



Incorporating **FRK**, the Global FIG Specialist

INDIA

UNBK IN Underperform

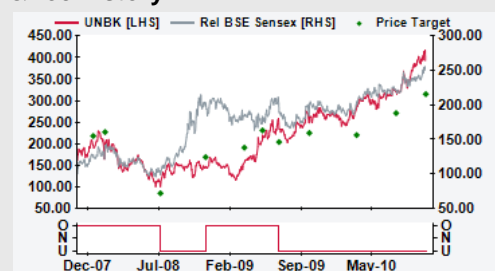
Price 26 Oct 10 Rs417.20

12-month target	Rs	315.00
Upside/Downside	%	-24.5
Valuation	Rs	315.00
- Gordon Growth		
GICS sector		Banks
Market cap	Rsm	210,735
Market cap	US\$m	4,729
Number shares on issue	m	505.1

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	m	41,258	55,372	65,328	77,599
Non interest Inc	m	20,413	17,690	16,816	17,686
PBT	m	28,329	28,496	34,248	40,781
PBT growth	%	20.8	0.6	20.2	19.1
Reported profit	m	20,749	20,802	25,001	29,770
EPS rep	Rs	41.08	41.18	49.49	58.94
EPS rep growth	%	20.2	0.3	20.2	19.1
EPS adj growth	%	20.2	0.3	20.2	19.1
PER rep	x	10.2	10.1	8.4	7.1
PER adj	x	10.2	10.1	8.4	7.1
Total DPS	Rs	5.50	5.00	5.00	5.00
Total div yield	%	1.3	1.2	1.2	1.2
ROA	%	1.2	1.0	1.0	1.0
ROE	%	21.7	18.4	18.8	18.9
Equity to assets	x	5.3	5.2	5.2	5.2
EV/EBITDA	x	2.6	2.6	2.2	1.8
P/BV	x	2.0	1.7	1.5	1.2

UNBK IN rel BSE Sensex performance, & rec history



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, October 2010
(all figures in INR unless noted)

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27 October 2010

Union Bank of India

Poor show

Event

- **Earnings significantly below our estimates:** Union Bank reported 2QFY11 net profit of Rs2bn, 40% below our estimate of Rs5bn mainly on account of higher than expected provisions.
- **Raising TP by 17% to Rs315:** We are raising our TP mainly on account of higher sustainable RoE coming out of higher NIM assumptions.

Impact

- **Asset quality woes:** In our view, the biggest concern is the increase in the delinquency rate to 3.7% from already high levels of 2% seen in 1QFY11. The agri-debt relief related amount of Rs4.14bn was classified as NPLs this quarter. Slippages from restructured assets have steadily increased from 1% last year to 15% currently. The bank's NPL coverage ratio has dropped down from a high of 85%+ to 70%, now leaving no headroom to provide less in case of slippages. Therefore, unless recoveries are high and/or slippages are low, credit costs could eat away earnings.
- **NII growth surprises mainly due to one-offs:** NII of Rs15.4bn was higher than our expectations mainly on account of interest on income tax refund. Core NIMs are at 3.21% (up 18bps QoQ) have peaked, in our view, and going forward, deposit re-pricing is likely to bring down margins. Union Bank's NIMs historically have been very volatile.
- **Opex pressures visible:** We have clearly articulated that the second option of pension and the increase in gratuity limit is likely to negatively affect earnings and that is precisely what happened in 2Q where staff expenses increased 36% QoQ. The second option of pension was opened up in 2Q and by the end of 3Q, banks will have clarity on their pension liabilities. In our view, further negative surprises cannot be ruled out. The fact that Union Bank has revised its pension liabilities from Rs12bn to Rs24bn (ie, from 12% of net-worth to 24% of net-worth) in a single quarter is quite alarming, in our view.

Earnings and target price revision

- We are marginally fine tuning earnings. Despite the earnings miss in 2QFY11, our EPS changes are minimal as we were very conservative on margins and hence our NIM increase has offset the higher credit charges. We are increasing our TP by 17% to Rs315 mainly on account of higher RoE driven by higher NIMs and some cost of equity changes.

