

Company Results Review

29 January 2007 | 8 pages

Andhra Bank (ADBK.BO)

Buy: 3Q07 Results - Strong Growth but Is There a Cost?

- 3Q07 profits slightly below but growth continues to be strong** — Andhra Bank reported profits of Rs1.36bn, 4% below expectations and down 7% qoq. Positives – strong increase in NII, protected margins despite strong growth in balance sheet in the quarter and controlled costs. Concerns – pressure on asset quality and higher MTM exposure of bond portfolio. Maintain Buy/ Low Risk with a Rs107 target price.
- Strong show at the 'margin'** — Andhra Bank's NII growth was about 23% yoy, ahead of peer state banks. Margins were stable at about 330bps, much above industry averages, despite the strong growth in deposits in 3Q07. P&L growth at the operating level was also strong; pre-provision profits were up 29% and 17% higher than expected.
- Will it last?** Deposits have grown an aggressive 11% over the quarter, a large part of which appears to be higher-cost wholesale deposits— the proportion of low-cost deposits has decreased to 37% from 40% in 2Q07. This could exert pressure on margins next quarter as deposit competition intensifies at quarter end. Higher than peers' MTM exposure on bond portfolio could increase risk in a rising rate scenario.
- Asset quality –deterioration in the quarter; comfortable for the moment** — Asset quality slipped over the quarter with about 40bps of incremental deterioration - well above peer government banks. Coverage levels also deteriorated almost 20bps despite higher loan loss provisioning and write-offs. Though overall comfortable, this needs to be watched carefully for further deterioration in the next quarter.

Buy/Low Risk	1L
Price (29 Jan 07)	Rs85.55
Target price	Rs107.00
Expected share price return	25.1%
Expected dividend yield	4.1%
Expected total return	29.2%
Market Cap	Rs41,492M
	US\$939M

Price Performance (RIC: ADBK.BO, BB: ANDB IN)



Figure 1. Statistical Abstract

Year to	Net Profit	FD EPS	EPS Growth	P/E	P/BV	RoAE	ROAA	Div Yld
March	(Rs Milis.)	(Rs)	(%)	(X)	(X)	(%)	(%)	(%)
FY05	5,201	13.0	12.2	6.6	1.9	31.6	1.7	3.5
FY06	4,855	11.0	-15.6	7.8	1.4	20.5	1.3	4.1
FY07E	4,407	9.1	-17.2	9.4	1.3	14.6	1.0	4.1
FY08E	5,859	12.1	33.0	7.1	1.2	17.6	1.1	4.4
FY09E	6,895	14.2	17.7	6.0	1.0	18.4	1.2	4.9

