

India Banks

PSU Banks: Time to use a finer brush

PSU banks are unfairly being painted by the same broad brush of asset quality concerns

Asset quality concerns have dogged the Indian banking space over the last four quarters with PSU banks being particularly affected as stock valuations have come off sharply across the board. We view the uniform punishment of PSU stocks to be unjustified, and a reflection more of uncertainty, heightened by opaque asset quality and volatile slippage reporting; than of real economic risk carried on the balance sheet. PSU banks have in fact reported divergent asset quality signs and there is a case to view their books to be qualitatively different.

Differentiating banks using an alternative approach to view asset quality risk

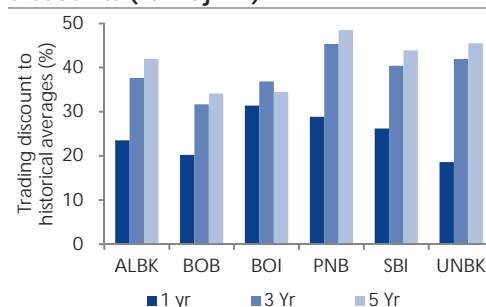
Instead therefore of trying to take a call on the proven unpredictable parameters of (1) the quantum of further asset quality deterioration i.e slippages (2) the timing of their recognition and (3) the success rate of recoveries and reductions – we assess PSU banks on the basis of their *ability to absorb further credit cost increases* over and above our base case estimates. The traditional approach of using absolute levels of (expected) NPL's to rank banks doesn't assess their ability to price in the asset risk and penalizes those who may have better risk adjusted spreads and high profitability cushions.

Stock selection using scoring framework

Applying this approach to our PSU coverage banks, we assess and score our coverage banks on 5 parameters that cover profitability cushion and earnings capacity to absorb accelerated credit costs, credit risk, asset quality risk from restructured assets and finally valuation comfort.

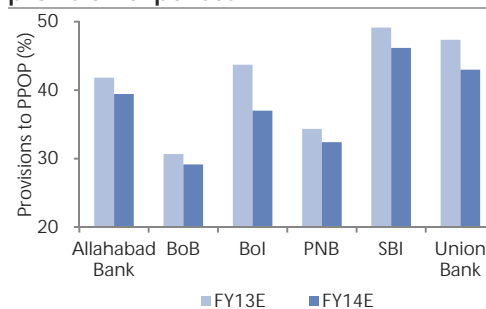
Bank of Baroda, Punjab National bank and Allahabad Bank emerge as clear winners in our scoring model, and are also our top picks in the PSU space. ICICI Bank and DCB are our top picks in the private bank space where the framework doesn't lend well to differentiate amongst the banks.

PSU banks suffering from similar trading discounts (P/ Adj BV)



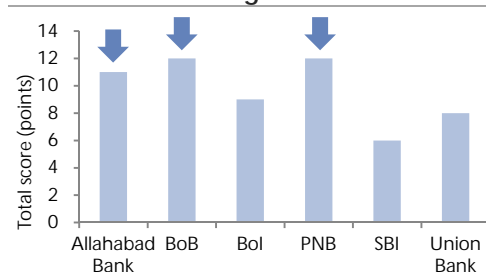
Source: Bloomberg and Elara Securities Estimates

Varying degrees of PPOP cushion over provision expenses



Source: Company and Elara Securities Estimates

BoB, PNB and ALBK emerge as winners based on our scoring framework



Source: Company and Elara Securities Research

Key Financials

Company	Rating	Market Cap		CMP	Target	Upside	P/E (x)		P/ Adj BV (x)		RoA (%)		RoE (%)	
		INR bn	USD mn				INR	INR	%	FY13E	FY14E	FY13E	FY14E	FY13E
Allahabad Bank	Buy	70	1,246	140	235	68.2	3.3	2.7	0.6	0.5	1.0	1.0	18.1	19.1
AXIS Bank	Buy	399	7,093	963	1,398	45.1	7.5	6.2	1.5	1.2	1.7	1.7	21.1	21.4
Bank of Baroda	Buy	257	4,578	657	925	40.8	5.1	4.5	0.8	0.7	1.0	1.0	16.9	16.9
Bank of India	Accumulate	179	3,185	312	405	29.9	4.6	3.7	0.8	0.7	0.9	1.0	17.1	18.6
DCB	Buy	9	165	39	60	55.6	12.0	8.6	1.0	0.9	0.8	0.9	8.6	10.8
HDFC Bank	Reduce	1,144	20,355	487	536	10.0	17.3	13.6	3.3	2.8	1.5	1.6	17.3	19.4
ICICI Bank	Buy	912	16,222	793	1,206	52.1	11.4	9.2	1.4	1.3	1.6	1.7	12.8	14.4
Indusind Bank	Accumulate	142	2,520	303	371	22.4	13.8	10.2	2.7	2.2	1.6	1.7	20.4	23.0
Punjab National Bank	Buy	240	4,273	708	1,026	44.9	4.1	3.5	0.8	0.7	1.1	1.1	19.1	19.8
State Bank of India	Accumulate	1,312	23,341	1,955	2,221	13.6	10.0	8.9	1.5	1.3	0.9	0.9	14.0	14.0
Union Bank of India	Buy	111	1,968	201	275	36.7	4.9	3.9	0.8	0.7	0.8	0.8	14.1	16.1
Yes Bank	Reduce	113	2,018	321	371	15.6	9.2	7.3	2.0	1.6	1.5	1.5	23.5	24.2

Source: Company, Elara Securities Estimate

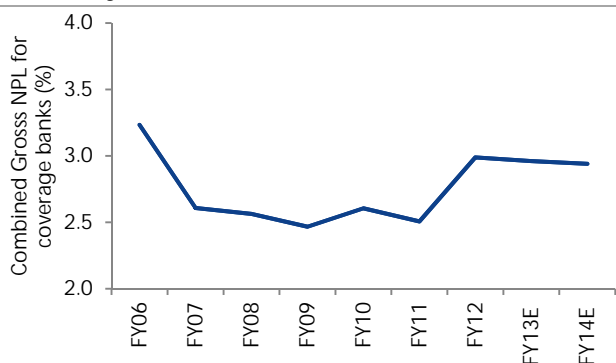
PSU stock selection – basis and framework

Post 4QFY12 results – we present a relative framework to evaluate PSU stocks on the basis of profitability cushions to absorb further credit costs and valuation comfort.

