

## Karnataka Bank

STOCK INFO.	BLOOMBERG
BSE SENSEX: 10,809	KBL IN
	REUTERS CODE
S&P CNX: 3,210	KBNK.BO

26 May 2006

Buy

Rs99

*Previous Recommendation: Buy*

Equity Shares (m)	121.3
52-Week Range	137/76
1,6,12 Rel.Perf.(%)	10/-25/-38
M.Cap. (Rs b)	12.0
M.Cap. (US\$ b)	0.3

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
3/06A	5,328	1,760	14.5	19.6	6.8	1.1	11.8	16.8	1.3	1.1
3/07E	5,965	2,079	17.1	18.1	5.8	0.9	10.8	17.3	1.3	1.0
3/08E	6,928	2,425	20.0	16.7	5.0	0.8	10.0	17.6	1.3	0.8

Karnataka Bank witnessed strong business growth in FY06, with the loan book expanding 24% and deposits growing 22%. NII increased by 21% YoY to Rs1b in 4QFY06. Asset quality has improved, with net NPAs now at 1.2%. For FY06, NII grew 16% and lower provisions due to improved asset quality enabled the bank to report a net profit growth of 20% to Rs1.8b.

- ✍ NII grows by 21% in 4QFY06; 16% in FY06
- ✍ Loans grow by 24%; deposits by 22%
- ✍ Other income declines, as treasury income falls
- ✍ Improving asset quality – net NPAs decline to 1.18%

Steady growth in balance sheet, leading to higher NII and lower provisioning, would drive the bank's earnings going forward. We expect earnings growth of 18% in FY07, followed by a growth of 17% in FY08. The stock trades at 5.8x FY07E earnings and 0.9x on FY07E book value. We maintain our **Buy** recommendation.

QUARTERLY PERFORMANCE	(RS MILLION)									
	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Income	2,077	2,121	2,134	2,067	2,406	2,400	2,664	2,709	8,399	10,180
Interest Expense	1,537	1,174	1,289	1,231	1,499	1,637	1,687	1,698	5,230	6,521
<b>Net Interest Income</b>	<b>541</b>	<b>947</b>	<b>845</b>	<b>836</b>	<b>908</b>	<b>763</b>	<b>978</b>	<b>1,011</b>	<b>3,169</b>	<b>3,659</b>
% Change (Y-o-Y)	32.9	74.5	36.6	47.7	67.9	-19.4	15.6	20.9	48.3	15.5
Other Income	1,049	311	467	385	477	452	367	372	2,211	1,668
<b>Net Income</b>	<b>1,589</b>	<b>1,258</b>	<b>1,312</b>	<b>1,222</b>	<b>1,385</b>	<b>1,215</b>	<b>1,345</b>	<b>1,383</b>	<b>5,380</b>	<b>5,327</b>
% Change (Y-o-Y)	6.3	4.5	10.8	27.9	-12.8	-3.4	2.5	13.2	11.2	-1.0
Operating Expenses	417	474	562	520	506	562	562	415	1,973	2,045
<b>Operating Profit</b>	<b>1,172</b>	<b>783</b>	<b>750</b>	<b>701</b>	<b>879</b>	<b>652</b>	<b>782</b>	<b>968</b>	<b>3,407</b>	<b>3,282</b>
Other Provisions	661	224	168	-48	230	32	128	202	1,005	592
Tax Provisions	124	247	213	347	233	203	240	256	931	931
<b>Net Profit</b>	<b>387</b>	<b>313</b>	<b>369</b>	<b>403</b>	<b>417</b>	<b>417</b>	<b>415</b>	<b>510</b>	<b>1,471</b>	<b>1,760</b>
% Change (Y-o-Y)	12.3	-9.1	1.2	47.2	7.6	33.4	12.6	26.7	10.5	19.6
Cost to Income Ratio (%)	26.2	37.7	42.8	42.6	36.5	46.3	41.8	30.0	36.7	38.4
Interest Expense/Interest Income (%)	74.0	55.4	60.4	59.5	62.3	68.2	63.3	62.7	62.3	64.1
Other Income/Net Income (%)	66.0	24.7	35.6	31.5	34.5	37.2	27.3	26.9	41.1	31.3

E: MOST Estimates

Karnataka Bank witnessed strong business growth in FY06, with the loan book expanding 24% and deposits growing 22%. NII increased by 21% YoY to Rs1b in 4QFY06. Asset quality has improved, with net NPAs now at 1.2%. For FY06, NII grew 16% and lower provisions due to improved asset quality enabled the bank to report a net profit growth of 20% to Rs1.8b.

