Banking Sector: Macro Situation with Top Picks **28th June, 2011**

Banking Sector: Macro Situation……..

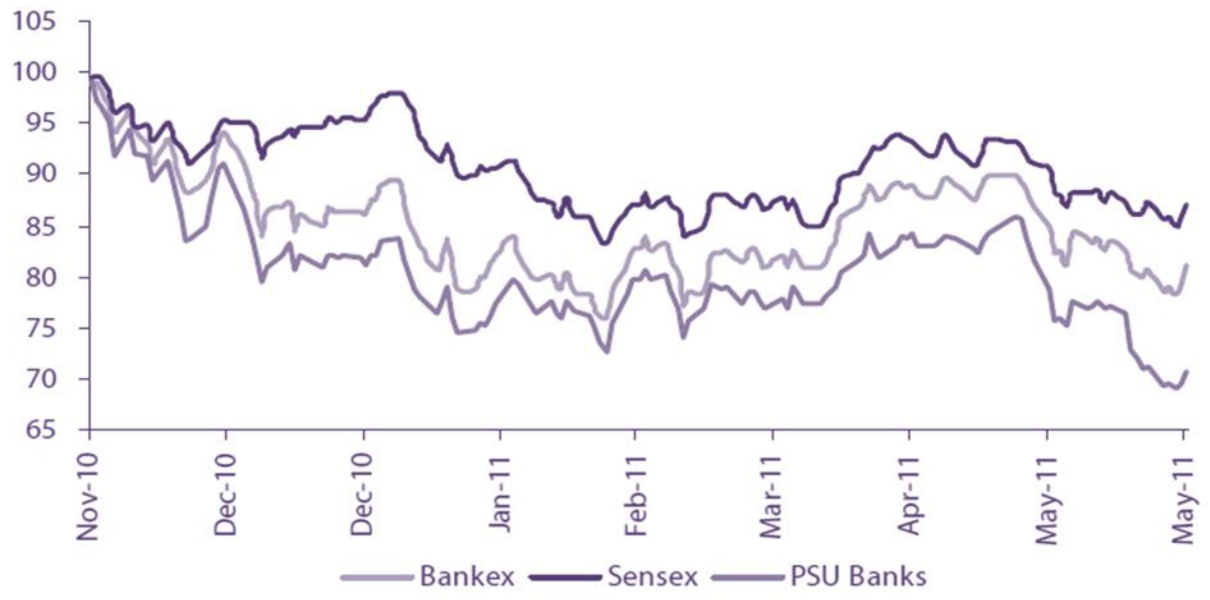
Past

One of the features of FY11 rather mixed performance in industrial output and economic growth (fourth quarter GDP closing lower at 7.8%) was the consistent expansion of bank credit. After hitting 24% in December, it tapered off to ~ 21% but stayed around that level, more or less fulfilling the RBI's expectations.

