Industry In-Depth

23 April 2007 | 28 pages

India Banks

Chances in a challenging environment

- Upgrading banks — Higher interest rates have hurt bank stocks, as they appear to risk growth, pressure margins and threaten asset quality. This, along with the RBI's risk-adverse approach, is a headwind. However, we believe a combination of: 1) sector underperformance; 2) possible peaking rate and regulatory tightening; 3) a still growing and profitable banking environment (not meaningfully hit by higher rates); and 4) attractive valuations, present an investing opportunity.

- Banking business fundamentals challenged but still robust — We believe fundamental drivers are hurt by rate increases, but not damaged. Specifically, 1) loan growth should moderate, but remain robust at 20-22% levels; 2) margins should hold with potential pressures 3-4 quarters down the line; and 3) asset quality will be on the watch-list, but general health should remain sound. In sum; we see the banking sector as attractive and profitable, with robust growth.

- Valuations are attractive — India's government banks appear cheap at 1-1.3x P/BV multiples, 20% earnings growth, 15-18% ROEs, large discounts to India's private sector banks and similarly positioned to Chinese banks, and relative to their own historical multiples. We see valuation upside on opportunity, scarcity, growth, returns and a modest risk outlook.

- Upgrading Canara, Union Corporation and OBC to Buy — We see stronger near-term returns for government banks than for private banks (large retail portfolios are more exposed to any slowdown). Canara bank is our preferred pick. Further rate increases are a primary business risk.

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Figure 1. India banks – Recommendation changes

Bank	Target price (Rs.)	New recommendation	Old recommendation	PE FY08	PB FY08	ROE - FY08
Canara Bank	295	1M	2M	5.7	0.9	17.0
Corporation bank	410	1M	3M	6.6	1.0	16.3
OBC	285	1M	2M	6.7	0.8	12.8
Union bank	125	1L	3L	5.4	0.9	17.9

Source: Citigroup Investment Research estimates

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Market India Private Limited

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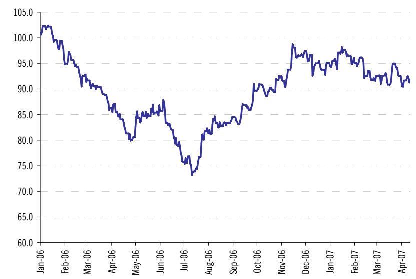
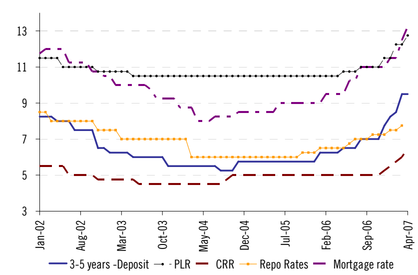
Figure 2. Bankex – Relative to the sensex



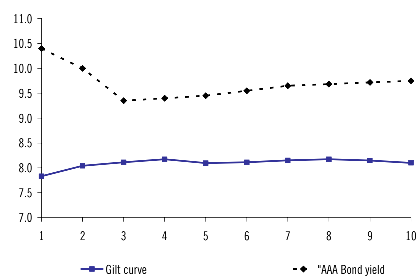
Source: Citigroup Investment Research

Figure 3. India – Macro Interest Rates



Source: Citigroup Investment Research

Figure 4. Yield curve – Gilts & AAA rated Corporate Bonds



Source: Citigroup Investment Research

Why a bullish stance?

We see an opportunity for strong stock returns from Indian banks, in the face of a challenging and uncertain environment. Our view is premised on: 1) government bank stocks have underperformed 10% over the past three months; 2) the rate cycle is probably at or near its peak; 3) regulatory tightening on lending is also potentially peaking; 4) sector growth and profitability remains relatively positive; and 5) valuations are low and fully factor in the risks of structurally higher rates.

Have all possible risks played out? … Possibly not

We believe: 1) higher rates have a fundamentally negative impact, some of which tends to show up over the longer rather than the near term; 2) the sector is exposed to more tightening/cautioning measures from the Reserve Bank of India, and the RBI's bias is towards risk mitigation in the macro-economic environment, as also bank balance-sheets; and 3) current valuations may not fully factor in downsides on bond portfolio value erosion, some pension liabilities and possibly enhanced capital needs on Basle 2 implementation. We also believe slowing risks are probably most pronounced in growth expectations, in the consumer asset segment, to which the private sector banks are a little more exposed.

Growth, profitability and valuation support, outweigh risks

We do however believe current business dynamics – current and sustainable growth prospects, profitability, stable asset quality, outweigh the risks of already higher interest rates, and any further (but limited) monetary or operating tightening by the Reserve Bank. This is backed by the comfort of low valuations

What has driven under-performance, heightened risk perception?

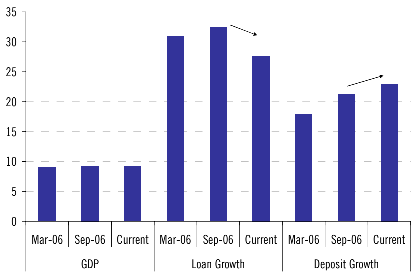
RBI's rate and regulatory tightening

The last quarter has been challenging – the RBI, concerned with consistently high inflation (averaging 6%+) and a possibly over-heated growth environment, has: 1) progressively raised interest rates (2.25% over 12 months; 2) sucked liquidity out by raising the CRR (200bp in 12 months); 3) raised the cost of CRR reserves; and 4) raised provisioning and risk weightage on lending to specific sectors. Collectively, these measures appear ahead of market expectations, while the timing, between credit policy announcements and within a short time frame, also surprised

Measure have hurt financial markets

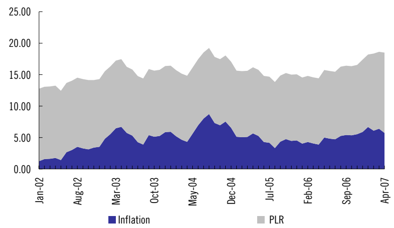
These measures have had an impact on the market interest rate, and liquidity environment. Banks have raised lending and deposit rates by 150-400bp on the lending and deposit rate side, the yield curve has also shifted up, and flattened. Overnight money rates have also moved up structurally. The RBI has also limited banking system access to some short-term funding instruments, and these measures collectively have created to more tightly balanced, controlled and some-what restrictive operating environment.

Figure 5. GDP, Loan and Deposit Growth at Different time periods



Source: Citigroup Investment Research & RBI

Figure 6. Interest rates and Inflation



Source: Citigroup Investment Research

… and will likely impact the banking business

While the measures are relatively recent and rose progressively, they have not hit banks yet – loan growth is down a bit but still running at 27.6% yoy, deposit growth has remained relatively buoyant at about 23%, and the pace of overall economic growth remains a high 9.3%. Will these measures take effect, and meaningfully unwind the banking and broader economic environment? We argue that there will be an impact – but only a modest one, which should moderate growth from current levels, but not structurally damage it. We have a similar argument for the growth, profitability and asset quality outlook of banks – and discuss it in greater detail in a later section in this report.

Is there further risk to the sector from RBI's policy orientation

Yes … though we believe these concerns are probably at a peak

We believe the RBI's bias has decisively shifted towards risk mitigation; this effectively means its focus is on:

- Macro-economic level: 1) Inflation control, 2) moderating the economy's fairly aggressive growth, and 3) a stable currency.
- Banking system: 1) credit risks, particularly in 'speculative or risky' sectors, 2) capital soundness given high growth and shift to Basle norms.
- Trade-off between macro-economic and banking sector balance? In such a scenario, we believe downside risk would lie with the banking sector.
- Any current examples? The recent strong appreciation of the currency, is a case in point. If the RBI protects the currency and intervenes, it would create money supply and risk inflation. To limit this risk, the RBI could well turn to a CRR increase, the impact of which falls squarely on banks.

