



Punjab National Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,469	PNB IN
	REUTERS CODE
S&P CNX: 3,876	PNBK.BO

15 November 2006

Buy

Rs546

Previous Recommendation: Buy

Equity Shares (m)	315.3
52-Week Range	554/300
1,6,12 Rel.Perf.(%)	0/2/-29
M.Cap. (Rs b)	172.3
M.Cap. (US\$ b)	3.8

YEAR END	NET INCOME (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	CAR (%)	ROE (%)	ROA (%)	P/ABV (X)
3/06A	58,979	14,393	45.6	2.1	12.0	1.9	12.0	16.4	1.1	1.9
3/07E	61,883	17,136	54.3	19.1	10.1	1.6	10.4	17.0	1.1	1.7
3/08E	74,227	21,512	68.2	25.5	8.0	1.4	10.3	18.4	1.2	1.4

Best positioned bank in the current scenario: We believe that liability management would be crucial to sustain margins over the medium term. With superior deposit franchise and CASA of 49%, PNB's is ideally placed to protect its NIMs at ~4%. The bank stands to benefit on margins should interest rates increase.

Valuable franchise: PNB has been among consistent players growing their core deposits. With 4,500 branches, PNB is ideally placed to grow its deposits at a steady pace. Its total deposits have grown at a CAGR of 17% over FY02-06, its CASA deposits have grown at a CAGR of 20% during the period.

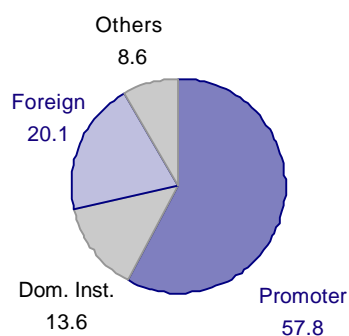
Investment in technology is paying off: PNB has made substantial investments in technology which has begun to reflect in higher fee income accretion. Further, management claims that the risk assessment capabilities have also improved resulting in lower slippages.

Leverage to enhance ROAs, RoEs: PNB is likely to generate a 1.2%+ RoA in FY08. With operating costs likely to grow at a slower pace, there is enough leverage to grow profitability. Further with higher recoveries and lower provisions, RoAs could increase going forward, resulting in a higher sustainable RoE.

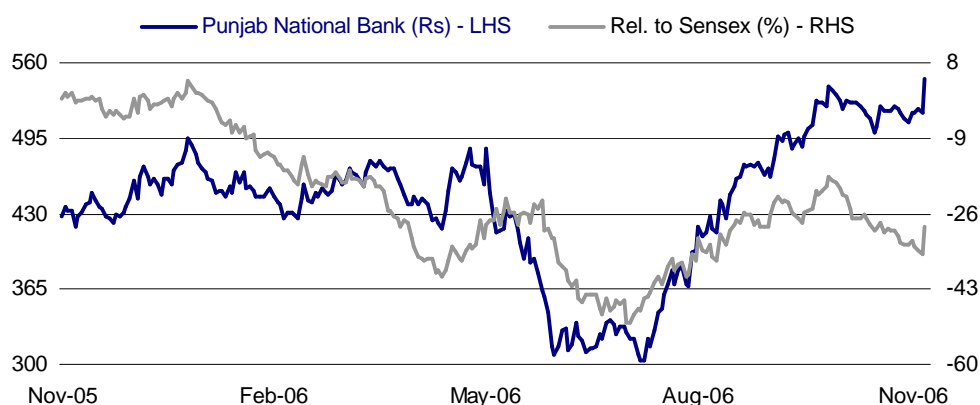
Asset quality amongst the best: PNB's net NPA ratio at 0.2% is amongst the best in Indian banks. With slippages likely to remain low, NPA recoveries can provide upside to our estimates.

Preferred bet among large cap banks: Current valuations at 1.4x FY08E book value and 8x FY08E earnings are attractive, given its high sustainable margins, strong deposit franchise and 18-19% RoE over the next two years. Earnings can surprise on the upside due to higher recoveries and lower provisions. On the back of high RoE of 19% and strong earnings visibility, we value the bank at 1.7x FY08E book value. PNB is our top pick amongst the large banks. We reiterate **Buy**, with a target price of Rs660.

