



Union Bank of India

STOCK INFO.	BLOOMBERG
BSE SENSEX: 18,513	UNBK IN
	REUTERS CODE
S&P CNX: 5,496	UNBK.BO

24 October 2007

Buy

Rs161

Previous Recommendation: Buy

Equity Shares (m)	505.1	YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
52-Week Range	191/84	END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
1,6,12 Rel.Perf. (%)	-9/20/-21	3/07A	34,768	8,454	16.7	25.3	9.6	1.7	12.8	19.2	0.9	1.9
M.Cap. (Rs b)	81.2	3/08E	39,344	10,635	21.1	25.8	7.6	1.5	12.0	20.7	0.9	1.6
M.Cap. (US\$ b)	2.0	3/09E	47,543	13,099	25.9	23.2	6.2	1.2	11.0	21.7	1.0	1.3

- Union Bank of India reported a 42% YoY increase in earnings on the back of stronger other income growth and lower provisions. Bank has disappointed on NII growth and margins front. Margin declined sharply to 2.56% in 2QFY08 v/s 2.76% in 2QFY07 (dropped QoQ from 3.11%). Yields on funds improved by 78bp to 8.58% while costs of funds increased by 98bp to 6.02% (up 61bp QoQ). Management has guided for near 3% NIM in FY08.
- The loan growth was 12% YoY to Rs686b (QoQ growth of 7%) on a higher base of September 2006. Deposits grew 21% YoY to Rs948b (QoQ growth of 9%) while core retail deposits increased by 24% YoY. The bank reduced the bulk deposit proportion to 19.1% from 21.5% a year ago and 21.9% a quarter ago. CASA ratio slipped QoQ to 32.5% from 33.3%.
- Trading profits increased 113% YoY to Rs810m in 2QFY08. Recoveries from written off accounts increased 103% to Rs530m. Thus, overall other income grew 77% in 2QFY08. Excluding recoveries, trading profits and HTM amortization, core fee income growth was robust at 36% YoY to Rs1.74b.
- Asset quality improved further with net NPAs at 0.65% (13bp decline QoQ) and Gross NPAs at 2.42% (36bp decline QoQ). CAR has increased to 11.6% from 10.8% a year ago, while Tier I CAR increased to 7.4% from 7% a year ago.
- Strong fee income growth, margins stability with steady asset growth and improving asset quality are the key strengths of Union Bank. While margins have disappointed in 2QFY08, we believe performance would improve in 2HFY08. Union Bank trades at 6.2x FY09E EPS and 1.2x FY09E BV. Maintain **Buy**.

QUARTERLY PERFORMANCE

(RS MILLION)

	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Interest Income	16,657	17,724	18,492	20,949	21,112	22,548	23,901	25,353	73,822	92,914
Interest Expense	10,312	11,449	11,633	12,526	13,399	15,820	16,532	16,540	45,920	62,292
Net Interest Income	6,345	6,276	6,859	8,423	7,713	6,728	7,369	8,813	27,902	30,622
% Change (Y-o-Y)	18.7	4.2	7.3	40.9	21.6	7.2	7.4	4.6	17.5	9.7
Other Income	1,258	1,918	2,052	2,418	1,783	2,708	2,100	2,130	6,865	8,722
Net Income	7,602	8,193	8,911	10,841	9,496	9,436	9,469	10,943	34,768	39,344
% Change (Y-o-Y)	16.8	15.8	14.5	40.6	24.9	15.2	6.3	0.9	21.2	13.2
Operating Expenses	3,730	3,910	3,860	3,259	4,241	4,153	4,175	4,444	14,759	17,013
Operating Profit	3,872	4,283	5,051	7,582	5,255	5,283	5,294	6,499	20,008	22,331
Other Provisions	1,186	1,220	1,426	3,153	1,554	976	1,400	2,371	6,204	6,300
Tax Provisions	1,018	1,122	1,067	2,144	1,450	1,550	1,000	1,396	5,350	5,396
Net Profit	1,668	1,942	2,558	2,285	2,251	2,758	2,894	2,732	8,454	10,635
% Change (Y-o-Y)	-30.6	217.8	11.7	58.0	34.9	42.0	13.1	19.5	25.3	25.8
Cost to Income Ratio (%)	49.1	47.7	43.3	30.1	44.7	44.0	44.1	40.6	42.5	43.2
Interest Expense/Interest Income (%)	61.9	64.6	62.9	59.8	63.5	70.2	69.2	65.2	62.2	67.0
Other Income/Net Income (%)	16.5	23.4	23.0	22.3	18.8	28.7	22.2	19.5	19.7	22.2

