kotak Institutional Equities

Punjab National Bank (PNB)

Banks/Financial Institutions

BUY

DECEMBER 18, 2009

UPDATE

Coverage view: Attractive

Price (Rs): 896

Target price (Rs): 930

BSE-30: 16,894

Business fundamentals remain impressive, retain BUY. PNB has ambitious plans to expand its reach over the next few years by leveraging its IT investments and drive growth over the next few years. The management appeared fairly hopeful about the outlook on asset quality and does not expect the gross NPL ratio to exceed 2%. The company's conservative provisioning policy provides it with significant cushion against adverse developments. We expect the company's RoE to remain healthy at around 20% over the next few years, retain BUY.

Company data and valuation summary

Punjab National Bank

Stock data			
52-week range (Rs) (high,low)			1,000-286
Market Cap. (Rs bn)			282.4
Shareholding pattern (%)			
Promoters			57.8
FIIs			19.1
MFs			3.4
Price performance (%)	**1M**	**3M**	**12M**
Absolute	(1.9)	17.0	78.1
Rel. to BSE-30	(1.0)	15.8	2.4

Forecasts/Valuations	2009	2010E	2011E
EPS (Rs)	98.0	110.4	118.6
EPS growth (%)	50.9	12.6	7.5
P/E (X)	9.1	8.1	7.6
NII (Rs bn)	70.3	81.8	97.1
Net profits (Rs bn)	30.9	34.8	37.4
BVPS	417.1	501.6	592.5
P/B (X)	2.1	1.8	1.5
ROE (%)	25.8	24.0	21.7
Div. Yield (%)	2.2	2.5	2.6

Ambitious plans to expand reach over the next three years

The management highlighted its strategy over the next few years to focus on steady business growth, (likely to outdo industry growth) with a continued focus on sustaining margins at current levels of 3.5%. Focus on the Indo-Gangetic basin is likely to continue – with a vision of Rs10 tn in business (loans + deposits) by March 2013, from Rs4 tn of business as of September 2009. The targeted customer base is 150 mn from the current levels of 44 mn customers by 2013.

PNB already has 100% of its branches under CBS and is working on financial inclusion projects in the Indo Gangetic belt (mainly in the states of Rajasthan and Uttar Pradesh). The focus is largely on customer acquisition by expanding branches / touch-points in the unbanked / under-banked areas. It intends to have 0.1 mn touch-points (branches, ATMs, kiosks and business correspondents) by 2013. This would help PNB garner retail deposits, CASA deposits and also enhance fee-based revenues over time.

Business growth likely to be slightly better than industry growth in the current fiscal

Credit growth for PNB has been slow in line with the broad industry trends. The management believes that the slower pick-up in loans may be due to credit substitution, with corporates accessing the commercial paper market to benefit from the lower interest rates rather than due to slackening of economic activity—a conclusion we concur with. The company expects credit demand to improve once there is a tightening of liquidity conditions and short-term interest rates move up. Overall, it expects credit growth to be marginally higher than industry growth in FY2010E and FY2011E. We estimate a 17% yoy growth in FY2010E and 21% yoy in FY2011E.

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However, the focus would be on margins rather than growth

