

Company

26 July 2010 | 8 pages

Union Bank Of India (UNBK.BO)

 Equity

1Q10 Results: Quantitatively Fine; Qualitative Decline

- 1Q11 profits up 36%; 6% above our estimates** – Union’s 1Q11 profits increased 36% yoy and were sustained by its strong loan growth (+30% yoy), higher NIMs (+74bps yoy) and sharply lower loan loss charges. However, qualitatively, we believe all was not so well – pains of growing were beginning to show up in NIM pressure (down 34bps qoq, higher than peers), decline in fee income growth, increase in operating costs (mostly permanent) and higher delinquencies. While the numbers look good, we believe, qualitatively this is a modest quarter.
- P&L: NIMs off peak, costs high, but watch for credit costs** — Union’s NIMs have fallen sharply (-34bps qoq) from their peak in 4Q10, core fee income growth dropped to 10% yoy (management though confident of regaining momentum) and operating costs increased 46% yoy (some one-offs in employee costs, but we believe largely recurring). This was, however, offset by higher trading gains qoq and a sharp decline in loan loss charges (sharply lowering coverage levels). We believe it raises income volatility going forward and, coupled with management guidance of delinquencies peaking in 2Q, could impact earnings meaningfully.
- Balance sheet: Growth, but watch the quality** — Union’s loan growth remains strong (+30% yoy), broad based and management maintains its 25% guidance for FY11. Its deposit franchise has sustained with improved CASA levels of 32%. However, we believe a rise in delinquencies (2.6% annualized) and lower coverage levels imply lesser cushion to absorb likely NPL pressures. Management guides to some pressures in 2Q – but improving thereafter, maintains its full-year guidance of 2.1% NPLs (2.2% currently).
- Maintain Sell: Good earnings profile but at risk of higher delinquencies** — Union’s overall return profile remains above most peers, but its higher valuations and near-term risk from higher delinquencies suggest downside pressures.

Sell/Low Risk	3L
Price (26 Jul 10)	Rs320.80
Target price	Rs275.00
Expected share price return	-14.3%
Expected dividend yield	1.6%
Expected total return	-12.7%
Market Cap	Rs162,042M US\$3,454M

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


Figure 1. Statistical Abstract

Year to	Net Profit	FD EPS	EPS Growth	P/E	P/BV	RoAE	ROAA	Div Yld
March	(Rs Mills.)	(Rs)	(%)	(X)	(X)	(%)	(%)	(%)
FY08	13,870	27.5	64.1	11.7	2.9	22.1	1.2	1.2
FY09	17,266	34.2	24.5	9.4	2.3	21.5	1.2	1.6
FY10E	19,435	38.5	12.6	8.3	1.9	20.3	1.1	1.6
FY11E	23,563	46.6	21.2	6.9	1.5	20.6	1.2	1.7
FY12E	27,123	53.7	15.1	6.0	1.2	19.9	1.2	1.7

Source: Citi Investment Research and Analysis estimates

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Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	11.7	9.4	8.3	6.9	6.0
P/E reported (x)	11.7	9.4	8.3	6.9	6.0
P/BV (x)	2.2	1.9	1.6	1.3	1.1
P/Adjusted BV diluted (x)	2.9	2.3	1.9	1.5	1.2
Dividend yield (%)	1.2	1.6	1.6	1.7	1.7
Per Share Data (Rs)					
EPS adjusted	27.46	34.18	38.48	46.65	53.70
EPS reported	27.46	34.18	38.48	46.65	53.70
BVPS	145.47	173.04	205.94	246.51	294.14
Tangible BVPS	145.47	173.04	205.94	246.51	294.14
Adjusted BVPS diluted	111.33	139.66	172.56	213.14	260.76
DPS	4.00	5.00	5.00	5.50	5.50
Profit & Loss (RsM)					
Net interest income	28,537	38,136	38,250	48,834	56,491
Fees and commissions	3,010	3,133	3,697	4,140	4,637
Other operating Income	10,187	11,693	16,273	15,279	17,031
Total operating income	41,733	52,961	58,220	68,254	78,159
Total operating expenses	-15,930	-22,141	-24,012	-26,863	-29,833
Oper. profit bef. provisions	25,803	30,820	34,207	41,390	48,326
Bad debt provisions	-6,652	-6,266	-5,442	-6,728	-8,578
Non-operating/exceptionals	-547	-989	-1,000	-1,000	-1,000
Pre-tax profit	18,604	23,566	27,765	33,662	38,748
Tax	-4,734	-6,300	-8,329	-10,099	-11,624
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	13,870	17,266	19,435	23,563	27,123
Adjusted earnings	13,870	17,266	19,435	23,563	27,123
Growth Rates (%)					
EPS adjusted	64.1	24.5	12.6	21.2	15.1
Oper. profit bef. prov.	19.7	19.4	11.0	21.0	16.8
Balance Sheet (RsM)					
Total assets	1,239,919	1,609,755	1,826,216	2,117,546	2,456,541
Avg interest earning assets	1,102,470	1,388,503	1,680,514	1,929,314	2,241,614
Customer loans	762,110	986,256	1,128,149	1,325,136	1,570,225
Gross NPLs	16,578	19,235	20,642	21,735	24,630
Liab. & shar. funds	1,239,919	1,609,755	1,826,216	2,117,546	2,456,541
Total customer deposits	1,038,586	1,387,028	1,578,539	1,840,551	2,146,121
Reserve for loan losses	19,441	20,914	18,005	19,679	22,010
Shareholders' equity	73,477	87,404	104,023	124,519	148,574
Profitability/Solvency Ratios (%)					
ROE adjusted	22.1	21.5	20.3	20.6	19.9
Net interest margin	2.59	2.75	2.28	2.53	2.52
Cost/income ratio	38.2	41.8	41.2	39.4	38.2
Cash cost/average assets	1.4	1.6	1.4	1.4	1.3
NPLs/customer loans	2.2	2.0	1.8	1.6	1.6
Reserve for loan losses/NPLs	117.3	108.7	87.2	90.5	89.4
Bad debt prov./avg. cust. loans	0.9	0.7	0.5	0.5	0.6
Loans/deposit ratio	73.4	71.1	71.5	72.0	73.2
Tier 1 capital ratio	7.5	8.2	7.6	8.0	8.4
Total capital ratio	12.5	13.3	11.8	11.9	11.5