Source: Citigroup Investment Research

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	6.6	7.8	9.4	7.1	6.0
P/E reported (x)	6.6	7.8	9.4	7.1	6.0
P/BV (x)	1.9	1.4	1.3	1.2	1.0
P/Adjusted BV diluted (x)	1.9	1.4	1.3	1.2	1.0
Dividend yield (%)	3.5	4.1	4.1	4.4	4.9
Per Share Data (Rs)					
EPS adjusted	13.00	10.97	9.09	12.08	14.22
EPS reported	13.00	10.97	9.09	12.08	14.22
BVPS	45.93	59.67	64.85	72.70	82.23
Tangible BVPS	45.93	59.67	64.85	72.70	82.23
Adjusted BVPS diluted	45.93	59.67	64.85	72.70	82.23
DPS	3.00	3.50	3.50	3.80	4.20
Profit & Loss (RsM)					
Net interest income	10,690	11,690	13,217	15,014	17,502
Fees and commissions	1,390	1,697	1,884	2,110	2,363
Other operating Income	6,143	3,537	3,418	3,882	4,335
Total operating income	18,224	16,923	18,519	21,006	24,200
Total operating expenses	-8,295	-8,579	-9,437	-10,381	-11,419
Oper. profit bef. provisions	9,929	8,344	9,081	10,624	12,780
Bad debt provisions	-124	-400	-1,186	-1,654	-2,330
Non-operating/exceptionals	-2,463	-2,289	-1,600	-600	-600
Pre-tax profit	7,343	5,655	6,295	8,370	9,851
Tax	-2,142	-800	-1,889	-2,511	-2,955
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	5,201	4,855	4,407	5,859	6,895
Adjusted earnings	5,201	4,855	4,407	5,859	6,895
Growth Rates (%)					
EPS adjusted	12.2	-15.6	-17.2	33.0	17.7
Oper. profit bef. prov.	6.7	-16.0	8.8	17.0	20.3
Balance Sheet (RsM)					
Total assets	327,287	406,693	472,953	552,089	645,800
Avg interest earning assets	292,036	356,302	424,321	496,584	582,861
Customer loans	179,526	225,733	277,540	333,280	390,563
Gross NPLs	4,409	4,369	5,321	7,027	8,654
Liab. & shar. funds	327,287	406,693	472,953	552,089	645,800
Total customer deposits	275,507	339,224	400,600	473,354	559,635
Reserve for loan losses	4,358	4,729	5,705	7,078	8,906
Shareholders' equity	18,370	28,939	31,453	35,258	39,882
Profitability/Solvency Ratios (%)					
ROE adjusted	31.6	20.5	14.6	17.6	18.4
Net interest margin	3.7	3.3	3.1	3.0	3.0
Cost/income ratio	45.5	50.7	51.0	49.4	47.2
Cash cost/average assets	2.8	2.3	2.1	2.0	1.9
NPLs/customer loans	2.5	1.9	1.9	2.1	2.2
Reserve for loan losses/NPLs	98.8	108.2	107.2	100.7	102.9
Bad debt prov./avg. cust. loans	0.1	0.2	0.5	0.5	0.6
Loans/deposit ratio	65.2	66.5	69.3	70.4	69.8
Tier 1 capital ratio	8.0	12.2	10.9	10.3	9.9
Total capital ratio	12.1	14.0	13.1	12.1	11.5

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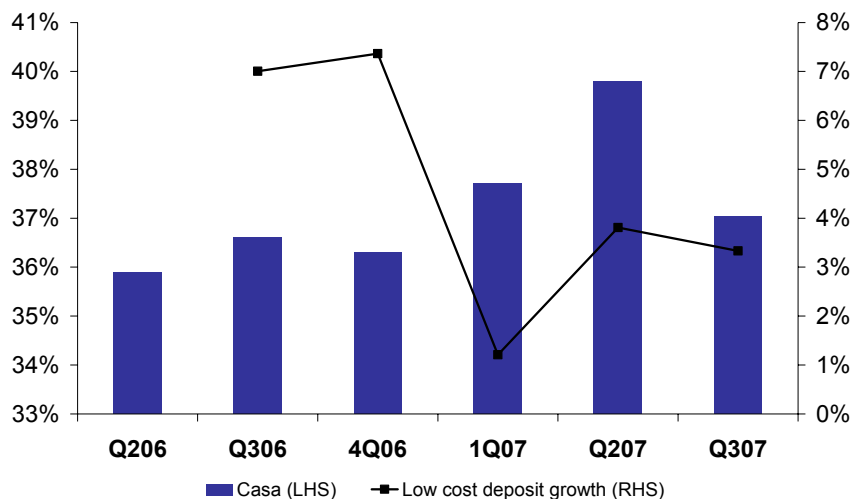


Figure 2. Andhra bank 3Q07 Financial Highlights (Rupees Million, %)

