

Jammu & Kashmir Bank

STOCK INFO.	BLOOMBERG
BSE SENSEX: 9,465	JKBK IN
	REUTERS CODE
S&P CNX: 2,884	JKBK.BO

23 January 2006

Buy

Rs538

Previous Recommendation: Buy

Equity Shares (m)	48.5
52-Week Range	564/308
1,6,12 Rel.Perf.(%)	7/-8/12
M.Cap. (Rs b)	26.1
M.Cap. (US\$ b)	0.6

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	RATIO
3/05A	6,783	1,151	23.7	-71.7	22.7	1.6	15.2	7.1	0.5	1.7
3/06E	7,618	2,010	41.7	74.7	12.9	1.4	14.0	11.6	0.8	1.5
3/07E	8,943	2,565	53.3	27.6	10.1	1.3	12.0	13.6	0.8	1.4

J&K Bank has reported Rs507m net profit in 3QFY06 compared with Rs719m in 3QFY05 (management as re-stated 3QFY05 numbers). 3QFY06 results were below our expectations with net interest income (NII) growing only 0.7% YoY compared with our expectation of 8%. Business continued to be robust with loan book growth at 29% YoY and deposit growth at 15%. 3QFY06 margins improved 2.97% YoY from 2.6%. Asset quality continued to improve with net NPAs declining 9bp QoQ.

- ⚡ Advances up 29%; deposits up by 15% YoY
- ⚡ Trading gains minimal, fee income grows 45% YoY
- ⚡ Asset quality improves YoY, with net NPAs at 1.13%
- ⚡ Key trigger — uptrend in J&K's economy

With strong latent demand in the J&K state, we expect healthy loan growth for J&K Bank to continue. However, margin improvement will be crucial as deposit costs will also start to inch up from here on. Post 3Q results, we have revised our earnings estimates downward by 23% for FY06 and by 24% for FY07, on back of lower margin expectation and higher provisions. The stock trades at a P/E of 10.1x and P/BV of 1.3x on FY07E earnings. We maintain our **Buy** recommendation.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q*	3Q	4Q	1Q	2Q	3Q	4QE		
Interest Income	3,892	3,861	3,872	3,867	4,278	4,168	4,148	4,321	15,492	16,916
Interest Expenses	2,470	2,317	2,273	2,471	2,773	2,532	2,538	2,622	9,530	10,466
Net Interest Income	1,422	1,545	1,599	1,397	1,505	1,636	1,610	1,699	5,962	6,450
% Change (Y-o-Y)	-9.7	-6.0	-5.5	8.3	5.8	5.9	0.7	21.7	-3.8	8.2
Other Income	448	17	102	336	225	267	319	357	820	1,168
Net Income	1,870	1,562	1,701	1,732	1,730	1,903	1,929	2,056	6,783	7,618
Operating Expenses	718	787	721	1,001	767	835	868	1,026	3,228	3,496
Operating Profit	1,152	775	980	731	962	1,068	1,061	1,031	3,555	4,122
% Change (Y-o-Y)	-30.9	-53.2	-45.9	-36.5	-16.5	37.8	8.3	41.0	-43.4	15.9
Prov. & Contingencies	410	1,315	253	293	311	298	274	367	2,195	1,250
Profit before Tax	742	-540	726	437	651	770	787	664	1,359	2,872
Provision for Taxes	270	-40	7	-21	167	220	280	194	209	861
Net Profit	472	-500	719	459	484	550	507	469	1,151	2,010
% Change (Y-o-Y)	-51.7	-149.6	-34.5	-53.2	2.6	n.a.	-29.6	2.3	-71.7	74.7
Cost to Income	38.4	50.4	42.4	57.8	44.4	43.9	45.0	49.9	47.6	45.9
Int.Expense/Int. Earned	63.5	60.0	58.7	63.9	64.8	60.8	61.2	60.7	61.5	61.9
Cost to Net Int.Income	50.5	50.9	45.1	71.7	51.0	51.0	53.9	60.4	54.1	54.2

E: MOST; * 3QFY05 has been re-stated by the management

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J&K Bank has reported net profit Rs507m in 3QFY06 v/s Rs719m in 3QFY05 (management has restated 3QFY05 numbers). 3QFY06 results were below our expectations with NII growing by only 0.7% YoY compared with our expectation of 8%. Business growth continued to be robust with loan book up 29% YoY and deposits up 15%. 3Q margins too improved 2.97% YoY from 2.6%. Asset quality continued to improve with net NPAs declining 9bp QoQ.

