

# 3Q: Earnings miss; Cut earnings; Retain Underperform

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## 3Q: Profit 10% below on topline miss and higher provisions

Canara bank reported earnings of Rs8.8bn, a +20% yoy decline and ~10% below estimates driven by lower topline and higher provisioning. Topline was down 10% yoy (10% below estimates), as loan growth slowed (16% yoy vs. 24% yoy in 2Q) and margins declined 79/10bps yoy/qoq. Lower share (29% now vs. 34% in 3Q11) of SME / Retail (high yielding) has resulted in sharp margin contraction yoy. Core fee income was up 21% yoy, but overall non-int. income is up +45% yoy (8% ahead). CASA is down +500bps yoy (190bps qoq) at ~24%.

## Slippage down qoq, but overall asset quality remains weak

Canara Bank's slippages came in at Rs8.6bn vs. Rs12.4bn in 2Q, down 30% qoq. Despite lower slippages, headline gross/net NPLs are up 5% each qoq and currently stand at 1.8/1.5%, resp. Provision cover at 68%. Moreover, interestingly, the proportion of doubtful assets within gross NPLs has moved up by 10% qoq to 46% (vs. 36% in 2Q). Canara Bk also had Rs15bn of additional restructuring during 3Q. Canara Bk's restructured book now stands at 4.4% (vs. 3.9% in 2Q). We est. slippages to sustain at elevated levels at +2.7-2.8% in FY12/13.

## Cut earnings for FY12/13 by ~7/5%; Retain Underperform

We have cut our FY12/13 earnings by ~7/5% for FY12/13. Hence, we estimate earnings to decline ~21% yoy in FY12. While the risk return looks attractive (trading at ~1.0x FY13 book; RoEs of ~16%), we believe the stock may de rate to +0.8-0.9x FY13 book owing to a) leg down to <16% RoEs vs. ~23% in FY10/11 and b) persistent margins / asset quality concerns.

## Estimates (Mar)

(Rs)	2010A	2011A	2012E	2013E	2014E
Net Income (Adjusted - mn)	30,214	40,259	34,126	38,886	44,753
EPS	73.69	97.83	77.03	87.78	101.02
EPS Change (YoY)	45.8%	32.8%	-21.3%	13.9%	15.1%
Dividend / Share	10.00	11.00	11.00	12.50	15.00
Pre-exceptional EPS	73.69	97.83	77.03	87.78	101.02
Pre-exceptional EPS Change (YoY)	45.8%	32.8%	-21.3%	13.9%	15.1%
Book Value / Share	357.85	452.37	517.03	590.74	674.89

## Valuation (Mar)

	2010A	2011A	2012E	2013E	2014E
P/E	6.3x	4.8x	6.0x	5.3x	4.6x
Dividend Yield	2.15%	2.37%	2.37%	2.69%	3.23%
Pre-exceptional PE	6.31x	4.75x	6.04x	5.30x	4.60x
Price / Book	1.40x	1.03x	0.899x	0.787x	0.689x
RoE / PB	16.01x	22.56x	17.67x	20.13x	23.17x
Price / Pre-Provision Profit	3.77x	3.37x	3.31x	2.75x	2.41x

## Stock Data

Price	Rs465.05
Price Objective	Rs365.00
Date Established	8-Jan-2012
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs341.30-Rs667.90
Mrkt Val / Shares Out (mn)	US\$4,111 / 443.0
Market Value (mn)	Rs206,017
Average Daily Volume	973,083
BofAML Ticker / Exchange	CNRKF / BSE
Bloomberg / Reuters	CBK IN / CNBK.BO
ROE (2012E)	15.9%
Total Dbt to Cap (Mar-2011A)	NA
Est. 5-Yr EPS / DPS Growth	10.0% / 6.0%
Free Float	26.8%

## Key Changes

(Rs)	Previous	Current
2012E EPS	82.86	77.03
2013E EPS	92.20	87.78
2014E EPS	107.79	101.02

