

Jammu & Kashmir Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,482	JKBK IN
	REUTERS CODE
S&P CNX: 3,081	JKBK.BO

22 May 2006

Buy

Previous Recommendation: Buy

Rs338

Equity Shares (m)	48.5
52-Week Range	564/310
1,6,12 Rel.Perf.(%)	-17/-50/-63
M.Cap. (Rs b)	16.4
M.Cap. (US\$ b)	0.4

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	RATIO
3/06A	7,969	1,769	36.7	53.7	9.2	0.9	12.1	10.2	0.7	1.0
3/07E	9,460	2,384	49.5	34.8	6.8	0.8	11.2	12.6	0.8	0.8
3/08E	11,057	3,020	62.7	26.7	5.4	0.7	10.6	14.4	0.9	0.8

J&K Bank reported 50% net profit decline in 4QFY06 due to prudent NPA provisions undertaken during 4QFY06 and MTM losses on its AFS book. NII for the quarter increased by 35% YoY to Rs1.89b, as margins improved by 60bp YoY to 3.04% and overall advances increased by 26%. Other income also rose 56% YoY to Rs522m, as fee-based income increased significantly due to greater third-party distribution and better economic conditions in J&K. For FY06, NII increased 11% to Rs6.64b, other income increased 62%, and earnings, 54% to Rs1.77b. Asset quality improved with both gross and net NPAs falling to 2.5% and 0.9%, respectively.

- ⚡ Advances up 26%; deposits up 9% YoY
- ⚡ Treasury turns profitable; fee/other income grows YoY by 16% in FY06
- ⚡ Asset quality improves YoY, with net NPAs falling below 1%
- ⚡ Key trigger — uptrend in J&K's economy

With strong latent demand in the state of J&K, we expect healthy loan growth for J&K Bank to continue. Margins are likely to improve, as the bank sustains its cost of deposits by improving CASA; yields on advances are likely to improve further, as the bank focuses on lending to the SME segment, wherein the yields are higher. Fee income is also likely to improve further, as the bank is focused on selling third-party products and undertakes more J&K state related businesses. The stock trades at a P/E of 6.8x FY07E EPS and P/BV of 0.8x FY07E BV. We maintain **Buy**.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06
	1Q	2Q	3Q*	4Q	1Q	2Q	3Q	4Q		
Interest Income	3,892	3,861	3,872	3,867	4,278	4,168	4,148	4,468	15,492	17,063
Interest Expenses	2,470	2,317	2,273	2,471	2,773	2,532	2,538	2,582	9,530	10,425
Net Interest Income	1,422	1,545	1,599	1,397	1,505	1,636	1,610	1,887	5,962	6,637
% Change (Y-o-Y)	-9.7	-6.0	-5.5	8.3	5.8	5.9	0.7	35.1	-3.8	11.3
Other Income	448	17	102	336	225	267	319	522	820	1,332
Net Income	1,870	1,562	1,701	1,732	1,730	1,903	1,929	2,408	6,783	7,970
Operating Expenses	718	787	721	1,001	767	835	868	982	3,228	3,453
Operating Profit	1,152	775	980	731	962	1,068	1,061	1,426	3,555	4,517
% Change (Y-o-Y)	-30.9	-53.2	-45.9	-36.5	-16.5	37.8	8.3	95.2	-43.4	27.1
Prov. & Contingencies	410	1,315	253	293	311	298	274	1,015	2,195	1,899
Profit before Tax	742	-540	726	437	651	770	787	411	1,359	2,619
Provision for Taxes	270	-40	7	-21	167	220	280	183	209	850
Net Profit	472	-500	719	459	484	550	507	228	1,151	1,769
% Change (Y-o-Y)	-51.7	-149.6	-34.5	-53.2	2.6	n.a.	-29.6	-50.3	-71.7	53.7
Cost to Income	38.4	50.4	42.4	57.8	44.4	43.9	45.0	40.8	47.6	43.3
Int.Expense/Int. Earned	63.5	60.0	58.7	63.9	64.8	60.8	61.2	57.8	61.5	61.1
Cost to Net Int.Income	50.5	50.9	45.1	71.7	51.0	51.0	53.9	52.1	54.1	52.0

