Banks

India

Sector View: **Attractive** NIFTY-50**: 23,519** **April 01, 2025**

The valuation explanation challenge

We view the recent outperformance of large private banks over other lenders as a flight-to-safety argument. The asset quality seems less worrisome than feared, with a recovery visible in segments such as unsecured loans. Hence, the upward normalization of credit cost might be slower than expected earlier, thereby making the risk-reward premise quite favorable outside of large private banks. We like Axis Bank and SBI in this framework given the recent underperformance. Bandhan can be a play on recovery in microfinance.

Large banks have outperformed when the best earnings are behind them

The recent outperformance of large private banks over others (mid-tier private banks, regional banks, SFBs and PSU banks) has come at a time when their peak earnings performance might be already behind. We observe the following trends: (1) Loan growth has slowed with no near-term drivers of recovery, (2) deposit growth remains sluggish and (3) no reduction in deposit rates despite rate cuts, thereby indicating potential disappointment in near-term NIM.

Keeping an optimistic view of the future can partially explain outperformance

We could explain this from two sides: (1) We are past the worst performance on growth for large private banks such as HDFC Bank and Axis Bank. As liquidity conditions improve, there is a probability that the frontline banks that have fewer concerns would lead growth in the initial stages of recovery. (2) Asset quality and growth remain an area of concern that is likely to persist. (3) On a relative basis, the risk-reward is favorable for large private banks as compared to other sectors in the market.

Flight to safety explains this performance, but it is not a strong argument

The common factor that explains the outperformance of HDFC Bank, ICICI Bank, Cholamandalam Finance and Bajaj Finance as compared to Axis Bank suggests that investors are looking for stocks that can have fewer large negative surprises (similar to the microfinance crisis or the recent case of IndusInd Bank). However, the flight-to-safety argument has its own idiosyncrasies. As the fears recede (as they always do at some point), the re-rating argument becomes stronger. The rally in corporate banks is a classical case-in-point, where we could risk overstaying on the safety argument. The best approach is to look at asset quality, growth and profitability, and refer to the same through the valuation framework. From that perspective, it is harder to justify a sustenance of the outperformance by large private banks hereon. We don't see asset quality as a serious area of concern for banks. We would want to believe that the microfinance stress would be behind us in FY2026E. We believe that the stress in unsecured loans has been lower than initially feared, and its impact was seen primarily on players who had a higher share of lower-ticket or shorter-duration loans as compared to the typical portfolio of private and PSU banks. Growth and NIM are still a work-in-progress, which would imply that the current outperformance may not sustain. We like Axis Bank and SBI with this framework, while we maintain our positive business outlook for ICICI Bank.

Full sector coverage on KINSITE

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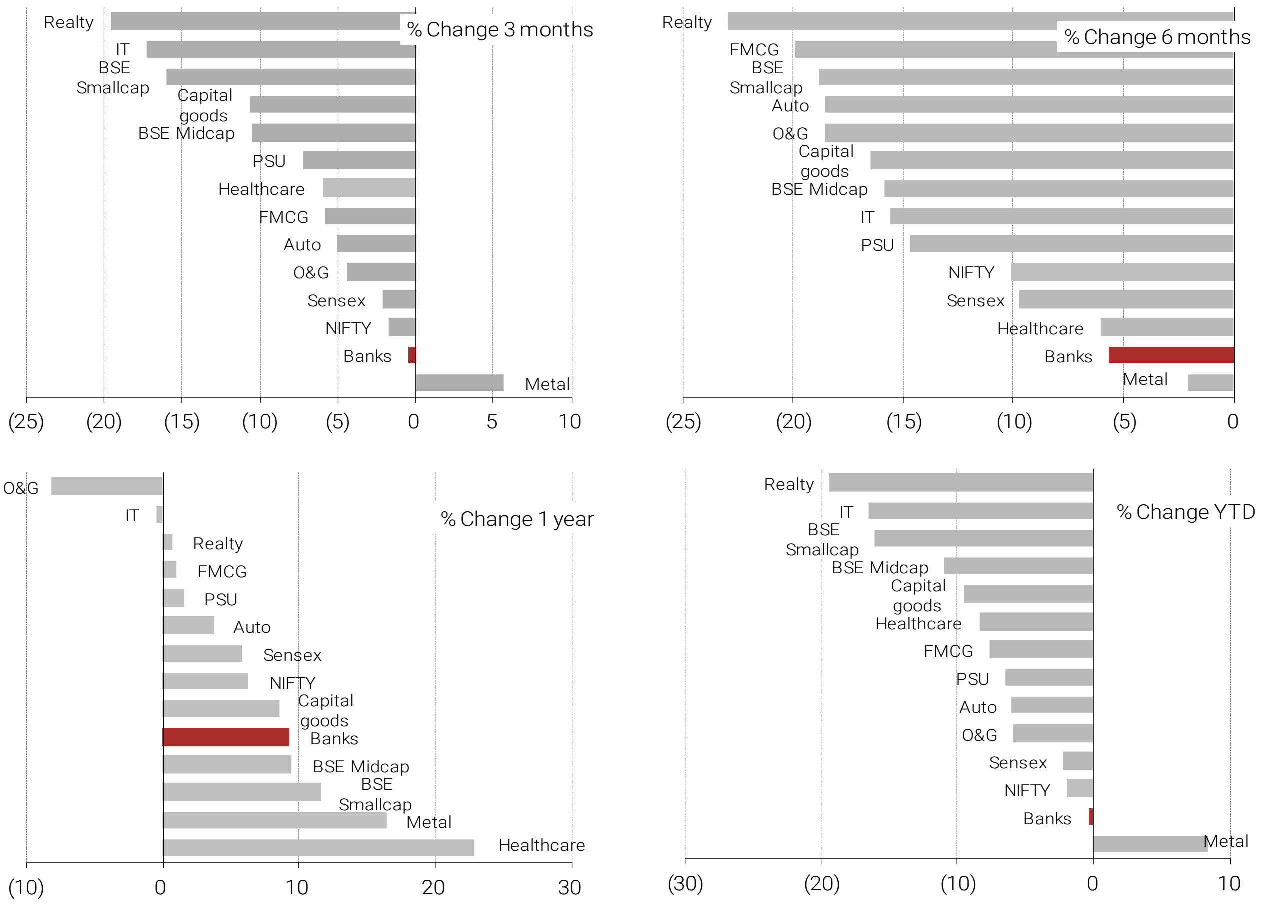
Flight to safety fits the recent outperformance argument of large private banks

Exhibit 1 shows the performance of banks compared with other sectors. We would want to believe that the inexpensiveness of the sector and relatively lower cuts in earnings are driving most of the outperformance. In general, the overall bank index has outperformed other spaces within the financial sector ecosystem as well after a prolonged period of underperformance. Within this, we see that the frontline banks (HDFC Bank and ICICI Bank) have done relatively better (see Exhibits 2-3).

Banks have outperformed most of the other sectors in recent times

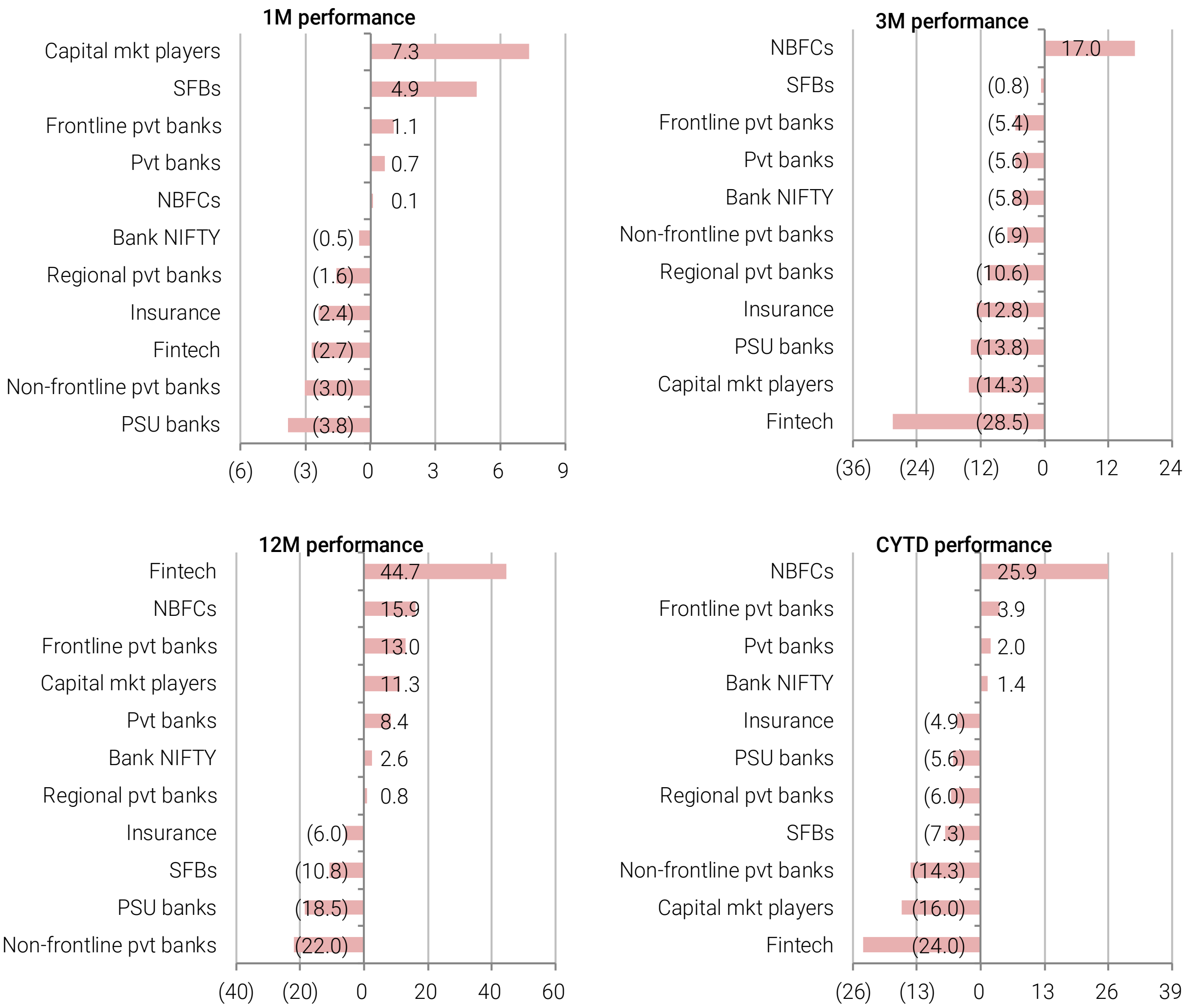
Exhibit 1: Price performance of various sectors across duration (%)



