CLSA
ASIA-PACIFIC MARKETS

Indian banks

Sector outlook

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8 July 2009

India
Financial services

BUY

- **Axis Bank**
- **HDFC**
- **ICICI Bank**
- **IDFC**
- **Union Bank**

Outperform

- **Bank of Baroda**
- **Bank of India**
- **HDFC Bank**

Underperform

- **Canara Bank**
- **Punjab National Bank**
- **State Bank of India**

Coming of age

Private banks will emerge stronger

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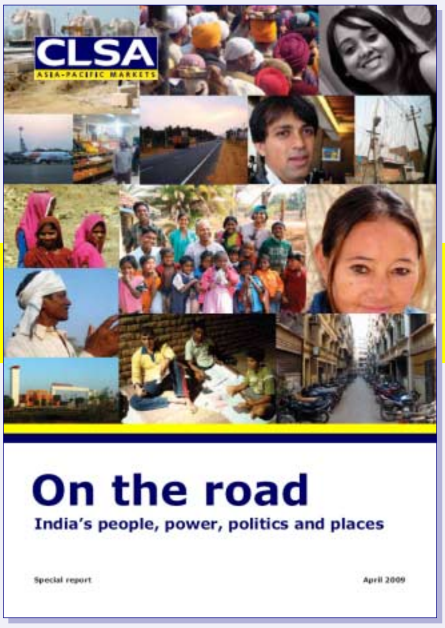
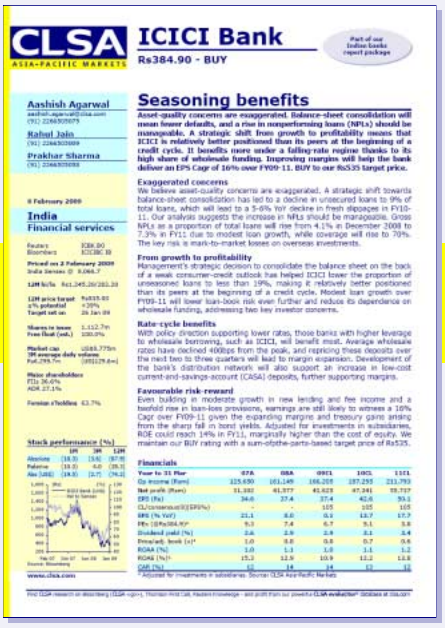
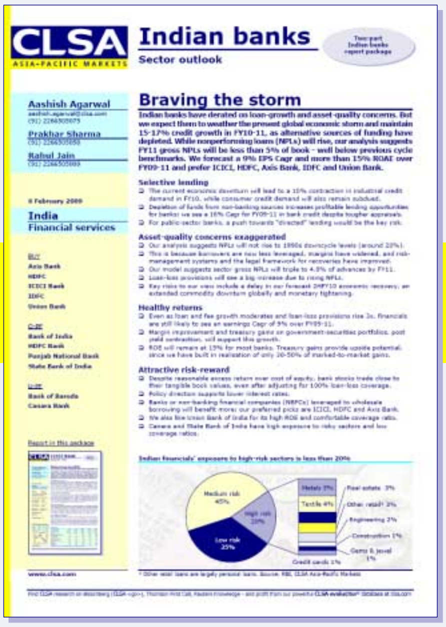
All prices quoted herein are as at close of business 6 July 2009, unless otherwise stated.

A structural growth story







Coming of age

Indian banks are likely to sustain their structural growth trajectory

Despite the growth and asset-quality issues facing global financials, Indian banks are likely to sustain their structural growth trajectory, driven by an under-penetrated financial-services sector, a conducive economic environment and a supportive regulatory regime. We estimate a 17% credit Cagr over FY09-14 and believe the current credit cycle is fairly manageable.

Margins to be function of liability franchise as lending is commoditised

Over the next five years, bond-market development will lead to commoditisation of credit and margins will mainly be a function of retail liability franchise. As the distribution network and technological infrastructure become basic requirements - which are insufficient to drive profit on their own - softer skills such as service standards and product innovation will be critical to enhance the franchise. Fee growth is likely to be healthy as a pickup in corporate activity further boosts retail-fee momentum. We expect industry consolidation to continue, but big-scale M&A activity is unlikely. Meanwhile, Tier II public-sector-undertaking (PSU) banks will lose market share at a faster pace. However, regulatory relaxation will help improve the industry's overall profitability.

Private banks are better positioned

Private banks are better positioned to leverage the changing industry landscape, as their superior servicing skills and innovation will drive market-share gains in retail liabilities, allowing wider margins. Their ability to generate higher fee revenue means a wider ROE differential between them and the public banks. Our customer survey of 100 small/medium enterprises and 300 individuals highlights evolving customer preferences, suggesting that private banks' market-share gains are structural. Although a few PSU banks have bridged the technological infrastructure gap to some extent, our on-the-ground study suggests that they are significantly lacking on the more important soft skills.

Private banks will report significantly higher ROEs

Private banks will continue to grow earnings ahead of their PSU counterparts over the next five years, even as the diversity in profitability increases. We expect the ROE differential between the two segments to expand to 500-600bps, leading to further widening of valuation multiples. On a three- to five-year investment horizon, we prefer private banks, especially ICICI Bank and Axis Bank, which still offer rerating potential on the back of their improving liability franchise. Be selective on PSU banks, where management continuity remains the key risk. We prefer only Tier I PSU banks for long-term investment. Some non-banking finance companies (NBFCs) like Housing Development Finance Corp (HDFC), Infrastructure Development Finance Corp (IDFC) and Reliance Capital can deliver returns over the longer term as they have built strong liability franchise and domain expertise.

Figure 1

Valuations and price targets

(Rs)	Axis	BoB	BoI	Canara	HDFC	HDFC Bank	ICICI Bank	IDFC	PNB	SBI	Union
Price	794	408	327	264	2,354	1,427	678	134	643	1,655	233
Recommendation	BUY	O-PF	O-PF	U-PF	BUY	O-PF	BUY	BUY	U-PF	U-PF	BUY
Estimated sustainable ROE (%)	21.0	15.0	15.5	14.0	25.0	22.0	18.0	20.0	15.5	15.5	15.5
Estimated book value, FY15	689	565	453	368	849	898	535	95	777	1,738	299
PB (x)	2.9	1.3	1.4	1.2	3.8	3.1	2.2	2.7	1.3	1.4	1.4
Value of the banking business	1,990	731	613	427	3,208	2,795	1,188	252	1,023	2,434	404
Value of subsidiaries	0	0	0	0	1,768	0	510	0	0	300	0
Price target, FY14	1,990	731	613	427	4,976	2,795	1,698	252	1,023	2,734	404
Upside (%)	150.6	79.1	87.3	61.3	111.4	95.8	150.5	88.3	59.1	65.2	73.4
Returns over five years (%)	1,271	377	334	195	2,909	1,449	1,092	126	488	1,266	201
Annualised returns incl dividends (%)	21.1	14.0	15.1	11.7	17.5	15.0	21.2	14.2	11.9	12.0	13.2

Note: Gordon growth model. Source: CLSA Asia-Pacific Markets

On a five-year basis, we prefer ICICI Bank, Axis Bank, HDFC, IDFC and Reliance Capital. Within PSU banks, State Bank of India (SBI), Bank of Baroda (BoB), Bank of India (BOI) and Union Bank are the names to own on a three to five-year investment horizon.

Figure 2

Key trends and investment themes for the next five years

Key trends

Supportive regulations
- Reduction in reserve ratios
- Liberalised branch licensing
- Risk weights in line with Basel II
- Conducive regulations for consolidation

Commoditisation of lending
- Development of bond market
- Rising competition from non-banking sources

Service-led deposit franchise
- Distribution network/IT infrastructure no longer a competitive edge
- Softer skills - service standard, product innovation will matter

Consolidation to pick up
- Larger banks to gain market share
- Big-scale M&A activity unlikely; small private banks may get acquired

Profitability diversity to widen
- Private banks' margins and fees would rise faster than those of PSU banks
- Private banks' earnings to grow faster
- ROE gap to widen to 500-600bps

Investment themes

Gap of valuation multiples to widen

Private banks
- Strong deposit franchise
- Fee-income potential
- Market-share gains
- ICICI, Axis, HDFC Bank

PSU banks
- Tier I PSU banks will widen lead over Tier II peers
- SBI, PNB, BoB, BoI, Union

Source: CLSA Asia-Pacific Markets

Indian financials offer structural growth opportunities

Sustainable growth momentum

Even as global financials face growth and asset-quality issues, Indian banks offer a healthy growth trajectory with minimal balance-sheet risks. Over the next five years, financial penetration will continue to rise as banks expand into new areas, focus on building their retail liability franchise and strengthen their risk-management systems amid margin contraction in traditional lending business. Despite the high growth rate of the past decade, penetration for most financial products/services in India remains low and this, coupled with a conducive economic environment, will drive a 17% credit Cagr over FY09-14.

Asset-quality issues cloud near-term outlook

Macroeconomic uncertainty and its implication on asset quality are clouding Indian banks' near-term outlook. However, rising nonperforming loans (NPL) is not a significant issue and the credit cycle will be fairly manageable. Recent sales pickup in sectors such as textiles, real estate and commodities suggest that NPL may be lower than most forecasts, driving earnings upgrade.

Penetration levels suggest healthy potential

Penetration of most products is way below regional benchmarks

Despite the aggressive growth in most financial segments over the past decade, we believe the Indian financial sector offers structural growth opportunities given the under-penetration of most financial products/services and an expanding target market. Even though Indian banking credit has enjoyed a 27% Cagr (23% in US-dollar terms) over 2003-08, credit penetration remains well below regional benchmarks, suggesting healthy growth potential for the next five years. Even large banks such as SBI, ICICI and BoB have been able to expand their loanbook at about a 30% Cagr over FY04-09 and may continue to gain market share.

Figure 3

Loan Cagr, 2003-08

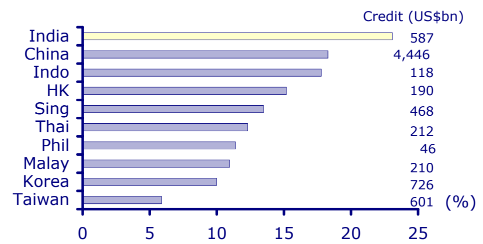
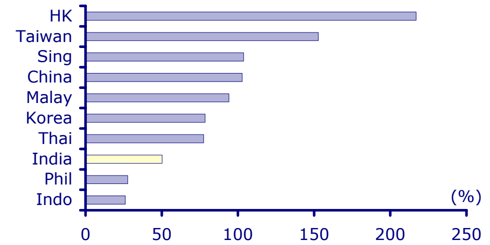


Figure 4

Credit/GDP ratio, 2008

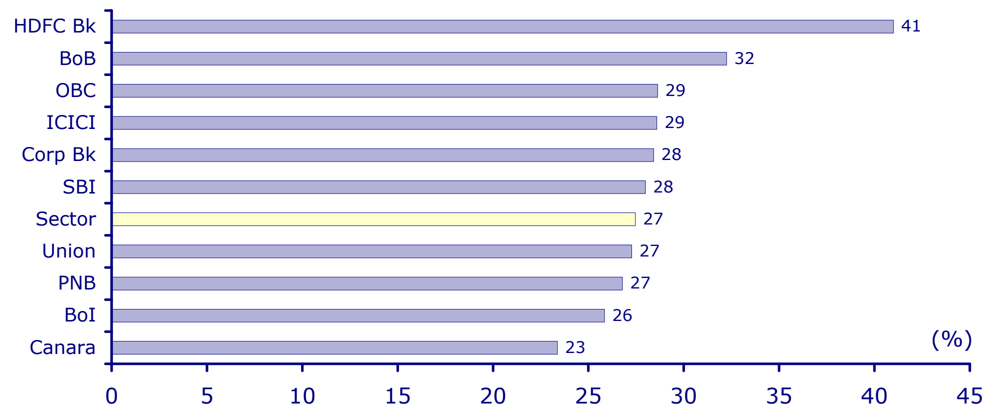


Note: Regional credit growth is in US-dollar terms. Source: RBI, CLSA Asia-Pacific Markets

Despite high-base effect, banks have maintained a healthy growth trajectory

Figure 5

Credit Cagr, FY04-09



Source: Company reports, RBI

Retail credit has been a key growth driver

The credit growth has encompassed all sectors. However, retail credit growth has been a primary driver, having delivered a 51% Cagr with share of retail credit in total bank credit rising from 10% in FY04 to 22% in FY09. Not only has industrial credit seen a healthy 27% Cagr, incremental lending has been much diversified compared to in the mid- and late-1990s.

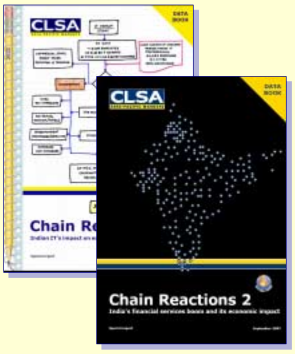
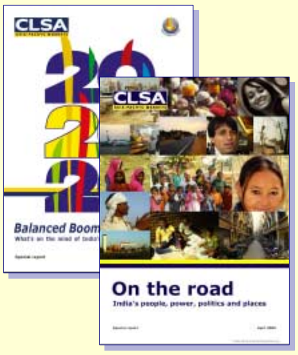



Figure 6

Bank-credit Cagr, FY04-09

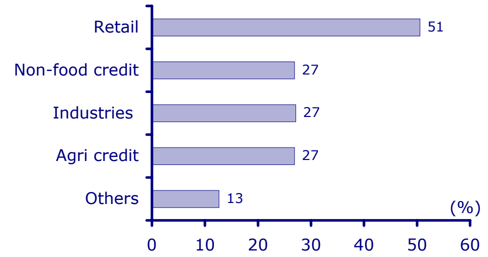
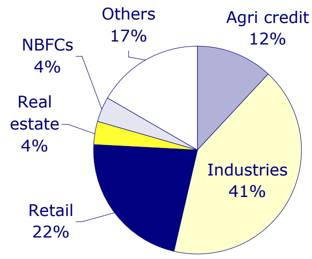


Figure 7

Total loans as on March 2009



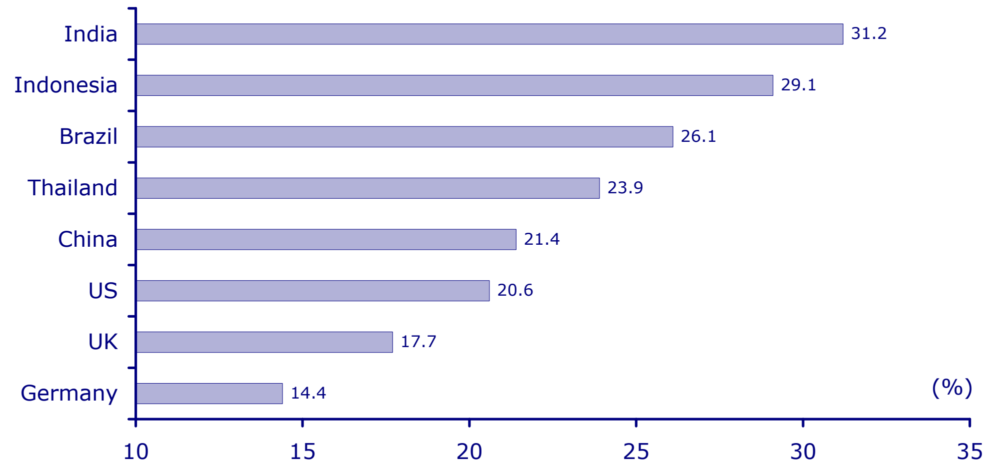
Source: RBI, IBA, company reports

Target market still expanding

While existing penetration levels are low, the "bankable population" is expanding at a healthy pace led by economic growth momentum, especially in rural India, and favourable demographic. The structural opportunity for banks is evident from the fact that more than 30% of Indians are below 15 years of age and over the next five to 10 years will enter in the "bankable population" category. As has been discussed in some of our thematic reports such as *Chain Reactions*, *20-20-20* and *On the road*, the younger generation is far more open to consumer loans, financial products like insurance, mutual funds, wealth management, etc, and thereby offers a much bigger revenue pie for financial-service providers.

Figure 8

Percentage of population below the age of 15



Source: UNDP

Credit Cagr of 17% over FY09-14

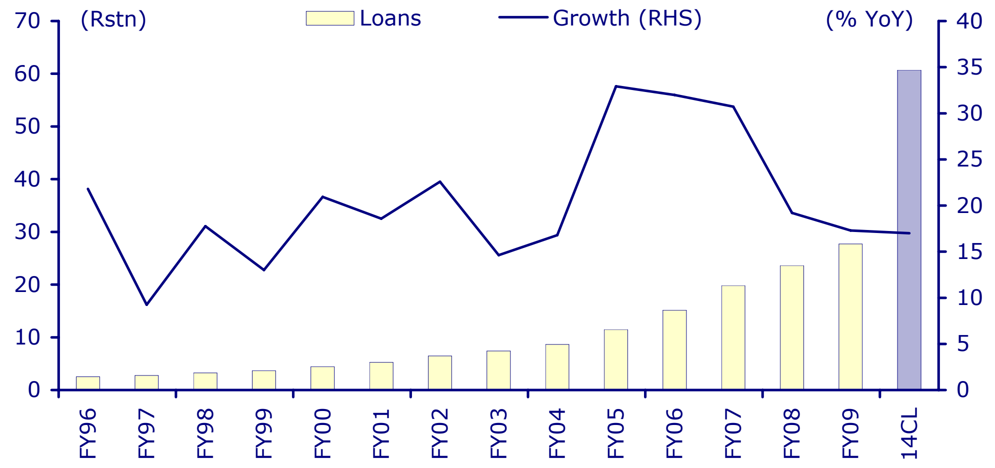
Credit demand will remain robust as India gets into a capex mode

Despite a high base, we expect banks to sustain a 17% credit-growth rate over FY09-14. Demand will not constrain credit growth. Rather, the ability of banks to mobilise funds to meet with the demand will be an important factor. We expect a deposit Cagr of 16% for FY09-14, based on which we derive our credit-growth target.

We expect a 17% credit Cagr over FY09-14

Figure 9

Loan growth



Source: RBI, IBA, CLSA Asia-Pacific Markets

New players may take credit market share from banks

Even at an estimated 17% credit Cagr for FY09-14, banking-credit penetration will rise only to 60% by FY14 - still below regional benchmarks. Two key challenges for banks are intensifying competition in lending activity from non-banking sources like insurance companies, mutual funds, overseas investors and external commercial borrowing (ECB); and mobilisation of long-term resources for project and infrastructure financing.

Corporate credit to grow at a healthy pace

We expect corporate loans to drive credit growth; share of retail credit is unlikely to rise, as banks remain averse towards high-risk, unsecured retail loans. Project financing will drive corporate credit demand (including infrastructure projects), as companies build up new capacities and government increases infrastructure spending. Demand for working capital is also likely to rise as most industries have reached peak efficiency levels and their working-capital demands will reflect volume pickup.

Challenge 1 - Deposit mobilisation

Banks' ability to mobilise deposits will constrain their credit growth

Over the past decade, Indian banks have expanded their loanbook ahead of their retail-deposit-growth rates. This was due to their ability to sell down excess government-securities (G-Sec) holding and the rising proportion of borrowings. With minimal excess statutory-liquidity-ratio (SLR) holding, drying-up of flow from non-banking sources (due to rising capex and higher alternative investment options), we expect banking credit growth over the next five years to be a function of retail deposit inflow in the banking system.

Figure 10

Investment in government securities

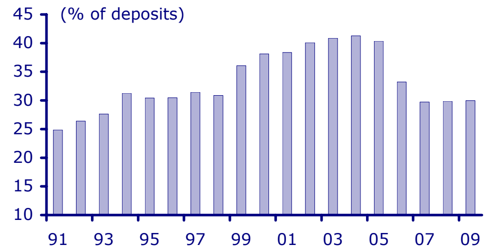
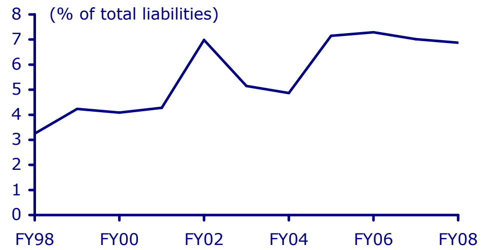


Figure 11

Borrowings as a share of liabilities



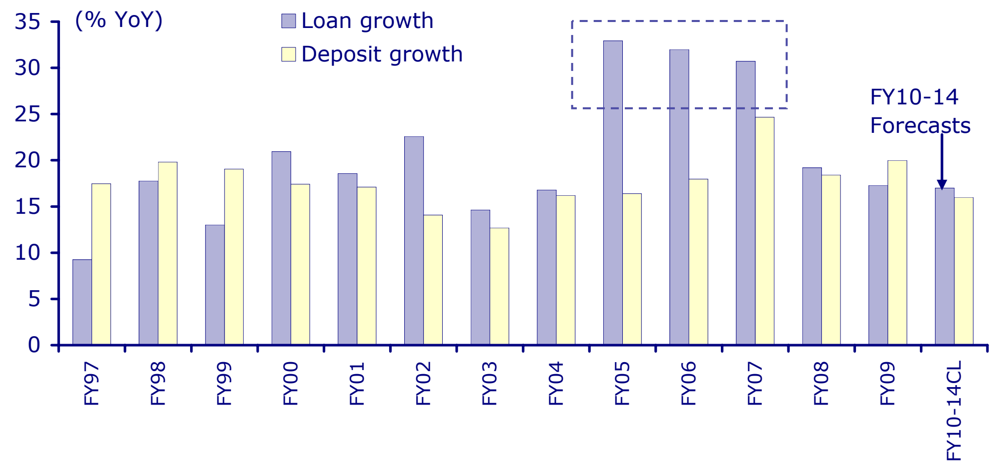
Source: Company Reports, RBI, IBA, CLSA Asia-Pacific Markets

Over the past five years, loan growth has outpaced deposit growth

But future loan growth will be dependent on deposit mobilisation

Figure 12

Sector credit and deposit growth



Source: RBI, IBA, CLSA Asia-Pacific Markets

Deposit growth to slow to 16% per annum as GDP growth moderates

In the past five years, banking-sector deposits have seen a healthy Cagr of 20%, driven by a host of factors: acceleration in nominal GDP growth; rising savings rate; increasing proportion of bank deposits in total financial savings; and inflow of non-retail deposits. With most of these factors being close to their peak levels, we don't foresee deposit growth running ahead of its long-term average multiple (to GDP) and hence are building in a moderation in deposit growth to 16% per annum over FY09-14. The key for banks to boost their deposit growth will be to increase presence in semi-urban and rural areas to improve banking penetration.

Previously favourable factors near peak levels

Figure 13

Nominal GDP growth

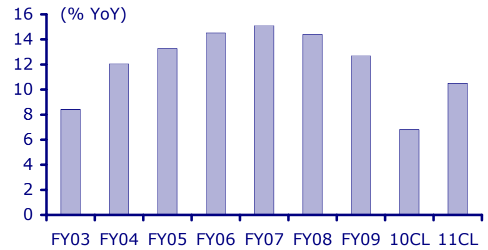
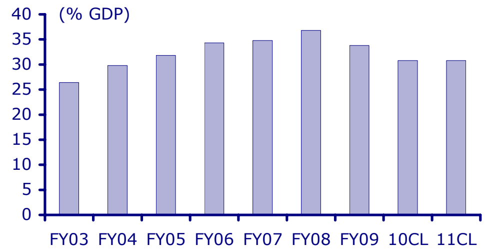


Figure 14

Gross domestic savings



Source: CMIE, CLSA Asia-Pacific Markets

Figure 15

Bank deposits in household assets

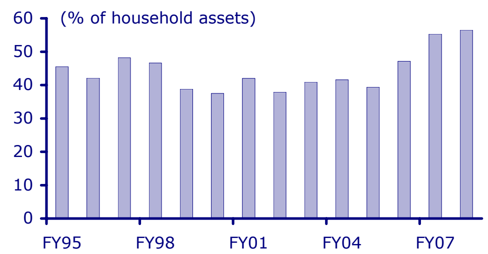
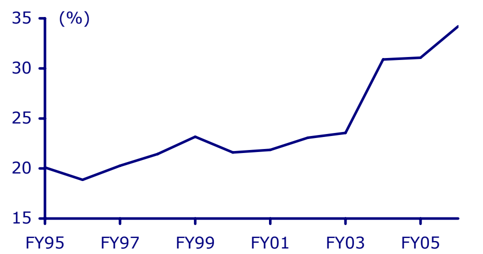


Figure 16

Flow of deposits from non-retail



Source: RBI, CLSA Asia-Pacific Markets

Challenge 2 - Rising competition in the lending space

Lending competition intensifies as non-banking players scale up

Credit growth for Indian banks over the next five years will not be as smooth as it has been over the past decades. Recent trends suggest new competition in the lending space from insurance companies, mutual funds and even foreign companies participating in the debt market. The entry of these new players forces Indian banks to restrict their balance-sheet growth to the extent that they are able to mobilise retail deposits.

Share of non-banking sources in corporate credit has increased

Figure 17

Outstanding credit, March 2008

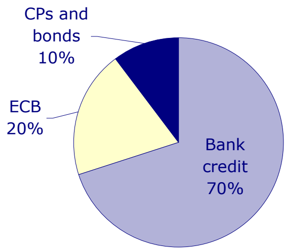
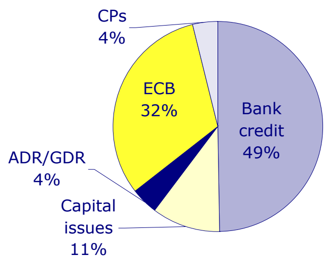


Figure 18

Funds to industry, FY06-August 2008



ECB and commercial papers are popular sources of finance

Figure 19

Funds raised by Indian corporations

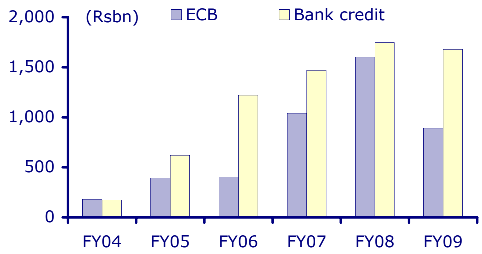
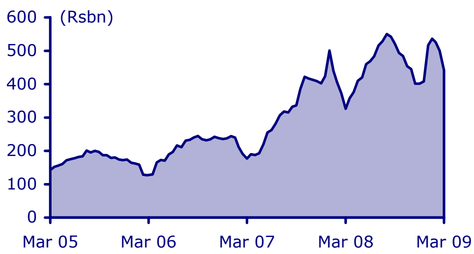


Figure 20

Outstanding commercial papers



Source: RBI, CLSA Asia-Pacific Markets

Banks will be unable to meet with rising demand for long-term resources

Banks will also find it difficult to provide long-term financing due to their shorter maturity profile. On the other hand, insurance companies have an ever-growing demand for long-term investments, due to their fast-growing corpuses, which are also long-term in nature. Other non-banking sources such as external commercial borrowings (ECB), insurance companies, mutual funds have also reported an increase in appetite for corporate debt over the past few years.

Insurers, mutual funds may meet up to 34% of corporate credit demand

We estimate that insurance companies will have an appetite for about Rs3.1tn of corporate bonds/debentures (9% of incremental bank credit) over FY09-14. Demand from mutual funds will be another Rs2.6tn, at least over FY09-14. Ease of foreign-ownership norms for investments in debt will also boost foreign participation in long-term financing, threatening Indian banks. These sources collectively could invest/lend Rs7-8tn to the corporate sector, ie, almost 24% of incremental banking credit over FY09-14 (34% of incremental corporate credit).

Hence, even though we expect credit-demand growth to be about 20% per annum; we have built in a 17% bank-credit Cagr, factoring in the rising share of non-banking players.

Figure 21

Life insurers' debt assets

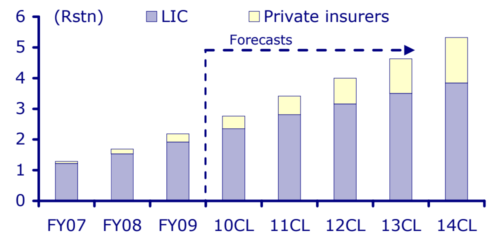
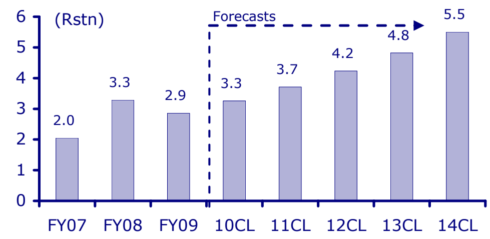


Figure 22

Mutual funds' debt AUM[1]



[1] Assets under management. Source: AMFI, IRDA, company reports, CLSA Asia-Pacific Markets

Banks need to step up on mobilising long term deposits

Challenge 3 - Requirement for long-term resources

Indian banks have historically focused on financing working-capital loans, while development financial institutions (DFI), such as Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) and ICICI, funded long-term project loans. With the death of the DFIs in early 2000, over the past few years banks have been funding even long-term project loans, but with limitations due to the shorter maturity profile of their liabilities (only 15% of deposits have maturity of over five years).

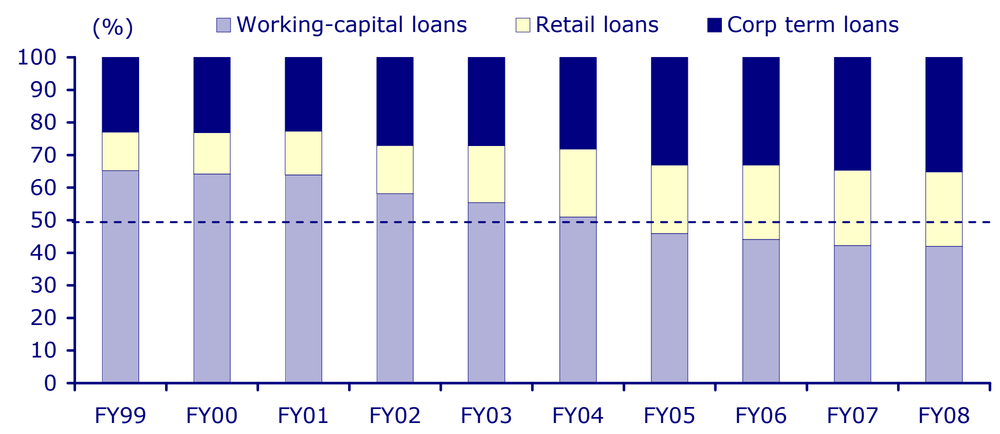
Term lending will dominate incremental credit

With long-term project financing making up more than 60% of incremental credit demand, it is key for banks to mobilise long-term liabilities, especially given the rising competition from insurance companies and foreign investors.

Term loans now make up nearly 60% of bank credit versus 35% in FY99

Figure 23

Share of term financing in total credit



Banks will need to source deposits of longer tenure

Figure 24

Incremental loans, FY09-14

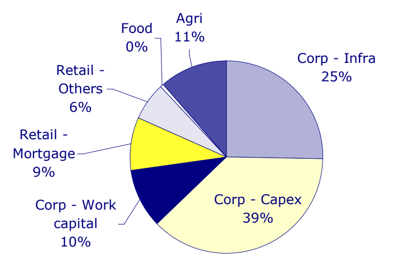
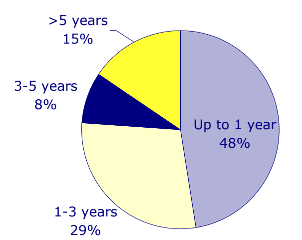


Figure 25

Maturity profit of deposits, FY08



Source: RBI, CLSA Asia-Pacific Markets

Regulatory incentives may support mobilisation of long-tenure deposits

Recent regulatory incentives, such as tax benefits on long-term deposits, have boosted flow of long-term deposits for banks. Given the government's focus on infrastructure, we believe it might offer some more sops to banks (in the form of tax-free bonds, etc) to improve flow of long-term retail deposits.

Challenge 4 - Capital constraints are bank-specific

Improving ROE may release dilution pressures for banks

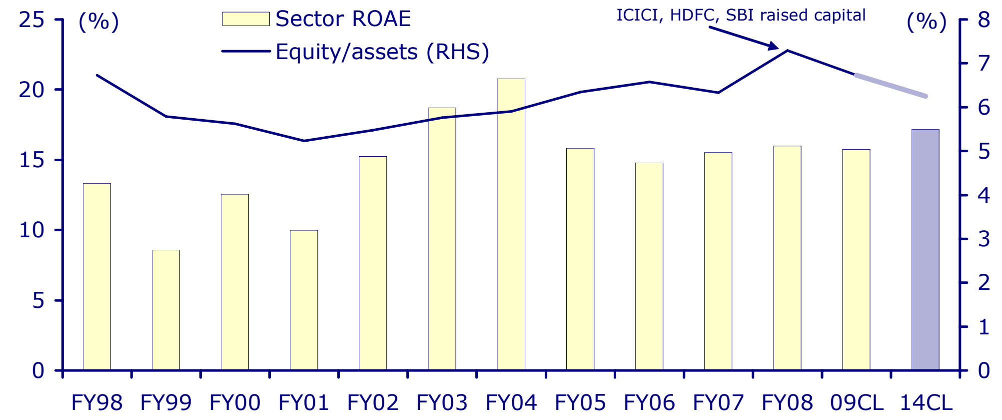
With ROE improving to 17% and the switch to Basel II, resulting in release of Tier I capital, Indian banks are adequately capitalised to support a 17% loan Cagr over the next five years. However, in some specific cases, banks targeting aggressive loan growth may look to raise capital.

Banks are well capitalised

A 17% loan Cagr can be funded through internal accruals

Figure 26

Sector profitability



Source: RBI, IBA, CLSA Asia-Pacific Markets

NPL issues not structural; credit cycle fairly manageable

Asset-quality issues likely manageable - book quality not risky

Even as macroeconomic uncertainty and its implication on asset quality continue to cloud the banks' near-term outlook, we expect the pressure on asset quality to be manageable. Earnings growth is likely to continue despite higher provisioning costs, driven by healthy top-line growth and higher fees.

In our February 2009 report, *Braving the storm*, we highlighted that asset-quality concerns were overdone and that asset-quality pressures should be manageable for following reasons:

- Even though credit has grown at a healthy pace over the past five years, the proportion of exposure to risky sectors remains low (below 20%).
- Corporate leverages are much lower than in previous cycles and profitability has improved significantly
- Better risk-management system and legal framework for recoveries.

