AMBIT INSIGHTS

30 November 2017

DAILY

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Analyst Notes: Small-caps: Addressing investor pushback on BEPL

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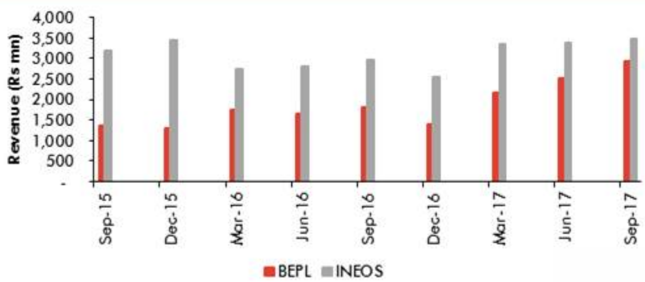
Several investors asked us yesterday why we prefer BEPL over INEOS especially as BEPL trades at ~60% premium to INEOS. We believe the following chart explains our perspective. Since the Sept'15 quarter, BEPL has been rapidly gaining market share, with revenue more than doubling from Rs1,370mn in the Sept'15 quarter to Rs2,929mn in the Sept'17 quarter. In contrast, INEOS' revenue from its specialty business has only marginally increased from Rs3,191mn in the Sept'15 quarter to Rs3,478mn (ex-GST) in the Sept'17 quarter. About 43% capital employed in the polystyrene business (more commodity-like, appears to be languishing), frequent management changes and manufacturing facilities that are not backward-integrated (INEOS imports butadiene) are other reasons why we prefer BEPL over INEOS (click here for our note on BEPL).

BEPL witnessed strong revenue growth in the recent quarters while INEOS' growth has moderated



Source: Company, Ambit Capital research. Note: This is gross revenue (i.e. including excise duty/GST). For INEOS, 2QFY18 revenue does not include GST.

Source: Ambit Capital research

Please refer to our website for complete coverage universe

http://research.ambitcapital.com

AMBIT
Acumen at work

ITC
BUY

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It is smoking hot

ITC has the resilience to overcome regulatory/taxation uncertainties. In fact during disruptions like periods of higher tax hikes, ITC's margin gains and dominance only increased. Globally, through pricing power, consolidation and innovation, tobacco has often offset volume hits from regulatory/taxation changes to grow its profit pool. As ITC's capital intensity moderates over FY17-20 (capex/sales to flatten at 5%), FCF CAGR (23%) should outpace EPS CAGR (15%). ITC's 45% discount to the FMCG sector (10-year average discount, 15%) and reduced premium of 44% to global tobacco (10-year average premium, 74%) are a result of over-pessimism and, hence, unjustified. Risks: Spurt in capex and higher-than-expected tax hikes and regulatory restrictions.

Competitive position: STRONG   Changes to this position: STABLE

Regulatory concerns are overdone

We understand investor concerns over unpredictability of tax changes for cigarettes post cess hike. But we believe pessimism is overdone given: 1) higher tax hikes have historically boosted margin gains; 2) frequent but smaller tax hikes could actually reduce price elasticity and volume impact; 3) being a dominant player, ITC is stronger than peers after tax/regulatory tightening; and 4) global comparison shows cigarettes in India are already highly regulated, hence impact of further tightening is likely to be low.

Tobacco and ITC are resilient; BUY into the weakness

Regulatory risks for tobacco have been high globally for over two decades. But there are examples of resilience: 1) high taxation on non-filter cigarettes in India in FY09 impacted 20% industry volumes but industry still managed to grow profits; 2) in the US, tobacco players navigated a spate of litigations through Master Settlement Agreement and have grown profits 2.5x since 2000, leading to re-rating from 5x to 20x one-year forward P/E; and 3) the profit pool in Australia has grown since plain packaging was introduced in 2012.

Improving cash generation being under appreciated by investors

ITC's capital intensity across its businesses is declining (capex/sales down from 9% to 5%; FY12-17); hence, FCF CAGR (14%) outpaced EPS CAGR (11%) in the past five years. Shift in focus of capex to F&B is positive as: 1) we prefer F&B within FMCG given low penetration and shift from unorganised to organised; 2) ITC's sourcing and R&D synergies with agri-commodities and hotels business.

Discount to FMCG and global tobacco unjustified

As ITC delivers 23%/15% FCF/EPS CAGR over FY17-20 and investor confidence is restored, we see a re-rating hereon. Also, lower valuation premium to global tobacco and improving cash generation could attract global investors. Our DCF-based TP of Rs351 (Rs320 earlier) implies 35% upside and 30x FY19E P/E, a 25% discount to FMCG. Near-term concerns around unexpected tax hike risks will keep the discount to FMCG higher than the historical average.

Key financials

Year to March	FY16	FY17	FY18E	FY19E	FY20E
Operating income (Rs mn)	365,827	400,887	450,296	519,727	598,003
EBITDA (Rs mn)	137,146	145,780	166,303	194,820	229,434
EBITDA Margin (%)	37.5%	36.4%	36.9%	37.5%	38.4%
Adjusted PAT (Rs mn)	203,831	219,665	290,820	338,195	393,363
Adjusted EPS (Rs)	7.8	8.6	9.7	11.4	13.2
RoE (%)	28.1%	28.0%	29.5%	31.3%	32.8%
P/E (x)	32.9	29.8	26.4	22.6	19.5

Source: Company, Ambit Capital research

Consumer Staples

Recommendation

Mcap (bn):	₹3,160/US$48.6
6M ADV (mn):	₹3,895/US$59.9
CMP:	₹257
TP (12 mths):	₹351
Upside (%):	35

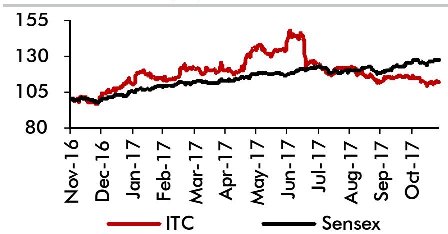
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	RED

Catalysts

- Revival of cigarette volumes and EBIT growth from 2HFY18
- Improvement in FCF generation as moderation in capex continues

Performance (%)



Source: Bloomberg, Ambit Capital research

Our SOTP valuation for ITC

Business	Value/ share (₹)
Cigarettes	259
Non-cigarettes FMCG	64
Hotels + Agribusiness + Paper & Packaging	16
Cash & others	12

Source: Ambit Capital research

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Agri Inputs

The party is about to begin

The on-ground situation is improving for domestic agrochemical distributors. Lower inventory placement pre-GST and a strong Kharif season have helped clear channel inventories. Regulatory changes inhibiting Chinese imports alongside capacity outages and increased costs in China have eased competitive pressure in generics (70% of the market). Consolidation is rising post GST and curbs on black money in the system. Lower Chinese imports have also improved volume utilisation of domestic manufacturers. Improving market prices (up ~20% in the last 3 months) and utilisation boosted realization/margins of domestic manufacturers, the effects of which should be visible from 3QFY18. These factors benefit domestic manufacturers like Rallis India (SELL), Insecticides India (Not Rated), Excel Cropcare (Not Rated), and Bharat Rasayan (Not Rated). Reduced competitive intensity, improving generic prices (reduced pricing gap vs specialty molecules), reduced inventory and strong Rabi outlook would benefit for PI (BUY) and Dhanuka.

POSITIVE

Quick Insight

Analysis	✓
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Key takeaways from our meeting with an expert

We met a senior agri expert with over 25 years of experience within agrochemical industry. He now runs his own agrochemical company which is ~Rs2bn in revenues and has a distribution spanning 7 key states.

- **Channel inventories cleared, water levels good, party to begin soon**: Thanks to GST and weaker liquidity situation, channel placement this year was muted during the Kharif season. Relatively healthy Kharif season helped in liquidating earlier inventories. During rising agrochemical prices over the last few want, companies too wanted to clear the inventories (and hence pump less) so that they don't end up having multiple pricing for old and new inventories. Cleared inventories should drive good volume growth in the upcoming Rabi season. Water levels in South India is good thanks to the strong late monsoon. South India contributes most Rabi sales.
- **Agrochemical product pricing up 20% over the last 3 months:** API prices are up across most generics. Many Chinese players had to undertake permanent capacity shutdowns due to pollution issues, which reduced pricing competition for Indian players and substantially decreased effectiveness of small players (primarily traders selling products by giving big margins to dealers) who rely on Chinese imports. Pricing growth will not translate into volume decline as farmers can't downtrade beyond generics given protecting the crop from pest infestation is basic and pesticide consumption forms not more than 7-8% of overall farming cost.
- **The Government has restricted Chinese imports**: The Government has banned players from holding manufacturing and import (primarily from China) licences simultaneously. Many players used to import final API on the name of intermediates. They then sell the product in the local markets at predatory pricing to legitimiate domestic manufacturers. This led to an implicit ban on imports from China. This alongside curtailed manufacturing capacities in China have led to better volumes as well as better pricing for Indian manufacturing players. This would turn the fortunes of some Indian agrochemical players who suffered due to cheaper Chinese generics imports over the last few years. Rallis, Insecticides India, Excel Cropcare are the key beneficiaries who have good generics manufacturing facilities which are not fully utilized (benefits for both volumes as well as operating leverage).
- There are no volume restrictions on legitimate imports (by in-licensors or innovators) or cap on generics pricing as feared earlier.