Source: Company, Kotak Institutional Equities

Frontline private banks have outperformed non-frontline private banks significantly over the past year

Exhibit 2: Market performance of various BFSI sub-indices (%)

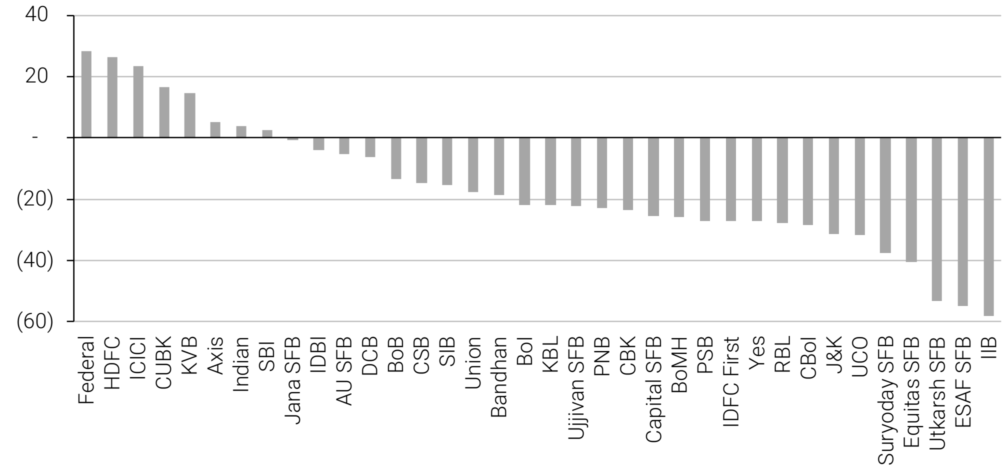


Source: Bloomberg, Kotak Institutional Equities

When we look back at the past year, we see the following rationale to explain the underperformance of other bank groups versus the larger private banks: (1) Mid-tier banks like IndusInd Bank, Yes Bank and RBL have had challenges on the deposits front accentuated by a worsening of asset quality problem in the microfinance business, (2) regional banks have no specific concern with even portfolios such as CUBK showing improvement in asset quality and recovery in return and growth ratios, (3) PSU banks have no specific attributable reason. While asset quality remains stable, the operational performance has only been steady with no strong improvement in growth ratios. We have seen that their credit cost cycle has bottomed out and it seems unlikely that it can reduce further from the current level.

Frontline private banks have done relative well among all banks

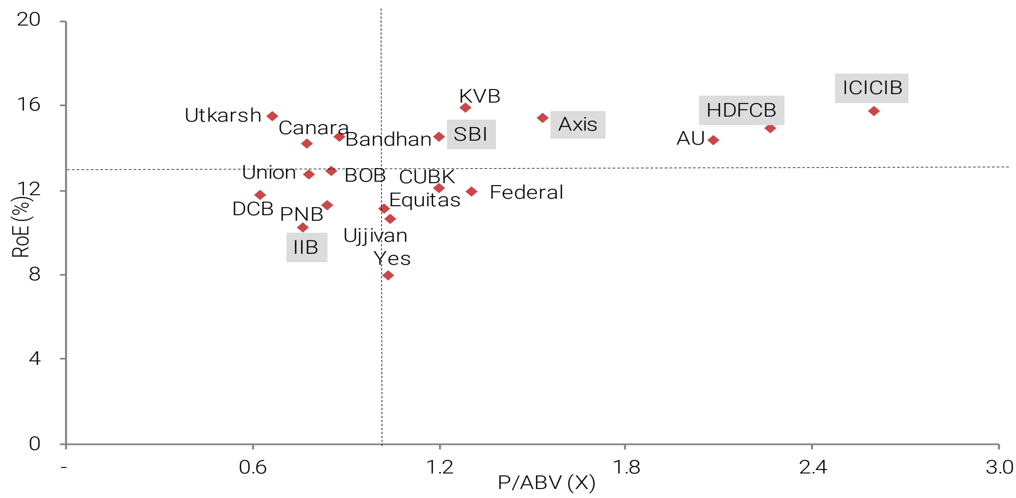
Exhibit 3: 1-year price performance across banks, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

Frontline banks have extended their valuation differential with other banks

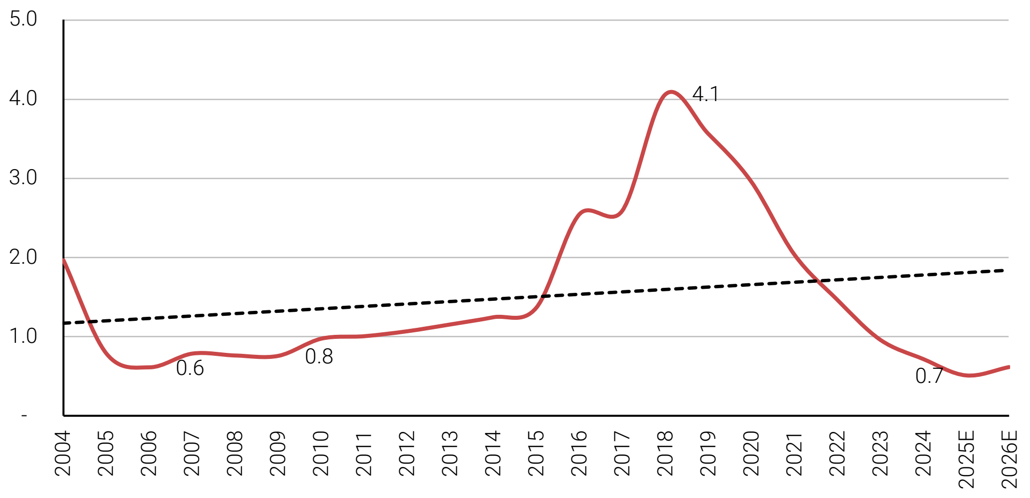
Exhibit 4: Valuation scatter of banks, March fiscal year-end, 2026



Source: Company, Kotak Institutional Equities

Credit cost is not expected to normalize upward quickly

Exhibit 5: Long-term history of credit cost for banking system, March fiscal year-ends (% of average loans)

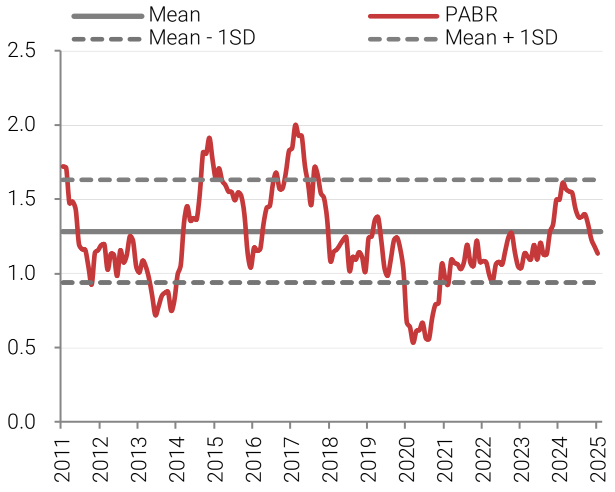


Source: Company, Kotak Institutional Equities estimates

Exhibit 8 shows the adjusted price to book differential between private and PSU banks. The period from FY2021 saw a sharp convergence in multiples between private and PSU banks. The thesis was relatively simple as investors continue to work through the asset quality improvement for PSU banks, which subsequently translated to a recovery in profitability metrics. However, this became a much harder thesis as an investment argument in FY2025 primarily as the discount had narrowed to historical lows. Note that the valuation of PSU banks is still similar to or marginally below long-term historical average. However, the challenge has been the long-term de-rating that we have witnessed in private banks led by the large private banks. This has put an upper cap on the extent of absolute re-rating that we can see in PSU banks even when their financial performance is satisfactory.

Valuation of PSU banks have corrected from peak level

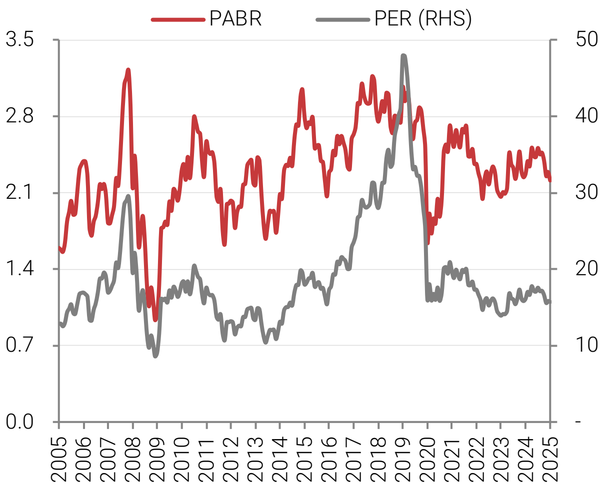
Exhibit 6: 1-year forward rolling PBR for PSU banks (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Private bank valuations have also struggled with the de-rating of HDFC Banks

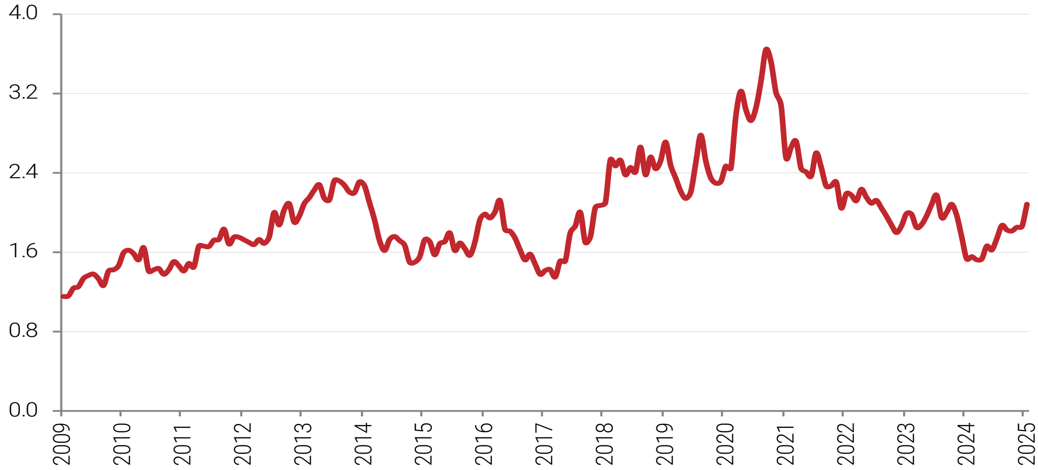
Exhibit 7: 1-year forward rolling PBR for private banks (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Valuation differential between private banks and PSU banks had declined sharply

Exhibit 8: Adjusted PBR of private banks relative to public banks, March fiscal year-ends, 2009-24 (X)



Source: Company, Kotak Institutional Equities

Flight to safety or start of recovery

We look at the conditions that we are facing today to understand the rationale for this outperformance.

