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Change in Recommendation

Bank of India: Asset quality concerns easing; Upgrade to ADD

Updates

Banks/Financial Institutions: Business in a sweet spot, valuations not so

News Round-up

- ▶ L&T (LT IN) will spin off its financial services vertical into an independent entity under a separate holding company. The move is aimed at facilitating its application for a banking license when the opportunity arises. *(BSTD)*
- ▶ BPCL (BPCL IN) to venture into power. The company is likely to invest USD 130 - 217 mn in the project. The petroleum refining and marketing plans to invest USD 1.63 bn over the next four years in exploration and production. *(BSTD-Sun)*
- ▶ BPCL (BPCL IN) plans to invest USD 1.06bn in the next 5 years for expansion of refinery capacity, overseas acquisitions of oil & gas assets & setting up power projects. *(ECNT)*
- ▶ IVRCL infrastructures & Projects Ltd (IVRC IN) has bagged a project for four laning and improvement of Karanj-Wani-Ghuggus-Chandrapur road of Maharashtra State Highways No. 6-7 worth USD 163 mn. *(THBL SUN)*
- ▶ RBI may soon allow micro-finance institutions (MFIs) to set up banks, Finance minister says RBI will take the final call. *(ECNT)*
- ▶ BHEL (BHEL IN) in JV talks with SAIL, Vizag Steel. *(BSTD-Sat)*
- ▶ Tata Power (TPWR IN), Reliance Power (RPWR IN), GMR, GVK, Lanco and others, would have to go for a joint venture with the Nuclear Power Corporation to foray into nuclear sector. *(BSTD-Sun)*
- ▶ REC (RECL IN) targets USD 5.86 bn disbursement in 2010-11. REC is keen to foray into the banking sector in association with Power Finance Company and is awaiting policy clarity from the regulator. *(BSTD-Sun)*
- ▶ R-Power (RPWR IN) hastens coal tie-ups for Krishnapatnam power plant. The company is building railway infrastructure to transport coal from the mines, which are in South Sumatra, to the port. *(BSTD-Sun)*
- ▶ Reliance Infrastructure Ltd (RELI IN) will complete the process of raising a debt of about USD 1.82 bn by next month to execute its current portfolio of 11 road projects worth USD 2.61 bn. *(THBL)*
- ▶ Shipping Corp. (SCI IN) will spend around USD 4.3bn to buy 57 new vessels of which it will get delivery of 27 vessels by end of FY 12. *(ECNT-Sat)*
- ▶ Sun Pharma's (SUNP IN) board has approved splitting the company's shares in the ratio of 1:5 which would result in every equity share of INR 5 face value being divided into five shares of INR 1 a piece. *(ECNT-Sat)*
- ▶ Ranbaxy (RBXY IN) arm exits Orchid, sells 13% stake in tranches. Orchid promoters also increased stake sharply to 31% from 26% during the last few months by purchasing 5% from the open market. *(FNLE-Sat)*

Source: ECNT= Economic Times, BSTD = Business Standard, FNLE = Financial Express, THBL = Business Line.

EQUITY MARKETS

India	Change %			
	24-Sep	1-day	1-mo	3-mo
Sensex	20,045	0.9	11.4	14.1
Nifty	6,018	1.0	11.3	14.2
Global/Regional indices				
Dow Jones	10,860	1.9	7.0	7.1
Nasdaq Composite	2,381	2.3	10.6	7.1
FTSE	5,598	0.9	7.6	10.9
Nikkie	9,594	1.3	6.7	(1.5)
Hang Seng	22,351	1.0	8.5	8.0
KOSPI	1,857	0.6	7.4	7.3
Value traded – India				
Cash (NSE+BSE)	211		198	183
Derivatives (NSE)	1,451		1,323	1,548
Deri. open interest	2,137		1,978	1,647

Forex/money market

	Change, basis points			
	24-Sep	1-day	1-mo	3-mo
Rs/US\$	45.3	(40)	(166)	(124)
10yr govt bond, %	7.9	(8)	(21)	22
Net investment (US\$m)				
	23-Sep		MTD	CYTD
FIs	128		4,404	17,285
MFs	(61)		(575)	(282)

Top movers -3mo basis

Best performers	Change, %			
	24-Sep	1-day	1-mo	3-mo
BOI IN Equity	496.6	(0.5)	11.1	44.2
BHARTI IN Equity	368.2	3.6	16.5	40.0
TTMT IN Equity	1072.9	(0.1)	8.3	39.5
IDEA IN Equity	77.4	1.2	11.0	36.8
SBIN IN Equity	3141.4	0.1	12.4	36.5
Worst performers				
RNR IN Equity	39.9	1.5	6.8	(39.6)
MMTC IN Equity	1359.6	0.0	0.1	(15.9)
RCOM IN Equity	169.7	1.0	5.8	(11.8)
FTECH IN Equity	1223.0	(10.9)	(11.2)	(9.7)
HH IN Equity	1863.8	3.2	4.4	(9.4)

SEPTEMBER 24, 2010

CHANGE IN RECO.

Coverage view: **Attractive**

Price (Rs): **497**

Target price (Rs): **560**

BSE-30: **20,045**

Asset quality concerns easing; Upgrade to ADD. We upgrade BoI to ADD from REDUCE as we believe that recoveries/upgradations could beat expectations over the next few quarters and result in a favorable asset quality outlook having a positive impact on earnings. We raise earnings by 10% in FY2011E and 7% in FY2012E, with a higher probability of further increases as well. Stock trades at 1.5X FY2012 PBR and 8.5X PER with RoEs in the range of 19-20%. Expect earnings CAGR at 32% over FY2010-13E. We increase our TP to ₹560, valuing the stock at 1.8X FY2012E PBR.

Company data and valuation summary

Bank of India

Stock data		Forecasts/Valuations			
		2010	2011E	2012E	
52-week range (Rs) (high,low)	509-309	EPS (Rs)	33.1	54.5	62.0
Market Cap. (Rs bn)	261.1	EPS growth (%)	(42.1)	64.7	13.6
Shareholding pattern (%)		P/E (X)	15.0	9.1	8.0
Promoters	64.5	NII (Rs bn)	57.6	74.6	84.5
FIIIs	14.0	Net profits (Rs bn)	17.4	28.7	32.6
MFs	1.6	BVPS	243.4	284.5	331.1
Price performance (%)		P/B (X)	2.0	1.7	1.5
Absolute	1M 3M 12M	ROE (%)	14.2	20.7	20.1
Rel. to BSE-30	(0.2) 26.4 2.8	Div. Yield (%)	1.4	2.3	2.6

QUICK NUMBERS

- **Upgrading to ADD from REDUCE**
- **Revising TP to ₹560 from ₹ 460 earlier**
- **Doubling recoveries to 2% of loans**

Upgrade to ADD from REDUCE; concerns on asset quality subsiding

We are upgrading BoI to ADD as concerns over asset quality ease up. We believe lower slippages but higher recoveries (especially after a recent restructuring package for airlines) can result in lower-than-initial estimates on gross NPLs. We have revised our target price to ₹560 from ₹460 earlier, largely driven by better confidence on RoE. The stock is trading attractively at 1.5X FY2012 PBR, but our rationale for an ADD is based on improving asset quality, which we believe could result in better-than-expected earnings as well.

Asset quality to improve sharply driven by higher recoveries

We are factoring gross NPLs to decline to 2.1% in FY2012 from 2.7% reported in 1QFY11. We are increasing our recovery estimates (doubling to 2% of loans) and marginally tweaking downwards on our slippages assumptions. FY2010 saw 18% of the total slippages coming from aviation sector – recent press releases indicate that RBI has allowed for special dispensation package for airlines. Bank of India, which was amongst few banks to classify its airline exposure as NPLs (about Rs7bn), could see upgrades coming in 2QFY12. Such packages risk underwriting standards for the industry, however, it is a near-term positive for banks, especially BOI. Further, we also believe that BOI was very conservative in recognizing NPLs in FY2010, which could throw up positive surprises in FY2012.

Revising estimates upwards to factor higher recoveries

We have revised our estimates by 10% in FY2011 and 7% FY2012 on the back of lower loan loss provisions. We have reduced our loan loss provisions by 10 bps for FY2011 at 90 bps. We have increased our credit growth estimates to 21% CAGR for FY2011-12 and NIMs to see marginal improvement. We are maintaining cost-income ratio at about 42% levels but might need to increase it marginally as we get better clarity on the liability for second pension/gratuity (currently factoring 13% growth in employee expenses or 2% of net worth despite wage arrears fully factored in our earnings).

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Upgrading to ADD from REDUCE driven by lower asset quality concern

We are upgrading Bol to ADD as concerns of asset quality ease significantly. The lower slippages in 1QFY11 offer comfort but the recent announcement of a restructuring package for the aviation sector will result in sharp decline in gross NPLs, especially for Bol.

We have revised our target price to ₹560 from ₹460. However, we are upgrading to an ADD and not BUY as we see better opportunities in the sector. Union Bank of India at 1.4X FY2012 PBR delivering RoEs over 23% offers a good alternative to Bank of India which is currently trading at 1.5X FY2012 PBR and delivering 19% RoE.

