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Banks

A few dark clouds

Three-month CD rates have increased about 130bp to 9.8% from near-term lows in mid-April. The sharp increase is a negative surprise, given that 1Q is generally a lean period for loan growth. We remain cautiously optimistic on the sector; we recently upgraded ICICI Bank and Axis Bank to Buy.

Table 1 : Key recommendations

	Reco	CMP	Target price	Change	PE (x, FY12F)	PABV (x, FY12F)	ROE (FY12F)
Axis Bank	Buy	1,278	1,388	9%	13.3	2.5	19.9%
HDFC Bank	Buy	2,398	2,574	7%	23.0	3.9	18.0%
ICICI Bank	Buy	1,085	1,197	10%	18.9	2.2	11.5%

Source: Bloomberg, RBS forecasts

Short-term wholesale borrowing costs have spiked up again; yield curve flat

Short-term wholesale borrowing costs as reflected by three-month certificate of deposit (CD) rates have increased about 130bp in the past 45 days, to 9.8% (see Chart 5). The sharp increase is a negative surprise, given that 1Q is generally a lean period for loan growth. The gap between the three-month and the one-year CD rates that had expanded in April has now narrowed. Most of the banks recently increased deposit rates across the shorter-tenure maturity buckets. The interest rate on three- to six-month deposits is now close to 7.0% (see Chart 3). The one-year G-sec yield is currently 8.3%, the five-year G-sec yield is about 8.5% and the 10-year G-sec yield is 8.4%, implying a flat yield curve (see Chart 2). In general, a sustained flattening of the yield curve will put pressure on net interest margins.

Base rate is now close to 10%; liquidity appears to be tightening

The base lending rate for banks, in general, is now close to 10% (see Chart 1). Loans grew 22.3% yoy and deposit growth was 17.4% yoy as of 20 May 2011 (see Table 1). The sharp rise in lending rates will likely slow loan growth and the increase in deposit rates will likely keep deposit growth steady. Liquidity as reflected by repo borrowings appears to be tightening steadily (see Chart 6). Banks were net borrowers to the tune of about Rs535bn in May 2011, compared to about Rs43bn average daily borrowing in April 2011.

Interest rates should remain elevated; rainfall remains a key variable

Given the RBI's stance, we believe interest rates are likely to remain elevated in the medium term. Two key questions arise at this point: 1) how much will loan growth slow?; and 2) in the event of a sharp slowdown, what will be the impact on asset quality? The near-term variable to watch is rainfall, which will have an indirect bearing on business growth and asset quality.

Cautious optimism; we recently upgraded Axis Bank and ICICI Bank to Buy

We remain cautiously optimistic on the sector. In general, asset quality trends look comfortable to us except in the case of certain public-sector banks, for which gross delinquency ratios have been higher than peers in FY11 (especially SBI and PNB). We believe that they may not outperform in the short term. SBI management had recently reiterated its positive outlook on margins and its focus on improving asset quality. However, the key trigger for the stock, in our view, will be the earnings actually delivered by SBI over the coming quarters. We recently upgraded ICICI Bank and Axis Bank to Buy (see our notes FY11 AR: *Some reasons to cheer*, dated 30 May, and *A few positive points*, dated 20 May).

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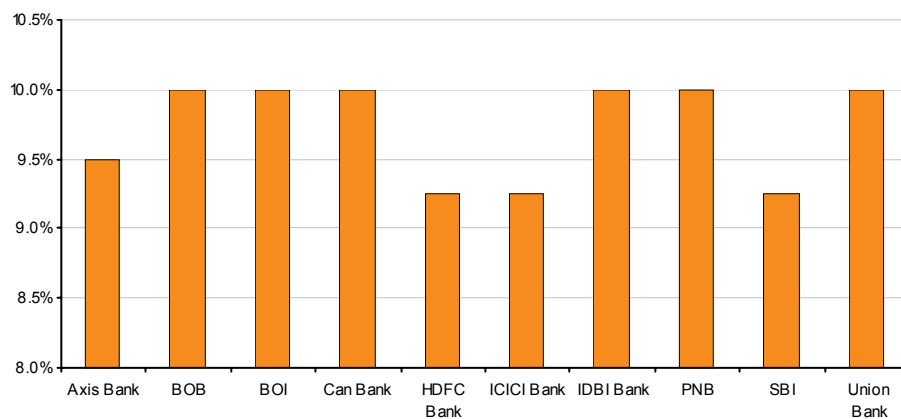
Important disclosures can be found in the Disclosures Appendix.

