



Punjab National Bank

STOCK INFO.	BLOOMBERG
BSE SENSEX: 19,978	PNB IN
	REUTERS CODE
S&P CNX: 5,906	PNBK.BO

29 October 2007

Buy

Previous Recommendation: Buy

Rs539

Equity Shares (m)	315.3
52-Week Range	594/305
1,6,12 Rel.Perf.(%)	-15/-37/-49
M.Cap. (Rs b)	170.0
M.Cap. (US\$ b)	4.3

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)
3/07A	65,569	15,401	48.8	7.0	11.0	1.7	12.3	16.0	1.0	1.8
3/08E	71,288	18,203	57.7	18.2	9.3	1.5	11.4	16.8	1.0	1.6
3/09E	86,867	22,446	71.2	23.3	7.6	1.3	11.0	18.2	1.1	1.4

- Punjab National Bank (PNB) reported flat NII for 2QFY08, as margins came under pressure due to higher deposit costs. NIM declined 37bp YoY in 1HFY08 to 3.49%.
- Advances grew 23% YoY to Rs1t while deposits grew 17% YoY to Rs1.5t. While CASA remained stable at 44% QoQ; it declined from 48.7% in 2QFY07.
- Other income increased 26% YoY on account of 17% growth in forex income, 21% growth in fees, and 67% increase in treasury profits during 2QFY08.
- Our concerns on asset quality aggravated further, as asset quality deteriorated significantly during 2QFY08. Gross NPAs increased by Rs10b (27% QoQ) in 2QFY08 while net NPAs increased by Rs9.4b (102% QoQ). Gross NPA ratio climbed to 4.57% and net NPA ratio to 1.86%.
- While the bank's quarterly performance has been below our expectations, we believe that this was one of the worst quarters for PNB in terms of asset quality – it recognized about Rs15b of NPAs. While the quantum of increase in NPAs is a big disappointment, the management indicated that a lot of these NPAs are technical in nature. 75-80% of these loans are recoverable over the next 6-12 months. Going forward, we expect asset quality to improve and recoveries to remain strong. The stock trades at 7.6x FY09E EPS and 1.3x FY09E BV. We maintain **Buy**.

QUARTERLY PERFORMANCE

	(RS MILLION)									
	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Interest Income	25,591	26,882	28,723	31,184	32,860	34,631	37,055	39,998	112,362	144,544
Interest Expense	13,476	14,015	15,024	17,714	19,850	21,716	23,236	25,074	60,229	89,876
Net Interest Income	12,115	12,867	13,699	13,470	13,010	12,915	13,819	14,925	52,133	54,668
% Change (YoY)					7.4	0.4	0.9	10.8		4.9
Other Income	-227	3,710	3,991	5,944	113	4,678	5,500	6,328	13,436	16,620
Net Income	11,888	16,577	17,689	19,414	13,124	17,593	19,319	21,253	65,569	71,288
% Change (YoY)					10.4	6.1	9.2	9.5	11.2	8.7
Operating Expenses	6,969	7,580	8,123	10,591	8,770	9,043	9,100	9,671	33,262	36,583
Operating Profit	4,920	8,997	9,567	8,824	4,354	8,550	10,219	11,582	32,306	34,704
Provision & Contingencies	-216	1,127	3,577	6,127	-1,905	778	3,000	6,827	10,615	8,700
PBT	5,135	7,870	5,990	2,697	6,259	7,772	7,219	4,755	21,691	26,004
Tax Provisions	1,460	2,820	1,691	320	2,009	2,386	1,800	1,606	6,291	7,801
Net Profit	3,675	5,050	4,299	2,377	4,250	5,385	5,419	3,149	15,401	18,203
% Change (YoY)	2.6	19.7	16.0	-17.7	15.6	6.6	26.1	32.5	7.0	18.2
Cost to Income Ratio (%)	58.6	45.7	45.9	54.6	66.8	51.4	47.1	45.5	50.7	51.3
Int exp/ Int Earned (%)	52.7	52.1	52.3	56.8	60.4	62.7	62.7	62.7	53.6	62.2
Other Income / Net Income (%)	-1.9	22.4	22.6	30.6	0.9	26.6	28.5	29.8	20.5	23.3

E: MOST Estimates

Higher deposit costs keep margins under pressure

PNB reported flat NII for 2QFY08 against our estimate of 7% growth, as margins came under pressure due to higher deposit costs. The bank has started deducting amortization on HTM investments from income from investments. This was shown as part of provisions in 2QFY07 and as part of other income in 1QFY08. Adjusted NIMs dropped to 3.49% in 1HFY08 from 3.86% a year ago, as cost of deposits increased 120bp YoY to 5.55%. PNB mobilized Rs150b (10% of current deposit base) from its 9.5% deposit scheme and it had also resorted to bulk deposits during 4QFY07. Both these factors resulted in sharp rise in its cost of deposits. Yield on advances increased by 123bp to 10.2% while yield on investments (based on reclassified amortization) dropped from 7.09% to 6.86% YoY. The management has guided higher margins, going forward, as yields on advances are expected to improve by 50-75bp during FY08, and increase in cost of deposits would be contained at 10-15bp. PNB has already withdrawn its 9.5% deposit scheme and aims to contain cost of deposits by slowing balance sheet growth.

