2013

The Indian Banking Sector

Trends and Challenges

Third Wave Solutions Private Limited

For Restricted Circulation Only

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THIRD WAVE SOLUTIONS

Research Lead: Vipul Goyal
vipul@thirdwavesolutions.in

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FOREWORD

The Indian Banking sector is on the rise. It is one of the few sectors which have shown consistent growth for the past decade, during which the amount of deposits in India have increased by over 500%. Even after this magnitude of growth, financial inclusion in India is far below the international standards, indicating that there is still a long way to go. In other words, there is still plenty of growth to be seen. And grow it should, as even if all the banks in India consolidated, it would still be miniscule compared to the scale of Deutsche Bank and such.

With the huge potential for growth, there are investment opportunities to take advantage of. In this report, we have tried to bring forth the strengths and weaknesses of our banking system and how they may propel or hinder the future growth of the Indian banks.

Taking a long-term perspective of five to seven years, we sought to identify trends that will play a significant role in the growth of the sector in the future.

The report includes a section on the key ratios exclusive to the banking industry. This is important since we have kept the investor in mind while writing this report, and these ratios play an essential role in the financial analysis of the banks. There is only so much that can be interpreted from the documents released by the management, but we believe numbers tell a truer story.

Finally, we have set out to find the bank which fits in our framework better than the rest. We discuss the pros and cons of the other candidates and conclude the report by sharing an investment opportunity.

Parijat Garg
Director
Third Wave Solutions Pvt. Ltd.

EXECUTIVE SUMMARY

The banking index, Bankex, has grown by more than 500% over the past decade, much like the amount of deposits. Compared to the rest of the world, India's banking sector is lagging behind in terms of financial penetration, domestic credit to GDP ratios, international presence and other measures which raise the possibility of the industry continuing its consistent high growth.

Indian regulatory system has learnt from the mistakes made by the developed countries. The safety and security measures are superior; risk management is as advanced as the developed nations and technology is being leveraged in the industry. There are some challenges too, such as the need for globalization, sticky inflation, the deteriorating asset quality (especially for public banks) and the looming Basel III norms. Overall, we think the positives outweigh the negatives for Indian banks.

There are some trends which have started to pick up pace such as the rise of plastic money as more people use cards and other convenient means to complete their transactions, greater participation as more people get financially included and take advantage of the services offered by banks.

In our quest to find the best investment, the parameters we laid focus on were the degree of financial inclusion and rural penetration, bank's adaptability to the change in technology, quality of the assets, past performance, rate of growth, and other financial details.

The asset quality, capital adequacy ratios and the efficiency of public banks is inferior to those of private banks, which is why the former were left out from our research. Among the private banks, the bigger ones have been able to make efforts towards financial inclusion, whereas the smaller ones have been concentrating on expanding their base and increasing their CASA Ratios by offering higher interest rates on savings accounts.

HDFC Bank was found to be superior to the other banks on an overall basis. ICICI Bank may be better than HDFC Bank in terms of technology, but several other parameters are in favour of HDFC Bank, making it our pick for long-term investment.

Introduction

The growth of the banking sector in the past decade has been truly spectacular. With a strong regulatory environment, huge customer base, innovation and a growing economy, the sector has seen a consistent growth with deposits increasing from 12.6 lac crores in Jan 2003 to 65.4 lac crores in Jan 2013. Despite the global slowdown, the banking industry is one of the few sectors that have shown considerable resilience and growth opportunities.

The banking index of India, BSE Bankex was 2,600 in Sept 2004 and had reached 14,000 in Jan 2013.

Source: Yahoo! Finance

The banks in India are divided into several groups: Allahabad Bank and Punjab National Bank are among the first banks established in India. The Private Banks such as ICICI Bank, HDFC Bank and Axis Bank are relatively new banks which were established post liberalization. The central bank of India, RBI, casts a watchful eye on all the banks in India. RBI is responsible for the regulation of the banks and controls key parameters such as repo rate, monetary policy etc.

According to The World Bank, Domestic Credit as a percentage of GDP for India is 75%, compared to 145% for China, 212% for UK and 234% for US. As India moves towards being a more developed country, the growth in credit is highly likely.

The commercial banks are composed of the scheduled banks, which in-turn include public banks (state-owned, nationalized or regional rural) private banks (either Indian or Foreign) and non-scheduled banks. Nationalized banks hold the largest share of deposits (accounting for 53% of the aggregate deposits as on March 2012).

There are currently a total of 173 commercial banks having around 97,000 branches in total. According to RBI, the aggregate deposits of scheduled commercial banks in India are Rs. 65.4 lacs crores (as on January 2013). Out of this, around 90% is in form of time deposits. The bank credit of scheduled banks in India as on January 2013 is Rs. 50.4 lacs crores. The credit to deposit ratio is 77%, which has increased from 56% in 2004.

The financial penetration in India is a mere 35%, whereas it is 64% in China, 88% in US and 97% in UK; suggesting the huge potential that this sector has in India.

Major Strengths

One of the most important strength of the Indian Banking Industry is the **regulatory system**. According to a survey conducted by FICCI, it is widely believed that the regulation is more robust than several other developing countries such as China, Brazil and Russia and most believe that it is at least at par with the US.

The trust and sense of security with the banking sector helps sectors that have special credit needs such as housing, small businesses and agriculture.

The above belief is corroborated by the fact that in India, banks are required to maintain a higher capital adequacy ratio than the global norms (9% instead of 8% as directed by Basel II norms). Furthermore, we believe that India has learnt from the mistakes made by the western banks and put in place a system that prevents such calamities from happening through tightening of the appraisal and monitoring processes.