SHAREHOLDING PATTERN (%)



STOCK PERFORMANCE (1 YEAR)

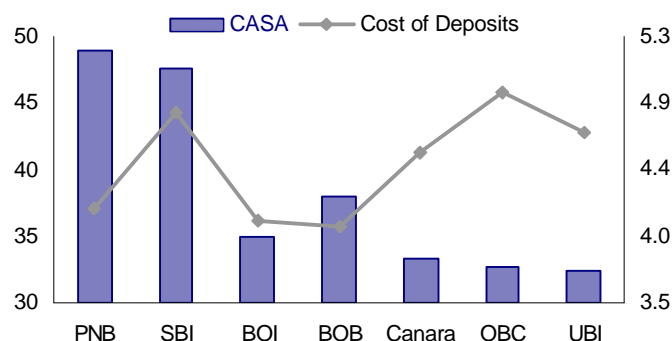


Best positioned bank in the current scenario

We believe that banks that can manage their liabilities well would be able to grow their balance sheet with reasonable margins. PNB clearly stands out in this respect; it has a strong liability base arising out of its historical presence in the cash rich northern belt of India. A strong branch network of 4,500 branches, allows the bank to grow its retail deposit base at a steady rate.

Currently, the bank's margins are ~4%, one of the highest amongst Indian banks, supported by its strong lowcost deposit franchise. In an environment where raising resources at a reasonable cost is very important, we believe PNB is best positioned compared with other state-owned banks. Despite rising interest rates over the last few quarters, PNB has been able to maintain its deposit costs, thereby enhancing its net interest margins.

HIGHER PROPORTION OF CASA - LOWER COST OF DEPOSITS (%)



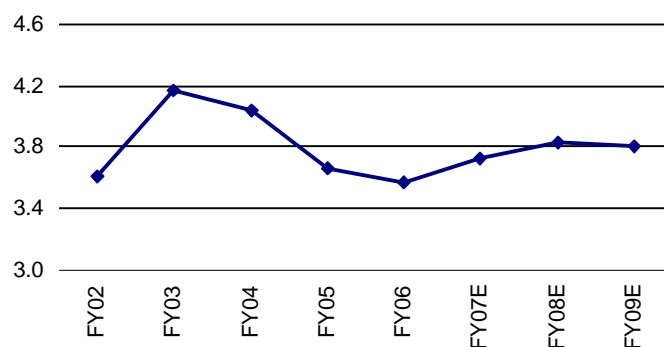
Source: Company/ Motilal Oswal Securities

EFFECT OF 50BP RATE HIKE ON PNB'S MARGINS

	BALANCE SHEET BREAKDOWN (%)	ASSUMPTION	EFFECT ON NIMS
Cash / Bank Deposits	17.1	50bp Increase	0.09
Loans	51.4	50bp Increase (Assuming 75% Reprice)	0.19
Investments	28.3	50bp Increase (Assuming 25% Reprice)	0.04
Other Assets	3.30	No Change	0.00
Total Assets	100.0		0.31
Demand Deposits	11.5	No Change in Cost	0.00
Savings Accounts	28.8	No Change in Cost	0.00
Time Deposits	42.0	Cost Rise 50bp, (Assuming 50% Reprice)	0.11
Borrowings	4.6	Cost Rise 50bp	0.02
Provisions & Other Liabilities	6.6	No Change	0.00
Share Holders Funds	6.5	No Change	0.13
Total Liabilities	100.0		0.15
Improvement in Margins (bp)			0.19

Source: Company/ Motilal Oswal Securities

TREND IN MARGINS (%)



Source: Company/ Motilal Oswal Securities

Not only does the bank have high a CASA composition (49% of total deposits), it also has the highest share of savings deposits (35% of total deposits). We believe that savings deposits are stickier than current account deposits. The management targets a CASA ratio of 51%, which we believe the bank would be able to attain especially given that it is adding branches in agri-rich rural communities in the northern region (68% of branches opened in FY06 were in rural and semi-urban areas).

