Company Research

Industry Focus

GEMS: Asia India
Banking/Finance Banks

Deutsche Bank

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Indian Banks

Clouds clearing

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Bullish outlook, though short term could be volatile

This note marks the transfer of coverage of Indian banks from Thomas Quarmby to Dipankar Choudhury. Our top Buys are PNB and BoB; other Buys are OBC, HDFC Bank, UTI Bank (initiation of coverage). Union Bank is a Hold and Canara Bank a Sell.

Broad-basing of loan demand to sustain the traction

The ongoing strength of loan growth is underpinned not just by economic buoyancy, but increased financial inclusion and banks' desire to diversify their portfolios. Even within industrial lending, activity is perceptibly picking up after a long hiatus. The participation of almost all segments – industry, retail, agriculture, SME – makes overall loan growth less interest-rate-sensitive than earlier. The momentum of loan demand is hence unlikely to slacken.

Margins: impending short-term despondency an opportunity

We may see margin compression in Q4FY07 as deposit rates are first raised and RBI moves contribute to interest-rate volatility. However, this is also an opportunity, because there is already enough evidence of return of bargaining power to banks, ability to scale up deposit growth, significant increase in banks' risk appetite favouring asset yields, and investment yields ceasing to be a drag. Increased leverage could be an icing, more so if preference capital is permitted.

PNB, BoB top picks

Our preference is for quality of the franchise and deep value, reflecting in PNB, BoB, and OBC. HDFC Bank and UTI Bank are primarily strong growth plays. Union Bank is fairly valued considering margin pressures, and Canara Bank trades at an unjustified premium on account of lower interest rates benefiting its bond portfolio. Key risks to the sector are stretching of the RBI's tightening cycle and increase in pension liabilities for state-owned banks. Valuation methodologies used are mainly P/BV-RoE, P/E and sum-of-parts.

Figure 1: Comparative data

(%, FY08E)	RoA	RoE	Loan growth	Net profit growth	NPLs	CAR
Bank of Baroda	0.91	14.2	19.3	31.3	3.09	10.76
Canara Bank	0.77	15.0	18.8	4.5	1.98	10.92
HDFC Bank	1.46	22.0	30.0	31.8	1.55	10.20
Oriental Bank	1.33	16.2	18.2	11.4	2.88	11.03
Punjab National Bank	1.29	19.1	17.8	19.9	3.05	10.45
Union Bank	0.86	17.9	17.7	23.5	2.19	11.99
UTI Bank	1.00	19.3	26.7	18.7	1.26	10.86

Source: Company data, Deutsche Bank

Transferring Coverage

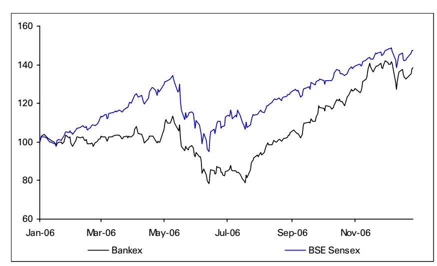
Top picks

PNB (PNBK.BO),INR515.80	Buy
Bank of Baroda (BOB.BO),INR247.55	Buy
Canara Bank (CNBK.BO),INR287.40	Sell

Companies featured

Bank of Baroda (BOB.BO),INR247.55			Buy
	2006A	2007E	2008E
P/E (x)	8.4	9.2	7.0
Div yield (%)	2.5	2.4	2.6
Price/book (x)	1.1	1.1	0.9
Canara Bank (CNBK.BO),INR287.40			**Sell**
	2006A	2007E	2008E
P/E (x)	6.9	9.7	9.3
Div yield (%)	2.9	2.4	2.6
Price/book (x)	1.5	1.5	1.3
HDFC Bank (HDBK.BO),INR1,065.80			**Buy**
	2006A	2007E	2008E
P/E (x)	23.6	28.8	21.9
Div yield (%)	0.0	0.0	0.0
Price/book (x)	4.6	5.3	4.4
OBC (ORBC.BO),INR229.55			**Buy**
	2006A	2007E	2008E
P/E (x)	7.9	6.6	5.9
Div yield (%)	2.0	1.5	1.7
Price/book (x)	1.1	1.0	0.9
PNB (PNBK.BO),INR515.80			**Buy**
	2006A	2007E	2008E
P/E (x)	9.2	8.6	7.2
Div yield (%)	2.1	1.9	2.1
Price/book (x)	1.6	1.5	1.3
Union Bank Of India (UNBK.BO),INR122.25			**Hold**
	2006A	2007E	2008E
P/E (x)	8.1	7.8	6.3
Div yield (%)	3.0	3.1	3.4
Price/book (x)	1.4	1.2	1.1
UTI Bank (UTBK.BO),INR474.95			**Buy**
	2006A	2007E	2008E
P/E (x)	14.5	22.5	19.0
Div yield (%)	1.3	0.8	0.9

Normalised sector performance



Deutsche Bank AG/Hong Kong

DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1

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Investment thesis

Outlook

We expect Q4FY07 to be a tumultuous period for Indian banks as the next round of tightening by the RBI, in its pursuit of lower loan growth and lower inflation, has begun. It is likely that deposit rate increases will by and large precede lending rate increases, as deposit growth is running at 21% and loan growth at 29%. However, this is also an opportunity for the medium-to-long term. The intrinsically broad-based, all-inclusive nature of the loan growth makes it less susceptible to a severe setback on interest-rate increases, thereby strengthening the bargaining power of banks, which should be able to effect lending rate increases, although with a lag.

There is already sufficient evidence of banks being able to deliver significant value in financial and stock price performance terms during an interest rate up-trend. At the same time, we demonstrate that higher interest-rate *volatility* has been detrimental to banks. Our short-term negative outlook on the sector is also due to our belief that year-end tightness and the RBI's resolve to curb lending growth can increase interest-rate volatility during Q4FY07.

We are significantly more positive on the medium-to-long-term outlook because the process of the loan and deposit growths meeting somewhere in between will engender increases in lending rates, helping interest margins. With government bond yields likely to be capped by increasing demand for paper by banks and insurance companies, the issue of mark-to-market risk could also be relegated to the background. Asset quality has considerable cushion against deterioration, and banks can now grow with the help of non-dilutive Tier I, which is likely to get a further boost once preference shares are permitted.

Valuation

Our primary valuation methodology is P/BV-RoE for PSU banks and P/E (coupled with sum of parts in some cases) for private banks. Banks are now trading at the higher end of the historical trading range in most cases. The representative BSE Bankex has been up ~18% and ~42% in the last three and 12 months, respectively. However, the environment is also more favourable than ever before: margin expansion, asset quality at a record best, non-dilutive capital raising possible and increased M&A action.

Based on our price targets, our best Buys are Punjab National Bank (PNB) and Bank of Baroda (BoB), the only Sell being Canara Bank. Our clear preference is for franchise quality – more so the liabilities franchise that is more difficult to build than assets.

Risks

The key risk for the sector is stretching of the RBI's tightening cycle for too long and more instances of unscheduled, mid-quarter moves like the rate hike in June'06 and cash reserve ratio increase in Dec'06. This increases volatility and makes balance sheet management tough for banks. Operating costs – more specifically accounting for pension gap – is the other risk, particularly since the quantum is not known at all.

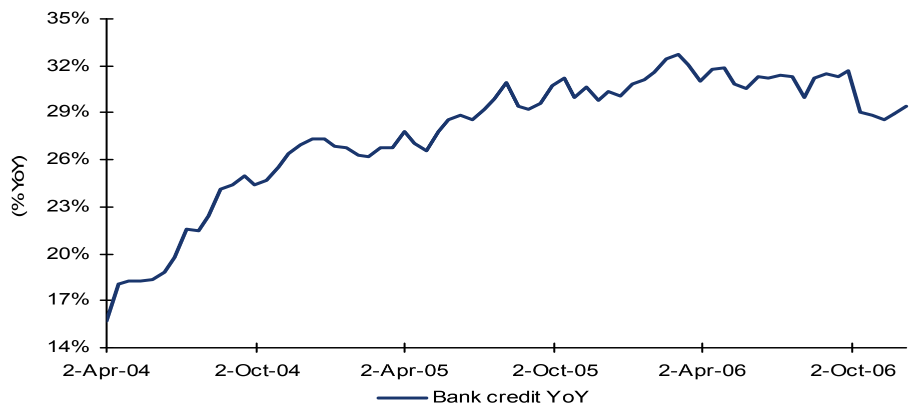
Loan demand – 'inclusive'

Demand let-up unlikely: firing on all cylinders

Our premise that three years of sustained strength in credit growth is not just a function of economic buoyancy but also the broad-basing of loan demand, has recently been articulated by the central bank too:

"A contextual analysis of the co-movement between macroeconomic performance and bank credit in the current phase of the business cycle suggests that factors other than demand may also be at work: financial deepening from a low base; structural shifts in supply elasticities; rising efficiency of credit markets; and competitive pressures augmenting the overall supply of credit." (Reserve Bank of India, *Monetary Policy Review*, October 2006).

