

PSU Banks: Time is Ripe .....Our Pick is SBI & BOB

# Current state in PSU Bank: Its in a messy affair ...



Concerns	Economic	Political	Skill set
Asset quality	✓	✓	✓
Cost structure	✓	✓	
Management vacuum		✓	
Capital	✓		

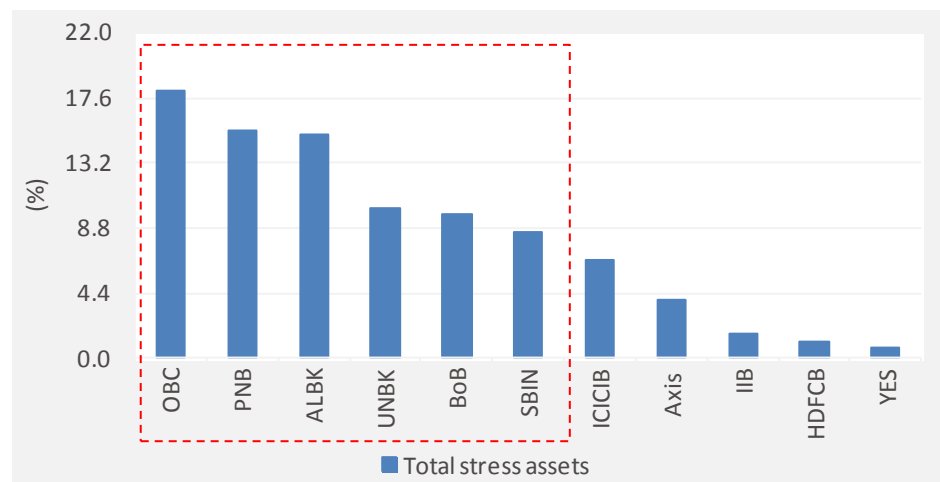
PSU banks have been marred by 4 critical problems viz., higher stress baggage, higher cost structure, capital requirement and management vacuum

A large part of problems driven by external constraints. Only once these get addressed will PSU banks be in a position to address internal weaknesses impeding competitiveness

Largely resultant of external constraints

Addressing these issue will be critical to restore competitiveness of PSU banks and pave the way for structural long-term improvement in banks' operational performance

## Asset quality concerns loom large on PSU banks...



Source: Company, Edelweiss research

## ... PSU banks running at higher opex growth

5-year CAGR growth	SOE banks	Private banks
Employee	4.2	13.7
Branches	7.2	25.2
Staff cost	17.9	21.4
Other opex	18.1	11.2
Operating expenses	18.0	14.5



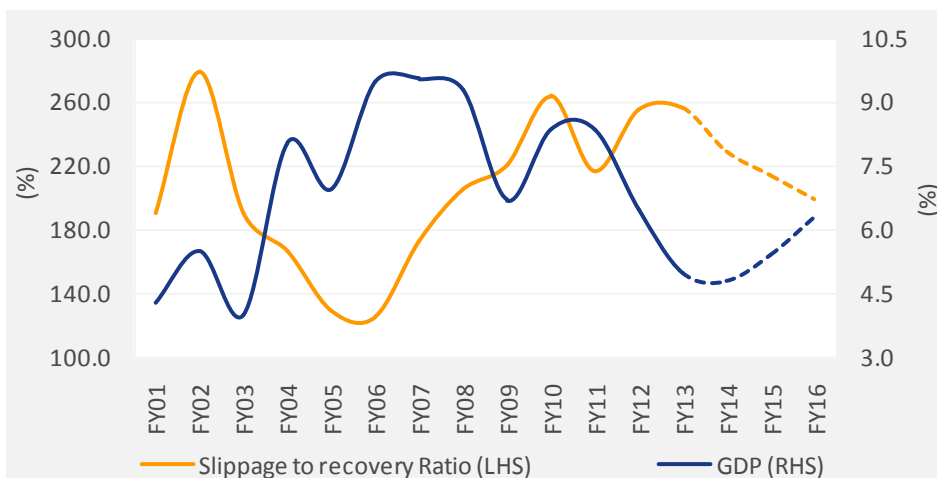
- **RBI moves on improving asset quality:**

