



Canara Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,771	CBK IN
	REUTERS CODE
S&P CNX: 4,067	CNBK.BO
Equity Shares (m)	410.0
52-Week Range	320/165
1,6, 12 Rel.Perf.(%)	10/-28/-30
M.Cap. (Rs b)	89.7
M.Cap. (US\$ b)	2.2

10 May 2007

Buy

Previous Recommendation: Buy

Rs219

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
3/07A	54,778	14,208	34.7	5.8	6.3	1.1	13.5	18.4	1.0	1.2
3/08E	59,571	15,778	38.5	11.0	5.7	1.0	12.7	17.7	1.0	1.0
3/09E	67,185	17,951	43.8	13.8	5.0	0.8	12.5	17.6	0.9	0.9

4QFY07 net interest income grew by 8% YoY on a reported basis, however adjusting for one-off interest income in 4QFY06, NII growth was healthy at 16% YoY. Margins declined YoY, as cost of funds increased for the bank. Other income grew by 58% in 4Q helped by robust recoveries and some one-offs. However, business growth remained strong with loans growing at 24% and deposits at 22%. On a QoQ basis gross NPA reduced by 20% in absolute numbers as the bank resorted to technical write-offs. Net NPAs remained at 0.9% on account of lower provisions.

- ✍ Strong business growth; NII growth is subdued
- ✍ Margins decline on back of higher funding costs
- ✍ Fee income growth dismal
- ✍ Asset quality remains robust
- ✍ Investment related provisions results in lower profitability

While Canara Bank's margins have declined by 22bp YoY in FY07, we believe that continued strong growth in the loan book will result in steady core NII growth. However relatively poor performance of fee income disappoints. We have increased our earning estimates by 12% for FY08 and 7% for FY09 building in lower provisions. The stock trades at PE of 5x FY09E and P/BV of 0.8x for FY09E. Maintain **Buy**.

QUARTERLY PERFORMANCE

(RS MILLION)

	FY06				FY07				FY06	FY07
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Earned	19,795	21,013	22,401	23,906	25,128	26,800	29,614	32,105	87,115	113,646
Interest Expended	11,467	12,946	12,818	14,069	15,649	16,988	19,220	21,512	51,300	73,377
Net Interest Income	8,328	8,067	9,582	9,838	9,478	9,811	10,394	10,593	35,815	40,268
% Change (YoY)	11.6	10.6	26.7	7.1	13.8	21.6	8.5	7.7	13.7	12.4
Non Interest Income	2,591	3,928	3,112	3,960	2,582	3,133	2,993	6,262	13,156	14,510
Net Income	10,919	11,995	12,694	13,797	12,060	12,944	13,387	16,855	48,971	54,778
Operating Expenses	5,316	6,184	5,702	6,269	6,158	6,792	6,369	6,334	23,471	25,653
Operating Profit	5,603	5,811	6,992	7,528	5,902	6,152	7,018	10,521	25,499	29,125
% Change (YoY)	-13.1	1.1	14.6	-0.4	5.3	5.9	0.4	39.8	-1.4	14.2
Other Provisions & Contingencies	3,034	2,026	2,449	2,992	3,743	1,534	2,630	4,970	10,067	12,417
PBT	2,569	3,785	4,543	4,535	2,159	4,618	4,388	5,551	15,432	16,708
Provision for Taxes	700	720	980	-400	250	1,000	750	500	2,000	2,500
Net Profit	1,869	3,065	3,563	4,935	1,909	3,618	3,638	5,051	13,432	14,208
% Change (YoY)	-44.4	-22.8	30.0	382.6	2.2	18.0	2.1	2.3	21.1	5.8
Cost / Income	48.7	51.6	44.9	45.4	51.1	52.5	47.6	37.6	47.9	46.8
Int Exp / Int Income	57.9	61.6	57.2	58.8	62.3	63.4	64.9	67.0	58.9	64.6
Other Income / Net Income	23.7	32.8	24.5	28.7	21.4	24.2	22.4	37.2	26.9	26.5

E: MOST Estimates

4QFY07 net interest income grew by 8% YoY on a reported basis, however adjusting for one-off interest income in 4QFY06, NII growth was healthy at 16% YoY. Margins declined YoY, as cost of funds increased for the bank. Other income grew by 58% in 4Q helped by robust recoveries and some one-offs. However, business growth remained strong with loans growing at 24% and deposits at 22%. On a QoQ basis gross NPA reduced by 20% in absolute numbers as the bank resorted to technical write-offs. Net NPAs remained at 0.9% on account of lower provisions.

