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On-line Share Trading

Initiating Coverage

Oriental Bank of Commerce (ORIBAN)

Oriental Express ...

Current price	Target price
Rs 267	Rs 324
Potential upside	Time Frame
21%	12 months

OUTPERFORMER

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Oriental Bank of Commerce (OBC) is the cheapest PSU banking stock available at almost1x FY09E ABV. Even after the absorption of Global Trust Bank's (GTB) losses, the book value would grow almost by 2x in FY09E. We expect a 20% CAGR in earnings (post GTB losses) over FY07-FY09E. We initiate coverage on the stock with an outperformer rating.

- **Turnaround and consolidation: The road ahead**

We expect OBC emerge stronger as it has successfully integrated the erstwhile Global Trust Bank (GTB) with itself, and looks set to wipe-off the latter's accumulated losses in FY09. We believe this definitely calls for a re-rating. Further, the bank would be a favoured choice in the consolidation process as the government's holding has reached the threshold limit of 51.10%. With one of the lowest cost-income ratios and extensive network across north India, the bank has the capacity to scale up in terms of human capital.

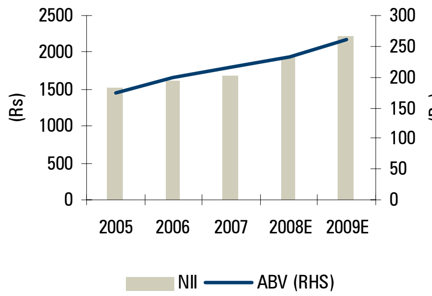
- **Investment book: A big surprise going forward**

What was a concern for OBC in the past could turn out to be a positive going forward. With an investment book over-exposed to the available-for-sale (AFS) category, investments and the interest rate cycle almost peaked; OBC is expected to witness a positive surprise in its non-interest income and profitability.

Valuations

The stock is available at an attractive valuation of almost 1x its FY09E ABV. It is trading at the lower P/ABV band in the PSU banking space. At the current price of Rs 267, the stock trades at 1.01x its FY09E ABV of Rs 261. Peers like PNB and IOB trade at 1.3x-1.5x FY09E ABV. We believe OBC deserves a re-rating after successfully integrating GTB with itself. The latter's accumulated losses would be wiped off in FY09E. OBC has managed its asset quality by aggressive provisioning and thereby maintaining low NPAs. We are also witnessing an upward trend on the ROE, which we believe would rise to around 18.1% in FY09E. Based on the Gordon growth model, the stock deserves a P/ABV multiple of 1.27x on its FY09E ABV (considering sustainable core RoE of 15.8% and beta of 1). We assign an **Outperformer** rating to the stock with a target price of Rs 324, an upside of 21% over a 12-month time frame.

NII & ABV trend



Stock metrics

Promoters holding	51.10%
Market Cap	Rs 6387 crore
52 Week H/L	284 / 156
Sensex	19,363
Average volume	79,414

Comparative return metrics (%)

Stock return	3 M	6M	12M
Andhra Bank	21.6	15.3	11.8
Union Bank	33.0	45.2	32.4
Corporation Bank	25.0	23.8	5.3
Allahabad Bank	27.0	28.9	21.7
OBC	24.0	12.0	5.0

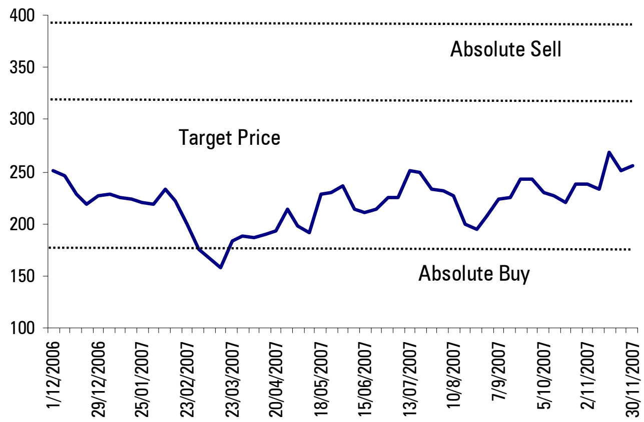
Exhibit 1: Key Financials

Year to March 31	FY06	FY07E	FY08E	FY09E
Net Profit (Rs crore)*	803.2	827.1	915.4	1184.8
EPS (Rs)	32.1	33.0	36.5	47.3
% Growth		3.0	10.7	29.4
P/E (x)	8.3	8.1	7.3	5.6
Price / Book (x)	1.3	1.2	1.1	1.0
Price / Adj Book (x)	1.3	1.2	1.1	1.0
GNPA%	6.3	3.3	2.2	1.8
NNPA%	0.5	0.5	0.5	0.6
RoNA (%)*	1.4	1.2	1.1	1.2

**-pre GTB losses*

Source: ICICIdirect Research

Price Trend



Company Background

Oriental Bank of Commerce (OBC), a mid-sized public sector bank, was first established in Lahore. The office was shifted to Amritsar post partition. Initially it was under the control of the Thapar group where it registered a steady growth before it was nationalised in 1980. The Government of India is the single largest shareholder with a controlling stake of 51.1% as on Q2FY08.

