India: Financial Services

Stay cautious due to macro headwind

Aggressive policy measures likely to boost short-term prospects

The Reserve Bank of India cut (RBI) its policy rate (reverse repo and repo rate) by 100 bp on 2 January 2009 and cash reserve ratio (CRR) by 50 bp. The cut was much expected by the market. Reverse repo rate has been cut to the lowest level signaling the policy makers concern about the economy's growth prospects. We believe the reverse repo rate is unlikely to be cut significantly from the current levels, given the aggressive policy intervention so far. We believe banks will more likely cut deposit and lending rates further on.

Maintain a cautious stance due to headwind for macro

We believe the monetary policy will likely lead to better near-term prospects for banks. Market consensus expectation of earnings would be propped up by potential revaluation gains and earn trading income from bonds. However, we expect the headwinds for the medium-term to stay. We expect aggregate SCB loan growth to ease significantly from 26% in 2008E to 14% in 2009E on the back of rapid deterioration in economic activity. Slower demand for loans and lending rate cuts would likely lead to slower operating revenue growth. Deterioration in real economy is likely to lead to higher NPA formation. We expect gross NPA for our coverage group to rise from 2.5% in 2008E to 4.5%-5% by 2010E. Rapid deterioration in economic activity could present downside risk to our expectation.

Maintain Buy on HDFC, Axis; IDFC as Conviction Sell

We retain our Buy rating on HDFC (HDFC.BO) and Axis (AXBK.BO) due to continued favorable growth prospects and strong profitability, which we do not think have been priced into market expectations. We retain IDFC (IDFC.BO) on our Conviction Sell list, mainly due to capital constraint and capital market related revenues affecting its growth prospect. We retain our Sell rating on KMB (KTKM.BO), PNB (PNBK.BO) and BOB (BOB.BO) due to our expectation of significant downside to earnings growth expectation in 2009E and 2010E. Key upside risks: sanguine outlook for corporate sector performance resulting in lower-than-expected deterioration in credit quality for banks; and continued strong growth rate for the economy, notwithstanding head-winds. Key downside risk arises from deterioration in growth outlook for the economy further from the 5.8% levels that our Econ team forecasts for2009E.

RATINGS SUMMARY

	Reuters Ticker	Rating	Price (Rs) 2-Jan-09	12-month TP (Rs)	Total return potential (%)
Axis	AXBK.BO	Buy	543	680	26.4
HDFC	HDFC.BO	Buy	1,545	1,890	24.3
HDFCB	HDBK.BO	Neutral	1,016	1,000	(0.6)
ICICIB	ICBK.BO	Neutral	471	450	(2.3)
SBI	SBI.BO	Neutral	1,330	1,150	(12.3)
IOB	IOBK.BO	Neutral	75	70	(1.8)
IBFSL	IBUL.BO	Neutral	138	110	(16.8)
IDFC	IDFC.BO	Sell*	72	50	(28.4)
KMB	KTKM.BO	Sell	392	250	(35.9)
PNB	PNBK.BO	Sell	532	340	(33.9)
BOB	BOB.BO	Sell	287	230	(17.4)

* Denotes stock is on our Conviction List. For important disclosures, please go to http://www.gs.com/research/hedge.html.
For methodology and risks associated with our price targets, please see our previously published research.
Source: Datastream, RBI, CEIC, Goldman Sachs Research estimates.

VALUATION SUMMARY

	Price (Rs)	P/E (x)		P/B (x)	
	2-Jan-09	2008E	2009E	2008E	2009E
Axis	543	13.2	10.3	1.95	1.70
HDFC	1,545	17.0	14.5	3.18	2.83
HDFCB	1,016	22.3	16.1	2.79	2.11
ICICIB	471	15.1	14.0	1.08	1.03
SBI	1,330	8.7	10.7	1.21	1.10
IOB	75	3.8	5.3	0.72	0.65
IBFSL	138	8.1	8.7	1.01	0.95
IDFC	72	14.7	14.0	1.53	1.42
KMB	392	18.0	20.1	2.08	1.92
PNB	532	7.6	11.8	1.34	1.25
BOB	287	7.1	12.1	0.86	0.81

Source: Datastream, Goldman Sachs Research estimates.