- Introduction of **"5:25 structure"** : Able to extend finance to such projects without getting adversely impacted by asset-liability management (ALM) issues
- Tighter leash on willful/non-cooperative defaulters

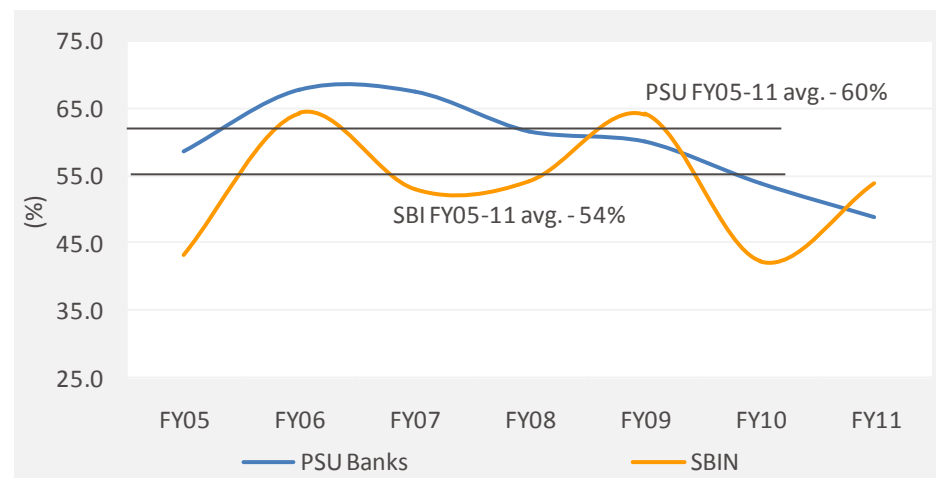
- **Recent announcements of various corporate to sell non-core assets to deleverage balance sheets: Recently Jaypee and Lanco has sold assets worth ~INR 23,000cr.**

**Economic revival to aid the cause:** There's strong correlation between slippages and GDP growth—with likely economic recovery, slippages should ease. Recoveries retracing to near historical average can significantly aid profitability of SoE banks as they are sitting on a large accumulated slippage pool.

**Likely economic recovery, slippages should ease and recoveries should pick up**



**Reversal of recovery rates to historical averages can aid profitability of SOE banks**





**Earnings upgrade imminent:** Structural changes, supported by improving macros, will fire rating upgrades engine

**We envisage earnings revision of over 5-15% for large PSU banks (and thus stand higher than Street estimate by 9-11%)**

- **Asset quality:** Streamlined board practices and improving macros will aid asset quality improvement—we expect 15-20% earnings benefit on this front

Net-net, we expect RoE to improve to respectable levels and significantly narrow the gap with private players

**RoE improvement to play out better than earlier envisaged ...**

INRbn	Edelweiss estimates		Consensus estimates		Difference (%)		EPS (CAGR) (FY15-FY17)	RoE (%)	
	FY16E	FY17E	FY16E	FY17E	FY16E	FY17E		FY15E	FY17E
ALBK	14.0	18.0	11.7	14.9	20.0	21.2	47.6	7.4	13.7
BoB	61.7	76.4	55.8	70.2	10.5	8.8	38.5	10.6	16.2
OBC	17.0	18.9	14.8	18.5	15.2	2.2	53.2	6.2	12.3
PNB	57.5	68.9	49.5	62.6	16.4	10.1	31.5	11.1	15.2
SBIN	193.8	244.3	173.5	220.2	11.7	11.0	29.7	11.7	15.6
UNBK	25.9	30.3	24.7	30.9	5.2	(2.1)	21.9	11.5	14.0

