Q3FY2009 Banking earnings preview

Healthy operational performance, MTM reversals to drive profitability

- **Business growth remains robust:** Amidst the rising concerns at the macro level, the business growth at the industry level remained strong in Q3FY2009. The year-till-date (YTD) credit growth (till December 19, 2008) stands at 24.4%, better than the ~22.0% credit growth recorded in the comparable period of the last year. The healthy credit demand is primarily due to the fact that alternative funding sources (external commercial borrowings, foreign currency convertible bonds) have dried up with rising risk aversion. Though the role of domestic banks has increased, we believe that the credit growth is expected to moderate going forward on the back of the economic slowdown.

- **NIMs likely to remain flat sequentially:** The net interest margin (NIM) for most of the banks under our coverage is likely to remain stable as we believe that the aggressive cuts in reserve requirements (cash reserve requirement [CRR] cut by 400 basis points [including the 50-basis-point cut effective January 17, 2009]) would help offset the cuts in the prime lending rates (PLRs; of 50-75 basis points effective in Q3FY2009).

- **PSBs to benefit from MTM write-backs:** The bond yields continued their declining trend during Q3FY2009 and have come off by ~300 basis points since Q2FY2009. Consequently, banks are likely to write back the marked-to-market (MTM) provisions made during the first quarter of the current fiscal. The impact of this is likely to be more pronounced in case of the public sector banks (PSBs; especially State Bank of India [SBI] and Union Bank of India [UBI]). However, the extent of the write-backs would depend on the changes in the composition of bank's investment portfolio during the quarter and the timing of realisation of write-back benefit.

Quarterly estimates (Rs crore)

Banks	NII			PPP			PAT		
	Q3FY09E	Q3FY08A	% yoy	Q3FY09E	Q3FY08A	% yoy	Q3FY09E	Q3FY08A	% yoy
Private Banks									
HDFC Bank	1,929	1,438	34.2	1,265	1,066	18.6	594	429	38.3
ICICI Bank	2,131	1,960	8.7	2,364	2,259	4.7	1,095	1,230	-11.0
Axis Bank	979	747	30.9	849	672	26.2	422	307	37.4
Public Banks									
Allahabad Bank	481	445	7.9	313	521	-40.0	355	365	-2.8
Andhra Bank	443	370	19.7	294	288	1.8	191	159	19.9
Bank of Baroda	1,150	997	15.3	917	932	-1.6	645	501	28.7
Bank of India	1,359	1,079	25.9	1,192	971	22.7	735	512	43.6
Canara Bank	1,156	934	23.7	778	758	2.7	579	459	26.3
Corp Bank	411	334	23.1	355	278	28.1	226	191	18.4
PNB	1,730	1,424	21.4	1,191	991	20.2	739	541	36.4
SBI#	5,404	4,256	27.0	4,121	3,660	12.6	2,794	1,809	54.5
UBI	1,002	788	27.1	761	636	19.7	501	365	37.3

#Standalone

NBFCs	NII			Operating profit			PAT		
	Q3FY09E	Q3FY08A	% yoy	Q3FY09E	Q3FY08A	% yoy	Q3FY09E	Q3FY08A	% yoy
HDFC*	787	666	18.3	814	765	6.4	591	552*	7.1
TFCI	9.1	6.1	48.6	7.9	5.1	54.3	5.7	3.4	65.1

*Ex-exceptionals

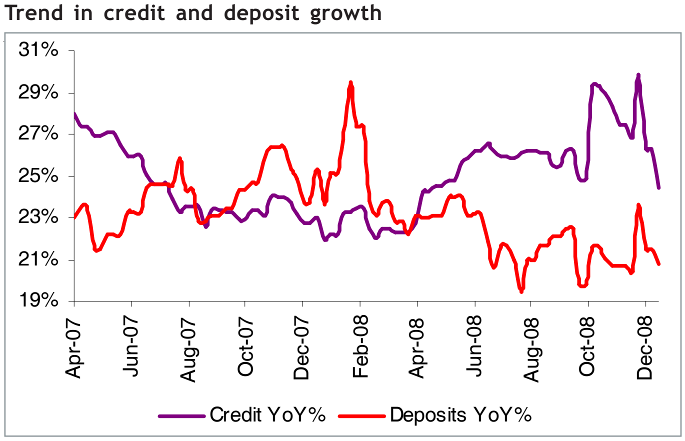
- **Asset quality at centre-stage:** In addition to the concerns over profitability, worries over the quality of assets of banks are on rise owing to the slowing economic growth and the after-effects of the high interest rates. Already, industry level data has indicated a reversal in trend of improving asset quality. The quality of banks' assets will remain at the centre-stage and will be keenly watched in the earnings seasons to come.