- **Business performance has no specific tailwinds**

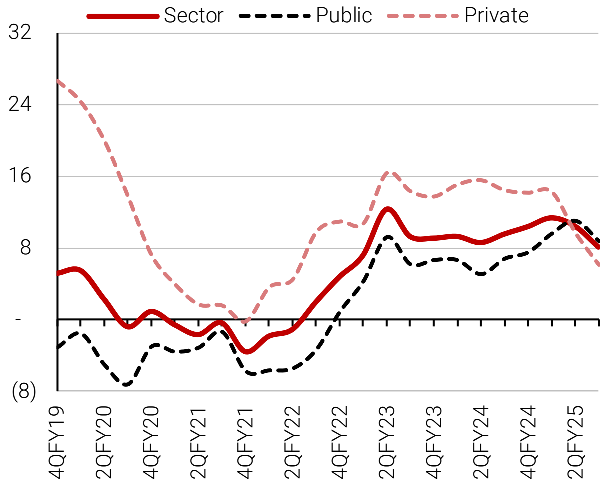
  - **Growth is still quite weak for the large private banks**. Private banks have slowed their loan growth in comparison with PSU banks (see Exhibit 9). Within this, the large private banks have slowed considerably (see Exhibit 10). We look at the underlying business environment and note the following:

    - Demand for loans has been a bit weaker in recent quarters. For a given level of economic growth, loan growth is largely tracking the same, suggesting that we are not creating any excess credit at a systemic level. However, it is quite likely that we could see some pockets of stress as we have seen recently in microfinance. However, as the contribution of these segments is fairly small, the impact on profits and return ratios might not be very high.

    - Supply of loans is also suggesting some degree of weakness, but here again there could be multiple reasons that could explain this phenomenon. These could include: (1) Pricing challenges, (2) funding challenges, and (3) asset quality challenges forcing lenders to slow down or report a loan decline till the balance sheet is adjusted to some degree of normalcy. When we look at the underlying growth or disbursements, we see the first two arguments playing a key role rather than the third. Weakness in asset quality is largely restricted to products that serve lower income segment rather than it being pervasive or specific to any sectors. The slowdown in growth is much more in private banks as compared to PSU banks. Their asset quality is holding up well even if it has increased marginally from the recent historical lows. HDFC Bank and Axis Bank are working through their respective liability-side challenges. HDFC Bank has shifted its preference to lower the loans-to-deposit ratio faster than initially anticipated, while Axis Bank has reported a deposit growth, which was weaker than expectation. These two large banks followed by mid-tier banks who have had challenges on asset side largely explain the weak supply of credit or intent-to-lend. To some extent, we would be less worried about this issue.

Loan growth has slowed more sharply for the private banks recently…

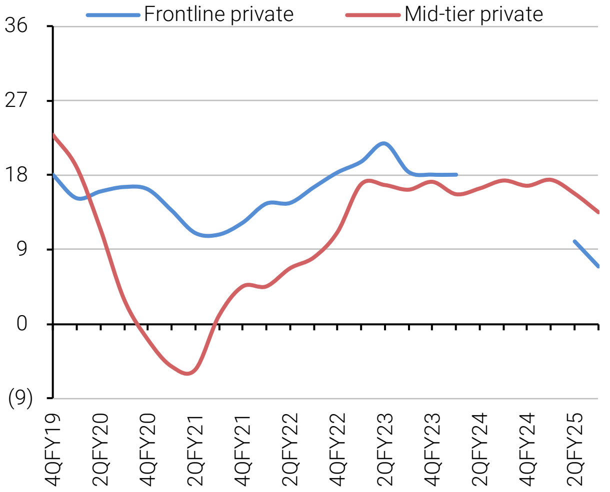
Exhibit 9: Loan growth across PSU banks and private banks, March fiscal year-ends (% yoy)



Source: RBI, Kotak Institutional Equities

…led by a sharper slowdown for the frontline private banks

Exhibit 10: Loan growth across frontline and mid-tier private banks, March fiscal year-ends (% yoy)



Source: Companies, Kotak Institutional Equities

- **NIM would be under pressure as we are in a softening rate cycle**. We have seen the softening of the rate cycle beginning this year. We are still not sure of the intensity, duration and pervasiveness of the pass-through across various segments. We saw a rate hike of 250 bps across a period of ~15 months with a better pass-through in the retail segment. Lending yields increased by ~180 bps post Covid. On the other hand, we have just begun the rate cut cycle. Economic activity is not yet weak enough to warrant steep rate cuts. This would imply that the variability of NIM would be significantly lower as compared to what we saw in FY2023-24.

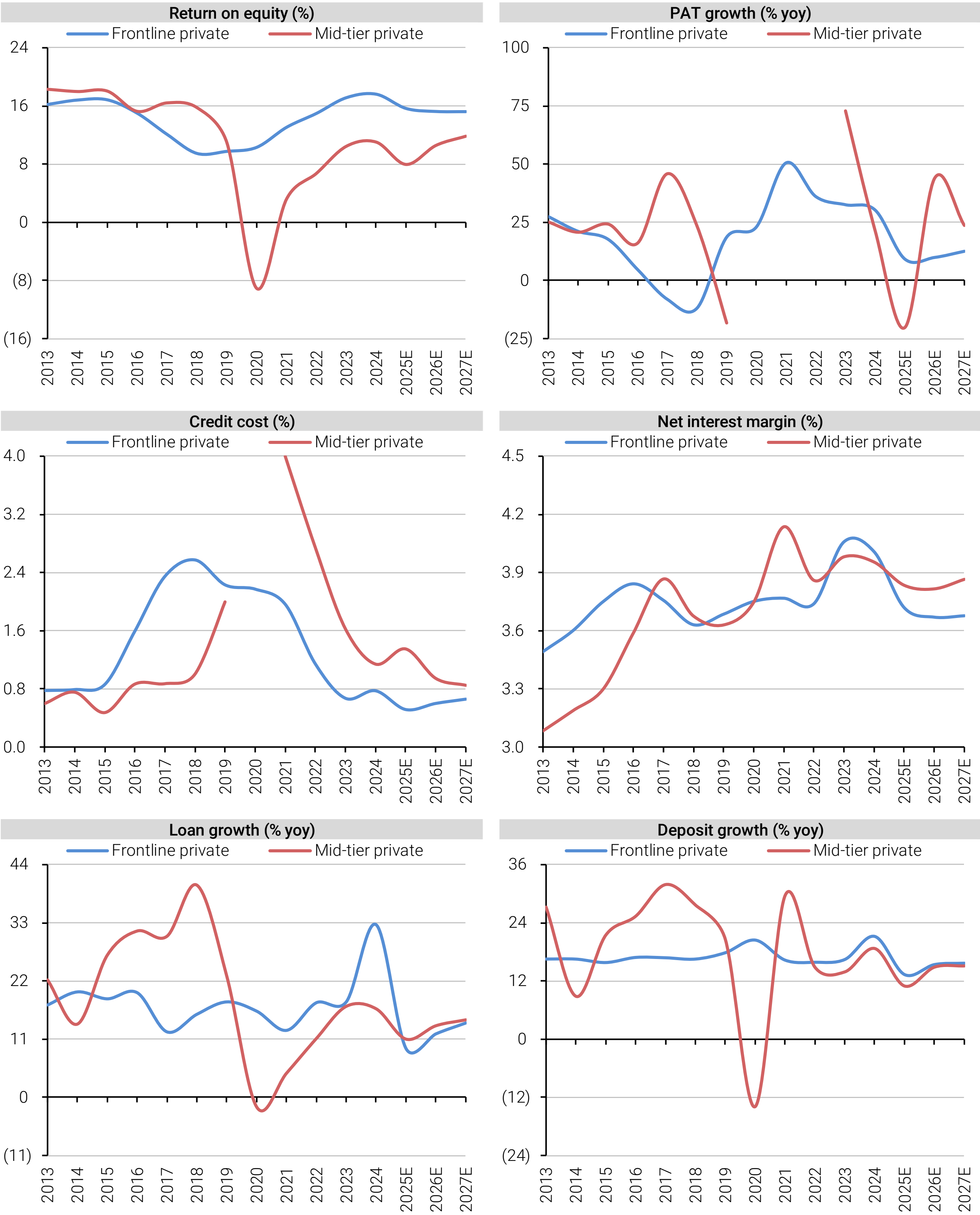
- **Cost structure has scope for improvement**. We expect cost ratios to remain under control and likely to be one area where lenders would have some degree of freedom to maneuver if revenue growth were to come under pressure. PSU banks would have lower flexibility compared to private banks. However, they too have completed their key cost variable which is of the wage settlement cycle. Investors are unlikely to give a higher multiple when lenders are able to maintain the operating cost ratio but would aid in stemming a possible de-rating.