E: MOST; * 3QFY05 has been re-stated by the management

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J&K Bank reported 50% net profit decline in 4QFY06 due to prudent NPA provisions undertaken during 4QFY06 and MTM losses on its AFS book. NII for the quarter increased by 35% YoY to Rs1.89b, as margins improved by 60bp YoY to 3.04% and overall advances increased by 26%. Other income also rose 56% YoY to Rs522m, as fee-based income increased significantly due to greater third-party distribution and better economic conditions in J&K. For FY06, NII increased 11% to Rs6.64b, other income increased 62%, and earnings, 54% to Rs1.77b. Asset quality improved with both gross and net NPAs falling to 2.5% and 0.9%, respectively.

Advances up 26%; deposits up 9% YoY

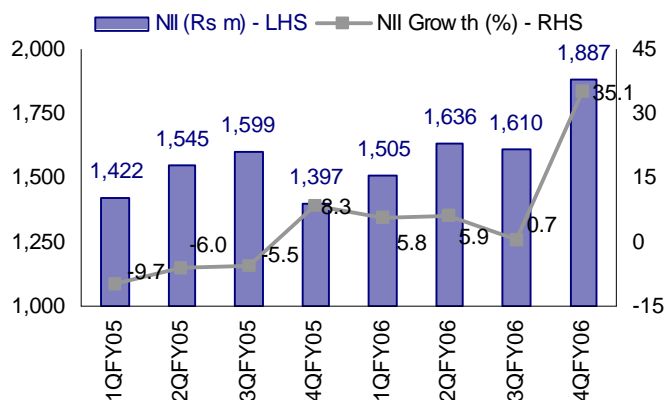
Business momentum continued across all segments with advances growing 26% YoY to Rs145b during FY06. The bank’s business portfolio currently has a mix of 33:67, with 33% of business in the state of J&K, whilst the remainder is ex-J&K. The bank continues to focus on the high-yielding small and medium enterprises (SME) segment and retail loans, which together constitute almost 55% of bank’s loan book. The increase in loan book has enabled the bank to earn a higher interest on advances up by 36% YoY in 4QFY06. Management has indicated that going forward it will concentrate on high-margin and low-volume business in the state of J&K, while high volume business outside the state of J&K.

Deposits have grown by a modest 9% YoY to Rs235b. Low-cost deposits have grown faster and now constitute 34.2% of total deposits. The loan-deposit ratio at 62% has expanded by 850bp from 53% at FY05. With a strong thrust on growing the loan book, we expect this ratio to further improve going forward. Management expects to increase CASA to between 40%-42% in next two-years, as the bank improves its CASA in the state of J&K from current CASA of 58% to 64% over the next two-years. This should enable the bank to lower its cost of deposits further.

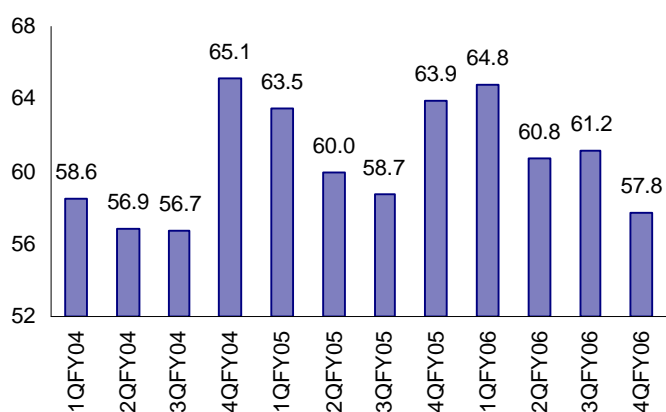
NII improves 35% in 4QFY06 and 11% in FY06, as margins improve

NII grew 35% YoY to Rs1.89b in 4QFY06. This was largely due to improved yields on advances to 9.08% and decline in cost of deposits to 4.72%. Core interest income from advances continued to grow on the back of robust loan growth, and in 4Q, growth in interest on advances was 36% YoY. Growth in interest expenses was modest, with interest expense growing by only 5%, as low-cost deposit growth was higher versus term deposits.

