Company Focus

31 January 2008 | 8 pages

Andhra Bank (ADBK.BO)

Target price change ☑
Estimate change ☑

3Q08 Results: Stable Quarter, Maintain Buy

- **3Q08 profits up 17%; in-line** — Andhra Bank had a stable quarter overall – growth in assets and profits were in-line with industry and estimates; net interest margins remained flat and trend improvement in asset quality continued. Operating performance was modest with pre-provision profit (ex-trading gains) growth of 3% on slower than expected fee income growth.
- **Margins flat as growth scales down** — Andhra Bank's margins remained flat QoQ as the pace of asset growth scaled down significantly relative to 1H08 (3% QoQ against 10% in 2Q08). Higher growth previously has pressured Andhra's above-industry margins; we expect moderation in growth targets in-line with industry to protect margins.
- **Fees disappoint but costs improve** — Core fee incomes fell 4% YoY and were a key disappointment. However, management suggests a pick up in distribution revenues from third-party products and is likely to gain traction in the seasonal 4Q. Cost improvements (-3% YoY) were a key support for profits however, provisions for wage revisions and pensions could impact it near term.
- **Asset quality continues steady improvements** — Asset quality has continued to improve with absolute NPLs declining 4% YoY, high and rising coverage levels.
- **Raising target price to 121** — We are adjusting earnings 5-6%, increasing our EVA-based target price to Rs121 on a lower risk free rate of 7.5% (from 8%) in-line with peers. We benchmark our valuations to 1.4x FY09E PBV translating to a fair value of Rs117.

Buy/Low Risk	1L
Price (31 Jan 08)	Rs91.80
Target price	Rs121.00
from Rs107.00	
Expected share price return	31.8%
Expected dividend yield	4.6%
Expected total return	**36.4%**
Market Cap	Rs44,523M
	US$1,133M

Price Performance (RIC: ADBK.BO, BB: ANDB IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	4,855	10.97	-15.6	8.4	1.5	20.5	3.8
2007A	5,379	11.09	1.1	8.3	1.4	17.8	4.1
2008E	6,165	12.71	14.6	7.2	1.3	18.4	4.4
2009E	7,182	14.81	16.5	6.2	1.1	18.9	4.6
2010E	8,416	17.35	17.2	5.3	1.0	19.3	4.6

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	8.4	8.3	7.2	6.2	5.3
P/E reported (x)	8.4	8.3	7.2	6.2	5.3
P/BV (x)	1.5	1.4	1.3	1.1	1.0
P/Adjusted BV diluted (x)	1.5	1.4	1.3	1.1	1.0
Dividend yield (%)	3.8	4.1	4.4	4.6	4.6
Per Share Data (Rs)					
EPS adjusted	10.97	11.09	12.71	14.81	17.35
EPS reported	10.97	11.09	12.71	14.81	17.35
BVPS	59.67	65.08	73.33	83.45	96.12
Tangible BVPS	59.67	65.08	73.33	83.45	96.12
Adjusted BVPS diluted	59.67	65.08	73.33	83.45	96.12
DPS	3.50	3.80	4.00	4.20	4.20
Profit & Loss (RsM)					
Net interest income	11,690	14,175	14,653	16,814	19,338
Fees and commissions	1,697	1,816	1,961	2,177	2,416
Other operating Income	3,537	3,409	3,805	4,190	4,612
Total operating income	**16,923**	**19,400**	**20,419**	**23,180**	**26,366**
Total operating expenses	-8,579	-9,332	-10,062	-10,624	-11,424
Oper. profit bef. provisions	**8,344**	**10,068**	**10,357**	**12,556**	**14,942**
Bad debt provisions	-400	-926	-1,056	-2,196	-2,819
Non-operating/exceptionals	-2,289	-1,374	-100	-100	-100
Pre-tax profit	**5,655**	**7,768**	**9,202**	**10,259**	**12,022**
Tax	-800	-2,389	-3,037	-3,078	-3,607
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**4,855**	**5,379**	**6,165**	**7,182**	**8,416**
Adjusted earnings	4,855	5,379	6,165	7,182	8,416
Growth Rates (%)					
EPS adjusted	-15.6	1.1	14.6	16.5	17.2
Oper. profit bef. prov.	-16.0	20.7	2.9	21.2	19.0
Balance Sheet (RsM)					
Total assets	**406,693**	**475,410**	**548,318**	**636,274**	**743,359**
Avg interest earning assets	356,302	429,481	504,156	585,122	683,440
Customer loans	225,733	284,331	340,650	399,047	467,483
Gross NPLs	4,369	3,970	6,563	8,511	10,295
Liab. & shar. funds	**406,693**	**475,410**	**548,318**	**636,274**	**743,359**
Total customer deposits	339,224	414,540	482,001	563,457	662,651
Reserve for loan losses	4,729	5,440	6,307	7,866	9,801
Shareholders' equity	**28,939**	**31,563**	**35,565**	**40,475**	**46,620**
Profitability/Solvency Ratios (%)					
ROE adjusted	20.5	17.8	18.4	18.9	19.3
Net interest margin	3.28	3.30	2.91	2.87	2.83
Cost/income ratio	50.7	48.1	49.3	45.8	43.3
Cash cost/average assets	2.3	2.1	2.0	1.8	1.7
NPLs/customer loans	1.9	1.4	1.9	2.1	2.2
Reserve for loan losses/NPLs	108.2	137.0	96.1	92.4	95.2
Bad debt prov./avg. cust. loans	0.2	0.4	0.3	0.6	0.7
Loans/deposit ratio	66.5	68.6	70.7	70.8	70.5
Tier 1 capital ratio	12.2	10.5	10.0	9.7	9.6
Total capital ratio	14.0	12.2	11.3	10.9	10.6

