Estimate Change

Equity | India | Banks-Retail
12 January 2009

Bank of America Merrill Lynch

RESEARCH

CY09: Low growth; High NPLs

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CY09 : Loan growth slowing; NPL's rising

CY09 is likely to throw up fresh challenges for Indian banks leading moderation of loan growth to an estimated 14% (from 22%) and likely spike in NPL's between FY08-10, especially in the SME segment resulting in steep rise in credit costs. We estimate fresh NPL accretion could rise to 3.5% of total loans (on 2-year lag). While lower than the 4.5-5% levels seen in the previous cycle, it may still result in a 2-3 fold jump in NPL's (with Axis Bank seeing quadrupling of NPL's by FY10E). We also expect +150bps cuts in lending and deposit rates. While that should eventually help credit growth and asset quality, it will pressurize bank margins in FY10.

Earnings growth to collapse in FY10; after +23% in FY09E

We believe FY10 earnings growth could collapse to <5% for most banks (-30% for OBC) owing to the moderation in loan growth, higher credit costs and weaker fees. This compares with 23% growth expected in FY09 (owing to bond profits). Govt. banks and Axis Bank are likely to be impacted the most in FY10. We think HDFC Bank followed by ICICI Bk should be better positioned (+20% for HDFC Bk).

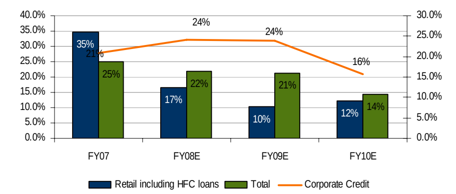
Like Govt. banks (SBI) near term; vulnerable in 2HCY09

We like govt. banks, especially SBI, near term, owing to the fall in bond yields. Fall in bond yields should drive FY09 earnings, especially for govt. banks that have higher % of G-secs in AFS. Apart from SBI, other govt. banks we like, near-term, are Indian, PNB, and BOI. We are, however, less positive on govt. banks in the 2HCY09 as they are more vulnerable to the expected spike in SME NPL's owing to their higher SME exposures and lower credit costs. This, coupled with lower trading profits and margin pressures, could result in FY10 earnings growth collapsing to <5%. In particular, Canara Bk and OBC look the most vulnerable, in our view.

Top picks: ICICI Bk, HDFC Bk; Switch from Axis Bk

Our preferred picks for CY09 are ICICI Bk and HDFC Bk as they appear better positioned to brace the CY09 challenges owing to lower SME exposure, higher NPL coverage, better capitalized and bigger beneficiaries of falling rates (high % of wholesale deposits for ICICI Bk; high % of fixed rate loans for HDFC Bk). Both banks also gain from their expanding customer base as they expand branch distribution. We recommend a Switch from Axis Bk (which is more vulnerable to a spike in SME NPL's) to HDFC Bk.

Chart 1: Sector loan growth coming down



Source: Banc of America Securities-Merrill Lynch Research Estimates

Table 1: Net Profit Growth (yoy)

Est.;%	FY09	FY10
BOB	18.6%	-3.2%
BOI	36.5%	11.6%
Canara Bank	19.6%	-23.2%
Corp. Bank	15.5%	-7.4%
OBC	13.8%	-29.5%
PNB	25.3%	11.4%
SBI	32.9%	4.8%
UBI	16.5%	-7.8%
Vijaya Bank	-9.2%	-14.6%
Indian Bank	36.8%	-7.5%
Axis Bank*	57.3%	11.5%
HDFC Bank	41.3%	26.5%
ICICI Bank	-3.4%	12.6%
Federal Bank	32.3%	-4.5%
Yes bank	26.2%	14.5%

Source: Banc of America Securities-Merrill Lynch Research Estimates
* See report dated 12/01/09

Refer to important disclosures on page 25 to 27. Analyst Certification on Page 23. Price Objective Basis/Risk on page 19.

CY09: Bracing for slower growth; higher NPLs

We believe the banking sector could see more pain in CY09 as the macro slowdown becomes more visible with export growth collapsing (potentially to nil). We are estimating FY10 GDP growth of 5.8%. In particular, we (BAS-ML) now expect export growth to grind to a standstill (nil growth for FY10E) in FY10 as Europe and the US slip into recession; industrial growth too is forecast to moderate sharply to 3% in FY10.

We think the operating environment for CY09, especially for FY10, is likely to be characterized by:

- **Moderation in loan growth to 14% in FY10 v/s +22% in FY09** due to slowdown in fresh capex plans, falling working capital requirements (as growth moderates and inflation also trends down) and absence of fertilizer subsidy financing that propped up growth in FY09. In contrast, FY09 loan growth is likely to be at +22% owing to upside from ongoing capex pipeline and funding of oil and fertilizer subsidies. As of Dec'08, loan growth is 26%.

- **Aggressive lending and deposit rate cuts** in CY09 as RBI, in an attempt to spur growth, continues to cut the CRR and SLR. Moreover, we also expect inflation to trend down progressively to 0-1% by mid-CY09. We believe banks could cut deposit and lending rates by as much as 200-250bps through CY09 (including the 75-100bps cut announced in the past few weeks post the repo rate cuts by RBI) as growth slowdown becomes visible. Mortgage rates (for home loans <Rs2mn) have already been cut by +200bps to 9.25%. Our economist also expects an additional 100bps CRR and 100bps SLR cut in CY09.

- **Fee revenue growth to also moderate** to ~14-16% yoy (v/s 20% earlier) for both private and govt. banks in sync with slowing loan growth and economic growth. However, operating costs may also rise less as banks begin to rein in marketing and other costs, especially private sector banks.

- **Bond yields may fall to <5% before rebounding to 5.5%.** We (our India fixed income team) expect the 10 year benchmark G-sec yield in the near term to touch <5%. However, we think it is likely to rebound in FY10 owing to rising fiscal deficit.

- **NPL's to rise 2-3x by FY10E due to likely spike in the SME.** We believe the collapse of the export growth cycle could impact the SME segment very adversely as many of the smaller companies are linked with India's export industry (directly or indirectly). The delinquency levels could touch 3.5% of total loans (with a 2 year lag) overall and possibly 5-6% for the SME segment (peak delinquency levels seen in the late '90s were at 4.5-5.0% of loans on a 2-yr lag when India faced its first credit crisis). This is likely to result in higher credit costs, especially for many govt. banks, Axis and YES Bank (amongst pvt. sector) that are more exposed to the SME segment (+20% of loans).

- **Retail NPL cycle may also get extended.** Retail NPL cycle may also get extended by a few quarters, though the cycle has begun about 6 quarters ago. In particular, HDFC Bk and ICICI Bk would be more impacted by this. But, the *incremental* additions will be much lower for both these banks as the cycle is already underway (and banks have been providing for the past 18 months).

We discuss each of these aspects in greater detail later in the report.

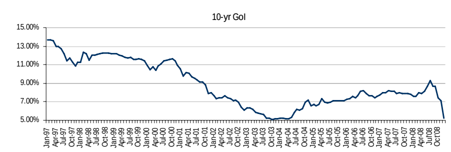
Implication for Earnings

From an earnings vantage point, we think FY10 is likely to be a weak year due to lower volumes, higher credit costs and compounded with a high base effect (FY09 earnings likely to be propped up by treasury gains).

Bond gains provide fillip to FY09 earnings; raising Erngs

Banks are likely to report stronger than estimated FY09 earnings owing to the sharp fall in bond yields of 340bps in 3Q itself, and 420bps from the peak levels of 9.5% (Jul'08). As a result banks could write back investment provisions made earlier in the year (provision writebacks could amount to 15-20% of pre-tax earnings of FY09E) and also book trading profits by selling G-secs in the AFS portfolio. Govt. banks, especially those having high % of G-secs in AFS portfolio could be bigger beneficiaries (including Canara and OBC, which we think could underperform, fundamentally).

Chart 2: Bond Yields have crashed



Source: Banc of America Securities-Merrill Lynch Research Estimates

Moreover, banks may also gain from loan growth at +20% (even after factoring moderation) and from the recent CRR and SLR cuts. Hence we are actually raising earnings estimates by 0-40% for FY09 across banks, exp govt. banks. In contrast, the expected spike in NPL's may be more visible in FY10. Amongst private banks, ICICI Bank may still see some pressure on earnings owing to CDS hits, retail NPLs etc and higher funding costs through Oct-Nov'08.

FY10 earnings growth expected to collapse

The second phase, which is likely to be much more painful, could become visible from 2HCY09 as loan growth moderates and NPL's, especially in the SME segment, spike. We also expect bond yields to rebound in FY10 (v/s. Mar'09) owing to a rising fiscal deficit and much lower trading profits.

Hence, as volumes begin to moderate, credit costs rise and trading gains fall, we think we are likely to see a sharp collapse in FY10 profit growth to -30% for banks like OBC to 11-12% growth for banks like PNB and BOI. Amongst private banks HDFC Bank (+25% yoy) followed by ICICI Bank with 13% yoy growth should be better positioned. In contrast, YES Bk and Axis Bk earnings could fall very sharply to an estimated 12-14% yoy.

Govt. banks, Axis and Yes Bank more vulnerable in FY10

Govt. banks, Axis Bank and YES Bank (amongst private) that have either higher exposure to the SME sector, or have rapidly grown their loan book in the past 2 years could be more vulnerable. Their earnings growth could be hit much more adversely. In contrast, as highlighted below, we think HDFC Bank and ICICI Bank should be better positioned in FY10.

Competitive positioning of banks

We highlight banks that may be better positioned to brace for an operating environment in CY09 characterized by falling rates, sharp moderation in growth and worsening asset quality. In particular, we have looked at the "delta change" for banks.

- **Banks with lower exposure to the SME segment look better placed** as we expect the biggest NPL rise in the SME segment and construction segment. ICICI Bank (with 4% exposure) and HDFC Bank (14%) appear less vulnerable to a sharp uptick in SME NPL's. Most govt. banks and Axis and YES Bank amongst private players have around 20% of loans to SME. *Least SME exposure: ICICI Bank; HDFC Bank;*

- **Incremental hit from retail NPL cycle extension to be less.** We also expect the retail NPLs to get extended as macro slows down and job losses risk remains high. But, the incremental additions should be much lower for pvt. banks for retail NPLs as the cycle began almost 18 months ago – and both HDFC Bk and ICICI Bk have been providing for these loans. In effect there is greater seasoning of their retail portfolio.

