



Indian Overseas Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,707	IOB IN
	REUTERS CODE
S&P CNX: 3,955	IOBK.BO

22 November 2006

Buy

Previous Recommendation: Buy

Rs115

Equity Shares (m)	544.8
52-Week Range	133/66
1,6,12 Rel.Perf.(%)	-3/31/-36
M.Cap. (Rs b)	62.7
M.Cap. (US\$ b)	1.4

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)
3/06A	27,954	7,833	14.4	20.3	8.0	2.1	13.0	27.2	1.4	2.2
3/07E	32,112	9,586	17.6	22.4	6.5	1.6	12.4	26.8	1.5	1.7
3/08E	35,544	11,187	20.5	16.7	5.6	1.3	12.0	25.2	1.5	1.3

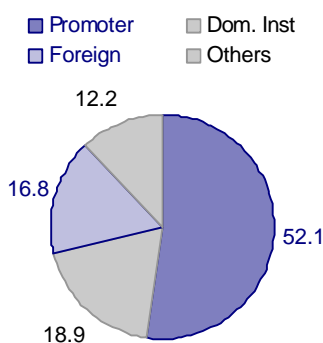
Hallmark is consistency: IOB has been the most consistent performer amongst state-owned banks in the last five years — net profit has grown 36% CAGR over FY02-FY06, margins have improved, RoE has recorded >25% and assets have grown 23% during the stated period.

Has earned 4%+ margins: The bank enjoys net interest margins of 4+%, one of the best in industry, and has been able to sustain these levels for last 6+ quarters on account of its high-yielding loan book. The high yields are on account of greater exposure to traders, the SME and agriculture sectors, which constitute around 42% of the credit portfolio.

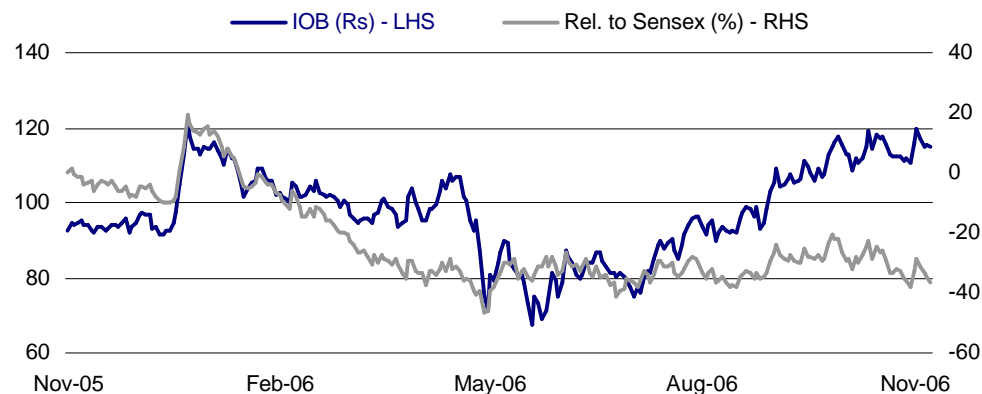
Well managed asset quality: NPA levels have been prudently reduced by progressive writeoffs, lower slippages and better recoveries. At the end of 2QFY07, NPA levels stood at gross: 2.9% (3.4% in FY06) and net: 0.6% (0.7% in FY06) respectively, which is low compared with peers amongst the large state-owned banks. In 1HFY07, recoveries amounted to Rs1.8b, 36%, higher v/s Rs1.4b in the corresponding period last year.

Sustained RoE and RoA - deserves better valuations: IOB has maintained consistency in core earnings growth, supported by steady growth in its advances portfolio and high and stable NIMs. We are impressed by the bank for maintaining profit growth despite cleaning up its balance sheet and sustaining high RoAs and RoEs. Given the growth prospects and high margins sustainability, we believe IOB will continue delivering historical RoAs and RoEs for the net couple of years. We expect earnings to grow by 22% in FY07 and by 17% in FY08. The stock trades at 5.6x FY08E EPS and 1.3x FY08E BV and offers a yield of ~3%. We expect the bank to deliver RoE of >24% for FY07 and FY08. We reiterate **Buy**, with a target price of Rs151.

