Earnings Review

Equity | India | Banks-Retail
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1QFY07 Results Review

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1QFY07 earnings ahead of estimates with better top line

Although bank earnings (yoy) were very volatile and all over the place, they were ahead of expectations and showed better top line growth. Key positive surprises:

- **Loan growth was stronger** than expected at +30% for most banks led by retail (still a key driver), SME and farm credit. Increasingly, we expect infrastructure-related lending to become more important. Balance sheet growth was modest as G-sec book shrank for many govt. banks.
- **Margins flat to up yoy** as loan yields rose sharply, surprising us on the upside, as banks appear to have already seen benefits of a rise in lending rates and repricing of their loan portfolios over past 6 months.
- **Uptick in fee growth at 15-20%,** in particular for govt. banks. It appears that the banks are finally managing to leverage their technology platforms that they have been rolling out.

Asset quality showing an 'amber' light

Asset quality, in contrast, is a key area where the amber light is coming on. The 1QFY07 results show a distinct slowdown in the *improving trend* seen in asset quality over the past few quarters. We may be close to the end of the best phase of the NPL cycle and as reiterated earlier, expect to see an uptick in the NPL cycle in possibly 12 months. But the uptick should be modest and manageable.

Easing rate concerns & improved earnings – key catalysts

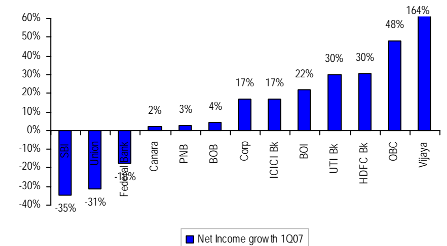
The key catalysts for the sector, going forward, are likely to be:

1. **Rise in lending rates** which should positively impact margins which have a greater impact on banks; profitability v/s loan growth
2. **Easing concerns of sharp rate hikes** post the 'pause' by US Fed. This, coupled with the possibility of slightly lower inflation, may prompt RBI to also moderate the rate hikes further resulting in downside risk to our forecast of the 10 year bond yields hitting 8.75% by Mar'07.
3. **Earnings to improve** in coming quarters and markedly in FY08 led by loan growth of +18%, improving margins and low investment hits.

Prefer private banks: ICICI Bk, HDFC Bk; SBI, PNB, UBI & BOI

We still prefer private banks as we still expect rates to rise and these banks are best positioned. In particular, we like ICICI Bank and HDFC Bank. Amongst govt. banks, our preferred plays are SBI and (ex-SBI) – PNB, UBI & BOI.

Chart 1: Volatile Earnings growth



Source: Company Reports

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1QFY07 Result Highlights

Earnings Ahead of Estimates & Better Quality

While the 1QFY07 results displayed a mixed bag of results, on balance, the bank earnings were better than we expected, especially the quality of the earnings appeared much better.

Net income growth was higher than estimates for most of the banks on account of

a) Strong loan growth at +30%, running ahead of our expectations (MLe 27-28%) despite rise in lending rates;

b) Stable to expanding margins driven by an unexpectedly sharp rise in loan yields, especially for many government banks.

c) A very visible pickup in fee income growth for government banks as they appear to seeing some benefits of their technology platforms that they have been rolling out over the past year; and

d) lower than estimated investment hits (due to a better hedged portfolio).

On the negative side

a) We saw some pressure beginning to come through on asset quality. The relative improvement in asset quality seen over the past few quarters appeared to be slowing down, although it may be early to identify this as a trend/signs of the expected uptick in the NPL cycle.

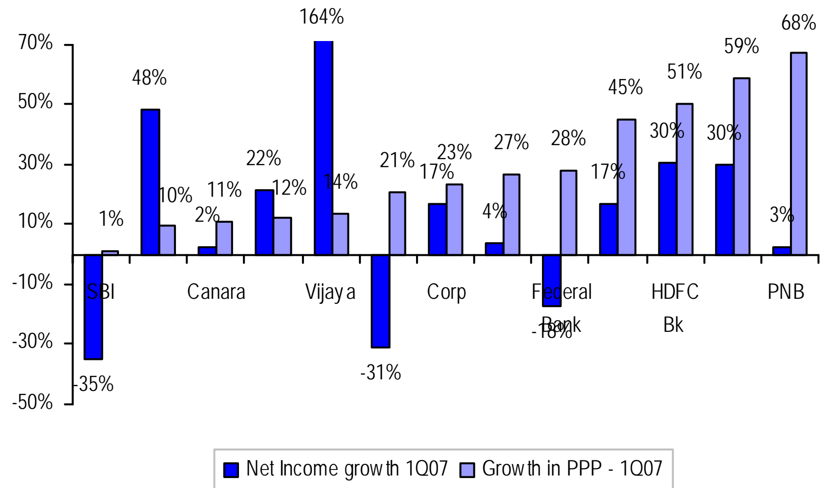
b) Operating expense growth was higher than expected for many banks owing in part to the base effect (as banks had begun to take the wage provisions only from the 2Q of FY06) and higher marketing spend.

Net Income Volatile; Core Earnings Resilient

Bottom line growth varied a lot due to base effects and investment hits in 1QFY07 but core operating profit growth for most of the government banks was around 10-20%yoy, while for private banks it was around 50% yoy as loan growth for most banks continued to be higher than our estimates while margin expansion surprised positively as banks gained pricing power. Most importantly, fee income started picking up as banks started leveraging their technology platform.