In July 1992, the merchant banking division was set up. The bank was authorised to act as a Category-I merchant banker by Sebi. It went public in October 1994 at a premium of Rs 50. The bank has been rated as a 'Customer Friendly Bank' by the National Institute of Bank Management (NIBM), Pune.

Under innovative banking, the bank pioneered a pilot project called Oriental Bank Grameen Project in 1995. The project is based on concept of Self-Help Groups - Bank Linkage.

The bank has been a bit conservative in terms of expansion of business. OBC has been very selective in its area of operations. It has been focusing more on creating a clean asset portfolio rather then expanding on anything. It has also been one of the exceptional performers amongst the public sector banks.

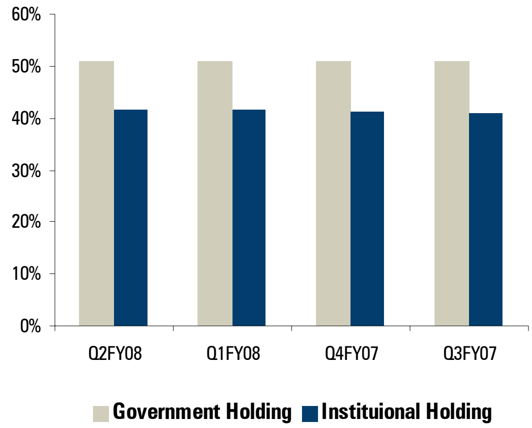
OBC acquired the assets and liabilities of the erstwhile Global Trust Bank (GTB) with effect from August 2004 as part of scheme of arrangement formulated by government. GTB brought with it strategic benefits like 104 branches, large base of high net-worth individuals, and a young and energetic workforce. On the negative side, GTB had accumulated losses of Rs 1,230 crore which OBC is amortising over a period of five years.

In FY07, the bank crossed the landmark of doing Rs 100,000 crore business in terms of business volume. The bank currently has a network of 1,273 branches, which are mostly situated in the northern parts of the country. It has signed a memorandum of understanding (MoU) with Canara Bank and HSBC Insurance (Asia-Pacific) Holdings Ltd to participate in the equity of proposed Joint Venture Company of Life Insurance Business

Shareholding pattern

Shareholder	% holding
Promoters	51.10
Institutional investors	41.70
Other investors	1.83
General public	5.38

Promoter & Institutional holding trend



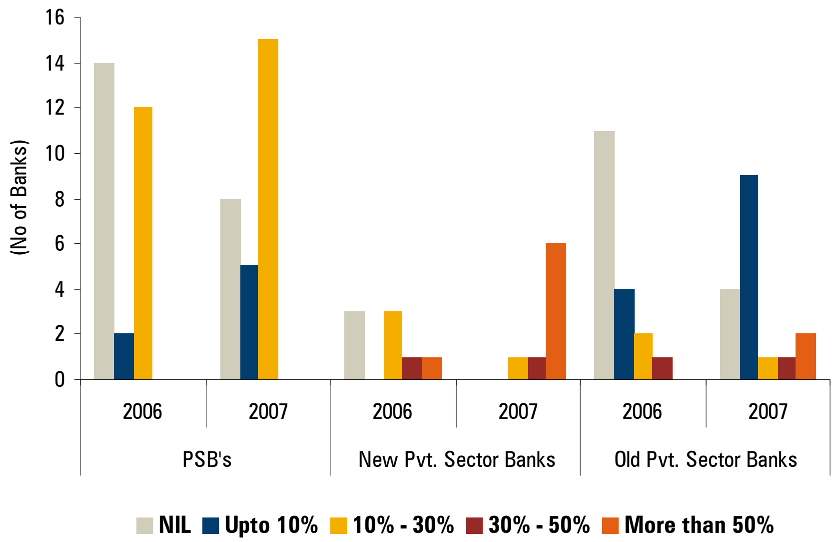
Investment Rationale

Turnaround and consolidation: *The road ahead …*

The government holding in OBC stands at 51.10%. According to the Banking Nationalisation Act, the minimum government holding in any PSU bank has been set at 51%. The opening up of the banking sector to foreign players (a recent RBI report highlights that the foreign players have significantly increased their holdings in Indian banks in FY07) will result in increased competition. All Indian banks, especially PSU banks, will have to improve their balance sheets, reduce delinquencies, and enhance fee-based income by introducing new innovative products, raise adequate capital at the right time and from the right source in order to keep their funding cost minimum.

PSU banks will have to consolidate if they are to face competition from private and foreign players

Exhibit 2: Foreign players gung-ho over increasing their share in the Indian banking pie



Source: RBI, ICICIdirect Research

We believe that OBC would be one of the first banks to participate in the consolidation process. The government stake of 51.10% leaves no room for raising funds through equity dilution.

OBC will be one of the favoured banks when the consolidation process kicks off in the banking industry

To keep pace with the changing environment, banks would have to scale-up in terms of financial capital, human capital and branch network. The moment the consolidation process kicks-off, OBC would be one among the favoured candidate for pairing up for consolidation.

