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Stock Rating
Underweight

Industry View
Cautious

May 19, 2006

Punjab National Bank

Poor Loan Spreads Underpin Weak Results

PNB announced its F4Q06 earnings at Rs2.9 bn, down 20% YoY and 22% sequentially. The results were weak with net interest income declining by 2% QoQ despite a 13% QoQ growth in deposits. NIMs contracted by about 13 bps this quarter due to a 26 bps contraction in the loan spreads. The bank took large bond losses (57% of its bond portfolio was in tradeable book) but this was made up by write-back of pension expense. This enabled the bank to report a 2% YoY growth in full year's earnings.

The key highlights of the results were:

Loan book grew by 24% YoY and 11% sequentially.

Retail loan book grew by 48% YoY and the share of retail now stands at 23% vs. 19% last year. However, loan yields declined by almost 30 bps during the quarter resulting in sequential interest on loan growth at 5% compared to loan growth of 11%.

Net Interest Income Growth for PNB was down 2% sequentially. This was held up by bond yields which expanded by 16 bps during the quarter to about 8.3% for F4Q06. However, the improvement in bond yields is not sustainable as the bank is carrying high coupon bonds which will come up for maturity resulting in lower bond yields. Moreover, cost of deposits have already started moving up (despite the increase in low cost deposit ratio from 46.3% last year to 49% now). Hence, weak loan yields, declining bond yields and firmer funding cost will keep NIMs under pressure, in our view.

Core fees were weak, declining by 2.5% YoY (on a sequential basis they increased, but this is not comparable due to the seasonal nature of fees income). The other non interest income (ex core fees) increased significantly by 36% YoY and 190% sequentially – due to higher capital gains in our view.

Key Ratios and Statistics

Reuters: **PNBK.BO** Bloomberg: **PNB IN**

India Financial Services

Price target	Rs350.0
Shr price, close (May 18, 2006)	Rs448.3
52-Week Range	Rs496.0-363.9
Sh out, basic, per-end (06e) (mn)	315.3
e = Morgan Stanley Research estimates	

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Operating expenses were a surprise, due to write-back of pension provision – Indian banks follow the ‘current unit method’ to calculate liabilities arising from pensions. Since F2005, PNB has provided for pension liabilities using ‘projected unit method’ (which is used for US GAAP). This had resulted in additional pension provision of Rs1.84 bn in F9M06 (and Rs3.68 bn in F2005). However, since the bank does not have to follow projected unit method under Indian GAAP, it has written back the pension expense of Rs1.84 bn taken in F9M06. This resulted in the sharp decline in operating expenses.

From F2007, Indian banks will have to follow projected unit method (under Indian GAAP too). However, the impact will not be felt on P&L as that expense could be taken through reserves.

Loan loss provision increased but coverage continues to reduce – LLP (as % of loans) increased to 80 bps this quarter from 40 bps last quarter. However, coverage continued to decline indicating potential weakening of underlying credit quality.

Significant interest rate risk remains - PNB has transferred about Rs61.9 bn of bonds from tradeable category to the Held to Maturity (HTM) category in the current financial year. This will result in the bank taking further bond losses of about Rs3 bn in F1Q07. However, after this transfer, almost 40% of bonds continue to reside in the tradeable book. This would impact earnings if interest rates continue to remain strong.

We maintain our Underweight rating on the stock. (The results table is in the next page).

Company Description

Punjab National Bank (PNB) is a 58% government-owned bank operating predominantly in North India. It is the second-largest state-owned bank in India, with a balance sheet size of US\$29 billion. PNB recently completed a follow-on equity offering of 80 million shares, of which it returned 30 million shares to the government.

Industry View: Cautious

The structural story is intact, but exposure to rising rates is a concern. Lack of pricing power will also impact performance, and valuations look full.

