FY 2014

Equity Research Report

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[INDIAN BANKING SECTOR]

The Indian Banking Sector is characterized by Public Sector Banks, which have achieved low margins and growth and Private Banks, which have achieved higher growth rates and profit margins. Indian Private Banks trade at high price to book multiples because of their superior performance. In this report, we seek to look at the reasons behind this performance, its future sustainability and whether the high valuations attributed to them are justified.

Value Investment Philosophy and Analysis Framework

Value Investing is a discipline that assesses the performance of a business independent of market perceptions. This enables us to identify major mispricing of stocks and use this to our advantage. Popular investment theory believes in efficient markets free of any mispricing, a notion that 'the markets are always right'. We dispel such notions and specifically look for such mispricing as investment opportunities. The discipline of value investing believes that the markets have wild mood swings ranging from exuberance to pessimism, thus implying that 'the markets are always wrong' when it comes to pricing stocks.

The mispricing that we observe in the market often tends to last for very long periods. Hence, it is important for us to be very long term investors. If one does not have the patience to hold onto an investment for 3 to 5 years, this is not an appropriate investment approach for them.

Since we start with the notion that the market is inaccurate at pricing stocks, what consequently follows is that there is no single correct valuation for a company and that value is a perception of every individual investor. The problem for small investors under such an approach is that transactions can only be executed at the market price, whatever may be their perception of value. Thus there is always a risk that one's perceived value may never be realized in the market. In order to reduce this risk, we have a section on 'market perception' in our report, to keep us cognizant of how the market has historically valued a company and how different is it from our valuation.

Another major concept in our valuation approach is conservatism. We are fully aware of the fact that there a multitude of assumptions that go into a valuation, many of which could be wrong. Hence, it is important to maintain a margin of safety in our recommendations. It is because of this that we come up with a very wide price range between the 'undervalued' and 'overvalued' state for a stock. This reduces our ability to do frequent trades in a stock but enables us to do a few transactions whit very little risk and high return potential.

The Indian Banking Opportunity

A value investor's perspective on the Indian Banking Sector

Globally, banking is a cyclical, commoditized business. The products are virtually uniform, the pricing is market determined and there is very little premium that a good brand can command in this space. However, India's Banking Sector is a little different. Indian private banks trade at a substantial premium to their book values, while the state owned banks trade mostly at or below their book value. Top Indian Banks with their PB ratios are as below.

Private Banks

Sr	Company Name	Last Price	% Chg	Book Value	PBV Ratio	Year
1	JK Bank	1,490.80	-0.18	1,180.67	1.26	Mar '14
2	ICICI Bank	1,556.55	1.01	632.67	2.46	Mar '14
3	ING Vysya Bank	628.00	-0.61	372.23	1.69	Mar '14
4	HDFC Bank	842.95	0.76	180.20	4.68	Mar '14
5	Yes Bank	571.65	-0.38	171.34	3.34	Mar '14
6	IndusInd Bank	583.70	1.26	170.98	3.41	Mar '14
7	Axis Bank	397.30	-0.34	162.07	2.45	Mar '14
8	Karnataka Bank	123.05	-0.61	161.97	0.76	Mar '14
9	Kotak Mahindra	1,036.00	-0.38	159.25	6.51	Mar '14
10	Federal Bank	120.80	-0.82	81.24	1.49	Mar '14
11	South Ind Bk	27.80	-0.18	24.99	1.11	Mar '14

State Owned Banks

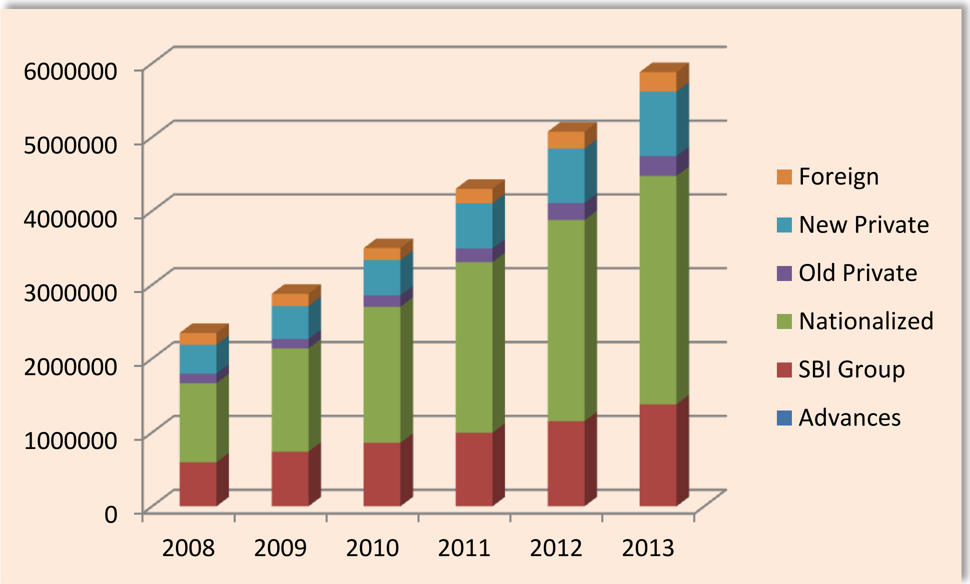
Sr	Company Name	Last Price	% Chg	Book Value	PBV Ratio	Year
1	SBI	2,460.45	-1.70	1,584.33	1.55	Mar '14
2	PNB	946.00	-1.70	991.39	0.95	Mar '14
3	Bank of Baroda	870.85	-1.90	835.56	1.04	Mar '14
4	Corporation Bk	327.00	1.66	601.95	0.54	Mar '14
5	Bank of India	277.35	-1.46	465.37	0.60	Mar '14
6	Oriental Bank	262.00	-2.58	447.91	0.58	Mar '14
7	Indian Bank	136.65	-5.01	298.40	0.46	Mar '14
8	Union Bank	208.40	-0.33	291.36	0.72	Mar '14
9	Allahabad Bank	113.95	-0.44	216.68	0.53	Mar '14
10	Syndicate Bank	119.55	-2.53	189.63	0.63	Mar '14
11	IDBI Bank	76.10	-2.31	147.38	0.52	Mar '14
12	Andhra Bank	72.15	-3.93	143.17	0.50	Mar '13
13	Dena Bank	58.45	-2.99	132.81	0.44	Mar '14
14	IOB	59.50	-4.80	130.90	0.45	Mar '14
15	UCO Bank	88.90	-1.50	110.64	0.80	Mar '14
16	Central Bank	64.20	0.31	99.69	0.64	Mar '14

