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Too fast, too furious

In desperate measures to curb inflation, the Reserve Bank of India (RBI) has increased the repo rate by 50bps to 8.5% (with immediate effect) and cash reserve ratio (CRR) by 50bps (in two stages) to 8.75%.

The language has turned more hawkish with the inflation fighting has taken the overriding priority for the RBI with the growth moving to sidelines. While in the annual monetary policy statement 2008-09, the RBI had taken cognizance of the improvement in the supply side, the statement accompanying the recent hike suggests that the demand side pressure have overridden them.

The RBI has further kept the doors open for further rate hikes as it says *"In view of the criticality of anchoring inflation expectations, a continuous heightened vigil over ensuing monetary and macroeconomic developments is warranted to enable swift responses"*.

We have downgraded our earnings estimates and book value estimates for the banks under our coverage by 2-9% and 0.5-2.0% respectively taking the above factors into account. We have also downgraded our target prices in range of 9-18% taking into account (a) downgrades in the earnings and book values and (b) contraction in the P/ABV multiple.

RBI raises key rates

Within a span of two weeks the RBI has swung into action again raising the repo rate by 50bps to 8.5% and the CRR by 50bps to 8.75%. The move comes on back of 25bps rise in repo rate on June 11, 2008.

Effective date	CRR
05-Jul-08	8.50
19-Jul-08	8.75
Repo rate	
Immediate effect	8.50

Source: RBI

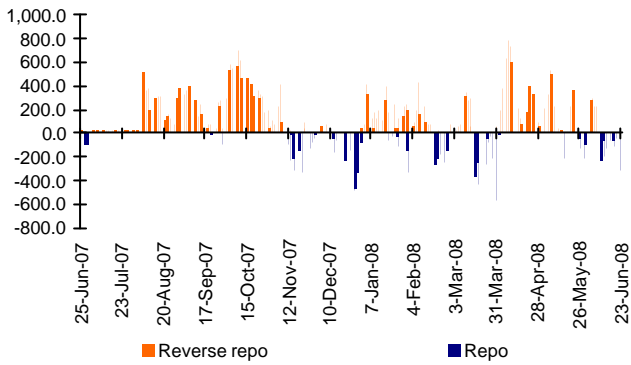
The language turns more hawkish

The language has turned more hawkish with the RBI in a way conceding that the demand side pressures are getting stronger and supply side improvements are not able to impact fully due to rising oil prices.

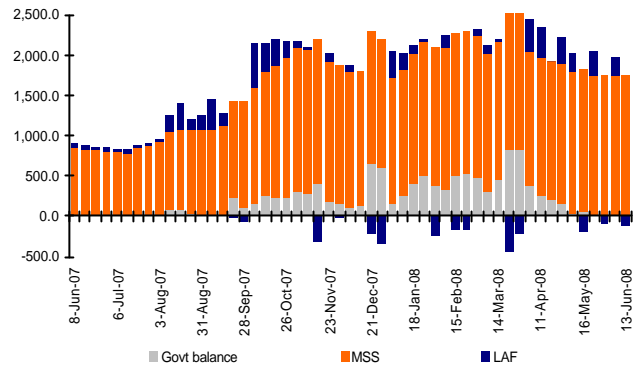
Flow back of advance tax money may not help liquidity

While the liquidity has been comfortable till first fortnight of June 2008, the advance tax on June 15, 2008 have dried the excess liquidity. With a hike of 50bps in CRR, we believe that the excess liquidity will continue to remain lower despite the advance tax money flowing back into the system through government spending over next few days.

Repo and Reverse Repo volumes (Rs bn)



Total excess liquidity (Rs bn)



Source: RBI, Emkay Research

Increase in PLR of 25bps a must now for PSU banks

We believe that with pressure on liquidity and increase in the repo rate, the banks will have to raise PLRs to mitigate the impact of 75bps increase in CRR over Q1FY09 and 75bps increase in repo rate. However, we have not taken any PLR hikes in our revised numbers as the PSU banks may not be able to do so for a while under political pressure.

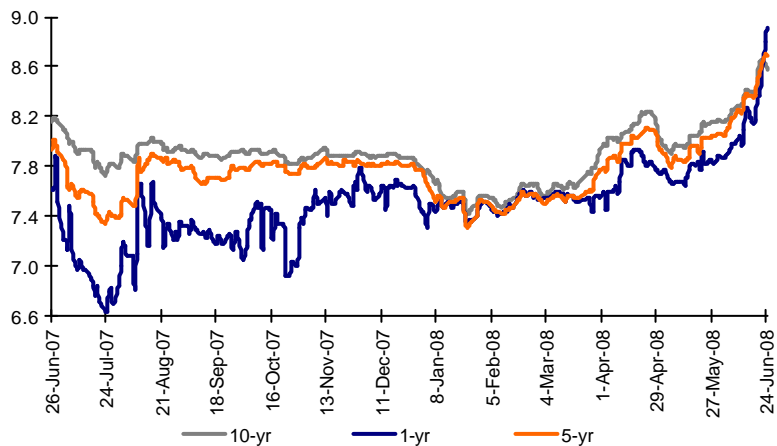
Credit quality – key monitorable

While the credit quality has not taken a beating for most of the banks till date (except for a few), we believe that with any upward pricing of loans from hereon, the credit quality may suffer. Some of private sector banks like ICICI Bank and HDFC Bank have already started witnessing stress on high priced non-collateralised portfolio. With rise in PLR, deterioration in other portfolios can not be ruled out.