Figure 2: Loan growth sustained for very long



Source: RBI, Deutsche Bank

The following sector-wise distribution of credit (Figure 3), though occasionally disturbed by classification changes by the RBI, shows that all sectors have been participating in formal bank credit with gusto.

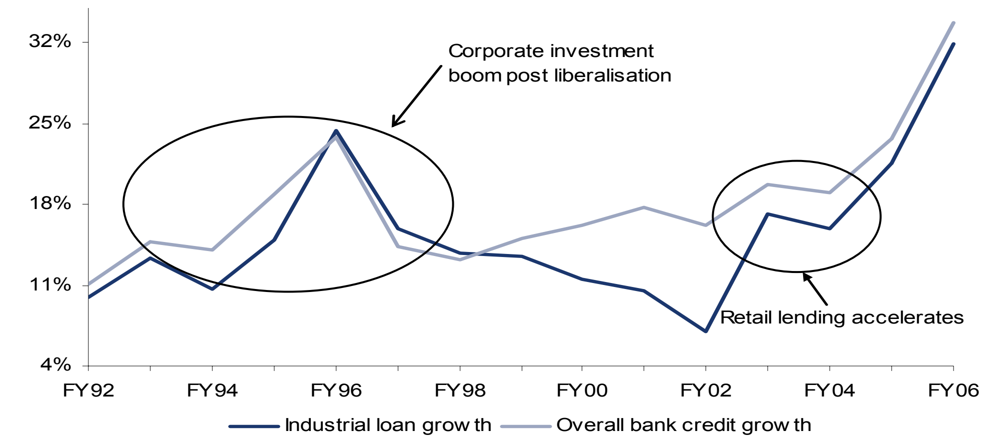
Figure 3: Loan-growth is substantially broad-based

(% growth YoY)	FY05	FY06	June'06
Agriculture	38.3	37.6	36.8
Services	NA	57.4	207.1
Housing	NA	44.8	54.3
Other retail	NA	30.5	29.3
Trade	133	40.5	70
Industry	36.4	28.6	26.6
Real estate	138.5	100.6	102.4

Source: RBI, Deutsche Bank

The slowdown of the mid-1990s hit the banks very hard because corporates, which accounted for a lion's share of bank credit, went into a less profitable and hence a financial restructuring mode. There was no retail credit then, banks did not focus on SMEs and farm lending was done grudgingly, under compulsion. Along with the diversification of the pie that keeps the tempo of demand intact, after a long time industry has also started demanding higher levels of credit.

Figure 4: Industrial credit growth picking up



Source: RBI, Deutsche Bank

In the five years prior to FY05, growth in industrial credit was almost wholly driven by infrastructure. There is a perceptibly wider participation from other segments during FY05 and FY06.

Figure 5: Several sub-segments participating within industry

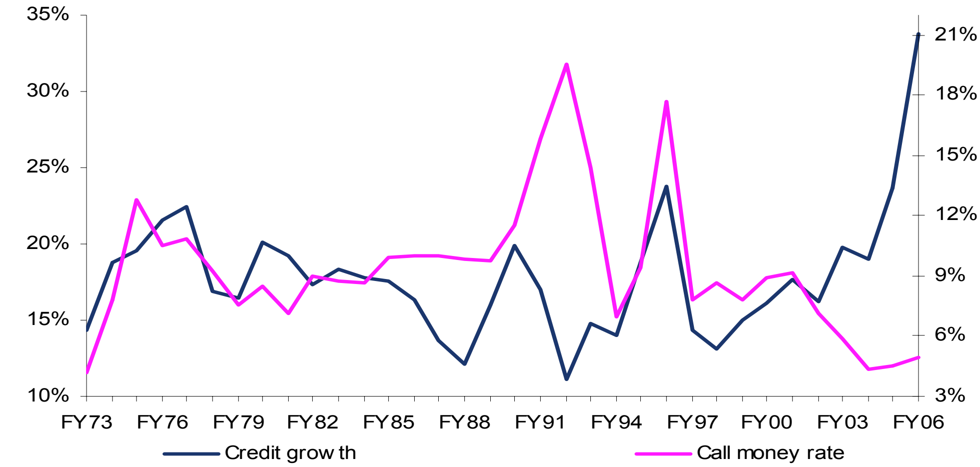
	CAGR (FY99-04)	FY05	FY06
Iron & steel	9.8%	14.6%	38.7%
Textiles	8.2%	18.5%	26.3%
Food processing	15.7%	85.9%	61.1%
Chemicals, dyes, paints etc	10.4%	12.3%	26.1%
Gems & jewellery	16.9%	40.5%	45.5%
Petroleum	18.3%	3.1%	42.5%
Electrical power	65.4%	68.3%	65.4%
Telecommunications	26.9%	70.6%	38.4%
Roads & ports	49.2%	61.5%	41.5%

Source: Deutsche Bank Note: Computation is based on average loans, not yr-end figures

Interest rate tool to control demand considerably blunted

If a substantial portion of loan growth gets driven by the banking system taking away market shares from informal sectors – this is clearly happening to farm credit, SMEs and to a limited extent non-mortgage retail – interest rate considerations influencing demand will be relatively low. SMEs and the rural folk have accessed credit from other sources at exorbitant interest rates, and hence banks' rates going by 200-300bps is not so meaningful. That explains the apparent lack of correlation between rates that have been rising and loan demand.

Figure 6: Correlation of loan growth with interest rates tenuous



Source: RBI, Deutsche Bank Note: Average call money rate taken as a benchmark for want of a better, consistent one

It is important to mention that this premise holds only for the aggregate and cannot be applied to every borrower segment. It is entirely possible that some segments, e.g. higher-end mortgages, are more vulnerable to interest-rate increases even as others may be comparatively less affected. But as long as there is increased financial deepening it will keep reducing the risks of a major demand shock.

Margins: longer-term strength

In the absence of resources coming out of excess holdings in government securities, there has to be a meeting between the deposit growth now at 21% and loan growth, which is now at 29%. The RBI has also been guiding the market towards a 20% loan growth by the end of FY07, and of late its disposition towards the stubbornly high loan growth has become increasingly strident. We believe that the two growth rates will settle down somewhere in between 21% and 29% – more like 23-24%. *The only way this can be achieved in an autonomous, non-disruptive fashion is an increase in interest rates*.

Rising funding costs with soft lending rates irrational

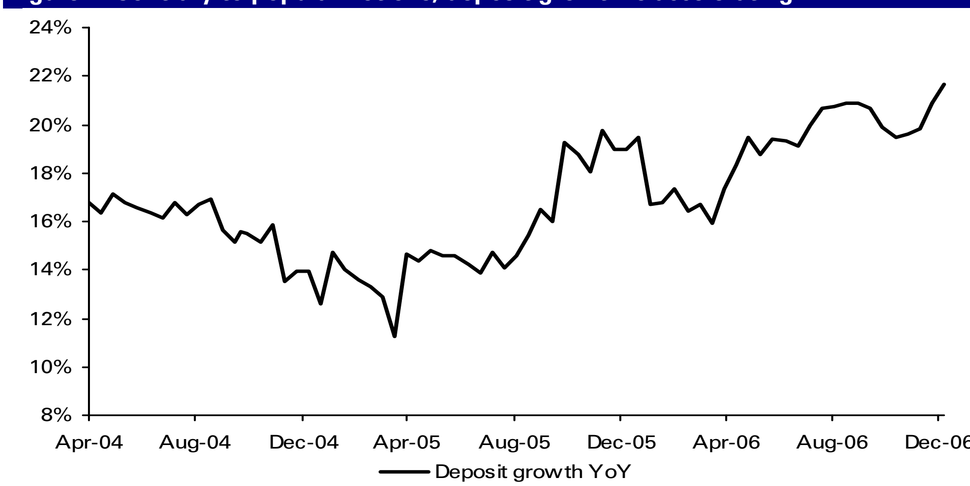
Plenty of historical evidence of return of pricing power to banks

Concerns are often expressed about banks' ability to increase lending rates in the face of competition and government pressure. The reality is that banks, which led the mortgage price war, have increased mortgage rate by 200-300bps from the bottom, and is yet to see significant resistance. That PSU banks raised prime lending rates twice in Q1FY07 and most of them again in Q3FY07 should also not be forgotten. Competition from overseas borrowings is a serious factor only with AAA companies, and banks have reduced exposure to them considerably during the last 3-4 years. Government stand is understandably against higher interest rates. However, it is unlikely that the government will be able to influence the course of interest rates single-handedly.

Inflexibility of deposit growth a myth

Empirical evidence does not corroborate the common belief that the stock market bull run is taking bank deposits away into the equities markets. With 100-200bps increase in the card rates of deposits, banks have managed to move the deposit growth rate from 15-16% to 19-20%, on a larger base.