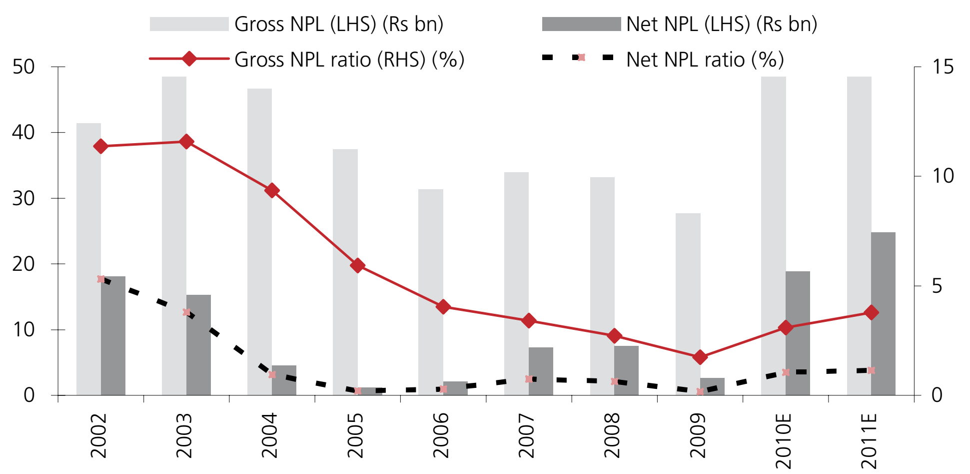
Despite slower industry growth and increasing competition on the lending side, the focus of the bank would continue to be on sustaining its current margin at 3.5%. The bank is willing to grow at a somewhat slower rate, but would not like to compromise on margins. The current strategy is similar - not to grow the balance sheet from short tenure loans, the bank is not comfortable lending below its PLR of 11%. PNB currently has the lowest PLRs amongst public banks, but the proportion of sub PLR loans is low. Even over the past few quarters, when most public banks had seen a sharp reduction in their margins, PNB managed its margins through better ALM management. The management highlighted that it would like to sustain margins at 3.5% and would increase the lending rates if its funding costs move up. With a 38% CASA franchisee and superior lending yield (on back of its loan mix in favor of SMEs and agriculture), we believe sustaining a 3.5% margins might not be a very difficult task for PNB.

Comfortable on asset quality despite high quantum of restructured loans

The management expects gross NPLs to be contained below 2% in a worst-case scenario (currently at 1.6% as of September 2009). Provision coverage remains a high 91% as of September 2009, which provides a fair amount of cushion against adverse credit shocks. Restructured loans are high at about 6% of its loan book but the management appeared sanguine on the overall asset quality and does not expect a sharp increase in delinquency from this stock of loans (delinquency out of its restructured assets may be less than 10%, as per the management). Incremental restructuring has been low post 2QFY09. Our slippages assumptions may turn out to be conservative if this assessment of the management turns out to be correct—2.8% in FY2010E and 2.3% in FY2011E against 1.4% observed in FY2009.

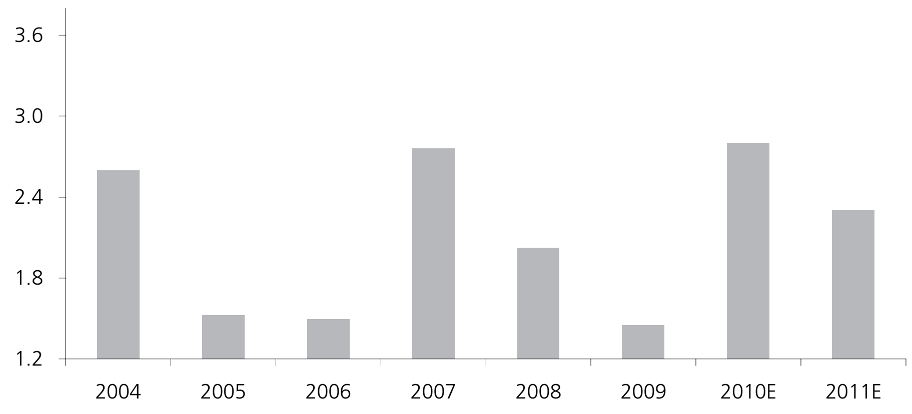
We assume a fairly sharp rise in delinquencies for PNB over the next few years

Gross NPLs, net NPLs of the company, March fiscal year-ends, 2002-2011E



Source: Company, Kotak Institutional Equities estimates

Incremental delinquency assumptions are steep compared to that observed in the past five years
Incremental delinquencies of PNB, March fiscal year-ends, 2004-2011E (%)