Advances grow by 29%; deposit by 15% YoY

Business momentum, across all segments, continued with advances growing 29% YoY to Rs121b during 3QFY06. The bank’s loan portfolio currently has a mix of 45:55, with 45% of loans in the state of J&K, whilst the remainder is ex-J&K. The bank continues to focus on the high-yielding small and medium enterprises (SME) segment and retail loans, which together constitute almost 55% of bank’s loan book. The increase in loan book has enabled the bank to earn higher interest on advances by 20% YoY. Management has indicated that going forward it will concentrate on high-margin and low-volume business in the state of J&K, and the reverse outside the state of J&K.

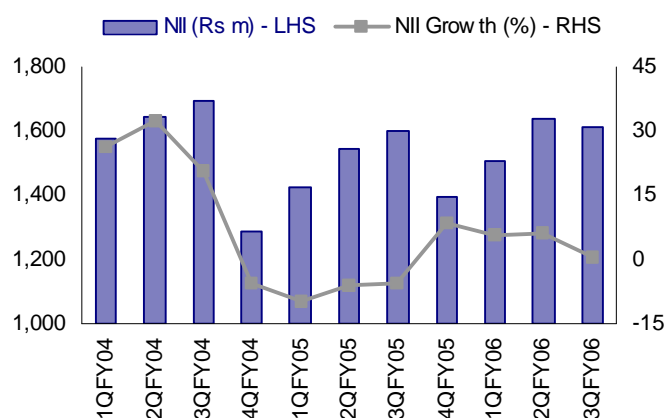
Deposits have grown by 15% YoY to Rs196b. Low-cost deposits have grown faster and now constitute 34% of total deposits. The loan-deposit ratio at 62% has expanded 700bp YoY from 55% at 3QFY05. With the strong thrust on growing the loan book, we expect this ratio to further improve going forward. Management expects to grow CASA to 36% by FY06, which will enable the bank to lower its cost of deposits further.

NII impacted by lower interest income arising out of re-pricing of investments

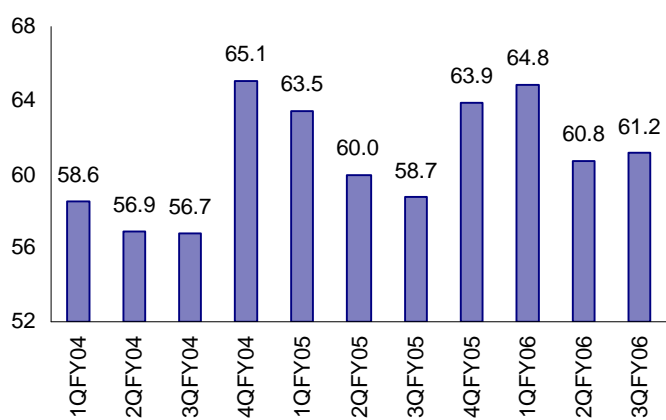
J&K Bank’s NII grew by a subdued 0.7% YoY to Rs1.61b in 3QFY06. This was largely due to re-pricing of investments. In fact, the bank has been going through investment re-pricing for the last 2-3 quarters. The bank has shed excess SLR and currently has an excess of only Rs2.5b above the required SLR requirement. However, core-interest income from advances continued to grow on the back of robust loan growth and in 3QFY06, growth in

interest on advances was 20% YoY. Growth in interest expenses was also modest, with interest expense growing by only 11%, as low-cost deposit growth was higher versus term deposits.

TRENDS IN NII



TRENDS IN INTEREST EXPENSE/INTEREST INCOME (%)



Source: Company/Motilal Oswal Securities

Margins improving as cost of deposits decline and yields improve

Despite pressure on yields on investments, net interest margins (NIM) have increased to 2.97% in 3QFY06 from 2.6% in 3QFY05, largely due to lowering the cost of deposits. Management is focused on protecting its current margins, by sourcing greater high-margin business. This coupled with the strong growth in the advances portfolio; higher accretion of low-cost deposits and sell-down of the low-yielding investment portfolio should result in higher margins going forward.

MARGINS (%)

	3QFY06	3QFY05
Yields on Advances	9.03	9.80
Yields on Investments	6.75	7.30
Cost of Deposits	4.97	5.13
NIMs	2.68	2.97

Source: Company/Motilal Oswal Securities

Trading gains minimal, fee income grows 45% YoY

J&K Bank earned only Rs12m as trading gains in 3QFY06 compared with Rs110m trading losses in 3QFY05 (management has restated 3QFY05 numbers). The investment portfolio of the bank is currently at Rs74b, with almost 65% in the HTM category. During 3QFY06, the bank's AFS book has created a cushion of almost 25bp with a modified duration of 2.3.

Excluding trading gains, non-interest other income has grown 45% YoY to Rs307m, (a QoQ increase of 24%). The bank has already initiated services such as distribution of non-life insurance products, merchant banking, equity trading, depository services, bill collection and increased volumes of government business to augment its fee income, which has resulted in higher non-interest other income.