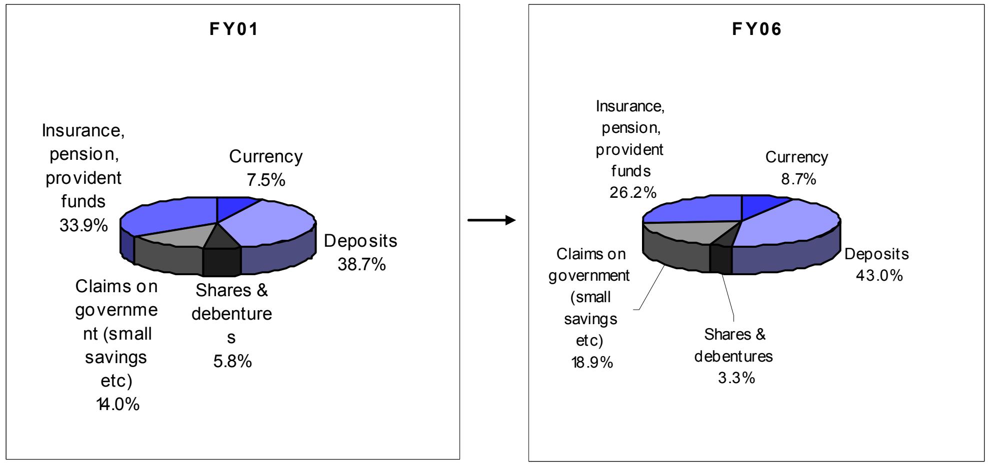
Figure 7: Contrary to popular notions, deposit growth is accelerating



Source: RBI, Deutsche Bank

Figure 8 is more remarkable – in the last five years, household financial savings have moved *out* of equities and long-term products to bank deposits in percentage terms. The point to note here is that component of cash (currency) has marginally risen – that's the real, incremental opportunity as more cash from chests moves into bank deposits first before potentially going to other avenues.

Figure 8: Increased importance of bank deposits in household savings



Source: Central Statistical Organization, Deutsche Bank

However, there is a time lag issue

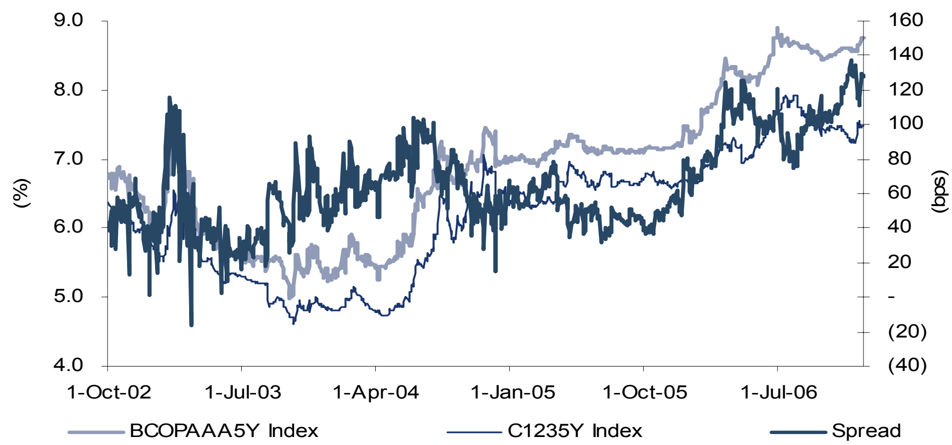
We however expect Q4FY07 to be a period of margin pressure (either reflected in Q4FY07 results or Q1FY08 results). This is because as the last interest-rate cycle showed, deposit costs increase first, followed by lending rates. Q4 is also usually a period of tight liquidity, and the RBI could be using all the weapons in their arsenal to tighten it further.

Also, banks will be cautious about the actual implementation of the lending rate increases and may do it in a graduated fashion so as not to invite outright resistance or overt attention from the government. HDFC Bank, PNB, SBI and a few others have nevertheless already made a beginning by increasing their prime lending rates after the cash reserve ratio hike by the RBI. However, the fight for deposits has intensified and it is possible that in Q4FY07 banks could be increasing their exposure to high-cost wholesale deposits, taken at higher than card rates.

Banks' increased risk appetite good for loan yields

Figures 9 &10 illustrate the fact that banks' lending risk appetite has increased significantly over the last five years – banks veering more towards lending at increasing spreads rather than investing in risk-free bonds. Admittedly these charts are only representative as they do not capture the entire lending spectrum, but do serve to show that unlike the 'lazy banking' attitude that marked most of 1997-2003, banks are willing to take higher risks, which is good for overall asset yields.

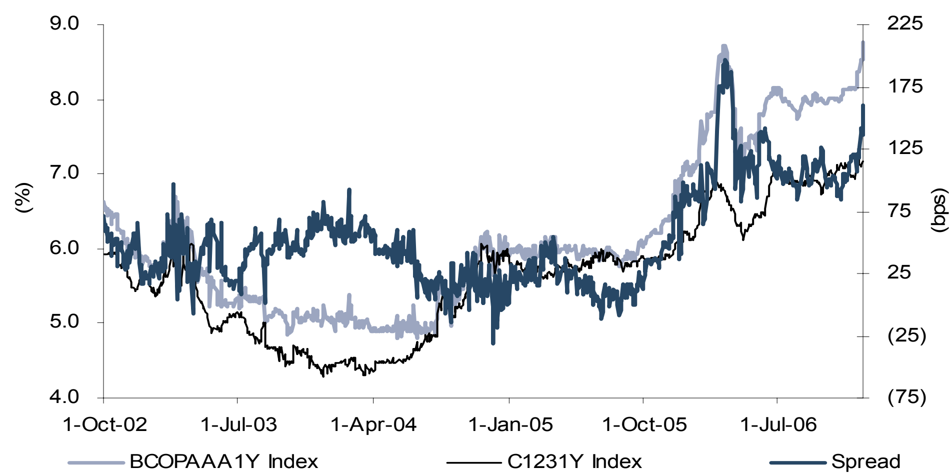
Figure 9: 5-yr AAA bond index and spread over risk-free rate



Source: Bloomberg, RBI, Deutsche Bank. BCOPAAA5Y refers to the 5-yr AAA bond index, and C1235Y the corresponding government security

The 5-yr term spread has been rising almost relentlessly, whereas the 1-yr spread shown in Figure 10 has taken a breather, though still remaining high.

Figure 10: 1-yr AAA bond index and spread over risk-free rate

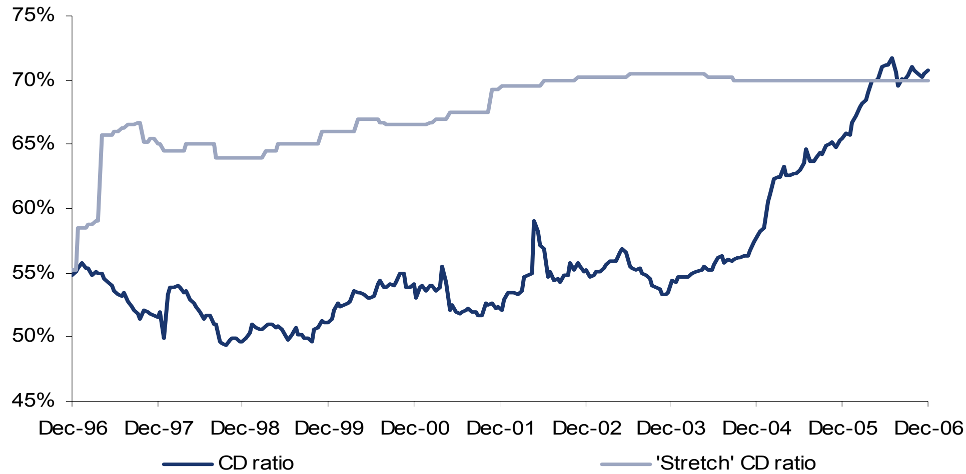


Source: Bloomberg, RBI, Deutsche Bank.

Figure 11 shows another measure of increased risk appetite. We have (from Dec'96, since when reliable data on all parameters is available) computed the 'stretch CD ratio', i.e. percentage of resources left after statutory appropriation. It is plotted with the actual CD ratio. Note that the stretch CD ratio has gone up over the years simply because of a decline in statutory appropriation.

The chart (Figure 11) shows a remarkable phenomenon – the last time the two lines intersected was ten years ago, and now again the two have converged. That means after ten years, banks are again finding the lending activity more profitable (and feasible) than passive investing.

