ANAND RATHI

India I Equities

Banks

Initiating Coverage

24 March 2009

Bank of Baroda

Rising fee income and high NPA coverage; Initiate at Buy

Rating: **Buy**
Target Price: Rs270
Share Price: Rs224

Clyton Fernandes
+9122 6626 6744
clytonfernandes@rathi.com

Kaitav Shah
+9122 6626 6735
kaitavshah@rathi.com

- **Buy.** We initiate coverage on Bank of Baroda with a Buy and a target price of Rs270. Its relatively larger share of international business would lead to a lower RoE than its peers. However, its rising fee income and high NPA coverage would restrict risks to earnings growth.

- **International business.** Some 23% of BoB's assets and profits arise from international operations. Investments in foreign corporate bonds (<1% of assets), margin pressure and lower fee income from its global exposure pose short-term risks.

- **Fee income has potential.** A key management focus area, BoB is targeting 25-30% growth, by leveraging its wealth management and corporate relationships. So far, there has been good growth in fee income. We expect improvement. However, given the lack of a clear competitive advantage, we may not see runaway growth.

- **Exceptional NPA coverage.** At ~76%, BoB's NPA coverage is one of the best, with net NPAs at 0.37%. We expect it to be on a stronger footing than its peers, especially when asset quality is under stress. The coverage ratio over FY09-FY11 is expected to be +75%, with net NPAs at ~0.6% in FY10.

- **Valuation.** Our target is based on the two-stage dividend-discount model (CoE: 13.0%; beta: 1.0; Rf: 6.5%). At our target price, the stock would trade at 0.8x FY10e ABV. BoB's target multiple is at a 20% discount to SBI's.

Key data

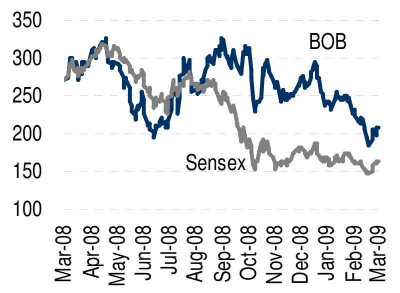
Key data	BOB IN/BOB.BO
52-week high/low	Rs339/170
Sensex/Nifty	9471/2939
3-m average volume	US$5.3m
Market cap	Rs82bn/US$1.6bn
Shares outstanding	364.3m
Free float	46%
Promoters	54%
Foreign Institutions	18%
Domestic Institutions	20%
Public	9%

Key financials

Year end 31 Mar	FY07	FY08	FY09e	FY10e	FY11e
Net interest income (Rsm)	35,775	39,118	48,242	56,439	61,864
Net profit (Rsm)	10,265	14,355	19,154	18,595	18,870
EPS (Rs)	28.1	39.3	52.4	50.9	51.6
Growth (%)	24.1	39.9	33.4	(2.9)	1.5
PE (x)	8.0	5.7	4.3	4.4	4.3
PABV (x)	1.0	0.8	0.7	0.6	0.6
RoE (%)	12.4	14.6	16.2	13.9	12.7
RoA (%)	0.8	0.9	1.0	0.8	0.7
Dividend yield (%)	2.9	3.9	3.9	4.2	4.4
Net NPA (%)	0.6	0.5	0.4	0.6	0.8

Source: Company, Anand Rathi Research ; Note: Price as on 24 March 2009

Relative price performance



Source: Anand Rathi Research

Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 31 Mar	FY07	FY08	FY09e	FY10e	FY11e
Net interest income	35,775	39,118	48,242	56,439	61,864
NII growth (%)	6.6	12.7	9.3	23.3	17.0
Non-interest inc	13,818	20,510	26,378	26,801	30,901
Total income	49,593	59,628	74,619	83,240	92,765
Total income growth (%)	15.3	20.2	25.1	11.6	11.4
Op. expenses	25,443	29,343	33,131	39,040	42,023
Operating profit	24,150	30,286	41,488	44,200	50,743
Operating profit growth (%)	25.9	25.4	37.0	6.5	14.8
Provisions	7,607	8,214	12,021	15,593	21,712
PBT	16,543	22,072	29,467	28,607	29,031
Tax	6,278	7,716	10,313	10,013	10,161
PAT	10,265	14,355	19,154	18,595	18,870
PAT growth (%)	24.1	39.9	33.4	(2.9)	1.5
FDEPS (Rs/share)	28.1	39.3	52.4	50.9	51.6
DPS (Rs/share)	6.0	8.0	8.0	8.5	9.0

