SME is the new Retail

Marked slowdown in retail growth for private banks as PSU banks advance

PVT SECTOR BANKS

RATING: HDFC BANK,
AXIS BANK: **BUY**
ICICI BANK: **SELL**
YES BANK: **NEUTRAL**

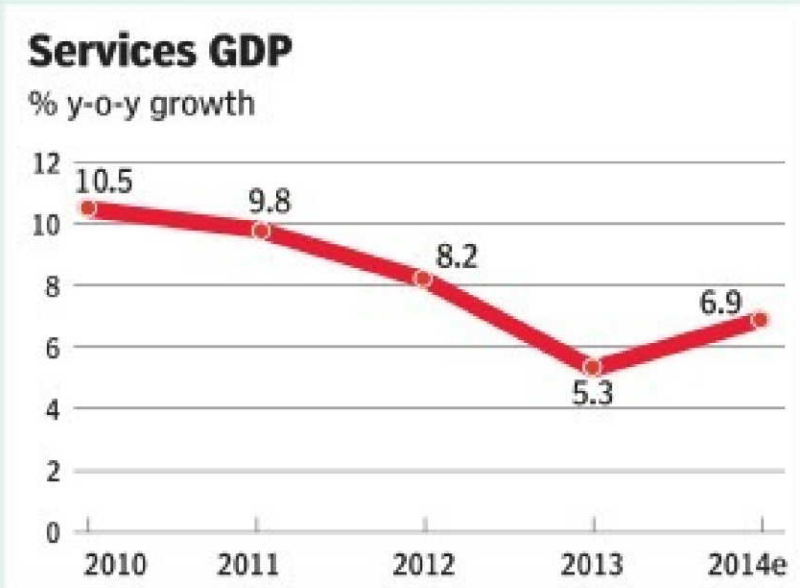
PRIVATE BANKS have rallied over the past one month anticipating a recovery. However, with strong competition eroding profitability in the retail segment and corporate recovery still some time away where will growth come from for private banks?

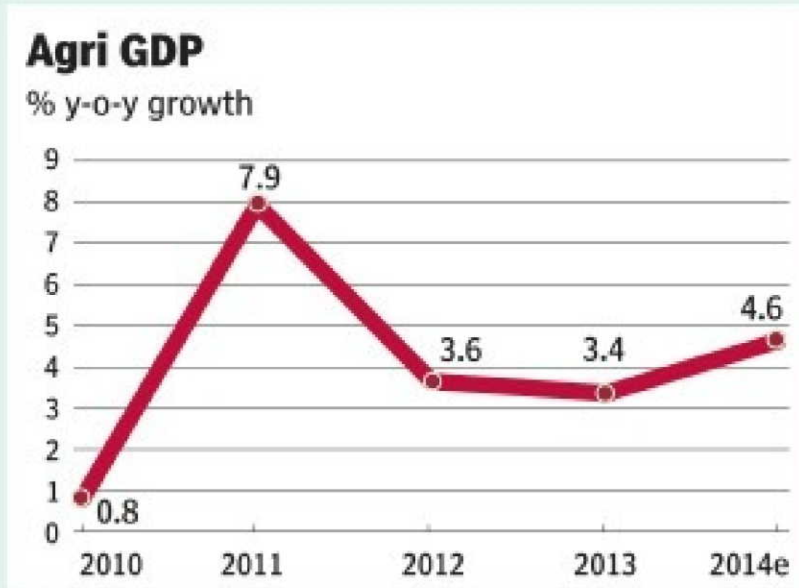
We think the micro, small and medium enterprises segment could plug this gap for private banks in the next leg of growth as they grab market share from PSU banks (76% of MSME market share vs 20% for private banks).

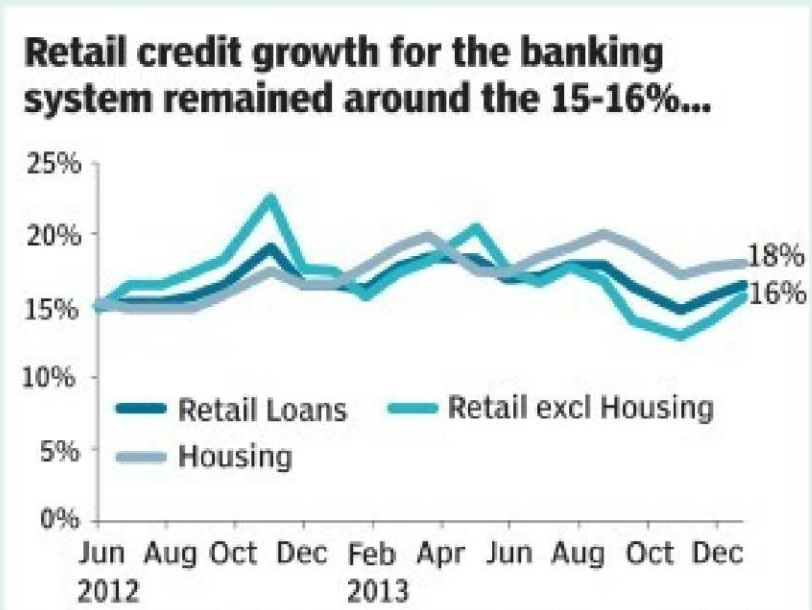
The MSME segment offers high growth potential and is performing well on the asset quality front despite the macro headwinds. It is already one of the most profitable divisions for the likes of HDFC Bank and Axis while ICICI seems to be struggling to get its strategy in place. We reiterate our Buy recommendation on HDFC Bank and Axis Bank but downgrade ICICI to Sell as post the recent rally we are not comfortable with its valuation. We upgrade Yes Bank to Neutral (from Sell) with a revised fair value of ₹360 as we believe most of the risks are priced at the current valuation.