- **The best in asset quality cycle is behind us**. The large banks have seen credit cost at historical lows. Hence, the probability of further positive surprises is likely to be negligible. In recent quarters, we have seen some degree of normalization from these lows, but we are still some time away from hitting historical average credit cost. When we break the entire loan book across segments, we note that the corporate credit book is unlikely to show any rise in stress. With hardly any capex-led demand for loans, the overall leverage levels look quite comfortable. The retail segment can be generally broken across secured and unsecured segments. While the unsecured products are showing higher delinquency than secured products, the causes of stress appear to be different. Our understanding and discussion with lenders broadly conclude that the challenge is primarily with borrowers who are in the semi-formal or informal segment and largely in the bottom half of the population by income. The microfinance segment is under a fair bit of stress with NPLs rising sharply in recent quarters. We should see stress remaining high for another couple of quarters as the balance of stress moves through NPLs that is current sitting in different SMA buckets currently. The SME part of the portfolio is holding up reasonably well. We see that the formalization of economy, as a theme, gaining traction. While income growth has been modest given the current state of the economy, the formalization theme allows lenders to work through higher credit with lower collateral. Importantly, the ability to monitor cashflows is superior than earlier.

- **Earnings growth is likely to be weak for FY2026 considering the above measures**. Exhibit 11 shows that the earnings growth is likely to be weak for the large private banks. With a higher share of loans linked to EBLR and a rate cycle that is a headwind to NIM, the ability to deliver superior earnings growth is unlikely. While we do believe that the asset quality cycle is benign, the probability of credit cost normalizing is higher, which would imply that the earnings growth is likely to trail loan growth. We build most of these assumptions in our models, which implies that the scope for a negative surprise is also equally lower. However, as these weak numbers are getting delivered over the next few quarters, it would be a bit challenging to see further re-rating of multiples, especially for the large banks.

Earnings growth for frontline private banks is likely to be weaker than mid-tier private banks over the medium term

Exhibit 11: Outlook for frontline and mid-tier private banks, March fiscal year-ends (%)



Source: Companies, Kotak Institutional Equities estimates

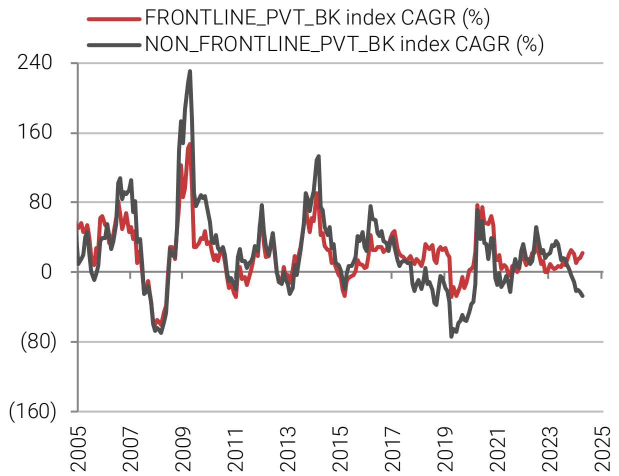
Frontline bank index has outperformed other banks since 2018, but underperformed in the last 2 years

Exhibit 12: Ratio of "frontline bank index" to "mid-tier private bank index" (X)

Source: Bloomberg, Companies, Kotak Institutional Equities

1-year returns on other banks are taking the lead over frontline banks after recent convergence

Exhibit 13: 1-year return on frontline private bank index and non-frontline private index (%)



Source: Bloomberg, Companies, Kotak Institutional Equities

- **Operational risks have been far fewer in large banks**. The fear of unexpected negative surprises is high resulting in lower multiples for banks. The recent episode with IndusInd Bank is an example that illustrates the issue quite well. The re-rating in large private banks coincided with the development that we saw with IndusInd Bank. Our discussion with lenders over the past fortnight suggests that the fear is not warranted. Most lenders have adequate checks and balances which implies that the risk of this event materializing with other lenders should be negligible.

There is some merit to believe that this rally in large private banks has been driven more by a flight-to-safety argument than by the outlook on underlying financials over the next few quarters. However, it is also fair to assume that large private banks were also poised to deliver at least closer to their internal accruals which they have struggled in recent years.

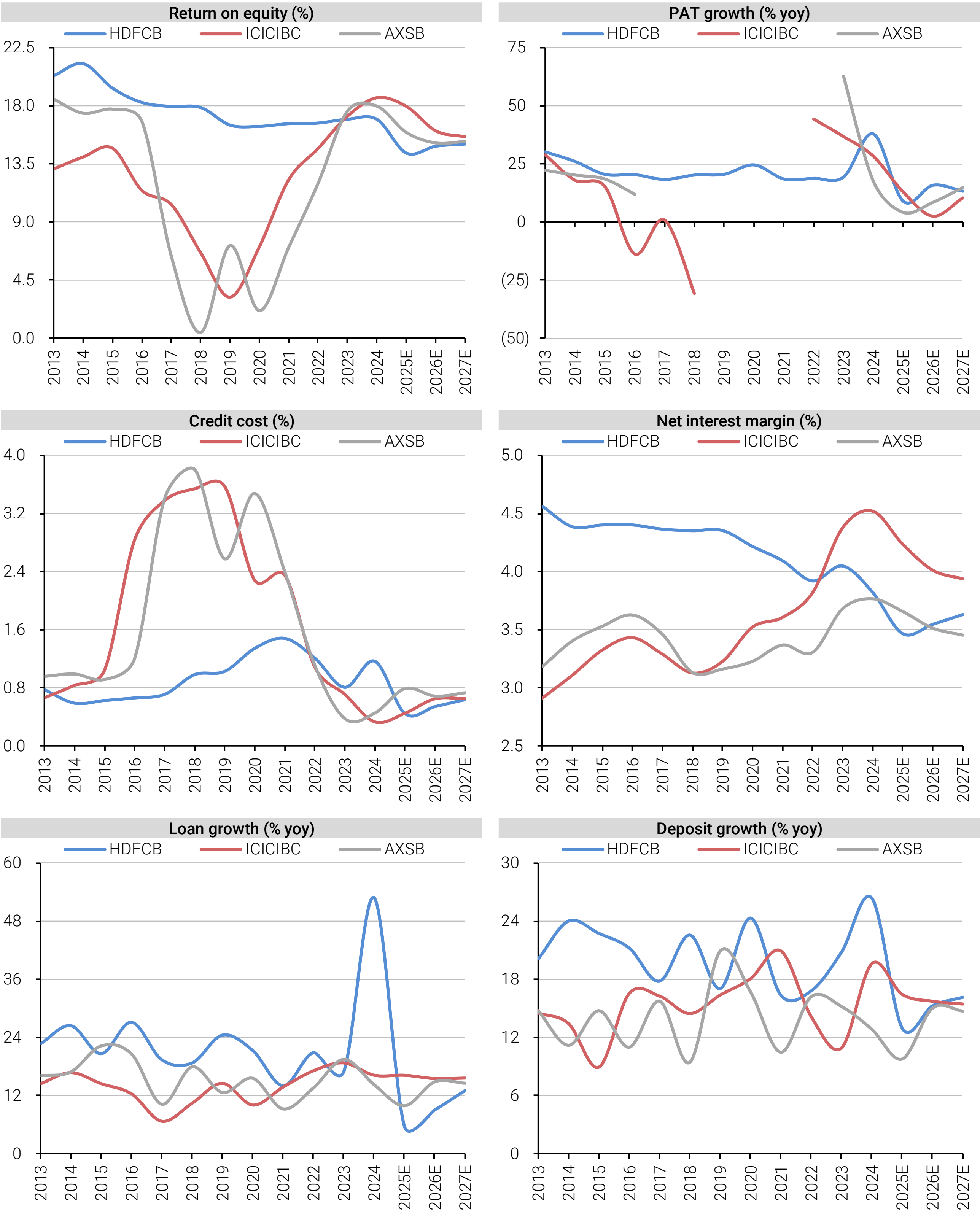
- ICICI Bank has delivered best-in-class performance and yet has struggled to sustain a higher valuation than where it is currently primarily as the benchmark of comparison shifted to relative metrics. From this perspective, we are looking at the performance of HDFC Bank to broadly understand the premium at which ICICI Bank is likely to sustain. We don't see a meaningful outperformance in ICICI Bank from hereon.

- HDFC Bank presents a few interesting arguments: (1) It is a company to own when there is some fear elsewhere in the market. HDFC Bank has corrected investor expectation on growth and the outcomes that they are targeting with respect to loans-to-deposit ratio. Hence, the scope for further de-rating looks limited as we are probably well past the peak of cut in earnings for the bank. The challenge with this thesis is that it is applicable to most large banks and not specific to HDFC Bank. An investor could look at this investment theme with any of the large private banks and SBI as well. (2) HDFC Bank's impeccable asset quality ratio positions them reasonably well when there is higher stress at an industry level. However, the challenge with this line of argument is that the expected level of stress and actual stress that we are witnessing is not adequate enough for this outperformance to play through. Most importantly, in the relative comparison set, which is Axis Bank and ICICI Bank—the differentiation is not meaningful enough as we saw during the corporate NPL cycle for the outperformance to play through. (3) Path to normalization of earnings is visible and the current discount to ICICI Bank is unlikely to sustain. The key challenge to this thesis is the cost of the funds. Today, we note that investors are looking at the loans-to-deposit ratio to decide the expected time of convergence. However, note that the differential in cost of funds is still quite high. We are currently witnessing a replacement of borrowings with term deposits, while the CASA deposit growth continues to lag overall deposit growth. With HDFC Bank management looking to accelerate growth from current levels in FY2026-27E, it becomes harder to build an investment thesis about a swift convergence in cost of funds for the two lenders. If this differential in cost of funds persists, then the probability of convergence in multiple is unlikely, in our view. We look at HDFC Bank and ICICI Bank with a near similar lens. We believe that these two banks are the best-in-class players in private banks. However, the current differential in valuation multiple needs to persist longer till we have clarity on the pace of convergence of cost of funds.

- **Axis Bank presents the best investment thesis among large private banks**. We look at the potential areas of risks and look at the near-term expected outcomes of these risks. We are less worried on asset quality and we have looked at various sub-segments within the retail portfolio to note that the fear is probably much more than the actual stress on the ground. We want to believe that the unsecured loans would see better outcomes on slippages and, hence, we should see lower credit cost in this business in the next few quarters. Credit bureau data already indicates that the stress from incremental originations is declining steadily. On the other hand, we would to believe that deposit growth would also eventually move back closer to industry average or perhaps better over the next few quarters.