Figure 27

Unseasoned loan book has moderated

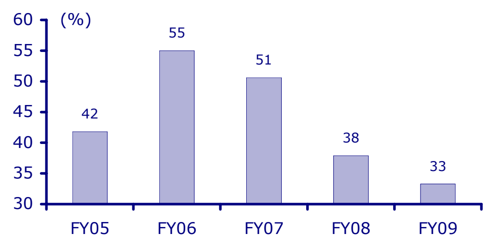
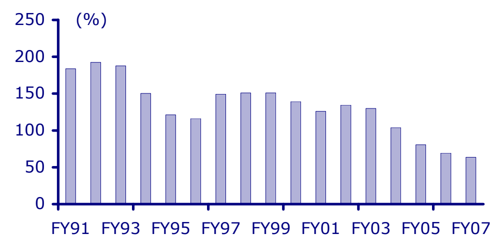


Figure 28

Overall corporate gearing is low



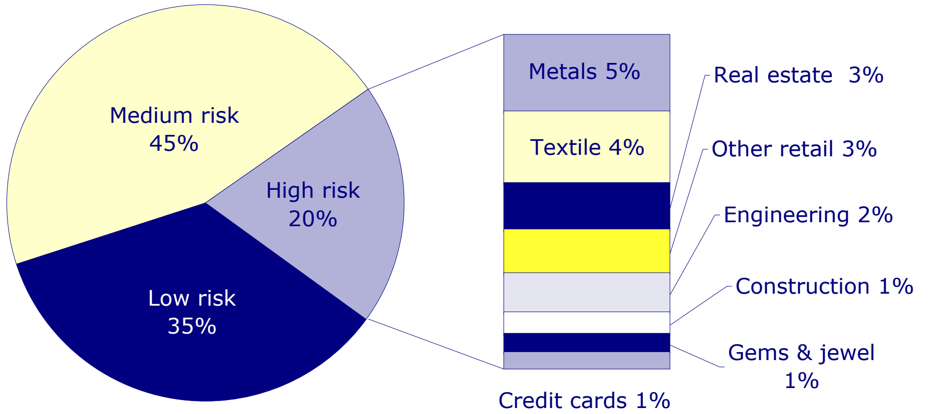
Source: RBI, CMIE, CLSA Asia-Pacific Markets

Asset quality of Indian banks is fairly healthy

Risky assets form 20% of FY08 loanbook

Figure 29

Loanbook composition

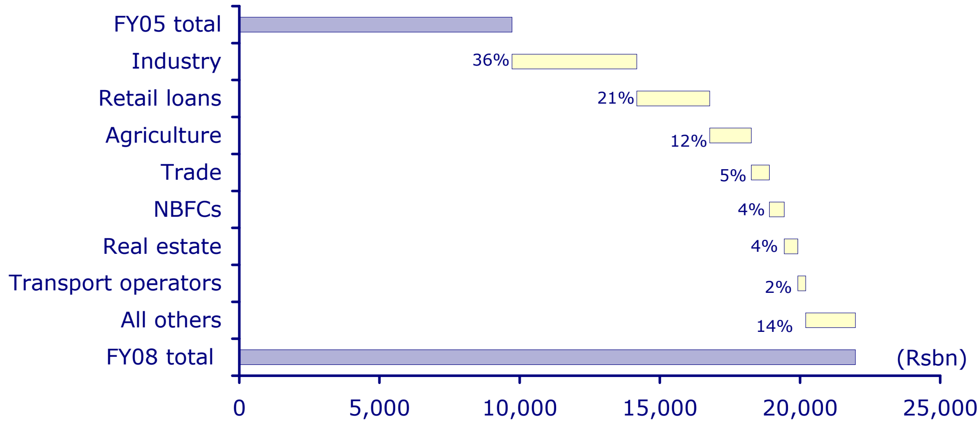


Loan growth driven by credit to industry

Even growth in industrial credit was well diversified

Figure 30

Loan growth over FY05-08



Source: RBI, CLSA Asia-Pacific Markets

Debt-servicing capacity of high-stress sectors has improved

Stimulus packages have eased pressures in high-stress sectors

Over the past nine months, the Indian government has announced multiple measures, aiming to accelerate demand in sectors like real estate, steel, autos, and extend support to labour-intensive, export-oriented sectors like gems and jewellery and textiles. The impact has been fairly prompt and visible, with industries such as autos, cement and real estate already showing a pickup in activity, partly driven by the pentup demand itself.

Figure 31

Key fiscal stimulus measures by Indian government

Measure	Beneficiary sector
A 400bps cut in excise duty	Manufactured goods: Autos, consumer durables, steel and other commodities, industrial products
Interest subvention and other incentives to labour-intensive, export-oriented sectors	Textiles, leather, gems and jewellery
Additional plan expenditure of Rs200bn	General employment generation
India Infrastructure Finance Company (IIFCL) authorised to raise Rs100bn through tax-free bonds by March 2009	Impetus to infrastructure expenditure
Relaxation of the fiscal-deficit targets for state governments	Facilitate state government to support local economies
A 200bps cut in excise duty and service tax	All forms of manufactured goods and services
RBI has taken measures to ease interest rates and infuse liquidity	Corporations in the form of easier credit availability, lower interest cost and uptick in demand for durables and house properties

Source: RBI, CLSA Asia-Pacific Markets

The Reserve Bank of India's restructuring guidelines also facilitated the revival in these sectors, as it encouraged banks to take a slightly longer-term view in financing the stressed sectors that were facing a temporary liquidity crunch.

Both have recovered

Figure 32

Sale of automobiles have picked up

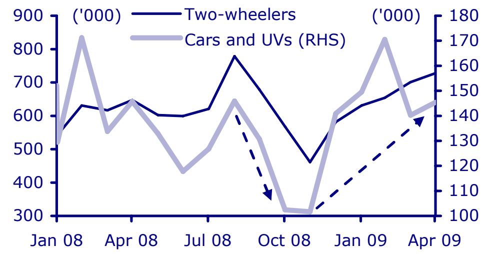
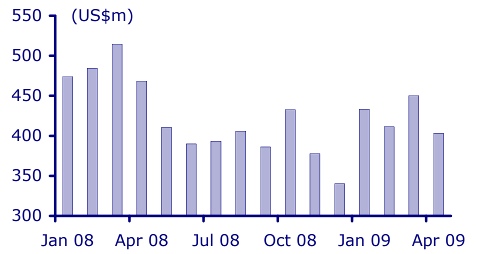


Figure 33

Textile/apparel exports to US recovers



Source: Bloomberg, SIAM, CLSA Asia-Pacific Markets

Both have picked up

Figure 34

Cement sales

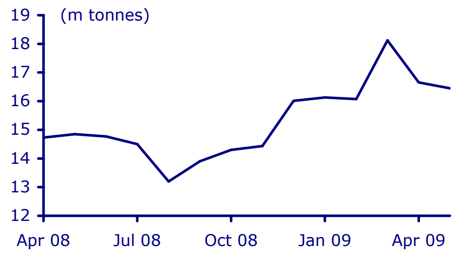
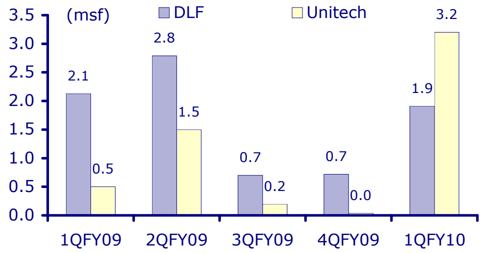


Figure 35

Real-estate sales



Source: Company reports, CLSA Asia-Pacific Markets

Figure 36

Homebuyers have responded to developers' price cuts and fall in interest rates

Source: Company reports

NPLs are unlikely to rise beyond 3.5-4%

Stressed assets are 6.3% of loans, much lower than estimates

Sales pickup in these sectors also eased debt-servicing pressure, which was reflected in lower-than-expected 4QFY09 NPLs. Most banks reported flat to marginal increase, despite what were arguably the toughest two quarters for corporate India in recent history. While the lower NPLs were also a result of 'regulatory flexibility' given to banks with respect to 'restructuring of loans'; even gross stressed assets (NPL plus restructured loans) for the sector, at 6.3% of loans, were much lower than concerns of double-digit NPLs.

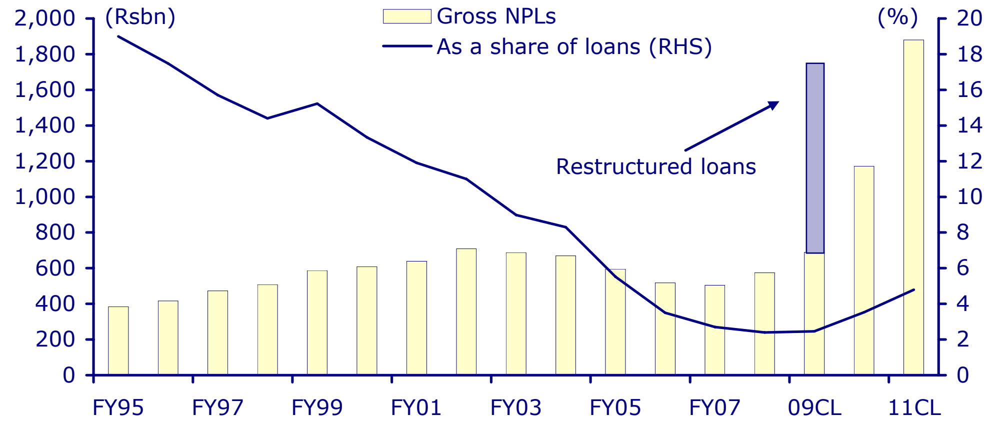
We conservatively build in NPL levels of about 4.4% by FY11

We are building in gross NPLs increasing to above 2.5x FY09 levels over the next two years, ie, from an estimated Rs689bn as on March 2009 to Rs1.7tn by March 2011. Gross NPLs as a share of advances will rise from 2.5% in FY09 to 4.4% by FY11.

NPLs unlikely to rise to previous highs

Figure 37

Sector gross NPLs



Source: RBI, CLSA Asia-Pacific Markets

Loan-loss charges will rise from 88bps in FY09 to 130bps in FY11

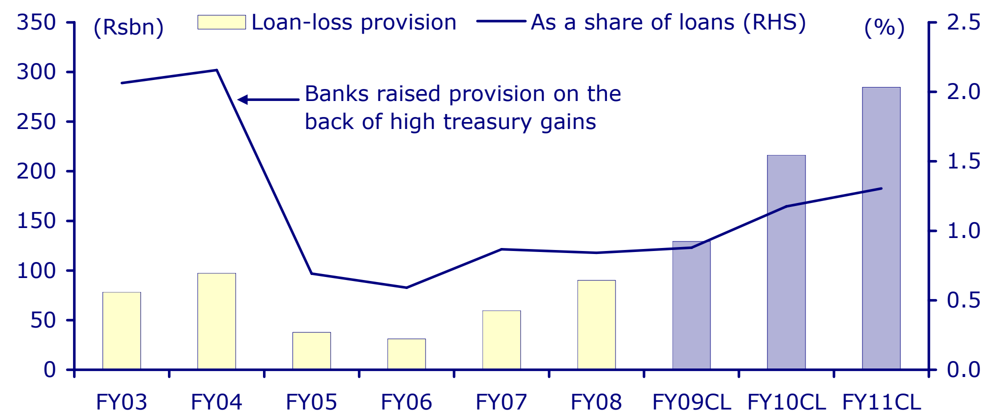
Loan-loss charges to rise, but will be manageable

We expect Indian banks' asset quality to deteriorate, but the resultant increase in loan-loss charges should be manageable. Based on our current estimate of increase in gross NPLs, we forecast loan-loss provision to rise from 88bps in FY09 to 130bps in FY11. But as we highlighted earlier, actual provisioning could be lower if economic growth momentum remains stable or improves.

An economic recovery could mean a smaller increase in provisions

Figure 38

Provisioning for banks under our coverage



Source: Company reports, RBI, IBA, CLSA Asia-Pacific Markets

Earnings upside from lower NPL could be 15-20%

Earnings/valuations could surprise positively

Despite higher loan-loss charges, we expect banks we cover to deliver positive earnings growth over FY09-11. More importantly, our base-case NPL implies that the slippages over the next two years will be double the total

Manageable - 4.6% of loans, 45.2% of net worth

Upside to our estimates could boost adjusted book values

Valuation will look more reasonable then

value of restructured loans (including pending cases). Unless the macro-economic environment deteriorates sharply, the actual NPL accretion could surprise on the upside, resulting in higher earnings, better ROE and higher adjusted book values (book value are adjusted for 100% coverage ratios).

Figure 39

Net stressed loans[1]

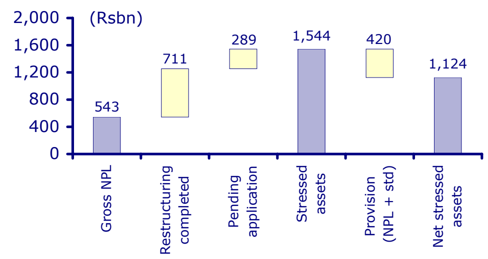
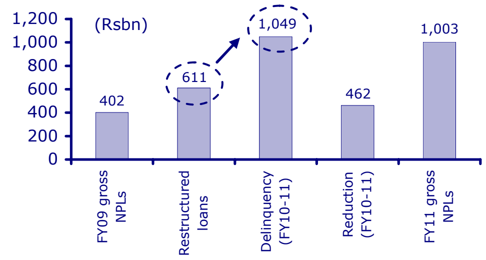


Figure 40

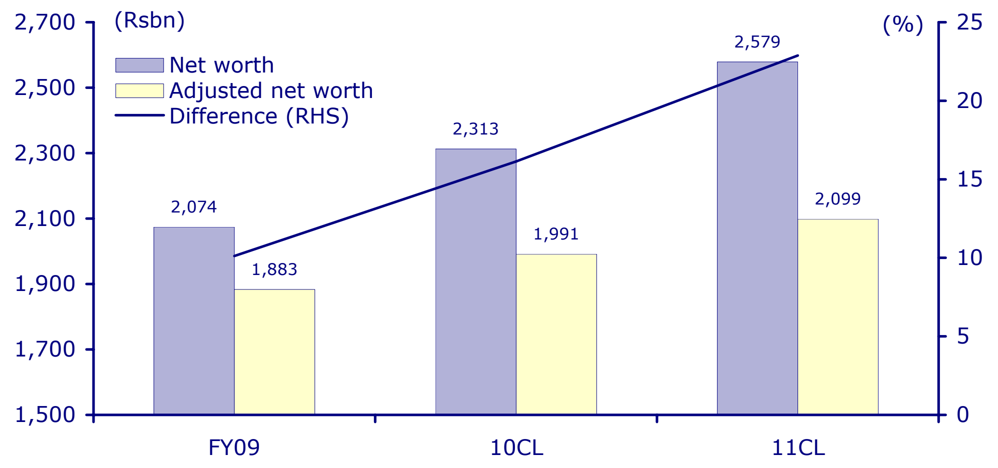
Base case for FY09-11 for our coverage



[1] Sample of 25 banks forming 88% of total credit. Source: RBI, companies, CLSA Asia-Pacific Markets

Figure 41

Net worth of banks in our coverage



Source: Company reports, CLSA Asia-Pacific Markets

Trends over the next five years

Retail liability and fees to be key earnings driver

Over the next five years, we expect development of the bond market to lead to commoditisation of corporate credit. As banks become price-takers, margins will become only a function of retail liability franchise. Sharing of distribution network and further development of non-branch banking models will reduce the competitive advantage of a wide distribution network. Customer-service standards will also be more critical for building a retail franchise. Fee-growth trajectory is likely to remain healthy as corporate activity picks up and retail fee momentum continues; treasury gains will cease to have meaningful impact on earnings. Consolidation is likely to continue but is likely to be in the form of bigger banks gaining market share at a faster pace. We do not expect large-scale M&A activity. A supportive regulatory regime will boost growth and improve profitability.

Traditional lending to be commoditised

Development of the bond market will commoditise lending

Over the next five years, banks' inability to fund long-term projects, rising demand for corporate debt paper from non-banking sources (discussed in the earlier section) and Basel II norms will facilitate the development of an active corporate-bond market in India. This will lead to commoditisation of corporate credit to some extent. With credit getting commoditised, liability franchise will become the key margin driver, while risk-evaluation skill set will be increasingly important for banks that are active in syndication.

Catalysts for an active bond market are in place

Even though India has been considering a bond market for quite some time, we believe the catalysts are now in place. A key hindrance to the development was a lack of a wider investor base, with banks being the only investor for corporate debt. However, rising assets under management (AUM) of insurance companies and relaxation of foreign-ownership norms in corporate debt have boosted demand for corporate debt, and could be the much-awaited catalysts for the development of bond markets.

Switch to Basel II norms is facilitating rating of corporate loans

A wider base of rated corporate debt is a prerequisite for greater participation of non-banks in corporate funding. Implementation of Basel II norms is driving banks to encourage their customers to get "rated" as it allows banks to utilise their capital efficiently, improving ROEs. Banks pass on some benefits to customers by cutting rates.

Share of non-banking financials in lending will rise

Insurance, mutual funds and ECBs will gain market share

Entry of new players in the lending business will lead to bank-credit growth lagging overall credit growth. We expect total credit growth of 19-21% per annum over the next five years but estimate bank credit to only grow 17% per annum as non-banking players like insurance companies, ECB and overall foreign participation in debt rises.

Lending structure to get complex

Vanilla credit has dominated banking credit . . .

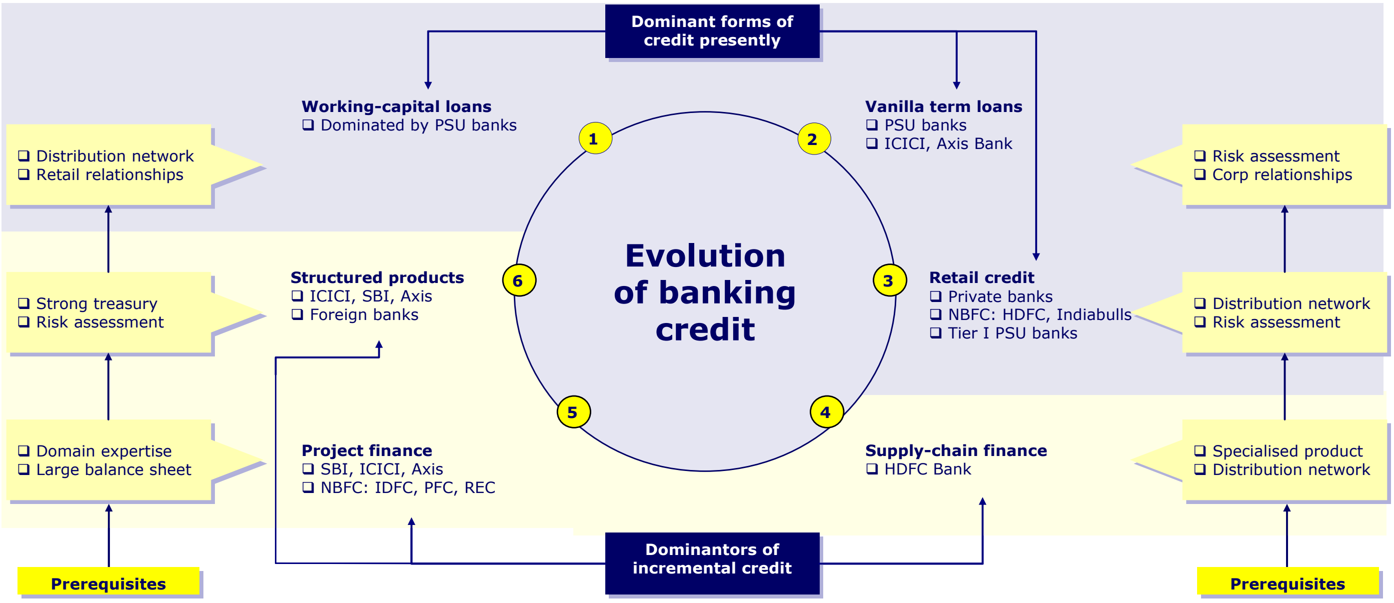
In the past, demand for credit has been mainly for short-term working-capital loans, which were secured by a primary charge on revenue and collateral security of land and plant and machinery. The demand for such "vanilla credit" made it easy for banks to evaluate credit risk in-house, as it didn't really require a strong domain expertise for doing detailed project analysis.

. . . financing structure will get more complex

With a rising share of long-term funding, especially for infrastructure and capex projects, we expect financing structure to get complex, involving multi-stage financing, vendor financing, off-balance sheet exposures, etc. Although most infrastructure projects are undertaken by reputed firms, they are housed in separate special-purpose vehicles (SPVs), with no recourse to the parent company. Hence, their debt-servicing capability is dependent on success of the projects. Credit-risk evaluation for such projects requires detailed feasibility studies that involve domain expertise in relevant space.

Figure 42

Debt-financing value chain - Project financing is more complicated and large banks have an edge



Source: CLSA Asia-Pacific Markets

Risk-evaluation requires domain expertise

Evaluation of credit risk for long-term, complex infrastructure/capex projects requires a more specialised skill set than what most Indian banks are used to for evaluation of short-term working-capital loans. As such, we believe the role of banks for such loans will be split in two parts: banks with strong domain expertise in project financing will structure the project, while others will be involved as investors. Even retail credit-risk evaluation will be standardised; external credit rating and past service records will become the key determinant for deciding pricing and exposure.

Spreads will contract but capital efficiency will improve

Spreads to contract but may not lead to ROE compression

Commoditisation of lending will squeeze corporate lending spreads. However, ROEs may remain stable, or even improve, as credit commoditisation would also improve bank's ability to leverage its capital. Under Basel II norms, exposures to AAA, AA and A-rated corporate loans carry lower risk weightings, allowing banks to leverage their capital base more efficiently. While spreads on AAA-rated corporate loans may fall from current levels, capital allocation would fall faster and thereby improving banks' ROE.

Figure 43

Risk weightings

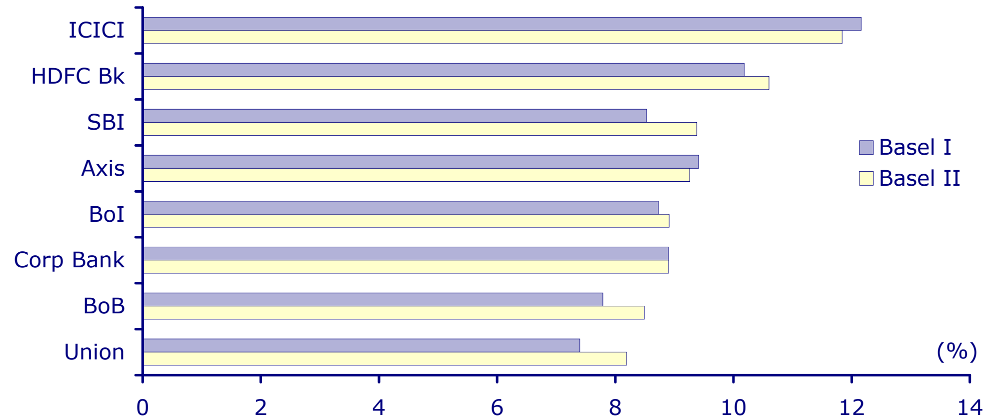
	Basel I	Basel II
AAA	100	20
AA	100	30
A	100	50
BBB	100	100
BB and below	100	150
Unrated	100	100

Source: RBI

Basel II norms have worked in favour of Indian banks

Figure 44

Tier I capital-adequacy ratio of banks



Source: Company reports

Banks to lose pricing power as investor base widens

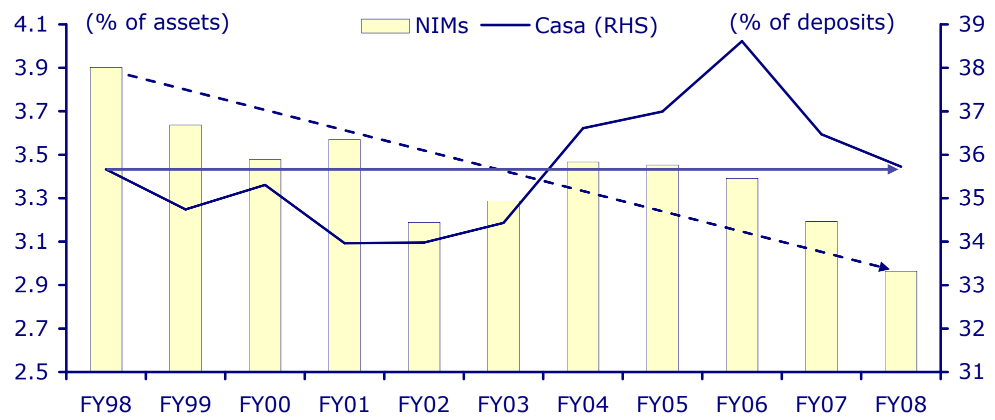
Liability franchise will be critical for growth, profitability

Credit disintermediation will lead to corporate-loan pricing reflecting the underlying risk on the corporations, as perceived by a wide investor base. This is a structural shift from the current pricing structure, which is based on assessment of individual risk and intermediation cost of a particular bank.

Spread compression is structural and likely to continue

Figure 45

Margin compression



Source: RBI, CLSA Asia-Pacific Markets

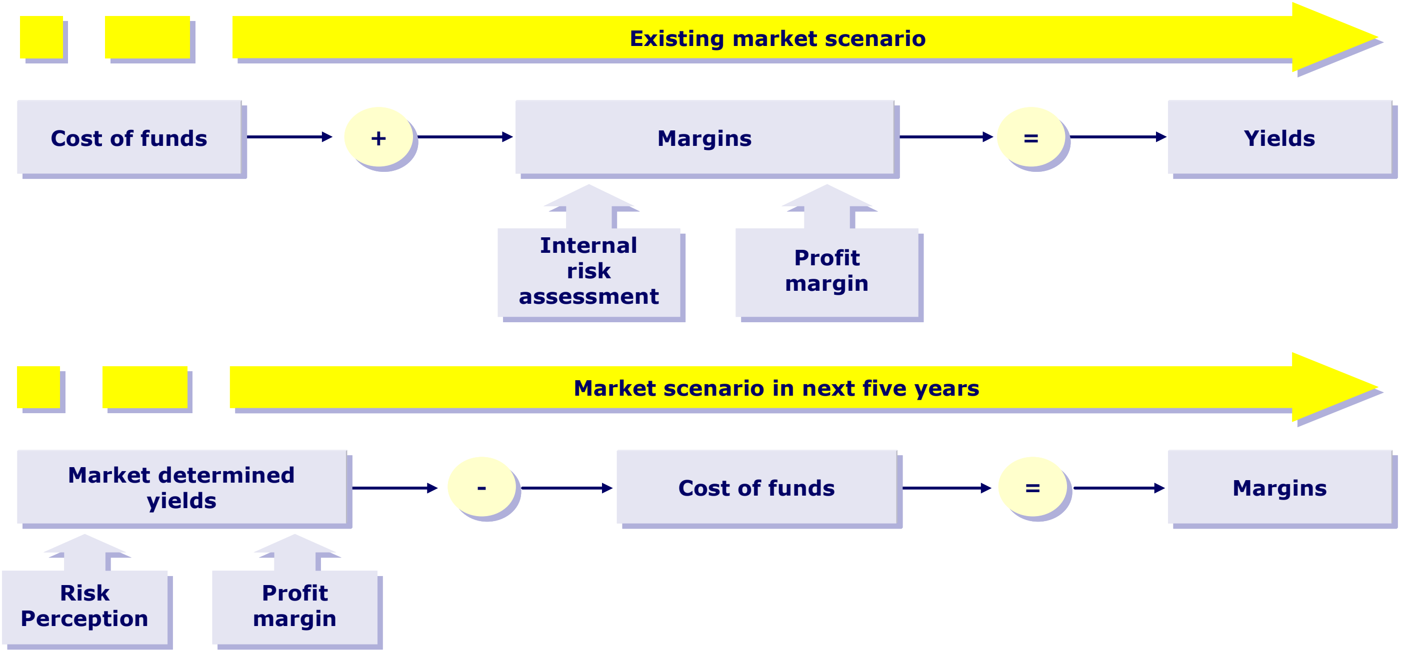
Historically, a lack of alternative options forced companies to borrow from domestic banks. Banks enjoyed tremendous pricing power and charged wider credit spreads, effectively leading to high intermediation cost for customers. Increasing competition over the past decade has led to some compression in intermediation cost, leading to margin contraction of 100bps between FY98 and FY09, despite a stable liability mix.

Funding costs will be the only variable for banks to improve margins

We believe development of a bond market will further reduce intermediation cost for corporate customers, leading to lower yields for banks. As banks become price-takers, net interest margins will narrow further. The only way to maintain/widen margins is to improve liability mix, ie, increasing the share of retail deposits. Thus, banks will be forced to restrict their balance-sheet growth to the extent of growth in retail deposits, ie, current-account savings-account (Casa) deposits plus retail term deposits.

Figure 46

Cost of funds is critical to future margins



Source: CLSA Asia-Pacific Markets

Service to displace distribution as key to retail franchise

Banks will need to create mind space among clients

As the technological infrastructure gap among large banks narrows, softer skills like customer-service standards, ability to innovate products, use of technology to understand customer needs will become the deciding factors for banking relationships. Banks that are able to transition into brands by offering a superior experience will enjoy a superior deposit franchise.

Banks need to scale up service standards to boost liability franchise

Until entry of private banks in the mid-1990s, distribution network was the only driver for retail deposit franchise. Entry of private banks led to development of non-branch networks such as automatic teller machines (ATMs), phone banking, internet banking and, more recently, mobile and TV banking, leading to dilution of branch network as a competitive edge.

Private banks have expanded through non-branch channels

Figure 47

Branch network

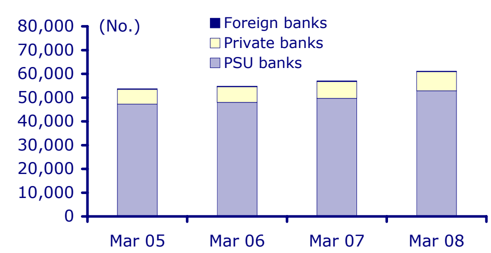
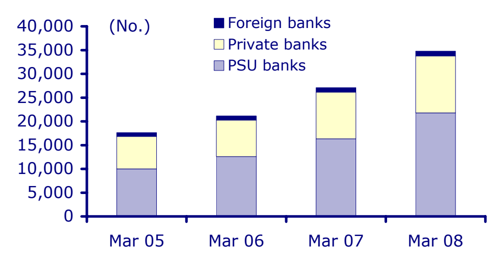


Figure 48

ATM network



Source: RBI, CLSA Asia-Pacific Markets

Soft skills will be key to growing liability franchise

Since the beginning of this decade, technology infrastructure has displaced distribution network as the critical success factor for building retail liability franchise. However, with most large PSU banks catching up on technological infrastructure, we believe softer skills are emerging as the differentiation factors and are likely to remain as the key driver for retail franchise buildup over the next five years.

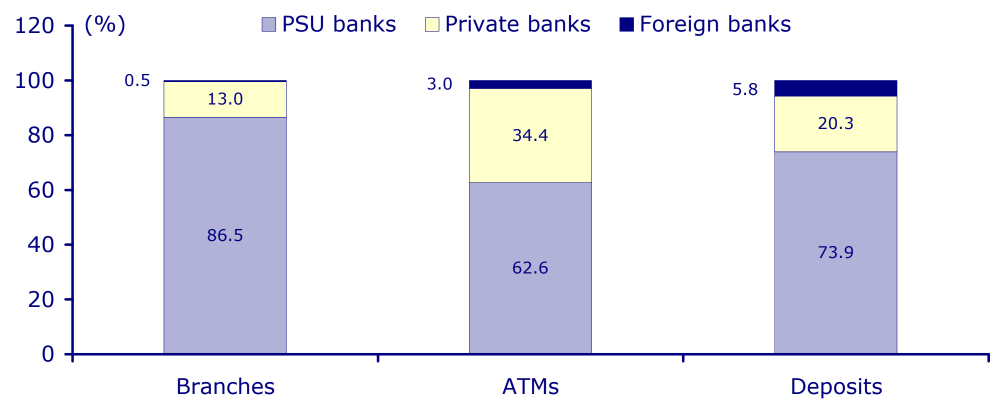
Distribution network becoming less important

The recent move of allowing full sharing of ATM network (any bank customer can access any bank's ATMs without any charges), has further reduced the need of having a wider physical distribution network. Even our proprietary survey of more than 300 individuals and 100 SMEs highlighted that customer service is displacing other factors (proximity of branch to home, ATM network) as the deciding factor for banking relationships (see Section 3).

Private banks have higher branch efficiency than their PSU peers

Figure 49

Share of branches, ATMs and deposits



Source: RBI, CLSA Asia-Pacific Markets

Figure 50

Reason for choosing the present bank

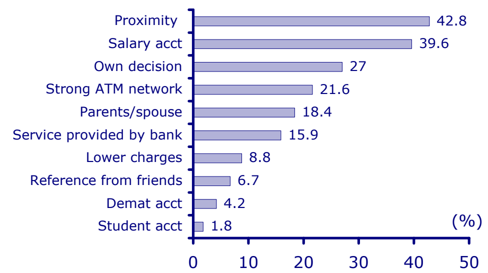
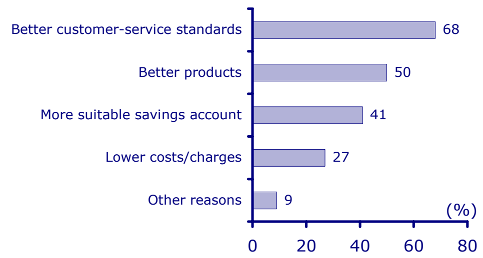


Figure 51

Reason for choosing the next bank



Source: CLSA Asia-Pacific Markets

Banks need to evolve into financial brands

India lacks true financial brands

In the longer run, Indian banks need to evolve into financial brands identified with a perception about customer-service levels. Most Indian banks have well-known names due to their long history. However, they lack a brand image. Unlike global peers, Indian banks do not offer a consistent service experience across their network and hence lack an experience image in minds of customer. For example, the experience at a metro branch of a private bank could be considerably different from that at an urban branch of the same bank. This is mainly because Indian banks are not used to training employees for offering service experience.

No bank focus on competing on experience delivery

Strategically, very few Indian banks have invested in brand-building and most of them compete only on pricing of products and services. Product innovation has been the strength of a few banks in India. However, once launched, most financial products and services, except treasury operations, are easy to replicate. As consumer and wholesale markets get saturated with alternatives, we believe branding will become a deciding factor for success. The banks will need to provide a consistent brand experience to prevent customers from switching to rival banks.

