January 12, 2007

India: Financial Services

Levered play on structural growth; initiating on five companies

Initiating coverage on the Indian financial services sector

We initiate coverage on five stocks in the Indian financial services sector with an Attractive view. Our top picks in the sector are UTI Bank (UTIB, UTBK.BO, adding it to our Conviction list), Housing Development Finance Corp (HDFC, HDFC.BO) and ICICI Bank (ICICIB, ICBK.BO). We initiate on HDFC Bank (HDFCB, HDBK.BO) with a Neutral rating and State Bank of India (SBI, SBI.BO) with a Sell. We believe the market will focus on growth in 2007 rather than deep value offered by most state-owned banks. We expect the trend witnessed in 2006 to continue with well-managed banks delivering robust earnings growth driven by structural and cyclical drivers.

Robust macro fundamentals provide a firm base

We expect the Indian economy to grow 7.8%-8% through FY2009E, with the financial services sector being one of the key beneficiaries. We estimate loans to grow 25%-30%, EPS 19%-33%, and ROE 17% during FY2007E-FY2009E, which we believe are among the best in Asia along with China banks but with lesser fundamental/NPL risks. We believe our BRICs hypothesis of a robust India growth story is shaping up well fueled by favorable demographics, urbanization and reforms.

Best Buy ideas: UTIB followed by HDFC and ICICIB

UTIB is our top pick with a GS CAMELOT-based 3-stage DDM 12-month target price of Rs695, implying 52% total potential return. We rate HDFC and ICICIB Buys with SOTP-based 12-month target prices of Rs1,926 and Rs1,068, respectively, implying total potential return of 28% and 22%.

Best Sell idea: SBI—no upside trigger in the medium term

We rate SBI Sell with an SOTP-based 12-month target price of Rs1,198, implying 7% total return potential. We expect loss of market share and depressed RoAA to hamper earnings growth. We believe the market will focus on earnings growth and give short shrift to short-term catalysts.

Key risks

We are mindful of high expectations and hence the risk to valuations. In our view, growth would be unsustainable if: (1) interest rates were to be raised significantly as against our estimates of just 25 bp-50 bp; and/or (2) statutory liquidity reserve requirements were to be kept at 25% as against our expectations of a cut to 20% by 2HFY2008E.

Summary ratings: India financial services stocks covered by Goldman Sachs

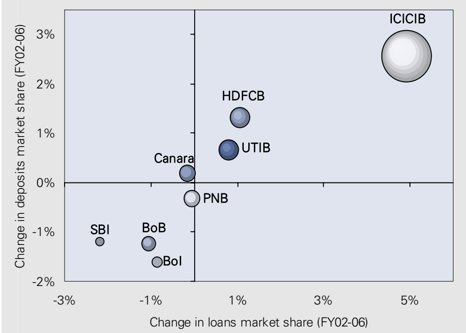
	Reuters ticker	Rtg	Current price	Target price	Total return potential
UTIB	UTBK.BO	B*	462	695	52%
HDFC	HDFC.BO	B	1,527	1,926	28%
ICICIB	ICBK.BO	B	883	1,068	22%
HDFCB	HDBK.BO	N	999	1,161	17%
SBI	SBI.BO	S	1,137	1,198	7%

*This stock is on our regional Conviction Buy list

Note: Prices as of market close of January 10, 2007.

Source: Goldman Sachs Research estimates.

Changes in relative market position of large banks during FY02-FY06



Note: Size of the bubble represents the relative market share change for respective banks

Source: RBI.

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Table of contents

EXPECTED NEWS FLOW/EVENTS

DATE	EVENT	COMMENT
31-Jan-2007	RBI's third-quarter review of credit and monetary policy for FY2007	Key event to watch for: RBI's monetary policy stance
28-Feb-2007	Union budget and fiscal policy announcement for FY2008	Key event to watch for: Impact on the economy and financials market
Feb/March 2007	Parliamentary approval for amendment to SBI Subsidiaries Act	Potential for SBI to realize value from its subsidiaries by selling its stake partially post the parliamentary approval to the amendment

Source: Company data, Goldman Sachs Research estimates.
The prices in the body of this report are based on the market close of January 10, 2007.

Exhibit 1: Our top picks among Indian banks: UTIB, HDFC and ICICIB. We rate HDFCB Neutral and SBI Sell
GS estimates, valuations, current versus through the cycle valuations (FY1996-FY2006 P/B range)

	Reuters Ticker	Stock Rating	Price 1/10/2007 (Rs)	P/B (x)				FY96-06# historical P/B range (x)	10-year# median P/B (x)	BVPS (Rs)			
				FY06	FY07E	FY08E	FY09E			FY06	FY07E	FY08E	FY09E
UTIB	UTBK.BO	B*	462	4.5	3.8	2.3	2.0	0.7 to 3.7	1.4	103.1	121.3	199.6	228.5
HDFC	HDFC.BO	B	1527	6.1	5.4	4.7	4.2	1.1 to 7.0	2.5	251.8	284.1	322.5	367.3
ICICIB	ICBK.BO	B	883	3.5	3.2	3.0	2.6	0.2 to 4.6	1.7	249.6	271.9	298.8	333.2
HDFCB	HDBK.BO	N	999	5.9	5.0	3.5	3.0	1.9 to 12.6	3.4	169.2	200.3	287.0	333.9
SBI	SBI.BO	S	1137	2.2	1.9	1.7	1.5	0.4 to 2.1	0.9	525.3	584.5	666.4	754.1

#since Jan-97 for HDFCB, Sep-97 for ICICIB, and Jan-01 for UTIB
* This stock is on our regional Conviction Buy list

Source: Company data, Goldman Sachs Research estimates.

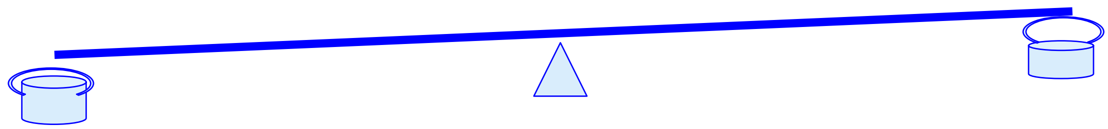
Exhibit 2: We believe growth stocks will outperform deep value stocks
GS estimates, valuations, GS versus consensus net profit estimates

	P/E (x)				Div yld (%)				EPS (Rs)				GS vs cnsnsus (NI)	
	FY06	FY07E	FY08E	FY09E	FY06	FY07E	FY08E	FY09E	FY06	FY07E	FY08E	FY09E	FY08E	FY09E
UTIB	27.0	20.6	14.7	12.3	0.8	1.1	1.4	1.7	17.08	22.39	31.52	37.54	15%	19%
HDFC	31.5	26.5	22.3	18.5	1.3	1.6	1.9	2.3	48.44	57.54	68.56	82.35	4%	4%
ICICIB	27.5	25.1	20.7	16.3	1.0	1.4	1.6	2.1	32.15	35.20	42.58	54.28	-3%	-3%
HDFCB	38.3	29.2	23.0	18.4	0.6	0.8	1.0	1.3	26.11	34.22	43.44	54.18	1%	6%
SBI	13.6	14.9	11.1	10.3	1.2	1.3	1.6	1.8	83.73	76.30	102.43	110.51	-3%	-13%

Source: Company data, Goldman Sachs Research estimates.

Exhibit 3: Indian financial services sector SWOT analysis

We believe liquidity will be the key swing factor in maintaining a stable industry dynamics



Strengths

1. Proven asset quality resilience in past downturns

2. Proven management teams, track record

3. Stable industry dynamics

4. Well-established regulatory framework

5. Stable/low NPL formation rates

Opportunities

1. Improving secular GDP growth prospects

2. Establishment of special economic zones likely to promote further industrialization

3. Years, if not decades, of catch-up economics—low per capita income, educated workforce

4. Rapid financial deepening, i.e. loan growth as multiple of nominal GDP growth

5. Rising consumer spending, consumer credit business

6. Rising corporate capex, investments

7. M&A optionality

Key issues / swing factors

1. Liquidity: Deposit growth sustaining momentum and loan growth moderating to 25% from the current level of 30%

2. Policy risks: Moderation in inflation outlook. Potential for further tightening in the short term. Our economist believes that the risk is less

3. Interest rate outlook: Some headwind from policy rate hike but won't be a shock factor

4. Loan growth: Moderation needed more for maintaining industry dynamics

5. Reduction in reserve requirements: Key swing factor for liquidity and hence for sustaining growth momentum

Key risk factors

1. "Running on empty" in terms of liquidity

2. Tightening in global liquidity may trickle down to India

3. Potentially hawkish RBI stance on inflation/monetary policy

4. Potential rise in long bond yields, MTM risk for banks

5. Potential for valuation pullback, should earnings delivery disappoint expectations

Weaknesses, key challenges

1. Continued crowding out effect from govt budget deficit, combined with accelerating private sector credit demands

2. Ownership restrictions

3. Constraints on state-owned banks' micro reforms, including HR, staff cut, branch cut constraints

Key investment themes in summary

1. Initiating coverage on 5 stocks with an Attractive view on the sector

2. Key theme—Sustained growth momentum albeit with some moderation

3. Preference for growth stocks

4. UTIB*, HDFC, ICICIB (all Buys); HDFCB (Neutral with +ve outlook); SBI (Sell)

5. Paired trade ideas: SBI with ICICIB

**The stock is on our regional Conviction Buy list.*

Source: Goldman Sachs Research.

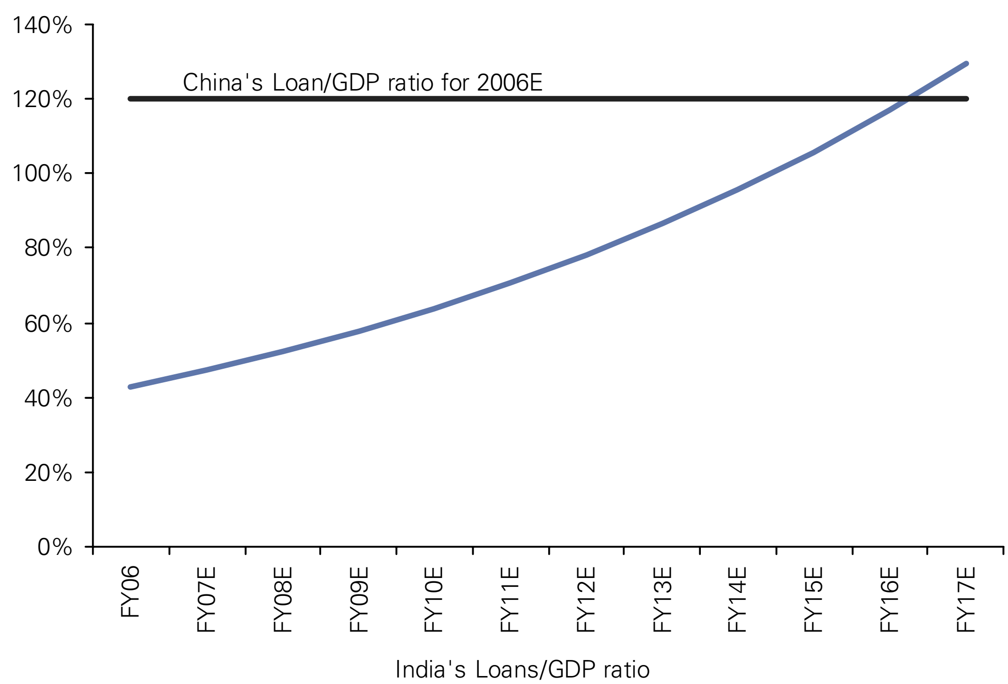
Riding the growth momentum in 2007

The Indian economy, in our view, is likely to sustain the strong growth momentum through FY2007E-FY2009E. We believe the financial sector will benefit from a robust macro environment and sustain 20%-32% earnings growth through FY2009E.

Strong macro fundamentals underpin our positive stance

- We expect the Indian economy to grow 7.8%-8% through FY2009E without any undue risks—associated with such rapid growth rates—to the economy and the financial services sector.
- We forecast demand for loans to rise 25%-30% during FY2007E-FY2009E supported by structural as well as cyclical drivers. We believe the liquidity scenario, although tight, is unlikely to have a significant impact on our loan growth expectations.

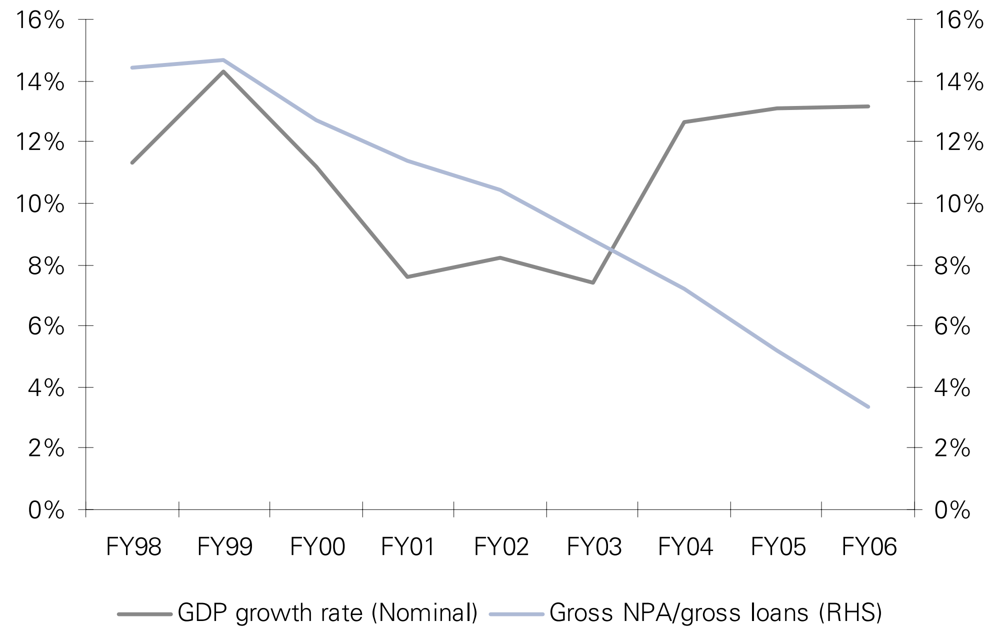
Exhibit 4: In our view, the structural growth story of Indian banks is well discounted
Indian banks' loan levels would likely match Chinese banks only by FY17E, even after assuming 25% CAGR in loans



Source: RBI, Goldman Sachs Research estimates.

- Concerns about potential blow-up in asset quality, in our view, are overdone given the scope for "catch up", management character, and proven track-record demonstrating resilience through business cycles.

Exhibit 5: Structural improvement in asset quality of Indian banks continues
Decline in NPL ratio led by lower rate of new NPL accrual and better recovery rates of existing NPLs, and not by loan growth alone



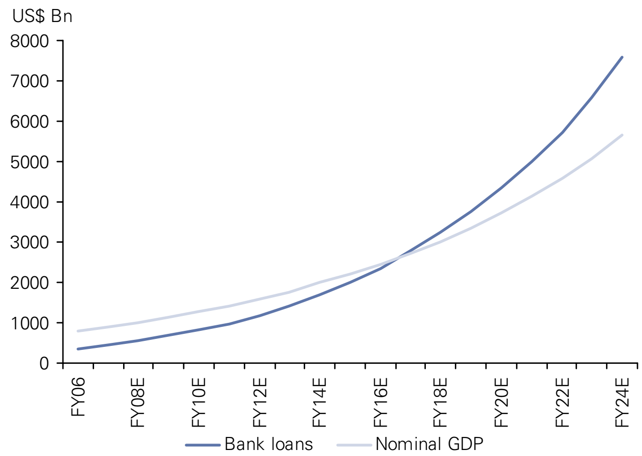
Source: RBI.

Growth as far as we can see

We believe our BRICs view of strong growth is taking shape and we are dovetailing the same with our growth expectations beyond FY2009.

- The projected GDP growth rate for India from 2010E is in the region of 5.5%-6% until 2050E driven by favorable demographics, rapid urbanization and a conducive growth environment.
- In such a scenario, we believe banks will continue to experience strong loan growth (a minimum of 15%-16%).
- We expect competition to intensify, and consequently temper profitability (hence our assumptions of stable, not rising, margins and RoAAs), as the Reserve Bank of India (RBI) gradually eases restrictions on foreign banks' expansion and reforms of state-owned banks pick up.
- We estimate the sustainable growth rate for banks under our coverage to be 11.2%-12.4% during the intermediate phase in our GS CAMELOT-based 3-stage dividend discount model (DDM).

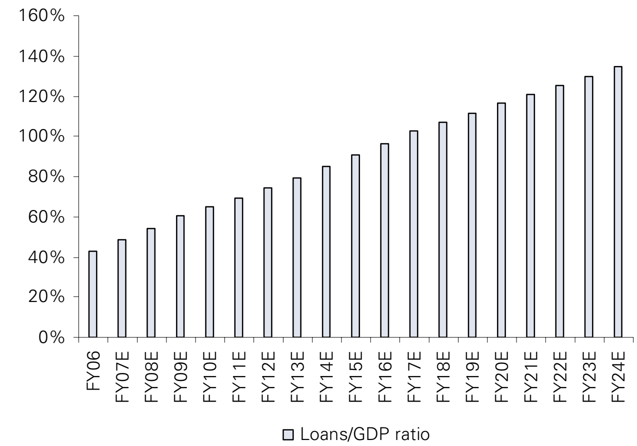
Exhibit 6: As per our BRICs hypothesis, Indian banks could potentially sustain loan growth of over 15% all the way through FY24E...



Source: RBI, Goldman Sachs Research estimates.

Exhibit 7: ...resulting in higher loans/GDP, but still comparable with other Asian markets

It would take 18 years for India to reach China's loans/GDP ratio of 125% in 2006E



Source: RBI, Goldman Sachs Research estimates.

Sustained earnings growth of 20%-32% through FY2009E…

Cyclical drivers: (1) a benign environment for banks' asset quality resulting in sustained low loan loss provisions (LLP); and (2) fee income pick up from distribution of third-party financial products.

Structural drivers: (1) favorable demographics driving consumer banking income streams; (2) increase in penetration levels of banking products and services spurring loan and deposit growth of 25%-30% and 21%-22%, respectively; (3) rising penetration of SME/middle market and corporate lending, driving 20%-25% loan growth; and (4) potential for lower statutory reserve requirement, increasing the liquidity of banks.

SBI—The outlier: We expect SBI to register 12% earnings CAGR through FY2009E on the back of slower growth resulting in market share loss and suboptimal returns from assets, albeit with some improvement in the trend.

We are projecting stable margins and ROA for leading players in the private sector rather than an improving trend in the face of robust macro prospects as we expect the private sector to invest in expansion of distribution over the next 3-5 years, thereby increasing the operating cost. We project the operating cost to outpace operating revenues during FY2007E and FY2008E. For FY2009E, we project operating cost to grow in line with operating revenues.

We believe the upside to expectations will primarily come from expansion of market share. Even the leading private banks have single-digit market share, which we believe has scope to rise significantly. We expect the earnings growth of these banks to stay ahead of state-owned banks even without structural and cyclical improvement in ROE.

...underpinned by their strengthening market position

A combination of restrictive policy for expansion of foreign banks in the domestic market and slow pace of reforms for state-owned banks has given a boost to the competitive position of key players in the private sector, namely HDFC, HDFC Bank, ICICI Bank, and UTI

Bank. We believe status quo will be maintained on reforms and regulations through 2008E, thereby strengthening the market position of these leading private sector players further.

Exhibit 8: We expect 30.7% and 19.8% average stated EPS growth for the sector in FY08E and FY09E respectively
Stated earnings' growth drivers and key metrics

	Key earnings drivers (Yoy % growth)											Memo (%)					
	Deposits	Loans	NII	Non-int income	Opng rev.e	Opng exp.	Pre-prov op. profit	Loan prov.	Pretax profits	NPAT	EPS	NIM	Yoy chg in NIM	Loan prov./ loans	Yoy chg in Prov./loan	ROA	ROE
FY06	**37.2**	**42.3**	**29.3**	**45.5**	**35.6**	**36.7**	**34.8**		**25.4**	**26.2**	**15.9**	**2.5**	**(0.0)**	**0.7**	**0.3**	**1.2**	**16.9**
UTIB	26.5	43.0	45.1	75.5	56.6	40.0	75.2	4,079.6	45.2	45.0	21.5	2.27	0.06	0.67	0.65	1.11	18.4
HDFC	NA	24.9	28.8	5.9	23.2	19.5	23.7	1.3	23.9	21.3	16.9	2.95	0.07	0.00	(0.00)	2.62	23.8
ICICIB	65.4	59.9	32.1	45.9	40.0	35.8	45.1	(475.5)	22.5	26.7	17.7	1.62	(0.13)	0.38	0.54	1.21	14.6
HDFCB	53.5	37.1	44.7	72.6	52.8	55.8	50.0	172.3	28.0	30.8	21.9	3.68	0.29	1.58	0.77	1.39	17.7
SBI	3.5	29.3	(4.7)	(11.8)	(7.1)	15.4	(31.0)	(87.7)	5.9	2.4	2.4	2.51	(0.39)	0.06	(0.60)	0.92	17.0
FY07E	**34.2**	**36.9**	**37.1**	**31.7**	**34.1**	**35.1**	**33.2**		**18.8**	**19.8**	**15.7**	**2.6**	**0.1**	**0.7**	**0.0**	**1.1**	**17.1**
UTIB	43.9	56.8	50.8	40.2	46.3	46.8	45.8	(10.5)	31.3	31.2	31.1	2.42	0.16	0.40	(0.27)	1.03	20.7
HDFC	NA	26.0	30.6	(8.9)	22.3	16.0	23.2	93.5	23.4	22.3	18.8	3.10	0.15	0.00	0.00	2.58	21.5
ICICIB	39.4	29.5	45.9	31.3	37.2	43.5	29.9	77.2	24.9	24.8	9.5	1.81	0.20	0.50	0.12	1.16	13.6
HDFCB	38.2	36.9	37.5	48.0	40.9	39.2	42.6	37.5	30.8	31.8	31.1	3.75	0.07	1.60	0.02	1.36	19.9
SBI	15.2	24.4	14.2	7.5	12.1	10.7	14.4	386.6	(11.9)	(8.9)	(8.9)	2.52	0.00	0.25	0.19	0.74	14.1
FY08E	**26.9**	**32.0**	**29.9**	**25.5**	**28.5**	**28.8**	**29.6**		**33.9**	**32.2**	**30.7**	**2.7**	**0.1**	**0.8**	**0.1**	**1.1**	**18.4**
UTIB	31.2	44.7	38.9	30.3	35.4	38.8	32.4	110.0	44.2	44.2	40.8	2.49	0.07	0.60	0.20	1.10	21.9
HDFC	NA	24.0	21.8	8.8	19.7	16.7	20.1	-	20.3	20.3	19.2	3.08	(0.02)	0.00	(0.00)	2.54	22.7
ICICIB	30.3	28.5	28.2	29.7	29.1	32.4	24.8	34.0	24.9	21.9	21.0	1.82	0.00	0.50	-	1.11	15.1
HDFCB	32.2	34.5	28.9	33.7	30.6	32.9	28.3	36.1	32.1	28.3	26.9	3.66	(0.09)	1.65	0.05	1.32	19.4
SBI	13.8	20.2	23.7	8.2	19.0	10.9	33.0	95.2	34.2	34.2	34.2	2.75	0.24	0.40	0.15	0.88	17.1
FY09E	**24.4**	**28.3**	**29.8**	**22.5**	**26.8**	**25.4**	**28.7**		**26.1**	**26.1**	**19.8**	**2.8**	**0.1**	**0.8**	**0.0**	**1.1**	**17.8**
UTIB	25.2	34.8	36.8	28.8	33.6	35.2	32.1	32.0	33.9	33.9	19.1	2.62	0.13	0.60	-	1.14	18.2
HDFC	NA	24.0	23.0	6.9	20.7	17.0	21.1	33.3	21.2	21.2	20.1	3.11	0.03	0.00	0.00	2.53	24.0
ICICIB	26.4	26.8	32.3	23.0	27.0	25.7	28.7	30.0	28.3	28.3	27.5	1.92	0.11	0.50	-	1.14	17.4
HDFCB	32.8	31.6	32.9	28.9	31.5	29.8	33.2	32.0	34.2	34.2	24.7	3.75	0.08	1.65	-	1.37	19.5
SBI	13.3	20.0	17.2	9.3	15.0	11.0	20.7	50.0	7.9	7.9	7.9	2.88	0.13	0.50	0.10	0.85	16.2

Source: Company data, Goldman Sachs Research estimates.

Top picks: Prefer growth stocks over deep value in 2007

We initiate coverage on five stocks in the Indian financial services sector (Attractive)—UTIB (Buy*), HDFC (Buy), ICICIB (Buy), HDFCB (Neutral), and SBI (Sell)—with 'growth' as the key investment theme for 2007.

UTIB is our best pick in the Indian financial services sector with a 12-month target price of Rs695—3.5x FY2008E BVPS—implying 52% total return potential. This is because: (1) the current market price reflects very low growth expectations (6% growth in DPS over the next 3 years) in market conditions that seem to favor growth stocks; (2) it has potential to beat consensus estimates—historically, consensus has underestimated growth for UTIB; and (3) inexpensive valuations relative to the peer group, trading at 14.7x FY2008E P/E and 2.3x P/B versus peer group multiples of 22x and 2.9x, respectively.

