Q1FY2008 Banking earnings preview

Numbers expected to be mixed as margins and provisions are expected to vary across banks

We expect the first quarter numbers from the banking industry to be mixed as the net interest margins (NIMs) and provisions are expected to vary across banks. With liquidity not being a concern for the major part of this quarter, we expect most of the banks had a sound operational quarter.

The NIM is expected to vary across banks mainly due to the impact of the deposit costs. The across-the-board prime lending rate (PLR) hikes would definitely show up as an improvement in the asset yields for all banks but the differentiator would be the higher increase in the cost of funds for certain banks who raised large-scale high cost bulk deposits during Q4FY2007.

For most banks the non-interest income component is expected to show a steady year-on-year (y-o-y) growth but a sequential decline, as the non-interest income is normally higher in the fourth quarter compared with the other quarters.

Although benchmark yields have not moved up significantly from March 2007 levels, yet provisions are expected to vary across the board for public sector banks, as some of them shifted securities from the "available for sale" (AFS) category to the "held to maturity" (HTM) category. This would result in a one-time hit during the quarter. The expected increase in the loan loss provisions would also keep the provision figure high.

Expected performance of certain private and public banks

Banks	Key highlights
SBI	We expect the NIM to improve marginally due to an increase of 125 basis points in the PLR. The NSE stake sale would keep treasury gains high. However provisions are expected to remain high on account of investment depreciation booked as the bank has shifted securities from its AFS portfolio to its HTM portfolio. Higher provisions on account of deterioration in asset quality are also expected. The y-o-y profit growth is likely to be sharp on account of a lower base in Q1FY2007.
PNB	Has also shifted securities from its AFS portfolio to HTM portfolio. But investment depreciation is not expected to be significant as the bank's investment book was protected till the benchmark yield of 8.01% as on March 2007 and at the time of shifting the securities the yield was only six to seven basis points higher than the March 2007 yield.
BOB	NIM expected to remain stable with global business reporting a growth of around 22-23%; has also shifted securities but the impact of the shift would be nominal. The treasury income is expected to remain high as we expect the NSE stake sale amount to get reflected in the current quarter. The y-o-y profit growth would be sharply influenced by a lower base in Q1FY2007.
ICICI	Expected to face some pressure on NIM, non-interest income growth to remain steady. However, provisions may remain high due to higher loan loss provisions.
UTI	Expected to show best earnings growth among the private players. Some pressure on NIM is expected on a sequential basis in line with past trends, as low yielding securities brought on books to meet regulatory requirements may affect the asset yields. Operating expenses are expected to remain high, as the bank has been hiring aggressively. So far we have not witnessed any weakness in asset quality of the bank but we have assumed a higher loan loss provision for the quarter.

Quarterly estimates (Rs crore)

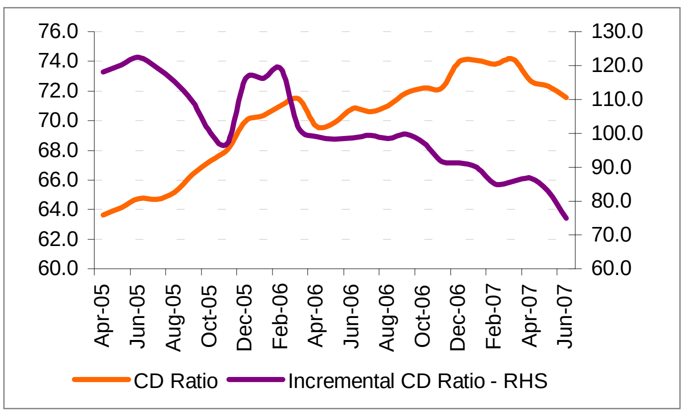
Banks	NII Q1FY08E	(%) yoy chg	(%) qoq chg	PPP Q1FY08E	(%) yoy chg	(%) qoq chg	PAT Q1FY08E	(%) yoy chg	(%) qoq chg
ICICI Bank	1854.2	25.7	1.6	1635.6	32.9	-21.7	704.0	13.6	-18.2
HDFC Bank	2121.0	41.0	8.5	855.8	39.0	8.3	313.5	31.0	-8.8
UTI Bank	471.7	46.6	1.6	374.7	22.0	-11.3	188.1	56.1	-11.2
Total - Private	**4446.9**	**34.7**	**4.8**	**2866.1**	**33.1**	**-13.2**	**1205.7**	**23.1**	**-14.9**
SBI	4767.6	22.7	8.2	3292.9	16.1	-8.5	1147.4	43.7	-23.2
PNB	1327.3	2.7	-2.9	868.3	-1.0	-17.0	401.5	9.2	68.9
BOB	1091.5	34.3	3.7	751.8	35.3	8.6	292.1	78.8	18.9
Total - Public	**7186.4**	**20.0**	**5.3**	**4913.0**	**15.1**	**-7.9**	**1841.0**	**38.5**	**-6.9**
Total	**11633.3**	**25.2**	**5.1**	**7779.1**	**21.1**	**-9.9**	**3046.7**	**32.0**	**-10.2**

The latest credit and deposit growth rates at 25.6% (31% in FY2007) and 23.4% respectively show that the gap in advances and deposits has reduced significantly. This would put less pressure on the deposit rates (especially on bulk deposits, some banks have reduced the bulk deposit rates by 200 basis points to 10% levels from the 12% levels offered during March 2007). With inflation having moderated to 4% levels and less pressure on deposit rates, we feel that interest rates are likely to remain stable in the medium term, thereby providing a good operational environment for banks going forward. Our top picks in the private bank space remain HDFC Bank and UTI Bank while in the public sector we like State Bank of India and Bank of Baroda.

