Update

SECTOR: BANKING

Union Bank of India

STOCK INFO.	BLOOMBERG
BSE Sensex: 15,422	UNBK IN
	REUTERS CODE
S&P CNX: 4,475	UNBK.BO

Equity Shares (m)	505.1
52-Week Range	168/84
1,6,12 Rel.Perf.(%)	-5/30/-9
M.Cap. (Rs b)	71.2
M.Cap. (US$ b)	1.7

3 September 2007

Buy

Previous Recommendation:Buy

Rs141

YEAR END	NET INCOME (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	CAR (%)	ROE (%)	ROA (%)	P/ABV (X)
3/07A	34,768	8,454	16.7	25.3	8.4	1.5	12.8	19.2	0.9	1.6
3/08E	40,342	10,634	21.1	25.8	6.7	1.3	12.0	20.7	0.9	1.4
3/09E	47,593	13,132	26.0	23.5	5.4	1.1	11.0	21.8	1.0	1.2

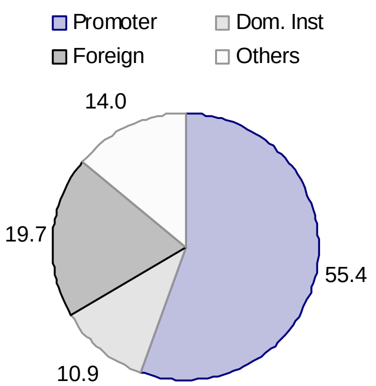
Investing for tomorrow: Union Bank is one of the few state owned banks, which is making extensive investments in building strong IT infrastructure, manpower training, robust credit processing/monitoring systems, and brand and branch makeovers. We believe this would enable the bank to grow faster than the industry. The CMD, Mr Nair's term extends to FY11, ensuring continuity in top management strategies and thought processes.

Targets appear bold...: The management's internal KRAs are: (i) improving RoA to 1% (0.9% in FY07); (ii) RoE to 20%+ (19% in FY07); (iii) maintaining margins at 3.05-3.10%; (iv) raising CASA ratio to 40% by FY10; (v) growing core fee income at 30-35% YoY; and (vi) restricting delinquencies at below 1% (1.4% in FY07). These highlight the management's commitment to improve operating performance. Post complete restructuring (IT infrastructure set up, honing manpower skills; expected by 1HFY09), management aims to achieve growth that is 5-10% above industry level.

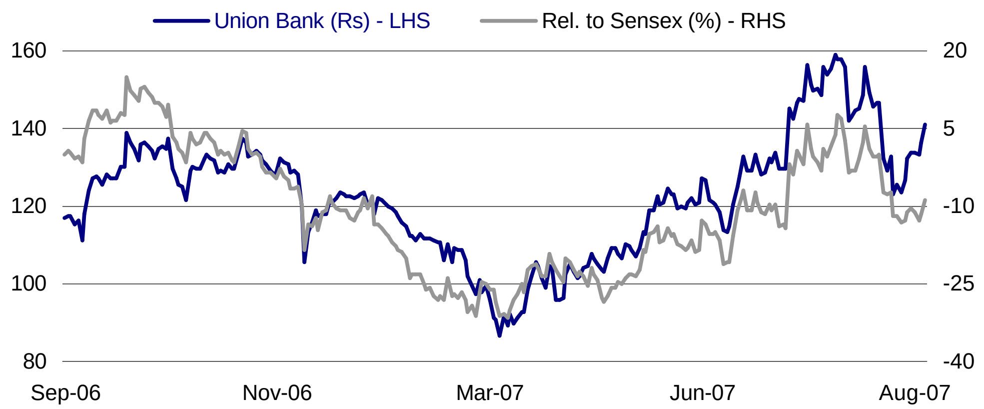
... but the bank is on track to achieve them: The bank has been working to achieve these targets over the last six quarters. Margins have been maintained at ~3% by realigning the credit portfolio and via stronger core deposit growth; fee income growth has gained traction at 25-30%, RoA is inching towards the 1% mark and asset quality has improved.

Strong earnings growth; valuations attractive: We expect earnings to grow at 24% CAGR over next two years with RoA improving to 1% and RoE to 22% by FY09E. We believe the bank could surprise positively on earnings growth on back of higher non interest income and lower costs. The stock trades at 1.1x FY09E BV and 5.4x FY09E EPS. We maintain Union Bank as one of our top picks amongst state-owned banks. Reiterate **Buy** with a target price of Rs180 (1.4x FY09E BV), an upside of 28%.

