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Down but not out

Long term investors can accumulate bank stocks as the expected lower credit growth and margin pressure seem to be factored in the stock prices. After touching its all-time high just a month ago, the BSE Bankex got a big blow last week as it tanked by 6 per cent over the previous trading session, thanks to an unexpected move of repo rate hike as well as an increase in the cash reserve ratio by the Reserve Bank of India. Stocks like Corporation Bank, Oriental Bank of Commerce, Punjab National Bank, Bank of India and Union Bank of India were worst hit. But for the week ended April 5, 2007, the BSE Bankex is down by just 2.6 per cent, thanks to the overall market recovery of 400 points. What's in store for investors of banking stocks now? In this context, four questions need to be answered first.

1) **How far can interest rates go up now?**
   Industry players as well as market experts feel that the long term view on interest rates is stable due to the effects of rabi harvest, high base effect of inflation and lowering of rates in the US, though it could rise by 50 basis points further over the next two-three months.

2) **How will the banking industry perform in the current financial year?**
   Industry experts expect a moderate growth in credit unlike the robust growth of over 30 per cent reported in the last few financial years. Further, profitability will be impacted to some extent due to some decline in margins varying from bank to bank, RBI's monetary measures and rising inflation.

3) What strategy should investors adopt after the recent correction?
Both analysts and fund managers unanimously agree that the valuations of a large number of banks have come to attractive levels. Most mutual funds managers feel that post correction, banking stocks have become good long term investment bets as their stock prices and valuations reflect most of the bad news. However, analysts recommend a cautious approach for the short term though very few are not bullish even for the long-term.

4) Which are the market player's top picks?
Market participants like State Bank of India, Punjab National Bank, Bank of India, HDFC Bank and ICICI Bank for varied reasons.

INTERESTING FALL		
	Price as on April,02	% chg
Corporation Bank	258.70	-10.40
Oriental Bank of Commerce	168.65	-10.10
Punjab National Bank	427.55	-9.40
Bank of India	154.10	-8.20
IDBI	71.65	-7.60
Union Bank of India	96.10	-7.50
Indian Overseas Bank	96.00	-6.80
Bank of Baroda	200.95	-6.70
SBI	930.25	-6.30
UTI Bank	460.00	-6.20
Canara Bank	183.10	-6.00
ICICI Bank	804.50	-5.70
HDFC Bank	901.60	-5.00
Allahabad Bank	69.15	-4.90
Kotak Mahindra Bank	459.50	-4.20
Note: % change is over the previous trading session (March 30)		

RBI's measures to tackle inflation In a scenario where the economy's growth is on the fast track, the fear of unabated rise in inflation rates putting a brake on the growth engine looms large. Inflation has been rising since the last few months due to higher foodgrain and commodity prices. Though it cooled down a bit at 6.39 per cent for the week ended March 24 against the firm 6.46 per cent reported in the previous week, it is still much higher than the government's desired level of 5-5.5 per cent. Moreover, robust growth of over 20 per cent in money supply for most part of the year has been creating asset bubbles, thus giving sleepless nights to RBI officials. Thus, RBI didn't wait till its annual policy statement for the year 2007-08 scheduled on April 24 and it slapped the banking system with one more hike in CRR (cash reserve ratio-money kept in cash with the RBI) from 6 per cent to 6.5 per cent in two phases of 25 basis points each and a repo rate (rate at which RBI infuses liquidity into the system) increase of 25 basis points sucking out liquidity of over Rs 15,000 crore. It also halved the interest paid on the CRR balance to 0.5 per cent. In response to the rate hikes, some banks including ICICI Bank, HDFC Bank, UTI Bank and Bank of Baroda have immediately raised their prime lending rates in the range of 75-100 basis points. However, deposit rates have not been raised at present as many banks recently had deposit rate hikes. On an average, lending rates have gone up by 200-250 basis points in the last year and a half, while deposits have increased in the range of 100-400 basis points across various maturities.

