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Banking -FINANCIAL ANALYSIS & INVESTMENT OPPORTUNITIES IN INDIAN BANKING INDUSTRIES

Project Report submitted in partial fulfilment for the award of the degree of

SCHOOL OF BUSINESS ADMINISTRATION

Submitted by :-

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FINANCE

SCHOOL OF BUSINESS

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EXECUTIVE SUMMARY

Objective of the research are:

To analyze the Banking Industry using internationally accepted norms of investment analysis.

To identify good investment opportunities among the listed companies in the Indian stock market.

There are three broad categories in which factors that affect a firm's profitability can be classified.

1. Economic-wide factors
2. Industry-wide factors
3. Company-specific factors.

Top-Down Approach

The Top-Down approach or the EIC (Economy, Industry and Company) was adopted in an attempt to identify the interrelationships between the three to for the Indian Banking Industry.

METHODOLOGY

Stage 1: Setting up of the research objectives and guidelines.

Stage 2: The data pertaining to the Economic and industry factors sensitive for the Indian banking Industry was studied.

Stage 3: Selection of the companies followed by company analysis:

Stage 4: Proper documentation and submission of the report to the M/s. Anand Rathi Investments.

AnandRathi is a leading full service securities firm providing the entire gamut of financial services. The firm, founded in 1994 by Mr. AnandRathi, today has a pan India presence as well as an international presence through offices in Dubai and Bangkok. AnandRathi provides a breadth of financial and advisory services including wealth management, investment banking, corporate advisory, brokerage & distribution of equities, commodities, mutual funds and insurance - all of which are supported by powerful research teams.

The firm's philosophy is entirely client centric, with a clear focus on providing long term value addition to clients, while maintaining the highest standards of excellence, ethics and professionalism. The entire firm activities are divided across distinct client groups: Individuals, Private Clients, Corporates and Institutions.

RESEARCH DESIGN

AnandRathi's research expertise is at the core of the value proposition that it offer to its clients. Research teams across the firm continuously track various markets and products. The aim is however common - to go far deeper than others, to deliver incisive insights and ideas and be accountable for results.

OBJECTIVE OF THE RESEARCH

To analyze the Banking Industry using internationally accepted norms of investment analysis.

To identify good investment opportunities among the listed companies in the Indian stock market.

Investments in shares can be a very risky business. However the risk can be minimized by a proper analysis before taking an investment decision. The research attempts to perform such an analysis for the banking industry adopting the internationally accepted norms of investment analysis.

The ultimate function of all economic activities is to produce goods and services to be consumed by the households. The aggregate demand from the household sector is influenced by the level of disposable income and its distribution.

There are three broad categories in which factors that affect a firm's profitability can be classified.

4. **Economic-wide factors**
5. **Industry-wide factors**
6. **Company-specific factors.**

TOP-DOWN APPROACH

Under this approach, an investor first reviews a country's macro economy and forecasts likely trends. From this analysis arise implications for different industries and sectors. By combining both the economic and industry analysis, firms are analyzed with an eye to identify purchase and sell candidates. The firms that are best positioned to take advantage of the expected economic and industry trends are purchase candidates while those firms that will suffer in the expected economic/industry
environment are sell candidates.

The Top-Down approach or the EIC (Economy, Industry and Company) will be adopted in an attempt to identify the interrelationships between the three to for the Indian Banking Industry.

FINANCIAL ANALYSIS

India is well positioned to become world's forth largest economy by 2025 following United States of America, Japan and China. GDP growth rates of 7-8% will be sustainable going forward if the key enabling factors are put in place. By 2025 the Indian economy is researched to be about 60 per cent the size of the US economy. The transformation into a tri-polar economy will be complete by 2035, with the Indian economy only a little smaller than the US economy but larger than that of Western Europe. By 2035, India is likely to be a larger growth driver than the six largest countries in the EU, though its impact will be a little over half that of the US. India, which is now the fourth largest economy in terms of purchasing power parity, will overtake Japan and become third major economic power within 10 years.

One of the enablers of the robust economic growth is a banking sector that is able to adequately and efficiently meet the needs of the growing economy. As India prepares herself for becoming an economic superpower, it must expedite socio-economic reforms and take steps for overcoming institutional and infrastructure bottlenecks inherent in the system. Availability of both physical and social infrastructure is central to sustainable economic growth. Since independence Indian economy has thrived hard for improving its pace of development. Notably in the past few years the cities in India have undergone tremendous infrastructure up gradation but the situation in not similar in most part of rural India. Similarly in the realm of health and education and other human development indicators India's performance has been far from satisfactory, showing a wide range of regional inequalities with urban areas getting most of the benefits. In order to attain the status that currently only a few countries in the world enjoy and to provide a more egalitarian society to its mounting population, appropriate measures need to be taken. Currently Indian economy is facing these challenges:

Sustaining the growth momentum and achieving an annual average growth of 7-8 % in the next five years.

Simplifying procedures and relaxing entry barriers for business activities.

