Q3FY2008 Banking earnings preview

Margin performance to remain mixed, earnings to be driven by higher non-interest income

Key points

- Last year, the cash reserve ratio (CRR) increased by 50 basis points to 7.5% effective from November 10, 2007, which should erode three to four basis points sequentially from banks' net interest margins (NIMs) during the third quarter of FY2008.
- Banks have discontinued their special deposit schemes and also cut deposit rates marginally. This together with some repricing of the bulk deposits at lower rates will restrict the escalation in the deposit costs sequentially.
- The sequential increase in the incremental credit deposit has been sharp. With the lending rates mostly remaining firm, the yields on advances should provide some fillip to the NIMs on a sequential basis.
- The non-interest income growth is likely to remain strong and be driven by a higher treasury income, as both bond and equity markets performed well during the quarter.
- The 10-year benchmark government bond yields have declined sequentially by 13 basis points. However, the yields at the shorter end for two-year and three-year bonds have declined by four and eight basis points respectively. Hence, some write-back in the mark-to-market provisions for the large public sector banks like Punjab National Bank (PNB), State Bank of India (SBI) and Canara Bank is expected.
- Our top picks in the private sector remain Axis Bank and ICICI Bank, while in the PSU space we like State Bank of India, Bank of India and Bank of Baroda. In the non-banking space our pick is HDFC.

Earnings to be driven by higher non-interest income

The net interest income (NII) for the major banks under our coverage is expected to grow by 19.4% year on year (yoy) and 6.9% quarter on quarter (qoq) while the net profits are likely to grow by 32.4% yoy. The earnings are likely to be driven by a higher non-interest income component mainly treasury gains.

Margin performance to remain mixed between public and private banks

We expect the NIM for the public sector banks (PSBs) to largely remain stable or show a marginal improvement (except PNB). However, for private banks a sequential

Quarterly estimates (Rs crore)

Banks	NII Q3FY08E	(%) yoy chg	(%) qoq chg	COP Q3FY08E	(%) yoy chg	(%) qoq chg	PAT Q3FY08E	(%) yoy chg	(%) qoq chg
ICICI Bank	2230.5	30.5	11.7	2043.4	22.6	6.3	1257.5	38.1	25.4
HDFC Bank	1378.0	48.4	12.8	938.0	30.6	12.5	406.6	37.5	10.4
UTI Bank	708.9	70.5	15.3	437.3	56.6	11.0	292.3	58.4	28.3
Total - Pvt	**4317.4**	**41.4**	**12.7**	**3418.7**	**28.3**	**8.5**	**1956.5**	**40.7**	**22.4**
SBI	4480.5	13.4	3.4	2466.8	20.7	0.2	1413.0	32.6	-12.3
UBI	725.0	5.7	7.8	489.6	7.0	13.5	298.8	17.1	8.5
BOI	1134.0	23.3	7.8	740.3	36.2	16.2	358.8	40.9	-15.6
PNB	1408.2	-2.6	2.9	826.4	-2.4	7.6	502.2	16.8	-6.7
BOB	1094.3	13.9	4.2	581.4	16.5	20.0	402.6	22.4	23.0
Total - Pub	8841.9	11.0	4.3	5104.6	16.2	6.7	2975.4	27.5	-6.4
Total	13159.3	19.4	6.9	8523.2	20.8	7.4	4931.9	32.4	3.3
Non-banks									
HDFC - w/o EO	673.6	63.9	9.3	606.3	63.6	2.1	472.2	34.3	10.5
HDFC - with EO	673.6	63.9	9.3	606.3	63.6	2.1	626.2	78.1	-3.1

Note: We have taken amortisation expenses in the other income segment and adjusted reported numbers accordingly.
COP: Core operating profit (excludes treasury) NII: Net interest income PAT: Profit after tax