- **Banks having rapid loan growth in past 2 years more vulnerable**. In our estimates, during the previous cycle, delinquency levels peaked at around 4.5-5.0% of loans (with a 2 year lag) with average loan growth at 15%. As shown, Axis Bank appears the most vulnerable with loan growth at 64% CAGR over FY06-08. HDFC Bank's growth, while second highest (34% CAGR) is better positioned due to history of higher credit costs and high NPL coverage that should help lower its earnings vulnerability. ICICI Bank, in contrast, has a much lower growth at 23% CAGR through FY06-08 and only 4% in FY09. *Highest growth: YES Bank; Axis Bank, HDFC Bank; Lowest growth: ICICI Bk*

- **Banks with higher credit costs and higher NPL coverage better positioned** to absorb higher NPL's. The private banks – HDFC Bank and ICICI Bank – again have higher credit costs and HDFC Bank is also the best provisioned. Amongst govt. banks, our comfort on asset quality is the most with BOI, UBI, and Indian. Higher historical credit costs, in our view, may help minimize the extent of earnings erosion that may happen. *Highest coverage/credit costs: HDFC Bank, BOI, UBI, Indian, ICICI Bk*

- **Banks with adequate capital are best positioned** to manage a spike in NPL's, if it were to happen, as raising capital during FY10 is likely to be very difficult. To have a feel for the possible capital erosion, we have compared the forecast NPL's (assuming delinquency levels at 3.5%) as a % of net worth and the corresponding Tier I post writedown, if required. Banks like Canara Bank, OBC and Vijaya would be in dire need of fresh capital infusion. In contrast, Indian Bank, Federal Bank (amongst the smaller banks) followed by ICICI Bank and HDFC Bank appear much better placed. Most govt. banks are likely to just make it through with Tier I at 6-6.5%. *Best Capitalized: HDFC Bk, ICICI Bank, BOI, Indian Bk*

- **Banks with higher % of wholesale deposits could benefit *more.*** While having a large retail deposit base is positive for a bank's franchise, the "delta" or gains are likely to be more for banks with a higher % of wholesale deposits as those could reprice (downwards) much faster owing to the sharp fall in bond yields. Many of the smaller govt. banks and ICICI Bank fall in this category, having almost 25-50% of their deposits sourced from wholesale. *Highest % of wholesale deposits: ICICI Bank, Axis Bank, PNB, Corporation*

- **Banks with higher % of fixed rate loans, and shorter deposit tenor to benefit more** as rates fall sharply. As detailed later, for every 50bps cut in lending and deposit rates, most banks' earnings are adversely impacted by 4-5%. Further, banks with long tenor deposits (reprice with a greater lag) would see greater margin pressure relative to other banks – as 60-70% of most banks are floating. Similarly, banks with high % of fixed rate loans are better placed. *High % of fixed loans; HDFC Bank; ICICI Bk; Lower deposit tenor: ICICI Bk, OBC*

- **Banks with high % in AFS key beneficiaries of falling bond yields.** In the near term (next few months), banks that have a higher % of G-secs in the AFS category will be bigger beneficiaries of falling bond yields as they would be able to book profits from the AFS portfolio, in addition to writing back provisions made earlier in the year. *High % in AFS: SBI, Indian Bk, Canara, OBC.*

Table 2: Key Variables

	Loan growth- 3 yr CAGR (A)	Credit costs / loans -(B)	Prov. cover- (B)	Tier 1- FY10 - ('C)	Adj. Tier 1 - ('C)	GOI holding	Bulk deposits- % (D)	Fixed rate loans	AFS-%
SBI	26.2	0.8%	62%	8.6%	6.8%	59.4%	15	30	22
ICICI	18.4	1.8%	72%	10.5%	8.9%	NA	47	60	20
HDFC Bk*	45.3	1.8%	110%	10.8%	10.3%	NA	16	55	19
Axis	53.0	1.0%	97%	7.9%	7.5%	NA	45	30	13
PNB	25.0	0.6%	74%	9.2%	7.8%	57.8%	27	30	13
BOB	28.7	0.7%	67%	7.9%	6.9%	53.8%	22	30	32
BOI	29.9	0.7%	77%	7.9%	6.7%	64.5%	12	35	10
UBI	19.5	1.0%	108%	7.2%	6.9%	55.4%	16	35	29
Indian	32.6	0.8%	126%	14.1%	13.9%	80.0%	10	30	36
Corp	25.2	0.7%	80%	10.7%	9.7%	57.2%	30	30	30
Federal	26.1	1.9%	99%	17.7%	17.1%	NA	20	40	33
Canara	17.7	0.7%	61%	6.6%	5.4%	73.2%	25	30	45
OBC	28.1	0.8%	55%	7.0%	5.8%	51.1%	30	25	50
Vijaya	31.7	0.7%	72%	5.4%	4.2%	53.9%	26	25	15

Source: Banc of America Securities-Merrill Lynch Research Estimates

* HDFC Bank, including CBOP acquisition, excluding this the loan growth CAGR is at 34%

A) FY06-09E CAGR; B) BAS-MLe for FY10, Prov. cover includes general provisions; C) FY10E, Adj, Tier 1 includes adjustment for estimated Net NPLs; D) BAS-ML estimates

HDFC Bk, ICICI Bk better positioned; Axis, YES vulnerable

We believe HDFC Bank and ICICI Bank appear better positioned to manage the challenging environment in CY09 owing to lower SME exposures, being well capitalized, gaining customers (enabling them to expand their low cost liability franchise) and having low loan growth in the past 2 years (for ICICI Bk) and high CASA (for HDFC Bk).

Amongst the private banks, Axis Bank, Federal Bk and YES Bank appear more vulnerable to a sharp NPL uptick in the SME segment owing to both higher SME exposure and rapid loan growth in the past few years (especially for Axis). In addition, we think YES Bank may need to raise additional capital during FY10.

Govt. bks more vulnerable to NPLs; but benefit from falling yields

Govt. banks are likely to be bigger beneficiaries of the sharp fall in the bond yields as many of them have a higher % of G-secs in AFS and also run a much longer duration.

However, their earnings are also more vulnerable to the expected spike in SME NPL's owing to their higher exposure and lower credit costs. Moreover, in FY10 they will likely also have to contend with much slower loan growth, margin pressures and lower trading profits compounding the earnings dilemma.

While all govt. banks' earnings are more vulnerable, OBC and Canara appear the worst positioned – while PNB and BOI amongst govt. banks look likely to be least impacted. SBI, prima facie, also appears more vulnerable, but owing to its dominant franchise, size and distribution should be able to manage the NPL uptick.

Investment Thesis

We like select govt. banks, near term

We believe govt. banks provide a tactical trade over the next few months owing to fall in bond yields which should result in strong earnings for 3Q and possibly 4Q. Amongst govt. banks we still prefer banks that are better positioned to manage the SME NPL uptick. Beyond 4-5 months, we think these stocks will likely become less attractive owing to the much higher earnings vulnerability of these banks to a spike in NPL's and attendant credit costs.

SBI remains our preferred pick; followed by BOI, PNB, and Indian

SBI remains our preferred play within the govt. banks owing to its dominant franchise, less impacted by liquidity issues and ability to manage the likely uptick in NPLs. More importantly, it is a key beneficiary of falling bond yields as it is amongst the very few banks to have excess SLR (enabling it to actually book more trading profits, if desired). We think the risk return is positive at 0.8x FY10E adj. book; estimated ROE of 15-16%.

Apart from SBI, amongst govt. banks, we like **Indian, PNB, and BOI** – these are better positioned in relation to asset quality, earnings growth, capitalization levels (post BV adjustment) and risk/return tradeoff (despite trading at higher P/B multiples), in our view. Additionally, these banks have large liability franchise, which enables them to capitalize on low cost deposit base allowing lower margin hits.

Banks like Canara and OBC look most vulnerable

We reiterate our U/P (Underperform) on these stocks as, fundamentally, we expect these banks will have margins remaining under pressure owing to weak funding profile (higher wholesale deposits and low CASA); weak asset quality (low credit costs, low coverage and high vulnerability to rising SME NPLs), and higher exposure to the export segment (15-17% of book). However, these banks are leveraged to falling bond yields.

ICICI Bank and HDFC Bank - preferred through CY09

ICICI Bank- better positioned to brace CY09 challenges

ICICI Bank, while exposed to the global market vagaries, appears much better positioned to brace the challenges in CY09 in the domestic market. ICICI Bank has the lowest % exposure to SME and also the lowest loan growth in the past 2 years. This should, in our view, make it better positioned against a likely spike in SME NPL's. Further, despite having only 20% G-secs in AFS portfolio, it is a key beneficiary of falling rates owing to high % of wholesale deposits and also benefits from the expanded branch distribution (*+1400 currently; has got license for 587 new branches*) that should further help the bank to expand its customer base (and CASA deposits). Stock trades at 1.0x FY10E book without assigning any value to its subs. While these multiples appear fair (given its low ROE of <10%), it implies that the subsidiaries are essentially being bought for free! Adjusting for the subs value, we reckon the risk return is still attractive at 0.6x FY10E book given its better positioning, strong franchise and better visibility for earnings in FY10E.

HDFC Bank is best positioned bank; though expensive relative to peers

HDFC Bank is, in our view, likely to be the least impacted by the emerging scenario in CY09. It has relatively lower SME exposure (lowest is ICICI Bk) and much higher NPL coverage and credit costs resulting in much stronger earnings cushion. Further, owing to its high CASA levels and low % of bulk deposits, it is still likely to retain good pricing power despite cut in rates. It would also be a beneficiary of the fresh branch licenses that should help it further capitalize on expanding its customer base (and liability franchise). We believe the stock could continue to trade at 18-19x estiamated earnings, one year forward as earnings visibility remains high (at +20%) in FY10E, benefiting from the expanded distribution and market share gains. On a P/B it could sustain the existing multiples of around 3x book, one year forward, especially as it leverages the fresh capital.

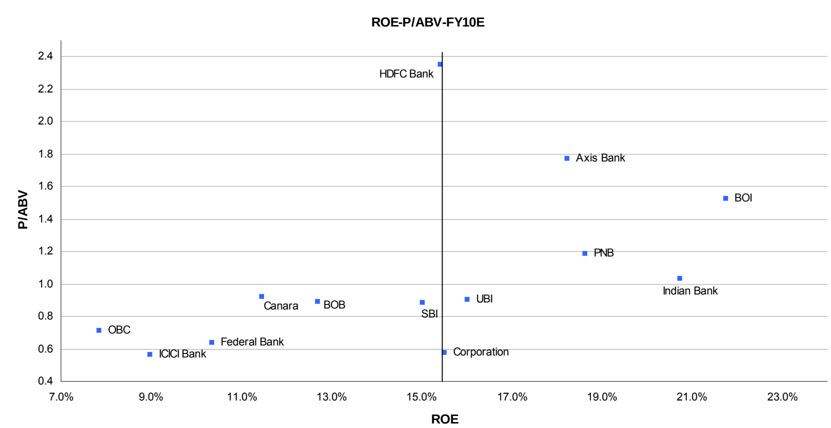
Axis Bank earnings more vulnerable; Downgraded to Underperform

Axis Bank earnings are more vulnerable owing to Axis' very rapid loan growth (+63% CAGR) in past 2 years and ~20% exposure to SME sector that, in our view, could see emergence of high NPL's and high credit costs, which could jeopardize its earnings in FY10 in the event of a spike in slippages. We downgraded Axis to U/P (see- Axis Bank Ltd., 12 January 2009) owing to a likely 2.5x-fold jump in NPL's between now and Mar'10 owing to its rapid loan growth of +63% (past 2 years), 20% SME exposure and low credit costs.

