INDIA RESEARCH

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Indian Banks

Sector update: PSU banks…Passing the baton!

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PSU banks, given their bond proxy nature, have outperformed the Sensex (60-100% over July-Dec '08) and private peers (20-40% vs Sensex) in a declining interest rate environment. As G-Sec yields have dropped 315bp to near all-time lows of 5.5% and the inverted curve has normalized, we see limited decline from here. This implies peaking out of bond gains and MTM write-backs for PSU banks in the current quarter. With other sources of credit drying up, banks have been enjoying a virtual monopoly – and pricing power – in Q3FY09. Core income is currently going strong with banks sustaining higher loan yields while optically cutting PLR rates and hiking fee income rates. In effect, core income for PSU banks would peak in Q3FY09 with some spillover in Q4FY09. Subsequently, we expect a marked change as credit growth tapers in a slowing economy and improving liquidity leads to lower lending and borrowing rates (reflected in easing corporate bond yields). While the period of good news for PSU banks may be approaching the fag end, private banks are increasingly better-poised on the back of declining wholesale borrowing costs and easing liquidity. We remain Overweight on Financials, but believe the tide would turn in favour of private banks over the next few quarters. We recommend PARTIAL trimming of PSU bank weights and advocate building positions in private banks like ICICI Bank and Axis Bank. ICICI Bank will be a key beneficiary as its wholesale borrowing costs are down 300-400bp (CD rates off 600bp+ from the peak), and imply margin expansion even as lending rates are trimmed. With lower exposure to sensitive sectors and corporates, the bank also scores higher on asset quality front. We favour Axis Bank given its strong liability franchise, high RoE and earnings potential as also a likely positive surprise on asset quality. Current valuations of ICICI Bank and Axis Bank offer an attractive entry point.

IS THE PSU BANKS PARTY NEARING AN END?

- **Good news largely priced in**

Large PSU banks have outperformed the Sensex and their private counterparts since July 2008 on the back of expectations of sustained decline in G-Sec yields. At 0.8-1.1x FY09E adjusted book, we believe the market is already pricing in a blockbuster quarter ahead for PSU banks.

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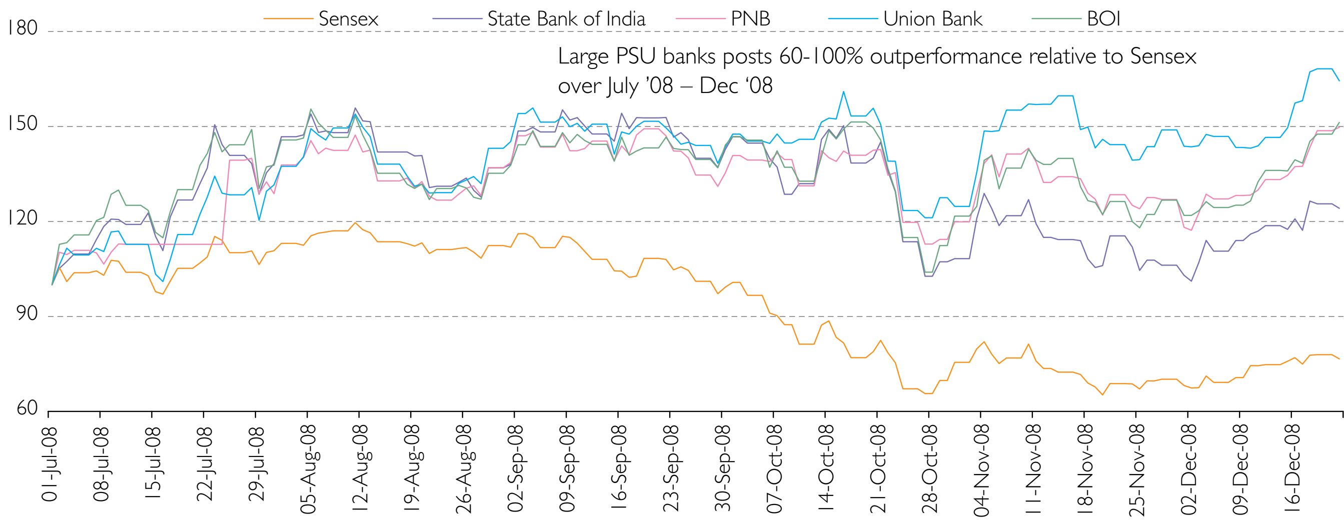
Exhibit 1: PSU banks outperform the Sensex (all rebased to 100)