Asset quality improves with net NPAs at 1.13%

Asset quality remains strong as the net NPAs declined to 1.13% compared with 1.30% in the corresponding quarter

last year. Management is confident of containing NPAs at current levels. With higher loan growth and provisioning, we expect net NPAs to decline to 1% at end-FY06.

Key trigger — uptrend in J&K economy

We believe that the uptrend in J&K's economy is likely to be a key trigger for J&K Bank. Since J&K Bank is a banker to the state government and also boasts a wide state network; it would be the biggest beneficiary of any new projects upcoming in the state. Already tourist flows have begun to improve (management has stated that the tourist flows are the highest over the last 15 years) and a couple of power projects have taken off in the state. Further, the positive news flow regarding the Indo-Pak peace process will also provide greater business opportunities and lead to better perception of the bank, leading to higher valuations.

Valuation and view

With strong latent demand in the J&K state, we expect healthy loan growth for J&K Bank to continue. However, margin improvement will be crucial as deposit costs will also start to inch up from here on. Post 3Q results, we have revised our earnings estimates downward by 23% for FY06 and by 24% for FY07, on back of lower margin expectation and higher provisions. The stock trades at a P/E of 10.1x and P/BV of 1.3x on FY07E earnings. We maintain our **Buy** recommendation.

Jammu & Kashmir Bank: an investment profile

Company description

J&K Bank is a private sector bank with the J&K government holding 53% of the bank's equity. With a balance sheet size of over Rs223b, the bank has a network of 510 branches and 178 ATMs. J&K Bank is the banker to the state government and also holds the agency to transact Central government business in the state of Jammu & Kashmir

Key investment arguments

- Loan growth is on acceleration, after remaining subdued for last few quarters. Margins are also expected to stabilize leading to positive growth in core earnings
- Fee income is expected to grow with new initiatives such as insurance product distribution, equity trading, depository services, bill collection and increased volumes of government business
- Best suited to benefit from the emerging business opportunities in J&K

Key investment risks

- Any significant upmove in interest rates could adversely impact the bond portfolio
- Any adverse political development in the state of J&K, could adversely affect the bank's growth opportunity

COMPARATIVE VALUATIONS

		J&K BANK	HDFC BANK	ICICI BK
P/E (x)	FY06E	12.9	26.0	20.5
	FY07E	10.1	19.8	16.4
P/ABV (x)	FY06E	1.5	4.4	2.4
	FY07E	1.4	3.7	2.1
RoE (%)	FY06E	11.6	18.0	14.1
	FY07E	13.6	20.1	13.2
RoA (%)	FY06E	0.8	1.4	1.2
	FY07E	0.8	1.5	1.1

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	53.2	53.2	53.2
Domestic Institutions	1.9	3.0	3.1
FII/FDIs	30.6	28.2	23.2
Others	14.4	15.6	20.5

Recent developments

- Mr. Haseeb A. Drabu, an eminent economist is now the chairman and managing director (CMD) of the bank after Mr. M. Y. Khan has retired
- J&K bank will partner with four other banks viz., Central Bank of India, Oriental Bank of Commerce, Union Bank of India and Standard Chartered Bank in a proposed asset reconstruction company

Valuation and view

- After a dismal performance in FY05, we expect earnings to rebound in FY06 with a growth of 80%. The bank will benefit from the increased economic activity in the state
- The stock trades at a P/E of 10.1x and P/BV of 1.3x on FY07E earnings. We maintain **Buy**

Sector view

- Loan growth of 29%+ at the beginning of the capex cycle
- Volatility in interest rates would impact treasury
- Benefits of significant improvement in asset quality not yet factored into earnings, valuations
- We maintain an overweight stance on the sector

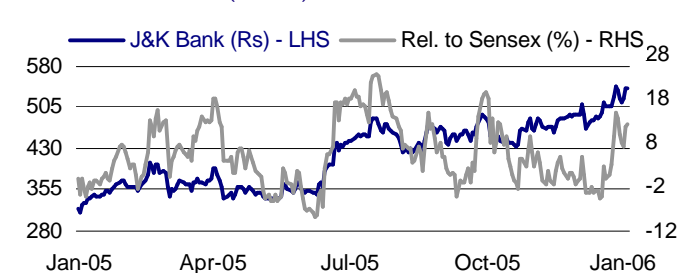
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	41.7	55.5	-24.8
FY07	53.3	69.8	-23.6