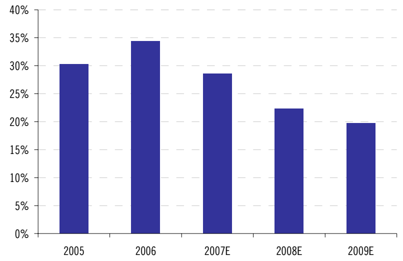
We believe the policy bias toward risk mitigation will remain until we see a slightly sustained cooling. If inflation and perceived over-heating continues, we believe the RBI would take incremental measures. This could include more of the same (higher rates and CRR), and extend to quantitative restrictions on lending to some segments, restricting foreign borrowings or other measures to cool growth levels. Citigroup's economist Rohini Malkani expects one more Repo rate hike this year; and expects the CRR will be raised.

In effect, we do not underestimate the risks of higher rates and further policy measures; but believe the RBI is now largely done with these measures.

The sector should still grow and remain profitable, and healthy

The RBI's actions and structurally higher interest rates should slow the sector, pressure margins and risk asset quality. However, we do not believe the measures effected so far will damage or undermine the growth outlook, and health of the sector. We also believe the step down in growth and some asset quality erosion – has in largely been factored in for a while. This is because the system was not expected to have the liquidity /deposit growth to fund higher than 20% loan growth, and growth restraints would have come from the supply side. We now believe growth will be slower, because loan demand will also slow. So, while we expect a relative slowdown; it will now be driven by demand and supply. The impact on growth would be similar to what has already been factored in. Effectively, our key estimates for the sector are as follows:

Figure 7. Loan Growth – FY05-FY09E



Source: Citigroup Investment Research estimates

Figure 8. India banks – Key Estimates

All banks	FY08E	FY09E
Loan growth	25%	21%
Earnings Growth	24%	22%
ROE	17%	18%
NIM	3.23%	3.14%
Asset Quality (NPA')	2.57%	2.63%
Government banks	**FY08E**	**FY09E**
Loan growth	20%	17%
Earnings Growth	21%	20%
ROE	16%	17%
NIM	2.97%	2.94%
Asset Quality (NPA')	2.86%	2.92%

Source: Citigroup Investment Research estimates

Valuations are attractive

We see opportunity in the banks, in spite of potential business and environment headwinds; largely because valuations, particularly for government banks, appear attractive.

Government banks have always been cheap with some valuation issues missed in the headline numbers. We point to slight adjustments including: 1) pension liabilities not fully factored in; 2) potential losses on banks' HTM portfolios not accounted for in the P&L, but given higher interest rates, we see an inherent economic loss; and 3) higher capital requirements under Basle 2 – new and tightened norms suggest a net impact of 60-100bp on capital, higher capital requirements and lower returns on capital. We do believe these issues under-state valuations anywhere from 5-20% for government banks.

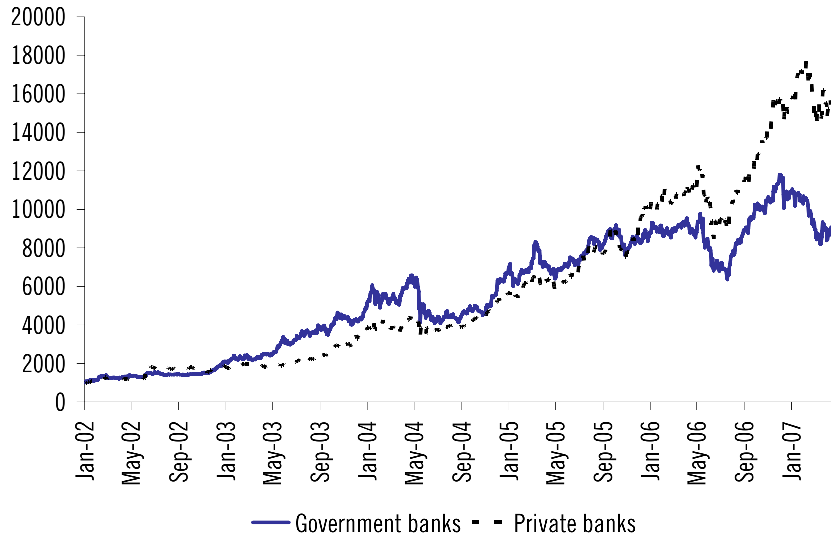
Figure 9. India banks – Key valuation Comparison

FY08	PE	PB	ROE	2yr EPS Growth 2007-2009E
Private banks	18.9	3.2	19%	23%
Government banks	7.2	1.1	16%	20%
China banks	16.6	2.8	18%	22%
Indian markets	16.7	3.8	26%	13%

Source: Citigroup Investment Research estimates

After factoring in these discounts, we argue that government banks remain attractively valued. They are generating ROEs in the 15-18% range, should generate earnings growth of 20% over FY07E-09E, are operating in a fairly rapidly growing sector with entry barriers. International investor appetitive to Buy into Indian banking franchises remains strong, kept in check by regulatory restrictions, and suggesting current valuations do not adequately franchise values, or market opportunity.

Figure 10. India banks – Government Banks vs Private Banks Performance



Source: Citigroup Investment Research and Bloomberg

The sector has also underperformed the broader Indian market, trades at a historical high discount to the broader Indian market, and the valuation gap with the comparable Chinese banking sector has widened. We believe a (favorable) turn in the broader environment could well be the catalyst to undo this relative undervaluation. Our view that we are close to the top of the interest rate and regulatory tightening cycle suggests valuation gaps could well be bridged over a short time frame.

We are upgrading…

We are upgrading our recommendations for Canara Bank, OBC and Union Bank, maintaining target prices. We are upgrading Corporation Bank, and raising our target price. These upgrades are premised on revised earnings in a few cases and our estimates on growth, asset quality and returns. We are not lowering target prices in spite of higher rates; as our estimates were premised on a relatively higher rate environment.

Figure 11. India banks – Recommendations for government banks

Bank	Target price (Rs.)	New recommendation	Old recommendation
Canara Bank	295	1M	2M
Corporation bank	410	1M	3M
OBC	285	1M	2M
Union bank	125	1L	3L
SBI	1235	1L	1L
Andhra	107	1L	1L
PNB	608	1L	1L
BOB	326	1M	1M

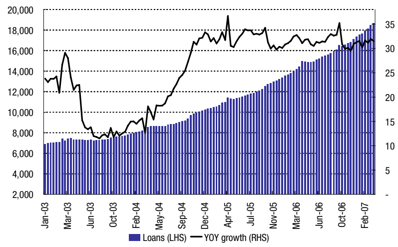
Source: Citigroup Investment Research estimates

Fundamentals, exposed to higher rates, but we are comfortable

A. Growth – Lower, at risk, but should remain robust

The Indian banking system has witnessed average loan growth of over 30% during the past three years. This is set to slow and we estimate loan growth should moderate to 20-22% in FY08, and to 18-20% over FY09.

Figure 12. India banks – Loan (Rs Bn) and YOY growth (%)



Source: Citigroup Investment Research

Our view of moderating loan growth to 20-22% levels is not different from our view of about 6 months ago. However, we see a qualitative difference in our expectation. In September 2006, our view of slower growth was largely premised on funding constraints (banks not able to mobilize adequate deposits). We now believe growth will moderate, but from the demand side

Why should the pace of loan demand slacken? We believe the primary drivers of lower loan growth would be 1) easing consumer demand, particularly mortgages and other asset-backed loans given affordability issues; 2) some shifting of corporate demand to offshore borrowing partly due to the currency's recent strength; 3) an expected slackening in consumer demand could hit immediate investments; and 4) the sheer expansion of credit over the past three years, with levels of credit penetration in India no longer very low.

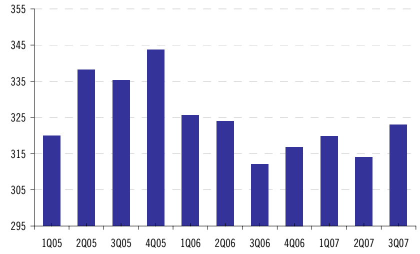
Could the bottom fall out of loan demand? We think not. This is because corporate demand remains robust, and given the relatively large investment pipeline, we infer that large segments of the corporate market are prepared to borrow at these higher rates.

