17 June 2013

India Banks

What can drive bank stocks?

Rating: **Neutral**
Sensex: 19178
Bankex: 13607

Key takeaways

Policy rate-cuts usually aid in bank outperformance. Our brief analysis of the Bankex (from 2002) reveals that policy rate (repo) cuts have a positive effect on banking stocks. Since 2002, the Bankex has outrun the Sensex by an average 3.2% in the month after a repo rate cut. Of the last 15 such instances, bank stocks have outclassed in 10. Buying bank stocks one quarter before rate-cut events, however, usually leads to better payoffs, with the Bankex outperforming the Sensex an average 5.5%.

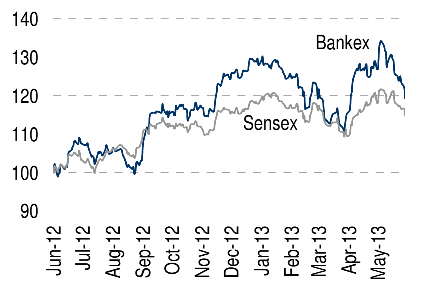
Asset quality improved in 2HFY13. In our theme report dated 20 Nov'12, *India Banks: IIP recovery in 2HFY13 to lift asset-quality overhang*, we had stated that asset-quality headwinds for banks are likely to subside, led by a likely recovery in industrial production. In 2HFY13, incremental gross NPA for large-cap banks was ₹38.7bn, substantially lower than the ₹229bn of 1HFY13. Over the same period, IIP grew 2.1% yoy, better than the 0.1% registered over 1HFY13. Moreover, in 4QFY13, banks' asset quality improved a shade, with gross NPA for large-cap banks down 2% qoq to ₹1,083bn.

Yet, banks underperformed in 4QFY13. Over Jan-Apr'13, policy rates were cut by 50bps, while gross NPAs of our banking universe fell. However, despite this favourable combination of lower interest rates and lower NPAs, the Bankex undershot the Sensex by 6.3% over the same period. A likely reason for the underperformance could be the ballooning of restructured loans for large-cap banks - from 4.6% of loans in FY12 to 5.3% in FY13, and the perception that defaults from these loans could be meaningful in FY14.

Congenial policy rate and asset quality outlook. With a 75-bp cut in the repo rate since Jan'13, the RBI has frontloaded monetary easing; this has yet to manifest itself in lower base rates of banks. Led by softening inflation and a slow pickup in overall economic growth, we expect the central bank to cut policy rates by another 50bps in CY13. This is likely to be positive for bank stocks. Moreover, our chief economist expects IIP growth to rebound from 1.1% in FY13 to 4.4% in FY14. Since there appears to be a strong correlation between NPA accretion and IIP growth, IIP revival could translate into lower NPAs and, consequently, manageable incremental credit costs for banks.

Our sector bias. We prefer banks with a high proportion of low-cost deposits, which could protect NIM when asset yields fall, and greater tier-1 capital to tap growth opportunities, both highly desirable attributes ahead of the likely monetary easing. **Top picks.** ICICI Bank, Yes Bank, ING Vysya Bank and South Indian Bank.

Relative price performance



Source: Bloomberg

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Policy rate-cuts usually aid banks' outperformance

Our brief analysis of the performance of the Bankex (from 2002) reveals that policy rate (repo) cuts have a positive effect on banking stocks. Since 2002, the Bankex, in the month after a repo rate cut, has outclassed the Sensex by an average 3.2%. Of the last 15 such instances, banks have outperformed in 10. However, buying bank stocks one quarter before rate-cut events usually leads to better payoffs, with banks outrunning the Sensex by an average 5.5%.

Bankex outshone in 10 of the last 15 instances of a repo rate cut

Of the 15 such instances of a repo rate cut, the Bankex in the month after the event outshone on ten occasions. While the Bankex does seem to outperform more strongly one quarter after the repo rate cut, it has only done so on six of the previous 15 such instances.

