Ambit
Asset Management

INVESTOR COMPASS

JULY 2023

MASTERING THE BALANCE: GROWTH AND RISKS

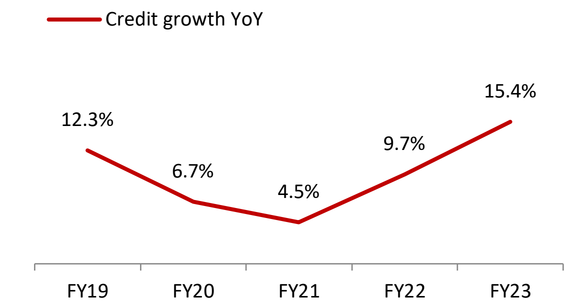
Dear Patron,

In this latest edition of Investor Compass, we talk about overall credit and deposit growth in FY23, performance of key operating indicators, and evolving trends in the Banking space. So far CY23 has been fairly dynamic with inflation, both WPI & CPI, softening sharply, RBI changing its stance towards accommodation and pausing the rate hikes, credit growth remaining strong and asset quality across banks continuing to improve. Despite the strong run-up in the last few months, we continue to remain constructive on the sector.

System credit and deposit growth

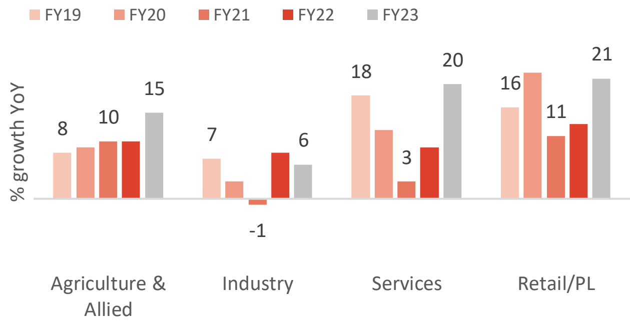
- **Overall credit growth** stayed healthy at 15.4% YoY in FY23, with accelerating trends seen in both, rural and urban regions. Credit growth has been relatively broad-based across segments (ref. Exhibit 2), supported by rather strong momentum in MSME, retail, and large corporate sectors.
- Within retail, while housing loan growth stood well at 15% YoY in FY23, unsecured credit experienced significant growth as personal loans and credit cards registered a growth of 25% and 31% YoY, respectively.

Exhibit 1: Revival of credit growth to mid-teens



Source: Ambit Asset Management, RBI database

Exhibit 2: Broad-Based credit growth

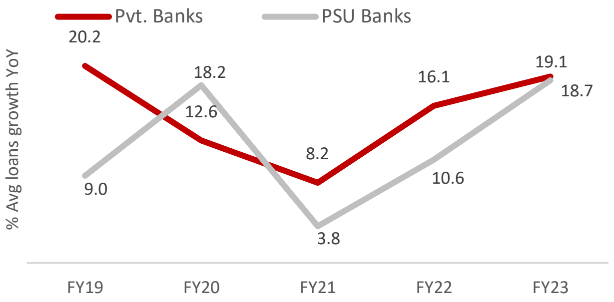


Source: Ambit Asset Management, RBI database

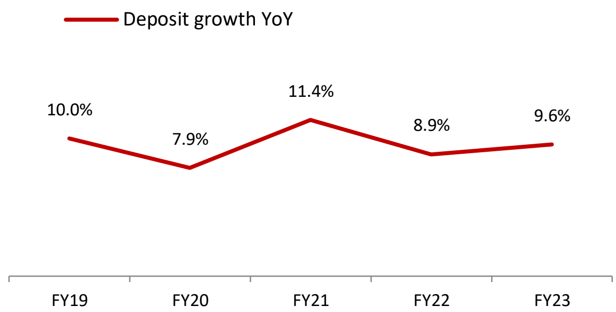
- **Private Banks** benefitted from their increased exposure to higher-yielding unsecured retail credit (credit cards, personal loans, MFI loans) and secured loans in housing, business banking, and SME segments. Focus on the unsecured book has increased for HDFC Bank, Kotak Bank, Indusind Bank, Axis Bank, and IDFC First Bank.
- On the other hand, while corporate segment growth remained subdued for most banks, ICICI Bank delivered 21% YoY growth in its domestic corporate portfolio.
- **PSU Banks** focused on secured retail credit, MSME loans, and agricultural loans, delivering credit growth on par with the overall system growth, unlike the pre-COVID period. It is important to note that the growth gap between private banks & PSU banks has narrowed significantly (ref. Exhibit 3). International loan book growth continued to be a key growth driver for PSU banks.

