

India Banks

A New (RBI) Mindset III – The Big Bang

- **It's now getting fairly radical** — The RBI has been pushing change since Governor Rajan took over (Sep 2013). Here's the big one: the RBI's made reserve requirement changes that should a) Facilitate an HDFC – HDFC Bank merger, sooner than later; b) Ease IDFC's conversion into a bank (beyond budget announcement); c) Provide incentives to banks for infra-lending, deepen the bond market; and d) Set the stage for differentiated bank licenses. There's fine print, clarifications needed and market challenges; but this should drive stocks of IDFC, HDFC & HDFC Bank, LICHT and the sector, and we remain positive & OW banks.
- **The change** — An aggressive budget and credit policy follow-through: a) Banks entirely exempt from onerous reserve requirements (27%) & priority sector lending, for Infra-financing & affordable housing (new); b) Benefit phased in for existing assets (6 years), but if assets taken over (HDFC-HDBK, IDFC), then with RBI permission, could be exempt; c) More flexibility on longer-term lending structures. This should start changing the structure & the mindset of India's banking structure.
- **HDFC/HDFC Bank merger - this could be the beginning** — The merger logic has always been strong: a) Business & brand synergy; b) Capital efficiency (HDBK planning a raise & HDFC surplus), and c) Scale & some costs. The push-back so far: poor merger economics (high CRR/SLR), and new rules should address it (estimate 8-10% CRR/SLR, lower than management's 15% threshold). It's not done (regulatory fine print/interpretation, execution & market issues): do not expect a merger announcement near term; but we believe the path's set. Both HDBK & HDFC should react positively, there's little obvious arbitrage between them. We raise Target Prices 10% each – factoring in a merger premium. Maintain Neutral.
- **IDFC - almost no conversion pain** — The rules could suggest (with RBI's permission) that in IDFC's bank conversion: a) almost no reserve needs on existing funds and b) limited need for priority sector lending. If so, it materially eases IDFC's bank conversion (funding, cost, and BS contraction) challenges, and goes beyond the budget announcement. We maintain a Buy, and raise our Target Price to Rs175.
- **There's something, but less, for the rest** — Most infra/mortgages get a break incrementally: but existing books should only see this full phase in over 6 years. A positive – SBI, Axis, & ICBK should be the big gainers – but gains only phased in.
- **But plenty of challenges (market/funding/pricing); will take time, and be tough** — There are real market / transition challenges. The biggest: infra/housing loans have to be funded by 7yr+ unsecured debt - it's a small market, costs will rise (could get unsettled with large supply), with an uncertainty in funding / lending market dynamics. That said, it eases regulatory burdens, transitions of IDFC & the HDFC group, boosts the sector. Please also see [A new Mindset](#), [A New Mindset II](#).

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Data Summary

Company	Ticker	Rating		Target Price		Current Year Earnings Estimates	
		Old	New	Old	New	Old	New
HDFC Bank	HDBK.BO	2	2	Rs830.00	Rs910.00	Rs34.64	Rs34.64
HDFC	HDFC.BO	2	2	Rs1,000.00	Rs1,100.00	Rs36.79	Rs36.79
IDFC	IDFC.BO	1	1	Rs135.00	Rs175.00	Rs13.27	Rs13.27

HDFC-HDFC Bank Merger: Now on the table

This is how they stack up: well, both high quality and high return, and little to choose between them

Figure 1. HDFC vs. HDFC Bank Comparison – Ready Reckoner

	HDFC Ltd	HDFC Bank
ROAE (% FY14)	20.6	21.3
ROAA (% FY14)	2.6	1.9
EPS growth (3 yr)	13%	28%
NIMs (bps)	410	437
CIR	9%	46%
Loan growth (3 year)	18.9%	23.9%
Gross NPLs (%)	0.7	1.0
Net NPLs (%)	-	0.3
Tier I (%)	12.1	11.8
Total capital (%)	14.6	16.1
Branches	354	3,403
Foreign shareholding	77.7%	51.2%
- o/w FII	77.4%	33.9%
Market Cap (USD m)	25,453	33,023