We argue that demand outlook for consumer credit may be at greater risk, particularly mortgages and auto finance (asset-backed segments). This is because these segments are price sensitive (reflected in banks' thin spreads), affordability is likely to have become an issue (particularly for mortgages, where property prices have risen sharply), and these segments have witnessed higher financing penetration. While we anticipate a slowdown, we expect consumer demand to average about 15-20% pa; but with meaningful risk of a more pronounced slowdown in the near term.

B. Margins – Should be OK, post asset pricing moves

Higher interest rates are usually support bank margins in India and globally. This is typically because rate increase transmissions tends to be more pronounced on assets, a share of deposits are often fixed rate or low cost, and managements typically seek to create a profit cushion to cover for risks on growth and asset quality.

Figure 13. India banks – NIM's (bps)



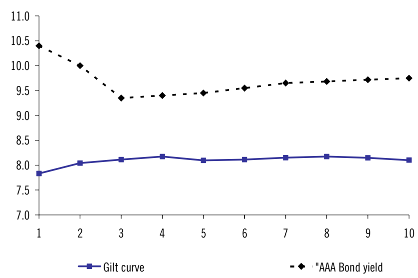
Source: Citigroup Investment Research

The broader Indian market however reacted with meaningful margin concern, as the RBI started raising rates aggressively and ahead of expectations. This is because: 1) rate increases were initially led by deposit rate increases; and were not adequately backed by lending rate increases; 2) relatively static yield curve suggested incremental government bond investments (for meeting SLR requirements); and 3) government banks were perceived to be wary of raising lending rates given perceived government pressure.

All these are legitimate concerns and would have hit margins negatively had they played out. However, they have not really played out, as: 1) banks have raised lending rates fairly aggressive, while government banks have lagged private peers, the increases have been substantial, and should support margins; and 2) the yield curve has flattened sharply, and should boost yields, at-least for a meaningful part of incremental bond portfolio investments; and 3) Indian banks, particularly government banks, have large low and fixed cost deposits that support margins disproportionately in a rising rate environment. In addition, given loan books run a relatively lower maturity profile that term deposits, higher rates boost margins upfront (partly offset by loss of margins on the investment portfolio).

We see marginal profitability for banks at about the 300bp level; largely in line with margin level that average banks generate. We highlight this for an average government bank.

Figure 14. India – Yield curve for Gilts & AAA rated Corporate Bonds



Source: Citigroup Investment Research

Figure 15. India banks – Government banks NIM (bps)

Government banks	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
NIM (Bps, LHS)	332	329	314	323	329	317	327

Source: Citigroup Investment Research

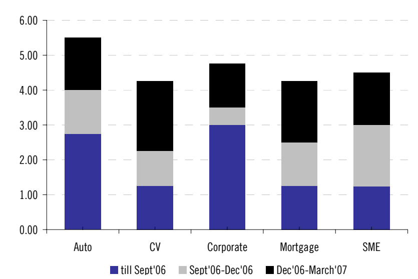
In effect, we believe near-term margins for the banks – government banks in particular, should be OK. Pressure, if any, should be limited – or driven by structural issues rather than recent interest rate developments. Still, this could lead to some pressure 3-4 quarters on; particularly when the bulk of deposit rate re-pricing takes effect. We expect margin pressure would range between 5-15bp, rather than a more dramatic level.

C. Asset quality – Watch time, but not a tipping point

We believe the biggest risk of higher interest rates to banks lies in the negative impact on asset quality. On the consumer side we see asset risks from higher interest payments, over-extended consumer borrowing, and a slowing economy. On the corporate side, higher interest payments lower coverage levels and raise break-even levels, while a slower economy pressures asset quality. The impact of higher rates also played out starkly in India during 1995-2000; when the asset environment deteriorated sharply after a years of high interest rates (though other factors also contributed).

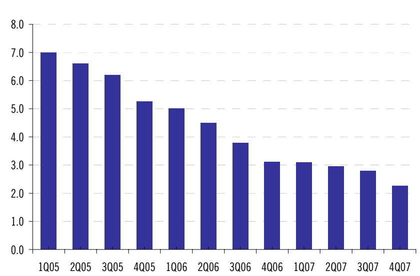
Have rates moved up enough to hurt asset quality meaningfully? We argue that rates in themselves – up 200-500bp over the last year across product and borrower classes – have moved up enough to warrant meaningful caution. This view has been echoed by quite a few bank managements.

Figure 16. India banks – Product price increases over different periods



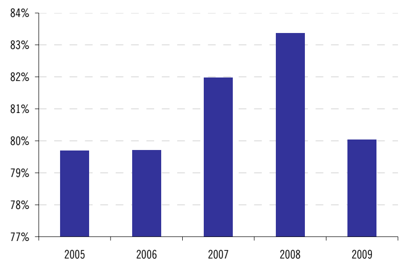
Source: Citigroup Investment Research

Figure 17. India banks – Gross NPL's



Source: Citigroup Investment Research

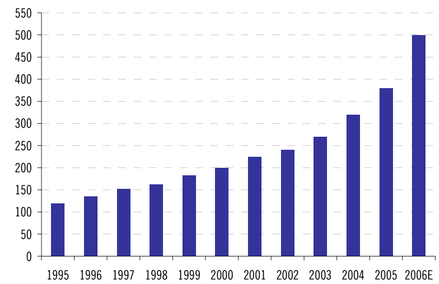
Figure 18. India banks – Loan Loss Coverage



Source: Citigroup Investment Research estimates

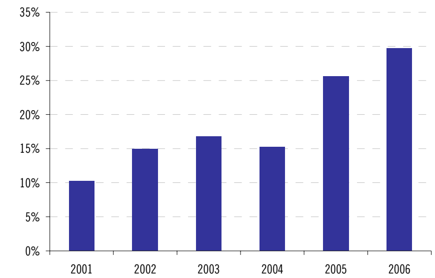
We believe there are mitigating and offsetting factors that should moderate the impact of higher rates. On the consumer side these include: 1) strong and broad-based income growth with the market estimating the private sector has seen wage growth over the past two years; 2) a substantial job creation; 3) Relatively low levels of consumer leverage in aggregate; 4) relatively large level of asset backing for consumer lending. We see these as meaningful offsets that should limit asset quality damage from higher interest rates.

Figure 19. Rising Average Salary (Rs Thousan4).



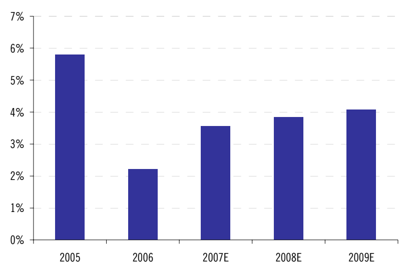
Source: Citigroup Investment Research estimates

Figure 20. Household Advances to Savings....



Source: Citigroup Investment Research & RBI

Figure 21. India banks – Provisioning charges % of total loans increasing



Source: Citigroup Investment Research estimates

We believe the corporate book will face fewer asset quality pressures than the consumer book, in the current growth and rate environment. This is because: 1) the economy is growing rapidly – our economist estimates GDP growth should remain 9%+ despite higher rates; 2) investment momentum remains strong – capital formation as a percentage of GDP is up to 32% and we see it at least sustaining these levels; 3) leverage levels in the corporate sector remain relatively low (16.3% on CIR's coverage universe), and interest coverage levels remain relatively high. We believe a combination this; the relatively easy access to capital (public and private markets), should limit asset damage.

We believe the risks that are embedded are not so much the impact of higher rates on balance-sheets and overall growth; but potentially more in terms of aggressive roll outs that could create execution issues, parts of the SME market where leverage levels, and business risks could be higher and do not get captured in available data, and potentially in asset backed financing, where weak asset prices could undermine collateral.