Incremental credit/deposit ratio on a steady decline

With most banks having run out of excess statutory liquidity ratio (SLR) holdings, the gap in credit and deposit growth is slowly going to close, as we are witnessing currently. The incremental credit/deposit (CD) ratio has steadily declined from 120% levels to 75% at present. We expect banks to be net buyers of investments in FY2008 and if there is a an SLR cut in the second half of the current fiscal, then it would be a significant earnings driver for the banking sector as incremental advances yields are higher by 2-3% compared to investment yields. Our estimates suggest that a 2% cut in the SLR would improve the earnings by 2.3% and improve the valuations by 5%.

CD ratio and incremental CD ratio

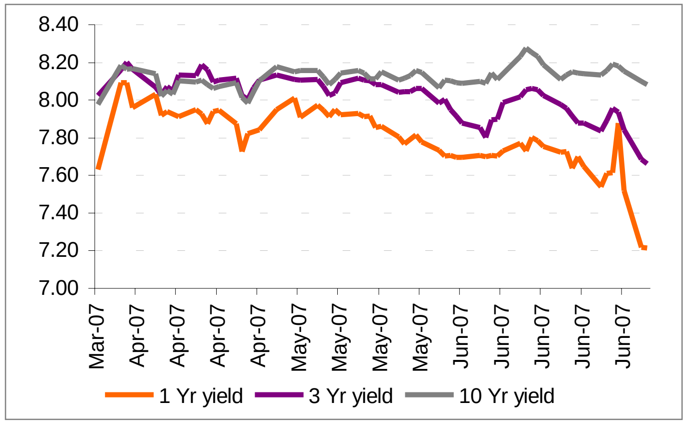


Source: RBI, Sharekhan Research

Benchmark yields have not increased significantly from the March 2007 levels

The benchmark yields of the shorter and medium ends of the yield curve (one-year and three-year) have declined while the 10-year yield has not moved up significantly from the March 2007 levels. Hence the marked-to-market provisions are expected to remain low. However provisions are expected to vary across the board for public sector banks as some of them shifted securities from the AFS category to HTM category which would result in a one-time hit during the quarter.

Benchmark yields for 1 year, 3 year and 10 year



Source: Bloomberg

The banking stocks had a phenomenal run in the last three months

Led by the largest bank State Bank of India, which gained 73%, the banking sector witnessed robust gains across the board. Easing interest rate concerns, improved liquidity conditions coupled with a positive macro and policy environment provided the best ground for the banking stocks to record robust gains.

Banking stock performance

Banks	3 Month	
	Absolute	Relative to Sensex
HDFC Bank	26.9	7.7
BOB	37.2	16.4
BOI	41.4	20.0
Canara	55.2	31.7
Corp Bank	30.4	10.7
ICICI Bank	21.5	3.1
SBI	72.6	46.5
UTI Bank	35.1	14.7
PNB	28.8	9.3
UBI	41.6	20.2
Allahabad Bank	24.1	5.3
Andhra Bank	22.3	3.8

Valuation table

Company	Price target	PER (x)			P/BV (x)			P/PPP (x)		
		FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Allahabad Bank	101	5.2	4.9	4.4	1.2	1.0	0.9	3.6	3.1	2.6
Andhra Bank	101	8.6	7.8	6.8	1.4	1.3	1.1	5.4	4.5	3.8
Bank of Baroda	310	12.0	9.7	7.6	1.3	1.1	1.0	4.9	4.1	3.4
Bank of India	219	15.3	9.6	8.0	2.2	1.8	1.5	5.5	4.1	3.4
Canara Bank	268	8.2	7.7	6.9	1.5	1.1	0.9	4.2	3.8	3.5
Corp Bank	374	10.1	8.4	7.1	1.3	1.2	1.1	4.3	3.7	3.3
PNB	578	11.6	10.8	8.5	1.8	1.6	1.4	5.3	5.2	4.3
SBI*	1,780	18.5	17.9	17.1	2.2	1.9	1.6	7.2	7.1	6.7
UBI	141	9.7	7.8	6.1	1.4	1.3	1.1	4.1	3.0	2.7
HDFC Bank	1,355	40.6	31.6	27.1	6.7	5.6	3.5	17.9	12.9	10.4
ICICI Bank	1,173	35.2	29.1	28.1	4.0	3.7	2.4	19.1	13.2	12.4
UTI Bank	638	36.2	26.9	25.6	6.1	5.2	2.7	11.0	10.8	8.1

*For P/BV we have taken consolidated book value

The author doesn't hold any investment in any of the companies mentioned in the article.