

Karnataka Bank

STOCK INFO. BLOOMBERG
 BSE Sensex: 9,849 KBL IN
 REUTERS CODE
 S&P CNX: 2.975 KBNK.BO

30 January 2006

Buy

Rs111

Previous Recommendation: Buy

Equity Shares (m)	121.3
52-Week Range	137/63
1,6,12 Rel.Perf.(%)	-2/-41/-22
M.Cap. (Rs b)	13.4
M.Cap. (US\$ b)	0.3

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	5,380	1,471	12.1	-63.2	9.1	1.4	14.2	17.6	1.3	1.5
3/06E	5,346	1,724	14.2	17.1	7.8	1.2	13.0	16.5	1.3	1.3
3/07E	6,188	2,081	17.2	20.7	6.5	1.1	11.4	17.4	1.3	1.1

Strong business growth is indicated by the bank's loan book expanding 28% YoY and deposits growing by 25% YoY. As a result, net interest income increased by 16% YoY to Rs978m. Additionally, asset quality improved (to 1.56%). Overall, while NII grew by 16% YoY, operating expenses also increased. Opex expenses were the result of the bank undertaking revisions in outgo for existing pensioners up to Rs67m as well as higher provisioning arising from the RBI's increased provision requirement for standard assets. The bank was thus able to report net profit growth of 13% YoY to Rs415m.

- ✍ NII increases as advances grow and margins expand in 3QFY06 (annualized basis)
- ✍ Loans grew 28%; deposits grew 25%
- ✍ Other income declines as both treasury gains and fee income decline
- ✍ Improving asset quality: net NPAs decline to 1.56%

Core income grew in 3QFY06, however, due to the RBI's increased provisioning requirement for standard assets, Karnataka Bank's provisions increased, along with one-time pension arrears that were expensed in staff costs, resulting in subdued QoQ earnings growth.

We believe that a steady growth in balance sheet and a lower provisioning requirement will drive earnings for the bank going forward. We expect earnings growth of 19% in FY06, followed by a growth of 15% in FY07. The stock trades at a P/E 6.5x and P/BV of 1.1x on FY07E earnings. We maintain **Buy**.

	QUARTERLY PERFORMANCE								(RS MILLION)	
	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Interest Income	2,077	2,121	2,134	2,067	2,406	2,400	2,664	2,694	8,399	10,165
Interest Expense	1,537	1,174	1,289	1,231	1,499	1,637	1,687	1,692	5,230	6,515
Net Interest Income	541	947	845	836	908	763	978	1,002	3,169	3,650
% Change (Y-o-Y)	32.9	74.5	36.6	47.7	67.9	-19.4	15.6	19.8	48.3	15.2
Other Income	1,049	311	467	385	477	452	367	400	2,211	1,696
Net Income	1,589	1,258	1,312	1,222	1,385	1,215	1,345	1,402	5,380	5,346
% Change (Y-o-Y)	6.3	4.5	10.8	27.9	-12.8	-3.4	2.5	14.8	11.2	-0.6
Operating Expenses	417	474	562	520	506	562	562	568	1,973	2,198
Operating Profit	1,172	783	750	701	879	652	782	834	3,407	3,148
Other Provisions	661	224	168	-48	230	32	128	185	1,005	575
Tax Provisions	124	247	213	347	233	203	240	174	931	849
Net Profit	387	313	369	403	417	417	415	474	1,471	1,724
% Change (Y-o-Y)	12.3	-9.1	1.2	47.2	7.6	33.4	12.6	17.9	10.5	17.1
Cost to Income Ratio (%)	26.2	37.7	42.8	42.6	36.5	46.3	41.8	40.5	36.7	41.1
Interest Expense/Interest Income (%)	74.0	55.4	60.4	59.5	62.3	68.2	63.3	62.8	62.3	64.1
Other Income/Net Income (%)	66.0	24.7	35.6	31.5	34.5	37.2	27.3	28.5	41.1	31.7