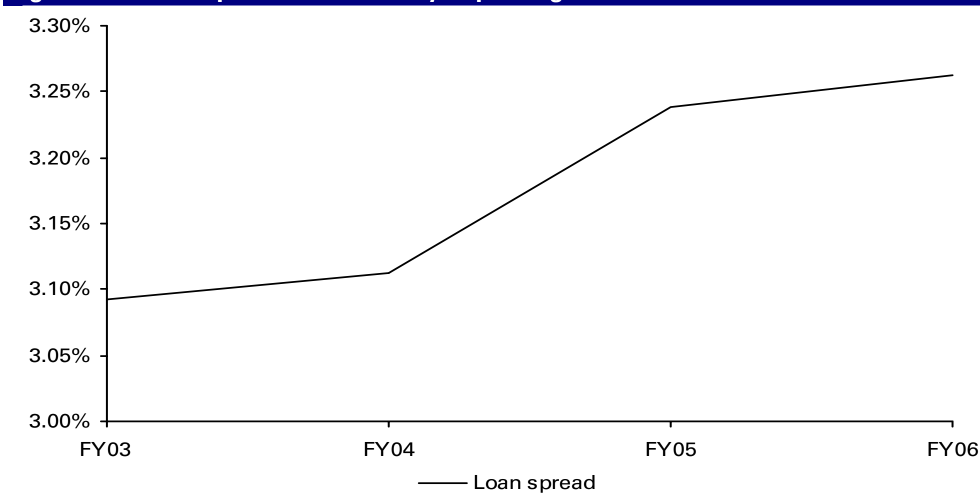
Figure 11: Banks are lending to the full extent after a long time



Source: RBI, Deutsche Bank

The spurt in risk appetite in the last two years has been immensely beneficial to asset yields. We do not have data going back too far, but spreads on advances are the highest in the last four years.

Figure 12: Credit spreads consistently improving

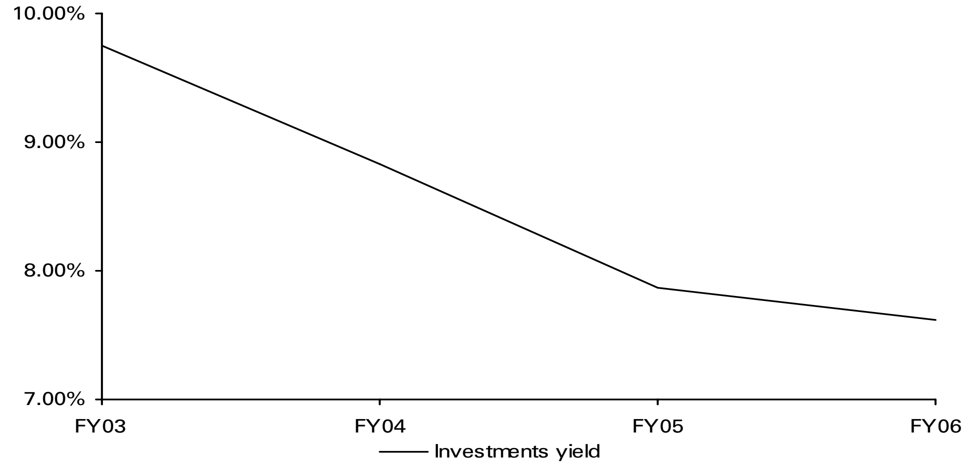


Source: RBI, Deutsche Bank

Investment spreads now less of a drag

As long-duration bonds at high interest rates have been coming up for maturity and getting re-priced at lower interest rates, yields on investments have been continuously falling over the last few years.

Figure 13: Decline of investment yields petering out



Source: RBI, Deutsche Bank

This situation is now likely to reverse because banks have almost completely run out of excess SLR securities. Hence there will be no winding-down process hurting yields – incrementally banks have to make further investments to satisfy SLR requirements at either steady or occasionally firming yields. Though that will still mean that investment *margins* may not go up (as deposit costs are rising), falling *yields* will not cause damage.

NPLs: concerns overstated

Loan growth-NPL nexus not as straightforward as believed

Asset prices: much ado about nothing?

We believe that the bogey of a possible asset price deflation (read real estate prices) hurting banks' asset quality has been blown out of proportion.

Residential mortgages

We believe it is very unlikely that there can be a large-scale increase in delinquencies on loans taken for the first house (typically self-occupied); unless there is a household income problem, it does not matter to the borrower whether the price of the house he is staying in is rising or falling. Even then, with an average loan-to-value of 75%, a 25% fall is theoretically buffered. LTVs had gone up to more risky levels at the peak of the mortgage boom; our field checks suggest that sanity has clearly returned.

Problems can arise more frequently for loans taken for the second house, typically for investment/speculation. Banks have been reluctant to disclose the exact volume of second houses financed. Most banks claim that it is in the range of 2-5% of incremental mortgage lending. There is a possibility that some individuals have been hiding from banks the fact that they already have one more loan, but this is becoming increasingly difficult with a credit bureau now in full swing.

Even if we assume that 10% of the *outstanding* mortgages are for the second house and all of that goes bad, it will mean 1% of the banking system's loans go bad.

Commercial real estate

It is instructive that according to figures disclosed by the RBI itself, real estate loans constituted 2.0% of gross non-food credit of banks as of end-June 2006. This figure is rarely highlighted anywhere. In our opinion, that it has been growing at high percentage rates is not material as the base was very low. In any case, by increasing standard assets provisioning on these loans to 100bps from 25bps, risk weights from 100% to 150% and instructing banks not to lend unless the developer has "all the permissions", the RBI has tightened the screws enough on real estate lending for it to become a major asset-quality concern.

Figure 14: Importance of housing and real estate loans to total

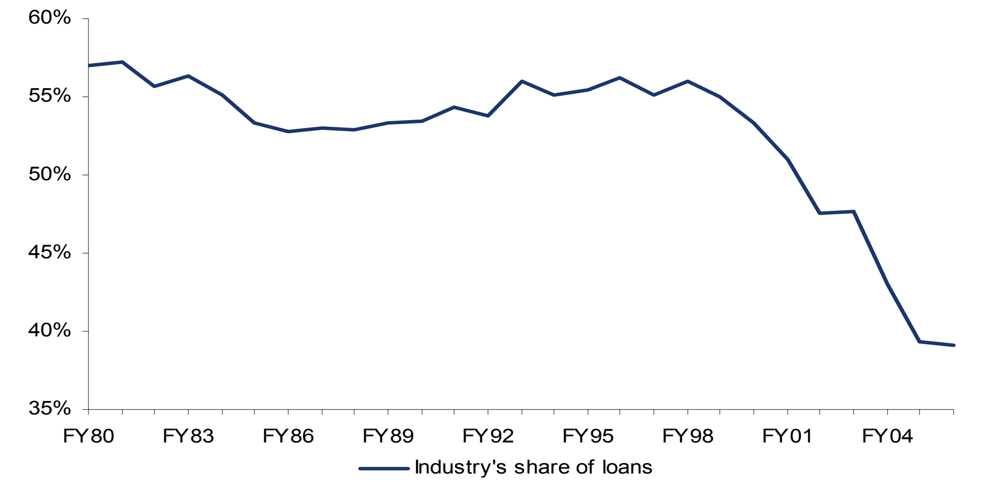
	Mar-01	Mar-02	Mar-03	Mar-04	Mar-05	Mar-06	Jun-06
Total bank loans (Rs bn)	4,691.5	5,367.3	6,169.1	7,643.8	10,409.1	14,458.4	15,231.7
Housing (Rs bn)	161.4	223.5	346.5	519.8	1287.3	1864.3	1719.2
Housing (% of total loans)	3.4	4.2	5.6	6.8	12.4	12.9	11.3
Real estate loans (Rs bn)	17.7	26.0	31.0	55.8	106.1	266.8	236.3
Real estate loans (% of total loans)	0.38	0.48	0.50	0.73	1.02	1.85	1.55

Source: RBI, Deutsche Bank

Portfolios substantially more granular, less risky

Over the years, banks have made their portfolios statistically less risky due to increased granularization, which is the reason why this asset-quality cycle is likely to be more prolonged than the previous one. Even within lending to industry, chunky exposures are few and far between as large bankable projects have either not been there or have substantially accessed overseas credit.

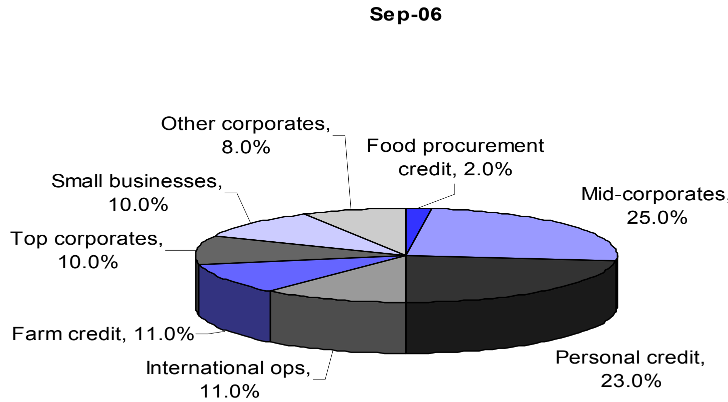
Figure 15: Industry's share of total credit has dropped considerably



Source: RBI, Deutsche Bank

One stark example of this is the largest bank SBI itself. In the mid 1990s, SBI's portfolio was distributed between large corporates, farm credit and trade, with little coming from others. The Sep'06 portfolio looks dramatically different.

