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Industry View
Cautious

India Financial Services Deposit Rate Hike – Sector Outlook Getting Gloomier

Quick Comment: We have been negative on Indian banks. However, given the manner in which events are unfolding, there appears to be significant downside to our estimates – implying even more weakness in stocks, compared to our current estimates. In last few weeks, the following things have happened

1. In F4Q08 results, SBI announced that it has seen significant increase in agricultural NPL's after the announcement of debt waiver on farm loans. Last week, newspapers reported that SBI asked its branches to stop giving new farm equipment loans. There was a lot of political opposition to this announcement. SBI later issued a statement saying that its move was misunderstood and it will keep giving these loans.
2. In April, the central bank raised reserve requirements by 75 bps – this move will reduce NIM's by 5-6 bps in our view.

So clearly, credit costs are rising, at least on farm loans, and NIM's are under pressure. Moreover, fees income growth is likely to decelerate given weaker capital markets and lack of derivative revenues in F2008.

Rational move could be to raise lending rates, but banks are raising deposit rates - From a profitability perspective, banks should be raising lending rates to compensate for pressure on NIM's and higher credit costs. However, banks are actually raising deposit rates (SBI raised rates by up to 50 bps, BOI had raised rates earlier) – accentuating impact on NIM's.

We had seen some pressure on NIM's in F4Q08 - this is likely to intensify. Until now, we were building in good NIM progression for banks in F2009 – we were concerned about fees, costs and credit costs, but not NIM's. However, now our NIM estimates are likely to trend down, implying that F2009 is likely to be even weaker than our current assumptions.

Recent Reports

Title	Date
India Financial Services: SOE Banks – Sitting on the Sidelines; For Time Being Anil Agarwal / Anil Bang / Mansi Shah	Mar 3, 2008
India Financial Services: The Unwinding of the Growth Premium Anil Agarwal / Ashish Jain / Mansi Shah	Mar 31, 2008
State Bank of India: Signs of Stress – Downgrade to Underweight Anil Agarwal / Mansi Shah / Ashish Jain	May 5, 2008

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We can't see economic rationale for raising deposit rates.

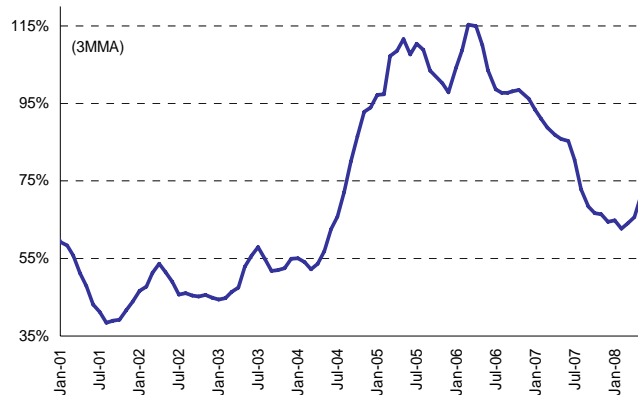
Currently, system deposit growth in India is running at 23%, the same as loan growth. Given that deposits are much larger than loans – this implies that incremental loan to deposit ratio is running at 70% (i.e. 70% of deposits raised are being given out as loans). This implies good liquidity in the banking system. Banks raise deposit rates when liquidity is tight and they need deposits – the move to increase deposit rates will likely imply that banks have even more liquidity and NIM's trend down further.

**Exhibit 1
SOE Banks: NIM's Were Already Under Pressure (NII Growth Was Trailing Asset Growth)**

YoY	Loan Growth	NII Growth	Difference
BOB (%)	28	-6	-34
Corp (%)	31	3	-28
SBI (%)	24	-3	-27
OBC (%)	22	-2	-24
Canara (%)	9	-13	-22
Union (%)	19	-1	-20
PNB (%)	24	17	-7
BOI (%)	32	26	-6
Sector (%)	21	1	-20