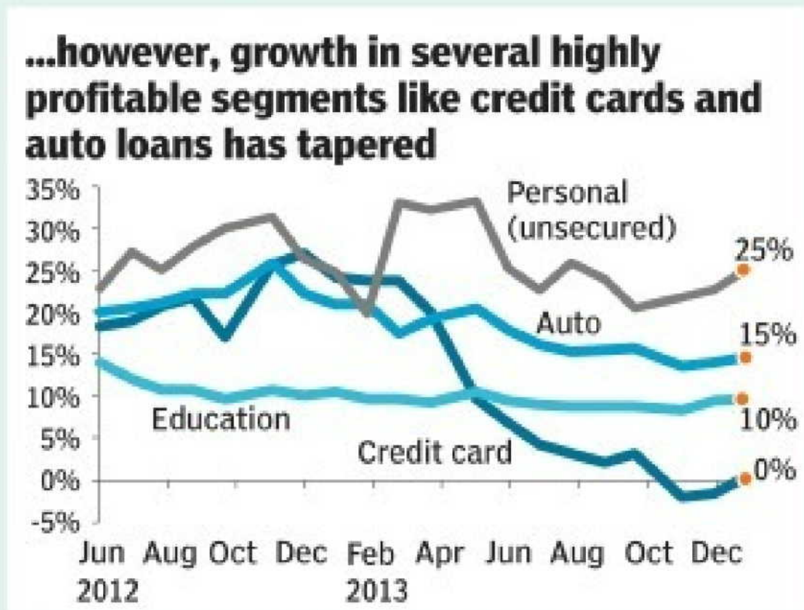
With retail slowing, MSME will drive the next leg of growth: Growth in retail credit, especially in the high profit segments like credit cards and auto loans, has tapered down. Also, increased competition in the home loans segment has forced private banks to guide for lower growth from retail, going forward. With previously lucrative segments slowing down, where's growth going to come from? We believe MSME or business banking will spur the next leg of growth for private banks as capital constraints weigh down PSU banks.

MSME segment remains highly underpenetrated: With nearly 45 million MSMEs, the segment accounts for nearly 15% of India's GDP. However, only 1.6m or under 5% of the total MSMEs are registered with various industry bodies or forums and a majority of them are unregistered. As per the Nachiket Mor committee report only 4% of these MSMEs have access to institutional sources of credit like banks and NFBCs with the remaining 96% relying on self-financing or non-institutional sources of credit. PSU banks control the majority of the market share (76%) while private banks have 20% market share; this presents a huge growth opportunity for private banks in an underpenetrated segment.







