

## State Bank of India

STOCK INFO.	BLOOMBERG
BSE Sensex: 10939	SBIN IN
	REUTERS CODE
S&P CNX: 3,247	SBI.BO

19 May 2006

**Buy**
*Previous Recommendation: Buy*
**Rs868**

Equity Shares (m)	526.3
52-Week Range	1,015/631
1,6,12 Rel. Perf.(%)	1/-31/-33
M.Cap. (Rs b)	456.8
M.Cap. (US\$ b)	10.0

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROAE	ROAA	P/ABV
END	(RS B)	(RS B)	(RS)	GROWTH (%)	RATIO	(X)	(%)	(%)	(%)	RATIO
3/06A	230.2	44.1	83.7	2.4	10.4	1.6	11.9	17.0	0.9	1.8
3/07E	236.4	51.7	98.2	17.3	8.8	1.4	11.2	17.3	1.0	1.5
3/08E	274.3	61.7	117.3	19.4	7.4	1.2	11.5	17.7	1.0	1.3

- State Bank of India (SBI) reported decline in profits of 20% in 4QFY06, lower compared with our expectations. Whilst reported net interest income (NII) declined by 10% YoY to Rs35.5b, after adjusting for tax refunds in 4QFY05, the actual NII decline was 3%. However, on a sequential basis, adjusted NII grew by 20%. For FY06, reported NII increased by 12% to Rs156b, actual NII, after adjusting for tax refunds and one-offs, grew by 6% to Rs136b.
- Overall, adjusted margins have declined to 2.92% in FY06 compared with 3.12% in FY05. While yield on loans have improved by 10bp in FY06, yield on investments have declined sharply by 84bp to 7.1%. Cost of deposits excluding IMDs has declined by 21bp to 4.49%. However, with lending rates rising from May 2006 by 50bp, margins are likely to improve from this level.
- Deposits grew 4% to Rs3,800b, as IMDs were repaid during the year. Adjusting for IMDs, deposits have grown by 13% in FY06. CASA deposits currently are at 43%. Net loans grew by 29% to Rs2,616b in FY06.
- Most significantly, we note core business trends improved — yields on advances were higher and cost of deposits, lower. We expect this trend to drive earnings ahead. Absence of one-offs should also result in strong earnings hereon. Moreover, the bank should benefit from slow growth in opex and lower provisioning requirements going forward.
- We expect SBI to report consolidated EPS of Rs145 in FY08 and consolidated B/V of Rs935 in FY08. The stock trades at P/E of 6x and P/BV of 0.9x FY08 earnings. Reiterate **Buy**.

**QUARTERLY PERFORMANCE**

(Rs Million)

	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Income	76,666	80,848	80,291	86,476	91,663	85,614	95,582	85,091	324,280	357,949
Interest Expenses	47,125	47,050	43,690	46,969	49,131	49,535	53,383	49,545	184,834	201,593
<b>Net Interest Income</b>	<b>29,541</b>	<b>33,798</b>	<b>36,601</b>	<b>39,507</b>	<b>42,532</b>	<b>36,079</b>	<b>42,199</b>	<b>35,546</b>	<b>139,446</b>	<b>156,356</b>
% Change (Y-o-Y)	10.0	40.0	32.0	19.2	44.0	6.8	15.3	-10.0	24.7	12.1
Other Income	15,387	16,525	22,380	16,907	15,766	12,946	18,404	26,770	71,199	73,886
Bond Gains	1,499	4,679	9,476	2,098	1,307	2,467	1,298	861	17,753	5,872
<b>Net Income</b>	<b>44,928</b>	<b>50,323</b>	<b>58,981</b>	<b>56,414</b>	<b>58,298</b>	<b>49,026</b>	<b>60,603</b>	<b>62,316</b>	<b>210,645</b>	<b>230,242</b>
% Change (Y-o-Y)	1.2	-0.7	51.4	4.5	29.8	-2.6	2.8	10.5	12.1	9.3
Operating Expenses	24,214	24,274	25,081	27,173	23,903	29,197	34,607	29,544	100,742	117,251
<b>Operating Profit</b>	<b>20,714</b>	<b>26,049</b>	<b>33,900</b>	<b>29,241</b>	<b>34,395</b>	<b>19,829</b>	<b>25,996</b>	<b>32,772</b>	<b>109,904</b>	<b>112,992</b>
% Change (Y-o-Y)	-18.0	-8.9	88.3	23.6	66.0	-23.9	-23.3	12.1	15.0	2.8
Other Provisions	3,287	7,574	17,105	16,722	17,666	8,175	4,698	13,391	44,688	43,930
Provision for Taxes	6,843	7,656	5,801	1,866	4,501	-500	10,147	10,847	22,166	24,995
<b>Net Profit</b>	<b>10,584</b>	<b>10,819</b>	<b>10,994</b>	<b>10,653</b>	<b>12,228</b>	<b>12,154</b>	<b>11,151</b>	<b>8,533</b>	<b>43,050</b>	<b>44,066</b>
% Change (Y-o-Y)	17.6	9.4	19.5	22.1	15.5	12.3	1.4	-19.9	17.0	2.4
Cost to Income Ratio	53.9	48.2	42.5	48.2	41.0	59.6	57.1	47.4	47.8	50.9
Interest Exp / Interest Earned	61.5	58.2	54.4	54.3	53.6	57.9	55.9	58.2	57.0	56.3
Other Income / Net Income	34.2	32.8	37.9	30.0	27.0	26.4	30.4	43.0	33.8	32.1