Strong business growth; NII growth muted

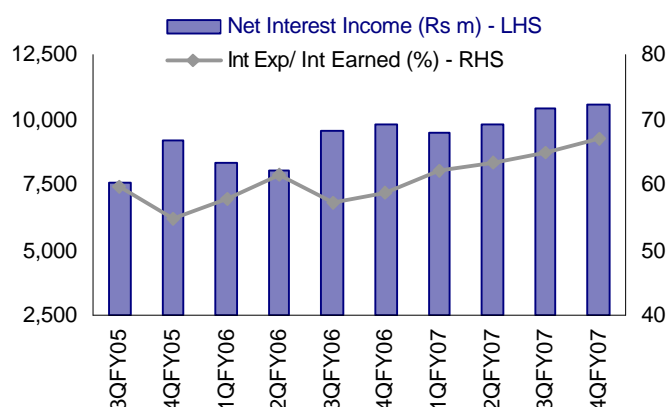
Net interest income grew by 8% YoY in 4QFY07 to Rs10.6b. However adjusting for one-offs, NII grew by 16% YoY. While yields on loans have risen, costs are rising faster and as a result margins have declined YoY.

NII GROWTH (RS M)

	4QFY06	3QFY07	4QFY07	QOQ GR. (%)	YOY GR. (%)
Int Income	23,906	29,614	32,105	8.4	34.3
Int Exp	14,069	19,228	21,512	11.9	52.9
NII (Reported)	9,838	10,386	10,593	2.0	7.7
One-offs	725	767	1	-100	-100
Adj NII	9,113	9,619	10,590	10.1	16.3

Source: Company/ Motilal Oswal Securities

TREND IN NII



Source: Company/ Motilal Oswal Securities

Deposits have grown by 22% YoY and stand at Rs1.4t. The advances portfolio has posted robust growth of 24%

and is at Rs985b. Loan/deposit ratio has moved up to 69% in FY07 from 68% in FY06. However, the bank has been mobilizing bulk deposits, which has resulted in the percentage of CASA deposits declining to 32% from 34% in FY06. The bank has guided for 22% growth in advances and 19% growth in deposits in FY08. Advances growth will be significantly driven by agriculture, SME, infrastructure and other productive sectors including the services sector.

SME loans were Rs142b at March 2007, a growth of 23% YoY. Agri advances grew by 29% YoY to Rs155b. The bank has realigned its portfolio away from retail loans. Retail loan growth slowed from 29% in 3QFY07 to 20% in 4QFY07. Share of retail loans in net credit decreased from 19% to 18%.

Margin decline continues

Margins have declined YoY, as the bank resorted to bulk deposits and borrowings to fund its credit growth. Margins declined 22bp YoY cost of deposits increased by 77bp. The yield on advances improved by 71bp while investment yields dropped by 12bp YoY. The bank also raised Rs19.8b and US\$250m as subordinated bonds. The cost of borrowings increased by 103bp to 8.13% in FY07, additionally increasing its cost of funds.

TREND IN NIMS (%)

	9MFY06	FY06	9MFY07	FY07
Yield on Advances	8.26	8.24	8.82	8.95
Yield On Investments	7.31	7.86	7.67	7.74
Cost of Deposits	4.64	4.69	5.28	5.46
Net Interest Margins	3.30	3.36	3.14	3.14

Source: Company/ Motilal Oswal Securities

Bank maintains that it would continue with its volumes, which would be a lower margin business. However bank aims to reduce its cost to income ratio (by improving efficiency and non-interest income) in order to grow profitability. We believe the bank would continue to be impacted by margin pressure going forward.

