

# Banks

India

Sector View: **Attractive** NIFTY-50: **21,659**

January 05, 2024

## PSU banks: Valuation convergence prompts a thesis review

The investment thesis of preferring Tier-2 PSU bank stocks has performed well in the past year or so, driven by credit cost normalization. However, valuation multiples have now converged sharply, prompting a review of our recommendations. Given the relative strength of SBI as a franchise (demonstrated over the last credit cycle), we now recommend owning it over other PSU banks. We maintain BUY on SBI and ADD on BOB, but downgrade Canara (ADD), Union (ADD) and PNB (REDUCE).

### Investment thesis on credit cost normalization has played out well

Asset quality for PSU banks has seen a steady recovery in the past few years toward the end of the corporate NPA cycle and even held up well through the Covid pandemic – contrary to the expectations of many. This recovery cycle began with a declining trend in slippages, which was followed by declining GNPA ratios. We have now seen credit costs also decline as net NPA ratios for most PSU banks have converged to a level of about 1.0%. The steady decline in credit cost has driven a steady improvement in RoE closer to mid-teen levels. With increasing comfort in the outlook for asset quality and return ratios, these Tier-2 PSU bank stocks saw a sharp rally recently and their valuation multiples have now converged closer to those of SBI, which traded at a valuation premium for a few years. As a consequence, the investment thesis of favoring these inexpensive stocks has played out very well.

### Valuation convergence encourages us to favor the stronger franchise

With the recent swift convergence in valuation multiples, we have reviewed our investment thesis on the PSU banking space. While we earlier favored holding these Tier-2 PSU bank stocks, given the anticipated asset-quality recovery, making an investment case for them is challenging unless we believe that Tier-2 banks would be able to deliver superior return ratios for a much longer period, led by a healthy differential in loan growth, superior revenue mix leading to better operating profit ratios and importantly lower credit costs.

We do not think we have any evidence to change this thesis. SBI, in our view, has demonstrated that its franchise has been better than other PSU banks peers in terms of through-the-cycle credit cost, liability franchise, asset franchise as well as digital/technological enhancements. Hence, we prefer to now go back to recommending SBI over the other PSU banks.

### Prefer SBI (retain BUY); downgrade PNB, Union and Canara Bank

We now recommend SBI (retain BUY) as our preferred stock within the PSU bank space, while retaining ADD on BOB and downgrading the others – PNB (REDUCE), Union Bank (ADD) and Canara Bank (ADD). We roll over our Fair Values to base them on March 2026 BVPS while maintaining the same pecking order – SBI (~1.2X), BOB (~1.0X) and the rest (Canara, Union and PNB) at ~0.9X.

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Exhibit 1: Changes in rating and Fair Value (FV) for PSU banks under coverage

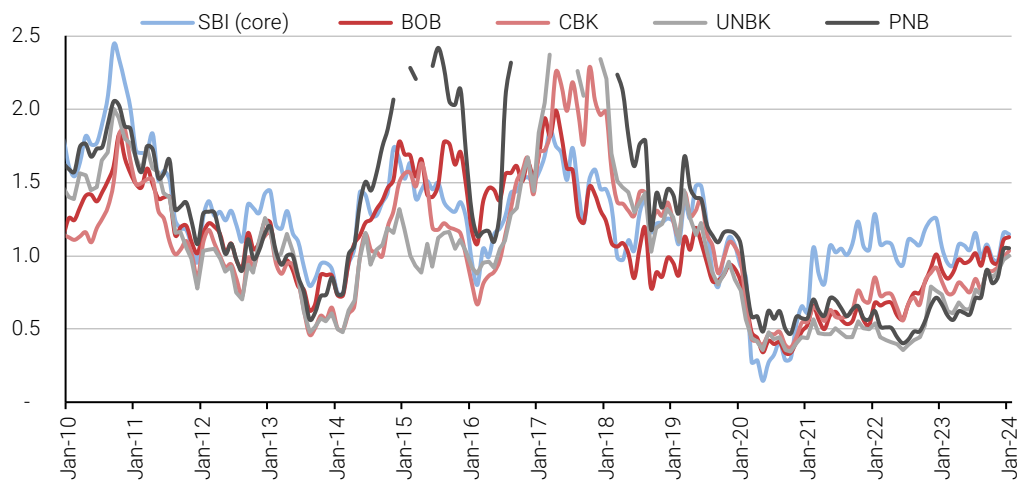
	Rating		Fair Value (Rs)		Market price (Rs)	Target PBR (adj, X)				Current PBR (adj, X)			
	Old	New	Old	New		2023	2024E	2025E	2026E	2023	2024E	2025E	2026E
	<b>Public banks</b>												
Bank of Baroda	ADD	ADD	215	250	238	1.5	1.3	1.2	1.0	1.4	1.2	1.1	1.0
Canara Bank	BUY	ADD	425	500	465	1.6	1.3	1.1	0.9	1.5	1.2	1.0	0.8
PNB	BUY	REDUCE	82	95	97	1.4	1.1	1.0	0.9	1.4	1.2	1.0	0.9
SBI	BUY	BUY	725	760	643	1.8	1.5	1.3	1.2	1.5	1.3	1.1	1.0
Union Bank	BUY	ADD	115	135	124	1.4	1.2	1.0	0.9	1.3	1.1	1.0	0.8

