Company Focus

30 October 2007 | 8 pages

Centurion Bank (CENB.BO)

Hold: 2Q08 – A Good Quarter and the Merger is Done

- **Operating and profit bounce-back –** Cent Bank has smartly bounced back after a poor 1Q08 – margins have inched up, fee income remains robust, asset deterioration has eased, and there is high and broadening growth. Profits are also up 41%yoy, 30% ahead of our expectations, and the quality and mix of earnings is also ahead. Overall, a fairly impressive quarter.
- **And LKB merger, an overhang, is finally done** — Little P&L damage (though making losses) as accounts are combined. How much and how quickly it can generate returns remain to be seen. LKB's modest balance sheet (7% of Cent) and margin contribution (well below Cent) suggest only modest and staggered returns ahead; the earnings and value add of its larger branch network (45% of Cent) will determine the acquisition's worth.
- **Acquisition cost - capital –** We do not have full details of the acquisition cost. Our sense is management has written-off LKB's book and 5%+ of its own book. This is in line with expectations; based on Cent's track record, it should cover all costs. However with 50% + growth, Tier1 Car at 10.5%, it should seek capital again within 18 months.
- **Sustaining growth – more diversification into SME –** Management is seeking to sustain 50%+ asset growth, with a rising thrust on SME. We see this as a natural extension – and a competitive necessity (given its high cost funding). We also see it as achievable at current profitability levels – risk lies in funding this growth, esp. if liquidity tightens (we don't expect it to though).

Hold/Medium Risk	**2M**
Price (30 Oct 07)	Rs42.65
Target price	Rs45.00
Expected share price return	5.5%
Expected dividend yield	0.0%
Expected total return	**5.5%**
Market Cap	Rs77,737M US$1,976M

Price Performance (RIC: CENB.BO, BB: CBOP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	878	0.60	329.8	71.1	6.5	12.5	0.0
2007A	1,204	0.74	23.8	57.4	4.9	10.5	0.0
2008E	1,947	1.07	43.8	40.0	3.8	11.3	0.0
2009E	2,648	1.36	27.3	31.4	3.3	12.0	0.0
2010E	3,986	2.05	50.5	20.9	2.8	15.8	0.0

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	71.1	57.4	40.0	31.4	20.9
P/E reported (x)	71.1	57.4	40.0	31.4	20.9
P/BV (x)	6.5	4.9	3.8	3.3	2.8
P/Adjusted BV diluted (x)	7.2	5.3	4.0	3.6	3.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	0.60	0.74	1.07	1.36	2.05
EPS reported	0.60	0.74	1.07	1.36	2.05
BVPS	6.52	8.75	11.37	12.83	15.02
Tangible BVPS	6.52	8.75	11.37	12.83	15.02
Adjusted BVPS diluted	5.95	8.07	10.60	11.96	14.01
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net interest income	3,988	5,696	6,961	9,614	13,621
Fees and commissions	1,973	3,587	5,201	6,761	8,790
Other operating Income	516	808	1,167	1,594	2,068
Total operating income	**6,476**	**10,091**	**13,330**	**17,969**	**24,479**
Total operating expenses	-4,997	-7,058	-9,284	-12,532	-16,522
Oper. profit bef. provisions	**1,480**	**3,033**	**4,046**	**5,437**	**7,957**
Bad debt provisions	-781	-862	-840	-1,185	-1,618
Non-operating/exceptionals	375	-346	-300	-300	-300
Pre-tax profit	**1,075**	**1,826**	**2,906**	**3,952**	**6,039**
Tax	-197	-622	-959	-1,304	-2,053
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**878**	**1,204**	**1,947**	**2,648**	**3,986**
Adjusted earnings	878	1,204	1,947	2,648	3,986
Growth Rates (%)					
EPS adjusted	329.8	23.8	43.8	27.3	50.5
Oper. profit bef. prov.	234.8	104.9	33.4	34.4	46.3
Balance Sheet (RsM)					
Total assets	**113,302**	**187,172**	**265,150**	**359,399**	**485,801**
Avg interest earning assets	97,489	142,224	214,977	298,849	406,508
Customer loans	67,744	113,627	168,750	238,823	332,086
Gross NPLs	3,150	3,120	4,141	5,775	7,916
Liab. & shar. funds	**113,302**	**187,172**	**265,150**	**359,399**	**485,801**
Total customer deposits	93,996	148,637	214,879	296,196	406,712
Reserve for loan losses	2,410	1,414	2,254	3,439	5,057
Shareholders' equity	**9,178**	**13,716**	**20,663**	**23,311**	**27,295**
Profitability/Solvency Ratios (%)					
ROE adjusted	12.5	10.5	11.3	12.0	15.8
Net interest margin	4.09	4.00	3.24	3.22	3.35
Cost/income ratio	77.2	69.9	69.6	69.7	67.5
Cash cost/average assets	4.8	4.7	4.1	4.0	3.9
NPLs/customer loans	4.6	2.7	2.5	2.4	2.4
Reserve for loan losses/NPLs	76.5	45.3	54.4	59.6	63.9
Bad debt prov./avg. cust. loans	1.3	0.9	0.6	0.6	0.6
Loans/deposit ratio	72.1	76.4	78.5	80.6	81.7
Tier 1 capital ratio	10.7	9.5	10.4	8.5	7.3
Total capital ratio	11.9	10.7	12.5	11.4	10.5