Checking the growth of population; India is the second highest populated country in the world after China. However in terms of density India exceeds China as India's land area is almost half of China's total land. Due to a high population growth, GNI per capita remains very poor. It was only $ 2880 in 2006 (World Bank figures).

Boosting agricultural growth through diversification and development of agro processing.

Expanding industry fast, by at least 10% per year to integrate not only the surplus labour in agriculture but also the unprecedented number of women and teenagers joining the labour force every year.

Developing world-class infrastructure for sustaining growth in all the sectors of the economy.

Allowing foreign investment in more areas

Effecting fiscal consolidation and eliminating the revenue deficit through revenue enhancement and expenditure management.

Empowering the population through universal education and health care. India needs to improve its HDI rank, as at 127 it is way below many other developing countries' performance. The government is committed to furtering economic reforms and developing basic infrastructure to improve lives of the rural poor and boost economic performance. Government had reduced its controls on foreign trade and investment in some areas and has indicated more liberalization in civil aviation, telecom and insurance sector in the future.

India's economy is on the fulcrum of an ever increasing growth curve. With positive indicators such as a stable 8 per cent annual growth, rising foreign exchange reserves of close to US$ 166 billion, a booming capital market with the popular "Sensex" index topping the majestic 14,000 mark, the Government estimating FDI flow of US$ 12 billion in this fiscal, and a more than 22 per cent surge in exports, it is easy to understand why India is a leading destination for foreign investment. With an overall growth in real Gross Domestic Product (GDP) at factor cost estimated at 8.4 per cent in 2007-08, and a ratcheting up of the average growth trajectory of the Indian economy was observed in the last three years.

The continuance of the robust momentum in the current year (2006-07) with GDP growth in the first half (April-September) at 9.4 per cent and in the mild acceleration in year-on-year growth from 8.9 per cent in the first quarter to 9.2 per cent in the second quarter vindicates this. At a disaggregated level, growth was 2.6 (1.7) per cent in agriculture, 10.0 (10.3) per cent in industry, and 10.7 (10.9) per cent in services in the first half (second quarter) of the fiscal.

AGRICULTURE

Agricultural growth remained subdued and averaged 2.6 per cent in the last eight quarters. Trend growth of foodgrains production during 1996-2006 was 0.22 per cent per annum. Negative growth was observed for rabi foodgrains, particularly for wheat and pulses, during this period.

With a decline in the relative importance of agriculture and allied sector, particularly the core agriculture sector, in GDP, the negative impact of a subdued agricultural performance on overall GDP is not pronounced; but is significant in terms of sharing of the fruits of growth with more than half of the population who directly or indirectly depend on the sector for earning a livelihood.

SERVICES

After registering a growth of 10.9 per cent in the fourth quarter of 2005-06, the services sector continued to grow at 10.7 per cent in the first half of the current year. Overall growth of the services sector in the last ten quarters averaged 10 per cent. Within services, in 19 of the 23 quarters since January 2001, the subsector of trade, transport & communication recorded the highest growth rate.

One of the major drivers of the rapid growth of this sub-sector was telecommunication which recorded an annual average growth of 27.1 per cent during 2000-05, resulting in an improvement in its share of total GDP at factor cost from 1.4 per cent in 1999-2000 to 3.5 per cent in 2004-05.

INFLATION

The period since mid-April 2008 has been characterized by some inflationary pressures, stemming from an upward strain on prices of primary commodities. The point-to-point inflation rate, measured in terms of the wholesale price index (WPI), reached a peak of 5.02 per cent in mid-June 2008. In the first 27 weeks of the current financial year until September 30, 2007, inflation in primary commodities exceeded the overall inflation in every week except in the three weeks ending on July 8, 15 and 22, 2007. The excess of inflation in primary commodities over the overall WPI inflation was at a high of 3.60 per cent on September 23, 2007. The commodity-specific structural nature of inflation was also manifest in the rise in the prices of some essential commodities such as wheat, pulses and sugar and a higher inflation rate in terms of the Consumer Price Index (CPI). CPI inflation, on a period average basis, was 6.5 per cent in the first six months of the current year. Crude oil price, which for the Indian basket had rapidly climbed from US$58.5 per barrel in July-September 2006 to US$67.9 per barrel in July-September 2007, softened somewhat to decline to US$93.03 per barrel around November 2007. This moderation in international oil prices was passed on to the consumers from the midnight of November 29, 2007 through a reduction in petrol and diesel prices of Rs.2 and Re 1 per litre; this would have a positive impact on inflation in the coming weeks.

Monetary policy continued to address the challenge of maintaining the growth momentum by meeting the credit needs of the productive sectors while containing the inflationary pressure. The acceleration in growth was achieved with a modest pick up in inflation, which was also reflective of the overall supply situation in real sector. Notwithstanding an increase in prices of certain essential primary commodities, largely because of a demand-supply mis-match and hardening of international prices, overall inflation measured in terms of wholesale price index in first two quarters of the current year averaged 4.81 per cent compared to 4.64 per cent in 2005-06 and 6.68 per cent in 2004-05 having successfully weathered the increase in prices of crude oil.

