Company

23 July 2009 | 8 pages

Union Bank Of India (UNBK.BO)

Equity

1Q10 Results: Not A Margin(al) Impact

- **1Q10 profits up 94% YoY, but NIMs under significant pressure** — Union's profits were 28% above estimates led by higher fee growth and trading gains. Growth remained strong and management is hopeful of maintaining stable asset quality. The key pressure point of the quarter was, however, a sharp 50bps drop in NIMs, which overshadows gains in the quarter.
- **Sharp margin pressure overshadows fee growth and support from bond gains** — Union's NIMs declined 50bps QoQ to 230bps, sharply ahead of 10-15bps declines amongst peers. High growth in high-cost deposits and declining loan yields resulted in margin pressure. Management suggests repricing of deposits in 2Q/3Q and targets FY10 NIMs of 300bps (which looks ambitious, in our view). Fee growth of 47% YoY was strong and reverses the previous quarter's slower growth. A jump in bond portfolio gains further boosted profits in 1Q10.
- **Growth at a strong clip, with stable asset quality** — Loan growth continued at 27% YoY, spread well amongst various segments with retail and agriculture growing faster. Management suggests credit demand is picking up and is hopeful of 25% growth in FY10 (also targets 500 new branches). Deposit growth at 34% is relatively high, mix has deteriorated to 30% CASA (34% in 4Q09) and Union has paid the price in NIMs. While management is keen to grow at a fair clip, the challenge is to improve NIMs.
- **Quality bank, but valuations leave little room for disappointment** — Union still has amongst the best fee growth, cost ratios and asset quality relative to peers. However, 1.2x 10E P/BV valuation leaves little room for further disappointment.

Sell/Low Risk	3L
Price (23 Jul 09)	Rs246.60
Target price	Rs226.00
Expected share price return	-8.4%
Expected dividend yield	2.0%
Expected total return	**-6.3%**
Market Cap	Rs124,562M US$2,573M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	13,870	27.46	64.1	9.0	1.7	22.1	1.6
2009A	17,266	34.18	24.5	7.2	1.4	21.5	2.0
2010E	18,047	35.73	4.5	6.9	1.2	19.0	2.0
2011E	19,991	39.58	10.8	6.2	1.0	18.0	2.2
2012E	22,280	44.11	11.4	5.6	0.9	17.2	2.2

Source: Powered by dataCentral

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

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	9.0	7.2	6.9	6.2	5.6
P/E reported (x)	9.0	7.2	6.9	6.2	5.6
P/BV (x)	1.7	1.4	1.2	1.0	0.9
P/Adjusted BV diluted (x)	2.2	1.8	1.5	1.2	1.0
Dividend yield (%)	1.6	2.0	2.0	2.2	2.2
Per Share Data (Rs)					
EPS adjusted	27.46	34.18	35.73	39.58	44.11
EPS reported	27.46	34.18	35.73	39.58	44.11
BVPS	145.47	173.04	203.19	236.69	274.73
Tangible BVPS	145.47	173.04	203.19	236.69	274.73
Adjusted BVPS diluted	111.33	139.66	169.81	203.32	241.35
DPS	4.00	5.00	5.00	5.50	5.50
Profit & Loss (RsM)					
Net interest income	28,537	38,136	45,185	53,082	60,358
Fees and commissions	3,010	3,133	3,603	4,035	4,519
Other operating Income	10,187	11,693	12,322	14,263	16,576
Total operating income	**41,733**	**52,961**	**61,109**	**71,380**	**81,454**
Total operating expenses	-15,930	-22,141	-24,586	-27,302	-30,321
Oper. profit bef. provisions	**25,803**	**30,820**	**36,524**	**44,078**	**51,132**
Bad debt provisions	-6,652	-6,266	-10,242	-15,019	-18,804
Non-operating/exceptionals	-547	-989	-500	-500	-500
Pre-tax profit	**18,604**	**23,566**	**25,782**	**28,559**	**31,829**
Tax	-4,734	-6,300	-7,735	-8,568	-9,549
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**13,870**	**17,266**	**18,047**	**19,991**	**22,280**
Adjusted earnings	13,870	17,266	18,047	19,991	22,280
Growth Rates (%)					
EPS adjusted	64.1	24.5	4.5	10.8	11.4
Oper. profit bef. prov.	19.7	19.4	18.5	20.7	16.0
Balance Sheet (RsM)					
Total assets	**1,239,919**	**1,609,755**	**1,839,376**	**2,118,502**	**2,427,895**
Avg interest earning assets	1,102,470	1,388,503	1,689,086	1,941,681	2,235,481
Customer loans	762,110	986,256	1,151,440	1,365,246	1,596,737
Gross NPLs	16,578	19,235	25,136	31,754	33,711
Liab. & shar. funds	**1,239,919**	**1,609,755**	**1,839,376**	**2,118,502**	**2,427,895**
Total customer deposits	1,038,586	1,387,028	1,593,087	1,846,467	2,127,278
Reserve for loan losses	19,441	20,914	21,990	26,312	30,800
Shareholders' equity	**73,477**	**87,404**	**102,635**	**119,558**	**138,770**
Profitability/Solvency Ratios (%)					
ROE adjusted	22.1	21.5	19.0	18.0	17.2
Net interest margin	2.59	2.75	2.68	2.73	2.70
Cost/income ratio	38.2	41.8	40.2	38.2	37.2
Cash cost/average assets	1.4	1.6	1.4	1.4	1.3
NPLs/customer loans	2.2	2.0	2.2	2.3	2.1
Reserve for loan losses/NPLs	117.3	108.7	87.5	82.9	91.4
Bad debt prov./avg. cust. loans	0.9	0.7	1.0	1.2	1.3
Loans/deposit ratio	73.4	71.1	72.3	73.9	75.1
Tier 1 capital ratio	7.5	8.2	7.4	7.5	7.7
Total capital ratio	12.5	13.3	11.5	11.2	10.8

