BANKING

Facing rough weather

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We believe the business environment is getting tougher for banks. Margins are under pressure with deposit costs rising by more than 100bps in the current quarter. There is negative bias on margins due to:

- Zero or negative spread the banks are making on the SLR book.
- Incremental loan spreads are lower than existing margins.

Demand-led credit growth is not completely price inelastic and we believe that growth is likely to slowdown in H1FY08. We do not expect interest rates to come down; we believe RBI will consider inflation, external flows, and credit growth before taking a pause on tightening measures. The best of asset quality is behind us and incrementally negative surprise has higher probability.

Result expectations

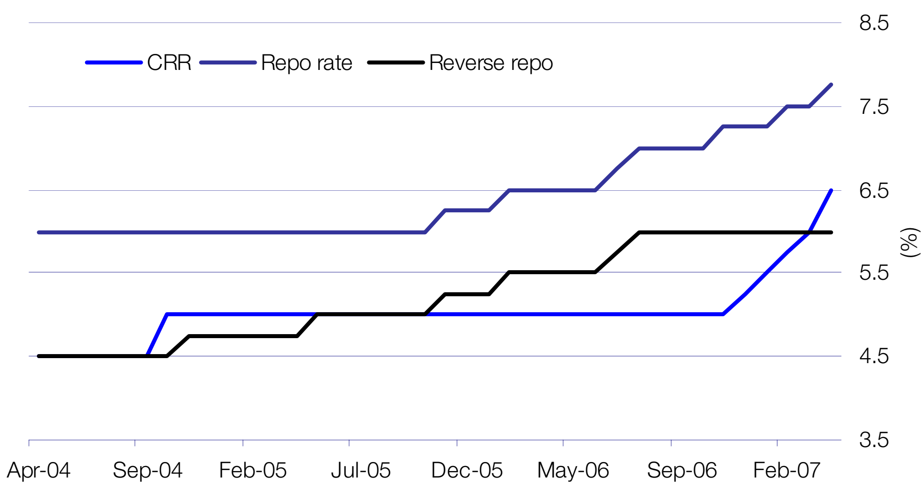
We expect our universe of banks to report 16% Y-o-Y growth in revenues, while profit is likely to be 43% higher Y-o-Y. (This is due to low base of Syndicate Bank in Q4FY06). Sequentially, we expect both revenues and profits to grow by 8%. We expect the pre-provisioning operating profit to grow by 17% Y-o-Y.

- Private banks are expected to maintain their growth momentum and post a 42% growth in pre- provisioning operating profit, 36% growth in revenues, and 39% growth in profits.
- Revenue and profit of PSU banks are expected to grow at 6% Y-o-Y and 46% Y-o-Y, respectively. Growth in PPOP is likely to be 5% Y-o-Y and 13% Q-o-Q due to loan book expansion.
- In the non-banking space, we expect our universe to post a revenue growth of 29% Y-o-Y and profit growth of 15% Y-o-Y.

Monetary tightening by RBI

During the current quarter, RBI has taken aggressive measures to curb inflation and money supply. RBI increased CRR twice by 50bps from 5.5% to 6.5%. Also, it increased the repo rate by 25bps to 7.75%.

Chart 1: Rate hikes



Source: Edelweiss research

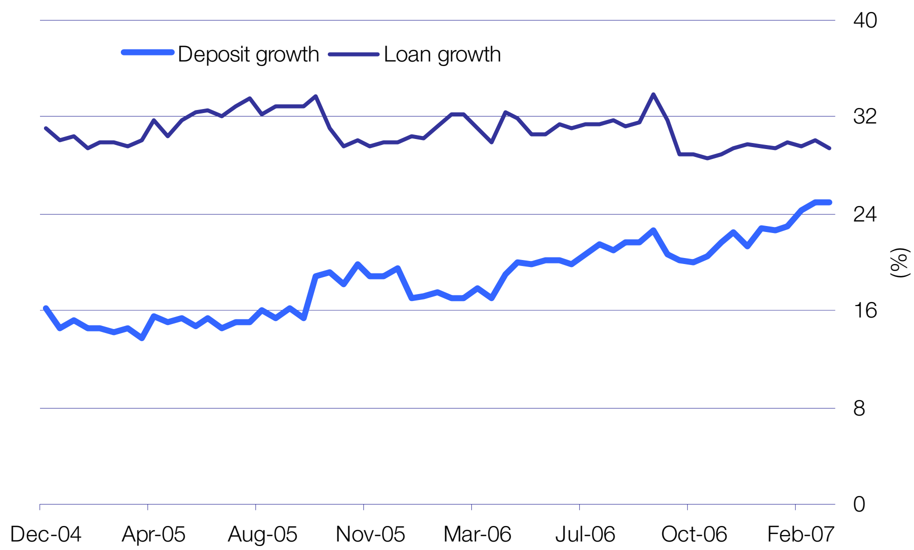
Liquidity at March end has historically been tight due to advance tax outflows and year-end scramble for funds to expand the balance sheet. Liquidity is expected to ease with resuming of government spending in April and RBI's exchange market operations.