SHAREHOLDING PATTERN SEP-06 (%)



STOCK PERFORMANCE (1 YEAR)



Investment arguments

Hallmark is consistency

IOB has been the most consistent performer amongst state-owned banks in the last five years — net profit has grown 36% CAGR over FY02-FY06, margins have improved YoY, RoE has recorded >25% and assets have grown 23% during the stated period.

On the back of high margins and efficient capital management, the bank has, for the fifth consecutive year, delivered 25%+ RoE. Moreover, expectation of RoAs at around 1.5% also indicate the improved asset utilization levels and profitability. The RoE-RoA combination in IOB is amongst the best in industry. We expect the bank to maintain RoAs at 1.5% and RoEs at 25%+ over next couple of years on the back of strong margins, lower operating expenses and lower provisions.

Has earned 4%+ margins

Indian Overseas Bank is amongst the few banks which continues to maintain higher margins (~4%) on account of higher advances and investment yields and relatively lower costs due to the higher proportion of its low-cost deposit base.

Yields on the credit portfolio are at 9.5% in 2QFY07 (60bp improvement from FY06; 9.1% in 1QFY07). High yields are on account of greater exposure to traders and the SME and agriculture sectors, which constitute around 42% of the bank’s credit portfolio. We expect this relatively higher yield to sustain, leading to higher margins ahead.

BREAK-UP ON MOVEMENT OF NIMs (%)

	2QFY06	3QFY06	4QFY06	FY06	1QFY07	2QFY07
Avg Yield on Adv.	8.9	8.9	8.8	8.9	9.1	9.5
Avg Yield on Inv.	8.6	8.6	8.5	8.5	8.4	8.3
Avg Cost of Dep.	4.6	4.6	4.7	4.7	4.8	5.0
NIMs	4.1	4.1	4.1	4.1	4.0	4.0

Source: Company / Motilal Oswal Securities

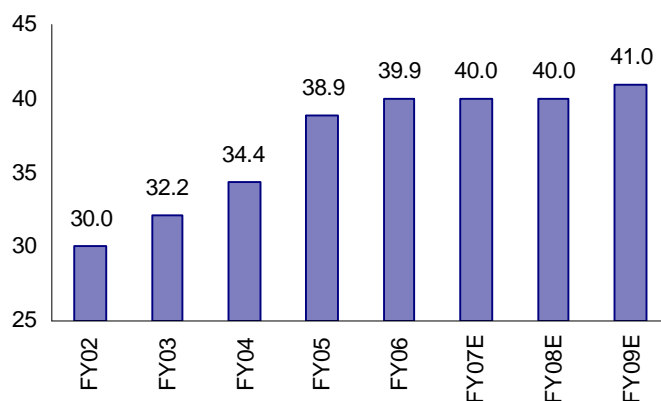
Management has stated their intent to continue to focus on retail trade, agriculture, and credit to the SSI/SME sectors, wherein average yields are 10%, 8.5-9.0%, and 8.5-10.5%, respectively compared with large and medium corporates wherein yields remain in the range of ~8.75%.

IOB ADVANCES PROFILE (RS B)

	FY04	FY05	FY06	% OF DOM. FY06	GR. (%)
Global Advances	203	252	348	NA	37.9
Domestic Advances	188	235	327	NA	39.4
Priority Sector Advances	79	99	137	41.9	39.0
Agriculture Adv.	34	43	60	18.2	39.7
SSI Adv.	22	25	32	9.7	28.6
SME Adv.	NA	37	47	14.3	28.1

Source: Company/ Motilal Oswal Securities

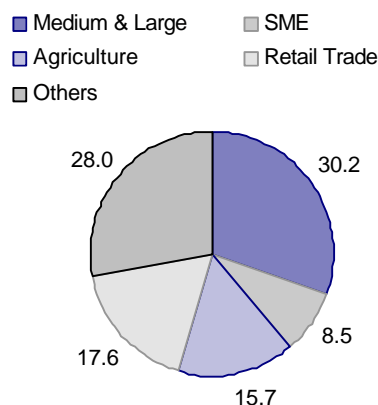
CASA DEPOSITS (%)



Source: Company/ Motilal Oswal Securities

While the bank has been able to contain increase in cost of deposits leading to higher margins, its investment yields continue to be on the higher side. We expect investment yield to taper off gradually to ~7.5% which could lead to some margin pressure. Nonetheless, we have built lower future margins on back of declining investment yields.

