India Banks
Which banks are most impacted by demonetisation?

Equities

India
Diversified Financial

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Sensitivity on what happens after 31st Dec

In this note we analyse 3 scenarios post demonetisation and sensitivity to key earnings are temporary driver for banking sector. In the optimistic Scenario 1, where demand and activities disrupted for only 1m, we estimate 0-4% decline in earnings for our coverage banks in FY17. In Scenario 2 (our base case), where currency supply normalises, however demand recovery takes another 6 months; we estimate 0-5% decline in earnings in FY17 and 1-9% decline in FY18 (from our earlier estimates) for our coverage banks. In Scenario 3, if a significantly lower level of activity within the informal economy, we expect 3-25% cut in FY18 earnings. We believe current stock price of coverage banks are fully pricing in Scenario 1, partly pricing in Scenario 2, however not all pricing in Scenario 3.

Which banks likely to be most impacted?

We believe loan growth for banks (like IndusInd, HDFCB, Kotak) with higher share of CV/Cars/mortgage finance is at greater risk due to potential slowdown in underlying demand. Due to falling wholesale deposit rates, bank would be forced to cut lending rates, leading to margin pressure, which would be partly offset by the potential increase in CASA ratio, in our view. Banks offering >5% SA deposit rate (Kotak, IndusInd, YES) are better placed to offset margin pressure due to falling term deposit costs. We believe credit cost is likely to rise for banks with exposure to small businesses dependant on cash-cycle (almost all banks).

We cut earnings and PT by 0-9%

We raise estimates for bond gains and CASA deposits for coverage banks. Also, as we build slightly lower loan growth and higher credit cost due to increasing NPL risks from SME, we cut earnings by 0-9%. Resultantly we cut PT by 0-6% for banks. While structurally strong, we believe the sector is facing near-term slowdown risks.

We prefer SBI, ICICI and HDFC Bank

We would use the current price correction as a further buying opportunity for stocks with strong retail liability franchise (link to our detailed note) and stable/improving asset quality at a reasonable valuation, such as SBI, ICICI, HDFC. We continue to prefer SBI, ICICI and HDFC Bank (rated Buy) as they maintain their lead in customer engagement across channels. YES Bank and PNB are least preferred picks.

Change in Earnings and Price Target

	Price Target		EPS- Old			EPS- New		
	Old	New	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
SBI	335	335	13.8	25.7	33.4	13.8	24.3	31.5
BOB	170	170	9.6	16.9	23.0	9.5	16.4	23.0
PNB	100	100	8.1	12.8	22.1	7.8	12.6	23.5
Axis	560	540	20.7	39.6	47.5	19.7	37.2	46.1
ICICI	350	350	15.5	19.5	27.9	15.6	18.5	26.5
HDFCB	1550	1450	59.1	73.2	89.8	56.1	67.0	81.0
KMB	910	880	18.0	22.8	29.2	18.3	21.2	27.8
IndusInd	1300	1250	48.7	60.3	74.9	46.7	55.9	71.2
Federal	95	95	4.8	6.6	8.6	4.7	6.2	7.8
YES	650	650	63.5	68.2	66.8	64.7	67.7	69.1

Source: UBS estimates

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UBS Research THESIS MAP

MOST FAVOURED

State Bank of India, ICICI Bank, HDFC Bank

LEAST FAVOURED

YES Bank, Punjab National Bank

PIVOTAL QUESTIONS

Q: Have NPL concerns peaked for Indian banks?

Not yet, but we believe we are closer to the peak of the NPL cycle. We expect gross NPL (GNPL) formation to decline YoY in FY17E and GNPL ratios to decline in FY18E. Based on our bottom-up study, 5.5% of loans are under stress and may turn into NPLs.

NPL cycle peaking?, 22 July 2016

Q: Can we expect >15% top-line growth for the banking sector over the next three years?

This is less likely given a weak investment pipeline. System loan growth may remain at 12-14% in the next three years, mainly driven by the retail and SME segments. We expect private banks to grow revenue by an average of 17%, while state-owned enterprise (SOE) banks may grow in the low double-digits over the same period.