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

Key Income Statement Data (Mar)	2010A	2011A	2012E	2013E	2014E
<b>(Rs Millions)</b>					
Net Interest Income	56,805	78,233	77,758	90,203	102,447
Net Fee Income	7,239	7,558	8,012	8,733	9,519
Securities Gains / (Losses)	7,295	1,124	3,000	5,000	5,500
Other Income	14,045	18,348	20,269	22,411	24,795
<b>Total Non-Interest Income</b>	<b>28,579</b>	<b>27,030</b>	<b>31,281</b>	<b>36,144</b>	<b>39,813</b>
Total Operating Income	85,384	105,263	109,039	126,347	142,261
Operating Expenses	(34,776)	(44,193)	(46,801)	(51,523)	(56,776)
<b>Pre-Provision Profit</b>	<b>50,608</b>	<b>61,070</b>	<b>62,238</b>	<b>74,824</b>	<b>85,485</b>
Provisions Expense	(15,180)	(11,855)	(13,041)	(13,041)	(14,997)
<b>Operating Profit</b>	<b>35,428</b>	<b>49,215</b>	<b>49,198</b>	<b>61,783</b>	<b>70,488</b>
Non-Operating Income	2,786	1,044	(6,000)	(10,618)	(10,818)
<b>Pre-Tax Income</b>	<b>38,214</b>	<b>50,259</b>	<b>43,198</b>	<b>51,165</b>	<b>59,670</b>
Net Income to Comm S/Hold.	30,214	40,259	34,126	38,886	44,753
<b>Adjusted Net Income (Operating)</b>	<b>30,214</b>	<b>40,259</b>	<b>34,126</b>	<b>38,886</b>	<b>44,753</b>

### Key Balance Sheet Data

Total Assets	2,647,411	3,360,788	3,890,936	4,339,550	4,954,229
Average Interest Earning Assets	2,356,604	2,927,700	3,529,509	4,009,846	4,531,592
<b>Weighted Risk Assets</b>	<b>1,506,478</b>	<b>1,761,685</b>	<b>1,985,358</b>	<b>2,504,294</b>	<b>3,247,098</b>
Total Gross Customer Loans	1,693,346	2,124,672	2,485,866	2,809,028	3,286,563
Total Customer Deposits	2,346,514	2,939,727	3,416,468	3,807,580	4,358,908
<b>Tier 1 Capital</b>	<b>128,700</b>	<b>191,390</b>	<b>208,059</b>	<b>240,715</b>	<b>277,992</b>
Tangible Equity	128,700	191,390	208,059	240,715	277,992
<b>Common Shareholders' Equity</b>	<b>146,718</b>	<b>200,398</b>	<b>229,042</b>	<b>261,698</b>	<b>298,975</b>

### Key Metrics

Net Interest Margin	2.41%	2.67%	2.20%	2.25%	2.26%
<b>Tier 1 Ratio</b>	<b>8.5%</b>	<b>10.9%</b>	<b>10.5%</b>	<b>9.6%</b>	<b>8.6%</b>
Effective Tax Rate	20.9%	19.9%	21.0%	24.0%	25.0%
Loan / Assets Ratio	64.0%	63.2%	63.9%	64.7%	66.3%
<b>Loan / Deposit Ratio</b>	<b>72.2%</b>	<b>72.3%</b>	<b>72.8%</b>	<b>73.8%</b>	<b>75.4%</b>
Oper Leverage (Inc Growth - Cost Growth)	8.0%	-3.8%	-2.3%	5.8%	2.4%
Gearing (Assets / Equity)	18.0x	16.8x	17.0x	16.6x	16.6x
Tangible Common Equity / Assets	4.9%	5.7%	5.3%	5.5%	5.6%
Tangible Common Equity / WRAs	8.5%	10.9%	10.5%	9.6%	8.6%
Revenue Growth	21.5%	23.3%	3.6%	15.9%	12.6%
Operating Expense Growth	13.5%	27.1%	5.9%	10.1%	10.2%
Provisions Expense Growth	68.7%	-21.9%	10.0%	0%	15.0%
Operating Revenue / Average Assets	3.5%	3.5%	3.0%	3.1%	3.1%
Operating Expenses / Average Assets	1.4%	1.5%	1.3%	1.3%	1.2%
<b>Pre-Provision ROA</b>	<b>2.1%</b>	<b>2.0%</b>	<b>1.7%</b>	<b>1.8%</b>	<b>1.8%</b>
ROA	1.2%	1.3%	0.9%	0.9%	1.0%
<b>Pre-Provision ROE</b>	<b>37.7%</b>	<b>35.2%</b>	<b>29.0%</b>	<b>30.5%</b>	<b>30.5%</b>
ROE	22.5%	23.2%	15.9%	15.8%	16.0%
RoTE	23.5%	21.0%	16.4%	16.2%	16.1%
RoWRAs	2.0%	2.3%	1.7%	1.6%	1.4%
Dividend Payout Ratio	15.9%	14.1%	16.1%	16.0%	16.7%
<b>Efficiency Ratio (Cost / Income Ratio)</b>	<b>44.5%</b>	<b>42.4%</b>	<b>44.1%</b>	<b>42.5%</b>	<b>41.5%</b>
<b>Total Non-Interest Inc / Operating Inc</b>	<b>33%</b>	<b>26%</b>	<b>29%</b>	<b>29%</b>	<b>28%</b>
Market-Related Revenue / Total Revenues	11.1%	4.7%	6.8%	7.9%	7.9%
Provisioning Burden as % of PPP	30.0%	19.4%	21.0%	17.4%	17.5%
NPLs plus Foreclosed Real Estate / Loans	1.5%	1.5%	1.9%	2.5%	2.7%
<b>Loan Loss Reserves / NPLs</b>	<b>30.5%</b>	<b>24.0%</b>	<b>44.1%</b>	<b>47.7%</b>	<b>54.8%</b>
Loan Loss Reserves / Total Loans	0.5%	0.4%	0.8%	1.2%	1.5%
Provisions Expense / Average Loans	1.0%	0.6%	0.6%	0.5%	0.5%

