

Cutting PO; but earnings quality better

Results lower than est.; but earnings quality better

Union Bank's 4QFY07 earnings at Rs2.28bn (up 58% yoy) came in about 6-7% lower than our estimates owing to higher provisions and taxes. However, the quality of earnings was much better, led by a 41% yoy top line growth supported by higher CASA, 38% rise in fee revenues and sharp improvement in asset quality as fresh delinquencies declined and recoveries increased by 50% yoy. Gross NPL's were at 2.9%; net NPL's were 0.96% (0.4% incl general provisions).

Earnings cut by 16-17%; but may get higher rating

We are cutting earnings by 16-17% for FY08E and FY09E primarily owing to higher general provisions (owing to new RBI norms). We are, however, cutting our PO by only 6% to Rs160 (in sync with BV) as we believe the stock could also re-rate to 1.3-1.4x FY09E book owing to improved quality of earnings and rising ROE. This underpins our new PO. Sharp rise in NPLs/interest rates key risk to PO.

Earnings to still grow at 26% in FY08E; 21% in FY09E

We still forecast a 26% growth in FY08 earnings and 21% in FY09 led by 18% loan growth, benign margin pressure and 25% rise in fees. We are factoring in much higher provisions as we build in a rising NPL cycle (despite the bank doing well) and higher general provisions. ROE to rise to 20.8% by FY09E as bank focuses on profitability v/s growth owing to capital constraints – the key challenge as Tier I could fall to <6.5% post Basle II. Net NPLs to fall to <0.5% by FY09E and to be nil by FY08 itself including general provisions despite a rising NPL cycle.

Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	7,191	6,752	9,648	12,791	15,557
EPS	15.63	13.37	19.10	25.32	30.80
EPS Change (YoY)	1.0%	-14.5%	42.9%	32.6%	21.6%
Dividend / Share	3.50	3.50	5.00	7.00	8.00
Pre-exceptional EPS	25.69	22.28	21.87	28.57	34.76
Pre-exceptional EPS Change (YoY)	312.5%	-13.3%	-1.8%	30.6%	21.7%
Book Value / Share	NA	NA	NA	NA	NA

Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	7.0x	8.1x	5.7x	4.3x	3.5x
Dividend Yield	3.12%	3.12%	4.46%	6.24%	7.13%
Pre-exceptional PE	4.24x	4.89x	4.98x	3.81x	3.13x
Price / Book	1.52x	1.21x	1.05x	0.898x	0.761x
RoE / PB	14.11x	13.70x	18.77x	25.07x	30.63x
Price / Pre-Provision Profit	3.81x	3.66x	2.93x	2.21x	1.80x

Equity | India | Banks-Retail
08 May 2007



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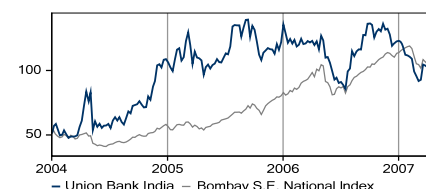
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Stock Data

Price	Rs108.85
Price Objective	Rs160.00
Date Established	7-May-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs80.50-Rs142.00
Mrkt Val / Shares Out (mn)	US\$1,346 / 505.1
Average Daily Volume	189,720
ML Symbol / Exchange	UBOIF / BSE
Bloomberg / Reuters	UNBK IN / UNBK.BO
ROE (2007E)	19.7%
Total Dbt to Cap (Mar-2006A)	NA
Est. 5-Yr EPS / DPS Growth	17.0% / 12.0%
Free Float	39.2%



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*iQprofile*SM Union Bank Of India

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
(Rs Millions)					
Net Interest Income	20,646	23,743	27,646	33,986	40,212
Net Fee Income	3,398	3,790	4,723	5,654	6,511
Securities Gains / (Losses)	1,666	1,498	1,947	2,239	2,508
Other Income	0	0	0	0	0
Total Non-Interest Income	5,064	5,288	6,670	7,893	9,019
Total Operating Income	25,709	29,031	34,316	41,880	49,231
Operating Expenses	(12,575)	(14,024)	(15,528)	(17,031)	(18,603)
Pre-Provision Profit	13,135	15,007	18,788	24,849	30,629
Provisions Expense	(2,391)	(1,557)	(3,200)	(4,400)	(5,750)
Operating Profit	9,231	12,949	15,088	19,949	24,379
Non-Operating Income	NA	NA	NA	NA	NA
Pre-Tax Income	6,116	8,946	14,188	18,811	22,878
Net Income to Comm S/Hold.	7,191	6,752	9,648	12,791	15,557
Adjusted Net Income (Operating)	7,191	6,752	9,648	12,791	15,557

