



Indian Overseas Bank

| | |
|--------------------|--------------|
| STOCK INFO. | BLOOMBERG |
| BSE Sensex: 19,978 | IOB IN |
| | REUTERS CODE |
| S&P CNX: 5,906 | IOBK.BO |

29 October 2007

Buy

Previous Recommendation: Buy

Rs135

| | |
|---------------------|-------------|
| Equity Shares (m) | 544.8 |
| 52-Week Range | 151/89 |
| 1,6,12 Rel.Perf.(%) | -23/-29/-36 |
| M.Cap. (Rs b) | 73.4 |
| M.Cap. (US\$ b) | 1.9 |

| YEAR | NET INCOME | PAT | EPS | EPS | P/E | P/BV | CAR | ROE | ROA | P/ABV |
|-------|------------|--------|------|------------|-----|------|------|------|-----|-------|
| END | (RS M) | (RS M) | (RS) | GROWTH (%) | (X) | (X) | (%) | (%) | (%) | (X) |
| 3/07A | 29,478 | 10,084 | 18.5 | 28.7 | 7.3 | 1.9 | 13.3 | 29.1 | 1.4 | 2.0 |
| 3/08E | 33,972 | 11,718 | 21.5 | 16.2 | 6.3 | 1.5 | 12.0 | 26.9 | 1.3 | 1.6 |
| 3/09E | 40,305 | 13,718 | 25.2 | 17.1 | 5.3 | 1.2 | 11.7 | 25.5 | 1.2 | 1.3 |

- IOB's 2QFY08 NII grew 3% YoY to Rs 6.3b (v/s est of Rs7.2b). NII de-grew 11% QoQ as cost of deposits increased while yields remained flat QoQ. As deposits growth far outpaced advances growth during the quarter, NIM decreased 60bp QoQ and 90bp YoY to 3.1% in 2QFY08. NIM for 1HFY08 was 3.39%.
- Gross advances grew 25% YoY to Rs513.5b, while deposits grew 37% to Rs783b. On a QoQ basis, advances increased 6% while deposits increased 12%. Incremental C-D ratio during the quarter was 34% and thus margins came under pressure. CASA ratio reduced to 31.8% in 2QFY08 from 38% a year ago and 33% in 1QFY08.
- Other income grew 81% YoY to Rs1.7b driven by fees, treasury as well as forex income. While treasury increased from Rs99m in 2QFY07 to Rs545m in 2QFY08, forex grew 54% to Rs282m. Core fee income grew by 24% YoY to Rs1.5b in 2QFY08.
- Asset quality improved significantly during the quarter. Gross NPAs declined 86bp YoY and 24bp QoQ to 2.1%. Net NPAs reduced 22bp YoY and 15bp QoQ to 0.35%. In absolute terms, gross NPAs decreased 5% QoQ, while net NPAs decreased 25% QoQ.
- Significant decline in margins and CASA ratio over the last couple of quarters is concerning. While liability growth remained strong, asset growth at 25% is disappointing considering merger of BhOB during 2QFY08. Consistently improving asset quality trends and build up of traction in core fees over the past couple of quarters is, however, impressive. The stock trades at 5.3x FY09E EPS and 1.2x FY09E BV. Maintain **Buy**.

QUARTERLY PERFORMANCE

(RS MILLION)

