Banking Sector –Q312 [QUARTERLY REVIEW]

February 17, 2012

Bank Nifty: 11075 **BSE Bankex: 12736** **OVERWEIGHT**

We analyzed the Q312 performance of the banking sector on aggregate basis involving a sample size of 38banks consisting of 16 private sector banks and 22 PSU banks.

The sustained rise in cost of funds, high provisions due to rise in NPAs, slowing credit demand has dragged the sector's performance. Public sector banks were the most impacted by the adverse economic environment, as provision burden rose significantly. Private sector banks have successfully managed to ride over the rising interest rate cycle maintaining healthy NII and PPOP growth as well as improving asset quality.

Key Observations:

NII up 13%, PAT up 7% driven by private sector banks, high interest expense and provisions hurt profitability.

Net interest income (NII) for Q312 grew 13% which equals the lowest level seen over the last two years by the industry. PSBs were the biggest drag on NII growth as the sector which contributes 76% of sector NII grew 12% on account of slower growth in interest earnings(32% vs.40% for pvt. bks). However excluding SBI, the NII growth is an anemic 7%. Higher proportion of low cost deposits aided NII growth for PSBs.

Private sector banks performed relatively well, with net interest income growing 18%YoY which is largely consistent with the 22% YoY average growth seen over the last two years.

Industry PAT growth stood at 7%YoY which is only ahead of 3%YoY and 2%YoY decline seen in Q112 and Q3FY10 respectively.

Operating expenses contained, C/I down 60bpsQoQ, flat YoY

The industry contained operating costs, growing 13% YoY which significantly lower than the 19% YoY avg. growth seen over last two years. Other income in Q312 grew 10%YoY however excluding SBI, other inc grew robust 23%. Operating cost to income ratio has declined 60bpsQoQ while remained flat (+5bps) on YoY basis. PSBs have been judicious on their operating expense, growing 10%YoY while Pvt banks operating spend has remained largely in-line with the trend seen over last two years, increasing 19%YoY. PPOP for industry as a result, grew 12%YoY, much below the 18% avg. growth seen over 2 years, due to the muted NII growth.

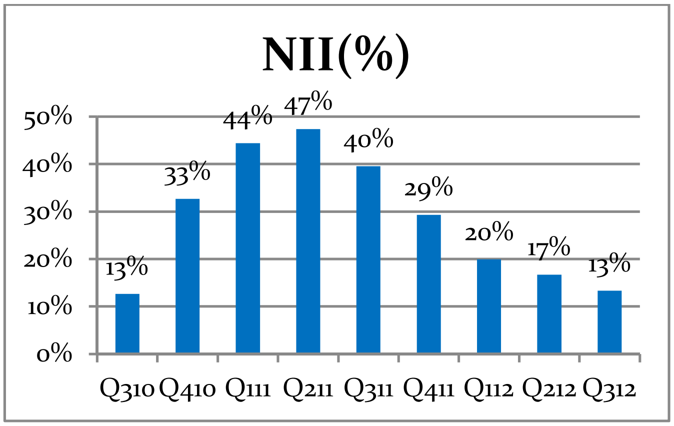
Provisions weigh on industry PAT, driven by PSBs

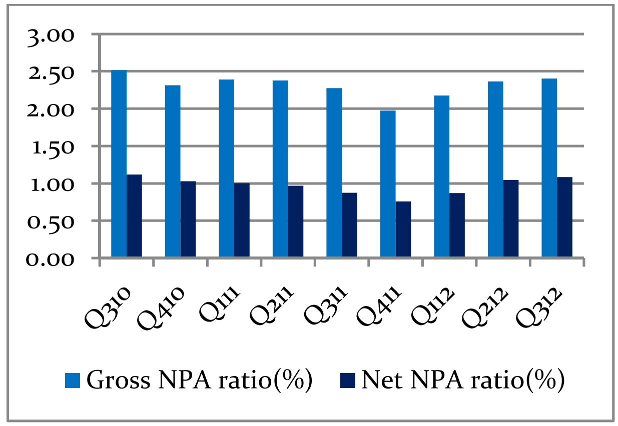
Banking sector profitability was hurt on account of the sharp 37%YoY increase in provisions due to investment losses, higher restructured accounts, higher slippages given the general economic slowdown . PSBs hiked provisions during the quarter by 49% while Provisions by pvt banks on the contrary, declined 13%YoY, which helped to alleviate pressure on profitability.