For the quarter ended December 31, 2008, we expect Bank of India, Punjab National Bank and State Bank of India from the public sector and HDFC Bank from the private sector to outperform. Meanwhile, we believe ICICI Bank, HDFC and Allahabad Bank are likely to be among the underperformers.

Robust credit demand

Despite the moderation in the economic growth, the non-food credit offtake remained strong during the quarter. The YTD credit growth (till December 19, 2008) stands at 24.4%, better than the ~22% growth seen in Q3FY2008. We believe the robustness of the credit growth stems from the fact that alternative sources of financing have dried up with rising risk aversion globally. Besides, higher credit demand from the fertiliser and infrastructure companies have added to the buoyancy in the non-food credit offtake. However, in light of the ongoing economic slowdown, the credit growth is expected to moderate going forward.

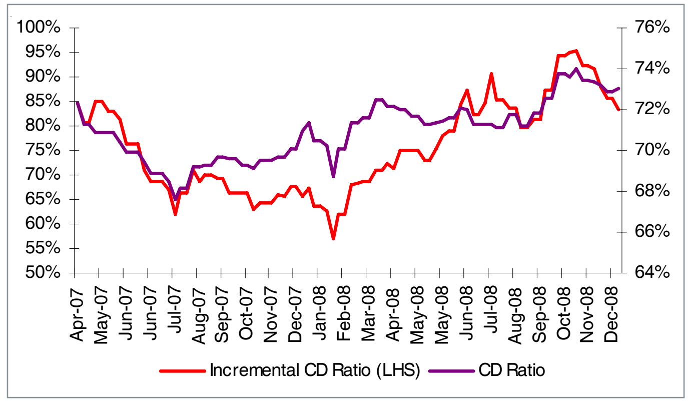
Trend in credit and deposit growth



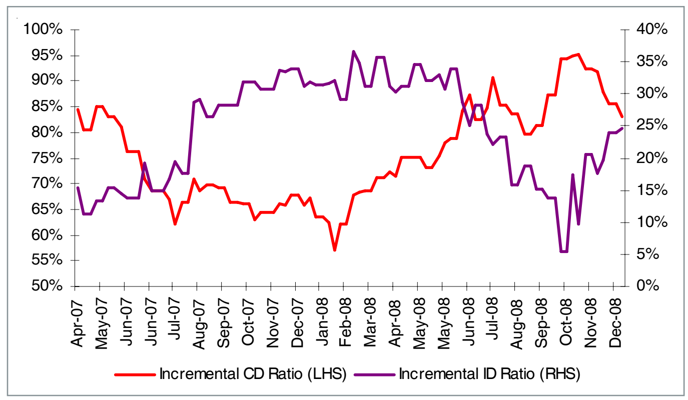
Incremental CD ratio high at ~83%

Since the beginning of the current fiscal, the credit demand has remained strong whereas the deposit growth has dropped to 20.8% year on year (yoy) by December 19, 2008. Consequently, the credit/deposit (CD) ratio has seen an upward trend in the year till date period. In the initial part of the Q3FY2009, the incremental CD (ICD) ratio had spiked to ~95%, which later tapered down to 83.2% by December 19, 2008. The ICD ratio of 83.2% is well above the ~80% level seen in the previous quarter.

