

Andhra Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,078	ANDB IN
	REUTERS CODE
S&P CNX: 4,151	ADBK.BO

3 May 2007

Buy

Previous Recommendation: Buy

Rs82

Equity Shares (m)	485.0
52-Week Range	99/56
1,6,12 Rel.Perf.(%)	2/-18/-20
M.Cap. (Rs b)	39.8
M.Cap. (US\$ b)	1.0

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	18,644	5,379	11.1	10.6	7.4	1.2	11.3	17.6	1.2	1.2
3/08E	21,077	6,171	12.7	14.7	6.4	1.1	10.9	18.1	1.2	1.1
3/09E	24,078	7,237	14.9	17.3	5.5	1.0	11.0	18.9	1.2	1.0

Andhra Bank reported 25% YoY growth in net interest income (NII) to Rs3.9b in 4QFY07, higher than our expectation of 22% NII growth. Interest on CRR of Rs166m helped strong growth in NII. Margins decreased by 12bp in FY07. Other income growth was 9% YoY, as treasury income reported a decline and fee income growth was dismal. Gross advances increased 26% YoY to Rs282b, while deposits increased 22% to Rs415b. Asset quality improved sequentially.

- ✗ NII grows 25% on the back of steady business growth
- ✗ Margins decrease to 3.2% in FY07, as the bank resorts to bulk deposits
- ✗ Operating profit grows 57% in 4Q and 32% in FY07
- ✗ Higher tax provision retards earnings growth
- ✗ NPAs reduce significantly — gross NPAs down to 1.4%; net NPAs down to 0.2%

Overall, core earnings growth has been above our expectation, and Andhra Bank has been able to maintain asset quality at a healthy level. The stock is trading at P/E of 5.5x and P/BV of 1x FY09E with RoE of 18.9%. The stock offers a dividend yield of ~5%. We expect the bank to continue to grow its loan portfolio at a healthy pace with stable margins and robust asset quality. Reiterate **Buy**.

QUARTERLY PERFORMANCE

(RS MILLION)

	FY06				FY07				FY06	FY07
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Income	6,172	6,353	6,986	7,232	7,599	7,721	8,128	9,699	26,751	33,153
Interest Expense	3,429	3,468	4,028	4,130	4,247	4,412	4,493	5,820	15,054	18,978
Net Interest Income	2,743	2,886	2,959	3,102	3,352	3,309	3,635	3,879	11,697	14,175
% Change (Y-o-Y)	2.4	5.6	13.0	16.6	22.2	14.7	22.8	25.1	9.4	21.2
Other Income	772	1,179	1,189	1,270	1,018	1,287	1,327	1,384	3,916	4,469
Net Income	3,515	4,065	4,148	4,372	4,371	4,596	4,962	5,263	15,613	18,644
% Change (Y-o-Y)	-13.9	-24.0	1.6	4.8	24.3	13.1	19.6	20.4	-11.1	19.4
Operating Expenses	1,914	2,060	2,118	2,488	2,306	2,365	2,356	2,305	8,579	9,332
Operating Profit	1,601	2,005	2,030	1,884	2,065	2,231	2,606	2,958	7,034	9,312
Other Provisions	449	146	296	1,054	466	92	645	810	1,371	1,463
Profit before Tax	1,152	1,859	1,734	830	1,599	2,140	1,961	2,148	5,663	7,849
Tax Provisions	300	530	445	-556	435	675	600	760	800	2,470
Net Profit	852	1,329	1,289	1,386	1,164	1,465	1,361	1,388	4,863	5,379
% Change (Y-o-Y)	-43.3	21.5	5.8	-0.1	36.7	10.2	5.6	0.1	-6.5	10.6
Cost to Income Ratio (%)	54.5	50.7	51.1	56.9	52.8	51.5	47.5	43.8	55.0	50.1
Interest Expense/Interest Income (%)	55.6	54.6	57.6	29.1	55.9	57.1	55.3	60.0	56.3	57.2
Other Income/Net Income (%)	22.0	29.0	28.7	29.1	23.3	28.0	26.7	26.3	25.1	24.0