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Figure 2. Union Bank of India: 1Q11 Financial Highlights (Rupees Million, Percent)

	1Q11	1Q10	YoY %	4Q10	QoQ%	CIRA Comments
Interest Income	36,859	31,753	16.1	35,617	3.5	
Interest Expense	-23,378	-23,737	-1.5	-21,656	8.0	107bps reduction in cost of funds
Net Interest Income	13,480	8,016	68.2	13,961	-3.4	Significant increase - largely due to funding cost gains, as well as a strong loan growth
Fee-Based Income	2,800	3,197	-12.4	4,775	-41.4	Disappointing with loss of the healthy momentum exhibited in recent quarters
Other Non-Interest Income	1,550	2,090	-25.8	150	933.3	Relatively subdued and in-line with most peers
Non Interest Income	4,350	5,287	-17.7	4,925	-11.7	
Operating Income	17,830	13,303	34.0	18,887	-5.6	
Operating Expenses	(7,393)	(5,429)	36.2	(7,411)	-0.2	Sharp increase, much higher than peers, management says includes one-offs for employee benefits - we believe partly recurring e.g pension costs (Rs0.6bn every quarter)
Pre-Provision Profit	10,437	7,875	32.5	11,475	-9.0	
Pre-Provision Profit (ex-trading gains and one-offs)	8,887	5,785	53.6	11,325	-21.5	Healthy, but slightly below estimates as cost rises moderate an otherwise healthy revenue quarter
Charges for Bad Debts	(1,090)	(2,860)	-61.9	(3,610)	-69.8	Sharp reduction, but management warned of further slippages, expecting it to peak next quarter
Other Operating Items	(883)	957	NM	210	NM	
Operating Profit	8,464	5,972	41.7	8,075	4.8	
Pre-Tax Profit	8,464	5,972	41.7	8,075	4.8	
Tax	(2,450)	(1,550)	58.1	(2,140)	14.5	
Net Profit	6,014	4,422	36.0	5,935	1.3	Overall, a reasonable quarter but increasing pains on NIMs and asset quality starting to show
EPS	11.91	8.76	36.0	11.75	1.3	
DPS	0.0	0.0	NM	5.5	NM	
Customer Loans	1,247,430	960,260	29.9	1,212,490	2.9	Strong growth and management continues to maintain its targeted 25% growth this year
Customer Deposits	1,714,840	1,438,890	19.2	1,700,400	0.8	CASA deposits are sustained at 32.5% and can be a key support in a rising rate environment
AIEA	1,778,917	1,398,222	27.2	1,654,110	7.5	
AIBL	1,707,620	1,412,960	20.9	1,605,625	6.4	
Total Assets	2,013,757	1,678,131	20.0	1,990,576	1.2	
Avg Assets	2,002,166	1,648,242	21.5	1,930,246	3.7	
Risk-Weighted Assets	0	0	NM	0	NM	
Avg RWA	0	0	NM	0	NM	
Non-Performing Loans (NPL)	27,356	18,740	46.0	26,709	2.4	Largely stable - though management suggests more deterioration likely in 2Q; will be watched keenly
Loan Loss Reserves (LLR)	(15,860)	(11,970)	32.5	(17,056)	-7.0	some reduction in coverage levels - has significantly come down form a year ago
Shareholders' Funds	93,580	77,921	20.1	88,078	6.2	
Book Value Per Share	185.3	154.3	20.1	174.4	6.2	
Key Ratios (%)	1Q11	1Q10	Bps Δ YoY	4Q10	Bps Δ QoQ	
ROAA (annualized)	1.20	1.07	13	1.23	-3	
ROAE (annualized)	25.71	22.70	301	26.95	-125	
Net Interest Margin (bps)	303	229	74	338	-34	Pressures of high growth and rising interest rates starting to show - has long been Union's Achilles Heel
Fee Inc/Operating Income	15.7	24.0	-833	25.3	-958	Fee income momentum moderating - though management confident of 30% growth for FY11
Other Non-Interest Inc/Op Inc	24.4	39.7	-1535	26.1	-168	
Op. Cost/ Operating Income	41.5	40.8	66	39.2	222	Has remained in-line; though pressures clearly evident and is partly recurring
Loan-to-Deposit Ratio (LDR)	72.7	66.7	601	71.3	144	
NPL/Loan Ratio	2.19	1.95	24	2.2	-1	Management guides to 2.1% NPLs by March 2011
LLR/NPL Ratio	58	64	-590	64	-588	
Reported LLR (Incl Technical w/o)	71	93	-2,155	74	-290	Continued decline in coverage levels - will make it vulnerable to higher delinquencies near term
Amount of Technical w/o's included	12,451	73,611	-83.1	10,448	19.2	