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- **Higher generics pricing means pricing differential between branded and generics guys has reduced**: This is positive for the branded business of Dhanuka, PI Industries and Rallis. Even the shift from exclusive in-licensing to multiple-player licensing by Japanese innovators is unlikely to have too much impact given the limited distribution reach and marketing ability of a single player.
- **Consolidation:** The expert noted that GST as well as reduced competitiveness of Chinese imports will drive consolidation of Indian agrochemical players (top 50 growing faster than tail of 500 small formulators). There is increased scrutiny of spurious products in various states (see various incidents in Maharashtra, Orissa, Kashmir, and Andhra Pradesh) which should also expand the shift from unorganized to organized.
- **Some happy news on PI:** The expert noted (this is as per his information, we haven't yet verified it) that PI has bagged manufacturing for Dupont's (now divested to FMC) US$1bn molecule Rynapyxyr (Rs10bn sales in India), which is a key positive. Oxathiapiprolyon is the another early-stage molecule (a discovery of Dupont and co-marketed by Syngenta as well as Dupont) that PI is working on. Nominee Gold hasn't been much impacted by the generics onslaught thanks to strong brand enjoyed by the product. PI continues to do well on Nominee Gold and may see some growth as indigenous manufacturing starts.
- Businesses like **Sharda Cropchem** which substantially source from China are under threat as Chinese manufacturing globally may see margin pressure. **Insecticides India** may face some pressure from phasing out of key brands (which are red triangle products) like Thimet and Monocil as per Government directives. **Rallis** is likely to see a strong 2HFY18-FY19 on the back of rising prices of most of its technicals (better export realizations) and reduced competitive intensity (better volume growth). Fully integrated manufacturing will be a key competitive advantage for the next few years at least.
- **Indian players are catching up with MNC players on farmer engagement:** Tier 2 Indian players (Crystal, Insecticides India, Dhanuka) have started to focus on the pull model (solutions-based selling, directly building connect with farmers through field demonstrations, training, call centers, etc.) rather than the push model (better dealer margins, higher debtor days). This is incrementally getting difficult to survive profitably on push models. Farmers are gradually becoming smarter (higher adoption) in terms of use of advanced agrochemicals.
- **Receivables situation still a weak point:** The Government procurement money on agri commodities under MSP is now being directly transferred to farmers and has delayed receivables at the dealers. The liquidity situation hasn't changed much post demonetisation.
- **PI plays it smart on Nominee Gold**
  - Demand for Nominee Gold (Bispyribac Sodium) is mainly during June-July. Since there was tough competition for this generic in the market due to its huge success, PI played early riser and started rolling this product to dealers in February itself way before others.
  - This was done with a slight decrease in prices (5-10%). It was a win-win deal for both dealers and PI. Dealers earned margins as they were able to sell it at past premium prices (due to strong brand recall) after some marketing efforts.
  - This proved beneficial to PI as it doubled volumes though with reduced prices (overall profitable) and got strong marketing (efforts from dealers to push inventory). This generic was pushed by other players as well, which led to increase in overall market for this generic.
- **Farmers are adopting new technologies** and are ready to pay more for better yield. This is evident from one new herbicide launch by Bayer for maize, Atrazine. Despite alternatives being available at lower prices, Bayer surpassed its budgeted figures. This was due to adoption of newer technologies by Indian farmers and marketing push by Indian companies.

Where do we go from here

Domestic agrochemical players witnessed muted sales/EBITDA growth of 5-6% over FY14-17 as weak monsoons led to inventory pile-ups even as competition rose due to increased imports from China. Domestic manufacturers bore the impact of lower volume utilisation. This coupled with the threat of regulations hit the share price performance of most agrochemical players. We believe the worst is over as:

- Rabi should be very strong – reservoirs levels are healthy, soil is moist from fresh rains in October, water levels have got somewhat replenished. Rabi acreages are already meaningfully up ~25% YoY (see Exhibit 1).
- Both the feared regulations – import restrictions and generics pricing regulation aren't likely to come.
  - Our checks suggest that the Commerce Ministry has already indicated to the Agriculture Ministry to not pursue import restriction as quantitative restrictions are not allowed under WTO.
  - Generics pricing idea came in as import restrictions would have caused artificial price inflation.
  - Unlike pharma, generics MRPs are very similar to branded ones. Generics thrive by offering high discounts to dealers who in turn decide what discount they want to give the farmer. Secondly, there is no dealer association (unlike in pharma) to give pricing data to the Government. Generic pricing doesn't make sense in a fairly unorganized market like agrochemicals.
- The past few difficult years have gradually reduced the competitive intensity in the sector. Problems within China have also reduced the pricing arbitrage offered by cheaper Chinese imports.
- Increase in MSPs (refer Exhibit 2) and increased rural sops by NDA in the run-up to the elections can further benefit the operations of these companies. The golden era of Indian agrochemicals was FY08-FY14 (refer Exhibit 3) when the UPA-led government was throwing cash at the rural economy.
- Sugarcane is likely to substantially gain this year as water levels are very good. Dhanuka has a product called Sempra, which is a very good herbicide for sugarcane. Dhanuka had put in lot of effort in marketing it but unfortunately sugarcane investments were very weak.
- Rallis too is likely to benefit from improvement in agrochemical prices (benefits exports) and reduced competitive intensity in generics (benefits branded business).

Exhibit 1: Rabi acreages (area in lakh hectares)

Crops	Normal Rabi Area for the week	FY18 Area Sown	FY17 Area Sown	% Inc/Dec over Normal	% Inc/Dec over FY17
Wheat	**5.13**	**8.43**	**3.88**	64.18%	117.31%
Rice	**0.02**	**6.64**	**4.18**	36761.11%	58.81%
Pulses	**24.05**	**42.01**	**28.58**	**74.68%**	**46.99%**
Gram	15.45	30.58	20.75	97.93%	47.37%
Lentil	2.46	4.94	2.13	100.81%	131.92%
Fieldpea	2.62	3.15	2.59	20.23%	21.62%
Kulthi	1.24	1.23	1.06	-0.81%	16.04%
Urdbean	0.81	0.77	0.72	-4.94%	6.94%
Moonzbean	0.25	0.14	0.18	-44.00%	-22.22%
LathYrus	0.47	0.32	0.53	-31.91%	-39.62%
Other Pulses	0.75	0.88	0.62	17.33%	41.94%
Coarse cereals	**20.91**	**16.79**	**15.14**	**-19.66%**	**10.94%**
Jowar	19.20	14.33	13.59	-25.36%	5.44%
Bajra	0.02	0.09	0.02	285.59%	468.75%
Ragi	0.16	0.38	0.05	147.42%	700.00%
Maize	1.42	1.50	1.14	5.82%	31.57%
Barley	0.11	0.49	0.34	346.33%	42.52%
Oilseeds	**25.71**	**29.44**	**29.58**	**14.58%**	**-0.39%**
Rapeseed & Mustard	21.82	26.57	26.81	21.77%	-0.89%
Groundnut	1.43	1.24	1.47	-12.85%	-15.24%
Safflower	0.41	0.23	0.15	-45.12%	56.50%
Sunflower	1.49	0.66	0.75	-55.71%	-11.69%
Sesamum	0.07	0.05	0.05	-22.41%	4.03%
Linseed	0.42	0.62	0.31	49.54%	102.90%
Other Oilseeds	0.07	0.07	0.04	12.28%	96.42%
Total Crops	**75.82**	**103.31**	**81.36**	**36.30%**	**27.02%**

Source: Central Water Commission, Ambit Capital research

Exhibit 2: MSP trend analysis – MSP growth stangnated post FY14; in the run up to elections, we expect MSP growth to accelerate