TRENDS IN NII



TRENDS IN INTEREST EXPENSE/INTEREST INCOME



Source: Company / Motilal Oswal Securities

Margins improve as cost of deposits decline and yield on advances go higher

Despite the pressure on investment yields due to a conscious management decision to move to a low duration portfolio,

net interest margins (NIM) have increased to 3.04% in 4QFY06 from 2.44% (in 4QFY05), largely due to improvement in yields on advances and lowering of the cost of deposits. Management is focused on protecting its current margins, by sourcing a greater share of high-margin business. This coupled with strong growth in the advances portfolio; higher accretion of low-cost deposits and sell-down of the low-yielding investment portfolio should result in higher margins going forward. For FY06, NIMs remained flat at 2.68%.

MARGINS (%)

	4QFY05	4QFY06	FY05	FY06
Avg. Yield on Advances	8.48	9.08	8.42	8.48
Avg. Yield on Investments	7.12	6.48	7.38	6.22
Avg. Cost of Deposits	4.96	4.72	4.61	4.55
NIMs	2.44	3.04	2.69	2.68

Source: Company / Motilal Oswal Securities

Treasury turns profitable; fee/other income grows 16% YoY in FY06

From Rs138m of treasury losses in FY05, the bank managed to earn Rs57m in FY06 on sale of investments. This was despite the rise in benchmark rates over the last one year.

In 4QFY06, the bank earned Rs392m, an increase of 111% YoY in commission and brokerage income by way of insurance commissions, increased credit-linked fee income, and distribution of third-party products, along with J&K government-related business income. For FY06, non-interest income, excluding trading gains, increased by 16% to Rs1.27b.

The bank expects non-interest income, excluding treasury to increase in the coming years, as the bank continues to forge alliances with reputed insurance companies and mutual fund companies to sell third-party products. Along with this, higher J&K government business would witness rising non-interest income, excluding trading income.

Investment book; low duration on AFS book

J&K Bank's investment book is now well de-risked from rising interest rates. The bank has 54% of the investment book in the HTM category, and in the AFS category, it has investments largely in short-dated securities. The modified duration on the AFS book is 1.2 years, with a cushion on the benchmark of 25bp.

Asset quality improves with net NPAs falling below 1%

Asset quality remains strong as the net NPAs declined to 0.9% compared with 1.4% in the corresponding period last year. Management has improved its coverage ratio to 64% in FY06 from 49% in FY05 for which the bank has made a significant provision in 4QFY06 for its NPAs. The bank aims to achieve international standards of 80% provision coverage ratio over the next two years. The bank effected recovery of Rs1.05b.

Key trigger — uptrend in J&K economy

We believe that the uptrend in J&K's economy is likely to be a key trigger for J&K Bank. Since J&K Bank is a banker to the state government and also boasts a wide state network; it would be the biggest beneficiary of any new projects upcoming in the state.

Valuation and view

With strong latent demand in the state of J&K, we expect healthy loan growth for J&K Bank to continue. Margins are likely to improve, as the bank reduces its cost of deposits by improving CASA; yields on advances are likely to improve further, as the bank focuses on lending to the SME segment, wherein the yields are higher. Fee income is also likely to improve further, as the bank is focused on selling third-party products and undertakes more J&K state related businesses. The stock trades at a P/E of 6.8x FY07E EPS and P/BV of 0.8x FY07E BV. We maintain **Buy**.

Jammu & Kashmir Bank: an investment profile

Company description

J&K Bank is a private sector bank with the J&K government holding 53% of the bank's equity. With a balance sheet size of Rs264b, the bank has a network of 517 branches and 178 ATMs. J&K Bank is the banker to the state government and also holds the agency to transact Central government business in the state of Jammu & Kashmir.