Exhibit 3: Narrowing gap between PVBs & PSBs growth

Exhibit 4: Deposits growth lags advance growth



Source: Ambit Asset Management, RBI database



Source: Ambit Asset Management, RBI database

- **Overall system deposit growth** improved to ~10% (ref. Exhibit 4). It continued to lag system loan growth in FY23. CD ratio stood at 75.8%. Low deposit growth for banks is attributable to slow-paced savings deposit rate revisions made by banks despite the 250bps rise in repo rate. Withdrawal of INR2000 notes from circulation may improve deposit growth in the near term.
- **CASA ratio** across most banks moderated in FY23 (ref. Exhibit 5) owing to favourable term deposit rate revisions by banks which made FD (Term Deposits) more attractive, relatively. However, as an exception, Axis Bank saw CASA improvement of 215bps YoY on account of Citi book inclusion during FY23.

Exhibit 5: Moderation in CASA mix…

CASA (%)	Q4FY23	Q3FY23	Q4FY22	QoQ	YoY
Public Sector Banks					
State bank of India	43.8	44.5	45.3	-70bp	-150bp
Bank of Baroda	42.3	41.6	44.2	70bp	-190bp
Private Sector Banks					
HDFC Bank	44.4	44.0	48.2	40bp	-380bp
ICICI Bank	45.8	45.4	48.7	40bp	-290bp
Axis Bank	47.2	44.5	45.0	270bp	220bp
Kotak Mahindra Bank	52.8	53.3	60.7	-50bp	-790bp
IndusInd Bank	40.0	41.9	42.7	-190bp	-270bp
Federal Bank	32.7	34.2	36.9	-150bp	-420bp
DCB Bank	28.0	27.6	26.8	40bp	120bp
AU SFB	38.4	38.4	37.3	0bp	110bp

Source: Ambit Asset Management, Company

Going into FY24…

- **Loan growth:** Channel checks reveal a clear and aggressive focus from both, private and public sector banks, to expand their loan portfolios, especially in retail and unsecured lending segments.
- Based on RBI's SCB (Scheduled Commercial Banks) fortnightly data releases and the current run-rate (Apr'23/May'23), system credit is expected to grow at a rate of ~3% QoQ (~15% YoY) for Q1FY24E, recording highest Q1 growth over the past 10 years, despite it being a slow period.

  Some key trends being witnessed:

  - Even though growth has started to slow down from 2QFY23 levels (~16-17%), the deceleration remains slow-paced.
  - Retail demand in rural and semi-urban markets is showing signs of continued growth.
  - Structural demand visibility, govt. support (reforms and subsidies) and healthier corporate balance sheets are likely to push capex up for the corporate sector.
  - Improving economic activities and the requirement of working capital-linked products for MSMEs is expected to drive loan growth through NBFCs.
- **Deposit growth:** Although the gap between credit growth and deposit growth is narrowing, deposit mobilization by banks at competitive rates remains a key factor to monitor from a long-term perspective.

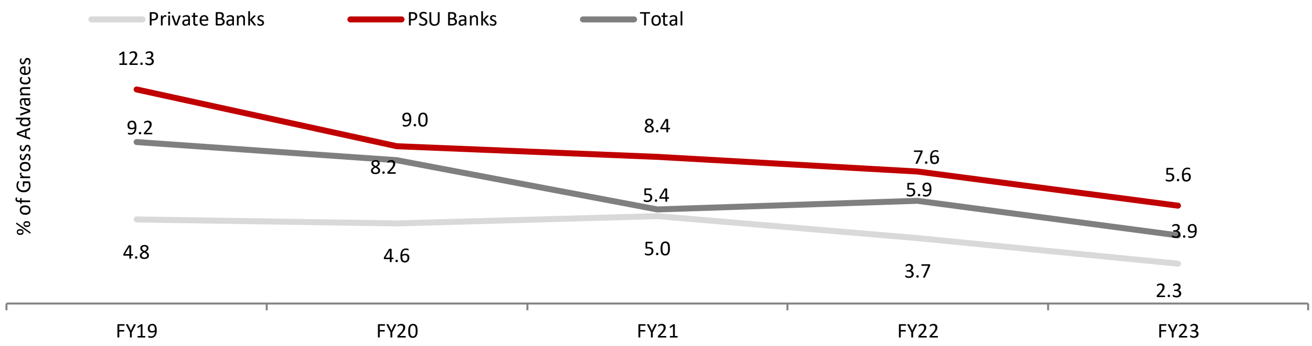
  Some key trends being witnessed:

- Deposit mobilization by banks was skewed in the 1- 3 year bucket owing to their preference for shorter-term deposits to mitigate the impact of potential rate reversals on NIMs.
- Lags in interest rate revision of deposits indicate likely increases in the cost of funds for banks as a very large share of term deposits are still below the card rate.
- Overall on the liquidity front, most private banks have LCR of ~123% while PSBs higher at ~150%, indicating PSBs to be better placed to fund their credit book growth. The Indian banks have bonds worth Rs17trn in excess of regulatory requirements which adds to their ability to lend & support growth.

Overall asset quality improved; no longer a concern for banks

- **Improved underwriting practices** resulted in GNPA at a 7-year low & NNPA at a 10-year low. The banking system witnessed the best asset quality trend (recoveries > slippages) since 2016.
- During Q4FY23, the asset quality continued to improve as the GNPA ratio at industry level declined by 66 bps QoQ to 3.9% (ref. Exhibit 6). Restructured book across banks continued to be on a declining trend.
- Going ahead, asset quality is unlikely to be a concern for most banks in the medium term, unless there is a sharp macroeconomic downturn.
- Expect incremental slippages to be low and recoveries/upgrades to stay strong, resulting in low credit cost in the near term. Some uncertainty may pertain around the implementation of ECL (Expected Credit Loss) regime. However, we believe, it can be seen as a mere change in accounting treatment with no bearing on the banking system's performance fundamentally.

Exhibit 6: Improving asset quality on broad based level…



Source: Ambit Asset Management, RBI database

Profitability: Return matrix to be maintained

- **Margins:** During FY23 most of the PVBs & PSBs witnessed flat to marginally positive trend on Net Interest Margins (NIMs). Yields inched up for most banks as they saw a modest pass-through of the higher benchmark interest rates after the RBI hiked repo rates.
- Banks with a higher External benchmark linked rate (EBLR) rated loan mix witnessed stronger growth upon immediate loan re-pricing.

Exhibit 7: Higher floating book results into faster NIMs expansion…

	Q4FY23	Q3FY23	Q4FY22	QoQ (bp)	YoY (bp)
Public Sector Banks					
State Bank of India	3.4	3.3	3.0	10bp	40bp
Bank of Baroda	3.5	3.5	3.1	0bp	40bp
Private Sector Banks					
HDFC Bank	4.2	4.3	3.9	-10bp	30bp
ICICI Bank	4.8	4.7	3.9	10bp	90bp
Axis Bank	3.9	4.1	3.3	-20bp	60bp
Kotak Mahindra Bank	5.8	5.5	4.8	30bp	100bp

IndusInd Bank	4.1	4.1	4.0	0bp	10bp
Federal Bank	3.2	3.5	3.1	-30bp	10bp
DCB Bank	4.0	3.9	3.7	10bp	30bp
AU SFB	5.8	6.0	6.0	-20bp	-20bp

Source: Ambit Asset Management, Company

- **Going ahead**, we expect banks with a higher share of Marginal Cost of Funds based Lending Rate (MCLR) linked loans (ref. Exhibit 7) to witness a higher amount of upward re-pricing of advances. However, re-pricing of deposits will gather pace slowly.
- For most banks, the cost of funds transmission is still not complete, while lending yields have limited room for improvement, thereby limiting the scope of growth for the net interest income.
- We expect margins to have peaked out and remain watchful of:
- Any disruption to the pace of deposit mobilization, thereby impacting NIMs.
- Any abrupt and sharp reversal of interest rates led by external conditions will have a negative impact on NII growth.

Exhibit 8: Higher floating book results into faster margin expansion…

<table>
<tr><th></th><th>Fixed Rate</th><th>EBLR</th><th>MCLR</th><th>Others</th></tr>
<tr><td>Public Sector Banks</td><td></td><td></td><td></td><td></td></tr>
<tr><td>SBI</td><td>25%</td><td>24%</td><td>41%</td><td>10%</td></tr>
<tr><td>Bank of Baroda</td><td>7%</td><td>30%</td><td>50%</td><td>13%</td></tr>
<tr><td>Private Sector Banks</td><td></td><td></td><td></td><td></td></tr>
<tr><td>HDFC Bank</td><td>45%</td><td>40%</td><td colspan="2">15%</td></tr>
<tr><td>ICICI Bank</td><td>30%</td><td>45%</td><td>20%</td><td>5%</td></tr>
<tr><td>Axis Bank</td><td>32%</td><td>41%</td><td>20%</td><td>7%</td></tr>
<tr><td>Kotak Mahindra Bank</td><td>30%</td><td>57%</td><td>13%</td><td></td></tr>
<tr><td>IndusInd Bank</td><td>51%</td><td colspan="2">49%</td><td></td></tr>
<tr><td>Federal Bank</td><td>25%</td><td>50%</td><td>15%</td><td>10%</td></tr>
<tr><td>AU SFB</td><td>66%</td><td colspan="3">34%</td></tr>
</table>