Trend in deployment



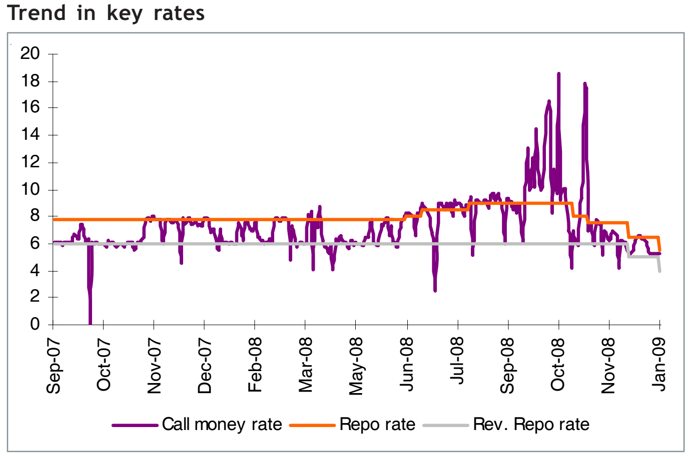
Trend in incremental CD and ID ratios



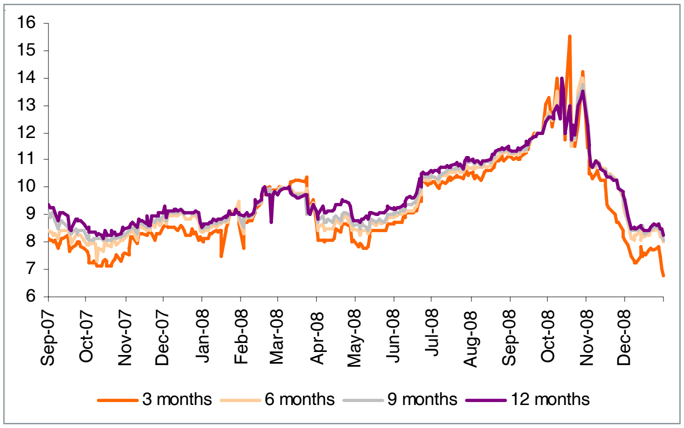
Liquidity crunch has eased off

In line with the Reserve Bank of India (RBI)'s monetary easing measures, the liquidity crunch has eased off significantly since November 2008, leading to the cooling of the money market rates (refer chart below). Importantly, the reverse repo rate has become the guiding rate for the money market. In line, the rates for the certificate of deposits have also eased substantially as the credit demand outlook for FY2010 has weakened.

