

Company Focus

31 October 2007 | 8 pages

Bank of Baroda (BOB.BO)

Buy: 2Q08 results; Standing Tall

- Operationally strong quarter** — BOB's net profits are up 14% YoY, 8% lower than expectations. However adjusting for pension liability charges, profits would rise 35%; 10% ahead of expectation. An operationally strong quarter; pre-provision profit was up 29%, stable margins, and 40% non-interest income growth. This is one of the strongest performances amongst government banks, and bucks a disappointing industry trend.
- Margins hold, non-interest income momentum** — BOB has held margins at about +3%, commendable in a challenging quarter, provides comfort and suggests growth is being managed profitably. Non-interest income has also grown 40%; likely boosted by recoveries and treasury gains
- Strong asset quality show** — Almost no deterioration in the quarter, coverage levels continue to rise, and Net NPL level at 0.55% is now amongst the best in the broader banking sector. BOB has been working steadily on this part of the business – and is increasingly differentiating itself from peers.
- 10% pension hole** — Owns up, and starts providing, BOB is probably the first bank to formally disclose its pension gap at Rs9b, or 10%. This is probably in line with expectations; and management seeks to plug this gap over 10 quarters. An earnings over-hang, but it removes uncertainty, and suggests an earnings cushion to gradually absorb the charge.
- Maintain Buy (1M) rRating** — We see value at current levels.

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	8,270	25.06	9.0	13.5	1.6	12.3	1.5
2007A	10,260	28.07	12.0	12.1	1.4	12.4	1.6
2008E	14,758	40.37	43.8	8.4	1.3	15.9	1.8
2009E	17,697	48.41	19.9	7.0	1.1	16.7	1.8
2010E	20,043	54.83	13.3	6.2	1.0	16.5	1.8

Source: Powered by dataCentral

See Appendix A-1 for Analyst Certification and important disclosures.

Buy/Medium Risk	1M
Price (31 Oct 07)	Rs338.65
Target price	Rs390.00
Expected share price return	15.2%
Expected dividend yield	1.8%
Expected total return	16.9%
Market Cap	Rs123,359M US\$3,135M

Price Performance (RIC: BOB.BO, BB: BOB IN)



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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	13.5	12.1	8.4	7.0	6.2
P/E reported (x)	13.5	12.1	8.4	7.0	6.2
P/BV (x)	1.6	1.4	1.3	1.1	1.0
P/Adjusted BV diluted (x)	1.6	1.5	1.3	1.1	1.0
Dividend yield (%)	1.5	1.6	1.8	1.8	1.8
Per Share Data (Rs)					
EPS adjusted	25.06	28.07	40.37	48.41	54.83
EPS reported	25.06	28.07	40.37	48.41	54.83
BVPS	214.61	236.64	270.22	309.11	354.41
Tangible BVPS	214.61	236.64	270.22	309.11	354.41
Adjusted BVPS diluted	208.46	230.79	264.37	303.26	348.56
DPS	5.00	5.50	6.00	6.00	6.00
Profit & Loss (RsM)					
Net interest income	32,249	37,861	45,267	52,836	60,340
Fees and commissions	3,610	4,729	5,296	5,984	6,822
Other operating Income	8,307	9,089	10,183	11,059	12,265
Total operating income	44,166	51,679	60,746	69,879	79,427
Total operating expenses	-23,848	-25,443	-29,260	-32,649	-36,042
Oper. profit bef. provisions	20,318	26,236	31,487	37,231	43,385
Bad debt provisions	-3,400	-4,262	-5,460	-6,817	-9,470
Non-operating/exceptionals	-5,772	-5,436	-4,000	-4,000	-4,000
Pre-tax profit	11,146	16,538	22,027	26,413	29,915
Tax	-2,876	-6,278	-7,269	-8,716	-9,872
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	8,270	10,260	14,758	17,697	20,043
Adjusted earnings	8,270	10,260	14,758	17,697	20,043
Growth Rates (%)					
EPS adjusted	9.0	12.0	43.8	19.9	13.3
Oper. profit bef. prov.	-11.7	29.1	20.0	18.2	16.5
Balance Sheet (RsM)					
Total assets	1,133,925	1,431,462	1,676,999	1,950,422	2,264,022
Avg interest earning assets	1,010,934	1,240,471	1,504,292	1,763,128	2,056,503
Customer loans	620,237	856,296	1,036,356	1,223,803	1,433,300
Gross NPLs	23,903	20,923	26,970	38,609	49,333
Liab. & shar. funds	1,133,925	1,431,462	1,676,999	1,950,422	2,264,022
Total customer deposits	936,620	1,249,160	1,474,009	1,724,590	2,017,770
Reserve for loan losses	21,119	20,087	24,544	29,864	36,391
Shareholders' equity	78,444	86,499	98,774	112,988	129,547
Profitability/Solvency Ratios (%)					
ROE adjusted	12.3	12.4	15.9	16.7	16.5
Net interest margin	3.19	3.05	3.01	3.00	2.93
Cost/income ratio	54.0	49.2	48.2	46.7	45.4
Cash cost/average assets	2.3	2.0	1.9	1.8	1.7
NPLs/customer loans	3.9	2.4	2.6	3.2	3.4
Reserve for loan losses/NPLs	88.4	96.0	91.0	77.3	73.8
Bad debt prov./avg. cust. loans	0.6	0.6	0.6	0.6	0.7
Loans/deposit ratio	66.2	68.5	70.3	71.0	71.0
Tier 1 capital ratio	10.4	8.5	8.2	8.0	8.0
Total capital ratio	13.7	11.5	11.1	10.9	10.4