Source: Citi Research, Company

Their businesses are different, but can become pretty complementary

Figure 2. HDFC vs. HDFC Bank – Loan Split

HDFC Ltd	Rs m	% of total	HDFC Bank	Rs m	% of total
Individual Loans	1,332,810	68%	Retail Banking	1,496,740	49%
			- o/w Mortgages	193,020	
Corporate Loans	616,250	31%	Corporate Banking	1,533,263	51%
Total	1,971,000		Total	3,030,003	
Deposits	565,780		Deposits	3,673,375	

Source: Citi Research, Company

If the market were to position for a merger... there's little to choose between them on valuations...absolute, or relative to history

Figure 3. HDFC*: 1 year forward P/B



Source: Citi Research, DataCentral *Standalone entity

Figure 4. HDFC Bank: 1 year forward P/B



Source: Citi Research, DataCentral

And if you think the market has caught onto this rising possibility of a merger over the last six months....then it's valuing them fairly similarly

Figure 5. Stock performance - HDFC vs. HDFC Bank

	1 month	3 months	6 months	1 year	3 year	5 year	10 year
HDFC Ltd	0.3%	12.8%	14.6%	14.9%	41.3%	106.0%	787.1%
HDFC Bank	-1.6%	13.7%	22.8%	18.5%	61.6%	197.8%	1022.8%
BSE Sensex	0.0%	13.2%	18.6%	25.9%	35.9%	77.0%	409.5%

Source: Citi Research, Data Central

Long-term bonds for Infrastructure Financing

Key Features

- Bonds can be issued for the purpose of lending to both Infrastructure as well as affordable housing sectors (New). These will not have any reserve requirements against them (CRR/SLR = 27% of net deposits)
- There will be no priority sector lending targets against these bonds (otherwise, 40% of loans)
- This will apply for incremental loans
- If assets acquired from other banks, then based on specific approval, could be eligible for exemptions (IDFC, and HDFC could become eligible on their existing books)
- Minimum maturity of 7 years (a challenge)
- Unsecured, denominated in INR (a challenge)
- The definition of affordable housing expanded substantially, and given as
 - Housing loans eligible for Priority Sector Lending (PSL) as defined by the RBI
 - Housing loans < Rs5.0m for houses of values up to Rs6.5m located in six key metropolitan cities
 - Loans < Rs4.0m for houses of values up to Rs5.0m in other centers for purchase/construction of dwelling unit per family
- No restriction on the quantum of bonds issued by banks
- Plain vanilla in nature (no put/call option)
- Cross holding among banks for these bonds will not be permitted

Flexible Structuring of Long-term Loans to Infrastructure & Core Industries

Key Features

- Banks encouraged to extend loans to projects with high repayment periods (25+ yrs)
- Loans will be refinanced every five years or so
- RBI has not prescribed any upper or lower limits on tenures of these loans

- Refinancing such loans under the takeout financing route will not be considered restructuring
- Banks can offer the IDF (Initial Debt Facility) for these projects for the medium term (5-7 years) to take care of construction/revenue ramp up. This will then be refinanced
- If the IDF or the refinanced debt becomes an NPA, further refinancing stops
- Pricing cannot be below the base rate of banks at any stage of the financing

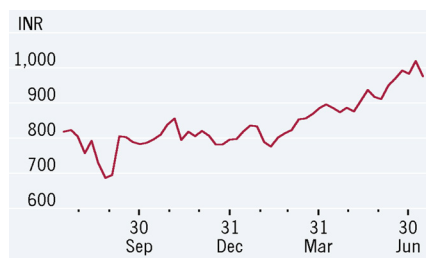
Company Focus

■ Target Price Change

Neutral	2
Price (15 Jul 14)	Rs976.65
Target price	Rs1,100.00
from Rs1,000.00	
Expected share price return	12.6%
Expected dividend yield	1.7%
Expected total return	14.3%
Market Cap	Rs1,530,361M
	US\$25,453M