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Powered by: dataCentral

Figure 1. 2Q08 Centurion Bank Financial Highlights (Rs Million, %)

	2Q08	2Q07	YoY %	1Q08	QoQ%	Citi Investment Research Comments
Interest Income	5,374	2,781	93.2	4,780	12.4	
Interest Expense	(3,670)	(1,519)	141.5	(3,386)	8.4	Deposit cost increases as it takes over LKB term deposit with slight deterioration on the deposit mix
Net Interest Income	**1,704**	**1,262**	**35.1**	**1,394**	**22.3**	**Better than expected and higher than peers as most of the deposit re-pricing completed in 1Q08. Creditable in a generally challenging quarter**
Fee-Based Income	1,500	873	71.9	1,399	7.2	Strong show continues, with insurance distribution, wealth management and other retail lines delivering on management promises. An increasingly dominant profitability driver
Other Non-Interest Income	71	8	787.5	148	-52.1	
Non Interest Income	1,571	881	78.4	1,547	1.5	
Operating Income	**3,275**	**2,142**	**52.9**	**2,941**	**11.4**	
Operating Expenses	(2,324)	(1,609)	44.5	(2,099)	10.7	Operating expenses increases as it merges with a slight expensive LKB bank
Pre-Provision Profit	**951**	**534**	**78.1**	**842**	**12.9**	
Provisions & Contingencies	(321)	(28)	1055.4	(384)	-16.4	
Pre-Tax Profit	**630**	**506**	**24.5**	**458**	**37.5**	
Tax	(231)	(195)	18.6	(172)	34.6	
Extraordinary Items	18	0	NM	0	NM	Prior period LKB profit for FY07 adjusted
Net Profit	**416**	**311**	**33.8**	**286**	**45.5**	**Net of LKB loss of 40 mn for 2Q08 and 43 mn for 1Q08**
Net profit Ex LKB merger	**439**	**311**	**41.1**	**330**	**33.0**	**30% higher than our estimates**
EPS	0.23	0.22	3.4	0.21	8.4	
Customer Loans	139,849	83,847	66.8	119,406	17.1	High growth largely in Retail and SME. Ex LKB Centurion grew at about 64% yoy
Customer Deposits	192,912	113,836	69.5	160,994	19.8	Slight deterioration on deposit mix casa now at 25% vs 28% in 1Q08 as takes over higher term deposits. Ex LKB Centurion grew at about 58% yoy and 20% qoq
AIEA	190,008	122,586	55.0	160,039	18.7	
Total Assets	235,789	138,684	70.0	196,647	19.9	Ex LKB Centurion balance sheet grew at about 64%.LKB added just about 7% to the total balance sheet
Avg Assets	216,218	131,747	64.1	190,718	13.4	
Net Non-Performing Loans (NPL)	5,026	3,532	42.3	3,750	34.0	Pressure on the asset book coming down. Management suggested additional deterioration during the quarter on Centurion only about 250mn - rest from LKB
Loan Loss Reserves (LLR)	(2,806)	(2,402)	16.8	(1,840)	52.5	
Shareholders' Funds	18,952	11,099	70.8	14,661	29.3	
Book Value Per Share	10.4	8	38.5	9	11.2	
Key Ratios (%)	**2Q08**	**2Q07**	**Bps Δ YoY**	**1Q08**	**Bps Δ QoQ**	**Citi Investment Research Comments**
ROAA (annualized)	0.71	0.90	-19	0.58	12	
ROAE (annualized)	8.79	11.21	-242	7.81	98	
Net Interest Margin (bps)	359	412	-53	348	11	Great show, in our view, in a generally challenging environment where most peers have struggled to maintain margins with growth
Fee Inc/Operating Income	45.8	40.7	506	47.6	-179	
Other Non-Interest Inc/Op Inc	48.0	41.1	686	52.6	-465	
Op. Cost/ Operating Income	71.0	75.1	-411	71.4	-40	Ex LKB cost income ratio would be about 68%
Loan-to-Deposit Ratio (LDR)	72.5	73.7	-116	74.2	-167	
Net NPL/Loan Ratio	3.6	4.2	-62	3.14	45	
LLR/NPL Ratio	56	68	-1,216	49	677	