Source: Business line June 06, 2011

Present

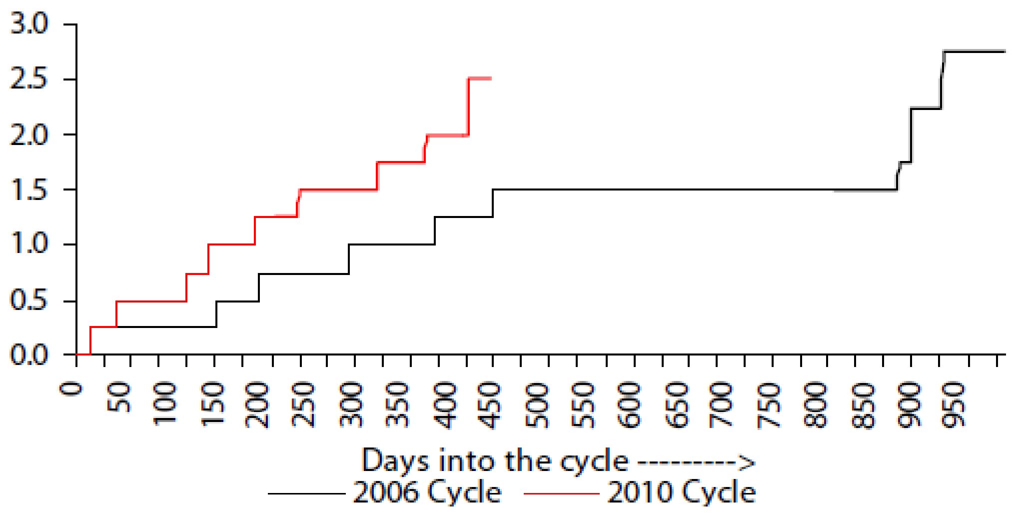
The banking sector which has been the most loved sector few months back has been facing a grim picture and increased risk aversion led by monetary policy tightening by the RBI, liquidity crunch and asset quality concerns due to higher provisioning by banks and slower growth in deposit mobilization. The PSU banks have widely disappointed market expectations and with developments like loan bribery scam, telecom scam along with dampener like 2nd pension write offs have impacted bottom line of Public sector banks and the sentimental impact on the banks have been far more severe than on the markets. Since the recent peak of Bankex (05th Nov, 2011) it has underperformed the bench mark indices i.e. Sensex



India in Last Phase of Monetary Tightening & Nearing its End……..

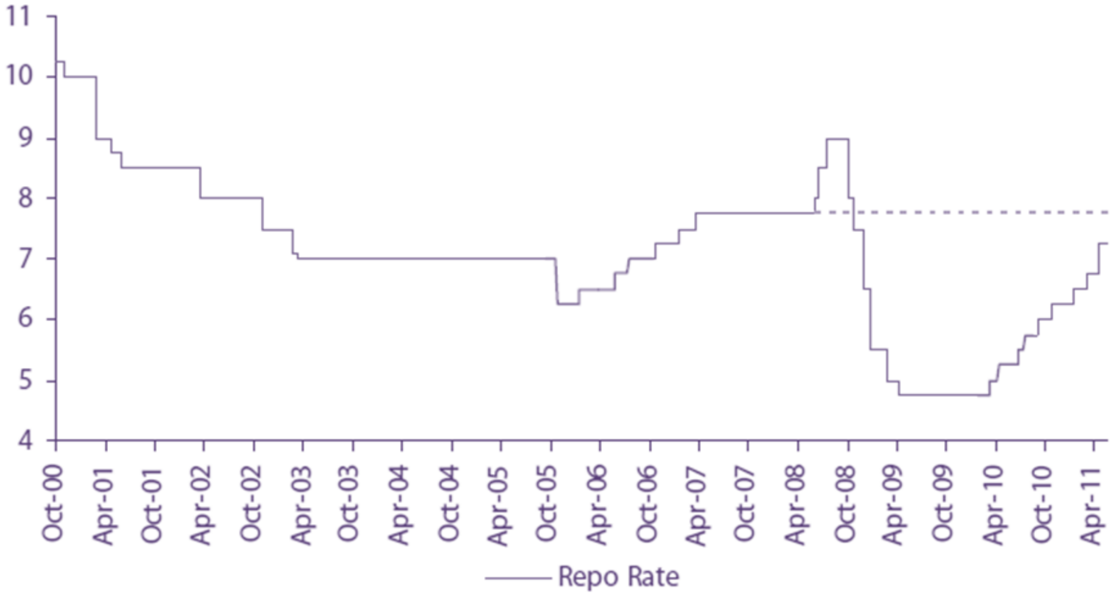
The current monetary tightening by the RBI in order to control inflation has been creating concerns among economists along with industry leaders over moderation in economic growth due to interest rate hikes. The policy rate cycle has been far steeper in 2010 cycle (% hike) as compared to 2006 cycle.

Policy Rate Cycle has been Steeper by RBI ………



Source: RBI

Pause in Policy Rates after 25- 50 Bps hike from Current Levels……..



Components of Wholesale Price Index……..