Key Balance Sheet Data

Total Assets	724,133	891,260	1,063,792	1,275,924	1,509,528
Average Interest Earning Assets	399,754	532,238	665,686	814,344	983,236
Weighted Risk Assets	460,406	561,301	738,685	890,665	1,059,243
Total Gross Customer Loans	411,028	546,440	671,614	819,361	983,877
Total Customer Deposits	618,306	740,943	879,107	1,054,929	1,244,816
Tier 1 Capital	27,947	40,925	47,744	56,575	67,607
Tangible Equity	NA	NA	NA	NA	NA
Common Shareholders' Equity	36,145	45,582	52,401	61,232	72,263

Key Metrics

Net Interest Margin	5.16%	4.46%	4.15%	4.17%	4.09%
Tier 1 Ratio	6.1%	7.3%	6.5%	6.4%	6.4%
Effective Tax Rate	NM	24.5%	32.0%	32.0%	32.0%
Loan / Assets Ratio	56.8%	61.3%	63.1%	64.2%	65.2%
Loan / Deposit Ratio	66.5%	73.7%	76.4%	77.7%	79.0%
Oper Leverage (Inc Growth - Cost Growth)	4.6%	1.4%	7.5%	12.4%	8.3%
Gearing (Assets / Equity)	20.0x	19.6x	20.3x	20.8x	20.9x
Tangible Common Equity / Assets	0%	0%	0%	0%	0%
Tangible Common Equity / WRAs	0%	0%	0%	0%	0%
Revenue Growth	20.5%	12.9%	18.2%	22.0%	17.6%
Operating Expense Growth	15.9%	11.5%	10.7%	9.7%	9.2%
Provisions Expense Growth	-63.4%	-34.9%	105.5%	37.5%	30.7%
Operating Revenue / Average Assets	3.9%	3.6%	3.5%	3.6%	3.5%
Operating Expenses / Average Assets	1.9%	1.7%	1.6%	1.5%	1.3%
Pre-Provision ROA	2.0%	1.9%	1.9%	2.1%	2.2%
ROA	1.1%	0.8%	1.0%	1.1%	1.1%
Pre-Provision ROE	39.2%	36.7%	38.4%	43.7%	45.9%
ROE	21.5%	16.5%	19.7%	22.5%	23.3%
RoTE	NA	NA	NA	NA	NA
RoWRAs	1.6%	1.2%	1.3%	1.4%	1.5%
Dividend Payout Ratio	NA	NA	NA	NA	NA
Efficiency Ratio (Cost / Income Ratio)	52.3%	50.9%	48.0%	43.0%	39.8%
Total Non-Interest Inc / Operating Inc	20%	18%	19%	19%	18%
Market-Related Revenue / Total Revenues	6.5%	5.2%	5.7%	5.3%	5.1%
Provisioning Burden as % of PPP	18.2%	10.4%	17.0%	17.7%	18.8%
NPLs plus Foreclosed Real Estate / Loans	5.0%	3.8%	3.2%	3.0%	3.0%
Loan Loss Reserves / NPLs	48.5%	60.3%	69.4%	75.4%	77.8%
Loan Loss Reserves / Total Loans	2.5%	2.4%	2.3%	2.3%	2.4%
Provisions Expense / Average Loans	0.7%	0.3%	0.5%	0.6%	0.6%

Other Metrics

Income / Employee	0.280	0.266	0.381	0.508	0.621
(Operating Expenses) / Employee	0.490	0.552	0.614	0.677	0.743
Pre-Provision Profit / Employee	0.238	0.352	0.561	0.747	0.914
Net Profit / Employee	0.280	0.266	0.381	0.508	0.621

Company Description

Union Bank of India, one of the largest state-owned banks with a balance sheet of Rs800bn, is based out of Western India and has over 2,000 branches. The bank is likely to be a key beneficiary of the pickup in corporate credit cycle. It has one of the lowest interest rate risk with a low duration and de-risked bond portfolio. Union Bank also has a superior technology platform and better asset quality among the government banks.