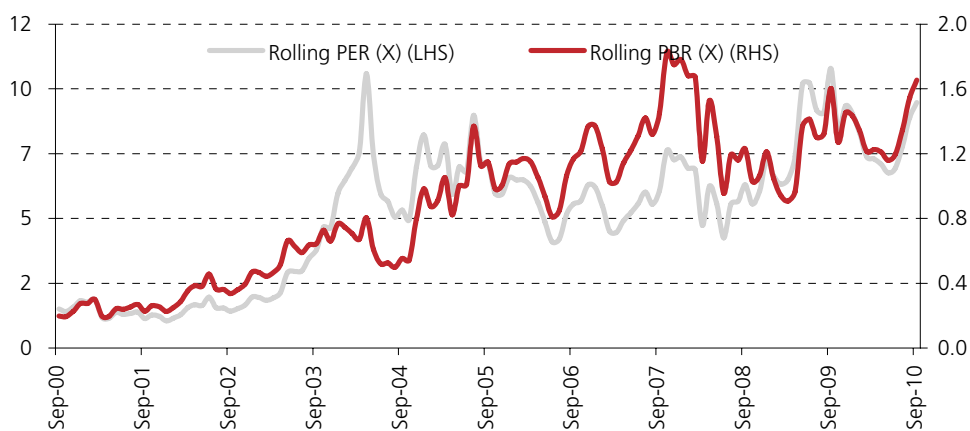
Valuations metrics across peers shows Bol trading relatively expensively

	Price (Rs)	Mkt Cap (USD bn)	EPS			PER (X)			BVPS (Rs)			PBR (X)			RoE (%)		
			2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E
PNB	1,271	9.0	124	133	163	10.4	9.6	7.9	524	626	750	2.5	2.1	1.7	26.2	23.2	23.7
Bol	499	5.8	33	50	61	15.0	9.9	8.1	243	281	327	2.0	1.8	1.5	14.2	19.0	19.2
BoB	734	7.1	84	89	112	10.5	9.8	7.8	376	446	535	2.3	2.0	1.6	24.4	21.7	22.8
Canara	479	5.2	74	84	103	7.8	6.8	5.6	309	381	470	1.9	1.5	1.2	22.4	20.9	20.9
Union	369	4.3	41	49	60	9.4	7.9	6.4	174	216	267	2.2	1.8	1.4	26.2	25.1	25.1

Source: Company, Kotak Institutional Equities

BOI valuation is not yet expensive

Rolling one year forward PBR and PER, March fiscal year-ends, September 2000-September 2010 (X)



Source: Kotak Institutional Equities

Selected financial parameters of peers

March fiscal year-ends, 1QFY11

	Loans (Rs bn)	Deposits (Rs bn)	CASA (%)	NIM (%)	CD Ratio (%)	Asset quality (%)				
						Gross NPA	Net NPA	Prov coverage (inc w/o)	Restructured assets/ loans	Slippages from restructured loans
PNB	1,969	2,553	40.9	3.9	77.1	1.8	0.7	77.6	6.6	8.0
Bank of India*	1,768	2,337	32.3	2.9	69.4	2.7	1.2	68.3	5.7	16.7
Bank of Baroda*#	1,856	2,547	35.2	2.9	69.2	1.4	0.4	85.7	2.8	9.0
Canara Bank	1,693	2,389	29.0	3.0	70.9	1.5	1.0	78.0	5.1	
Union Bank	1,247	1,715	32.6	3.0	72.7	2.2	0.9	71.1	4.0	13.6

Note:

(1) * Domestic deposits and advances have been taken

(2) # Bank of Baroda reports facility wise restructuring

Source: Company, Kotak Institutional Equities

Asset quality can show improvement; restructuring package to aid recoveries

Improving confidence on the underlying macro environment allows us to increase our recovery estimation for BoI, resulting in lower gross NPLs for the bank. 1QFY11 saw a reduction in slippages (1.6%) after many quarters. This also includes agri debt waiver of ₹1.3 bn. We believe that recent press releases which will allow banks to restructure airline loans as well as reclassify as standard asset as a part of yet another special dispensation will result in sharp recoveries in BoI. In FY2010, BoI saw ₹7.3 bn (18% of loans) slipping from the aviation sector. We are building gross NPLs to decline 2.2% in FY2012 from 2.9% in FY2010. We are building loan loss provisions to decline to 0.8% in FY2012 from 1.1% in FY2010.

Slippages and recoveries can positively surprise in the coming quarters

Movement of gross NPL, March fiscal year-end, 3QFY08-1QFY11 (Rs bn)

	3QFY08	4QFY08	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11
Gross NPL (beginning)	19.8	19.6	19.3	20.2	19.8	22.1	24.7	27.9	39.2	41.9	48.8
Recovery	1.8	2.9	1.3	2.0	1.6	(0.4)	1.1	1.7	2.4	1.6	2.4
Upgradation	0.3	0.9	0.4	0.8	0.7	(0.7)	0.6	0.4	0.6	1.0	2.1
Write-off	0.9	1.0	0.5	0.9	1.0	1.5	1.1	0.7	0.9	4.7	2.4
Slippages	2.8	4.4	3.0	5.2	5.6	2.9	5.9	13.8	6.8	14.5	6.9
Closing gross NPLs	19.7	19.2	20.2	21.6	22.2	24.6	27.9	38.9	42.2	49.1	48.8
Slippages	1.1	1.5	1.0	1.6	1.7	0.8	1.6	3.7	1.7	3.4	1.6
Loan loss provisions	0.8	0.6	0.5	0.2	0.6	0.5	0.5	1.3	1.1	1.5	0.7

Source: Company, Kotak Institutional Equities

Bank of India saw higher slippages and lower recoveries in FY2010 resulting in sharp rise in gross NPL

Slippages and recoveries to loans, March fiscal year-ends, FY2008-2010 (%)

	FY2008		FY2009		FY2010	
	Slippages	Recoveries	Slippages	Recoveries	Slippages	Recoveries
Bank of Baroda	1.8	1.3	1.3	1.1	1.3	0.8
Bank of India	1.6	1.8	1.9	1.3	2.8	1.1
PNB	2.0	2.1	1.4	1.9	1.8	1.4
SBI	2.3	1.5	2.7	2.0	2.2	1.5
Canara Bank	1.4	1.5	2.2	1.4	2.8	2.1

Source: Company, Kotak Institutional Equities

Break-up of gross NPL

March fiscal year-ends, FY2010 (₹ bn)

Sector	Gross NPL
Agriculture	4.2
Industry	13.0
Chemicals	3.1
Metals	2.4
Textile	1.7
Infrastructure	1.6
Others	4.2
Services	21.2
Transport/aviation	7.7
Trade retail	3.6
Others	9.8
Retail	6.5
Foreign	4.0
Total	48.8

Source: Company, Kotak Institutional Equities

Break-up of slippages

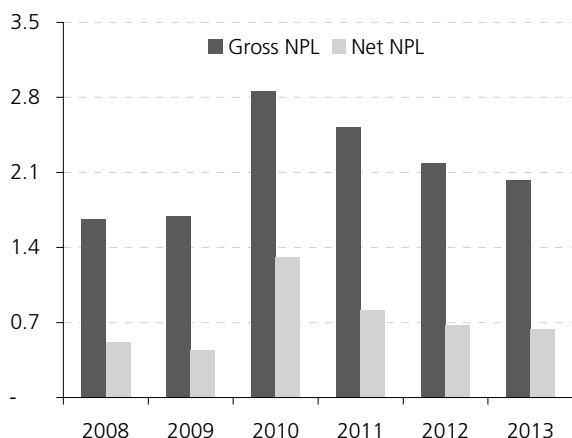
March fiscal year-ends, FY2010 (₹ bn)

Sector	Slippages
Aviation	7.3
Pharma	3.9
Steel	2.6
IT	2.5
Infra	2.2
Minerals	1.8
Others	19.5
Total	39.8

Source: Company, Kotak Institutional Equities

Gross NPL to decline with lower slippages and higher recovery

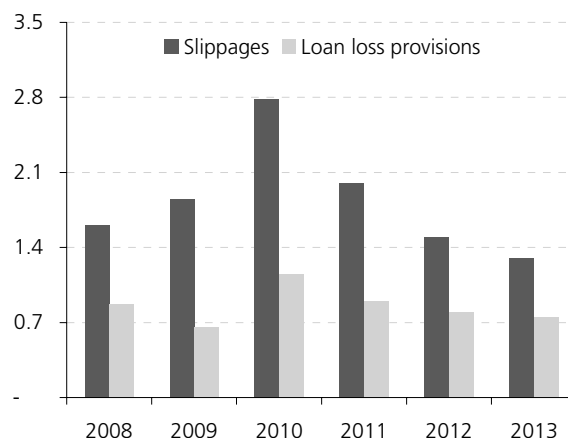
Gross and net NPL, March fiscal year-ends, 2008-2013 (%)



Source: Company, Kotak Institutional Equities

Lower slippages and higher recoveries to reduce provision costs

Gross and net NPL, March fiscal year-ends, 2008-2013 (%)



Source: Company, Kotak Institutional Equities

Key changes to estimates: Reducing loan loss provisions
 March fiscal year-ends, FY2011-2012

	Old estimates		New estimates		% change	
	2011E	2012E	2011E	2012E	2011E	2012E
Net interest income	72,931	83,669	74,603	84,535	2.3	1.0
Loan growth (%)	19.3	19.7	20.1	20.6		
NIM (%)	2.5	2.4	2.6	2.5		
Loan loss provisions	18,473	19,872	16,688	17,855	(9.7)	(10.2)
Other income	26,502	30,111	26,502	30,111	-	-
Treasury income	3,000	3,000	3,000	3,000	-	-
Others	23,502	27,111	23,502	27,111	-	-
Operating expenses	40,940	48,432	40,940	48,432	-	-
Employee expenses	25,922	31,184	25,922	31,184	-	-
Net profit	26,265	30,572	28,684	32,591	9.2	6.6
PBT-treasury + loan loss provisions	52,994	47,445	54,665	47,446	3.2	0.0

Source: Kotak Institutional Equities

Bank of India's growth rates and key ratios
 March fiscal year-ends, 2008-2013E (%)