Table 2 : Indian banking – key statistics

Rs bn	20-May-11	21-May-10	% yoy growth	Last fortnight	FY11 yoy growth
Loans	39,521	32,321	22.3%	-53	21.4%
Deposits	53,193	45,319	17.4%	32	15.8%
Investments	15,831	14,473	9.4%	133	8.3%

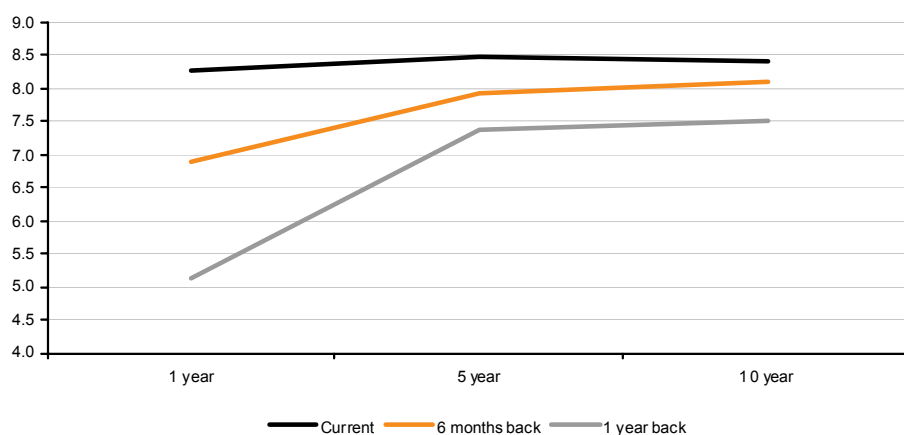
Source: RBI

The base rate for lending is now close to 10% for most banks

Chart 1 : Current base rate comparison

Source: Company data

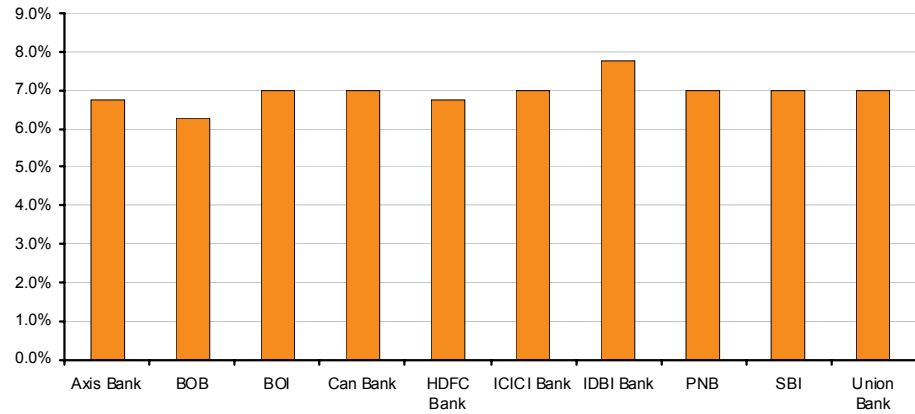
The government bond yield curve has also become flat

Chart 2 : Government bonds – one year, five year and 10 year (%)

Source: Bloomberg

Most banks have raised short-term deposit rates recently and the three- to six-month deposit rate is about 7%, in general

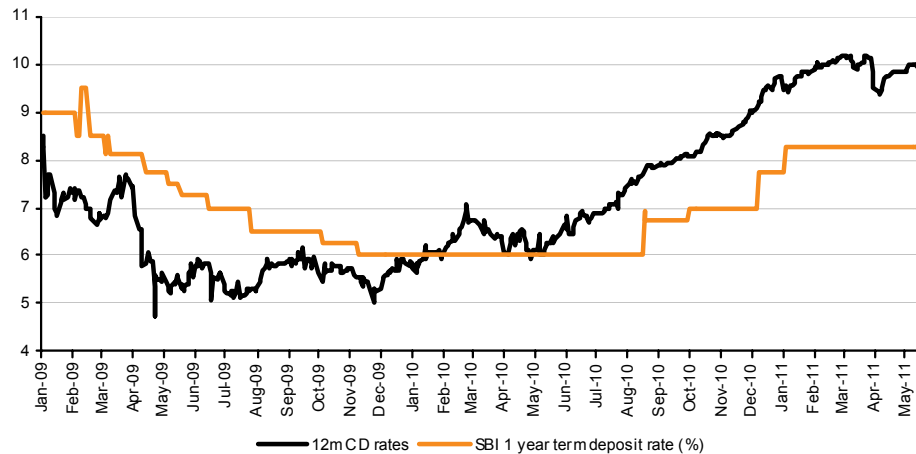
Chart 3 : 91- to 180-day deposit rate comparison across banks