Commodity	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	CAGR-10 years
PADDY (Common)	580	850	850	950	1,000	1,080	1,250	1,310	1,360	1,410	1,470	10%
PADDY (Grade A)	610	880	880	980	1,030	1,110	1,280	1,345	1,400	1,450	1,510	9%
JOWAR (Hybrid)	540	600	840	840	880	980	1,500	1,500	1,530	1,570	1,625	12%
JOWAR (Maldandi)	555	620	860	860	900	1,000	1,520	1,520	1,550	1,590	1,650	12%
BAJRA	540	600	840	840	880	980	1,175	1,250	1,250	1,275	1,330	9%
MAIZE	540	620	840	840	880	980	1,175	1,310	1,310	1,325	1,365	10%
RAGI	540	600	915	915	965	1,050	1,500	1,500	1,550	1,650	1,725	12%
ARHAR (Tur)	1,410	1,550	2,000	2,300	3,000	3,200	3,850	4,300	4,350	4,625	5,050	14%
MOONG	1,520	1,700	2,520	2,760	3,170	3,500	4,400	4,500	4,600	4,850	5,225	13%
URAD	1,520	1,700	2,520	2,520	2,900	3,300	4,300	4,300	4,350	4,625	5,000	13%
COTTON (Medium Staple)	1,770	1,800	2,500	2,500	2,500	2,800	3,600	3,700	3,750	3,800	3,860	8%
COTTON (Long Staple)	1,990	2,030	3,000	3,000	3,000	3,300	3,900	4,000	4,050	4,100	4,160	8%
GROUNDNUT IN SHELL	1,520	1,550	2,100	2,100	2,300	2,700	3,700	4,000	4,000	4,030	4,220	11%
SUNFLOWER SEED	1,500	1,510	2,215	2,215	2,350	2,800	3,700	3,700	3,750	3,800	3,950	10%
SOYABEEN (Black)	900	910	1,350	1,350	1,400	1,650	2,200	2,500	2,500	-	-	NA
SOYABEEN (Yellow)	1,020	1,050	1,390	1,390	1,440	1,690	2,240	2,560	2,560	2,600	2,775	11%
SESAMUM	1,560	1,580	2,750	2,850	2,900	3,400	4,200	4,500	4,600	4,700	5,000	12%
NIGERSEED	1,220	1,240	2,405	2,405	2,450	2,900	3,500	3,500	3,600	3,650	3,825	12%
Rabi Crops												
WHEAT	750	1,000	1,080	1,100	1120&	1,285	1,350	1,400	1,450	1,525	1,625	8%
BARLEY	565	650	680	750	780	980	980	1,100	1,150	1,225	1,325	9%
GRAM	1,445	1,600	1,730	1,760	2,100	2,800	3,000	3,100	3,175	3,500	4,000	11%
MASUR (LENTIL)	1,545	1,700	1,870	1,870	2,250	2,800	2,900	2,950	3,075	3,400	3,950	10%
RAPESEED/MUSTARD	1,715	1,800	1,830	1,830	1,850	2,500	3,000	3,050	3,100	3,350	3,700	8%
SAFFLOWER	1,565	1,650	1,650	1,680	1,800	2,500	2,800	3,000	3,050	3,300	3,700	9%
TORIA	1,680	1,735	1,735	1,735	1,780	2,425	2,970	3,020	3,020	3,290	3,560	8%
Other Crops												
COPRA (Milling)	3,590	3,620	3,660	4,450	4,450	4,525	5,100	5,250	5,250	5,550	5,950	6%
COPRA (Ball) (Calendar Year)	3,840	3,870	3,910	4,700	4,700	4,775	5,350	5,500	5,500	5,830	6,240	5%
DE-HUSKED COCONUT (Calender Year)	-	-	988	1,200	1,200	1,200	1,400	1,425	1,425	1,500	1,600	6%
JUTE	1,000	1,055	1,250	1,375	1,575	1,675	2,200	2,300	2,400	2,700	3,200	13%
SUGARCANES	80	81	81	130	139	145	170	210	220	230	230	12%

Source: Ministry of Agriculture, Ambit Capital research

Exhibit 3: Revenue growth rates stagnated for most of the domestic players during FY14-FY17 (data in Rs mn)

Name of the Company	FY08	FY09	FY10	FY11	FY12	FY13	FY14	CAGR FY08-14	FY15	FY16	FY17	CAGR FY14-17
Bayer Crop	11,710	13,694	15,994	19,455	20,747	24,166	27,260	15.1%	30,669	31,760	25,031	-2.8%
UPL	6,517	9,213	10,998	13,277	14,949	17,363	21,420	21.9%	25,193	24,154	31,140	13.3%
PI Industries	3,703	4,056	4,147	5,800	6,133	6,869	8,860	15.6%	10,681	11,671	9,448	2.2%
Rallis	6,156	5,578	7,059	8,307	8,577	10,203	12,332	12.3%	12,986	12,115	13,125	2.1%
Insecticides	1,974	2,634	3,774	4,501	5,218	6,167	8,641	27.9%	9,642	9,881	11,074	8.6%
Dhanuka	2,007	2,486	3,368	4,081	4,910	5,292	5,823	19.4%	7,384	7,851	8,288	12.5%
Total Domestic	**32,068**	**37,661**	**45,340**	**55,421**	**60,534**	**70,059**	**84,335**	**17.5%**	**96,555**	**97,433**	**98,106**	**5.2%**

Source: Company, Ambit Capital research

Exhibit 4: Relative valuations

Company	Mcap (US$ mn)	ADTV 6M (US$ mn)	EV/EBITDA (x)			P/E (x)			P/B (x)			ROE			CAGR - (FY17-19)		
			FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	Sales	EBITDA	PAT
UPL Ltd	5,952	17.0	13	12	10	22	19	15	5	4	3	24	25	25	13	18	21
Sharda Cropchem Ltd	650	0.3	14	12	10	22	20	17	4	4	3	22	20	20	15	15	13
PI Industries Ltd	1,956	3.2	19	22	19	28	30	26	8	7	6	31	24	23	11	7	4
Rallis India Ltd	779	1.3	18	15	13	16	25	20	4	4	3	18	16	17	13	15	(11)
Dhanuka Agritech Ltd	525	0.3	23	17	15	27	25	22	6	5	5	24	23	23	13	13	11
Excel Crop Care Ltd	349	0.1	19	NA	NA	29	NA	NA	5	NA	NA	17	NA	NA	NA	NA	NA
Insecticides India Ltd	264	0.9	11	13	11	29	20	17	4	3	3	13	16	18	14	25	32
Bharat Rasayan Ltd	234	0.1	12	NA	NA	28	NA	NA	8	NA	NA	31	NA	NA	NA	NA	NA
Kaveri Seed Co Ltd	593	7.5	23	14	12	49	16	14	4	4	3	8	23	25	12	42	87
Monsanto India Ltd	665	0.5	26	NA	NA	29	NA	NA	8	NA	NA	31	NA	NA	NA	NA	NA
Median			**15**	**14**	**11**	**27**	**23**	**18**	**5**	**4**	**3**	**19**	**18**	**20**	**13**	**18**	**17**

Source: Company, Ambit Capital research

Exhibit 5: Cash conversion has improved across key listed players.

Name of the Company	Pre-tax CFO to EBITDA						
	FY11	FY12	FY13	FY14	FY15	FY16	FY17
PI Industries Ltd	35%	75%	77%	100%	80%	99%	78%
Rallis India Ltd	81%	65%	84%	89%	47%	119%	180%
Dhanuka Agritech Ltd	2%	88%	74%	373%	101%	124%	64%
Excel Crop Care Ltd	104%	115%	138%	82%	59%	125%	102%
Insecticides India Ltd	107%	-48%	13%	50%	2%	107%	13%
Bharat Rasayan Ltd	148%	95%	-19%	57%	89%	81%	25%

Source: Company, Ambit Capital research

BFSI

NEGATIVE

Quick Insight

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Asset quality - Moderating but far from normsalisation

Total stressed loans of Indian banks moderated to 12.6% of total loans in 2QFY18 after showing some pick-up in 1QFY18. However, changing mix of stressed loans towards NPAs (83% of stressed loans vs 81% a quarter ago), increased provisioning coverage on NPAs (from 43% to 46%) and elevated write-offs led to elevated credit cost of 343bps in 2QFY18. We expect provisioning costs for banks to remain high in 2HFY18/FY19, at ~188bps/126bps, as they accelerate write-offs and provisions in response to the PSU bank recap. Thus, we expect significant reduction in NPAs by end-FY19 and cyclical recovery in credit cost and RoE in FY20E on cleaner balance sheets. We prefer ICICI Bank and Bank of Baroda (both BUYs) among corporate lenders due to valuation support and improvement in both cyclical and structural earning drivers.

We analysed 2QFY18 asset quality trends of 31 major banks; these are the key takeaways:

Stressed loans stabilised in 2QFY18

Total stressed loans (NPAs+ standard restructured loans) moderated to 12.6% of total loans in 2QFY18 after jumping to 12.8% at end-1QFY18. Gross slippages moderated to 3.9% in 2QFY18 vs 4.8% in 2QFY17 and 6.6% in 1QFY18. Growth in total stressed loans for private sector banks, at 28% YoY, continued to outpace growth in stressed loans for PSU banks (6% YoY). However, lower loan growth for PSU banks, at 1% YoY vs 17% for private sector banks, means that stressed asset ratio for PSU banks at ~15.5% remains much higher than that of private sector banks' ~4.8%.

However, provisioning costs remains elevated

However, provisioning costs were high, at 343bps, in 2QFY18 vs 250bps in 2QFY17 and 238bps in 1QFY18. Both PSU and private banks saw their provisioning costs increasing QoQ due to change in composition of stressed loans. Share of gross NPAs (requiring higher provisioning) in total stressed loans further increased to 83% at the end of 2QFY18 from 81% in 1QFY18. Hence, gross NPAs of banks increased by 19% YoY to ~10.3% of advances at end-2QFY18. Moreover, provisioning coverage on NPAs increased to 46% at the end of the 2QFY18 vs 43% at 1QFY18.

