

## BLYTH FUND

**Date:** February 19, 2004  
**Proposal:** Buy Proposal for 500 shares  
**Ticker:** HDB  
**Current price:** \$31.41 (as of closing Feb 19, 2004)  
**Analyst:** Nishant Berlia  
**Profile:** HDFC Bank Limited is a private sector bank and financial services company in India. The wholesale banking group provides its corporate and institutional clients an array of commercial banking products and transactional services with an emphasis on customer service and relationship management. The retail banking group provides a range of financial products including deposit products, loans, credit cards, debit cards, bill payment services, third-party mutual funds, investment advice and other services. The treasury group manages its balance sheet, including its maintenance of reserve requirements and its management of market and liquidity risk. The treasury group also provides advice and execution services to its corporate and institutional customers with respect to their foreign exchange and derivatives transactions. In addition, the treasury group seeks to optimize profits from its proprietary trading, which is principally concentrated on Indian government securities. (*Yahoo! Finance*)

### The Numbers:

<b>Shares Outstanding:</b>	93.24 (Float 62.47)	<b>Market Cap:</b>	2.886 B
<b>P/E</b>	30.47	<b>PEG Ratio</b>	0.86
<b>Gross Revenue</b>	\$538.28M	<b>Beta</b>	0.20
<b>P/book</b>	5.03	<b>P/sales</b>	5.44
<b>Operating Margins</b>	43.10%	<b>Net Margins</b>	19.34%
<b>Cash Now / April 2003</b>	\$461.22 M	<b>EV</b>	2.86B
<b>ROE</b>	19.46%	<b>ROA</b>	1.48%
<b>Profit to Commons</b>	\$104.12M	<b>Dividend Yield (Div)</b>	0.61% (0.19)

### Indian Economic Outlook

- **Quick History**
  - Independence in 1947; **democratic, socialist grassroots** movement
  - **Strong democracy** with guarantee of fundamental rights and **strong institutions** developed
  - A license economy put in place: Soviet Style 5 year plans (Glasnost) and some market forces – a **“license raj”** (rule of licenses or a license empire).
  - Height of socialization in the 70s, including **nationalization particularly of banks**
  - **1991, BoP crisis** forces govt to appoint visionary economist as Finance Minister and IMF financing (with caveats): **result “Reforms Package I”**
  - **General Elections in April 2004: BJP-led** National Democratic Alliance (NDA) coalition clearly favored to win with a strong BJP.
  - **BJP fighting elections on liberalization card** – if they win well and I believe they should it would probably mean **the passing of the long pending “Reforms Package II”**.
  - Great news that they are trying, great news that it seems to be working, great news for **a future sustained or, perhaps, faster growth rate**.
- **Economic Growth**
  - Economic growth to be **8.1% of GDP** for this year.
  - Led due to tremendous **labor and capital accumulation** (export and domestic) as markets are coming into their own
  - **Strong institutions**, perhaps, favor, under the assumptions of Solow-Swan and neo-institutional theory, a sustained in fact if not faster growth rate due to **“undiscovered” productivity benefits** – a more promising curve, **country quite long term stable anyhow**.
  - Examples: Strong institutions (**private property risk same as HK – no Russia**, recent laws that significantly strengthen bank foreclosure and debt restructuring; **pioneering in Asia**)
- **Structural Implications:**
  - **Fast emerging middle class:** engineers, call centers (Infosys, Wipro plan to hire 15,000 each) know earn between \$2000-\$5000 a yr. Can

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- afford mobile phones, cars on lease, etc.
- o Growth likely to move into manufacturing (exports) and domestic oriented sectors (new wealth) resulting in **strong returns for India based firms** (TISCO – world's cheapest producer of steel has better earnings reports the last two years than Infy, Wipro, etc) and **capital deepening** (a money supply expansion).
- o **Corporate offtake has not really taken off though related "services" have:** reverse hawala and high government (fortunately domestic currency) deficit of 10% of GDP
- o Consumer spending has **sky rocketed at 12% a year**
- o **Consumer Credit** boom expected: Expanding New Horizons (only 7-8% Economist report)

**Government realizes importance:** recently allowed foreign investors to have till 74% stake (26% stake guarantees veto powers in certain "strategic" decisions): **pressure from many big investors.**

### HDFC Bank Origins

**HDFC Bank:** The Housing Development Finance Corporation Limited (HDFC) was amongst the first to receive an 'in-principle' approval from the Reserve Bank of India (RBI) to set up a bank in the private sector, as part of the RBI's liberalisation of the Indian Banking Industry in 1994. HDFC Bank commenced operations as a Scheduled Commercial Bank in January 1995.