INDUSTRY ANALYSIS

The last decade has seen many positive developments in the Indian banking sector. The policy makers, which comprise the Reserve Bank of India, Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favourably with the banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation in the sector. This is reflected in their market valuation.

However, improved regulations, innovation, growth and value creation in the sector remain limited to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India’s banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus of this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical for their success.

The failure to respond to the changing market realities has stunted the development of financial service industry in many developing countries. A weak banking structure has been unable to fuel continued growth, which has harmed the long term health of their economies.

GOOD PERFORMANCE, QUESTIONABLE HEALTH

Indian banks have compared favourably on growth, asset quality and profitability with other regional banks over the last few years. The banking index has grown at a compounded annual rate of over 51 per cent since April 2001 as com pared to a 27 per cent growth in the market index for the same period. Policy makers have made some notable changes in policy and regulation to help strengthen the sector.

These changes include strengthening prudential norms, enhancing the payments system and integrating regulayions between commercial and cooperative banks. However, the cost of intermediation remains high and bank penetration is limited to only a few customers segments and geographies. While bank lending has been a significant driver of GDP growth and employment, periodic instances of the "failure" of some weak banks have often threatened the stability of the system. Structural weaknesses such as a fragmented industry structure, restrictions on capital availability and deployment, lack of institutional support infra structure, restrictive labour laws, weak corporate governance and ineffective regulations beyond Scheduled Commercial Banks (SCBs), unless addressed, could seriously weaken the health of the sector. Further, the inability of bank managements (with some notable exceptions) to improve capital allocation, increase the productivity of their service platforms and improve the performance ethic in their organisations could seriously affect future performance.

OPPORTUNITIES AND CHALLENGES FOR PLAYERS

The bar for what it means to be a successful player in the sector has been raised. Four challenges must be addressed before success can be achieved. First, the market is seeing discontinuous growth driven by new products and services that include opportunities in credit cards, consumer finance and wealth management on the retail side, and in fee-based income and investment banking on the wholesale banking side. These banks require new skills in sales & marketing credit and operations. Second, banks will no longer enjoy windfall treasury gains that the decade-long secular decline in interest rates pro vided.

This will expose the weaker banks. Third, with increased interest in India, competition from foreign banks will only intensify. Fourth, given the demographic shifts resulting from changes in age profile and household income, consumers will increasingly demand enhanced institutional capabilities and service levels from banks.

ONE OF THREE SCENARIOS WILL PLAY OUT BY 2010

The interplay between policy and regulatory interventions and management strategies will determine the performance of Indian banking over the next few years. Legislative actions will shape the regulatory stance through six key elements industry structure and sector consolidation; freedom to deploy capital; regulatory coverage; corporate governance; labour reforms and human capital development; and support for creating industry utilities and service bureaus. Management success will be determined on three fronts: fundamentally upgrading organisational capability to stay in tune with the changing market; adopting value-creating M&A as an avenue for growth; and continually innovating to develop new business models to access untapped opportunities.

Through these scenarios, we paint a picture of the events and outcomes that will be the consequence of the actions of policy makers and bank managements. These actions will have dramatically different outcomes; the costs of inaction or insufficient action will be high. Specifically, at one extreme, the sector could account for over 7.7 per cent of GDP with over Rs. 7,500 billion in market cap, while at the other it could account for just 3.3 per cent of GDP with a market cap of Rs. 2,400 billion. Banking sector intermediation, as measured by total loans as a percentage of GDP, could grow marginally from its current levels of 30 per cent to 45 per cent or grow significantly to over 100 per cent of GDP. In all of this, the sector could generate employment to the tune of 1.5 million compared to 0.9 million today. Availability of capital would be a key factor the banking sector will require as much as Rs. 600 billion

(US$ 14 billion) in capital to fund growth in advances, non-performing loan (NPL) write offs and investments in IT and human capital upgradation to reach the high-performing scenario. Three scenarios can be defined to characterise these outcomes:

HIGH PERFORMANCE:

In this scenario, policy makers intervene only to the extent required to ensure system stability and protection of consumer interests, leaving managements free to drive far-reaching changes. Changes in regulations and bank capabilities reduce intermediation costs leading to increased growth, innovation and productivity. Banking becomes an even greater driver of GDP growth and employment and large sections of the population, gain access to quality banking products. Management is able to overhaul bank organisational structures, focus on industry consolidation and transform the banks into industry shapers. In this scenario we witness consolidation with- in public sector banks (PSBs) and within private sector banks. Foreign banks begin to be active in M&A, buying out some old private and newer private banks. Some M&A activity also begins to take place between private and public sector banks. As a result, foreign and new private banks grow at rates of 50 per cent, while PSBs improve their growth rate to 15 per cent. The share of the private sector banks (including through mergers with PSBs) increases to 35 per cent and that of foreign banks increases to20 per cent of total sector assets. The share of banking sector value add in GDP increases to over 7.7 per cent, from current levels of 2.5 per cent. Funding this dramatic growth will require as much as Rs. 600 billion in capital over the next few years.