Stronger gains if one buys bank stocks a quarter before the actual repo rate cut

Interestingly, the early bird does get the worm! One stands to make stronger gains on bank stocks if they are bought one quarter before the actual repo rate cut. On average, the outdistancing of the Bankex with respect to the Sensex is 5.5%. One would have achieved these gains two-thirds of the time, as banks have outperformed the Sensex in eleven of the previous 15 occasions of a rate cut, if one bought bank stocks one quarter before a rate cut was actually instituted.

Only mild outperformance in the Bankex a month before a repo rate cut

The outperformance in banks tends to be mild a month before a repo rate cut, which would suggest that the market has already "priced in" the possibility of the event occurring. Since 2008, in six of the past ten instances, the Bankex has outperformed one month before the cuts. This would probably imply that bank stocks' performance is not entirely dependent on repo rate cuts, at least in the very short term.

Fig 1 – Bankex relative to Sensex before and after policy rate cuts (pre-2009)

	28 Mar'02	12 Nov'02	7 Mar'03	19 Mar'03	31 Mar'04	20 Oct'08	3 Nov'08	8 Dec'08
Repo (%)	8	7.5	7.1	7	6	8	7.5	6.5
Cut (bps)	50	50	40	10	100	100	50	100
Gains in the Bankex (%), relative to the Sensex, if one had bought								
1Q before	8.9	(3.2)	15.5	10.2	9.9	13.4	5.5	3.5
1M before	(1.7)	(4.5)	0.3	(0.5)	7.9	7.3	1.3	(4.2)
1M after	4.2	3.2	3.2	8.9	5.4	(5.1)	(0.2)	10.0
1Q after	12.2	17.1	15.6	9.2	(4.9)	(2.8)	(0.2)	(13.2)

Source: Capitaline, The RBI, Anand Rathi Research

Fig 2 – Bankex relative to Sensex before and after policy rate cuts (post-2009)

	2 Jan'09	4 Mar'09	21 Apr'09	17 Apr'12	29 Jan'13	19 Mar'13	2 May'13	Mean	Median
Repo (%)	5.5	5	4.75	8	7.75	7.50	7.25		
Cut (bps)	100	50	25	50	25	25	25		
Gains in the Bankex (%), relative to the Sensex, if one had bought									
1Q before	8.8	(11.6)	(10.0)	11.6	3.4	(5.7)	0.7	**4.1**	**5.5**
1M before	11	(9.2)	7.3	2.8	(1.0)	(4.1)	6.2	**1.3**	**0.3**
1M after	(8.3)	1.5	19.9	(5.2)	4.5	(6.0)	1.8	**2.5**	**3.2**
1Q after	(18.3)	31.1	20.2	(2.1)	(1.9)	(2.1)	NA	**4.3**	**(1.0)**

Source: Capitaline, The RBI, Anand Rathi Research

However, post-2009, the Bankex has undershot the Sensex in three instances out of seven despite repo rate cuts. We have examined these periods in little more detail to understand the reasons for the underperformance of bank stocks. On two of the occasions – Mar'09 and Apr'09, asset quality of banks deteriorated significantly. However, the most recent instances of policy rate cuts (Mar'13 and May'13) have seen underperformance or mild outperformance of banks relative to the broader markets. In fact, banks' asset quality actually improved in Mar'13.