Key expectations

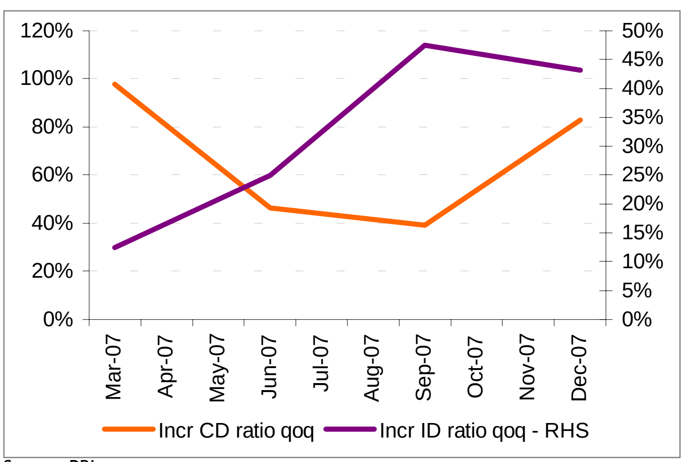
Banks	Key highlights
SBI	It is likely to report marginally higher business growth than industry. Margins are also likely to witness marginal sequential improvement with redemption of some high cost bulk deposits. Provisions are expected to be higher as we feel the bank would like to improve its provision coverage. Profit growth is likely to remain strong yoy due to a lower base in Q3FY2007 on account of higher provisions.
PNB	Margin pressure is likely to continue, hence NII growth is likely to remain weak. However, non-interest income growth is likely to remain high driven by higher treasury gains, fee income and recoveries. The operating expenses are likely to remain elevated as the bank continues to provide for its AS-15 expenses. Provisions are likely to remain high with sequential increase in non-performing loans (NPLs).
BOB	Margins are likely to remain stable, with strong non-interest income growth driven by higher treasury and fee income components. Business growth is likely to show moderation in line with the trend in the previous quarters.
BOI	Business growth is likely to remain strong. The bank is also likely to show some marginal sequential improvement in margins. The non-interest income growth is expected to remain robust. We expect the bank to maintain its stable business growth in line with the trend in the previous quarters.
ICICI	Domestic loan growth is likely to remain subdued, however the margins are likely to show an improvement, as the benefits of the large capital issue are available for the full quarter. The non-interest income growth is likely to remain very strong driven by a higher treasury income. Provisions are likely to remain high with a sequential increase in NPLs. The profit growth is likely to remain strong. Some MTM provision on the collateralised debt obligation (CDO) exposure (Rs100 crore in Q2FY2008) cannot be ruled out. Among Indian Banks ICICI bank has the highest exposure around Rs6,000 crore to foreign CDO.
UTI	The bank is expected to show a sequential improvement in the margins driven by a strong loan growth and benefits of the large capital raising exercise completed in the previous quarter. The profit growth is likely to remain very strong
HDFC	Likely to show very strong core income growth. Loan growth likely to remain strong driven by the festive season demand. Margins likely to show some sequential improvement due to decline in wholesale funding costs while lending rates have remained firm. Extraordinary incomes (EO) likely to remain high in this quarter too with capital gains arising from one-third stake sale in Computer Age Management Services Pvt Ltd at Rs100 crore and 7.2% stake sale in its life insurance JV for a profit of around Rs120 crore.

improvement in the margins could be expected, as the benefits of retiring the high cost bulk deposits with the capital raised in Q2FY2008 is likely to play out over the full quarter. We have worked out the expected possible margin impact for SBI in Q3FY2008 on a sequential basis.

Explanation on the drivers mentioned in the table

1. *Yield on advances:* The same is likely to improve because the sequential incremental credit deposit (ICD) ratio has improved sharply. Thus, with a rise in the ICD ratio more funds are likely to be diverted towards advances where the yields are higher compared with investments. Thus, the contribution from the yield on advances is likely to increase and boost the NIMs.

Trend in incremental CD ratio and ID ratio



Source: RBI

2. *Yield on investments:* With a sharp jump in the ICD, the incremental investment deposit (IID) ratio has declined. Thus, the contribution from this segment to the NIMs is likely to show some decline.
3. *Yield on money market:* With a pick-up in the credit demand, we expect this segment to also show a decline in the contribution towards the NIMs.
4. *Increase in deposit costs:* Some bulk deposit repricing may be on the cards. The bulk deposit rates have almost declined by 150-200 basis points from their peak in March 2007. Our calculations suggest that from the deposit cost an improvement of around one basis point is expected in the NIMs. The improvement in NIM from decline in deposit costs is likely to be more pronounced and visible from Q4FY2008 onwards.

SBI's stance to hike deposit rates came as a surprise

SBI has announced a hike in its term deposit rates effective from January 04, 2008. The increase in the interest rates is primarily concentrated in the deposits with shorter maturities, with the highest increase in the 46-270-day maturity period. We believe the rate hike is aimed at funding the credit growth till the time rights issue proceeds are available for deployment. Besides, the funds may be used for redemption of bulk deposits raised by the bank last year. More clarity is expected to emerge after the announcement of the Q3FY2008 numbers.

Deposit rate for various maturities (%)

Effective date	15 - 45	46 -270	271 - < 1Yr	1yr - 549d	551d - >2yr	2yr- >3 yrs	3yr- 10 yrs
17-Dec-07	4.75	5.25	6.50	8.25	8.25	8.25	8.50
4-Jan-07	4.75	7.50	7.50	8.75	8.50	8.50	8.50
Change	0	2.25	1.00	0.50	0.25	0.25	0

Source: SBI

Sequential impact on NIM

Drivers of NIM	Likely outcome	Reason	State Bank of India Q1FY08 (%)	Q2FY08E (%)	Change (bps)
Yield on advances (as % of TA)	Increase	A sharp increase in sequential ICD ratio	5.29	5.40	0.11
Yield on investments (as % of TA)	Decline	Increase in IID ratio	1.86	1.82	-0.04
Yield on money market (as % of TA)	Stable	No significant change during Q3FY2008	0.12	0.10	-0.02
Deposit costs (as % of TA)	Marginal decrease	Repricing of bulk deposits	-	0.01	-0.01
CRR cost (as % of TA)	Increase	A 50-basis-point hike in CRR from Nov 2007			0.03
Impact on NIM (bps)					**0.03**

CRR costs: Banks are required to set aside a further 50 basis points as increased CRR from November 10, 2007 onwards, which would also erode around three basis points from the NIMs.