Primary Articles (Includes Food Articles – 14.33%)	**20.12%**
Fuel, Power, Light & Lubricants	**14.91%**
Manufactured Products (Includes Food Products – 9.97%)	**64.97%**
Total	**100%**

Food Inflation Gradually Moderating…..

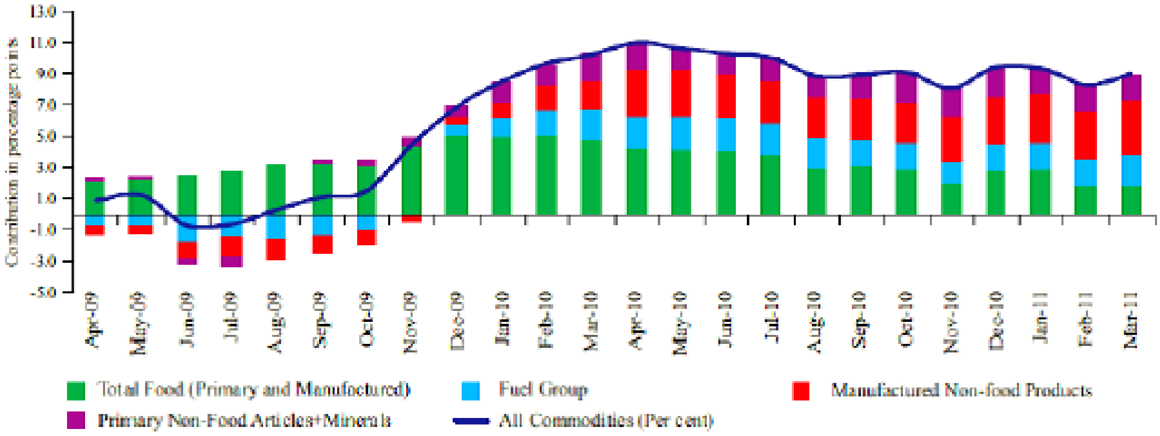
Inflation clearly remains the top priority of the central bank given that its efforts to tame the same have not paid the desired results. Historically, the food inflation has proved to be a passing phase at the onset of monsoon and has moderated substantially with monsoon spreading Pan India in July – Aug. Overall, we expect the inflation rate to ease to 7% by end of FY2012 with structural demand-supply imbalance in food and higher global commodity prices as key risks. Importantly, an average inflation rate of ~7% for FY2012 (compare with the average inflation rate of the last three years) should enable the RBI to opt for a pause and reduce its hawkish stance years in medium term future. Easing of inflation to ~7% along with anticipated moderation in economic activity will generate growth in economic activities.