PO's based on RoE-P/BV

We continue to use the RoE-P/BV model for valuing banks based on the ROE the banks are able to generate in excess of the minimum hurdle rate (taken at 12%). Moreover, we still contend that the relationship between RoE and P/B is non-linear and tends to be more exponential, justifying higher P/B multiples for banks that generate sharply higher RoE's in excess of the hurdle rate of 12% on a normalized basis. The PO discussion for each bank is given at the end.

Chart 3: RoE-P/BV chart



Source: Banc of America Securities-Merrill Lynch Research Estimates

Private Banks – Premium to P/B justified

For private banks' valuations (and PO) we use a combination of P/B and other measures. The target P/B multiples we use imply a premium to the P/B multiples arrived as per Gordon model. We believe this is warranted owing to the private banks' ability to offer customers a much stronger value position, higher visibility of earnings and their relatively better positioning during CY09, especially as the environment becomes tougher.

We, at this juncture are not revising our POs as:

A) The hurdle rate has come down to 12% from 13.5% earlier due to reduction in risk-free rate

B) FY09 earnings growth for most banks, especially govt. banks is likely to be very strong, in our view, given the strong trading profits.

Sector outlook – details

We discuss below in greater detail the key sector aspects:

1. Fall in rates; and its implications for banks' margins
2. Impact of falling bond yields on banks' earnings
3. Loan growth to moderate sharply to <13-14% in FY10E
4. Impact on asset quality owing to the slowdown; and the collapse of export growth, in particular.
5. Capitalization levels to become critical in CY09E

1: Aggressive rate cuts could hurt bank margins in FY10

We expect banks to cut lending and deposit rates by +150bps through CY09 as growth slows down markedly. This is in addition to the 75-100bps rate cuts done in the past few weeks. In effect, we expect lending rates for housing loans to fall to <9.5%; SME loans to be closer to 12-13% and deposit rates for 1 year deposits to be at <7.5%.

Our economist also expects CRR to be cut by an additional 100bps and SLR by 100bps in CY09. These regulatory cuts, in our view, would give banks some cushion to absorb the expected lending rate cuts (as banks can begin earning interest on money that is redeployed from cash to loans). The impact of rate cuts on banks is likely to be captured through:

- **Margins to be under pressure in FY10E due to ALM mismatch.** While banks have been given leverage by the RBI (through CRR and SLR cuts), we think banks' margins could come under pressure in FY10 as banks cut lending and deposit rates more aggressively in ensuing months. This is principally owing to the ALM mismatch (deposits, having longer tenor, reprice later). Govt. banks are likely to be more vulnerable relative to private sector banks. Moreover, private players such as HDFC Bk and ICICI Bk that have fixed rate retail loans are likely to be less impacted. We show below the earnings sensitivity to change in lending and deposit rates and CRR. *Less impacted: HDFC Bank; ICICI Bank.*

Table 3: Earnings sensitivity to 50bps change in PLR, Deposit rates, CRR and SLR

FY10E; %	SBI	BOB	BOI	PNB	UBI	Canara	Corp.	Vijaya	Indian	Axis	HDFC Bk	ICICI Bk	Fed Bk
PLR chg. - 50bps	-14.9%	-20.8%	-12.4%	-13.7%	-16.3%	-24.0%	-16.0%	-39.3%	-10.6%	-12.0%	-8.4%	-11.8%	-10.0%
Deposit chg.- 50bps	7.3%	17.2%	9.1%	8.1%	12.0%	20.9%	9.2%	30.0%	7.8%	8.1%	4.7%	9.8%	3.7%
Net Impact	-7.6%	-3.6%	-3.3%	-5.6%	-4.3%	-3.1%	-6.9%	-9.3%	-2.8%	-3.8%	-3.7%	-2.0%	-6.2%
CRR chg.- 50bps	1.3%	2.0%	1.2%	1.3%	1.6%	2.3%	1.4%	3.9%	1.1%	1.3%	1.0%	1.1%	1.3%
SLR chg. - 50bps	1.0%	1.6%	0.9%	1.0%	1.2%	1.8%	1.1%	3.0%	1.0%	1.0%	0.8%	0.8%	1.0%
Net Impact	2.4%	3.6%	2.1%	2.4%	2.8%	4.1%	2.6%	6.9%	2.1%	2.3%	1.7%	1.9%	2.4%

Source: Banc of America Securities-Merrill Lynch Research Estimates

- **Banks with higher % of wholesale borrowings to benefit**. We believe the marginal ("delta") impact of falling rates could be 'more' beneficial to banks that have traditionally had greater reliance on wholesale borrowings and have a higher share of term deposits (that can get repriced). Examples of these are *ICICI Bank, Canara, OBC*, etc.

- **Bank margins to also be hurt by falling bond yields.** Banks' earnings are expected to get a fillip from bond profits arising from the fall in bond yields (discussed later) through writeback of earlier provisions and possible trading profits through sale of G-secs in AFS portfolio. However, the fall in bond yields would adversely impact bank margins as banks would now earn substantially lower returns on their G-secs holdings. This again could have a more adverse impact on govt. bank earnings as they traditionally have had much higher yields on their investment (G-sec) book that could see a sharp correction in FY10. *Less impacted : Private banks*

2: Fall in bond yields to help govt. banks' FY09 earnings

The recent contraction in bond yields should provide banks with an opportunity to deliver strong earnings through 3QFY09 and possibly the next quarter. Moreover, banks having a high % of G-secs in the AFS portfolio could also see much higher trading profits as they can book more profits (by selling G-secs in AFS segment) and also write back the provisions that these banks made in 1QFY09.

Table 4: Possible trading gains and writebacks in FY09 for banks

Rsmn	% G-sec in AFS	AFS duration-yrs	Est. w/b + Trading gains	% of FY09 Erngs
SBI	22	1.9	26074	27.8%
BOB	32	1.9	3667	22.3%
BOI	10	2.3	3243	10.6%
Canara	45	1.3	6602	45.9%
UBI	29	2.7	6220	41.7%
PNB	13	1.7	3920	13.7%
OBC	50	2.6	6634	98.4%
Indian	36	3.4	5348	41.9%
Corp.	30	1.8	2043	26.0%
Vijaya	15	3.3	3256	116.2%
Federal	33	3.5	2950	63.4%
ICICI Bk	20	1.2	4942	10.9%
HDFC Bk	19	0.8	1626	5.7%
Axis Bk	13	1.5	3320	21.8%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

Unrealized gains could be significant in FY10…

The extent of HTM unrealized gains on a bank's G-sec portfolio could be very high (estimated at 20% of their FY10 ABV) owing to the fall in bond yields (as shown in table) – and >50% for banks like Vijaya. Moreover, it is more than the expected value of net NPL's (except for Canara) assuming NPL accretion at 3.5% of loans (with 2 year lag).

However, we reckon they may be able to crystallize only 10-15% of that owing to the factors discussed above (low excess SLR and minimal % in AFS). Hence, to that extent, it limits the cushioning impact that they can get through bond gains. Also, most of the bond gains may be in FY09, while NPL's may spike in Fy10.

Table 5: Possible trading gains and slippages impact on book values

	ABVPS post 3.5% slippages	10% HTM & AFS- per shr.*	% of FY10E ABV	HTM U/R gains as a % of NW	U/R gains % of Net NPLs
OBC	234	8.0	3.4%	23%	127%
Axis Bank	310	4.3	1.4%	11%	199%
UBI	189	4.2	2.2%	23%	492%
Federal	265	3.4	1.3%	10%	303%
PNB	451	11.9	2.6%	22%	145%
Indian	142	3.6	2.5%	20%	1023%
Corp	337	9.1	2.7%	22%	222%
Canara	216	4.6	2.1%	15%	82%
BOB	328	9.3	2.8%	19%	165%
BOI	198	6.7	3.4%	20%	146%
ICICI	418	3.3	0.8%	6%	52%
HDFCB	436	4.1	0.9%	8%	200%
SBI	798	19.4	2.4%	17%	81%
Vijaya bank	44	3.3	7.7%	54%	215%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

* We have assumed that banks transfer 10% post April'09 to AFS book from HTM and realize profits by selling down securities in FY10.

...What is different this time around

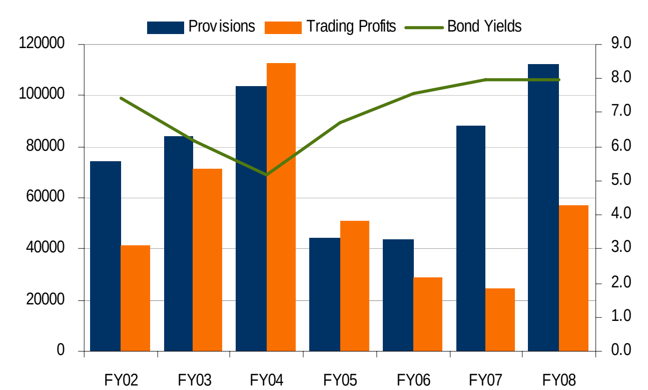
It is interesting to note that the banks had seen somewhat of a similar cycle through FY02-04. While the increase in NPL formation per se was not that high; banks used trading profits aggressively to write off high NPL's existing on their B/S. The key difference between FY02-04 and the scenario today is that banks currently have a) much lower % of G-secs in their AFS book restricting their ability to trade and sell; and b) the excess SLR is also minimal. Further, the NPL spike is yet to be fully visible; unlike in FY04 when we were coming off the peak of NPL cycle.

Table 6: Trading Profits as a % of PBT

	2002	2003	2004	2005	2006	2007	2008
Bank of Baroda	1.9	1.9	1.5	1.6	3.5	12.1	4.1
Bank of India	1.6	1.4	1.4	1.3	7.0	7.5	7.3
Canara Bank	1.6	2.0	1.4	2.6	13.8	12.5	4.4
Corporation Bank	3.4	2.4	3.4	3.0	5.0	6.7	7.9
ORBC	1.8	2.0	2.3	3.6	4.7	10.2	8.2
Punjab	1.7	1.8	1.4	3.6	4.4	-156.2	7.5
SBI	11.5	3.1	1.6	3.7	11.8	13.4	6.3
Union Bank India	2.9	1.7	1.9	2.3	-25.1	-29.5	12.9
Vijaya Bank	1.5	0.9	1.6	2.5	1.2	4.7	1.3
Axis Bank	0.7	1.2	1.3	-44.4	5.6	16.4	7.5
HDFC Bank	4.1	4.3	26.7	-14.9	-24.1	-24.0	9.4
ICICI Bank	2.6	1.6	1.5	4.6	4.1	3.4	6.2
Federal Bank	1.0	1.3	1.2	2.1	16.6	8.1	6.7
Indian Bank	0.2	0.9	1.1	1.6	7.4	17.9	5.1

Source: Banc of America Securities-Merrill Lynch Research Estimates

Chart 4: Provisions / Trading Profits / Bond Yields over the years



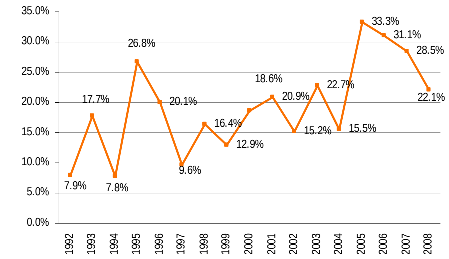
Source: Banc of America Securities-Merrill Lynch Research Estimates

Moreover, the loan growth in the past 2 year period has been much more rapid, which raises the risk. Hence, we think there is a high possibility that credit costs could rise much faster than the treasury profits – and most treasury profits could be booked in FY09; while the credit costs will hit banks' earnings in FY10.