EVOLUTION:

Policy makers adopt a pro-market stance but are cautious in liberalising the industry. As a result of this, some constraints still exist. Processes to create highly efficient organisations have been initiated but most Amity Business School, Noida banks are still not best-in-class operators. Thus, while the sector emerges as an important driver of the economy and wealth in 2010, it has still not come of age in comparison to developed markets. Significant changes are still required in policy and regulation and in capability-building measures, especially by public sector and old private sector banks. In this scenario, M&A activity is driven primarily by new private banks, which take over some old private banks and also merge among themselves. As a result, growth of these banks increases to 35 per cent. Foreign banks also grow faster at 30 per cent due to a relaxation of some regulations. The share of private sector banks increases to 30 per cent of total sector assets, from current levels of 18 per cent, while that of foreign banks increases to over12 per cent of total assets. The share of banking sector value add to GDP increases to over 4.7 per cent.

NEED FOR DECISIVE ACTION BY BANK MANAGEMENTS

Management imperatives will differ by bank. However, there will be common themes across classes of banks: PSBs need to fundamentally strengthen institutional skill levels especially in sales and marketing, service operations, risk management and the overall organisational performance ethic. The last, i.e., strengthening human cap- ital will be the single biggest challenge. Old private sector banks also have the fundamentally strengthen skill levels. However, even more imperative is their need to examine their participation in the Indian banking sector and their ability to remain independent in the light of the discontinuities in the sector. New private banks could reach the next level of their growth in the Indian banking sector by continuing to innovate and develop

differentiated business models to profitably serve segments like the rural/ low income and affluent/HNI segments; actively adopting acquisitions as a means to grow and reaching the next level of performance in their service plat- forms. Attracting, developing and retaining more leadership capacity would be the key to achieving this and would pose the biggest challenge. Foreign banks committed to making a play in India will need to adopt alternative approaches to win the “race for the customer” and build a valuecreating customer franchise in advance of regulations potentially opening up post 2009. At the same time, they should stay in the game for potential acquisition opportunities as and when they appear in the near term.

Maintaining a fundamentally long-term value-creation mindset will be their greatest challenge. The extent to which Indian policy makers and bank managements develop and execute such a clear and complementary agenda to tackle emerging discontinuities will lay the foundations for a high-performing sector in 2010.

COMPANY ANALYSIS

BANK OF INDIA

Bank of India's presentation focused on management's strategy of derisking the balance sheet and improving return ratios. The presentation highlighted the following strategies:

EXPANDING REACH TO NET A WIDER CUSTOMER BASE:

Bank of India has a well diversified presence across India with 2,622 branches and 24 overseas offices. Global assets total Rs 1,123 billion.

Currently, its international operations account for 19% of the asset base. The bank aims to increase the number of branches by 50 in India in FY08 and expand global operations by opening branches in Antwerp (Belgium) and Tanzania. Representative offices are likely to be opened in China, Qatar, South Africa and in South East Asia.

FOCUSING ON QUALITATIVE GROWTH:

In FY07 till date, while deposits grew by 19%, loans grew by 17%. The slower loan growth was on account of a 5% decline in international assets owing to repayment of IMDs, wherein Bank of India has extended loans to its customers. The bank aims to achieve a steady growth of 20%-25% in its loan book and 15%-16% in deposits. The bank has plans to focus on quality loans, with its spotlight on Small and Medium Enterprise, agriculture and retail, that can realize reasonable margins. Also, the bank does not intend to raise funds at a high cost to fund balance sheet growth.

BETTING ON HIGHER MARGINS:

Post the PLR hike, 50% of the loan book has been re-priced, which should result in higher loan yields and margin improvement. In FY07, Bank of

India had a global spread of 2.78% and domestic spread of 3.11%.

Deposit costs are also likely to move up, but as the bank has 40% in

CASA (for domestic deposits), this shall check the rise in deposit cost.

Overall, rising yields should result in margins improving for the bank. Additionally, management has indicated that it intends to increase international margins, thereby also improving the bank's blended margins.

ENHANCING GROWTH VIA TECHNOLOGY

IMPLEMENTATION AND COST CONTROL:

By end-FY08, the bank is likely to have 1,000 branches under CBS (737 branches currently under CBS track 66% of the business), which would command 80% of the business. Bank of India is probably the only bank which is expensing the costs related to its CBS and, hence, does not expect its technology related costs to increase from hereon. Further, as employee retirements are likely to be considerable, these expenses are also likely to grow marginally (5%-7%) from current levels.

INVESTMENT BOOK IS DE-RISKED:

Bank of India's investment book is well positioned with a low duration of 0.6 years on the AFS book and more than 75% of SLR in HTM. Thus, we do not foresee any mark-to-market provisions for Bank of India.

