India

Banking Sector Review

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Raising rate forecasts, downgrade earnings: We are downgrading our earnings estimate for Indian banks by 3-15% on back of a 50bps increase in our interest rate assumption. Our forecasts now build in 10 yr bond yields at 8.5% by Mar-07 and 9% by Mar-08, which translates to larger mark-to-market (MTM) hit on bond books for the government banks. These earnings revision also build in the impact (a 3-4% earnings cut for all banks) of recent change in regulation discontinuing payment of interest on excess cash reserve ratio maintained with the central bank.

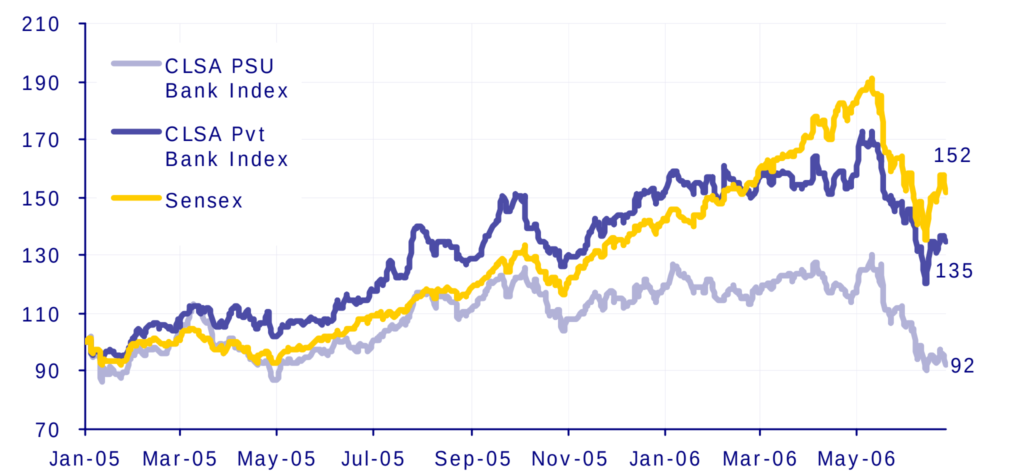
Loan growth to moderate, margins expand: Over the past year, domestic bond rates are up 120bps on back of 75bps hike in repo rates by RBI. Banks have also pushed through similar/higher rate hike on their loans (viz. mortgage rates are up 125bps in past 12 months). Despite the higher rates, we are maintaining our 22% loan growth forecast (a moderation from 31% growth in FY06) given the strong economic outlook and large corporate capex pipeline. With rising loan book yields we expect bank margins to expand in FY07 as deposit re-pricing is relatively slower. Asset quality is the key risk to watch particularly on SME and mortgage books. Higher rates have not yet translated to larger monthly payments as banks have chosen to stretch out mortgage repayment schedules. However, room for this is now limited and further rate rise will necessitate an increase in mortgage payments, which can impact asset quality.

Sector to report dip in 1Q07 earnings: With a large part (60bps) of our forecasted 100bps rate rise for FY07 already coming through, we expect bank earnings in 1Q to be depressed. Most of the government banks are expected to report a 10-15% drop in 1Q profits on this account. Moreover, as full benefits of recent lending rate increases are expected to come through only in 2Q, we expect SBI and ICICI Bank margins to contract in 1Q.

Valuations cheap even building higher rate risk: Indian banks have underperformed the broader market by 25% YTD. We therefore believe that the interest rate risk is already well discounted. Even after our current earnings downgrade, Indian bank valuations are among the cheapest in the region at 1.3x FY07 book and 7.9x earnings and we retain our O-WT on the sector.

