Q3FY2008 Banking earnings review

Strong quarter driven by higher-than-expected treasury gains

Most of the banks under our coverage reported higher-than-expected earnings for Q3FY2008 driven by higher-than-expected treasury gains in most of the cases, while lower-than-expected provisions also contributed in some cases to higher earnings.

Sequential improvement in NIM helps boost top-line

The quarter saw pressure on net interest margin (NIM) easing sequentially for most of the banks under our coverage. This was primarily due to lower cost of funds on account of re-pricing of bulk deposits at lower rates. All the three private sector banks under our coverage registered a sequential margin expansion, while amongst public sector banks, the margin movement was mixed. Bank of Baroda (BoB) and Punjab National Bank (PNB) continued to witness some sequential pressure on their NIMs, while Bank of India (BOI), Union Bank of India (UBI) and State Bank of India (SBI) showed marginal improvement in their NIMs. The sequential NIM improvement coupled with strong advances growth during the quarter led to a robust growth in top-line or net interest income for most of the private sector players and select public sector players.

Credit growth moderates, deployment improves marginally

Credit growth during the quarter moderated more than expected, on the back of lower-than-expected retail advances growth. In specifics, the housing advances witnessed significant slowdown. Some of the banks have intentionally reduced exposure to retail segment with a view to rebalance their loan books. While the public sector banks' advances growth during the quarter has largely been in line with industry, the private banks grew at a much faster rate (except ICICI Bank). The slower credit growth relative to the year-ago period was largely due to moderation in retail lending on account of peak lending rates. In addition, the corporate advances also moderated, as capital expenditure plans seems to have been postponed due to bias towards softening of policy rates.

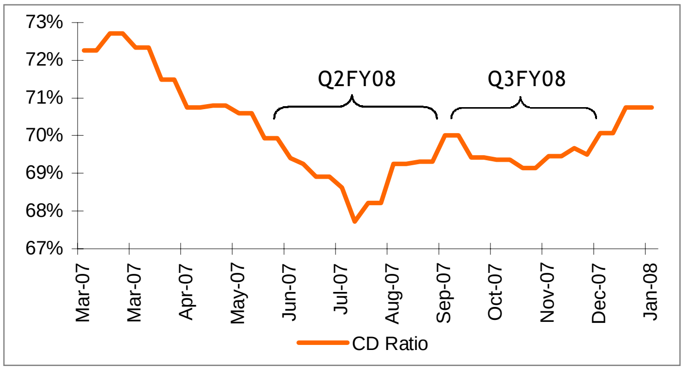
While the advances growth was moderate compared with that of last year, the deployment of deposits improved sequentially as evidenced by the credit-deposit (CD) ratio. At industry level, the average CD ratio during Q2FY2008

Performance synopsis

	NII growth yoy (%)		Credit growth yoy (%)		CD ratio (%)		Cost-income ratio (%)		GNPA (%)	
	Q3FY08	Q2FY08	Q3FY08	Q2FY08	Q3FY08	Q2FY08	Q3FY08	Q2FY08	Q3FY08	Q2FY08
Private banks										
ICICI Bank	32.0	33.9	24.7	33.3	93.8	90.7	48.5	51.1	3.0	2.8
Axis Bank	74.7	72.9	50.4	53.5	70.9	69.7	45.6	52.4	0.8	1.0
HDFC Bank	65.6	47.6	48.7	45.6	71.8	68.4	49.6	49.7	1.2	1.2
Public sector banks										
State Bank of India	23.8	6.3	27.7	26.7	77.5	74.1	47.4	48.5	2.7	2.9
Bank of India	25.7	16.1	29.9	27.6	76.3	73.9	40.5	44.5	1.9	2.1
Union Bank of India	14.9	7.2	27.4	11.6	74.8	72.4	44.0	44.0	2.1	2.4
Canara Bank	-2.9	-19.8	11.4	15.4	68.4	65.6	48.8	52.1	1.5	1.7
Punjab National Bank	4.0	0.4	15.9	23.3	66.5	67.7	48.0	51.4	4.1	4.6
Corporation Bank	6.0	17.5	19.4	16.6	70.1	71.4	44.6	45.2	1.7	1.9
Bank of Baroda	9.8	17.1	23.0	27.1	69.8	68.7	42.3	55.6	2.1	2.3
Allahabad Bank	5.3	13.3	18.3	17.7	67.3	63.6	36.3	47.5	2.1	2.4
Andhra Bank	1.8	4.2	22.7	29.2	71.3	68.6	44.3	51.9	1.4	1.4

