

## Canara Bank

STOCK INFO.	BLOOMBERG
BSE SENSEX: 9,686	CBK IN
S&P CNX: 2,940	REUTERS CODE
	CNBK.BO

25 January 2006

**Buy**
*Previous Recommendation: Buy*
**Rs225**

Equity Shares (m)	410.0
52-Week Range	258/170
1,6, 11 Rel.Perf.(%)	-4/-33/-43
M.Cap. (Rs b)	92.2
M.Cap. (US\$ b)	2.0

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	8.3	1.5	12.8	19.5	1.1	1.8
3/06E	48,470	12,187	29.7	9.8	7.6	1.3	13.0	18.5	1.0	1.4
3/07E	53,265	14,647	35.7	20.2	6.3	1.1	13.3	19.1	1.1	1.2

Canara Bank reported strong 27% YoY net interest income (NII, reported basis) growth to Rs9.58b. However, excluding income tax refund (Rs440m), NII growth was 21% YoY. Earnings also grew 30% YoY to Rs3.56b in 3QFY06. Non-interest other income growth was 18% YoY to Rs2.71b YoY. Business momentum continued with loan book growing by 32% YoY and deposits, by 12%. Asset quality continued to post improvement on the back of better NPA management and credit administration. Net NPAs registered a 173bp decline YoY to 1.2% in 3QFY06.

- ✍ Steady business growth, strong net interest income growth
- ✍ Yield on advances improve; cost of deposits decline from FY05
- ✍ Trading gains witnesses sharp decline, fee income grows YoY
- ✍ Asset quality continues to improve
- ✍ Investment book well cushioned

With earnings momentum picking up, we believe Canara Bank is likely to witness steady earnings growth going forward, as concerns on margins decline and high NPA levels are now behind. The stock is trading at P/E of 6.3x, P/BV of 1.1x FY07E. We maintain **Buy**.

QUARTERLY PERFORMANCE	(RS MILLION)									
	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Interest Earned	18,191	18,397	18,803	20,329	19,795	21,013	22,401	23,085	75,720	86,294
Interest Expended	10,731	11,105	11,237	11,142	11,467	12,946	12,818	13,590	44,215	50,821
<b>Net Interest Income</b>	<b>7,460</b>	<b>7,292</b>	<b>7,566</b>	<b>9,187</b>	<b>8,328</b>	<b>8,067</b>	<b>9,582</b>	<b>9,495</b>	<b>31,505</b>	<b>35,473</b>
% Change (YoY)	23.6	13.0	7.4	26.0	11.6	10.6	26.7	3.4	17.5	12.6
Non Interest Income	3,666	3,665	3,503	4,604	2,591	3,928	3,112	3,367	15,438	12,998
<b>Net Income</b>	<b>11,126</b>	<b>10,956</b>	<b>11,069</b>	<b>13,791</b>	<b>10,919</b>	<b>11,995</b>	<b>12,694</b>	<b>12,863</b>	<b>46,943</b>	<b>48,470</b>
Operating Expenses	4,680	5,208	4,969	6,232	5,316	6,184	5,702	5,644	21,090	22,846
<b>Operating Profit</b>	<b>6,446</b>	<b>5,748</b>	<b>6,100</b>	<b>7,558</b>	<b>5,603</b>	<b>5,811</b>	<b>6,992</b>	<b>7,218</b>	<b>25,853</b>	<b>25,624</b>
% Change (YoY)	29.7	-42.4	-11.0	11.5	-13.1	1.1	14.6	-4.5	-9.6	-0.9
Other Provisions & Contingencies	1,782	731	3,570	6,976	3,034	2,026	2,449	2,491	13,058	10,000
<b>PBT</b>	<b>4,664</b>	<b>5,018</b>	<b>2,530</b>	<b>583</b>	<b>2,569</b>	<b>3,785</b>	<b>4,543</b>	<b>4,727</b>	<b>12,795</b>	<b>15,624</b>
Provision for Taxes	1,300	1,050	-210	-440	700	720	980	1,037	1,700	3,437
<b>Net Profit</b>	<b>3,364</b>	<b>3,968</b>	<b>2,740</b>	<b>1,023</b>	<b>1,869</b>	<b>3,065</b>	<b>3,563</b>	<b>3,690</b>	<b>11,095</b>	<b>12,187</b>
% Change (YoY)	31.5	22.0	-26.5	-73.4	-44.4	-22.8	30.0	260.8	-17.1	9.8
Cost / Income	42.1	47.5	44.9	45.2	48.7	51.6	44.9	43.9	44.9	47.1
Int Exp / Int Income	59.0	60.4	59.8	54.8	57.9	61.6	57.2	58.9	58.4	58.9
Other Income / Net Income	33.0	33.4	31.6	33.4	23.7	32.8	24.5	26.2	32.9	26.8