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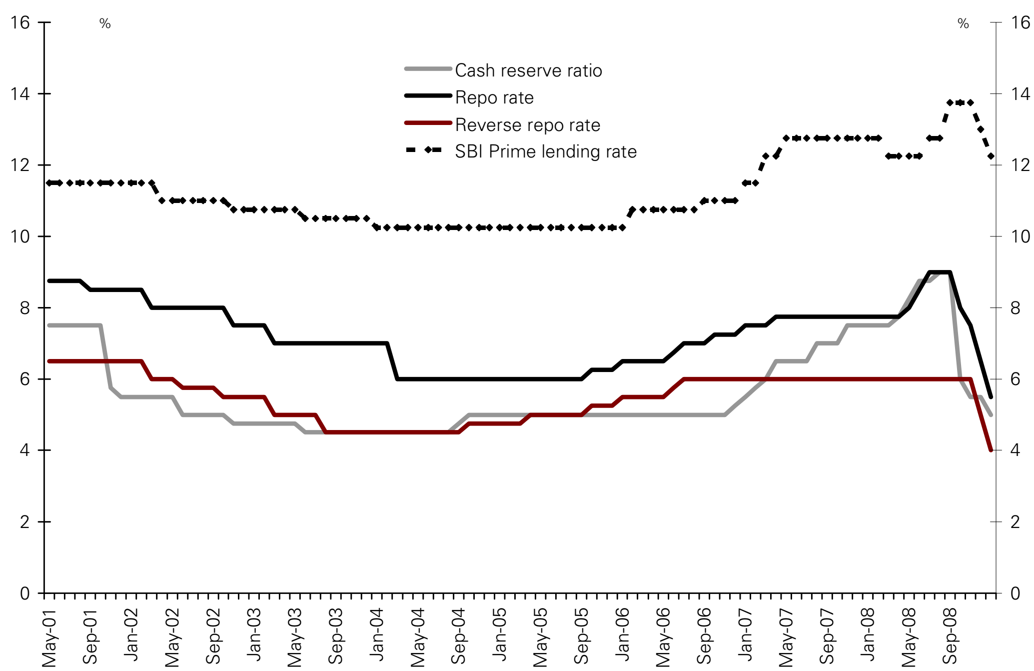
Stay cautious due to macro headwind

Aggressive policy easing measures likely to boost short-term prospects

The RBI cut the benchmark interest rates, reverse repo and repo, by 100 bp and CRR by 50 bp on 2 January 2009. Since October 2008, the RBI has cut reverse repo rate by 200 bp, repo rate by 350 bp and CRR by 400 bp. With these measures, RBI has lowered one of its key benchmark rate, reverse repo, to a historically low level.

We believe the policy actions thus far undertaken by the RBI were largely anticipated given the adverse developments seen in global economic conditions and rapid decline in the domestic economic activity. We view the measures undertaken so far as fairly aggressive and leaves little room for significant easing measures from the current levels.

Exhibit 1: RBI has undertaken an aggressive approach in its monetary policy stance. We believe this is predicated on a tougher outlook for the domestic macro environment
Key policy rate, reserve ratio and PLR of Indian banks



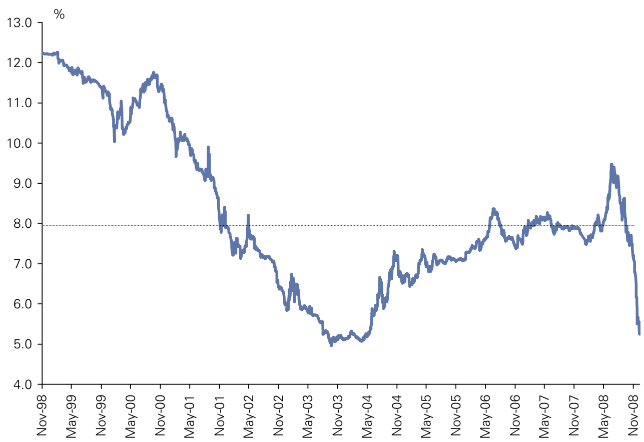
Source: CEIC.