Figure 16: SBI's loan portfolio now quite diversified and granular



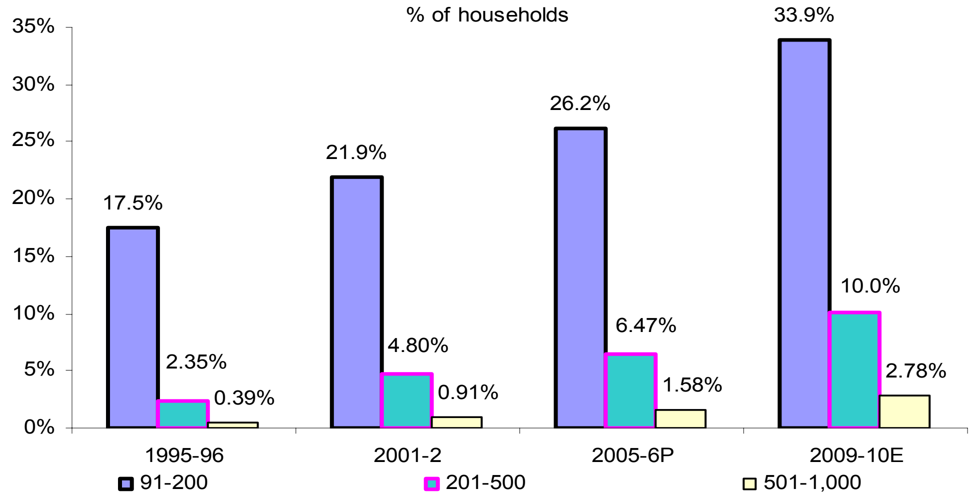
Source: Company data, Deutsche Bank

Cost of borrowing has risen, but so have incomes

The apparent disconnect between interest rates rising now for two years and lending not losing steam can be explained by i) rising incomes in case of individuals, thereby imparting increased thrust to retail lending, and ii) improved corporate profitability through better pricing power.

While there are several studies illustrating the household income growth in India, Figure 17 from National Council for Applied Economic Research is instructive. An explosive growth is underway in the percentage of households earning Rs91,000-1,000,000 pa, the most prominent individual borrowers for banks. The time-series suggests that the migration to higher categories is fairly rapid.

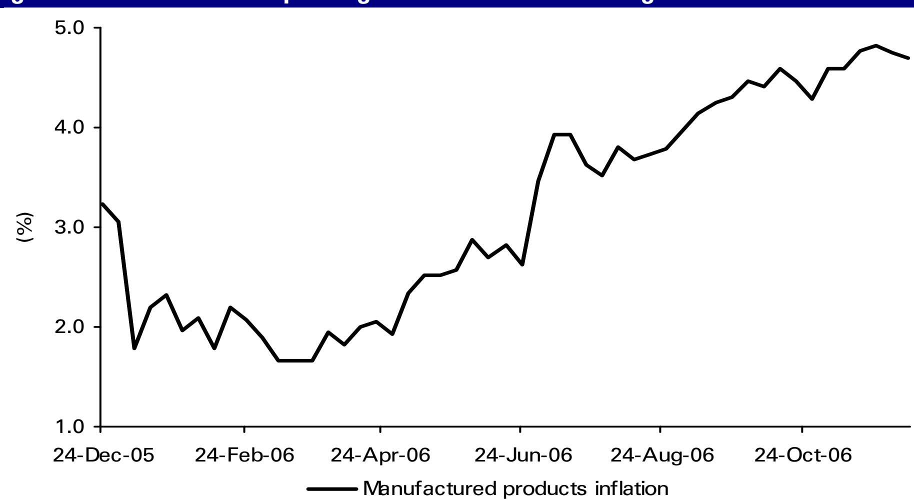
Figure 17: Indian households getting richer



Source: www.ncaer.org, Deutsche Bank Note: Income bands are in Rs '000

The corporate pricing power story is less known because of the media harping on high competition and margin compression. While these issues cannot be summarily dismissed, it is a fact that manufactured product inflation has been rising. Even the RBI has recently commented on the increased ability of manufacturers to pass on cost increases. And with a considerably de-leveraged corporate India compared with the early/mid 1990s, these levels of increases in interest costs have been easily absorbed by companies.

Figure 18: Manufacturers passing on cost increases with greater ease



Source: Bloomberg, Deutsche Bank

Valuation and stock picks

Since banks tend to trade off their book values, we use the P/BV-RoE method as the primary valuation methodology with a few adjustments. The adjustments take into account the fact that most banks in India, in a particular year in question, will likely exhibit some unusual (or fundamentally non-recurring but not separately classified so) features like treasury profits and early separation expenses. These may also be recurring features, but in our opinion should not be a determinant of valuations, e.g. mark-to-market depreciation of bond portfolios.

The key adjustment is the computation of 'schematic RoE', which is the RoE that the bank is expected to deliver on a sustainable basis. The underlying principles behind the schematic RoE are:

- No treasury profits
- Normalized provisioning assuming that the bank starts booking assets today, ignoring legacy
- Our assumptions on margins and costs after removing non-sustainable features (positive or negative).
- Tax rate of a flat 33% which is the base corporate tax rate, ignoring tax benefits arising out of exemptions given by law currently.
- A normalized leverage calculated on the basis of a targeted 7% Tier I capital adequacy and the average risk weight depending on the asset profile

We do provide some weightage to the estimated RoEs along with the schematic RoE, as follows, to calculate a blended RoE. The blended RoE that is included in the calculation is a result of 70% weight to schematic RoE and 30% to FY09E. We take FY09E RoE because one year from now the market will be looking at FY09E estimates to value stocks.

The blended RoE is fed into the well-established, time-tested formula:

(P/BV) = (RoE – g)/(CoE – g)

where g = perpetual growth rate (assumed to be 4%)

and CoE = Cost of equity (=risk-free + risk premium x β)

g is taken at 4% which is a notch below the 'consensus' long-term GDP growth of 5% for India. The risk-free and market risk premium are regularly reviewed and updated by Deutsche Bank – they are available at http://tyo.research.ge.cib.intranet.db.com/coe.shtml and are currently 9.8% and 4.4%, respectively. Data for β of individual stocks is taken from Bloomberg (2-yr period, weekly returns-based).

The theoretical P/BV obtained through the above is multiplied with the FY09E adjusted book value (i.e. adjusted for uncovered NPLs) to obtain the target price. Since our price targets are for 12 months, FY09E numbers are the relevant set.

Shortcomings and alternatives

Since the P/BV-RoE methodology (derived from the Gordon Growth Model) assumes a steady growth to perpetuity, it is not typically suitable for high-growth (read private sector) banks, for which we use P/E, depending on near-term EPS growth rates. The other shortcoming of the Gordon methodology is its inability to factor in a premium for image and positioning in the sector, which may exist for a protracted period of time, such as in the case of HDFC Bank.

Figure 19: Key assumptions behind price targets of banks

	Basis	Key assumptions	Price target (Rs)
Bank of Baroda	Gordon Growth	Schematic RoE at 15.8%	301
Canara Bank	Gordon Growth	Schematic RoE at 13.8%	209
HDFC Bank	P/E	P/E of 22x on FY09E diluted EPS	1,260
Oriental Bank	Gordon Growth	Schematic RoE at 13.5%	283
Punjab National Bank	Gordon Growth	Schematic RoE at 19.3%	675
Union Bank of India	Gordon Growth	Schematic RoE at 14.9%	127
UTI Bank	P/E	P/E of 18x on FY09E diluted EPS	530

Source: Deutsche Bank

Our top Buys are PNB and BoB, and the only Sell is Canara Bank. The clear first preference is for franchise power – more specifically the liabilities side – manifested in our choice of PNB, HDFC Bank, and Canara Bank. Oriental Bank (Buy) and Union Bank (Hold) are essentially calls on valuations; prospects are comparatively less exciting. Bank of Baroda (Buy) is a value/value-unlocking play. UTI Bank (Buy) is a combination of profitable growth and value, but management transition is a question mark.

