

## ACCUMULATE

Price	Rs234
Target Price	Rs264
Investment Period	12 months

Stock Info	
Sector	Banking
Market Cap (Rs cr)	11,802
Beta	0.6
52 WK High / Low	265/113
Avg Daily Volume	269563
Face Value (Rs)	10
BSE Sensex	15,332
Nifty	4,564
BSE Code	532477
NSE Code	UNIONBANK
Reuters Code	UNBK.BO
Bloomberg Code	UNBK@IN

Shareholding Pattern (%)	
Promoters	55.4
MF/Banks/Indian FIs	16.8
FII/ NRIs/ OCBs	17.4
Indian Public	10.4

Abs.	3m	1yr	3yr
Sensex (%)	39.4	6.8	43.6
Union Bank (%)	41.6	79.0	135.3

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## Performance Highlights

- Strong Retail Deposit growth continues:** The Bank's growth in Advances slowed down from 32% yoy in 4QFY2009 to 27% yoy in line with industry-wide slowdown, declining by Rs2,200cr sequentially. On the other hand, Deposits continued to grow at a substantial 34% yoy – much above the industry growth rate of 22% – driven by large accretion in Retail Term Deposits of Rs4,700cr during the quarter (63% yoy growth). The Bank's CASA ratio was stable sequentially at 30%, driven by a Rs2,000cr accretion during the quarter and driving a creditable, above industry-average 17.3% yoy growth. Bulk Deposits continued to flow off the Bank's books, declining by another 140bp sequentially (a substantial 630 yoy) to 9% of Total Deposits.
- NIMs fall below expectations:** While a sequential fall in NIMs was expected, the Bank's reported NIMs contracted much more than expected by 50bp sequentially to 2.3%. Due to the substantial NIM compression for the second successive quarter, the Bank's Net Interest Income fell by a substantial 13% qoq (and almost 29% lower than the Net Interest Income delivered in 3QFY2009), below expectations and evidencing the negative impact of premature PLR cuts by large PSU Banks in the wake of likely government suasion. The fall in NIMs was also partly attributable to substantial funds (about Rs4,500cr) being deployed in low-yield (5%) liquid funds. Moreover, the income from this was accounted under Other income, adjusted for which NIMs would be higher by 12bp. NIMs are expected to improve going forward, as benefits from downward repricing of Deposits, as well as increasing CD ratio start kicking in over the next few quarters. Accordingly, we have factored in 14% growth in Net Interest Income for the whole of FY2010E.
- Net Profit spurts 94% yoy:** The Bank reported a Net Profit growth of 94% yoy to Rs442cr (Rs228cr), far ahead of expectations although Net Interest Income fell short of expectations. The high growth is mainly on account of the low base of 1QFY2009 on account of substantial MTM provisions as well as the large Treasury gains booked during 1QFY2010 in line with the sectoral trends.

### Key Financials

Y/E March (Rs cr)	FY2008	FY2009	FY2010E	FY2011E
<b>NII</b>	<b>3,086</b>	<b>3,986</b>	<b>4,510</b>	<b>5,180</b>
% chg	10.6	29.1	13.2	14.8
<b>Net Profit</b>	<b>1,387</b>	<b>1,727</b>	<b>1,950</b>	<b>2,156</b>
% chg	64.1	24.5	12.9	10.6
NIM (%)	2.8	2.9	2.6	2.4
<b>EPS (Rs)</b>	<b>27.5</b>	<b>34.2</b>	<b>38.6</b>	<b>42.7</b>
P/E (x)	8.5	6.8	6.0	5.5
P/BV (x)	2.1	1.7	1.4	1.1
P/ABV (x)	2.1	1.7	1.4	1.1
RoAA (%)	1.2	1.2	1.1	1.0
RoANW (%)	26.8	27.2	25.0	22.9