E: MOST Estimates

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State Bank of India (SBI) reported profit decline of 20% in 4QFY06, lower than our expectations. Whilst reported NII declined by 10% YoY to Rs35.5b, after adjusting for tax refunds in 4QFY05, the actual NII decline was 3%. However, on a sequential basis, adjusted NII grew by 20%. For FY06 reported NII increased by 12% to Rs156b, actual NII after adjusting for tax refunds and one-offs, grew by 6% to Rs136b.

### Reported NII declines 10% YoY, actual NII declines 3% in 4QFY06

On a reported basis, NII declined by 10% YoY. However, after adjusting for the tax refund of Rs3b received in 4QFY06, actual NII declined by 3%. On a sequential basis, NII increased by 20%, as during 3QFY06 the bank was earning negative NII on the IMD investments. The bank had mobilized bulk deposits during 2QFY06 and 3QFY06, which had been invested in T-bills and were earning negative spreads. However, post the redemption (IMDs were redeemed on 29, December 2005), this negative spread was no longer present, and coupled with higher loan growth, sequential NII growth for SBI was strong.

#### ADJUSTED NII (RSB)

	4QFY06	4QFY05	3QFY06	YOY (%)	OOQ (%)
Interest Income	85.1	83.5	86.1	1.94	-1.17
Interest Expenses	49.5	47.0	56.4	5.49	-12.15
NII	35.5	36.5	29.7	-2.6	19.7

Source: Company/ Motilal Oswal Securities

### Loan yields improve; Investment yields close to bottom

We believe that the most important trend of SBI's results are its growth in advances and yield on these loans. Advances have grown by 29% YoY, while deposits have grown merely 3%. Yield on advances has improved 10bp in FY06. The strong growth in loans along with the better yields has resulted in 37% growth in interest on loans in FY06. Further, as SBI has increased its PLR (prime lending rate) by 50bp effective May 2006, lending yields are likely to expand further. This trend will be positive for SBI, as the bank is more focused on loans, which will offset the impact of the low yield on investments.

#### BREAKDOWN OF NIMS (%)

	FY02	FY03	FY04	FY05	FY06
Avg. yield on advances	9.66	8.97	8.17	7.68	7.78
Avg. yield on investments	10.06	9.53	8.62	7.94	7.10
Avg. cost of deposits	7.60	7.11	6.02	5.11	4.69
Avg. cost of deposits (ex IMDs)	7.07	6.43	5.48	4.70	4.49
NIMs (reported)	2.91	2.95	3.04	3.39	3.40
NIMs (adjusted)	2.91	2.95	3.04	3.12	2.92

Source: Company/ Motilal Oswal Securities

As seen from, the table, margin pressure for SBI has been mainly on account of its falling yields on its investment book. However, with yields on investment already at 7.1%, we do not expect any significant decline from these levels. This coupled with the faster growing loan yields should result in better margins going forward.

### Other income up 58% in 4QFY06

Other income increased sharply by 58%, led by strong growth in fee income, one-off miscellaneous income of Rs3.2b and recoveries from written-off NPA accounts. Fee income, on the other hand, was driven by a rise in earnings from the government business, as the government has changed the accounting method again to both *ad valorem* and trade-based with retrospective effect. As a result of this even 2Q and 3Q income (Rs1.6b) were booked in 4Q. Going forward, management expects the trend of fee income to remain strong, as commissions from the government business have improved coupled with an increase in the bank's service charges.

