

## Canara Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,353	CBK IN
S&P CNX: 3,023	REUTERS CODE
	CNBK.BO

20 July 2006

**Buy**
*Previous Recommendation: Buy*
**Rs180**

Equity Shares (m)	410.0
52-Week Range	300/173
1,6, 11 Rel.Perf.(%)	-19/-28/-65
M.Cap. (Rs b)	73.9
M.Cap. (US\$ b)	1.6

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)
3/05A	46,943	11,095	27.1	-17.1	6.7	1.2	12.8	19.5	1.1	1.4
3/06E	49,590	13,432	32.8	21.1	5.5	1.0	11.2	20.2	1.1	1.1
3/07E	52,970	13,629	33.2	1.5	5.4	0.9	10.7	17.6	1.0	0.9

Canara Bank's 1QFY07 reported profits were in line our with estimates at Rs1.9b, a YoY growth of 2%. NII growth at 14% was higher than our estimate of 12% growth. Non-interest income, excluding treasury grew by 13% YoY, while treasury profits were marginal, recording merely Rs10m. However, the business growth remained strong and the bank continued to report improvement in its asset quality, with net NPAs improved by 76bp YoY to 0.91%.

- ✍ Robust business led to 14% NII growth
- ✍ Trading gains witness a sharp decline, fee income grows
- ✍ Asset quality continues to improve
- ✍ Investment provisions result in flat bottomline

While Canara Bank's margins have declined by 14bp YoY, we believe that continued strong growth in the loan book will result in steady core NII growth. Further, with asset quality having improved significantly, incremental NPA provisions are likely to be lower. However, higher investment related provisions and lower treasury income would result in flat bottomline in FY07. We expect the bank to report EPS of Rs33.2 and book of Rs200 in FY07. The stock trades at P/E of 5.4x FY07E EPS and P/BV of 0.9x FY07E. We maintain **Buy**.

**QUARTERLY PERFORMANCE**

(RS MILLION)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Interest Earned	19,795	21,013	22,401	23,906	25,128	25,846	26,433	27,932	87,115	105,338
Interest Expended	11,467	12,946	12,818	14,069	15,649	16,053	16,279	16,879	51,300	64,860
<b>Net Interest Income</b>	<b>8,328</b>	<b>8,067</b>	<b>9,582</b>	<b>9,838</b>	<b>9,478</b>	<b>9,793</b>	<b>10,154</b>	<b>11,053</b>	<b>35,815</b>	<b>40,478</b>
% Change (YoY)	11.6	10.6	26.7	7.1	13.8	21.4	6.0	12.4	13.7	13.0
Non Interest Income	2,591	3,928	3,112	4,145	2,582	3,300	3,200	3,410	13,775	12,492
<b>Net Income</b>	<b>10,919</b>	<b>11,995</b>	<b>12,694</b>	<b>13,982</b>	<b>12,060</b>	<b>13,093</b>	<b>13,354</b>	<b>14,464</b>	<b>49,590</b>	<b>52,970</b>
Operating Expenses	5,316	6,184	5,702	6,269	6,158	6,555	6,181	6,602	23,471	25,497
<b>Operating Profit</b>	<b>5,603</b>	<b>5,811</b>	<b>6,992</b>	<b>7,713</b>	<b>5,902</b>	<b>6,538</b>	<b>7,173</b>	<b>7,861</b>	<b>26,119</b>	<b>27,473</b>
% Change (YoY)	-13.1	1.1	14.6	2.0	5.3	12.5	2.6	1.9	1.0	5.2
Other Provisions & Contingencies	3,034	2,026	2,449	3,178	3,743	2,200	2,450	1,607	10,687	10,000
<b>PBT</b>	<b>2,569</b>	<b>3,785</b>	<b>4,543</b>	<b>4,535</b>	<b>2,159</b>	<b>4,338</b>	<b>4,723</b>	<b>6,254</b>	<b>15,432</b>	<b>17,473</b>
Provision for Taxes	700	720	980	-400	250	954	1,039	1,376	2,000	3,844
<b>Net Profit</b>	<b>1,869</b>	<b>3,065</b>	<b>3,563</b>	<b>4,935</b>	<b>1,909</b>	<b>3,383</b>	<b>3,684</b>	<b>4,878</b>	<b>13,432</b>	<b>13,629</b>
% Change (YoY)	-44.4	-22.8	30.0	382.6	2.2	10.4	3.4	-1.2	21.1	1.5
Cost / Income	48.7	51.6	44.9	44.8	51.1	50.1	46.3	45.6	47.3	48.1
Int Exp / Int Income	57.9	61.6	57.2	58.8	62.3	62.1	61.6	60.4	58.9	61.6
Other Income / Net Income	23.7	32.8	24.5	29.6	21.4	25.2	24.0	23.6	27.8	23.6