Valuable franchise

Punjab National Bank (PNB) is the second largest bank in India after State Bank of India (SBI). It has over 4,500 branches spread across the country but it is particularly strong in the northern region. In terms of deposit growth, PNB has been consistent in growing its deposit base at a steady pace with improving ratio. While its total deposits

have grown at a CAGR of 17% over FY02-06, its CASA deposits have grown at a CAGR of 20% during the period. PNB has the highest CASA ratio (CASA deposits as a percentage of total deposits) amongst the state-owned banks in India. Their incremental CASA deposit as a percentage of incremental total deposits during FY03-06 has been as high as 60%.

DEPOSIT GROWTH OVER FY02-06 (RS B)

	FY02	FY03	FY04	FY05	FY06	CAGR (%)
Current Deposits	67.6	98.9	99.0	124.7	167.2	25.4
Savings Deposits	216.6	256.5	304.2	353.4	419.1	17.9
CASA Deposits	284.2	355.4	403.2	478.1	586.3	19.8
Term Deposits	357.0	402.8	475.9	553.6	610.5	14.4
Total Deposits	641.2	758.1	879.2	1031.7	1196.9	16.9

Source: Company/ Motilal Oswal Securities

Core value of CASA franchisee could increase further

The current franchise value of the bank is 13% of its deposits (FY06). However, the core CASA franchisee value at 27% is available at best value (except SBI) amongst the larger state-owned banks. We expect this franchise to get more valuable, as deposits become costlier for the whole system. Further, a high CASA component supports strong loan growth with higher margins.

PNB: A VALUE BUY

	MCAPI/TOTAL DEPOSITS (%)	MCAPI/ CASA (%)	MCAPI/ SAVINGS (%)
PNB	13.4	27.4	38.3
SBI Cons.	9.8	23.0	35.4
BoB	10.0	26.3	34.4
Union Bank	8.8	27.2	36.2
OBC	11.6	35.6	51.4
IOB	12.1	30.3	42.3
Canara	9.9	29.8	40.5
HDFC Bank	56.5	101.9	194.8
UTI Bank	30.2	75.6	150.3
ICICI Bank	42.4	186.6	334.2

Source: Company/ Motilal Oswal Securities

Diversified, high-yielding loan book

PNB has a diversified loan book, with the retail segment constituting 24% and priority sector constituting 44% (including agri-loans, which constitute 19%) of the total loan book. Given the underlying demand for credit, we expect PNB's loan book to grow at a CAGR of 23% over FY06-09. Retail and SME credit are likely to remain the key drivers of credit growth in the coming years. With high proportion of low cost deposits and a high-yielding loan book, we expect margins to remain strong.

The bank's yield on advances has increased from 8.3% in FY06 to 9% in 2QFY07, on the back of PLR hikes and also due to focus on retail and agri-loan generation. The management reiterated that agriculture is the most profitable segment for PNB, as it still enjoys a blended yield of over 9%. With current recovery rates being in excess of 9%, agriculture loans have the highest RoA.

Special focus on agri loans: PNB has a strong branch network in the traditionally rich agricultural belt of Punjab and Haryana. This has helped the bank to build a large agri-loan portfolio (19% of total loans). PNB does not face risks of inadequate rains, as the northern belt is very well irrigated. The recovery rate in agricultural loans for PNB has been ~ 95%.

Technology initiatives – will pay off over the next few years

PNB is one of the few large state-owned banks in India to have rolled out CBS in almost 50% of its branches. CBS has been implemented in 2,171 service outlets at 571 centres, covering 76.2% of bank's total business. CBS implementation has lowered revenue leakages, resulting in higher revenues.

PNB has been an early entrant in the technology space. We believe that the experience gained by its staff in the technology domain puts the bank much ahead of its peers. This would be a key differentiator in the years to come, enabling better service standards, improved better credit monitoring, enhanced fee revenues, etc.

