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Global Markets Research

ANCHOR REPORT

India financials: In for the long haul

Expect more re-rating and importantly, an earnings revival in FY16F

8 July 2014

Research analysts

India Financials

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We resume coverage on India financials with a sanguine view. The new government's decisive mandate under Prime Minister Modi should help address key asset quality concerns. A large part of the stress in non-infrastructure corporate exposure has been recognised already and a faster, more decisive policy framework should help restart stalled infrastructure projects. While hopes of reforms have been priced in over the last six months, we expect earnings upgrades and a compounding cycle to provide more upside.

Axis and ICICI are our top picks: their granular balance sheets and higher profitability should drive multiples higher as asset quality concerns ease. Our other preferred names are HDFCB and BOB.

Key analysis in this report includes:

- Detailed study of the corporate credit cycle – infra and non-infra assets.
- Earnings drivers over the next two to three years.
- Company reports for 16 stocks on which we either resume or initiate coverage.

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

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India financials

EQUITY: FINANCIALS

In for the long haul

Expect more re-rating and importantly, an earnings revival in FY16F

Action: Expect a gradual recovery; Axis/ICICI are our top picks

We resume coverage on India financials with a sanguine view as a historic mandate to the NDA should lead to positive outcomes on the macros. While FY15F earnings trajectory is still likely to be challenged, we expect stability in asset quality in the next two quarters and a strong earnings rebound from FY16F (+20% CAGR over FY16/17F). Our top picks are names where we still see scope for material mean reversion in valuations over the next 2-3 years as concerns on asset quality ebb (Axis/ICICI/BOB) and names where earnings is structural and leveraged to an upswing (HDFCB). NBFCs have not been that challenged on asset quality (except CVs) but current valuations are largely not enticing enough to play for uncertain and back-ended rate cuts, in our view.

Catalyst: Gradual credit cycle recovery and consequent earnings pick-up

- **What drives our comfort on asset quality: (1)** On the non-infrastructure corporate book, ~60% of stressed assets are from 5-6 sectors where weaker companies have been recognised as stressed (15-20% sector exposure is NPA/restructured) and we see lower incremental stress. **(2)** On the infrastructure book, most issues seem addressable in a time-sensitive manner by a pro-growth administration except for pockets like gas power – *we expect system delinquencies to come off to 2.3% from +4% in the next 2-3 years; however, the credit recovery may take longer than in the previous cycle, given issues with long gestation assets in this cycle*.
- **Earnings cycle:** We expect sector earnings growth to pick up from ~7% in FY13/14 to +20% in FY16F. While private banks should continue their secular earnings growth, certainty of EPS growth for Axis/ICICI will increase considerably, in our view. PSU banks' PAT is likely to double in the next three years but ROEs in a few cases will likely remain below cost of equity (CoE). We prefer PSUs where ROEs would revert to above CoEs (SBI/BOB).

Valuations: Big mean reversion behind, some more to go

(1) Axis/ICICI's valuations are ~15-20% off vs. their FY04-07 levels – growth will be slower than in the previous cycle but a more granular balance sheet and higher RORWAs imply higher multiples as credit concerns ease; **(2) retail banks** have only just got re-rated and hence returns are likely to mirror earnings growth (~20% CAGR for 3 years); **(3) PSUs'** valuations are now off by only ~20-30% vs. FY04-07 multiples; ROEs are likely to be lower structurally even factoring in a recovery so comparison to peak multiples is unjustified – we prefer better underwriters **(BOB).**

Fig. 1: India financials: Our top picks

Expect further re-rating in Axis/ICICI/BOB; HDFCB is our preferred defensive for earnings compounding

					P/B (x)		P/E (x)	ROE			3M Avg.
	Price	Rating	PT	Upside	FY15F	FY16F	FY16F	FY15F	FY16F	Mcap (USDmn)	DTV (USDmn)
Axis	1,926	BUY	2,300	19%	2.06	1.78	10.9	17.0%	17.5%	15,514	42.0
HDFCB	837	BUY	950	14%	3.97	3.36	16.4	21.5%	21.8%	34,440	32.8
ICICI	1,463	BUY	1,650	13%	2.06	1.82	10.8	14.0%	15.1%	28,907	81.7
BOB	876	BUY	1,025	17%	1.04	0.92	6.0	13.6%	15.5%	6,430	30.1

Source: Company data, Nomura estimates

Global Markets Research

8 July 2014

Anchor themes

Reforms by the new government will drive asset quality improvement over the next 2-3 years. Axis and ICICI are best leveraged to an upcycle and we expect further re-rating as credit concerns ease.

Nomura vs consensus

Our FY15/16F earnings estimates are largely in line with consensus. The certainty of our earnings estimates for corporate banks has increased.

Research analysts

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Contents

Our sector view in charts

Fig. 2: Valuations have mean-reverted – we expect a gradual/steady recovery and hence remain sanguine on the sector

Current valuations for corporate banks are at ~15-30% discount to FY04-07 multiples; our top picks Axis/ICICI are ~15-25% below FY04-07 multiples

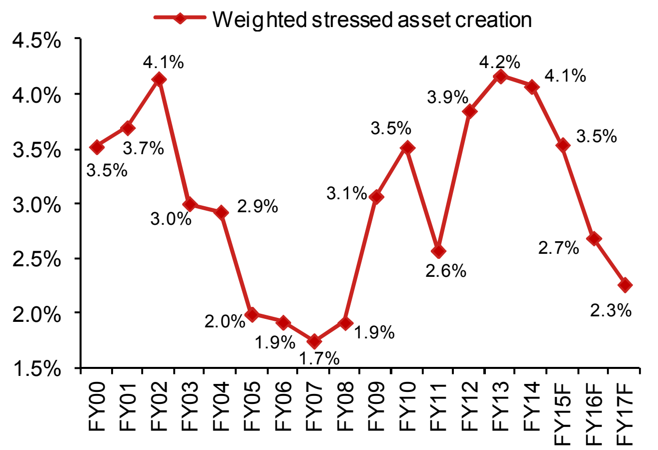
Private Banks	**Axis**	**ICICIBC**	**Yes Bank**	**IndusInd**	**KMB**	**HDFCB**	**HDFC**	**LICHF**
Avg. from 2004	2.03	1.79	NA	1.94	2.59	3.39	4.52	1.42
Pre 2004	1.35	1.44	NA	1.26	1.24	2.54	3.57	1.48
2004-2007	2.38	2.08	3.20	1.70	2.70	3.70	4.75	1.07
2009-2011	2.23	1.80	2.13	2.13	2.59	3.37	4.74	1.89
From 2011 onwards	1.67	1.69	1.97	2.39	2.76	3.50	4.49	1.70
Sep-13 1-yr Frd	**1.11**	**1.39**	**1.24**	**2.19**	**2.76**	**3.21**	**4.10**	**1.13**
Mar-16 book Vals	**1.78**	**1.82**	**1.78**	**2.53**	**2.87**	**3.36**	**4.40**	**1.62**
% mean revertion	**60%**	**31%**	**44%**	**16%**	**4%**	**5%**	**7%**	**44%**
% discount v/s 04-07 cycle	**-25%**	**-12%**	**-44%**	**48%**	**6%**	**-9%**	**-7%**	**52%**

PSBs & NBFCs	**SBI**	**BOB**	**PNB**	**BOI**	**UNBK**	**SHTF**	**MMFS**	**IDFC**
Avg. from 2004	1.26	1.03	1.23	1.07	1.12	1.87	NA	NA
Pre 2004	0.76	0.89	0.97	0.64	0.86	1.08	NA	NA
2004-2007	1.16	1.00	1.40	1.13	1.25	1.68	1.90	2.59
2009-2011	1.64	1.25	1.49	1.31	1.38	2.36	1.86	2.03
From 2011 onwards	1.24	1.03	1.03	0.93	0.93	1.95	2.27	1.41
Sep-13 1-yr Frd	0.88	0.62	0.53	0.43	0.47	1.44	2.74	0.86
Mar-16 book Vals	**1.19**	**0.92**	**0.93**	**0.72**	**0.82**	**1.94**	**2.13**	**1.14**
% mean revertion	**36%**	**49%**	**77%**	**68%**	**75%**	**35%**	**-22%**	**33%**
% discount v/s 04-07 cycle	**3%**	**-8%**	**-33%**	**-36%**	**-34%**	**16%**	**12%**	**-56%**

Source: Company data, Bloomberg, Nomura estimates

Fig. 3: Expect stress accretion to come off by 40% in 3 years

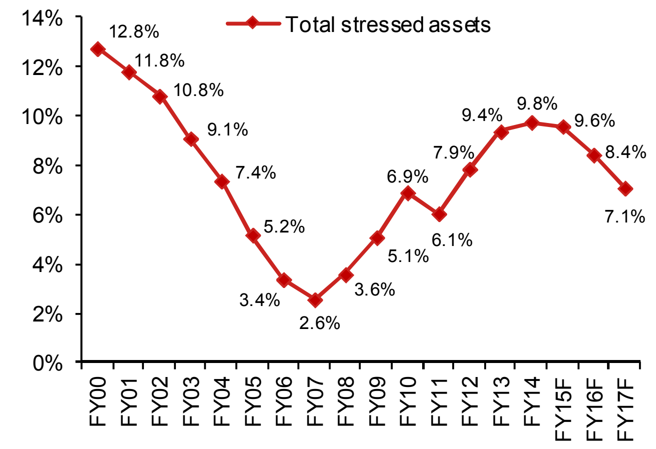
Incremental restructuring + 40% of Incremental restructuring (% of loans)



Source: RBI, Nomura estimates

Fig. 4: Stress asset stock to also reduce by ~30% by FY17F

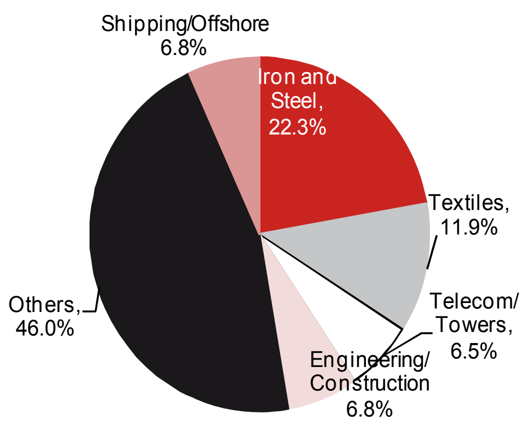
Gross NPAs + Restructured assets (% of loans)



Source: RBI, Nomura estimates

Fig. 5: What drives our comfort - 5-6 sectors contributed ~60% of the non-infra stress- FY14

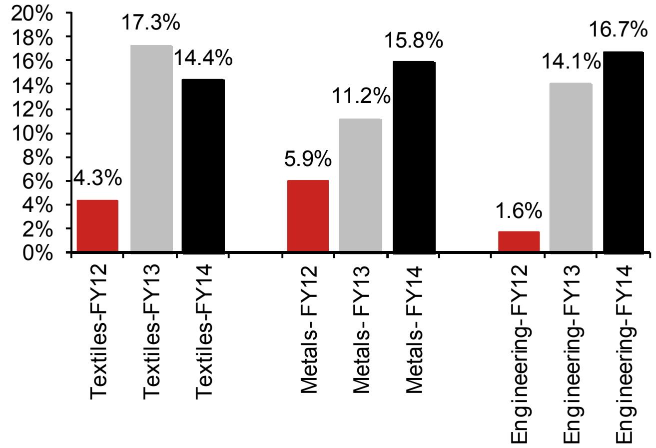
% of segmental contribution to total system CDR referral and SBI NPAs



Source: Company data, Nomura research

Fig. 6: Most weak names have been recognised as stressed and macro improvement will aid incremental performance

% of segmental exposure either declared NPA or restructured (SBI)



Source: Company data, Nomura research

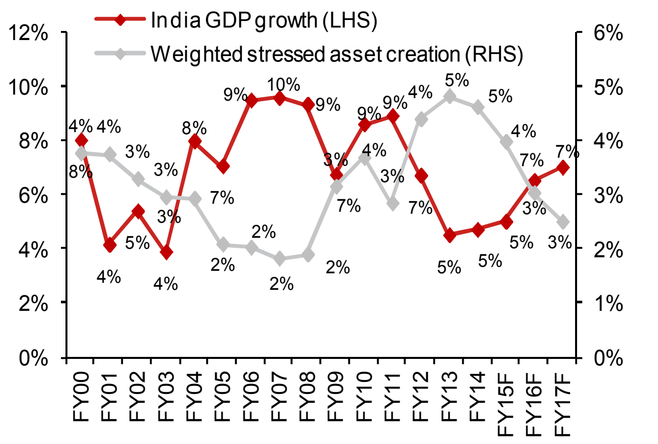
Fig. 7: What drives our comfort - On infra - most issues seem addressable by a reformist govt. except a few pockets

Over medium to long term most issues seem addressable

Issues with Infra Asset Quality	Ability of New government to deliver (Low or high impact/ Near term or Longer term)
Gas power assets	No Impact
SEB Reforms	High Impact but Long term
Excess Leverage/Equity Raising	High Impact but Long term
Tariff pass through for aggressively bid power plants	High impact and Near term
Environmental/Forest Clearances	High impact and Near to Medium term
Aggressively bid Road projects	Near term impact
Coal/Fuel availability	Medium impact + Near to Medium Term

Source: Nomura research

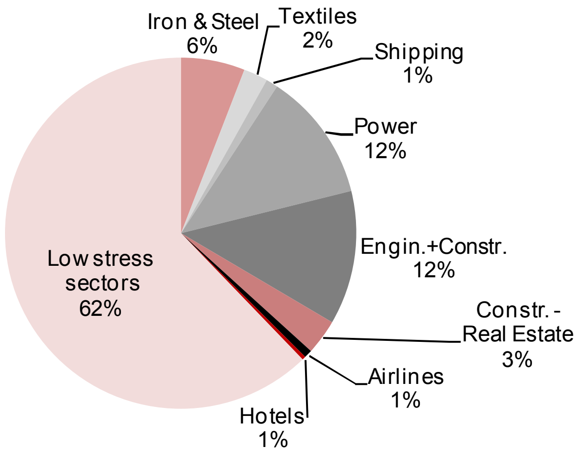
Fig. 8: GDP growth expectations vs. incremental delinquency



Source: Company data, RBI

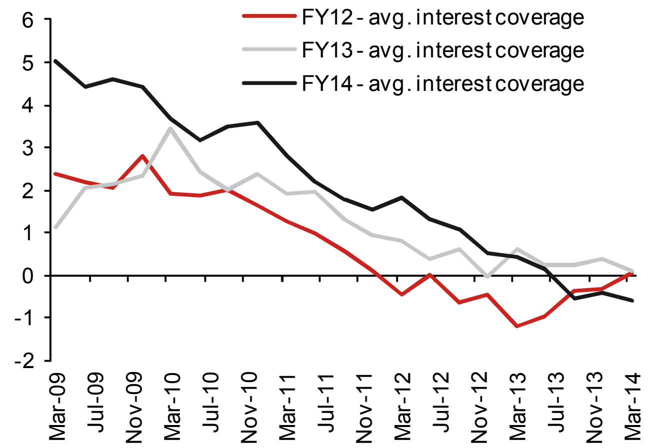
Fig. 9: Caveat on asset quality - Most asset stressed in this cycle is long gestation and hence recovery could take longer than last cycle

Pie-chart of sectors facing stress



Source: RBI, Nomura research

Fig. 10: Caveat on asset quality for PSUs - Restructured accounts coming out of moratorium and their interest coverage performance has been weak



Source: ACE Equities, Nomura estimates

Fig. 11: Our top picks - Looking for some more re-rating and then a compounding earnings cycle

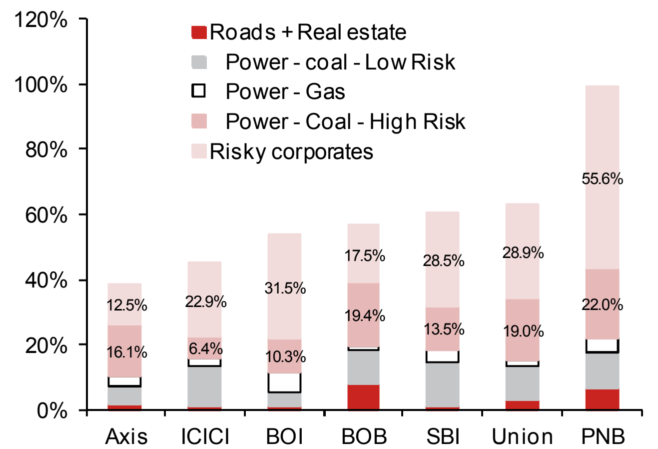
List of our BUYS - Axis/ICICI/HDFCB/BOB are our top BUYs

	Rating	PT	Upside	P/B - FY16F	RoE - FY16F
Axis	BUY	2300	19%	1.78	17.5%
HDFCB	BUY	950	14%	3.36	21.8%
ICICI	BUY	1650	13%	1.82	15.1%
BOB	BUY	1025	17%	0.92	15.5%
IndusInd	BUY	630	10%	2.53	19.1%
Yes	BUY	620	10%	1.78	18.1%
BOB	BUY	1025	17%	0.92	15.5%
BOI	BUY	330	9%	0.72	12.4%
SBI	BUY	3050	13%	1.19	13.3%
LIC housing	BUY	370	14%	1.62	18.7%

Source: Nomura estimates

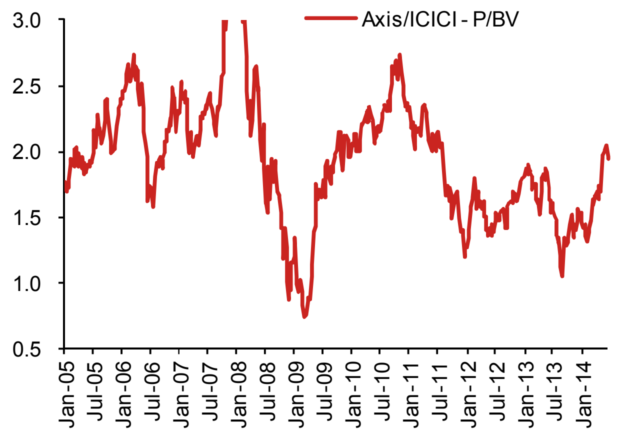
Fig. 12: Choosing better underwriters among corporate banks - Axis/ICICI better even on infra underwriting vs. PSUs

% of exposure to INR4trn of stressed assets we analysed (% of networth)



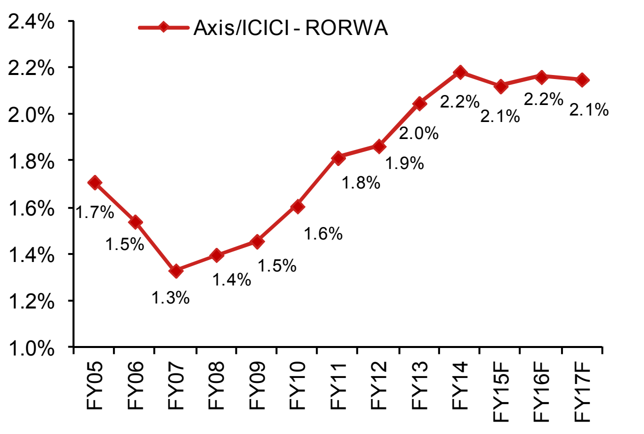
Source: Ministry of corporate affairs, Media sources, Nomura estimates

Fig. 13: Valuations still very comforting for Axis/ICICI even post the recent re-rating…



Source: Company data, Nomura estimates

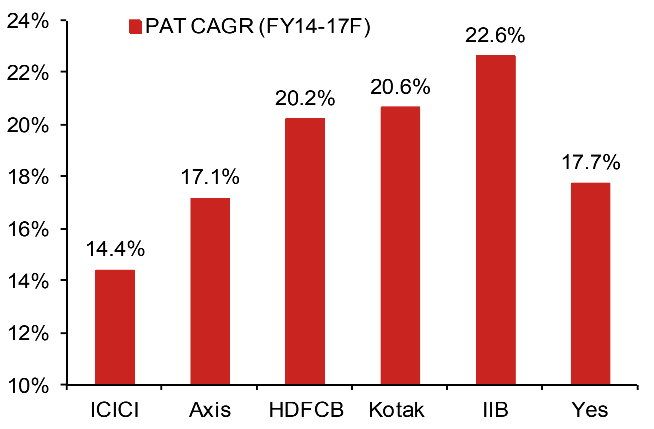
Fig. 14: …especially considering the huge improvement in their return ratios vs. the previous cycle



Source: Company data, Nomura estimates

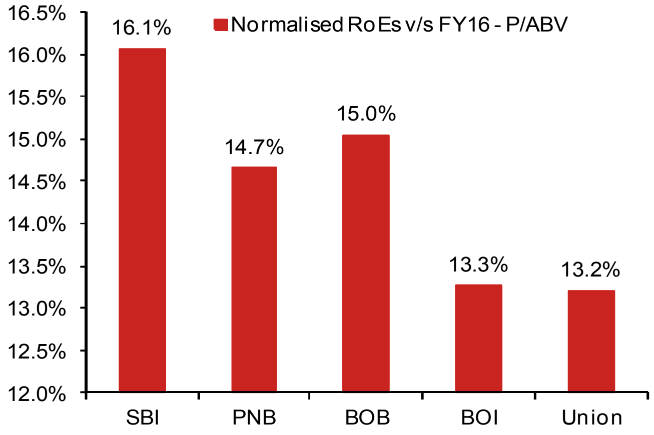
Fig. 15: Retail banks - Their multiples have only expanded in the last 3 years but they remain good compounding stories

We expect +20% EPS CAGR for most retail banks



Source: Nomura estimates

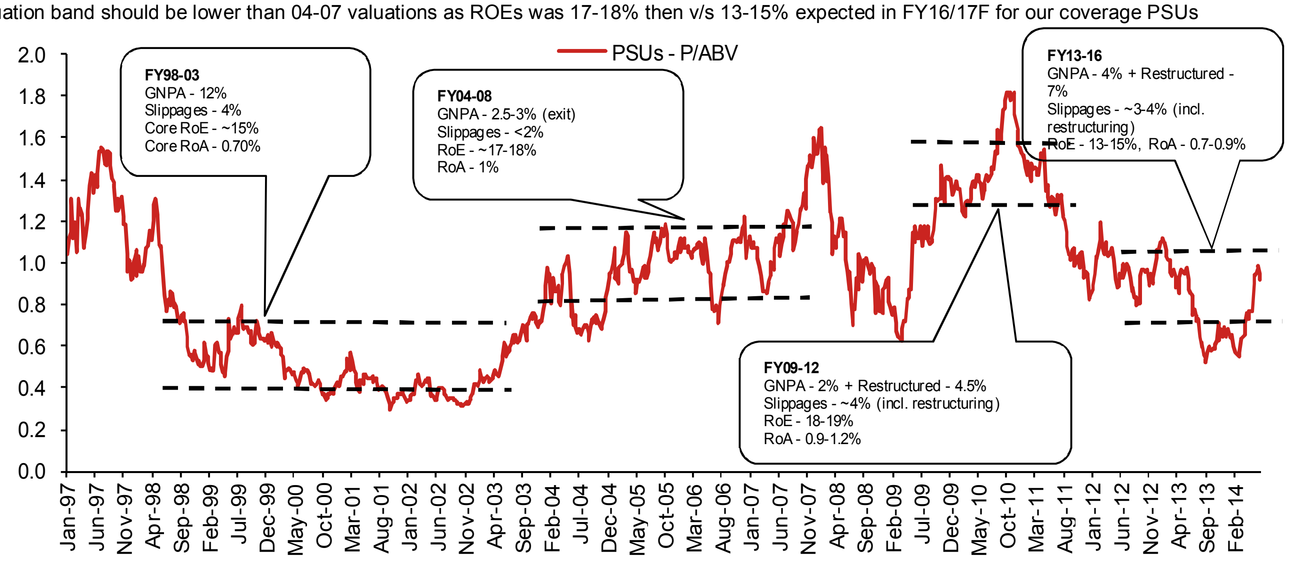
Fig. 16: Within PSUs, we prefer banks with respectable ROEs and relatively better underwriting (ruling out PNB)



Source: Nomura estimates

Fig. 17: PSU banks - ROEs at 13-15% likely to be lower than 17-18% in the previous cycle and hence benchmarking valuations to the previous cycle may not be the right comparison

Valuation band should be lower than 04-07 valuations as ROEs was 17-18% then v/s 13-15% expected in FY16/17F for our coverage PSUs



Source: Bloomberg, company data, Nomura estimates

Executive summary

India financials have mean-reverted meaningfully in the last nine months, firstly driven by stability in the currency, followed by increasing conviction on an NDA government assuming charge and finally the positive surprise of a complete majority for the BJP on its own. While hopes of quick reforms have been priced into India financials, we believe there are pockets of opportunities where valuations will mean-revert further as asset quality concerns ebb but larger upsides will be made over the next 2-3 years in earnings upgrades/compounding. We thus resume coverage on India financials with a sanguine view.

Different risks and hence different drivers for each of the sub-segments: We have summarised the 2 key themes on the cover page: **(1)** corporate credit cycle recovery and (2) earnings revival. As risks and growth drivers are very different for each of the sub-segments in India financials, we summarise our outlook for each of the segments separately below (private corporate banks, private retail banks, PSU banks and NBFCs).

Private corporate banks - Prefer Axis/ICICI – Our top picks

- **Axis/ICICI's underwriting** was much superior on the non-infra corporate book than PSUs and our detailed analysis on large infra SPVs (special purpose vehicles) indicates that Axis/ICICI's exposure was low to infra sub-segments where LGD (loss given default) could be higher.
- Our key highlight for both Axis and ICICI is that they significantly improved the granularity in their balance sheets in the last 4-5 years, especially on liabilities, leading to an improvement in quality of earnings (lower volatility) and quantity as well (ROAs up from 1.2% in FY06-07 to 1.8% currently) - ***we thus believe that Axis/ICICI could trade in line or at higher multiples than in the previous cycle as credit concerns ease.***
- **Yes Bank** is more leveraged to higher growth but as asset quality has not faltered there will not be a meaningful recovery either. Liabilities, though improving, remain inferior to peers and hence, at similar valuations, we prefer Axis/ICICI.

Private retail banks: HDFCB preferred

- Asset quality has only improved for retail banks in the last three years (ex- CVs) and hence risks remain to the downside over the long term. But all three retail banks under our coverage are well managed and remain earnings compounding plays (20% EPS growth over FY14-17F).
- **HDFCB's** profitability remains best in class as it continues to deliver on most underlying metrics (CASA share, RTGS share, asset quality) and its recent under-performance makes valuations relatively more attractive to us. We prefer HDFCB among retail banks as its valuation gap is down to 10-20% vs. peers.

PSU banks: Prefer SBI/BOB, avoid PNB

- We expect a meaningful rebound in earnings for PSU banks over FY14-17F driven largely by asset quality improvement and related improvement in margins. While PAT growth will likely be strong, we expect ROEs for PSU banks to at best touch cost of equity (CoE) as: **(1)** incremental growth will be less profitable; **(2)** leverage ability will be significantly lower than in the previous cycle; and **(3)** structurally they will continue to lose CASA and fee market share.
- We thus prefer corporate private banks over PSU banks – **within PSUs,** we prefer **BOB and SBI**. **BOB's** normalised ROEs look the best and the chairman transition risks seem overplayed to us. Our **Buy on SBI** is driven by our expectation of mean reversion in asset quality issues and a leap of faith on delivery by the current chairman.
- We avoid banks where credit underwriting was weakest in the previous cycle **(PNB).**
- Among capital starved banks, **Union's** recent outperformance already factors in a strong recovery, in our view. While **BOI's** valuations look reasonable still, we will be more comfortable if management slows down on growth.

NBFCs: Mixed bag + valuations not enticing enough

- **HFCs' (HDFC/LICHF)** growth outlook remains robust. Though we are concerned about competition on mortgages, our benign liquidity outlook over the near-to- medium term addresses spread concerns for HFCs – ***we thus like LICHF on a tactical basis. Structurally we prefer HDFCB over HDFC Limited.***
- **Auto Financiers (SHTF/MMFS)** are seeing a cyclical downcycle and monsoon risks could delay the recovery process. Capex cycle improvement will have a larger impact on SHTF but current valuations price in the improvement, in our view. MMFS remains a structural rural story but monsoon risk is not fully priced in, in our view.
- **IDFC** could have been the most obvious beneficiary of this recovery but for its large gas exposure and long-gestation banking foray.

Fig. 18: India Financials – Valuations, TP and upside

						P/B		P/E		P/PPOP			ROE			EPS Growth		
	Price	Mcap ($ mn)	Rating	PT	Upside	FY15F	FY16F	FY15F	FY16F	FY14	FY15F	FY16F	FY14	FY15F	FY16F	FY14	FY15F	FY16F
Axis	1926	15,514	BUY	2300	19%	2.06	1.78	13.0	10.9	7.92	6.98	5.97	17.4%	17.0%	17.5%	19.6%	12.0%	19.3%
HDFCB	837	34,440	BUY	950	14%	3.97	3.36	19.7	16.4	14.03	11.41	9.42	21.3%	21.5%	21.8%	29.9%	20.2%	20.1%
ICICI	1463	28,907	BUY	1650	13%	2.06	1.82	12.9	10.8	10.19	9.11	7.88	14.0%	14.0%	15.1%	17.5%	9.6%	18.8%
Kotak	891	11,737	Neutral	920	3%	3.28	2.87	24.7	20.7	18.23	16.02	13.33	13.7%	13.5%	14.3%	11.3%	16.1%	19.4%
IndusInd	573	5,156	BUY	630	10%	2.98	2.53	17.9	14.4	11.62	9.99	8.25	17.6%	18.0%	19.1%	32.0%	19.4%	24.2%
Yes	563	3,990	BUY	620	10%	2.03	1.78	12.6	10.5	8.68	7.46	6.26	25.0%	19.9%	18.1%	23.7%	-0.5%	20.1%
BOB	876	6,430	BUY	1025	17%	1.04	0.92	7.5	6.0	4.05	3.49	2.86	13.8%	13.6%	15.5%	-0.6%	10.7%	24.3%
BOI	304	3,335	BUY	330	9%	0.81	0.72	6.6	5.7	2.32	2.01	1.74	11.2%	11.7%	12.4%	-7.9%	8.4%	15.2%
PNB	991	6,133	Reduce	925	-7%	1.06	0.93	8.4	6.4	3.15	2.91	2.54	10.2%	11.9%	14.0%	-31.3%	27.1%	32.1%
Union	231	2,486	Neutral	240	4%	0.92	0.82	8.2	7.0	2.79	2.39	2.06	10.4%	10.9%	11.7%	-25.6%	5.0%	16.9%
SBI	2696	34,409	BUY	3050	13%	1.35	1.19	10.5	8.5	4.87	4.13	3.58	10.1%	11.8%	13.3%	-28.8%	33.4%	24.3%
HDFC	1008	27,004	Neutral	1050	4%	4.23	3.70	18.1	15.7	20.95	17.70	15.29	20.5%	21.6%	22.2%	11.2%	17.5%	15.8%
IDFC	133	3,455	Neutral	140	5%	1.23	1.14	10.9	10.2	6.33	6.22	5.95	12.5%	12.1%	11.4%	-2.0%	2.8%	6.7%
LIC housing	324	2,795	BUY	370	14%	1.87	1.62	10.6	9.3	8.85	7.50	6.53	18.8%	19.0%	18.7%	28.7%	17.2%	13.8%
MMFS	274	2,668	Neutral	290	6%	2.44	2.13	14.3	12.4	8.43	7.31	6.19	18.6%	18.2%	18.4%	0.4%	11.9%	15.6%
Shriram	936	3,629	Reduce	880	-6%	2.25	1.94	15.3	12.4	7.43	6.87	5.95	16.3%	15.7%	16.8%	-7.1%	9.7%	23.7%

Source: Company data, Bloomberg, Nomura estimates. Note: Share prices are as of 3 July 2014.

Asset quality: Gradual but steady improvement expected

Economic recovery to aid asset quality – incremental stress accretion to come off from 2H15F and we see material improvement in FY16/17F

The asset quality of India's banks, especially PSUs, have deteriorated over the last four years with a significant contraction in GDP/IIP growth with total stressed assets reaching ~10% of system loans in FY14 with ~4% accretion of bad loans in each of the last three years. Our economic team expects GDP growth rate to improve to ~6-6.5% with meaningful improvement from 2HFY15F. Over the next three years, we forecast NPAs plus restructuring to come down to 7% each by FY17F with incremental accretion coming off to ~2% annual delinquency rate from 4% currently.

What drives our turnaround expectations: 1) Ex-infra, five to six sectors contribute ~60% of the bad loans where already ~15% of the sector loans (inferior business models) have been recognised as NPA/restructured and incremental debt servicing trends for these sectors are stabilizing and hence we are more sanguine on incremental stress accretion on these sectors. 2) On infra, while risks in gas power are likely to continue and the central government will likely have little say in tariff reforms, faster environment/forest clearances, faster decisions on tariff pass through/premium rescheduling, better coal availability and improved ability of developers to de-leverage (asset sales and equity raising) are clear near to medium-term positives expected from the new government.

Quantum and pace of recovery vs last cycle: Corporate health (leverage, interest coverage) is similar to the last cycle, in our view. Based on our observations, the difference in this credit cycle v/s last cycle is that the asset quality issues are in sectors with longer gestation unlike the last cycle (commodity linked) and hence recovery should take a bit longer. Also, treasury income buoyancy is likely to be 10-15% of the last cycle and hence the ability of PSU banks to write off bad loans should be lower and hence credit costs reductions are likely to be more gradual.

Fig. 19: Asset quality – comparison to the last credit cycle- We expect a steady but gradual improvement

	Real GDP	Global GDP	CPI	Repo/ Rev. Repo	SBI base rate	Loan growth	PSU Gross NPAs	PSU Net NPAs	PSU Restrcutured book	Total stresses Assets	PSU Gross Slippages	Annual Net Restructuring	PSU Slippages + Restructuring weighted
FY97	8.0%	4.1%	9.2%		10.8%	14.9%	17.84%	9.18%		17.8%			
FY98	4.3%	2.6%	4.8%		9.8%	11.2%	16.02%	8.15%		16.0%			
FY99	6.7%	3.7%	11.9%		8.8%	16.9%	15.89%	8.13%		15.9%			
FY00	8.0%	4.7%	4.0%	9.1%	8.3%	16.5%	13.98%	7.42%		14.0%	3.76%	0.00%	3.76%
FY01	4.1%	2.3%	1.4%	9.0%	7.3%	21.3%	12.37%	6.74%		12.4%	3.74%	0.00%	3.74%
FY02	5.4%	2.8%	2.5%	8.0%	7.3%	14.6%	11.09%	5.82%		11.1%	3.29%	0.00%	3.29%
FY03	3.9%	3.8%	3.5%	7.0%	6.5%	23.4%	9.36%	4.53%		9.4%	2.95%	0.00%	2.95%
FY04	8.0%	5.1%	3.9%	6.0%	6.0%	13.7%	7.79%	2.99%		7.8%	2.93%	0.00%	2.93%
FY05	7.1%	4.7%	3.1%	6.0%	6.0%	25.4%	5.51%	1.99%		5.5%	2.08%	0.00%	2.08%
FY06	9.5%	5.2%	4.1%	6.5%	6.5%	31.8%	3.64%	1.32%		3.6%	1.66%	0.71%	2.02%
FY07	9.6%	5.3%	7.3%	7.5%	8.0%	30.3%	2.66%	1.05%		2.7%	1.51%	0.62%	1.82%
FY08	9.3%	2.7%	6.9%	7.8%	8.0%	23.6%	2.23%	0.99%	1.24%	3.5%	1.47%	0.86%	1.90%
FY09	6.7%	-0.4%	9.7%	5.0%	8.0%	24.3%	1.98%	0.93%	3.10%	5.1%	1.53%	3.24%	3.15%
FY10	8.6%	5.2%	13.2%	5.0%	7.5%	14.3%	2.19%	1.11%	5.18%	7.4%	1.79%	3.79%	3.68%
FY11	8.9%	3.9%	10.2%	6.8%	8.3%	21.0%	2.22%	1.09%	4.46%	6.7%	1.91%	1.86%	2.84%
FY12	6.7%	3.2%	8.3%	8.5%	10.0%	19.0%	2.93%	1.48%	6.00%	8.9%	2.52%	3.74%	4.39%
FY13	4.5%	3.0%	10.2%	7.5%	9.5%	16.7%	3.49%	1.91%	7.30%	10.8%	2.75%	4.14%	4.82%
FY14	4.7%	3.6%	9.5%	8.0%	10.0%	15.1%	4.03%	2.20%	7.15%	11.2%	2.90%	3.43%	4.62%
FY15F	5.5%	3.9%	7.5%	7.5%	9.5%	14.0%	4.16%	2.16%	6.69%	10.9%	2.50%	2.75%	3.87%
FY16F	6.3%	4.0%				16.0%	4.18%	2.05%	5.35%	9.5%	2.30%	1.25%	2.93%
FY17F	6.8%	3.9%				16.5%	3.91%	1.80%	3.94%	7.9%	1.90%	1.00%	2.40%

Source: RBI, Bloomberg, Nomura estimates

What gives us a comfort of an improvement in Infra and non-Infra asset quality?

Fig. 20: Ex-Infra Asset quality - ~6-7 sectors contribute ~60% of corporate stress - we look for improvements in most of these sectors except for shipping/aviation (as of FY14)

Sector	Contribution to CDR referrals (ex-Infra)	% of SBI's Corporate NPA + Restructuring (ex Infra)	Trend of incremental stress	Comments
Iron and Steel	26%	18.3%	▼	(1) We had seen signifcant deterioration in asset quality for medium and small metal/steel convertors - inferior business/ lack of backward integration/etc (2) But financials of most large metal players have held up well on debt servicing though profitability has moderated in last 2-3 yrs. (3) The smaller/weaker metal companies have already been recognised as NPAs (15-20% of PSU bank's metal exposure is recognised as NPA/restructured) and with large players still comfortable on debt servicing, incremental stress is likely to come off.
Textiles	12%	11.6%	▼	(1) Textiles especially spinning companies has recovered from FY12 shock when cotton prices crashed 40-50% - Sector interest coverage ~2x now (2) Incrementally power situation has improved in Tamilnadu (textile belt in India) and overall competitiveness has improved with china with labour cost/exchange working in India's favour. (3) So largely we expect some improvement in textiles over next 1-2 yrs.
Telecom/ Towers	7%	N/A	▼	(1) Competitive dynamics amongst existing players likely to remain stable, which bodes well for incumbents. However, Reliance-Jio's entry next year remains a key risk. (2) Upcoming spectrum auctions shouldn't lead to strain on cashflows – only ~30% of payments are to be made upfront, while the rest over a 10-year period. (3) Cashflows of larger telecom operators seem comfortable inspite of some inch up in competition expected.
Engineering/ Construction	6%	7.9%	▼	(1) Asset quality issues due to slowdown in execution + large receivables from government + problems with BOT subsidiaries. Many of the large names already referred to the CDR - Gammon/IVRCL/HCC (2) We believe some of the receivables could get cleared easily and pick up in execution will further help these companies.
Hotels	3%	4.5%	◀▶	(1) Banks have restructured some loans and have increased lending tenure from 5-7yrs to 10-12 yrs which is more alligned to the expected cash flows in the sector (2) Growth pick up will help occupancies but it will likely be a gradual recovery.
Shipping/Offshore	10%	3.6%	▲	(1) Challenges continue for shipping companies but fortunes here more alligned to global growth - We see limited positives for shipping companies due to change in government.
Aviation	N/A	N/A	▲	(1) Challenges continue with players like Spicejet/Jet reporting record losses but induction of strategic partners is a saving grace. (2) Competition is only picking up and hence recovery will be difficult.
Total (ex-Infra)	**64%**	**46%**		Overall expect of Shipping/Aviation, we believe incremental stress in most sectors discussed above is likely to be lower.

Source: Nomura research

Fig. 21: Infra asset quality – Many issues relating to infra asset quality look solvable except for gas power

Issues with Infra Asset Quality	Ability of New government to deliver (Low or high impact/ Near term or Longer term)	Nomura View
Gas power assets	No Impact	(1) We are least optimistic on this Infra asset class. Running on imported LNG is not viable and there is limited visibility of signifcant increase in domestic gas production. (2) Fortunately, system exposure to gas is material for only a few banks/NBFCs - IDFC/IDBI
SEB Reforms	High Impact but Long term	(1) Tariff hike decisions is a state government subject but the central government w ill positively impact FRP implementation, ATC loss reduction, etc
Coal/Fuel availability	High Impact but Long term	(1) While FSAs have been signed by Coal India, the government needs to sort out Infrastructure build up/Environment permissions w hich has been constraining coal production. (2) Environmental clearnaces for extra mining in existing mines could be a near term fix till the longer term issues are sorted out.
Tariff pass through for aggresively bid power plants	High impact and Near term (The UPA govt. had already set the ball rolling on this)	(1) Imported pow er plants (based on fixed bidding) have got a compensatory tariff hike (Tata/Adani). Though this is being contested by SEBs and w ould involve legal complications, on a long term basis w e believe most coal assets including imported coal plants w ould produce pow er at economically viable pow er tariffs (relative to gas plants) and hence financial instituions w ill not need to take large haircuts. (2) The ideal solution could be re-bidding these project w hich w ill involve time-delays - Again there could be NPA hits in these cases in viable projects, banks w ill not loose too many cents to a dollar
Environmental/Forest Clearances	High impact and Near to Medium term	(1) This issue has impacted the w hole Infra chain right from coal production to project execution and also in road projects. (2) We believe this is one of the areas w here the new government can deliver on a near to medium term basis. (3) Fixed time bound accountability for ECs w ill help addressing a lot of the concerns relating to indecisiveness
Excess Leverage/Equity Raising	Near term impact	(1) Asset sales have inched up in last 12mnts - With macro outlook improving, BUYers w ould be keen to close more transactions - Some groups like GMR/JPA/DLF have been more successful in selling dow n assets (2) Improved valuations of Infra companies in last 6mnts provides promoters an ideal opputunity to raise equity capital - Some groups like GMR/JPA have already raised equity through QIP.
Aggresively bid Road projects	Medium impact + Near to Medium Term	(1) Recently the government has allow ed premium rescheduling of stressed road projects (to be evaluated on case to case basis). Government could be liberal in granting reschedulling to more number of projects to reduce the stress for asset ow ners

Source: Nomura research

Corporate credit cycle: Our expectations for the next three years

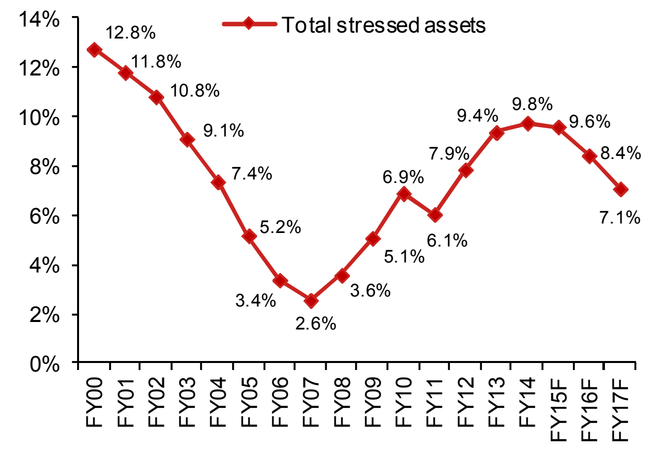
While PSU banks and corporate B/S linked private banks have discounted some turnaround in corporate credit cycle and asset quality but the quantum of improvement and timeline remains the key questions. While overall improvement in GDP growth and IIP should finally determine the quantum/pace of improvement, we look at: **(1)** quantum and pace of recovery in the last cycle and **(2)** Sectoral distribution of stressed assets in this cycle vs last.

Quantum and pace of recovery in the last cycle

Stressed asset accretion higher in last three years than last cycle: Gross NPA levels were structurally higher in the 90s at +15% of loans and hence comparing current stressed asset levels now vs 2000-03 and subsequent recovery cycle would not be right given the higher NPA base then. However, we think gross additional slippages and restructuring would be a correct comparison. In 2001-03, when GDP growth averaged 4.5%, gross slippage levels were ~3.5-4.0% for the system. On a weighted basis (40% weight for restructuring), stressed asset creation in the last three years have been mildly higher at ~4% of loans each year with 4.7% weighted stressed asset accretion for PSU banks and ~2% accretion for private banks.

Fig. 22: Stressed assets: this cycle vs last

NPA % and restructured %

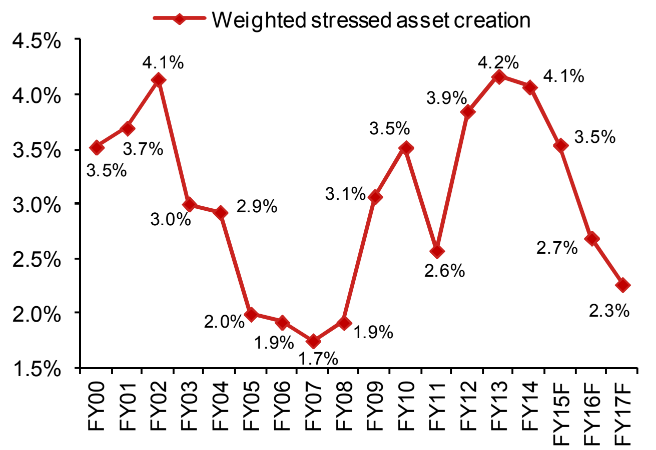


Note: We have considered 50% of restructured assets as stressed asset

Source: RBI, Nomura estimates

Fig. 23: Accretion in the last three years has been slightly higher than the last cycle

Incremental slippages + 40% of restructuring



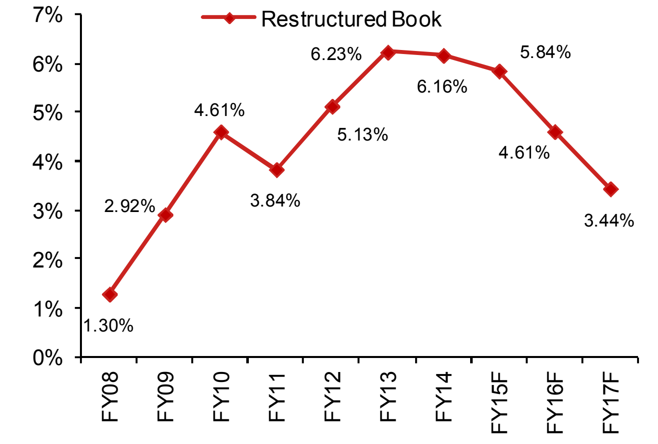
Note: We have considered 50% of restructured assets as stressed asset

Source: RBI, Nomura estimates

Improvement from 2H15F but pace of recovery may be slower than last cycle: Incremental stressed asset creation came off meaningfully in the second year of higher growth (FY05) in the last credit cycle with gross slippages coming off by ~50% from 4% in FY02-03 to ~2% slippages in FY05 making it a relatively quick asset quality recovery. In this cycle, we look for a moderation in stressed asset creation starting from 2HFY15F. The government has some low hanging fruits to deliver on but large part of the asset quality issues is long gestation sectors/projects and with regulatory dispensation for restructuring ending in FY15, we believe the recovery will be steady but a little more gradual. While restructuring is likely to ebb significantly from FY16F, gross NPA reduction make take a little longer (asset quality issues in long gestation assets, end of regulatory forbearance on restructuring, slippage risk from restructuring).

Fig. 24: Restructured loans to come off

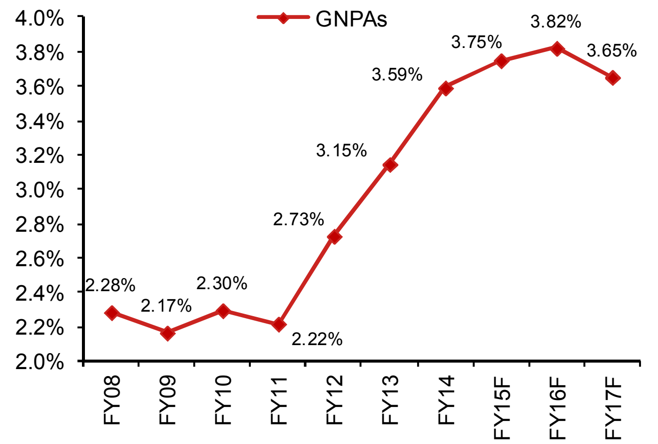
As dispensation to non-infra restructuring end in FY15F



Source: RBI, Nomura estimates

Fig. 25: Gross NPA reduction to be a little more gradual

Restructuring dispensation goes off in FY15+ ability to write off is lower



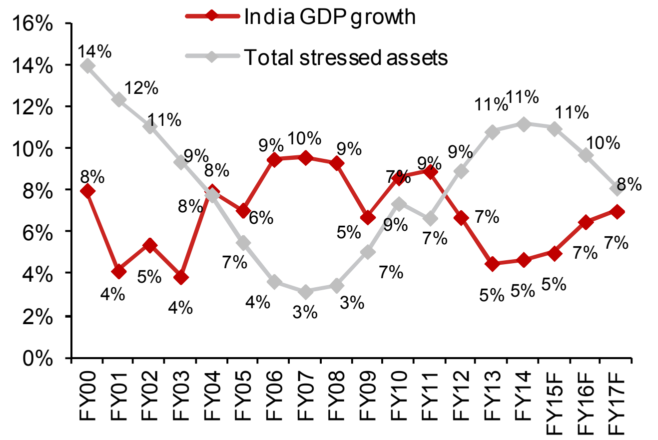
Source: RBI, Nomura estimates

Fig. 26: Our expectations of asset quality for the next three years

	FY00	FY01	FY02	FY03	FY04	FY05	FY06-09 avg.	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
India Real GDP (%)	8.0%	4.1%	5.4%	3.9%	8.0%	7.1%	8.8%	8.6%	8.9%	6.7%	4.5%	4.7%	5.0%	6.5%	7.0%
PSU banks															
Gross NPAs	14.0%	12.4%	11.1%	9.4%	7.8%	5.5%	2.6%	2.2%	2.2%	2.9%	3.5%	4.0%	4.3%	4.4%	4.2%
Net NPAs	6.9%	6.3%	5.5%	4.3%	2.8%	1.9%	1.1%	1.1%	1.1%	1.5%	1.9%	2.2%	2.2%	2.1%	1.9%
Coverage	50.6%	48.8%	50.5%	54.0%	63.4%	65.1%	58.9%	50.5%	51.7%	49.6%	45.4%	45.4%	48.0%	51.0%	54.0%
Restructured book	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.1%	5.2%	4.5%	6.0%	7.3%	7.2%	6.7%	5.4%	4.0%
Gross Slippages	**3.8%**	**3.7%**	**3.3%**	**3.0%**	**2.9%**	**2.1%**	**1.5%**	**1.8%**	**1.9%**	**2.5%**	**2.7%**	**2.9%**	**2.6%**	**2.4%**	**2.0%**
Recoveries/upgrades	0.0%	0.0%	1.7%	1.0%	2.4%	0.0%	0.6%	0.5%	0.7%	0.7%	0.5%	0.5%	0.5%	0.5%	0.5%
Write off	0.0%	0.0%	0.6%	1.8%	1.4%	1.7%	0.6%	1.3%	0.3%	0.3%	0.5%	0.5%	0.6%	0.5%	0.5%
Net Slippages (ex write offs)	**0.0%**	**0.0%**	**6.7%**	**2.2%**	**0.5%**	**1.6%**	**1.1%**	**1.4%**	**0.5%**	**0.4%**	**0.7%**	**0.9%**	**0.8%**	**0.8%**	**0.7%**
Addition to Restructuring	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**1.4%**	**3.8%**	**1.9%**	**3.7%**	**4.1%**	**3.4%**	**2.7%**	**1.3%**	**1.0%**
Reduction from restructuring	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	1.1%	1.6%	1.4%	1.7%	2.6%	2.3%	1.8%	1.8%
Private Banks															
Gross NPAs	7.0%	8.4%	9.7%	8.1%	5.8%	3.9%	2.5%	2.7%	2.2%	1.9%	1.8%	1.9%	1.8%	1.8%	1.7%
Net NPAs	4.5%	5.2%	5.5%	4.7%	2.7%	1.9%	1.1%	1.0%	0.5%	0.4%	0.5%	0.6%	0.5%	0.5%	0.5%
Coverage	35.7%	38.0%	42.8%	41.6%	53.1%	52.0%	57.2%	63.1%	76.2%	77.0%	71.1%	68.0%	70.0%	72.0%	72.0%
Restructured book	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.9%	2.2%	1.3%	1.6%	2.0%	2.4%	3.0%	2.1%	1.8%
Gross Slippages	**2.3%**	**3.4%**	**8.4%**	**3.2%**	**2.9%**	**1.7%**	**1.6%**	**1.9%**	**1.2%**	**1.1%**	**1.2%**	**1.3%**	**1.3%**	**1.3%**	**1.2%**
Recoveries/upgrades	0.0%	0.0%	1.7%	1.0%	2.4%	0.0%	0.6%	0.5%	0.7%	0.7%	0.5%	0.5%	0.5%	0.5%	0.5%
Write off	0.0%	0.0%	0.6%	1.8%	1.4%	1.7%	0.6%	1.3%	0.3%	0.3%	0.5%	0.5%	0.6%	0.5%	0.5%
Net Slippages (ex write offs)	**0.0%**	**0.0%**	**6.7%**	**2.2%**	**0.5%**	**1.6%**	**1.1%**	**1.4%**	**0.5%**	**0.4%**	**0.7%**	**0.9%**	**0.8%**	**0.8%**	**0.7%**
Addition to Restructuring	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.6%**	**1.9%**	**0.6%**	**1.1%**	**1.3%**	**1.8%**	**1.6%**	**0.5%**	**0.5%**
Reduction from restructuring	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.8%	1.1%	0.5%	0.5%	1.1%	1.0%	1.0%	0.5%

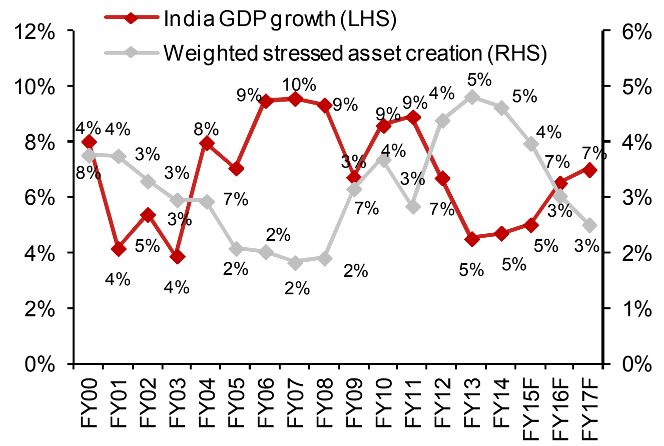
Source: RBI, Nomura estimates

Fig. 27: GDP growth to overall gross NPAs



Source: RBI, Nomura estimates

Fig. 28: GDP growth to incremental stress asset flow



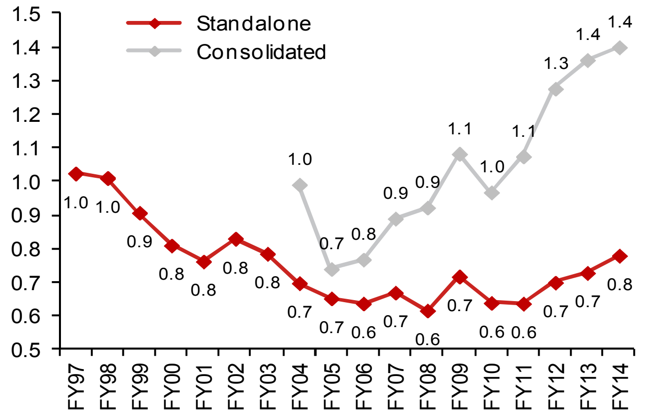
Source: RBI, Nomura estimates

Corporate health & distribution of stressed asset vs last cycle

- **Corporate health equally weak vs last cycle:** Our analysis indicates that corporate health is equally weak vs the last cycle with overall debt/equity higher than the peak in the last cycle and interest coverage almost now at similar levels.

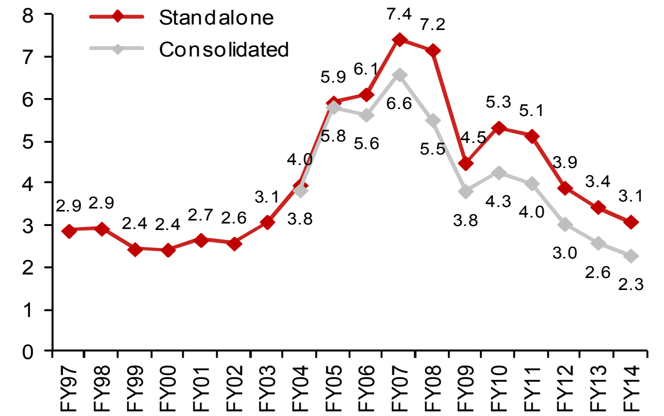
Fig. 29: Corporate leverage higher than the last cycle (x)

Debt to equity levels across cycle



Source: ACE equity, Nomura research

Fig. 30: Interest coverage at similar levels vs last cycle



Source: ACE equity, Nomura research

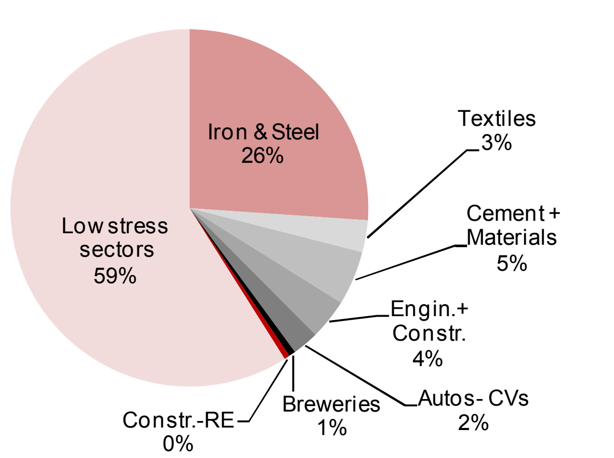
Fig. 31: Corporate India health check in the last 14-15 years

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Sales growth y/y															
Sales Standalone	13.6%	13.5%	5.6%	14.1%	24.5%	29.2%	13.9%	33.2%	21.8%	19.0%	11.6%	19.4%	17.3%	6.3%	5.6%
Sales Consolidated				23.9%	38.2%	49.9%	21.3%	50.9%	50.3%	30.8%	4.0%	23.8%	21.3%	8.4%	6.0%
Operating Profit Margin															
Standalone	21.1%	21.3%	20.1%	20.6%	22.6%	23.3%	22.3%	24.3%	24.7%	20.9%	22.5%	20.8%	19.0%	18.9%	18.8%
Consolidated			16.2%	16.9%	18.4%	22.0%	21.0%	23.3%	21.9%	17.6%	20.4%	20.1%	18.1%	17.9%	17.8%
Interest Coverage															
Standalone	2.43	2.66	2.57	3.09	3.96	5.92	6.12	7.43	7.17	4.49	5.33	5.13	3.90	3.44	3.09
Consolidated					3.84	5.81	5.64	6.60	5.51	3.82	4.26	4.01	3.04	2.59	2.29
Debt/Equity															
Standalone	0.81	0.76	0.83	0.79	0.70	0.65	0.64	0.67	0.62	0.72	0.64	0.64	0.70	0.73	0.78
Consolidated					0.99	0.74	0.77	0.89	0.92	1.08	0.97	1.08	1.28	1.36	1.40

Source: ACE equity, Nomura research

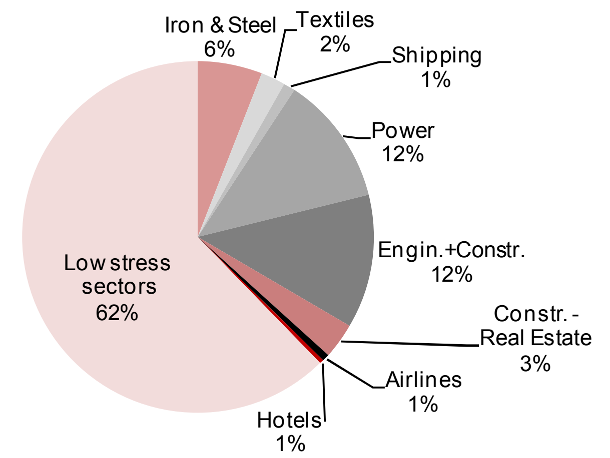
- **Stressed assets are of longer gestation in this cycle:** The key difference in this cycle is that most assets that are stressed are long gestation assets unlike commodity industry-related stress in the last cycle which recovered as commodity prices recovered in FY02-04. Thus, while we expect improvement in asset quality from 2H15F the pace of improvements in gross NPAs is likely to be slower.

Fig. 32: Sectors with low interest coverage in FY98-02



Source: ACE equity, Nomura research

Fig. 33: Sectors with low interest coverage in current cycle

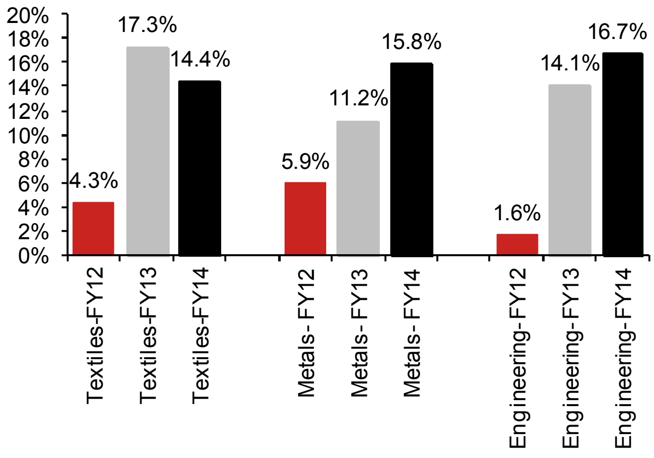


Source: ACE equity, Nomura research

- **However, some positives at the margin:** The only heartening thing is that ex-Infra, most of the weaker names in stressed sectors (eg, Iron and steel, textiles, Engineering) have been recognized as NPA or restructured assets. As well, interest coverage, though at low levels, is stabilizing, incremental restructuring is plateauing (lower CDR references) and with expected improvement in macros, we expect an improvement in asset quality to show up meaningfully from 2H15F.

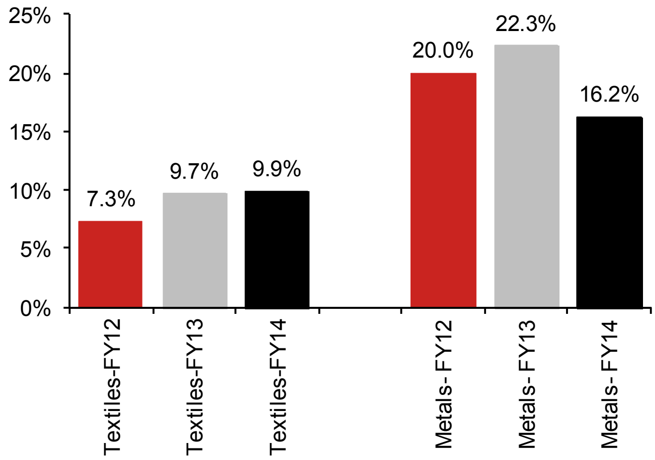
Fig. 34: SBI's stress recognised high in a few sectors already

Stress in a few large sectors already ~15-20% of SBI's sector exposure



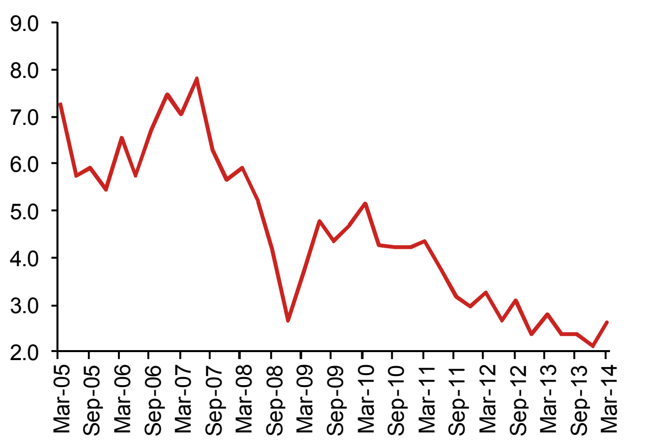
Source: Company data, Nomura research

Fig. 35: CDR references (% of sector loans)



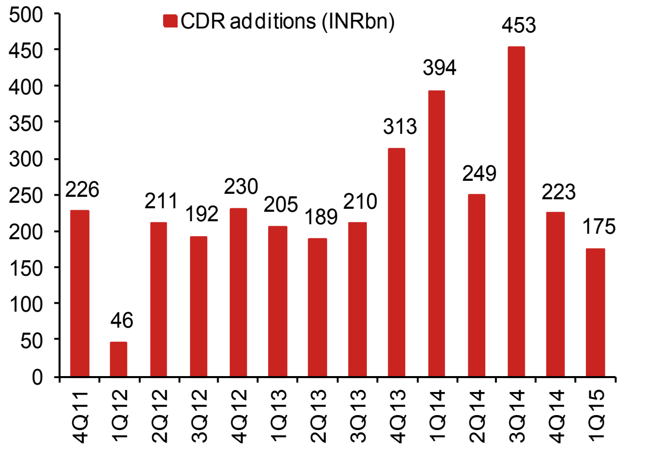
Source: CDR cell, RBI, Nomura research

Fig. 36: Quarterly interest coverage stabilising at lower levels



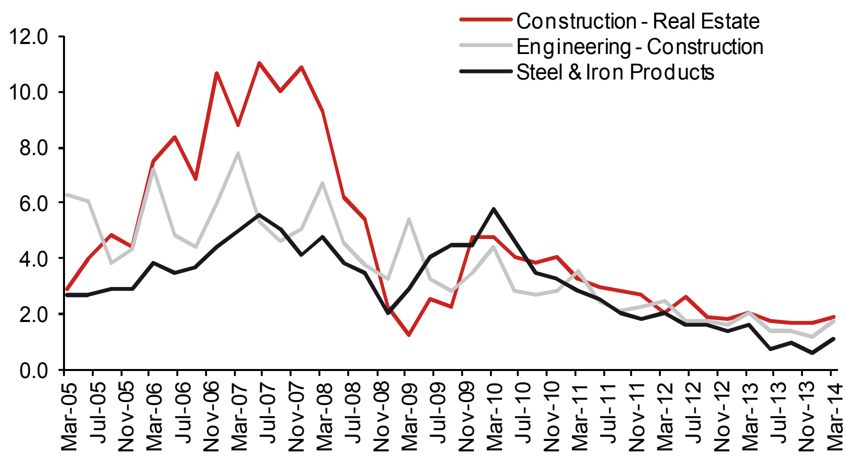
Source: ACE Equity, Nomura research

Fig. 37: No large negative surprise in CDR quantum as well



Source: CDR cell, Nomura research

Fig. 38: Incremental interest coverage stabilising in a few sectors



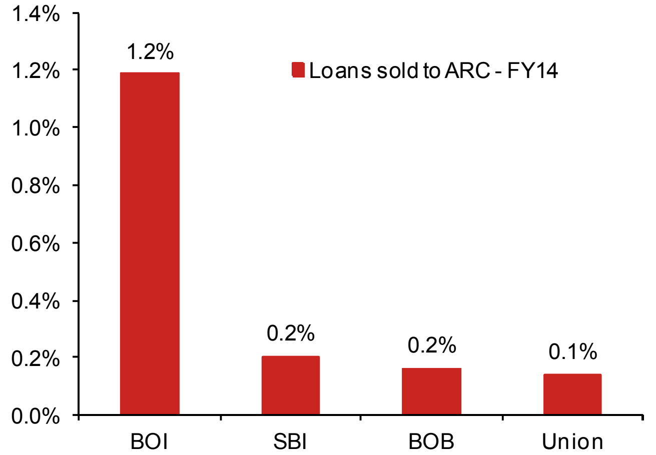
Source: ACE Equity, Nomura estimates

Risks to asset quality

- **Slippages from restructured book:** In the last three-four years, ~3% of loans annually were restructured. Most restructured accounts enjoyed ~two years of principal moratorium and ~0.5/1 year of interest moratorium and hence their financial performance was not fully tested for interest servicing capabilities. We expect 5-6% of loans to come out of moratorium in next 2-2.5 years and our analysis suggests that +50% of these accounts currently face significant interest coverage challenges – PSUs are largely exposed to this risk.
- **Large difficult gas power and international coal assets:** In spite of our expectations of decisive policy-making from the new government, some large Infra assets funded are unlikely to have a viable solution. **(1)** Gas power assets: Luckily, only a few financial institutions (IDFC/IDBI) have material exposure to gas power assets; and **(2)** International coal assets funded: Griffin, Hancock, Bumi are some large overseas coal assets funded by Indian banks - The economics of these coal assets look challenged as coal prices have come off since acquisition/funding and these could present some bulky challenges for the system. ICICI has been active in these assets.
- **Monsoon** impact **on agriculture loans and potential moral hazards:** The current monsoon has largely been a non-starter until now with current monsoon trends ~40% below historical trends. Apart from the direct impact to agri and rural loans, food inflation is likely to likely move up and delay the possible rate cut cycle. Direct impact is likely to be higher for PSU banks and NBFCs like MMFS. As well, Andhra Pradesh (southern Indian state) has been pushing for a debt waiver and a monsoon failure increase the likelihood of waivers in other states as well. Waivers in the past have impacted agri credit culture for 2-3 cropping seasons after a waiver.
- **Beware of** NPA management - **NPA** s**ales and SBLC linked offshoring:** Banks to some extent have managed NPAs by: **(1) selling down NPAs**: Most PSUs have sold down assets to ARCs and the trend is likely to increase in FY15F- The extent of sell-downs is higher for BOI among PSUs till FY14 . IIB/Yes have also sold down assets but quantum of sales is relatively low. **(2) SBLC linked offshoring:** Some large corporate loans of PSU banks/ICICI have been re-financed based on Standby letter of comfort/guarantee issued by domestic bank. The positive aspect is that a recent RBI guideline has refused to allow this and incremental off-shoring based on domestic guarantees seem unlikely.

Fig. 39: NPAs sold to ARCs by various banks

Reported NPA look better post the sell-downs



Source: Company data, Nomura research

Fig. 40: Guarantee-linked offshoring of Indian debt

RBI's recent diktat reduces chances of off shoring based on guarantees

Date	Issuer	Instrument	Amt.
Apr-14	Lanco Infratech - Griffin coal acquisition	Direct Financial Gurantee	USD450mn
2013	Videocon Industries	SBLC structured	USD400mn
Feb-14	Essar steel	Export gurantees	USD500mn
Apr-14	ABG Shipyard	Export Gurantee	USD250mn
Mar-13	Suzlon	SBLC linked	USD650mn

Source: Media sources, Nomura research

Earnings cycle: Material improvement from FY16F onwards

Credit demand has not crashed in this cycle; we look for a modest recovery in credit offtake

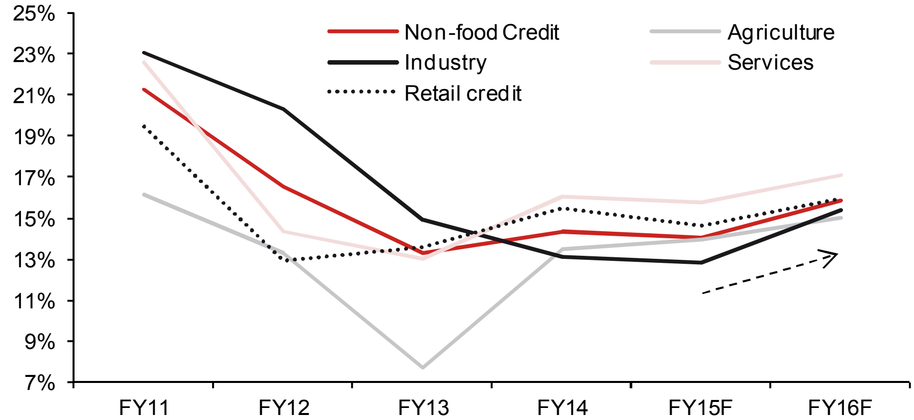
System loan growth has come off in the last two-three years from ~18% in FY09-12 to 13-14% in last 2-2.5 years but the slowdown in credit growth has not been as drastic as the fall in IIP/GDP growth. While industrial credit growth (including Infra) has fallen from ~23% y-y in FY09-11 to ~12-13% in FY14, overall credit growth held up due to relatively resilient credit demand in services and retail (both contribute ~42% of system credit and these segments grew by ~16% y-y in FY14).

With expectations of pick up in GDP/IIP we look for industrial credit growth to increase again from 2H15F (we estimate 12% industrial credit growth to move to ~15% in FY16F) and this is likely to drive overall credit growth from <14% to ~15.5% in FY16F. However, the gains as our numbers suggest are likely to remain modest due to:

1. **Some reforms are not credit-accretive, in our view:** 1) releasing government payments (lower debtor days); 2) SEB reforms (lower working capital and transition financing for SEBs) and 3) execution of projects (lower capital WIP).
2. **New capex announcement trend unlikely to rise anytime soon:** More importantly, while initiatives by the new government are likely to revive activity in existing/stuck projects, the announcement of new capex is unlikely to scale up in a big way in the next 18 months and hence industrial capex-related credit off-take should only see a moderate uptick as mentioned above.

