

# Disappointing Quarter

## Disappointing results: Margins Contract 20bpsyoy

Canara Bank's 3QFY07 net income grew 2%yoy to Rs3.6bn, significantly lower than our estimate (MLE Rs4.4bn) due to contraction in NIMs and slowdown in NPL recoveries. Despite 29%yoy growth in advances, the adjusted net interest income grew only 5%yoy (adjusted for interest on income tax refund) as NIMs contracted 20bps yoy to 3.1% as deposit costs increased due to a higher proportion of wholesale deposits. Fee income grew 14%yoy, in line with estimates.

## Asset quality also disappoints: NPL up 6%qoq, recoveries dip

Asset quality disappointed, with gross NPLs rising 6% qoq (2.2% of loans) primarily owing to rise in agricultural and retail loan NPL. Further, the bank made lower provisions, resulting in a 10% qoq rise in net NPLs to 0.9% of loans. NPL recoveries also slowed (Rs6.5bn in 9MFY07 v/s Rs9.6bn in 9MFY06). With >60% of portfolio being in the non-HTM category (which is required to be marked to market) and the sharp rise in short term investment yield, the bank had to provide Rs2bn toward MTM on its investment portfolio.

## Earnings cut 3-5% for FY07-09; Maintain Neutral

We have cut our earning forecast by 4% for FY07, 5% for FY08 and 3% for FY09, factoring in a slowdown in recoveries and lower margin. We expect FY08 earnings to rebound to 24%yoy, with ROE estimated to rise to >19%. However, with tier I capital at 7.7%, the bank might raise equity capital in the next 12 months. But given the rise in ROE, Canara Bank (trading at 1.4x FY08E Adj book), could trade up to 1.3-1.4x FY09E Adj book, implying potential upside of <20%. Maintain Neutral.

### Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	11,091	13,432	14,297	17,729	19,823
EPS	27.05	32.76	34.87	43.24	48.35
EPS Change (YoY)	-17.1%	21.1%	6.4%	24.0%	11.8%
Dividend / Share	5.50	6.60	7.50	8.50	9.00
Pre-exceptional EPS	27.05	32.76	34.87	43.24	48.35
Pre-exceptional EPS Change (YoY)	-17.1%	21.1%	6.4%	24.0%	11.8%
Book Value / Share	149.00	173.96	200.39	234.07	272.29

### Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	9.7x	8.0x	7.5x	6.1x	5.4x
Dividend Yield	2.09%	2.51%	2.86%	3.24%	3.43%
Pre-exceptional PE	9.71x	8.02x	7.53x	6.07x	5.43x
Price / Book	1.76x	1.51x	1.31x	1.12x	0.965x
RoE / PB	11.08x	13.44x	14.21x	17.74x	19.80x
Price / Pre-Provision Profit	NA	NA	NA	NA	NA



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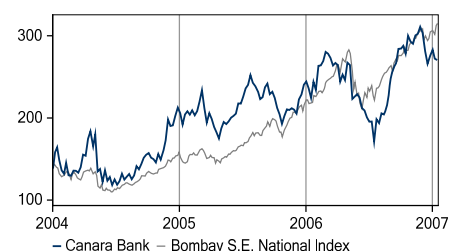
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### Stock Data

Price	Rs262.65
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	Rs165.10-Rs319.90
Mrkt Val / Shares Out (mn)	US\$2,429 / 410.0
Average Daily Volume	74,323
ML Symbol / Exchange	CNRKF / BSE
Bloomberg / Reuters	CBK IN / CNBK.BO
ROE (2007E)	18.6%
Total Dbt to Cap (Mar-2006A)	NA
Est. 5-Yr EPS / DPS Growth	18.0% / 10.0%
Free Float	20.0%



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Refer to important disclosures on page 7 to 8. Analyst Certification on page 5.

