



## Indian Overseas Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,962	IOB IN
	REUTERS CODE
S&P CNX: 3,744	IOBK.BO

31 October 2006

Buy

Previous Recommendation: Buy

Rs118

Equity Shares (m)	544.8
52-Week Range	133/66
1,6,12 Rel.Perf.(%)	4/11/-34
M.Cap. (Rs b)	64.4
M.Cap. (US\$ b)	1.4

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	27,954	7,833	14.4	20.3	8.2	2.1	13.0	27.2	1.4	2.2
3/07E	32,112	9,586	17.6	22.4	6.7	1.7	12.4	26.8	1.5	1.7
3/08E	35,544	11,187	20.5	16.7	5.8	1.3	12.0	25.1	1.5	1.4

Indian Overseas Bank reported 2QFY07 results better than estimates. PAT grew 26% YoY driven by strong loan growth and steady margins. NII grew by 18% YoY in line with our estimate of 17%. Business growth remained strong so did core other income growth. Asset quality though improved YoY, did experience some deterioration QoQ in absolute term, although in percentage term continues to be low.

- Net interest income grows by 18%
- Margins continue to be strong; yield on advances improves
- Growth in fee income continues
- Asset quality - marginal dip QoQ

Over the last several quarters, IOB has been the most consistent state-owned bank on various operating parameters. The bank has also managed its bond portfolio and asset quality relatively better than other banks. Its RoE of ~25% is one of the highest in the sector. We expect earnings growth to remain strong. The stock trades at 5.8x FY08E EPS and 1.3x FY08E BV. We retain IOB as one of our best bets in the sector and believe it can command premium valuations versus other banks. Reiterate **Buy**.

### QUARTERLY PERFORMANCE

(RS MILLION)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Interest Income	10,254	10,758	11,433	11,618	12,409	13,721	14,063	14,452	44,063	54,646
Interest Expense	5,423	5,585	6,177	6,207	6,654	7,602	7,845	8,050	23,391	30,151
<b>Net Interest Income</b>	<b>4,831</b>	<b>5,173</b>	<b>5,256</b>	<b>5,411</b>	<b>5,755</b>	<b>6,119</b>	<b>6,218</b>	<b>6,402</b>	<b>20,672</b>	<b>24,494</b>
% Change (Y-o-Y)	10.5	11.2	10.7	13.1	19.1	18.3	18.3	18.3	11.4	18.5
Other Income	1,814	1,746	1,600	2,122	2,511	1,520	1,632	1,954	7,282	7,617
<b>Net Income</b>	<b>6,646</b>	<b>6,919</b>	<b>6,856</b>	<b>7,533</b>	<b>8,266</b>	<b>7,639</b>	<b>7,850</b>	<b>8,356</b>	<b>27,954</b>	<b>32,112</b>
% Change (Y-o-Y)	-0.8	3.8	7.0	38.5	24.4	10.4	14.5	10.9	12.0	14.9
Operating Expenses	2,913	3,085	3,194	3,424	3,302	3,491	3,513	3,749	12,616	14,055
<b>Operating Profit</b>	<b>3,732</b>	<b>3,834</b>	<b>3,663</b>	<b>4,110</b>	<b>4,965</b>	<b>4,148</b>	<b>4,337</b>	<b>4,607</b>	<b>15,338</b>	<b>18,057</b>
Other Provisions	1,415	912	869	2,285	2,299	541	826	1,009	5,482	4,675
Tax Provisions	485	937	821	-220	445	1,108	1,084	1,158	2,023	3,795
<b>Net Profit</b>	<b>1,832</b>	<b>1,985</b>	<b>1,972</b>	<b>2,044</b>	<b>2,220</b>	<b>2,499</b>	<b>2,427</b>	<b>2,441</b>	<b>7,834</b>	<b>9,586</b>
% Change (Y-o-Y)	4.9	25.4	22.3	30.0	21.2	25.9	23.1	19.4	20.3	22.4
Cost to Income Ratio (%)	43.8	44.6	46.6	45.4	39.9	45.7	44.7	44.9	45.1	43.8
Interest Expense/Interest Income (%)	52.9	51.9	54.0	53.4	53.6	55.4	55.8	55.7	53.1	55.2
Other Income/Net Income (%)	27.3	25.2	23.3	28.2	30.4	19.9	20.8	23.4	26.1	23.7