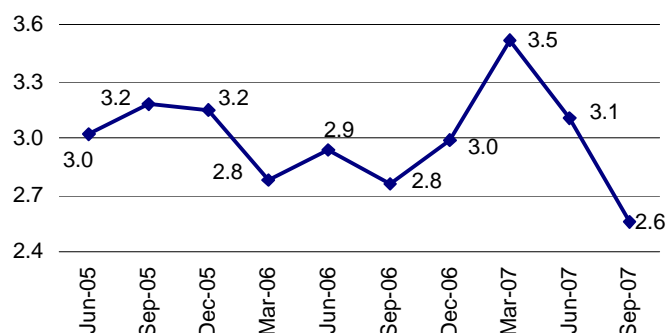
E: MOST Estimates

Margins drop to 2.6%

Margins declined sharply to 2.56% in 2QFY08 v/s 2.76% in 2QFY07 (dropped QoQ from 3.11%). Yields on funds improved 78bp to 8.58% while costs of funds increased by 98bp to 6.02% (up 61bp QoQ). Management has guided for near 3% NIM in FY08. The lower credit off take coupled with strong built up of retail term deposits during the quarter has put pressure on margins during 2QFY08. Margins for 1HFY08 were, however, stable YoY at 2.86%.

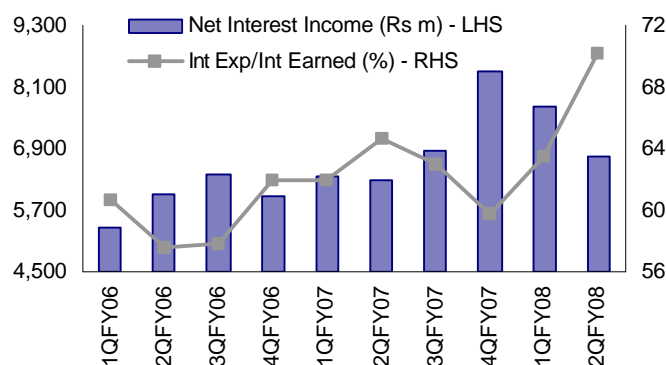
Deposit costs increased from 5.30% in 2QFY07 to 6.41% in 2QFY08 (up 69bp QoQ), while loan yields increased 155bp to 10.26% YoY. A key reason for fall in margins has been a significant built up of term deposits base by the bank during 2QFY08.

NIM QOQ TRENDS (%)



	2QFY08	1QFY08	2QFY07	FY07
Cost of deposits	6.4	5.7	5.3	5.2
Yields on advances	10.3	10.0	8.7	9.0
Yield on investments	7.3	7.6	7.6	7.7
Net interest margins	2.6	3.1	2.8	3.1

TREND IN NII (%)



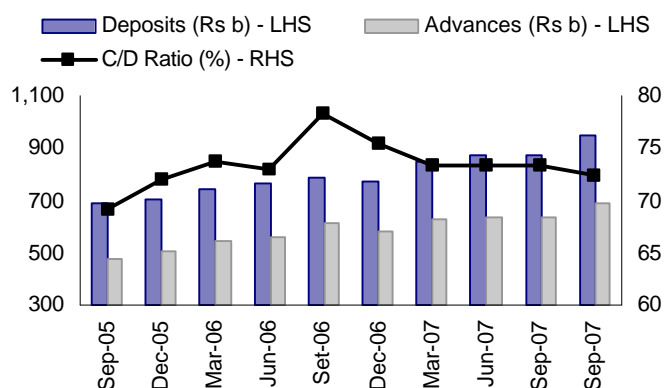
Source: Company/Motilal Oswal Securities

Advances growth lower on high base effect; core deposits pick up

The loan growth was 12% YoY to Rs686b (QoQ growth of 7%) on a higher base of September 2006. Management is restructuring its loan portfolio towards high yielding asset classes viz. SME and retail trade. SME advances grew 47% YoY to Rs106b while retail trade grew 21% to Rs73b. SME, agriculture, retail and infrastructure would be growth engines for credit growth.