Fee-based income to grow on the back of technology rollout

While the CBS rollout has been favorably impacting its fee income, PNB has also taken various initiatives to augment its fee-based income. Some of these include:

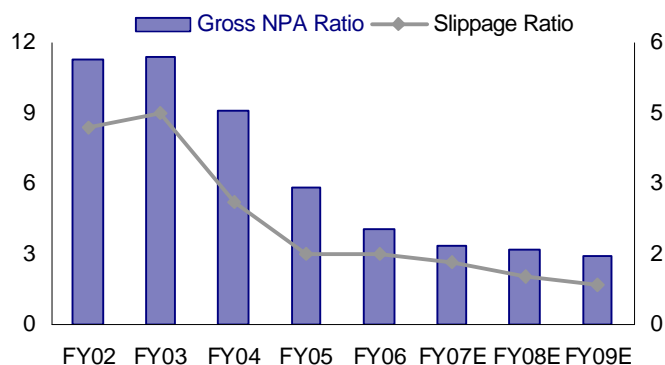
- ✍ Cash Management Services (CMS is operational at 500 centres).
- ✍ Marketing and distribution of financial and bancassurance products
- ✍ Depository services: The bank has installed new software to provide centralized online depository services at 85 CBS branches. Going forward, it plans to offer end-to-end solutions such as online trading, speed –e facility and broking services).
- ✍ Implementation of online tax accounting system for the collection of taxes.
- ✍ PNB also handles the payments of dividend / interest warrants / refund orders. The bank has obtained SEBI registration for category -1 merchant banker.

In 1H, fee income for PNB has grown by 54% YoY. We believe this to be a result of CBS implementation resulting in lower revenue leakages. Going forward, we expect fee income to remain strong on back of CBS rollout and added focus on management's part to grow non-fund based income.

Asset quality amongst the best in the system

PNB has one of the cleanest loan books amongst the state-owned banks, with net NPAs close to zero (0.2% as of 2QFY07). PNB has enough floating provisions on its books (Rs9.8b as of FY06) as against its actual net NPAs, resulting in lower provisioning and possible writeback in future. Its higher provision coverage at 95%, and expected low incremental defaults would protect earnings in coming years. Higher recoveries of written-off accounts could be a possible upside to our estimates.

IMPROVING ASSET QUALITY (%)



Source: Company/ Motilal Oswal Securities

Stable opex to provide strong leverage

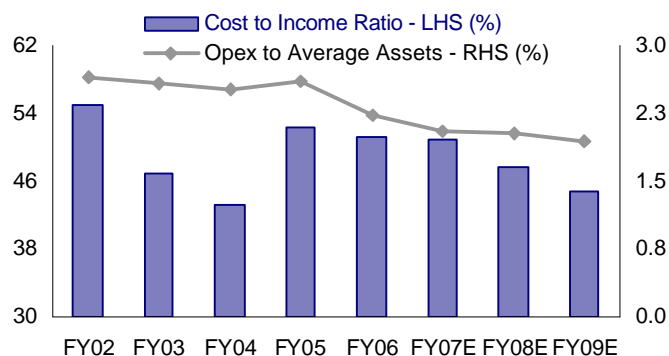
About 70% of PNB's operating costs are wages, which are largely fixed in nature, apart from the normal inflation-related hike in salaries. Over the last three quarters, PNB's wage costs have largely remained flat. With most incremental costs owing to higher pensions and higher wages being taken care of, we expect wage costs to remain at similar levels. The new wage revision would be effective from November 2007 and the impact of higher wages would only come in FY09. Further, there are several retirements coming up over the next few years. The management has stated that over the next five years, ~15% of the current workforce is likely to retire.

In terms of other operating costs, PNB has already made a larger investment in technology. We do not expect technology costs to increase substantially from here on. Thus, from the current base, we do not expect a sharp growth in opex. In our projections, we are assuming overall opex to grow by 9% CAGR in FY06-09E.

Net reduction in PNB's workforce over the next few years would lead to a significant improvement in operating ratios. For instance, a mere 3% reduction in PNB's workforce could result in a 50bp improvement in RoE. However, the big benefit for state-owned banks from this exercise would be a sustainable growth in earnings. While the business income over the next few years will continue to grow at 15%, cost growth will be lower at 10%, resulting in earnings growth of 20-22%. This is possible, as a decline in C/I ratio could result in strong earnings growth for PNB.