Figure 1

PSU banks have significantly underperformed the market



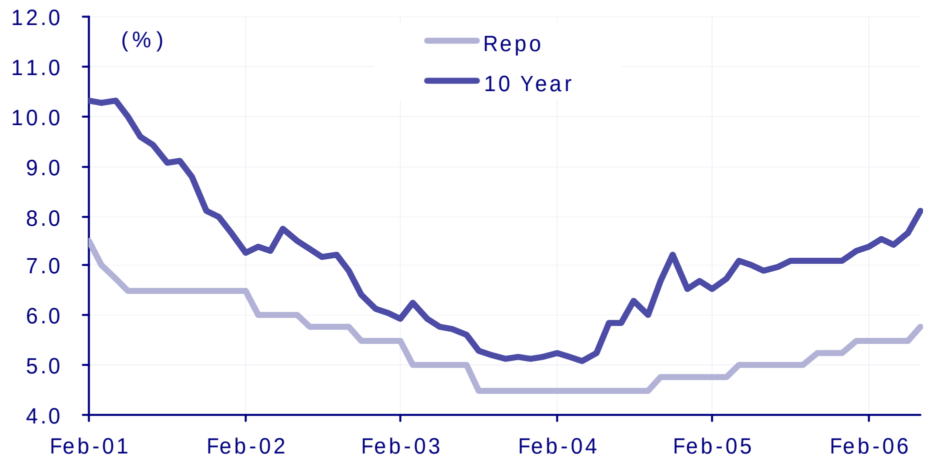
Source: CLSA Asia-Pacific Markets

Earnings estimates for FY07-08CL cut by 7-7.5%

Over the past 12 months 10 year bond yields have moved up 120bps to 8.1%. RBI has already raised repo-rates thrice during this period (75bps aggregate increase). With global interest rates expected to move up further and credit growth still strong, our economist team forecast a further 50bps rise in repo rates to 7.25% during current fiscal. We are therefore raising our interest rate estimate for the current year by 50bps and now expect a 100bps rise in bond yields by Mar-07 to 8.5% (cf. earlier estimate of 8%). We are building in a further 50bps rise in rates during FY08 to 9% (cf. earlier estimate of 8.5%).

Figure 2

Rates have moved up 75-125bps over the last 12 months



Source: CLSA Asia-Pacific Markets

5-10% earnings impact from higher hit on bond book

a) This revision in bond yield estimate translates to a 5-10% earnings impact for government banks in our universe.

Addl. 3-4% earnings hit from change in CRR regulation

b) RBI was till now paying the banks interest @3.5% for cash reserve ratio (CRR) maintained above the statutory level of 3%. With CRR currently prescribed at 5% RBI was paying interest on the 2% excess CRR (5% - the floor 3%). Recent regulatory changes have removed the floor. Consequent to this, RBI will not be paying any interest on this excess CRR, which effectively raises cost of funds (and drops the NIMs) for the banks by 7bps (int. @ 3.5% x 2%). This translates to 3-4% earnings hit for the banks.

Earnings cut

Pvt. banks 2-5%

PSU bank cut 6-15%

Figure 3

Banking sector earnings cut by 7%

Rsm	FY07CL	% chg*	FY08CL	% chg*
ICICI Bank	30,047	(4.5)	37,871	(5.2)
Canara Bank	14,300	(10.3)	16,869	(10.1)
HDFC Bank	11,135	(0.7)	13,794	(1.6)
UTI Bank	6,112	(1.7)	7,849	(2.5)
SBI (st alone)	45,497	(5.6)	51,328	(5.5)
Oriental Bank	7,874	(10.2)	8,467	(16.2)
Corp Bank	5,270	(14.7)	6,220	(14.6)
PNB	17,177	(12.7)	20,735	(12.4)
J&K Bank	2,536	(2.7)	3,360	(2.3)
Bank of Baroda	10,420	(7.6)	11,479	(10.7)
Total	**150,367**	**(6.9)**	**177,971**	**(7.5)**