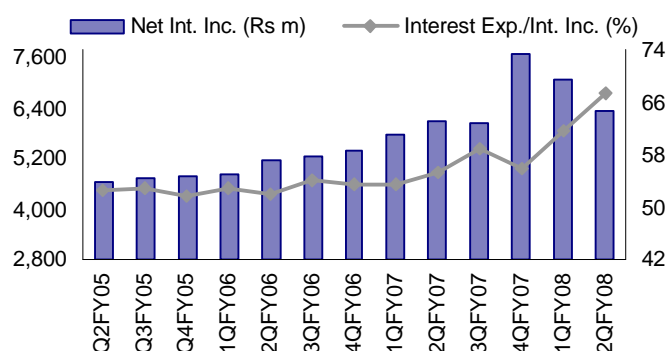
| | FY07 | | | | FY08 | | | | FY07 | FY08E |
|--------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3QE | 4QE | | |
| Interest Income | 12,409 | 13,721 | 14,737 | 17,454 | 18,462 | 19,303 | 20,172 | 21,097 | 58,321 | 79,034 |
| Interest Expense | 6,654 | 7,602 | 8,686 | 9,771 | 11,372 | 12,982 | 13,176 | 13,485 | 32,713 | 51,015 |
| Net Interest Income | 5,755 | 6,119 | 6,051 | 7,682 | 7,090 | 6,321 | 6,995 | 7,613 | 25,608 | 28,020 |
| % Change (Y-o-Y) | | | 15.1 | 42.0 | 23.2 | 3.3 | 15.6 | -0.9 | 23.9 | 9.4 |
| Other Income | -342 | 964 | 1,980 | 1,905 | 616 | 1,745 | 1,750 | 1,842 | 3,870 | 5,953 |
| Net Income | 5,413 | 7,083 | 8,031 | 9,587 | 7,706 | 8,066 | 8,745 | 9,455 | 29,478 | 33,972 |
| % Change (Y-o-Y) | | | 17.1 | 27.3 | 42.4 | 13.9 | 8.9 | -1.4 | 5.5 | 15.2 |
| Operating Expenses | 3,302 | 3,491 | 3,116 | 3,970 | 3,614 | 3,486 | 4,050 | 4,447 | 13,878 | 15,598 |
| Operating Profit | 2,111 | 3,592 | 4,916 | 5,618 | 4,092 | 4,580 | 4,695 | 5,008 | 15,600 | 18,375 |
| Other Provisions | -554 | -15 | 1,251 | 1,820 | 620 | 83 | 500 | 897 | 1,866 | 2,100 |
| Tax Provisions | 445 | 1,108 | 1,197 | 900 | 787 | 1,300 | 1,300 | 1,170 | 3,650 | 4,557 |
| Net Profit | 2,220 | 2,499 | 2,468 | 2,898 | 2,685 | 3,197 | 2,895 | 2,941 | 10,084 | 11,718 |
| % Change (Y-o-Y) | 21.2 | 25.9 | 25.1 | 41.7 | 20.9 | 28.0 | 17.3 | 1.5 | 28.7 | 16.2 |
| Cost to Income Ratio (%) | 61.0 | 49.3 | 38.8 | 41.4 | 46.9 | 43.2 | 46.3 | 47.0 | 47.1 | 45.9 |
| Interest Expense/Interest Income (%) | 53.6 | 55.4 | 58.9 | 56.0 | 61.6 | 67.3 | 65.3 | 63.9 | 56.1 | 64.5 |
| Other Income/Net Income (%) | -6.3 | 13.6 | 24.7 | 19.9 | 8.0 | 21.6 | 20.0 | 19.5 | 13.1 | 17.5 |

E: MOST Estimates

Net interest income grows 3% YoY; margins drop significantly

IOB's 2QFY08 NII grew 3% YoY to Rs 6.3b (v/s est of Rs7.2b). NII de-grew by 11% QoQ as cost of deposits increased while yields remained intact QoQ. As deposits growth far outpaced advances growth during the quarter, NIM decreased 60bp QoQ and 90bp YoY to 3.1% in 2QFY08. NIM for 1HFY08 was 3.39%.

TREND IN NII



Source: Company/Motilal Oswal Securities

BREAK-UP ON MOVEMENT OF NIMS (%)

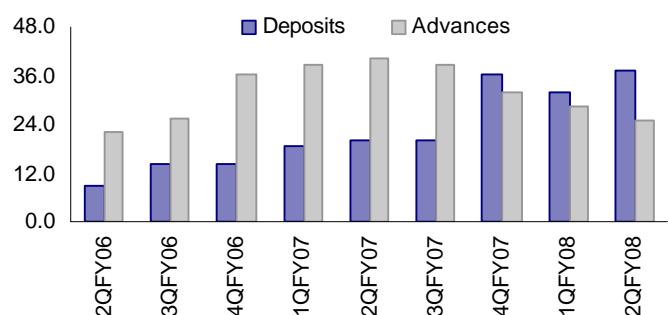
| | 1QFY07 | 2QFY07 | FY07 | 1QFY08 | 2QFY08 |
|----------------------|-------------|-------------|-------------|-------------|-------------|
| Avg Yield on Adv. | 9.05 | 9.49 | 9.06 | 10.49 | 10.50 |
| Avg Yield on Inv. | 8.41 | 8.33 | 7.91 | 8.00 | 7.87 |
| Avg Cost of Deposits | 4.78 | 4.99 | 4.89 | 5.93 | 6.43 |
| NIMs | 4.01 | 4.01 | 3.82 | 3.71 | 3.11 |