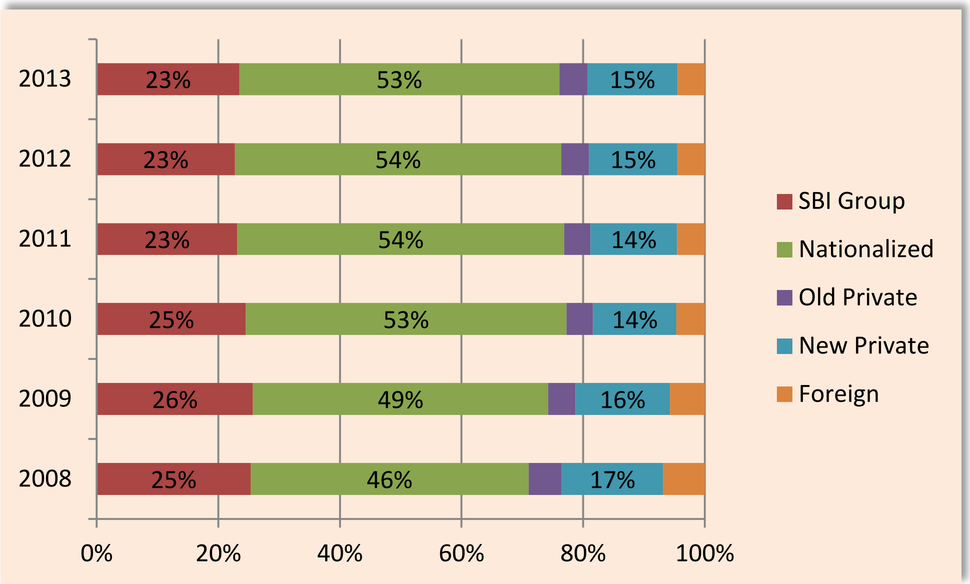
This is the phenomenon we are trying to study in this report. We are trying to look at why is there such a wide difference in the valuations of public and private banks in India. Moreover, we are trying to understand if there is a sustainable competitive advantage for the private players in banking. If so, how do we value this advantage and figure out if any of these players are undervalued? Let's try and answer some of these questions.

Market Size and Share

When we think about a company or a group of companies doing better than the Industry is – They must be gaining market share in a growing market. In case of banking, we can look at market share in many ways. We have looked at market share in terms of Advances, Savings Account Balances and Current Account Balances.

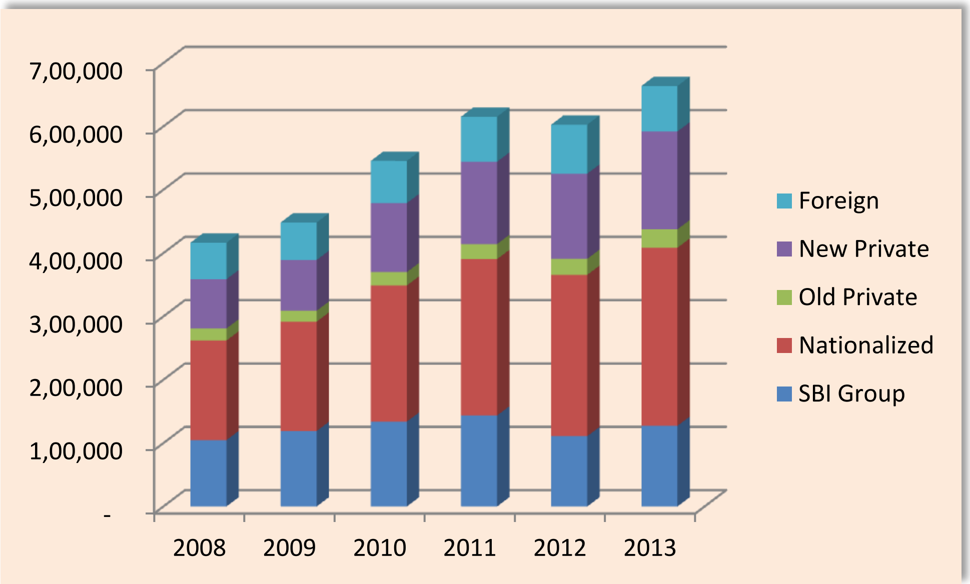
Advances Growth and Market Share

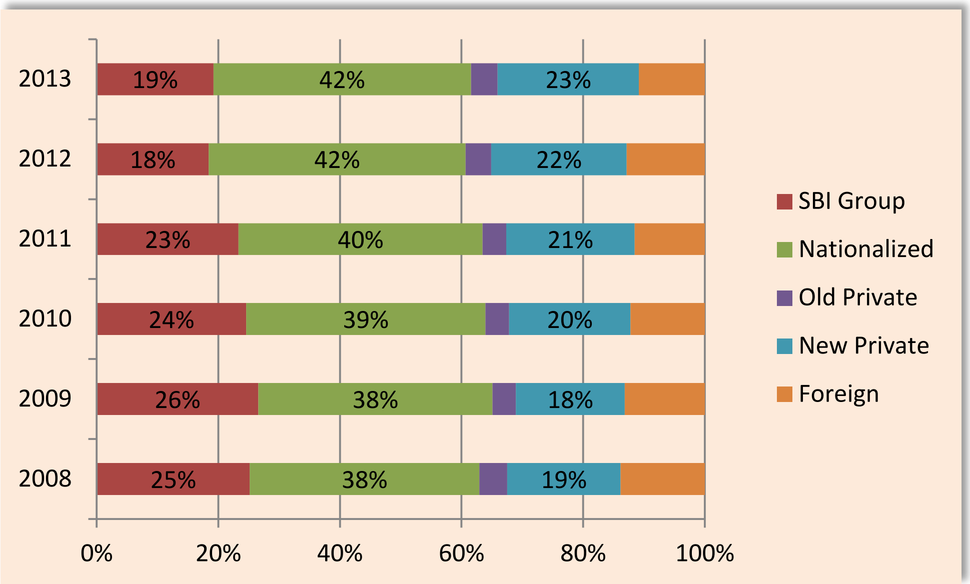




As we can observe, the total advances of the banking system have increased from Rs. 20 lac crs in FY08 to Rs. 55 lac crs in FY13. However, the share of private banks in these advances has remained stagnant at around 15%.

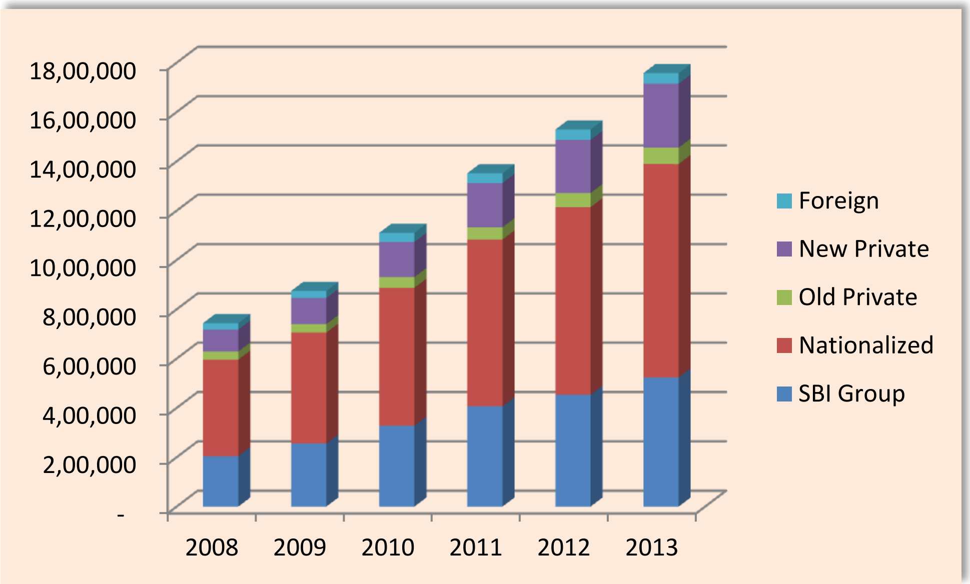
Current Account Balances - Growth and Market Share

