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HDFC BANK

Rating: BUY **Price: Rs248**

Profits tucked away for a rainy day

Suppression of profits by Indian banks is a pleasant but rare event and HDFC Bank has used ingenious ways to understate its profits under Indian provisioning rules for FY2000. Apparently the year ended with the bank being flush with profits and, therefore, management decided to use some of its FY2000 profits for future contingencies. While such measures are frowned on internationally, we believe HDFC Bank is adopting a prudent practice in a country like India where the risks for banks are higher and cushions for future problems are more appropriate. We estimate HDFC Bank's reported net profit in FY2000 is 26% lower than what Indian norms permit.

52-Week Range	Rs296-63	Market Capitalisation	Rs60.3bn (US$1.4bn)
Reuters code	HDBK.BO	BSE Sensex	4372

Year to 31st March	1998	1999	2000	2001E	2002E
Net Profit (Rs mn)	632	824	1,200	2,227	2,856
EPS (Rs)	3.2	4.1	4.8	9.0	11.5
EPS Growth (%)	56.1	30.4	19.7	85.6	28.2
P/E (x)	78.5	60.2	50.3	27.1	21.1
BV (Rs)	14.3	16.9	30.9	37.6	46.5
P/BV (x)	17.4	14.6	8.0	6.6	5.3
DPS (Rs)	1.0	1.3	1.6	2.0	2.4
Yield (%)	0.4	0.5	0.6	0.8	1.0

- **Much stronger profit growth than reported earnings suggest:** FY2000 earnings (includes Times Bank earnings from 26th February till 31st March 2000) increased by a healthy 45.7% to Rs1.2bn and even though the directors stated that FY2000 was "exceptionally strong" (p 6 FY2000 annual report) we believe that this was an understatement, since the bank has made extra-ordinarily high general provisions which nestle innocuously in tier-II capital, away from shareholders eyes. The bank has also decided to take hefty charges during the year which it could have deferred. All these items have depressed the net profit for FY2000 .
- **Excessive standard asset provisions:** According to the Reserve Bank of India (RBI) norms, banks have to provide 25 basis points for standard assets from FY2000 onwards. Instead, HDFC Bank decided to provide 100 basis points for its standard assets. We estimate the Rs536mn loan loss provision in FY2000 includes Rs345mn of standard asset provision. If HDFC Bank had to provide 25 basis points on standard assets, the provision would be only Rs84mn. The excess over minimum provision on standard assets therefore amounts to Rs261mn.

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- **Surplus provision for Times Bank merger:** HDFC Bank reportedly provided around Rs600mn for Times Bank merger costs which was directly reduced from the erstwhile Times Bank reserves. This amount is unfortunately not disclosed in the annual accounts. We had also believed that the amount was excessive despite Times Bank's asset quality being inferior to that of HDFC Bank. We estimate, of the total Rs600mn provided, around Rs334mn is surplus. This amount may be utilised in future if the erstwhile Times Bank assets deteriorate in excess of the specific provisions already made.

- **General provisions in tier-II capital increase sharply:** As a result of the excessive standard asset and Times Bank provisions, HDFC Bank's general provisions in tier-II capital increased to Rs749mn in FY2000 from only Rs70mn in FY1999. It is therefore apparent that the management decided to cap its reported profits by building up provisions. The management, however, maintains that the general provisions are "linked to projected delinquencies for retail loans and other advances." (p. 25 FY2000 annual report).The bank reported net NPLs (net of specific provisions) of Rs370mn but including the general provisions, the bank would have nil net NPLs. The general provision in tier-II capital will have to be carefully monitored in future, it would be unfortunate if the bank were to decide to charge future losses to general provisions instead of to profits so as to "even out" future earnings.

Composition of FY2000 Tier-II Capital

	(Rs mn)
Opening Balance General Provision	70
Standard Assets Provision	345
Surplus Provision for Times Bank loans	334
Closing Balance General Provision	749
Subordinate Debt	1,300
Investment Fluctuation Reserve	13
Total Tier-II Capital	**2,062**

- **RBI's new norms do not permit provisions for standard assets to be included in capital:** The RBI's guideline dated 24th April 2000 issued after HDFC Bank had finalised its accounts states that the general provision of 0.25% on standard assets, "will not be eligible for inclusion in tier-II capital." Therefore for FY2001, HDFC Bank may have to remove some or all of its general provisions from tier-II capital.