Bond yields to remain high – but no significant impact on MTM

While we expect the bond yields to continue to remain high, the impact of MTM losses on the banks' profitability may not be meaningful with lower proportion of AFS securities in the investment portfolio. We have taken the 10-year bond yield at 8.7% in our assumptions.

Repo and Reverse Repo volumes (Rs bn)



Source: Bloomberg

RBI to remain open to further hikes

The hawkish stance of the RBI in the statement released alongwith the policy rate hikes indicates that the RBI may not be done with the monetary tightening in the economy. Targeting of the inflation and inflationary expectations has become 'overriding priority' for the RBI.

Revising numbers and price targets – valuations compelling

We have downgraded our earnings estimates and book value estimates for the banks under our coverage by 2-9% and 0.5-2.0% respectively taking the above factors into account. We have also downgraded our target prices in range of 9-18% taking into account (a) downgrades in the earnings and book values and (b) contraction in the P/ABV multiple.

We believe that in anticipation of severe monetary tightening, the banking stocks also have seen steep correction and are currently quoting at their four year low valuations which we find very attractive.

Even at our target P/ABV most of the PSU banks are at 1.1-1.5x P/ABV and private sector banks are at 1.8-3.1x P/ABV. Our top picks – ICICI Bank, BOI, Axis Bank, HDFC Bank and BOB.

Earnings revisions

	New EPS (Rs)		% Change		New ABV (Rs)		% change	
	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
Allahabad Bank	18.1	23.7	-6.7	-3.3	105.4	125.8	-1.2	-1.6
Andhra Bank	12.7	16.6	-2.9	-2.6	75.1	88.0	-0.5	-0.9
Axis Bank	39.6	51.8	-7.8	-5.3	273.8	322.1	-1.2	-1.9
Bank of Baroda	37.8	45.6	-6.8	-7.0	290.1	329.6	-1.3	-2.0
Bank of India	46.8	58.0	-2.4	-2.2	197.6	250.5	-0.6	-1.0
Canara Bank	29.0	37.7	-10.5	-5.3	198.2	224.7	-1.7	-2.4
Corp Bank	49.7	61.8	-6.9	-6.5	335.1	402.5	-1.2	-2.0
HDFC Bank	44.8	79.5	-1.6	-0.9	349.3	485.4	-1.6	-1.8
ICICI Bank	46.4	61.1	-6.0	-6.0	430.5	479.6	-0.8	-1.1
PNB	69.9	87.5	-4.0	-1.5	372.5	448.7	-0.8	-0.9
SBI	119.2	144.7	-2.8	-1.2	746.9	845.7	-0.4	-0.6
UBI	25.0	31.1	-3.9	-2.4	131.4	153.9	-0.8	-1.1
Yes Bank	9.4	15.1	-3.4	-4.7	63.8	75.8	-0.5	-1.4

Price target revisions

	CMP (Rs)	Reco	Old target price (Rs)	New target price (Rs)	PER (Rs)		P/ABV (Rs)		Target P/ABV (x) FY10E
					FY09E	FY10E	FY09E	FY10E	
Allahabad Bank	58	BUY	170	130	3.2	2.5	0.6	0.5	1.1
Andhra Bank	59	BUY	110	100	4.6	3.5	0.8	0.7	1.1
Axis Bank	679	BUY	1,200	1,000	17.2	13.1	2.5	2.1	2.8
Bank of Baroda	211	BUY	440	330	5.6	4.6	0.7	0.6	1.0
Bank of India	217	BUY	425	375	4.6	3.7	1.1	0.9	1.5
Canara Bank	184	REDUCE	228	185	6.3	4.9	0.9	0.8	0.8
Corp Bank	256	BUY	470	395	5.1	4.1	0.8	0.6	1.0
HDFC Bank	1,060	BUY	1,700	1,500	23.7	13.3	3.0	2.2	3.1
ICICI Bank	705	BUY	1,600	1,300	15.2	11.5	1.6	1.5	1.8
PNB	421	BUY	595	515	6.0	4.8	1.1	0.9	1.1
SBI	1,212	BUY	2,200	1,930	10.2	8.4	1.6	1.4	1.3
UBI	116	BUY	240	210	4.7	3.8	0.9	0.8	1.3
Yes Bank	135	BUY	260	225	14.4	9.0	2.1	1.8	2.5

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