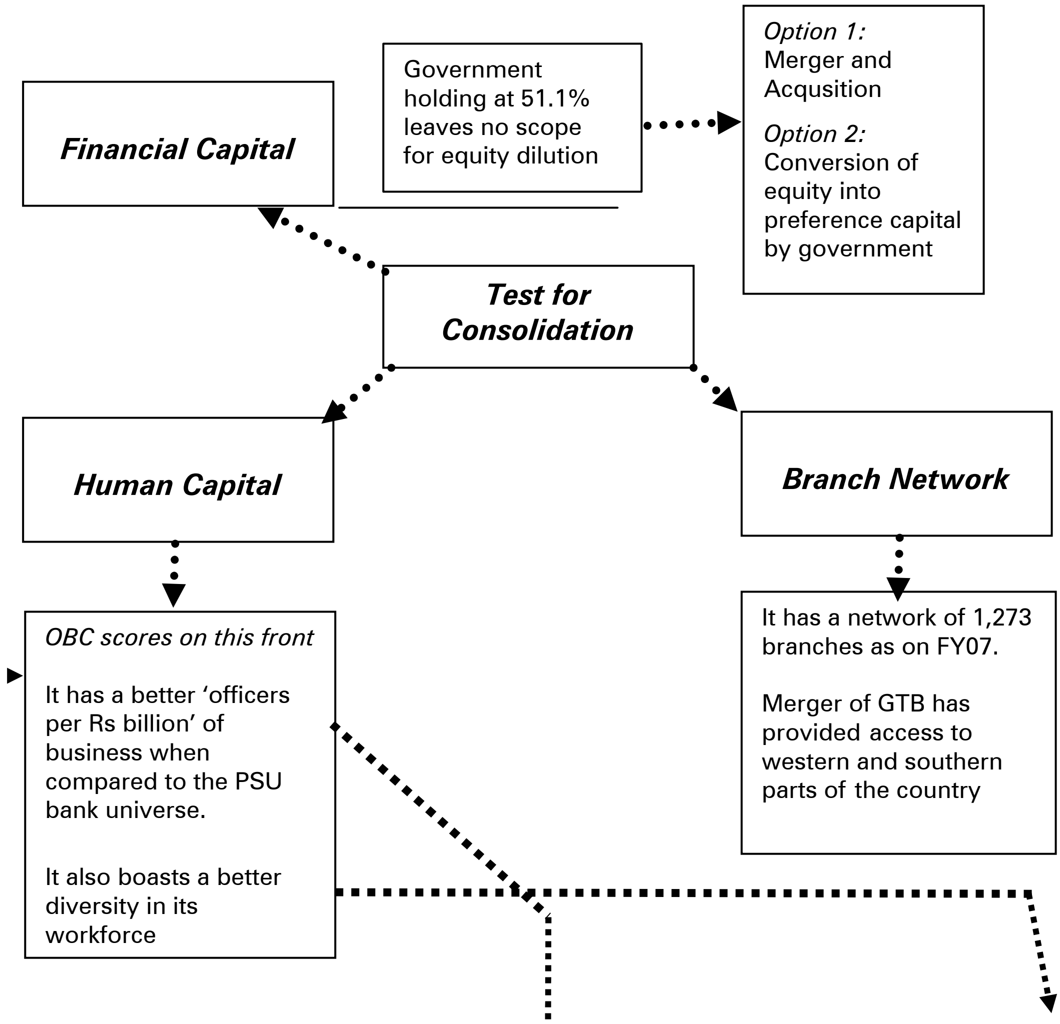


Exhibit 3: Officers per Rs billion of business

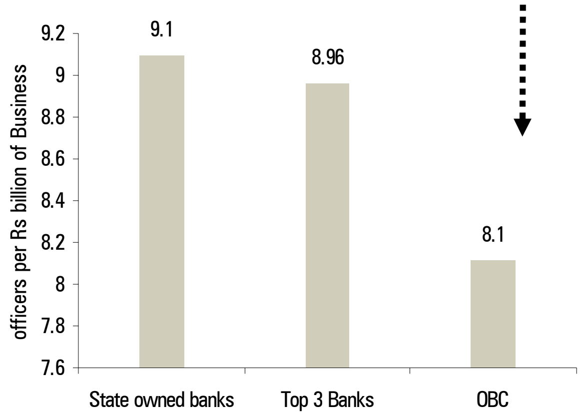
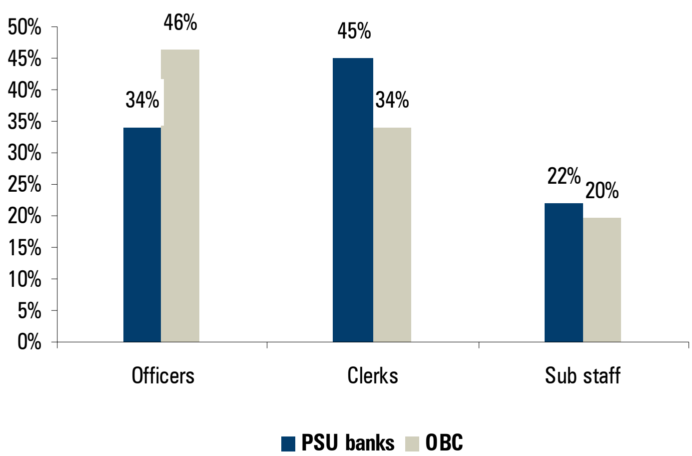