Figure 52

PSU banks are rebranding to win customers

Bank of Baroda		Union Bank of India		Canara Bank	
Old	New	Old	New	Old	New

Source: Company websites

Figure 53

Union Bank's campaign focuses on relationships

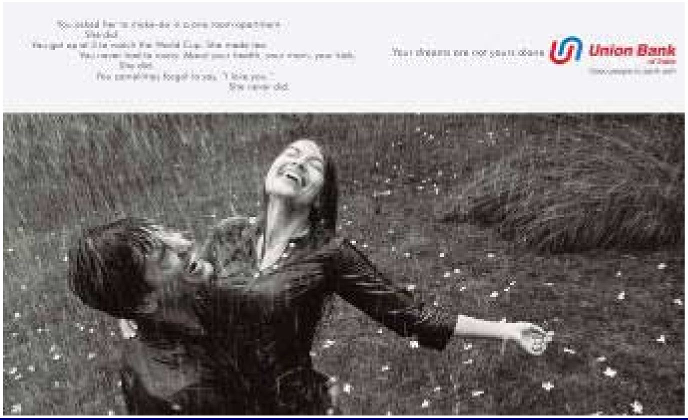


Figure 54

Canara Bank's campaign focuses on "change"

Addressing target audience

Figure 55

SBI positions as a bank to all Indians

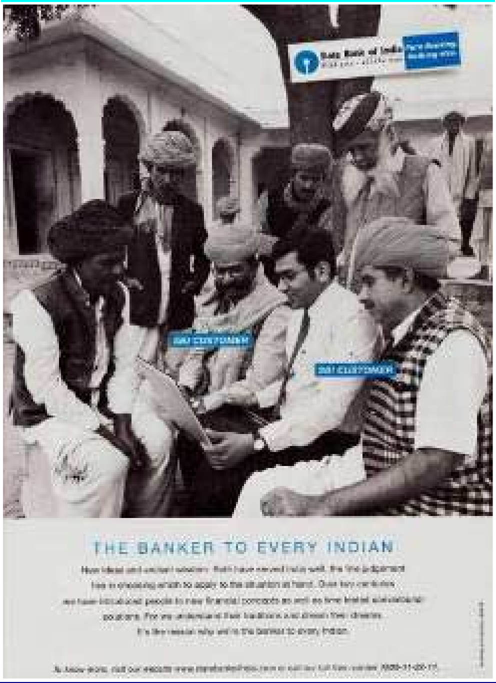


Figure 56

BoI as a bank for all generations

Source: Company reports

Power of celebrities

Figure 57

Movie star Shahrukh Khan for ICICI

Figure 58

Cricketer Rahul Dravid for BoB

Source: Company reports

Contribution of fees to revenue will rise

Fee income will support expansion of ROAs

We expect banks to retain an above-20% fee Cagr over the next five years and fees to make up 30% of operating revenue (excluding treasury gains) in FY14 (versus 25% currently). A pickup in corporate activity will bring fee opportunities for banks, even as retail fee growth remains healthy. Rising fees will boost ROEs, reduce capital needs per dollar of income and enhance earnings stability - a structural positive for the sector.

Retail fee growth momentum to remain strong

Fee growth likely to remain at 20% over the next five years

Indian banks have traditionally under-utilised their distribution network and vast client base and moved into a harvest phase only over the past five years, supported by technological advancement. Rising affluence, favourable demographic and accelerating urbanisation also led to rising demand for financial products. As a result of greater demand for these products and better harvesting of franchise network by banks, fee growth for the sector has accelerated to a Cagr of 27% over FY04-09 versus a mere 10% over FY99-04.

Role of brands in financial services

In financial services, "brand" is often a service perception in consumers' minds; consistent experiences over a period of time ensure steady buildup in perceived quality of the "brand", translating to repeat business and, in some cases, premium pricing.

Consumer banking versus wholesale banking

In consumer banking, functional demand drivers like product/service quality are the start point for customer choice. Increasing access to the internet allows potential customers to compare and review a wide range of financial products, ie, price and product details can be scrutinised in more details. However, for most consumers, image attributes often swing the final decision; hence the need for "brand" is much higher for consumer banking than for wholesale banking.

Corporate banking - a business-to-business purchasing decision - should theoretically be more rational and informed than a consumer purchasing decision. Yet, brand and reputation are still extremely important. This is because a degree of practical competence is assumed to be present across the competitor set. While "hygiene factors" include price and technical capability, the two most significant drivers of demand in business banking are personal relationships and brand reputation.

Financial brands are more vulnerable than consumer brands

One big difference between financial brands and consumer brands is that a financial brand can get squandered very quickly because of the high quotient of trust and safety. There are many recent such examples where strong financial brands that have existed for decades have disappeared in a few weeks' time as consumers lost their trust in the brand.

Branding needs to focused on customer moods

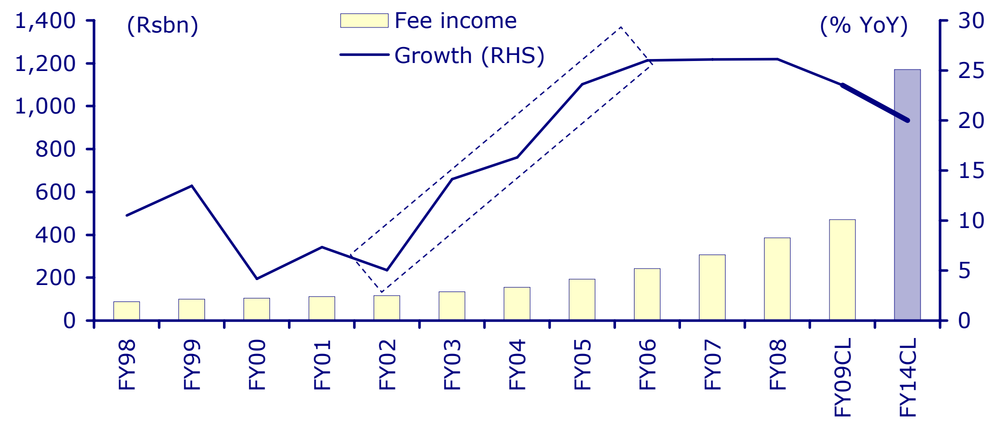
The other critical factor on which Indian banks haven't been able to deliver upon effectively is matching their service offerings to what the customer mood is. Most marketing campaigns by financial companies are internally focused and don't really focus on addressing consumer sentiment.

One good example has been the marketing campaign of ICICI Bank, which it ran post the Lehman crisis, and which aimed at addressing the basic question in every consumer's mind - will my money be safe with this company? We believe financial companies, to emerge as a strong brand, need to focus on prevalent consumer moods and match their offerings and marketing campaigns to capture the mood.

Cagr of 20% over FY09-14

Figure 59

Sector fee-income



Source: RBI, company reports, CLSA Asia-Pacific Markets

Overall fee growth will be linked to loan growth

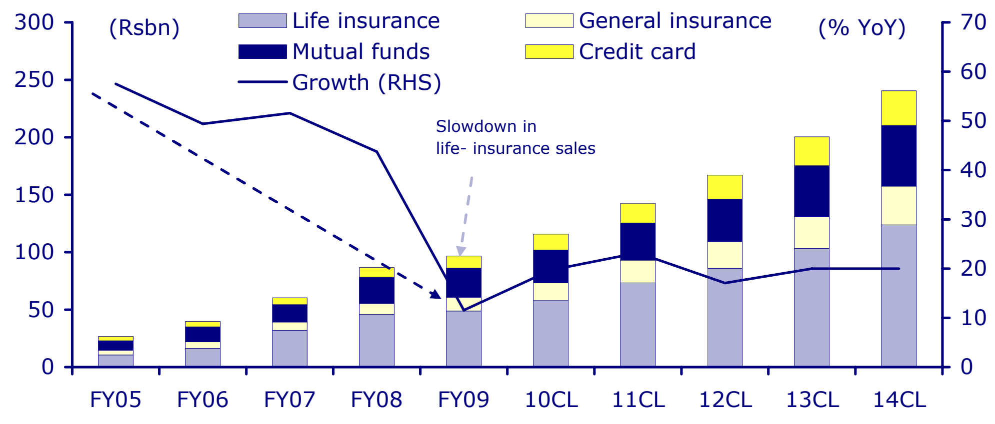
Retail fee growth will be driven by retail loan, distribution of products

Various factors will drive retail demand for financial products. Over the next five years, India's working population will grow by 44m, and the consuming category by 62m. Penetration levels are too low - only 2% of the population has credit cards and insurance sales make up only 3% of GDP. With a wide and credible distribution network, banks continue to be the best positioned to take advantage of this opportunity. We estimate fees from distribution of third-party products and on card transactions to more than double over the next five years to Rs240bn, accounting for almost 26% of total fees in FY14.

A 20% growth rate in retail fee is sustainable

Figure 60

Retail fee



Source: Company reports, CLSA Asia-Pacific Markets

Figure 61

Penetration of credit cards

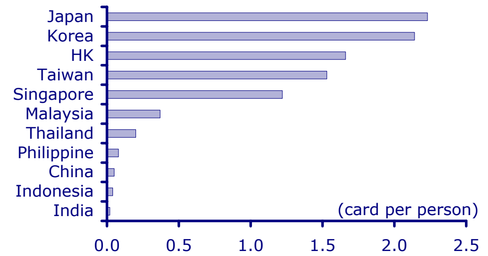
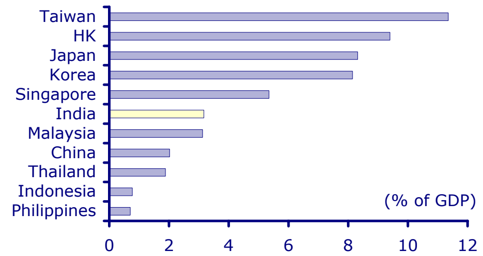


Figure 62

Penetration of life insurance



Source: RBI, CEIC, CLSA Asia-Pacific Markets

Regulatory intervention, like in developed markets, may hamper fee growth

Regulatory intervention is the key risk to retail fees

As the market grows in terms of size and penetration, the regulators - RBI, SEBI or the government - will look to propagate new regulations, which will, in most cases, favour the customer. Pro-customer regulations are available even in developed markets, including the US and Australia; and regulatory intervention could hurt the retail-fee growth in India. So, even though India's retail fee has potential to grow at a much faster pace, we are assuming 20% per annum over the next five years, discounting some of the regulatory risks.

RBI and SEBI have imposed some restrictions on Indian banks

Figure 63

Key regulatory changes regarding retail fees

India	Banks disallowed from charging ATM interchange fees to customers
	SEBI bans upfront load on mutual funds - makes distribution fees more transparent
US	The Card Act 2009 caps/monitors charges and fees on credit cards
Australia	Australia capped the interest rate on credit cards

Source: CLSA Asia-Pacific Markets

An expanding pie of corporate credit fee

Uptick in credit demand to drive corporate fees

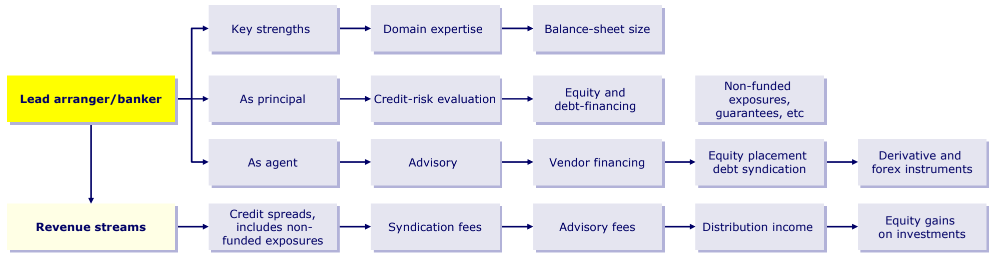
Rising corporate-credit demand should lead to higher fees for banks from credit-origination activities, such as loan-processing charges and syndication fees. Banks were not major players in previous capex cycles, when credit origination fees mainly came from working-capital loans (a much lower percentage given the shorter nature of loans). Requirement of long-term credit would increase the share of fees on credit origination, which is in some cases as high as 3%, compared 50bps in traditional working-capital loan. Further fees on structured products is much higher given the complexity of the product; total fees on syndication is estimated to be over Rs275bn over the next five years, based on a fee of 2-2.5% on total disbursements.

Only few have the skill to act as lead arrangers for project financing

Key factors influencing decision of debt-syndication lead arranger include: domain expertise in project financing, ability to underwrite the issue and corporate relationships. The role of lead arranger is important as it allows banks to break into an account, earn fees on syndication and win downstream financing requirements such as working-capital loans, non-funded exposures, etc. Thus, while syndication may be a one-time activity, the downstream business is longer-term in nature and at times is even a larger fee generator than the syndication activity.

Figure 64

Lead banks can monetise various revenue streams



Source: CLSA Asia-Pacific Markets

Fee/income ratio is low and can expand further

Higher fees to lift ROE - A structural positive for the sector

Rising contribution of fee revenues would improve the profitability for banks and reduce cyclicality in earnings. Fees require lower capital, per dollar of income, and hence can significantly boost ROE: banks with higher proportion of fee revenues have traditionally delivered higher ROE. With central banks all over the world aiming to restrict bank leverage ratios, bank capital has become scarcer than even; hence banks need to look at non-capital linked revenue sources to improve profitability. Indian banks' fee to average assets is still much lower to the foreign players in India, suggesting the strong potential for fee growth.

Figure 65

Share of fee income in total income

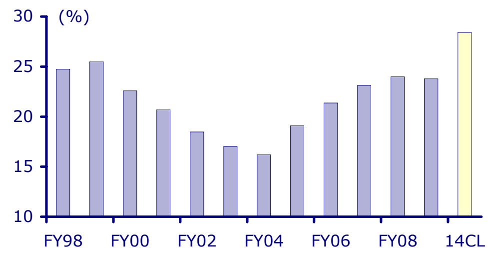
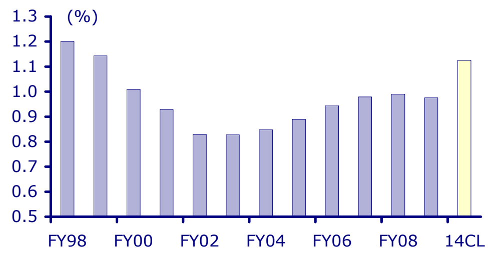


Figure 66

Share of fee income in average assets

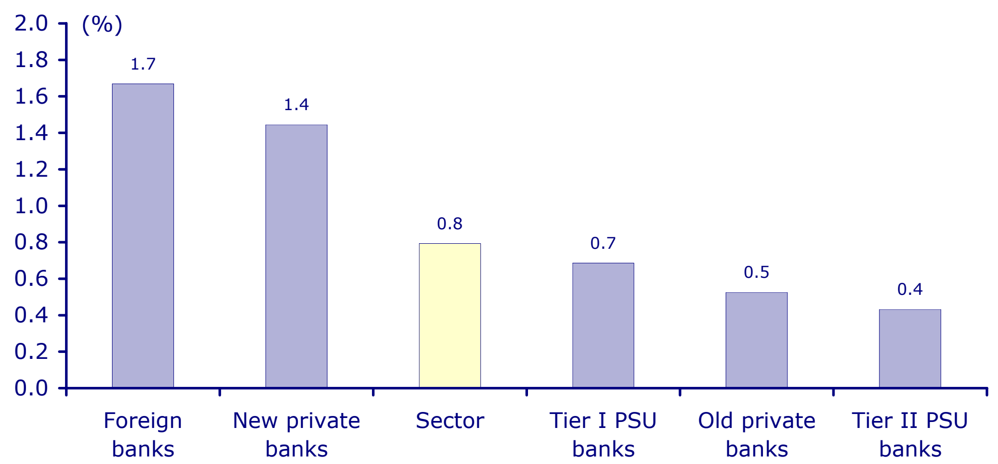


Source: RBI, CLSA Asia-Pacific Markets

Foreign banks in India generate higher fee income than Indian banks

Figure 67

FY08 fee income/average assets



Source: Company reports, CLSA Asia-Pacific Markets

Larger banks are likely to gain market share

Consolidation to increase, but M&A to remain subdued

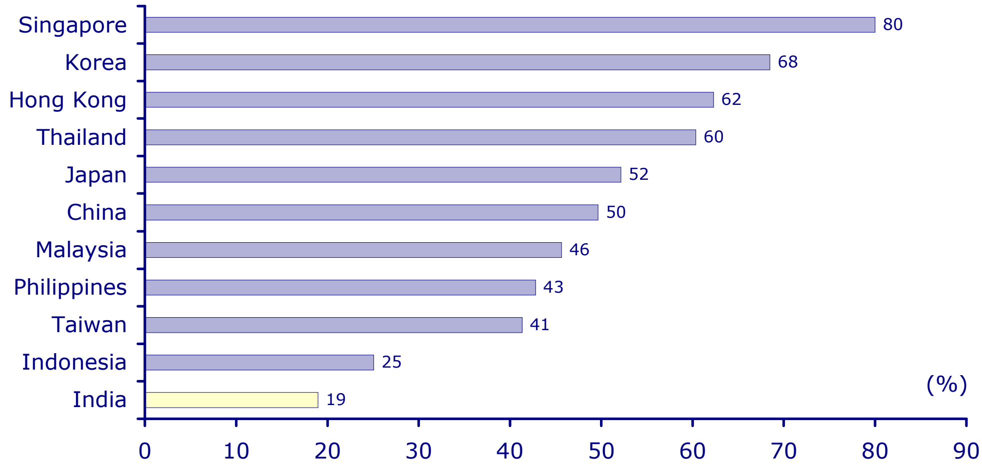
We expect consolidation in the Indian banking sector to crystallise further over the next five years, driven by market-share shifts rather than big-scale M&A activity. We expect the top-five banks to gain market share, at the expense of smaller private and PSU banks.

The smaller banks will lose market share at a rising pace, as they lag the large banks on most critical parameters, right from the basic technological infrastructure to the more sophisticated, softer skill set. We expect the market share of Tier II PSU banks to fall to 33% in total deposits and to 31% in Casa deposits over the next five years, which will further deteriorate their operating metrics, setting the platform for a pickup in M&A activity.

Indian market is far more fragmented than others in the region

Figure 68

Share of top-five banks in domestic credit



Note: SBI's data is based on standalone operations. Source: RBI, CLSA Asia-Pacific Markets

Most of the M&A has been to extend financial support to weaker banks

Only a few commercial acquisitions in the sector

Figure 69

Mergers and acquisitions among Indian banks over the past four decades

Date	Acquiring bank/institution	Acquired bank/institution
	Compulsive M&A	
Nov 69	State Bank of India	Bank of Bihar
Feb 70	State Bank of India	National Bank of Lahore
Jul 85	Union Bank of India	Miraj State Bank
Aug 85	Canara Bank	Lakshmi Commercial Bank
Aug 85	State Bank of India	Bank of Cochin
Dec 86	Punjab National Bank	Hindustan Commercial Bank
May 88	Bank of Baroda	Traders Bank
Oct 89	Allahabad Bank	United Industrial Bank
Feb 90	Indian Overseas Bank	Bank of Tamilnadu
Feb 90	Indian Bank	Bank of Thanjavur
Feb 90	Bank of India	Parur Central Bank
Aug 90	Central Bank of India	Purbanchal Bank
Sep 93	Punjab National Bank	New Bank of India
Jan 96	State Bank of India	Kashi Nath Seth Bank
Apr 97	Oriental Bank of Commerce	Bari Doab Bank
Apr 97	Oriental Bank of Commerce	Punjab Co operative Bank
Jun 99	Bank of Baroda	Bareilly Corporation Bank
Dec 99	Union Bank of India	Sikkim Bank
Jun 02	Bank of Baroda	Benares State Bank
Feb 03	Punjab National Bank	Nedungadi Bank
Jun 04	Bank of Baroda	South Gujarat Local Area Bank
Aug 04	Oriental Bank of Commerce	Global Trust Bank
Apr 05	IDBI Ltd	IDBI Bank
Oct 06	IDBI	United Western Bank
Mar 07	Indian Overseas Bank	Bharat Overseas Bank
	Commercial M&A	
Feb 00	HDFC Bank	Times Bank
Mar 01	ICICI Bank	Bank of Madura
May 02	ICICI Bank	ICICI
Sep 06	Federal Bank	Ganesh Bank of Kurudwad
Apr 07	ICICI Bank	Sangli Bank
Aug 07	Centurion Bank of Punjab	Lord Krishna Bank
May 08	HDFC Bank	Centurion Bank of Punjab
Oct 05	Centurion Bank	Bank of Punjab

Source: RBI, CLSA Asia-Pacific Markets

Most M&A have been to bail out weak banks

The expectations of big-scale consolidation within the sector have been belied, be it within PSU banks or large private banks acquiring smaller private-sector banks. Over the past four decades, few M&As have happened from a commercial standpoint, and most acquisitions have been forced upon PSU banks, aiming to bail out troubled banks.

Regulatory incentives have driven commercial M&A for brief periods

Looking back at the past five years, there was a brief period when RBI's issuance of new branch licences slowed, resulting in some commercial M&A activity as private banks acquired smaller banks to ramp up their distribution networks. However, once RBI became liberal again in the issuance of fresh licenses, the inclination of private banks to acquire smaller banks died down. Within state-owned banks, SBI amalgamated one of its banking subs with itself, but couldn't carry the process further due to labour/political issues.

We do not envisage any big-scale M&A

Although we believe M&A activity will pick up, we do not envisage any big-scale ones such as merger of two large PSU banks, acquisition of Indian banks by foreign players or even a private bank acquiring a public-sector banks. Foreign-ownership guidelines are unlikely to be relaxed substantially; private banks have been lobbying to restrain the opening-up of the Indian financial-services sector to foreign players, given that Indian banks are not getting permissions to operate in developed economies.

Two likely forms of M&A

The M&A activity is likely to be split into private banks acquiring few small, and not well-run, private and cooperative banks to strengthen their distribution networks, and large PSU banks acquiring smaller PSU banks, beginning with the merger of associate banks of SBI with the parent.

Managing liability franchise will be a key driver of future M&A

Key catalysts for M&A activity include rising demand for big-ticket project financing, which increases need of bigger balance sheets, inability of smaller private-sector banks and Tier II PSU banks to compete with the large banks due to their fast-depleting liability franchise, and a supportive regulatory regime. In Figure 70-71, we list some of the potential acquisition targets and potential acquirers; a few names such as Yes Bank and Kotak could either be an acquirer themselves or get acquired by a larger player.

Most of the M&A has been to extend financial support to weaker banks

Figure 70

Potential acquisition targets

Company	Code	Market cap (US$m)	FY09 deposits (Rsm)
Federal Bank	FB IN	854	321,982
Dhanlakshmi Bank	DHLBK IN	137	49,688
Karnataka Bank	KBL IN	344	203,333
IndusInd Bank	IIB IN	568	221,103
Karur Vysya Bank	KVB IN	316	151,014
Yes Bank	YES IN	848	161,700
South Indian Bank	SIB IN	211	180,923
ING Vysya Bank	VYSB IN	357	248,900

Source: RBI, CLSA Asia-Pacific Markets

Figure 71

Banks likely to acquire other banks

Company	Code	Market cap (US$m)	FY09 deposits (Rsm)
ICICI Bank	ICICIBC IN	16,101	2,183,478
HDFC Bank	HDFCB IN	12,912	1,428,116
Axis Bank	AXSB IN	6,081	1,173,741
Kotak	KMB IN	4,399	156,449
Yes Bank	YES IN	848	161,700

Source: Bloomberg, CLSA Asia-Pacific Markets

Supportive regulatory regime to boost growth, profitability

Conservative regulator led to sub-optimal metrics

A tightly regulated environment and a conservative regulator have always led to sub-optimal operating metrics for Indian banks. As the regulator continues to adopt global banking practices, easing some regulatory requirements, Indian banks are likely to see an improvement in their growth trajectory, and more importantly, profitability.

A tightly regulated market even now

Even after the number of regulatory reforms over the past 15 years, the Indian banking sector remains the most tightly regulated one in the region and also globally. The tight regulatory regime has helped Indian banks to withstand the Asian financial crisis and, more recently, the subprime turmoil relatively unhurt. However, it has also led to a sub-optimal profitability metrics for Indian banks for a long period of time, at times hindering the growth of the market's financial system per se.

Figure 72

Key regulations governing Indian banks

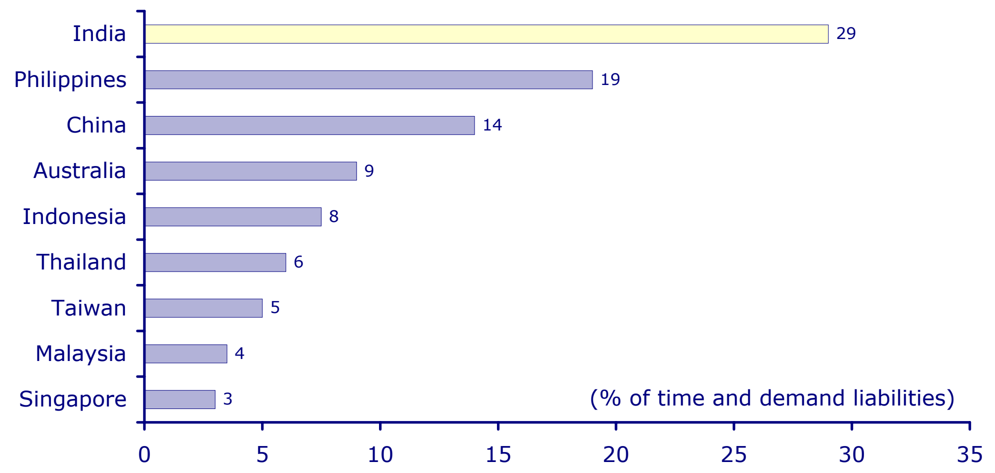
Aspect	Present regulations
Reserve requirement	Indian banks need to keep 29% of time and demand liabilities in reserves (CRR and SLR), higher than other markets in the region.
Priority sector lending	Banks need to lend 40% of their (previous year) loans to priority sectors with sub-limits for loans towards agriculture, weaker sections, etc.
Branch licensing	Banks need to get licences to open branches. Licences are issued subject to conditions, including branch requirements in rural, semi-urban areas.
Securitisation norms	Banks need to amortise gains on their securitised portfolio over the life of the asset and also need to provide capital in specific cases.
Ownership restrictions	Banks are not allowed to own more than a 5% stake in other banks unless permitted by RBI, aggregate foreign-ownership restrictions are 20% for PSU banks and 74% for private banks.
Fee income	Semi-regulated area; SEBI had recently capped distribution commission on mutual funds, while RBI has barred banks from levy of ATM interconnect charges on customers of other banks.

Source: RBI, CLSA Asia-Pacific Markets

Indian banks maintain higher reserves than peers in other markets

Figure 73

Reserve requirements



Source: RBI, CLSA Asia-Pacific Markets

Regulatory easing may boost ROEs by 200-300bps

We expect RBI to loosen some strings

Although globally there is an argument in favour of increased regulatory intervention, Indian banks remain far too tightly regulated and have only one way forward - regulatory easing.

RBI has steadily lowered reserve requirements for banks

Peak reserve requirement was 54% compared with 29% presently

Over the next five years, RBI may continue with its regulatory-easing policies, allowing more efficient use of capital and a commercially competitive landscape, with reduced dependence on "regulatory will" like branch licences. In the table below we highlight key measures that we believe RBI will adopt over the next five years that will boost ROE of Indian banks to the extent of 200-300bps.

Figure 74

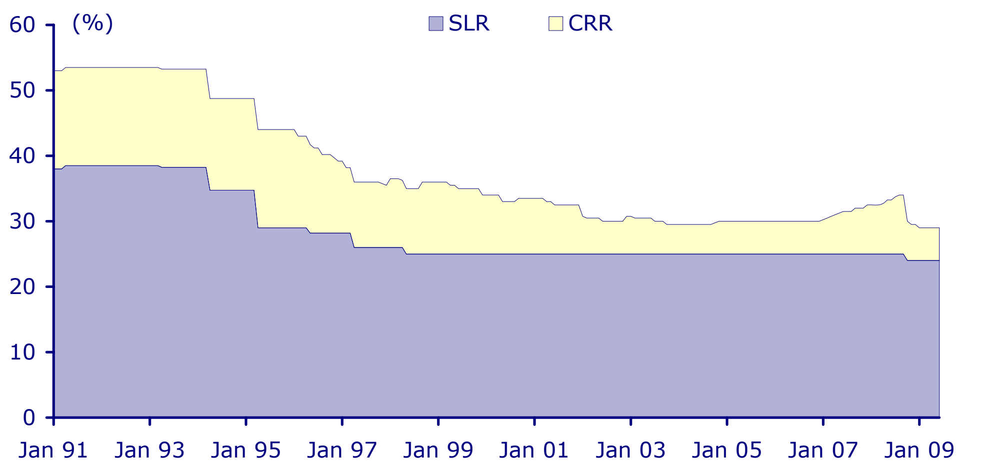
Likely changes in key regulations

Aspect	Likely change	Impact
Reserve requirement	Lower fiscal deficit, rising demand for G-Sec from non-banking players may lead to fall in reserve requirements.	+100-200bps ROE
Priority sector lending	Priority sector targets could be lowered - or the definition could be widened to include infrastructure, etc.	Positive for ROE
Branch licensing	RBI may to liberalise licensing norms for branches, ease rural branch norms.	Benefits private banks
Securitisation norms	In the long term, RBI needs to ease policies to allow development of the securitisation market.	Benefits Tier II PSU banks
Cross holdings	Banks may be permitted to own more than a 5% stake in other banks.	Could help consolidation and M&A in the sector
Fee income	RBI/SEBI could also cap the fee on distribution of other third-party products like insurance, etc.	Negative for ROE

Source: CLSA Asia-Pacific Markets

Figure 75

Reserve requirements for Indian banks



Source: RBI

Private banks are better positioned

Private banks will continue to gain market share

We believe private banks are better positioned to leverage from the changing banking landscape as their superior soft skills will drive market-share gains in retail liabilities, enabling them to expand margins. Their ability to generate higher fee revenues will also widen their ROE differential with PSU banks.

Meanwhile, even though a few PSU banks have caught up on the technology gaps, they lack the much required softer skills. Further, we view the bridging of the technology gap as a constant cycle for PSU banks. While they will continue to lose market share, within the group, diversity will increase: few Tier I banks will maintain their market share while Tier II banks will continue to lose theirs.

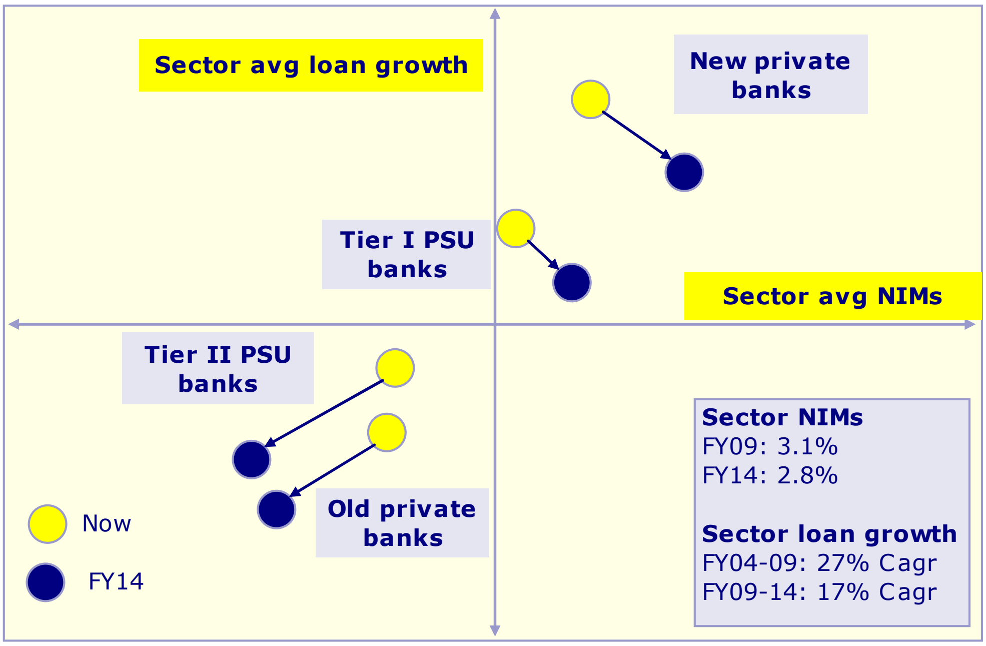
Our survey suggests rising preference for private banks

Our proprietary customer survey of 100 SMEs and 300 individuals highlight that private banks can sustain their high earnings growth, as they remain the preferred choice of banking for the next generation - both retail and corporate - due to factors such as technology and customer service. Our on-the-ground experience also corroborates our survey results, that while PSU banks have, to some extent, bridged the technology infrastructure gap between them and private banks, they are still way behind on critical parameters such as customer service and harvesting of retail client franchise.

Private banks will maintain their edge over the next five years

Figure 76

NIM and loan-growth positions



Source: CLSA Asia-Pacific Markets

Ability to build a stronger liability franchise

Private banks have an edge for growing their liability franchise

We believe private banks have far superior ability to build a stronger liability franchise than PSU banks due to their more efficient distribution network, superior customer-service standards and ability to innovate products. These factors will help private banks to expand their Casa deposits at a healthy Cagr of 23% over FY09-14, when sector average Casa growth will moderate to 16% per annum.

Private banks use an effective non-branch distribution model

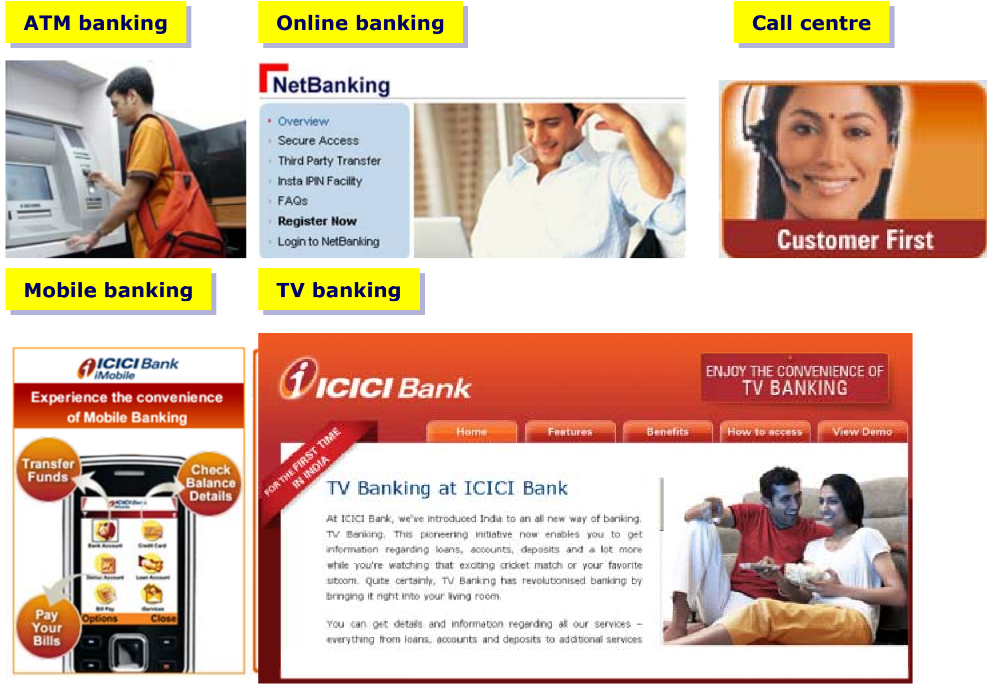
Efficient distribution network

Faced with a limited branch network and RBI's tight licensing regime for branches, private-sector banks have aggressively built up a more effective, non-branch distribution network focused around ATMs, internet banking, mobile banking cards, etc. Given that more than 47% of customers rarely visit bank branches and 80% of the visits pertain to cash deposits and withdrawals (based on survey), this model has been a good substitute to the traditional branch-network approach.

