



Union Bank of India

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,698	UNBK IN
	REUTERS CODE
S&P CNX: 3,678	UNBK.BO

26 October 2006

Buy

Previous Recommendation: Buy

Rs129

		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)
Equity Shares (m)	505.1	3/06A	29,994	6,752	13.4	-14.5	9.7	1.6	11.4	16.5	0.8	1.8
52-Week Range	142/81	3/07E	32,879	7,688	15.2	13.9	8.5	1.4	9.2	15.9	0.8	1.6
1,6,12 Rel.Perf.(%)	-4/0/-44	3/08E	38,412	9,668	19.1	25.8	6.7	1.2	9.1	17.7	0.8	1.3
M.Cap. (Rs b)	65.2											
M.Cap. (US\$ b)	1.4											

Union Bank of India (UBI) reported earnings growth of 218% YoY for 2QFY07 on a low base. NII growth was muted at 4% due to a big jump in interest expenses and margins declined due to a rise in funding costs. Recoveries drove growth in core other income. On an absolute basis, asset quality worsened on a QoQ basis due to one large account being treated as an NPA.

- ✍ Margin pressure continues; 2Q margins at 2.76%
- ✍ Strong business growth; loans up by 29%, deposits by 14%
- ✍ Recoveries drive non-interest income
- ✍ Asset quality on absolute basis worsens QoQ

Union Bank has been one of the fastest growing bank amongst the state-owned banks; however this aggressive growth has led to resources cost rising faster for the bank leading to margin pressure. We believe that the bank needs to focus on margins more than volumes to continue to grow its earnings at a strong pace. We expect margins to improve from hereon for the bank, as it focuses on quality loans and emphasizes on growing its low-cost deposit base. We expect the bank to report an EPS of Rs15.2 and Rs19.1 in FY07 and FY08. The stock trades at 6.7x FY08E EPS and 1.2x FY08E BV. Maintain **Buy**.

QUARTERLY PERFORMANCE

(RS MILLION)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Interest Income	13,578	14,202	15,135	15,723	16,657	17,724	18,616	20,044	58,638	73,041
Interest Expense	8,230	8,179	8,741	9,744	10,312	11,449	12,063	13,182	34,894	47,006
Net Interest Income	5,347	6,023	6,394	5,979	6,345	6,276	6,553	6,862	23,743	26,035
% Change (Y-o-Y)	14.6	31.9	10.3	6.5	18.7	4.2	2.5	14.8	15.0	9.7
Other Income	1,337	1,403	1,390	2,122	1,650	1,918	1,529	1,746	6,251	6,843
Net Income	6,684	7,426	7,784	8,100	7,995	8,193	8,082	8,608	29,994	32,879
% Change (Y-o-Y)	-4.7	20.2	1.0	9.4	19.6	10.3	3.8	6.3	6.0	9.6
Operating Expenses	3,153	3,855	3,501	3,515	3,730	3,910	4,026	4,230	14,024	15,896
Operating Profit	3,531	3,571	4,283	4,585	4,265	4,283	4,056	4,378	15,970	16,982
Other Provisions	647	2,690	1,302	2,384	1,579	1,220	1,300	1,902	7,024	6,000
Tax Provisions	480	270	690	755	1,018	1,122	690	466	2,195	3,295
Net Profit	2,404	611	2,291	1,446	1,668	1,942	2,067	2,011	6,752	7,688
% Change (Y-o-Y)	14.3	-71.0	287.8	-39.5	-30.6	217.8	-9.8	39.1	-6.1	13.9
Cost to Income Ratio (%)	47.2	51.9	45.0	43.4	46.7	47.7	49.8	49.1	46.8	48.3
Interest Expense/Interest Income (%)	60.6	57.6	57.8	62.0	61.9	64.6	64.8	65.8	59.5	64.4
Other Income/Net Income (%)	20.0	18.9	17.9	26.2	20.6	23.4	18.9	20.3	20.8	20.8

E: MOST Estimates

Union Bank of India (UBI) reported earnings growth of 218% YoY for 2QFY07 on a low base. NII growth was muted at 4% due to a big jump in interest expenses and margins declined due to a rise in funding costs. Recoveries drove growth in core other income. On an absolute basis, asset quality worsened on a QoQ basis due to one large account being treated as an NPA.