PNB reported the highest operating profit growth (68%yoy) on the back of a strong top line, sharp rise in fee income and lower operating expenses (the last due to a high base in 1QFY06). In contrast, SBI appeared to show the worst reported growth in earnings but its operating earnings were largely in line and marginally up yoy.

Chart 2: Improving Quality of Earnings



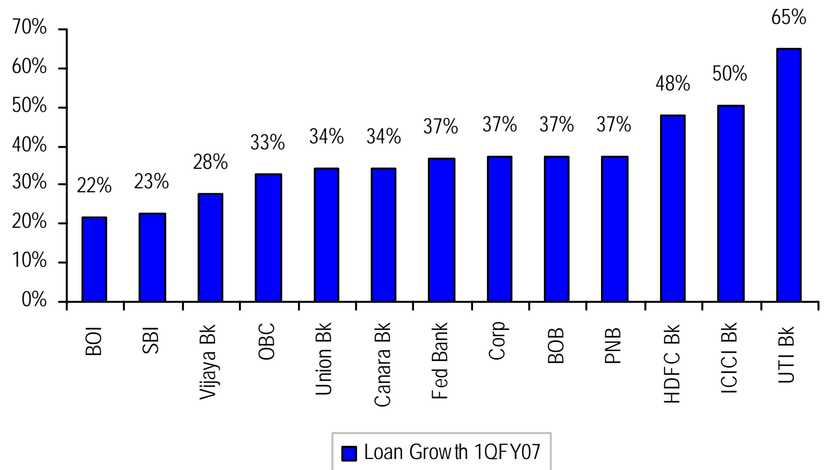
Source: Company Reports

Loan growth ahead of estimates; Likely to decelerate

Loan growth in 1QFY07 continued to be +30%yoy for most banks (45-50% for private banks), higher than our estimates of 27-28% (24-25% for full year). This was despite a 100-150bps hike in lending rates over the past six months. While retail credit demand sustained at around 25-30% (there is some slowdown in the incremental growth rate) the corporate credit is estimated to have picked up.

While loan growth for private sector banks continued to be driven by retail credit, most government banks reported non-retail credit growth at par or higher than retail loan growth. This reinforces our view that government banks, given their vast network and strong relationships, are more leveraged to a pickup in non retail credit, especially SME and farm, which have been the principal drivers.

Chart 3: Loan Growth



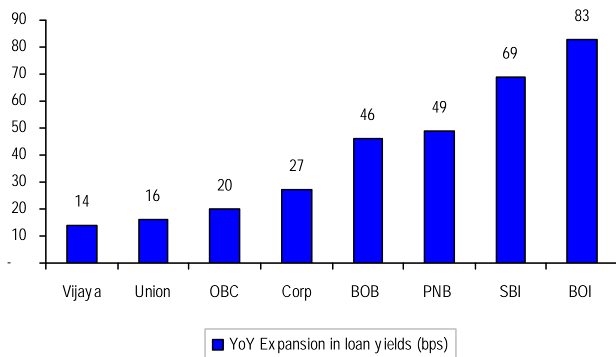
Source: Company Reports

Expansion of Loan Yields much higher than estimated; Margins appear to be flat to expanding

A more positive development in the 1QFY07 was the rise in loan yields, which was a result of the recent lending rate hike done by the bank but more importantly also displayed that banks are regaining the pricing pressure on the corporate loan book.

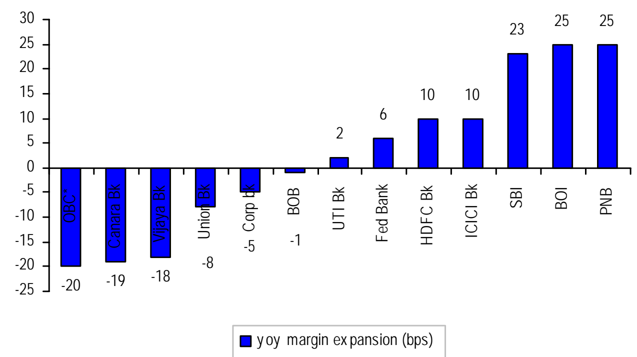
Despite strong concerns on margins, only 3 banks in our coverage showed a sharp margin contraction owing to fall in investment yields. In contrast, many government banks reported flat to higher margins (both over 1QFY06 and over 4QFY06 levels) due to rising loan yields and reducing reinvestment risk on the investment portfolio.

Chart 4: Loan Yields Expansion, YoY



Source: Company Reports

Chart 5: Net Interest Margin Expansions / Contraction, YoY



Source: Company Reports

Loan growth to decelerate; margin could surprise on upside

We remain positive on the FY07 loan growth outlook, although we expect it to decelerate relative to its present levels. We are forecasting loan growth of 23-24% for FY07 relative to the +30% currently. Growth, at the margin, would be driven by incremental spending on infrastructure projects and retail.

However, we believe the growth momentum could decelerate sharply in FY08 as lending rates rise and loan growth could fall to around the 18% level by FY08, especially if some of the infrastructure projects are impacted by rising rates.

Margins could, however, surprise on the upside on the back of a sharp rise in lending rates as banks benefit from higher spread on their low-cost demand deposits (CASA) and the rising bond yields also reduce the repricing risk on the investment portfolio.

Banks' profitability appears more sensitive to margins v/s loan growth

The profitability of banks, in our view, appears more sensitive to margin changes versus changes in loan growth. We estimate bank earnings change by around 5-6% for every 10bps change in margins, while loan growth needs to contract by almost 10-12 percentage points to have the same impact. To that extent we reckon it is more likely that we could see margin movements of 8-10bps v/s loan growth changes of +10 percentage points for a similar impact on earnings.