* Growth versus margins

Credit growth remained robust during the quarter, growing at ~30% Y-o-Y, which was higher than our expectations. We believe the CD ratio is peaking at 75% and expect the loan growth to taper off due to lagged effect of rate hikes. Deposits have grown by more than 22% throughout this quarter driven by attractive rates being offered. Increased interest rates have made deposits competitive with other saving instruments. This robust deposit mop-up is helping banks meet the credit demand despite a tight liquidity environment. We believe deposit growth will cap loan growth next fiscal.

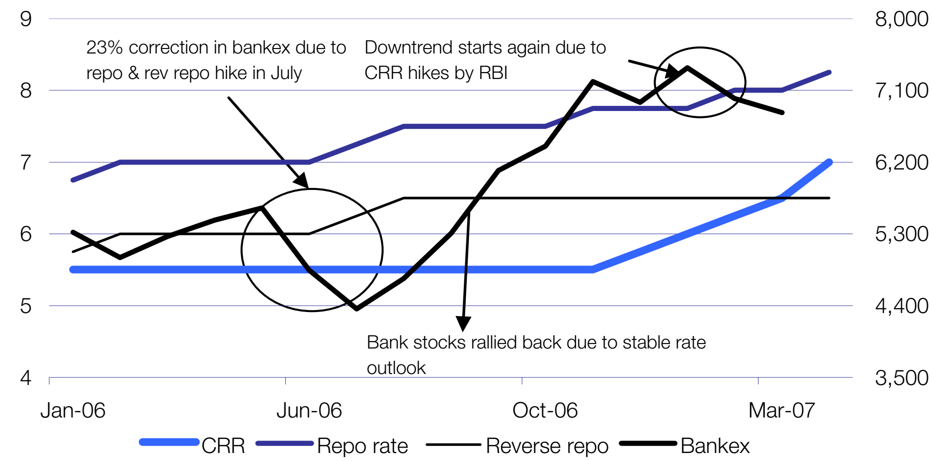
The high cost of deposits is negating any possibility of margin expansion. The re-pricing of deposits is happening at a faster pace compared to loan book. Banks are aggressively hiking lending rates, but the incremental spreads are lower than existing margins. Spreads on SLR book are also putting a negative bias on margins. This margin crunch would offset upsides from higher-than-expected credit growth.

Chart 2: Strong growth in both credit and deposit growth



Source: RBI, Edelweiss research

Chart 3: After effects of the recent hike



Source: Edelweiss research

Post the recent correction, valuations have become attractive. However near-term negative news flow would weigh down investor expectations and depress the valuations. Valuations are expected to remain at current levels till the interest rate outlook stabilises. We maintain our neutral stance on banking for the near term and recommend investors to remain selective. Our top picks are PNB and UTI Bank.

* Q4FY07 results: Earning expectations

After recent hike in rates, we have increased provisions for FY07 for three of our banks viz., PNB, Union Bank, and ICICI Bank. Credit growth has been higher than expected although its impact on profitability has been negated due to pressure on margins.

We expect ICICI Bank to post 47% Y-o-Y growth in profits and 39% growth in revenues driven by its stake sale in NSE for INR 5 bn. ICICI Bank had hiked its lending rates by 50bps in December 2006 and by 100bps in February 2007, but this will be negated to an extent by increase in rates of wholesale deposits. We expect NII to grow by 39% Y-o-Y. However, concern on asset quality has prompted us to increase provisions by 7% for FY07E, which revises our FY07 profit estimate by 3%.

Punjab National Bank is expected to post profit growth of 32% Y-o-Y and revenue growth of 43%. We believe that credit growth will surpass our estimate of 25%. However, margins are expected to be stable. We expect a marked-to-market hit on PNB bond book and have therefore increased our provisions by ~ INR 1,000 mn, consequently lowering our profit estimate by 4%.