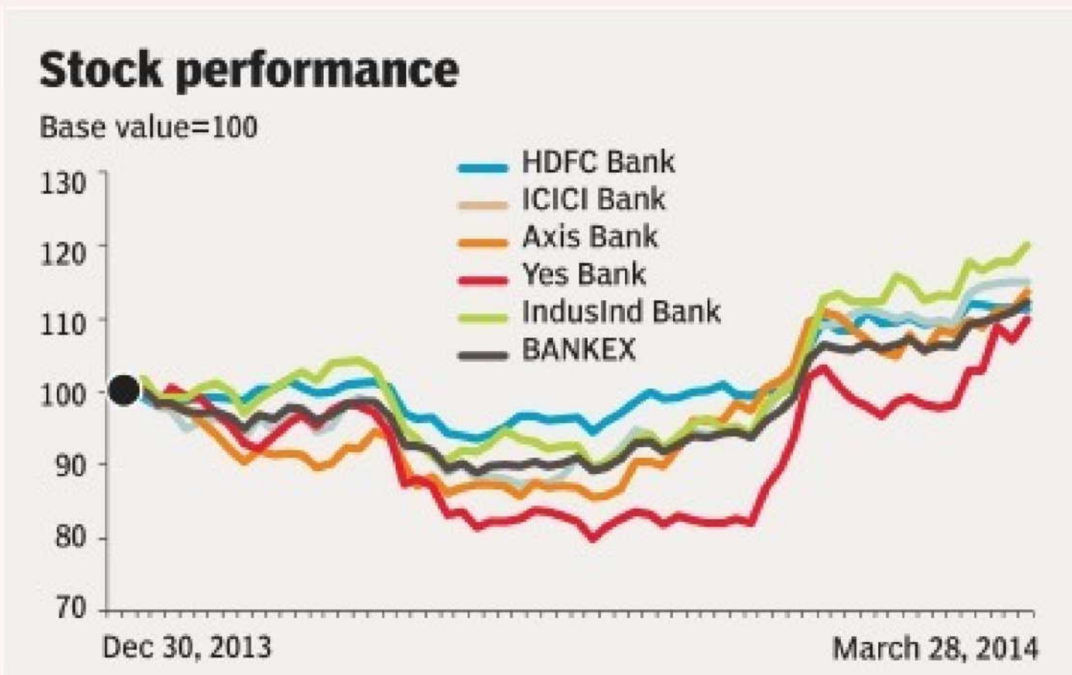


Source: Espirito Santo Investment Bank Research, RBI

MSMEs PRESENT A HUGE GROWTH OPPORTUNITY FOR PRIVATE BANKS IN AN UNDERPENETRATED SEGMENT

Huge growth and fee income opportunity for private banks: In addition to the growth opportunity, the MSME segment also offers strong fee income and cross-sell opportunity for private banks. For example, the strong retail FX fee income growth for a number of private banks, including HDFC Bank and IndusInd, is a result of these banks offering FX services to their MSME customers via the banks' branches.

Private banks have rallied in anticipation of a recovery: Over the past one month private banks like ICICI, HDFC and IIB have rallied 20% on average and are now trading close to their average historical multiples. However, Axis and Yes still continue to trade at 25% and 37% discount respectively to their historical average multiples.



How strong is the current economic recovery? While macro indicators point to economy bottoming out industry is yet to show signs of revival. While the overall GDP numbers are showing signs of revival this is primarily driven by a recovery in the services and agri GDP numbers. However, the industrial GDP numbers have continued to slump, with sell-side analysts not factoring in any recovery for industrial and manufacturing growth.

Base case GDP of 6% & 2.5x credit multiplier—credit growth of 14-16% for FY15e: We looked at the historical relationship between credit growth and GDP growth and observed that when the credit multiplier is around 2.6-2.7x (as in during 2006-2013 period) then the CD (credit-deposit) ratio is above 70%. Now given that we are at the higher end of CD ratio (76%) for the banking system we expect credit multiplier to remain around the 2.5-3.0x, implying a credit growth range of 14-16% for FY15e using our FY15e GDP growth estimate of 5.4%.

Growth in retail credit has slowed and competition is now more intense: Over the past two decades from 1994-2014 retail credit has been the mainstay for private banks, helping them grow at a faster rate than the system and increase their market share significantly. More importantly the higher growth came along with higher RoEs (returns on equity) with the introduction of highly profitable products such as credit cards, personal loans, consumer durables loans & auto loans in addition to the traditional home loan segment.

For the system as a whole the retail segment continues to grow at a brisk pace of 16% year-on-year driven by relatively higher growth from the housing loans segment. However, the higher RoE businesses have slowed down dramatically with the credit card segment showing no growth while the auto segment grew only at 15% y-o-y.

While retail growth has slowed down, the number of players vying for the retail pie has increased with PSU banks trying hard to grow their retail portfolios by offering highly competitive pricing in the secured segments of housing and auto loans. This is clearly visible from the marked slowdown in the retail growth for private banks while PSU banks experienced a sharp pickup in retail growth.

Another key trend which is visible is the higher growth in retail advances for Axis and ICICI during the last few quarters. When we dig deeper into the reasons for this higher growth for Axis, ICICI and PSU banks, the clear driver seems to be the higher growth from the housing loans segments.

While the home loans segment has helped the some of the private banks deliver higher retail growth, several large private mortgage players have hinted at a slowdown in the housing segment as well as increased competition from PSU banks as this segment is their mainstay.

To conclude:

(i) Growth in higher RoE retail segments has declined.

(ii) Banks driving retail growth through higher growth from housing loan segment.

(iii) HDFC Bank has acknowledged the increased competition in the retail segment.

(iv) Private banks like Axis, Kotak and HDFC Bank have hinted at lower growth from retail.

So with previously lucrative segments slowing down, where's growth going to come from? The answer we believe is newer product segments. As growth in retail credit slows private banks will foray into hitherto PSU strongholds to drive growth and PSU banks constrained by capital requirements could falter.

—**Espirito Santo Securities**