

Karnataka Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,813	KBL IN
	REUTERS CODE
S&P CNX: 3,151	KBNK.BO

7 August 2006

Buy

Rs95

Previous Recommendation: Buy

Equity Shares (m)	121.3
52-Week Range	137/74
1,6,12 Rel.Perf.(%)	2/-19/-71
M.Cap. (Rs b)	11.5
M.Cap. (US\$ b)	0.2

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)
3/06A	5,328	1,760	14.5	19.6	6.5	1.0	11.8	16.9	1.3	1.1
3/07E	6,025	2,036	16.8	15.7	5.6	0.9	10.8	17.1	1.3	0.9
3/08E	6,985	2,446	20.2	20.1	4.7	0.8	10.0	17.8	1.3	0.8

Karnataka Bank reported net interest income (NII) growth of 12% to Rs1.02b in 1QFY07. However due to higher provision on account of its investment book, PAT was flat at Rs410m. Margins remained flat at 2.74% YoY. Business grew strongly with advances growing 26% YoY and deposits by 28%. However, asset quality worsened QoQ as the bank had to recognize Rs240m of NPAs on account of a few advances given to coffee growers.

- ✍ NII grew 12%; margins were flat YoY
- ✍ Loans grew 26%; deposits grew by 28%
- ✍ Other income declined, as treasury declined
- ✍ Asset quality QoQ worsens: net NPAs up to 1.5%

Steady growth in balance sheet leading to higher NII and the lower provisioning requirement will likely drive earnings ahead. We expect earnings to grow to 18% in FY07. The stock trades at a P/E 5.6x on FY07E EPS and P/BV of 0.9x on FY07E BV. We maintain **Buy**.

QUARTERLY PERFORMANCE									(RS MILLION)	
	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Interest Income	2,406	2,400	2,664	2,709	2,922	3,024	3,171	3,196	10,180	12,312
Interest Expense	1,499	1,637	1,687	1,698	1,904	1,965	2,070	2,023	6,521	7,962
Net Interest Income	908	763	978	1,011	1,017	1,059	1,101	1,173	3,659	4,350
% Change (Y-o-Y)	67.9	-19.4	15.6	20.9	12.1	38.9	12.6	16.0	15.5	18.9
Other Income	477	452	367	372	449	400	380	446	1,668	1,675
Net Income	1,385	1,215	1,345	1,383	1,466	1,459	1,481	1,619	5,327	6,025
% Change (Y-o-Y)	-12.8	-3.4	2.5	13.2	5.8	20.2	10.1	17.1	-1.0	13.1
Operating Expenses	506	562	562	415	520	550	590	620	2,045	2,281
Operating Profit	879	652	782	968	946	909	890	999	3,282	3,744
Other Provisions	230	32	128	202	331	200	115	104	592	750
Tax Provisions	233	203	240	256	204	246	236	273	931	958
Net Profit	417	417	415	510	410	464	540	623	1,760	2,036
% Change (Y-o-Y)	7.6	33.4	12.6	26.7	-1.6	11.2	29.9	22.1	19.6	15.7
Cost to Income Ratio (%)	36.5	46.3	41.8	30.0	35.5	37.7	39.9	38.3	38.4	37.9
Interest Expense/Interest Income (%)	62.3	68.2	63.3	62.7	65.2	65.0	65.3	63.3	64.1	64.7
Other Income/Net Income (%)	34.5	37.2	27.3	26.9	30.6	27.4	25.7	27.6	31.3	27.8

E: M0St Estimates

Karnataka Bank reported net interest income (NII) growth of 12% to Rs1.02b in 1QFY07. However due to higher provision on account of its investment book, PAT was flat at Rs410m. Margins remained flat at 2.74% YoY. Business grew strongly with advances growing 26% YoY and deposits by 28%. However, asset quality worsened QoQ as the bank had to recognize Rs240m of NPAs on account of a few advances given to coffee growers.