Union Bank is likely to post a 9% growth in revenues and 83% growth in profits driven by strong credit growth, albeit margins will be under stress due to increased costs. We expect the provisioning for NPA to go up post these interest rate hikes. We have increased the provisions and cost of funds which leads us to revise FY07E profits downward by 4.5%.

UTI Bank will continue with the growth momentum during this quarter and is expected to post profit growth of 25% Y-o-Y. Provisions are expected to be higher due to investment depreciation this quarter.

We expect HDFC Bank to have another strong quarter with 33% Y-o-Y growth in net profit in Q4FY07. With CASA proportion of above 50%, HDFC Bank is better placed in a rising interest rate scenario. We expect NIM to remain stable.

Oriental Bank of Commerce's profits are likely to decline by 47% Y-o-Y due to pressure on margins continuing and marked-to-market depreciation.

Allahabad Bank is expected to show a decline of 25% Y-o-Y in profits and **Indian Overseas Bank** will show a decline of 12% Y-o-Y. The pressure on margins for **Syndicate Bank** will continue as reliance on wholesale funds will take its toll. We expect it to post a profit of INR 1.6 bn (1400% plus growth, but on a low base due to MTM provisions in Q4FY06).

State Bank of India is expected to post a growth of 86% Y-o-Y in profits (on a lower base of Q4FY06). Credit growth is expected to be around 25% with stable margins due to its high CASA ratio (43%) and lending rate hikes of 125bps since December.

We expect good results from **Centurion Bank of Punjab** and **Yes Bank** with strong growth in fee income expected. **Karnataka Bank,** with lower CASA base, may again see its cost of funds moving up at a higher pace, restricting NIM improvement. Also, exposed bond book will dampen profitability.

IDFC and **SREI** are expected to post strong revenue growth at 44% and 27% Y-o-Y, respectively. The margins for both are expected to be under pressure due to high cost of borrowings. **HDFC** and **LIC Housing** are likely to post lower growth number for disbursements. We expect profit growth of 6% Y-o-Y for HDFC and 61% Y-o-Y for LIC (on a lower base).

Table 1: Quarterly expectations

	Net Revenue					PAT				
Public sector	Q4FY06A	Q4FY07E	Q3FY07A	*%YoY*	*%QoQ*	Q4FY06A	Q4FY07E	Q3FY07A	*%YoY*	*%QoQ*
Allahabad bank	6,311	5,741	6,102	*(9.0)*	*(5.9)*	1,505	1,129	2,861	*(25.0)*	*(60.5)*
Indian Overseas Bank	7,533	7,952	8,031	*5.6*	*(1.0)*	2,044	1,808	2,468	*(11.5)*	*(26.7)*
Oriental Bank Of Commerce	5,618	5,926	5,543	*5.5*	*6.9*	2,672	1,426	2,436	*(46.6)*	*(41.5)*
Punjab National Bank	16,627	19,512	18,459	*17.4*	*5.7*	2,886	4,120	4,299	*42.8*	*(4.2)*
State Bank of India	62,316	64,030	57,624	*2.8*	*11.1*	8,533	15,414	10,651	*80.6*	*44.7*
Syndicate Bank	5,972	7,174	7,049	*20.1*	*1.8*	103	1,568	2,261	*1,419.1*	*(30.7)*
Union Bank Of India	8,100	8,822	8,911	*8.9*	*(1.0)*	1,446	2,632	2,558	*82.0*	*2.9*
PSU banks	112,477	119,158	111,720	*5.9*	*6.7*	19,189	28,097	27,534	*46.4*	*2.0*
Private Sector										
Centurion Bank of Punjab	2,063	2,835	2,483	*37.4*	*14.2*	261	439	335	*68.5*	*31.1*
Federal Bank	2,420	2,400	2,328	*(0.8)*	*3.1*	507	626	838	*23.3*	*(25.4)*
HDFC Bank	10,436	14,572	13,019	*39.6*	*11.9*	2,632	3,491	2,956	*32.6*	*18.1*
ICICI Bank	29,600	41,030	36,898	*38.6*	*11.2*	7,899	11,593	9,105	*46.8*	*27.3*
Karnataka Bank	1,383	1,460	1,448	*5.6*	*0.8*	510	344	539	*(32.6)*	*(36.2)*
UTI Bank	5,409	7,421	6,956	*37.2*	*6.7*	1,517	1,895	1,846	*24.9*	*2.7*
Yes Bank	591	1,047	945	*77.2*	*10.7*	153	287	251	*87.3*	*14.3*
Private banks	51,901	70,764	64,077	*36.3*	*10.4*	13,479	18,675	15,871	*38.5*	*17.7*
All banks	164,378	189,922	175,796	*15.5*	*8.0*	32,668	46,772	43,405	*43.2*	*7.8*
IDFC	1,139	1,637	1,420	*43.7*	*15.3*	824	1,190	1,240	*44.4*	*(4.0)*
HDFC	12,398	16,085	14,585	*29.7*	*10.3*	4,263	4,531	3,649	*6.3*	*24.2*
LIC housing finance	1,182	1,332	1,236	*12.7*	*7.8*	414	666	766	*61.0*	*(13.0)*
SREI Infrastructure Finance	381	485	347	*27.4*	*39.7*	159	138	179	*(13.3)*	*(22.9)*
Total Non banking	15,100	19,539	17,587	*29.4*	*11.1*	5,660	6,526	5,834	*15.3*	*11.9*

