Union Bank Of India (UNBK.BO)

Buy: 2Q08 Results: Growth, but at a Cost

- **2Q08 profits up 42%, though qualitatively weak** — Union's strong profit growth likely masks an operationally weak quarter. Key pressure point was on margins; though growth was high - was also the likely cause for margin reduction. Key positives: fees and sustained asset quality improvement. Maintain Buy (1L).
- **Margins: second consecutive quarter of sharp declines** — 2Q08 NIMs declined sharply to 256bps (-55bps qoq) after a sharp 40bps fall in 1Q08. Though yoy decline in margins is a more modest 20bps – this does not reflect the true extent of margin erosion, due to a lower base effect in 2Q07 (average margins for the last 3 quarters were about 320bps).
- **Higher growth: likely cause of margin pressure —** In what seems to be a repeat of 2Q07, margins declined sharply, in a high-growth quarter (loans increased +8% qoq). This does suggests that structurally Union is finding it difficult to co-manage high growth and profitability; should remain its key challenge.
- **Asset quality: sustained improvement** — Union's asset quality performance remained impressive and with absolute reductions in Gross NPLs (2.4% of loans against 3.3% in 2Q07). Delinquencies were contained at 1.3%; suggests sustained direction and management focus on balance sheet quality.
- **Fee incomes: some positives but boosted by recoveries** — Though headline non-interest income growth (+77% yoy) was boosted by trading gains and recoveries, core fees also remained healthy with a 36% yoy increase.

Buy/Low Risk	**1L**
Price (24 Oct 07)	Rs161.30
Target price	Rs180.00
Expected share price return	11.6%
Expected dividend yield	2.2%
Expected total return	**13.8%**
Market Cap	Rs81,476M US$2,058M

Price Performance (RIC: UNBK.BO, BB: UNBK IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	6,750	13.99	-10.5	11.5	1.8	16.5	2.2
2007A	8,454	16.74	19.7	9.6	1.6	17.3	2.1
2008E	10,472	20.73	23.9	7.8	1.4	18.7	2.2
2009E	12,437	24.62	18.8	6.6	1.2	19.0	2.5
2010E	14,513	28.73	16.7	5.6	1.0	19.0	2.8

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	11.5	9.6	7.8	6.6	5.6
P/E reported (x)	11.5	9.6	7.8	6.6	5.6
P/BV (x)	1.8	1.6	1.4	1.2	1.0
P/Adjusted BV diluted (x)	2.0	1.7	1.5	1.2	1.0
Dividend yield (%)	2.2	2.1	2.2	2.5	2.8
Per Share Data (Rs)					
EPS adjusted	13.99	16.74	20.73	24.62	28.73
EPS reported	13.99	16.74	20.73	24.62	28.73
BVPS	90.24	102.75	119.40	139.45	163.11
Tangible BVPS	90.24	102.75	119.40	139.45	163.11
Adjusted BVPS diluted	81.02	93.53	110.18	130.23	153.89
DPS	3.50	3.41	3.50	4.00	4.50
Profit & Loss (RsM)					
Net interest income	23,743	27,902	30,956	35,424	40,342
Fees and commissions	2,178	2,737	3,147	3,525	3,948
Other operating Income	4,073	5,681	5,867	6,414	7,016
Total operating income	**29,994**	**36,320**	**39,970**	**45,363**	**51,306**
Total operating expenses	-14,024	-14,759	-16,536	-18,536	-20,788
Oper. profit bef. provisions	**15,970**	**21,561**	**23,434**	**26,826**	**30,517**
Bad debt provisions	-1,560	-3,300	-4,259	-5,107	-6,067
Non-operating/exceptionals	-5,470	-4,457	-4,214	-3,953	-3,717
Pre-tax profit	**8,940**	**13,804**	**14,961**	**17,767**	**20,733**
Tax	-2,190	-5,350	-4,488	-5,330	-6,220
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**6,750**	**8,454**	**10,472**	**12,437**	**14,513**
Adjusted earnings	6,750	8,454	10,472	12,437	14,513
Growth Rates (%)					
EPS adjusted	-10.5	19.7	23.9	18.8	16.7
Oper. profit bef. prov.	1.5	35.0	8.7	14.5	13.8
Balance Sheet (RsM)					
Total assets	**891,260**	**1,026,779**	**1,202,582**	**1,397,737**	**1,621,176**
Avg interest earning assets	788,786	937,666	1,090,612	1,274,525	1,482,044
Customer loans	549,219	639,333	760,924	889,568	1,031,388
Gross NPLs	20,981	18,727	28,392	33,602	39,531
Liab. & shar. funds	**891,260**	**1,026,779**	**1,202,582**	**1,397,737**	**1,621,176**
Total customer deposits	740,943	851,802	1,011,622	1,187,928	1,389,455
Reserve for loan losses	15,420	15,468	18,525	20,961	23,805
Shareholders' equity	**45,582**	**51,899**	**60,313**	**70,439**	**82,390**
Profitability/Solvency Ratios (%)					
ROE adjusted	16.5	17.3	18.7	19.0	19.0
Net interest margin	3.01	2.98	2.84	2.78	2.72
Cost/income ratio	46.8	40.6	41.4	40.9	40.5
Cash cost/average assets	1.7	1.5	1.5	1.4	1.4
NPLs/customer loans	3.8	2.9	3.7	3.8	3.8
Reserve for loan losses/NPLs	73.5	82.6	65.2	62.4	60.2
Bad debt prov./avg. cust. loans	0.3	0.6	0.6	0.6	0.6
Loans/deposit ratio	74.1	75.1	75.2	74.9	74.2
Tier 1 capital ratio	7.3	7.8	7.2	7.3	7.5
Total capital ratio	11.4	12.8	11.1	11.0	11.0