Source: Company, Angel Research

- **Strong Retail Deposit accretion to be a positive going forward:** The Bank's strong Retail Deposit accretion is being driven by strong network expansion in the past year (265 branches, 722 ATMs) and has temporarily led to a decline in the Bank's CD ratio from a high of 75% in 2QFY2009 to 67% in 1QFY2010. We view sustainable Retail Deposit accretion as one of the most significant pillars of core competitiveness in rating Domestic Banks, and although sequential management of Balance Sheet growth by the Bank was below par, we expect this Deposit growth to underpin above-average earnings growth in the medium term. In this regard, the Bank plans to open a further 500 branches in FY2010E (19% yoy increase in branch network).
- **Non-Interest Income driven by Treasury gains:** A 139% yoy surge in Other Income aided earnings, driven by large Treasury gains of Rs209cr during the quarter in line with industry trends. While on a sequential basis, Other Income excluding Treasury gains was flattish, on a yoy basis, growth remained high, underpinned by strong Balance Sheet growth. Core Fee income was up 37% yoy to Rs183cr, Forex-related income was up 56% yoy to Rs91cr and Recoveries were up 109% yoy to Rs46cr.
- **Large restructuring:** The Bank reported further restructuring of Rs2,600cr during 1QFY2009 (Rs1,500cr based on facility-wise rather than borrower-wise calculations). Consequently, cumulative restructuring increased to Rs5,550cr, amounting to 5.8% of Advances and a substantial 75% of Networth. The Bank's gross NPA ratio was flattish sequentially, with fresh slippages being moderate at 0.8% of Advances on an annualised basis. The Net NPA ratio increased to 0.7% and NPA provision coverage declined to 64% on account of the RBI-mandated change in the treatment of floating provisions, treating them as a part of Tier 2 capital instead of adjusting against NPAs.
- **Operating Expenses:** The Bank continued to incur substantial Operating expenses (up 31% yoy) towards branch expansion, advertising, staff recruitment, wage hike provisions, etc. The Bank's Cost-to-Income ratio stood at 41%, a level that we expect the Bank to remain at over FY2010E, keeping in mind sustained expansion plans.
- **Investment book:** On account of high Deposit growth and declining Credit growth, the Bank had to deploy substantial funds in Investments, leading to 48% yoy surge in the Investment book and a sequential increase in the AFS portion from 23% to 31% of total Investments, with a very high duration of 4 years, increasing the Bank's earnings sensitivity to bond yields substantially.
- **Capital Adequacy:** Capital Adequacy was at a comfortable 13.7% (Basel II), with Tier 1 at 8.2%. Management had earlier indicated that it had in-principle approval from the government for a Rights Issue once the capital market conditions improve, though it appears that capital release under Basel 2 norms have prompted it to postpone such plans for about a year. Currently, strong internal generation is supporting its Balance Sheet growth.

The Bank's leverage (Assets to Networth) at approximately 22x is however, already above the high-end of the range we consider reasonable for PSU Banks. Once the RBI withdraws the countercyclical relaxations in risk weightages implemented in the past two quarters and potentially recalibrates Basel 2 risk weightages for rated exposures (based on the view that the ongoing substantial release of capital being enjoyed by Banks is an unintended outcome of Basel 2 implementation), Capital Adequacy ratios are likely to come down. This will be exacerbated by the expected increase in the credit/Deposit ratio from 2HFY2010E onwards. Hence, in our view, the need for fresh equity issuance is likely to arise sooner than would be suggested by currently reported capital adequacy ratios.

## Outlook and Valuation

At the CMP, the stock is trading at 5.5x FY2011E EPS of Rs42.7 and 1.1x FY2011E Adjusted Book Value of Rs203.1. In our view, the Bank is amongst the more profitable and competitive PSU Banks and have a positive outlook on the Bank due to its robust traction in CASA deposits and relatively faster network expansion than peers. We believe this traction in core Deposits will underpin bottomline growth ahead of peers going forward as Deposits reprice downwards and Credit demand picks up, notwithstanding the negative surprise on NIMs in the quarter under review. Government interference remains the key risk for the Bank's peer group. **We maintain an Accumulate on the stock, with a 12-month Target Price of Rs264, implying an upside of 13%.**

### Exhibit 1: 1QFY2010 Performance

Y/E March (Rs cr)	1QFY2010	1QFY2009	% chg	FY2009	FY2008	% chg
Interest Earned	3,175	2,533	25.3	11,916	9,427	26.4
Interest Expenses	2,374	1,723	37.7	8,076	6,361	27.0
<b>Net Interest Income</b>	<b>802</b>	<b>810</b>	<b>(1.0)</b>	<b>3,840</b>	<b>3,066</b>	<b>25.2</b>
Non-Interest Income	529	222	138.5	1,456	1,144	27.2
Total Income	1,330	1,032	28.9	5,296	4,210	25.8
Operating Expenses	543	416	30.6	2,214	1,593	39.0
Pre-Prov Profit	787	616	27.8	3,082	2,617	17.8
Provisions & Cont.	190	296	(35.6)	737	766	(3.7)
PBT	597	320	86.5	2,345	1,851	26.6
Prov. for Taxes	155	92	68.5	618	464	33.1
<b>PAT</b>	<b>442</b>	<b>228</b>	<b>93.7</b>	<b>1,727</b>	<b>1,387</b>	<b>24.5</b>
EPS (Rs)	8.8	4.5	93.7	34.2	27.5	24.5
Cost to Income (%)	40.8	40.3		41.8	37.8	
Effective Tax Rate (%)	26.0	28.7		26.4	25.1	
Net NPA (%)	0.7	0.2				

Source: Company, Angel Research


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**Ratings (Returns) :** **Buy (Upside > 15%)**  
**Reduce (Downside upto 15%)**

**Accumulate (Upside upto 15%)**  
**Sell (Downside > 15%)**

**Neutral (5 to -5%)**