Fee income picking up; Higher treasury gains

Most of the government banks reported fee income growth of 15-25% as the banks appear to be getting the benefits of leveraging their technology platform. For instance,

a) **Leveraging technology platform.** Banks are able to more effectively levy charges in areas like account maintenance fees, minimum balance charges following a CBS (technology driven) platform as this ensures minimum error on levying these charges on every account. Earlier it was done through manual accounting and there was some oversight, resulting in shortfall.

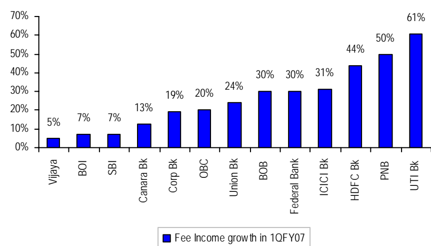
b) **Increased cross sell** of various products to their existing client base

c) **Distribution of third party products** including insurance and mutual funds

d) **Rise in fund based fees.** Banks have also benefited from a rise in fund based linked fees arising from L/Cs, guarantees etc, which are rising rapidly in sync with the loan growth coupled with emergence of pricing power on fees.

e) **Expanding current a/c biz.** Implementation of CBS has enabled banks to grow their current account business (all banks that are leading in technology implementation have shown an improvement in proportion of high cost demand deposits) that gives them float and also fee revenues.

Chart 6: Rising Fee income



Source: Company Reports

Private banks continued to report healthy fee income growth of 30-50% on the back of an expanding client base; however, the incremental growth rate got moderated owing to the correction in equity markets (significant fees come from distribution of third party products like mutual funds etc).

Amongst the government banks, while PNB surprised the most on the upside (fee income up 50%yoy) it was, in our view, also partly due to a change in accounting norms. On the other side, fee income growth for SBI was disappointing (up 7%yoy). However, a large part of that was owing to the base effect as in 1QFY06 the commission rates on government business were higher which were subsequently reduced from 2QFY06 onwards, and then hiked again from 4QFY06 (though kept at 10% lower than the initial levels).

Treasury gains; Recoveries in written off accounts drive other income

A few banks (like SBI, OBC) also showed a yoy growth in treasury gains, which came in as a surprise given the volatile debt and equity market conditions. These gains, in our view, were mainly booking of unrealized gains on some of the high yielding securities and are accordingly likely to result in pressure on investment yields in coming quarters. We have factored the same in our estimates.

Reported non-interest income for many banks was significantly higher than the fee income growth largely on the back of a rise in recoveries from written off NPL accounts (which are recognized as other income).

Higher Operating Expenses Disappoint; Efficiency Likely to Improve

Total operating expenses for most government banks grew 15-20% yoy due to

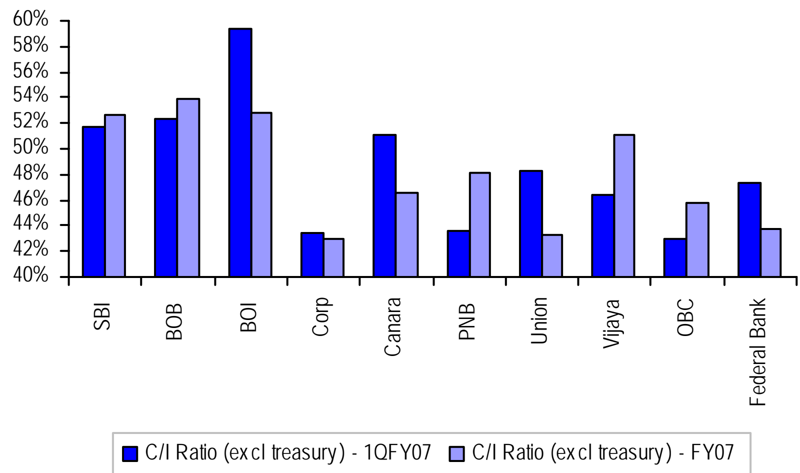
a) the base effect of the wage hike (the wage hike was not captured in the 1QFY06) and

b) Increased spend on technology ramp-up

Private banks reported operating expenses growth of 40-50%yoy (in synch with their revenue growth) due to increasing spend on expansion of their distribution network.

We, however, expect the C/I ratio for banks to improve in coming quarters owing to both a) an expected rise in the top line and fee income, and b) relatively lower growth in operating expenses as banks benefits from absence of wage hike pressures. A few banks, like PNB and OBC, should have higher C/I ratio for FY07 (v/s 1QFY07) due to base effect; however should still have a 400-500bps improvement for the full year v/s FY06.