Further to the central bank's measures, the Indian government undertook measures to boost the liquidity of the domestic credit market. This included a) raising the ceiling for foreign institutional investors in domestic corporate bond market from US$6 bn to US$15 bn, b) raising the credit growth target for state owned banks, c) allowing NBFCs, dealing exclusively in infrastructure financing, to access external commercial borrowing (ECB) market and d) recapitalization of state owned banks by Rs200 bn between 2009 and 2010 in order to facilitate these banks meet capital adequacy requirements.

We believe market expectations would likely perceive the measures undertaken by the Indian government to boost the domestic credit market conditions as liquidity enhancing. This could leave further room for bond yields to decline from current levels, although prospects of a steeper decline from the current levels may be limited given the pace and extent of decline.

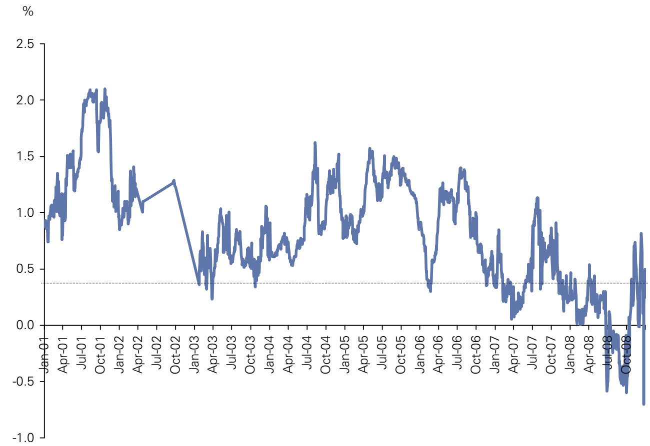
Bond yields have declined by over 350 bp since September 2008. The decline in bond yields will likely allow the banks to recoup the MTM losses incurred in 1H2008. Further, market expectations are likely to factor higher trading income arising from the banks' bond portfolio. Both these factors are likely to boost market expectations of earnings growth for banks. Given state owned banks' weaker profitability and their higher duration of the bond book, market expectations would likely view the potential upside from lower interest rates as more beneficial for them (refer to exhibit 4 & 5). In aggregate, state owned banks have outperformed their peers in private banks over the last 3 months.

Exhibit 2: We believe the market anticipated the policy measures; bond yields have shown sharp decline since October 2008
10-year Government bond yield



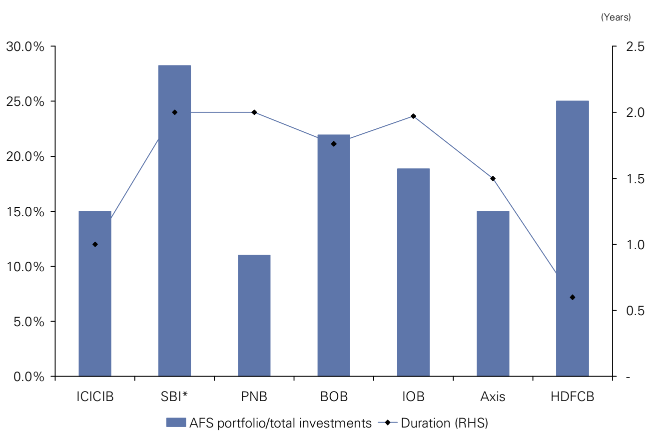
Source: Bloomberg.

Exhibit 3: The spread between short-duration and long-duration bonds have compressed; potentially, short-duration bonds could see further decline in yields
Spread of 10-year government bond over 1-year



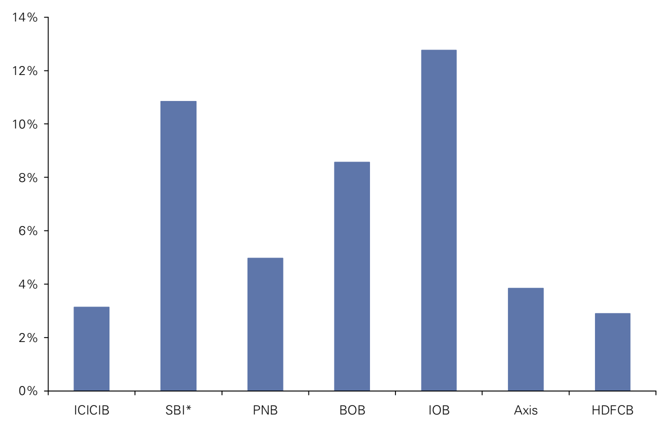
Source: Bloomberg.