Margin pressure continues

In 2QFY07, cost of deposits rose by 62bp YoY to 5.33%, as absence of excess SLR and low CASA deposits resulted in high interest cost – the bank had to resort to bulk borrowings to fund its strong loan growth. The result was a 40% increase in the bank’s interest expense. UBI had raised its PLR by 75bp in two stages. This helped to re-price some loans and improve yield on advances by 46bp YoY to 8.77%. Yield on investments declined 33bp to 7.61% in 2QFY07.

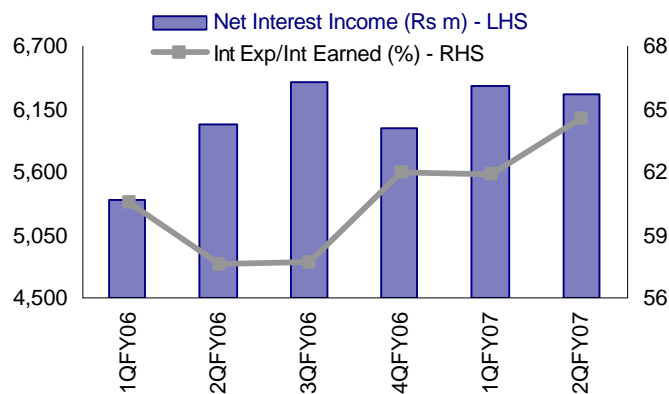
NIMS UNDER PRESSURE (%)

	SEP-05	MAR-06	JUN-06	SEP-06
Yields on Advances	8.3	7.9	8.5	8.8
Yield on Investments	7.9	7.8	7.6	7.6
Cost of Deposits	4.7	5.2	5.0	5.3
Net Interest Margins	3.2	2.8	2.9	2.8

Source: Company/ Motilal Oswal Securities

The management has set a target of reducing high cost deposits (~Rs17b decline in 2QFY07) in 3QFY07 by Rs20b, thereby curtailing its cost of deposits. The management expects margins to be 2.9% in 3QFY07 and 3% in 4QFY07.

TREND IN NII (%)

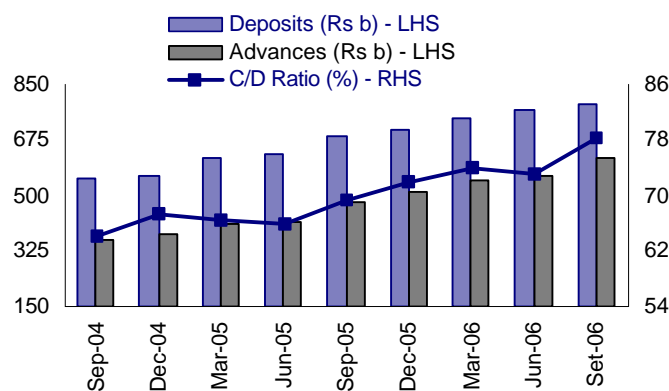


Source: Company/ Motilal Oswal Securities

Business growth continues

The bank’s loan book has grown 29% YoY to Rs614b. Deposits have grown 14% YoY to Rs785b. Low-cost deposits have grown by 18% YoY to Rs263b and currently constitute 33.5% of total deposits. UBI hopes to improve its share of low-cost deposits from 33.5% to 35% by FY07. The growth target for advances is 25% and that for deposits is 20% by March 2007.

STRONG LOAN AND DEPOSIT GROWTH



Source: Company/ Motilal Oswal Securities

Retail loans have grown by 33% YoY to Rs127b and account for 20.7% of total advances. Agriculture lending stood at Rs93b as at end-2QFY07 compared with Rs73b as at end-2QFY06, registering growth of 27%. Advances to SMEs have grown by 25% YoY to Rs72b in 2QFY07.

Recoveries drive core other income growth

Trading profits increased by 16% YoY in 2QFY07 to Rs376m. Core other income growth was largely driven by strong recoveries in written-off accounts, which were up by over 300% YoY. Income from commission & exchange increased by 26% YoY to Rs932m in 2QFY07.

The bank has highlighted the change in its focus towards sales. It has been gradually building up a strong marketing team, which will focus on retail loans, CASA deposits and fee income through third-party distribution products.