Exhibit 4: Diversity in workforce brings efficiency



Source: RBI, ICICIdirect Research

Exhibit 5: Qualitative matrix of prospective acquisition targets

M&A parameters	OBC	Dena Bank*	Andhra Bank
Government stake (%)	51.1	51.19	51.55
Branch Capital (FY07)			
Number of branches	1273	1135	1930
Geographical spread	Mainly North	Mainly West	Mainly South
Business per branch (Rs crore)	85.93	41.17	36.11
Profit per branch (Rs crore)	0.65	0.18	0.28
Human Capital (FY07)			
Number of employees	14,730	10,120	13,831
Officers	46	36	58
Subordinate staff	34	41	17
Clerk	20	23	25
Business per employee (Rs crore)	7	5	4
Profit per employee (Rs crore)	0	0	0
Technology (CBS rollout)	96	99 -	
Financial Parameters (FY09E)			
Return on equity (ROE)	18.1	17.4	18.4
P/ABV (x)	0.9	1.9	1.26

**-Financials based on FY07 figures*

Source: ICICIdirect Research

We have constructed a quantitative matrix of three PSU banks (OBC, Dena Bank and Andhra Bank) where the government holding has reached the threshold limit. It can be seen that OBC would be a favoured choice as it scores better in parameters discussed (branch capital, human capital and financials).

OBC scores over other banks in terms of human and branch capital

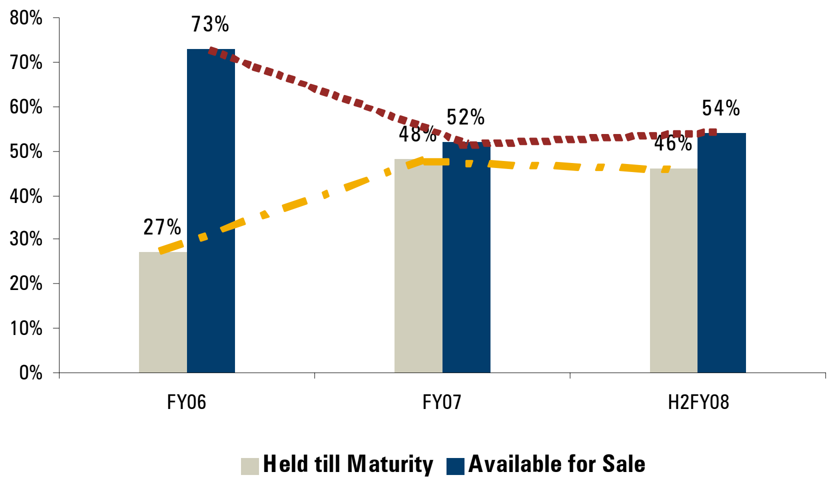
Investment book: A big surprise going forward

What was a matter of concern for OBC in the past could turn out to be a positive for the bank going forward. The bank's investment book is highly vulnerable to interest rate risks (more so in a rising interest rate scenario). Most of its investments (52% of the total) are in the available-for-sale (AFS) category, and the remaining in the held-till-maturity (HTM) category.

The bank has taken marked-to-market hit in its books on account of an unfavourable (rising) interest rate scenario. But now we believe that the interest rates have peaked, and would exhibit a downward bias going forward. We believe this would provide a big boost to OBC as its investments in the AFS category will start yielding handsome profits. This in turn would enhance the bank's non-interest income. The increase in investment allocation in the AFS category to 54% during H1FY08 gives credence to this view.

A downward bias in interest rates would be a positive for OBC's investment book

Exhibit 6: Breakdown of investment book



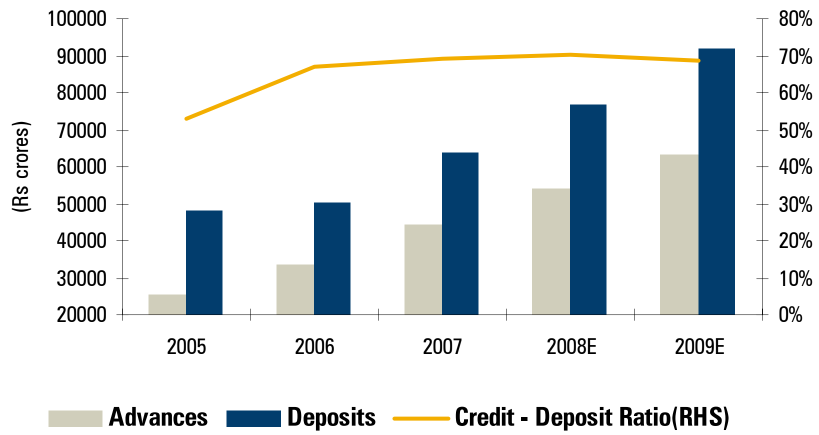
Source: Company, ICICIdirect Research

Business volumes, momentum to pick pace

Growth in business coupled with shift of focus on the retail side expected to ensure better yields on advances.