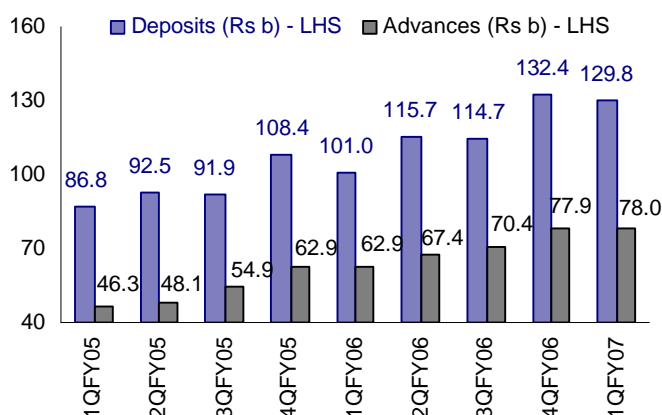
NII grows 12%; but margins flat YoY

During 1QFY07 NII grew 12% YoY, on the back of steady growth in advances and deposits. However NIMs have remained flat YoY at 2.74%, as higher loan yields (8.92% v/s 8.86%), compensated for the higher cost of funds (5.95% v/s 5.78%). The bank has effected a PLR hike by 50bp from July 2006, wherein 40% of the loans are likely to get re-priced immediately and about 30%-35% will get re-priced during the course of the year. Thus margins are likely to improve from 2QFY07 onwards.

Loans grew 26%; deposits up by 28%

The bank has done extremely well on the business front with its loan book expanding by 26% YoY to Rs78b in 1QFY07. Strong growth in retail, SME and the agricultural segments drove this expansion. Deposits have grown faster by 28% YoY to Rs130b.

TREND IN BUSINESS GROWTH



Source: Company / Motilal Oswal Securities

Other income declines, as treasury decline

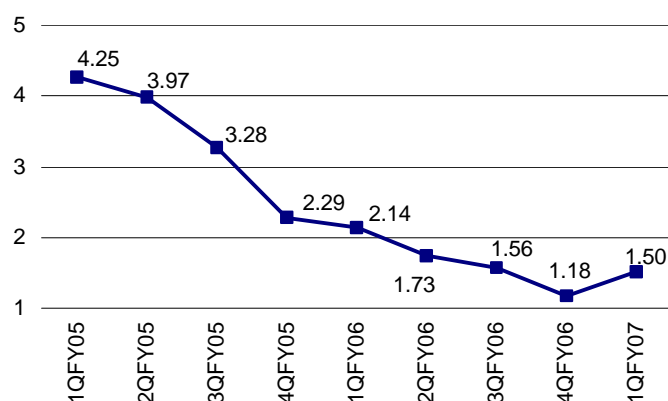
Trading income for the bank during the quarter declined by 41% to Rs170m, while non-interest other income increased by 49% to Rs279m. Non-interest income, excluding treasury has grown by 49% YoY, as commissions increased and recoveries were strong.

The bank's investment book is well cushioned against rising interest rates. Of the total investment book of Rs55b, Rs41b is in SLR. Of the SLR, 52% of the investment book is in HTM and the remainder in AFS (duration of 3.7 years). The bank is cushioned up to only 8.12% for the 10-year G-sec rate. Management mentioned that for every 10bp increase over 8.1%, the bank will need to make a provision of Rs25m.

Asset quality worsens QoQ: net NPAs increase to 1.5%

Asset quality worsened QoQ, as the bank had to recognize Rs240m of NPAs on account of a few coffee advances in 1QFY07. Net NPAs increased from 1.18% to 1.5% QoQ, however still declined from 2.14% in 1QFY06. The bank intends to restrict slippages to just 0.5% of advances going forward, and expects net NPAs of < 0.75% by FY07.

TREND IN NPAs



Source: Company / Motilal Oswal Securities

Network expansion to continue; technology on track

Management expects to increase its branch network to 415 and the number of ATMs to 125 (currently, 398 branches and 75 ATMs). Bank branches will mainly be in the western and northern regions of the country. The bank has networked 328 offices under Core Banking Solution (CBS) with business coverage up to 95%. The bank, which currently has 398 branches, has plans to increase this number to 415 during FY07.