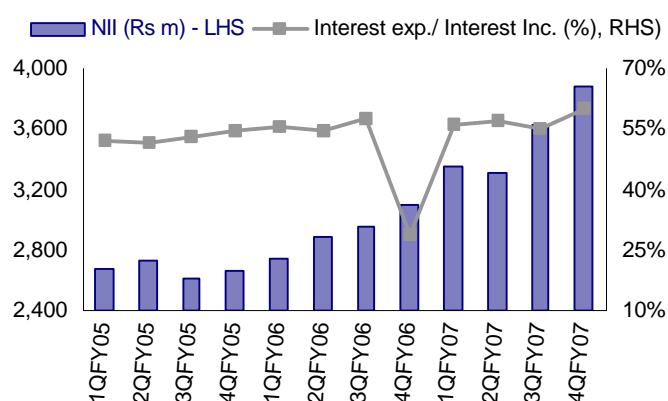
E: MOST Estimates

Andhra Bank reported 25% YoY growth in net interest income (NII) to Rs3.9b in 4QFY07, higher than our expectation of 22% NII growth. Interest on CRR of Rs166m helped strong growth in NII. Margins decreased 12bp in FY07. Other income growth was 9% YoY, as treasury income reported a decline and fee income growth was dismal. Gross advances increased 26% YoY to Rs282b, while deposits increased 22% to Rs415b. Asset quality improved sequentially.

NII up 25% on the back of steady business growth

Andhra Bank's NII grew 25% YoY to Rs3.9b in 4QFY07. Even after stripping the one-off interest on CRR, Rs166m, booked in 4Q, NII growth was strong at 20% YoY.

TRENDS IN NII



Source: Company/Motilal Oswal Securities

Gross advances expanded by 26% to Rs282b. SME advances increased by 33% to 32.5b. Credit extended to the housing sector (direct + indirect) increased to Rs40b from Rs24b, recording a growth rate of 63%. Educational loans have risen by 34% to Rs9.1b.

Priority sector advances stood at Rs114b (constituting 41% of ANBC). Advances for agriculture have risen by 27% to Rs51.5b (constituting 18.5% of ANBC).

Deposits grew 22% to Rs414.5b. Low-cost deposits of the bank increased by 16% YoY to Rs143b constituting 35% of

total deposits. However CASA declined QoQ by 250bp and 178bp YoY. Management admitted that during October 2006 to January 2007, it resorted to building up bulk deposits to meet credit commitments. Bulk deposits accounted for 34% of the total deposit base for the bank as on 31 March 2007. It plans to shred these deposits over next quarter by replacing them with retail term deposits.

Margins drop on back of funding cost pressure

Andhra Bank's net interest margins (NIMs) decreased from 3.32% in FY06 to 3.20% in FY07, as the bank faced funding cost pressure and it resorted to bulk deposits. However, management has given guidance for improvement in NIMs in forthcoming quarters on three counts: (1) the recent hike in PLR by 75bp in April 2007; (2) the bank repaying bulk deposits; and (3) replacing bulk deposits with retail term deposits.

YIELDS, COST AND MARGINS (%)

	FY06	FY07
Avg Yield on Advances	9.26	9.88
Avg Yield on Investments	7.29	7.34
Avg Cost of Deposits	4.86	5.32
Net Interest Margin	3.32	3.20

Source: Company/Motilal Oswal Securities

Management reiterated its philosophy of growing its assets modestly with focus on margins, profitability and asset quality.

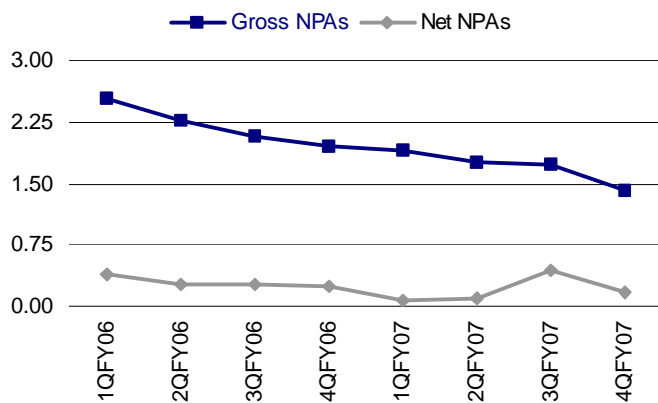
Treasury records decline YoY, Other Income growth dismal

Other income growth was 9% YoY, as treasury income reported a YoY decline by 40% YoY to Rs141m. Commission exchanges and brokerage (CEB) income remained flat YoY at Rs455m. Miscellaneous other income comprising third party distribution income, recovery from written off accounts and incidental charges etc. surged 31% YoY to Rs852m. For FY07, total other income grew by 14%, again helped by 36% growth in miscellaneous other income, as treasury profits dropped from Rs708m to Rs537m and CEB income grew merely 7%.

Asset quality improves significantly

Gross NPAs declined 31bp QoQ to 1.41% in 4QFY07, while net NPAs decreased from 0.44% to 0.17% QoQ. The management had guided for upgradations/recoveries to improve asset quality during 4Q, which has been realized. Thus Andhra Bank continued with its status of having the best asset quality amongst PSU banks. However, management agreed that asset quality has peaked and further improvement would be difficult to achieve.