Asset quality to remain tarnished

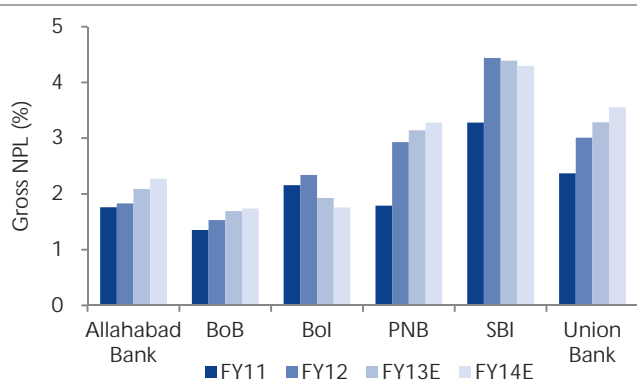
We would like to reiterate our view on the asset quality cycle being a protracted one, with Gross NPLs remaining at elevated levels over the next few years, and declining in only very modest terms. In the last few cycles, asset quality improved sharply post an initial decline as banks had the benefit of a growth economy and a profitable operating environment – neither of which are applicable currently.

Exhibit 1: Gross NPLs not expected to improve materially over FY13E-FY14E



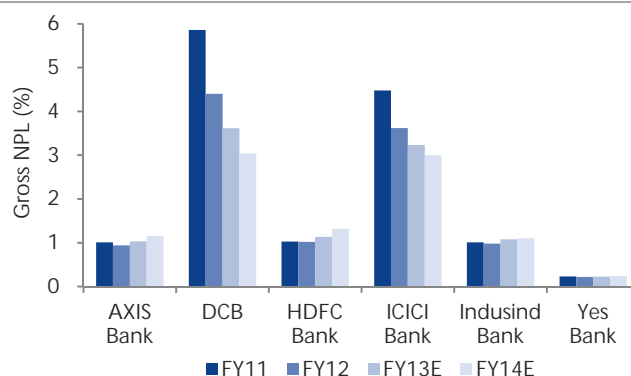
Source: Company and Elara Securities Estimates

Exhibit 2: PSU bank Gross NPLs projected to marginally deteriorate...



Source: Company and Elara Securities Estimates

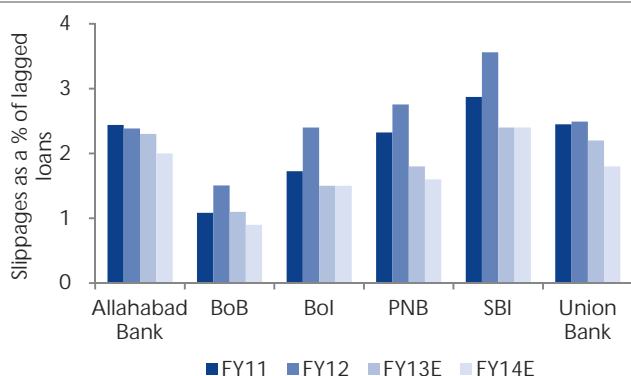
Exhibit 3: ...while for Private banks its expected to either improve or remain static



Source: Company and Elara Securities Estimates

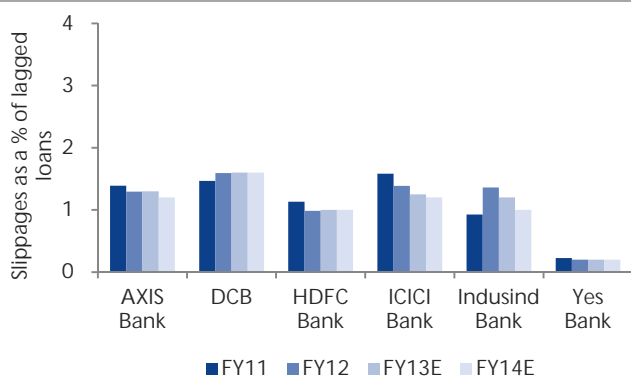
However, we do expect that FY12 was an extreme in terms of the quantum of slippages declared – both as a resultant of the migration to system-based recognition of NPL, as well as from the dramatic change in economic climate. Consequently, we expect slippages for our PSU coverage banks to come off sharply in FY13E & FY14E, but continuing to remain at levels higher than historical averages.

Exhibit 4: Slippages for PSU banks to come off from FY12 peaks



Source: Company and Elara Securities Estimates

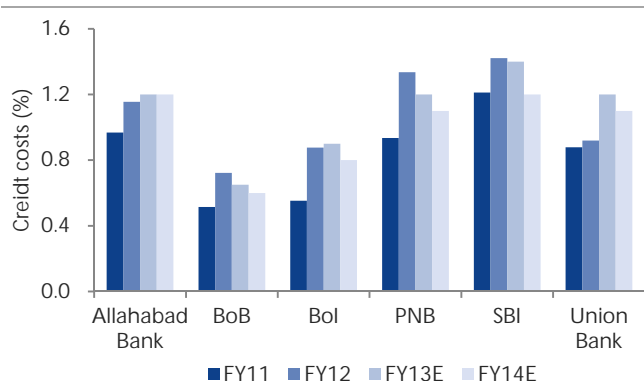
Exhibit 5: Private bank slippages to remain low



Source: Company and Elara Securities Estimates

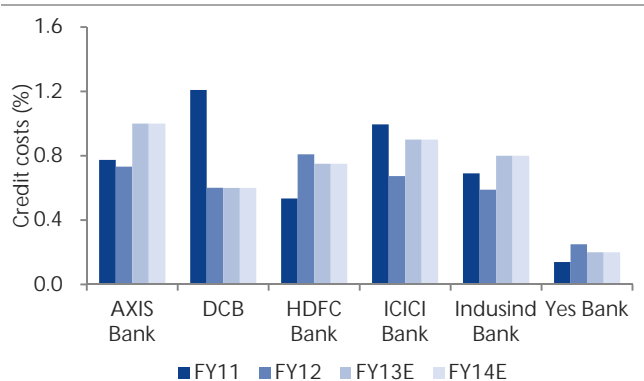
Resultantly, credit costs also which saw a spike in FY12 are expected to stay at elevated levels. While some part of the FY12 rise in credit costs was on account of regulatory changes and increased NPLs from system-based recognition; we expect upward pressure from further regulatory changes (restructured assets and dynamic provisions).