E: MOST Estimates

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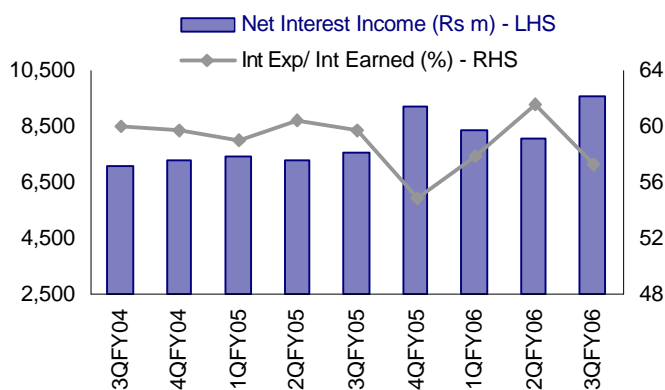
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### Steady business growth, strong NII

Net interest income, on reported basis, has posted 27% growth in 3QFY06 to Rs9.58b. Excluding tax refund of Rs440m, NII growth has been 21%. Strong growth in interest earned on advances has been the key factor for this growth. The interest expense to interest income ratio declined from 59.8% in 3QFY05 to 57.2% in 3QFY06.

#### TRENDS IN NII



Source: Company/Motilal Oswal Securities

Deposits grew by 12% YoY to Rs1,045b. The bank's advances portfolio has posted robust 32% YoY growth and stands at Rs705b. Thus loan/deposit ratio has moved up from 57% in 3QFY05 to 68% in 3QFY06.

The retail loan book grew by 33% to Rs134b. The main growth drivers in retail were the direct housing and the personal loans segments, which grew by 35% and 31% respectively. The retail loan book comprises 19% of the bank's total loan portfolio.

#### RETAIL SEGMENTS (RS M)

	3QFY06	3QFY05	% GROWTH
Housing Finance	37,971	51,340	35.2
Other Retail	62,956	82,650	31.3
<b>Total</b>	<b>100,927</b>	<b>133,990</b>	<b>32.8</b>

Source: Company/Motilal Oswal Securities

Outstanding advances to the priority sector moved up to Rs286b, clocking a YoY growth of 25.34%. Advances to the priority sector formed 43.2% of the bank's net credit. Agricultural advances grew by 35.8% to reach Rs109b. Outstanding SSI advances amounted to Rs61b.

### Yield on advances improve; cost of deposits decline from FY05

NIMs declined by 5bp YoY to 3.31% due to the falling yield on its investment book. Management reiterated that yield on loan book has started to move up while cost of funds is stable (declined by 3bp during 9MFY06) and should result in stable NIMs going forward.

#### YIELD MOVEMENT (%)

	3QFY06	3QFY05	FY05
Avg Yield on Advances	8.26	8.30	8.19
Avg Yield on Investments	7.31	8.02	8.04
Avg Cost of Deposits	4.64	4.77	4.67
Net Interest Margin	3.31	3.36	3.41

Source: Company/Motilal Oswal Securities

### Trading gains decline sharply, fee income grows

Trading gains booked by the bank declined sharply to Rs400m in 3QFY06 from Rs1.2b in 3QFY05. As a result, trading gains as a proportion of operating profit have declined steeply to 5.7% from 19.7% in 3QFY06. However, fee income of the bank grew by 18% YoY to Rs2.7b.

### Investment book well cushioned

The bank had transferred Rs30b worth of securities from the AFS to the HTM portfolio in 1QFY06, taking a hit of Rs170b. At 3QFY06, approximately 33% of the SLR investment book of Rs285b lay in the HTM category. The total modified duration of the AFS portfolio is less than 3.6 years, with a cushion up to the 1-year G-Sec rate of 7.7%.