	3Q07	3Q06	YoY %	2Q07	QoQ%	Citigroup Investment Research Comments
Interest Income	8,128	6,986	16.3	7,721	5.3	
Interest Expense	-4,493	-4,028	11.5	-4,412	1.8	
Net Interest Income	3,635	2,959	22.8	3,309	9.9	Strong show - well above sector averages, maintaining margins though there could be challenges ahead
Non Interest Income	1,329	1,189	11.8	1,287	3.3	Ahead of expectations
Operating Income	4,964	4,148	19.7	4,595	8.0	Relatively higher than peers - appears in part on account of certain employee provisioning
Operating Expenses	(2,356)	(2,118)	11.3	(2,365)	-0.3	
Pre-Provision Profit	2,607	2,030	28.5	2,231	16.9	
Charges for Bad Debts	(185)	0	NM	(92)	101.0	
Other Operating Items	(460)	(296)	55.2	1	NM	Higher than expectations - relatively interest rate exposed portfolio
Operating Profit	1,963	1,734	13.2	2,139	-8.3	In line with expectations
Tax	(600)	(445)	34.8	(675)	-11.1	
Net Profit	1,363	1,289	5.8	1,464	-6.9	4% lower than expectations
EPS	2.81	3.22	-12.8	3.02	-6.9	
Customer Loans	255,790	207,150	23.5	236,000	8.4	Strong growth in quarter - acceleration after a modest first half
Customer Deposits	361,090	313,310	15.3	325,130	11.1	Aggressive and well ahead of industry growth - there is however an erosion in the deposit mix, with deposit growth primarily in term deposits - deposit mix peaking risk?
AIEA	440,138	378,518	16.3	400,125	10.0	
AIBL	380,769	331,269	14.9	343,035	11.0	
Total Assets	442,435	368,447	20.1	398,590	11.0	
Avg Assets	420,512	358,821	17.2	401,625	4.7	
Non-Performing Loans (NPL)	4,396	4,283	2.6	4,160	5.7	A level of deterioration, in spite of write-offs - weaker than Government banking peers that have reported so far
Loan Loss Reserves (LLR)	(3,286)	(3,715)	-11.6	(3,930)	-16.4	
Shareholders' Funds	32,931	21,839	50.8	31,568	4.3	
Book Value Per Share	67.90	54.60	24.4	65.09	4.3	
Key Ratios (%)	3Q07	3Q06	Bps Δ YoY	2Q07	Bps Δ QoQ	Citigroup Investment Research Comments
ROAA (annualized)	1.23	1.40	-17	1.47	-24	
ROAE (annualized)	16.55	23.60	-705	18.56	-200	
Net Interest Margin (bps)	330	313	18	331	0	Relatively strong show, in spite of a tighter funding environment, and an erosion in deposit mix - possible risk to margins into the next quarter
Other Non-Interest Inc/Op Inc	26.8	28.7	-189	28.0	-123	
Op. Cost/ Operating Income	47.5	51.1	-359	51.5	-398	
Loan-to-Deposit Ratio (LDR)	70.8	66.1	472	72.6	-175	
NPL/Loan Ratio	1.7	2.1	-35	1.8	-4	Asset book remains comfortable, but the quarter does see an erosion in assets, and coverage levels have fallen
LLR/NPL Ratio	75	87	-1,199	94	-1,973	

Source: Company Reports and Citigroup Investment Research

Figure 3. Andhra Bank – Low cost deposit growth QOQ (%) and Percent of total Deposit (%)



Source: Company Reports and Citigroup Investment Research

Andhra Bank

Company description

Andhra is the 18th largest Indian Bank, and the 15th largest among government banks. This broadly positions it as a small-sized bank even among government banks, with a deposit market share of about 1.6%. Andhra is less than one-third the size of the larger government banks. Over 70% of Andhra's branches are located in the state of Andhra Pradesh in southern India. Its business is also concentrated—about 58% of its loans and 64% of deposits are in the state, with the rest spread across the country.