Exhibit 6: PSU credit costs to remain close to FY12 levels



Source: Company and Elara Securities Estimates

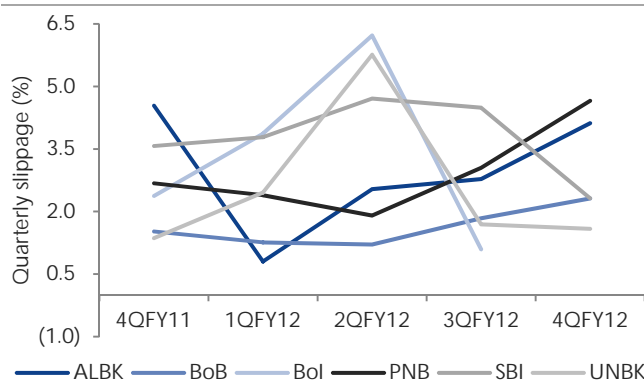
Exhibit 7: Stable to slight increase in private bank credit costs



Source: Company and Elara Securities Estimates

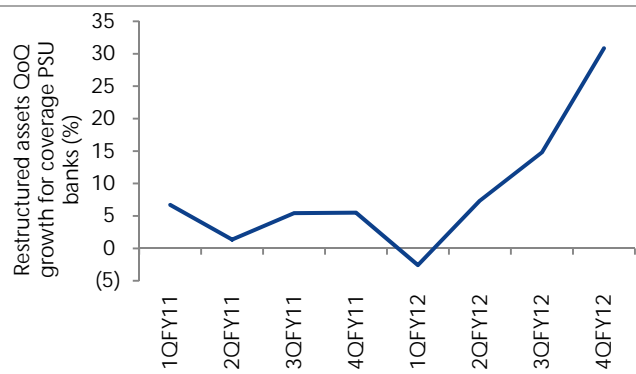
Slippages as well as restructured asset growth in the last 6 quarters has been volatile, with no clear trends either within a bank nor across banks, and management guidance often being non-indicative.

Exhibit 8: PSU slippages have been volatile



Source: Company and Elara Securities Research

Exhibit 9: Quarterly additions to restructured assets have been unpredictable



Source: Company and Elara Securities Research

Despite increased efforts on recoveries and more active and prudent monitoring of weak and stressed assets, taking a call on the rate of movement of asset quality still remains speculative. We expect Agri and SME books to continue posing as risks, which due to their small ticket nature tend to be notoriously difficult to predict with regards to the timing of their classification and recovery effort success. If the last six quarters of results have taught us anything – it is that slippages, NPL recoveries as well as restructured asset movement is volatile and taking a call on any of them is speculative at best.

An alternative approach to gauging asset quality risk

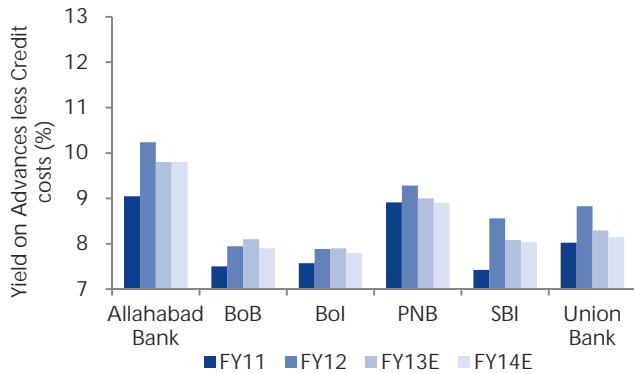
Instead therefore of trying to take a call on (1) the extent of further asset quality deterioration (2) the timing of its recognition and (3) the success rate of recoveries and reductions – we assess PSU banks on the basis of their *ability to absorb further credit cost increases*. The traditional approach of using absolute levels of (expected) NPL's to rank banks doesn't assess their ability to price in the asset risk and penalizes those who may have better risk adjusted asset yields (asset yields less credit costs).

In continuation with this approach, slippages as a standalone parameter are not necessarily indicative of profitability or earnings quality – *provided the bank has priced it efficiently* and made suitable provisions.

Additionally, when viewed through this alternate approach- differences in the ability of banks to effectively price in risk, as well as the size of their profitability cushions to absorb additional credit costs (losses) become more apparent.

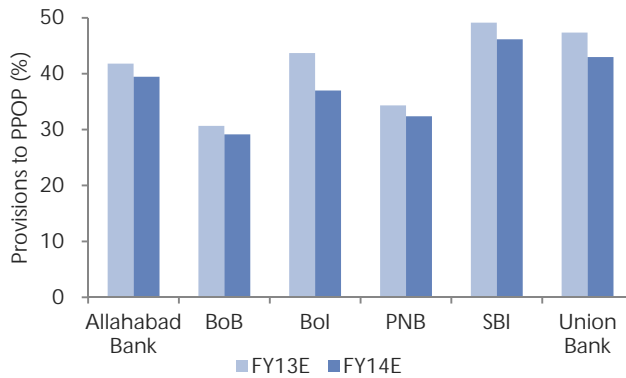
India Banks

Exhibit 10: The marked divergence in PSU risk-adjusted loan yields and...