Price Performance

(RIC: HDFC.BO, BB: HDFC IN)



Housing Development Finance (HDFC.BO) Raise Target Price to Rs1,100

- We raise our Target Price of HDFC to Rs1,100. Our Target Price is based on a sum-of-the-parts valuation with the parent valued at 3.75x 1 year fwd PBV (Rs631). We value the subsidiaries at Rs369 and now add a 10% premium to factor in potential merger synergies with HDFC Bank.

Figure 6. HDFC – Sum of the Parts Valuation

HDFC Business	Total Value, Rsm	Value per share, Rs	Basis of valuation
Life Insurance	99,032	63	Valued at 12x 1Yr Fwd NBAP; and 2X Embedded Value
Asset management	58,190	37	6% of AUMs
Non-life insurance	5,061	3	Valued at 1.5x PBV
Alternative Asset Management	4,357	3	8% of AUMs
Gruh Finance	47,379	30	Valued at market price
Associate Bank- HDFC Bank	425,089	272	Valued at HDFCB market price
Total Subsidiary value (with 10% holding discount)	639,107	369	
HDFC Value	984,676	631	3.75x PBV FY14 - after adjusting for investments in subsidiaries.
SOTP Value	1,623,783	1000	
Merger premium		100	10% potential merger premium
Total Value		1100	

Source: Citi Research

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2012A	41,226	27.57	15.8	35.4	7.6	22.7	1.1
2013A	48,874	31.23	13.3	31.3	6.0	22.2	1.3
2014E	57,577	36.79	17.8	26.5	5.4	21.7	1.5
2015E	67,697	43.26	17.6	22.6	4.7	22.6	1.7
2016E	79,337	50.70	17.2	19.3	4.1	23.2	1.9

Source: Powered by dataCentral

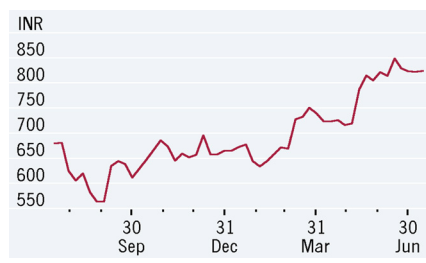
Company Focus

HDFC Bank (HDBK.BO) Raise Target Price to Rs910

■ Target Price Change

Neutral	2
Price (15 Jul 14)	Rs824.25
Target price	Rs910.00
from Rs830.00	
Expected share price return	10.4%
Expected dividend yield	1.0%
Expected total return	11.4%
Market Cap	Rs1,985,522M
	US\$33,023M

Price Performance (RIC: HDBK.BO, BB: HDFCB IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2012A	51,671	21.94	29.8	37.6	6.5	18.7	0.5
2013A	67,263	28.21	28.6	29.2	5.4	20.3	0.7
2014E	83,482	34.64	22.8	23.8	4.6	21.2	0.8
2015E	104,296	43.10	24.4	19.1	3.9	22.3	1.0
2016E	129,214	53.39	23.9	15.4	3.2	23.1	1.1

Source: Powered by dataCentral

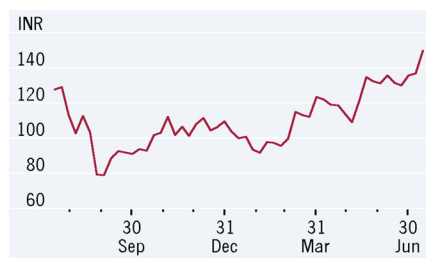
Company Focus

■ Target Price Change

Buy	1
Price (15 Jul 14)	Rs149.95
Target price	Rs175.00
from Rs135.00	
Expected share price return	16.7%
Expected dividend yield	2.0%
Expected total return	18.7%
Market Cap	Rs227,450M
	US\$3,783M