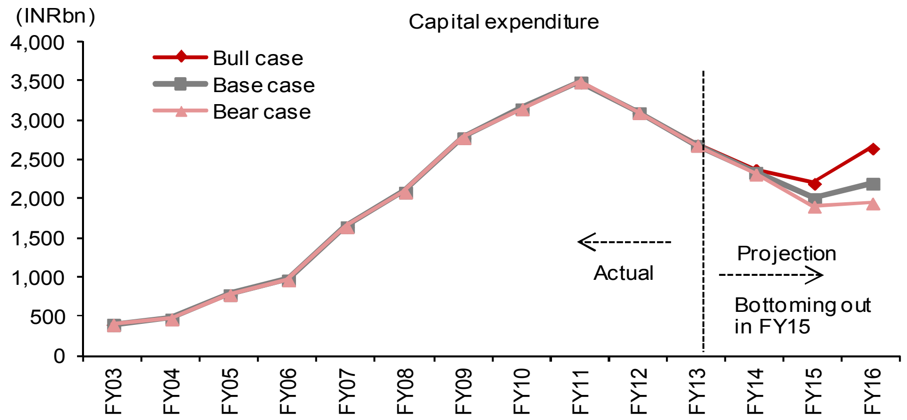
Fig. 41: Segmental credit growth expectations

Services and Retail held up in the downturn, we expect only a modest recovery in industrial credit demand



Source: RBI, Nomura estimates

Fig. 42: Modest pick-up in investment cycle expected



Source: Nomura strategy team

Fig. 43: Sectoral credit growth expectations

We look for a modest pickup in Industrial credit growth from 2HFY15F

y/y growth	FY14 loan mix	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F
Non-food Credit	**100.0%**	**18.1%**	**16.8%**	**21.3%**	**16.6%**	**13.3%**	**14.3%**	**14.0%**	**15.8%**
Agriculture	**12.0%**	**23.8%**	**22.9%**	**16.2%**	**13.3%**	**7.7%**	**13.5%**	**14.0%**	**15.0%**
Industry	**45.3%**	**20.9%**	**24.4%**	**23.0%**	**20.3%**	**14.9%**	**13.1%**	**12.9%**	**15.4%**
Infrastructure	**15.1%**	**33.5%**	**40.7%**	**37.8%**	**20.5%**	**15.7%**	**15.1%**	**12.1%**	**15.3%**
Power	8.8%	32.5%	50.9%	42.4%	23.9%	25.5%	17.4%	13.0%	16.0%
Telecom	1.6%	35.6%	18.0%	57.8%	0.5%	-6.8%	3.0%	3.0%	10.0%
Roads	2.8%	42.6%	56.3%	23.6%	22.1%	18.2%	19.9%	16.0%	18.0%
Other Infra	1.9%	25.7%	22.8%	20.7%	32.2%	0.5%	9.3%	10.0%	12.0%
Ex-Infra Industrial credit	30.2%	17.1%	18.8%	17.0%	20.2%	14.5%	12.2%	13.2%	15.4%
Basic Metal	6.5%	23.0%	26.5%	31.6%	22.4%	19.7%	15.2%	14.5%	16.0%
Textiles	3.7%	7.0%	18.2%	20.4%	9.4%	14.9%	11.1%	12.0%	14.0%
Chemicals	3.0%	17.3%	13.4%	27.0%	17.0%	25.0%	5.3%	10.0%	12.0%
Engineering	2.6%	25.5%	12.2%	26.4%	21.4%	13.4%	13.3%	13.0%	16.0%
Food Processing	2.7%	7.1%	22.1%	17.6%	22.1%	24.5%	26.1%	23.0%	22.0%
Petroleum	1.1%	63.3%	15.3%	-35.1%	20.1%	5.0%	-1.3%	8.0%	10.0%
Other ex-Infra credit	10.6%	11.3%	18.6%	16.1%	23.2%	8.5%	11.1%	12.0%	15.0%
Services	**24.0%**	**18.3%**	**12.5%**	**22.6%**	**14.4%**	**13.1%**	**16.1%**	**15.7%**	**17.1%**
Trade	5.8%	18.1%	13.9%	13.1%	21.1%	22.4%	17.0%	18.0%	20.0%
NBFCs	5.3%	31.3%	14.8%	62.3%	23.9%	14.1%	13.2%	15.0%	15.0%
Commercial Real Estate	2.8%	48.4%	-0.3%	5.8%	15.6%	11.9%	22.4%	18.0%	18.0%
Other services	8.5%	8.9%	12.1%	16.0%	6.6%	9.0%	16.0%	15.0%	16.0%
	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Retail credit	**18.6%**	**11.3%**	**4.1%**	**19.5%**	**12.9%**	**13.6%**	**15.5%**	**14.6%**	**16.0%**
Mortgages	9.7%	9.3%	7.7%	19.3%	12.3%	13.2%	18.4%	16.5%	17.0%
Vehicle Loans	2.3%	NA	2.9%	14.5%	22.2%	24.5%	17.4%	14.0%	17.0%
Other retail	6.6%	NA	-0.1%	21.1%	11.1%	10.9%	10.8%	12.0%	14.0%

Source: RBI, Nomura estimates

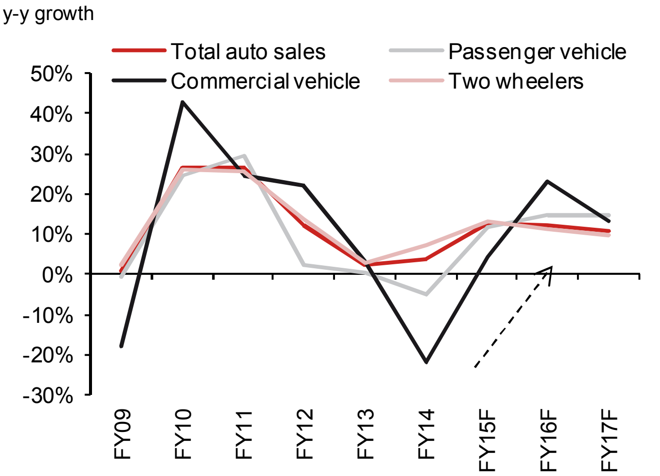
Fig. 44: As Industrial credit recovery is likely to be modest; we look for only a modest tick up in credit multipliers

	Real GDP	WPI Inflation	Nominal GDP	Avg. Loan Growth	Credit growth to	Credit growth to
FY02	5.4%	3.7%	9.1%	14.6%	1.6	2.7
FY03	3.9%	3.4%	7.3%	23.4%	3.2	6.0
FY08	9.3%	4.7%	15.2%	23.6%	1.6	2.5
FY09	6.7%	8.1%	15.4%	24.3%	1.6	3.6
FY10	8.6%	3.8%	15.9%	14.3%	0.9	1.7
FY11	8.9%	9.6%	17.4%	21.0%	1.2	2.4
FY12	6.7%	8.9%	15.6%	19.0%	1.2	2.8
FY13	4.5%	7.4%	11.8%	16.7%	1.4	3.7
FY14	4.7%	6.0%	10.7%	15.1%	1.4	3.2
FY15F	5.5%	5.0%	10.5%	14.0%	1.4	2.5
FY16F	6.3%	4.5%	10.8%	16.0%	1.5	2.6

Source: RBI, Nomura estimates

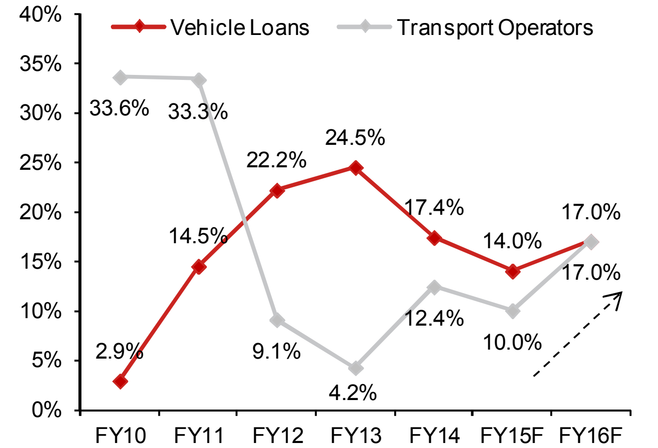
Retail credit growth: Retail credit offtake improved in FY14 from FY13 levels as banks refocused on mortgages (after two years of losing share in FY12-13). Steady growth should continue in mortgages as job losses have not been material and some correction in real estate prices along with improving macros could aid real estate volumes and mortgage growth. Auto credit offtake held up well until FY13 despite slow OEM numbers in the last two-three years due to increasing share of diesel cars/SUVs (higher ticket prices) but this trend has started to reverse in FY14; consequently, we have seen a fall in auto credit demand. With our Indian auto team looking for a pick-up in car demand in 2H15F and large rebound in CV volumes in FY16F, we expect non-mortgage retail credit demand to improve from 2H15F.

Fig. 45: OEM numbers to pick up from FY15/16F



Source: SIAM, Nomura estimates

Fig. 46: We expect non-mortgage retail credit growth to pick up accordingly



Source: RBI, Nomura estimates

How are banks positioned to grow?

- **Private banks should continue to gain share as PSU banks** will have to bear with capital constraints but in the recent past we have seen many PSUs growing aggressively despite significant capital constraints (BOI grew 28% y-y in FY14 with Tier-1 capital <7%). Most domestic private banks are well capitalised (including Yes bank now) and within our covered PSU banks, SBI/BOB are better placed vs BOI/Union, in our opinion.
- Among private banks, we believe **Kotak/IIB are best leveraged to growth** with Kotak historically running a switch-on-switch-off model for growth and IIB's growth expected to pick up with improvement in CVs in FY16F. Yes bank's capital raising addresses

capital constraints and hence it should start growing faster than the system now as corporate activity picks up.

- As we expect only a moderate improvement in Industrial credit demand, we look for **ICICI's loan growth at 16-17% y-y in next two years and Axis at ~18% y-y.**
- **Among NBFCs/HFCs,** Banks have inched up competition in mortgages but we expect HFCs to maintain share (vs increasing share in last three-four years). Shriram's AUM growth is likely to continue to remain muted over the next two-three quarters (<5-7% AUM growth) and we expect a pick up only after that. While MMFS remains a play on rural India, weak monsoons will likely impact disbursements in the near term.

Fig. 47: Our loan growth assumptions for banks/NBFCs in our coverage

Loan Growth y/y	FY14	FY15F	FY16F	FY17F		FY14	FY15F	FY16F	FY17F
ICICI	14.0%	15.0%	16.9%	17.9%	BOB	21.1%	14.0%	16.0%	17.0%
Axis	13.7%	16.0%	19.0%	20.0%	BOI	28.1%	13.0%	15.0%	16.0%
HDFCB	26.6%	18.0%	21.0%	22.0%	Union	12.3%	10.0%	13.9%	15.8%
Kotak	10.6%	14.8%	22.5%	24.1%	HDFC	15.9%	16.4%	18.4%	19.2%
IIB	25.3%	22.0%	24.0%	25.0%	LICHF	17.4%	16.9%	18.2%	19.2%
Yes	15.0%	16.9%	20.8%	20.5%	MMFS	23.2%	12.4%	21.7%	23.1%
SBI	15.7%	14.5%	16.0%	17.0%	STFC	17.2%	10.0%	17.0%	16.0%
PNB	14.7%	13.0%	15.9%	16.9%	IDFC	1.5%	5.0%	8.0%	10.0%

Source: Company data, Nomura estimates

Margins: Private banks at best will likely hold on to high NIM levels, some revival in margins for PSUs, retail banks and NBFCs seem better placed for a falling rate cycle

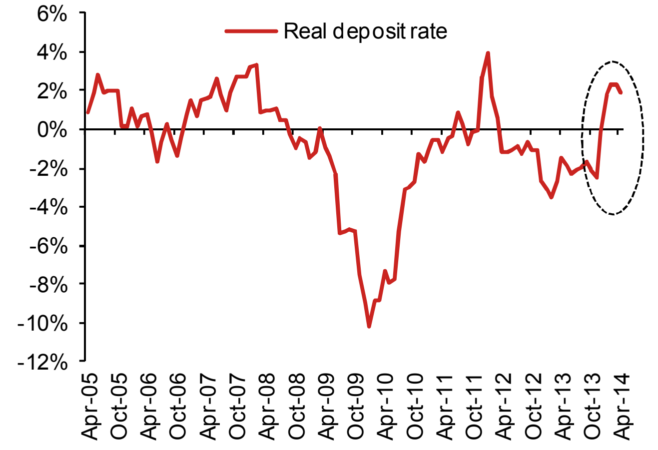
On the macro factors relating to margins:

1) In our opinion real deposit rates have remained negative for a significantly long period of time (from Oct-08 onwards) and hence**,** despite our expectations of ample domestic liquidity (relating to foreign flows), we do not think that banks will move down on term deposit rates before they move on base rates.

2) For wholesale funds dependent entities (Yes/IIB/NBFCs), rates have cooled and differential of wholesale money (<1 year certificate of deposit) to term deposits (TDs) are again very low with liquidity improving but we do not subscribe to assigning similar multiples to wholesale and retail funded businesses despite the lower rate differentials.

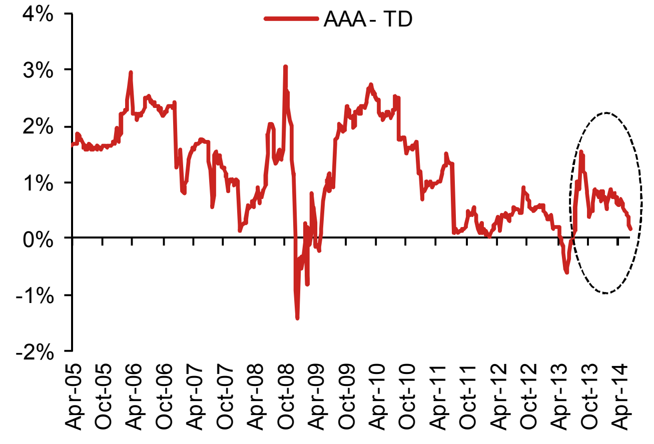
Fig. 48: Real deposit rates have been negative for too long

Implying that banks cannot move on deposit rates very quickly



Source: Bloomberg, Nomura research

Fig. 49: Wholesale funds now similar priced to retail TD



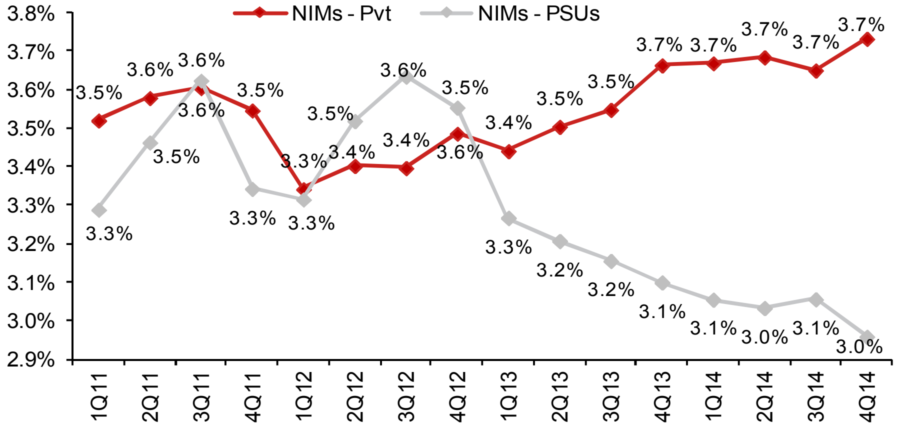
Source: Bloomberg, Nomura research

Within banks, margins have remained and would remain a story of contrasting halves

- While margins for private banks have improved by 20-30bps in the last two-three years, PSU bank margins have contracted by ~30-40bps.
- **For private banks,** margins held up and to some extent improved as LDRs inched up, CASA improved especially SA ratios and large private banks did not have any material NPA related interest reversals/drags. With LDRs peaking (at 77% from 73% about two-three years back) and business mix getting less risky (higher retail and move to more completed projects vs WIP projects), we see that margin levers have peaked largely for corporate private banks. The only respite in next 18 months could be pick up CA deposit growth but it is unlikely to move the cost of funds needle much – **Overall we look for margins to remain steady for corporate private banks.**
- **For PSU banks**, the story has been reverse with increasing NPA levels, falling CASA and higher reversals hitting margins in last two-three years. As we expect slippages to plateau in 1H15F and come off there on, interest reversal impact is likely to be lower. From a loan growth mix perspective, retail and SME are current focus areas for most PSUs and while retail growth is likely to be NIM dilutive (mortgages largely), SME growth is likely to be NIM accretive in our view. **We look for margins to tick up by 10-20bps for PSU banks especially for BOB/BOI/Union.**
- **For retail banks and retail NBFCs,** there could be a tick up in margins when the rate cycle turns as large parts of their asset book will be fixed in nature and should reprice after liabilities. However, we do not recommend playing NBFCs as yet as valuations for most retail NBFCs are unattractive and timelines of a rate cut remain uncertain.

Fig. 50: Margins has been a story of contrasting halves

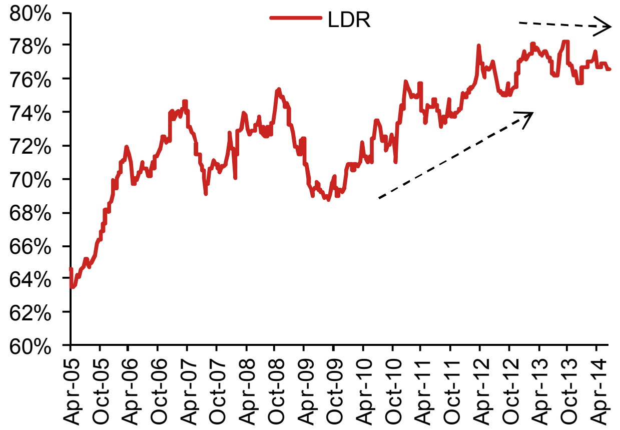
Private bank margins have held up whereas PSU banks margins have contracted by 30-40bps



Source: Company data, Nomura research

Fig. 51: Higher systemic LDRs have aided private banks

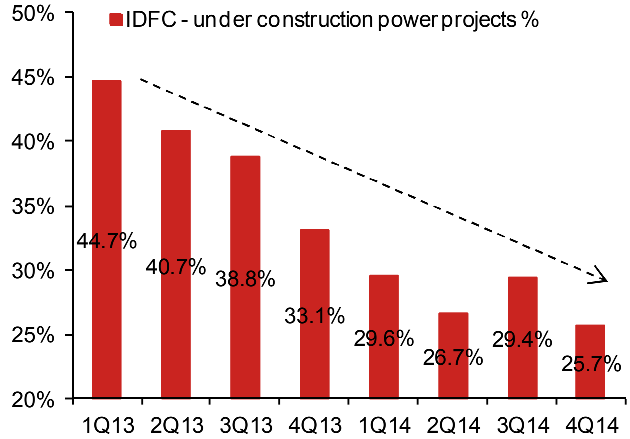
However, this lever seems to be peaking



Source: Bloomberg, Nomura research

Fig. 52: Move to completed projects from WIP projects to impact yields

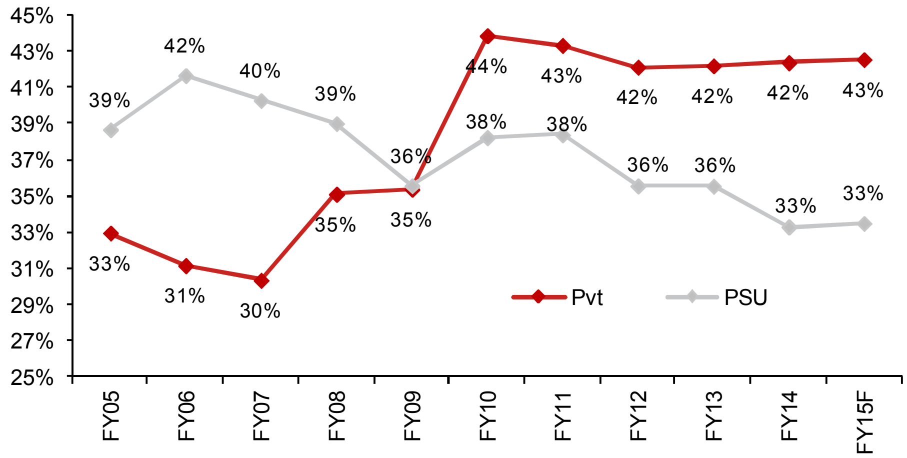
Completed assets have ~100bps lower yields



Source: Company data, Nomura research

Fig. 53: CASA for private banks have held up much better than PSUs

Private banks gaining CASA market share as their CASA ratios have also held up well



Source: Company data, Nomura estimates

Fig. 54: PSU banks' domestic margins - BOB/Union have seen the highest NIM fall in spite of lower NPA reversals/drags

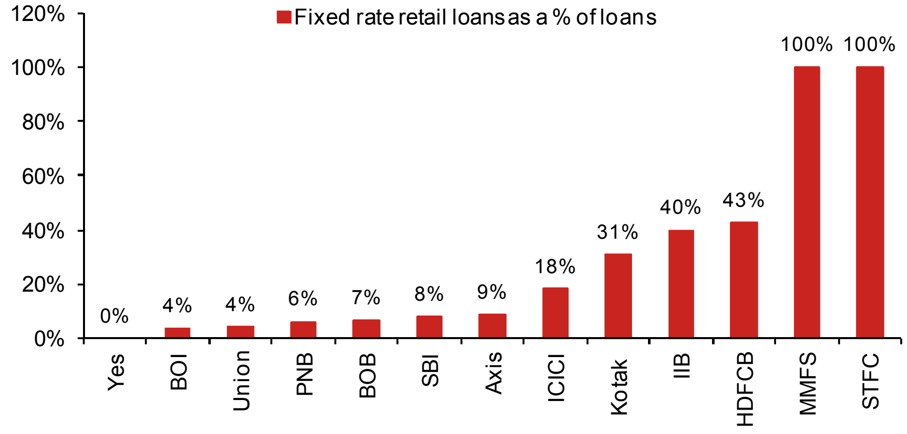
BOB/Union's margins likely to see highest mean reversal

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	Average	Change from FY11	Change from FY09	Change from Average
BOB	3.06%	3.21%	3.12%	3.72%	3.51%	3.12%	2.87%	3.26%	-0.85%	-0.34%	-0.39%
BOI	3.42%	3.38%	2.92%	3.31%	2.85%	2.80%	2.85%	3.02%	-0.46%	-0.53%	-0.17%
SBI			2.83%	3.63%	4.17%	3.66%	3.49%	3.48%	-0.14%	0.39%	0.01%
PNB	3.16%	3.26%	3.23%	3.61%	3.30%	3.26%	3.22%	3.31%	-0.39%	-0.04%	-0.10%
UNBK	2.73%	2.95%	2.53%	3.09%	2.91%	2.79%	2.48%	2.79%	-0.60%	-0.46%	-0.31%

Source: Company data, Nomura research

Fig. 55: Retail banks and Retail NBFCs to benefit in case of a reduction in rates

(% of loan book which is non-mortgage retail - fixed rate in nature)



Source: Company data, Nomura estimates

Fig. 56: Our margin assumptions for banks in our coverage

These are our calculated margins and could be different from reported margins/ WE report spreads in case of NBFCs

NIMs	FY14	FY15F	FY16F	FY17F		FY14	FY15F	FY16F	FY17F
ICICI	3.11%	3.09%	3.12%	3.08%	BOB	2.03%	2.08%	2.17%	2.18%
Axis	3.46%	3.38%	3.32%	3.23%	BOI	2.20%	2.27%	2.32%	2.36%
HDFCB	4.30%	4.37%	4.37%	4.30%	Union	2.48%	2.57%	2.66%	2.70%
Kotak	4.64%	4.59%	4.51%	4.48%	HDFC	3.48%	3.55%	3.52%	3.52%
IIB	3.75%	3.74%	3.68%	3.65%	LICHF	2.25%	2.29%	2.24%	2.24%
Yes	2.76%	2.94%	3.02%	3.02%	MMFS	8.81%	8.67%	8.71%	8.56%
PNB	3.22%	3.10%	3.07%	3.04%	STFC	6.66%	6.76%	6.93%	6.94%
SBI	3.03%	2.99%	2.98%	2.99%	IDFC	4.00%	3.94%	3.95%	3.93%

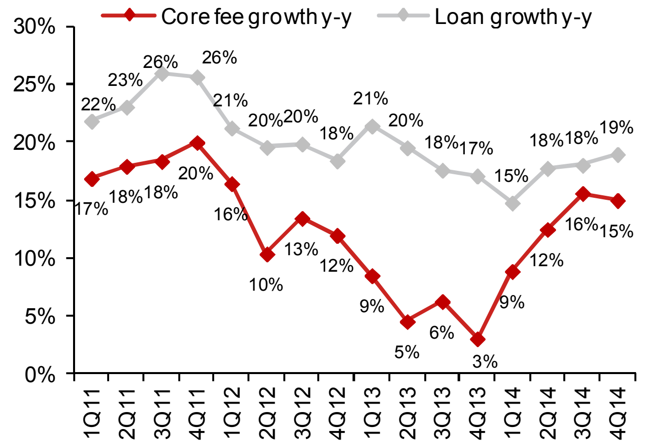
Source: Company data, Nomura estimates

Fee growth outlook mixed: retail robust but corporate fees to see only moderate improvement; some treasury respite for PSU banks

Fee growth has been weak in last two years: Core fee growth has lagged B/S growth for banks in general for the last two years and reported non-interest income has been inflated by non- core or recurring items (repatriation profit in the case of Axis, dividends in the case of ICICI, recoveries in the case of PSU banks). The slowdown has been a function of slower corporate fund and non-fund based fees, a large slowdown in volumes and cuts to commission rates in third-party distribution business and in government business for PSU banks.

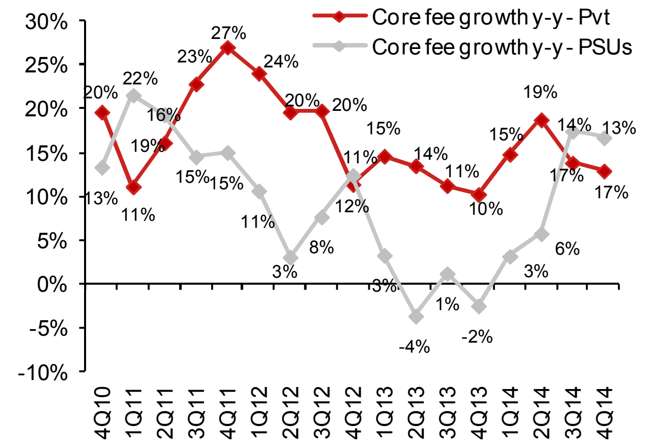
Fig. 57: Core fees have lagged B/S growth in last two years

Fee growth has lagged B/S growth for the system



Source: Company data, Nomura research

Fig. 58: Private banks have still done a better job



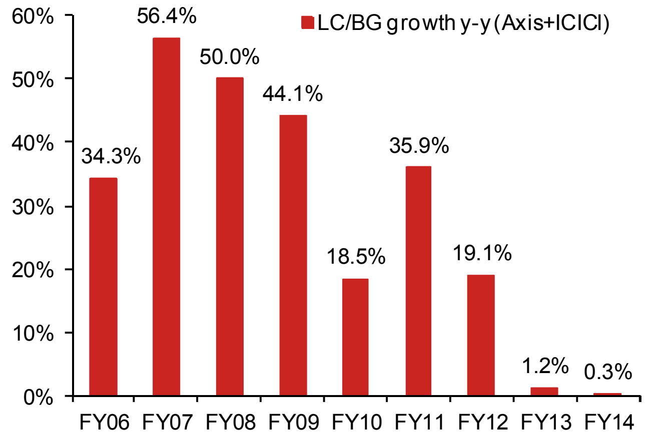
Source: Company data, Nomura research

Outlook on various fee streams:

- **Corporate capex fees:** While we expect some tick up in industrial credit and related fees, large fee machines like project finance especially on the non-fund fees side are unlikely to revive materially as new capex announcements is not likely to rebound sharply.
- **Third-party distribution fees:** Both volumes and commission rates have been hit in the last two-three years, but with stability in insurance product structures now and pick up in capital markets, we believe third-party fees have bottomed out and we expect a pick up.
- **Business banking, trade and CMS:** This segment has held up well and we expect stable trends to continue. For smaller banks like IIB/Yes, success in this segment in the next two-three years should address issues on their bulky fees from corporate bonds/IB.
- **Client FX:** FX volatility has led to strong client FX revenues for most banks including PSUs and, with some stability, FX fees may be a near-term laggard.
- **Retail asset and liability fees:** Trends have largely been stable and we expect a similar trend to continue.

Fig. 59: LC/BG exposure of banks flat for last 2 years

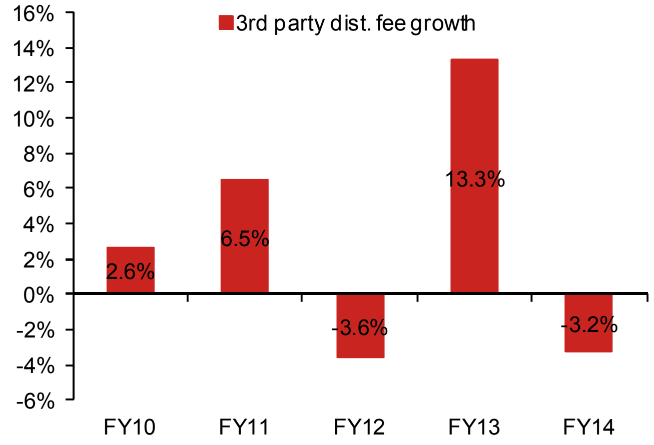
Implying lower non-fund based fees (large contributors in FY06-12)



Source: Company data, Nomura research

Fig. 60: Third-party distribution fees for ICICI/HDFCB

Low growth for 4-5 years; we believe this has bottomed out now



Source: Company data, Nomura research

Among our coverage universe

- **ICICI** has already seen normalisation in large corporate fees, hence we are seeing a pickup in overall fees for ICICI. This normalisation of large corporate fees is under way for **Axis,** hence fee growth is likely to improve for Axis in FY16F.
- **HDFCB's** fees have been muted due to slow capital markets and very weak third-party fees and we are likely to see a revival from here on.
- Among the mid-sized private banks, **IIB's** fee growth has been high but looks more sustainable to us vs. **Yes bank** (retail FX, mid-sized debt IB has worked well for IIB).
- **For PSUs**, fees remain more aligned to B/S growth, hence we expect some pick up in FY16 as B/S growth should improve marginally.

Fig. 61: Core fee growth assumptions for banks under our coverage

Core fee growth y/y	FY14	FY15F	FY16F	FY17F		FY14	FY15F	FY16F	FY17F
ICICI	12.4%	13.3%	15.4%	16.1%	PNB	8.6%	13.5%	14.3%	14.3%
Axis	15.8%	10.8%	18.3%	18.1%	BOB	18.6%	9.5%	15.0%	15.0%
HDFCB	10.2%	16.4%	21.0%	21.1%	BOI	12.0%	8.7%	13.3%	13.3%
Kotak	17.8%	17.5%	18.2%	18.4%	Union	18.2%	14.5%	15.5%	15.5%
IIB	29.9%	15.6%	21.0%	21.0%	SBI	9.5%	14.0%	15.0%	15.0%
Yes	31.0%	16.8%	19.3%	19.8%					

Source: Company data, Nomura estimates

How big will treasury be for PSU banks?

- G-Sec yields have moderated from Mar-14 levels. Our economist expects G-Sec yields to remain almost flat at 8.7% through FY16, but with the improvement in macros, the trajectory is likely to remain flat or marginally lower, hence PSU banks could benefit.
- While **PSU banks** have a sensitivity to lower bond yields, their sensitivity is down to one-tenth of what it was in the previous cycle (FY02-04), given lower treasury book and lower share of AFS book in that. In the previous recovery cycle, PSU banks made about 4-5% of loans as treasury profits between FY03-05, and that provided PSU banks the flexibility in their P&L to write off bad loans, which we believe is unlikely to recur in any comparable magnitude in this cycle.
- Among our covered PSU banks, we believe that **PNB/Union** are most sensitive to falling yields.
- Among private banks, **Yes Bank** has a large corporate bond book which was hedged through Mar-14 through SWAPs.

Fig. 62: Bumper treasury gains in the previous cycle …

Treasury gains (03-05) as a % of various metrics	% of PAT (03-05 gains)	% of Assets (03-05 gains)	% of Loans (03-05 Gains)	% of Networth (03- 05 gains)
SBI	65.2%	2.3%	4.7%	39.8%
PNB	72.0%	2.8%	5.2%	46.5%
BOB	90.1%	2.8%	5.7%	43.3%
BOI	88.8%	2.6%	4.1%	50.5%
Union	59.0%	2.3%	3.7%	44.9%

Source: Company data, Nomura estimates

Fig. 63: … unlikely to recur as investment/AFS book share of banks' B/S is lower and so is their AFS duration

Treasury gain potential currently 1/10th of 2002-03	2002-05	Currently
Investments (% of Assets)	45.0%	25.0%
AFS (% of investments)	30-40%	20.0%
AFS duration	4-5 yrs	3-4 yrs
G-Sec Fall potential	3-4%	1-1.5%
Treasury gain potential (% of Assets)	2.48%	0.26%

Source: Company data, Nomura estimates

Fig. 64: PSU banks' sensitivity to bond yields

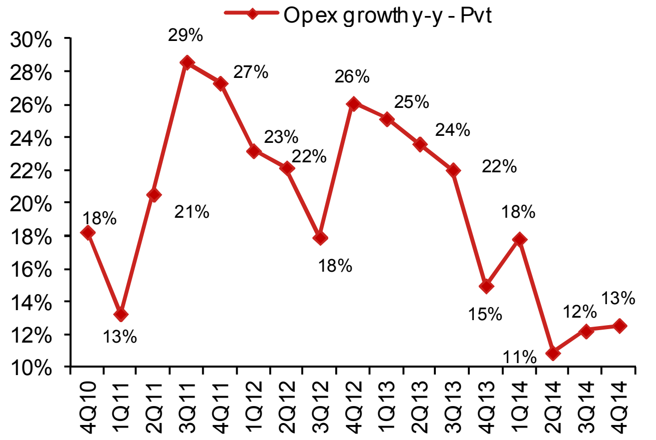
PBT impact on 50bps reduction in yields	AFS book (INRbn)	AFS duration	PBT impact (INRbn)	FY15 PBT (INRbn)	On FY15 PBT
Axis Bank	514	3.40	5.34	104.0	5.1%
Yes Bank	207	3.00	1.88	27.2	6.9%
SBI	1,431	1.89	9.13	285.6	3.2%
PNB	442	4.10	6.55	62.8	10.4%
BOI	278	2.31	2.35	47.5	4.9%
BOB	296	3.10	3.21	66.1	4.9%
Union	233	2.86	2.47	28.6	8.6%

Source: Company data, Nomura estimates

Operating cost: Private banks will continue to show flexibility; most PSUs better placed on pensions now

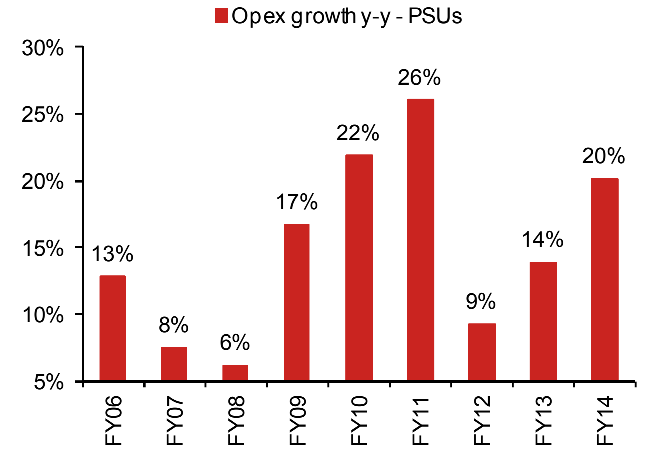
- Like margins, opex has also been a story of contrasting halves with private banks exhibiting significantly high flexibility in the past two years when revenue growth has slowed down, whereas PSU banks' opex has been hit by increasing provisions for wage settlements and much-needed provisioning on pensions.
- **For private banks,** our discussions with banks have indicated that private banks can continue with the austerity in overheads and staff expenses for two more quarters after which opex growth is likely to align with B/S growth. **HDFCB/Axis** has been more successful than **ICICI** in cutting opex growth in FY14, but ICICI has added significantly to employee strength and that will likely aid its opex growth in the next two years.
- **For PSU banks,** although not all pension provisioning is behind us, the pension provisioning run-rate in the P&L has increased to 3-5x in the past four years (from INR60K/employee/year to ~ INR0.3mn/employee/year), hence large negative surprises are unlikely for most PSUs. While pension provisioning at SBI/PNB/Union has been better than peers, BOB caught up on pension provisioning in FY14.

Fig. 65: Private banks have shown high flexibility in opex
Led by the big 3 private banks (ICICI/Axis/HDFCB)



Source: Company data, Nomura research

Fig. 66: PSUs have been constrained due to wages/pensions
Overall opex growth was ~20% y-y in FY14



Source: Company data, Nomura research

Fig. 67: Opex growth forecasts for banks
ICICI bank should report least opex growth among private banks, SBI best placed among PSUs

Opex growth y/y	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
ICICI	-13.6%	-16.8%	12.9%	18.6%	14.8%	14.4%	10.4%	13.6%	13.6%
Axis	33.4%	30.9%	27.0%	25.7%	15.1%	14.3%	14.1%	15.0%	16.1%
HDFCB	47.7%	4.2%	24.1%	29.7%	14.8%	7.2%	16.1%	17.3%	17.4%
Kotak	-0.4%	-2.7%	24.8%	12.8%	12.8%	12.7%	11.3%	16.0%	16.9%
IIB	36.0%	34.5%	37.0%	33.2%	30.8%	24.4%	21.3%	20.1%	20.2%
Yes	22.7%	19.5%	35.9%	37.2%	43.1%	31.1%	20.0%	20.7%	18.7%
SBI	24.1%	29.8%	13.3%	13.3%	12.3%	22.0%	7.9%	13.3%	13.3%
PNB	19.3%	13.2%	33.6%	10.0%	16.6%	14.4%	13.2%	11.8%	12.0%
BOB	21.9%	6.6%	21.5%	11.4%	15.3%	20.0%	14.1%	13.6%	13.9%
BOI	17.0%	18.5%	38.2%	-2.5%	7.9%	25.7%	18.9%	12.4%	12.6%
Union	39.0%	13.3%	57.5%	1.0%	13.2%	21.5%	13.2%	12.1%	13.6%

Source: Company data, Nomura estimates

Fig. 68: We believe pension provisioning run-rates are reasonable now

While assumptions on pension are still aggressive, we draw comfort from the 3-4x Increase in P&L provisioning run-rate for PSU banks

	FY10	FY11	FY12	FY13	FY14	Increase (x)
Pension P&L provisioning (Rs mn)						
SBI	23,457	24,731	32,194	25,530	50,880	2.2
BOI	2,652	14,563	7,432	6,604	10,636	4.0
Union	1,596	11,450	8,976	10,129	11,222	7.0
BOB	1,332	10,073	6,719	6,840	10,150	7.6
PNB	5,608	13,185	14,426	20,058	21,580	3.8
Top-5 PSUs Pension provisions	**34,645**	**74,002**	**69,748**	**69,161**	**104,468**	**3.0**
BOB/BOI/Union	**5,580**	**36,086**	**23,127**	**23,573**	**32,008**	**5.7**
Pension expenses per employee						
SBI	117,107	110,935	149,407	111,829	229,155	2.0
BOI	66,851	366,053	186,814	156,176	246,487	3.7
Union	57,461	443,405	291,073	318,545	331,953	5.8
BOB	34,191	251,538	162,106	158,662	220,647	6.5
PNB	98,514	231,235	232,202	318,387	329,395	3.3
Top-5 PSUs Pension provisions	**95,274**	**191,911**	**178,988**	**169,310**	**254,487**	**2.7**
BOB/BOI/Union	52,442	341,553	206,365	201,147	260,318	5.0

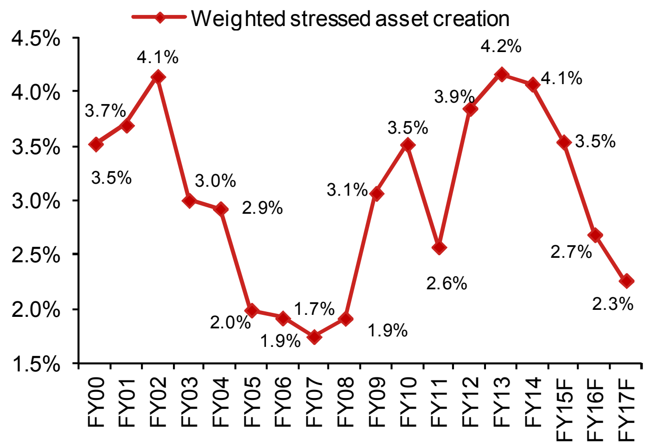
Source: Company data, Nomura estimates

Credit costs/Provisioning - Relief likely from FY16F

- **Incremental stress to be lower by 2H15 but gross NPAs unlikely to come off in a hurry**: As discussed in detail in the "asset quality" section of this report, with the improving growth outlook and the expected pick up in capex execution, we believe incremental stress formation will peak in 1HFY15F and start coming off from 2HFY15F. Incremental stress asset formation is likely to come off from ~4% pa in the past three years to 2.7% in FY16F and 2.3% in FY17F. With recoveries and upgrades also expected to inch up, net NPA slippage levels should come off from 2% in FY12-14 to ~1% in FY16/17F. However, gross NPA levels are unlikely to fall as they did in the FY02-05 cycle given the ability of banks, especially PSUs, to write off bad loans is significantly lower (treasury gains unlike the previous cycle).

Fig. 69: Stress asset accretion to come off meaningfully from FY16...

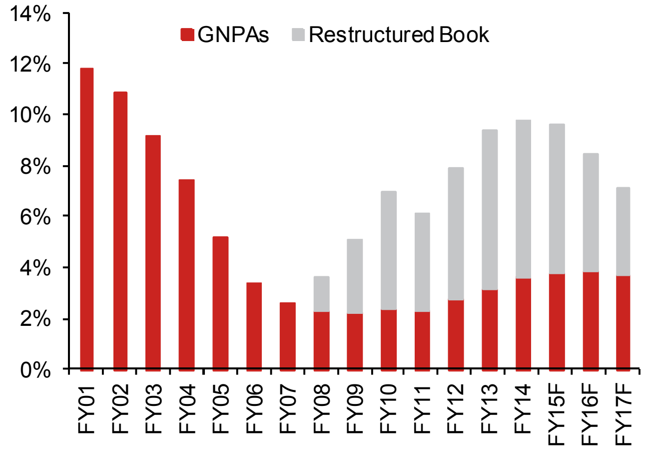
Gross NPA accretion +40% weighted restructuring



Source: RBI, Nomura estimates. 40% weight for incremental restructuring

Fig. 70: ... but PSU banks' gross NPAs should only marginally trend down

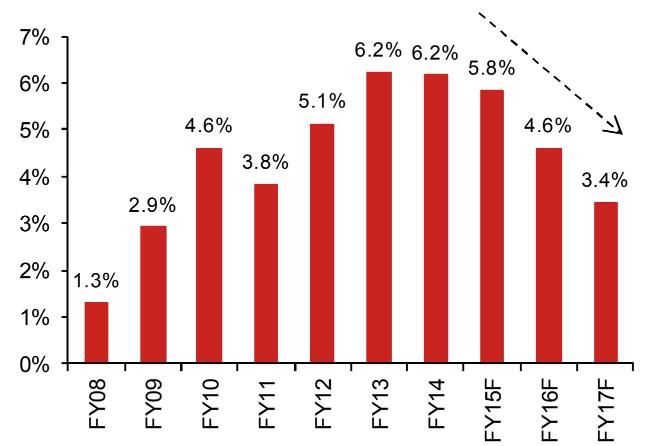
Ability to write-off bad loans is lower in this cycle



Source: RBI, Nomura estimates

- **Restructuring book is likely to come off sharply but slippage risks high**: RBI's dispensation on restructuring is likely to come to an end in by FY15F, hence inflows into restructuring for PSU banks are likely to come off to <1%, from 3-4% annual restructuring seen in the past three years. While restructured book % is likely to come off as performing accounts get upgraded and the dispensation for restructuring ends in FY15F, our analysis still indicates that risk of slippages from the current restructured book is very high as these accounts complete their moratorium and are tested for their interest and principal payment capabilities.

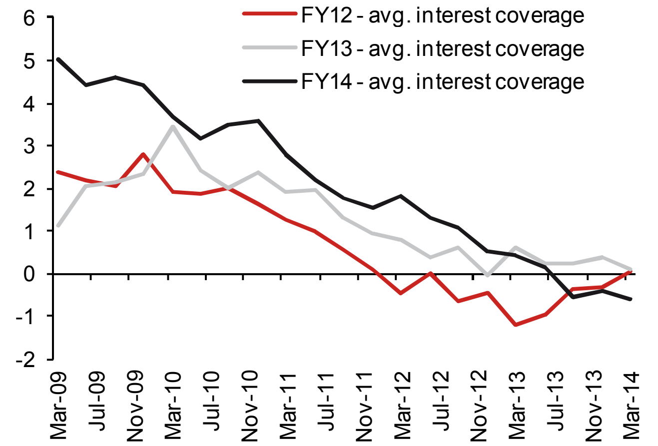
Fig. 71: Restructured book to come off sharply



Source: RBI, Nomura estimates

Fig. 72: However, slippage risk high from existing book

Average interest coverage for large accounts referred to CDR

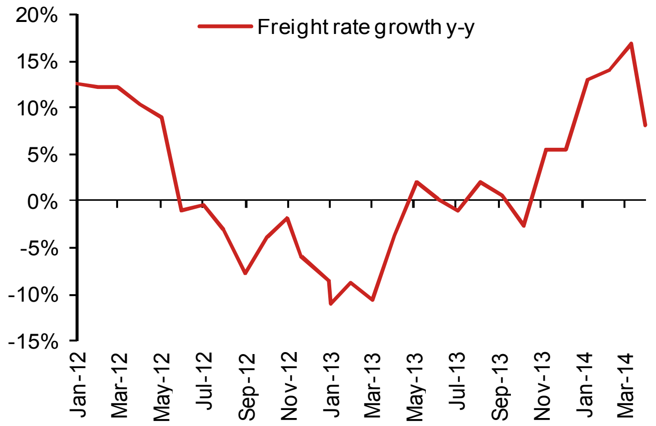


Source: ACE Equity, Nomura estimates

- **SME and retail asset quality – No worries yet, CVs to improve by FY16**:
  - **SME and retail asset quality** (ex CVs) have held up well in this credit cycle. Our interaction with credit bureaus still do not indicate any unhealthy origination of retail loans and no large-scale job losses indicates that the trend is likely to remain robust in the near to medium term.
  - **For CV/CEs,** expected increases in utilisation (due to low capacity addition in the past two-three years) and some buoyancy in freight rates indicate some stabilisation but monsoon-related risks remain. In line with our expectation of improvement in CV sales in FY16, we look for CV asset quality to also recover meaningfully in FY16 and incremental stress could be lower from 2HFY15F.

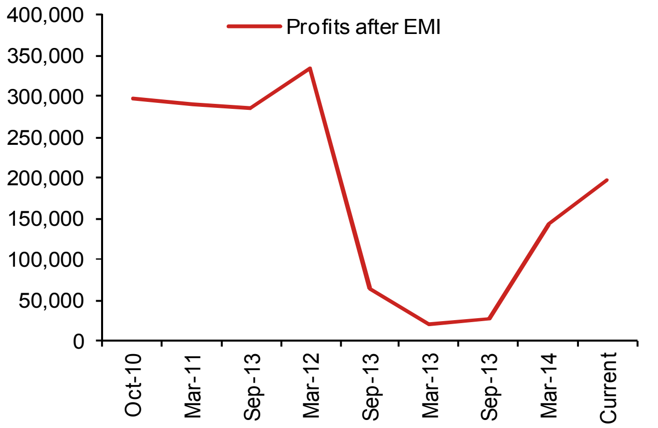
Fig. 73: Freight rates have improved in past 6-9 months

Hikes from Oct-13 exceed



Source: IFTRT, Company data, Nomura estimates

Fig. 74: Leading to improvement in truckers' profitability

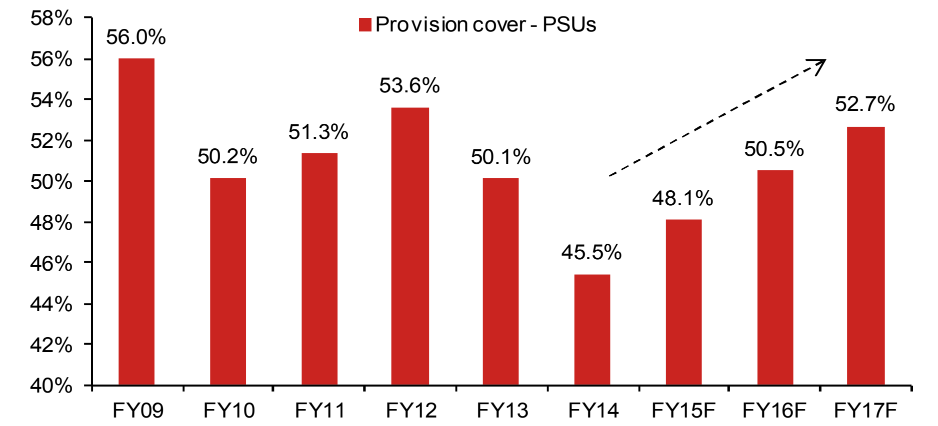


Source: IFTRT, Company data, Nomura estimates

- **Seasoning and regulations should normalise come of the cyclical gains:** As we expect net stressed asset accretion to come off by 50% in the next 2-3 years (from 4% net stressed asset accretion to ~2%), credit costs should also come off, but the fall in credit costs should be less drastic due to seasoning of NPA (higher NPA coverage) for PSU banks and potential imposition of counter-cyclical provisions that should impact private banks and NBFCs. While a slower fall in credit costs should impact profit growth, the fall in net stressed asset accretion is likely to remain the key driver for stock performance.
  1. **For PSU banks**, we expect NPAs to season as accretion of fresh NPAs is lower, hence we factor in NPA coverage to increase by 5-7% in the next two-three years.
  2. **For private banks and NBFCs**: RBI has put some of the counter-cyclical improvement in macro measures, including: **1)** dynamic provisions for banks; and **2)** 180-day to 90-day NPA recognition for NBFCs could be implemented and this would likely increase accounting credit costs for banks/NBFCs.

Fig. 75: PSU banks – We expect an increase in NPA coverage by 5-7%

As the NPA book of PSU bank season - This would push up their adjusted books



Source: Company data, Nomura estimates

Bank-wise asset quality and credit cost expectations:

- **Corporate private banks:** Asset quality performance at **ICICI/Axis/Yes bank** has held up better than investor expectations in spite of significant stress, we believe indicating superior underwriting. Our analysis on large corporate/infra SPV debt indicates that exposure of **ICICI/Axis** to sub-segments where LGD (loss given default) could be high is low (like gas power, unviable roads/ports). As well, we are seeing signs of some deleveraging, which should help their infra conglomerate exposure. Thus, we expect credit costs for **ICICI/Axis to come off to ~75bps in FY16.**
- **Retail private banks:** Asset quality has held up remarkably well and we expect the trend to continue. The only spoiler could be implementation of dynamic provisioning for which **HDFCB** is best placed given ~70bps of additional provisioning buffer that it has built. CV recovery is likely to aid credit costs for IIB (CVs contribute +20% of loans).
- **PSUs:** We look for credit costs to come off from ~140bps to 100bps in the next two-three years in spite of factoring in a 5-7% increase in NPA coverage. Our key concern for PSU banks is potential of high slippages from restructured book (as explained above).
- **NBFCs:** Shriram is likely to see an improvement in credit costs in FY16 due to expected revival in the CV cycle from 2HFY15F. For MMFS, we see a process of credit costs normalisation (moving up again) in FY15 over FY13/14 and this could negatively surprise if the monsoon disappoints further (already 40% below normal). IDFC's fortunes are linked to outcomes on gas power assets on which we remain negative.

Fig. 76: Expected credit costs for banks under coverage

Drop in credit costs for ICIC/Axis and PSU banks

Credit cost	FY14	FY15F	FY16F	FY17F		FY14	FY15F	FY16F	FY17F
ICICI	0.81%	0.88%	0.76%	0.74%	**PNB**	1.79%	1.64%	1.33%	1.21%
Axis	1.03%	1.05%	0.96%	0.82%	**BOB**	0.99%	0.98%	0.89%	0.82%
HDFCB	0.68%	0.65%	0.69%	0.71%	**BOI**	1.46%	1.25%	1.12%	1.00%
Kotak	0.23%	0.38%	0.41%	0.40%	**Union**	1.35%	1.35%	1.20%	0.98%
IIB	0.76%	0.79%	0.67%	0.65%	**MMFS**	1.77%	2.01%	2.12%	2.14%
Yes	0.51%	0.67%	0.62%	0.59%	**STFC**	1.94%	1.90%	1.63%	1.51%
SBI	1.37%	1.29%	1.17%	1.00%	**IDFC**	1.12%	0.89%	0.78%	0.80%

Source: Company data, Nomura estimates

Capital: private comfortable; some PSUs challenged but some comfortable as well

For PSU banks:

- From a capital perspective, a lot has been written about the shortage of capital for PSU banks. We estimate that PSU banks will require ~INR1.5tn of capital infusion assuming 14-15% growth and some pick up in profitability from here on. ***This is about 40% of current net worth and ~35% of current market cap of PSU banks.***
- While the numbers look large, ~40% of the PSUs (including SBI/PNB/BOB) require just 20-25% of current net worth to be raised over the next four-five years, which we believe is manageable. The problem is the other 50-60% of PSUs which require ~60% of their FY14 net worth and ~75% of their market cap to be raised over the next four-five years.
- Within our coverage, Union and BOI require material dilutions as their current core equity tier-1 is <7%. In our models, we assume a phased dilution for all PSUs such that they are +9% Tier-1 by FY17 (comfortable from RBI's mandated BASEL- III Path). This requires ~40% dilution in the case of Union/BOI and <10% dilution in the case of PNB/BOB/SBI.

Fig. 77: Some PSUs comfortable on capital but for some, capital is a big challenge

We see no challenges for those marked in blue, minor challenge for those in white and significant challenges for those in red.

Summary of outcome for various PSU banks:	Normalised ROAs (FY16)	FY14 Tier-1	Innovative instruments (% of capital)	FY14 CET Tier-1	FY16 ROEs	Capital needed (% of FY19 NW)	Capital needed (% of FY14 NW)
Indian	0.8%	10.3%	4,000	9.9%	12.7%	7.1%	12.2%
BOB	0.8%	9.8%	19,117	9.3%	14.7%	4.8%	9.1%
PNB	0.9%	9.3%	20,205	8.9%	13.6%	14.2%	25.5%
SBI	0.9%	9.7%	67,330	9.3%	13.4%	14.5%	25.6%
Syndicate	0.7%	7.9%	7,730	7.4%	14.8%	29.3%	55.6%
Allahabad	0.7%	7.8%	3,000	7.6%	14.8%	29.2%	55.4%
Canara	0.7%	9.0%	15,896	8.5%	12.9%	23.4%	40.9%
OBC	0.7%	8.8%	8,500	8.3%	12.2%	31.8%	53.6%
Andhra	0.6%	7.9%	2,000	7.7%	12.1%	43.7%	73.8%
Union	0.7%	7.9%	11,510	7.5%	14.4%	33.6%	62.2%
Corporation	0.7%	7.7%	7,375	7.2%	14.2%	39.4%	72.0%
Punjab & Sind	0.5%	7.9%	1,600	7.7%	12.9%	64.4%	112.5%
BOI	0.7%	7.6%	20,579	7.0%	15.0%	36.0%	68.2%
IOB	0.6%	7.9%	7,800	7.5%	12.8%	47.7%	80.8%
UCO	0.7%	9.1%	22,030	7.2%	15.1%	21.4%	40.7%
IDBI	0.6%	7.7%	17,088	7.2%	10.7%	65.4%	102.3%
United	0.6%	6.3%	8,000	5.3%	15.6%	72.6%	136.9%
Central	0.6%	7.3%	22,000	6.3%	13.1%	67.5%	117.0%
Vijaya	0.6%	8.1%	12,000	6.4%	12.6%	51.8%	89.2%
Private Banks							
ICICIB	1.6%	12.9%	31,430	12.3%	13.6%	0.0%	0.0%
Axis	1.6%	11.8%	464	11.8%	17.8%	0.0%	0.0%
Yes	1.3%	9.7%	7,724	8.8%	16.5%	0.5%	1.5%
Indusind	1.6%	13.4%	-	13.4%	17.9%	0.0%	0.0%
HDFCB	1.9%	11.5%	2,000	11.4%	20.1%	0.0%	0.0%

Source: RBI, Company data, Nomura estimates

Fig. 78: Basel-III assumptions

Assumptions	FY13	FY14	FY15	FY16	FY17	FY18	FY19
Total Core Equity Requirement	4.50%	5.00%	5.50%	6.13%	6.75%	7.38%	8.00%
Total Tier-1 Requirement	6.00%	6.50%	7.00%	7.63%	8.25%	8.88%	9.50%
Assuming earlier migration	**6.50%**	**7.00%**	**7.50%**	**8.13%**	**8.75%**	**9.38%**	**9.50%**

Credit growth (%)	**14.5%**	*Sensitivity to Loan growth for PSU banks*
Dividend Payout (%)	**14.0%**	*Assumption of dividend payout (retention)*
Cost of Deposits	**8.0%**	*Incremental cost of term deposits (cost savings for higher leverage)*

Source: RBI, Nomura estimates

Fig. 79: Capital raising expected for PSU banks – PSU banks ex SBI/PNB/BOB will need to raise ~70% of their Mcap in next 4 years to meet capital requirements

Material dilution only for BOI/Union within our coverage universe

Total capital to be raised	Cummulative capital to be raised (Rs mn)	FY15	FY16	FY17	FY18	FY19	FY14 NW	Capital to be Raised (% of 14' NW)	Mcap (INRmn)	Capital to be Raised (% of Mcap)
SBI	304,885	-	-	7,619	195,973	101,293	1,189,348	26%	2,000,965	15%
IDBI	184,056	27,451	41,200	51,506	63,899	47,048	225,862	81%	172,664	105%
Central	134,968	38,968	25,591	31,587	38,822	25,141	136,840	99%	102,566	129%
BOI	148,457	23,200	32,636	41,144	51,477	28,282	259,137	57%	195,569	77%
UCO	38,336	3,180	8,999	11,528	14,629	5,314	107,255	36%	106,798	36%
IOB	86,090	8,506	20,121	25,484	31,979	21,442	133,050	65%	99,198	85%
Union	90,653	4,374	22,278	28,326	35,675	20,271	178,383	51%	147,838	60%
PNB	63,128	-	-	13,210	49,918	25,484	347,317	18%	360,803	18%
Syndicate	54,172	2,616	13,310	16,925	21,321	11,478	118,056	46%	107,678	49%
Vijaya	44,405	12,134	8,670	10,621	12,980	7,868	58,574	76%	46,822	93%
OBC	53,066	-	6,104	20,731	26,231	16,949	39,646	134%	98,530	54%
Canara	78,053	-	-	32,956	45,097	26,865	256,259	30%	212,825	37%
Corporation	63,838	7,040	14,740	18,654	23,404	13,982	108,129	59%	66,280	97%
United	58,647	25,134	9,063	11,035	13,416	7,909	48,630	121%	23,743	237%
Punj. & Sind	34,819	-	8,740	11,496	14,582	9,785	39,646	88%	19,944	174%
Andhra	52,743	499	13,465	17,156	21,623	15,110	91,955	57%	59,463	87%
BOB	18,227	-	-	-	18,227	13,426	349,080	5%	377,134	5%
Allahabad	54,116	-	13,300	17,990	22,826	12,807	120,876	45%	76,953	69%
Indian	6,224	-	-	-	6,224	8,394	119,337	5%	83,115	7%
Total	**1,568,883**	**153,104**	**238,216**	**367,969**	**708,302**	**418,848**	**3,927,382**	**40%**	**4,358,889**	**36%**
Total ex SBI/BOB/PNB	**1,182,643**	**153,104**	**238,216**	**347,140**	**444,184**	**278,645**	**2,041,637**	**58%**	**1,619,987**	**72%**

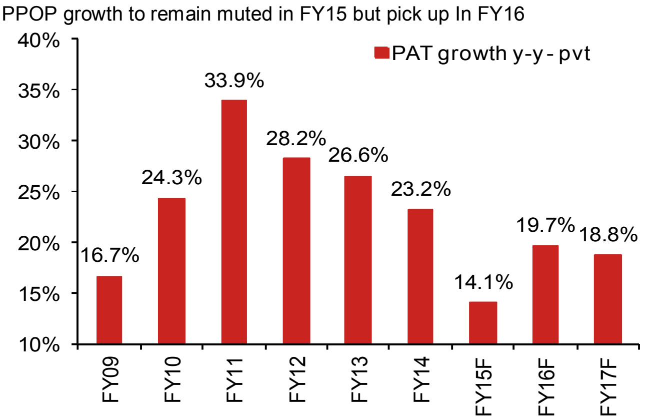
Source: Bloomberg, ACE Equity, Nomura estimates

Overall earnings growth: FY15F to be modest; FY16F could be large

Private banks: Expected to maintain high return ratios

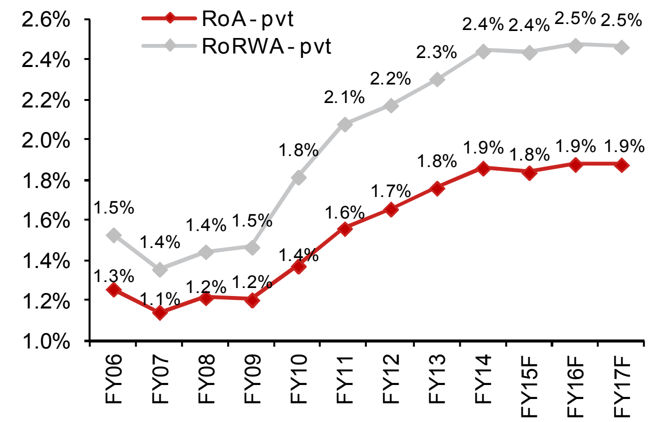
- **ICICI and Axis:** With NIMs and opex levers peaking out and B/S and fee income growth largely expected to improve in FY16F, we look for only <10-12% core PPOP growth for ICICI/Axis this year because some of the non-core earnings are unlikely to recur in the same magnitude as in FY14 (dividends, FX repatriation profits). However, post FY15, we look for earnings growth for ICICI/Axis to pick up with ~17% PAT growth for ICICI over FY16/17F and ~20% PAT growth for Axis.
- **For defensives**, PPOP growth has moderated in FY15F but continued low credit costs have aided PAT growth even in FY14. As we expect credit costs to remain low, PAT growth trends should remain steady.
- **Return ratios have inched up; we expect them to sustain at high levels:** In spite of the slowdown, profitability of private banks has improved with ROA expected to reach an all time high of 1.8% by FY16F vs. 1.3% in FY06-07 and 1.5-1.6% in FY10-11. While PPOP levers as we have mentioned earlier have peaked, credit costs should moderate in FY16F, hence we expect private banks to maintain their high return ratios.

Fig. 80: PAT growth expectations for private banks



Source: Company data, Nomura estimates

Fig. 81: RORWAs have improved in spite of the slowdown



Source: Company data, Nomura estimates

Fig. 82: Significant improvement in RORWAs by most private banks even in the downturn

HDFCB's RORWA improvement has been the highest - ICICI/Axis has also reported strong improvement

Company		FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Axis	ROA	1.17%	1.11%	1.21%	1.46%	1.69%	1.75%	1.72%	1.75%	1.80%	1.73%	1.75%	1.76%
	RORWA	1.61%	1.41%	1.51%	1.86%	1.98%	2.01%	1.98%	2.11%	2.28%	2.24%	2.27%	2.29%
	ROE	18.3%	21.0%	17.6%	19.1%	18.9%	19.3%	20.3%	18.5%	17.4%	17.0%	17.5%	18.2%
ICICI	ROA	1.30%	1.11%	1.19%	1.03%	1.16%	1.42%	1.55%	1.75%	1.85%	1.81%	1.89%	1.88%
	RORWA	1.47%	1.25%	1.28%	1.05%	1.24%	1.62%	1.75%	1.98%	2.09%	2.00%	2.05%	2.01%
	ROE	14.6%	13.4%	11.7%	7.8%	8.0%	9.7%	11.2%	13.1%	14.0%	13.9%	15.0%	15.6%
HDFCB	ROA	1.39%	1.42%	1.43%	1.44%	1.48%	1.62%	1.77%	1.84%	1.97%	2.00%	2.02%	2.01%
	RORWA	1.68%	1.70%	1.75%	1.90%	2.07%	2.25%	2.37%	2.37%	2.61%	2.71%	2.74%	2.73%
	ROE	17.5%	19.5%	17.7%	16.9%	16.1%	16.7%	18.7%	19.6%	21.3%	21.5%	21.8%	22.1%
IIB	ROA	0.22%	0.38%	0.36%	0.63%	1.18%	1.49%	1.62%	1.68%	1.83%	1.81%	1.83%	1.84%
	RORWA	0.28%	0.51%	0.48%	0.84%	1.72%	2.18%	2.30%	2.29%	2.34%	2.25%	2.27%	2.27%
	ROE	4.0%	7.1%	6.9%	11.7%	19.5%	19.3%	19.3%	17.8%	17.6%	18.0%	19.1%	20.1%
Yes	ROA	2.14%	1.29%	1.43%	1.62%	1.69%	1.58%	1.62%	1.59%	1.65%	1.67%	1.69%	1.69%
	RORWA	2.04%	1.27%	1.46%	1.79%	2.17%	2.12%	2.05%	2.18%	2.25%	2.23%	2.24%	2.21%
	ROE	14.0%	13.9%	18.1%	20.7%	20.3%	21.1%	23.1%	24.8%	25.0%	19.9%	18.1%	18.6%
Kotak	ROA	1.47%	0.98%	1.28%	1.03%	1.80%	1.94%	1.93%	1.89%	1.82%	1.86%	1.81%	1.91%
	RORWA	1.80%	1.21%	1.61%	1.30%	2.37%	2.65%	2.60%	2.50%	2.36%	2.40%	2.35%	2.49%
	ROE	14.8%	11.4%	11.4%	7.5%	13.5%	14.5%	14.7%	15.6%	13.8%	13.0%	13.2%	14.9%

Source: Company data, Nomura estimates

PSU banks: Expect high profit growth but ROE in this cycle to remain under or at best in line with cost of equity

- **No PAT growth in past five years:** PSU banks in the past five years have not seen any PAT growth, largely owing to lower margins and more importantly higher NPAs/credit costs. As a result, return ratios for PSU banks have come down to 10-year lows of ~65bps ROA and 10.5% ROE.
- **Expect 25% CAGR earnings growth in next three years:** With some tick up expected in margins, primarily driven by lower interest reversals and a fall in credit costs (as recovery picks up), we estimate PSU banks to report PAT CAGRs of ~23-25% for the next three years, which is likely to lead to an improvement in return ratios but ROEs should remain lower or at best at par with cost of equity in spite of factoring in a strong recovery in earnings.
- **ROE should remain sub-optimal:**

(1) Inherent leverage is likely to be lower in this cycle with BASEL III implementation (leverage should come off from +20x in the previous recovery or 18-19x in 2009-10 to ~15-16x in FY16/17F).

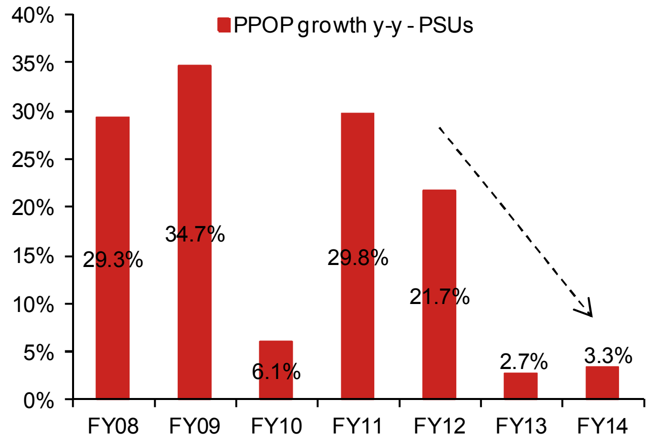
(2) Infra contributed 20% of overall system growth between FY08-12. During origination, this product was very attractive with high yields and fees and very low opex and credit costs. We are unlikely to get such a highly profitable growth engine in the next two-three years. Retail credit, which is the current focus segment for PSUs, is not that profitable.

(3) We are less concerned on pensions today given 3-4x increase in P&L pension provisioning over the past three-four years. However, in spite of that we think, the upside in terms of lower opex/assets was exhausted in the previous cycle as PSU banks will need to employ people and open more branches, hence opex/assets is unlikely to be a lever for profitability improvement.

(4) Structural factors like losing fee income share + CASA market share continue.

Fig. 83: PPOP growth and PAT growth for PSU banks

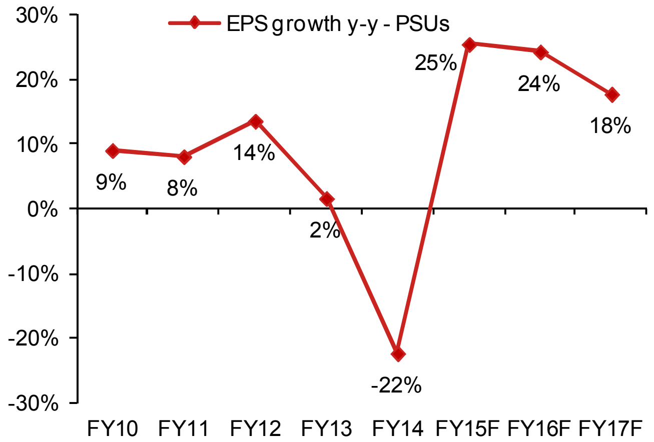
Weak performance in past 2-3 years in spite of B/S growth



Source: Company data, Nomura research

Fig. 84: We expect some improvement

Driven by plateauing margins and improvement in asset quality



Source: Company data, Nomura research

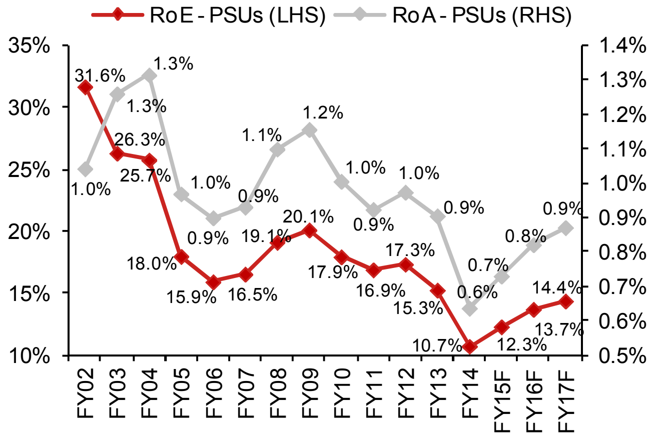
Fig. 85: EPS for PSU banks has not grown over the past five years - We expect some pick up in the next two-three years

PSU Banks (INRbn)	FY09	FY10	FY11	FY12	FY13	FY14	CAGR (FY09-14)	FY15F	FY16F	FY17F	CAGR (FY14-17F)
Net Interest Income	505	579	802	968	1,039	1,144	17.8%	1,312	1,512	1,738	14.9%
Fees	207	240	280	274	309	343	10.6%	388	445	511	14.2%
Net revenues	712	819	1,082	1,243	1,348	1,487	15.9%	1,699	1,957	2,249	14.8%
Operating Expense	340	414	522	570	649	780	18.1%	856	967	1,097	12.0%
Operating profit	372	405	560	673	698	707	13.7%	844	989	1,152	17.7%
Provisions	100	113	204	280	306	393	31.6%	399	399	417	2.0%
PBT	326	338	382	433	427	364	2.2%	491	632	777	28.7%
PAT	213	225	241	296	318	261	4.1%	341	437	536	27.1%
EPS growth							1.4%				25.1%
Loans	12,885	15,189	18,413	21,715	25,270	29,244	17.8%	33,253	38,482	44,947	15.4%
ABVPS growth							10.2%				11.5%

Source: Company data, Nomura estimates

Fig. 86: However, this will just be enough to earn COE or in many cases ROE will remain below COE, on our estimates

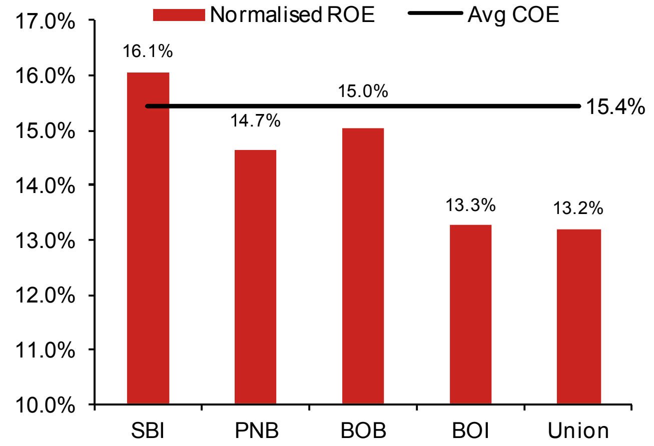
ROE trend for PSU banks



Source: ACE Equity, Nomura estimates

Fig. 87: Our normalised ROE assumptions for PSU banks

Some PSUs ROEs will still remain below par



Source: Nomura estimates

Fig. 88: PSU banks – We see a tick up in profitability over next 3 years but ROEs to remain sub-optimal

SBI/PNB/BOB to earn near cost of Equity returns while BOI/Union's ROEs will be lower than their Cost of Equity

Company		FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
SBI	ROA	0.89%	0.92%	1.05%	1.02%	0.89%	0.73%	0.92%	0.93%	0.63%	0.77%	0.85%	0.89%
	RORWA	1.50%	1.42%	1.45%	1.47%	1.36%	1.10%	1.41%	1.45%	0.96%	1.16%	1.28%	1.33%
	ROE	16.1%	16.6%	17.6%	16.8%	15.0%	13.0%	16.1%	15.3%	10.1%	12.3%	13.8%	14.3%
BOB	ROA	0.83%	0.84%	0.93%	1.13%	1.24%	1.36%	1.28%	0.92%	0.77%	0.73%	0.83%	0.85%
	RORWA	1.34%	1.27%	1.35%	1.78%	2.12%	2.32%	2.16%	1.60%	1.37%	1.30%	1.47%	1.49%
	ROE	12.3%	12.4%	15.7%	21.1%	24.2%	25.3%	21.7%	15.7%	13.8%	13.6%	15.5%	15.7%
PNB	ROA	1.12%	1.05%	1.17%	1.43%	1.48%	1.35%	1.20%	1.04%	0.67%	0.77%	0.91%	0.97%
	RORWA	1.65%	1.55%	1.72%	2.19%	2.27%	2.02%	1.81%	1.54%	0.96%	1.12%	1.32%	1.40%
	ROE	17.0%	16.0%	19.6%	25.8%	26.6%	24.4%	21.1%	16.5%	10.2%	11.9%	14.0%	14.8%
BOI	ROA	0.70%	0.91%	1.29%	1.54%	0.72%	0.89%	0.78%	0.68%	0.55%	0.59%	0.67%	0.77%
	RORWA	1.17%	1.44%	1.90%	2.29%	1.15%	1.36%	1.22%	1.05%	0.86%	0.93%	1.05%	1.19%
	ROE	15.4%	21.2%	27.6%	29.2%	14.2%	17.3%	15.0%	12.9%	11.2%	11.7%	12.4%	13.5%
Union	ROA	0.91%	0.94%	1.33%	1.33%	1.25%	1.03%	0.75%	0.80%	0.53%	0.58%	0.68%	0.81%
	RORWA	1.44%	1.48%	1.89%	1.95%	1.90%	1.58%	1.16%	1.16%	0.78%	0.86%	1.01%	1.19%
	ROE	18.7%	19.2%	26.8%	27.2%	26.2%	20.9%	14.8%	15.0%	10.4%	10.9%	11.7%	13.1%

Source: Company data, Nomura estimates

NBFCs: It's going to be a mixed bag

In our view, earnings growth for NBFCs is going to be a mixed bag with HFCs (HDFC/LICHF) likely to report secular growth of 15-17% in earnings over the next two years, asset financiers (Shriram and MMFS) likely to see a recovery in earnings from FY16 onwards while, for IDFC, near-term profitability is likely to be challenged as it transforms into a bank

For HFCs: We factor in a stable funding environment as liquidity is expected to remain benign but increasing competition in mortgages will likely constrain margins. We look for stable ~15-17% PAT growth for LICHF and HDFC over the next two years. There is a possibility of an upside surprise in the case of LICHF if both liquidity and competition are benign in mortgages.

For Asset Financers: FY15 is likely to be a weak growth year both for Shriram and MMFS and hence earnings growth should remain muted. While for Shriram credit costs have peaked and we expect improvement from 2H1FY15, a weak monsoon could delay credit costs improvement in the case of MMFS.

Fig. 89: Earnings for NBFCs are going to be a mixed bag

Company		FY14	FY15F	FY16F	FY17F
HDFC	Loan growth	15.91%	16.43%	18.44%	19.18%
	NII growth	13.3%	17.6%	15.5%	18.1%
	PPOP growth	12.2%	18.4%	15.8%	18.0%
	PAT growth	12.2%	17.5%	15.8%	18.1%
LICHF	Loan growth	17.4%	16.9%	18.2%	19.2%
	NII growth	23.5%	17.1%	17.5%	18.8%
	PPOP growth	28.2%	15.5%	17.2%	18.4%
	PAT growth	30.2%	14.7%	16.1%	18.4%
MMFS	AUM growth	22.3%	14.0%	22.0%	23.0%
	NII growth	22.1%	15.9%	18.8%	20.5%
	PPOP growth	20.7%	15.3%	18.1%	20.6%
	LLPs	1.77%	2.01%	2.12%	2.14%
	PAT growth	3.9%	11.9%	15.6%	19.2%
STFC	AUM growth	6.9%	8.7%	17.0%	16.0%
	NII growth	4.0%	9.5%	15.7%	16.8%
	PPOP growth	-0.1%	8.2%	15.2%	17.5%
	LLPs	1.94%	1.90%	1.63%	1.51%
	PAT growth	-7.1%	9.7%	23.3%	21.9%
IDFC	Loan growth	1.5%	5.0%	8.0%	10.0%
	NII growth	6.7%	2.4%	7.4%	8.9%
	PPOP growth	9.4%	1.9%	4.5%	3.2%
	LLPs	1.12%	0.89%	0.78%	0.80%
	PAT growth	-0.2%	6.8%	6.6%	1.7%

Source: Company data, Nomura estimates

How valuations compare now: Axis/ICICI are our top picks

Sector valuations have mean-reverted meaningfully – Pricing in a decent recovery
Bank valuations had moved down from the end of Dec-10 to Sep-13, in line with the significant GDP growth slowdown, build-up in NPAs, elongated rate cycle and lastly exaggerated by BOP/CAD concerns (in mid CY13). However, valuations have mean-reverted quite significantly over the last 6-8 months, led first by easing BOP/CAD pressures, then by consensus expectations of a possibility of a NDA led government and lately due to an absolute majority to the BJP government.

In comparison, sector valuations are just about 15-20% lower than valuations seen at the beginning of the slowdown (end of FY11) when GDP growth levels were much higher (~7%) than current levels but decelerating. With economic growth currently ~200-300bps lower than end FY11 levels, stock prices are implying a meaningfully large improvement in overall growth levels and fundamental profitability improvement.

Fundamental performance and risks have played out very differently for different segments of India financials (corporate private, retail private, PSUs, NBFC) and we, hence, evaluate the way forward in each segment separately.