ROBUST ASSET QUALITY (%)



Source: Company/Motilal Oswal Securities

Higher tax provisions retard earnings growth

The bank reported YoY 57% growth in operating profit in 4QFY07 and 32% growth in FY07. However higher tax provisions on account of higher profitability during the year (Rs770m of higher tax impact) and non-availability of tax shelter on investment depreciation which was availed in FY06 (Rs700m of higher tax impact) stunted EPS growth to mere 11% in FY07.

Valuation and view

Overall, core earnings growth has been above our expectation, and bank has been able to maintain the best of asset quality. ANDB trades at P/E of 5.5x and P/BV of 1x FY09E with RoE of 18.9%. The stock offers a dividend yield of ~5%. We expect the bank to continue to grow its loan portfolio at a healthy pace with stable margins and robust asset quality. Reiterate **Buy**.

Andhra Bank: an investment profile

Company description

Andhra Bank is a mid-sized public sector bank with dominant presence in southern India. It was incorporated in 1923 as a private sector bank but was nationalized in 1980. The bank has an extensive network of 1,930 business delivery channels. Consistency in core earnings with greater focus on retail assets, superior asset quality and high RoE are the strong positives of the bank. The bank has implemented cluster-based core banking across 1,104 units viz. 1,006 branches, 83 extension counters and 15 service centers, tracking 94 % of its business.

Key investment arguments

- ✎ We like the management strategy of modest balance sheet growth with focus on margins, profitability and asset quality
- ✎ Since a major portion of the securities are held in the HTM category, volatile interest rate fluctuations will not warrant higher mark-to-market provisioning.
- ✎ The asset quality remains one of the best amongst public sector banks (PSB) as the gross and net NPAs stand at low levels of 1.4% and 0.2% respectively.

COMPARATIVE VALUATIONS

		ANDHRA BK	SYNDICATE	IOB
P/E (x)	FY08E	6.4	4.8	5.4
	FY09E	5.5	4.4	4.6
P/ABV (x)	FY08E	1.1	1.1	1.4
	FY09E	1.0	1.0	1.1
RoE (%)	FY08E	18.1	21.9	26.4
	FY09E	18.9	20.5	25.0
RoA (%)	FY08E	1.2	0.9	1.3
	FY09E	1.2	0.8	1.3

SHAREHOLDING PATTERN (%)

	MAR.07	DEC.06	MAR.06
Promoter	51.6	51.6	51.6
Domestic Inst	10.7	10.2	6.7
Foreign	19.1	19.0	17.5
Others	18.6	19.2	24.2

Key investment risks

- ✎ The bank relies on its proprietary core banking software based on the cluster approach. We understand the bank will have to move to an off-the-shelf CBS product in next 2 years to equip itself to meet Basel II requirements. This late migration to a sophisticated CBS platform puts the bank at a relative disadvantage to the majority of PSU banks.

Recent developments

- ✎ Andhra Bank has increased its PLR by 75bp to 13% during April 2007 .
- ✎ The bank plans to undertake a joint venture in banking operations in Malaysia with BoB and PNB as partners.

Valuation and view

- ✎ The stock is trading at 5.5x FY09E earnings and 1x FY09E book value.
- ✎ We maintain **Buy** with a price target of Rs126.

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 on the sector.