COMFORTABLE ON CAPITAL FRONT:

Total CAR as at FY06 is 10.8%, of which Tier 1 is 6.75%. We anticipate the bank will require capital in FY07 to support its growth. However, it is comforting to note that Bank of India is one of the few state owned banks that have adequate room for equity dilution (Government of India holding is 69.5%). Whilst management agrees this offers a comfort level, they would not utilize this as a means to dilute equity. Bank of India has applied to the RBI for raising capital via hybrid capital from international markets and is hopeful of gaining permission.

VALUATION AND RECOMMENDATION:

Bank of India will likely be a beneficiary of low operating expenses, steady net interest income growth and low risk on its AFS portfolio. We expect PAT to grow at 23% CAGR during FY06-FY08.

The stock trades at 0.9x FY07E BV and 5.5x FY07E EPS. We recommend

Buy.

INCOME STATEMENT **(Rs Million)**

Year Ending Mar	2004	2005	2006	2007	2008
Interest Income	57,959	60,315	70,287	82,927	97,804

Interest Expended	35,945	37,946	43,967	52,323	61,997
Net Interest Income	22,014	22,369	26,320	30,603	35,806
Other Income	7,920	11,560	11,844	11,275	11,897
Net Income	39,934	33,929	38,164	41,878	47,704
Operating Expenses	17,515	19,323	21,151	23,604	26,443
Operating Income	22,419	14,606	17,012	18,274	21,260
Other Provisions	8,910	9,993	7,859	6,700	6,600
PBT	13,509	4,613	9,154	11,574	14,660
Tax	3,426	1,210	2,142	2,894	4,032
Tax Rate (%)	25.4	26.2	23.4	25.0	27.5
PAT	10,083	3,403	7,012	8,681	10,629
Proposed Dividend	1,650	976	1,660	1,953	2,441

RATIOS

SPREADS ANALYSIS (%)

Y /E March	2004	2005	2006	2007E	2008E
Avg.Yield -Earning As.	7.5	7.0	7.0	7.1	7.3
Avg. Cost-Int. Bear. Liab.	4.9	4.6	4.6	4.7	4.8

Interest Spread	2.5	2.4	2.4	2.4	2.4
Net Interest Margin	2.8	2.6	2.6	2.6	2.7

PROFITABILITY RATIOS (%)

Y /E March	2004	2005	2006	2007E	2008E
RoE	26.7	8.0	14.9	16.5	17.7
RoA	1.3	0.4	0.7	0.7	0.8
Int. Expen/Int.Earned	62.0	62.9	62.6	63.1	63.4
Other Inc./Net Income	44.9	34.1	31.0	26.9	24.9

EFFICIENCY RATIOS (%)

Op. Exps./Net Income	43.9	57.0	55.4	56.4	55.4
Empl. Cost/Op. Exps.	66.9	65.4	62.8	60.2	57.3
Busi. per Empl.(Rs m)	26.0	29.5	34.8	41.2	48.2
NP per Empl. (Rs lac)	2.3	0.8	1.7	2.1	2.6

ASSET-LIABILITY PROFILE (%)

Adv./Deposit Ratio	64.6	70.4	69.4	70.0	70.0
Invest./Deposit Ratio	38.3	36.4	33.8	33.8	33.8
G-Sec/Invest. Ratio	67.9	69.6	71.6	65.3	59.7
Gross NPAs to Adv.	7.9	5.5	3.7	3.1	2.7
Net NPAs to Adv.	4.5	2.8	1.5	0.9	0.6
CAR	13.0	11.5	10.8	10.1	9.6

Tier	17.5	7.1	6.8	6.5	6.2
VALUATION					
Book Value (Rs)	78.6	88.1	98.0	111.9	
128.9					
Price-BV (x)	1.2	1.1	1.0	0.9	0.8
Adjusted BV (Rs)	51.1	67.4	85.0	103	122
Price-ABV (x)	1.9	1.4	1.1	0.9	0.8
EPS (Rs)	20.7	7.0	14.4	17.8	21.8
EPS Growth (%)	18.5	(66.3)	106.0	23.8	22.4
Price-Earnings (x)	4.7	14.0	6.8	5.5	4.5
OPS (Rs)	45.9	29.9	34.9	37.4	43.6

MARGINS TO EXPAND FROM 4QFY07:

ICICI Bank has raised lending rates thrice over the last four months

(overall rates are up 150bp). Of this, the 50bp hike is already effective April 2006 onward and the 100bp hike will be effective from July 2006 onward. We expect margins to be lower in 1QFY07, compared with

4QFY06, as the full impact of the higher deposit (raised in the month of March) costs would be felt. However we expect margins to improve from 4QFY07 on the back of the lending rate increase. Management does not expect slowdown in its business or deterioration of asset quality.

SUBSIDIARIES TO GAIN SIGNIFICANCE:

ICICI Bank has subsidiaries in almost every sphere of the financial service domain. Over the years, the buoyant Indian economy and increased capital market interest has enabled the bank's subsidiaries to grow at a healthy rate. We believe that these subsidiaries could result in significant value for ICICI Bank. We value the bank's key subsidiaries at Rs144 per share. We also believe it would be realistic to assume a 20% increase in value on an annualized basis going forward.