- **Entire Employees Stock Option Scheme (ESOS) expenses charged-off in FY2000:** Salary expenses in FY2000 include a charge of Rs136mn for compensation expense relating to share options granted to employees. Whilst the options will vest in employees and directors over a 36 month period, HDFC Bank decided to charge-off the entire amount in the year of grant rather than amortise it over a 36 month period. We estimate that if the bank had deferred this expense, it would have had to provide only Rs11mn in FY2000 and its profits were, therefore, lower by Rs125mn (note 14 in notes to accounts, p. 23 of FY2000 annual report).

- **Higher depreciation charge:** In FY2000, HDFC Bank reviewed the remaining useful life of certain fixed assets pertaining to electrical and technology equipment and consequent to the re-assessment the depreciation was higher by Rs55mn.

- **Accounting excessively prudent:** While HDFC Bank would naturally argue that its accounting norms are prudent, and the provisions are for likely losses on newly disbursed retail loans, we believe that the bank has attempted to suppress FY2000 profits, creating a provision available to "even-out" future earnings so as to report earnings growth in line with stock market expectations. Otherwise making such large general provisions does not make sense since the bank could have reported higher net profits and higher tier-I capital.

- **Net profits for FY2000 could have been higher by 26% at Rs1,516mn:** Excluding the extra provision for Times Bank merger which was directly adjusted against the amalgamation reserve and the ESOS expense, we estimate that HDFC Bank's actual net profit for FY2000 was Rs1,516mn, i.e. 26% over reported earning of Rs1,200mn.
- **International norms moving towards transparency:** To prevent "evening out" of earnings, international norms dictate that the profit and loss account should reflect the actual earnings in that year. While we believe that suppression of earnings is better than inflating profits, we do understand that in a country like India which has higher risk associated with banking, HDFC Bank has decided to create a significant general provision for future contingencies.
- **Capital markets division contributed to strong overall profit growth:** Although HDFC Bank does not disclose division-wise profits, we believe that its capital markets division (custodial and depository services, loans to brokers, loans against shares, etc) was a significant contributor to overall earnings. As at 31st March 2000, loans to the capital markets sector were Rs6.74bn constituting 15% of total customer assets (credit plus credit-like substitutes). We believe that during the year, the composition was significantly higher and the Reserve Bank of India requested the bank to prune down its capital market lending.
- **BUY opinion reiterated:** The excellent results, which show the bank exceeding our forecast even after the excessive provisioning, underline HDFC Bank's successful business model and reinforce our view that management achieves an excellent balance between growth and caution. We reiterate our BUY recommendation.

Income Statement

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Net interest income	1,033	1,468	3,056	4,749	5,877
Other income	621	681	1,254	1,653	2,276
Total income	**1,654**	**2,149**	**4,310**	**6,402**	**8,153**
Salaries	(149)	(221)	(357)	(518)	(673)
ESOS	0	0	(128)	0	0
Stamp duty	0	0	(37)	0	0
Other expenses	(478)	(667)	(1,192)	(1,741)	(2,276)
Total overheads	**(627)**	**(888)**	**(1,714)**	**(2,259)**	**(2,949)**
Profit before provisions	**1,027**	**1,261**	**2,596**	**4,143**	**5,204**
Bad debt provisions	(72)	(76)	(191)	(265)	(315)
Provision for standard assets	0	0	(345)	(197)	(164)
Investment provisions	(10)	(9)	(58)	0	0
Others	0	(7)	(53)	0	0
Tax	(313)	(345)	(749)	(1,453)	(1,870)
Total provisions	**(395)**	**(437)**	**(1,396)**	**(1,916)**	**(2,348)**
Net profit	**632**	**824**	**1,200**	**2,227**	**2,856**
Dividend	(200)	(260)	(324)	(487)	(584)
DPS (Rs)	1.0	1.3	1.6	2.0	2.4
EPS (Rs)	3.2	4.1	4.8	9.0	11.5
EPS Growth (%)	100.5	30.4	17.5	85.6	28.2
Net Interest Margin (%)	5.1	4.6	4.2	3.9	3.7
Cost-to-Income (%)	31.4	34.3	33.6	29.1	28.9
Average Tax Rate (%)	30.8	27.6	34.2	35.0	35.0
Gross NPL (%)	2.8	1.8	2.5	2.4	2.1
Net NPL (%)	1.2	0.7	0.8	1.0	0.9
Provisions/Gross NPL (%)	38.3	62.9	69.7	60.0	60.0