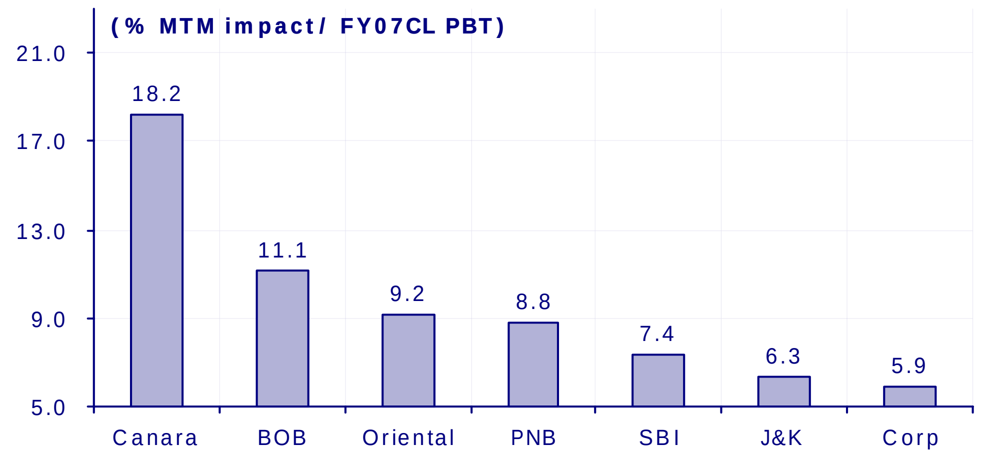
* change from earlier estimates for the respective years; Source: CLSA Asia-Pacific Markets

Rate risk at SBI is now relatively lower than peers

A 50bps move in interest rates above our current estimate of 8.5% for Mar-07, can potentially erode 6-18% of FY07CL pre-tax earnings. Risk is relatively higher at Canara, Bank of where a 50bps rate hike eroding over 10% of profits. SBI and J&K Bank, which have over the past year reduced the size and duration of their bond portfolio, are now relatively less exposed.

Figure 4

An additional 50bps rate surge can shave off 6-18% of bank's PBT



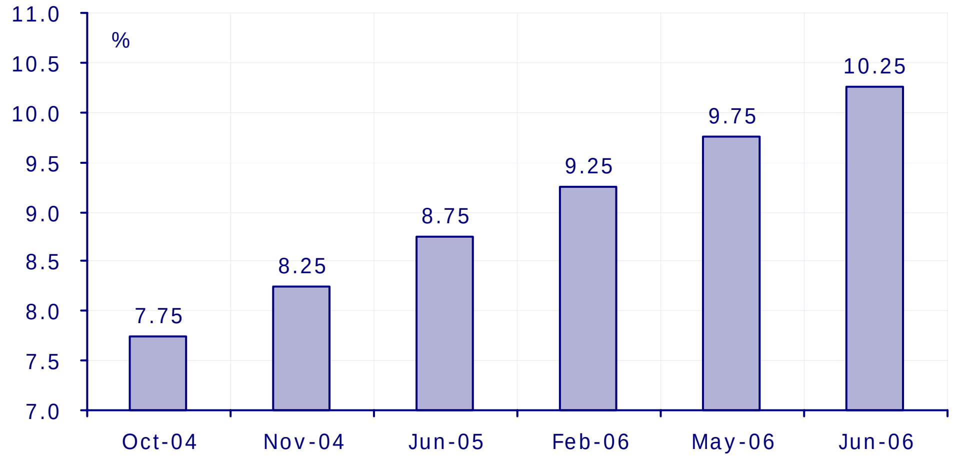
Source: CLSA Asia-Pacific Markets, Banks

Banks have been able to push up lending rates

While, bank treasuries will hurt from the rate increases, we expect these to be beneficial for their net interest margins. Over the past 12 months, strong credit growth and dry-up of excess liquidity in the system have enabled the banks to push through rate increases in virtually all loan segments. Auto loans are up 200bps, mortgages are up 150bps in the past 12 months.

Figure 5

Mortgage rates have been pushed up



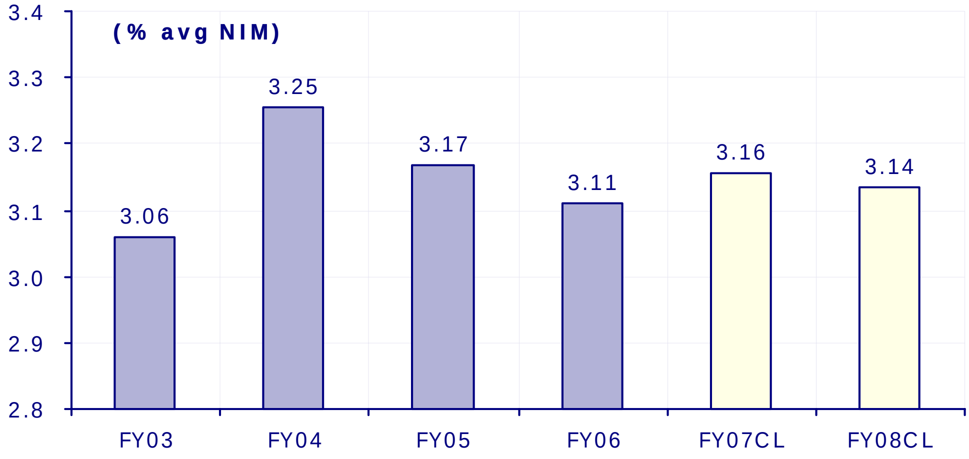
Source: CLSA Asia-Pacific Markets, ICICI Bank

