CANARA BANK

12 January, 2009

Management Meet Note; Improving core operations; Valuations extremely attractive; BUY We met the management of Canara Bank (CBK IN, Mkt Cap US$1.8b, CMP Rs206, Buy)

Key takeaways:

- Business growth accelerated after balance sheet restructuring exercise was completed in FY08. Management guided for loan growth of 25%+ and deposit growth of ~23% in FY09.
- Margin expansion is expected to continue and NIM is expected to stabilize at ~2.75% vs 2.4% in FY08 and 2.7% in 1HFY09.
- Earnings traction to remain strong on the back of improvement in core operations, strong trading profits and higher recoveries.
- Asset quality to remain strong as the management aims to continue with the policy of aggressive write offs and is targeting Gross NPA of 1.5%.

Strong business growth:

- Management highlighted that the balance sheet restructuring exercise is over and the bank is growing aggressively loan growth of 28% YoY and deposit growth of 22% YoY in 3QFY09.
- In FY08, CBK undertook the balance sheet restructuring exercise by cutting share of high cost bulk deposits and share of the low yielding loans. In FY08, total business grew by just 9%.
- In 1HFY09, loan book grew 25% YoY and Deposits grew 18% YoY. Management guided for loan growth of 25% and deposit growth of ~23% YoY in FY09. The bank has the liberty to choose its customers in the current environment and has exercised its pricing power. The bank is not willing to compromise on quality of loan book and margins to increase its balance sheet size.
- Focus on low cost deposits remains in a bid to contain cost of funds. In 1HFY09, low cost deposits grew 23% YoY and CASA ratio improved to 32% vs 30.7% in 1HFY08.

Margins expansion to continue:

- As the balance sheet restructuring exercise is over in FY08, the share of high yielding loans in total loan book is rising. Also fall in the share of bulk deposits and increased share of low cost deposits will help the bank to improve margins. Yield on loans improved from 10% in 1QFY08 to 10.5% in 1HFY09 whereas, cost of deposits increased only by 9bp to 6.6% from 6.51%. NII grew 29% YoY in 1HFY09.
- NIM has improved from 2.36% in 1HFY08 to 2.7% in 1HFY09. Management expects 3QFY09 NIMs to be even higher, with NIMs stabilising ~2.75-2.8% over the next few years. We model NIM (calculated) improvement of 27bp YoY in FY09 to 2.54%.
- CBK has cut its peak deposit rates by 150bp to 9% effective Jan 1, 2009 and has guided for further fall in 4QFY09 cost of deposits.

Strong earnings growth expected:

- Management expects net profit of ~Rs20b in FY09 (28% YoY growth) despite making higher provisions for NPA and provisions for likely wage increase of Rs550-600m.
- Earnings growth would be driven by: 1) Strong growth in NII backed by improving margins (~2.75%) coupled with the robust growth of 25%+ YoY in loans book; 2) Fee income to grow at 20-25% (grew ~16% in 1HFY09), 3) Strong bond gains (MTM and realized) and 4) Strong recoveries from written off accounts.

Asset quality manageable:

- CBK has one of the best asset quality among PSU banks with Gross NPA of 1.3%. However, its provision coverage ratio is one of the lowest in the industry at 32% (Net NPA of 0.9%) as the bank follows a policy of writing off of loans (leading to lower tax rate for the bank).
- CBK has total written off accounts of ~Rs40b as of Sep-08 and expects recoveries to remain strong. In 1HFY09, CBK recovered Rs1.4b as recoveries from written off accounts.
- In FY09, an infrastructure project exposure of Rs3.5b will be classified as NPA as per RBI directive. This may lead to spike in Gross NPAs (Rs15.7b as of Sep-08) in 2HFY09. Still, CBK is targeting Gross NPA of 1.5% as it will write off NPAs aggressively.
- Slippages are expected to rise in FY10 due to slow down in the economy.

We model Slippage ratio to rise to 2% in FY09 and 3% in FY10 vs 1.5% in FY08. We model Provision coverage ratio of 35% over FY09-10 and the credit cost for the bank to increase to 1.1% in FY09 and 1.15% in FY10 vs 0.9% in FY08.

Unrealized gains on investment book will provide cushion against higher NPAs:

- CBK has a total investment book of ~Rs524b, of which ~ 71% (Rs 375b) is HTM category and the balance 29% (~Rs145b) is AFS / HFT category. Duration of the overall investment book is 4.15 years and the duration of AFS book is 1.48 years. Excess SLR ratio is 1.5% of the book.
- Total unrealized gains could be ~Rs40b (Rs95/share) in HTM book (based on the yields on Dec 30, 2008. We believe that strong gains in investment book will provide cushion for higher NPA provisions, going forward.

Comfortable capital adequacy:

- CBK has comfortable CAR of 13.2% as on 1HFY09 though Tier I CAR is lower at 7.2%. CBK has headroom to raise Rs14.5b under Tier II bonds to fund growth.
- We believe that the internal accrual coupled with headroom to raise Tier II bonds will fund balance sheet growth till FY11. Capital dilution will come only in FY11 to take care of balance sheet growth, in our view. Further, CBK has GoI holding of ~73%, one of the highest in the listed PSU banking space.

Extremely attractive valuations:

- We expect earnings growth to remain strong on the back of the strong improvement in core operation and higher earnings from trading profits / recoveries. While we expect NPA provisions to increase by 30% YoY over FY09-FY10, trading profits cushion the same.
- Overall, we expect CBK to sustain RoA of 1% and RoE of 20%+ over FY09-10.We will review our estimates post 3QFY09 results. Based on our current estimates, we expect CBK to report EPS and BV of Rs48 and Rs238 respectively in FY09 and Rs52 and Rs277 respectively in FY10.
- CBK trades at a PE of 4x and P/B of 0.7x FY10E, which is extremely attractive. CBK remains one of our top picks in PSU banking space due to a) visible improvement in core operations, b) huge unrealized investment gains (our estimate of Rs50b+ or Rs95/share) available to withstand slippage in asset quality, c) superior return ratios (RoE of 20%) and attractive valuation of 0.9x FY09 BV. Maintain Buy with the target price of Rs277(1x FY10E BV), an upside of 35%.