

Sector : Bank	Union Bank of India
CMP : Rs. 113	Rating : Outperform

Reason for report

a) Revision of business growth targets, b) Earnings revisions and c) Upgrading price target.

We are revising our financial forecast for FY08E and introducing FY09E estimates based on our assessment of industry growth in general and Union Bank (UBI) in particular. Net interest margins (NIMs) of UBI are expected to be in the corridor of 2.9-3.0% over the next couple of years. This coupled with better business volumes would enable the bank to deliver 19% average RoE and 15% CAGR earnings growth during the period.

- **Margins expected to be in the range of 2.9-3.0%**
Union Bank has hiked rates by almost 250 bps over the last 12 months in a bid to save its margins. More importantly UBI intends to curb reliance on high cost bulk deposits to fund its credit growth. Hence, overall we expect the margins to sustain in the range of 2.9-3.0%.
- **Credit quality in control; slippages at relatively lower levels.**
UBI's gross and net NPA declined and stood at 2.94% and 0.96% respectively at end of FY07. Slippages also stood at 1.4% as compared to 1.8% in FY06. Favorable trend in NPA is expected to continue in near to medium term driven by better recoveries and lower slippages resulting in lower credit cost.
- **UBI's RoE are best amongst the peer banks**
UBI's RoE at 19% continue to be the best amongst the peer banks. We expect the bank to maintain RoE at same levels over the next couple of years.
- **Lower than expected business growth and NIMs are the key risk**
Lower than expected growth in business volumes and decline in NIMs owing to cost pressure are key risk to our earnings estimates and valuation.
- **Valuation**
At CMP of Rs. 113, the stock trades at 1.0x (FY2008E) and 0.9x (FY2009E) its adjusted book value and 2.5x (FY2008E) and 2.1x (FY2009E) its core operating profits. We continue to maintain outperform rating on the stock. We are revising our price target from Rs. 135 to Rs. 147 to factor in revised earnings estimates

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Company Update

(Rs. mn)

Key Financials*	FY06	FY07	FY08E	FY09E
Net Interest Income	23,743	27,902	32,181	38,402
Operating Income	28,688	34,768	39,423	46,375
Core Op. Profits	13,710	18,923	21,363	25,073
Net Profits	6,752	8,454	9,737	11,261
EPS (Rs.)	13.4	16.7	19.3	22.3
Book Value (Rs.)	81.0	93.7	117.4	134.5
Net NPAs (%)	1.6	1.0	0.9	0.8

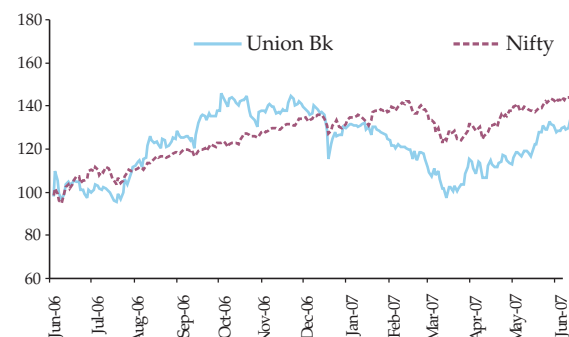
Key Ratios(%)	FY06	FY07	FY08E	FY09E
Credit Growth	33.1	16.9	24.2	21.8
Deposits Growth	19.8	15.0	22.6	18.2
RoA	0.8	0.9	0.9	0.8
RoE	18.7	19.2	19.1	19.1
NIMs	3.1	3.0	2.9	2.9

Key Data

Face Value (Rs.)	10
Shares Outstanding(mn)	505
Market Cap (Rs. bn/US\$ mn)	61.3/1.5
52 Week High/Low (Rs.)	141/81
Nifty	4113
Reuters code	UNBK.NS
Bloomberg Code	NUNBK.IN
*Year End	March

Shareholding pattern(%)	March '07
Other	2.4%
Public	13.5
MF and FIIs	9%
FII	19.7
GoI	55.4%

Relative Price Performance



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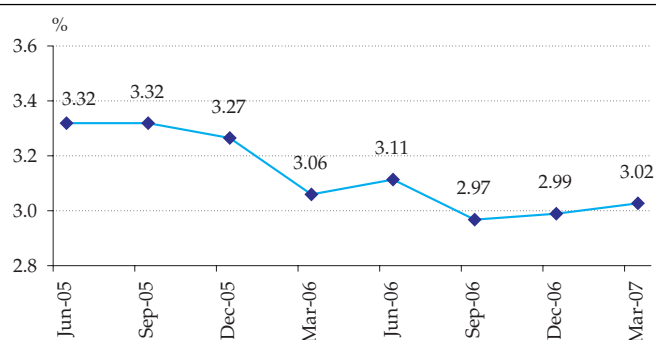
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Investment Arguments