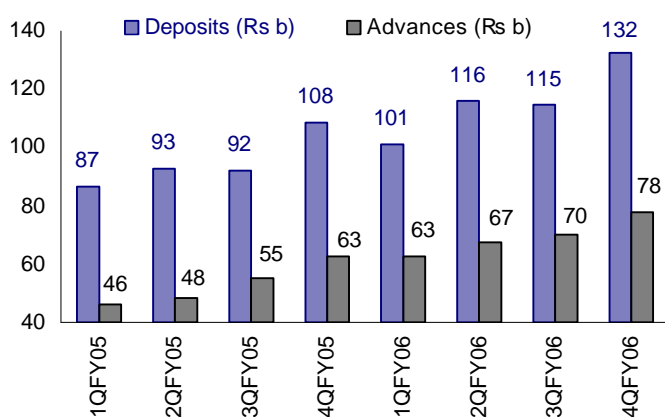
**NII grows by 21% in 4QFY06; 16% in FY06**

Karnataka Bank’s NII grew 21% YoY in 4QFY06 and 16% in FY06, on the back of steady growth in advances and deposits. NIMs, however, declined by 8bp in FY06 to 2.66%, as investment yields came under pressure and there was a marginal increase in the cost of deposits. Yields on advances increased to 8.86% in FY06 from 8.81% in FY05, while yields on investments declined to 7.42% from 8.02%. Cost of deposits has increased by 9bp to 5.77% in FY06. The management has indicated that during FY07, the bank is targeting a margin of 2.75%, which will be driven by higher yield on advances.

**Loans grow by 24%; deposits by 22%**

The bank has done extremely well on the business front, with the loan book expanding by 24% to Rs77.9b as at end-FY06. This strong expansion has been driven by a strong growth in retail, SME and the agricultural segment. Deposits have grown by 22% in FY06 to Rs132b.

TREND IN BUSINESS GROWTH



Source: Company / Motilal Oswal Securities

**Other income declines, as treasury income falls**

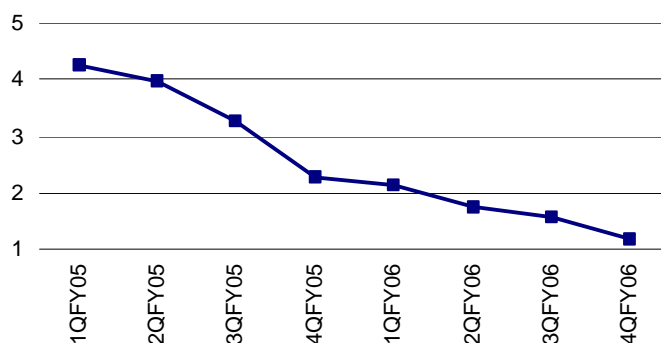
Trading income declined by 44% in FY06 to Rs779m, while non-interest other income increased by a modest 7% to Rs889m. For 4QFY06, treasury gains were only Rs100m, as compared to Rs179m in 4QFY05. Non-interest income excluding treasury grew 31% YoY in 4QFY06, as commission income increased and recoveries were strong.

As at end-FY06, the bank’s investment book stood at Rs56b. About 40% of the investment book was in HTM. The AFS book had a modified duration of 3.77 years. The management is comfortable with the current AFS book, which has a cushion of approximately 10bp from the current 10-year G-Sec yield of 7.6%.

**Improving asset quality – net NPAs decline to 1.18%**

The bank has maintained its trend of improving NPAs QoQ. Net NPAs have declined to 1.18% during 4QFY06 from 1.56% in 3QFY06. Even on an absolute basis, net NPAs have declined by 16% QoQ to Rs915m in 4QFY06. The bank intends to restrict slippages to just 0.5% of advances going forward, and expects net NPAs of <0.75% by FY07. Provision coverage stood at 78% as at end-FY06.

TREND IN NPAS



Source: Company / Motilal Oswal Securities

**Operating expenses declined sharply in 4QFY06**

Karnataka Bank’s operating expenses declined by 20% in 4QFY06, as staff expenses declined by 47% during the

same period. The decline was due to earlier quarters having higher wage arrears and provision for pensions. The bank did not have any need for additional pension provision resulting in lower employee expense in 4QFY06. In FY07, the management has guided for a 10%-12% increase in employee expenses.

### **Technology upgradation on track**

The bank has networked 319 offices under Core Banking Solution (CBS) with business coverage of 95%. The bank has 395 branches, which it plans to increase to 415 during FY07. It plans to concentrate on opening branches in the

Northern and North Eastern parts of the country during FY07. ATM outlets would be increased to 125. We believe that with expanding network, the bank will be able to attract higher business and commensurately higher fee income.