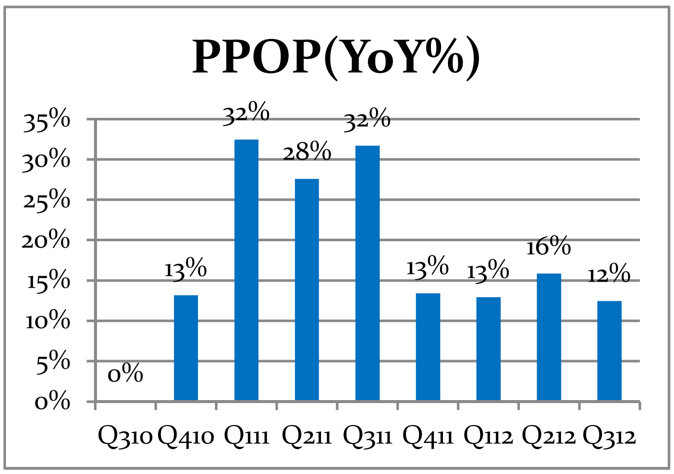
Asset quality deteriorates for PSBs, stable for Pvt Sector

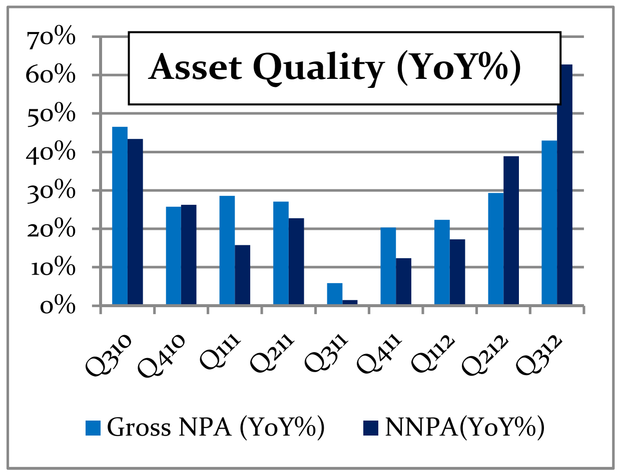
Asset quality deteriorated with Gross NPAs surging 43% YoY and 14% QoQ which is fastest pace since Q310. The PSBs which account for 84% of industry Gross NPAs, grew 54% while Private sector GNPAs grew mere 3%. PSBs witnessed avg. GNPA ratio for Q312 of 2.66% (vs.2.22% avg over last 2 years) while comparative figure for private banks stood at 2.06% (vs.2.43% avg over last 2 years). PSBs NNPA ratio stood at 1.4% while Pvt. peers, NNPA ratio stood at 0.6%.

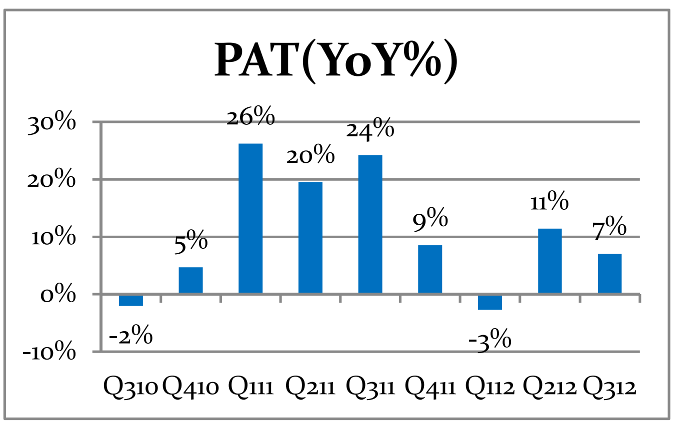
Banking industry performance – Downtrend closer to bottoming out…

