

State Bank of India

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,742	SBIN IN
	REUTERS CODE
S&P CNX: 3,156	SBI.BO

27 July 2006

Buy
Previous Recommendation: Buy
Rs763

		YEAR	NET INCOME	PAT	EPS	CONS.	P/E	P/BV	CONS.	CAR	ROE	ROA
		END	(RS M)	(RS M)	(RS)	EPS (RS)	(X)	(X)	P/BV (X)	(%)	(%)	(%)
Equity Shares (m)	526.3	3/06A	230,243	44,067	83.7	107.6	9.1	1.5	1.1	11.9	17.0	0.9
52-Week Range	1,015/84	3/07E	235,622	45,426	86.3	114.0	8.8	1.3	0.9	10.5	15.4	0.9
1,6,12 Rel.Perf.(%)	-1/-25/-43	3/08E	270,808	52,163	99.1	139.2	7.7	1.1	0.8	10.4	15.6	0.9
M.Cap. (Rs b)	401.6											
M.Cap. (US\$ b)	8.6											

State Bank of India's 1QFY07 results were ahead of our estimates in core earnings, even as PAT growth was lower due to higher taxes. Adjusting for one-offs, NII grew by 10% YoY. However the key positive was a sharp margin improvement to 3.37% in 1Q, as loan yields improved. Balance sheet growth was muted for SBI, as it redeemed IMDs in December 2005 and did not chase bulk deposits to fund its loan book. Asset quality continued to improve with net NPAs declining further to 1.67% in 1QFY07.

- Balance sheet growth muted
- Adjusted NII (for tax refunds in 1QFY06) increased by 10% YoY
- Margins improved in 1QFY07 with improvement in loan yields
- Higher treasury gains YoY; fee income growth muted

Core business trend has improved with yield on advances higher and cost of deposits lower resulting in a margin expansion. We expect this trend to drive earnings going forward. Moreover, the bank should also benefit on lower opex cost and low provisioning requirements going forward. Tier I at 9% is comfortable and we do not expect any equity dilution in the near to medium term. We expect SBI to report consolidated EPS of Rs114 and book value of Rs804. The stock trades at P/E of 6.7x and P/BV of 0.95x FY07 earnings. We maintain **Buy**.

	QUARTERLY PERFORMANCE								(Rs Million)	
	FY06				FY07E				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Income	91,663	85,614	95,582	85,091	88,362	94,175	101,530	113,278	357,949	397,345
Interest Expenses	49,131	49,535	53,383	49,545	49,521	54,488	60,203	70,790	201,593	235,003
Net Interest Income	42,532	36,079	42,199	35,546	38,841	39,687	41,326	42,488	156,356	162,342
% Change (Y-o-Y)	44.0	6.8	15.3	-10.0	-8.7	10.0	-2.1	19.5	12.1	3.8
Other Income	15,766	12,946	18,404	26,770	17,626	13,076	16,355	26,223	73,886	73,280
Bond Gains	1,307	2,467	1,298	861	2,113	600	700	587	5,872	4,000
Net Income	58,298	49,026	60,603	62,316	56,467	52,763	57,681	68,710	230,242	235,622
% Change (Y-o-Y)	29.8	-2.6	2.8	10.5	-3.1	7.6	-4.8	10.3	9.3	2.3
Operating Expenses	23,903	29,197	34,607	29,544	28,101	30,656	33,051	36,971	117,251	128,780
Operating Profit	34,395	19,829	25,996	32,772	28,366	22,107	24,630	31,739	112,992	106,842
% Change (Y-o-Y)	66.0	-23.9	-23.3	12.1	-17.5	11.5	-5.3	-3.2	2.8	-5.4
Other Provisions	17,666	8,175	4,698	13,391	12,820	6,000	7,000	13,221	43,930	39,041
Provision for Taxes	4,501	-500	10,147	10,847	7,559	4,863	5,419	4,533	24,995	22,374
Net Profit	12,228	12,154	11,151	8,533	7,987	11,243	12,212	13,985	44,066	45,426
% Change (Y-o-Y)	15.5	12.3	1.4	-19.9	-34.7	-7.5	9.5	63.9	2.4	3.1
Cost to Income Ratio	41.0	59.6	57.1	47.4	49.8	58.1	57.3	53.8	50.9	54.7
Interest Exp / Interest Earned	53.6	57.9	55.9	58.2	56.0	57.9	59.3	62.5	56.3	59.1
Other Income / Net Income	27.0	26.4	30.4	43.0	31.2	24.8	28.4	38.2	32.1	31.1