### **Valuation and view**

Steady growth in balance sheet, leading to higher NII and lower provisioning, would drive the bank's earnings going forward. We expect earnings growth of 18% in FY07, followed by a growth of 17% in FY08. The stock trades at 5.8x FY07E earnings and 0.9x on FY07E book value. We maintain our **Buy** recommendation.

## Karnataka Bank: an investment profile

### Company description

Karnataka Bank is amongst the largest old generation private sector banks, with dominance in the Southern and Western parts of India. It is a mid-sized bank, with a network of 395 branches and a balance sheet size of over Rs150b. Karnataka Bank is amongst the cheapest stocks in our banking universe and offers a strong play on loan growth, improving asset quality and consolidation.

### Key investment arguments

- ✍ Trading at extremely attractive valuations.
- ✍ Structural improvement in core business.
- ✍ Improved asset quality; set to get better.
- ✍ Could emerge as a play on the M&A space.

### Key investment risks

- ✍ Any significant upmove in the interest rates could adversely impact the bond portfolio.
- ✍ Slowdown of the economy could hurt the bank's asset quality.

#### COMPARATIVE VALUATIONS

		KARNATAKA BK	J&K	ICICI BK
P/E (x)	FY07E	5.8	8.0	16.0
	FY08E	5.0	6.3	12.6
P/ABV (x)	FY07E	1.0	1.0	2.1
	FY08E	0.8	0.9	1.8
RoE (%)	FY07E	17.3	12.6	13.3
	FY08E	17.6	14.4	15.0
RoA (%)	FY07E	1.3	0.8	1.1
	FY08E	1.3	0.9	1.1

#### SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	0.0	0.0	0.0
Domestic Institutions	7.7	7.6	3.4
FII's/FDIs	19.2	17.8	4.5
Others	73.1	74.6	92.1

### Recent developments

- ✍ Karnataka Bank has indicated its willingness to pick up an equity stake in the general insurance venture proposed by the public sector Allahabad Bank.

### Valuation and view

- ✍ The bank has witnessed strong growth in its core earnings in FY06, which is likely to continue, as NII grows and lower incremental provisions for NPAs are required due to improving asset quality.
- ✍ The stock trades at 5.8x FY07E earnings and 0.9x FY07E book value.
- ✍ We maintain **Buy**.

### Sector view

- ✍ Loan growth of 30% in FY06; likely to remain strong in FY07.
- ✍ Volatility in interest rates would impact treasury income.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

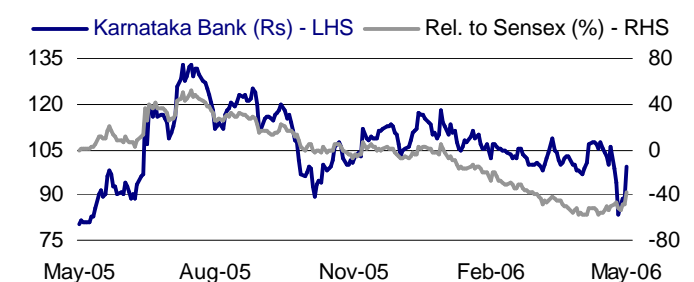
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	17.1	-	-
FY08	20.0	-	-

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
99	144	45.1	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E March	2004	2005	2006	2007E	2008E	
Interest Income	8,484	8,399	10,180	12,311	14,599	
Interest Expended	6,348	5,230	6,521	7,965	9,480	
<b>Net Interest Income</b>	<b>2,137</b>	<b>3,169</b>	<b>3,660</b>	<b>4,346</b>	<b>5,119</b>	
Change (%)	38.0	48.3	15.5	18.8	17.8	
Other Income	2,703	2,211	1,668	1,618	1,809	
<b>Net Income</b>	<b>4,840</b>	<b>5,380</b>	<b>5,328</b>	<b>5,965</b>	<b>6,928</b>	
Change (%)	22.8	112	-10	12.0	16.1	
Operating Expenses	1,542	1,973	2,045	2,258	2,562	
<b>Operating Income</b>	<b>3,298</b>	<b>3,407</b>	<b>3,283</b>	<b>3,707</b>	<b>4,366</b>	
Change (%)	30.2	3.3	-3.6	12.9	17.8	
Other Provisions	1,283	1,005	592	650	800	
<b>P B T</b>	<b>2,015</b>	<b>2,402</b>	<b>2,691</b>	<b>3,057</b>	<b>3,566</b>	
Tax	683	931	931	978	1,141	
Tax Rate (%)	33.9	38.8	34.6	32.0	32.0	
<b>P A T</b>	<b>1,332</b>	<b>1,471</b>	<b>1,760</b>	<b>2,079</b>	<b>2,425</b>	
Change (%)	20.9	10.5	19.6	18.1	16.7	
Proposed Dividend	182	277	364	424	485	