Figure 20: Estimated returns from coverage universe

	Target price (Rs)	Current price (Rs)	Upside/downside	Recommendation
Bank of Baroda	301	247.6	21.6%	BUY
Canara Bank	209	287.4	-27.3%	SELL
HDFC Bank	1,260	1,065.8	18.2%	BUY
Oriental Bank	283	229.6	23.3%	BUY
Punjab National Bank	675	515.8	30.9%	BUY
Union Bank	127	122.3	3.9%	HOLD
UTI Bank	530	475.0	11.6%	BUY

Source: Deutsche Bank Prices as on January 3, 2007

Bias in favour of PSU banks as a class

In the last one-year period, the BSE Bankex is up ~42% as against the BSE Sensex ~48%. In the first half of CY06, the sector delivered unsatisfactory returns because of interest-rate volatility, margin pressure and mark-to-market hit on bonds. Thereafter, performance did pick up, but not enough to overshadow the performance of some other sectors in the index. Relative performance in CY07 is likely to be better as bond losses are less of an issue and margin trend is firmer.

Figure 21: Stock price performance

	MoM	QoQ	YoY
Bank of Baroda	-8.2%	-14.5%	0.8%
Canara Bank	-8.7%	-0.7%	19.4%
HDFC Bank	-3.2%	14.5%	49.4%
Oriental Bank	-7.6%	-15.9%	-14.1%
Punjab National Bank	-10.6%	-4.3%	8.9%
Union Bank	-6.8%	-10.1%	0.6%
UTI Bank	-4.2%	22.4%	64.1%
BSE Sensex	1.0%	13.1%	46.9%
BSE Bankex	-1.5%	17.2%	37.6%

Source: Deutsche Bank Prices as on January 3, 2007

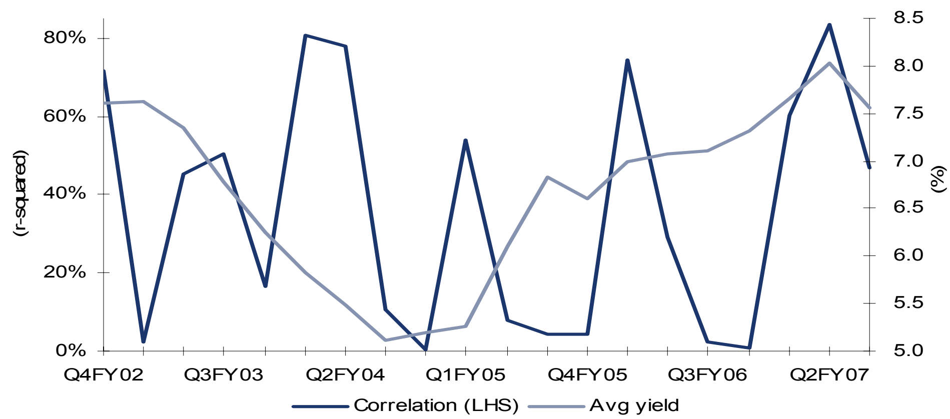
Within banks, private bank stocks have performed better than PSU banks. There were lesser bond hit-related issues and they did not suffer from the perception of government interference in loan pricing. However, from now on we would prefer PSU banks as a class. That follows directly from the importance that we would like to attach to deposit franchises. It is also a result of our belief that the markets would recognize eventually that PSU banks also enjoy pricing power in reality. Thirdly, PSU banks also suffered from reduction in investment yields on long-duration bonds – most of that is already over and portfolios have also been whittled down to lower levels.

Based on estimates for FY08E EPS, our forecasts are materially different (more than 5%) for HDFC Bank, PNB (we are higher), and Canara Bank, UTI Bank, and Union Bank (we are lower). On OBC we appear to be materially higher, but that may be because consensus takes EPS after the amortization costs.

Rate volatility – impact

As Figure 22 shows, neither in times of rising nor during declining yields, the correlation between bank stock prices (as represented by the BSE Bankex) and the benchmark yields has been conclusive. This is probably because there are more powerful drivers of stock prices at every point in time than just the bond yields. Banks have also been steadily restructuring their investment portfolios to get rid of the ill-effects of rising yields. It is important to note this observation, particularly since the rather short-term behaviour of bank stocks relative to bond yields tends to give a false impression of close correlation.

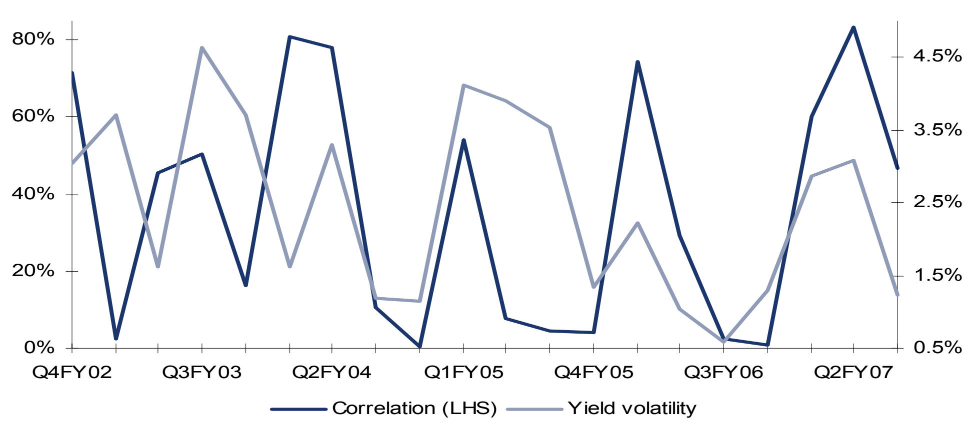
Figure 22: Bank stocks' correlation with bond yields not conclusive



Source: Bloomberg, Deutsche Bank Note: correlation is between BSE Bankex and the average 10-yr risk-free yields

However, Figure 23 is also noteworthy – the correlation tends to strengthen with increased volatility in yields, and generally stays weak in calmer times.

Figure 23: Correlation increases with yield volatility



Source: Bloomberg, Deutsche Bank

The preceding charts offer an important conclusion for short-term stock price performance of banks – a rise in interest rates need not necessarily be detrimental to stock performance, but disorderly movement generally is. This is one of the reasons underpinning our negative short-term call on the sector – it is likely that interest-rate volatility will increase in Q4FY07 because of year-end tightness, uncertainty over the RBI's next move and inflation staying higher than the RBI's 'comfort zone'.

GEMS: Asia India
Banking/Finance Banks

4 January 2007

Bank of Baroda

Reuters: **BOB.BO** Bloomberg: **BOB IN**

Past haunts valuations; upgrade to Buy

All-round improvement in outlook
This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We upgrade from Sell to Buy and raise the target price from Rs200 to Rs301.

Core business back on track with a bang
After a gut-wrenching makeover process involving scaling down of treasury, reshaping the international business and a re-branding exercise, Bank of Baroda is back in reckoning from the underdog status. Fee income resurgence is even more remarkable: the 2.1% (10-year) and 3.9% (5-year) CAGR to FY06 changed to a 19.4% YoY growth in H1FY07.

Stable margins, reduced provisioning key drivers of increased returns
Loans are expected to grow at a 21.8% CAGR over FY06-FY09E, driving NII CAGR by 14.6%, and fees by 12.5% CAGR during FY06-FY09E. Bond redemption losses are expected to be modest and we believe that the growth rate of the international business will gravitate to lower levels, thus stabilising margins. At a net NPL (Sep'06) of just 0.77%, provision charges on bad assets are unlikely to be a major drag any more. We estimate RoA to move from 0.79% in FY06 to 0.96% in FY09E, taking RoE too up from 12.3% to 15.3%.

Volatility, haunting valuations, now behind
Our TP is based on an (RoE – g)/(CoE – g) model. Bank of Baroda trades at ~ FY08E book, one of the lowest among state-owned banks. The overdependence on treasury and lack of focus on the core business during FY02-FY05 is probably still in memory. However, steady improvement expected in RoE should help re-rate the stock. Key company-specific risks are worsening asset quality due to rapid loan growth and a relapse in NIMs.

