Flashnote

HSBC Global Research

Financial Institutions Group
Commercial Banks
Equity – India

India Banks

London conference takeaways – increased visibility for asset quality trends

- **Power sector issues need time for resolution, no near-term solution clearly visible – but problems aren't irreversible**
- **While slippages to continue in slow environment, formation rate likely to slow and recoveries likely to improve**
- **Slowing growth but higher NIMs in 2H12 likely to be viewed as positive catalysts, along with rate pause and incremental asset-quality improvement trends**

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Sachin Sheth*
Analyst
HSBC Securities & Capital Markets (India) Private Limited
+91 22 2268 1224
sachinsheth@hsbc.co.in

Tejas Mehta*
Analyst
HSBC Securities & Capital Markets (India) Private Limited
+91 22 2268 1243
tejasmehta@hsbc.co.in

Todd Dunivant*
Head of Banks Research, Asia Pacific
The Hongkong and Shanghai Banking Corporation Limited
+852 2996 6599
tdunivant@hsbc.com.hk

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London Infra Day: CEOs and top management of SBI, BOI, IDBI, IDFC, and PFC, along with other corporate chiefs and government representatives, presented at our event.

Key messages – Power sector: a) Uncertainty about when coal linkage problems would be resolved, b) may see restructuring increase to buy time for this and to raise power tariffs, c) ways to resolve problems for projects under construction: either Coal India takes a hit on imported coal cost, or tariffs increased (legal challenges possible), or government bears a subsidy, d) free/subsidised power may end as availability concerns dominate cost, e) SEB problems starting to get resolved, although a long way from completion; work-throughs possible for some SEBs but no more concessions likely for them, and f) sluggish funding to power sector until problems get resolved.

Key messages – Banking sector: a) NPLs likely to continue to increase albeit at slower pace, driven by slower rate of slippages and better recoveries in 2H, b) sources of slippages mainly exporting SMEs (textiles, jewellery, and leather) and also agri (harvest delayed to end-Nov), c) NIMs trending higher in 2H, including from overseas trade finance business, d) sub-20% loan growth this year (large PSUs), and e) more than 160bps increment to SBI's CAR from various measures in FY12.

Conclusion: Is the worst behind us? With guidance for improving asset quality, higher margins, and hopes for a rate pause, current valuations appear promising for an entry point, particularly in private bank stocks. Our preferred plays include high wholesale-funded entities with relatively better earnings clarity and attractive valuations: YES, LICHF, and ICBK.

HSBC

Key takeaways from the HSBC conference

	SBI	BOI	IDBI	IDFC	PFC
Sector Issues					
Rates outlook	If inflation remains high, RBI likely to continue hiking rates.				
Savings rate deregulation	7-day 8.5% deposit scheme is targeted to compete with post office scheme; about USD200bn sitting with public savers as cash and USD26bn in liquid MFs - looking to target this as well; savings rate is function of customer experience, convenience and reach, not rates.				
Bank-specific issues					
Asset quality	NPL problems for sector likely to continue in 2H and next year, especially if IIP and agri output weakens; however, recoveries likely to improve in 2H; NPLs below USD1m are responsibility of one GM and sending notices to them on account of wilful default - collections have improved significantly; Hence, NPL slippages likely to slow below INR80bn per qtr.	Core slippages at 2.6% vs. reported number of 5.2%; have been gradually booking all pain on its books over last six quarters, and 2H likely to see improvement vs 2Q trends; looking to recover chunk of NPLs recognised under system-based; targeting gross NPL at 2.9% for FY12; restructured slippages expected to peak at current 24%.		No FX problem at IDFC, although customers do have them; adequately provided with 7x cover on gross NPLs.	Nine SEBs profitable currently, 10 others with subsidy. In three years, most should turn profitable; appear unlikely to lose in private sector power projects, as Coal India has agreed to supply 50% of coal (42% PLF), and 30% is anyways imported coal. That's 70% PLF - enough to service debt, if not equity
Power sector	Exposure mainly to strong players like NTPC; no lending to IPPs; INR30bn exposure to state power utilities mainly w.c. and all are standard currently; have lost many projects to PFC and other PSU banks due to unreasonable aggressive pricing.		Power exposure about 8.5% of loans; power tariff for BEP should ideally be 3.25 for domestic coal, 4.25 for imported coal, and 3.75 for half and half; currently, average national tariff is INR4/unit; 50% imported coal projects are viable.	43% exposure to energy sector; projects with 60-70% PLF can be viable; current sector issues will get resolved over time; currently restructuring would increase.	Most states have raised tariffs; TN tariff hike announced but yet to happen; UP not yet announced; in 1,400 towns using IT to cut losses; working on development of a low-cost smart meter to be deployed across the country.
SME/exports	Export-driven segments are facing pressure - diamond, leather, textiles - about 10-15% of total NPLs; about USD6bn now under ECGC scheme where insurance premium is 0.5% and thus will release some capital.				Private sector projects - projects up to Mar09 CIL have guaranteed supply; after Apr11, new tougher conditions on fuel linkages; issue is for projects between Apr10 and Mar11.
Agri	Agri book at 17% of loans; harvest slightly delayed, which is affecting repayments - crop should hit market by end-Nov; also input costs going up more than food prices; allowing farmers to collateralise gold and pay after selling their produce; moral hazard continues.				Recognise NPLs on 180-day basis.
Airlines	USD600m exposure including AI, Jet and KF - AI covered by government, other two by collateral.				

