Bank of India Ltd. | INR: 335

Risk Reward turning positive | BUY

We reiterate our Buy on Bank of India and increase our price target to Rs 390. We believe the recent underperformance of the stock provides an attractive entry point for investors given our expectation of earnings rebound in FY11 on back of pickup in net interest margins, higher fee income and lower credit costs.

Pickup in Net Interest Margins - BoI's margin compression in Q1FY10 was driven by muted loan growth and the overhang of high cost deposits mobilized in H2FY09.

We believe that margins will bottom out in H1FY10 and the move up meaningfully to ~2.65% by end of FY10 on the back of pickup in loan growth and downward repricing of liabilities. Bank of India's management has indicated that high cost deposits amounting to Rs 28,000 crore (20% of FY09 term deposits) will mature in the rest of FY10. These liabilities will be refinanced at substantially lower rates as Bank of India has aggressively cut deposit rates. Another catalyst for lower funding costs will be increase in the CASA ratio, which declined to 27% in FY09 as term deposits grew faster than CASA deposits. With concerted management efforts and reduced interest rate differential between savings deposits and term deposits, CASA ratio will improve to 30% in FY10E.

	PNB	SBI	BoI
7 to 14 days	2.5		2.5
15 to 45 days	3	3	2.75
31-45 days			3
46 to 90 days	4.25	4	4
91 to 179 days	4.5	5.25	5
6 Months to less than 9 months			
180 days to less than 1 year	5.5	6	6
9 months to less than 1 year			6.25
1 year to less than 2 years	6.5	6.5	6.5
2 years to less than 3 years	7	7	6.5
1000 Days		7.25	
1001 days to less than 3 years		7	

Source: Companies, KRC Research

Notwithstanding the deficient monsoons, the recovery in Indian industrial production continues to be robust. The IIP recovery will accelerate in H2FY10 as the drag of weak external demand and subdued private capex investment eases. The pickup in industrial production coupled with increasing government and private infrastructure investment will boost credit demand. Credit growth in India has a greater correlation to industrial and service sector growth than GDP growth. Moreover, credit growth in India is seasonal and picks up in the second half of a fiscal year. While the management has guided for 20 – 22% loan growth for FY10, we are less optimistic. We expect a 19% pickup in loan growth in FY10 and 22% in FY11, allowing the bank boost yields by redeploying surplus liquidity from lower yielding assets like liquid MF investments and RBI repo balances, which have negative spreads, to higher yielding advances. Providing further impetus to NIM is the improvement in LDR as advances growth picks up and incremental deposit accretion slows down, given the interest rate differential between BoI and some peer PSU banks

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wealth enhancement solutions

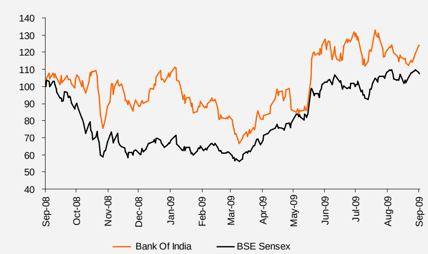
Price Outlook (INR): 390

Market Data	Aug 03 2009
Shares outs (Cr)	52.51
Equity Cap (Rs. Cr)	525.17
Mkt Cap (Rs. Cr)	17,590.85
52 Wk H/L (Rs)	368/179
Avg Vol (1yr avg)	587298
Face Value (Rs)	10
Bloomberg Code	BOI IN

Market Info:

SENSEX	15,924
NIFTY	4,711

Price Performance



Share Holding pattern (%)

Particulars	31-Mar	30-Jun	Chg
Promoters	64.47	64.47	0.0
Institutions	12.80	13.34	0.54
FIIs	14.33	14.06	-0.27
Public & Others	8.4	8.13	-0.27
Total	100.0	100	