	2008	2009	2010	2011E	2012E	2013E
Growth rates (%)						
Net loan	33.6	25.9	17.9	20.1	20.6	20.5
Customer assets	31.7	25.7	17.1	19.7	20.3	20.3
Investments excld. CPs and debentures growth	24.3	25.8	30.2	30.9	14.7	17.6
Net fixed and leased assets	207.4	4.4	(7.1)	17.4	15.0	2.2
Cash and bank balance	1.8	22.8	43.5	(10.9)	7.9	9.2
Total Asset	26.3	26.1	21.9	18.3	17.3	18.2
Deposits	25.1	26.5	21.1	17.2	18.6	19.3
Current	33.2	0.9	26.3	17.5	19.1	20.0
Savings	14.3	14.2	25.9	20.1	19.1	20.0
Fixed	28.1	33.5	19.3	16.3	18.3	19.1
Net interest income	14.8	30.0	4.7	29.6	13.3	17.3
Loan loss provisions	11.5	(2.6)	112.5	(6.5)	7.0	13.0
Total other income	36.8	44.2	(14.3)	1.3	13.6	15.6
Net fee income	31.2	39.4	0.4	18.0	18.0	18.0
Net capital gains	78.7	103.7	(20.4)	(49.5)	-	16.7
Net exchange gains	36.8	103.4	(40.4)	20.0	15.0	15.0
Operating expenses	1.4	17.0	18.5	11.6	18.3	18.2
Employee expenses	2.7	16.9	18.5	12.9	20.3	20.3
Key ratios (%)						
Yield on average earning assets	8.0	8.4	7.4	7.8	8.1	8.2
Yield on average loans	9.3	9.8	8.4	8.7	9.1	9.1
Yield on average investments	6.9	7.2	7.6	7.8	7.9	8.1
Average cost of funds	5.5	5.9	5.3	5.4	5.9	6.0
Interest on deposits	5.2	5.8	5.2	5.0	5.6	5.7
Difference	2.5	2.5	2.1	2.3	2.2	2.2
Net interest income/earning assets	2.7	2.8	2.4	2.6	2.5	2.4
Spreads on lending business	3.9	3.9	3.1	3.3	3.2	3.0
Spreads on lending business (incl. Fees)	4.6	4.8	3.8	4.0	3.9	3.7
New provisions/average net loans	0.9	0.7	1.1	0.9	0.8	0.8
Total provisions/gross loans	2.3	2.4	3.1	3.4	3.5	3.6
Interest income/total income	66.6	64.3	68.7	73.8	73.7	74.0
Other income / total income	33.4	35.7	31.3	26.2	26.3	26.0
Fee income to total income	12.3	12.8	13.1	12.8	13.3	13.5
Fee income to advances	0.8	0.9	0.7	0.7	0.7	0.7
Fees income to PBT	29.2	26.2	44.0	31.6	32.8	33.2
Net trading income to PBT	10.5	6.5	14.0	3.7	4.3	4.2
Exchange income to PBT	11.4	15.0	14.9	10.9	11.0	10.9
Operating expenses/total income	41.7	36.2	43.8	40.5	42.2	42.7
Operating expenses/assets	1.7	1.5	1.5	1.4	1.4	1.4
Operating profit /AWF	1.5	1.8	0.8	1.3	1.3	1.3
Tax rate	25.2	27.8	30.2	30.0	30.0	30.0
Dividend payout ratio	10.5	14.0	21.1	21.1	21.1	21.1
Share of deposits						
Current	9.9	7.9	8.1	8.1	8.1	8.1
Fixed	63.4	68.2	67.5	66.9	66.9	66.9
Savings	26.7	23.9	24.5	25.0	25.0	25.0
Loans-to-deposit ratio	75.6	75.3	73.3	75.2	76.5	77.2
Equity/assets (EoY)	5.9	6.0	5.2	5.0	4.9	4.8
Dupont analysis (%)						
Net interest income	2.7	2.7	2.3	2.5	2.4	2.4
Loan loss provisions	0.5	0.4	0.7	0.6	0.5	0.5
Net other income	1.3	1.5	1.1	0.9	0.9	0.8
Operating expenses	1.7	1.5	1.5	1.4	1.4	1.4
Invt. depreciation	0.1	0.2	0.1	0.1	0.0	0.0
(1- tax rate)	74.8	72.2	69.8	70.0	70.0	70.0
ROA	1.3	1.5	0.7	1.0	0.9	0.9
Average assets/average equity	21.9	19.4	20.2	21.5	21.7	22.0
ROE	27.6	29.2	14.2	20.7	20.1	20.2

Source: Company, Kotak Institutional Equities estimates

Bank of India's P&L and balance sheet
March fiscal year-ends, 2008-2013E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
Income statement						
Total interest income	123,552	163,474	178,780	225,118	279,019	333,825
Loans	92,751	125,392	131,032	161,973	203,063	244,289
Investments	26,390	33,703	44,643	58,715	71,616	84,823
Cash and deposits	4,411	4,378	3,105	4,429	4,340	4,713
Total interest expense	81,260	108,485	121,220	150,515	194,485	234,700
Deposits from customers	70,585	97,765	108,122	124,747	163,864	199,547
Net interest income	42,293	54,989	57,559	74,603	84,535	99,125
Loan loss provisions	8,628	8,403	17,855	16,688	17,855	20,175
Net interest income (after prov.)	33,665	46,586	39,704	57,915	66,680	78,950
Other income	21,169	30,519	26,166	26,502	30,111	34,800
Net fee income	7,829	10,916	10,965	12,939	15,268	18,016
Net capital gains	3,662	7,461	5,936	3,000	3,000	3,500
Net exchange gains	3,066	6,235	3,718	4,462	5,131	5,900
Operating expenses	26,450	30,940	36,678	40,940	48,432	57,251
Employee expenses	16,570	19,374	22,961	25,922	31,184	37,513
Depreciation on investments	834	4,741	2,435	1,500	1,000	1,200
Other Provisions	703	(220)	1,820	1,000	800	1,000
Pretax income	26,846	41,644	24,938	40,977	46,559	54,299
Tax provisions	6,753	11,571	7,528	12,293	13,968	16,290
Net Profit	20,094	30,073	17,411	28,684	32,591	38,009
% growth	78.9	49.7	(42.1)	64.7	13.6	16.6
PBT - Treasury + Provisions	33,349	47,107	41,112	57,165	63,213	73,174
% growth	54.5	41.3	(12.7)	39.0	10.6	15.8
Balance sheet						
Cash and bank balance	177,174	217,613	312,301	278,298	300,404	327,967
Cash	4,563	4,580	6,507	6,507	6,507	6,507
Balance with RBI	112,855	84,573	149,519	115,516	137,622	165,185
Balance with banks	19,524	26,101	78,795	78,795	78,795	78,795
Net value of investments	418,029	526,072	670,802	864,234	983,931	1,149,988
Govt. and other securities	330,318	425,310	568,693	768,157	889,012	1,056,034
Shares	3,145	3,800	7,925	8,690	9,455	10,220
Debentures and bonds	24,820	28,462	21,362	19,226	17,303	15,573
Net loans and advances	1,134,763	1,429,094	1,684,907	2,023,550	2,440,109	2,939,857
Fixed assets	24,261	25,319	23,518	27,599	31,740	32,444
Net leased assets	-	-	-	-	-	-
Net Owned assets	24,261	25,319	23,518	27,599	31,740	32,444
Other assets	34,073	56,920	58,136	58,136	58,136	58,136
Total assets	1,788,300	2,255,018	2,749,665	3,251,818	3,814,321	4,508,393
Deposits	1,500,120	1,897,085	2,297,619	2,691,858	3,191,208	3,808,276
Borrowings and bills payable	133,562	167,097	235,715	322,471	361,511	410,311
Other liabilities	48,724	55,887	74,030	74,030	74,030	74,030
Total liabilities	1,682,406	2,120,068	2,607,365	3,088,359	3,626,748	4,292,616
Paid-up capital	5,259	5,259	5,259	5,259	5,259	5,259
Reserves & surplus	100,635	129,690	137,041	158,200	182,314	210,517
Revaluation reserves	17,631	17,103	14,286	13,858	13,442	13,039
Total shareholders' equity	105,894	134,949	142,300	163,460	187,573	215,777

Source: Company, Kotak Institutional Equities estimates

SEPTEMBER 27, 2010

UPDATE

BSE-30: 20,045

Business in a sweet spot, valuations not so. We remain confident of the business outlook for the banking sector and expect most banks to perform better than expected in the areas of asset quality and earnings traction. However, the recent movements in stock prices have made valuations expensive, compelling us to downgrade our ratings on HDFC, HDFC Bank and REC to REDUCE. We upgrade BOI to ADD on back of positive asset quality outlook. Our outlook on public sector banks is relatively bright as valuations are reasonable. Our top picks remain BOB, PNB and Union Bank amongst public banks and Yes Bank amongst private.

Downgrade HDFC, HDFC Bank and REC to REDUCE on expensive valuations; upgrade BOI to ADD

We are revising our rating on HDFC Bank to REDUCE (from BUY) and on HDFC to REDUCE (from ADD). Both stocks have seen very strong outperformance recently and we do not expect any valuation upside despite assuming a strong business environment. We are also downgrading REC to REDUCE as we believe that the current valuations (2.3XFY2012E PBR) appear full and do not factor any margin any error on account of a rise in slippages, decline in margins etc. We upgrade BOI to ADD (from REDUCE) on the back of increased confidence on asset quality and likely surprises on recoveries. We raise our target prices for select stocks (detailed later in the note) on the back of higher confidence on book, limited risk to earnings coupled with likely higher longer term RoEs.

Post run-up, valuations at highs; earnings still can surprise for PSU Banks

Our outlook on public sector banks continues to be bright as valuations at 1.3-1.8XFY2012E PBR for about 20-25% RoEs remain reasonable. We believe that earnings trend can be stronger than expected with better pricing power and lower loan loss provisions. PNB, BOB and Union Bank are our top picks. We revise our target prices on other banks on the back of likely higher earnings in FY2012E. Amongst private banks, we continue to remain positive on Yes Bank and Axis Bank. We see a similar trend amongst all private banks, where negative earnings surprise appears limited.

We continue to prefer public banks over private banks and NBFCs

Banking stocks, especially PSU banks, have seen strong appreciation in recent times. Valuations have become expensive, but with many stocks trading at an all time high valuations, we argue that medium-term RoEs for many PSU banks, especially BOB, PNB and Union Bank are likely to be higher than reported in the previous cycles. This, coupled with a higher comfort on asset quality and increases confidence on book have resulted in high valuations that are likely to sustain. Even SBI has got enough earnings cushion in FY2011 and FY2012, emanating from better margins, strong control on operating expenditure and lower provisioning requirement.