Fig 3 – Despite policy rate cuts, Bankex underperfomed Sensex on two instances

	4 Mar'09		21 Apr'09
Incremental NPAs for 4QFY09 (large-cap banks*)	34	Incremental NPAs for 1QFY10 (large-cap banks*)	6
QoQ chg %	9.5	QoQ chg %	1.5
YoY chg %	22.7	YoY chg %	22.8
Inc NPAs 6M later	32	Inc NPAs 6M later	54
Inc NPAs 12M later	86	Inc NPAs 12M later	103
YoY NPA % 12M later	21.9	YoY NPA % 12M later	25.8

*Source: The RBI, Companies, Anand Rathi Research (*market-cap > US$4bn)*

Asset quality improved in 2HFY13

In our theme report dated 20 Nov'12, *India Banks: IIP recovery in 2HFY13 to lift asset-quality overhang*, we had stated that asset-quality headwinds for banks are likely to subside, led by a likely recovery in industrial production. In 2HFY13, incremental gross NPAs for large-cap banks were ₹38.7bn, substantially lower than the ₹229bn of 1HFY13. Over the same period, IIP grew 2.1% yoy, better than the 0.1% registered over 1HFY13. Moreover, in 4QFY13, banks' asset quality improved slightly, with gross NPA for large-cap banks down 2% qoq to ₹1,083bn.

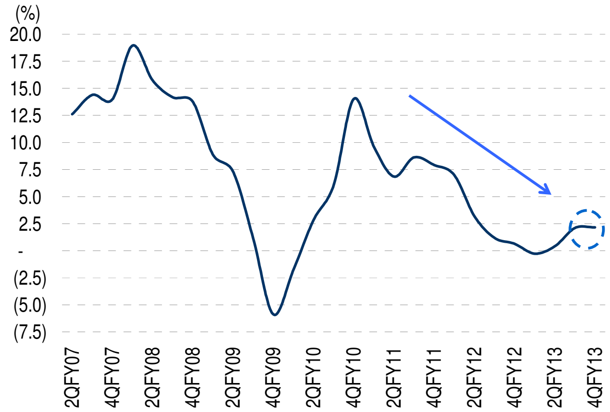
Gross slippages (fresh additions to NPA) of large government-owned banks have risen 1.5x in the past four quarters, from 1.8% of loans (annualised) in Mar'12 to 2.4% in Mar'13. Excluding SBI, gross slippages have risen 2.4x in the past four quarters, from 1.7% of loans (annualised) in Mar'12 to 3.7% in Mar'13. However, these slippages appear to have peaked in Sep'12 and are now on a declining trend (see Fig.4).

Fig 4 – Gross slippages of large government banks

(₹m)	3QFY12	4QFY12	1QFY13	2QFY13	3QFY13	4QFY13	QoQ
BoB	9,026	13,116	12,212	14,715	19,997	21,160	5.8
BoI	5,196	3,770	17,500	44,804	12,210	16,770	37.3
Canara	8,620	11,210	14,970	19,220	13,140	10,860	(17.4)
IDBI	12,340	3,760	10,430	6,240	29,680	29,570	(0.4)
PNB	16,830	23,300	27,690	45,440	81,750	58,680	(28.2)
SBI	81,610	43,830	108,440	71,060	6,770	8,750	29.2
Union BoI	8,620	6,070	16,310	7,920	7,140	9,070	27.0
Total	**142,242**	**105,056**	**207,552**	**209,399**	**170,687**	**154,860**	**(9.3)**
Ex-SBI	60,632	61,226	99,112	138,339	163,917	146,110	(10.9)

