Banking

BSE Sensex: 14,003 | S&P CNX: 4,113 | 13 June 2007

FY08 would be a year of significant capital raising by the financial sector, driven by tougher regulatory requirements and significant loan growth ahead. While private players like HDFC, HDFC Bank and UTI Bank would be able to raise equity at substantial premium to their book value, we believe that the urgent necessity of regulatory compliance might prompt some state-owned banks to dilute equity at prices close to their book value. Amongst state-owned banks, we expect State Bank of India, Bank of India and Syndicate Bank to raise capital during FY08. We are positive on banks that can raise capital at higher premium, where RoEs would bounce back in a couple of years as they leverage the new capital.

For most state-owned banks, capital raising might be return-dilutive: With their Tier-I ratios nearing 6%, the level recommended by RBI under the revised Basel II guidelines, we expect several state-owned banks to approach the capital markets in 2HFY08 and 1HFY09. Unlike private banks, we do not expect capital raising to be at a substantial premium. Capital raising by most state-owned banks would be return-dilutive.

Issues by private entities would be book value accretive: Private banks are likely to raise capital at substantial premium to book value. Thus, capital raising is likely to be substantially book-accretive for private banks. While HDFC has raised capital at 7.9x FY07 BV (5.6x adjusted for value of subsidiaries). We expect HDFC Bank to raise capital at 5.7x FY07 BV, UTI Bank at 4.8x FY07 BV and ICICI Bank at 3.4x FY07 BV. Considering the relatively higher premium to book value commanded, the impact of equity dilution on HDFC Bank and UTI Bank would be lower than on ICICI Bank.

Prefer banks with positive traction in RoE: When banks raise capital at a hefty premium to their book value, it results in an increase in their book value per share, benefiting the current shareholders. Though the capital raising brings down immediate return ratios, it also increases the leverage potential for the banks. As they build up their asset books, the return ratios improve. Our top picks are HDFC, HDFC Bank and UTI Bank among the private players, and State Bank of India, Bank of India and Union Bank among the state-owned banks.

TOP PICKS

				FY09E							
PRICES AS ON 13 JUNE 2007	CMP (RS)	MKT. CAP (RS B)	MKT. CAP (US $ B)	EPS (RS)	BV (RS)	P/E (X)	P/BV (X)	ROE (%)	TARGET PRICE (RS)	UPSIDE (%)	TARGET P/B (X)
Private Entities*											
HDFC	1,751	443	10.8	86.7	476	14.4	2.6	21.2	2,235	28	20x EPS+500
HDFC Bank	1,083	346	8.4	60.1	393	18.0	2.8	16.6	1,373	27	3.5x
UTI Bank	585	163	4.0	34.0	251	17.2	2.3	14.3	750	28	3x
State-Owned Banks											
State Bank of India (cons)	1,289	678	16.5	160.4	1088	8.0	1.2	16.7	1618	25	1.4x+100
Bank of India	183	89	2.2	33.2	161	5.5	1.1	21.4	258	41	1.6x
Union Bank of India	113	57	1.4	25.9	129	4.4	0.9	20.3	167	48	1.3x

** Multiple and target price based on diluted nos* *Source: Motilal Oswal Securities*

For HDFC, P/E and P/BV after adjusting for subsidiary value of Rs500/share

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FY08 would be a year of significant capital raising by the financial sector, driven by tougher regulatory requirements and significant loan growth ahead. While private players like HDFC, HDFC Bank and UTI Bank would be able to raise equity at substantial premium to their book value, we believe that the urgent necessity of regulatory compliance might prompt some state-owned banks to dilute equity at prices close to their book value. Amongst state-owned banks, we expect State Bank of India (SBI), Bank of India (BoI) and Syndicate Bank to raise capital during FY08. We are positive on banks that can raise capital at higher premium, where RoEs would bounce back in a couple of years as they leverage the new capital.

Financial sector to raise US$10b of capital in FY08

The financial sector is set to raise over US$10b of capital in FY08 to support strong perceived growth and to meet tougher regulatory requirements due to the approaching Basel-II. Most private banks have already announced their plans and are in the process of raising capital. We also expect a number of state-owned banks to approach the capital markets in the second half of the year.