Exhibit 4: State owned banks' net income have higher leverage to changes in bond portfolio value...
Available for sale (AFS) portfolio and its duration, bank-wise



Source: Company data, Goldman Sachs Research estimates.

Exhibit 5: ...we believe this is already reflected in market expectations
MTM gains from AFS/2008E net income for 1% fall in interest rate

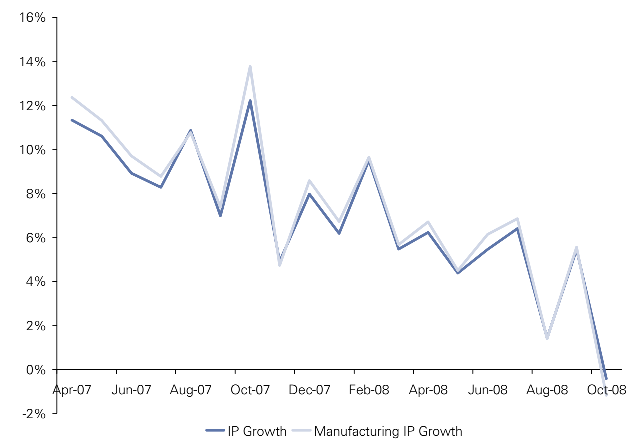


Source: Company data, Goldman Sachs Research estimates.

Our concern of a weaker operating environment in 2009 stays

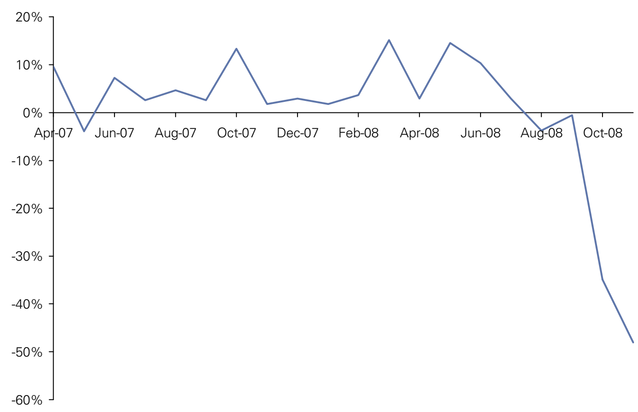
We believe the monetary and fiscal measures undertaken since October 2008 point to policy makers concern about the growth prospect for the economy. All concurrent indicators of economic activity are showing rapid decline intensifying concerns on cyclical headwinds that the economy is currently faced with.

Exhibit 6: Industrial activity has seen a sharp slowdown since August 2008
IIP and manufacturing sector growth



Source: Bloomberg.

Exhibit 7: Commercial vehicle sales, a key concurrent indicator of activity, is seeing contraction in its volume
Commercial vehicle sales growth



Source: Bloomberg.

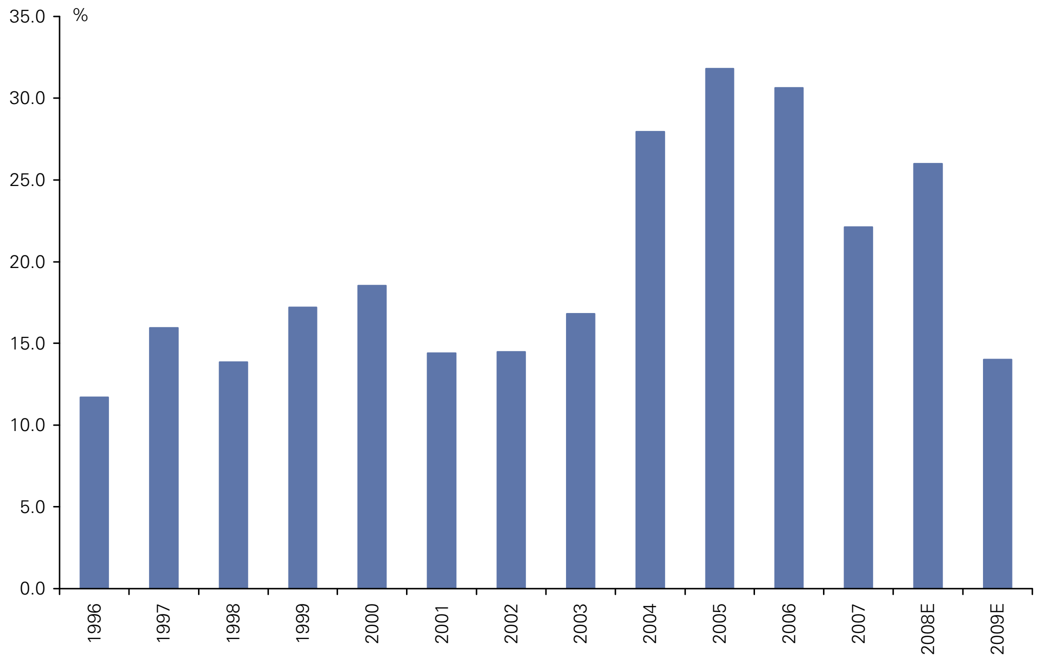
Banks' growth outlook is correlated with overall economic activity. We believe the intensification of cyclical headwinds will be felt by the banks through three channels of earnings drivers:

- Slower loan growth—loan growth is strongly correlated with GDP growth. Slowing economic activity should imply lower demand for new loans. In addition to the above, we expect demand for loans to weaken further as corporates work out higher working capital levels seen during the early phase of slowdown in demand.
- Lower NIM—banks are currently witnessing strong pricing power. However, slower loan growth would likely weaken their pricing power. An accommodative monetary policy is likely to lead to lower NIM as assets are likely to re-price quicker than their liabilities.

  We believe slower loan growth and lower NIM are likely to weaken growth prospects of banks' operating revenue. We believe there is less flexibility to cut cost due to new investments needed for network expansion as well as rigid cost structure of state owned banks (mainly employee cost).
- Rising credit costs—corporate and SME borrowers are likely to witness slower growth and decline in operating margins affecting their cash flows; this is likely to lead to higher NPA and credit costs for banks. We flagged our concerns when we downgraded our sector stance to cautious (refer to the report "Downgrade to a cautious stance due to rising NPA headwinds" dated September 9, 2008). Given the sharp decline in activity levels, NPA could surprise our expectations on the downside.

Higher revenue from bond trading would likely be key mitigation to our expectations of significant decline in earnings growth particularly for state owned banks in 2009. Our sensitivity analysis suggests that banks could boost their book value by 12%-32% if they chose to transfer securities from HTM (held to maturity category) to AFS. However, such actions would likely a) pressure NIM as bonds would be reinvested in lower yielding securities, and b) increase the risk profile of investments thus exposing them to MTM risks in the future. In our view, higher bond trading revenue could boost earnings and BVPS of banks in the medium-term; however, this would unlikely add value to shareholders due to lower NIM and higher risk profile of assets.

Exhibit 8: We expect loan growth to slow in 2009E owing to slowing economy and high base in 2008E
Loan growth 1996-2009E



*Excluding the impact of conversion of a non-banking entity into a banking entity.

Source: Bloomberg, Goldman Sachs Research estimates.