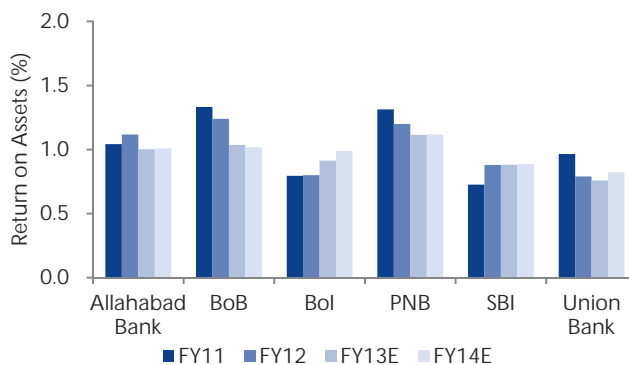
Source: Company and Elara Securities Estimates

Exhibit 11: ...varying degrees of PPOP cushion over provision expenses for PSU banks become a strong basis for differentiation



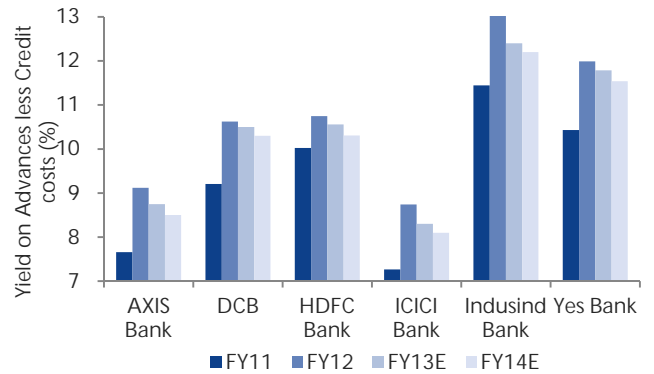
Source: Company and Elara Securities Estimates

Exhibit 12: Declining profitability in PSU banks heightens their sensitivity to increasing (credit) costs



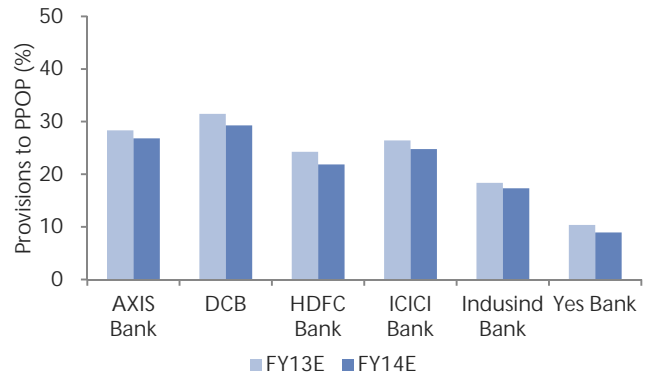
Source: Company and Elara Securities Estimates

Exhibit 13: Private bank risk-adjusted loan yields materially higher than PSU counterparts



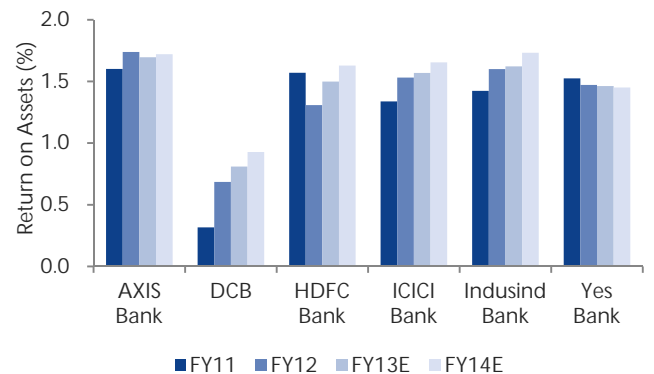
Source: Company and Elara Securities Estimates

Exhibit 14: Private banks have higher earnings cushion over provision expenses



Source: Company and Elara Securities Estimates

Exhibit 15: With higher RoA's, Private bank profitability is better insulated to increased (credit) costs

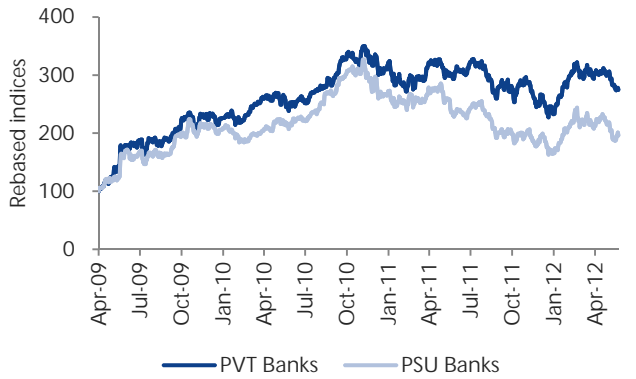


Source: Company and Elara Securities Estimates

Valuations: one size does not fit all

After peaking in October 2010, both the PSU as well as the Private bank indices (based on our coverage universe) have declined, with the PSU index losing more value. A story that is mirrored in their valuations as well, with PSU stocks trading at substantial discounts to their historical averages.

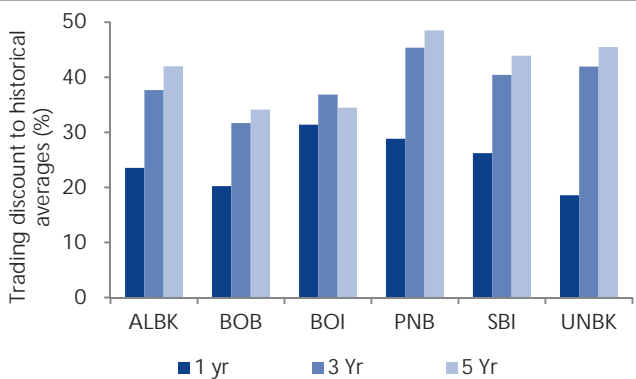
Exhibit 16: PSU bank underperformance



Source: Company and Elara Securities Research

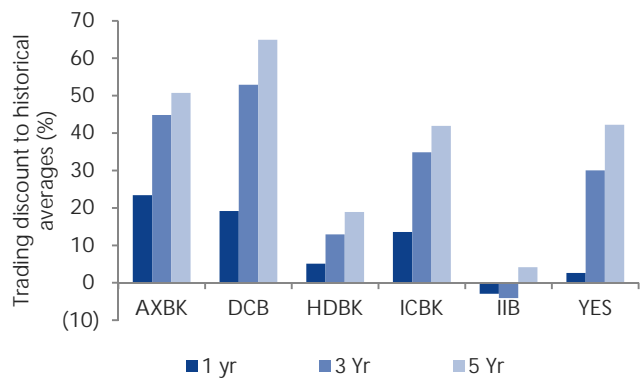
Trading discounts to the 1 year, 3 year and 5 year averages are broadly similar across our large cap PSU stocks. On the other hand, trading discounts for private banks have been more divergent, with IndusInd bank actually trading at premiums to its historical averages and Axis Bank having suffered one of the highest discounts. For PSU's we use book values adjusted for the post-tax outstanding Net NPL's in order to (1) make historical comparisons over asset cycles more reliable and (2) value the stock based only on its earning assets.

