

## Union Bank of India

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,215	UNBK IN
	REUTERS CODE
S&P CNX: 2,986	UNBK.BO

24 July 2006

**Buy**
*Previous Recommendation: Buy*
**Rs88**

Equity Shares (m)	505.1
52-Week Range	149/81
1,6,12 Rel.Perf.(%)	-10/-36/-66
M.Cap. (Rs b)	44.6
M.Cap. (US\$ b)	1.0

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
3/06A	29,994	6,752	13.4	-14.5	6.6	1.1	11.4	16.5	0.8	1.3
3/07E	33,144	8,138	16.1	20.5	5.5	1.0	9.5	16.8	0.8	1.1
3/08E	39,250	10,414	20.6	28.0	4.3	0.8	9.5	18.8	0.9	0.9

Union Bank of India reported a 31% decline in earnings due to higher-than-expected provisions and higher taxes (tax rate was 38% in 1QFY07). NII growth was 19% (higher than expected), driven by strong credit growth of 34% YoY and despite margins declining YoY to 2.94% (3.02% in 1QFY06). Non-interest income increased, as trading profits increased along with core other income. Asset quality improved QoQ on back of healthy cash recoveries/upgradation.

- ✍ Strong growth in loans and deposits
- ✍ Margins improve QoQ
- ✍ YoY increase in core fee income
- ✍ Asset quality improves

Union Bank has been one of the fastest growing state-owned banks in our banking universe. It has already created a strong technology platform and now has 75% of its business under core banking solutions (CBS). This should help the bank maintain strong growth going forward. However, margin pressure and Tier I capital adequacy ratio (CAR) of just 7.3% (post-capital raising) have been key concerns. While PAT numbers are below our expectations due to higher provisioning and higher taxes, core income growth is strong. We expect earnings to grow by 21% in FY07 (EPS of Rs16.1) and by 28% in FY08 (EPS of Rs20.6). The stock trades at 5.5x FY07E EPS and 1x FY07E BV. Maintain **Buy**.

**QUARTERLY PERFORMANCE**

(RS MILLION)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Interest Income	13,578	14,202	15,135	15,723	16,657	17,468	18,162	19,838	58,638	72,125
Interest Expense	8,230	8,179	8,741	9,744	10,312	10,796	11,276	12,690	34,894	45,074
<b>Net Interest Income</b>	<b>5,347</b>	<b>6,023</b>	<b>6,394</b>	<b>5,979</b>	<b>6,345</b>	<b>6,672</b>	<b>6,886</b>	<b>7,148</b>	<b>23,743</b>	<b>27,051</b>
% Change (Y-o-Y)	14.6	31.9	10.3	6.5	18.7	10.8	7.7	19.6	15.0	13.9
Other Income	1,337	1,403	1,390	2,122	1,650	1,262	1,383	1,797	6,251	6,093
<b>Net Income</b>	<b>6,684</b>	<b>7,426</b>	<b>7,784</b>	<b>8,100</b>	<b>7,995</b>	<b>7,935</b>	<b>8,269</b>	<b>8,945</b>	<b>29,994</b>	<b>33,144</b>
% Change (Y-o-Y)	-4.7	20.2	1.0	9.4	19.6	6.9	6.2	10.4	6.0	10.5
Operating Expenses	3,153	3,855	3,501	3,515	3,730	3,932	4,026	4,208	14,024	15,896
<b>Operating Profit</b>	<b>3,531</b>	<b>3,571</b>	<b>4,283</b>	<b>4,585</b>	<b>4,265</b>	<b>4,003</b>	<b>4,243</b>	<b>4,737</b>	<b>15,970</b>	<b>17,248</b>
Other Provisions	647	2,690	1,302	2,384	1,579	1,300	1,300	1,921	7,024	6,100
Tax Provisions	480	270	690	755	1,018	680	690	622	2,195	3,010
<b>Net Profit</b>	<b>2,404</b>	<b>611</b>	<b>2,291</b>	<b>1,446</b>	<b>1,668</b>	<b>2,022</b>	<b>2,253</b>	<b>2,195</b>	<b>6,752</b>	<b>8,138</b>
% Change (Y-o-Y)	14.3	-71.0	287.8	-39.5	-30.6	231.0	-1.6	51.8	-6.1	20.5
Cost to Income Ratio (%)	47.2	51.9	45.0	43.4	46.7	49.6	48.7	47.0	46.8	48.0
Interest Expense/Interest Income (%)	60.6	57.6	57.8	62.0	61.9	61.8	62.1	64.0	59.5	62.5
Other Income/Net Income (%)	20.0	18.9	17.9	26.2	20.6	15.9	16.7	20.1	20.8	18.4