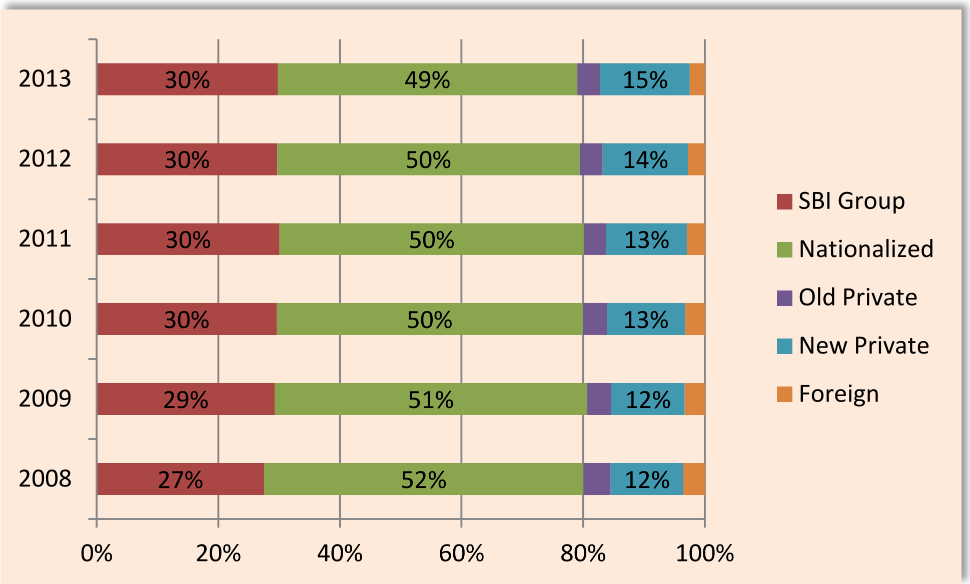




The increase in current account balances has not been as fast as that of advances. Part of the reason for this could be the rising popularity of money market mutual funds as an alternative. There has been some increase in the market share of private banks from 19% to 23%.

Savings Account Balances – Growth and Market Share



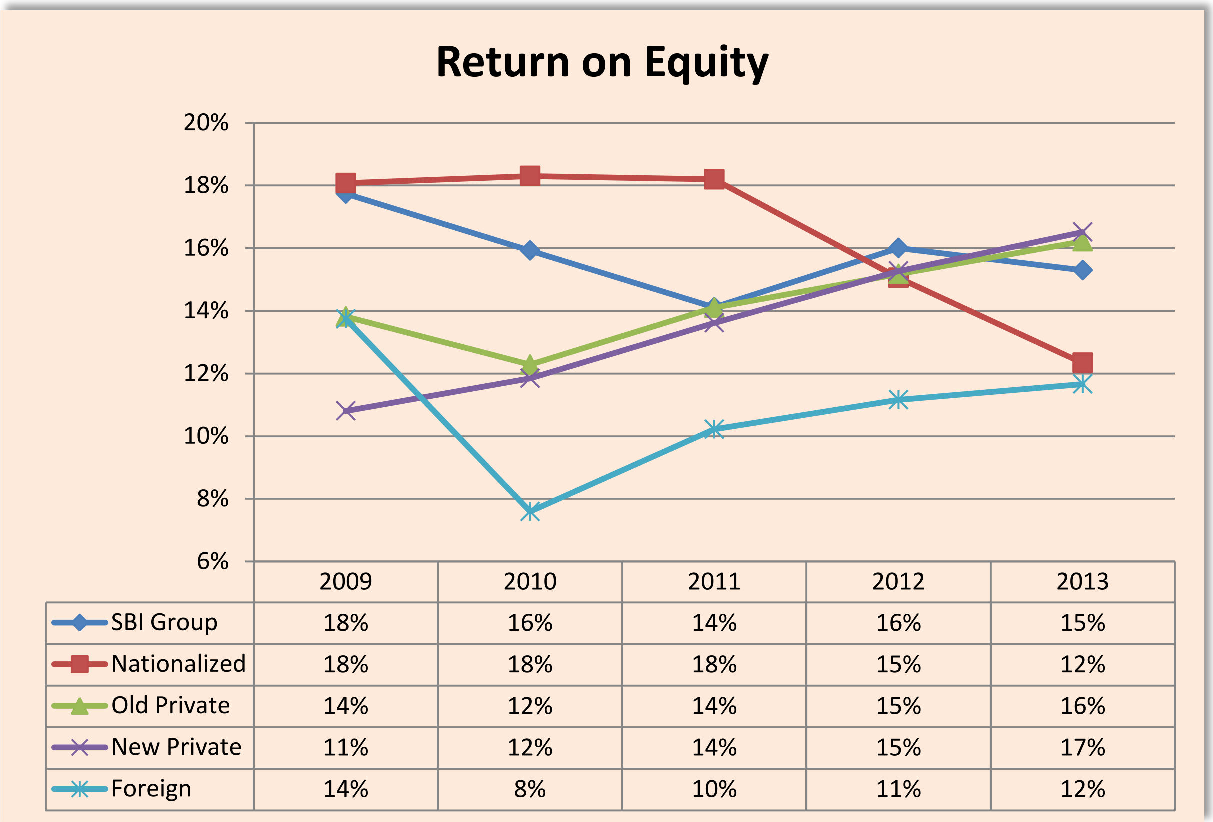


The Savings Balances of India have increased very fast from Rs. 7 lac crs in FY08 to Rs. 17 lac crs in FY13. The market share of private players in this has increased from 12% to 15%.

Overall, it doesn't seem like the private banks are eating into the market of public sector banks – especially when it comes to loans and advances. On the CASA side, they seem to be gaining market share slowly and incrementally. Hence, we do not believe that market share can explain the Indian private bank story.