At the aggregate though, we expect asset deterioration levels will inch up. This would be an area of much greater focus for banks, and the asset recovery cycle recovery in evidence until the current year is probably done. We also expect P&L provisioning to rise almost across the board (in part as it comes off a low base). We do not believe the asset quality cycle has reversed, is on the brink, or would be a dominant theme over the next 12-18 months. In effect, while asset quality remains high on the watch list, it is unlikely to damage balance sheets or P&Ls, shift focus away from lending or fee businesses, and should not be a drain on capital.

Canara Bank (CNBK.BO)

Buy/Medium Risk	1M
from Hold/Medium Risk	
Price (20 Apr 07)	Rs204.35
Target price	Rs295.00
Expected share price return	44.4%
Expected dividend yield	3.2%
Expected total return	**47.6%**
Market Cap	Rs83,784M
	US$2,014M

Price Performance (RIC: CNBK.BO, BB: CBK IN)

Upgrade to Buy; Large Bank, Attractive Valuation

- Upgrading to Buy post stock price correction — We are upgrading Canara Bank (Canbank) to a Buy (1M) from a Hold (2M) as current valuations at 0.9x FY08E PBV offer strong returns to our target price of Rs295. Stock price has corrected 23% in last 3 months, underperformed Sensex by 20% and offers 48% upside potential.

- Higher rate environment a risk; but the business remains fine — Higher interest rates could be a drag on growth, moderate margins, and threaten asset quality. We see a slower environment, but growth should remain above 20%, margins above 300bp, and we do not see significant enough risk on asset quality to risk capital or earnings.

- High growth, healthy margin bank — Canbank has historically been an above-industry growth bank; but we would expect growth rates to moderate to industry levels. We also expect to see margin stability (sustained at around 300bp). While we could see some earnings instability on account of bond portfolio mark down and pension charges, we expect ROE of more than 16% this year.

- Stable asset quality, management confident on capital — Canbank's asset quality has continued to improve and is now almost best in class, and management suggests little apparent strain. Management also suggests capital comfort, though we believe capital raising (Canbank is one of the few Government banks with the leeway to raise new capital) is a possibility given expected capital erosion on account of Basle 2 norms in March 2008.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	11,095	27.06	-17.1	7.6	1.4	19.5	2.7
2006A	13,432	32.76	21.1	6.2	1.2	20.3	3.2
2007E	12,403	30.25	-7.7	6.8	1.0	16.3	3.2
2008E	14,703	35.86	18.5	5.7	0.9	17.0	3.2
2009E	16,920	41.27	15.1	5.0	0.8	17.1	3.2

Source: Powered by dataCentral

Earnings revision Table

	Net Profit			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
2007E	12,335	12,403	0.55%	30.09	30.25	0.55%	6.6	6.6
2008E	14,558	14,703	1.00%	35.51	35.86	1.00%	6.6	6.6
2009E	16,491	16,920	2.60%	40.22	41.27	2.60%	6.6	6.6

Source: Citigroup Investment Research estimates

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	7.6	6.2	6.8	5.7	5.0
P/E reported (x)	7.6	6.2	6.8	5.7	5.0
P/BV (x)	1.4	1.2	1.0	0.9	0.8
P/Adjusted BV diluted (x)	1.4	1.2	1.1	0.9	0.8
Dividend yield (%)	2.7	3.2	3.2	3.2	3.2
Per Share Data (Rs)					
EPS adjusted	27.06	32.76	30.25	35.86	41.27
EPS reported	27.06	32.76	30.25	35.86	41.27
BVPS	149.00	173.96	196.68	225.01	258.75
Tangible BVPS	149.00	173.96	196.68	225.01	258.75
Adjusted BVPS diluted	146.15	171.19	193.92	222.25	255.99
DPS	5.50	6.60	6.60	6.60	6.60
Profit & Loss (RsM)					
Net interest income	31,505	35,815	40,956	48,393	55,730
Fees and commissions	4,109	4,308	4,825	4,922	5,020
Other operating Income	11,329	9,467	8,407	9,193	9,884
Total operating income	**46,943**	**49,590**	**54,188**	**62,508**	**70,635**
Total operating expenses	-21,090	-23,471	-26,281	-28,741	-31,432
Oper. profit bef. provisions	**25,853**	**26,119**	**27,906**	**33,767**	**39,202**
Bad debt provisions	-8,069	-6,352	-4,377	-9,135	-11,439
Non-operating/exceptionals	-4,989	-4,335	-7,210	-3,627	-3,592
Pre-tax profit	**12,795**	**15,432**	**16,319**	**21,004**	**24,171**
Tax	-1,700	-2,000	-3,917	-6,301	-7,251
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**11,095**	**13,432**	**12,403**	**14,703**	**16,920**
Adjusted earnings	11,095	13,432	12,403	14,703	16,920
Growth Rates (%)					
EPS adjusted	-17.1	21.1	-7.7	18.5	15.1
Oper. profit bef. prov.	-8.0	1.0	6.8	21.0	16.1
Balance Sheet (RsM)					
Total assets	**1,103,052**	**1,328,219**	**1,636,749**	**1,932,919**	**2,222,993**
Avg interest earning assets	1,030,555	1,190,831	1,451,276	1,749,263	2,040,376
Customer loans	617,115	805,161	1,029,254	1,236,565	1,436,706
Gross NPLs	23,706	17,926	16,781	20,533	26,091
Liab. & shar. funds	**1,103,052**	**1,328,219**	**1,636,749**	**1,932,919**	**2,222,993**
Total customer deposits	967,959	1,168,032	1,456,165	1,728,420	1,993,960
Reserve for loan losses	12,901	10,904	9,006	12,268	16,521
Shareholders' equity	**61,090**	**71,322**	**80,639**	**92,256**	**106,089**
Profitability/Solvency Ratios (%)					
ROE adjusted	19.5	20.3	16.3	17.0	17.1
Net interest margin	3.06	3.01	2.82	2.77	2.73
Cost/income ratio	44.9	47.3	48.5	46.0	44.5
Cash cost/average assets	2.0	1.9	1.8	1.6	1.5
NPLs/customer loans	3.8	2.2	1.6	1.7	1.8
Reserve for loan losses/NPLs	54.4	60.8	53.7	59.7	63.3
Bad debt prov./avg. cust. loans	1.4	0.9	0.5	0.8	0.9
Loans/deposit ratio	63.8	68.9	70.7	71.5	72.1
Tier 1 capital ratio	7.3	7.6	5.8	5.6	5.7
Total capital ratio	12.9	11.4	10.0	9.5	9.0

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Canara Bank

Company description

Canara Bank (Canbank) was incorporated in 1910 and nationalized in the first round in 1969. The bank is headquartered in Bangalore, Karnataka. The government holds 73% of the bank's equity. Canara Bank is among the top-five banks in the country, with nearly 5% share in deposits and advances of the banking system. The bank has a large nationwide network of 2,400 branches.

Investment thesis

We rate Canbank Buy/Medium Risk (1M), with a target price of Rs295. It is one of India's larger government banks that has recorded strong and consistent growth over the past five years, with ROE in the 16-17% range. It has also maintained rapid loan growth, which has traditionally been above industry average. In addition, it is one of India's largest banks and, we believe, after SBI, is among the best positioned to participate in relatively large capex-related funding. Canbank's bond portfolio, in the current interest-rate environment, carries limited cushion. The bank also has a mixed record of asset quality; while its NPA levels have improved markedly and are among the best in the sector, its coverage levels remain modest. While the bank's asset quality concerns and higher interest-rate risk should see it trade at a discount to quality government banks, a more favorable loan growth outlook and interest environment could narrow the current large valuation gap.

Valuation

Our target price of Rs295 is based on CIR's EVA model, which in our view captures the long-term value of the business and is a standard valuation measure for our India banking universe. We factor in a risk-free rate of 8.0% in line with other banks in the sector and maintain an industry average margin. We are also benchmarking our target price on a 1.3x FY08E P/BV, which is in line with our valuations for peer banks. Our target multiple continues to be at discounts to the target multiples for the higher quality government banks such as SBI, PNB and Corporation Bank.