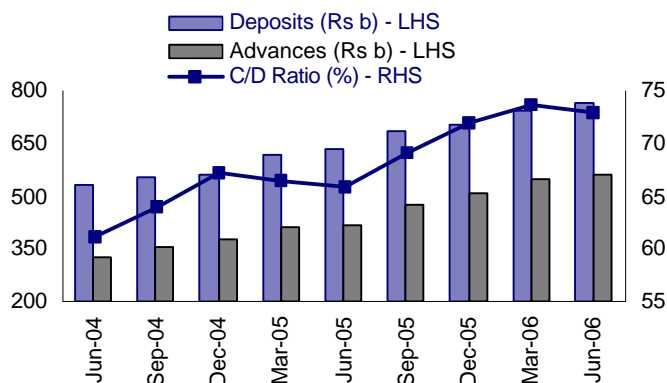
E: MOST Estimates

Union Bank of India reported a 31% decline in its earnings due to higher-than-expected provisions and higher taxes (tax rate was 38% in 1QFY07). NII growth was 19% (higher than expected) driven by strong credit growth of 34% YoY and despite margins declining YoY to 2.94% (3.02% in 1QFY06). Non-interest income increased as trading profits increased along with core other income. Asset quality improved QoQ on the back of healthy cash recoveries/upgradation.

**Strong loan and deposit growth**

The bank’s loan book has grown 34% to Rs558b. Deposits grew 21% to Rs765b. Low-cost deposits have grown by 27% YoY to Rs257b and currently make up 34% of total deposits.

STRONG LOAN AND DEPOSIT GROWTH



Source: Company/ Motilal Oswal Securities

Retail loans during the year grew by 38% YoY to Rs119b. Retail loans now account for 21.3% of total advances. Home loans witnessed healthy growth and the portfolio is now at Rs47b, with growth of 44% over 1QFY06, accounting for 39% of the retail portfolio.

Priority sector lending stood at Rs225b in 1QFY07 compared with Rs182b in 1QFY06, recording growth of 24%. Agriculture lending stood at Rs84b as on 1QFY07 compared with Rs65b in 1QFY06, registering growth of 30%.

UBI’s management stated that it has plans to focus on SME, retail and agriculture going forward in order to grow its loan book as well as improve the yield on advances. UBI has plans to make significant loans to the SME segment to increase its share in the total loans portfolio to 20% by 2010 from 12.5%. Similarly, the bank plans to increase the share of its retail portfolio to 25% from the current 21%. The other area the bank wants to focus on is agricultural lending. It wants agri lending to be 20% of the total portfolio by 2010 from 16% currently.

**Margins improve QoQ**

In 1QFY07, yield on advances moved up by 16bp to 8.46% YoY while yield on investments came down by 28bp to 7.61% in 1QFY07. Cost of deposits too increased marginally to 4.96% from 4.89% in 1QFY06.

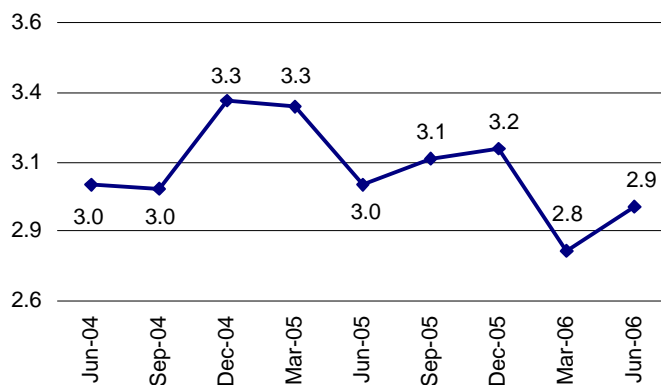
TREND IN QUARTERLY NIMS (%)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Yields on Advances	8.30	8.28	8.18	7.88	8.46
Yield on Investments	7.89	8.20	7.80	7.76	7.61
Cost of Deposits	4.89	4.78	4.90	5.19	4.96
<b>Net Interest Margins</b>	<b>3.02</b>	<b>3.11</b>	<b>3.15</b>	<b>2.78</b>	<b>2.94</b>

Source: Company / Motilal Oswal Securities

The full effect of the recently effected PLR hike by 50bp has not yet been realized and management has indicated this will come through in 2QFY07. Management has set an NIM target of 3.07% for FY07. This indicates that margins are likely to be stronger in the following quarters.