Price Performance

(RIC: IDFC.BO, BB: IDFC IN)



IDFC (IDFC.BO)

Raise Target Price to Rs175; Maintain Buy

- We raise our Target Price for IDFC to Rs175. Our valuation is based on a sum-of-the-parts methodology. We value IDFC's core lending business at Rs155 per share, which is benchmarked at a P/BV multiple of 1.5x 1yr-fwd BV (Sep'15E). We have raised our target multiple from 1.2x previously to factor in 1) the value to accrue from its transition into a bank and 2) recent regulatory announcements that ease their transition by lowering the reserve/PSL requirements. We ascribe a total value of Rs20 to IDFC's subsidiaries.

Figure 7. IDFC – Sum of the Parts Valuation

IDFC Business	Total Value, Rsm	Value per share, Rs	Basis of valuation
Asset Management - PE	4,198	3	5% of AUMs
Asset Management - AMC	12,236	8	4% of AUMs
Other Investment Value	4,955	3	1.1x P/BV
NSE stake	6,881	5	Last transaction value
SSKI Stake	860	1	12x 1Yr Fwd PE
Total Subsidiary value	29,129	20	
IDFC	234,752	155	1.5x PBV 1Yr fwd - after adjusting for investments in subsidiaries.
Total Price	263,882	175	

Source: Citi Research

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2012A	15,540	10.28	17.1	14.6	1.8	13.2	1.5
2013A	18,362	12.12	18.0	12.4	1.7	14.1	1.7
2014E	20,094	13.27	9.4	11.3	1.5	13.9	1.8
2015E	22,187	14.65	10.4	10.2	1.3	13.8	2.0
2016E	25,598	16.90	15.4	8.9	1.2	14.3	2.0

Source: Powered by dataCentral

Housing Development Finance

Company description

HDFC was set up in 1978 and today is India's premier housing-finance company with around 25% market share in mortgages and a loan book of ~Rs2trn as at FY14. It has had strong asset quality and gross NPLs of below 1% for several years. The company has more than 300 offices and 90 outreach programs. HDFC has strongly positioned itself across the banking and financial-services space. It has a commercial bank (23% ownership), and has subsidiary businesses in life insurance, non-life insurance, and asset management.

Investment strategy

We rate HDFC Neutral. It offers exposure to the high-growth mortgage market in India and to market leadership through its associates and subsidiary companies in commercial banking, life insurance and asset management. We believe HDFC is in a sweet spot strategically, structurally and cyclically, and the environment remains supportive. There is also some leverage to the market, coming from its subsidiaries. The stock's valuation framework is high; however, we see potential upsides resulting from a likely future merger with HDFC Bank.

Valuation

Our target price of Rs1,100 is based on a sum-of-the-parts valuation, reflecting the significant and diverse values of its subsidiaries. We value the parent HDFC business at 3.75x PBV (long-term average), HDFC Bank at current market price, the life-insurance business at 15x NBAP or 2x embedded value (slight premium to sector benchmarks to reflect return to profitability), and the asset-management business at 6% of assets (peer-group multiple) - all benchmarked off Sep'15E. HDFC has always traded at a premium owing to its high quality and credible management. We add a 10% potential merger premium to our SOTP value, to factor in synergies from a likely merger with HDFC Bank.

Risks

The key downside risks are primarily external in the form of aggressive and disruptive price competition, a challenging and unstable interest-rate environment, regulatory and policy changes, and market dislocations. Potential business risks are asset deterioration, mismatches and operational risks. Key upside risks to our recommendation and target price are a better competitive environment and its business impact on expanding margins and profitability, consequently.

HDFC Bank

Company description

HDFC Bank, which began operations in 1994, is 23%-owned by HDFC - India's premier mortgage-finance institution. HDFC Bank has a network of more than 3,400

branches and more than 11,000 ATMs in 2100 cities. HDFC Bank has had strong and steady growth over the past 10 years and continues to grow at more than 25%. HDBK is now the second-largest private sector bank in India, by a relatively large margin.