E: MOSt Estimates

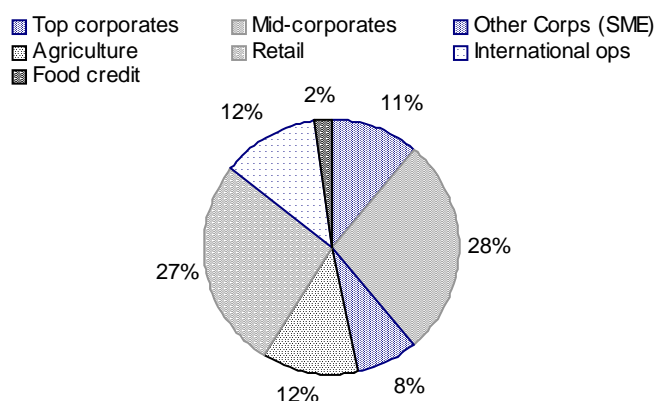
State Bank of India's 1QFY07 results were ahead of our estimates in core earnings, front, even as PAT growth was lower due to higher taxes. Adjusting for one-offs, NII grew by 10% YoY. However the key positive was a sharp margin improvement to 3.37% in 1Q, as loan yields improved. balance sheet growth was muted for SBI, as it redeemed IMDs in December 2005 and did not chase bulk deposits to fund its loan book. Asset quality continued to improve with net NPAs declining further to 1.67% in 1QFY07

Balance sheet growth muted

Balance sheet growth was muted as it paid off the IMDs (~Rs300b) in December 2005. Overall the bank deposits grew by 7% YoY, excluding IMDs, to Rs3,800b. The bank has not been chasing high cost bulk deposits which have resulted in slow deposit growth for the bank. CASA ratio however has improved from 38.3% to 42.7% YoY.

Advances have increased by 21% YoY to Rs2619b. Retail advances grew by 23% YoY. Housing constitutes 53% of retail credit. Advances on a QoQ basis, have largely remained flat as there was a seasonal decline in food credit. Additionally, exposure to corporates in 1QFY07 declined by Rs59b. Exposure to retail, SME and agri increased in 1QFY07, which has primarily resulted in higher loan yields.

BREAK-DOWN OF SBI'S LOAN BOOK AT 1QFY07



Source: Company /Motilal Oswal Securities

Adjusted NII (for tax refunds in 1QFY06) up 10% YoY

On a reported basis, NII declined by 9% YoY to Rs38.8b. However after, adjusting for tax refunds in 1QFY06, NII actually grew by 10% YoY. This was higher than our estimate of a 6% increase.

ADJUSTED NII (RSB)

	1QFY07	1QFY06	YOY (%)
Interest Income	88.4	91.7	-3.60
Interest Expenses	49.5	49.1	0.79
NII (reported)	38.8	42.5	-8.68
Less: IT refund	0	7.1	NA
NII	38.8	35.4	9.7

Source: Company /Motilal Oswal Securities

Margins improvement in 1QFY07 as loan yields improve

We believe the most important trend in SBI's results is growth in advances and yield on these loans. The yield on advances has improved by 69bp YoY in 1QFY07. The strong growth in loans along with better yields has resulted in a 38% growth in interest on loans in 1QFY07. Further, as SBI has increased its PLR (prime lending rate) by 50bp effective May 2006 (only two months effect in 1Q), lending yields are likely to expand further. Further the bank has been shedding its investment book to fund its loan book. This trend is positive as the bank has higher yields on loans, which will aid the bank in sustaining margins.