Source: HSBC, Company reports

HSBC

Key takeaways from the HSBC conference (contd.)

	SBI	BOI	IDBI	IDFC	PFC
NIMs	November NIM trending higher at ~3.8% vs. Sep-qtr NIM of 3.65%; current cost of deposits is 6.9% and yield on loans is 11.2%.	Targeting FY12 NIM at 2.6% with domestic at 3% and int'l at 1.2%; 2H expected to be better for NIM and asset quality.	Margins over 2% now.	Bank license not important, as institutional funding cost is not much different from retail.	Spread down from 2.5% to 2.2%; asset repricing is quarterly; spreads should rise once RBI halts rate rises; 65% of debt is fixed rate; negligible mismatch.
Growth	Loan book likely to grow at 16-18% this year; int'l book a bit faster as USD sources dry up.	17-18% loan growth likely for FY12.		Growth has slowed from 28% 3yr CAGR to 5% currently; expect to grow 15-20% over next four quarters.	
Branches	Looking to increase urban and metro presence, with four high-growth cities identified - Mumbai, B'lore, Chennai, and Hyderabad.		900 so far; looking to add 200 p.a.; targeting 24% CASA by FY12 (large chunk comes from HNIs).		
Cost income	Currently at 45%; targeting 41%; will not go for another early retirement scheme as pension costs are high; currently fully provided on pension liabilities.				
Capital position	Incremental capital likely to come from: a) gov't at USD800m (40bps addn); b) accruals of USD2bn from profits in FY12 (80bps), c) insuring export & MSME loans (25bps + 10-15bps), d) data purification by McKinsey (wrong data input) - eg erroneously using sanction instead of disb. data to compute capital.		Government has converted INR21bn in Tier 1 bonds to equity.	CAR is 21%; will raise debt and increase ROEs.	
International business	USD30b int'l book of which 80% is USD-funded; about USD11bn is trade finance where spreads over Libor have increased by 200bps, impacting NIMs positively; no shortage seen of USD funding for trade finance, where demand is picking up.				
Miscellaneous	Chairman to retire in Sep-13; looking to merge SBH in 2012 but needs a fair bit of groundwork before that; typically takes two years to digest a merger and thus would take 10 years to complete all mergers of associate banks.	Reorganising business structure with McKinsey's help to reduce layers.	Given project finance expertise, looking to advise corporates and cut down share in projects to 10-15% from 30-40% earlier.	Sold 1.2% stake in NSE, balance is 6%; AMC has sold 25% stake to Netaxis, with which it has formed a JV for distributing MFs; MTM loss on equity book is INR350cr.	