BREAK-UP OF LOAN BOOK (%)

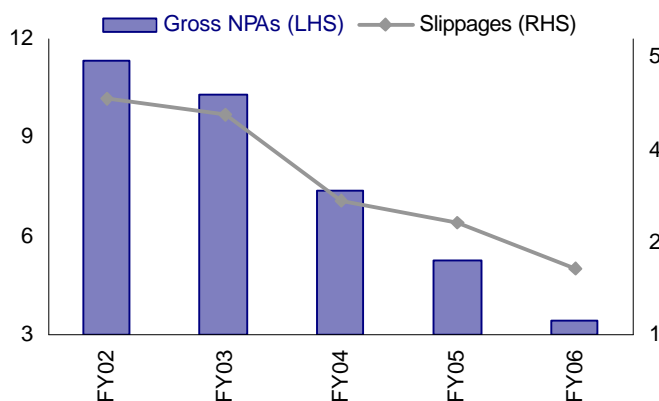


Source: Company/ Motilal Oswal Securities

The bank earns one of the best NIMs in the sector; additionally, IOB has been able to manage these 4%+ margins over the last eight quarters. However, going forward, we believe that while asset yields would tend to improve (we believe the recent PLR hike is not fully captured in the current quarter), investment yields would tend to decline and could result in slight margin pressure. Overall, we are factoring in declining margins for the next few fiscals, in our expectations.

Asset quality well managed/recoveries can provide upside: IOB has progressively reduced its NPA levels by its prudent strategy of writeoffs, lower slippages and better recoveries. At the end of 2QFY07, gross and net NPA levels stood at 2.9% (3.4% in FY06) and 0.6% (0.7% in FY06), respectively, which is low versus peers amongst large state-owned banks. Also, the bank has effected cash recovery of Rs3.5b in FY06 versus Rs2.5b in FY05. In 1HFY07, recoveries amounted to Rs1.8b, 36% higher than Rs1.4b in the corresponding period last year.

ASSET QUALITY WELL MANAGED (%)

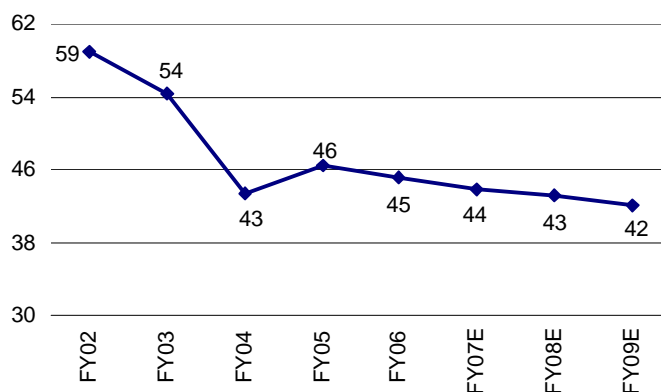


Source: Company/ Motilal Oswal Securities

Low op-ex growth: IOB’s operating expenses including employee expenses have grown by only 7.5% CAGR over FY01-FY06, which is perhaps one of the lowest growth rates in the system. With income growth and slower growth in operating expenses over the stated period, cost- income

ratio has also trended downward from as high as 74% in FY01 to 45% in FY06. We expect C-I ratio to move further downward to 42% by FY09E on the back of controlled expenses.

COST TO INCOME RATIO (%)

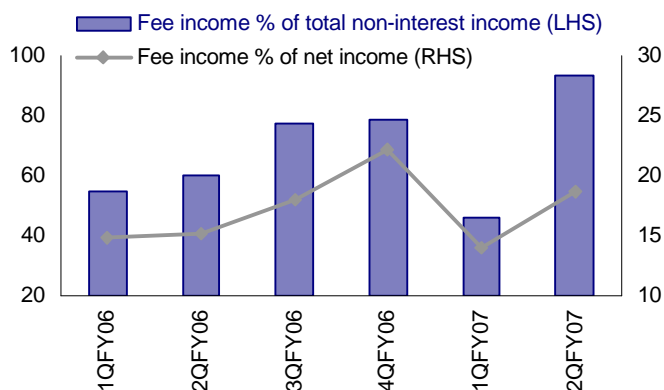


Source: Company/ Motilal Oswal Securities

Fee income initiatives paying off well: IOB has been diversifying its fee income stream by focusing on the retail segment apart from traditional fee income streams (LCs, guarantees etc.) from corporate sector. The bank has alliances with third party financial companies to distribute their mutual fund and insurance products (8AMC, LIC & United India). The bank has also started to sell gold products through select retail branches, which also earn good returns. Additionally, the bank recently signed an MoU for a five-way tie-up (Allahabad Bank, Karnataka Bank, Dabur Investments and Sampo Japan) for setting up a non-life JV in the non-life insurance space. IOB will have 19% stake in the non-life venture. The results are already visible in the bank’s fee income growth, which has recorded 27% YoY growth in 1HFY07 in income from fee-based sources.