Chart 7: Improving Operating Efficiency



Source: Company Reports

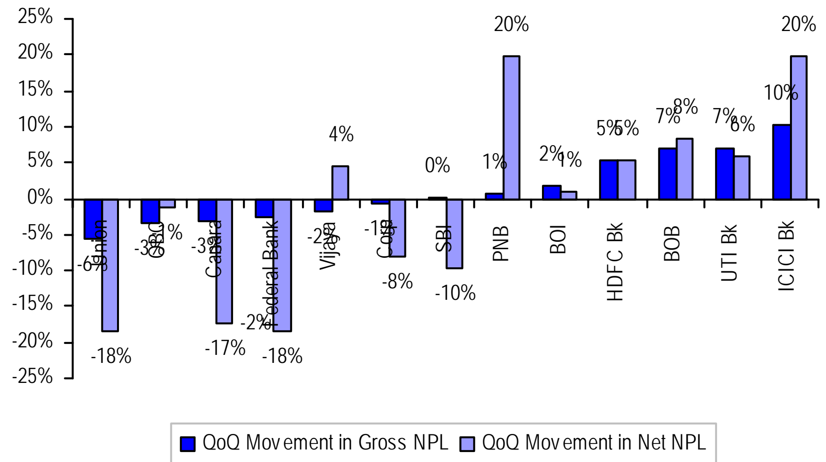
Asset quality improvement slows down

In 1QFY07 banks saw some pressure on asset quality as some of the banks reported an uptick in fresh NPLs (with gross NPLs rising) while for other banks the qoq decline in gross NPLs slowed down. While this many not still be fully indicative of an uptick in the NPL cycle but the relative improvement in NPL quality appears to be clearly slowing down.

Increase in NPL Provisioning; still running lower than estimates

While most of the banks reported a qoq increase in NPL provisioning (resulting in Net NPLs improving better than gross NPL), the absolute level of provisioning continued to be lower than our estimates as banks made lower provisions to offset the impact of investment hits (transfer hit and MTM hit on the AFS portfolio).

Chart 8: Uptick in Credit Cycle



Source: Company Reports

Investment hits volatile, but most banks' reported earnings better hedged

Investment hits continued to be volatile in the 1QFY07 on account of

a) Banks transferring further G-Sec from AFS to HTM

b) Sharp increase in MTM losses on the AFS portfolio due to a 60bps rise in bond yields in the 1QFY07 and also due to MTM losses on the equity portfolio

While on a yoy basis the investment provisions were lower for a few banks (as they had booked significantly higher transfer hits in 1QFY06), the absolute amount of investment hit for all the banks was around 50% of our full year estimates.

Going forward, however, we expect the investment hits to decline sharply as most banks are now well hedged against rising bond yields and also due to the likely muted expansion in bond yields over the next 9-12 months.

While private banks and government banks like Union Bank of India, Bank of India and State Bank of India are well placed, with around 90% of their G-Sec holding being in HTM, even most of the other government banks (except OBC and Canara) have around 65-70% of their G-Sec portfolio in HTM and have also significantly reduced the duration of their AFS portfolio.

In the table below we have highlighted each bank's vulnerability to rising bond yields; as highlighted, the most vulnerable banks are OBC and Canara Bank. Based on our sensitivity analysis every 10bps higher than estimated rise in bond yields would impact OBC and Canara Bank's earnings growth by 4% in FY07 and 2-3% in FY08.

Table 1: Sensitivity to Rising Bond Yields

	SBI	BOB	BOI	Corp Bk	Canara	PNB	UBI	Vijaya	OBC	Federal bank	HDFC Bk	ICICI Bk	UTI Bank
% of G-Sec in HTM	**79%**	**70%**	**81%**	**77%**	**40%**	**60%**	**91%**	**61%**	**33%**	**65%**	**83%**	**85%**	**90%**
% of G-Sec in AFS	21%	30%	19%	23%	60%	40%	9%	39%	67%	35%	17%	15%	10%
Duration of total portfolio (yrs)	3.5	4.0	3.6	4.2	4.3	4.5	4.0	4.5	4.1	5.0	2.2	2.3	1.7
Duration of AFS (yrs)	1.8	2.6	1.0	1.4	3.7	3.5	1.2	2.5	3.2	3.5	0.9	0.9	0.9
Int rate hedge	7.5%	7.5%	7.5%	8.0%	7.8%	7.5%	7.5%	7.5%	7.8%	7.70%	7.5%	7.5%	7.5%
10bps rise in yields > 8.35% in FY07 and 9% in FY08													
Impact on earnings - FY07	-0.6%	-1.5%	-0.3%	-0.7%	-3.7%	-2.0%	-0.2%	-2.0%	-3.9%	-1.46%	-0.3%	-0.3%	-0.3%
Impact on earnings - FY08	-0.4%	-0.8%	-0.2%	-0.7%	-2.9%	-1.3%	-0.2%	-1.7%	-2.3%	-0.99%	-0.2%	-0.2%	-0.2%

Source: Company Reports, ML Research Estimates

Draft guidelines on investment valuation (once implemented) to provide fillip to FY08 reported earnings

The Reserve Bank of India (RBI) came out with new draft investment guidelines which in essence change the accounting norms currently followed while marking to market G-secs (govt. securities) held in the AFS (available for sale) category and the method of interest calculation on new G-secs bought by banks. In effect:

a) All investment hits arising from mark to market of G-secs have to be routed through the balance sheet and *not* through the earnings, thereby providing a fillip to *reported* earnings.

b) The change in interest calculation would effectively raise the bank's net interest income (and hence margins) while reducing its capital gains.

These guidelines would provide a fillip to FY08 earnings (unlikely to impact book values), especially for banks like Canara Bank and Oriental Bank whose reported earnings, otherwise, would have been more vulnerable to rising bond yields. FY07 reported earnings would, however, continue to be under pressure as bond yield rise.

The aforesaid changes, if implemented, would, in our view, help remove much of the distortion in reported earnings that was arising from banks' marking to market their bond portfolios. The move is largely to align the norms in sync with those prevalent in most markets - even though it could be argued that it is somewhat less conservative. It would, in our view, help in reported earnings (adjusted for premia amortization) being more reflective of a bank's underlying profitability. This gains relevance in the Indian context, where we contend that bank stocks still, to a large extent, continue to be valued on reported earnings.