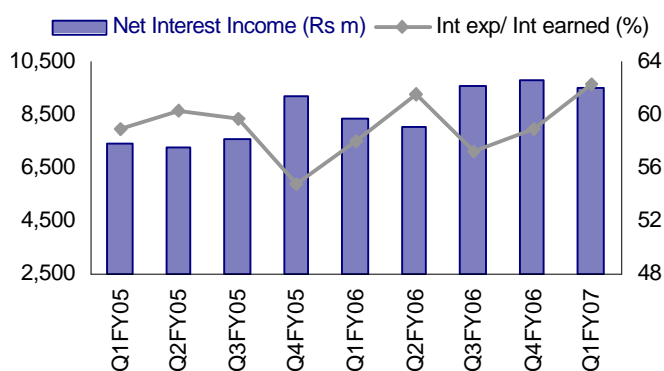
E: MOST Estimates

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### Robust business led to 14% NII growth

Net Interest Income grown by 14% in 1QFY07 to Rs9.5b. The strong growth in advances has been the key factor for this growth. NIMs for the bank have declined, despite the increasing yield on its advances portfolio due to increased cost of deposits and falling investment yields.

TREND IN NII



Source: Company/ Motilal Oswal Securities

Deposits of the bank have grown by 25.4% and stand at Rs1,230b. The advances portfolio has posted robust growth of 36% and records at Rs803b. loan / deposit ratio for the bank has moved up from 60% in 1QFY06 to 65% in 1QFY07.

The retail loan book grew by 38% to Rs155b. The retail loan book comprises 19.3% of the total loan portfolio. The other segment driving the loan book expansion has been the agricultural segment, which grew by 27% in 1QFY07 over 1QFY06.

RETAIL BOOK (RS M)

	1QFY07	1QFY06	% GROWTH
Retail Disbursements	19,140	12,660	51.2
Outstanding Retail Loans	155,090	112,330	38.1
of which: Housing Loans	59,260	44,220	34.0

Source: Company/ Motilal Oswal Securities

### Margins decline marginally; yields on advances improve

Canara bank's margins declined by 14bp YoY to 3.22% in 1QFY07, as cost of deposits increase by 51bp YoY to 5% and investment yields declined by 16bp to 7.66% in 1QFY07. Yield on advances have not only improved on YoY but also from FY06 levels. We expect margins to decline by 15bp in FY07 over FY06 levels.

TREND IN MARGINS (%)

	1QFY06	1QFY07	FY06
Yield on Loans	8.1	8.6	8.2
Yield on Inv	7.8	7.7	7.9
Cost of Deposits	4.5	5.0	4.7
Cost of Funds	4.2	4.6	N.A.
Spread	3.0	2.8	N.A.
Margins	3.4	3.2	3.0

Source: Company/ Motilal Oswal Securities

### Trading gains witness a sharp decline, fee income grows

The trading gains booked by the bank declined sharply from Rs304m in 1QFY06 to Rs10m in 1QFY07. However, the fee income of the bank grew by 13% to Rs2.57b.