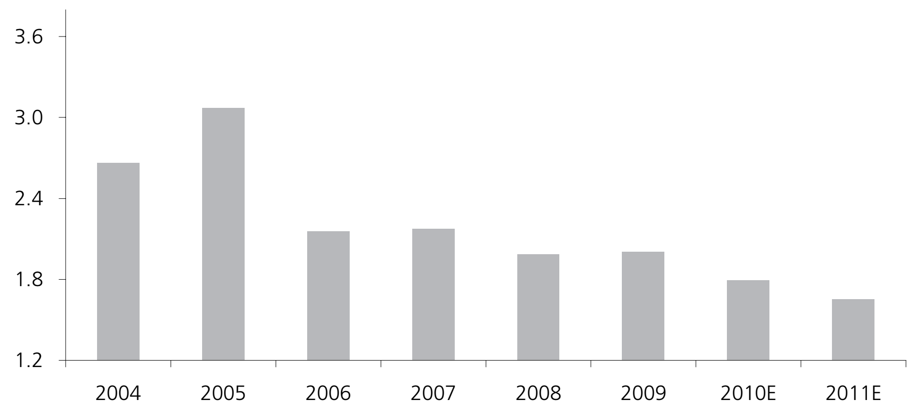


Source: Company, Kotak Institutional Equities estimates

Operating expense ratios unlikely to witness negative surprises

Over the past couple of years, PNB has made provisions assuming a 20% wage-hike. The actual hike has been finalized at 17.5% and thus PNB is likely to have some write-back on its employee expenses over the next few years. The additional burden on account of the second pension option is likely to be about Rs5 bn and could be spread over a 5-year period or PNB could utilize some of its excess provisions made in the past for funding this gap. Almost all of its CBS related expenses have already been incurred and is unlikely to increase from the current levels. Overall, the bank seems to have a fair cushion to manage its costs and could see operating leverage playing out over the next 2-3 years.

Operating expenses are likely to be under control and support earnings
Operating expenses to average assets, March fiscal year-ends, 2004-2011E (%)

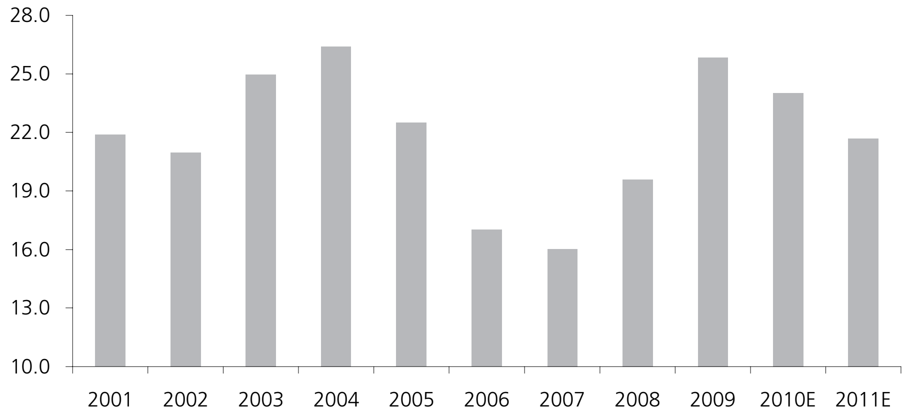


Source: Company, Kotak Institutional Equities estimates

Return ratios likely to remain healthy

PNB is the one of the very few banks, which has consistently maintained a high return ratio on its equity over the last 10 years of near 20%. With sustained margins at 3.5%, increased reliance on fee income, cushion on operating costs and high provision coverage ratio, the bank can easily sustain a RoA of >1% and RoEs of about 20%, in our opinion. Given a healthy capital adequacy ratio of 14.7%, of which Tier I ratio is at 9.4% as of September 2009 along with a healthy RoE, the bank is unlikely to require additional capital for in the immediate term for funding its loan growth.