Deposits grew 21% YoY to Rs948b (QoQ growth of 9%) while core retail deposits increased 24% YoY. The bank reduced the bulk deposit proportion to 19.1% from 21.5% a year ago and 21.9% a quarter ago. CASA ratio slipped QoQ to 32.5% from 33.3%. While current account growth is strong at 30% YoY for the bank (expected to sustain), savings bank account growth has been sluggish. Bank has announced a term deposits rate cut of 75-100bp across various maturities. The 9% scheme is continued for only 94 months tenure while shorter maturity deposit rates have been brought down to 8-8.25%.

SLOWER LOAN AND DEPOSIT GROWTH



Source: Company/Motilal Oswal Securities

The bank has built up significant liquidity during the quarter (Rs78b of total deposits raised - predominantly in non-bulk segment), which would enable it to abstain from raising high cost bulk deposits over the next two quarters. The management is optimistic of meeting its annual target of 25% credit growth (would mean Rs110b of incremental loan growth in 2HFY08 v/s Rs621b achieved in 1HFY08) and 23% deposit growth (would mean Rs102b of deposits

growth in 2HFY08 v/s Rs96b achieved in 1HFY08). This would lead to an incremental C-D ratio of 112% for 2HFY08. Management's endeavor in 2H FY08 would be to grow purely CASA deposits and low interest rate term deposits. We believe the stronger credit off take in 2HFY08 coupled with lower deposits growth (with lower cost of deposits) would lead to a margin improvement for the bank 3QFY08 onwards.

Strong growth in recoveries, treasury as well as fee income

Trading profits increased 113% YoY to Rs810m in 2QFY08. Recoveries from written off accounts increased 103% to Rs530m. Thus, overall other income grew 77% in 2QFY08. Excluding recoveries, trading profits and HTM amortization, core fee income growth was robust at 36% YoY to Rs1.74b. Management is hopeful of 30-35% growth in fee income for FY08. With a pool of Rs14b of written off accounts, recoveries are likely to remain strong in FY08. Management aims at a total other income of Rs10b for FY08 (Rs4.5b in 1HFY08), which implies a YoY growth of 46%. Other income growth in 1HFY08 has been 61% YoY.

NON INTEREST INCOME YOY (RS M)

	2Q FY08	2Q FY07	GR. YOY %	1H FY08	1H FY07	GR. YOY %
Fee income	1,738	1,280	36	3,352	2,258	31
Trading income*	440	(14)	NM	400	(120)	NM
Recovery from w/o accounts	530	260	104	740	350	206
Total non int. inc.	2,708	1,528	77	4,492	2,788	61

*Including amortization loss

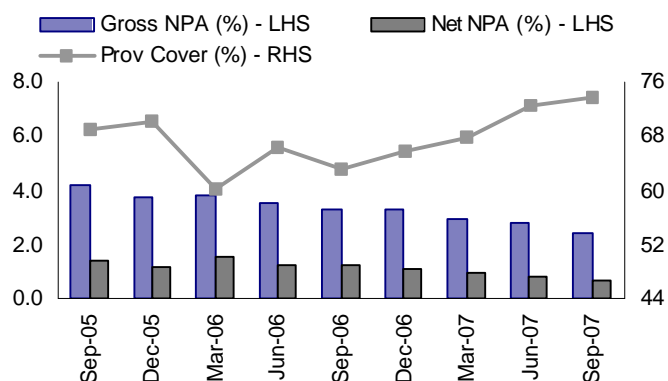
Source Company/MOSL

Asset quality improves further

Asset quality has improved further with net NPAs at 0.65% (13bp decline QoQ) and Gross NPAs at 2.42% (36bp decline QoQ). NPA coverage increased to 74% from 63% a year ago. In absolute numbers, Gross advances declined 6% and Net NPAs declined 10% on QoQ basis. Management expects Gross NPA ratio to be ~2% and Net NPA ratio to fall to 0.5% by FY08. It aims to contain slippages ratio to

1.25% in FY08 as it believes it has substantially improved its risk assessment and credit control processes and systems.