3: Loan growth to moderate to 14%

We believe loan growth could moderate sharply to 14% in FY10 from +22% in FY09.

Chart 5: Historical loan growth for the sector



Source: Banc of America Securities-Merrill Lynch Research Estimates

Table 7: Infra and Oil cos remain strong growth drivers in FY09

Loan growth- yoy-%	Aug06	Aug07	Aug08
Agriculture	35	25	19
Industry	29	25	31
Infrastructure	29	32	36
Petroleum	34	33	92
Personal Loans	NA	21	17
Services	NA	26	35

Source: Banc of America Securities-Merrill Lynch Research Estimates

FY09 loan growth to remain at +20-22% due to capex pipeline, subsidies

Loan growth is still running at 26% as of Dec'08 owing to sustained growth in SME loans; drawdown of capex pipeline, ECB substitution as corporates rely on domestic funding due to tight funding conditions abroad and funding of fertilizer subsidy.

FY10 loan growth could fall sharply to 14%

We estimate FY10 loan growth could moderate very sharply owing to a combination of factors discussed below (see table for segment mix). However, our Economist expects ECB substitution effect through domestic banking channels due to which loan growth for FY10E is at 14%, without which it would have been <13%.

- Absence of fertilizer subsidy funding as it may remain static if not be lower.
- Fresh projects are likely to be delayed/get pushed back owing to slackening demand and higher rates. This, coupled with lower macro growth (industry growth at 3%; nil export growth) and fall in commodity prices (further lowering working capital requirements) could result in much lower growth at 15-16%.
- Working capital requirements also likely to see a sharp moderation owing to lower input costs and minimal SME growth (a key driver through FY06-09).

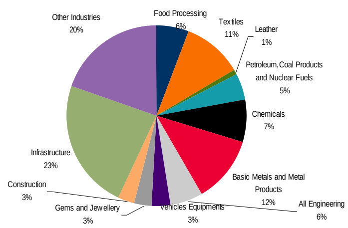
In the table below, we estimate the broad mix across key segments.

Table 8: Loan Estimates for the Sector

(Rs bn)	FY07	FY08E	FY09E	FY10E
Retail including HFC loans	6,133	7,154	7,897	8,872
Agriculture and Allied Activities*	2,705	3,300	4,294	4,723
Corporate Credit	14,597	18,136	22,490	26,046
- Infra	1,430	2,023	2,630	3,129
- Capex	3,919	4,938	6,227	7,238
- Working Capital	9,249	11,175	13,633	15,678
Total	23,435	28,590	34,681	39,641
Loan Market (US$ bn)	572	715	867	991
Loan Mix (%)				
Retail including HFC loans	26.2%	25.0%	22.8%	22.4%
Agriculture and Allied Activities*	11.5%	11.5%	12.4%	11.9%
Corporate Credit	62.3%	63.4%	64.8%	65.7%
- Infra	6.1%	7.1%	7.6%	7.9%
- Capex	16.7%	17.3%	18.0%	18.3%
- Working Capital	39.5%	39.1%	39.3%	39.6%
Total	100.0%	100.0%	100.0%	100.0%
Growth (YoY)				
Retail including HFC loans	34.6%	16.7%	10.4%	12.3%
Agriculture and Allied Activities*	27.0%	22.0%	30.1%	10.0%
Corporate Credit	20.9%	24.2%	24.0%	15.8%
- Infra	26.7%	41.5%	30.0%	19.0%
- Capex	24.0%	26.0%	26.1%	16.2%
- Working Capital	18.7%	20.8%	22.0%	15.0%
Total	24.9%	22.0%	21.3%	14.3%

Source: Banc of America Securities-Merrill Lynch Research Estimates
*Adjusted for US$10bn Fertilizer subsidy in FY09, excl. which growth would be 20%

Chart 6: Composition of Industry Credit (40% of system credit) for the system



Source: Banc of America Securities-Merrill Lynch Research Estimates

SME; Corporate loans drive growth; Govt. banks more exposed

Over the last three years, backed by strong macro fundamentals, Indian banks, especially govt. banks, have been growing their loan books at +25-30%. Axis Bank has been the most aggressive of the lot, growing its loan book almost 2.5x the average system growth. While this has been positive it could begin to hurt in ensuing quarters as growth moderates and we see a more visible NPL uptick, especially in the SME segment. The only mitigating factor could be higher trading profits (discussed earlier).

We show the broad loan mix across banks. As shown, at risk for the sector are loans to the export oriented sectors (leather, textiles, jewellery, construction, engineering, etc). Banks that are exposed to these sectors are likely to be the most impacted, in our view.

While govt. banks are most exposed to the SME/export sector; private banks are largely retail focused. For instance, ICICI Bank has <4% of its loan exposure to SME; though it has +25% to overseas – which is minimal for most Indian banks.

Retail loan growth to remain muted as India Inc sees job losses!

Retail loan growth that has seen a sharp moderation to 16-17% in FY08 is likely to see growth remaining in low double digits through FY09-10. This is despite the rapidly changing demographics that still point to a fairly rapid rise in income levels in the past 5-7 years, which is still likely to sustain, though at a more modest pace. We estimate retail loan growth at 12% in FY09 and 11% in FY10 driven primarily by personal loans and credit cards — which are also likely to see a sharp moderation in FY10. Vehicle loans too are forecast to be much muted, as shown below.

Mortgage loans remain the wildcard! We continue to estimate housing loan growth at 13-14% as we think any pickup in demand is likely to be only back ended in FY10 following rate cuts and at least 20% fall in property prices (our real estate analyst continues to expect further pressure on property prices).

Table 9: Retail Loan Demand Forecast

(Rs bn)	FY07	FY08E	FY09E	FY10E
Mortgage Mkt, incl. HFCs	3,369	3,899	4,378	4,998
YoY Growth	*22%*	*15.7%*	*12.3%*	*14.2%*
Credit card receivables	133	193	241	278
YoY Growth	*45%*	*45%*	*25%*	*15%*
Vehicle loans	1,338	1,446	1,340	1,386
YoY Growth	*63%*	*8%*	*-7%*	*3%*
Other consumer loans	1,293	1,616	1,939	2,210
YoY Growth	*46%*	*25%*	*20%*	*14%*
Total Retail Market	6,133	7,154	7,897	8,872
YoY Growth	*34.6%*	*16.7%*	*10.4%*	*12.3%*
Retail Market (US$ bn)	149.6	178.9	197.4	221.8
YoY Growth	*34.6%*	*16.7%*	*10.4%*	*12.3%*
Retail Market Mix (%)	FY07	FY08E	FY09E	FY10E
Mortgage	54.9%	54.5%	55.4%	56.3%
Vehicle	21.8%	20.2%	17.0%	15.6%
Credit Card	2.2%	2.7%	3.1%	3.1%
Other consumer loans	21.1%	22.6%	24.6%	24.9%
Total	100%	100%	100%	100%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

4: Managing NPL uptick remains key challenge

We believe the biggest challenge ahead of banks is to manage a likely uptick in the NPL cycle through FY10. While we are not seeing a sharp rise in NPL's currently, we believe NPL's are likely to rise rapidly in the SME segment, especially as growth begins to moderate. The macro slowdown is likely to be most pronounced in the export segment (as we forecast no export growth; leading to industrial growth of ~3%). Moreover, the NPL uptick already visible in the retail sector may be extended as India faces job losses, unseen in the past.

Delinquencies in SME to be higher than in previous cycle

While there is limited hard data relating to total NPL formation prior to FY03-04, we believe peak NPL formation levels during the late 90's were around 3.5-4.0% of loans (on 1 year lag) and 4.5-5% on a 2 year lag. Given the rapid growth in banks' loan books over FY06-08 of +27-30% (v/s. 20-22% in FY02-04), especially to the SME sector (+30% pa through FY06-08) we believe NPL formation levels in the SME segment could be higher than seen in the previous credit crisis.

SME NPL formation levels could be 5-6%; total taken at 3.5%

We believe NPL formation in the SME segment itself could easily be 5-6% of loans (with a 2 year lag) given the likely collapse in export growth and rapid SME loan growth in the past 2 years. However, total NPL formation levels assumed lower at 3.5% of loans (with 2 year lag) given the low corporate leverage; better risk assessment systems; foreclosure/SARFARSI Act.

NPL's could rise 2-3x for most banks between FY08-10

Assuming delinquency levels of 3.5% of loans, it could result in NPL's potentially doubling to even tripling between FY08-10. As shown in the table, for some of the banks, we think there is a risk of NPL's more than quadrupling – like in the case of Axis Bank. It would also lead to much higher credit cost,s as detailed below.

Table 10: NPL formation -% of loan (2-yr lag)

	FY06	FY07	FY08	FY09	FY10
BOB	1.5%	1.8%	1.7%	1.9%	3.5%
BOI	1.5%	1.7%	2.1%	2.4%	3.5%
Canara	2.9%	2.1%	1.8%	2.2%	3.5%
Corp. Bank	1.5%	1.4%	1.5%	1.9%	3.5%
ORBC	1.9%	1.5%	1.9%	2.3%	3.5%
Punjab	1.3%	4.7%	0.9%	2.0%	3.5%
SBI	2.8%	2.5%	3.0%	2.8%	3.5%
UBI	2.6%	1.9%	1.4%	1.8%	3.5%
Vijaya	3.5%	2.8%	2.4%	2.5%	3.5%
Indian	0.0%	0.9%	1.1%	1.8%	3.5%
Axis Bank	2.3%	1.1%	1.7%	2.0%	3.5%
HDFC BK	3.2%	3.0%	3.4%	2.8%	3.5%
ICICI Bank	3.7%	4.7%	3.7%	4.5%	3.6%
Fed. Bank	2.1%	2.1%	2.2%	1.8%	3.5%

Source: BAS-ML Research Estimates for FY09-10

Table 11: NPL formation to result in higher Gross NPLs

Rs bn	FY07	FY08	FY09	FY10	FY10/08
BOB	20.9	19.8	27.3	49.2	148%
BOI'	21.0	19.3	26.7	51.6	167%
Canara	14.9	14.2	19.8	35.3	150%
Corp	6.2	5.8	8.2	12.8	119%
ORBC	14.5	12.8	17.9	27.8	118%
Punjab	41.4	33.2	43.2	67.0	102%
SBI	100.0	128.4	180.9	269.7	110%
UBI	18.7	16.6	23.3	34.6	109%
Vijaya	5.6	5.1	7.1	12.7	149%
Indian	5.5	4.9	6.7	10.7	120%
Axis Bk	4.2	4.9	9.2	20.1	305%
HDFC Bk	6.6	9.1	18.1	32.7	260%
ICICI Bk	42.1	76.1	133.5	186.7	145%
Fed Bk	4.5	4.7	9.2	15.1	222%