NPL cycle peaking?, 22 July 2016

Q: How is the sector positioned against digital competition?

Indian consumers appear keen to embrace digital banking (mobile and online banking), as shown by our survey, and banks are responding fast to digital competition to protect their deposits and fee business—however, not all are moving at the same pace.

Who is gaining in the retail liability franchise?, 24 November 2016

WHAT'S PRICED IN?

Most banks are now trading near the five-year average P/BV (except SOE banks), which we believe indicates investors are less concerned about NPLs now than three months ago. Our analysis suggests that high provisions will continue in FY17E, but may start declining from FY18E onwards.

more →

UBS VIEW

We believe NPL risk remains the key near-term catalyst and stocks would sustain a re-rating only if the underlying trends improve. We saw greater NPL recognition in FY16, which if continued in FY17 would lead to a peak in the NPL cycle. We differentiate between the banks that are ahead in NPL recognition and those that are lagging at this point.

EVIDENCE

Based on our analysis (see report) of 14,000 companies (90% of corporate debt), we estimate 14.6% of system loans are stressed, of which 9.1% are already recognised as NPLs. We think the NPL recognition cycle could peak in FY17 and banks should report improvements in asset quality from FY18 onwards. Our analysis of franchise SA suggests improvement in engagement for SBI, Axis, BOB and Federal Bank. UBS Evidence Lab analysis of mobile app downloads suggests a continued lead for ICICI, SBI and HDFC Bank.

COMMENTARY

9 key trends post demonetisation

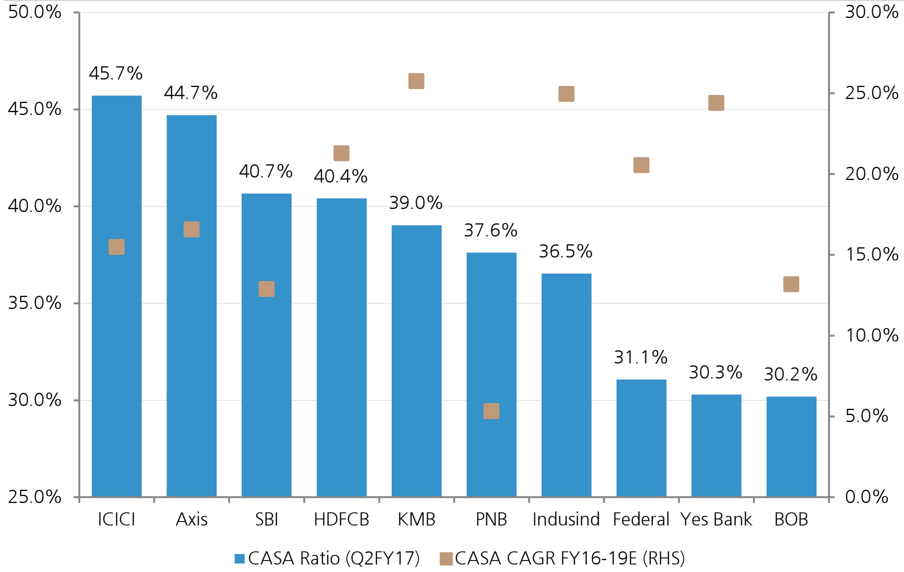
We expect following key trends to emerge from de-monetization, and not all of them are fully priced in current valuations:

Next 3 months

CASA deposit growth and margin impact – seem priced in now

As per RBI data, all banks put together garnered roughly Rs4,000bn of deposits (net of withdrawals) during Nov 11-18. We understand around 80% of these deposits are in the form of CASA deposits currently. We believe SBI could be the biggest beneficiary of this CASA bonanza due to its wide network. We have raised CASA deposits estimates by 2-10% in FY17 for coverage banks.