TRENDS IN YIELDS, COST AND NIM (%)

	FY06	1QFY07	1HFY07*	FY07*	1QFY08*	1HFY08*
Yield on Advances	8.3	8.8	9.0	9.2	10.2	10.2
Yield on Investments	8.2	7.9	7.1	7.1	6.7	6.9
Cost of Deposits	4.3	4.4	4.4	4.5	5.5	5.6
NIMs	4.0	4.1	3.9	3.8	3.6	3.5

* Adjusted for amortization reclassification

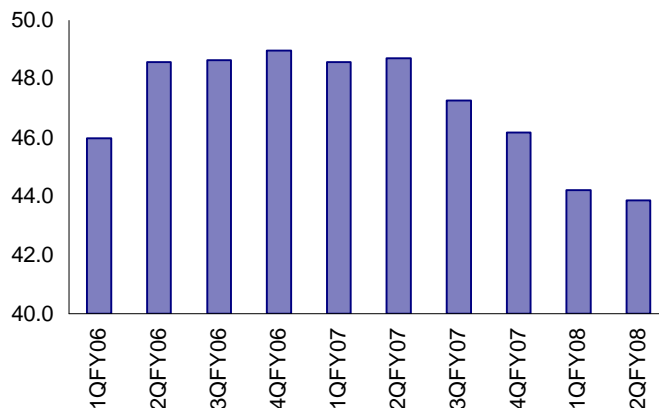
Source: Company/Motilal Oswal Securities

Business growth slows down

Advances grew 23% YoY (6% QoQ) to Rs1t, while deposits grew 17% YoY (5% QoQ) to Rs1.5t. While CASA remained stable at 44% QoQ, it has declined from 48.7% in 2QFY07.

SME (19% growth YoY), SSI (23% growth YoY), agriculture (14% growth YoY), and retail credit (22% growth YoY) have driven credit growth for the bank. The management has guided ~20% credit growth for FY08, with more focus on quality of assets and margins. Retail (includes retail trade) and SMEs would continue to drive credit growth.

CASA RATIO TREND (%)



Source: Company/Motilal Oswal Securities

Treasury profits and fees drive other income growth

Other income increased 26% YoY on account of 17% growth in forex income, 21% growth in fees, and 67% increase in treasury profits during 2QFY08.

OTHER INCOME BREAK UP (RS M)

	2QFY08	2QFY07	YOY GR.
Commission Exchange and Brokerages	2,620	2,170	21%
Profit on Exchange Transactions	420	360	17%
Misc Other Income	568	540	5%
Treasury Profits	1,070	640	67%
Total Other Income	4,687	3,710	26%

Source: Company/Motilal Oswal Securities

Operating expenses higher on account of AS-15 provision

PNB's total transitional liability towards revised AS-15 is estimated at Rs9b, which would be amortized over the next five years (Rs0.5b per quarter). The incremental liability on account of AS-15 is expected to be Rs6b (Rs1.5b per quarter). Staff cost increased 26% YoY in 2QFY08 mainly on account of provisions towards AS-15. Non-staff opex grew just 6% YoY.

Asset quality deteriorates further, net NPAs at 1.86%

Our concerns on asset quality aggravated further, as asset quality deteriorated further during 2QFY08. Gross NPAs

NPA TREND

	1QFY06	2QFY06	3QFY06	4QFY06	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Gross NPAs (Rs m)	35,290	33,586	33,180	31,383	31,617	30,910	32,680	33,910	37,083	47,165
Net NPAs (Rs m)	490	2,013	1,660	2,100	7,256	1,454	3,651	7,256	9,257	18,662
Gross NPA Ratio (%)	6.0	5.1	4.8	4.1	4.0	3.7	3.7	3.5	3.8	4.6
Net NPA Ratio (%)	0.1	0.3	0.3	0.3	0.4	0.2	0.5	0.8	1.0	1.9

Source: Company/Motilal Oswal Securities

increased 27% QoQ to Rs47b. Gross NPA ratio increased 76bp QoQ to 4.57%. Net NPAs in absolute terms increased from Rs9.3b in June 2007 to Rs18.7b in September 2007 – a growth of 100% QoQ. Net NPA ratio increased to 1.86% v/s 0.98% in 1QFY07 and 0.8% in FY07. Fresh delinquency was Rs15b during 2QFY08 and ~Rs20b during 1HFY08. During FY07, overall delinquency was Rs20b.