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

Year end 31 Mar	FY07	FY08	FY09e	FY10e	FY11e
Share capital	3,655	3,655	3,655	3,655	3,655
Reserves & surplus	82,844	106,784	122,516	137,476	152,497
Deposits	1,249,160	1,520,341	1,811,909	2,225,401	2,534,297
Borrowings	95,803	165,215	200,436	232,634	270,483
Minority interests	-	-	-	-	-
Total Liabilities	1,431,462	1,795,995	2,138,517	2,599,167	2,960,932
Advances	836,209	1,067,013	1,344,437	1,626,768	1,828,488
Investments	349,436	438,701	579,811	689,874	798,304
Cash & Bank Bal	182,804	222,993	133,005	183,755	221,626
Fixed & Other Assets	63,013	67,288	81,264	98,768	112,515
Total Assets	1,431,462	1,795,995	2,138,517	2,599,167	2,960,932
No. of shares (m)	366	366	366	366	366
Deposits growth (%)	33.4	21.7	19.2	22.8	13.9
Advances growth (%)	39.6	27.6	26.0	21.0	12.4

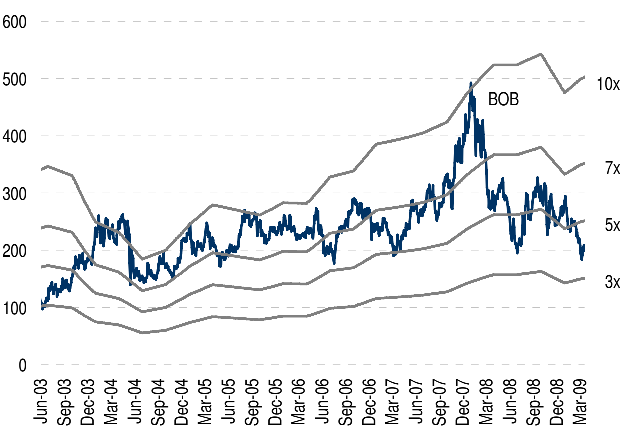
Source: Company, Anand Rathi Research

Fig 3 – Ratios

Year end 31 Mar	FY07	FY08	FY09e	FY10e	FY11e
Interest spread (%)	2.8	2.4	2.5	2.2	2.0
NIM (%)	2.9	2.5	2.6	2.5	2.3
Other inc / Total inc (%)	27.9	34.4	35.3	32.2	33.3
Cost-Income (%)	51.3	49.2	44.4	46.9	45.3
Provisions / Loans (%)	76.0	75.1	76.7	75.6	74.4
Dividend Payout (%)	21.3	20.3	15.3	16.7	17.4
Credit-Deposit (%)	66.9	70.2	74.2	73.1	72.1
Investment-Deposit (%)	28.0	28.9	32.0	31.0	31.5
Gross NPA (%)	2.5	1.9	1.7	2.4	3.2
Net NPA (%)	0.6	0.5	0.4	0.6	0.8
BV (Rs)	236.6	302.1	345.2	386.1	427.2
Adj BV (Rs)	222.9	288.6	330.9	359.8	386.6
CAR (%)	11.8	12.9	13.2	12.8	13.0
- Tier 1 (%)	8.74	7.6	8.5	8.0	7.9
Dividend Yield (%)	2.7	3.6	3.6	3.8	4.0