Figure 1: CASA ratio and growth forecast

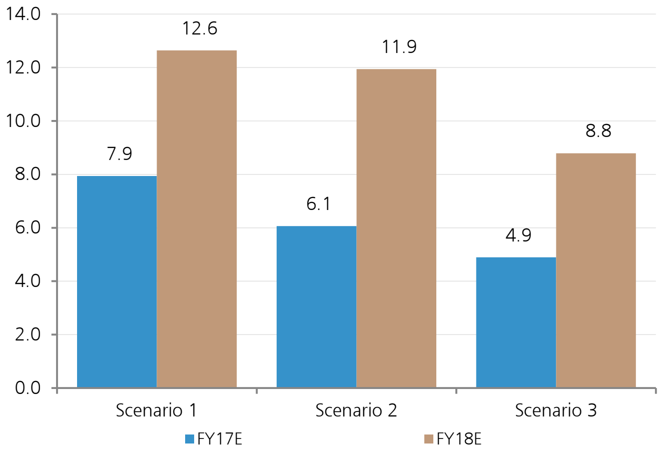


Source: Company, UBS estimates

Slowdown in retail lending due to slowdown in consumption – 1 month priced in, 6-12m not priced in

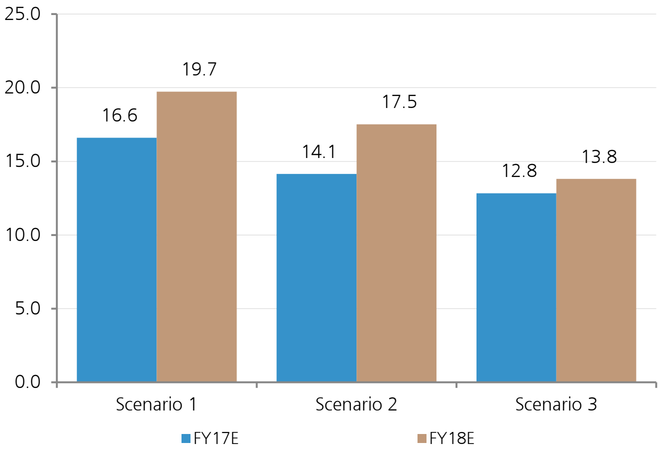
From our channel checks, we understand that retail lending (especially CV, Cars, mortgage) has slowed down significantly since the announcement of demonetisation, which we believe may continue for another 3 months. We are cutting our loan growth estimates by 0.5-2% in FY17 and 2-5% in FY18 as we expect current weakness in loan demand to continue for 6 months.

Figure 2: SOE- Loan growth (%)



Source: UBS estimates

Figure 3: Private banks- Loan growth (%)