Risks

We rate Canara Bank Medium Risk due to its significantly improved asset quality and a relatively large size, as opposed to High Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Canbank remains a high-growth bank, though we believe that the risks are more muted with improvements in asset quality. Downside risks to our target price include: (1) deterioration in asset quality; (2) interest-rate volatility and depreciation in the bond portfolio; (3) trading losses in the bond portfolio or equity exposure that the bank might take in the current market environment; and (4) a marked slowdown in credit growth. Key upside risks to our target price include further improvement in asset quality and interest rates moving down.

Bank of Baroda (BOB.BO)

Buy: Lower Growth, But Value Intact

Buy/Medium Risk	1M
Price (20 Apr 07)	Rs229.85
Target price	Rs326.00
Expected share price return	41.8%
Expected dividend yield	2.4%
Expected total return	**44.2%**
Market Cap	Rs83,727M
	US$2,013M

Price Performance (RIC: BOB.BO, BB: BOB IN)

- **Tougher environment hurts growth; profits remain on course** — The higher interest rate scenario in the Indian banking sector will likely be a drag on growth, lead to higher provisioning on loans and bonds. However, it should be supportive of margins and profitability, with asset quality declining but not significantly. The stock price has corrected 10% in the last 3 months and our target price offers 44% upside potential. We maintain our Buy (1M) rating.

- **Loan growth should ease, margins hold** —BoB's Loan growth has been running high at 35%+ and NIMs, though slightly volatile, have been around 300bps. While growth should moderate to 20-25% levels, margins should remain at around 300bps. BoB's international business (19% of advances) is seeing strong momentum (60%+ growth) and broadens and hedges the bank's business, although it does moderate the leverage to the domestic opportunity.

- **Asset quality improving, provisioning moderate** — BoB has made among the most consistent and impressive improvements on the asset quality front; net NPLs are at 0.6%. While asset provisioning could increase, the underlying asset environment should be stable. On the bond portfolio, while rising interest rates would require additional provisioning relative to peer banks, BoB is one of the better protected from an accounting perspective.

- **Valuations look attractive** — We continue to see value in BoB and raise FY07-09 estimates 9-5% on account of higher growth and fees. Growth and margins are likely to be in line with industry average, asset quality is fine, and, with the technology rollout on schedule. Valuations look attractive to us at 0.9x FY08E book.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	6,768	22.98	-30.1	10.0	1.2	12.6	2.2
2006A	8,270	25.06	9.0	9.2	1.1	12.3	2.2
2007E	10,469	28.64	14.3	8.0	1.0	12.7	2.4
2008E	12,460	34.09	19.0	6.7	0.9	13.6	2.6
2009E	15,606	42.69	25.3	5.4	0.8	15.2	2.6

Source: Powered by dataCentral

Earnings revision table

	Net Profit			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
2007E	9,565	10,469	9.45%	26.17	28.64	9.45%	5.5	5.5
2008E	12,281	12,460	1.46%	33.60	34.09	1.46%	6	6
2009E	14,830	15,606	5.23%	40.57	42.69	5.23%	6	6

Source: Citigroup Investment Research estimates

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	10.0	9.2	8.0	6.7	5.4
P/E reported (x)	10.0	9.2	8.0	6.7	5.4
P/BV (x)	1.2	1.1	1.0	0.9	0.8
P/Adjusted BV diluted (x)	1.3	1.1	1.0	0.9	0.8
Dividend yield (%)	2.2	2.2	2.4	2.6	2.6
Per Share Data (Rs)					
EPS adjusted	22.98	25.06	28.64	34.09	42.69
EPS reported	22.98	25.06	28.64	34.09	42.69
BVPS	191.08	214.61	236.95	264.25	297.41
Tangible BVPS	191.08	214.61	236.95	264.25	297.41
Adjusted BVPS diluted	182.22	207.47	229.81	257.11	290.27
DPS	5.00	5.00	5.50	6.00	6.00
Profit & Loss (RsM)					
Net interest income	29,793	32,249	37,549	42,842	48,905
Fees and commissions	3,426	3,610	4,332	4,938	5,630
Other operating Income	9,622	8,307	8,291	9,222	10,371
Total operating income	**42,841**	**44,166**	**50,171**	**57,002**	**64,906**
Total operating expenses	-19,822	-23,848	-25,303	-27,898	-30,761
Oper. profit bef. provisions	**23,019**	**20,318**	**24,868**	**29,104**	**34,145**
Bad debt provisions	-4,562	-3,400	-3,243	-5,547	-6,851
Non-operating/exceptionals	-9,826	-5,772	-6,000	-5,500	-5,000
Pre-tax profit	**8,631**	**11,146**	**15,625**	**18,057**	**22,294**
Tax	-1,863	-2,876	-5,156	-5,598	-6,688
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**6,768**	**8,270**	**10,469**	**12,460**	**15,606**
Adjusted earnings	6,768	8,270	10,469	12,460	15,606
Growth Rates (%)					
EPS adjusted	-30.1	9.0	14.3	19.0	25.3
Oper. profit bef. prov.	-7.2	-11.7	22.4	17.0	17.3
Balance Sheet (RsM)					
Total assets	**946,642**	**1,133,925**	**1,361,983**	**1,580,520**	**1,837,520**
Avg interest earning assets	879,725	1,010,934	1,212,050	1,434,200	1,672,047
Customer loans	462,112	620,237	799,837	967,155	1,151,185
Gross NPLs	33,220	23,903	25,925	29,586	39,239
Liab. & shar. funds	**946,642**	**1,133,925**	**1,361,983**	**1,580,520**	**1,837,520**
Total customer deposits	813,335	936,620	1,153,005	1,356,282	1,595,423
Reserve for loan losses	28,108	21,119	23,326	27,576	33,086
Shareholders' equity	**56,278**	**78,444**	**86,613**	**96,589**	**108,712**
Profitability/Solvency Ratios (%)					
ROE adjusted	12.6	12.3	12.7	13.6	15.2
Net interest margin	3.39	3.19	3.10	2.99	2.92
Cost/income ratio	46.3	54.0	50.4	48.9	47.4
Cash cost/average assets	2.2	2.3	2.0	1.9	1.8
NPLs/customer loans	7.2	3.9	3.2	3.1	3.4
Reserve for loan losses/NPLs	84.6	88.4	90.0	93.2	84.3
Bad debt prov./avg. cust. loans	1.1	0.6	0.5	0.6	0.6
Loans/deposit ratio	56.8	66.2	69.4	71.3	72.2
Tier 1 capital ratio	7.5	10.3	9.0	8.4	8.0
Total capital ratio	13.3	13.7	11.7	10.7	10.0

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Bank of Baroda

Company description

Bank of Baroda (BoB) was incorporated in 1908 as a private institution, and subsequently nationalized in 1969. The bank is headquartered in Baroda, Gujarat. The government holds 66% of the bank's equity. BoB is among the top-five banks in the country, with a nearly 5% share of the deposits and advances of the banking system. BoB has a large nationwide branch network of 2,730 branches, and has 38 branches in 10 countries.

Investment thesis

We rate BoB Buy (1M) with a target price of Rs326. BoB has made visible improvements in key operating parameters. However, it has lagged behind the sector: loan growth, until recently, has been well below the industry levels and its technology plan has been slow to take off. Management's aggressive interest-rate positioning on the bank's bond portfolio led to losses in the portfolio when interest rates reversed. This aspect of its balance sheet has meant that BoB has been viewed largely as an interest-rate cyclical stock, with falling/rising rates increasing/decreasing the value of its bond portfolio. Structurally, we believe BoB will continue to trade at a discount to its larger peers due to lower fee incomes, a higher proportion of international businesses, a modest lending franchise, and a slight geographic concentration. BoB will also likely remain the most interest-rate cyclical bank among its larger peers. However, the focus on bond yields has camouflaged changes in what the market formerly perceived as other weakness. We believe positive changes have come about, and the market appears to have failed to fully appreciate them.