Source: Company Reports and Citi Investment Research

Centurion Bank

Company description

Centurion Bank is India's fourth largest private-sector bank, after the significantly larger ICICI Bank, HDFC Bank and UTI Bank. Centurion's balance-sheet is of modest scale, much smaller than those of major private-sector banks. The bank is capitalized to support rapid growth, and its high fixed operating costs suggest that profitability is leveraged to asset growth. Centurion's acquisition of Bank of Punjab has substantially bolstered its distribution franchise, widened its product and customer mix, and gives it the platform to aggressively expand its balance-sheet; which it has hitherto achieved quite well. It is predominantly a Consumer bank – with almost 70% of its loans are in relatively high yield segments. Its distribution concentration is largely in the Western and Northern parts of the country, and it is seeking to acquire a mid-sized bank in the Southern parts of the country, to broaden and expand its distribution franchise. Bank Muscat is the largest shareholder in the bank post-merger with a 20.5% stake; Keppel Corp holds 9.0% and 18.6% is held through GDRs. Sabre Capital and BOP promoters hold 4.4% and 5.0% stakes in the bank, respectively.

Investment strategy

We have a Hold (2M) rating on the stock. Our core investment thesis remains intact: (1) one of few 'new private sector banks' with unique private-equity ownership; (2) distinct high-yield retail/SME lending profile with strong distribution post BoP merger; (3) strong management team; and (4) high asset growth expectations, along with a relatively high operating leverage given a high fixed cost pace, which it needs to leverage. However, while we think the investment thesis remains attractive, the stock has run up over the past 12 months, and our target price implies only limited upside over a one-year horizon.

Valuation

We are valuing Centurion on our EVA methodology, based on which our fair value is Rs45. An EVA model appears appropriate for Centurion because it takes into account (1) earnings growth that we believe will be sustainably higher than that for the overall industry, (2) reduced operating costs as the bank leverages its existing infrastructure and builds scale, and (3) asset quality control — our credit loss forecast is 1% pa . As our secondary valuation method, we apply a P/BV multiple of 3x FY09E, which generates target multiples. While these multiples are relatively higher than some of the other private sector banks; with larger and more profitable franchises, our target multiples factor in relatively higher earnings and asset growth expectations, as also an implicit acquisition premium, given that Centurion Bank could well be a relatively aggressively targeted bank in the event the market is opened up to International Banks.

Risks

Our risk rating is Medium for Centurion Bank. The risks that could impede the stock from reaching our target price include: (1) competition could erode the high margins of its main credit lines – some of which has been apparent in recent times (2) Centurion's focus segments are all mid-market and relatively high-risk businesses; (3) Modest Deposit franchise, which could be under threat in a sharply rising rate environment (4) a relatively high-cost operating structure. Upside risks to our target price include: (1) an acquisition which significantly improves distribution or adds a strong asset acquisition platform, and diversifies profitability and risks; (2) faster-than-expected growth with higher margins and stable asset quality could lead to upside to our earnings because of significant operating leverage, and to faster utilization of capital; and (3) any positive change in foreign ownership guidelines for private banks.

Appendix A-1

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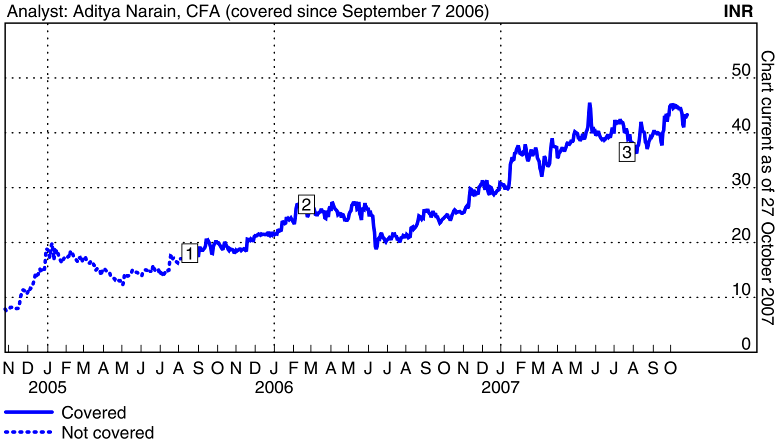
Centurion Bank (CENB.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Aditya Narain, CFA (covered since September 7 2006)



#	Date	Rating	Target Price	Closing Price
1:	18 Aug 05	1H	24.00	18.00
2:	22 Feb 06	*2M	*29.00	25.65
3:	23 Jul 07	2M	*45.00	40.20

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