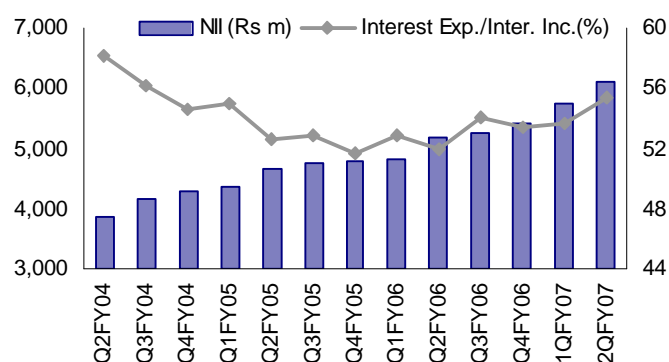
E: MSt Estimates

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### Net interest income grows 18% YoY

IOB has grown its NII by 18% in 2QFY07 to Rs6.1b. This growth was achieved on the back of the bank's strategy to grow its loan book in high yielding segment-SME, retail etc. While loans have grown by 40% YoY to Rs411b, deposits have grown by 20% to Rs570b. Low cost-CASA deposits have grown 17% YoY, whilst the proportion of CASA has declined marginally by 92bp YoY to 37.7% in 2QFY07.

TREND IN NII



Source: Company/ Motilal Oswal Securities

### Margins continue to be strong; yield on advances improves

Continuous deposit re-pricing, higher proportion of low-cost deposits, improving asset yields and near stable investment yields resulted in net interest margins (NIMs) remaining at 4.0%. However, YoY they have fallen by 11bp to 4.01% on the back of falling investment yields and rising cost of deposit. While deposit cost has increased YoY by 50bp YoY to 5.2% in 2QFY07, yield on advances has firmed up by 63bp to 9.5% in 2QFY07. Investment yields have declined 23bp YoY to 8.3% in 2QFY07.

BREAK-UP ON MOVEMENT OF NIMS (%)

	2QFY06	3QFY06	4QFY06	FY06	1QFY07	2QFY07
Avg Yield on Adv.	8.9	8.9	8.8	8.9	9.1	9.5
Avg Yield on Inv.	8.6	8.6	8.5	8.5	8.4	8.3
Avg Cost of Dep.	4.6	4.6	4.7	4.7	4.8	5.0
NIMs	4.1	4.1	4.1	4.1	4.0	4.0

Source: Company / Motilal Oswal Securities

The NIMs earned by the bank are one of the best in the sector and IOB has been able to manage these 4% plus margins over the last eight quarters. However, going forward, we believe that while asset yields would tend to improve, as the recent PLR hike is not fully captured in the current quarter, investment yields will tend to decline and could result in slight margin pressure. Overall in our expectations, we are factoring in declining margins for the next few fiscals.

### Growth in treasury and fee incomes ups other income by 38% YoY

Treasury declined by 86% YoY to Rs99m. Non-interest income excluding treasury gains increased by 36% from Rs1.05b in 2QFY06 to Rs1.42b in 2QFY07. Of this, Other income from core banking operations increased by 43% from Rs643m to Rs918m while fee income from sale of insurance and mutual fund products rose by 27% from Rs216m to Rs274m in 2QFY07.

### Provisions lower YoY

Provisions were lower YoY on account of lower NPA provisions and writeback of investment depreciation to the extent of Rs350m in 2QFY07, with interest rates declining from 1QFY07 levels. Provision for NPAs was Rs305m in 2QFY07 compared with Rs503m in 2QFY06. Standard assets provisions in 2QFY07 were Rs157m, while the provision for restructured accounts was Rs50m. Amortization provisions in 2QFY07 were Rs550m.