Forecasts and ratios

Year End Mar 31	2005A	2006A	**2007E**	2008E	2009E
Provisioning (INRm)	4,293.9	3,400.1	**2,396.5**	2,308.9	3,213.6
Pre-prov profit (INRm)	12,925.1	14,546.2	**16,870.0**	21,598.6	26,633.6
Net profit (INRm)	6,768.4	8,269.7	**9,842.0**	12,924.1	15,691.4
EPS (INR)	22.98	27.10	**26.93**	35.36	42.93
EPS growth (%)	-30.0	17.9	**-0.6**	31.3	21.4
PER (x)	8.3	8.4	**9.2**	7.0	5.8
Price/book (x)	1.14	1.07	**1.05**	0.94	0.83
DPS (net) (INR)	5.67	5.68	**6.00**	6.50	7.00
Yield (net) (%)	3.0	2.5	**2.4**	2.6	2.8

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

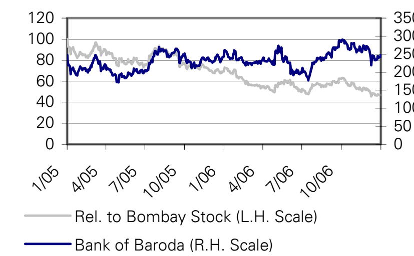
Buy

Price at 3 Jan 2007 (INR)	**247.55**
Price target - 12mth (INR)	**301.00**
52-week range (INR)	**290.35 - 176.85**
Bombay Stock Exchange (BSE 30)	**13,942**

Key changes

Rating	Sell to Buy ↑	
Price target	200.00 to 301.00 ↑	**50.5%**
Provisioning (FYE)	5,410.5 to 2,396.5 ↓	**-55.7%**
Net int margin (FYE)	3.29 to 3.09 ↓	**-6.1%**
Net profit (FYE)	10,896.5 to 9,842.0 ↓	**-9.7%**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-9.1*	*-12.9*	*0.8*
Bombay Stock Exchange (BSE 30)	*0.7*	*12.7*	*46.2*

Stock data

Market cap (INRm)	**90,486**
Market cap (USDm)	**2,045**
Shares outstanding (m)	**365.5**
Major shareholders	**Govt of India (53.8%)**
Free float (%)	**46**

Key indicators

ROE (%)	**12.0**
Loan/deposit ratio (%)	**71.1**
Book value/share (INR)	**234.78**
Price/book (x)	**1.1**
NPL/total loans (%)	**3.2**
Net int margin (%)	**3.09**

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

Bank of Baroda

Reuters code BOB.BO

Buy

Price as at 02-Jan Rs242.15

Target Price Rs301.00

Company Website
http://www.bankofbaroda.com

Company description

Bank of Baroda owns and operates commercial banks in India. The Group's banks provide the traditional forms of banking services, including CD's, Credit Card services and a variety of car loans, in addition to gold banking and a range of insurance services. The Group also owns IBU International Finance Limited, an international banking company in Hong Kong.

Research Team

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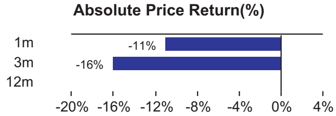
Absolute Price Return(%)



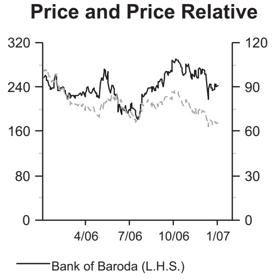
52-week Range:	Rs176.85 - Rs290.35
Market Cap (m):	Rs 88,207
	US$ 1,998

Company identifiers

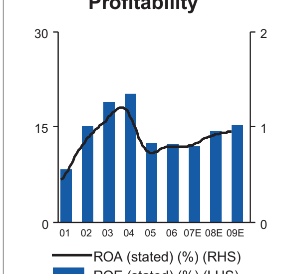
Bloomberg	BOB IN
Cusip	NA
SEDOL	6099778

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	9.33	18.55	26.25	32.83	22.98	27.10	26.93	35.36	42.93
EPS FD (stated) (Rs)	9.33	18.55	26.25	32.83	22.98	22.62	26.93	35.36	42.93
EPS FD (DB adj.) (Rs)	9.33	18.55	26.25	32.83	22.98	22.62	26.93	35.36	42.93
Growth Rate - EPS (stated) (%)	-45.4	98.8	41.6	25.1	-30.0	17.9	-0.6	31.3	21.4
DPS	4.02	4.02	6.03	6.47	5.67	5.68	6.00	6.50	7.00
BVPS (stated) (Rs)	114.03	130.05	149.04	174.21	191.08	214.61	234.78	262.83	297.88
BVPS (DB adj.) (Rs)	51.16	65.05	91.28	138.83	170.04	200.43	221.32	250.71	286.97
Average market cap (Rs m)	13,498	13,505	17,435	47,708	56,179	69,199	88,207	88,207	88,207
Shares in issue (m)	294	294	294	295	295	366	366	366	366
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	4.9	2.5	2.3	4.9	8.3	8.4	9.0	6.8	5.6
P/E FD (stated)	4.9	2.5	2.3	4.9	8.3	10.0	9.0	6.8	5.6
P/E FD (DB adj.)	4.9	2.5	2.3	4.9	8.3	10.0	9.0	6.8	5.6
P/B (stated)	0.53	0.37	0.58	1.39	1.14	1.07	1.03	0.92	0.81
P/B (DB adj.)	1.18	0.74	0.94	1.75	1.28	1.15	1.09	0.97	0.84
ROE (stated) (%)	8.3	15.2	18.8	20.3	12.6	12.3	12.0	14.2	15.3
ROA (stated) (%)	0.45	0.81	1.05	1.20	0.75	0.79	0.80	0.91	0.96
Dividend yield (%)	8.77	8.77	10.19	4.00	2.97	2.51	2.48	2.68	2.89
Dividend cover (x)	2.32	4.61	4.35	5.07	4.05	4.77	4.49	5.44	6.13
Payout ratio (%)	43.1	21.7	23.0	19.7	24.7	25.1	22.3	18.4	16.3
PROFIT & LOSS (Rs m)									
Net interest income	19,378	18,794	21,034	25,716	29,793	32,249	36,262	41,991	48,555
Non-interest income	6,479	9,515	12,229	16,682	4,950	4,672	8,673	10,232	11,449
Fees & Commissions	2,977	3,055	3,441	3,444	3,426	3,610	4,151	4,670	5,137
Trading revenue	1,786	4,912	7,309	11,363	-814	-2,942	-272	362	948
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	14	51	64	115	190	128	138	149	161
Other revenue	1,701	1,498	1,414	1,760	2,148	3,876	4,655	5,051	5,202
Total revenue	25,857	28,310	33,262	42,398	34,742	36,921	44,935	52,223	60,004
Total Operating Costs	16,438	16,148	16,917	17,389	21,817	22,375	28,065	30,624	33,370
Pre-Provision profit / (loss)	**9,419**	**12,162**	**16,345**	**25,008**	**12,925**	**14,546**	**16,870**	**21,599**	**26,634**
Bad debt expense	4,821	4,205	4,640	9,679	4,294	3,400	2,396	2,309	3,214
Operating Profit	4,598	7,956	11,705	15,329	8,631	11,146	14,474	19,290	23,420
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	4,598	7,956	11,705	15,329	8,631	11,146	14,474	19,290	23,420
Tax	1,851	2,497	3,977	5,659	1,863	2,876	4,632	6,366	7,729
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**2,747**	**5,459**	**7,728**	**9,670**	**6,768**	**8,270**	**9,842**	**12,924**	**15,691**
DB adj. core earnings	**2,747**	**5,459**	**7,728**	**9,670**	**6,768**	**8,270**	**9,842**	**12,924**	**15,691**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	378,625	454,056	472,416	508,922	573,985	798,210	995,361	1,162,709	1,349,245
Interest-earnings assets	593,596	661,152	719,267	804,845	893,318	1,079,444	1,266,405	1,463,387	1,686,455
Total loans	297,559	359,560	376,066	375,476	453,357	612,398	785,294	936,171	1,103,101
Total deposits	540,704	618,045	663,664	729,673	813,335	936,620	1,104,994	1,298,012	1,508,427
Stated Shareholder Equity	33,563	38,278	43,870	51,309	56,278	78,444	85,819	96,070	108,883
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	32,145	34,327	38,266	43,106	47,124	87,643	85,819	96,070	108,883
Tier 1 ratio (%)	8.49	7.56	8.10	8.47	8.21	10.98	8.62	8.26	8.07
Tangible equity / total assets (%)	5.30	5.40	5.74	6.03	5.94	6.92	6.51	6.26	6.22
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	14.07	12.49	11.08	10.60	7.33	3.90	3.19	3.09	2.98
Provisions / NPLs (%)	55.79	51.08	54.19	48.91	58.26	55.56	62.61	62.17	64.53
Bad debt chg / Avg loans (%)	1.71	1.28	1.26	2.58	1.04	0.64	0.34	0.27	0.32
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	15.9	-3.0	11.9	22.3	15.9	8.2	12.4	15.8	15.6
Growth in fee income (%)	6.2	2.6	12.6	0.1	-0.5	5.4	15.0	12.5	10.0
Growth in non-interest income (%)	-4.3	46.9	28.5	36.4	-70.3	-5.6	85.6	18.0	11.9
Growth in revenues (%)	10.1	9.5	17.5	27.5	-18.1	6.3	21.7	16.2	14.9
Growth in costs (%)	29.0	-1.8	4.8	2.8	25.5	2.6	25.4	9.1	9.0
Pre-provision earnings growth (%)	**-12.4**	**29.1**	**34.4**	**53.0**	**-48.3**	**12.5**	**16.0**	**28.0**	**23.3**
Growth in bad debts (%)	44.9	-12.8	10.3	108.6	-55.6	-20.8	-29.5	-3.7	39.2
Growth in RWA (%)	10.8	19.9	4.0	7.7	12.8	39.1	24.7	16.8	16.0
Growth in loans (%)	11.8	20.8	4.6	-0.2	20.7	35.1	28.2	19.2	17.8
Growth in deposits (%)	5.5	14.3	7.4	9.9	11.5	15.2	18.0	17.5	16.2
Loan-to-deposits ratio (%)	55.0	58.2	56.7	51.5	55.7	65.4	71.1	72.1	73.1
Net int. margin (%)	3.15	2.81	2.94	3.34	3.40	3.31	3.09	3.08	3.08
Cost income ratio (%)	63.6	57.0	50.9	41.0	62.8	60.6	62.5	58.6	55.6
Cost asset ratio (%)	2.7	2.4	2.3	2.2	2.4	2.2	2.3	2.1	2.0
Trading income / Total Rev (%)	6.9	17.4	22.0	26.8	-2.3	-8.0	-0.6	0.7	1.6