MOVEMENT OF YIELDS (YOY)

	1QFY06	FY06	1QFY07
Avg. Yield on Advances	7.8	7.8	8.5
Avg. Yield on Investments	7.8	7.1	7.2
Avg. Cost of Deposits	4.6	4.5	4.5
NIMs	3.1	2.9	3.4

Source: Company /Motilal Oswal Securities

Overall, while we believe that the current margins might decline marginally as the bank starts building up its balance sheet, adjusted margins are likely to be much better than FY06 adjusted margins of 2.92%.

Higher treasury gains; fee income growth muted

Other income increased by 12%, led by strong growth in treasury income. Treasury income increased from Rs1.3b in 1QFY06 to Rs2.1b in 1QFY07. Core fee income growth

was muted at 4% YoY to Rs7.6b, while foreign exchange income grew by 21% YoY to Rs1.04b in 1QFY07.

Fees on government business had declined sharply from 2QFY06. This resulted in a lower base for the next couple of quarters. With the change in government fee payments and increase in service charges, fee income growth is likely to be strong from 2QFY07 onwards.

High provisions result in lower earnings

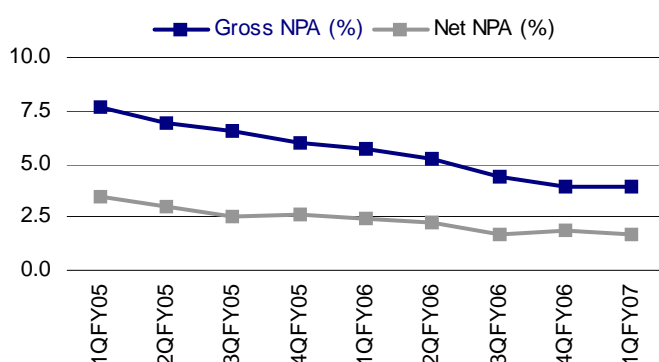
Provisions were higher on account of higher amortization and redemption provisions (Rs7.5b), HTM transfer hit (Rs2b) and MTM provisioning (Rs1.5b). Going forward, we expect provisions to decline which should result in stronger earnings, as the bank will tend to book only amortization expenses (in the range of Rs5b-Rs6b per quarter).

High tax rates of 49%, resulted in PAT being lower than our estimates. SBI is known to have volatile tax rates and we expect tax rates to moderate in the following quarters. Overall, for FY07, we expect a 32% tax rate for SBI.

Net NPAs at 1.67%

Net NPAs declined during 1QFY07 to 1.69% (QoQ decline of 18bp) from 2.44% in 1QFY06. The bank has used Rs2.5b of provision against restructured loans for its provisions against NPLs during the quarter. Gross NPAs also declined to 3.88% (stable QoQ) from 5.67% as incremental delinquencies continued to decline coupled with increased recoveries. Overall, we expect net NPAs to fall further to near 1% by March 08

TREND IN NPAS



Source: Company /Motilal Oswal Securities

Tier 1 capital of 9%, hybrid capital norms positive

Currently SBI has a total capital adequacy of 12% with a Tier 1 of 9%. This will ensure smooth compliance with the Basel 2 norms and will also enable the bank to grow its loan book comfortably without any capital dilution.

Further the current hybrid capital allowance by RBI is positive for the larger banks. SBI is likely to be a key beneficiary as it is best placed to raise resources through perpetual debt / preference shares at competitive rates in domestic as well as international markets. This should result in higher leverage and higher RoE going forward.

Post transfer in 1QFY07, HTM is 64% of the investment book

SBI has transferred securities worth Rs110b during 1QFY07 and has taken a hit of Rs2.0b. Post transfer, HTM currently is 64% of the investment book. Of the AFS book, the duration of the portfolio is less two years. While there is no cushion on the AFS book, it has been marked to market at the June yield of 8.12%. The mark-to-market losses are likely to be near Rs70m per bpof increase in interest rates.

Valuation and view

Core business trend has improved with yield on advances higher and cost of deposits being steady, resulting in margin expansion. We expect this trend to drive earnings going forward. Moreover, the bank should also benefit owing to lower opex cost and low provisioning requirement going forward. Tier I at 9% is comfortable. We do not expect any equity dilution in the near; to; medium term. We expect SBI to report consolidated EPS of Rs114 and book value of Rs804. The stock trades at P/E of 6.7x and P/BV of 0.95x FY07 earnings. We maintain **Buy**.