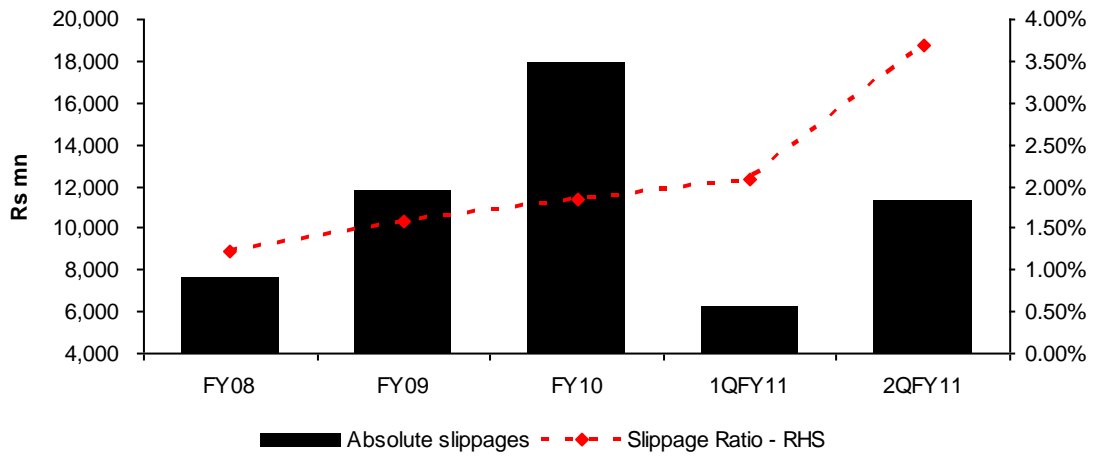
Price catalyst

- 12-month price target: Rs315.00 based on a Gordon Growth methodology.
- Catalyst: Decline in NIMs and possible disappointment in loan growth

Action and recommendation

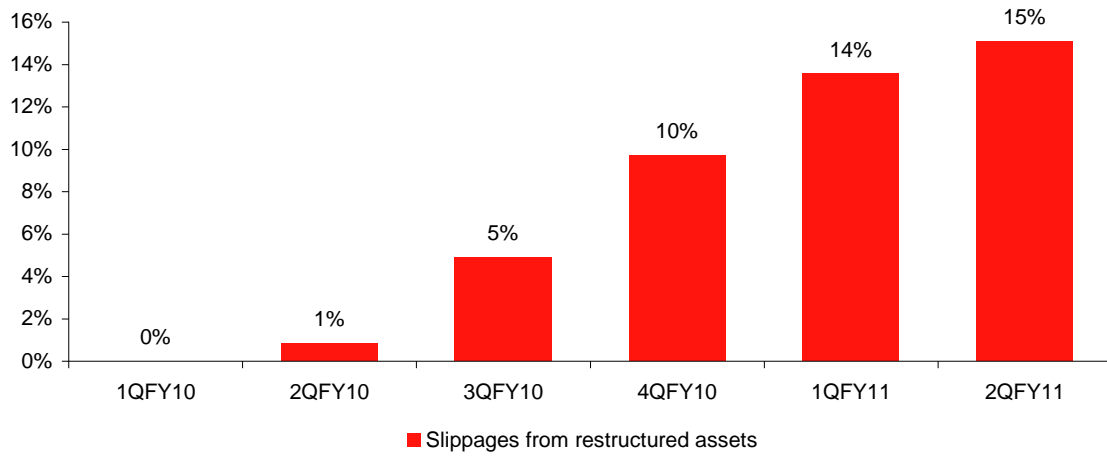
- **Maintain Underperform – chance of disappointment is very high:** Union Bank historically has over guided and under-delivered on several important parameters such as loan growth, slippages, etc. Even the current guidance of 25% loan growth, stable NIMs, etc. are a tall task. Reiterating Underperform with revised TP of Rs315.