RETAIL SHARE TO DECLINE BUT STRONG GROWTH PROSPECTS AHEAD:

Whilst the proportion of retail assets is likely to decline with increasing rural and international focus, the bank would maintain leadership in retail assets (33% market share) through multi-product offerings, wide distribution network, robust technology platform and strong credit operations. Management believes that with retail loans/GDP penetration at 11% (lower versus other countries) coupled with low household leverage; the retail segment will continue to witness steady growth going forward.

VALUATION AND RECOMMENDATION:

We expect ICICI Bank's earnings to grow at 25% CAGR over FY06FY08 Adjusting for the value of its subsidiaries, the stock quotes at 9.6x FY07E earnings and 1.2x FY07E book value. With concerns over profitability and asset quality allayed and given the bank's high growth visibility, we maintain Buy.

INCOME STATEMENT (Rs Million)

Y /E	March 2005	2006	2007E	2008E
Interest Income	94,099	137,845	194,460	262,045
Interest Expended	65,709	95,975	137,843	189,460
Net Interest Income	28,390	41,870	56,617	72,586
Other Income	35,397	49,821	62,741	80,275
Profit on sale of invest	5,461	9,270	5,000	4,000
Other incomes	29,935	40,551	57,741	76,275
Net Income	63,787	91,692	119,358	152,861
Operating Expenses	33,013	44,795	56,440	69,851
Employee expense	7,374	10,823	15,401	18,360

Operating Income	30,774	46,897	62,918	83,010
Prov & contin	5,532	15,941	18,843	24,053
Provision for NPAs	116	7,947	9,135	11,053
PBT	25,242	30,956	44,074	58,958
Tax	5,190	5,563	12,908	19,429
PAT	20,052	25,393	31,167	39,529

SERVICE QUALITY THE KEY DIFFERENTIATOR:

The management highlighted that for banks of the size of Karnataka Bank, personalised service is the key differentiator as compared to the larger banks. The chairman highlighted that small banks in order to survive must compete with larger banks on the platform of service quality and constantly enhance it, if they must grow and survive. Karnataka Bank is constantly looking at improving its personalised service and at the same time is improving its technology platform and product suites in order to retain and grow its customer base.

VALUATION AND RECOMMENDATION:

Karnataka Bank continues to be a preferred bet amongst the universe of smaller private banks. We estimate the bank to report PAT of Rs2.1b in FY07. We estimate EPS at Rs17.2. The stock trades at 5.2x FY07E EPS and 0.9x FY07E

BV. Maintain Buy.

STATE BANK OF INDIA

SBI plans to simultaneously focus on growing its retail loan book with high yielding loans and thrust fee income growth thereby improving return ratios.

LOAN BOOK GROWTH TO CONTINUE:

SBI expects its loan book to continue growing comfortably by 20% over the next few years with focus on retail, SME and agriculture, which currently make up 50% of SBI's loan book. FY06 saw mid-corporates, SME, and retail growing strongly and the bank expects this trend to continue.

INTERNATIONAL EXPANSION DRIVE:

SBI's international network of 70 overseas offices in 30 countries across all time zones is by far the largest for any Indian bank. SBI has built a correspondent relationship with 539 international banks in 124 countries. In FY06, SBI was also on an acquisition mode internationally and has acquired three banks in Mauritius, Kenya and Indonesia. SBI expects to record 15%-20% profit from its international operations by 2008 (from the present 5 %).

FEE INCOME AVENUES EXPAND:

SBI has raised service charges and introduced new service charges from February 2006, which will add to fee income. Also its government business has become value-cum-transaction based. For all receipt related business of the

Government of India, it will be transaction based, whilst for Government of India's payment business, it will be value based. Further, SBI is also thrusting increasing its fee income from credit-linked and non-fund based sources.

INVESTMENT BOOK, DE-RISKING IN PROGRESS:

SBI's investment book contracted by 18% in FY06. Moreover, over the past year the bank shifted a substantial part of this book to the held-to-maturity portfolio and simultaneously reduced duration of the available-for-sale book from 4 years to <2 years. In 1QFY07, the bank has again shifted securities to

HTM. Currently 67% of its investment book is in HTM. Consequently, the

MTM risk on its bond book has, as per management estimates, dropped to Rs60m/bp from ~Rs490m in March 2005. The increase in the HTM portfolio however now mandates the bank to provide Rs24bn annually as securities premium amortization.

MARGINS TO IMPROVE:

SBI's adjusted margins declined to 2.92% in FY06 from 3.14% in FY05 on account of pressure on yield from investments, which declined by 84bp to 7.1% in FY06. Going forward, while investment yield will decline by another 15bp-20bp, SBI's advance yield is likely to improve (up by 10bp YoY in FY06) on the back of recent 50bp PLR hike (60% of SBI's loan book is on a floating rate basis) and improving CASA share (43% in FY06).

ASSET QUALITY IMPROVED SUBSTANTIALLY:

SBI's asset quality has improved from net NPAs of 3.5% in FY04 to 1.8% in

FY06. Management expects this status to decline further to 1.25% in FY07. Improved asset quality has necessitated lower NPA provisioning over the last couple of years. Slippages too have been reducing, recording in only 1.9% in FY06 versus over 3.5% historically.