On the AS-15 impact, PNB has already started making higher provisions as per actuarial valuations (~Rs1.5b in 1HFY07). On the past arrears, the management indicated that the gap is likely to be in the range of Rs4-5b (~4% of FY07 book value).

DECLINING COST/INCOME RATIO

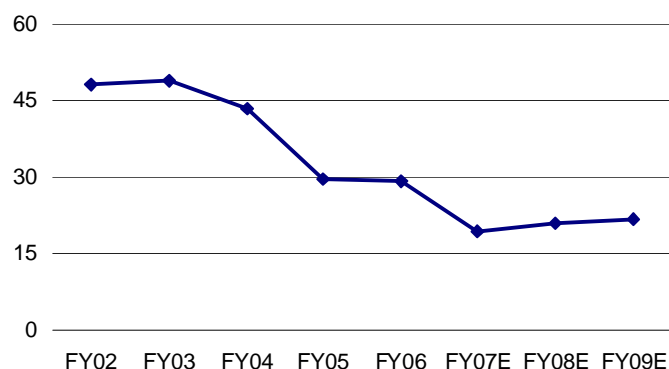


Source: Company/ Motilal Oswal Securities

Provisioning requirement to decline substantially

Over the last three years, PNB has been resorting to very high provisioning, either on the back of its pension expenses or investment provisions. PNB had a high duration investment book exposed to mark-to-market risks. As a result, in a rising rate environment, it had to make heavy provisioning.

PROVISIONS AS A % OF OPERATING PROFITS



Source: Company/ Motilal Oswal Securities

However, with interest rates coming off, PNB need not make any more provisions for its investment book. Further, with net NPAs being at 0.2%, it does not have any requirement of NPA-related provisions. We expect provisioning requirement for PNB to also come off, going forward.

Investment book – no risks

PNB has been selling securities to fund its loan growth. The investment portfolio has reduced to Rs449b from Rs524b as of 2QFY06. Post transfers and sell downs, the proportion of SLR securities in HTM category has been increased to 62%. The AFS duration is still >3 years and the AFS book has been marked-to-market up to 8.1%. PNB was one of the most vulnerable banks in a rising rate scenario. However, with the current interest rates almost 60bp lower, PNB is likely to witness gains on its investment portfolio

Well placed on capital front

Capital adequacy is 12.7% (Tier-1 is 9.6%). Basel-2 operational risk impact on PNB is likely to be ~90bp in FY07. Post Basel-2 impact, the management stated that by FY07, they would like to maintain a capital adequacy ratio (CAR) of over 12%. Further, the option to raise capital by way of hybrids exists for PNB and the bank also has room to augment its tier-2 capital.

Strong RoA – leverage to enhance RoE

PNB has consistently delivered strong RoA since FY03 (1.0-1.2%), driven by high margins, improving cost ratios, and declining provisions. We believe that its high RoA could generate higher than presently reported RoE (~18%). As per our calculations, RoE could improve 200bp on the back of higher-than-expected fee income and containment of costs coupled with already strong margins.

DU PONT ANALYSIS OF ROE

PNB	FY04	FY05	FY06	FY07E	FY08E	FY09E
Net Interest Income/Avg. Assets (%)	3.84	3.51	3.44	3.54	3.62	3.63
Fee Income/Avg. Assets (%)	0.79	1.16	0.75	0.83	0.77	0.71
Treasury Income/ Avg. Assets (%)	1.19	0.31	0.16	-0.34	-0.12	-0.02
Total revenue/avg assets (%)	5.82	4.97	4.34	4.04	4.27	4.32
Operating Costs/income (%)	43	52	51	51	48	45
Operating Costs/Avg. Assets (%)	2.51	2.60	2.23	2.06	2.03	1.94
- Emp. Costs/Avg. Assets (%)	1.75	1.86	1.56	1.43	1.40	1.32
- Other Exp. / Avg. Assets (%)	0.76	0.75	0.67	0.63	0.63	0.61
Pre-provision Profits/Avg. Assets (%)	3.31	2.37	2.12	1.98	2.24	2.38
Loan-loss-provisions/Avg. Assets (%)	1.27	0.15	0.24	0.08	0.17	0.19
Other Provisions/Avg. Assets (%)	0.17	0.55	0.38	0.31	0.30	0.32
Tax/Avg. Assets (%)	0.70	0.43	0.44	0.48	0.53	0.56
RoAA (%)	1.2	1.2	1.1	1.1	1.2	1.3
Leverage (x)	20.85	17.35	15.48	15.21	14.91	14.76
RoAE (%)	24.5	21.4	16.4	17.0	18.4	19.3