19 January 2007

# iQprofile<sup>SM</sup> Canara Bank

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
<b>(Rs Millions)</b>					
Net Interest Income	31,505	35,815	40,849	49,990	59,179
Net Fee Income	4,109	4,308	4,825	5,549	6,659
Securities Gains / (Losses)	4,998	1,116	600.00	350.00	300.00
Other Income	6,327	8,351	7,227	7,188	7,732
<b>Total Non-Interest Income</b>	<b>15,434</b>	<b>13,775</b>	<b>12,652</b>	<b>13,087</b>	<b>14,690</b>
Total Operating Income	46,939	49,590	53,500	63,077	73,869
Operating Expenses	(21,090)	(23,471)	(25,856)	(28,425)	(31,158)
<b>Pre-Provision Profit</b>	<b>25,849</b>	<b>26,119</b>	<b>27,645</b>	<b>34,652</b>	<b>42,711</b>
Provisions Expense	(8,379)	(7,832)	(6,000)	(10,000)	(13,500)
<b>Operating Profit</b>	<b>17,470</b>	<b>18,287</b>	<b>21,645</b>	<b>24,652</b>	<b>29,211</b>
Non-Operating Income	(4,679)	(2,855)	(4,419)	(1,628)	(2,056)
<b>Pre-Tax Income</b>	<b>12,791</b>	<b>15,432</b>	<b>17,226</b>	<b>23,024</b>	<b>27,155</b>
Net Income to Comm S/Hold.	11,091	13,432	14,297	17,729	19,823
<b>Adjusted Net Income (Operating)</b>	<b>11,091</b>	<b>13,432</b>	<b>14,297</b>	<b>17,729</b>	<b>19,823</b>

## Key Balance Sheet Data

Total Assets	1,103,052	1,328,219	1,616,323	1,919,164	2,238,874
Average Interest Earning Assets	1,013,013	1,181,837	1,434,556	1,726,400	2,033,696
<b>Weighted Risk Assets</b>	<b>724,137</b>	<b>841,880</b>	<b>1,077,611</b>	<b>1,300,245</b>	<b>1,530,200</b>
Total Gross Customer Loans	604,214	794,257	1,000,764	1,230,939	1,464,818
Total Customer Deposits	969,084	1,168,032	1,432,825	1,710,629	2,002,572
<b>Tier 1 Capital</b>	<b>49,008</b>	<b>71,322</b>	<b>82,160</b>	<b>95,968</b>	<b>111,640</b>
Tangible Equity	49,008	71,322	82,160	95,968	111,640
<b>Common Shareholders' Equity</b>	<b>61,090</b>	<b>71,322</b>	<b>82,160</b>	<b>95,968</b>	<b>111,640</b>

## Key Metrics

Net Interest Margin	3.11%	3.03%	2.85%	2.90%	2.91%
<b>Tier 1 Ratio</b>	<b>6.8%</b>	<b>8.5%</b>	<b>7.6%</b>	<b>7.4%</b>	<b>7.3%</b>
Effective Tax Rate	13.3%	13.0%	17.0%	23.0%	27.0%
Loan / Assets Ratio	54.8%	59.8%	61.9%	64.1%	65.4%
<b>Loan / Deposit Ratio</b>	<b>62.3%</b>	<b>68.0%</b>	<b>69.8%</b>	<b>72.0%</b>	<b>73.1%</b>
Oper Leverage (Inc Growth - Cost Growth)	-12.5%	-5.6%	-2.3%	8.0%	7.5%
Gearing (Assets / Equity)	18.1x	18.6x	19.7x	20.0x	20.1x
Tangible Common Equity / Assets	4.4%	5.4%	5.1%	5.0%	5.0%
Tangible Common Equity / WRAs	6.8%	8.5%	7.6%	7.4%	7.3%
Revenue Growth	-1.3%	5.6%	7.9%	17.9%	17.1%
Operating Expense Growth	11.2%	11.3%	10.2%	9.9%	9.6%
Provisions Expense Growth	-30.0%	-6.5%	-23.4%	66.7%	35.0%
Operating Revenue / Average Assets	4.5%	4.1%	3.6%	3.6%	3.6%
Operating Expenses / Average Assets	2.0%	1.9%	1.8%	1.6%	1.5%
<b>Pre-Provision ROA</b>	<b>2.5%</b>	<b>2.1%</b>	<b>1.9%</b>	<b>2.0%</b>	<b>2.1%</b>
ROA	1.1%	1.1%	1.0%	1.0%	1.0%
<b>Pre-Provision ROE</b>	<b>45.5%</b>	<b>39.5%</b>	<b>36.0%</b>	<b>38.9%</b>	<b>41.1%</b>
ROE	19.5%	20.3%	18.6%	19.9%	19.1%
RoTE	22.6%	18.8%	17.4%	18.5%	17.8%
RoWRAs	1.5%	1.6%	1.3%	1.4%	1.3%
Dividend Payout Ratio	23.1%	23.0%	24.2%	22.1%	20.9%
<b>Efficiency Ratio (Cost / Income Ratio)</b>	<b>50.3%</b>	<b>48.4%</b>	<b>48.9%</b>	<b>45.3%</b>	<b>42.4%</b>
<b>Total Non-Interest Inc / Operating Inc</b>	<b>33%</b>	<b>28%</b>	<b>24%</b>	<b>21%</b>	<b>20%</b>
Market-Related Revenue / Total Revenues	14.7%	5.4%	4.0%	3.1%	2.8%
Provisioning Burden as % of PPP	32.4%	30.0%	21.7%	28.9%	31.6%
NPLs plus Foreclosed Real Estate / Loans	3.9%	2.3%	1.9%	1.9%	2.0%
<b>Loan Loss Reserves / NPLs</b>	<b>52.5%</b>	<b>51.0%</b>	<b>37.2%</b>	<b>36.5%</b>	<b>40.9%</b>
Loan Loss Reserves / Total Loans	2.1%	1.2%	0.7%	0.7%	0.8%
Provisions Expense / Average Loans	1.6%	1.1%	0.7%	0.9%	1.0%