Source: BSE

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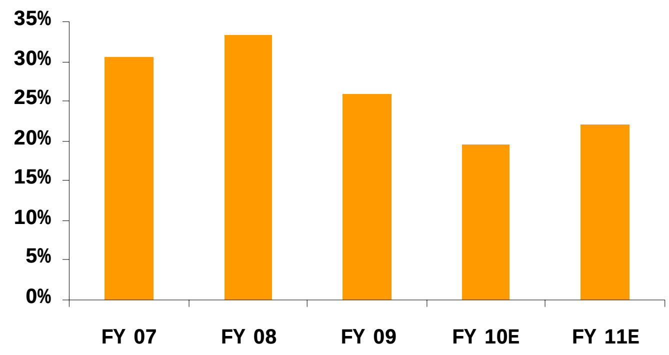
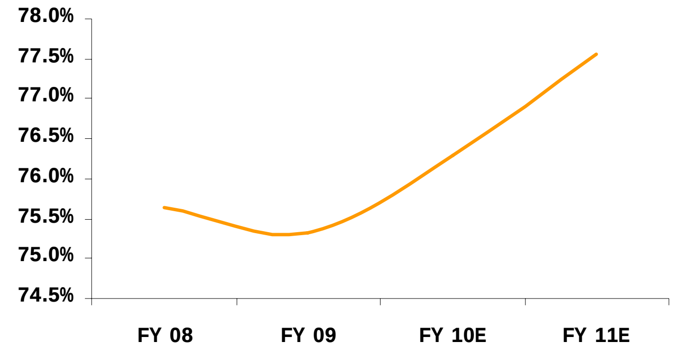
Advances Growth



Source: Company, KRC Research

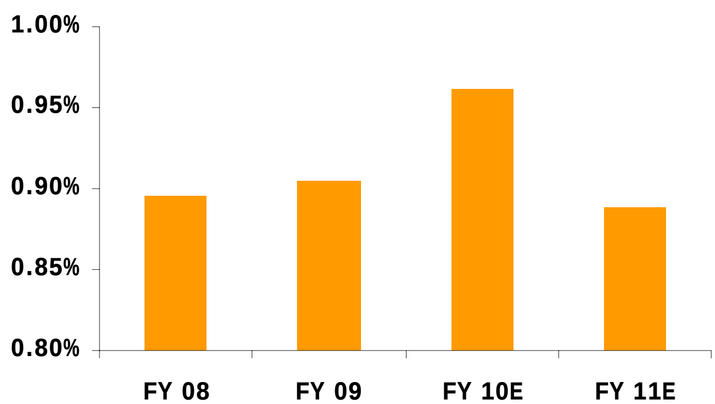
LDR



Source: Company, KRC Research

Stabilizing Asset Quality – Above industry average loan growth for the past 3 years hurt Bank of India's asset quality during the cyclical downturn. RBI's regulatory forbearance policy, allowing banks to restructure loans, prevented a sharp increase in non performing assets. Bank of India's gross stressed assets (GNPA + Restructured Assets) stand at Rs 9425 crore (~6.4% of advances). Given the quantum of restructured assets and a relatively unseasoned loan book, we believe that Bank of India's asset quality will continue to deteriorate in FY10. We expect incremental slippages to increase to 1.7% in FY10 before declining to 1.55% in FY11. We also expect Gross NPAs to peak in FY10E at 2.2% of advances (from 1.9% currently). In view of our quality outlook, we forecast credit costs to stay above mid cyclical levels at 100 bps in FY10E and decline to 90 bps in FY11.

Credit Costs



Source: Company, KRC Research

Our asset quality concerns have significantly abated with the opening up of equity capital markets and improvement in economic conditions. Bank of India's exposure to SME and Retail unsecured loans, which are most vulnerable to asset quality downturn, is limited.