Source: BAS-ML Research Estimates for FY09-10

Table 12: Higher credit costs (NPL prov. /Loans) resulting from higher NPL formation

	FY06	FY07	FY08	FY09	FY10
BOB	0.6%	0.5%	0.6%	0.6%	0.7%
BOI	0.8%	0.9%	0.8%	0.6%	0.7%
Canara	1.0%	0.7%	0.8%	0.7%	1.0%
Corp. Bank	0.8%	0.9%	0.5%	0.5%	0.7%
ORBC	-0.2%	-0.5%	-0.3%	0.6%	0.8%
Punjab	-0.1%	0.8%	0.4%	0.5%	0.6%
SBI	0.2%	0.6%	0.6%	0.7%	0.8%
UBI	0.5%	0.7%	0.9%	0.9%	1.0%
Vijaya	0.9%	0.9%	0.4%	0.5%	0.7%
Indian	0.6%	0.6%	0.8%	0.9%	0.8%
Axis Bank	0.8%	0.5%	0.8%	0.9%	1.0%
HDFC BK	1.4%	1.8%	1.9%	1.5%	1.8%
ICICI Bank	0.5%	1.1%	1.2%	1.6%	1.8%
Fed. Bank	0.8%	0.6%	1.3%	1.9%	1.9%

Source: BAS-ML Research Estimates for FY09-10

Uptick in retail NPLs may be extended as India faces job losses

The retail NPL cycle began almost 6-7 quarters ago (most visible in ICICI Bk and HDFC Bk) and was, in our view, past the mid-way mark. However, with growth moderating more sharply than envisaged and job losses becoming tangible for the Indian consumer (not seen in the past), we could see the NPl cycle being extended for at least an additional 2-3 quarters – implying the cycle may begin to trend down only by FY11 and the level of NPL formation in the retail loans (in absolute levels) may remain at current levels through FY10.

Credit costs to rise in sync with rising delinquencies

Given that we expect delinquencies to rise to 3.5% from 2% levels seen in FY08, we also expect credit costs to rise in sync. For the purpose of consistency, we have assumed that banks tend to maintain a coverage ratio of at least 50% and accordingly forecast credit costs. Post this, we expect credit costs to rise to +100bps levels from 75bps levels seen in FY08. For banks like Canara and OBC, given their very low current coverage levels, a 3.5% delinquency implies that their earnings could contract by 25-30% in FY10 with their coverage levels continuing to be sub 50% levels.

Trading profits to help enhance NPL coverage; net NPLs manageable

Banks may have some flexibility to book higher trading profits in ensuing quarters. This would give them some additional flexibility to increase credit costs to ensure net NPL's remain within manageable levels. Additionally, most banks are adequately capitalized compared to a decade earlier. For FY08, net NPAs in the system accounted for 8-9% of the total net worth of the banking system as compared to +50% in FY97.

Table 13: Specific Coverage

Coverage	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
BOB	69%	74%	81%	78%	76%	75%	83%	67%
BOI	37%	45%	51%	61%	70%	69%	79%	59%
Canara	41%	56%	53%	51%	38%	36%	22%	43%
Corp. Bk	70%	65%	68%	75%	77%	78%	68%	58%
ORBC	75%	94%	84%	88%	74%	38%	37%	37%
Punjab	69%	90%	97%	93%	82%	77%	75%	63%
SBI	54%	57%	57%	53%	47%	42%	50%	52%
UBI	48%	64%	48%	60%	68%	92%	94%	89%
Vijaya	59%	74%	80%	74%	74%	65%	58%	50%
Indian	54%	68%	67%	74%	81%	80%	89%	88%
Axis Bank	29%	59%	30%	42%	36%	50%	44%	67%
HDFC BK	84%	92%	86%	70%	69%	67%	63%	73%
ICICI Bk	47%	46%	40%	43%	52%	53%	58%	66%
Fed. Bank	42%	63%	71%	80%	86%	91%	92%	90%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

Table 14: Total NPL Coverage (including General Provisions)

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
BOB	69%	74%	81%	78%	76%	75%	83%	67%
BOI	37%	46%	55%	70%	91%	104%	108%	77%
Canara	41%	60%	59%	67%	71%	72%	51%	61%
Corp. Bk	74%	70%	75%	90%	105%	119%	100%	80%
ORBC	80%	100%	87%	92%	85%	58%	57%	55%
Punjab	69%	92%	104%	102%	93%	95%	90%	74%
SBI	54%	61%	62%	62%	63%	59%	65%	62%
UBI	48%	64%	53%	70%	86%	117%	118%	108%
Vijaya	59%	74%	83%	81%	100%	99%	90%	72%
Indian	54%	69%	70%	83%	105%	126%	141%	126%
Axis Bank	38%	70%	44%	65%	87%	123%	96%	97%
HDFC BK	130%	139%	120%	106%	121%	126%	112%	110%
ICICI Bk	87%	92%	67%	64%	68%	69%	67%	72%
Fed. Bank	42%	63%	71%	89%	100%	110%	105%	99%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

Overall, we factor in +35-40% pa rise in credit costs and believe net NPLs are still likely to be 1-1.5%, keeping the overall asset quality manageable. Thus earnings may be at risk in FY10E

Table 15: Gross NPLs as % of loans

	FY07	FY08	FY09	FY10
OBC	3.2%	2.3%	2.6%	3.6%
Axis Bank	1.1%	0.8%	1.1%	1.9%
UBI	2.9%	2.2%	2.5%	3.2%
Federal	2.9%	2.3%	3.6%	5.0%
PNB	4.1%	2.7%	2.9%	3.9%
Indian	1.8%	1.2%	1.2%	1.7%
Corp	2.1%	1.5%	1.7%	2.4%
Canara	1.5%	1.3%	1.5%	2.4%
BOB	2.5%	1.8%	2.1%	3.3%
BOI	2.4%	1.7%	1.9%	3.1%
ICICI	2.1%	3.3%	5.4%	6.8%
HDFCB	1.3%	1.3%	1.6%	2.5%
SBI	2.9%	3.0%	3.4%	4.4%
Vijaya bank	2.3%	1.6%	1.8%	2.8%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

Table 16: Net NPLs as % of loans

	FY07	FY08	FY09	FY10
OBC	0.5%	1.0%	1.1%	1.6%
Axis Bank	0.7%	0.4%	0.6%	0.6%
UBI	1.0%	0.2%	0.1%	0.4%
Federal	0.4%	0.2%	0.3%	0.5%
PNB	0.8%	0.6%	0.8%	1.5%
Indian	0.3%	0.2%	0.1%	0.2%
Corp	0.5%	0.3%	0.6%	1.0%
Canara	0.9%	0.8%	1.2%	1.4%
BOB	0.6%	0.5%	0.4%	1.1%
BOI	0.7%	0.5%	0.4%	1.3%
ICICI	1.0%	1.6%	2.3%	2.4%
HDFCB	0.4%	0.4%	0.6%	0.6%
SBI	1.6%	1.8%	1.7%	2.2%
Vijaya bank	0.6%	0.6%	0.8%	1.4%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

Table 17: GOI holding in Govt. banks-%

Bank of Baroda	53.8%
Bank of India	64.5%
Canara Bank	73.2%
Corporation Bank	57.2%
ORBC	51.1%
Punjab	57.8%
SBI	59.4%
Union Bank India	55.4%
Vijaya Bank	53.9%
Indian Bank	80.0%

Source: BAS-ML Research Estimates

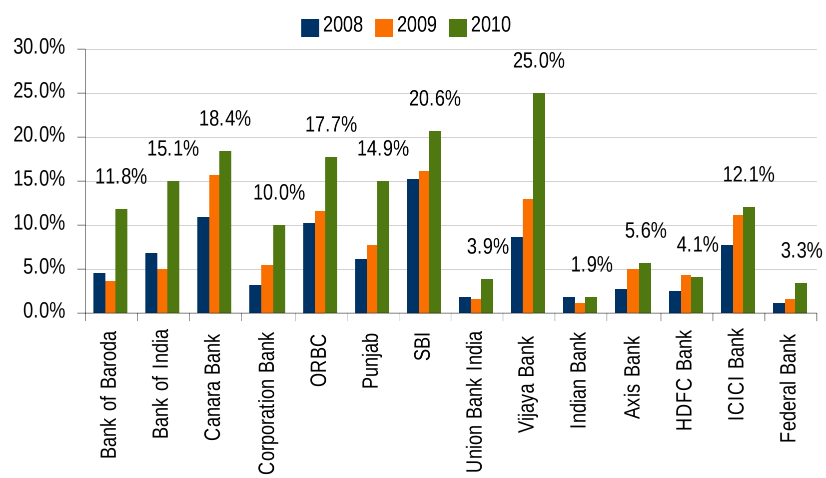
5: Capital constraints for some banks if B/S clean-up done

If banks are forced to undertake clean-up of their balance sheets when NPLs spike, many banks that are already capital constrained owing to govt. stake regulations (as govt. stake cannot fall below 51%) could come under severe pressure. These include Bank of Baroda, Union Bank of India and Vijaya, in particular. These banks are close to reaching their minimum required GOI holding limits in the event they have to turn towards raising equity capital.

Net NPL to NW to also rise rapidly, but should be manageable

However, when looking at the net NPLs to Net Worth ratio it is likely to be in much better shape now than in the previous cycle as banks have raised equity and also strong profits over the last few years along with clean balance sheets will result in the net NPL to Net Worth ratio being much better.

Chart 7: Net NPLs to Net Worth-%



Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10

Also, a point to note is that, as highlighted by Basel 2 requirements, banks loans which are to be rated by independent rating agencies are only a minuscule percentage of their loan books. We are not factoring in our Tier 1 estimates for FY10, the benefits that these banks can derive to the extent of 70-90bps from getting their loan books rated by rating agencies, which could provide cushion.

Raising FY09E earnings; Cutting FY10E

We expect bumper trading profits in 2HFY09, especially for govt. banks, resulting in +20-30% earnings growth. Hence we are raising profit estimates by 4-40% for Govt. banks in our universe and 0-30% for private banks. Further, higher than estimated loan growth and CRR cuts have also positively impacted FY09 earnings. Hence we are raising FY09 earnings estimates. Biggest beneficiaries of the downward movement in bond yields are likely to be banks like Canara, OBC, BOB, and Federal.