Return on Assets

Year to 31st March (%)	1998	1999	2000	2001E	2002E
Net Interest Income	4.4	4.1	3.8	3.6	3.4
Other Income	2.7	1.9	1.6	1.2	1.3
Less Overheads	(2.7)	(2.5)	(2.1)	(1.7)	(1.7)
Less Provisions	(1.7)	(1.2)	(1.7)	(1.4)	(1.4)
ROA	**2.72**	**2.30**	**1.50**	**1.67**	**1.67**
ROE	**23.9**	**26.4**	**22.0**	**26.7**	**27.9**

Valuation

Year to 31st March (x)	1998	1999	2000	2001E	2002E
P/E	22.4	16.8	53.1	27.6	21.5
Price to Book Value/ROE	20.8	15.5	37.8	24.7	19.1
P/BV	5.0	4.1	8.3	6.6	5.3
Price to Adjusted BV	5.1	4.2	7.9	6.4	5.3
Dividend yield (%)	1.4	1.9	0.6	0.8	1.0

(Historic at year end prices)

Balance Sheet

As at 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Cash with RBI	2,121	2,917	8,498	9,196	11,875
Cash at call	3,290	2,479	7,678	9,598	11,997
Total Cash	5,411	5,396	16,176	18,794	23,872
Investments	11,213	19,037	57,483	65,088	81,903
Advances	**8,420**	**14,006**	**33,622**	**54,780**	**71,214**
Net Block	1,103	1,280	2,368	3,078	4,002
Other assets	2,152	3,781	6,913	8,640	10,800
Assets	**28,299**	**43,500**	**116,562**	**150,380**	**191,791**
Demand Deposits	6,732	9,815	27,799	32,868	42,728
Savings Deposits	1,774	3,465	11,250	10,956	14,243
Term Deposits	13,412	15,871	45,228	65,736	85,457
Total Deposits	**21,918**	**29,151**	**84,277**	**109,560**	**142,428**
Other Borrowing	546	4,479	14,288	17,814	22,222
Subordinate Debt	1,000	1,350	1,500	4,000	5,000
Total Borrowing	**1,546**	**5,829**	**15,788**	**21,814**	**27,222**
Other liabilities	1,984	5,131	8,847	9,713	10,693
Equity	2,000	2,000	2,433	2,433	2,433
Reserves	851	1,389	5,082	6,725	8,880
Total Equity	**2,851**	**3,389**	**7,514**	**9,158**	**11,313**
ESOS	0	0	136	136	136
Total Liab & Equity	**28,299**	**43,500**	**116,562**	**150,380**	**191,791**

Capital Adequacy

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Tier I Capital	2,839	3,367	7,503	9,158	11,313
Tier II Capital	1,032	1,420	2,062	3,962	4,762
Total Capital	3,871	4,787	9,565	13,120	16,075
Risk-Weighted Assets	27,803	40,357	78,472	120,300	150,441
Tier I Capital (%)	10.2	8.3	9.6	7.6	7.5
Tier II Capital (%)	3.7	3.5	2.6	3.3	3.2
Capital Adequacy (%)	**13.9**	**11.9**	**12.2**	**10.9**	**10.7**

Adjusted Book Value

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Book Value (Rs)	14.3	16.9	30.9	37.6	46.5
Equity	2,851	3,389	7,514	9,158	11,313
Net NPLs	(104)	(145)	(369)	(536)	(616)
General Provisions	32	70	749	749	749
Adjusted Equity	2,779	3,314	7,895	9,371	11,446
Adjusted BV (Rs)	**13.9**	**16.6**	**32.5**	**38.5**	**47.1**