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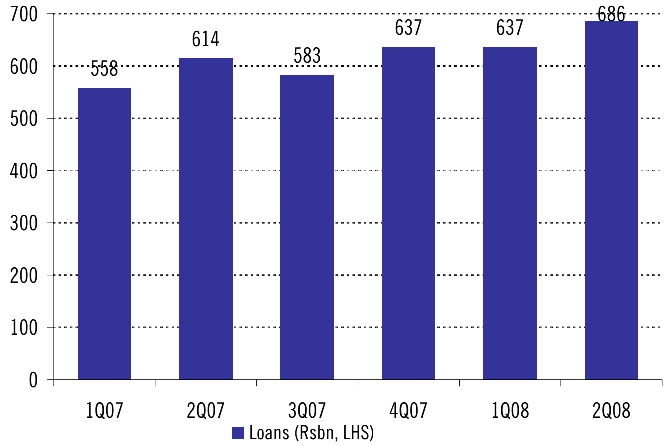
Figure 1. Union Bank – 2Q08 Results: Key Highlights (Rupees Million, Percent)

	2Q08	2Q07	YoY %	1Q08	QoQ%	Citi Investment Research Comments
Interest Income	22,548	17,724	27.2	21,112	6.8	Driven by improvements in yields even as loan growth remains below industry levels
Interest Expense	-15,820	-11,449	38.2	-13,399	18.1	Sharp increase in costs of funds - over 70bps in the quarter; suggests funding of growth remains the key challenge for the bank
Net Interest Income	6,728	6,275	7.2	7,713	-12.8	Disappointing quarter - significantly below expectations due to a steep decline in margins
NII - Net of Premium on amortization	**6,358**	**5,885**	**8.0**	**7,343**	**-13.4**	
Fee-Based Income	2,270	1,540	47.4	1,820	24.7	Boosted by asset recoveries, though core fees growth also remained healthy at about 36% yoy
Other Non-Interest Income	438	-12	NM	-37	NM	
Non Interest Income	2,708	1,525	77.6	1,783	51.9	Strong growth in trading gains on bond portfolio and asset recoveries
Operating Income	9,436	7,800	21.0	9,496	-0.6	
Operating Expenses	(4,153)	(3,910)	6.2	(4,242)	-2.1	Costs largely controlled; sustained improvement in cost income ratios
Pre-Provision Profit	5,283	3,890	35.8	5,254	0.6	
Pre-Provision Profit (ex-trading gains)	**4,845**	**3,903**	**24.2**	**5,291**	**-8.4**	**Sharp reduction in operating performance over the quarter; 9% below expectations**
Charges for Bad Debts	(940)	(700)	34.3	(1,280)	-26.6	Asset quality continues to improve - among the key highlights for the quarter
Other Operating Items	(36)	(127)	-72.0	(274)	-87.0	
Operating Profit	4,308	3,063	40.6	3,701	16.4	
Pre-Tax Profit	4,308	3,063	40.6	3,701	16.4	
Tax	(1,550)	(1,122)	38.2	(1,450)	6.9	
Net Profit	**2,757.8**	**1,942**	**42.0**	**2,250.6**	**22.5**	**Strong headline profits - 12% above expectations - though boosted by strong trading gains on bond portfolio and asset recoveries**