Investment strategy

We rate HDFC Bank as Neutral. HDBK has now been through a couple of business cycles, and has distinguished itself consistently. We believe its relative value is most obvious in challenging times, though its current valuations are high. However, we do expect potential upsides from a likely future merger with HDFC Ltd. given recent regulatory announcements on exemption of SLR/CRR requirements on low-cost housing loans. We expect HDFC Bank to trade in the 3-4x P/BV band over the longer term, the middle of its long-term trading band. We are positive on the bank's prospects and management's ability to deliver, and believe it stands out relative to peers in the currently challenging environment.

Valuation

Our target price of Rs910 is based on a 3.6x P/BV Sep'15E, with a 10% valuation premium added to factor in a potential merger with HDFC Ltd in the future and resultant synergies. HDBK's valuation target multiple is a premium to almost all other Indian commercial banks, but is justified, we believe, by HDBK's structurally higher margin, de-risked earnings and balance sheet mix, as well as by gains in the consumer-lending franchise.

Risks

The key downside and upside risks to our target price lie in: (1) any negative/positive news on asset quality; (2) potential management changes; (3) emergence of high quality and scale competitors; and (4) changing risk perceptions of private banks. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

IDFC

Company description

IDFC was established in 1997 as a specialized Infrastructure financier / advisor and to encourage private sector investments in the infrastructure sector. It has been actively associated with the government in policy formulation, and has probably the foremost set of skills in this space. It enjoys a central positioning as amongst the forerunners on the policy advisory space in infrastructure and is seen as the preferred investor, lender and advisor. Though IDFC has diversified its product offerings to include non-fund based products, asset management and private equity along with debt finance and syndication opportunities, the lending business remains its key operational focus. It was one of two entities to receive a banking license from the RBI this year, and is in the process of transitioning into a bank.

Investment strategy

We rate IDFC shares a Buy. IDFC was one of two participants to receive a banking license this year, and is currently transitioning into a bank. We believe IDFC has a quality management team, and offers long-term growth potential. However, it does face cyclical challenges on - a) Growth in its core lending business (policy and approval delays, fuel availability); b) Likely asset quality concerns - especially in the

power segment (30-40% of exposure), though IDFC has high coverage levels; c) Competitive and profitability pressures in the capital market-related businesses; and d) Execution challenges in transitioning into a bank. We believe some of these challenges can ease in the event of a better interest rate and macro environment, though still linked to a turnaround in execution in the infrastructure and power segments.

Valuation

We value IDFC at Rs175 based on our sum-of-the-parts methodology. We value IDFC's core lending business at Rs155 per share; we prefer a P/BV multiple of 1.5x 1yr-Fwd BV (Sep'15E) benchmarked at the lower band of private banks' target P/BV multiples, given its sub-15% core ROE. We raise the multiple from 1.2x previously, to factor in the value and superior return profile accruing from its future banking transformation. We value the asset-management business as a percentage of assets and value this business at Rs12 per share sub-divided into Rs3 for the private equity segment (5% of AUMs) and Rs9 for the domestic AMC business (4% of AUMs). We value IDFC's broking and investment banking business at Rs1 per share based on 12x 1yr Fwd profits. Finally, we also add Rs8 for IDFC's investment portfolio including the NSE (valued in line with the last reported transaction).