GROWTH IN NON-INTEREST INCOME (RS M)

	SEP-05	SEP-06	GR. (%)
Trading Income	324	376	16.0
Fee Income, Brokerage & Comm.	739	932	26.1
Third-party Income	110	90	-18.2
Misc. Income	230	520	126.1
Income from w/o Accounts.	70	290	314.3
Total non interest income	1,403	1,918	36.7

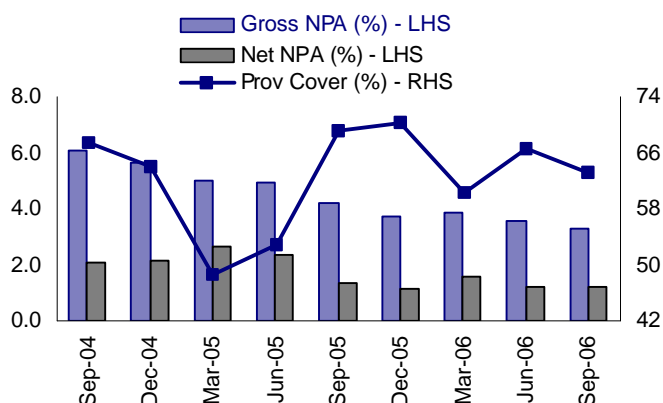
Source: Company/ Motilal Oswal Securities

Asset quality improves YoY but worsens QoQ

Asset quality worsened in 2QFY07 largely due to one large account turning non-performing. Gross and net NPAs have increased by 2% and 12% QoQ respectively on the back of this large account. Net NPAs have come down YoY to 1.24% and gross NPAs have come down to 3.28% in 2QFY07. Provision cover stands at 63%.

Cash recoveries/ Upgradations improved substantially to Rs1.7b (Rs3.6b in 1HFY07) during the quarter as against Rs1.3b (Rs2.6b in 1HFY06) in the corresponding period in the previous year due to the robust credit monitoring system put in place to arrest slippage and help recovery. The bank has issued 8,300 notices for outstandings worth Rs20b. The management has also stated that the bank has written-off some Rs12.5b worth of NPAs in FY06 and they expect to recover substantial NPAs in FY07.

MOVEMENT OF NPAS (%)



Source: Company/ Motilal Oswal Securities

Provisions decline on absence of shifting loss, resulting in strong PAT growth

UBI's provisions in 2QFY06 included a huge Rs2.4b hit due to shifting of Rs72b of securities to HTM, resulting in a thin bottom-line. Absence of any such item in 2QFY07 resulted in a 55% decline in provisions on YoY basis.

NPA-related provisions have also continued to increase since 1QFY07 primarily due to new RBI norms requiring banks to provide for 100% on loans above three years (despite having full collateral) as compared to 75% earlier.

PROVISIONS DECLINE ON A YOY BASIS

	SEP-05	SEP-06	GR. (%)
NPA Provisions	200	660	230.0
Depreciation Write-back (-)	490	410	-16.3
Amortization	430	390	-9.3
Shifting Loss	2,350	0	-11.9
Standard Asset	140	310	121.4
Others	60	270	350.0
Total	2,690	1,220	-54.6

Source: Company/ Motilal Oswal Securities

Tier-I capital still at 7%

UBI's Tier-I capital is a mere 7%. After accounting for Basel-II norms, we believe that Tier-I capital could reduce to <6.5%. Whilst equity dilution in the near term cannot be ruled out, the management as of now is raising capital through hybrid instruments. The bank has so far raised Rs7.5b through upper Tier-II issue and Rs3b through hybrid Tier-I capital in October 2006, which shall add 30bps to Tier-II capital. The bank also plans to mobilize Rs14b capital funds through issuance of bonds over the next five months. With government stake at 55.4% only, the bank has limited ability to raise equity capital. Lower capital adequacy will continue to be a concern for the bank.

Branch expansion to continue

UBI proposes to open another 100 branches in the current fiscal. It already has 2,090 branches spread all across India.

Of the 100 branches, seven will be opened in Chandigarh, comprising Haryana, Himachal Pradesh and the Union Territory of Chandigarh. The bank is also considering branches in Doha and Hong Kong and representative offices in Dubai and Shanghai, during the current fiscal. It intends to take the total number of ATMs from the present 570 to 1,000 by the end of FY07. It currently has 765 branches & 70 extension counters under the CBS, handling 76% of the total business.