### Other Metrics

Income / Employee	1.97	2.43	2.53	2.96	3.35
(Operating Expenses) / Employee	0.802	1.02	1.09	1.21	1.34
Pre-Provision Profit / Employee	1.17	1.41	1.44	1.75	2.02
Net Profit / Employee	0.697	0.928	0.792	0.910	1.05

### Company Description

Canara Bank, established in 1906, is the third largest state-owned bank with a balance sheet size of Rs2.7trn. It has a network of about 3,060 branches, mainly in southern India.

### Investment Thesis

Canara Bank has a strong deposit franchise in South India, but focuses on volume-led growth. We believe the pressure on margins will continue as the bank's low-cost deposit mix continues to be among the lowest in the industry, at around 25 percent. Weak liability franchise coupled with high interest rate risk on its bond book (26pct in AFS) and asset quality concerns remain key issues for the bank, resulting in earnings instability in the medium term.

### Stock Data

Price to Book Value 0.9x

## 3QFY12 Result Summary

Table 1: 3QFY12 Result Summary

Particulars	3QFY11	3QFY12	yoy grth	Remarks
Interest earned	59,079	78,121	32.2%	
- on Advances / Bills	43,259	59,457	37.4%	Loan growth of ~16% yoy driven by Infra. (19% yoy) and Corporate (27% yoy)
- Income on investments	15,308	18,098	18.2%	
- on bal with RBI and others	512	564	10.0%	
- Others	1	3	211.1%	
Interest Expended	37,887	58,935	55.6%	CoD up 161bps yoy, CASA down ~500bps yoy to ~24%
<b>Net Interest Income</b>	<b>21,192</b>	<b>19,186</b>	<b>-9.5%</b>	10% below estimates. Margins down 79bps yoy, 10bps qoq
Other income	5,366	7,791	45.2%	
- Treasury Income	290	1,570	441.4%	Includes gains from bond book
- Other Income	5,076	6,221	22.5%	Core fee income up 21%
Operating income	26,558	26,976	1.6%	
Total Operating Expenses	11,428	11,209	-1.9%	
-Employee expenses	7,838	7,125	-9.1%	
-Other Operating expenses	3,591	4,084	13.7%	
<b>Operating profit</b>	<b>15,130</b>	<b>15,767</b>	<b>4.2%</b>	
Provisions and contingencies	1,573	5,012	218.7%	Canara Bank has restructured one off the large account (in telecom space) and has booked an NPV loss of Rs1.5bn on the same.
- NPL provisions	1,300	1,420	9.2%	Headline gross/net NPLs are up 5% each qoq and currently stand at 1.8/1.5%, resp. Provision cover at 68%.
PBT	13,557	10,756	-20.7%	
Provision for Tax	2,500	2,000	-20.0%	
<b>PAT</b>	<b>11,057</b>	<b>8,756</b>	<b>-20.8%</b>	Earnings 10% below estimate driven by topline miss and higher provisioning
PPP (Ex treasury)	14,840	14,197	-4.3%	

Source: BoFA Merrill Lynch Global Research Estimates

## Price objective basis & risk

### Canara Bank (CNRKF)

We set our PO at Rs365. Our PO is based on historical forward average PB multiple. Weak earnings growth (decline of +15% yoy in FY12 earnings and modest +10-11% yoy in FY13) and exposure to high risk sectors (Power, Textiles, Steel ,etc) at almost 24% of loans vs. sector average of 17% of loans. A sharp rise in bond yields can hurt earnings growth and faster overseas spreads can come under pressure if international rates spike. Alternatively, upside risks from better than expected asset quality going ahead could improve earnings and stock performance.

## Link to Definitions

### Financials

Click [here](#) for definitions of commonly used terms.