Food Inflation/Overall Inflation trends ………

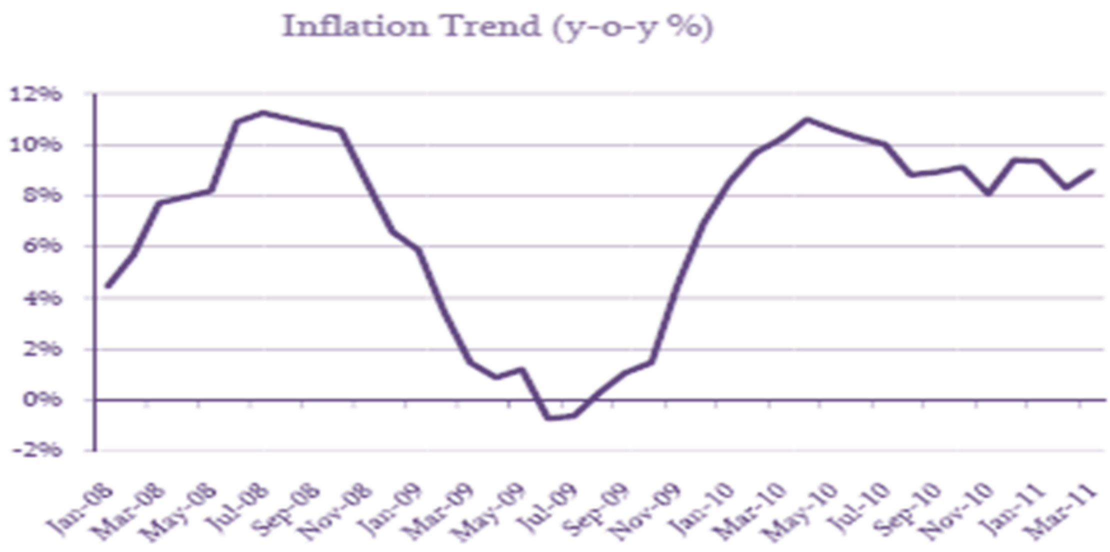
RBI Policy Date	Food Inflation				Overall Inflation
	2nd June 2011	9th June 2011	16th June 2011	23rd June 2011	
June 16,2011	**8.06 %**	**9.01%**	**8.96%**	**9.13%**	
	5th May 2011	12th May 2011	26th May 2011		
May 03 2011	**8.53%**	**7.70%**	**8.55%**		**9.06%**
	3rd March 2011	10th March 2011	17th March 2011	24th march 2011	
March 17 2011	**10.39%**	**9.52%**	**9.42%**	**10.05%**	**9.68%**
	13th January 2011	20th January 2011	27th January 2011		
January 25 2011	**16.91%**	**15.52%**	**15.57%**		**9.47%**
	04th Nov 2010				
November 02 2010	**12.45%**				**8.20%**
	3rd Sep 2010	9th Sep 2010	30th Sep 2010		
September 16 2010	**10.86%**	**11.47%**	**16.44%**		**8.98%**
	01st July 2010	22nd July 2010			
July 27 2010		**12.47%**			**9.98%**
July 02 2010	**12.92%**				
	17th April 2010				
April 20 2010	**16.61%**				**10.88%**
	13th March 2010				
March 19 2010	**16.22%**				**10.36%**

Inflation Trends…..

% Contribution of All Commodities in Inflation…..



The share of food inflation in total inflation is falling. Inflation remains the key concern for the economy, especially since December 2010 when food prices increased steeply. Food prices have now started abating but have been replaced by rise in fuel and non-food manufactured products inflation. With domestic fuel prices yet to fully adjust to international oil price increases and also pressures rising in non-food manufactured products, the risks to inflation are clearly on the upside. High global crude oil and other commodity prices pose the biggest risk to India's growth and inflation. Persistently high inflation has kept inflation expectations elevated. Inflation during FY12 is likely to moderate slowly but may remain above the comfort level as the pass-through of international commodity prices is likely to continue.



The above chart depicts the inflation trend from Jan 2008 till Mar 2011

Rainfall Trends……

Year	Actual (mm)	Normal (mm)	Percentage Departure
2001	821.9	892.2	-8%
2002	**737.3**	**892.2**	**-17%**
2003	919.5	892.2	3%
2004	**774.2**	**892.2**	**-13%**
2005	874.3	892.2	-2%
2006	886.6	892.2	-1%
2007	936.9	892.2	5%
2008	873.2	892.2	-2%
2009	**689.9**	**892.2**	**-23%**
2010	910.6	892.2	2%