EPS	5.46	3.84	42.0	4.46	22.5	
Customer Loans	685,950	614,440	11.6	637,080	7.7	Higher growth in the quarter - after a flat 1Q08. Likely cause for margin pressure and suggests structural concern in managing higher growth and profitability simultaneously
Customer Deposits	948,040	785,280	20.7	869,840	9.0	Accelerated deposit growth though more growth in higher cost term deposits as low cost deposit ratio slips to 32.5% from 33.3% in the previous quarter
AIEA	1,051,384	933,120	12.7	991,872	6.0	
AIBL	883,207	752,816	17.3	833,214	6.0	
Total Assets	1,062,306	954,630	11.3	1,041,476	2.0	
Avg Assets	1,051,891	931,858	12.9	1,024,300	2.7	
Non-Performing Loans (NPL)	16,593	20,160	-17.7	17,690	-6.2	Sustained improvement with reductions in absolute NPLs and containment in delinquencies - suggests strong focus on balance sheet quality
Loan Loss Reserves (LLR)	(12,227)	(12,717)	-3.9	(12,830)	-4.7	
Shareholders' Funds	52,288	44,535	17.4	49,531	5.6	
Book Value Per Share	103.54	88.19	17.4	98	5.6	
Key Ratios (%)	**2Q08**	**2Q07**	**Bps Δ YoY**	**1Q08**	**Bps Δ QoQ**	**Citi Investment Research Comments**
ROAA (annualized)	1.04	0.83	20	0.86	17	
ROAE (annualized)	21.10	17.44	366	18.18	292	
Net Interest Margin (bps)	256	276	-20	311	-55	Second consecutive quarter of sharp declines - yoy decline masked by a low base effect as 2Q07 margins had also declined sharply in a similar, high growth quarter
Fee Inc/Operating Income	24.1	19.7	431	19.2	489	
Other Non-Interest Inc/Op Inc	28.7	19.5	915	18.8	992	
Op. Cost/ Operating Income	44.0	50.1	-612	44.7	-66	
Loan-to-Deposit Ratio (LDR)	72.4	78.2	-589	73.2	-89	
NPL/Loan Ratio	2.4	3.3	-86	2.8	-36	
LLR/NPL Ratio	74	63	1,061	73	116	
NIM (net of amortization)	**242**	**252**	**-10**	**296**	**-54**	

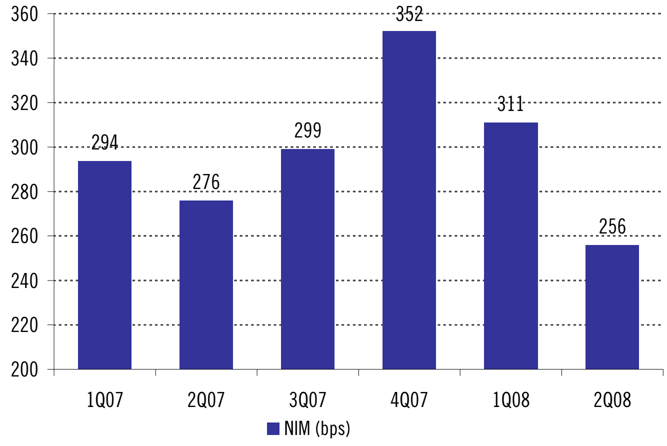
Source: Company Reports and Citi Investment Research

Figure 2. Union Bank – Loan growth acceleration in 2QFY07 and 2QFY08 ...