Exhibit 17: PSU banks all suffer from similar P/Adj BV trading discounts



Source: Bloomberg and Elara Securities Research

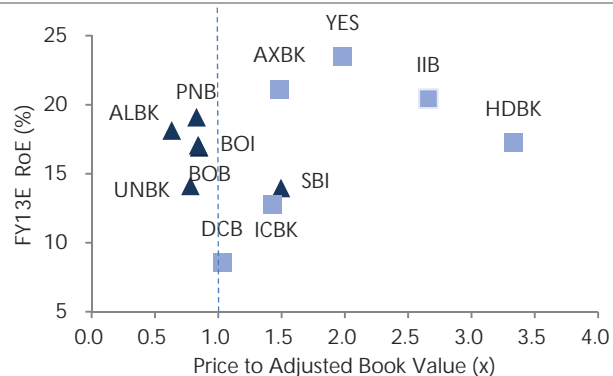
Exhibit 18: Trading discounts for private banks are more divergent



Source: Bloomberg and Elara Securities Research

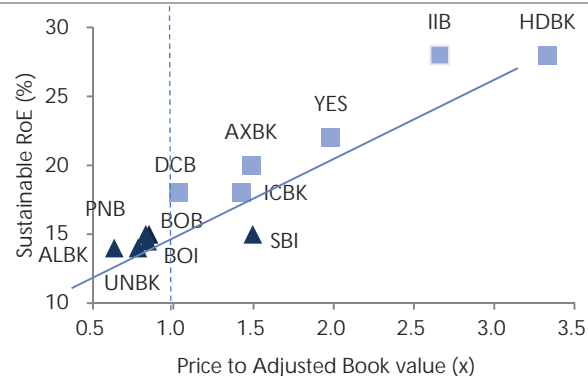
Furthermore, currently PSU banks are all trading in a similar band – symptomatic of a case of all of them being painted by the same brush of asset quality concerns. We believe that a finer brush needs to be used to make a distinction between banks which have more prudent credit underwriting skills and higher profitability cushions – and those that do not.

Exhibit 19: PSU banks all trading below adjusted book values



Source: Bloomberg and Elara Securities Research

Exhibit 20: PSU banks all trading in a similar bucket



Source: Bloomberg and Elara Securities Research

Applying the framework

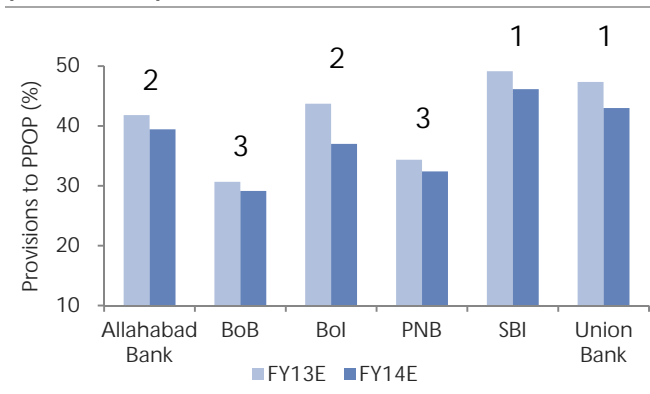
Applying this approach to our PSU coverage banks, we assess and score our coverage banks (from 1 to 3 points) on the following parameters:

1. Earnings cushion over provisions
2. Profitability cushion from high margins
3. Credit appraisal skills from expected slippages
4. Asset quality risk from restructured assets
5. Valuation comfort

1...Earnings cushion over provisions

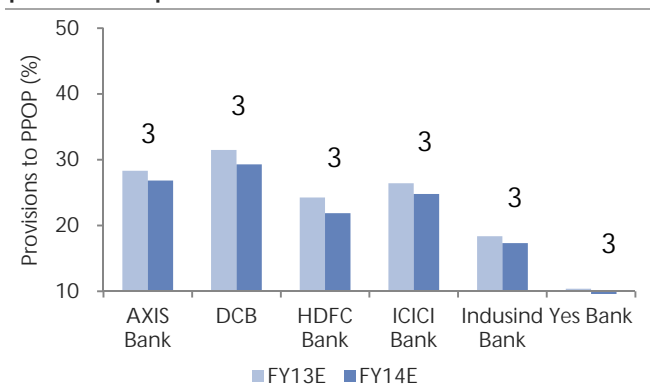
To gauge the capacity of earnings to be able to absorb further increased provisions, we rank banks in terms of the share of provisions to PPOP - the balance share being the headroom available for PPOP to absorb increased provision expenses. A higher ratio therefore denotes lesser earnings cushion and hence attracts a lower score.

Exhibit 21: PSU bank scoring for PPOP cushion over provision expenses



Source: Company and Elara Securities Estimates

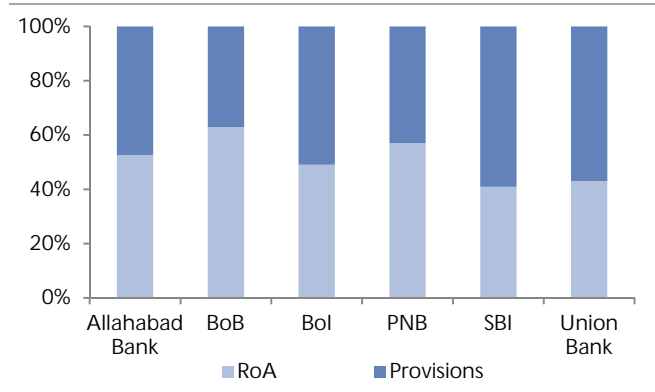
Exhibit 22: Pvt bank scoring for PPOP cushion over provision expenses



Source: Company and Elara Securities Estimates

Viewed in another way, a bank with a lower provisions-to-assets share to RoA is viewed more favourably.