CIBIL Success Story:

An individual, who had applied to one of our members for a loan of Rs. 10 lacs, was found to have 8 loans of the same type from a single bank and one credit card outstanding, totalling approx. Rs. 14 lacs. This was revealed in the CIBIL CIR.

Through the heavy regulation, public savings are protected; confidence in the financial system is promoted, concentration of financial power in hands of few institutions is avoided and equal opportunity and fairness in terms of access to credit is ensured.

The **risk management** system is also as advanced as those of the developed nations' banks. Even though the NPAs (non-performing assets) is on the rise, recent stress results performed by FICCI show that the Indian banks have the capacity to deal with them with relative ease.

With the establishment of CIBIL, India's first **credit information bureau**, the credit quality of commercial and consumer borrowers can be measured. Members are more aware of their customer's credit history which helps in the prevention of potential bad loans.

CIBIL's members include all the leading banks, housing finance companies, institutions, NBFCs, state corporations and credit card companies.

Furthermore, the banking industry depends to a great extent on the domestic economy. India has shown considerable **economic growth** in the past decade and there is scope for much more. Needless to say, the banking sector will thrive on the further growth that lies ahead for our economy.

IMF expects the Indian Economy to grow at a rate of 5.9% in 2013 and 6.4% in 2014.

Lastly, the **technology** base of the Indian banking sector is fairly advanced (FICCI research) and the banks are not shy from the continuous innovation process and upgrading the current systems as required. Software developed by Infosys and others are among the most robust in the world and have played an important role in the growth of the industry.

Challenges

Despite the tremendous growth in the sector for the past decade, Indian banks still have a long way to go before they reach the level of international banks. Even if all the banks in India consolidated, it would be a minnow in front of the biggest bank in China, based on total assets. The challenge is that even though there is huge potential, in order to tap it, the banks have to be supported by a sound system: from encouraging regulation to an effective back office.

The Indian banks are insulated from the foreign markets and have very little presence in the foreign countries. In order to become leaders, there is a need for **globalisation**, as people will require being able to use their services in other countries (the NRIs for example).

Another challenge faced mostly by the Public Banks is the level of **NPAs** on their balance sheets, which are on the rise. This can partly be attributed to the government-directed priority sector lending required from these banks. RBI issued new draft guidelines whereby banks would need to step up provisioning on restructured loans by 1% from FY14 to 3.75% and to 5% by FY15 on the existing stock of restructured loans, which may reduce earnings by 3-8% over the next two years, according to Bank of America.

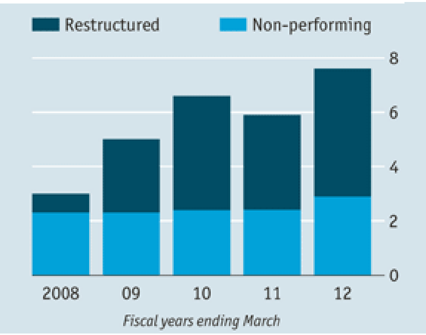
Inflation is another potential challenge for the Indian banking sector. With the continuous high level of inflation, there is omnipresent pressure on the central bank to keep the interest rates high. This does not bode well for the banks as it also reduces the real value of money they earn from their credit lending. Furthermore, high inflation reduces the savings rate, as people end up spending more.

Basel III will also slow down the growth of the banks as it requires them to maintain a higher capital adequacy ratio. For every rupee the banks lend, they would require a higher percentage of amounts coming out from their own pockets. This will put a downward pressure on the profitability of the banks. In addition, the banks will be required to raise further capital, which adds a bit more of uncertainty to the equation.

	Basel III	Existing RBI
Common equity + Conservation buffer + Countercyclical buffer	7-9.5%	3.6%
Tier I (including buffers)	8.5-11%	6%
Total capital (including buffers)	10.5-13%	9%

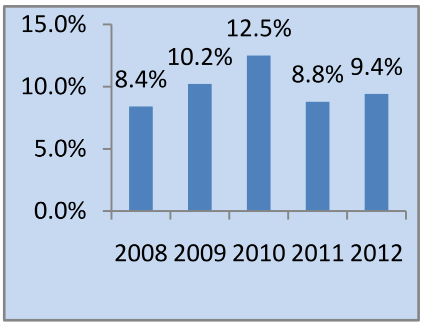
Private Banks, on average, have lower non-performing assets as compared to their public counterparts. According to The Economist, 93% of the restructured loans are on the books of Public Sector Banks.

There are only around 165 branches overseas compared to around 97,000 branches in India.



Source: RBI

Average Inflation based on CPI



Source: Labour Bureau

Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk and will be implemented in a phased manner, starting from April 2013 to 2018.

Future Trends

For the Twelfth Five Year Plan, funds from the budget will finance around 50% of the total estimated 1 trillion dollars (~53 lac crores) investment in infrastructure. The remaining 50% is divided between debt (37%) and equity (13%). Commercial banks alone will finance around 17% or 9 lac crores.

From Dec 2011 to Dec 2012, according to RBI, the amount of transactions (in rupees) done through debit cards have increased by 18.5% and credit cards have increased by 32%.

Use of cash could become increasingly limited in the future, making it more difficult to spend black money. Already, major transactions such as buying a car or booking a plane ticket require a bank transaction.