Valuation and view

Steady growth in balance sheet leading to higher NII and lower provisioning requirement will drive earnings for the bank going forward. We expect earnings growth of 18% in FY07. The stock trades at a P/E 5.6x on FY07E EPS and P/BV of 0.9x on FY07E BV. We maintain **Buy**.

Karnataka Bank: an investment profile

Company description

Karnataka Bank is amongst the largest old-generation private sector banks that are dominant in the southern and western parts of India. It is a mid-sized bank with a network of 398 branches and balance sheet size of over Rs150b. The stock is amongst the most inexpensive 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 in the M&A space

Key investment risks

- Any significant upmove in interest rates could adversely impact its bond portfolio
- Slowdown of the economy could hurt asset quality of the bank.

Recent developments

- At the 82nd AGM, the FII limit was increased to 49% from the present 24%.
- The Chairman and CEO, Mr. Anantakrishna's term in office, has been extended for three years, effective 13 July 2006. He has completed 6 years in office.

Valuation and view

- The bank has witnessed strong growth in its core earnings in FY06, which is likely to continue, as NII grows and lower incremental provisions for NPAs are required due to improving asset quality.
- The stock trades at a P/E of 5.6x FY07E EPS and P/BV of 0.9x on FY07E BV.
- We maintain **Buy**.

Sector view

- YTD loan growth of 30%+, highest in the last 12 years.
- Volatility in interest rates would impact treasury.
- Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- We maintain an Overweight stance on the sector.

COMPARATIVE VALUATIONS

		KARNATAKA BK	OBC	ICICI BK
P/E (x)	FY07E	5.6	5.4	16.3
	FY08E	4.7	4.7	12.9
P/ABV (x)	FY07E	0.9	0.8	2.1
	FY08E	0.8	0.7	1.9
RoE (%)	FY07E	17.1	14.3	13.3
	FY08E	17.8	15.3	15.2
RoA (%)	FY07E	1.3	1.2	1.1
	FY08E	1.3	1.2	1.0

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	16.8	17.0	-1.0
FY08	20.2	19.8	2.1

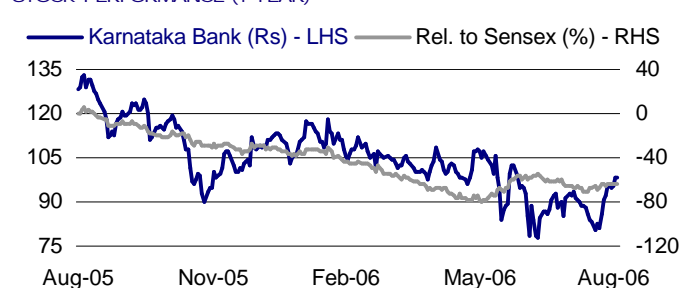
TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
95	145	53.0	Buy

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	0.0	0.0	0.0
Domestic Institutions	7.9	7.7	8.0
FII's/FDIs	21.8	19.2	8.8
Others	70.3	73.1	83.2

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)					
Y/E March	2004	2005	2006	2007E	2008E
Interest Income	8,484	8,399	10,180	12,312	14,593
Interest Expended	6,348	5,230	6,521	7,962	9,474
Net Interest Income	2,137	3,169	3,660	4,350	5,119
Change (%)	38.0	48.3	15.5	18.9	17.7
Other Income	2,703	2,211	1,668	1,675	1,866
Net Income	4,840	5,380	5,328	6,025	6,985
Change (%)	22.8	112	-10	13.1	15.9
Operating Expenses	1,542	1,973	2,045	2,281	2,588
Operating Income	3,298	3,407	3,283	3,744	4,397
Change (%)	30.2	3.3	-3.6	14.1	17.4
Other Provisions	1,283	1,005	592	750	800
P B T	2,015	2,402	2,691	2,994	3,597
Tax	683	931	931	958	1,151
Tax Rate (%)	33.9	38.8	34.6	32.0	32.0
P A T	1,332	1,471	1,760	2,036	2,446
Change (%)	20.9	10.5	19.6	15.7	20.1
Proposed Dividend	182	277	364	424	485