Exhibit 23: Provision expenses to RoA ratio

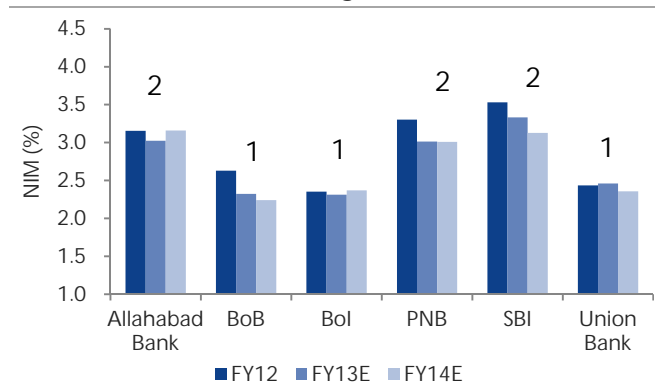


Source: Company and Elara Securities Research

2...Profitability cushion from high margins

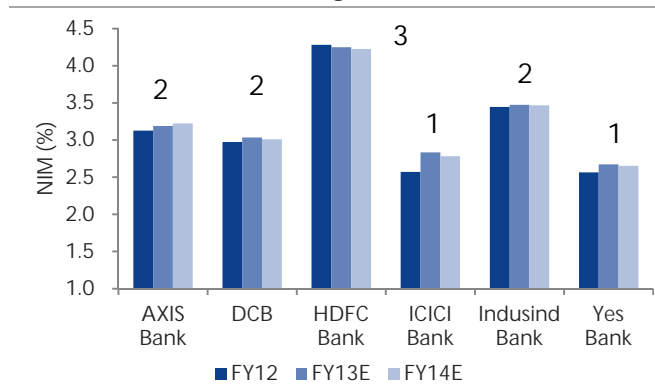
With close to 80% of PSU bank revenues coming from balance sheet related business, net interest margins become a key indicator of profitability. With non-interest based income being a volatile income stream even for the private sector banks, a high margin capability provides support to earnings. In our evaluation therefore, high projected margins therefore are assigned a higher score.

Exhibit 24: PSU bank scoring for NIM



Source: Company and Elara Securities Estimates

Exhibit 25: Pvt bank scoring for NIM

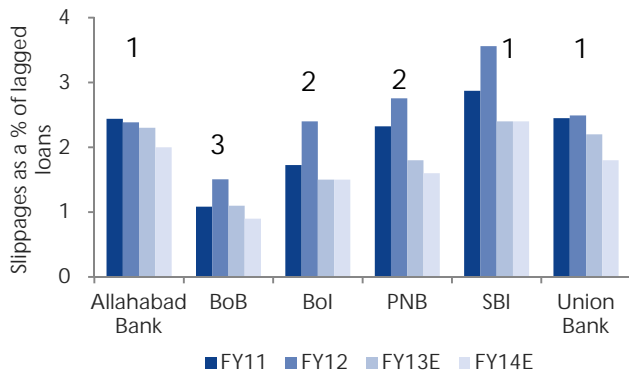


Source: Company and Elara Securities Estimates

3...Credit risk appraisal from expected slippages and credit cost-adjusted asset yields

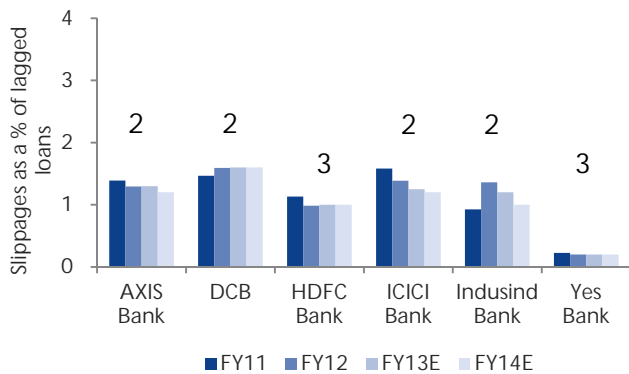
With recovery effort results being difficult to predict, we focus on expected slippages – as being a direct measure of the quality of the asset book being carried. As discussed earlier, we expect some moderation across the board in slippages, but a clear divergence amongst the banks to be evidence of risk differences. Lower slippages attract higher scores.

Exhibit 26: PSU bank scoring for slippages



Source: Company and Elara Securities Estimates

Exhibit 27: Pvt bank scoring for slippages



Source: Company and Elara Securities Estimates

In addition, the 230bps difference between the best and the worst credit-cost adjusted asset yields is a distinct indication of varying credit appraisal skills.

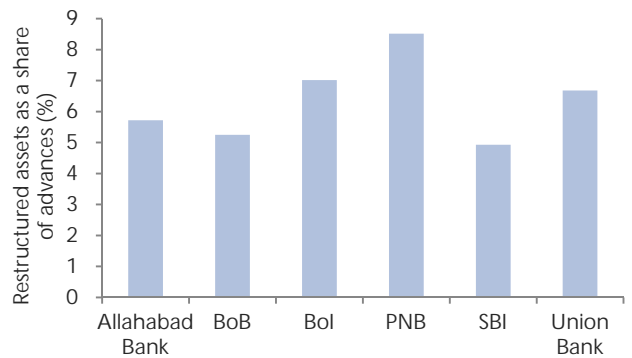
4...Asset quality risk from restructured assets

We do not view large restructured books as necessarily bearing more risk than smaller ones; and instead draw attention to the wide range of slippage rates and infer that *real economic risk arises from the quality off the restructured book, as opposed to the quantity of the restructured book.*

RBI is expected to make public a working group paper on restructuring of advances by banks which will hopefully bring transparency to the system and make more comparable the restructured books of various banks. Until such time however, we gauge the quality of restructured books based on their historical rates of

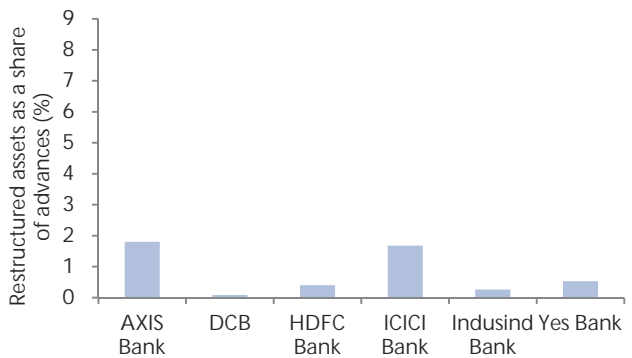
slippage into NPA. Higher slippage rates are viewed as higher risk and therefore deserve lower scores.