## Other Metrics

Income / Employee	0.991	1.06	1.14	1.35	1.58
(Operating Expenses) / Employee	0.445	0.501	0.551	0.606	0.664
Pre-Provision Profit / Employee	0.545	0.557	0.590	0.739	0.911
Net Profit / Employee	0.234	0.286	0.305	0.378	0.423

## Company Description

Canara Bank, established in 1906, is the third largest state-owned bank with a balance sheet size of Rs1.1trn. It has a network of about 2,500 branches, mainly in southern India. Over FY03-05, the bank delivered strong loan growth with a marked improvement in asset quality. It is vulnerable to rising rates owing to relatively low proportion of G-Secs in Held-to-Maturity (HTM) and relatively high Available for Sale (AFS) duration.

## Stock Data

Price to Book Value 1.3x

19 January 2007

**Table 1: 3QFY07 Income Statement**

Quarter Ended Dec (Rs mn)	3QFY06	3QFY07	yoy growth	3QFY07 Mle	Remarks
Interest earned	22,401	29,614	32%	28,468	Loan growth of 29%, slightly higher than the sector and q marginal pickup qoq Sharp rise in funding cost due to liquidity pressures in the 3Q, increasing proportion of wholesale deposits (CASA declined >3%)
Interest Expended	12,818	19,228	50%	17,668	
Net Interest Income	9,582	10,386	8%	10,800	Margins contracted 20bps qoq to 3.1% due to rise in funding costs
Other income	3,112	2,993	-4%	3,536	
- Treasury Income	374	270	-28%	250	Fee income has grown 14%yoy; the decline in total other income is due to lower recoveries from written off accounts
- Other Income	2,738	2,723	-1%	3,286	
Total Operating Expenses	5,702	6,369	12%	6,493	Operating expenses largely in line; rise in non employee exp is due to technology expansion
-Employee expenses	3,781	4,013	6%	3,976	
-Other Operating expenses	1,922	2,356	23%	2,517	
Operating profit	6,992	7,010	0%	7,843	
Provisions and contingencies	2,449	2,630	7%	2,695	Lower NPL provision, Higher MTM losses on investment portfolio due to rise in yields of shorter duration investments and Canara Bank holding >60% of its investments in non HTM category that needs to be marked to market
- NPL provisions	493	790	60%	2,000	
PBT	4,543	4,380	-4%	5,148	
Provision for Tax	980	750	-23%	772	
PAT	3,563	3,630	2%	4,376	Net income was significantly lower than estimated on back of lower operating profit
PPP (Ex treasury)	6,618	6,740	2%		- Disappointing top line; lower other income led to a relatively flat operating profit

Source: Company Reports, ML Research Estimates

## Financials

**Table 2: Income Statement**

Year to March (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Interest income	75,720	87,115	111,003	139,200	168,816
Interest expense	44,215	51,300	70,155	89,210	109,638
<b>Net interest income</b>	<b>31,505</b>	<b>35,815</b>	<b>40,849</b>	<b>49,990</b>	<b>59,179</b>
Other income	15,434	13,775	12,652	13,087	14,690
- Treasury Gains	4,998	1,116	600	350	300
<b>Total income</b>	<b>46,939</b>	<b>49,590</b>	<b>53,500</b>	<b>63,077</b>	<b>73,869</b>
Operating expenses	21,090	23,471	25,856	28,425	31,158
<b>Pre Provisions Profit</b>	<b>25,849</b>	<b>26,119</b>	<b>27,645</b>	<b>34,652</b>	<b>42,711</b>
Total Provisions	13,058	10,687	10,419	11,628	15,556
-Provision for NPL	8,379	7,832	6,000	10,000	13,500
- Provision for Investments	4,584	3,704	4,419	1,628	2,056
- Others	95	-850	0	0	0
<b>PBT</b>	<b>12,791</b>	<b>15,432</b>	<b>17,226</b>	<b>23,024</b>	<b>27,155</b>
Tax	1,700	2,000	2,928	5,296	7,332
<b>PAT</b>	<b>11,091</b>	<b>13,432</b>	<b>14,297</b>	<b>17,729</b>	<b>19,823</b>