Valuation

Our target price of Rs326 is based on CIR's EVA model, which we believe captures the long-term value of the business and is a standard valuation measure for our India banking coverage. We are factoring in a risk-free rate of 8%. We maintain industry-average margin (230bps) and higher-than-industry capital ratio (6%).We are also benchmarking our target price on a 1.3x one-year forward P/BV. Our target multiple factors in the healthy asset pricing and operating environment. Our target multiple continues to be at discounts to those for SBI and PNB. We believe a valuation discount to some peer banks is still justified due to the quality and structure of the businesses. BoB generates relatively low fee income, has a higher proportion of international businesses that we believe adds less value to the business, and its business has a modest geographic concentration.

Risks

We rate BoB Medium Risk based on our quantitative risk-rating system, which tracks 260-day share price volatility. The following downside risks could impede the stock from reaching our target price: (1) sharp rises in interest rates, which could undermine the performance of the bond portfolio; (2) BoB's inability to sustain loan growth; and (3) further delays in management's technology plans.

Union Bank Of India (UNBK.BO)

Upgrade to Buy: High ROE; Low Multiple

Buy/Low Risk	**1L**
from Sell/Low Risk	
Price (20 Apr 07)	Rs103.75
Target price	Rs125.00
Expected share price return	20.5%
Expected dividend yield	3.9%
Expected total return	**24.3%**
Market Cap	Rs52,406M
	US$1,260M

Price Performance (RIC: UNBK.BO, BB: UNBK IN)

- Upgrade to Buy post stock price correction — Upgrading Union Bank to Buy/ Low Risk (1L) from Sell (3L) as current valuation is at 0.9x FY08E book value, following a 21% correction from its peak. Maintain target price and estimates.

- Tougher environment hurts growth; profits remain on course — The higher interest rate scenario in the Indian banking sector will be a drag on growth, lead to higher provisioning on loans and bonds. However, it should be supportive of margins and profitability, with asset quality declining but not damaging.

- Managing growth and profitability, better — Union Bank bounced back in 3Q07 – with a strong profit performance, and a healthy growth and margin mix. We see management more focused and committed to manage this equation than in the past, where profitability was sacrificed for growth. Limited funding flexibility, and slightly higher share of wholesale funding is a constraint

- Amongst most profitable, but finely balanced on capita — Union generates one of the highest ROE's amongst Government banks, has significant fee income momentum, and is ahead of peers on technology. Its relatively finely balanced capital position is an offset, though prudent management – which we see evidence of - could well support higher valuations.

- Maintain target price, valuations in-line with peers — We maintain our target price of Rs125 based on our EVA model and value the bank in-line with the Government banks.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	7,191	15.63	1.0	6.6	1.3	21.5	2.4
2006A	6,750	13.99	-10.5	7.4	1.1	16.5	3.4
2007E	8,260	16.35	16.9	6.3	1.0	17.0	3.9
2008E	9,861	19.52	19.4	5.3	0.9	17.9	4.3
2009E	11,321	22.41	14.8	4.6	0.8	17.9	4.3

Source: Powered by dataCentral

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	6.6	7.4	6.3	5.3	4.6
P/E reported (x)	6.6	7.4	6.3	5.3	4.6
P/BV (x)	1.3	1.1	1.0	0.9	0.8
P/Adjusted BV diluted (x)	1.5	1.3	1.1	1.0	0.8
Dividend yield (%)	2.4	3.4	3.9	4.3	4.3
Per Share Data (Rs)					
EPS adjusted	15.63	13.99	16.35	19.52	22.41
EPS reported	15.63	13.99	16.35	19.52	22.41
BVPS	78.55	90.24	102.02	116.46	133.80
Tangible BVPS	78.55	90.24	102.02	116.46	133.80
Adjusted BVPS diluted	68.23	81.02	92.80	107.25	124.58
DPS	2.50	3.50	4.00	4.50	4.50
Profit & Loss (RsM)					
Net interest income	20,646	23,743	27,524	30,532	34,941
Fees and commissions	1,769	2,178	2,505	2,880	3,226
Other operating Income	5,892	4,073	2,512	4,135	4,551
Total operating income	**28,307**	**29,994**	**32,541**	**37,547**	**42,717**
Total operating expenses	-12,575	-14,024	-15,694	-17,572	-19,683
Oper. profit bef. provisions	**15,732**	**15,970**	**16,847**	**19,975**	**23,034**
Bad debt provisions	-2,165	-1,560	-3,447	-4,289	-5,261
Non-operating/exceptionals	-7,451	-5,470	-1,600	-1,600	-1,600
Pre-tax profit	**6,116**	**8,940**	**11,800**	**14,087**	**16,173**
Tax	1,075	-2,190	-3,540	-4,226	-4,852
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**7,191**	**6,750**	**8,260**	**9,861**	**11,321**
Adjusted earnings	7,191	6,750	8,260	9,861	11,321
Growth Rates (%)					
EPS adjusted	1.0	-10.5	16.9	19.4	14.8
Oper. profit bef. prov.	6.1	1.5	5.5	18.6	15.3
Balance Sheet (RsM)					
Total assets	**724,131**	**891,260**	**1,039,694**	**1,222,751**	**1,422,749**
Avg interest earning assets	639,081	788,392	944,034	1,106,755	1,295,465
Customer loans	412,008	548,430	667,229	792,851	927,565
Gross NPLs	20,581	20,981	22,992	26,240	32,787
Liab. & shar. funds	**724,131**	**891,260**	**1,039,694**	**1,222,751**	**1,422,749**
Total customer deposits	618,306	740,943	878,243	1,048,154	1,232,787
Reserve for loan losses	10,957	14,631	15,993	17,881	20,850
Shareholders' equity	**36,144**	**45,582**	**51,531**	**58,828**	**67,587**
Profitability/Solvency Ratios (%)					
ROE adjusted	21.5	16.5	17.0	17.9	17.9
Net interest margin	3.23	3.01	2.92	2.76	2.70
Cost/income ratio	44.4	46.8	48.2	46.8	46.1
Cash cost/average assets	1.9	1.7	1.6	1.6	1.5
NPLs/customer loans	5.0	3.8	3.4	3.3	3.5
Reserve for loan losses/NPLs	53.2	69.7	69.6	68.1	63.6
Bad debt prov./avg. cust. loans	0.6	0.3	0.6	0.6	0.6
Loans/deposit ratio	66.6	74.0	76.0	75.6	75.2
Tier 1 capital ratio	6.2	7.3	6.8	6.7	6.7
Total capital ratio	12.4	11.4	10.2	9.5	9.1

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Union Bank of India

Company description

Union Bank is the seventh largest bank in India and sixth largest government bank, with a large balance sheet size and diversified distribution network. It currently has 2082 branches and 473 ATMs spread across the country. Its business is distributed across the country with a slight concentration in Western India. Union Bank listed in 2002. A follow-on offer was transacted in February 2006, with the government holding a 55% stake in the bank.

Investment thesis

We rate Union Bank Buy/Low Risk (1L) with a target price of Rs125. Union has four key strengths, in our view: large balance sheet and distribution; low operating costs (as a proportion of assets), below industry averages; good technology, ahead of its peer group in implementation; and a clean balance sheet with low gross and net NPLs, in line with the industry's. However, the risks to Union lie in its low balance sheet liquidity, and the need to grow term deposits rapidly to fund loan growth. The stock price has corrected over 20% from its peak and offers reasonable upside potential to our target price.