Source: Ambit Asset Management, RBI database

- **Operating Profitability:** In FY23, banks reported healthy earning growth, led by strong operating profit and declining provisions.
- **Going forward,** given the branch expansion and technology investment plans undertaken by most banks, it is clear that the opex will remain at elevated levels across banks but lower credit costs (assuming there is no higher provision for ECL) should ensure sustenance of RoEs at the current levels.

Outlook:

- We expect the current convergence theme in terms of loan growth between PVBs & PSUs to continue leading to higher competitive intensity.
- We expect deposit growth to accelerate from here in the medium term, supported by improved real deposit rates and normalization of CASA deposits. This coupled with a loan growth of 13-14% should drive strong overall performance for banks.
- From a macro perspective, while we expect a likely moderation in working capital demand as the spreads between WPI & CPI have moved from 880bs in May'22 to -780bps in May'23, we expect strong acceleration in capex by Centre, State & Corporates in FY24.
- For banks, while we expect NIMs to have peaked, operating leverage, and lower credit costs should support RoEs and thereby the valuations.

Valuation (portfolio companies):

- **HDFC Bank**: Post-merger of Housing Development Finance Corporation with HDFC Bank, the bank will have the country's second-largest branch network, which will further add value to its strong deposit franchise. Especially so, as balance sheet growth instead of margins will become key in FY24. We believe HDFC Bank is strongly footed to deliver quality performance. The stock trades at 2x FY25E P/B.
- **ICICI Bank**: The franchise is well-positioned to maintain its margins and deliver consistent loan growth, even in the expected moderation. Coupled with a strong deposit franchise, and high-tech infrastructure, the bank has key levers in place to outperform peers. The stock trades at 2.1x FY25E P/B.

- **Axis Bank**: Amongst the banks, we believe Axis Bank is well positioned and showing signs of RoA re-rating upon complete integration of Citi Bank's portfolio. Although there persists pressure on opex from the merger and on NIMs from higher CoF, the stock trades at 1.6x PB FY25E at a discount against peers, making the risk-reward attractive.
- **Federal Bank**: Management's guidance of high-teen loan growth, FY24E NIMs at 3.3-3.35%, peaking out of CoF as 80% of deposits have been repriced reinstates our confidence in the franchise to have front-loaded expected risks and readied itself to deliver performance. The stock trades 0.9x FY25E BV.
- **DCB Bank:** We have faith in DCB's core focus on a high proportion of secured lending to high-yielding self-employed customers, the ability to maintain a stable liability mix, maintain strong profitability with adequate cost controls. The stock currently trades at 0.7x FY25E BV.
- **AU SFB:** We believe the management implemented effective tech investment strategies and the bank will soon benefit from them as the operating leverage plays out. The bank enjoys margin comfort due to incremental high-yield lending despite the rise in deposit rates. Top management's continuity plan further builds our confidence in the franchise. The stock currently trades at 3.5x FY25E BV.

Exhibit 9: Valuation of portfolio companies…

Particulars	CMP	RoA (%)			RoE (%)			P/BV		
		FY23	**FY24E**	**FY25E**	**FY23**	**FY24E**	**FY25E**	**FY23**	**FY24E**	**FY25E**
HDFC Bank	1648	2.0	1.9	1.9	17.0	17.8	16.3	2.9	2.4	2.0
ICICI Bank	944	2.2	2.1	2.1	17.2	16.9	16.8	2.9	2.5	2.1
Axis Bank	953	0.8	1.7	1.7	8.0	16.9	16.2	2.3	1.8	1.5
DCB Bank	127	1.0	1.0	1.0	10.8	12.0	12.2	0.9	0.8	0.7
Federal Bank	135	1.3	1.2	1.2	14.9	13.6	14.1	1.3	1.2	1.0
AU SFB	763	1.8	1.7	1.7	15.4	14.2	15.1	4.6	4.1	3.5

*CMP as on 11/07/23

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