Source: Company/Motilal Oswal Securities

Deposits up 37%; advances 25%

Gross advances grew 25% YoY to Rs513.5b, while deposits grew 37% to Rs783b. On a QoQ basis, advances increased by 6% while deposits increased by 12%. Incremental C-D ratio during the quarter was 34% and thus margins came under pressure.

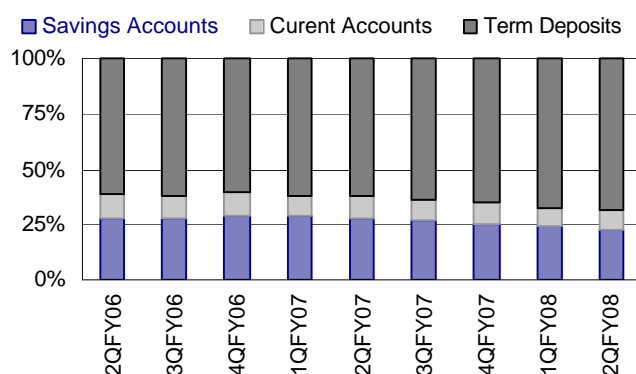
BUILT UP IN DEPOSITS GROWTH (YOY, %)



Source: Company/Motilal Oswal Securities

CASA ratio continues to decline. CASA ratio reduced to 31.8% in 2QFY08 from 38% a year ago and 33% in 1QFY08. Savings account grew 13% YoY while current account grew 23% YoY. Term deposits increased 50% YoY. Management attributed this fall to shift of deposits from savings to term on account of higher interest rates offered for retail depositors. A sharp decline in CASA in the last one year is a matter of concern and we expect margins to remain under pressure during FY08 on this count. The high cost deposits proportion has increased to 20% during 2QFY08 as the bank also resorted to bulk deposits intake during the quarter.

CASA RATIO ON A DECLINE



Source: Company/Motilal Oswal Securities

Core fee income up 24% YoY

Other income grew 81% YoY to Rs1.7b driven by fees, treasury as well as forex income. Treasury income increased from Rs99m in 2QFY07 to Rs545m in 2QFY08, while forex income grew 54% to Rs280m. Core fee income grew by 24% YoY to Rs1.5b in 2QFY08.

BREAK UP OF OTHER INCOME

| | 2QFY08 | 2QFY07 | YOY GR. % |
|------------------------------|--------------|------------|-----------|
| Core fee income | 1,460 | 1,177 | 24 |
| Treasury Profits | 545 | 99 | 450 |
| Forex income | 280 | 182 | 54 |
| Amortization and Revaluation | (660) | (556) | 19 |
| Recovery from w/off accounts | 120 | 62 | 94 |
| Total Other income | 1,745 | 964 | 81 |

Source: Company/Motilal Oswal Securities

NPA TREND (RS M)

| | 2QFY06 | 3QFY06 | 4QFY06 | 1QFY07 | 2QFY07 | 3QFY07 | 4QFY07 | 1QFY08 | 2QFY08 |
|--------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| Gross NPAs | 14,230 | 14,060 | 12,276 | 11,878 | 12,192 | 11,220 | 11,202 | 11,368 | 10,770 |
| Net NPAs | 2,650 | 2,377 | 2,243 | 1,768 | 2,296 | 2,070 | 2,578 | 2,364 | 1,766 |
| Gross NPA (%) | 4.9 | 4.4 | 3.4 | 3.1 | 3.0 | 2.5 | 2.3 | 2.3 | 2.1 |
| Net NPA (%) | 0.9 | 0.8 | 0.7 | 0.5 | 0.6 | 0.5 | 0.6 | 0.5 | 0.4 |

Source: Company/Motilal Oswal Securities

Over the last few quarters, IOB's fee income growth has been robust at 20%+ on YoY basis. Fees grew 26% in 1QFY08 and 23% in FY07. Management is highly focused on improving its fee income through sale of forex and derivatives products, as well as third party distribution of products.