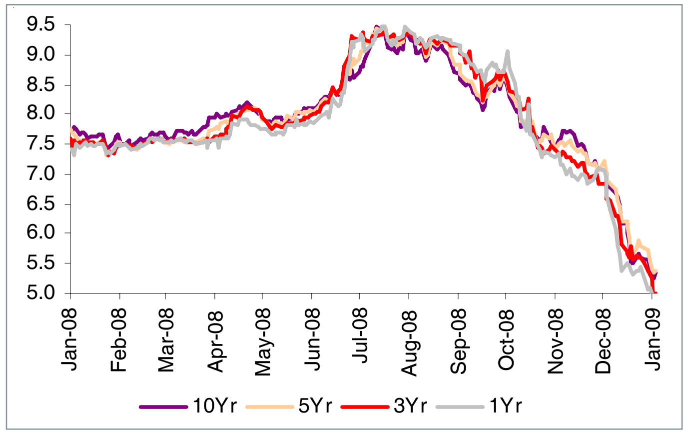
Trend in key rates



Trend in rates for certificate of deposits



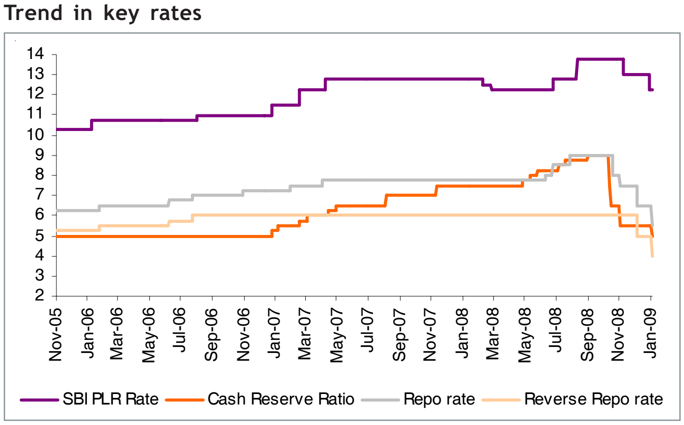
Trend in G-Sec yields



NIMs to remain largely flat sequentially

The NIM for most of the banks under our coverage is likely to remain stable as we believe that the aggressive cuts in reserve requirements would help offset the cuts in the PLRs. In line with the rate actions by the regulator, many banks have cut their lending and deposit rates by 50-75 basis points during the quarter (another ~75-basis-point cut effective in Q4FY2009). Though the effect of the PLR cuts on loan yields is immediate, the benefit of the cut in the deposit rates accrues with a lag, thereby creating pressure on the margins. However, the CRR cut of 400 basis points (including the 50-basis-point cut effective January 17, 2009) should help offset the pressure on the NIM as banks have more funds available for lending.

Trend in key rates



Growth in non-interest income likely to be healthy

As discussed above, the non-interest income of the PSBs should benefit significantly from the cooling of the yields. Moreover, the robust loan growth augurs well for the fee income. Collectively, healthy treasury gains and loan processing fee income should help outweigh the likely lower income from the distribution of third party products.

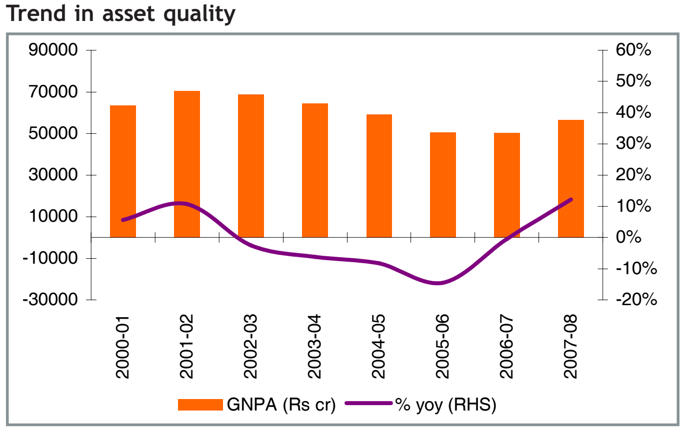
Reversal of MTM provisioning to support bottom line

As a result of the cooling in the bond yields, we expect banks to write back the MTM provisioning made during Q1FY2009. The impact is likely to be more pronounced in case of the PSBs (especially SBI), as they tend to have a larger portion of their investments in government securities (G-Secs). However, the extent of the write-backs would depend on the changes in the composition of bank's investment portfolio during the quarter and the timing of realisation of write-back benefit.

Asset quality at centre-stage

The asset quality of banks would be keenly watched in the quarters to come, in view of the ongoing economic slowdown and the after-effects of the high interest rates until recently. Already, the decade-long trend of improving asset quality reversed in FY2008. The performance of banks in terms of their asset quality is likely to remain mixed for Q3FY2009.

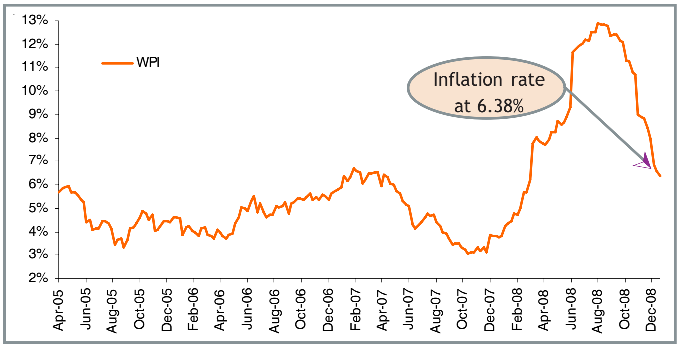
Trend in asset quality



Further monetary easing likely

The inflation rate (as represented by the Wholesale Price Index) has dropped off its peak of 12.91% and now stands at 6.38%. Notably, "fuel, power & light" segment is already witnessing deflationary situation. The easing in inflation has allowed significant leeway to the RBI to shift its focus to stimulating growth through aggressive rate cuts. With the economic growth likely to slow further, regulators may continue to cut rates. Notably, monetary measures assume great importance with regard to India's efforts to revive economic growth due to the limited scope for fiscal measures.