Additionally, SBI has also been active in NPA sell-offs and write-offs. The bank expects strong recovery ahead.

VALUATION AND RECOMMENDATION:

While we expect a positive trend in interest margins from QFY07 coupled with improving fee income, bond losses will act as near term negative for SBI. With 10 yr bond yields already at 8.15 (60bps higher than March 06 yields), SBI will have to provide for a big mark to market loss in 1QFY07 (~Rs2.5b). Going forward, it will benefit from slow growth in operating expenses and lower provisioning requirements. We expect SBI to report consolidated EPS of Rs114 and BV of Rs804 in FY07. The stock trades at FY07 P/E of 6.3x and P/BV of

0.9x FY07 earnings. Reiterate Buy.

HDFC BANK LTD.

END OF WAIT FOR BRANCH LICENCES SPELLS GOOD FOR SUSTAINING MARGINS:

Regardless of the movement in interest rates, shift in the asset mix towards relatively higher risk retail assets and more of SMEs is expected to keep yield on advances firm. With the wait for new branch licences over, HDFC Bank should not have a problem in maintaining high levels of CASA (45%), thereby keeping margins also high at around 4% till FY08E.

INCOME FROM FEES A MAJOR CONTRIBUTOR TO ROA IMPROVEMENT:

We expect fees to stay at 1.7% of average assets. With limited operating expenses and no credit charges, this income stream is extremely profitable and a major contributor to RoA improvement (1.39% in FY06 to 1.52% in FY08E). The bank's rapidly accelerated provisioning policy prepares it adequately for credit losses in its admittedly high-risk portfolio. In FY06, the bank's NPL provisioning was as much as 1.2% of average assets (excluding risk-free securities) and 4.7% of incremental assets. This also shows that the P&L account does not reflect supernormal profits.

PREMIUM VALUATIONS JUSTIFIED:

We upgrade HDFC to a Buy with a P/Ebased price target of Rs1,260/share. The squeaky-clean asset quality, a large fee component in income and high margins have historically led the bank to enjoy a premium (at 22x 08E diluted EPS), which we believe should continue. Any delay in branch rollout and erosion in systemic floats due to new transaction technologies are key risks.

SUSTAINED STRENGTH:

We raise our target price to Rs1260 and upgrade from Hold to Buy.

INCOME STATEMENT (Rs Million)

Y /E March	2004	2005	2006	2007E	2008E
Net interest income	13,379	17,779	25,458	32,432	40,905
Non-interest income	3,868	4,633	8,788	13,221	15,816
Fees & Commissions	3,204	6,050	10,451	14,422	17,594
Trading revenue	77 -1,	627 -1,	979 -1,	546 -2,	158
Other revenue	588	210	317	345	380
Total revenue	17,247	22,412	34,247	45,653	56,721
Total Operating Costs	8,267	10,854	16,911	22,178	26,981
Pre-Pro profit	8,980	11,558	17,336	23,475	29,740
Bad debt expense	1,783	1,762	4,798	6,662	7,578
PBT	7,197	9,796	12,538	16,813	22,162
Tax	2,102	3,140	3,830	5,212	6,870
Net profit	5,095	6,656	8,708	11,601	15,292

VALUATIONS & RATIOS

Y /E March	2004	2005	2006	2007E	2008E
P/E	16.8	19.1	23.6	28.9	22.0
P/E FD	18.7	20.5	25.1	30.6	23.2
P/B	4.00	3.73	4.57	5.32	4.43
P/B	33.48	74.10	120.22	196.87	238.09
ROE (%)	20.6	18.5	17.7	20.0	22.0
ROA (%)	1.40	1.42	1.39	1.39	1.46
Dividend yield (%)	5.94	5.23	0	0	0
Dividend cover (x)	1.00	1.00	nm	nm	nm
Payout ratio (%)	19.6	21.0	19.8	17.6	14.4

PER SHARE

Y /E March	2004	2005	2006	2007E	2008E
EPS (Rs)	32.83	22.98	27.10	26.93	35.36
EPS (adj.)(Rs)	32.83	22.98	22.62	26.93	35.36
Growth Rate EPS (%)	25.1	-30.0	17.9	-0.6	31.3
DPS	6.47	5.67	5.68	6.00	6.50
BVPS(Rs)	174.21	191.08	214.61	234.78	262.83
BVPS (adj.) (Rs)	138.83	170.04	200.43	221.32	250.71
Average Mkt cap (Rs)	47,708	56,179	69,199	88,207	88,20

PUNJAB NATIONAL BANK

STRONG NII GROWTH AS MARGINS MOVE EVEN FURTHER UP:

PNB has reported a 14.4% YoY growth in the net interest income in Q2FY07 on the back of 16bp YoY increase in margin. More importantly, NIM for H1FY07 6bp higher than that in Q1FY07, indicating that margins improved on QoQ basis. PNB is the only major PSU Bank to have enjoyed a sequential margin improvement in the quarter.