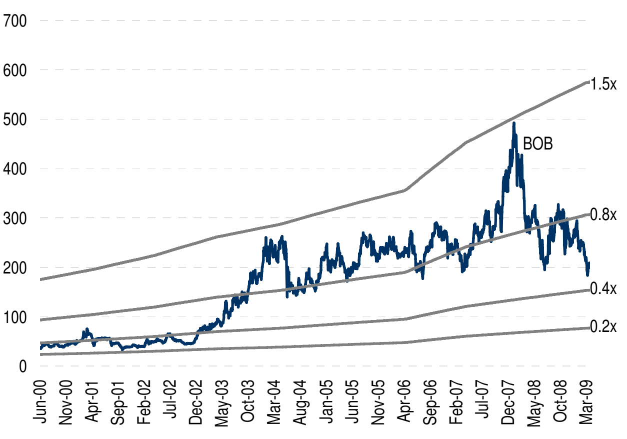
Source: Company, Anand Rathi Research

Fig 4 – PE Band



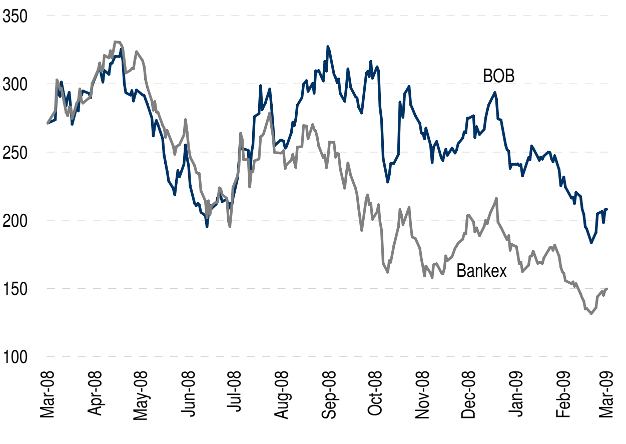
Source: Anand Rathi Research

Fig 5 – Price-to-Book Band



Source: Anand Rathi Research

Fig 6 – Bankex vs Bank of Baroda



Source: Anand Rathi Research

Investment Argument and Valuation

We initiate coverage on BoB with a Buy and a target price of Rs270. We expect its RoE to be lower than its peers, on account of its relatively higher proportion of international business. However, its improving fee income and high NPA coverage would help restrict risks to earnings growth.

International business

Bank of Baroda differentiates itself from most PSU banks, as 23% of its assets and profits arise from international operations. In the present disturbed macro-economic environment, however, investments in foreign corporate bonds (<1% of assets), margin pressure and lower fee income from its global exposure pose short-term risks.

Fee income has potential

A key management focus area, BoB is targeting 25-30% growth, by leveraging its wealth management and corporate relationships. So far, there is good progress in fee income growth. We expect the improvement to continue, However, the lack of a clear competitive advantage would continue to bite.

Superior NPA coverage

At ~76%, the bank's NPA coverage is one of the best, with its net NPAs at 0.37%. We expect it to be on a stronger footing than its peers, especially when asset quality is coming under stress. The coverage ratio is expected to be +75% over FY09-FY11, with net NPAs at ~0.6% in FY10.

Valuation

The stock trades at 0.6x FY10 and 0.6x FY11 estimated ABV. We rate it a Buy with a target price of Rs270. At our target, it would trade at 0.8x FY10 and 0.7x FY11 estimated ABV. Our target is based on the two-stage dividend-discount model. (CoE: 13.0%; beta: 1; Rf: 6.5%).

Risks to our target price

A sharp rise in NPLs is a key risk. The bank's capital position could be a growth constraint, with tier-1 at 8.5% and government holding at 53.8%.

- We have factored into our earnings estimates a sharp rise in the bank's NPAs. A further deterioration in asset quality, more than our NPA estimates could see a downside risk to our target.
- The bank's capital adequacy is comfortable. We expect it to be 12.8% in FY10. If management, however, intends to keep CAR much above 12% in FY11, it would have to raise tier-I capital. This would dilute equity capital and strike at the RoE.

International business

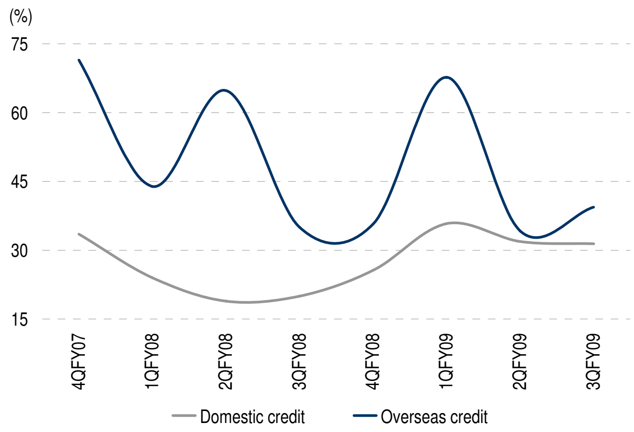
Bank of Baroda is different from most PSU banks by the fact that 23% of its assets and profits arise from international operations. Investments in foreign corporate bonds (<1% of assets), margin pressures and lower fee income from its global exposure pose a short-term risk in the present macro-economic environment.