Private banks have pioneered non-branch banking in India

Figure 77

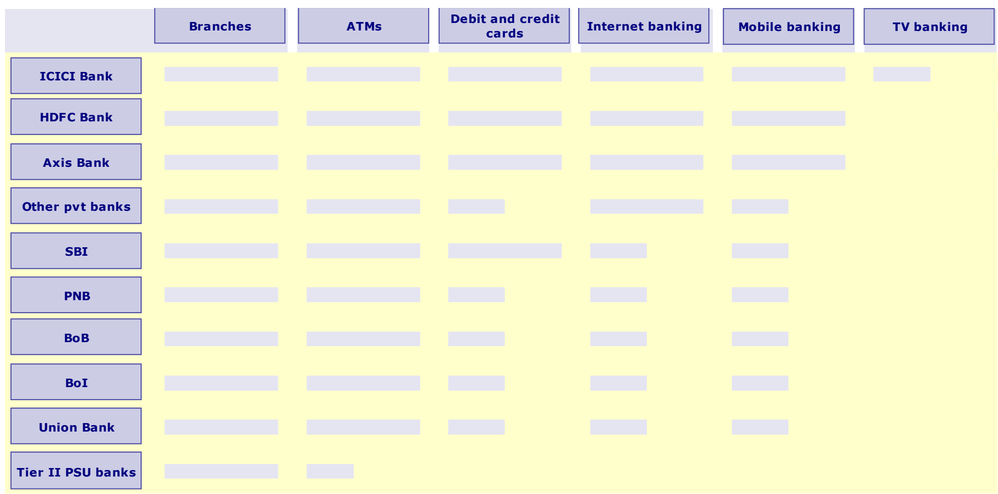
New and effective channels of banking



Source: Internet, CLSA Asia-Pacific Markets

Figure 78

Private banks have adopted a non-branch distribution model



Source: Company reports, CLSA Asia-Pacific Markets

New private banks have 6% of branches but nearly 30% of ATMs

Figure 79

Branch of a leading private bank

Figure 80

PSU branch in a prime Mumbai area

Source: Company reports

Figure 81

Number of branches as on March 2009

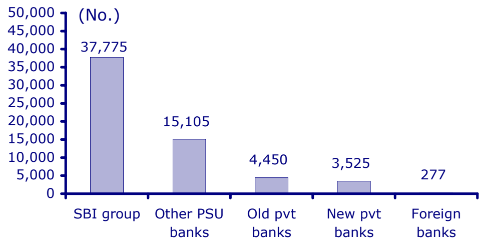
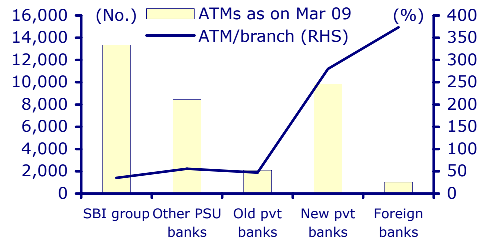


Figure 82

Number of ATMs as on March 2009



Source: RBI

Supported by a strong non-branch distribution network and customer-friendly layouts, private banks' branches have scored higher than those of their PSU counterparts on most efficiency parameters such as business per branch, deposits per branch and, most importantly, Casa per branch.

Private banks mobilise higher deposits per branch . . .

Figure 83

Deposit per branch

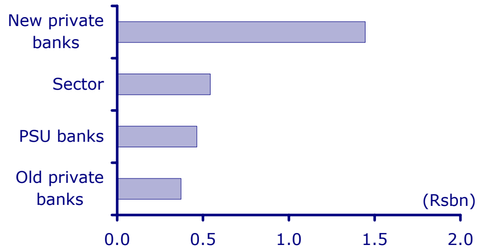
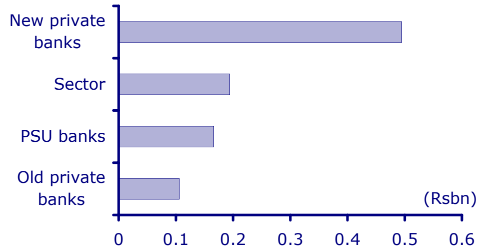


Figure 84

Casa deposit per branch



. . . and dispose higher advances per branch and generate higher fee income

Figure 85

Advances per branch

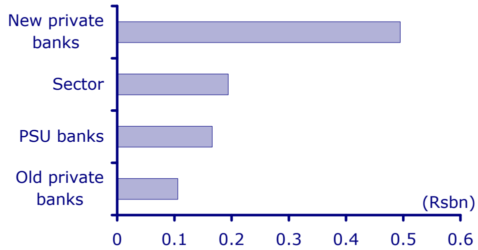
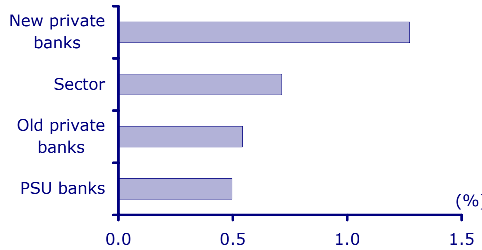


Figure 86

Fee generation as a share of assets



Source: RBI, CLSA Asia-Pacific Markets

We visited branches, opened savings accounts, applied for credit cards

Our on-the-ground experience: Better customer-service standards

To gain a first-hand experience of customer-service levels, we visited three branches each of eight banks in different localities of Mumbai and Nashik (Tier II city in the state of Maharashtra), opening savings bank accounts with five banks at two different locations, followed by closure of these accounts.

Private banks are more efficient with more attentive branch staff

Key takeaways from our visits to these branches were that the private banks are much more efficient and courteous in handling customers. While it took 35 minutes at a PSU bank to apply for a new savings account and eight days before the account was activated, time spent at the branch and waiting time in the case of private banks was nearly a third lesser. Some public-sector banks still require referral by an existing customers, and did not permit us to open an account. Employee attention to customer service, branch ambience and organisation at a PSU bank was far lower than at private banks, even at branches within the same locality.

Private banks are more efficient . . .

Figure 87

Waitng time

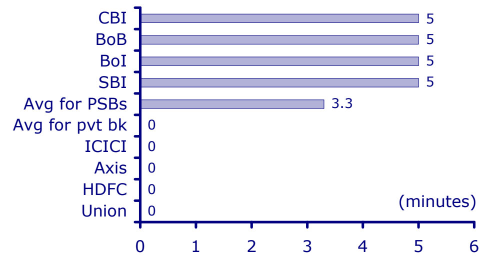
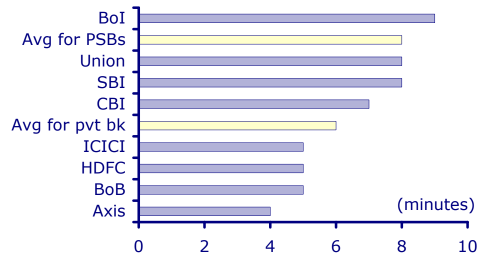


Figure 88

Time to withdraw cash



. . . and offered superior customer service

Figure 89

Rating on customer service

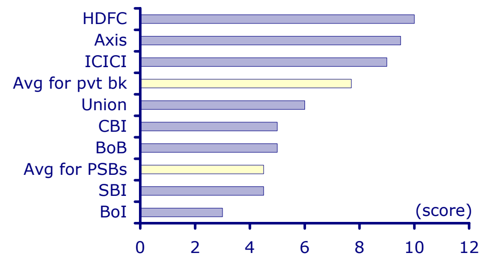
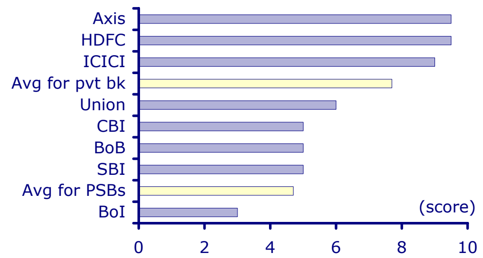


Figure 90

Rating on overall experience



Source: CLSA Asia-Pacific Markets

PSU banks will need to lift customer-service levels

While one could argue that PSU banks target the mass market (evident in their lower minimum deposit per account, lower charges for services like demand drafts, etc) and hence, even though their customer-service level is lower, these banks are still able to meet the requirements of their customers. But our survey of existing customers of private and PSU banks shows this is not exactly the case. The satisfaction level of customers of PSU banks with the service standards are lower than that of private banks on every parameter (Figure 108). As a result, PSU banks have been losing customers to private banks and will continue to loose market share.

No follow-up on our unsolicited credit-card applications

Banks have been risk-averse from extending unsecured retail credit to new customers and this was evident when our applications for new credit cards did not get even one follow-up call from the bank. Over the past few months, banks have been trying to prune risky/inactive credit-card holders and are apparently not interested in growing their card base presently.

Figure 91

Summary of branch visits

	SBI	BoI	Union	BoB	CBI	HDFC Bank	Axis	ICICI	Avg for PSU bks	Avg for pvt bks
Types of savings acct offered	5	5	4	9	4	12	12	11	5.4	11.7
Differentiation in minimum balance requirement	Yes	No	No	Yes		Yes	Yes	Yes		
Average time for a/c opening	**35**	**40**	**30**	**na**	**na**	**25**	**30**	**30**	**35.0**	**31.7**
Waiting	5	5	0	5	5	0	0	0	3.3	1.1
Interaction	15	15	10	5	20	12	15	15	13.3	14.4
Formalities	15	20	20	na	na	13	15	15	18.3	16.1
No. of days to open account	14	4	7	na	na	6	7	4	8.3	6.4
Rating										
Ambience	5.0	3.0	5.0	8.0	6.0	9.0	10.0	9.0	4.3	7.8
Customer service	4.5	3.0	6.0	5.0	5.0	10.0	9.5	9.0	4.5	7.7
Overall experience	5.0	3.0	6.0	5.0	5.0	9.5	9.5	9.0	4.7	7.7
Average time										
To make a DD	10	12	15			10	10	8	12	10
To deposit cash	8	9	8	5	7	5	4	5	8	6
To withdraw cash	5	4	5	5	3	5	5	5	5	5
Account opening										
Follow-up	No	No	No	na	na	Yes	No	No		
Flexibility in service	Yes	No	No	na	na	Yes	Yes	Yes		
Cross-selling	No	No	Yes	na	na	Yes	No	No		
Account closing										
Reluctance to close	No	Yes	No			Yes	No	No		
Feedback for closure	No	Yes	No			Yes	Yes	No		
Charges										
A/c opening	0	0	0	0	0	100	250	100	0	117
A/c closing	0	150				0	0	500	75	192
DD charges	35	45	25			50	32	83	35	50

Note: "na" where banks did not allow to open accounts unless existing customer provides an introduction. Source: CLSA Asia-Pacific Markets

Ability to use technology is more important than technology per se

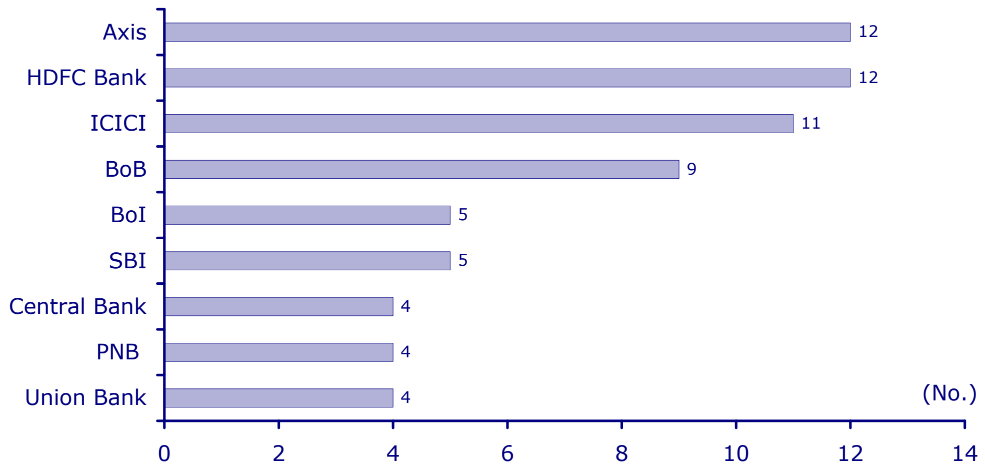
Efficient use of technology, ability to innovate products

We believe it's the effective use of technology, not the technology itself, that gives private banks their edge to build retail franchise, despite a limited distribution network. On the other hand, PSU banks have rolled out technology platforms but still do not seem to be leveraging it efficiently.

Private banks offer customised services

Figure 92

Types of saving accounts



Source: CLSA Asia-Pacific Markets

Private banks have used technology to innovate products, improve service

A critical factor to build strong liability franchise is the ability of banks to use its technology platforms to understand customer needs and channelise it to innovate products (first mover advantage is critical even in banking) and improve service standards. Technology platforms have also helped private banks' senior management to monitor risk; strong management information systems helps management make strategic decisions.

Private banks have been able to slice customers and offer tailored services

Private banks have been efficiently leveraging technology. This is reflected in their product innovations (debit cards, auto linked fixed-deposit accounts), segmenting customer base (salary accounts, accounts for high-net-worth individuals (HNI) senior citizen, women, etc) and efficient cross-selling ratios (investment products, loans, third-party products, etc).

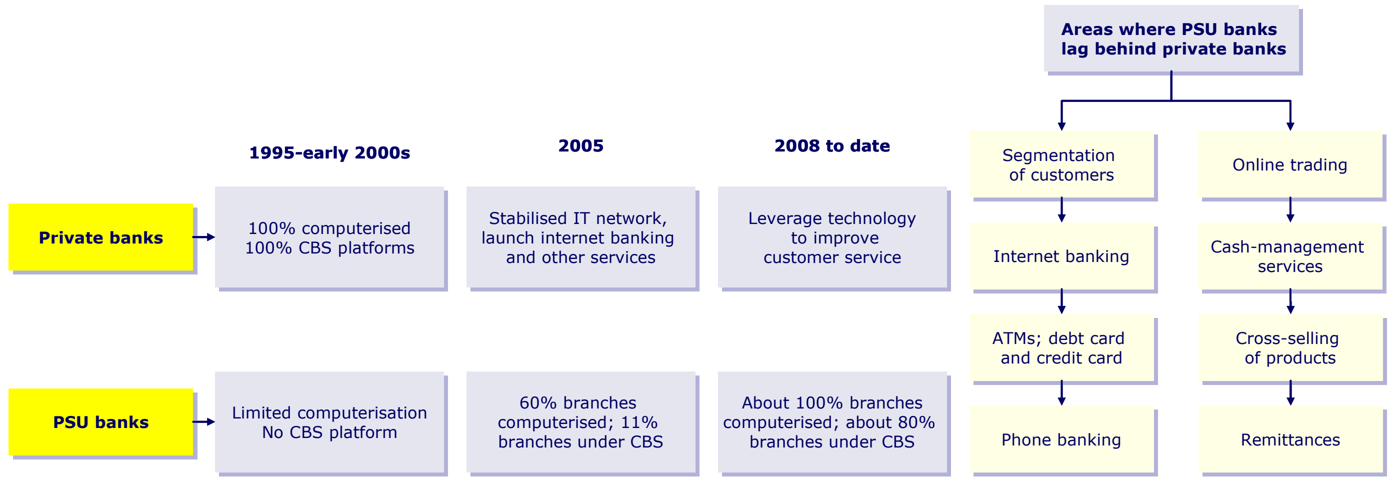
PSU banks catching up on technology but lack softer skills

PSU banks took a decade to match up with private banks' basic platforms

Faced with transforming dynamics in their business, few public-sector banks have decisively built non-branch networks, stepped up technology initiatives and expanded their employee talent pools, aiming to improve customer-service standard. However, they still lack their private-sector peers in areas of non-banking financial services and, more importantly, in softer skills such as customer services, advisory, etc.

Figure 93

PSU banks have been a decade behind private banks in terms of information technology

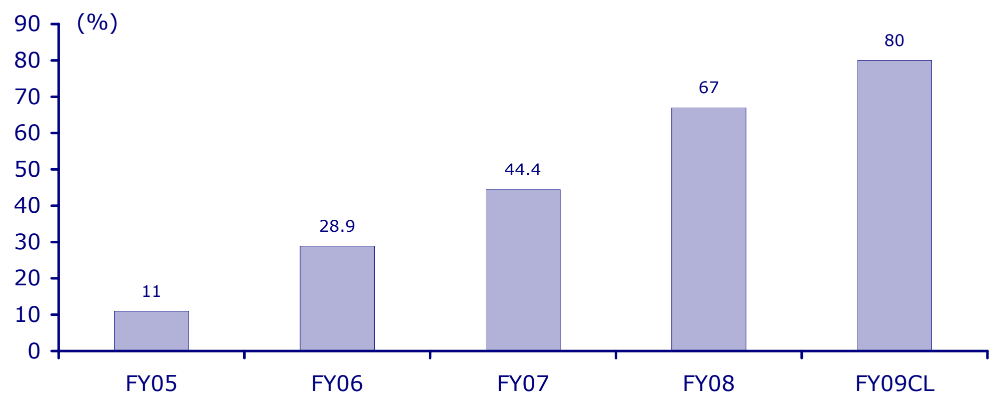


Note: CBS = Core banking solutions (ERP software). Source: CLSA Asia-Pacific Markets

But private banks have over a decade of technological experience

Figure 94

Share of branches using CBS[1] among PSU bank branches



[1] Core banking solutions (ERP software). Source: RBI, CLSA Asia-Pacific Markets

Tier II PSU banks lag private banks on softer skills

Our proprietary customer survey and on-the-ground experiences (discussed in detail later) also suggest that even Tier II PSU banks that have scaled up their technology platforms lag private banks significantly on customer-service standards and efficient use of technology.

Constant cycle of bridging the gap

PSU banks have focused only on bridging the infrastructure gap

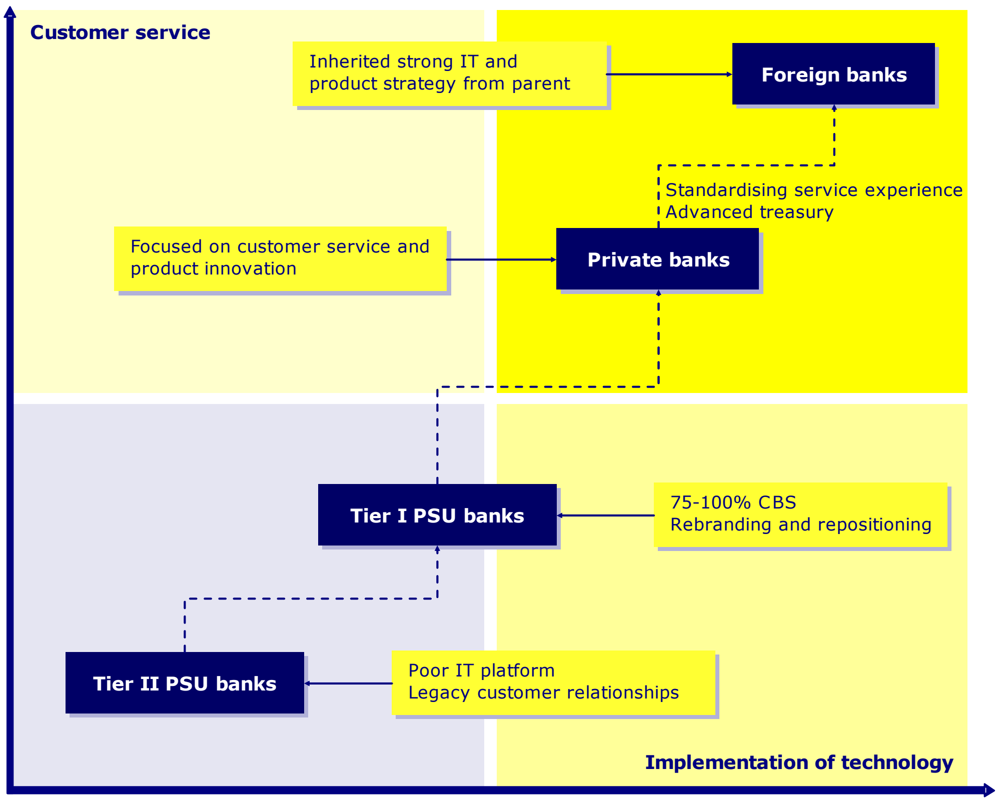
We expect a constant cycle of bridging of gap for PSU banks. It's been a decade since they started matching private bank's technological infrastructure and yet only a handful of them have succeeded. Meanwhile, private banks have moved ahead, efficiently leveraging their technology platforms to broaden product portfolio, improve management information systems and build new distribution channels (internet banking, mobile banking, etc). Also, while PSU banks have tried to bridge the technology-infrastructure gap with private banks, they have remained ignorant of other wide gaps in customer-service standards, management diversity.

Private banks are significantly ahead of PSU banks . . .

. . . especially Tier II PSU banks

Figure 95

Customer-service and technological positions



Source: CLSA Asia-Pacific Markets

Big gap in customer-service standards

PSU banks have lagged on building employee skill set for customer service

We believe the key challenge for PSU banks will continue to be to inculcate "external (customer) focus" at branch levels in employees, who for more than three decades have been used to an "internal focus" mindset. While most PSU banks have been launching multiple training initiatives aimed at upgrading the skill set of employees to use new technology platforms to market third-party products, very few have employee training programmes at branch levels that focus on awareness of the importance of good customer service.

Figure 96

Key initiatives by PSU banks towards employee training and development

Bank	Programme	Objective	Coverage
SBI	Parivartan (Transformation)	Aims to enhance awareness among staff on importance of good customer service; training programmes conducted for staff were revamped to focus on marketing, attitudinal changes, business strategies and goals.	174,000 employees, including officers, clerks and subordinate staff; 1000 workshops in 50 days
	Parivartan II	Envisages deep routed multilevel attitudinal change and transformation in the organisation through waves of HR intervention.	
Union Bank	Nav Nirman (transformation initiative)	Training on soft skills; each branch to develop relationship banking benefits to a group of customers based on their customer profile	na

Source: Company reports, CLSA Asia-Pacific Markets

New private banks' Casa market share to rise 50% in five years

We expect private banks to continue to offer a superior value proposition to its customers, by having a wider range of products, provided through multiple distribution networks. Hence, they will continue to gain market share in retail deposits, mainly in Casa deposits, even over the next five years.

New private banks' Casa share to rise from 14% currently to 21% by FY14

We expect Casa ratios for the sector to remain stable at 36% but expect the share of new private banks to rise to 21% by FY14, from the current levels of 14%. While Tier I PSU banks will be able to maintain their market share, Tier II PSU banks will continue to lose theirs.

Figure 97

Share in Casa deposits, FY09

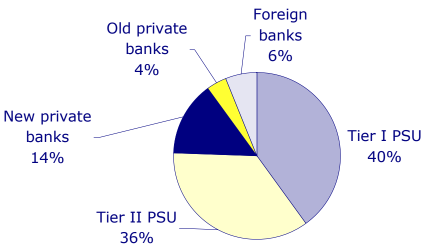
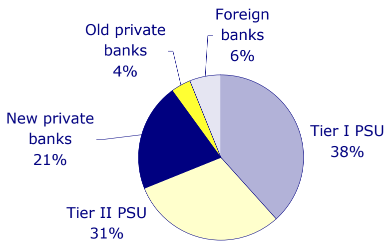


Figure 98

Estimated share in Casa deposits, FY14

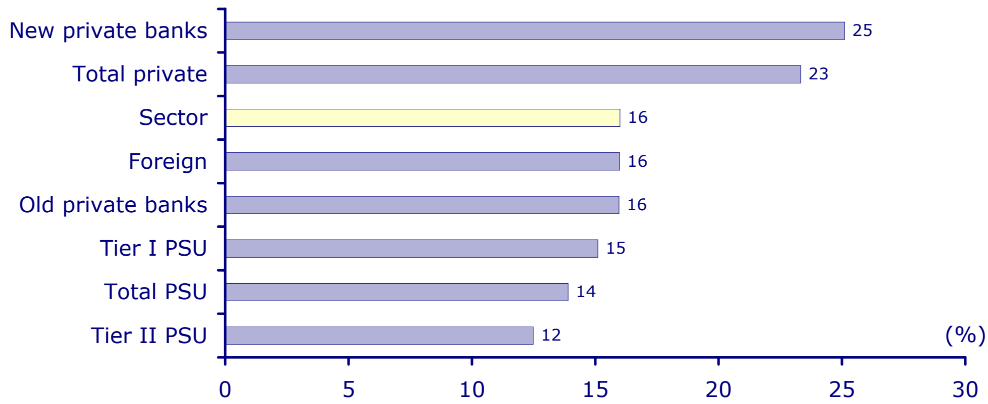


Source: RBI, CLSA Asia-Pacific Markets

Private banks will continue to grow at a faster pace

Figure 99

Implied Casa growth, FY09-14



Source: CLSA Asia-Pacific Markets

Private banks see higher implied growth in Casa deposit than PSU banks

As a result of the shift in market, the annualised growth rate of Casa deposits for private banks is likely to be 9-10% higher than sector growth rate (ie, 25% versus 16% for the sector), enabling them to grow their loanbook at a similar pace, without leading to margin contraction.

Ability to generate fee revenue

Private banks have grown fee income at a faster pace . . .

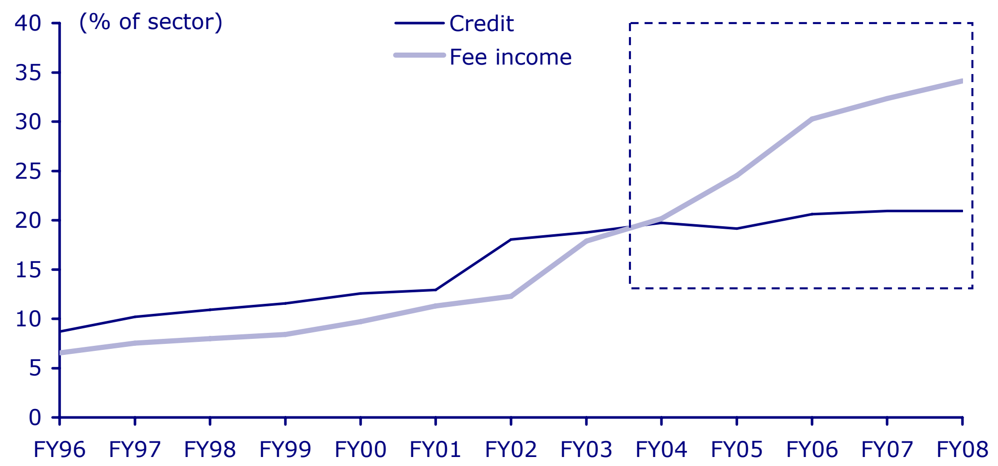
Traditionally, private banks have demonstrated their ability to generate higher fee revenue on the back of their wider product portfolio and expanding retail client base. Although PSU banks have seen a pickup in fee growth, it has mainly been in the area of distribution of third-partly products.

. . . evident from their share in fee income

Share of private banks in fee income is higher than their share in loans

Figure 100

Market share of private banks



Source: RBI, IBA, CLSA Asia-Pacific Markets

Figure 101

Fee growth

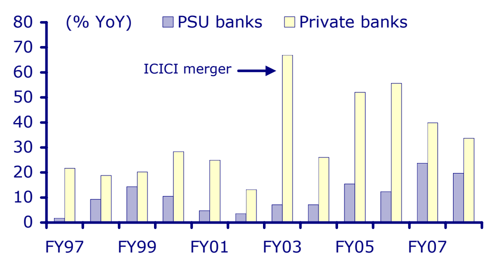
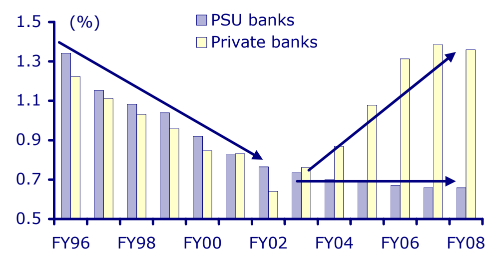


Figure 102

Fee income as a share of total assets



Source: RBI, IBA, company reports, CLSA Asia-Pacific Markets

Having diversified sources of fee income is critical

We believe private banks have an edge over PSU banks in most upcoming areas of fees - retail, debt syndication, advisory and structured products. On the corporate side, except a handful of PSU banks such as SBI and BoB, most PSU banks lack the expertise to generate fee revenue from project financing. Even as foreign banks have been an active player in loan syndication, especially for foreign currency-denominated borrowings, we see their role being muted due to their own issues and also the lack of willingness within Indian corporations to bank with them.

Figure 103

Private banks have built a strong services portfolio

	Card fees	Remittances	Distribution fees: insurance, MFs	Loan syndication, investment bkg	Cash management	Off-balance sheet facilities
ICICI Bank	✓	✓	✓	✓	✓	✓
HDFC Bank	✓	✓	✓	x	✓	✓
Axis Bank	✓	✓	✓	✓	✓	✓
Other private banks	✓	<>	✓	x	✓	✓
SBI	✓	✓	✓	✓	✓	✓
PNB	✓	x	<>	x	<>	<>
BoB	✓	✓	<>	x	<>	<>
BoI	✓	✓	<>	x	<>	<>
Union Bank	✓	<>	<>	x	<>	<>
Tier II PSU banks	x	x	x	x	<>	<>

Note: √ indicates that the bank has a strong presence; **<>** indicates that the bank provides the service but is not strong; × indicates that the bank does not provide this service. Source: CLSA Asia-Pacific Markets

Ability to take strategic initiatives

PSU banks have been unable to transform swiftly . . .

Despite a more experienced workforce, PSU banks have traditionally lagged private banks in their ability to transform and expand business models in response to a changing business environment. In our view, this is mainly a result of a lack of management continuity and their inability to attract and retain new talent.

PSU banks haven't adapted to the changing business environment

. . . and continue to play catchup

Private Banks have expanded their business models and invested in long-term businesses, often at the cost of near-term margin pressures and lower ROEs. Meanwhile, PSU banks have in most cases lagged on strategic initiatives, both within banking and non-banking services. Instead, they have always tried to catch up with private banks on technological infrastructure, products and other initiatives.

.Lack of management continuity is the key reason

We believe the key reason for this is a lack of management continuity and short-term delivery criteria for most bank chairpersons. In contrast to private banks, where the average tenure of a CEO is 10-15 years, PSU banks' chairpersons only last for three to four years. Shorter tenure at senior levels limit the ability to take long-term views.

Top management of PSU banks is subject to frequent changes

Further, unlike private banks, where the chair person and other senior management team is mostly internally promoted (and hence aware of bank's culture, long term strategic targets etc), for PSU banks, senior management team is mostly external (except for SBI). As a result, in many cases, by the time senior management is able to adjust into the culture of the bank, their tenure is close to completion.

Figure 104

Chairmen of PSU banks come from different banks

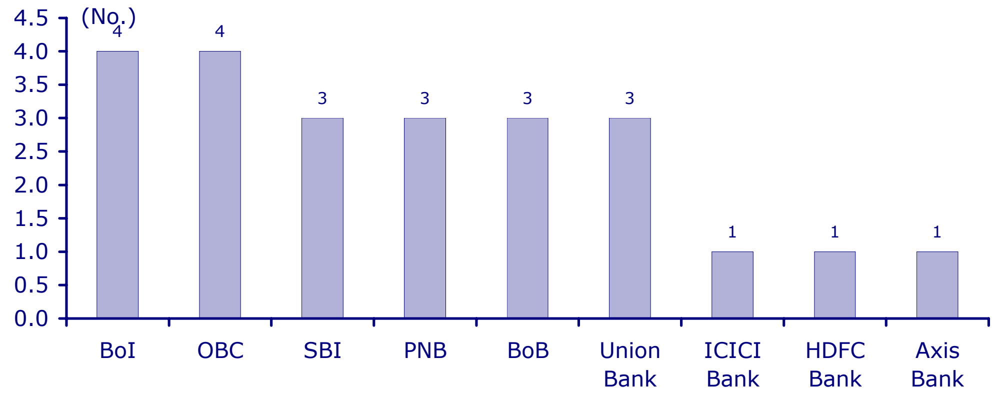
Bank	Chairman	Previous assignment
State Bank of India	OP Bhat	CMD State Bank of Travancore
Punjab National Bank	KC Chakrabarty	CMD Indian Bank
Bank of Baroda	MD Mallaya	CMD Bank of Maharashtra
Bank of India	TS Narayanaswamy	CMD of Andhra Bank
Union Bank	MV Nair	CMD Dena Bank
Oriental Bank of Commerce	Alok Mishra	ED Canara Bank

Source: Company reports

PSU banks have seen three to four chairmen in the past 10 years

Figure 105

Number of chairmen in the past 10 years



Source: Company reports

PSU banks have not been able to attract younger talent

Another hindrance for PSU banks to scale up new business initiatives and to adapt to newer trends has been a more aged workforce. Their inability to attract new talent due to lower salaries, a lax work culture and absence of adequate employee ownership (through employee stock option scheme) make PSU banks a "no choice" for ambitious management graduates. On the other hand, private banks have the ability to attract talent across the board as they also offer a much broader career platform versus a traditional bank.

Our survey on individuals and SMEs

We surveyed over 300 individuals and 100 SMEs

While the structural shift in market share from PSU banks and private banks has been talked about for quiet a while, reasons for the same and key trends have been relatively vague.

Only 30% of SME respondents are located in metro areas

Attempting to get some more clarity on the trends, we conducted a proprietary survey of over 300 individual account holders and more than 100 SME clients in 50 cities. Our survey of individual respondents was mainly targeted towards metros, which we believe are the lead indicators of trends that can emerge in urban and semi urban areas over the next five years. Our SME survey, however, was widespread: only 30% of our respondents were in metros. Our accompanying data books show the detailed survey results.

Private banks have the edge

Private banks enjoyed an 51% market share among our survey respondents, compared to their total market share of 19%. On the other hand, market share of Tier II banks among our respondents was only 8%, compared to their market share of 40%.