Treasury gains declined YoY from Rs2.01b to Rs0.8b in 4QFY06. For FY06, treasury gains were lower at Rs.5.9b from Rs.17.8b in FY05, declining by 67%.

### Operating expenses up 9% in 4QFY06

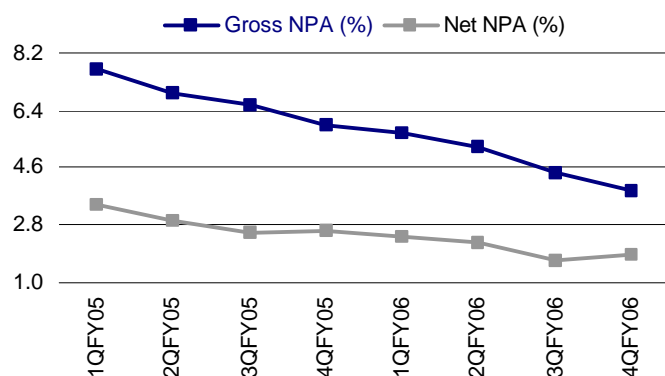
Of total operating expenses, the wage bill has gone up by 4% YoY, as the bank provided for lower pension provisions in 4QFY06. Other operating expenses increased by 19% in 4QFY06. For FY06, total staff expenses increased by 18%, on account of higher wages post revised wages.

SBI has not charged off the recent change in pension liability in FY06. In our last interaction with management, the latter had mentioned that the bank might have to provide ~Rs8b to create a fund which can pay additional pensions. We believe that SBI would amortize this cost over the next three years and thus the impact on profits in FY07 is likely to be restricted to Rs2.5b-Rs3b.

### Net NPAs are at 1.87%

Net NPAs declined during FY06 to 1.87% from 2.65% in FY05. We believe this is a significant achievement going by the size of SBI's balance sheet. However on QoQ basis, net NPAs increased by 20bp, as the bank wrote back floating provisions. Gross NPAs also declined to 3.88% from 5.96%, as incremental delinquencies continued to decline, coupled with increased recoveries. Overall, we expect net NPAs to fall further to near 1% by March 2008.

TREND IN ASSET QUALITY



Source: Company/ Motilal Oswal Securities

### Tier 1 capital of 9.4%; RBI's hybrid capital norms positive for SBI

Currently SBI has total capital adequacy of 11.9% with Tier 1 capital of 9.4%. This will ensure smooth compliance

with Basel 2 norms and also enable the bank to grow its loan book comfortably without any capital dilution.

Further, the current hybrid capital allowance permitted by the RBI is expected to be extremely positive for the larger state-owned banks. SBI is likely to be a key beneficiary, as it is best placed to raise resources through perpetual debt/preference shares at competitive rates. This should result in higher leverage and increased RoE going forward.

### Post transfer in 1QFY07, HTM is 70% of the investment book

SBI transferred securities worth Rs109b during 1QFY06 and had to take an impact of up to Rs6.5b. Post transfer, HTM increased to 70% of the investment book. Of the AFS book, duration of the portfolio is two years. However, we believe SBI will be at risk, if interest rates were to move upward from current levels and would take mark-to-market hits on its AFS portfolio. In 4QFY06, SBI took a hit of Rs12.5b towards investment depreciation (inclusive of amortization).

### Valuation and view

We believe that the worst is behind us and we expect an improving trend in net interest margins (NIM). Fee income will start improving from 1QFY07 onward. We continue to believe that SBI is doing well in its core operations. Moreover, it will benefit from slow growth in operating expenses and lower provisioning requirements going forward. We expect SBI to report consolidated EPS of Rs125 in FY07 and Rs145 in FY07. The consolidated book value in these years would be Rs82 and Rs935. The stock trades at P/E of 6x and P/BV of 0.9x FY08 earnings. Reiterate **Buy**.

## State Bank of India: an investment profile

### Company description

State Bank of India (SBI) is the largest commercial bank in India, with a balance sheet size of over Rs4,700b. The bank, along with associate banks, has a network of over 13,000 branches across India and controls over 25% of the banking business. The government owns 57% of the bank, with FIIs owning 20% (maximum permissible is 20%). Over the last couple of years, SBI has been focusing on sourcing significant synergies through an internal consolidation of its associate banks.