Source: Edelweiss research

**... with cost and asset quality a major delta**

(%)	FY15E	FY17E
Net interest income/Assets	2.6	2.7
Fees/Assets	0.8	0.8
Investment profits/Assets	0.2	0.1
Net revenues/Assets	3.5	3.6
Operating expense/Assets	(1.7)	(1.6)
Provisions/Assets	(1.0)	(0.8)
Taxes/Assets	(0.3)	(0.3)
Total costs/Assets	(3.0)	(2.8)
ROA	0.6	0.8
Equity/Assets	5.8	5.6
ROAE	9.7	14.5



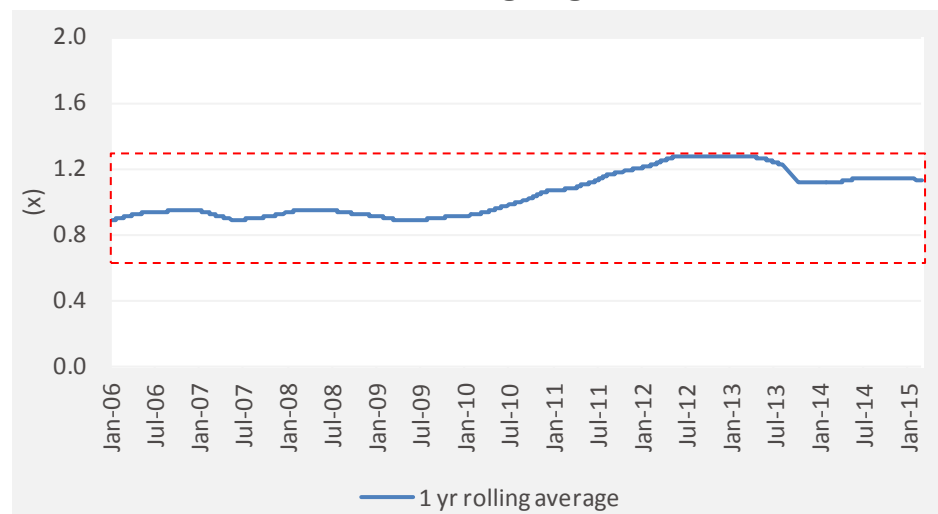
**Valuation: Set to re-rate**



## Foundation being laid for an efficient and focused PSU banks' structure

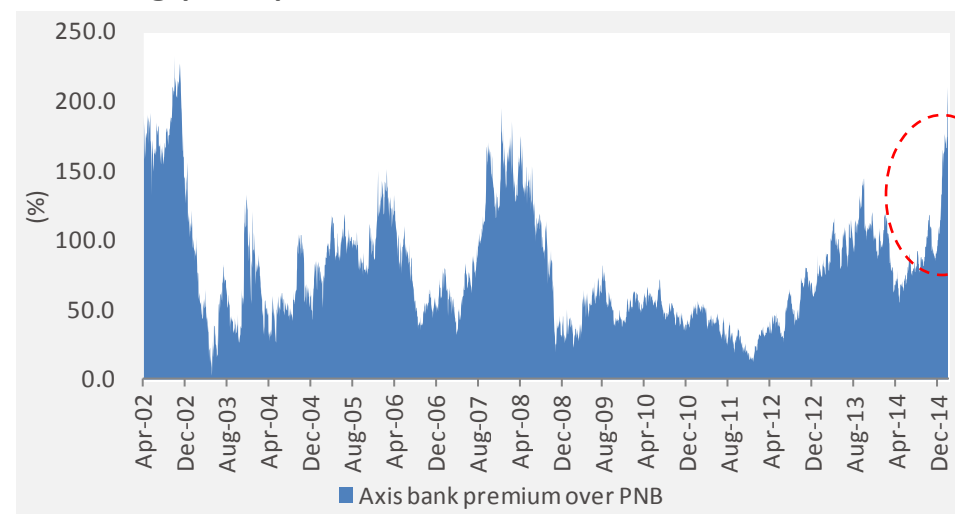
- A multi-tiered, capital-efficient structure will evolve with a few larger banks leading the pack and mid-sized banks focusing on different niches. The government will aid larger banks to build scale
- Time is ripe to look at large PSU banks as structural long-term plays—**they will breach the historical trading range and narrow the gap with private players. Increase weight on SBI and BoB**
- At the same time, be **cautious on smaller PSU banks** for which consolidation is likely take longer till they find their niche
- In light of our stance, we recommend '**BUY**' on **SBI and BOB**.