Figure 106

Share of existing bank accounts

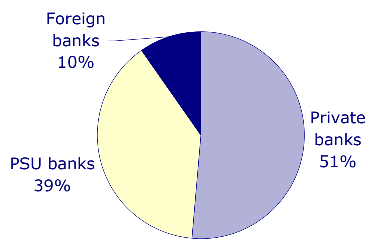
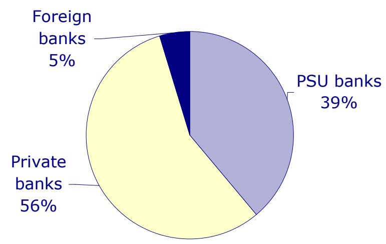


Figure 107

Share of new accounts



Source: CLSA Asia-Pacific Markets

Structural market-share gains for private banks

As mentioned earlier, the diversity in market share is primarily on account of our survey being focused on metro areas, which we see as lead indicators for the next five years' trends. Existing market share of private banks in metro areas suggests that they can maintain their healthy growth trajectory over the next five years.

Most customers identify customer service as the key influencing factor

Customer service is displacing distribution as the deciding factor

An interesting finding from our survey was that while in past, the key deciding factor for banking relationships was proximity of the branch to the customer's residence, most customers now identify customer service as the deciding factor for banking relationships.

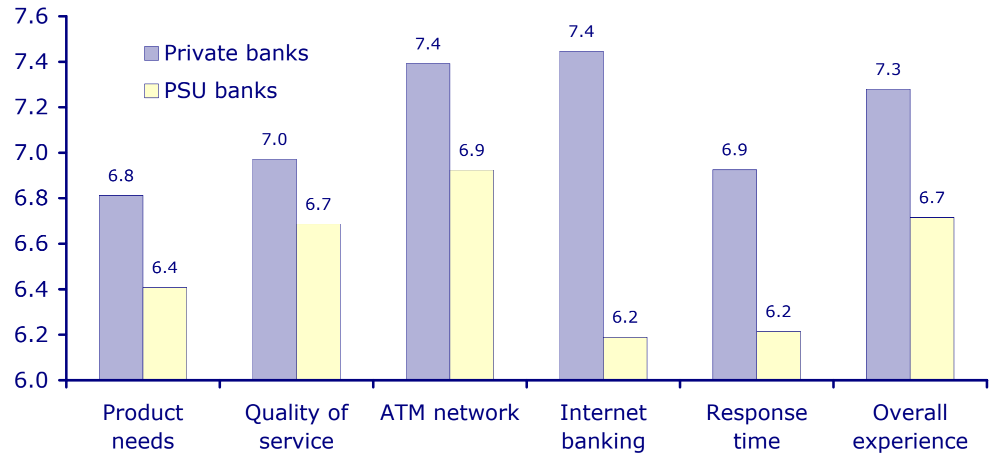
Private banks score higher on customer satisfaction ratings

Customers of most private banks find that products and services of these banks suit their needs better and are more satisfied with service levels. While the average score of private banks on overall experience is 7.3 (out of 10), it is 6.7 for PSU banks. Some 39% of the respondents cited longer response time as the key reason for dissatisfaction and 26% were disgruntled with the attitude of the staff. On the other hand, the main dislike of private-bank customers lies in the aggression for cross-selling of other products.

Customers of private banks are more satisfied

Figure 108

Customer rating



Service standards will become more important than branch network

Figure 109

Reasons for account opening

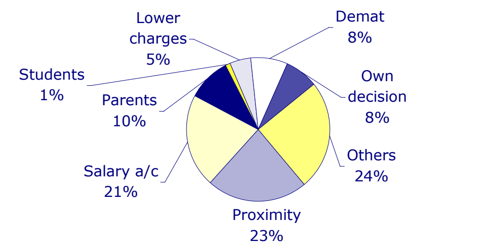
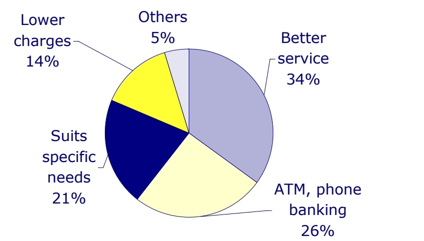


Figure 110

Reasons for what they chose next



Source: CLSA Asia-Pacific Markets

PSU-bank customers fancy banking with private banks

Some 16% PSU-bank customers mentioned that they plan to shift their bank accounts. Among them, 65% wanted to move to private banks. Interestingly, while 15% of private-bank customers mentioned that they too wanted to move their bank accounts, only 30% wanted to move to PSUs.

Figure 111

PSU-bank users: Plan to move accounts?

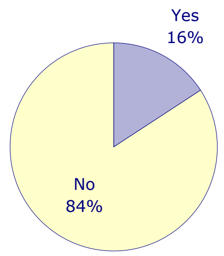
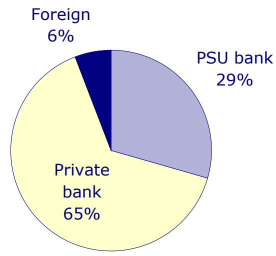


Figure 112

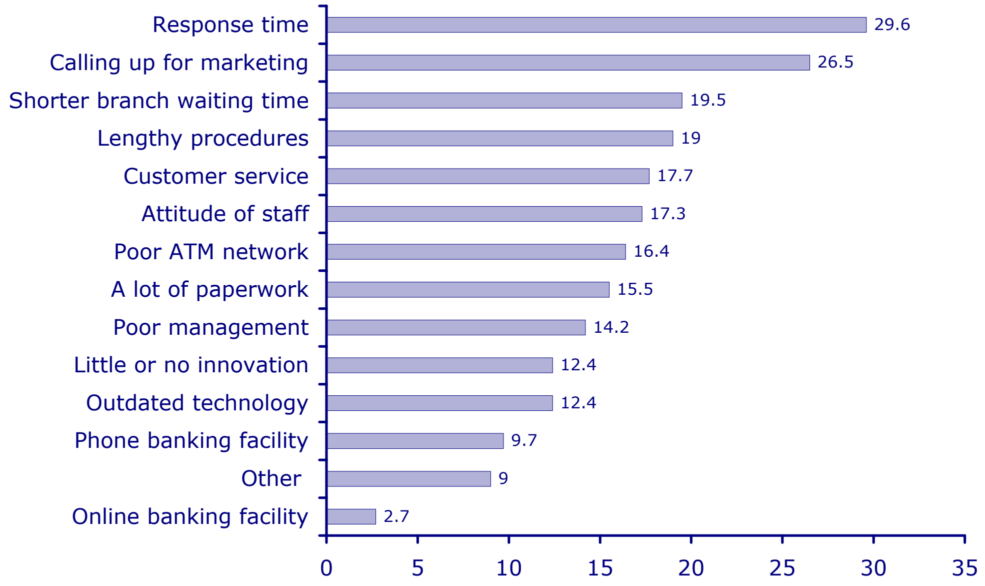
Where to?



Customers dislike inefficiencies and marketing calls

Figure 113

What do respondents dislike about their banks



Source: CLSA Asia-Pacific Markets

Over 30% respondents have availed products marketed by banks

Cross-selling efforts are effective

Even as banks have been more aggressive in marketing credit-related product (personal loans, credit cards) than fee products (insurance, depository); the conversion rate was surprisingly high at 32%. A fifth of our respondents had more than three banking relationships, which suggest cross-selling efforts in metro areas have fructified and offer potential in other areas.

Private banks are more aggressive in marketing products

Figure 114

Got cross-selling calls from private banks?

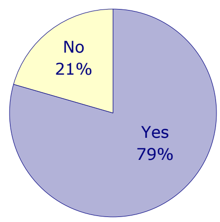
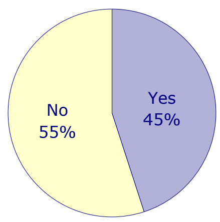


Figure 115

Got cross-selling calls from PSUs?



Source: CLSA Asia-Pacific Markets

Figure 116

What private banks call to offer

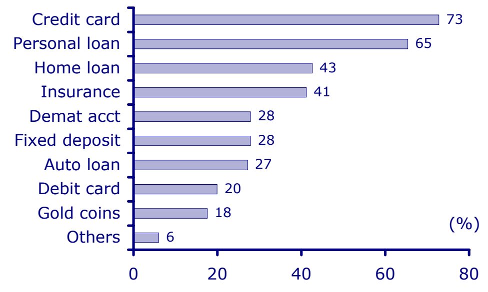
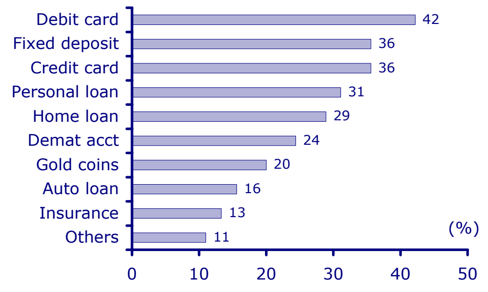


Figure 117

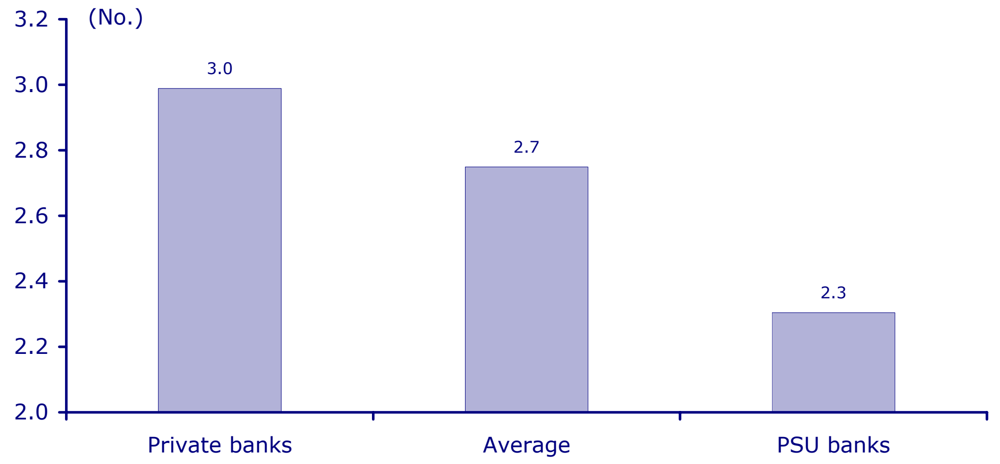
What PSU banks call to offer



Private banks establish more relationships with customers

Figure 118

Average number of customer relationships



Source: CLSA Asia-Pacific Markets

Private banks have made significant in-roads

Private banks will continue to gain SME market share

Our survey of over 100 owners of SMEs across 24 sectors in 50 cities indicates that the private banks have been able to make significant in-roads and will continue to gain market share. Proximity of branches is the key reason for choosing a bank for opening current accounts. But it is interesting to note that among our PSU-bank respondents, 62% stated that long-standing relationship with the bank is the key reason for choosing it, while the customers of private banks have chosen on the basis of better online platform and faster cheque clearance.

Figure 119

Source of private banks' new adds

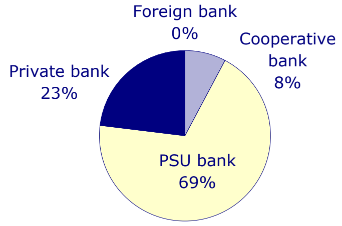
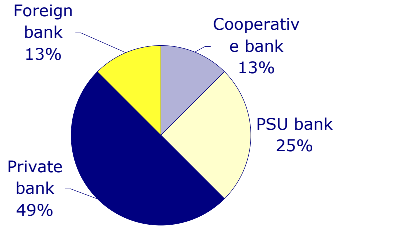


Figure 120

Preferences of those leaving PSU banks



Source: CLSA Asia-Pacific Markets

Customers of PSU banks are moving to private banks for better service

Some 48% of our respondents presently with private banks were associated with other banks until two years back and nearly 70% of them were with PSU banks. Moreover, half of the respondents planning to shift out of PSU banks are likely to bank with a private bank. The market-share gains have and will come largely because private banks are more efficient. While 54% of the respondents with PSU banks visit their branches almost every day, only 27% of those with private banks do; 23% visit less than once a month.

PSU bank customers upset with lengthy procedures

PSU banks need to boost efficiency; private banks to cut costs

The most important aspect that SME customers judge a bank on is the level of efficiency it could bring to their routines. But most customers of PSU banks are dissatisfied by the lengthy procedures, longer response time and quantum of paper work at these banks. On the other hand, customers of private banks are quite pleased with the performance of their bank. However, they are unhappy for having to pay a higher price. We believe that private banks could gain significant market share if they are able to lower some of these costs.

Figure 121

Private-bank customers think costs of services are high

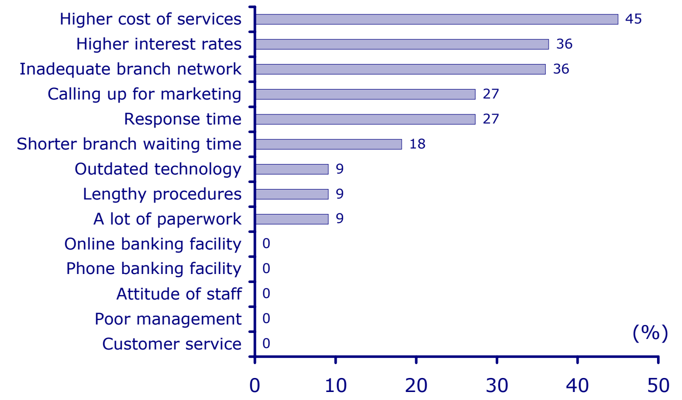
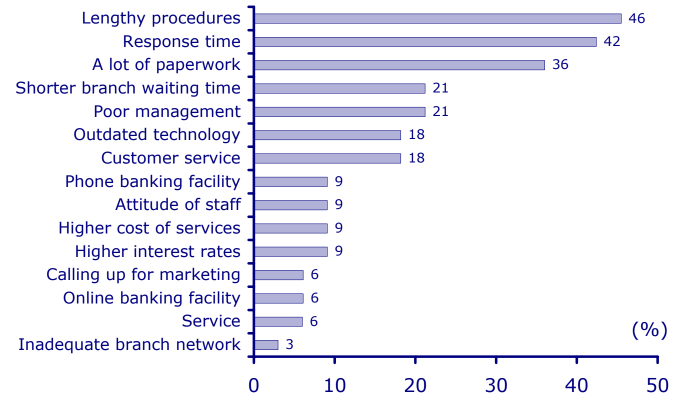


Figure 122

PSU bank customers dislike lower efficiency levels



Source: CLSA Asia-Pacific Markets

Customer service, management diversity, strategic maturity key

Evaluating banking franchises

Comparison among banks is simpler compared to other sectors due to a less dynamic competitive environment. The factors at play over a three to five-year period are fairly constant. For large banks such as SBI and ICICI, the challenge lies in defending their existing strengths and expanding in newer business initiatives. For Tier II banks, the challenge is more evolutionary - changes in business mix, management composition, inefficient branch network and inadequate capitalisation. However, for a small bank, the key challenge is survival, especially in phases of aggressive price wars by the incumbents. On a three to five-year view, we use the following key factors to evaluate banks:

Traditionally branch banking had been more important

- **Distribution network.** In India, traditionally distribution networks have been far more critical due to licensing regime for branches, lack of shared ATM network and absence of full fledged correspondent banking model. We have evaluated banks on this parameter based on their distribution network (both branch and no branch) and, more importantly, on the efficiency of their distribution network.

Customer service will be more critical than branch network

- **Customer-service standards.** We believe customer-service standards will emerge as the biggest driver of improvement/deterioration in liability franchise over the next five years, as the technology-infrastructure gap narrows down. Higher customer-service levels will continue to drive market-share gains in Casa, driving margins and ROEs.

Portfolio of services get standardised; innovation capabilities differ

- **Portfolio of services.** Products and services are relatively simpler to offer in financial services compared to other service industries. However, our evaluation on this parameter is based on the ability to innovate product and the delivery capability of product portfolio. ICICI Bank, with its strong presence across banking and non-banking space, leads on this criteria and remains the best positioned to expand on this lead.. Tier II PSU banks are laggards as their strength lies only in lending

Yes Bank has built a strong domain expertise

- **Domain expertise.** An important factor in global banking parlance is an area where most Indian banks lack. Banking in India is not centred on building industry line depths, or domain expertise that can offer advisory services on various banking needs - lending, structuring, M&A advisory, etc. ICICI Bank has some focus on this, but the only bank that has adopted it as a business model is Yes Bank. It's the non-banking financial companies, such as HDFC, IDFC, PFC and REC that aim to build domain expertise for broadening their product/service offerings, thereby trying to develop an edge over banks.

PSU banks are unable to attract and retain new talent

- **Talent pool.** Even though PSU banks have multiple layers of management expertise with experience of multiple credit cycles, in our view they lack the ability to attract and retain new talent. Lower salaries, a lax work culture, absence of adequate employee ownership (through ESOPs) make PSUs a "no choice" for ambitious management graduates. On the other hand, private banks offer a broader career platform and hence are better positioned to attract talent.

PSU management is more experienced but lacks continuity

- **Strategic initiatives.** Given the lack of management continuity at the top levels, PSU banks have lacked the ability to transform and expand their business models in response to the changing business environment. On the other hand, private banks have expanded their business models, invested in long-term business, often at the cost of near term margin pressures and lower ROEs.

ICICI and SBI have strong product portfolio

Figure 123

ICICI Bank

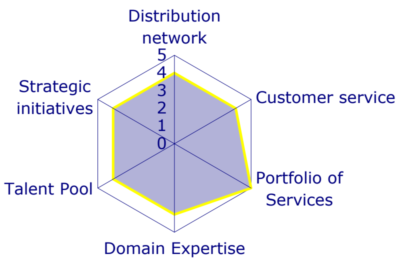
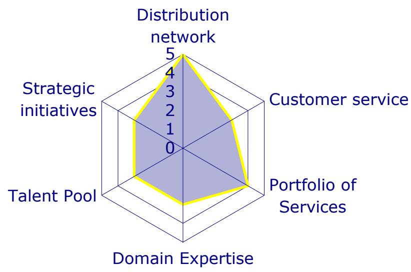


Figure 124

SBI



HDFC Bank and Axis have built a strong liability franchise

Figure 125

HDFC Bank

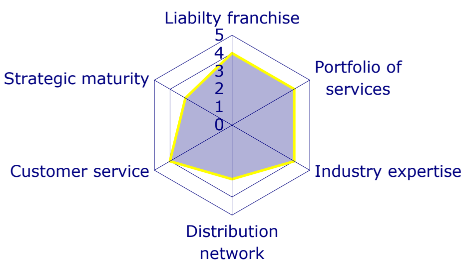
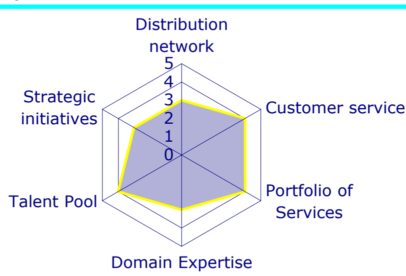


Figure 126

Axis Bank



Source: CLSA Asia-Pacific Markets

Strong domain experts among non-banks

Figure 127

HDFC

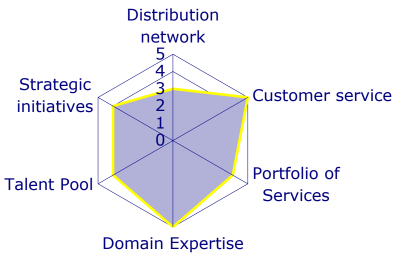
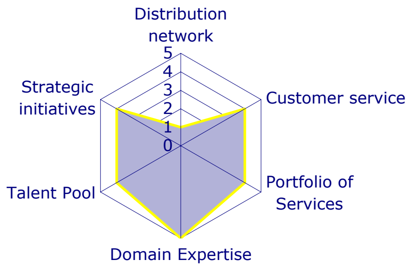


Figure 128

IDFC



Mid-sized PSU banks focusing to reposition themselves

Figure 129

Bank of India

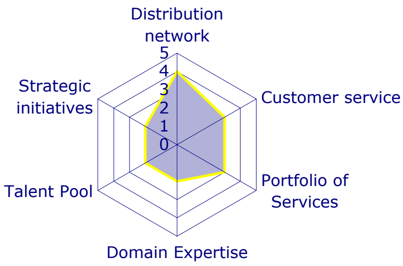
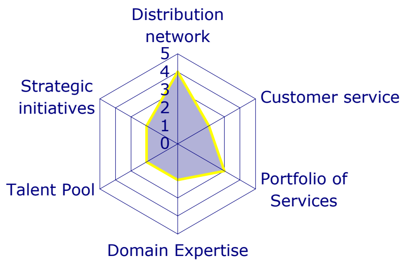


Figure 130

Bank of Baroda



Reliance Capital has built a strong distribution network

Figure 131

Union Bank of India

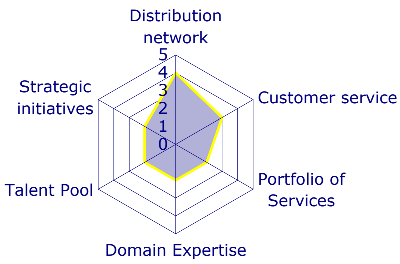
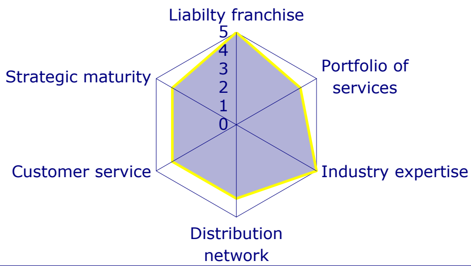


Figure 132

Reliance Capital



Source: CLSA Asia-Pacific Markets

ICICI, Axis and HDFC Bank seen strongly positioned

Overall, our analysis suggests that ICICI Bank will maintain its leadership among private banks, with Axis Bank and HDFC Bank continuing to build up scale. Among the PSU banks we see only SBI as a challenger to private banks across the gamut of the financial-services space. Most PSU banks are too narrowly focused, and lack strategic maturity, to challenge the long-term growth trajectory of private banks. Even though globally wholesale financing institutions have failed, we believe institutions like HDFC and IDFC are likely to thrive in India, due to their domain expertise and the regulatory arbitrage available to them. In our view development of the Indian financial landscape, distributors such as Reliance Capital and credit-rating agencies like CRISIL could facilitate a multi-year story.

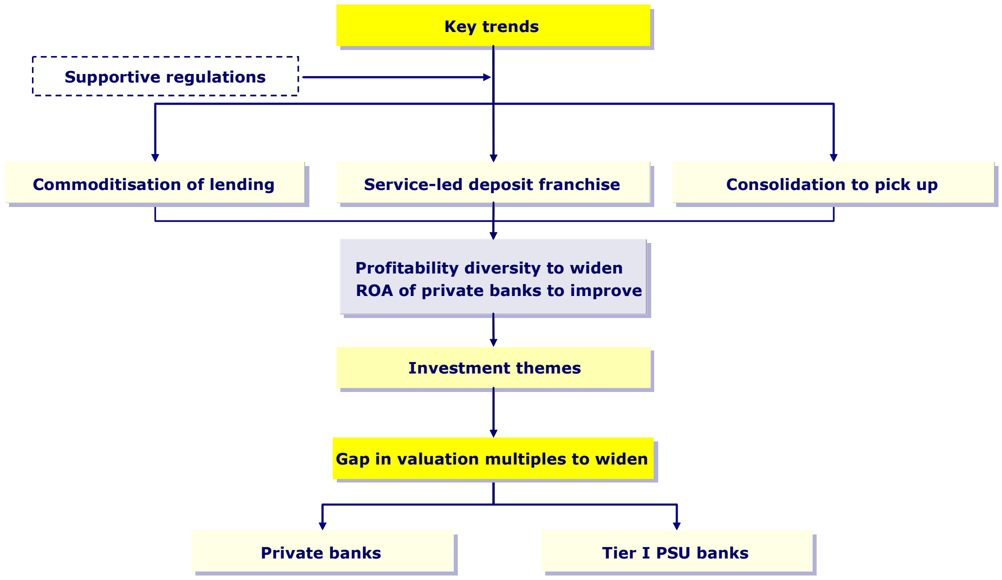
Investment themes

India offers structural growth opportunity, NPLs issues will get sorted

The long-term investment theme in the Indian financial sector, at times, gets clouded by its 12-month outlook, which is influenced by bond yields and newsflow. In our view, the industry's changing landscape and continuing market-share trend are paramount drivers behind a long-term investment framework.

Figure 133

Investment themes



Source: CLSA Asia-Pacific Markets

Private banks will deliver higher earnings growth

Over the next five years, private banks will continue to grow earnings ahead of their PSU counterparts, even as diversity in profitability increases. We expect the ROE differential to expand to 500-600bps, leading to further widening of valuation multiples. On a three- to five-year investment horizon, we prefer private banks, especially names like ICICI Bank and Axis Bank, which still offer rerating potential on the back of their improving liability franchise. PSU banks, in our view, are selective play and from a long-term perspective we recommend investing only in Tier I PSU banks; management continuity remains the key risk in PSU banks.

Select non-banking companies can also deliver strong growth

Even though globally few wholesale financing institutions have failed, we believe non-banking financial companies (HDFC, IDFC) will thrive due to their domain expertise and the regulatory arbitrage available to them. Reliance Capital could deliver attractive returns in the long term as it emerges as a distribution power house for financial products/services. Our preferred picks on a five-year investment horizon are ICICI Bank, Axis Bank, Housing HDFC, IDFC and Reliance Capital. Within PSU banks SBI, BoB, BoI and Union Bank are the names to own from a three to five-year investment horizon.

A 16% earnings Cagr

Rising fee to offset margin pressures

We estimate a 16% Cagr for aggregate bank earnings, largely reflecting the top-line growth as margin pressures would be offset by fee revenues. Private bank are likely to sustain a stronger growth trajectory on the back of higher fee to total asset contribution, superior margins and lower loan loss charges. As discussed earlier, we expect credit costs to rise and estimate average annualised credit costs to be about 100bps over the cycle, which will be fairly manageable for banks.

Margin, fees will be a function of retail customer base

Margins and fee to drive earnings

We believe margin management and fee revenue will emerge as the key earnings driver, while relevance of treasury gains will decline. As discussed earlier, margin management will be a function of liability franchise and, as a result, diversity of margins within banks will increase further. Fee revenue will be a function of retail liability franchise, too, with the retail fee pie estimated to increase 2.5x over the next five years. Fees on debt syndication, structured products and advisory services will also become significant. Key risk to fee revenue is regulatory intervention.

Treasury gains will moderate to 6-7% of pre-provision profits

Impact of treasury gains to be muted

One thing that continues to cloud the performance of Indian banks, especially PSU banks, is treasury gains on their government-bond holding. Over the past 10 years, treasury gains have accounted for as high as 37% of pre-provision profits. Indian bank's large government holding (due to the regulatory requirement) and their longer duration portfolios make their earnings fairly volatile. We believe that, over next five years, while treasury gains would continue to contribute to earnings, their contribution would fall to 6-7% of pre-provision profits due to a lower share of government securities in total assets; a decline of two to three years in average duration of investment portfolios; 60-80% of portfolios now being in held-to-maturity (HTM) category (versus 15-20% in FY03).

Figure 134

Share of treasury gains

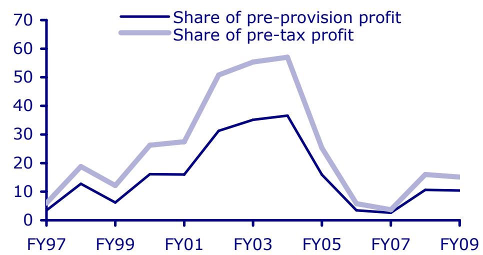
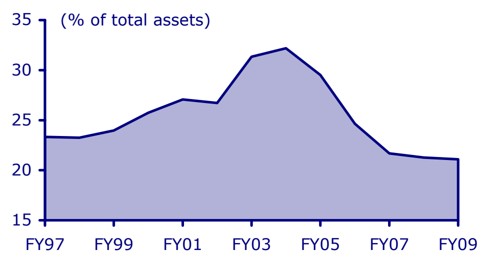


Figure 135

Investment in government securities



Source: Company reports, IBA, CLSA Asia-Pacific Markets

Lower wage-inflationary pressures, rising share of fees to boost efficiency

Operating efficiency - Still room for improvement

Indian banks' cost/income ratio (excluding the treasury component) has steadily improved from 68% in FY01 to 48% in FY09, mainly driven by improvement in PSU banks' operating efficiencies. PSU banks have been traditionally over-staffed and ridden with cost inefficiencies. Computerisation and focus on cost controls over the past decade has led to a steady improvement in their cost efficiencies: PSU banks have tripled their balance sheets with a 10% lower employee force than they had in FY01.

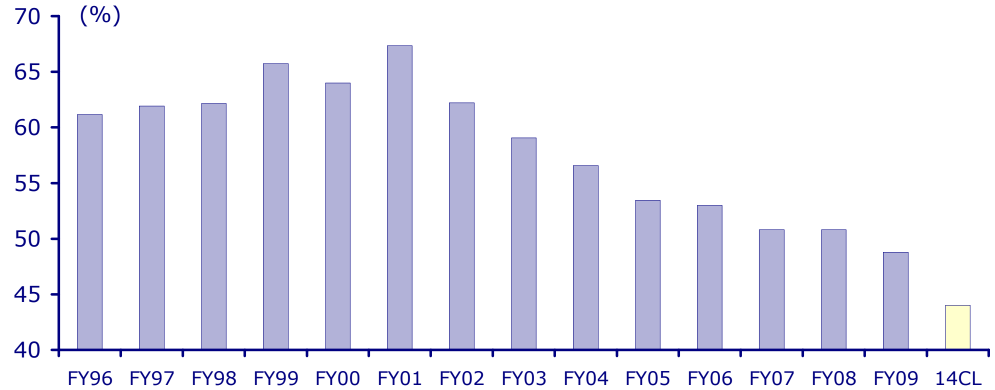
Indian banks' current cost structures are in line with those of global peers but still offer room for improvement, albeit limited - the upcoming wage hike (for PSU banks), and recent aggressive hiring by a few large PSU banks will limit the improvement. Private banks remain in an investment phase, but with the pace of investment moderating, operating efficiency are likely to improve, also supported by lower wage-inflationary pressure.

Operating performance of banks has improved over the past 14 years

Cost/income ratio can fall another 400-500bps from FY09 levels

Figure 136

Cost to ex-treasury income



Source: RBI, IBA, RBI, CLSA Asia-Pacific Markets

DuPont analysis - ROEs likely to improve further

ROAs to remain stable; ROE to improve on Basel II adoption

Over the past decade, Indian banks' ROA has improved by a significant 38bps to 110bps, mainly driven by greater operating efficiency. ROE has also increased from 11% in FY97 to 16% in FY09. The ROE expansion has been muted in recent years mainly due to an under-leveraged balance sheet - most large banks had raised equity in FY08 and haven't leveraged it yet.

ROAs are depressed due to regulatory costs and investment in growth

In our view, ROA for Indian banks are currently depressed due to two key factors: high regulatory costs and that the private banks are in an investment phase. First, a very high reserve-requirement structure and lending norms towards priority sectors (40% of total credit) have always forced Indian banks to carry a sub-optimal asset mix, leading to lower ROA. Second, most private banks are still in an investment phase and hence their current ROA don't depict sustainable efficiency levels. However, over the next five years, we expect ROAs to remain at current levels, as any improvement on the back of easing in any of the above-mentioned factors will be offset by margin compression in the traditional lending business.

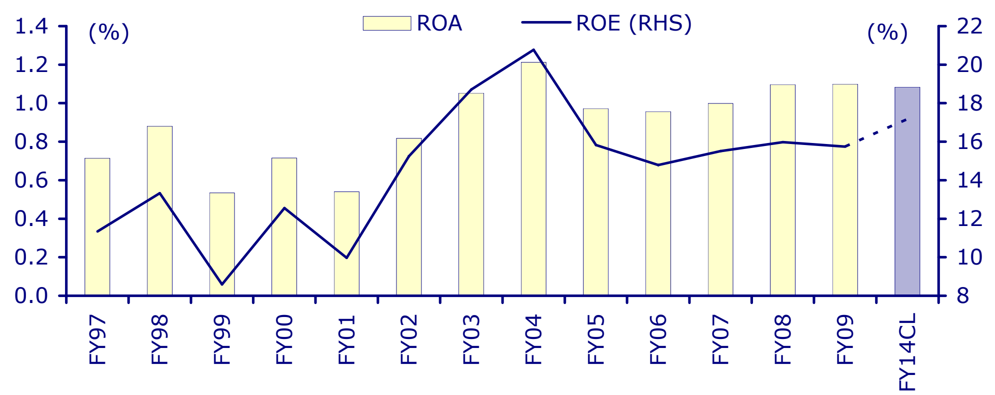
ROE will improve with better leverage

Even as ROA remains stable, we expect ROE to rise on the back of better capital utilisation; leverage ratios will improve as Basel II enables banks to charge risk-weights based on the riskiness of the exposure and, unlike global peers, a significant proportion of Indian banks' portfolio comprises corporate exposures, including exposure to AAA, AA and A-rated corporations.