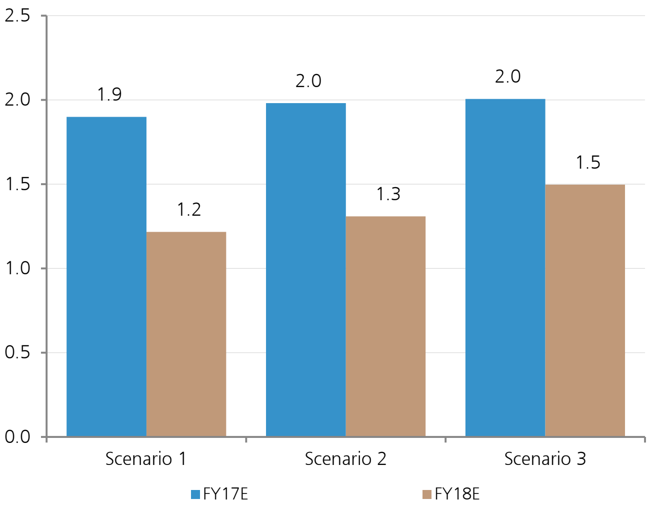


Source: UBS estimates

NPLs from small and medium businesses – not priced in

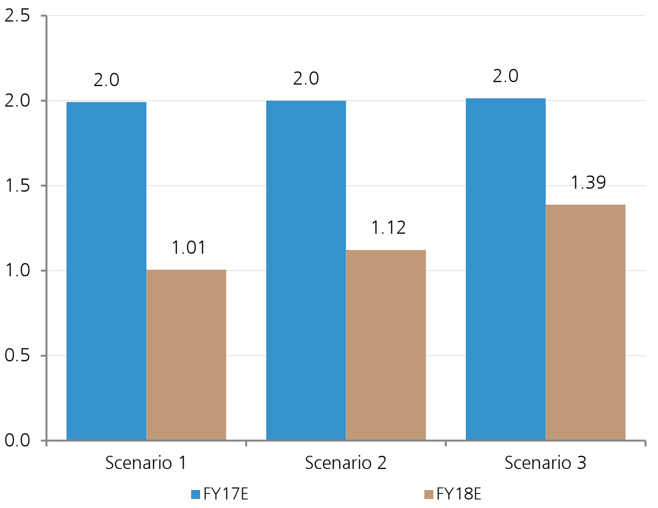
Since many of the small and medium businesses are run on "Cash" working capital, liquidity tightness is leading to delay in repayments at all levels, as per our channel checks. We also understand that suppliers are extending 10-30 days credit in many segments. Moreover RBI has also allowed the moratorium of two months for loans smaller than Rs10mn. While banks might not report higher NPL in December quarter, the uncertainty around business model of SME in the new regime might lead to higher delinquencies. We believe credit cost could be higher by 10-50 bps in FY18 if Scenario 2 or 3 plays out.

Figure 4: SOE- Credit costs (%)



Source: UBS estimates

Figure 5: Private banks- Credit costs (%)



Source: UBS estimates

Potential government actions (stimulus, recapitalization) – not priced in

Key question here is how much old currency RBI exchanges Vs Rs14,180bn (Rs500 and Rs1,000 notes) it demonetised. There is a school of thought (eg, Hindu Business Line, 24 November) that if RBI receives less than Rs14,180bn, then the remaining can be booked as gain and transferred to the government. Government then can use these additional funds to recapitalise SOE banks and/or provide

stimulus to the economy. We have not factored any such potential government action in our estimates.

Next 6-12 months

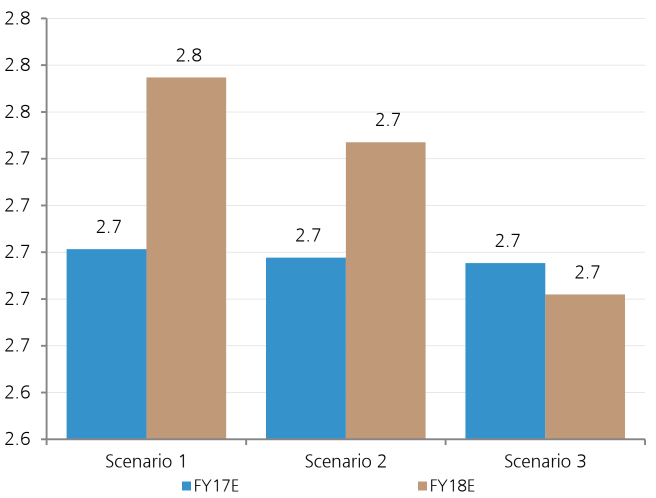
Resurgence of corporate NPLs due to general economic slowdown – not priced in

Sectors like steel, power, textiles have been ailing for the last 3-4 years and are in a nascent stage of recovery. General economic slowdown (especially Scenario 3) could extend the corporate NPL cycle further into FY18 vs. our current expectation of peak in FY17. In Scenario 3 – we are assuming higher credit cost from corporate segment as well for corporate lenders. Our current estimates don't factor in the relapse of corporate segment into NPL. Please refer to our note (*NPL cycle peaking? 22 July 2016*) for our detailed view on corporate NPLs.