We rate HDFC and ICICIB Buys with 12-month target prices of Rs1,926 and Rs1,068, respectively, implying total return potential of 28% and 22%. We believe the price performance of HDFC and ICICIB will be driven by their increasing franchise strength—75% and 83% of current market capitalization, respectively. We also estimate increasing contribution from their strategic investments—life insurance, asset management, and banking subsidiaries—will drive the share price over the next 12 months.

* We are placing the stock on our regional Conviction Buy list.

We initiate on HDFCB with a Neutral rating (positive outlook). Our 12-month target price of Rs1,161—4.0x FY2008E BVPS—implies 17% total return potential. We are positive on the business fundamentals of the company, but premium valuations constrain our view.

We rate SBI Sell with the 12-month target price of Rs1,198, implying 7% total return potential. We believe loss of market share and depressed RoAA will hamper earnings growth and cap the upside to current expectations. Newsflow on increasing the free float for SBI and its subsidiaries could be potential short-term catalysts, but we believe fundamental issues will dominate expectations over a 12-month investment horizon.

Versus consensus

- We believe growth stocks will outperform deep value stocks that lack catalysts in 2007E, which is reflected in our ratings. Consensus' stock rating distribution seems to suggest that their opinion is biased towards deep value stocks.
- We believe quality of management and progressive strategies will prevail and the market will take cognizance of strong growth and liquidity conditions in valuing banks.

Exhibit 9: We initiate coverage on the Indian financial services sector, with top picks—ranked by total return potential—UTIB, HDFC and ICICIB

GS CAMELOT-based 12-month target prices and ex-growth bond-equivalent values

		Price target and price floor						GS CAMELOT valuation model (%)											Ex-growth
		Current Price	GS Target Price	Total potential	GS CAMELOT Implied value	Price floor		Capital asset pricing model			3-stage dividend discount model						CAMELOT Implied targets (x)		bond equiv valuation
											stage 1	stage 2		stage 3					
Stock	Rating	Price 1/10/2007 Rs	12-mo tgt price Rs	returns incl div yield	Target P/B x FY08E BVPS Rs	Ex-gth P/B x 08E BVPS Rs	Potntl Dwnside	Risk-free rate	CAMELOT quotient (x)	(d) Total disc rate	3-year Div CAGR	15-year ROE	Div payout	(a) Sust ROE	(b) Div payout	c= a*(1-b) L/T growth	P/B	P/E	(e) = (a)/(d) Ex-growth P/B
UTIB	B*	462	695	52%	695	286	-38%	7.50%	0.80	11.50%	31.0%	18.0%	31.0%	16.5%	71.0%	4.8%	3.5	21.1	1.4
HDFC	B	1,527	1,926	28%	1,528	586	-62%	7.50%	0.70	11.00%	20.5%	23.0%	46.0%	20.0%	76.0%	4.8%	4.7	23.7	1.8
ICICIB	B	883	1,068	22%	980	429	-51%	7.50%	0.80	11.50%	29.0%	17.5%	30.0%	16.5%	71.0%	4.8%	3.3	19.9	1.4
HDFCB	N	999	1,161	17%	1,161	449	-55%	7.50%	0.80	11.50%	32.0%	19.0%	35.0%	18.0%	73.5%	4.8%	4.0	22.5	1.6
SBI	S	1,137	1,198	7%	989	771	-32%	7.50%	1.05	12.75%	13.0%	15.5%	30.0%	14.8%	70.0%	4.4%	1.5	10.1	1.2

* The stock is on our regional Conviction Buy list

Source: Goldman Sachs Research estimates, Datastream.

GS CAMELOT-based 3-stage DDM and SOTP methodologies the cornerstones

The Indian financial services sector has consistently outperformed its Asian peers since 2003, which throws up challenges while valuing stocks that are trading well above the historical range.

We value the core banking/financial services business using GS CAMELOT-based 3-stage DDM. Given that the current valuation multiples are over the historical range, we are using GS CAMELOT-based P/B ceiling as our guide for valuing the franchise of the stocks.

We use sum-of-the-parts methodology for HDFC, ICICIB and SBI to reflect the contribution of their strategic investments.

Exhibit 10: Absolute and relative share price performance of the Indian financial services sector

	Price (Rs)	Mkt cap	daily vol	1-year		Absolute price perf (%)					Rel price perf % (to BSE)					Rel to MSCI APxJ Bk				
	1/10/2007	(US $ bn)	(US $ mn)	High	Low	1-wk	1-mo	3-mo	1-yr	ytd	1-wk	1-mo	3-mo	1-yr	ytd	1-wk	1-mo	3-mo	1-yr	ytd
UTIB	462	2.92	0.96	505	240	(2.8)	(0.7)	18.7	47.6	29.6	1.9	2.5	10.7	6.2	11.1	0.8	(1.9)	10.7	31.3	18.3
HDFC	1,527	8.58	1.01	1,665	997	(5.0)	(1.5)	7.9	25.0	14.3	(0.3)	1.7	(0.2)	(16.5)	(4.2)	(1.4)	(2.7)	(0.1)	8.7	2.9
ICICIB	883	17.72	5.20	913	455	(1.3)	0.7	27.1	51.0	49.8	3.4	3.9	19.0	9.5	31.4	2.3	(0.5)	19.0	34.7	38.5
HDFCB	999	7.07	1.53	1,145	642	(6.2)	(7.9)	6.4	33.6	29.2	(1.6)	(4.7)	(1.6)	(7.9)	10.7	(2.6)	(9.1)	(1.6)	17.3	17.9
SBI	1,137	13.44	10.79	1,360	690	(10.1)	(16.0)	10.8	24.9	17.4	(5.5)	(12.8)	2.7	(16.6)	(1.0)	(6.6)	(17.2)	2.8	8.5	6.1

Source: Goldman Sachs Research estimates, DataStream.

Growth vs. value—We root for the former

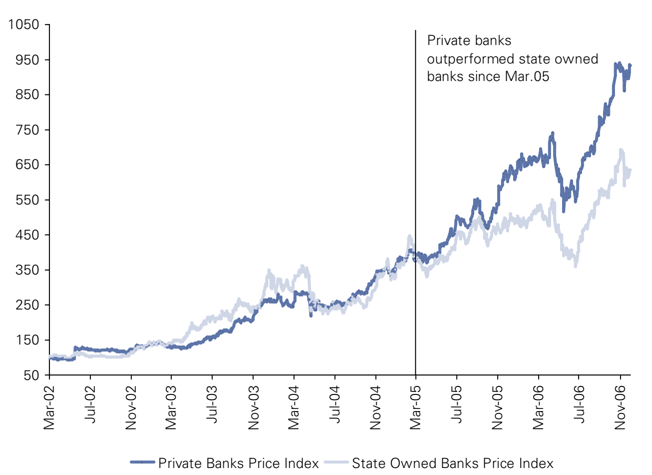
The valuation range within the Indian financial sector is fairly wide with large state-owned banks and private sector players trading at 7.7x-10.8x FY2008E P/E and 17x-24x FY2008E P/E, respectively (consensus estimates). State-owned banks offer deep value and, perhaps, a better investment proposition as against some of their Asian peers. But, the moot point is whether investors should give preference to deep value at the expense of growth stocks particularly against the backdrop of:

- Favorable operating environment benefiting all players;
- Significant convergence in RoAA; and
- Well discounted future expectations for growth stocks (as reflected in their valuation multiples)

All these factors remaining constant, the only differentiating factor would be the ability of banks to capitalize on growth opportunities and create sustainable competitive advantages over extended periods. Given the high entry barriers and slow/unfinished reforms of state-owned banks, we believe leading private players are best positioned to leverage growth opportunities. We expect the market to reward these players and the same reflects in the valuation differential till such time the operating environment deteriorates because of either a change in the economic environment or reforms within the sector. Hence, we recommend maintaining a growth bias in stock selection.

Exhibit 11: Private sector players have outperformed state-owned banks since FY06

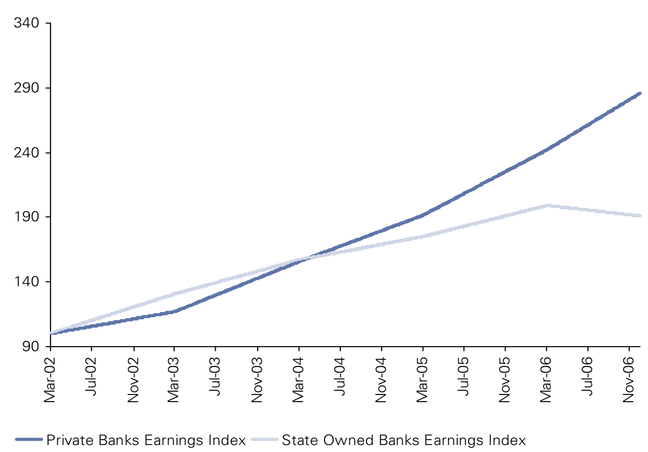
Share price of four large private sector players and five large state-owned banks indexed with FY02 as base year



Source: Company data, Goldman Sachs Research, Bloomberg.

Exhibit 12: Earnings growth of private banks has outperformed state-owned banks since FY05

Earnings growth of four large private sector players and five large state-owned banks indexed with FY02 as base year



Source: Company data.

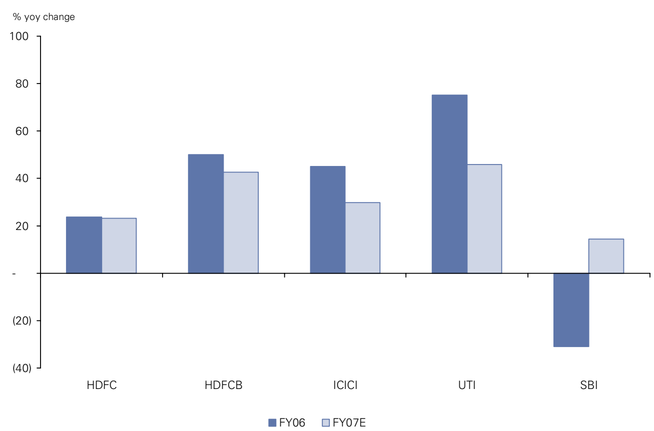
Although we prefer growth stocks, we do not have any specific preference in terms of ownership, i.e., private sector as against state-owned banks. In other words, the ability of a company to capitalize on the opportunity alone would be a guiding factor.

Expect an encore in 2007; current valuation levels not a deterrent

The moot point for investors is whether growth stocks—seemingly rich on valuations in the regional context—would continue to outperform in 2007. So long as the operating conditions remain unchanged, we believe that 2007 would be a repeat of 2006.

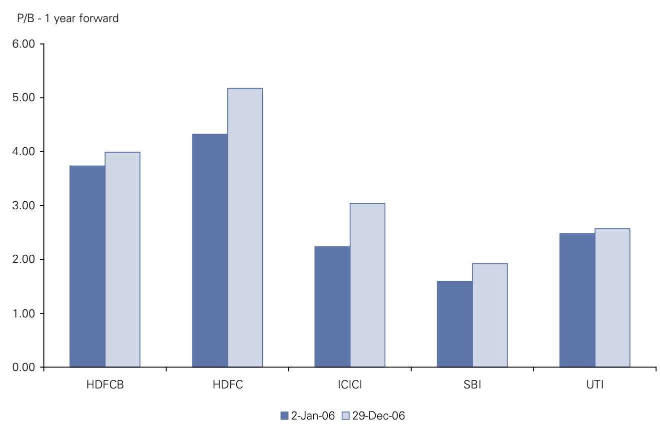
In our view, the key performance drivers in 2007 for leading players will be an underpenetrated market, stronger operating metrics, and a conducive growth environment.

Exhibit 13: Preprovision operating profit growth (yoy) for coverage stocks



Source: Company data, Goldman Sachs Research estimates.

Exhibit 14: Rich valuations not a deterrent for outperformance



Source: Company data, Goldman Sachs Research estimates.

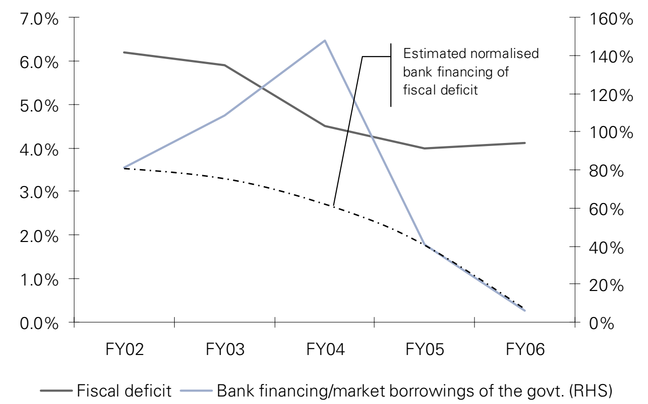
Tighter monetary scenario—Key risk to our expectations

We are mindful of the risk to our expectations given the high valuations and, consequently, the volatility in prices. We believe investors would be concerned about two key risk factors. In both scenarios, industry dynamics will be affected adversely and stocks would unlikely yield any upside.

- **Indian banks are "running on empty" in terms of liquidity**—loan growth may not be sustainable given that the deposit growth rate has lagged significantly so far. We believe the following would be key swing factors for financial services stocks to outperform:
  - Sustained growth momentum in deposits—we forecast 22% deposit growth for FY2007E and 21% each for FY2008E and FY2009E;
  - Moderation in loan growth momentum from 30% in FY2007E to 25% in FY2008E as well as FY2009E; and
  - Reduction in statutory liquidity reserve (SLR) requirement from 25% to 20%—to provide liquidity for sustaining loan growth expectations. Reduction in SLR should be feasible given the improving trend in the fiscal position and reduced dependence on bank finances to fund fiscal deficit.

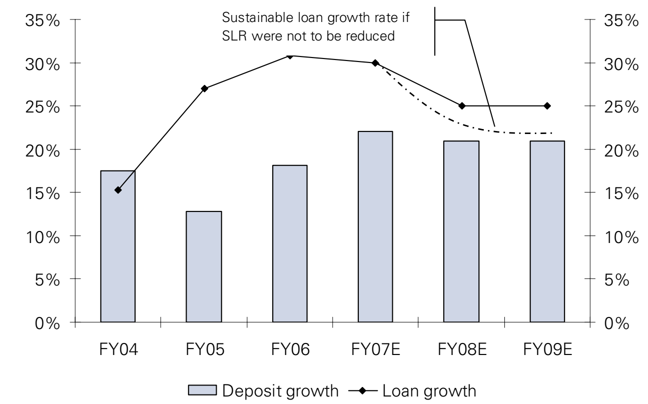
Reduction in SLR requires a regulatory change to be initiated by the government/RBI. If SLR were to be maintained at current levels, loan growth would likely align with deposit growth from FY2008E.

Exhibit 15: Improving fiscal position and reduced dependence on bank financing to make SLR cut feasible
SLR requirement of 25%, and not the government financial position, is a binding constraint for banks



Source: RBI.

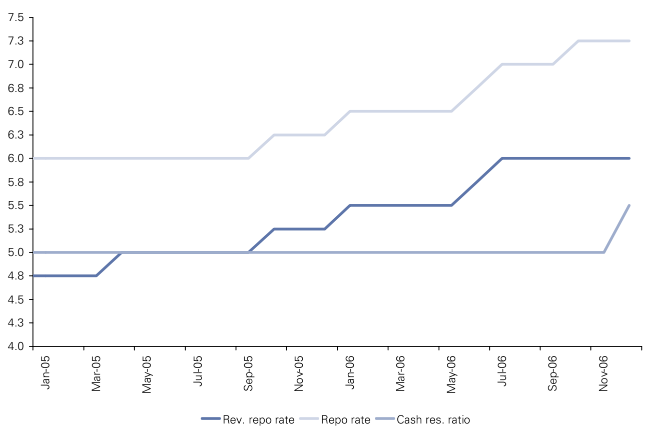
Exhibit 16: If status quo maintained on SLR, loan growth would be just marginally ahead of deposit growth
Cut in SLR from 25% to 20% would be key to sustaining medium-term loan growth expectations



Source: RBI, Goldman Sachs Research estimates.

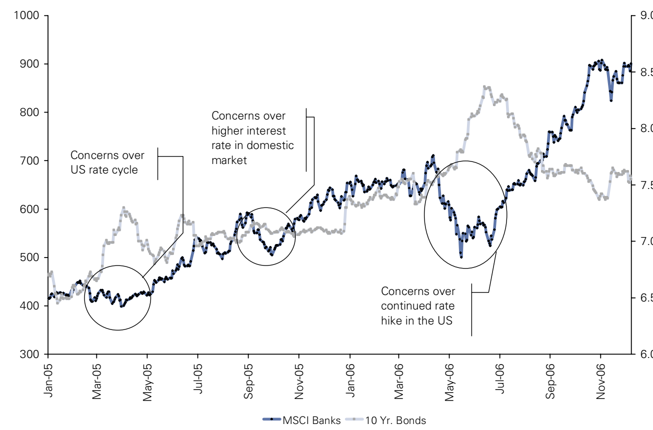
- **RBI becoming more hawkish in its inflation outlook**—should RBI hike the policy rate significantly, loan growth will moderate to 20%.
  – Our economist believes that threat of significant monetary policy tightening is less likely given that inflationary expectations are well anchored and that the policy would be supportive of growth rates.
  – We expect RBI to raise the policy rate by 25 bp-50 bp in 2007E, the extent of hike depending on data.
  – We believe hike in policy rates will not alter our outlook for the banks' fundamentals/growth. We believe the market expectations, too, will remain unchanged.
  – We rate the prospects for stable long yields in 2007E as high given the improving trend in the fiscal position and the potential for reduction in SLR.
  – Although the risks are tilted towards further tightening in the short term, we expect an easing in the monetary stance as inflationary pressures ease in 2007E.

Exhibit 17: Since Sept 2005, the monetary policy is in a tightening phase
We expect stabilization by 1H2007E



Source: RBI.

Exhibit 18: Banking stocks have outperformed despite continued tightening in monetary outlook
Market has reassessed growth expectations



Source: DataStream, Goldman Sachs Research.

Favorable macro + limited competition = advantage well-run banks

In our view, the leading players in the Indian financial services sector are likely to benefit from a confluence of economic and policy issues. We expect the mainstream companies to make rapid strides in gaining market share and delivering earnings growth in the range of 20%-32% through FY2009E.

We expect high economic growth rates to be maintained

Key highlights from our economic research report are:

- India's trend GDP growth rate has accelerated to 7.8% from 6% in the previous two decades driven by productivity gains. According to our projections, growth will remain close to 8% in 2007E as well as 2008E powered by the twin engines of manufacturing and services. We expect the monetary tightening measures—undertaken since the beginning of 2006—to moderate the growth rate from the feverish pace witnessed in 1H2006 (over 9% growth).
- In our view, overheating concerns are overdone. High credit growth is because of increasing penetration of bank finances (financial deepening).
- We expect the overall direction of the monetary policy to be supportive of growth. We believe the recent hike in the cash reserve ratio is aimed at tempering the feverish pace of growth seen in 1H2006. Our expectations for loan growth in 2007 and 2008 already reflect moderation from the dizzying 30% levels seen in 2006.
- Liquidity conditions would likely remain tough, but we do not perceive any threat to our current loan growth expectations.
- We forecast the rupee to strengthen against the US dollar on the back of productivity gains in the tradable sector, a moderate current account deficit, and a significant increase in capital inflows.
- The key risk to our outlook on the downside is from the policy being accommodative which could stoke inflation, eventually leading to the central bank slamming the brakes abruptly.

- The upside risk to our expectations is from higher investment growth than we expect currently because of a favorable outlook for FDI and planned infrastructure investments, including SEZs, as India tries to catch up on its massive shortfall of power, ports, roads and airports. The benefits of demographics could potentially offer further upside to our growth expectations.

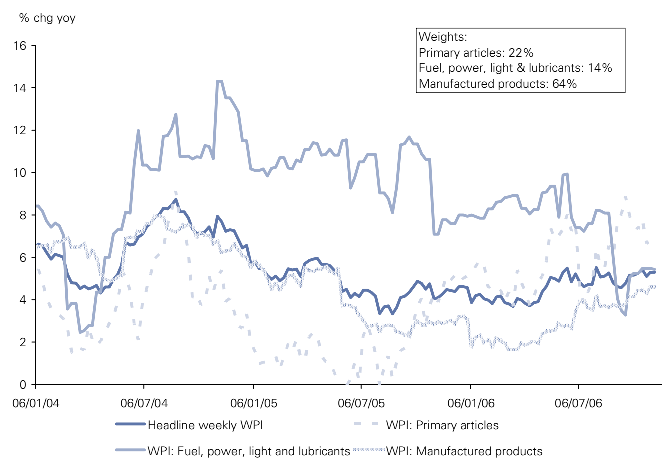
For further details, refer our report titled *India: An acceleration in trend growth* dated November 30, 2006.

Exhibit 19: 2006-2008E outlook: Manufacturing and services to fuel growth
Historical GDP growth trend and our estimates

	Weights (%)	Low growth period 2000-02	Average of 2003-05	2006E	2007E	2008E
Real GDP (% chg yoy)	100.0	4.6	8.1	8.2	8.0	7.8
Agriculture	20.8	-0.2	4.9	2.0	2.5	2.1
Mining	2.2	4.4	4.0	3.0	2.5	2.5
Manufacturing	15.1	5.7	8.1	10.4	9.0	8.9
Electricity	2.2	2.8	4.8	6.3	7.0	7.0
Construction	6.5	5.9	11.8	10.0	10.0	9.9
Services	53.2	6.7	9.4	10.0	9.6	9.3
Trade, Hotels and restaurants	15.5	7.1	9.0	8.4	7.8	7.3
Transport, storage and communication	10.0	11.1	15.2	16.2	15.2	14.6
Communication	3.5	24.0	23.6	24.0	20.0	20.0
Financing, Insurance, Real estate and Business services	13.4	6.5	7.8	9.5	9.0	8.9
Banking and insurance	5.8	6.2	7.1	10.2	9.5	9.3
Business services	7.6	6.9	8.4	9.0	8.6	8.5
Community, social and personal services	14.3	4.1	7.5	7.1	7.5	7.5

Source: CEIC, Goldman Sachs Research estimates.

Exhibit 20: Headline WPI driven by primary articles
WPI refers to Wholesale Price Index, a key measure of inflation



Source: CEIC.

Structural drivers stoking loan growth

Given the macro overlay, we believe the financial sector is at the cusp of an exciting and profitable phase, wherein financial deepening is leading to higher economic growth rates and vice versa.

Exhibit 21: Demographics and rising penetration are ongoing structural drivers; lower reserves could be a near-term driver
Private sector better positioned to leverage structural catalysts

	UTIB	HDFC#	ICICIB	HDFCB	SBI
Qualitative Assessment					
Favorable demographics	++	+++	+++	+++	+
Rising penetration of bank lending	+++	+++	+++	+++	++
Reduction in statutory reserve requirements	=	=	=	=	++
Ownership restructuring	+++	+++	+++	+++	++
M&A optionalities/ financial sector liberalization	?	+++	+++	+++	-ve
Quantitative Assessment					
Market share of loans	1.5%	25-30%	10.0%	2.4%	17.9%
Market share of consumer loans	1.8%	NA	26.1%	6.0%	17.2%
Government ownership	NA	NA	NA	NA	59%
Statutory Liquidity Ratio	26%	NA	25%	32%	36%

Legend:	Negative	Highly Positive

HDFC's market share is that of mortgage market; for others, it is shown as a % of the banking system.

Source: Company data, Goldman Sachs Research.

Consumer financing—Still an underpenetrated market

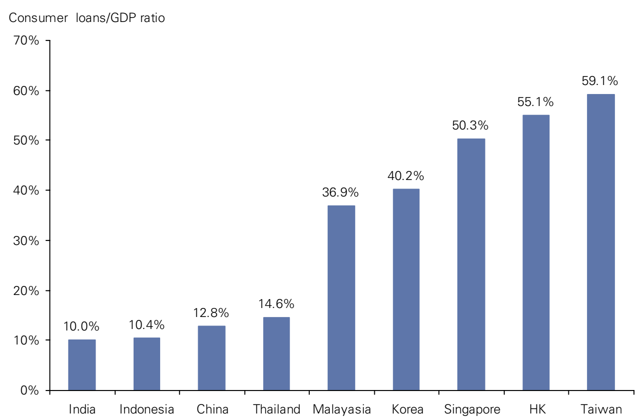
Despite high loan growth in consumer financing, we believe it remains an underpenetrated market. We believe demand for consumer loans will be stronger going forward given that household gearing remains low and disposable income continues to rise rapidly.

We believe credit availability, affordability and consumer confidence are the key drivers for consumer loan growth. We expect this position to remain unchanged.

The key question is whether rising interest rates would affect loan growth. Evidence seems to suggest that the demand is inelastic to price changes; despite rising rates in 2006, loan growth is still rising.

Exhibit 22: India is a credit-constrained market in consumer finance

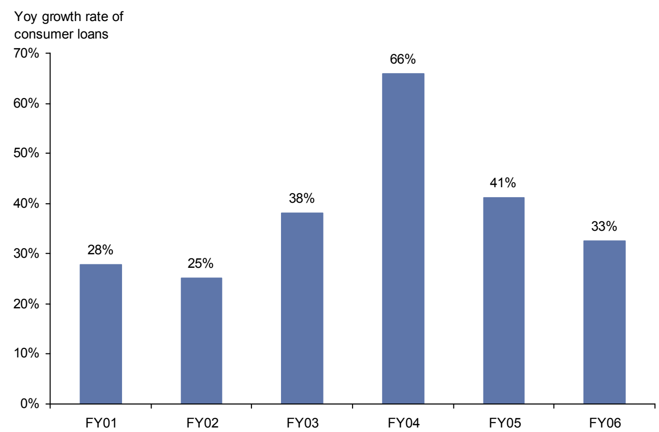
Rapid growth doubled market size over past three years



Source: CEIC.