Stock Data

Price to Book Value 1.0x

Summary results table

Table 1: 4QFY07 Results Summary

Income statement	4QFY06	4QFY07	yoy growth	4QFY07E	Remarks
Interest earned	15,723	20,949	33.2%	22,330	Strategy focussed on conserving capital; focus on profitability
- on Advances / Bills	10,250	14,305	39.6%	15,964	Rising loan yields and run down of lower yielding corporate loans
- Income on investments	4,980	5,386	8.1%	5,481	
- on bal with RBI and other banks	315	668	112.2%	886	
- Others	178	591	232.7%	-	Jump in cash yields owing to one time payment of interest on CRR balances
Interest Expended	9,744	12,526	28.5%	14,162	
Net Interest Income	5,979	8,424	40.9%	8,168	Significant increase in margins improving by 53 bps qoq and 72 bps yoy reaching 3.52% for the quarter. Key segments were high yielding assets and rise in CASA by 214bps to 34.5%
Other income	1,732	2,418	39.6%	2,049	39.6% increase in other income is mainly driven by increase in fee income; one of the most positive aspects of the results
- Profit on Sale of Investments	300	130	-56.7%	40	
- Other income	1,432	2,288	59.8%	2,009	
Operating income	7,710	10,841	40.6%	10,217	
Operating expenses	3,515	3,259	-7.3%	4,028	Opex restrained to 3259 mn, down 7% yoy due to stringent cost containment measures adopted by the bank; but unsustainable
- Employee expenses	2,050	1,488	-27.4%	2,375	
- Other Operating expenses	1,465	1,771	20.8%	1,653	
Operating profit	4,195	7,583	80.8%	6,190	
Provisions and contingencies	1,994	3,153	58.1%	1,376	Provisions were much higher owing to general provisions and writeoffs; coverage increased to 67.9% as compared to 60.3% in the previous year
- NPL provisions	850	1,580	85.9%	1,480	
PBT	2,201	4,430	101.3%	4,813	
Provision for Tax	755	2,144	184.1%	1,334	Base effect
PAT	1,446	2,286	58.1%	3,479	Contributed by increase in NIM yoy from 2.8% in 4QFY06 to 3.52% in 4QFY07, increase in fee based income and controlling the Opex which is down about 7% yoy

Source: Merrill Lynch Research Estimates

Price Objective Basis & Risk

We believe the stock could also re-rate to 1.3-1.4x FY09E book owing to improved quality of earnings and rising ROE. This underpins our new PO. Sharp rise in NPLs/interest rates key risk to PO.

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Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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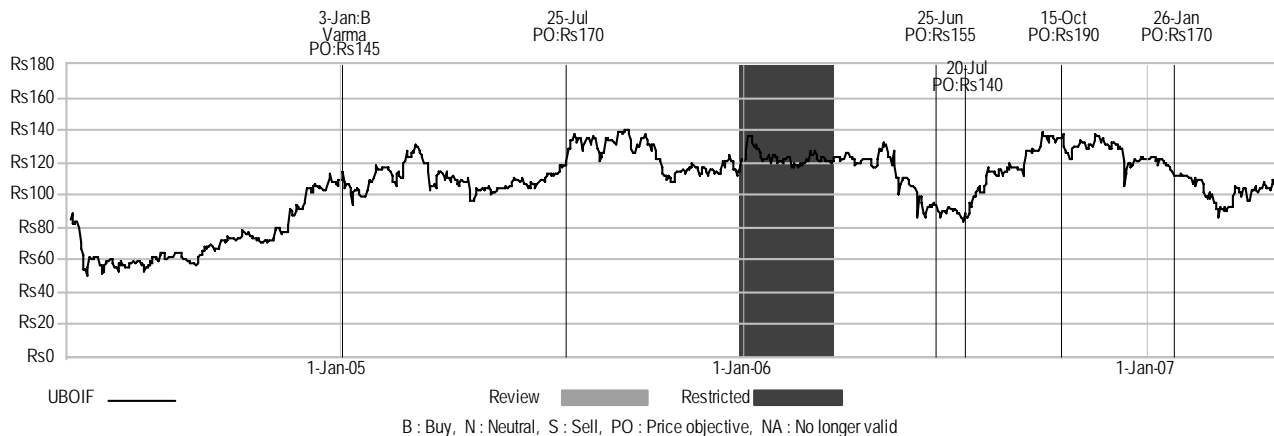
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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	119	44.57%	Buy	49	52.13%
Neutral	122	45.69%	Neutral	57	54.81%
Sell	26	9.74%	Sell	14	58.33%

Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
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Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

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