**HDFC:** HDFC is India's premier housing finance company and enjoys an impeccable track record in India as well as in international markets. Since its inception in 1977, the Corporation has maintained a consistent and healthy growth in its operations to remain a market leader in mortgages. Its outstanding loan portfolio covers well over a million dwelling units. HDFC has developed significant expertise in retail mortgage loans to different market segments and also has a large corporate client base for its housing related credit facilities

Critical elements:

- Acquired TimesBank in merger from Times Of India Group (5 – 6% present holding) in 2000.
- HDFC owns only 24.4%, rest owned by public and private equity investors JP Morgan Chase (5-6%).
- Large Foreign Institutional Investors (in India) including Putnam, etc. (big vote in Indian equity markets) – 10-11%
- Warburg Pincus has a significant holding in HDFC (its promoter)

***On mortgages: HDFC Bank has entered into an Memorandum of Understanding with HDFC Ltd. wherein HDFC Bank will source housing loans for HDFC Ltd. (possible future merger – ICICI and ICICI Bank; didn't bring in due to very broad-based and industry focus and felt more comfortable with HDFC)***

### People, Processes and Reputation

- Excellent management team** (not high profile) with a very strong reputation for running a tight ship and high performing ship.
- Mr. Jagdish Capoor took over as the bank's Chairman in July 2001. Prior to this, **Mr.Capoor was a Deputy Governor of the Reserve Bank of India.**
- The Managing Director, Mr. Aditya Puri**, has been a professional banker for over 25 years, and before joining HDFC Bank in 1994 **was heading Citibank's operations in Malaysia.**
- Board is full of quite imminent and well respected personalities** with experience in public policy, administration, industry and commercial banking. Senior executives representing HDFC are also on the Board, however, 'decent' number and share of independent directors.
- HDFC also has a **very good reputation for recruiting people** – could not lookup BT Employer Survey due to short time.
- Ratings (by Care and Fitch) have it in **highest class of asset ratings (AAA)**. These rating though Indian (*and therefore not counting country risk premium*) including

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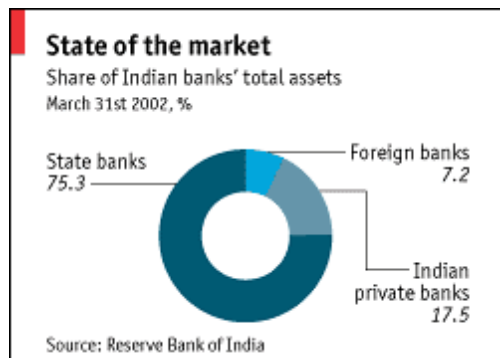
ratings of foreign bank operations in India.

**HDFC Bank named Best Domestic Bank in India Region - Asset Triple A Country Awards 2003**

**HDFC Bank named Best Bank in India in KPMG-Business Today survey (2003)**

**HDFC Bank is one of Forbes Global's "Best Under a Billion" (Oct 2003)**

### Market



### Critical Debate:

#### What happens when state banks privatize or restructure?

- **My two or three bits:**
  - **Its really, really painful.** Yes, they have a huge distribution network but restructuring will not be easy and will take time. Meanwhile, the private banks will make hay particularly due to their ability to be more customer focused and provide far better services.
  - **The Davids Eat the Goliaths.** HDFC Bank, ING Vyasa, ICICI and their ilk will look at acquisitions and their would be consolidation. The industry, however, is small enough that enormous leverage can be raised, particularly, internationally. HDFC Bank's listing is a good indication.
  - **The Battle Easily Won.** Private Banks will definitely wipe out the state banks when it comes to retail (or private) banking. For large corporates, they will also look for "sweet" deals from the state banks but critically their deposits – technology and service are critical factors will be with private banks. However, for SMEs and local merchants HDFC Banks's offerings are quite irresistible as they provide not only great deposit, but due to low cost of deposits, the most competitive loans too.