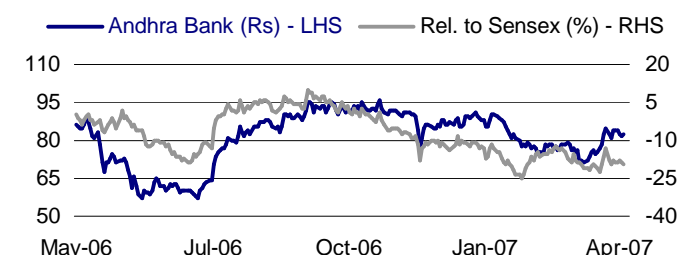
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	12.7	13.0	-2.4
FY09	14.9	14.4	3.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
82	126	53.6	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007	2008E	2009E	
Interest Income	22,735	26,751	33,153	41,593	49,902	
Interest Expended	12,044	15,054	18,978	24,975	30,752	
Net Interest Income	10,690	11,697	14,175	16,618	19,150	
Change (%)	17.4	9.4	21.2	17.2	15.2	
Other Income	6,869	3,916	4,469	4,459	4,928	
Net Income	17,559	15,613	18,644	21,077	24,078	
Change (%)	10.5	-11.1	19.4	13.0	14.2	
Operating Expenses	8,295	8,579	9,332	10,252	11,185	
Operating Income	9,265	7,034	9,312	10,825	12,893	
Change (%)	-0.4	-24.1	32.4	16.2	19.1	
Other Provisions	1,836	1,371	1,463	1,750	2,250	
PBT	7,429	5,663	7,849	9,075	10,643	
Tax	2,228	800	2,470	2,904	3,406	
Tax Rate (%)	30.0	14.1	31.5	32.0	32.0	
PAT	5,201	4,863	5,379	6,171	7,237	
Change (%)	12.2	-6.5	10.6	14.7	17.3	
Proposed Dividend	1,357	1,698	1,843	2,037	2,328	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Capital	4,000	4,850	4,850	4,850	4,850	
Reserves & Surplus	14,370	24,089	27,312	31,100	35,613	
Net Worth	18,370	28,939	32,162	35,950	40,463	
Deposits	275,507	339,224	414,540	489,157	567,423	
Change (%)	20.1	23.1	22.2	18.0	16.0	
Borrowings	9,832	7,585	8,495	9,515	10,656	
Other Liabilities & Prov.	23,577	30,945	34,658	38,817	43,475	
Total Liabilities	327,287	406,693	489,856	573,439	662,018	
Current Assets	35,233	51,394	50,281	58,770	62,413	
Investments	106,463	114,442	143,007	155,281	176,938	
Change (%)	3.2	7.5	25.0	8.6	13.9	
Advances	175,168	221,004	276,471	337,294	398,007	
Change (%)	35.9	26.2	25.1	22.0	18.0	
Net Fixed Assets	1,873	1,928	1,992	2,179	2,752	
Other Assets	8,550	17,926	18,105	19,916	21,907	
Total Assets	327,287	406,693	489,856	573,439	662,018	

ASSUMPTIONS	(%)				
Deposit Growth	20.1	23.1	22.2	18.0	16.0
Advances Growth	35.9	26.2	25.1	22.0	18.0
Investments Growth	3.2	7.5	25.0	8.6	13.9
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	30.0	35.0	38.0	42.0	48.0

E: MOST Estimates

RATIOS						
Y/E MARCH	2005	2006	2007	2008E	2009E	
Spreads Analysis (%)						
Avg. Yield - Earning Assets	8.0	7.7	7.8	8.3	8.5	
Avg. Cost-Int. Bear. Liab.	4.6	4.8	4.9	5.4	5.7	
Interest Spread	3.4	2.9	2.9	2.8	2.7	
Net Interest Margin	3.8	3.4	3.4	3.3	3.2	

Profitability Ratios (%)						
RoE	316	20.6	17.6	18.1	18.9	
RoA	17	13	12	12	12	
Int. Expended/Int. Earned	53.0	56.3	57.2	60.0	61.6	
Other Inc./Net Income	39.1	25.1	24.0	21.2	20.5	

Efficiency Ratios (%)						
Op. Exps./Net Income	47.2	55.0	50.1	48.6	46.5	
Empl. Cost/Op. Exps.	65.0	57.5	58.8	54.8	53.2	
Busi. per Empl. (Rs m)	30.9	38.4	47.4	57.4	67.7	
NP per Empl. (Rs lac)	4.0	3.7	4.1	4.7	5.5	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	63.6	65.1	66.7	69.0	70.1	
Invest./Deposit Ratio	38.6	33.7	34.5	31.7	31.2	
G-Sec/Invest. Ratio	83.9	86.5	80.5	87.4	88.2	
Gross NPAs to Adv.	2.5	1.9	1.4	1.5	1.6	
Net NPAs to Adv.	0.3	0.3	0.2	0.3	0.3	
CAR	12.1	14.0	11.3	10.9	11.0	
Tier 1	8.0	12.2	10.0	9.5	9.0	

VALUATION						
Book Value (Rs)	45.9	59.7	66.3	74.1	83.4	
Price-BV (x)	18	14	12	11	10	
Adjusted BV (Rs)	45.1	58.9	65.7	72.9	81.9	
Price-ABV (x)	18	14	12	11	10	
EPS (Rs)	13.0	10.0	11.1	12.7	14.9	
EPS Growth (%)	12.2	-22.9	10.6	14.7	17.3	
Price-Earnings (x)	6.3	8.2	7.4	6.4	5.5	
OPS (Rs)	23.2	14.5	19.2	22.3	26.6	
OPS Growth (%)	-0.4	-37.4	32.4	16.2	19.1	
Price-OP (x)	3.5	5.7	4.3	3.7	3.1	

E: MOST Estimates



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motiloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOST*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement

Andhra Bank

- | | |
|---|----|
| 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 |

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.