OBC exhibited moderate growth in H1FY08. We expect things to improve in H2FY08 and FY09E in terms of business volumes. The second half has always been good for the bank, and we expect the business to gather more momentum. We expect a 21% CAGR in advances and 20% CAGR in deposits to Rs 63,121 crore and Rs 91,959 crore respectively over FY07-09E. This would result in a 15% CAGR in net interest income.

Exhibit 7: Business growth to pick up

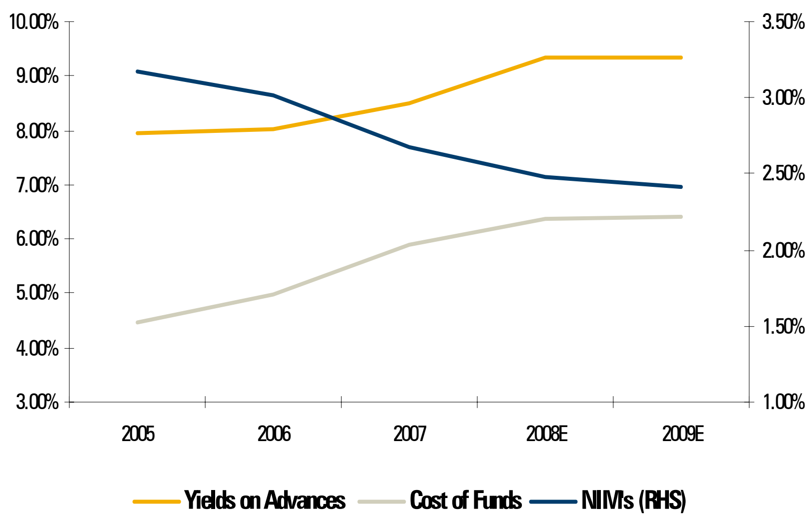


Source: ICICIdirect Research

OBC registered lower yield on advances of around 8%-8.5%. The average yields for PSU banks are above 9%. The bank's low exposure to retail (17%) is one of the significant reasons for the low yield on advances (exposure of other PSU banks is above 20%). Now with increased competition, OBC has started focusing on the retail side of the business. This is quite evident from the yields on advances during Q2FY08, which stood at 10.16%. We expect further improvement to 9.35% in FY09E. The low retail exposure has also affected the bank's CASA deposit levels, thereby increasing its cost of funds. CASA levels for FY07 and H1FY08 stood at 30.3% and 27% respectively. This was on account of the high amount of term deposits that escalated the cost of funds and put pressure on the NIMs. Now the worst seems to be over. OBC has started reducing rates on term deposits. It has introduced various innovative products to attract savings deposits (for instance the bank has introduced a deposits scheme with an attached insurance scheme), and all the 104 branches of GTB have now been empowered to extend retail loans. We expect the cost of funds to stabilise at 6.4% in FY09E and the NIM's to hover around 2.4%-2.5% in FY08E-09E. We also expect CASA levels to go up to 30.8% in FY09E.

New innovative products to attract saving deposits. Reduction in term deposit rates will provide cushion to the rising cost of funds

Exhibit 8: NIM's to stabiliise going forward



Source: ICICIdirect Research

Operating efficiency: One of the best in the industry

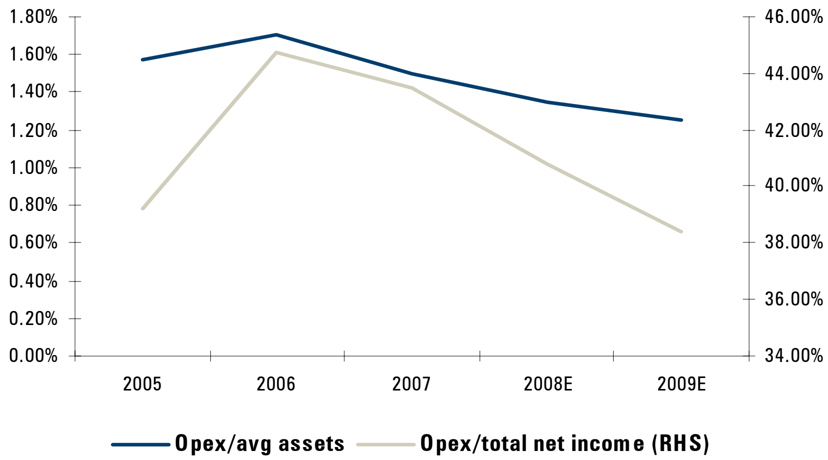
OBC has the best efficiency ratios in the PSU banking space. The integration of core business solution (CBS) across 96% of its business, and a well-diversified workforce has enabled the bank to maintain a cost-to-income ratio of 43% in FY07. We expect this figure to come down to 38.4% in FY09E.