Non-interest income excluding treasury income increased by 36% from Rs1.05b in 2QFY06 to Rs1.4b in 2QFY07. Of this, other income from core banking operations increased by 43% to Rs920m while fee income from sale of insurance and mutual fund products rose by 27% to Rs270m during 2QFY07.

FEE INCOME GROWTH PICKING UP



Source: Company/ Motilal Oswal Securities

Investment book well cushioned: IOB's investment book size is Rs198b, of which 77% is in HTM (85% in HTM-SLR). The balance in the AFS book is largely floating notes. IOB's modified duration on the AFS book has been brought down to two years.

Adequate capital: Currently total capital adequacy is 14.7%; an improvement of 129bp QoQ in CAR, coming in largely from Tier 2, with Tier 1 at 8.9%. IOB has been raising capital in the form of Upper Tier 2 capital (raised Rs10b in 1HFY07), allowing the bank to improve its Tier 2 ratio by 126bp YTD. Until date, besides raising Rs10b as Upper Tier 2 capital, it has also raised Rs2.8b as perpetual debt and Rs8b as syndicated debt. Management also indicated that post implementation of Basel 2 norms, the bank could see erosion of ~125bp in its capital (based on risk-weighted assets as of September 2006).

Moreover, with government holding at 61%, IOB has further headroom ahead to increase its capital requirements by way of equity dilution. We believe the bank will have minimal problems as far as regulatory capital requirements are concerned.

Pension adequately funded; AS-15 impact ~Rs2b: Close to 40% of the bank's employees have opted for the pension scheme. Management indicated that their pension corpus is adequately funded and there are no material

issues. As far as AS-15 is concerned, management stated that discussions are ongoing with the RBI to apportion this shortfall. Nonetheless, management mentioned about likely pension shortfall on account of AS-15 to be close to Rs2b (5% of FY07E BV).

Bharat Overseas Bank acquisition at reasonable price; will add to valuations: IOB has recently taken control of Bharat Overseas Bank Ltd. (BhoB), an unlisted private sector bank. IOB has bought out the stakes of the six other banks in BhoB, in which IOB held the highest stake, 30%. The consideration had been agreed at Rs155 a share resulting in IOB having paid out Rs1.7b for the acquisition.

While as of now it is a 100% subsidiary of IOB, post regulatory approvals from the Thailand regulators, the bank plans to fold BhoB into itself. Clearly, IOB has got a better bank with net NPAs of less than 2% and adequate capital strength. BhoB also strengthens IOB's branch network with addition of ~100 additional branches and would add about Rs20b of advances to its portfolio apart from its famous Thaioperations.

The acquisition would also allow IOB to expand the balance sheet to around 6%. The acquisition would not strain IOB's capital levels, given capital adequacy 11% for BhoB. Moreover, BhoB is neither sick nor weak and we do not expect it to be a drag on BOB's existing credit quality levels.

AS OF MARCH 2006 (RS M)

	BHOB	IOB	BHOB AS A % OF IOB
Deposits	32,441	505,293	6.4
Advances	20,535	347,562	5.9
Investments	9,606	189,523	5.1
SLR	7,867	155,181	5.1
Assets	37,304	593,578	6.3
Net Worth	2,038	31,774	6.4
Nil	1,066	20,672	5.2
Net Profit	56	7,833	0.7
CAR (%)	11.24	13.04	NA
Net NPA (%)	1.87	0.65	NA
No of branches	102	1,513	6.7
No of employees	1,049	24,178	4.3