BANKS TO RAISE OVER US$10B CAPITAL IN FY08

	CMP (RS)	RAISING (RS B)	RAISING (US$B)	DILUTION (%)
ICICI Bank	913	200	5.0	28.0
HDFC Bank	1,083	42	1.0	12.3
UTI Bank	585	42	1.0	26.0
SBI	1,289	62	1.5	8.0
Syndicate Bank	71	6	0.1	15.0
Central Bank of India	-	7	0.2	25.0
HDFC	1,751	31	0.8	13.5
IDFC	106	21	0.5	15.0
Total		**411**	**10.0**	

Source: Motilal Oswal Securities

RBI recommends a minimum Tier-I CAR of 6%...

RBI has recommended a minimum Tier-I CAR of 6% under the revised guidelines, up from the earlier 4.5%. Most banks have enough room for growing Tier-I by raising perpetual bonds. However, we understand that the higher coupon rates on these perpetual instruments are making them less popular. (HDFC Bank raised Rs2b perpetual bonds at an annualized rate of 9.92%, payable semi-annually).

ROOM TO RAISE INNOVATIVE TIER I INSTRUMENTS (RS M)

	HDFC BANK	UTI BANK
Tier I Funds on March 2007	63,527	36,362
Cap on Perpetual bonds	9,529	5,454
Perpetual Bonds on March 2007	2,000	4,140
Room for Further Perpetual Bonds Issue	7,529	1,315
% of Tier I Funds on March 2007	*11.9*	*3.6*

Source: Company/Motilal Oswal Securities

With their Tier-I ratios nearing 6%, Syndicate Bank, BoI and Canara Bank would look to raise equity capital in the next 6-18 months. So far, only Syndicate Bank has announced its plans to dilute equity during FY08; we expect BoI and SBI to follow. The managements of Union Bank and Canara Bank have indicated that they would dilute equity only post FY08.

STATE-OWNED BANKS TO NEED CAPITAL

	GOVT. HOLDING (%)	TIER 1 RATIO (FY07 %)
Syndicate Bank	66.5	6.2
Bank of India	69.5	6.5
Canara Bank	73.2	7.2
Union Bank (I)	55.4	7.8
SBI	59.7	8.0
IOB	61.2	8.2
Bank of Baroda	53.8	8.7
PNB	57.8	8.9
Andhra Bank	51.6	10.0
OBC	51.1	10.1
Corporation Bank	57.2	10.5

Source: Company/Motilal Oswal Securities

…in cognizance of tougher regulatory requirements

The revised Basel-II guidelines are stricter than expected earlier. In fact, the draft Basel-II guidelines would have saved some capital for banks. However, under the revised guidelines, banks may lose 50-150bp of capital depending upon their loan book composition. Further, banks having an international presence have to comply with Basel-II by March 2008, while others need be compliant by March 2009.

So far, banks provide capital to cover credit risk and market risk, only. Under Basel-II they would be required to set aside additional capital for operational risk as well.

- **Credit risk: required capital could increase starting FY09**
  Key considerations in revised Basel-II
  - Under the revised guidelines, all unrated non-retail advances would attract a risk weight of 100% for FY08 (same currently) and retail advances (i.e. advances below Rs50m but excluding personal loans, credit cards, commercial real estate, capital market exposure and claims secured by residential properties) would attract 75% risk weight (against 100% currently).
  - In FY09 all unrated non-retail advances above Rs500m would attract 150% risk weight; in FY10 the threshold of Rs500m would be reduced to Rs100m. The sensitive segments like commercial real estate, credit cards and personal loans would continue to attract higher risk weights of 125-150%.

- Banks will take a hit on capital due to the new requirement of applying risk weights to the undrawn credit limits. So far, there was no risk weight attached to this item. Banks would, thus, have to compile data of their total undrawn sanctions to arrive at an exact loss of capital due to this requirement.

- Banks with higher retail assets (as defined above) may see some release of capital in FY08, while their capital requirement for non-retail assets would remain practically unchanged even if that portfolio is unrated.

- Thus, for FY08, the capital adequacy ratio (CAR) may improve on account of credit risk for many banks.

- However, as the risk weight on unrated non-retail advances would increase from FY09, to prevent deterioration in their CAR, bankers would have to progressively persuade clients to get themselves rated. As lending to corporate clients having a rating above BBB would attract a risk weight lower than 100%, banks could witness some capital release if they succeed in persuading corporate clients to get rated.

- **Market risk: no impact**

There is practically no difference under the revised Basel-II and the practices currently followed by the banks. Thus, there would neither be a release nor an incremental demand for capital to cover market risk under the revised guidelines.

- **Operational risk: would dent CAR**

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Banks would have to set aside capital for operational risk under the basic indicator approach to begin with. They would have to set aside 15% of the average net operating income (NII + Other Income) for the past three years as a capital charge towards operational risk. So far, banks have not been setting aside capital for operational risk.