ROA to improve and better leveraging will improve ROE

Figure 137

ROA and ROE



Source: RBI, IBA, CLSA Asia-Pacific Markets

Figure 138

ROA movement over the past 13 years

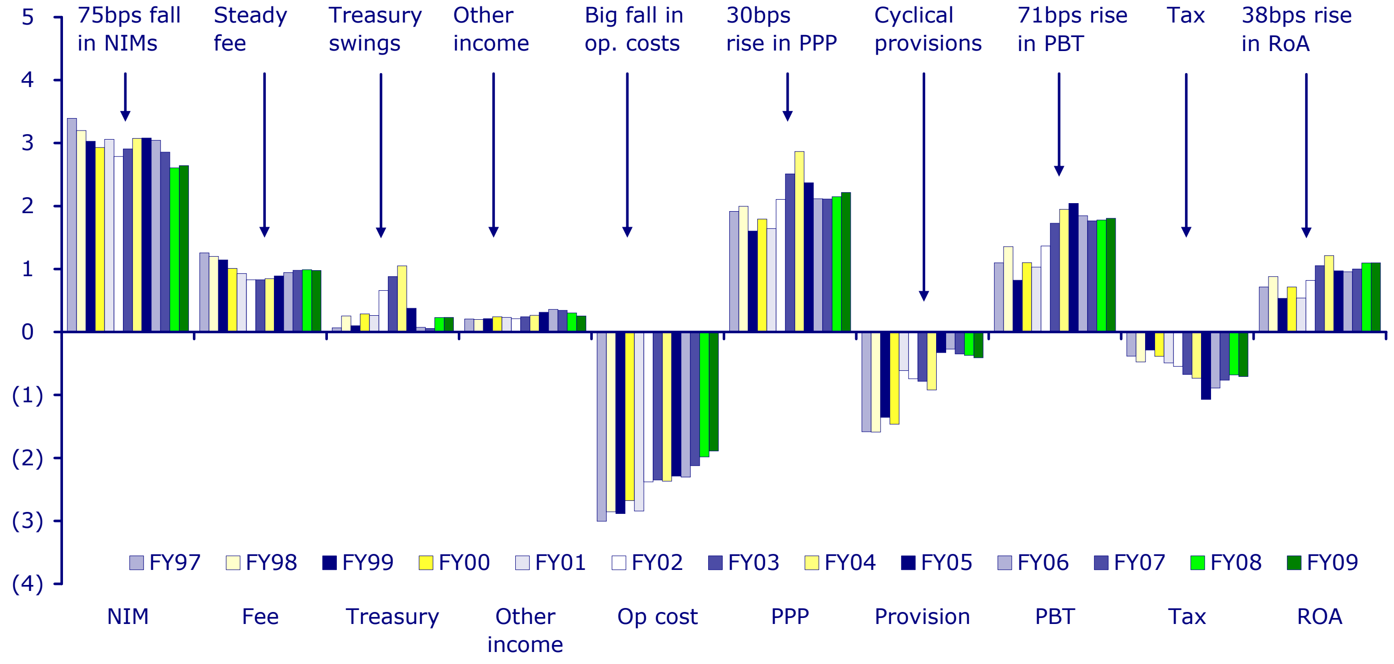
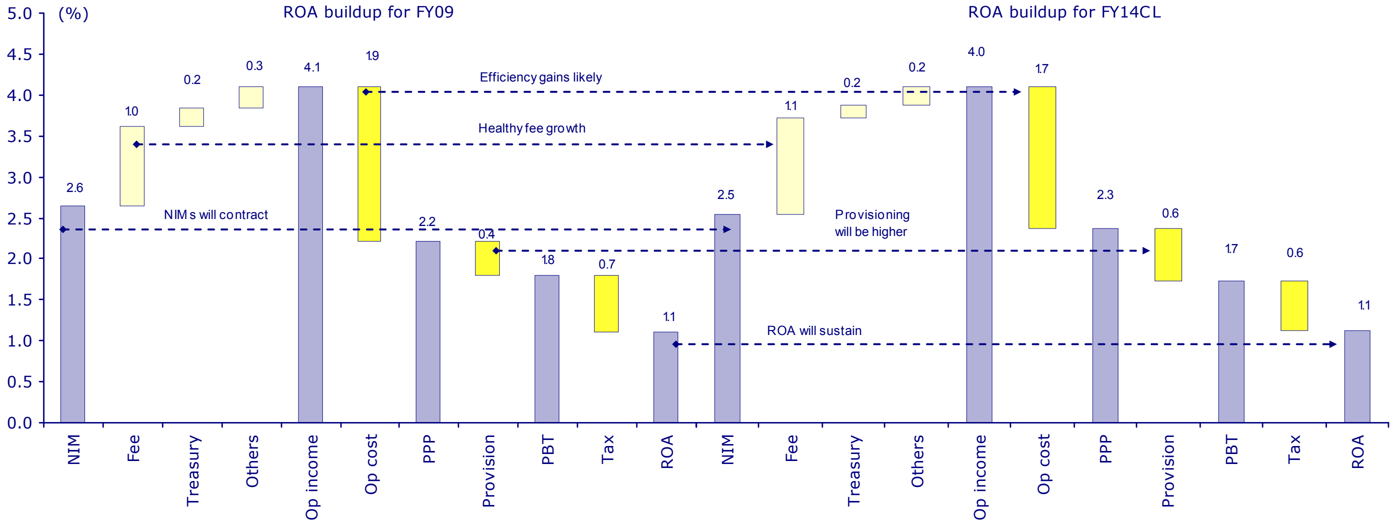


Figure 139

DuPont comparison, FY09 and FY14CL



Source: RBI, IBA, CLSA Asia-Pacific Markets

Yield compression is structural and is likely to continue

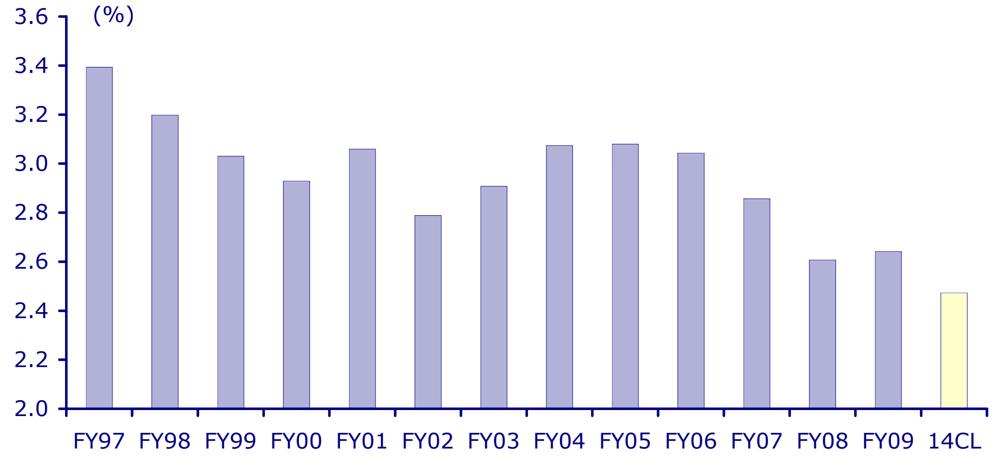
Key trends from DuPont analysis and our outlook

- **NIMs declined by 75bps since FY97.** Rising competition and high reserve requirement has led to increasing margin pressures, as a result of which net interest income as a share of average assets have declined from a peak of 3.4% in FY97 to around 2.5% in FY09. While we expect traditional net interest margins to contract due to commoditisation of credit, the contribution of NII to average assets may not fall substantially as we expect the regulatory cost (reserve requirements, priority-sector lending norms) to fall, leading to improvement in the asset mix.

Net interest margins will contract

Figure 140

Net interest income as a share of assets



Source: RBI, IBA, CLSA Asia-Pacific Markets

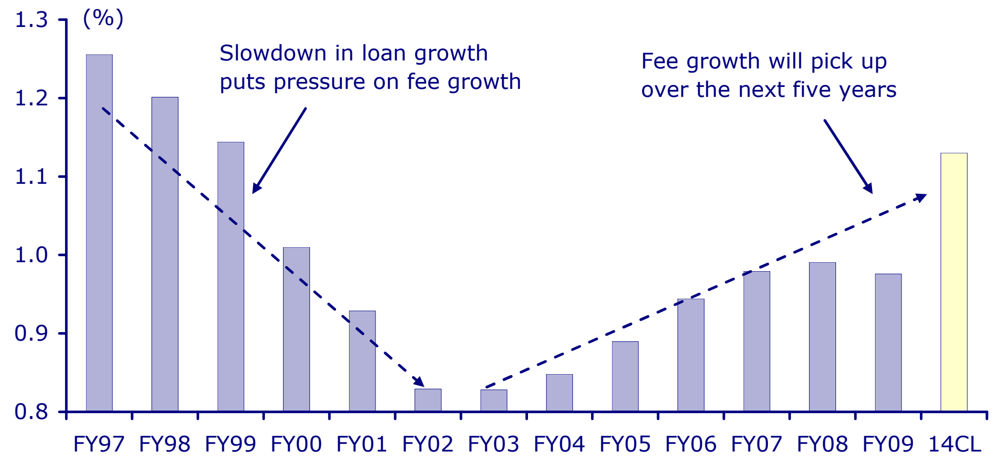
Fee has been dependent on credit offtake; but likely to diversify

- **Fee contribution is lower now than in FY98.** It is very interesting to note that the contribution of fee revenue has declined in FY09 versus FY97 levels. Fee revenue has largely reflected the trend in credit growth, which is due to the low retail-fee penetration. However, this is likely to change over the next five years and a rising share of retail fee, coupled with a pickup in corporate lending activity, will drive the share of fee revenue, which will rise to 113bps by FY14.

Share of fee income in profit will rise

Figure 141

Fee income as a share of assets



Source: RBI, IBA, CLSA Asia-Pacific Markets

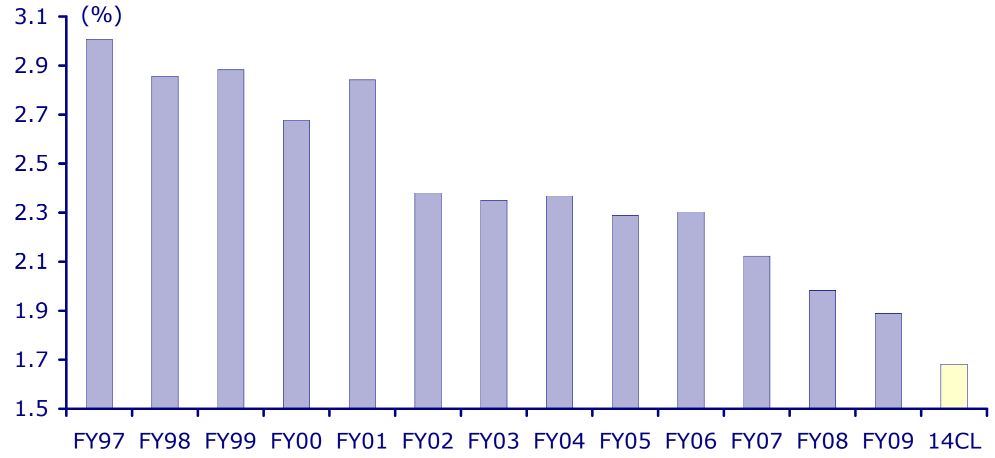
Operating efficiency offers further scope for improvement

- **Operating-efficiency improvement boosts ROA.** Surprisingly, it has been the improvement in operating efficiency that has, to a large extent, been the sole driver of structural improvement in ROA for Indian banks. Cost to assets has declined by 100bps over the past decade. We, however, see limited scope for improvement from the current levels and expect the cost/asset ratio to decline only by 20-30bps from the current levels to 170bps by FY14.

We expect operating costs to total assets to fall by 20-30bps

Figure 142

Operating costs as a share of assets



Source: RBI, IBA, CLSA Asia-Pacific Markets

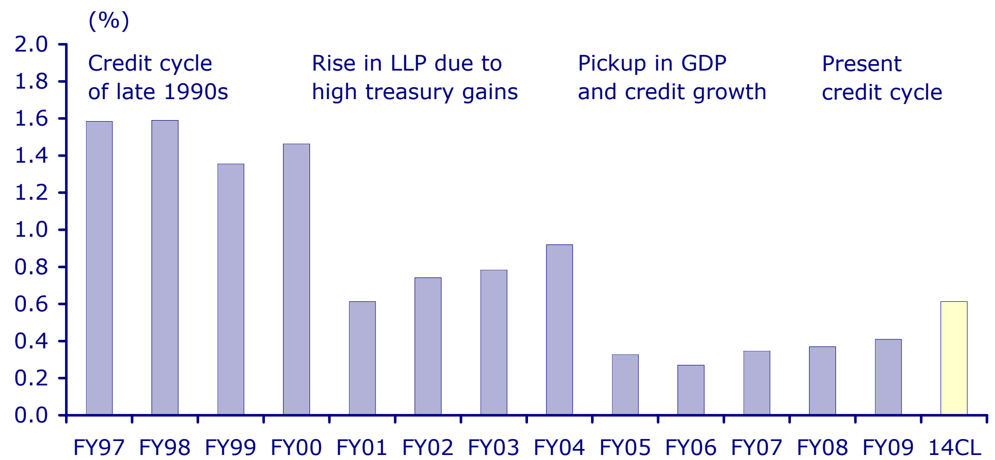
We don't expect a sharp rise in credit costs

- **Provision costs have been stable.** Interestingly, aggregate provision costs (includes loan losses, investment depreciation and tax payments) have been fairly consistent at about 120bps, barring the period of FY03-05, where banks were utilising their windfall treasury gains to step up loan-loss reserves. However, the internal composition of provisions has been fairly volatile as banks have created/utilised floating loan-loss provisions to normalise the treasury gains/losses in their bond portfolios. We expect loan-loss charges to stabilise at 80-100bps and provisions during FY10-11 will be high due to credit cycle.

To rise in the upcoming credit cycle

Figure 143

Provision charges as a share of assets



Source: RBI, IBA, CLSA Asia-Pacific Markets

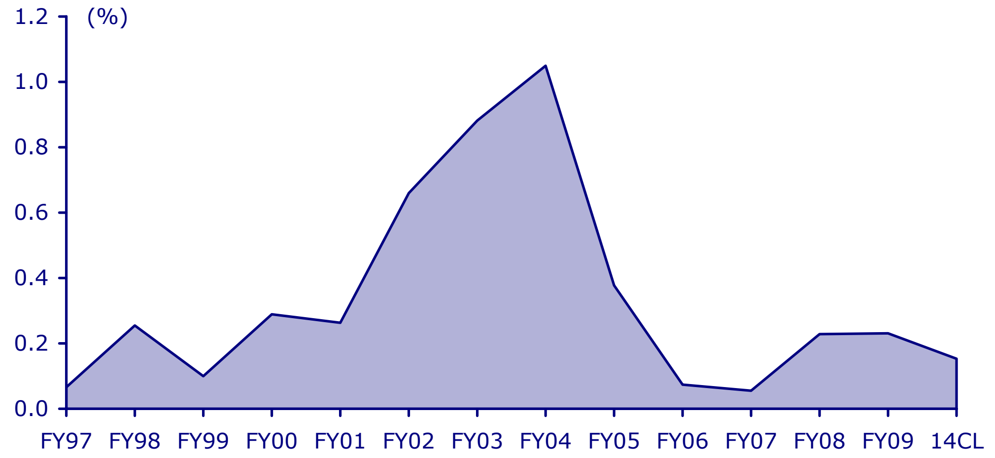
Share of treasury gains to fall to realistic levels of 20-30bps of assets

- **Treasury gains have been the most volatile.** Contribution of treasury gains has been fairly volatile, rising to +1% of assets in FY04, due to a sharp fall in interest rates, and thereafter declining to 10bps in FY07, when interest rates started rising. In FY09, treasury gains as a share of average assets contributed 20bps. We, however, expect the share to fall to 10-15bps on a sustainable basis.

Treasury gains will be cyclical

Figure 144

Treasury as a share of assets



Source: RBI, IBA, CLSA Asia-Pacific Markets

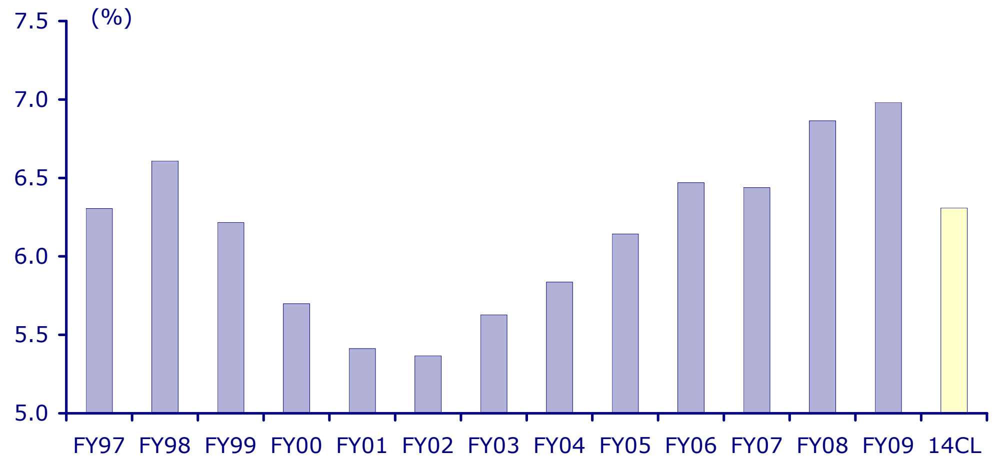
Sustainable leverage ratio to increase to 15x

- **Efficient leveraging of capital may boost ROE.** A conservative regulator (higher risk-weight on most category of assets) and capital-raising done by large banks in FY08 has reduced the aggregate leverage ratios for the sector, from 19x in FY01 to 14x in FY09, thereby keeping the ROE expansion muted in recent years, despite sustained improvement in the ROA. We expect aggregate ROE to improve by 146bps over the next five years to 17.2%. However, the diversity in ROE will be higher, in line with the trend in earnings growth.

Leverage can increase

Figure 145

Equity as a share of assets



Source: RBI, IBA, CLSA Asia-Pacific Markets

Earnings diversity, profitability to increase

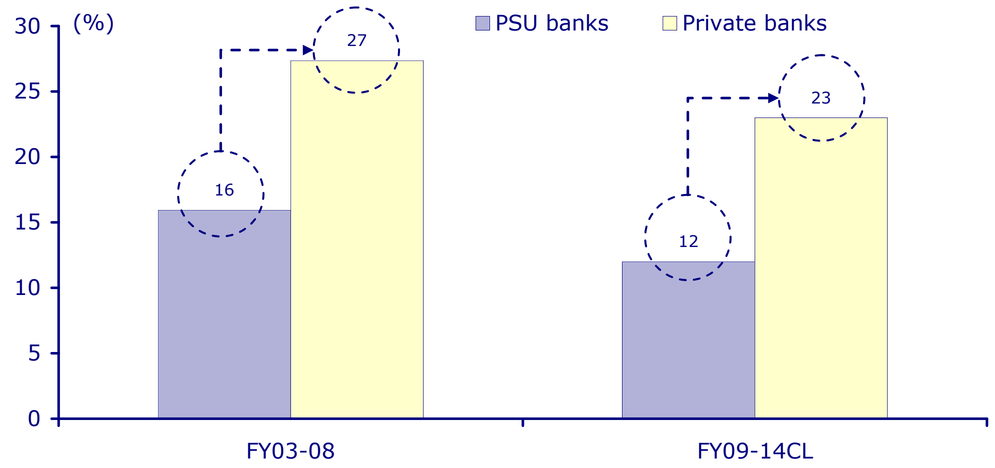
Private banks will continue to deliver higher earnings growth

Private banks have posted superior earnings growth (27% Cagr) over FY03-08 versus 16% for PSU banks. We believe that over the next five years, not only will private banks continue to grow at a faster pace than PSU banks, their profitability differential, ie, ROA and ROE, will widen due to diversity in margins and difference in fee contribution. We expect private banks to see a 23% earnings Cagr over FY09-14 compared to 12% for PSU banks. Within PSU banks, however, Tier I banks may sustain above-15% earnings growth.

Private banks will report stronger profit growth in next five years

Figure 146

Net-profit Cagr



Source: RBI, IBA, CLSA Asia-Pacific Markets

Liability mix to drive margin

Margin to become more diverse

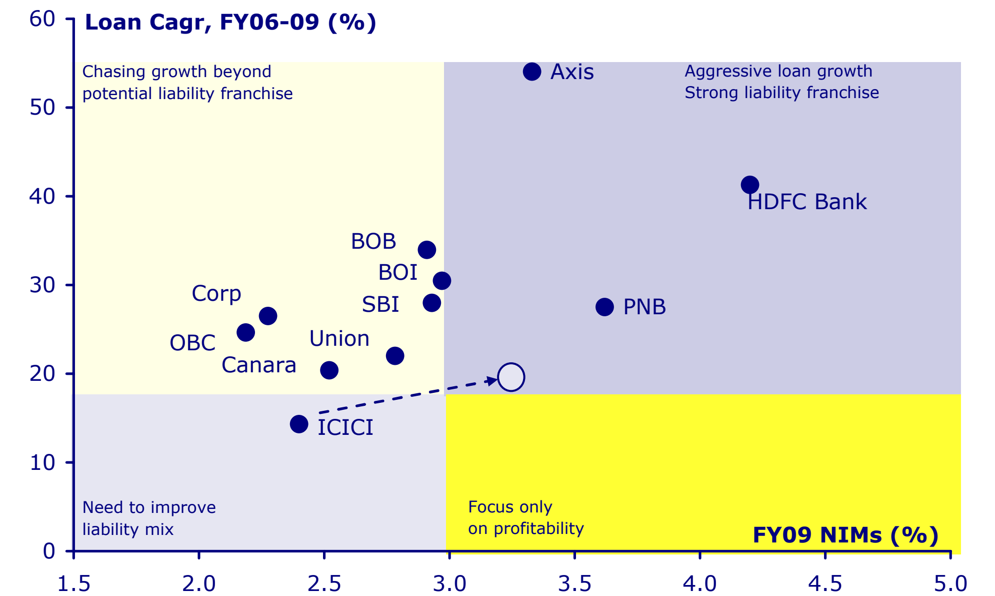
As discussed earlier, we expect yield contraction to be structural due to compression in credit spreads and a declining share of high-yield (and high-risk) credit, such as unsecured retail loans. With margins becoming a function of liability mix, we expect margin to become more diverse due to an increasing diversity in the liability mix. This is in line with the trend seen in the past few years, with the standard deviation of net interest margins for banks rising from 39bps in FY06 to 68bps in FY09; banks chasing aggressive balance-sheet growth without matching growth in retail liabilities have seen sharp margin contraction, whereas banks like Axis have been able to boost NIM on the back of an improved liability mix.

Focus on Casa does not necessarily hinder growth

Loan growth and margins will become a trade-off

Figure 147

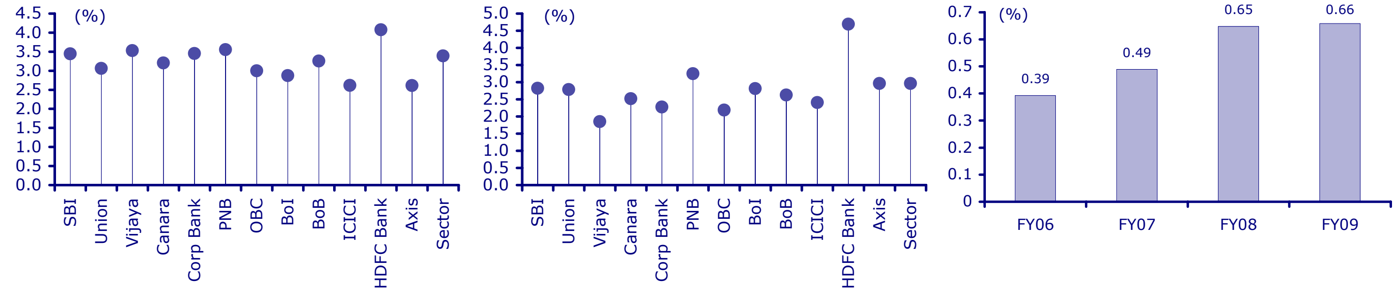
NIM and loan-growth positions



Source: CLSA Asia-Pacific Markets

Figure 148

NIMs, FY06 | **NIMs, FY09** | **Deviation of NIMs**



Source: Company reports, CLSA Asia-Pacific Markets

Over the next five years, scale efficiencies to lift ROA of private banks

ROA differential to expand to 40bps, ROE differential to 500-600bps

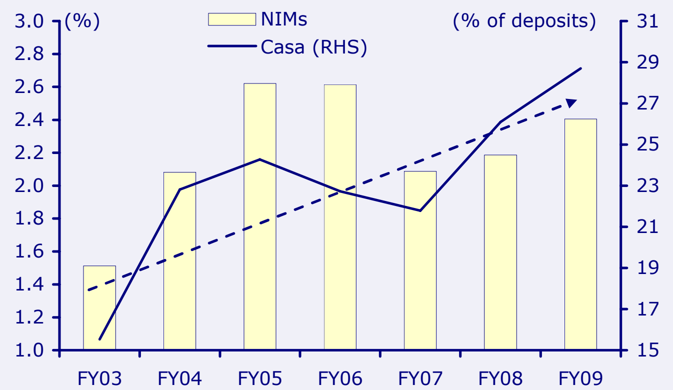
Increasing margin diversity and a rising share of fee revenue for private banks will widen the ROA differential between private and PSU banks. As highlighted in Figure 149, private banks score higher than PSU banks on most profitability metrics, especially fee, and but for the high cost structure could have much better ROA and higher ROE.

Analysing net interest margins

While a number of factors, such as asset mix, liquidity situation and reserve requirements, are relevant from a short-term perspective, the structural margin dynamic of Indian banks depends mainly on one variable - the retail liability franchise, especially Casa deposits. An analysis of ICICI Bank and Axis Bank's margin movement from FY03-09 shows that this is the key variable to worry about. Over a longer period, other variables lose their potency.

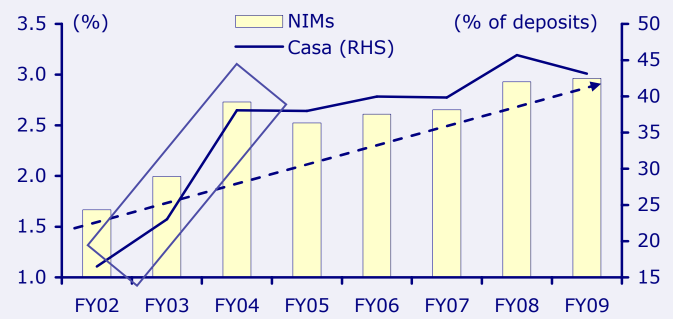
Although the structural decline in yields has led to margin pressures across the board, ICICI Bank and Axis have been able to improve NIM by 90bps and 100bps, respectively (versus a 25-30bps contraction in sector margin over the same period) due to an improving Casa mix.

ICICI Bank annual NIM



Source: Company reports, CLSA Asia-Pacific Markets

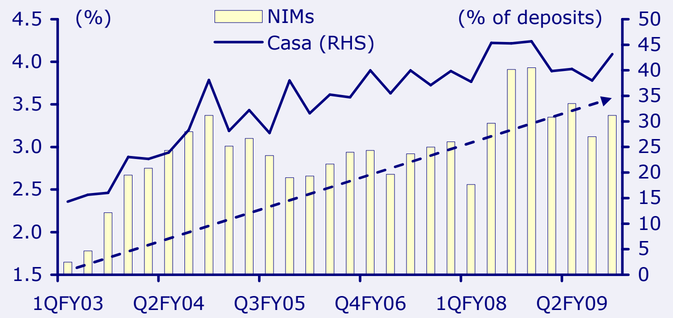
Axis Bank annual NIM



Source: Company reports, CLSA Asia-Pacific Markets

A study of Axis' quarterly NIM suggests that while margins tend to be volatile due to factors such as interest-rate movements, exposure towards the priority sector and liquidity scenario, over a period of time, what matters is the improvement in liability franchise.

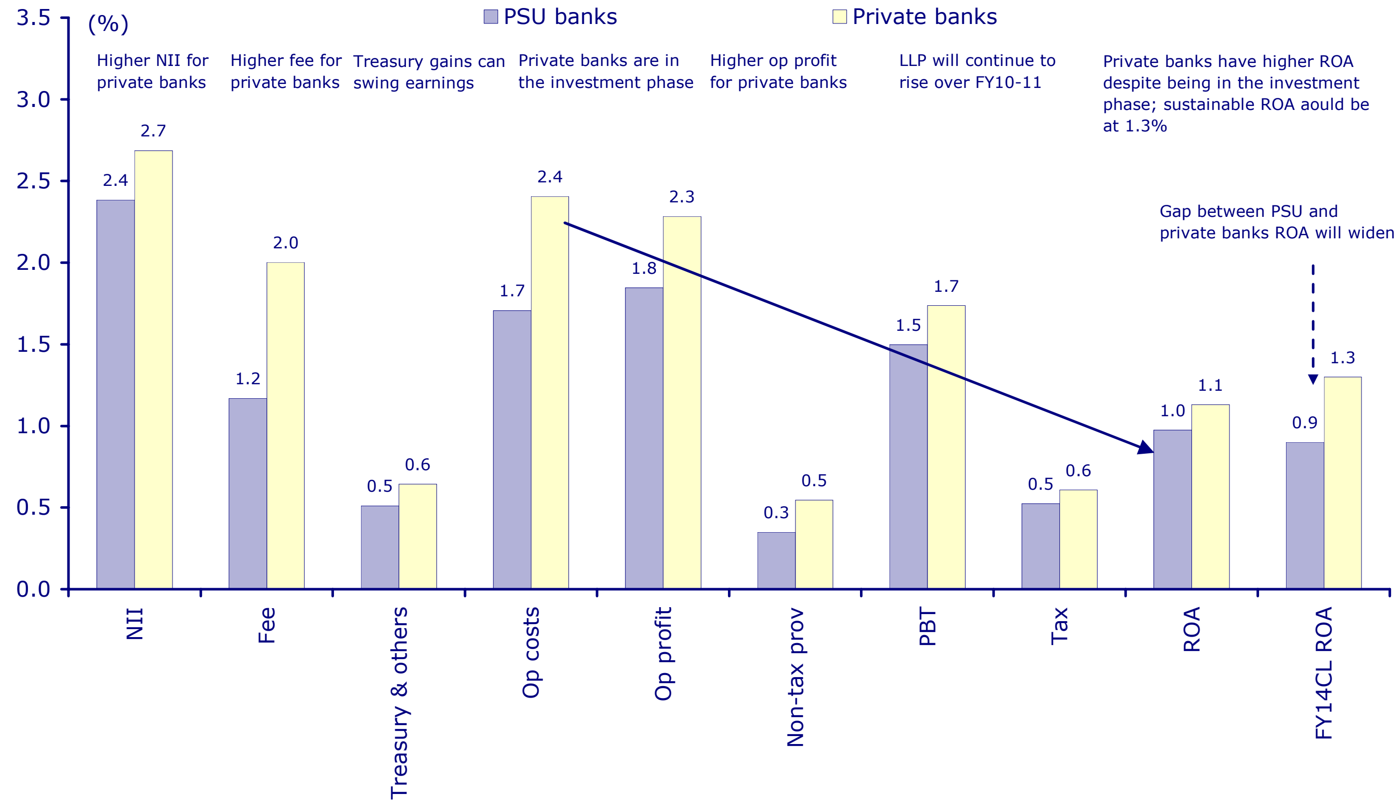
Axis Bank quarterly NIM



Source: Company reports

Figure 149

Bank ROAs, FY08



Source: RBI, IBA, CLSA Asia-Pacific Markets

A key reason for private banks' high-cost structure is that they are still in an investment phase and aren't really harvesting their distribution or client franchise to the fullest. We believe over the next five years, as the cost structure stabilises and share of fee revenue rises, private banks will be able to report at least 35-40bps higher ROA than their PSU peers. Given that the leverage ratios might be a little lower for private banks, owing to their higher off-balance sheet exposures, the ROE differential could be about 500-600bps.

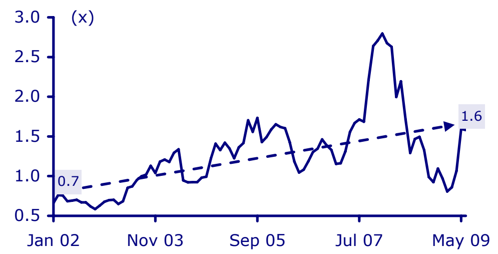
Rerating - Is the best behind us?

Best in rerating is behind us and stock returns will match growth

Over the past seven years, Indian banks have delivered annualised returns of over 30%, a function of strong growth trajectory and rerating of banking stocks on the back of improving profitability. We believe the best rerating potential, at an aggregate sector level, is behind us and expect annualised stock returns to reflect each bank's underlying growth.

Figure 150

PB - 12-month forward

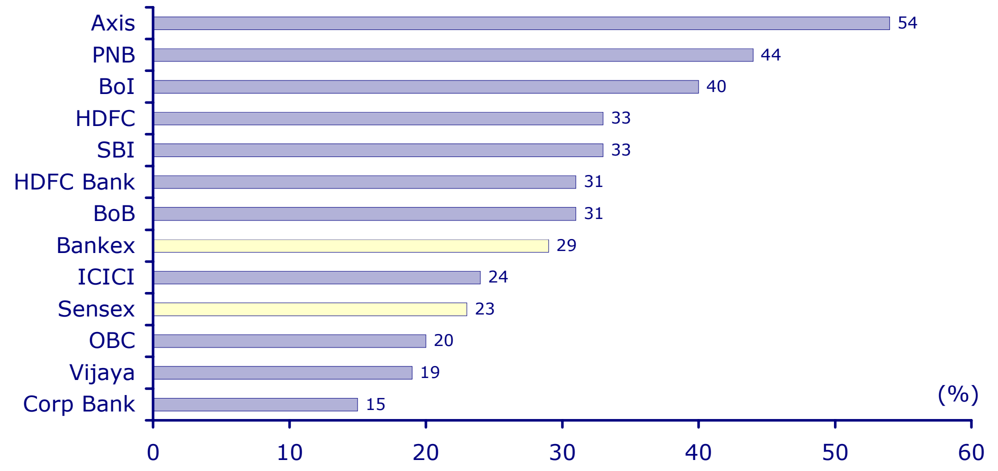


Source: Company reports, CLSA Asia-Pacific Markets

Banks have outperformed the broad market

Figure 151

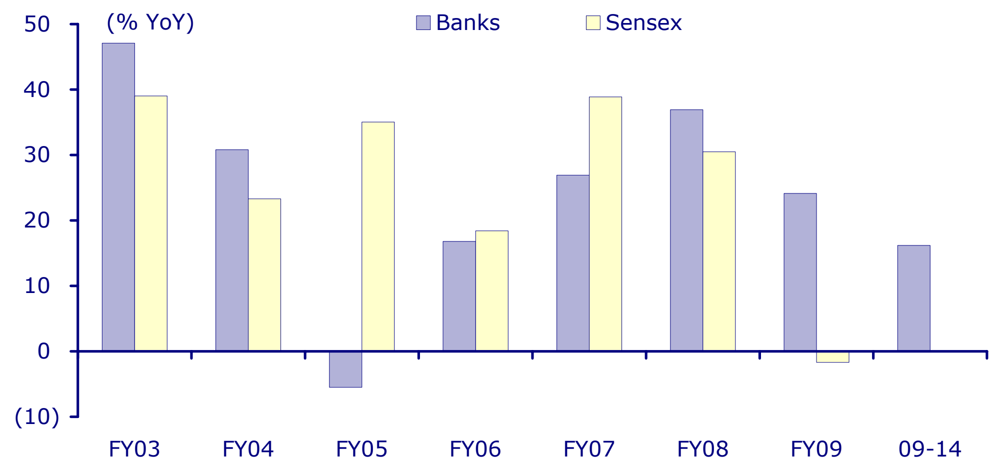
Annualised seven-year returns



In four of past seven years banks' earnings grew ahead of Sensex

Figure 152

Earnings growth



Source: Bloomberg, CLSA Asia-Pacific Markets

Variance in valuation multiples to widen further

Private banks will continue to command premium multiples

Over the next five years, valuation multiples between private and PSU banks will expand further due to a number of reasons:

- **Diversity in earnings growth/ROE.** As highlighted earlier, we believe private banks will enjoy a stronger earnings growth trajectory and better profitability compared to PSU banks. On the contrary, for PSU banks, earnings growth will reflect only their ability to grow their retail deposits and credit with little room for gaining market share.
- **Talent and management.** Ability to attract talent and management continuity ensures long-term stable delivery track record for private banks, which itself will demand a premium from PSU counterparts. The only PSU bank that can demand some premium from the rest on this parameter is SBI due to its relatively stable management structure.
- **Acquisition premium.** We believe, barring a couple of large private banks, most others will trade at a premium to the PSU banks on the potential of being acquired in the event of liberalisation of the banking

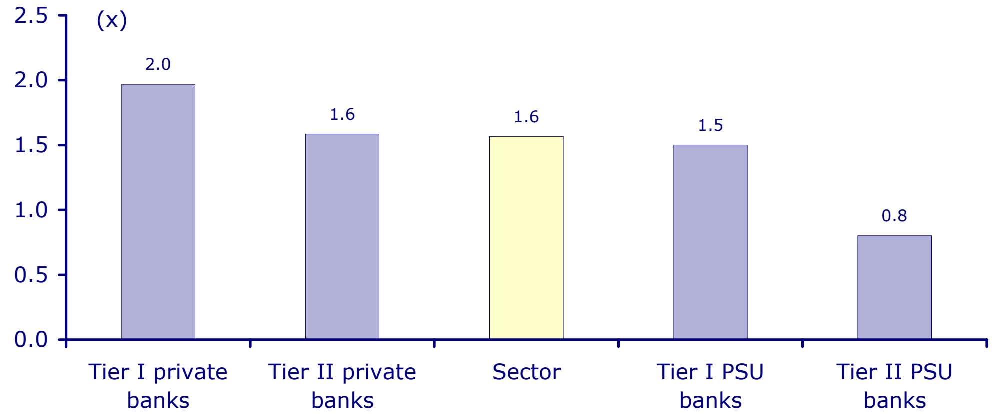
sector. Over the past five years, private-bank premium has also been a result of limited free float in PSU banks, due to foreign-ownership restrictions. However, we see this premium reducing as holding restrictions get relaxed.