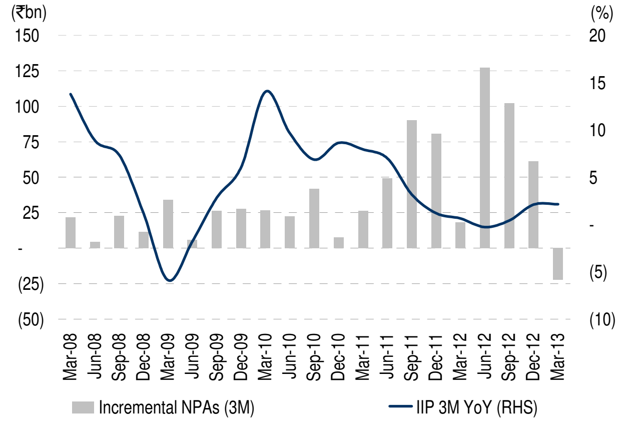
Source: Companies

Fig 5 – Declining IIP growth since Mar'10, but small uptick in 2HFY13



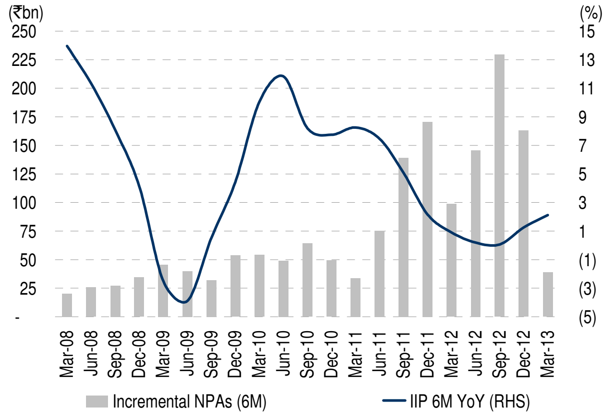
Source: Company, Anand Rathi Research

Fig 6 – NPA formation correlation with IIP growth (three-month)



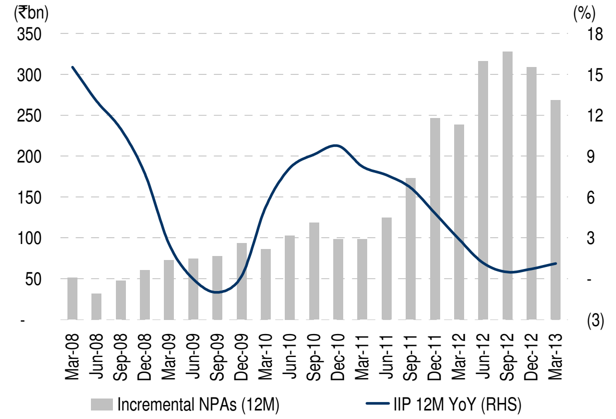
Source: Company, Anand Rathi Research

Fig 7 – NPA formation correlation with IIP growth (6-month)



Source: Company, Anand Rathi Research

Fig 8 – NPA formation correlation with IIP growth (12-month)



Source: Company, Anand Rathi Research

Yet, banks underperformed in 4QFY13

Over Jan-Apr'13, policy rates were cut by 50bps, while gross NPAs of our banking universe declined. However, despite this favourable combination of lower interest rates and lower NPAs, the Bankex undershot the Sensex by 6.3% over the same period. A likely reason for the underperformance could be the ballooning of restructured loans for large-cap banks, from 4.6% of loans in FY12 to 5.3% in FY13, and the perception that defaults from these loans could be meaningful in FY14.

Fig 9 – Restructured loans of large-cap banks

Bloomberg code	4Q12	1Q13	2Q13	3Q13	4Q13	YoY
AXSB	30,600	38,270	40,680	42,570	43,680	42.7
ICICIBC	45,540	41,720	41,720	45,620	53,150	16.7
SBIN	281,330	369,040	404,540	347,830	431,110	53.2
BOB	186,208	194,913	210,791	229,930	226,174	21.5
BOI	179,000	205,894	211,399	181,358	163,530	(8.6)
CBK	78,962	140,559	148,949	145,014	181,130	129.4
PNB	250,090	255,180	278,520	303,290	321,430	28.5
UNBK	118,790	135,206	143,600	155,650	116,260	(2.1)
Total	**1,170,520**	**1,380,782**	**1,480,199**	**1,451,262**	**1,536,464**	**31.3**
% of advances	**4.62**	**5.31**	**5.68**	**5.33**	**5.28**	**66bps**