RoEs have always remained over 15% and has averaged 20% in the past
Return on Equity, March fiscal year-ends, 2004-2011E (%)



Source: Company, Kotak Institutional Equities estimates

PNB - growth rates and key ratios
March fiscal year-ends, 2007-2011E (%)

	2007	2008	2009	2010E	2011E
Growth rates (%)					
Net loan	29.4	23.7	29.5	16.6	20.6
Total Asset	11.8	22.5	21.6	19.0	17.3
Deposits	16.9	19.0	25.8	20.8	18.6
Current	(1.5)	8.0	6.1	20.8	18.6
Savings	14.7	11.8	16.5	20.8	19.0
Fixed	23.3	26.0	34.8	20.8	18.4
Net interest income	18.2	5.8	20.5	16.4	18.6
Loan loss provisions	746.3	(27.5)	76.4	39.3	63.3
Total other income	13.9	15.4	46.2	6.1	4.3
Net fee income	28.9	14.0	24.7	15.0	15.0
Net capital gains	(18.6)	18.5	50.4		
Net exchange gains	44.7	19.6	3.8	10.0	10.0
Operating expenses	10.0	6.0	19.3	10.5	11.2
Employee expenses	11.2	4.6	18.8	11.5	10.0
Key ratios (%)					
Yield on average earning assets	7.8	8.4	9.1	8.4	8.4
Yield on average loans	8.9	9.7	10.7	9.7	9.7
Yield on average investments	8.4	8.0	7.7	7.1	7.1
Average cost of funds	4.4	5.3	6.1	5.5	5.5
Interest on deposits	4.3	5.4	6.0	5.4	5.4
Difference	**3.4**	**3.0**	**2.9**	**2.8**	**2.8**
Net interest income/earning assets	3.5	3.2	3.3	3.2	3.2
New provisions/average net loans	0.9	0.5	0.7	0.8	1.1
Interest income/total income	76.1	74.5	70.7	72.5	75.0
Fee income to total income	13.4	14.1	13.9	14.1	14.1
Operating expenses/total income	45.9	45.0	42.3	41.2	39.9
Tax rate	29.0	37.8	34.0	33.0	33.0
Dividend payout ratio	26.6	20.0	20.0	20.0	20.0
Share of deposits					
Current	11.8	10.7	9.0	9.0	9.0
Fixed	53.8	57.0	61.1	61.1	61.0
Savings	34.4	32.3	29.9	29.9	30.0
Loans-to-deposit ratio	69.1	71.8	73.9	71.3	72.6
Equity/assets (EoY)	6.4	6.2	6.0	5.9	5.8
Dupont analysis (%)					
Net interest income	3.4	3.1	3.2	3.1	3.1
Loan loss provisions	0.5	0.3	0.4	0.5	0.7
Net other income	1.1	1.1	1.3	1.2	1.0
Operating expenses	2.2	2.0	2.0	1.8	1.7
Invt. depreciation	0.4	0.1	(0.1)	0.0	0.0
(1- tax rate)	71.0	62.2	64.8	67.0	67.0
ROA	1.0	1.1	1.4	1.3	1.2
Average assets/average equity	16.0	17.3	18.4	18.3	18.1
ROE	**16.0**	**19.6**	**25.8**	**24.0**	**21.7**

Source: Company, Kotak Institutional Equities estimates

PNB - P&L and balance sheet
March fiscal year-ends, 2007-2011E (Rs mn)