Note: We have shown standalone bank valuation multiples for SBI.

Source: Company, Bloomberg, Kotak Institutional Equities estimates

**Valuation multiples of other PSU banks have converged with that of SBI recently**

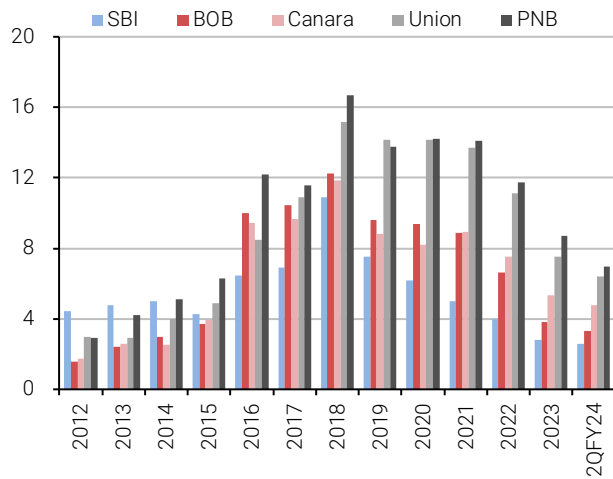
Exhibit 2: Price-to-book value (adjusted, 12-month forward) ratio for PSU banks (X)



Source: Company, Bloomberg, Kotak Institutional Equities estimates

**Peak GNPA ratio in the last decade was lower for SBI than other PSU banks**

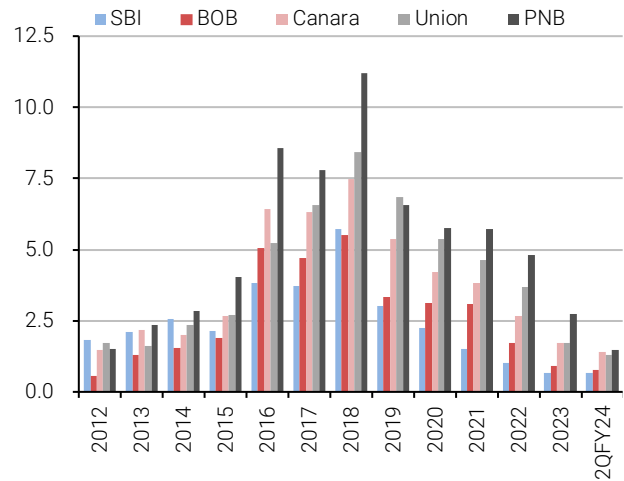
Exhibit 3: Gross NPA ratio for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

**Net NPA declined more swiftly for SBI than other PSU banks**

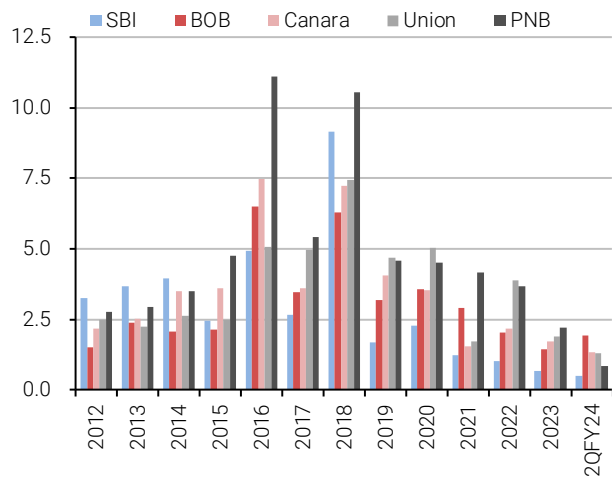
Exhibit 4: Net NPA ratio for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