E: MOST Estimates

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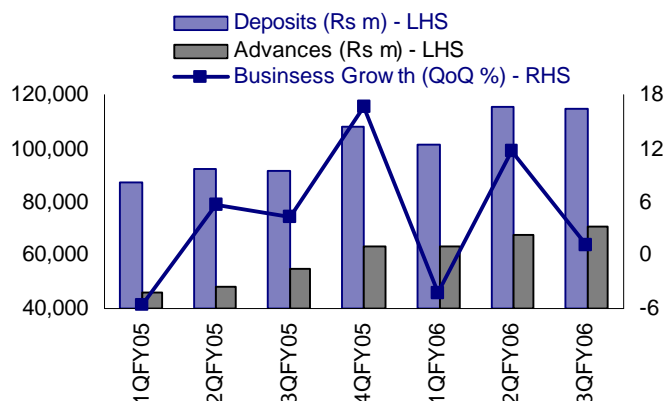
NII increases as advances grow and margins expand in 3QFY06 (annualized basis)

During 3QFY06, NII grew by 16% YoY, helped by increased advances coupled with expanding margins (from 1HFY06). NIMs of the bank have expanded 14bp and 9bp to 2.62% (annualized basis) in 3QFY06 since 3QFY05 and March 2005, respectively. Increasing yield on advances since March 2005 and lowering of cost of deposits are a result of margin expansion. Yield on advances have increased to 8.81% in 3QFY06 from 8.62% in March 2005, although they are marginally down from the comparable period last year. Cost of deposits too has come down on a YoY basis by 14bp to 5.81% in 3QFY06. Management has indicated their target to achieve a spread of 3.0% by FY06, which is currently the spread for the bank.

Loans grew by 28%; deposits grew by 25%

The bank has done extremely well in its business segments with the loan book expanding by 28% YoY to Rs70b at 3QF06. Driving this strong expansion is the strong growth in retail, small and medium enterprises (SME) and the agricultural segments. Deposits have grown 25% YoY to Rs115b. However, on a QoQ basis, deposits have declined marginally (down 90bp). Management has indicated that this is largely owing to bulk deposits. Management has consciously decided to stay away from high-cost bulk deposits. CASA growth has been weak at 10% YoY and as a percent of total deposits has declined YoY to 19.7% in 3QFY06 from 22.4% in 3QFY05.

TREND IN BUSINESS VOLUME



Source: Company/Motilal Oswal Securities

Other income declines, as both treasury gains and fee income decline

Trading income for the bank declined by 31% YoY to Rs158m in 3QFY06 and so did non-interest other income, which declined by 12% YoY to Rs209m.

The investment book of the bank stood at Rs48.5b in 3QFY06. Of this, approximately Rs36b was in SLR, with HTM of Rs21b of the SLR book. The AFS book had a modified duration of two years and a cushion was available on 10-year G-sec yield until 7.5%.

Staff costs includes one-off

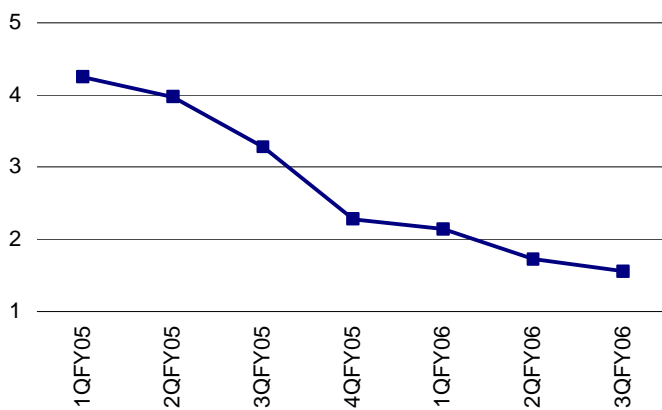
According to a wage settlement reached at the bank in May 2005, staff pension revisions had to be made from 1 June 2005. The bank bought LIC annuity policy with respect to these pension revisions, thereby taking a charge of Rs67m in 3QFY06 for pension arrears. As pension liabilities have been fully covered through this pension charge, going forward, the bank will not have any effect of this expense subsequent to 3QFY06.

Improving asset quality: net NPAs decline to 1.56%

The bank has maintained its trend of improving NPAs QoQ. Net NPAs have declined to 1.56% during 3QFY06 from 3.28% in 3QFY05 and 2.29% at FY05. Even on an absolute basis, net NPAs have declined by almost 24% to Rs1.09b from FY05.

The bank intends to restrict slippages to just 0.5% during FY06 and expects better recoveries in FY06 compared with FY05. The bank expects to achieve gross NPAs of Rs4.5b by end-FY06. Net NPAs are likely to decline to 1.25% by end of FY06. The bank has also provided an extra Rs68m towards the standard advances provision requirement increase put forth by the RBI recently.