SHAREHOLDING PATTERN (%) JUN-07



STOCK PERFORMANCE (1 YEAR)



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Investing for tomorrow

Union Bank is one of the few state owned banks, which is making extensive investments in building strong IT infrastructure, manpower training, robust credit processing/ monitoring systems, and brand and branch makeovers. We believe this would enable the bank to grow faster than the industry. The CMD, Mr Nair's term extends to FY11, ensuring continuity in top management strategies and thought processes.

Building capacities

Management is strictly focused on readying the infrastructure required and enhancing staff capabilities within the bank to sustain above-industry growth ahead. Management has been investing substantially in technology and manpower training to further its goal of achieving a high growth (5-10% above industry) phase, targeted from 2HFY09. The bank is also working toward 100% CBS implementation in all its branches by FY08.

Centralization of processes and branch makeover

Management is working toward converting its branches into 'sales and service' outfits by 1QFY09 by adopting total centralization of data processes and transactions handling. Advisors to the bank for total centralization are the Boston Consultancy Group. The bank is considering adoption of lending automation software to streamline its credit sanctioning processes. All bank branches would undergo a makeover, which includes standardization of branch format and appearance in line with the foreign banks. Management is also undertaking a branding exercise from October 2007 onward to reposition itself and increase visibility.

Organizational restructuring

Bank has reorganized itself to grow aggressively in its self identified areas of SME, agriculture and rural and retail businesses going forward. Accordingly, the bank has adopted organizational restructuring with dedicated branches; deployed skilled manpower and identified geographical areas for growing these businesses. While the bank's overall advances grew merely 16.5% in FY07, SME growth was 35%, and agriculture grew 31% during the period. With centralization of data and processes and having equipped itself with improved risk management systems, the bank also aims to grow the retail book aggressively.

Overseas presence: The bank is also making its debut in international banking in FY08 with primary focus on Asia. The first representative office overseas was opened at Shanghai in May 2007. It has also received approval from the Central Bank of United Arab Emirates to open a representative office in Abu Dhabi and also permission to open its first overseas branch in Hong Kong.

Top management continuity

Mr. M. V. Nair took over as chairman and managing director of Union Bank of India in April 2006. He started his career with Corporation Bank in 1973 and rose to be its general manager. In August 2004, he was appointed executive director, Dena Bank and was elevated thereafter to chairman and managing director. During his tenure Dena Bank recorded a remarkable turnaround. His tenure was also marked by industry's best human resources management strategies, which helped build a strong base for Dena Bank's growth.

Likewise, he has been instrumental with new initiatives and organizational makeovers at Union Bank over the past 15 months. His term with the bank extends to FY11, which would ensure continuity in top management strategies and thought processes – we believe this to be a key success factor for any state-owned bank.

Targets appear bold...

Management's internal KRAs of improving RoA to 1% (0.9% in FY07) and RoE to 20%+ (19% in FY07), maintaining margins at 3.05-3.10%, raising CASA ratio to 40% by FY10, growing core fee income at 30-35% YoY and restricting delinquencies to below 1% (1.4% in FY07) highlight management's commitment to all-round improvement in operating performance going forward. Post complete organizational restructuring, setting up of IT infrastructure, adequate manpower skill honing (expected by 1HFY09), management expects to target growth of 5-10% above industry level.

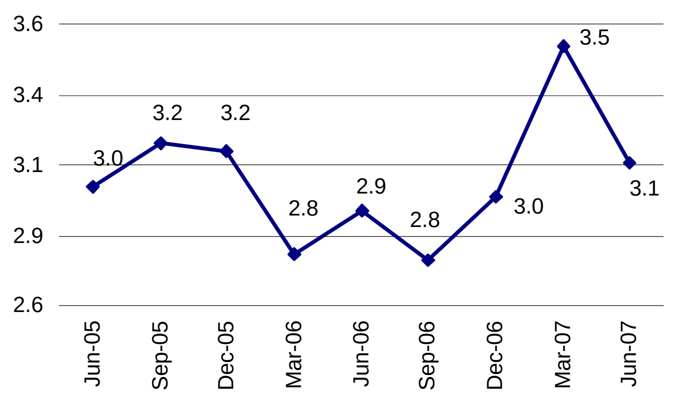
… but on track to achieve them

The bank has been working to achieve these targets over the last six quarters. Margins have been maintained at ~3% by realigning the credit portfolio and via stronger core deposit growth; fee income growth has gained traction at 25-30%, RoAs are inching toward the 1% mark and asset quality has improved significantly, also, outlook for recoveries remains strong.