Private Banks Grow In Line

Private banks continued to grow in line with estimates, with loan growth driving strong top line growth. In line with government banks trend, most of the private banks also showed growth in interest income on advances in line with loan growth, reassuring our belief of hardening of lending rates even on the retail front. With a lower repricing risk on the investment portfolio, a rise in loan yields has also resulted in margin expansion for private sector banks.

Fee income growth for private sector banks also continued to be robust, driven by retail fees although the momentum slowed down due to correction in equity markets (key contributor to income from distribution of third party products).

FY07-08 Outlook

Earnings growth expected to rebound in FY08

We believe the worst in terms of earnings could be behind us for most banks, and expect bank earnings to improve in coming quarters, and more visibly in FY08, driven by

a) **Loan growth** (estimated at 24% in FY07 and 18% in FY08) driven increasingly by infrastructure related lending apart from retail and SME that may still continue to grow at +20% through FY08.

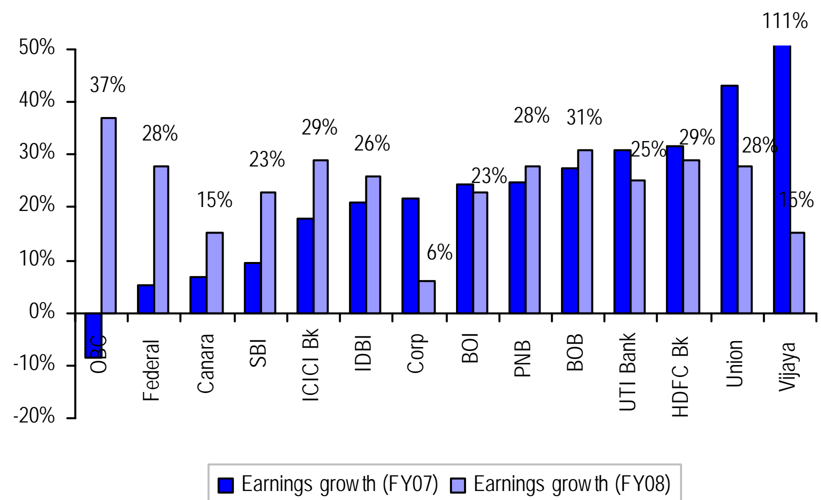
b) **Margin expansion** of 5-7bps due to rising lending rates which should positively impact margins owing to the ALM mismatch. Further, the reinvestment risk on the banks' investment portfolio is also diminishing.

c) **Fee income growth to sustain** at 15-20%yoy growth driven by increasing contribution from new areas like distribution of third party products, card fees and higher cross sell ratios for various retail products.

d) **Improving operating efficiency** as the top line grows much faster than the rise in operating expenses.

e) **Lower investment hits**: Going forward we expect a more moderate rise in bond yields, especially post the "pause" in the US Fed fund, resulting in sharply lower investment hits (due to absence of further transfer hits and minimal MTM loss on the AFS portfolio) in coming quarters and almost none in FY08 (if the new guidelines are implemented).

Chart 9: Earnings to Rebound in FY08



Source: Company Reports, ML Research Estimates

Hence, we expect banks' reported earnings to be volatile in FY07, rebounding to 20-40%yoy growth in FY08, especially if there are no investment hits (following the proposed RBI guidelines). The growth in core operating earnings is likely to be equally resilient at 20% yoy (in FY07 and FY08) for most government banks.

Private banks' earnings are estimated to grow at a buoyant pace, with both UTI Bank and HDFC Bank estimated to grow around 30% in FY07-08. ICICI Bank's earnings could grow by 18% in FY07 before rebounding by +29% in FY08.

A few banks like Corporation Bank, Vijaya Bank are likely to report sharp deceleration in earnings growth in FY08 due to lower treasury gains and a high base effect.

Factoring In Rising NPL Cycle

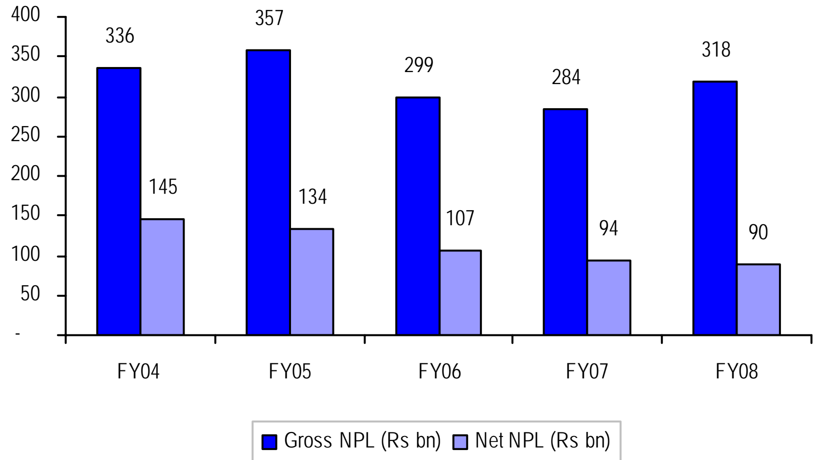
In the past three years the aggregate gross NPLs of banks in our coverage universe have declined 18% in absolute terms (most of it was in FY06) with rising recoveries and lower incremental slippages on back of a buoyant economy.

