Company Results Review

30 October 2006 | 7 pages

Oriental Bank of Commerce (ORBC.BO)

2Q07 Results: Asset Recoveries, but What About the Margin?

- Up 50%: And 50% ahead of our estimates: — OBC has meaningfully beaten our estimates at the net profit level. Not so at the pre-provisioning ex-trading gains levels, where its 28% yoy growth is in-line with expectations. The strong outperformance is driven by large write-backs on the loan book; a positive and ahead of expectations.
- Write-backs: Continue, and are large — OBC is delivering – relatively belatedly – on recoveries from GTB that it had acquired about 2 years ago. The trickle is becoming a flow, the numbers are large and even going forward, and the recoveries could be ahead of most estimates. A positive, for earnings, capital and management deliveries.
- But, low margins fall further, and disappoint — OBC operates at among the lowest margins among peers; instead of normalizing, margins have dipped further. We believe this possibly reflects a modest funding franchise, aggressive asset growth, and poor management pricing. While base margins suggest more upside than risk, concrete measures are not in evidence yet.
- Maintain Hold/Medium Risk — The stock's strong bounce-back, valuations in-line with the market, the best likely on asset recoveries, and not enough apparent measures on margin revival, suggest modest stock performance rather than meaningful upside or downside movements ahead.

Hold/Medium Risk	2M
Price (30 Oct 06)	Rs259.65
Target price	Rs285.00
Expected share price return	9.8%
Expected dividend yield	1.7%
Expected total return	11.5%
Market Cap	Rs65,053M
	US$1,444M

Price Performance (RIC: ORBC.BO, BB: OBC IN)

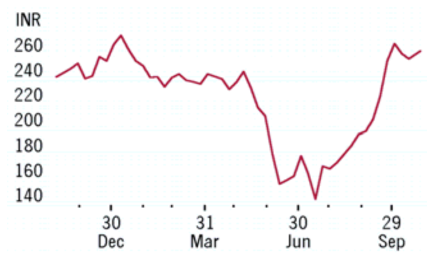

Figure 1. Statistical Abstract

Year to March	Net Profit (Rs Mils.)	FD EPS (Rs)	EPS Growth (%)	P/E (X)	P/BV (X)	ROAE (%)	ROAA (%)	Div Yld (%)
FY05	7,608	39.5	10.9	6.6	2.1	30.3	1.6	1.2
FY06	5,572	25.1	-36.4	10.3	1.5	16.4	1.0	1.7
FY07E	5,947	23.7	-5.6	10.9	1.3	12.7	0.9	1.7
FY08E	7,817	31.2	31.4	8.3	1.2	14.9	1.1	1.7
FY09E	9,612	38.4	23.0	6.8	1.0	16.1	1.2	1.7

Source: Company Reports and Citigroup Investment Research

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See page 5 for Analyst Certification and important disclosures.

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E (x)	6.6	10.3	10.9	8.3	6.8
P/E - reported (x)	6.6	10.3	10.9	8.3	6.8
P/BV (x)	2.1	1.5	1.3	1.2	1.0
P/Adjusted BV (x)	2.1	1.5	1.3	1.2	1.0
Dividend yield (%)	1.2	1.7	1.7	1.7	1.7
Per Share Data (Rs)					
EPS (adjusted)	39.51	25.15	23.74	31.20	38.36
EPS (reported)	39.51	25.15	23.74	31.20	38.36
BVPS	121.95	177.13	195.80	221.94	255.24
Tangible BVPS	121.95	177.13	195.80	221.94	255.24
Adjusted BVPS	121.95	177.13	195.80	221.94	255.24
DPS	3.00	4.50	4.50	4.50	4.50
Profit & Loss (RsM)					
Net interest income	15,237	16,051	17,033	19,938	23,046
Fees and commissions	1,565	2,043	2,452	2,820	3,243
Other operating Income	3,532	3,317	2,152	2,335	2,898
Total operating income	**20,334**	**21,411**	**21,636**	**25,093**	**29,187**
Total operating expenses	-7,957	-9,659	-10,893	-11,987	-13,412
Oper. profit bef. provisions	**12,377**	**11,753**	**10,743**	**13,106**	**15,775**
Bad debt provisions	-4,001	-3,598	302	-1,189	-1,294
Non-operating/exceptionals	-45	167	-2,550	-750	-750
Pre-tax profit	**8,330**	**8,322**	**8,496**	**11,167**	**13,731**
Tax	-722	-2,750	-2,549	-3,350	-4,119
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**7,608**	**5,572**	**5,947**	**7,817**	**9,612**
Reported net income	**7,608**	**5,572**	**5,947**	**7,817**	**9,612**
Adjusted earnings	7,608	5,572	5,947	7,817	9,612
Growth Rates (%)					
EPS (adjusted)	10.9	-36.4	-5.6	31.4	23.0
Oper. profit bef. prov.	-19.5	-5.0	-8.6	22.0	20.4
Balance Sheet (RsM)					
Total assets	**530,905**	**582,043**	**678,195**	**779,133**	**892,073**
Avg Interest earning assets	474,159	557,539	625,970	720,298	823,223
Customer loans	275,915	356,876	428,327	509,662	592,634
Gross NPLs	25,128	21,163	17,826	18,888	21,165
Liab. & shar. funds	**530,905**	**582,043**	**678,195**	**779,133**	**892,073**
Total customer deposits	478,503	501,975	591,931	684,677	787,420
Reserve for loan losses	22,923	21,104	18,685	18,091	17,497
Shareholders' equity	23,480	44,378	49,056	55,605	63,948
Profitability/Solvency Ratios (%)					
ROE adjusted	30.3	16.4	12.7	14.9	16.1
Net interest margin	3.2	2.9	2.7	2.8	2.8
Cost/income ratio	39.1	45.1	50.3	47.8	46.0
Cash cost/average assets	1.7	1.7	1.7	1.6	1.6
NPLs/customer loans	9.1	5.9	4.2	3.7	3.6
Reserve for loan losses/NPLs	91.2	99.7	104.8	95.8	82.7
Bad debt prov./avg. cust. loans	1.6	1.1	-0.1	0.3	0.2
Loans/deposit ratio	57.7	71.1	72.4	74.4	75.3
Tier 1 capital ratio	6.1	11.7	10.7	10.2	10.1
Total capital ratio	9.8	12.5	11.8	11.1	10.9