State Bank of India: an investment profile

Company description

State Bank of India (SBI) is the largest commercial bank in India, with a balance sheet size of over Rs4,700b. The bank, along with associate banks, has a network of over 13,000 branches across India and controls over 18% of the banking business. The government owns 57% of the bank, with FIIs owning 20% (maximum permissible is 20%). Over the last couple of years, SBI has been focusing drawing significant synergies through an internal consolidation of its associate banks.

Key investment arguments

- Proxy to Indian economy; will benefit from uptick in loan growth
- Significant repricing of funds will result in stable margins
- Associate banks have been performing well and add significant value
- Natural attrition will pull down operating costs significantly over the next 3-4 years

Key investment risks

- Significant rise in interest rates. The bank currently has 36% of its investment book in AFS
- Delay in technology upgradation could result in loss of market share

Recent developments

- Has divested 37% stake of its fully owned subsidiary, SBI Funds Management Pvt. Ltd. realizing a profit of Rs1.4b.
- SBI has appointed Infosys to network its overseas branches and TCS is networking the domestic branch network
- The bank has made clear its intention of acquiring banks both locally and overseas to strengthen its position

Valuation and view

- We expect loan growth, stable margins to drive earnings growth over the next few quarters. Cost efficiency and NPA recovery will be the next big triggers for earnings growth
- The stock trades at P/E of 6.7x FY07E cons. EPS and P/BV of 0.9x FY07E cons. BV. We maintain a **Buy**.

Sector view

- YTD loan growth of 30%+, highest in the last 12 years
- Volatility in interest rates will impact bond gains
- Benefits of significant improvement in asset quality not yet factored in earnings, valuations
- We maintain an Overweight stance on the sector

COMPARATIVE VALUATIONS

		SBI	PNB	BOB
P/E (x)	FY07E	8.8	7.3	7.9
	FY08E	7.7	5.9	6.7
P/ABV (x)	FY07E	1.4	1.1	0.9
	FY08E	1.2	1.0	0.8
RoE (%)	FY07E	15.4	15.6	11.8
	FY08E	15.6	16.7	12.7
RoA (%)	FY07E	0.9	1.0	0.8
	FY08E	0.9	1.1	0.9

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	59.7	59.7	59.7
Domestic Institutions	11.9	11.6	12.0
FIIs/FDIs	19.8	19.8	19.8
Others	8.6	8.9	8.5

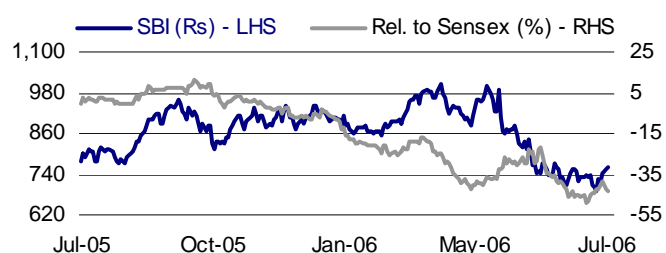
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	87.6	91.2	-4.0
FY08	99.1	107.3	-7.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
763	965	26.5	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E March	2005	2006	2007E	2008E	
Interest Income	324,280	357,949	397,345	467,466	
Interest Expended	184,834	201,593	235,003	278,441	
Net Interest Income	139,446	156,356	162,342	189,025	
Change (%)	24.7	12.1	3.8	16.4	
Other Income	71,199	73,887	73,280	82,028	
Profit on sale of investment	17,753	5,872	4,000	4,000	
Other non-interest income	53,446	68,015	69,280	78,028	
Net Income	210,645	230,243	235,622	271,053	
Change (%)	12.1	9.3	2.3	15.0	
Operating Expenses	100,742	117,251	128,780	143,045	
Employee expense	69,073	81,230	83,494	89,235	
Operating Income	109,904	112,992	106,842	128,008	
Change (%)	15.0	2.8	-5.4	19.8	
Provisions & contingencies	44,688	43,931	39,041	41,919	
Provision for NPAs	12,040	1478	6,541	9,419	
PBT	65,216	69,062	67,801	86,089	
Tax	22,171	24,995	22,374	33,927	
PAT	43,045	44,067	45,426	52,163	
Change (%)	16.9	2.4	3.1	14.8	
Proposed Dividend	7,516	8,402	7,894	8,947	