Tax rates at 31% in 2QFY07 were higher than in 1QFY07 (17% rate) due to the bank having the benefit of higher provisions in 1QFY07. Management indicated that tax rates would be in the range of 28%-33% in FY07.

### Pension - adequately funded; AS-15 impact ~Rs2b

Close to 40% of the bank's employees have opted for the pension scheme. Management indicated that their pension corpus is adequately funded and there are no material issues. As far as AS-15 is concerned, management indicated that discussions are ongoing with the RBI to apportion this shortfall. Nonetheless, management mentioned about likely pension shortfall on account of AS-15 to be close to Rs2b (5% of FY07E BV).

### CAR comfortable

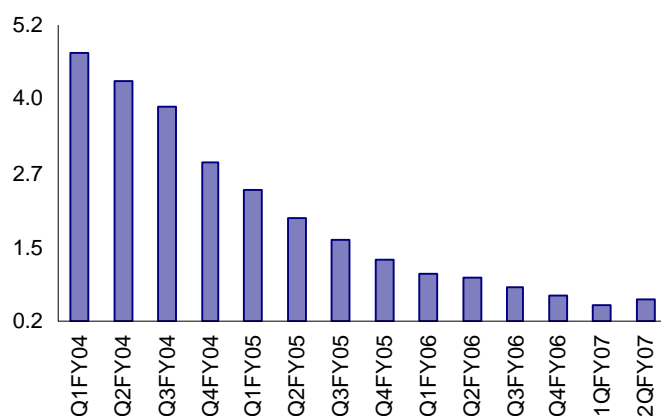
Currently IOB has a total capital adequacy of 14.7%; improvement of 129bp QoQ in CAR, largely coming in from Tier 2, with a Tier 1 of 8.9%. IOB has been raising capital in the form of Upper Tier 2 capital (raised Rs10b in 1HFY07), allowing the bank to improve its Tier 2 ratio by 126bp YTD. Until date, the bank besides raising Rs10b of Upper Tier 2 capital has also raised Rs2.8b in perpetual debt and Rs8b as syndicated debt. Management also indicated that post Basel 2 the bank could see erosion of ~125bp in capital (based on risk-weighted assets as of September 2006).

### Asset quality - marginal dip QoQ

While the bank has achieved significant strides in improving its asset quality over the last 10 quarters on a YoY basis, in 2QFY07, on QoQ basis, on absolute levels, gross NPAs have increased by 3%. Management indicated that this is

not of any material concern and does not involve any large single accounts. Nonetheless, the bank has managed to reduce its gross NPAs in percentage terms by 17bp QoQ; its net NPAs have risen by 9bp QoQ.

TREND IN NET NPAS (%)



Source: Company/ Motilal Oswal Securities

### Valuation and view

Over the last several quarters, IOB has been the most consistent state-owned bank on various operating parameters. The bank has also managed its bond portfolio and asset quality relatively better than other banks. Its RoE of ~25% is one of the highest in the sector. We expect earnings growth to remain strong. The stock trades at 5.8x FY08E EPS and 1.3x FY08E BV. We retain IOB as one of our best bets in the sector and believe it can command premium valuations over other banks. Reiterate **Buy**.

## Indian Overseas Bank: an investment profile

### Company description

Indian Overseas Bank (IOB), with a balance-sheet size of over Rs600b+, ranks amongst the 10 largest banks in India. Predominantly spread in the southern region of India, the bank has a network of over 1,500 branches (out of which 52 are specialized), 252 extension counters in India and 5 overseas branches. After the bank introduced IPOs in 2000 and 2003, the government's stake has reduced to 61.2%.

### Key investment arguments

- Consistent growth in core earnings for last several quarters
- Has one of the best margins in the industry and has maintained high margins for over six quarters.