With the banking transactions leaving a trail, technological vigilance should improve in the future. With more eyes on the transactions, there should be an increased sense of security in use of plastic money, net banking or mobile banking.

There are strong signs that the banking sector will continue its impressive growth over the long-term, provided there is continuous innovation, adaptation to new technology and the banks take advantage of the business opportunities, while keeping their balance sheet on check.

With economic growth in a developing country comes the need for building infrastructure, which is mostly supported by private funding in India. It would not be surprising to see the amount of infrastructure loans growing since nearly 2.6 lac crores were required to be invested by commercial banks in infrastructure during 2010-2012.

There is an increased use of plastic money and net banking. We believe this trend will accelerate in the future as more people benefit from the convenience of using cards.

The young demography shall also be favourable to the industry as lots of new individuals will open bank accounts to receive their salaries or to book flight tickets or other transactions that require a bank account. A study by Goldman Sachs suggests that 110 million people will be added to the workforce in India by 2020. Furthermore, younger generation is more adaptive to new technology (due to the perceived ease of use), resulting in increased transactions done through mobile banking, for example.

We expect the banks to profit from the sheer increase in the number and volume of transactions. As more people become accustomed to net banking and credit cards, banks' cut in these transactions will increase their income.

Financial inclusion will also play an important part in the future of banks. As mentioned before, only 35% of the population has banking access. With appropriately engineered products such as no-frill accounts and other low-cost means of proving banking services to the rural areas, we believe that India will slowly and gradually converge to international levels of financial inclusion.

With the growth, there will be a need for a more strict regulation and effective risk management systems and credit information bureaus. We also expect that the debt market is set to grow in the future to support the increased demand for capital. Banks will face competition if companies start issuing a lot more bonds of their own.

Financial Inclusion

The central bank of India has initiated several measures to achieve greater financial inclusion, such as facilitating no-frill accounts and General Credit Cards (GCCs) for small deposits and credit.

Going forward, banks need to realize, and some of them already have, that small customers are an important key to the untapped opportunities in India. The challenge is to bring banking services in a cost-effective way to their doorstep. This is possible with the use of technology and innovation.

Low cost braches can be opened in the rural areas, with proper data connectivity and without the need for ATMs and point of sale facilities. Banks needs to design products and plan the expansion keeping the customer in mind, since the rural customer is very different from the urban one.

The No-frill savings account is one such example. This type of account provides access to only the basic banking services that customers in the rural areas may need and it requires a very minimal balance. The charges for opening and maintaining the account are also very limited.

According to the report made by Dr. C. Rangarajan on Financial Inclusion in 2008, over 73 percent of farmer households currently do not have access to formal sources of credit in India.

RBI realizes the importance and has taken many initiatives towards delivering affordable banking services to the disadvantaged and low income groups. Currently, around 40% of the adult population does not have a bank account and most of the potential lies in the rural markets. Around 70% of the farmers do not have a formal source of credit and some of them end up taking loans from money lenders at very high interest rates. RBI is also trying to educate the people by making them understand the basic concepts of banking and how it can help them.

Furthermore, in 2011, RBI mandated that the banks allocate at least 25% of the total proposed branches to be opened in under-banked rural centre during the year. The central bank has also relaxed its requirements on the KYC (Know Your Customer) norms, making it much simpler and faster to open a bank account.

From 2009, banks are allowed to freely open branches in the lower tier centres, which they were not permitted to do before. Hence, we believe that there is a clear road laid by the central bank, inviting the commercial banks to take their services to all the areas in the country.

Rise of Plastic and E-Money

There is no proposal to discourage use of net banking and debit and credit cards. In fact, we must encourage it as such transactions are recorded and leave an audit trail" – P. Chindambaram

The median age of India is 25 years, with more than 50% below 25 and more than 65% below 35 years of age. This young population is generally more adaptive and demands new and improved technologies as it is more convenient, saves time and the banks are happy to provide it as it reduces their costs as well.

Use of credit and debit cards is on the rise. According to RBI, the number of credit cards used has increased from 17.7 million in April 2011 to 18.4 million in September 2012. Similarly, number of debit cards in use has increased from 230 million to 302 million over the same period. The sharp increase in debit cards is complemented by the increase in ATMs in the country and the number of ATMs has risen from 75,645 in April 2011 to 101,646 in September 2012.

From Dec 2011 to Dec 2012, the number of transaction done through credit cards has from 2.8 crores to 3.6 crores (increase of 28%) and those done through debit cards has increased from 47 crores to almost 52 crores (increase of 9.2%).

The argument given against use of plastic money is the risk of fraud. With the implementation of 3-D Secure, the fraud cases involving credit or debit cards have fallen drastically. Furthermore, if it can be proved that the customer was not responsible for the use and was subject to fraudulent activity, the banks usually do not hold the customer responsible and end up bearing the loss.

Mobile banking is the latest addition to the use of technology in providing banking services and it is picking up quite a trend. Adults in the age group 18 to 30 are more adaptable towards using their mobile for banking and India has a high percentage population in that age group. People can now buy stuff from phones, pay bills, check account balance, transfer money, recharge phones, book tickets, etc. The customer wins since he can do the above effortlessly while on the move, not having to worry about security; and banks win as it reduces cost of hiring more employees to staff their branches.

According to RBI, the number of mobile banking transactions in India has also increased from 4,437,205 in October 2012 to 4,720,871 in November 2012, an increase of 6.39 percent.