Provisioning costs to accelerate in 2HFY18-19

Given (a) low provisioning coverage (~40%) on existing bad loans and performance of the existing stock of bad loans; and (b) recapitalisation of PSU banks along with regulator and government push to resolve stressed assets, we expect accelerated write-offs and provisioning over 2HFY18-FY19E. This would lead to meaningfully high credit cost of 188bps in FY18E and 126bps in FY19E (vs 209bps in FY17 and 203bps in FY16). In FY20E, we expect credit cost to normalise to 90bps.

Where do we go from here?

Overall, we expect corporate lenders to clean up the bulk of their bad loans by end-FY19 and perform on cleaner balance sheets in FY20. This increased visibility on clean-up following the recap plan announcement reflects in the sharp share price performance of these banks. We prefer ICICI Bank and Bank of Baroda among corporate lenders due to valuation support and improvement in both cyclical and structural earning drivers. For **ICICI Bank**, we expect credit cost of 105bps in FY20 (vs 280bps in FY18E). ICICI Bank has historically had the lowest interest and operating cost (in aggregate) among peers. Standalone bank RoE would increase to 15.0% in FY20E vs 5.9% in FY18E. Moreover, life insurance, general insurance, asset management and stock broking businesses should continue to do well due to

State Bank of India	**SELL**
Bloomberg Code:	SBIN IN
CMP (₹):	329
TP (₹):	361
Mcap (₹ bn/US$ bn):	2,891/44.8
3M ADV (₹ mn/US$ mn):	7,046/109

ICICI Bank	**BUY**
Bloomberg Code:	ICICIBC IN
CMP (₹):	315
TP (₹):	355
Mcap (₹ bn/US$ bn):	2,051/31.8
3M ADV (₹ mn/US$ mn):	5,282/81.9

Axis Bank	**SELL**
Bloomberg Code:	AXSB IN
CMP (₹):	550
TP (₹):	507
Mcap (₹ bn/US$ bn):	1,305/20.5
3M ADV (₹ mn/US$ mn):	5,192/78.9

Bank of Baroda	**BUY**
Bloomberg Code:	BOB IN
CMP (₹):	172
TP (₹):	200
Mcap (₹ bn/US$ bn):	410/6.4
3M ADV (₹ mn/US$ mn):	2,893/44.8

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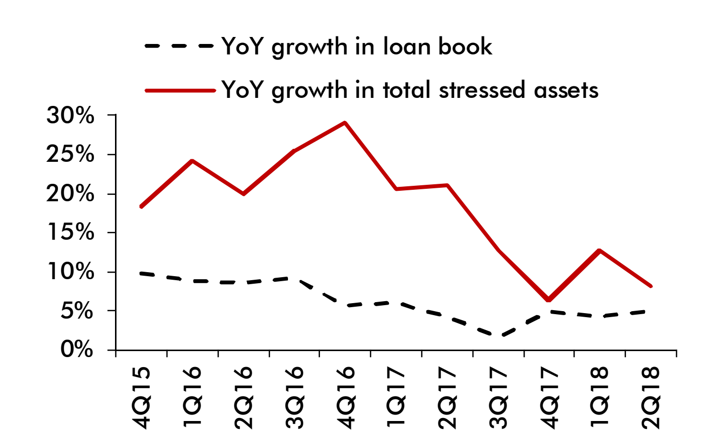
financialisation of savings and consolidation in some of the subsidiaries' better-than-expected trends. We are BUYers on ICICI Bank (implied 1.1x FY19E P/B).

Bank of Baroda is ahead of its peers on stressed loan provisions (48% vs SBI's 45% and PNB's 35%). Thus, BOB is likely to be ahead on cyclical recovery in credit cost and RoE in the next 12-18 months. Further, with the change in the government's stance on PSU banks, we expect no risk of a disruptive merger with a weak PSU bank derailing turnaround initiatives of new management (early signs of these measures are reflecting in retail scale-up, CASA growth and NIM pick-up). We expect BOB to have ~14% RoE in FY20E, in line with SBI and higher than other PSUs (9-11%). BOB trades at 1.2x FY20EBV vs SBI's 1.4x

Some moderation in asset quality trends but far from being normal

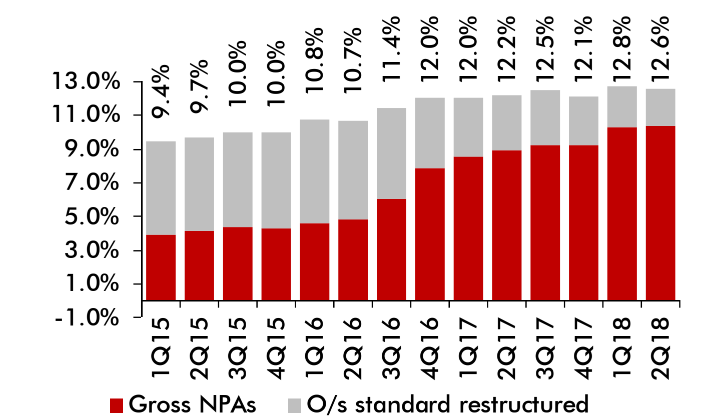
After a spike in 1QFY18, growth of reported **stressed loans (gross NPAs plus standard restructured loans)** of the Indian banks (our sample covers 31 banks) moderated to 8% YoY in 2QFY18 with total stressed loans as a percentage of total loans declining 20bps QoQ to 12.6% in 2QFY18.

Exhibit 1: YoY growth in stressed assets moderated



Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Exhibit 2: Total stressed assets decreased marginally



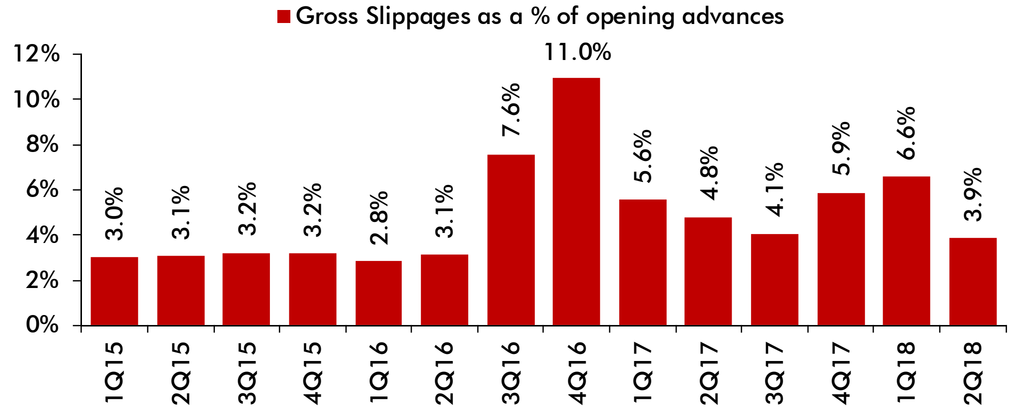
Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Note: Our sample covers **31 banks** includes Axis Bk, ICICI Bk, HDFC Bk, Kotak Mahindra Bk, Yes Bk, IndusInd Bk, DCB Bk, SBI, BOB, BOI, PNB, Union Bank, OBC, Canara Bk, Federal Bk, Karur Vysya Bk, City Union Bk and South Indian Bk, Central Bank of India, IDBI Bk, Indian Bk, Syndicate Bk, UCO Bk, Indian Overseas Bk, Allahabad Bk, Corporation Bk, Andhra Bk, Bk. Of Maharashtra, Vijaya Bk, Dena Bk, United Bank of India.

The spike in 1QFY18 was driven by SBI's merger with its associates as the asset quality of associate banks was worse than that of the parent bank's and the merger led to a spike in total stressed loans for SBI in 1QFY18. However, in 2QFY18, the addition to NPAs moderated and led to reduction in overall stressed assets for SBI leading to 40bps QoQ decline in stressed assets for SBI.

After seven quarters (from 3QFY16 to 1QFY18) of >4% gross slippages for the overall banking system, there was some moderation in gross slippages as well with gross slippages of 3.9% in 2QFY18 vs 4.8% in 2QFY17 and 6.6% in 1QFY18. The gross slippages in absolute terms reduced by 40% QoQ and 12% YoY. However, gross slippages are still high from the historical context (average of ~2.9% in FY13-15) and are far from being normal.