Exhibit 23: We expect continued loan growth of 25%-30% through FY09E

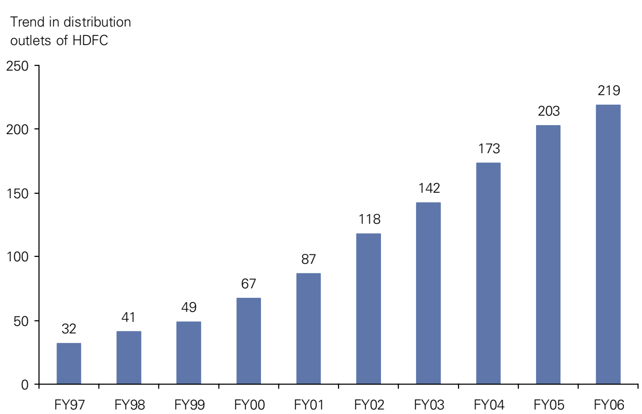
Growth as far as we can see; demographics a key element



Source: RBI.

Exhibit 24: Distribution is key to sustaining momentum in consumer finance

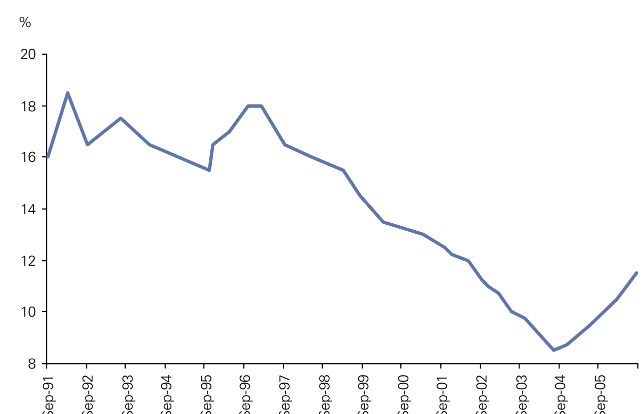
Continued increase in HDFC's distribution network



Source: Company data.

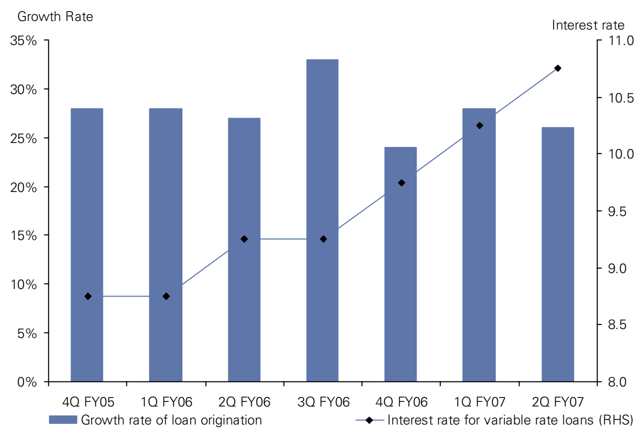
Exhibit 25: Lending rates have risen, but remain affordable

Trend in HDFC's mortgage lending rate



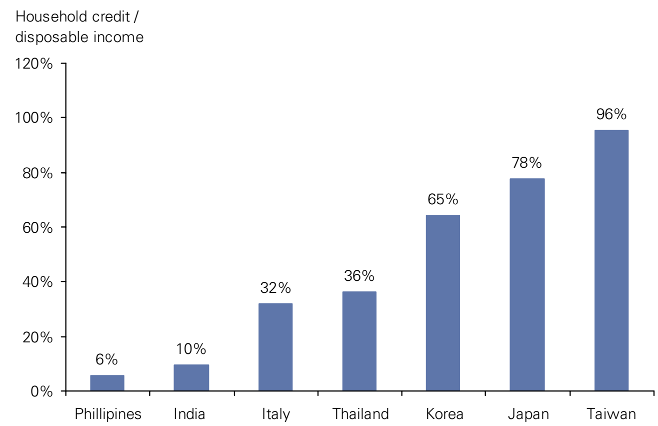
Source: Company data.

Exhibit 26: Inelasticity of demand to price changes evident
Growth rates in mortgage and other consumer finance have remained robust



Source: Company data.

Exhibit 27: Faster growth is a prerequisite for financial deepening
We believe there is enough room for growth in consumer loans



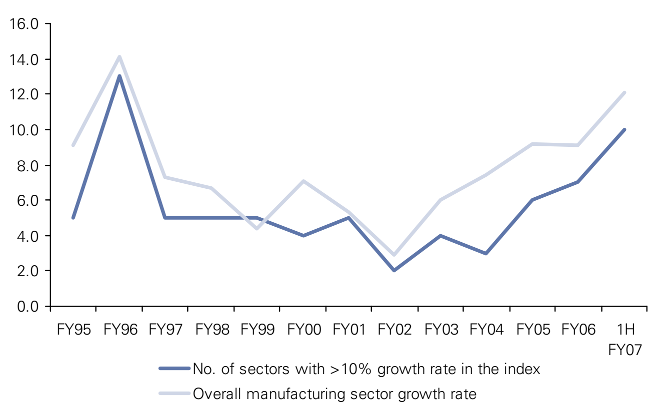
Source: CEIC, Goldman Sachs Research estimates.

Higher investment growth to be the key driver for wholesale loan growth

Demand for wholesale loans rebounded sharply from the trough witnessed in 2003. We believe the early part of the recovery was driven by consumption growth but, increasingly, higher demand for loans appears to be led by higher demand for investment. We cite the growth in the capital goods index as evidence of higher investment-led growth.

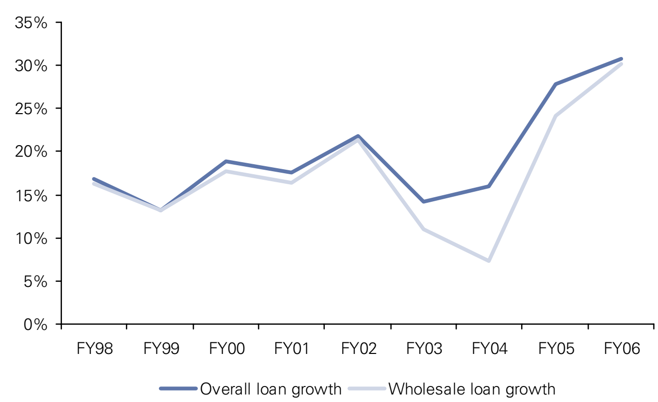
In our view, India is an underinvested market in terms of infrastructure. We believe it has the potential to sustain higher investment growth over a long term without raising any significant concerns about asset quality. The rapid growth in consumption is driving demand for new capacities in the manufacturing sector. In our view, investment growth from infrastructure and manufacturing would likely drive demand for wholesale loans strongly through FY2009E.

Exhibit 28: Growth rate in manufacturing sector, key element of wholesale loan, is broadbased now
Growth rate less vulnerable to quick reversals



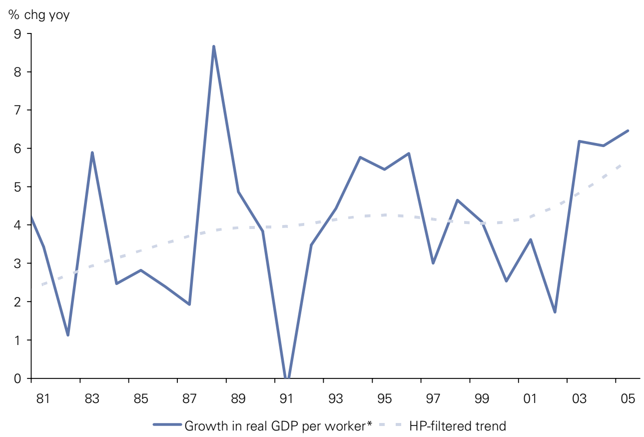
Source: Government of India.

Exhibit 29: We expect strong wholesale loan growth to support higher overall loan growth for Indian banks



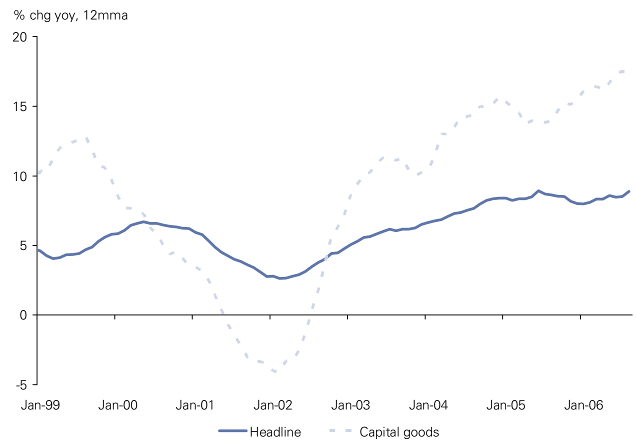
Source: RBI.

Exhibit 30: We expect sustained productivity gains to make growth rates less volatile



Source: CEIC, Goldman Sachs Research estimates.

Exhibit 31: Growth in capital goods index is an indication of rising demand from investments



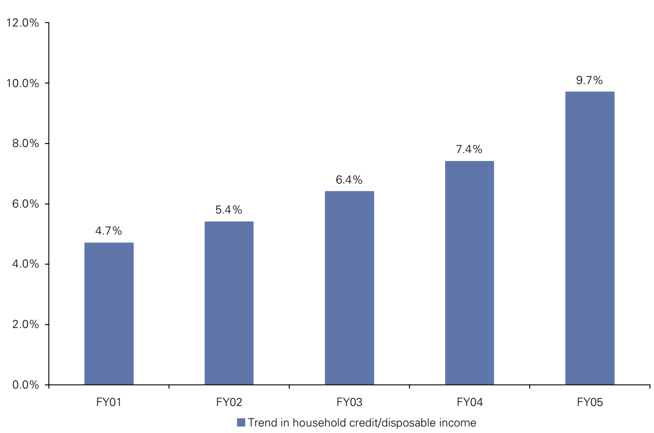
Source: CEIC, Goldman Sachs Research estimates.

Concerns over potential asset quality deterioration overdone

We agree with the market and consensus view that banks and financial companies are riding the benefits arising from procyclicality. However, there is no evidence to suggest that higher debt accumulation by private and household sectors is unsustainable.

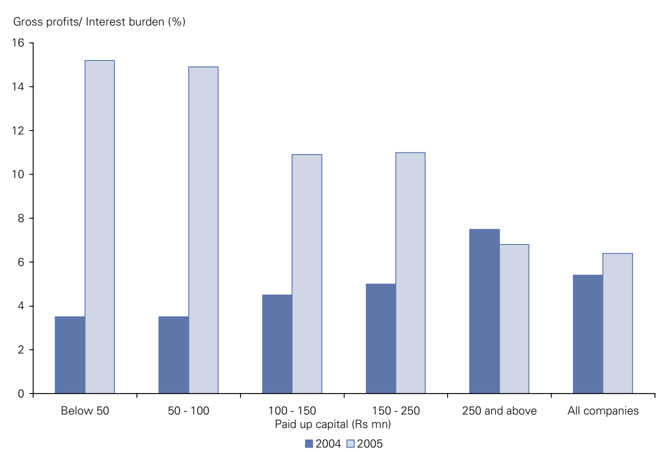
- We cite low household gearing (despite rapid growth in consumer loans) and improved interest coverage ratio of the private sector as evidence of stronger asset quality in the financial system.
- The private sector's, including unincorporated entities, debt accumulation grew 16% during FY2003-FY2006 and 26% in FY2006. Despite a sharp increase in debt accumulation, the debt servicing indicators have shown improvement over the previous year.

Exhibit 32: Household debt increased rapidly in FY05. Levels significantly low to warrant any concerns



Source: Government of India.

Exhibit 33: Private sector health appears to be in the pink; strong revenue growth seems to be key



Source: RBI.

Consensus may argue that higher debt accumulation rate would have lagged impact on private sectors' debt servicing capacity; and the impact would likely be magnified with higher interest rates seen in 2006. We believe strong growth rate in operating revenues should negate the effect of debt accumulation significantly.

Boost to performance from cyclical catalysts as well

The cyclical factors include declining LLP, expectations of a favorable outcome to the US rate cycle and boost to fee income from buoyant markets.

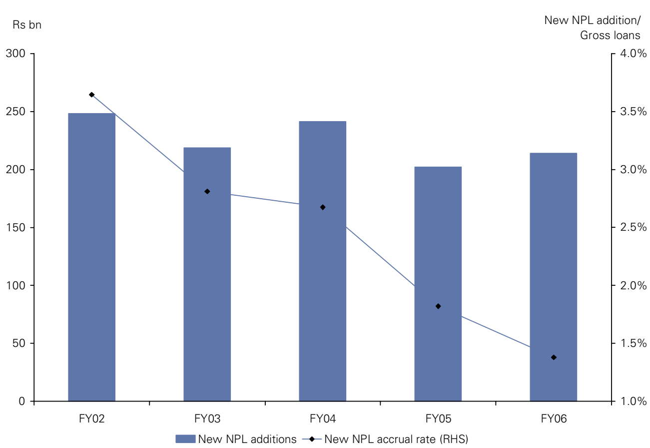
- We point to the declining trend in gross new NPL accrual rate as evidence of cyclical upside. With recovery rates improving, we expect further upside from reduction in LLP.
- Our expectations of US rate hikes pausing and then reversing would support bond yields at current levels.
- We expect buoyant market conditions to boost consumer banking related fee income. Private sector banks have witnessed a significant increase in fee income from third-party financial products' distribution. We expect this trend to continue.

Exhibit 34: Ongoing cyclical catalysts in place
Qualitative and quantitative assessment, bankwise

	UTIB	HDFC	ICICIB	HDFCB	SBI
Qualitative Assessment					
End to US rate hikes followed by rate cuts	+	=	+	+	+
Benign business cycle	+++	+++	+++	+++	+++
Domestic interest rate hike	-ve	=	-ve	-ve	-ve
Fee income pick up	+	=	++	++	=
Quantitative Assessment					
Investments subject to Revaluation/ Total Investments	50%	=	38%	39%	34%
Modified duration of the investment portfolio	1.88	NA	2.47	2.29	4.75
New NPL formation rate	0.8%	NA	0.7%	1.6%	1.6%
Legend:	Negative	Highly Positive			

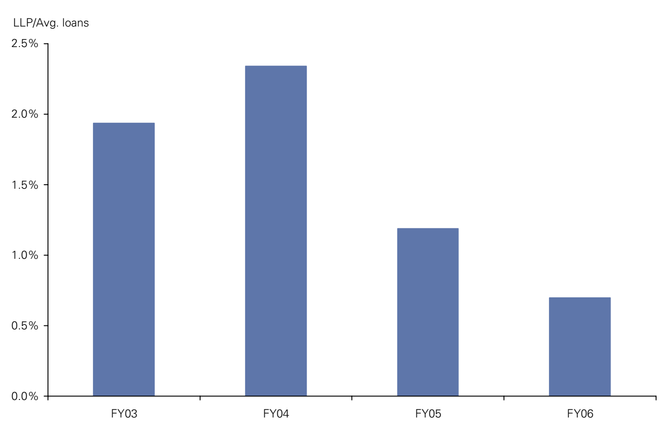
Source: Company data, Goldman Sachs Research estimates.

Exhibit 35: New NPL accrual rate structurally down each year since FY02
Loans rose 130% during FY02-FY06 and new NPL accrual rate declined 164%



Source: RBI.

Exhibit 36: Improvement in NPL recovery rates would drive LLP down further



Source: RBI.

Stable NIM outlook in FY2008E-FY2009E

We believe loan growth is not a challenge for the Indian financial services sector; deposit growth and pricing both deposits and loans could prove to be challenging. We believe monetary conditions will be accommodative of growth rates. Deposit cost would likely rise due to tighter liquidity, but banks enjoy pricing power in majority of lending segments. Hence, NIMs would likely remain stable in FY2008E-FY2009E.

Exhibit 37: Sensitivity of NIM to higher increase in deposit cost

	NIM decline (bp)		Net profit decline (%)	
	FY08E	FY09E	FY08E	FY09E
UTIB	6	6	3.4%	3.3%
HDFC	10	14	3.2%	4.0%
ICICIB	11	11	7.7%	7.6%
HDFCB	5	6	2.6%	2.9%
SBI	3	3	2.1%	2.1%

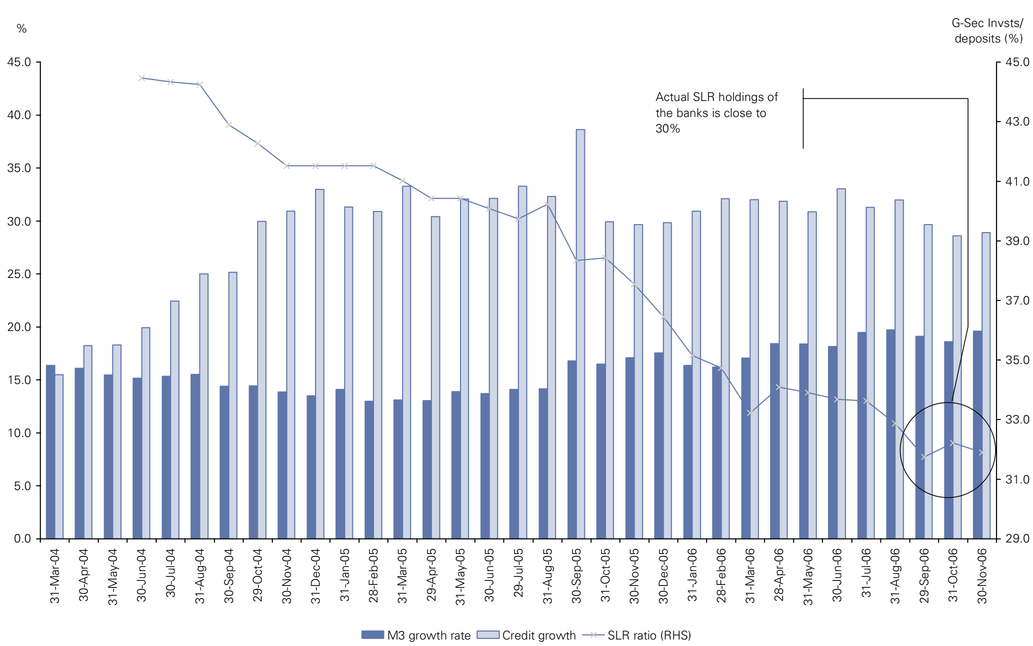
Source: Goldman Sachs Research estimates.

We expect monetary conditions to be supportive of growth

Indian banks have sustained high loan growth with relatively low deposit growth rates between FY2005 and FY2007 ytd. Monetary conditions remained accommodative through this period. Banks were able to unwind their excess statutory reserves and fund loan growth. We now believe Indian banks have reached an inflection point, whereby the divergence between deposit and loan growth cannot be sustained any further.

Exhibit 38: M3 growth rate has trended upwards since Sept 2005, but loan growth continued well ahead of deposits

Even though SLR ratio appears to be higher for the sector as a whole, excess liquidity is concentrated among very few players



Source: Company data, Goldman Sachs Research estimates.

The moot point, in our opinion, now is whether deposit rates will sustain high growth rates to fund loan growth expectations of 25%-30% through FY2009E. We believe loan growth expectations could be achieved provided monetary conditions remain supportive of economic growth rates. In our view, a supportive monetary policy would mean the central bank providing enough liquidity to support trend growth rates in GDP. We believe this will include a reduction in statutory reserves. This may appear contrary to the recent monetary tightening measures effected, but not necessarily conflicting with RBI's objective of balancing growth and prices.

Exhibit 39: Higher deposit growth rate could be achieved by raising M3 growth rate
Required rate of deposit growth is significantly higher with SLR requirement of 25% and hence a strong case for an SLR cut

	Loan growth											
	FY06		FY07E		FY08E				FY09E			
	33%		30%		25%		20%		25%		20%	
Reserve requirements (CRR+SLR)	Dep. gr.	L/D	Dep. gr.	L/D	Dep. gr.	L/D	Dep. gr.	L/D	Dep. gr.	L/D	Dep. gr.	L/D
30.5%	19%	71%	22%	76%	23%	77%	19%	77%	24%	78%	19%	78%
25.5%					22%	78%	17%	78%	22%	80%	18%	79%

Source: Goldman Sachs Research estimates.

GDP growth rate of 7.8%-8% would imply credit growth requirement of 24%-25% going by the empirical relationship between GDP and credit growth rates. Our economist expects the monetary policy to stay supportive of growth and believes that RBI would rather refrain from impeding the growth process.

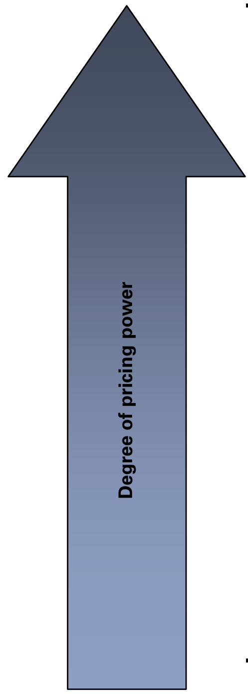
While we believe that monetary conditions will be supportive of growth, we expect deposit cost to rise further from current levels. Our discussions with large players suggest that competition would unlikely intensify in the near future, implying that the trend growth rate for various players would unlikely change significantly. Assuming no disruptive competitive behavior, deposit cost would likely rise 50 bp over the next 12 months merely reflecting the cost of tighter liquidity.

Banks' pricing power in most lending segments intact

We expect banks to raise lending rates, should funding costs rise further from current levels, assuming no disruptive competitive behavior. We believe that pricing power in most lending segments is strong and that demand will stay inelastic to 25 bp-50 bp increase in interest rates as long as the macroeconomic environment remains robust.

While the pricing power of banks is largely intact, we believe it is weak in the corporate segment. These borrowers typically are large and well rated and have access to diversified funding sources. For the mainstream lenders, we believe there are offsets to the weak pricing factor through higher share of non-interest income sources.

Exhibit 40: Lending margins likely to remain intact in most borrower segments
Pricing power is weak only in directed lending and corporate customer segments



Degree of banks' pricing power in the loan market

SME/Mid-market lending

Competition intensity in this segment is the lowest. Banks enjoy significant advantages because of their relationship-based lending model and proximity to borrowers. Pricing power tends to be the highest in this segment vis-à-vis others.

Agriculture/Directed lending

Theoretically speaking, the degree of pricing power of banks in agriculture and directed lending markets should be high just as in the case of SME/mid-market lending. However, pricing in a large part of the market is constrained by regulatory framework. Whereas cost increases can be passed on, regulation would likely cause NIM pressure in this segment.

Mortgage lending

An intensely competed market until the past 12 months despite concentration of market share with a select few. However, the market has shown oligopolistic behaviour of late. Demand has generally proven to be less elastic to loan pricing. Pricing is largely influenced by HDFC, ICICI Bank and SBI.

Other retail lending

Competition intensity has shown significant decline over the past 12 months. Market share is concentrated in the hands of fewer players. Demand has proven to be less elastic to loan pricing such as mortgages and likely to remain so as long as consumer confidence stays high.

Corporate lending

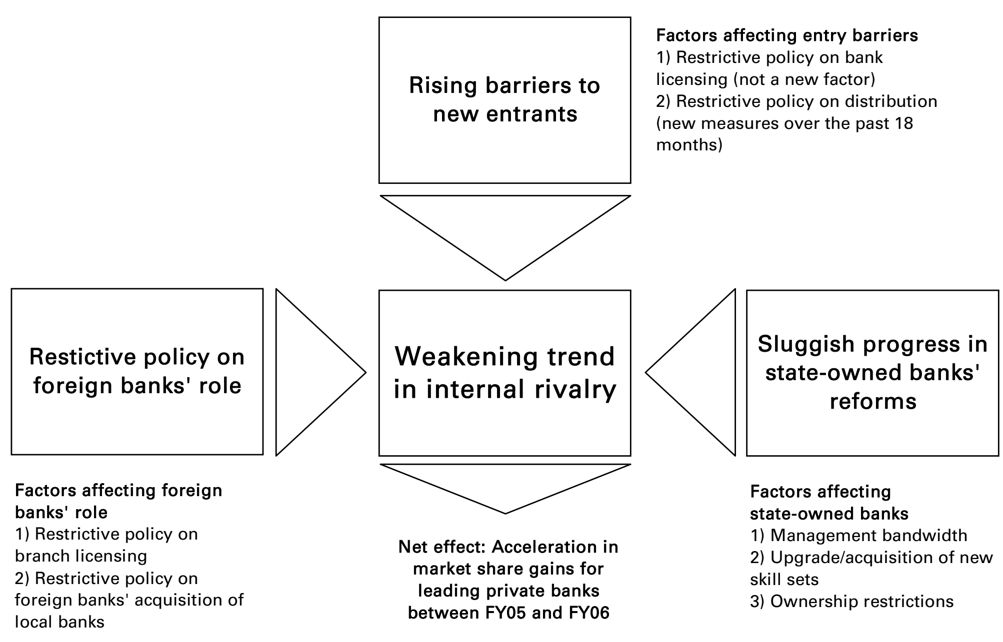
Large and well-rated corporates enjoy significant bargaining power becasue of their ability to tap diversified funding sources. Loan pricing would be guided by other sources of funds, mainly foreign currency loans and borrowings. Given the GS view that interest rates in the US market would likely soften in later half of 2007, lending rates are unlikely to see a significant increase.