Exhibit 9: Operating efficiency depends on right employee mix

	PSU banks	OBC
Officers	34%	46%
Clerks	45%	34%
Sub staff	22%	20%

Source: RBI, ICICIdirect Research

Exhibit10: Focus on achieving efficiency to continue

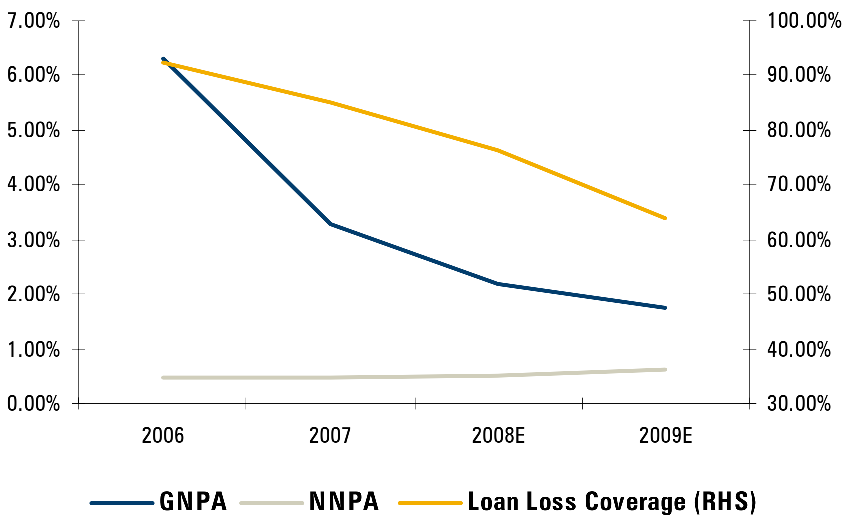


Source: ICICIdirect Research

OBC has one of the best cost/income ratios in the industry due to a better mix of the employee group and extensive technological back-up

Prior to acquiring GTB, OBC's asset quality was strong with gross non-performing assets (GNPA) and net non-performing assets (NNPA) among the lowest in the industry. The bank follows an aggressive provisioning policy. This is quite evident from the loan-loss coverage ratio, which stood at 92.3% and 85.1% in FY06 and FY07 respectively. Post GTB acquisition, asset quality deteriorated. However, with an aggressive provisioning policy and recoveries, OBC's GNPA and NNPA were at 3.29% and 0.49% respectively in FY07. We expect the bank to maintain this aggressive provisioning policy and with a cushion of excess provisions available (Sept 2007: Rs 225 crore), overall impact on profitability will be less. This coupled with successful recoveries should reduce GNPA to 1.76% in FY09E. We also expect NNPA to be stable at 0.63% in FY09E.

Exhibit 11: Focus on recoveries to continue



Source: ICICIdirect Research

The bank continuous focus on aggressive provisioning coupled with successful recoveries going forward will keep the GNPA and NNPA at 1.76% and 0.63% respectively in FY09E

Growth in other income to supplement core business

Other income has been growing at a steady pace with core fee income rising 48% in FY07 to Rs 303.2 crore. The bank has various tie-ups in the form of third party distributor for various financial products. We expect the same trend to continue, where the fee-based income will increase at a CAGR of 24% over FY07-09E. The bank has also entered into a joint venture with Canara Bank and HSBC Life insurance for life insurance business, which would further add to the kitty.

Strong 37% growth in fee based income in H1FY07 and foray into insurance business to supplement overall other income growth.

Risk & Concerns

- **Tight monetary policy could hamper credit off-take**
  Credit off-take in the banking industry has fallen from 30% in May 2007 to 23% in Sept 2007. If off-take further slows down, it could affect OBC's advances growth.

- **Adverse movement in interest rates**
  Interest rates in India have almost peaked. If the RBI hikes the benchmark rates further on liquidity concerns, then it is bound to have a negative impact on investment book of the bank and thereby on profitability.

- **Negative effects of consolidation**
  A host of factors like branch rationalisation, integration of workforce from two different cultures, union-related issues and regulatory hassles could create bottlenecks and hamper the bank's growth.

Exhibit 12: RoE decomposition matrix

	FY06	FY07E	FY08E	FY09E
Net interest income/ Avg. assets	2.8	2.5	2.4	2.3
Non-interest income/ Avg. assets	1.0	0.9	0.9	1.0
Net total income/ Avg. assets	3.8	3.5	3.3	3.3
Operating expenses/ Avg. assets	1.7	1.5	1.4	1.3
Operating profit/ Avg. assets	2.1	2.0	2.0	2.0
Provisions/ Avg. assets	0.4	0.4	0.5	0.4
Return on Avg. assets	**1.4**	**1.2**	**1.1**	**1.2**
Leverage (Avg assets/ Avg equity)	13.3	12.3	13.8	14.7
Return on equity (RoE)	**18.9**	**15.4**	**15.6**	**18.1**