Margin compression in FY18 due to lack of loan demand and fall in corporate bond yields – not priced in

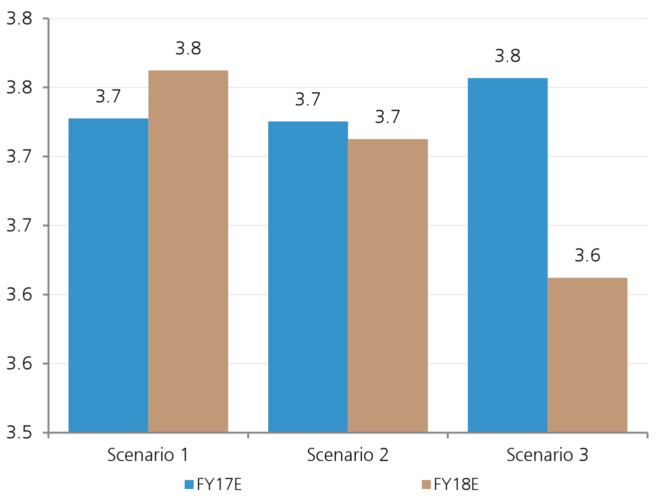
Intense competition in better rated corporates, weak retail loan demand and falling corporate bond yields jointly can put pressure on lending spreads of the banks. Banks (like HDFCB, IndusInd, Kotak) with large retail loan books might face greater margin pressure due to weak demand and therefore worsening loan mix (towards lower yield loans). However, banks offering higher SA rate (Kotak, YES, IndusInd) would have greater flexibility in managing cost of funds and margins in a falling interest rate scenario.

Figure 6: SOE- NIM (%)



Source: UBS estimates

Figure 7: Private banks- NIM (%)



Source: UBS estimates

Positive impact of lower interest rates on consumption and investments – not priced in

With excess liquidity building up in the banking system, interest rates are falling sharply (bond yields down 60bps in 1m, SBI cut bulk deposit rates by 1.9% recently). Lower interests boosting consumption and investments could be a >12m phenomenon and therefore not priced in.

Property price correction and its impact on mortgage growth and asset quality

Demonetisation is likely to dry up excess "Cash" liquidity from the system which may lead to softening of property prices. We believe impact of such softening would not be significant for asset quality of retail mortgages given low loan-to-value. However delinquencies of business loans or loan against property could rise as the "cash" business gets impacted and also the collateral value of property diminishes. We believe this trend will play out over 6-12m period in Scenario 2 and 3. We have not built credit losses on mortgages or LAP in our current estimates.

Long-term balance sheet expansion of banks due to formalization of shadow economy – partly priced in

Indian banks are seeing strong deposit growth (5% absolute growth within first 9 days), which we believe is likely to continue till December 31st 2016. This merging of the informal economy into formal economy could produce additional 2-3% point annual growth in deposits of banks for next 5 years. If we assume 25% of currency with public goes into banking system, it could lead to 15% increase in SA deposits in 3 months (without the multiplier effect) and around 20% increase in overall deposit (at 5x money multiplier) over medium term. We have raised deposit growth estimates in FY17, however not fully captured in the multiplier effect if currency with public falls by >10% and stay with banks.

Sensitivity Analysis:

In this note we analyse 3 scenarios post demonetisation and sensitivity to key earnings driver for banking sector.

In the optimistic Scenario 1, where demand and activities are temporary disrupted for only 1m, we estimate 0-3% decline in earnings for our coverage banks in FY17. Banks with higher share of retail lending (CVs, cars, micro-finance) are mostly impacted in this scenario. SOE Banks are likely to benefit from CASA accretion and bond gains in this scenario.

In Scenario 2, where demand recovery takes another 6 months, we estimate 0-5% decline in earnings in FY17 and 1-9% decline in FY18 for our coverage banks. Again, banks (like Kotak, HDFC Bank, IndusInd) with higher growth expectations and higher share of retail lending (CVs, cars, micro-finance) are most likely impacted in this Scenario 2.