Key investment arguments

- ✎ Loan growth has accelerated, after remaining subdued for last few quarters. Margins are also expected to stabilize leading to positive growth in core earnings.
- ✎ With AFS portfolio concentrated in short-dated securities, the bank is largely insulated from fluctuations in G-sec rate swings.
- ✎ Fee income is expected to grow with new initiatives such as insurance product distribution, equity trading, depository services, bill collection and increased volumes of government business.
- ✎ Best suited to benefit from the emerging business opportunities in J&K.

Key investment risks

- ✎ Any adverse political development in the state of J&K, could adversely affect the bank's growth opportunity.

Recent developments

- ✎ Mr. Haseeb A. Drabu, an eminent economist is now the chairman and managing director (CMD) of the bank after Mr. M. Y. Khan, who has retired.
- ✎ J&K Bank will partner with four other banks viz., Central Bank of India, Oriental Bank of Commerce, Union Bank of India and Standard Chartered Bank in a proposed asset reconstruction company.

Valuation and view

- ✎ The bank will benefit from the increased economic activity in the state of J&K.
- ✎ The stock trades at a P/E of 6.8x FY07E EPS and P/BV of 0.8x FY07E BV. We maintain **Buy**.

Sector View

- ✎ Loan growth of 30% in FY06. Likely to remain strong in FY07.
- ✎ 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

		J&K BANK	HDFC BANK	ICICI BK
P/E (x)	FY07E	6.8	21.8	15.8
	FY08E	5.4	16.4	12.8
P/ABV (x)	FY07E	0.8	4.0	2.0
	FY08E	0.8	3.3	1.8
RoE (%)	FY07E	12.6	19.6	13.3
	FY08E	14.4	21.8	14.6
RoA (%)	FY07E	0.8	1.4	1.1
	FY08E	0.9	1.4	1.1

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	53.2	53.2	53.2
Domestic Institutions	2.2	1.9	4.5
FII/FDIs	30.4	30.6	23.0
Others	14.3	14.4	19.3

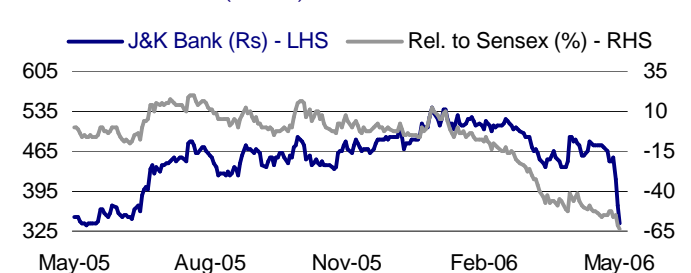
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	49.5	54.8	-9.6
FY08	62.7	75.3	-16.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
338	510	50.7	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
Interest Income	15,212	15,492	17,063	19,732	22,942	
Interest Expended	9,014	9,530	10,425	11,834	13,668	
Net Interest Income	6,199	5,962	6,637	7,898	9,275	
Change (%)	17.8	-3.8	11.3	19.0	17.4	
Other Income	3,017	820	1,332	1,562	1,783	
Net Income	9,216	6,783	7,969	9,460	11,057	
Change (%)	13.3	-26.4	17.5	18.7	16.9	
Operating Expenses	2,932	3,228	3,453	3,855	4,318	
Operating Income	6,284	3,555	4,517	5,606	6,740	
Change (%)	13.5	-43.4	27.1	24.1	20.2	
Other Provisions	521	2,195	1,905	2,200	2,425	
PBT	5,763	1,359	2,612	3,406	4,315	
Tax	1,700	209	843	1,022	1,294	
Tax Rate (%)	29.5	15.3	32.3	30.0	30.0	
PAT	4,063	1,151	1,769	2,384	3,020	
Change (%)	20.3	-71.7	53.7	34.8	26.7	
Proposed Dividend	547	439	443	554	665	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Capital	482	485	482	482	482	
Reserves & Surplus	15,455	16,169	17,495	19,325	21,680	
Net Worth	15,937	16,654	17,976	19,806	22,162	
Deposits	186,614	216,450	234,846	270,073	309,234	
Change (%)	27.2	16.0	8.5	15.0	14.5	
Borrowings	2,970	3,195	3,500	3,850	4,235	
Other Liabilities & Prov.	6,536	8,503	8,503	8,928	9,375	
Total Liabilities	212,058	244,802	264,826	302,658	345,005	
Current Assets	29,168	31,783	23,145	26,735	28,837	
Investments	84,511	90,892	90,023	94,525	99,251	
Change (%)	25.4	7.6	-1.0	5.0	5.0	
Advances	92,849	15,171	144,831	173,797	208,557	
Change (%)	15.9	24.0	25.8	20.0	20.0	
Net Fixed Assets	1,961	2,024	2,327	2,651	2,916	
Other Assets	3,569	4,931	4,500	4,950	5,445	
Total Assets	212,058	244,802	264,826	302,658	345,005	