TREND IN NIMS (%)



Source: Company / Motilal Oswal Securities

### Non-interest income increases YoY

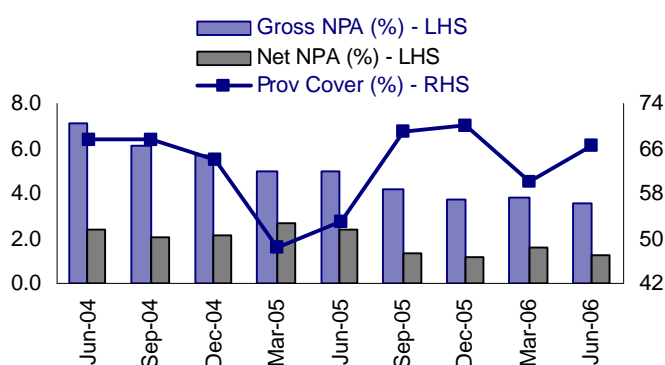
Trading profits increased by 26% YoY in 1QFY07 to Rs284m. Core other income was up 23% YoY to Rs1.4b in 1QFY07. Income from commission and exchange increased by 24% YoY to Rs1.05b in 1QFY07. Recovery in written-off accounts amounted to Rs91m in 1QFY07 compared with Rs54m in 1QFY06.

The bank has highlighted its changed focus in favor of marketing and sales. It has been gradually building up a strong marketing team which will focus on retail loans, CASA deposits and fee income through third party distribution products.

### Asset quality improves

The key negative in 4QFY06 was sharp deterioration in asset quality. However, in 1QFY07 the bank has managed to improve upon that and resultantly its gross and net NPAs have come down by 29bp and 34bp respectively. Net NPAs have reduced to 1.2% and gross NPAs have come down to 3.6% in 1QFY07. Provision cover stands at 66%. Cash recoveries/upgradations improved substantially to Rs1.9b during the quarter compared with Rs1.3b in the corresponding period of the previous year due to the robust credit monitoring system put in place. Management has also stated that the bank has written-off around Rs12.5b worth of NPAs in FY06 and they expect to recover substantial NPAs in FY07. Management also indicated that they had faced some concerns on home loans in FY06, as some frauds were detected. The bank has strengthened its due diligence process over the last couple of quarters and has actually seen a decline in delinquencies in 1QFY07.

MOVEMENT OF NPAS (%)



Source: Company /Motilal Oswal Securities

### Provisions increase

Union Bank's provisions including tax provisions increased substantially by 130% YoY in 1QFY07 to Rs2.6b. Tax provisions alone increased to Rs1.2b from Rs480m in 1QFY07. The bank did not have the benefit of shifting securities, as it did in 1QFY06 and also recently removed Sec 10 (23) (G) related to infrastructure loans leading to higher tax rates. Management expects full year tax rates in the range of 25%-27%.

NPA related provisions also increased to Rs550m in 1QFY07 from Rs240m in 1QFY06, primarily due to new RBI norms requiring banks to provide for 100% on loans above three years (despite having full collateral) compared with 75% earlier. The bank also made standard assets provisions of entire 1% (from 0.4%), as per new RBI norms resulting in a hit of Rs120m in 1QFY07 compared with Rs10m in 1QFY06.

Investment related provisions were Rs890m in 1QFY07 compared with Rs310m comprising Rs390m due to amortization of investments, and the balance due to MTM hits on its non-SLR book.

### Tier I still at 7.1%

UBI's Tier I capital is a mere 7.1%. After accounting for Basel II norms, we believe that Tier I capital could reduce to ~6.5%. Whilst management has ruled out any dilution in the near term, as it would first avail capital through hybrid instruments, lower capital adequacy will continue to be a concern for the bank. Further, as the bank has no presence in the form of branches outside India, raising perpetual debt in the international market would be expensive, compared with other banks having international presence.

### Strong business momentum, Maintain Buy

Union Bank has been one of the fastest growing state-owned banks in our banking universe. It has already created a strong technology platform and now has 75% of its business under core banking solutions (CBS). This should help the bank maintain strong growth going forward.

However, margin pressure and Tier I capital adequacy ratio (CAR) of just 7.3% (post-capital raising) have been key concerns. While PAT numbers are below our expectations due to higher provisioning and higher taxes, core income

growth is strong. We expect earnings to grow by 21% in FY07 (EPS of Rs16.1) and by 28% in FY08 (EPS of Rs20.6). The stock trades at 5.5x FY07E EPS and 1x FY07E BV. We maintain **Buy**.