### Key investment risks

- Investments yields are still at 8.3%, which are likely to decline in future resulting in margin pressure

### Recent developments

- Indian Overseas Bank (IOB) has raised Rs2.0b through an issue of 'perpetual bonds,' the first bank to use this means of funding. These bonds carry an interest rate of 9.3%.
- IOB plans to raise Rs12b via lower Tier II subordinated debt in FY07 on a private placement basis.

### Valuation and view

- Aggressive loan growth and stable margins will drive core earnings growth
- The bank could be an active participant in the consolidation process
- The stock trades at P/E of 5.8x on FY08E EPS and P/BV of 1.3x on FY08E BV. We reiterate our **Buy** recommendation.

### Sector view

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

#### COMPARATIVE VALUATIONS

		IOB	ANDHRA BK	VIJAYA BK
P/E (x)	FY07E	6.7	7.8	8.5
	FY08E	5.8	6.7	6.6
P/ABV (x)	FY07E	1.7	1.4	1.4
	FY08E	1.4	1.2	1.2
RoE (%)	FY07E	26.8	18.7	16.5
	FY08E	25.1	19.3	18.8
RoA (%)	FY07E	1.5	1.3	0.9
	FY08E	1.5	1.3	0.9

#### SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	61.2	61.2	61.2
Domestic Inst	4.5	4.2	4.5
Foreign	18.3	17.7	16.3
Others	16.0	16.9	17.9

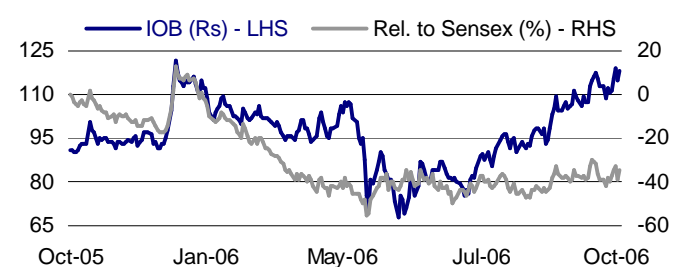
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	17.6	15.7	12.1
FY08	20.5	17.8	14.9

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
118	151	28.0	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (RS MILLION)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Interest Income	39,510	44,063	54,646	65,347	76,682
Interest Expended	20,955	23,391	30,151	37,119	44,564
<b>Net Interest Income</b>	<b>18,555</b>	<b>20,672</b>	<b>24,494</b>	<b>28,228</b>	<b>32,118</b>
Change (%)	16.0	11.4	18.5	15.2	13.8
Other Income	6,398	7,282	7,617	7,316	8,127
<b>Net Income</b>	<b>24,953</b>	<b>27,954</b>	<b>32,112</b>	<b>35,544</b>	<b>40,245</b>
Change (%)	6.6	12.0	14.9	10.7	13.2
Operating Expenses	11,585	12,616	14,055	15,329	16,923
<b>Operating Income</b>	<b>13,368</b>	<b>15,338</b>	<b>18,057</b>	<b>20,215</b>	<b>23,321</b>
Change (%)	0.9	14.7	17.7	12.0	15.4
Other Provisions	3,498	5,482	4,675	3,900	4,300
<b>PBT</b>	<b>9,870</b>	<b>9,856</b>	<b>13,382</b>	<b>16,315</b>	<b>19,021</b>
Tax	3,356	2,023	3,795	5,128	6,096
Tax Rate (%)	34.0	20.5	28.4	31.4	32.0
<b>PAT</b>	<b>6,514</b>	<b>7,833</b>	<b>9,586</b>	<b>11,187</b>	<b>12,925</b>
Change (%)	27.0	20.3	22.4	16.7	15.5
Proposed Dividend	1,484	1,416	1,634	1,634	1,907