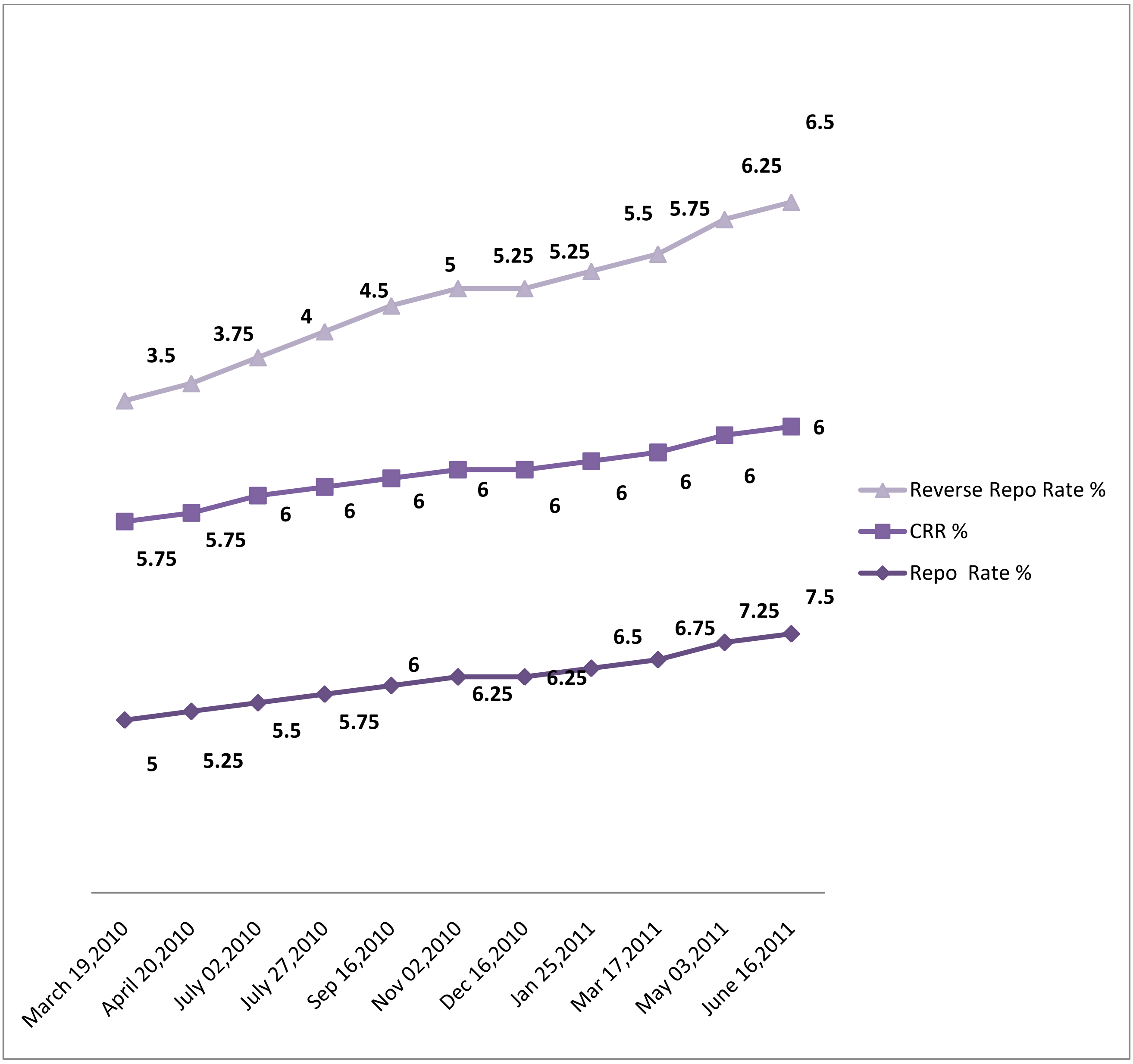
Source: IMD

There was drought condition in India in year 2009. The Normal rainfall is 892.2 mm whereas actual was 689.9 mm in year 2009. Whenever such a natural calamity happens the food inflation picks up .Further in 2010 the actual rainfall was 910.6 mm 2 % more than normal rainfall which lead to moderation in inflationary trends in food articles

Forecast for the 2011 South-west monsoon is expected to be Normal to have Favorable effect in Taming Food Inflation even Further…….

IMD’s long range forecast for the 2011 south-west monsoon season (June to September) is that the rainfall for the country as a whole is most likely to be Normal (96-104% of Long Period Average (LPA)). There is very low probability for season rainfall to be deficient (below 90% of LPA) or excess (above 110% of LPA).The normal monsoon would falling in food inflation even further and the effects will filter in non food areas like manufacturing non food products etc and the overall inflation will be having a downward trend having a positive effect on the economy.