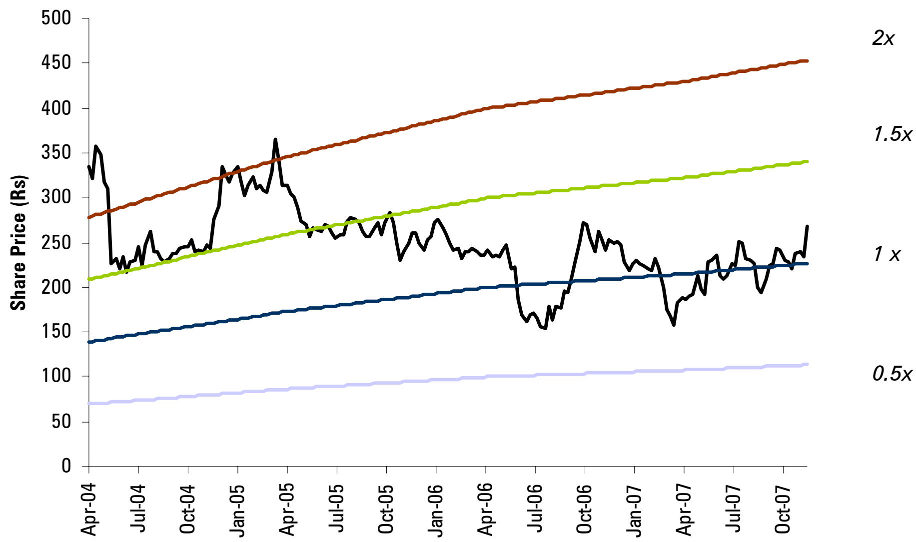
Source: ICICIdirect Research

ROE's to expand to 18.1% by FY09E

Valuations

The stock is available at an attractive valuation of almost 1x its FY09E ABV. It is trading at the lower P/ABV band in the PSU banking space. At the current price of Rs 267, the stock trades at 1.01x its FY09E ABV of Rs 261. Peers like PNB and IOB trade at 1.3x-1.5x its FY09E ABV. We believe OBC deserves a re-rating after successfully integrated GTB with itself. The latter's accumulated losses would be wiped of in FY09E. OBC has managed its asset quality by aggressive provisioning and thereby maintaining low NPA's. We are also witnessing an upward trend on the ROE, which we believe would rise to around 18.1% in FY09E. Based on the Gordon growth model, the stock deserves a P/ABV multiple of 1.27x on its FY09E ABV (considering sustainable core RoE of 15.8% and beta of 1). We assign an **Outperformer** rating to the stock with a target price of Rs 324, an upside of 21% over a 12-month time frame.

Exhibit 12: P/ABV Band



Source: ICICIdirect Research

The stock is one of the cheapest in the PSU banking space and has always traded at the lower band of valuations.

Post the GTB merger, the OBC stock has been trading in a narrow range of 0.9x-1.1x its ABV. With GTB losses coming down and interest rate cycle peaking out, we believe it would catch up with its peers on the valuation front.

Exhibit 13: Peer group valuations

	FY09E			
Bank	**ROE (%)**	**ROA (%)**	**NNPA (%)**	**P/ABV (x)**
IOB	27.70	1.40	0.50	1.64
Dena Bank*	17.40	0.84	1.99	1.90
PNB	17.40	1.10	0.70	1.55
Andhra Bank	18.40	1.20	0.30	1.32
OBC	18.10	1.20	0.63	1.01

**-Figures of FY07 considered*

Source: Consensus estimates, ICICIdirect Research

Financial Summary

Profit and Loss Account

Rs crore

Year to March 31	FY06	FY07	FY08E	FY09E
Interest Earned	4118.9	5164.9	6584.4	7799.3
Interest Expended	2513.9	3473.6	4650.5	5572.3
Net Interest Income	**1605.1**	**1691.3**	**1933.9**	**2226.9**
% growth		5	14	15
Non Interest Income	552.8	603.3	748.2	919.1
Fees and advisory	204.3	303.2	394.2	465.2
Treasury Income and sale of Invt.	205.2	102.7	180.5	262.6
Other income	143.3	197.3	173.6	191.3
Net Income	**2157.9**	**2294.6**	**2682.1**	**3146.0**
Employee cost	500.5	520.9	556.0	613.8
Other operating Exp.	465.4	477.0	538.1	593.6
Operating Income	**1192.0**	**1296.7**	**1588.0**	**1938.6**
Provisions	227.5	243.6	421.8	419.6
PBT	**964.5**	**1053.1**	**1166.1**	**1519.0**
Taxes	161.3	226.1	250.7	334.2
Net Profit	**803.2**	**827.1**	**915.4**	**1184.8**
% growth		3	11	29
GTB losses	246	246	246	246
Net profit (post GTB losses)	**557.2**	**581.1**	**669.4**	**938.8**

NII to grow at a CAGR of 23% over FY07-FY09E

PAT (pre GTB losses) to register a CAGR of 20% over FY07-FY09E

Balance Sheet

Rs crore

Year to March 31	FY06	FY07	FY08E	FY09E
Liabilities				
Capital	251	251	251	251
Reserves and Surplus	4920	5350	5889	6698
Networth	**5171**	**5600**	**6140**	**6949**
Deposits	50197	63996	76789	91959
Borrowings	876	623	663	682
Subordinated Debt	567	1476	1976	2026
Other Liabilities & Provisions	2126	2242	2366	2473
Total	**58937**	**73936**	**87934**	**104089**
Assets				
Fixed Assets	384	383	387	388
Investments	16818	19808	23696	27106
Advances	33577	44138	53898	63121
Other Assets	2633	2098	1684	4005
Cash with RBI & call money	5526	7509	8268	9469
Total	**58937**	**73936**	**87934**	**104089**