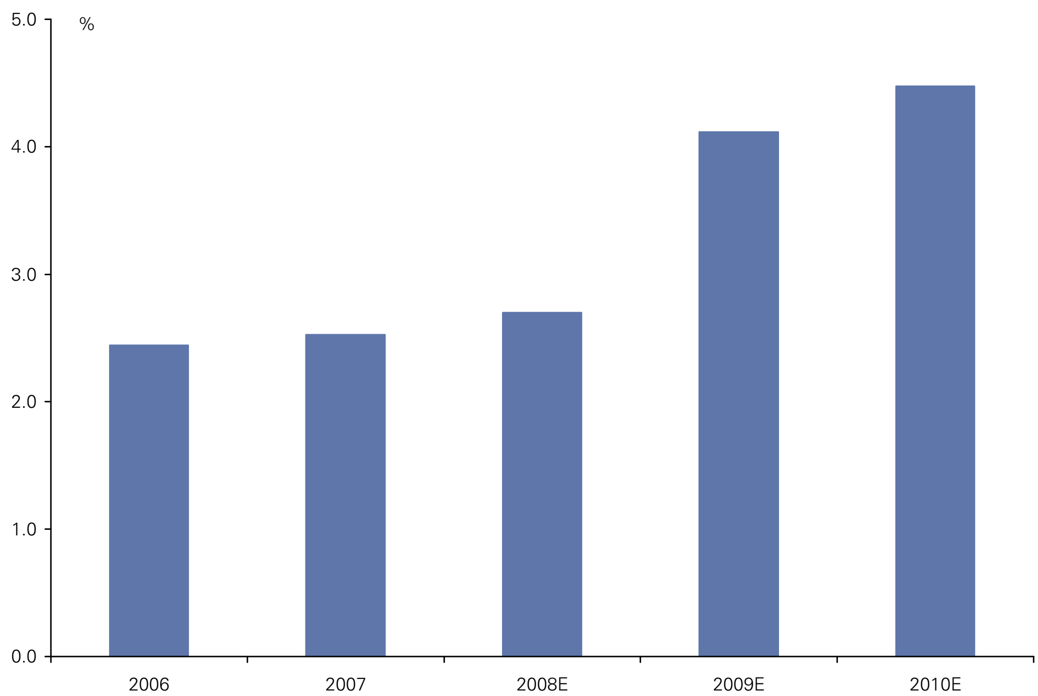
Exhibit 9: Banks with positive asset-liability gap positions will likely be negatively affected due to cut in interest rates as assets would reprice quicker than liabilities; we believe ICICIB, KMB and BOB should benefit from this move
Assets and liabilities re-pricing within a year and the gap thereof

As of	Repricing within a year			As a % of interest bearing assets/liabilities			% of liabilities	% of assets	
Mar-08	% of deposits	% of loans	% of investments	% of deposits	% of loans	% of investments	getting repriced	getting repriced	Gap (%)
Axis	48%	65%	57%	91%	56%	32%	43%	55%	11%
HDFC	77%	81%	0%	84%	92%	0%	65%	74%	10%
HDFCB	28%	41%	56%	93%	50%	39%	26%	42%	15%
ICICIB	65%	45%	57%	77%	60%	28%	69%	43%	-26%
SBI	23%	60%	9%	88%	62%	28%	20%	40%	19%
IOB	41%	70%	43%	90%	61%	29%	37%	55%	18%
KMB	71%	58%	73%	88%	57%	26%	63%	52%	-11%
PNB	32%	60%	12%	96%	61%	29%	30%	40%	10%
BOB	60%	75%	17%	97%	61%	26%	59%	50%	-8%

For HDFC depsoits refers to all funding sources and not just deposits.

Source: Company data, Goldman Sachs Research estimates.

Exhibit 10: We expect a sharp increase in NPA owing to slowing economic activity
Gross NPA ratio for coverage universe of banks



Source: RBI, Goldman Sachs Research estimates.

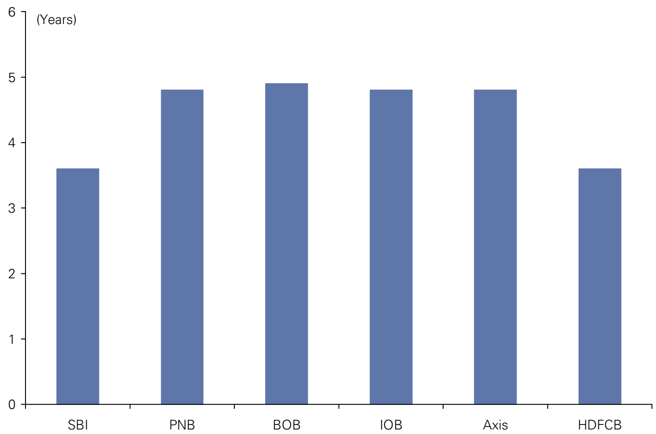
Exhibit 11: Higher incidence of NPAs likely to cause net NPA/equity to rise meaningfully for state owned banks
Forecast trend in NPA accrual, NPA ratio, loan loss reserves and net NPA/equity position