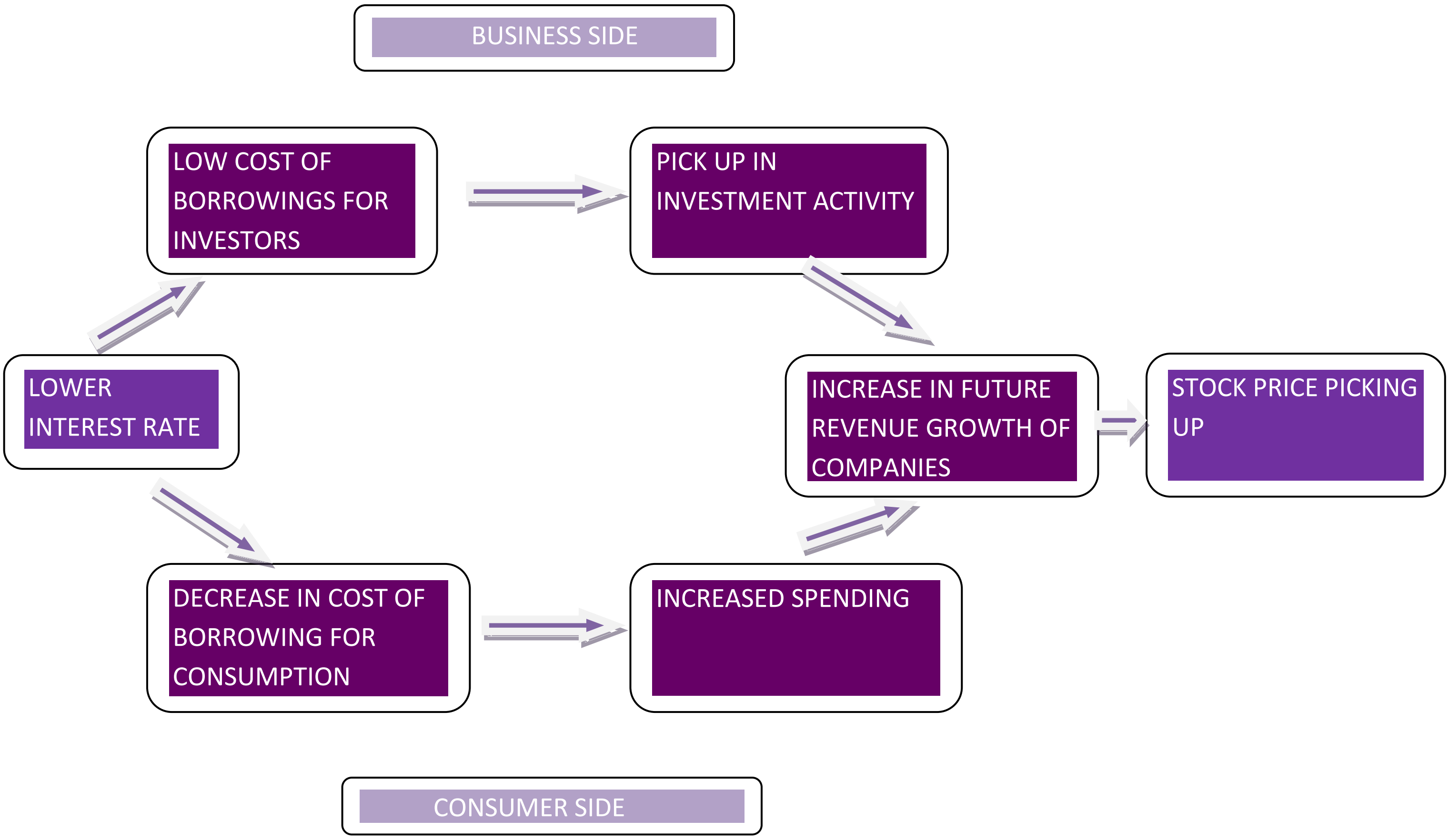
Key Policy Rates Announced by RBI in the past….