Source: Company/ Motilal Oswal Securities

Current valuations at 1.3x FY08E book and 7.5x FY08E earnings are attractive, given its high sustainable margins, strong deposit franchise and 18-19% RoE over next two years. We expect PNB to deliver 22% CAGR in earnings during FY06-09.

Key risks

Investment yield at 8%: PNB continues to enjoy high yields on its investment book. However, we expect the yields to decline as the bank churns its portfolio. We are building in a decline in investment yields in our projections.

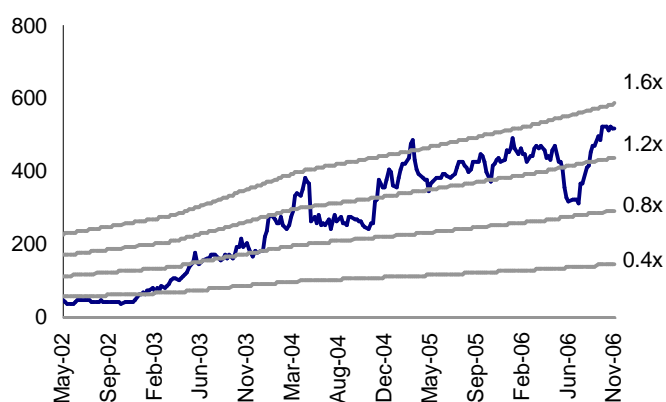
Pension – AS-15: On the AS-15 impact, PNB has already started making higher provisions as per actuarial valuations (~Rs1.5b in 1HFY07). With regard to past arrears, management indicated that the gap is likely to be in the range of Rs4b-5b (~4% of FY07 book value). We have not built in pension related costs in our projections.

Re-iterate Buy with a price target of Rs660

While margins continue to be high with low cost pressures on account of high CASA component, PNB could surprise on the earnings front on account of lower-than-expected

provisions going forward, high recoveries, and stronger fee income growth. Current valuations at 1.4x FY08E book value and 8x FY08E earnings are attractive given its high sustainable margins, strong deposit franchise and 18-19% RoE over the next two years, with possibility of higher RoE stemming from better earnings arising from recoveries and lower provisions. On the back of high RoE of 19%, we value the bank at 1.7x FY08E book value. PNB is our top pick amongst the large state-owned banks. Reiterate **Buy**, with a target price of Rs660.