Source: HSBC, Company reports

India banks: Coverage universe (closing prices as on 22 November 2011)

RIC code	Stock	Market price INR/sh	Target price INR/sh	HSBC rating	Market cap (USDm)	HSBC PE Fy12e	HSBC PE Fy13e	HSBC PE Fy14e	HSBC P/B Fy12e	HSBC P/B Fy13e	HSBC P/B Fy14e	EPS CAGR Fy11-14e
Public sector banks												
BOB.BO	Bank of Baroda	695	961	OW	5,185	5.7	4.8	3.9	1.2	1.0	0.8	16.7%
BOI.BO	Bank of India	329	330	UW	3,425	8.6	7.0	5.8	1.0	0.9	0.8	7.2%
CNBK.BO	Canara Bank	437	572	OW	3,686	5.2	4.6	3.8	0.9	0.8	0.7	6.8%
PNBK.BO	Punjab National	884	1,244	OW	5,338	5.6	4.7	3.9	1.2	1.0	0.8	17.5%
SBI.BO	SBI	1,690	2,000	N	20,441	10.2	7.8	6.2	1.5	1.3	1.1	27.9%
UNBK.BO	Union Bank	205	250	OW	2,044	5.7	4.6	3.7	0.9	0.8	0.7	10.8%
PSU universe					**40,119**	**7.5**	**6.1**	**4.9**	**1.2**	**1.1**	**0.9**	**18.0%**
Private sector banks												
AXBK.BO	Axis Bank	947	1,477	OW	7,441	9.7	7.8	6.4	1.8	1.5	1.3	21.3%
HDBK.BO	HDFC Bank	444	603	OW	19,790	19.7	15.8	12.9	3.5	3.0	2.5	26.5%
ICBK.BO	ICICI Bank	745	1,127	OW	16,368	13.6	11.5	9.9	1.4	1.3	1.2	18.5%
INBK.BO	IndusInd Bank	252	362	OW	2,239	14.8	11.2	8.6	2.6	2.2	1.8	30.6%
YESB.BO	Yes Bank	267	369	OW	1,785	9.5	7.5	5.9	2.0	1.6	1.3	28.6%
Pvt universe					**47,625**	**14.4**	**11.8**	**9.7**	**2.1**	**1.8**	**1.6**	**23.2%**
NBFC												
HDFC.BO	HDFC	638	808	OW	17,899	22.5	18.7	15.9	4.7	4.1	3.6	18.6%
LICHF.BO	LIC Housing Finance	222	299	OW(V)	2,004	11.0	7.4	5.9	2.1	1.7	1.4	22.6%
NBFC universe					**19,903**	**20.4**	**16.2**	**13.6**	**4.2**	**3.6**	**3.1**	**20.5%**
Total coverage universe					**107,646**	**11.2**	**9.1**	**7.4**	**1.8**	**1.5**	**1.3**	**19.6%**

HSBC ratings: OW = Overweight, N = Neutral, UW = Underweight, V = Volatile.
Note: Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for Indian stocks of 11%, or 1-21% around the share price, and for stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate for Indian stocks of 11%, or 6-16% around the share price. At the time we set our target prices, they implied potential returns that were above, below, or within the Neutral band; therefore, we respectively rate the stocks OW(V), OW, UW(V), UW, N(V), or N, as indicated in the HSBC Rating column above. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.
Source: Company data, Bloomberg, HSBC

Valuation and risks

We continue to value Indian banks stocks using a weighted average combination of PE, PB, and economic profit model (EPM) methodologies. We assign a 50%, 20% and 30% weighting each to the PE, PB, and EPM components, respectively. The three-stage EPM uses explicit forecasts until FY14, followed by 10 years of semi-explicit forecasts. The final stage of 12 years (fade period) assumes convergence of ROE and COE. EPM is based on the assumptions in the following table.