NIMs likely to be in the range of 2.9-3.0%

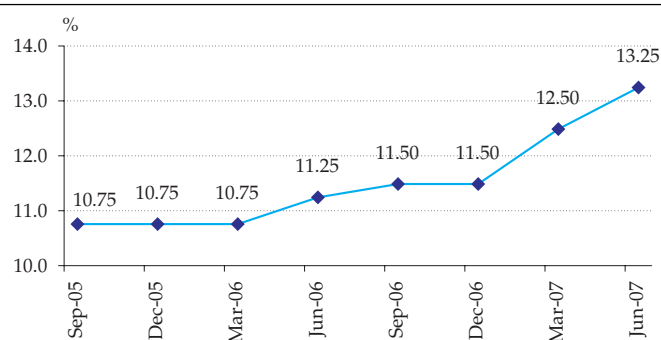
We expect NIMs of UBI to be in the range of 2.9-3.0% over the next couple of years. UBI has responded swiftly to rising rates by hiking PLR. Over the last 12 months it has raised its PLR by 250 bps to 13.25%, which are amongst the highest in the state owned banks. Moreover, it intends to reduce the dependence on the high cost bulk deposits and grow its retail deposits portfolio to fund the credit growth. CASA has improved in last 12 months by almost 200 bps to 34.5%, we expect the CASA ratio to further improve by 100-150 bps over the next couple of years.

Chart 1: Movement in NIMs (TTM)



Source: Company, SBICAP Research

Chart 2: Movement in PLR

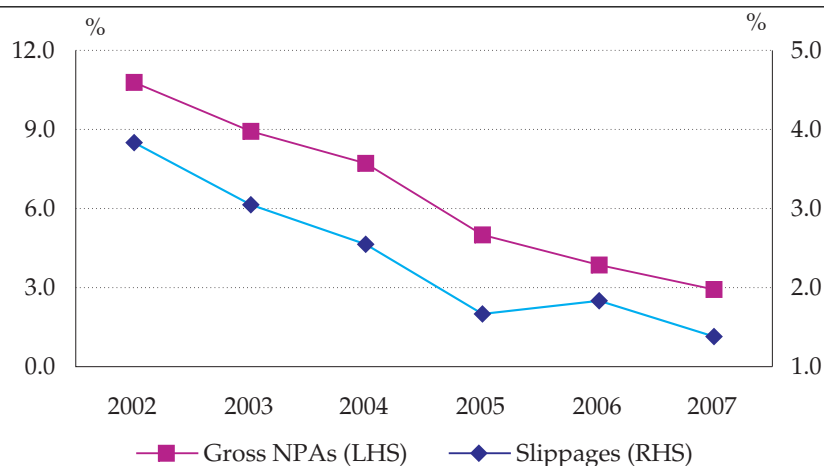


Source: Company, SBICAP Research

Credit quality under control, slippages at relatively lower levels

Gross and Net NPAs of the bank continue to decline progressively. They stood at 2.94% and 0.96% at the end of FY2007. Decline in NPAs is driven by relatively lower slippages and better recoveries. Slippages have declined from high of 3.8% in FY2002 to 1.4% in FY2007 reflecting better quality of assets being added to portfolio and also the fact that overall macro environment is currently favorable. We are factoring in slippages of 1.5% over the next couple of years. Any further improvement in slippages would be upside in terms of higher earnings and consequently better valuations.

Chart 3: Movement in Gross NPAs and Slippages



Source: Company, SBICAP Research

RoE of the bank are best amongst the peer banks

UBI has reported an ROE of 19.2% during FY2007 and we expect the average ROE of the bank to be ~19% over the next couple of years driven by stable NIMs and higher business volumes. Current RoEs are best amongst the peer banks.

Capital adequacy comfortable post issuance of Tier I bonds

UBI has raised Tier I bonds of Rs. 3 bn to support the growth in business volumes. This coupled with the internal capital generation of 21% has helped the Tier I ratio to be around 7.8% at the end of FY2007. We believe that current capital coupled with available legroom to raise further capital through issuance of Tier I and Tier II bonds would enable the bank to meet the business growth objectives and BASEL II norms comfortably over near to medium term.

Lower than expected business growth and NIMs are the key risk

Lower than expected business growth on account of slowdown in credit demand could lead to lower earnings growth. Further any decline in NIMs relative to our assumption would also impact earnings growth and hence, valuation for the bank.

Revision in business growth and earnings estimates

We are revising the business growth and earnings estimates for UBI for FY2008E and introducing estimates for FY2009E based on our assessment of industry growth in general and UBI in particular. Following is the table indicating change in key parameters in our financial forecast.