Exhibit 3: Gross slippages as a percentage of opening advances has improved

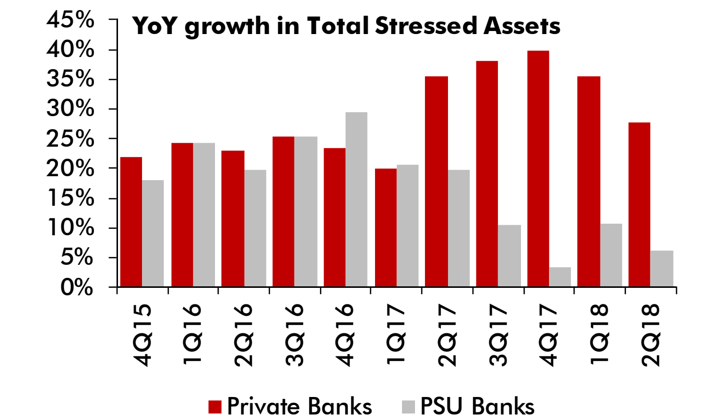


Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Private sector banks driving increase in stressed assets

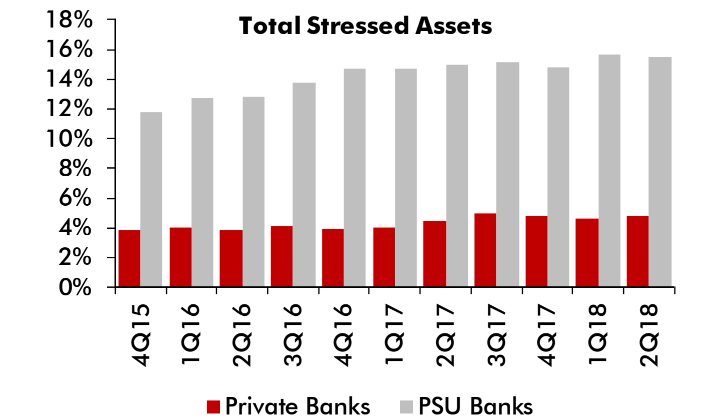
The total stressed asset growth for private sector banks (28% YoY) remains higher than that of PSU banks (6%). However, due to lower loan book growth for PSU banks (1% YoY vs 17% YoY for private), total stressed loans as a percentage of loans was higher for PSU banks (17%) vs private sector banks (5%). Though there is still a significant gap between the reported stressed loans of PSU and private sector banks, the gap is narrowing.

Exhibit 4: YoY growth in stressed assets was higher for private sector banks vs PSU banks…



Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Exhibit 5: …however, there is still a significant gap in the reported stressed assets of PSU and private sector banks

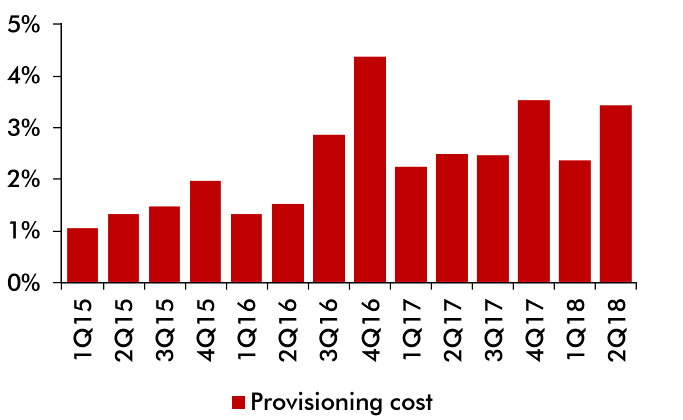


Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Provisioning cost increased during the quarter

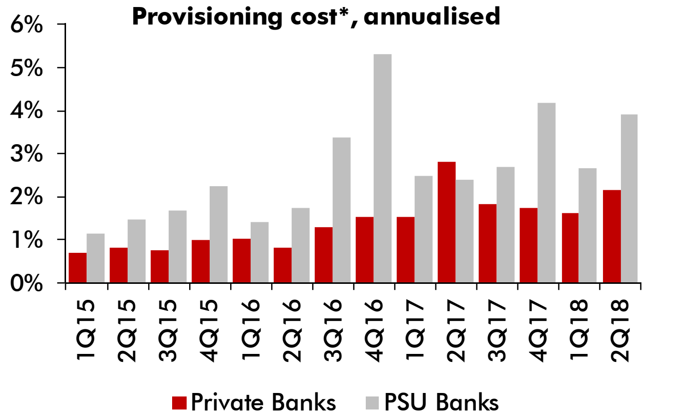
However, provisioning cost increased to 343bps (annualised) in 2QFY18 vs 250bps in 2QFY17 and 238bps in 1QFY18. Both PSU and private banks saw their provisioning cost increasing QoQ.

Exhibit 6: Provisioning cost* for banks increased in 2QFY18



*Source: Company, Ambit Capital research; Note: For our sample of 31 bank; Note: *total provisions as a % of advances*

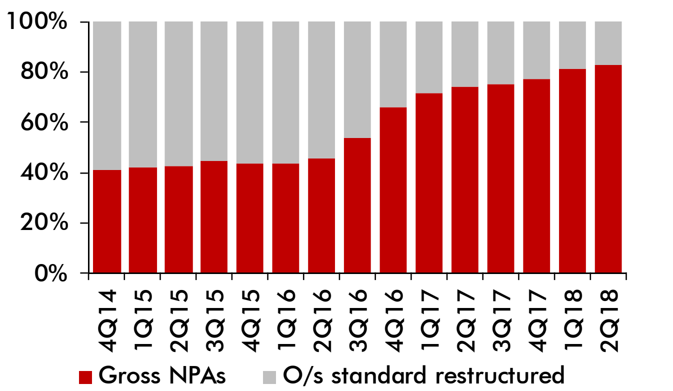
Exhibit 7: And it increased for both PSU and private banks



*Source: Company, Ambit Capital research; Note: For our sample of 31 banks; Note: *total provisions as a % of advances*

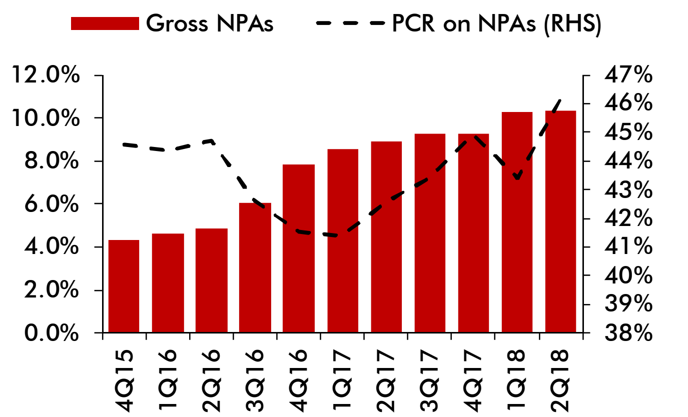
The reason behind the high provisioning cost was increase in provisioning cover and elevated write-offs during the quarter. Share of gross NPAs (requiring higher provisioning) in total stressed loans increasing to 83% at the end of 2QFY18 from 81% at 1QFY18. Hence, gross NPAs of banks increased by 19% YoY to ~10.3% of advances at end-2QFY18. Moreover, provisioning cover on NPAs increased from 43% last quarter to 46% at the end of this quarter.

Exhibit 8: Composition of stressed assets is shifting towards NPAs...



Source: Company, Ambit Capital research; Note: For our sample of 31 banks

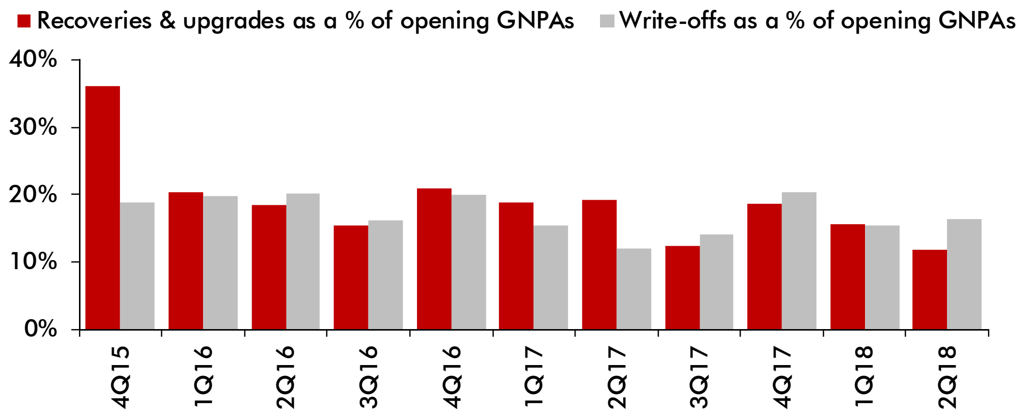
Exhibit 9: ...which has been leading to a continuous increase in gross NPAs



Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Moreover, write-offs as a percentage of opening gross NPAs remained elevated at 16% (annualised) in 2QFY18 (vs 12% in 2QFY17), leading to overall elevated levels of provisioning cost. Write-offs as a percentage of opening GNPAs at 16% were higher than recoveries as a percentage of opening GNPAs at 12% in 2QFY18.