BALANCE SHEET (RS MILLION)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Capital	5,448	5,448	5,448	5,448	5,448
Reserves & Surplus	20,304	26,326	34,278	43,831	54,850
<b>Net Worth</b>	<b>25,752</b>	<b>31,774</b>	<b>39,726</b>	<b>49,279</b>	<b>60,298</b>
<b>Deposits</b>	<b>442,412</b>	<b>505,293</b>	<b>606,352</b>	<b>703,368</b>	<b>815,907</b>
Change (%)	6.7	14.2	20.0	16.0	16.0
Borrowings	5,907	7,366	8,840	11,050	13,813
Other Liabilities & Prov	34,079	49,144	51,602	54,182	56,891
<b>Total Liabilities</b>	<b>508,150</b>	<b>593,578</b>	<b>706,520</b>	<b>817,879</b>	<b>946,907</b>
Current Assets	49,540	37,072	32,300	37,210	45,336
Investments	190,147	189,523	208,475	237,662	270,934
Change (%)	-5.7	-0.3	10.0	14.0	14.0
Advances	252,052	347,562	444,879	520,509	606,393
Change (%)	24.2	37.9	28.0	17.0	16.5
Net Fixed Assets	4,523	4,577	4,537	4,537	4,487
Other Assets	11,888	14,843	16,328	17,961	19,757
<b>Total Assets</b>	<b>508,150</b>	<b>593,578</b>	<b>706,520</b>	<b>817,879</b>	<b>946,907</b>

ASSUMPTIONS (%)					
Deposit Growth	6.7	14.2	20.0	16.0	16.0
Advances Growth	24.2	37.9	28.0	17.0	16.5
Investments Growth	-5.7	-0.3	10.0	14.0	14.0
Dividend	24.0	26.0	30.0	30.0	0.0
CRR	5.0	5.0	5.0	5.0	5.0

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
<b>Spreads Analysis (%)</b>					
Avg. Yield - Earning As:	8.4	8.3	8.5	8.5	8.6
Avg. Cost-Int. Bear. Lia	4.8	4.9	5.3	5.6	5.8
Interest Spread	3.6	3.4	3.2	2.9	2.9
Net Interest Margin	3.9	3.9	3.8	3.7	3.6

Profitability Ratios (%)					
RoE	28.0	27.2	26.8	25.1	23.6
RoA	13	14	15	15	15
Int. Expended/Int. Earned	53.0	53.1	55.2	56.8	58.1
Other Inc./Net Income	25.6	26.1	23.7	20.6	20.2

Efficiency Ratios (%)					
Op. Exps./Net Income	46.4	45.1	43.8	43.1	42.1
Empl. Cost/Op. Exps.	72.8	70.8	69.9	68.5	66.7
Busi. per Empl. (Rs m)	26.9	32.0	39.8	47.7	55.7
NP per Empl. (Rs lac)	2.7	3.2	4.0	4.7	5.4

Asset-Liability Profile (%)					
Adv./Deposit Ratio	57.0	68.8	73.4	74.0	74.3
Invest./Deposit Ratio	43.0	37.5	34.4	33.8	33.2
G-Sec/Invest. Ratio	82.7	81.9	83.4	79.7	76.2
Gross NPAs to Adv.	5.3	3.4	2.8	2.6	2.4
Net NPAs to Adv.	1.3	0.7	0.4	0.4	0.3
CAR	14.2	13.0	12.4	12.0	11.7
Tier 1	7.1	8.5	7.9	7.5	7.2

VALUATION					
Book Value (Rs)	44.7	56.1	70.9	88.6	109.0
Price-BV (x)	2.6	2.1	1.7	1.3	1.1
Adjusted BV (Rs)	40.9	53.4	68.5	86.3	106.9
Price-ABV (x)	2.9	2.2	1.7	1.4	1.1
EPS (Rs)	12.0	14.4	17.6	20.5	23.7
EPS Growth (%)	27.0	20.3	22.4	16.7	0.0
Price-Earnings (x)	9.9	8.2	6.7	5.8	5.0
OPS (Rs)	24.5	28.2	33.1	37.1	42.8
OPS Growth (%)	0.9	14.7	17.7	12.0	15.4
Price-OP (x)	4.8	4.2	3.6	3.2	2.8

E: MOST Estimates

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Disclosure of Interest Statement	Indian Overseas Bank
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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