Note: The dark shade in the arrow reflects higher degree of pricing power

Source: Goldman Sachs Research.

Strengthening market position of well-managed banks/institutions

Exhibit 41: Direction of policy changes more restrictive than before
The unintended effect of this appears to be a weakening trend in competitive conduct and rapid gains for mainstream players

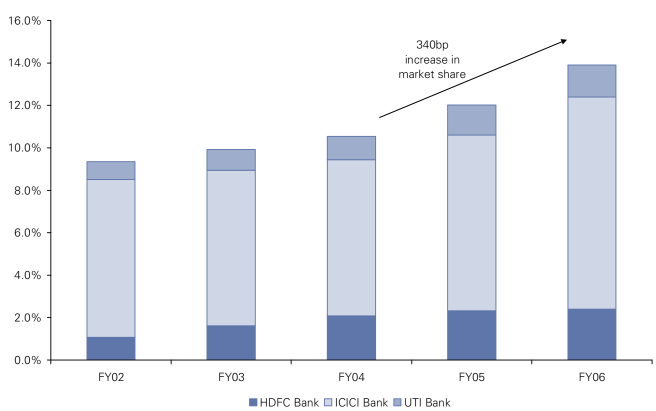


Source: Goldman Sachs Research.

We believe a combination of restricted market access to new entrants and foreign banks and lack of significant reforms for state-owned banks has been strengthening the market position of mainstream players, namely HDFC, HDFCB, ICICIB and UTIB. This may not be intentional, but this is how we see the operating environment shaping up.

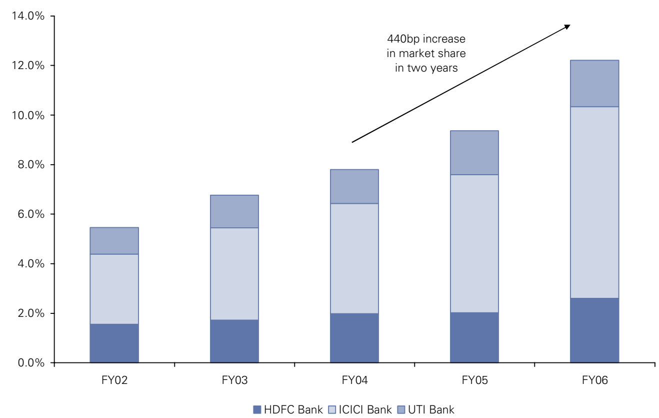
What is new about the structural growth story for mainstream players? For a brief period, state-owned banks appeared to gain ground from improved cost competitiveness and a favorable operating environment. When interest rates began hardening, the branch network seemed to matter and state-owned banks appeared to enjoy comparative advantage. However, evidence suggests that private sector companies are gaining ground far more rapidly in recent years despite constraints in distribution.

Exhibit 42: Distribution constraints not a deterrent; mainstream players gain market share through focused strategies



Source: RBI.

Exhibit 43: Market share gain in loan market more dramatic; state-owned banks are unable to leverage structural growth drivers



Source: RBI.

We believe three key issues are constraining state-owned banks in defending their market position:

- Inability to acquire new/upgrade existing skill sets and hence not being able to leverage structural drivers of the financial market;
- Lack of adequate depth in the organizational structure, leading to a focus on operational issues rather than strategic ones by the senior management; and
- Constraints imposed by ownership structure on the ability of state-owned banks to raise capital to support growth rates

We believe these factors are proving to be bigger constraints than ever before and explain the rapid strides made by mainstream players.

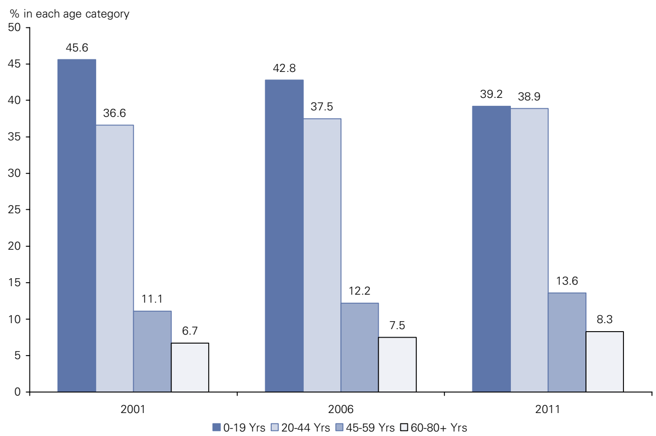
BRICs hypothesis is shaping up well

Sustained high growth potential as far as we can see

Five years on, our BRICs hypothesis seems to be taking shape. The highlight of our BRICs research was the underappreciated growth potential. Our key forecasts are:

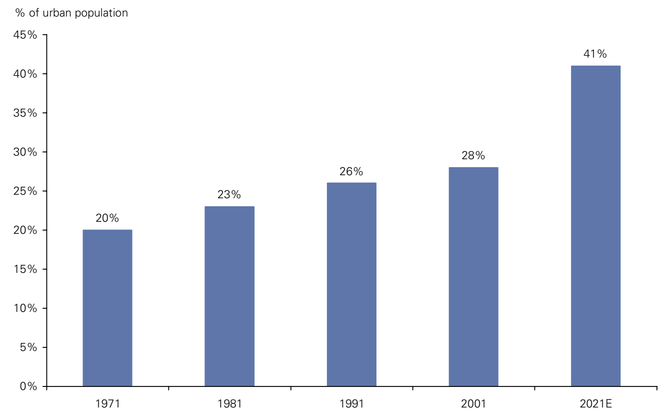
- India becomes one of the three largest economies in the world by 2030
- It will be the only BRICs economy to sustain growth above 5% throughout the next 45 years
- Income per capita in 2050 will increase 35 times from current levels
- India is the only country to have favorable demographics for many years to come

Exhibit 44: India likely to enjoy favorable demographics, longer than any other BRICs country



Source: Government of India.

Exhibit 45: Rapid urbanization likely to gain momentum as India's trend growth continues to show improvement



Source: Government of India.

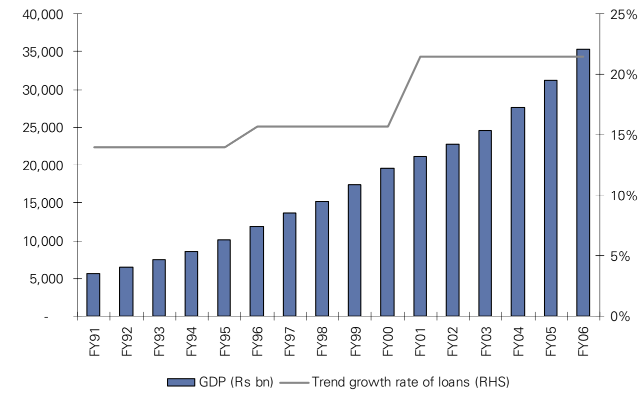
Key factors that underpin these expectations are the scope for India to "catch up" with developed economies, favorable demographics, rapid urbanization and a conducive environment.

Financial sector principal beneficiary of favorable growth conditions

As discussed earlier, financial deepening would likely lead to higher economic growth rates and vice versa. We believe that the BRICs hypothesis is taking shape now and expect the financial sector is set to reap huge dividends.

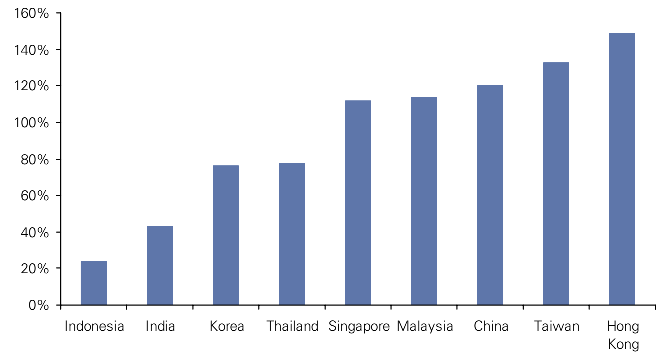
- Average annual GDP growth of over 5% for the next 45 years would imply 14%-17% growth in financial assets, going by the empirical relationship between GDP and financial assets growth. We believe the compounded effect of 14%-17% growth for the financial sector will raise long-term growth expectations for mainstream players.

Exhibit 46: With higher levels of economic activity, trend growth levels for Indian banks have moved up
Banks' trend growth rate rose to 20% in mid-2000s from 14% in the mid-1990s



Source: RBI.

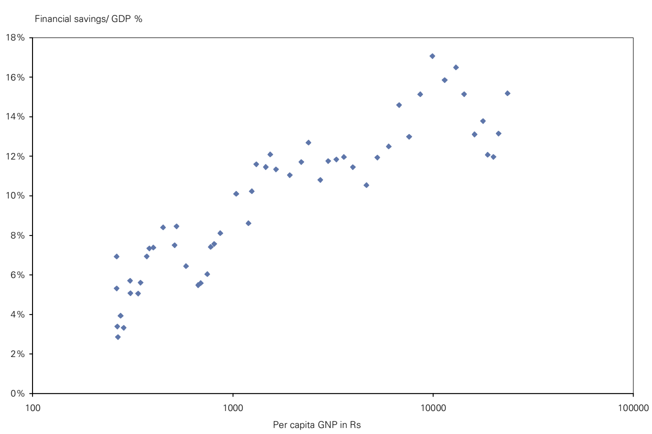
Exhibit 47: Despite trend growth rate moving up, India remains a structurally underpenetrated market
Loans/GDP compares well within the region



Source: CEIC.

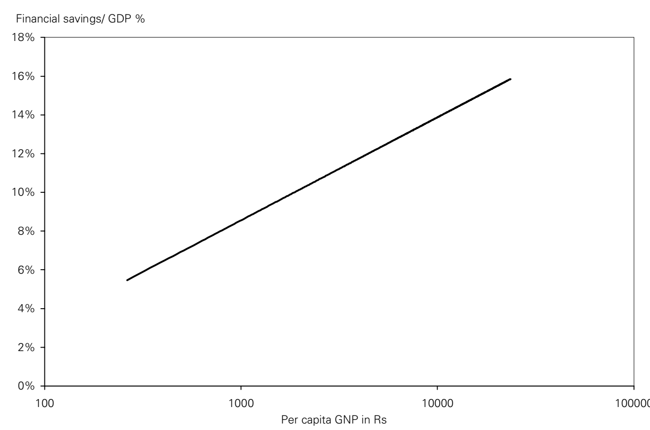
- Favorable demographics and rapid urbanization suggest huge upside potential to the consumer banking activity from the current underdeveloped status.
- Strengthening conditions of change would imply upside from efficiency gains as well for the financial sector.

Exhibit 48: Financial deepening would gather momentum as economy reaches higher activity levels
India's household financials rate vs. per capita GNP



Source: CEIC.

Exhibit 49: Higher level of GDP has a direct impact on savings rate



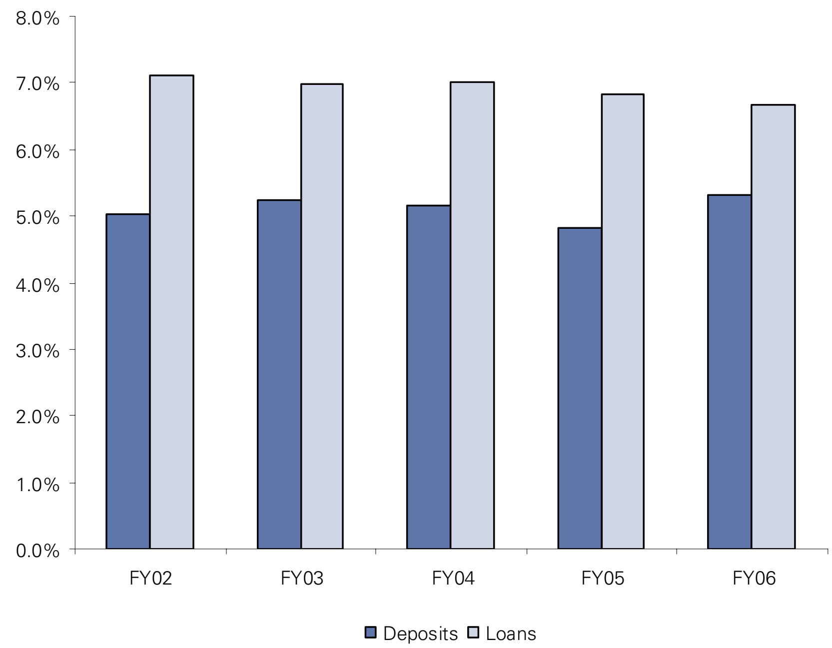
Source: CEIC.

Robust growth prospects to raise level of competition

High growth rates would also attract more entrants and hence intensify competition assuming that free market principles are in play, but this will be a function of regulations and reforms.

- The RBI has chalked out a roadmap that would likely allow foreign banks to play a bigger role in the domestic market from 2009. We believe foreign banks' expansion will increase the M&A optionality within the sector.

Exhibit 50: Foreign banks' market share has remained unchanged during FY02-FY06



Source: RBI.

Exhibit 51: Key regulations governing foreign banks operating in India

Regulation	Remarks
Branch licensing	15 branch licences in a year. No obligation to open rural branches.
Acquisition of private banks in India	Foreign banks are not allowed to acquire more than 5% of a domestic bank.
Restriction on expansion through NBFCs	Restriction on activities undertaken through NBFCs by foreign banks.
Priority sector lending requirements	32% of loans to priority sector.

Source: RBI.

- We believe the reform process for state-owned banks will gather momentum earlier or simultaneously with the relaxation of foreign banks' expansion restrictions. Should it lag the liberalization process, the competitiveness of state-owned banks will be impaired significantly.
- We expect Indian banks' profitability to align with the observed trend in the developed markets at the end of transition stage—RoAA of banks under our coverage is 1.14% whereas median level for banks in the developed markets is about 1%.
- We do not see the likelihood of disruptive competition affecting profitability and sustainable growth rates through the transition phase.

Factoring in lower sustainable growth rates during transition phase

We are factoring in 10.9%-12.4% sustainable growth rate during the transition phase (stage 2) in our 3-stage DDM based on:

- GDP growth projections of over 5% would imply loan growth potential of 14%-17%.
- As per the BRICs hypothesis, India is expected to sustain GDP growth rate of over 5% for the next 45 years. However, we have assumed earnings growth of the financial sector to align with a sustainable rate within a 15-year time horizon.
- We believe competition intensity will rise during the transition stage and sustainable earnings growth would more likely be 10.9%-12.4%.
- Sustainable RoAA at the end of the transition phase would likely moderate to 1% from the current average of 1.2%.

We believe the upside for leading players is significantly higher, going by the above analysis. We believe market expectations will factor in the upside as India continues to realize the potential outlined in our BRICs hypothesis.

UTIB (UTBK.BO): Buy*; TP: Rs695; total return potential: 52%

UTIB is the third-largest private sector bank in India with a market share of 1.5% in deposits and 1.9% in loans. The bank's customer base includes a rapidly growing consumer and transactional banking franchise, and a niche in corporate banking focused on large and mid-sized companies. The bank registered a CAGR of 36% in assets and 40% in earnings during FY2002-FY2006.

Investment view: Best positioned to ride the growth momentum

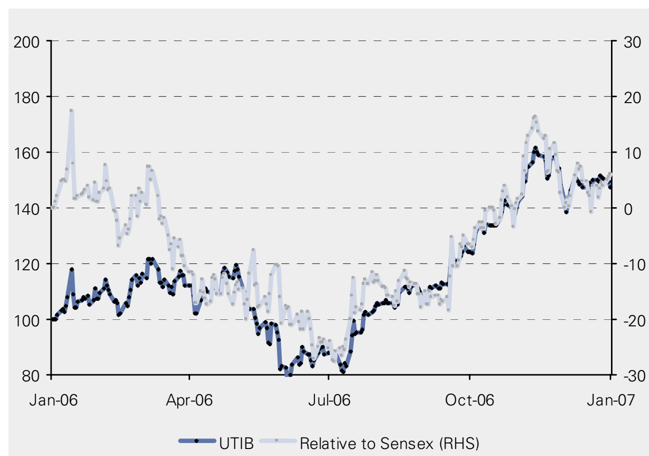
We initiate coverage on UTIB with a Buy rating and add it to our regional Conviction list. Our 12-month target price of Rs695 based on 3.5x FY2008E P/B implies 52% total return potential.

Exhibit 52: We forecast 31% EPS CAGR through FY09E
Strong franchise growth and improving profitability key drivers of EPS

Key data				Current
Price (Rs)				462
Price target (Rs)				695
Market cap (Rs mn / US$ mn)			129,869 /	2,915
Foreign ownership (%)				38.7
	3/06	3/07E	3/08E	3/09E
EPS (Rs)	17.08	22.39	31.52	37.54
EPS growth (%)	21.5	31.1	40.8	19.1
P/B (X)	4.5	3.8	2.3	2.0
P/E (X)	27.0	20.6	14.7	12.3
Dividend yield (%)	0.8	1.1	1.4	1.7
P/PPOP (X)	14.5	9.9	7.7	6.5
PPOP growth (%)	75.2	45.8	32.4	32.1
Preprovision ROA (%)	2.1	2.1	2.1	2.1
Credit Cost (%)	0.7	0.4	0.6	0.5
ROA (%)	1.11	1.03	1.10	1.14
ROE (%)	18.4	20.7	21.9	18.2

Source: Company data, Goldman Sachs Research estimates.

Exhibit 53: We expect UTIB to outperform the market in 2007 too
This will be on the back of its relative outperformance in 2005 and 2006



Source: DataStream.

We rate UTIB Buy* for the following reasons:

1. **Low expectations as implied by the current market price—We don't see a rationale for this**

- The current stock price, in our view, appears to be discounting a 6% CAGR in dividend during FY2007E-FY2009E/ROE of 14.5% beyond the explicit forecast period versus our forecast of dividend growth rate and ROE of 31% and 18%, respectively. We have deduced the price implied growth expectations/ROE using GS CAMELOT-based 3-stage DDM.
- The low expectations seem to suggest that investors may be concerned about either an execution risks or a significant change in industry dynamics depressing ROE over an extended period of time. We do not see any rationale behind these concerns.

* We are placing the stock on our regional Conviction list.

- We believe the execution risks will recede as UTIB continues to build out the franchise. UTIB has been successful with its current business strategy since the time it embarked upon a turnaround in FY2000. Given the current market share of the bank, we believe it has achieved critical mass in its key business segments.
- We expect industry dynamics to remain unchanged through FY2009E and believe concerns over sustainability of UTIB's profitability are overdone.
- HSBC and Barclays Capital each own 5% of UTIB. We believe this makes UTIB an optional play on M&A as and when RBI liberalizes norms for foreign banks' expansion in the domestic market.

2. Rapid market share gains likely underpinned by a favorable environment

We forecast CAGR of 45%, 36% and 33% for UTIB's loans, assets and deposits, respectively, during FY2007E-FY2009E.

- We believe significant distribution expansion will enable UTIB to meet our growth expectations. The bank has 469 distribution outlets spread over 268 cities as of September 30, 2006. We expect this to grow to 750 outlets by FY2009E spread over 400 cities.
- UTIB's key lending segments include corporate and retail customers. We expect CAGR of 45% and 46% during FY2007E-FY2009E in corporate and consumer loans, respectively.
- We believe high entry barriers arising from restrictive policies/regulations for foreign banks and new entrants and slow pace of reforms for state-owned banks have created a favorable environment for private banks such as UTIB to grow rapidly and gain market share.
- We believe UTIB has good credit structuring skills, which along with a buoyant macro environment should assuage any concerns over deterioration in asset quality because of rapid growth.

3. Sustained improvement in profitability likely during FY2007E-FY2009E

- We forecast a modest improvement in the headline RoAA to 1.14% by FY2009E from 1.11% in FY2006. However, this masks the improvement in core operating profitability of the bank.
- We forecast the preprovision RoAA to rise to 2.10% by FY2009E from 1.78% in FY2006 driven by improvement in NIM and higher level of fee income.
- Within business segments, we expect profitability to rise driven by economies of scale in consumer banking. We estimate the contribution of consumer banking as a percentage of pretax profit to be 15% in FY2006 and forecast the same to increase to over 30% by FY2009E.
- We believe market expectations do not factor in improvement in profitability and therefore the discount in valuation of the stock as compared with its peers.

Exhibit 54: Aggressive expansion of franchise and augmentation of fee income to drive earnings 37% through FY09E

	Key earnings drivers (yoy % growth)											Memo (%)						
	Deposits	Loans	NII	Non-int income	Operating revenue	Operating expenses	Pre-prov op. profit	Loan provisions	Pretax profits	NPAT	EPS	NIM	Yoy chg in NIM	Loan prov./ loans	Yoy chg in Prov./loans	ROA	ROE
FY06	26.5	43.0	45.1	75.5	56.6	40.0	75.2	4,079.6	45.2	45.0	21.5	2.27	0.06	0.67	0.65	1.11	18.4
FY07E	43.9	56.8	50.8	40.2	46.3	46.8	45.8	(10.5)	31.3	31.2	31.1	2.42	0.16	0.40	(0.27)	1.03	20.7
FY08E	31.2	44.7	38.9	30.3	35.4	38.8	32.4	110.0	44.2	44.2	40.8	2.49	0.07	0.60	0.20	1.10	21.9
FY09E	25.2	34.8	36.8	28.8	33.6	35.2	32.1	32.0	33.9	33.9	19.1	2.62	0.13	0.60	-	1.14	18.2
CAGR (07E-09E)	33.0	45.1	41.7	32.7	38.0	40.0	36.2	41.5	37.1	37.1	31.1						

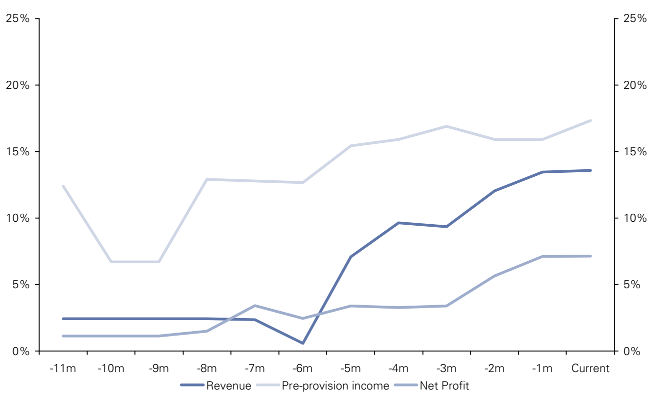
Source: Company data, Goldman Sachs Research estimates.

4. **We believe UTIB's earnings delivery will likely surprise consensus expectations**

- Our net income estimates are ahead of consensus by 15% for FY2008E and 19% for FY2009E.
- The consensus estimates for UTIB's net income have witnessed 7% upward revision for FY2007, which is significant for operating revenues and preprovision income. We believe consensus estimates will likely see upward revision in earnings for FY2008E and FY2009E.
- Despite revisions to consensus estimates, UTIB has surprised expectations on the positive side.

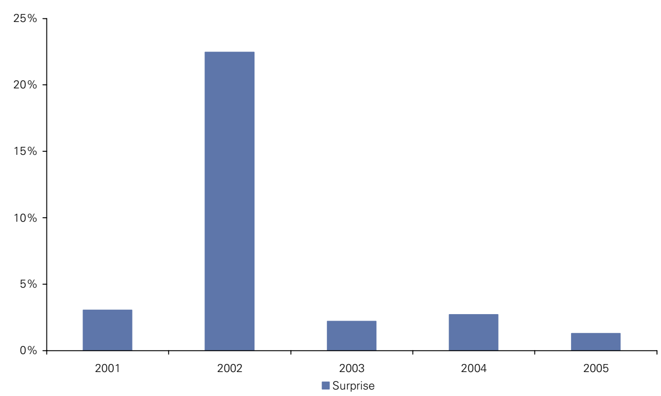
Exhibit 55: We believe consensus forecasts underestimate earnings growth

This is evident from 7% ytd upward revision for FY2007E net income



Source: I/B/E/S.

Exhibit 56: We expect consensus expectations to witness yet another positive surprise



Source: I/B/E/S.

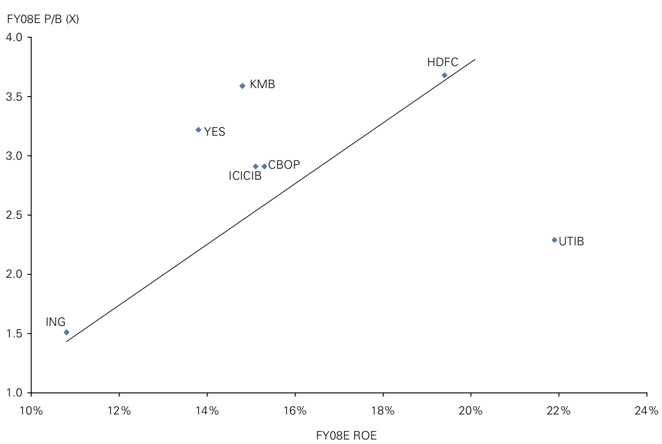
5. **Inexpensive valuations relative to the peer group—2.3x FY2008E P/B for UTIB versus 2.9x for peer group**

- The median FY2008E P/E and net income growth for the peer group are 22x and 29%, respectively, versus 14.7x and 42% for UTIB.
- The median FY2008E P/B and ROE for the peer group are 2.9x and 15%, respectively, based on I/B/E/S consensus versus 2.3x and 21.9% for UTIB.