Convergence of RoE of HDFC Bank and ICICI Bank might not play through over the medium term

Exhibit 14: Outlook for frontline private banks, March fiscal year-ends (%)



Source: Companies, Kotak Institutional Equities estimates

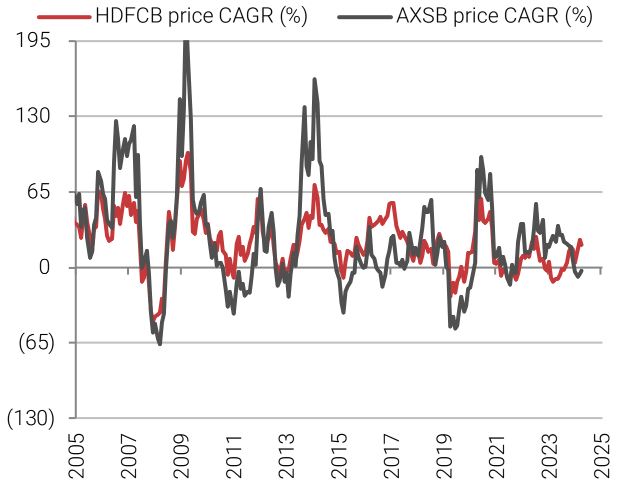
HDFC Bank has outperformed Axis Bank recently

Exhibit 15: Ratio of HDFC Bank stock price to AXSB stock price (indexed to 1 as of January 2000)

Source: Bloomberg, Companies, Kotak Institutional Equities

Returns on HDFCB stock are much less volatile than returns on the AXSB; HDFCB stock has recently outperformed AXSB stock

Exhibit 16: 1-year return on stock price (%)



Source: Bloomberg, Companies, Kotak Institutional Equities

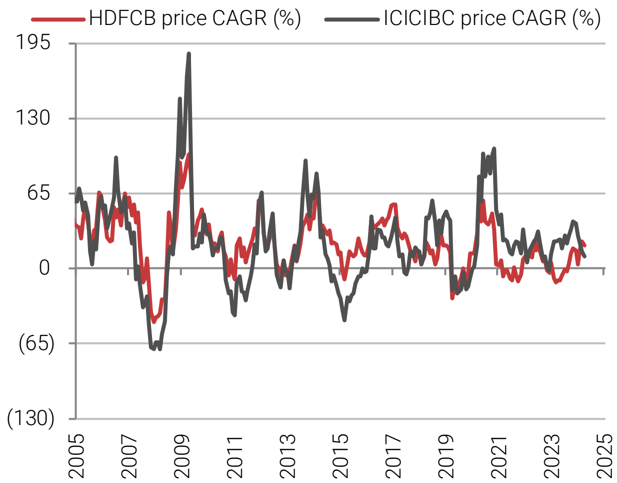
HDFC Bank has delivered similar returns to ICICI Bank over the past year

Exhibit 17: Ratio of HDFC Bank stock price to ICICIBC stock price (indexed to 1 as of January 2000)

Source: Bloomberg, Companies, Kotak Institutional Equities

Returns on HDFCB stock have recently converged with those of ICICI Bank

Exhibit 18: 1-year return on stock price (%)

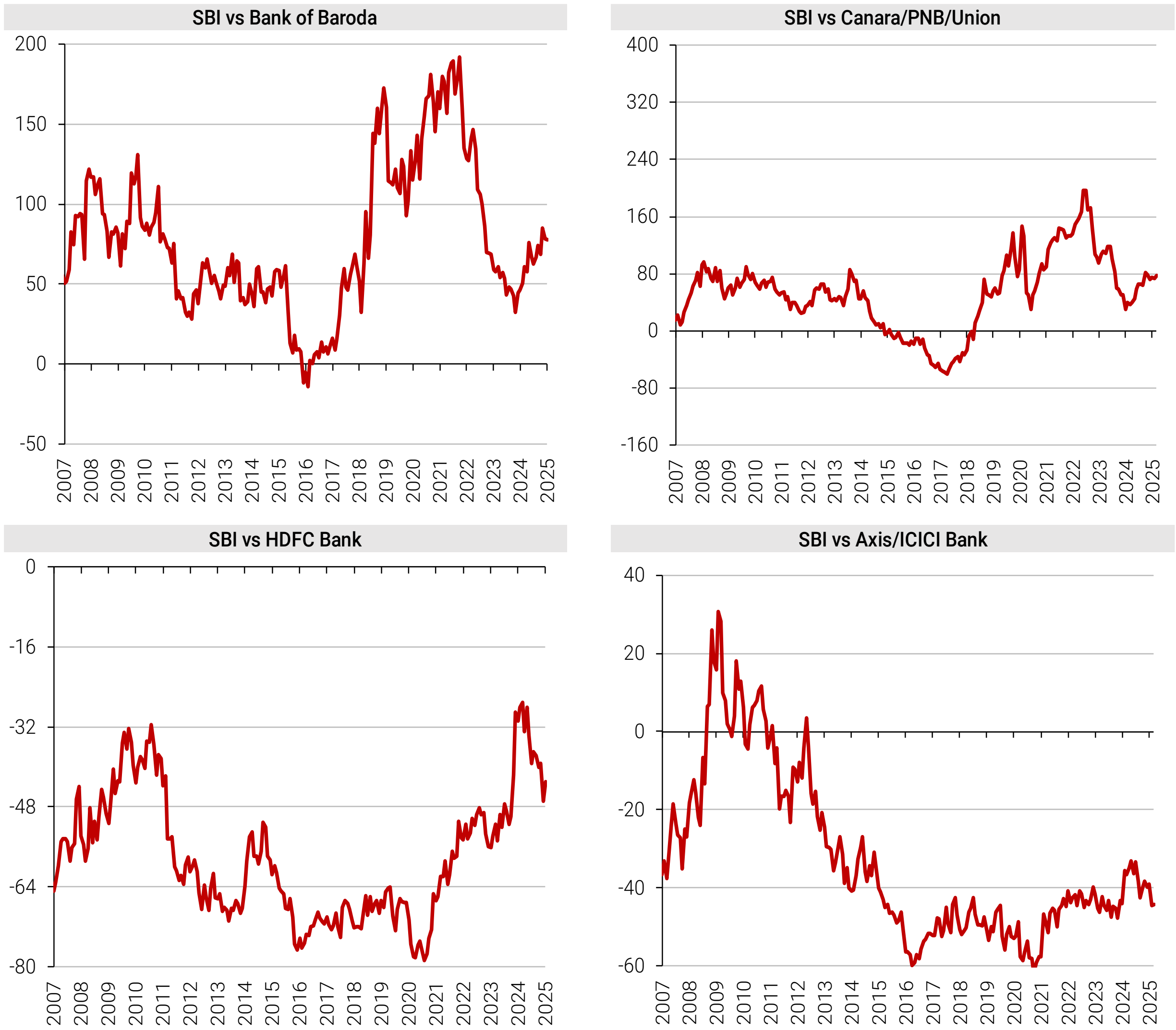


Source: Bloomberg, Companies, Kotak Institutional Equities

- **SBI is between large private banks on one side and PSU banks on the other side**. We would want to believe that SBI would trade below private banks and at a premium to all other PSU banks on a through-the-cycle basis. We don't see any specific risks to asset quality here. The bank has largely worked through the challenges faced by the sector on unsecured loans with negligible stress to report. This has given a fair degree of comfort that their portfolio of customers is distinct to other private bank lenders. We note that they tend to operate in a marginally higher age segment and mostly in the salaried segment. A large part of their portfolio is with customers with defined cash flow but there is some degree of uncertainty on the timing of these cash flows. For example, we have the bank allude to timing in salary payout by various institutions (specifically with employees in various state government departments) causing inflation in early delinquent buckets. However, these delinquent borrowers tend to cure quite quickly and the actual losses are significantly lower. The rest of the portfolio (corporate loans and secured housing loans) has low risk at this stage. The bank has shown a bit of weakness on NIM and the management has highlighted that it would look to keep NIM closer to these levels on a through-the-cycle basis. There is likelihood that the NIM would initially decline as the loan portfolio would re-price faster than liabilities. However, this would reverse course once the rate cuts reflect in liabilities with a lag. From a valuation perspective, we expect SBI to trade between the large private banks and other PSU banks. While the extent of discount is likely to vary over time depending on the situation on the ground and the performance of the bank in those specific situations, we believe that the current discount to Axis Bank (15-25%) is an adequate one. On the other hand, we expect SBI to trade at a premium of ~15% to the mid-tier public banks (BoB, Canara, PNB and Union).