We conduct a stress test for Bank of India to gauge the impact of asset quality pressures on Bank of India's profitability and networth if the economy relapses into a 'double dip' recession and corporates face cashflow pressures. We assume that: 1) 40% of restructured loans slip in FY10 and the loss rate on NPAs is 50% (so Bank of India will loose Rs 20 (40% * 50%) for every Rs 100 worth of restructured assets); 2) slippages in non restructured assets will be high (0.5% of FY10E advances).

Gross NPA (as at June 09)	Rs 2,788 crore
Restructured Loans (as at June 09)	Rs 6,637 crore
Non Restructured Loans Slippages	Rs 829 crore
Restructured Loan Slippages (40% default rate)	Rs 2,655 crore
New Gross NPA (FY10E)	Rs 4,945 crore
% Impact on BV (Net of Tax Breaks for Loan Loss Provisions)	12%
Impact as % of FY10E PAT (base case)	35%

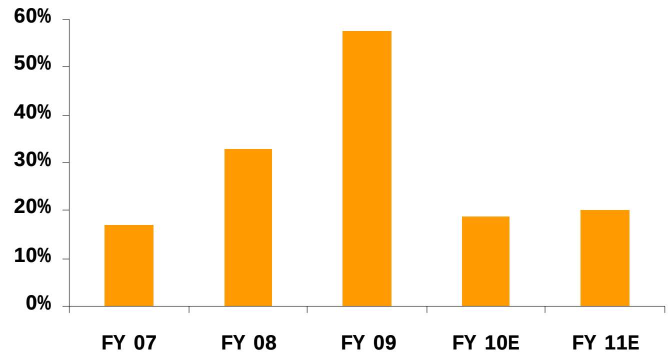
We find that the impact of loan losses (net of tax breaks for additional loan loss provisions) under this scenario to be 12% of Net Worth and 35% of FY10E PAT.

Earnings Rebound

We believe that Bank of India's FY11E earnings growth would rebound (21% with significant upside risks in FY11E) due to a favorable operating environment. The likely catalysts for the earnings rebound are: 1) increase in NIMs to 2.75 (FY11E) as incremental funding costs decline and existing liabilities are refinanced at lower rates; 2) acceleration in credit growth to 21% (FY11E) as the economy returns to trend growth rate; and 3) stabilization of asset quality as incremental delinquencies decline, leading to credit costs below mid cyclical averages at ~90 bps (FY11E).

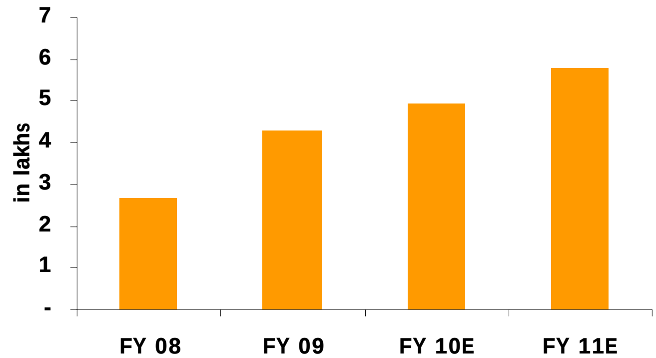
The upside risk to our earnings estimates comes from Bank of India's significant operating leverage to a pick up in credit growth in event of faster than expected economic growth. We believe Bank of India can redeploy ~Rs 5000 crores in FY10E towards advances from low yielding assets, such as investments and cash, merely by reducing their proportion to deposits to mid-cyclical levels. Another source of upside risk to our earnings estimates is fee income. With CBS in place and economic recovery well underway, Bank of India's fee income from both retail and corporate clients will grow at a swift pace. We believe Bank of India's productivity (measured by fee + forex income per employee) would increase as it improves productivity by exploiting technology franchise.

Fee Income Growth



Source: Company, KRC Research

Fee Income per Employee



Source: Company, KRC Research

Valuation

We value Bank of India using the single stage Gordon Growth Model. We arrive at our 12-month target price of Rs 390 (~1.2x FY11E Adj BV/s and 5.7x FY11E EPS) by assigning a 25% probability to our Bull-case scenario; 75% probability to our Base-case scenario and 5% probability to our Bear-case scenario. Our target price implies a 16.4% upside to the current price of Rs 335.