Source: Companies

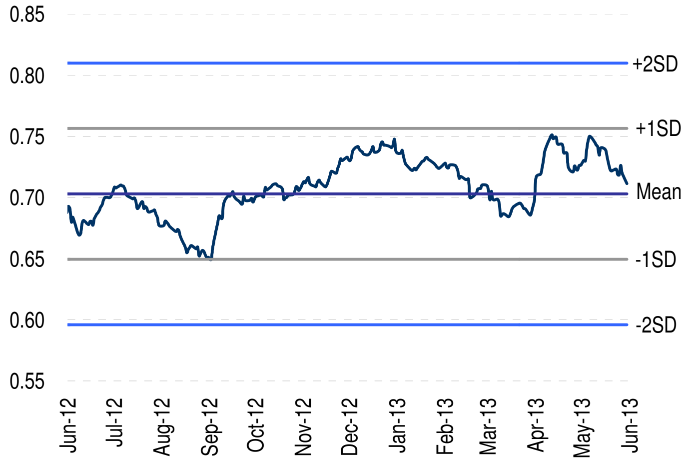
Congenial policy rate and asset quality outlook

With 75bps cumulative cuts in the repo rate since Jan'13, the RBI has frontloaded monetary easing, though this has yet to manifest itself in lower base rates of banks. Led by softening in inflation and a slow pickup in overall economic growth, we expect the central bank to cut policy rates by another 50bps in CY13, which is likely to be positive for bank stocks.

Moreover, our chief economist expects IIP growth to rebound from 1.1% in FY13 to 4.4% in FY14. The revival in the IIP is likely to have led to lower NPA as there appears to be a strong correlation between NPA accretion and IIP growth. On most occasions in the past, sliding IIP growth led to an increase in NPA, and vice-versa. We believe that the asset-quality cycle is likely to have reached its peak in terms of asset-quality deterioration. While the Indian economy is seeing decelerating IIP growth, it is expected to rebound in 2HFY14. Our chief economist expects IIP growth to rebound from 1.1% in FY13 to 4.4% in FY14. The likely improvement in industrial-production growth would lead to lower NPA in 2HFY14 due to the lag effect of NPA formation on asset quality. Credit costs are likely to be lower as asset-quality headwinds ease.

From Jan to Jun'13 bank stocks undershot the Sensex; while the Bankex registered ~7% losses, the Sensex fell ~4%. This underperformance was likely driven by higher incremental restructuring in 2HFY13, despite a 75-bp rate cut over the same period. The underperformance possibly implies that risks associated with asset deterioration have been priced in. While perceptions of default risk would continue until asset quality actually improves or shows signs of stabilizing, an easing interest-rate environment and lower incremental NPAs could be congenial to price movements of banking stocks.

Fig 10 – Bankex vs Sensex



Source: Capitaline, RBI, Anand Rathi Research

Sector bias to banks with high tier-1 capital, high CASA share

While most bank stocks are trading near the mean of their past valuations, we see scope for further valuation upsides for select banks. Rising business growth, steady margins and the likelihood of lower NPAs could support valuations. We prefer banks that are better placed to manage the likely monetary easing cycle ahead with a high proportion of low-cost deposits (to protect NIM when asset yields are likely to fall) and high tier-1 capital (to benefit from growth opportunities when credit demand accelerates). A further re-rating in the near term, in particular for PSU banks, is also likely if the government infuses capital at favourable valuations (equal to or higher than book value). Top picks: ICICI Bank, Yes Bank, ING Vysya Bank and South Indian Bank.

We have a Buy on ICICI Bank, Punjab National Bank, Axis Bank, IndusInd Bank, Yes Bank, IDBI Bank, Federal Bank, Indian Bank, Indian Overseas Bank, Jammu & Kashmir Bank, ING Vysya Bank, Karur Vysya Bank, South Indian Bank, City Union Bank, Vijaya Bank, Karnataka Bank and DCB Bank.

We have a Hold on HDFC Bank, Bank of Baroda, Union Bank of India and Andhra Bank.