*NII and Credit growth represents YoY growth for Q3FY08 and Q2FY08. All data based on restated numbers stood at 69.2%, which improved to 69.7% during Q3FY2008. While the improvement in CD ratio was not substantial in Q3FY2008, the recent data for January 2008 indicates an uptick in the credit off take and further improvement in the CD ratio. This bodes well for margins going forward, as banks would be able to lock in better spreads owing to higher deployment in advances.

Credit-deposit ratio trend

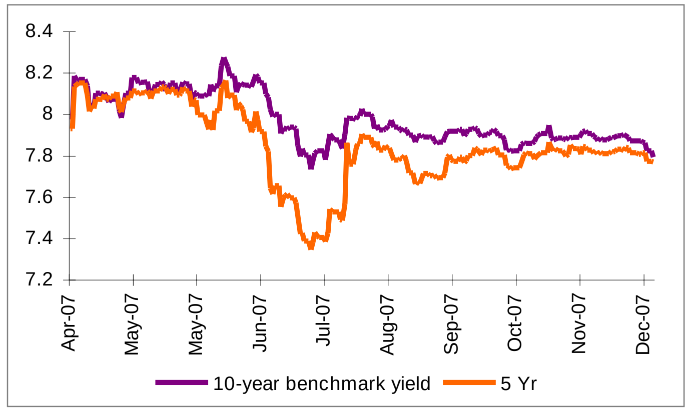


Source: RBI

Robust treasury gains

Across the banks, treasury gains witnessed robust growth year on year (yoy) on the back of favourable environment in debt and equity markets. Also, investment losses arising from mark-to-mark adjustments were minimal, in line with expectations. Some of the banks have used higher treasury gains to shore up their provisions.

Yield movements



Source: Bloomberg

Stable or improving asset quality

Asset quality remained stable or showed improvement for most of the banks under our coverage. PNB, which was saddled with highest non-performing assets (NPAs) amongst the banks under our coverage, too registered a sequential improvement in its asset quality. For some banks, the improvement stemmed from increased focus on recoveries. The only outlier on asset quality front was ICICI Bank, which witnessed an increase in gross NPA as percentage of advances mainly due to increased focus on non-collateralised loans (offering higher yields).

Progress on AS-15 provisions front

AS-15 provisions pertaining to transitional pension liability has been a hot potato for public sector banks. Amongst the

Company comments

Banks	Key highlights
Allahabad Bank	NIM continues to be under pressure. Spike in treasury gains, robust fee income growth buttress bottomline.
Andhra Bank	Positive from retirement of bulk deposits.
Axis Bank	Impressive core operating performance with significant improvement in adjusted NIM, robust credit growth. Besides, the treasury gains were strong in line with industry trend.
Bank of Baroda	Strong treasury gains support profit growth. Bank has taken up various initiatives to improve core fee income and diversify its revenue streams.
Bank of India	Strong NII growth driven by NIM improvement, robust credit growth. Also, non-interest income jumped on the back of spike in treasury gains and NPA recoveries. PAT received a further boost due to contained operating expenditure and almost flat provisions.
Canara Bank	Disappointing core performance as pressure on NIM continues coupled with moderate advances growth. However, sequential improvement in margins is a positive and may signal bottoming out of pressure.
Corporation Bank	Lacklustre core performance. Lower credit-deposit ratio yoy. Pressure on NIM continues. Lower provisions helped improve PAT performance.
HDFC	Continues to clock strong growth in core income on the back of margin improvement and strong loan disbursals. Other income flow remains strong driven by stake sale in insurance subsidiary.
HDFC Bank	Continues to register an all-round growth with robust growth in NII as well as other income. Amidst difficult environment, the bank has improved its NIM.
ICICI Bank	Robust core performance on the back of margin improvement and strong credit growth though moderate yoy. Notable improvement in CASA ratio. Strong traction in fee income. NPL continues to rise but at a slower pace.
Punjab National Bank	Advances moderated consciously as focus shifts to asset quality. Sequential improvement in asset quality, a big positive.
State Bank of India	Strong all-round growth continues. Core income growth strong helped by NIM improvement. Treasury gains, forex income spike up yoy.
Union Bank of India	Sequential improvement in margins. Robust growth in treasury and lower provisions helped boost PAT.

