

HDFC Bank is Overvalued at Rs 1100/share

Share price of HDFC Bank has fallen substantially from its peak level of more than Rs 1800. In our opinion the share price is still more than 30 % higher than its upper level of valuation band of Rs 700-800. With inflation running at a four year high and turmoil in global financial sector we believe that the premium is not quite deserved. Even though HDFC Bank has probably the best risk management among all banks in India and after April 2009 foreign banks can take 74 per cent stake in Indian banks (implying a takeover premium) the long term holders should avoid buying the share till it gets into its valuation band.

The primary reason we think that the shares are overpriced is because of its low return on net worth. For last three years the return on net worth has been between 15-19% based on accounting standards used by banks. In our opinion the real return on net worth has been lower than stated by 10 per cent, because of lower profits but more about that later. The pay out ratio has been close to 25 per cent, including the tax paid on dividend. So if the bank is not raising any extra capital, each year it has about 15 per cent of capital more compared to last year. In that situation the banks earnings per share can grow by 15 %, or less. That would be disappointing for a share priced at 25 times trailing twelve months earnings.

HDFC Bank's management had a decent solution for this problem. They issued shares, largely ADRs at high prices. Typically the Bank had a capital base of Rs 100 on which it earned and retained Rs 15. So from operations it had a capital of Rs 115. At the same time ADRs were trading at Rs 500 or so (in rupee terms). The bank issued 10 per cent of equity to new ADR holders raising a total of Rs 50. So instead of Rs 115 it had Rs 165. While the equity base was increased only 10 per cent the capital base increased by more than 40 per cent. So even if the return on net worth was 15 per cent the earnings per share grew by close to 25 per cent. This process was again repeated after couple of years. This process had been easy in last 5 years as share prices increased, more shares were issued and earnings per shares rose rapidly which lead to even higher share prices. However all good things end. This is no different. The last time ADRs were issued at 92 USD in mid of last year. Now the ADRs are at 85 USD. It is not possible for HDFC Bank to issue new ADRs at lower price. When no new shares are issued the amount of capital is bounded by return on net worth of the Bank. That means earnings cannot grow faster than 15 % once the effect of capital raising wears off. Slow growth of earnings would cause the share prices to fall further making capital raising even more difficult.

The stated earning per share for HDFC Bank is close to Rs 45. However, if one takes fair valuation norms for stock options the earnings falls to Rs 40. In our opinion stock options are a clear cost for the company's shareholders. As the number of shares increase, the earnings gets divided amongst larger number of shares which is clear dilution of earnings potential hence a cost. Once the share prices stagnate the Bank would have to increase the cash compensation because the ESOPs which had been so profitable for employees would no longer be so. Also as share issuance against ESOPs would decrease. The Bank would be deprived of another source of capital that had been so plentiful when share prices had been increasing. ESOPs served dual purpose. It reduced the cash compensation and it provided capital to the Bank. Elimination of this source would be another reason to expect slower growth.

Now the Bank is expanding into rural and semi urban areas. The returns in these areas would be much worse than compared to returns in metros as well as mini metros. This has been true for banks all over world and India. HDFC Bank's experience would be no different.