ROLLING P/BV BAND



Source: Company/ Motilal Oswal Securities

INCOME STATEMENT (Rs Million)						RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E	Y/E MARCH	2005	2006	2007E	2008E	2009E
Interest Income	84,599	95,842	111,858	133,407	157,154	Spreads Analysis (%)					
Interest Expended	44,531	49,174	57,568	70,482	84,053	Avg. Yield - Earning	7.7	7.3	7.7	8.1	8.2
Net Interest Inco	40,067	46,668	54,290	62,925	73,101	Avg. Cost-Int. Bear. l	4.6	4.2	4.3	4.7	4.8
Change (%)	10.5	16.5	16.3	15.9	16.2	Interest Spread	3.2	3.1	3.4	3.4	3.4
Other Income	16,757	12,312	7,593	11,302	13,724	Net Interest Margin	3.7	3.6	3.7	3.8	3.8
Bond Gains	3,528	2,109	-5,170	-2,000	-500	Profitability Ratios (%)					
Net Income	56,824	58,979	61,883	74,227	86,825	RoE	21.4	16.4	17.0	18.4	19.3
Change (%)	3.5	3.8	4.9	19.9	17.0	RoA	12	1.1	1.1	1.2	1.3
Operating Expenses	29,752	30,232	31,503	35,296	38,961	Int. Expended/Int.Ear	52.6	51.3	51.5	52.8	53.5
Operating Incom	27,072	28,748	30,380	38,931	47,864	Other Inc./Net Incom	29.5	20.9	12.3	15.2	15.8
Change (%)	-13.3	6.2	5.7	28.1	22.9	Efficiency Ratios (%)					
Other Provisions	8,016	8,399	5,900	8,200	10,300	Op. Exps./Net Incom	52.4	51.3	50.9	47.6	44.9
P B T	19,056	20,348	24,480	30,731	37,564	Empl. Cost/Op. Exps	71.3	70.0	69.4	68.8	68.4
Tax	4,955	5,955	7,344	9,219	11,269	Busi. per Empl. (Rs r	25.6	30.9	37.5	45.4	54.5
Tax Rate (%)	26.0	29.3	30.0	30.0	30.0	NP per Empl. (Rs lac	2.4	2.5	3.0	3.8	4.8
P A T	14,101	14,393	17,136	21,512	26,295	Asset-Liability Profile (%)					
Change (%)	27.2	2.1	19.1	25.5	22.2	Adv./Deposit Ratio	58.6	62.4	69.4	72.4	74.9
Proposed Dividend	1977	2,838	3,153	3,784	4,730	Invest./Deposit Ratio	49.1	34.3	32.8	31.1	29.5
BALANCE SHEET (Rs Million)						G-Sec/Invest. Ratio	85.7	84.4	85.9	87.5	89.1
Y/E MARCH	2005	2006	2007E	2008E	2009E	Gross NPAs to Adv	5.8	4.0	3.4	3.1	2.9
Capital	3,153	3,153	3,153	3,153	3,153	Net NPAs to Adv.	0.2	0.3	0.3	0.3	0.3
Reserves & Surplus	78,460	90,611	104,594	122,322	143,887	CAR	14.8	12.0	10.4	10.3	10.3
Net Worth	81,613	93,764	107,747	125,475	147,040	Tier 1	8.9	10.1	8.7	8.6	8.7
Deposits	1,031,669	1,196,850	1,376,378	1,596,598	1,852,054	VALUATION					
Change (%)	17.3	16.0	15.0	16.0	16.0	Book Value (Rs)	249	288	332	388	457
Borrowings	27,183	66,872	18,000	18,000	18,000	Price-BV (x)	2.2	1.9	1.6	1.4	1.2
Other Liabilities & Pr	121,948	95,188	110,188	125,188	140,188	Adjusted BV (Rs)	246	283	326	380	448
Total Liabilities	1,262,413	1,452,674	1,612,312	1,865,261	2,157,282	Price-ABV (x)	2.2	1.9	1.7	1.4	1.2
Current Assets	110,890	247,917	148,172	153,561	168,739	EPS (Rs)	44.7	45.6	54.3	68.2	83.4
Investments	506,728	410,553	451,608	496,769	546,446	EPS Growth (%)	7.0	2.1	19.1	25.5	22.2
Change (%)	20.3	-19.0	10.0	10.0	10.0	Price-Earnings (x)	12.2	12.0	10.1	8.0	6.6
Advances	604,128	746,274	955,230	1,155,829	1,386,994	OPS (Rs)	85.9	91.2	96.4	123.5	151.8
Change (%)	27.9	23.5	28.0	21.0	20.0	OPS Growth (%)	-27.0	6.2	5.7	28.1	22.9
Net Fixed Assets	9,652	10,302	12,302	14,102	18,102	Price-OP (x)	6.4	6.0	5.7	4.4	3.6
Other Assets	310,15	37,628	45,000	45,000	47,000	E: Most Estimates					
Total Assets	1,262,414	1,452,674	1,612,313	1,865,261	2,157,282						
ASSUMPTIONS (%)											
Deposit Growth	17.3	16.0	15.0	16.0	16.0						
Advances Growth	27.9	23.5	28.0	21.0	20.0						
Investments Growth	20.3	-19.0	10.0	10.0	10.0						
Dividend	60.0	90.0	100.0	120.0	150.0						
GRR	5.0	5.0	5.0	5.0	5.0						

E: Most Estimates

E: Most Estimates

For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

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

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

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Disclosure of Interest Statement

Punjab National Bank

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

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