Business remain in a sweet spot on all counts for banks—growth; margins and asset quality

We believe that the banking business is in a sweet spot on all counts. We expect overall credit growth (with retail credit also likely to contribute), at >20% for FY2011-12. With just about enough liquidity in the system, pricing power has shifted back to banks. In the near term, we expect margins for public banks to track higher on the back of increased PLR during 2QFY11. A favorable business cycle leads us to expect positive trends in asset quality. Our recent discussions with several banks suggest that recovery momentum is very strong and likely to beat expectations – gross NPLs may turn out lower than expected. We believe margins for NBFCs will remain under pressure given rising interest rates in the systems even as growth remains strong.

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VALUATIONS: IN AN EXPENSIVE ZONE

We remain confident of the business outlook and believe that we could see asset quality surpass expectations, especially for public banks. Our preference for public banks continues as, adjusted for the return ratios, valuations still appear reasonable. However, post the recent run up, we downgrade HDFC Bank, HDFC and REC to REDUCE. We upgrade BOI to ADD on the back of a favourable asset quality outlook. Our top picks remain BOB, PNB and Union Bank and Yes Bank amongst private banks.

Private banks/NBFCs getting expensive; PNB, Union and BoB are our favorites

The recent outperformance gives limited upside to our target price and limited room for disappointment for select banks/NBFC. The sector remains attractive as NPL risks have receded while a tight liquidity cycle has shifted pricing power back to banks. We continue to maintain our positive bias towards public sector banks. Strong earnings growth, low NPL risk and sustenance of strong return ratios (RoEs of over 18%), gives comfort to our recommendation.

We continue to see further upside to our target price for public sector banks, despite the recent run-up in prices and valuations multiples for few banks reaching new highs. Our preferred picks are Bank of Baroda, PNB and Union Bank. We continue to like a few mid-cap PSU Banks like Allahabad Bank (NOT RATED), Dena Bank (NOT RATED) and IOB (BUY).

- ▶ We are revising our rating on HDFC Bank to REDUCE (from BUY) with a TP of Rs 2,500 on expensive valuations. The stock has outperformed Sensex by 10% in the past three months and 15% in the past six months. We see limited risk to our earnings but valuations are expensive with the bank trading at 4X FY2012 PBR and 23X FY2012E PER for medium term RoEs at about 18% and earnings growth of 30%.
- ▶ HDFC has also outperformed by 7% over the past three months and 22% over the past six months. We downgrade HDFC Ltd to REDUCE. We believe that the current valuations - 6.2X FY2012E PBR and 19X FY2012E PER are expensive and fully factor high profitability of the core business (26-30% RoE in core business). Even as the growth outlook on mortgages continues to remain strong, rising rates could have some dent on NBFC margins. Competition in the sector also remains a concern.
- ▶ We upgrade BOI to ADD (from BUY). We have revised our TP to ₹560 from ₹460 earlier. We believe asset quality can throw up positive surprises—much higher than earlier envisaged. The recent announcement of airlines/transportation restructuring could see an upgradation of about Rs7 bn. Valuations are at 1.5X FY2012E PBR. We have downgraded Corporation Bank to ADD (from REDUCE) as valuations are relatively expensive (1.3X FY2012 PBR) for a bank that is highly vulnerable to interest rates as the underlying franchise is weak.
- ▶ We downgrade REC to REDUCE, as valuations at 2.3X FY2012E PBR do not suggest any significant upsides from here. We believe that REC NIMs will likely be under pressure as interest rates move up. We believe that RECs current valuations do not leave any margin of safety in light of any risk of slippages (likely driven by poor financial health of state utilities and project risk of underlying projects) and contraction in margins due to rising interest rates in the system.
- ▶ We are revising our target price upwards for BoB, OBC, PNB, Shriram Transport and Federal Bank by 5-20% on the back of better confidence on earnings and financials. We are revising our target price for SBI to ₹3400 from ₹3100 earlier, increasing our target price multiple for banking subsidiaries to 1.7X (from 1.3X earlier).

Key changes to our target price and recommendations

	CMP (Rs)	Upside (%)	Current rating		Old	
			Target Price (RS)	Rating	Target Price (RS)	Rating
Rating and TP change						
Bank of India	497	12.8	560	ADD	460	REDUCE
Corporation Bank	703	6.7	750	ADD	700	BUY
HDFC Bank	2,495	0.2	2,500	REDUCE	2,400	BUY
HDFC Ltd	733	(1.8)	720	REDUCE	690	ADD
REC	343	(5.2)	325	REDUCE	325	ADD
Target price change						
Andhra	165	15.1	190	BUY	180	
Axis Bank	1,507	6.2	1,600	ADD	1,500	
BoB	876	14.1	1,000	BUY	950	
Federal	388	10.7	430	ADD	360	
OBC	441	2.1	450	ADD	430	
PNB	1,285	12.8	1,450	BUY	1,300	
SBI	3,141	8.2	3,400	BUY	3,100	
Shriram Trasport Finance	758	5.6	800	ADD	700	
Yes	337	11.3	375	BUY	350	

Source: Kotak Institutional Equities

SBI SOTP

	SBI holding (%)	NW FY2012E (Rs mn)	Multiple assumed (X)	Value FY2012 (Rs mn)	Value per share FY2012 (Rs)	Methodology adopted
SBI standalone					2,696	Residual income model
Non banking subs and investments						
SBI Life				85,195	134	Based on appraisal value
SBI MF	63%			13,572	21	4% of AUM of Rs37.4 tn (20% CAGR - AUM)
NSE	8%			14,976	24	NSE value at Rs130 bn (last transaction)
UTI MF	17%			3,966	6	4% of Rs583 bn AUM (20% AUM growth over FY2009)
SBI Caps	86%			14,048	22	10X 2012 PAT
SBI DFHI	57%			6,892	11	1X FY2012 network
Value of all non-bank subs					219	
SBI Associate banks						
State Bank of Bikaner and Jaipur	75%	20,719	1.7	35,223		BV multiple based on RoE
State Bank of Hyderabad	100%	50,632	1.7	86,075		BV multiple based on RoE
State Bank of Mysore	92%	36,223	1.7	61,579		BV multiple based on RoE
State Bank of Patiala	100%	40,057	1.7	68,097		BV multiple based on RoE
State Bank of Travancore	75%	25,735	1.7	43,750		BV multiple based on RoE
State Bank of Indore	98%	20,059	1.7	25,877		BV multiple based on RoE
Banking subsidiaries and associates		193,426		328,824		
post discount of 10%		174,083		295,942	466	
Value of all subsidiaries					685	
Total value of the bank					3,381	

Source: Company, Kotak Institutional Equities

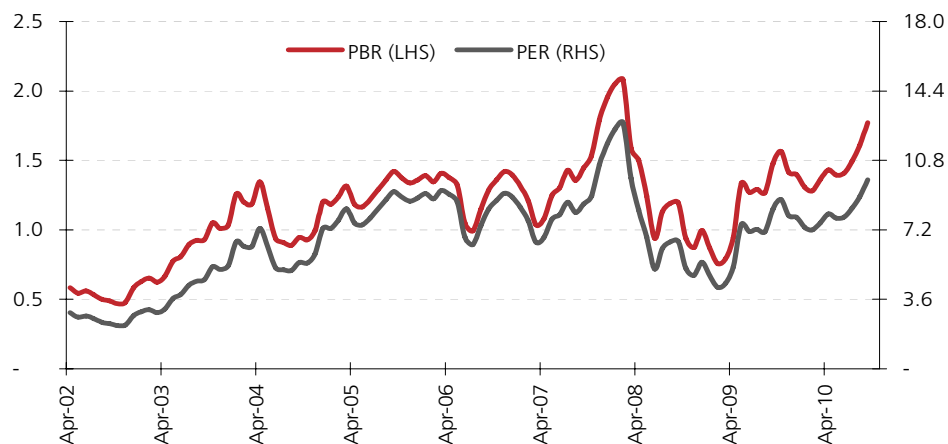
HDFC- sum-of-the-parts valuation

Business/ subsidiaries	HDFC's holding (%)	Based on 2012E		Valuation methodology
		Value of companies (Rs mn)	Value per share (Rs)	
HDFC			401	Based on residual growth model, 3.9X PBR FY2013E discounted to FY2011E/ FY2012E
Value of subsidiaries and associates			257	
HDFC Bank	23	1,130,000	164	Based on target price
HDFC Standard Life MF	60	54,720	23	4% of AUMs- 20% growth assumed
-PMS business	60	2,074	1	10% of AUMs (20% yoy growth)
Life Insurance	72	115,000	54	13.5% margins and 19X NBV multiple
General insurance	74	9,890	5	Based on deal with ERGO
Gruh Finance	62.0	15,738	6	Based on market price
IDFC	1.9	236,899	3	Based on market price
HDFC Venture capital				
HDFC Property Fund	81	1,500	1	Rs10bn of fund assuming value of 15%
HDFC IT Corridor Fund	81	697	0	Rs4.64bn of fund assuming value of 15%
Real estate fund	60	2,520	1	US\$800 mn assuming value of 7.5%
Equity investments			56	
BVPS of non-strategic inv.			6	
Unrealised gains			50	
Total value per share			714	

Source: Kotak Institutional Equities estimates

PSU banks are still trading at attractive multiples with RoE's at an impressive 20% levels

One year forward PBR and PER for public sector banks, March fiscal year-ends, April 2002-September 2010 (X)