Effects of RBI Policy on Sensex on Announcement Day……

Dates	Closing Sensex Value	Difference
18 Mar,2010	17519.26	
19 Mar, 2010 (Policy)	**17578.23**	**+58.97**
19 April,2010	17400.68	
20 April,2010 (Policy)	**17460.58**	**+59.90**
1 July,2010	17509.33	
2 July,2010 (Policy)	**17460.95**	**-48.38**
26 July,2010	18020.05	
27 July,2010 (Policy)	**18077.61**	**+57.56**
15 Sept,2010	19502.11	
16 Sept,2010 (Policy)	**19417.49**	**-84.62**
1 Nov,2010	20355.63	
2 Nov,2010 (Policy)	**20345.69**	**-9.94**
24 Jan,2011	19151.28	
25 Jan,2011 (Policy)	**18969.45**	**-181.83**
16 Mar,2011	18358.69	
17 Mar,2011 (Policy)	**18149.87**	**-208.82**
2 May,2011	18998.02	
3 May,2011 (Policy)	**18534.69**	**-463.33**
15 June,2011	18132.24	
16 June,2011 (Policy)	**17985.88**	**-146.36**

Linkage between Interest Rate and Stock Market…..



A fall in interest rate has positive affects the stock market both from Investment as well as Consumption side. Combining the affects of both it is a promising as well as much better situation for the Indian economy the overall future growth of the companies will be positively affected which would lead to positive and bullish sentiments in the market leading to pick up in stock pricing. Also at lower interest rate people tend to invest in stocks as compared to fixed deposits and bonds since the rate offered by banks are lower and make such investments unattractive. Hence the outflow of funds from banks and inflow of funds via investment in stock market have a positive effect.

ARM View….

We believe that the monetary policy tightening may end in Q2FY12 and RBI will tilt for a more growth oriented approach H2FY12 onwards. However in near term we believe that RBI might potentially hike repo rate by 25- 50 bps from current 7.50%. However this would be the last leg followed by a long pause in the policy rates and will help in improving the sentiments of investors and providing much needed momentum for economic growth.

Further the forecast of the normal monsoon by IMD and potentially high disposable income in the hands of rural population arising out of the same would lead to increasing consumption among masses thereby credit growth picking up would have positive effects.
Rise in rural incomes bear testimony to good monsoon in FY11 and would reflect in improving the rural spending power in FY12.

Banking on Future……

- **Credit demand for FY12E expected to remain healthy ~18% & ~19% in FY13E though expected to moderate from current levels**

- **Revival in Deposit growth is anticipated ~17.5 % in FY12E due to steep term deposit hike in rates**

- **NIM's should be under pressure in HIFY12E however expected to stabilize in H2FY12E with marginal incremental erosion. Further deregulation of savings bank interest rates by RBI is one of the key risks**

- **Asset Quality and Provisions should speak out in FY12 and restructured asset quality would give a clear picture once migration to system based NPA would be complete. Further in FY12E there would likely lower slippages since removal of 70 % provisioning requirement should lead to lower credit cost as a % of advances**

- **Most of the challenges will be faced by banking sector should peak out by mid FY12 and will enable the investors to focus on value buy and attractiveness of Indian banking sector and banks would back in zest for investors giving potential good returns**

Real interest rates nearing positive territory…..

The lack of response from depositors so far is not a structural shift, in our view, and is more a cyclical phenomenon led by negative real rates for extended periods. Real interest rates are nearing positive territory post aggressive term deposit rate hikes thereby incentivizing depositors to park money with banks. Moreover, weakening return potential in alternative asset classes (real estate & gold) would encourage& support shift a part of the "currency with public" to bank deposits.

Central Bank – A Wealth Creation Idea!!!!!