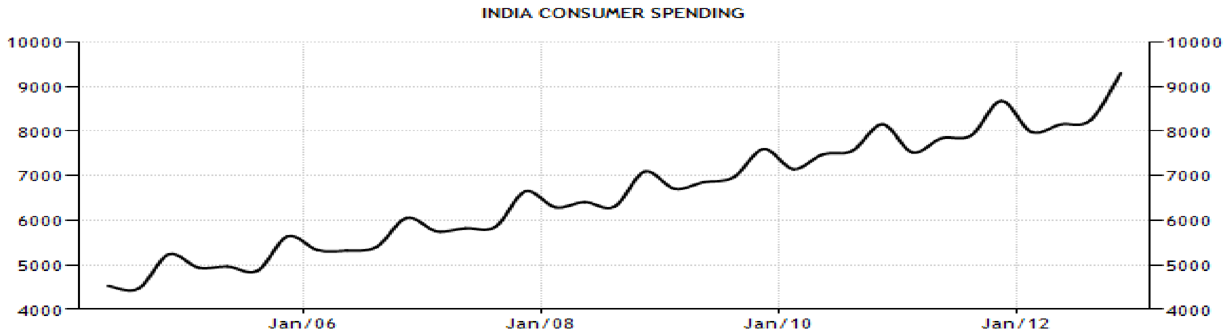
Over the same period, the total amount of the transactions increased by 8.3%.

According to Mckinsey & Company, 7% of account holders in India use net banking in 2011, as compared to a mere 1% in 2007. People are rightly shifting from branch banking to net banking as branch banking reduced by 15% over the same period. Customers no longer need to go to the branch to transfer money for example; they can do so from their computers at home.

Growth in Volumes of Transactions

Nearly 370 million Indians currently live in towns and cities. McKinsey believes that this number will soar to around 600 million in the next twenty years, a belief shared by the Planning Commission of India. This is because it is expected that 70% of the net new jobs will be created in the cities.

There is an increased trend in the country of individuals moving to tier-1 and tier-2 cities after completing their education to work in the service sector. Around 400 million people in India belong to the age group that has just started working or will start working in the near future. These individuals have raised the demand for banking services and we expect that the growth in the number of customers will increase even more in the future. Furthermore, we believe that there is a high probability of such individuals to exercise good saving habit and reflect another good opportunity for the banks.



Source: Central Statistical Organisation, India

Indian Consumer Spending is on an upward trend; so is the percentage of spending done through a medium whereby the banks earn a cut, such as net banking and debit/credit cards

According to a study done by Credit Suisse, an average Indian spends around 70% of the salary on basic requirements such as rent, food, travelling and education. Due to the persistently high inflation, these expenditures are set to increase, as are the salaries. Even though inflation is an issue for the overall growth of the economy, banks will gain partly from the increase in the volume of transactions.

The study also shows that the higher middle class Indians manage to save 17% of their incomes, which is good news for the banks, as the volume of deposits are directly proportional to the savings rate.

The Planning commission of India expects that around 1 trillion dollars will be spent on infrastructure during the 12th 5-year plan from 2012 to 2017 in order to support the economic growth. This implies that the demand for capital funds will continue to be high in the future. Since bank credit is the most important source of credit in India, there will be increased amount of money lent out by the banks. We also believe that the domestic credit as a percentage of GDP will converge to the levels of the more developed nations. China itself has a domestic credit of 145% to the GDP, whereas India's ratio is 75%.

Important Banking Ratios

The business model of a bank is completely different from a manufacturing or a service company. As per the banking regulations, a bank's financial statements are presented in a different manner. Therefore, there are unique ratios one needs to understand before investing in the banking sector.

Capital Adequacy Ratio – Due to regulations, for every loan that the bank gives out, 9% of the amount has to come from the bank's own pocket. This is a safety measure in order to make sure the bank does not take unnecessary risk with the depositors' money. It is mandatory for a bank to have an adequate ratio in order to be able to grow. However, excess capital may lower the return on equity.

CAR = (Tier I capital + Tier II capital) / Risk weighted assets

Capital of a bank is divided into two tiers:

Tier I capital consists mostly of the shareholder's equity and disclosed reserves.

Tier II capital comprises of the undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated term debt.

Net Interest Margin – This is a measure of the spread that the bank makes over the rate it gives on deposits by giving out loans. NIM is the net interest income earned by the bank relative to its average earning assets. These assets comprises of advances, investments, balance with the central bank and money at call.

NIM = (Interest income - Interest expenses) / Average earning assets

Net NPA - The net non-performing assets to loans (advances) ratio is used as a measure of the overall quality of the bank's loan book. Higher ratio reflects worsening quality of loans.

NPA ratio = Net non performing assets / Loans given

Non-performing assets (or NPAs) are those assets which do not generate periodical income.

In India, the time frame given for classifying the assets as NPA is 180 days instead of 45 to 90 days as per international norms.

Net NPA is amount of Gross NPA less
i) Balance left in the interest suspense account.
ii) Amount of provisions held for NPAs.

Cost of Funds – It is the average interest rate paid to depositors on savings accounts and time deposits and other sources of financing. A lower cost will generate better returns when the funds are deployed in the form of short-term and long-term loans to borrowers.

CASA Ratio – The current and savings account ratio is the ratio of deposits in the current and savings accounts of a bank to its total deposits. A high CASA ratio indicates that a higher portion of the bank's deposits come at low cost.

Other ratios that should not be overlooked are Return on Equity (ROE), Loan/Credit Growth, Deposit Growth and the P/E and P/B multiples.