Stable margins – key focus

Management is conscious of maintaining net interest margins (NIMs) at 3.05-3.1% going forward. The key strategy to achieve this objective would be to: (i) contain cost of funds via higher growth in core retail deposits; and (ii) improve yields by increasing focus on retail and SME businesses.

TREND IN NIMS (%)



Source: Company/Motilal Oswal Securities

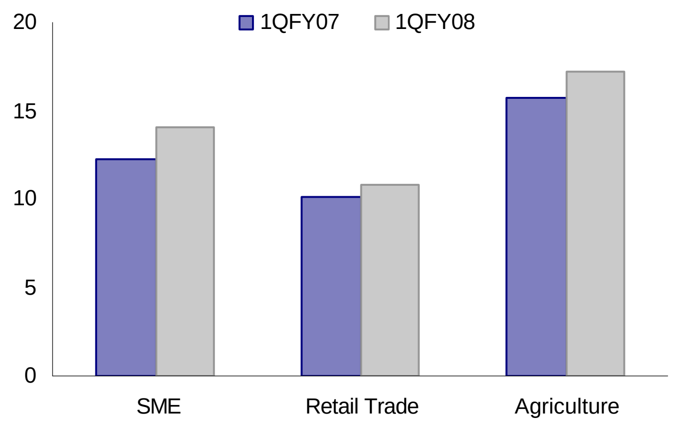
The bank's margins were impacted in 4QFY06-2QFY07, as it had to disburse loans to meet commitments by borrowing in bulk from the market. Thereafter management has consciously reduced the proportion of bulk deposits by shredding them in a phased manner and focusing on core deposits growth successfully. Further, it has realigned its credit growth in favor of SMEs, agriculture and retail trade. We believe this is a prudent policy of moderate but qualitative growth that enabled the bank to improve its margins to ~3%.

The efforts to grow high yielding assets are reflected in the improving share of SME, retail trade and agriculture in the overall loan book.

YOY GROWTH IN ADVANCES - 1QFY08 (%)

Source: Company/Motilal Oswal Securities

INCREASING SHARE OF SME, RETAIL AND AGRI ADVANCES (%)



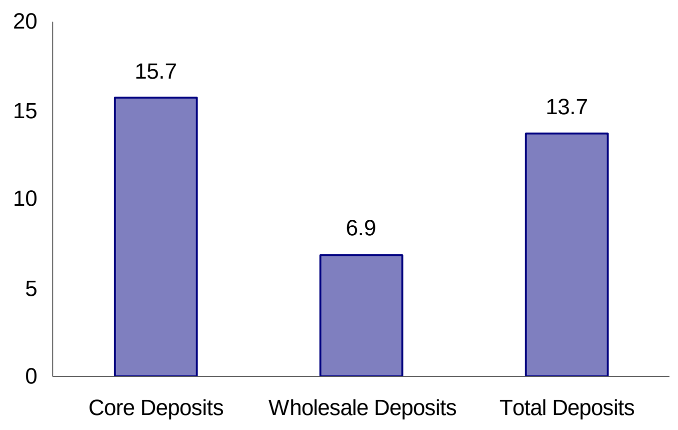
Source: Company/Motilal Oswal Securities

Core deposits growth – results visible

Management has an objective to raise the CASA ratio to 36% by FY08 (33% in 1QFY08) and to 40% by FY10. The specialized focus in the last one year on growth of current accounts (from government and PSU businesses) as well as via product innovations is yielding good results for the bank. Management expects growth in current accounts to sustain at the current level of 30-35% YoY (current account deposits were up 44% in FY07).