**SBI has consistently reported lower slippages than other PSU banks in the past few years**

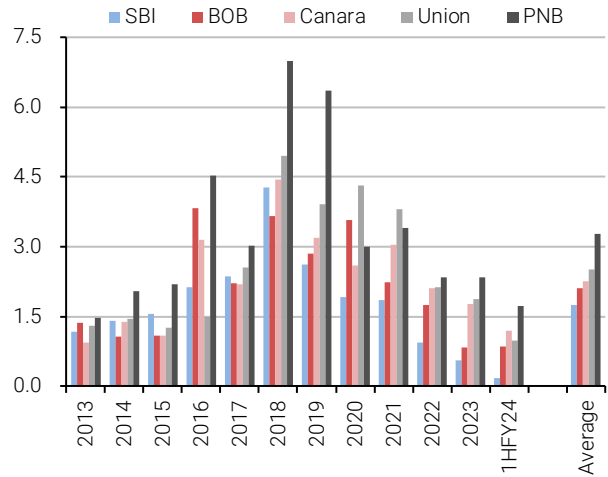
Exhibit 5: Slippage ratio for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

**Average credit cost over the last decade has been lower for SBI as compared to other PSU banks**

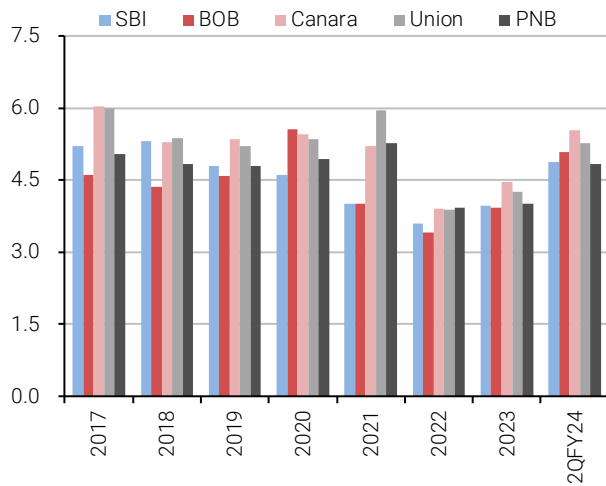
Exhibit 6: Credit cost ratio for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

**Other PSU banks have reported a higher cost of funds than SBI**

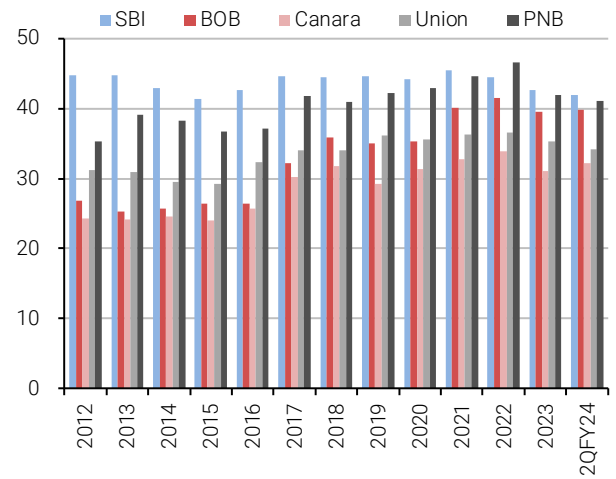
Exhibit 7: Cost of funds for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