Investment Rationale

The banks taken into consideration were the private sector Banks such as Axis Bank, ICICI Bank, IndusInd Bank, HDFC Bank, Yes Bank, Kotak Mahindra Bank, Development Credit Bank, Credit Union Bank, ING Vysya, Karur Vysya and Federal Bank.

It is clear to us that the banking sector will continue to see growth for the prolonged future in India which presents an opportunity for the investors. But with so many banks in the mix, one has to be careful before investing as some banks might not do as well as the others.

The parameters we laid focus on in our research were the degree of financial inclusion and rural penetration, bank's adaptability to the change in technology, quality of the assets, past performance, rate of growth, and other financial details.

With the above framework in mind, we set towards searching for a bank that has the best prospects for the long term future. It involved finding a bank, which in our opinion, not only has healthy financials, but an intelligent strategy; on the backdrop of which continuously good performance can be delivered.

Development Credit Bank and ING Vysya were left out from detailed analysis owing to their weak financials. Both the banks have the weakest margins and ROE in the private banking sector.

We decided to leave out the public banks from our research on the basis that the asset quality of these banks is inferior to the private banks (owing much to the government directed lending and as mentioned before, around 90% of the restructured loans in India are in public sector banks). Furthermore, we believe that the private sector is more efficient in doing business. The private banks are more aggressive and hungrier than the public banks for growth, which bodes well for the investor.

City Union Bank was also ignored due to its concentration in the South Indian cities which is a drawback since we believe that the geographical diversification is essential to a bank's prospects.

Private Banks in India are all very well capitalized and their Capital Adequacy Ratios and Tier-I capital ratios are well above the required norms. The implementation of Basel III regulations will have less impact on their growth or performance compared to the effect of the norms on public banks, which are not as adequately capitalized. Current Tier I Capital requirement as mandated by RBI is 6% and is expected to increase to 8.5-11%, but for example, Kotak Mahindra Bank already operates with a Tier-I Capital of 15.7%, and almost all private banks in India operate at levels above 10%.

ICICI Bank

When it comes to technology in banking, ICICI Bank is undoubtedly the leader. It was the first to launch a Facebook App and is always seeking ways to offer new technologically driven products such as smart phone apps, interactive kiosks, applications that help corporate treasury managers etc. Consequently, the largest amount of mobile transactions is done by customers of ICICI Bank.

According to RBI data, in January 2013, the value of transactions that took place through mobile was Rs. 216 Cr for ICICI Bank, Rs. 75 Cr for Axis Bank and Rs. 0.94 Cr for HDFC Bank.

The bank recently launched a training academy that focuses on educating its employees with functional knowledge to support the bank's rural strategies, and are also hiring local professionals and trusting them with sales in their rural areas. At the end of December 2012, rural advances were 6.9% of the total loan portfolio.

The bank has opened around 10 million financial inclusion accounts and seeks to expand its rural reach over the next few years. They added 233 new branches in the last fiscal year, growing to a total of 2750 branches with over 9000 ATMs.

For the data till March 2012, ICICI Bank has a net profit margin of 20.9% but a much lower than average ROE of 13.6% due to a weaker asset turnover and lower leverage.

ICICI's Insurance tie ups with Prudential and Lombard are consolidated under ICICI Bank. The standalone profits of ICICI Bank account for 80% of the net profit.

As on March 2012, the bank has a capital adequacy ratio (CAR) of 18.5% and a Tier-I ratio of 12.7%, both well above the required percentages. The bank has a better than average CASA Ratio of 43.5% and hence a relatively low cost of funds of 6.33%.

For the 9 months in FY 2012-2013, ICICI Bank has seen a below average deposit growth of around 10% and below average loan growth of 16.5%; the other private banks have done much better in terms of growth for the current fiscal year. Furthermore, the 5-year CAGR of deposits is only 8%, where other banks have seen an average growth of 30%.

ICICI Bank has the highest levels of Gross NPAs and Net NPAs in the private banking sector. The bank also has higher than average percentage of restructured loans of around 1.6%. Almost 60% of those are from their retail portfolio, which form 34% of their total loan portfolio.

Pros:

- Leader in Technology
- Above average effort towards financial inclusion

Cons:

- Asset quality
- Growth rate
- ROE

HDFC Bank

HDFC is one of the biggest private banks in India with revenues of around 33,000 Cr. and Net profit of 5,300 Cr in FY-2011-2012. 97% of the PAT was generated by core banking operations. Total advances amount to almost 2 lac crores; 54% of which are in retail segment.

The bank has the highest numbers of credit cards issued among its competitors with a total of 6.2 million till December 2012, resulting in the highest value of transactions taking place through credit cards in the private banking sector. It shares the spot for the highest transactions done through debit cards with ICICI Bank, both having similar amount of transactions in the past.

The bank has been a little slow to adapt to new technology as mobile banking was introduced only last year. But as of today, the bank has all the major means of banking demanded such as mobile banking, smart phone app, net banking and IT enabled kiosks. The highest number (and value) of National Electronic Fund Transfers (NEFT) in the private banking sector are done by HDFC customers.

HDFC has laid focus on financial inclusion and rural penetration for the past couple of years. 46% of the branches are located in semi-urban and rural areas, 400 of which are located near Mandis.

Not only is the bank offering products such as Kisan Gold Card, Tractor loans, joint liability group loans, no-frill account and other such rural-friendly initiatives, they are also actively raising financial awareness in these areas through education programs.