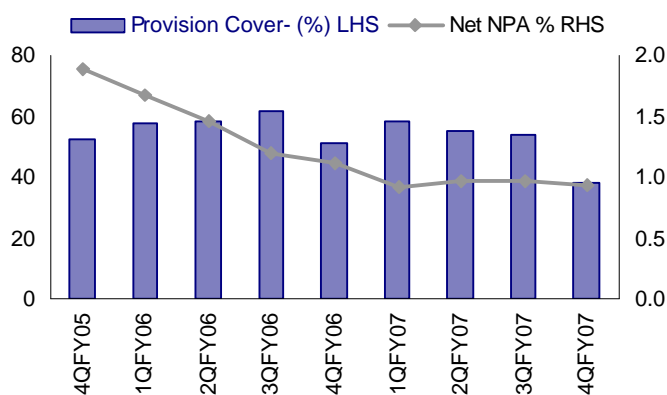
Fee income growth dismal, treasury and recoveries help other income growth

For FY07 commission exchange and brokerage (CEB) increased by 10% YoY to Rs4.8b, while in 4QFY07 CEB increased by 25% to Rs1.4b. However, service charges in the form of incidental charges and processing charges, DP and locker charges, posted healthy growth of 24% YoY to Rs2.1b in FY07. Treasury profits in FY07 increased by 20% YoY to Rs1.3b, whilst for 4Q they increased by 153% to Rs910m. Recoveries from written-off accounts amounted to Rs2.0b, which helped other income growth. The bank has credited inter-bank reconciliation of Rs0.6b to the profit and loss account, which is a one-off income in 4QFY07.

Asset quality improves as bank resorts to technical write off of gross NPAs

During the quarter gross NPAs decreased QoQ by 20%, while net NPAs increased by 7%, on an absolute basis. As a percentage, gross NPAs have declined by 55bp QoQ to 1.51% (YoY decline of 74bp). The bank aggressively follows a practice of making technical write-offs in 4Q every year, thereby decreasing its gross NPAs. Net NPAs were flat QoQ at 0.94% (YoY decline by 18bp). Cash recovery was to the tune of Rs3.8b in 4Q and, overall, Rs10.5b in FY07 v/s Rs9.7b in FY06. Recovery from written-off accounts amounted to Rs2b for the year.

TREND IN QOQ NET NPA LEVELS (%)



Source: Company/ Motilal Oswal Securities

Investment related provisions results in lower profitability

Canara Bank had to make a total provision for its investment portfolio up to Rs5.5b during the year, of which Rs4.0 was on account of MTM losses on its AFS book. This was on account of yields on the shorter duration (1yr-2yr bucket), moving up during the quarter. Bank has reduced the duration of its AFS portfolio during the year to 2.48 from 3.76 a year earlier. Investment book increased to Rs452b in FY07 (up 22% YoY), of which 57% is in AFS. The bank has guided that its AFS duration would reduce to below two years by June 2007, as we understand the bank has transferred certain securities from AFS to HTM during 1QFY08.

Higher investment provisions caused the total provisions to increase by 18% YoY while the operating profit grew 12% YoY. Resultantly net profit growth was muted at 6% YoY to Rs14.2b

Capital adequacy comfortable

CAR improved to 13.5% from 11.2% in FY06, wherein Tier I was 7.2%. The bank raised Rs19.8b and US\$250m by way of Tier II funds during the year. With GoI holding at 73%, the bank has enough room to dilute equity to increase its Tier I. It also has room to raise subordinate bonds up to Rs9b.