	Bear	**Bull**	**Base**
RoE	13.97	21.43	19.5
CoE	14	14	14
g	3	5	4
Therotical P/Adj Bv	1.00	1.83	1.5
Discount	30%	18%	24%
P/Adj Bv	0.70	1.50	1.18
Price	**188**	**547**	**363**

Risks

Firming Bond Yields

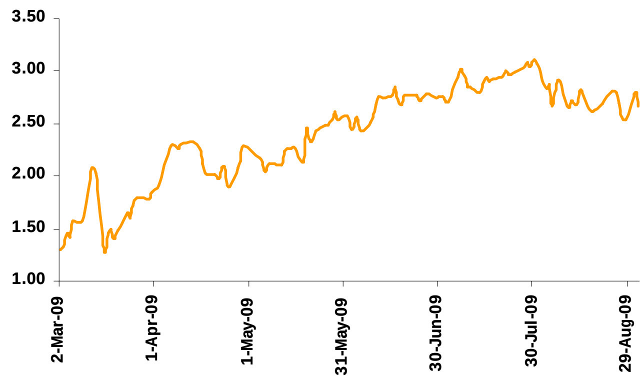
PSU banks have underperformed the market recently on account of concerns over MTM losses in wake of firming of bond yields. Bank of India is more vulnerable to risk of MTM losses given its relatively high proportion of securities held in AFS portfolio (28%) and its high duration AFS portfolio (4.1 years). We believe the recent underperformance prices in a big chuck of the MTM risk. Bank of India held Rs 14,304 crore worth of securities in its AFS portfolio as of Q1FY10. We conduct a scenario analysis to gauge potential MTM losses incase of a spike in bond yields.

	0.25 bps	0.50 bps	0.75 bps
MTM Losses (Rs crores)	92	184	276
% of FY 10 E PAT	3.1%	6.2%	9.3%
% of BV	0.8%	1.6%	2.3%

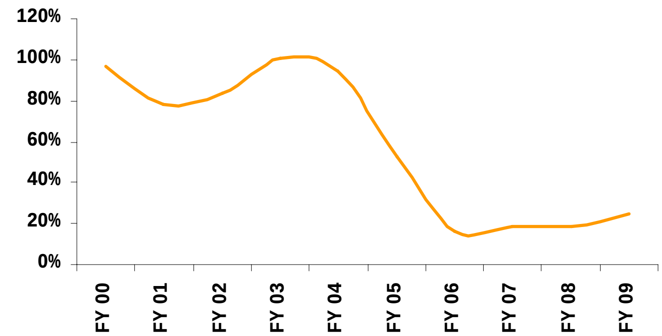
We do not believe that GSec yields will jump sharply (i.e. more than 75 bps) on account of RBI's relatively accommodative monetary policy stance, given the uncertainty over the pace of economic recovery in face of deficient monsoons, and the benign liquidity environment. Moreover, Bank of India holds Rs 195.8 crore CLN provisions in its investment book as at Q1FY10, which will be written back once spreads narrow to pre-Lehman levels. We have not account of these in our estimates but they act as a buffer to potential MTM losses from increasing GSec yields.

The 1yr – 10yr government bond spread has increased because of a glut of short term liquidity. The increase in 10yr-1yr spreads will help PSU banks boost their margins by reducing pressure on their yields and lowering short term funding costs. Moreover, Bank of India's earning quality has considerably improved as the share of capital gains in PAT has decreased considerably. It is no longer dependant on trading gains to propel earnings growth.