We benchmark UTIB with HDFCB and evaluate its relative attractiveness:

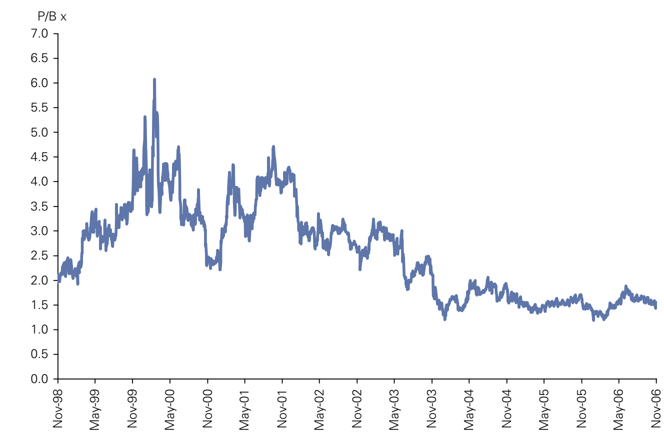
- We believe HDFCB serves as an appropriate benchmark because of its proven track record and superior performance metrics such as RoAA and RoAE.
- HDFCB enjoys premium valuations over other banks, including UTIB. Over the years, the valuation differential between HDFCB and UTIB has narrowed considerably, reflecting the market's growing confidence in UTIB's execution skills.
- We believe the likely improvement in core profitability through FY2009E will drive down the valuation gap further.

Exhibit 57: UTIB's valuations compare well with peers
Consensus estimates do not seem to reflect potential dilution of equity



Source: Goldman Sachs Research estimates, I/B/E/S.

Exhibit 58: We expect the valuation gap between UTIB and HDFCB to narrow
Trend in relative valuation gap of UTIB and HDFCB



Source: DataStream, Goldman Sachs Research estimates.

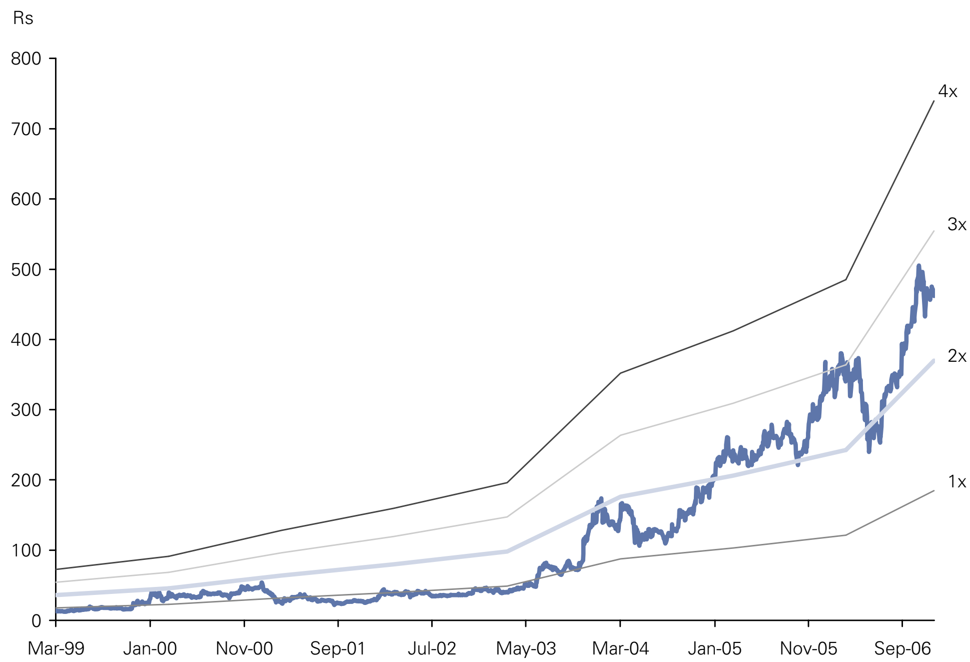
Valuations

- Our 12-month target price of Rs695 is based on 3.5x FY2008E P/B derived using the GS CAMELOT-based 3-stage DDM.

Our key assumptions are:

- 30% dividend growth and ROE of 20-22% for FY2007E-FY2009E.
- A sustainable growth rate and ROE of 12.4% and 18%, respectively, during the transition phase. We have assumed the length of the transition phase to be 15 years based on our BRICs hypothesis.
- For the terminal phase, we have assumed a sustainable growth rate and ROE of 4.8% and 16.5%, respectively.
- We have assumed COE of 11.5% for UTIB. This is based on the risk-free rate of 7.5%, equity risk premium of 5% and a GS CAMELOT beta quotient of 0.8x (that we estimate on the bank's fundamentals versus peers).

Exhibit 59: UTIB's current and target valuation multiples are well above historical range



Source: Company data, Goldman Sachs Research estimates.

Our target multiple of 3.5x FY2008E P/B implies expansion of the valuation multiple from the current level. We believe this will not be a deterrent to share price performance.

- At 2.5x 12-month forward P/B, UTIB is trading close to the peak seen in its historical trend (3.2x). This is not surprising given the buoyant operating environment and strong growth momentum in earnings.
- Our Asia-Pacific strategy team believes that the Indian market will be biased towards growth stocks in 2007. For further details, refer our report 2*007 Outlook: Too Legit to Quit* dated December 4, 2006. Given this view and stronger growth prospects for UTIB, we believe any concerns over valuation expansion will be unsubstantiated.

Exhibit 60: Sensitivity of valuations to COE and stage-2 growth rate assumptions

	COE				
Growth rate	**10.5%**	**11.0%**	**11.5%**	**12.0%**	**12.5%**
12.0%	848	757	680	613	555
12.2%	861	768	689	620	561
12.4%	871	776	**695**	625	564
12.6%	880	783	701	630	568
12.8%	890	791	707	635	572

Legend	**GS target price & assumptions**	Target price less than current price

Source: Company data, Goldman Sachs Research estimates.

Key catalysts for the share price performance:

- Continued market share gains and stronger earnings growth prompting consensus to upgrade its estimates; and
- Favorable environment and a supportive monetary policy from a macro perspective.

Key risks

- Execution risks: We are mindful of the high expectations and consequently higher valuation risks on any earnings setback.
- Potential disruption to the planned senior management transition process. The CEO is due to retire in July 2007. According to the management, the process of identifying his successor will begin early 2007. Any disruption in this process will be an obstacle in the company's strategic initiatives. We rate this risk as not significant.
- Macro-related: Unexpected slowdown in the economic activity and/or tighter monetary policy adversely affecting interest rates.

Exhibit 61: UTIB summary financials (Rs mn)

Profit model (Rs mn)	03/06	03/07E	03/08E	03/09E
Net interest income	9,906.8	14,943.5	20,752.7	28,382.8
Non-interest income	7,296.3	10,226.0	13,327.7	17,161.5
Operating revenue	17,203.2	25,169.4	34,080.4	45,544.3
Non-interest expense	(8,140.5)	(11,954.1)	(16,586.5)	(22,428.6)
Preprovision oper profits	9,062.7	13,215.3	17,493.9	23,115.7
Total provision charge	(1,748.3)	(3,612.9)	(3,645.7)	(4,567.7)
Associates	0.0	0.0	0.0	0.0
Pretax profit	7,314.4	9,602.5	13,848.2	18,548.1
Tax	(2,463.5)	(3,236.0)	(4,666.8)	(6,250.7)
Minorities	0.0	0.0	0.0	0.0
Net profit	**4,850.9**	**6,366.4**	**9,181.3**	**12,297.4**
Dividends	1,125.5	1,403.5	2,110.5	2,613.5
Dividends payout (%)	20.1	22.0	20.4	21.2

Earnings growth drivers (%)	03/06	03/07E	03/08E	03/09E
Net interest margin	2.27	2.42	2.49	2.62
Provision charge/total loans	(0.78)	(1.03)	(0.72)	(0.67)
YoY Growth (%)				
Customer deposits	26.5	43.9	31.2	25.2
Loans	43.0	56.8	44.7	34.8
Net interest income	45.1	50.8	38.9	36.8
Fee income	47.9	60.0	40.0	30.0
Non-interest income	75.5	40.2	30.3	28.8
Operating revenue	56.6	46.3	35.4	33.6
Operating expenses	(40.0)	(46.8)	(38.8)	(35.2)
Preprovision Operating profit	**75.2**	**45.8**	**32.4**	**32.1**
Provision charges	--	10.5	(110.0)	(32.0)
Pretax profit	45.2	31.3	44.2	33.9
Net profit	45.0	31.2	44.2	33.9
EPS	21.5	31.1	40.8	19.1
DPS	25.0	42.9	30.0	23.1

Market dimensions	03/06	03/07E	03/08E	03/09E
No of branches	450.0	--	--	--
No of staff (000s)	6,553.0	--	--	--
Revenues/staff (Rs)	2,625.2	--	--	--
Net profit/staff (Rs)	740.3	--	--	--

DuPont analysis	03/06	03/07E	03/08E	03/09E
ROE (%)	**18.4**	**20.7**	**21.9**	**18.2**
x leverage	6.0	5.0	5.0	6.3
= ROA (%)	**1.11**	**1.03**	**1.10**	**1.14**

% of assets	03/06	03/07E	03/08E	03/09E
Net interest income	2.27	2.46	2.46	2.55
Fee income	1.12	1.29	1.30	1.28
Non-interest income	1.67	1.68	1.58	1.54
Operating revenue	3.93	4.15	4.04	4.09
Operating expenses	1.86	1.97	1.97	2.01
Preprovision Operating profit	2.07	2.18	2.08	2.08
Loan loss provisions	0.29	0.19	0.28	0.28
Pretax profits	1.67	1.58	1.64	1.67
Taxes	0.56	0.53	0.55	0.56

Balance sheet (Rs mn)	03/06	03/07E	03/08E	03/09E
Gross loans	224,709.1	351,544.1	509,738.9	688,147.5
NPLs	3,742.8	4,190.5	5,272.5	6,867.9
Loan loss reserves	1,718.2	3,085.2	3,645.7	4,567.7
Total interest earning assets	**474,834.2**	**684,820.9**	**929,348.6**	**1,201,860.8**
Other non-interest earning assets	22,476.9	32,269.0	38,722.9	56,632.2
Total assets	**497,311.2**	**717,090.0**	**968,071.5**	**1,258,492.9**
Customer deposits	401,135.3	577,052.6	757,154.3	948,049.4
Total interest-bearing liabilities	445,830.6	647,155.8	844,651.2	1,063,301.4
Total equity	**28,721.9**	**34,041.5**	**64,799.1**	**74,647.0**

CAMEL ratios	03/06	03/07E	03/08E	03/09E
C: Tier 1 capital ratio (%)	7.3	6.8	8.8	7.8
C: Equity/loans (X)	12.9	9.7	12.8	10.9
C: Equity/assets (X)	5.8	4.7	6.7	5.9
A: NPL ratio (%)	1.7	1.2	1.0	1.0
A: Loan loss reserves/NPLs (%)	45.9	73.6	69.1	66.5
E: Net interest margin (%)	2.3	2.4	2.5	2.6
E: Non int inc/oper revenues (%)	42.4	40.6	39.1	37.7
E: Cost-income ratio (%)	47.3	47.5	48.7	49.2
E: ROAA (%)	1.1	1.0	1.1	1.1
L: Loan/deposit ratio (%)	55.6	60.6	66.9	72.0

Key CAMELOT assumptions	03/06	03/07E	03/08E	03/09E
GS CAMELOT fair P/B (X)	--	--	3.5	--
GS CAMELOT fair P/E (X)	--	--	21.1	--
Risk-free rate (%)	7.5	7.5	7.5	7.5
Equity risk premium (%)	5.0	5.0	5.0	5.0
CAMELOT beta (X)	--	--	0.8	--
Risk-adjusted cost of equity (%)	--	--	11.5	--
3-yr adjusted DPS CAGR (%)	--	--	31.0	--
Sustainable ROE estimate (%)	--	--	16.5	--
Long-term dividend payout estimate (%)	--	--	71.0	--
Ex-growth bond-equivalent P/B (X)	--	--	1.4	--

Loan portfolio (%)	03/06	03/07E	03/08E	03/09E
Commercial & corporate	71.1	70.5	70.5	70.5
Mortgages/home loans	0.0	0.0	0.0	0.0
Consumer	28.9	29.5	29.5	29.5

Valuation (current price)	03/06	03/07E	03/08E	03/09E
P/E basic (X)	28.1	21.5	15.2	12.8
P/B (X)	4.7	4.0	2.4	2.1
P/PPOP (X)	14.9	10.2	7.7	5.8
Dividend yield (%)	0.7	1.0	1.4	1.7
EPS, basic (Rs)	17.45	22.76	31.88	37.76
EPS, fully-diluted (Rs)	17.08	22.39	31.52	37.54
EPS, basic Growth (%)	21.9	30.4	40.1	18.4
EPS, fully diluted Growth (%)	21.5	31.1	40.8	19.1
BVPS (Rs)	103.06	121.28	199.57	228.49
DPS (Rs)	3.50	5.00	6.50	8.00

Source: Company data, Goldman Sachs Research estimates.

HDFC (HDFC.BO): Buy; TP: Rs1,926; total return potential: 28%

Housing Development Finance Corporation (HDFC.BO), promoted in 1977, is a specialized mortgage finance institution and enjoys a strong market position. It has financed 2.9 mn units by disbursing Rs1,044 bn till September 2006 and currently accounts for 25%-30% of the total outstanding mortgage balance. HDFC's interests in the financial services sector include banking, asset management and insurance businesses.

Investment Summary: Room for further upside

We initiate coverage on HDFC with a Buy rating and a 12-month target price of Rs1,926 based on the sum-of-the-parts methodology, implying total return potential of 28%. We value the core business at 4.7x FY2008E P/B and adopt multiple approaches for valuing its interests in various strategic investments.

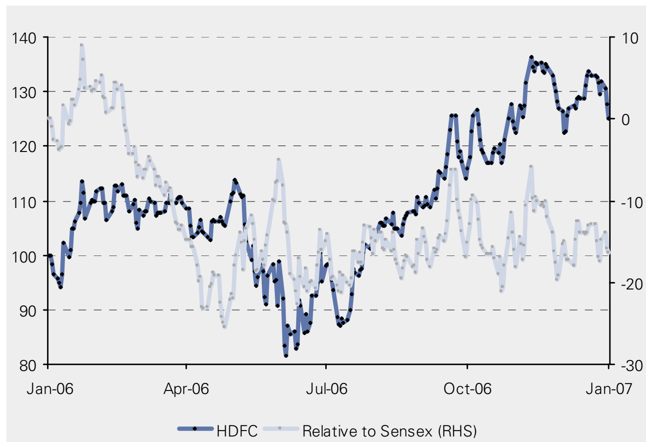
Exhibit 62: HDFC has high degree of predictability

Key data				Current
Price (Rs)				1527
Price target (Rs)				1926
Market cap (Rs mn / US$ mn)			381,912 /	8,572
Foreign ownership (%)				79.3

	3/06	3/07E	3/08E	3/09E
EPS (Rs)	48.44	57.54	68.56	82.35
EPS growth (%)	16.9	18.8	19.2	20.1
P/B (X)	6.1	5.4	4.7	4.2
P/E (X)	31.5	26.5	22.3	18.5
Dividend yield (%)	1.3	1.6	1.9	2.3
P/PPOP (X)	25.1	21.1	17.7	14.7
PPOP growth (%)	23.7	23.2	20.1	21.1
Preprovision ROA (%)	3.3	3.3	3.2	3.2
Credit Cost (%)	0.0	0.0	0.0	0.0
ROA (%)	2.62	2.58	2.54	2.53
ROE (%)	23.8	21.5	22.7	24.0

Source: Company data, Goldman Sachs Research estimates.

Exhibit 63: We believe healthy outlook for the core business and strategic investments will be key catalysts



Source: DataStream.

We rate HDFC Buy for the following reasons:

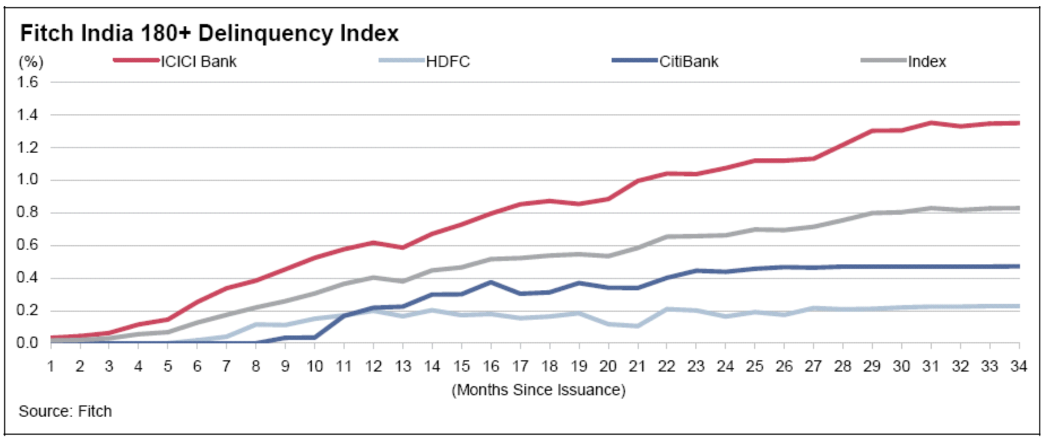
1. Underperformance of the stock with no apparent concerns

- HDFC has delivered growth in line with market expectations over the past several years even when the environment was challenging in terms of competition intensity and rising interest rates. Therefore, concerns over sustainability of the growth rate, in our view, are unlikely to be a cause for underperformance.
- Despite the volatility in the interest rate market, HDFC's NIMs remained well protected demonstrating the defensive quality of its earnings.
- HDFC's premium valuations versus peers may have been a factor for the share price underperformance. In our view, valuations are not set in vacuum; the market position and profitability of the core lending business and value accruing from the strategic investments should have only strengthened the justification for HDFC's premium valuations.

2. **Best play in an underpenetrated and rapidly growing market**

- India's mortgage loans/GDP ratio at 4.5% compares well with that of other developing markets. Some market watchers seem to suggest that the Indian mortgage market in relation to the per capita income level is overpenetrated and that growth rate would likely slow down. We beg to differ. The key metrics to watch for are home ownership (population with owned-housing/total population), affordability (home price/household income ratio) and household density (no. of individuals per household). When viewed in this context, we believe the Indian mortgage market is not overpenetrated.
- Rising interest rates and property prices could have raised market concerns about deterioration in affordability. But the sustained growth momentum seems to suggest affordability has remained favorable on the back of rising income levels.
- In our view, HDFC derives its competitiveness from very strong credit underwriting standards. This is evident from its credit loss levels over time (5 bp through the cycle versus more than 25 bp for key competitors).

Exhibit 64: Performance of securitized pools of mortgage assets should reinforce market confidence on HDFC's credit underwriting standards



Source: Fitch Ratings.

- HDFC's cost structure compares well with key competitors—ICICIB and SBI. Our discussions with key players suggest that HDFC's cost/income and cost/assets ratio of 12% and <50 bp, respectively, are well ahead of the industry average of 40% and 100 bp.
- We believe strong growth in assets, stable lending spreads and continued improvement in cost efficiency will drive earnings CAGR of 21% and ROE higher to 24% through FY2009E.

Exhibit 65: We forecast 19.3% EPS CAGR through FY2009E even after factoring in slower fee income growth and moderation in income from capital gains

	Key earnings drivers (yoy % growth)											Memo (%)					
	Deposits	Loans	NII	Non-int income	Operating revenue	Operating expenses	Pre-prov op. profit	Loan provisions	Pretax profits	NPAT	EPS	NIM	Yoy chg in NIM	Loan prov./ loans	Yoy chg in Prov./loans	ROA	ROE
FY06	NA	24.9	28.8	5.9	23.2	19.5	23.7	1.3	23.9	21.3	16.9	2.95	0.07	0.00	(0.00)	2.62	23.8
FY07E	NA	26.0	30.6	(8.9)	22.3	16.0	23.2	93.5	23.4	22.3	18.8	3.10	0.15	0.00	0.00	2.58	21.5
FY08E	NA	24.0	21.8	8.8	19.7	16.7	20.1	-	20.3	20.3	19.2	3.08	(0.02)	0.00	(0.00)	2.54	22.7
FY09E	NA	24.0	23.0	6.9	20.7	17.0	21.1	33.3	21.2	21.2	20.1	3.11	0.03	0.00	0.00	2.53	24.0
CAGR (07E-09E)	NA	24.6	24.7	2.6	20.8	16.6	21.3	32.9	21.5	21.2	19.3						

Source: Company data, Goldman Sachs Research estimates.

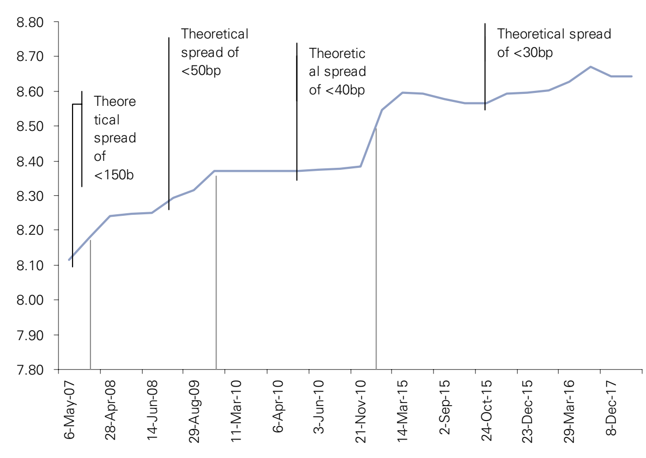
3. Overdone concerns about cost competitiveness/funding position

- We believe the market views HDFC's operating structure–as a non-banking finance company—as a disadvantage as compared with the bank structure. However, empirically, there is no evidence to confirm this view.
- HDFC derives its competitiveness through high operating efficiency and stronger underwriting standards, which we believe will negate the disadvantages of its operating structure.
- Concerns over HDFC's reliance on wholesale funding: The two key issues that consensus has not considered are: 1) shift in the loan product mix in favor of variable rate that minimizes interest rate risk substantially; and 2) no significant advantage in the cost curve of SBI over HDFC if we were to compare a matched profile of funding.

Exhibit 66: Structural shift in product mix towards variable rate loans helps HDFC in managing volatility arising from interest rate risk

Source: Company data.

Exhibit 67: Empirical evidence negates perceived disadvantages in NBFC structure



Source: Reuters, Goldman Sachs Research estimates.

4. Rising contribution from strategic investments

We believe HDFC's price performance will be driven by value accruing from its strategic investments as well, namely banking, insurance and asset management.

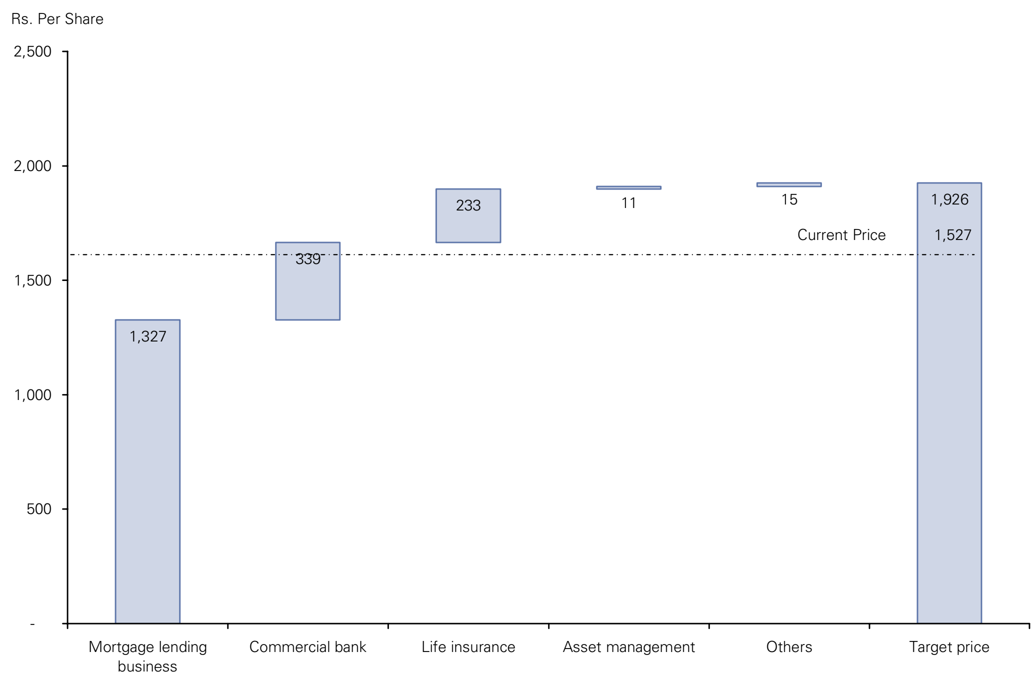
- We estimate the value accruing from subsidiaries to be 25% of HDFC's current market capitalization. We expect this to rise to 30% of HDFC's target potential value over the next 12 months.

- HDFC's life insurance business has been incurring losses on an accounting basis due to continued investment in expanding the scale and scope of the business. We believe the life insurance business is creating wealth for shareholders driven by market share gains and improving efficiencies.
- The asset management and venture capital fund of HDFC makes an insignificant contribution currently. However, we believe these businesses hold significant upside potential as they achieve scale economies.