	2007	2008	2009	2010E	2011E
Income statement					
Total interest income	115,375	145,660	193,262	216,234	255,909
Loans	76,439	104,391	146,378	162,116	192,532
Investments	35,896	39,123	44,100	51,320	62,436
Cash and deposits	3,040	2,146	2,784	2,798	941
Total interest expense	60,229	87,309	122,953	134,409	158,856
Deposits from customers	56,175	82,651	112,174	125,258	149,706
Net interest income	55,146	58,352	70,309	81,825	97,053
Loan loss provisions	7,518	5,452	9,620	13,405	21,896
Net interest income (after prov.)	47,628	52,899	60,689	68,420	75,157
Othet income	17,296	19,964	29,197	30,990	32,328
Net fee income	9,700	11,062	13,794	15,863	18,242
Net capital gains	3,729	4,419	6,647	5,500	3,500
Net exchange gains	1,767	2,114	2,194	2,413	2,655
Operating expenses	33,262	35,255	42,062	46,465	51,660
Employee expenses	23,524	24,615	29,244	32,612	35,873
Depreciation on investments	9,762	4,052	(2,000)	-	-
Other Provisions	217	609	2,154	1,000	-
Pretax income	21,691	32,959	47,669	51,945	55,824
Tax provisions	6,291	12,472	16,760	17,142	18,422
Net Profit	**15,401**	**20,488**	**30,909**	**34,803**	**37,402**
% growth	7	33	51	13	7
PBT+provisions-treasury gains	32445	37643	52797	62851	76220
% growth	32	16	40	19	21
Balance sheet					
Cash and bank balance	156,455	188,307	197,414	175,694	200,544
Cash	9,634	14,421	12,258	13,484	14,832
Balance with RBI	114,086	138,160	149,430	126,484	149,985
Balance with banks	11,707	25,631	25,631	25,631	25,631
Net value of investments	451,898	539,918	619,906	842,719	941,180
Govt. and other securities	366,310	442,167	567,605	790,418	888,879
Shares	7,549	8,692	8,692	8,692	8,692
Debentures and bonds	43,056	40,067	36,060	36,060	36,060
Net loans and advances	965,965	1,195,016	1,547,030	1,804,318	2,176,776
Fixed assets	10,098	23,155	11,248	12,777	14,253
Net leased assets	20	6	6	6	6
Net Owned assets	10,078	23,149	11,242	12,771	14,247
Other assets	39,808	43,808	43,808	43,808	43,808
Total assets	**1,624,225**	**1,990,204**	**2,419,406**	**2,879,317**	**3,376,562**
Deposits	1,398,597	1,664,572	2,094,810	2,529,685	2,999,709
Current	164,657	177,912	188,814	228,011	270,376
Savings	480,886	537,697	626,460	756,511	899,913
Borrowings and bills payable	65,942	137,244	114,378	114,378	114,378
Other liabilities	55,332	65,203	65,203	65,203	65,203
Total liabilities	**1,519,870**	**1,867,020**	**2,274,391**	**2,709,266**	**3,179,290**
Paid-up capital	3,153	3,153	3,153	3,153	3,154
Reserves & surplus	101,202	120,030	141,862	166,897	194,118
Total shareholders' equity	**104,355**	**123,183**	**145,015**	**170,051**	**197,272**

Source: Company, Kotak Institutional Equities estimates

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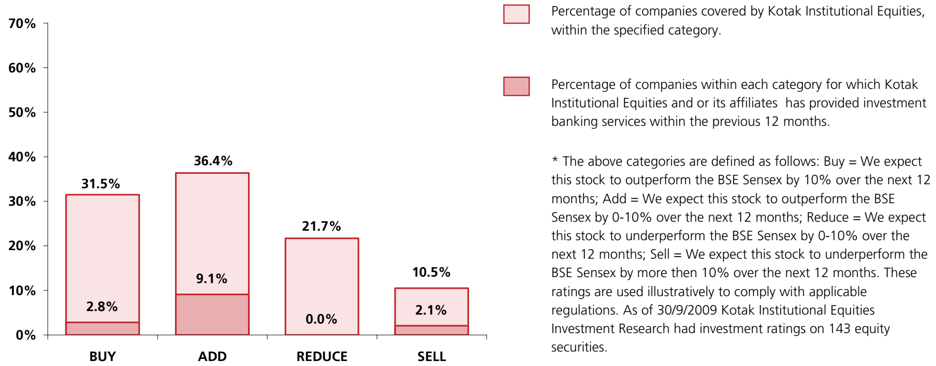

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Source: Kotak Institutional Equities | As of September 30, 2009

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