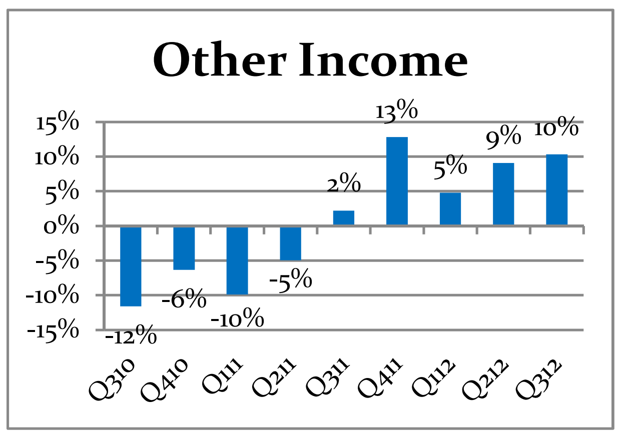




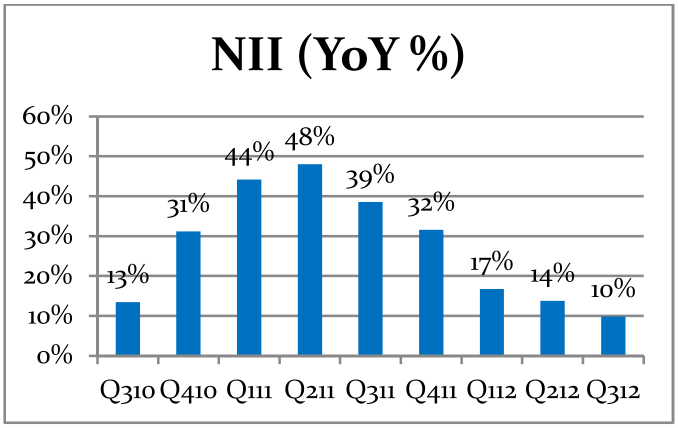


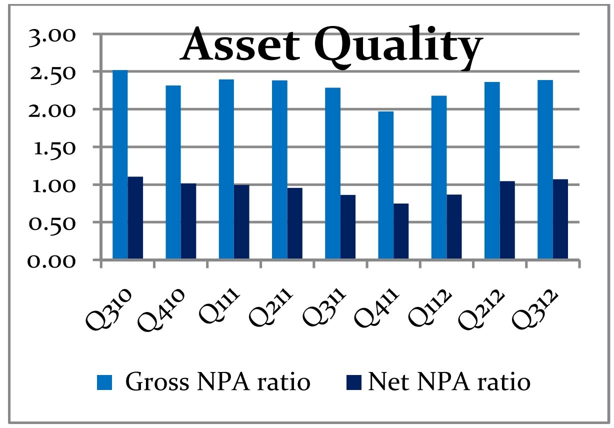


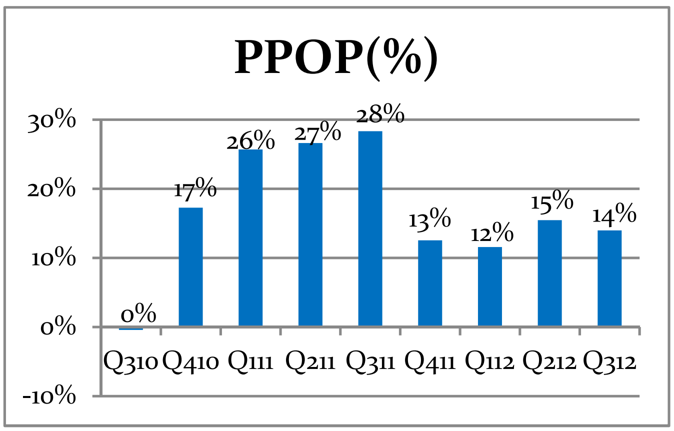


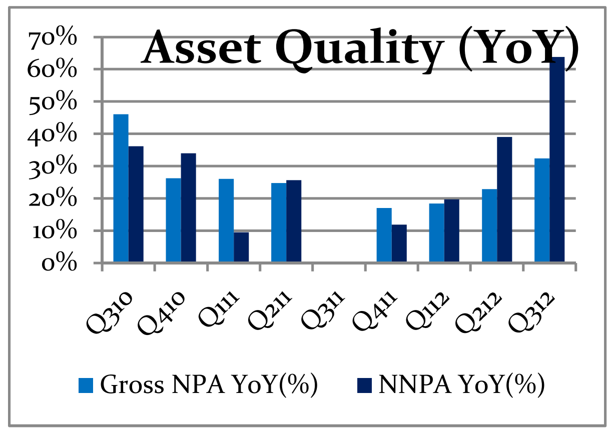