While the quantum of increase in NPAs is a big disappointment, the management indicated that a lot of these NPAs are technical in nature. PNB has treated these loans (mostly in the infrastructure segment) as NPAs to comply with RBI guidelines, and 75-80% of these loans are recoverable over the next 6-12 months. However, no other bank has treated these infrastructure loans as NPAs.

Valuation and view

Fast deterioration in asset quality is concerning. The management has guided lower asset growth (20%) in FY08, with greater focus on sustaining margins and improving asset quality. The bank's fee income growth should remain strong. Structurally, PNB remains one of the best state-owned banks, with a well-spread branch network, large customer franchise, high CASA and NIMs, and advanced technological platform.

While the bank's quarterly performance has been below our expectations, we believe that this was one of the worst quarters for PNB in terms of asset quality – it recognized about Rs15b of NPAs. Going forward, we expect asset quality to improve and recoveries to remain strong. The stock trades at 7.6x FY09E EPS and 1.3x FY09E BV. We maintain **Buy**.

Punjab National Bank: an investment profile

Company description

Punjab National Bank (PNB) is the second largest state-owned bank with a strong presence in North and Central India. Established in 1894, it has a balance sheet size of ~Rs1.7t and a network of over 4,500 branches. It is one of the most technologically advanced state-owned banks, with the government owning 57.8% of its equity.

Key investment arguments

- ✍ One of the few state-owned banks to have strong traction in fee income at ~25% YoY.
- ✍ Transfer of bonds to HTM would protect its earnings from interest rate volatility.
- ✍ Has networked 2,526 branches under core banking solutions, covering 83% of the business.

Key investment risks

- ✍ Huge workforce resulting in higher wage bill.
- ✍ Asset quality has worsened during FY07 with slippage ratio increasing to 2.8%
- ✍ In the past, the bank has been involved in bailouts. Any such event in the future would adversely impact valuations.

COMPARATIVE VALUATIONS

		PNB	BOI	CANARA BANK
P/E (x)	FY08E	9.3	10.1	7.3
	FY09E	7.6	8.5	6.5
P/ABV (x)	FY08E	1.6	2.3	1.4
	FY09E	1.4	1.9	1.2
RoE (%)	FY08E	16.8	23.7	18.4
	FY09E	18.2	23.2	17.9
RoA (%)	FY08E	1.0	1.0	1.0
	FY09E	1.1	1.0	0.9

SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	57.8	57.8	57.8
Domestic Inst	16.0	16.2	13.6
Foreign	20.1	20.1	20.1
Others	6.1	5.9	8.5

Recent developments

- ✍ PNB has recently raised Rs15b in Tier-2 bonds.
- ✍ Standard & Poor's, a leading index provider, recently released the global challengers list in which PNB is featured as one of the major challengers to the world's leading blue chip companies.

Valuation and view

- ✍ We expect loan growth of 23% and earnings growth of 18% in FY08.
- ✍ Improvement in asset quality and margins would drive valuation re-rating.
- ✍ The stock trades at 7.6x FY09E EPS and 1.3x FY09E BV. We maintain **Buy**.

Sector view

- ✍ YTD loan growth of 23%, down from 30% for the past three years.
- ✍ Volatility in interest rates will impact bond gains.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

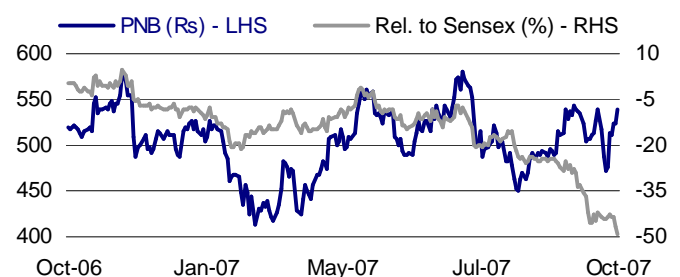
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	57.7	59.7	-3.3
FY09	71.2	70.5	1.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
539	628	16.5	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2006	2007	2008E	2009E	
Interest Income	93,371	112,362	144,544	167,187	
Interest Expended	49,174	60,229	89,876	103,578	
Net Interest Income	44,197	52,133	54,668	63,609	
Change (%)	10.3	18.0	4.9	16.4	
Other Income	15,206	13,436	16,620	23,258	
Bond Gains	4,580	139	30	4,000	
Net Income	59,403	65,569	71,288	86,867	
Change (%)	4.5	10.4	8.7	21.9	
Operating Expenses	30,232	33,262	36,583	40,800	
Operating Inc.	29,171	32,306	34,704	46,066	
Change (%)	7.8	10.7	7.4	32.7	
Other Provisions	8,823	10,615	8,700	14,000	
PBT	20,348	21,691	26,004	32,066	
Tax	5,955	6,291	7,801	9,620	
Tax Rate (%)	29.3	29.0	30.0	30.0	
PAT	14,393	15,401	18,203	22,446	
Change (%)	2.1	7.0	18.2	23.3	
Proposed Dividend	2,838	3,153	3,784	4,730	