The bank has an average net profit margin of 16% and an attractive ROE of 19%, owing to its better than average leverage and asset turnover. IT has a comfortable Capital Adequacy Ratio of 17%, with Tier-1 Capital of 10.9%, as on December 2012.

HDC Bank has a slightly above average asset quality with Gross NPA of 0.9%, Net NPA of 0.2%, and the restructured loans amount to 0.3% of the total advances. Cost of funds for the bank is one of the lowest at 5.72% as on March 2012, due to its high CASA ratio of 48%. This in turn, has resulted in a high Net Interest Margin of 4.2%

Despite being one of the bigger private banks, it has seen a 5-year CAGR of 33% and even during the current fiscal year, the deposits have grown by over 20%. This can be party attributed to the huge number of braches they added last fiscal year (558), and continuous growth has seen them bringing the total to 2776 branches.

Pros:

- Asset Quality
- Growth rate
- ROE
- Satisfactory technology
- The best efforts towards financial inclusion

Cons:

- Slow in implementing mobile banking.

Axis Bank

As on 31st March 2012, total advances of Axis Bank were Rs. 1.7 Lac Crores, making it the third largest bank in the private space, behind ICICI Bank which had more than Rs. 2.9 Lac Crores and HDFC Bank which had nearly Rs. 2 Lac Crores.

The total deposits with the bank were nearly Rs. 2.2 Lac Crores as on 31st March 2012. Despite being smaller than HDFC Bank and ICICI Bank, Axis Bank has similar number of ATMs in the country. Like the other two, Axis Bank too has a smart phone mobile app, phone baking, internet banking and has braches equipped with self-service kiosks. Much like other banks, use of the above is very much on the rise: NEFT increased by 70% from Dec 2010 to Dec 2011 and 50% from Dec 2011 to Dec 2012.

Axis Bank sees financial inclusion as a business opportunity, rather than a corporate social responsibility. It has opened 44 lac no-frill accounts and has over 400 branches with dedicated officers for issuing farm loans. Agriculture advances account for nearly 12% of their domestic advances.

The bank even has strong presence in the domain of Electronic Benefit Transfer (EBT) and has over 37 lac beneficiaries already. They also target migrant labourers and slum dwellers in the urban cities such as Delhi, Bangalore and Chennai and help them open no frill accounts. Furthermore, they too have customised products such as Chotta RD, Chotta FD and Chotta SIP.

The bank has one of the better ROE in the private banking sector: an attractive 20.3%; backed by a strong net profit margin of 19.2% and leverage of 12.7. However, the bank has a slightly weaker than average asset turnover of 0.08.

Like most of the private banks in India, Axis Bank is adequately capitalized with a CAR of 15.17% and a Tier-I capital of 10.27% (as on Dec 2012). It has a lower than average cost of funds of 6.5% owing to its relatively higher CASA ratio of 40% and a higher than average Net Interest Margin of 3.5%.It has grown considerably over the past few years with a 5-year CAGR of 37.5% and for the current fiscal year (2012-2013), deposits and loans have grown by nearly 20%. 220 branches were added in last fiscal year (2011-2012).

Asset Quality as measured by Gross NPA and Net NPA is average, with 1.1% and 0.33% respectively. Restructured loans, however, are the highest among the private sector banks and have grown over the past year, rising from 1.8% to 2%.

Pros:

- Good efforts towards financial inclusion
- Growth rate
- ROE
- Satisfactory technology

Cons:

- Restructured Loans

YES Bank

Several products and services are being offered by the bank such as Yes Touch, Yes Money, Money Monitor, Yes Transact and the common internet banking, phone banking and smart phone mobile app.

The bank has been slow to issue credit cards: currently only American Express Plantinum and Gold cards are available and that too, to the top-end customers. Furthermore, these credit cards are being issued only since Dec 2012.

Due to the small scale of the bank, they have not been able to make significant steps towards financial inclusion, especially when compared to the efforts made by the bigger banks such as Axis Bank, HDFC Bank and ICICI Bank. The bank is however doing what it can by offering services such as direct micro-credit, micro saving and micro insurance and remittance services.

Yes Bank has one of the most attractive ROE among its competitors. With an asset turnover of 0.1 and high leverage of 15.7, its ROE is 23%. However, the net profit margin is slightly lower than average at 15.5%.

Agriculture and allied sector formed 14.5% of the total advances as on 31st March 2012.

The bank has also tied up with NGOs to provide credit and saving facilities to Self Help Group.

It is also the fastest growing banks in the country and has grown at a 5-year CAGR of 60%. It has continued to grow at a quick pace and added 142 branches in the fiscal year 2011-2012, taking the total to over 350 branches. By December 2012, the number of braches had reached 412. During the current fiscal year (2012-2013), the deposits have grown by 20% and loans by 27.5%.

Yes bank has a CAR of 18.2% as on 31st December 2012, and a Tier-I capital of 9%. Even though the ratios are well within the requirements, further Tier-I capital may have to be raised to maintain the growth appetite.

Asset Quality is among the best in the industry for Yes Bank. Gross NPA is a mere 0.17% and Net NPA is 0.04%. These ratios are well below the average and are a credit to the quality of risk management placed at the bank. Restructured loans are average 0.45% of the total advances.

Yes bank has the lowest CASA Ratio among the banks we considered for our research, which in turn has lead to a very high cost of fund of 8.8% as on 31st March 2012. The bank has a clear strategy on improving the situation and taken steps towards it by offering rates as high as 7% on savings account. The net interest margin is 3% at the end of Dec 2012.

