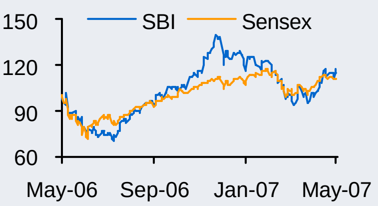
State Bank of India (Q4 FY07) - Investment Update

Recommendation	HOLD
CMP	Rs1153
Target Price	Rs1261
Upside	9%
Market Cap	Rs607bn
52 Week H/L	Rs1617/ 685
Face Value	Rs10
BSE Code	500112
NSE Code	SBIN
Bloomberg Code	SBIN@IN
Reuters Code	SBI.BO
1 Month avg vol.	0.6mn

Share Holding Pattern

(%)	Dec'06	Mar'07
Government	59.7	59.7
Institutions	12.9	12.2
FII	19.8	19.8
Public	7.6	8.3

Share Price Trend



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SBI's profit growth of 75% was far above our expectation despite us being ahead of consensus. However, adjusting for the Rs4.6bn amortization write back, profitability was in line with expectations. The management has indicated that it intends to improve its business market share, and maintain margins by raising CASA ratio. However, we feel both might not be possible and margins would remain under pressure. With tier I CAR at 8%, equity issuance is on the cards. A smaller issuance is value accretive, while a large issue could hamper valuations. We maintain our HOLD rating on the stock with an upward revision in earnings by 4% for FY08 and FY09 respectively and price target to Rs1261.

Result update

Strong core profit growth performance.....

Net profit growth of 75% was driven by strong core business performance with net interest income growing by 21.5% (NIM at 3.31% against 3.29% in Q3 FY07) and fee income growing by 20.8%. Also higher dividend income in the current quarter (generally comes in Q1, though new tax laws prompted this move) more than made up for the 43% drop in forex income and 53% drop in trading profits.

..... though business growth far higher than expected

Advances growth of 28.9% was far higher than expected, as we estimated moderation from Q4 FY07. The higher growth follows management's guidance that the Bank will continue to focus on gaining business market share. Deposit growth though remained moderate at 14.6% as Bank continued to substitute investments for incremental credit growth.

Amortization write back of Rs4.6bn propelled profitability

The Bank witnessed an amortization premium write back of Rs4.6bn during the quarter. This resulted in profit reporting higher than expected growth during Q4 FY07.

Asset quality reported a marginal blip

While gross NPAs dropped by 4% sequentially to Rs100bn, net NPAs increased by 17% to Rs52.6bn. Consequently provision cover also dropped down significantly to 47%, now at 2003 level. The management has been vocal of increased defaults on its retail and SME lending, which we feel would continue in the near future as well.

Table: Valuation summary

	FY05	FY06	FY07E	FY08E	FY09E
Net Profit (Rs bn)	43.0	44.1	45.4	51.9	58.7
Growth (%)	16.9	2.4	3.1	14.2	13.2
EPS (Rs)	81.8	83.7	86.3	98.6	111.6
ROAA (%)	1.0	0.9	0.9	0.9	0.9
ROE (%)	19.4	17.0	15.4	15.5	15.4
PE (x)	14.1	13.8	13.4	11.7	10.3
P/ Bv (x)	2.5	2.2	1.9	1.7	1.5
P/ Adj Bv (x)	3.2	2.7	2.3	2.1	1.9

Source: Company data, India Infoline research

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Analyst meet takeaway

Management keen on gaining market share

SBI over the past 4 years has consistently lost market share to private players, though this has stabilized in the past 6 months. The management is keen on now improving its market share in both the deposits and advances. While we think this is manageable, maintaining asset quality at such high growth rate is difficult, which is amply evident currently.

Plans to maintain margin by raising CASA ratio

Twin focus on improving market share and maintaining asset quality is a difficult task. The Bank expects to achieve this by improving its CASA ratio by 300bps in FY08 (100bps in Current deposits and 200bps in Savings deposits). Rural segment is expected to be Bank's focus area for savings deposits, which has already seen improvement with Rs66bn mobilized in the past 3months.

We expect margins to remain under pressure

We feel either market share or improved margins, both would require a supreme effort to be achieved. While the management expects margins to remain flat, we expect them to remain under pressure as funding costs continue to remain high and passing rate hikes to customer is increasingly becoming difficult as asset quality is at risk.