## SOE banks to breach historical trading range



Source: Bloomberg, Edelweiss research

## Valuation gap with private banks to narrow with structural reforms





State Bank of India is our preferred bet within the SOE space. The rationale for the same stems from it being **a cyclical as well a structural play**

**Superior liability franchise:** SBI Group has the best franchise garnering 30% of the industry's SA with just 24% of the industry's branches. Further, the productivity in garnering deposits reflected in CA/branch and SA/branch is also substantially higher even compared to private peers

Private banks' network expansion aggression has failed to dent SBI's market share

**Best placed to capture economic recovery:** Within SOE banks, given large stress assets recognition done through the NPA route, SBI has maximum upside potential to EPS. Also, its stressed assets (NNPA+Restructured) are the lowest

Continuity in current top management provides comfort

Operating leverage benefits to kick in as staff cost rationalisation is underway

Well placed on capital requirements – dilution of 10% of NW till FY19 against SOE peers' 30-40% average

Subsidiaries	Method	(INR mn)	PB/PE (x)	Value (INR mn)	Stake (%)	Value-SBI (INR mn)	Per share (INR)
Banking business (A)	P/ABV (x)	1,774,245	1.5	2,661,367		2,661,367	356
<b>Subs</b>							
Asset management	% of AUMs	850,000	5.0	42,500	63.0	26,775	4
Life insurance	Appraisal value (xNBAP)	87,488	1.9	166,402	74.0	123,137	16
SBI capital market	P/E	3,906	14.0	54,684	100.0	54,684	7
<b>Value of subs (B)</b>				<b>263,586</b>		<b>204,596</b>	<b>27</b>
Value of subs (at 15% holding co discount)							23
<b>Value per share (INR) (A+B)</b>							<b>380</b>

# Financials: Income statement



Income statement		(INR mn)			
Year to March	FY14	FY15E	FY16E	FY17E	
Interest income	1,363,508	1,506,100	1,678,582	1,935,912	
Interest expenses	870,686	950,328	1,042,400	1,193,825	
Net interest income	492,822	555,772	636,182	742,087	
Non interest income	185,529	210,770	230,889	256,456	
- Fee & forex income	145,066	166,660	188,776	211,165	
- Misc. income	18,056	19,109	22,113	25,291	
- Investment profits	22,408	25,000	20,000	20,000	
Net revenues	678,351	766,542	867,071	998,542	
Operating expense	357,259	377,099	403,047	444,500	
- Employee exp	225,043	236,210	241,905	260,494	
- Other opex	132,216	140,889	161,142	184,006	
Preprovision profit	321,092	389,443	464,024	554,042	
Provisions	159,354	181,883	179,040	194,739	
- Loan loss provisions	142,236	154,883	161,040	176,739	
- Investment depreciation	5,633	3,000	3,000	3,000	
- Other provisions	11,485	24,000	15,000	15,000	
PBT	161,739	207,560	284,984	359,303	
Taxes	52,827	62,268	91,195	114,977	
PAT	108,912	145,292	193,789	244,326	
EPS	14.6	19.5	26.0	32.7	
DPS	3.0	3.5	3.5	3.5	
Payout ratio (%)	23.0	20.8	15.6	12.3	

Growth ratios (%)					
Year to March	FY14	FY15E	FY16E	FY17E	
NII growth	11.2	12.8	14.5	16.6	
Fees growth	10.1	14.9	13.3	11.9	
Opex growth	22.0	5.6	6.9	10.3	
PPOP growth	(0.5)	22.0	21.8	20.3	
PPP growth	3.3	21.3	19.2	19.4	
Provisions growth	33.5	8.9	4.0	9.7	
PAT growth	(22.8)	33.4	33.4	26.1	