Expect margin recovery in FY07

On back of these lending rate increases we expect net interest margins for banks to reverse their past two years downward trend. While, with rising rates banks have had to raise deposit rates as well, we expect bank margins to expand in FY07 as deposit re-pricing is relatively slower. Moreover, in rising rates margins banks enjoy on their low cost deposits and capital funds also expand.

Figure 6

Expect NIM recovery in FY07 on back of stronger lending margins



Source: CLSA Asia-Pacific Markets

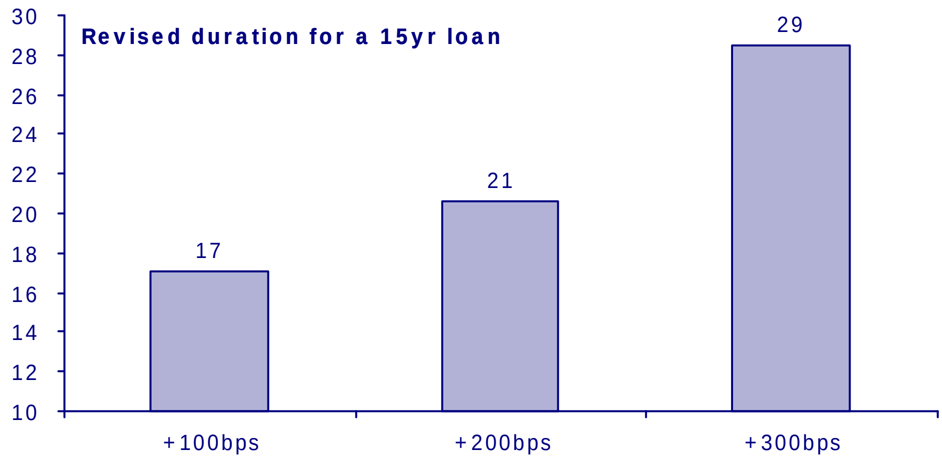
Asset quality is key risk to watch for

Asset quality is the key risk to watch particularly on SME and mortgage books that have been aggressively grown in the past two years and most of the bank loans in these segments are on a floating rate basis.

Till now banks higher rates have not yet translated to increase monthly mortgage payments for most of the borrowers as banks have chosen to stretch out mortgage repayment schedules. However, with rates already up 200bps for most loans, room to stretch mortgage duration is limited. We believe any further rate rise will necessitate an increase in mortgage payments (a 1% rise in rates increases EMI by 6%), which can impact asset quality, delinquency experience of the banks.

Figure 7

Little room to stretch mortgage repayment



Source: CLSA Asia-Pacific Markets

Sector to report dip in 1Q07 earnings

In the current quarter, bond yields have moved up a sharp 60bps and with a large part of our forecasted 100bps rate rise for FY07 already coming through, bank earnings in 1Q will be depressed. We expect most government banks to report a 20-25% drop in 1Q profits on this account and overall sector to report a 4-5% earning dip.

As the full benefits of recent lending rate increases will also accrue only from 2Q we expect margin pressures to continue in 1Q. We expect the large banks SBI and ICICI Bank to report a YoY dip in margins.