IMPACT OF PROVISION FOR OPERATIONAL RISK - A DENT TO CAPITAL ADEQUACY

	HDFC BANK	UTI BANK	UNION BANK
FY07 CAR (%)	13.09	11.57	12.80
Tier I (%)	8.58	6.42	7.79
Tier II (%)	4.51	5.15	5.01
FY07 Risk Weighted Assets (RWAs) - Rs m	740,819	566,434	644,939
RWA For Operational Risk - Rs m	62,916	30,734	50,979
FY07 RWAs Inclduing Operational Risk - Rs m	803,735	597,167	695,918
Revised CAR (%)	12.06	10.98	11.87
Tier I (%)	7.90	6.09	7.22
Tier II (%)	4.16	4.89	4.65
Impact on CAR of Operational Risk (bp)	103	59	93

Source: Motilal Oswal Securities

HDFC BANK: IMPACT OF OPERATIONAL RISK (FY07) - (RS M)

Credit Risk Weighted Assets (CRWAs)	656,248
Market Risk Weighted Assets (MRWAs)	84,571
Total RWAs	740,819
a) Average NOI (FY05-07)	37,750
b) Operational Risk (a*15%)	5,662
c) Risk Weighted Assets for Opertional Risk (ORWAs) (b/9%)	**62,916**
Restated RWAs FY07 including ORWAs	803,735
Total Capital Funds (Tier I + Tier II)	96,927
CAR ex-ORWAs (%)	13.1
CAR cum ORWAs (%)	12.1
Dent on CAR due to Operational Risk (bp)	**103**

Source: Motilal Oswal Securities

In a nutshell

The revised Basel-II may not have a material impact on CAR for FY08, as capital release on retail assets would partly offset increased capital requirements for operational risk. The loan book composition of each bank would determine the quantum of offset. Banks with higher retail assets (as defined above)– SBI, Union Bank – would benefit more.

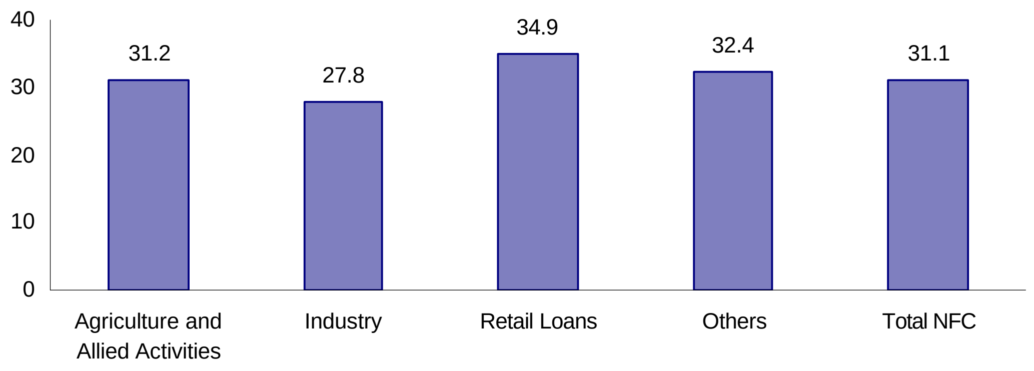
Starting FY09, banks would have to persuade their big corporate clients to get rated; else, credit risk might pose a dent to capital. State-owned banks with higher exposure to big corporate clients could benefit substantially if they are able to persuade them to get rated. Most of their big corporate clients would be rated BBB or above, attracting a risk weight of just 20%-50%. Thus, such banks could witness significant release of capital.