FEE INCOME GROWTH ROBUST; BUT NOT AS STRONG AS IN Q1FY07:

Fee income growth is 18% while being robust, does represent a slowdown from the 52% growth rate seen in Q1FY07. We note that, we are building a full year growth of 18% in the fee income. Hence, there could still be an upside to our forecast.

OW OPERATING COST SEEN IN Q1FY07:

Not an aberration, we cut our cost estimated. Operating expenses declined by 8% after being flat in Q1FY07. We had't extrapolated the cost trend seen in Q1FY07 to entire year, as we were not confident about its sustainability. However, the bank has surprised again in Q2FY07. Consequently, we are not reducing our operating cost assumption by -10% for FY07 and FY08.

WRITE BACK OF INVESTMENT PROVISION SHORES UP BOTTOM LINE:

The bank made a write back of investment provisions of Rs. 1.45Bn in Q2. However the bank made a higher than expected NPA provision of Rs. 1.89Bn Vs an expectation of 0.98Bn. Consequently, net NPA ratio has come down to 0.18% from 0.34% in Q1FY07. We note that the net income NPA ratio was better than expected at 0.3%

TOP OF THE LINE RESULTS-PNB REMAINS OUR TOP PICK IN BANKING:

PNB is the best positioned bank in rising rate environment thanks to its high quality deposit franchise in our view. The result of Q2FY07 leads further confidence to this view, with PNB being almost the only bank to have enjoyed a QoQ increase in margin. Operating cost and asset quality came in above expectation.

We are increasing our EPS estimates by 15% for FY07 and 6% for FY08 on lowering operating costs. FY07 EPS is also boosted because of the Rs. 1.45Bn write back of investment provision revieled in Q2FY07. PNB is clearly a top pick in banking space. Maintain BUY with end FY07 price target of Rs. 580 Share.

CONCLUSION

One of the problems faced during the duration of the research was the recent change in the environmental factors like inflation, interest rate hike and the recent slump in the market etc. It was really difficult to incorporate these changes in the research. But the long term views on the scrips remain as researched. Researchions are based on the long term out look of the banking industry. In the short term the forecasts may not hold true. It may be due to some economic cycles or the government policies. This report has been made assuming that the prevalent economic conditions remain the same.

This research is subject to approval from the research board of

AnandRathi before it can be circulated.

QUESTIONNAIRE

1. Name...
2. Address..
3. Gender Male Female
4. Date of Birth Date Month Year
5. Marital Status Single Married
6. No. of dependents (could include family members like children, spouse, parents etc.)

	Name	Relationship with you	Age
1.	....	....	....
2.	....	....	....
3.	....	....	....
4.	....	....	....

7. Your occupation ....
8. Your Job/Profession is

(a) Secured

(b) Not Secured

9. Your Tax Bracket

(a) Non Tax Payer

(b) 10%

(c) 20%

(d) 30%

10. Your monthly income (from all sources)

(a) Less than 10000

(b) 10000 - 20000

(c) 20000 - 50000

(d) More than 50000

(e) What percentage of your income do you invest

....

11. How long have you been investing (a) For the last 1 - 5 years.

(b) For the last 5 - 10 years

(c) For over 10 years and above.

12. I would like my investment to grow

(a) Steady

(b) At an average rate

(c) Fast

13. My approach in making an investment

(a) I take educated view of the investment

(b) I take friendly advice and make decision

(c) I rely on my guess

14. While investing in my funds, I am most concerned about.

(a) Safety of my principal

(b) Earning return above the inflation rate

(c) Earning high returns

15. My current portfolio includes majority of

1.	Bank Deposit amount	5.	Bond & Debenture
2.	F.D.	6.	U.T.I. Scheme
3.	M.F.	7.	Post Office Scheme
4.	Shares	8.	L.I.C. Scheme
		9.	Others

16. My knowledge about various investment schemes is :-

(a) Nil

(b) Average

(c) Good

17. Imagine that the stock market drops immediately and you invest in it.

(a) I would withdraw my money.

(b) I would wait and watch (c) I would invest more in it

18. Have you taken any loans ?

(a) Yes

(b) No

19. Do you have Life Insurance Cones

(a) Yes

(b) No

20. If I give you 100 Rs., how much you will allocate in these investment options

1.	Bank deposit amount __	5.	Bond & Debenture __
2.	F.D. __	6.	U.T.I. Scheme __
3.	M.F. __	7.	Post Office Scheme __
4.	Shares __	8.	L.I.C. Schemes __

21. Have you ever invest in stock market ?

(a) Yes

(b) No

22. If yes, have you ever withdraw money from your safe investment (P.P.F., Bank FDs etc.) or availed of an overdraft facility to buy stocks.

....

23. Did you sell your father's blue chip or dispose of P.A. to buy hot sector stocks?

....

24. Do you have any investment goal ?

....

25. Did you ever take a flat / car or the anticipated profit of yours portfolio ?

....

(Thanks for your Support)

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