Fig. 90: Valuations are certainly pricing in a meaningful improvement

P/BV	Axis	ICICIBC	SBI	BOB	PNB	BOI	UNBK
Average from 2004	2.03	1.79	1.26	1.03	1.23	1.07	1.12
Pre 2004	1.35	1.44	0.76	0.89	0.97	0.64	0.86
2004-2007	2.38	2.08	1.16	1.00	1.40	1.13	1.25
2009-11	2.23	1.80	1.64	1.25	1.49	1.31	1.38
From 2011 onw ards	1.67	1.69	1.24	1.03	1.03	0.93	0.93
Sep-13	1.11	1.39	0.88	0.62	0.53	0.43	0.47
Current valuations	**1.78**	**1.82**	**1.19**	**0.92**	**0.93**	**0.72**	**0.82**

Source: Company data, Bloomberg, Nomura estimates

Fig. 91: Bank stock performance - Strong mean reversion seen in the last 3-6 months

	Absolute performance					Relative performance				
	1M	3M	6M	1Yr	2Yr	1M	3M	6M	1Yr	2Yr
Private										
ICICI	-0.7%	15.0%	31.5%	37.7%	69.7%	-5.0%	-16.2%	16.3%	4.5%	-8.4%
HDFCB	4.0%	11.1%	26.1%	32.6%	52.3%	-0.3%	-20.1%	10.9%	-0.7%	-25.7%
Axis	2.8%	34.6%	50.1%	54.9%	89.8%	-1.5%	3.4%	34.8%	21.6%	11.8%
Kotak	2.3%	14.2%	20.9%	27.0%	50.6%	-2.0%	-17.0%	5.6%	-6.3%	-27.5%
Yes	1.4%	39.2%	48.8%	26.9%	64.4%	-2.9%	8.0%	33.6%	-6.4%	-13.6%
Indus Ind	4.5%	17.3%	35.7%	26.7%	77.2%	0.2%	-13.9%	20.5%	-6.5%	-0.8%
PSUs										
SBI	-1.6%	50.4%	51.1%	36.5%	23.2%	-5.9%	19.2%	35.9%	3.2%	-54.8%
PNB	-4.6%	43.6%	53.7%	50.5%	25.1%	-8.9%	12.4%	38.5%	17.2%	-52.9%
BOB	-4.9%	27.7%	34.1%	57.5%	22.4%	-9.2%	-3.5%	18.9%	24.3%	-55.7%
BOI	-10.7%	40.5%	29.6%	28.2%	-14.8%	-15.0%	9.3%	14.3%	-5.0%	-92.8%
Union	9.9%	95.1%	81.2%	26.9%	15.9%	5.6%	63.9%	66.0%	-6.4%	-62.1%

Source: Bloomberg, Nomura research Note: Pricing as on 1st July 2014

Private Corporate – Scope for more re-rating for Axis/ICICI

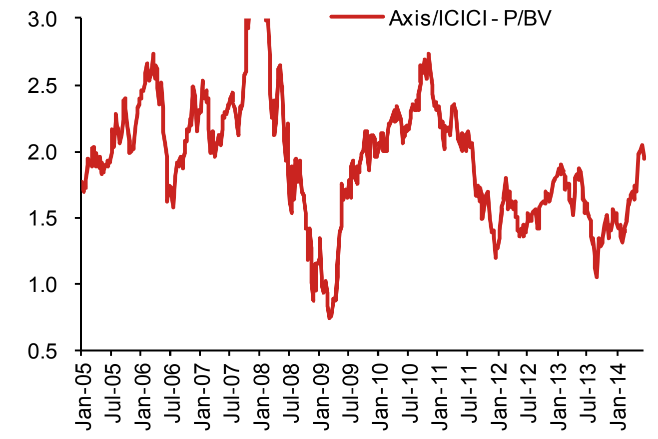
Better underwriting in the corporate book: Private banks such as ICICI and Axis had also built in large exposures to infrastructure-/capex-heavy industries over FY07-11 and the slowdown in corporate book has also been clearly visible for them as well in the last two years. However, their asset quality has held up well vs. street expectations, indicating better underwriting and, more importantly, they have managed their PPOP performance very well by diversifying more into retail, improving on liabilities and of late exhibiting significant opex flexibility.

Balance sheet much more granular: Admittedly, valuations for ICICI/Axis have mean-reverted to ~1.8x (Mar-16F book), risks still remain on their mid corporate and infrastructure conglomerate exposure and growth is unlikely to revert to levels seen in the previous cycle. However, business models for ICICI/Axis have evolved since the previous cycle with: ***1) liabilities much more granular now, 2) retail asset/fee mix improving for Axis, and 3) most importantly, RORWAs at peak levels leading to higher normalised ROEs than the last cycle.***

Thus, we believe that there is more scope for re-rating in case of both Axis and ICICI, especially as and when some the asset quality concerns get addressed. Axis is higher on our pecking order due to (1) relatively better RORWAs, (2) better liability franchise (especially on CA) and (3) similar asset quality risks vs perception of higher risk.

Fig. 92: Valuations have mean-reverted for ICICI/Axis but still cheap in the historical context…

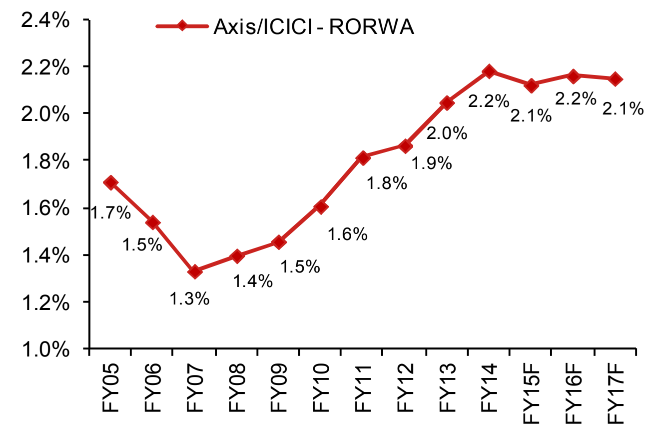
Valuations still ~15-20% lower than FY04-07 levels



Source: RBI, Nomura research

Fig. 93: …especially considering the ROROWA improvement

Profitability at least 30% higher than FY04-07 levels



Source: RBI, Nomura estimates

Fig. 94: Many fundamental metrics for Axis/ICICI have improved in the last

	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Axis									
SME+Retail+Agri as a % of loans	59.1%	53.2%	51.3%	49.5%	49.7%	46.7%	46.4%	50.1%	53.9%
CASA+retail TD as a % of deposits						59.1%	63.3%	69.6%	75.0%
Retail fees as a % of total fees					27.6%	23.4%	23.9%	28.6%	26.6%
Acceptance+LCs as a % of loans	32.0%	26.7%	33.9%	44.2%	51.6%	55.5%	51.2%	43.5%	39.2%
Non-funded exposure as a % of funded exposure					29.9%	33.3%	31.8%	25.5%	24.3%
ICICI									
SME+Retail+Agri as a % of loans			58.4%	62.6%	57.0%	53.2%	52.8%	42.2%	43.4%
CASA+retail TD as a % of deposits				53.7%	65.6%	70.9%	73.4%	76.2%	80.0%
Acceptance+LCs as a % of loans	20.4%	24.4%	29.4%	40.7%	51.9%	56.4%	60.1%	53.9%	45.1%
Non-funded exposure as a % of funded exposure					62.9%	66.6%	70.0%	47.7%	45.3%

Source: Company data, Nomura research Note: For ICICI Retail TD estimates are used for FY10-13

Valuations held up for defensives – Continue to remain a play on earnings growth

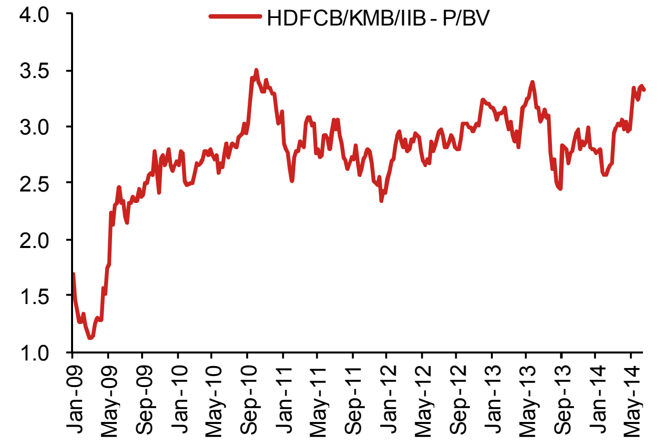
For most retail banks, valuations have held up well given that retail asset quality has surprised even the most optimistic expectations and no exposure to capex-/infrastructure-linked term lending aided asset quality. It is only in the last 18 months that CV growth and asset quality has faltered and of late there has been a slowdown in overall retail lending, which they have managed well through opex flexibility.

While there should not be recovery-linked credit costs upside, retail credit growth ex-mortgages will pick up as the overall recovery improves. Thus, for defensives, we are unlikely to see any re-rating of multiples and earnings growth should remain the key driver for stock performance. Most defensives scan out well on expected earnings growth for the next 2-3 years.

HDFCB preferred: We like HDFCB among defensives and its recent underperformance provides a unique opportunity. IIB does have its lumpiness in fees and its recent high corporate growth was not desirable, but improving macros will aid its CV book (+20% of loans) and credit risks from the recent hyper growth in corporate book will be lower in an upcycle, in our view. We see valuation constraints in case of Kotak and HDFC.

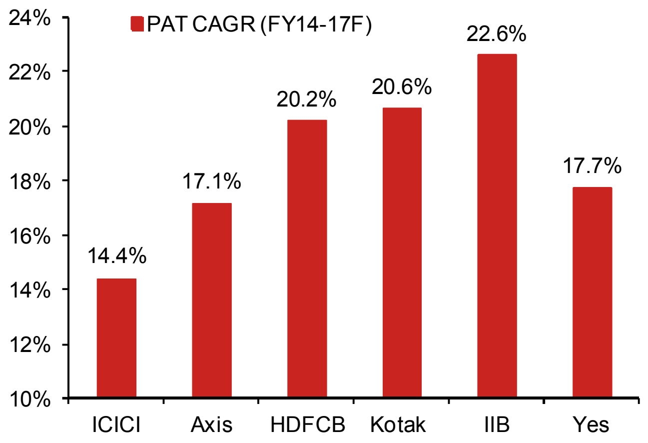
Fig. 95: Valuations have held up well for defensives

Hence we do not see any re-rating



Source: Bloomberg, company data, Nomura estimates

Fig. 96: However, earnings growth is likely to remain robust

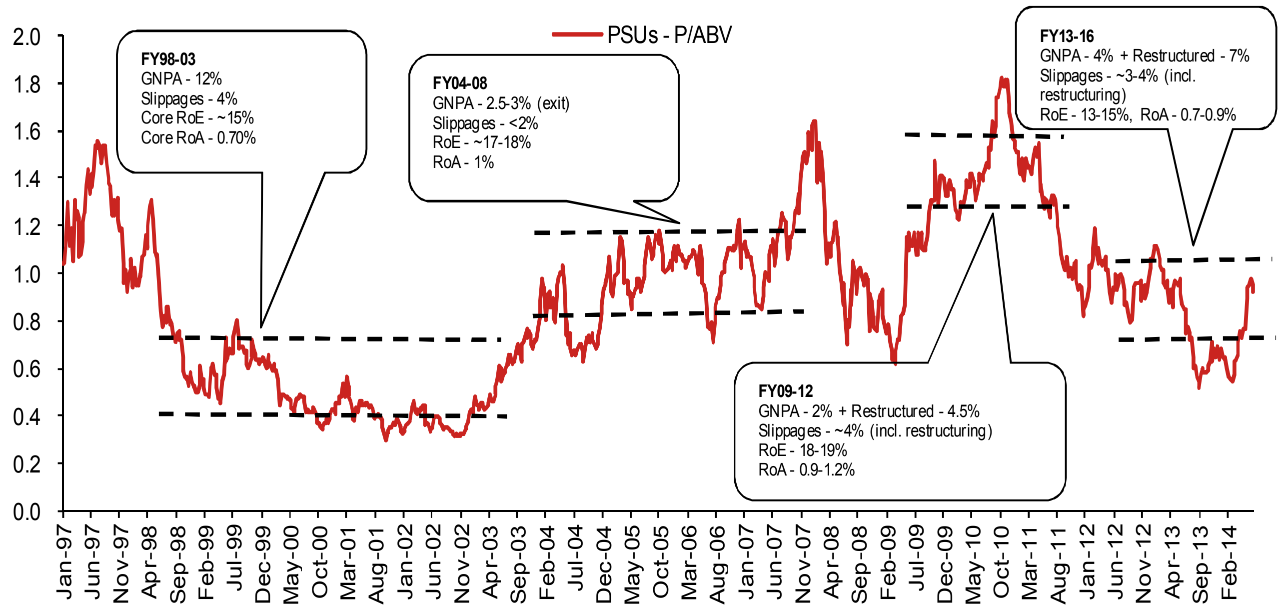


Source: Company data, Nomura estimates

PSU banks – finding the right P/B for their new normalised ROEs

PSU banks valuations have suffered the most in the last three years driven by a spike in stressed assets to ~12% of loans and the consequent impact on margins/return ratios, compounded by BASEL III challenges and catch-up on pension provisioning. With credit costs reversing, we look for earnings to post a robust ~22% CAGR over the next three years but we have explained in detail in the previous section why normalised ROEs for PSU banks will be much inferior to what we have seen in previous cycles and, hence, investors should evaluate PSUs in the context of lower normalised ROEs.

Fig. 97: PSU banks' valuations vs return ratios and asset quality in last 15 years

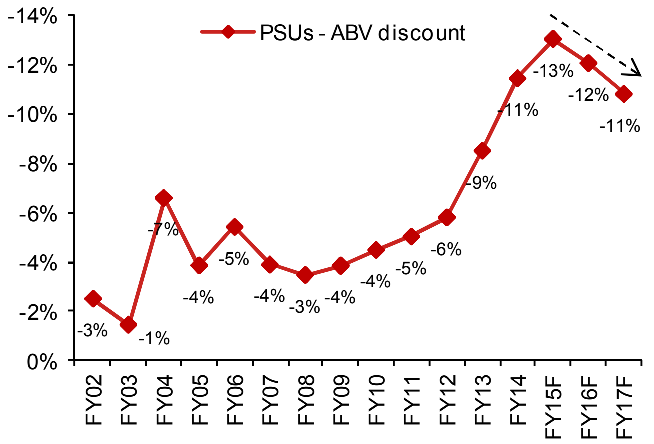


Source: Bloomberg, Company data, Nomura estimates

Some comfort from book adjustments going forward: In a downcycle, consensus has penalized PSU banks by adjusting their book value down for higher coverage on stressed assets and basing ROEs and multiples on reported book. We think the ideal valuation comparison should be on reported ROEs and unadjusted book (70% NPA coverage) or adjusted book (reported) and adjusted ROEs. Our adjusted book for PSU banks is ~10% lower and the adjustment is likely to come off as slippages abate into FY16F. Thus, we base our valuations on an average of adjusted and unadjusted book.

Fig. 98: Adjusted book vs reported book

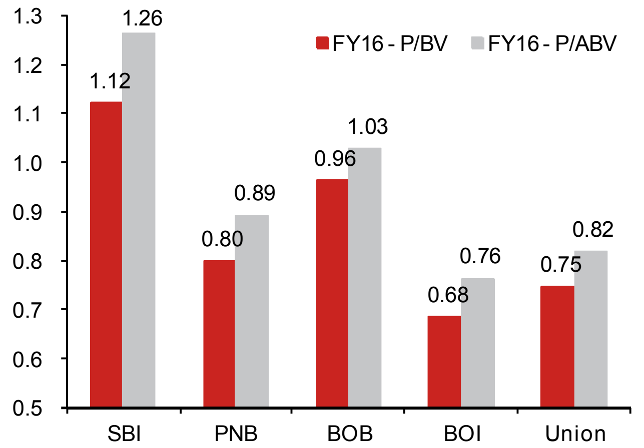
The gap will likely narrow from here on as we expect increase in coverage



Source: Company data, Nomura estimates

Fig. 99: Valuations a tad better on reported book

In upcycle, investors may look at reported book rather than adjusted book



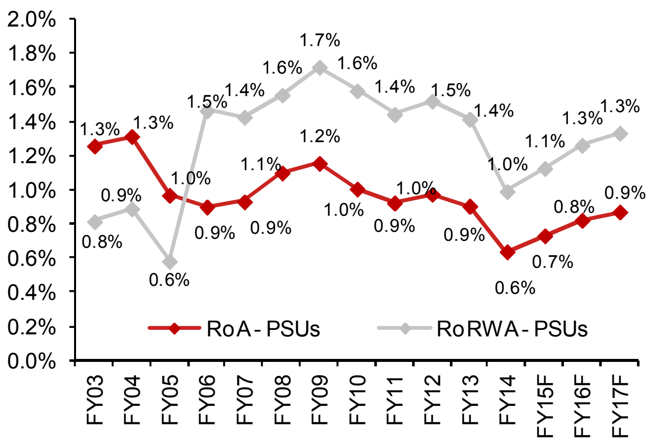
Source: Nomura estimates

Within our PSU coverage:

- We see **BOB, PNB and SBI** generating ROEs which should be at par with their cost of equity. Among them, we like BOB and SBI.
- **BOB's** recent underperformance vs peers and superior underwriting drives our positive view as we believe transition risks to asset quality will be lower.
- **For SBI**, we expect a mean reversion of their asset quality with peers to play out in FY15F and admittedly we take a leap of faith on delivery of strong performance with the new chairman.

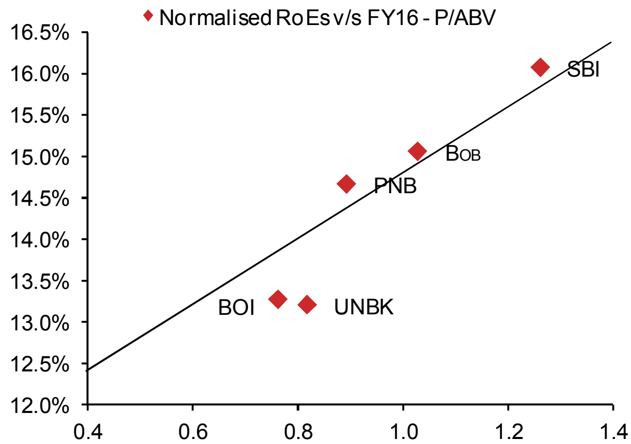
- **PNB's** underwriting has been the weakest and relapse risk from restructured book highest. After recent mean reversion in valuations with peers, we are negative on PNB.
- Of the two capital starved PSUs, **Union's** ~30% outperformance has brought back valuations to just 10-20% discount to BOB/PNB, which, in our view, is more than fair given the 200-250bp lower ROEs and lower capital levels. **BOI's** valuations seem reasonable to us but we are uncomfortable with management's growth focus in spite of low capital levels.
- We have factored in enough dilutions for PSU banks so that their tier-1 capital in FY17 is +9% – the dilution is 10% or lower in case of BOB/PNB/SBI but ~40% in case of BOI/Union.

Fig. 100: RORWAs low for



Source: Company data and Nomura estimates

Fig. 101: PSU banks' normalised ROEs and current P/B



Source: Nomura estimates

Top sector picks:

- **Axis Bank (TP of INR2,300 - 19% upside):** Axis Bank's business model has become less risky vs. the last upcycle as the bank continues to build significant granularity in its liabilities/assets and fees. While we believe asset quality concerns will only gradually reduce, our analysis of its large corporate/SPV exposure is comforting given the low exposure to sub-segments where the loss given default could be higher – **our preferred recovery play.**
- **ICICI Bank (TP of INR1,650 - 15% upside):** ICICI's ROEs, over the past 2-3 years, have improved despite a slowdown driven primarily by NIM improvement. Though margins levers look exhausted now, we see opex levers playing out in the near-term and credit cost and leverage improvements should drive core ROEs (to 16-17%) over the next 2-3 years. ICICI finally seems to be delivering on business banking/CA business (historic weakness), and while asset quality concerns will only ebb gradually, our analysis of its large corporate/SPV exposures is comforting given ICICI's low exposure to sub-segments where LGD (loss given default) could be higher.
- **HDFC Bank (TP of INR850 – 14% upside):** Our positive view is driven by a mix of: (1) steady profitability with large floating provision cushion, (2) improvement on most underlying metrics, and (3) increasing and sector-best RORWAs/ROAs. In our view, the recent underperformance due to technical reasons provides a good entry opportunity.
- **Bank of Baroda (TP of INR1025 – 17% upside):** BOB's underwriting has been superior to peers in the last cycle and its delivery on CASA has also been better than peers. BOB is the most improved PSU bank and the recent under-performance on chairman transition related risks is factored in well.

Fig. 102: India financials – Our target multiples factor in longer term profitability and growth expectations – We could see more upsides for ICICI/Axis as our target multiple is lower than FY04-07 levels

		Pre 2004	2004-07	2009-11	2011 onwards	FY16 vals/nos.	Target
Axis Bank	P/B	1.35	2.38	2.23	1.67	1.78	2.10
	RORWAs		1.57%	1.99%	2.12%	2.27%	
	ROEs		18.9%	19.5%	18.8%	17.6%	
	Core PPOP		2.09%	3.07%	3.06%	3.08%	
	Loan Growth (%)		57.2%	26.6%	16.5%	18.3%	
ICICI Bank	P/B	1.44	2.08	1.80	1.69	1.88	2.10
	RORWAs		1.41%	1.54%	1.94%	2.03%	
	ROEs		14.7%	11.7%	14.4%	15.7%	
	Core PPOP		1.83%	2.54%	2.71%	3.04%	
	Loan Growth (%)		36.3%	9.0%	14.7%	16.6%	
HDFC Bank	P/B	2.54	3.70	3.37	3.50	3.27	3.75
	RORWAs		1.72%	2.23%	2.45%	2.71%	
	ROEs		18.3%	17.2%	19.8%	21.8%	
	Core PPOP		3.20%	3.18%	3.26%	3.46%	
	Loan Growth (%)		29.7%	24.9%	23.9%	20.3%	
Kotak bank	P/B	1.24	2.70	2.59	2.79	2.84	3.0
	RORWAs		18.76%	15.53%	14.18%	13.94%	
	ROEs		15.7%	17.3%	15.9%	16.2%	
	Core PPOP		4.55%	4.36%	3.42%	3.44%	
	Loan Growth (%)		42.2%	35.6%	22.5%	18.6%	
IndusInd	P/B	1.26	1.70	2.13	2.39	2.50	2.70
	RORWAs		0.42%	2.06%	2.31%	2.26%	
	ROEs		11.1%	19.3%	18.2%	19.0%	
	Core PPOP		1.44%	2.49%	2.92%	3.15%	
	Loan Growth (%)		12.8%	30.8%	29.1%	23.7%	
Yes	P/B		3.20	2.13	1.97	1.70	1.95
	RORWAs		1.59%	2.12%	2.16%	2.23%	
	ROEs		10.6%	21.5%	24.3%	18.9%	
	Core PPOP		1.77%	2.63%	2.50%	2.73%	
	Loan Growth (%)		135.0%	52.2%	19.9%	19.4%	
SBI	P/B	0.76	1.16	1.64	1.24	1.16	1.30
	RORWAs		1.43%	1.29%	1.27%	1.21%	
	ROEs		17.3%	14.7%	13.8%	13.0%	
	Core PPOP		2.04%	2.04%	2.03%	1.90%	
	Loan Growth (%)		26.8%	15.5%	16.4%	15.8%	
PNB	P/B	0.97	1.40	1.49	1.03	0.90	0.90
	RORWAs		1.70%	2.03%	1.44%	1.28%	
	ROEs		18.8%	24.0%	15.9%	13.6%	
	Core PPOP		2.07%	2.56%	2.32%	2.08%	
	Loan Growth (%)		23.6%	23.8%	14.2%	15.3%	
BOB	P/B	0.89	1.00	1.25	1.03	0.89	1.10
	RORWAs		1.31%	2.20%	1.71%	1.42%	
	ROEs		13.2%	23.8%	17.1%	14.9%	
	Core PPOP		1.83%	1.95%	1.74%	1.56%	
	Loan Growth (%)		28.8%	25.6%	20.3%	15.7%	
BOI	P/B	0.64	1.13	1.31	0.93	0.69	0.80
	RORWAs		1.31%	1.24%	1.04%	1.05%	
	ROEs		18.1%	15.5%	13.0%	12.5%	
	Core PPOP		1.74%	1.78%	1.64%	1.61%	
	Loan Growth (%)		24.4%	20.4%	20.6%	14.7%	
Union	P/B	0.86	1.25	1.38	0.93	0.80	0.85
	RORWAs		1.67%	1.55%	1.03%	1.02%	
	ROEs		22.4%	20.6%	13.4%	11.9%	
	Core PPOP		2.15%	1.93%	1.80%	1.66%	
	Loan Growth (%)		23.4%	22.1%	16.0%	13.2%	

Source: Company data, Nomura estimates

Five underlying analysis that support our longer-term investment thesis

#1 Historical underwriting standards in large corporates/project finance:

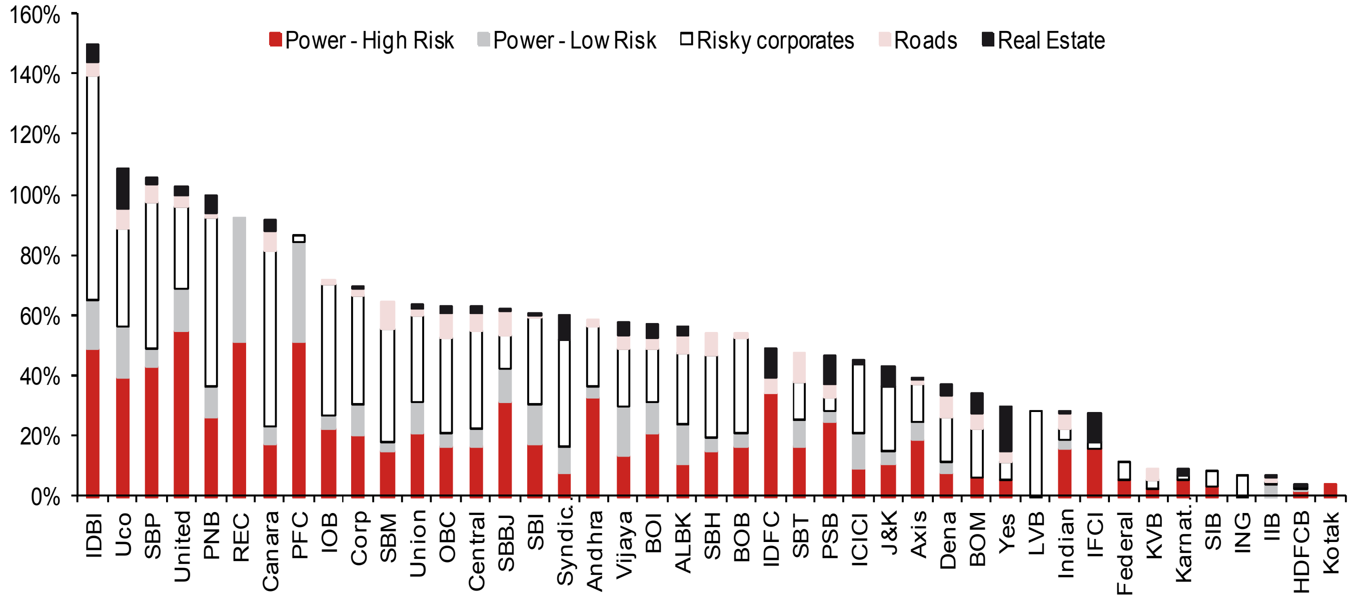
With an expected improvement in macros and policy initiatives, some investors' concerns relating to infrastructure/large corporate exposures will partially get addressed in next two years, in our view. We use the last cycle data to map bank-wise exposure (source: Ministry of Corporate Affairs [MCA]) to risky SPVs/large and mid corporates to get a sense of underwriting standards of various banks and factor that into valuations.

Our analysis: We looked at +INR4trn of bank-wise SPV/corporate exposure (fund and non-fund based) to risky sectors such as power/roads/metros/commercial real estate (RE) and ex-infrastructure risky corporate names. **Key highlights below:** *(Note: Please email us or ask your sales representative in case you would like to have an excel version of risky exposures of various corporates.)*

1. **For ICICI and Axis,** exposure to the above mentioned names is ~40% of their NW vs ~60% of NW for PSUs. More importantly, exposure to accounts with high loss given default is low for both **ICICI** and **Axis.** On a relative basis, risks for Axis and ICICI look pretty similar to us vs. perception of higher risk in the case of Axis.
2. **Retail banks' exposure** to these segments is negligible (<10% of NW). **Yes Bank's** exposure (at ~30% of NW) is primarily to commercial RE where LGD (loss given default) will likely be lower.
3. **Among PSUs**, **PNB's** book both in quality and quantity is the most risky (exposure is100% of NW to these accounts). **All other PSUs under our coverage** have almost similar exposure of 55-60% of their NW. Among them, **SBI's** book looks least risky to us with underwriting to better groups (in line with management guidance) and **BOB**'s book is most diversified (most exposures are <INR4bn).

Fig. 103: Bank-wise exposure to risky corporate/SPVs in the INR4trn of assets we looked at (% of net worth)

We have done a bank wise analysis of INR4trn of stressed assets across power/ roads/ real estate and standalone corporates



Source: Corporate affairs ministry, ACE equity, media sources, Nomura estimates

Fig. 104: Split of the Rs4trn of exposure we have looked at in our bank wise risky exposure analysis

Group	Asset Class	Plant	MW	Fuel	Debt Calculated
Lanco	Power	Udupi Power	1200	Coal	60,009
Lanco	Power	Anapara	1200	Coal	38,768
Lanco	Power	Kondapalli	1214	Gas	37,887
Lanco	Power	Amarkantak	1320	Coal	75,441
Lanco	Power	Vidarbha	1320	Coal	55,490
GVK	Power	Alkananda -Tehri	330	Hydro	33,530
GVK	Power	Goindwal Sahib- Punjab	540	Coal	24,405
GVK	Power	Gautami Power- AP	469	Gas	13,452
Tata	Power	Mundra UMPP	4000	Coal	139,883
Abhijit	Power	Chandwa	1080	Coal	34,370
Abhijit	Power	Banka - Bihar	1320	Coal	59,130
KSK	Power	Mahanadi - Chattisgarh	3600	Coal	121,411
Rpower	Power	Butibori	600	Coal	26,730
Rpower	Power	Sasan UMPP	3960	Coal	177,920
Rpower	Power	Samalkot -AP	2400	Gas	30,000
GMR Infra	Power	Rajamundry I/II	768	Gas	19,990
CESC	Power	Chandrapur - Maha	660	Coal	26,325
Indiabulls	Power	Nashik - Phase I	1350	Coal	51,220
Indiabulls	Power	Amravati - Phase I	1350	Coal	52,060
Vizag Bottling Co	Power	Konaseema	445	Gas	16,273
Adani	Power	Mundra UMPP	4620	Coal	96,217
Adani	Power	Tiroda	3300	Coal	135,250
JSW	Power	Ratnagiri	1200	Coal	33,750
JPA	Power	Nigre	1320	Coal	56,700
JPA	Power	Bina	1320	Coal	42,410
JPA	Power	Karchana	1980	Coal	29,000
JPA	Power	Bara	1980	Coal	80,850
NTPC & GAIL	Power	Dabhol	1967	Gas	66,689
Torrent Power	Power	Sugen - Torrent	1,148	Gas	44,223
Torrent Power	Power	Dahej Power	1,200	Gas	39,430
SKS Ispat power	Power	Chattisgarh	1,200	Coal	35,000
Bajaj Hindustan	Power	Lalitpur Power	1,980	Coal	88,360
Coal & Oil Group	Power	Coastal Energen	1,200	Coal	31,827
Monnet Ispat	Power	Malibrahmani TPP	525	Coal	38,190
Ind Bharat	Power	Orissa	700	Coal	25,480
Avantha Power	Power	Seoni,Madhya Pradesh	600	Coal	21,800
Moser Baer	Power	Anuppur, MP	1,320	Coal	46,800
RKM power gen	Power	Uchpinda TPP	1,440	Coal	38,740
Visa Power	Power	Raigarh TPP(Visa)	600	Coal	19,640
DB Power	Power	Baradarha TPP	1,200	Coal	14,500
East Coast Energy	Power	Bhavanpadu TPP	1,320	Coal	49,270
NCC / Gayathri	Power	NCC Power Projects Ltd	1,320	Coal	52,850
Others	Power	Kashipur CGT	225	Gas	8,334
Others	Power	Beta Infratech	225	Gas	8,640
					2,198,242

Group	Asset Class	Debt
Unitech Ltd	Real Estate	61,523
HDIL	Real Estate	38,917
DB Realty	Real Estate	13,587
Hubtown	Real Estate	26,431
Parasvanath	Real Estate	21,182
Omaxe	Real Estate	13,974
Ansal Properties	Real Estate	27,903
		203,517

Group	Asset Class	Location	Debt (Rs Mn)
Lanco	Road	Bangalore-Hoskote	3,568
Lanco	Road	Devanahalli	2,610
Soma	Road	Panipat-Jalandhar	33,890
GMR	Road	Ambala-Chandigarh	2,820
Soma-Maytas-NCC	Road	Silk Rd Jn-Electronic City Jn	6,000
IVRCL	Road	Kumarapalayam-Chengapally	3,080
IVRCL	Road	Salem-Kumarapalayam	2,665
Madhucon	Road	Karur-Dindigul	1,805
Madhucon	Road	Trichy-Thanjavur	2,677
Madhucon	Road	Madurai-Tuticorin	6,140
Reliance Infra	Road	Gurgaon-Faridabad	5,840
HCC	Road	Delhi-Agra Section	4,890
IVRCL	Road	Jalhandar-Amritsar	2,865
HCC	Road	Raiganj-Dalkhola	3,216
HCC	Road	Farakka-Raiganj	7,168
DSC Limited	Road	Delhi-Gurgaon Expressway	16,000
DSC Limited	Road	Kundli-Manesar-Palwal	11,490
DSC Limited	Road	Delhi-Gurgaon Expressway	7,666
Reliance Infra	Metro	New Delhi-Dwarka via Airport	20,385
R-Infra/MMRDA	Metro	Versova-Andheri-Ghatkopar	21,930
			166,704

Risky Corporates	(Rs m)
Essar Steel	334,620
Aircel	175,850
Jindal stainless	87,383
Suzlon	82,840
Electrosteel Steel	64,677
Soma group	56,610
Bombay Rayons	36,156
Winsome	38,450
Gitanjali	38,188
Gammon	26,770
Rcom	281,215
Jet Airways	40,400
Videocon	174,720
Bharti Shipyard	33,342
HCC	47,401
GTL Limited	102,250
ABG Shipyard	92400
IVRCL Ltd	74,238
	1,787,509

	% of Equity	% of Loans
Total Power	**32%**	**3.5%**
Power - Gas	4%	0.5%
Power - IPPs	7%	0.8%
Power - Coal - High Risk	16%	1.7%
Power - coal - Low Risk	12%	1.3%
Power -Coal	28%	3.1%
Risky corporates	**27%**	**3.0%**
Roads	**2%**	**0.3%**
Real Estate	**3%**	**0.3%**
Total Risky Asssets	**65%**	**7.1%**

Source: Corporate affairs ministry, ACE equity, company data, Nomura estimates

#2 Who is gaining consistently on the liability side?

The latest phase of correction in India financials (July-13 to Sep-13) was related to an intended squeeze by the RBI to increase domestic rates and try to bring some stability in the rupee. This phase highlighted the importance of having granular deposits (CASA and retail TD) as valuations of wholesale funded entities (NBFCs and Yes/IIB) were significantly impacted. Though currently wholesale rates have eased in the last 6mnts and differential with retail term deposits is <50bps, we believe investors should value wholesale-funded banks accordingly.

Our analysis: We have looked at the quantum/composition of CASA mobilization in the last decade (2003-13), growth factors/drivers and market share patterns and qualitatively assess relative positioning of various banks/sub-groups based on their CASA SWOT. **Key highlights below:**

1. **On current accounts (CA): (1)** Private banks continue to gain share (35% share currently) contributing ~40% of incremental CA flow - Interactions suggest that though CA products are available with PSUs, branch staff lack the drive to push for CA flows; **(2)** among private banks, **HDFCB/Axis have been clear winners with ICICI lagging in the last 5-6 years** but we see some improvement in CA growth for ICICI in the last 12-18 months as it is now focusing on branch banking as well; **(3) Kotak/IIB/Yes** have consistently gained share with IIB's CA performance being the best **(4)** Among PSUs, BOB's CA growth has been better while PNB/SBI have suffered.

2. **On saving accounts (SA): (1)** Private banks continue to gain share but the share drift is slower; **(2)** PSUs banks' growth in last 4-5 years almost matched that of private banks as rural SA growth was high – with private banks having expanded their rural and semi-urban network to >50% of their branches, incremental SA share in rural India will be key to watch; **(3)** among large private banks, again Axis/HDFCB have done better than ICICI; **(4)** SA de-regulation continues to aid Kotak/IIB/Yes; **(5)** among PSUs, we have seen similar SA growth in the last 2-3 years for most PSUs – SBI's superlative SA growth vs peers seems to have ended.

Fig. 105: Private banks have gained CASA market share

CA share accretion faster than SA share accretion

	CA growth			CA Ratio			Market Share			Incremental Market share	
	FY03-13	FY03-08	FY08-13	FY03	FY08	FY13	FY03	FY08	FY13	FY03-08	FY08-13
Top-7 Private banks	29.0%	45.2%	14.5%	12.1%	16.5%	15.5%	10.6%	25.4%	28.8%	34.0%	33.5%
Regional Private	14.8%	17.5%	12.2%	9.0%	9.4%	6.8%	4.2%	3.5%	3.6%	3.1%	3.7%
Top-6 PSUs	12.8%	15.6%	10.0%	10.9%	11.4%	7.8%	54.2%	41.5%	38.5%	34.0%	34.5%
Other PSUs	16.0%	21.0%	11.2%	10.0%	9.3%	6.7%	30.9%	29.7%	29.1%	28.9%	28.3%
Total	**16.7%**	**22.0%**	**11.6%**	**10.6%**	**11.4%**	**8.6%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: RBI, Nomura research

Fig. 106: Bank-wise CA and SA growth and incremental market share trends

Among large banks, Axis/HDFCB are clear winners, BOB does better on SA among PSUs, mid cap private banks building on due to the de-reg

	CA Market share (%)			Inc. CA Share (%)		SA Market share (%)			Inc. SA Share (%)	
	2003	2008	2013	2003-08	2008-13	2003	2008	2013	2003-08	2008-13
SBI	27.7%	22.0%	19.3%	18.6%	15.3%	24.8%	22.6%	25.1%	21.2%	27.2%
BOB	3.9%	2.8%	3.6%	2.1%	5.0%	6.1%	5.1%	5.0%	4.5%	4.9%
PNB	8.3%	5.4%	5.2%	3.7%	4.8%	9.7%	7.9%	7.5%	6.8%	7.2%
Union	4.2%	3.6%	4.2%	3.2%	4.9%	4.2%	3.6%	3.5%	3.2%	3.4%
BOI	4.1%	3.3%	2.8%	2.8%	2.3%	5.6%	4.9%	4.7%	4.4%	4.6%
Axis	2.04%	6.01%	7.23%	8.29%	9.29%	0.54%	2.94%	3.86%	4.46%	4.55%
HDFCB	4.16%	8.77%	9.12%	11.24%	9.40%	1.77%	3.85%	5.34%	5.17%	6.45%
ICICI	3.10%	7.53%	6.44%	9.92%	4.88%	1.44%	5.75%	5.18%	8.49%	4.84%
IIB	0.69%	0.55%	1.54%	0.46%	2.81%	0.09%	0.17%	0.43%	0.23%	0.61%
Yes	0.00%	0.30%	1.16%	0.46%	2.27%	0.00%	0.02%	0.36%	0.04%	0.61%
Kotak	0.04%	0.96%	1.33%	1.47%	1.80%	0.00%	0.22%	0.44%	0.36%	0.60%

Source: RBI, Nomura research

Fig. 107: NEFT and RTGS market share

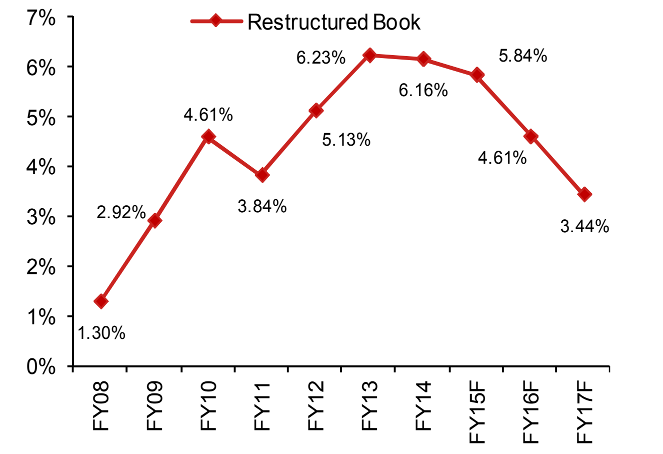
	RTGS Market Share					NEFT Market Share				
	Oct to Dec-12	Jan to Mar-13	Apr to Jun-13	Jul to Sep-13	Oct to Dec-13	Oct to Dec-12	Jan to Mar-13	Apr to Jun-13	Jul to Sep-13	Oct to Dec-13
ICICI	4.4%	4.2%	4.4%	6.0%	6.0%	6.9%	6.9%	6.7%	6.8%	7.2%
HDFCB	19.7%	19.3%	19.9%	20.5%	21.5%	13.1%	13.2%	13.0%	12.6%	12.6%
Axis	6.4%	6.5%	6.3%	6.7%	7.4%	5.7%	5.8%	5.7%	5.5%	5.7%
Kotak	1.9%	1.7%	1.9%	1.6%	1.8%	1.5%	1.7%	1.6%	1.6%	1.6%
IIB	0.8%	0.7%	0.7%	0.7%	0.7%	1.2%	1.3%	1.0%	1.0%	1.0%
Yes	1.2%	1.2%	1.3%	1.3%	1.2%	1.3%	1.3%	1.1%	1.3%	1.2%
Top Private banks	**34.4%**	**33.7%**	**34.5%**	**36.8%**	**38.4%**	**29.6%**	**30.2%**	**29.0%**	**28.7%**	**29.3%**
SBI	9.5%	9.2%	9.0%	8.9%	9.5%	14.8%	14.5%	16.6%	16.0%	16.4%
PNB	1.7%	1.7%	1.5%	1.6%	1.8%	2.9%	3.1%	3.0%	2.9%	2.7%
BOB	1.2%	1.3%	1.2%	1.1%	1.2%	1.9%	2.1%	2.0%	2.0%	2.2%
BOI	1.4%	1.5%	1.5%	1.4%	1.2%	1.8%	1.8%	1.8%	1.7%	1.7%
Canara	1.3%	1.5%	1.3%	1.1%	1.2%	2.1%	2.0%	2.1%	2.0%	1.9%
Union	1.3%	1.4%	1.4%	1.2%	1.2%	2.0%	2.0%	2.0%	1.9%	1.9%
Other PSUs	14.3%	14.8%	13.5%	13.7%	14.3%	16.0%	16.2%	15.2%	14.9%	15.2%
Total PSUs	**30.7%**	**31.4%**	**29.5%**	**29.0%**	**30.4%**	**41.5%**	**41.7%**	**42.7%**	**41.5%**	**41.9%**

Source: RBI, Nomura research

#3 Restructured book – Coming out of moratorium; real test of servicing in the next two years

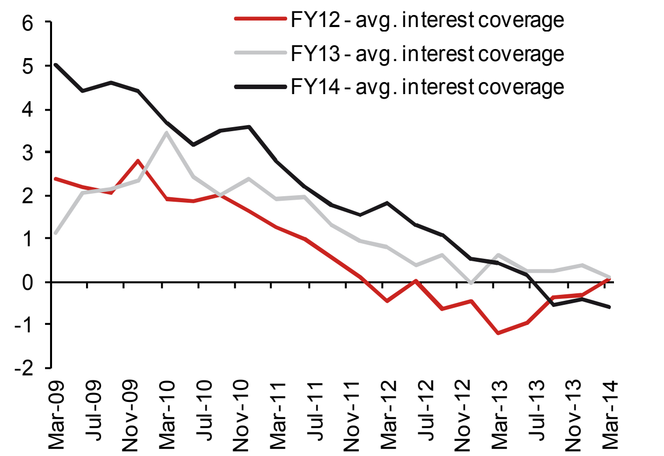
- In the last 3-4 years, of the 5.5% incremental stressed loan accretion annually, ~55-60% was restructured and 40-45% was reclassified as NPAs. Most of the restructured accounts did enjoy ~two years of principal moratorium and ~0.5/1 year of interest moratorium and hence their financial performance was not fully tested for interest servicing capabilities. We expect 5-6% of loans to come out of moratorium in the next 2-2.5 years with 2.5% of loans for private banks and 6-7% of loans for PSU banks.
- **Our analysis:** Our quarterly interest coverage analysis of the accounts restructured in the last 2-3 years indicates that >50% of companies still face interest coverage challenges. While an improving macro should lead to improvement in the financials of some of these restructured accounts, but some of these accounts should still face challenges and hence run the risk of getting downgraded. Hence, as restructuring ends in FY15, slippages could likely increase.
- PSU banks are most exposed as mentioned above - Among PSU banks, **PNB is worst placed** with ~8% of loans restructured in last two years vs 4-5% of loans restructured in the same period for peers.

Fig. 108: Restructured book as a % of loans



Source: Company data, Nomura estimates

Fig. 109: More than 50% of restructured companies continue to see deterioration in interest coverage



Source: ACE Equities, Nomura estimates

Fig. 110: Many of the FY12/13/14 accounts restructured are still facing interest coverage challenges

Relapse risk remains high from the restructured book

Accounts	Debt	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
FY12 Referrals	**605,361**																	
Bharti Shipyard	32,141	3.24	1.60	1.68	1.56	1.62	1.24	1.27	1.02	0.30	0.02	-0.19	-0.38	-0.27	-0.32	-0.70	-0.21	NA
HCC	78,222			1.72				0.93				0.63				0.94		
Kingfisher Airlines	75,000	-0.55	0.11	0.00	-0.06	-0.53	-0.27	-1.04	-0.66	-1.31	-0.53	-0.55	-1.07	-1.99	-0.98	-0.37	-0.25	-0.86
3i Infotech	24,000	3.49	2.04	1.68	1.92	1.74	1.43	1.56	-0.86	-0.68	-0.22	-0.27	-0.56	-0.35	-0.11	-0.29	-0.59	NA
GTL Infra	160,000	0.87	0.56	0.75	0.10	0.40	0.21	-0.75	0.99	0.12	0.02	0.10	0.02	-2.39	0.06	-0.02	0.09	-1.29
GTL Ltd		2.52	2.34	7.00	2.31	1.36	1.16	0.06	-0.22	0.19	-0.56	0.25	0.45	0.03	0.05	0.02	0.15	0.51
KSL Inds	27,000	-1.92	1.14	1.25	1.09	0.62	1.08	1.15	-1.61	-0.59	0.07	-5.00	-0.37	-0.66	-1.14	-1.02	0.16	1.76
Moser Baer India	37,000			2.15				1.40				0.84			NA	NA	NA	
Hotel Leela	37,440	3.72	3.04	0.69	2.42	1.16	0.04	-0.13	0.11	-0.63	-0.14	-0.28	0.17	-0.04	-0.22	-0.06	0.21	0.18
Electrotherm	30,218	2.13	1.46	1.26	1.13	1.08	-0.87	-0.86	-0.73	-0.51	-0.32	NA	-1.13	-1.61	-6.18	NA	-2.66	NA
Surya Pharma	16,880	2.46	2.48	2.51	2.38	2.06	1.95	1.41	1.48	-1.10	-0.55	-0.55	-0.32	-4.22	NA	-0.27	-39.72	NA
Kemrock	12,009	2.34	2.46	2.02	1.82	1.85	2.02	1.67	1.55	1.60	1.03	0.26	-1.55	NA	-1.87	NA	NA	NA
ICSA	12,180	2.89	3.13	3.11	3.09	2.30	2.24	2.00	-0.22	-2.60	-0.11	-0.09	-0.20	-0.72	NA	-0.40	0.01	0.12
Futura Polyesters	6,335							B-	B-	D	D	D	D	D	D	D	D	D
Gold Plus Glass	3,688						BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB	C	C	C
Bhartiya Samruddhi	7,249								C	C	C	D	D	D	D	D	D	D
Lanco - Udipi	36,000		BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB+	BB+	BB+	BB+	D	D	D	D	D
Moser Baer Solar	10,000					BB+	BB+	BB+	BB+	B	B	B	B	B	B	B	B	B
FY13 Referrals	**700,237**																	
Visa Steel	25,400	2.14	1.69	1.94	1.80	2.82	1.81	-0.07	-0.30	-0.27	0.02	-0.10	-8.58	-0.89	-0.17	0.09	0.11	0.28
Varun Inds	17,550	1.38	1.91	1.68	1.42	1.64	2.29	1.96	1.92	-0.61	1.11	NA	0.45	0.92	0.62	-0.89	-0.21	NA
Ind-Swift Labs	12,000	1.63	2.13	2.51	3.78	1.78	2.08	2.05	2.91	1.40	-0.99	0.66	0.73	0.19	0.69	0.74	0.56	-1.77
NITCO Tiles	12,660	0.97	1.33	2.00	1.95	2.07	1.77	1.48	1.66	-0.57	-1.03	-0.31	-0.62	-1.31	-0.43	-0.40	-0.54	-0.51
Kamath Hotels	4,360	7.56	1.03	1.03	1.55	1.11	1.10	1.04	1.06	0.98	0.50	0.43	0.77	0.92	0.71	0.55	1.17	0.87
Dwarikesh Sugar	6,075	-0.71	1.54	-1.68	0.67	2.44	-0.05	-0.15	-1.27	2.08	0.43	1.48	1.40	0.85	0.96	NA	-1.74	NA
Jindal Stainless	60,000	2.05	2.78	1.91	2.23	1.69	2.07	1.14	0.86	0.63	0.37	-0.18	-0.15	-0.13	0.23	0.31	-0.04	0.27
Deccan Chronicle	35,000	6.53	10.03	8.72	5.37	-0.59	2.07	2.75	2.77	1.35	NA	NA	0.61	7.20	-27.36	NA	-1.34	NA
Jai Balaji	20,000	1.75	1.52	1.40	1.79	2.23	1.20	-0.01	-0.60	-0.53	-0.87	-0.73	-1.24	-0.48	0.02	-0.34	-0.12	NA
Suzlon	110,000	0.51	-1.32	0.31	1.01	2.44	1.70	0.91	-0.60	1.19	-1.47	-0.75	-1.48	-0.68	-0.43	-0.96	-0.08	0.36
PSL	46,000	1.62	1.58	1.75	1.77	1.73	1.47	1.37	1.23	1.35	1.27	1.13	0.77	0.59	-0.49	NA	-35.56	-1.46
Spentex	9,000	1.04	1.22	1.48	1.48	1.68	-0.44	-1.63	-1.16	0.02	1.04	1.18	1.28	1.62	1.07	1.06	0.59	0.73
Spanco	13,000	3.58	2.47	2.96	2.96	2.77	2.11	1.98	1.94	2.22	1.45	0.09	-0.14	NA	-0.98	NA	NA	NA
Ramky	25,644	2.97		3.44				2.82			2.55	2.21	2.04	2.03	0.77	0.18	2.64	1.99
S kumar	30,000	1.79	1.49	1.48	1.61	2.11	1.61	1.61	1.68	1.84	1.46	1.00	0.84	0.31	NA	0.50	0.28	-5.66
Winsome	40,000	21.01	5.96	60.38	6.42	2.89	7.48	6.70	4.94	1.91	1.74	2.09	1.79	-2.40	-0.18	NA	0.00	-0.02
Bodal Chemicals	6,000	2.32	2.47	2.31	1.96	1.75	2.29	-0.32	-2.07	-0.28	-1.60	0.96	0.40	0.80	1.28	1.96	4.12	5.84
Surya Vinayak	21,700	BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	Susp	Susp	Susp	Susp	Susp
ICOMM Tele	23,900			BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	D	D	D	D	Susp	Susp	Susp	Susp
Aravali Infrapower	8,350					BBB+	BBB+	BBB+	BBB+	BBB-	BBB-	BBB-	BBB-	BBB-	Susp	Susp	Susp	Susp
Indu Projects	28,000		BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	D	D	D	D	D	Susp	Susp	Susp
Totem Infra	7,160			BB+	BB+	BB+	BB+	BB+	BB+	BB+	Susp	Susp	Susp	Susp	Susp	Susp	Susp	Susp
Rithwik Projects	9,100					A-	BB	BB	BB	BB	Susp	Susp	Susp	Susp	Susp	Susp	Susp	Susp
Ascend Telecom	6,390			BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	B	B	B	B	Susp	Susp	Susp	Susp
Seven Hills	7,630												B-	B-	B-	D	D	D
Lanco Anpara Power	65,318									BB-	BB-	BB-	BB-	D	D	D	D	D
GMR Rajamundry	26,000						BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB	BB	BB	BB	BB
Lanco Teesta Hydro Power	24,000										BB-	BB-	BB-	BB-	D	D	D	D
FY14 Referrals	**917,450**																	
Gammon	135,000	2.30		2.49				1.71				0.97			NA	NA	NA	
Bilcare	15,000	4.90	4.08	4.10	4.20	3.13	2.66	2.67	2.19	2.01	1.45	1.90	1.93	0.18	-0.08	-0.13	-0.16	0.04
Electrosteel	70,000		-0.77	NA	NA	-3.06	-0.80	-0.58	-0.52	-1.22	-1.01	-1.34	-0.88	-1.11	-0.59	-0.45	-0.31	-1.23
Orchid Pharma	20,000	-5.64	2.27	1.79	3.52	1.89	1.68	1.75	1.85	0.84	0.22	NA	-0.22	-0.29	0.01	NA	0.55	0.50
Pradip Overseas	10,890		2.56	2.18	1.25	2.32	1.52	1.24	-0.62	-0.79	1.08	-1.39	-0.69	-0.05	0.00	-0.01	-0.54	0.41
Lanco Group (Infratech)	75,000	3.31		2.29				1.56			1.28	1.95	1.31	1.70	1.05	1.03	0.67	0.47
Parekh Aluminex	22,000	2.94	3.43	3.72	3.00	2.85	2.85	2.51	2.57	2.51	2.52	2.46	-1.24	0.03	-0.29	NA	NA	NA
Educomp	21,750	12.59	7.37	8.88	8.38	9.31	3.80	2.92	3.46	4.69	1.37	1.21	1.38	-0.92	-0.47	-1.25	-0.99	NA
Jyoti Ltd	8,000	1.65	1.56	1.59	1.43	1.52	1.21	1.05	1.07	1.74	1.04	0.84	0.36	-0.35	-0.35	-0.70	-0.48	-1.78
Shivani Oil	25,000	1.66	1.80	0.83	1.06	1.82	1.57	0.66	0.47	3.17	1.45	1.56	1.08	0.69	-0.27	-0.67	-0.94	NA
Bombay Rayon	40,550	3.70	3.27	3.58	2.60	2.53	2.61	2.35	1.99	2.67	2.09	1.86	1.87	2.83	NA	-0.06	0.89	0.09
Hanung Toys	6,100	3.30	2.88	2.84	2.86	2.52	2.34	1.98	1.67	1.99	1.74	2.06	1.84	NA	-0.17	-2.63	-3.23	-1.20
Everonn Edu	7,500	5.75	4.80	5.23	9.51	6.14	2.97	1.62	0.35	-1.86	-2.03	-2.37	-5.72	-1.24	-0.74	-1.44	-0.74	0.13
Core Education	13,000	4.57	3.17	2.52	2.46	4.96	3.84	2.77	3.19	3.59	3.01	2.77	2.68	1.60	-0.35	0.40	-0.64	-1.23
Gujarat NRE Coke	30,000	2.81		3.65				2.28				2.62			NA	NA	NA	NA
ABG Shipyard	59,000	2.81	2.69	3.29	3.03	1.83	2.63	2.65	2.51	1.96	1.71	1.47	1.26	1.34	1.05	1.01	0.47	0.24
Era Infra Engg	58,000	2.46	2.28	2.22	2.03	2.01	1.75	1.75	1.63	1.80	1.52	1.41	1.34	1.64	1.35	NA	0.02	0.13
Shree Ganesh Jewellery	34,600	5.64	6.12	6.61	5.06	3.03	3.77	2.88	1.68	4.33	2.72	2.60	2.07	1.78	2.38	NA	0.22	-0.47
CCCL	8,000	4.93	3.84	3.01	3.68	1.65	1.45	0.31	1.05	1.87	0.46	0.40	0.42	-0.74	-0.05	-2.49	-1.28	-4.77
IVRCL	65,000	3.27		2.23				1.36				1.06			NA	NA	NA	NA
Arch Pharma	18,000				A	A	A	A	A	A	A	A	BB+	BB+	D	D	D	D
Corporate Power (Abhijit)	30,000						BBB-	BBB-	BBB-	BB	BB	BB	BB	Susp	Susp	Susp	Susp	Susp
Soma Group	60,000					BBB	BBB	BBB	BBB	D	D	D	D	D	D	D	D	D
Corporate Ispat	16,500		BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	Susp	Susp	Susp	Susp	Susp
AMR India	13,300					BBB+	BBB+	BBB+	BBB+	BBB-	BBB-	BBB-	BBB-	BBB-	Susp	Susp	Susp	Susp
Hanjer Biotech	7,860								BBB	BBB	BBB	BBB-	BBB-	BBB-	BBB-	BBB-	Susp	Susp
Coastal Projects	37,000		A	A	A	A+	A+	A+	A+	A	A	A	Susp	Susp	Susp	Susp	Susp	Susp
Raj Rayon Inds	5,410							BB+	BB+	BB+	BB+	BB+	Susp	Susp	Susp	Susp	Susp	Susp
Janki Corp.	4,990	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	B+	B+	B+
Deepak Cable	10,000						BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB	D	D	D	D	D
Gupta Coal India	8,500	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BB-	Susp	Susp

** Note that we have standalone interest coverage in case of most companies if otherwise mentioned; **Year of restructuring is approximate not necessarily linked to approval or even admission in that year; ** Debt numbers mentioned are approximate numbers from media reports and actual restructuring numbers may differ.

Source: Media reports, ACE Equity, rating agencies, Nomura research

#4 Regulator has been counter-cyclical by relaxing or not implementing certain regulations –We expect implementation as economy improves

The RBI has pushed out certain regulations or not finalised certain draft guidelines of certain regulations in the last two years as these regulations would have further strained the P&L for banks/NBFCs. Our interactions with the regulators in the past suggest that these below mentioned regulations are certain to be implemented but the RBI will time the implementation based on improvement in financial performance of banks. Hence, some part of the improvement in core profitability of banks over the next 2-3 years could be impacted due to implementation of these guidelines. **Key regulations that could get implemented in the next two years:**

Fig. 111: Regulations announced that were put on the back-burner which could get implemented as the cycle recovers

Some of this could be counter-cyclical in nature

Regulations	Announcements/Status	Possibility and impact of regulation	Banks/NBFCs impacted from our coverage universe
180 to 90 day NPAs for NBFCs	The Usha Thorat committee report on NBFCs in Sep-11 had recommeded this. In Dec-12, RBI had included moving to 90 day NPA recognition in a phased manner but this has not yet finalised given w eak cycle	We believe this is likely to get implemented - Asset financiers like MMFS/SHTF w ill likely be hit more w ith ~200-300bps increase in NPAs - Ultimate credit costs w ill not change but there could be a spike in credit costs	For Shriram, NPAs could inch up by ~250ps and for MMFS NPAs could inch up by ~3-3.5% due to 90 day NPA recognition
Dynamic Provisioning	RBI had released a draft guidelines of dynamic provisioning in Mar-12 and RBI had mentioned in May-13 monetary policy that they w ill issue final guidelines by Jun-13.	Again, due to a w eak credit cycle, RBI had put dynamic provisioning on a back burner but as economy improves w e expect this to be implemented. Though dynamic provisioning w ill help strengthen bank's B/S in the long term but there w ill be a spike for banks w ith low credit costs in the near term	Banks w ith low credit costs (mostly retail banks - HDFCB/IIB/Kotak) and some corporate/regional banks could be impacted more (Yes/ING) as their expected loss w ould be higher than actual credit costs. Some banks have inched up floating provisions in anticipation - HDFCB (85bps), Yes (40bps), Axis (30bps)
End of Restructuring in FY15	RBI has decided to end the dispensation given to first time restructuring cases in FY15	After 9 mnts, banks w ill not be able to restructure w ithout classifing an account as NPA. Some w eak accounts w hich should have been classfied as NPAs aer currently standard as they have been restructured	PSU banks w ill be impacted more but given that the cycle is likely to improve the impact w ill be limited. As mentioned earlier, w e are more w orried on relapse risk of w eak accounts that w ere restructured to push its NPA recognition
BASEL III phasing pushed out by 1 yr	In Mar-14, RBI pushed out BASEL III implementation by 1 year bringing the Indian implementation in sync w ith global BASEL Phasing due to challenges in capitalising PSUs	While this w as a w elcome relief as near term capital raising requirements w as cut dow n, but longer term capital raising quantum remains high in case of few banks	Within our coverage universe, w e are not excessively w orried on capital for SBI/PNB/BOB. Union and BOI are the ones w here dilutions w ill be high over next 3-4 yrs

Source: Nomura research

#5 PSU banks' pensions – Reasonably comfortable now

Pensions and provisions for wage settlements have increased opex growth for PSU banks at a time when growth and profitability has been weak leading to spike in cost-income. While pension assumptions are still sub-par and pension obligations calculations are under-reported, in our view, we believe a large part of the structural pain of higher P&L pension provisioning is in the numbers for PSU banks and we do not expect large negative surprise on opex growth due to pensions going forward.

How weak are pension assumptions?

Life expectancy assumptions: Most large PSU banks managements have indicated that they have migrated to the new LIC mortality table with life expectancy ~80 years from 75-76 years earlier and hence currently there would not be any shortfalls on this count. Within our coverage, only BOI has not migrated to the new table yet.

Wage inflation assumptions: Most PSU banks have increased this assumption to 5-6% from 4% earlier. While actual wage inflation would be ~8-9% for PSU banks, an increase in assumptions is a step in the right direction.

Discount rates: With rates expected to go lower in the next two years, there is likely to be some increase in pension liabilities as discount rates will get adjusted lower.

Why are we relatively comfortable with pensions now?

More than improving assumptions for pensions, the increase in P&L provisioning run-rate is encouraging. Pension provisioning for PSU banks in our coverage has increased by 3x in the last four years from INR35bn to INR105bn annually. This implies a pension provisioning of INR250K per employee vs <INR100K in FY10. This increase in pension provisioning is already in the cost base for PSU banks now and we do not see any reason for such a large disproportionate increase in pension provisioning going forward.

Within our coverage PSUs, SBI/PNB/Union are better placed on P&L run-rate vs BOB/BOI. BOB has substantially inched up pension provisioning in FY14 whereas BOI is yet to migrate to the new mortality table and pension costs may surprise negatively for BOI in FY15F.

Fig. 112: Pension assumptions of various PSU banks

	Wage Inflation			Discount rate			Plan Return		
	FY12	FY13	FY14	FY12	FY13	FY14	FY12	FY13	FY14
SBI	5.0%	5.0%	5.0%	8.8%	8.5%	9.3%	8.6%	8.6%	8.7%
PNB	5.0%	5.0%	5.5%	8.8%	8.5%	9.1%	8.6%	8.6%	8.6%
BOB	4.0%	6.0%	6.0%	8.8%	8.3%	8.5%	8.0%	8.0%	8.7%
BOI	4.0%	5.0%	6.0%	9.0%	8.0%	9.3%	8.0%	8.0%	8.4%
Union	4.0%	4.0%	5.0%	8.5%	8.5%	9.3%	8.0%	8.7%	8.7%

Source: Company data, Nomura research

Fig. 113: P&L Pension expenses have increased by 3-4x in last 4 years from FY10 levels

Pension P&L provisioning (Rs mn)	FY10	FY11	FY12	FY13	FY14	Increase FY10-FY14 (x)
SBI	23,457	24,731	32,194	25,530	50,880	2.2x
BOI	2,652	14,563	7,432	6,604	10,636	4x
Union	1,596	11,450	8,976	10,129	11,222	7x
BOB	1,332	10,073	6,719	6,840	10,150	7.6x
PNB	5,608	13,185	14,426	20,058	21,580	3.8x
Top-5 PSUs Pension provisions	**34,645**	**74,002**	**69,748**	**69,161**	**104,468**	**3x**
BOB/BOI/Union	**5,580**	**36,086**	**23,127**	**23,573**	**32,008**	**5.7x**

Source: Company data, Nomura research

Fig. 114: P&L pension provisioning run-rates per employee has improved significantly

	FY10	FY11	FY12	FY13	FY14
Pension expenses per employee					
SBI	117,107	110,935	149,407	111,829	229,155
BOI	66,851	366,053	186,814	156,176	246,487
Union	57,461	443,405	291,073	318,545	331,953
BOB	34,191	251,538	162,106	158,662	220,647
PNB	98,514	231,235	232,202	318,387	329,395
Top-5 PSUs Pension provisions	95,274	191,911	178,988	169,310	254,487
BOB/BOI/Union	52,442	341,553	206,365	201,147	260,318
Ex Pension employee Costs per employee					
SBI	519,673	538,595	638,321	693,306	784,401
BOI	511,854	507,503	580,666	584,161	678,461
Union	430,257	563,368	512,890	547,865	646,503
BOB	**569,217**	**476,820**	**558,231**	**641,572**	**679,273**
PNB	**449,740**	**551,140**	**528,092**	**582,362**	**664,354**

Source: Company data, Nomura research

Fig. 115: Valuation comps table

		Private banks						PSU banks				
		ICICI	Axis	HDFCB	Kotak	IIB	Yes	SBI	PNB	BOB	BOI	Union
Price		1,454	1,926	837	891	573	563	2,696	991	876	304	231
Mcap (US$ mn)		28,733	15,514	34,440	11,737	5,156	3,990	34,409	6,133	6,430	3,335	2,486
Sub Value		272	-	-	40	-	-	234	-	-	-	-
P/B	**FY15**	2.02	2.06	3.91	3.18	3.00	2.03	1.13	0.94	0.97	0.70	0.81
	FY16	1.79	1.78	3.30	2.78	2.55	1.77	1.01	0.83	0.86	0.65	0.75
	FY17	1.58	1.53	2.78	2.39	2.15	1.54	0.89	0.73	0.77	0.59	0.68
P/AB	**FY15**	2.02	2.06	3.97	3.26	2.98	2.03	1.29	1.06	1.04	0.81	0.92
(For 70% coverage)	**FY16**	1.79	1.78	3.36	2.85	2.53	1.78	1.14	0.93	0.92	0.72	0.82
	FY17	1.58	1.53	2.83	2.46	2.12	1.54	0.99	0.81	0.81	0.65	0.74
P/E	**FY15**	12.8	13.0	19.7	24.7	17.9	12.6	10.0	8.4	7.5	6.6	8.2
	FY16	10.8	10.9	16.4	20.7	14.4	10.5	8.1	6.4	6.0	5.7	7.0
	FY17	9.3	9.0	13.6	16.6	11.6	8.8	6.9	5.3	5.3	4.8	5.7
P/PPOP	**FY15**	7.40	6.96	11.37	15.31	9.98	7.45	3.77	3.03	3.50	2.33	2.76
	FY16	6.40	5.95	9.38	12.74	8.24	6.25	3.33	2.71	2.99	2.26	2.66
	FY17	5.56	5.09	7.76	10.23	6.67	5.27	2.97	2.40	2.65	2.09	2.51
Loan Growth	**FY15**	15.0%	16.0%	18.0%	12.1%	22.0%	16.9%	14.5%	13.0%	14.0%	13.0%	10.0%
	FY16	16.9%	19.0%	21.0%	20.3%	24.0%	20.8%	16.0%	15.9%	16.0%	15.0%	13.9%
	FY17	17.9%	20.0%	22.0%	23.3%	25.0%	20.5%	17.0%	16.9%	17.0%	16.0%	15.8%
Margins	**FY15**	3.09%	3.38%	4.37%	4.59%	3.74%	2.94%	2.99%	3.10%	2.08%	2.27%	2.57%
	FY16	3.12%	3.32%	4.37%	4.51%	3.68%	3.02%	2.98%	3.07%	2.17%	2.32%	2.66%
	FY17	3.08%	3.23%	4.30%	4.48%	3.65%	3.02%	2.99%	3.04%	2.18%	2.36%	2.70%
Core Fee growth	**FY15**	13.3%	10.8%	16.4%	23.3%	15.6%	16.8%	14.0%	13.5%	9.5%	8.7%	14.5%
	FY16	15.4%	18.3%	21.0%	17.7%	21.0%	19.3%	15.0%	14.3%	15.0%	13.3%	15.5%
	FY17	16.1%	18.1%	21.1%	17.6%	21.0%	19.8%	15.0%	14.3%	15.0%	13.3%	15.5%
Opex Growth	**FY15**	9.9%	14.1%	16.1%	11.6%	21.3%	20.0%	7.9%	13.2%	14.1%	18.9%	13.2%
	FY16	13.6%	15.0%	17.3%	15.5%	20.1%	20.7%	13.3%	11.8%	13.6%	12.4%	12.1%
	FY17	13.6%	16.1%	17.4%	16.2%	20.2%	18.7%	13.3%	12.0%	13.9%	12.6%	13.6%
PPOP Growth	**FY15**	11.9%	13.6%	23.0%	13.8%	16.3%	16.4%	3.7%	8.4%	16.1%	15.2%	16.8%
	FY16	15.6%	16.9%	21.1%	20.2%	21.1%	19.1%	5.9%	14.4%	21.8%	15.3%	16.1%
	FY17	15.2%	17.0%	21.0%	24.5%	23.6%	18.7%	12.1%	16.5%	17.4%	18.4%	16.1%
Gross NPAs	**FY15**	2.99%	1.68%	1.08%	1.70%	1.40%	0.55%	5.37%	5.79%	3.28%	3.57%	4.43%
	FY16	2.94%	1.83%	1.22%	1.81%	1.57%	0.77%	5.48%	5.89%	3.47%	3.62%	4.49%
	FY17	2.92%	1.90%	1.33%	1.88%	1.70%	0.95%	5.41%	5.71%	3.47%	3.63%	4.47%
Credit costs	**FY15**	0.88%	1.05%	0.65%	0.38%	0.79%	0.67%	1.29%	1.64%	0.98%	1.25%	1.35%
	FY16	0.76%	0.96%	0.69%	0.41%	0.67%	0.62%	1.17%	1.33%	0.89%	1.12%	1.20%
	FY17	0.74%	0.82%	0.71%	0.40%	0.65%	0.59%	1.00%	1.21%	0.82%	1.00%	0.98%
PAT Growth	**FY15**	9.6%	12.0%	20.2%	16.1%	19.4%	14.3%	32.0%	32.5%	10.7%	25.3%	21.3%
	FY16	18.8%	19.3%	20.1%	19.4%	24.2%	20.1%	25.1%	35.3%	29.4%	28.9%	30.7%
	FY17	15.3%	20.4%	20.2%	24.9%	24.2%	18.8%	30.1%	23.6%	18.8%	31.1%	34.4%
ROAs	**FY15**	1.81%	1.73%	2.00%	2.28%	1.81%	1.67%	0.76%	0.77%	0.73%	0.59%	0.58%
	FY16	1.89%	1.75%	2.02%	2.26%	1.83%	1.69%	0.83%	0.91%	0.83%	0.67%	0.68%
	FY17	1.89%	1.76%	2.01%	2.29%	1.84%	1.69%	0.93%	0.97%	0.85%	0.77%	0.81%
ROEs	**FY15**	14.0%	16.8%	21.5%	13.2%	18.0%	19.9%	11.6%	11.9%	13.6%	11.7%	10.9%
	FY16	15.1%	17.5%	21.8%	13.7%	19.1%	18.1%	13.0%	14.0%	15.5%	12.4%	11.7%
	FY17	15.6%	18.4%	22.1%	15.0%	20.1%	18.6%	14.6%	14.8%	15.7%	13.5%	13.1%

Source: Company data, Nomura estimates

NOMURA

Axis Bank AXBK.NS AXSB IN

EQUITY: BANKS

B/S and P&L more granular than ever!

Business model gaps vs. peers bridged; valuation gap to close in as asset quality concerns ebb

Action: Transferring coverage with Buy (TP: INR2,300) – Top sector pick

Axis Bank's business model has become less risky vs. the last upcycle as the bank continues to build significant granularity in its liabilities/assets and fees. While we believe asset quality concerns will only gradually reduce, our analysis of its large corporate/SPV exposure is comforting given the low exposure to sub-segments where the loss given default could be higher – **our preferred recovery play**.

- Our analysis of +INR4trn of large corporate/Infra SPV exposures indicates that the **asset quality risk is similar to that of ICICI vs**. consensus analyst **perception of higher risk**.
- **Significant granularity in assets/fees**: The retail book now contributes ~40% of the incremental fees and the loan book is much more diversified.
- **Underappreciated liability franchise**: While the CASA success of Axis is well known, its CA dominance in business banking is still under-appreciated. Also, the share of bulk term deposits is down from +40% in FY10 to <25% currently.
- **Return ratios remain best in class** with ROAs of ~1.7-1.8%. With an improvement in asset quality, we estimate +20% PAT growth in FY16/17F.

Catalysts: A reduction in stress asset accretion from 2HFY15F will drive further re-rating as investors will acknowledge the above fundamental improvements.

Valuations: Reasonable, in spite of the recent re-rating

Our TP of INR2,300 is based on 2.1x FY16F book. This is higher than the multiples at which Axis has traded in the past 2-3 years but lower than FY04-07 multiples. While growth over the next 2-3 years is likely to be lower than the last cycle, ROAs are much more superior currently at 1.75% vs. 1.2% in FY04-07) and B/S and P&L granularity makes the business model less risky.

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	114,561		130,086		152,041		177,850
Reported net profit (mn)	62,177		69,664		83,078		100,039
Normalised net profit (mn)	62,177		69,664		83,078		100,039
FD normalised EPS	132.34		148.27		176.82		212.92
FD norm. EPS growth (%)	19.6		12.0		19.3		20.4
FD normalised P/E (x)	14.6	N/A	13.0	N/A	10.9	N/A	9.0
Price/adj. book (x)	2.4	N/A	2.1	N/A	1.8	N/A	1.5
Price/book (x)	2.4	N/A	2.1	N/A	1.8	N/A	1.5
Dividend yield (%)	1.2	N/A	1.4	N/A	1.6	N/A	1.8
ROE (%)	17.4		17.0		17.5		18.2
ROA (%)	1.7		1.7		1.7		1.7

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 2300
Closing price 3 July 2014	INR 1926
Potential upside	+19.4%

Anchor themes

Granularity in B/S and revenue lines has increased significantly and further re-rating is likely as asset quality concerns ebb.

Nomura vs consensus

Our FY15/16F earnings are at par with consensus. Axis Bank could surprise positively on earnings if the asset quality turnaround is faster.