In Scenario 3, if a significantly lower level of activity within the informal economy, we expect 3-25% cut in FY18 earnings. Fall in consumption and economic activity might give rise to higher delinquencies for banks. Almost all banks are impacted since small business loan exposure (and LAP exposures), CV finance exposures, and even corporate exposures in some segments would become stressed.

Figure 8: Scenario Analysis

Particulars	Loan Book growth (%)		CASA Ratio (%)		NIM (%)		Credit costs (%)		EPS (Rs)		EPS Growth (%)	
	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
HDFC Bank												
Scenario 1	16.0	22.0	48.3	46.6	4.5	4.6	0.7	0.7	57.1	71.2	17.5	24.5
Scenario 2 (Base Case)	13.0	20.0	49.2	47.0	4.5	4.5	0.7	0.7	56.1	67.0	15.4	19.3
Scenario 3	13.0	15.0	49.6	43.8	4.5	4.3	0.7	1.0	56.1	58.1	15.4	3.4
ICICI Bank												
Scenario 1	14.0	16.0	44.2	44.0	3.1	3.1	3.7	1.5	15.5	19.6	(7.1)	26.0
Scenario 2 (Base Case)	12.0	14.0	44.9	45.6	3.1	3.1	3.7	1.6	15.6	18.5	(6.6)	18.7
Scenario 3	10.0	10.0	44.9	46.4	3.1	3.0	3.7	2.0	15.7	15.3	(6.3)	(2.6)
Axis Bank												
Scenario 1	17.0	18.0	46.1	45.5	3.6	3.5	3.0	1.3	19.9	38.7	(42.5)	94.9
Scenario 2 (Base Case)	14.0	15.0	46.1	45.5	3.6	3.4	3.0	1.4	19.7	37.2	(42.9)	88.8
Scenario 3	12.0	12.0	50.4	46.8	3.7	3.4	3.1	1.6	20.6	31.5	(40.4)	53.0
IndusInd Bank												
Scenario 1	23.0	25.0	38.0	36.0	4.0	4.0	0.8	0.6	47.5	60.6	23.7	27.4
Scenario 2 (Base Case)	18.0	23.0	38.0	36.0	4.0	3.9	0.9	0.9	46.7	55.9	21.5	19.7
Scenario 3	18.0	18.0	38.0	36.0	4.0	3.8	0.9	1.1	45.1	46.4	17.3	3.0
Kotak Bank												
Scenario 1	14.0	23.0	46.3	41.3	3.9	3.9	0.7	0.5	17.5	22.9	206.9	30.8
Scenario 2 (Base Case)	14.0	20.0	45.8	42.8	3.9	3.8	0.6	0.6	18.3	21.2	221.4	15.8
Scenario 3	12.0	18.0	44.8	39.8	3.9	3.9	0.6	0.6	18.2	20.6	220.1	12.8
YES Bank												
Scenario 1	25.0	22.0	30.3	31.0	3.3	3.5	1.1	1.1	65.3	73.5	8.1	12.6
Scenario 2 (Base Case)	24.0	20.0	30.3	31.0	3.4	3.5	1.2	1.3	64.7	67.7	7.1	4.7
Scenario 3	22.0	20.0	30.3	31.0	3.3	3.4	1.2	1.5	63.7	61.5	5.5	(3.4)
Federal Bank												
Scenario 1	20.0	20.0	35.3	33.9	3.3	3.3	0.8	0.6	4.8	6.4	73.0	34.4
Scenario 2 (Base Case)	18.0	20.0	35.3	33.9	3.3	3.3	0.9	0.7	4.7	6.2	71.0	30.2
Scenario 3	16.0	16.0	35.3	33.9	3.3	3.2	0.9	0.9	4.7	5.1	68.3	9.9
SBI												
Scenario 1	10.0	14.0	41.1	41.0	2.8	2.9	1.8	1.0	14.8	26.2	15.3	77.4
Scenario 2 (Base Case)	9.0	14.0	46.0	41.0	2.8	2.8	1.9	1.1	13.8	24.3	8.0	75.7
Scenario 3	8.0	10.0	46.0	41.0	2.8	2.8	1.9	1.3	13.9	20.2	8.7	44.7
BOB												
Scenario 1	-	10.0	36.5	31.0	2.3	2.4	1.9	1.3	10.0	17.4	(142.7)	75.1
Scenario 2 (Base Case)	(4.0)	10.0	33.0	29.0	2.3	2.3	1.9	1.4	9.5	16.4	(140.9)	71.7
Scenario 3	(6.0)	8.0	33.0	29.0	2.3	2.3	2.0	1.5	7.7	13.0	(132.9)	69.1
PNB												
Scenario 1	8.0	10.0	39.0	36.5	2.6	2.7	2.3	2.0	8.4	13.3	(141.3)	58.9
Scenario 2 (Base Case)	5.0	6.0	36.2	34.7	2.6	2.7	2.4	2.1	7.8	12.6	(138.6)	61.7
Scenario 3	4.0	5.0	40.0	37.5	2.6	2.7	2.4	2.3	7.1	9.5	(135.1)	34.2