Note: 9 banks under PSU's have been used for computation

Source: Company, Kotak Institutional Equities

Valuation metrics for companies under coverage

	CMP (Rs)	Market Cap (Rs bn)	Rating		PER (X)			PBR (X)			RoE (%)		
			Target Price (RS)	Rating	2010	2011	2012	2010	2011	2012	2010	2011	2012
Public													
Andhra	165	80	190	BUY	7.7	7.2	6.2	1.8	1.5	1.3	26	23	23
BoB	876	319	1000	BUY	10.5	9.8	7.8	2.3	2.0	1.6	24	22	23
Bol	497	261	560	ADD	15.0	9.9	8.1	2.0	1.8	1.5	14	19	20
Canara	574	235	580	ADD	7.8	6.8	5.6	1.9	1.5	1.2	22	21	21
Corporation	703	101	750	ADD	8.6	8.0	6.9	1.7	1.5	1.3	22	20	20
Indian	265	114	280	ADD	7.5	8.2	6.0	1.7	1.5	1.2	25	19	22
IOB	137	75	160	BUY	10.6	8.2	5.5	1.2	1.0	0.9	10	12	15
OBC	441	110	450	ADD	9.7	7.6	6.6	1.5	1.3	1.1	15	17	17
PNB	1,285	405	1450	BUY	10.4	9.6	7.9	2.5	2.1	1.7	26	23	24
SBI	3,141	1,995	3400	BUY	21.8	17.7	14.9	3.0	2.7	2.3	15	16	17
Union	385	195	450	BUY	9.4	7.9	6.4	2.2	1.8	1.4	26	25	25
Private													
Axis Bank	1,507	615	1600	ADD	24.3	19.3	15.3	3.8	3.3	2.8	19	18	20
Federal Bank	388	66	430	ADD	14.3	10.7	7.9	1.4	1.3	1.1	10	13	15
J&K Bank	798	39	850	ADD	7.6	6.7	5.7	1.3	1.1	1.0	18	18	18
HDFC Bank	2,495	1,151	2500	REDUCE	38.7	29.4	22.5	5.3	4.7	4.0	16	17	19
ICICI Bank	1,114	1,278	1000	REDUCE	30.9	24.6	19.5	2.4	2.3	2.1	8	9	11
Yes Bank	337	116	375	BUY	22.5	19.0	15.0	3.7	3.2	2.7	20	18	19
NBFC's													
HDFC	733	1,069	720	REDUCE	37.2	31.6	26.4	6.9	6.1	5.4	20	21	22
IDFC	206	266	205	ADD	24.6	21.9	18.4	3.8	2.8	2.4	17	15	14
India Infoline	111	32	130	BUY	13.7	15.6	12.8	2.0	1.8	1.7	15	13	15
LIC HF	1,352	128	1250	REDUCE	19.4	14.5	13.0	3.8	3.2	2.7	24	24	22
M&M Finance	627	52	635	REDUCE	17.5	13.5	11.2	3.5	2.9	2.4	22	23	24
PFC	342	393	275	SELL	16.7	14.9	12.4	2.9	2.6	2.2	19	18	19
REC	343	338	325	REDUCE	16.9	13.6	11.0	3.1	2.7	2.3	22	21	22
Shriram Transport	758	128	800	ADD	19.4	14.2	11.6	4.4	3.7	3.0	28	28	29

Source: Kotak Institutional Equities

Relative performance of banks and non banking financial companies

	Change in price (%)					Relative performance to sensex (%)					Price (Rs)		% change from high
	1M	3M	6M	12M	Ytd	1M	3M	6M	12M	Ytd	52 wk high	52 wk low	
Public banks													
Andhra Bank	6.6	22.1	66.5	59.6	58.3	(2.7)	8.0	45.0	33.6	37.9	170	94	(2.8)
Bank of Baroda	7.6	26.9	40.3	83.8	70.5	(1.7)	12.3	22.1	53.9	48.5	906	431	(3.3)
Bank of India	6.9	42.5	60.2	24.6	29.0	(2.4)	26.0	39.4	4.3	12.4	509	309	(2.4)
Canara Bank	12.3	33.5	43.2	85.3	47.5	2.6	18.1	24.7	55.1	28.5	596	303	(3.7)
Corporation	15.0	33.5	58.3	75.8	66.8	5.1	18.1	37.9	47.2	45.3	724	356	(2.9)
Indian Bank	5.0	17.4	61.8	64.8	51.6	(4.1)	3.9	40.8	38.0	32.1	274	146	(3.3)
IOB	4.9	29.2	55.5	12.3	24.1	(4.2)	14.3	35.4	(5.9)	8.1	144	81	(4.9)
OBC	3.9	34.8	48.7	94.4	76.1	(5.1)	19.2	29.4	62.7	53.5	477	220	(7.5)
PNB	8.2	20.8	32.4	62.5	41.8	(1.2)	6.9	15.3	36.0	23.6	1,328	759	(3.2)
SBI	10.4	33.2	53.3	44.9	38.4	0.8	17.9	33.5	21.3	20.6	3,175	1,863	(1.1)
Union Bank	12.7	23.4	36.6	56.1	45.8	2.9	9.2	18.9	30.7	27.1	393	232	(2.0)
Old private													
Federal Bank	10.9	19.7	51.6	56.8	64.9	1.3	5.9	32.0	31.3	43.7	390	218	(0.5)
J&K Bank	(7.8)	(0.7)	20.0	36.4	37.5	(15.8)	(12.2)	4.5	14.2	19.8	924	540	(13.6)
New private													
Axis Bank	9.8	19.3	29.7	63.8	52.3	0.3	5.5	12.9	37.2	32.7	1,583	888	(4.8)
HDFC Bank	13.0	24.7	32.4	53.7	46.6	3.2	10.3	15.3	28.6	27.7	2,502	1,546	(0.3)
ICICI Bank	11.2	25.8	20.4	29.5	27.0	1.6	11.3	4.8	8.4	10.7	1,148	712	(3.0)
Yes Bank	2.5	24.3	41.6	74.4	26.6	(6.3)	10.0	23.3	46.0	10.3	345	184	(2.2)
Non-banks													
HDFC	17.4	21.2	39.8	33.4	36.9	7.3	7.2	21.7	11.7	19.3	780	390	(6.0)
IDFC	10.3	21.0	30.3	43.6	33.7	0.7	7.0	13.4	20.2	16.5	207	140	(0.4)
Indiabifoline	10.0	13.8	(4.0)	(25.2)	(13.6)	0.5	0.7	(16.4)	(37.4)	(24.7)	164	88	(32.2)
LIC HF	9.9	30.7	67.8	72.4	68.4	0.4	15.6	46.1	44.3	46.8	1,374	687	(1.6)
MMFS	5.4	37.8	61.2	182.6	83.1	(3.7)	21.9	40.3	136.6	59.5	725	218	(13.5)
PFC	1.0	19.8	33.3	48.1	31.0	(7.7)	6.0	16.0	23.9	14.1	365	205	(6.0)
Shriram Transport	(4.1)	26.2	53.1	91.2	55.3	(12.4)	11.6	33.3	60.1	35.3	809	362	(6.3)
REC	3.1	13.7	36.7	74.3	41.2	(5.8)	0.6	19.0	46.0	23.0	361	188	(5.1)

Source: Company, Kotak Institutional Equities

CREDIT GROWTH OUTLOOK STRONG STILL; SOME MODERATION IN NEAR TERM

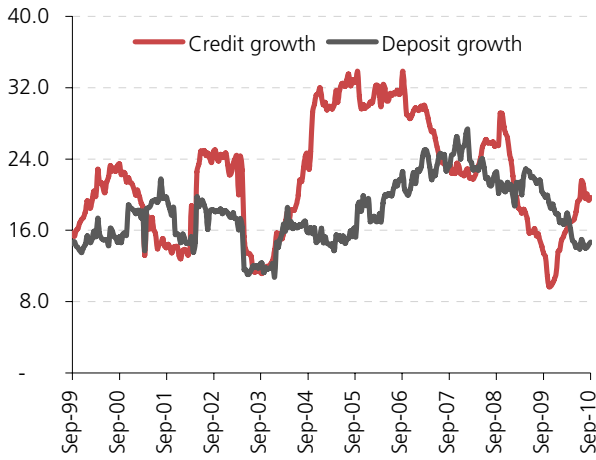
We are building credit growth at 21% CAGR for FY2011-12 for stocks under coverage. As of 2QFY11, credit growth has been soft with YTD growth at 4.4% (despite headline credit growth being impressive at about 20% mainly due to lower base in FY2010) but we expect credit growth to improve and become more widespread.

We are building credit growth at 21% for FY2011 for stocks under coverage, marginally ahead of our overall industry growth estimate of 19%. Credit growth, till 2QFY11, has been soft, despite headline credit growth at about 20% mainly due to lower base in this period in FY2010. Most private banks like Axis, HDFC Bank and Yes Bank would continue to grow at a much faster pace but we expect ICICI Bank to report marginally lower-than-average credit growth. Amongst PSU banks, SBI's credit growth (ex merger with SBI Indore) is likely to be at industry levels but we see BoB and Union Bank doing better than the industry.

At a sector level, we see diverging trends emerging with corporate credit growth being somewhat moderate in recent times, while retail has shown improvement.

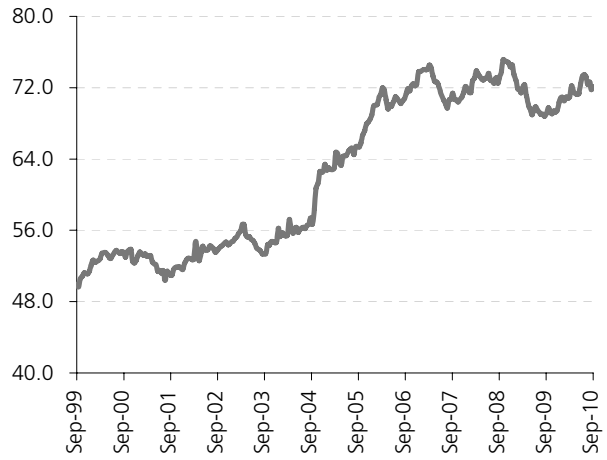
- ▶ Corporate credit growth has slowed in recent times for various reasons: (1) Longer-than-expected monsoon impacting construction activity; (2) the discounting business has declined with the introduction of a base rate as the interest rate for these loans is higher than the base rate for most PSU banks; (3) some of the mid-tier PSU banks are reaching internal exposure limits for infrastructure and these banks would need to identify new business lines to increase balance sheet. We remain positive on credit to the infrastructure sector. Lending to telecom boosted growth in 1QFY11 to some extent. We expect credit growth in 2QFY11 to be somewhat below 1Q. Lending to the power sector remains strong while the road sector is yet to see meaningful traction.
- ▶ The past few months has seen a pick up in credit through alternate channels such as corporate debentures, commercial paper and partly from short-term credit from abroad/ECBs. Investment in corporate debentures has increased by about 40 bps of total loans in the past quarter to 2.1% of loans. As of July 2010, outstanding CPs have grown by 41% yoy to Rs 1127 bn and forms 3.4% of total credit compared to 2.8% in July 2009. Banks exposure to CPs is about 1% of loans. Allowing FII participation of additional USD 10 bn in the debt market can further channel credit growth away from the banking system in the near term.
- ▶ Retail credit is picking up mainly driven by mortgages and auto loans. Private banks like HDFC Bank have seen a pick up in their unsecured lending (expect single-digit credit growth). Loan growth for HDFC and LICHF will likely remain strong over the next few quarters. A sharp rise in real estate prices in select pockets raises some concerns though demand remains strong as of now.
- ▶ New business segments like microfinance have been growing at 70-100% on a low base, driven by a large latent market and favourable macro environment. We believe that the traction in these segments will continue to remain strong.