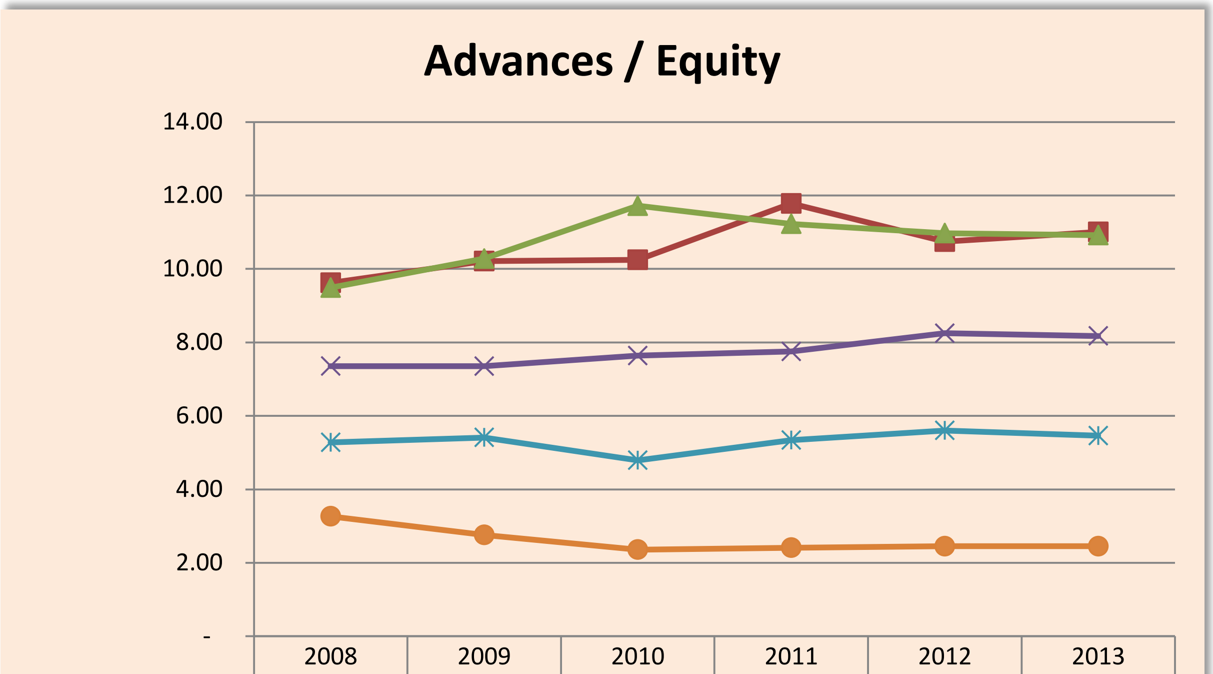
Profitability and its Drivers

Since market share does not explain the story, we look at profitability. A comparison of the profitability of various classes of banks is done below.



	2009	2010	2011	2012	2013
SBI Group	18%	16%	14%	16%	15%
Nationalized	18%	18%	18%	15%	12%
Old Private	14%	12%	14%	15%	16%
New Private	11%	12%	14%	15%	17%
Foreign	14%	8%	10%	11%	12%

The return on equity of SBI group has declined from 18% to 15%, while that of nationalized banks has reduced from 18% to 12%. Over the same period, the return on equity of new private banks has increased from 11% to 17%. Thus, there is a definite improvement in the performance of private banks and deterioration in the performance of public banks. But this in itself does not explain the whole story. The entire story can be explained only when we look at profitability with leverage. Below table shows the advances/equity ratio of various banks.



	2008	2009	2010	2011	2012	2013
SBI Group	9.62	10.21	10.25	11.78	10.74	11.01
Nationalized	9.49	10.28	11.72	11.23	10.97	10.92
Old Private	7.35	7.35	7.64	7.75	8.25	8.18
New Private	5.28	5.41	4.79	5.34	5.60	5.46
Foreign	3.27	2.76	2.36	2.41	2.45	2.45

As we can observe, the Advances / Equity ratio for public banks is in the range of 9-11, while that of private banks is in the range of 5-6. This means that private banks have significant capability to expand their balance sheet and improve their profitability further. Conversely, we can say that private banks have taken much lesser risk for an equivalent amount of income earned, as compared to public sector banks.

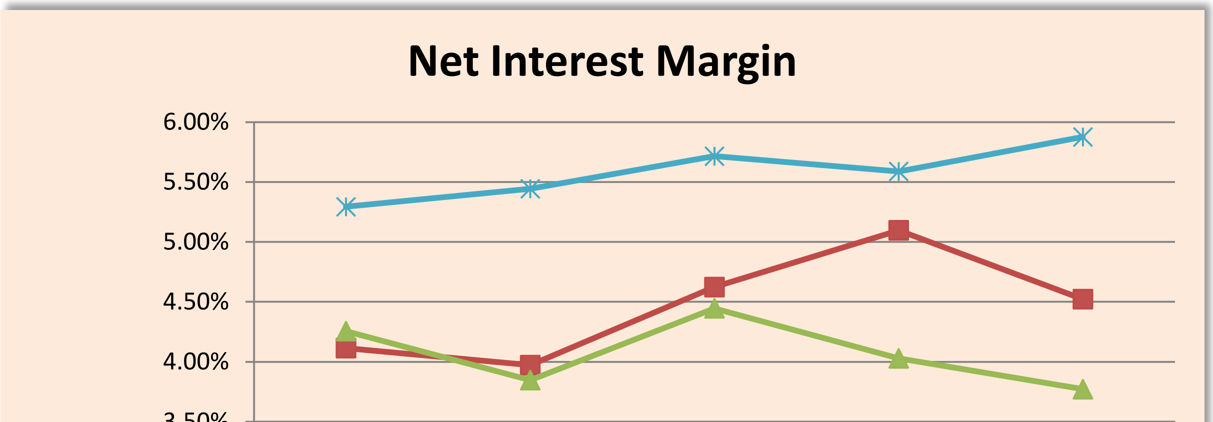
We can re-confirm this by looking at the Capital Adequacy Ratios of various banks.

Tier I - Capital Adequacy (Basel II)	
SBI Group	9.31
Nationalized	8.82
Old Private	12.01
New Private	12.18
Foreign	15.82

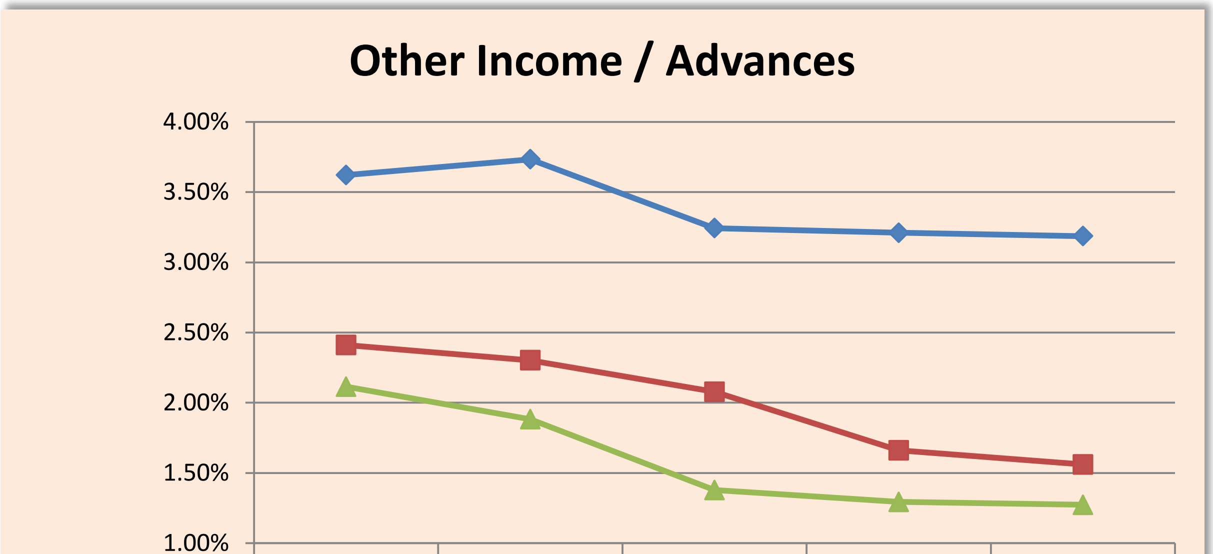
As we can observe from the above table, the private banks are certainly better capitalized than public sector banks. This strengthens our contention that private banks have been able to achieve lower risk for the same returns.