Growth to cool down

Industry experts feel that as a fall-out of hike in interest rates, credit is expected to grow at a moderate pace of 20-25 per cent for this financial year unlike 30 per cent reported in the past few years. "However," says Paresh Sukthankar, country head, credit and market risks, HDFC Bank, "this credit growth is still healthy given the high base which has grown at 30 per cent a year for the last three years." Demand for retail assets especially mortgages and other big ticket loans like real estate and commercial vehicle fleet will decelerate. Yes Bank's chairman Rana Kapoor says, "Growth in retail assets will come down from the present 40 per cent to about 24 per cent and realty loans will fall even sharply from 30-35 per cent to almost half rate of 15-20 per cent." The impact on corporate loans and small value loans like two-wheelers and personal loans is likely to be low. Says Anil Khandelwal, chairman and managing director, Bank of Baroda, "The credit flows to sectors like commercial real estate, commodities sectors, non-deposit taking NBFCs would definitely moderate; however, demand from productive sectors like SMEs and farm sector, which do not have very high internal accruals will continue." But, there is a silver lining for banks. So far, deposits were growing at 20 per cent against the growth in advances at 30 per cent. Now Kapoor feels, this 10 per cent gap will narrow down to 2-3 per cent in 2007-08. But would that ease the pressure on margins? "It will be different for different banks," says Sukthankar of HDFC Bank. While pressure on margins is not ruled out, the impact will be less harsh for banks that have a higher proportion of low cost deposits or current and savings accounts (CASA), or those that are less reliant on bulk deposits or have high fee-based income. While Kapoor foresees an impact of 22-25 basis points on the banking sector's margins, Bank of India's CMD M Balachandran expects 10-15 basis point erosion in margins due to CRR hike, lower interest on the CRR balance and lost lending opportunities. Overall, investors should expect some impact on profitability but on a higher base, a moderate growth is still healthy. **Have interest rates peaked out?**

Industry experts expect interest rates to go up by another 50 basis points in next two-three months. However, after monsoon, they expect inflation to soften and interest rates to stabilise due to arrival of rabi harvest and the full impact of the RBI's monetary measures taken so far. By the end of the third quarter or in the fourth quarter of this financial year, market experts are also talking of a reversal in interest rates due to pressure on overseas interest rates and substantial control over inflation.

Buy, sell or hold?
Some analysts are advising a wait-and-watch strategy till the March 2007 quarter results are out. Says Parthapratim Gupta, analyst, Man Financial, “The short term view on banking stocks is negative as a further downside could be expected on account of expectations of poor March quarter results, led by margins pressure and higher provision.” He advises buying select stocks after the March 2007 results though. A Balasubramanium, CIO, Birla Mutual Fund, says, “It’s advisable to have a marginal exposure to the sector at present due to current volatility in interest rate movement.” However, some of the fund managers are optimistic. Says Nilesh Shah, chief investment officer, ICICI Prudential Mutual Fund, “Though there could be a marginal downside risk, most of the bad news seems to be factored into the stock prices after the correction and thus banking stocks could be a good investment bet.” The correction has lowered bank stock valuations. Says Anup Maheshwari, fund manager, DSP Merrill Lynch Mutual Fund, “Valuations for public sector banks have become attractive.” Here is a look at some of the better-managed banks.

TOP PICKS

	Price (Rs)	P/BV (FY08E)	P/BV (FY09E)
Bank of India	161.10	1.3	1.2
PNB	440.45	1.1	1
SBI	947.95	1.0*	0.9*
HDFC Bank	943.25	4.1	3.5
ICICI Bank	838.55	1.9*	1.6*

* excluding value of investments in subsidiaries
CMP: Current market price

Bank of India
Most analysts prefer Bank of India in the PSU space due to comparatively strong earnings visibility, consistent margin expansion in last few quarters, lesser proportion of bulk deposits and a lower duration of 1.5 years in its investment portfolio. The company’s strategy of overseas business expansion also augurs well in terms of de-risking the business mix. .

HDFC Bank
HDFC Bank has consistently shown a consistent growth of 30 per cent in earnings for the past several quarters. However, the 100 per cent increase

in general provisions on unsecured retail, capital market and real estate loans is expected to impact the bank as they account for about 30 per cent of its loans. However, the negatives are compensated by high share of CASA due to a robust deposit base. Analysts have a neutral view on the bank.

ICICI Bank

ICICI Bank has posted rapid growth in the past three years. However, it could be affected due to its high reliance on wholesale term deposits on one hand and impact of slowdown in retail lending on the other (as it contributes about 60 per cent of its loans). However, analysts say that beyond the core banking business, investors should also value its investment stakes in insurance, mutual fund and venture capital subsidiaries, all of which are growing at a robust pace.

Punjab National Bank

The banks' higher proportion of low cost deposits (CASA ratio) of about 50 per cent is its biggest strength and thus makes it a safe investment in a rising interest rate scenario. Moreover its net interest margins of over 3.5 per cent is also one of the highest in the industry and is expected to expand further. Though the bank has transferred majority of its investment portfolio to AFS category, the high duration of about 3 years remains a concern.

State Bank of India

The country's largest bank, State bank of India, has the biggest advantage of its large distribution network with over 9000 branches and high CASA ratio. Moreover it has excess SLR of 3-4 per cent over the statutory minimum of 25 per cent which provides liquidity in a monetary tightening scenario. However the biggest trigger lies in its stakes in the associate banks and non-banking subsidiaries like life insurance, mutual funds and credit cards.