### Key investment arguments

- ✍ Proxy for the Indian economy; will benefit from uptick in loan growth
- ✍ Significant repricing of funds will result in stable margins
- ✍ Associate banks have been performing well and add significant value
- ✍ Natural attrition will bring down operating costs significantly over the next 3-4 years

### Key investment risks

- ✍ Significant rise in interest rates. The bank currently has 35% of its SLR investment book in AFS
- ✍ Delay in technology upgradation could result in loss of market share

### Recent developments

- ✍ Has divested 37% stake in its fully-owned subsidiary, SBI Funds Management Pvt. Ltd. realizing a profit of Rs1.4b.
- ✍ SBI has appointed Infosys to network its overseas branches and TCS to network the domestic branch network
- ✍ The bank has made clear its intention to acquire banks both locally and overseas to strengthen its position

### Valuation and view

- ✍ We expect loan growth and stable margins to drive earnings growth over the next few quarters. Cost efficiency and NPA recovery will be the next big triggers for earnings growth
- ✍ The stock trades at P/E of 6x and P/BV of 0.9x FY08 earnings. Reiterate **Buy**.

### Sector view

- ✍ Loan growth of 30% at the beginning of capex cycle
- ✍ Volatility in interest rates will impact bond gains
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations
- ✍ We maintain an Overweight stance on the sector

#### COMPARATIVE VALUATIONS

		SBI	PNB	BOB
P/E (x)	FY07E	8.8	7.9	8.7
	FY08E	7.4	6.7	7.3
P/ABV (x)	FY07E	1.5	1.3	1.0
	FY08E	1.3	1.1	0.9
RoE (%)	FY07E	17.3	16.7	11.8
	FY08E	17.7	17.1	12.7
RoA (%)	FY07E	1.0	1.1	0.8
	FY08E	1.0	1.2	0.9

#### SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	59.7	59.7	59.7
Domestic Institutions	11.6	12.0	11.5
FIIs/FDIs	19.8	19.8	19.8
Others	8.9	8.5	8.9

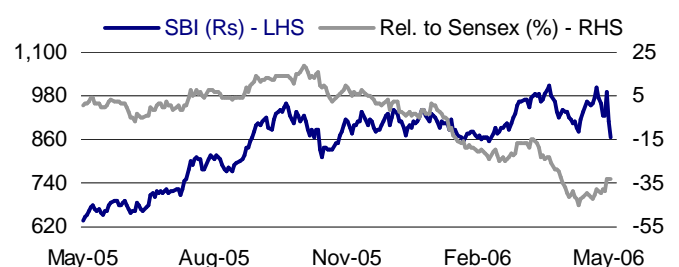
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	98.2	97.8	0.4
FY08	117.3	112.9	3.9

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
868	1,120	29.0	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Billion)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Interest Income	304.6	324.3	357.9	401.2	471.6	
Interest Expended	192.7	184.8	201.6	235.9	276.7	
<b>Net In. Income</b>	<b>111.9</b>	<b>139.4</b>	<b>156.4</b>	<b>165.3</b>	<b>194.8</b>	
Change (%)	2.1	24.7	2.1	5.7	17.9	
Other Income	76.1	71.2	73.9	71.1	79.5	
<b>Net Income</b>	<b>188.0</b>	<b>210.6</b>	<b>230.2</b>	<b>236.4</b>	<b>274.3</b>	
Change (%)	9.6	2.1	9.3	2.7	16.0	
Operating Expenses	92.5	100.7	117.3	132.6	148.6	
<b>Operating Income</b>	<b>95.5</b>	<b>109.9</b>	<b>113.0</b>	<b>103.8</b>	<b>125.7</b>	
Change (%)	22.9	15.0	2.8	-8.1	21.1	
Other Provisions	46.3	44.7	43.9	32.0	40.0	
<b>PBT</b>	<b>49.3</b>	<b>65.2</b>	<b>69.1</b>	<b>71.8</b>	<b>85.7</b>	
Tax	12.4	22.2	25.0	20.1	24.0	
Tax Rate (%)	25.3	34.0	36.2	28.0	28.0	
<b>PAT</b>	<b>36.8</b>	<b>43.0</b>	<b>44.1</b>	<b>51.7</b>	<b>61.7</b>	
Change (%)	18.6	17.0	2.4	17.3	19.4	
Proposed Dividend	5.3	6.3	7.4	7.9	7.9	