Credit growth has been near 20% in recent months
September 1999-September 2010 (%)



Source: RBI, Kotak Institutional Equities

Scope to improve CD ratio from current levels remains limited
September 1999-September 2010 (%)



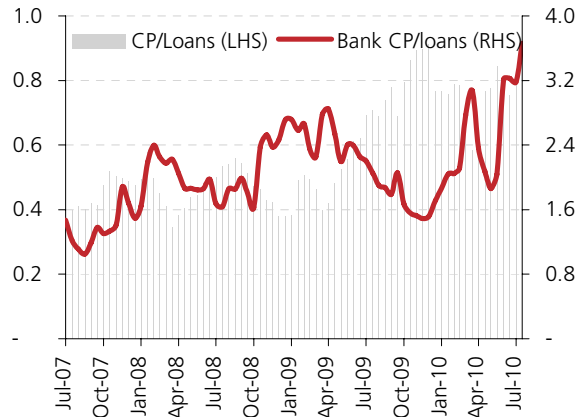
Source: RBI, Kotak Institutional Equities

Banks investment in corporate bonds have increased
Investments in corporate bonds to total loans, Jan 2008-July 2010 (%)



Source: Company, Kotak Institutional Equities

...and so have investments in commercial paper
Investments in CPs to total loans, July 2007-July 2010 (%)



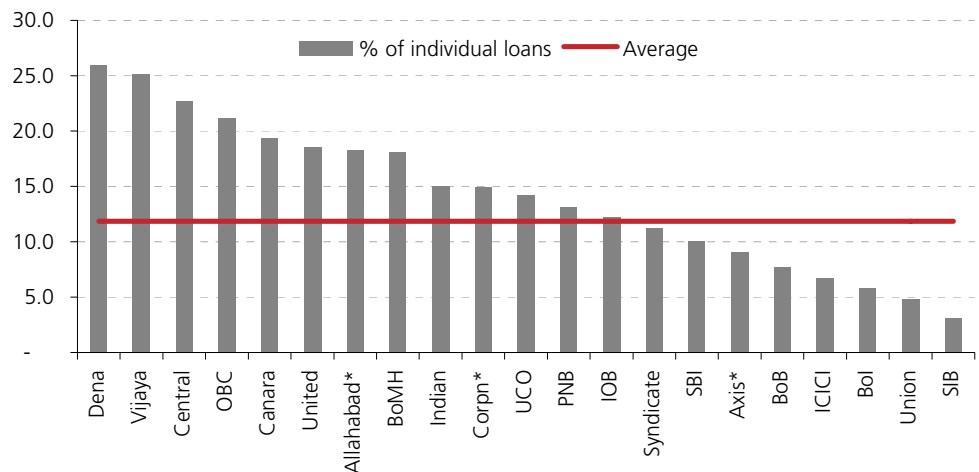
Source: Company, Kotak Institutional Equities

Credit growth estimates for stocks under coverage at about 21% for FY2011-2013
March fiscal year-ends, FY2008-2013 (%)

	2008	2009	2010	2011E	2012E	2013E
Public banks						
Andhra Bank	22.8	28.9	27.1	18.9	18.8	18.8
BoB	27.6	34.9	21.6	23.4	23.6	22.5
BoI	33.6	25.9	17.9	19.3	19.7	19.6
Canara Bank	8.9	28.9	22.5	20.3	20.8	20.7
Corporation Bank	30.8	23.8	30.3	21.7	22.7	22.5
Indian Bank	37.1	29.2	20.8	21.3	21.2	20.9
IOB	28.4	23.9	5.5	15.0	20.7	20.5
OBC	23.6	25.5	21.9	22.0	22.0	21.3
PNB	23.7	29.5	20.6	22.6	21.4	21.3
SBI	23.5	30.2	16.5	19.7	20.7	20.0
Union Bank	19.2	29.8	23.6	21.2	21.1	21.0
Old private banks						
Federal Bank	26.9	18.4	20.4	20.1	21.0	20.8
J&K Bank	10.6	10.8	10.2	18.3	21.1	23.9
New private banks						
Axis Bank	61.8	36.7	27.9	25.3	25.5	23.1
HDFC Bank	35.1	55.9	27.3	27.2	25.1	25.0
ICICI Bank	15.2	(3.2)	(17.0)	17.1	17.7	18.9
Yes Bank	49.9	31.5	78.9	40.8	35.3	31.3
Coverage universe	24.0	25.5	16.2	21.0	21.4	21.1

Source: Company, Kotak Institutional Equities

Infrastructure credit exposure to total loans has increased sharply for mid tier PSU banks
Infrastructure exposure to total loans, March fiscal year-ends, FY2010 (%)



Note:

(1) * represents exposure as of 1QFY11.

(2) Exposure includes undrawn limits or outstanding exposure. Hence, exposures

Source: Company, Kotak Institutional Equities

MARGINS TO REMAIN STRONG; BASE RATE TO HAVE POSITIVE IMPACT IN SHORT TERM

We expect strong margins for most banks—margins are likely to be higher in 2Q for most public banks, due to the PLR hike and base rate introduction during the quarter. Over the medium term, better pricing power and the positive effects of moving to a base rate can more than offset the rise in deposit costs. However, a rise in bulk borrowings rates will temper margins for NBFCs over the next two quarters.

We are building margins to improve yoy as the benefit of lower average cost of funds, tight liquidity conditions and the base rate introduction will impact margins positively in FY2011.

Tight liquidity and base rate implementation will be positive for margins

We believe that at times when banks are able to increase lending rates without much difficulty and larger banks behaving rationally especially on liability pricing, margin outlook for the sector remains strong. Assets are likely to re-price faster than deposits and the recent PLR hike will have a positive impact on margins. Even as banks have been steadily increasing deposit rates in recent months—introducing special deposit rates for longer tenor deposits (1.5 years and 3 years), the impact is likely to be felt only over the medium term.

In the near term, we see several developments (1) slower credit growth in a tight liquidity environment will be positive for banks from a margin perspective as they would not have to aggressively mobilize deposits (especially volatile wholesale deposits); (2) the recent move by RBI to move to a mid-quarterly review is positive for banks as it reduces the surprise element and gives banks reasonable time period to adjust their lending yields and manage deposit costs; and (3) the base rate has resulted in few PSU banks compulsorily exiting certain products such as LC discounting as interest rates charged are below the base rate. This has impacted credit growth even while it has resulted in better margins.

We believe NBFC NIMs have been in a sweet spot and will likely be under pressure as the bulk borrowings rates move up. NIMs have been at peak and lower borrowing costs are rising fast on back of reasonable pricing power with the banks.

Base rate remains unchanged despite change of about 50 bps in PLR

	Prime Lending Rate	Base rate
Private Banks		
Andhra Bank	12.5	8.3
Bank of Baroda	12.5	8.0
Bank of India	12.5	8.0
Canara Bank	12.0	8.0
Corporation Bank	12.5	7.8
Indian Bank	12.5	8.0
IOB	12.5	8.3
OBC	12.5	8.0
PNB	11.8	8.0
SBI	12.3	7.5
Union Bank	12.3	8.0
Private Banks		
Axis Bank	14.8	7.5
HDFC Bank	16.3	7.3
ICICI Bank	16.3	7.5
Yes Bank	17.5	7.0
Dhanalakshmi	16.0	7.0
IndusInd	17.3	7.0
Foreign Bank		
SCB	14.3	7.3
Citibank	13.8	7.3
HSBC	13.8	7.0
RBS		6.5

Source: Company websites, Press releases

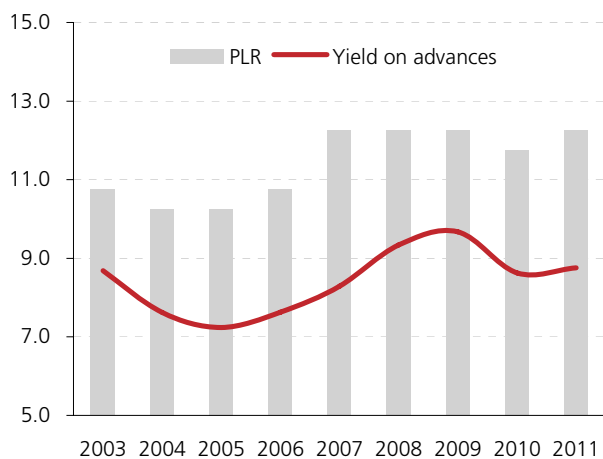
Further increase in deposit rates being witnessed across tenors