Source: Bloomberg; Note: Rebased to 100 over price as of 1st July'08

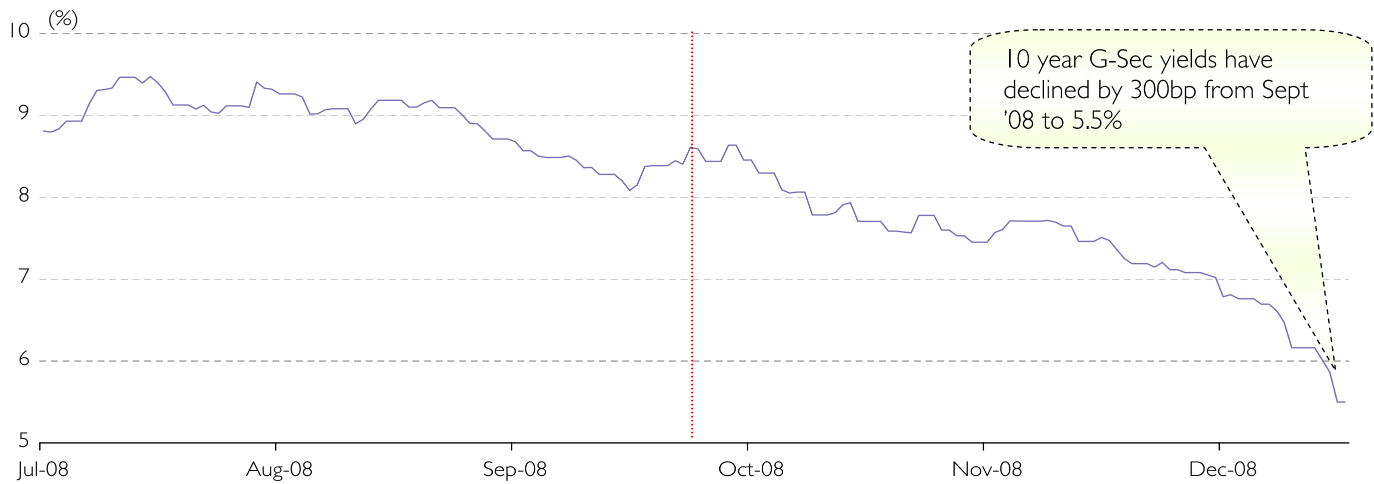
As G-Sec yields have declined sharply by 315bp to near all-time lows of 5.5% and the inverted curve normalized during the period, a sharp decline is unlikely in G-Sec yields from these levels. With the best returns from Gilts behind us, bond gains and MTM write-backs would peak for PSU banks in Q3FY09. At the same time, the period of good news for PSU banks has come to the fag end.

❑ Q3FY09 – a blockbuster quarter ahead for PSU banks

Large PSU banks are well poised to report blockbuster numbers in Q3FY09 given the multiple levers at play including strong volume growth, steady margins, robust fee income growth, significant MTM depreciation write-back and possible treasury gains. We have used State Bank of India (SBI) as a proxy for large cap PSU banks. While the SBI management has guided for ~30% net profit growth in FY09, other large PSU banks too are guiding for strong profit growth.