Operating ratios (%)					
Year to March	FY14	FY15E	FY16E	FY17E	
Yield on advances	9.1	8.9	8.9	9.0	
Yield on investments	8.8	8.4	8.1	8.0	
Yield on assets	8.4	8.3	8.3	8.3	
Net interest margins	3.0	3.05	3.14	3.19	
Cost of funds	5.5	5.4	5.4	5.4	
Cost of deposits	6.0	5.8	5.7	5.7	
Cost of borrowings	5.2	5.1	5.0	4.9	
Spread	2.8	2.8	2.9	3.0	
Cost-income	52.7	49.2	46.5	44.5	
Tax rate	32.7	30.0	32.0	32.0	



# Financials: Balance sheet



Balance sheet				(INR mn)
Year to March	FY14	FY15E	FY16E	FY17E
<b>Liabilities</b>				
Equity capital	7,466	7,466	7,466	7,466
Reserves	1,175,357	1,290,482	1,454,104	1,668,263
<b>Net worth</b>	<b>1,182,823</b>	<b>1,297,947</b>	<b>1,461,569</b>	<b>1,675,729</b>
Sub bonds/pref cap	388,364	416,364	444,364	472,364
Deposits	13,944,085	15,177,000	17,226,742	20,134,975
Borrowings	1,442,945	1,672,945	1,902,945	2,132,945
Other liabilities	935,751	975,828	1,050,353	1,155,942
<b>Total</b>	<b>17,893,968</b>	<b>19,540,084</b>	<b>22,085,974</b>	<b>25,571,955</b>
<b>Assets</b>				
Loans	12,098,287	13,429,099	15,376,333	17,992,082
<b>Investments</b>			<i>0.13</i>	<i>0.16</i>
<i>Gilts</i>	<i>3,081,988</i>	<i>3,632,848</i>	<i>4,124,361</i>	<i>4,800,963</i>
<i>Others</i>	<i>901,094</i>	<i>796,177</i>	<i>706,310</i>	<i>629,415</i>
Cash & equi	1,325,496	1,154,703	1,310,785	1,529,106
Fixed assets	80,022	99,470	117,419	133,868
Other assets	407,081	427,787	450,767	486,520
<b>Total</b>	<b>17,893,968</b>	<b>19,540,084</b>	<b>22,085,974</b>	<b>25,571,955</b>
<b>Balance sheet ratios (%)</b>				
Credit growth	15.0	10.4	14.0	16.6
Deposit growth	15.9	8.8	13.5	16.9
EA growth	15.2	9.2	13.2	16.0
SLR ratio	20.0	22.0	22.0	22.0
C-D ratio	88.7	89.9	90.3	90.1
Low-cost deposits	42.9	43.5	44.2	44.2
Gross NPA ratio	5.0	5.0	4.5	3.6
Net NPA ratio	2.3	2.6	2.1	1.5
Provision coverage	54.4	48.8	53.9	60.6
Incremental slippage	3.9	3.4	2.9	2.5
Book value	188	207	234	269

ROA decomposition (%)				
Year to March	FY14	FY15E	FY16E	FY17E
Net interest income/Assets	3.03	3.05	3.14	3.19
Fees/Assets	1.0	1.0	1.0	1.0
Investment profits/Assets	0.1	0.1	0.1	0.1
Net revenues/Assets	4.2	4.2	4.3	4.3
Operating expense/Assets	(2.2)	(2.1)	(2.0)	(1.9)
Provisions/Assets	(1.0)	(1.0)	(0.9)	(0.8)
Taxes/Assets	(0.3)	(0.3)	(0.5)	(0.5)
Total costs/Assets	(3.5)	(3.4)	(3.3)	(3.2)
ROA	0.7	0.8	1.0	1.1
Equity/Assets	6.7	6.8	6.8	6.8
ROAE	10.0	11.7	14.0	15.6

Valuation metrics				
Year to March	FY14	FY15E	FY16E	FY17E
Diluted EPS (INR)	14.6	19.5	26.0	32.7
<i>EPS growth (%)</i>	<i>(29.3)</i>	<i>33.4</i>	<i>33.4</i>	<i>26.1</i>
Book value per share (INR)	188	207	234	269
Adjusted book value/share (INR)	154	167	197	238
Diluted P/E (x)	19.5	14.7	11.0	8.7
Price/ BV (x)	1.5	1.4	1.2	1.1
Price/ ABV (x)	1.8	1.7	1.5	1.2