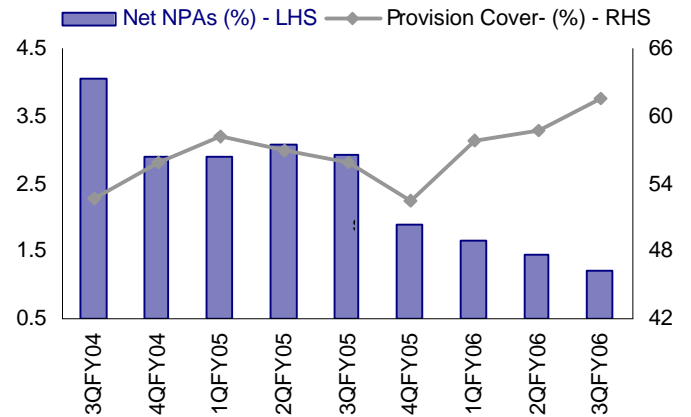
### Asset quality continues to improve

Net NPAs declined to 1.2% at end-December 2005 from 2.9% at end-December 2004. This is because the bank could effect robust cash recovery of Rs9.38b in 9MFY06, including Dabhol, as against Rs5.02b in 9MFY05. The coverage ratio of the bank stands at a healthy 62%. With net NPAs being at only 1.2% (Rs8.5b) coupled with strong recoveries flowing through, we believe that going forward, recoveries could emerge as a big earnings stream for the bank. Management also stated that it could recover Rs10b through its written-off accounts over the next three years.

### We maintain Buy

With earnings momentum picking up, we believe Canara Bank is likely to witness steady earnings growth going forward, as concerns on margins decline and high NPA levels are now behind. The stock trades at P/E of 6.3x, P/BV of 1.1x FY07E. We maintain **Buy**.

TREND IN QOQ NET NPA LEVELS AND PROVISION COVER



Source: Company/Motilal Oswal Securities

## 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 of Rs1,103b and a network of 2,526 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 and deposit growth.
- ✍ 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 1.2%).

### Key investment risks

- ✍ Since 62% of the bank's investment portfolio is in the AFS category with a breakeven yield of 7.70%, any rise in interest rates will adversely affect its bond portfolio

### Recent developments

- ✍ Has transferred securities worth Rs30b during 1QFY06 to the HTM category taking a hit of Rs1.7b.
- ✍ Mr. M. B. N. Rao is appointed as the CMD of the bank

### Valuation and view

- ✍ We expect earnings to grow by 10% in FY06 and 20% in FY07 resulting in an EPS of Rs29.7 and Rs35.7 in FY06 and FY07, respectively.
- ✍ The stock trades at P/E of 6.3x, P/BV of 1.1x FY07E. We maintain **Buy** with a target price of Rs279 (24%).

### Sector view

- ✍ Loan growth of 29%+ at the beginning of the capex cycle.
- ✍ Volatility in interest rates would impact treasury.
- ✍ Benefits of significant improvement in asset quality not yet factored into earnings, valuations.
- ✍ We maintain an overweight stance on the sector

#### COMPARATIVE VALUATIONS

		CANARA	PNB	VIJAYA BANK
P/E (x)	FY06E	7.6	8.4	9.7
	FY07E	6.3	7.1	6.1
P/ABV (x)	FY06E	1.4	1.5	1.5
	FY07E	1.2	1.3	1.3
RoE (%)	FY06E	18.5	18.9	16.3
	FY07E	19.1	19.0	22.7
RoA (%)	FY06E	1.0	1.2	0.9
	FY07E	1.1	1.3	1.2

#### SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	73.2	73.2	73.2
Domestic Institutions	3.2	4.1	2.2
FIs/FDIs	16.4	15.3	16.2
Others	7.2	7.4	8.4

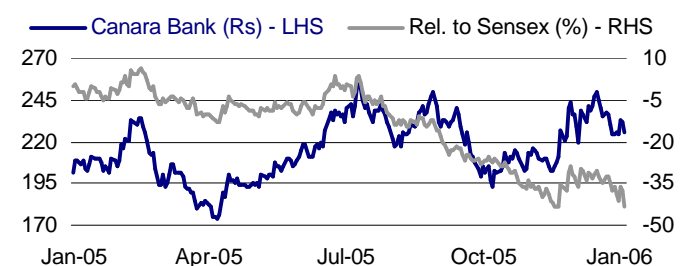
#### EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	29.7	30.2	-1.8
FY07	35.7	34.8	2.6