Source: Company Reports

Figure 3. ...Led to a decline in margins



Source: Company Reports

Union Bank Of India

Company description

Union Bank is the seventh largest bank in India and sixth largest government bank, with a large balance sheet size and diversified distribution network. It currently has 2206 branches and 769 ATMs spread across the country. Its business is distributed across the country with a slight concentration in Western India. Union Bank listed in 2002. A follow-on offer was transacted in February 2006, with the government holding a 55% stake in the bank.

Investment strategy

We rate Union Bank Buy/Low Risk (1L) with a target price of Rs180. Union has four key strengths, in our view: large balance sheet and distribution; low operating costs (as a proportion of assets), below industry averages; good technology, ahead of its peer group in implementation; and a clean balance sheet with low gross and net NPLs, improving above industry levels. However, the risks to Union lie in its low balance sheet liquidity, and the need to grow term deposits rapidly to fund loan growth. The stock price is up 46% since April '07. We believe, given Union's sharper focus on profitability, creation of a track record in sticking to fundamentals and a favorable industry outlook, Union could trade at valuations higher than peers and offers reasonable upside potential to our target price.

Valuation

Our target price of Rs180 (Rs125 earlier) is based on our EVA model, which we believe captures the long-term value of the business and is a standard valuation measure for our India banking coverage. We are factoring in a riskfree rate of 8% while maintaining an industry average margin (230bps) and a slightly lower than industry average cost income ratio (42% vs average 45%). We are also benchmarking our target price on a 1.4x FY09E PBV (1.25x one-year forward earlier). This translates to a fair value of Rs182. We believe that Union could trade at higher than peers' multiples due to its sharp focus on growth and shareholder value, lead on utilizing technology for consistent fee income growth, its above-sector average RoE, lower bond risk relative to peers and large and scaled balance sheet. We think Union is likely pulling ahead of peers and could be valued higher than peers despite its relatively higher risk to margins and earnings or to loan growth from the lack of surplus liquidity and the need to grow deposits rapidly. We use EVA as a primary methodology as we believe it better adjusts for the relatively dynamic cost of capital, and as it is usually the more conservative target price in a difficult interest rate environment.

Risks

We rate Union Bank Low Risk, based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Key downside risks that could impede the stock from reaching our target price are: low surplus balance sheet liquidity; modest deposit mix; reversal in loans growth and asset quality; large bond portfolio could erode economic value; and some geographic concentration in Western India.

Appendix A-1

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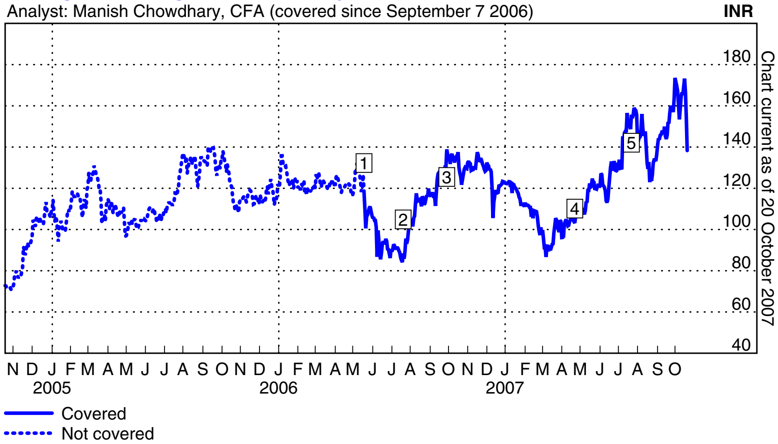
Union Bank Of India (UNBK.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Manish Chowdhary, CFA (covered since September 7 2006)



#	Date	Rating	Target Price	Closing Price
1:	18 May 06	2L	135.00	118.15
2:	20 Jul 06	2L	*96.00	88.35
3:	28 Sep 06	*3L	*125.00	138.90
4:	23 Apr 07	*1L	125.00	103.20
5:	23 Jul 07	1L	*180.00	155.65

*Indicates change.

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