MSCI Country: India

Asia Strategist's Recommended Weight: 1.8%
MSCI Asia/Pac All Country Ex Jp Weight: 6.3%

Exhibit 1

PNB: F4Q06 Results

Rs. Mn	F4Q05	F3Q06	F4Q06	YoY	QoQ
Interest on loans/bills	10798	13919	14640	35.6%	5.2%
Interest on investments	10222	10033	9640	-5.7%	-3.9%
Interest on others	827	595	409	-50.6%	-31.4%
Total Interest Income	21847	24548	24689	13.0%	0.6%
Interest Expense	11126	12474	12887	15.8%	3.3%
Net interest Income	10721	12074	11802	10.1%	-2.3%
Core Fees	2360	1784	2300	-2.5%	28.9%
Non Interest Income (ex CEB)	1414	661	1915	35.5%	189.6%
Non-Interest income	3774	2445	4215	11.7%	72.4%
Total Income	14494	14519	16017	10.5%	10.3%
Expenditure	9225	9036	6034	-34.6%	-33.2%
---Employee	6224	6814	3526	-43.4%	-48.3%
---Other	3000	2222	2508	-16.4%	12.9%
Operating profit	5270	5484	9983	89.4%	82.0%
Provisions - Loan Loss	1946	695	1579	-18.9%	127.2%
Others	-1419	337	4532	NA	1244.1%
Total Provisions	527	1032	6111	1059.7%	492.1%
Pre-Tax Profit	4743	4451	3871	-18.4%	-13.0%
Total Tax	1137	747	985	-13.4%	31.8%
Net Profit	3606	3704	2887	-20.0%	-22.1%
Loans	604130	671900	746270	23.5%	11.1%
---Retail	115890	142290	171140	47.7%	20.3%
---Non Retail	488240	529610	575130	17.8%	8.6%
Deposits	1031670	1057490	1196850	16.0%	13.2%
Investment	506730	455672	410550	-19.0%	-9.9%
Gross NPA Ratio	5.96%	4.79%	4.10%		
Net NPA Ratio	0.20%	0.25%	0.29%		
Coverage Ratio	96.8%	95.0%	93.0%		
LLP / loans (annualized)	1.3%	0.4%	0.8%		
NIM	3.90%	4.09%	3.96%		
Yield on Loans	7.60%	8.43%	8.14%		
Cost of Deposits	4.10%	4.35%	4.32%		
Yield on Investments	8.21%	8.13%	8.29%		
Loan Spread	3.50%	4.08%	3.82%		
Bond Spread	4.11%	3.78%	3.97%		

Source: Company data, Morgan Stanley Research



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(as of April 30, 2006)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	713	36%	261	41%	37%
Equal-weight/Hold	883	45%	295	46%	33%
Underweight/Sell	367	19%	84	13%	23%
Total	1,963		640		

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Industry Coverage: India Financial Services

Company (Ticker)	Rating (as of)	Price (05/18/2006)
Anil Agarwal		
Canara Bank (CNBK.BO)	U (06/03/2005)	Rs240.30
Corporation Bank (CRBK.BO)	U (05/16/2003)	Rs319.05
HDFC (HDFC.BO)	E (04/08/2004)	Rs1289.35
HDFC Bank (HDBK.BO)	O (04/04/2006)	Rs818.00
ICICI Bank (ICBK.BO)	E (04/04/2006)	Rs591.55
IDBI (IDBI.BO)	U (10/21/2005)	Rs80.45
IDFC (IDFC.BO)	O-V (09/16/2005)	Rs64.95
Kotak Mahindra Bank (KTKM.BO)	E (04/24/2006)	Rs330.80
Oriental Bank of Commerce (ORBC.BO)	U (06/09/2004)	Rs236.50
Punjab National Bank (PNBK.BO)	Underweight (05/05/2005)	Rs448.25
State Bank of India (SBI.BO)	U (11/19/2004)	Rs908.00
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Union Bank of India (UNBK.BO)	O (05/15/2006)	Rs118.15

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