HSBC Indian banks coverage universe: EPM assumptions

	BOB	BoI	CNBK	PNBK	SBI	UNBK	AXSB	HDBK	ICBK	IIB	Yes	HDFC	LICHF
Semi-explicit forecasts for 10 yrs													
Loan CAGR	8%	8%	8%	8%	8%	8%	13%	20%	14%	8%	13%	14%	10%
Dividend payout	18%	18%	15%	18%	20%	10%	23%	25%	30%	20%	13%	45%	20%
Fade period of 12 yrs													
Risk free rate	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.7	1.0	1.0	1.0	1.0	1.0
Equity risk premium	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
Cost of equity	14%	14%	14%	14%	14%	14%	14%	12%	14%	14%	14%	14%	14%
EPM value	934	414	544	1,198	1,877	299	1,003	475	668	157	314	647	299

Source: HSBC

Under our research model, for stocks with or without a volatility indicator, the Neutral band is 10 or 5 ppts, respectively, above and below the hurdle rate for Indian stocks of 11%, or 1-21% or 6-16% around the share prices. For a stock to be rated Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, must exceed the required return by at least 5 percentage points over the next 12 months or 10 percentage points for a stock classified as volatile. For a stock to be rated Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months or 10 percentage points for a stock classified as volatile. Stocks between these bands are rated Neutral.

HSBC Indian banks coverage universe: Valuation and risk factors

	PE multiple	PE-based TP	PB multiple	PB-based TP	DCF value	Weighted target price (INR)	Upside risks	Downside risks
Public sector banks								
BOB	6.3	1,020	1.2	953	934	961	---	Management change in FY13, Asset delinquencies
BOI	5.0	261	0.8	307	414	330	Upside surprise in asset quality; rebound in margins	
CNBK	5.0	527	1.0	607	544	572	---	Higher slippages, management change in 2HFY13
PNBK	6.2	1,282	1.3	1,256	1,198	1,244	---	Adverse asset quality and margins pressure
SBI	9.3	2,276	1.4	1,963	1,877	2,000	Upturn in the economic cycle and capital infusion	Higher slippages and negative margin surprise
UNBK	5.0	246	0.8	223	299	250	---	Weak asset-quality trends, negative margins surprise, management change
Private sector banks								
AXSB	13.0	1,750	2.1	1,464	1,003	1,469	---	Slower-than-expected fee income growth, asset quality risks
HDBK	22.0	688	3.6	586	475	603	---	Slower loan growth, worsening asset quality
ICBK	20.0	1,405	1.9	1,122	668	1,127	---	Slowing loan growth momentum, spike in NPLs
IIB	19.0	493	2.7	340	157	362	---	Further policy tightening by RBI, higher-than-expected loan slippages and credit costs
YES	10.0	380	1.8	330	314	350	---	Longer-than-expected buildup of retail liabilities; asset quality risks
HDFC	24.2	898	5.0	827	647	808	---	Any sharp increase in rates could temporarily slow business momentum; asset quality risks
LICHF	10.0	339	2.0	286	241	299	---	LICHF risks

Source: HSBC

Disclosure appendix

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BANK OF BARODA	BOB.NS	685.85	24-Nov-2011	1, 5, 6, 7, 11
BANK OF INDIA	BOI.NS	345.15	24-Nov-2011	1, 4, 5, 6, 7, 11
CANARA BANK	CNBK.BO	438.90	24-Nov-2011	1, 4, 5, 6, 7, 11
HDFC	HDFC.NS	626.10	24-Nov-2011	6, 7
HDFC BANK	HDBK.BO	429.65	24-Nov-2011	6, 7
ICICI BANK	ICBK.NS	730.10	24-Nov-2011	1, 2, 4, 5, 6, 7, 9, 11
INDUSIND BANK	INBK.BO	254.65	24-Nov-2011	4, 7
LIC HOUSING FINANCE LTD	LICH.BO	213.80	24-Nov-2011	4, 7
PUNJAB NATIONAL BANK	PNBK.BO	885.00	24-Nov-2011	6, 7
STATE BANK OF INDIA	SBI.NS	1653.90	24-Nov-2011	2, 4, 6, 7, 11
UNION BANK OF INDIA	UNBK.BO	213.95	24-Nov-2011	7, 11
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Source: HSBC

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Issuer of report
HSBC Securities and Capital Markets (India) Private Limited
Registered Office
52/60 Mahatma Gandhi Road
Fort, Mumbai 400 001, India
Telephone: +91 22 2267 4921
Fax: +91 22 2263 1983
Website: www.research.hsbc.com

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