We have a Sell on State Bank of India, Canara Bank and Bank of India.

Key risks to our call

Slower-than-expected growth rate of the Indian economy. Our economist estimates India's GDP to grow 5.8% in FY14. Any downside to this growth forecast would mean less-than-estimated credit demand.

Tight fiscal policies and no monetary easing. We expect 100bps policy-rate action in CY13, with the RBI likely to focus on keeping liquidity comfortable. No monetary easing or tight fiscal policies could lead to lower-than-anticipated earnings for banks in the short term

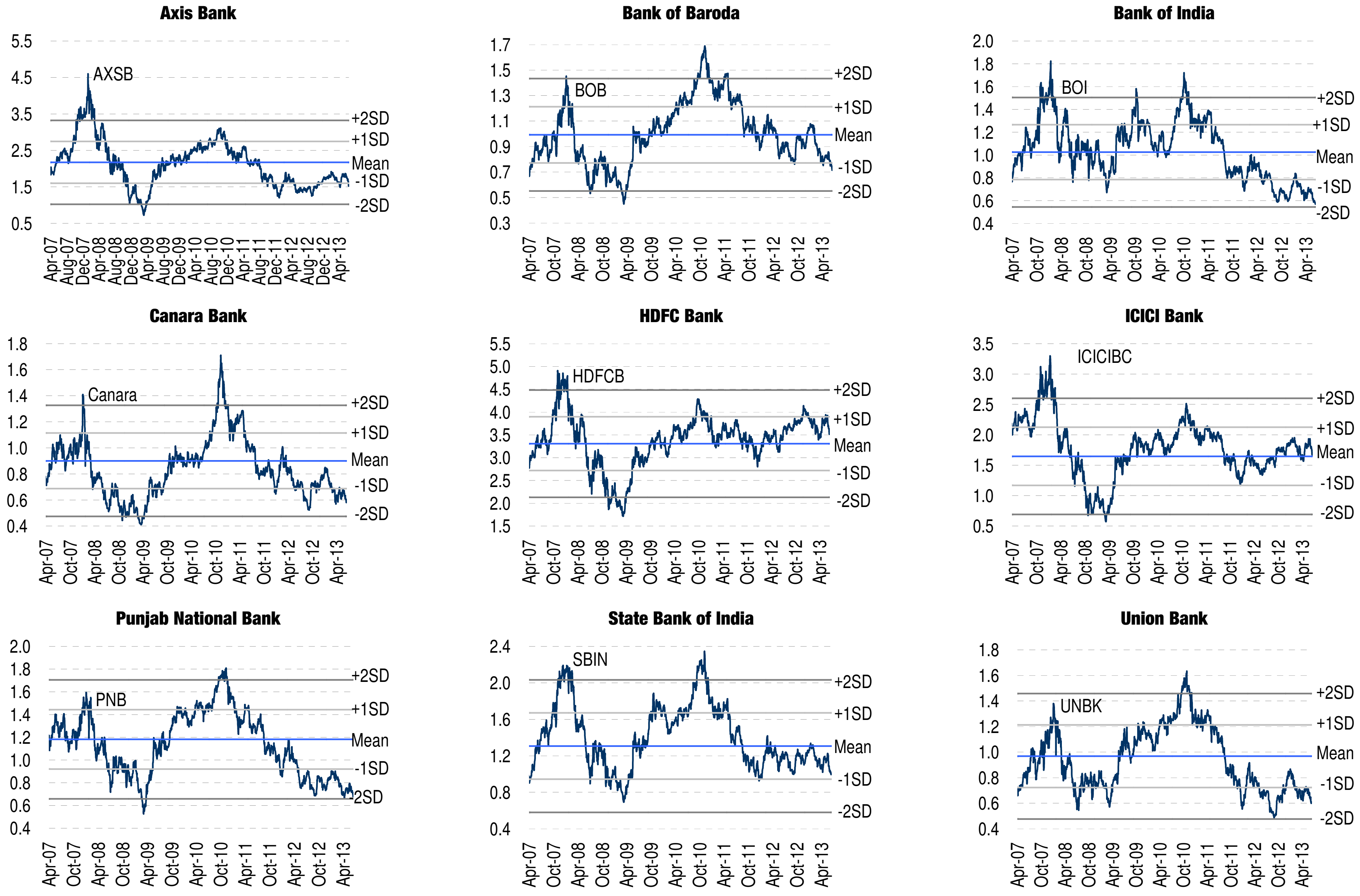
Higher-than-expected increase in re-structured-loan defaults. A higher-than-expected increase in re-structured-loan defaults could trim banks' earnings in FY14 as provisions for bad loans would increase.