We believe we are currently in the best phase of the asset quality cycle and expect the cycle to show an upturn in next 12-18 months (we have seen some of that in 1QFY07) as the recoveries slow down and fresh delinquencies start rising (with loan growth also likely to slow down). The upturn is likely to be led by retail NPLs, including some mortgage NPLs. However, we believe the upturn is likely to be modest – unlike what we saw in the mid-90s as corporate balance sheets, in our view, are healthier today and leverage is much lower. Further, we continue to expect GDP growth and industrial growth to be well above 7% through FY07-08.

We have accordingly factored in a +20% yoy increase in fresh slippages in FY07 and FY08 and expect the total gross NPLs (for banks in our coverage universe) to increase 16% by FY08. However, gross NPLs as a % of advances are still likely to decline for most banks due to the strong loan growth.

On the positive side, we expect the level of net NPLs for most banks to remain at <1% (decline 15-20% in absolute terms over FY06-08) as banks are likely to have adequate operating earnings to set aside the higher provisions that may be required.

Chart 10: Asset quality trend



Source: Company Reports, ML Research Estimates

Valuations - Which Banks To Play

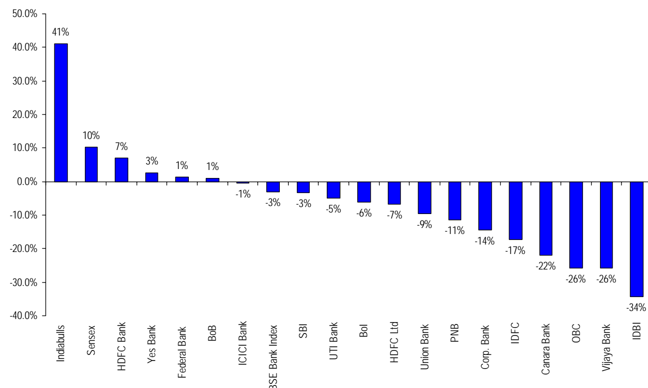
Banking stocks have outperformed the market in the past month on the back of

a) Stronger than expected 1QFY07 results, and

b) Expectations of a "pause" in the interest rate hikes by the US Fed raising expectations that the Reserve Bank of India (RBI) may 'pause'. While we still expect rates to continue to rise, the rate hike could be more modest, going forward, especially if the external environment triggers become more benign. Rate hikes would then principally be driven by the strong credit growth.

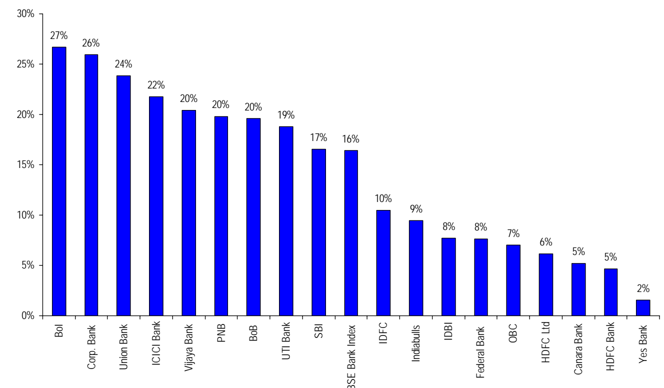
Over the past month most banking stocks have outperformed the benchmark Sensex, with the relatively better positioned banks (against rising bond yields) i.e. private banks and Bank of India seeing the greatest outperformance. However, YTD banks have still underperformed on concerns of rising interest rates and volatility in reported earnings.

Chart 11: Price Performance (6 Month)



Source: Bloomberg

Chart 12: Price Performance (1 Month)



Source: Bloomberg

Going forward, with interest rates estimated to rise further, we continue to prefer private banks over government banks, and even within government banks we would recommend banks like Punjab National Bank, Union Bank of India and Bank of India owing to their superior positioning in a rising rate environment.

Rise in lending rates; "pause" in FED rates key catalysts

The key catalysts for banks, going forward, are likely to be:

1. **Visibility of rise in lending rates** (which has begun from earlier this year) and is the key differentiating factor between the current environment and what prevailed for the past 2 years when bond yields were rising (but lending rates were static). Rising lending rates positively impact margins, and banks' profitability is more geared towards margins v/s loan growth.

2. **Easing concerns on rate hikes.** While we are maintaining our forecast of a 50bps rise in bond yields by year-end (FY07) owing to the strong credit growth, we believe there could be downside risk to our interest rate forecast owing to: a) the recent "pause" in the rate hikes by the US Fed which could prompt other central banks to also consider more modest hikes including RBI, and b) likelihood of inflation being slightly lower than originally anticipated.

3. **Earnings improvement in coming quarters.** As discussed earlier, we believe the 1QFY07 could be the worst quarter in earnings for most banks. To that extent, we expect to see improved earnings growth in coming quarters and markedly in FY08, as discussed earlier.

Preferred Plays - Private Banks (ICICI Bk, HDFC Bk); SBI, PNB, Union & BOI

Private Banks: **ICICI Bank, HDFC Bank** and UTI Bank. We recommend the private banks that are likely to show strong earnings growth despite sharp rise in bond yields – ICICI Bank and HDFC Bank. Both these banks have low interest rate risk and continue to rapidly gain market share on both the asset and liability side.

We believe HDFC Bank is also well positioned in terms of having the highest % of low cost deposits. ICICI Bank, on the other hand, is more attractively valued and also provides exposure to the life insurance, asset management and securities businesses. The sum of parts is estimated to add almost Rs155/share. UTI Bank has low LDR and we estimate earnings will grow at +25% despite higher bond yields.