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Powered by: dataCentral

Figure 1. Union Bank of India: 1Q FY10 Highlights (Rupees Million, Percent)

	1Q10	1Q09	YoY %	4Q09	QoQ%	CIRA Comments
Interest Income	31,753	25,332	25.3	32,897	-3.5	
Interest Expense	-23,737	(17,232)	37.7	(23,633)	0.4	
Net Interest Income	8,016	8,100	-1.0	9,264	-13.5	Reduction in NIMs- largely an industry phenomenon but higher for Union
Fee-Based Income	3,197	1,927	65.9	3,320	-3.7	Core fee growth of 43% YoY; reverses the dip in growth in previous quarter
Other Non-Interest Income	2,090	290	620.7	2,270	-7.9	Sharp rise in bond portfolio gains for the third consecutive quarter - includes Rs300-400m of income from MF investments
Non Interest Income	5,287	2,217	138.5	5,590	-5.4	
Operating Income	**13,303**	**10,317**	**28.9**	**14,854**	**-10.4**	**Higher than estimates - though driven by higher trading gains**
Operating Expenses	(5,429)	(4,157)	30.6	(5,740)	-5.4	Should trend slightly higher as management continues to expand distribution and employee strength
Pre-Provision Profit	7,875	6,160	27.8	9,115	-13.6	
Pre-Provision Profit (ex-trading gains and one-offs)	5,785	5,870	-1.5	6,845	-15.5	7% lower than estimates - though fee growth is substantially higher
Charges for Bad Debts	(2,860)	563	NM	(2,700)	5.9	Loan loss charges remain at relatively elevated levels though incremental deterioration levels have come down
Other Operating Items	957	(3,520)	NM	(134)	NM	
Pre-Tax Profit	5,972	3,203	86.5	6,281	-4.9	
Tax	(1,550)	(920)	68.5	(1,630)	-4.9	
Net Profit	**4,422**	**2,283**	**93.7**	**4,651**	**-4.9**	**Headline nos. 28% above estimates - weaker NIMs overshadow an otherwise good quarter**
EPS	8.8	4.5	93.7	9.2	-4.9	
Customer Loans	960,260	758,100	26.7	982,650	-2.3	Continues to be strong - management targets 25% growth
Customer Deposits	1,438,890	1,072,480	34.2	1,387,030	3.7	CASA has dipped to 30% - management has a longer term target of reaching 35% by Mar12
AIEA	1,398,222	1,227,083	13.9	1,323,288	5.7	
AIBL	1,412,960	1,034,424	36.6	1,341,750	5.3	
Total Assets	1,678,131	1,281,016	31.0	1,618,354	3.7	
Avg Assets	1,648,242	1,253,521	31.5	1,615,176	2.0	
Non-Performing Loans (NPL)	18,740	15,755	18.9	19,233	-2.6	Deterioration remains under control - though restructured assets rise to 4.7% of loans (3.9% in 4Q09)
Loan Loss Reserves (LLR)	(11,970)	(14,660)	-18.3	(15,974)	-25.1	Has reclassified floating provisions as Tier 2 capital instead of provisions - excluding this - coverage levels remain stable
Shareholders' Funds	77,921	58,516	33.2	73,499	6.0	
Book Value Per Share	154.3	116	33.2	145.5	6.0	
Key Ratios (%)	**1Q10**	**1Q09**	**Bps Δ YoY**	**4Q09**	**Bps Δ QoQ**	
ROAA (annualized)	1.07	0.73	34	1.15	-8	
ROAE (annualized)	22.70	15.61	709	25.31	-261	
Net Interest Margin (bps)	229	264	-35	280	-51	Could be 12bps higher excluding impact of differential classification of MF income. Management suggests 300bps NIMs for FY10 - we see this as ambitious
Fee Inc/Operating Income	24.0	18.7	536	22.4	168	
Other Non-Interest Inc/Op Inc	39.7	21.5	1826	37.6	211	
Op. Cost/ Operating Income	40.8	40.3	51	38.6	217	Cost ratios likely to trend higher as management continues on aggressive expansion mode
Loan-to-Deposit Ratio (LDR)	66.7	70.7	-395	70.8	-411	
NPL/Loan Ratio	2.0	2.1	-13	2.0	-1	Stable asset quality with relatively lower asset deterioration in 1Q. Restructured assets at 4.7% of loans (expected 4% as at Mar09) - management expects only 5-10% of these to slip to NPLs
LLR/NPL Ratio	64	93	-2,918	83	-1,918	Excluding floating provisions of Rs5.3bn - coverage remains stable