Source: UBS estimates

WHAT'S PRICED IN?

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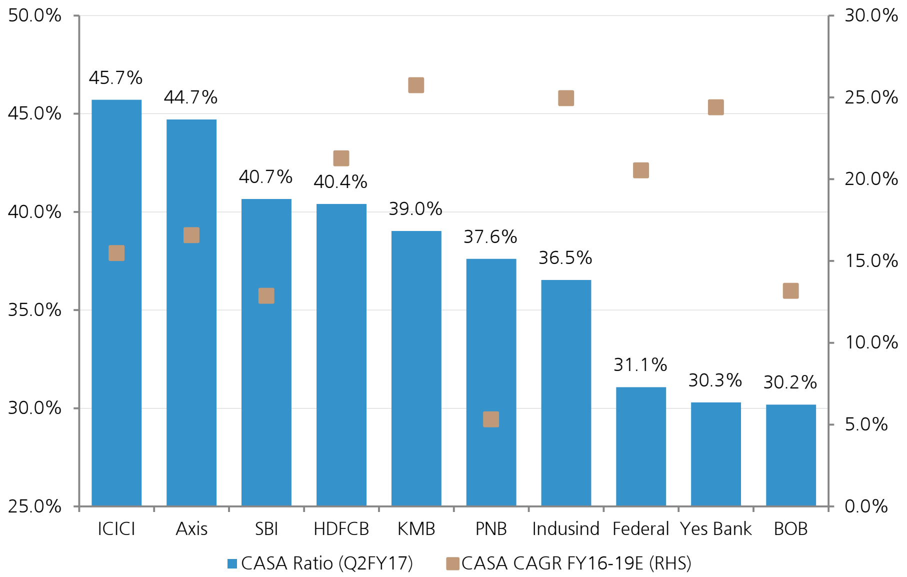

Source: Company data, UBS estimates

Amongst the 3 scenarios, we believe HDFC Bank is likely to be the most impacted amongst our coverage universe wherein the loan book growth is expected to slow down 2/3% in FY17/18 under Scenario 1 to 7/9% in Scenario 3. Earnings growth is also likely to witness a sharp slowdown between 300-500bps in FY17 and 300-2000bps in FY18. IndusInd Bank is also likely to witness a sharp decline in earnings led by higher loan loss provision for IndusInd Bank.

SoE banks are likely to be the least impacted as strong rural presence would lead the banks to garner higher share of low cost deposits supporting the overall earnings. As most of the SOE are currently in the consolidation phase, lower loan growth is unlikely to impact the earnings growth.

Based on current consensus estimates (FY18), the street appears to be expecting better earnings than our optimistic Scenario 1 in case of BOB, IndusInd, PNB, Kotak, and YES.