Exhibit 10: Write-offs as a percentage of opening advances remained elevated

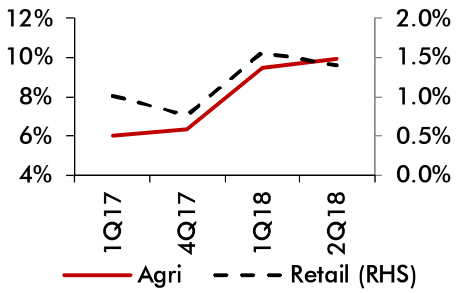


Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Some moderation in retail NPAs

After a spike in 1QFY18, there was some moderation in NPAs in the retail segment. In 1QFY18, banks retail loans were impacted due to demonetisation and farm loan waivers. Whilst most banks don't separately report retail/agri NPAs, the disclosures of some major banks showed that the stress in retail loans moderated sequentially. E.g. gross NPAs of SBI in retail loans decreased from 1.6% in 1QFY18 to 1.4% in 2QFY18. Gross slippages of ICICI Bank and Axis Bank in retail loans also decreased in 2QFY18 vs 1QFY18. However, we expect credit cost in retail loans to be higher vs historical trends given higher share of unsecured loans in retail loans

Exhibit 11: Retail NPAs of SBI moderated in 2QFY18

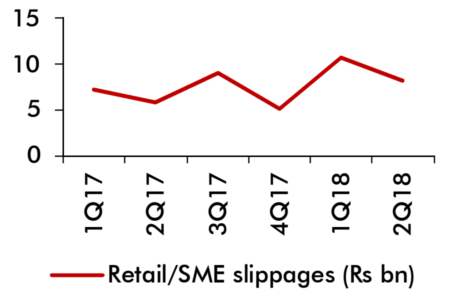


Source: Company, Ambit Capital research

Exhibit 12: Retail slippages declined for ICICI Bank in 2QFY18

Source: Company, Ambit Capital research

Exhibit 13: Slippages from Retail/SME for Axis Bank moderated in 2QFY18



Source: Company, Ambit Capital research

Provisioning cost to moderate but remain above average

Despite plateauing growth in stressed loans, provisioning cost for large lenders under our coverage (10 banks) should remain high at ~160bps in FY18-19E vs 210bps in FY16-17. Our expectation of elevated provisioning cost in FY18-19E is driven by: (i) higher provisioning cost on existing stressed loans given current low provisioning of ~40%; and (ii) addition of 2.0-3.0% of stressed loans over the next 5-6 quarters from the watch-lists of banks. Even for the retail sector, we expect credit costs to be higher in FY18-19E vs FY16-17 due to some pressure on SME asset quality due to impact of GST and higher credit costs in retail loans due to higher share of unsecured loans in the loan book than in the past.

Exhibit 14: Credit cost estimates for large banks under our coverage

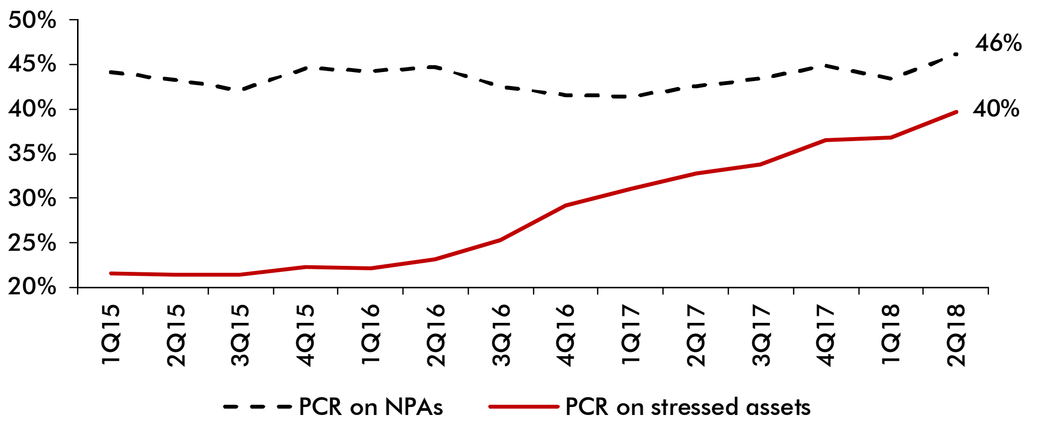
Credit cost (in bps)	FY15	FY16	FY17	FY18E	FY19E	FY20E
State Bank of India	139	216	213	330	172	69
Bank of Baroda	92	345	209	154	98	94
Punjab National Bank	219	444	305	264	225	194
Union Bank of India	105	178	218	204	169	158
Bank of India	135	371	322	172	132	139
Axis Bank	70	123	313	272	125	74
ICICI Bank	87	175	327	285	149	100
HDFC Bank	52	51	62	71	66	64
Kotak Mahindra	32	62	48	52	50	50
IIB	55	64	70	74	72	72
RBL Bank	31	46	64	76	72	70
Average credit costs	**92**	**189**	**195**	**178**	**121**	**98**

Source: Company, Ambit Capital research

Higher provisioning on existing stressed loans

The change in the mix of stressed assets (towards NPAs and away from restructured loans) led to a rise in the provision coverage for banks over the last 6-7 quarters. Yet, the overall provisioning coverage on stressed assets remains low, at ~40%.

Exhibit 15: Provisioning coverage ratio (PCR) on NPAs and total stressed loans



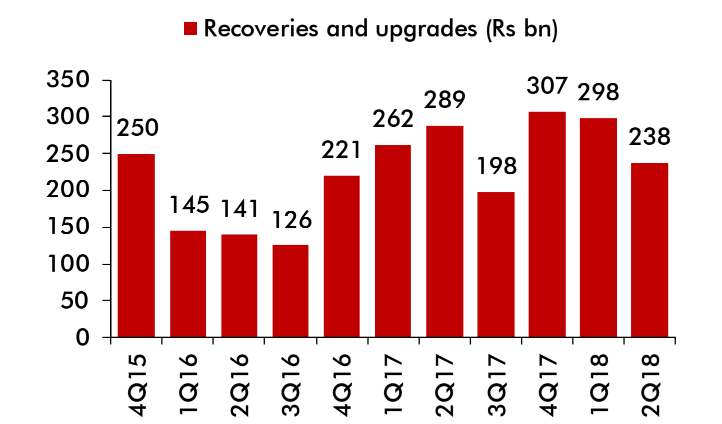
Source: Company, Ambit Capital research; Note: For our sample of 31 banks

Looking at the performance of the existing stock of stressed loans (~50% of the outstanding standard restructured book as at FY14 slipped into NPAs), we expect provisioning coverage on the existing stock of stressed loans to rise to ~55% by FY19 from current levels of 40%.

Recoveries and upgrades in existing stressed loans remain weak

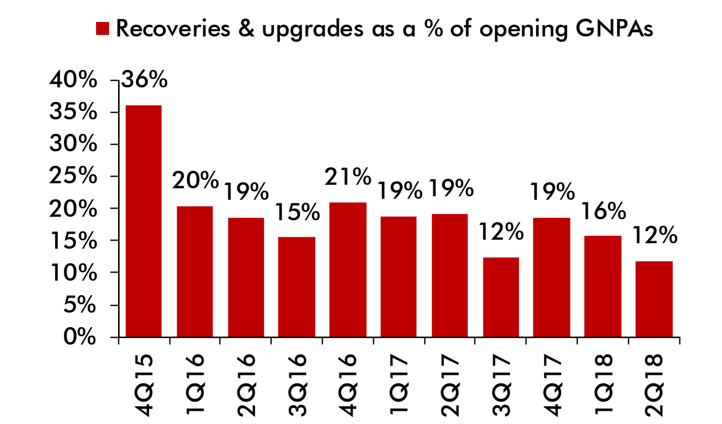
Recoveries and upgrades from NPAs decreased in 2QFY18 vs 1QFY18 in absolute terms. Also, the recovery rate as a percentage of opening gross NPA remained low, at ~12%, in 2QFY18. The 2Q recovery rate was the lowest in the last 14 quarters, indicating that there remains stress in corporate profitability and there is time for corporate profitability to turn the corner.