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
225	279	24.0	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Interest Income	70,069	75,720	86,294	98,974	113,647	
Interest Expended	43,246	44,215	50,821	58,502	67,366	
<b>Net Interest Income</b>	<b>26,824</b>	<b>31,505</b>	<b>35,473</b>	<b>40,472</b>	<b>46,282</b>	
Change (%)	18.3	17.5	12.6	14.1	14.4	
Other Income	20,729	15,438	12,998	12,792	13,555	
<b>Net Income</b>	<b>47,553</b>	<b>46,943</b>	<b>48,470</b>	<b>53,265</b>	<b>59,836</b>	
Change (%)	27.0	-1.3	3.3	9.9	12.3	
Operating Expenses	18,965	21,090	22,846	25,487	28,767	
<b>Operating Income</b>	<b>28,587</b>	<b>25,853</b>	<b>25,624</b>	<b>27,778</b>	<b>31,069</b>	
Change (%)	43.1	-9.6	-0.9	8.4	11.8	
Other Provisions	11,907	13,058	10,000	9,000	9,000	
<b>PBT</b>	<b>16,680</b>	<b>12,795</b>	<b>15,624</b>	<b>18,778</b>	<b>22,069</b>	
Tax	3,300	1,700	3,437	4,131	5,297	
<b>PAT</b>	<b>13,380</b>	<b>11,095</b>	<b>12,187</b>	<b>14,647</b>	<b>16,773</b>	
Change (%)	31.3	-17.1	9.8	20.2	14.5	
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	66,717	78,698	92,601	
<b>Net Worth</b>	<b>52,516</b>	<b>61,090</b>	<b>70,817</b>	<b>82,798</b>	<b>96,701</b>	
<b>Deposits</b>	<b>863,446</b>	<b>969,084</b>	<b>1,114,447</b>	<b>1,292,758</b>	<b>1,486,672</b>	
Change (%)	19.8	12.2	15.0	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>1,258,765</b>	<b>1,453,330</b>	<b>1,659,517</b>	
Current Assets	120,270	86,687	94,100	110,356	119,146	
Investments	357,930	380,539	418,593	468,824	515,706	
Change (%)	17.5	6.3	10.0	12.0	10.0	
Advances	476,386	604,214	712,973	841,308	991,060	
Change (%)	17.7	26.8	18.0	18.0	17.8	
Net Fixed Assets	6,802	6,728	6,972	5,408	4,799	
Other Assets	34,006	24,883	26,128	27,434	28,806	
<b>Total Assets</b>	<b>995,395</b>	<b>1,103,052</b>	<b>1,258,765</b>	<b>1,453,330</b>	<b>1,659,517</b>	

ASSUMPTIONS	(%)				
Deposit Growth	19.8	12.2	15.0	16.0	15.0
Advances Growth	17.7	26.8	18.0	18.0	17.8
Investments Growth	17.5	6.3	10.0	12.0	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	7.5	7.4	7.4	
Avg. Cost-Int. Bear. Li	5.3	4.7	4.8	4.7	4.7	
Interest Spread	2.8	2.8	2.7	2.7	2.6	
Net Interest Margin	3.1	3.1	3.1	3.0	3.0	

Profitability Ratios (%)						
RoE	28.5	19.5	18.5	19.1	18.7	
RoA	15	1.1	10	1.1	1.1	
Int. Expended/Int. Earned	61.7	58.4	58.9	59.1	59.3	
Other Inc./Net Income	43.6	32.9	26.8	24.0	22.7	

Efficiency Ratios (%)						
Op. Exps./Net Income	39.9	44.9	47.1	47.8	48.1	
Empl. Cost/Op. Exps.	67.1	65.4	62.4	61.2	60.6	
Busi. per Empl. (Rs m)	30.0	35.1	36.0	42.1	47.1	
NP per Empl. (Rs lac)	3.0	2.5	2.6	3.1	3.6	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	55.2	62.3	64.0	65.1	66.7	
Invest./Deposit Ratio	41.5	39.3	37.6	36.3	34.7	
G-Sec/Invest. Ratio	81.1	78.3	78.3	78.3	78.3	
Gross NPAs to Adv.	6.3	3.8	3.3	3.1	2.9	
Net NPAs to Adv.	2.9	1.9	1.1	0.8	0.6	
CAR	12.7	12.8	13.0	13.3	12.6	
Tier 1	7.8	7.3	7.5	7.5	6.8	

VALUATION						
Book Value (Rs)	125.1	146.1	169.9	199.1	233.0	
Price-BV (x)	1.8	1.5	1.3	1.1	1.0	
Adjusted BV (Rs)	103.3	128.3	157.3	188.7	224.4	
Price-ABV (x)	2.2	1.8	1.4	1.2	1.0	
EPS (Rs)	32.6	27.1	29.7	35.7	40.9	
EPS Growth (%)	31.3	-17.1	9.8	20.2	14.5	
Price-Earnings (x)	6.9	8.3	7.6	6.3	5.5	
OPS (Rs)	69.7	63.1	62.5	67.8	75.8	
OPS Growth (%)	43.1	-9.6	-0.9	8.4	11.8	
Price-OP (x)	3.2	3.6	3.6	3.3	3.0	



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**Canara Bank**

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| 2. Group/Directors ownership of the stock    | No |
| 3. Broking relationship with company covered | No |

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