Credit growth led by international business

Over the last 12 months the bank's credit growth has consistently outstripped average credit growth for the sector, led mainly by its international business, which forms 23% of total advances. Foreign advances grew 39% yoy in 3QFY09 due to more outbound M&As, further buoyed by rupee depreciation over the year.

In the light of the ongoing global economic turmoil, we see the bank's global exposure as a short-term risk to earnings and profitability.

Fig 7 – Overseas credit vs domestic credit growth



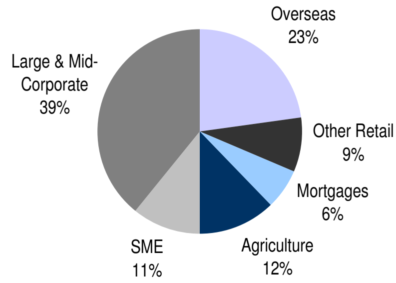
Source: Company, Anand Rathi Research

The international business has so far been ahead of the domestic business in spread, efficiency and asset quality. So far, it appears a value addition with higher growth, better normalized returns and margins and apparently lower risk. However, we view it more as a hedge and less valuable than its local franchise. In the light of the ongoing global economic turmoil, we see the bank's global exposure as a short-term risk to earnings and profitability.

Loan-book concentration suggests some caution

The bank's loan book continues to grow better than the industry (~33% yoy in 9mFY09), and in relatively higher-risk segments such as SME, retail and mid-sized companies, suggesting caution ahead. The bank has a fairly diversified loan portfolio, with companies having the lion's share at ~50.1% (large and mid-sized companies: 39.3% and SME: 10.8%). Retail credit's share is 14.8%.

Fig 8 – Loan-book composition, %



Source: Company, Anand Rathi Research

Loan growth to slow down

An economic slowdown in FY09 and FY10 could crunch credit growth and increase the risk of asset quality. Indian banks are now more cautious in this downturn than previously, and are cutting down on credit lines. However, there is some pressure from the finance ministry on PSU banks to maintain credit flow in the system. Therefore, growth could still be healthy in FY09 and fall in FY10.

In the light of the difficult economic conditions and of qualitative growth taking centre-stage, we expect credit growth for the bank to slow down to 21% in FY10. We estimate international advances to grow at a faster 27% in FY10. The industry-wide slowdown in retail credit and associated high risk are expected to fuel the fall in Bank of Baroda's retail credit share to ~13.5% by FY10. The share of SME and large-company loans by FY10 is expected to hover at ~11% and ~40%, respectively.

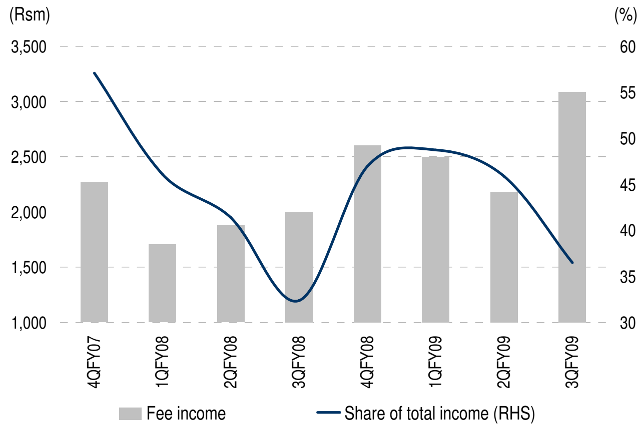
Fee income holds potential

Fee income is a key management focus area. Here, the bank is aiming at 25-30% growth by leveraging its wealth management and corporate relationships. So far, growth has been good. We expect further improvement. However, given the lack of a clear competitive advantage, we may not see runaway growth.

Strong fee-income growth

Over the last seven quarters, the bank's fee income has grown well. It now averages ~41.7% of total non-interest income.

Fig 9 – Fee income: last seven quarters



Source: Company, Anand Rathi Research

We believe that several factors have been driving fee income growth: strong loan growth, technology implementation, focus on government business and third-party product distribution. This momentum is likely to continue as the bank brings more branches into the core-banking solution (CBS). By 31 Dec '08, 1,970 of its domestic branches and 64 international branches were covered under the CBS.

We estimate BoB's fee income to be robust, led by its strong wealth management and corporate relationships, vast liability franchise and increased branches on the 'Core Banking' platform.