- **Robust NII performance buoyed by credit momentum and steady margins:** NII performance is expected to be robust in H2FY09 on the back of: (i) strong loan growth for the sector (with large PSU banks at the forefront) and; (ii) steady margins as unwind in CRR and SLR ratios as also improvement in CD ratio over-ride the impact of PLR cut and elevated deposit costs. Albeit, SBI's credit growth is indicated to have seen some moderation from previous aggressive levels (in the wake of liquidity crunch and elevated interest rates), but lending to mid-corporates and SMEs continues to be strong at ~30% yoy and ~47% yoy growth respectively. We expect SBI's margins to remain steady sequentially in Q3FY09 (2.7-2.8% on a calculated basis).
- **Strong fee income growth:** As banks continue to charge higher rates for LCs and guarantee business, we expect fee income growth to be strong in H2FY09, further buoyed by sustained credit momentum. Pricing power and strong credit growth would enable SBI to report a strong fee income growth of 30%+ in Q3FY09.
- **PSU banks riding the only asset class in a bull run:** G-Sec yields have declined sharply by 315bp over Sept-Dec '08 to near all-time lows of 5.5% and the inverted curve has normalized.

Exhibit 2: 10 – year G-Sec yields on a secular down-trend



Source: Bloomberg

1. **Time ripe for treasury gains:** While equity markets are jittery world-over, government securities have been the only asset class in a rally. This has presented an attractive opportunity for Indian banks to book treasury gains (~30% of their balance sheets in government bonds) – thereby providing another catalyst for near-term earnings performance.
2. **Significant MTM depreciation write-back in the offing:** Due to high yields prevailing in the system during Q1FY09, large PSU banks had incurred MTM depreciation amounting to 20-40% of PBT in H1FY09. SBI incurred high MTM depreciation of Rs16.57bn, out of which Rs7.84bn was attributable to MTM on Rs100bn government bonds issued as a part of rights offering during Q4FY08. Subsequently in Q2FY09, the bank booked a write-back of Rs4.8bn. On an aggregate basis, MTM depreciation is ~20% of SBI's PBT in H1FY09.

   G-Sec yields have sharply moved southward since Sept '08 with 10 year G-Sec yields falling from 8.6% to 5.5%. Although status of government bonds (bank's plea to consider as part of HTM to ward-off vulnerability to yield movements) remains under consideration, the decline in G-sec yields through YTDQ3FY09 would bolster near-term earnings. With ~41% of SBI's investment book in the AFS category (duration of ~2.7 years), MTM write-back on G-Sec book is expected to be Rs10bn-15bn, also bolstered by MTM write-backs on corporate bond book. However, equities book may result in some incremental MTM hit.

- **NPLs to remain stable in the near term:** While NPLs are expected to rise in the context of the economic slowdown and elevated interest rates, it would take 12-18 months for the adverse impact to manifest. In effect, credit costs would remain under control in Q3FY09. In H2FY09, SBI's Gross NPLs are expected to remain within the 2.5-3.0% band, as against 2.5% as of Sept '08.

❑ What lies in the quarters ahead?

With aggressive monetary easing (to prime the economy) coming to an end, a challenging scenario is likely to emerge for PSU banks as pressure on margins, vulnerability to MTM depreciation (rising yields) and asset quality issues begin to manifest.

- **Pressure on margins…as PLR cuts get priced in:** We expect sector credit growth to slow down to 17-18% in FY10 from 20-25% currently and SBI's credit growth to moderate from ~30% to 20-25%. On the other hand, deposits would continue to grow at robust rates given the flight to safety in the system, in turn implying deterioration in banks' CD ratios. Also, the price of credit would initially crash for top corporates and then for mid-corporates, which would take away banks' current supernormal profits. Subsequently, as the full impact of PLR cuts plays out, margins may decline by 15-25bp in Q4FY09 over Q2FY09 and would remain under pressure in FY10 as well.