**Other PSU banks have reported a lower CASA ratio than SBI**

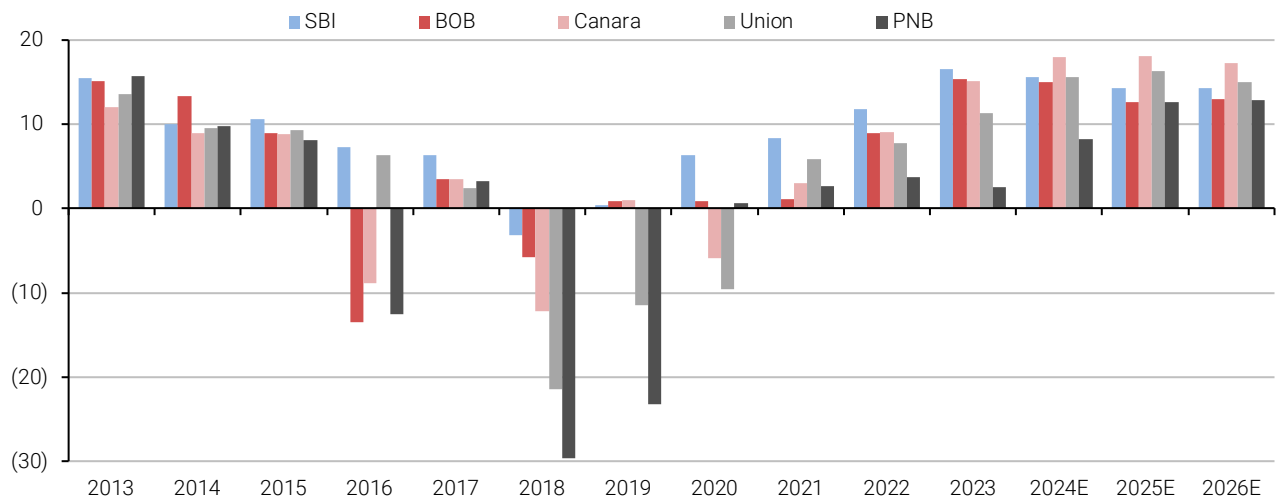
Exhibit 8: CASA deposit ratio for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

**RoE recovery for PNB is expected in FY2025E, while the others will see RoE recovery in FY2024E**

Exhibit 9: Return on equity for PSU banks under coverage, March fiscal year-ends (%)



Source: Company, Bloomberg, Kotak Institutional Equities estimates

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**ADD.** We expect this stock to deliver 5-15% returns over the next 12 months.

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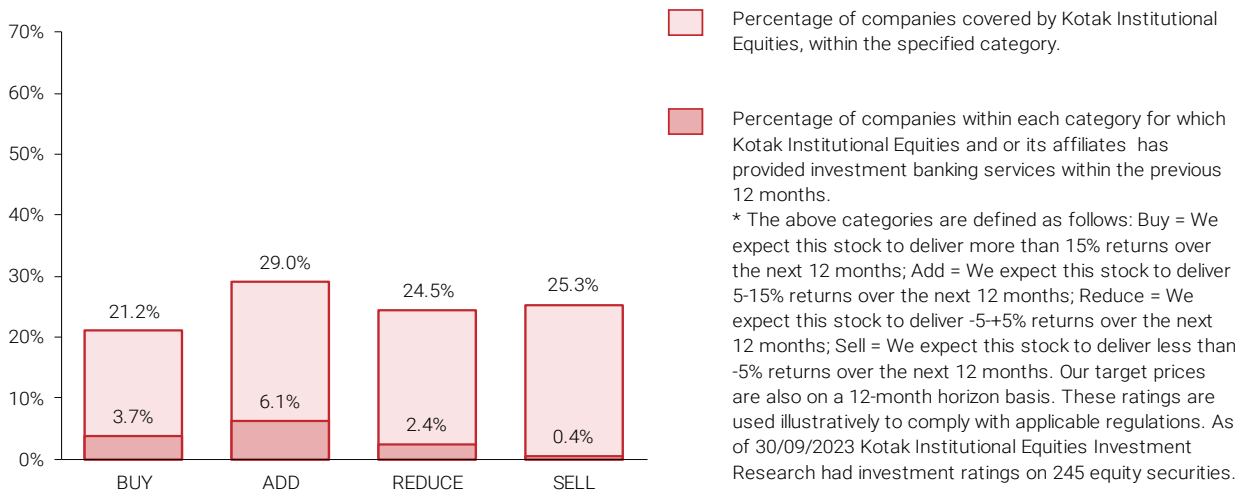
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Source: Kotak Institutional Equities

As of September 30, 2023

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