Private banks trade at a premium to PSU banks

Tier I PSU banks trade a premium to Tier II PSU banks

Figure 153

Trailing adjusted PB across banks



Note: Adjusted to 100% NPL coverage. Source: Capitaline, CLSA Asia-Pacific Markets

Over the past six years, leading private banks have traded at a premium of 60-150% on adjusted PB to Tier I PSU banks, driven by their strong earnings growth trajectory and gain of market share. But due to concerns on the asset quality of private banks, their premium had narrowed sharply from mid-2008 till the release of 4QFY09 results, which, to a large extent, eased these concerns. Since then, the premium of private banks has been on a consistent rise. We expect the premium of private banks to rise back to the range of 100-150% over the next five years.

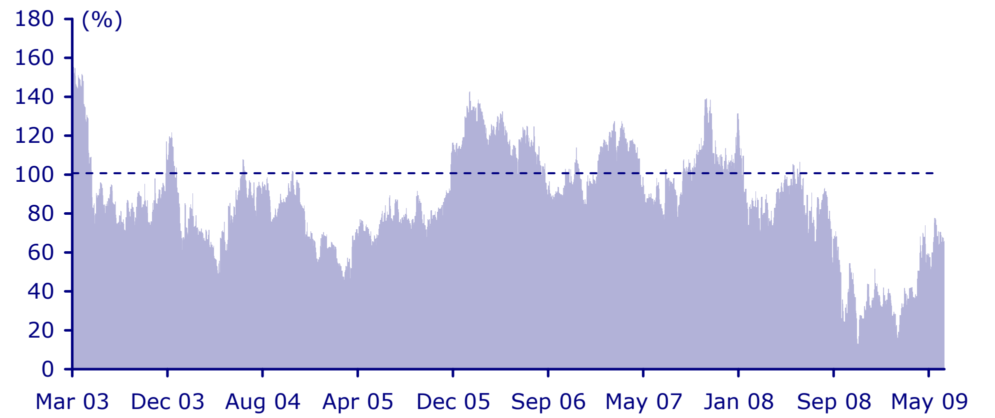
Premium of Tier I PSUs over Tier II PSUs has widened in past six years

Even among the PSU banks the premium of Tier I PSU banks (reported book) over Tier II PSU banks has widened in the past six years. As discussed earlier, we believe the Tier I PSU banks will continue to gain market share from Tier II PSU banks and report stronger earnings growth. As a result, their premium to smaller PSU banks will continue to widen.

Premium of private banks will widen further

Figure 154

Adjusted 12M forward PB premium - Large private banks versus Tier I PSU banks

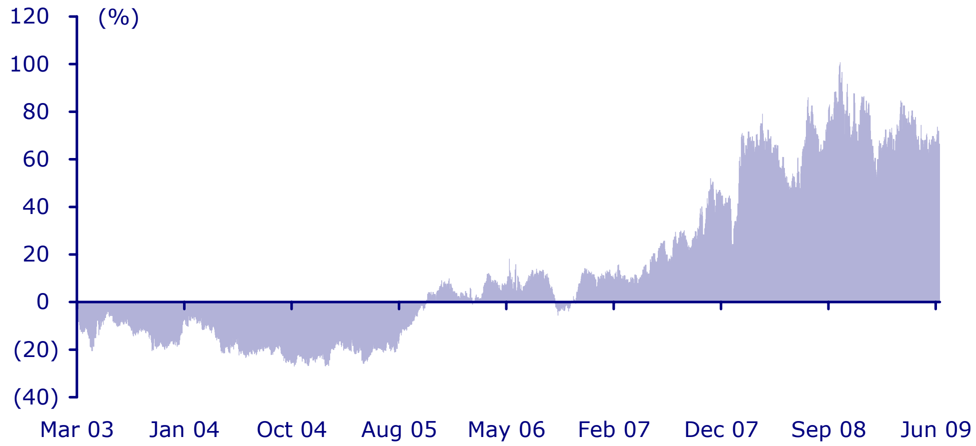


Note: Private banks include ICICI, Axis and HDFC Bank; Tier I PSU banks include SBI, PNB, BoB and BoI. Source: Bloomberg, Capitaline, CLSA Asia-Pacific Markets

Premium of Tier I PSU banks will widen further

Figure 155

Reported 12M forward PB premium of PSU Banks- Tier I versus Tier II



Note: Tier I PSU banks include SBI, PNB, BoB and BoI; Tier II PSU banks include Allahabad Bank, Andhra Bank, Canara Bank, Corporation Bank, Dena Bank, OBC, Vijaya Bank. Source: Bloomberg, Capitaline, CLSA Asia-Pacific Markets

Investment ideas

Despite healthy earnings growth, Indian banks at a discount to Asian peers

Our analysis of long-term returns indicates that private banks offer the best positioning to play the continuing story of the Indian banking sector. Their low market share, coupled with their ability to gain more, promises sustained healthy growth trajectory over the next five years. In our view:

Private bank stocks to deliver annualised returns of about 20%

- Private banks could rerate, barring a couple of banks that trade over 4x, even from current levels, as they sustain their healthy earnings growth trajectory and report improvement in ROE.

Limited rerating potential for PSU banks

- Returns on public-sector banks will vary significantly as the valuation range expands, unlike in the past when most PSU bans have traded in a narrow band. We believe select PSU banks could re-rate marginally from current levels as they maintain stable earnings growth with high ROEs.

Treasury gains may lead to short-term variations in returns

- Short-term variations in the overall-return scenario are possible, especially given the triggers in the form of movement of bond yields (especially for banks like Oriental Bank of Commerce and Corporation Bank, which have a higher proportion of holding in non-held to maturity (HTM) category and are vulnerable to mark-to-market hits), NPL issues (corporate blowout might lead to short-term underperformance for the lead bankers) and other near-term factors. However, in our view, long-term sustainable stock returns are likely to revert to about 20% for private banks and to mid to high teens for well-run PSU banks.

ICICI Bank, Axis among the few that offer rerating potential

- Excluding a structural slowdown scenario for the Indian economy, ICICI Bank offers the best risk-reward from a three- to five-year perspective owing to its presence across the financial-services space. ICICI Bank has recently reorganised its operating structure, aiming to improve profitability, a move that may address the long-due investor concern of frequent equity dilution, stemming from sub-par profitability metrics. Trading at a discount to most of its peers, ICICI may see a structural rerating, if it is able to demonstrate an improvement in its operating metrics to match up with its peers. Over time, we expect ICICI to expand its footprint further into rural banking, micro credit, and even explore overseas M&A. A sharp economic slowdown can expose ICICI to faster changes in its business environment than it can manage, leading to structural pain points like NPL.

Axis is highly focussed on growth driven by liability franchise

- Axis Bank, in our view, is the other long-term play among Indian banks owing to its strong focus on liability franchise, a relatively diversified business model - both within the banking business and outside the banking domain, and a lower premium multiple compared to peers. Axis Bank also has a number of strategic initiatives at work; some key areas where it could build significant presence are asset management, insurance and further strengthening of its investment-banking franchise. Axis Bank is among the few banks that can offer a chunky strategic stake to a foreign bank, in the event of relaxation in foreign-ownership guidelines, and this itself could lead to a premium to its multiple.

HDFC Bank has developed an enviable liability franchise

- HDFC Bank has been the most envied banking franchise in India and we believe it could continue to deliver high returns even over the next three to five years due to its retail liability franchise, strong management and brand recognition. However, for HDFC Bank, the stock returns over next three to five years will be lower than in the past five years as we see little room for a rerating in the stock from its current premium valuations. On the contrary, we believe steady earnings growth by ICICI Bank and Axis Bank may lead to some structural shifts from HDFC Bank into one of these banks, both still trade at significant discount to HDFC Bank.

In PSU banks, stick to Tier I names such as SBI, BoB, BoI and Union

- Among the public-sector banks, we believe only banks that have rolled out technology platforms and have been focusing on employee motivation and training over the past one or two years will make strong in-roads over the next three to five years. Management continuity remains a big challenge for PSU banks and we believe the government needs to ensure longer stay of bank chairmen along with some succession plan to ensure continuity and successful implementation of strategic initiatives.

HDFC, IDFC could deliver annualised returns of 20% over five years

- Within the non-banking space, HDFC remains the best long-term play owing to its diversified presence in the financial-services space. Like HDFC Bank, we don't see much room for a rerating due to HDFC's current premium valuations. However, its ROE of 24-26% will ensure an annualised stock return of 20-25%, even over the next three to five years. Value-locking from other businesses may come as further upside.

Our five-year outlook on earnings on key banks

Figure 156

Five-year comparison

Headline financials (%)	Past five years	Next five years
Credit growth		
ICICI Bank	29	24
HDFC Bank	41	27
Axis Bank	54	28
SBI	28	16
Casa growth		
ICICI Bank	32	23
HDFC Bank	31	26
Axis Bank	45	27
SBI	19	15
Net-profit growth		
ICICI Bank	18	20
HDFC Bank	35	22
Axis Bank	46	23
SBI	20	14
EPS growth		
ICICI Bank	5	20
HDFC Bank	24	21
Axis Bank	33	23
SBI	15	14
ROE	**FY09**	**FY14**
ICICI Bank	10	18
HDFC Bank	17	22
Axis Bank	19	21
SBI	18	16

Source: CLSA Asia-Pacific Markets

Figure 157

Our five-year target prices and stock returns

(Rs)	Axis	BoB	BoI	Canara	HDFC	HDFC Bank	ICICI Bank	IDFC	PNB	SBI	Union
Price	794	408	327	264	2,354	1,427	678	134	643	1,655	233
Recommendation	BUY	O-PF	O-PF	U-PF	BUY	O-PF	BUY	BUY	U-PF	U-PF	BUY
Estimated sustainable ROE (%)	21.0	15.0	15.5	14.0	25.0	22.0	18.0	20.0	15.5	15.5	15.5
Estimated book value, FY15	689	565	453	368	849	898	535	95	777	1,738	299
PB (x)	2.9	1.3	1.4	1.2	3.8	3.1	2.2	2.7	1.3	1.4	1.4
Value of the banking business	1,990	731	613	427	3,208	2,795	1,188	252	1,023	2,434	404
Value of subsidiaries	0	0	0	0	1,768	0	510	0	0	300	0
Price target, FY14	1,990	731	613	427	4,976	2,795	1,698	252	1,023	2,734	404
Upside (%)	150.6	79.1	87.3	61.3	111.4	95.8	150.5	88.3	59.1	65.2	73.4
Returns over five years (%)	1,271	377	334	195	2,909	1,449	1,092	126	488	1,266	201
Annualised returns incl dividends (%)	21.1	14.0	15.1	11.7	17.5	15.0	21.2	14.2	11.9	12.0	13.2

Note: Gordon growth model. Source: CLSA Asia-Pacific Markets

Company profiles

ICICI Bank

ICICI offers the best risk-reward on a three to five-year investment horizon

ICICI Bank, in our view, offers the best risk-reward from a three to five-year perspective owing to its presence across the financial-services space. Its recent reorganisation of operating structure, to improve profitability, may address the long-due investor concern of frequent equity dilution, stemming from sub-par profitability metrics. Trading at a discount to most of its peers, ICICI may see a structural rerating, if it is able to improve its operating metrics to catch up with its peers. Over time, we expect ICICI to expand its footprint further into rural banking, and even explore overseas M&A. A sharp economic slowdown can expose ICICI to faster changes in its business environment than it can manage, leading to structural pain points like NPL.

Among the few banks that offer rerating potential

Seasoned loan portfolio reduces credit risk

What has gone right over the past few years? Contrary to perception that nothing went right for ICICI in the past few years, we believe the bank's decision to slow credit growth was a right move as it came in just ahead of the upturn in credit cycle. Asset-quality issues continue to cloud the near-term outlook for banks, and with its seasoned loanbook, ICICI is better placed compared to most peers. ICICI has also been able to build a strong presence in overseas markets, and even though this led to some bumps in the past two years, it has positioned ICICI well to leverage the rising overseas presence of Indian companies.

Management focuses more on profitability, lifting shareholders return

New strategic initiatives in play for the next five years. ICICI has lagged peers on retail liability franchise; over the past couple of years it has focused on improving the liability mix and has aggressively expanded its distribution network, even acquiring a small cooperative bank in 2006. Through a mix of expansion in distribution network, expansion in wealth management and technological initiatives, we believe ICICI will continue to strengthen its retail liability franchise in India. Even in the overseas market, ICICI has been focused on mobilising retail deposits, a shift from its traditional wholesale borrowing model.

To expand presence in rural banking

ICICI has also realigned its investment-banking platform, to gear itself up, for the increasing activity on loan syndication and project advisory. Its healthy Tier 1 capital makes it well-positioned to leverage on rising credit demand, and also to increase its non-funded exposures. Over the next five years, we expect the bank to revisit its rural banking strategy, which has been on a back burner following a failed start. We also believe, to further improve its overseas presence, ICICI Bank may acquire an international bank, especially in the UK/Europe geography.

Management delivery key to stock performance

Key factors to watch for over the next 12 months. Over the next 12 months, watch out for the trend on loan-loss charges - which seem to have peaked, margin improvement - any disappointment on this could lead to a derating, and change in credit-growth outlook. Management's stance on credit growth has been centred around improvement in liability mix. As such, growth pickup could drive a rerating. Other factors to watch for include increase in restructured loans and roadmap for unlocking value in subsidiaries, especially the life-insurance subsidiary.

Axis Bank

Best-performing bank over the past five years

Axis Bank has done the right thing on most parameters over the past decade and, as a result, has built a strong liability franchise and demonstrated its ability to generate healthy fee revenue. Unsurprisingly, it has been among the best-performing banking stock over the past five years with an annualised return of about 30%. We believe the key challenge for the new management will be to sustain the growth momentum on retail liability franchise and at the same time expand its presence in areas like project financing, rural banking and even in non-banking financial services. Short-term factors to watch out for are management transition and trend in loan loss charges, which if rise, could lead to a derating.

Axis' long-term focus on 'liability franchise' has been its success driver

What has gone right over the past few years? Axis has been among the most focused private-sector bank in building a retail liability franchise, which it achieved through a mix of aggressive distribution expansion and product innovation. Its Casa has seen a 45% Cagr over the past five years, improving the share of Casa deposits from 38% in FY04 to 43% in FY09. Led by an increasing client base, an expanding product portfolio and effective cross-selling, fee revenue has enjoyed a 65% Cagr of 65% to 1.7% of assets, among the best in the sector. Axis has also had a stable track record on asset quality despite aggressive credit growth. The average loan-loss charges have been 103bps, a notch higher than the sector average. However, we believe the bank hasn't seen a credit cycle yet and it could be little early to make a definitive judgement on its risk-management systems.

Focusing on expanding distribution network in Tier II and Tier III cities

Rural banking, expanding overseas presence are the new strategic initiatives of the bank

New strategic initiatives in play for the next five years. Axis Bank has built a base-level retail franchise and is now focusing on expanding distribution network in Tier II and Tier III cities in India; it is also looking to expand its overseas presence, targeting ethnic Indian community. Unlike its peers, Axis Bank's expansion plans in most markets are driven by deposit mobilisation rather than asset growth. It is yet to step up on its rural banking initiative, but is looking to scale up in non-banking financial services such as asset management and private equity. Axis Bank's new MD and CEO, Shikha Sharma, has headed the life-insurance business of India's largest private-sector life-insurance company and hence the possibility of Axis venturing into life insurance cannot be ruled out.

Smooth management transition is critical in the short term

Key factors to watch for over the next 12 months. We believe the most critical factor for Axis Bank over the next 12 months, will be a smooth management transition. Following the exit of Dr P J Nayak, who was at the helm of the bank for almost a decade; any senior management exits may not be positive for stock sentiment. A change in management growth strategy from being liability-driven to assets-driven may also be looked upon as negative by investors. Fresh delinquencies, behaviour of restructured loans would be the other factors to watch out for.

Has the most consistent delivery track record on most parameters

HDFC

HDFC's long (and consistent) delivery track record makes it a good defensive play within India's financial-services sector. Its high ROE (+25%) promises annualised return of +15% for the next five years, even after building in a marginal derating from current premium multiples. We see aggressive competition from PSU banks as a short-term issue, as HDFC enjoys better competitive positioning, due to its low-cost structure and superior risk-management system. A merger with HDFC Bank is inevitable and is likely to be favourable for HDFC shareholders, due to the hidden value of subsidiaries. Key factors to watch for over the next 12 months include revival in mortgage demand and decline in stress on developer exposure.

Under-penetration of mortgage credit offers growth opportunities

What has gone right over the past few years? Amid all the volatility in global and Indian financial markets, HDFC has been able to maintain its steady performance, despite its dependence on wholesale funds. It has diversified its funding mix, leveraging its strong brand image with retail customers, aiming to weather the tight liquidity situation. RBI's recent directive of allowing NBFC to raise overseas funds and classifying loans given by bank to HDFC as priority sector lending (subject to certain conditions) have further opened up the funding channels for HDFC, and that too at a concessional rate. In the past few years, HDFC's group companies, except its general insurance subsidiary, have also scaled up well and most of them are among the top three/four players in their respective business areas.

HDFC has scaled up its presence in most financial product and services

New strategic initiatives in play for the next five years. Given the under-penetration of housing in India, demand for mortgages is a structural growth opportunity; hence the key to HDFC's growth trajectory is not credit demand but its ability to manage funding at reasonable costs. HDFC has been focusing on further diversifying its funding base, trying to ensure a steady stream of retail deposit flow, even though it comes at marginally higher cost amid excess liquidity conditions. HDFC's operating metrics (spreads, cost structure and risk management) are best among peers, both locally as well as globally, and hence leaves little room for improvisation. Key challenge for HDFC is to maintain its status quo.

Key challenge is to retain its operating metrics and diversify funding base

Therefore, the strategic initiatives for HDFC will be mainly in group companies as it tries to scale up its insurance and venture-fund businesses. Key event that is likely to unfold over the next five years is the much-awaited merger between HDFC and its associate, HDFC Bank. The merger, in our view, is likely to be more favourable to the shareholders of HDFC owing to HDFC's higher ROE and the value of other non-banking subsidiaries.

Weak mortgage demand could hamper short term performance

Key factors to watch for over the next 12 months. We believe the key factors to watch for over the next 12 months are demand for mortgages - expectation of a fall in property prices may hamper demand in the short term, aggressive competition from PSU banks - unlikely to last over the longer term, but in short term may lead to margin pressures, and asset-quality pressures on developer exposures. On the positive side, listing of its life-insurance business and issue of warrants at significant conversion premium may act as rerating catalysts.

Most consistent and healthy growth trajectory over the past seven years

HDFC Bank

HDFC Bank's strong liability franchise, high customer-service standards and efficient risk-management system have contributed to its healthy earnings growth trajectory (24% Cagr over the past five years). They also made it well-positioned in an environment where importance of liability franchise will rise further. Having arguably the best deposit franchise among Indian banks, HDFC Bank has been focusing on diversifying its asset mix from retail loans to include rural banking and even corporate banking. However, the bank is not keen on long-term project financing. It is focusing on ancillary opportunities in projects, like working-capital loans, fee products, etc. The bank is likely to remain a pure banking play as its parent company, HDFC, has a presence in most other non-banking financial services. Key factors to watch for in the short term include a weak outlook for retail credit and rising margin pressure.

Among the few banks that have got everything right

What has gone right over the past few years? HDFC Bank is among the few banks that seem to have got everything right in the past many years. It has been one of the few practisers of basic banking approach ("focus on liability franchise and risk management, everything else is non critical"). The effectiveness of this strategy has been visible in what has arguably been the most consistent, high earnings growth trajectory among global financials. Even during the recent crisis, the bank was able to contain its credit costs, when other banks faced soaring retail loan-loss charges. HDFC Bank's superior profitability metrics is also a result of its focus on transactional banking opportunities and its ability to maximise revenue as it attempts to meet every financing need of its customers.

Will focus on leveraging the acquisition of CBoP

New strategic initiatives in play for the next five years. HDFC Bank's main strategic focus over the next few years is to leverage the under-utilised branch network of the recently acquired Centurion Bank of Punjab (CBoP) and simultaneously improve the cost structure of the bank. HDFC Bank has also been focusing on building its SME and rural businesses. The SME business targets emerging corporations and offers a wider range of products and services to the group, which very few banks are able to match. HDFC Bank has also scaled up its rural banking business and provides financing at every stage of the agri-cycle; it is also looking to scale up its micro finance business, which promises to be a structural growth opportunity in India.

HDFC Bank has not been keen on undertaking long-term project financing, as it is a highly competitive business with thin margins. Instead, the bank aims to leverage the ancillary demand for financial products and services within the project-financing space, like working-capital loans, transaction banking, etc. It has a broking subsidiary that offers institutional and retail broking services. This has been a non-starter for the bank and it may look to scale up this business over the next five years.

Focussing on scaling up rural and SME banking

Key factors to watch for over the next 12 months. We believe the key factors to watch over the next 12 months are weak retail credit demand for most non-mortgage retail products, aggressive competition from PSU banks - unlikely to last over the longer term, but in short term may lead to margin pressures, and asset-quality pressures on unsecured retail loanbook. Another closely watched factor is the progress on integration of people, process and systems of erstwhile Centurion Bank of Punjab.

State Bank of India

SBI offers a play on the Indian economic growth

SBI arguably has the best deposit franchise among Indian banks and its vast distribution network, coupled with presence across financial spectrum, makes it an attractive play on the Indian economy over the long term. Despite being a late mover, SBI has been aggressive to ramp up its technology platforms, modernise branches, and has gained market share across segments. It is now looking to expand presence in private equity and general insurance. While we view it as an attractive investment opportunity from a three to five-year perspective, we believe over the next 12 months, it may underperform as the present management focus on market share is coming at cost of profitability and may lead to margin and asset-quality disappointment.

Among few PSU banks that have scaled up technology platforms

What has gone right over the past few years? SBI was a late mover in rolling out technology initiatives; however it has been swift in ramping it up and achieved the entire rollout in arguably the fastest span of time among all peers. It has also been aggressive in expanding branch network (and employee base), redesigning of exiting branches and expanding into new business areas. It is among the few PSU banks that have rolled out an aggressive employee training programme to improve service standards at the branch level.

Only PSU bank with a strategic focus on employee training

SBI has also raised long-term resources to increase its presence in project and infrastructure financing, and has been aggressive in pricing loans to gain market share. Its market-share gains have been across banking and non-banking segments. In life insurance, its growth has been spectacular, surprising on the upside for past many quarters.

New strategic initiatives in play for the next five years. We believe SBI's technological initiatives would help it to further improve its retail liability franchise, and may even lead to market-share gains at the cost of Tier II PSU banks. SBI plans to merge its six associate banks with itself, which should lead to synergy benefits.

SBI is also among the few banks that have a separate team for identifying and formulating strategies for new business initiatives. In the past two years, SBI has ventured into various new businesses, to complete its product portfolio with an aim to harvest its vast retail client base. Through different joint ventures, it has entered into general insurance, custodial services and private equity, and has rolled out wealth-management and online trading services.

SBI has positioned itself to benefit from the rising financial penetration in India and could offer annualised returns of +10% in the next five years. We, however, maintain an Underperform rating on the stock as we believe its recent aggression in credit growth is likely to lead to margin and asset-quality pressures over the next few quarters.

Aggressive focus on market share may impact margins, asset quality

Key factors to watch for over the next 12 months. The key factors to watch over the next 12 months are margin trends, especially as the bank continues to adopt an aggressive pricing policy to gain market share and NPL accretion - SBI's restructured loans are highest among peers and conversion of these loans into NPLs could be negative from earnings and valuations.

Reliance Capital

A multi-year play on India's low financial penetration

Reliance Capital's vast distribution network, as large as that of SBI, makes it a distribution power house for financial products and services in India. It, thus, offers a direct play on rising penetration of retail financial products/services. More importantly, it offers little capital risk, as most of its businesses are fee-based. A number of strategic initiatives will enable Reliance Capital to further strengthen its position in the financial-services space and the big upside could come from an eventual banking licence. In the short term, positive catalysts could be listing of its life-insurance business.

Leverage on regulatory arbitrage to build largest distribution network

What has gone right over the past few years? Reliance Capital, being a non-banking finance company, didn't require RBI approval for expansion of distribution network. It has used this "regulatory arbitrage" to build the largest distribution network among all Indian financials. With a network of +10,000 outlets, it offers every financial product, except banking, to retail consumers. It is a strong household brand in India, which is critical for the success of its distribution-focused business model, especially in Tier II/III cities. From the largest asset-management company in India, it has expanded its presence into life insurance, general insurance, retail broking and, more recently, consumer financing. Of these, life-insurance and retail-broking businesses have scaled up significantly and the company is already among the top three/four players in this space.

Strong presence in most non-banking financial products and services

New strategic initiatives in play for the next five years. Reliance Capital plans to expand its overseas presence through the wealth-management route, eyeing the ethnic Indian community. In India, it plans to expand/scale up its presence in areas like asset reconstruction, institutional broking and consumer financing. Scale-up in its distribution business, by expanding reach and adding products, is likely to be an ongoing process. Reliance Capital also plans to launch a private-equity fund and a marketing company to cross-sell its products and services to internal customer of the Reliance ADA group. Eventually, the group may be eyeing a banking licence, to gain access to retail deposits and to complete its product offering. Execution risk remains the key challenge for Reliance Capital, especially as the company continues to aggressively expand its presence in multiple business areas.

Listing of insurance business can be a big trigger

Key factors to watch for over the next 12 months. We believe the key factors to watch for over next 12 months are listing of its insurance subsidiary - which could trigger a rerating, scale-up of its consumer-financing and retail-broking operations. On the other hand, a pickup in NPL in its consumer-financing business could be a negative surprise.

Appendix 1: Restructured loans

Overall restructuring at 4.6% of loans and 45% of equity . . .

Restructuring of loans by banks has been lower than initial estimates. Our analysis on 25 banks (covering 88% of loans) indicates that 4.1% of loans have been restructured. Gross stressed loans (including NPL of 2.2%) are 6.3% of loans while net stressed loans are at 4.6%. The biggest negative surprise came in SBI's restructuring of 4% of its loans, highest among the large banks. Stress is visibly higher in Tier II public-sector banks, with net stressed loans for some banks exceeding 100% of net worth. On the other hand, private banks are better placed with net stressed loans being less than 30% of net worth. Our base-case estimates capture more aggressive slippages.

Restructured loans lower than initial estimates

. . . lower than market fears of more than 10% of loans

Our analysis of 25 banks capturing 88% of banking sector loans indicates that overall restructured loans (including pending applications) are at 4.1% of loans. Gross stressed loans, including NPLs of 2.2%, are 6.3% of loans, much lower than the fears of double-digit NPL. Even net stressed loans, at 4.6% of loans and 45% of current net worth, are at comfortable levels. Further, in most cases, restructuring is "rescheduling of principal payment" and does not necessarily reflect insolvency risks. Banks have stated that in most cases, they have not taken any haircut on principal or interest. Refer to the last table in this appendix for bank-wise stressed assets details.

Restructuring high at SBI and tier II PSU banks

SBI's high restructuring had surprised negatively

Most private banks have a healthy profile

Smaller PSU banks in a tight spot

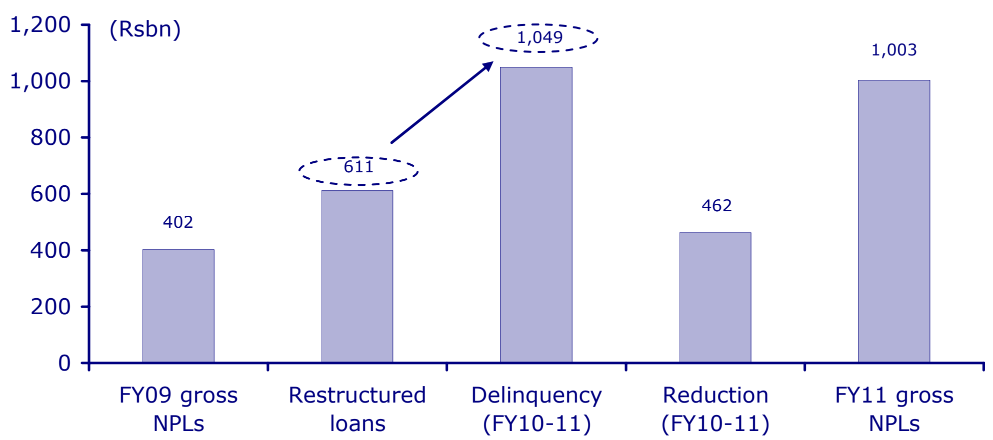
SBI has restructured 4% of its loans and its net stressed loans, at 5.3% of loans and 50% of net worth, are among the highest in Tier I banks. The stress on asset quality is higher for Tier II PSU banks, but private banks and PSU banks like BoI, BoB, which have ramped up risk-management systems, reported fairly resilient asset quality. Banks that look well capitalised to bear stress on asset quality are HDFC Bank (net stressed loans at 1.4% of net worth), Axis Bank (19%), ICICI (23%). Among PSUs, BoI (33%) and BoB (39%) have some cushion, but mid-sized PSUs like IDBI Bank (175%), IoB (160%) and UCO Bank (101%) have little room and might need capital.

Stressed assets in line with estimates

Our slippage estimates for FY10-11 have cushion for higher slippages

We are building in gross NPLs rising 2.2x over FY09-11 to 4.4% of FY11 loans in our earnings forecast. Our assumptions for fresh slippage over FY10-11 are 1.7x of restructured loans (including applications) and we do not see much risk to our NPL estimates and maintain our positive stance on the sector.