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Figure 1. Bank of Baroda – 2Q08 Financial Highlights (Rupees Million, %)

	2Q08	2Q07	YoY %	1Q08	QoQ%	Citigroup Investment Research Comments
Interest Income	28,798	21,334	35.0	26,004	10.7	Higher than estimated -on loan growth, and higher yields
Interest Expense	(18,983)	(12,952)	46.6	(16,961)	11.9	
Net Interest Income	9,814	8,383	17.1	9,044	8.5	Strong show, higher than expected, maintaining margins with growth
Non Interest Income	4,541	3,217	41.1	4,243	7.0	Another strong quarter - await details on fee and trading gain mix
Operating Income	14,355	11,600	23.8	13,287	8.0	Higher than expected after a sluggish 1Q08
Operating Expenses	(7,983)	(5,968)	33.8	(6,843)	16.7	Operating expenses higher as management starts provides for transitional pension liability total of Rs901 (10% of total liability) - excluding this, expense growth at 18%
Pre-Provision Profit	6,372	5,632	13.2	6,444	-1.1	Operationally holding up, higher than expected
Charges for Bad Debts	(981)	(632)	55.3	(1,119)	-12.4	Modest, though underlying asset quality holds
Other Operating Items		(437)	NM	(296)	NM	
Pre-Tax Profit	5,392	4,564	18.1	5,030	7.2	
Tax	(2,120)	(1,680)	26.2	(1,722)	23.1	Taxes remain high ,effective tax rate at 39% for this quarter
Net Profit	3,272	2,884	13.5	3,308	-1.1	8% lower than expected but if adjusted for pension liability adjustments, 10 % higher than expected
EPS	9.0	9.8	-8.6	9.1	-1.1	
Customer Loans	902,120	709,567	27.1	782,590	15.3	Accelerated loan growth after a slow 1Q08 - gains market share
Customer Deposits	1,313,730	1,076,815	22.0	1,224,620	7.3	Aggressive deposit growth quarter
AIEA	1,306,616	1,192,785	9.5	1,198,730	9.0	
AIBL	1,223,795	1,050,018	16.6	1,165,520	5.0	
Total Assets	1,455,392	1,265,558	15.0	1,440,848	1.0	Higher than expected after a sluggish growth in the 1Q08
Avg Assets	1,448,120	1,215,569	19.1	1,436,155	0.8	
Non-Performing Loans (NPL)	21,294	24,880	-14.4	22,070	-3.5	Stable asset quality, provides comfort - ahead of peers
Loan Loss Reserves (LLR)	(16,329)	(19,478)	-16.2	(16,874)	-3.2	Relatively high coverage levels, with good underlying asset quality
Shareholders' Funds	90,899	80,714	12.6	87,627	3.7	Pension charge about 10% of the total net worth
Book Value Per Share	249	222	12.2	240	3.7	
Key Ratios (%)	2Q08	2Q07	Bps Δ YoY	1Q08	Bps Δ QoQ	Citigroup Investment Research Comments
ROAA (annualized)	0.90	0.91	-1	0.92	-2	
ROAE (annualized)	14.40	14.29	11	15.10	-70	
Net Interest Margin (bps)	300	281	19	302	-1	Strong show - holds margins, better than peers who have faced pressures, almost across the board; structurally however, margins dampened by its high share of offshore assets
Other Non-Interest Inc/Op Inc	31.6	27.7	389	31.9	-31	
Op. Cost/ Operating Income	55.6	51.4	416	51.5	411	
Loan-to-Deposit Ratio (LDR)	68.7	65.9	277	63.9	476	Ability to leverage
NPL/Loan Ratio	2.4	3.5	-115	2.8	-46	Continues to keep a focus on asset quality
LLR/NPL Ratio	77	78	-161	76	22	

Source: Company Reports and Citi Investment Research estimates

Bank of Baroda

Company description

Bank of Baroda (BoB) was incorporated in 1908 as a private institution, and subsequently nationalized in 1969. The bank is headquartered in Baroda, Gujarat. The government holds 66% of the bank's equity. BoB is among the top-five banks in the country, with a nearly 5% share of the deposits and advances of the banking system. BoB has a large nationwide branch network of 2,730 branches, and has 38 branches in 10 countries.