	7-14 days	15-30 days	31-45 days	46-90 days	91-179 days	180-269 days	270-364 days	1 Year- less than 2 years	2 Year- less than 3 years	3 years and above
Allahabad Bank	2.5	2.8	3.0	4.0	5.5	5.5	6.0	6.8	6.8	7-7.25
Andhra Bank	2.0	3.5	3.5	4.0	5.3	6.3	6.3	7.0	7.3	7.25-7.5
Bank of Baroda	2.5	3.0	3.0	4.0	5.5	6.0	6.0	7.0	7.3	7.3
Bank of India	2.5	2.8	3.0	4.0	5.5	6.0	6.0	7-7.25	7.25-7.6	7.25-7.75
Canara Bank	2.5	3.5	3.5	4.0	5.5	6.0	6.0	7-7.25	7.25-7.5	7.25-7.75
OBC	2.5	3.0	3.5	4.3	5.5	6.0	6.0	7.0	7-7.5	7.25-7.5
PNB	2.5	3.0	3.0	4.0	5.3	6.0	6.0	7.0	7.0	7.25-7.5
SBI	NA	4.0	4.0	4.8	4.8	6.0	6.0	6.75-7.25	7-7.25	7.25-7.75
Union Bank	2.5	3.5	3.5	4.0	5.5	5.8	6.0	7.0	7.0	7.25-7.8
ICICI Bank	3.5	3.5	3.8	3.75-4.25	5.5	6.0	6.5	6.5-7.0	7.25-7.5	7.8
Axis Bank	NA	2.5	3.0	3.5-4.0	5.3	6.25-6.5	6.5	7.1	7.4	7.0
HDFC Bank	3.0	3.0	3.8	3.75-4.5	5.25-5.75	5.75-6.5	6.25-6.5	6.5-7.0	7-7.5	7.5
Federal Bank	3.5	4.0	4.0	4.5	5.3	6.5	6.5	7.5	7.5	7.75-8
Yes Bank	3.5	3.5	4.0	4.5-5.25	5.5-6.5	6.3	6.75-7.25	7.1-7.25	7.8	7.8

Source: Company websites

Advances repricing is much faster if lending rates are passed with limited constraints

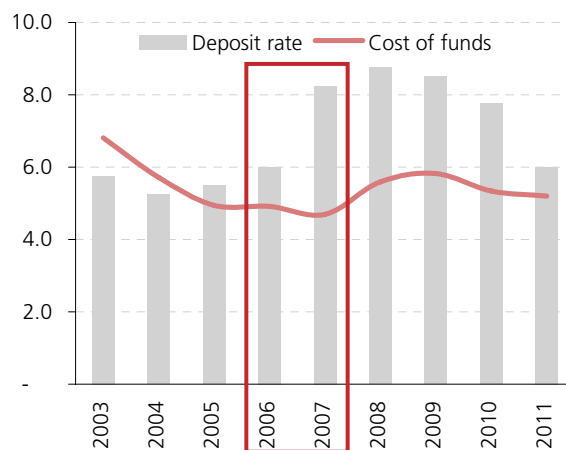
Yield on advances and PLR of SBI, March fiscal year-ends, FY2003-2011 (%)



Source: Company, Kotak Institutional Equities

Cost of funds to respond slower than change in marginal deposit costs due to repricing benefits still flowing through

Deposit rate and average cost of funds of SBI, March fiscal year-ends, FY2003-2011 (%)



Source: Company, Kotak Institutional Equities

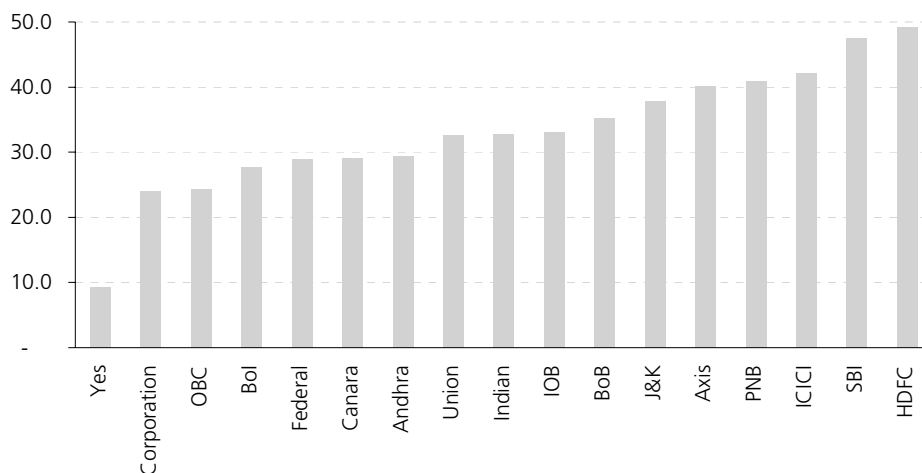
Margins to remain strong for the entire sector in FY2011

Net interest margins, March fiscal year-ends, 2007-2013 (%)

	2007	2008	2009	2010	2011E	2012E	2013E
Public banks							
Andhra Bank	3.2	2.7	2.7	2.8	3.0	2.9	2.8
BoB	2.9	2.6	2.6	2.4	2.4	2.5	2.5
BoI	3.0	2.7	2.8	2.4	2.5	2.4	2.5
Canara Bank	2.8	2.1	2.5	2.4	2.6	2.6	2.4
Corporation Bank	2.9	2.5	2.3	2.3	2.4	2.3	2.2
Indian Bank	3.5	3.2	3.5	3.7	3.7	3.5	3.4
IOB	3.7	3.0	2.7	2.6	2.8	2.9	2.9
OBC	2.7	2.1	2.0	2.4	2.7	2.6	2.5
PNB	3.5	3.2	3.2	3.3	3.4	3.4	3.4
SBI	3.0	2.8	2.6	2.5	2.8	2.8	2.7
Union Bank	2.9	2.7	2.8	2.4	2.8	2.8	2.7
Old private banks							
Federal Bank	3.3	3.2	3.8	3.5	3.6	3.6	3.5
J&K Bank	2.9	2.7	2.9	2.9	3.3	3.1	3.2
New private banks							
Axis Bank	2.7	2.9	3.0	3.1	3.2	3.2	3.2
HDFC Bank	4.7	5.1	4.9	4.3	4.2	4.1	4.1
ICICI Bank	2.4	2.1	2.4	2.4	2.6	2.8	2.8
Yes Bank	2.3	2.5	2.7	2.8	2.8	2.7	2.7

Source: Kotak Institutional Equities

Banks with high CASA ratio to witness higher benefits with rising interest rates
CASA ratio for banks, March fiscal year-ends, 1QFY11 (%)



Source: Company, Kotak Institutional Equities

Market share of current and savings deposits across 26 banks
March fiscal year-ends, 2006-2010 (%)

	Savings account					Current account				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
Allahabad	3.2	3.2	3.1	3.0	2.9	1.9	2.0	1.7	1.8	1.9
Andhra	2.0	2.0	1.9	1.8	1.7	1.4	1.4	1.3	1.4	1.5
Axis	1.7	2.2	3.1	3.4	3.5	3.7	4.2	6.0	6.9	7.3
BoB	5.9	5.8	5.6	5.6	5.5	3.9	3.7	3.5	4.0	4.3
Bol	5.5	5.4	5.3	5.0	5.0	3.4	3.5	3.7	3.5	3.6
BoMH	1.9	1.9	2.0	1.8	1.8	1.3	1.5	1.5	1.4	1.4
Canara	6.2	6.0	5.5	5.5	5.2	4.7	4.6	4.0	4.0	4.1
Central	5.1	4.9	4.7	4.4	4.2	3.5	3.2	3.0	2.8	3.4
Corporation	1.4	1.4	1.4	1.3	1.4	2.2	2.5	3.1	3.6	3.1
Dena	1.7	1.7	1.6	1.5	1.4	1.1	1.2	0.9	1.0	1.1
Federal	0.8	0.8	0.8	0.9	0.8	0.4	0.5	0.4	0.4	0.4
HDFCB	3.5	3.6	4.1	4.6	5.2	6.8	7.4	8.6	7.9	8.5
ICICI	4.5	5.3	6.1	5.4	5.5	7.6	8.0	7.4	6.0	7.1
Indian	2.4	2.4	2.4	2.3	2.3	1.5	1.4	1.4	1.5	1.5
ING Vysya	0.5	0.5	0.5	0.4	0.5	0.7	0.7	1.0	0.9	0.9
IOB	3.1	3.2	3.0	2.9	2.7	2.6	2.5	2.7	2.2	2.2
J&K Bank	1.1	1.2	1.1	1.0	1.1	1.4	1.3	1.3	1.3	1.1
OBC	2.5	2.4	2.2	2.1	2.1	2.3	2.4	2.3	2.1	2.3
PNB	9.1	8.9	8.4	8.3	8.1	7.7	6.1	5.3	5.2	5.4
SBI	24.4	23.9	24.2	26.2	26.8	31.3	30.6	29.3	30.6	27.9
SIB	0.4	0.4	0.5	0.5	0.4	0.3	0.2	0.2	0.2	0.2
Syndicate	3.1	3.0	2.9	2.8	2.7	2.8	2.8	3.2	2.9	2.3
UCO	2.6	2.5	2.3	2.2	2.2	1.8	2.0	1.7	2.0	2.0
Union	3.9	3.8	3.8	3.8	3.9	2.8	3.2	3.5	3.6	3.7
United	2.3	2.2	2.0	2.0	2.0	1.4	1.5	1.5	1.5	1.5
Vijaya	1.4	1.4	1.3	1.2	1.1	1.6	1.6	1.4	1.1	1.0

Source: Company, Kotak Institutional Equities

ASSET QUALITY AND CREDIT COSTS TO SHOW IMPROVEMENT

We expect the healthy macro environment will result in slippages that could eventually be lower than our current estimates. We are building loan loss provisions in FY2011 at similar levels of FY2010 for public sector banks but sharp decline for private banks as they are well past their peak slippages. FY2011-12 should see lower slippages and loan loss provisions.