Research analysts

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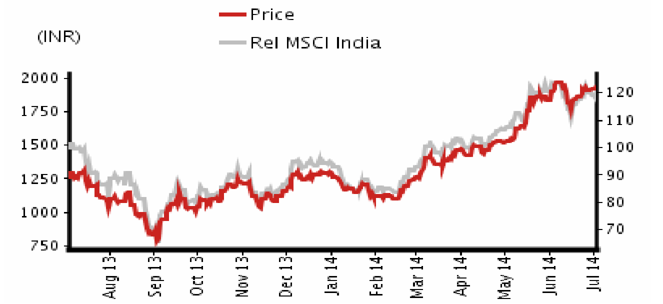
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Axis Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	1.4	34.2	50.7	M cap (USDmn)	15,185.4
Absolute (USD)	0.5	35.3	51.9	Free float (%)	36.0
Rel to MSCI India	-0.5	23.6	23.8	3-mth ADT (USDmn)	42.1

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	271,826	306,412	353,150	408,905	477,819
Interest expense	-175,163	-186,895	-217,016	-251,211	-294,484
Net interest income	96,663	119,516	136,134	157,694	183,335
Net fees and commissions	50,266	53,956	60,431	71,309	84,144
Trading related profits	5,863	3,276	5,500	5,000	5,000
Other operating revenue	9,382	16,820	18,177	21,688	25,658
Non-interest income	65,511	74,052	84,108	97,997	114,803
Operating income	162,174	193,569	220,242	255,690	298,137
Depreciation	-3,517	-3,639	-4,003	-4,404	-4,844
Amortisation					
Operating expenses	-41,855	-49,355	-57,005	-66,696	-78,034
Employee share expense	-23,770	-26,013	-29,147	-32,550	-37,409
Pre-provision op profit	93,031	114,561	130,086	152,041	177,850
Provisions for bad debt	-14,799	-17,810	-26,109	-28,044	-28,537
Other provision charges	-2,702	-3,261	0	0	0
Operating profit	75,531	93,490	103,977	123,996	149,313
Other non-op income					
Associates & JCEs					
Pre-tax profit	75,531	93,490	103,977	123,996	149,313
Income tax	-23,736	-31,313	-34,312	-40,919	-49,274
Net profit after tax	51,794	62,177	69,664	83,078	100,039
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	51,794	62,177	69,664	83,078	100,039
Extraordinary items	0	0	0	0	0
Reported NPAT	51,794	62,177	69,664	83,078	100,039
Dividends	-9,855	-11,011	-12,644	-14,540	-16,721
Transfer to reserves	41,939	51,166	57,021	68,538	83,318

Growth (%)

Net interest income	20.6	23.6	13.9	15.8	16.3
Non-interest income	20.9	13.0	13.6	16.5	17.1
Non-interest expenses	16.8	17.9	15.5	17.0	17.0
Pre-provision earnings	25.2	23.1	13.6	16.9	17.0
Net profit	22.1	20.0	12.0	19.3	20.4
Normalised EPS	7.8	19.6	12.0	19.3	20.4
Normalised FDEPS	7.8	19.6	12.0	19.3	20.4
Loan growth	16.0	16.8	16.0	19.0	20.0
Interest earning assets	16.0	16.5	16.1	19.0	20.0
Interest bearing liabilities	16.7	11.7	16.5	19.3	20.2
Asset growth	19.2	12.5	16.6	18.9	19.9
Deposit growth	14.8	11.2	16.7	20.0	21.3

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	163,811	240,741	281,631	337,831	408,625
Inter-bank lending					
Deposits with central bank	40,539	41,647	51,147	61,354	74,211
Total securities					
Other int earning assets					
Gross loans	1,986,552	2,321,881	2,700,624	3,218,913	3,866,125
Less provisions	-16,893	-21,214	-31,849	-43,072	-55,115
Net loans	1,969,660	2,300,668	2,668,774	3,175,842	3,811,010
Long-term investments	1,137,375	1,135,484	1,330,776	1,580,276	1,890,236
Fixed assets	23,556	24,102	24,648	25,193	25,739
Goodwill					
Other intangible assets					
Other non IEAs	70,666	89,808	110,295	132,305	160,030
Total assets	3,405,607	3,832,449	4,467,271	5,312,800	6,369,850
Customer deposits	2,526,136	2,809,446	3,278,795	3,935,297	4,772,918
Bank deposits, CDs,	403,855	452,639	509,636	576,332	649,875
Other int bearing liabilities	35,656	50,270	70,270	90,270	110,270
Total int bearing liabilities	2,965,647	3,312,355	3,858,701	4,601,899	5,533,063
Non-int bearing liabilities	108,881	137,889	169,345	203,138	245,706
Total liabilities	3,074,528	3,450,244	4,028,046	4,805,037	5,778,769
Minority interest					
Common stock	4,680	4,698	4,698	4,698	4,698
Preferred stock					
Retained earnings	326,399	377,506	434,527	503,065	586,383
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	331,079	382,205	439,226	507,763	591,081
Total liabilities and equity	3,405,607	3,832,449	4,467,271	5,312,800	6,369,850
Non-perf assets	23,934	35,051	45,499	59,002	73,487

Balance sheet ratios (%)

Loans to deposits	78.6	82.6	82.4	81.8	81.0
Equity to assets	9.7	10.0	9.8	9.6	9.3

Asset quality & capital

NPAs/gross loans (%)	1.2	1.5	1.7	1.8	1.9
Bad debt charge/gross	0.74	0.77	0.97	0.87	0.74
Loss reserves/assets (%)	0.50	0.55	0.71	0.81	0.87
Loss reserves/NPAs (%)	70.6	60.5	70.0	73.0	75.0
Tier 1 capital ratio (%)	12.2	12.8	12.7	12.4	12.1
Total capital ratio (%)	17.0	17.0	16.9	16.5	15.9

Per share

Reported EPS (INR)	110.68	132.34	148.27	176.82	212.92
Norm EPS (INR)	110.68	132.34	148.27	176.82	212.92
FD norm EPS (INR)	110.68	132.34	148.27	176.82	212.92
DPS (INR)	21.06	23.44	26.91	30.95	35.59
PPOP PS (INR)	198.80	243.83	276.87	323.60	378.53
BVPS (INR)	707.50	813.47	934.83	1,080.70	1,258.04
ABVPS (INR)	707.50	811.57	934.49	1,080.70	1,258.04
NTAPS (INR)	707.50	813.47	934.83	1,080.70	1,258.04

Valuations and ratios

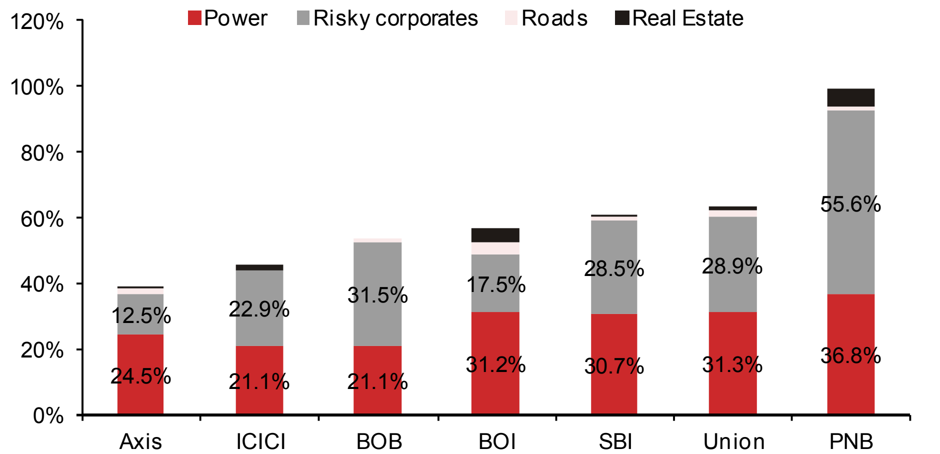
Reported P/E (x)	17.4	14.6	13.0	10.9	9.0
Normalised P/E (x)	17.4	14.6	13.0	10.9	9.0
FD normalised P/E (x)	17.4	14.6	13.0	10.9	9.0
Dividend yield (%)	1.1	1.2	1.4	1.6	1.8
Price/book (x)	2.7	2.4	2.1	1.8	1.5
Price/adjusted book (x)	2.7	2.4	2.1	1.8	1.5
Net interest margin (%)	5.16	5.49	5.38	5.29	5.15
Yield on assets (%)	14.52	14.08	13.95	13.73	13.42
Cost of int bearing liab (%)	6.36	5.95	6.05	5.94	5.81
Net interest spread (%)	8.16	8.13	7.90	7.79	7.61
Non-interest income (%)	40.4	38.3	38.2	38.3	38.5
Cost to income (%)	42.6	40.8	40.9	40.5	40.3
Effective tax rate (%)	31.4	33.5	33.0	33.0	33.0
Dividend payout (%)	19.0	17.7	18.1	17.5	16.7
ROE (%)	18.5	17.4	17.0	17.5	18.2
ROA (%)	1.65	1.72	1.68	1.70	1.71
Operating ROE (%)	27.0	26.2	25.3	26.2	27.2
Operating ROA (%)	2.41	2.58	2.51	2.54	2.56

Source: Company data, Nomura estimates

Asset quality risk manageable – Exposure to sub-segments with high LGD is low
Axis Bank's asset quality performance has surprised in the credit cycle with gross NPA of <1.5% of loans and slippage levels holding up at comparable levels of ICICI vs. consensus analyst perception of higher risk. In 1HFY15F, we expect slippages run-rate to track the bank's guidance of INR60-65bn of slippages + restructuring (for full-year FY15F) and come off from there on. We, thus, expect credit costs to remain stable at 1.05% in FY15F and come off to 95bps in FY16F and ~80bps in FY17F. **On specific segments:**

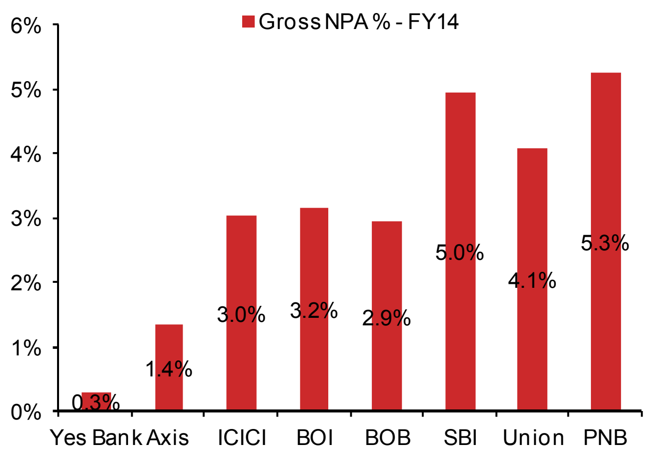
- **Retail/agri/SME** together contributes ~54% of the loan book and the asset quality outlook on business banking (SME) continues to remain robust with an improvement in the business sentiment. The retail book for Axis is lower risk with mortgages/LAP constituting ~72% of the book.
- **On corporates/infra,** our bank-wise analysis of +INR4trn of stressed infra/large corporate exposure shows that Axis's underwriting has been relatively better among project financiers and the exposure to segments that could see high loss given default is low (gas power/ unviable roads/ports). This, along with increasing floating provisions stock (~30bps of loans) and a turning credit cycle, is comforting, in our view.

Fig. 116: Axis's risk in large corporate/Infra is similar to that of ICICI – Exposure to sub-segments with high LGD is low



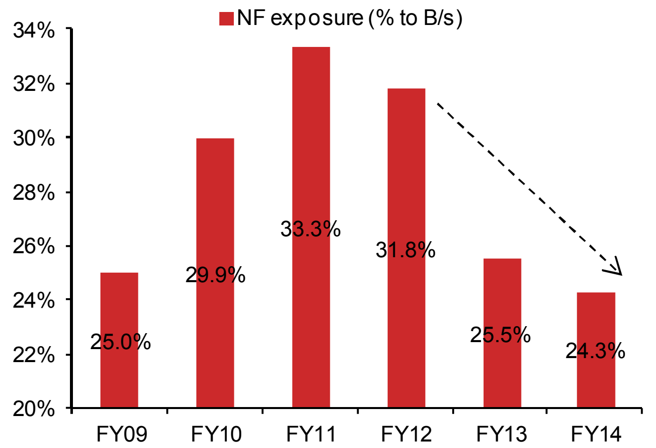
Source: Ministry of Corporate Affairs, Nomura estimates

Fig. 117: Asset quality has held up relatively well among corporate banks



Source: Company data, Nomura research

Fig. 118: Contingent liabilities now running down as well



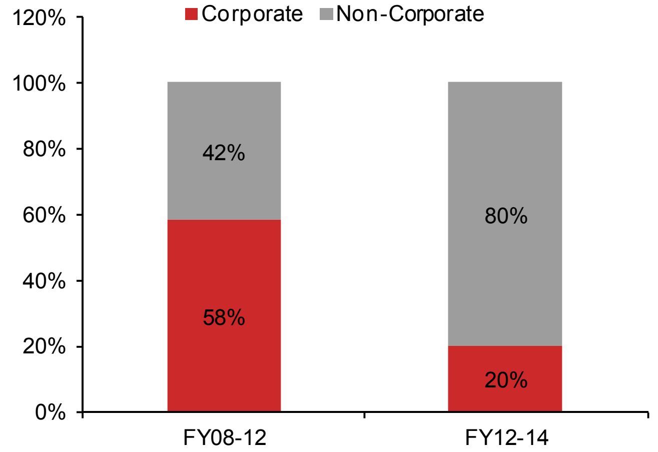
Source: Company data, Nomura research

Significant granularity built in assets/fees

- From being a largely wholesale bank, Axis Bank's share of retail assets has increased to +30% in FY14 from <20% in FY11 and granular retail assets along with SME business contributed ~65% of the incremental growth in the past three years as the corporate book growth has slowed down. Currently, Axis Bank's asset mix is more granular than that of ICICI on a consolidated basis – we believe this makes Axis Bank's loan book less risky/cyclical than the last cycle.
- Also, granularity has increased significantly in Axis Bank's fee business with retail fees now contributing +30% of incremental fees. Even though Axis does not run a life insurance business, it has scaled up its third-party distribution income with its tie-up with Max New York – The bancassuarnce fees of Axis is now comparable with that of ICICI/HDFCB vs. being 70-80% lower till FY10.

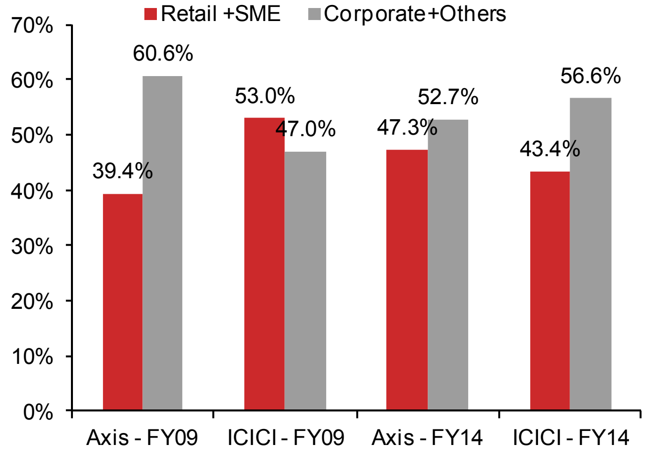
Fig. 119: Growth in the past 2-3 years largely retail/SME driven

Contribution to incremental growth



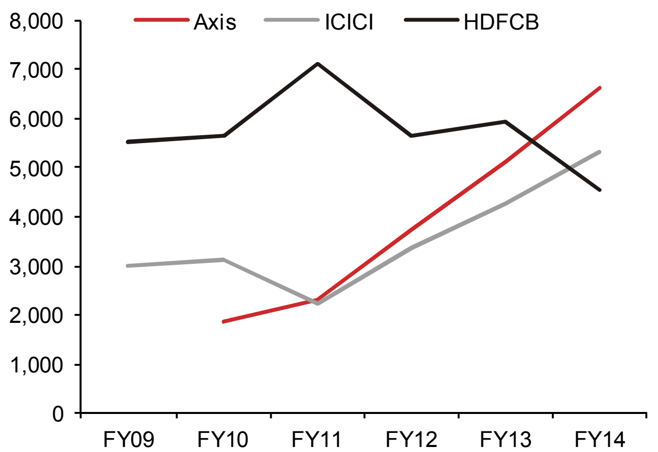
Source: Company data, Nomura research

Fig. 120: Asset book composition now comparable with ICICI



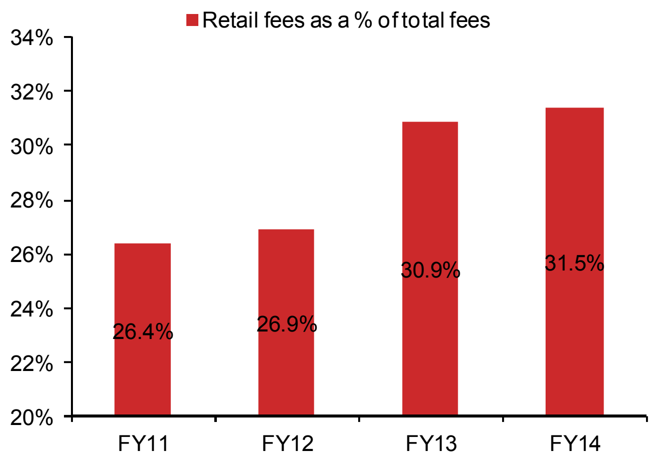
Source: Company data, Nomura research

Fig. 121: Life insurance fees comparable with HDFCB/ICICI now



Source: Company data, Nomura research

Fig. 122: Share of overall retail fees has increased

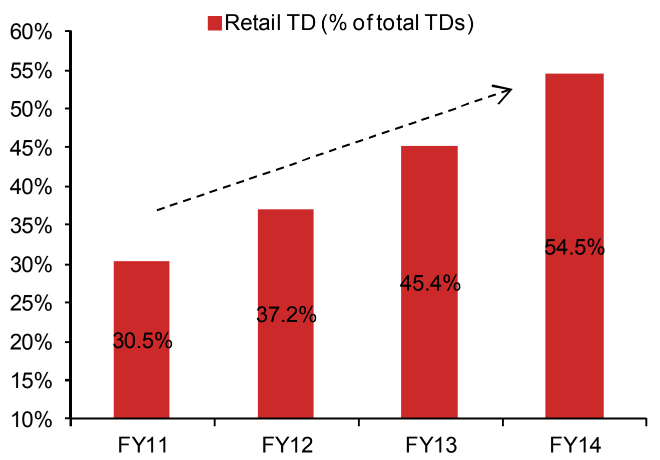


Source: Company data, Nomura research

Liability franchise remains underappreciated

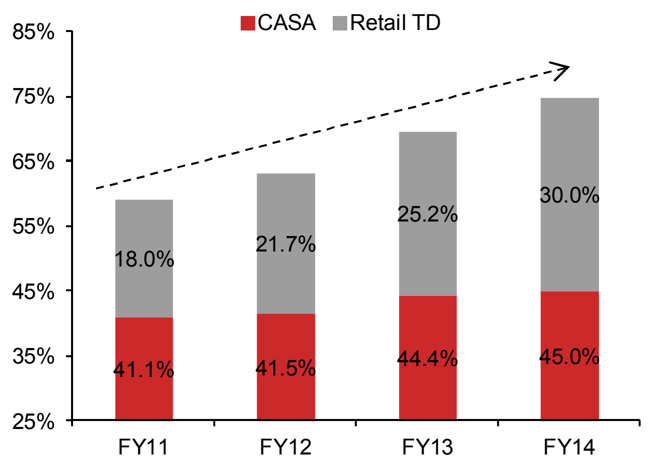
- Axis Bank's CASA success is well known, but we believe that the bank's improvement on the liability side, especially on current accounts (CA), is under-appreciated. Also, bulk term deposits' share of Axis is down from +40% in FY10-11 to currently <25%, thus improving Axis Bank's ability to protect margins when rates spike.
- **The highest incremental market share in the CA business:** CA growth has suffered for the system in general in the past three-four years and so has it for Axis. But, given Axis Bank's dominance in branch banking (SME), its market share in the CA business has continuously increased and the incremental CA share of 9% over the past five years was best in class and significantly better than peer ICICI. Our interactions with liability heads at various banks suggest that the business banking dominance of Axis Bank remains unchanged.

Fig. 123: Retail TDs as a % of overall TD has increased



Source: Company data, Nomura research

Fig. 124: CASA + retail TD now contribute ~75% of deposits



Source: Company data, Nomura research

Fig. 125: CA and SA market share is best in class for Axis and remains underappreciated

Incremental CA share for Axis has been 2x that of ICICI

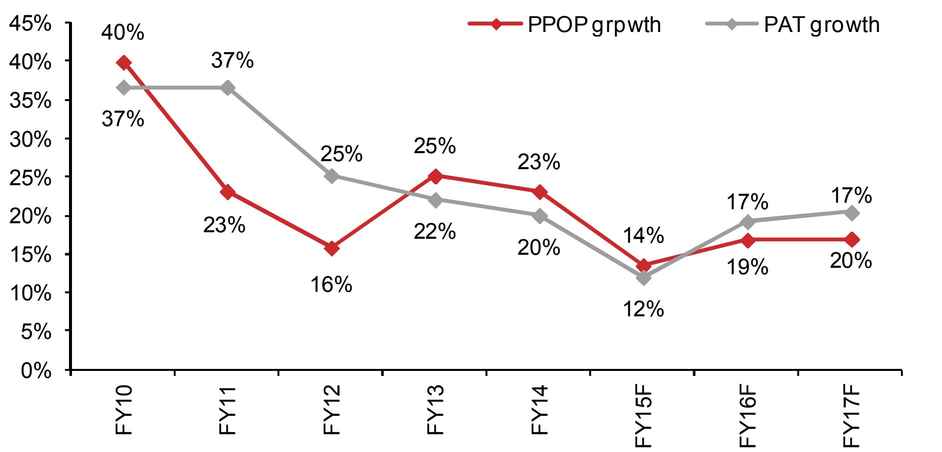
	CA Market share (%)			Inc. CA Share (%)		SA Market share (%)			Inc. SA Share (%)	
	2003	2008	2013	2003-08	2008-13	2003	2008	2013	2003-08	2008-13
SBI	27.7%	22.0%	19.3%	18.6%	15.3%	24.8%	22.6%	25.1%	21.2%	27.2%
Axis	2.04%	6.01%	7.23%	8.29%	9.29%	0.54%	2.94%	3.86%	4.46%	4.55%
HDFCB	4.16%	8.77%	9.12%	11.24%	9.40%	1.77%	3.85%	5.34%	5.17%	6.45%
ICICI	3.10%	7.53%	6.44%	9.92%	4.88%	1.44%	5.75%	5.18%	8.49%	4.84%
BOB	3.9%	2.8%	3.6%	2.1%	5.0%	6.1%	5.1%	5.0%	4.5%	4.9%
PNB	8.3%	5.4%	5.2%	3.7%	4.8%	9.7%	7.9%	7.5%	6.8%	7.2%

Source: RBI, Nomura research

Return ratios best in class now – Earnings growth to pick up in FY16F as credit costs moderate

- **We expect a pick up in earnings growth in FY16F:** The core PPOP growth for Axis Bank has moderated in the past three-four quarters and we expect earnings growth to consolidate in FY15F as near-term NIMs have peaked and some of the non-core FX revaluation gains on the repatriation of overseas business profits are unlikely to recur in FY15F. But, as we expect credit costs to come off in FY16F/F17F, Axis Bank could deliver an earnings CAGR of 21% over FY16-17F.
- **ROAs and RORWAs significantly higher than that in the last cycle when valuations were 2.3x the forward book:** NIMs improvement, led by CASA improvement and the sustenance of high fee/assets at ~2%, has led to ROAs moving up from 1.2% in FY06-08 to 1.7-1.8% in FY14 and hence RORWAs have moved from 1.5% in FY06-08 to 2.2% currently. This would imply higher normalised ROEs for Axis in this cycle than in the last cycle and hence valuations could likely surprise, in our view. Axis Bank's RORWAs are comparable with that of most retail banks in spite of the high credit costs currently.

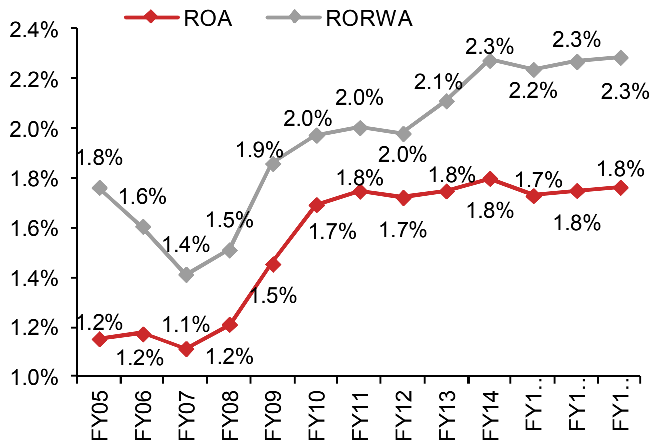
Fig. 126: We expect a pick up in earnings from FY16F



Source: Company data, Nomura estimates

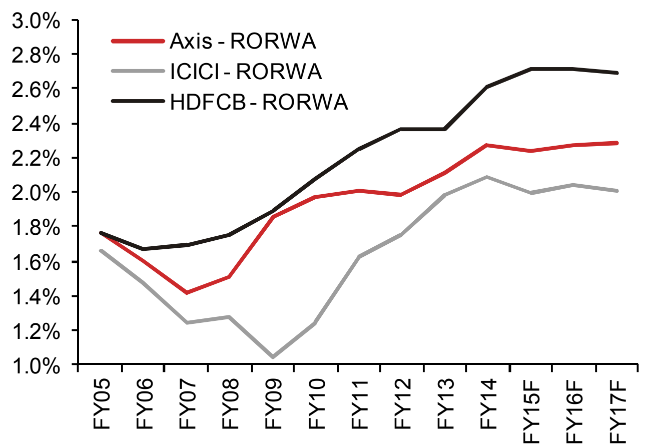
Fig. 127: Return ratios at all-time highs

This is in spite of the rise in credit costs



Source: Company data, Nomura estimates

Fig. 128: ROAs/RORWAs comparable with retail banks



Source: Company data, Nomura estimates

Valuations: Reasonable in spite of the recent re-rating

Our target price of INR2,300 is based on 2.1x FY16F book (BVPS: INR1,080). This is higher than the multiples at which Axis has traded in the past two-three years but lower than FY04-07 multiples. While growth over the next two-three years is likely to be lower than the last cycle, ROAs are much more superior now (1.75% vs. 1.2% in FY04-07) and B/S and P&L granularity makes the business model less risky. We, thus, expect Axis Bank to close the valuation gap with private peers as risks surrounding large corporate asset quality ebb.

Risks: (1) A slower-than-expected recovery in corporate capex execution; and **(2)** the indirect impact of weak monsoons – higher rates.

Fig. 129: Return ratios have improved in the past 5-7 years – we expect Axis to maintain ROAs/RORWAs

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	2.93%	2.96%	3.42%	3.39%	3.29%	3.27%	3.46%	3.38%	3.32%	3.23%
Fees/Assets	1.80%	2.11%	2.22%	2.21%	2.18%	2.02%	2.05%	1.95%	1.96%	1.94%
Investment profits/Assets	0.23%	0.23%	0.49%	0.19%	0.04%	0.20%	0.09%	0.14%	0.11%	0.09%
Net revenues/Assets	**4.96%**	**5.30%**	**6.13%**	**5.78%**	**5.51%**	**5.48%**	**5.60%**	**5.47%**	**5.39%**	**5.26%**
Operating Expense/Assets	-2.44%	-2.31%	-2.57%	-2.47%	-2.46%	-2.34%	-2.29%	-2.24%	-2.18%	-2.12%
Provisions/Assets	-0.66%	-0.75%	-0.95%	-0.66%	-0.47%	-0.59%	-0.61%	-0.65%	-0.59%	-0.50%
Taxes/Assets	-0.65%	-0.78%	-0.92%	-0.90%	-0.84%	-0.80%	-0.91%	-0.85%	-0.86%	-0.87%
Total Costs/Assets	**-3.75%**	**-3.84%**	**-4.44%**	**-4.03%**	**-3.77%**	**-3.73%**	**-3.80%**	**-3.74%**	**-3.64%**	**-3.49%**
ROA	**1.21%**	**1.46%**	**1.69%**	**1.75%**	**1.74%**	**1.75%**	**1.80%**	**1.73%**	**1.75%**	**1.76%**
Equity/Assets	6.89%	7.62%	8.97%	9.05%	8.57%	9.45%	10.33%	10.20%	9.98%	9.69%
ROE	**17.6%**	**19.1%**	**18.9%**	**19.3%**	**20.3%**	**18.5%**	**17.4%**	**17.0%**	**17.5%**	**18.2%**
RORWA	**1.51%**	**1.86%**	**1.98%**	**2.01%**	**1.98%**	**2.11%**	**2.28%**	**2.24%**	**2.27%**	**2.29%**

Source: Company data, Nomura estimates

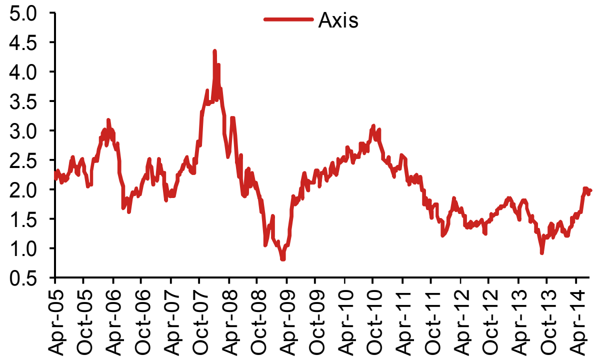
Fig. 130: TP of INR2,300

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.15
Cost of Equity	14.9%
Terminal grow th	5.0%
Normalised ROE	21.1%
Stage 2 grow th	20.0%
Mar-15 PT	2300
Implied Mar-16 P/B	2.13
Implied Mar-16 P/E	13.01

Source: Nomura estimates

Fig. 131: Valuations still reasonable

1yr fwd p/b chart



Source: Company data, Bloomberg, Nomura estimates

NOMURA

HDFC Bank HDBK.NS HDFCB IN

EQUITY: BANKS

Continues to tick all the right boxes

Delivering not only on earnings growth but also on most underlying metrics

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 950
Closing price 3 July 2014	INR 837
Potential upside	+13.5%

Action: Enough buffers to deliver consistent earnings growth

Following a transfer of coverage, we have a Buy rating on HDFCB and a target price of INR950. Our positive view is driven by a mix of: 1) steady profitability with a large floating provision cushion; 2) improvements in most underlying metrics; and 3) increasing and sector-best RORWAs/ROAs. We view recent underperformance due to technical reasons as a good entry point.

- HDFCB has been able to manage earnings well, driven by slower opex growth in FY14. It also has more levers in the form of floating provisions (INR18bn) that provide a cushion to profitability.
- Strength in most underlying metrics – HDFCB has top CASA market share, top NEFT/RTGS market share (3x that of ICICI/Axis) and improving PSL compliance. This should help sustain premium valuations, in our view.
- We expect EPS growth to moderate from 23-24% over the last decade to a ~20-21% CAGR over the next three years. RORWAs have grown from 1.7% to 2.7% and hence we believe through-cycle ROEs are likely to be higher than historical levels.

Catalysts: 1) Pick-up in retail credit in 2H15F in cars and FY16F in commercial vehicles to aid growth; 2) MSCI issue priced-in; 3) any announcement of firm capital raising plans as that would be book accretive without material EPS dilution.

Valuations: Premium valuations to hold; our preferred defensive pick

Our INR950 TP is based on 3.75x Mar-16F book (3.4x Mar-16F book assuming an INR80bn dilution). Recent underperformance has been due to technical reasons and we believe premium valuations will be sustained as we expect earnings to be the most resilient in the sector while underlying metrics remain superior to those of its peers. The valuation gap with peer retail banks is low at 10-20% on FY16F P/B and <10% on FY16F P/E.

Anchor themes

Prefered defensive pick - delivering on most underlying metrics + earnings most resilient.

Nomura vs consensus

Our FY15/16F earnings estimates are largely in line with consensus.

Research analysts

India Banks

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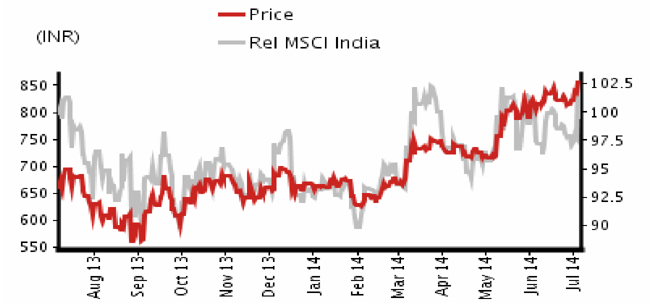
Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	143,601		176,583		213,922		258,843
Reported net profit (mn)	84,784		101,940		122,404		147,180
Normalised net profit (mn)	84,784		101,940		122,404		147,180
FD normalised EPS	35.34		42.49		51.02		61.35
FD norm. EPS growth (%)	29.9		20.2		20.1		20.2
FD normalised P/E (x)	23.7	N/A	19.7	N/A	16.4	N/A	13.6
Price/adj. book (x)	4.7	N/A	4.0	N/A	3.4	N/A	2.8
Price/book (x)	4.6	N/A	3.9	N/A	3.3	N/A	2.8
Dividend yield (%)	1.0	N/A	1.2	N/A	1.4	N/A	1.7
ROE (%)	21.3		21.5		21.8		22.1
ROA (%)	1.9		1.9		1.9		1.9

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Key data on HDFC Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	1.5	14.8	28.6	M cap (USDmn)	33,701.5
Absolute (USD)	0.7	15.7	29.7	Free float (%)	90.3
Rel to MSCI India	-3.0	1.3	-1.6	3-mth ADT (USDmn)	32.9

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	350,649	411,355	495,603	585,490	700,017
Interest expense	-192,538	-226,529	-272,596	-320,065	-384,350
Net interest income	158,111	184,826	223,007	265,426	315,667
Net fees and commissions	51,677	57,359	67,110	81,874	99,887
Trading related profits	1,613	1,105	2,500	2,500	2,500
Other operating revenue	15,237	20,733	23,751	28,093	33,302
Non-interest income	68,526	79,196	93,361	112,467	135,688
Operating income	226,637	264,023	316,368	377,893	451,356
Depreciation	-6,517	-6,716	-7,388	-8,126	-8,939
Amortisation					
Operating expenses	-66,191	-71,916	-86,299	-103,559	-124,271
Employee share expense	-39,654	-41,790	-46,098	-52,285	-59,302
Pre-provision op profit	114,276	143,601	176,583	213,922	258,843
Provisions for bad debt	-13,579	-18,539	-21,372	-27,267	-34,257
Other provision charges	-3,185	2,666	-1,636	-2,253	-2,856
Operating profit	97,512	127,728	153,575	184,403	221,730
Other non-op income					
Associates & JCEs					
Pre-tax profit	97,512	127,728	153,575	184,403	221,730
Income tax	-32,764	-42,944	-51,634	-61,999	-74,550
Net profit after tax	64,749	84,784	101,940	122,404	147,180
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	64,749	84,784	101,940	122,404	147,180
Extraordinary items	0	0	0	0	0
Reported NPAT	64,749	84,784	101,940	122,404	147,180
Dividends	-15,312	-19,227	-23,118	-27,759	-33,377
Transfer to reserves	49,437	65,557	78,822	94,645	113,803

Growth (%)

Net interest income	22.7	16.9	20.7	19.0	18.9
Non-interest income	18.5	15.6	17.9	20.5	20.6
Non-interest expenses	24.1	8.6	20.0	20.0	20.0
Pre-provision earnings	21.7	25.7	23.0	21.1	21.0
Net profit	25.3	30.9	20.2	20.1	20.2
Normalised EPS	23.6	29.9	20.2	20.1	20.2
Normalised FDEPS	23.6	29.9	20.2	20.1	20.2
Loan growth	22.7	26.4	18.0	21.0	22.0
Interest earning assets	25.1	24.8	17.9	21.0	22.0
Interest bearing liabilities	21.7	23.5	16.9	20.6	21.9
Asset growth	18.5	22.8	16.4	19.6	20.8
Deposit growth	20.1	24.0	17.1	21.3	22.9

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	96,197	214,951	251,724	304,776	373,418
Inter-bank lending	176,605	180,885	211,830	256,474	314,238
Deposits with central bank					
Total securities					
Other int earning assets					
Gross loans	2,415,808	3,051,695	3,603,908	4,365,266	5,331,203
Less provisions	-18,602	-21,692	-28,505	-39,028	-53,193
Net loans	2,397,206	3,030,003	3,575,403	4,326,238	5,278,010
Long-term investments	1,116,136	1,209,511	1,376,302	1,616,609	1,927,357
Fixed assets	27,043	29,411	32,970	36,529	40,088
Goodwill					
Other intangible assets					
Other non IEAs	190,138	251,240	276,364	304,000	334,400
Total assets	4,003,325	4,916,001	5,724,593	6,844,626	8,267,512
Customer deposits	2,962,470	3,673,375	4,301,247	5,219,421	6,415,613
Bank deposits, CDs,	302,926	394,390	436,943	480,677	525,541
Other int bearing liabilities	27,140	0	18,000	36,000	54,000
Total int bearing liabilities	3,292,536	4,067,765	4,756,190	5,736,098	6,995,153
Non-int bearing liabilities	348,648	413,450	454,795	500,275	550,302
Total liabilities	3,641,183	4,481,215	5,210,985	6,236,372	7,545,455
Minority interest					
Common stock	4,759	4,798	4,798	4,798	4,798
Preferred stock					
Retained earnings	357,383	429,988	508,811	603,456	717,258
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	362,141	434,786	513,609	608,254	722,057
Total liabilities and equity	4,003,325	4,916,001	5,724,593	6,844,626	8,267,512
Non-perf assets	23,292	29,892	39,047	53,463	70,924

Balance sheet ratios (%)

Loans to deposits	81.5	83.1	83.8	83.6	83.1
Equity to assets	9.0	8.8	9.0	8.9	8.7

Asset quality & capital

NPAs/gross loans (%)	1.0	1.0	1.1	1.2	1.3
Bad debt charge/gross	0.56	0.61	0.59	0.62	0.64
Loss reserves/assets (%)	0.46	0.44	0.50	0.57	0.64
Loss reserves/NPAs (%)	79.9	72.6	73.0	73.0	75.0
Tier 1 capital ratio (%)	11.1	11.1	11.4	11.4	11.2
Total capital ratio (%)	16.8	16.8	16.5	15.8	15.0

Per share

Reported EPS (INR)	27.21	35.34	42.49	51.02	61.35
Norm EPS (INR)	27.21	35.34	42.49	51.02	61.35
FD norm EPS (INR)	27.21	35.34	42.49	51.02	61.35
DPS (INR)	6.44	8.01	9.64	11.57	13.91
PPOP PS (INR)	48.03	59.86	73.61	89.17	107.89
BVPS (INR)	152.20	181.23	214.09	253.54	300.98
ABVPS (INR)	150.82	178.84	211.01	249.33	295.80
NTAPS (INR)	152.20	181.23	214.09	253.54	300.98

Valuations and ratios

Reported P/E (x)	30.8	23.7	19.7	16.4	13.6
Normalised P/E (x)	30.8	23.7	19.7	16.4	13.6
FD normalised P/E (x)	30.8	23.7	19.7	16.4	13.6
Dividend yield (%)	0.8	1.0	1.2	1.4	1.7
Price/book (x)	5.5	4.6	3.9	3.3	2.8
Price/adjusted book (x)	5.5	4.7	4.0	3.4	2.8
Net interest margin (%)	6.83	6.39	6.37	6.34	6.20
Yield on assets (%)	15.15	14.22	14.16	13.99	13.76
Cost of int bearing liab (%)	6.42	6.16	6.18	6.10	6.04
Net interest spread (%)	8.73	8.07	7.99	7.89	7.72
Non-interest income (%)	30.2	30.0	29.5	29.8	30.1
Cost to income (%)	49.6	45.6	44.2	43.4	42.7
Effective tax rate (%)	33.6	33.6	33.6	33.6	33.6
Dividend payout (%)	23.6	22.7	22.7	22.7	22.7
ROE (%)	19.6	21.3	21.5	21.8	22.1
ROA (%)	1.75	1.90	1.92	1.95	1.95
Operating ROE (%)	29.5	32.1	32.4	32.9	33.3
Operating ROA (%)	2.64	2.86	2.89	2.93	2.93

Source: Company data, Nomura estimates

Delivering on most underlying metrics

We look at many of the underlying metrics which may or may not be drivers for near-term earnings growth, but certainly contribute to improving the business model and hence the longer-term profitability of the business. HDFCB continues to deliver on many of these:

- **Top CASA market share:** HDFCB's high CASA share is well known, but even its incremental share of the capital account (CA) and savings account (SA) market has grown over the last five years – in CA it dominates the SME/business banking market with Axis, and in SA it dominates the salary SA market with ICICI. Its CA business is a lot more reliant on capital market businesses and any improvements in capital markets should help its CA flows.
- **Top NEFT/RTGS market share:** HDFCB has a market share of over 20% in RTGS and ~13% in NEFT – the two payment systems that process ~80% of banking system flows. Its market share is 3-4x of ICICI/Axis, indicating its dominance. This shows HDFCB's ability to get customer flows across the retail, SME, corporate and government segments through its systems.
- **Best positioned for rural growth:** Currently, **more than 50% of HDFCB's network is in rural areas**, which should aid PSL compliance over time. HDFCB is better placed than its peers on PSL compliance, hence its RIDF burden should be lower.

Fig. 132: Incremental CASA market share is the highest

	CA Market share (%)			Inc. CA Share (%)		SA Market share (%)			Inc. SA Share (%)	
	2003	2008	2013	2003-08	2008-13	2003	2008	2013	2003-08	2008-13
SBI	27.7%	22.0%	19.3%	18.6%	15.3%	24.8%	22.6%	25.1%	21.2%	27.2%
Axis	2.04%	6.01%	7.23%	8.29%	9.29%	0.54%	2.94%	3.86%	4.46%	4.55%
HDFCB	4.16%	8.77%	9.12%	11.24%	9.40%	1.77%	3.85%	5.34%	5.17%	6.45%
ICICI	3.10%	7.53%	6.44%	9.92%	4.88%	1.44%	5.75%	5.18%	8.49%	4.84%
BOB	3.9%	2.8%	3.6%	2.1%	5.0%	6.1%	5.1%	5.0%	4.5%	4.9%
PNB	8.3%	5.4%	5.2%	3.7%	4.8%	9.7%	7.9%	7.5%	6.8%	7.2%

Source: RBI, Nomura research

Fig. 133: No competitor in RTGS/NEFT flows

	RTGS Market Share					NEFT Market Share				
	Oct to Dec-12	Jan to Mar-13	Apr to Jun-13	Jul to Sep-13	Oct to Dec-13	Oct to Dec-12	Jan to Mar-13	Apr to Jun-13	Jul to Sep-13	Oct to Dec-13
ICICI	4.4%	4.2%	4.4%	6.0%	6.0%	6.9%	6.9%	6.7%	6.8%	7.2%
HDFCB	19.7%	19.3%	19.9%	20.5%	21.5%	13.1%	13.2%	13.0%	12.6%	12.6%
Axis	6.4%	6.5%	6.3%	6.7%	7.4%	5.7%	5.8%	5.7%	5.5%	5.7%
SBI	9.5%	9.2%	9.0%	8.9%	9.5%	14.8%	14.5%	16.6%	16.0%	16.4%
PNB	1.7%	1.7%	1.5%	1.6%	1.8%	2.9%	3.1%	3.0%	2.9%	2.7%
BOB	1.2%	1.3%	1.2%	1.1%	1.2%	1.9%	2.1%	2.0%	2.0%	2.2%

Source: RBI, Nomura research

Low risk to earnings growth; steady improvement in profitability

Moderation in retail growth pulled down revenue growth in 2HFY13 and FY14, but significant consolidation on the opex side (just 7% y-y growth in FY14) led to strong PPOP growth of ~25% y-y in FY14. While we expect opex levers to peak in 1HFY15, we see two or three levers for profit growth in the next two to three years:

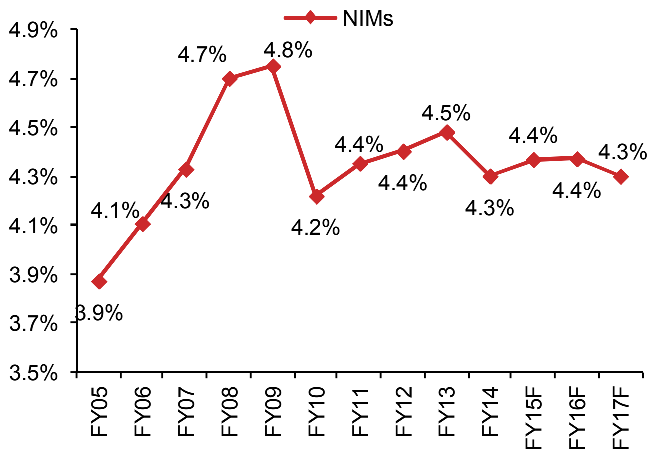
1. We expect improvement in retail growth from 2HFY15F, which is generally margin accretive as yields are higher in the retail than the corporate book.
2. Fee income growth looks to have bottomed, especially on third-party distribution income (contracted ~28% y-y in FY14). We expect an improvement there.
3. Floating provision stock of INR18bn provides significant cushion to credit costs (60bp of loans) – extra provisions amount to almost one year of specific provisions.

Fig. 134: Revenue growth has moderated with slower balance sheet growth, but opex provides a buffer in FY14. We expect to see more levers in FY15F

	P&L (INRbn)					y/y growth			
	FY12	FY13	FY14	FY15F	FY16F	FY13	FY14	FY15F	FY16F
Net Interest Income	129	158	185	223	265	22.7%	16.9%	20.7%	19.0%
Fees	60	67	78	91	110	12.0%	16.6%	16.4%	21.0%
Operating Expense	93	112	120	140	164	21.1%	7.2%	16.1%	17.3%
Investment profits	-2	2	1	3	3	-182.4%	-29.0%	119.8%	0.0%
Preprovision profit	94	114	144	177	214	21.7%	25.7%	23.0%	21.1%
Provisions	19	17	16	23	30	-10.7%	-5.3%	45.0%	28.3%
Taxes	23	33	43	52	62	39.7%	31.1%	20.2%	20.1%
PAT	52	65	85	102	122	25.3%	30.9%	20.2%	20.1%
EPS (Rs)	22.0	27.2	35.3	42.5	51.0	23.6%	29.9%	20.2%	20.1%
Loans	1,954	2,397	3,030	3,575	4,326	22.7%	26.4%	18.0%	21.0%

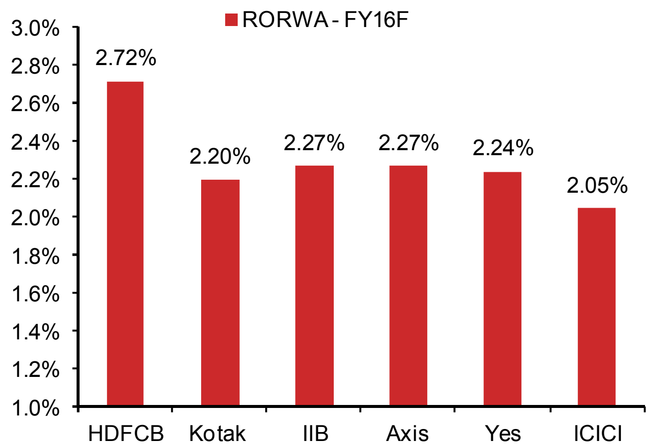
Source: Company data, Nomura estimates

Fig. 135: Margins steady through cycle



Source: Company data, Nomura estimates

Fig. 136: We expect HDFCB to sustain best-in-class return ratios



Source: Nomura estimates

Premium valuations to be sustained; our preferred defensive pick

Our TP of INR950 is based on 3.75x Mar-16F book (3.4x Mar-16F book assuming an INR80bn dilution). The reasons for the recent underperformance have been rather technical and we believe premium valuations will be sustained as not only do we expect HDFCB's earnings to be the most resilient in the space, but its underlying metrics remain superior to those of its peers as well. Its valuation gap with peer retail banks (Kotak and IIB) is now low at 10-20% on FY16F P/B and <10% on FY16F P/E.

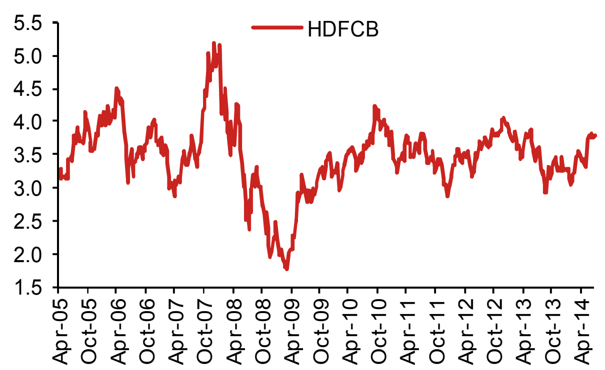
Risks: 1) A slower-than-expected pick-up in retail credit growth; and 2) any significant change in underwriting standards of retail loans.

Fig. 137: Earnings growth to slightly moderate but return ratios have only gone up

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	4.70%	4.75%	4.22%	4.35%	4.40%	4.48%	4.30%	4.37%	4.37%	4.30%
Fees/Assets	1.84%	1.86%	1.74%	1.81%	2.04%	1.90%	1.82%	1.78%	1.81%	1.82%
Investment profits/Assets	0.22%	0.25%	0.18%	-0.02%	-0.07%	0.05%	0.03%	0.05%	0.04%	0.03%
Net revenues/Assets	**6.76%**	**6.86%**	**6.14%**	**6.15%**	**6.38%**	**6.43%**	**6.15%**	**6.20%**	**6.23%**	**6.15%**
Operating Expense/Assets	-3.37%	-3.54%	-2.90%	-2.95%	-3.17%	-3.19%	-2.80%	-2.74%	-2.70%	-2.62%
Provisions/Assets	-1.34%	-1.20%	-1.08%	-0.79%	-0.64%	-0.48%	-0.37%	-0.45%	-0.49%	-0.51%
Taxes/Assets	-0.62%	-0.68%	-0.67%	-0.78%	-0.80%	-0.93%	-1.00%	-1.01%	-1.02%	-1.02%
Total Costs/Assets	**-5.33%**	**-5.42%**	**-4.65%**	**-4.52%**	**-4.62%**	**-4.59%**	**-4.17%**	**-4.20%**	**-4.21%**	**-4.15%**
ROA	**1.43%**	**1.44%**	**1.48%**	**1.62%**	**1.77%**	**1.84%**	**1.97%**	**2.00%**	**2.02%**	**2.01%**
Equity/Assets	8.06%	8.50%	9.20%	9.69%	9.45%	9.38%	9.28%	9.29%	9.24%	9.07%
ROE	**17.7%**	**16.9%**	**16.1%**	**16.7%**	**18.7%**	**19.6%**	**21.3%**	**21.5%**	**21.8%**	**22.1%**
RORWA	**1.75%**	**1.90%**	**2.07%**	**2.25%**	**2.37%**	**2.37%**	**2.61%**	**2.71%**	**2.72%**	**2.69%**
EPS growth (%)	25.6%	17.6%	22.1%	31.0%	30.4%	23.6%	29.9%	20.2%	20.1%	20.2%
PAT growth	39.4%	41.2%	31.4%	33.1%	31.6%	25.3%	30.9%	20.2%	20.1%	20.2%

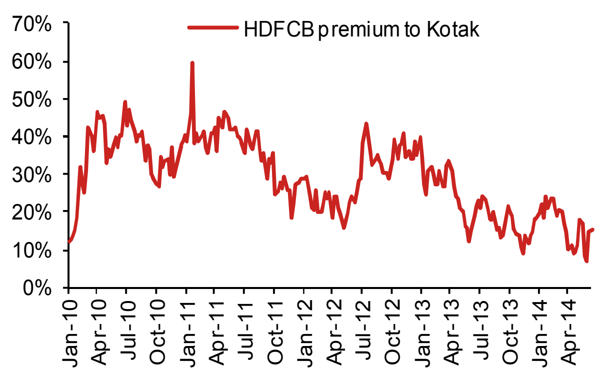
Source: Company data, Nomura estimates

Fig. 138: HDFCB's valuations reasonable (1 yr fwd book)



Source: Company data, Bloomberg, Nomura estimates

Fig. 139: Valuation discount to Kotak also low



Source: Company data, Bloomberg, Nomura estimates

Fig. 140: TP of INR950

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.00
Cost of Equity	14.0%
Terminal growth	5.0%
Stage 2 growth	28.0%
Normalised ROE	23.1%
Mar-15 PT	950
Implied Mar-16 P/B	3.75
Implied Mar-16 P/E	18.62

Source: Nomura estimates

NOMURA

ICICI Bank ICBK.NS ICICIBC IN

EQUITY: BANKS

ROE improvement to continue

Valuation gap with peers to narrow as asset quality concerns ebb

Action: Assuming coverage with INR1,650 TP– Among our top Buys

Following transfer of coverage of ICICI Bank, we rate the shares Buy with a TP of INR1,650. ICICI's ROEs, over the past 2-3 years, have improved despite a slowdown driven primarily by NIM improvement. Though margin levers look exhausted now, we see opex levers playing out in the near-term and credit cost and leverage improvements should drive core ROEs (to 16-17%) over the next 2-3 years. ICICI finally seems to be delivering on business banking/CA business (historic weakness), and while asset quality concerns will only ebb gradually, our analysis of its large corporate/SPV exposures is comforting given ICICI's low exposure to sub-segments where LGD (loss given default) could be higher.

- **ROE improvement levers:** 1) Opex levers are high as ICICI added more employees in the past 18 months vs HDFCB/Axis. 2) We expect credit costs to come off for ICICI meaningfully from FY16F. 3) Leverage improvement.
- **Asset quality** guidance on reduction in delinquency (NPA +restructuring) is comforting after a miss in FY14 – Overseas coal + a legacy gas asset are lumpy risks but otherwise its large corporate/infra risks are manageable.
- **Liabilities** more granular than the last cycle and even ROAs at 1.8% are significantly higher than the last cycle (1.2-1.3% ROAs between FY06-10).

Catalysts: (1) Reduction in incremental slippages and restructuring as guided will be positive (2) Continued traction in business banking/CA business which has been an inherent weakness for ICICI.

Valuation: Reasonable despite recent re-rating

Our INR1,650 TP is based on 2.1x Mar-16F book for the lending business and INR 272 of subsidiary valuations. As ICICI closes the ROE gap with peers as the B/S leverages up and asset quality concerns on large corporates ebb, we would expect its valuation gap to narrow vs. retail peers and current valuations at 1.75x Mar-16F book look undemanding. We prefer Axis on a relative basis.

Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	165,946		185,633		214,542		247,220
Reported net profit (mn)	98,099		107,527		127,777		147,350
Normalised net profit (mn)	98,099		107,527		127,777		147,350
FD normalised EPS	84.45		92.57		110.00		126.85
FD norm. EPS growth (%)	17.5		9.6		18.8		15.3
FD normalised P/E (x)	17.2	N/A	15.7	N/A	13.2	N/A	11.5
Price/adj. book (x)	2.3	N/A	2.1	N/A	1.9	N/A	1.7
Price/book (x)	2.3	N/A	2.1	N/A	1.9	N/A	1.7
Dividend yield (%)	1.9	N/A	2.0	N/A	2.4	N/A	2.8
ROE (%)	14.0		14.0		15.1		15.6
ROA (%)	1.7		1.7		1.8		1.8

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 1650
Closing price 3 July 2014	INR 1454
Potential upside	+13.5%

Anchor themes

B/S more granular now and ROEs are inching up to optimum levels - further re-rating likely as asset quality concerns ebb.

Nomura vs consensus

Our FY15/16F EPS growth estimates are in line with consensus, adjusted for non-core earnings.

Research analysts

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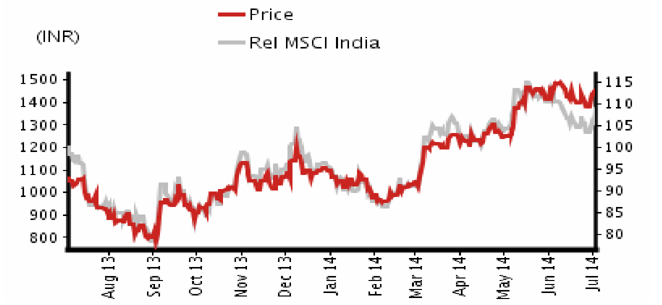
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on ICICI Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	-0.3	17.9	36.7	M cap (USDmn)	28,120.7
Absolute (USD)	-1.1	18.8	37.8	Free float (%)	90.3
Rel to MSCI India	-2.2	7.2	9.8	3-mth ADT (USDmn)	83.4

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	400,756	441,782	496,737	560,366	638,107
Interest expense	-262,092	-277,026	-313,236	-349,705	-397,303
Net interest income	138,664	164,756	183,501	210,662	240,804
Net fees and commissions	54,617	63,073	72,534	85,591	100,997
Trading related profits	4,364	7,654	7,500	8,000	8,000
Other operating revenue	24,476	33,552	35,430	39,020	43,676
Non-interest income	83,457	104,279	115,465	132,610	152,672
Operating income	222,121	269,034	298,966	343,272	393,476
Depreciation	-4,902	-5,760	-5,760	-6,220	-6,718
Amortisation					
Operating expenses	-46,294	-55,128	-62,294	-71,639	-82,384
Employee share expense	-38,933	-42,201	-45,279	-50,871	-57,153
Pre-provision op profit	131,992	165,946	185,633	214,542	247,220
Provisions for bad debt	-13,948	-22,527	-32,022	-32,003	-36,719
Other provision charges	-4,147	-3,741	0	0	0
Operating profit	113,897	139,677	153,610	182,539	210,501
Other non-op income					
Associates & JCEs					
Pre-tax profit	113,897	139,677	153,610	182,539	210,501
Income tax	-30,642	-41,578	-46,083	-54,762	-63,151
Net profit after tax	83,255	98,099	107,527	127,777	147,350
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	83,255	98,099	107,527	127,777	147,350
Extraordinary items	0	0	0	0	0
Reported NPAT	83,255	98,099	107,527	127,777	147,350
Dividends	-27,100	-31,259	-34,263	-40,716	-46,953
Transfer to reserves	56,155	66,840	73,264	87,061	100,397

Growth (%)

Net interest income	29.2	18.8	11.4	14.8	14.3
Non-interest income	11.2	24.9	10.7	14.8	15.1
Non-interest expenses	21.5	19.1	13.0	15.0	15.0
Pre-provision earnings	27.1	25.7	11.9	15.6	15.2
Net profit	28.8	17.8	9.6	18.8	15.3
Normalised EPS	28.4	17.5	9.6	18.8	15.3
Normalised FDEPS	28.4	17.5	9.6	18.8	15.3
Loan growth	14.4	16.7	15.0	17.0	18.0
Interest earning assets	15.7	14.6	15.2	16.9	18.0
Interest bearing liabilities	10.3	11.1	13.2	15.3	16.7
Asset growth	13.3	10.8	13.1	14.8	16.2
Deposit growth	14.5	13.4	14.2	16.3	18.0

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	143,752	166,349	188,416	218,847	258,010
Inter-bank lending					
Deposits with central bank					
Total securities	270,423	248,947	293,091	340,429	401,349
Other int earning assets					
Gross loans	2,976,266	3,459,105	3,978,307	4,653,002	5,489,592
Less provisions	-73,772	-72,079	-83,226	-95,758	-112,044
Net loans	2,902,494	3,387,026	3,895,080	4,557,244	5,377,548
Long-term investments	1,713,936	1,770,218	1,914,690	2,109,727	2,357,862
Fixed assets	46,471	46,781	47,092	47,403	47,714
Goodwill					
Other intangible assets					
Other non IEAs	290,871	327,094	385,095	447,293	527,337
Total assets	5,367,947	5,946,416	6,723,464	7,720,943	8,969,821
Customer deposits	2,926,136	3,319,137	3,791,616	4,409,661	5,204,997
Bank deposits, CDs,	1,377,307	1,432,481	1,572,156	1,723,441	1,891,533
Other int bearing liabilities	76,108	115,110	145,110	220,110	320,110
Total int bearing liabilities	4,379,551	4,866,728	5,508,882	6,353,212	7,416,640
Non-int bearing liabilities	321,336	347,555	409,185	475,274	560,325
Total liabilities	4,700,887	5,214,283	5,918,067	6,828,485	7,976,965
Minority interest					
Common stock	11,581	11,616	11,616	11,616	11,616
Preferred stock					
Retained earnings	655,478	720,517	793,781	880,842	981,239
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	667,060	732,133	805,397	892,458	992,856
Total liabilities and equity	5,367,947	5,946,416	6,723,464	7,720,943	8,969,821
Non-perf assets	96,078	105,058	118,895	136,797	160,062

Balance sheet ratios (%)

Loans to deposits	101.7	104.2	104.9	105.5	105.5
Equity to assets	12.4	12.3	12.0	11.6	11.1
Asset quality & capital					
NPAs/gross loans (%)	3.2	3.0	3.0	2.9	2.9
Bad debt charge/gross	0.47	0.65	0.80	0.69	0.67
Loss reserves/assets (%)	1.37	1.21	1.24	1.24	1.25
Loss reserves/NPAs (%)	76.8	68.6	70.0	70.0	70.0
Tier 1 capital ratio (%)	12.8	12.8	12.6	12.0	11.5
Total capital ratio (%)	18.7	17.7	17.0	16.0	15.0
Per share					
Reported EPS (INR)	71.89	84.45	92.57	110.00	126.85
Norm EPS (INR)	71.89	84.45	92.57	110.00	126.85
FD norm EPS (INR)	71.89	84.45	92.57	110.00	126.85
DPS (INR)	23.40	26.91	29.50	35.05	40.42
PPOP PS (INR)	113.97	142.86	159.81	184.69	212.82
BVPS (INR)	575.99	630.27	693.34	768.29	854.72
ABVPS (INR)	575.99	628.45	692.70	767.56	853.87
NTAPS (INR)	575.99	630.27	693.34	768.29	854.72

Valuations and ratios

Reported P/E (x)	20.2	17.2	15.7	13.2	11.5
Normalised P/E (x)	20.2	17.2	15.7	13.2	11.5
FD normalised P/E (x)	20.2	17.2	15.7	13.2	11.5
Dividend yield (%)	1.6	1.9	2.0	2.4	2.8
Price/book (x)	2.5	2.3	2.1	1.9	1.7
Price/adjusted book (x)	2.5	2.3	2.1	1.9	1.7
Net interest margin (%)	4.69	4.84	4.69	4.64	4.51
Yield on assets (%)	13.55	12.98	12.70	12.33	11.95
Cost of int bearing liab (%)	6.28	5.99	6.04	5.90	5.77
Net interest spread (%)	7.27	6.98	6.66	6.44	6.18
Non-interest income (%)	37.6	38.8	38.6	38.6	38.8
Cost to income (%)	40.6	38.3	37.9	37.5	37.2
Effective tax rate (%)	26.9	29.8	30.0	30.0	30.0
Dividend payout (%)	32.6	31.9	31.9	31.9	31.9
ROE (%)	13.1	14.0	14.0	15.1	15.6
ROA (%)	1.65	1.73	1.70	1.77	1.77
Operating ROE (%)	17.9	20.0	20.0	21.5	22.3
Operating ROA (%)	2.25	2.47	2.42	2.53	2.52

Source: Company data, Nomura estimates

Profitability improvement to continue

ICICI's ROAs have improved consistently over the past 3-4 years, driven largely by a ~60-70bp improvement in margins over the past four years. With domestic CASA ratios stabilising and asset mix unlikely to move up yields, we believe NIM improvement looks largely done in the near- to medium-term. But we see other levers that will aid profitability:

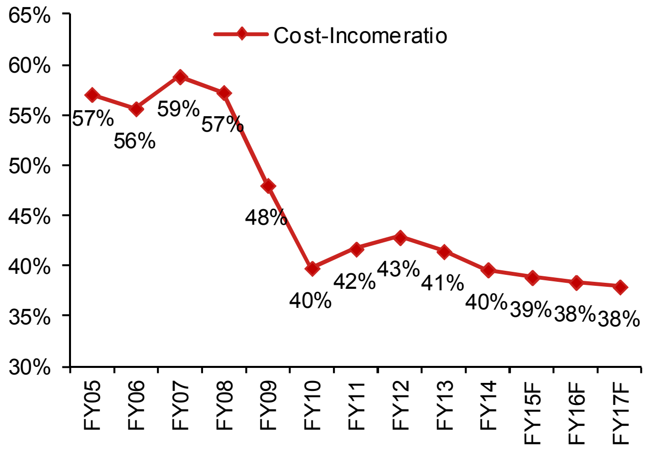
1. **Opex growth:** Most large private banks, in their austerity drive, hired fewer employees in the past 12 months. However, ICICI's net employee addition was the highest among the large private banks, and hence we believe opex growth could surprise in FY15F. We factor in ~200bp cost-income drop for ICICI over the next 2-3 years.
2. **Fee growth likely to keep pace with B/S growth now:** Core fee-to-assets has been falling for ICICI, as large corporate fees have contracted and third-party fees suffered due to regulatory changes. We see both these fee streams bottoming out and hence expect core fee growth to keep pace with B/S growth from here on.
3. **Credit costs:** Unlikely to improve in FY15F given some regulatory provisioning required, but we expect an improvement in credit costs from FY16F.
4. **Leverage:** ICICI's leverage in the lending business has been low, and with growth expected to pick-up we expect leverage to gradually improve.

Fig. 141: ROA improvement was led by NIMs in the past. Going forward, ROA improvement will be led by opex and credit costs. Improvement in leverage to aid ROEs

ROA decomposition	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F	FY09-14	FY14-17F
Net Interest Income/Assets	2.30%	2.34%	2.48%	2.57%	2.91%	3.11%	3.09%	3.12%	3.08%	0.80%	-0.02%
Fees/Assets	1.73%	1.91%	1.89%	1.82%	1.65%	1.80%	1.82%	1.84%	1.85%	0.06%	0.06%
Investment profits/Assets	0.36%	0.25%	-0.06%	-0.02%	0.10%	0.17%	0.13%	0.12%	0.10%	-0.19%	-0.07%
Net revenues/Assets	**4.40%**	**4.50%**	**4.31%**	**4.37%**	**4.66%**	**5.07%**	**5.04%**	**5.08%**	**5.04%**	**0.68%**	**-0.04%**
Operating Expense/Assets	-1.94%	-1.69%	-1.82%	-1.88%	-1.89%	-1.94%	-1.91%	-1.90%	-1.87%	0.00%	0.07%
Provisions/Assets	-1.05%	-1.27%	-0.63%	-0.38%	-0.38%	-0.50%	-0.54%	-0.47%	-0.47%	0.55%	0.03%
Taxes/Assets	-0.37%	-0.38%	-0.44%	-0.56%	-0.64%	-0.78%	-0.78%	-0.81%	-0.81%	-0.41%	-0.02%
Total Costs/Assets	**-3.36%**	**-3.34%**	**-2.90%**	**-2.82%**	**-2.92%**	**-3.22%**	**-3.23%**	**-3.19%**	**-3.15%**	**0.14%**	**0.07%**
ROA	**1.03%**	**1.16%**	**1.42%**	**1.55%**	**1.75%**	**1.85%**	**1.81%**	**1.89%**	**1.89%**	**0.82%**	**0.04%**
Equity/Assets	13.22%	14.61%	14.70%	13.84%	13.34%	13.20%	12.96%	12.56%	12.07%	-0.02%	-1.13%
ROE	**7.8%**	**8.0%**	**9.7%**	**11.2%**	**13.1%**	**14.0%**	**14.0%**	**15.1%**	**15.6%**	**6.2%**	**1.6%**
RORWA	**1.05%**	**1.24%**	**1.62%**	**1.75%**	**1.98%**	**2.09%**	**2.01%**	**2.05%**	**2.02%**	**1.03%**	**-0.07%**

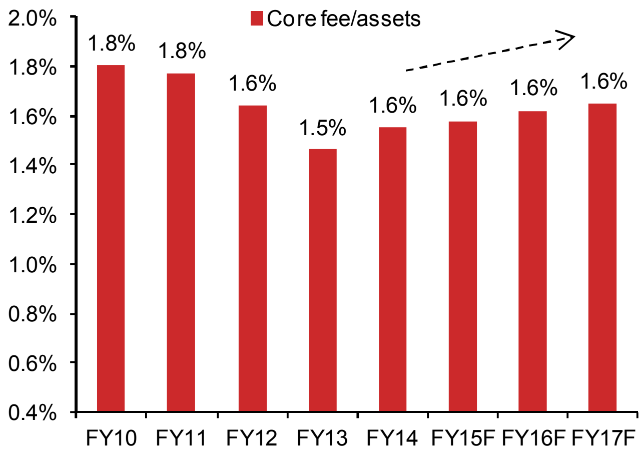
Source: Company data, Nomura estimates

Fig. 142: We expect cost-income improvement in FY14-16F



Source: Company data, Nomura estimates

Fig. 143: Core fee-to-assets will likely bottom out



Source: Company data, Nomura estimates

Good on SA always; working on CA now

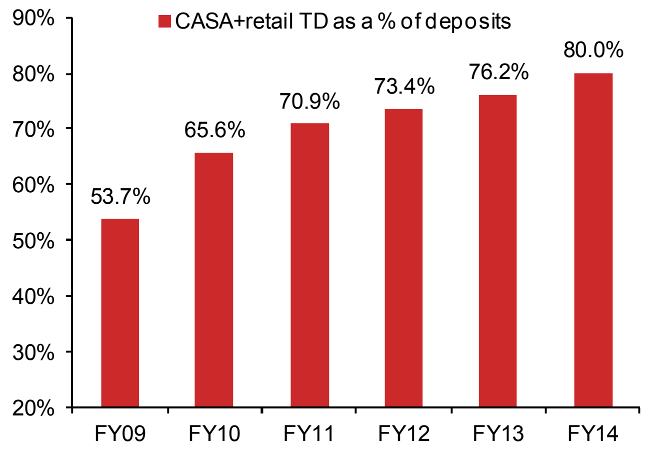
ICICI's liability franchise has seen a significant transformation from the past cycle, with CASA improving to 42-43% from 22-23% in FY07-08, and total CASA + retail term deposit ratio improving to 80% from 54% in FY09. While ICICI's SA momentum has held up well given its leadership in the salary SA segment along with HDFCB, its CA business suffered between FY10-13 given its weakness in business banking and CA mobilisation. Management has been working on business banking and CA sourcing, and FY14 current account numbers indicate some pick-up for ICICI in CA mobilisation in FY14. If the business banking and CA momentum continues, it will be a positive for ICICI as it will bridge a large gap in ICICI's business model with peers.

Fig. 144: CASA market share – ICICI has managed SA share well but has lost out on CA market share in the past 3-4 years

	CA Market share (%)			Inc. CA Share (%)		SA Market share (%)			Inc. SA Share (%)	
	2003	2008	2013	2003-08	2008-13	2003	2008	2013	2003-08	2008-13
SBI	27.7%	22.0%	19.3%	18.6%	15.3%	24.8%	22.6%	25.1%	21.2%	27.2%
Axis	2.04%	6.01%	7.23%	8.29%	9.29%	0.54%	2.94%	3.86%	4.46%	4.55%
HDFCB	4.16%	8.77%	9.12%	11.24%	9.40%	1.77%	3.85%	5.34%	5.17%	6.45%
ICICI	3.10%	7.53%	6.44%	9.92%	4.88%	1.44%	5.75%	5.18%	8.49%	4.84%
BOB	3.9%	2.8%	3.6%	2.1%	5.0%	6.1%	5.1%	5.0%	4.5%	4.9%
PNB	8.3%	5.4%	5.2%	3.7%	4.8%	9.7%	7.9%	7.5%	6.8%	7.2%

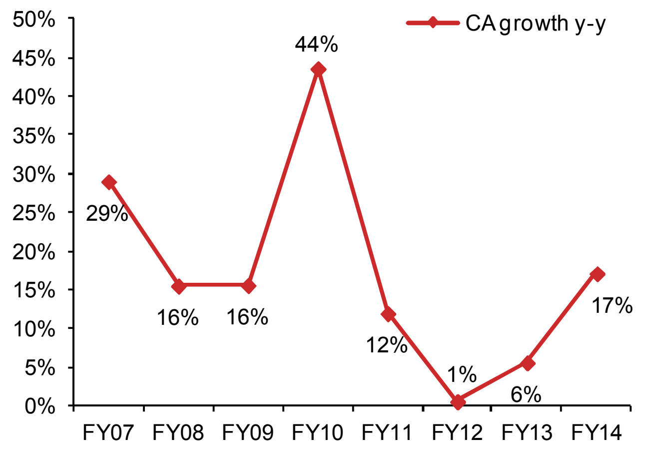
Source: RBI, Nomura estimates

Fig. 145: Overall CASA and retail TD trend is very positive



Source: Company data, Nomura research

Fig. 146: CA growth has been weak but there has been some pick-up in FY14

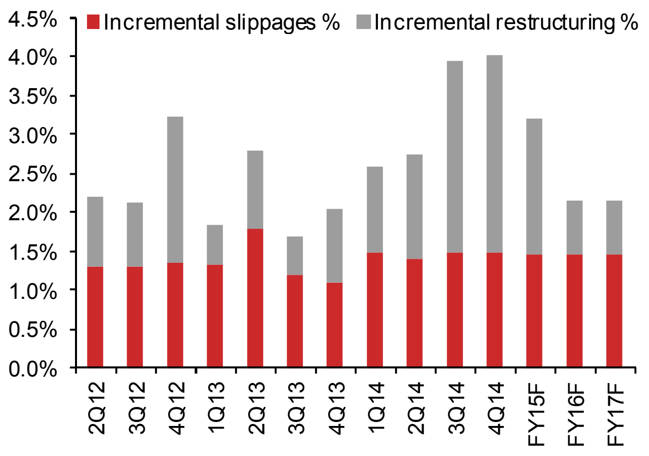


Source: Company data, Nomura research

Asset quality guidance indicates that the worst is behind

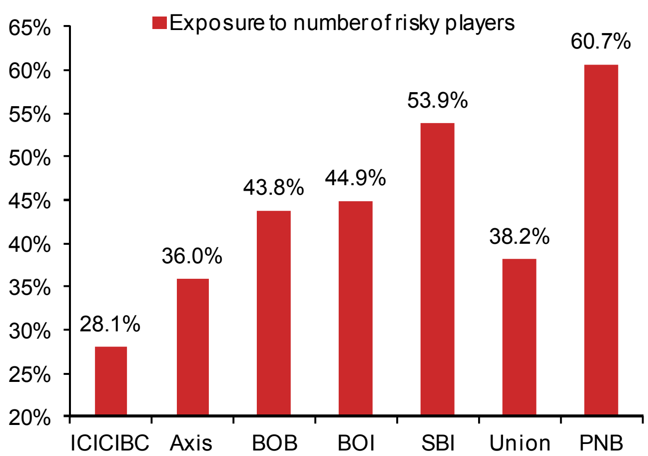
ICICI Bank's incremental stress accretion inched up in FY14, with some large restructuring cases in 2HFY14. With most of these accounts recognised, management believes that incremental stress accretion for ICICI will be lower in FY15F vs. FY14 which is a positive. There are some lumpy asset quality risks in a legacy gas asset and two international coal assets that ICICI has funded, but apart from that our analysis of INR4tn of risky large corporate/infra SPV exposures indicates that ICICI's risk is manageable with low exposure to sub-sectors that could have high LGDs (loss given default).

Fig. 147: ICICI's incremental stress accretion will be lower from here on



Source: Company data, Nomura estimates

Fig. 148: ICICI's risk lower to the INR4tn of risky large corporate/infra SPVs we looked at



Source: Ministry of corporate affairs, Media sources, Nomura estimates

Valuation: Reasonable despite recent re-rating

Our TP of INR1650 is based on 2.1x Mar-16F book for the lending business and INR272 of subsidiary valuations. As ICICI closes the ROE gap with peers as the B/S leverages up and asset quality concerns on large corporates ebb, we would expect its valuation gap to narrow vs. retail peers and current valuations at 1.75x Mar-16F book look undemanding.

We prefer Axis Bank (Buy) on a relative basis vs. ICICI for its better delivery on CASA over the past 4-5 years, better capital efficiency and relatively same asset quality risk as ICICI vs. consensus perception of higher risk. ICICI's recent underperformance vs. Axis though (~30% in past six months) has closed down Axis's discount to ICICI though.

Risks: 1) Some lumpy asset quality risks – legacy gas assets and overseas coal assets funded by ICICI; and 2) slower-than-expected turnaround of GDP growth.

Fig. 149: Standalone and consolidated ROEs continue to inch up

Standalone Business (INRmn)	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
PAT	**40,248**	**51,514**	**64,653**	**83,255**	**98,099**	**107,527**	**127,777**	**147,350**
Adjusted PAT for Dividends	**37,184**	**48,103**	**58,544**	**75,685**	**87,344**	**95,696**	**115,354**	**134,058**
Adjusted Assets	3,506,423	3,931,513	4,604,810	5,239,989	5,821,380	6,598,429	7,595,908	8,844,785
Adjusted Equity	387,952	420,086	472,391	539,101	607,098	680,361	767,422	867,820
Reported ROA (%)	**1.15%**	**1.39%**	**1.51%**	**1.69%**	**1.77%**	**1.73%**	**1.80%**	**1.79%**
Adjusted ROA (%)	***1.06%***	***1.29%***	***1.37%***	***1.54%***	***1.58%***	***1.54%***	***1.63%***	***1.63%***
Adjusted ROE (%)	***9.8%***	***11.9%***	***13.1%***	***15.0%***	***15.2%***	***14.9%***	***15.9%***	***16.4%***
Subsidiaries:								
Subsidiary profit	10,489	13,847	15,612	21,636	25,536	27,267	29,053	30,727
Subsidiary Equity	125,013	132,939	140,374	148,523	157,202	170,216	184,302	199,015
Adjusted ROE (%)	***9.2%***	***10.7%***	***11.4%***	***15.0%***	***16.7%***	***16.7%***	***16.4%***	***16.0%***
Reported Numbers:								
Standalone ROAs	1.15%	1.39%	1.51%	1.69%	1.77%	1.73%	1.80%	1.79%
Standalone ROEs	8.0%	9.7%	11.2%	13.1%	14.0%	14.0%	15.1%	15.6%
Consolidated ROEs	***9.5%***	***11.4%***	***13.1%***	***14.8%***	***15.2%***	***14.9%***	***15.7%***	***16.0%***

Source: Company data, Nomura estimates

Fig. 150: PT of INR1,650

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.15
Cost of Equity	14.9%
Terminal growth	5.0%
Stage 2 growth	25.0%
Normalised ROE	19.1%
Lending business value (Mar-14)	1378
Mar-15 PT	**1650**
Implied Mar-16 P/E	**13.9**
Implied Mar-16 P/B	**2.09**
Susbdiary valuation	272

Source: Nomura estimates

Fig. 151: Valuations still reasonable considering improvement in ROEs

Source: Company data, Bloomberg, Nomura estimates

Fig. 152: Subsidiary valuation table

	Valuation basis	Value of sub - [A] (INRmn)	ICICIBC's share [B]	ICICI share (INRmn)	Per share of parent
Life Insurance	Appraisal value	242,667	74%	179,574	161
Asset Management	4% of AUM	56,497	51%	28,814	26
ICICI Securities	PE of 12x Mar-16	15,698	100%	15,698	14
ICICI Home Finance	PE of 8x Mar-16	17,840	100%	17,840	16
General Insurance	5x Mar-16 PAT	33,790	74%	25,005	22
Foreign subsidiaries	0.75x Mar-16 book	89,180	100%	89,180	80
Total Subsidiary value				**356,109**	**319**
Value post holding discount (15%)				**302,693**	**272**

Source: Nomura estimates

NOMURA

Indusind Bank INBK.NS IIB IN

EQUITY: BANKS

Recovery play but valuations not undemanding

Delivering well on most counts but CV recovery to some extent priced in

Action: Resume coverage with Buy rating and TP of INR630

IndusInd Bank has delivered well on most targets set on profitability in the past five years under the new management and navigated the recent volatility in the asset quality/rate cycle well. While IIB is well leveraged to an upcycle (CV improvement + growth tick-up) and our earnings growth expectation is one of the highest (23% CAGR over FY14-17F) on the Street for IIB, we believe current valuations are factoring in some of the positives. We prefer HDFCB on a relative basis.

- **What we like in IIB: (1)** a niche CV financing NBFC-like business housed within a bank which leads to better margins; **(2)** strong build-up on CASA both on CA and SA businesses; and **(3)** good niches built for fees like debt IB and retail that have led to one of the highest fee/assets for IIB.
- **What needs to improve for us to become more positive: (1)** recent growth in the mid-corporate book has been high and higher RWA/loans in FY14 vs. FY13 indicate some increase in risk-taking – building up risk in an upcycle may not materialise in higher credit costs but investors should consider valuations accordingly; **(2)** while the deposit franchise has improved significantly for CASA, IIB's term deposits are still ~50% funded through wholesale deposits which expose the bank to liquidity squeeze.

Catalysts: Steady trends in corporate asset quality and improvement in CVs will be positive catalysts.

Valuations: Not undemanding

Our TP of INR630 implies ~2.8x Mar-16F book. While profitability and profit growth for IIB are best in class, IIB's earnings will be a little more cyclical than HDFCB/Kotak given its liability and asset mix and high loan growth, in our view. Our TP of INR630 implies a 25% discount to HDFCB's P/B multiple, which we believe is fair.