Source: Edelweiss research

Table 2: Valuation metrics

	M Cap	Price	P/B	P/B	EPS	ROE	P/E	PE / G	EPS CAGR	Div Yield	P/PPOP	Rating
			FY07E	FY08E	FY08E	FY08E	FY08E	FY07-09	FY07-09	FY08E	FY08E	
	USD mn	(INR)	(x)	(x)	(INR)	(%)	(x)	(x)	(%)	(%)	(x)	
State Owned Banks												
Allahabad Bank	685	69	0.9	0.8	17.3	20.2	4.0	0.4	9.0	7.2	2.3	BUY
Indian Overseas Bank	1,166	96	1.4	1.2	18.2	23.9	5.3	0.4	13.4	3.1	2.7	BUY
Oriental Bank	938	169	0.8	0.7	31.7	14.5	5.3	3.6	1.5	4.2	3.5	ACCU
Pun. Natl. Bank	2,990	427	1.3	1.1	73.2	20.4	5.8	0.2	23.3	2.8	2.9	BUY
SBI (stand alone)	10,883	931	1.6	1.4	109.7	17.1	8.5	0.4	20.2	1.6	3.8	ACCU
SBI (Consolidated)	10,883	931	1.2	1.0	136.8		6.8	0.4	17.9			ACCU
Syndicate Bank	682	59	1.0	0.8	14.1	21.7	4.2	0.5	8.5	6.1	2.3	BUY
Union Bank (I)	1,078	96	1.0	0.9	20.6	20.2	4.7	0.3	17.7	4.2	2.3	BUY
Private Sector Banks												
Centurion Bank	1,229	36	4.1	3.5	1.3	14.5	27.8	0.7	37.4	0.2	10.3	BUY
Federal Bank	385	203	1.2	1.0	34.7	18.6	5.8	0.4	15.3	1.7	3.1	BUY
HDFC Bank	6,333	901	4.6	3.8	47.7	22.0	18.9	0.8	24.2	0.8	8.0	REDUCE
ICICI Bank	15,983	804	2.9	2.6	46.0	15.7	17.5	1.1	16.3	1.3	8.4	BUY
ICICI Bank (adj)#	15,983	630	2.3	2.0	46.0	15.7	13.7	0.8	16.3	1.6	6.6	BUY
Karnataka Bank	447	166	1.6	1.4	16.2	14.7	10.3	0.9	11.3	1.9	5.7	ACCU
UTI Bank	2,875	459	3.8	3.2	29.2	22.1	15.7	0.8	20.0	1.0	7.5	BUY
Yes Bank	857	138	4.9	2.8	4.8	12.9	28.7	0.5	53.5	-	7.4	BUY
Speciality Finance												
HDFC	8,003	1,435	6.0	4.2	69.2	24.1	20.7	1.3	15.9	1.9		ACCU
HDFC (adj)#	8,003	965	4.1	2.8	69.2	24.1	13.9	0.9	15.9	2.8		ACCU
LIC HF	253	134	0.7	0.7	28.0	15.8	4.8	173.9	0.0	4.2		BUY
IDFC	1,981	79	3.1	2.8	5.0	18.6	15.7	3.8	4.2	2.5		ACCU
SREI	111	46	1.1	0.9	6.7	15.9	6.9	0.8	8.9	3.3		REDUCE

Source: Edelweiss research

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period