## Union Bank of India: an investment profile

### Company description

Union Bank is amongst the large state-owned banks with a balance sheet size of over Rs900b+. While the bank is based in western India, its branch network of over 2,085 branches and 542 ATMs is well spread countrywide. 728 branches and 63 extension counters (EC) located in 215 centers are designated to be part of CBS, which contributes to around 75% of the bank's total business.

### Key investment arguments

- ✍ Strong focus on loan growth.
- ✍ Has networked 728 branches under core banking solution (2<sup>nd</sup> highest after PNB)
- ✍ Strong and expanding technology platform to ensure robust fee income going forward

### Key investments risks

- ✍ Tier-1 capital adequacy of 7.1% constrains significant asset expansion.

### Recent developments

- ✍ Dena Bank chairman and managing director M. V. Nair has taken over as CMD of UBI on 1 April 2006.
- ✍ UBI recently introduced a Rs4b Tier-II capital bond issue, with a greenshoe option of Rs4b. This was oversubscribed by the participants.
- ✍ Union Bank has permission from the RBI for opening branches in Doha and Hong Kong and for representative offices in Dubai and Shanghai. All these are under various stages of permission of the local authorities, in these countries

### Valuation and view

- ✍ We expect earnings to grow 21% in FY07 and 28% in FY08. Stronger momentum in core earnings will result in better valuations for the stock.
- ✍ The stock is trading at 1x FY07E BV of 5.5x FY07E earnings.

### Sector view

- ✍ YTD loan growth of 30%+, highest in the last 12 years.
- ✍ Volatility in interest rates would impact treasury.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

#### COMPARATIVE VALUATIONS

		UBI	BOI	VIJAYA BANK
P/E (x)	FY07E	5.5	5.5	6.4
	FY08E	4.3	4.5	5.3
P/ABV (x)	FY07E	1.1	0.9	1.0
	FY08E	0.9	0.8	0.9
RoE (%)	FY07E	16.8	16.2	15.2
	FY08E	18.8	17.4	16.5
RoA (%)	FY07E	0.8	0.7	0.8
	FY08E	0.9	0.7	0.8

#### SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	55.4	55.4	60.9
Domestic Institutions	7.7	6.6	4.9
FIs/FDIs	19.9	20.0	18.2
Others	16.9	18.0	16.1

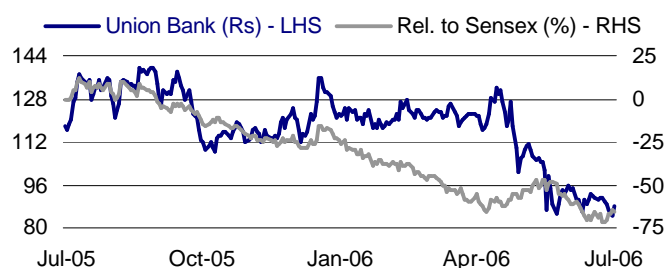
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	16.1	17.9	-10.2
FY08	20.6	21.5	-4.1

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
88	120	36.4	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E March	2004	2005	2006E	2007E	2008E
Interest Income	45,163	49,698	58,638	72,125	85,980
Interest Expended	27,801	29,052	34,894	45,074	53,740
<b>Net Interest Income</b>	<b>17,362</b>	<b>20,646</b>	<b>23,743</b>	<b>27,051</b>	<b>32,241</b>
Change (%)	15.9	18.9	15.0	13.9	19.2
Other Income	8,315	7,661	6,251	6,093	7,009
<b>Net Income</b>	<b>25,677</b>	<b>28,307</b>	<b>29,994</b>	<b>33,144</b>	<b>39,250</b>
Change (%)	10.6	10.2	6.0	10.5	18.4
Operating Expenses	10,846	12,575	14,024	15,896	17,784
<b>Operating Income</b>	<b>14,831</b>	<b>15,732</b>	<b>15,970</b>	<b>17,248</b>	<b>21,466</b>
Change (%)	13.7	6.1	15	8.0	24.5
Other Provisions	6,630	9,616	7,024	6,100	7,200
<b>PBT</b>	<b>8,200</b>	<b>6,116</b>	<b>8,946</b>	<b>11,148</b>	<b>14,266</b>
Tax	1,080	-1,075	2,195	3,010	3,852
Tax Rate (%)	13.2	-17.6	24.5	27.0	27.0
<b>PAT</b>	<b>7,120</b>	<b>7,191</b>	<b>6,752</b>	<b>8,138</b>	<b>10,414</b>
Change (%)	28.8	1.0	-6.1	20.5	28.0
Proposed Dividend	1,817	1,821	2,020	2,273	2,526