BALANCE SHEET		(Rs Billion)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Capital	5.3	5.3	5.3	5.3	5.3	
Reserves & Surplus	197.0	235.5	272.2	316.0	369.8	
<b>Net Worth</b>	<b>202.3</b>	<b>240.7</b>	<b>277.4</b>	<b>321.2</b>	<b>375.0</b>	
<b>Deposits</b>	<b>3,186.2</b>	<b>3,670.5</b>	<b>3,800.5</b>	<b>4,332.5</b>	<b>4,939.1</b>	
Change (%)	7.6	15.2	3.5	14.0	14.0	
Borrowings	134.3	191.8	214.9	240.6	269.5	
Other Liabilities & Prov.	555.3	495.8	689.4	717.5	753.1	
<b>Total Liabilities</b>	<b>4,078.2</b>	<b>4,598.8</b>	<b>4,982.1</b>	<b>5,611.9</b>	<b>6,336.8</b>	
Current Assets	435.7	393.2	391.3	282.4	252.5	
Investments	1,856.8	1,971.0	1,754.4	1,960.0	2,139.6	
Change (%)	7.7	6.2	-11.0	11.7	9.2	
Advances	1,579.3	2,023.7	2,616.4	3,139.7	3,704.9	
Change (%)	14.6	28.1	29.3	20.0	18.0	
Net Fixed Assets	26.5	27.0	27.0	27.0	27.0	
Other Assets	179.9	183.9	193.1	202.8	212.9	
<b>Total Assets</b>	<b>4,078.2</b>	<b>4,598.8</b>	<b>4,982.1</b>	<b>5,611.9</b>	<b>6,336.8</b>	

ASSUMPTIONS	(%)				
Deposit Growth	7.6	15.2	3.5	14.0	14.0
Advances Growth	14.6	28.1	29.3	20.0	18.0
Investments Growth	7.7	6.2	-11.0	11.7	9.2
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	110.0	125.0	140.0	150.0	150.0
CRR	4.5	5.0	5.0	5.0	5.0

E: MOSt Estimates

RATIOS						
Y/E MARCH	2004	2005	2006E	2007E	2008E	
<b>Spreads Analysis (%)</b>						
Avg. Yield - Earning Asse	8.2	7.9	8.0	8.0	8.2	
Avg. Cost-Int. Bear. Liab.	5.8	5.0	4.9	5.1	5.3	
Interest Spread	2.5	2.9	3.1	2.9	2.9	
Net Interest Margin	3.0	3.4	3.5	3.3	3.4	

Profitability Ratios (%)						
RoE	19.7	19.4	17.0	17.3	17.7	
RoA	0.9	1.0	0.9	1.0	1.0	
Int. Expended/Int. Earned	63.3	57.0	56.3	58.8	58.7	
Other Inc./Net Income	40.5	33.8	32.1	30.1	29.0	

Efficiency Ratios (%)						
Op. Exps./Net Income	49.2	47.8	50.9	56.1	54.2	
Empl. Cost/Op. Exps.	69.7	53.9	56.4	53.0	51.5	
Busi. per Empl. (Rs m)	25.3	30.3	34.4	40.7	47.6	
NP per Empl. (Rs lac)	2.0	2.3	2.4	2.8	3.4	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	49.6	55.1	68.8	72.5	75.0	
Invest./Deposit Ratio	58.3	53.7	46.2	45.2	43.3	
G-Sec/Invest. Ratio	87.2	81.5	80.0	80.0	80.0	
Gross NPAs to Adv.	7.8	6.0	3.9	3.8	3.2	
Net NPAs to Adv.	3.5	2.7	1.9	1.2	1.0	
CAR	13.5	12.5	11.9	11.2	11.5	
Tier 1	8.3	8.0	9.4	8.2	8.2	

VALUATION						
Book Value (Rs)	384.4	457.4	527.1	610.3	712.6	
Price-BV (x)	2.3	1.9	1.6	1.4	1.2	
Adjusted BV (Rs)	317.2	391.3	477.2	564.0	666.3	
Price-ABV (x)	2.7	2.2	1.8	1.5	1.3	
EPS (Rs)	69.9	81.8	83.7	98.2	117.3	
EPS Growth (%)	18.6	17.0	2.4	17.3	19.4	
Price-Earnings (x)	12.4	10.6	10.4	8.8	7.4	
OPS (Rs)	181.5	208.8	214.7	197.2	238.9	
OPS Growth (%)	22.9	15.0	2.8	-8.1	21.1	
Price-OP (x)	4.8	4.2	4.0	4.4	3.6	

E: MOSt Estimates



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**State Bank of India**

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|--|-----|
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| 2. Group/Directors ownership of the stock    | Yes |
| 3. Broking relationship with company covered | No  |

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