Exhibit 28: Restructured asset risk more relevant for PSU banks...



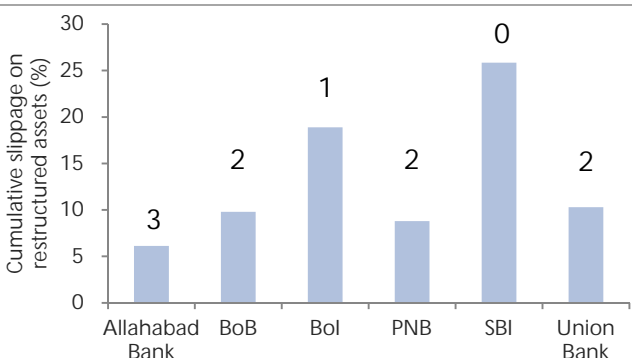
Source: Company and Elara Securities Research

Exhibit 29:...while for Private banks it remains at relatively benign levels



Source: Company and Elara Securities Research

Exhibit 30: Restructured asset risk scoring for PSU banks

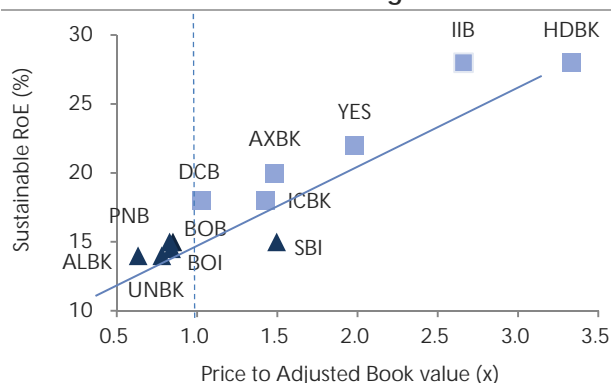


Source: Company and Elara Securities Research

5...Valuation comfort

The recent underperformance of bank stocks has led to valuations now being at historical lows and with it valuation comfort. All our stocks with the exception of SBI are now trading at discounts to their adjusted book values.

Exhibit 31: Valuation comfort high for all PSU banks



Source: Company and Elara Securities Research

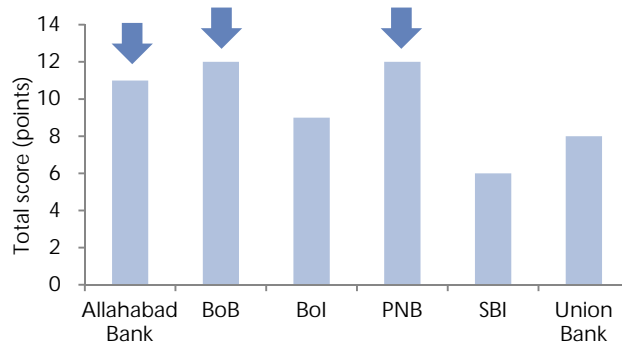
Conclusions and summary

By design, our scoring system assigns 40% weightage to the profitability of the franchise (cushion over provisions and NIMs); 40% to asset quality concerns (slippages and restructured book) and the balance 20% to valuation comfort.

Our framework as can be seen from the below table therefore, evaluates BoB, PNB and Allahabad Bank as the highest scoring banks across these parameters.

We have included the scores of our coverage private banks for reference. With the variance amongst private banks being markedly less on our defined parameters, the framework does not lend particularly well to stock selection in the private space – where valuations are the primary means of differentiation.

Exhibit 32: BoB, PNB and Allahabad bank emerge as winners



Source: Company and Elara Securities Research

Exhibit 33: Summary table

	Earnings cushion from higher credit costs	High margins	Slippage levels	Restructured assets	Valuation comfort	Total
PSU Banks						
Allahabad Bank	2	2	1	3	3	11
BoB	3	1	3	2	3	12
BoI	2	1	2	1	3	9
PNB	3	2	2	2	3	12
SBI	1	2	1	-	2	6
Union Bank	1	1	1	2	3	8
Private banks						
AXIS Bank	3	2	2	3	2	12
DCB	3	2	2	3	2	12
HDFC Bank	3	3	3	3	-	12
ICICI Bank	3	1	2	3	2	11
Indusind Bank	3	2	2	3	-	10
Yes Bank	3	1	3	3	1	11

Source: Company and Elara Securities Research

Exhibit 34: Valuation table summary

	CMP 23-May-12	CMP/Adjusted Book		CMP / Book		RoA (%)		RoE (%)	
		FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
State banks									
Allahabad Bank	140	0.63	0.5	0.57	0.5	1.0	1.0	18.1	19.1
Bank of Baroda	657	0.85	0.7	0.81	0.7	1.0	1.0	16.9	16.9
Bank of India	312	0.84	0.7	0.75	0.6	0.9	1.0	17.1	18.6
Punjab National Bank	708	0.83	0.7	0.74	0.6	1.1	1.1	19.1	19.8
State Bank of India	1,955	1.50	1.3	1.33	1.2	0.9	0.9	14.0	14.0
Union Bank of India	201	0.78	0.7	0.67	0.6	0.8	0.8	14.1	16.1
Private banks									
AXIS Bank	963	1.48	1.25	1.46	1.23	1.7	1.7	21.1	21.4
DCB	39	1.03	0.93	0.99	0.89	0.8	0.9	8.6	10.8
HDFC Bank	487	3.33	2.80	3.33	2.80	1.5	1.6	17.3	19.4
ICICI Bank	793	1.43	1.30	1.39	1.27	1.6	1.7	12.8	14.4
Indusind Bank	303	2.66	2.20	2.60	2.16	1.6	1.7	20.4	23.0
Yes Bank	321	1.98	1.62	1.98	1.61	1.5	1.5	23.5	24.2