Investment thesis

We rate Andhra Bank Buy/Low Risk (1L) with a target price of Rs107. We believe Andhra has three key things going for it: (1) Strong, and consistent, profitability, driven by high margins thanks to high loan yields, backed by low deposit costs, consistently strong returns on the bond portfolio and a relatively low provision requirement, given low NPL levels. We expect ROE to decline, but remain at about 18%, which is ahead of most industry peers; (2) It has a strong balance sheet with low gross and net NPLs – 2.8% and 0.25% respectively; and (3) The Bank has innovative human resources practices as well as technology. It also has adequate scale, a sufficient distribution network, and some surplus balance sheet liquidity. This combination, we believe, should enable it to actively participate in the current strong asset environment — on the consumer as well as the corporate side.

Valuation

Our target price of Rs107 is based on Citigroup's EVA model, which captures the long-term value of the business, and is a standard valuation measure for our India Banking coverage. We are factoring a risk free rate of 8%. We are also factoring in longer-term margins of 220bps vs. 230bps average, and industry average capital ratio of 6%.

We are benchmarking our target price on a 1.4x one-year forward P/BV multiple. The target multiple accounts for the healthy asset pricing and operating environment. Our target multiple continues to be at discounts to our target multiples for SBI, PNB and Corporation (which are at 1.5x FY07E PBV). We believe this discount is warranted, despite Andhra's 1) above-sector average RoEs and margins and 2) lower gross and net NPLs, to factor in possible risks of its relatively small balance sheet size, and regional concentration. This translates to a fair value of Rs96. We are using the EVA measure as we believe it better adjusts for the relatively dynamic cost of capital, and better captures the long-term value of the business.

Risk

We rate Andhra Bank Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share-price volatility.

Key downside risks to Andhra Bank are for the most part industry risks, in the form of the following: 1) A reversal in the positive loan growth and asset quality environment—Andhra does carry some mid-market, geographic concentration and specific industry risk; 2) Sharp increases in bond yields—only a small part of the portfolio, with low duration, is exposed; and 3) Government ownership—as the primary shareholder, the government's interests and decisions could be at odds with minority shareholder interests. These risks could impede the stock from reaching our target price.

Upside risks to our forecasts include improvement in asset quality and stronger than expected loan growth and margins.

Analyst Certification Appendix A-1

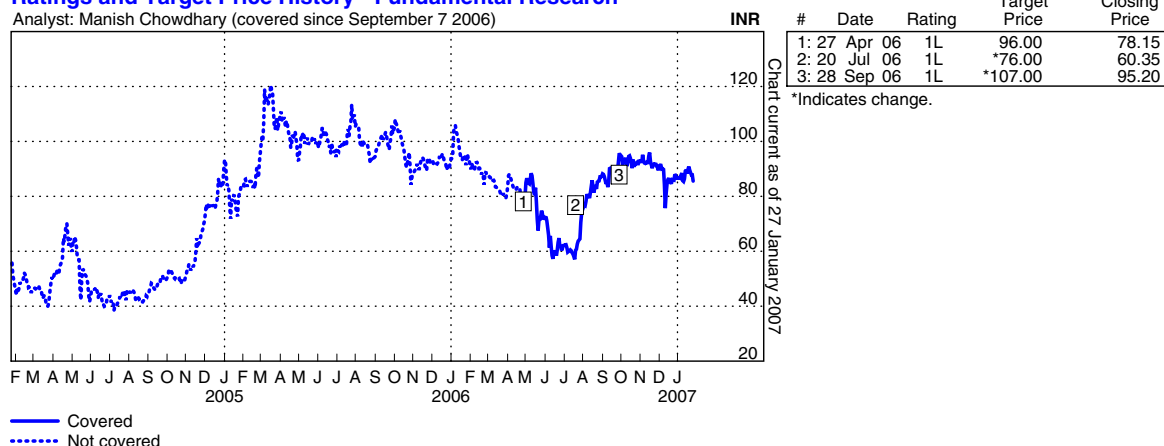
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Analyst: Manish Chowdhary (covered since September 7 2006)



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