- **Vulnerable to MTM hit…as yields bottom out:** We expect G-Sec yields to begin rising again in H1FY10 as at~5%, they are nearing the historic low for 10 year G-Sec yields. There are significant impediments for yields to fall materially below these levels, such as (i) a sustained deflationary scenario setting in, and; (ii) an outsized government deficit in FY10 on the back of compulsions to provide tax sops and sustain government spending to prime the slowing economy. In a rising yield environment, large PSU banks are vulnerable to MTM depreciation given their larger AFS proportion. SBI currently has ~40% of its investment book in AFS.
- **Asset quality pressures would emerge:** Banks have not yet experienced a rise in NPLs and we do not expect the asset quality problem to be acute. Also, the at-the-margin scenario is improving with interest rates turning benign. We have conservatively built in a 130% rise in Gross NPAs in FY10 over H1FY09 for our banking universe. Our conservative provision estimates impute Gross NPL of ~6% for SBI in FY10, a 140%+ rise from 2.5% currently.
- **Fee income growth to normalize:** Over past few years, robust fee income growth was primarily driven by strong credit growth, buoyant economic activity and significant pricing power. With economy on a slower growth trajectory and higher base effect of FY09 coming into play, we expect fee income growth to taper to normalized levels.

Core income is currently going strong with banks sustaining higher loan yields while optically cutting PLR rates and increasing fee income rates. In effect, core income for PSU banks would peak in Q3FY09 with some spillover in Q4FY09. Subsequently, we expect a marked change as credit growth tapers in a slowing economy and improving liquidity leads to lower lending and borrowing rates (reflected in easing corporate bond yields). Given the marked outperformance of the recent past, we believe there would be relatively limited upside for large PSU bank stocks.

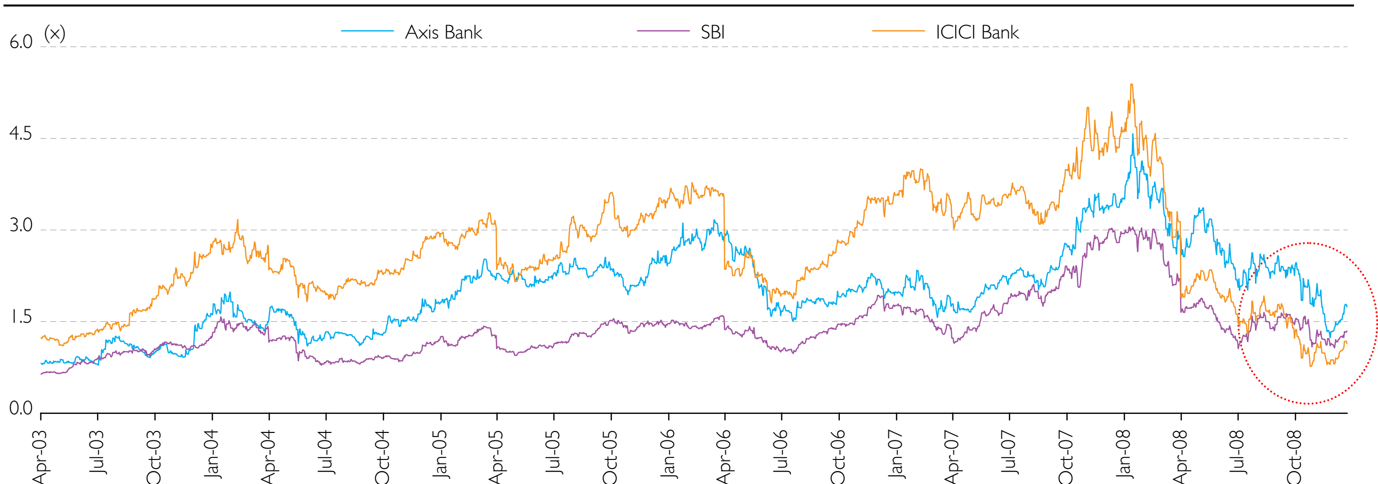
PRIVATE BANKS: ATTRACTIVE OPPORTUNITIES

We recommend PARTIAL trimming of PSU bank weights and advocate building positions in private banks like ICICI Bank and Axis Bank. ICICI Bank will be a key beneficiary as wholesale borrowing costs are down 300-400bp (CD rates off 600bp+ from the peak), and imply margin expansion even as lending rates are trimmed. With lower exposure to sensitive sectors and corporates, the bank scores higher on asset quality front. We also favour Axis Bank given its strong liability franchise, high RoE and earnings potential as also a likely positive surprise on asset quality. Current valuations of ICICI Bank and Axis Bank offer an attractive entry point.