Source: Company and Elara Securities Research

Exhibit 35: Summary of price target derivation and recommendations

	CMP 23-May-12	PT (INR)	Upside (%)	Rating	Implied P/B (x)	Current FY13E P/B (x)	Sustainable RoE (%)	CoE (%)	Rf rate (%)	Terminal growth (%)	Beta (x)
State banks											
Allahabad Bank	140	235	68	Buy	1.07	0.57	14.0	13.5	8.0	6.0	1.1
Bank of Baroda	657	925	41	Buy	1.20	0.81	15.0	13.5	8.0	6.0	1.1
Bank of India	312	405	30	Accumulate	1.21	0.75	14.5	13.0	8.0	6.0	1.0
Punjab National Bank	708	1,026	45	Buy	1.20	0.74	15.0	13.5	8.0	6.0	1.1
State Bank of India	1,955	2,221	14	Accumulate	1.29	1.33	15.0	13.0	8.0	6.0	1.0
Union Bank of India	201	275	37	Buy	1.07	0.67	14.0	13.5	8.0	6.0	1.1
Private banks											
AXIS Bank	963	1,398	45	Buy	2.15	1.46	20.0	12.5	8.0	6.0	0.9
DCB	39	60	56	Buy	1.60	0.99	18.0	13.5	8.0	6.0	1.1
HDFC Bank	487	536	10	Reduce	3.67	3.33	28.0	12.0	8.0	6.0	0.8
ICICI Bank	793	1,206	52	Buy	1.71	1.39	18.0	13.0	8.0	6.0	1.0
Indusind Bank	303	371	22	Accumulate	3.14	2.60	28.0	13.0	8.0	6.0	1.0
Yes Bank	321	371	16	Reduce	2.29	1.98	22.0	13.0	8.0	6.0	1.0

Source: Company and Elara Securities Research

Rolling P/Adj BV charts for coverage banks

Exhibit 36: Allahabad Bank rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

Exhibit 40: State Bank of India rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

Exhibit 37: Bank of Baroda rolling P/Adjusted BV



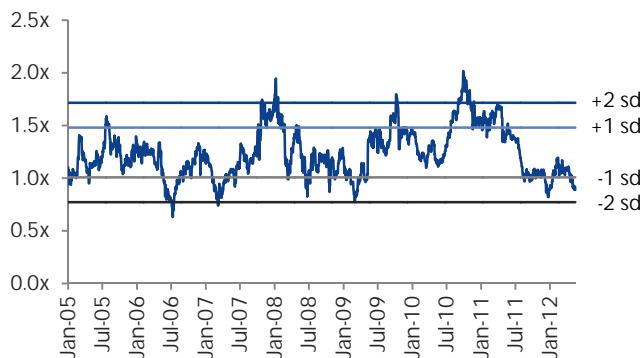
Source: Bloomberg and Elara Securities Research

Exhibit 41: Union Bank of India rolling P/Adjusted BV



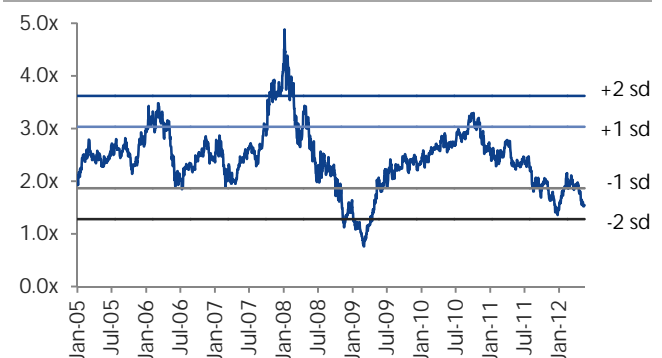
Source: Company and Elara Securities Research

Exhibit 38: Bank of India rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

Exhibit 42: Axis Bank rolling P/Adjusted BV



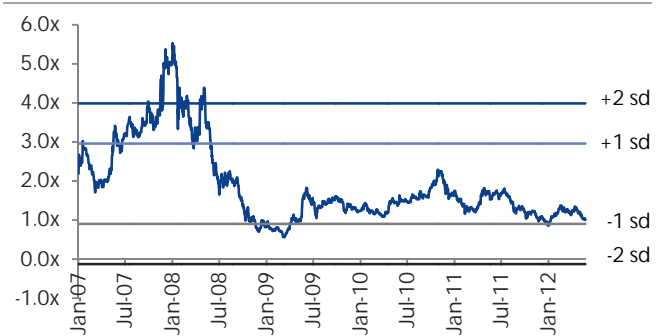
Source: Bloomberg and Elara Securities Research

Exhibit 39: Punjab National Bank rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

Exhibit 43: DCB rolling P/Adjusted BV



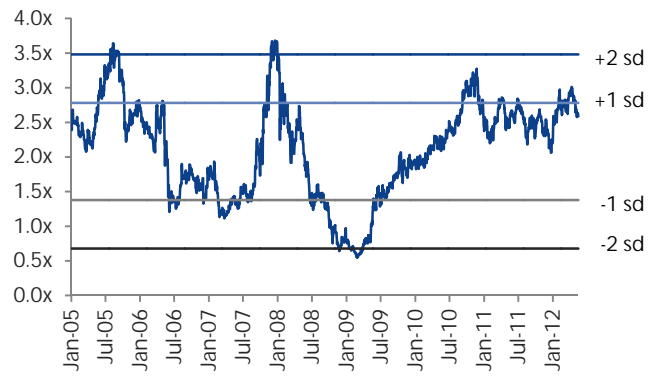
Source: Bloomberg and Elara Securities Research

Exhibit 44: HDFC Bank rolling P/Adjusted BV



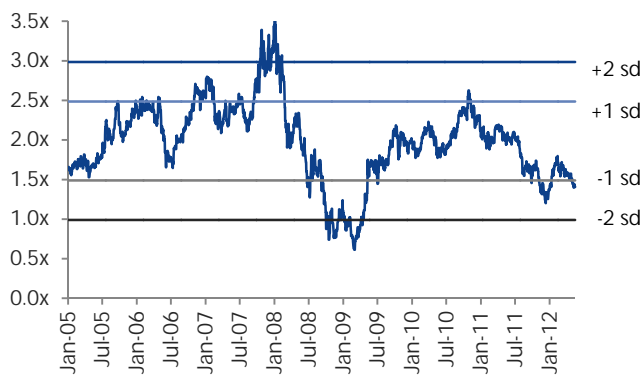
Source: Bloomberg and Elara Securities Research

Exhibit 46: IndusInd Bank rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

Exhibit 45: ICICI Bank rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

Exhibit 47: Yes Bank rolling P/Adjusted BV



Source: Bloomberg and Elara Securities Research

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