Table 1: Revision in key financial variables

	FY2008E		2009E
	Earlier	Revised	New
Credit growth (%)	20.0	24.2	21.8
Deposit growth (%)	16.2	22.6	18.2
NII (Rs. Mn)	30,717	32181	38402
NIMs (%)	2.9	2.9	2.9
PAT	9,255	9737	11261
PAT growth	15.0	15.2	15.6

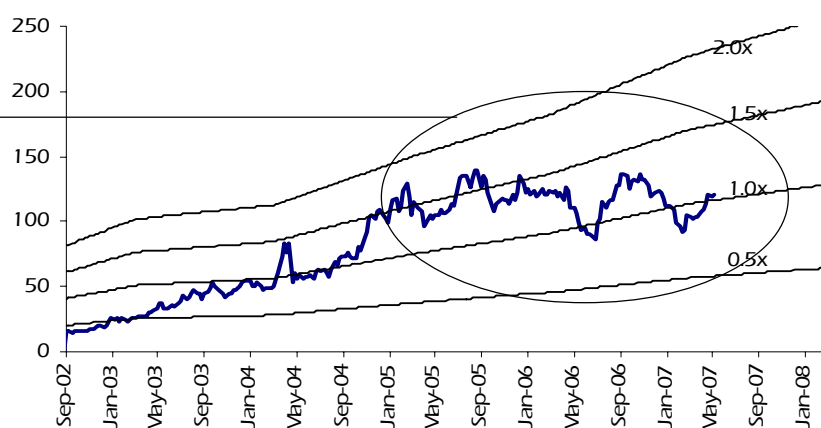
Source: Company

Valuation

At CMP of Rs. 113, UBI trades at 1.0x (FY2008E) and 0.9x (FY2009E) its adjusted book value and 2.5x (FY2008E) and 2.1x (FY2009E) its core operating profits. We are maintaining our outperform rating on the stock and upgrading price target to Rs. 147 (earlier Rs. 135) to factor in earnings revision and introduction of FY2009 estimates. Target price puts the value of stock at 1.3x its adjusted book value and 3.5x its core operating profits for FY2008E

Chart 4: 1 yr Forward Price to adjusted book value

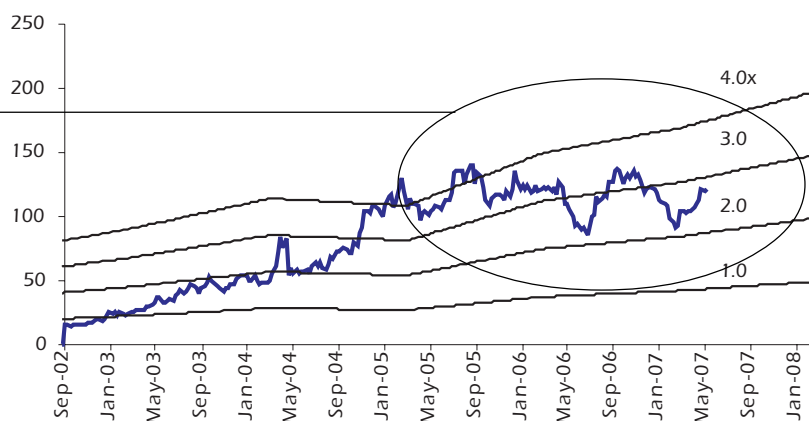
UBI has been trading in the band of 0.9x to 1.4x its adjusted book value



Source: BSE, SBICAP Research

Chart 5: 1 yr Forward Price to core operating profits

UBI has been trading in the band of 2.3x to 3.5x its core operating profits.



Source: BSE, SBICAP Research

Forecasted Income Statment

(Rs Mn)

Y/E. March	FY2006	FY2007	FY2008E	FY2009E
Interest Earned	58,637	73,822	92,866	114,330
Interest Expended	34,894	45,920	60,684	75,928
Net Interest Income	23,743	27,902	32,181	38,402
- YoY Growth (%)	15.0	17.5	15.3	19.3
- as a % of Operating Income	82.8	80.3	81.6	82.8
Other Income	4,945	6,865	7,241	7,973
- YoY Growth (%)	-35.5	38.8	5.5	10.1
- as a % of Operating Income	17.2	19.7	18.4	17.2
Operating Income	28,688	34,768	39,422	46,375
- YoY Growth (%)	1.3	21.2	13.4	17.6
Operating Expenses	14,024	14,759	17,310	20,402
- YoY Growth (%)	11.5	5.2	17.3	17.9
- as a % of Operating Income	48.9	42.5	43.9	44.0
- Employee Costs	8,668	8,737	10,022	11,833
- Other Operating Expenses	5,357	6,023	7,288	8,569
Core Operating Profits	15,016	20,475	23,113	27,113
- YoY Growth (%)	14.4	36.4	12.9	17.3
Pre - Provision Profit	14,664	20,008	22,113	25,973
- YoY Growth (%)	-6.8	36.4	10.5	17.5
Provision and Contingencies	5,717	6,204	7,426	8,988
Profit Before Tax	8,946	13,804	14,687	16,985
Taxes	2,195	5,350	4,949	5,724
- as a % of PBT	24.5	38.8	33.7	33.7
PAT	6,752	8,454	9,737	11,261
- YoY Growth (%)	-6.1	25.2	15.2	15.6