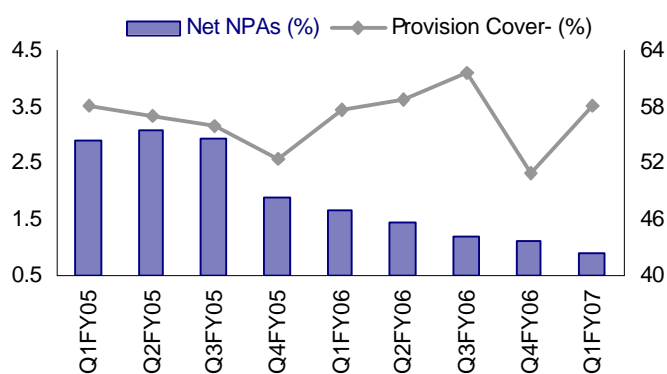
### Investment provisions result in flat bottomline

The bank has transferred Rs16b worth of securities from the AFS portfolio to the HTM portfolio in 1QFY07, taking a hit of Rs1.5b. Further the bank has taken a MTM hit of Rs1.04b during 1QFY07. With the AFS book still in losses and G-Sec yields having moved up in 2QFY07, the bank could witness MTM hits in 2QFY07 as well.

### Asset quality continues to improve

On back of strong recoveries, the bank continued to witness improvement in its asset quality. Gross NPAs declined by 10bp QoQ to 2.15% while net NPAs declined to 0.91% (against 1.67% in 1QFY06 and 1.12% in 4QFY06). Cash recoveries continued to be strong at Rs1.9b in 1QFY07 versus Rs1.8b in 1QFY06. The coverage ratio of the bank stands at 58%. Continued strong recoveries could start flowing towards profits as absolute net NPAs are just Rs7.3b (total recovery in FY06 was Rs9.7b, including Dabhol) as of June 2006.

TREND IN QOQ NET NPA LEVELS (%)



Source: Company/Motilal Oswal Securities

### Will require capital in FY07

Canara Bank's CAR has declined to 11.02%, with Tier 1 near 7%. We believe that in order for the bank to continue to grow its loan book robustly it will require capital infusion shortly. Management has indicated that it will raise Rs30b from various sources, including capital markets and also explore hybrid capital options.

### We maintain Buy

While Canara Bank's margins have declined by 14bp YoY, we believe that continued strong growth in the loan book will result in steady core NII growth. Further, with asset quality having improved significantly, incremental NPA provisions are likely to be lower. However, higher investment related provisions and lower treasury income would result in flat bottomline in FY07. We expect the bank to report EPS of Rs33.2 and book of Rs200 in FY07. The stock trades at PE of 5.4x FY07E EPS and P/BV of 0.9x FY07E. We maintain **Buy**.

## Canara Bank: an investment profile

### Company description

Canara bank, the third largest public sector bank of India, was established in 1906. It has a balance sheet size in excess of Rs~1300b and a network of 2513 branches with 57% of them being located in southern parts of India. The government owns 73.2% of the bank's equity.

### Key investment arguments

- ✍ Has strong focus on loan growth with focus on agriculture, SME and retail.
- ✍ Has significantly improved its technological platform and has achieved 100% computerization of branches.
- ✍ Is well placed to benefit from increased agri-lending as 57% of its branches are located in rural and semi-urban areas.
- ✍ Increasing cash recoveries and aggressive provisions have led to a steep decline in Net NPAs (currently at 0.9%).

### Key investment risks

- ✍ Since 62% of the bank's investment portfolio is in the AFS category any rise in interest rates will adversely affect its earnings.

### Recent developments

- ✍ Has transferred securities worth Rs16b during 1QFY07 to the HTM category, taking a hit of Rs1.5b.
- ✍ Mr. M. B. N. Rao is appointed as the CMD of the bank.