Amongst the government banks, **SBI remains our preferred pick,** given its dominant franchise, attractive valuations and relatively low interest rate risk. Further, it is well placed in terms of CASA and ability to expand credit.

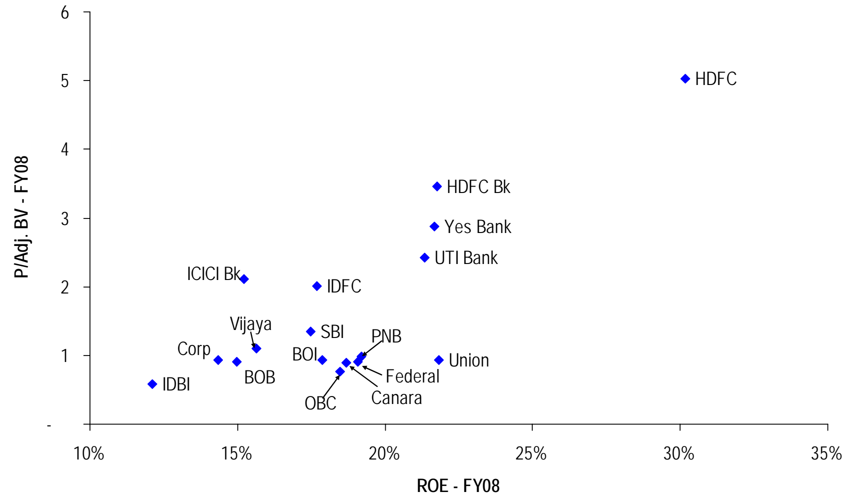
Government Banks (ex-SBI)

Punjab National Bank – PNB is amongst the best placed banks on all parameters *except* interest risk. Hence, we argue it could still command a premium over its book and trade up to 1.2x book (lower than the 1.5x expected earlier when rate fears were less) despite the moderate interest rate risk.

Union Bank of India – Best positioned government bank in terms of minimal interest risk, high RoE at +20% even assuming bond yields spike to 9% in FY07; trading at 1.1x book in FY07E and also ahead on technology. Earnings growth should be upwards of +-45-50% even if rates were to keep rising.

Bank of India – Lowest interest risk along with UBI. The bank is doing the most to improve asset quality relative to peer banks and is more actively involved in strengthening its fees.

Chart 13: Valuation Matrix



Source: ML Research Estimates

Price Objective Basis & Risk

Bank of Baroda (BBRDF, C-1-7, INR 239.55)

We believe BOB could arguably trade up to 1-1.1x one year forward book owing to
1. its strong earnings growth trajectory; earnings to grow +27% in FY07E and FY08E
2. rising ROE from 12% in FY06 to 15% in FY08E and
3. now moderated interest rate risk

Thus one year from now, BOB could arguably trade up to 1-1.1x Fy08E adj book, underpinning our PO of Rs255, which is at the lower end of the valuation range. Sharp rise in bond yields is the risk to our PO.

Bank of India (XDIIF, C-1-7, INR 126.50)

We believe BOI, based on its RoE of 18% in FY08E and estimated earnings growth of +23% in the next two years, could trade up to 1.2-1.3x one year forward book, implying a fair value range of Rs153-165 based on FY08E adj book, underpinning our PO of Rs155. Sharp rise in NPLs is the key risk to our PO.

Federal Bank (XFDRF, C-1-7,INR 182.70)

We believe Federal Bank, with an estimated ROE of 19% in FY08E offers a positive risk return. We believe the stock, based on its surplus RoE of 4% (ROE in excess of 15%) could trade at the higher end of government bank valuation multiples. Thus one year from now it could arguably trade up to 1.1-1.2x FY08E adj book i.e. in the range of 220-240, underpinning our PO of Rs220, at the lower end of the valuation range. Sharp rise in bond yields is the risk to our PO.

HDFC (HGDFF, C-1-7, INR 1239.30)

We reiterate our Buy on HDFC with a PO of Rs1450, supported by
1. Consistent earnings growth with minimal margin pressure, helping reinforce its ability to deliver earnings growth of >17-18% through FY07E;
2. Amongst the highest ROE (of +31%) across banks; and
3. Rising value of its subsidiaries forecast at Rs557/share by FY08 (factoring in 15% discount to estimated value of HDFC's share in the subsidiaries).

HDFC trades at 3.2x FY07E book adjusting for value of subsidiaries (5.2x stand-alone). It has traditionally traded at 3.5-4x one year forward book (without factoring value of subs) owing to its strong franchise, high ROE and consistent growth. We believe it could trade up to 3.5x FY08E book, implying a price of Rs850. Adding value of subsidiaries (Rs557/share), we get our PO of Rs1450. Sharp rise in rates impacting demand is the key risk to our PO.

HDFC Bank (HDDCF, C-1-7, INR 808.55)

HDFC Bank trades at 3.5x FY07E book. While it is at the higher end of our banking universe, we believe the current results once again underpin the bank's ability to potentially sustain earnings growth at around 30% helping the bank to sustain the current P/B multiple at +3.5x, one year forward. This is supported by ROE rising to almost 22% and being amongst the best positioned banks in a rising rate environment. Hence, we reiterate our Buy with our PO of Rs900. Sharp rise in bond yield or worsening asset quality are the risks to the shares achieving our PO.