Premium of SBI over peer PSU banks has declined sharply from peak level

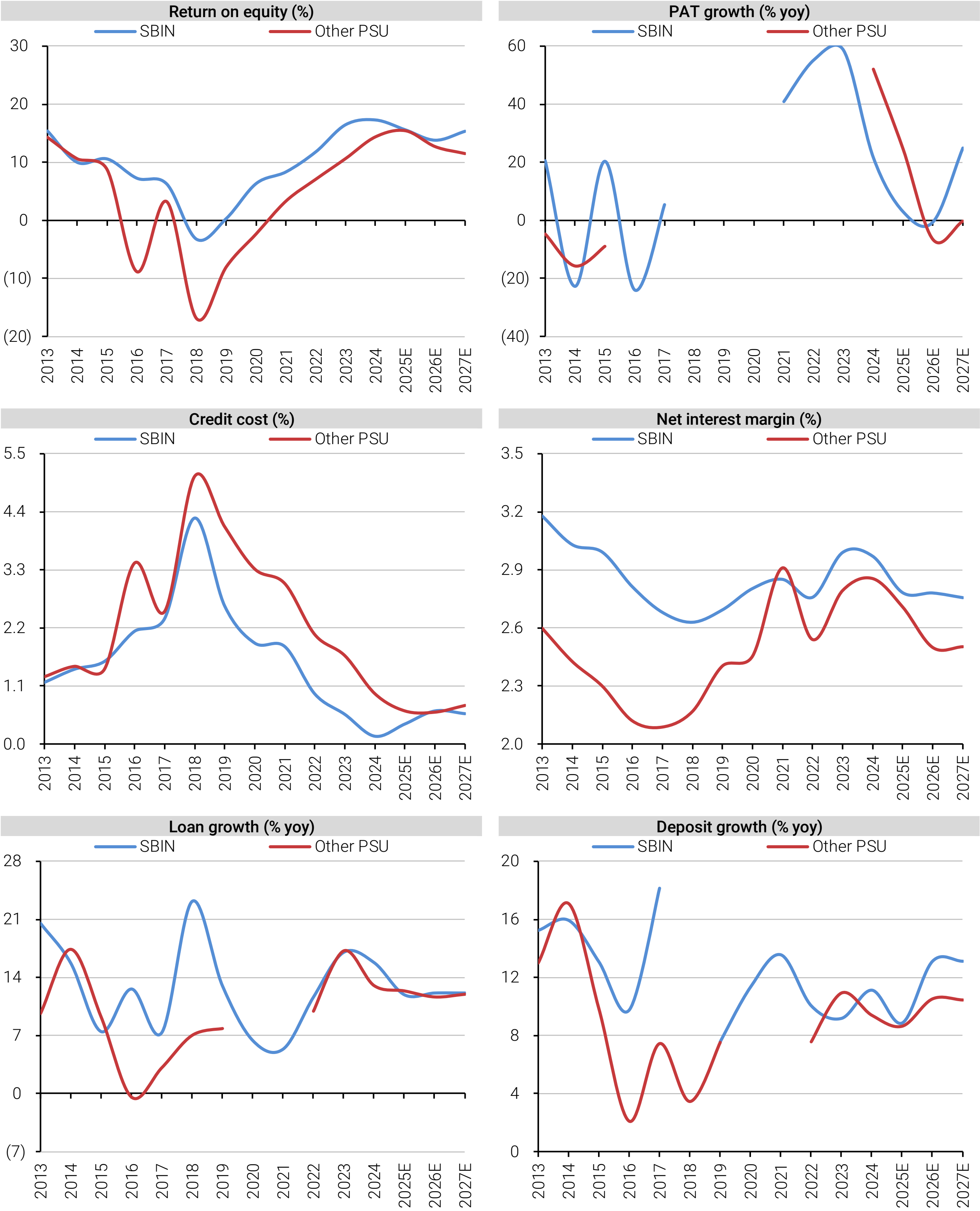
Exhibit 19: Comparison of valuation multiples (12-month forward price-to-book) for select bank combination pairs (%)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

SBI seems to be fairly well placed on earnings outlook over the medium term

Exhibit 20: Outlook for public sector banks, March fiscal year-ends (%)

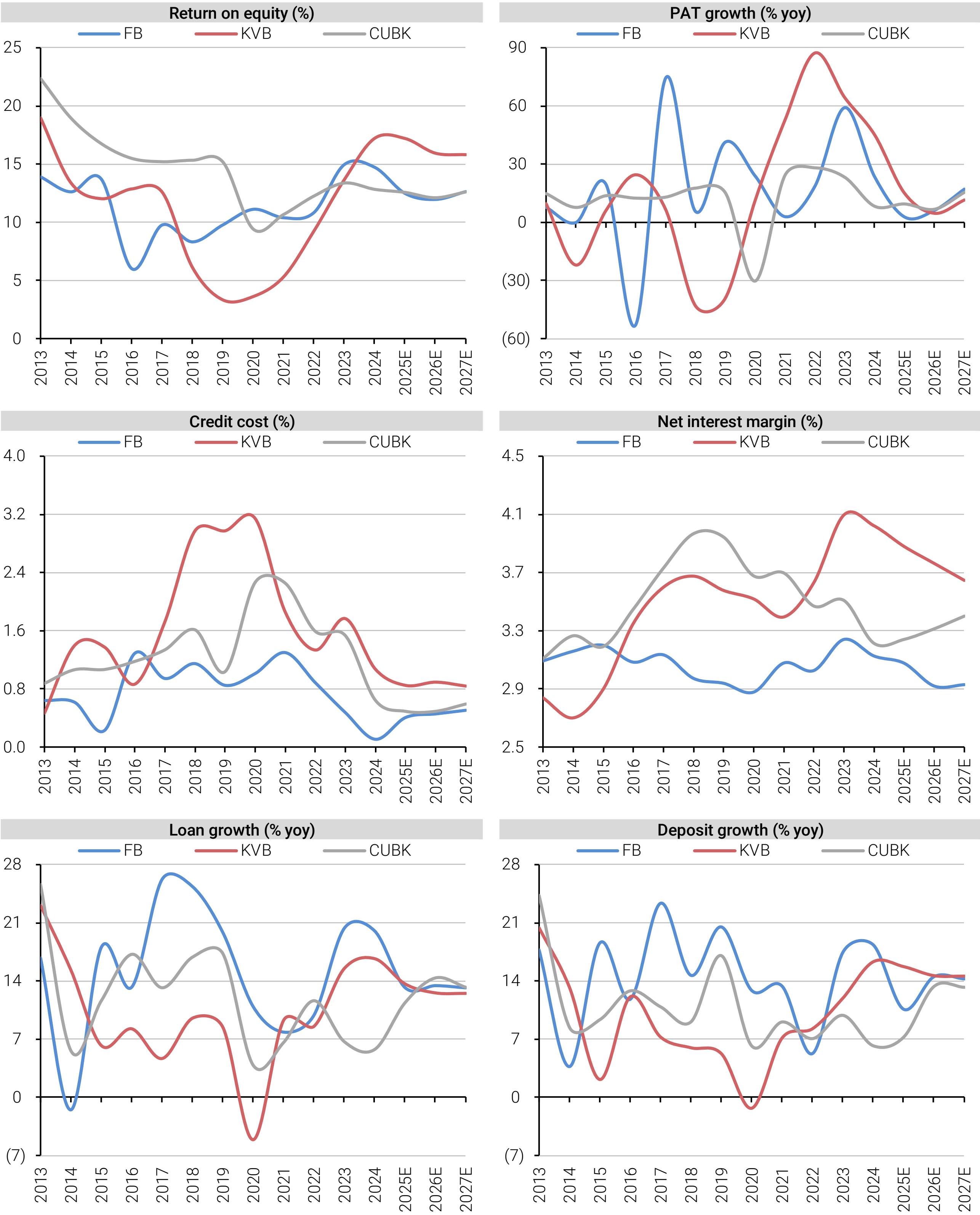


Source: Companies, Kotak Institutional Equities estimates

- **Regional banks**. We don't expect any meaningful outperformance in regional banks either within the regional banks that we cover and in relation to other banks (large banks or public banks).
  - Federal Bank is building an investment thesis that it would be able to improve its RoA/RoE profile by increasing its sustainable NIM from current level and improving the contribution of fee income while keeping its cost structure intact over the next three years. We don't disagree with this thesis but much of it lies in execution and extracting any improvement in NIM through liability side improvement when conditions are not too conducive will be a challenging exercise. Hence, it is unlikely that the investors would want to re-rate the bank till there is a tangible sight of improvement in place.
  - Karur Vysya Bank has executed well in recent years. The bank has delivered healthy return ratios through a combination of lower credit cost and keeping its NIM higher than most peers by consistently passing through the higher cost of deposits and offsetting any pressure of pass-through loan mix. However, much of this improvement is well discovered and scope for further earnings surprises appears to be negligible. Over the medium term, we would want to believe that the investments made by Federal Bank in building its franchise is better than KVB even if the near-term financials are superior for KVB. From that context, it would be fair to assume that both these banks trade at similar multiples.
  - City Union Bank could trade at a marginal discount or at par with these banks but a premium looks unlikely. The bank is undergoing a change with fresh leadership at the senior management level and attempts are being made to diversify their loan portfolio toward retail loans. However, much of this improvement needs to be delivered without altering the cost structure and we intend to wait a bit longer till we have some clarity on this performance. Even if this is delivered, the extent of outperformance is unlikely to be high and the best-case scenario is that it would trade at a similar valuation as Federal Bank and KVB in this cycle.

City Union Bank is unlikely to deliver better RoE, loan growth on earnings growth than Federal or KVB on a sustained basis

Exhibit 21: Outlook for regional private banks, March fiscal year-ends (%)