Fig 1 Union Bank: Overall slippages have increased

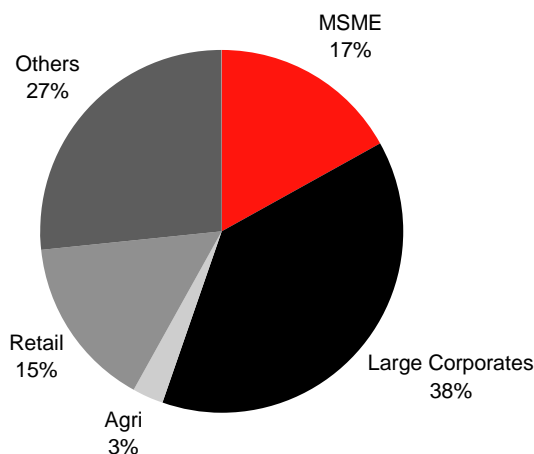


Source: Company data, Macquarie Research, October 2010

Fig 2 Union bank: Slippages from restructured assets have steadily increased



Source: Company data, Macquarie Research, October 2010

Fig 3 Union Bank: Composition of restructured assets

Source: Company data, Macquarie Research, October 2010

Valuations – raising TP to Rs315 from Rs271

We value Union Bank on a two-stage Gordon growth model:

$P/BV = RoE * \{ \{ p(1+g) * (1 - (1+g)^n / (1+r)^n) \} + \{ pn(1+g)^n(1+gn) \} / \{ (r-gn)(1+r)^n \}$ where g=growth rate for the first n (high-growth period) years, p=payout ratio in the first n years, gn=perpetual growth rate, pn=perpetual payout ratio.

Fig 4 Union Bank valuation methodology

r (cost of equity)	13.9%
RoE estimate	
FY12E RoE	18.8%
Schematic RoE	17.4%
Blended RoE estimate	17.8%
Computed P/BV – two stage Gordon growth model	1.40x
FY12E adj book value (INR)	226
Target Price (Rounded off)	315

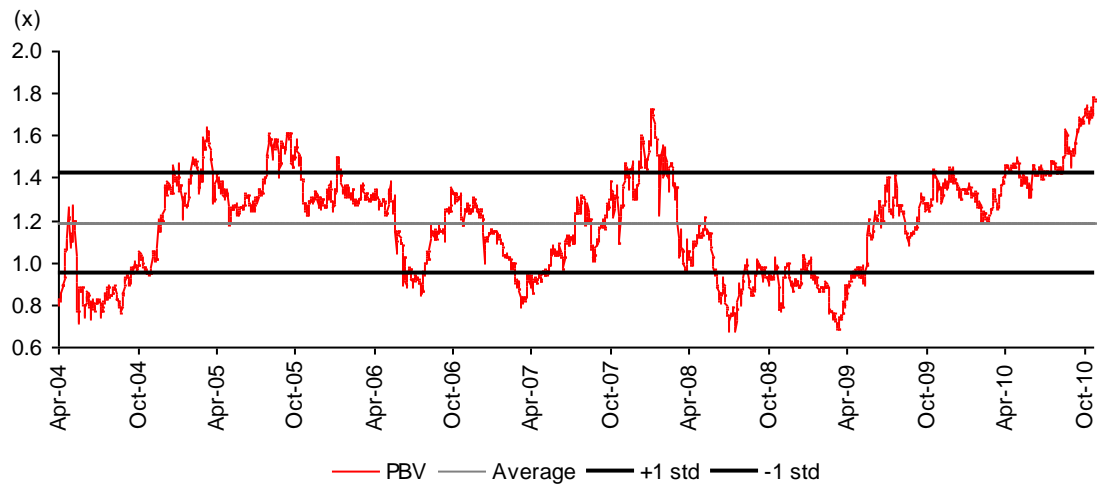
Source: Company data, Macquarie Research, July 2010

The increase in TP from Rs271 to Rs315 is mainly on account of increase in sustainable RoE from 15.8% to 17.4%. We have increased normalised NIMs to closer to 3% from 2.8% assumed earlier as we believe the bank has managed to improve its deposits franchise and is likely to maintain NIMs closer to 3% over the longer term. We had already factored higher credit costs as well as opex into our nos.

Valuations offer no room for comfort

Union Bank is now trading two standard deviations above historical average. The stock now trades at 1.7x 1yr fwd P/BV and 1.6x FY12E P/BV. We reiterate our Underperform rating on the stock.