A huge loan growth opportunity is perceived

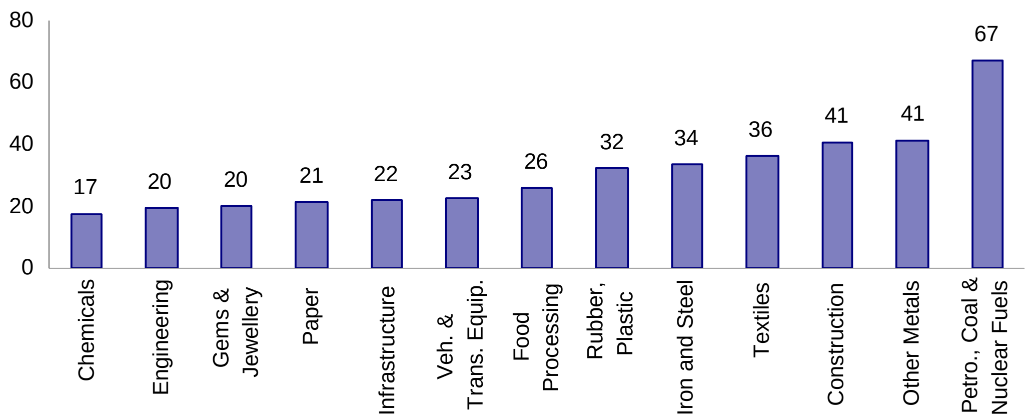
The Indian economy continues to be buoyant and the demand for institutional loans from both the infrastructure and corporate segments is likely to remain robust. To support the perceived huge loan growth opportunity, banks would require additional funds. This is the key reason that the managements of most banks that have announced their capital raising plans cite for approaching the markets.

CREDIT GROWTH CONTINUES TO BE ROBUST

SECTORIAL CREDIT GROWTH (DEC-06; % YOY)



CREDIT GROWTH ACROSS INDUSTRIES (DEC-06; % YOY)



Source: RBI

We estimate loan growth for the banking sector at 25% in FY08. Banks are finding it increasingly difficult to raise resources through alternate means and the difference between the cost of raising debt and capital has reduced. While raising capital is still expensive, we believe that banks would like to capitalize themselves in good times and could actually raise more capital than actually required.

For state-owned banks, capital raising might be return-dilutive

For state-owned banks, the capital raising could be return-dilutive, as their equity issues are unlikely to command a substantial premium to book value. However, we expect SBI and BoI to command a higher premium than other state-owned banks, as reflected in their current P/BV multiples.

CAPITAL DILUTION – AT A PRICE NEAR BOOK VALUE FOR STATE-OWNED BANKS

	ISSUE SIZE (RS B)	ISSUE PRICE (E) (RS)	FY07 BV (RS)	P/BV FY07 (X)
State Bank of India	62	1,400	808	1.7
Bank of India	15	220	113	1.9
Syndicate Bank	6	80	61	1.3

Source: Motilal Oswal Securities

CAPITAL DILUTION NOT SIGNIFICANTLY BOOK VALUE ADDITIVE

FY09E	PRE ISSUE	POST ISSUE	PRE ISSUE	POST ISSUE	PRE ISSUE	POST ISSUE
	BOOK VALUE (RS)		P/B (X)		ROE (%)	
State Bank of India	771	847	1.7	1.5	16.4	14.6
Bank of India	161	182	1.1	1.0	21.4	18.3
Syndicate Bank	88	99	0.8	0.7	19.7	17.6

Source: Motilal Oswal Securities

Issues by private entities, however, would be book value accretive

Private banks are likely to raise capital at substantial premium to book value. Thus, capital raising is likely to be substantially book-accretive for private banks. While HDFC has raised capital at 7.9x FY07 BV (5.6x FY07 BV adjusted for subs value), HDFC Bank would raise capital at 5.7x FY07 BV, UTI Bank at 4.8x FY07 BV and ICICI Bank at 3.4x FY07 BV. Considering the relatively higher premium to book value commanded by them, the impact of equity dilution on HDFC Bank and UTI Bank would be much lower than on ICICI Bank.

CAPITAL DILUTION - TO HAPPEN AT A SIGNIFICANT PREMIUM TO BOOK VALUE FOR PRIVATE PLAYERS

	ISSUE SIZE (RS B)	ISSUE PRICE (E) (RS)	FY07 BV (RS)	P/BV FY07 (X)
HDFC	31	1,730	219	7.9
HDFC Bank	42	1,150	201	5.7
ICICI Bank	200	935	271	3.4
UTI Bank	42	575	120	4.8

Source: Company/Motilal Oswal Securities

CAPITAL DILUTION TO INCREASE BV SIGNIFICANTLY ... BUT BRING DOWN ROE IN SHORT TERM

FY09E	PRE ISSUE	POST ISSUE	PRE ISSUE	POST ISSUE	PRE ISSUE	POST ISSUE
	BOOK VALUE (RS)		P/B (X)		ROE (%)	
HDFC	324	476	3.6	2.6	30.9	21.2
HDFC Bank	288	393	3.8	2.8	23.2	16.6
ICICI Bank	341	460	1.9	1.6	16.0	11.0
UTI Bank	175	251	3.3	2.3	23.4	14.3

Source: Motilal Oswal Securities

Issuance in foreign markets to command premium

State-owned banks (especially banks having reached their FII limit of 20%) would be raising higher proportion of their capital in domestic market while private players would target higher placements in international markets. Getting a significant premium in domestic markets is challenging. Thus, state-owned banks stand at a relative disadvantage.