Source: Company/ Motilal Oswal Securities

Valuation and view

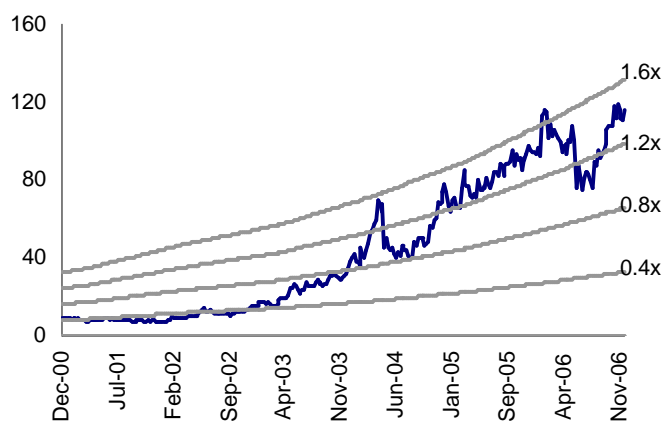
IOB has maintained consistency in core earnings growth, supported by steady growth in its advances portfolio and high and stable NIMs. It has continued to impress by maintaining profit growth, despite cleaning up of its balance sheet and sustaining high RoEs. We expect earnings to grow by 22% in FY07 and by 17% in FY08. The stock trades at 5.6x FY08E EPS and 1.3x FY08E BV and offers a yield of ~3%. We expect the bank to deliver an RoE of >24% for FY07 and FY08. We reiterate **Buy**, with a target price of Rs151.

Concerns

☞ In the medium-to-long term, the key risk for the bank is economic slowdown, which could impact asset growth as well as lead to increase in NPA levels given that the bank is significantly focused and has exposure to the SME/retail sectors, which will likely be more susceptible to a slowdown.

☞ Investment yields continue to be above 8%, which are likely to decline in future, resulting in margin pressure.

ROLLING P/BV BAND



Source: Company/ Motilal Oswal Securities

DU PONT ANALYSIS OF ROA

	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E
Net interest income/avg assets (%)	3.19	3.62	3.78	3.75	3.77	3.70	3.64
Fee income/avg assets (%)	0.78	0.77	0.87	0.90	0.86	0.83	0.81
Treasury Income/ avg assets (%)	0.58	0.91	0.43	0.42	0.31	0.13	0.11
Total revenue/avg assets (%)	4.55	5.29	5.09	5.07	4.94	4.66	4.56
Operating costs/income (%)	54	43	46	45	44	43	42
Operating costs/avg assets (%)	2.47	2.29	2.36	2.29	2.16	2.01	1.92
- Emp Costs/avg assets (%)	1.88	1.70	1.72	1.62	1.51	1.38	1.28
- Other Exp / avg Assets (%)	0.59	0.59	0.64	0.67	0.65	0.63	0.64
Pre-provision profits/avg assets (%)	2.07	3.00	2.72	2.78	2.78	2.65	2.64
Loan-loss-provisions/avg assets (%)	0.61	1.16	0.60	0.28	0.12	0.13	0.14
Other provisions/avg assets (%)	0.32	0.05	0.11	0.72	0.60	0.38	0.35
Tax/avg assets (%)	0.05	0.63	0.68	0.37	0.58	0.67	0.69
ROAA (%)	1.1	1.2	1.3	1.4	1.5	1.5	1.5
Leverage (x)	29.55	24.99	21.08	19.15	18.18	17.18	16.22
ROAE (%)	32.1	29.0	28.0	27.2	26.8	25.2	23.8

Source: Company/ Motilal Oswal Securities

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2005	2006	2007E	2008E	2009E
Interest Income	39,510	44,063	54,646	65,347	76,682
Interest Expended	20,955	23,391	30,151	37,119	44,564
Net Interest Income	18,555	20,672	24,494	28,228	32,118
Change (%)	16.0	11.4	18.5	15.2	13.8
Other Income	6,398	7,282	7,617	7,316	8,127
Net Income	24,953	27,954	32,112	35,544	40,245
Change (%)	6.6	12.0	14.9	10.7	13.2
Operating Expenses	11,585	12,616	14,055	15,329	16,923
Operating Income	13,368	15,338	18,057	20,215	23,321
Change (%)	0.9	14.7	17.7	12.0	15.4
Other Provisions	3,498	5,482	4,675	3,900	4,300
PBT	9,870	9,856	13,382	16,315	19,021
Tax	3,356	2,023	3,795	5,128	6,096
Tax Rate (%)	34.0	20.5	28.4	31.4	32.0
PAT	6,514	7,833	9,586	11,187	12,925
Change (%)	27.0	20.3	22.4	16.7	15.5
Proposed Dividend	1,484	1,416	1,634	1,907	2,179