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	25,960		30,191		36,551		45,191
Reported net profit (mn)	14,080		16,807		20,884		25,946
Normalised net profit (mn)	14,080		16,807		20,884		25,946
FD normalised EPS	26.79		31.97		39.73		49.36
FD norm. EPS growth (%)	32.0		19.4		24.3		24.2
FD normalised P/E (x)	21.4	N/A	17.9	N/A	14.4	N/A	11.6
Price/adj. book (x)	3.5	N/A	3.0	N/A	2.5	N/A	2.1
Price/book (x)	3.5	N/A	3.0	N/A	2.5	N/A	2.1
Dividend yield (%)	0.7	N/A	0.9	N/A	1.1	N/A	1.3
ROE (%)	17.6		18.0		19.1		20.1
ROA (%)	1.8		1.7		1.8		1.8

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 630
Closing price 3 July 2014	INR 573
Potential upside	+9.9%

Anchor themes

A good recovery play but largely in the price.

Nomura vs consensus

Our FY15/16F earnings estimates are marginally below consensus due to some moderation in fees that we expect.

Research analysts

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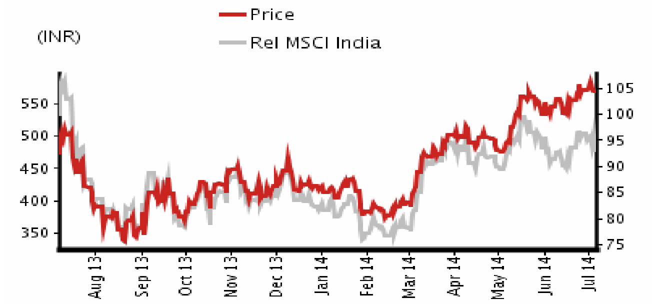
Key data on Indusind Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	5.9	15.7	22.7	M cap (USDmn)	5,045.2
Absolute (USD)	5.0	16.6	23.7	Free float (%)	90.3
Rel to MSCI India	1.3	2.1	-7.5	3-mth ADT (USDmn)	14.3

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	69,832	82,535	98,893	119,479	145,720
Interest expense	-47,504	-53,628	-64,145	-77,597	-94,275
Net interest income	22,329	28,907	34,749	41,881	51,445
Net fees and commissions	9,470	11,706	14,164	17,139	20,738
Trading related profits	644	518	700	800	900
Other operating revenue	3,515	6,681	7,096	8,586	10,389
Non-interest income	13,630	18,905	21,960	26,525	32,027
Operating income	35,958	47,812	56,709	68,406	83,472
Depreciation	-734	-981	-1,080	-1,296	-1,555
Amortisation	0	0	0	0	0
Operating expenses	-10,215	-12,778	-15,334	-18,708	-22,823
Employee share expense	-6,615	-8,093	-10,104	-11,852	-13,902
Pre-provision op profit	18,395	25,960	30,191	36,551	45,191
Provisions for bad debt	-2,551	-3,785	-4,841	-5,052	-6,057
Other provision charges	-80	-891	0	0	0
Operating profit	15,764	21,283	25,350	31,499	39,134
Other non-op income					
Associates & JCEs					
Pre-tax profit	15,764	21,283	25,350	31,499	39,134
Income tax	-5,152	-7,203	-8,543	-10,615	-13,188
Net profit after tax	10,612	14,080	16,807	20,884	25,946
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	10,612	14,080	16,807	20,884	25,946
Extraordinary items	0	0	0	0	0
Reported NPAT	10,612	14,080	16,807	20,884	25,946
Dividends	-1,835	-2,152	-2,569	-3,193	-3,966
Transfer to reserves	8,777	11,928	14,238	17,691	21,979

Growth (%)

	FY13	FY14	FY15F	FY16F	FY17F
Net interest income	31.0	29.5	20.2	20.5	22.8
Non-interest income	34.7	38.7	16.2	20.8	20.7
Non-interest expenses	30.5	25.1	20.0	22.0	22.0
Pre-provision earnings	34.0	41.1	16.3	21.1	23.6
Net profit	32.2	32.7	19.4	24.3	24.2
Normalised EPS	18.3	32.0	19.4	24.3	24.2
Normalised FDEPS	18.3	32.0	19.4	24.3	24.2
Loan growth	26.4	24.3	22.0	24.0	25.0
Interest earning assets	27.1	19.9	22.1	24.0	25.0
Interest bearing liabilities	24.5	18.4	23.1	23.5	24.6
Asset growth	27.4	18.5	22.4	22.9	24.1
Deposit growth	27.7	11.8	24.9	25.3	26.5

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	28,530	39,172	48,646	60,514	75,896
Inter-bank lending					
Deposits with central bank					
Total securities	39,957	28,523	35,421	44,063	55,264
Other int earning assets					
Gross loans	446,416	555,386	679,415	843,827	1,056,161
Less provisions	-3,210	-4,367	-7,155	-10,223	-14,155
Net loans	443,206	551,018	672,260	833,604	1,042,006
Long-term investments	196,542	215,630	265,462	318,468	387,148
Fixed assets	5,435	6,192	6,949	7,706	8,463
Goodwill					
Other intangible assets					
Other non IEAs	17,267	25,751	31,979	39,781	49,892
Total assets	730,936	866,285	1,060,717	1,304,136	1,618,669
Customer deposits	541,167	605,023	755,584	946,616	1,197,797
Bank deposits, CDs,	62,677	88,767	103,821	122,276	144,967
Other int bearing liabilities	32,012	58,947	66,947	74,947	82,947
Total int bearing liabilities	635,857	752,736	926,352	1,143,838	1,425,711
Non-int bearing liabilities	21,011	27,201	33,780	42,022	52,703
Total liabilities	656,868	779,938	960,133	1,185,860	1,478,414
Minority interest					
Common stock	5,229	5,256	5,256	5,256	5,256
Preferred stock					
Retained earnings	68,840	81,090	95,328	113,019	134,999
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	74,069	86,347	100,585	118,276	140,255
Total liabilities and equity	730,936	866,284	1,060,717	1,304,136	1,618,669
Non-perf assets	4,578	6,208	9,540	13,277	17,918

Balance sheet ratios (%)

	FY13	FY14	FY15F	FY16F	FY17F
Loans to deposits	82.5	91.8	89.9	89.1	88.2
Equity to assets	10.1	10.0	9.5	9.1	8.7
Asset quality & capital					
NPAs/gross loans (%)	1.0	1.1	1.4	1.6	1.7
Bad debt charge/gross	0.57	0.68	0.71	0.60	0.57
Loss reserves/assets (%)	0.44	0.50	0.67	0.78	0.87
Loss reserves/NPAs (%)	70.1	70.4	75.0	77.0	79.0
Tier 1 capital ratio (%)	13.8	12.7	12.2	11.5	11.0
Total capital ratio (%)	15.4	14.0	13.8	13.3	12.8
Per share					
Reported EPS (INR)	20.30	26.79	31.97	39.73	49.36
Norm EPS (INR)	20.30	26.79	31.97	39.73	49.36
FD norm EPS (INR)	20.30	26.79	31.97	39.73	49.36
DPS (INR)	3.51	4.10	4.89	6.07	7.55
PPOP PS (INR)	35.18	49.39	57.44	69.54	85.97
BVPS (INR)	141.66	164.27	191.36	225.01	266.83
ABVPS (INR)	141.67	164.31	192.26	226.78	269.90
NTAPS (INR)	141.66	164.27	191.36	225.01	266.83

Valuations and ratios

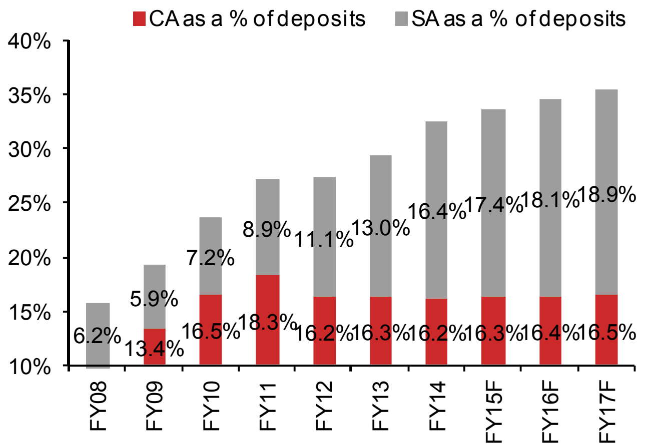
	FY13	FY14	FY15F	FY16F	FY17F
Reported P/E (x)	28.2	21.4	17.9	14.4	11.6
Normalised P/E (x)	28.2	21.4	17.9	14.4	11.6
FD normalised P/E (x)	28.2	21.4	17.9	14.4	11.6
Dividend yield (%)	0.6	0.7	0.9	1.1	1.3
Price/book (x)	4.0	3.5	3.0	2.5	2.1
Price/adjusted book (x)	4.0	3.5	3.0	2.5	2.1
Net interest margin (%)	5.17	5.44	5.40	5.28	5.21
Yield on assets (%)	16.18	15.53	15.37	15.07	14.76
Cost of int bearing liab (%)	8.29	7.72	7.64	7.50	7.34
Net interest spread (%)	7.89	7.81	7.72	7.58	7.42
Non-interest income (%)	37.9	39.5	38.7	38.8	38.4
Cost to income (%)	48.8	45.7	46.8	46.6	45.9
Effective tax rate (%)	32.7	33.8	33.7	33.7	33.7
Dividend payout (%)	17.3	15.3	15.3	15.3	15.3
ROE (%)	17.8	17.6	18.0	19.1	20.1
ROA (%)	1.63	1.76	1.74	1.77	1.78
Operating ROE (%)	26.5	26.5	27.1	28.8	30.3
Operating ROA (%)	2.42	2.67	2.63	2.66	2.68

Source: Company data, Nomura estimates

IIB has delivered well on most fundamental metrics under new management
IndusInd Bank has been the most improved bank in the past five years in India since the time the new management under Mr. Sobti took over. While IIB had a niche CV financing arm working within the bank, the new management has delivered extremely well on getting the liability franchise in place with CASA moving up from <20% to ~33% currently and improving fee/assets from ~1.1-1.2% of assets (in line with regional private banks) to +2% currently (which is best in class among private banks). This momentum has largely led the transition in profitability from <50bp of ROAs to ~1.8% of ROAs currently.

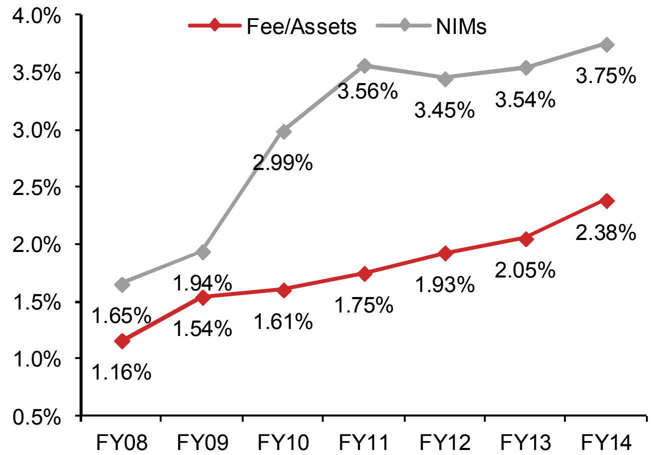
Our expectation is that there could be some moderation in fees/asset for IIB over the medium term as current yields in its debt IB business are too high to sustain but cost-income will likely moderate and IIB will be able to maintain its profitability. As we expect loan growth to remain higher than peers, we believe EPS growth for IIB in the next two-three years could be one of the highest in our coverage universe.

Fig. 153: CASA momentum has been strong in the past 4-5 years and we expect the robust performance to continue



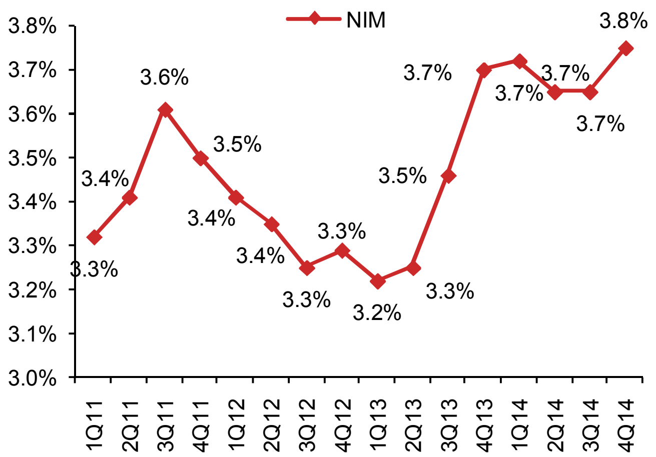
Source: Company data, Nomura estimates

Fig. 154: NIMs and fees to assets have driven large part of the ROA improvement under the new management



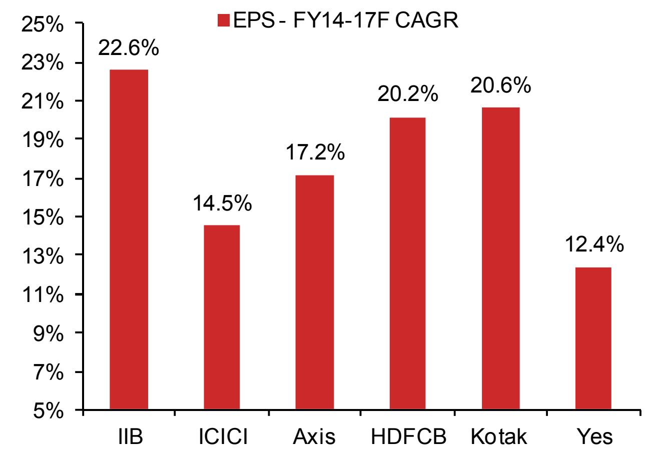
Source: Company data, Nomura research

Fig. 155: Stable trends in margins in FY14 in spite of the volatile funding environment



Source: Company data, Nomura research

Fig. 156: We expect EPS growth to be among the highest for IIB in our coverage universe

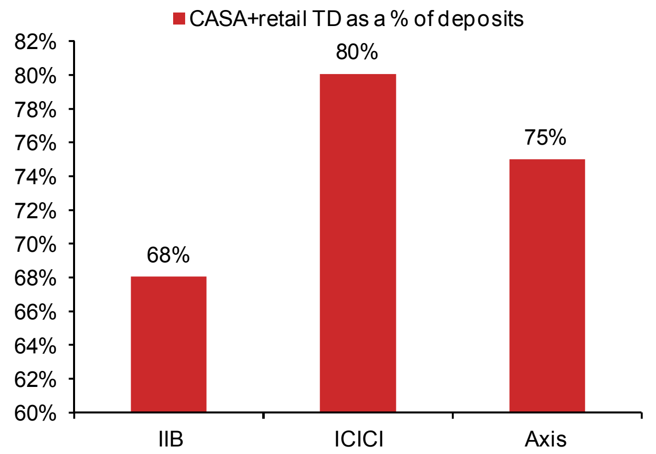


Source: Company data, Nomura estimates

What needs to change for us to be more positive?

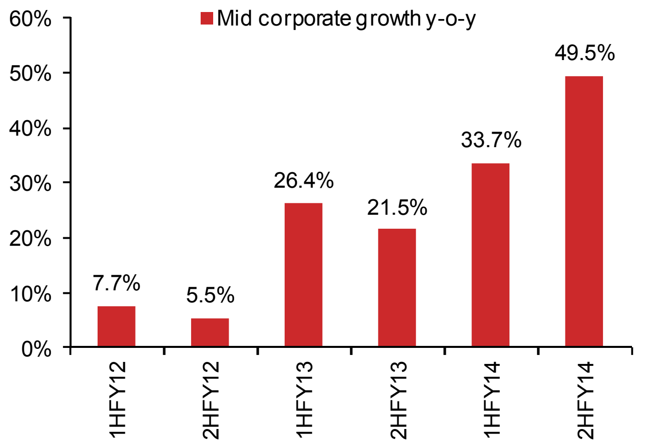
1. **Valuations:** As we have mentioned above, some of the positives seem to be factored in the price and current valuations at ~2.55x Mar-15F book (BVPS: INR225) look relatively fair to us. So, if valuations correct by >10%, then the risk-reward will get incrementally attractive, in our view.
2. **Large share of retail term deposits:** While the CASA franchise for IIB has improved significantly and has exceeded expectations, IIB's term deposit book is still ~50% funded by wholesale deposits and that exposes IIB to liquidity squeeze (like in July-13) – While IIB exhibited significant flexibility in raising funding through IBPC and overseas funding during July to Sep-13, we believe longer term risks remain. If IIB is able to build on its retail term deposit franchise, it will ensure lower margin volatility, we believe.
3. **How risks play out in IIB's corporate book**: IIB's mid-corporate loan growth of 50% y/y in FY14F was high and segmental exposure analysis suggests that IIB did take some exposure to sensitive segments with RWA/loans increasing. While management is comfortable with the names it has underwritten and risks may not play out in an upcycle, how eventually the corporate book asset quality plays out will also be key to watch out for.

Fig. 157: While CASA has inched up, overall liability franchise still much weaker than the big boys



Source: Company data, Nomura research

Fig. 158: Some risk build-up in the corporate book in 2HFY14



Source: Company data, Nomura research

Valuations: Not enticing enough

Our TP of INR630 implies ~2.8x Mar-16F book (BVPS: INR225). While profitability and profit growth for IIB are best in class, IIB's earnings will be a little more cyclical than HDFCB/Kotak given its liability/asset mix and high loan growth, in our view. Our TP implies 25%/10% discounts to the P/B multiple of HDFCB/Kotak which we believe is fair. If some of the expected improvements materialise over time, then we believe that the discount to some of the defensive peers may come off.

Risks: slower-than-expected recovery in the CV cycle and higher-than-expected credit costs.

Fig. 159: ROAs and ROEs have improved significantly over the past 5 years - We expect it to remain stable from here on

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	1.65%	1.94%	2.99%	3.56%	3.45%	3.54%	3.75%	3.74%	3.68%	3.65%
Fees/Assets	1.16%	1.54%	1.61%	1.75%	1.93%	2.05%	2.38%	2.29%	2.26%	2.21%
Investment profits/Assets	0.09%	0.38%	0.26%	0.10%	0.12%	0.11%	0.07%	0.08%	0.07%	0.06%
Net revenues/Assets	**2.91%**	**3.86%**	**4.85%**	**5.41%**	**5.49%**	**5.71%**	**6.20%**	**6.11%**	**6.00%**	**5.93%**
Operating Expense/Assets	-1.95%	-2.31%	-2.48%	-2.61%	-2.72%	-2.79%	-2.83%	-2.86%	-2.80%	-2.72%
Provisions/Assets	-0.40%	-0.59%	-0.58%	-0.52%	-0.36%	-0.42%	-0.61%	-0.52%	-0.44%	-0.43%
Taxes/Assets	-0.19%	-0.33%	-0.62%	-0.78%	-0.79%	-0.82%	-0.93%	-0.92%	-0.93%	-0.94%
Total Costs/Assets	**-2.54%**	**-3.24%**	**-3.67%**	**-3.91%**	**-3.87%**	**-4.02%**	**-4.37%**	**-4.30%**	**-4.17%**	**-4.08%**
ROA	**0.36%**	**0.63%**	**1.18%**	**1.49%**	**1.62%**	**1.68%**	**1.83%**	**1.81%**	**1.83%**	**1.84%**
Equity/Assets	5.26%	5.36%	6.06%	7.75%	8.43%	9.46%	10.40%	10.07%	9.61%	9.18%
ROE	**6.9%**	**11.7%**	**19.5%**	**19.3%**	**19.3%**	**17.8%**	**17.6%**	**18.0%**	**19.1%**	**20.1%**
RORWA	**0.48%**	**0.84%**	**1.72%**	**2.18%**	**2.30%**	**2.29%**	**2.34%**	**2.25%**	**2.27%**	**2.27%**

Source: Company data, Nomura estimates

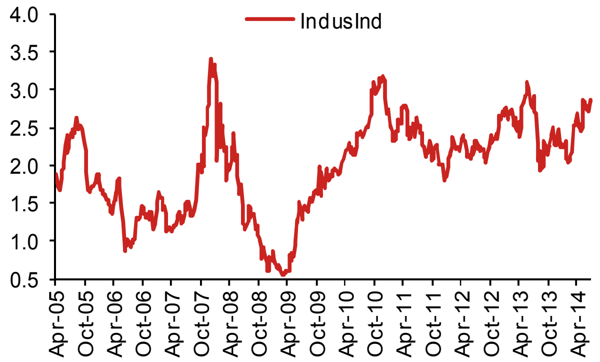
Fig. 160: TP of INR630

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.20
Cost of Equity	15.2%
Terminal growth	5.0%
Stage 2 growth	28.0%
Normalised ROE	21.6%
Mar-15 PT	630
Implied Mar-16 P/B	2.80
Implied Mar-16 P/E	15.9

Source: Company data, Nomura estimates

Fig. 161: Valuations at near highs

1-year fwd P/B chart



Source: Company data, Nomura estimates

NOMURA

Kotak Mahindra Bank KTKM.NS KMB IN

EQUITY: BANKS

Not much to complain except for valuations

Management comfort high but valuation comfort low

Global Markets Research

8 July 2014

Rating Starts at	**Neutral**
Target price Starts at	INR 920
Closing price 3 July 2014	INR 891
Potential upside	+3.2%

Action: Positioned well for an upcycle in spite of low credit costs

We initiate coverage of Kotak Bank with a Neutral rating and TP of INR920. While we like Kotak's low risk business model, valuations look expensive.

Kotak Bank has been able to consistently deliver profitable and low risk growth even in the past 3-4 years and its profitability remains second just to HDFCB with RORWAs of 2.3%. While credit costs at ~40bps in the past 3 years (FY11-14) do not leave any scope for any significant asset quality upside in an upturn, but we think Kotak Bank is still well positioned for an upcycle because:

- Capital levels of ~18% tier-1 are the highest -- with an improving macro, management will likely push on the growth peddle over the next 2-3 years and historic evidence of ramping up growth in an upcycle is strong -- the only challenge will be getting back corporate relationships which Kotak will have let go off in stressed times, in our view.
- As mentioned above, asset quality-linked upside is limited but Kotak has been acquiring stressed assets which management expects to yield ~INR8-10bn of gains in the next 3 years -- we factor in ~INR3-4bn of gains.
- Kotak has retained its leadership in most capital market businesses and with improvement in market sentiment/volumes, we expect profits of Kotak's flow business to grow ~2x in the next three years.

Catalysts: Continued delivery on CASA/fees/business banking + pick-up in retail credit growth

Valuations: Expensive, but can remain so

Our TP of INR920 for Kotak implies ~3x Mar-16F book for its lending business (bank + NBFC) after factoring in INR140 for its flow business. Its current valuations are just at ~10% discount to HDFCB on P/B (for ~500bps lower ROEs) and ~20% premium to HDFCB on P/E. We, thus, prefer HDFCB.

Anchor themes

Kotak can kickstart growth quickly as it did in the previous cycle. Also, our comfort with Kotak's underwriting remains high.

Nomura vs consensus

Our earnings estimates are not comparable due to a mix of standalone and consolidated reporting by consensus.

Research analysts

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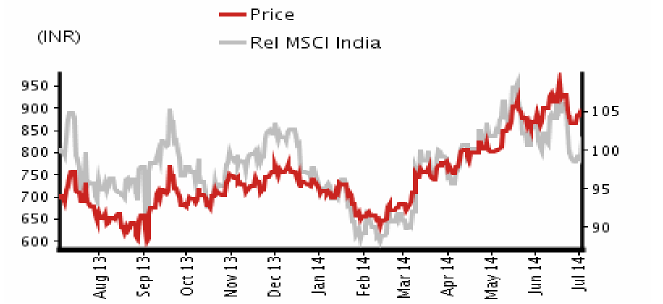
Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	25,772		29,000		34,942		44,309
Reported net profit (mn)	15,025		17,326		20,672		26,401
Normalised net profit (mn)	15,025		17,326		20,672		26,401
FD normalised EPS	19.51		22.49		26.84		34.27
FD norm. EPS growth (%)	7.0		15.3		19.3		27.7
FD normalised P/E (x)	45.7	N/A	39.6	N/A	33.2	N/A	26.0
Price/adj. book (x)	5.8	N/A	5.1	N/A	4.5	N/A	3.9
Price/book (x)	5.6	N/A	4.9	N/A	4.3	N/A	3.7
Dividend yield (%)	0.1	N/A	0.1	N/A	0.2	N/A	0.2
ROE (%)	13.8		13.2		13.9		15.4
ROA (%)	1.8		1.8		1.8		1.8

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Key data on Kotak Mahindra Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	2.1	17.3	27.5	M cap (USDmn)	11,488.0
Absolute (USD)	1.2	18.2	28.6	Free float (%)	90.3
Rel to MSCI India	-2.5	3.8	-2.7	3-mth ADT (USDmn)	19.2

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	80,425	87,671	96,909	115,178	140,620
Interest expense	-48,368	-50,471	-55,210	-65,973	-79,911
Net interest income	32,057	37,200	41,700	49,205	60,709
Net fees and commissions	7,964	9,337	10,644	13,199	16,367
Trading related profits	1,546	1,818	700	800	800
Other operating revenue	2,097	2,842	4,736	5,541	6,415
Non-interest income	11,607	13,997	16,081	19,540	23,581
Operating income	43,663	51,198	57,780	68,745	84,290
Depreciation	-1,325	-1,652	-1,793	-2,009	-2,525
Amortisation					
Operating expenses	-10,021	-12,053	-14,222	-16,782	-19,803
Employee share expense	-10,751	-11,722	-12,765	-15,011	-17,653
Pre-provision op profit	21,566	25,772	29,000	34,942	44,309
Provisions for bad debt	-2,044	-1,473	-2,797	-3,678	-4,380
Other provision charges	199	-1,575	0	0	0
Operating profit	19,721	22,725	26,204	31,265	39,929
Other non-op income					
Associates & JCEs					
Pre-tax profit	19,721	22,725	26,204	31,265	39,929
Income tax	-6,113	-7,699	-8,878	-10,593	-13,528
Net profit after tax	13,607	15,025	17,326	20,672	26,401
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	13,607	15,025	17,326	20,672	26,401
Extraordinary items	0	0	0	0	0
Reported NPAT	13,607	15,025	17,326	20,672	26,401
Dividends	-611	-705	-1,014	-1,209	-1,544
Transfer to reserves	12,996	14,320	16,312	19,463	24,856

Growth (%)

Net interest income	27.6	16.0	12.1	18.0	23.4
Non-interest income	18.8	20.6	14.9	21.5	20.7
Non-interest expenses	18.5	20.3	18.0	18.0	18.0
Pre-provision earnings	30.3	19.5	12.5	20.5	26.8
Net profit	25.4	10.4	15.3	19.3	27.7
Normalised EPS	24.4	7.0	15.3	19.3	27.7
Normalised FDEPS	24.4	7.0	15.3	19.3	27.7
Loan growth	24.0	9.4	18.0	23.0	25.0
Interest earning assets	21.4	12.4	16.9	23.1	25.1
Interest bearing liabilities	29.6	0.7	22.6	24.3	25.9
Asset growth	27.5	4.6	20.4	22.9	24.6
Deposit growth	32.4	15.8	21.3	24.5	27.2

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	18,776	25,121	42,742	53,359	67,435
Inter-bank lending					
Deposits with central bank					
Total securities	18,116	34,678	34,454	43,012	54,358
Other int earning assets					
Gross loans	489,157	535,135	632,095	778,158	973,272
Less provisions	-4,467	-4,859	-6,369	-8,515	-11,218
Net loans	484,690	530,276	625,726	769,643	962,054
Long-term investments	288,734	254,845	311,119	379,813	471,036
Fixed assets	4,644	11,069	17,495	23,920	30,345
Goodwill					
Other intangible assets					
Other non IEAs	21,977	19,863	22,843	26,269	30,210
Total assets	836,937	875,853	1,054,378	1,296,016	1,615,437
Customer deposits	510,288	590,723	716,557	891,910	1,134,407
Bank deposits, CDs,	166,086	92,868	99,548	108,143	119,303
Other int bearing liabilities	38,020	36,088	66,088	96,088	126,088
Total int bearing liabilities	714,394	719,679	882,193	1,096,141	1,379,798
Non-int bearing liabilities	27,898	33,338	33,123	41,350	52,258
Total liabilities	742,292	753,017	915,315	1,137,491	1,432,056
Minority interest					
Common stock	3,733	3,852	3,852	3,852	3,852
Preferred stock					
Retained earnings	90,912	118,985	135,211	154,674	179,530
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	94,645	122,836	139,063	158,525	183,382
Total liabilities and equity	836,937	875,853	1,054,378	1,296,016	1,615,437
Non-perf assets	7,580	10,594	13,269	17,378	22,436

Balance sheet ratios (%)

Loans to deposits	95.9	90.6	88.2	87.2	85.8
Equity to assets	11.3	14.0	13.2	12.2	11.4
Asset quality & capital					
NPAs/gross loans (%)	1.5	2.0	2.1	2.2	2.3
Bad debt charge/gross	0.42	0.28	0.44	0.47	0.45
Loss reserves/assets (%)	0.53	0.55	0.60	0.66	0.69
Loss reserves/NPAs (%)	58.9	45.9	48.0	49.0	50.0
Tier 1 capital ratio (%)	14.7	17.8	17.1	16.0	14.8
Total capital ratio (%)	16.0	18.8	18.0	16.7	15.4
Per share					
Reported EPS (INR)	18.23	19.51	22.49	26.84	34.27
Norm EPS (INR)	18.23	19.51	22.49	26.84	34.27
FD norm EPS (INR)	18.23	19.51	22.49	26.84	34.27
DPS (INR)	0.82	0.92	1.32	1.57	2.00
PPOP PS (INR)	28.89	33.46	37.65	45.36	57.52
BVPS (INR)	126.77	159.46	180.53	205.79	238.06
ABVPS (INR)	124.12	154.08	174.15	197.67	227.87
NTAPS (INR)	126.77	159.46	180.53	205.79	238.06

Valuations and ratios

Reported P/E (x)	48.9	45.7	39.6	33.2	26.0
Normalised P/E (x)	48.9	45.7	39.6	33.2	26.0
FD normalised P/E (x)	48.9	45.7	39.6	33.2	26.0
Dividend yield (%)	0.1	0.1	0.1	0.2	0.2
Price/book (x)	7.0	5.6	4.9	4.3	3.7
Price/adjusted book (x)	7.2	5.8	5.1	4.5	3.9
Net interest margin (%)	6.99	6.97	6.81	6.68	6.64
Yield on assets (%)	17.54	16.42	15.82	15.64	15.38
Cost of int bearing liab (%)	7.64	7.04	6.89	6.67	6.45
Net interest spread (%)	9.90	9.38	8.93	8.97	8.92
Non-interest income (%)	26.6	27.3	27.8	28.4	28.0
Cost to income (%)	50.6	49.7	49.8	49.2	47.4
Effective tax rate (%)	31.0	33.9	33.9	33.9	33.9
Dividend payout (%)	4.5	4.7	5.9	5.9	5.9
ROE (%)	15.6	13.8	13.2	13.9	15.4
ROA (%)	1.82	1.75	1.80	1.76	1.81
Operating ROE (%)	22.7	20.9	20.0	21.0	23.4
Operating ROA (%)	2.64	2.65	2.72	2.66	2.74

Source: Company data, Nomura estimates

Fig. 162: Kotak consolidated financials

Kotak Bank

Kotak Bank Standalone	FY12	FY13	FY14	FY15F	FY16F	FY17F
Income Statement						
Net Interest Income	**25,125**	**32,057**	**37,200**	**41,700**	**49,205**	**60,709**
Fees	8,952	10,049	12,167	15,381	18,740	22,781
Net revenues	**34,077**	**42,106**	**49,368**	**57,080**	**67,945**	**83,490**
Operating Expense	18,348	22,097	25,426	28,780	33,802	39,981
Operating profit	**15,728**	**20,009**	**23,942**	**28,300**	**34,142**	**43,509**
Investment profits	822	1,557	1,830	700	800	800
Preprovision profit	**16,550**	**21,566**	**25,772**	**29,000**	**34,942**	**44,309**
Provisions	551	1,846	3,047	2,797	3,678	4,380
PBT	**15,999**	**19,721**	**22,725**	**26,204**	**31,265**	**39,929**
Taxes	5,149	6,113	7,699	8,878	10,593	13,528
PAT	**10,851**	**13,607**	**15,025**	**17,326**	**20,672**	**26,401**

Balance sheet	FY12	FY13	FY14	FY15F	FY16F	FY17F
Liabilities						
Net worth	79,459	94,470	122,751	139,063	158,525	183,382
Sub bonds/pref cap	7,467	6,967	6,180	6,180	6,180	6,180
Term deposits	261,341	361,105	402,445	478,499	585,784	738,243
Total deposits	**385,365**	**510,288**	**590,723**	**716,557**	**891,910**	**1,134,407**
Borrowings	158,488	197,139	122,776	159,455	198,050	239,211
Other liabilities	25,537	27,898	33,338	33,123	41,350	52,258
Total Liabilities	**656,317**	**836,762**	**875,768**	**1,054,378**	**1,296,016**	**1,615,437**
Assets						
Loans	**390,792**	**484,690**	**530,276**	**625,726**	**769,643**	**962,054**
Investments	199,367	246,370	205,005	254,300	309,927	383,678
Cash/equiv	26,346	36,892	59,799	77,196	96,371	121,793
Fixed assets	4,500	4,644	11,069	17,495	23,920	30,345
Other assets	19,011	21,977	19,863	22,843	26,269	30,210
Total Assets	**656,316**	**836,937**	**875,853**	**1,054,378**	**1,296,016**	**1,615,437**

Growth and Ratios	FY12	FY13	FY14	FY15F	FY16F	FY17F
Loan growth	33.8%	29.5%	10.1%	17.7%	23.0%	25.0%
NII/Assets	**4.5%**	**4.4%**	**4.5%**	**4.5%**	**4.4%**	**4.3%**
CASA Ratio	32.2%	29.2%	31.9%	33.2%	34.3%	34.9%
Gross NPAs	1.6%	1.5%	2.0%	2.1%	2.2%	2.3%
Net NPAs	0.9%	0.7%	1.1%	1.1%	1.2%	1.2%
Coverage	59.2%	52.0%	45.4%	47.5%	48.4%	49.4%
LLP/Loans	0.2%	0.5%	0.3%	0.5%	0.5%	0.5%

Consolidated DuPont	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	**4.8%**	**4.6%**	**4.6%**	**4.6%**	**4.5%**	**4.5%**
Fees/Assets	2.6%	2.1%	2.2%	2.4%	2.3%	2.2%
Investment profits/Assets	0.1%	0.2%	0.2%	0.1%	0.1%	0.0%
Net revenues/Assets	**7.5%**	**6.9%**	**7.0%**	**7.0%**	**6.9%**	**6.8%**
Operating Expense/Assets	-3.8%	-3.4%	-3.4%	-3.4%	-3.2%	-3.0%
Provisions/Assets	-0.1%	-0.2%	-0.3%	-0.3%	-0.3%	-0.3%
Taxes/Assets	-1.1%	-1.1%	-1.1%	-1.1%	-1.1%	-1.2%
Total Costs/Assets	**-5.1%**	**-4.7%**	**-4.8%**	**-4.8%**	**-4.6%**	**-4.5%**
ROA	**2.39%**	**2.20%**	**2.19%**	**2.28%**	**2.26%**	**2.29%**
Equity/Assets	16.6%	15.2%	16.1%	16.8%	15.8%	14.8%
ROE	**14.4%**	**14.4%**	**13.7%**	**13.5%**	**14.3%**	**15.5%**

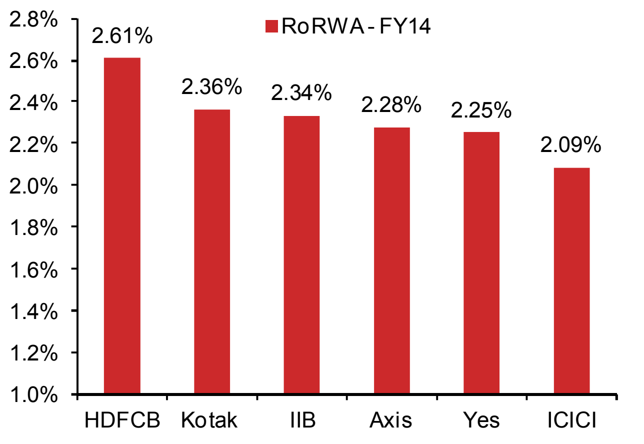
Kotak Prime	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income	**7,010**	**7,462**	**8,441**	**9,890**	**11,894**	**14,426**
Net revenues	7,932	9,040	10,611	12,277	14,520	17,314
Operating Expense	1,990	2,476	2,861	3,290	3,783	4,351
Operating profit	5,942	6,564	7,750	8,987	10,737	12,964
Provisions	468	248	235	194	233	283
PBT	5,703	6,410	7,520	8,793	10,503	12,681
Taxes	1,855	2,103	2,610	2,990	3,571	4,311
PAT	**3,849**	**4,307**	**4,910**	**5,803**	**6,932**	**8,369**
Loan book	**134,018**	**170,220**	**174,108**	**208,929**	**254,894**	**310,970**
Loan Growth	18.3%	27.0%	2.3%	20.0%	22.0%	22.0%
Gross NPAs	0.7%	0.4%	0.5%	0.6%	0.6%	0.6%
Net NPAs	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%

Other Subsidiary PAT	FY12	FY13	FY14	FY15F	FY16F	FY17F
Kotak Securities	1,819	1,145	1,602	2,185	2,583	2,960
KMCC	59	167	142	235	287	383
Asset Management	144	35	334	492	607	744
Kotak Investments	153	310	421	360	458	627
Kotak International and UK	(46)	131	163	270	297	327
Kotak Prime	3,849	4,307	4,910	5,803	6,932	8,369
Kotak Advisors	360	310	180	234	304	395
Consoldiated PAT (ex. Insu)	**17,211**	**19,909**	**22,858**	**26,544**	**31,683**	**39,579**
Profit growth (%)	15.3%	15.7%	14.8%	16.1%	19.4%	24.9%

Source: Company data, Nomura estimates

Well positioned for an upcycle in spite of lower credit costs currently

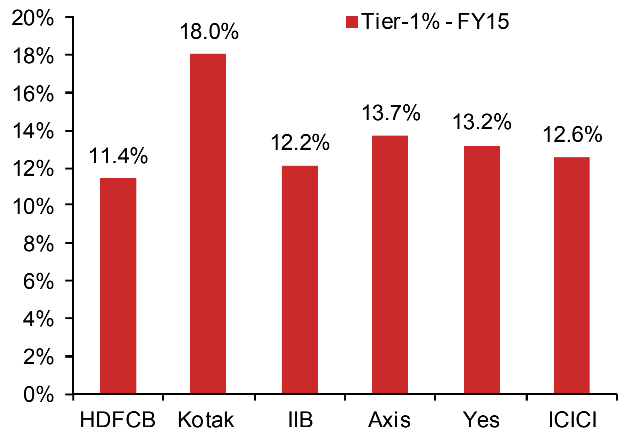
Fig. 163: RORWAs are second best to HDFCB



Source: Company data, Nomura research

Fig. 164: Capital is more than adequate

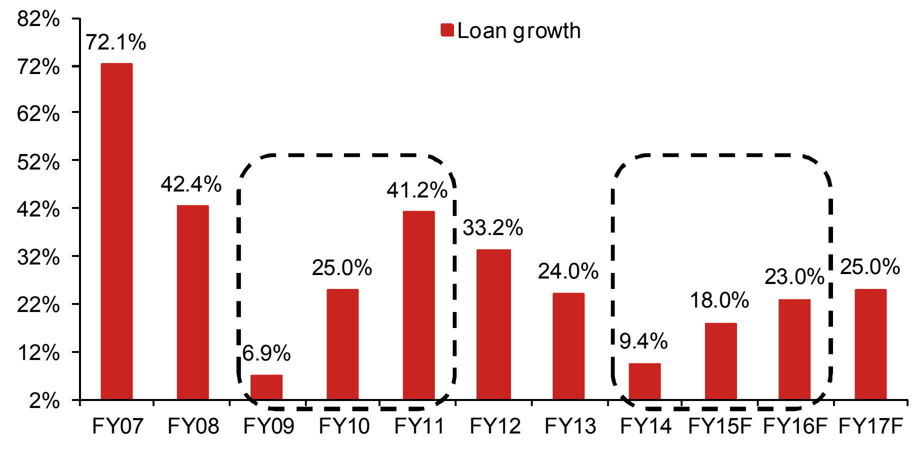
Increases the ability to ramp up on growth



Source: Company data, Nomura research

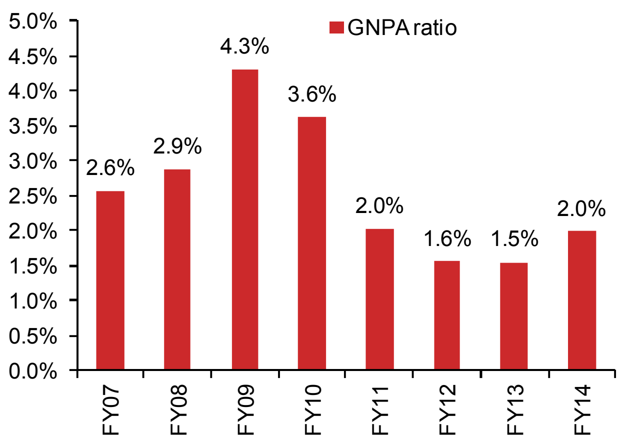
Fig. 165: Historically, Kotak has been successful in its switch on-switch-off model for the growth in downcycles and upturns

After almost no growth in FY09, Kotak recorded +30% CAGR over FY10-11. The ramp-up in growth could be fast again after the slowdown in growth in FY14



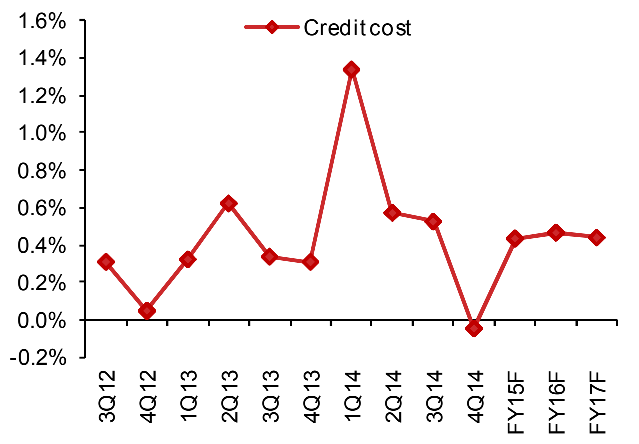
Source: Company data, Nomura estimates

Fig. 166: Gross NPAs have held up well across the cycle



Source: Company data, Nomura research

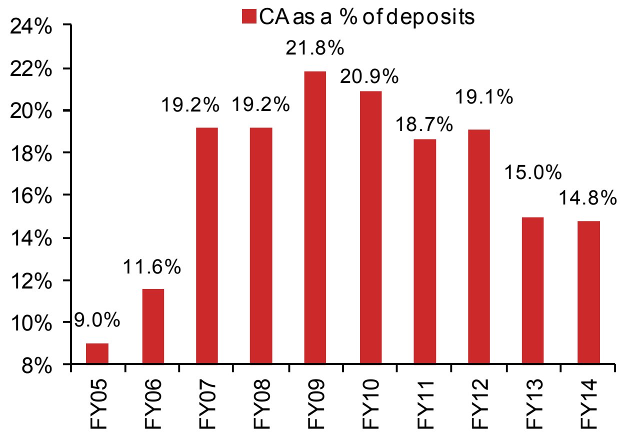
Fig. 167: And hence credit costs have only come off



Source: Company data, Nomura estimates

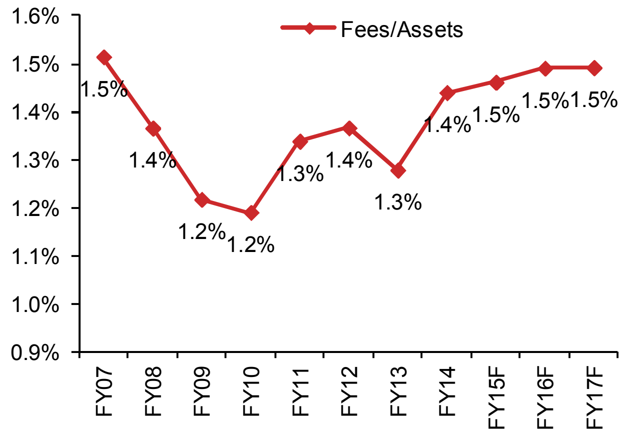
Fig. 168: Delivery on CA/business banking has been relatively week and an improvement on this will help

CA as a % of deposits has come off



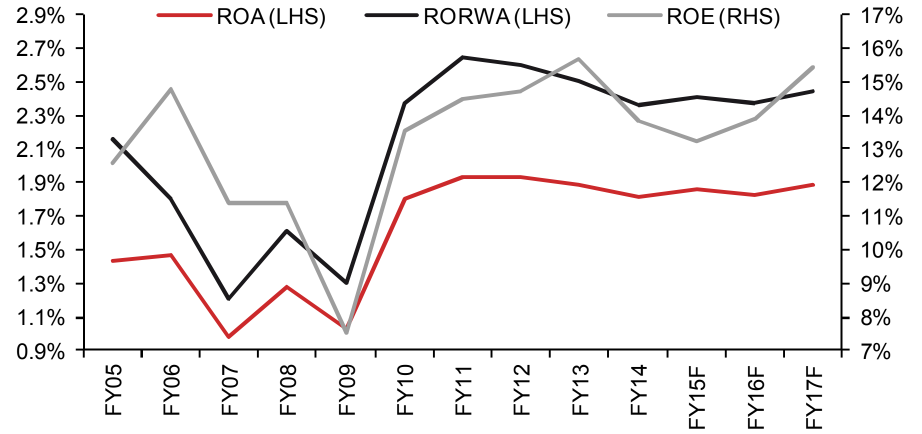
Source: Company data, Nomura research

Fig. 169: Core fees ex- treasury and stressed assets have been weak



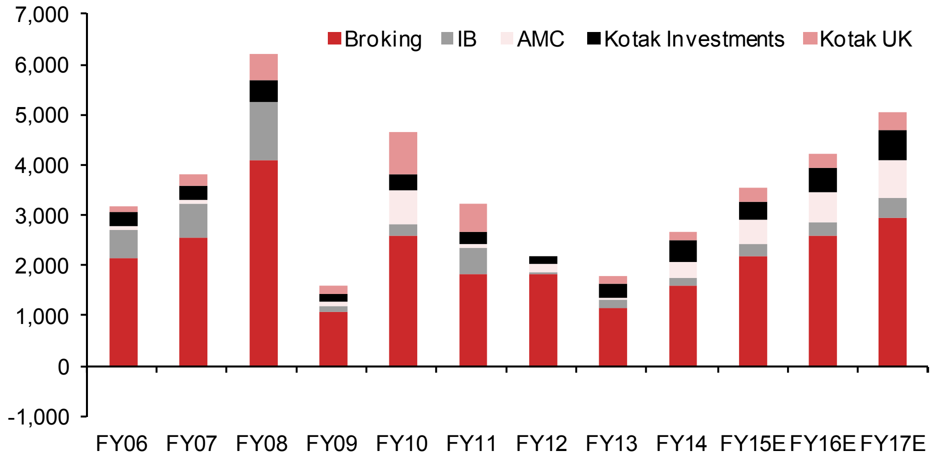
Source: Company data, Nomura estimates

Fig. 170: Our expectations on Kotak's profitability in the banking business



Source: Company data, Nomura estimates

Fig. 171: We expect capital market profitability to grow 2x in next three years



Source: Company data, Nomura estimates

Valuations: Expensive but can remain so:
Kotak Bank's current valuations at ~2.9x Mar-15F book after adjusting for INR140 of valuations for its flow business is certainly expensive, in our view. While asset quality is likely to hold up the best as management has been very conservative on growing in the past 18 months, we see valuations stretched on a relative basis with HDFCB (Kotak just at a 10% discount on FY16F P/B and ~20% premium on FY16F P/E). The premium valuations could sustain given: **(1)** high RORWAs; **(2)** continuity of top management and investor comfort with its conservative approach to asset quality; and **(3)** relatively strong leverage to an upcycle as well.

We value Kotak Bank on a sum-of-the-parts basis with a TP of INR920. We value all the subsidiaries (ex-Kotak Prime) at INR140. Our residual TP for Kotak implies a ~3x Mar-16 book (BVPS: INR259) for its lending business.

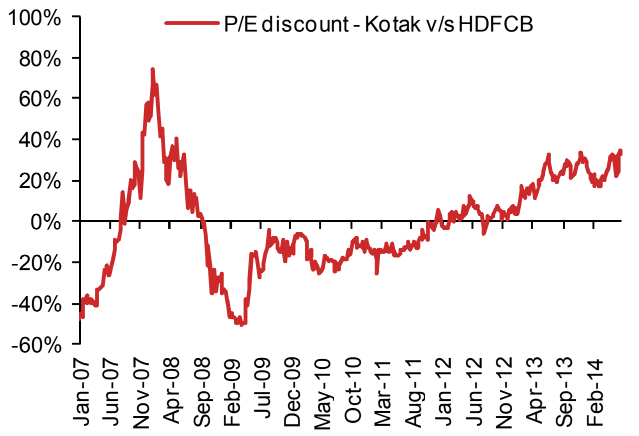
Risk: (1) Downside: Slower-than-expected loan growth will delay the leveraging up process. (2) Upside: A better-than-expected turn in profitability of capital market businesses and higher-than-expected gains from stressed asset book.

Fig. 172: Kotak Bank SOTP value of INR920

Valuation assumptions	Value	Per Share	Basis
Kotak Securities	30,991	40	12x Mar-16 Earnings
Asset Management	20,524	27	4% of AUMs
KMCC	5,747	7	20x Mar-16 Earnings
International subsidiaries	9,001	12	2.0x Mar-16 book
Others	11,426	15	15x Mar-16 Earnings
Insurance	30,458	40	P/NBAP
Total	**108,148**	**140**	
Ex insurance	77,689	101	
Shares	**770**		
Total Subsidiary valuation	108,148	140	
Lending business valuation (3x Mar-16 book)	600,493	780	3.0x Mar-16 book
Total Valuation	708,641	920	
Mar-16 PT		**920**	

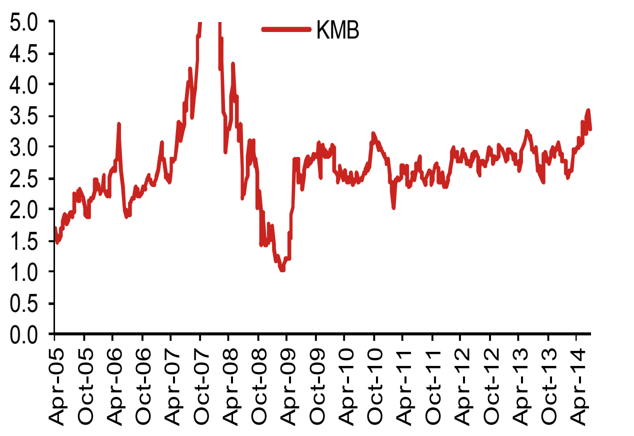
Source: Nomura estimates

Fig. 173: Kotak's valuations look stretched vs. HDFCB
Kotak trades at +20% premium on P/E basis



Source: Company data, Bloomberg, Nomura estimates

Fig. 174: Kotak's valuations have been inching up
1year fwd P/AB



Source: Company data, Bloomberg, Nomura estimates

NOMURA

Yes Bank YESB.NS YES IN

EQUITY: BANKS

The cycle in its favour

Comfortable with its underwriting, but B/S and P&L lumpiness needs to be addressed

Action : Assuming coverage with Buy and a TP of INR620

Yes Bank's asset quality has held up well in the current cycle and our analysis of its past loan/bond syndications, and limited exposure to INR4tn of risky corporate/SPV lending that we looked at, provide us comfort on its underwriting. But part of its fees/margins is generated from lumpy churn business which adds to its earnings volatility and though its liability franchise is improving, 45-50% of its deposits are still bulky and hence we believe investors should assign a multiple accordingly. An expected upcycle in corporate credit (growth/asset quality) drives our Buy rating.

- **Positives: (1)** Underwriting comfortable: Bloomberg data on loan/bond syndications done by Yes Bank indicates reasonable underwriting. Also, except for some commercial real estate exposure, the bank has limited exposure to stressed corporate we looked into. (2) With Tier-1 at +13% now, we believe it is now well positioned for a pick-up in corporate credit.
- **Improvements needed to drive multiples up: (1)** Wholesale funds form 45-50% of Yes Bank's deposits – highest among private banks; **(2)** Churn business (syndications/IBPC) contribute +50bp to lending yields/margins and this is unlikely to continue in the same proportion of B/S; **(3)** Financial advisory/markets (lumpy fees) contribute ~60% of fees which is generally more volatile – improving share of transaction banking/retail fees will help.

Catalysts: (1) Benign liquidity will be a near-term trigger (2) Reducing P&L and B/S granularity will drive long-term valuations

Valuations : Cyclical tailwinds to help

Our TP of INR620 implies 1.9x Mar-16F book which is ~10% discount to our multiple for Axis/ICICI. While the growth outcome over FY14-17F would be higher for Yes Bank, its assets/liabilities need to get a lot more granular vs. Axis/ICICI, we think.

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	26,884		31,305		37,284		44,264
Reported net profit (mn)	16,183		18,497		22,224		26,408
Normalised net profit (mn)	16,183		18,497		22,224		26,408
FD normalised EPS	44.87		44.65		53.65		63.75
FD norm. EPS growth (%)	23.7		-0.5		20.1		18.8
FD normalised P/E (x)	12.5	N/A	12.6	N/A	10.5	N/A	8.8
Price/adj. book (x)	2.9	N/A	2.0	N/A	1.8	N/A	1.5
Price/book (x)	2.9	N/A	2.0	N/A	1.8	N/A	1.5
Dividend yield (%)	1.7	N/A	2.0	N/A	2.3	N/A	2.6
ROE (%)	25.0		19.9		18.1		18.6
ROA (%)	1.6		1.6		1.6		1.6

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 620
Closing price 3 July 2014	INR 563
Potential upside	+10.1%

Anchor themes

We are comfortable with its underwriting but B/S needs to be more granular. Currently, the improving cycle is in its favour.

Nomura vs consensus

Our FY15/16F earnings estimates are slightly lower than consensus.

Research analysts

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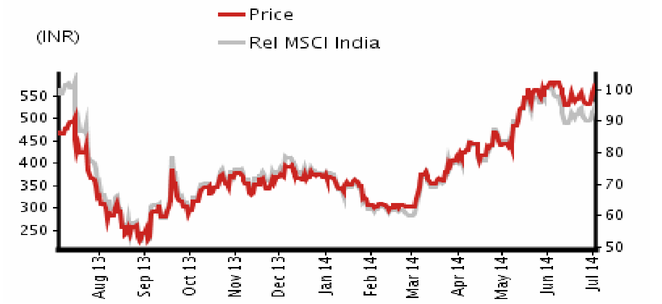
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Yes Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	-3.0	36.6	21.5	M cap (USDmn)	3,902.0
Absolute (USD)	-3.8	37.7	22.5	Free float (%)	90.3
Rel to MSCI India	-7.6	23.1	-8.7	3-mth ADT (USDmn)	55.5

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	82,940	99,814	112,027	130,851	154,608
Interest expense	-60,752	-72,651	-79,396	-91,211	-107,255
Net interest income	22,188	27,163	32,630	39,641	47,353
Net fees and commissions	10,762	12,609	0	0	0
Trading related profits	1,557	1,662	1,500	1,300	1,000
Other operating revenue	256	2,945	18,174	21,683	25,977
Non-interest income	12,574	17,216	19,674	22,983	26,977
Operating income	34,762	44,378	52,304	62,624	74,331
Depreciation	-517	-632	-695	-764	-841
Amortisation					
Operating expenses	-6,273	-9,018	-11,093	-13,644	-16,509
Employee share expense	-6,555	-7,844	-9,212	-10,932	-12,717
Pre-provision op profit	21,417	26,884	31,305	37,284	44,264
Provisions for bad debt	-2,222	-2,637	-4,103	-4,602	-5,428
Other provision charges	62	-980	0	0	0
Operating profit	19,257	23,268	27,202	32,682	38,836
Other non-op income					
Associates & JCEs					
Pre-tax profit	19,257	23,268	27,202	32,682	38,836
Income tax	-6,251	-7,085	-8,705	-10,458	-12,428
Net profit after tax	13,007	16,183	18,497	22,224	26,408
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	13,007	16,183	18,497	22,224	26,408
Extraordinary items	0	0	0	0	0
Reported NPAT	13,007	16,183	18,497	22,224	26,408
Dividends	-2,518	-3,376	-4,605	-5,332	-6,059
Transfer to reserves	10,489	12,807	13,893	16,892	20,349

Growth (%)

Net interest income	37.3	22.4	20.1	21.5	19.5
Non-interest income	46.7	36.9	14.3	16.8	17.4
Non-interest expenses	50.6	43.8	23.0	23.0	21.0
Pre-provision earnings	39.1	25.5	16.4	19.1	18.7
Net profit	33.1	24.4	14.3	20.1	18.8
Normalised EPS	31.0	23.7	-0.5	20.1	18.8
Normalised FDEPS	31.0	23.7	-0.5	20.1	18.8
Loan growth	23.7	18.4	20.0	24.0	23.0
Interest earning assets	15.5	19.5	25.3	23.8	22.8
Interest bearing liabilities	38.8	8.7	13.5	19.8	19.9
Asset growth	34.5	10.0	16.6	19.1	19.2
Deposit growth	36.2	10.8	15.4	23.4	23.1

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	31,754	43,116	10,273	12,377	14,920
Inter-bank lending					
Deposits with central bank					
Total securities	8,903	15,801	49,060	59,110	71,253
Other int earning assets					
Gross loans	470,869	557,818	670,742	832,926	1,025,990
Less provisions	-873	-1,489	-3,146	-5,108	-7,773
Net loans	469,996	556,330	667,596	827,818	1,018,217
Long-term investments	429,760	409,504	469,251	527,810	600,987
Fixed assets	2,298	2,938	3,577	4,216	4,855
Goodwill					
Other intangible assets					
Other non IEAs	48,329	62,470	71,841	82,617	95,010
Total assets	991,041	1,090,158	1,271,597	1,513,949	1,805,241
Customer deposits	669,556	741,920	856,385	1,056,826	1,301,098
Bank deposits, CDs,	184,462	181,588	195,588	209,588	223,588
Other int bearing liabilities	24,759	31,554	31,554	31,554	31,554
Total int bearing liabilities	878,777	955,063	1,083,528	1,297,969	1,556,241
Non-int bearing liabilities	54,187	63,877	73,459	84,478	97,150
Total liabilities	932,965	1,018,940	1,156,987	1,382,447	1,653,390
Minority interest					
Common stock	3,586	3,606	4,143	4,143	4,143
Preferred stock					
Retained earnings	54,490	67,611	110,467	127,359	147,708
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	58,077	71,217	114,610	131,502	151,851
Total liabilities and equity	991,041	1,090,158	1,271,597	1,513,949	1,805,241
Non-perf assets	943	1,749	3,702	6,385	9,716

Balance sheet ratios (%)

Loans to deposits	70.3	75.2	78.3	78.8	78.9
Equity to assets	5.9	6.5	9.0	8.7	8.4

Asset quality & capital

NPAs/gross loans (%)	0.2	0.3	0.6	0.8	0.9
Bad debt charge/gross	0.47	0.47	0.61	0.55	0.53
Loss reserves/assets (%)	0.09	0.14	0.25	0.34	0.43
Loss reserves/NPAs (%)	92.6	85.1	85.0	80.0	80.0
Tier 1 capital ratio (%)	9.5	9.8	13.2	12.5	12.0
Total capital ratio (%)	18.3	14.4	18.3	17.6	17.0

Per share

Reported EPS (INR)	36.27	44.87	44.65	53.65	63.75
Norm EPS (INR)	36.27	44.87	44.65	53.65	63.75
FD norm EPS (INR)	36.27	44.87	44.65	53.65	63.75
DPS (INR)	7.02	9.36	11.12	12.87	14.63
PPOP PS (INR)	59.72	74.55	75.57	90.00	106.85
BVPS (INR)	161.94	197.48	276.66	317.43	366.55
ABVPS (INR)	161.94	197.48	276.66	316.66	365.38
NTAPS (INR)	161.94	197.48	276.66	317.43	366.55

Valuations and ratios

Reported P/E (x)	15.5	12.5	12.6	10.5	8.8
Normalised P/E (x)	15.5	12.5	12.6	10.5	8.8
FD normalised P/E (x)	15.5	12.5	12.6	10.5	8.8
Dividend yield (%)	1.2	1.7	2.0	2.3	2.6
Price/book (x)	3.5	2.9	2.0	1.8	1.5
Price/adjusted book (x)	3.5	2.9	2.0	1.8	1.5
Net interest margin (%)	4.97	5.17	5.06	4.94	4.79
Yield on assets (%)	18.57	18.99	17.38	16.32	15.65
Cost of int bearing liab (%)	8.04	7.92	7.79	7.66	7.52
Net interest spread (%)	10.53	11.07	9.60	8.66	8.13
Non-interest income (%)	36.2	38.8	37.6	36.7	36.3
Cost to income (%)	38.4	39.4	40.1	40.5	40.4
Effective tax rate (%)	32.5	30.5	32.0	32.0	32.0
Dividend payout (%)	19.4	20.9	24.9	24.0	22.9
ROE (%)	24.8	25.0	19.9	18.1	18.6
ROA (%)	1.51	1.56	1.57	1.60	1.59
Operating ROE (%)	36.7	36.0	29.3	26.6	27.4
Operating ROA (%)	2.23	2.24	2.30	2.35	2.34

Source: Company data, Nomura estimates

Positives: Comfortable with underwriting + Cycle in its favour

We see limited risks to Yes Bank's underwriting:

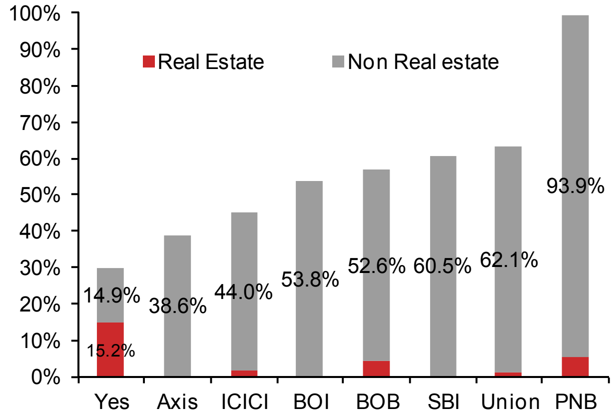
- Bloomberg provides data on syndications/underwriting of loans/bonds historically done by banks. Our analysis of Yes Bank's past transactions does not indicate any excessive risk-taking and since part of the exposure is retained in its B/S, it provides us some comfort on asset quality.
- Our analysis of INR4tn of risky corporate/SPV exposure indicates that Yes Bank's exposure to risky corporate/infra SPVs is limited, except for some exposure to commercial real estate where LGD (loss given default) is likely to be lower.

Fig. 175: Break-up of syndicated loans by Yes Bank in past five years

Total Syndications	**14,426**	
NBFCs	4,369	30.3%
PSU Enterprises	1,040	7.2%
Corporates/ SPVs	**9,017**	62.5%
Large AAA/AA groups	4,253	29.5%
Mid corporates/SPVs	2,779	19.3%
Small Caps	1,985	13.8%

Source: Bloomberg, Nomura research

Fig. 176: Exposure to risky corporate is low except commercial real estate

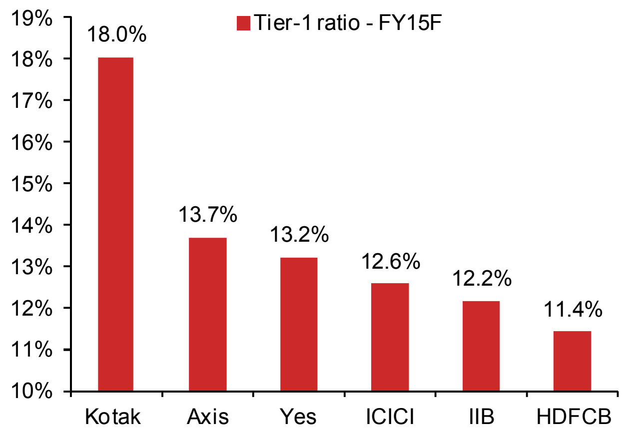


Source: Ministry of corporate affairs, Media sources, Nomura estimates

The cycle in its favour:

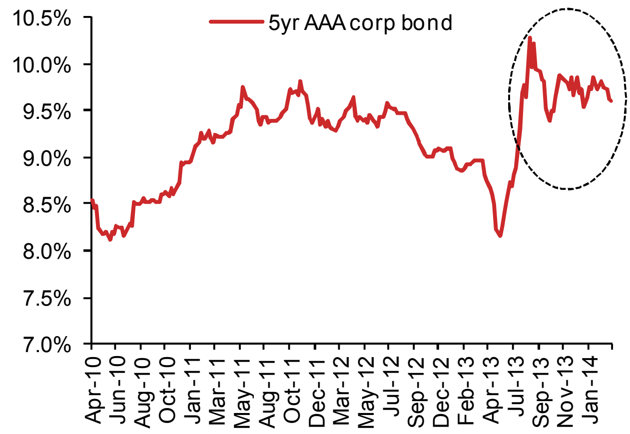
- ~90% of Yes Bank's loan book comprises corporate loans, where growth has slowed down over the past 1-2 years. However, as we expect a pick-up in corporate loan growth, and Yes bank having raised sufficient capital (Tier-1 level of +13%), we believe Yes Bank is leveraged to an expected pick-up in growth.
- Also, we expect liquidity to remain benign over the next 12-18 months, and with Yes Bank being wholesale funded, stability in rates should aid margins - We take this benefit in Yes Bank's P&L but would refrain from assigning a multiple, as we believe wholesale funded entities like Yes will remain vulnerable to a liquidity squeeze, as it did during Jun to Sep-13.

Fig. 177: Capital now adequate for growth (Tier-1 capital %)



Source: Company data, Nomura estimates

Fig. 178: Wholesale cost of funds has eased

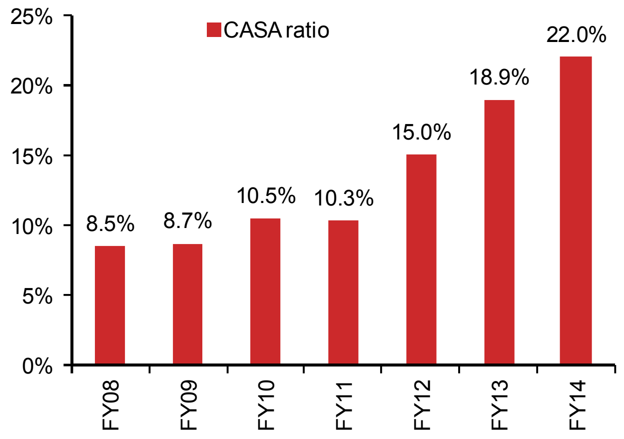


Source: Bloomberg, Nomura research

Improvements needed to drive up multiples:

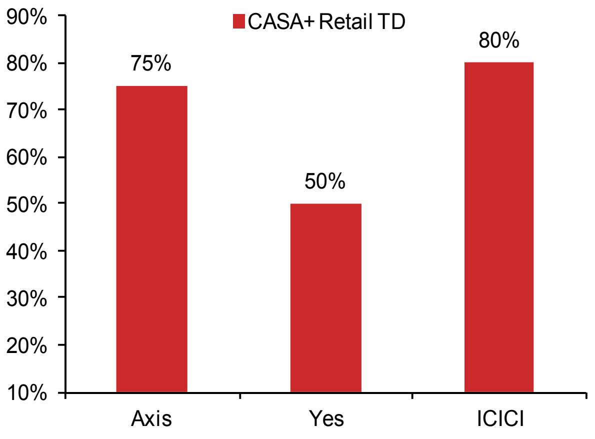
- While CASA, especially SA accretion, has received a flip-up from saving de-regulation and Yes Bank's share of retail TD has been inching up, wholesale funding is still ~45-50% of Yes bank's deposits vs. just 20-25% wholesale funding for Axis/ICICI.
- Financial markets and advisory (ex treasury income) contribute ~60% of Yes Bank's fee. While this number has dropped from +75% since its inception, its reliance on these fee streams has remained at ~60% over the past 4-5 years. We factor in an increase in the share of transaction and retail fees, and strong delivery on making granular fee streams will be a positive.
- Yes Bank's yields on a calculated basis are higher owing to the interest spreads that Yes Bank makes on its IBPC book (inter-bank participatory certificates) and inter-quarter interest on its syndication book (which gets sold down before the ends of a quarter). We are unsure if Yes Bank will be able to grow this portfolio in line with its B/S size going forward.

Fig. 179: CASA share has improved



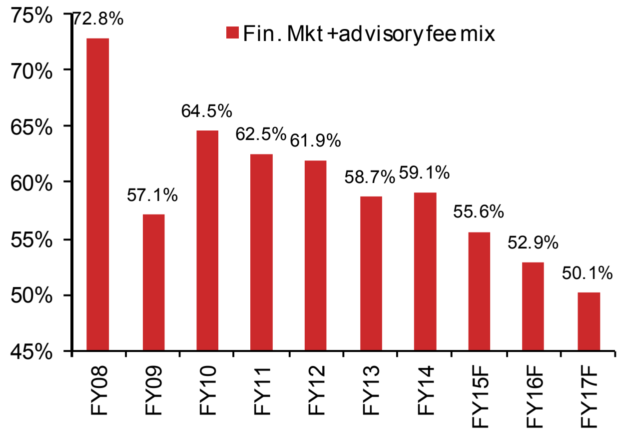
Source: Company data, Nomura research

Fig. 180: But still lower than peers



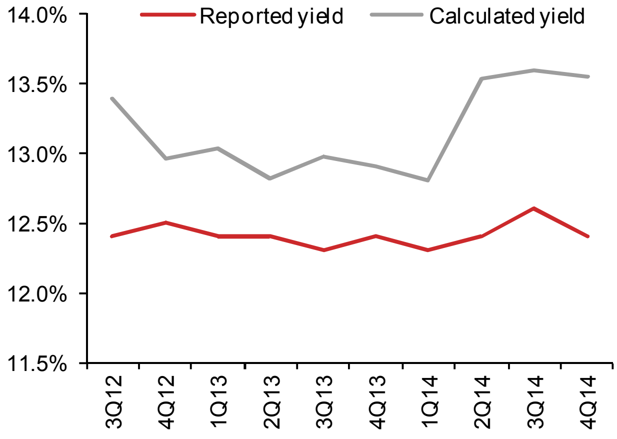
Source: Company data, Nomura research

Fig. 181: Financial markets and advisory still contribute ~60% of the fees – This is generally bulky in nature



Source: Company data, Nomura estimates

Fig. 182: Calculated yields are higher than reported yields due to income on IBPC and income on syndicated loans (before selldowns)



Source: Company data, Nomura research

Valuations: Cyclical tailwinds to help

Our TP of INR620 implies 1.9x Mar-16F book which is at ~10% discount to our multiple for Axis/ICICI. While the growth outcome over FY14-17F would be higher for Yes Bank, its assets/liabilities need to get a lot more granular like Axis/ICICI, and hence the discount in our target multiple. Yes Bank trades at 1.75x Mar-16F book which is similar to what ICICI/Axis trade at currently, and hence, at similar valuations, we prefer Axis/ICICI.

Risks: (1) Spike in wholesale rates will impact Yes bank's margins – our base case is of benign liquidity and stable wholesale funds; and (2) any large negative surprise on asset quality.

Fig. 183: We expect ROEs at +18% despite the dilution

ROA decomposition	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15F**	**FY16F**	**FY17F**
Net Interest Income/Assets	2.51%	2.71%	2.79%	2.72%	2.67%	2.72%	2.76%	2.94%	3.02%	3.02%
Fees/Assets	2.18%	1.53%	1.69%	1.46%	1.36%	1.35%	1.58%	1.64%	1.65%	1.66%
Investment profits/Assets	0.40%	0.79%	0.35%	-0.10%	0.06%	0.19%	0.17%	0.14%	0.10%	0.06%
Net revenues/Assets	**5.09%**	**5.03%**	**4.82%**	**4.08%**	**4.09%**	**4.26%**	**4.52%**	**4.71%**	**4.77%**	**4.75%**
Operating Expense/Assets	-2.55%	-2.23%	-1.77%	-1.48%	-1.54%	-1.63%	-1.78%	-1.89%	-1.93%	-1.92%
Provisions/Assets	-0.32%	-0.33%	-0.48%	-0.21%	-0.15%	-0.26%	-0.37%	-0.37%	-0.35%	-0.35%
Taxes/Assets	-0.79%	-0.86%	-0.88%	-0.80%	-0.78%	-0.77%	-0.72%	-0.78%	-0.80%	-0.79%
Total Costs/Assets	**-3.66%**	**-3.42%**	**-3.13%**	**-2.49%**	**-2.47%**	**-2.66%**	**-2.87%**	**-3.04%**	**-3.08%**	**-3.06%**
ROA	**1.43%**	**1.62%**	**1.69%**	**1.58%**	**1.62%**	**1.59%**	**1.65%**	**1.67%**	**1.69%**	**1.69%**
Equity/Assets	7.86%	7.83%	8.34%	7.50%	7.00%	6.42%	6.58%	8.37%	9.38%	9.05%
ROE	**18.1%**	**20.7%**	**20.3%**	**21.1%**	**23.1%**	**24.8%**	**25.0%**	**19.9%**	**18.1%**	**18.6%**
RORWA	**1.46%**	**1.79%**	**2.17%**	**2.12%**	**2.05%**	**2.18%**	**2.25%**	**2.23%**	**2.24%**	**2.21%**

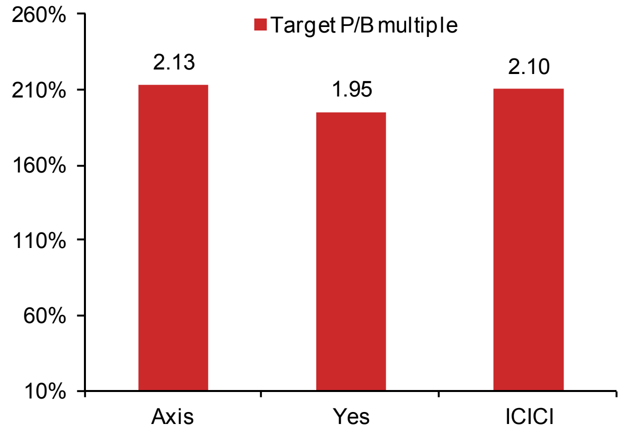
Source: Company data, Nomura estimates

Fig. 184: TP of INR620

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.25
Cost of Equity	15.5%
Terminal growth	5.0%
Stage 2 growth	23.0%
Normalised ROEs	18.9%
Mar-15 PT	620
Implied Mar-16 P/B	1.95
Implied Mar-16 P/E	11.56

Source: Nomura estimates

Fig. 185: Our target multiple is 10% lower than that for ICICI/Axis



Source: Nomura estimates

Bank of Baroda BOB.NS BOB IN

EQUITY: BANKS

Most improved PSU bank in the past decade

Valuations now factor in transition risk; underwriting has been relatively better

Action: Better asset quality plus undemanding valuations

Following transfer of coverage of Bank of Baroda (BOB) we rate the shares Buy, with a TP of INR1,025. Not only has BOB's asset quality held up better than most PSU banks in this cycle, even its delivery on the liabilities side has been better than peers (CASA growth higher than peers), leading to BOB's industry-leading RORWAs. This, we believe, has been driven by three successive successful Chairmen changes making it the most improved PSU bank. Fundamentally, a low stressed asset base for BOB implies lower asset quality upsides in a macro recovery, but we see meaningful margin levers for BOB in FY15/16F and capital adequacy ensures flexibility to grow in case of an upcycle.

- Recent underperformance (~20% since elections) factors in a transition risk, with valuations now at par with PNB (2x stressed assets as BOB). Also, our analysis of large corporate/infra SPV exposure indicates that BOB's underwriting has been relatively less concentrated and risky than peers, and this reduces possibility of an asset book clean up in case of a transition.
- Profit levers: **1)** highest NIM contraction despite lower NPAs indicates low-risk lending and hence we see significant scope for margin improvement for BOB; and **2)** ability to grow faster due to low capital constraints.

Catalysts: The current Chairman retires after 1QFY15, and stability in asset quality after the transition will be a key stock catalyst

Valuation: Underperformance adequately factors in transition risk

Our TP of INR1,025 implies 1.1x Mar-16F book based on our normalised ROE assumption of 15.5%, and is ~20% higher than our target multiple for PNB given the lower asset quality risk/better under writing. While an impending transition will remain a concern till transition, the recent underperformance and better historical underwriting provide us some comfort.

Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	92,910		107,866		131,375		154,204
Reported net profit (mn)	45,410		50,267		65,069		77,277
Normalised net profit (mn)	45,410		50,267		65,069		77,277
FD normalised EPS	105.44		116.72		145.02		165.53
FD norm. EPS growth (%)	-0.6		10.7		24.3		14.1
FD normalised P/E (x)	8.3	N/A	7.5	N/A	6.0	N/A	5.3
Price/adj. book (x)	1.2	N/A	1.0	N/A	0.9	N/A	0.8
Price/book (x)	1.1	N/A	1.0	N/A	0.9	N/A	0.8
Dividend yield (%)	2.9	N/A	3.2	N/A	4.1	N/A	4.9
ROE (%)	13.8		13.6		15.5		15.7
ROA (%)	0.8		0.7		0.8		0.8

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 1025
Closing price 3 July 2014	INR 876
Potential upside	+17%

Anchor themes

The most improved PSU bank - transition risk is overplayed, in our view.