10 yr - 1 yr Bond Spread



Capital Gains as % of PAT



Source: Company, KRC Research

Drought Policy Response

Notwithstanding the recent pickup in rainfall, most of India is faces the prospect of a sever drought, raising the risk of unfavourable government policy response. The government can potentially direct PSU banks to restructure agriculture loans without adequate compensation. Government can use PSU banks to direct credit to the agriculture sector without adequate compensation for the risk. We believe the risks of an extreme policy response is limited and already priced into PSU bank stocks.

Key Financials (Rs In crore)

Particulars	FY08	FY09	FY10E	FY11E
Interest earned	**12,355.2**	**16,347.36**	**19,118.5**	**22,055.7**
-Interest on advances/bills	9,275.1	12,539.25	14,664.8	16,871.0
-Income on investments	2,639.0	3,370.31	427.6	446.6
-Interest on bal. with RBI	389.0	373.76	4,011.0	4,718.1
-Others	52.1	64.04	15.0	20.0
Interest expenses	8,126.0	10,848.45	12,455.0	14,475.7
Net Interest Income (NII)	**4,229.3**	**5,498.91**	**6,663.5**	**7,580.0**
Other Income	2,116.9	3,051.86	2,979.7	3,488.0
Total income	**6,346.2**	8,550.77	**9,643.2**	**11,068.0**
Operating expenses	**2,645.0**	**3,093.97**	**3,557.9**	**3,843.2**
-Employee cost	1,657.0	1,937.41	2,304.7	2,431.5
-Other operating expenses	988.0	1,156.56	1,253.2	1,411.7
Operating profit	**3,701.2**	**5,456.80**	**6,085.3**	**7,224.9**
Provision for contigencies	**1,016.5**	1,292.37	1,641.8	1,850.3
PBT	**2,684.7**	**4,164.43**	**4,443.5**	**5,374.6**
Provision for taxes	**683.8**	1,157.08	1,466.3	1,773.6
Net profit	**2,000.94**	**3,007.35**	**2,977.1**	**3,601.0**
Equity	525.9	525.9	525.9	525.9
EPS	38.0	57.2	56.6	68.5
Ratios (%)				
Int. exp/Int earned (%)	65.8	66.4	65.1	65.6
Cost/Income ratio (%)	41.7	36.2	36.9	34.7
Emp. cost/Int. Income (%)	13.4	11.9	12.1	11.0
GPM (%)	30.0	33.4	31.8	32.8
Prov & Cont/Int Income (%)	8.2	7.9	8.6	8.4
Tax/PBT (%)	25.5	27.8	33.0	33.0
NPM (%)	16.2	18.4	15.6	16.3
Gross NPAs (Rs)	1,930.92	2,470.88	3,751.83	4,689.39
Net NPAs (Rs)	591.90	628.21	1,012.99	1,078.56
Gross NPAs (%)	1.7%	1.7%	2.2%	2.3%
Net NPAs (%)	0.52%	0.44%	0.59%	0.52%
ROA (%)	1.12%	1.33%	1.14%	1.15%
CAR (%)	12.95%	13.01%	13.05%	13.05%

Source: Company, KRC Research

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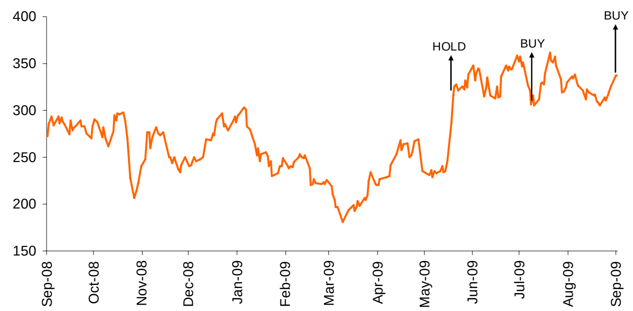
Bank of India Ltd



Rating Legend

Our Rating	Upside
Strong Buy	More than 25%
Buy	15% - 25%
Hold	10% - 15%
Reduce	Nil – 10%
Sell	Less than 0%

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