#### Within the hunters, what's HDFC's strategy for increasing market share:

**Technology:** HDFC Bank operates in a highly automated environment in terms of information technology and communication systems. All the bank's branches have connectivity which enables the bank to offer speedy funds transfer facilities to its customers. Multi-branch access is also provided to retail customers through the branch network and Automated Teller Machines (ATMs).

The Bank has made substantial efforts and investments in acquiring the best technology available internationally to build the infrastructure for a world-class bank. In terms of software, the Corporate Banking business is supported by Flexcube, while the Retail Banking business by Finware, both from i-flex Solutions Ltd (no.1 banking software in the world). The systems are open, scaleable and web-enabled.

**Among the first and only to offer netbanking, mobile banking, universal access, extended hours, large ATM network, electronic collection & payment gateways (bills, payrolls), etc. Key differentiators in India.**

**Lowest Funding Costs:** The technology driven customer service attracts a lot of deposits due to the services HDFC can offer being more leaner and technology driven.

**Focus on auto loans:** 2-wheeler and car loans are among the fastest growing

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segment. Likely to be the bank's largest retail loan segment in the near future.

**Expanding portfolio – home loans, possible merger with HDFC:** It has recently signed an MoU with HDFC for home loans. HDFC also has very well respected insurance, securities business (insurance with Standard Life). Will definitely leverage its distribution network.

**Geographic Expansion:** has gone from 60 cities 2 years ago to over 150 today. Critical as a lot of the untapped market is in the "heartland" of the emerging middle class, i.e., Tier II and Tier III cities.

### Market Growth:

Scheduled commercial banks touched, on the deposit front, a growth of 14% as against 18% registered in the previous year (2002-2003). And on advances, the growth was 14.5% against 17.3 % of the earlier year.

Retail finance business to grow at a **CAGR of 34% in FY2003-07**. ICICI and HDFC best positioned to take advantage. The retail loan portfolio of both these banks are expected by analysts to grow at an **annualised 45-60% over FY2003-07**. This would increase the share of retail loans in their asset books, contributing to a rise in the margins and RoEs of both.

*Could not get more product specific market information*

### Wholesale Banking

The Company's principal commercial banking products include **a range of financing products**, documentary credits (primarily letters of credit) and bank guarantees, foreign exchange and derivative products and corporate deposit products. **Its financing products** include loans and credit substitutes such as bills discounting, commercial paper and **other funded products**. **Its foreign exchange and derivatives products** assist corporations in managing their currency and interest rate exposures.

HDFC Bank's **principal transactional services include cash management services, capital markets transactional services and correspondent banking services**. The Company provides physical and electronic payment and collection mechanisms to a range of corporations, financial institutions and government entities. It was also **appointed by the government of India to collect direct taxes**. **The Company's capital markets transactional services include custodial services and stock exchange clearing bank services**. HDFC Bank provides custodial services primarily to Indian mutual funds. The Company is a clearing bank for seven major Indian stock exchanges, including the National Stock Exchange and The Stock Exchange, Mumbai. In addition, it provides correspondent banking services, including cash management services and funds transfers, to approximately 20 foreign banks and more than 900 cooperative banks.

### Retail Banking

The Company offers **an array of retail loans, including loans against securities, auto loans, personal loans and two-wheeler loans**. It offers loans against equity securities, mutual fund units and against bonds issued by the Reserve Bank of India (RBI) that are on its approved list. It offers auto loans at fixed interest rates for financing new automobile and used car purchases. HDFC Bank offers unsecured personal loans at fixed rates, repayable in equal monthly installments over a period of 12 to 60 months. It offers loans at fixed rates, repayable in monthly installments typically over a period up to 36 months for financing the purchase of new scooters or motor cycles.

**HDFC Bank offers business loans to address the borrowing needs of the trading community** typically around the bank branches by offering them various facilities like credit lines, term loans for expansion/addition of facilities, discounting of credit card receivables, letters of credit, guarantees and other basic trade finance products and cash management services. The Company also offers silver and gold credit cards and loans for commercial vehicles, construction equipment and housing.