Composition of Returns

Now that we know what is working in favour of private banks, the question we ask ourselves is – why? Why have private banks been able to achieve higher risk adjusted returns? To understand this, we look at each component of the returns in the below tables.



	2009	2010	2011	2012	2013
SBI Group	4.11%	3.97%	4.62%	5.10%	4.52%
Nationalized	4.26%	3.85%	4.45%	4.03%	3.77%
New Private	5.29%	5.44%	5.71%	5.59%	5.88%



	2009	2010	2011	2012	2013
SBI Group	2.41%	2.30%	2.08%	1.66%	1.56%
Nationalized	2.11%	1.88%	1.38%	1.29%	1.27%
New Private	3.62%	3.73%	3.24%	3.21%	3.19%

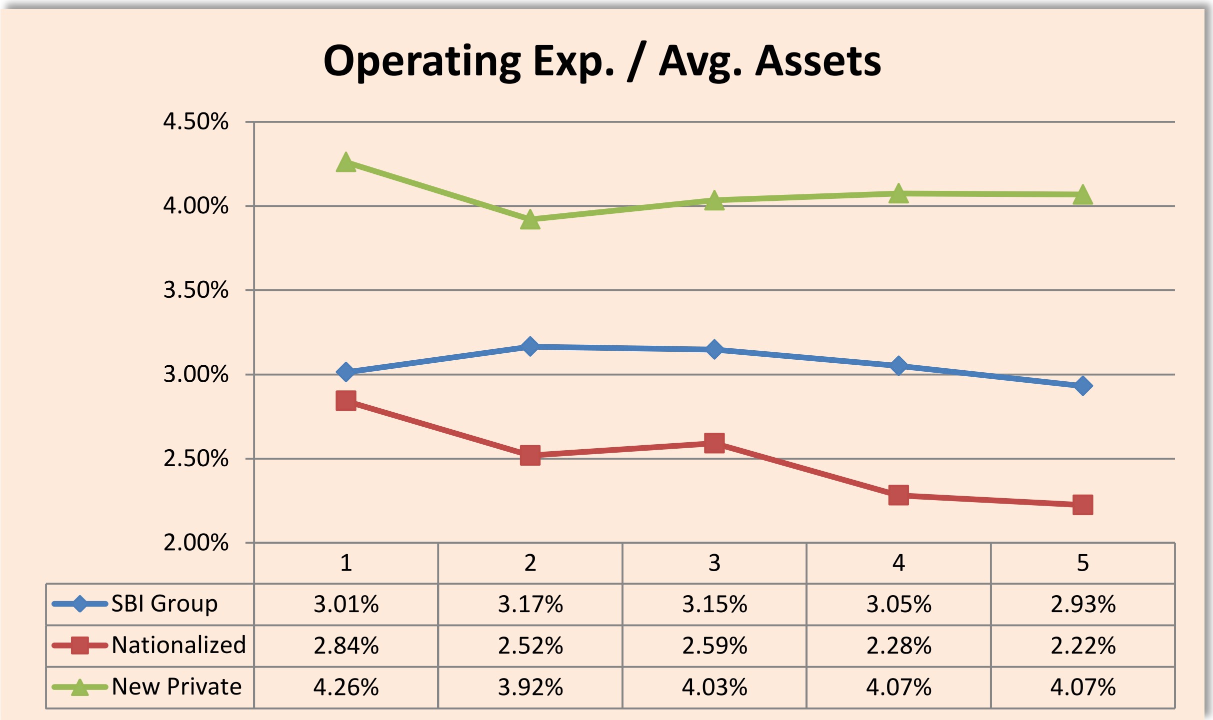
As we can observe from the above two tables, private banks have earned higher Interest Margins as well as higher fee based income. On the other hand, they have taken lower risk as is evident from their Gross NPA ratio as shown in below table.

Gross NPA Ratio	
SBI Group	4.42
Nationalized	3.24
Old Private	1.91
New Private	1.76
Foreign	2.96

Thus we can say that private banks are able to achieve higher risk adjusted return as compared to their PSU peers.

Operating Costs

We have already seen that private banks are able to achieve higher revenue than PSU banks. But are they the also the lowest cost players? We look at this in the below tables.



	1	2	3	4	5
SBI Group	3.01%	3.17%	3.15%	3.05%	2.93%
Nationalized	2.84%	2.52%	2.59%	2.28%	2.22%
New Private	4.26%	3.92%	4.03%	4.07%	4.07%

As we can observe, the operating expenses of private banks are much higher than that of PSUs. This can be because of two reasons. Firstly, the asset base of private banks is smaller than PSUs. Secondly, since private banks earn higher fee based income, the corresponding expenses also hit their P&L. There may be a time in the future when private banks become the least cost players due to superior technology, but due to their small asset base, this seems to be far off.

Despite their higher costs, private banks have been able to generate higher profits due to their high revenue generation capabilities. A comparative common size statement is presented below.

Common Size (FY13)	SBI Group	Nationalized	Old Private	New Private	Foreign
Gross Advances	100.00	100.00	100.00	100.00	100.00
Net Interest Income (NII)	4.52	3.77	4.83	5.88	9.55
Provisioning (Std. + NPA)	1.75	1.69	1.41	2.01	3.58
NII after provisioning	2.78	2.08	3.42	3.87	5.96
Other Income	1.56	1.27	1.66	3.19	2.29
Operating Expenses	2.93	2.22	3.10	4.07	5.79
Net Profit	1.41	1.13	1.98	2.99	2.47
Advances / Equity Capital	11.01	10.92	8.18	5.46	2.45
Equity Capital Employed	9.09	9.16	12.23	18.31	40.80
ROE (%)	15.46	12.31	16.16	16.32	6.05

Interim Conclusion

Based on the above analysis, we may conclude that private banks have not gained substantial market share from the PSUs. Their higher valuations are a result of their higher profitability, which results out of better risk management and underwriting ability. However, this would only be half the picture. In order to fully understand whether this story holds, we need to analyse the private banks individually. A comparative performance analysis of private banks is presented below.

Bank-Wise Analysis

We have specifically look at 6 private banks – Axis, HDFC, ICICI, IndusInd, Kotak and Yes. We have compared their individual performance on all of the above parameters to see how they are doing versus their competition.

Market Share Analysis

Our broad assessment in our study of market shares of individual banks is that on all parameters, ICICI Bank's market share has reduced over the years, while that of other banks has increased. Thus, our earlier conclusion that private banks have not gained market share holds true only statistically, but not analytically.