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Figure 1. Andhra Bank – Earnings Revision Table

	Net Profit			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
FY08E	5,859.2	6,165	5.2	12.1	12.7	5.2	3.8	4.0
FY09E	6,895.4	7,182	4.2	14.2	14.8	4.2	4.2	4.2
FY10E	NA	8,416	NA	NA	17.4	NA	NA	4.2

Source: Citi Investment Research estimates

Figure 2. 3Q08 Andhra Bank – Financial Highlights

	3Q08	3Q07	YoY %	2Q08	QoQ%	Citigroup Investment Research Comments
Interest Income	10,857	8,128	33.6	10,455	3.8	
Interest Expense	-7,156	-4,493	59.3	-7,008	2.1	
Net Interest Income	**3,701**	**3,635**	**1.8**	**3,447**	**7.4**	**3% lower than estimates, slight reduction in margins yoy; though pace of increase over previous quarter suggests most of the pain is over**
Fee-Based Income	1,208	1,254	-3.7	1,104	9.3	Fee income muted though a pick up in distribution revenues could see more traction in 4Q08
Other Non-Interest Income	269	75	259.8	275	-2.1	
Non Interest Income	1,477	1,329	11.1	1,379	7.1	
Operating Income	**5,178**	**4,964**	**4.3**	**4,826**	**7.3**	
Operating Expenses	(2,295)	(2,356)	-2.6	(2,505)	-8.4	Reduction in costs - a surprise and in contrast to most peers
Pre-Provision Profit	**2,883**	**2,607**	**10.6**	**2,322**	**24.2**	
Charges for Bad Debts	(366)	(185)	97.9	(110)	232.7	Higher provisioning - though backed by strong asset quality and increasing coverage levels
Other Operating Items	88	(460)	NM	0	NM	
Operating Profit	**2,605**	**1,963**	**32.7**	**2,212**	**17.8**	
Tax	(1,015)	(600)	69.2	(700)	45.0	High effective tax ratio of about 39% - should normalise in 4Q
Net Profit	**1,590**	**1,363**	**16.7**	**1,512**	**5.2**	**In-line quarter - stable growth and margins, continuing asset quality improvements**
EPS	3.28	3.41	-3.8	2.81	16.7	
Customer Loans	313,140	255,790	22.4	304,940	2.7	Consistent growth - in-line with industry - focus on agriculture and SME continues
Customer Deposits	439,110	361,090	21.6	444,340	-1.2	Deposit accretion slower - likely shedding some higher cost deposits
AIEA	506,158	440,138	15.0	488,153	3.7	
Total Assets	517,648	442,435	17.0	478,308	8.2	
Avg Assets	497,978	420,512	18.4	471,833	5.5	
Non-Performing Loans (NPL)	4,219	4,396	-4.0	4,124	2.3	Some deterioration in the quarter, though overall asset remains far ahead of peers
Loan Loss Reserves (LLR)	(3,721)	(3,286)	13.2	(3,558)	4.6	
Shareholders' Funds	37,320	32,931	13.3	35,729	4.5	
Book Value Per Share	76.95	67.90	13.3	73.67	4.5	
Key Ratios (%)	**3Q08**	**3Q07**	**Bps Δ YoY**	**2Q08**	**Bps Δ QoQ**	**Citigroup Investment Research Comments**
ROAA (annualized)	1.28	1.23	5	1.26	-4	Consistently amongst the highest profitability relative to peers
ROAE (annualized)	17.04	16.55	49	16.93	12	
Net Interest Margin (bps)	315	330	-15	310	5	Margins pressures seem to have subsided, will likely continue to earn relatively higher margins given agri. and mid-market focus
Fee Inc/Operating Income	23.3	25.3	-194	22.9	44	
Other Non-Interest Inc/Op Inc	28.5	26.8	175	28.6	-6	
Op. Cost/ Operating Income	44.3	47.5	-315	51.9	-757	Significantly ahead of peers - strong control on costs after a relatively modest 2Q performance
Loan-to-Deposit Ratio (LDR)	71.3	70.8	47	68.6	268	
NPL/Loan Ratio	1.3	1.7	-37	1.4	0	Strong asset quality - continues to be better than peers
LLR/NPL Ratio	88	75	1,344	86	192	Higher coverage levels provide additional comfort