Valuations

Our 12-month target price of Rs1,926 for HDFC is based on the sum-of-the-parts methodology to capture the value of core mortgage lending business and strategic investments in its subsidiaries/associates. We value the mortgage-lending business based on 4.7x FY2008E P/B derived using GS CAMELOT-based 3-stage DDM and employ different valuation methodologies for various strategic investments.

Exhibit 68: We value HDFC's core banking business based on 3-stage DDM and subsidiaries using other techniques



Source: Company data, Goldman Sachs Research estimates.

The key assumptions include:

- Dividend CAGR of 20.5% and ROE of 21.5%-24% (after considering the effect of FCCB dilution) for FY2007E-FY2009E.
- Sustainable growth rate of 12.4% and ROE of 23% during the transition phase (stage 2). We have assumed the length of the transition phase to be 15 years based on our BRICs hypothesis.
- Sustainable growth rate and ROE of 4.8% and 20%, respectively, for the terminal phase.

- We have assumed COE of 11% for HDFC. This is based on a risk-free rate of 7.5%, equity risk premium of 5% and a GS CAMELOT beta quotient of 0.7x (that we estimate on the bank's fundamentals versus peers.)

Exhibit 69: Sensitivity of valuations to COE and stage-2 growth rate assumptions

	COE				
Growth rate	**10.0%**	**10.5%**	**11.0%**	**11.5%**	**12.0%**
12.0%	2,194	2,028	1,886	1,764	1,658
12.2%	2,222	2,052	1,906	1,781	1,672
12.4%	2,250	2,076	**1,926**	1,798	1,687
12.6%	2,272	2,094	1,942	1,811	1,698
12.8%	2,294	2,113	1,958	1,825	1,709

Legend	**GS target price & assumptions**	Target price less than current price

Source: Company data, Goldman Sachs Research estimates.

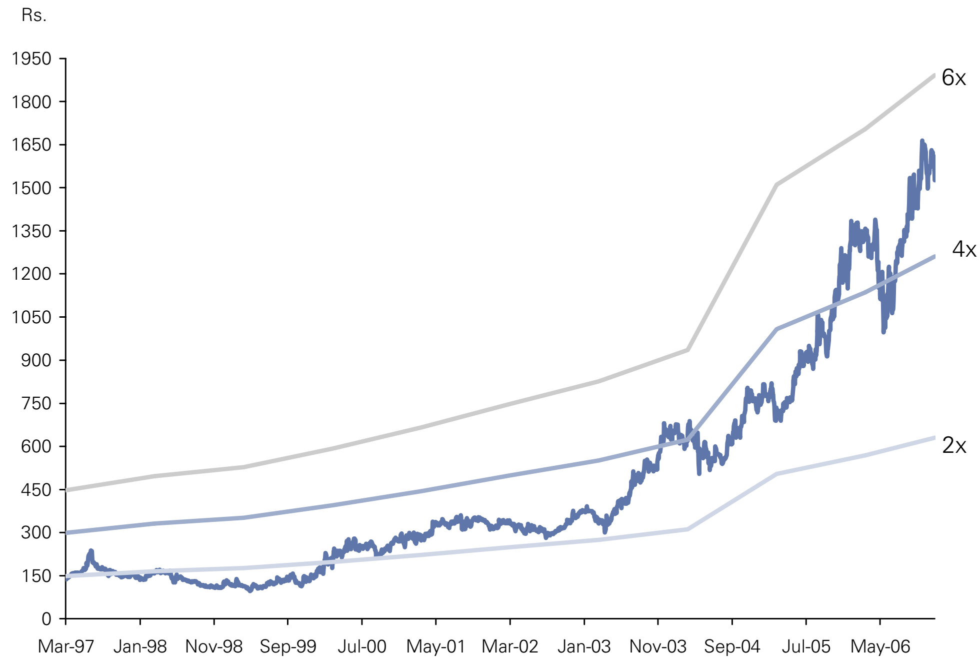
Key catalysts for the share price performance include:

- Delivering earnings in line with market expectations;
- Continued strong visibility on the growth outlook for strategic investments; and
- A positive macroeconomic environment, rising disposable income and favorable affordability factors for housing.

HDFC is trading at well over the historical P/B range on standalone as well as consolidated basis after taking into consideration the value accruing from strategic investments. The key question is whether our expectations, particularly for the core mortgage-lending business, are sustainable.

- In our opinion, sustainability could be derived from growth opportunities, evolution of competition and its impact on returns, expectations discounted in the current prices and scope for the same to expand/contract.
- Mortgage is an underpenetrated market in India and would likely sustain robust growth rates for many years, if not for decades. As a leading player in the market, HDFC would likely benefit from the growth opportunities.
- Given the huge potential for growth, we expect competition to intensify. Even after taking increased competition into account, we believe HDFC will remain a key player in the market. HDFC gets its competitive advantage from very high underwriting standards vis-à-vis the market and high operating efficiency, and will likely maintain its position.
- We believe the current market price implied growth expectations are discounting the 9% CAGR in earnings for 15 years beyond FY2007E-FY2009E. We believe that the market is potentially pricing in the growth prospects, but not the competitive advantage that HDFC enjoys. Our target price-implied growth expectation is a CAGR of 12%. Even after accounting for the effect of increased competition on profitability, we believe that our expectations are undemanding.

Exhibit 70: Historical valuation range not a guiding factor
We are guided by our investment theme and GS CAMELOT-based 3-stage DDM



Source: Company data, Goldman Sachs Research estimates, DataStream.

Key risks

- Unexpected slowdown in economic activity and/or tighter monetary policy affecting the interest rates adversely.
- Significant deterioration in affordability factors affecting home loan sales—property price changes, consumer confidence and interest rate and fiscal policy changes.
- Sharp pull back in valuations, particularly of subsidiaries, because of negative surprise to expectations.

Exhibit 71: HDFC summary financials (Rs mn)

Profit model (Rs mn)	03/06	03/07E	03/08E	03/09E
Net interest income	14,120.6	18,448.2	22,462.4	27,619.4
Non-interest income	3,752.0	3,418.1	3,719.1	3,975.2
Operating revenue	17,872.6	21,866.3	26,181.5	31,594.7
Non-interest expense	(2,149.6)	(2,492.9)	(2,909.7)	(3,403.0)
Preprovision oper profits	15,723.0	19,373.4	23,271.8	28,191.7
Total provision charge	(150.0)	(150.2)	(154.3)	(167.5)
Associates	0.0	0.0	0.0	0.0
Pretax profit	15,573.0	19,223.2	23,117.5	28,024.1
Tax	(3,000.0)	(3,844.6)	(4,623.5)	(5,604.8)
Minorities				
Net profit	**12,573.0**	**15,378.6**	**18,494.0**	**22,419.3**
Dividends	4,991.3	6,037.4	7,353.2	8,944.6
Dividends payout (%)	39.8	39.1	39.6	39.7

Earnings growth drivers (%)	03/06	03/07E	03/08E	03/09E
Net interest margin	2.95	3.10	3.08	3.11
Provision charge/total loans	(0.03)	(0.03)	(0.02)	(0.02)
YoY Growth (%)				
Customer deposits	--	--	--	--
Loans	24.9	26.0	24.0	24.0
Net interest income	28.8	30.6	21.8	23.0
Fee income	(33.7)	(22.2)	26.0	26.0
Non-interest income	5.9	(8.9)	8.8	6.9
Operating revenue	23.2	22.3	19.7	20.7
Operating expenses	(19.5)	(16.0)	(16.7)	(17.0)
Preprovision Operating profit	**23.7**	**23.2**	**20.1**	**21.1**
Provision charges	(1.3)	(93.5)	--	(33.3)
Pretax profit	23.9	23.4	20.3	21.2
Net profit	21.3	22.3	20.3	21.2
EPS	16.9	18.8	19.2	20.1
DPS	17.6	20.0	20.8	20.7

Market dimensions	03/06	03/07E	03/08E	03/09E
No of branches	--	--	--	--
No of staff (000s)	--	--	--	--
Revenues/staff (Rs)	--	--	--	--
Net profit/staff (Rs)	--	--	--	--

DuPont analysis	03/06	03/07E	03/08E	03/09E
ROE (%)	**23.8**	**21.5**	**22.7**	**24.0**
x leverage	11.0	12.0	11.2	10.5
= ROA (%)	**2.62**	**2.58**	**2.54**	**2.53**

% of assets	03/06	03/07E	03/08E	03/09E
Net interest income	2.95	3.10	3.08	3.11
Fee income	0.14	0.09	0.09	0.09
Non-interest income	0.78	0.57	0.51	0.45
Operating revenue	3.73	3.67	3.59	3.56
Operating expenses	0.45	0.42	0.40	0.38
Preprovision Operating profit	3.28	3.25	3.19	3.18
Loan loss provisions	0.00	0.01	0.00	0.00
Pretax profits	3.25	3.23	3.17	3.16
Taxes	0.63	0.65	0.63	0.63

Balance sheet (Rs mn)	03/06	03/07E	03/08E	03/09E
Gross loans	449,901.2	567,026.0	703,112.2	871,859.1
NPLs	--	--	--	--
Loan loss reserves	15.5	30.0	30.0	40.0
Total interest earning assets	**483,335.9**	**598,594.5**	**734,924.2**	**904,582.9**
Other non-interest earning assets	50,645.9	58,203.1	66,368.9	68,988.2
Total assets	**533,981.8**	**656,797.6**	**801,293.1**	**973,571.1**
Customer deposits	87,414.2	144,233.5	187,503.5	234,379.4
Total interest-bearing liabilities	445,057.3	556,209.9	683,117.5	834,092.5
Total equity	**66,839.5**	**75,974.2**	**86,872.1**	**99,693.2**

CAMEL ratios	03/06	03/07E	03/08E	03/09E
C: Tier 1 capital ratio (%)	8.5	8.2	8.4	8.6
C: Equity/loans (X)	9.9	9.5	9.2	8.9
C: Equity/assets (X)	8.4	8.2	8.1	8.0
A: NPL ratio (%)	0.0	0.0	0.0	0.0
A: Loan loss reserves/NPLs (%)	0.0	0.0	0.0	0.0
E: Net interest margin (%)	2.9	3.1	3.1	3.1
E: Non int inc/oper revenues (%)	21.0	15.6	14.2	12.6
E: Cost-income ratio (%)	12.0	11.4	11.1	10.8
E: ROAA (%)	2.6	2.6	2.5	2.5
L: Loan/deposit ratio (%)	514.7	393.1	375.0	372.0

Key CAMELOT assumptions	03/06	03/07E	03/08E	03/09E
GS CAMELOT fair P/B (X)	--	--	4.7	--
GS CAMELOT fair P/E (X)	--	--	23.7	--
Risk-free rate (%)	7.5	7.5	7.5	7.5
Equity risk premium (%)	5.0	5.0	5.0	5.0
CAMELOT beta (X)	--	--	0.7	--
Risk-adjusted cost of equity (%)	--	--	11.0	--
3-yr adjusted DPS CAGR (%)	--	--	20.5	--
Sustainable ROE estimate (%)	--	--	20.0	--
Long-term dividend payout estimate (%)	--	--	76.0	--
Ex-growth bond-equivalent P/B (X)	--	--	1.8	--

Loan portfolio (%)	03/06	03/07E	03/08E	03/09E
Commercial & corporate	31.1	31.1	31.1	31.1
Mortgages/home loans	0.0	0.0	0.0	0.0
Consumer	67.3	67.2	67.2	67.2

Valuation (current price)	03/06	03/07E	03/08E	03/09E
P/E basic (X)	31.4	26.5	22.2	18.5
P/B (X)	6.0	5.4	4.7	4.1
P/PPOP (X)	24.2	19.7	16.4	13.5
Dividend yield (%)	1.3	1.6	1.9	2.3
EPS, basic (Rs)	50.25	61.38	73.23	88.07
EPS, fully-diluted (Rs)	48.44	57.54	68.56	82.35
EPS, basic Growth (%)	20.4	22.1	19.3	20.3
EPS, fully diluted Growth (%)	16.9	18.8	19.2	20.1
BVPS (Rs)	251.84	284.13	322.47	367.34
DPS (Rs)	20.00	24.00	29.00	35.00

Source: Company data, Goldman Sachs Research estimates.

ICICIB (ICBK.BO): Buy; TP: Rs1,068; total return potential: 22%

ICICIB is the second-largest bank in India in terms of market share and the largest within the private sector. ICICIB's key businesses include retail banking, wholesale banking and treasury operations. The bank enjoys a leadership position in retail lending and a strong market position in other businesses.

Investment summary: Best procyclical play on growth

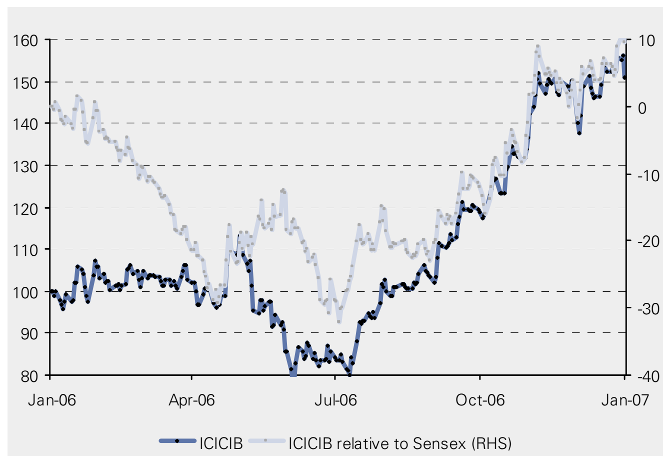
We initiate coverage on ICICIB with a BUY rating and a 12-month target price of Rs1,068 based on the sum-of-the-parts methodology, implying a total return potential of 22%. We have valued the core banking business using GS CAMELOT-based 3-stage DDM at 3.3x FY2008E P/B and strategic investments using multiple valuation techniques.

Exhibit 72: We forecast 19% EPS CAGR through FY08E
The growth rate is affected by a significant dilution in equity during end-FY05

Key data				Current
Price (Rs)				883
Price target (Rs)				1068
Market cap (Rs mn / US$ mn)			789,080 /	17,711
Foreign ownership (%)				62.6
	3/06	**3/07E**	**3/08E**	**3/09E**
EPS (Rs)	32.15	35.20	42.58	54.28
EPS growth (%)	17.7	9.5	21.0	27.5
P/B (X)	3.5	3.2	3.0	2.6
P/E (X)	27.5	25.1	20.7	16.3
Dividend yield (%)	1.0	1.4	1.6	2.1
P/PPOP (X)	17.9	15.7	12.7	9.9
PPOP growth (%)	45.1	29.9	24.8	28.7
Preprovision ROA (%)	1.9	1.9	1.8	1.9
Credit Cost (%)	0.4	0.5	0.5	0.5
ROA (%)	1.21	1.16	1.11	1.14
ROE (%)	14.6	13.6	15.1	17.4

Source: Company data, Goldman Sachs Research estimates.

Exhibit 73: Favorable macro likely to be a key driver of stock performance
We believe price performance will be in line with earnings prospects



Source: DataStream.

Four reasons why investors should Buy ICICIB:

1. **Best play in a buoyant environment—Favorable macro, buoyant market-related revenues and a benign environment for asset quality**

- ICICIB—as a player focused on maintaining and/or improving market share in key business segments, particularly retail lending—will, in our view, benefit immensely from a positive operating environment.
- In our view, ICICIB benefited from the procyclicality effect of the economic cycle as its borrowers in the legacy project financing activity witnessed their debt servicing ability increasing considerably. We believe profitability of this segment has improved as a result of lower loan loss provisions and lower taxable rates of income from this source. We expect the procyclical benefit to continue and hence profitability of legacy lending to be sustained at levels seen earlier.
- We believe market-related revenues contribute 14%-15% to ICICIB's operating revenues and have boosted its preprovision RoAA. We expect a buoyant environment to sustain the contribution from market-related revenues and hence the operating profitability.

Exhibit 74: Strong loan growth, stable NIM and strong fee income growth to drive 25% CAGR in earnings through FY09E
We expect operating costs to grow ahead of revenues till FY2008E because of anticipated investments in distribution infrastructure

	Key earnings drivers (yoy % growth)											Memo (%)					
	Deposits	Loans	NII	Non-int income	Operating revenue	Operating expenses	Pre-prov op. profit	Loan provisions	Pretax profits	NPAT	EPS	NIM	Yoy chg in NIM	Loan prov./ loans	Yoy chg in Prov./loans	ROA	ROE
FY06	65.4	59.9	32.1	45.9	40.0	35.8	45.1	(475.5)	22.5	26.7	17.7	1.62	(0.13)	0.38	0.54	1.21	14.6
FY07E	39.4	29.5	45.9	31.3	37.2	43.5	29.9	77.2	24.9	24.8	9.5	1.81	0.20	0.50	0.12	1.16	13.6
FY08E	30.3	28.5	28.2	29.7	29.1	32.4	24.8	34.0	24.9	21.9	21.0	1.82	0.00	0.50	-	1.11	15.1
FY09E	26.4	26.8	32.3	23.0	27.0	25.7	28.7	30.0	28.3	28.3	27.5	1.92	0.11	0.50	-	1.14	17.4
CAGR (07E-09E)	31.8	28.3	34.5	28.1	30.8	33.6	27.5	44.4	25.9	24.7	19.3						

Source: Company data, Goldman Sachs Research estimates.

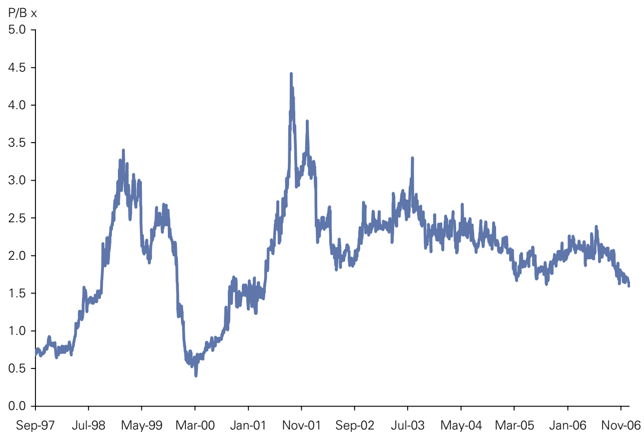
2. Pricing power in consumer financing segment buffers profitability against potential shocks

- ICICIB enjoys a dominant market position across customer categories in retail lending. We believe the strong market position and robust demand for consumer financing vests significant pricing power with ICICIB either by allowing a hike in lending rates, negotiating higher subvention from manufacturers or cutting distribution costs.
- Strong pricing power and a balance sheet that is significantly biased towards retail lending buffers ICICIB’s profitability from potential shocks in the bank’s funding cost.
- ICICIB has an adverse mismatch profile between assets and liabilities. High volatility in interest rates could adversely affect profitability in the short term; however, as the back book gets repriced at new lending rates upon maturity, the bank’s NIM will likely show improvement. We expect this phenomenon to play out through FY2008E and FY2009E.

3. Our view is in line with consensus, but we recommend Buy ICICIB for growth reasons and not for the relative valuation appeal

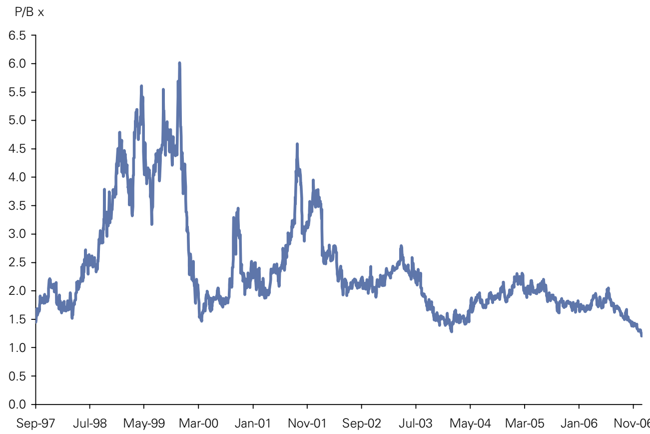
- In our view, it is not so much about ICICIB versus HDFC or HDFCB, but about their respective operating metrics and growth conditions. Market has rewarded both strategies:
  - ICICIB’s broad-based strategy allows capturing value across the value chain in a customer segment; and
  - HDFC and HDFCB—Narrow focus allows specialization and hence advantages in terms of efficiency and risk management.
- We believe ICICIB, like other large players in the private sector, enjoys favorable conditions arising from a restrictive regulatory/policy environment towards new entrants and foreign banks and slow pace of reforms for state-owned banks.

Exhibit 75: Trend in relative valuations of HDFC and ICICIB



Source: Company data, DataStream, Goldman Sachs Research estimates.

Exhibit 76: Trend in relative valuations of HDFCB and ICICIB



Source: Company data, DataStream, Goldman Sachs Research estimates.

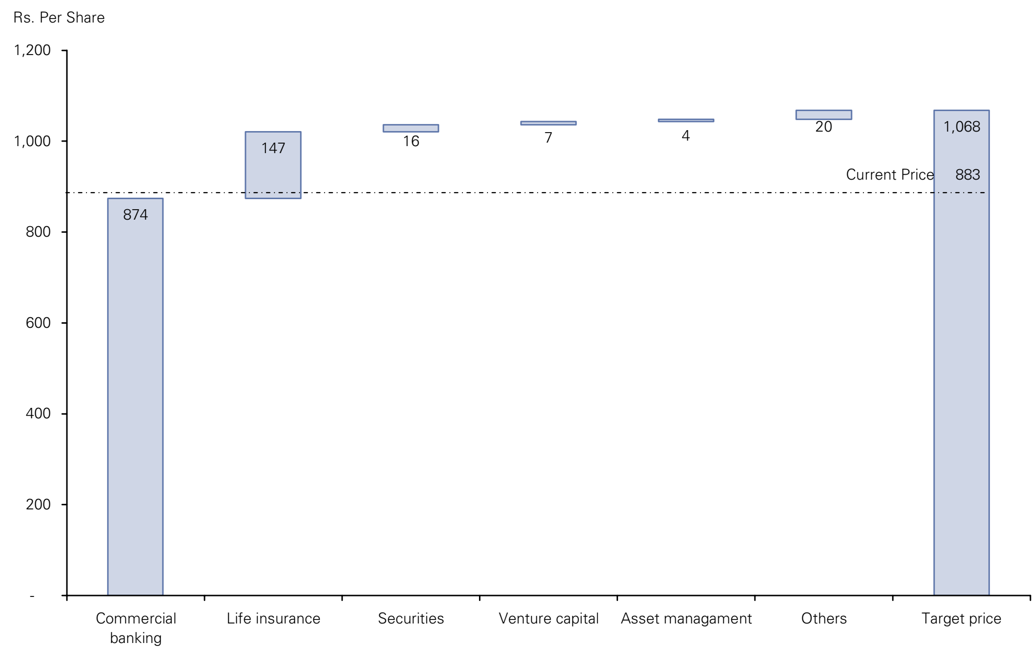
4. Increasing contribution from strategic investments—Yet another driver

- We estimate the value accruing from subsidiaries to be 17% of ICICIB's current market capitalization. We expect this to rise to 20% of ICICIB's target price over the next 12 months, with banking and life insurance being the key drivers.
- The life insurance business of ICICIB has been incurring losses on an accounting basis due to continued investment in expanding the scale and scope of the business. We believe the life insurance business is creating wealth for its shareholders through market share gains, increasing penetration of life insurance and improving operating efficiency.
- The asset management and venture capital fund of ICICIB makes a negligible contribution currently; however, we believe these businesses hold significant upside potential as they achieve scale economies.

Valuations

Our 12-month target price of Rs1,068 is based on the sum-of-the-parts methodology to capture the value of the core banking business and strategic investments in the subsidiaries. We value the core banking business based on 3.3x FY2008E P/B derived using the GS CAMELOT-based 3-stage DDM.

Exhibit 77: We value ICICIB's core banking business based on 3-stage DDM and subsidiaries using P/E on historical earnings



Source: Company data, Goldman Sachs Research estimates.

Our key assumptions are:

- Dividend CAGR of 29% and ROE of 13.7%-17.4% for FY2007E-FY2009E.
- Sustainable growth rate and ROE of 12.3% and 17.5%, respectively, during the transition phase (stage 2). We have assumed the length of the transition phase to be 15 years based on our BRICs hypothesis.
- Sustainable growth rate and ROE to be 4.8% and 16.5%, respectively, for the terminal phase.
- We have assumed COE of 11.5% for ICICIB. This is based on a risk-free rate of 7.5%, equity risk premium of 5% and a GS CAMELOT beta quotient of 0.8x (that we estimate on the bank's fundamentals versus peers).

Exhibit 78: Sensitivity of target price to COE and stage-2 growth rate assumptions

	COE				
Growth rate	**10.5%**	**11.0%**	**11.5%**	**12.0%**	**12.5%**
11.9%	1,269	1,153	1,055	970	896
12.1%	1,280	1,162	1,061	975	900
12.3%	1,291	1,171	**1,068**	980	904
12.5%	1,308	1,184	1,079	989	911
12.7%	1,319	1,194	1,086	994	915

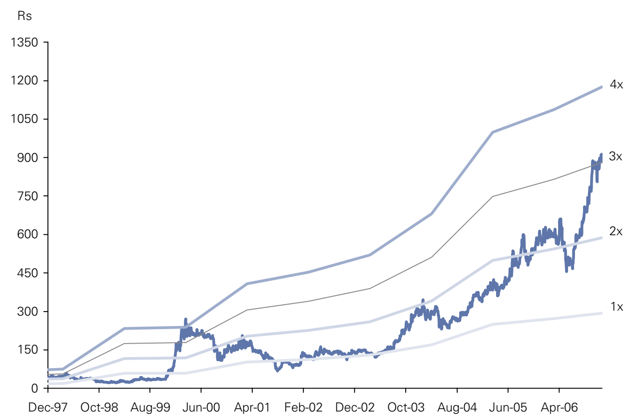
Legend	**GS target price & assumptions**	Target price less than current price

Source: Company data, Goldman Sachs Research estimates.