BALANCE SHEET (RS MILLION)

Y/E MARCH	2005	2006	2007E	2008E	2009E
Capital	5,448	5,448	5,448	5,448	5,448
Reserves & Surplus	20,304	26,326	34,278	43,559	54,305
Net Worth	25,752	31,774	39,726	49,007	59,753
Deposits	442,412	505,293	606,352	703,368	815,907
Change (%)	6.7	14.2	20.0	16.0	16.0
Borrowings	5,907	7,366	8,840	11,050	13,813
Other Liabilities & Prov	34,079	49,144	51,602	54,182	56,891
Total Liabilities	508,150	593,578	706,520	817,606	946,363
Current Assets	49,540	37,072	32,300	36,938	44,792
Investments	190,147	189,523	208,475	237,662	270,934
Change (%)	-5.7	-0.3	10.0	14.0	14.0
Advances	252,052	347,562	444,879	520,509	606,393
Change (%)	24.2	37.9	28.0	17.0	16.5
Net Fixed Assets	4,523	4,577	4,537	4,537	4,487
Other Assets	11,888	14,843	16,328	17,961	19,757
Total Assets	508,150	593,578	706,520	817,606	946,363

ASSUMPTIONS (%)

Deposit Growth	6.7	14.2	20.0	16.0	16.0
Advances Growth	24.2	37.9	28.0	17.0	16.5
Investments Growth	-5.7	-0.3	10.0	14.0	14.0
Dividend	24.0	26.0	30.0	35.0	0.0
CRR	5.0	5.0	5.0	5.0	5.0

E: MOST Estimates

RATIOS

Y/E MARCH	2005	2006	2007E	2008E	2009E
Spreads Analysis (%)					
Avg. Yield - Earning As:	8.4	8.3	8.5	8.5	8.6
Avg. Cost-Int. Bear. Lia	4.8	4.9	5.3	5.6	5.8
Interest Spread	3.6	3.4	3.2	2.9	2.9
Net Interest Margin	3.9	3.9	3.8	3.7	3.6

Profitability Ratios (%)

RoE	28.0	27.2	26.8	25.2	23.8
RoA	13	14	15	15	15
Int. Expended/Int. Earned	53.0	53.1	55.2	56.8	58.1
Other Inc./Net Income	25.6	26.1	23.7	20.6	20.2

Efficiency Ratios (%)

Op. Exps./Net Income	46.4	45.1	43.8	43.1	42.1
Empl. Cost/Op. Exps.	72.8	70.8	69.9	68.5	66.7
Busi. per Empl. (Rs m)	26.9	32.0	39.8	47.7	55.7
NP per Empl. (Rs lac)	2.7	3.2	4.0	4.7	5.4

Asset-Liability Profile (%)

Adv./Deposit Ratio	57.0	68.8	73.4	74.0	74.3
Invest./Deposit Ratio	43.0	37.5	34.4	33.8	33.2
G-Sec/Invest. Ratio	82.7	81.9	83.4	79.7	76.2
Gross NPAs to Adv.	5.3	3.4	2.8	2.6	2.4
Net NPAs to Adv.	1.3	0.7	0.4	0.4	0.3
CAR	14.2	13.0	12.4	12.0	11.7
Tier 1	7.1	8.5	7.9	7.5	7.2

VALUATION

Book Value (Rs)	44.7	56.1	70.9	88.1	108.0
Price-BV (x)	2.6	2.1	1.6	1.3	1.1
Adjusted BV (Rs)	40.9	53.4	68.5	85.8	105.9
Price-ABV (x)	2.8	2.2	1.7	1.3	1.1
EPS (Rs)	12.0	14.4	17.6	20.5	23.7
EPS Growth (%)	27.0	20.3	22.4	16.7	15.5
Price-Earnings (x)	9.6	8.0	6.5	5.6	4.8
OPS (Rs)	24.5	28.2	33.1	37.1	42.8
OPS Growth (%)	0.9	14.7	17.7	12.0	15.4
Price-OP (x)	4.7	4.1	3.5	3.1	2.7

E: MOST Estimates

N O T E S

For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOST*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement	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

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.