Source: Company data, Morgan Stanley Research

**Exhibit 2
India: Incremental Credit Deposit Ratio (3MMA)**

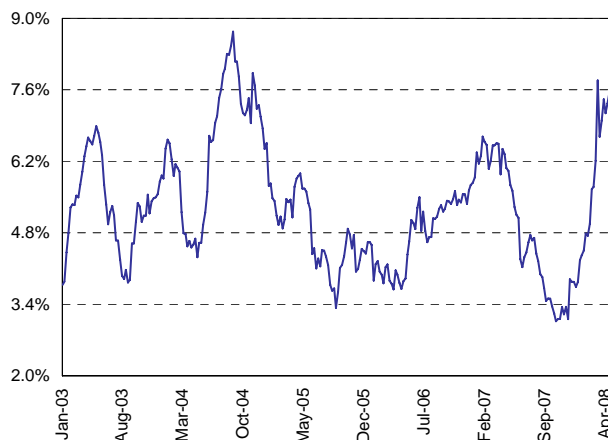


Source: Company data, Morgan Stanley Research

Our negative call on Indian banks is premised on weaker volume growth, deceleration in fees and a spike in credit costs – we believe that these themes will continue to play out over the next year. NIM compression adds to the problem areas, implying potentially even lower earnings (compared to our estimates) in F2009. In our view, this, coupled with deteriorating macro (high inflation, weak currency), will cause

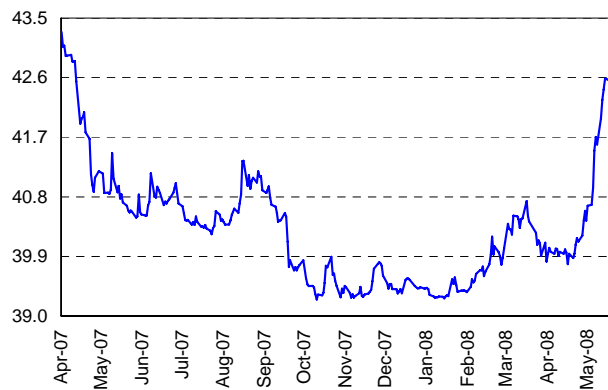
banks to keep underperforming broad market. We continue to advocate shifting money from banks to other sectors.

**Exhibit 3
India: WPI Inflation (YoY)**



Source: Company data, Morgan Stanley Research

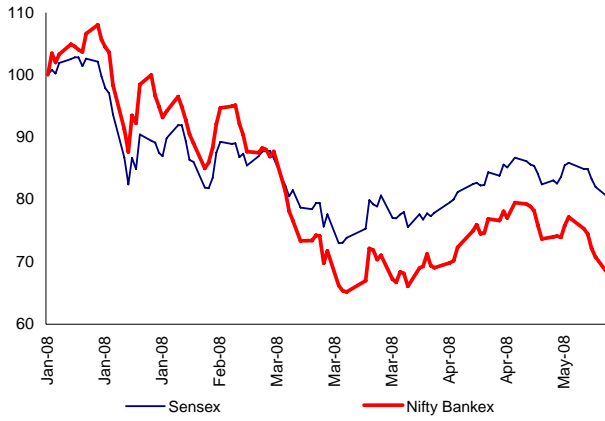
**Exhibit 4
INR vs US\$**



Source: Company data, Morgan Stanley Research

Exhibit 5

Banks Have Lagged This Year...Can Fall Further



Source: Company data, Morgan Stanley Research

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1012	43%	326	44%	32%
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Total	2,371		748		

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May 26, 2008

India Financial Services

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May 26, 2008

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Industry Coverage: India Financial Services

Company (Ticker)	Rating (as of)	Price (05/23/2008)
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Bank of India (BOI.BO)	O (11/30/2006)	Rs325.35
Canara Bank (CNBK.BO)	E (03/03/2008)	Rs225.45
Corporation Bank (CRBK.BO)	E (03/03/2008)	Rs344.7
HDFC (HDFC.BO)	O (07/13/2007)	Rs2,678.3
HDFC Bank (HDBK.BO)	E (10/18/2006)	Rs1,383.35
ICICI Bank (ICBK.BO)	E (03/10/2008)	Rs863.75
IDBI (IDBI.BO)	U (10/21/2005)	Rs95.1
IDFC (IDFC.BO)	O (09/16/2005)	Rs156.05
Kotak Mahindra Bank (KTKM.BO)	U (08/21/2006)	Rs700
Oriental Bank of Commerce (ORBC.BO)	E (03/03/2008)	Rs202.05
Punjab National Bank (PNBK.BO)	E (03/03/2008)	Rs513.65
Reliance Capital (RLCP.BO)	O (09/12/2007)	Rs1,321.05
State Bank of India (SBI.BO)	U (05/05/2008)	Rs1,573.25
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