Maintain Buy

Union Bank has been one of the fastest growing bank amongst the state-owned banks; however this aggressive growth has led to resources cost rising faster for the bank leading to margin pressure. We believe that the bank needs to focus on margins more than volumes to continue to grow its earnings at a strong pace. We expect margins to improve from hereon for the bank, as it focuses on quality loans and emphasizes on growing its low-cost deposit base. We expect the bank to report an EPS of Rs15.2 and Rs19.1 in FY07 and FY08 respectively. The stock trades at 6.7x FY08E EPS and 1.2x FY08E BV. **Maintian Buy.**

Union Bank of India: an investment profile

Company description

Union Bank is a large state-owned bank, with a balance sheet size of over Rs950b. While the bank is based in western India, its network of over 2,090 branches and 542 ATMs is well spread countrywide. 765 branches and 70 extension counters (EC) located in 235 centers are part of CBS, which contributes around 76% of the bank's total business.

Key investment arguments

- ✍ Strong focus on loan growth.
- ✍ Has networked 765 branches under core banking solution (2nd highest after PNB).
- ✍ Strong and expanding technology platform to ensure robust fee income going forward.

Key investments risks

- ✍ Tier-1 capital adequacy of 7% constrains significant asset expansion.

Recent developments

- ✍ Union Bank of India (UBI) has tied up with Small Farmers' Agri-business Consortium (SFAC) to facilitate growth of agri business.
- ✍ UBI recently raised Rs10.5b by way of upper Tier-II and hybrid Tier-I issue.
- ✍ Union Bank has permission from the RBI for opening branches in Doha and Hong Kong and for representative offices in Dubai and Shanghai. All these are under various stages of permission from the local authorities, in these countries.

Valuation and view

- ✍ We expect earnings to grow 26% in FY07 and 25% in FY08. Stronger momentum in core earnings will result in better valuations for the stock.
- ✍ The stock trades at 6.7x FY08E EPS and 1.2x FY08E BV. We maintain **Buy**.

Sector view

- ✍ YTD loan growth of 30%+, highest in the last 12 years.
- ✍ Volatility in interest rates would impact treasury.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

COMPARATIVE VALUATIONS

		UBI	BOI	VIJAYA BANK
P/E (x)	FY07E	8.5	8.9	8.3
	FY08E	6.7	7.2	6.4
P/ABV (x)	FY07E	1.6	1.5	1.4
	FY08E	1.3	1.3	1.2
RoE (%)	FY07E	15.9	16.3	16.5
	FY08E	17.7	17.6	18.8
RoA (%)	FY07E	0.8	0.7	0.9
	FY08E	0.8	0.8	0.9

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoters	55.4	55.4	60.9
Domestic Institutions	8.7	7.7	4.9
FII's/FDIs	19.9	19.9	19.2
Others	16.0	17.0	15.0

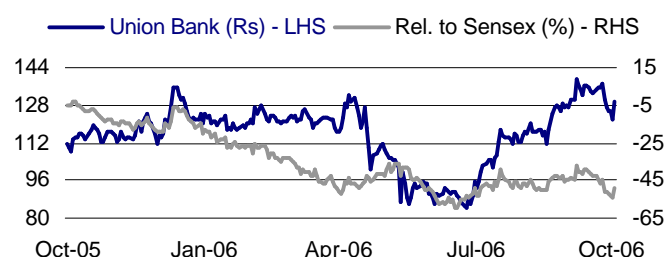
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	15.2	18.7	-18.7
FY08	19.1	23.1	-17.3

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
129	147	14.0	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E March	2005	2006E	2007E	2008E	2009E	
Interest Income	49,698	58,638	73,041	88,042	103,687	
Interest Expended	29,052	34,894	47,006	56,689	66,775	
Net Interest Incom	20,646	23,743	26,035	31,353	36,911	
Change (%)	18.9	15.0	9.7	20.4	17.7	
Other Income	7,661	6,251	6,843	7,059	7,745	
Net Income	28,307	29,994	32,879	38,412	44,657	
Change (%)	10.2	6.0	9.6	16.8	16.3	
Operating Expenses	12,575	14,024	15,896	17,884	20,060	
Operating Income	15,732	15,970	16,982	20,528	24,596	
Change (%)	6.1	1.5	6.3	20.9	19.8	
Other Provisions	9,616	7,024	6,000	7,100	7,800	
PBT	6,116	8,946	10,982	13,428	16,796	
Tax	-1,075	2,195	3,295	3,760	4,703	
Tax Rate (%)	-17.6	24.5	30.0	28.0	28.0	
PAT	7,191	6,752	7,688	9,668	12,093	
Change (%)	1.0	-6.1	13.9	25.8	25.1	
Proposed Dividend	1,821	2,020	2,273	2,526	2,778	