Trend in WPI % change yoy

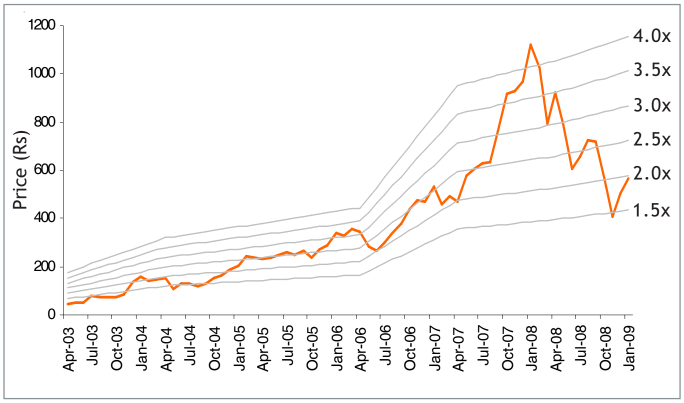


Revision

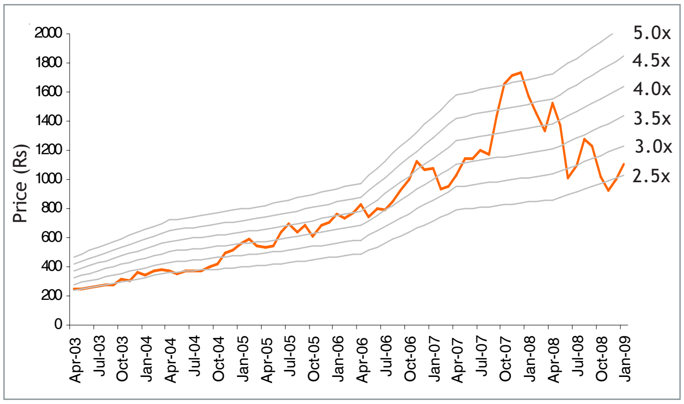
We shall revisit our earnings estimates after the end of the Q3FY2009 earnings season. In specifics, we would like to re-look our asset quality projections on account of the slowdown in the overall economic activity and the uncertain macro economic conditions. Secondly to factor in the effect of the reversal in the interest rate cycle and the aggressive rate cuts undertaken by banks. Lastly, we would revisit our projections for growth in advances in FY2010 considering the ongoing economic moderation.