Nomura vs consensus

Our FY15/16F earnings estimates are largely in line with consensus.

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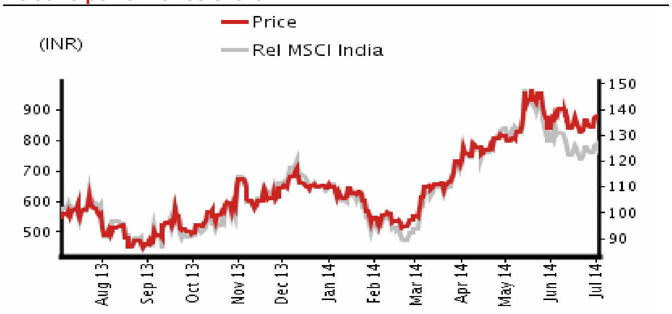
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Bank of Baroda

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	0.7	15.7	61.0	M cap (USDmn)	6,291.9
Absolute (USD)	-0.1	16.6	62.3	Free float (%)	36.0
Rel to MSCI India	-1.1	5.1	34.2	3-mth ADT (USDmn)	30.9

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	351,967	389,397	453,549	516,381	596,917
Interest expense	-238,814	-269,744	-310,963	-346,300	-398,126
Net interest income	113,153	119,653	142,586	170,081	198,791
Net fees and commissions	12,957	14,781	16,851	19,378	22,285
Trading related profits	6,173	7,438	6,000	7,000	7,000
Other operating revenue	17,177	22,408	23,861	27,440	31,556
Non-interest income	36,306	44,627	46,712	53,818	60,841
Operating income	149,459	164,281	189,298	223,899	259,632
Depreciation	-3,006	-3,450	-3,795	-4,175	-4,592
Amortisation					
Operating expenses	-21,965	-26,523	-30,236	-34,772	-39,988
Employee share expense	-34,496	-41,397	-47,400	-53,577	-60,848
Pre-provision op profit	89,992	92,910	107,866	131,375	154,204
Provisions for bad debt	-38,432	-34,702	-41,725	-43,445	-46,874
Other provision charges	-3,247	-3,235	0	0	0
Operating profit	48,312	54,973	66,141	87,930	107,331
Other non-op income					
Associates & JCEs					
Pre-tax profit	48,312	54,973	66,141	87,930	107,331
Income tax	-3,505	-9,563	-15,874	-22,862	-30,053
Net profit after tax	44,807	45,410	50,267	65,069	77,277
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	44,807	45,410	50,267	65,069	77,277
Extraordinary items	0	0	0	0	0
Reported NPAT	44,807	45,410	50,267	65,069	77,277
Dividends	-10,628	-10,834	-11,992	-16,173	-19,985
Transfer to reserves	34,179	34,576	38,275	48,896	57,292

Growth (%)

Net interest income	9.7	5.7	19.2	19.3	16.9
Non-interest income	6.1	22.9	4.7	15.2	13.0
Non-interest expenses	15.8	20.8	14.0	15.0	15.0
Pre-provision earnings	4.9	3.2	16.1	21.8	17.4
Net profit	-10.5	1.3	10.7	29.4	18.8
Normalised EPS	-12.7	-0.6	10.7	24.3	14.1
Normalised FDEPS	-12.7	-0.6	10.7	24.3	14.1
Loan growth	14.2	21.0	14.0	16.0	17.0
Interest earning assets	24.4	27.6	9.8	16.0	17.0
Interest bearing liabilities	22.5	21.0	13.0	15.7	16.9
Asset growth	22.4	20.6	12.8	15.6	16.7
Deposit growth	23.1	20.0	13.6	16.2	17.4

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	15,595	22,185	211,591	245,347	287,443
Inter-bank lending	838,394	1,286,594	1,247,276	1,446,255	1,694,399
Deposits with central bank					
Total securities					
Other int earning assets					
Gross loans	3,319,763	4,028,470	4,605,889	5,352,047	6,268,739
Less provisions	-37,906	-58,411	-80,023	-102,042	-126,233
Net loans	3,281,858	3,970,058	4,525,866	5,250,005	6,142,506
Long-term investments	1,213,937	1,161,127	1,300,570	1,481,779	1,707,660
Fixed assets	13,489	16,815	20,142	23,468	26,795
Goodwill					
Other intangible assets					
Other non IEAs	97,039	127,740	123,836	143,592	168,229
Total assets	5,460,312	6,584,519	7,429,282	8,590,446	10,027,032
Customer deposits	4,738,833	5,688,944	6,464,862	7,510,819	8,818,910
Bank deposits, CDs,	263,742	368,109	380,867	409,586	439,236
Other int bearing liabilities	2,051	21	21	21	21
Total int bearing liabilities	5,004,626	6,057,073	6,845,750	7,920,426	9,258,167
Non-int bearing liabilities	147,034	178,115	195,927	215,519	237,071
Total liabilities	5,151,660	6,235,188	7,041,676	8,135,945	9,495,238
Minority interest					
Common stock	4,225	4,307	4,307	4,487	4,669
Preferred stock					
Retained earnings	304,427	345,024	383,298	450,014	527,125
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	308,652	349,331	387,605	454,501	531,793
Total liabilities and equity	5,460,312	6,584,519	7,429,282	8,590,446	10,027,032
Non-perf assets	79,826	118,759	150,987	185,531	217,643

Balance sheet ratios (%)

Loans to deposits	70.1	70.8	71.2	71.3	71.1
Equity to assets	5.7	5.3	5.2	5.3	5.3

Asset quality & capital

NPAs/gross loans (%)	2.4	2.9	3.3	3.5	3.5
Bad debt charge/gross	1.16	0.86	0.91	0.81	0.75
Loss reserves/assets (%)	0.69	0.89	1.08	1.19	1.26
Loss reserves/NPAs (%)	47.5	49.2	53.0	55.0	58.0
Tier 1 capital ratio (%)	10.1	9.3	9.1	9.2	9.3
Total capital ratio (%)	13.3	12.3	11.9	11.9	11.7

Per share

Reported EPS (INR)	106.05	105.44	116.72	145.02	165.53
Norm EPS (INR)	106.05	105.44	116.72	145.02	165.53
FD norm EPS (INR)	106.05	105.44	116.72	145.02	165.53
DPS (INR)	25.16	25.16	27.85	36.05	42.81
PPOP PS (INR)	212.99	215.73	250.46	292.81	330.30
BVPS (INR)	730.51	811.12	899.99	1,012.98	1,139.09
ABVPS (INR)	687.32	752.52	838.57	948.59	1,080.33
NTAPS (INR)	730.51	811.12	899.99	1,012.98	1,139.09

Valuations and ratios

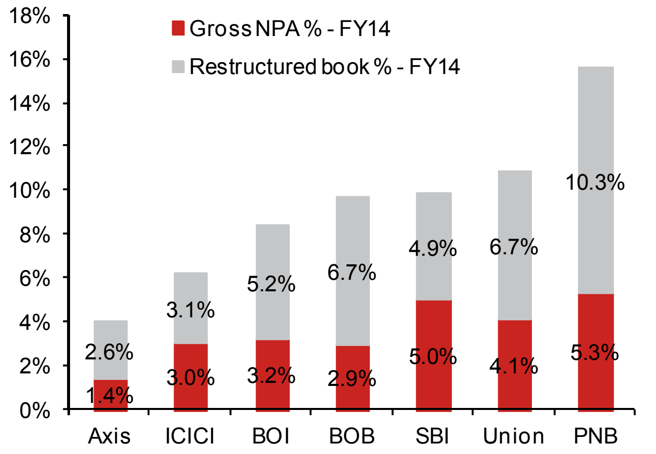
Reported P/E (x)	8.3	8.3	7.5	6.0	5.3
Normalised P/E (x)	8.3	8.3	7.5	6.0	5.3
FD normalised P/E (x)	8.3	8.3	7.5	6.0	5.3
Dividend yield (%)	2.9	2.9	3.2	4.1	4.9
Price/book (x)	1.2	1.1	1.0	0.9	0.8
Price/adjusted book (x)	1.3	1.2	1.0	0.9	0.8
Net interest margin (%)	3.05	2.55	2.59	2.73	2.74
Yield on assets (%)	9.47	8.31	8.22	8.28	8.21
Cost of int bearing liab (%)	5.25	4.88	4.82	4.69	4.64
Net interest spread (%)	4.22	3.43	3.40	3.59	3.58
Non-interest income (%)	24.3	27.2	24.7	24.0	23.4
Cost to income (%)	39.8	43.4	43.0	41.3	40.6
Effective tax rate (%)	7.3	17.4	24.0	26.0	28.0
Dividend payout (%)	23.7	23.9	23.9	24.9	25.9
ROE (%)	15.7	13.8	13.6	15.5	15.7
ROA (%)	0.90	0.75	0.72	0.81	0.83
Operating ROE (%)	16.9	16.7	18.0	20.9	21.8
Operating ROA (%)	0.97	0.91	0.94	1.10	1.15

Source: Company data, Nomura estimates

Asset quality and better underwriting provide some comfort from impending transition

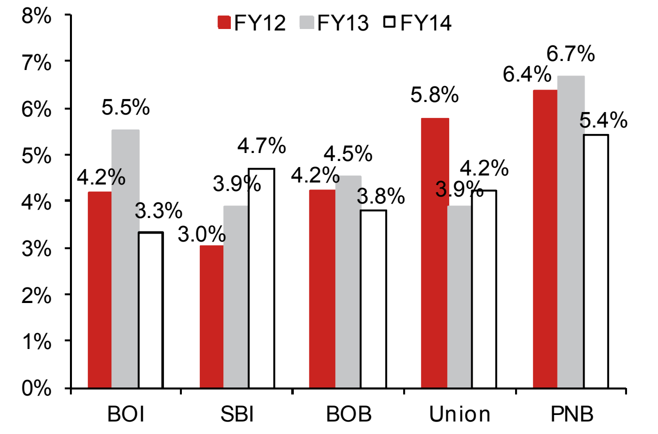
BOBs incremental stress accretion, over the past three years, has been the least, leading to a stressed asset book of 8.5% of loans vs. +10% of loans for peers. While exposure quantum to stressed assets is largely similar, we attribute the better asset quality performance largely to difference in asset selection. Our analysis of +INR4tn of risky large corporate and SPV assets corroborates this view with BOB's exposures to these assets being lowest among PSUs and, more importantly, less concentrated. This provides us comfort on BOB's asset quality and reduces the likelihood of large negative surprises on asset quality.

Fig. 186: Gross NPA + restructured book is the lowest



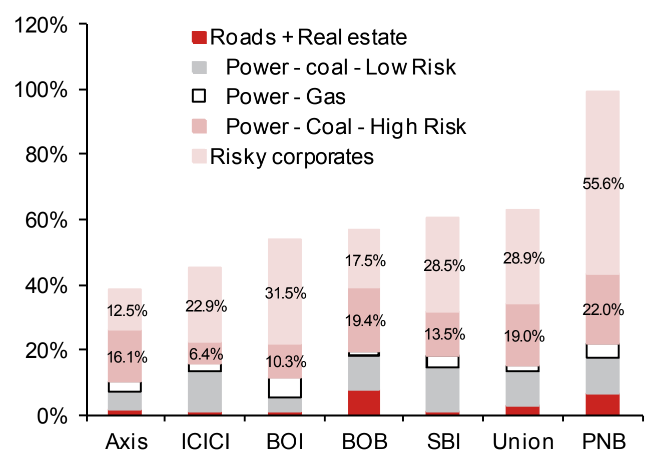
Source: Company data, Nomura research

Fig. 187: Flow of stressed asset also lowest in past three years



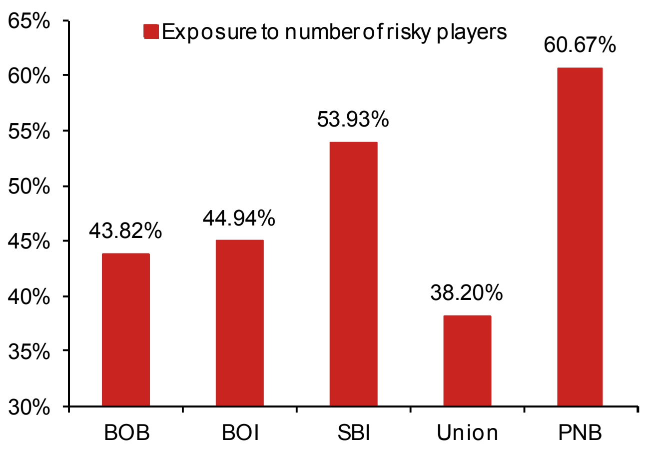
Source: Company data, Nomura research

Fig. 188: Exposure to stressed sectors similar to peers



Source: Ministry of corporate affairs, media sources, Nomura research

Fig. 189: But exposure to risky names lower – Indicates better underwriting/asset selection

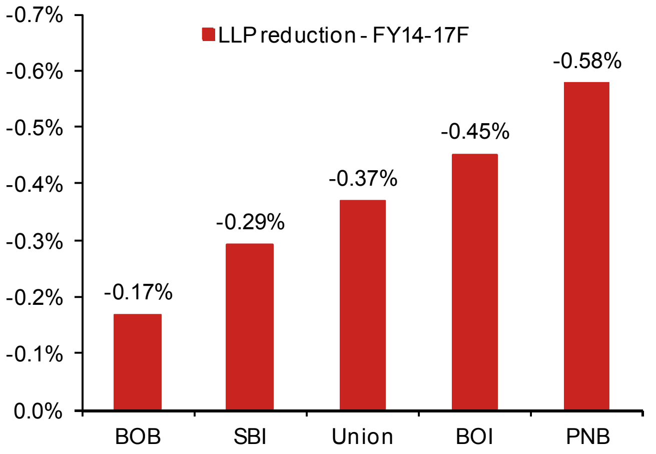


Source: Ministry of corporate affairs, media sources, Nomura research

How much would BOB benefit in an upcycle?

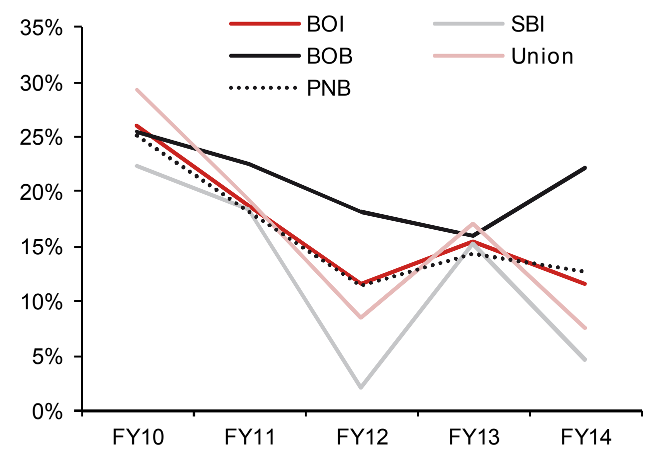
From an asset quality perspective, BOBs improvement should be lower than peers (we estimate a 20-30bp drop in credit costs over the next two years vs. 40-50bp for peers), given the low base of stressed assets but we believe growth over the next two years and margins improvement could be better. **(1)** BOB's domestic margin contraction has been highest among PSUs despite its lower interest reversals / NPA impact and that indicates that BOB has reduced its riskiness in its asset book and hence there is a higher scope for margins to move up **(2)** Also, BOBs Tier-1 capital of +9% is the highest among PSU banks and hence BOB is unlikely to have any growth constraints in case of an up cycle.

Fig. 190: Credit cost reduction expected in next 2-3 yrs



Source: Company data, Nomura estimates

Fig. 191: BOB's CASA growth has been better than peers in the past five years



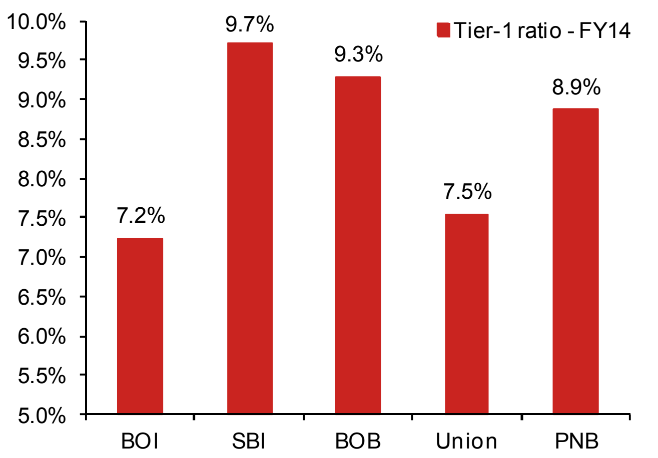
Source: Company data, Nomura research

Fig. 192: Margin contraction in past three years has been highest despite lower NPAs – Scope for improvement in upcycle

	Change from FY11	Change from FY09	Change from Average
BOB	-0.85%	-0.34%	-0.39%
BOI	-0.46%	-0.53%	-0.17%
SBI	-0.14%	0.39%	0.01%
Union	-0.60%	-0.46%	-0.31%
PNB	-0.39%	-0.04%	-0.10%

Source: Company data, Nomura research

Fig. 193: CET-1 levels best among peers – We see limited growth concerns for BOB in case of an upcycle



Source: Company data, Nomura research

Valuation: Underperformance adequately factors in transition risk

Our TP of INR1,025 implies 1.1x Mar-16 book based on our normalised ROE assumption of 15.5% and is 15% higher than our target multiple for PNB given the lower asset quality risk/better under writing. While an impending transition will remain a concern till transition, the recent underperformance and better historical underwriting provide us some comfort.

Risks: (1) Any near-term asset quality volatility due to a transition, and (2) slower-than-expected pick-up in economic activity.

Fig. 194: ROEs for BOB will improve to +15.5% (higher than Cost of Equity)

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	2.53%	2.60%	2.41%	2.83%	2.63%	2.33%	2.03%	2.08%	2.17%	2.18%
Fees/Assets	0.98%	0.94%	0.85%	0.76%	0.72%	0.62%	0.63%	0.59%	0.60%	0.59%
Investment profits/Assets	0.34%	0.46%	0.29%	0.14%	0.15%	0.13%	0.13%	0.09%	0.09%	0.08%
Net revenues/Assets	**3.85%**	**4.01%**	**3.55%**	**3.74%**	**3.50%**	**3.08%**	**2.79%**	**2.76%**	**2.85%**	**2.84%**
Operating Expense/Assets	-1.89%	-1.82%	-1.55%	-1.49%	-1.31%	-1.23%	-1.21%	-1.19%	-1.18%	-1.16%
Provisions/Assets	-0.53%	-0.49%	-0.28%	-0.43%	-0.65%	-0.86%	-0.64%	-0.61%	-0.55%	-0.51%
Taxes/Assets	-0.50%	-0.57%	-0.48%	-0.45%	-0.26%	-0.07%	-0.16%	-0.23%	-0.29%	-0.33%
Total Costs/Assets	**-2.92%**	**-2.87%**	**-2.31%**	**-2.37%**	**-2.23%**	**-2.16%**	**-2.02%**	**-2.03%**	**-2.02%**	**-2.00%**
ROA	**0.93%**	**1.13%**	**1.24%**	**1.36%**	**1.28%**	**0.92%**	**0.77%**	**0.73%**	**0.83%**	**0.85%**
Equity/Assets	5.91%	5.37%	5.13%	5.40%	5.87%	5.90%	5.58%	5.37%	5.36%	5.40%
ROE	**15.7%**	**21.1%**	**24.2%**	**25.3%**	**21.7%**	**15.7%**	**13.8%**	**13.6%**	**15.5%**	**15.7%**
RORWA	**1.35%**	**1.78%**	**2.12%**	**2.32%**	**2.16%**	**1.60%**	**1.37%**	**1.30%**	**1.47%**	**1.49%**

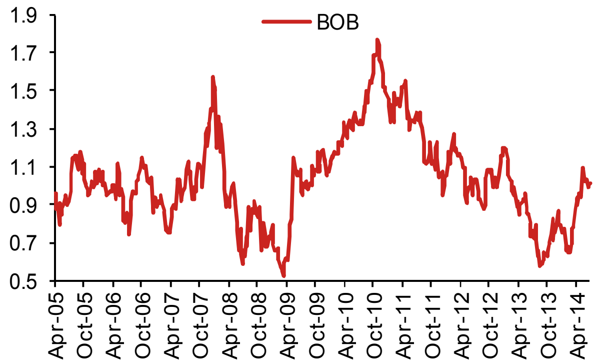
Source: Company data, Nomura estimates

Fig. 195: TP of INR1,025

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.20
Cost of Equity	15.2%
Terminal growth	5.0%
Stage 2 growth	14.0%
Normalised ROE	15.0%
March-15 PT	1025
Implied Mar-16 P/B	1.08
Implied Mar-16 P/E	7.07

Source: Nomura estimates

Fig. 196: Valuations reasonable now after the underperformance



Source: Company data, Bloomberg, Nomura estimates

NOMURA

Bank of India BOI.BO BOI IN

EQUITY: FINANCIALS

An intended consolidation will help!

Valuations reasonable but will need to step off the growth pedal

Action: NPA accretion in line with peers; Capital + Pensions to be sorted

We initiate coverage of Bank of India (BOI) with a Buy rating and TP of INR330. While NPA spelldowns and higher reductions from restructuring make BOI's stressed asset comparison difficult with peers, incremental NPAs+ restructuring flow has been similar to better-valued peers, and historic underwriting in large corporates/infra SPVs has not been the most aggressive. Valuations at 0.7x Mar-16F book look reasonable in that context but a moderation in management's growth outlook would help.

- BOI's capital position remains worst among our covered PSUs (CET-1 of <7%), and we remain surprised with management's higher-than-system growth strategy (28%/21% loan/RWA growth in FY14 - Our interactions don't suggest an intended consolidation in FY15 either and this adds to dilution risk. We already assume ~40% dilution for BOI over FY14-17F.
- Our analysis shows that BOI is underprovided on pensions and its P&L provisioning will need to catch up with peers like it did for BOB in FY14.

Catalysts: B/S consolidation for 12-18 months should help improve capital position and help consolidate asset quality and liabilities as well - We would also get more constructive if mgmt slows down on growth

Valuations: Scope to move up if growth is more aligned to capital levels

Our TP of INR330 is based on 0.8x Mar-16F book which is marginally lower than our target multiple for Union (targeting slower growth) and at a 15-25% discount to PNB/BOB, factoring in lower normalised ROEs (13.5% vs. 15-16% for PNB/BOB) and capital raising challenges expected. While asset quality and some dilution-linked NIM improvement should move up ROAs from 0.55% in FY14 to +0.70% in FY16/17F, ROEs will remain constrained at 13.5% due to lower leverage; an intended consolidation could push up valuations though.

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	84,229		96,995		111,861		132,436
Reported net profit (mn)	27,292		34,190		44,070		57,763
Normalised net profit (mn)	27,292		34,190		44,070		57,763
FD normalised EPS	42.45		46.02		53.02		63.46
FD norm. EPS growth (%)	-7.9		8.4		15.2		19.7
FD normalised P/E (x)	7.2	N/A	6.6	N/A	5.7	N/A	4.8
Price/adj. book (x)	0.9	N/A	0.8	N/A	0.7	N/A	0.6
Price/book (x)	0.7	N/A	0.7	N/A	0.6	N/A	0.6
Dividend yield (%)	1.9	N/A	2.2	N/A	2.4	N/A	2.7
ROE (%)	11.2		11.7		12.4		13.5
ROA (%)	0.5		0.6		0.6		0.7

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating Starts at	**Buy**
Target price Starts at	INR 330
Closing price 3 July 2014	INR 304
Potential upside	+8.6%

Anchor themes

ROAs are likely to pick up but ROEs appear constrained due to capital calls.

Nomura vs consensus

Our FY15F earnings estimates are in line, but FY16F numbers are higher than consensus as we assume dilution.

Research analysts

India Banks

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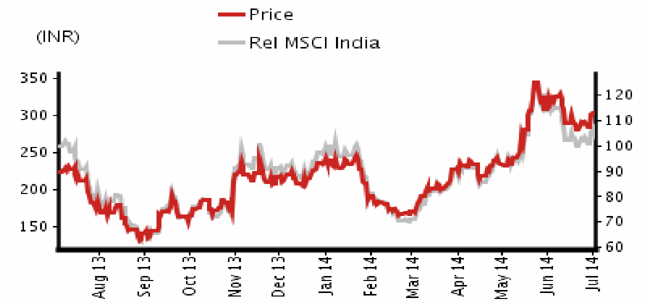
Key data on Bank of India

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	-4.4	30.9	37.9	M cap (USDmn)	3,264.9
Absolute (USD)	-5.2	31.9	39.0	Free float (%)	90.3
Rel to MSCI India	-6.2	20.2	11.0	3-mth ADT (USDmn)	3.7

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	319,089	379,101	459,900	514,457	584,557
Interest expense	-228,849	-270,796	-328,288	-362,132	-406,116
Net interest income	90,240	108,305	131,612	152,325	178,441
Net fees and commissions	13,078	14,708	16,767	19,282	22,174
Trading related profits	4,471	7,960	7,000	6,000	6,000
Other operating revenue	20,112	20,250	21,246	23,776	26,619
Non-interest income	37,660	42,918	45,013	49,058	54,794
Operating income	127,900	151,223	176,624	201,383	233,235
Depreciation	-1,839	-2,129	-2,342	-2,482	-2,631
Amortisation					
Operating expenses	-20,171	-24,954	-28,698	-33,002	-37,952
Employee share expense	-31,305	-39,912	-48,590	-54,037	-60,215
Pre-provision op profit	74,585	84,229	96,995	111,861	132,436
Provisions for bad debt	-43,741	-48,053	-49,510	-50,652	-52,209
Other provision charges	-766	-726	0	0	0
Operating profit	30,077	35,450	47,486	61,209	80,227
Other non-op income					
Associates & JCEs					
Pre-tax profit	30,077	35,450	47,486	61,209	80,227
Income tax	-2,584	-8,158	-13,296	-17,138	-22,464
Net profit after tax	27,493	27,292	34,190	44,070	57,763
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	27,493	27,292	34,190	44,070	57,763
Extraordinary items	0	0	0	0	0
Reported NPAT	27,493	27,292	34,190	44,070	57,763
Dividends	-6,981	-3,762	-4,999	-6,151	-7,409
Transfer to reserves	20,513	23,531	29,191	37,919	50,354

Growth (%)

Net interest income	8.5	20.0	21.5	15.7	17.1
Non-interest income	13.4	14.0	4.9	9.0	11.7
Non-interest expenses	17.2	23.7	15.0	15.0	15.0
Pre-provision earnings	11.4	12.9	15.2	15.3	18.4
Net profit	2.7	-0.7	25.3	28.9	31.1
Normalised EPS	-1.1	-7.9	8.4	15.2	19.7
Normalised FDEPS	-1.1	-7.9	8.4	15.2	19.7
Loan growth	16.3	28.1	13.0	15.0	16.0
Interest earning assets	20.1	27.5	12.7	14.9	16.0
Interest bearing liabilities	19.1	25.9	11.4	14.0	15.3
Asset growth	17.8	26.1	11.9	14.4	15.6
Deposit growth	20.0	24.9	11.2	14.1	15.5

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	202,099	190,734	210,355	239,383	276,762
Inter-bank lending					
Deposits with central bank					
Total securities	346,260	423,089	466,610	531,001	613,915
Other int earning assets					
Gross loans	2,921,854	3,751,849	4,253,116	4,901,102	5,691,959
Less provisions	-28,179	-44,514	-63,827	-83,419	-103,447
Net loans	2,893,675	3,707,335	4,189,289	4,817,682	5,588,512
Long-term investments	946,134	1,141,524	1,251,017	1,411,393	1,617,168
Fixed assets	16,880	20,441	21,441	22,441	23,442
Goodwill					
Other intangible assets					
Other non IEAs	109,158	211,359	233,100	265,268	306,688
Total assets	4,514,206	5,694,482	6,371,812	7,287,168	8,426,486
Customer deposits	3,818,396	4,769,741	5,303,676	6,049,211	6,988,426
Bank deposits, CDs,	291,142	392,978	438,650	490,184	548,268
Other int bearing liabilities	62,534	91,297	111,451	134,628	161,282
Total int bearing liabilities	4,172,072	5,254,016	5,853,776	6,674,024	7,697,977
Non-int bearing liabilities	114,774	178,656	197,033	224,223	259,235
Total liabilities	4,286,846	5,432,671	6,050,810	6,898,247	7,957,211
Minority interest					
Common stock	5,966	6,430	7,430	8,312	9,102
Preferred stock					
Retained earnings	221,394	255,381	313,572	380,609	460,173
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	227,360	261,811	321,002	388,921	469,275
Total liabilities and equity	4,514,206	5,694,482	6,371,812	7,287,168	8,426,486
Non-perf assets	87,653	118,203	151,969	177,488	206,894

Balance sheet ratios (%)

Loans to deposits	76.5	78.7	80.2	81.0	81.4
Equity to assets	5.0	4.6	5.0	5.3	5.6

Asset quality & capital

NPAs/gross loans (%)	3.0	3.2	3.6	3.6	3.6
Bad debt charge/gross	1.50	1.28	1.16	1.03	0.92
Loss reserves/assets (%)	0.62	0.78	1.00	1.14	1.23
Loss reserves/NPAs (%)	32.1	37.7	42.0	47.0	50.0
Tier 1 capital ratio (%)	8.2	7.2	8.4	8.8	9.2
Total capital ratio (%)	11.0	10.0	11.1	11.4	11.5

Per share

Reported EPS (INR)	46.08	42.45	46.02	53.02	63.46
Norm EPS (INR)	46.08	42.45	46.02	53.02	63.46
FD norm EPS (INR)	46.08	42.45	46.02	53.02	63.46
DPS (INR)	11.70	5.85	6.73	7.40	8.14
PPOP PS (INR)	125.01	130.99	130.55	134.57	145.50
BVPS (INR)	381.07	407.17	432.04	467.88	515.58
ABVPS (INR)	326.00	347.90	375.62	419.61	470.95
NTAPS (INR)	381.07	407.17	432.04	467.88	515.58

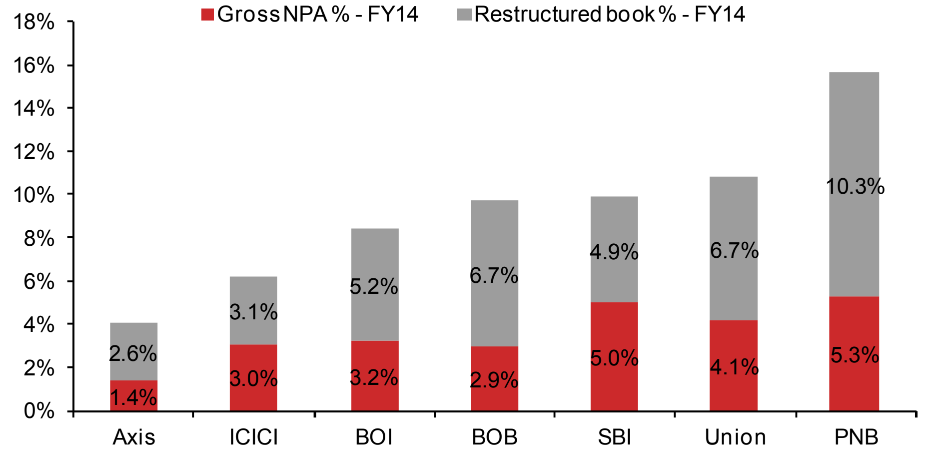
Valuations and ratios

Reported P/E (x)	6.6	7.2	6.6	5.7	4.8
Normalised P/E (x)	6.6	7.2	6.6	5.7	4.8
FD normalised P/E (x)	6.6	7.2	6.6	5.7	4.8
Dividend yield (%)	3.8	1.9	2.2	2.4	2.7
Price/book (x)	0.8	0.7	0.7	0.6	0.6
Price/adjusted book (x)	0.9	0.9	0.8	0.7	0.6
Net interest margin (%)	3.04	2.94	3.00	3.05	3.09
Yield on assets (%)	10.75	10.29	10.47	10.28	10.12
Cost of int bearing liab (%)	5.96	5.75	5.91	5.78	5.65
Net interest spread (%)	4.79	4.54	4.56	4.50	4.47
Non-interest income (%)	29.4	28.4	25.5	24.4	23.5
Cost to income (%)	41.7	44.3	45.1	44.5	43.2
Effective tax rate (%)	8.6	23.0	28.0	28.0	28.0
Dividend payout (%)	25.4	13.8	14.6	14.0	12.8
ROE (%)	12.9	11.2	11.7	12.4	13.5
ROA (%)	0.66	0.53	0.57	0.65	0.74
Operating ROE (%)	14.2	14.5	16.3	17.2	18.7
Operating ROA (%)	0.72	0.69	0.79	0.90	1.02

Source: Company data, Nomura estimates

Stressed assets levels not strictly comparable, but past 2-3 years' incremental stress accretion is similar to peers

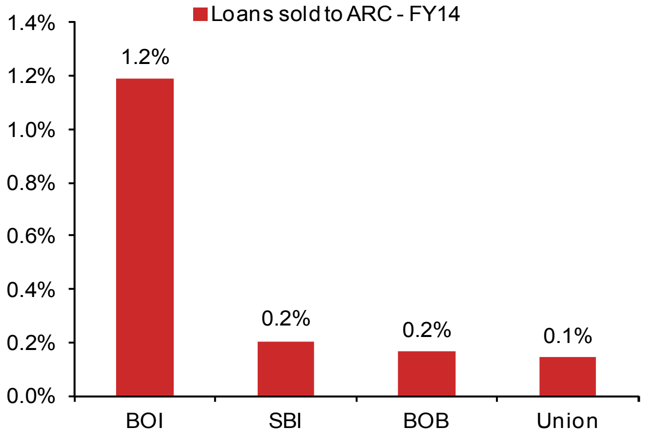
Fig. 197: Stock of NPAs + Restructuring is better than peers on a reported basis but as we explain below these numbers are not comparable



Source: Company data, Nomura research

Fig. 198: Because of aggressive selldowns to ARCs…

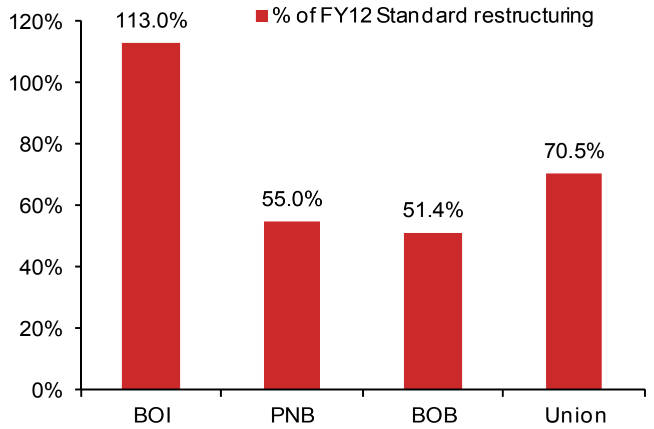
(Selldowns to ARC - % of loans)



Source: Company data, Nomura estimates

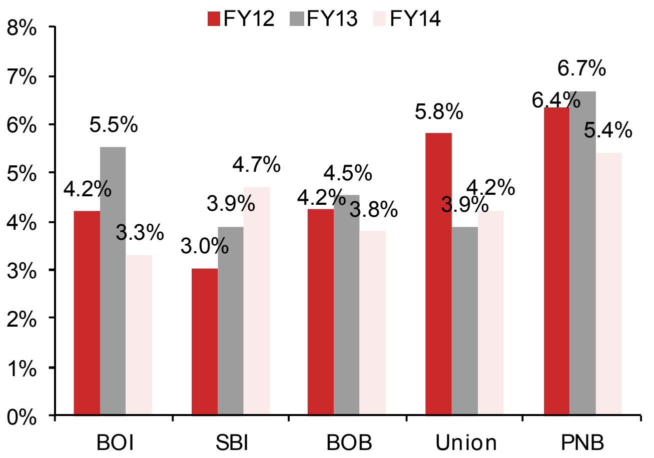
Fig. 199: …and also due to higher restructuring reductions

Possibly BOI's accounting is more lenient than peers



Source: Company data, Nomura estimates

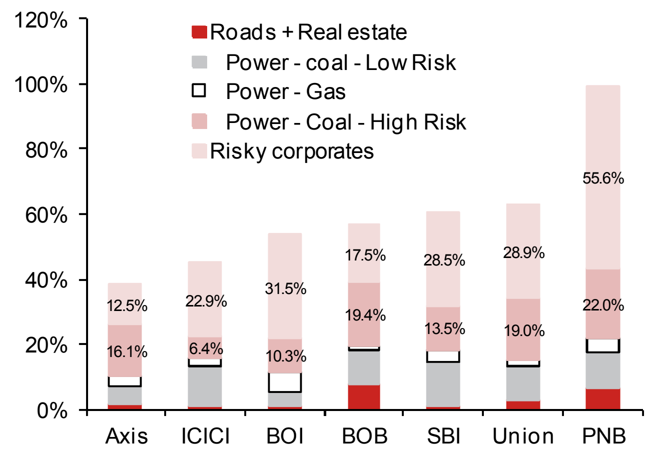
Fig. 200: Incremental flow of NPAs + restructuring has been comparable to peers



Source: Company data, Nomura research

Fig. 201: Large corporate/infra SPV underwriting looks less aggressive

Exposure to INR4tn of risky assets - % of net worth

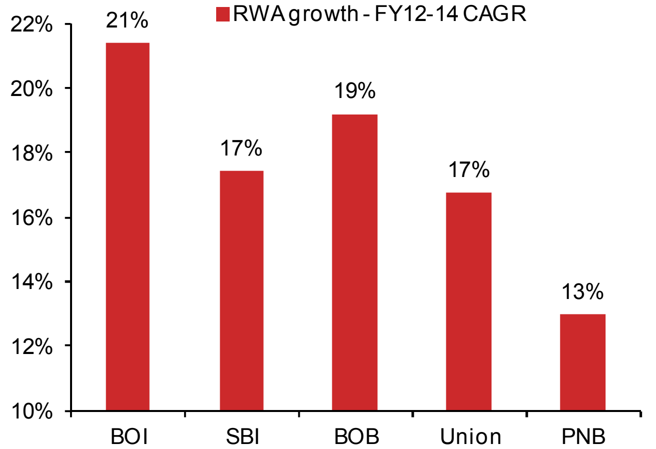


Source: Ministry of Corporate Affairs, media sources, Nomura estimates

Serious consolidation required to soften capital challenges; pensions under-provided on a relative basis

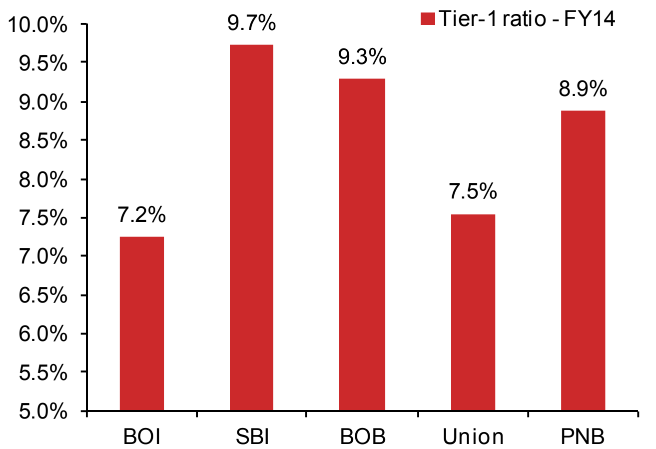
Fig. 202: Growing aggressively over the past two years…

BOI's RWA growth has been highest



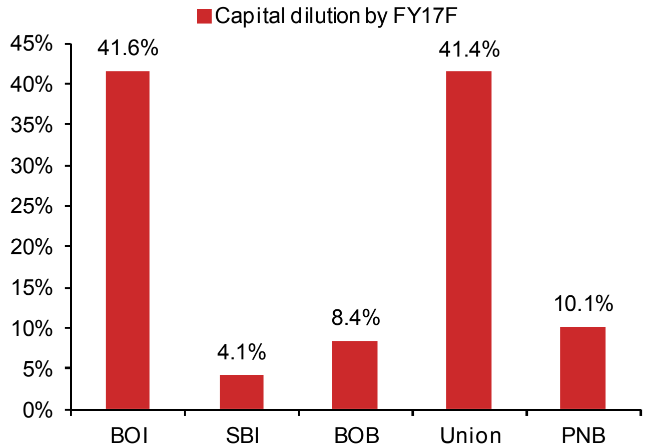
Source: Company data, Nomura research

Fig. 203: …in spite of being the most capital-challenged



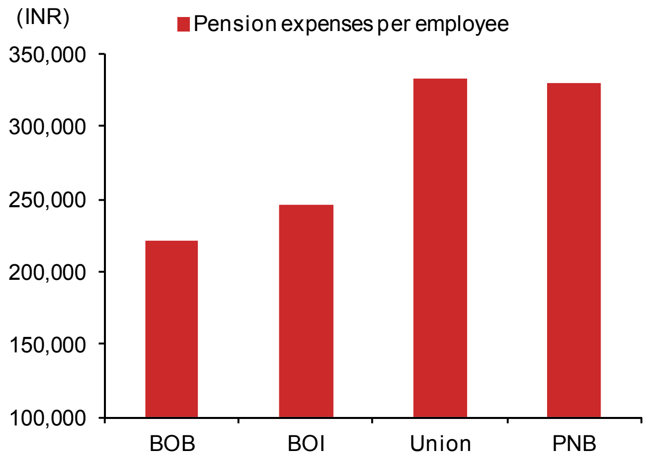
Source: Company data, Nomura research

Fig. 204: We assume large dilutions to get to Tier-1 of +9% by FY17F



Source: Company data, Nomura estimates

Fig. 205: P&L provisioning for pensions worse off than peers



Source: Company data, Nomura estimates

Valuations: Scope to move up if growth is more aligned to capital levels

Our TP of INR330 is based on 0.8x Mar-16F book which is marginally lower than our target multiple for Union Bank (targeting slower growth) and at a 15-25% discount to PNB/BOB factoring in lower normalised ROEs (13.5% vs. 15-16% for PNB/BOB) and expected capital raising challenges. While asset quality and some dilution-linked NIM improvement should move up ROAs from 0.55% in FY14 to +0.70% in FY16/17F, ROEs will remain constrained at 13.5% due to lower leverage; an intended consolidation could push up valuations though.

Downside risk: 1) Continued aggression on growth by management.

Fig. 206: ROEs to improve but still remain sub-optimal vs. Cost of Equity despite NIM/credit cost improvement

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	2.72%	2.82%	2.38%	2.78%	2.42%	2.23%	2.20%	2.27%	2.32%	2.36%
Fees/Assets	1.13%	1.18%	0.84%	0.83%	0.85%	0.82%	0.71%	0.66%	0.66%	0.65%
Investment profits/Assets	0.24%	0.38%	0.25%	0.11%	0.12%	0.11%	0.16%	0.12%	0.09%	0.08%
Net revenues/Assets	**4.08%**	**4.38%**	**3.46%**	**3.72%**	**3.39%**	**3.16%**	**3.07%**	**3.05%**	**3.07%**	**3.09%**
Operating Expense/Assets	-1.70%	-1.59%	-1.52%	-1.81%	-1.44%	-1.32%	-1.36%	-1.38%	-1.36%	-1.34%
Provisions/Assets	-0.65%	-0.66%	-0.91%	-0.67%	-0.91%	-1.10%	-0.99%	-0.86%	-0.77%	-0.69%
Taxes/Assets	-0.43%	-0.59%	-0.31%	-0.36%	-0.26%	-0.06%	-0.17%	-0.23%	-0.26%	-0.30%
Total Costs/Assets	**-2.79%**	**-2.84%**	**-2.74%**	**-2.84%**	**-2.61%**	**-2.48%**	**-2.52%**	**-2.46%**	**-2.40%**	**-2.32%**
RoA	**1.29%**	**1.54%**	**0.72%**	**0.89%**	**0.78%**	**0.68%**	**0.55%**	**0.59%**	**0.67%**	**0.77%**
Equity/Assets	4.69%	5.28%	5.08%	5.13%	5.20%	5.25%	4.97%	5.03%	5.41%	5.68%
RoE	**27.6%**	**29.2%**	**14.2%**	**17.3%**	**15.0%**	**12.9%**	**11.2%**	**11.7%**	**12.4%**	**13.5%**
RORWA	**1.90%**	**2.29%**	**1.15%**	**1.36%**	**1.22%**	**1.05%**	**0.86%**	**0.93%**	**1.05%**	**1.19%**

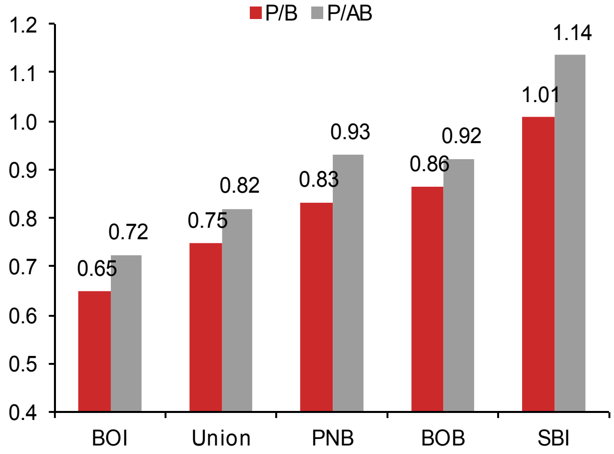
Source: Company data, Nomura estimates

Fig. 207: Out TP of INR330

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.25
Cost of Equity	15.5%
Terminal grow th	5.0%
Stage 2 grow th	14.0%
Normalised ROEs	13.3%
Mar-15 PT	330
Implied Mar-16 P/B	0.79
Implied Mar-16 P/E	6.22

Source: Nomura estimates

Fig. 208: Valuations appear reasonable on a relative basis



Source: Nomura estimates

NOMURA

Punjab National Bank PNBK.NS PNB IN

EQUITY: BANKS

Significant exposure to tail risks

Gradual recovery does not warrant exposure to the most aggressive underwriter

Action: Recovery to help, but tail risks remain; Reduce

We assume coverage of PNB with a Reduce rating and INR925 target price. PNB's stressed assets (gross NPAs + restructuring) are the highest of the large PSUs, but this does not make PNB an ideal recovery play, in our view:

- We expect only a gradual recovery in asset quality, as in this cycle the stressed assets have longer gestation periods than in the last. Hence, PNB's credit costs will continue to be higher than peers'.
- PNB's restructured book, at ~10% of loans, is one of the highest among PSUs. Our analysis indicates that relapse risk from system restructuring is very high, as over 50% of CDR cases continue to have weak interest coverage. Within our universe, we expect PNB to be the most affected.
- While PNB's profitability should be comparable to BOB/SBI over FY15-17F factoring in a recovery, we do not see merit in assigning the same multiple to a more aggressive underwriter. Our analysis shows that PNB's participation and concentration in risky large corporate loans/infra SPVs exposure is the highest.
- **Positives:** 1) high CASA bank, though growth in CASA has been weaker than peers; 2) relatively better provided on pensions; and 3) slower balance sheet growth in the past 18-24 months has aided consolidation of liabilities.

Catalysts: Delinquencies to remain higher than peers. Risks of relapse in restructured book to play out in the near term.

Valuations – Not worth the risk after the mean reversion in valuations

Our INR925 TP is based on 0.8x Mar-16F book (0.9x Mar-16F adjusted book) and implies a discount of 15% to our valuation multiple for BOB (better asset quality and higher ROEs). Recent share price outperformance has narrowed PNB's valuation discount to peers significantly (from 30-40% to 10-20%) and hence at current valuations we prefer SBI/BOB among the PSUs.

Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	113,845		123,401		141,115		164,375
Reported net profit (mn)	33,425		44,292		59,911		74,022
Normalised net profit (mn)	33,425		44,292		59,911		74,022
FD normalised EPS	92.32		117.34		154.99		185.62
FD norm. EPS growth (%)	-31.3		27.1		32.1		19.8
FD normalised P/E (x)	10.7	N/A	8.4	N/A	6.4	N/A	5.3
Price/adj. book (x)	1.2	N/A	1.1	N/A	0.9	N/A	0.8
Price/book (x)	1.0	N/A	0.9	N/A	0.8	N/A	0.7
Dividend yield (%)	1.2	N/A	1.6	N/A	2.1	N/A	2.6
ROE (%)	10.2		11.9		14.0		14.8
ROA (%)	0.7		0.8		0.9		1.0

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Reduce**
Target price From N/A	INR 925
Closing price 3 July 2014	INR 991
Potential downside	-6.7%

Anchor themes

Recovery not quick enough to turn positive on the most aggressive underwriter.

Nomura vs consensus

Our FY15/16F PAT assumptions are below consensus as we assume higher credit costs.

Research analysts

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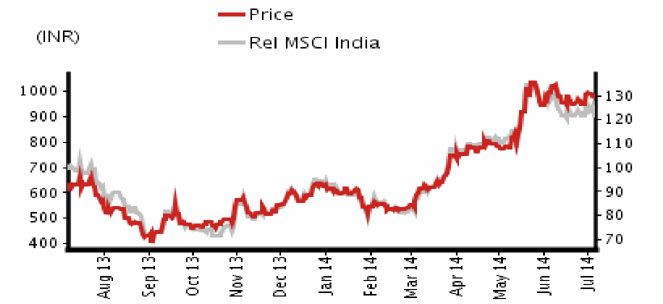
Key data on Punjab National Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	1.9	33.6	59.4	M cap (USDmn)	6,001.6
Absolute (USD)	1.1	34.7	60.7	Free float (%)	90.3
Rel to MSCI India	-2.6	20.1	29.2	3-mth ADT (USDmn)	24.4

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	418,933	432,233	497,979	564,748	644,968
Interest expense	-270,368	-270,773	-319,537	-361,659	-411,931
Net interest income	148,565	161,460	178,443	203,088	233,037
Net fees and commissions	23,543	25,124	28,390	32,649	37,546
Trading related profits	4,866	5,490	5,000	4,000	4,000
Other operating revenue	13,750	15,153	17,317	19,580	22,142
Non-interest income	42,159	45,767	50,707	56,228	63,687
Operating income	190,724	207,227	229,150	259,317	296,724
Depreciation	-3,185	-3,295	-3,295	-3,460	-3,633
Amortisation					
Operating expenses	-21,718	-24,983	-28,980	-33,617	-38,996
Employee share expense	-56,747	-65,105	-73,473	-81,125	-89,721
Pre-provision op profit	109,074	113,845	123,401	141,115	164,375
Provisions for bad debt	-42,106	-58,910	-61,048	-56,843	-60,301
Other provision charges	-1,750	-8,030	-200	-200	-200
Operating profit	65,218	46,905	62,154	84,073	103,874
Other non-op income					
Associates & JCEs					
Pre-tax profit	65,218	46,905	62,154	84,073	103,874
Income tax	-17,741	-13,479	-17,862	-24,162	-29,852
Net profit after tax	47,477	33,425	44,292	59,911	74,022
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	47,477	33,425	44,292	59,911	74,022
Extraordinary items	0	0	0	0	0
Reported NPAT	47,477	33,425	44,292	59,911	74,022
Dividends	-11,166	-4,236	-5,852	-8,106	-10,333
Transfer to reserves	36,311	29,189	38,440	51,805	63,689

Growth (%)

Net interest income	10.8	8.7	10.5	13.8	14.7
Non-interest income	0.3	8.6	10.8	10.9	13.3
Non-interest expenses	9.3	15.0	16.0	16.0	16.0
Pre-provision earnings	2.8	4.4	8.4	14.4	16.5
Net profit	-2.8	-29.6	32.5	35.3	23.6
Normalised EPS	-6.7	-31.3	27.1	32.1	19.8
Normalised FDEPS	-6.7	-31.3	27.1	32.1	19.8
Loan growth	5.1	13.1	13.0	16.0	17.0
Interest earning assets	4.5	16.4	11.1	16.0	17.0
Interest bearing liabilities	3.4	15.8	14.3	15.2	16.2
Asset growth	4.5	15.0	13.5	15.3	16.3
Deposit growth	3.2	15.3	13.7	14.8	15.9

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	159,470	222,456	253,426	291,346	338,135
Inter-bank lending					
Deposits with central bank					
Total securities	111,884	229,729	187,301	215,327	249,907
Other int earning assets					
Gross loans	3,149,545	3,582,322	4,064,430	4,722,808	5,527,069
Less provisions	-62,293	-89,631	-117,689	-144,588	-170,552
Net loans	3,087,252	3,492,691	3,946,741	4,578,220	5,356,517
Long-term investments	1,298,962	1,437,855	1,751,009	1,993,105	2,289,383
Fixed assets	19,288	19,911	20,534	21,156	21,779
Goodwill					
Other intangible assets					
Other non IEAs	97,626	87,271	71,153	81,800	94,937
Total assets	4,774,482	5,489,913	6,230,164	7,180,954	8,350,657
Customer deposits	3,915,601	4,513,970	5,130,598	5,888,329	6,826,757
Bank deposits, CDs,	384,449	466,560	528,191	599,140	680,831
Other int bearing liabilities	11,761	13,784	50,212	92,103	140,279
Total int bearing liabilities	4,311,810	4,994,314	5,709,001	6,579,573	7,647,867
Non-int bearing liabilities	150,191	150,934	123,059	141,473	164,192
Total liabilities	4,462,001	5,145,249	5,832,060	6,721,045	7,812,059
Minority interest					
Common stock	3,535	3,621	3,775	3,865	3,988
Preferred stock					
Retained earnings	308,946	341,044	394,330	456,044	534,610
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	312,481	344,664	398,104	459,909	538,598
Total liabilities and equity	4,774,482	5,489,913	6,230,164	7,180,954	8,350,657
Non-perf assets	134,658	188,808	235,378	278,055	315,837

Balance sheet ratios (%)

Loans to deposits	80.4	79.4	79.2	80.2	81.0
Equity to assets	6.5	6.3	6.4	6.4	6.4

Asset quality & capital

NPAs/gross loans (%)	4.3	5.3	5.8	5.9	5.7
Bad debt charge/gross	1.34	1.64	1.50	1.20	1.09
Loss reserves/assets (%)	1.30	1.63	1.89	2.01	2.04
Loss reserves/NPAs (%)	46.3	47.5	50.0	52.0	54.0
Tier 1 capital ratio (%)	9.8	8.9	9.1	9.1	9.2
Total capital ratio (%)	12.7	11.5	11.5	11.1	10.9

Per share

Reported EPS (INR)	134.31	92.32	117.34	154.99	185.62
Norm EPS (INR)	134.31	92.32	117.34	154.99	185.62
FD norm EPS (INR)	134.31	92.32	117.34	154.99	185.62
DPS (INR)	31.59	11.70	15.50	20.97	25.91
PPOP PS (INR)	308.58	314.43	326.93	365.07	412.18
BVPS (INR)	884.03	951.93	1,054.71	1,189.79	1,350.58
ABVPS (INR)	795.38	837.40	933.60	1,064.28	1,227.77
NTAPS (INR)	884.03	951.93	1,054.71	1,189.79	1,350.58

Valuations and ratios

Reported P/E (x)	7.4	10.7	8.4	6.4	5.3
Normalised P/E (x)	7.4	10.7	8.4	6.4	5.3
FD normalised P/E (x)	7.4	10.7	8.4	6.4	5.3
Dividend yield (%)	3.2	1.2	1.6	2.1	2.6
Price/book (x)	1.1	1.0	0.9	0.8	0.7
Price/adjusted book (x)	1.2	1.2	1.1	0.9	0.8
Net interest margin (%)	4.75	4.67	4.54	4.55	4.48
Yield on assets (%)	13.39	12.49	12.68	12.65	12.40
Cost of int bearing liab (%)	6.38	5.82	5.97	5.89	5.79
Net interest spread (%)	7.01	6.67	6.71	6.77	6.61
Non-interest income (%)	22.1	22.1	22.1	21.7	21.5
Cost to income (%)	42.8	45.1	46.1	45.6	44.6
Effective tax rate (%)	27.2	28.7	28.7	28.7	28.7
Dividend payout (%)	23.5	12.7	13.2	13.5	14.0
ROE (%)	16.5	10.2	11.9	14.0	14.8
ROA (%)	1.02	0.65	0.76	0.89	0.95
Operating ROE (%)	22.6	14.3	16.7	19.6	20.8
Operating ROA (%)	1.40	0.91	1.06	1.25	1.34

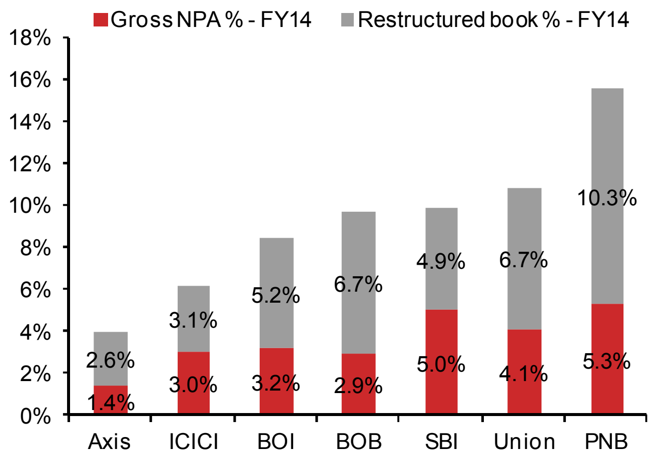
Source: Company data, Nomura estimates

Underwriting was the most aggressive in the last cycle – We assign a discount to PNB vs. PSUs with similar ROEs

PNB's stressed assets at ~15% (gross NPA of 5.25% and a restructured book of 10.5%) are the highest among PSUs because of its adverse selection and higher concentration. While an overall recovery should aid asset quality for all PSUs, we believe investors should assign a lower multiple to PNB even against banks expected to generate similar ROEs.

Aggressive underwriting in the past cycle: In our analysis of bank-wise exposure to INR4trn of risky infrastructure SPV / commercial real estate / large corporate exposure, we found that: (1) PNB's exposure to the stressed assets that we looked at is 60-70% higher than that of the other large PSUs; (2) its presence in these risky assets was the highest, with PNB present in 60% of the risky assets we looked at against average participation levels for peer PSUs at 40%; and (3) concentration risks are higher than they are at SBI/BOB.

Fig. 209: Stressed assets highest among peers



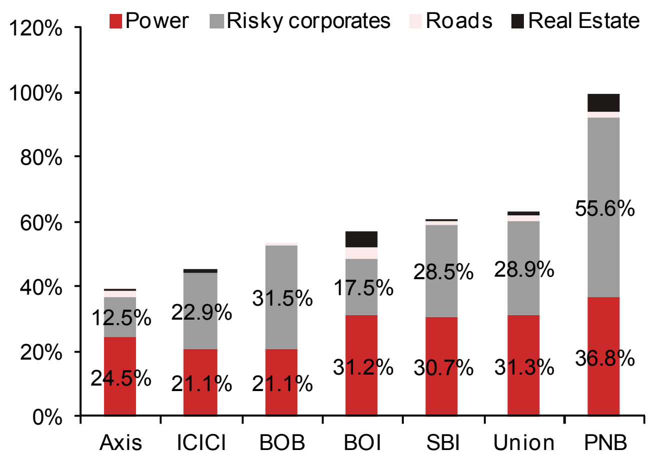
Source: Company data, Nomura research

Fig. 210: Our TP multiples factor in the risks

Company	Normalised ROEs	P/BV implied multiple
Union	13.2%	0.85
BOI	13.3%	0.76
SBI	16.1%	1.28
PNB	14.7%	0.89
BOB	15.5%	1.08

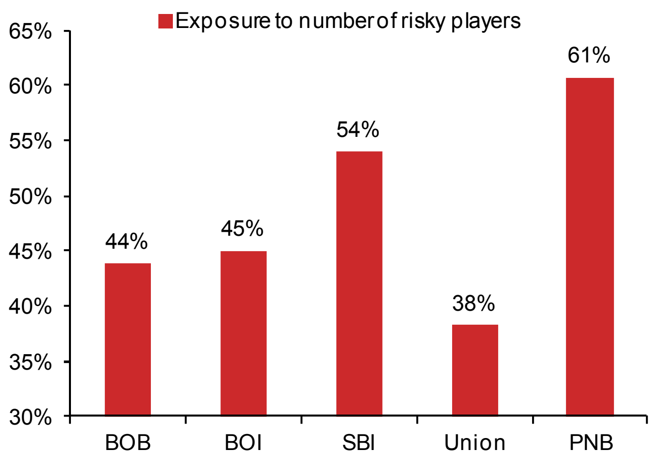
Source: Nomura estimates

Fig. 211: PNB's exposure: 60% higher in INR4trn of risky assets we looked at



Source: Ministry of corporate affairs, Nomura estimates

Fig. 212: PNB's participation highest in the risky assets (Participation = PNB's presence / No. of overall projects)

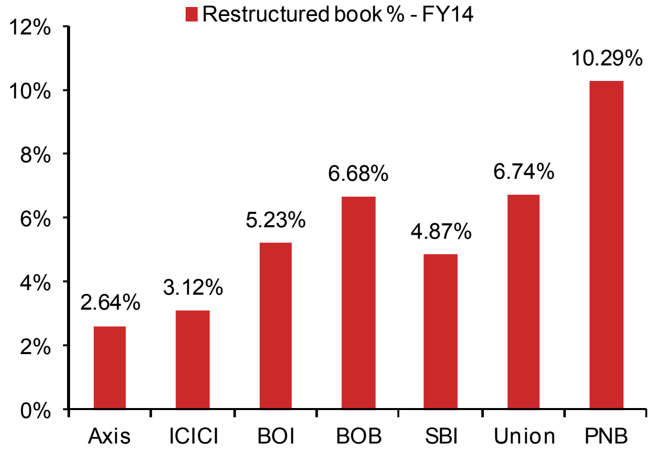


Source: Ministry of corporate affairs, Media sources, Nomura estimates

PNB remains more exposed to one of our key tail risks

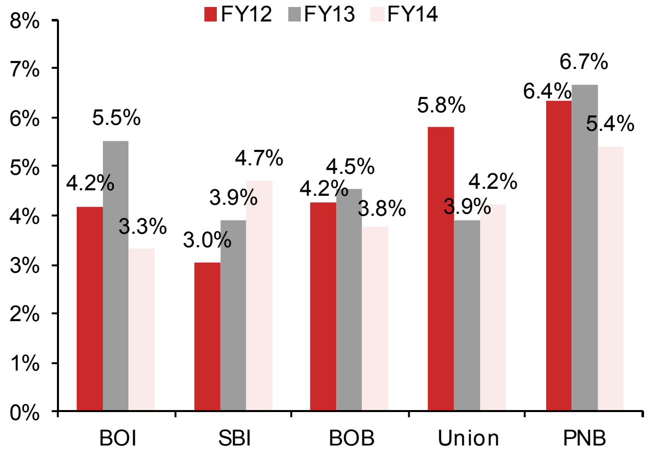
As highlighted earlier in our report, a large part of PNB's restructuring book comes from its principal and interest moratoriums over the next two years. Our analysis of the financial performance of CDR cases indicates that there is a large relapse risk in the restructured book. PNB, on average, has restructured ~4% of its loan book in the past three years and remains the most vulnerable – our discussions with management also indicate possible stress from the restructured book.

Fig. 213: PNB's standard restructured book is the highest



Source: Company data, Nomura research

Fig. 214: Restructuring in last three years is also the highest



Source: Company data, Nomura research

Valuations – Not worth the risk after the mean-reversion in valuations

Our INR925 TP is based on 0.8x Mar-16 book (0.9x Mar-16 adjusted book) and implies a discount of 15% to our valuation multiple for BOB (better asset quality and higher ROEs). The recent outperformance has narrowed PNB's valuation discount to peers significantly (from 30-40% to 10-20%) and hence at current valuations we prefer SBI/BOB among the PSUs. While PNB's ROEs are comparable to BOB/SBI, as we have mentioned above, the same multiple is not warranted given the higher risk inherent in PNB's higher-yield/ higher-credit cost model.

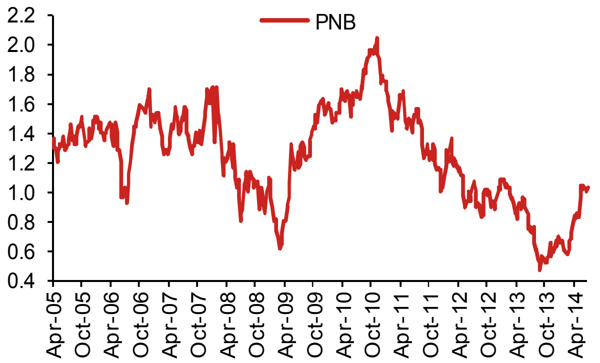
Risks: A larger-than-expected economic recovery, such that even inferior businesses turn around quickly.

Fig. 215: We factor in profitability to improve as asset quality improves

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	3.16%	3.26%	3.23%	3.61%	3.30%	3.26%	3.22%	3.10%	3.07%	3.04%
Fees/Assets	0.89%	1.04%	1.05%	1.01%	0.95%	0.82%	0.80%	0.79%	0.79%	0.78%
Investment profits/Assets	0.25%	0.31%	0.31%	0.09%	0.09%	0.11%	0.11%	0.09%	0.06%	0.05%
Net revenues/Assets	**4.31%**	**4.61%**	**4.58%**	**4.71%**	**4.34%**	**4.19%**	**4.13%**	**3.98%**	**3.92%**	**3.88%**
Operating Expense/Assets	-2.02%	-1.95%	-1.81%	-1.94%	-1.72%	-1.79%	-1.86%	-1.84%	-1.79%	-1.73%
Provisions/Assets	-0.41%	-0.45%	-0.54%	-0.76%	-0.88%	-0.96%	-1.33%	-1.06%	-0.86%	-0.79%
Taxes/Assets	-0.71%	-0.78%	-0.76%	-0.65%	-0.53%	-0.39%	-0.27%	-0.31%	-0.37%	-0.39%
Total Costs/Assets	**-3.14%**	**-3.18%**	**-3.10%**	**-3.36%**	**-3.14%**	**-3.14%**	**-3.46%**	**-3.21%**	**-3.02%**	**-2.91%**
ROA	**1.17%**	**1.43%**	**1.48%**	**1.35%**	**1.20%**	**1.04%**	**0.67%**	**0.77%**	**0.91%**	**0.97%**
Equity/Assets	5.98%	5.54%	5.57%	5.54%	5.71%	6.32%	6.55%	6.45%	6.49%	6.52%
ROE	**19.6%**	**25.8%**	**26.6%**	**24.4%**	**21.1%**	**16.5%**	**10.2%**	**11.9%**	**14.0%**	**14.8%**
RORWA	**1.72%**	**2.19%**	**2.27%**	**2.02%**	**1.81%**	**1.54%**	**0.96%**	**1.12%**	**1.32%**	**1.40%**

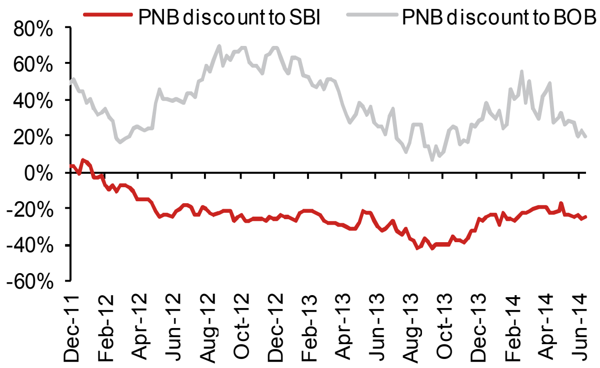
Source: Company data, Nomura estimates

Fig. 216: But valuations have mean-reverted quite a bit…



Source: Company data, Bloomberg, Nomura estimates

Fig. 217: … especially on a relative basis



Source: Company data, Bloomberg, Nomura estimates

Fig. 218: TP of INR925

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.30
Cost of Equity	15.8%
Terminal grow th	5.0%
Stage 2 grow th	13.0%
Normalised ROEs	14.7%
Mar-15 PT	925
Implied Mar-16 P/B	0.87
Implied Mar-16 P/E	5.97

Source: Nomura estimates

NOMURA

State Bank of India SBI.NS SBIN IN

EQUITY: BANKS

Better macro recovery play

Current management inspires some confidence

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 3050
Closing price 3 July 2014	INR 2696
Potential upside	+13.1%

Action: Expect delinquency levels to converge with peers soon

Following transfer of coverage of State Bank of India (SBI), we rate the shares Buy with a TP of INR3,050. SBI's recent trends on incremental net delinquency have been weaker than peers' especially on gross slippages. While mid-corporate NPAs are the highest for SBI (~11% of loans), its underwriting in large corporate/infra SPVs is relatively of better quality vs. PSU peers and hence we expect SBI's delinquency levels to converge with peers' in FY15F. Its liability franchise remains best-in-class among PSUs despite slower growth over the past few years and SBI remains well placed on capital/pensions.

- Our analysis indicates that SBI's large corporate/infra exposure is relatively to better rated corporates and hence the higher-than-peers delinquency seen in mid-corporates is unlikely to repeat in large corporates.
- With pensions being well provided, opex growth over FY14-16F is likely to be lower vs. peers and with a larger mean reversion expected in asset quality, we expect SBI to deliver highest earnings growth in FY14-17F.
- Admittedly, SBI's valuation premium to peers does factor in some of the positives and we are taking a leap of faith with management on delivering better vs. peers in this cycle.

Catalysts: Slippage levels for SBI have been higher than peers over the past eight quarters – We expect a convergence in SBI's slippages vs. peers in 2HFY15 and that will be a strong stock catalyst.

Valuations: Assume coverage with a Buy and TP of INR3,050

Our TP of INR3,050 is based on 1.3x Mar-16F book after deducting for subsidiary value of INR235. We expect SBI's ROEs to inch up to ~15% and hence our valuation multiple (above book), in that context, prices in some premium for its liability franchise and, to some extent, our comfort with current management.

Anchor themes

We expect normalisation of its slippages to peer levels by 1HFY15F. Our comfort with SBI's management is one of the highest among PSUs.

Nomura vs consensus

Our FY15/16F earnings estimates are in line with consensus. We expect SBI's earnings growth to be the highest among peers as asset quality normalises.

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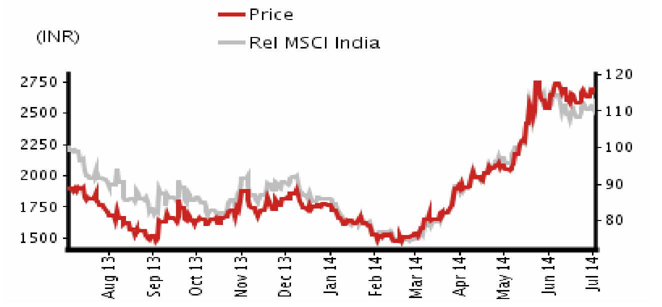
Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	321,092		382,270		443,267		523,545
Reported net profit (mn)	108,912		143,798		179,835		233,904
Normalised net profit (mn)	108,912		143,798		179,835		233,904
FD normalised EPS	145.88		192.61		236.66		300.82
FD norm. EPS growth (%)	-29.3		32.0		22.9		27.1
FD normalised P/E (x)	18.5	N/A	14.0	N/A	11.4	N/A	9.0
Price/adj. book (x)	1.9	N/A	1.7	N/A	1.5	N/A	1.3
Price/book (x)	1.7	N/A	1.6	N/A	1.4	N/A	1.2
Dividend yield (%)	1.3	N/A	1.6	N/A	1.9	N/A	2.3
ROE (%)	10.0		11.6		13.0		14.6
ROA (%)	0.6		0.7		0.8		0.9

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Key data on State Bank of India

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	1.9	42.2	42.0	M cap (USDmn)	33,670.6
Absolute (USD)	1.1	43.3	43.2	Free float (%)	90.3
Rel to MSCI India	-2.6	28.7	11.8	3-mth ADT (USDmn)	107.2

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	1,196,571	1,363,508	1,601,974	1,821,801	2,084,092
Interest expense	-753,258	-870,686	-	-	-
Net interest income	443,313	492,822	561,877	648,084	753,928
Net fees and commissions	121,960	131,107	149,462	171,882	197,664
Trading related profits	11,019	20,767	18,000	16,000	16,000
Other operating revenue	27,369	33,655	38,366	44,121	50,740
Non-interest income	160,348	185,529	205,829	232,003	264,404
Operating income	603,661	678,351	767,705	880,087	1,018,332
Depreciation	-11,396	-10,553	-12,734	-15,970	-18,473
Amortisation					
Operating expenses	-97,639	-121,663	-141,129	-163,710	-189,903
Employee share expense	-183,809	-225,043	-231,572	-257,140	-286,410
Pre-provision op profit	310,817	321,092	382,270	443,267	523,545
Provisions for bad debt	-121,174	-154,843	-167,645	-174,855	-174,433
Other provision charges	9,866	-4,511	0	0	0
Operating profit	199,509	161,739	214,625	268,412	349,112
Other non-op income					
Associates & JCEs					
Pre-tax profit	199,509	161,739	214,625	268,412	349,112
Income tax	-58,459	-52,827	-70,827	-88,577	-115,208
Net profit after tax	141,050	108,912	143,798	179,835	233,904
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	141,050	108,912	143,798	179,835	233,904
Extraordinary items	0	0	0	0	0
Reported NPAT	141,050	108,912	143,798	179,835	233,904
Dividends	-33,213	-26,205	-31,970	-39,049	-47,947
Transfer to reserves	107,837	82,707	111,828	140,787	185,958

Growth (%)

Net interest income	2.4	11.2	14.0	15.3	16.3
Non-interest income	11.7	15.7	10.9	12.7	14.0
Non-interest expenses	20.7	24.6	16.0	16.0	16.0
Pre-provision earnings	-1.6	3.3	19.1	16.0	18.1
Net profit	20.5	-22.8	32.0	25.1	30.1
Normalised EPS	18.2	-29.3	32.0	22.9	27.1
Normalised FDEPS	18.2	-29.3	32.0	22.9	27.1
Loan growth	20.5	15.7	14.5	16.0	17.0
Interest earning assets	20.0	13.7	15.5	15.9	17.0
Interest bearing liabilities	17.2	15.0	15.9	15.4	16.4
Asset growth	17.3	14.4	16.8	15.2	16.4
Deposit growth	15.2	15.9	15.2	15.0	16.5

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	542,782	849,557	917,168	1,053,750	1,226,059
Inter-bank lending					
Deposits with central					
Total securities	605,419	475,940	667,032	766,364	891,679
Other int earning					
Gross loans	10,748,495	12,403,380	14,250,284	16,558,940	19,387,629
Less provisions	-292,329	-305,093	-397,745	-489,995	-586,963
Net loans	10,456,166	12,098,287	13,852,539	16,068,945	18,800,666
Long-term investments	3,509,273	3,983,082	4,793,626	5,426,374	6,222,846
Fixed assets	70,050	80,022	91,987	106,346	123,577
Goodwill					
Other intangible assets					
Other non IEAs	478,920	435,459	610,298	701,181	815,838
Total assets	15,662,610	17,922,346	20,932,649	24,122,960	28,080,665
Customer deposits	12,027,396	13,944,085	16,056,749	18,463,583	21,515,459
Bank deposits, CDs,	1,642,883	1,769,832	2,154,754	2,541,058	2,930,392
Other int bearing	48,944	61,477	75,263	90,428	107,109
Total int bearing	13,719,223	15,775,394	18,286,767	21,095,069	24,552,960
Non-int bearing	954,551	964,130	1,351,232	1,552,453	1,806,310
Total liabilities	14,673,774	16,739,524	19,637,999	22,647,522	26,359,270
Minority interest					
Common stock	6,840	7,466	7,466	7,599	7,776
Preferred stock					
Retained earnings	981,997	1,175,357	1,287,185	1,467,838	1,713,620
Reserves for credit					
Proposed dividends					
Other equity					
Shareholders' equity	988,837	1,182,823	1,294,651	1,475,438	1,721,395
Total liabilities and	15,662,610	17,922,346	20,932,649	24,122,960	28,080,665
Non-perf assets	511,894	616,054	764,894	907,397	1,048,148

Balance sheet ratios

Loans to deposits	89.4	89.0	88.7	89.7	90.1
Equity to assets	6.3	6.6	6.2	6.1	6.1
Asset quality &					
NPAs/gross loans (%)	4.8	5.0	5.4	5.5	5.4
Bad debt charge/gross	1.13	1.25	1.18	1.06	0.90
Loss reserves/assets	1.87	1.70	1.90	2.03	2.09
Loss reserves/NPAs	57.1	49.5	52.0	54.0	56.0
Tier 1 capital ratio (%)	9.5	9.7	9.3	9.3	9.4
Total capital ratio (%)	12.9	12.4	12.0	12.0	12.0
Per share					
Reported EPS (INR)	206.20	145.88	192.61	236.66	300.82
Norm EPS (INR)	206.20	145.88	192.61	236.66	300.82
FD norm EPS (INR)	206.20	145.88	192.61	236.66	300.82
DPS (INR)	48.56	35.10	42.82	51.39	61.66
PPOP PS (INR)	454.39	430.09	512.03	583.32	673.33
BVPS (INR)	1,445.60	1,584.34	1,734.13	1,941.61	2,213.87
ABVPS (INR)	1,351.74	1,419.53	1,554.86	1,756.21	2,030.86
NTAPS (INR)	1,445.60	1,584.34	1,734.13	1,941.61	2,213.87

Valuations and

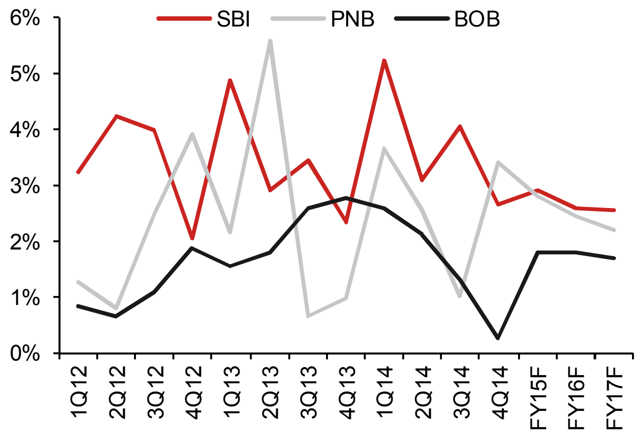
Reported P/E (x)	13.1	18.5	14.0	11.4	9.0
Normalised P/E (x)	13.1	18.5	14.0	11.4	9.0
FD normalised P/E (x)	13.1	18.5	14.0	11.4	9.0
Dividend yield (%)	1.8	1.3	1.6	1.9	2.3
Price/book (x)	1.9	1.7	1.6	1.4	1.2
Price/adjusted book (x)	2.0	1.9	1.7	1.5	1.3
Net interest margin (%)	4.37	4.17	4.15	4.13	4.13
Yield on assets (%)	11.80	11.54	11.83	11.62	11.41
Cost of int bearing liab	5.93	5.90	6.11	5.96	5.83
Net interest spread (%)	5.88	5.63	5.72	5.66	5.58
Non-interest income	26.6	27.4	26.8	26.4	26.0
Cost to income (%)	48.5	52.7	50.2	49.6	48.6
Effective tax rate (%)	29.3	32.7	33.0	33.0	33.0
Dividend payout (%)	23.5	24.1	22.2	21.7	20.5
ROE (%)	15.4	10.0	11.6	13.0	14.6
ROA (%)	0.97	0.65	0.74	0.80	0.90
Operating ROE (%)	21.8	14.9	17.3	19.4	21.8
Operating ROA (%)	1.38	0.96	1.10	1.19	1.34

Source: Company data, Nomura estimates

SBI's slippage levels to converge with peers, better placed on restructuring

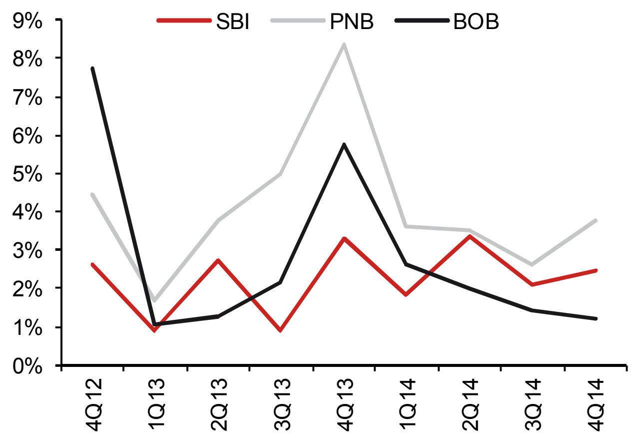
- **Slippage levels to converge with peers:** SBI's slippage levels over the past 2-3 years have been higher than peers', with higher NPAs of mid-corporate and agri loans. This indicates some aggressive underwriting in the mid corporate space by SBI, but we believe that in large corporate/infra SPV lending SBI's underwriting has been relatively better. Our analysis of INR4tn of risky large corporate/infra SPV debt indicates that SBI's exposure to these risky assets is similar to peers but the names are less risky especially in the infra space. We thus believe that SBI's incremental slippage levels are likely to converge with peers' over the next 2-3 quarters and this would be a likely stock trigger.
- **Restructured book lower than peers – SBI has been less aggressive on restructuring:** SBI's restructured book (<5% of loans) is the lowest among peers, in part, due to lower SEB/Air India exposure and also because SBI was less aggressive on restructuring till mid-FY13. As mentioned in our sector report, we are concerned on the performance of accounts restructured over the past 2-3 years, and with a low percentage of the restructured book, relapse risk is lower for SBI on a relative basis.