LIKELY RAISING - DOMESTIC INVESTORS V/S INTERNATIONAL (RS B)

	ISSUE	DOMESTIC	INTERNATIONAL/FIIS
ICICI Bank	200	75	125
HDFC Bank	42	14*	28
UTI Bank	42	17*	25
SBI	62	50	12
Syndicate Bank	6	3	3
HDFC	31	0	31*
IDFC	21	0	21
Total	**404**	**133**	**271**

** Refers to private/preferential placements announced* *Source: Motilal Oswal Securities*

Prefer banks with positive traction in RoE

When banks raise capital at a hefty premium to their book value, it results in an increase in their book value per share, benefiting the current shareholders. Though the capital raising brings down immediate return ratios, it also increases the leverage potential for the banks. As they build up their asset books, the return ratios improve. Our top picks are HDFC, HDFC Bank and UTI Bank among the private players, and SBI, BoI and Union Bank among the state-owned banks.

BANKING: VALUATION MATRIX AND ORDER OF PREFERENCE

PRICES AS ON 13 JUNE 2007	CMP (RS)	MKT. CAP (RS B)	MKT. CAP (US$B)	FY09E EPS (RS)	FY09E BV (RS)	FY09E P/E (X)	FY09E P/BV (X)	FY09E ROE (%)	TARGET PRICE (RS)	UPSIDE (%)	TARGET P/B (X)
Private Banks											
UTI Bank*	585	163	4.0	34.0	251	17.2	2.3	14.3	750	28	3x
HDFC Bank*	1,083	346	8.4	60.1	393	18.0	2.8	16.6	1,373	27	3.5x
Federal bank	275	24	0.6	52.9	258	5.2	1.1	22.5	387	40	1.5x
ICICI Bank*	913	812	19.8	48.8	460	12.6	1.3	11.0	989	8	1.5x + 300
Karnataka Bank	170	21	0.5	22.4	136	7.6	1.2	17.7	177	4	1.3x
PSU Banks											
Bank of India	183	89	2.2	33.2	161	5.5	1.1	21.4	258	41	1.6x
State Bank of India (cons)	1,289	678	16.5	160.4	1,088	8.0	1.2	16.7	1,618	25	1.4x+100
Union Bank of India	113	57	1.4	25.9	129	4.4	0.9	20.3	167	48	1.3x
Punjab National Bank	488	154	3.8	80.0	441	6.1	1.1	19.1	617	26	1.4x
Indian Overseas Bank	111	60	1.5	25.4	110	4.4	1.0	25.1	153	38	1.4x
Syndicate Bank	71	37	0.9	17.7	88	4.0	0.8	19.7	97	38	1.1x
Andhra Bank	82	40	1.0	14.9	83	5.5	1.0	18.9	108	32	1.3x
Bank of Baroda	248	91	2.2	43.1	289	5.8	0.9	15.4	289	16	1x
Oriental Bank of Commerce	206	52	1.3	37.8	264	5.4	0.8	14.9	264	28	1.0x
J&K Bank	655	32	0.8	84.1	530	7.8	1.2	16.9	742	13	1.4x
Canara Bank	236	97	2.4	43.8	261	5.4	0.9	17.6	288	22	1.1x
Vijaya Bank	45	20	0.5	10.2	56	4.4	0.8	19.3	56	24	1x
Corporation Bank	291	42	1.0	52.6	335	5.5	0.9	16.7	335	15	1x
IDBI	98	71	1.7	10.7	111	9.1	0.9	10.1	108	10	0.7x + 30
Bank of Maharashtra	47	20	0.5	9.8	53	4.8	0.9	19.8	63	35	1.2x
Dena Bank	44	13	0.3	11.3	60	3.9	0.7	17.7	60	36	1x

** Multiple and target price based on diluted nos* *Source: Motilal Oswal Securities*

For ICICI Bank P/E and P/BV after adjusting for subsidiary value of Rs300/share

N O T E S

NOTES

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Disclosure of Interest Statement

The MOSt group and its Directors own shares in the following companies covered in this report: Dena Bank, Indian Overseas Bank and State Bank of India.

MOSt does not have a broking relationship with any of the companies covered in this report.

MOSt is engaged in providing investment-banking services in the following companies covered in this report: Nil