Advances – Market Share and Growth

Advances - Share	2008	2009	2010	2011	2012	2013
Axis	2.54%	2.83%	2.98%	3.31%	3.35%	3.35%
HDFC	2.70%	3.44%	3.60%	3.72%	3.85%	4.08%
ICICI	9.62%	7.59%	5.18%	5.03%	5.00%	4.94%
IndusInd	0.55%	0.55%	0.59%	0.61%	0.69%	0.75%
Kotak	0.66%	0.58%	0.59%	0.68%	0.77%	0.82%
Yes	0.40%	0.43%	0.63%	0.80%	0.75%	0.80%
Others	83.53%	84.58%	86.42%	85.84%	85.59%	85.26%
Industry	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Advances - Growth	2009	2010	2011	2012	2013
Axis	36.70%	27.94%	36.48%	19.21%	16.03%
HDFC	55.90%	27.25%	27.14%	22.15%	22.67%
ICICI	-3.24%	-17.00%	19.40%	17.27%	14.39%
IndusInd	23.25%	30.31%	27.32%	34.01%	26.40%
Kotak	6.90%	24.96%	41.18%	33.24%	24.03%
Yes	31.52%	78.93%	54.84%	10.55%	23.72%
Others	24.16%	24.18%	22.11%	17.68%	15.44%
Industry	22.61%	21.54%	22.94%	18.03%	15.89%

ICICI Bank has lost its share of advances from 9.62% to 4.94%. This is probably because of a more conservative lending policy followed after they made losses during the financial crisis years.

Current Account Balances – Market Share and Growth

Current Account Deposits - Share	2008	2009	2010	2011	2012	2013
Axis	4.58%	5.22%	5.63%	5.75%	6.23%	6.82%
HDFC	6.67%	6.15%	6.61%	7.36%	7.36%	7.70%
ICICI	5.78%	4.64%	5.39%	5.31%	5.46%	5.24%
IndusInd	0.42%	0.65%	0.79%	1.01%	1.11%	1.19%
Kotak	0.74%	0.74%	0.89%	0.87%	1.20%	1.12%
Yes	0.23%	0.27%	0.44%	0.62%	0.74%	0.97%
Others	81.57%	82.34%	80.25%	79.09%	77.91%	76.95%
Industry	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Current Account Deposits - Growth	2009	2010	2011	2012	2013
Axis	22.67%	31.17%	15.17%	6.11%	20.56%
HDFC	-0.82%	30.65%	25.63%	-2.08%	15.23%
ICICI	-13.66%	41.30%	11.01%	0.75%	5.70%
IndusInd	65.14%	49.15%	42.86%	8.53%	17.98%
Kotak	7.93%	46.33%	9.53%	34.93%	3.58%
Yes	24.19%	97.49%	59.75%	16.98%	44.11%
Others	8.63%	18.53%	11.10%	-3.49%	8.74%
Industry	7.62%	21.61%	12.74%	-2.03%	10.09%

Most private banks have gained in terms of share of current account balances, while ICICI is stagnant. However, there is a wide variation in year on year growth rates, as the industry's growth itself has fluctuated wildly.

Savings Account Balances – Market Share and Growth

Savings Account Deposits - Share	2008	2009	2010	2011	2012	2013
Axis	2.68%	2.95%	3.05%	3.02%	3.38%	3.62%
HDFC	3.51%	3.98%	4.49%	4.69%	4.83%	5.01%
ICICI	5.24%	4.68%	4.79%	4.94%	4.97%	4.87%
IndusInd	0.16%	0.15%	0.17%	0.23%	0.31%	0.40%
Kotak	0.20%	0.19%	0.22%	0.25%	0.33%	0.41%
Yes	0.02%	0.02%	0.04%	0.06%	0.16%	0.34%
Others	88.19%	88.03%	87.25%	86.82%	86.02%	85.34%
Industry	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

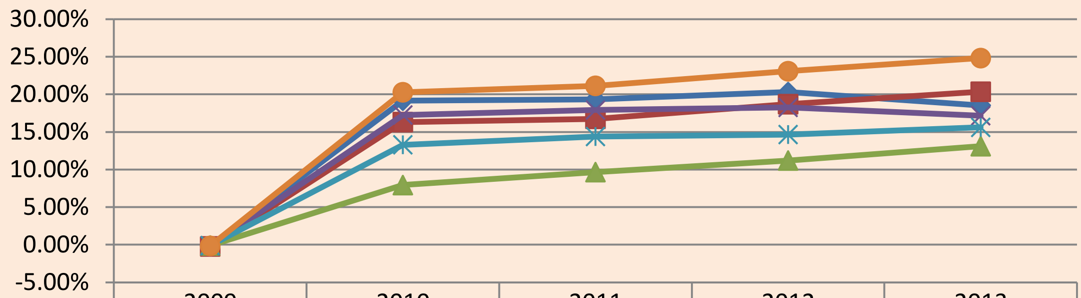
Savings Account Deposits - Growth	2009	2010	2011	2012	2013
Axis	29.22%	31.13%	20.64%	26.48%	23.44%
HDFC	33.50%	42.85%	27.21%	16.63%	19.21%
ICICI	4.98%	29.69%	25.65%	13.72%	12.63%
IndusInd	9.57%	47.31%	59.73%	53.46%	49.82%
Kotak	12.08%	45.28%	34.78%	51.64%	43.92%
Yes	31.07%	103.58%	108.97%	206.45%	140.54%
Others	17.26%	25.74%	21.15%	12.04%	14.06%
Industry	17.49%	26.85%	21.75%	13.08%	14.97%

The story is similar with savings balances, although industry growth rate for savings balances is steadier.

Profitability Drivers

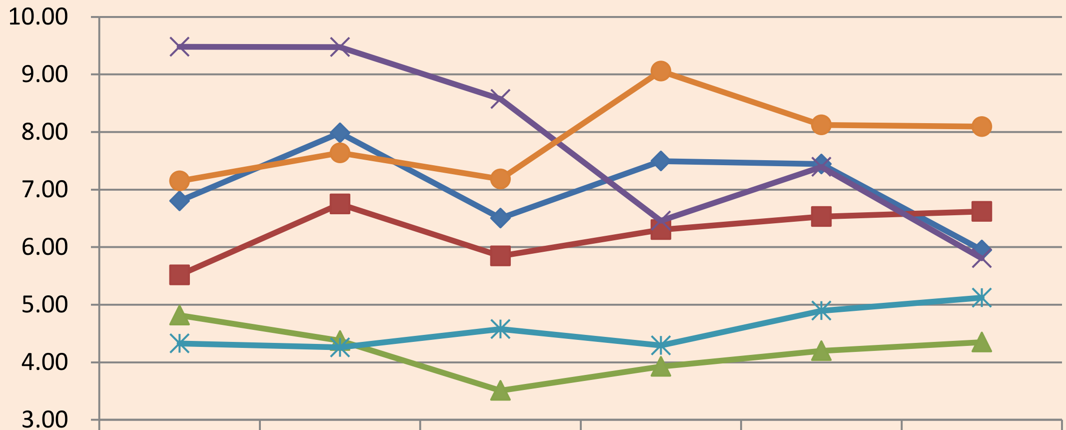
We have looked at various profitability parameters of private banks to see if all of them are indeed more profitable than their PSU counterparts. We also look at the relative profitability of various private banks on different parameters.