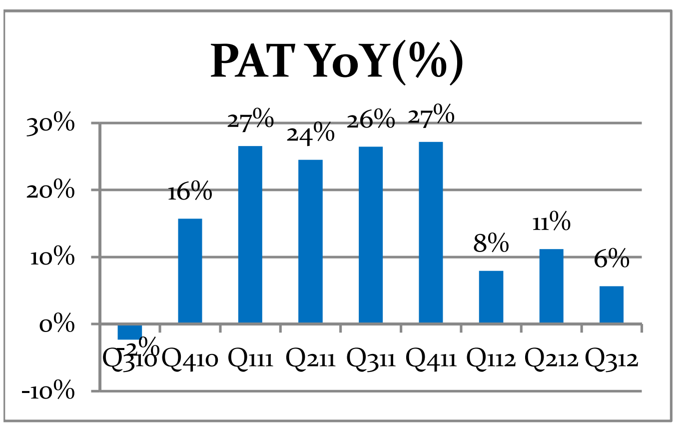
Industry performance excluding SBI

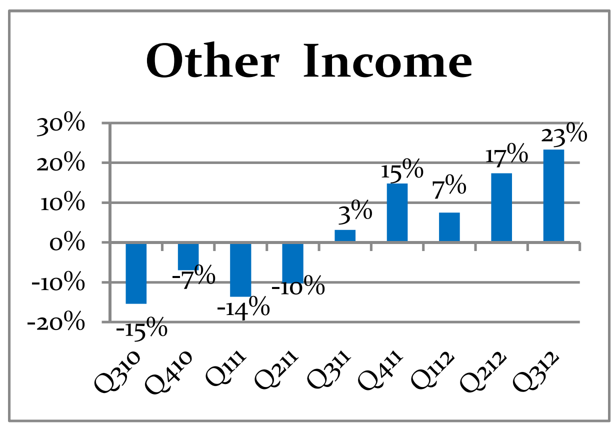




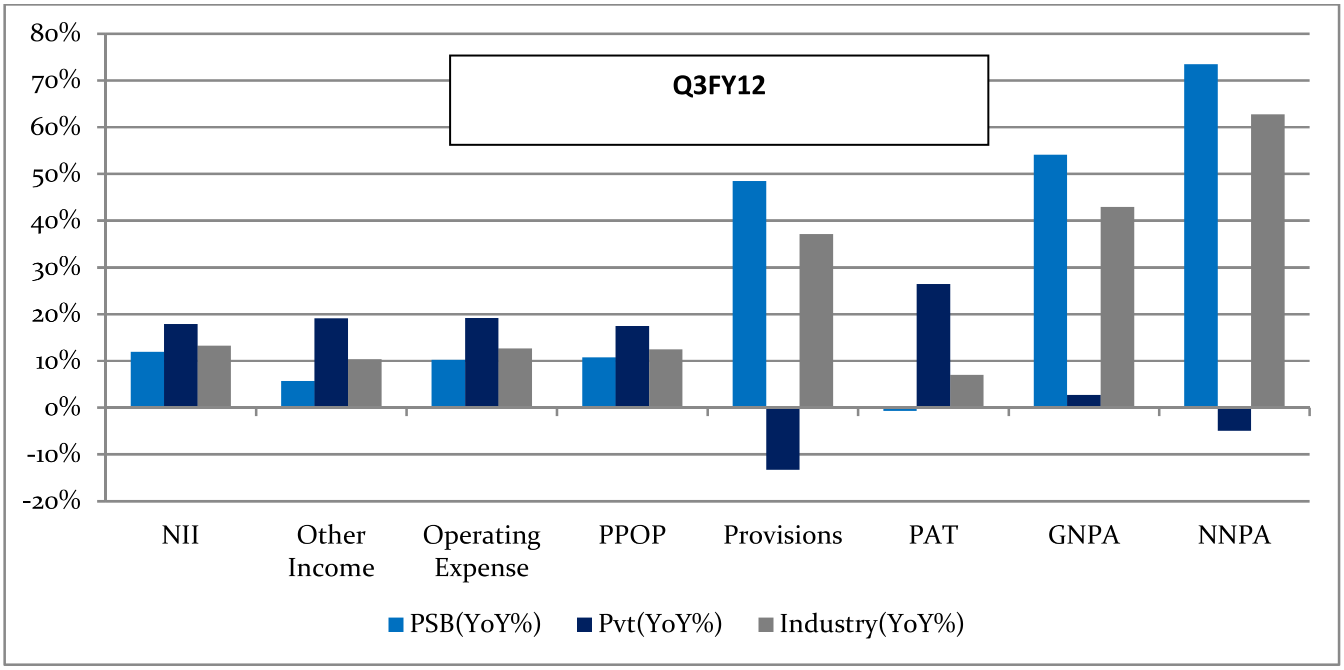


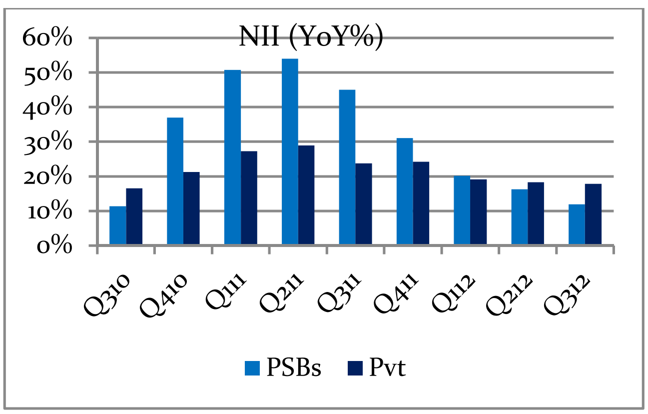