Asset quality problems in retail and SME segment

The Bank continues to face increased delinquencies in its retail and SME segment and has also voiced that passing on rate hikes is increasingly becoming difficult especially in the SME segment. This reiterates our stance on the sector asset quality stance (Read our latest report on the Banking sector 'Interest rate pangs").

Faster recruitment in future to reduce operating leverage

With SBI carrying the highest employee per branch of 22, operating leverage playing out remains high. However, the Bank's recent recruitment plan makes us believe that operating leverage playing out would be much slower than expected. Our assumption is based on management guidance that despite a natural attrition of 6,000 employees per year, Bank intends to recruit 6000-8000 new employees each year over the next 2-3 years.

As-15 impact maintained at Rs40-50bn

The Bank has maintained that the impact of As-15 relating to contribution towards employee pension funds is expected to remain around Rs40-50bn.

Tier I at 8%, equity dilution on the cards

With tier I capital adequacy at 8%, the Bank is expected to raise capital during FY08. The Bank has indicated that it would raise around Rs150bn through a combination of debt and equity and maintain year end tier I capital at 8%.

With current government holding at ~60%, Bank has around ~5% headroom to raise fresh capital as government holding should remain at 55%. Post the passage of SBI Act amendment bill in parliament the Bank can reduce government stake to 51%. However, we feel a higher equity dilution with government stake falling down to 51% would pull down ROE significantly and impact valuations. A smaller dilution with government stake at 55% would raise Rs55bn for the Bank, maintain ROE attractive at 14% and still meet its target tier I of 8%.

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Table: Quarterly Financials

(Rs bn)	Q4 FY07 (3)	Q4 FY06 (3)	Growth (%)	Q3 FY07* (3)	Growth (%)	FY07 (12)	FY06 (12)	Growth (%)
Interest Earned	115	85	35.6	97	18.5	395	360	9.8
Interest Expended	(72)	(50)	45.8	(58)	24.8	(234)	(204)	14.9
Net Interest Income	43	36	21.5	40	9.3	161	156	3.0
Other Income	29	24	22.6	18	59.8	58	44	31.6
Net Total Income	72	59	21.9	58	25.2	218	200	9.3
Operating Expenses	(32)	(30)	9.9	(29)	11.6	(118)	(117)	0.8
Pre Provisioning Profit	40	30	34.0	29	39.0	100	82	21.4
Provisions	(14)	(10)	38.0	(12)	21.1	(24)	(13)	79.4
Profit Before Tax	26	19	31.9	17	51.3	76	69	10.1
Tax	(11)	(11)	(2.0)	(6)	70.4	(30)	(25)	22.0
Profit After Tax	15	9	75.0	11	40.2	46	44	3.3
Total Advances	3,373	2,616	28.9	3,094	9.0	3,373	2,616	28.9
Deposits	4,355	3,800	14.6	4,044	7.7	4,355	3,800	14.6
CASA ratio (%)		43.4	-	43.3	-		43.4	-
Credit Deposit ratio (%)	77.5	68.8	-	76.5	-	77.5	68.8	-
Yield on Advances (%)	8.7	7.8	-	8.6	-	8.7	7.8	-
Yield on Invts (%)	6.9	7.1	-	6.9	-	6.9	7.1	-
Cost of deposits (%)	4.8	4.5	-	4.6	-	4.8	4.5	-
NIM (%)	3.3	3.4	-	3.3	-	3.3	3.4	-
NIM Adjusted (%)	3.3	2.9	-	3.3	-	3.3	2.9	-
GNPA (%)	2.9	3.9	-	3.3	-	2.9	3.9	-
NNPA (%)	1.6	1.9	-	1.5	-	1.6	1.9	-
GNPA (Rs bn)	100	104	(3.6)	104	(4.1)	100	104	(3.6)
NNPA (Rs bn)	53	49	7.2	45	17.2	53	49	7.2
CAR (%)	12.3	11.9	-	11.9	-	12.3	11.9	-
Tier I (%)	8.0	9.4	-	8.1	-	8.0	9.4	-

Source: Company data, India Infoline research

* *income statement is not comparable due to the change in accounting policy reported in the Q4 FY07 results relating to investment premium amortization.*

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