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Every week, the ICICIdirect research team selects a stock based on fundamental and/or technical parameters, which is likely to give a return of 20% or more over a 3-6 month perspective.

Union Bank of India (UNIBAN)

Current Price: Rs 93	Target Price: Rs 116
Potential upside: 25%	Time Frame: 9-12 mths

With earnings progression expected to remain strong supported by rising non-interest income and high loan growth, we believe Union Bank of India is an Outperformer and is available at attractive valuations.

Background

Union Bank of India , a public sector bank was incorporated in 1919. The bank came out with its first initial public offer (IPO) in Aug 2002, offering 180,000,000 equity shares of Rs 10 each at a premium of Rs 6 per share aggregating Rs 288 crore through the fixed price route. The bank has a large network of geographically well-diversified branches, which enables it to raise low-cost long-term deposits. It had a network of 2,082 branches with 25,421 employees as on March 2006. Total business has increased from Rs 102,934 crore in FY05 to Rs 128,738 crore in FY06, a growth of 25% y-o-y.

Investment Rationale

Well capitalised

Through a mix of perpetual debt and hybrid tier II borrowings, the bank has notched up a capital adequacy ratio CAR in excess of 12% (150 bps increase over H1FY07 levels) and addressed capital adequacy concerns without impacting RoE. We believe with significant headroom available for raising further perpetual debt under tier I, the bank is comfortably placed to sustain over 20% growth in risk-weighted assets. Further, it is unlikely to contemplate a dilution until end-FY09E, which puts to rest any concerns about RoE compression. Margins to remain stable despite pressures.

Lower operating expenses to sustain higher RoEs

The bank's operating leverage (operating expenses/average assets) is higher than most PSU banks and this singly boosts its RoE. Operating efficiencies are unlikely to suffer in the medium term on the back of a predominantly wholesale resource strategy and savings from staff costs (about 5-7% of the workforce is retiring by FY10E).

Credit growth to continue with stable margins

Advances are expected to grow at a CAGR of 23.8% over FY06-08E to Rs 79,877 crore and deposits at 19.7% to Rs 105,156 crore. Future growth in credit to the SME and agriculture sectors that will be driven by a network of rural and semi-urban branches supported by organizational reinforcement in the form of SME cells and agriculture clusters. Net interest margins (NIMs) are expected to stabilize around 2.9% during next couple of years with net interest income set to grow at 16% CAGR.

Focus on asset quality

The bank's asset quality has improved with net NPAs declining to 1.56% in FY06 from 2.64% in FY05. For the first nine months in FY07, it has further reduced to 1.34%, which gives indications of further improvements in asset quality. We believe the company will be able to maintain net NPAs at 0.8% by end FY08E.

Risks and Concerns

Pressure on margins due to rising interest rates

Unlike most other PSU banks, Union Bank of India 's resource profile with 33% current account savings account (CASA) deposits is below average. This intensifies the pressure to solicit costlier bulk deposits, and in turn puts margins under pressure. Further, rising interest rates remains a key concern for the sector as a whole.

Financials

The bank's net interest income (NII) grew by 15.1% to Rs 2,065 crore in FY06 from Rs 2,375 crore in FY05. For the 9 months of FY07, NII has increased 10% y-o-y to Rs 1,948 crore. NIMs have been under pressure due to rising interest rates. We expect NIMs to fall from 3.0% in FY06 to 2.9% in FY07E and thereafter to remain stable within the range of 2.8- 2.9% over next couple of years.

Advances grew 33% y-o-y to Rs 66,733 crore in FY06 and are expected to grow at a CAGR of 23.8% over FY06-08E. Though PBT has risen by 46% to Rs 894 crore in FY06, net profits declined from Rs 719 crore in FY05 to Rs 675 crore mainly due to increased tax burden. Net profit for the first nine months of FY07 have jumped 15% y-o-y to Rs 616.8 crore from Rs 536.4 crore. Earnings are estimated to grow at a CAGR of 26% over FY06-08E.

Key Financial Ratios

	2006/03	2005/03	2004/03	2003/03	2002/03
EPS	13.37	15.63	15.48	12.01	9.29
CEPS	15.07	17.22	16.57	13.14	10.6
Book Value	81.02	68.23	56.56	45.03	47.38
Dividend/Share	3.5	3.5	3.5	2.1	1.33
OPM	24.04	22.74	14.69	24.85	18.5
RONW	16.47	22.92	27.37	26.68	19.63
Debt/Equity	18.1	19.69	19.43	21.6	24.85
Ratio	0.4	0.42	0.49	0.46	0.79
Interest Cover	1.48	1.49	1.32	1.48	1.34

Valuation

At the current price of Rs 93, the stock trades at 4.5x its FY08E EPS of Rs 20.7. The bank is poised to sustain healthy earnings growth momentum and is available at attractive valuations of 1x its FY08E ABV. We believe its RoA at 0.9% and sustainable RoE at 19 –20% in FY08. The bank a de-risked investment portfolio with 94% of SLR in HTM category leading to lower future provisioning requirement on the same. Based on theoretical P/BV multiple of 1.4x, we get a fair value of Rs 138 on FY08E. However, considering current market conditions we expect the stock to trade at 1.2x its FY08E ABV, giving us a target price of Rs 116, an upside of 25% over a 9-12 month period.

Technical Outlook

The stock has corrected from Rs 132 and is now finding support at Rs 85 from where it has bounced. The long-term support for the stock is at Rs 80. The 200-Day EMA is at Rs 111 and the current price is well below it. The RSI indicator clearly remains oversold and the MACD indicator also signals the end of distribution phase. The stock could face short-term resistance at Rs 94.50, above which it could rally to Rs 102 and even higher.

ICICIdirect Research Desk

ICICI Brokerage Services Limited,
2nd Floor, Stanrose House,
Appasaheb Marathe Road,
Prabhadevi, Mumbai - 400 025
research@icicidirect.com