BALANCE SHEET		(Rs Million)			
Y/E March	2005	2006	2007E	2008E	
Capital	5,263	5,263	5,263	5,263	
Reserves & Surplus	235,458	271,178	307,723	349,820	
Net Worth	240,721	276,441	312,986	355,083	
Deposits	3,670,475	3,800,461	4,351,527	4,960,741	
Change (%)	15.2	3.5	14.5	14.0	
Borrowings	191,843	306,412	352,374	405,230	
Other Liabilities & Prov.	495,790	555,384	583,152	612,309	
Total Liabilities	4,598,829	4,938,696	5,600,039	6,333,363	
Current Assets	393,221	445,600	397,901	396,601	
Investments	1,970,979	1,625,342	1,787,877	1,930,907	
Change (%)	6.2	-17.5	10.0	8.0	
Advances	2,023,745	2,616,415	3,139,698	3,704,844	
Change (%)	28.1	29.3	20.0	18.0	
Net Fixed Assets	26,977	27,529	28,373	30,335	
Other Assets	183,907	223,808	246,189	270,808	
Total Assets	4,598,829	4,938,696	5,600,039	6,333,495	

ASSUMPTIONS	(%)			
Deposit Growth	15.2	3.5	14.5	14.0
Advances Growth	28.1	29.3	20.0	18.0
Investments Growth	6.2	-17.5	10.0	8.0
Dividend	125.0	140.0	150.0	170.0
CRR	5.0	5.0	5.0	5.0

E: M OSt Estimates

RATIOS		2005	2006	2007E	2008E
Y/E March					
Spreads Analysis (%)					
Avg. Yield - Earning Assets		7.9	7.9	7.9	8.1
Avg. Cost-Int. Bear. Liab.		5.1	5.1	5.3	5.5
Interest Spread		2.7	2.9	2.6	2.6
Net Interest Margin		3.4	3.5	3.2	3.3

Profitability Ratios (%)		2005	2006	2007E	2008E
RoE		19.4	17.0	15.4	15.6
RoA		1.0	0.9	0.9	0.9
Int. Expended/Int. Earned		57.0	56.3	59.1	59.6
Other Inc./Net Income		33.8	32.1	31.1	30.3

Efficiency Ratios (%)		2005	2006	2007E	2008E
Op. Exps./Net Income		47.8	50.9	54.7	52.8
Empl. Cost/Op. Exps.		68.6	69.3	64.8	62.4
Busi. per Empl. (Rs m)		25.4	30.5	35.7	42.3
NP per Empl. (Rs lac)		2.1	2.2	2.3	2.7

Asset-Liability Profile (%)		2005	2006	2007E	2008E
Adv./Deposit Ratio		55.1	68.8	72.2	74.7
Invest./Deposit Ratio		53.7	42.8	41.1	38.9
G-Sec/Invest. Ratio		88.9	85.0	85.0	85.0
Gross NPAs to Adv.		6.0	3.9	2.8	2.2
Net NPAs to Adv.		2.6	1.9	1.5	1.2
CAR		12.5	11.9	10.5	10.4
Tier 1		8.0	9.4	7.9	7.6

VALUATION		2005	2006	2007E	2008E
Book Value (Rs)		457.4	525.3	594.7	674.7
Price-BV (x)		1.7	1.5	1.3	1.1
Adjusted BV (Rs)		391.3	464.7	536.6	618.4
Price-ABV (x)		1.9	1.6	1.4	1.2
EPS (Rs)		81.8	83.7	86.3	99.1
EPS Growth (%)		16.9	2.4	3.1	14.8
Price-Earnings (x)		9.3	9.1	8.8	7.7
OPS (Rs)		208.8	214.7	203.0	243.2
OPS Growth (%)		15.0	2.8	-5.4	19.8
Price-OP (x)		3.7	3.6	3.8	3.1

E: M OSt Estimates



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Disclosure of Interest Statement

State Bank of India

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

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