BALANCE SHEET		(Rs Million)			
Y/E MARCH	2006	2007	2008E	2009E	
Capital	3,153	3,153	3,153	3,153	
Reserves & Surplus	90,611	101,202	114,978	131,891	
Net Worth	93,764	104,355	118,131	135,044	
Deposits	1,196,850	1,398,600	1,650,348	1,947,411	
Change (%)	16.0	16.9	18.0	18.0	
Borrowings	66,872	19,489	18,000	18,000	
Other Liabilities & Prov.	95,188	101,785	116,785	131,785	
Total Liabilities	1,452,674	1,624,228	1,903,264	2,232,239	
Current Assets	247,917	156,458	161,140	174,425	
Investments	410,553	451,898	497,088	571,651	
Change (%)	-19.0	10.1	10.0	15.0	
Advances	746,274	965,965	1,188,137	1,425,765	
Change (%)	23.5	29.4	23.0	20.0	
Net Fixed Assets	10,302	10,098	11,898	13,398	
Other Assets	37,628	39,808	45,000	47,000	
Total Assets	1,452,674	1,624,228	1,903,264	2,232,239	

ASSUMPTIONS	(%)			
Deposit Growth	16.0	16.9	18.0	18.0
Advances Growth	23.5	29.4	23.0	20.0
Investments Growth	-19.0	10.1	10.0	15.0
Dividend	90.0	100.0	120.0	150.0

E: MOST Estimates

RATIOS		2006	2007	2008E	2009E
Spreads Analysis (%)					
Avg. Yield - Earning Asset:		7.1	7.6	8.6	8.4
Avg. Cost-Int. Bear. Liab.		4.2	4.5	5.8	5.7
Interest Spread		2.9	3.1	2.7	2.7
Net Interest Margin		3.4	3.5	3.2	3.2
Profitability Ratios (%)					
RoE		17.0	16.0	16.8	18.2
RoA		11	10	10	11
Int. Expended/Int. Earned		52.7	53.6	62.2	62.0
Other Inc./Net Income		25.6	20.5	23.3	26.8
Efficiency Ratios (%)					
Op. Exps./Net Income		50.9	50.7	51.3	47.0
Empl. Cost/Op. Exps.		70.0	70.7	69.5	68.0
Busi. per Empl. (Rs m)		30.9	37.8	46.5	56.5
NP per Empl. (Rs lac)		2.5	2.7	3.3	4.1

Asset-Liability Profile (%)		2006	2007	2008E	2009E
Adv./Deposit Ratio		62.4	69.1	72.0	73.2
Invest./Deposit Ratio		34.3	32.3	30.1	29.4
G-Sec/Invest. Ratio		84.4	83.3	84.8	82.6
Gross NPAs to Adv.		4.0	3.4	3.2	3.1
Net NPAs to Adv.		0.3	0.8	1.3	1.2
CAR		12.0	12.3	11.4	11.0
Tier 1		10.1	8.9	7.9	7.5

VALUATION		2006	2007	2008E	2009E
Book Value (Rs)		288	322	365	419
Price-BV (x)		1.9	1.7	1.5	1.3
Adjusted BV (Rs)		283	307	333	382
Price-ABV (x)		1.9	1.8	1.6	1.4
EPS (Rs)		45.6	48.8	57.7	71.2
EPS Growth (%)		2.1	7.0	18.2	23.3
Price-Earnings (x)		11.8	11.0	9.3	7.6
OPS (Rs)		92.5	102.5	110.1	146.1
OPS Growth (%)		7.8	10.7	7.4	32.7
Price-OP (x)		5.8	5.3	4.9	3.7

E: MOST Estimates



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motiloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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Disclosure of Interest Statement	Punjab National Bank
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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