BALANCE SHEET (Rs Million)					
Y/E March	2004	2005	2006	2007E	2008E
Capital	404	1,213	1,213	1,213	1,213
Reserves & Surplus	6,577	8,568	9,899	11,510	13,471
Net Worth	6,982	9,780	11,111	12,723	14,684
Deposits	94,069	108,370	132,432	152,959	175,902
Change (%)	13.4	15.2	22.2	15.5	15.0
Borrowings	1,833	2,437	1,827	2,101	2,521
Other Liabilities & Prov.	2,883	4,680	4,163	4,579	5,037
Total Liabilities	105,766	125,267	149,533	172,362	198,145
Current Assets	7,493	13,725	12,146	13,906	15,364
Investments	48,789	45,557	55,486	58,815	63,520
Change (%)	10.1	-6.6	21.8	6.0	8.0
Advances	46,679	62,874	77,916	95,057	114,069
Change (%)	19.7	34.7	23.9	22.0	20.0
Net Fixed Assets	932	966	1,043	1,347	1,632
Other Assets	1,873	2,145	2,942	3,236	3,560
Total Assets	105,766	125,267	149,533	172,362	198,145

ASSUMPTIONS (%)					
Deposit Growth	13.4	15.2	22.2	15.5	15.0
Advances Growth	19.7	34.7	23.9	22.0	20.0
Investments Growth	10.1	-6.6	21.8	6.0	8.0
Dividend Yield (%)	3.7	2.1	3.2	3.7	4.2
Dividend	35.0	20.0	30.0	35.0	40.0
CRR	4.5	5.0	5.0	5.0	5.0

E: Most Estimates

RATIOS					
Y/E March	2004	2005	2006	2007E	2008E
Spreads Analysis (%)					
Avg. Yield - Earning Asset:	8.9	7.5	7.6	7.8	8.0
Avg. Cost-Int. Bear. Liab.	7.0	5.1	5.3	5.5	5.7
Interest Spread	18	2.4	2.3	2.3	2.3
Net Interest Margin	2.2	2.8	2.7	2.8	2.8

Profitability Ratios (%)					
RoE	20.8	17.6	16.9	17.1	17.8
RoA	13	13	13	13	13
Int. Expended/Int. Earned	74.8	62.3	64.1	64.7	64.9
Other Inc./Net Income	55.8	41.1	31.3	27.8	26.7

Efficiency Ratios (%)					
Op. Exps./Net Income	319	36.7	38.4	37.9	37.1
Empl. Cost/Op. Exps.	610	63.4	56.8	57.4	58.5
Busi. per Empl. (Rs m)	30.5	35.5	43.9	49.3	56.0
NP per Empl. (Rs lac)	3.1	3.3	4.1	4.4	5.1

Asset-Liability Profile (%)					
Adv./Deposit Ratio	49.6	58.0	58.8	62.1	64.8
Invest./Deposit Ratio	519	42.0	419	38.5	36.1
G-Sec/Invest. Ratio	617	74.7	73.7	73.7	73.7
Gross NPAs to Adv.	119	7.6	5.1	4.1	3.3
Net NPAs to Adv.	5.0	2.3	12	0.9	0.5
CAR	13.0	14.2	11.8	10.8	10.0
Tier 1	10.4	12.2	11.3	9.8	9.0

VALUATION					
Book Value (Rs)	172.7	80.7	916	104.9	1211
Price-BV (x)	0.5	12	10	0.9	0.8
Adjusted BV (Rs)	135.5	73.0	86.7	100.3	117.9
Price-ABV (x)	0.7	13	11	0.9	0.8
EPS (Rs)	32.9	12.1	14.5	16.8	20.2
EPS Growth (%)	20.9	-63.2	19.6	15.7	20.1
Price-Earnings (x)	2.9	7.8	6.5	5.6	4.7
OPS (Rs)	816	28.1	27.1	30.9	36.3
OPS Growth (%)	30.1	-65.5	-3.7	14.1	17.4
Price-OP (x)	12	3.4	3.5	3.1	2.6

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 |
| 4. Investment Banking relationship with company covered | No |

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