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
538	615	14.3	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Interest Income	15,212	15,492	16,916	19,289	21,734
Interest Expended	9,014	9,530	10,466	11,709	12,888
Net Interest Income	6,199	5,962	6,450	7,580	8,846
Change (%)	17.8	-3.8	8.2	17.5	16.7
Other Income	3,017	820	1,168	1,362	1,500
Net Income	9,216	6,783	7,618	8,943	10,346
Change (%)	13.3	-26.4	12.3	17.4	15.7
Operating Expenses	2,932	3,228	3,496	4,028	4,694
Operating Income	6,284	3,555	4,122	4,915	5,652
Change (%)	13.5	-43.4	15.9	19.2	15.0
Other Provisions	521	2,195	1,250	1,250	1,200
P B T	5,763	1,359	2,872	3,665	4,452
Tax	1,700	209	861	1,099	1,336
Tax Rate (%)	29.5	15.3	30.0	30.0	30.0
P A T	4,063	1,151	2,010	2,565	3,116
Change (%)	20.3	-71.7	74.7	27.6	21.5
Proposed Dividend	547	439	665	831	831

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Capital	482	485	482	482	482
Reserves & Surplus	15,455	16,169	17,515	19,249	21,535
Net Worth	15,937	16,654	17,996	19,731	22,016
Deposits	186,614	216,450	253,246	291,233	333,462
Change (%)	27.2	16.0	17.0	15.0	14.5
Borrowings	2,970	3,195	3,500	3,850	4,235
Other Liabilities & Prov.	6,536	8,503	8,503	8,928	9,375
Total Liabilities	212,058	244,802	283,245	323,742	369,088
Current Assets	29,168	31,783	33,738	35,058	35,653
Investments	84,511	90,892	99,982	109,980	119,878
Change (%)	25.4	7.6	10.0	10.0	9.0
Advances	92,849	115,171	142,813	171,375	205,650
Change (%)	15.9	24.0	24.0	20.0	20.0
Net Fixed Assets	1,961	2,024	2,214	2,379	2,462
Other Assets	3,569	4,931	4,500	4,950	5,445
Total Assets	212,058	244,802	283,245	323,742	369,088

ASSUMPTIONS					
(%)					
Deposit Growth	27.2	16.0	17.0	15.0	14.5
Advances Growth	15.9	24.0	24.0	20.0	20.0
Investments Growth	25.4	7.6	10.0	10.0	9.0
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	100.0	80.0	120.0	150.0	150.0
CRR	4.5	5.0	5.0	5.0	5.0

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Spreads Analysis (%)					
Avg. Yield - Earning Asset:	8.3	7.0	6.7	6.6	6.5
Avg. Cost-Int. Bear. Liab.	5.3	4.7	4.4	4.2	4.1
Interest Spread	3.0	2.3	2.3	2.4	2.4
Net Interest Margin	3.4	2.7	2.5	2.6	2.6

Profitability Ratios (%)					
RoE	28.7	7.1	11.6	13.6	14.9
RoA	2.1	0.5	0.8	0.8	0.9
Int. Expended/Int. Earned	59.3	61.5	61.9	60.7	59.3
Other Inc./Net Income	32.7	12.1	15.3	15.2	14.5

Efficiency Ratios (%)					
Op. Exps./Net Income	31.8	47.6	45.9	45.0	45.4
Empl. Cost/Op. Exps.	57.4	55.4	54.6	53.5	53.1
Busi. per Empl. (Rs m)	34.5	48.3	52.7	61.3	69.1
NP per Empl. (Rs lac)	5.7	1.7	2.9	3.7	4.3

Asset-Liability Profile (%)					
Adv./Deposit Ratio	49.8	53.2	56.4	58.8	61.7
Invest./Deposit Ratio	45.3	42.0	39.5	37.8	35.9
G-Sec/Invest. Ratio	61.0	64.4	64.4	64.4	64.4
Gross NPAs to Adv.	3.0	2.7	2.1	1.8	1.6
Net NPAs to Adv.	1.5	1.4	0.9	0.6	0.4
CAR	16.9	15.2	14.0	12.0	12.0
Tier 1	13.0	12.5	12.7	10.2	10.0

VALUATION					
Book Value (Rs)	330.3	343.4	373.7	409.7	457.2
Price-BV (x)	16	16	14	13	12
Adjusted BV (Rs)	311.7	321.6	357.0	396.0	444.7
Price-ABV (x)	1.7	1.7	1.5	1.4	1.2
EPS (Rs)	84.2	23.7	41.7	53.3	64.7
EPS Growth (%)	20.3	-71.7	74.7	27.6	21.5
Price-Earnings (x)	6.4	22.7	12.9	10.1	8.3
OPS (Rs)	130.3	73.3	85.6	102.1	117.4
OPS Growth (%)	13.5	-43.4	15.9	19.2	15.0
Price-OP (x)	4.1	7.3	6.3	5.3	4.6

E: MOST Estimates



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Jammu & Kashmir Bank

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| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |

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