Our Rs1,068 target price for ICICIB implies 3.6x FY2008E P/B as against the current level as well as peers of 2.9x. In our view, the market will be biased towards growth stocks and concerns over expansion of multiples will not be a deterrent for share price performance.

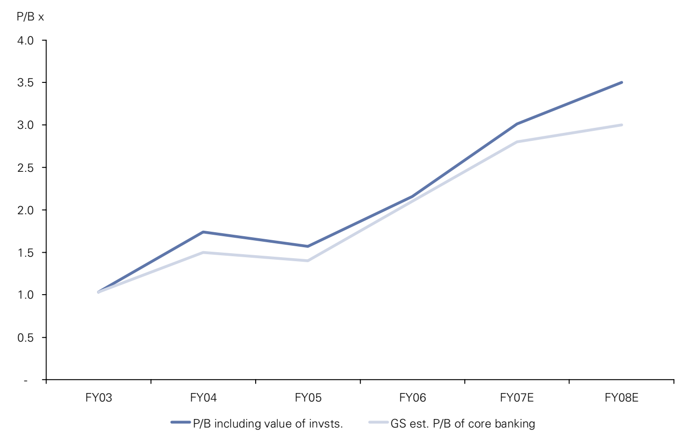
Our implied P/B for ICICIB reflects the value of the commercial banking business as well as subsidiaries. According to our estimates, both factors have contributed towards multiple expansion; but, we believe it will be increasingly driven by strategic investments.

Exhibit 79: Current P/B well above the historical range
Investments contribute 17% to ICICIB's market cap



Source: Company data, Goldman Sachs Research estimates, DataStream.

Exhibit 80: Strategic investments to play a greater role
Estimating drivers of ICICIB's multiple expansion



Source: Company data, Goldman Sachs Research estimates, DataStream.

Key catalysts for the share price performance:

- Delivering earnings in line with market expectation;
- Continued strong visibility on the growth outlook for strategic investments, mainly, life insurance; and
- Sustained high GDP growth and a supportive monetary policy from a macro perspective.

Key risks

- Tighter monetary policy affecting interest rates adversely. ICICIB's deposit profile is significantly skewed towards shorter duration. An unfavorable movement in interest rates will likely affect its NIM adversely.
- Adverse market conditions affecting ICICIB's market-related income streams such as wealth management, distribution of third-party financial products, treasury products and trading income.
- Regulatory risk—Penalty of rural banking.
- Unexpected slowdown in economic activity—This could affect the asset quality of legacy project finance assets adversely.
- Sharp pullback in valuations including that of subsidiaries on the back of disappointment in earnings delivery.

Exhibit 81: ICICIB summary financials (Rs mn)

Profit model (Rs mn)	03/06	03/07E	03/08E	03/09E
Net interest income	33,850.5	49,384.5	63,315.8	83,788.9
Non-interest income	49,831.4	65,419.4	84,847.7	104,340.7
Operating revenue	83,681.9	114,803.9	148,163.5	188,129.6
Non-interest expense	(44,795.2)	(64,298.4)	(85,157.2)	(107,013.5)
Preprovision oper profits	38,886.7	50,505.5	63,006.3	81,116.1
Total provision charge	(7,920.6)	(11,841.8)	(14,712.5)	(19,140.3)
Associates	0.0	0.0	0.0	0.0
Pretax profit	30,966.1	38,663.7	48,293.8	61,975.8
Tax	(5,565.3)	(6,959.5)	(9,658.8)	(12,395.2)
Minorities	0.0	0.0	0.0	0.0
Net profit	**25,400.7**	**31,704.2**	**38,635.0**	**49,580.6**
Dividends	7,593.3	10,732.0	13,033.1	16,720.9
Dividends payout (%)	26.2	33.8	33.6	33.6

Earnings growth drivers (%)	03/06	03/07E	03/08E	03/09E
Net interest margin	1.62	1.81	1.82	1.92
Provision charge/total loans	(0.54)	(0.63)	(0.60)	(0.62)
YoY Growth (%)				
Customer deposits	65.4	39.4	30.3	26.4
Loans	59.9	29.5	28.5	26.8
Net interest income	32.1	45.9	28.2	32.3
Fee income	56.3	40.0	35.0	25.0
Non-interest income	45.9	31.3	29.7	23.0
Operating revenue	40.0	37.2	29.1	27.0
Operating expenses	(35.8)	(43.5)	(32.4)	(25.7)
Preprovision Operating profit	**45.1**	**29.9**	**24.8**	**28.7**
Provision charges	(475.5)	(77.2)	(34.0)	(30.0)
Pretax profit	22.5	24.9	24.9	28.3
Net profit	26.7	24.8	21.9	28.3
EPS	17.7	9.5	21.0	27.5
DPS	--	41.2	20.8	27.6

Market dimensions	03/06	03/07E	03/08E	03/09E
No of branches	614.0	--	--	--
No of staff (000s)	25,384.0	--	--	--
Revenues/staff (Rs)	3,296.6	--	--	--
Net profit/staff (Rs)	1,000.7	--	--	--

DuPont analysis	03/06	03/07E	03/08E	03/09E
ROE (%)	**14.6**	**13.6**	**15.1**	**17.4**
x leverage	8.3	8.5	7.3	6.5
= ROA (%)	**1.21**	**1.16**	**1.11**	**1.14**

% of assets	03/06	03/07E	03/08E	03/09E
Net interest income	1.62	1.74	1.78	1.90
Fee income	1.43	1.48	1.59	1.61
Non-interest income	2.38	2.30	2.38	2.37
Operating revenue	3.99	4.04	4.16	4.27
Operating expenses	2.14	2.26	2.39	2.43
Preprovision Operating profit	1.86	1.78	1.77	1.84
Loan loss provisions	0.22	0.28	0.30	0.32
Pretax profits	1.48	1.36	1.35	1.41
Taxes	0.27	0.25	0.27	0.28

Balance sheet (Rs mn)	03/06	03/07E	03/08E	03/09E
Gross loans	1,473,058.6	1,905,967.3	2,448,968.3	3,104,303.5
NPLs	22,225.9	25,407.7	32,295.6	44,086.5
Loan loss reserves	7,947.2	11,841.8	14,712.5	19,140.3
Total interest earning assets	**2,318,900.3**	**2,942,585.4**	**3,723,209.2**	**4,577,824.5**
Other non-interest earning assets	194,989.3	224,640.5	238,702.6	264,512.1
Total assets	**2,513,889.5**	**3,167,226.0**	**3,961,911.8**	**4,842,336.6**
Customer deposits	1,650,831.7	2,301,487.5	2,998,121.0	3,790,039.0
Total interest-bearing liabilities	2,137,494.6	2,756,179.7	3,503,612.5	4,327,521.9
Total equity	**222,059.9**	**243,149.7**	**268,614.4**	**301,133.2**

CAMEL ratios	03/06	03/07E	03/08E	03/09E
C: Tier 1 capital ratio (%)	9.2	8.7	7.6	6.9
C: Equity/loans (X)	15.2	12.8	11.0	9.8
C: Equity/assets (X)	8.8	7.7	6.8	6.2
A: NPL ratio (%)	1.5	1.3	1.3	1.4
A: Loan loss reserves/NPLs (%)	35.8	46.6	45.6	43.4
E: Net interest margin (%)	1.6	1.8	1.8	1.9
E: Non int inc/oper revenues (%)	59.5	57.0	57.3	55.5
E: Cost-income ratio (%)	53.5	56.0	57.5	56.9
E: ROAA (%)	1.2	1.1	1.1	1.1
L: Loan/deposit ratio (%)	88.5	82.2	81.1	81.4

Key CAMELOT assumptions	03/06	03/07E	03/08E	03/09E
GS CAMELOT fair P/B (X)	--	--	3.3	--
GS CAMELOT fair P/E (X)	--	--	19.9	--
Risk-free rate (%)	7.5	7.5	7.5	7.5
Equity risk premium (%)	5.0	5.0	5.0	5.0
CAMELOT beta (X)	--	--	0.8	--
Risk-adjusted cost of equity (%)	--	--	11.5	--
3-yr adjusted DPS CAGR (%)	--	--	29.0	--
Sustainable ROE estimate (%)	--	--	16.5	--
Long-term dividend payout estimate (%)	--	--	71.0	--
Ex-growth bond-equivalent P/B (X)	--	--	1.4	--

Loan portfolio (%)	03/06	03/07E	03/08E	03/09E
Commercial & corporate	37.4	34.7	32.4	30.7
Mortgages/home loans	30.8	0.0	0.0	0.0
Consumer	62.6	65.3	67.6	69.3

Valuation (current price)	03/06	03/07E	03/08E	03/09E
P/E basic (X)	27.8	25.4	21.0	16.5
P/B (X)	3.6	3.3	3.0	2.7
P/PPOP (X)	20.6	15.8	12.7	9.9
Dividend yield (%)	1.0	1.3	1.6	2.1
EPS, basic (Rs)	32.49	35.54	43.09	55.01
EPS, fully-diluted (Rs)	32.15	35.20	42.58	54.28
EPS, basic Growth (%)	17.9	9.4	21.2	27.7
EPS, fully diluted Growth (%)	17.7	9.5	21.0	27.5
BVPS (Rs)	249.55	271.88	298.85	333.17
DPS (Rs)	8.50	12.00	14.50	18.50

Source: Company data, Goldman Sachs Research estimates.

HDFCB (HDBK.BO): Neutral; TP: Rs1,161; total return potential: 17%

HDFCB was incorporated by HDFC when RBI opened up the banking sector in 1994. The bank has an impressive track record and is the second-largest private bank. HDFCB enjoys a significant market position in each of its key businesses, namely corporate, transactional and retail banking. As of March 31, 2006, the bank has 535 branches with an asset base of Rs844 bn.

Investment summary: Expectations embedded in valuations

We are initiating coverage on HDFCB with a Neutral rating (positive bias) and 12-month target price of Rs1,161, implying total return potential of 17%. We have valued HDFCB using GS CAMELOT-based 3-stage DDM at 4.0x FY2008E P/B.

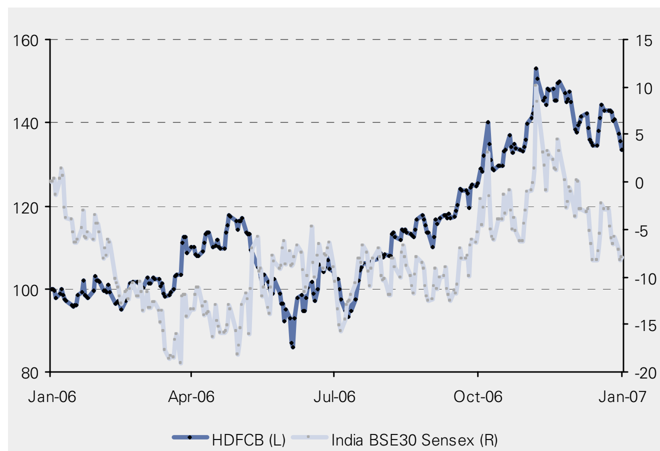
Exhibit 82: We forecast 27.5% EPS CAGR through FY08E
As in the case of HDFC, the element of surprise to expectations will remain negligible

Key data				Current
Price (Rs)				999
Price target (Rs)				1161
Market cap (Rs mn / US$ mn)			314,960 /	7,069
Foreign ownership (%)				42.0

	3/06	3/07E	3/08E	3/09E
EPS (Rs)	26.11	34.22	43.44	54.18
EPS growth (%)	21.9	31.1	26.9	24.7
P/B (X)	5.9	5.0	3.5	3.0
P/E (X)	38.3	29.2	23.0	18.4
Dividend yield (%)	0.6	0.8	1.0	1.3
P/PPOP (X)	17.0	12.0	9.4	7.6
PPOP growth (%)	50.0	42.6	28.3	33.2
Preprovision ROA (%)	2.8	2.9	2.8	2.9
Credit Cost (%)	1.6	1.6	1.6	1.6
ROA (%)	1.39	1.36	1.32	1.37
ROE (%)	17.7	19.9	19.4	19.5

Source: Company data, Goldman Sachs Research estimates.

Exhibit 83: We are positive on fundamentals, but believe valuations could be a constraint for the stock to outperform Sensex



Source: DataStream.

We rate HDFCB Neutral with a positive bias for the following reasons:

1. **We expect the bank to deliver strong growth, but our view is constrained by valuations**

- We believe current prices discount the 22% dividend CAGR during FY2007E-FY2009E or 17% CAGR in ROE for the transition phase from high growth phase. We deduced the implied growth expectations from current prices using GS CAMELOT based 3-stage DDM.
- We are factoring in a 32% dividend CAGR during FY2007E-FY2009E, ROE of 19% and 18% for the transition and terminal growth phases, respectively. Our base case scenario builds further valuation expansion from current levels but not enough to rate the stock as a Buy.
- Improvement in profitability from economies of scale in consumer banking and reduced risk of equity capital dilution because of higher internal accruals financing growth could drive expectations higher but this will be realized as the regulatory framework become clearer on distribution expansion and new capital adequacy framework under BIS II.

- Expectations could rise for HDFCB as the high growth phase (stage 1 in our 3-stage DDM) extends beyond our assumption of 3 years. But this would likely hold true for other banks in our coverage as well. We do not see this as a catalyst for HDFCB alone.

Exhibit 84: High performance benchmark leaves little room to surprise expectations on the upside
The performance benchmark is sometimes a hard act for HDFCB itself to follow

	Key earnings drivers (yoy % growth)											Memo (%)						
	Deposits	Loans	NII	Non-int income	Operating revenue	Operating expenses	Pre-prov op. profit	Loan provisions	Pretax profits	NPAT	EPS	NIM	Yoy chg in NIM	Loan prov./ loans	Yoy chg in Prov./loans	ROA	ROE
FY06	53.5	37.1	44.7	72.6	52.8	55.8	50.0	172.3	28.0	30.8	21.9	3.68	0.29	1.58	0.77	1.39	17.7
FY07E	38.2	36.9	37.5	48.0	40.9	39.2	42.6	37.5	30.8	31.8	31.1	3.75	0.07	1.60	0.02	1.36	19.9
FY08E	32.2	34.5	28.9	33.7	30.6	32.9	28.3	36.1	32.1	28.3	26.9	3.66	(0.09)	1.65	0.05	1.32	19.4
FY09E	32.8	31.6	32.9	28.9	31.5	29.8	33.2	32.0	34.2	34.2	24.7	3.75	0.08	1.65	-	1.37	19.5
CAGR (07E-09E)	34.1	34.3	32.6	36.3	33.9	33.8	33.9	35.3	32.3	31.1	27.5						

Source: Company data, Goldman Sachs Research estimates.

2. **We are positive on the fundamentals of the bank—Aggressive and well managed**

- HDFCB enjoys the best operating metrics—Optimal mix of deposits (low-cost deposits/total deposits of 52% as of September 30, 2006), high asset utilization rate (operating revenues/ATA of 5.5% versus 4% for ICICIB in FY2006), low net NPA ratio and superior RoAA (0.4% and 1.39%, respectively, in FY2006)
- The superior performance metrics have been maintained (improved in a few instances) even as the bank is sustaining faster growth. HDFCB has seen its market share of deposits and loans increase 110 bp and 130 bp, respectively, during FY2002-FY2006. Assets, operating income and net profits grew at CAGR of 32%, 37% and 31%, respectively, during FY2002-FY2006.
- We believe HDFCB enjoys a strong market position in corporate and consumer lending segments (among the top-3 players). It enjoys a very strong deposit franchise, but lacks scale. We believe rapid expansion of distribution will strengthen the deposit franchise of HDFCB.
- HDFCB's target customer segments for lending are guided by the predictability of risks and hence credit losses. This is often misconstrued as the bank lacking aggressiveness.

3. **Upside potential from a clearer distribution licensing policy and changes to regulatory capital requirement**

- Currently, RBI licenses the distribution network through a policy framework. Thus far the approval process has remained unclear, thereby affecting the distribution expansion plans of all private banks. For HDFCB, which has the best performance metrics, uncertainty would have an adverse impact on expectations more than any other bank.
- HDFCB's management has indicated that implementation of new regulatory capital requirements under BIS II guidelines will release significant amount of excess capital (estimated to be over 200bp) provided the framework becomes clear.
- The distribution licensing policy is getting elucidated with its implementation. We believe that the new capital requirement will follow suit. Both these events could be potential catalysts for HDFCB.

4. **Rural banking penalty a concern**

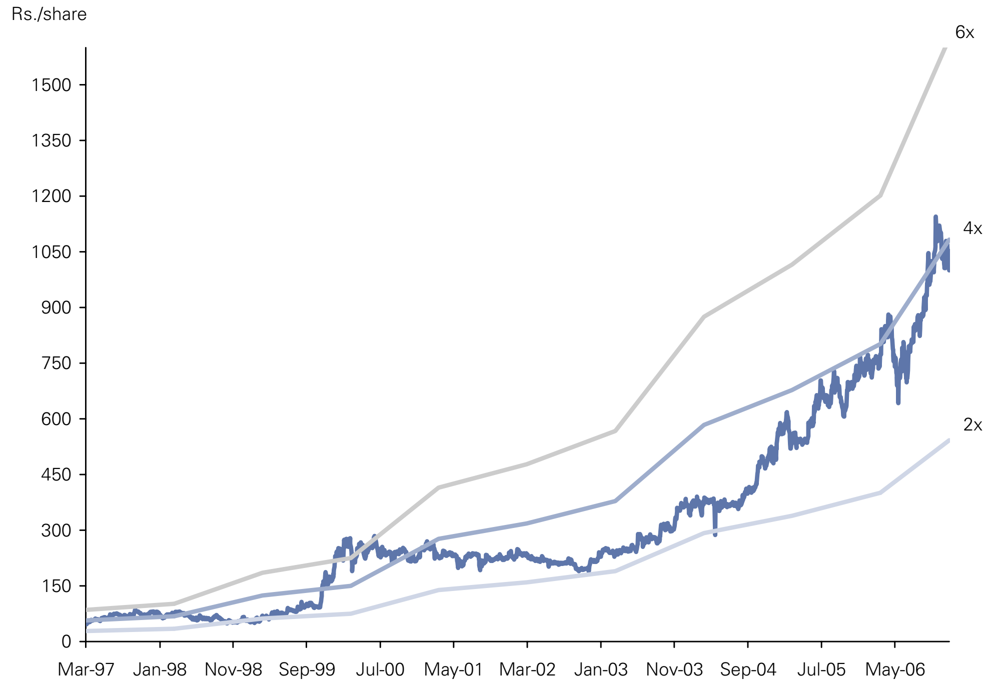
- All Indian banks are required to fulfill social sector obligations, which includes rural banking as well. Private banks, including HDFCB, have enjoyed regulatory forbearance until FY2006. Increasingly, there is pressure on private banks to begin fulfilling their obligations.
- Rural banking obligation includes provision of banking services in areas/markets that are underdeveloped. Our concern is specific to the lending activity in these markets. Lending rates are capped by a regulatory ceiling which effectively under-prices the risk.
- The obligation may not prove to be drain over the medium term as private banks have the opportunity to cherry pick markets for providing rural banking services in the initial phase. However, as they achieve higher scale of operations, ability to cherry pick risks could get constrained.
- The risk may prove to be higher for HDFCB given the high expectations embedded in current prices.

Valuations

Our 12-month target price of Rs1,161 is derived using GS CAMELOT-based 3-stage DDM. Our target price implies 4.0x FY2008E P/B versus 3.5x for our coverage companies. The key assumptions are:

- Dividend growth rate and ROE of 32% CAGR and 19.5%-20%, respectively, for FY2007E-FY2009E.
- Sustainable growth rate and ROE of 12.4% and 19%, respectively, during the transition phase (stage 2). We have assumed the length of the transition phase to be 15 years based on our BRICs hypothesis.
- Sustainable growth rate and ROE to be 4.8% and 18%, respectively, for the terminal phase.
- We have assumed COE of 11.5% for HDFCB based on the risk-free rate of 7.5%, equity risk premium of 5% and a GS CAMELOT beta quotient of 0.8x (that we estimate on the bank's fundamentals versus peers.)

Exhibit 85: Strong fundamentals likely to lend support to current valuations
Upside potential possible from reduced capital requirement under BIS II, but would need more clarity on the extent of relief



Source: Company data, Goldman Sachs Research estimates.

Key catalysts for the share price performance:

- Delivering earnings in line with market expectations; and
- Sustained high GDP growth and a supportive monetary policy from a macro perspective.

Exhibit 86: Sensitivity of valuations to COE and growth rate assumptions

	COE				
Growth rate	**10.5%**	**11.0%**	**11.5%**	**12.0%**	**12.5%**
12.0%	1,413	1,265	1,138	1,028	933
12.2%	1,430	1,279	1,149	1,037	941
12.4%	1,448	1,293	**1,161**	1,047	948
12.6%	1,474	1,315	1,179	1,061	960
12.8%	1,492	1,330	1,191	1,071	968

Legend	**GS target price & assumptions**	Target price less than current price

Source: Company data, Goldman Sachs Research estimates.

Key risks

- The upside risk to our target price arises from expectations discounting the benefits of scale economies and lower capital requirement under new regulatory guidelines.
- The downside risk arises from tighter monetary policy affecting industry dynamics and growth outlook. In the long term, rural banking penalty could potentially affect high growth expectations embedded in the stock price.

Exhibit 87: HDFCB summary financials (Rs mn)

Profit model (Rs mn)	03/06	03/07E	03/08E	03/09E
Net interest income	23,006.8	31,634.6	40,772.0	54,196.1
Non-interest income	11,239.8	16,629.7	22,238.4	28,662.0
Operating revenue	34,246.6	48,264.3	63,010.3	82,858.1
Non-interest expense	(16,910.9)	(23,539.9)	(31,291.5)	(40,610.5)
Preprovision oper profits	17,335.7	24,724.4	31,718.9	42,247.7
Total provision charge	(4,797.6)	(8,323.5)	(10,054.4)	(13,177.3)
Associates	0.0	0.0	0.0	0.0
Pretax profit	12,538.1	16,401.0	21,664.4	29,070.3
Tax	(3,830.3)	(4,920.3)	(6,932.6)	(9,302.5)
Minorities	0.0	0.0	0.0	0.0
Net profit	**8,707.8**	**11,480.7**	**14,731.8**	**19,767.8**
Dividends	1,722.3	2,536.3	3,397.9	4,512.6
Dividends payout (%)	19.7	22.0	21.6	22.6

Earnings growth drivers (%)	03/06	03/07E	03/08E	03/09E
Net interest margin	3.68	3.75	3.66	3.75
Provision charge/total loans	(1.37)	(1.73)	(1.56)	(1.55)
YoY Growth (%)				
Customer deposits	53.5	38.2	32.2	32.8
Loans	37.1	36.9	34.5	31.6
Net interest income	44.7	37.5	28.9	32.9
Fee income	72.7	40.0	35.0	30.0
Non-interest income	72.6	48.0	33.7	28.9
Operating revenue	52.8	40.9	30.6	31.5
Operating expenses	(55.8)	(39.2)	(32.9)	(29.8)
Preprovision Operating profit	**50.0**	**42.6**	**28.3**	**33.2**
Provision charges	(172.3)	(37.5)	(36.1)	(32.0)
Pretax profit	28.0	30.8	32.1	34.2
Net profit	30.8	31.8	28.3	34.2
EPS	21.9	31.1	26.9	24.7
DPS	22.2	45.5	25.0	30.0

Market dimensions	03/06	03/07E	03/08E	03/09E
No of branches	535.0	--	--	--
No of staff (000s)	14,878.0	--	--	--
Revenues/staff (Rs)	2,301.8	--	--	--
Net profit/staff (Rs)	585.3	--	--	--

DuPont analysis	03/06	03/07E	03/08E	03/09E
ROE (%)	**17.7**	**19.9**	**19.4**	**19.5**
x leverage	7.9	6.9	6.8	7.0
= ROA (%)	**1.39**	**1.36**	**1.32**	**1.37**

% of assets	03/06	03/07E	03/08E	03/09E
Net interest income	3.68	3.66	3.54	3.60
Fee income	1.67	1.69	1.72	1.70
Non-interest income	1.80	1.93	1.93	1.90
Operating revenue	5.48	5.59	5.48	5.50
Operating expenses	2.71	2.73	2.72	2.70
Preprovision Operating profit	2.78	2.86	2.76	2.81
Loan loss provisions	0.77	0.76	0.78	0.79
Pretax profits	2.01	1.90	1.88	1.93
Taxes	0.61	0.57	0.60	0.62

Balance sheet (Rs mn)	03/06	03/07E	03/08E	03/09E
Gross loans	354,149.7	485,149.1	652,613.8	858,866.2
NPLs	5,088.9	6,999.1	9,042.0	11,481.4
Loan loss reserves	4,797.6	7,863.5	10,054.4	13,177.3
Total interest earning assets	**703,526.6**	**947,272.4**	**1,257,016.6**	**1,625,673.7**
Other non-interest earning assets	31,537.3	44,861.6	52,600.3	76,828.2
Total assets	**735,063.9**	**992,134.0**	**1,309,616.9**	**1,702,501.9**
Customer deposits	557,968.2	770,860.1	1,019,208.8	1,353,467.3
Total interest-bearing liabilities	603,573.0	829,333.9	1,090,648.9	1,365,936.1
Total equity	**52,995.3**	**63,490.7**	**97,534.6**	**115,890.2**

CAMEL ratios	03/06	03/07E	03/08E	03/09E
C: Tier 1 capital ratio (%)	8.6	8.4	9.5	8.6
C: Equity/loans (X)	15.1	13.2	15.1	13.6
C: Equity/assets (X)	7.2	6.4	7.4	6.8
A: NPL ratio (%)	1.4	1.4	1.4	1.3
A: Loan loss reserves/NPLs (%)	94.3	112.4	111.2	114.8
E: Net interest margin (%)	3.7	3.8	3.7	3.7
E: Non int inc/oper revenues (%)	32.8	34.5	35.3	34.6
E: Cost-income ratio (%)	49.4	48.8	49.7	49.0
E: ROAA (%)	1.4	1.3	1.3	1.3
L: Loan/deposit ratio (%)	62.8	62.3	63.3	62.8

Key CAMELOT assumptions	03/06	03/07E	03/08E	03/09E
GS CAMELOT fair P/B (X)	--	--	4.0	--
GS CAMELOT fair P/E (X)	--	--	22.5	--
Risk-free rate (%)	7.5	7.5	7.5	7.5
Equity risk premium (%)	5.0	5.0	5.0	5.0
CAMELOT beta (X)	--	--	0.8	--
Risk-adjusted cost of equity (%)	--	--	11.5	--
3-yr adjusted DPS CAGR (%)	--	--	32.0	--
Sustainable ROE estimate (%)	--	--	18.0	--
Long-term dividend payout estimate (%)	--	--	73.5	--
Ex-growth bond-equivalent P/B (X)	--	--	1.5	--

Loan portfolio (%)	03/06	03/07E	03/08E	03/09E
Commercial & corporate	40.1	36.5	34.0	32.3
Mortgages/home loans	0.0	0.0	0.0	0.0
Consumer	59.9	63.5	66.0	67.7

Valuation (current price)	03/06	03/07E	03/08E	03/09E
P/E basic (X)	38.3	29.2	23.0	18.4
P/B (X)	5.9	5.0	3.5	3.0
P/PPOP (X)	18.2	12.7	9.9	7.5
Dividend yield (%)	0.6	0.8	1.0	1.3
EPS, basic (Rs)	27.92	36.44	46.22	57.56
EPS, fully-diluted (Rs)	26.11	34.22	43.44	54.18
EPS, basic Growth (%)	21.8	30.5	26.8	24.5
EPS, fully diluted Growth (%)	21.9	31.1	26.9	24.7
BVPS (Rs)	169.24	200.26	287.04	333.86
DPS (Rs)	5.50	8.00	10.00	13.00

Source: Company data, Goldman Sachs Research estimates.