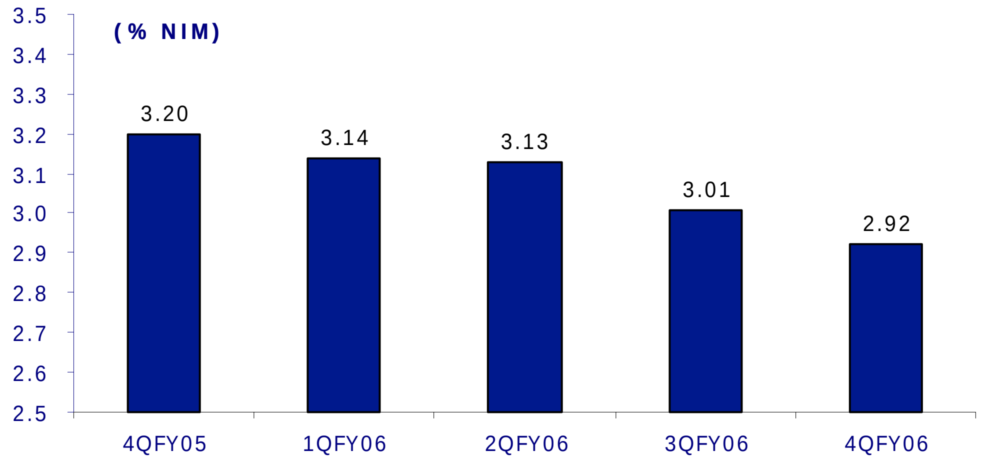
Figure 8

MTM hit will hurt 1Q profits

Bank	Tot income (Rsm)			PAT (Rsm)		
	1QFY06A	1QFY07CL	% YoY	1QFY06A	1QFY07CL	% YoY
ICICI Bank	17,412	22,502	29.2	5,300	6,092	15.0
BOB	9,675	11,246	16.2	1,569	1,639	4.4
HDFC Bank	7,872	9,950	26.4	1,835	2,388	30.1
UTI Bank	3,722	4,692	26.1	924	1,174	27.0
SBI (st alone)	58,298	55,464	(4.9)	12,228	9,913	(18.9)
Oriental Bank	4,986	5,101	2.3	1,048	1,556	48.5
Corp Bank	4,505	4,482	(0.5)	1,235	927	(25.0)
PNB	13,412	15,612	16.4	3,582	2,903	(18.9)
Total	**119,882**	**129,049**	**7.6**	**27,720**	**26,592**	**(4.1)**

Figure 9

SBI 1Q07 margins will improve sequentially but will still be lower on YoY basis



Source: CLSA Asia-Pacific Markets

Figure 10

Indian banks: Summary valuation matrix

FY07	Reco	Mcap(US$m)	Eps(Rs)	Bvps(Rs)	PE(x)	PBV(x)
ICICI Bank	BUY	9,490	34	272	14.5	1.8*
SBI - con	O-PF	8,330	107	763	6.8	1.0
HDFC Bank	BUY	5,123	35	198	21.5	3.8
PNB	BUY	2,131	54	344	5.7	0.9
Canara Bank	SELL	1,750	35	202	5.6	1.0
UTI Bank	BUY	1,660	22	121	12.5	2.3
Bank Baroda	BUY	1,251	29	235	6.9	0.8
OBC	O-PF	920	31	229	5.4	0.7
Corp Bank	SELL	737	37	265	6.4	0.9
J&K Bank	BUY	407	52	413	7.4	0.9

Note: Figs based on FY07CL; Source: CLSA Asia-Pacific Markets

* 1.0x adjusted for subsidiary stake value

Figure 11

Indian financials are amongst the cheapest in the region

	2007CL			
Market	**P/E (x)**	**P/B (x)**	**ROE(%)**	**ROA(%)**
China	10.8	1.8	20.1	0.6
Indonesia	11.1	1.8	19.9	2.3
Malaysia	12.5	1.7	12.9	1.1
HK *	12.4	1.6	13.0	1.4
Singapore	12.6	1.4	10.7	1.1
Taiwan	11.7	1.3	11.0	0.9
Korea	8.4	1.3	16.0	1.2
India	**7.9**	**1.3**	**16.7**	**1.1**
Philippines	9.1	1.2	12.8	1.4
Thailand	7.6	1.1	15.7	1.4

Note: * (ex-HSBC, STD, HSI, JCG), sorted by P/B (desc); Source: CLSA Asia-Pacific Markets

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