Balance sheet size to register a CAGR of 19% over FY07-FY09E

Ratios

Year to March 31	FY06	FY07	FY08E	FY09E
Number of equity shares	25.1	25.1	25.1	25.1
EPS (Rs)	32.1	33.0	36.5	47.3
BV (Rs)	206.4	223.5	245.1	277.4
BV-ADJ (Rs)	190.5	211.3	233.9	265.0
P/E (x)	8.0	7.7	7.0	5.4
P/BV	1.2	1.1	1.0	0.9
P/adj BV	1.3	1.2	1.1	1.0
Dividend Yield (%)	1.4	1.4	1.8	1.8
DPS (Rs)	3.5	3.5	4.5	4.5
Yields & Margins				
Yield on average interest earning assets (%)	7.7	8.2	8.4	8.4
Avg. cost on funds (%)	5.0	5.9	6.4	6.4
Net Interest Margins (%)	3.0	2.7	2.5	2.4
Avg. cost of Deposits (%)	4.9	5.8	6.3	6.3
Yield on average advances (%)	8.0	8.5	9.4	9.4
Profitability				
Interest expense / total avg. assets (%)	4.4	5.2	5.7	5.8
Interest income/ total avg. assets (%)	7.3	7.8	8.1	8.1
Non-interest income/ avg. assets (%)	1.0	0.9	0.9	1.0
Non-interest income/ Net income (%)	25.6	26.3	27.9	29.2
Net-interest income/ Net income (%)	74.4	73.7	72.1	70.8
Cost / Total net income	44.8	43.5	40.8	38.4
Quality and Efficiency				
Credit/Deposit ratio (%)	66.9	69.0	70.2	68.6
GNPA (%)	6.3	3.3	2.2	1.8
NNPA (%)	0.5	0.5	0.5	0.6
RONW (%)*	18.9	15.4	15.6	18.1
ROA (%)*	1.4	1.2	1.1	1.2

**pre GTB losses*

Key assumptions growth ratios

Year to March 31	FY06	FY07	FY08E	FY09E
Advances (%)	32.7	31.5	22.1	17.1
Deposits (%)	4.9	27.5	20.0	19.8
Borrowings (%)	4.9	45.4	25.8	2.6
Operating expenses (%)	21.4	3.3	9.6	10.4
Fee income (%)	30.6	48.4	30.0	18.0
Trading gains (%)	-11.8	-49.9	75.6	45.5
Staff cost (%)	26.1	4.1	6.8	10.4
Effective tax rate (%)	16.7	21.5	21.5	22.0
Other assumptions				
Yield on average advances (%)	8.0	8.5	9.4	9.35
Cost of deposits (%)				
Current (%)	0.0	0.0	0.0	0.0
Term (%)	6.0	7.3	8.0	8.0
Savings (%)	3.5	3.5	3.5	3.5

Glossary

Cash Reserve Ratio (CRR): Every scheduled commercial bank was required to maintain with the RBI every fortnight a minimum average daily cash reserve equivalent to 5% of its Net Demand and Time Liabilities (NDTL) outstanding as on the Friday of the previous week.

Statutory Liquidity Ratio (SLR) - Every bank is required to maintain at the close of business every day, a minimum proportion (25%) of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold and un-encumbered approved securities.

Current Account Savings Account (CASA): It is the proportion of current account and savings account deposits in total deposits.

Net interest margin (NIM) – It is the ratio of banks net interest income to its interest earning assets. It basically depicts banks net interest earning capability from the assets deployed.

Held-to-Maturity (HTM) – Investments that the bank intends to hold till maturity.

Available for Sale (AFS) - Investments that are available for sale anytime after 90 days from the date of purchase.

Capital Adequacy Ratio (CAR) – Capital adequacy is determined as a ratio of capital funds to total Risk Weighted Assets of the bank. Currently, the minimum CAR to be maintained is 9%.

Capital structure of banks is made up of 2 tiers.

Tier I refers to core capital consisting of Capital, Statutory Reserve, Revenue and other reserves, Capital Reserve (excluding Revaluation Reserves) and unallocated surplus/profit but excluding accumulated losses, investments in subsidiaries and other intangible assets.
Tier II is comprised of Hybrid Capital, Subordinated Term Debt, Undisclosed Reserves and General Provisions. This is Supplementary Capital.

Non-Performing Assets (NPA) – These are advances where the principal and interest is not paid by borrower for 90 days.

Net NPA = Gross NPA – Provisions

CAGR – Compounded annual growth rate

RATING RATIONALE

ICICIdirect endeavours to provide objective opinions and recommendations. ICICIdirect assigns ratings to its stocks according to their notional target price vs current market price and then categorises them as Outperformer, Performer, Hold, and Underperformer. The performance horizon is 2 years unless specified and the notional target price is defined as the analysts' valuation for a stock.

Outperformer: 20% or more;
Performer: Between 10% and 20%;
Hold: ±10% return;
Underperformer: -10% or more.

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