Source: Company data

Retail term deposit rates still continue to be below wholesale borrowing costs

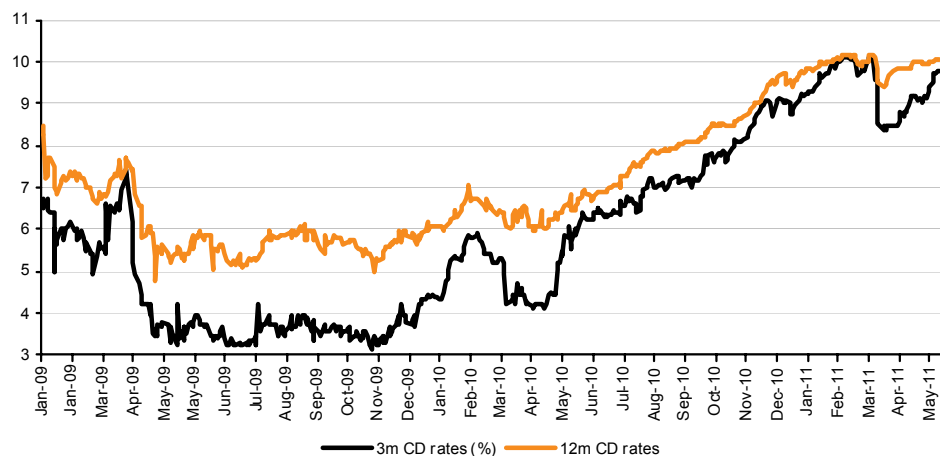
Chart 4 : SBI one-year term deposit rate vs one-year certificate of deposit rate (%)



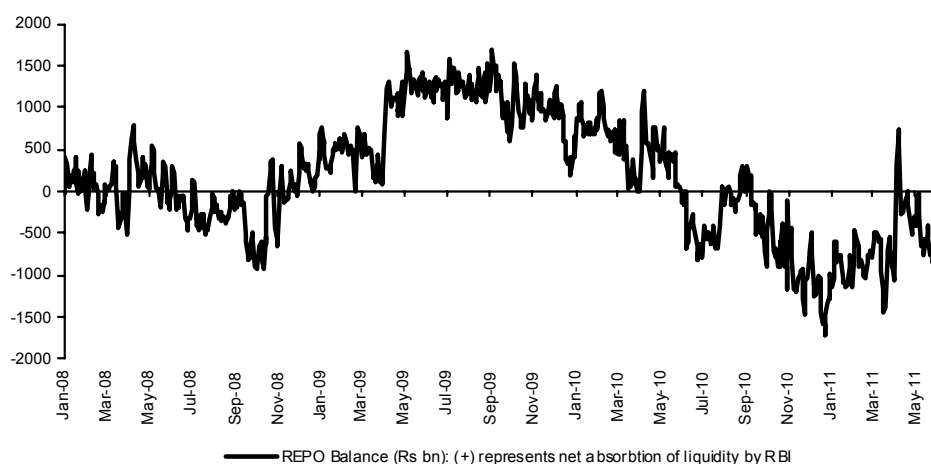
Source: Bloomberg

Note the gap between the 3m and 12m has narrowed recently

Chart 5 : Certificate of deposit rates (%)



Source: Bloomberg

Chart 6 : Repo balance (Rs bn)

Source: Company data, Bloomberg

Table 3 : Nifty vs Bank Nifty Index

	1 month	3 months	6 months	1 year	2 years	3 years	5 years
Absolute performance							
Nifty Index	-2%	1%	-6%	11%	23%	18%	81%
Bank Nifty Index	-2%	1%	-10%	20%	50%	74%	164%
Relative performance							
Bank Nifty vs Nifty Index	0%	0%	-4%	9%	26%	56%	83%

Source: Bloomberg

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 01 Jun 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	791 (13)	513 (3)
Hold	409 (6)	227 (2)
Sell	90 (2)	55 (0)
Total (IB%)	1290 (10)	795 (3)

Source: RBS

Trading recommendations (as at 01 Jun 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	2 (0)	2 (0)
Trading Sell	2 (0)	2 (0)
Total (IB%)	4 (0)	4 (0)

Source: RBS

Valuation and risks to target price

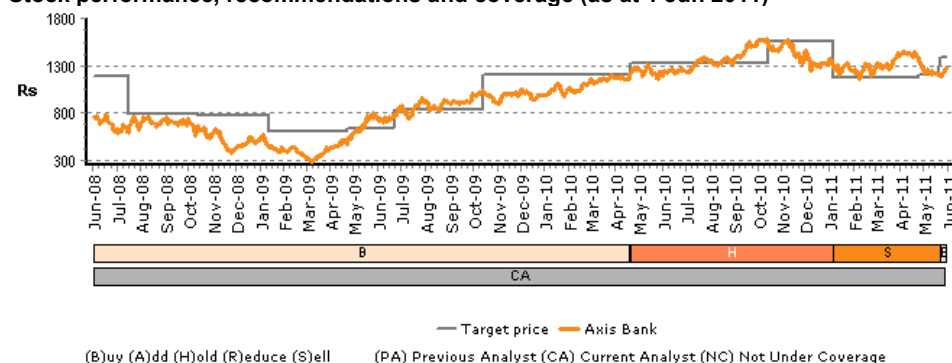
Axis Bank (RIC: AXBK.BO, Rec: Buy, CP: Rs1278.25, TP: Rs1388.00): We value Axis Bank using EVA. Key downside risks to our target price are: a slowdown in economic activity leading to slower-than-expected growth in business; declines in NIM and fee income; a worsening of the asset-quality cycle leading to higher-than-expected provisions for NPLs; and changes in government regulations.