Asset quality remains robust – Net NPA at 0.35%

Asset quality improved significantly during the quarter. Gross NPAs declined 86bp YoY and 24bp QoQ to 2.1%. Net NPAs reduced 22bp YoY and 15bp QoQ to 0.35%. In absolute terms, gross NPA decreased 5% QoQ, while net NPAs decreased 25% QoQ. Provision coverage increased to 84% in 2QFY08 from 81% in 2QFY07 and 79% in 1QFY08.

Valuation and view

Significant decline in margins and CASA ratio over the last couple of quarters is concerning. While liability growth remained strong, asset growth at 25% is disappointing considering merger of BhOB during 2QFY08. Consistently improving asset quality trends and built up of traction in core fees over past couple of quarters is, however, impressive.

We have downgraded our earnings estimate by 2.3% for FY08 and 6% for FY09 on account of steep decline in margins for the bank. While we expect RoA to decline to 1.2% by FY09; RoE would remain superior at 25-26% over next two years. The stock trades at 5.3x FY09E EPS and 1.2x FY09E BV. Maintain **Buy**.

Indian Overseas Bank: an investment profile

Company description

Indian Overseas Bank (IOB), with a balance-sheet size of over Rs750b+, ranks among the 10 largest banks in India. Predominantly spread in the southern region of India, the bank has a network of over ~1,800 branches and 5 overseas branches. After the bank introduced IPOs in 2000 and 2003, the government's stake has reduced to 61.2%.

Key investment arguments

- ✍ Consistent improvement in performance parameters over the last several quarters.
- ✍ One of the best margins in the industry; maintained high margins over six quarters.
- ✍ We expect the bank to maintain high RoAs and RoEs of 1.2-1.3% and 25-26% for FY08 and FY09.

Key investment risks

- ✍ CASA has declined sharply in the last one year. We believe margins would remain under pressure as cost of funds maintains upward trend.
- ✍ High treasury profits increase the volatility of earnings.

COMPARATIVE VALUATIONS

| | | IOB | ANDHRA BK | INDIAN BK |
|-----------|-------|------|-----------|-----------|
| P/E (x) | FY08E | 6.3 | 6.9 | 6.6 |
| | FY09E | 5.3 | 6.1 | 5.3 |
| P/ABV (x) | FY08E | 1.6 | 1.2 | 1.6 |
| | FY09E | 1.3 | 1.1 | 1.3 |
| RoE (%) | FY08E | 26.9 | 18.4 | 25.5 |
| | FY09E | 25.5 | 18.8 | 26.0 |
| RoA (%) | FY08E | 1.3 | 1.2 | 1.6 |
| | FY09E | 1.2 | 1.2 | 1.6 |

SHAREHOLDING PATTERN (%)

| | SEP-07 | JUN-07 | SEP-06 |
|---------------|--------|--------|--------|
| Promoter | 61.2 | 61.2 | 61.2 |
| Domestic Inst | 6.0 | 5.8 | 4.5 |
| Foreign | 19.3 | 18.2 | 18.3 |
| Others | 13.5 | 14.8 | 16.0 |

Recent developments

- ✍ IOB in joint venture with four other parties including Allahabad Bank and Karnataka Bank would float a general insurance company.
- ✍ IOB has taken over Bharat Overseas Bank (erstwhile associate of the bank) adding ~100 branches to its network and presence in Thailand. The acquisition price paid by IOB is reasonable in our view.

Valuation and view

- ✍ Consistent performance and improvement from the bank deserves a valuation premium.
- ✍ Bank could be an active participant in the consolidation process.
- ✍ Stock trades at P/E of 5.3x on FY09E EPS and P/BV of 1.2x on FY09E BV. We reiterate our **Buy** recommendation.

Sector view

- ✍ YTD loan growth of 23% and deposit growth of 25%.
- ✍ Macro economic factors remain conducive for strong profitable growth.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings and valuations.
- ✍ We maintain an overweight stance on the sector.