Source: Company Reports and Citi Investment Research estimates

Andhra Bank

Company description

Andhra is the 18th largest Indian Bank, and 15th largest among government banks. This broadly positions it as a small bank even among government banks, with a deposit market share of about 1.6%. Andhra is less than one-third the size of larger government banks. Over 70% of its branches are in the state of Andhra Pradesh in southern India. Its business is also concentrated—about 58% of its loans and 64% of deposits are in the state, with the rest spread across the country.

Investment strategy

We rate Andhra Bank Buy/Low Risk (1L). We believe Andhra has three key things going for it: 1) Strong and consistent profitability, driven by high margins thanks to high loan yields, backed by low deposit costs, consistently strong returns on the bond portfolio and a relatively low provision requirement, given low NPL levels. We expect ROE to decline, but remain at about 18%, which is ahead of most industry peers. 2) It has a strong balance sheet with low gross and net NPLs – 1.35% and 0.16% respectively. 3) It has innovative human resources practices as well as technology. It also has adequate scale, a sufficient distribution network, and some surplus balance sheet liquidity. This combination, we believe, should enable it to actively participate in the current strong asset environment — on the consumer as well as the corporate side.

Valuation

Our target price of Rs121 is based on Citigroup's EVA model, which captures long-term business value, and is a standard valuation measure for our India Banking coverage. We factor a risk free rate of 7.5%. We also factor in longer-term margins of 220bps vs. 230bps average, and industry average capital ratio of 6%. We benchmark our target price on a 1.4x FY09E P/BV multiple, which accounts for the healthy asset pricing and operating environment. Our target multiple remains at discounts to larger public sector banks, at 1.5x FY09E PBV. We believe this discount is warranted, despite Andhra’s 1) above-sector average RoEs and margins, and 2) lower gross and net NPLs, to factor in possible risks of its relatively small balance sheet size, and regional concentration. This translates to a fair value of Rs117. We use the EVA measure as we believe it better adjusts for the relatively dynamic cost of capital, and better captures the long-term value of the business.

Risks

We rate Andhra Bank Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share-price volatility. Key downside risks to Andhra Bank are largely industry risks: 1) A reversal in the positive loan growth and asset quality environment—Andhra does carry some mid-market, geographic concentration and specific industry risk; 2) Sharp increases in bond yields—only a small part of the portfolio, with low duration, is exposed;

and 3) Government ownership—as the primary shareholder, the government's interests and decisions could be at odds with minority shareholder interests. These risks could impede the stock from reaching our target price. Upside risks to our forecasts include improvement in asset quality and stronger than expected loan growth and margins.

Appendix A-1

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Andhra Bank (ADBK.BO)

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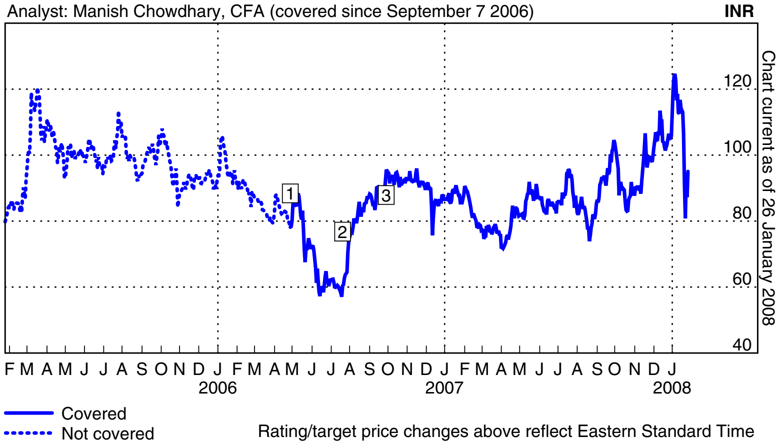
Analyst: Manish Chowdhary, CFA (covered since September 7 2006)



#	Date	Rating	Target Price	Closing Price
1:	27 Apr 06	1L	96.00	78.15
2:	20 Jul 06	1L	*76.00	60.35
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