Source: Company reports, Citi Investment Research and Analysis

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 2558 branches and 1790 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 strategy

We rate Union Bank Sell/Low Risk (3L). Union has key strengths with its large balance sheet and distribution, low operating costs (as a proportion of assets) below industry average, good technology ahead of its peer group in implementation, and a clean balance sheet with low gross and net NPLs (improving above industry levels). However, the risks to Union lie in: 1) Its low balance sheet liquidity, and the need to grow term deposits rapidly to fund loan growth; 2) Its relatively lower capital cushion, which is likely to moderate asset growth in a higher growth environment; 3) its NIMs have been impacted recently due to dependence on bulk deposits induced by the highly volatile interest rate environment. We believe Union's current valuations are pricing in most of the upside and leave little room for outperformance.

Valuation

Our target price of Rs226 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 6.5%, while maintaining a slightly higher than industry spread (220bps) and a cost income ratio of 39%. We also benchmark our target price on a 1.25x 1Yr Fwd PBV, which translates to a fair value of Rs233. We believe Union should trade at a 10% discount to the larger banks like SBI and PNB, due to: 1) its lower capital cushion which is likely to cap upside in a higher growth environment; 2) its modest deposit mix, which increases dependence on wholesale funding; and 3) the recent increase in asset deterioration. Additionally, Union's NIMs have come under pressure and could remain subdued as its high cost bulk deposits are likely to re-price with a lag. 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 upside risks to our target price include: 1) continued low interest rate environment which could support NIMs, 2) easing of asset quality pressures, 3) higher loan growth environment, and 4) improvement in its deposit mix.

Appendix A-1

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Union Bank Of India (UNBK.BO)

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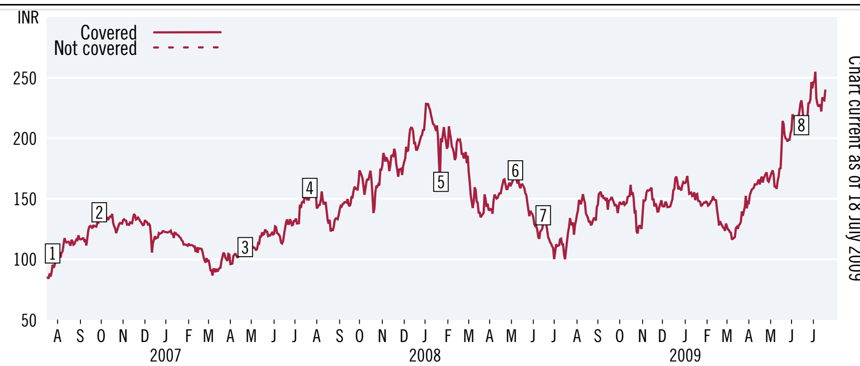
Fundamental Research

Analyst: Manish Chowdhary, CFA
Covered since September 7 2006



	Date	Rating	Target Price	Closing Price
1	20-Jul-06	2L	*96.00	88.35
2	28-Sep-06	*3L	*125.00	138.90
3	23-Apr-07	*1L	125.00	103.20
4	23-Jul-07	1L	*180.00	155.65
5	23-Jan-08	1L	*242.00	200.05
6	7-May-08	1L	*217.00	173.55
7	16-Jun-08	1L	*165.00	129.80
8	14-Jun-09	*3L	*226.00	228.85

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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