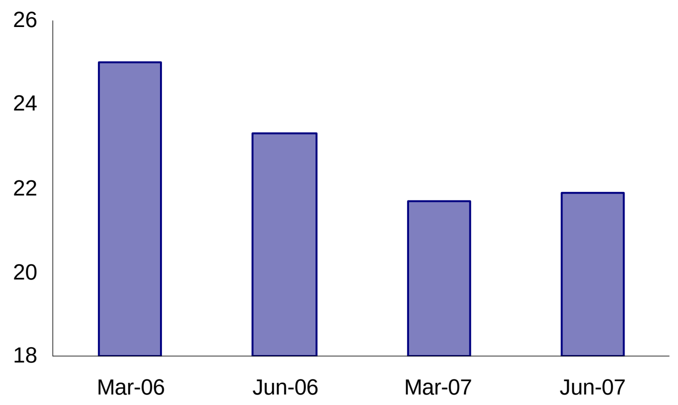
In the case of savings accounts, growth has become sluggish (an industrywide phenomenon) on account of increased interest rates on term deposits. With deposits shifting from savings to term, management plans to target corporate salary savings accounts aggressively with a view to address this issue. The bank has developed a suitable product comparable with any private sector bank offering and management aims to roll out and market this product aggressively from September/October 2007. Additionally, the bank's rural initiatives would also help garner more savings accounts going forward.

YOY GROWTH IN DEPOSITS - 1QFY08 (%)



Source: Company/Motilal Oswal Securities

WHOLESALE DEPOSITS PROPORTION FALLING (%)



Source: Company/Motilal Oswal Securities

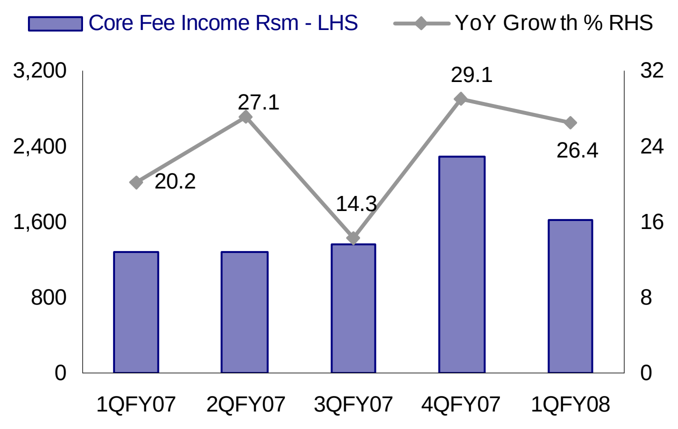
With contained cost of funds on account of traction in CASA and lower reliance on high-cost bulk deposits, management is confident of sustaining margins at 3.05-3.10% (3.11% in 1QFY08).

Fee income growing rapidly

We believe other income would maintain a strong growth trajectory for the bank on account of strong traction in fee income and higher recoveries from written-off accounts. Overall management aims to increase its non-treasury other income at 30-35% YoY over the next couple of years (up 39% in 1QFY08).

Fee income has been growing at a rapid pace for the past couple of quarters (26% in 1QFY08). Management expects to double its fees during FY08 from third party distribution — Rs490m in FY07. Traditional fee income is also expected to register 30%+ YoY growth. Management foresees much stronger traction in fee income from third party distribution from FY09 once it begins marketing (expected from 1QFY09) its own life insurance products.

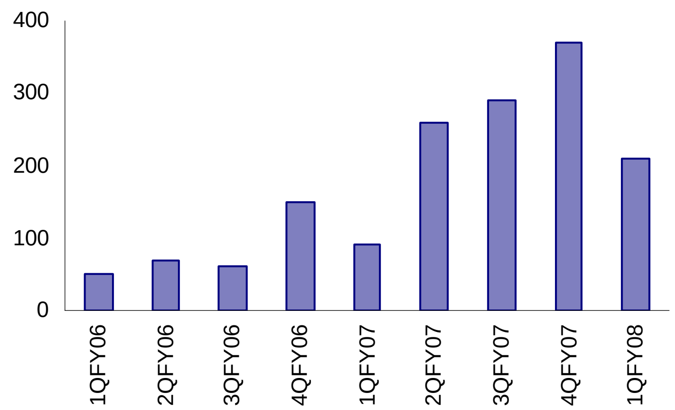
STRONG TRACTION IN FEE INCOME



Source: Company/Motilal Oswal Securities

Recoveries from written-off accounts are also expected to double from Rs1b in FY07 to Rs2b+ in FY08. The bank has a pool of Rs15b written-off accounts. Management is optimistic of superior recoveries from this pool going forward. The recoveries from written off accounts if realized would introduce significant upside to our earnings estimate.