### Valuation and view

- ✍ We expect an EPS of Rs33.2 and book value of Rs200. The stock trades at PE of 5.4x FY07E and P/BV of 0.9x FY07E BV. We maintain **Buy**.

### Sector view

- ✍ YTD loan growth of 30% highest in the last 12 years.
- ✍ Volatility in interest rates will impact bond gains.
- ✍ Benefits of significant improvement in asset quality, not factored into earnings, valuations.
- ✍ We maintain an overweight on the sector.

#### COMPARATIVE VALUATIONS

		CANARA	PNB	BOB
PE (x)	FY07E	5.4	6.5	6.9
	FY08E	4.6	5.3	5.8
P/ABV (x)	FY07E	0.9	1.0	0.8
	FY08E	0.8	0.9	0.7
RoE (%)	FY07E	17.6	15.6	11.8
	FY08E	17.8	16.7	12.7
RoA (%)	FY07E	1.0	1.0	0.8
	FY08E	1.1	1.1	0.9

#### SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	73.2	73.2	73.2
Domestic Institutions	1.5	1.5	3.5
FII/DFIs	18.3	18.5	15.4
Others	7.0	6.8	7.9

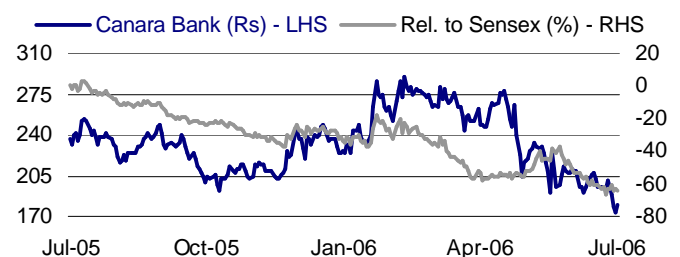
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	33.2	35.0	-5.1
FY08	39.4	40.9	-3.7

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
180	260	44.2	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Interest Income	70,069	75,720	87,115	105,338	123,744
Interest Expended	43,246	44,215	51,300	64,860	76,695
<b>Net Interest Income</b>	<b>26,824</b>	<b>31,505</b>	<b>35,815</b>	<b>40,478</b>	<b>47,049</b>
Change (%)	18.3	17.5	13.7	13.0	16.2
Other Income	20,729	15,438	13,775	12,492	13,355
<b>Net Income</b>	<b>47,553</b>	<b>46,943</b>	<b>49,590</b>	<b>52,970</b>	<b>60,404</b>
Change (%)	27.0	-1.3	5.6	6.8	14.0
Operating Expenses	18,965	21,090	23,471	25,497	28,453
<b>Operating Income</b>	<b>28,587</b>	<b>25,853</b>	<b>26,119</b>	<b>27,473</b>	<b>31,951</b>
Change (%)	43.1	-9.6	10	5.2	16.3
Other Provisions	11,907	13,058	10,687	10,000	10,700
<b>PBT</b>	<b>16,680</b>	<b>12,795</b>	<b>15,432</b>	<b>17,473</b>	<b>21,251</b>
Tax	3,300	1,700	2,000	3,844	5,100
<b>PAT</b>	<b>13,380</b>	<b>11,095</b>	<b>13,432</b>	<b>13,629</b>	<b>16,151</b>
Change (%)	31.3	-17.1	21.1	1.5	18.5
Proposed Dividend	2,312	2,255	2,460	2,665	2,870