Fig 5 Union Bank: 1-yr fwd P/BV



Source: Bloomberg, Macquarie Research, July 2010

Fig 6 Union Bank: 2QFY11 Snapshot

All figures in Rs Mn	2QFY10	1QFY11	2QFY11	YoY	QoQ
Income Statement (Rs mn)					
Net Interest Income	8,634	13,480	15,358	78%	14%
Non Interest Income	5,553	4,350	5,096	-8%	17%
Trading Profits	2,180	1,130	1,870	-14%	65%
Total Income	14,187	17,830	20,455	44%	15%
Core Revenues	12,007	16,700	18,585	55%	11%
Non Interest Income (excl Treasury)	3,373	3,220	3,226	-4%	0%
Staff expenses	3,059	4,350	5,919	94%	36%
Other expenses	3,028	3,044	3,229	7%	6%
Total Operating Expenses	6,086	7,393	9,149	50%	24%
Operating profit	8,101	10,437	11,306	40%	8%
Core Operating Profit	5,921	9,307	9,436	59%	1%
Provision - NPL	1,020	1,000	6,290	517%	529%
Provision - investments	(40)	210	(340)	NM	NM
Other provisions	370	763	39	-89%	-95%
Total provisions	1,350	1,973	5,989	344%	204%
PBT	6,751	8,464	5,317	-21%	-37%
Tax	1,700	2,450	2,284	34%	-7%
PAT	5,051	6,014	3,034	-40%	-50%
Balance Sheet (Rs mn)					
Loans	975,631	1,231,571	1,241,423	27%	1%
Deposits	1,490,660	1,714,840	1,777,700	19%	4%
CASA ratio	33%	33%	32.7%	-0.28%	0.12%
NIMs	2.42%	3.03%	3.35%	0.93%	0.32%
Key Ratios					
Cost/Income	43%	41%	45%	1.8%	3.3%
Core Cost/Income ratio	51%	44%	49%	-1.5%	5.0%
Tax rate	25%	29%	43%	17.8%	14.0%
Core Fee Income/Operating Income	24%	18%	16%	-8.0%	-2.3%
Loan to Deposit ratio	65%	72%	70%	4.4%	-2.0%
Capital Adequacy Ratios					
Tier-I Ratio	8.7%	7.9%	7.9%	-0.8%	0.0%
Tier-II Ratio	5.0%	4.7%	4.7%	-0.4%	0.0%
Total CAR Ratio	13.8%	12.6%	12.5%	-1.2%	-0.1%
Asset Quality Ratios					
Gross NPAs	19,185	27,356	35,243	84%	29%
Net NPAs	2,229	11,496	14,620	556%	27%
Reserve Coverage ratio	88%	58%	59%	-29.9%	0.5%
Gross NPA Ratio	1.93%	2.20%	2.79%	0.86%	0.59%
Net NPA Ratio	0.23%	0.94%	1.18%	0.95%	0.24%

Source: Company data, Macquarie Research, October 2010

Union Bank of India (UNBK IN, Underperform, Target Price: Rs315.00)