ICICI Bank (ICIJF, C-1-7, INR 590.05)

We believe the stock, currently trading at 1.9x FY07E adj. book (1.4x FY07E adj book, adjusted for the subsidiaries) can continue to trade at least at 1.9-2.0x one year forward (FY08E) adj. book, if not higher owing to the improving earning growth trajectory, ROE

expansion, low interest rate risk and IBank's dominant retail franchise. This gives a range of Rs534-562. Adding Rs154 / share for the subsidiaries, we get our PO of Rs700.
Sharp rise in rates that severely dampens growth or results in much sharper than expected rise in NPL's are the risks to our PO.

IDBI (XDBIF, C-1-7, INR 57.20)

Trading at <0.6x FY07E (0.5x FY08E adj. book), we view IDBI as a value play over the medium term. We reckon as the benefits become visible (which they should in due course as the liabilities get repriced and lending rates rise) the stock could re-rate to around 0.7-0.8x over a 12-month horizon,
This implies a price band of Rs67-78, underpinning our new PO of Rs72. Further, the increase in investment hit for IDBI due to the change in our bond yield forecast is estimated to be minimal, due to a relatively lower G-Sec book (<8% of total assets).
The sharper re-rating to 1.0x adj. book now is likely to be only over the longer term based on how it builds out its franchise.
Sharp rise in NPLs or consistent delay in the restructuring benefits remain the key risks to our PO.

Oriental Bank (ORBCF, C-1-7, INR 179.80)

We maintain Buy on OBC as we believe the stock (currently trading at 0.9x FY07E adj book) could based on its ROE of 18.5% in FY08E arguably trade up to 1.0x one year forward book. Thus one year from now OBC could trade up to 1.0FY08E adj book, we however maintain our PO at Rs210 factoring in the negative sentiment on rate risk which is also why it is lower in our pecking order. Sharp rise in bond yields is the key risk to our PO. OBC is the most vulnerable bank in our universe to rising bond yields even after the transfer of G-Sec to HTM in 1QFY07 with over 65% of its G-Sec portfolio being in AFS category having a relative higher duration of 3.7 years. The impact of a 10bpds higher than estimated rise in bond yields could be around 4.6% in FY07 and 2.5% in FY08 (to out base case earnings growth).

Punjab National Bank (PUJBF, C-1-7, INR 397.50)

At 1.1x FY07E Adj book we believe PNB offers a positive risk/return with anticipated +25% earnings growth, rising ROE (estimated to rise to >19% in FY08) and moderate interest rate risk. We believe the stock could trade up to 1.2- 1.3x FY08E adj book, as it is amongst the best placed banks in a rising interest rate environment as a) it's amongst the best positioned banks to expand credit and b) it has the highest proportion of CASA (enabling it to control its cost of funds). This implies a fair value of Rs475-520, underpinning our PO of Rs475 (at the lower end). Sharp rise in bond yields is the key risk to our PO.

SBI (SBINF, C-1-7, INR 865.45)

We believe the stock could arguably trade at least at 1.2-1.3x one year forward book (FY08E adj. book), on a consolidated basis, given the strong growth in its recurring earnings, positive risk return and its rising ROE. This underpins our PO of Rs1,000. We maintain our PO of US$56 on the GDR. We reiterate our Buy.
A sharper than expected rise in bond yields or worsening asset quality are the key risks to our PO.

Union Bank India (UBOIF, C-1-7, INR 112.20)

We believe the stock (currently trading at 0.8x FY08E Adj book) could re-rate to 1.2-1.3x one year forward adj book due to a) Expected rebound in earnings in coming quarters; b) RoE of 20% (rising to 22% in FY08); and c) Lowest interest rate risk to rising bond yields.

This implies a fair value range of Rs135-150 (based on FY08E adj book) underpinning our PO of Rs140, at the lower end of the fair value range. Sharp rise in rates or NPLs are the key risks to our PO.

UTI Bank (UTBKF, C-1-7, INR 327.60)

Based on its strong growth trajectory and rising ROE to 21% in FY08E we expect the bank to sustain its present multiples. Hence one year from now UTI Bank could, in our view, trade up to at least 2.5-2.6x one year forward (FY08E) adj book underpinning our PO of Rs350 on the domestic stock and US$8 on the GDR. The risk to our price objective is a sharp rise in NPL.

Yes Bank (YESBF, C-1-7, INR 86.05)

We reiterate our Buy rating on the stock, as we believe YES Bank, currently trading at 3.4x FY07E adj book, could sustain its multiple of around 3.4-3.6x one year from now owing to its strong growth trajectory, and rebound in ROE from 14% in FY06 to 22% in FY08E.
Thus one year from now, based on its FY08E adj book, we think YES Bank could trade in the price range of Rs95-100, underpinning our PO of Rs100. Inability to manage growth is the key risk to our PO.

Analyst Certification

We, Rajeev Varma and Aashish Agarwal, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	85	38.46%	Buy	49	57.65%
Neutral	111	50.23%	Neutral	57	51.35%
Sell	25	11.31%	Sell	14	56.00%

Investment Rating Distribution: Financial Services Group (as of 30 Jun 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	92	41.63%	Buy	46	50.00%
Neutral	120	54.30%	Neutral	62	51.67%
Sell	9	4.07%	Sell	3	33.33%

Investment Rating Distribution: Global Group (as of 30 Jun 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1264	44.12%	Buy	430	34.02%
Neutral	1398	48.80%	Neutral	404	28.90%
Sell	203	7.09%	Sell	45	22.17%

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