Pros:

- Growth rate
- ROE
- Best asset quality

Cons:

- Low CASA Ratio
- Credit Card Service
- No significant efforts towards financial inclusion

Kotak Mahindra Bank

For the financial year 2011 – 2012, Kotak Mahindra Bank reported a net profit of Rs. 1850 crores on a consolidated basis. Out of this, Rs. 1085 crores (or 59%) was due to core banking activities, while the rest were due to Kotak Life Insurance and other financial services offered by Kotak.

By the end of FY11-12, Kotak Mahindra bank had opened around 100,000 no frill accounts, penetrated more than 300 villages and issued nearly 73,000 biometric smart cards.

On the technology front, Kotak Mahindra Bank offers only the basic services that other banks do: credit cards, net banking, mobile and phone banking. There is little to suggest that the bank lays any focus on technology based on the lack of experimental products launched. They do not have a smart phone app either. However, they did upgrade their Core Banking System to Finacle – the most popular system in Indian banking.

Considering the size of the bank, not much can be expected on the financial inclusion side of things. The bank does what little it can and opened 25 branches in the last fiscal year (2011-12) dedicated to providing services to the rural areas with products such as loans for tractor and farm equipments. Loans to the Agriculture sector formed around 15% of the total advances at the end of March 2012.

The return on equity on a consolidated basis is 15.5% due to a high net profit margin of 22%. But on a standalone basis, the core banking business only manages a net profit margin of 4.5% and ROE of 3.7%. The leverage of the bank is 7.9%, which is lower than the other private banks in the sector.

Kotak Mahindra bank has taken advantage of the de-regulation of interest rates on savings account by offering up to 6% and spreading the news via a successful campaign. This resulted in increase of savings account by 50%, taking the CASA ratio to 32% at the end of March 2012; total deposits saw a growth of over 30% in the same fiscal year. Interestingly, net interest margin of 4.8% is the highest in the sector.

The bank has seen average growth over the past years and the 5-year CAGR is 34%. There were 34 branches added last year taking the total to 355 branches. This year has seen further growth and by end of third quarter, Kotak Mahindra Bank had 407 branches and 907 ATMs.

At the end of December 2012, the CAR was 15.6% and Tier-I capital ratio was 14.2%, which are well above the required norms.

The gross NPA was 1% and net NPA was 0.5%. Amount of restructured loans are only 0.02% of the total advances, which happen to be the lowest in the sector.

Pros:

- Growth rate
- Asset quality

Cons:

- No significant efforts towards financial inclusion
- Low CASA Ratio
- ROE
- No real focus on technology

IndusInd Bank

Besides from providing the basic services such as credit cards, net banking, smart phone app, mobile banking, the bank has sought to improve customer satisfaction by launching products such as Cash on mobile, Direct Connect and Quick Redeem Service. In addition, the bank has upgraded its e-Banking portal to Finacle and revamped its IVR and contact centre platform. In doing so, we believe that the bank is moving with the times.

Indusind Bank is similar to Yes Bank in size, with both banks having total advances of Rs. 36,000 crores.

IndusInd bank has not made strides in its efforts towards financial inclusion, which can partly be explained by the size of the bank. However, it has surpassed RBI's mandated target for priory sector lending. Ending March 2012, the advances to the agriculture sector were 16% of the total advances, finance to weaker sections stood at 9% of the total and SME were 33% of the total.

Cash on mobile enables the customer to transfer money to the beneficiary's mobile number. Direct Connect allows exclusive customers to by-pass the IVR and speak directly to the banking executive. Quick Redeem allows customers to redeem their reward points by sending an SMS.

IndusInd bank has a return on equity of 18.3%, with a net profit margin of 15%, asset turnover of 0.1 and leverage of 11.7. Even though the NPM is slightly below average, the leverage helps magnify investor returns.

The bank has seen average growth (by the industry standards); it has a 5-year CAGR of 29%. For the fiscal year 2011-2012, the deposits grew by 23% and the advances grew by 34%.

The CAR of the bank as on 31st December 2012 was 13.4%, compared to 13.8% at the end of 31st March 2012. The Tier-I capital ratio has been stable over the year and has remained in the whereabouts of 11.4%, much higher than the required 6%.

The asset quality as measured by gross NPA of 1.02% and net NPA of 0.29% is average by the industry standards. Restructured loans are relatively with only 0.26% of the total advances falling into that category.

The bank has followed other smaller banks like Yes Bank and Kotak Mahindra Bank and increased the interest rate on savings account to 5.5% and 6%. It too seeks to take advantage of the savings account interest rate deregulation which came into effect on 25th October 2011. Similar to the other smaller banks, IndusInd Bank has a low CASA ratio of 28%, which translates into high cost of funds of around 7.3%. However, the bank has been able to maintain an average net interest margin of 3.3%.

Pros:

- Growth rate
- ROE
- Asset quality
- Focus on technology

Cons:

- No significant efforts towards financial inclusion
- Low CASA Ratio

Conclusion

KEY INFORMATION

Company: HDFC Bank
Sector: Banks – Private Sector
Ticker Symbol: HDFCBANK
Current Price: 635
P/E (TTM): 23.9
P/B: 5.0

Category	% Share Cap
Promoters	23
ADS (JP Morgan Chase Bank)	17
FII	31
Institution + Companies + Others	21
Indian Public	8

Investment Rationale:

- Asset Quality as measured by NPAs and restructured loans are below average.
- Growth rate has been impressive despite having a much higher base than the smaller banks.
- ROE has been consistently above 17% over the past years.
- Satisfactory use of technology to provide the essential products.
- The best efforts towards financial inclusion.