Data as of Mar-08 (unless specified)	Axis	HDFCB	ICICIB	SBI	IOB	BOB	PNB
Corporate as a % of total loans	48.7	12.9	34.1	50.0	59.5	48.9	30.8
SME as a % of total loans	19.3	25.2	0.16	18.9	12.4	11.1	15.0
NPA accrual rate (%)							
2007	0.64	1.88	1.61	0.61	1.07	0.93	1.60
2008E	0.70	2.00	2.69	0.58	0.93	0.97	1.50
2009E	1.50	2.80	2.82	2.09	2.32	2.50	3.17
2010E	0.90	1.60	2.94	1.34	1.60	1.65	2.56
NPA ratio (%)							
2007	0.82	1.42	3.30	2.72	1.62	1.84	2.73
2010E	2.57	1.96	5.85	5.28	3.06	3.17	4.52
LLR/gross loans (%)							
2007	0.93	1.78	2.26	1.77	1.38	1.36	2.29
2010E	2.08	1.95	4.22	2.77	1.73	1.69	2.39
Net NPA/equity (%)							
2007	3.31	2.60	8.27	14.1	8.59	9.84	8.98
2010E	7.92	5.13	15.7	36.8	22.0	24.0	30.0
Tier 1 ratio 2010E (%)	7.30	8.17	8.49	6.60	5.63	6.04	7.46
Assets/equity ratio 2010E (x)	16.4	13.4	10.5	20.1	25.0	21.7	18.8

Note: SME loans for ICICI bank only includes Small scale industries.

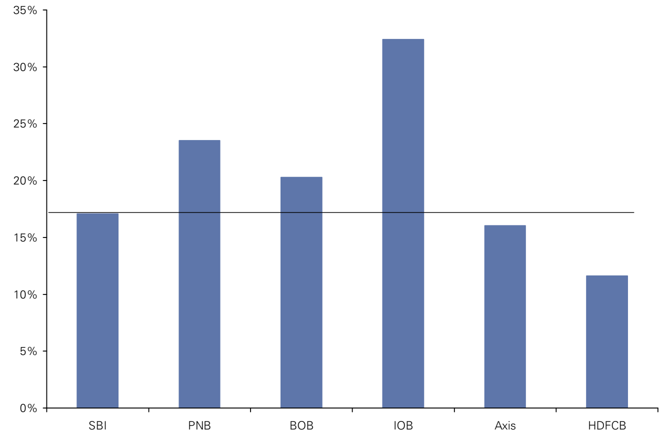
Source: Company data, Goldman Sachs Research estimates.

Exhibit 12: Duration of bonds in HTM category is significantly higher than AFS
Duration of bonds in held-to-maturity category (HTM)



Source: Company data, Goldman Sachs Research estimates.

Exhibit 13: This could yield significant upside to the market expectation of earnings of banks in 2009E
Estimated MTM gains/shareholders funds assuming 20% of investments are moved from HTM to AFS



Source: Company data, Goldman Sachs Research estimates.

Recapitalization a positive step but lack of clarity unlikely to be a trigger

The government announced that it would seek to recapitalize banks between 2009 and 2010 to the extent of Rs200 bn to facilitate them in meeting capital adequacy requirements. This would amount to 18% of the total shareholder funds' of state owned banks, excluding SBI and its subsidiaries. We believe this would unlikely be a positive catalyst for state owned banks:

- The quantum of support envisaged by the government may not be able to fully cover any potential capitalization needs of state owned banks, even after excluding SBI and its subsidiaries. It remains to be seen whether the government's fiscal position would allow them to enlarge the recapitalization program subsequently.
- We believe the government could seek to recapitalize weaker banks that are already facing difficulties in meeting capital adequacy norms. Given that any additional capitalization needs of such banks are not known, it makes it even more difficult to estimate the amount available for recapitalizing other state owned banks.

Reg AC

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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.

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	Rating Distribution			Investment Banking Relationships		
	Buy	Hold	Sell	Buy	Hold	Sell
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Coverage views: Attractive (A). The investment outlook over the following 12 months is favorable relative to the coverage group's historical fundamentals and/or valuation. **Neutral (N).** The investment outlook over the following 12 months is neutral relative to the coverage group's historical fundamentals and/or valuation. **Cautious (C).** The investment outlook over the following 12 months is unfavorable relative to the coverage group's historical fundamentals and/or valuation.

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