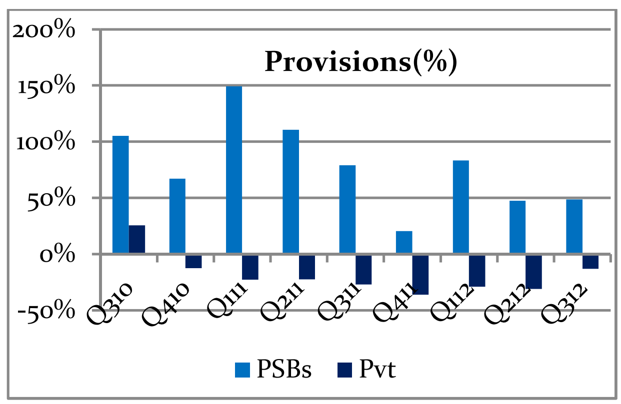


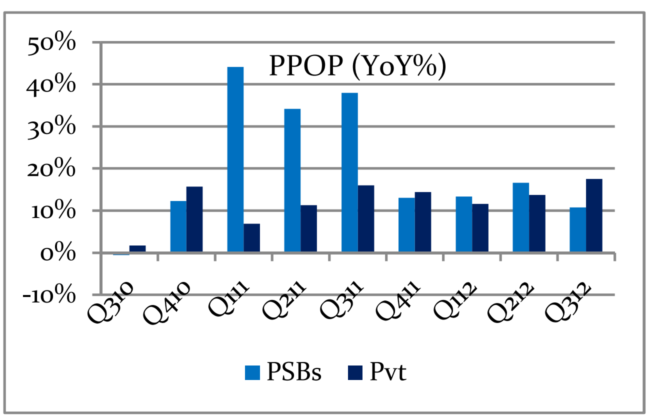


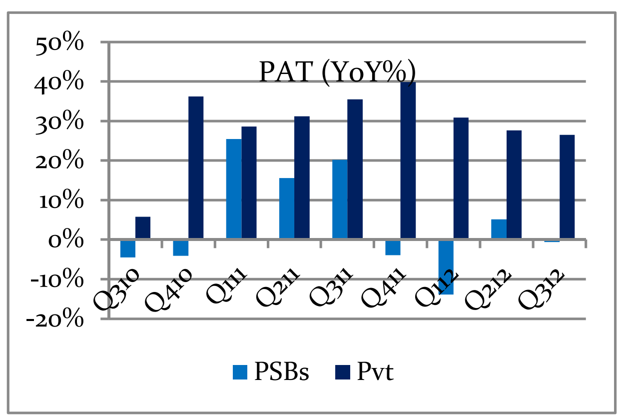
Pvt. Banks outperform PSBs on bottom-line front as provisions key differentiator…