Return on Equity



	2009	2010	2011	2012	2013
Axis	-0.20%	19.15%	19.34%	20.29%	18.53%
HDFC	-0.23%	16.30%	16.74%	18.69%	20.34%
ICICI	-0.11%	7.93%	9.65%	11.20%	13.10%
IndusInd	-0.15%	17.25%	17.91%	18.26%	17.15%
Kotak	-0.11%	13.29%	14.39%	14.65%	15.60%
Yes	-0.15%	20.27%	21.13%	23.07%	24.81%

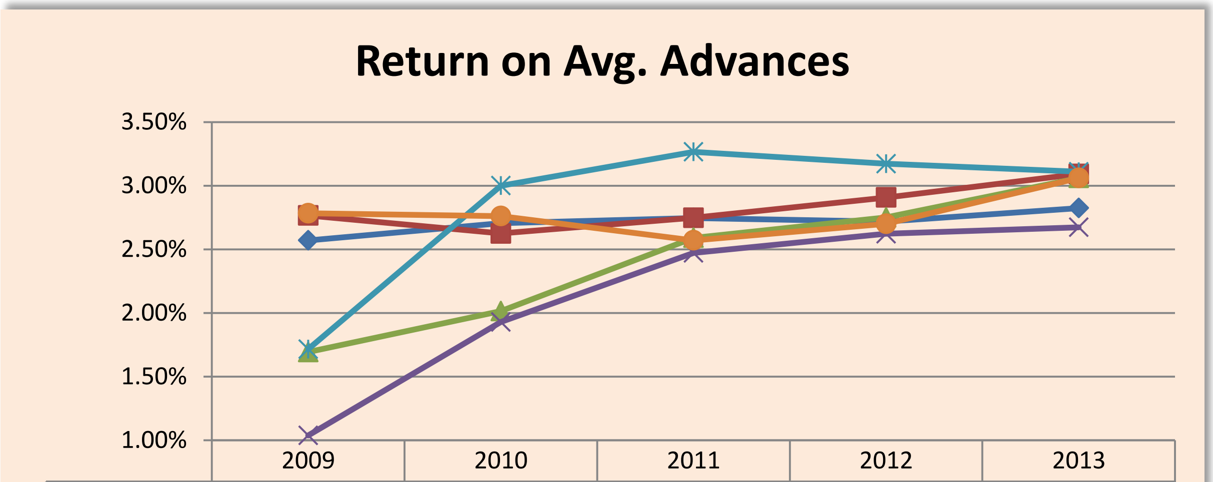
Advances / Equity



	2008	2009	2010	2011	2012	2013
Axis	6.80	7.98	6.50	7.50	7.44	5.95
HDFC	5.52	6.75	5.85	6.30	6.53	6.62
ICICI	4.82	4.38	3.51	3.93	4.20	4.35
IndusInd	9.48	9.48	8.57	6.46	7.39	5.81
Kotak	4.33	4.26	4.58	4.29	4.90	5.12
Yes	7.15	7.64	7.18	9.06	8.12	8.09

As we can observe, Yes and HDFC have a very high ROE, while ICICI and Kotak's ROE is at the lower end. It should be of no surprise then, that Yes and HDFC are the highest leveraged banks, while Kotak and ICICI are the lowest.

We can neutralize the leverage effect to look at the inherent return generating capacity of a bank. We do so by looking at the Return on Average Advances.

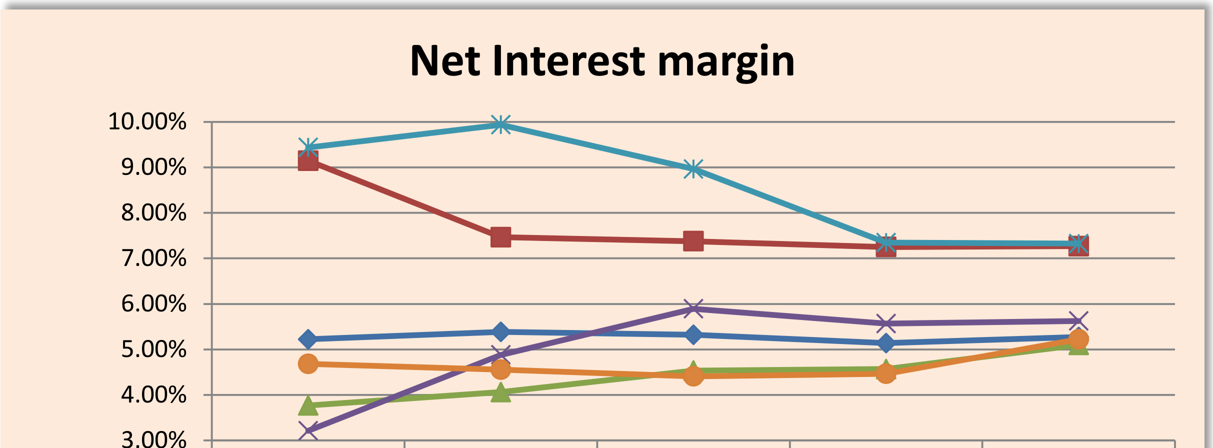


	2009	2010	2011	2012	2013
Axis	2.57%	2.71%	2.75%	2.72%	2.82%
HDFC	2.77%	2.62%	2.75%	2.91%	3.09%
ICICI	1.69%	2.01%	2.59%	2.75%	3.06%
IndusInd	1.04%	1.93%	2.47%	2.62%	2.67%
Kotak	1.72%	3.00%	3.27%	3.17%	3.11%
Yes	2.78%	2.76%	2.57%	2.70%	3.06%

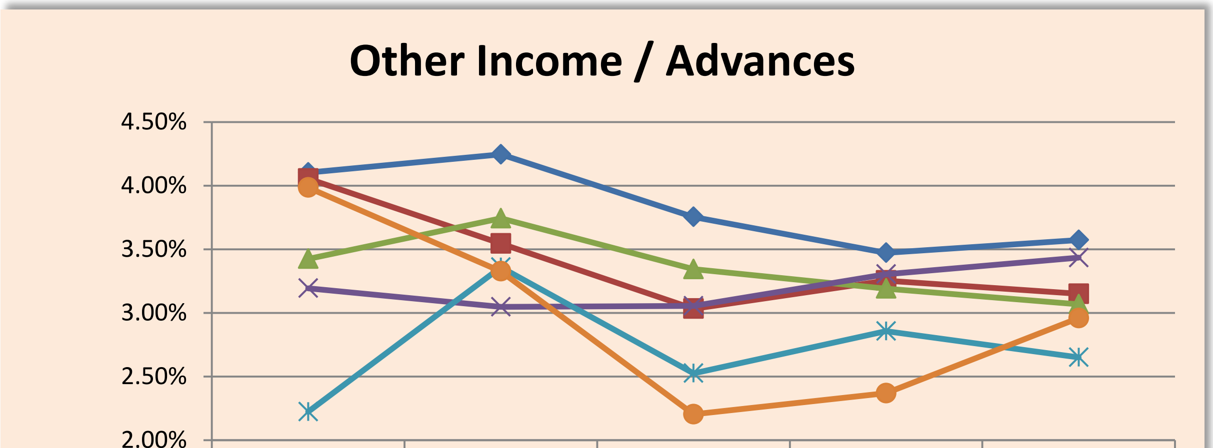
Once we neutralize the leverage effect, we can see that all four banks – Yes, HDFC, Kotak and ICICI have achieved very similar net returns on their advances. These are within a narrow range of 3.06% to 3.11% in FY13. Returns of Axis and IndusInd are lower. However, we also observe that Kotak had led the pack with a substantial difference from FY10 to FY12, but the others have narrowed the gap in FY13.