RECOVERIES FROM W/OFF ACCOUNTS (RS M)



Source: Company/Motilal Oswal Securities

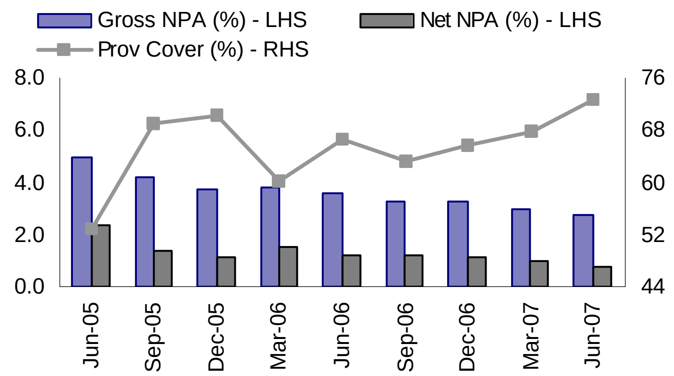
Cost to income ratio to reduce further

Union Bank has one of the lowest cost to income ratios in the industry at 42.5% in FY07. Management is hopeful of reducing it further to below 40% ahead on account of expected strong traction in operating income. We have factored in higher opex growth for Union Bank (15-16%) compared with other state-owned banks (~12%) on account of increased expenses for branding, advertising, IT, training, branch makeover and reorganization. Despite factoring in higher opex growth, we expect the cost to income ratio to decline to 41% for the bank by FY09E.

Asset quality has improved significantly

Asset quality has improved significantly over last couple of quarters and management expects further improvement going forward. Recoveries are expected to be strong while incremental slippages would be restricted to 1% or below. Higher operating profits growth would enable the bank to make higher provisions towards NPA and thereby reduce net NPA ratio. Management is targeting gross NPA of 2% (2.8% in 1QFY08) by end-FY08.

TREND IN NPA (%)



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Strong earnings growth, valuations attractive

We expect earnings to grow at 24% CAGR over next two years with RoA improving to 1% and RoE to 22% by FY09E. We believe the bank could surprise positively on earnings growth on back of higher non interest income and lower costs. The stock trades at 1.1x FY09E BV and 5.4x FY09E EPS. We maintain Union Bank as one of our top picks amongst state-owned banks. Reiterate **Buy** with a target price of Rs180 (1.4x FY09E BV), an upside of 28%.

INCOME STATEMENT					(Rs Million)
Y/E March	2005	2006	2007	2008E	2009E
Interest Income	49,698	58,638	73,822	92,583	114,297
Interest Expended	29,052	34,894	45,920	59,944	75,081
Net Interest Income	**20,646**	**23,743**	**27,902**	**32,639**	**39,216**
Change (%)	*18.9*	*15.0*	*17.5*	*17.0*	*20.2*
Other Income	7,661	4,945	6,865	7,703	8,376
Net Income	**28,307**	**28,688**	**34,768**	**40,342**	**47,593**
Change (%)	*10.2*	*1.3*	*21.2*	*16.0*	*18.0*
Operating Expenses	12,575	14,024	14,759	17,013	19,698
Operating Income	**15,732**	**14,664**	**20,008**	**23,329**	**27,895**
Change (%)	*6.1*	*-6.8*	*36.4*	*16.6*	*19.6*
Other Provisions	9,616	5,724	6,204	7,300	8,100
PBT	**6,116**	**8,940**	**13,804**	**16,029**	**19,795**
Tax	-1,075	2,195	5,350	5,395	6,663
Tax Rate (%)	*-17.6*	*24.5*	*38.8*	*33.7*	*33.7*
PAT	**7,191**	**6,745**	**8,454**	**10,634**	**13,132**
Change (%)	*1.0*	*-6.2*	*25.3*	*25.8*	*23.5*
Proposed Dividend	1,821	2,020	1,768	2,273	2,778