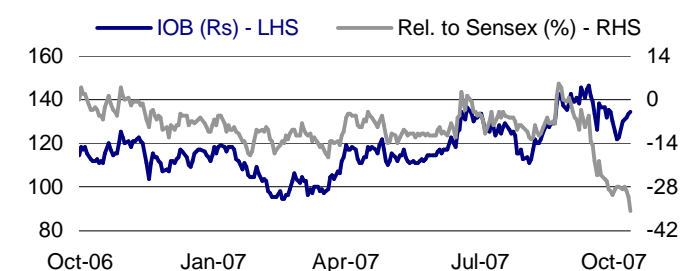
EPS: MOST FORECAST VS CONSENSUS (RS)

| | MOST FORECAST | CONSENSUS FORECAST | VARIATION (%) |
|------|---------------|--------------------|---------------|
| FY08 | 21.5 | 22.4 | -4.1 |
| FY09 | 25.2 | 23.6 | 6.8 |

TARGET PRICE AND RECOMMENDATION

| CURRENT PRICE (RS) | TARGET PRICE (RS) | UPSIDE (%) | RECO. |
|--------------------|-------------------|------------|-------|
| 135 | 175 | 29.9 | Buy |

STOCK PERFORMANCE (1 YEAR)



| INCOME STATEMENT | | (RS MILLION) | | | |
|----------------------------|---------------|---------------|---------------|---------------|--|
| Y/E MARCH | 2006 | 2007 | 2008E | 2009E | |
| Interest Income | 44,063 | 58,321 | 79,034 | 96,376 | |
| Interest Expended | 23,391 | 32,713 | 51,015 | 63,737 | |
| Net Interest Income | 20,672 | 25,608 | 28,020 | 32,639 | |
| Change (%) | 11.4 | 23.9 | 9.4 | 16.5 | |
| Other Income | 5,411 | 3,870 | 5,953 | 7,666 | |
| Net Income | 26,083 | 29,478 | 33,972 | 40,305 | |
| Change (%) | 4.5 | 13.0 | 15.2 | 18.6 | |
| Operating Expenses | 12,616 | 13,878 | 15,598 | 17,683 | |
| Operating Income | 13,467 | 15,600 | 18,375 | 22,621 | |
| Change (%) | 0.7 | 15.8 | 17.8 | 23.1 | |
| Other Provisions | 3,611 | 1,866 | 2,100 | 3,300 | |
| PBT | 9,856 | 13,734 | 16,275 | 19,321 | |
| Tax | 2,023 | 3,650 | 4,557 | 5,603 | |
| Tax Rate (%) | 20.5 | 26.6 | 28.0 | 29.0 | |
| PAT | 7,834 | 10,084 | 11,718 | 13,718 | |
| Change (%) | 20.3 | 28.7 | 16.2 | 17.1 | |
| Proposed Dividend | 1,416 | 1,634 | 1,907 | 2,179 | |

| BALANCE SHEET | | (RS MILLION) | | | |
|---------------------------|----------------|----------------|------------------|------------------|--|
| Y/E MARCH | 2006 | 2007 | 2008E | 2009E | |
| Capital | 5,448 | 5,448 | 5,448 | 5,448 | |
| Reserves & Surplus | 26,326 | 34,456 | 43,943 | 55,111 | |
| Net Worth | 31,774 | 39,904 | 49,391 | 60,559 | |
| Deposits | 505,293 | 687,404 | 852,381 | 1,022,857 | |
| Change (%) | 14.2 | 36.0 | 24.0 | 20.0 | |
| Borrowings | 7,366 | 28,962 | 36,203 | 45,254 | |
| Other Liabilities & Prov. | 49,144 | 66,298 | 76,243 | 83,867 | |
| Total Liabilities | 593,578 | 822,568 | 1,014,218 | 1,212,537 | |
| Current Assets | 37,072 | 89,793 | 109,304 | 126,184 | |
| Investments | 189,523 | 239,745 | 287,694 | 330,848 | |
| Change (%) | -0.3 | 26.5 | 20.0 | 15.0 | |
| Advances | 347,562 | 470,603 | 592,960 | 729,340 | |
| Change (%) | 37.9 | 35.4 | 26.0 | 23.0 | |
| Net Fixed Assets | 4,577 | 5,107 | 5,207 | 5,207 | |
| Other Assets | 14,843 | 17,321 | 19,053 | 20,959 | |
| Total Assets | 593,578 | 822,568 | 1,014,218 | 1,212,537 | |

| ASSUMPTIONS | (%) | | | |
|--------------------|------|------|------|------|
| Deposit Growth | 14.2 | 36.0 | 24.0 | 20.0 |
| Advances Growth | 37.9 | 35.4 | 26.0 | 23.0 |
| Investments Growth | -0.3 | 26.5 | 20.0 | 15.0 |
| Dividend | 26.0 | 30.0 | 35.0 | 40.0 |