The bank is aiming at 25-30% growth in fee income, by leveraging its wealth management and corporate relationships. We expect some improvement despite the fact that the lack of a clear competitive edge would not see runaway growth. We estimate a 34.4% CAGR in fee income over FY09-11.

Good liability franchise to aid fee-income growth

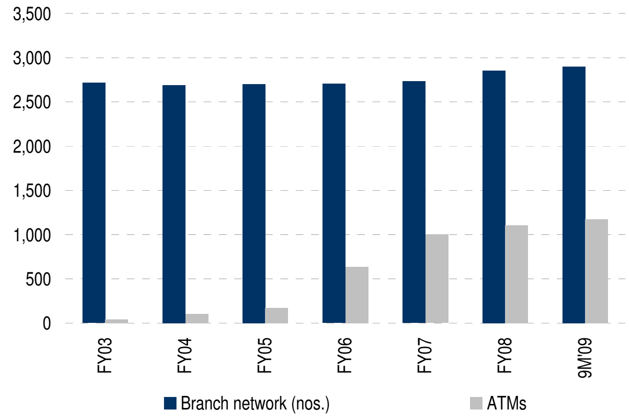
The bank has built a strong rural franchise; ~38% of its network covers rural areas. It has also sharpened focus on semi-urban and urban regions, by opening more branches there. We expect these branches to give it relatively higher growth, by virtue of being relatively under-banked compared to metros. We expect its vast liability franchise to offer considerable scope for improvement in fee income, especially with more branches to be gradually included in the CBS.

Fig 10 – Branches – demographic break-up (FY08)

Rural	1,092
Semi-urban	642
Urban	525
Metro	627
Total	**2,886**

Source: Company

Fig 11 – Branches – CBS



Source: Company

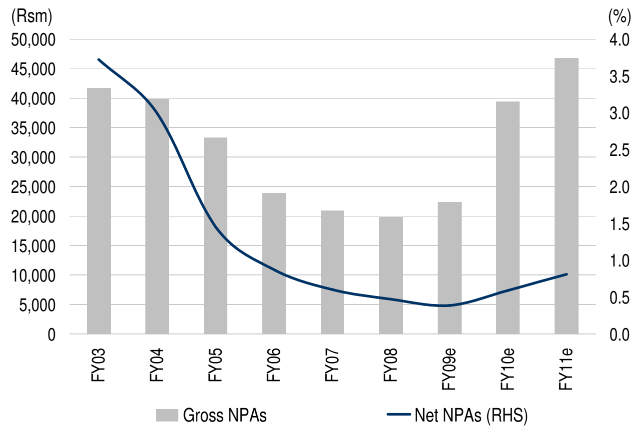
Exceptional NPA coverage

At ~76%, Bank of Baroda's NPA coverage is one of the best, with net NPAs at 0.37%. We expect it to be on a stronger footing than its peers, especially when asset quality is coming under strain. The coverage ratio is expected to be +75% over FY09-FY11, with net NPAs at ~0.6% in FY10.

Asset quality holding up

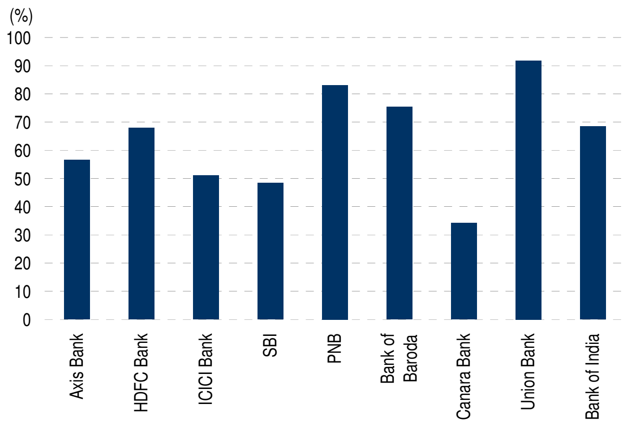
BoB's asset quality is among the best in its class. In 9mFY09, gross NPAs slipped 1.7% qoq, coverage at 76% was the second highest, a sharp contrast to the rapid deterioration in the sector. In the last several quarters, its NPAs have declined both in absolute terms and percent-wise. Gross and net NPAs now stand at 1.5% and 0.4%, respectively.