1-year forward PBV band charts

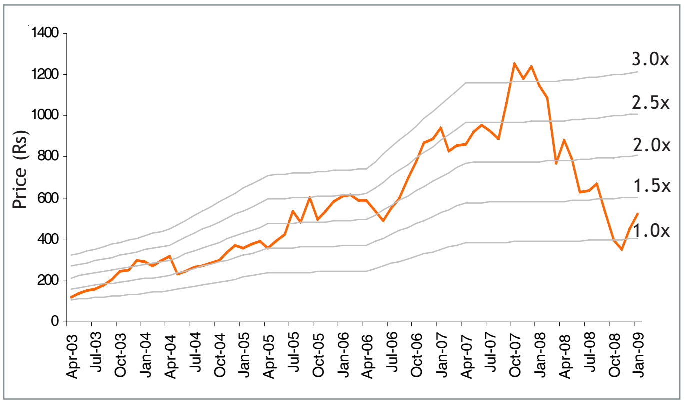
Axis Bank



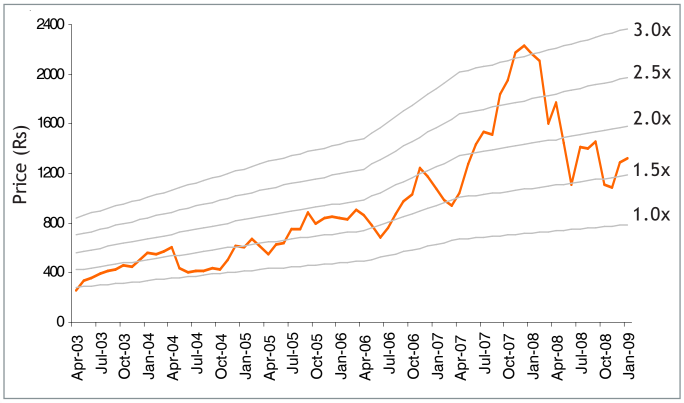
HDFC Bank



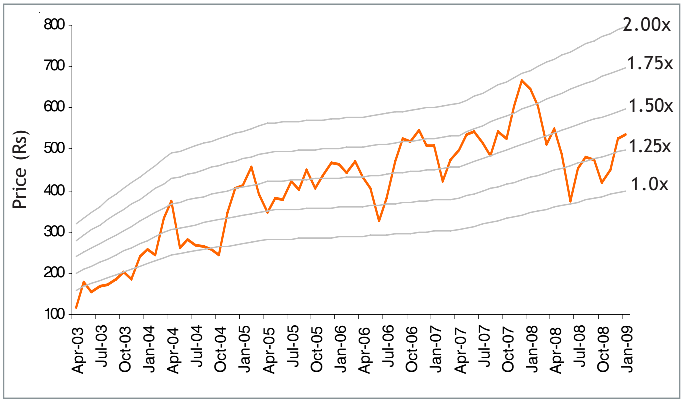
ICICI Bank



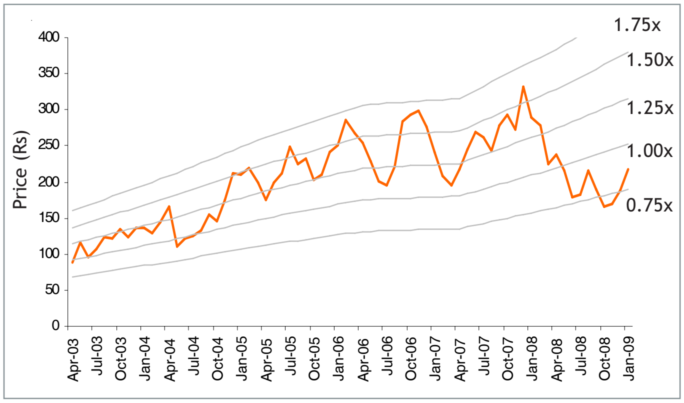
State Bank of India



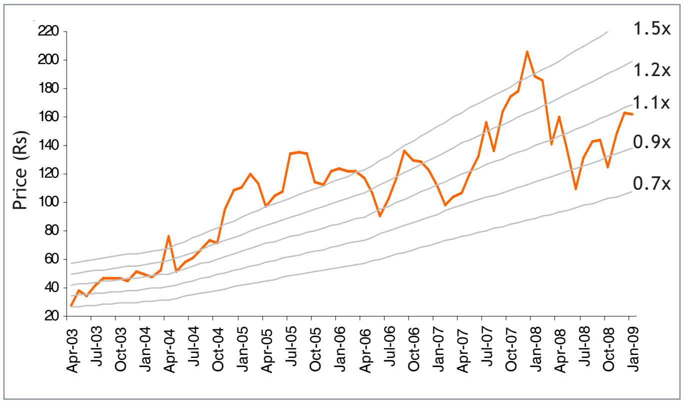
Punjab National Bank



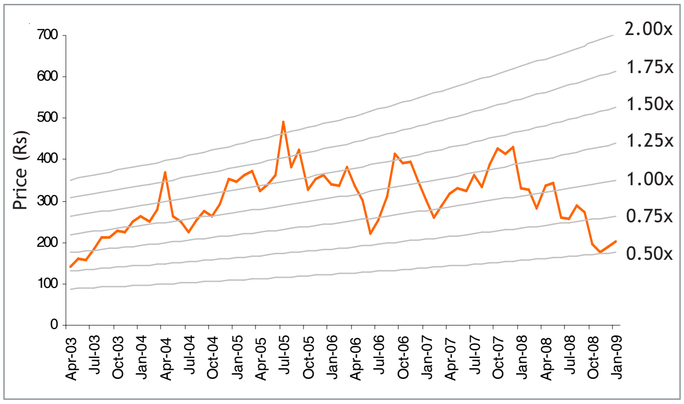