BALANCE SHEET					
(Rs Million)					
Y/E March	2004	2005	2006E	2007E	2008E
Capital	4,601	4,601	5,051	5,051	5,051
Reserves & Surplus	26,270	31,543	40,530	46,395	54,284
<b>Net Worth</b>	<b>30,871</b>	<b>36,144</b>	<b>45,581</b>	<b>51,446</b>	<b>59,335</b>
<b>Deposits</b>	<b>505,589</b>	<b>618,306</b>	<b>740,940</b>	<b>859,490</b>	<b>997,009</b>
Change (%)	13.0	22.3	19.8	16.0	16.0
Borrowings	9,342	20,210	39,745	48,488	58,186
Other Liabilities & Prov.	37,364	49,473	64,992	82,540	104,825
<b>Total Liabilities</b>	<b>583,167</b>	<b>724,131</b>	<b>891,256</b>	<b>1,041,964</b>	<b>1,219,354</b>
Current Assets	38,479	65,721	63,905	77,180	93,694
Investments	224,420	227,927	259,175	298,051	342,758
Change (%)	15.9	1.6	13.7	15.0	15.0
Advances	294,259	401,051	533,800	629,883	743,262
Change (%)	15.3	36.3	33.1	18.0	18.0
Net Fixed Assets	7,668	8,238	8,104	7,948	7,848
Other Assets	18,340	21,196	26,275	28,902	31,793
<b>Total Assets</b>	<b>583,167</b>	<b>724,132</b>	<b>891,258</b>	<b>1,041,965</b>	<b>1,219,355</b>

ASSUMPTIONS					
(%)					
Deposit Growth	13.0	22.3	19.8	16.0	16.0
Advances Growth	15.3	36.3	33.1	18.0	18.0
Investments Growth	15.9	1.6	13.7	15.0	15.0
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	35.0	35.0	40.0	45.0	50.0
CRR	4.5	5.0	5.0	5.0	5.0

E: MOST Estimates

RATIOS					
Y/E March	2004	2005	2006E	2007E	2008E
<b>Spreads Analysis (%)</b>					
Avg. Yield - Earning Assct	8.7	8.0	7.6	7.8	8.0
Avg. Cost-Int. Bear. Liab	5.8	5.0	4.9	5.3	5.5
Interest Spread	2.9	2.9	2.7	2.5	2.5
Net Interest Margin	3.3	3.3	3.1	2.9	3.0

Profitability Ratios (%)					
RoE	25.2	21.5	16.5	16.8	18.8
RoA	1.3	1.1	0.8	0.8	0.9
Int. Expended/Int. Earned	61.6	58.5	59.5	62.5	62.5
Other Inc./Net Income	32.4	27.1	20.8	18.4	17.9

Efficiency Ratios (%)					
Op. Exps./Net Income	42.2	44.4	46.8	48.0	45.3
Empl. Cost/Op. Exps.	66.5	64.1	61.8	59.6	58.6
Busi. per Empl. (Rs m)	28.6	34.6	45.1	55.5	66.2
NP per Empl. (Rs lac)	2.8	2.8	2.7	3.3	4.3

Asset-Liability Profile (%)					
Adv./Deposit Ratio	58.2	64.9	72.0	73.3	74.5
Invest./Deposit Ratio	44.4	36.9	35.0	34.7	34.4
G-Sec/Invest. Ratio	74.1	72.0	78.3	78.3	78.3
Gross NPAs to Adv.	7.6	5.0	3.8	3.4	3.0
Net NPAs to Adv.	2.9	2.6	1.6	1.2	0.8
CAR	12.3	12.1	11.4	9.5	9.5
Tier 1	6.5	6.1	7.3	6.3	6.3

VALUATION					
Book Value (Rs)	56.6	68.2	81.0	92.6	108.2
Price-BV (x)	1.6	1.3	1.1	1.0	0.8
Adjusted BV (Rs)	44.6	53.3	70.3	83.2	100.7
Price-ABV (x)	2.0	1.7	1.3	1.1	0.9
EPS (Rs)	15.5	15.6	13.4	16.1	20.6
EPS Growth (%)	28.8	1.0	-14.5	20.5	28.0
Price-Earnings (x)	5.7	5.7	6.6	5.5	4.3
OPS (Rs)	32.2	34.2	31.6	34.1	42.5
OPS Growth (%)	13.7	6.1	-7.5	8.0	24.5
Price-OP (x)	2.7	2.6	2.8	2.6	2.1

E: MOST Estimates

**N O T E S**



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**Union Bank of India**

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

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