Quarterly Results					Profit & Loss						
		2Q/11A	3Q/11E	4Q/11E	1Q/12E		2010A	2011E	2012E	2013E	
Net Interest Income	m	14,215	15,032	13,679	14,683	Net Interest Income	m	41,258	55,372	65,328	77,599
+ Loan Fees	m	1,084	1,146	1,043	1,138	+ Loan Fees	m	14,683	4,221	5,065	6,078
+ Trading Income	m	1,777	1,879	1,710	1,464	+ Trading Income	m	5,730	6,922	6,513	6,264
+ Insurance Income	m	0	0	0	0	+ Insurance Income	m	0	0	0	0
+ Other Income	m	1,681	1,778	1,618	1,177	+ Other Income	m	0	6,548	5,238	5,343
Non Interest Income	m	4,542	4,803	4,370	3,780	Non Interest Income	m	20,413	17,690	16,816	17,686
Total Operating Inc	m	18,757	19,835	18,049	18,462	Total Operating Inc	m	61,672	73,062	82,145	95,284
+ Staff expenses	m	3,983	4,212	3,832	3,912	+ Staff expenses	m	13,545	15,513	17,406	19,529
+ Other expenses	m	4,312	4,560	4,149	4,549	+ Other expenses	m	11,534	16,796	20,241	23,926
Total Operating Exp	m	8,295	8,771	7,982	8,461	Total Operating Exp	m	25,078	32,309	37,647	43,455
Pre-Provision Profit	m	10,462	11,064	10,067	10,001	Pre-Provision Profit	m	36,593	40,752	44,498	51,829
Loan Provisions	m	3,146	3,327	3,028	2,304	Loan Provisions	m	8,264	12,256	10,250	11,049
Post Provision Profit	m	7,316	7,736	7,040	7,697	Post Provision Profit	m	28,329	28,496	34,248	40,781
Other Profit	m	0	0	0	0	Other Profit	m	0	0	0	0
- Amortisation	m	0	0	0	0	- Amortisation	m	0	0	0	0
- Non Recurring Items	m	0	0	0	0	- Non Recurring Items	m	0	0	0	0
- Associates	m	0	0	0	0	- Associates	m	0	0	0	0
Pre-Tax Profit	m	7,316	7,736	7,040	7,697	Pre-Tax Profit	m	28,329	28,496	34,248	40,781
- Taxation	m	1,975	2,089	1,901	2,078	- Taxation	m	7,580	7,694	9,247	11,011
Net Profit After Tax	m	5,341	5,647	5,139	5,619	Net Profit After Tax	m	20,749	20,802	25,001	29,770
- Minority Interests	m	0	0	0	0	- Minority Interests	m	0	0	0	0
Reported Profit	m	5,341	5,647	5,139	5,619	Reported Profit	m	20,749	20,802	25,001	29,770
Adjusted Profit	m	5,341	5,647	5,139	5,619	Adjusted Profit	m	20,749	20,802	25,001	29,770
Attributable Profit	m	5,341	5,647	5,139	5,619	Attributable Profit	m	20,749	20,802	25,001	29,770
EPS (rep)		10.57	11.18	10.17	11.12	EPS (rep)		41.08	41.18	49.49	58.94
EPS growth pcp (rep)	%	5.7	5.7	-13.4	20.2	EPS growth yoy (rep)	%	20.2	0.3	20.2	19.1
EPS (adj)		10.57	11.18	10.17	11.12	EPS (adj)		41.08	41.18	49.49	58.94
EPS growth pcp (adj)	%	5.7	5.7	-13.4	20.2	EPS growth yoy (adj)	%	20.2	0.3	20.2	19.1
DPS		1.25	1.25	1.25	1.25	DPS		5.50	5.00	5.00	5.00
						Payout ratio	%	13.4	12.1	10.1	8.5
						Book Value p.s (wgted)		206.4	241.9	285.8	339.1
						Tangible Book Value p.s (wgted)		206.4	241.9	285.8	339.1
						Weighted average shares	m	505	505	505	505
Key Ratios					Key Ratios						
		2Q/11A	3Q/11E	4Q/11E	1Q/12E		2010A	2011E	2012E	2013E	
Interest Spread	%	1.31	1.38	1.26	1.25	Interest Spread	%	2.22	2.55	2.59	2.64
Net Interest Margin	%	1.35	1.42	1.30	1.27	Net Interest Margin	%	2.33	2.62	2.61	2.60
Non Int Inc / Total Inc	%	24.2	24.2	24.2	20.5	Non Int Inc / Total Inc	%	33.8	24.2	20.5	18.6
Cost to Income	%	44.2	44.2	44.2	45.8	Cost to Income	%	40.7	44.2	45.8	45.6
Cost to Assets	%	0.71	0.75	0.68	0.61	Cost to Assets	%	1.29	1.38	1.35	1.31
Provisions / Loans	%	0.43	0.46	0.42	0.27	Provisions / Loans	%	0.68	0.84	0.60	0.55
Tax Rate	%	27.0	27.0	27.0	27.0	Tax Rate	%	26.8	27.0	27.0	27.0
Loan Deposit Ratio (LDR)	%	70.1	70.1	70.1	68.8	Loan Deposit Ratio (LDR)	%	70.2	70.1	68.8	67.5
NPLs	%	2.65	2.65	2.65	2.58	NPLs	%	2.21	2.65	2.58	2.19
Reserve Cover	%	65.5	65.5	65.5	71.3	Reserve Cover	%	61.5	65.5	71.3	71.3
Tier 1 Capital Ratio	%	7.0	7.0	7.0	7.2	Tier 1 Capital Ratio	%	7.9	7.0	7.2	7.2