MOVEMENT OF NPAs (%)



Source: Company/Motilal Oswal Securities

Tier I at 7.6%

CAR has increased to 11.6% from 10.8% a year ago, while Tier I CAR has increased to 7.4% from 7.0% a year ago. Management mentioned that it has enough headroom to raise this capital through bonds, innovative instruments and retained profits to sustain 25% credit growth in FY08 without diluting equity. Management plans to issue Rs3b of Tier II bonds during 2HFY08 out of its head room availability of Rs140b for the bank.

Strong earnings growth, Maintain Buy

Strong fee income growth, margins stability with steady asset growth and improving asset quality are the key strengths of Union Bank. While margins have disappointed in 2QFY08, we believe performance would improve in 2HFY08. the management has reiterated its strong operating performance guidance of 1%+ RoA, 20%+ RoE, ~3% NIM and 30-35% growth in fee income for FY08. We expect earnings to grow 26% in FY08 and 23% in FY09 for the bank. We have built in pressure on margins during FY08 getting offset by strong traction in non interest income. We like management's endeavor to achieve a profitable and qualitative asset growth. Union Bank trades at 6.2x FY09E EPS and 1.2x FY09E BV. **Maintain Buy.**

Union Bank of India: an investment profile

Company description

Union Bank is among the large state-owned banks with a balance sheet size of over Rs950b+. While the bank is based in western India, its branch network of over 2,200 branches and ~770 ATMs is well spread countrywide. Currently, ~80% of its business is covered under CBS.

Key investment arguments

- ✍ Improved focus on margins and profitability.
- ✍ Well spread branch network across India.
- ✍ Strong and expanding technology platform to ensure robust fee income going forward.

Key investments risks

- ✍ Management's inability to increase asset growth without losing margins.
- ✍ Reversal of asset quality improvement being witnessed currently.

Recent developments

- ✍ Union Bank, Bank of India and Japanese company Dai Ichi Mutual Life Insurance have entered a joint venture to form a life insurance company in which Union Bank would hold 23% stake.
- ✍ UBI recently raised Rs10.5b by way of upper tier 2 and hybrid tier 1 issue.
- ✍ Bank has opened its first overseas representative office at Shanghai, China in May 2007.

Valuation and view

- ✍ We expect earnings to grow 26% in FY08 and 23% in FY09. Stronger momentum in core earnings will result in better valuations for the stock.
- ✍ The stock is trades at 1.2x FY09E BV of 6.2x FY09E earnings.

Sector view

- ✍ YTD loan growth of 22% and deposit growth of 23%.
- ✍ Macro economic factors remain conducive for strong profitable growth for Indian banks.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

COMPARATIVE VALUATIONS

		UBI	BOB	BOI
P/E (x)	FY08E	7.6	8.8	10.5
	FY09E	6.2	7.3	8.8
P/ABV (x)	FY08E	1.6	1.2	2.3
	FY09E	1.3	1.1	1.9
RoE (%)	FY08E	20.7	13.6	22.2
	FY09E	21.7	14.7	22.1
RoA (%)	FY08E	0.9	0.8	0.9
	FY09E	1.0	0.8	0.9

SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	55.4	55.4	55.4
Domestic Inst	11.5	10.9	8.8
Foreign	19.7	19.7	19.9
Others	13.4	14.0	15.9

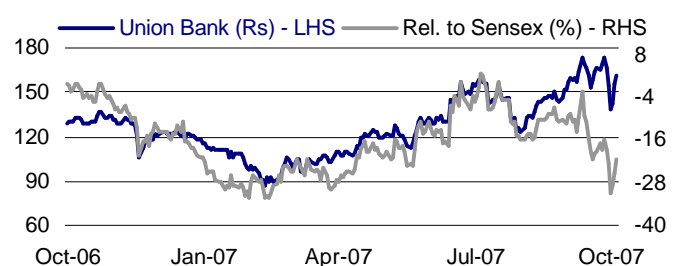
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	21.1	21.8	-3.3
FY09	25.9	25.4	2.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
161	181	12.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E March	2006	2007	2008E	2009E	
Interest Income	58,638	73,822	92,914	114,302	
Interest Expended	34,894	45,920	62,292	76,523	
Net Interest Income	23,743	27,902	30,622	37,778	
Change (%)	5.0	17.5	9.7	23.4	
Other Income	4,945	6,865	8,722	9,765	
Net Income	28,688	34,768	39,344	47,543	
Change (%)	1.3	21.2	13.2	20.8	
Operating Expenses	14,024	14,759	17,013	19,698	
Operating Income	14,664	20,008	22,331	27,845	
Change (%)	-6.8	36.4	11.6	24.7	
Other Provisions	5,724	6,204	6,300	8,100	
PBT	8,940	13,804	16,031	19,745	
Tax	2,195	5,350	5,396	6,646	
Tax Rate (%)	24.5	38.8	33.7	33.7	
PAT	6,745	8,454	10,635	13,099	
Change (%)	-6.2	25.3	25.8	23.2	
Proposed Dividend	2,020	1,768	2,273	2,778	