E: MOST Estimates

| RATIOS | | 2006 | 2007 | 2008E | 2009E |
|-----------------------------|--|------|------|-------|-------|
| Spreads Analysis (%) | | | | | |
| Avg. Yield - Earning Assets | | 8.3 | 8.5 | 8.9 | 8.9 |
| Avg. Cost-Int. Bear. Liab. | | 4.9 | 5.3 | 6.4 | 6.5 |
| Interest Spread | | 3.4 | 3.2 | 2.5 | 2.4 |
| Net Interest Margin | | 3.9 | 3.7 | 3.2 | 3.0 |

| Profitability Ratios (%) | | 2006 | 2007 | 2008E | 2009E |
|---------------------------|--|------|------|-------|-------|
| RoE | | 28.5 | 29.1 | 26.9 | 25.5 |
| RoA | | 14 | 14 | 13 | 12 |
| Int. Expended/Int. Earned | | 53.1 | 56.1 | 64.5 | 66.1 |
| Other Inc./Net Income | | 20.7 | 13.1 | 17.5 | 19.0 |

| Efficiency Ratios (%) | | 2006 | 2007 | 2008E | 2009E |
|------------------------|--|------|------|-------|-------|
| Op. Exps./Net Income | | 48.4 | 47.1 | 45.9 | 43.9 |
| Empl. Cost/Op. Exps. | | 70.8 | 67.1 | 65.7 | 63.4 |
| Busi. per Empl. (Rs m) | | 32.0 | 42.0 | 52.1 | 64.2 |
| NP per Empl. (Rs lac) | | 3.2 | 4.2 | 4.7 | 5.5 |

| Asset-Liability Profile (%) | | 2006 | 2007 | 2008E | 2009E |
|-----------------------------|--|------|------|-------|-------|
| Adv./Deposit Ratio | | 68.8 | 68.5 | 69.6 | 71.3 |
| Invest./Deposit Ratio | | 37.5 | 34.9 | 33.8 | 32.3 |
| G-Sec/Invest. Ratio | | 81.9 | 86.2 | 86.2 | 89.9 |
| Gross NPAs to Adv. | | 3.4 | 2.3 | 2.1 | 2.1 |
| Net NPAs to Adv. | | 0.7 | 0.5 | 0.6 | 0.6 |
| CAR | | 13.0 | 13.3 | 12.0 | 11.7 |
| Tier 1 | | 8.5 | 8.2 | 7.5 | 7.2 |

| VALUATION | | 2006 | 2007 | 2008E | 2009E |
|--------------------|--|------|------|-------|-------|
| Book Value (Rs) | | 56.1 | 71.1 | 88.6 | 109.2 |
| Price-BV (x) | | 2.4 | 19 | 15 | 12 |
| Adjusted BV (Rs) | | 53.4 | 68.0 | 84.1 | 103.5 |
| Price-ABV (x) | | 2.5 | 2.0 | 16 | 13 |
| EPS (Rs) | | 14.4 | 18.5 | 21.5 | 25.2 |
| EPS Growth (%) | | 20.3 | 28.7 | 16.2 | 17.1 |
| Price-Earnings (x) | | 9.4 | 7.3 | 6.3 | 5.3 |
| OPS (Rs) | | 24.7 | 28.6 | 33.7 | 41.5 |
| OPS Growth (%) | | 0.7 | 15.8 | 17.8 | 23.1 |
| Price-OP (x) | | 5.4 | 4.7 | 4.0 | 3.2 |

E: MOST Estimates



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Indian Overseas Bank

- | | |
|---|-----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | Yes |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with Company covered | No |

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