Fig. 219: SBI slippage levels expected to converge with peers



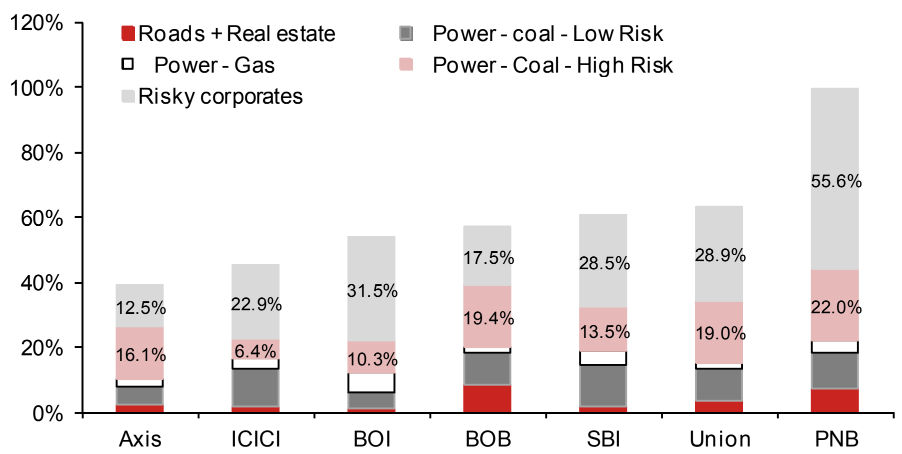
Source: Company data, Nomura estimates

Fig. 220: SBI has been better than peers on restructuring



Source: Company data, Nomura research

Fig. 221: SBI's exposure in quantum to risky assets, we looked at, is similar to peers but exposure to higher risk SPVs is lower

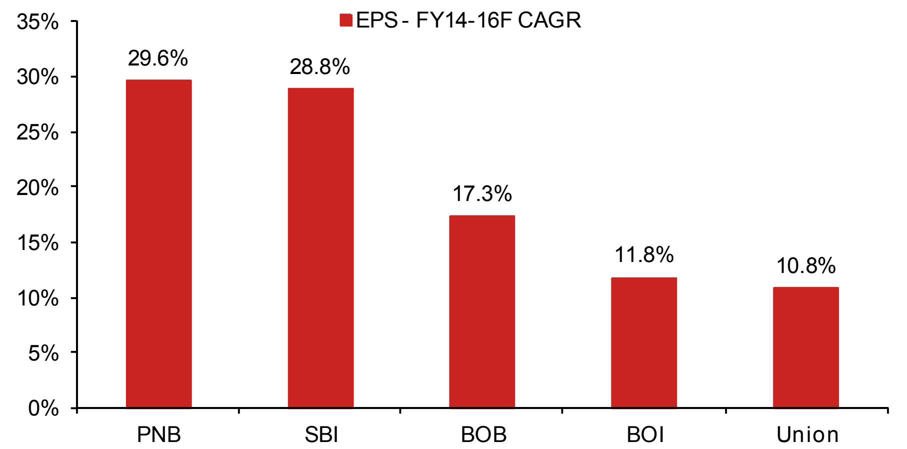


Source: Ministry of corporate affairs, Media sources, Nomura estimates

Operationally, we see some levers from lower opex growth – pensions/capital not a large constraint

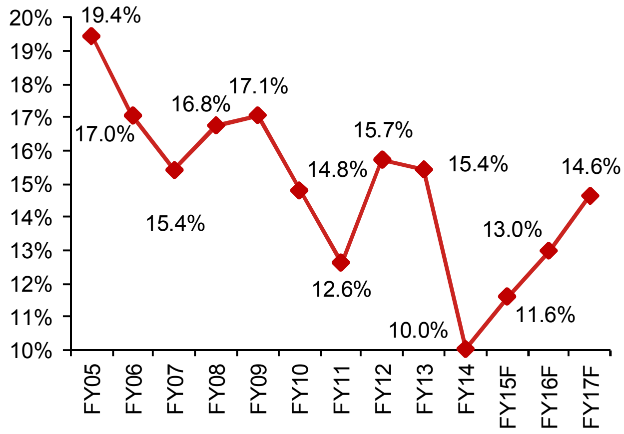
- Operationally, we expect SBI to report the highest EPS growth among our coverage PSUs (29% EPS growth over FY14-17F vs. 10-20% EPS growth for peers). This is likely to be driven by: 1) Lower pension provisioning as SBI looks relatively better placed on pensions after the INR24bn charge on life expectancy which it took in FY14F (2) Also due to lower credit costs which will be a common benefit across PSU banks and (3) Due to lower dilutions expected (high in the case of Union/BOI).
- From a profitability perspective, we expect SBI's ROEs to recover to ~15% from ~10% in FY14F. SBI's profitability will be comparable to BoB/PNB and higher than BOI/Union. While ROEs, on a comparable basis to BOB/PNB, do not warrant a large premium but we believe premium valuations will likely sustain given: (1) SBI's superior liability franchise, (2) Management quality and (3) Historic premium levels which have had a direct co-relation with market multiples (liquidity premium).

Fig. 222: We expect profit growth for SBI to be higher over the next two years



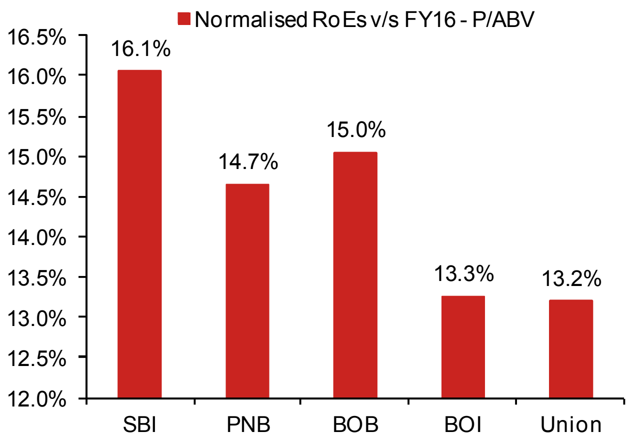
Source: Company data, Nomura estimates

Fig. 223: We expect ROEs to improve to ~15%



Source: Company data, Nomura estimates

Fig. 224: Normalised ROEs in line with BOB/PNB, but better than Union/BOI



Source: Nomura estimates

Valuations: Assume coverage with a Buy rating and TP of INR3,050

Our TP of INR3,050 is based on 1.3x Mar-16F book after deducting for subsidiary value of INR235. We expect SBI's ROEs to inch up to ~15% which is just about equal to its Cost of Equity which justifies 1x book valuations. Our valuation multiple, in that context, factors in some premium for its superior liability franchise, and some of our comfort with current management.

Risks: Slower-than-expected recovery of corporate credit cycle will be a key risk.

Fig. 225: SBI's ROE expectations (standalone business)

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	2.81%	2.61%	2.44%	2.97%	3.53%	3.18%	3.03%	2.99%	2.98%	2.99%
Fees/Assets	1.28%	1.27%	1.33%	1.36%	1.25%	1.07%	1.01%	1.00%	0.99%	0.98%
Investment profits/Assets	0.16%	0.32%	0.22%	0.08%	-0.08%	0.08%	0.13%	0.10%	0.07%	0.06%
Net revenues/Assets	**4.24%**	**4.20%**	**3.99%**	**4.42%**	**4.70%**	**4.33%**	**4.17%**	**4.08%**	**4.04%**	**4.04%**
Operating Expense/Assets	-2.08%	-1.96%	-2.10%	-2.10%	-2.13%	-2.10%	-2.20%	-2.05%	-2.01%	-1.96%
Provisions/Assets	-0.44%	-0.47%	-0.45%	-0.95%	-1.07%	-0.80%	-0.98%	-0.89%	-0.80%	-0.69%
Taxes/Assets	-0.61%	-0.63%	-0.49%	-0.61%	-0.55%	-0.42%	-0.32%	-0.38%	-0.41%	-0.46%
Total Costs/Assets	**-3.13%**	**-3.06%**	**-3.04%**	**-3.66%**	**-3.75%**	**-3.32%**	**-3.50%**	**-3.32%**	**-3.22%**	**-3.11%**
ROA	**1.11%**	**1.14%**	**0.95%**	**0.76%**	**0.95%**	**1.01%**	**0.67%**	**0.76%**	**0.83%**	**0.93%**
Equity/Assets	6.63%	6.70%	6.40%	5.98%	6.07%	6.56%	6.68%	6.58%	6.36%	6.34%
ROE	**16.8%**	**17.1%**	**14.8%**	**12.6%**	**15.7%**	**15.4%**	**10.0%**	**11.6%**	**13.0%**	**14.6%**
RORWA	**1.50%**	**1.63%**	**1.43%**	**1.10%**	**1.41%**	**1.53%**	**1.02%**	**1.18%**	**1.28%**	**1.44%**

Source: Company data, Nomura estimates

Fig. 226: TP of INR3,050

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.20
Cost of Equity	15.2%
Terminal growth	5.0%
Stage 2 growth	16.0%
Normalised ROE	16.1%
Mar-15 PT	3050
Implied Mar-16 P/B	1.30
Implied Mar-16 P/E	9.66

	Per Share
Insurance Valuation	125
SBI Subsidiaries	475
Capital market businesses	109
Total Subsidiary valuation	709
Value of Standalone business	2341

Source: Nomura estimates

Fig. 227: SBI 1-year fwd P/B

Source: Company data, Bloomberg, Nomura estimates

NOMURA

Union Bank UNBK.BO UNBK IN

EQUITY: FINANCIALS

Positives priced in

Management strategy prudent but reflected in recent outperformance as well

Action: Profitability to improve but ROEs still lower than cost of equity
We initiate coverage on Union Bank with a Neutral rating and TP of INR240. We expect profitability for Union to improve over the next two years, driven by margin improvement, stability in opex growth and lower credit costs. Also, although capital remains a challenge, management's slower growth strategy seems prudent and reduces the capital raising urgency. But, despite the expected improvement, RORWAs will remain 20-25% lower than peers and, hence, we expect ROEs to remain constrained at 13-13.5%. Also, Union will still need ~40% dilution to get to 9% Tier-1 capital levels by FY17. The recent outperformance has narrowed the valuation gap vs. peers (with better profitability) and hence the risk-reward now does not look attractive to us.

- **The positives: (1)** Prudent strategy of slowing down RWA growth to <10%; **(2)** NIM bottoming out and core spreads likely to improve with better yields in corporate book; and **(3)** asset quality stabilising with 2H14 slippages ~20% lower than 1H14 and management expecting gradual improvement.
- **The not-so-positives**: **(1)** RORWAs/ROEs in FY16F will remain one of the lowest among PSUs despite the profitability improvement; and (**2**) ~40% expected dilution despite the slower growth targeted.

Catalysts: While its margin trajectory should improve from 1H15F and asset quality is expected to remain stable, continuous capital raising needs will likely constrain ROEs and valuations.

Valuations: Risk-reward not attractive after the recent outperformance
Our TP of INR240 is based on 0.85x Mar-16F book, marginally higher than our multiple for BOI and a 10-25% discount to PNB/BOB, after factoring in lower ROEs. While we are positive on Union's profitability potential, the recent outperformance has reduced Union's valuation gap with PNB and BOB to ~10-20% from 35-40% in the last six months, and hence some of the positives expected seem priced in.

Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	52,181		60,932		70,720		82,091
Reported net profit (mn)	16,961		20,571		26,893		36,138
Normalised net profit (mn)	16,961		20,571		26,893		36,138
FD normalised EPS	26.91		28.25		33.02		40.53
FD norm. EPS growth (%)	-25.6		5.0		16.9		22.7
FD normalised P/E (x)	8.6	N/A	8.2	N/A	7.0	N/A	5.7
Price/adj. book (x)	1.0	N/A	0.9	N/A	0.8	N/A	0.7
Price/book (x)	0.9	N/A	0.8	N/A	0.7	N/A	0.7
Dividend yield (%)	2.0	N/A	2.4	N/A	2.9	N/A	3.5
ROE (%)	10.4		10.9		11.7		13.1
ROA (%)	0.5		0.6		0.7		0.8

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating Starts at	**Neutral**
Target price Starts at	INR 240
Closing price 3 July 2014	INR 231
Potential upside	+3.9%

Anchor themes

ROAs are likely to pick up but ROEs are constrained due to capital calls.

Nomura vs consensus

Our FY15F estimates are in line with consensus but FY16F numbers are higher due to dilution assumed.

Research analysts

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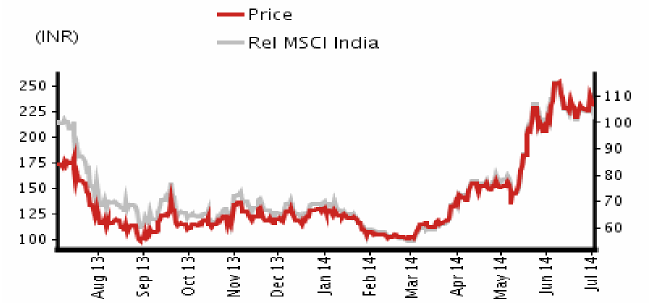
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Union Bank

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	6.6	62.0	34.9	M cap (USDmn)	2,435.0
Absolute (USD)	5.8	63.2	36.0	Free float (%)	90.3
Rel to MSCI India	4.8	51.3	8.0	3-mth ADT (USDmn)	2.5

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	251,247	293,494	325,885	356,425	400,629
Interest expense	-175,819	-214,701	-234,601	-251,986	-280,168
Net interest income	75,428	78,793	91,284	104,439	120,461
Net fees and commissions	3,640	4,470	5,140	5,963	6,917
Trading related profits	4,773	4,857	5,000	5,000	5,001
Other operating revenue	17,107	18,888	21,578	24,900	28,734
Non-interest income	25,520	28,215	31,718	35,863	40,652
Operating income	100,949	107,009	123,003	140,302	161,113
Depreciation	-1,509	-1,938	-2,132	-2,345	-2,579
Amortisation					
Operating expenses	-16,062	-19,812	-22,784	-26,202	-30,132
Employee share expense	-27,550	-33,078	-37,155	-41,036	-46,311
Pre-provision op profit	55,827	52,181	60,932	70,720	82,091
Provisions for bad debt	-23,041	-29,533	-32,362	-32,300	-30,464
Other provision charges	-2,143	-1,978	0	0	0
Operating profit	30,642	20,670	28,571	38,419	51,627
Other non-op income					
Associates & JCEs					
Pre-tax profit	30,642	20,670	28,571	38,419	51,627
Income tax	-9,064	-3,709	-8,000	-11,526	-15,489
Net profit after tax	21,578	16,961	20,571	26,893	36,138
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	21,578	16,961	20,571	26,893	36,138
Extraordinary items	0	0	0	0	0
Reported NPAT	21,578	16,961	20,571	26,893	36,138
Dividends	-5,586	-2,950	-4,089	-5,488	-7,210
Transfer to reserves	15,992	14,011	16,482	21,405	28,928

Growth (%)

Net interest income	9.2	4.5	15.9	14.4	15.3
Non-interest income	9.4	10.6	12.4	13.1	13.4
Non-interest expenses	17.9	23.3	15.0	15.0	15.0
Pre-provision earnings	6.3	-6.5	16.8	16.1	16.1
Net profit	20.7	-21.4	21.3	30.7	34.4
Normalised EPS	11.4	-25.6	5.0	16.9	22.7
Normalised FDEPS	11.4	-25.6	5.0	16.9	22.7
Loan growth	17.0	10.1	10.0	14.0	16.0
Interest earning assets	17.4	9.4	10.7	13.9	15.9
Interest bearing liabilities	19.4	13.7	8.8	12.3	14.4
Asset growth	19.1	13.5	9.5	12.8	14.8
Deposit growth	18.3	12.9	7.6	11.0	13.0

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	99,876	176,350	175,233	195,413	221,892
Inter-bank lending					
Deposits with central bank					
Total securities	62,228	54,378	75,100	83,748	95,097
Other int earning assets					
Gross loans	2,110,630	2,333,084	2,574,920	2,942,999	3,416,648
Less provisions	-29,608	-42,040	-54,771	-70,030	-84,003
Net loans	2,081,022	2,291,044	2,520,149	2,872,970	3,332,645
Long-term investments	808,304	937,232	1,016,408	1,119,784	1,252,494
Fixed assets	9,832	11,491	13,150	14,809	16,468
Goodwill					
Other intangible assets					
Other non IEAs	42,388	52,720	57,991	66,110	76,688
Total assets	3,103,650	3,523,216	3,858,031	4,352,834	4,995,283
Customer deposits	2,637,616	2,976,756	3,203,308	3,554,590	4,017,724
Bank deposits, CDs,	235,621	281,347	317,796	378,005	454,477
Other int bearing liabilities	3,461	12,929	37,949	65,053	100,289
Total int bearing liabilities	2,876,698	3,271,032	3,559,053	3,997,649	4,572,490
Non-int bearing liabilities	70,058	83,133	91,446	104,249	120,928
Total liabilities	2,946,756	3,354,165	3,650,499	4,101,897	4,693,419
Minority interest					
Common stock	5,968	6,303	7,281	8,144	8,916
Preferred stock					
Retained earnings	150,926	162,747	200,251	242,793	292,949
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	156,894	169,050	207,532	250,937	301,865
Total liabilities and equity	3,103,650	3,523,215	3,858,031	4,352,834	4,995,283
Non-perf assets	63,138	95,443	114,107	132,132	152,733

Balance sheet ratios (%)

Loans to deposits	80.0	78.4	80.4	82.8	85.0
Equity to assets	5.1	4.8	5.4	5.8	6.0
Asset quality & capital					
NPAs/gross loans (%)	3.0	4.1	4.4	4.5	4.5
Bad debt charge/gross	1.09	1.27	1.26	1.10	0.89
Loss reserves/assets (%)	0.95	1.19	1.42	1.61	1.68
Loss reserves/NPAs (%)	46.9	44.0	48.0	53.0	55.0
Tier 1 capital ratio (%)	8.2	7.5	8.4	9.0	9.4
Total capital ratio (%)	11.5	10.8	11.8	12.2	12.4
Per share					
Reported EPS (INR)	36.16	26.91	28.25	33.02	40.53
Norm EPS (INR)	36.16	26.91	28.25	33.02	40.53
FD norm EPS (INR)	36.16	26.91	28.25	33.02	40.53
DPS (INR)	9.36	4.68	5.62	6.74	8.09
PPOP PS (INR)	93.54	82.79	83.69	86.84	92.08
BVPS (INR)	262.90	268.20	285.04	308.14	338.58
ABVPS (INR)	238.79	229.61	251.29	281.21	313.52
NTAPS (INR)	262.90	268.20	285.04	308.14	338.58

Valuations and ratios

Reported P/E (x)	6.4	8.6	8.2	7.0	5.7
Normalised P/E (x)	6.4	8.6	8.2	7.0	5.7
FD normalised P/E (x)	6.4	8.6	8.2	7.0	5.7
Dividend yield (%)	4.1	2.0	2.4	2.9	3.5
Price/book (x)	0.9	0.9	0.8	0.7	0.7
Price/adjusted book (x)	1.0	1.0	0.9	0.8	0.7
Net interest margin (%)	3.80	3.51	3.70	3.76	3.77
Yield on assets (%)	12.66	13.08	13.19	12.84	12.55
Cost of int bearing liab (%)	6.65	6.98	6.87	6.67	6.54
Net interest spread (%)	6.01	6.09	6.32	6.17	6.01
Non-interest income (%)	25.3	26.4	25.8	25.6	25.2
Cost to income (%)	44.7	51.2	50.5	49.6	49.0
Effective tax rate (%)	29.6	17.9	28.0	30.0	30.0
Dividend payout (%)	25.9	17.4	19.9	20.4	20.0
ROE (%)	15.0	10.4	10.9	11.7	13.1
ROA (%)	0.76	0.51	0.56	0.66	0.77
Operating ROE (%)	21.4	12.7	15.2	16.8	18.7
Operating ROA (%)	1.07	0.62	0.77	0.94	1.10

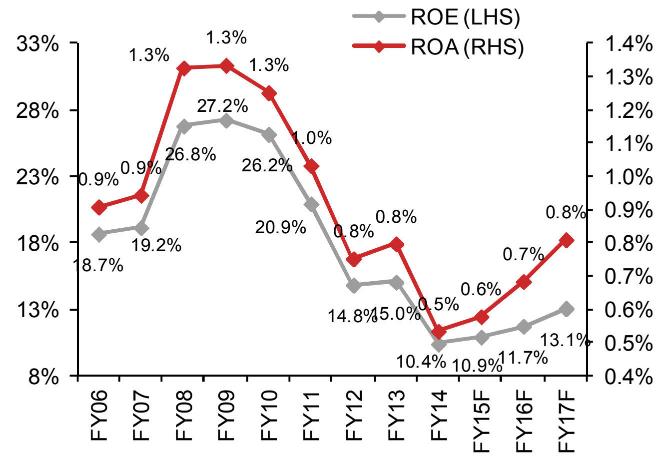
Source: Company data, Nomura estimates

Weak profitability in FY14 but we expect some improvement in FY15F

Union's profitability, as for most other PSUs, dipped in FY14 with +30bps contraction in margins, high opex growth (~21% y/y) and high credit costs. **We expect profitability to inch up from FY15F as**: **(1)** we factor in ~20bps improvement in margins over FY14-16F due to lower interest reversals, higher capital levels and marginally higher yields in their corporate portfolio as the bank will concentrate less on AAA corporates that borrow at just base rate; and **(2) opex growth** has inched up in FY14 due to higher wage settlement and pension provisioning. Our numbers indicate that Union is well provided on a relative basis on pensions and hence opex growth is likely to moderate.

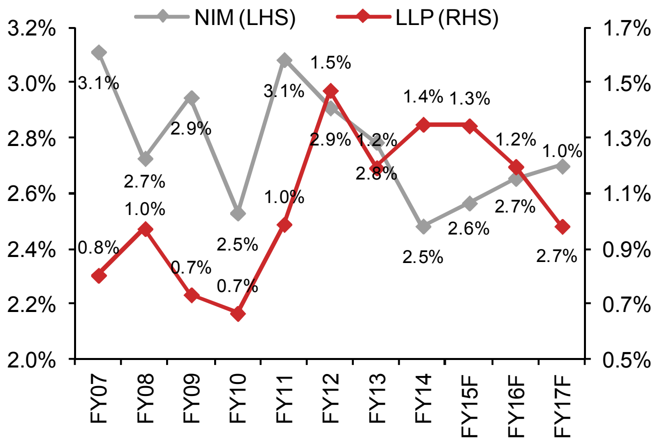
Fig. 228: We expect profitability to improve...

ROA improvement stronger, Capital raising to constrain ROEs



Source: Company data, Nomura estimates

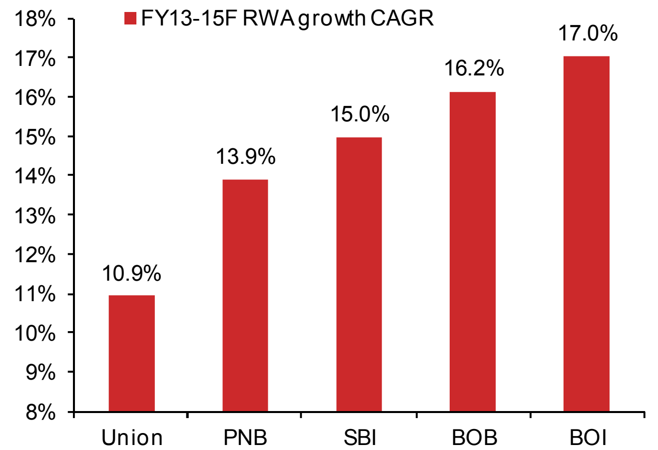
Fig. 229: ...with improvement in margins and lower credit costs



Source: Company data, Nomura estimates

Fig. 230: Management strategy of slower RWA growth target prudent

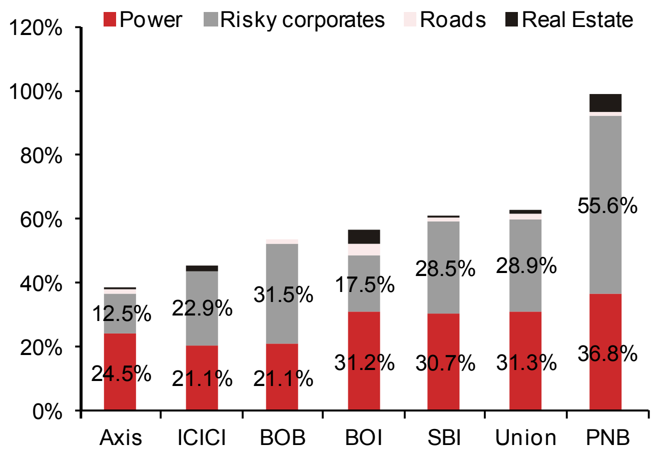
Union will deliver slowest RWA growth in FY13-15F



Source: Company data, Nomura estimates

Fig. 231: Large corporate/Infra SPV underwriting not most aggressive

Exposure to INR4trn of risky assets - % of net worth **(**FY14)



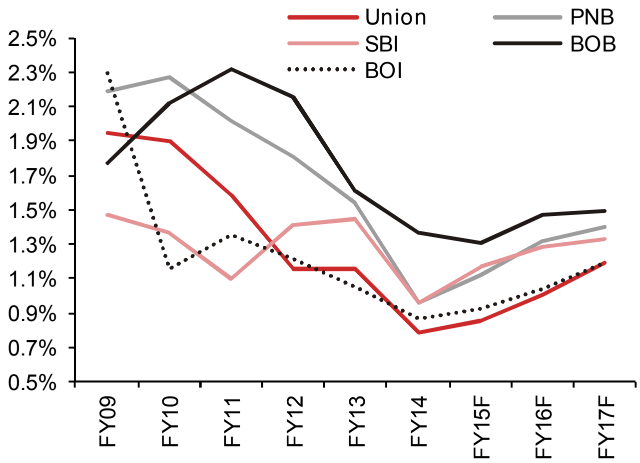
Source: Ministry of corporate affairs, Media sources, Nomura estimates

But ROEs are still among the lowest despite the expected improvement– now valuations have also caught up and capital calls will continue.

- **Profitability will remain lower than peers**: The above improvements in margins/opex coupled with lower credit costs should lead to a bounce-back in RORWAs from 0.8% to 1.2% but Union's RORWAs at 1.2% in FY16/17F will still remain inferior to RORWAs of peer PSU banks (20-25%) and hence our normalised ROE expectation for Union at 13.5% is lower than our ROE expectation for peers like BOB/PNB.
- **Capital needs remain high despite slower growth:** While we have been positively surprised by management's prudent strategy of slowing growth considering the bank's capital position unlike BOI, we still estimate that Union will need ~40% dilution in the next three years to bring its total Tier-1 capital level to +9% by FY17F.

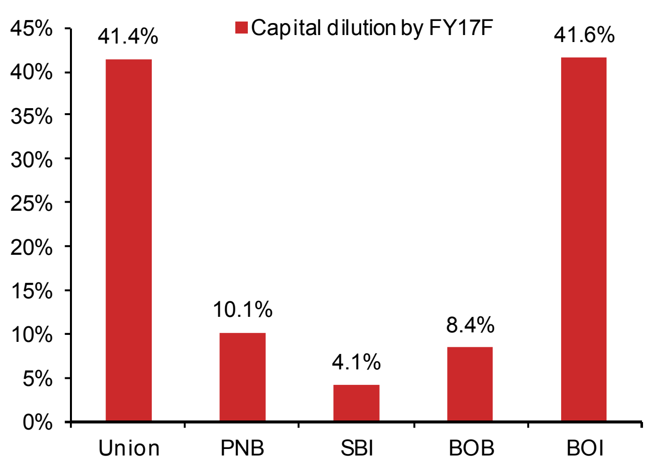
The recent outperformance of Union vs. PSU peers is factoring in some of the profitability improvement and prudent capital decisions by management, in our view.

Fig. 232: RORWAs to pick up but will be lower than peers'



Source: Company data, Nomura estimates

Fig. 233: Dilution need one of the highest inspite of slower RWA growth in FY14 and FY15F



Source: Company data, Nomura estimates

Valuations: Risk-reward not attractive after the recent outperformance

Our TP of INR240 is based on 0.85x Mar-16F book, marginally higher than our multiple for BOI and ~10-20% discount to PNB/BOB factoring in lower ROEs. In our view, profitability is likely to improve from FY14 levels but will remain among the lowest and below its cost of equity, which will likely constrain valuations on an absolute basis. On a relative basis, the recent outperformance has reduced Union's valuation gap with PNB and BOB to ~10-20% from 35-40% in last six months, which we believe is fair considering the ROE differentials.

Risks: Stronger-than-expected pick-up in margins/profitability.

Fig. 234: ROEs to improve but still remain sub-optimal vs. cost of equity inspite of NIM/credit cost improvement

ROA decomposition	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	2.73%	2.95%	2.53%	3.09%	2.91%	2.79%	2.48%	2.57%	2.66%	2.70%
Fees/Assets	0.90%	0.89%	0.85%	0.78%	0.80%	0.77%	0.74%	0.75%	0.78%	0.80%
Investment profits/Assets	0.36%	0.26%	0.35%	0.23%	0.19%	0.18%	0.15%	0.14%	0.13%	0.11%
Net revenues/Assets	**3.99%**	**4.09%**	**3.72%**	**4.10%**	**3.89%**	**3.73%**	**3.37%**	**3.46%**	**3.57%**	**3.61%**
Operating Expense/Assets	-1.52%	-1.71%	-1.51%	-1.96%	-1.68%	-1.67%	-1.73%	-1.74%	-1.77%	-1.77%
Provisions/Assets	-0.69%	-0.56%	-0.50%	-0.67%	-1.07%	-0.93%	-0.99%	-0.91%	-0.82%	-0.68%
Taxes/Assets	-0.45%	-0.49%	-0.46%	-0.43%	-0.39%	-0.33%	-0.12%	-0.22%	-0.29%	-0.35%
Total Costs/Assets	**-2.66%**	**-2.76%**	**-2.47%**	**-3.06%**	**-3.14%**	**-2.93%**	**-2.84%**	**-2.88%**	**-2.88%**	**-2.80%**
ROA	**1.33%**	**1.33%**	**1.25%**	**1.03%**	**0.75%**	**0.80%**	**0.53%**	**0.58%**	**0.68%**	**0.81%**
Equity/Assets	4.95%	4.90%	4.79%	4.94%	5.07%	5.30%	5.14%	5.29%	5.83%	6.20%
ROE	**26.8%**	**27.2%**	**26.2%**	**20.9%**	**14.8%**	**15.0%**	**10.4%**	**10.9%**	**11.7%**	**13.1%**
RORWA	**1.89%**	**1.95%**	**1.90%**	**1.58%**	**1.16%**	**1.16%**	**0.78%**	**0.86%**	**1.01%**	**1.19%**

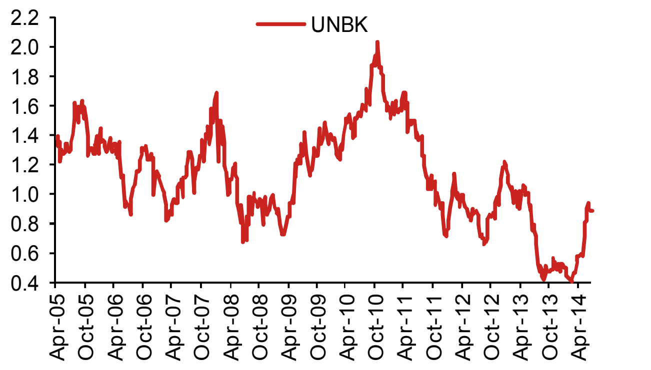
Source: Company data, Nomura estimates

Fig. 235: Our TP of INR240

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.25
Cost of Equity	15.5%
Terminal growth	5.0%
Normalised ROE	13.2%
Stage 2 growth	14.0%
Mar-15 PT	240
Implied Mar-16 P/B	0.85
Implied Mar-16 P/E	7.27

Source: Nomura estimates

Fig. 236: Valuations have mean-reverted the most for Union



Source: Company data, Bloomberg, Nomura estimates

NOMURA

HDFC HDFC.NS HDFC IN

EQUITY: FINANCIALS

Stable performance to continue

Risk-reward evenly placed; we prefer HDFCB instead

Action: Steady play on increasing mortgage penetration
Following transfer of coverage of HDFC Limited, we rate the shares Neutral with a TP of INR1,050. We believe HDFC Limited is a stable play on the Indian mortgage market. Its market share has been gradually inching up from 13.5% in FY08-09 to ~15% now, and it is the market leader along with SBI (Buy). While most mortgage lenders including LICHF (Buy) have been facing spread challenges due to a volatile external funding environment, we believe HDFC's flexibility in borrowing has helped maintain margins in a relatively tight band. We are concerned about increasing competition in the individual mortgage market and that it will exert pressure on spreads; however, benign liquidity over the near-term and increased ability to leverage (lower risk weight for individual mortgages) should help offset any material ROE pressure.
Some risks we see: 1) Past transactions indicate that HDFC's builder/corporate book is well collateralised and ultimate loss on defaults is low, but there could be more volatility linked to builder/corporate cash flow and asset quality as disclosure requirements have been made more stringent for NBFCs in Jan '14 and this will be applied to HFCs as well. 2) With no prepayment charges allowed and lower swapping costs now for existing customers, we believe spread differences between new and old customers is likely to reduce.

Catalysts: (1) Wholesale rates have stabilised and continued benign liquidity should aid margins (2) Disclosures relating to restructuring will lead to some volatility in asset quality (introduced for NBFCs in Jan-14).

Valuations: Risk-reward evenly placed, We prefer HDFCB (Buy)
Our INR1,050 TP implies 4x Mar-16F book for the mortgage business after deducting INR370 for its subsidiaries. We expect HDFC's core mortgage business to generate ~27-28% ROEs and hence 4x valuation looks justified. But with current valuations already at 3.65x FY16 book, we believe the risk-reward is evenly placed. We prefer HDFC Bank instead, given its liability franchise and better asset growth prospects.

Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	75,402		89,265		103,342		121,961
Reported net profit (mn)	54,402		63,920		74,046		87,456
Normalised net profit (mn)	54,402		63,920		74,046		87,456
FD normalised EPS	34.86		40.96		47.45		56.04
FD norm. EPS growth (%)	11.2		17.5		15.8		18.1
FD normalised P/E (x)	28.9	N/A	24.6	N/A	21.2	N/A	18.0
Price/adj. book (x)	5.6	N/A	5.0	N/A	4.5	N/A	3.9
Price/book (x)	5.6	N/A	5.0	N/A	4.5	N/A	3.9
Dividend yield (%)	1.4	N/A	1.6	N/A	1.9	N/A	2.2
ROE (%)	20.5		21.6		22.2		23.3
ROA (%)	2.6		2.6		2.6		2.6

Source: Company data, Nomura estimates
Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Neutral**
Target price From N/A	INR 1050
Closing price 3 July 2014	INR 1008
Potential upside	+4.2%

Anchor themes
Remains a play on mortgages, but valuations are not enticing.

Nomura vs consensus
Our FY15/16F earnings estimates are marginally lower than consensus.

Research analysts

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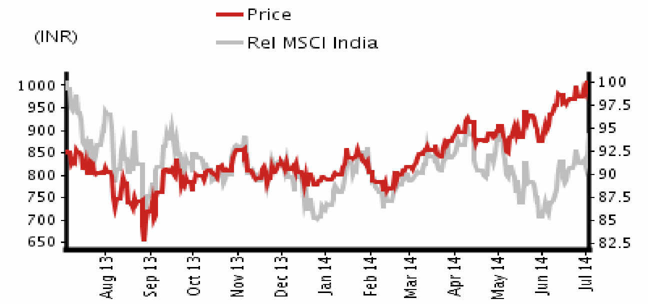
Key data on HDFC

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	10.5	11.5	18.1	M cap (USDmn)	26,424.4
Absolute (USD)	9.5	12.4	19.1	Free float (%)	90.3
Rel to MSCI India	8.6	0.9	-8.8	3-mth ADT (USDmn)	60.3

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	200,707	230,323	268,101	309,670	365,313
Interest expense	-138,909	-160,294	-185,727	-214,552	-252,932
Net interest income	61,798	70,030	82,373	95,118	112,381
Net fees and commissions	7,614	9,164	10,653	12,704	15,202
Trading related profits	3,156	2,490	3,362	3,602	3,602
Other operating revenue	0	0	0	0	0
Non-interest income	10,769	11,653	14,015	16,307	18,804
Operating income	72,567	81,683	96,389	111,425	131,185
Depreciation	-236	-319	-341	-365	-390
Amortisation					
Operating expenses	-2,691	-3,170	-3,628	-4,153	-4,806
Employee share expense	-2,462	-2,792	-3,155	-3,565	-4,028
Pre-provision op profit	67,178	75,402	89,265	103,342	121,961
Provisions for bad debt	-1,450	-1,000	-1,100	-1,210	-1,331
Other provision charges					
Operating profit	65,728	74,402	88,165	102,132	120,630
Other non-op income					
Associates & JCEs					
Pre-tax profit	65,728	74,402	88,165	102,132	120,630
Income tax	-17,245	-20,000	-24,245	-28,086	-33,173
Net profit after tax	48,483	54,402	63,920	74,046	87,456
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	48,483	54,402	63,920	74,046	87,456
Extraordinary items	0	0	0	0	0
Reported NPAT	48,483	54,402	63,920	74,046	87,456
Dividends	-19,329	-21,847	-25,669	-29,735	-35,121
Transfer to reserves	29,154	32,555	38,251	44,310	52,336

Growth (%)

Net interest income	16.2	13.3	17.6	15.5	18.1
Non-interest income	22.5	8.2	20.3	16.3	15.3
Non-interest expenses	19.3	17.8	14.5	14.5	15.7
Pre-provision earnings	16.9	12.2	18.4	15.8	18.0
Net profit	17.6	12.2	17.5	15.8	18.1
Normalised EPS	12.3	11.2	17.5	15.8	18.1
Normalised FDEPS	12.3	11.2	17.5	15.8	18.1
Loan growth	20.7	15.9	16.4	18.4	19.2
Interest earning assets	20.7	15.9	16.4	18.4	19.2
Interest bearing liabilities	14.2	16.0	15.7	18.9	19.5
Asset growth	16.7	15.5	14.9	17.6	18.2
Deposit growth	43.1	8.9	31.9	25.7	19.5

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	35,972	43,886	53,541	65,320	79,690
Inter-bank lending					
Deposits with central bank					
Total securities					
Other int earning assets					
Gross loans	1,712,363	1,984,600	2,310,645	2,736,756	3,261,769
Less provisions	-11,903	-13,600	-15,834	-18,754	-22,352
Net loans	1,700,460	1,971,000	2,294,811	2,718,001	3,239,417
Long-term investments	136,135	139,127	139,127	139,127	139,127
Fixed assets	2,379	2,805	2,805	2,805	2,805
Goodwill					
Other intangible assets					
Other non IEAs	80,362	100,757	104,420	125,788	145,953
Total assets	1,955,308	2,257,574	2,594,703	3,051,040	3,606,991
Customer deposits	519,330	565,780	746,451	937,930	1,120,431
Bank deposits, CDs,	1,068,950	1,277,200	1,386,266	1,597,016	1,907,760
Other int bearing liabilities					
Total int bearing liabilities	1,588,280	1,842,980	2,132,718	2,534,945	3,028,191
Non-int bearing liabilities	117,028	135,042	148,546	163,401	179,741
Total liabilities	1,705,308	1,978,022	2,281,264	2,698,346	3,207,932
Minority interest					
Common stock	3,093	3,121	3,121	3,121	3,121
Preferred stock					
Retained earnings	246,907	276,431	310,318	349,573	395,938
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	250,000	279,552	313,439	352,694	399,059
Total liabilities and equity	1,955,308	2,257,574	2,594,703	3,051,040	3,606,991
Non-perf assets	11,903	13,600	15,834	18,754	22,352

Balance sheet ratios (%)

Loans to deposits	329.7	350.8	309.6	291.8	291.1
Equity to assets	12.8	12.4	12.1	11.6	11.1

Asset quality & capital

NPAs/gross loans (%)	0.7	0.7	0.7	0.7	0.7
Bad debt charge/gross	0.08	0.05	0.05	0.04	0.04
Loss reserves/assets (%)	0.61	0.60	0.61	0.61	0.62
Loss reserves/NPAs (%)	100.0	100.0	100.0	100.0	100.0
Tier 1 capital ratio (%)	13.5	15.4	15.2	14.8	14.4
Total capital ratio (%)	15.9	17.9	17.6	17.1	16.5

Per share

Reported EPS (INR)	31.35	34.86	40.96	47.45	56.04
Norm EPS (INR)	31.35	34.86	40.96	47.45	56.04
FD norm EPS (INR)	31.35	34.86	40.96	47.45	56.04
DPS (INR)	12.50	14.00	16.45	19.06	22.51
PPOP PS (INR)	43.44	48.32	57.20	66.22	78.15
BVPS (INR)	161.67	179.14	200.86	226.01	255.73
ABVPS (INR)	161.67	179.14	200.86	226.01	255.73
NTAPS (INR)	161.67	179.14	200.86	226.01	255.73

Valuations and ratios

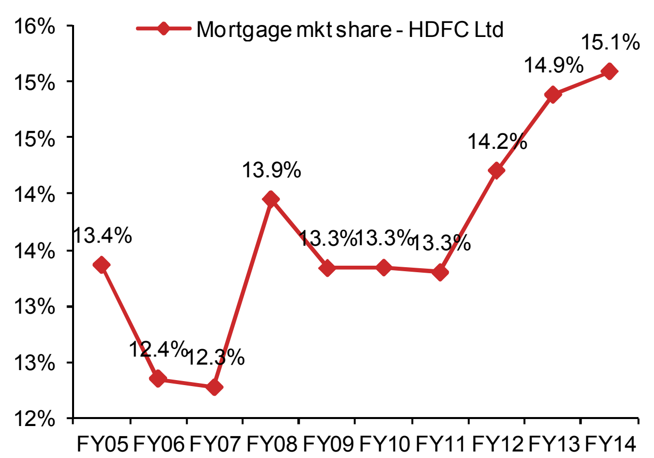
Reported P/E (x)	32.2	28.9	24.6	21.2	18.0
Normalised P/E (x)	32.2	28.9	24.6	21.2	18.0
FD normalised P/E (x)	32.2	28.9	24.6	21.2	18.0
Dividend yield (%)	1.2	1.4	1.6	1.9	2.2
Price/book (x)	6.2	5.6	5.0	4.5	3.9
Price/adjusted book (x)	6.2	5.6	5.0	4.5	3.9
Net interest margin (%)	3.98	3.81	3.86	3.79	3.77
Yield on assets (%)	12.91	12.55	12.57	12.36	12.26
Cost of int bearing liab (%)	9.32	9.34	9.34	9.19	9.09
Net interest spread (%)	3.59	3.20	3.23	3.16	3.17
Non-interest income (%)	14.8	14.3	14.5	14.6	14.3
Cost to income (%)	7.4	7.7	7.4	7.3	7.0
Effective tax rate (%)	26.2	26.9	27.5	27.5	27.5
Dividend payout (%)	39.9	40.2	40.2	40.2	40.2
ROE (%)	22.0	20.5	21.6	22.2	23.3
ROA (%)	2.67	2.58	2.63	2.62	2.63
Operating ROE (%)	29.9	28.1	29.7	30.7	32.1
Operating ROA (%)	3.62	3.53	3.63	3.62	3.62

Source: Company data, Nomura estimates

Positives: Steady market share gains + Flexibility in funding + Higher leverage now

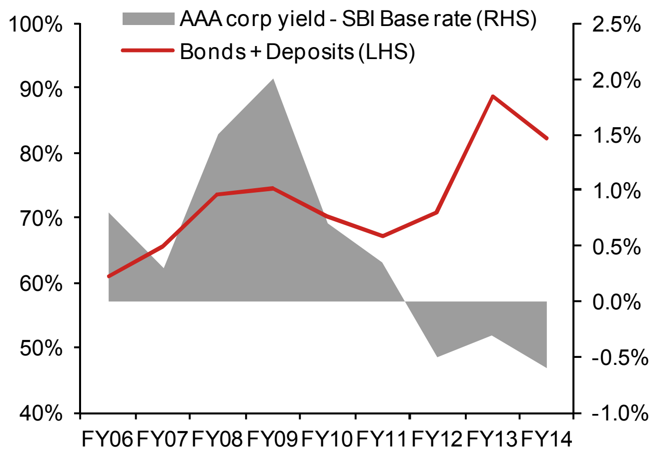
- **Steady market share gains:** HDFC Ltd has gained steady market share over the past 5-7 years, with very stable growth in its individual businesses. Unlike periods of hyper growth (ICICI in pre-FY08 days or SBI after the GFC), we note HDFC Ltd's growth has been more consistent and that helps preserve asset quality.
- **Flexibility in funding:** HDFC Limited has been able to maintain its lending spreads in a tight band given its funding and asset mix flexibility. During periods of easy liquidity, HDFC's share of bond + deposit funding increases, like it has increased over the past 2-3 years (except 2Q14 and 3Q14 when the RBI tightened liquidity). This funding flexibility has helped HDFC Limited to keep its margins in a tight band.
- **Higher leverage in mortgage business now:** The RBI/NHB revised their risk weights for individual and residential builder exposures lower. This has increased the ability of HDFC Limited to leverage up by ~20-25% and will aid ROEs even if pricing competition adds to spreads/ ROA pressures.

Fig. 237: HDFC limited has seen a steady increase in market share



Source: RBI, NHB, Nomura estimates

Fig. 238: Funding flexibility has aided spreads to remain in a tight band



Source: Company data, Bloomberg, Nomura research

Fig. 239: Risk weight changes have improved HDFC Ltd's ability to leverage up in the mortgage business

		May-08	Dec-10	Jun-13
<INR 2mn	LTV	<75%	<90%	<90%
	Risk weight	50%	50%	50%
INR 2-3mn	LTV	<75%	<75%	<80%
	Risk weight	50%	50%	50%
INR 3-7.5mn	LTV	<75%	<75%	<80%
	Risk weight	75%	75%	50%
>INR7.5mn	LTV	<75%	<75%	<75%
	Risk weight	75%	125%	75%
CRE- Residential	LTV			<75%
	Risk weight	100%	100%	75%
	Standard provisioning	0.40%	1.00%	0.75%
CRE- Commerial	LTV			
	Risk weight	100%	100%	100%
	Standard provisioning	0.40%	1.0%	1.0%

Source: RBI, Nomura research

Some risks that we see:

1. **Rising competition in mortgages:** With limited growth avenues for banks in the corporate space, most banks, including PSUs, are targeting retail/SME growth and hence competition in mortgages is likely to remain high. Benign liquidity and easy wholesale funding rates provide near-term relief currently and over the longer run, we believe that the ability to leverage up due to lower risk weights will aid ROEs for HFCs despite lower spreads.

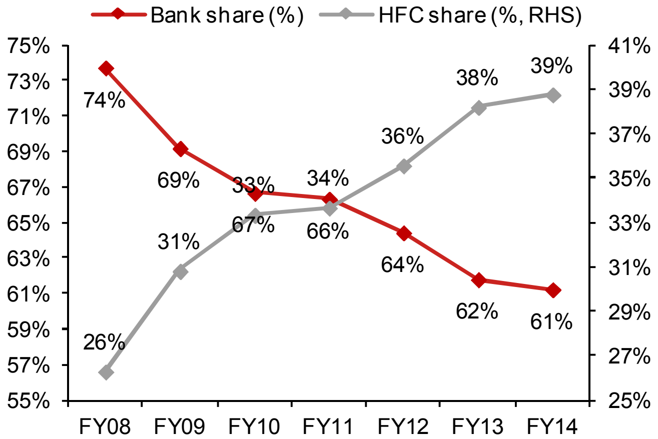
2. Spread gap between new and old customers to reduce: Generally, yields of existing customers do not keep pace with the yields offered to new customers in a falling rate environment, and hence spreads of existing customers are higher than new customers. But with prepayment charges being abolished for floating loans (Jun-12) and conversion fees also being reduced by HFCs, the swapping costs for old customers to new rates is lower and the gap between new and old customers will likely come off.

3. Disclosures relating to restructuring: In Jan-14, the RBI mandated NBFCs to disclose details of restructuring from Mar-14, and overtime we believe this could be applied to HFCs (housing finance companies) as well. While past transactions indicate that HDFC's builder/ corporate book is well collateralised and ultimate loss on defaults is low, there could be more volatility linked to the builder/corporate book once disclosures are mandated for HFCs as well.

Fig. 240: Banks have been aggressive in retail lending off late

Source: RBI, Nomura research

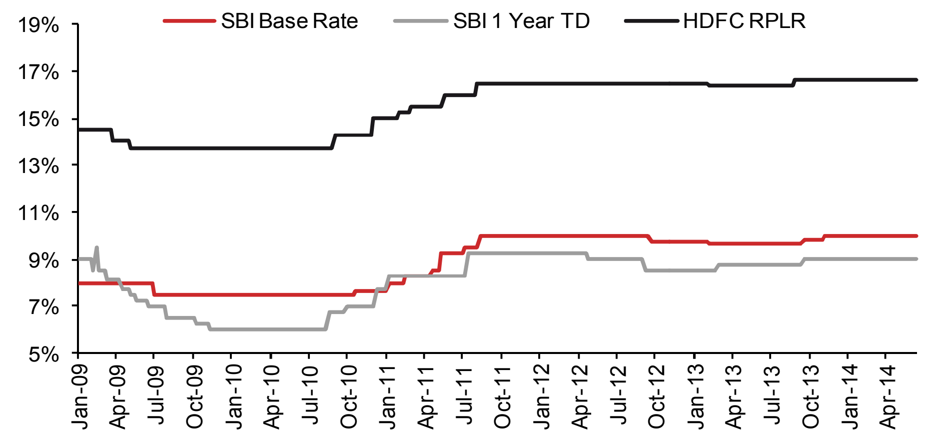
Fig. 241: Banks' share in the mortgage market is stabilising after falling from FY08-13



Source: RBI, NHB, Nomura estimates

Fig. 242: Yield adjustments for old customers are historically lower in the case of a falling rate environment

HDFC PLR v/s SBI base rate vs. term deposit rates



Source: Bloomberg, Nomura research

Valuations: Risk-reward evenly placed. We prefer HDFCB
Our TP of INR1,050 implies 4x Mar-16F book for the mortgage business after deducting INR370 for its subsidiaries. We expect HDFC Limited's core mortgage business to generate ~27-28% ROEs and hence 4x valuation looks justified. But with current valuations already at 3.6x FY16F book we believe the risk-reward is evenly placed. We prefer HDFC Bank, instead, given its liability franchise and better asset growth prospects.

Risks: 1) A very benign funding environment could lead to an increase in margins/spreads and that will be an upside risk; 2) while the builder book for HDFC Limited is well collateralised, there always remains a risk of downgrades/slippages and is hence a downside risk.

Fig. 243: HDFC Limited: ROEs or standalone mortgage business and subsidiaries

	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Standalone Equity	131,374	151,977	173,165	190,176	250,000	279,552	313,439	352,694	399,059
Subsidiary investment	33,678	76,696	79,351	79,351	79,351	79,351	79,351	79,351	79,351
Adjusted Standalone Equity	***97,696***	***75,281***	***93,814***	***110,825***	***170,649***	***200,201***	***234,088***	***273,343***	***319,708***
Adjusted Standalone PAT	22,394	26,341	30,029	36,376	44,103	50,831	60,348	70,474	83,885
Adjusted Standalone ROE		**30.5%**	**35.5%**	**35.6%**	**31.3%**	**27.4%**	**27.8%**	**27.8%**	**28.3%**
Adjusted Subsidiary PAT	-213	4,785	15,251	18,255	22,297	28,647	33,191	39,128	46,181
Adjusted Susidiary Capital	40,742	106,542	118,087	133,415	149,951	201,099	230,749	266,337	308,977
Adjusted Subsidiary ROE		**6.5%**	**13.6%**	**14.5%**	**15.7%**	**16.3%**	**15.4%**	**15.7%**	**16.1%**

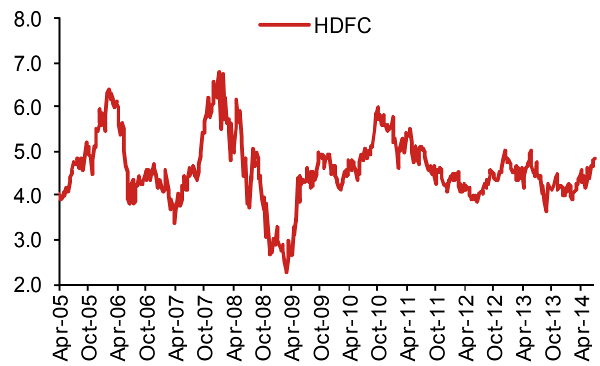
Source: Company data, Nomura estimates

Fig. 244: TP of INR1,050

Key subsidiary valuations	Value per share
HDFC Bank	274
HDFC Standard Life	55
HDFC Asset Management	19
Gruh Finance	23
Fair value of key subsidiaries	**371**
HDFC Ltd (standalone)	681
Mar-15 PT	1,052
Implied P/E	14.1
Implied P/B	3.6

Source: Nomura estimates

Fig. 245: Valuations - Risk-reward evenly placed



Source: Company data, Bloomberg, Nomura estimates

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IDFC IDFC.NS IDFC IN

EQUITY: BANKS

Reforms to help but risks remain

Gas assets + long gestation for banking foray our key concerns

Global Markets Research

8 July 2014

Rating From Suspended	**Neutral**
Target price From N/A	INR 140
Closing price 3 July 2014	INR 133
Potential upside	+5.1%

Action: Resume coverage with a Neutral rating and TP of INR140

While IDFC will be one of the key beneficiaries of the expected reforms and our benign liquidity expectations over the next one-two years, our optimism is affected by: **(1)** IDFC has the highest gas power exposure (~4% of loans and +20% of FY14 net worth) on which the outlook will remain uncertain till we see a material pick up in domestic gas production; **(2)** the long gestation road to profitability after migrating to a bank model, especially given IDFC has not had any presence/experience in retail liability/assets and NBFCs did not get any regulatory forbearance for priority sector and SLR/CRR obligations.

- **A lot of positives for sure:** Except for IDFC's gas exposure, the expected reforms will improve the asset quality outlooks of its coal/road assets and our analysis indicates that its underwriting in Infra has been relatively better. Also, a benign liquidity environment will reduce the pressure on margins that are underway due to the seasoning of the project book, in our view.
- **Bank optionality less attractive without regulatory dispensation:** We expect IDFC's ROEs to move down to ~10% as IDFC migrates to a bank structure and improvement back to ~15% ROE levels would take at least 4-5 years as: **(1)** NBFCs have not got any transition period for PSL and SLR/CRR compliance; and **(2)** IDFC's retail experience/presence is limited.

Catalysts: Any significant increase in domestic gas production

Valuations: Undemanding but risks remain

Our TP of INR140 is based on 1.2x FY16F book, which we believe is reasonable for the banking optionality but with sub-optimal ROEs of 10-12% for the next 3-4 years. IDFC's floating provision of INR10bn provides ~30% cover on its gas exposure of +INR30bn and in the worst case, adjusting IDFC's book fully for its gas exposure implies a ~10% hit to its net worth and our TP then would imply a valuation multiple of 1.35x Mar-16F book.

Anchor themes

Current reforms will help but gas power risk is too high to ignore and execution risk in the banking foray is high.

Nomura vs consensus

Our FY15/16/17F earnings estimates are below consensus as we start factoring in a transformation to a bank.

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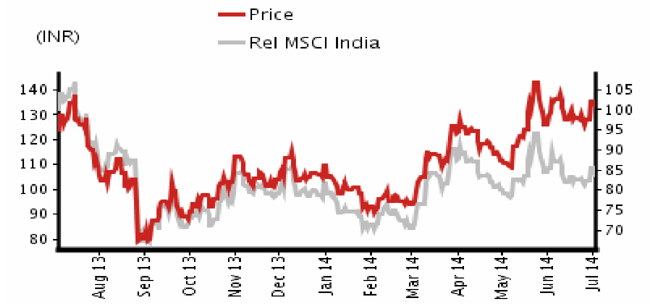
Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	31,912		32,506		33,984		34,994
Reported net profit (mn)	20,522		19,832		21,157		21,459
Normalised net profit (mn)	20,522		19,832		21,157		21,459
FD normalised EPS	13.53		12.22		13.04		13.23
FD norm. EPS growth (%)	-0.6		-9.7		6.7		1.4
FD normalised P/E (x)	9.8	N/A	10.9	N/A	10.2	N/A	10.1
Price/adj. book (x)	1.3	N/A	1.2	N/A	1.1	N/A	1.0
Price/book (x)	1.3	N/A	1.2	N/A	1.1	N/A	1.0
Dividend yield (%)	2.4	N/A	2.7	N/A	2.9	N/A	2.9
ROE (%)	14.3		12.1		11.4		10.7
ROA (%)	2.8		2.6		2.6		2.4

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Key data on IDFC

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	1.8	6.7	7.3	M cap (USDmn)	3,380.9
Absolute (USD)	0.9	7.5	8.2	Free float (%)	90.3
Rel to MSCI India	-0.1	-4.0	-19.5	3-mth ADT (USDmn)	25.0

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	71,784	77,592	80,105	83,701	89,827
Interest expense	-46,758	-50,552	-52,411	-53,947	-57,499
Net interest income	25,025	27,040	27,694	29,754	32,328
Net fees and commissions	6,450	6,516	7,857	8,929	9,536
Trading related profits	2,020	3,180	2,726	2,916	3,161
Other operating revenue	360	614	755	868	998
Non-interest income	8,830	10,310	11,338	12,713	13,695
Operating income	33,855	37,350	39,032	42,467	46,023
Depreciation	-344	-310	-372	-483	-628
Amortisation	0	0	0	0	0
Operating expenses	-2,034	-2,246	-2,695	-3,503	-4,554
Employee share expense	-2,916	-2,883	-3,459	-4,497	-5,846
Pre-provision op profit	28,561	31,912	32,506	33,984	34,994
Provisions for bad debt	-2,060	-5,040	-5,152	-4,802	-5,396
Other provision charges	1,440	1,250	0	0	0
Operating profit	27,941	28,122	27,355	29,182	29,599
Other non-op income	0	0	0	0	0
Associates & JCEs	0	0	0	0	0
Pre-tax profit	27,941	28,122	27,355	29,182	29,599
Income tax	-7,311	-7,600	-7,522	-8,025	-8,140
Net profit after tax	20,630	20,522	19,832	21,157	21,459
Minority interests	0	0	0	0	0
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	20,630	20,522	19,832	21,157	21,459
Extraordinary items	0	0	0	0	0
Reported NPAT	20,630	20,522	19,832	21,157	21,459
Dividends	-4,613	-4,935	-5,801	-6,188	-6,277
Transfer to reserves	16,017	15,587	14,031	14,969	15,182

Growth (%)

Net interest income	22.2	8.1	2.4	7.4	8.7
Non-interest income	2.6	16.8	10.0	12.1	7.7
Non-interest expenses	14.1	10.4	20.0	30.0	30.0
Pre-provision earnings	19.6	11.7	1.9	4.5	3.0
Net profit	21.2	-0.5	-3.4	6.7	1.4
Normalised EPS	21.0	-0.6	-9.7	6.7	1.4
Normalised FDEPS	21.0	-0.6	-9.7	6.7	1.4
Loan growth	15.7	1.5	5.0	8.0	10.0
Interest earning assets	15.7	1.5	5.0	8.0	10.0
Interest bearing liabilities	16.8	4.3	1.8	7.4	9.7
Asset growth	16.5	5.8	5.5	7.7	9.3
Deposit growth	na	na	na	na	na

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	2,627	3,904	4,685	5,528	6,523
Inter-bank lending	0	0	0	0	0
Deposits with central bank	0	0	0	0	0
Total securities	0	0	0	0	0
Other int earning assets	0	0	0	0	0
Gross loans	557,360	565,950	594,248	641,787	705,966
Less provisions	0	0	0	0	0
Net loans	557,360	565,950	594,248	641,787	705,966
Long-term investments	110,042	113,087	124,016	135,891	148,910
Fixed assets	3,445	3,286	3,214	3,032	2,704
Goodwill	9,571	9,571	9,571	9,571	9,571
Other intangible assets	0	0	0	0	0
Other non IEAs	27,549	55,833	56,999	58,238	59,556
Total assets	710,593	751,630	792,732	854,046	933,230
Customer deposits	0	0	0	0	0
Bank deposits, CDs,	542,274	565,650	575,750	618,450	678,455
Other int bearing liabilities	0	0	0	0	0
Total int bearing liabilities	542,274	565,650	575,750	618,450	678,455
Non-int bearing liabilities	31,239	34,996	38,255	41,878	45,852
Total liabilities	573,513	600,646	614,004	660,329	724,307
Minority interest	254	402	422	443	465
Common stock	15,147	15,163	16,224	16,224	16,224
Preferred stock	0	0	0	0	0
Retained earnings	121,679	135,420	162,082	177,051	192,233
Reserves for credit losses	0	0	0	0	0
Proposed dividends	0	0	0	0	0
Other equity	0	0	0	0	0
Shareholders' equity	136,826	150,583	178,306	193,275	208,457
Total liabilities and equity	710,593	751,630	792,732	854,046	933,230
Non-perf assets	851	3,396	7,074	10,878	14,985

Balance sheet ratios (%)

Loans to deposits	na	na	na	na	na
Equity to assets	19.3	20.0	22.5	22.6	22.3
Asset quality & capital					
NPAs/gross loans (%)	0.2	0.6	1.2	1.7	2.1
Bad debt charge/gross	0.37	0.89	0.87	0.75	0.76
Loss reserves/assets (%)	0.00	0.00	0.00	0.00	0.00
Loss reserves/NPAs (%)	0.0	0.0	0.0	0.0	0.0
Tier 1 capital ratio (%)	19.8	21.5	24.5	24.9	24.8
Total capital ratio (%)	22.1	23.8	26.7	27.0	26.7
Per share					
Reported EPS (INR)	13.62	13.53	12.22	13.04	13.23
Norm EPS (INR)	13.62	13.53	12.22	13.04	13.23
FD norm EPS (INR)	13.62	13.53	12.22	13.04	13.23
DPS (INR)	3.05	3.25	3.58	3.81	3.87
PPOP PS (INR)	18.86	21.05	20.04	20.95	21.57
BVPS (INR)	90.33	99.31	109.90	119.13	128.48
ABVPS (INR)	90.33	99.31	109.90	119.13	128.48
NTAPS (INR)	84.01	93.00	104.00	113.23	122.59

Valuations and ratios

Reported P/E (x)	9.8	9.8	10.9	10.2	10.1
Normalised P/E (x)	9.8	9.8	10.9	10.2	10.1
FD normalised P/E (x)	9.8	9.8	10.9	10.2	10.1
Dividend yield (%)	2.3	2.4	2.7	2.9	2.9
Price/book (x)	1.5	1.3	1.2	1.1	1.0
Price/adjusted book (x)	1.5	1.3	1.2	1.1	1.0
Net interest margin (%)	4.82	4.81	4.77	4.81	4.80
Yield on assets (%)	13.82	13.81	13.81	13.54	13.33
Cost of int bearing liab (%)	9.29	9.13	9.18	9.03	8.87
Net interest spread (%)	4.52	4.69	4.63	4.51	4.46
Non-interest income (%)	26.1	27.6	29.0	29.9	29.8
Cost to income (%)	15.6	14.6	16.7	20.0	24.0
Effective tax rate (%)	26.2	27.0	27.5	27.5	27.5
Dividend payout (%)	22.4	24.0	29.3	29.3	29.3
ROE (%)	15.9	14.3	12.1	11.4	10.7
ROA (%)	3.12	2.81	2.57	2.57	2.40
Operating ROE (%)	21.5	19.6	16.6	15.7	14.7
Operating ROA (%)	4.23	3.85	3.54	3.54	3.31

Source: Company data, Nomura estimates

Gas power exposure - No visible solution

As mentioned in our sector note, we believe that gas power plants will remain stressed as we do not see any visible improvement in this sub-sector of infra lending. While gas power based on imported LNG will be unviable, our oil and gas team's expectations on incremental domestic gas production is just ~10-12 mmscmd over the next two-three years and hence we believe the stress will remain high for gas power plants.

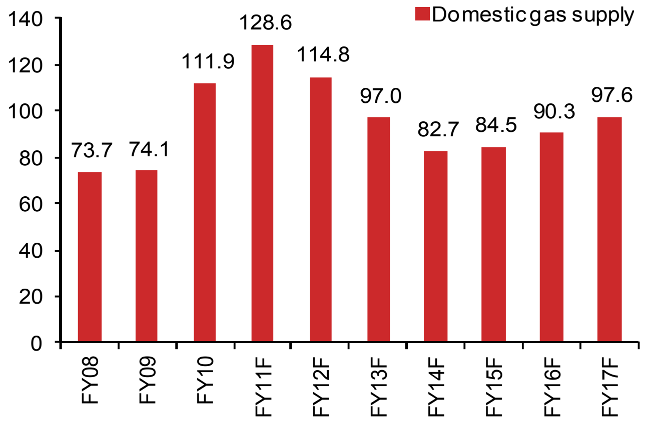
IDFC's exposure to domestic gas assets is +INR30bn, of which 75% is near fully completed gas plants waiting for gas and ~25% of plants are running plants but utilisation remains sub-par. While floating provisions of ~INR10bn provides some comfort, it just covers IDFC's gas exposure by ~33% and hence write-offs could be large. Assuming IDFC's floating provisions are used for writing off its gas exposure, even then additional write-off would be ~10% of IDFC's FY16F net worth, we estimate.

Fig. 246: Meaningfully large gas exposure

Gas exposure details	
Gas exposure	INR 31bn
% of FY14 NW	20.6%
% of FY14 Exposure	4%
% of gas assets restructured	~50%
Floating provisions	INR 10bn
Unprovided portion	INR 21bn
% of FY16F NW	10%

Source: Company data, Nomura estimates

Fig. 247: Domestic gas production unlikely to recover in a material way



Source: Nomura oil and gas team's estimates

Banking foray - Long gestation to above par profitability

While IDFC will take 12-18 months to start its banking foray and as management prepares to migrate the current book to the banking structure, loan growth in the interim is likely to get impacted. Over the next three-five years, we expect IDFC's profitability to trend lower as it will pay upfront some network cost and compliance with PSL and SRR/SLR requirements will impact margins. We await a clear business plan by management to judge the initial cost strain for IDFC but our sensitivity analysis shows that ROEs may recover back to 12-15% levels by FY19-20F (after five years of banking operations).

Fig. 248: Banking foray Timeline (as per management)

Step 1	IDFC Promoter Company has to be a domestic company – FII+ FDI stake has to be brought below 50% - Currently this is between 53-54% - Will launch a offer for domestic investors in next few months and this will help comply with FII+FDI stake below 50%
Step 2	Creation of additional subsidiaries plus Creating an IDF NBFC – Transfer all eligible assets to this entity before creation of the NOHFC – Only Rs15-20bn of assets could get transferred (no SLR/CRR on this).
Step 3	Create a NOHFC – It will have stake in AMC, PE, Bank, Capital market business and create IDF
Step 4	Creation of the bank - Options: (1) De-merger of the bank – Listed from day one or (2) Bank will be as a subsidiary and listed 3 years from now

Source: Company concall 4QFY14

Fig. 249: Our sensitivity for IDFC's expected ROEs in five years

FY20 Exit ROE tree			
CAGR growth	**10%**	**15%**	**20%**
NIMs	3.25%	2.86%	2.57%
Other income	1.45%	1.45%	1.45%
Total income	**4.70%**	**4.31%**	**4.02%**
Opex/Assets	1.42%	1.30%	1.21%
PPOP/Assets	**3.28%**	**3.01%**	**2.81%**
Provisions/Assets	0.50%	0.50%	0.50%
Pre tax profit	**2.78%**	**2.51%**	**2.31%**
Post tax	**1.86%**	**1.68%**	**1.55%**
Leverage in FY20	5.64	7.37	9.51
ROEs in FY20	**10.51%**	**12.39%**	**14.74%**

Source: Nomura estimates

Valuations: Reasonable in spite of the recent re-rating

Our TP of INR140 is based on 1.2x FY16F book (BVPS: INR119), which we believe is reasonable for the banking optionality but with sub-optimal ROE estimates of 10-12% for the next three-four years. IDFC's floating provision of INR10bn provides ~30% cover on its gas exposure of +INR30bn and adjusting for the uncovered gas exposure, IDFC's FY16F book would be ~10% lower and our TP then would imply a valuation multiple of 1.35x Mar-16 book.

Risks: (1) An upside risk is if domestic gas production improves faster than expected. (2) Downside risks - any miss on the execution on the banking foray + slower improvement in macros/capex cycle implying stress from ex-gas exposure for IDFC.

Fig. 250: ROEs likely to trend lower

ROA decomposition	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Margin	2.9%	3.5%	3.9%	4.1%	4.1%	4.0%	3.9%	4.0%	3.9%
Core Fees	1.6%	2.2%	1.6%	0.9%	1.1%	1.0%	1.2%	1.3%	1.2%
Capital gains- Infra	1.2%	1.5%	0.7%	0.8%	0.4%	0.5%	0.4%	0.4%	0.4%
Net revenues	5.7%	7.3%	6.2%	5.8%	5.6%	5.5%	5.6%	5.6%	5.6%
Operating costs	-1.3%	-1.9%	-1.3%	-1.0%	-0.9%	-0.8%	-0.9%	-1.1%	-1.3%
Provisions	-0.6%	-0.4%	-0.6%	-0.6%	-0.6%	-0.9%	-0.7%	-0.6%	-0.7%
Taxes	-1.0%	-1.3%	-1.2%	-1.2%	-1.2%	-1.1%	-1.1%	-1.1%	-1.0%
Costs	-2.9%	-3.6%	-3.1%	-2.8%	-2.6%	-2.9%	-2.7%	-2.8%	-3.0%
ROA	2.8%	3.7%	3.1%	3.0%	3.0%	2.7%	2.8%	2.8%	2.6%
Equity/Assets	21.4%	22.7%	21.2%	22.2%	21.0%	21.2%	23.4%	24.7%	24.4%
ROE	12.9%	16.1%	14.7%	13.7%	14.1%	12.5%	12.1%	11.4%	10.7%
Adjusted ROA	1.4%	2.4%	2.0%	1.8%	1.6%	1.3%	1.4%	1.3%	1.1%
LLP/Average loans	0.8%	0.6%	0.7%	0.7%	0.7%	1.1%	0.9%	0.8%	0.8%

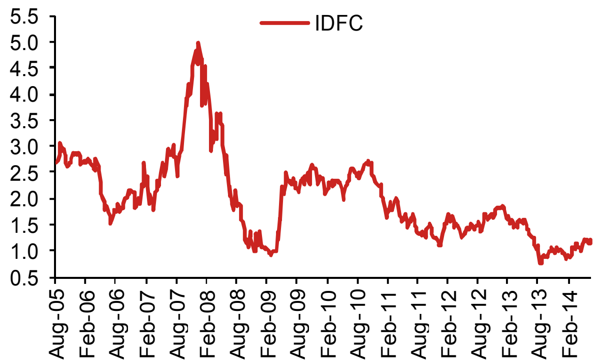
Source: Company data, Nomura estimates

Fig. 251: TP of INR140

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.17
Cost of Equity	15.0%
Terminal growth	5.0%
Stage 2 growth	12.5%
Normalised ROE	14.5%
Mar-15 PT	140
Implied Sep-15 P/E	11.08
Implied Sep-15 P/B	1.22

Source: Nomura estimates

Fig. 252: Valuations are reasonable though



Source: Company data, Bloomberg, Nomura estimates

NOMURA

LIC Housing Finance LICH.NS LICHF IN

EQUITY: FINANCIALS

Steady profitability + reasonable valuations

Competition will remain tough; we take a tactical call on liquidity

Action: Steady ROEs now

Following the transfer of coverage, we have a Buy rating for LIC housing Finance (LICHF) with a TP of INR370. Low mortgage penetration will continue to drive the medium-term growth in mortgages and LICHF remains well positioned, in our view. Increasing competition remains our concern and spreads in the individual mortgage business are unlikely to go back to FY07-11 levels and hence ROAs for LICHF will be structurally lower. But, lower risk weights by NHB has increased the potential leverage in the mortgage business and hence with ROAs of 1.5% currently, we expect LICHF to generate 18-19% ROE over FY16/17F, assuming benign liquidity.

- The change in risk weights to mortgages (Jun-13) has raised the potential leverage in individual mortgages to 15-16x from 12-13x earlier (with tier-1 of 12%) - ROEs will, thus, be comparable to past trends with lower ROAs.
- Banks will increasingly focus on low risk retail asset growth and hence competition is likely to remain high. But we are sanguine on stable liquidity/rates (stable wholesale funding cost) and that would support spreads. Also, builder book is unlikely to dip further and any material increase in builder exposure will add to our spread estimates. (We factor in spreads to increase from 1.28% in FY14 to 1.35-1.4% by FY16/17F).

Catalysts: (1) Stability in funding in wholesale cost of funds; (2) recoveries in corporate NPAs which are currently being auctioned.

Valuations: Undemanding for structural growth + respectable ROEs

LICHF currently trades at ~1.6x Mar-16F book which we believe is undemanding for a structural growth of ~17-18% at least, with respectable ROEs. Our TP of INR370 implies 1.85x Mar-16F book. While visibility on growth could provide scope for higher multiples than implied by our TP, we believe competition will constraint mortgage spreads and though current liquidity/wholesale funding costs are benign, we cannot extrapolate the same.