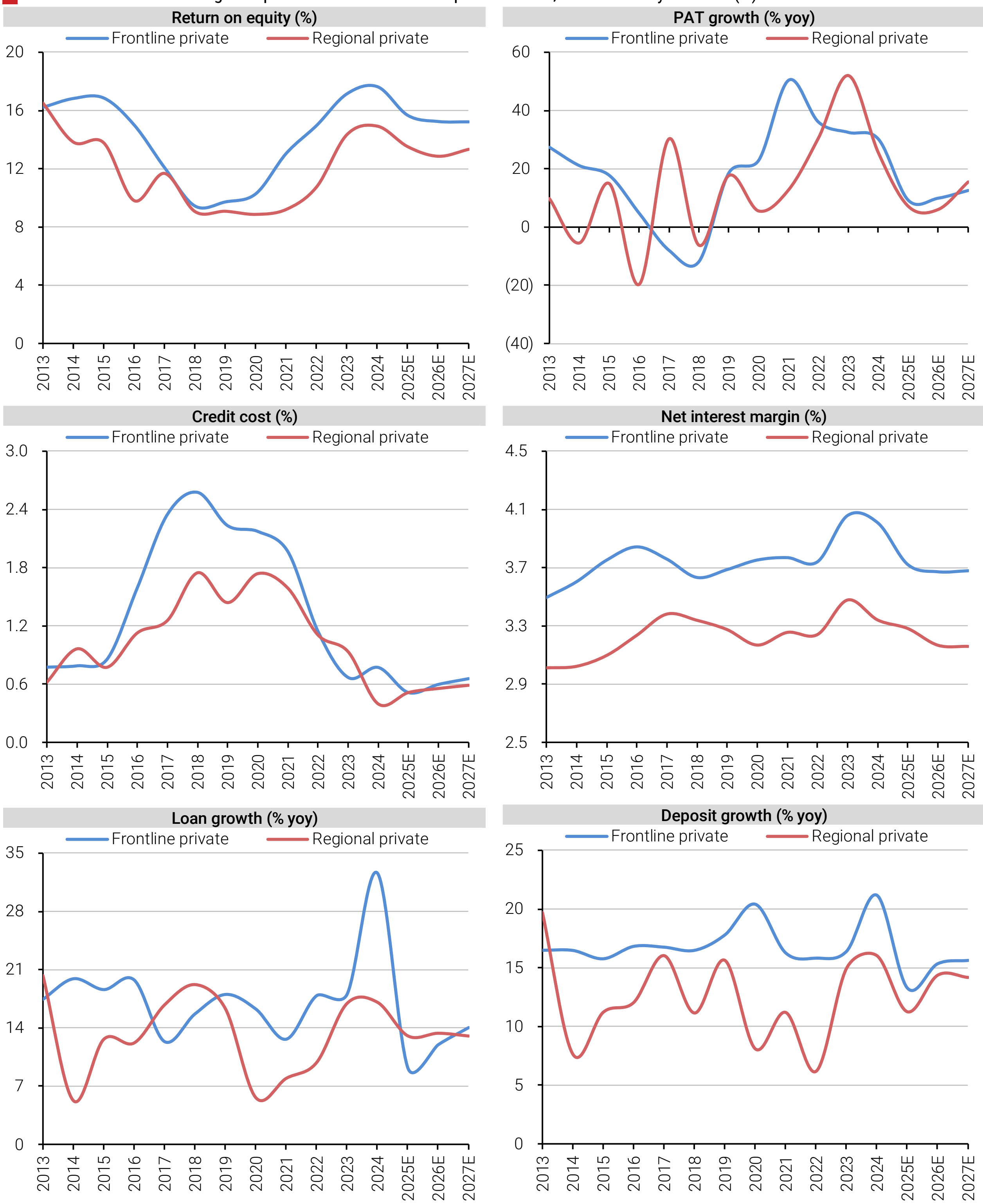


Source: Companies, Kotak Institutional Equities estimates

- We believe that regional banks would trade at a discount to Axis Bank as the latter is likely to deliver superior growth, profitability and asset quality performance on a through-the-cycle basis. Hence, we believe that the current valuation premium is justified. The scope for further divergence is higher if Axis Bank is able to deliver on growth and profitability metrics that we have discussed in the previous section.

We do not expect regional private banks to deliver RoE or loan growth meaningfully higher than frontline private banks over the medium term

Exhibit 22: Outlook for regional private banks vs frontline private banks, March fiscal year-ends (%)



Source: Companies, Kotak Institutional Equities estimates

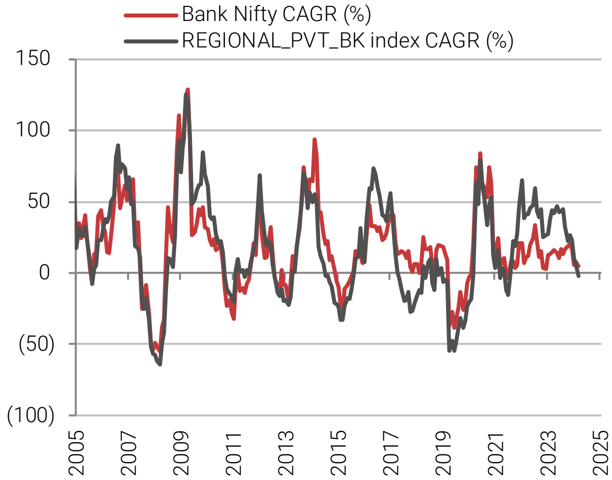
Regional private bank index has not outperformed the broad bank index over the past 12 months

Exhibit 23: Ratio of NIFTY bank index to "regional private bank index" (X, indexed to 1 as of January 2000)

Source: Bloomberg, Companies, Kotak Institutional Equities

Regional private bank index has not outperformed the broad bank index over the past 12 months

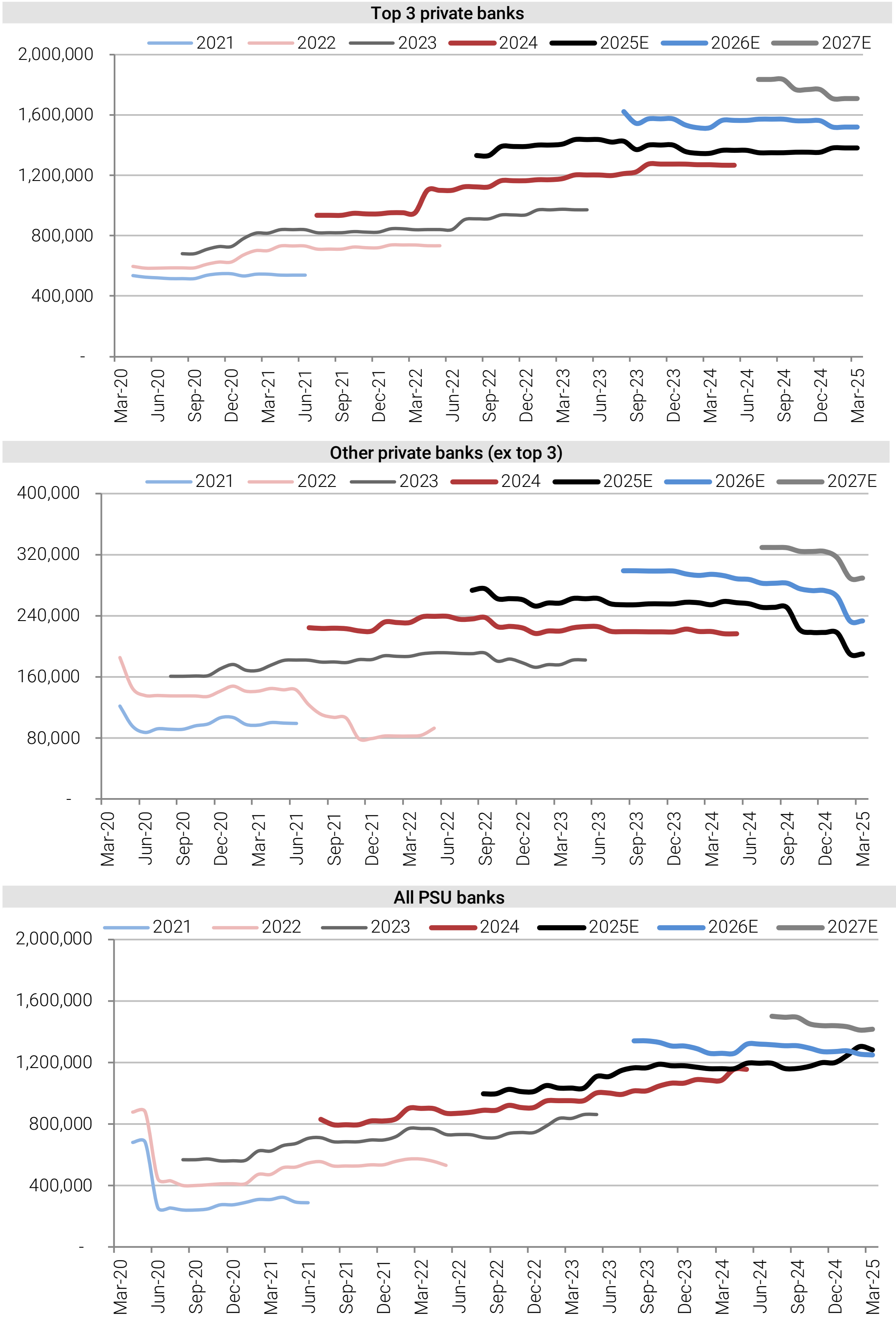
Exhibit 24: 1-year CAGR in stock price (%)



Source: Bloomberg, Companies, Kotak Institutional Equities

Earnings cut for PSU banks and large private banks has been much lower as compared to other private banks

Exhibit 25: Change in KIE estimates of earnings for private banks, March fiscal year-ends (Rs mn)



Notes:

(1) "Frontline private banks" includes HDFCB, ICICIBC and AXSB.

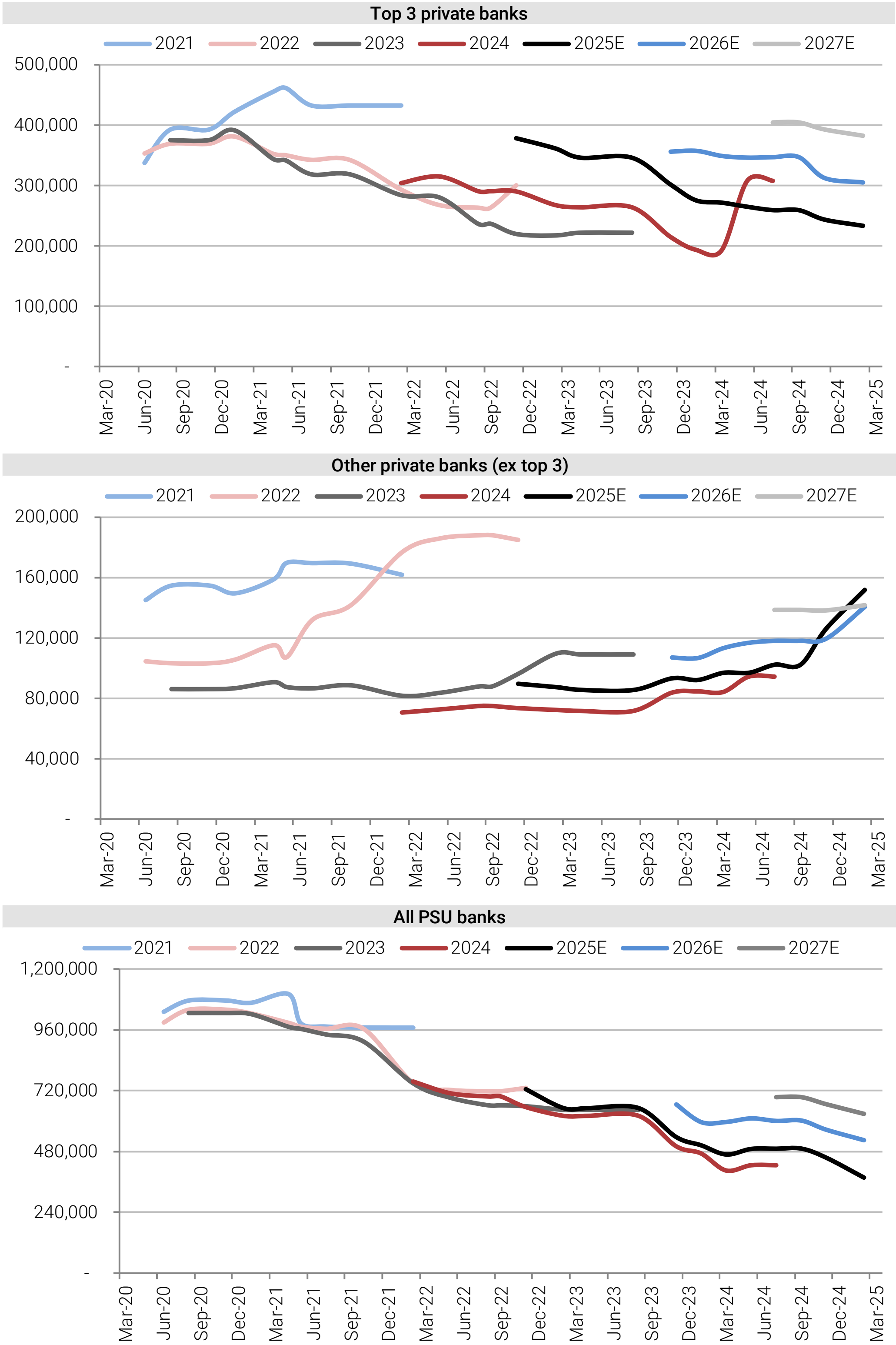
(2) "Other private banks" includes IIB, FB, Bandhan, KVB, CUBK, DCBB, AUBANK, EQUITASB and UJJIVANS.