Investment strategy

We rate BoB Buy (1M) with a target price of Rs390. BoB has made visible improvements in key operating parameters. However, it has lagged behind the sector: loan growth, until recently, has been well below the industry levels and its technology plan has been slow to take off. Management's aggressive interest-rate positioning on the bank's bond portfolio led to losses in the portfolio when interest rates reversed. This aspect of its balance sheet has meant that BoB has been viewed largely as an interest-rate cyclical stock, with falling/rising rates increasing/decreasing the value of its bond portfolio. Structurally, we believe BoB will continue to trade at a discount to its larger peers due to lower fee incomes, a higher proportion of international businesses, a modest lending franchise, and a slight geographic concentration. BoB will also likely remain the most interest-rate cyclical bank among its larger peers. However, the focus on bond yields has camouflaged changes in what the market formerly perceived as other weakness. We believe positive changes have come about, and the market appears to have failed to fully appreciate them.

Valuation

Our target price of Rs390 (previously Rs326) is based on our EVA model, which we believe captures the long-term value of the business and is a standard valuation measure for our India banking coverage. We are factoring in a risk-free rate of 8%. We maintain industry-average margin (230bps) and higher-than-industry capital ratio (6%). Our EVA value is revised upwards on account of new estimates, a higher yield environment long term, and slightly greater fee momentum. We are also benchmarking our target price on a 1.3x FY09E PBV (previously one-year forward). Our target price based on this methodology is now Rs394. Our target multiple factors in the healthy asset pricing and operating environment. Our target multiple continues to be at discounts to those for SBI and PNB. We believe a valuation discount to some peer banks is still justified due to the quality and structure of the businesses. BoB generates relatively low fee income, has a higher proportion of international businesses that we believe adds less value to the business, and its business has a modest geographic concentration. Important to note, its ROEs have also tended to lag the sector, and though we do see signs of a catch-up, management still needs to deliver.

Risks

We rate BoB Medium Risk based on our quantitative risk-rating system, which tracks 260-day share price volatility. The following downside risks could impede the stock from reaching our target price: 1) sharp rises in interest rates, which could undermine the performance of the bond portfolio; 2) BoB's inability to sustain loan growth; and 3) further delays in management's technology plans.

Appendix A-1

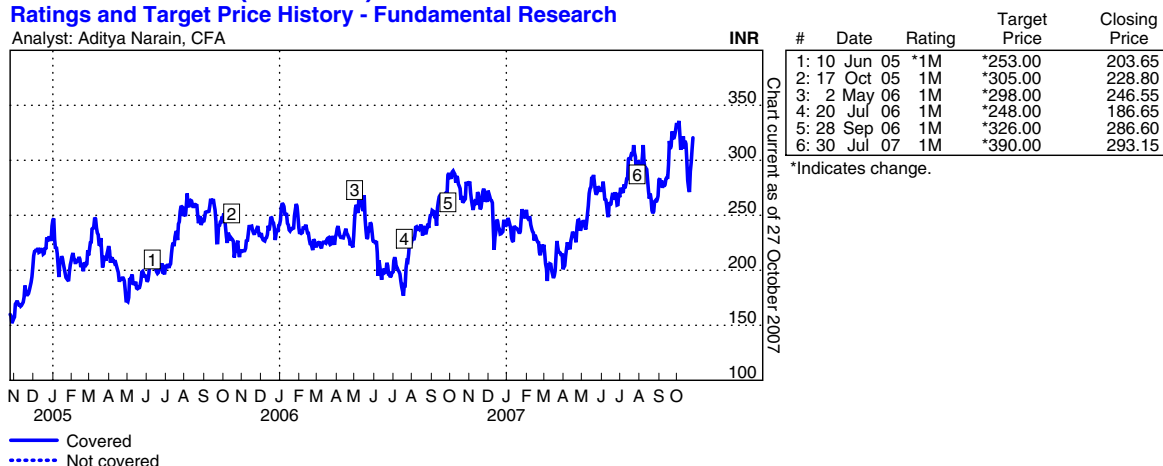
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Analyst: Aditya Narain, CFA



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