Canara Bank



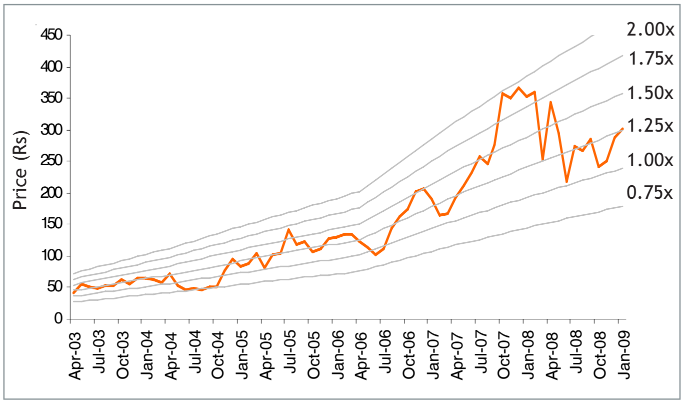
Union Bank of India



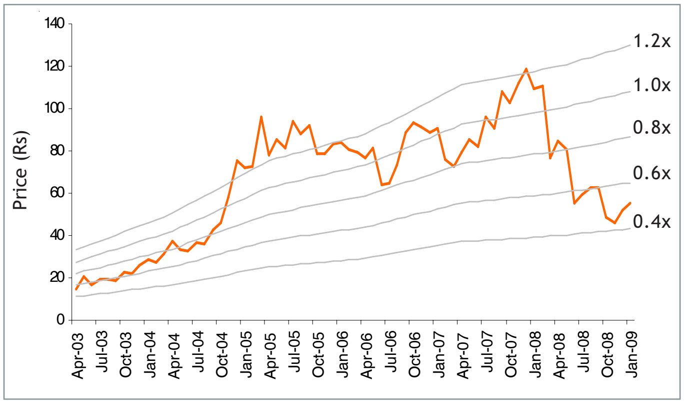
Corporation Bank



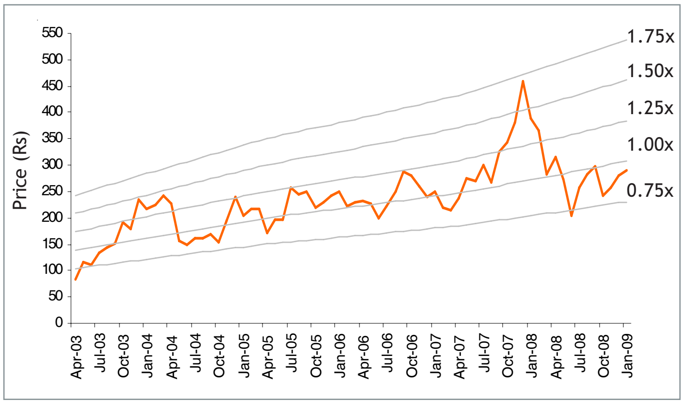
Bank of India



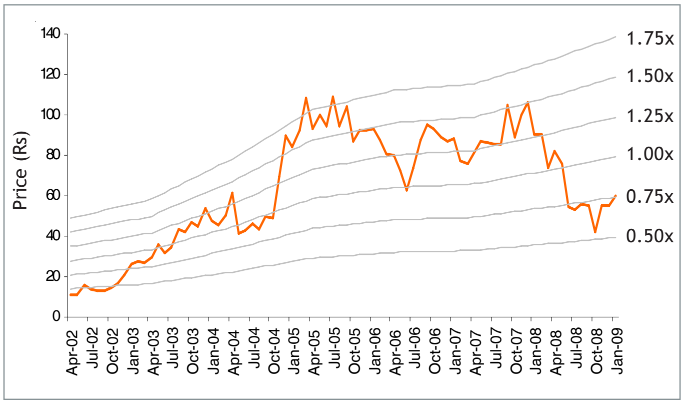
Allahabad Bank



Bank of Baroda



Andhra Bank



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