Figure 9: UBS (different scenarios) vs consensus

Company Name				FY2017E				FY2018E
	Cons Est.	Scenario 1	Scenario 2	Scenario 3	Cons Est.	Scenario 1	Scenario 2	Scenario 3
Axis	21.12	19.85	19.71	20.56	36.04	38.69	37.21	31.46
BOB	10.73	9.96	9.54	7.68	17.93	17.45	15.79	12.98
Federal	4.49	4.79	4.73	4.66	6.02	6.44	6.16	5.12
HDFCB	58.15	57.15	56.13	56.15	70.70	71.17	66.97	58.06
ICICI	17.46	15.53	15.61	15.67	20.25	19.57	18.53	15.25
IndusInd	49.43	47.54	46.70	45.09	62.58	60.59	55.88	46.44
KMB	20.97	17.48	18.31	18.24	26.25	22.88	21.20	20.57
PNB	9.23	8.36	7.81	7.10	15.10	13.28	12.62	9.53
SBI	15.30	14.79	13.85	13.93	21.91	26.23	24.32	20.16
YES	73.45	65.30	64.69	63.72	91.42	73.53	67.75	61.54

Source: Bloomberg, UBS estimates

Figure 10: Change in estimates

Particulars	Price Target		EPS- Old			EPS- New		
	Old	New	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
SBI	335	335	13.8	25.7	33.4	13.8	24.3	31.5
BOB	170	170	9.6	16.9	23.0	9.5	16.4	23.0
PNB	100	100	8.1	12.8	22.1	7.8	12.6	23.5
Axis	560	540	20.7	39.6	47.5	19.7	37.2	46.1
ICICI	350	350	15.5	19.5	27.9	15.6	18.5	26.5
HDFCB	1550	1450	59.1	73.2	89.8	56.1	67.0	81.0
KMB	910	880	18.0	22.8	29.2	18.3	21.2	27.8
IndusInd	1300	1250	48.7	60.3	74.9	46.7	55.9	71.2
Federal	95	95	4.8	6.6	8.6	4.7	6.2	7.8
YES	650	650	63.5	68.2	66.8	64.7	67.7	69.1

Source: UBS estimates

Valuation Method and Risk Statement

We use a residual income model to value banks and a sum-of-the-parts methodology to value companies owning other financial service businesses. We expect a gradual recovery in economic growth. However, a sustained economic slowdown could impact the banking and finance sector on several fronts—it may lead to a slowdown in credit, increase NPL risk, impact fee income and exert pressure on NIM. Lower rates could put pressure on margins and we expect stable to marginal declines for banks in our coverage universe. However, a sharp decline in lending rates could lead to a higher decline in margins and profitability. We expect asset quality to stay weak in the near term and improve only gradually. However, exposure to large leveraged corporates remains a risk and a default by a large corporate could significantly impact some banks in our coverage.

Required Disclosures

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	45%	28%
Neutral	FSR is between -6% and 6% of the MRA.	39%	25%
Sell	FSR is > 6% below the MRA.	15%	17%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 September 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Axis Bank[6a, 6b, 7]	AXBK.BO	Neutral	N/A	Rs471.35	25 Nov 2016
Bank of Baroda[7]	BOB.BO	Neutral	N/A	Rs167.85	25 Nov 2016
Federal Bank	FED.BO	Buy	N/A	Rs70.70	25 Nov 2016
HDFC Bank[6a, 6b, 7, 16]	HDBK.BO	Buy	N/A	Rs1,189.15	25 Nov 2016
ICICI Bank[4, 6a, 6b, 7, 16]	ICBK.BO	Buy	N/A	Rs259.85	25 Nov 2016
IndusInd Bank	INBK.BO	Neutral	N/A	Rs1,073.10	25 Nov 2016
Kotak Mahindra Bank[7]	KTKM.BO	Buy	N/A	Rs749.75	25 Nov 2016
Punjab National Bank[7]	PNBK.BO	Sell	N/A	Rs140.30	25 Nov 2016
State Bank of India[6a, 6b, 7]	SBI.BO	Buy	N/A	Rs260.95	25 Nov 2016
YES Bank[7]	YESB.BO	Sell	N/A	Rs1,167.50	25 Nov 2016

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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