HDFC Bank (RIC: HDBK.BO, Rec: Buy, CP: Rs2398.20, TP: Rs2574.00): We value HDFC Bank using EVA. Key downside risks to our target price are: a slowdown in economic activity leading to slower-than-expected growth in business; declines in NIM and fee income; a worsening of the asset-quality cycle leading to higher-than-expected provisions for NPLs; and changes in government regulations.

ICICI Bank (RIC: ICBK.BO, Rec: Buy, CP: Rs1084.70, TP: Rs1278.00): Key downside risks to our SOTP-based TP are: 1) a sharp slowdown in business resulting in lower core earnings growth; 2) deterioration of asset quality and, hence, a higher-than-expected provision for NPLs; and 3) pressure on the profitability of ICICI's non-banking and international subsidiaries.

Axis Bank coverage data

Stock performance, recommendations and coverage (as at 1 Jun 2011)



Trading recommendation history (as at 01 Jun 2011)

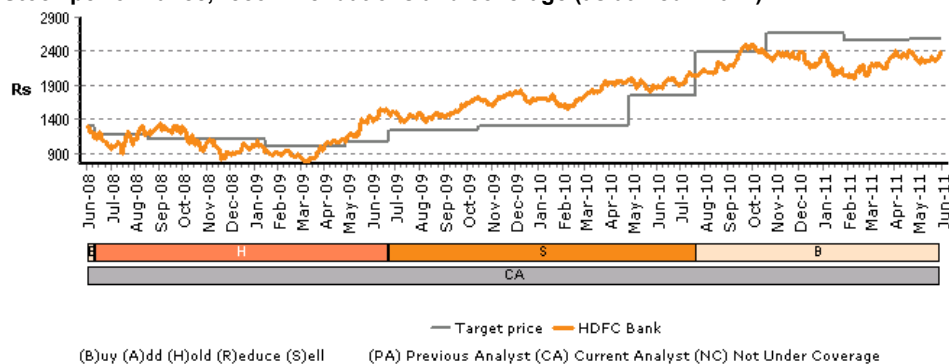
Date	Rec	Analyst
	n/a	

Source: RBS

Jatinder Agarwal started covering this stock on 6 Dec 06. Moved to new recommendation structure between 1 November 2005 and 31 January 2006. Source: RBS

HDFC Bank coverage data

Stock performance, recommendations and coverage (as at 1 Jun 2011)



Jatinder Agarwal started covering this stock on 6 Dec 06. Moved to new recommendation structure between 1 November 2005 and 31 January 2006. Source: RBS

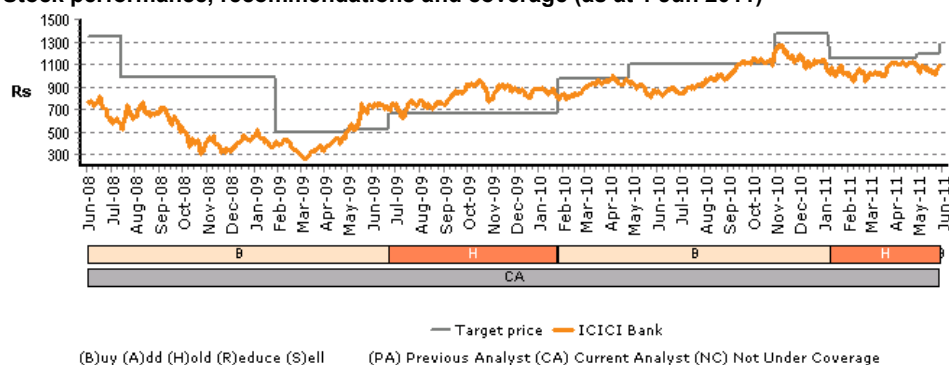
Trading recommendation history (as at 01 Jun 2011)

Date	Rec	Analyst
	n/a	

Source: RBS

ICICI Bank coverage data

Stock performance, recommendations and coverage (as at 1 Jun 2011)



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Trading recommendation history (as at 01 Jun 2011)

Date	Rec	Analyst
	n/a	

Source: RBS

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