Fig 12 – NPAs



Source: Company, Anand Rathi Research

Fig 13 – NPA coverage of large-cap banks (9MFY09)



Source: Company

Asset quality concerns genuine

In the current macro-economic environment, asset quality concerns are genuine. Accordingly, we have factored in a 76% yoy jump in gross NPAs in FY10. The impact of the economic slowdown, in our view, would be reflected in higher NPAs in FY10, rather than in FY09, as banks are planning to reschedule loans, especially to SME customers. With the window of restructuring available, we expect some NPAs to further spill over to FY11.

However, with a high NPA coverage, we expect Bank of Baroda to be on a stronger footing than its peers. The coverage ratio is expected to be +75% over FY09-FY11, with net NPAs at ~0.6 in FY10.

Financials

We expect a 13.2% CAGR in Bank of Baroda's NII over FY09-11, and –0.7% in PAT. RoE is expected to come in at 13.9% in FY10 and 12.7% in FY11.

Business growth to decelerate

We expect the bank to register business growth of 22% in FY10 and 13.3% in FY11. Over FY09-11, we expect CAGRs of 16.6% in advances and 18.3% in deposits. Within advances, the bank has maximum growth in loans to large and mid-sized companies. These have increased 43.5% yoy and account for 39.3% of 9MFY09 loans at the bank.

The bank's focus on low-cost deposits (CASA) is expected to continue. Its present CASA ratio is 36.1%, and management's target is to raise that to 40%.

NIM to decline

In 3QFY09, the bank reported an improvement in its NIM, from 2.4% to 3%, driven by better lending yields. We factor in a decline in NIM in FY10 – by 16bps yoy to 2.48% and by 17bps in FY11 to 2.31%.

An increasing share of CASA and falling cost of deposits (due to PSU banks benefiting from the "flight to safety") and further cuts in SLR and CRR could lead to actual NIM being better than our estimates.

Non-interest income has potential

Fee-based income for the bank has improved in FY09 (against a ~15.2% CAGR through FY05-08), driven by an increasing number of branches under CBS and new fee-based products. We believe that several factors have been driving income growth – strong loan growth, technology implementation, focus on government business and third-party product distribution. However, as we expect business growth to slow down, we estimate a 34.4% CAGR in fee income over FY09-11.

We expect the bank's treasury income over FY09-11 at levels much lower than in the past. We have conservatively factored in treasury income at 90bps of average G-Secs, compared to ~349bps in the previous downturn (FY02-FY04). Treasury income would be much lower than in the past because banks have lower SLR holdings now (~29%, vs 34% then), excess SLR is now ~5% (vs ~9% then) and banks would protect their NIMs to an extent by holding high-yield investments.

We estimate Bank of Baroda's non-interest income to have a CAGR of 8.2% over FY09-11.

Increasing NPA coverage

In the current macro-economic environment, asset quality concerns are genuine. Accordingly, we have factored in a 76% yoy increase in gross NPAs in FY10. We expect loan-loss provisions to increase from an average of 48bps over the past three years to 96bps in FY09, 102bps in FY10 and 117bps in FY11.

However, with a high NPA coverage, we expect BoB to be on a stronger footing than its peers. Coverage ratio is expected to be +75% over FY09-FY11, with net NPAs at ~0.6% in FY10.

The sharp rise in provisions is expected to partly offset operating-profit growth and any treasury gains. However, BoB will get some relief from the cut in provisioning requirement on standard assets from 50-200bps to 40bps.

Fig 14 – Income Statement

Year end 31 Mar (Rsm)	FY07	FY08	FY09e	FY10e	FY11e
Interest Income	90,041	118,135	150,628	178,547	203,505
Interest Expended	54,266	79,017	102,387	122,109	141,641
Net Interest Income	35,775	39,118	48,242	56,439	61,864
Growth (%)	12.7	9.3	23.3	17.0	9.6
Non-interest Income	13,818	20,510	26,378	26,801	30,901
Total Income	49,593	59,628	74,619	83,240	92,765
Non-interest income / Total Income (%)	27.9	34.4	35.3	32.2	33.3
Operating Expenses	25,443	29,343	33,131	39,040	42,023
Employee Expenses	16,441	18,038	20,541	24,204	26,054
Other Expenses	9,003	11,305	12,590	14,835	15,969
Pre-provisioning profit	24,150	30,286	41,488	44,200	50,743
Growth (%)	25.9	25.4	37.0	6.5	14.8
Provisions	7,607	8,214	12,021	15,593	21,712
Profit Before Tax	16,543	22,072	29,467	28,607	29,031
Taxes	6,278	7,716	10,313	10,013	10,161
Tax Rate (%)	38.0	35.0	35.0	35.0	35.0
Profit After Tax	10,265	14,355	19,154	18,595	18,870
Growth (%)	24.1	39.9	33.4	(2.9)	1.5
Number of Shares	366	366	366	366	366
Earnings Per Share	28.1	39.3	52.4	50.9	51.6