❑ ICICI Bank/ Axis Bank – trading at lower band of historic P/BV

In the aftermath of the global financial crisis and asset quality fears, ICICI Bank and Axis Bank have seen significant correction in their valuations, and are currently trading at the lower-end of their historic P/BV bands. While multiples are due to compress from the peak, current valuations offer an attractive buying opportunity.

Exhibit 3: Private banks trading at lower-end of historic P/BV bands



Source: Bloomberg; Note: Price to book on last reported book value

❑ ICICI Bank – the worst seems to be over

- **Wholesale borrowing costs to decline:** CP and CD rates are on a declining trend with 3-month CD rates down 48% and CP rates down ~30% from the peak. ICICI Bank is among the largest beneficiaries of declining wholesale borrowing costs given the lower CASA proportion. Declining wholesale costs imply improving margins, even as lending rates are trimmed. While CASA has improved by 470bp yoy to ~30% as of Sept '08, the liquidity crunch of Sept-Oct '08 has hit retail deposits, but the deposit mix is returning to normalcy at a fast pace.
- **Loan growth tempered:** ICICI Bank has consciously slowed loan growth over the last three quarters (7-15% yoy growth as against 35-40% growth of past few years), while shifting focus on managing the liabilities side.
- **Asset quality scare limited…albeit some pressure on retail portfolio remains:** While Gross NPLs rose to ~4% as of Sept '08 from ~2% in FY06 on the back of increasing slippages in retail portfolio, ICICI Bank is better placed vis-à-vis peers with asset quality pressure brewing in the corporate portfolio of banks due to: (i) lower corporate exposure at 12-14% of total outstanding loan book; (ii) selective exposure to mostly AAA corporates; and (iii) limited exposure to sensitive sectors. We have conservatively built in a rise in NPLs to ~11% in FY10, which is highly unlikely as interest rates decline. This provides a significant cushion to our earnings estimates.
- **MTM problems behind:** The bank suffered an MTM hit on the overseas CDO/ CLN exposure and its overseas investments through Q4FY08-Q2FY09. The overseas CDO exposure has been sold off and losses booked, and change in UK regulation (investments virtually held to maturity) implies that impact of spread movements would be P&L- and balance sheet-neutral for the bank.

We expect the bank to deliver 6.4% CAGR in net profit over FY08-10; however, RoE would remain depressed at ~9% over FY09-10. The stock, currently trading at attractive valuations of 0.96x FY09E and 0.89x FY10E adjusted book, completely ignores the value of subsidiaries, which account for 30-40% of the bank's market cap.

❑ Axis Bank – steady performer

- **Sustained performance…a strong liability franchise:** Axis Bank has demonstrated strong operating performance (60%+ yoy growth in net profit over the last five quarters), even during the challenging operating environment. The bank's strong liability franchise (CASA ratio at ~40%) continues to compensate for the high borrowing costs, lending further credence to sustainability of strong NII performance in the quarters ahead. Further, the bank's diversified revenue streams would continue to bolster fee income performance.
- **Asset quality concerns overblown:** Axis Bank's Gross NPLs are at 0.91% as of Sept '08, with a provision coverage ratio of ~80%. We believe the bank could surprise positively on asset quality, but have nonetheless conservatively built in a substantial rise in gross NPAs to 2.9% in FY10 – around 90% CAGR in credit costs over FY08-10. We derive additional comfort from the bank's cautious loan growth posture in an environment of tight liquidity, elevated interest rates and a slowing economy.

Axis Bank currently trades at ~1.8x FY09 and ~1.6x FY10E adjusted book, which we believe does <u>not</u> fully capture the bank's high RoE and earnings potential. We expect the bank to report a 32% CAGR in earnings over FY08-10, and believe the market would soon start focusing on the earnings momentum as the bank surprises positively on asset quality.

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