Source: Company Reports, ML Research Estimates

**Table 3: Balance Sheet**

As at March (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Cash balances	86,687	128,236	154,608	164,467	188,473
Advances	604,214	794,257	1,000,764	1,230,939	1,464,818
Investments	380,539	369,742	421,506	480,516	538,178
Fixed assets	6,728	6,885	7,435	8,030	8,673
Current assets	24,883	29,099	32,009	35,210	38,731
<b>Total Assets</b>	<b>1,103,052</b>	<b>1,328,219</b>	<b>1,616,323</b>	<b>1,919,164</b>	<b>2,238,874</b>
Equity Capital	4,100	4,100	4,100	4,100	4,100
Reserves & Surplus	56,990	67,222	78,060	91,868	107,540
<b>Shareholders' funds</b>	61,090	71,322	82,160	95,968	111,640
Deposits	969,084	1,168,032	1,432,825	1,710,629	2,002,572
- Demand deposits	328,239	388,890	455,001	532,351	612,204
- Term deposits	640,845	779,142	977,824	1,178,278	1,390,368
Borrowings	26,938	35,304	41,351	45,381	49,415
- Subordinated debt	25,796	35,046	41,046	45,046	49,046
Current liabilities	45,940	53,560	59,987	67,185	75,247
<b>Total Liabilities</b>	<b>1,103,052</b>	<b>1,328,219</b>	<b>1,616,323</b>	<b>1,919,164</b>	<b>2,238,874</b>

Source: Company Reports, ML Research Estimates

**Table 4: Key Ratios**

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS	27.1	32.76	34.87	43.24	48.35
Earnings growth	-17%	21%	6%	24%	12%
CEPS	30.3	36.3	38.7	47.4	52.9
PPP / Share	63.0	63.7	67.4	84.5	104.2
BV/share	149	174	200	234	272
Adjusted BV / Share	122	153	171	197	230
ROAA	1.1%	1.1%	1.0%	1.0%	1.0%
ROAE	19.5%	20.29%	18.63%	19.91%	19.10%
NIM	3.11%	3.03%	2.85%	2.90%	2.91%
Gross NPLs	3.9%	2.2%	1.9%	1.9%	2.0%
Net NPLs	1.9%	1.1%	1.2%	1.2%	1.2%
Coverage Ratio	53%	51%	37%	37%	41%
Total Capital Adequacy Ratio (CAR)	12.8%	11.2%	9.5%	9.1%	8.9%
- Tier I CAR	7.3%	7.8%	7.6%	7.4%	7.3%
C/D ratio	62%	68%	70%	72%	73%
Cost-Income ratio (Excl Treasury)	50%	48%	49%	45%	42%
Other Inc (Excl treasury) / Total Inc (Excl Treasury)	12.1%	12.7%	9.8%	8.4%	7.9%
Cost Asset Ratio	2.0%	1.9%	1.8%	1.6%	1.5%
Loan Growth	27%	31%	26%	23%	19%
Equity / Assets	5.5%	5.4%	5.1%	5.0%	5.0%
Equity / Loans	10.1%	9.0%	8.2%	7.8%	7.6%
Provision/ Loans	1.4%	1.0%	0.6%	0.8%	0.9%
CASA	34%	33%	32%	31%	31%
Tax Rates	13%	13%	17%	23%	27%
Yield on Advances	7.9%	7.8%	8.8%	9.0%	9.2%
Yield on Investments	8.3%	7.6%	7.3%	7.5%	7.7%
Cost of funds	4.7%	4.7%	5.2%	5.5%	5.8%
Dividend per Share	5.5	6.6	7.5	8.5	9.0
Dividend Payout	23%	23%	24%	22%	21%
Dividend Yield	2.0%	2.4%	2.7%	3.1%	3.3%
P/E	10.2	8.4	7.9	6.4	5.7
P/PPP	4.4	4.3	4.1	3.3	2.6
P/ABV	2.3	1.8	1.6	1.4	1.2

Source: Company Reports, ML Research Estimates

## Analyst Certification

I, Aashish Agarwal, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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**iQmethod<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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## Important Disclosures

### CNRKF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of December 31, 2006 or such later date as indicated.

### Investment Rating Distribution: Banks Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	92	40.35%	Buy	50	54.35%
Neutral	113	49.56%	Neutral	66	58.41%
Sell	23	10.09%	Sell	11	47.83%

### Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

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