E**
Spread analysis (%)				
Yield on advances	11.6	11.6	11.9	12.0
Yield on investments	7.7	8.4	8.6	8.6
Yield on interest-earning assets	9.5	9.9	10.2	10.2
Cost of deposits	5.6	5.8	5.8	5.8
Cost of borrowings	10.3	10.6	10.9	12.4
Cost of funds	6.1	6.3	6.3	6.4
Spread	3.4	3.6	3.8	3.8
Net Interest Income to AWF	4.3	4.3	4.3	4.3
Non Interest Income to AWF	1.8	2.0	1.9	1.9
Operating Profit to AWF	3.1	3.4	3.6	3.7
Net Profit to AWF	1.8	2.0	2.1	2.2

Valuation ratios (x)				
P/E	27.8	21.5	16.9	13.4
P/BV	4.8	4.5	3.5	2.8
P/ABV	4.9	4.6	3.6	2.8

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Stock Rating Scale

	Absolute Return
BUY	>20
ACCUMULATE	12-20
HOLD	5-12
REDUCE	<5