## Analyst Certification

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27 January 2012

**India - Financials Coverage Cluster**

<b>Investment rating</b>	<b>Company</b>	<b>BofA Merrill Lynch ticker</b>	<b>Bloomberg symbol</b>	<b>Analyst</b>
<b>BUY</b>				
	Corporation Bank	XCRRF	CRPBK IN	Veekesh Gandhi
	Federal Bank	XFDRF	FB IN	Veekesh Gandhi
	HDFC	HGDFF	HDFC IN	Rajeev Varma
	HDFC Bank	XHDFE	HDFCB IN	Rajeev Varma
	HDFC Bank	HDB	HDB US	Rajeev Varma
	ICICI Bank	ICIJF	ICICBC IN	Rajeev Varma
	ICICI Bank - A	IBN	IBN US	Rajeev Varma
	IndiaBulls Financial Services	IBLFF	IBULL IN	Veekesh Gandhi
	Indian Bank	INDIF	INBK IN	Rajeev Varma
	LIC Housing Finance, Ltd.	LHFLF	LICHF IN	Veekesh Gandhi
	Manappuram	XMGPF	MGFL IN	Veekesh Gandhi
	Max India	XMJIF	MAX IN	Rajeev Varma
	Power finance corporation Ltd	PWFEE	POWF IN	Veekesh Gandhi
	Punjab	PUJBF	PNB IN	Rajeev Varma
	Reliance Capital	RLCCF	RCAPT IN	Veekesh Gandhi
	Rural Electrification Corporation Ltd	XULEF	RECL IB	Veekesh Gandhi
	SBI	SBINF	SBIN IN	Rajeev Varma
	SBI -G	SBKFF	SBID LI	Rajeev Varma
	Shriram Transport Finance	SHTFF	SHTF IN	Veekesh Gandhi
	Yes Bank Ltd	YESBF	YES IN	Veekesh Gandhi
<b>NEUTRAL</b>				
	Axis Bank	XAXSF	AXSB IN	Rajeev Varma
	Axis Bank - GDR	XBKSF	AXB LI	Rajeev Varma
	Bank of Baroda	BKBAF	BOB IN	Rajeev Varma
<b>UNDERPERFORM</b>				
	Bank of India	XDIIF	BOI IN	Rajeev Varma
	Canara Bank	CNRKF	CBK IN	Rajeev Varma
	IDBI	XDBIF	IDBI IN	Veekesh Gandhi
	Infrastruct Dev	IFDFF	IDFC IN	Rajeev Varma
	Kotak Mahindra Bank	XXRVF	KMB IN	Rajeev Varma
	ORBC	ORBCF	OBC IN	Rajeev Varma
	Union Bank India	UBOIF	UNBK IN	Rajeev Varma

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

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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

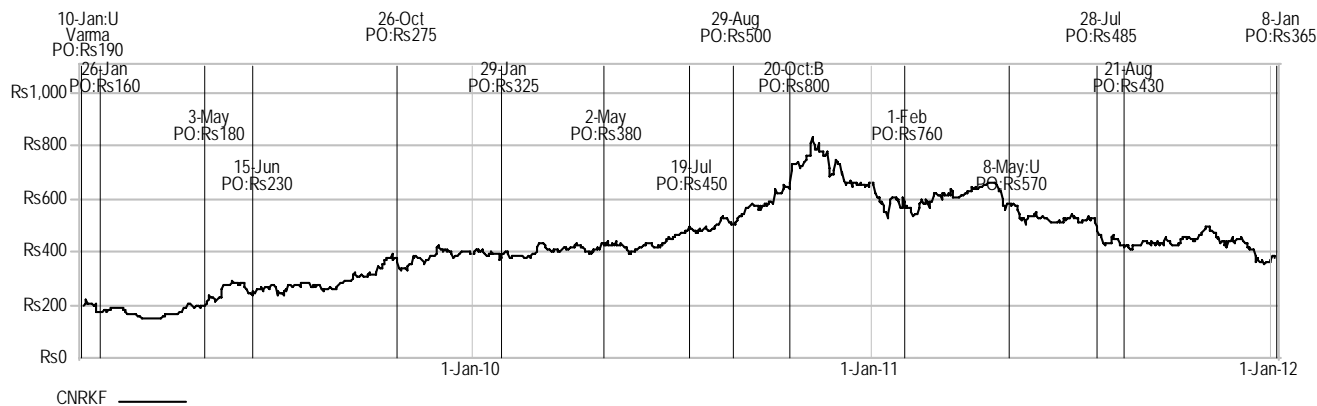
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### CNRKF Price Chart



B : Buy, N : Neutral, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

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. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of [December 31, 2011] or such later date as indicated.

### Investment Rating Distribution: Banks Group (as of 01 Jan 2012)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	120	48.00%	Buy	85	89.47%
Neutral	76	30.40%	Neutral	53	82.81%
Sell	54	21.60%	Sell	37	71.15%

### Investment Rating Distribution: Global Group (as of 01 Jan 2012)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2029	52.00%	Buy	1337	72.11%
Neutral	1009	25.86%	Neutral	657	71.34%
Sell	864	22.14%	Sell	487	60.20%

\* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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