BoB has been build on a foundation of efficient structure and focused approach. Government initiatives for structural reforms will further strengthen its franchise with more professional management at the helm

It is our preferred pick amongst SOE banks owing to its superior asset quality performance, healthy wage/pension provisioning cushion and higher capitalisation level

- While higher capital requirement over next 3-4 years will be a challenge, BoB can comfortably grow at 18-20% for 2 years without raising equity. Moreover, dilution requirement till FY19 to meet Basel III norms will be sub-10% for the bank compared to >40% for peers
- **Efficient cost structure:** Cost-to-income at 40-43% compared to between 45% and 50% for peers. Provided adequately for wage provision at ~15% and remains unaffected by the recent wage settlement
- Better positioned among SOE banks with presence in lucrative regions of Western India and stringent risk management practices. Defying macro challenges, BoB reports superior asset quality with relatively lower stressed asset baggage (GNPL plus restructured book) at ~9%

No let up on building liability franchise—relatively more aggressive in branch expansion (>30% of existing branches added in past 3 years). Also figures among the most granular profiles (top-20 depositors constitute 8% of overall deposits)

The stock is trading at 0.8x FY17E P/ABV.'

## Financials

Year to March	FY14	FY15E	FY16E	FY17E
Net revenues (INR mn)	164,281	181,227	214,469	246,559
Net rev growth (%)	9.9	10.3	18.3	15.0
Net profit (INR mn)	45,411	39,856	61,702	76,422
Shares outstanding (mn)	431	431	431	431
Diluted EPS (INR)	21.1	18.5	28.7	35.5
EPS growth (%)	(0.6)	(12.2)	54.8	23.9
Diluted P/E (x)	8.4	9.6	6.2	5.0
Price to adj book (x)	1.2	1.2	1.0	0.8
ROAE (%)	13.6	10.6	14.9	16.2

# Financials: Income statement



Income statement		(INR mn)			
Year to March	FY14	FY15E	FY16E	FY17E	
Interest income	389,397	446,222	504,433	577,074	
Interest expenses	269,744	311,542	346,478	394,597	
Net Interest income	119,653	134,680	157,954	182,477	
Non interest income	44,628	46,546	56,514	64,082	
- Fee & forex income	24,765	27,241	31,872	37,290	
- Misc. income	12,423	12,805	15,642	17,792	
- Investment profits	7,440	6,500	9,000	9,000	
Net revenues	164,281	181,227	214,469	246,559	
Operating expense	71,371	83,554	90,923	101,790	
- Employee exp	41,397	49,696	49,063	52,827	
- Other opex	29,974	33,858	41,860	48,964	
Preprovision profit	92,910	97,673	123,546	144,769	
Provisions	37,937	37,285	39,022	40,081	
- Loan loss provisions	29,352	40,285	37,822	38,881	
- Investment depreciation	1,986	(3,500)	700	700	
- Other provisions	6,600	500	500	500	
PBT	54,973	60,388	84,523	104,687	
Taxes	9,562	20,532	22,821	28,266	
PAT	45,411	39,856	61,702	76,422	
Reported PAT	45,411	39,856	61,702	76,422	
EPS	21.1	18.5	28.7	35.5	
DPS	21.5	22.0	23.0	23.0	
Payout ratio (%)	23.9	27.4	18.5	15.0	

## Growth ratios (%)

Year to March	FY14	FY15E	FY16E	FY17E
NII growth	5.7	12.6	17.3	15.5
Fees growth	20.2	10.0	17.0	17.0
Opex growth	20.0	17.1	8.8	12.0
PPOP growth	2.0	6.7	25.6	18.5
PPP growth	3.2	5.1	26.5	17.2
Provisions growth	(9.0)	(1.7)	4.7	2.7
PAT growth	1.3	(12.2)	54.8	23.9