Risks

Key downside risks that could restrict the stock from achieving our target price are: a) Sharp increases in interest rates; b) Significant slowdown in infrastructure growth and asset quality; c) Continued softness in capital markets for a relatively longer period; d) Regulatory changes and a higher tax rate.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

IDFC (IDFC.BO)

Ratings and Target Price History Fundamental Research

Analyst: Aditya Narain, CFA
Covered since December 4 2012



	Date	Rating	Target Price	Closing Price
1	28-Jul-11	1M	*154.00	129.50
2	26-Sep-11	1M	*135.00	109.10
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	135.00	116.10

* Indicates change

	Date	Rating	Target Price	Closing Price
5	13-Feb-12	1	*164.00	133.15
6	29-Oct-12	1	*196.00	158.80
7	23-May-13	1	*210.00	154.30
8	30-Jul-13	1	*155.00	113.40

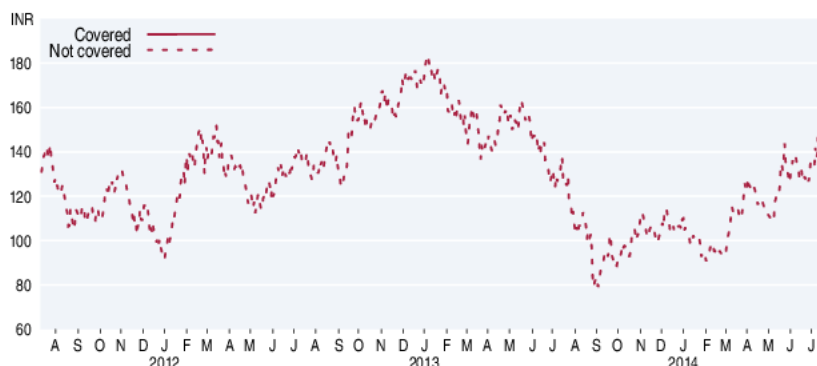
	Date	Rating	Target Price	Closing Price
9	4-Dec-13	1	*160.00	105.70
10	3-Feb-14	1	*135.00	90.70

Rating/target price changes above reflect Eastern Standard Time

IDFC (IDFC.BO)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Aditya Narain, CFA
Covered since December 4 2012



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Housing Development Finance (HDFC.BO)

Ratings and Target Price History Fundamental Research

Analyst: Aditya Narain, CFA



	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	2-Nov-12	*1	*860.00	767.00

* Indicates change

	Date	Rating	Target Price	Closing Price
3	23-May-13	*2	*940.00	902.95
4	6-May-14	2	*1,000.00	876.00

Rating/target price changes above reflect Eastern Standard Time

Housing Development Finance (HDFC.BO)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Aditya Narain, CFA



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

HDFC Bank (HDBK.BO)

Ratings and Target Price History Fundamental Research

Analyst: Aditya Narain, CFA

Covered since March 26 2012



	Date	Rating	Target Price	Closing Price
1	20-Jul-11	2L	*535.00	502.95
2	26-Sep-11	2L	*500.00	450.00
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*2	500.00	450.00

* Indicates change

	Date	Rating	Target Price	Closing Price
5	26-Mar-12	2	*550.00	508.50
6	16-Jul-12	2	*620.00	582.15
7	10-Oct-12	2	*645.00	617.70
8	21-Jan-13	2	*690.00	656.00

Rating/target price changes above reflect Eastern Standard Time

	Date	Rating	Target Price	Closing Price
9	23-May-13	2	*750.00	698.70
10	23-Apr-14	2	*830.00	736.80

HDFC Bank (HDBK.BO)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Aditya Narain, CFA

Covered since March 26 2012



	Date	Rating	Target Price	Closing Price
1	20-Oct-11	*ADD LP	-	490.55
2	9-Apr-12	*REM LP	-	524.95

* Indicates change

	Date	Rating	Target Price	Closing Price
3	30-Jun-12	*N	-	562.65
4	23-Oct-12	*ADD LP	-	634.50

	Date	Rating	Target Price	Closing Price
5	31-Oct-13	*REM LP	-	679.00

Rating/target price changes above reflect Eastern Standard Time

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of HDFC Bank Ltd

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Citi Research Equity Ratings Distribution

Data current as of 30 Jun 2014

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Research Global Fundamental Coverage	49%	40%	12%	0%	100%	0%
% of companies in each rating category that are investment banking clients	55%	53%	46%	0%	54%	0%

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