Valuation

Our target price of Rs125 is based on our EVA model, which we believe captures the long-term value of the business and is a standard valuation measure for our India banking coverage. We are factoring in a risk-free rate of 8% while maintaining an industry average margin (230bps) and a slightly lower than industry average cost income ratio (42% vs average 45%). We are also benchmarking our target price on a 1.25x one-year forward PBV multiple. This translates to a fair value of Rs125. We maintain a discount to our target multiples for the larger, quality government banks. We believe this discount is warranted, due to the risk to margins and earnings or to loan growth from the lack of surplus liquidity and the need to grow deposits rapidly. This is despite Union's above-sector average RoE, lower bond risk relative to peers and large and scaled balance sheet. We use EVA as a primary methodology as we believe it better adjusts for the relatively dynamic cost of capital, and as it is usually the more conservative target price in a difficult interest rate environment.

Risks

We rate Union Bank Low Risk, based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Key downside risks that could impede the stock from reaching our target price are: low surplus balance sheet liquidity; modest deposit mix; reversal in loans growth and asset quality; large bond portfolio could erode economic value; and some geographic concentration in Western India.

Corporation Bank (CRBK.BO)

Upgrade to Buy; Catch a Falling Star

Buy/Medium Risk	**1M**
from Sell/Medium Risk	
Price (20 Apr 07)	Rs305.50
Target price	Rs410.00
from Rs375.00	
Expected share price return	34.2%
Expected dividend yield	2.6%
Expected total return	**36.8%**
Market Cap	Rs43,821M
	US$1,054M

Price Performance (RIC: CRBK.BO, BB: CRPBK IN)

- **Upgrade to Buy, post 26% underperformance** — We are raising CRBK to a Buy/Medium Risk (1M), from Sell (3M), post significant 26% under-performance over the past 6 months – raising target price to Rs410 (Rs375 previously). Corp is amongst the best managed and capitalized Government banks, and offers potential returns at industry average benchmark valuations.

- **Higher rate environment a risk; but the business remains fine** — Higher interest rates could be a drag on growth, moderate margins, and threaten asset quality. We see a slower growth environment, and while Corp should see a structural slowdown in growth, we expect it to sustain its mix of profitability with quality.

- **Growth and margins; should settle in-line with industry** — Corp Bank's loan growth has been moderating after an accelerated performance; and along with margins, should settle at industry averages. Corp should continue to generate a higher proportion of fees than peers; but its large fee share could well moderate growth levels.

- **Amongst better managed Government Banks** — Corp Bank is a leader amongst Government peers; in management, fee businesses, use of technology, capital cushion, alliances (strategic alliance with LIC), and disclosures. We believe this, along with volatile stock performance and recent underperformance – offers an attractive investment opportunity. We are also raising earning 22-30%, to factor in a strong 9M FY07 operating performance.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	4,022	28.04	-20.2	10.9	1.4	13.8	2.1
2006A	4,445	30.99	10.5	9.9	1.3	13.8	2.3
2007E	5,417	37.77	21.9	8.1	1.2	15.1	2.5
2008E	6,662	46.44	23.0	6.6	1.0	16.3	2.6
2009E	8,115	56.58	21.8	5.4	0.9	17.2	2.6

Source: Powered by dataCentral

Earnings Revision Summary

	Net Profit (RsM)			EPS (Rs)			DPS (Rs)	
	Old	New	% change	Old	New	% change	Old	New
2007E	4,160	5,417	30.2%	29.0	37.8	30.2%	7.5	7.5
2008E	5,357	6,662	24.4%	37.3	46.4	24.4%	8.0	8.0
2009E	6,653	8,115	22.0%	46.4	56.6	22.0%	8.0	8.0

Source: Citigroup Investment Research estimates

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	10.9	9.9	8.1	6.6	5.4
P/E reported (x)	10.9	9.9	8.1	6.6	5.4
P/BV (x)	1.4	1.3	1.2	1.0	0.9
P/Adjusted BV diluted (x)	1.4	1.3	1.2	1.0	0.9
Dividend yield (%)	2.1	2.3	2.5	2.6	2.6
Per Share Data (Rs)					
EPS adjusted	28.04	30.99	37.77	46.44	56.58
EPS reported	28.04	30.99	37.77	46.44	56.58
BVPS	212.98	235.29	265.55	304.00	352.57
Tangible BVPS	212.98	235.29	265.55	304.00	352.57
Adjusted BVPS diluted	212.98	235.29	265.55	304.00	352.57
DPS	6.50	7.00	7.50	8.00	8.00
Profit & Loss (RsM)					
Net interest income	11,294	12,268	13,243	16,051	18,902
Fees and commissions	1,551	1,568	1,804	2,038	2,242
Other operating Income	4,095	4,146	4,426	4,508	4,538
Total operating income	**16,940**	**17,983**	**19,474**	**22,597**	**25,683**
Total operating expenses	-6,370	-7,468	-7,995	-8,794	-9,673
Oper. profit bef. provisions	**10,570**	**10,515**	**11,479**	**13,803**	**16,009**
Bad debt provisions	-1,603	-2,348	-1,893	-2,360	-2,397
Non-operating/exceptionals	-2,921	-1,422	-1,500	-1,500	-1,500
Pre-tax profit	**6,046**	**6,745**	**8,086**	**9,943**	**12,112**
Tax	-2,024	-2,300	-2,668	-3,281	-3,997
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**4,022**	**4,445**	**5,417**	**6,662**	**8,115**
Adjusted earnings	4,022	4,445	5,417	6,662	8,115
Growth Rates (%)					
EPS adjusted	-20.2	10.5	21.9	23.0	21.8
Oper. profit bef. prov.	16.5	-0.5	9.2	20.2	16.0
Balance Sheet (RsM)					
Total assets	**339,238**	**405,066**	**508,537**	**591,800**	**682,671**
Avg interest earning assets	304,119	360,801	444,101	537,275	625,046
Customer loans	190,478	245,301	318,161	382,477	448,207
Gross NPLs	6,473	6,256	8,390	10,153	11,912
Liab. & shar. funds	**339,238**	**405,066**	**508,537**	**591,800**	**682,671**
Total customer deposits	272,332	328,765	423,355	497,529	578,083
Reserve for loan losses	5,014	5,676	7,570	9,930	12,327
Shareholders' equity	**30,549**	**33,749**	**38,090**	**43,605**	**50,572**
Profitability/Solvency Ratios (%)					
ROE adjusted	13.8	13.8	15.1	16.3	17.2
Net interest margin	3.71	3.40	2.98	2.99	3.02
Cost/income ratio	37.6	41.5	41.1	38.9	37.7
Cash cost/average assets	2.0	2.0	1.8	1.6	1.5
NPLs/customer loans	3.4	2.6	2.6	2.7	2.7
Reserve for loan losses/NPLs	77.5	90.7	90.2	97.8	103.5
Bad debt prov./avg. cust. loans	1.0	1.1	0.7	0.7	0.6
Loans/deposit ratio	69.9	74.6	75.2	76.9	77.5
Tier 1 capital ratio	12.2	11.4	10.0	9.5	9.4
Total capital ratio	13.5	12.6	11.0	10.4	10.3

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Corporation Bank

Company description

Corporation Bank is a small government bank based in the southern city of Mangalore, where most of its branches are located. It has 809 branches and extension counters, 660 ATMs and around 10,700 employees. The government has a 57.17% stake in the bank. Around 60% of its business is in metropolitan locations. It has a strategic alliance with LIC, India's largest life-insurance company which holds a 27% stake. The obvious synergies of this alliance are in insurance distribution and treasury. The bank has 102 service outlets in LIC premises. The bank has high credit standards. Gross NPAs have been between 5.0% and 5.6% since FY99, much below the average for government banks. Loan loss reserve ratios have been high, at 65-85% over the past 10 years.

Investment thesis

We rate Corporation Bank Buy/Medium Risk (1M) with a target price of Rs410. We believe it offers reasonable upside in the current market environment. Corporation has historically traded at a premium to peers given higher profitability. Margins though under pressure in the current environment, should remain relatively protected. Additionally, its better than industry asset quality and high coverage levels should provide support to earnings and valuations in a rising interest rate scenario. Corp Bank however, has a relatively modest scale; and regional concentration that moderates its funding franchise. We believe this will be a competitive challenge, as banks compete more aggressively for liabilities; and should structurally support valuations only in line with peers, rather than the premium it has historically operated at.