BALANCE SHEET		(Rs Million)			
Y/E March	2006	2007	2008E	2009E	
Capital	5,051	5,051	5,051	5,051	
Reserves & Surplus	40,530	46,848	54,732	64,489	
Net Worth	45,581	51,899	59,783	69,541	
Deposits	740,940	851,802	1,039,199	1,226,254	
Change (%)	19.8	15.0	22.0	18.0	
Borrowings	39,745	42,155	48,479	53,326	
Other Liabilities & Prov.	64,992	80,923	102,772	130,520	
Total Liabilities	891,256	1,026,778	1,250,231	1,479,641	
Current Assets	63,905	84,264	99,090	120,299	
Investments	259,175	279,818	335,781	386,148	
Change (%)	13.7	8.0	20.0	15.0	
Advances	533,800	623,864	773,592	928,310	
Change (%)	33.1	16.9	24.0	20.0	
Net Fixed Assets	8,104	8,250	8,127	7,877	
Other Assets	26,275	30,582	33,641	37,005	
Total Assets	891,258	1,026,779	1,250,231	1,479,639	

ASSUMPTIONS	(%)			
Deposit Growth	19.8	15.0	22.0	18.0
Advances Growth	33.1	16.9	24.0	20.0
Investments Growth	13.7	8.0	20.0	15.0
Dividend	40.0	35.0	45.0	55.0

E: MOST Estimates

RATIOS		2006	2007	2008E	2009E
Spreads Analysis (%)					
Avg. Yield - Earning Assets		7.6	8.0	8.5	8.8
Avg. Cost-Int. Bear. Liab.		4.9	5.5	6.3	6.5
Interest Spread		2.7	2.5	2.3	2.3
Net Interest Margin		3.1	3.0	2.8	2.9

Profitability Ratios (%)		2006	2007	2008E	2009E
RoE		18.7	19.2	20.7	21.7
RoA		0.8	0.9	0.9	1.0
Int. Expended/Int. Earned		59.5	62.2	67.0	66.9
Other Inc./Net Income		17.2	19.7	22.2	20.5

Efficiency Ratios (%)		2006	2007	2008E	2009E
Op. Exps./Net Income		48.9	42.5	43.2	41.4
Empl. Cost/Op. Exps.		61.8	59.2	55.6	52.7
Busi. per Empl. (Rs m)		45.1	49.9	59.9	72.6
NP per Empl. (Rs lac)		2.7	3.1	3.9	4.8

Asset-Liability Profile (%)		2006	2007	2008E	2009E
Adv./Deposit Ratio		72.0	73.2	74.4	75.7
Invest./Deposit Ratio		35.0	32.9	32.3	31.5
G-Sec/Invest. Ratio		78.3	81.9	85.3	85.3
Gross NPAs to Adv.		3.8	2.9	2.4	2.4
Net NPAs to Adv.		1.6	1.0	0.6	0.6
CAR		11.4	12.8	12.0	11.0
Tier 1		7.3	7.8	7.0	6.5

VALUATION		2006	2007	2008E	2009E
Book Value (Rs)		81.0	93.7	109.5	129.0
Price-BV (x)		2.0	1.7	1.5	1.2
Adjusted BV (Rs)		70.3	86.0	103.7	122.0
Price-ABV (x)		2.3	1.9	1.6	1.3
EPS (Rs)		13.4	16.7	21.1	25.9
EPS Growth (%)		-14.5	25.3	25.8	23.2
Price-Earnings (x)		12.0	9.6	7.6	6.2
OPS (Rs)		29.0	39.6	44.2	55.1
OPS Growth (%)		-15.1	36.4	11.6	24.7
Price-OP (x)		5.5	4.1	3.6	2.9

E: MOST Estimates



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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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