Table 18: Revised Net Profit Estimates

	New FY09 Erngs Est.	New FY10 Erngs Est.	FY09- yoy	% chg. From earlier est.	FY10- yoy	% chg. From earlier est.
BOB	17,022	16,476	18.6%	21.6%	-3.2%	-5.0%
BOI	27,430	30,604	36.5%	4.7%	11.6%	-5.9%
Canara Bank	18,712	14,376	19.6%	39.1%	-23.2%	-11.6%
Corp. Bank	8,486	7,857	15.5%	12.1%	-7.4%	-14.4%
OBC	9,570	6,742	13.8%	20.7%	-29.5%	-23.8%
PNB	25,671	28,597	25.3%	3.7%	11.4%	-0.7%
SBI	89,433	93,729	32.9%	15.6%	4.8%	1.5%
UBI	16,167	14,901	16.5%	27.8%	-7.8%	-6.0%
Vijaya Bank	3,280	2,803	-9.2%	-14.4%	-14.6%	-34.6%
Indian Bank	13,803	12,763	36.8%	31.2%	-7.5%	6.8%
Axis Bank*	16,847	18,781	57.3%	10.7%	11.5%	-8.3%
HDFC Bank	22,470	28,415	41.3%	0.0%	26.5%	-6.6%
ICICI Bank	40,166	45,209	-3.4%	1.6%	12.6%	-5.3%
Federal Bank	4,871	4,651	32.3%	33.2%	-4.5%	1.8%

Source: Banc of America Securities-Merrill Lynch Research Estimates for FY09-10
* Axis Bank Downgraded to Underperform. (See BAS-ML report dated 12/01/2009)

FY10 earnings growth to collapse

In FY10, we expect earnings growth to collapse for most govt. banks with earnings likely to be flat yoy for many banks; some banks could also see sharp contraction in earnings (up to +40% for banks like OBC) due to:

- Sharp moderation in loan growth (discussed above) and margin pressure resulting in weak top-line growth. Further, sharply lower bond yields could add to the margin pressure.
- Fee revenues to be also subdued. This may, however, be partly offset by better control on operating expenses as most govt. banks have completed their CBS. However, we expect wage arrears provisions to remain. For private banks, distribution expansion related opex costs are likely to remain.
- Trading gains are also likely to evaporate as we expect minimal downward movement in bond yields. However, we do expect banks to transfer 10-15% from HTM to AFS to book some gains.
- Credit costs to rise sharply as slippages accelerate due to slowdown in macro. We expect slippages to rise to 3.5% by FY10 from 2.0% levels in FY08, resulting in credit costs rising to almost +100bps on an average from >75bps in FY08.

Comparative Valuations

Table 19: Comparative Valuations

	SBI	BoB	BoI	Canara	Corp Bk	OBC	PNB	Union	Vijaya	Indian Bk	ICICI Bk	HDFC Bk	Axis Bk	YES Bk	Federal
Mkt Price	1,153	255	264	198	186	155	474	152	33	122	437	1,004	452	74	152
Recommendation	Buy	Neutral	Buy	U/P	Buy	U/P	Buy	Buy	U/P	Buy	Buy	Buy	U/P	Buy	U/P
PO	1,650	310	415	190	350	170	600	195	52	165	650	1,550	465	185	190
Rating	C-1-7	C-2-7	C-1-7	C-3-7	C-1-7	C-3-7	C-1-7	C-1-7	C-3-7	C-1-7	C-1-7	C-1-7	C-3-7	C-1-7	C-3-7
Symbol	SBINF	BKBAF	XDIIF	CNRKF	XCRRF	ORBCF	PUJBF	UBOIF	VJYAF	INDIF	ICIJF	XHDFF	UTBKF	YESBF	XFDRF
Market Cap.(US$ mn)	15,168	1,942	2,893	1,691	556	809	3,114	1,600	294	1,092	10,133	7,413	3,368	456	542
NPL Adj. BV (FY08)															
/share(Rs)	791	289	123	180	276	190	367	149	44	100	384	316	238	45	227
ROE - FY08E	16.8%	14.6%	24.4%	15.0%	18.7%	14.8%	18.0%	22.1%	16.6%	23.7%	11.7%	17.7%	17.6%	19.0%	13.6%
P/ Adj Book (FY08) (x)	1.5	0.9	2.1	1.1	0.7	0.8	1.3	1.0	0.7	1.2	1.1	3.2	1.9	1.7	0.7
Adj. for Subsidiaries	*0.7*										*0.7*				
NPL Adj. BV (FY09)															
/share(Rs)	747	326	173	202	313	232	422	179	47	124	398	334	270	53	248
ROE - FY09E	17.0%	14.5%	23.4%	16.6%	19.2%	15.5%	19.2%	20.1%	12.7%	25.9%	8.3%	16.5%	17.8%	17.5%	11.8%
P/ Adj Book (FY09) (x)	*1.5*	*0.8*	*1.5*	*1.0*	*0.6*	*0.7*	*1.1*	*0.9*	*0.7*	*1.0*	*1.1*	*3.0*	*1.7*	*1.4*	*0.6*
Adj. for Subsidiaries	*0.9*										*0.7*				
NPL Adj. BV (FY10)															
/share(Rs)	798	328	198	216	337	234	451	200	44	142	418	436	310	59	265
ROE - FY10E	15.7%	12.7%	21.7%	11.5%	15.5%	9.8%	18.4%	16.0%	10.1%	20.7%	8.8%	15.3%	17.1%	16.9%	10.3%
P/ Adj Book (FY10) (x)	*1.4*	*0.8*	*1.3*	*0.9*	*0.6*	*0.7*	*1.1*	*0.8*	*0.7*	*0.9*	*1.0*	*2.3*	*1.5*	*1.3*	*0.6*
Adj. for Subsidiaries	*0.8*										*0.6*				
EPS (Rs)															
FY07	86.3	28.1	23.0	34.7	37.4	33.0	48.8	16.7	7.6	16.9	35.0	35.7	23.4	3.4	34
FY08E	116.2	39.3	39.6	38.2	51.2	33.6	65.0	27.5	8.3	22.7	37.4	44.9	29.9	6.9	22
FY09E	141.6	46.6	52.2	45.6	59.2	38.2	81.4	32.0	7.6	31.4	36.1	50.1	47.1	8.5	28
FY10E	148.4	45.1	58.2	35.1	54.8	26.9	90.7	29.5	6.5	29.0	40.6	62.6	52.5	9.8	27
PER (x)															
FY07	13.4	9.1	11.5	5.7	5.0	4.7	9.7	9.1	4.3	7.2	12.5	28.1	19.3	22.0	4.4
FY08E	9.9	6.5	6.7	5.2	3.6	4.6	7.3	5.5	3.9	5.4	11.7	22.4	15.1	10.7	7.1
FY09E	8.1	5.5	5.1	4.3	3.1	4.1	5.8	4.7	4.3	3.9	12.1	20.0	9.6	8.7	5.3
FY10E	7.8	5.7	4.5	5.6	3.4	5.8	5.2	5.2	5.0	4.2	10.8	16.1	8.6	7.6	5.6
Net Income															
FY07	45,413	10,265	11,232	14,208	5,361	8,268	15,401	8,454	3,313	7,598	31,353	11,415	6,590	943	2,927
FY08E	67,291	14,355	20,092	15,650	7,350	8,409	20,488	13,873	3,613	10,088	41,577	15,902	10,710	2,000	3,681
FY09E	89,433	17,022	27,430	18,712	8,486	9,570	25,671	16,167	3,280	13,803	40,166	22,470	16,847	2,524	4,871
FY10E	93,729	16,476	30,604	14,376	7,857	6,742	28,597	14,901	2,803	12,763	45,209	28,415	18,781	2,891	4,651
Book value (Rs)															
FY07	595	237	121	198	263	224	331	103	44	80	269	201	120	28	175
FY08E	776	302	201	202	285	211	391	111	49	107	414	324	245	45	230
FY09E	890	339	244	240	332	263	456	138	54	131	444	349	285	53	253
FY10E	1005	372	292	265	375	284	530	162	58	149	470	454	329	62	274
Price to Book (x)															
FY07	1.9	1.1	2.2	1.0	0.7	0.7	1.4	1.5	0.7	1.5	1.6	5.0	3.8	2.6	0.9
FY08E	1.5	0.8	1.3	1.0	0.7	0.7	1.2	1.4	0.7	1.1	1.1	3.1	1.8	1.7	0.7
FY09E	1.3	0.8	1.1	0.8	0.6	0.6	1.0	1.1	0.6	0.9	1.0	2.9	1.6	1.4	0.6
FY10E	1.1	0.7	0.9	0.7	0.5	0.5	0.9	0.9	0.6	0.8	0.9	2.2	1.4	1.2	0.6
P/ PPP (x)															
FY07	7.3	3.9	5.4	2.7	2.3	3.0	4.6	3.8	1.9	3.9	6.6	12.5	9.3	12.0	2.1
FY08E	5.6	3.1	3.8	2.7	2.1	3.2	3.7	3.0	1.9	3.2	6.1	9.5	6.8	6.3	3.3
FY09E	4.1	2.7	2.9	2.4	1.9	2.3	3.0	2.4	1.9	2.2	5.4	9.2	4.5	4.7	2.1
FY10E	3.8	2.6	2.6	2.4	1.8	2.5	2.8	2.4	1.9	2.3	4.5	7.3	3.9	4.0	2.0
Gross NPLs (%)															
FY07	2.9%	2.5%	2.4%	1.5%	2.1%	3.2%	4.1%	2.9%	2.3%	1.8%	2.1%	1.3%	1.1%	0.0%	2.9%
FY08E	3.0%	1.8%	1.7%	1.3%	1.5%	2.3%	2.7%	2.2%	1.6%	1.2%	3.3%	1.3%	0.8%	0.1%	2.3%
FY09E	3.4%	2.1%	1.9%	1.5%	1.7%	2.6%	2.9%	2.5%	1.8%	1.2%	5.4%	1.6%	1.1%	1.0%	3.6%
FY10E	4.4%	3.3%	3.1%	2.4%	2.4%	3.6%	3.9%	3.2%	2.8%	1.7%	6.8%	2.5%	1.9%	1.6%	5.0%