Exhibit 16: Recoveries and upgrades reduced sequentially



Source: Company, Ambit Capital research; Note: For our sample of 31 banks

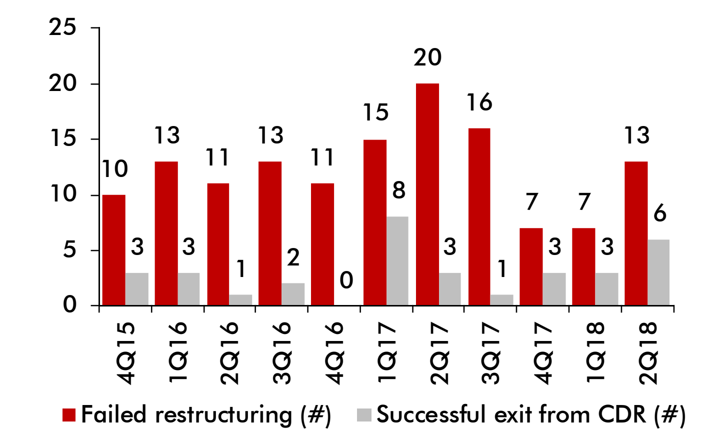
Exhibit 17: Recovery rates were lower than past trends



Source: Company, Ambit Capital research; Note: For our sample of 31 banks

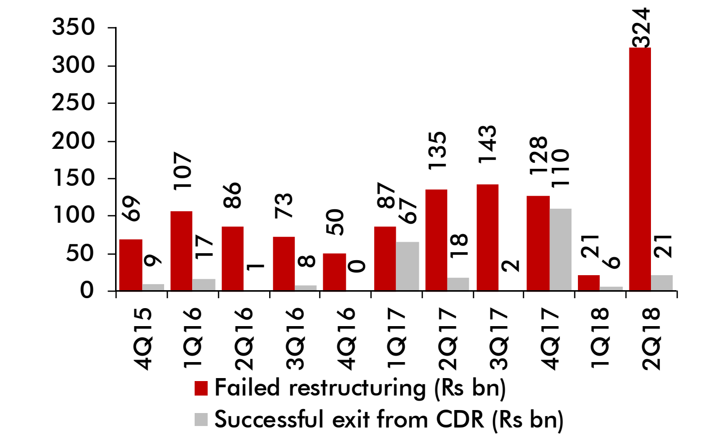
Data from the corporate debt restructuring (CDR) cell also points to slippages from restructuring assets to NPAs far outweighing upgrades of failed cases of restructuring.

Exhibit 18: Number of failed restructuring continues to significantly outpace successful turnarounds…



Source: CDR cell, Ambit Capital research

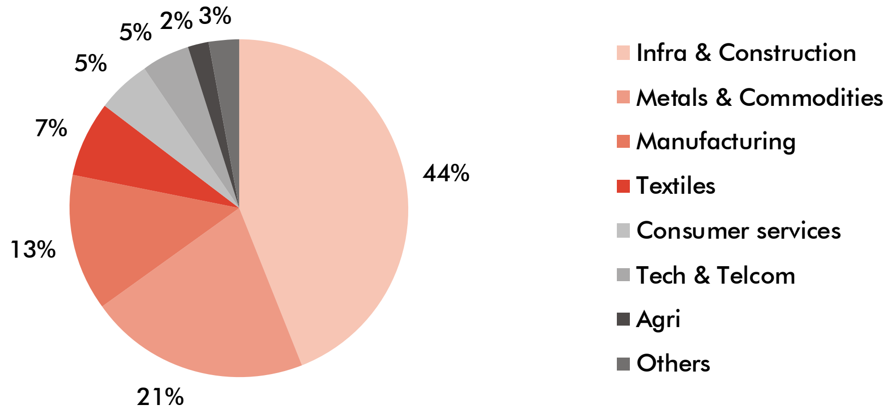
Exhibit 19: …and a similar trend is visible in value terms as well



Source: CDR cell, Ambit Capital research

Remaining outstanding restructured loans under CDR continue to be from stressed sectors like iron & steel and power and, hence, the flow from restructured assets to NPAs should continue in FY18 as well.

Exhibit 20: Infra, construction and metals dominated remaining restructuring cases in absolute amount at the end of 1HFY18



Source: CDR cell, Ambit Capital research

Further addition of 2.5-3.0% in stressed loans likely

We expect further addition of 2.0% to 3.0% in stressed loans for banks over the next 5-6 quarters. Our estimates are based on the watch-list loans declared by some large banks. E.g. watch-list loans are 4.1%, 1.7% and 1.2% of the loan book for ICICI Bank, Axis Bank and State Bank of India respectively. Moreover, gross slippages for some major banks outside their restructured loans and watch-lists remained high. E.g. gross slippages outside watchlist/restructured loans were 63%, 73% and 73% of total slippages for ICICI, Axis and SBI respectively in 2QFY18.

Provisioning and write-offs to accelerate in next 12 months

In last six months, **(a)** the government has empowered the RBI to direct banks to resolve specified stressed cases through the Insolvency and Bankruptcy Code (IBC); **(b)** the RBI has asked banks to first immediately refer 12 large NPAs (~25% of banking system gross NPAs) for immediate insolvency proceeding under; and **(c)** the RBI further asked bank to resolve next 30-40 cases by December 2017, falling which the accounts will be transferred to IBC. For accounts referred to IBC, the RBI has asked banks to make at least 50% provisions on secured exposure and 100% provisions on unsecured exposure.

Following these developments, last month, the government announced its enhanced plan of recapitalising PSU banks by providing roadmap for capital infusion of Rs2.1tn over FY18-19E. This places the agenda firmly in place for PSU banks to accelerate clean-up of their balance sheets and be in position to restart the lending cycle.

Hence, we expect corporate lenders, in general, to write-off and raise provisions for their stressed cases. Our discussions with insolvency experts indicate an expected haircut of 50-60% under insolvency proceedings. As explained in earlier sections, ***Indian banks carry aggregate provision coverage of ~40% on their bad loans.***

Credit cost sensitive to estimates on loss given default

The total current stressed loans of 12.6% with provisioning coverage of 40% and additional 2.0-3.0% of the loans becoming stressed over next 12-18 months mean that credit cost will remain high for banks. However, credit costs in FY18-19 would largely be a factor of how much provisioning banks would need to do on these stressed loans. Depending on feedback from various industry participants, the estimates on provisioning required on these bad loans range from 50% to 60%. Hence, the average credit cost in FY18-19E could be anywhere between 120bps and 210bps vs the average of 225bps in FY16-17.

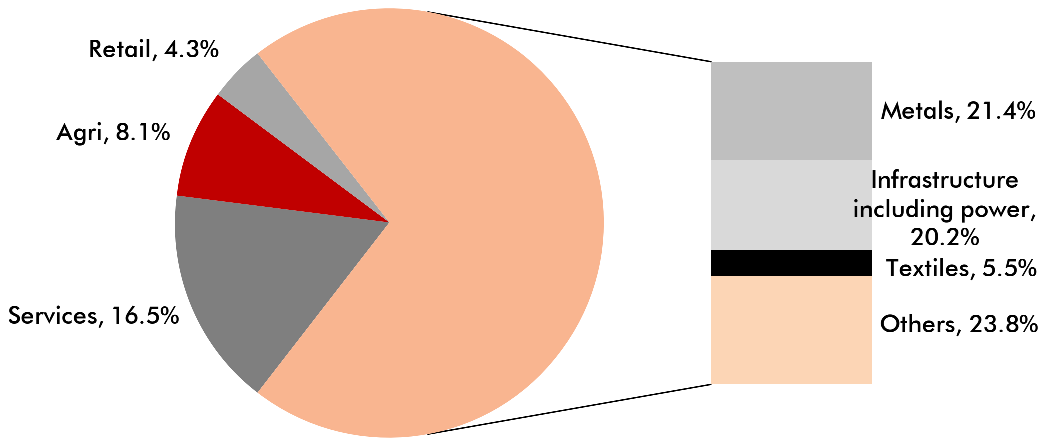
Exhibit 21: Sensitivity analysis on expected credit cost due to incremental stressed assets and increase in provision coverage

Average credit cost in FY18-19 (BPS)		Provision coverage							
		40%	**45%**	**50%**	**55%**	**60%**	**65%**	**70%**	**75%**
Incremental stressed assets	**1.50%**	45	76	108	139	170	201	232	263
	1.75%	50	81	113	145	177	208	240	272
	2.00%	54	86	**119**	**151**	**183**	216	248	280
	2.25%	59	91	**124**	**157**	**190**	223	256	288
	2.50%	63	97	**130**	**163**	**197**	230	263	297
	2.75%	68	102	**135**	**169**	**203**	237	271	305
	3.00%	72	107	**141**	**176**	**210**	245	279	314
	3.25%	76	112	147	182	217	252	287	322
	3.50%	81	117	152	188	223	259	295	330

Source: Ambit Capital research

As shown in the table above, the credit cost assumptions have a very high sensitivity to provisioning requirement on the stock of bad loans. The provisioning requirement would be primarily a function of the health of some major sectors like steel, power, infrastructure etc. which contribute to the Indian banks' bad loans.

Exhibit 22: Metals and Infrastructure (including power) dominated stressed loans of the banking system as at end-FY17



Source: RBI, Ambit Capital research; Note: total stressed loans (Gross NPAs + restructured) as a percentage of total loans

Where do we go from here?

Given (a) low provisioning coverage (~40%) on existing bad loans and the performance of the existing stock of bad loans; and (a) recapitalisation of PSU Banks along with regulator and government push to resolve stressed assets, we expect accelerated write-offs and provisioning over 2HFY18-FY19E. This would lead to meaningfully high credit cost of 188bps in FY18E and 126bps in FY19E (vs 209bps in FY17 and 203bps in FY16). In FY20E, we expect credit cost to normalise to 90bps.

Overall, we expect corporate lenders to clean up the bulk of their bad loans by end-FY19 and perform on cleaner balance sheets in FY20. This increased visibility on clean-up following the recap plan announcement reflects in the sharp share price performance of these banks. Since 24 October, PSU bank Index, Axis Bank and ICICI Bank are up 28%, 22% and 18% respectively.