Fig 11 – India Banks' valuation matrix

Bloomberg code	Price	M Cap	Target	Upside (Downside)	Rating	FY12-14 EPS CAGR	P/ABV (x)		Target P/ABV (x)		P/BV (x)		Target P/BV (x)		P/E (x)		RoE (%)		EPS (₹)		Dividend Yield %	Consol BV (₹)		Consol ABV (₹)	
Bank	(₹)	US$ bn	(₹)	%		%	FY14e	FY15e	FY14e	FY15e	FY14e	FY15e	FY14e	FY15e	FY14e	FY15e	FY14e	FY15e	FY14e	FY15e	FY14e	FY14e	FY15e	FY14e	FY15e
HDFCB	665	27.6	725	9.0	Hold	27.9	3.8	3.2	4.1	3.4	3.7	3.1	4.1	3.4	18.3	14.4	22.0	23.7	36.3	46.2	0.6	179	213	177	211
SBIN	2,046	24.3	2,200	7.6	Sell	14.5	1.7	1.5	1.8	1.6	1.3	1.2	1.4	1.3	8.7	7.6	15.6	16.1	235.1	270.3	1.7	1,541	1,748	1,202	1,398
ICICIBC	1,102	22.1	1,375	24.8	Buy	18.7	1.8	1.6	2.2	2.0	1.7	1.6	2.2	1.9	12.7	10.9	14.3	15.0	87.0	101.3	1.5	636	706	614	683
AXSB	1,298	10.6	1,635	25.9	Buy	23.5	1.7	1.4	2.1	1.8	1.6	1.4	2.0	1.7	9.5	7.7	18.1	19.5	136.2	168.7	1.2	802	935	786	917
BOB	634	4.6	775	22.3	Hold	23.1	0.9	0.8	1.1	0.9	0.8	0.7	0.9	0.8	4.8	3.9	16.5	17.5	133.4	160.8	2.7	838	961	719	836
PNB	741	4.6	875	18.1	Buy	18.6	0.9	0.8	1.1	1.0	0.7	0.6	0.8	0.7	4.8	3.9	15.6	17.0	152.9	188.9	3.0	1,041	1,186	785	901
IIB	482	4.4	486	0.8	Buy	27.9	3.0	2.6	3.0	2.6	2.9	2.5	2.9	2.5	18.6	14.5	16.6	18.3	26.0	33.2	0.5	169	195	162	188
CBK	390	3.0	405	3.8	Sell	35.1	0.8	0.7	0.9	0.7	0.6	0.5	0.6	0.6	4.0	3.3	16.3	17.3	97.5	118.3	2.8	637	727	466	552
BOI	284	2.9	295	3.8	Sell	29.9	0.9	0.7	0.9	0.8	0.6	0.6	0.7	0.6	4.3	3.6	15.5	16.2	65.8	77.7	2.5	450	508	330	390
YES	479	3.0	595	24.4	Buy	24.8	2.4	2.0	3.0	2.5	2.4	2.0	3.0	2.5	10.8	8.5	24.8	26.0	44.2	56.5	0.8	196	240	196	239
UNBK	212	2.2	235	10.8	Hold	17.6	0.8	0.7	0.9	0.8	0.7	0.6	0.7	0.7	5.1	4.2	13.7	14.7	42.0	50.0	3.8	321	358	261	296
IDBI	77	1.8	129	67.7	Buy	34.6	0.6	0.5	1.0	0.9	0.4	0.4	0.8	0.7	3.7	3.0	12.6	14.2	20.8	25.6	4.0	171	189	131	147
VYSB	632	1.7	713	12.8	Buy	30.0	2.2	2.0	2.4	2.2	2.2	2.0	2.4	2.1	16.4	12.7	14.2	16.4	39.6	51.4	0.6	299	332	298	330