TRENDS IN NET NPAS (%)



Source: Company/Motilal Oswal Securities

Valuation and view

Core income grew in 3QFY06, however, due to the RBI's increased provisioning requirement for standard assets, Karnataka Bank's provisions increased, along with one-time pension arrears that were expensed in staff costs, resulting in subdued QoQ earnings growth.

We believe that a steady growth in balance sheet and a lower provisioning requirement will drive earnings for the bank going forward. We expect earnings growth of 19% in FY06, followed by a growth of 15% in FY07. The stock trades at a P/E 6.5x and P/BV of 1.1x on FY07E earnings. We maintain **Buy**.

Karnataka Bank: an investment profile

Company description

Karnataka Bank is amongst the largest old-generation private sector banks and has a dominant presence in the southern and western parts of India. It is a mid-sized bank with a branch network of 387 and balance sheet size of Rs133b (3QFY06). Karnataka Bank is amongst the cheapest stock in our banking universe and offers a strong play on loan growth, improving asset quality and consolidation.

Key investment arguments

- ✍ Trading at extremely attractive valuations.
- ✍ Structural improvement in core business.
- ✍ Improved asset quality; set to get better.
- ✍ Could emerge as a play on the M&A space.

Key investment risks

- ✍ Any significant upmove in interest rates could adversely impact the bond portfolio.
- ✍ Economic slowdown could hurt asset quality of the bank.

COMPARATIVE VALUATIONS

		KARNATAKA BK	J&K	ICICI BK
P/E (x)	FY06E	7.8	12.0	22.2
	FY07E	6.5	9.4	17.7
P/ABV (x)	FY06E	1.3	1.4	2.5
	FY07E	1.1	1.3	2.3
RoE (%)	FY06E	16.5	11.6	14.1
	FY07E	17.4	13.6	13.2
RoA (%)	FY06E	1.3	0.8	1.2
	FY07E	1.3	0.8	1.1

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	0.0	0.0	0.0
Domestic Institutions	7.6	5.2	4.6
FII's/FDIs	17.8	20.2	2.2
Others	74.6	74.6	93.2

Recent developments

- ✍ Karnataka Bank has indicated its willingness to pick up an equity stake in the general insurance venture proposed by the public sector Allahabad Bank.
- ✍ There have been a lot of media reports indicating a possible takeover of Karnataka Bank. However management has denied any such move.

Valuation and view

- ✍ The bank has witnessed strong growth in its core earnings for FY05, even as PAT growth was impacted by HTM transfer and wage arrears.
- ✍ The stock trades at a P/E 6.5x and P/BV of 1.1x on FY07E earnings.
- ✍ We maintain **Buy**.

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.

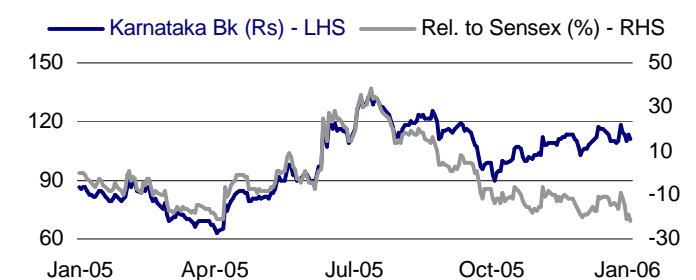
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	14.2	-	-
FY07	17.2	-	-

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
111	146	31.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)

Y/E March	2004	2005	2006E	2007E	2008E
Interest Income	8,484	8,399	10,165	11,873	13,793
Interest Expended	6,348	5,230	6,515	7,510	8,699
Net Interest Income	2,137	3,169	3,650	4,363	5,094
Change (%)	38.0	48.3	15.2	19.5	16.8
Other Income	2,703	2,211	1,696	1,825	1,918
Net Income	4,840	5,380	5,346	6,188	7,013
Change (%)	22.8	112	-0.6	15.8	13.3
Operating Expenses	1,542	1,973	2,198	2,457	2,731
Operating Income	3,298	3,407	3,148	3,731	4,282
Change (%)	30.2	3.3	-7.6	18.5	14.8
Other Provisions	1,283	1,005	575	625	650
P B T	2,015	2,402	2,573	3,106	3,632
Tax	683	931	849	1,025	1,199
Tax Rate (%)	33.9	38.8	33.0	33.0	33.0
P A T	1,332	1,471	1,724	2,081	2,433
Change (%)	20.9	10.5	17.1	20.7	16.9
Proposed Dividend	182	277	364	485	546