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Capital	4,100	4,100	4,100	4,100	4,100
Reserves & Surplus	48,416	56,990	67,962	78,926	92,207
<b>Net Worth</b>	<b>52,516</b>	<b>61,090</b>	<b>72,062</b>	<b>83,026</b>	<b>96,307</b>
<b>Deposits</b>	<b>863,446</b>	<b>969,084</b>	<b>1,168,030</b>	<b>1,354,915</b>	<b>1,558,152</b>
Change (%)	19.8	12.2	20.5	16.0	15.0
Borrowings	27,549	26,938	27,357	29,629	28,000
Other Liabilities & Pro	51,883	45,940	46,144	48,144	48,144
<b>Total Liabilities</b>	<b>995,395</b>	<b>1,103,052</b>	<b>1,313,593</b>	<b>1,515,714</b>	<b>1,730,603</b>
Current Assets	120,270	86,687	67,642	68,002	64,927
Investments	357,930	380,539	418,593	460,452	506,497
Change (%)	17.5	6.3	10.0	10.0	10.0
Advances	476,386	604,214	794,260	953,112	1,122,766
Change (%)	17.7	26.8	31.5	20.0	17.8
Net Fixed Assets	6,802	6,728	6,972	5,408	4,799
Other Assets	34,006	24,883	26,128	28,740	31,614
<b>Total Assets</b>	<b>995,395</b>	<b>1,103,052</b>	<b>1,313,593</b>	<b>1,515,714</b>	<b>1,730,603</b>

ASSUMPTIONS					
(%)					
Deposit Growth	19.8	12.2	20.5	16.0	15.0
Advances Growth	17.7	26.8	31.5	20.0	17.8
Investments Growth	17.5	6.3	10.0	10.0	10.0
Dividend	50.0	55.0	60.0	65.0	70.0
CRR	4.5	5.0	5.0	5.0	5.0

E: Most Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
<b>Spreads Analysis (%)</b>					
Avg. Yield - Earning Assets	8.1	7.5	7.3	7.4	7.5
Avg. Cost-Int. Bear. Liab.	5.3	4.7	4.7	5.0	5.2
Interest Spread	2.8	2.8	2.6	2.3	2.3
Net Interest Margin	3.1	3.1	3.0	2.8	2.8

Profitability Ratios (%)					
RoE	28.5	19.5	20.2	17.6	18.0
RoA	15	11	11	10	11
Int. Expended/Int. Earned	61.7	58.4	58.9	61.6	62.0
Other Inc./Net Income	43.6	32.9	27.8	23.6	22.1

Efficiency Ratios (%)					
Op. Exps./Net Income	39.9	44.9	47.3	48.1	47.1
Empl. Cost/Op. Exps.	67.1	65.4	64.6	62.4	61.3
Busi. per Empl. (Rs m)	30.0	35.1	37.4	45.3	51.0
NP per Empl. (Rs lac)	3.0	2.5	2.8	2.9	3.4

Asset-Liability Profile (%)					
Adv./Deposit Ratio	55.2	62.3	68.0	70.3	72.1
Invest./Deposit Ratio	41.5	39.3	35.8	34.0	32.5
G-Sec/Invest. Ratio	81.1	78.3	78.3	78.3	78.3
Gross NPAs to Adv.	6.3	3.8	2.2	2.4	2.7
Net NPAs to Adv.	2.9	1.9	1.1	0.3	0.5
CAR	12.7	12.8	11.2	10.7	10.3
Tier 1	7.8	7.3	7.8	7.1	6.7

VALUATION					
Book Value (Rs)	125.1	146.1	172.9	199.7	232.0
Price-BV (x)	14	12	10	0.9	0.8
Adjusted BV (Rs)	103.3	128.3	159.0	195.2	222.9
Price-ABV (x)	17	14	11	0.9	0.8
EPS (Rs)	32.6	27.1	32.8	33.2	39.4
EPS Growth (%)	31.3	-17.1	21.1	1.5	18.5
Price-Earnings (x)	5.5	6.7	5.5	5.4	4.6
OPS (Rs)	69.7	63.1	63.7	67.0	77.9
OPS Growth (%)	43.1	-9.6	1.0	5.2	16.3
Price-OP (x)	2.6	2.9	2.8	2.7	2.3



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**Canara 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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