The Company's individual retail account holders receive the benefit of a wide range of direct banking services, **including a free automated teller machine (ATM) card, access to its growing branch and ATM network**, access to its other distribution

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channels and eligibility for utility bill payment and other services. Its **retail deposit products** include current accounts, which are non-interest-bearing checking accounts designed primarily for small businesses; savings accounts, which are demand deposits in checking accounts designed primarily for individuals and trusts; fixed or time deposits, which pay a fixed return over a predetermined time period; special value-added accounts, which offer its customers added value and convenience, and e-broking accounts that are offered as checking accounts to customers of stock brokers where all transactions are routed electronically between the broker and beneficiaries. **It also provides international debit cards, bill payment services, individual depositary accounts, mutual funds sales, investment advice, Internet brokerage, credit cards, electronic data capture terminals and insurance.**

### Treasury

HDFC Bank's client-based activities consist **primarily of advising corporate and institutional customers and transacting spot and forward foreign exchange contracts, rupee-based derivatives and cross-currency derivatives.** The Company has been allowed to offer Indian rupee options and exchange traded futures to its clients. Its primary customers are multi-national corporations, large and medium-sized domestic corporations, financial institutions and public sector undertakings. It also advises and transacts with some small companies and non-resident Indians.

The Company trades spot and forward foreign exchange contracts, primarily with maturities of up to one year with its customers. To support its clients' activities, it is an active participant in the Indian inter-bank foreign exchange market. **HDFC Bank also trades to a more limited extent for its own account.**

HDFC Bank offers rupee-based interest-rate swaps, cross-currency, interest-rate swaps, forward rate agreements, options and other products. The Company is also engaged in proprietary trades of rupee-based, interest-rate swaps and uses them as part of its asset liability management.

**The Company's principal activity in the domestic money market and debt securities market is to ensure that it complies with its reserve requirements.**

These consist of a cash reserve ratio, which it meets by maintaining balances with the RBI and a statutory liquidity ratio, which it meets by purchasing Indian government securities. The Company also participates in the inter-bank call deposit market and is engaged in limited trading of other debt instruments, as well as trades a very limited amount of equities of Indian companies for its own account.

### Valuation

(Rs in Crores)

1\$ = Rs. 45.22

	Mar-2002	Mar-2001	Mar-2000	Mar-1999
Sales	1702.99	1259.46	679.87	376.08
Net profit	297.04	210.12	120.04	82.40
Return on networth(%)	20.81	25.25	22.02	26.41

### Quarterly Earnings

Quarter	Dec-2003	Sep-2003	Mar-2003	Dec-2002
Sales	658.30	640.24	557.22	504.86
Operating Profit	487.16	468.03	461.77	452.09
Other Income	121.09	86.26	128.85	141.42
Interest	303.98	302.44	310.80	300.02
Depreciation	0.00	0.00	0.00	0.00

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Tax	52.82	48.45	34.35	53.19
Net Profit	130.36	117.14	116.62	98.88

**Growth expectations:** HDFC Bank can be expected to grow around 30% for the next 3 year with even a slightly slower rate of economic growth. Growth rate could expand too if reforms package is put through.

**Low peg:** expected future growth rate far outweighs the PEG indicator of valuation.

**Low beta:** tremendous advantages for risk diversification.

**Dollar Depreciation:** My conservative guess would be 5-8% over next 1 yr.

**Target:** 1 yr target of \$38-42; if had more market information could have created a far more sophisticated model.

HDFC BANK LTD  
as of 18-Feb-2004



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### SWOT **Strengths**

Blue chip – excellent management and processes  
Cutting edge technology, at least by Indian standards

## **BLYTH FUND**

Lowest funding costs

Best access among Indian banks to capital markets

Very low beta

### **Weaknesses**

Scale, some state banks are larger – much larger though sitting targets right now

### **Opportunities**

Fast growing Indian economy and massive rise of middle class – the “**yuppification of India**”

Rapid expansion of distribution network and retail offerings

Merger with HDFC – some MoUs for products are in place; others emerging

Low beta

Low valuation

Depreciating dollar

### **Threats**

Miracle restructuring of state banks. Either that or they “go nuts” in trying to compete  
Indian Economic growth peters off.