Total Capital Ratio	%	11.4	11.4	11.4	11.6	Total Capital Ratio	%	12.5	11.4	11.6	11.6
Equity to Assets	%	5.2	5.2	5.2	5.2	Equity to Assets	%	5.3	5.2	5.2	5.2
ROA (ave)	%	0.50	0.53	0.48	0.44	ROA (ave)	%	1.17	0.97	0.98	0.98
ROE (ave)	%	9.4	10.0	9.1	8.4	ROE (ave)	%	21.7	18.4	18.8	18.9
ROTE (ave)	%	9.4	10.0	9.1	8.4	ROTE (ave)	%	21.7	18.4	18.8	18.9
					Growth rates						
							2010A	2011E	2012E	2013E	
Income Growth	%					Income Growth	%	16.4	18.5	12.4	16.0
Cost Growth	%					Cost Growth	%	13.3	28.8	16.5	15.4
Pre-Prov Profit Growth	%					Pre-Prov Profit Growth	%	18.7	11.4	9.2	16.5
PBT Growth	%					PBT Growth	%	20.8	0.6	20.2	19.1
Loan Growth	%					Loan Growth	%	23.6	20.0	18.0	18.0
Ave Int Earning Assets	%					Ave Int Earning Assets	%	20.8	19.2	18.8	19.0
					Valuation data						
							2010A	2011E	2012E	2013E	
P/E (rep)	x					P/E (rep)	x	10.2	10.1	8.4	7.1
P/E (adj)	x					P/E (adj)	x	10.2	10.1	8.4	7.1
P/B (wgted)	x					P/B (wgted)	x	2.0	1.7	1.5	1.2
P/TB (wgted)	x					P/TB (wgted)	x	2.0	1.7	1.5	1.2
Dividend yield	%					Dividend yield	%	1.3	1.2	1.2	1.2
					Balance Sheet						
							2010A	2011E	2012E	2013E	
Cash & Equivalent	m					Cash & Equivalent	m	124,682	137,072	150,694	165,672
Net Loans to Customer	m					Net Loans to Customer	m	1,193,153	1,431,783	1,689,505	1,993,615
Other Interest Earning Assets	m					Other Interest Earning Assets	m	577,120	678,211	816,644	989,270
Other Assets	m					Other Assets	m	56,663	90,164	126,007	169,781
Total Assets	m					Total Assets	m	1,951,617	2,337,231	2,782,850	3,318,338
Customer Deposits	m					Customer Deposits	m	1,700,398	2,043,723	2,456,428	2,952,545
Other Int Bearing Liab	m					Other Int Bearing Liab	m	31,253	37,044	44,016	52,405
Other Liabilities	m					Other Liabilities	m	115,730	134,262	138,043	142,092
Total Liabilities	m					Total Liabilities	m	1,847,381	2,215,030	2,638,488	3,147,043
Ordinary Equity	m					Ordinary Equity	m	5,051	5,051	5,051	5,051
Retained Earnings	m					Retained Earnings	m	0	0	0	0
Reserves	m					Reserves	m	99,187	117,150	139,311	166,245
Minority Interests	m					Minority Interests	m	0	0	0	0
Total S/H's Funds	m					Total S/H's Funds	m	104,238	122,201	144,362	171,296

All figures in INR unless noted.

Source: Company data, Macquarie Research, October 2010

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe

Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South - South Africa

Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada

Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA

Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell) – return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high-highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low-medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Australian/NZ/Canada stocks only

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / epowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 September 2010

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	51.06%	64.41%	55.07%	46.58%	66.99%	50.00%	(for US coverage by MCUSA, 13.73% of stocks covered are investment banking clients)
Neutral	34.15%	17.31%	36.23%	48.40%	28.71%	36.81%	(for US coverage by MCUSA, 11.76% of stocks covered are investment banking clients)
Underperform	14.79%	18.28%	8.70%	5.02%	4.31%	13.19%	(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)

Company Specific Disclosures:

Important disclosure information regarding the subject companies covered in this report is available at www.macquarie.com/disclosures.

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