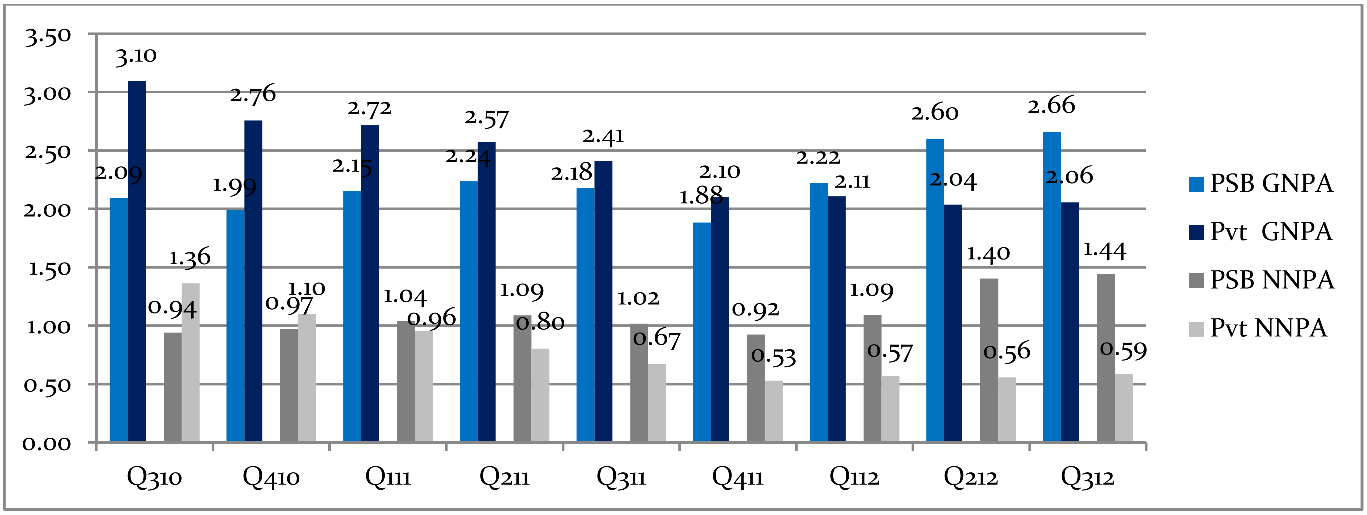












View:

We continue to remain overweight on the sector as we expect the downward shift in policy rates in the months ahead to bring major relief for the sector which has been under significant pressure in terms of cost of funds, weakening credit demand and deteriorating asset quality. The central bank is expected to further reduce CRR at its Mar15 meet which should ease liquidity in the system and reduce the pressure on banks to offer high yielding deposits rates. Thus NIMs are expected to improve going forward as banks would begin to cut deposit rate at much faster pace than lower lending rates.

We believe asset quality pressures seems to be on its last leg and hence provisioning burden on the sector, especially PSBs is likely to moderate going forward. The government's focus on reviving the power and aviation sector which are amongst key problem areas bode well for the sector. Bankers focus and confidence on boosting recoveries also provides comfort of NPAs issue remaining within reach.

We believe the declining trend in NII and PAT growth to be bottoming out and expect credit demand to pick up as economic activity and business sentiment revives with interest rates moving lower in the quarters ahead.

Overall the expected revival in core lending activity, deceleration in cost of funds and asset quality concerns besides valuations still in attractive zone, makes the sector a strong bet. Maintain overweight on the sector.

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RATINGS

Buy	Accumulate	Neutral	Reduce	Sell
>15%	+5>15%	+5%/-5%	-5%<-15%	>-15%

Research:

Swati Hotkar	Technical	91 22 421 20 938
Avdhut Bagkar	Technical	91 22 421 20 926
Hedley Albuquerque	Fundamental	91 22 421 20 934

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