SBI (SBI.BO); Sell; TP: Rs1,198; total return potential: 7%

SBI is the largest bank in India with a network of 9,050 branches; it has a market share of 17% each in deposits and loans as of September 30, 2006. RBI holds 59% stake in the bank. Because of its mammoth size, SBI acts as a banker to the government as well as to many large corporate. The bank owns 28 different subsidiaries with interests in commercial banking, life insurance, asset management and investment banking.

Investment summary: Value inherent but lacks catalysts

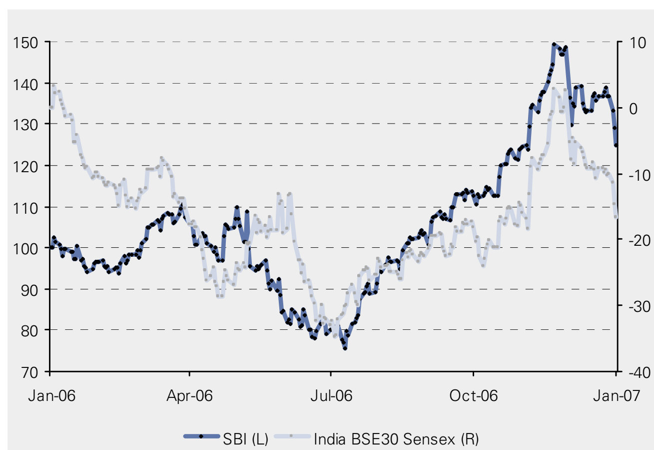
We initiate coverage on SBI with a Sell rating and 12-month target price of Rs1,198 using sum-of-the parts methodology, implying a total return potential of 7%. We value the core banking business using GS CAMELOT-based 3-stage DDM at 1.5x FY2008E P/B and the value of investments in subsidiaries at 1x FY2006 P/B.

Exhibit 88: We forecast 12% EPS CAGR through FY09E
Our forecasts are below that of consensus for FY07E and FY09E by 10%

Key data				Current
Price (Rs)				1137
Price target (Rs)				1198
Market cap (Rs mn / US$ mn)			598,349 /	13,430
Foreign ownership (%)				13.0
	3/06	3/07E	3/08E	3/09E
EPS (Rs)	83.73	76.30	102.43	110.51
EPS growth (%)	2.4	(8.9)	34.2	7.9
P/B (X)	2.2	1.9	1.7	1.5
P/E (X)	13.6	14.9	11.1	10.3
Dividend yield (%)	1.2	1.3	1.6	1.8
P/PPOP (X)	7.4	6.4	4.8	4.0
PPOP growth (%)	(31.0)	14.4	33.0	20.7
Preprovision ROA (%)	1.3	1.3	1.6	1.7
Credit Cost (%)	0.1	0.2	0.4	0.5
ROA (%)	0.92	0.74	0.88	0.85
ROE (%)	17.0	14.1	17.1	16.2

Source: Company data, Goldman Sachs Research estimates.

Exhibit 89: We expect the underperformance to continue in FY08E
Deep value is apparent, but not a catalyst as consensus believes



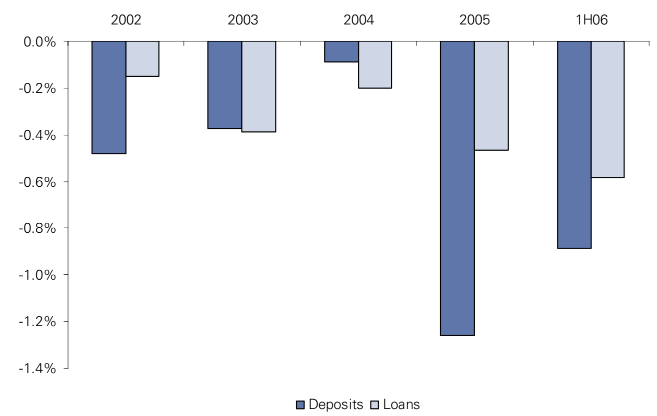
Source: DataStream.

Four reasons why we rate SBI Sell:

1. **Potential headwind to price performance from loss of market share and weaker RoAA**

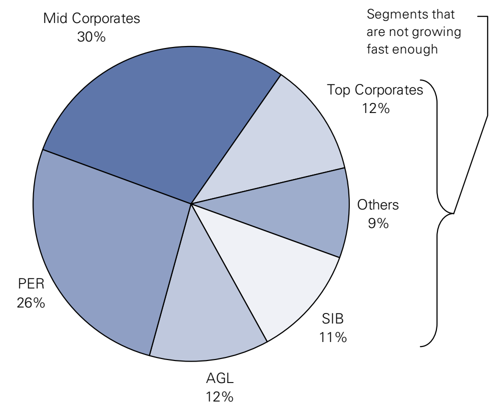
- SBI has been losing market share, both in terms of loans and deposits, for quite some time. But, the extent of loss over the past 18 months has been staggering, particularly for deposits (2.2%).
- In a bid to protect its profitability, we believe SBI has embarked on a selective growth strategy. But given the bank's spread and size, it would be difficult to pursue a selective growth strategy unless it reconciles to a significant loss of market share over time. We do not believe that this debate is done and over within SBI.

Exhibit 90: Significant erosion seen in the past 18 months
Annual loss of market share



Source: RBI, Company data.

Exhibit 91: We believe SBI's selective growth strategy will exacerbate loss of market share
Nearly a third of its exposure grew below the average growth rate in 1HFY07



Source: Company data.

- SBI's challenges are compounded by weaker profitability. We expect the core operating profits to rebound past FY2004 levels only in FY2008E. Nonrecurring revenues and costs masked this condition in FY2005 and FY2006.
- SBI's size and potential to improve efficiency may sway consensus opinion; the deep value inherent makes the investment case compelling. Although there is potential to improve performance, it remains unrealized thus far. We are less convinced by the size and potential.

2. Limited upside to growth expectations in the medium term

We believe SBI's earnings growth will remain volatile. Lack of exceptional income/cost elements and need to raise loan loss provisions from very low levels will likely cause volatility in earnings growth through FY2009E, in our view.

- We forecast 12% CAGR in net profit through FY2009E. However, on yoy basis, we expect significant volatility in net profit growth.

Exhibit 92: We expect core operating income and profits to show significant improvement, but believe this is already factored in by the market
Cost may overshoot expectations due to higher pension obligations and continued technology spends

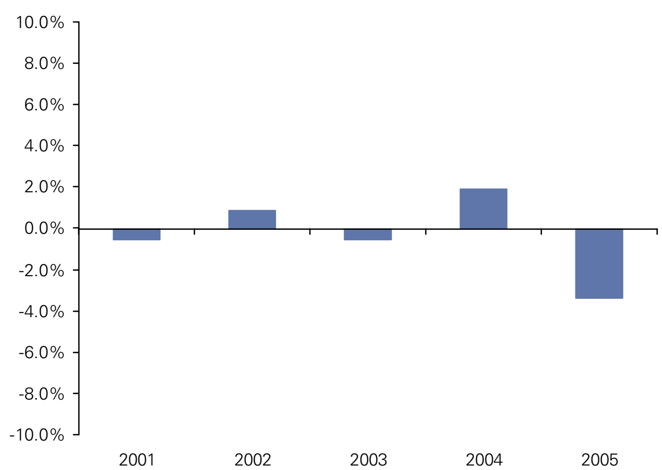
	Key earnings drivers (yoy % growth)											Memo (%)					
	Deposits	Loans	NII	Non-int income	Operating revenue	Operating expenses	Pre-prov op. profit	Loan provisions	Pretax profits	NPAT	EPS	NIM	Yoy chg in NIM	Loan prov./ loans	Yoy chg in Prov./loans	ROA	ROE
FY06	3.5	29.3	(4.7)	(11.8)	(7.1)	15.4	(31.0)	(87.7)	5.9	2.4	2.4	2.51	(0.39)	0.06	(0.60)	0.92	17.0
FY07E	15.2	24.4	14.2	7.5	12.1	10.7	14.4	386.6	(11.9)	(8.9)	(8.9)	2.52	0.00	0.25	0.19	0.74	14.1
FY08E	13.8	20.2	23.7	8.2	19.0	10.9	33.0	95.2	34.2	34.2	34.2	2.75	0.24	0.40	0.15	0.88	17.1
FY09E	13.3	20.0	17.2	9.3	15.0	11.0	20.7	50.0	7.9	7.9	7.9	2.88	0.13	0.50	0.10	0.85	16.2
CAGR (07E-09E)	14.1	21.4	18.8	8.3	15.7	10.9	23.5	137.2	10.8	11.9	11.9						

Source: Company data, Goldman Sachs Research estimates.

- Our estimates are below that of consensus for FY2007E and FY2009E by 10%. We believe consensus is overestimating revenues by either assuming higher loan growth or NIM. The latter is more likely than the former, in our view.

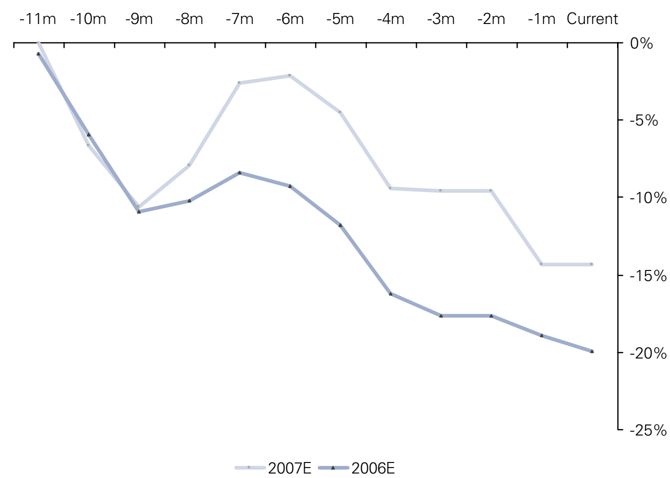
- We have seen significant downward revision to consensus estimates for operating revenues and profits over the past 12 months.
- Consensus appears to be positive about excess liquidity that SBI has—reserve holdings are significantly higher than the minimum required level. SBI would likely utilize the excess liquidity over the next 12 months. In our view, excess liquidity provides upside only in the short term.

Exhibit 93: We expect SBI to underperform consensus expectations in FY08E as well



Source: I/B/E/S.

Exhibit 94: Consensus earnings estimates have seen significant downward revision over the past 12 months



Source: I/B/E/S.

3. **Value inherent, but catalysts limited**

- We believe investors will maintain a growth bias in the Indian market. Our growth expectations for SBI are below that of consensus (12% CAGR through FY2009E versus consensus' 15% CAGR).
- Newsflow about reduction of government holding in SBI to 51% and amendment to the SBI Subsidiary Act could be potential short-term catalysts. However, we believe the focus of the market will be on earnings. In our view, there are no catalysts to drive earnings strongly.

4. **Reforms could be a trigger—We assign a low probability**

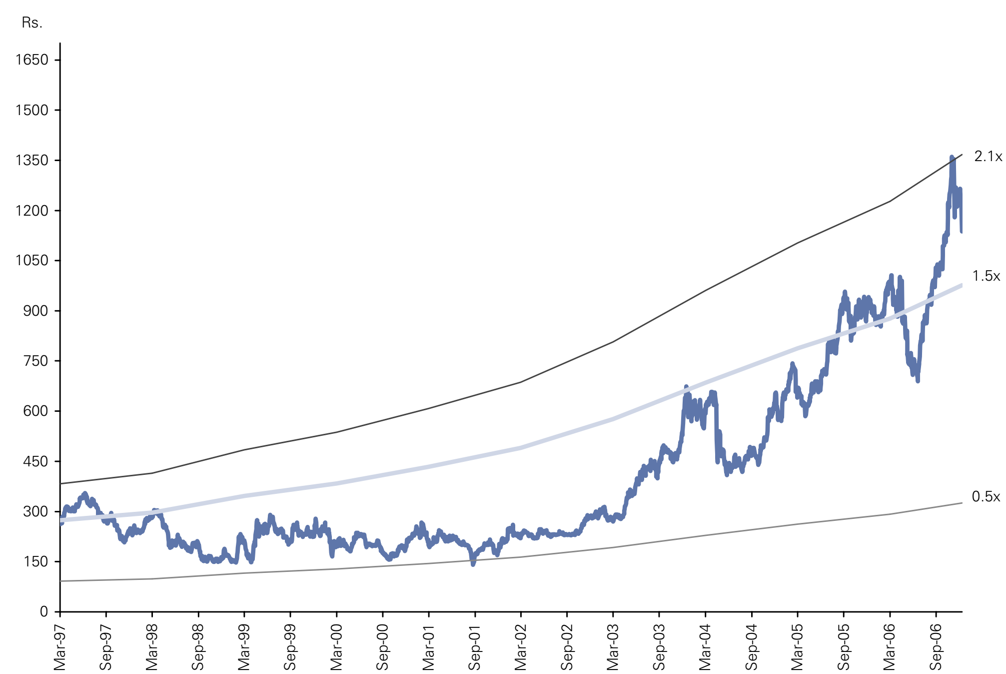
- In our view, SBI will need flexibility in reorganizing its distribution network and human resources. As long as the constraints remain, we believe it will be at a disadvantage to peers in the private sector.
- There have been a few incremental changes such as introduction of voluntary retirement scheme for employees. However, we believe these changes tend to drain the productive resources rather than eliminating redundancy.
- The RBI has chalked out a roadmap for opening up the sector to foreign banks in 2009. Should this come to fruition, it will leave state-owned banks, including SBI, significantly disadvantaged as we expect to see consolidation within the private sector.

Valuations

Our 12-month target price of Rs1,198 is derived using the sum-of-the-parts methodology. We value the core banking business at 1.5x FY2008E P/B using the GS CAMELOT-based 3-stage DDM and value of investments in subsidiaries at 1x FY2006 P/B. The key assumptions for SBI's core banking valuation are:

- Dividend CAGR of 13% and ROE of 14.1%-16.2% for FY2007E-FY2009E.
- Sustainable growth rate of 10.9% and ROE of 15.5% during the transition phase (stage 2). We have assumed the length of the transition phase to be 15 years based on our BRICs hypothesis.
- Sustainable growth rate and ROE to be 4.4% and 15%, respectively, for the terminal phase.
- We have assumed COE of 12.75% for SBI. This is based on risk-free rate of 7.5%, equity risk premium of 5% and a GS CAMELOT beta quotient of 1.05x (that we estimate on the bank's fundamentals versus peers.)

Exhibit 95: Short-term upside from newsflow, but unlikely to be sustained



Source: Company data, Goldman Sachs Research estimates.

Key catalysts for share price performance include:

- Delivering earnings in line with our expectations; and
- Sustained high GDP growth and a supportive monetary policy from a macro perspective.

Key upside risk to our recommendation, target price and forecast arises from stronger than expected growth in assets and net profit.

Exhibit 96: Sensitivity of valuations to COE and growth rate assumptions

	COE				
Growth rate	**11.8%**	**12.3%**	**12.8%**	**13.3%**	**13.8%**
10.4%	1,354	1,247	1,154	1,073	1,002
10.7%	1,385	1,274	1,178	1,094	1,021
10.9%	1,416	1,302	**1,198**	1,117	1,041
11.2%	1,449	1,331	1,229	1,140	1,061
11.4%	1,484	1,361	1,255	1,163	1,082

Source: Company data, Goldman Sachs Research estimates.

Exhibit 97: SBI summary financials (Rs mn)

Profit model (Rs mn)	03/06	03/07E	03/08E	03/09E
Net interest income	119,761.6	136,742.4	169,173.0	198,263.6
Non-interest income	55,355.7	59,480.1	64,378.4	70,347.8
Operating revenue	175,117.2	196,222.4	233,551.4	268,611.4
Non-interest expense	(112,122.3)	(124,162.8)	(137,679.9)	(152,869.0)
Preprovision oper profits	62,995.0	72,059.6	95,871.5	115,742.4
Total provision charge	(29,355.7)	(21,214.8)	(19,194.5)	(27,615.3)
Associates	0.0	0.0	0.0	0.0
Pretax profit	69,061.6	60,844.9	81,676.9	88,127.1
Tax	(24,994.8)	(20,687.3)	(27,770.2)	(29,963.2)
Minorities	0.0	0.0	0.0	0.0
Net profit	**44,066.8**	**40,157.6**	**53,906.8**	**58,163.9**
Dividends	7,368.2	7,894.5	9,473.4	10,526.0
Dividends payout (%)	16.7	19.7	17.6	18.1

Earnings growth drivers (%)	03/06	03/07E	03/08E	03/09E
Net interest margin	2.51	2.52	2.75	2.88
Provision charge/total loans	(1.12)	(0.65)	(0.49)	(0.59)
YoY Growth (%)				
Customer deposits	3.5	15.2	13.8	13.3
Loans	29.3	24.4	20.2	20.0
Net interest income	(4.7)	14.2	23.7	17.2
Fee income	12.7	15.0	10.0	10.0
Non-interest income	(11.8)	7.5	8.2	9.3
Operating revenue	(7.1)	12.1	19.0	15.0
Operating expenses	(15.4)	(10.7)	(10.9)	(11.0)
Preprovision Operating profit	**(31.0)**	**14.4**	**33.0**	**20.7**
Provision charges	87.7	(386.6)	(95.2)	(50.0)
Pretax profit	5.9	(11.9)	34.2	7.9
Net profit	2.4	(8.9)	34.2	7.9
EPS	2.4	(8.9)	34.2	7.9
DPS	12.0	7.1	20.0	11.1

Market dimensions	03/06	03/07E	03/08E	03/09E
No of branches	9,247.0	--	--	--
No of staff (000s)	198,774.0	--	--	--
Revenues/staff (Rs)	881.0	--	--	--
Net profit/staff (Rs)	221.7	--	--	--

DuPont analysis	03/06	03/07E	03/08E	03/09E
ROE (%)	**17.0**	**14.1**	**17.1**	**16.2**
x leverage	5.4	5.2	5.1	5.2
= ROA (%)	**0.92**	**0.74**	**0.88**	**0.85**

% of assets	03/06	03/07E	03/08E	03/09E
Net interest income	2.51	2.57	2.77	2.86
Fee income	0.84	0.86	0.83	0.80
Non-interest income	1.16	1.12	1.06	1.02
Operating revenue	3.67	3.69	3.83	3.88
Operating expenses	2.35	2.34	2.26	2.21
Preprovision Operating profit	1.32	1.36	1.57	1.67
Loan loss provisions	0.03	0.14	0.23	0.30
Pretax profits	1.45	1.14	1.34	1.27
Taxes	0.52	0.39	0.46	0.43

Balance sheet (Rs mn)	03/06	03/07E	03/08E	03/09E
Gross loans	2,662,719.3	3,297,267.2	3,956,720.6	4,748,064.8
NPLs	103,757.6	108,416.3	120,443.9	138,739.2
Loan loss reserves	5,529.8	14,005.2	19,194.5	27,615.3
Total interest earning assets	**4,663,325.2**	**5,412,356.3**	**6,216,596.6**	**7,040,226.2**
Other non-interest earning assets	275,370.3	280,197.4	284,058.7	318,376.6
Total assets	**4,938,695.5**	**5,692,553.7**	**6,500,655.4**	**7,358,602.8**
Customer deposits	3,800,460.6	4,377,926.8	4,982,305.4	5,644,149.1
Total interest-bearing liabilities	4,156,731.1	4,796,961.9	5,462,849.7	6,130,780.8
Total equity	**276,440.9**	**307,598.7**	**350,705.8**	**396,870.1**

CAMEL ratios	03/06	03/07E	03/08E	03/09E
C: Tier 1 capital ratio (%)	9.4	8.9	8.8	8.7
C: Equity/loans (X)	10.6	9.5	9.0	8.5
C: Equity/assets (X)	5.6	5.4	5.4	5.4
A: NPL ratio (%)	3.9	3.3	3.0	2.9
A: Loan loss reserves/NPLs (%)	5.3	12.9	15.9	19.9
E: Net interest margin (%)	2.5	2.5	2.8	2.9
E: Non int inc/oper revenues (%)	31.6	30.3	27.6	26.2
E: Cost-income ratio (%)	64.0	63.3	59.0	56.9
E: ROAA (%)	0.9	0.8	0.9	0.8
L: Loan/deposit ratio (%)	68.8	74.3	78.5	83.1

Key CAMELOT assumptions	03/06	03/07E	03/08E	03/09E
GS CAMELOT fair P/B (X)	--	--	1.5	--
GS CAMELOT fair P/E (X)	--	--	10.1	--
Risk-free rate (%)	7.5	7.5	7.5	7.5
Equity risk premium (%)	5.0	5.0	5.0	5.0
CAMELOT beta (X)	--	--	1.1	--
Risk-adjusted cost of equity (%)	--	--	12.8	--
3-yr adjusted DPS CAGR (%)	--	--	13.0	--
Sustainable ROE estimate (%)	--	--	14.8	--
Long-term dividend payout estimate (%)	--	--	70.0	--
Ex-growth bond-equivalent P/B (X)	--	--	1.1	--

Loan portfolio (%)	03/06	03/07E	03/08E	03/09E
Commercial & corporate	77.1	76.0	76.0	76.0
Mortgages/home loans	12.0	0.0	0.0	0.0
Consumer	22.9	24.0	24.0	24.0

Valuation (current price)	03/06	03/07E	03/08E	03/09E
P/E basic (X)	13.7	15.1	11.2	10.4
P/B (X)	2.2	2.0	1.7	1.5
P/PPOP (X)	9.6	8.4	6.3	5.2
Dividend yield (%)	1.2	1.3	1.6	1.7
EPS, basic (Rs)	83.73	76.30	102.43	110.51
EPS, fully-diluted (Rs)	83.73	76.30	102.43	110.51
EPS, basic Growth (%)	2.4	(8.9)	34.2	7.9
EPS, fully diluted Growth (%)	2.4	(8.9)	34.2	7.9
BVPS (Rs)	525.25	584.46	666.36	754.08
DPS (Rs)	14.00	15.00	18.00	20.00

Source: Company data, Goldman Sachs Research estimates.

Reg AC

I, Sampath S.K. Kumar, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Investment profile

The Goldman Sachs Investment Profile provides investment context for a security by comparing key attributes of that security to its peer group and market. The four key attributes depicted are: growth, returns, multiple and volatility. Growth, returns and multiple are indexed based on composites of several methodologies to determine the stocks percentile ranking within the region's coverage universe.

The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

Growth is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

Quantum

Quantum is Goldman Sachs' proprietary database providing access to detailed financial statement histories, forecasts and ratios. It can be used for in-depth analysis of a single company, or to make comparisons between companies in different sectors and markets.

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Goldman Sachs Investment Research global coverage universe

	Rating Distribution			Investment Banking Relationships		
	Buy	Hold	Sell	Buy	Hold	Sell
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Ratings, coverage groups and views and related definitions

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Definitions

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