Table 19: Comparative Valuations

	SBI	BoB	BoI	Canara	Corp Bk	OBC	PNB	Union	Vijaya	Indian Bk	ICICI Bk	HDFC Bk	Axis Bk	YES Bk	Federal
Net NPLs (%)															
FY07	1.6%	0.6%	0.7%	0.9%	0.5%	0.5%	0.8%	1.0%	0.6%	0.3%	1.0%	0.4%	0.7%	-0.6%	0.4%
FY08E	1.8%	0.5%	0.5%	0.8%	0.3%	1.0%	0.6%	0.2%	0.6%	0.2%	1.6%	0.4%	0.4%	-0.2%	0.2%
FY09E	1.7%	0.4%	0.4%	1.2%	0.6%	1.1%	0.8%	0.1%	0.8%	0.1%	2.3%	0.6%	0.6%	0.4%	0.3%
FY10E	2.2%	1.1%	1.3%	1.4%	1.0%	1.6%	1.5%	0.4%	1.4%	0.2%	2.4%	0.6%	0.6%	0.6%	0.5%
Provisions as a % of loans															
FY07	0.6%	0.5%	0.9%	0.7%	0.9%	-0.5%	0.8%	0.7%	0.9%	0.3%	0.7%	1.6%	0.5%	0.4%	0.6%
FY08E	0.6%	0.6%	0.8%	0.8%	0.5%	-0.3%	0.4%	0.9%	0.4%	0.6%	0.9%	1.7%	0.8%	0.2%	1.3%
FY09E	0.7%	0.6%	0.6%	0.7%	0.5%	0.6%	0.5%	0.9%	0.5%	0.6%	1.6%	1.4%	0.9%	0.5%	1.9%
FY10E	0.8%	0.7%	0.7%	1.0%	0.7%	0.8%	0.6%	1.0%	0.7%	0.7%	1.7%	1.7%	1.0%	0.7%	1.9%
Total Capital (%)															
FY07	12.2%	11.8%	11.6%	13.5%	15.9%	12.5%	12.3%	12.8%	11.2%	14.1%	11.7%	13.1%	11.6%	14.3%	13.4%
FY08E	13.5%	12.9%	12.9%	11.0%	13.4%	12.1%	13.0%	12.5%	10.7%	13.2%	14.0%	13.6%	13.7%	15.6%	22.5%
FY09E	12.4%	10.3%	10.7%	10.5%	13.9%	9.5%	11.8%	11.9%	10.5%	15.6%	13.7%	11.6%	11.2%	13.4%	22.1%
FY10E	12.5%	10.3%	10.9%	10.1%	14.5%	9.0%	12.1%	12.0%	10.0%	15.3%	13.2%	12.7%	11.2%	13.5%	21.1%
Tier 1 Capital (%)															
FY07	7.9%	8.7%	6.5%	7.2%	12.7%	10.1%	8.9%	7.8%	7.1%	12.3%	7.4%	8.6%	6.4%	11.9%	8.9%
FY08E	9.3%	7.6%	8.2%	6.7%	11.1%	9.3%	8.5%	7.5%	5.5%	11.7%	11.8%	10.3%	10.2%	8.5%	19.1%
FY09E	8.6%	8.1%	7.3%	6.7%	10.8%	7.4%	9.0%	7.0%	5.8%	14.3%	11.2%	9.3%	8.4%	6.8%	18.7%
FY10E	8.6%	7.9%	7.9%	6.6%	10.7%	7.0%	9.2%	7.2%	5.4%	14.1%	10.5%	10.8%	7.9%	6.0%	17.7%
PPP / share															
FY07	158	66	49	73	79	52	102	40	17	32	66	80	49	6	72
FY08E	208	83	70	72	87	49	127	51	17	39	72	106	67	12	46
FY09E	282	95	90	81	98	66	156	63	17	55	82	110	101	16	74
FY10E	306	97	101	84	105	62	172	64	17	52	97	137	115	19	75
RoA (%)															
FY07	0.9%	0.8%	0.9%	1.0%	1.2%	1.2%	1.0%	0.9%	0.9%	1.4%	1.0%	1.4%	1.1%	1.2%	1.3%
FY08E	1.0%	0.9%	1.3%	0.9%	1.2%	1.0%	1.1%	1.2%	0.7%	1.5%	1.1%	1.4%	1.2%	1.4%	1.3%
FY09E	1.1%	0.9%	1.4%	1.0%	1.2%	1.0%	1.2%	1.2%	0.5%	1.8%	1.0%	1.4%	1.4%	1.3%	1.4%
FY10E	1.1%	0.8%	1.3%	0.7%	1.0%	0.6%	1.2%	1.0%	0.4%	1.4%	1.1%	1.5%	1.2%	1.2%	1.1%
Equity/Assets (%)															
FY07	5.5%	6.0%	4.2%	6.2%	7.1%	7.6%	6.4%	5.1%	4.5%	6.8%	7.1%	7.1%	4.6%	7.1%	6.0%
FY08E	6.8%	6.1%	5.9%	5.8%	6.1%	6.4%	6.2%	5.9%	4.4%	7.4%	11.6%	8.6%	8.0%	7.8%	12.1%
FY09E	6.7%	5.9%	5.9%	6.0%	6.3%	6.0%	6.3%	5.9%	4.2%	7.2%	12.3%	8.5%	7.3%	7.1%	11.3%
FY10E	6.9%	6.0%	6.4%	6.0%	6.5%	5.8%	6.7%	6.2%	4.1%	7.2%	11.9%	10.4%	7.1%	6.9%	10.9%
CASA															
FY07	48.5%	33.2%	32.2%	31.5%	34.1%	30.3%	46.2%	34.5%	30.8%	35.4%	21.8%	57.7%	39.9%	5.8%	25.2%
FY08E	47.0%	31.2%	30.6%	31.5%	34.7%	27.9%	43.0%	34.9%	27.3%	32.3%	26.1%	54.5%	45.7%	8.5%	25.1%
FY09E	45.2%	31.1%	29.7%	31.7%	35.6%	25.7%	40.9%	34.5%	26.2%	31.5%	30.7%	50.0%	44.9%	9.8%	24.5%
FY10E	44.4%	30.5%	29.6%	30.7%	34.0%	24.9%	39.8%	33.6%	25.5%	30.3%	31.3%	49.6%	43.3%	11.6%	23.1%
NIM (%)															
FY07	3.0%	2.9%	2.8%	2.8%	2.9%	2.7%	3.5%	3.1%	3.0%	3.7%	2.3%	4.4%	2.6%	2.3%	3.2%
FY08E	2.8%	2.5%	2.7%	2.1%	2.5%	2.1%	3.2%	2.8%	1.9%	3.2%	2.4%	4.9%	3.1%	2.5%	3.1%
FY09E	2.9%	2.4%	2.8%	2.4%	2.3%	2.0%	3.2%	3.0%	1.8%	3.5%	2.5%	5.0%	3.2%	2.6%	3.7%
FY10E	2.8%	2.4%	2.7%	2.4%	2.2%	2.0%	3.1%	2.9%	1.7%	3.4%	2.4%	5.2%	3.1%	2.6%	3.6%
C-I Ratio (%)															
FY07	56%	53%	54%	47%	44%	46%	51%	42%	49%	49%	58%	48%	50%	54%	42%
FY08E	52%	54%	4%	53%	44%	50%	50%	40%	56%	50%	53%	52%	52%	54%	39%
FY09E	47%	53%	41%	50%	44%	50%	46%	41%	58%	45%	46%	55%	48%	50%	33%
FY10E	47%	54%	42%	51%	44%	52%	46%	44%	59%	45%	43%	52%	49%	50%	33%

Source: Banc of America-Merrill Lynch Research Estimates

Price objective basis & risk

Axis Bank (UTBKF / UTIBY)

We set our PO at Rs465 for Axis owing to concerns of a sharp rise in NPLs in ensuing quarters and the weak quality of earnings. We believe Axis Bank could see NPLs rising 2.5x between now and Mar10 owing to rapid loan growth (64% avg.) in the past 2 years and 20% exposure to SME. We expect a sharp uptick in SME NPLs at sector level. Going forward too, we think recurring earnings growth could fall to <12% in FY10 owing to a rise in credit costs, margin pressure and weakening loan growth. Hence, with FY10 RoE of 17%, and earnings growth of 12%, we think the stock is unlikely to trade beyond 1.5x FY10E book, assuming no premium under Gordon model (hurdle rate at 12%), underpinning our new PO of Rs465. Downside risks to our PO are a sharp rise in NPLs leading to higher credit costs or the MTM hits arising from the forex derivatives exposure or inability to grow in sync with expectations owing to moderation in the growth cycle. Upside risks to our POs are improvement in macro and NPLs rising much lower than expected providing a fillip to earnings in FY10.

Bank of Baroda (BKBAF)

We believe that on our PO of Rs310 the stock is fairly valued (0.9-1.0x FY10 book at theoretical valuations given RoE of 12-14%). We think risk/return is less attractive relative to banks like Corporation or UBI, both of which trade at much lower multiples but have better risk-return. We believe BOB, despite low valuation (0.9-1.0x FY10E book) may not see any re-rating as EPS is likely to contract 3-4% yoy in FY10 with ROE of +12% as trading profits lower. We think the very low valuations for BOB provide downside support to the stock. On a PE basis we believe the bank can continue to trade at least at 6.7-6.8x FY10E earnings, as banks' net NPLs shrink. A surge in NPLs, inability to manage margin pressure as it expands it expands its overseas loans (20pct of loans) and expanding its fees through implementation of the technology platform are risks to our PO.

Bank of India (XDIIF)

Our PO of Rs415 is based on the stock, currently trading at 1.7x FY09E book, could arguably rerate to 2.0-2.1x FY10E book given a) profit growth of +20% CAGR over FY08-10E, b) ROE of +20% in FY10E, amongst the higest in Indian govt. banks, c) manageable asset quality, and d) only large govt. bank that FIIs can invest in. As banks net NPLs shrink, the PE may gain some relevance. We believe the stock could trade up to 7.0-7.1x FY10E earnings, at par with its historical trading range. A spike in NPLs as the cycle turns, ability to sustain strong earnings/loan growth (premium valuation implies market is pricing in stronger delivery for BOI) and ensuring margins are maintained as it expands its overseas loan book are risks to our PO.

Canara Bank (CNRKF)

Our PO of Rs190 factors in that the stock, trading at 1.0x FY09E book, may not re-rate further owing to the +20% earnings contraction in FY10E, RoEs of 11-12%, higher risks on asset quality (cover at 35%), and higher exposure to SME/export segment. Moreover, operating earnings also weak (3% yoy in FY10E) due to margin pressure and lower other income. We think risk/return is less attractive relative to banks like Corporation or UBI, both of which trade at lower multiples (0.6-0.8x FY10E book) but have better risk-return (RoAs at 1% and RoEs at16%). Upside risks are the ability of the bank to build a strong liability franchise, improve margins and leverage distribution to increase fee income, which would improve earnings quality, and trigger a modest price rally. Downside risks to PO are a rise in NPLs and margin pressure, and the overall weak quality of earnings.

Corporation Bank (XCRRF)

Our PO of Rs350 is after 1) EPS cut by 11-14% for FY09E-10E driven by weaker than expected top line emanating from margin pressure, 2) MTM hits and much lower trading profits and, 3) moderation in growth on macro headwinds. While theoretically the stock could trade up to 1.2x FY10E book given RoE of 17-18% and hurdle rate of 14.5%, we factor a 20-25% discount due to weak FY09E earnings, macro headwinds especially post the rate hikes by RBI. Hence, valuing it 0.9-1.0x FY10E book, we get our PO of Rs350. The bank is also well capitalized and asset quality is comfortable. Potential upside from current stock price should warrant an outperformance. Alternatively, as banks' net NPLs shrink, the PE may gain some relevance. At our PO, the stock would trade up to 5.3-5.5x FY10E earnings, which is still at a 20-25 percent discount to its historical trading range. Risks are margin compression owing to mismatch between lending and deposit cuts. A sharp rise in NPLs is another other risk.

Federal Bank (XFDRF)

Or PO of Rs190 reflects the lower multiples the bank may get given its lower ROE (10%) and higher vulnerability to erosion in margins and NPL uptick in the current environment. Hence, we think it is unlikely to trade beyond 0.7-0.8x FY10E book, underpinning our PO of Rs190. Downside risks for the stock, along with sector issues, are: a) small size and geographical concentration, b) high dependence on the NRI business, and c) management and ownership control (there was a public boardroom dispute in 2004). Sharp rise in NPLs is key risk to PO. Upside risks are the ability of the bank to build a strong liability franchise and leverage distribution to increase fee income, which could improve earnings quality, and trigger a modest price rally.