Our recommendations for these corporate lenders are thus functions of these banks valuations and cyclical improvement in their profitability by FY20E.

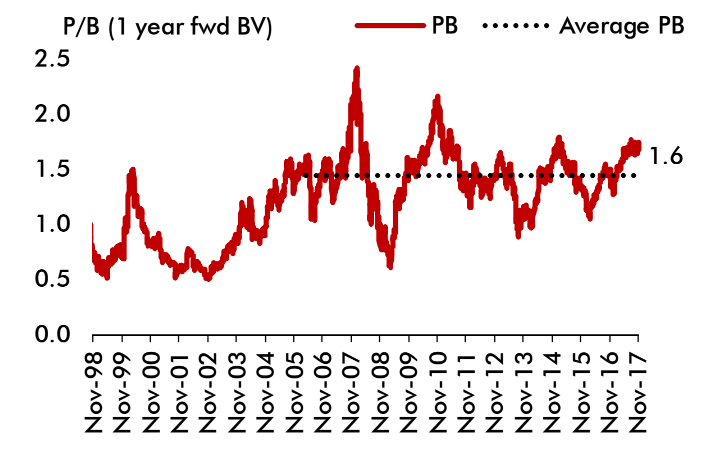
In our note 'Look beyond asset quality', we highlighted that while earnings of **ICICI Bank** will remain weak in FY18, they would begin to improve in FY19. We expect credit cost of 105bps in FY20 (vs 280bps in FY18E). Moreover, continuous improvement on the liability side (CASA ratio of 49%) implies NIMs should start improving once gross NPA ratio decreases from FY19. We highlighted that, historically, ICICI Bank had the lowest interest and operating cost (in aggregate) vs its peers. In 2QFY18, ICICI Bank's cost of funds declined further (by 12bps) while core cost-to-income ratio also improved sequentially. Hence, standalone bank RoE would increase to 15.0% in FY20E vs 5.9% in FY18E as asset quality, NIMs and operating efficiencies start improving. Moreover, life insurance, general insurance, asset management and stock broking businesses should continue to do well due to financialisation of savings and consolidation in some of the subsidiaries' better-than expected trends. We are BUYers on ICICI Bank (implied 1.1x FY19E P/B).

As highlighted in our note 'Better something than nothing', even as questions on credit demand, margin outlook and governance reforms for PSU banks persist, the recap does relieve banks' stressed balance sheets. We see material NPA reduction and RoE recovery by end-FY19. Larger, better-run banks would receive preferential support on growth capital beyond the regulatory minimum. On cleaned-up balance sheets, post government recapitalisation, SBI, BOB and PNB would be able to deliver RoE of 11-14% (vs 9-10% for BOI and UNBK) led by superior underlying operating profitability.

Our implied target P/ABV multiples for banks reflect their projected RoE on cleaner balance sheets in FY20E. Even with these higher multiples, there is little upside left for SBI, PNB, BOI and UNBK. We are BUYers on Bank of Baroda (implied 1.4x FY20E BV).

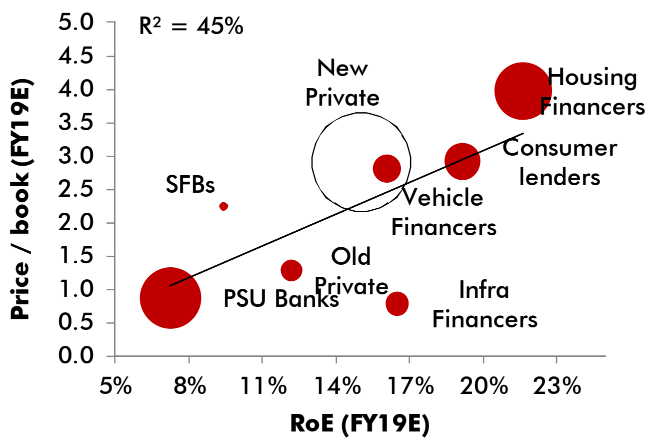
Bank of Baroda is ahead of its peers on stressed loan provisions (48% vs SBI's 45% and PNB's 35%). Thus, BOB is likely to be ahead on cyclical recovery in credit cost and RoE in next 12-18 months. Further, with the change in the government's stance on PSU banks, we expect no risk of a disruptive merger with a weak PSU bank derailing turnaround initiatives of new management (early signs of these measures are reflecting in retail scale-up, CASA growth and NIM pick-up). We expect BOB to have ~14% RoE in FY20E, in line with SBI and higher than other PSUs (9-11%). BOB trades at 1.2x FY20EBV, vs SBI's 1.4x

Exhibit 26: Overall bank valuations are above the long-run average



Source: Bloomberg, Ambit Capital research; Average valuation multiple for PSU and private sector banks.

Exhibit 27: Relative valuations are closely aligned with potential RoE (FY19E) of the sub-sectors



Source: Bloomberg, Ambit Capital research

Exhibit 28: Relative valuations

	Mcap US$bn	Price (Rs)	Reco.	TP (Rs)	Up/ (Down)	P/B at CMP		P/E at CMP		EPS CAGR FY18-19E
						FY18E	FY19E	FY18E	FY19E	
New Private										
HDFC Bank	74.6	1,858	SELL	1,330	-28%	4.67	4.08	27.8	23.4	18%
ICICI Bank	31.2	313	BUY	355	13%	1.80	1.61	25.8	13.4	21%
Kotak Mahindra Bank	30.4	1,030	SELL	664	-36%	3.92	3.44	33.2	27.8	17%
Axis Bank	20.8	558	SELL	507	-9%	2.28	2.00	33.8	14.2	60%
IndusInd Bank	15.7	1,684	UR	UR	NA	4.32	3.72	27.8	22.8	24%
Yes Bank	11.2	314	NA	NA	NA	2.59	2.19	17.2	13.6	24%
RBL Bank	3.4	519	SELL	389	-25%	3.26	2.96	34.4	27.0	27%
IDFC Bank	2.9	55	NA	NA	NA	1.21	1.14	17.1	13.9	17%
DCB Bank	0.9	191	NA	NA	NA	2.28	2.03	22.3	17.6	24%
Average						**2.92**	**2.57**	**26.6**	**19.3**	**26%**
Large PSUs										
State Bank of India*	44.7	333	SELL	361	8%	1.25	1.09	-85.3	16.0	n.a.
Bank of Baroda	6.2	173	BUY	200	16%	1.07	0.97	71.5	9.1	78%
Punjab National Bank	6.1	184	SELL	202	10%	1.06	1.02	-25.2	87.8	-42%
Bank of India	3.7	199	SELL	134	-33%	0.98	0.97	-10.2	-2207.0	-92%
Union Bank of India	1.9	165	SELL	173	5%	0.69	0.73	-8.7	116.3	-58%
Average						**1.01**	**0.96**	**-11.6**	**-395.6**	**-29%**
Old Private										
Federal Bank	3.4	112	SELL	77	-32%	1.77	1.62	18.4	15.5	23%
Karur Vysya bank	1.1	117	SELL	93	-21%	1.35	1.25	18.4	11.6	1%
South Indian Bank	0.9	31.3	SELL	19.1	-39%	1.16	1.06	16.4	9.3	24%
City Union Bank	1.7	164	SELL	167	2%	2.68	2.36	18.5	15.4	18%
Average						**1.74**	**1.57**	**17.9**	**13.0**	**16%**

*Source: Bloomberg, Ambit Capital estimates; *Note: We have adjusted valuation of State Bank of India for standalone bank multiples. For non-covered banks, we have used consensus estimates.*

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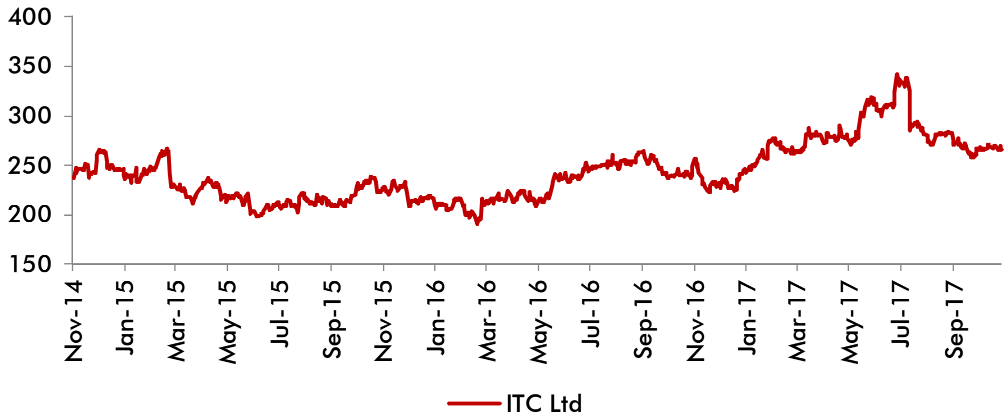

Source: Bloomberg, Ambit Capital research

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