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Figure 2. 2QFY07 Results: Highlights

	2Q07	2Q06	YoY %	1Q07	QoQ%	Citigroup Investment Research Comments
Interest Income	12,822	10,069	27.3	11,353	12.9	Bolstered by aggressive loan expansion
Interest Expense	(8,695)	(6,027)	44.3	-7,244	20.0	Aggressive, and apparently high cost, deposit expansion
Net Interest Income	**4,128**	**4,042**	**2.1**	**4,110**	**0.4**	Lower than expectation, reflecting a margin compression on already low margins
Fee-Based Income	1,380	747	84.8	1,211	14.0	Very strong gains; could well include some one-offs, clarity needed
Other Non-Interest Income	199	973	-79.6	476	-58.3	Sharp dip - relatively surprising in a favorable fixed income market
Non Interest Income	1,579	1,720	-8.2	1,687	-6.4	
Operating Income	5,707	5,762	-1.0	5,797	-1.5	
Operating Expenses	(2,566)	(2,503)	2.5	(2,287)	12.2	Key driver of operating profitability
Pre-Provision Profit	**3,141**	**3,259**	**-3.6**	**3,510**	**-10.5**	
Charges for Bad Debts	737	(324)	NM	648	13.8	Impressive write-backs on NPL's - consistent with previous quarter, and a little ahead of expectations
Other Operating Items		0	NM	(2,124)	NM	
Operating Profit	3,878	2,935	32.1	2,033	90.7	
Pre-Tax Profit	3,878	2,935	32.1	2,033	90.7	
Tax	(771)	(670)	15.1	(481)	60.3	
Extraordinary Items	(612)	(612)	0.0	(612)	0.0	
Net Profit	**2,495**	**1,653**	**51.0**	**940**	**165.4**	**About 50% ahead of our expectations - driven entirely by loan book write-backs**
EPS	9.96	7.44	33.8	3.75	165.4	
Customer Loans	386,501	300,416	28.7	364,494	6.0	Inline with industry growth
Customer Deposits	597,815	493,622	21.1	545,063	9.7	Aggressive deposit growth - well ahead of market expansion
AIEA	617,830	490,342	26.0	594,971	3.8	
AIBL	564,959	470,799	20.0	580,499	-2.7	
Total Assets	685,916	570,646	20.2	647,776	5.9	
Avg Assets	666,846	547,823	21.7	626,587	6.4	
Non-Performing Loans (NPL)	18,486	23,853	-22.5	20,450	-9.6	Asset quality performance has been impressive
Loan Loss Reserves (LLR)	(16,776)	(21,734)	-22.8	(18,840)	-11.0	
Shareholders' Funds	45,929	26,173	75.5	42,167	8.9	
Book Value Per Share	183	118	55.5	168	8.9	
Key Ratios (%)	**2Q07**	**2Q06**	**Bps Δ YoY**	**1Q07**	**Bps Δ QoQ**	**Citigroup Investment Research Comments**
ROAA (annualized)	1.46	1.16	30	0.58	87	
ROAE (annualized)	21.73	25.26	-353	8.92	1281	
Net Interest Margin (bps)	267	330	-62	276	-9	Key disappointment - well below industry margins get pushed even lower
Fee Inc/Operating Income	24.2	13.0	1123	20.9	330	Smart pickup, though clarity needed on composition
Other Non-Interest Inc/Op Inc	27.7	29.9	-218	29.1	-143	
Op. Cost/ Operating Income	45.0	43.4	152	39.4	551	Cost efficiencies fundamentally ahead of market; though current performance in line with industry
Loan-to-Deposit Ratio (LDR)	64.7	60.9	379	66.9	-222	Relatively greater funding flexibility than peers
NPL/Loan Ratio	4.8	7.9	-316	5.61	-83	
LLR/NPL Ratio	91	91	-37	92	-138	

Source: Company Reports and Citigroup Investment Research

Oriental Bank of Commerce

Company Description

Oriental Bank of Commerce was established in 1943 and nationalized in the second round of nationalization in 1980. The bank is headquartered in Delhi, and the government holds 66% of the bank's equity. OBC is a medium-sized bank with a share of about 2% in deposits and advances of the Indian banking system. OBC has a domestic network of 1,100 branches and extension counters.