BALANCE SHEET		(Rs Million)				
Y/E March	2004	2005E	2006E	2007E	2008E	
Capital	404	1,213	1,213	1,213	1,213	
Reserves & Surplus	6,577	8,568	9,964	11,619	13,559	
<b>Net Worth</b>	<b>6,982</b>	<b>9,780</b>	<b>11,177</b>	<b>12,831</b>	<b>14,771</b>	
<b>Deposits</b>	<b>94,069</b>	<b>108,370</b>	<b>132,430</b>	<b>150,970</b>	<b>173,616</b>	
Change (%)	13.4	15.2	22.2	14.0	15.0	
Borrowings	1,833	2,437	3,655	4,569	5,711	
Other Liabilities & Prov.	2,883	4,680	5,943	7,548	9,586	
<b>Total Liabilities</b>	<b>105,766</b>	<b>125,267</b>	<b>153,205</b>	<b>175,918</b>	<b>203,683</b>	
Current Assets	7,493	13,725	16,136	17,865	20,222	
Investments	48,789	45,557	55,530	58,862	64,748	
Change (%)	10.1	-6.6	21.9	6.0	10.0	
Advances	46,679	62,874	77,920	95,062	114,075	
Change (%)	19.7	34.7	23.9	22.0	20.0	
Net Fixed Assets	932	966	1,259	1,532	1,783	
Other Assets	1,873	2,145	2,360	2,596	2,855	
<b>Total Assets</b>	<b>105,766</b>	<b>125,267</b>	<b>153,205</b>	<b>175,918</b>	<b>203,683</b>	

ASSUMPTIONS	(%)				
Deposit Growth	13.4	15.2	22.2	14.0	15.0
Advances Growth	19.7	34.7	23.9	22.0	20.0
Investments Growth	10.1	-6.6	21.9	6.0	10.0
Dividend Yield (%)	3.5	2.0	3.0	3.5	4.0
Dividend	35.0	20.0	30.0	35.0	40.0
CRR	4.5	5.0	5.0	5.0	5.0

E: Most Estimates

RATIOS		2004	2005E	2006E	2007E	2008E
<b>Spreads Analysis (%)</b>						
Avg. Yield - Earning Asset:	8.9	7.5	7.6	7.7	7.9	
Avg. Cost-Int. Bear. Liab.	7.0	5.1	5.3	5.5	5.7	
Interest Spread	18	2.4	2.3	2.3	2.3	
Net Interest Margin	2.2	2.8	2.7	2.7	2.8	
<b>Profitability Ratios (%)</b>						
RoE	20.8	17.6	16.8	17.3	17.6	
RoA	13	13	13	13	13	
Int. Expended/Int. Earned	74.8	62.3	64.1	64.7	64.9	
Other Inc./Net Income	55.8	41.1	31.3	27.1	26.1	
<b>Efficiency Ratios (%)</b>						
Op. Exps./Net Income	31.9	36.7	38.4	37.9	37.0	
Empl. Cost/Op. Exps.	61.0	63.4	56.8	57.0	58.1	
Busi. per Empl. (Rs m)	30.5	35.5	42.4	49.1	55.6	
NP per Empl. (Rs lac)	3.1	3.3	3.9	4.5	5.1	

Asset-Liability Profile (%)		2004	2005E	2006E	2007E	2008E
Adv./Deposit Ratio	49.6	58.0	58.8	63.0	65.7	
Invest./Deposit Ratio	51.9	42.0	41.9	39.0	37.3	
G-Sec/Invest. Ratio	61.7	74.7	74.7	74.7	74.7	
Gross NPAs to Adv.	11.9	7.6	5.1	4.2	3.5	
Net NPAs to Adv.	5.0	2.3	1.2	0.9	0.5	
CAR	13.0	14.2	11.8	10.8	10.0	
Tier 1	10.4	12.2	11.3	9.8	9.0	

VALUATION		2004	2005E	2006E	2007E	2008E
Book Value (Rs)	172.7	80.7	92.2	105.8	121.8	
Price-BV (x)	0.6	12	1.1	0.9	0.8	
Adjusted BV (Rs)	135.5	73.0	87.3	101.5	118.6	
Price-ABV (x)	0.7	14	1.1	1.0	0.8	
EPS (Rs)	32.9	12.1	14.5	17.1	20.0	
EPS Growth (%)	20.9	-63.2	19.6	18.1	16.7	
Price-Earnings (x)	3.0	8.2	6.8	5.8	5.0	
OPS (Rs)	816	28.1	27.1	30.6	36.0	
OPS Growth (%)	30.1	-65.5	-3.6	12.9	17.8	
Price-OP (x)	12	3.5	3.7	3.2	2.8	

E: Most Estimates



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**Karnataka Bank**

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

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