Maintain Buy

While Canara Bank's margins have declined by 22bp YoY in FY07, we believe that continued strong growth in the loan book will result in steady core NII growth. However relatively poor performance of fee income disappoints. We have lowered our estimates 3% for FY07 and 8% for FY08, building in lower margins and lower other income. The stock trades at P/E of 5x FY09E and P/BV of 0.8x for FY09E. **Maintain Buy.**

Canara Bank: an investment profile

Company description

Canara Bank, the third largest public sector bank of India, was established in 1906. It has a balance sheet size in excess of Rs~1.5t and a network of 2,578 branches with 55% of them being located in southern parts of India. The bank aims to bring 1,500 branches covering more than 80% of its business under CBS by FY08. The government owns 73.2% of the bank's equity.

Key investment arguments

- ☞ Has strong focus on loan growth with thrust on agriculture, SME and retail.
- ☞ Is improving its technological platform and has achieved 100% computerization of branches.
- ☞ Is well placed to benefit from increased agri-lending as 57% of its branches are located in rural and semi-urban areas.

Key investment risks

- ☞ Since 60% of the bank's investment portfolio is in the AFS category, rise in interest rates will continue to impact earnings adversely
- ☞ As bank's CASA remains lower, sustaining and improving margins is a tough challenge for the bank.

Recent developments

- ☞ Bank signed an MoU with HSBC Holdings (Asia Pacific) and Oriental Bank of Commerce to promote life insurance company in joint venture
- ☞ Joint venture was formed with Robeco Groep NV of the Netherlands for undertaking asset management business. Robeco acquired 49% stake in Canbank MF for Rs1.15b

Valuation and view

- ☞ We expect an EPS of Rs38.5 and Rs43.8 in FY08 and FY09, respectively. The stock trades at P/E of 5x FY09E and P/BV of 0.8x for FY09E. Maintain **Buy**.

Sector view

- ☞ YTD loan growth of 28%
- ☞ Volatility in interest rates would 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

		CANARA	PNB	BOI
P/E (x)	FY08E	5.7	7.2	7.1
	FY09E	5.0	5.9	5.9
P/ABV (x)	FY08E	1.0	1.3	1.5
	FY09E	0.9	1.1	1.3
RoE (%)	FY08E	17.7	19.0	20.9
	FY09E	17.6	20.0	21.4
RoA (%)	FY08E	1.0	1.2	0.9
	FY09E	0.9	1.3	0.9

SHAREHOLDING PATTERN (%)

	MAR.07	DEC.06	MAR.06
Promoter	73.2	73.2	73.2
Domestic Inst	2.6	3.7	1.5
Foreign	17.2	17.0	18.5
Others	7.0	6.1	6.8

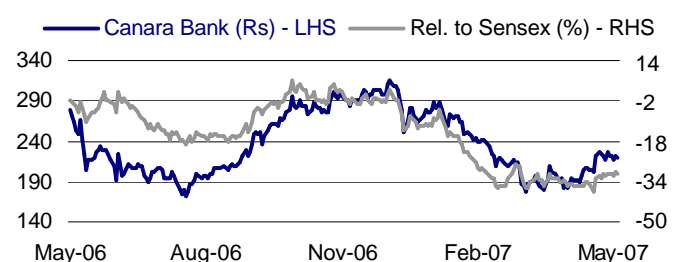
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	38.5	38.3	0.5
FY09	43.8	43.0	1.8

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
219	265	21.2	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2006	2007	2008E	2009E	
Interest Income	87,115	113,646	139,169	165,014	
Interest Expended	51,300	73,377	93,336	112,104	
Net Interest Incom.	35,815	40,268	45,833	52,910	
Change (%)	13.7	12.4	13.8	15.4	
Other Income	13,775	14,510	13,738	14,275	
Net Income	49,590	54,778	59,571	67,185	
Change (%)	5.6	10.5	8.7	12.8	
Operating Expenses	23,471	25,653	28,591	31,494	
Operating Incom.	26,119	29,125	30,979	35,690	
Change (%)	10	11.5	6.4	15.2	
Other Provisions	10,687	12,417	10,300	10,800	
PBT	15,432	16,708	20,679	24,890	
Tax	2,000	2,500	4,901	6,939	
PAT	13,432	14,208	15,778	17,951	
Change (%)	2.11	5.8	11.0	13.8	
Proposed Dividend	2,706	2,870	3,280	4,100	