(3) "All PSU banks" includes SBIN, BOB, CBK, PNB and UNBK.

Source: Companies, Kotak Institutional Equities estimates

Estimates for credit provision have been hiked for "Other private banks", while they have been cut for large private banks and PSU banks

Exhibit 26: Change in KIE estimates of credit provisions for private banks, March fiscal year-ends (Rs mn)



Notes:

(1) "Frontline private banks" includes HDFCB, ICICIBC and AXSB.

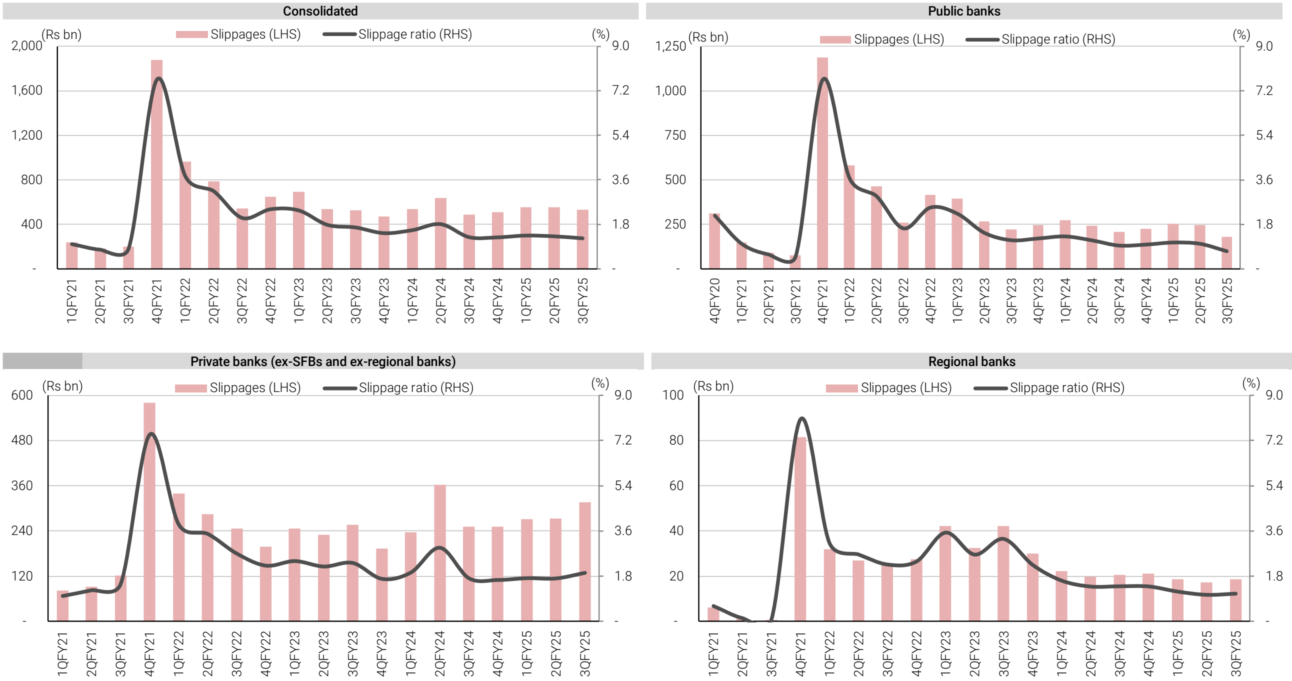
(2) "Other private banks" includes IIB, FB, Bandhan, KVB, CUBK, DCBB, AUBANK, EQUITASB and UJJIVANS.

(3) "All PSU banks" includes SBIN, BOB, CBK, PNB and UNBK.

Source: Companies, Kotak Institutional Equities estimates

Asset quality has held up much better for PSU banks, large private banks and regional banks

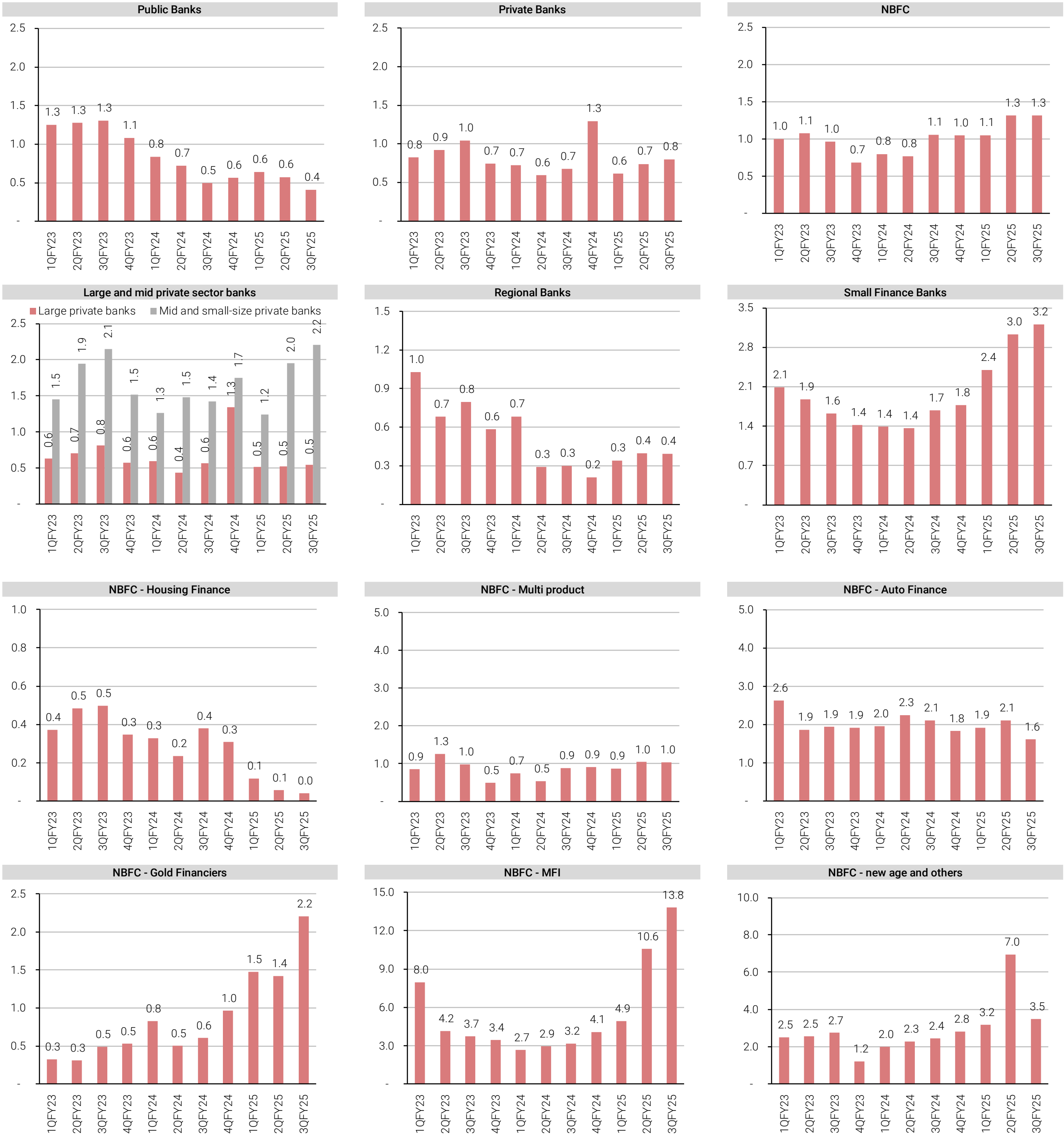
Exhibit 27: Slippages across different bank groups, March fiscal year-ends (%)



Source: Companies, Kotak Institutional Equities

Asset quality has held up much better for PSU banks, large private banks and regional banks

Exhibit 28: Credit cost across different lending groups, March fiscal year-ends (%)



Source: Companies, Kotak Institutional Equities

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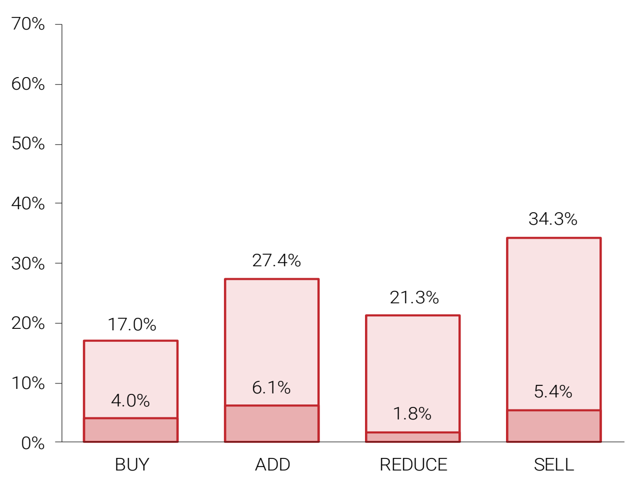

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Source: Kotak Institutional Equities

As of December 31, 2024

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