Investment Thesis

We rate OBC as a Hold/Medium Risk (2M) stock, with a target price of Rs285. OBC is a small North India-based government bank that has over the past few years aggressively cleaned up its balance sheet and lowered net NPLs to zero. In August 2004, OBC embarked on the takeover of Global Trust Bank, a failed private-sector bank based in Southern India, with a view to acquiring a branch network in that region. This has not worked out well, in our view. It was too expensive, integration has taken too much time, management has changed at OBC, and overall profitability has been hurt. This transaction has effectively pegged down OBC from being among the most profitable and expensive banks among government banks to one of the cheapest but least profitable banks in the system. Interest rates remain a risk. OBC's bond portfolio is among the most exposed to interest rates in the sector, in our view: high yield, high duration, and with limited accounting protection.

However, the basic business and franchise remains solid: the asset book is clean and OBC's geographic concentration in North India is an advantage. We believe the balance sheet and operating structure is lean enough to be aggressively turned around, supporting higher profitability and valuations. The stock has had a good run in the last couple of months and valuations no longer look cheap at 1.25x one-year forward BV.

Valuation

Our target price of Rs285 is based on our EVA methodology. We assume a risk-free rate of 8% and a beta of 1. Our loan loss expectation is 75bps, in line with the average for government banks. We are also benchmarking our target price against 1.3x one-year forward P/BV, which translates into a valuation of Rs272. Our target multiple continues to be at discounts to those for SBI, PNB and Corporation Bank. We believe a valuation discount to some peer banks is still justified due to the quality and structure of the businesses and given pressures on operating profitability, and franchise issues on the funding front. We prefer to use EVA as our primary methodology, as we believe it adjusts well for the relatively dynamic cost of capital and captures well the long-term value of the business.

Risks

We rate OBC as Medium Risk, as implied by our quantitative risk-rating system, which tracks 260-day share price volatility and based on its business profile. Its NPLs are low, operating profitability is high and management has some gains as a cushion for its bond portfolio. The risks to our target price for OBC lie in its relatively small size, new top management team, and more negative surprises from its recently consummated acquisition. The small size of the bank suggests that a few mistakes or individuals could hurt what we believe is a safe and high-quality balance sheet. In addition, a sharp increase in interest rates could erode the bond portfolio and raise deposit mobilization costs. The key upside risks to our target price include: (1) significant recoveries from the large NPL book it has recently acquired; (2) fall in interest rates, which would ease the pain from its bond book; and (3) pick-up in acquisition execution and effectiveness.

Analyst Certification Appendix A-1

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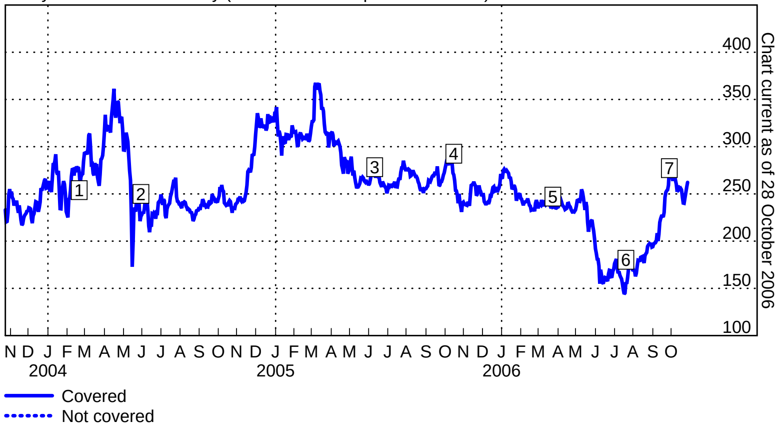
Oriental Bank of Commerce (ORBC.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Manish Chowdhary (covered since September 7 2006)



#	Date	Rating	Target Price	Closing Price
1:	20 Feb 04	*2M	*312.00	272.90
2:	31 May 04	2M	*280.00	226.30
3:	10 Jun 05	2M	*305.00	269.70
4:	17 Oct 05	2M	*325.00	270.10
5:	24 Mar 06	2M	*275.00	236.00
6:	20 Jul 06	*1M	*194.00	156.40
7:	28 Sep 06	*2M	*285.00	277.30

*Indicates change.

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