Treasury income to drive higher non-interest income growth

The non-interest income growth is likely to remain strong and be driven by a higher treasury income as both bond and equity markets performed well during the quarter. A sequential decline in the 10-year benchmark yields should also result in some mark-to-market write-back in investment provisions.

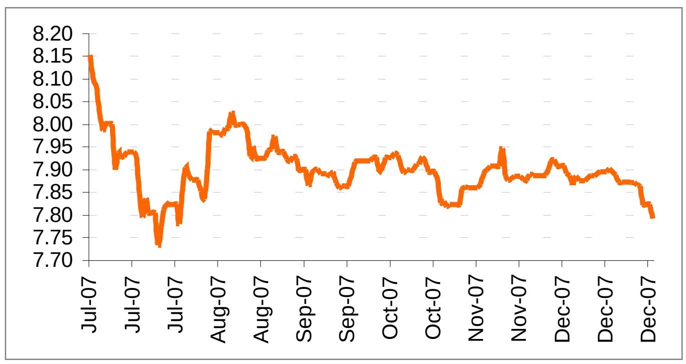
NPA levels likely to show an increasing trend

However, the non-performing assets (NPAs) are likely to show an increase and hence banks may prefer to utilise the higher treasury gains and release the mark-to-market provisions to improve their provision coverage by making higher provisions.

FM takes cognisance of slow credit growth

The finance minister's (FM) comments after a meeting with the PSB chairmen, indicates that the slower credit growth is worrying him in view of the targeted 9% gross domestic product (GDP) growth. The FM hinted at the need to cut the deposit and lending rates by 50 basis points to stimulate growth in consumption expenditure and investments. With the FM taking cognisance of the slower credit growth and persuading banks to lower the lending rates, we might see the Reserve Bank of India (RBI) taking some action on the policy rate front in the months to come.

10-year benchmark yields



Source: Bloomberg and Sharekhan Research

Outlook

We feel the interest rates have peaked out. With inflation too within the RBI's comfort range, the central bank is likely to take cognisance of the slowdown in the credit growth. The FM has also expressed hopes of a stable to declining interest rate scenario in the medium term, which should be conducive to maintenance of the robust economic growth. With the bank margins likely to get a fillip in Q4FY2008 from deposit repricing, a pick-up in the credit demand would further help in improving the margins. Thus, the stage is set for the banks to improve their operating performance. Overall, we remain bullish on the sector as the interest rates have peaked out and banks perform their best in a stable to declining interest rate scenario.

Valuation table

Banks	PER (x)			P/BV (x)			P/PPP (x)			RoNW (%)		
	FY07	FY08E	FY09E	FY07	FY08E	FY09E	FY07	FY08E	FY09E	FY07	FY08E	FY09E
Allahabad Bank	8.0	7.7	6.2	1.7	1.5	1.3	5.5	4.9	3.8	22.6	20.1	21.7
Andhra Bank	11.1	10.6	8.4	1.9	1.7	1.5	6.4	6.0	4.5	17.8	16.8	19.0
Bank of Baroda	16.6	12.4	10.4	2.0	1.8	1.6	7.7	6.0	5.2	12.4	15.0	16.1
Bank of India	16.2	12.6	10.5	3.2	2.4	2.0	7.6	6.1	5.1	21.2	21.5	20.9
Canara Bank	11.6	11.6	9.7	1.6	1.4	1.3	5.6	6.5	5.0	16.3	13.0	14.1
Corp Bank	12.3	9.8	8.5	1.7	1.6	1.4	5.8	5.0	4.4	15.0	16.8	17.3
PNB	14.1	12.1	10.0	2.1	1.9	1.6	6.7	6.6	5.1	15.8	16.5	17.5
SBI*	27.8	26.8	22.5	3.0	2.3	2.0	11.1	10.9	8.9	15.4	12.3	11.9
UBI	13.5	9.9	8.8	2.4	2.0	1.7	5.7	4.9	4.6	19.2	22.3	21.3
HDFC Bank	46.3	39.2	30.0	8.2	5.0	4.4	18.9	15.0	11.5	19.3	15.9	15.6
ICICI Bank	39.4	43.2	29.5	5.0	3.2	3.0	20.9	21.6	14.4	13.3	9.1	10.6
Axis (UTI) Bank	46.6	38.1	28.9	9.0	4.4	4.0	22.5	18.0	13.4	20.9	15.6	14.5
HDFC	34.6	29.7	23.9				9.8	4.9	4.3	22.0	22.2	22.6

* for SBI it is consolidated book value

valuations are based on 07-01-08 BSE closing prices.

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