HDFC Bank (XHDFF / HDB)

We set our PO at Rs1550 and US$120 on ADR. We believe the stock, trading at 3.0x FY09E book, could continue to trade at 3.5-3.6 levels as earnings visibility remains strong in FY10, has higher credit cost provisioning, low SME exposure and as the benefits of the merger, distribution become visible. The risk return is still likely to be positive given P/B of 3.0x and RoE of +15-16%. Moreover, post merger, earnings could sustain on a higher growth trajectory for a longer period as the bank capitalizes on the expanded distribution and also benefits from a high level of capitalization (Tier I to be +9-10% through FY10E) as we anticipate HDFC pumps in US$900mn to maintain its holding in HDFC Bank by Dec09. This could, in our view, see the stock trading back at historical levels. We believe the stock price is likely to mirror the growth in its earnings and adjusted book value. Inability to expand distribution would be an added risk to the implementation of its growth strategy. A sharp rise in NPLs and inability to maintain growth are risks to our Price Objective.

ICICI Bank (ICIJF / IBN)

Our PO is Rs650. ICICI Bank while exposed to the global market vagaries, appears much better positioned, relative to its peers to brace the challenges in CY09 in the domestic market. Beginning with having the lowest % exposure to SME and also the lowest loan growth in past 2 years, it should, in our view, be the least impacted from a possible spike in SME NPLs. Further, despite having only 20% G-secs in AFS portfolio, it is a key beneficiary of falling rates owing to high % of wholesale deposits and also benefits from the expanded branch distribution (+1400 currently, has got license for 587 new branches) that should further help the bank to expand its customer base (and CASA deposits). The stock trades at 1.2x FY10E book on adj. book without assigning any value to its subs. While these multiples appear fair (given its low ROE of <10%), it implies that the subsidiaries are being bought essentially for free.Adjusting for the subs value, we reckon the risk return is still attractive at 0.8x FY10E book given its better positioning, strong franchise and better visibility for earnings in FY10E. Hence, we believe the stock could still trade up to 1.1x book on a standalone basis. Risks are a sharp rise in NPLs or the investment hits arising from the CDO/domestic investment book or inability to grow.

Indian Bank (INDIF)

Our PO os Rs165 is on the back of the stock, trading at 1.0-1.2x FY09E book with forecast RoEs of +20% (core RoEs, ex recoveries of 18%), could arguably sustain these multiples, one-year forward as operating earnings (ex recoveries) are likely to remain strong (+18-20% in FY09-10E) and as also the risk-return tradeoff is attractive, in our view. Also, Indian could be proxy for FIIs to invest in given the present holding (13.5%). As banks' net NPLs shrink, the PE may gain some relevance. We believe the stock could trade up to 5.7-5.8x FY10E earnings. We believe our PO is reasonable given its estimated operating earnings growth of +17 -18 percent through FY09-10E, improved quality of earnings arising from lower trading profits. A sharp rise in NPLs and margin pressure are risks to our PO.

ORBC (ORBCF)

Our PO of Rs170 is after factoring in a earnings contraction by +40% yoy in FY10E driven by 1) building in higher NPL provisions (v/s. writebacks in FY08) and, 2) margin pressure due to poor B/S management (CASA at 24%) and mid-market focus along with absence of windfall trading profits. We believe OBC, trading at 0.7x FY09E book (a 25-30% discount to its peers), will likely continue to trade at similar multiples one-year out due to weak earnings outlook, its relatively higher vulnerability to earnings due to poor funding profile. As banks' net NPL's shrink, the PE may gain some relevance. We believe the stock could trade upto 8.0x FY10E earnings, which is at a 30-35 percent discount to its historic trading range. Upside risks are the ability of the bank to build a strong liability franchise, improve margins and leverage distribution to increase fee income, which could improve earnings quality, and trigger a modest price rally. Downside risks are a sharp rise in NPLs, rise in bond yields and higher wage costs. Further, inability to improve margins owing to rise in its funding costs (as it has high exposure to wholesale borrowings) is also a risk to our PO.

Punjab (PUJBF)

Our PO of Rs600 captures the +19-20% CAGR earnings growth over FY08-10E driven by topline and fees, controlled opex and higher NPL provisions- in sync with our macro call for an uptick in NPL cycle. We believe the stock could trade at 1.3x FY10E book, given earnings CAGR of +19% over FY08-10E, RoE of 18-19%, and comfortable asset quality, underpinning our PO of Rs600. On a PE basis we believe the bank can continue to trade at least at 6.5-6.6x FY10E earnings, as banks' net NPL's shrink. Sharp rise in rates/NPLs and inability to manage growth are risks. Also, inability to maintain margins in the event of rate cut mismatch remains a risk to our PO.

SBI (SBINF / SBKFF)

Our PO for SBI ofRs1650 (US$74) captures strong earnings growth of 17% CAGR over FY08-10E, driven by strong topline and fees. Although the stock trades at 1.6-1.7x FY09E book assuming no value for subs, if we were to assume that the market is assigning the full value to the subs of Rs484/shr for FY09E and Rs542/shr for FY10E, then the stock would trade at just 1.0x FY09E book with

ROE forecast to rise to about 16% by FY10E. Given its strong brand franchise, dominant deposit franchise (market leader with 18-19% share), core operating profit growth of +20% CAGR through FY08-10E, low interest risk and manageable asset quality, we believe the stock could arguably trade up to 1.4-1.5x book. While this reflects a significant rerating, we reckon the market is assigning much lower value to the subs itself making the valuation of 1.0x look more understated. Moreover, the markets are also pricing in worst case valuations which, in our research implied a value of Rs911/shr (assuming target multiple pf 0.8x book, seen at the trough of the cycle). Moreover, it is also likely to be a beneficiary of the expected downtrend in the interest rate cycle. At 1.4x FY10E book, we get a value of Rs1100/sh. and adding Rs542/shr we get our PO of Rs1650 on the stock. As banks' net NPLs shrink, the PE may gain some relevance. We believe the stock could trade up to 7.5-8.0x FY10E earnings, which is still at a 20-30% discount to its historical trading range. Risks are a sharp rise in rates and in NPLs.

Union Bank India (UBOIF)

Our PO is Rs195 as we think the stock, trading at 0.9x FY09E book (RoE of +16-17 percent) could arguably trade up to 1.1x one year forward. Given the near term earnings contraction, rising macro headwinds, and capital constraints which could also hurt growth we value the stock at 1.1x given the PPP growth at +11 percent CAGR over FY08-10E and comfortable asset quality. As banks' net NPL's shrink, the PE may gain some relevance. We believe the stock could trade up to 6.5-6.6x FY10E earnings on estimated PPP earnings growth of +11 percent CAGR through FY08-10E, improved quality of earnings arising from lower trading profits and lower risk from interest rate changes. Sharp rise in NPLs, managing moderation in growth (owing to capital constraints) and ability to raise fresh capital to avoid sacrificing growth are risks to our PO.

Vijaya Bank (VJYAF)

We rate Vijaya as underperform (PO of Rs52 based on <0.9x FY10E book) due to unfavorable risk-return as 1) capital constraints would limit growth (Tier 1 at 5.7%), 2) near-term earnings growth of only 6-8% as we build in lower treasury gains (30% of PPP in FY08 was from treasury) and also build in wage revisions (not done so far), and 3) macro headwinds arising from inflationary pressures could hurt growth prospects as with relatively modest scale and regional concentration would moderate its funding franchise. As bank net NPL shrink, the PE may gain some relevance. We believe the stock could trade upto 5-5.3x FY10E earnings. Upside risks are the ability for the bank to lower the cost of funds and improve margins and leverage distribution to increase fee income in which case the earnings quality could improve and we could see a modest increase in the price. Sharp rise in NPL, rise in bond yields and excessive loan growth resulting in deposit mobilization pressure leading to margin pressure are downside risks to our PO.

Yes Bank Ltd (YESBF)

Our PO of Rs185 captures the 1) earnings cut by 4-7% for FY09-10E to capture lower fees and margin pressure arising from the wholesale nature of deposits and, 2) moderation in growth on macro risks. While the stock is currently trading at 2.5-2.6x FY09E book, we believe that it will continue to trade at a 15-20% premium to current levels given the bank's ability to a) deliver stronger earnings growth (+36% CAGR by FY10), b) ROE rising to +20% by FY10, c) manageable asset quality and c) attractive positioning as a potential takeover target. Yes Bank's focus on sectors having immense growth potential, coupled with a strong domain expertise should help it grow its balance sheet on the asset side considerably. The bank has the ability to leverage its unique technology strategy and domain expertise, along with existing client relationships, to cross-sell a wide variety of financial products to its clients, thus maximizing revenue generated per customer. A sharp rise in NPLs and inability to manage growth are risks.

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India - Financials Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Bank of India	XDIIF	BOI IN	Rajeev Varma
	Corporation Bank	XCRRF	CRPBK IN	Veekesh Gandhi
	HDFC	HGDFF	HDFC IN	Rajeev Varma
	HDFC Bank	HDB	HDB US	Rajeev Varma
	HDFC Bank	XHDFF	HDFCB IN	Rajeev Varma
	ICICI Bank	ICIJF	ICICIBC IN	Rajeev Varma
	ICICI Bank - A	IBN	IBN US	Rajeev Varma
	IndiaBulls Finan	IBLFF	IBULL IN	Rajeev Varma
	Indian Bank	INDIF	INBK IN	Rajeev Varma

India - Financials Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
	Max India	XMXIF	MAX IN	Rajeev Varma
	Punjab	PUJBF	PNB IN	Rajeev Varma
	Reliance Capital	RLCCF	RCFT IN	Rajeev Varma
	SBI	SBINF	SBIN IN	Rajeev Varma
	SBI -G	SBKFF	SBID LI	Rajeev Varma
	Union Bank India	UBOIF	UNBK IN	Rajeev Varma
	Yes Bank Ltd	YESBF	YES IN	Veekesh Gandhi
NEUTRAL				
	Bank of Baroda	BKBAF	BOB IN	Rajeev Varma
	Infrastruct Dev	IFDFF	IDFC IN	Rajeev Varma
UNDERPERFORM				
	Axis Bank	UTBKF	AXSB IN	Rajeev Varma
	Axis Bank - GDR	UTIBY	AXB LI	Rajeev Varma
	Canara Bank	CNRKF	CBK IN	Rajeev Varma
	Federal Bank	XFDRF	FB IN	Veekesh Gandhi
	IDBI	XDBIF	IDBI IN	Veekesh Gandhi
	ORBC	ORBCF	OBC IN	Rajeev Varma
	Vijaya Bank	VJYAF	VJYBK IN	Rajeev Varma

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Investment Rating Distribution: Banks Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	76	28.57%	Buy	28	43.75%
Neutral	73	27.44%	Neutral	29	46.77%
Sell	117	43.98%	Sell	48	47.52%

Investment Rating Distribution: Financial Services Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
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Neutral	93	30.00%	Neutral	29	32.22%
Sell	83	26.77%	Sell	20	24.69%

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
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Neutral	859	25.47%	Neutral	210	28.23%
Sell	1216	36.06%	Sell	229	20.71%

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