ASSUMPTIONS	(%)				
Deposit Growth	27.2	16.0	8.5	15.0	14.5
Advances Growth	15.9	24.0	25.8	20.0	20.0
Investments Growth	25.4	7.6	-1.0	5.0	5.0
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	100.0	80.0	80.0	100.0	120.0
GRR	4.5	5.0	5.0	5.0	5.0

E: MOST Estimates

RATIOS						
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Spreads Analysis (%)						
Avg. Yield - Earning Assets	8.3	7.0	6.9	7.1	7.2	
Avg. Cost-Int. Bear. Liab.	5.3	4.7	4.6	4.6	4.7	
Interest Spread	3.0	2.3	2.3	2.5	2.6	
Net Interest Margin	3.4	2.7	2.7	2.8	2.9	

Profitability Ratios (%)						
RoE	28.7	7.1	10.2	12.6	14.4	
RoA	2.1	0.5	0.7	0.8	0.9	
Int. Expended/Int. Earned	59.3	61.5	61.1	60.0	59.6	
Other Inc./Net Income	32.7	12.1	16.7	16.5	16.1	

Efficiency Ratios (%)						
Op. Exps./Net Income	31.8	47.6	43.3	40.7	39.0	
Empl. Cost/Op. Exps.	57.4	55.4	55.7	54.1	52.0	
Busi. per Empl. (Rs m)	34.5	48.3	51.5	58.8	66.3	
NP per Empl. (Rs lac)	5.7	1.7	2.6	3.4	4.2	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	49.8	53.2	61.7	64.4	67.4	
Invest./Deposit Ratio	45.3	42.0	38.3	35.0	32.1	
G-Sec/Invest. Ratio	61.0	64.4	64.4	64.4	64.4	
Gross NPAs to Adv.	3.0	2.7	2.5	2.1	1.9	
Net NPAs to Adv.	1.5	1.4	0.9	0.6	0.4	
CAR	16.9	15.2	12.1	11.2	10.6	
Tier 1	13.0	12.5	11.8	10.5	9.8	

VALUATION						
Book Value (Rs)	330.3	343.4	373.3	411.3	460.2	
Price-BV (x)	1.0	1.0	0.9	0.8	0.7	
Adjusted BV (Rs)	311.7	321.6	355.2	398.2	447.9	
Price-ABV (x)	1.1	1.1	1.0	0.8	0.8	
EPS (Rs)	84.2	23.7	36.7	49.5	62.7	
EPS Growth (%)	20.3	-71.7	53.7	34.8	26.7	
Price-Earnings (x)	4.0	14.3	9.2	6.8	5.4	
OPS (Rs)	130.3	73.3	93.8	116.4	139.9	
OPS Growth (%)	13.5	-43.4	27.1	24.1	20.2	
Price-OP (x)	2.6	4.6	3.6	2.9	2.4	

E: MOST Estimates



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Disclosure of Interest Statement

Jammu & Kashmir 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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