Valuation

Our target price of Rs410 (revised up from Rs375) is based on our EVA model, which captures the long term value of the business, and is a standard valuation measure for our India Banking coverage. Our EVA based target price of Rs410 is premised on a risk free rate of 8%, industry average margins of 230bps and higher than industry long term capital ratio of 6.5% vs 6% average. The upward revision to our target price is premised on revised estimates, and a high asset yield. We are also benchmarking our target price on a 1.3x one-year forward P/BV multiple (previously 1.25x), which is in line with our industry average target multiple. This translates into a fair value of Rs395 (previously Rs345). We use EVA to derive our target price as this is our preferred valuation measure for our India banks sector, and reflects our more optimistic outlook on the sector.

Risks

We rate Corporation Bank Medium Risk based on our quantitative risk-rating system which tracks the 260-day share price volatility of the stock. Key downside risks that could impede the stock from reaching our target price include: (1) a less developed funding franchise — a liquidity squeeze in the market could make funding distinctly more expensive; (2) LIC's 27% stake could create a situation where there is increased management interference and control from LIC; (3) Corporation Bank is also overcapitalized — any aggressive measures to address this issue, through an acquisition or aggressive loan growth, could raise its own set of risks; and (4) its large government bond portfolio — this is interest-rate sensitive, and further increases in interest rates would impact bond and stock values.

Appendix A-1

Analyst Certification

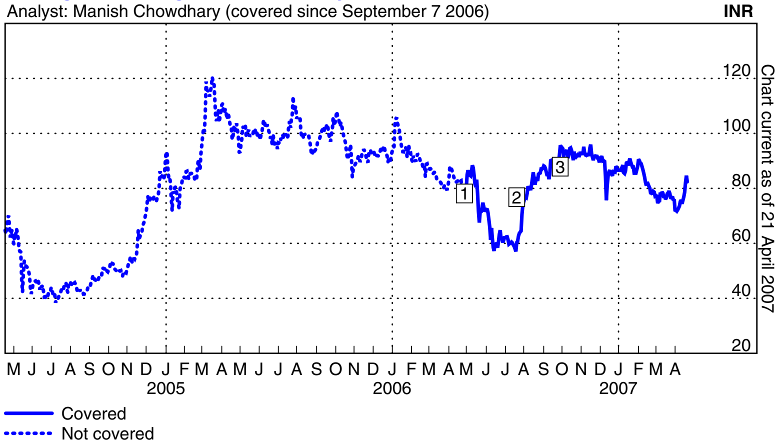
We, Aditya Narain, CFA and Manish Chowdhary, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Andhra Bank (ADBK.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Manish Chowdhary (covered since September 7 2006)



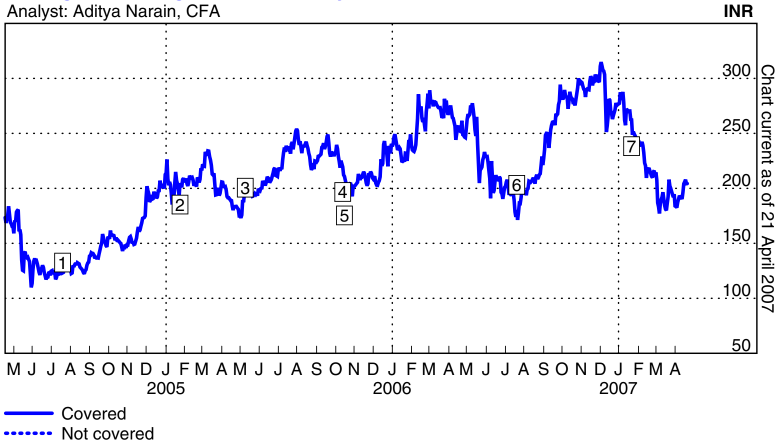
#	Date	Rating	Target Price	Closing Price
1:	27 Apr 06	1L	96.00	78.15
2:	20 Jul 06	1L	*76.00	60.35
3:	28 Sep 06	1L	*107.00	95.20

*Indicates change.

Canara Bank (CNBK.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Aditya Narain, CFA



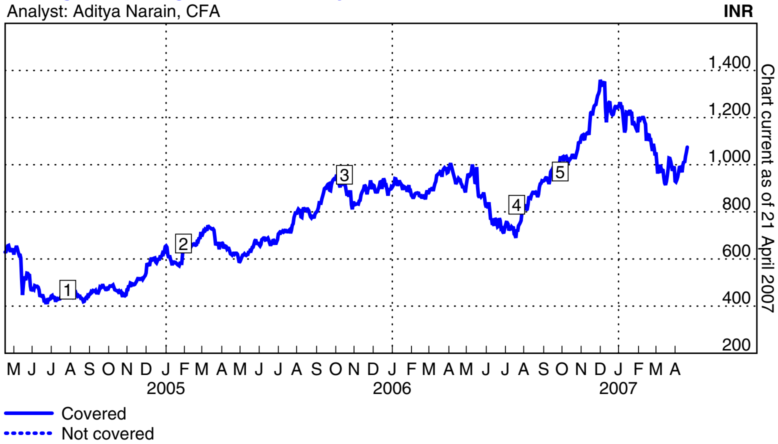
#	Date	Rating	Target Price	Closing Price
1:	20 Jul 04	1H	*170.00	123.10
2:	25 Jan 05	*2H	*235.00	204.65
3:	10 May 05	2H	*225.00	200.60
4:	13 Oct 05	2H	*255.00	219.50
5:	17 Oct 05	2H	255.00	210.90
6:	20 Jul 06	2H	*203.00	180.25
7:	22 Jan 07	*2M	*295.00	262.40

*Indicates change.

State Bank of India (SBI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Aditya Narain, CFA



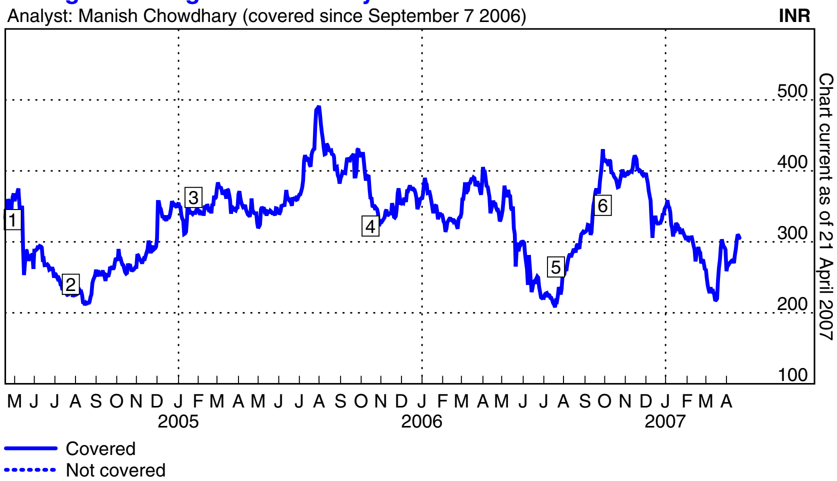
#	Date	Rating	Target Price	Closing Price
1:	28 Jul 04	1L	*685.00	433.05
2:	31 Jan 05	1L	*790.00	642.80
3:	17 Oct 05	1L	*1,110.00	924.30
4:	20 Jul 06	1L	*950.00	725.75
5:	28 Sep 06	1L	*1,235.00	1,028.85

*Indicates change.

Corporation Bank (CRBK.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Manish Chowdhary (covered since September 7 2006)



#	Date	Rating	Target Price	Closing Price
1:	27 Apr 04	1M	*420.00	331.35
2:	26 Jul 04	1M	*335.00	236.50
3:	25 Jan 05	1M	*400.00	341.00
4:	17 Oct 05	*3M	*410.00	360.40
5:	20 Jul 06	*1M	*300.00	216.80
6:	28 Sep 06	*3M	*375.00	430.55

*Indicates change.

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