BALANCE SHEET (Rs Million)

Y/E March	2004	2005E	2006E	2007E	2008E
Capital	404	1,213	1,213	1,213	1,213
Reserves & Surplus	6,577	8,568	9,928	11,524	13,412
Net Worth	6,982	9,780	11,140	12,736	14,624
Deposits	94,069	108,370	127,877	147,059	169,118
Change (%)	13.4	15.2	18.0	15.0	15.0
Borrowings	1,833	2,437	3,655	4,569	5,711
Other Liabilities & Prov.	2,883	4,680	5,943	7,548	9,586
Total Liabilities	105,766	125,267	148,616	171,912	199,038
Current Assets	7,493	13,725	17,311	17,747	19,619
Investments	48,789	45,557	47,835	52,619	57,880
Change (%)	10.1	-6.6	5.0	10.0	10.0
Advances	46,679	62,874	79,850	97,418	116,901
Change (%)	19.7	34.7	27.0	22.0	20.0
Net Fixed Assets	932	966	1,259	1,532	1,783
Other Assets	1,873	2,145	2,360	2,596	2,855
Total Assets	105,766	125,267	148,616	171,912	199,038

ASSUMPTIONS (%)

Deposit Growth	13.4	15.2	18.0	15.0	15.0
Advances Growth	19.7	34.7	27.0	22.0	20.0
Investments Growth	10.1	-6.6	5.0	10.0	10.0
Dividend Yield (%)	3.2	1.8	2.7	3.6	4.1
Dividend	35.0	20.0	30.0	40.0	45.0
CRR	4.5	5.0	5.0	5.0	5.0

E: Most Estimates

RATIOS

Y/E March	2004	2005E	2006E	2007E	2008E
Spreads Analysis (%)					
Avg. Yield - Earning Asset:	8.9	7.5	7.7	7.7	7.7
Avg. Cost-Int. Bear. Liab.	7.0	5.1	5.4	5.3	5.3
Interest Spread	1.8	2.4	2.3	2.4	2.3
Net Interest Margin	2.2	2.8	2.8	2.8	2.8

Profitability Ratios (%)

RoE	20.8	17.6	16.5	17.4	17.8
RoA	1.3	1.3	1.3	1.3	1.3
Int. Expended/Int. Earned	74.8	62.3	64.1	63.3	63.1
Other Inc./Net Income	55.8	41.1	31.7	29.5	27.4

Efficiency Ratios (%)

Op. Exps./Net Income	31.9	36.7	41.1	39.7	38.9
Empl. Cost/Op. Exps.	61.0	63.4	62.6	63.0	63.2
Busi. per Empl. (Rs m)	30.5	35.5	42.6	50.2	57.7
NP per Empl. (Rs lac)	3.1	3.3	3.9	4.6	5.3

Asset-Liability Profile (%)

Adv./Deposit Ratio	49.6	58.0	62.4	66.2	69.1
Invest./Deposit Ratio	51.9	42.0	37.4	35.8	34.2
G-Sec/Invest. Ratio	61.7	74.7	74.7	74.7	74.7
Gross NPAs to Adv.	11.9	7.6	5.6	4.6	3.8
Net NPAs to Adv.	5.0	2.3	1.8	1.4	1.1
CAR	13.0	14.2	13.0	11.4	11.4
Tier 1	10.4	12.2	11.0	10.0	10.0

VALUATION

Book Value (Rs)	172.7	80.7	91.9	105.0	120.6
Price-BV (x)	0.6	1.4	1.2	1.1	0.9
Adjusted BV (Rs)	135.5	73.0	84.3	97.6	113.7
Price-ABV (x)	0.8	1.5	1.3	1.1	1.0
EPS (Rs)	32.9	12.1	14.2	17.2	20.1
EPS Growth (%)	20.9	-63.2	17.1	20.7	16.9
Price-Earnings (x)	3.4	9.1	7.8	6.5	5.5
OPS (Rs)	816	28.1	26.0	30.8	35.3
OPS Growth (%)	30.1	-65.5	-7.6	18.5	14.8
Price-OP (x)	1.4	3.9	4.3	3.6	3.1

E: Most Estimates



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Karnataka Bank

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| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |

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