BALANCE SHEET		(Rs Million)				
Y/E March	2005	2006E	2007E	2008E	2009E	
Capital	4,601	5,051	5,051	5,051	5,051	
Reserves & Surplus	31,543	40,530	45,945	53,088	62,403	
Net Worth	36,144	45,581	50,996	58,139	67,454	
Deposits	618,306	740,940	870,605	1,009,901	1,171,485	
Change (%)	22.3	19.8	17.5	16.0	16.0	
Borrowings	20,210	39,745	48,488	58,186	69,823	
Other Liabilities & Pro	49,473	64,992	82,540	104,825	133,128	
Total Liabilities	724,131	891,256	1,052,628	1,231,051	1,441,890	
Current Assets	65,721	63,905	66,492	80,295	113,888	
Investments	227,927	259,175	298,051	342,758	394,172	
Change (%)	16	13.7	15.0	15.0	15.0	
Advances	401,051	533,800	651,235	768,458	891,411	
Change (%)	36.3	33.1	22.0	18.0	16.0	
Net Fixed Assets	8,238	8,104	7,948	7,748	7,448	
Other Assets	21,196	26,275	28,902	31,793	34,972	
Total Assets	724,132	891,258	1,052,629	1,231,052	1,441,891	

ASSUMPTIONS	(%)				
Deposit Growth	22.3	19.8	17.5	16.0	16.0
Advances Growth	36.3	33.1	22.0	18.0	16.0
Investments Growth	16	13.7	15.0	15.0	15.0
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	35.0	40.0	45.0	50.0	55.0
CRR	5.0	5.0	5.0	5.0	5.0

E: M OSt Estimates

RATIOS						
Y/E March	2005	2006E	2007E	2008E	2009E	
Spreads Analysis (%)						
Avg. Yield - Earning As	8.0	7.6	7.8	8.0	8.1	
Avg. Cost-Int. Bear. Li	5.0	4.9	5.5	5.7	5.8	
Interest Spread	2.9	2.7	2.3	2.3	2.3	
Net Interest Margin	3.3	3.1	2.8	2.8	2.9	
Profitability Ratios (%)						
RoE	215	16.5	15.9	17.7	19.3	
RoA	1.1	0.8	0.8	0.8	0.9	
Int. Expended/Int. Earn	58.5	59.5	64.4	64.4	64.4	
Other Inc./Net Income	27.1	20.8	20.8	18.4	17.3	
Efficiency Ratios (%)						
Op. Exps./Net Income	44.4	46.8	48.3	46.6	44.9	
Empl. Cost/Op. Exps.	64.1	61.8	59.6	58.3	57.6	
Busi. per Empl. (Rs m)	34.6	45.1	56.2	67.6	80.4	
NP per Empl. (Rs lac)	2.8	2.7	3.1	4.0	5.1	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	64.9	72.0	74.8	76.1	76.1	
Invest./Deposit Ratio	36.9	35.0	34.2	33.9	33.6	
G-Sec/Invest. Ratio	72.0	78.3	78.3	78.3	78.3	
Gross NPAs to Adv.	5.0	3.8	3.3	2.9	2.6	
Net NPAs to Adv.	2.6	1.6	1.1	0.7	0.4	
CAR	12.1	11.4	9.2	9.1	10.5	
Tier 1	6.1	7.3	6.1	6.0	5.8	

VALUATION						
Book Value (Rs)	68.2	81.0	91.7	105.9	124.3	
Price-BV (x)	19	16	14	12	10	
Adjusted BV (Rs)	53.3	70.3	82.3	98.5	119.5	
Price-ABV (x)	2.4	1.8	1.6	1.3	1.1	
EPS (Rs)	15.6	13.4	15.2	19.1	23.9	
EPS Growth (%)	10	-14.5	13.9	25.8	25.1	
Price-Earnings (x)	8.3	9.7	8.5	6.7	5.4	
OPS (Rs)	34.2	31.6	33.6	40.6	48.7	
OPS Growth (%)	6.1	-7.5	6.3	20.9	19.8	
Price-OP (x)	3.8	4.1	3.8	3.2	2.7	

E: M OSt Estimates

N O T E S

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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

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