Source: Company, SBICAP Research

Forecasted Balance Sheet

(Rs Mn)

Y/E. March	FY2006	FY2007	FY2008E	FY2009E
Share Capital	5,051	5,051	5,051	5,051
Reserve & Surplus	40,530	46,848	54,247	62,877
Deposits	740,943	851,802	1,044,449	1,234,348
Borrowings	39,744	42,155	53,602	51,860
Bond Capital	27,700	34,200	37,200	49,200
Other Liabilities & Provisions	37,292	46,723	56,288	66,126
Total Liabilities	891,260	1,026,779	1,250,837	1,469,462
Cash in Hand and with RBI	43,873	59,176	75,050	88,168
Bal. with banks & money at call	20,032	25,089	25,017	29,389
Investments	259,177	279,818	331,319	356,845
Advances	533,800	623,864	775,046	944,364
Fixed Assets	8,104	8,250	10,007	11,021
Other Assets	26,275	30,582	34,398	39,675
Total Assets	891,260	1,026,779	1,250,837	1,469,462

Source: Company, SBICAP Research

Ratio Analysis

Y/E. March	FY2006	FY2007	FY2008E	FY2009E
Per Share Data (Rs.)				
Earnings (EPS)	13.4	16.7	19.3	22.3
Core. Op. Profits (COPPS)	29.7	40.5	45.8	53.7
Pre-Provision Profits (PPP)	29.0	39.6	43.8	51.4
Book Value	81.0	93.7	117.4	134.4
Adj. Book Value	74.9	91.1	115.1	132.7
Dividend	3.5	3.5	4.0	4.5
Profitability ratios (%)				
Yield on earning assets	7.6	8.0	8.5	8.7
Cost of funds	4.8	5.3	5.9	6.1
NIMs	3.1	3.0	2.9	2.9
Other Inc/Avg. assets	0.6	0.7	0.6	0.6
Cost to Income ratio	48.9	42.5	43.9	44.0
COPPS/Avg. assets	1.9	2.1	2.0	2.0
Return on Avg. Assets	0.8	0.9	0.9	0.8
Return on Avg. Equity	18.7	19.2	19.1	19.1
Liquidity & Leverage (%)				
Loan deposit ratio	72.0	73.2	74.2	76.5
Investment deposit ratio	35.0	32.9	31.7	28.9
Networth/ Assets	4.6	4.6	4.4	4.3
Networth/Loans	7.7	7.6	7.0	6.7
Internal capital generation	21.5	20.7	20.6	20.6
Asset growth	23.0	15.2	21.8	17.5
CAR	11.4	12.8	11.6	11.5
- Tier I	7.3	7.8	7.1	6.9
Asset Quality (%)				
Gross NPAs	3.8	2.9	2.5	2.1
Net NPAs	1.6	1.0	0.8	0.6
Slippages	1.8	1.4	1.5	1.5
Loan loss prov. / PPP	10.6	16.5	19.4	20.5
Loan loss prov. /avg. assets	0.2	0.3	0.4	0.4
Provision coverage	60.3	67.9	69.2	70.7
Net NPAs as % of Networth	23.1	13.6	11.0	9.5
Valuation Ratios				
PER (x)	8.5	6.8	5.9	5.1
P/BVPS (x)	1.4	1.2	1.0	0.8
P/ABVPS (x)	1.5	1.3	1.0	0.9
P/COPPS (x)	3.8	2.8	2.5	2.1
P/PPP (x)	3.9	2.9	2.6	2.2
Market Cap as % of Total Assets	6.5	5.6	4.6	3.9
Dividend Yield	3.1	3.1	3.5	4.0

Source: Company, SBICAP Research

Key to investment Ratings: Guide to the expected return relative to market over the next 12 months. 1=Buy (expected to outperform the market by 15 or more percentage points); 2=Outperform (expected to outperform the market by 5-15 percentage points); 3=Marketperform (expected to perform in line with the market); 4=Underperform (expected to underperform the market) by 5-15 percentage points); 5=Sell (expected to underperform the market by 15 or more percentage points)

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