Weighing in the pros and cons with respect to the framework we set for ourselves, we believe that HDFC Bank has the strongest potential in the Indian Private Banking Sector.

The bank is the leader in financial inclusion and it made its presence known in the rural areas. It has the highest number of branches in the semi-urban and rural areas. The growth in this space is immense and HDFC Bank is setting up more braches in a year than the total branches of Yes Bank or Kotak Mahindra Bank.

Apart from this, HDFC Bank is educating the people in these areas on the benefits of being financial services, and it is doing so on a serious level, covering 1.4 lac households in a single year. The bank offers customized products such as Kisan Gold Card, Tractor and Cattle Loans, Joint Liability Group loans and has 400 branches located near Mandis.

We believe that the bank will benefit from the hard work it has put in to raise awareness and set up the infrastructure. Once people in the under-banked areas realize the advantages of the services that banks bring to their door-steps, HDFC Bank has the system and presence to take full advantage of it. This we believe is what sets HDFC Bank apart from the rest of the private banks in India.

Furthermore, it has very good asset quality and hence implies that the risk management system in robust. There is adequate capital in the bank needed to expand further and to adhere to the norms set out by incoming Basel III norms. It has seen considerable growth and seeks to widen its reach in the future, based on the number of branches it opened in the last year. The financials too, are strong for the bank, with an attractive ROE of 19%. The bank also has amongst the lowest cost of funds in the market due to the highest CASA ratio and it also has one of the best net income margins. The only hitch is that the bank is a little slow in adapting to technology compared to others; however it still provides the major services required by the customers.

To summarize, the bank ticks all the checks we believe to be important in judging the future of the bank and on that basis, HDFC Bank is a good investment for the long term.

Appendix

Name of Bank	ICICI Bank	HDFC Bank	Axis Bank	Yes Bank	Kotak Mahindra	IndusInd Bank
Advances	2,92,125	1,98,837	1,69,759	37,989	53,144	35063
Net Sales	37,995	33,252	22,000	6,307	8,470	5,359
PAT	7,937.16	5,273.77	4,219.60	976.94	1,850.70	802.61
Standalone PAT	6,465.26	5,167.00	4,242.00	976.94	1,085.00	802.61
Net Profit Margin	20.89%	15.86%	19.18%	15.49%	21.85%	14.98%
Asset Turnover	0.07	0.11	0.08	0.10	0.10	0.104
Leverage	9.76	11.05	12.7	15.66	6.94	11.742
ROE	13.62%	18.90%	20.29%	23.07%	15.46%	18.26%
Capital Adequacy	18.50%	16.50%	13.66%	17.90%	17.50%	13.85%
Tier I	12.70%	11.60%	10.30%	9.90%	15.70%	11.37%
Gross NPA	3.10%	0.90%	0.95%	0.20%	1.10%	0.98%
Net NPA	0.62%	0.20%	0.25%	0%	0.50%	0.27%
Restructured/Total	1.49%	0.40%	1.80%	0.50%	0.06%	0.26%
Cost of Funds	6.33%	5.72%	6.28%	8.80%	-	7.23%
Net Interest Margin	2.73	4.22	3.59%	2.80%	4.8	3.33%
CASA	43.50%	48.40%	41.50%	15%	32.20%	27%
Deposit Growth	8.82%	18.37%	16.29%	6.99%	33.49%	23.27%
Loan Growth	14.10%	23.63%	19.21%	10.55%	28.86%	34.01%
5-year CAGR	9.62%	32.26%	37.58%	60.75%	33.71%	29.00%
Retail advances	37%	53.88%	22%	18.20%	53.85%	49.15%
Advances/Assets	48.35%	58.50%	59.48%	51.50%	57.50%	60.88%
Investment/Assets	39.50%	28.50%	32.56%	37.50%	34.50%	25.30%
Deposits/Total Debt	63%	90.34%	86.50%	77.50%	55.50%	96.57%
Branches	2750	2544	1613	350	355	400
ATMs	9000	8913	9924	600	848	692
Braches Added Last Year	233	558	220	142	34	100

Third Wave Solutions Pvt. Ltd.

Our Belief System

A Third Wave economy refers to a Knowledge-driven economy. Therefore, we believe, the future belongs to those who have KNOWLEDGE and INFORMATION. Money may continue to generate more money, but not as much as when leveraged with Knowledge and Information.

We are much inspired by Alvin Toffler, a futurologist and Warren Buffet - an investor grounded in reality. **An eye to the future and an ear to the ground.**

With the above guiding philosophy, we are in relentless pursuit of knowledge, unmoved by smooth-talking and passing fads. As a corollary, we strive to empower our clients with relevant knowledge, information and business insights.

Our Services

Our team of professionals consisting of engineers, financial analysts, lawyers and accountants is equipped to provide a variety of services including:

- Customized wealth management services for HNIs
- Investment advice
- Bespoke country/industry/company research
- Business data analytics for operational efficiencies
- IT solutions for decision support functions
- Financial technology solutions – specializing in process automation and risk assessment/management tools
- Business proposal appraisals
- Enterprise structuring
- Contract negotiation assistance

Corp. Office: 002/25, Heritage City, M.G.Road, Gurgaon-122002 ☎+91-124-428700 / 4288701
E-Mail: info@thirdwavesolutions.in (www.thirdwavesolutions.in)