BALANCE SHEET					(Rs Million)
Y/E March	2005	2006	2007	2008E	2009E
Capital	4,601	5,051	5,051	5,051	5,051
Reserves & Surplus	31,543	40,530	46,848	54,731	64,521
Net Worth	**36,144**	**45,581**	**51,899**	**59,782**	**69,572**
Deposits	**618,306**	**740,940**	**851,802**	**1,039,199**	**1,226,254**
Change (%)	*22.3*	*19.8*	*15.0*	*22.0*	*18.0*
Borrowings	20,210	39,745	42,155	48,479	53,326
Other Liabilities & Prov.	49,473	64,992	80,923	102,772	130,520
Total Liabilities	**724,131**	**891,256**	**1,026,778**	**1,250,230**	**1,479,672**
Current Assets	65,721	63,905	84,264	99,089	120,331
Investments	227,927	259,175	279,818	335,781	386,148
Change (%)	1.6	13.7	8.0	20.0	15.0
Advances	401,051	533,800	623,864	773,592	928,310
Change (%)	*36.3*	*33.1*	*16.9*	*24.0*	*20.0*
Net Fixed Assets	8,238	8,104	8,250	8,127	7,877
Other Assets	21,196	26,275	30,582	33,641	37,005
Total Assets	**724,132**	**891,258**	**1,026,779**	**1,250,230**	**1,479,671**

ASSUMPTIONS					(%)
Deposit Growth	22.3	19.8	15.0	22.0	18.0
Advances Growth	36.3	33.1	16.9	24.0	20.0
Investments Growth	1.6	13.7	8.0	20.0	15.0
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	35.0	40.0	35.0	45.0	55.0
CRR	5.0	5.0	5.0	5.0	5.0

E: MOSt Estimates

RATIOS					
Y/E March	2005	2006	2007	2008E	2009E
Spreads Analysis (%)					
Avg. Yield - Earning Asse	8.0	7.6	8.0	8.5	8.8
Avg. Cost-Int. Bear. Liab	5.0	4.9	5.5	6.0	6.3
Interest Spread	2.9	2.7	2.5	2.5	2.5
Net Interest Margin	3.3	3.1	3.0	3.0	3.0
Profitability Ratios (%)					
RoE	25.0	18.7	19.2	20.7	21.8
RoA	1.1	0.8	0.9	0.9	1.0
Int. Expended/Int.Earned	58.5	59.5	62.2	64.7	65.7
Other Inc./Net Income	27.1	17.2	19.7	19.1	17.6
Efficiency Ratios (%)					
Op. Exps./Net Income	44.4	48.9	42.5	42.2	41.4
Empl. Cost/Op. Exps.	64.1	61.8	59.2	55.6	52.7
Busi. per Empl. (Rs m)	34.6	45.1	49.9	59.9	72.6
NP per Empl. (Rs lac)	2.8	2.7	3.1	3.9	4.8
Asset-Liability Profile (%)					
Adv./Deposit Ratio	64.9	72.0	73.2	74.4	75.7
Invest./Deposit Ratio	36.9	35.0	32.9	32.3	31.5
G-Sec/Invest. Ratio	72.0	78.3	81.9	85.3	85.3
Gross NPAs to Adv.	5.0	3.8	2.9	2.4	2.4
Net NPAs to Adv.	2.6	1.6	1.0	0.6	0.6
CAR	12.1	11.4	12.8	12.0	11.0
Tier 1	*6.1*	*7.3*	*7.8*	*7.0*	*6.5*

VALUATION					
Book Value (Rs)	68.2	81.0	93.7	109.5	129.1
Price-BV (x)	2.1	1.7	1.5	1.3	1.1
Adjusted BV (Rs)	53.3	70.3	86.0	104.0	122.4
Price-ABV (x)	2.6	2.0	1.6	1.4	1.2
EPS (Rs)	15.6	13.4	16.7	21.1	26.0
EPS Growth (%)	1.0	-14.5	25.3	25.8	23.5
Price-Earnings (x)	9.0	10.6	8.4	6.7	5.4
OPS (Rs)	34.2	29.0	39.6	46.2	55.2
OPS Growth (%)	6.1	-15.1	36.4	16.6	19.6
Price-OP (x)	4.1	4.9	3.6	3.1	2.6

E: MOSt Estimates

N O T E S

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Disclosure of Interest Statement	Union Bank of India
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No