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	18,470		21,789		25,036		29,631
Reported net profit (mn)	13,172		15,436		17,560		20,781
Normalised net profit (mn)	13,172		15,436		17,560		20,781
FD normalised EPS	130.42		152.84		173.87		205.76
FD norm. EPS growth (%)	30.2		17.2		13.8		18.3
FD normalised P/E (x)	2.5	N/A	2.1	N/A	1.9	N/A	1.6
Price/adj. book (x)	0.4	N/A	0.4	N/A	0.3	N/A	0.3
Price/book (x)	0.4	N/A	0.4	N/A	0.3	N/A	0.3
Dividend yield (%)	9.0	N/A	10.6	N/A	12.0	N/A	14.2
ROE (%)	18.8		19.0		18.7		19.1
ROA (%)	1.5		1.5		1.4		1.4

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Buy**
Target price From N/A	INR 370
Closing price 3 July 2014	INR 324
Potential upside	+14.2%

Anchor themes

Competition will not ease in the near-term and that will contrain margins for HFCs. Our positive view is a tactical call on liquidity.

Nomura vs consensus

Our FY15F/FY16F earnings estimates are in line with consensus.

Research analysts

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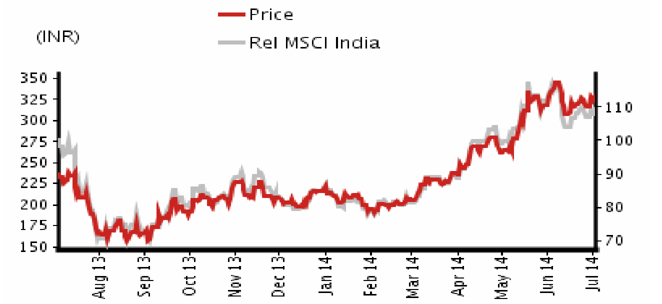
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on LIC Housing Finance

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	-3.0	32.5	35.3	M cap (USDmn)	2,735.1
Absolute (USD)	-3.8	33.6	36.4	Free float (%)	90.3
Rel to MSCI India	-4.9	21.9	8.4	3-mth ADT (USDmn)	18.5

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	74,622	90,733	105,022	122,365	145,298
Interest expense	-59,246	-71,744	-82,328	-96,208	-114,235
Net interest income	15,376	18,989	22,694	26,158	31,063
Net fees and commissions	1,850	2,613	2,705	3,049	3,415
Trading related profits	0	0	0	0	0
Other operating revenue	0	0	0	0	0
Non-interest income	1,850	2,613	2,705	3,049	3,415
Operating income	17,226	21,602	25,399	29,207	34,478
Depreciation	-75	-76	-84	-92	-101
Amortisation					
Operating expenses	-1,839	-2,018	-2,332	-2,706	-3,167
Employee share expense	-904	-1,038	-1,194	-1,373	-1,579
Pre-provision op profit	14,408	18,470	21,789	25,036	29,631
Provisions for bad debt	-789	-215	-396	-699	-830
Other provision charges	0	0	0	0	0
Operating profit	13,619	18,255	21,393	24,336	28,800
Other non-op income					
Associates & JCEs					
Pre-tax profit	13,619	18,255	21,393	24,336	28,800
Income tax	-3,504	-5,083	-5,957	-6,776	-8,019
Net profit after tax	10,115	13,172	15,436	17,560	20,781
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	10,115	13,172	15,436	17,560	20,781
Extraordinary items	0	0	0	0	0
Reported NPAT	10,115	13,172	15,436	17,560	20,781
Dividends	-2,241	-2,954	-3,462	-3,938	-4,661
Transfer to reserves	7,874	10,218	11,974	13,622	16,120

Growth (%)

Net interest income	10.3	23.5	19.5	15.3	18.8
Non-interest income	-16.3	41.3	3.5	12.7	12.0
Non-interest expenses	17.0	9.7	15.6	16.0	17.0
Pre-provision earnings	4.6	28.2	18.0	14.9	18.4
Net profit	11.8	30.2	17.2	13.8	18.3
Normalised EPS	11.8	30.2	17.2	13.8	18.3
Normalised FDEPS	11.8	30.2	17.2	13.8	18.3
Loan growth	23.4	17.4	16.9	18.2	19.2
Interest earning assets	23.4	17.4	16.9	18.2	19.2
Interest bearing liabilities	22.6	19.8	16.7	18.7	20.0
Asset growth	22.5	18.9	16.2	17.9	19.1
Deposit growth	na	na	na	na	na

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	6,399	4,911	5,770	7,989	9,585
Inter-bank lending					
Deposits with central bank					
Total securities					
Other int earning assets					
Gross loans	780,079	915,964	1,073,087	1,267,882	1,511,166
Less provisions	-1,953	-2,554	-4,954	-5,244	-6,227
Net loans	778,127	913,410	1,068,133	1,262,637	1,504,939
Long-term investments	10,921	28,048	26,444	28,533	34,234
Fixed assets	624	756	731	841	921
Goodwill					
Other intangible assets					
Other non IEAs	9,531	10,646	11,784	12,568	14,138
Total assets	805,602	957,770	1,112,862	1,312,568	1,563,818
Customer deposits	0	0	0	0	0
Bank deposits, CDs,	687,641	824,041	961,598	1,141,302	1,369,352
Other int bearing liabilities	0	0	0	0	0
Total int bearing liabilities	687,641	824,041	961,598	1,141,302	1,369,352
Non-int bearing liabilities	53,149	58,400	63,961	70,341	77,420
Total liabilities	740,789	882,441	1,025,559	1,211,643	1,446,772
Minority interest					
Common stock	1,010	1,010	1,010	1,010	1,010
Preferred stock					
Retained earnings	63,803	74,319	86,293	99,915	116,036
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	64,813	75,329	87,303	100,925	117,046
Total liabilities and equity	805,602	957,770	1,112,862	1,312,568	1,563,818
Non-perf assets	4,712	6,090	9,908	10,488	12,454

Balance sheet ratios (%)

Loans to deposits	na	na	na	na	na
Equity to assets	8.0	7.9	7.8	7.7	7.5

Asset quality & capital

NPAs/gross loans (%)	0.6	0.7	0.9	0.8	0.8
Bad debt charge/gross	0.10	0.02	0.04	0.06	0.05
Loss reserves/assets (%)	0.24	0.27	0.45	0.40	0.40
Loss reserves/NPAs (%)	41.4	41.9	50.0	50.0	50.0
Tier 1 capital ratio (%)	11.5	12.6	12.5	12.2	11.9
Total capital ratio (%)	16.5	17.3	16.5	15.6	14.7

Per share

Reported EPS (INR)	100.16	130.42	152.84	173.87	205.76
Norm EPS (INR)	100.16	130.42	152.84	173.87	205.76
FD norm EPS (INR)	100.16	130.42	152.84	173.87	205.76
DPS (INR)	22.19	29.25	34.28	38.99	46.15
PPOP PS (INR)	142.66	182.88	215.74	247.89	293.38
BVPS (INR)	641.74	745.86	864.42	999.30	1,158.91
ABVPS (INR)	641.74	745.86	864.42	999.30	1,158.91
NTAPS (INR)	641.74	745.86	864.42	999.30	1,158.91

Valuations and ratios

Reported P/E (x)	3.2	2.5	2.1	1.9	1.6
Normalised P/E (x)	3.2	2.5	2.1	1.9	1.6
FD normalised P/E (x)	3.2	2.5	2.1	1.9	1.6
Dividend yield (%)	6.8	9.0	10.6	12.0	14.2
Price/book (x)	0.5	0.4	0.4	0.3	0.3
Price/adjusted book (x)	0.5	0.4	0.4	0.3	0.3
Net interest margin (%)	2.18	2.25	2.29	2.24	2.24
Yield on assets (%)	10.59	10.73	10.60	10.50	10.50
Cost of int bearing liab (%)	9.49	9.49	9.22	9.15	9.10
Net interest spread (%)	1.10	1.24	1.38	1.35	1.40
Non-interest income (%)	10.7	12.1	10.7	10.4	9.9
Cost to income (%)	16.4	14.5	14.2	14.3	14.1
Effective tax rate (%)	25.7	27.8	27.8	27.8	27.8
Dividend payout (%)	22.2	22.4	22.4	22.4	22.4
ROE (%)	16.6	18.8	19.0	18.7	19.1
ROA (%)	1.38	1.49	1.49	1.45	1.44
Operating ROE (%)	22.4	26.1	26.3	25.9	26.4
Operating ROA (%)	1.86	2.07	2.07	2.01	2.00

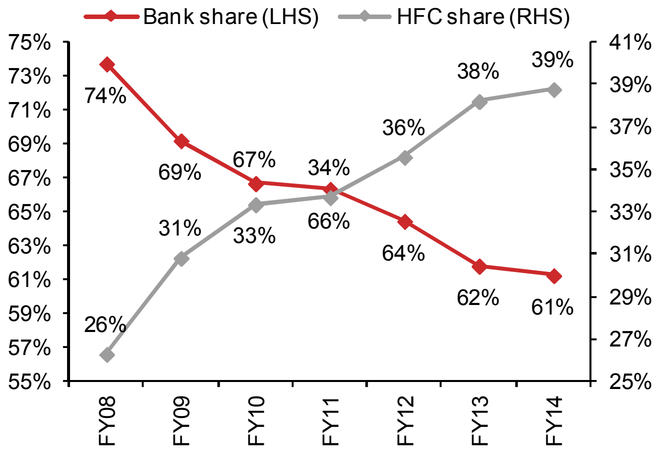
Source: Company data, Nomura estimates

Competition from banks will remain high

Banks are now refocusing on retail/mortgage/SME growth as growth avenues in large corporate/Infra have dried up. After losing market share in mortgages to HFCs over FY08-13, mortgages growth for banks has picked up from mid-FY13 with ~20% growth y/y over the past 18-24 months and this trend will likely continue till corporate credit demand picks up in a meaningful manner – this will ensure that competition in individual mortgages remains high for HFCs, in our view.

Fig. 253: Banks lost market share to HFCs over FY08-13

But their market share is stabilising now



Source: RBI, NHB, Nomura estimates

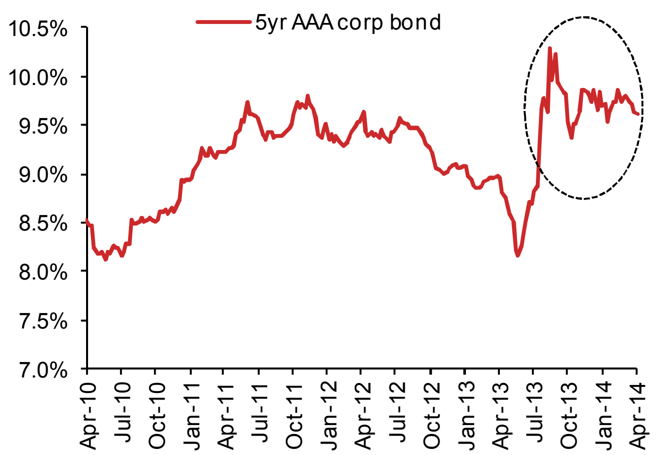
Fig. 254: But mortgage growth for banks picking up now

Source: RBI, Nomura research

Liquidity tightness and wholesale cost of funds have eased; we do not extrapolate this into our numbers

Liquidity has eased in the past three-six months with significant foreign inflows and hence AAA funding rates have come off to 9.1-9.2%. With mortgage rates at 10.25%, this implies incremental spreads of +150bps vs. average FY14 spreads of ~125-130bps. Though wholesale funding rates have remained volatile in the past and differentials with term deposits at low points, we do not think that it will be prudent to extrapolate this trend. But certainly, easier liquidity will certainly aid margins for HFCs, in our view. One of the longer-term margin levers could be an increase in builder book share (which yields ~300-400bps higher than the individual book). We do not expect further dip in the builder book but a material build up is also not expected in the near term.

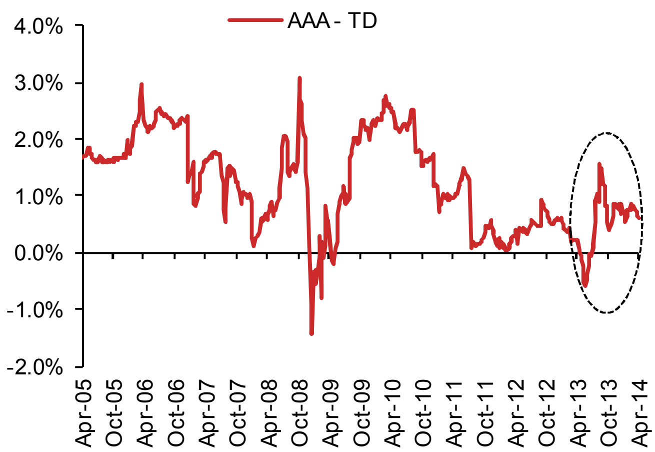
Fig. 255: AAA funding rates have eased



Source: Bloomberg, Nomura research

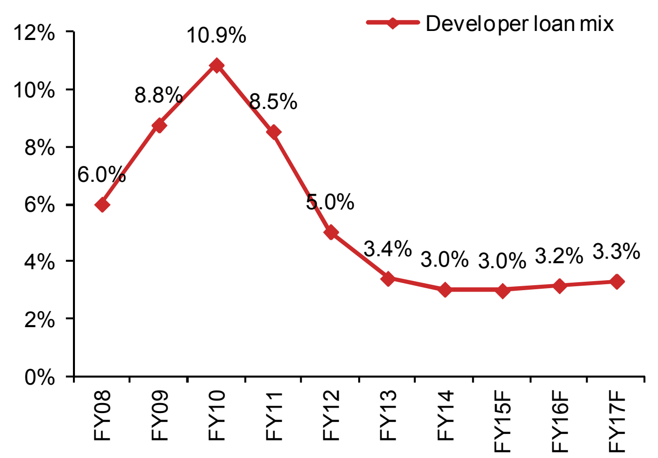
Fig. 256: AAA funding spreads over term deposits very low

Difference in cost of funding for wholesale and retail borrower is low



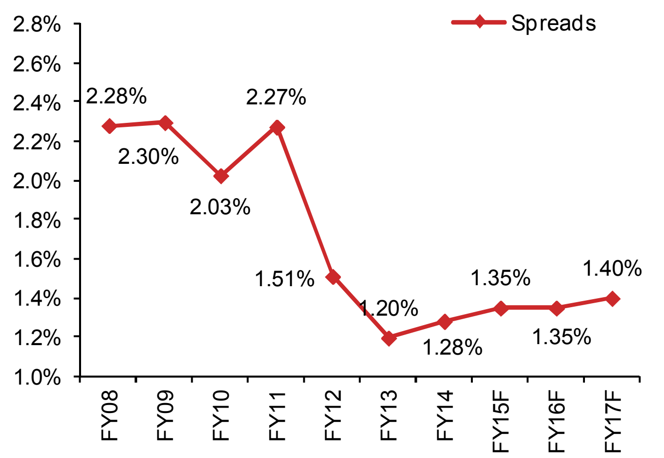
Source: Bloomberg, Nomura research

Fig. 257: Builder book proportion to stabilise



Source: Company data, Nomura estimates

Fig. 258: Our spread improvement expectations are moderate



Source: Company data, Nomura estimates

Fig. 259: Our assumptions on yields, cost and spreads

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Yield on assets	10.37%	11.11%	9.99%	10.03%	10.48%	10.59%	10.73%	10.60%	10.50%	10.50%
Cost of funds	8.09%	8.81%	7.96%	7.75%	8.97%	9.40%	9.45%	9.25%	9.15%	9.10%
Spreads	2.28%	2.30%	2.03%	2.27%	1.51%	1.20%	1.28%	1.35%	1.35%	1.40%
Margins	2.97%	3.02%	2.72%	3.17%	2.46%	2.20%	2.25%	2.29%	2.24%	2.24%

Source: Company data, Nomura estimates

The change in risk weights has increased the inherent leverage in the mortgage business

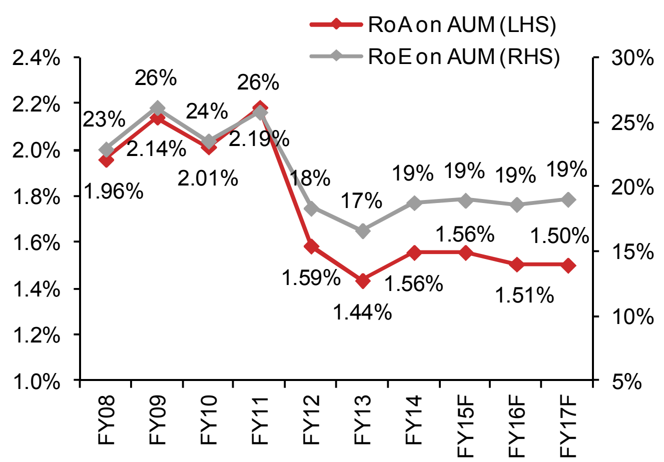
RBI and NHB have changed the risk weight in Jun-13 by relaxing the risk weight/LTVs in most categories. Previously, RBI had tightened mortgage risk weights in Dec-10. The recent changes normalise the previous tightening and effectively increases the inherent leverage in the individual mortgage book from 12-13x to 15-16x (even assuming tier-1 capital of 12% vs. a 6% requirement). Thus, while margins and ROAs are unlikely to move up to pre-FY11 levels unless the mix changes dramatically for LICHF, higher leverage will lead to respectable ROEs, in our view.

Fig. 260: Changes in the risk weight for mortgages have increased HFCs' ability to leverage up

		May-08	Dec-10	Jun-13
<INR 2mn	LTV	<75%	<90%	<90%
	Risk weight	50%	50%	50%
INR 2-3mn	LTV	<75%	<75%	<80%
	Risk weight	50%	50%	50%
INR 3-7.5mn	LTV	<75%	<75%	<80%
	Risk weight	75%	75%	50%
>INR7.5mn	LTV	<75%	<75%	<75%
	Risk weight	75%	125%	75%
CRE- Residential	LTV			<75%
	Risk weight	100%	100%	75%
	Standard provisioning	0.40%	1.00%	0.75%
CRE- Commercial	LTV			
	Risk weight	100%	100%	100%
	Standard provisioning	0.40%	1.0%	1.0%

Source: RBI, Nomura research

Fig. 261: ROAs lower but ROEs still relatively comparable



Source: Company data, Nomura estimates

Valuation, TP and risks

LICHF currently trades at ~1.6x Mar-16 book (BVPS: INR199), which we believe is undemanding for a structural growth of ~17-18% at least, with respectable ROEs. Our TP of INR370 implies 1.85x Mar-16 book. While visibility on growth could provide scope for a higher multiple than implied by our TP, we believe competition will constraint mortgage spreads and though current liquidity/wholesale funding costs are benign, we cannot extrapolate the same.

Risks: A significant change in the liquidity outlook could impact margins and LICHF's profitability - we assume liquidity to remain benign.

Fig. 262: ROEs remain respectable in spite of lower margins/ROAs

ROE Decomposition (on AUM)	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15F**	**FY16F**	**FY17F**
Net Interest Income/Assets	2.97%	3.02%	2.72%	3.17%	2.44%	2.18%	2.25%	2.29%	2.24%	2.24%
Fees/Assets	0.53%	0.55%	0.55%	0.80%	0.39%	0.26%	0.31%	0.27%	0.26%	0.25%
Investment profits/Assets	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Net revenues/Assets	**3.50%**	**3.57%**	**3.27%**	**3.97%**	**2.83%**	**2.45%**	**2.55%**	**2.56%**	**2.51%**	**2.49%**
Operating Expense/Assets	0.68%	0.62%	0.58%	0.48%	0.42%	0.40%	0.37%	0.36%	0.36%	0.35%
Provisions/Assets	0.12%	0.02%	-0.09%	0.59%	0.27%	0.11%	0.03%	0.04%	0.06%	0.06%
Taxes/Assets	0.73%	0.79%	0.76%	0.72%	0.55%	0.50%	0.60%	0.60%	0.58%	0.58%
Total Costs/Assets	**1.54%**	**1.43%**	**1.25%**	**1.79%**	**1.24%**	**1.01%**	**1.00%**	**1.01%**	**1.00%**	**0.99%**
ROA	**1.96%**	**2.14%**	**2.01%**	**2.19%**	**1.59%**	**1.44%**	**1.56%**	**1.56%**	**1.51%**	**1.50%**
Equity/AUM	9.27%	9.01%	10.30%	9.35%	9.95%	9.20%	8.91%	8.81%	8.66%	8.46%
ROE	**22.9%**	**26.2%**	**23.6%**	**25.8%**	**18.4%**	**16.6%**	**18.8%**	**19.0%**	**18.7%**	**19.1%**

Source: Company data, Nomura estimates

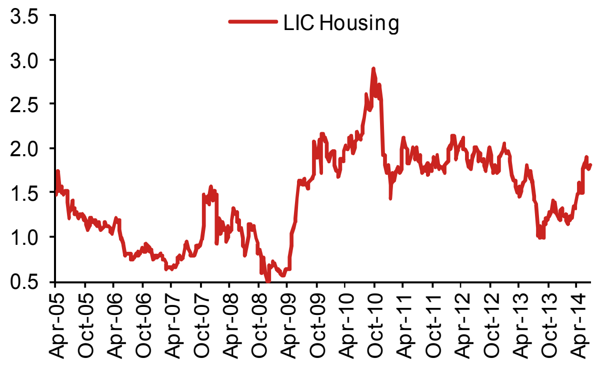
Fig. 263: Valuation of INR370

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.15
Cost of Equity	14.9%
Terminal growth	5.0%
Normalised ROE	18.9%
Stage 2 growth	19.0%
Mar-15 PT	370
Implied Mar-16 P/B	1.85
Implied Mar-16 P/E	10.64

Source: Nomura estimates

Fig. 264: Valuations reasonable from a historical perspective

1-year fwd P/B chart



Source: Company data, Bloomberg, Nomura estimates

NOMURA

Mahindra & Mahindra Financial Services MMFS.NS MMFS IN

EQUITY: FINANCIALS

Profitability normalising + monsoon risks

Longer-term growth prospects fine, but near-term cyclical growth and asset quality risks high

Action: Too many cyclical risks under way

Following transfer of coverage of Mahindra Finance (MMFS) we rate the shares Neutral, with a TP of INR290. While MMFS is one of the better plays on rural buoyancy from a medium- to longer-term perspective, we are seeing near-term growth and asset quality challenges, and with the monsoons being a non-starter so far, risk of the cyclical downturn extending has increased. Disbursement growth is likely to remain negative in 1H15F and we thus expect <15% AUM growth for FY15F and a weak monsoon could likely defer a recovery in asset quality.

- FY14 asset quality was impacted owing to issues related to specific geographies. With lower MSP increases and a weak start to the monsoons, rural buoyancy will be impacted, we think. We expect credit costs to increase to ~200bp in FY15/16F vs. 120bp in FY11-13.
- Profitability has normalised from ~22-23% ROEs in FY11-13 to 18% in FY14 and we expect ROEs to remain ~18-19% till FY16F. Investors should thus look at valuations in that context.

Catalysts: We would prefer to wait for risks on monsoons to play out before we get incrementally positive on MMFS - Though non-agricultural use for MMFS customers has increased, underlying asset quality still remains anchored to rural buoyancy.

Valuations: Not enticing enough to ignore near-term risks

MMFS currently trades at 2.1x Mar-16F book after adjusting for INR22 for its subsidiaries (rural housing + insurance brokers). At current valuations, we believe valuations are not enticing enough to ignore risks to asset quality and growth in FY15F. While lower rates should be margin accretive given fixed rate book, food inflation risks will only delay rate cut expectations. Our TP of INR290 implies 2.25x FY16F book (BVPS: INR118).

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	18,516		21,340		25,204		30,407
Reported net profit (mn)	8,872		9,931		11,484		13,686
Normalised net profit (mn)	8,872		9,931		11,484		13,686
FD normalised EPS	15.74		17.62		20.38		24.29
FD norm. EPS growth (%)	3.8		11.9		15.6		19.2
FD normalised P/E (x)	17.4	N/A	15.6	N/A	13.5	N/A	11.3
Price/adj. book (x)	3.0	N/A	2.7	N/A	2.3	N/A	2.0
Price/book (x)	3.0	N/A	2.7	N/A	2.3	N/A	2.0
Dividend yield (%)	1.6	N/A	1.7	N/A	2.0	N/A	2.3
ROE (%)	18.6		18.2		18.4		19.1
ROA (%)	3.1		3.0		2.9		2.8

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Neutral**
Target price From N/A	INR 290
Closing price 3 July 2014	INR 274
Potential upside	+5.7%

Anchor themes

Remains a good rural play, but too many cyclical headwinds.

Nomura vs consensus

Our earnings estimates for FY15/16F are below consensus, as we expect credit costs and growth to surprise negatively in the near-term.

Research analysts

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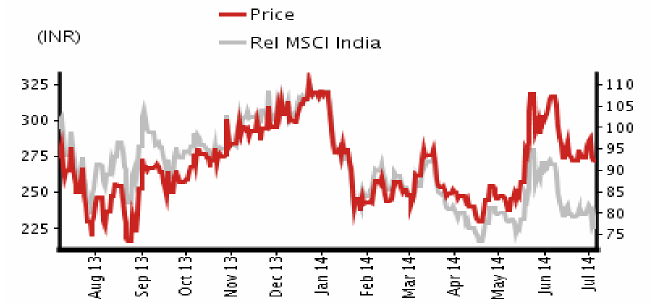
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Mahindra & Mahindra Financial Services

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	-9.9	11.7	3.5	M cap (USDmn)	2,610.6
Absolute (USD)	-10.6	12.6	4.4	Free float (%)	90.3
Rel to MSCI India	-14.4	-1.8	-26.7	3-mth ADT (USDmn)	9.6

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	38,567	49,216	56,855	66,418	80,465
Interest expense	-16,188	-21,880	-25,181	-28,805	-35,145
Net interest income	22,380	27,336	31,674	37,614	45,319
Net fees and commissions	380	314	361	415	477
Trading related profits	0	0	0	0	0
Other operating revenue	0	0	0	0	0
Non-interest income	380	314	361	415	477
Operating income	22,759	27,650	32,034	38,028	45,796
Depreciation	-222	-243	-245	-285	-342
Amortisation					
Operating expenses	-3,581	-4,162	-4,870	-5,844	-7,013
Employee share expense	-3,616	-4,729	-5,580	-6,696	-8,035
Pre-provision op profit	15,340	18,516	21,340	25,204	30,407
Provisions for bad debt	-581	-667	-2,616	-3,443	-4,310
Other provision charges	-2,252	-4,391	-4,120	-4,872	-5,971
Operating profit	12,506	13,458	14,604	16,888	20,127
Other non-op income					
Associates & JCEs					
Pre-tax profit	12,506	13,458	14,604	16,888	20,127
Income tax	-3,965	-4,586	-4,673	-5,404	-6,441
Net profit after tax	8,541	8,872	9,931	11,484	13,686
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	8,541	8,872	9,931	11,484	13,686
Extraordinary items	0	0	0	0	0
Reported NPAT	8,541	8,872	9,931	11,484	13,686
Dividends	-2,371	-2,505	-2,609	-3,017	-3,596
Transfer to reserves	6,170	6,367	7,322	8,467	10,090

Growth (%)

	FY13	FY14	FY15F	FY16F	FY17F
Net interest income	35.8	22.1	15.9	18.8	20.5
Non-interest income	41.2	-17.4	15.0	15.0	15.0
Non-interest expenses	29.3	16.2	17.0	20.0	20.0
Pre-provision earnings	41.7	20.7	15.3	18.1	20.6
Net profit	37.7	3.9	11.9	15.6	19.2
Normalised EPS	25.6	3.8	11.9	15.6	19.2
Normalised FDEPS	25.6	3.8	11.9	15.6	19.2
Loan growth	37.4	23.2	12.4	21.7	23.1
Interest earning assets	37.4	23.2	12.4	21.7	23.1
Interest bearing liabilities	35.2	28.7	11.5	23.8	25.3
Asset growth	37.3	24.2	12.0	21.5	22.9
Deposit growth	na	na	na	na	na

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	3,454	5,533	6,640	7,968	9,561
Inter-bank lending					
Deposits with central bank					
Total securities					
Other int earning assets					
Gross loans	245,414	304,471	343,707	419,342	517,194
Less provisions	-5,030	-8,301	-10,917	-14,361	-18,670
Net loans	240,384	296,170	332,790	404,981	498,524
Long-term investments	5,610	8,692	8,320	10,125	12,463
Fixed assets	1,068	1,195	1,426	1,711	2,053
Goodwill					
Other intangible assets					
Other non IEAs	4,409	5,067	5,608	6,233	6,959
Total assets	254,924	316,657	354,783	431,017	529,559
Customer deposits	0	0	0	0	0
Bank deposits, CDs,	188,723	242,977	270,928	335,486	420,324
Other int bearing liabilities	0	0	0	0	0
Total int bearing liabilities	188,723	242,977	270,928	335,486	420,324
Non-int bearing liabilities	21,655	22,738	25,590	28,801	32,414
Total liabilities	210,378	265,715	296,519	364,287	452,738
Minority interest					
Common stock	1,126	1,127	1,127	1,127	1,127
Preferred stock					
Retained earnings	43,420	49,815	57,137	65,604	75,694
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	44,546	50,942	58,264	66,731	76,821
Total liabilities and equity	254,924	316,657	354,783	431,017	529,559
Non-perf assets	11,903	13,600	15,834	18,754	22,352

Balance sheet ratios (%)

	FY13	FY14	FY15F	FY16F	FY17F
Loans to deposits	na	na	na	na	na
Equity to assets	17.5	16.1	16.4	15.5	14.5
Asset quality & capital					
NPAs/gross loans (%)	4.9	4.5	4.6	4.5	4.3
Bad debt charge/gross	0.24	0.22	0.76	0.82	0.83
Loss reserves/assets (%)	1.97	2.62	3.08	3.33	3.53
Loss reserves/NPAs (%)	42.3	61.0	68.9	76.6	83.5
Tier 1 capital ratio (%)	17.0	15.5	15.9	15.0	14.1
Total capital ratio (%)	19.7	18.0	18.1	16.8	15.6
Per share					
Reported EPS (INR)	15.17	15.74	17.62	20.38	24.29
Norm EPS (INR)	15.17	15.74	17.62	20.38	24.29
FD norm EPS (INR)	15.17	15.74	17.62	20.38	24.29
DPS (INR)	4.21	4.45	4.63	5.35	6.38
PPOP PS (INR)	27.25	32.86	37.87	44.73	53.96
BVPS (INR)	79.12	90.40	103.40	118.42	136.33
ABVPS (INR)	79.12	90.40	103.40	118.42	136.33
NTAPS (INR)	79.12	90.40	103.40	118.42	136.33

Valuations and ratios

	FY13	FY14	FY15F	FY16F	FY17F
Reported P/E (x)	18.1	17.4	15.6	13.5	11.3
Normalised P/E (x)	18.1	17.4	15.6	13.5	11.3
FD normalised P/E (x)	18.1	17.4	15.6	13.5	11.3
Dividend yield (%)	1.5	1.6	1.7	2.0	2.3
Price/book (x)	3.5	3.0	2.7	2.3	2.0
Price/adjusted book (x)	3.5	3.0	2.7	2.3	2.0
Net interest margin (%)	10.78	10.19	10.07	10.20	10.03
Yield on assets (%)	18.57	18.35	18.08	18.01	17.81
Cost of int bearing liab (%)	9.86	10.14	9.80	9.50	9.30
Net interest spread (%)	8.71	8.21	8.28	8.51	8.51
Non-interest income (%)	1.7	1.1	1.1	1.1	1.0
Cost to income (%)	32.6	33.0	33.4	33.7	33.6
Effective tax rate (%)	31.7	34.1	32.0	32.0	32.0
Dividend payout (%)	27.8	28.2	26.3	26.3	26.3
ROE (%)	23.1	18.6	18.2	18.4	19.1
ROA (%)	3.88	3.10	2.96	2.92	2.85
Operating ROE (%)	33.8	28.2	26.7	27.0	28.0
Operating ROA (%)	5.68	4.71	4.35	4.30	4.19

Source: Company data, Nomura estimates

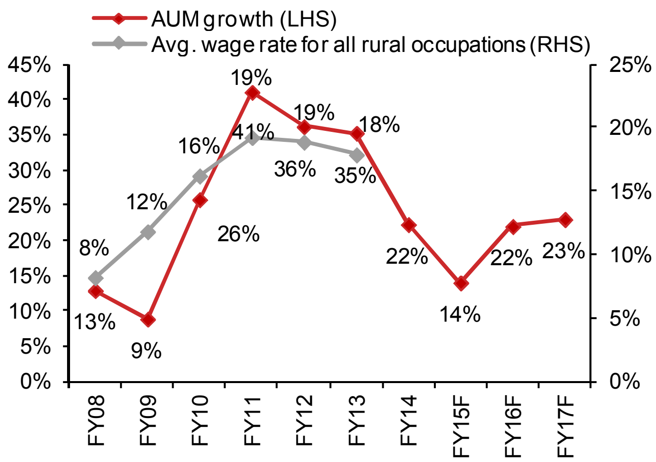
Too many cyclical risks

MMFS's asset quality deteriorated in FY14 despite good monsoons owing to an overall slowdown and, more importantly, collection issues in Madhya Pradesh and most of the southern states. Concerted efforts aided collection in most states, except Tamil Nadu in 4QFY14, but management remains cautious on the overall asset quality trend.

With a weak start to the monsoons this year, risks to asset quality have only increased and low increases in Agri MSPs (minimum support price) are unlikely to aid rural buoyancy. Over the past few years, there has been a clear correlation of MMFS growth and asset quality with rural buoyancy, which we think could falter in FY15F.

We thus factor in gross NPAs to increase to 5.5% in FY16F from 4.7% in FY14, and credit costs to inch up to ~200bp in FY15/16F from 120bp in FY11-13 and ~175bp in FY14.

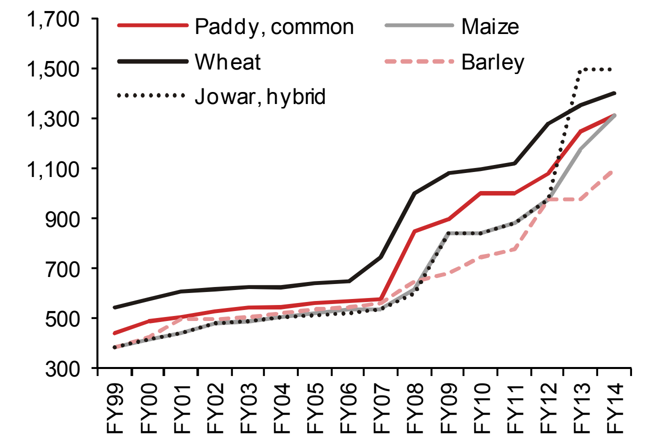
Fig. 265: AUM growth linked to rural income growth



Source: Company data, Business beacon

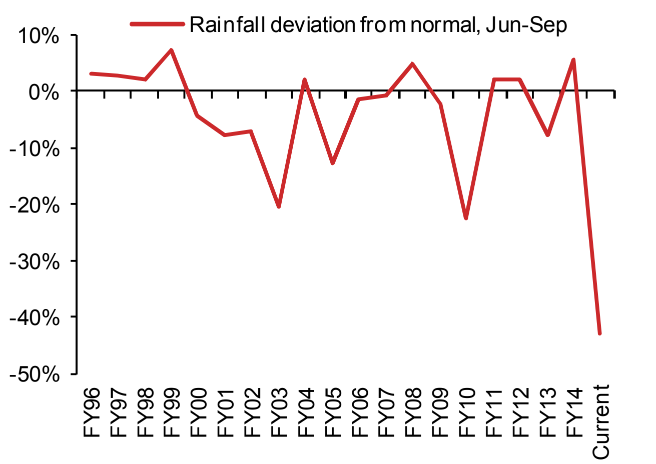
Fig. 266: MSP price hikes are coming off

(INR)



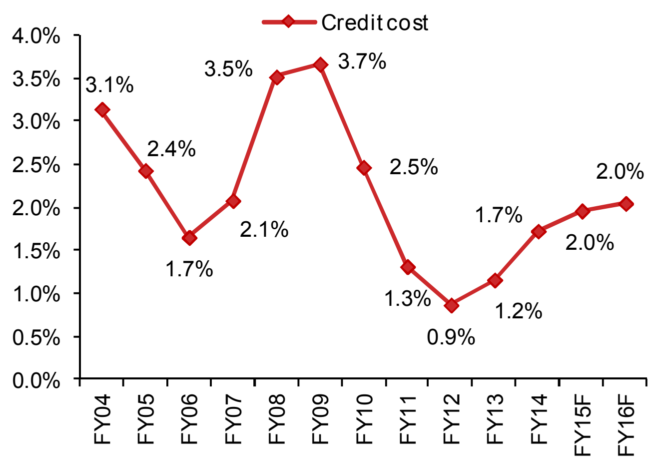
Source: Business beacon

Fig. 267: Monsoons significantly below normal till now



Source: IMD, Nomura research

Fig. 268: We expect credit costs to continue to inch up



Source: Company data, Nomura estimates

Valuations are not cheap either

MMFS currently trades at 2.1x Mar-16F book after adjusting for INR22 for its subsidiaries (rural housing + insurance brokers). Investors will also need to evaluate valuations from the context of normalising ROEs (down from 22-23% in FY11-13 to our expected ~18-19% in FY14-16F) and slower profit growth (~30% EPS growth in FY11-13 to ~13% EPS growth in FY14-16F after a year of flat EPS in FY14). At current valuations, we believe valuations are not enticing enough to ignore risks to asset quality and growth in FY15F. While lower rates should be margin accretive given fixed rate book, food inflation risks will only delay rate cut expectations. Our TP of INR290 implies 2.25x FY16F book (BVPS: INR118).

Risks: A pick-up in monsoons from here, such that it covers up for the June shortfall.

Fig. 269: Back to normalised ROEs from super normal profitability in FY11-13

ROE Decomposition (on AUM)	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Net Interest Income/Assets	10.55%	10.67%	10.14%	9.20%	9.22%	8.81%	8.67%	8.71%	8.56%
Fees/Assets	0.13%	0.39%	0.30%	0.15%	0.16%	0.10%	0.10%	0.10%	0.09%
Investment profits/Assets	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Net revenues/Assets	**10.67%**	**11.06%**	**10.44%**	**9.35%**	**9.37%**	**8.91%**	**8.77%**	**8.80%**	**8.65%**
Operating Expense/Assets	3.25%	3.36%	3.78%	3.31%	3.06%	2.94%	2.93%	2.97%	2.91%
Provisions/Assets	3.45%	2.31%	1.23%	0.88%	1.17%	1.63%	1.84%	1.93%	1.94%
Taxes/Assets	1.36%	1.83%	1.85%	1.70%	1.63%	1.48%	1.28%	1.25%	1.22%
Total Costs/Assets	**8.06%**	**7.49%**	**6.86%**	**5.89%**	**5.86%**	**6.05%**	**6.05%**	**6.15%**	**6.07%**
ROA	**2.62%**	**3.57%**	**3.57%**	**3.46%**	**3.52%**	**2.86%**	**2.72%**	**2.66%**	**2.59%**
Equity/Assets	17.93%	17.92%	19.22%	16.48%	18.35%	16.42%	15.95%	15.45%	14.51%
ROE	**15.4%**	**21.5%**	**22.0%**	**22.8%**	**23.1%**	**18.6%**	**18.2%**	**18.4%**	**19.1%**

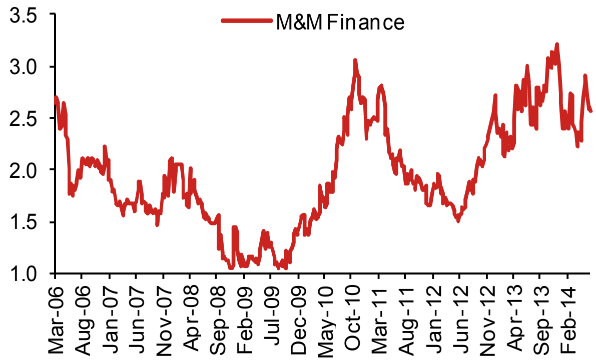
Source: Company data, Nomura estimates

Fig. 270: Valuation of INR290 (INR22 for subs)

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.10
Cost of Equity	14.6%
Terminal growth	5.0%
Normalised ROE	20.2%
Stage 2 growth	20.0%
Mar-15 PT	290
Implied Mar-16 P/B	2.26
Implied Mar-16 P/E	13.13
Subsidiary valuation	22

Source: Nomura estimates

Fig. 271: Valuations have corrected, but not enticing enough to overlook monsoon risks



Source: Company data, Bloomberg, Nomura research

NOMURA

Shriram Transport Finance

SRTR.NS SHTF IN

EQUITY: FINANCIALS

CV cycle to turn, but too much priced in

Growth and profitability are unlikely to reach levels seen in the last cycle

Action: We expect a turn in the CV cycle, but see too much priced in
We resume coverage of Shriram (SHTF) with target price of INR880 and a Reduce call. Freight rates have risen since October 2013, capacity utilisation is bottoming out and the macro outlook is improving, causing us to factor in a turn in the commercial vehicle cycle in FY16F. However, the current valuation of 1.9x Mar-16F book already factors in much of the expected improvement, in our view. While peak multiples in the previous cycle were much higher, we also doubt that profitability and growth will match the previous cycle's levels.

- **We factor in an FY16F recovery in the CV cycle**: A ~15% increase in freight rates since October 2013 has helped truckers' profitability, while a better macro outlook should lift freight utilisation rates over coming quarters. We expect AUM growth to rebound to ~17% in FY16F, from 9% in FY15F, and credit costs to fall by ~30bp over the next two years.
- **But profitability is unlikely to match the previous cycle:** Lending spreads over the last three years have narrowed significantly, despite lower leverage, and the asset mix is unlikely to be yield-accretive, in our view. Potential leverage has fallen to 7-8x from 9-11x in FY07-10 on changes in capital charges for securitisations. We expect a 15.5-18.0% ROE over FY15-17F (25%-plus in FY07-11), and believe valuations should be compared in that context.

Catalysts: Asset quality will likely recover over six months, but growth is likely to disappoint in the near term – wait for better valuation.

Valuation: Pricing in some recovery
Our TP of INR880 is based on 1.75x Mar-16F book after adjusting for INR44 of subsidiary valuation (equipment finance + Auto Mall). SHTF's growth rate is likely to be lower than peers' over the next two to three years despite the CV recovery, with profitability unlikely to return to previous-cycle highs; we do not believe that benchmarking to historical valuations is justified.

Year-end 31 Mar	FY14		FY15F		FY16F		FY17F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	28,574		30,924		35,699		41,822
Reported net profit (mn)	12,642		13,874		17,161		20,847
Normalised net profit (mn)	12,642		13,874		17,161		20,847
FD normalised EPS	55.71		61.14		75.63		91.87
FD norm. EPS growth (%)	-7.1		9.7		23.7		21.5
FD normalised P/E (x)	16.9	N/A	15.4	N/A	12.5	N/A	10.3
Price/adj. book (x)	2.6	N/A	2.3	N/A	2.0	N/A	1.7
Price/book (x)	2.6	N/A	2.3	N/A	2.0	N/A	1.7
Dividend yield (%)	0.9	N/A	1.0	N/A	1.2	N/A	1.5
ROE (%)	16.3		15.7		16.8		17.7
ROA (%)	2.7		2.7		3.0		3.2

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart

Global Markets Research

8 July 2014

Rating From Suspended	**Reduce**
Target price From N/A	INR 880
Closing price 3 July 2014	INR 936
Potential downside	-6%

Anchor themes
The CV cycle is likely to improve from 2HFY15F but the stock is pricing in too much optimism, in our view.

Nomura vs consensus
Our FY15/16F PAT estimates are 4-5% lower than consensus.

Research analysts

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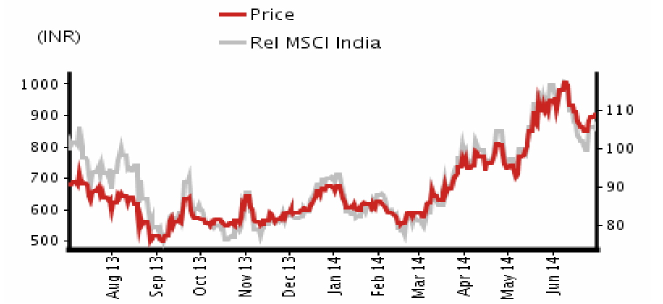
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Shriram Transport Finance

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	0.1	23.2	38.9	M cap (USDmn)	3,580.0
Absolute (USD)	-0.9	23.0	38.8	Free float (%)	90.3
Rel to MSCI India	-2.7	12.7	14.0	3-mth ADT (USDmn)	10.6

Profit and loss (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Interest income	61,333	74,207	80,924	90,395	103,754
Interest expense	-28,439	-39,982	-43,436	-46,955	-53,112
Net interest income	32,894	34,226	37,488	43,440	50,642
Net fees and commissions	3,579	3,909	3,961	4,110	4,638
Trading related profits	0	0	0	0	0
Other operating revenue	0	0	0	0	0
Non-interest income	3,579	3,909	3,961	4,110	4,638
Operating income	36,473	38,134	41,449	47,550	55,280
Depreciation	-183	-291	-306	-321	-344
Amortisation					
Operating expenses	-3,829	-5,181	-5,803	-6,673	-7,674
Employee share expense	-3,848	-4,089	-4,416	-4,857	-5,440
Pre-provision op profit	28,613	28,574	30,924	35,699	41,822
Provisions for bad debt	-8,451	-10,293	-10,962	-11,006	-11,826
Other provision charges	0	0	0	0	0
Operating profit	20,162	18,281	19,963	24,692	29,996
Other non-op income					
Associates & JCEs					
Pre-tax profit	20,162	18,281	19,963	24,692	29,996
Income tax	-6,556	-5,638	-6,089	-7,531	-9,149
Net profit after tax	13,606	12,642	13,874	17,161	20,847
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	13,606	12,642	13,874	17,161	20,847
Extraordinary items	0	0	0	0	0
Reported NPAT	13,606	12,642	13,874	17,161	20,847
Dividends	-1,858	-1,858	-2,040	-2,523	-3,171
Transfer to reserves	11,748	10,784	11,835	14,639	17,676

Growth (%)

Net interest income	9.8	4.0	9.5	15.9	16.6
Non-interest income	0.0	9.2	1.3	3.8	12.8
Non-interest expenses	16.8	35.3	12.0	15.0	15.0
Pre-provision earnings	8.3	-0.1	8.2	15.4	17.2
Net profit	8.2	-7.1	9.7	23.7	21.5
Normalised EPS	7.9	-7.1	9.7	23.7	21.5
Normalised FDEPS	7.9	-7.1	9.7	23.7	21.5
Loan growth	42.1	17.2	10.0	17.0	16.0
Interest earning assets	42.1	17.2	10.0	17.0	16.0
Interest bearing liabilities	34.1	15.9	4.9	16.7	14.7
Asset growth	24.5	10.7	6.9	15.6	14.3
Deposit growth	na	na	na	na	na

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash and equivalents	64,615	70,860	64,937	72,129	79,484
Inter-bank lending					
Deposits with central bank					
Total securities					
Other int earning assets					
Gross loans	319,064	376,213	416,019	486,980	563,290
Less provisions	-7,837	-11,476	-14,809	-17,564	-18,767
Net loans	311,227	364,737	401,210	469,416	544,523
Long-term investments	35,689	27,253	28,517	32,998	34,721
Fixed assets	601	1,007	1,162	1,220	1,252
Goodwill					
Other intangible assets					
Other non IEAs	32,447	28,401	30,416	32,722	35,261
Total assets	444,578	492,257	526,242	608,484	695,241
Customer deposits	0	0	0	0	0
Bank deposits, CDs,	310,025	359,300	376,909	439,701	504,506
Other int bearing liabilities	0	0	0	0	0
Total int bearing liabilities	310,025	359,300	376,909	439,701	504,506
Non-int bearing liabilities	62,606	50,225	54,766	59,577	63,852
Total liabilities	372,631	409,525	431,675	499,279	568,359
Minority interest					
Common stock	2,269	2,269	2,269	2,269	2,269
Preferred stock					
Retained earnings	69,679	80,463	92,298	106,936	124,613
Reserves for credit losses					
Proposed dividends					
Other equity					
Shareholders' equity	71,947	82,732	94,567	109,205	126,882
Total liabilities and equity	444,578	492,257	526,242	608,484	695,241
Non-perf assets	10,254	14,505	18,718	22,200	23,721

Balance sheet ratios (%)

Loans to deposits	na	na	na	na	na
Equity to assets	16.2	16.8	18.0	17.9	18.3

Asset quality & capital

NPAs/gross loans (%)	3.2	3.9	4.5	4.6	4.2
Bad debt charge/gross	2.65	2.74	2.63	2.26	2.10
Loss reserves/assets (%)	1.76	2.33	2.81	2.89	2.70
Loss reserves/NPAs (%)	76.4	79.1	79.1	79.1	79.1
Tier 1 capital ratio (%)	16.7	17.7	18.7	18.4	18.4
Total capital ratio (%)	20.7	23.4	24.3	24.0	24.1

Per share

Reported EPS (INR)	59.97	55.71	61.14	75.63	91.87
Norm EPS (INR)	59.97	55.71	61.14	75.63	91.87
FD norm EPS (INR)	59.97	55.71	61.14	75.63	91.87
DPS (INR)	8.19	8.19	8.99	11.12	13.97
PPOP PS (INR)	126.11	125.92	136.29	157.32	184.31
BVPS (INR)	317.10	364.60	416.76	481.27	559.17
ABVPS (INR)	317.10	364.60	416.76	481.27	559.17
NTAPS (INR)	317.10	364.60	416.76	481.27	559.17

Valuations and ratios

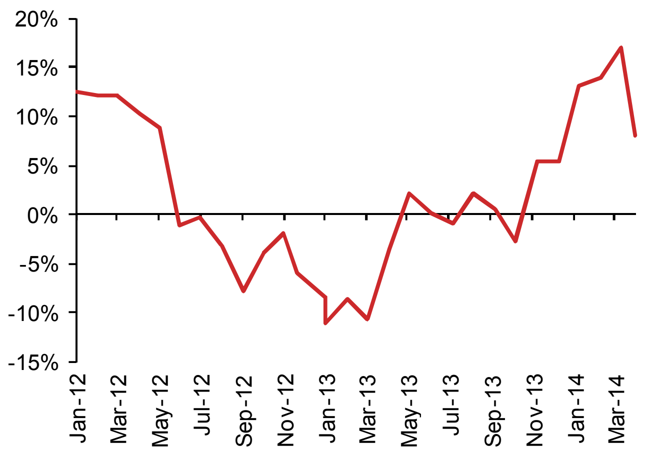
Reported P/E (x)	15.7	16.9	15.4	12.5	10.3
Normalised P/E (x)	15.7	16.9	15.4	12.5	10.3
FD normalised P/E (x)	15.7	16.9	15.4	12.5	10.3
Dividend yield (%)	0.9	0.9	1.0	1.2	1.5
Price/book (x)	3.0	2.6	2.3	2.0	1.7
Price/adjusted book (x)	3.0	2.6	2.3	2.0	1.7
Net interest margin (%)	12.41	10.13	9.79	9.98	9.99
Yield on assets (%)	23.13	21.96	21.13	20.77	20.47
Cost of int bearing liab (%)	10.51	11.95	11.80	11.50	11.25
Net interest spread (%)	12.63	10.01	9.33	9.27	9.22
Non-interest income (%)	9.8	10.3	9.6	8.6	8.4
Cost to income (%)	21.6	25.1	25.4	24.9	24.3
Effective tax rate (%)	32.5	30.8	30.5	30.5	30.5
Dividend payout (%)	13.7	14.7	14.7	14.7	15.2
ROE (%)	20.6	16.3	15.7	16.8	17.7
ROA (%)	3.39	2.70	2.72	3.02	3.20
Operating ROE (%)	30.6	23.6	22.5	24.2	25.4
Operating ROA (%)	5.03	3.90	3.92	4.35	4.60

Source: Company data, Nomura estimates

We expect a turn in the CV cycle in FY16F

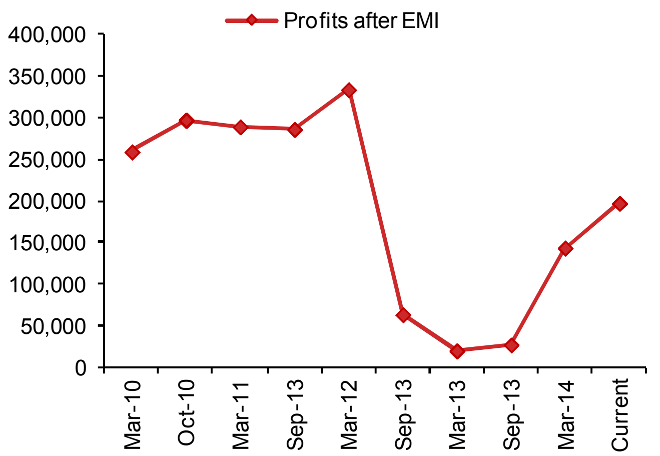
We believe the commercial vehicle (CV) cycle will bottom out in 1H FY15F: 1) Freight rates have consistently risen up over the last nine months, more than compensating for higher diesel prices; 2) truckers' profitability has improved significantly since October 2013; 3) The Indian Foundation for Transport Research and Training (IFTRT) suggests that freight utilization has begun to improve, especially of vehicles with national permits, where there size of the fleet available has shrunk. With an uptick in economic activity, we believe utilisation will improve further – hence our belief in a CV cycle revival by 2H FY15F. Our auto analyst, Kapil Singh, expects heavy CV (HCV) sales to improve by ~10-15% in FY15F, from negative growth YTD. We therefore factor in material growth in AUM for SHTF of 17% y-y, along with lower credit costs of ~170bp for FY16F (from 200bp in FY15F).

Fig. 272: Freight rates have inched up from October 2013



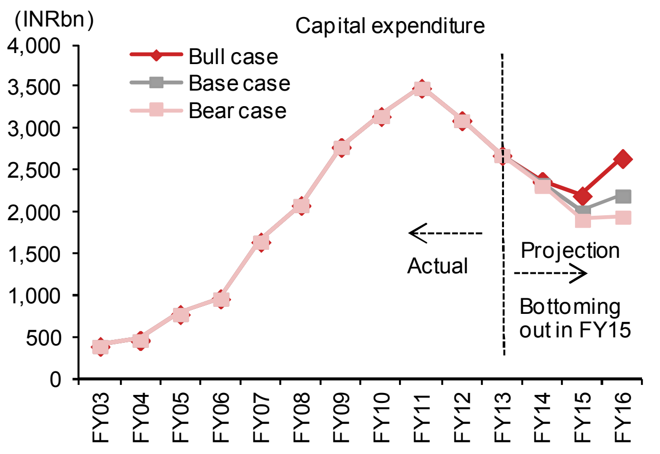
Source: Bloomberg, Nomura research

Fig. 273: Recent pick-up in truckers' profitability



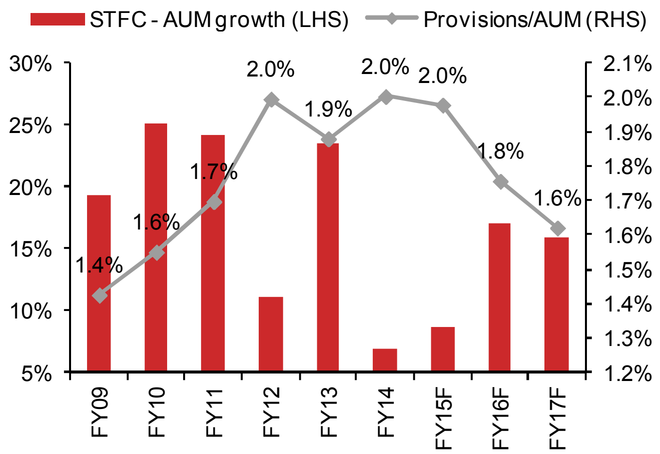
Source: Bloomberg, Nomura estimates

Fig. 274: Meaningful improvement expected as capex cycle picks up from FY16F



Source: Nomura Strategy team estimates

Fig. 275: Higher growth and lower credit costs in FY16/17F



Source: Company data, Nomura estimates

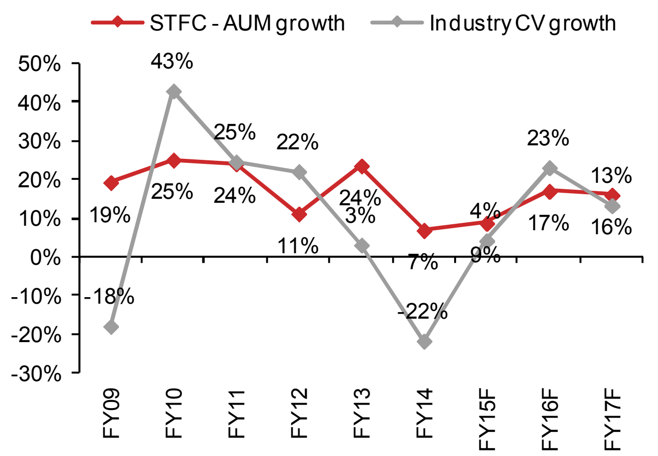
Profitability and growth unlikely to match the previous cycle

While we factor in a CV cycle recovery, profitability for Shriram is unlikely to match pre-FY12F levels given:

1) Risk-adjusted margins (adjusted for capital levels) have come off by ~150bp over the past four to five years due to a combination of asset mix and higher funding costs. Lower rates over the next two years and a shedding of the excess liquidity on the balance sheet should lead to some margin improvement (we expect a 30bp improvement over the next two to three years). However, we believe it is unlikely that margins will recover meaningfully from a mix perspective given that once the growth cycle starts; we would expect new CV credit offtake to outstrip that of used CVs.

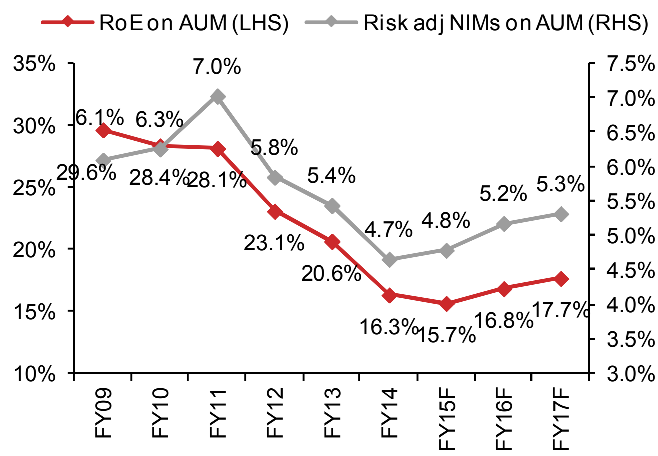
2) With changes in capital charges for securitisations, potential leverage falls to ~7-8x, from 9-11x in FY07-10. We expect a 15.5-18% ROE over FY15-17F, compared with an ROE of 25%-plus in FY07-11.

Fig. 276: Growth pick-up to be lower given SHTF's size



Source: Company data, Nomura estimates

Fig. 277: Risk-adjusted margins much lower; lower leverage makes ROEs incomparable



Source: Company data, Nomura estimates

Valuations already pricing in a recovery

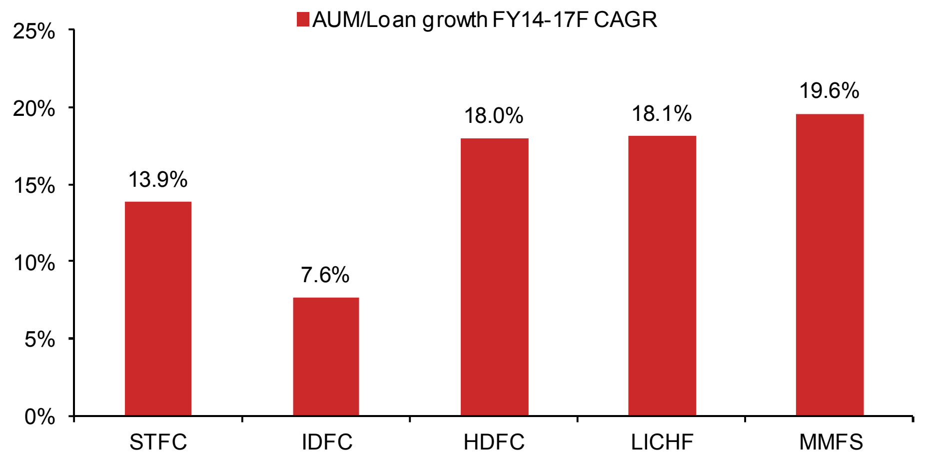
Our TP of INR880 is based on 1.8x Mar-16F book after adjusting for INR44 of subsidiary valuation (equipment finance + Auto Mall). Thus, with the recent outperformance, we believe risk-reward is no longer as attractive. SHTF's growth rate is likely to be lower than its NBFC peers' over the next two to three years, despite the CV recovery, and we do not expect profitability to be comparable to the previous cycle. As such, we believe that any benchmarking to historical valuations is unjustified. Risks include a faster-than-expected recovery in CV demand and asset quality.

Fig. 278: Valuation has to be considered in conjunction with significantly lower ROE than the previous cycle

ROE Decomposition (on AUM)	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15F**	**FY16F**	**FY17F**
Net Interest Income/AUM	7.52%	7.81%	8.72%	7.84%	7.32%	6.66%	6.76%	6.93%	6.94%
Fees/AUM	0.66%	0.76%	0.94%	0.94%	0.80%	0.76%	0.71%	0.66%	0.64%
Investment profits/AUM	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Net revenues/AUM	**8.18%**	**8.57%**	**9.67%**	**8.78%**	**8.12%**	**7.42%**	**7.48%**	**7.59%**	**7.58%**
Operating Expense/AUM	2.46%	1.97%	2.31%	1.86%	1.75%	1.86%	1.90%	1.89%	1.84%
Provisions/AUM	1.43%	1.55%	1.70%	2.00%	1.88%	2.00%	1.98%	1.76%	1.62%
Taxes/AUM	1.44%	1.72%	1.89%	1.63%	1.46%	1.10%	1.10%	1.20%	1.25%
Total Costs/AUM	**5.32%**	**5.24%**	**5.90%**	**5.49%**	**5.09%**	**4.96%**	**4.98%**	**4.85%**	**4.72%**
ROA	**2.86%**	**3.33%**	**3.76%**	**3.29%**	**3.03%**	**2.46%**	**2.50%**	**2.74%**	**2.86%**
Equity/AUM	9.93%	13.18%	13.55%	14.90%	14.48%	15.58%	16.38%	16.16%	16.19%
ROE	**29.6%**	**28.4%**	**28.1%**	**23.1%**	**20.6%**	**16.3%**	**15.7%**	**16.8%**	**17.7%**

Source: Company data, Nomura estimates

Fig. 279: Medium-term growth expectations are lower than for peers



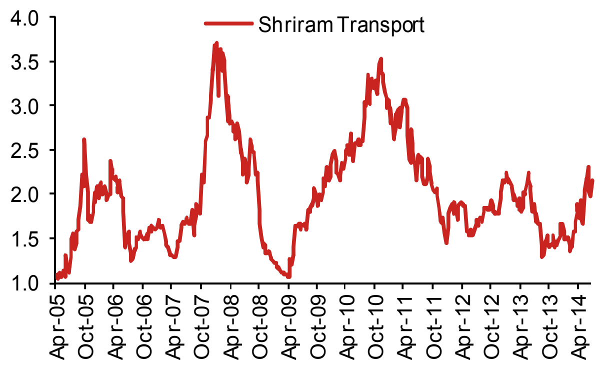
Source: Company data, Nomura estimates

Fig. 280: TP of INR880 implies only downside

Valuation assumptions	
Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.15
Cost of Equity	14.9%
Terminal growth	5.0%
Normalised ROE	18.0%
Stage 2 growth	20.0%
Mar-15 PT	880
Implied Mar-16 P/B	1.74
Implied Mar-16 P/E	11.06
Value of Subs	44

Source: Nomura estimates

Fig. 281: Valuations have mean-reverted



Source: Company data, Bloomberg, Nomura estimates

Appendix A-1

Analyst Certification

We, Adarsh Parasrampuria and Amit Nanavati, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Previous rating	Date of change	Sector rating
Axis Bank	AXSB IN	INR 1923	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
Bank of Baroda	BOB IN	INR 865	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
Bank of India	BOI IN	INR 301	07-Jul-2014	Buy	Not rated	08-Jul-2014	N/A
HDFC	HDFC IN	INR 1021	07-Jul-2014	Neutral	Suspended	08-Jul-2014	N/A
HDFC Bank	HDFCB IN	INR 840	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
ICICI Bank	ICICIBC IN	INR 1451	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
IDFC	IDFC IN	INR 142	07-Jul-2014	Neutral	Suspended	08-Jul-2014	N/A
Indusind Bank	IIB IN	INR 555	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
Kotak Mahindra Bank	KMB IN	INR 870	07-Jul-2014	Neutral	Not rated	08-Jul-2014	N/A
LIC Housing Finance	LICHF IN	INR 333	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
Mahindra & Mahindra Financial Services	MMFS IN	INR 273	07-Jul-2014	Neutral	Suspended	08-Jul-2014	N/A
Punjab National Bank	PNB IN	INR 970	07-Jul-2014	Reduce	Suspended	08-Jul-2014	N/A
State Bank of India	SBIN IN	INR 2685	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A
Shriram Transport Finance	SHTF IN	INR 960	07-Jul-2014	Reduce	Suspended	08-Jul-2014	N/A
Union Bank	UNBK IN	INR 223	07-Jul-2014	Neutral	Not rated	08-Jul-2014	N/A
Yes Bank	YES IN	INR 542	07-Jul-2014	Buy	Suspended	08-Jul-2014	N/A

Rating and target price changes

Issuer	Ticker	Old stock rating	New stock rating	Old target price	New target price
Axis Bank	AXSB IN	Suspended	Buy	N/A	INR 2300
Bank of Baroda	BOB IN	Suspended	Buy	N/A	INR 1025
Bank of India	BOI IN	Not rated	Buy	N/A	INR 330
HDFC	HDFC IN	Suspended	Neutral	N/A	INR 1050
HDFC Bank	HDFCB IN	Suspended	Buy	N/A	INR 950
ICICI Bank	ICICIBC IN	Suspended	Buy	N/A	INR 1650
IDFC	IDFC IN	Suspended	Neutral	N/A	INR 140
Indusind Bank	IIB IN	Suspended	Buy	N/A	INR 630
Kotak Mahindra Bank	KMB IN	Not rated	Neutral	N/A	INR 920
LIC Housing Finance	LICHF IN	Suspended	Buy	N/A	INR 370
Mahindra & Mahindra Financial Services	MMFS IN	Suspended	Neutral	N/A	INR 290
Punjab National Bank	PNB IN	Suspended	Reduce	N/A	INR 925
State Bank of India	SBIN IN	Suspended	Buy	N/A	INR 3050
Shriram Transport Finance	SHTF IN	Suspended	Reduce	N/A	INR 880
Union Bank	UNBK IN	Not rated	Neutral	N/A	INR 240
Yes Bank	YES IN	Suspended	Buy	N/A	INR 620

Axis Bank: Valuation Methodology Our TP of INR2,300 is based on 2.15x FY16F book. This is higher than the multiples at which Axis has traded in the past 2-3 years but lower than FY04-07 multiples. While growth over the next 2-3 years is likely to be lower than the last cycle, ROAs are much more superior (1.75% vs. 1.2% in FY04-07) and B/S and P&L granularity makes the business model less risky. We, thus, expect Axis Bank to close the valuation gap with private peers as risks surrounding large corporate asset quality ebb. MSCI India is the benchmark index for the stock.

Axis Bank: Risks that may impede the achievement of the target price (1) A slower-than-expected recovery in corporate capex execution; and (2) the indirect impact of weak monsoons – higher rates.

Bank of Baroda: Valuation Methodology Our TP of INR1025 implies 1.1x Mar-16F book based on our normalized ROE assumption of 15.5% and is 15% higher than our PNB's target multiple given lower asset quality risk/better under writing. While an impending transition will remain a concern till transition, the recent underperformance and better historic underwriting provides us some comfort. The benchmark index for this stock is MSCI India.

Bank of Baroda: Risks that may impede the achievement of the target price Risks: (1) Any near-term asset quality volatility due to a transition, and (2) slower-than-expected pick-up in economic activity.

Bank of India: Valuation Methodology Our TP of INR330 is based on 0.8x Mar-16F book which is marginally lower than our target multiple for Union (targeting slower growth) and at a 15-25% discount to PNB/BOB factoring in lower normalised ROEs (13.5% vs. 15-16% for PNB/BOB) and expected capital raising challenges. While asset quality and some dilution-linked NIM improvement will move up ROAs from 0.55% in FY14 to +0.70% in FY16/17F, ROEs will remain constrained at 13.5% due to lower leverage; an intended consolidation could push up valuations though. The benchmark index for this stock is MSCI India.

Bank of India: Risks that may impede the achievement of the target price Continued aggression on growth by management is a downside risk.

HDFC: Valuation Methodology Our TP of INR1,050 implies 4x Mar-16F book for the mortgage business after deducting for INR370 for its subsidiaries. We expect HDFC's core mortgage business to generate ~27-28% ROEs and hence 4x valuation looks justified. But with current valuations already at 3.6x FY16 book we believe risk-reward is evenly placed. We prefer HDFC Bank instead given its liability franchise and better asset growth prospects. The benchmark index for this stock is MSCI India.

HDFC: Risks that may impede the achievement of the target price (1) Very benign funding environment could lead to increase in margins/spreads and that will be a upside risk (2) while the builder book for HDFC Limited is well collateralised, there always will remain risk of downgrades/slippages and is a downside risk.

HDFC Bank: Valuation Methodology Our TP of INR950 is based on 3.75x Mar-16F book (3.4x Mar-16F book assuming an INR80bn dilution). The reasons for the recent underperformance have been rather technical and we believe premium valuations will be sustained as not only do we expect HDFCB's earnings to be the most resilient in the space, but its underlying metrics remain superior to those of its peers as well. Its valuation gap with peer retail banks (Kotak and IIB) is now low at 10-20% on FY16F P/B and less than 10% on FY16F P/E. The benchmark index for this stock is MSCI India.

HDFC Bank: Risks that may impede the achievement of the target price 1) A slower-than-expected pick-up in retail credit growth; and 2) any significant change in underwriting standards of retail loans.

ICICI Bank: Valuation Methodology Our TP of INR1,650 is based on 2.1x Mar-16F book for the lending business and INR 272 of subsidiary valuations. As ICICI closes the ROE gap with peers as the B/S leverage up and asset quality concerns on large corporate ebb, we would expect their valuation gap to narrow vs. retail peers and current valuations at 1.75x Mar-16F book look undemanding. The benchmark index for this stock is MSCI India.

ICICI Bank: Risks that may impede the achievement of the target price (1) Some lumpy asset quality risks – legacy gas assets and overseas coal assets funded by ICICI,and (2) slower-than-expected turnaround of GDP growth.

IDFC: Valuation Methodology Our TP of INR140 is based on 1.2x FY16F book (BVPS: INR119), which we believe is reasonable for the banking optionality but with sub-optimal ROE estimates of 10-12% for the next three-four years. IDFC's floating provision of INR10bn provides ~30% cover on its gas exposure of +INR30bn and adjusting for the uncovered gas exposure, IDFC's FY16F book would be ~10% lower and our TP then would imply a valuation multiple of 1.35x Mar-16 book. MSCI India is the benchmark index for the stock.

IDFC: Risks that may impede the achievement of the target price (1) An upside risk is if domestic gas production improves faster than expected. (2) Downside risks - any miss on execution on the banking foray + slower improvement in macros/capex cycle implying stress from ex-gas exposure for IDFC.

Indusind Bank: Valuation Methodology Our TP of INR630 implies ~2.8x Mar-16F book. While profitability and profit growth for IIB are best in class, IIB's earnings will be a little more cyclical than HDFCB/Kotak given its liability/asset mix and high loan growth. Our TP implies 25%/10% discounts on P/B multiples of HDFCB/Kotak which we believe is fair. If some of the expected improvements materialise over time, then we believe that the discount to some of the defensive peers may come off. MSCI India is the benchmark index for this stock.

Indusind Bank: Risks that may impede the achievement of the target price A slower-than-expected recovery in the CV cycle and higher-than-expected credit costs.

Kotak Mahindra Bank: Valuation Methodology Kotak Bank's current valuations at ~2.9x Mar-15F book after adjusting for INR140 of valuations for its flow business are certainly expensive. While asset quality is likely to hold up the best as management has been very conservative in growing in the past 18 months, we see valuations stretched on a relative basis with HDFCB (Kotak just at a 10% discount on FY16F P/B and ~20% premium on FY16F P/E). Premium valuations could sustain given: (1) high RORWAs, (2) continuity of top management and investor comfort with its conservative approach to asset quality; and (3) relatively strong leverage to an upcycle as well. We value Kotak Bank on sum-of-the-parts basis with a TP of INR920. We value all the subsidiaries (ex-Kotak Prime) at INR140. Our residual TP for Kotak implies a ~3x Mar-16F book for its lending business. MSCI India is the benchmark index for this stock.

Kotak Mahindra Bank: Risks that may impede the achievement of the target price (1) Downside risks: Slower-than-expected loan growth will delay the leveraging up process. (2) Upside: A better-than-expected turn in profitability of capital market businesses and higher-than-expected gains from stressed asset book.

LIC Housing Finance: Valuation Methodology LICHF currently trades at ~1.6x Mar-16F book which we believe is undemanding for a structural growth of ~17-18% at least, and respectable ROEs. Our TP of INR370 implies 1.85x Mar-16F book. While visibility on growth could provide scope for a higher multiple than implied by our TP, we believe competition will constraint mortgage spreads and though current liquidity/wholesale funding costs are benign, we cannot extrapolate the same. MSCI India is the benchmark for this stock.

LIC Housing Finance: Risks that may impede the achievement of the target price A significant change in the liquidity outlook could impact margins and LICHF's profitability - we assume liquidity to remain benign.

Mahindra & Mahindra Financial Services: Valuation Methodology MMFS currently trades at 2.2x Mar-16F book after adjusting for INR22 for its subsidiaries (rural housing + insurance brokers). Investors will also need to evaluate valuations from a context of normalising ROEs (down from 22-23% in FY11-13 to ~18-19% expected in FY14-16F) and slower profit growth (~30% EPS growth in FY11-13 to ~13% EPS growth in FY14-16F after a yr of flat EPS in FY14). At current valuations, we believe valuations are not enticing enough to ignore risks to asset quality and growth in FY15F. While lower rates will be margin accretive given fixed rate book, food inflation risks will only delay the rate cut expectations. Our TP of INR290 implies 2.25x FY16F book. The benchmark index for this stock is MSCI India.

Mahindra & Mahindra Financial Services: Risks that may impede the achievement of the target price A pick-up in monsoons from here, such that it covers up for the June shortfall.

Punjab National Bank: Valuation Methodology Our TP of INR925 is based on 0.8x Mar-16F book (0.9x Mar-16F adjusted book) and implies a discount of 15% to our valuation multiple for BOB (better asset quality + higher ROEs). Recent outperformance has narrowed PNB's valuation discount to peers significantly (from 30-40% to 10-20%) and hence at current valuations we prefer SBI/BOB among the PSUs. While PNB's ROEs are comparable to BOB/SBI, we believe the same multiple is not warranted given the higher risk inherent in PNB's higher-yield/higher-credit cost model. The benchmark index for this stock is MSCI India.

Punjab National Bank: Risks that may impede the achievement of the target price A larger-than-expected economic recovery, such that even inferior businesses turn around quickly.

State Bank of India: Valuation Methodology Our TP of INR3,050 is based on 1.3x Mar-16 book after deducting for subsidiary value of INR235. We expect SBI's ROEs to inch up to ~15% which is just about equal to its Cost of Equity which justifies 1x book valuations. Our valuation multiple, in that context, factors in some premium for its superior liability franchise, and some of our comfort with current management. The benchmark index for this stock is MSCI India.

State Bank of India: Risks that may impede the achievement of the target price Slower-than-expected recovery of corporate credit cycle will be a key risk.

Shriram Transport Finance: Valuation Methodology Our TP of INR880 is based on 1.8x Mar-16F book after adjusting for INR44 of subsidiary valuation (equipment finance + Auto Mall). MSCI India is the benchmark for this stock.

Shriram Transport Finance: Risks that may impede the achievement of the target price Faster-than-expected recovery in CV demand and asset quality.

Union Bank: Valuation Methodology Our TP of INR240 is based on 0.85x Mar-16F book, marginally higher than our multiple for BOI and ~10-20% discount to PNB/BOB factoring in lower ROEs. In our view, profitability is likely to improve from FY14 levels but will remain among the lowest and below its cost of equity, which will likely constrain valuations on an absolute basis. On a relative basis, the recent outperformance has reduced Union's valuation gap with PNB and BOB to ~10-20% from 35-40% in last six months, which we believe is fair considering the ROE differentials. MSCI India is the benchmark index for this stock.

Union Bank: Risks that may impede the achievement of the target price Stronger-than-expected pick-up in margins/profitability.

Yes Bank: Valuation Methodology Our TP of INR620 implies 1.9x Mar-16F book which is ~10% discount to our multiple for Axis/ICICI. While growth outcomes over FY14-17F would be higher for Yes Bank, its assets/liabilities need to get a lot more granular vs. Axis/ICICI and hence the discount in target multiple. Yes Bank trades at 1.75x Mar-16F book which is similar to what ICICI/Axis trade at currently and hence, at similar valuations, we prefer Axis/ICICI. The benchmark index for this stock is MSCI India.

Yes Bank: Risks that may impede the achievement of the target price Lower-than-expected NIM expansion and loan growth, sharp deterioration in asset quality and slower-than-expected SA growth.

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Online availability of research and conflict-of-interest disclosures

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