## Operating ratios (%)

Year to March	FY14	FY15E	FY16E	FY17E
Yield on advances	7.7	7.6	7.6	7.6
Yield on investments	7.5	7.3	7.7	7.7
Yield on assets	6.6	6.7	6.9	6.9
Net interest margins	2.0	2.01	2.15	2.18
Cost of funds	4.7	4.8	4.9	4.9
Cost of deposits	4.8	4.9	4.9	4.9
Cost of borrowings	5.5	6.0	6.2	6.4
Spread	1.87	1.84	1.96	1.99
Cost-income	43.4	46.1	42.4	41.3
Tax rate	17.4	34.0	27.0	27.0

# Financials: Balance sheet



Balance sheet				(INR mn)
As on 31st March	FY14	FY15E	FY16E	FY17E
<b>Liabilities</b>				
Equity capital	4,307	4,307	4,307	4,307
Reserves	355,550	384,467	434,733	499,719
Net worth	359,857	388,774	439,040	504,026
Sub bonds/pref cap	114,017	124,017	134,017	144,017
Deposits	5,688,944	6,153,023	6,784,830	7,957,821
Borrowings	254,113	304,513	354,913	405,313
Other liabilities	178,115	127,757	139,785	163,737
<b>Total</b>	<b>6,595,045</b>	<b>7,098,085</b>	<b>7,852,585</b>	<b>9,174,914</b>
<b>Assets</b>				
Loans	3,970,058	4,208,262	4,881,583	5,711,453
Investments				
Gilts	967,810	1,485,246	1,427,961	1,672,640
Others	193,316	216,305	241,923	270,517
Cash & equi	1,308,779	1,067,166	1,169,734	1,370,584
Fixed assets	27,341	29,482	31,132	32,292
Other assets	127,740	91,625	100,251	117,429
<b>Total</b>	<b>6,595,045</b>	<b>7,098,085</b>	<b>7,852,585</b>	<b>9,174,914</b>
<b>Balance sheet ratios (%)</b>				
Credit growth	22.2	6.2	16.0	17.0
Deposit growth	20.0	8.2	10.3	17.3
EA growth	20.4	8.3	10.7	16.9
SLR ratio	16.3	23.0	20.0	20.0
C-D ratio	71.4	70.1	73.7	73.5
Low-cost deposits	25.7	26.1	26.5	26.9
Gross NPA ratio	3.0	4.0	3.5	2.7
Net NPA ratio	1.5	2.2	1.7	1.0
Provision coverage	49.2	46.6	51.6	62.0
Incremental slippage	2.1	2.4	1.8	1.6
Net NPA / Equity	16.8	23.5	19.2	11.9
Book value	167.1	180.5	203.9	234.1

ROA decomposition (%)				
Year to March	FY14	FY15E	FY16E	FY17E
Net interest income/Assets	2.0	2.0	2.1	2.2
Fees/Assets	0.6	0.6	0.6	0.7
Investment profits/Assets	0.1	0.1	0.1	0.1
Net revenues/Assets	2.8	2.7	2.9	2.9
Operating expense/Assets	(1.2)	(1.2)	(1.2)	(1.2)
Provisions/Assets	(0.6)	(0.6)	(0.5)	(0.5)
Taxes/Assets	(0.2)	(0.3)	(0.3)	(0.3)
Total costs/Assets	(2.0)	(2.1)	(2.1)	(2.0)
ROA	0.8	0.6	0.8	0.9
Equity/Assets	5.7	5.6	5.6	5.6
ROAE	13.6	10.6	14.9	16.2

Valuation metrics				
Year to March	FY14	FY15E	FY16E	FY17E
EPS (INR)	21.1	18.5	28.7	35.5
EPS growth (%)	(0.6)	(12.2)	54.8	23.9
Book value per share (INR)	167	181	204	234
Adjusted book value/share (INR)	147	151	176	215
Price/Earnings (x)	8.4	9.6	6.2	5.0
Price/ BV (x)	1.1	1.0	0.9	0.8
Price/ ABV (x)	1.2	1.2	1.0	0.8



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