Source: Anand Rathi Research

Fig 15 – Balance Sheet

As at 31 Mar (Rsm)	FY07	FY08	FY09e	FY10e	FY11e
Share Capital	3,655	3,655	3,655	3,655	3,655
Reserves and Surplus	82,844	106,784	122,516	137,476	152,497
Net Worth	86,499	110,439	126,172	141,131	156,152
Deposits	1,249,160	1,520,341	1,811,909	2,225,401	2,534,297
Other Liabilities & Provisions	95,803	165,215	200,436	232,634	270,483
Total Loans	1,344,962	1,685,556	2,012,345	2,458,035	2,804,780
Total Liabilities	1,431,462	1,795,995	2,138,517	2,599,167	2,960,932
Advances	836,209	1,067,013	1,344,437	1,626,768	1,828,488
Investments	349,436	438,701	579,811	689,874	798,304
Cash & Bank Balances	182,804	222,993	133,005	183,755	221,626
Fixed & Other Assets	63,013	67,288	81,264	98,768	112,515
Total Assets	1,431,462	1,795,995	2,138,517	2,599,167	2,960,932

Source: Anand Rathi Research

Company Background & Management

BoB is among the top-five public sector banks in the country, with nearly 4% share of the deposits and advances of the system. BoB also has one of the largest domestic branch networks (2,899 branches) and 74 offices in 25 countries.

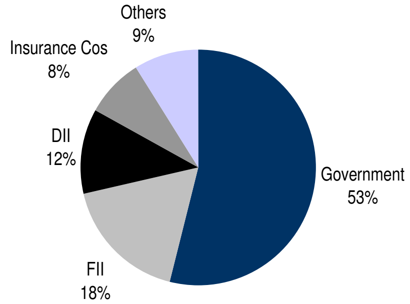
Background

Bank of Baroda (BoB) was incorporated in 1908 as a private institution, and subsequently nationalized in 1969. The bank is headquartered in Baroda, Gujarat. BoB holds a 25% stake in UTI AMC and has recently tied up with Pioneer Investments to create a joint asset management business in India. Pioneer will take a 51% stake in the venture.

Management

Currently chairman and managing director, Mr M. D. Mallya, prior to joining the Bank, was the chairman and managing director of Bank of Maharashtra. In a career of over 31 years, his previous positions include executive director of Oriental Bank of Commerce (OBC), marked by the merger of erstwhile Global Trust Bank with OBC.

Fig 16 – Shareholding Pattern



Source: Bloomberg, Company

Appendix 1

Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

Anand Rathi Ratings Definitions

Analysts' ratings and the corresponding expected returns take into account our definitions of Large Caps (>US$2bn) and Mid/Small Caps (<US$2bn) as described in the Ratings Table below.

Ratings Table

	Buy	Hold	Sell
Large Caps (>US$1bn)	>20%	5-20%	<5%
Mid/Small Caps (<US$1bn)	>30%	10-30%	<10%

Other Disclosures

This report has been issued by Anand Rathi Financial Services Limited (ARFSL), which is regulated by SEBI. The information herein was obtained from various sources; we do not guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities or any options, futures or other derivatives related to such securities ("related investments"). ARFSL and its affiliates may trade for their own accounts as market maker / jobber and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders. ARFSL, its affiliates, directors, officers, and employees may have a long or short position in any securities of this issuer(s) or in related investments. ARFSL or its affiliates may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any entity mentioned in this report. This research report is prepared for private circulation. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Past performance is not necessarily a guide to future performance. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report.

Anand Rathi Financial Services Limited and Anand Rathi Share & Stock Brokers Limited are members of The Stock Exchange, Mumbai, and the National Stock Exchange of India.

Additional information on recommended securities/instruments is available on request.