BALANCE SHEET		(Rs Million)			
Y/E MARCH	2006	2007E	2008E	2009E	
Capital	4,100	4,100	4,100	4,100	
Reserves & Surplus	67,222	79,135	91,075	104,229	
Net Worth	71,322	83,235	95,175	108,329	
Deposits	1,168,030	1,423,810	1,680,096	1,932,110	
Change (%)	20.5	2.19	18.0	15.0	
Borrowings	35,304	114,190	84,000	100,800	
Other Liabilities & Prov.	53,557	38,375	52,375	69,175	
Total Liabilities	1,328,213	1,659,610	1,911,646	2,210,414	
Current Assets	128,236	184,809	173,952	207,107	
Investments	369,742	452,260	515,576	577,446	
Change (%)	-2.8	22.3	14.0	12.0	
Advances	794,257	985,060	1,182,072	1,383,024	
Change (%)	31.5	24.0	20.0	17.0	
Net Fixed Assets	6,885	5,477	4,841	4,113	
Other Assets	29,094	32,004	35,204	38,725	
Total Assets	1,328,213	1,659,610	1,911,646	2,210,414	

ASSUMPTIONS	(%)			
Deposit Growth	20.5	21.9	18.0	15.0
Advances Growth	31.5	24.0	20.0	17.0
Investments Growth	-2.8	22.3	14.0	12.0
Dividend	66.0	70.0	80.0	100.0

E: MOSt Estimates

RATIOS		2006	2007E	2008E	2009E
Spreads Analysis (%)					
Avg. Yield - Earning Assets		7.4	7.9	8.1	8.2
Avg. Cost-Int. Bear. Liab.		4.7	5.4	5.7	5.9
Interest Spread		2.7	2.6	2.4	2.3
Net Interest Margin		3.0	2.8	2.7	2.6

Profitability Ratios (%)		2006	2007E	2008E	2009E
RoE		20.3	18.4	17.7	17.6
RoA		1.1	1.0	1.0	0.9
Int. Expended/Int.Earned		58.9	64.6	67.1	67.9
Other Inc./Net Income		27.8	26.5	23.1	21.2

Efficiency Ratios (%)		2006	2007E	2008E	2009E
Op. Exps./Net Income		47.3	46.8	48.0	46.9
Empl. Cost/Op. Exps.		64.6	62.7	60.5	59.1
Busi. per Empl. (Rs m)		37.7	46.8	53.8	63.8
NP per Empl. (Rs lac)		2.9	3.0	3.4	3.9

Asset-Liability Profile (%)		2006	2007E	2008E	2009E
Adv./Deposit Ratio		68.0	69.2	70.4	71.6
Invest./Deposit Ratio		31.7	31.8	30.7	29.9
G-Sec/Invest. Ratio		84.6	84.6	84.6	84.6
Gross NPAs to Adv.		2.2	1.5	1.7	1.8
Net NPAs to Adv.		1.1	0.9	0.8	0.9
CAR		11.2	13.5	12.7	12.5
Tier 1		7.8	7.2	6.7	6.5

VALUATION		2006	2007E	2008E	2009E
Book Value (Rs)		171.2	200.2	229.4	261.5
Price-BV (x)		1.3	1.1	1.0	0.8
Adjusted BV (Rs)		157.3	185.6	214.4	242.3
Price-ABV (x)		1.4	1.2	1.0	0.9
EPS (Rs)		32.8	34.7	38.5	43.8
EPS Growth (%)		21.1	5.8	11.0	13.8
Price-Earnings (x)		6.7	6.3	5.7	5.0
OPS (Rs)		63.7	71.0	75.6	87.0
OPS Growth (%)		1.0	11.5	6.4	15.2
Price-OP (x)		3.4	3.1	2.9	2.5

E: MOSt Estimates



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Canara Bank

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|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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