public sector banks under our coverage, UBI, BoB, BOI etc have already started providing for AS-15 liability, while SBI, PNB and Canara Bank are yet to decide on this matter. Meanwhile, Andhra Bank has decided to provide for AS-15 against its reserves (one-time).

Valuation synopsis

Banks	P/BV (x)			PER (x)		
	FY07	FY08E	FY09E	FY07	FY08E	FY09E
Allahabad Bank	1.4	1.2	1.0	6.7	5.1	4.3
Andhra Bank	1.4	1.3	1.1	8.3	8.0	6.3
Bank of Baroda	1.8	1.6	1.4	15.2	10.1	9.0
Bank of India	3.2	2.3	1.9	16.2	10.9	9.0
Canara Bank	1.2	1.1	1.0	8.8	8.1	7.0
Corp Bank	1.3	1.2	1.0	9.1	7.3	6.3
PNB	1.9	1.7	1.5	12.7	10.4	8.8
SBI*	2.8	2.2	1.9	26.1	23.3	19.4
UBI	2.1	1.8	1.5	11.9	8.8	7.5
HDFC Bank	7.7	4.7	4.1	43.6	36.3	27.7
ICICI Bank	4.5	2.8	2.6	34.9	31.9	22.4
Axis Bank	8.7	4.3	3.8	44.9	35.7	25.6

Top picks

Of the private banking players under our coverage, we prefer Axis Bank owing to aggressive balance sheet growth in recent quarters coupled with healthy margins and asset quality. We expect the bank to grow its assets at a compounded annual growth rate (CAGR) of 36.9% over FY2007-09E.

In the public sector banking space, we prefer BoB and SBI compared with their peers. BoB has displayed stability and consistency in growth and has expanded its balance sheet aggressively, while maintaining its margins at healthy levels. Also, the bank has chalked out new business initiatives such as foray into asset management, online broking and insurance business, and third party distribution of financial products, making it one of our top picks. Our positive stance on SBI is driven by the bank's focus on margin improvement and fee income by effectively leveraging its leading branch franchisee. In addition, the bank has been aggressively expanding its non-banking businesses (asset management, life insurance etc), thereby diversifying its revenue streams. Lastly, successful merger of its associate banks holds significant upside for the company.

Developments following Q3FY2008

RBI maintains status quo on policy rates

- The Reserve Bank of India maintained status quo on policy rates, when it presented its monetary and credit review on January 29, 2008, on account of domestic inflation concerns and turmoil in international financial markets. The decision to leave the rates unchanged was against the widely held expectation of a 25-basis-points cut.

Major PSBs cut PLR, home loan rates

- SBI and Canara Bank announced a cut in their benchmark prime-lending rate (PLR) by 25 basis points to stimulate credit demand, which has slowed during the fiscal 2008 compared with that of the previous year. The move, we believe, is the result of two factors. Firstly, the cost of deposits have witnessed some easing during Q3FY2008 as the high-cost bulk deposits were reprised or retired, which helped the bank announce a cut in PLR to stimulate credit offtake. Secondly, the finance minister noted recently a scope for rate cuts in current circumstances considering healthy margins.

- Charting a different line, other banks (Allahabad Bank, PNB etc) have reduced rates on consumer loans (largely housing loans) to stimulate advances growth. We do not expect pressure on NIM due to the rate cuts on housing and consumer loans, as most of the banks should be able to lower their cost of funds by meaningfully retiring high-cost bulk deposits.

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