CMP: Rs 119.20/-

"Invest Significantly at Maximum Pessimism" + "Maintaining Margin of Safety Capping Downside Risk since Upside has enormous Potential" = Wealth Creation

NIM: 3.31%

CASA: 35.2 %

Book Value: Rs 106.10

P/BV: 1.12x

India is a growing economy & banks to be the greatest beneficiary from the same ……

Bank ranks third in geographical pan India network and is well poised to gain from rural prosperity. There are 3728 branches of which 1416 are in rural & 936 in semi urban area which is a key changer to fortunes of the bank as well as investors in years to come. The blessing of the monsoon gods would be an another feather in the cap since good harvest would lead to high disposable income among the rural and hence pick up in rural credit .The bank has already hit a century in terms of its existence .The Promoters i.e. GOI holds 80.20% of the equity hence the quality and management of the bank gives an adequate comfort level.

The bank has already provided Rs.569.62 crs is debited in FY11 towards pension liability.CBI profit Q4FY11 was a dampener with Rs 133 Cr as compared to Rs 171 Cr in Q4FY10.This is due to an exceptional debit of retired employee's pension .This pension liability will not be provided in FY12 and hence is a one off item.

PAT FY11 Rs 1252 Cr V/s Rs 1058 Cr.

The one of effect if exceptional item - pension liability of Rs.569.62 is excluded then PAT for FY11 would have phenomenal with ~ Rs 1821 Cr

ROA - Fy11 - 0.70% (Fy10- 0.66%) if exceptional item is not factored ROA - FY 11 would have been 0.87%. **ROA - FY 12 E ~ 1% (this is going to be the turning point of re rating for Central bank)**

The area for concern Central bank needs to improve the business level per branch since presently the bank is lagging behind because the per branch level business is under penetrated. The bank is will take a giant stride in ATM's presence from 1006 to be increased by 2500 during FY12.

The NIM's of the bank to be in range of 3-3.5%in FY12 would be an icing on the cake with Net Npa under control. The bank has recently come out with rights issue of ~ Rs2500 Cr and GOI infusion will lead to CAR Tier 1 above 8 % complimenting the growth plans of the bank.

We Recommend "Accumulate" with price band of Rs 109 - Rs119 for CAGR ~25 % return per year for next 2 years.

Karnataka Bank – Possibility & An Ideal Take Over Candidate!!!!!

CMP: Rs 129.30/-

NIM: 2.15%

CASA: 24.9 %

Book Value: Rs 121.66

P/BV: 1.06x

The bank is one of the oldest banks being incorporated in 1924. The Bank has recently successfully completed its rights issue of Rs 457 Cr issuing shares to existing shareholders in the ratio of 2:5 at a price of Rs 85 /- per share

Karnataka Bank is a Mangalore based bank which is looking forward to grow its retail business to 60% of total from current 55%

The bank is looking forward to strongly focus on retail segment for driving its growth engine. They will be giving more thrust to housing loans, vehicle loans, and SMEs. The bank's exposure to Agricultural credit is also seemed to pick up

Karnataka Bank also expects to double its gold loan business to 15 billion rupees in the current fiscal ending March 2012.

Branch expansion of the bank is also very much on the cards from 483 branches to 500 in FY12.

The bank has one of the strongest presences in South India with 360+ branches. Further 40 % of the bank branches are in semi urban & rural areas.

The bank is targeting a credit growth of 24 % to ~ Rs 21,500 Cr while deposits are expected to grow to ~ Rs 32,500 Cr a growth of 19 % in FY12.

The average business per branch has risen from Rs 71.9 Cr in FY09 to Rs 93.5 Cr in FY11. The bank is focusing on improving the share of low cost CASA deposits which have increased From Rs 5520 Cr in FY10 to Rs 6803 Cr in FY11 & further expected to improve in FY12E.

We believe that Karnataka Bank is one of the good takeover targets of any large cap bank since it will enable to give a robust branch network in South India.

We Recommend "Accumulate" with price band of Rs 119 - Rs129 for CAGR ~25 % return per year for next 2 years.

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