Composition of Returns

In order to assess the sustainability of these returns, we look at what these returns are composed of.

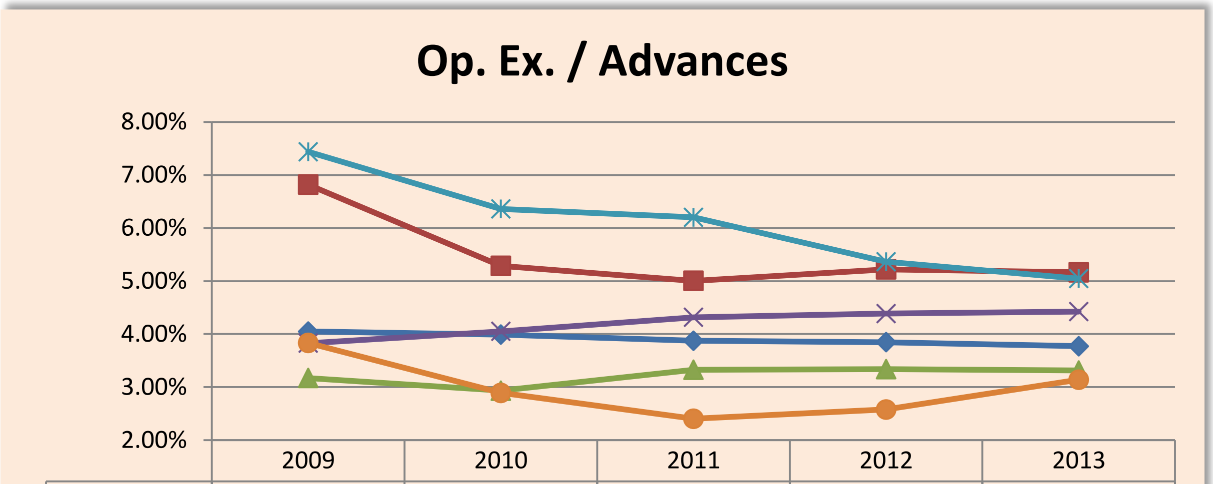


	2009	2010	2011	2012	2013
Axis	5.22%	5.38%	5.32%	5.14%	5.27%
HDFC	9.14%	7.46%	7.38%	7.25%	7.27%
ICICI	3.77%	4.06%	4.54%	4.57%	5.10%
IndusInd	3.21%	4.88%	5.89%	5.57%	5.63%
Kotak	9.44%	9.94%	8.96%	7.35%	7.32%
Yes	4.68%	4.56%	4.41%	4.47%	5.22%



	1	2	3	4	5
Axis	4.10%	4.25%	3.75%	3.47%	3.57%
HDFC	4.05%	3.55%	3.03%	3.25%	3.15%
ICICI	3.43%	3.74%	3.34%	3.19%	3.07%
IndusInd	3.19%	3.05%	3.06%	3.30%	3.43%
Kotak	2.22%	3.36%	2.53%	2.86%	2.65%
Yes	3.98%	3.33%	2.20%	2.37%	2.96%

As we can observe, Kotak and HDFC have the highest NIM in the Industry. On the other hand, Axis and IndusInd have earnings on account of fee based income. This is largely on account of the nature of these banks' businesses. Kotak and HDFC are much more retail focussed, giving them larger interest margins, while Axis is into a lot more corporate and institutional business, where the fee and services income is higher. Fee income is also a result of upfront income booking practices of banks. Thus, we remain sceptical of any bank which reports higher fee income.



	2009	2010	2011	2012	2013
Axis	4.05%	3.99%	3.87%	3.85%	3.77%
HDFC	6.82%	5.29%	5.01%	5.22%	5.16%
ICICI	3.17%	2.93%	3.33%	3.34%	3.31%
IndusInd	3.83%	4.05%	4.32%	4.39%	4.43%
Kotak	7.44%	6.36%	6.20%	5.36%	5.05%
Yes	3.83%	2.89%	2.40%	2.58%	3.14%

The Operating expense to Advances ratio further reinforces our view mentioned above. Kotak and HDFC being larger retail focussed banks have a higher Op. Ex. to Advances ratio than their peers. Yes and ICICI have much lower operating cost ratios than others. Whether this can be a source of sustained competitive advantage is something to be studied much deeper.

Final Conclusion

The purpose of this exercise was to look at 'What makes private banks tick'? Over the past years, private banks other than ICICI have gained market share in terms of advances as well as deposits. This has enabled them to grow faster than the market. Additionally, private banks continue to achieve better profitability margins than PSUs, leading to super-normal profits. The combination of these two factors leads to the incredibly high valuations of private banks.

But is the premium justified? How many years of super profits and above average growth do these valuations imply? We have made a simple financial model below to assess this.

<u>Assumptions:</u>

1. Profit margins of private banks to continue as present
2. Leverage of private banks to gradually increase to levels similar to nationalised banks
3. No fresh equity infusion. Growth to be funded from internal accruals.
4. 1/3rd profits are distributed as dividend, rest re-invested.

Details	PSU	Private	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Book Value	100	100	112.00	127.68	148.11	174.77	209.72	251.67	302.00	362.40
P/B	1.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Market Price	100	400	448	511	592	699	839	1,007	1,208	1,450
Advances / Equity	11.00	6.00	7	8	9	10	10	10	10	10
Advances	1,100	600	784	1,021	1,333	1,748	2,097	2,517	3,020	3,624
NPAT / Advances	1.13%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
PAT	12.43	18.00	23.52	30.64	39.99	52.43	62.92	75.50	90.60	108.72
ROE on Mkt Price	12.43%	4.50%	5.25%	6.00%	6.75%	7.50%	7.50%	7.50%	7.50%	7.50%
Advances Growth (Implied)			31%	30%	31%	31%	20%	20%	20%	20%
PV		**585.47**								

It must be noted that the Advances Growth above is a derived number, based on the bank's capacity to lend, not taking into account the market's ability to absorb that much lending. Advances growth of around 30% may be achievable if the economic growth momentum picks up. If not, private banks will have to sit on excess capital for a longer time.

Based on the above model, we can observe that the market values private banks at 8 years super profits. If we assume growth rates to be slower, this could go up to 10 years. This is not too unrealistic an expectation. Other industries where incumbents have a clean run - such as FMCG value incumbents at a much higher premium.

The above analysis is only indicative of the industry in general. In order to take final investment calls, we need to look at individual banks, their competitive position and their valuation in relation to the above. This analysis will help us in modelling our expectation of these individual banks. What we can conclude with this is that Indian Private Banks look attractive in spite of their seemingly high valuations.

Analyst Certification

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