Source: Citi Investment Research and Analysis, Company

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 2,821 branches and 2,127 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 Sell/Low Risk. Union has key strengths with its large balance sheet and distribution, low operating costs (as a proportion of assets) below industry average, 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: 1) Its low balance sheet liquidity, and the need to grow term deposits rapidly to fund loan growth; 2) Its relatively lower capital cushion, which is likely to moderate asset growth in a higher growth environment; 3) Its NIMs have been impacted recently due to dependence on bulk deposits induced by the highly volatile interest rate environment. We believe Union's current valuations are pricing in most of the upside and leave little room for outperformance.

Valuation

Our target price of Rs275 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 risk-free rate of 8.0%, with an industry average spread (200bps) and a longer term cost income ratio of 37%. We also benchmark our target price on a 1.3x 1Yr Fwd PBV, which translates to a fair value of Rs293. We believe Union should trade at a 10% discount to the larger banks like SBI and PNB, due to: 1) its lower capital cushion which is likely to cap upside in a higher growth environment; 2) its modest deposit mix, which increases dependence on wholesale funding; and 3) sharp increase in restructured assets. Additionally, Union's NIMs have come under pressure and could remain subdued as its high cost bulk deposits are likely to re-price with a lag. 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, as opposed to the Medium Risk suggested by our quantitative risk rating system, which tracks 260-day historical share price volatility, given Union's large balance sheet, strong management and superior return profile. Key upside risks which could sustain the shares above our target price include: 1) continued low interest rate environment which could support NIMs, 2) easing of asset quality pressures, 3) higher loan growth environment, and 4) improvement in its deposit mix.

Appendix A-1

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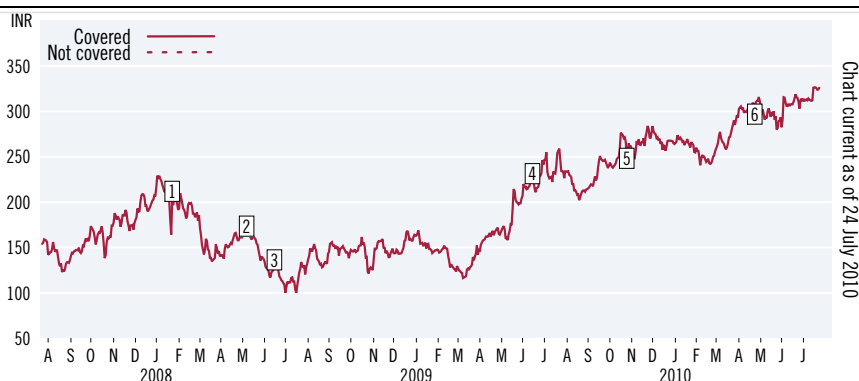
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Union Bank Of India (UNBK.BO)

Ratings and Target Price History

Fundamental Research

Analyst: Manish Chowdhary, CFA



Date	Rating	Target Price	Closing Price
1 23-Jan-08	1L	*242.00	200.05
2 7-May-08	1L	*217.00	173.55

Date	Rating	Target Price	Closing Price
3 16-Jun-08	1L	*165.00	129.80
4 14-Jun-09	*3L	*226.00	228.85

Date	Rating	Target Price	Closing Price
5 26-Oct-09	3L	*248.00	248.25
6 23-Apr-10	3L	*275.00	306.25

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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