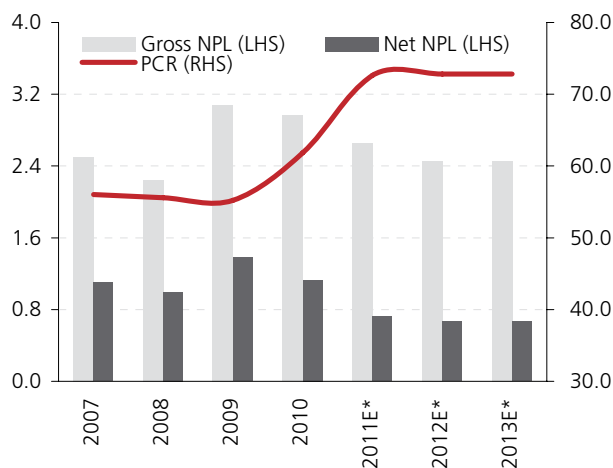
Slippages estimated at 1.8% in FY2011 for the sector; net slippages to be lower

We estimate slippages at 1.8% in FY2011 for the sector with PSU banks higher at 1.9% while private banks likely to be at 1.4%. Private banks have shown a sharp improvement with lower slippages, public sector banks may not be completely out of the woods. We estimate slippages to remain at FY2010 levels for public sector banks to factor the impact of the agri debt waiver and restructured loans, apart from the normal slippages. However, we believe that recoveries are likely to be very strong, coupled with a lot of upgradations of loans classified as NPLs over the past couple of years. A new restructured package for airline companies should benefit banks as airline exposure is unlikely to be an NPL for some time, at least on the books. We expect net delinquencies to increase at 60 bps in FY2011E and 35 bps in FY2012E compared to 60 bps in FY2010.

Loan loss provisions to witness marginal decline to about 1%

We see loan loss provisions declining, albeit marginally, in FY2011 mainly due to lower loan loss provisions by private banks (120 bps in FY2011 compared to 180 bps in FY2010). Public sector banks would see provisions maintained at FY2010 levels at about 90 bps. With most banks under coverage (barring SBI and ICICI Bank amongst the large caps) having reached 70% provision coverage ratio (including technical w/o), we see credit costs broadly tracking net slippages. We see loan loss provisions declining by 10 bps each for two years to 80 bps by FY2013.

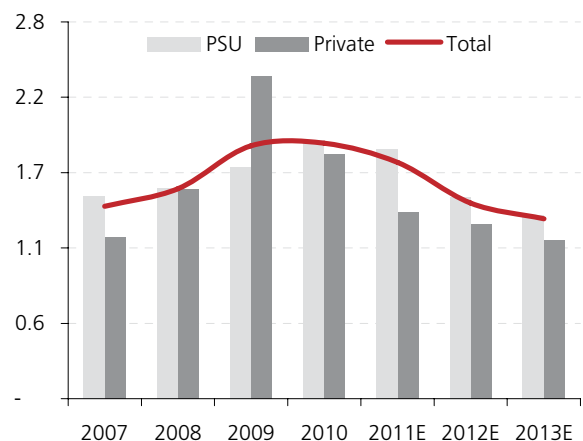
Unlikely to see sharp deterioration with lower slippages and higher write-offs, if required, as earnings are impressive
Gross NPL, net NPL and provision coverage (ex technical write-off), March fiscal year-ends, FY2005-2010 (%)



Note: For stocks under coverage

Source: Company, Kotak Institutional Equities

Building slippages conservatively for PSU banks at FY2010 levels but to decline from thereon for the industry
Fresh additions to NPL for PSU and private banks, March fiscal year-ends, FY2007-2013 (%)

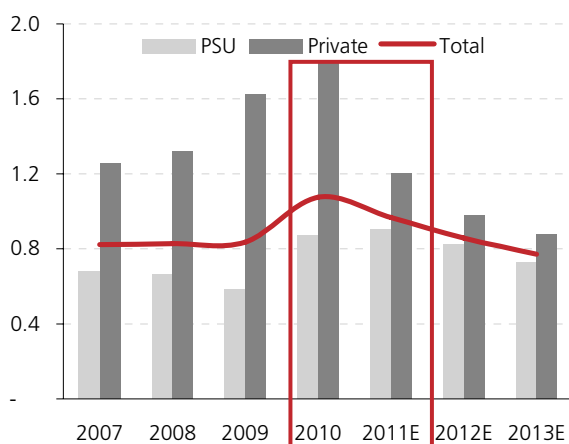


Note: For stocks under coverage

Source: Company, Kotak Institutional Equities

Loan loss provisions can surprise with better recoveries

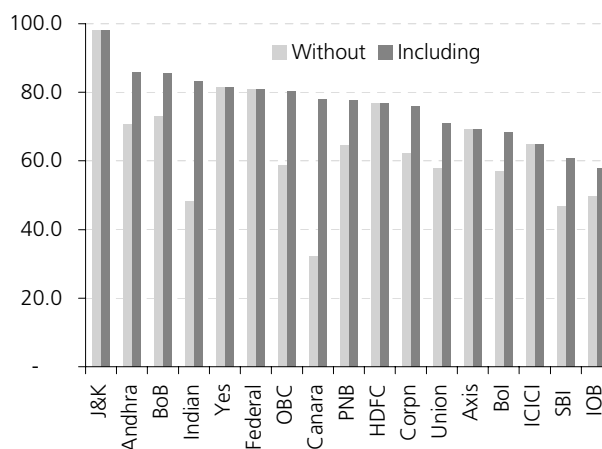
Loan loss provisions to loans, March fiscal year-ends, FY2007-2013 (%)



Source: Company, Kotak Institutional Equities

Provision coverage ratio for most banks is over 70%

Provision coverage ratio with and without technical written-off assets, March fiscal year-ends, 1QFY11 (%)



Source: Company, Kotak Institutional Equities

Data on loans restructured and as % loans as of June 2010

March fiscal year-ends, 1QFY11

	Restructured Loans (Rs bn)	As % of loan book (%)	Slippage (Rs bn)	As % of restructured book (%)	Gross NPLs (Rs bn)	Net NPLs (Rs bn)	(Restructured + proposals + net NPLs) (Rs bn)	As % of loan book (%)	Nature of Restructuring
Public									
Andhra	30.0	5.2	2.2	7.3	5.8	1.7	31.7	5.5	Borrower
BoB	52.8	2.8	4.8	9.0	26.6	7.2	60.0	3.2	Facility
Bol	101.3	5.7	16.9	16.7	47.9	20.6	121.9	6.9	Borrower
Canara	70.0	4.0	5.0	7.1	25.5	17.3	87.3	5.0	Borrower
Corporation	28.1	4.3	1.7	6.2	7.3	2.8	30.9	4.8	Borrower
Indian	51.0	7.5	3.9	7.7	9.9	5.1	56.1	8.2	Facility
IOB	67.0	8.1	8.1	12.1	35.7	17.9	84.9	10.2	Borrower
OBC	53.2	6.2	2.8	5.3	15.0	6.2	59.3	6.9	Borrower
PNB	129.7	6.6	10.4	8.0	36.1	12.8	142.6	7.2	Facility
SBI	268.5	4.1	10.6	3.9	208.3	110.7	379.2	5.8	Facility
Union	49.8	4.0	6.7	13.6	27.4	11.5	61.3	4.9	Borrower
Private									
Axis Bank	21.5	2.0			13.4	4.1	25.6	2.4	Facility
HDFC Bank	2.0	0.1			17.9	4.1	6.1	0.4	Facility
ICICI Bank	37.4	2.0			99.8	35.1	72.5	3.9	Facility

Source: Company, Kotak Institutional Equities

RISKS TO OUR CALL

Non calibrated move from RBI can disrupt margins

A non-calibrated move from RBI, resulting in frequent but, importantly, unexpected changes in policy rates, would render ineffective any transmission of interest rates, in turn pressuring margins. The recent move toward mid-quarterly reports eases concerns (but not completely) on the timing of RBI's scheduled actions.

Unanticipated credit recovery will result in banks campaigning for time deposits

Credit growth currently has slowed at about 20% levels (YTD growth is muted) and a sharper-than-expected recovery in credit in 2HFY10 will result in banks aggressively raising interest rates to garner deposits. Such increases in deposit costs, along with higher reliance on wholesale deposits, will increase pressure on maintaining margins.

Inefficient transfer due to other factors

Tight liquidity shifts pricing power towards banks—transmission is important for margins to remain at current levels. Margins could come off in FY2012 more than we estimate if (1) external pressures interest rates low, (2) management focus shifts towards balance sheet growth rather than margins on the back of a substantially improved macro environment and (3) competition picks up in various products. From a liability perspective, individual deposits to term deposits are on a steady decline resulting in higher volatility in deposit costs.

Impact of new Basel guidelines, change in management and others

Some of the other headwinds include the revised RBI guidelines on capital adequacy framework for banks, frequent changes in top management for public sector banks as well as the accounting treatment/ total liability for revised pension and gratuity.

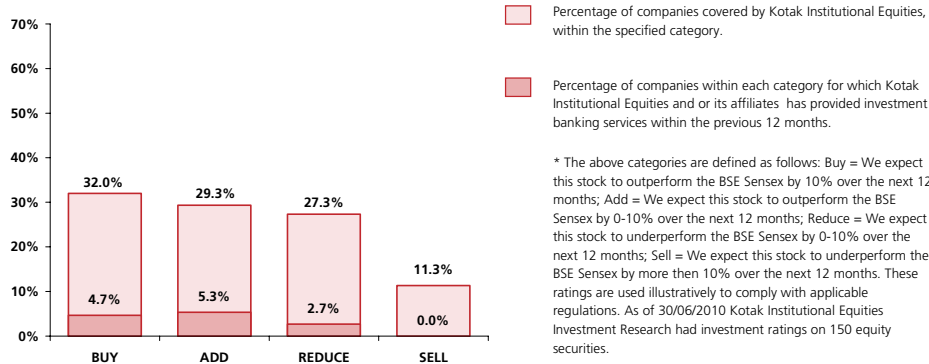
Retirement liabilities can reach nearly 9% of networth for public sector banks (our report on *"Retirement benefits costs likely to impact profitability of PSU's only marginally"*, dated August 19, 2010). We believe that banks should be able to amortize it as the liability can be quite large for any bank to take it in a single year.

Asset quality showing deterioration sharper than current estimates will result in higher provisions, especially with the mandated 70% provision coverage ratio.

"Each of the analysts named below hereby certifies that, with respect to each subject company and its securities for which the analyst is responsible in this report, (1) all of the views expressed in this report accurately reflect his or her personal views about the subject companies and securities, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report: Manish Karwa, M.B. Mahesh."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2010

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

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