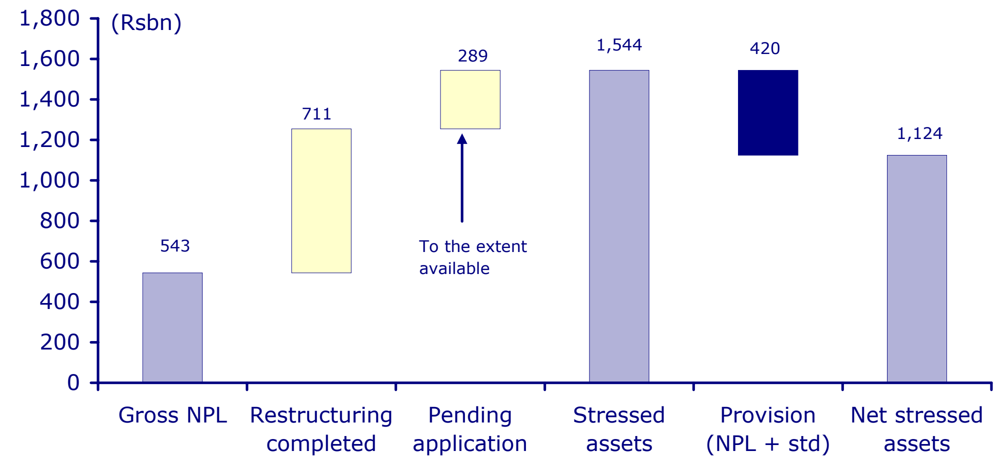
Our estimates for slippages factor 1.7x of restructured loans turning bad



Note: Based on CLSA coverage. Source: CLSA Asia-Pacific Markets

Net stressed loans: 4.6% of loans 45% of net worth

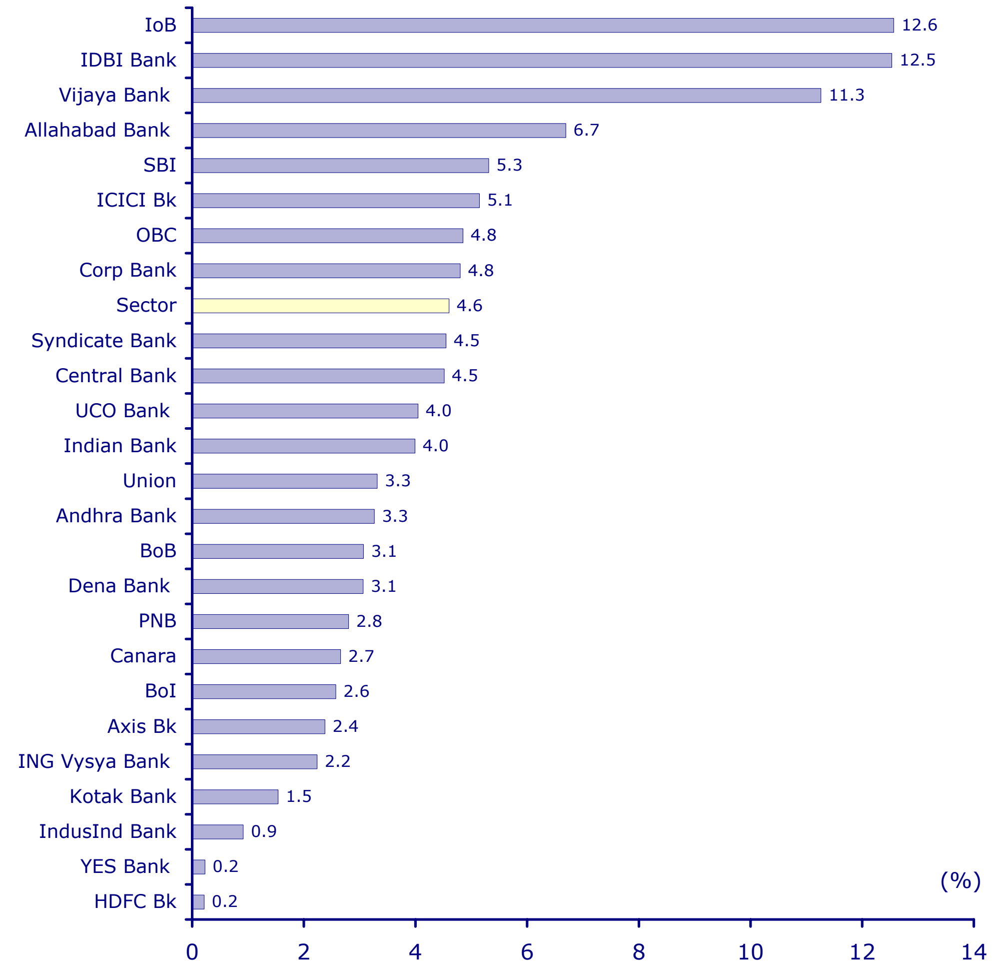
Sector - Net stressed loans



Source: CLSA Asia-Pacific Markets

Stress levels are manageable

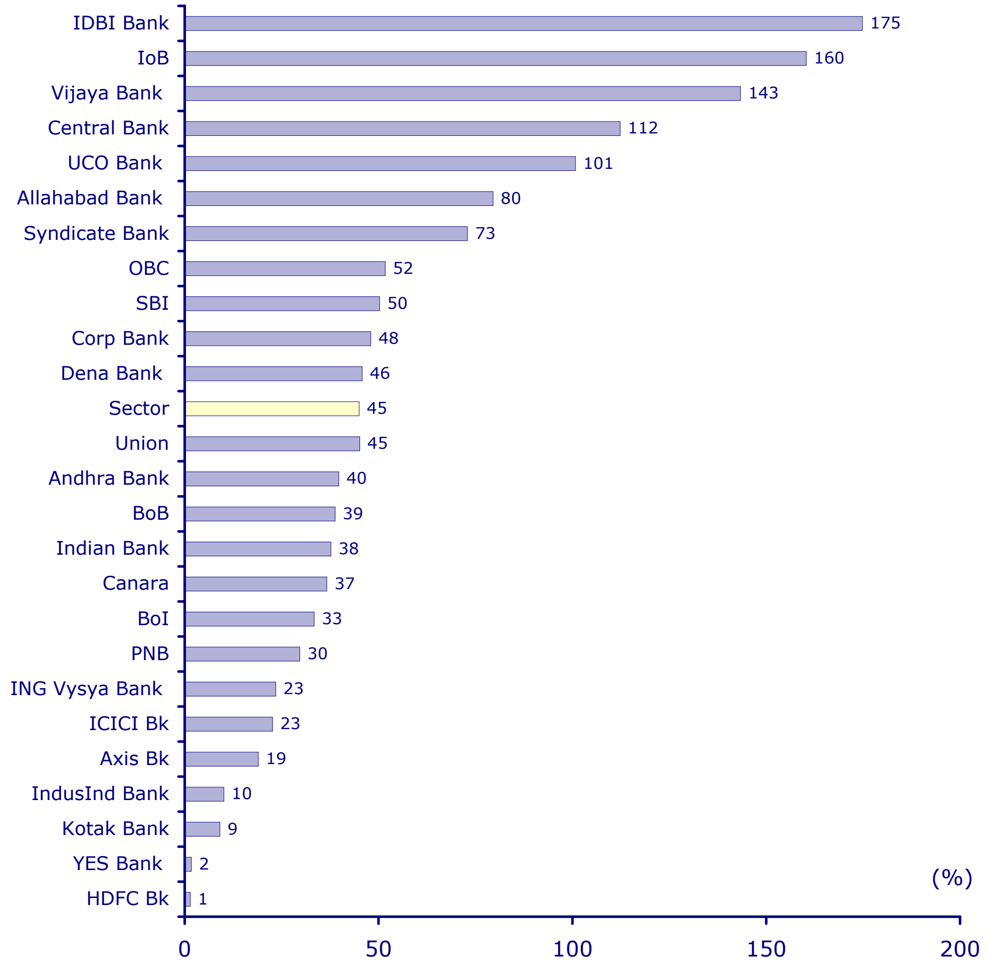
Net stressed assets as a share of loans



Note: Net stressed loans = gross NPLs + restructured loans (including pending applications wherever available) – provisions (specific provision and provision on standard loans). Source: CLSA Asia-Pacific Markets

Stress is very high among smaller PSU banks

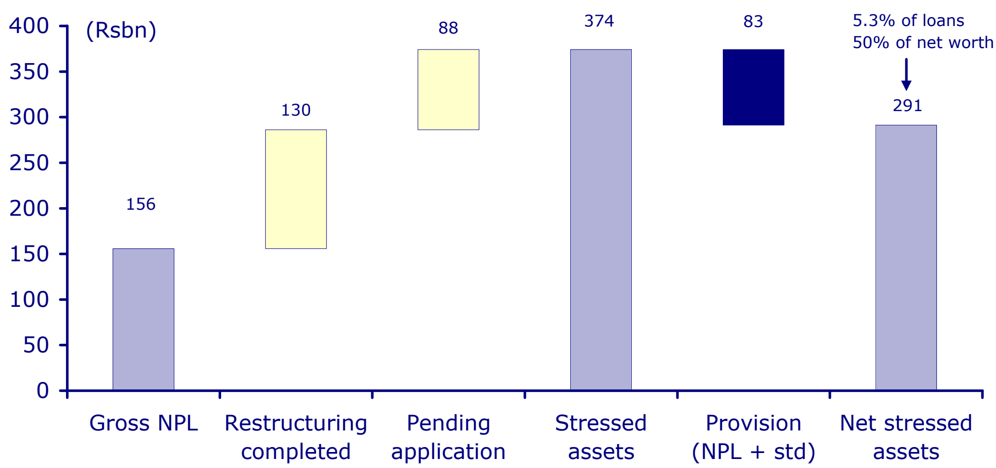
Net stressed loans as a share of net worth



Note: Net stressed loans= gross NPLs + restructured loans (including pending applications wherever available) – provisions (specific provision and provision on standard loans). Source: CLSA Asia-Pacific Markets

At 50% of net worth, it is the highest among Tier I banks

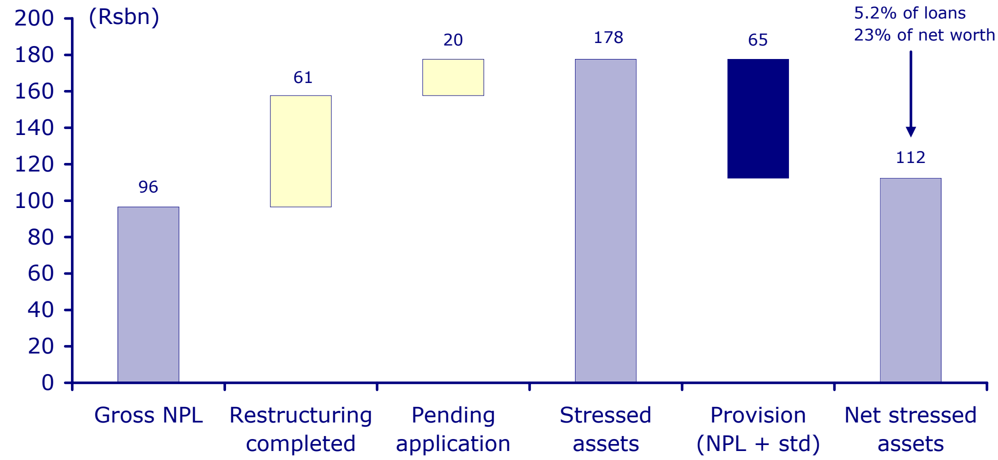
SBI - Net stressed loans



Source: CLSA Asia-Pacific Markets

Only Rs14bn restructured loans out of Rs61bn were restructured in 4QFY09

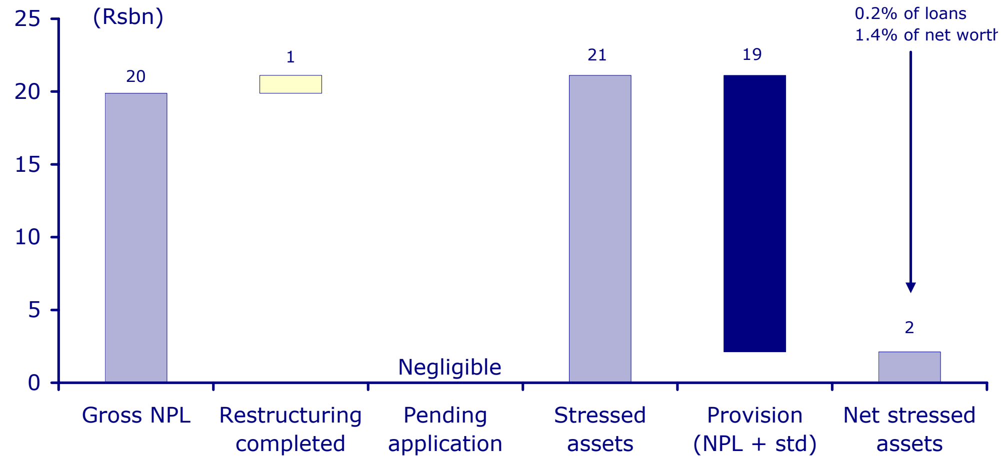
ICICI - Net stressed loans



Among the lowest in the sector

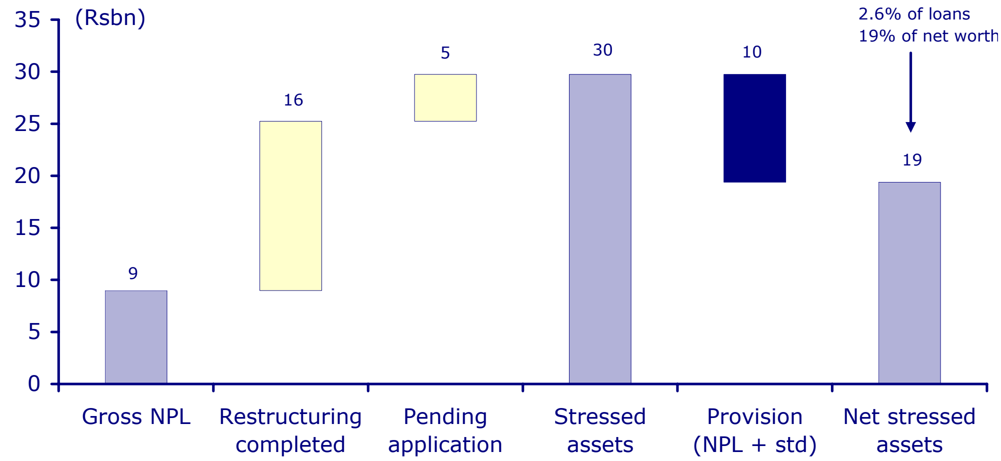
HDFC Bank follows an aggressive policy to provide/write off NPLs

HDFC Bank - Net stressed loans



Some 40% of restructuring in form of CDR or multi-lateral cases

Axis - Net stressed loans

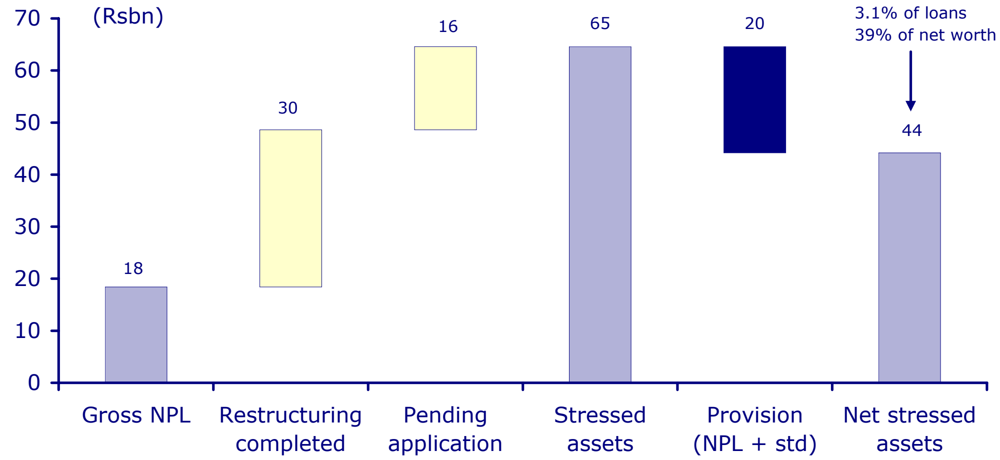


Source: CLSA Asia-Pacific Markets

Within manageable limits

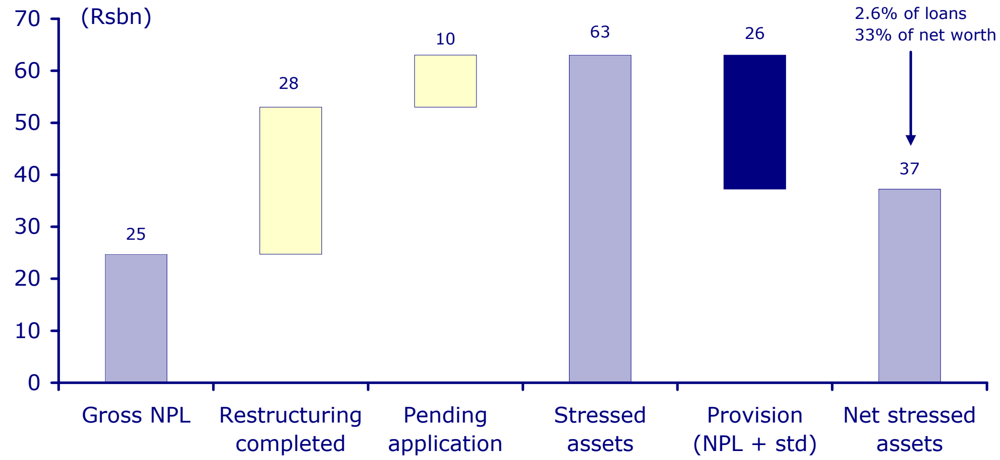
BoB has lowered interest rates in some cases

Bank of Baroda - Net stressed loans



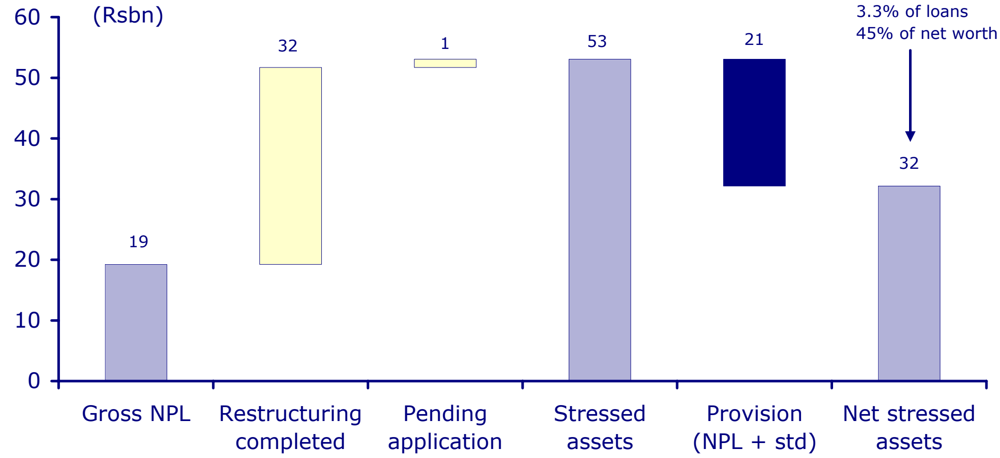
BoI's net stressed loans are among the lowest in PSU banks

Bank of India - Net stressed loans



Lower capital cushion - most of the restructuring has been completed

Union Bank - Net stressed loans



Source: CLSA Asia-Pacific Markets

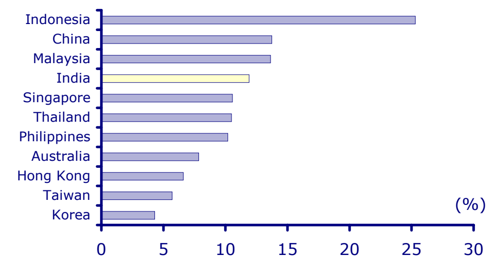
Details of stressed loans

Bank	Restructured loans			Gross NPL		Total stressed loans		Provisions			Net stressed loans			Balance sheet (Rsm)	
	Rsm	% of loans	% of net worth	Rsm	% of loans	Rsm	% of loans	Specific	General	Total	Rsm	% of loans	% of net worth	Loans	Net worth
Allahabad Bank	38,375	6.5	77.1	10,782	1.8	49,157	8.3	6,591	2,959	9,550	39,607	6.7	79.6	591,770	49,786
Andhra Bank	15,930	3.6	43.7	3,681	0.8	19,611	4.4	2,889	2,221	5,111	14,501	3.3	39.8	444,280	36,470
Axis Bank	20,759	2.5	20.3	8,978	1.1	29,736	3.6	5,706	4,644	10,351	19,386	2.4	19.0	815,570	102,136
BoB	46,163	3.2	40.5	18,429	1.3	64,592	4.5	13,918	6,487	20,405	44,187	3.1	38.8	1,439,860	113,872
BoI	38,299	2.6	34.4	24,709	1.7	63,007	4.4	18,427	7,357	25,783	37,224	2.6	33.4	1,447,320	111,436
Canara	27,952	2.0	27.8	21,680	1.6	49,632	3.6	6,607	5,894	12,501	37,131	2.7	37.0	1,385,260	100,396
Central Bank	32,860	3.8	94.3	23,166	2.7	56,026	6.5	12,531	4,337	16,868	39,157	4.5	112.3	867,400	34,861
Corp Bank	24,486	5.0	50.0	5,592	1.2	30,079	6.2	4,209	2,463	6,672	23,407	4.8	47.8	485,120	48,965
Dena Bank	7,249	2.5	37.2	6,208	2.1	13,457	4.6	3,074	1,457	4,531	8,925	3.1	45.8	291,441	19,489
HDFC Bank	1,227	0.1	0.8	19,881	2.0	21,108	2.1	13,604	5,382	18,986	2,122	0.2	1.4	988,831	146,463
ICICI Bank	81,150	3.7	16.4	96,493	4.4	177,643	8.1	50,954	14,361	65,314	112,329	5.1	22.7	2,183,109	495,330
IDBI Bank	125,286	12.1	169.0	14,357	1.4	139,643	13.5	4,867	5,171	10,039	129,604	12.5	174.8	1,034,280	74,135
Indian Bank	22,332	4.3	40.7	4,592	0.9	26,924	5.2	3,654	2,592	6,245	20,679	4.0	37.7	518,310	54,803
IndusInd Bank	440	0.3	3.1	2,550	1.6	2,990	1.9	759	789	1,547	1,443	0.9	10.1	157,706	14,276
ING Vysya Bank	2,524	1.5	15.8	3,132	1.9	5,656	3.4	1,073	838	1,910	3,746	2.2	23.5	167,510	15,941
IOB	89,046	11.7	149.9	19,234	2.5	108,280	14.3	9,243	3,790	13,033	95,247	12.6	160.3	758,095	59,414
Kotak Bank	620	0.3	1.6	7,307	3.2	7,927	3.5	3,339	1,125	4,464	3,463	1.5	9.1	225,000	38,136
OBC	32,134	4.7	49.8	10,581	1.5	42,715	6.2	6,157	3,177	9,334	33,380	4.8	51.7	688,450	64,524
PNB	57,016	3.7	39.1	27,675	1.8	84,690	5.5	33,188	8,152	41,339	43,351	2.8	29.7	1,547,030	145,988
SBI	218,213	4.0	37.7	155,886	2.8	374,099	6.8	60,366	22,450	82,816	291,283	5.3	50.3	5,485,400	579,477
Syndicate Bank	30,894	4.2	67.2	15,945	2.2	46,840	6.4	9,628	3,688	13,315	33,524	4.5	73.0	737,540	45,951
UCO Bank	23,530	3.4	84.2	15,395	2.2	38,925	5.6	7,268	3,483	10,752	28,173	4.0	100.8	696,690	27,951
Union	33,827	3.5	47.6	19,233	2.0	53,060	5.5	15,974	4,950	20,924	32,136	3.3	45.2	969,600	71,135
Vijaya Bank	29,680	11.1	140.9	6,988	2.6	36,668	13.7	4,065	2,407	6,472	30,196	11.3	143.4	268,110	21,064
Yes Bank	492	0.4	3.0	849	0.7	1,341	1.1	438	620	1,058	283	0.2	1.7	124,031	16,242
Sector	**1,000,483**	**4.1**	**40.2**	**543,324**	**2.2**	**1,543,806**	**6.3**	**298,528**	**120,793**	**419,321**	**1,124,485**	**4.6**	**45.2**	**24,317,713**	**2,488,240**

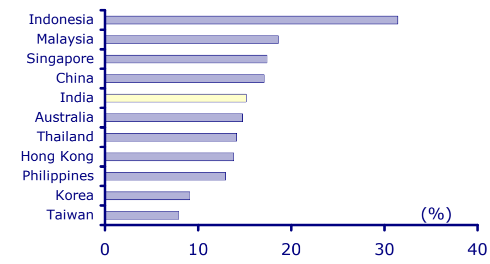
Source: Company reports, CLSA Asia-Pacific Markets

Appendix 2: Global valuations

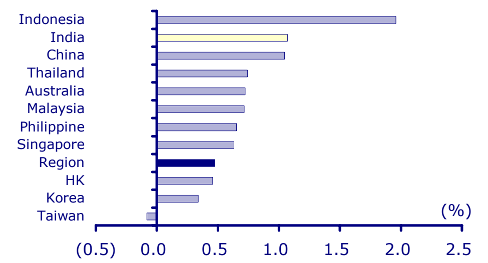
Market cap/assets



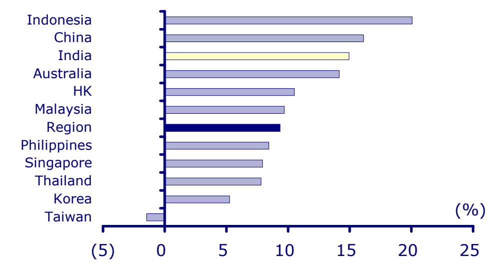
Market cap/deposits



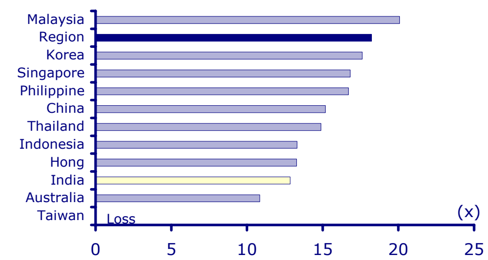
ROA, 2009



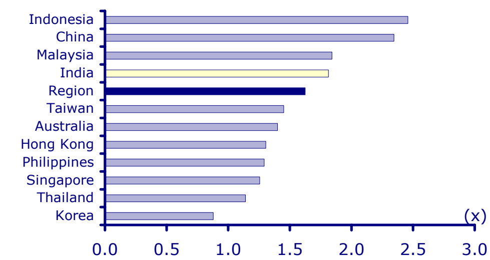
ROE, 2009



PE, 2009



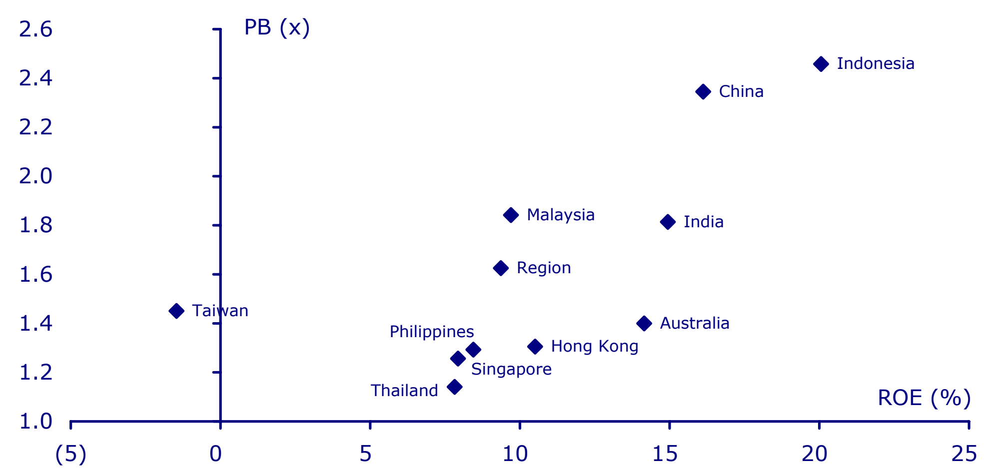
PB, 2009



Source: Company reports, IBA, CLSA Asia-Pacific Markets

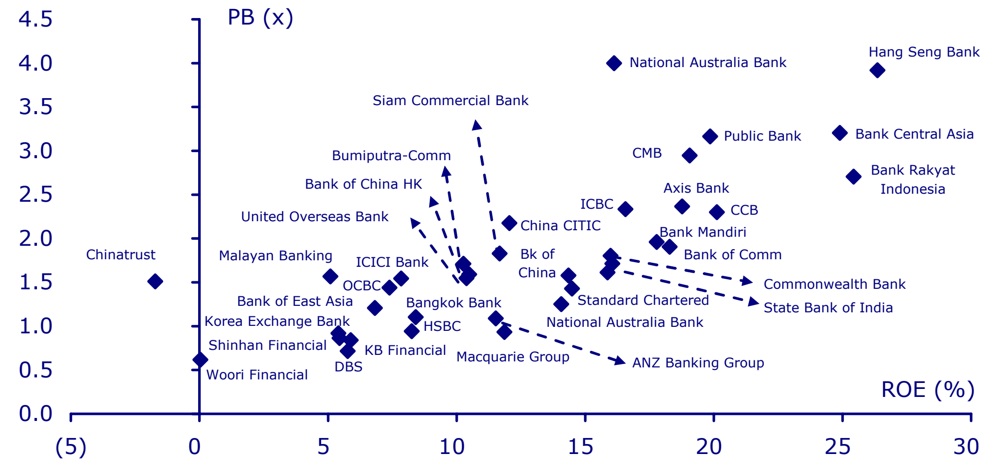
Valuations of Indian banks justified by higher ROE

PB versus ROE, 2009



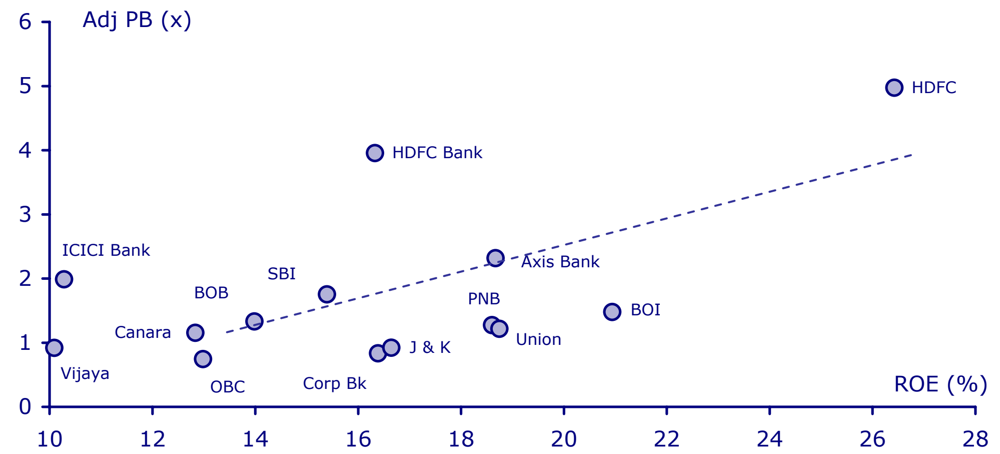
Source: CLSA Asia-Pacific Markets

Regional banks' PB versus ROE, 2009



Most banks still trade below 2x FY10 adjusted PB

Adjusted PB versus ROE, FY10CL



Source: CLSA Asia-Pacific Markets

Regional valuations

Market/bank	Price	MCap (US$m)	ROE (%)[1]		PE (x)		PB (x)[1]		Dividend yield (%)	
			CY09	CY10	CY09	CY10	CY09	CY10	CY09	CY10
India										
Axis Bank	Rs794.2	5,945	18.8	18.7	14.2	12.3	2.5	2.1	1.4	1.5
Bank of Baroda	Rs407.9	3,109	15.0	13.3	7.5	7.6	1.1	1.0	1.7	1.5
Bank of India	Rs327.0	3,599	22.0	19.5	5.8	5.5	1.2	1.0	1.9	1.7
Canara Bank	Rs264.4	2,268	13.3	11.5	6.8	7.2	0.9	0.8	2.3	2.1
HDFC Bank	Rs1,427.2	12,704	16.1	16.1	24.5	21.4	3.7	3.2	0.8	0.9
ICICI Bank	Rs678.0	15,786	7.8	8.8	19.2	16.2	1.5	1.4	1.6	1.6
Punjab Nat Bank	Rs643.0	4,242	19.6	17.7	6.8	6.6	1.2	1.1	3.4	3.3
State Bank of India	Rs1,655.0	21,986	16.1	14.9	10.9	10.4	1.6	1.5	1.6	1.5
Union Bank	Rs233.3	2,465	19.4	17.9	6.8	6.5	1.2	1.1	2.1	2.1
Australia										
ANZ Banking Group	A$15.98	27,393	11.5	10.7	9.6	9.2	1.1	1.0	5.8	6.2
Commonwealth Bank	A$37.05	43,296	16.0	14.6	11.2	11.2	1.7	1.6	5.5	5.6
Macquarie Group	A$36.36	8,186	11.9	13.4	8.9	6.7	0.9	0.8	5.1	6.6
National Australia Bank	A$21.83	33,266	14.1	10.6	9.4	11.5	1.2	1.2	6.6	6.7
Westpac Banking	A$19.08	44,117	15.9	13.2	11.7	11.1	1.5	1.4	5.8	5.9
China										
Bank of Comm	HK$8.73	55,190	18.3	18.8	13.0	11.1	2.2	2.0	2.7	3.1
Bank of China	HK$3.70	121,189	14.3	16.0	12.0	10.1	1.7	1.6	4.6	5.5
CCB	HK$5.95	179,415	20.1	20.0	12.4	11.3	2.4	2.2	4.0	4.4
China Citic	Rmb6.00	34,280	12.0	12.9	19.4	16.5	2.2	2.0	1.3	1.5
CMB	HK$17.76	43,803	19.1	17.8	18.0	16.2	3.2	2.7	0.4	0.4
ICBC	HK$5.34	230,153	16.6	17.0	15.1	13.5	2.4	2.2	3.3	3.7
Hong Kong										
Bank of China HK	HK$14.48	19,754	10.5	13.8	17.1	12.2	1.7	1.6	3.5	4.9
Bank of East Asia	HK$22.75	4,904	6.8	6.9	13.6	11.9	1.1	1.1	2.3	3.1
Hang Seng Bank	HK$106.20	26,198	26.4	26.0	14.7	14.3	3.8	3.7	5.9	5.9
HSBC	HK$63.30	98,871	8.3	6.9	11.7	12.9	0.9	0.9	3.9	3.9
Standard Chartered	HK$145.10	35,498	14.5	14.7	10.1	8.7	1.4	1.2	3.4	4.0
Indonesia										
Bank Central Asia	Rp3,625	8,711	24.9	24.4	14.2	12.6	3.3	2.9	2.9	3.5
Bank Mandiri	Rp3,250	6,679	17.8	17.5	11.8	10.6	2.0	1.8	2.7	2.9
Bank Rakyat Indonesia	Rp6,650	7,999	25.4	24.3	12.9	11.2	3.0	2.5	1.8	1.9
Korea										
KB Financial	45,200 won	12,705	5.9	6.1	16.6	15.0	0.9	0.9	0.0	0.0
Korea Exchange Bank	10,450 won	5,316	5.4	4.9	18.1	19.1	0.9	0.9	0.0	1.6
Shinhan Financial	34,000 won	12,717	5.4	6.2	19.0	15.1	1.0	0.9	0.0	0.0
Woori Financial	11,350 won	7,216	0.0	1.9	2,166.6	36.2	0.7	0.7	0.0	0.0
Malaysia										
Bumiputra-Comm	RM9.50	9,595	10.3	9.4	18.3	18.4	1.8	1.6	2.1	2.1
Malayan Banking	RM5.65	11,288	5.1	7.8	32.7	19.4	1.6	1.5	3.2	3.2
Public Bank	RM9.10	9,073	19.9	19.3	16.6	15.9	3.2	2.9	3.8	3.8
Philippines										
BPI	P42.00	2,835	10.8	11.7	20.0	18.1	2.1	2.1	4.3	4.3
Singapore										
DBS	S$11.34	11,807	5.8	5.4	13.4	12.6	0.7	0.7	2.1	2.3
OCBC	S$6.60	14,155	7.4	7.6	19.6	18.3	1.4	1.4	2.7	2.9
United Overseas Bank	S$14.16	14,837	10.4	10.7	15.0	13.6	1.5	1.4	3.2	3.5
Taiwan										
Chinatrust	NT$21.6	5,979	(1.7)	5.0	(102.5)	33.5	1.7	1.7	0.0	2.3
Mega Financial	NT$16.9	5,670	(3.2)	1.6	(33.1)	68.3	1.1	1.1	0.0	1.2
SinoPac	NT$12.0	2,541	(3.1)	0.5	(31.5)	194.4	1.0	1.1	0.0	0.0
Thailand										
Bangkok Bank	Bt106.0	5,934	8.4	9.0	13.4	12.0	1.1	1.0	2.6	2.6
Kasikornbank	Bt65.0	4,552	10.2	11.1	13.0	11.2	1.3	1.2	2.3	2.7
Siam Commercial Bank	Bt70.5	7,028	11.7	12.0	15.6	14.2	1.8	1.6	2.8	3.1

[1] ROE and PB are based on actual book value. Source: CLSA Asia-Pacific Markets

Notes

Notes

Notes

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