FB	424	1.3	539	27.1	Buy	15.4	1.3	1.2	1.6	1.4	1.2	1.1	1.4	1.3	9.4	7.6	13.9	15.3	49.0	60.5	2.0	372	417	347	390
INBK	130	1.0	242	86.4	Buy	22.5	0.5	0.4	1.0	0.8	0.4	0.4	0.8	0.7	2.8	2.4	15.8	16.4	46.8	55.2	5.8	313	355	254	294
JKBK	1,211	1.0	1,605	32.5	Buy	19.3	1.0	0.8	1.3	1.1	1.0	0.8	1.3	1.1	4.7	3.9	23.3	23.2	259.0	309.5	2.8	1,216	1,452	1,202	1,437
IOB	59	0.9	88	50.8	Buy	22.0	0.6	0.5	0.8	0.8	0.3	0.3	0.5	0.5	4.4	3.7	8.1	9.1	13.3	15.7	8.9	168	177	105	112
ANDB	88	0.9	110	25.6	Hold	6.8	0.9	0.7	1.1	0.9	0.6	0.5	0.7	0.7	3.8	3.2	16.2	17.0	23.0	27.4	5.7	151	165	102	119
KVB	444	0.8	574	29.3	Buy	18.1	1.7	1.4	2.1	1.8	1.6	1.4	2.0	1.7	9.1	7.1	18.9	21.2	50.8	65.3	3.2	285	332	278	324
SIB	25	0.6	35	42.8	Buy	23.5	1.0	0.9	1.5	1.2	0.9	0.8	1.4	1.2	5.6	4.3	18.2	20.3	4.4	5.7	2.4	26	30	24	28
CUB	55	0.5	71	28.7	Buy	32.4	1.3	1.1	1.7	1.4	1.3	1.0	1.6	1.3	6.1	4.7	23.3	24.4	9.2	11.9	1.8	44	54	42	52
VJYBK	51	0.4	76	50.0	Buy	12.4	0.8	0.7	1.2	1.1	0.6	0.5	0.9	0.8	5.0	3.5	11.9	15.9	10.2	14.8	4.9	89	98	62	69
KBL	140	0.5	188	34.5	Buy	35.8	1.1	1.0	1.4	1.3	1.0	0.9	1.2	1.1	7.9	6.1	12.8	15.2	18.5	24.1	2.4	152	164	132	143
DEVB	46	0.2	58	26.5	Buy	21.9	1.1	0.9	1.4	1.2	1.0	0.9	1.3	1.1	8.8	7.6	12.2	12.6	5.2	6.1	0.0	45	51	43	48

*Source: Anand Rathi Research Note: Prices as on 19 Nov'12 * Standalone*

Fig 12 – India large-cap banks: One-year-forward price to book-value (PBV)



Source: Bloomberg, Anand Rathi Research

Appendix

Analyst Certification

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Large Caps (>US$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US$1bn)	>25%	5-25%	<5%

Anand Rathi Research Ratings Distribution (as of 28 Feb 2013)	**Buy**	**Hold**	**Sell**
Anand Rathi Research stock coverage (184)	65%	27%	8%
% who are investment banking clients	4%	2%	0%

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