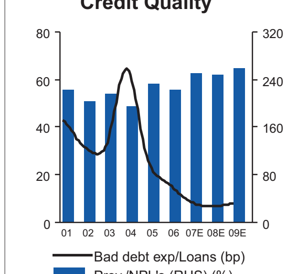
Price and Price Relative



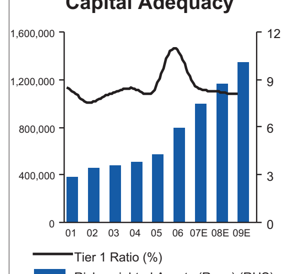
Profitability



Credit Quality



Capital Adequacy



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

Bank of Baroda's turnaround – credible and fast by the standards of state-owned banks – has removed the stigma of being a slow-growth bank and helped restore market standing lost in the last decade. Fortunately, now it is in a good position to grow aggressively through the following levers: increased recognition in the retail marketplace through the re-branding and technology rollout exercise, greater focus on the hitherto grossly underutilized international franchise, higher turnaround of branch resources by keeping them open longer and higher volumes of transaction banking/third party distribution driving a moribund fee income line.

After having recapitalized itself through an equity issue and improving the asset quality, Bank of Baroda is well poised to deliver a net profit growth of 19.0%, 31.3% and 21.4%, respectively in FY07E, FY08E and FY09E. Loans are expected to grow 28.5%, 19.3% and 17.8%, in these years, with stable margins around the ~ 3.08% level. Fee income is expected to grow at a 12.5% CAGR during FY06-FY09E after the meagre 2.1% CAGR for ten years to FY06 and 3.9% for five years to FY06.

With the treasury book already reduced and asset quality also improved, we expect considerable savings in provision charges to help escalate RoA from 0.79% in FY06 to 0.96% in FY09E, pulling the RoE up from 12.3% to 15.3% during the same period. Note that this is after factoring in an increase in the effective tax rate from 25.8% in FY06 to 32-33% during FY07E-FY09E.

BoB has managed to hold its operating cost-to-average assets ratio in the 2.2-2.3% range for FY04-FY06. This is on the higher side by peer standards and an attempt to improve it was impeded by two issues: the wage increase in FY06 and large technology expenses. The bulk of the latter is already complete. Another wage increase is due in November 2007, but unlike the last wage agreement when loan growth was low for the bank, this time around better business volumes should make up for it. We expect the cost-to-assets ratio to drop from 2.15% in FY06 to 2.03% in FY09E.

Valuation

BoB's low NIM and the comparatively under-leveraged status are serving to keep the current RoE in the mid-teens. However, we are indeed estimating a significant degree of improvement. In particular, the overcapitalized situation will cure itself with asset growth – after all, BoB diluted its equity by 24% as recently as in January 2006. Our (RoE – g)/(CoE – g) model generates a target price of Rs301/share.

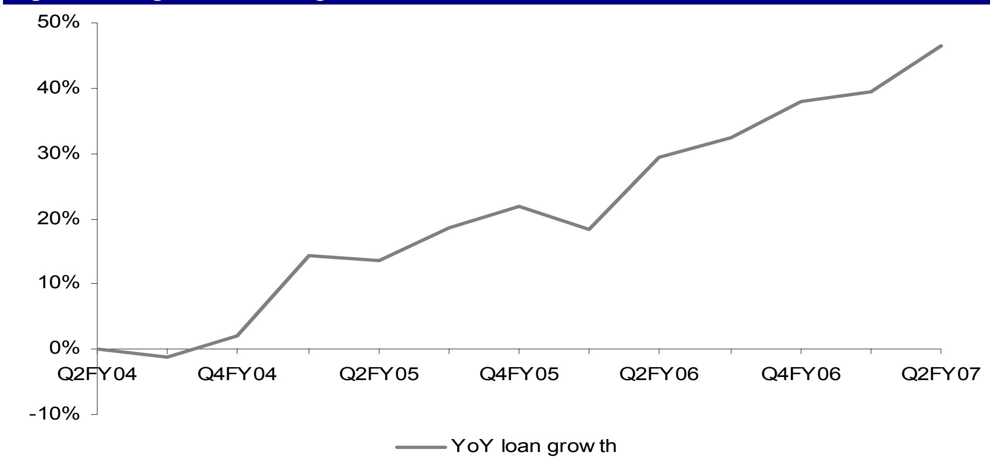
Risks

The key risk is management continuity and its impact. The recent improvements have been pushed through aggressively by the current CEO Dr Khandelwal who took charge in March 2005 and whose term expires in March 2008. At a more micro level, a lot will depend on the ability of the bank to sustain margins and asset quality – a cooling of growth, particularly on the international business front, is critical.

Core business back on track

The credible increase in the loan growth momentum that is evident from the Figure 1 is likely to sustain (though the % growth number is likely to come down as the base gets bigger) because of multiple initiatives undertaken by the bank. The market share loss of competitors because of slow decision making and inadequate technology is steadily being restored. The bank improved response time by putting in place two general managers for credit and starting a central processing cell. 8-to-8 banking has now been rolled out in 500+ branches. Loan applications above a certain level are now transferred to the head office directly to save on appraisal time. BoB has also re-energised its farm credit network as a result of which this segment is also growing very rapidly and profitably.

Figure 24: Significant loan growth acceleration



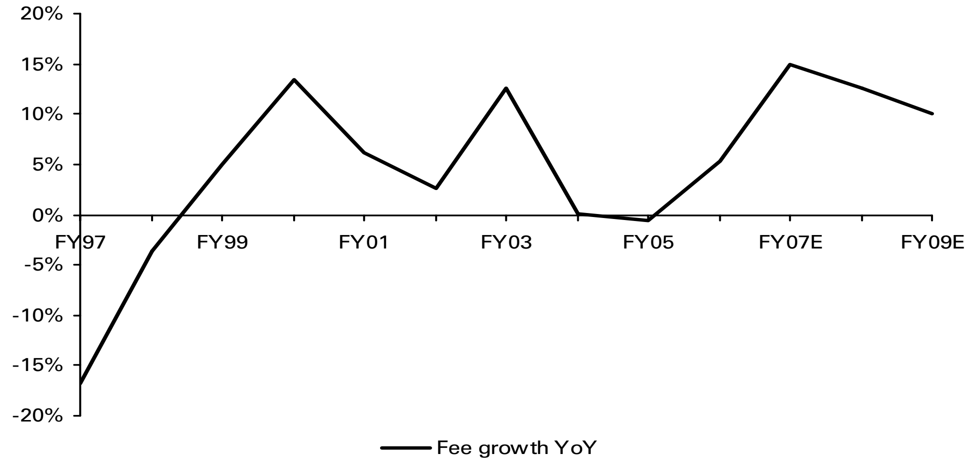
Source: Company data, Deutsche Bank

The management, of late, has taken special interest in the international operations, which unlike most other banks is quite meaningful for BoB – 16% of total revenues and 28% of profits (lower margins but much lower operating expenses and provision charges). Aggressive targets have been set for international branch managers. Results are already evident – in Sep'06 the international business shot up by 61%. Spreads on international advances have also improved from 2.05% in H1FY06 to 2.50% in H1FY07.

The CEO, being an HR person himself by qualification, has been instituting some key changes, at the same time bearing in mind the pervasive constraints that the public sector has to work with. Post the 'autonomy package' announced by the government for PSU banks last year, BoB has reduced the age-based eligibility norms for promotion to a general manager, thereby expediting promotions of capable personnel. The recruitment process, stalled for many years, has been restarted with plans to induct 200 officers, including 100 specialists. 400-500 officers with an aptitude in marketing have been selected for a pilot project in retail banking

BoB is quickly catching up on technology. By March 2007, it expects to have 800 branches on-line offering core banking solution, thereby covering about 70% of the business. The effect of technology is more visible in the resurgence of the hitherto moribund fee income line, used to growing at low single digits in all of the last decade. In H1FY07, fees have risen 19.4%. There is another reason to believe that the growth trajectory could be faster henceforth: BoB has also started leveraging its large network for third-party products distribution.

Figure 25: Fee income – from doldrums to strong growth



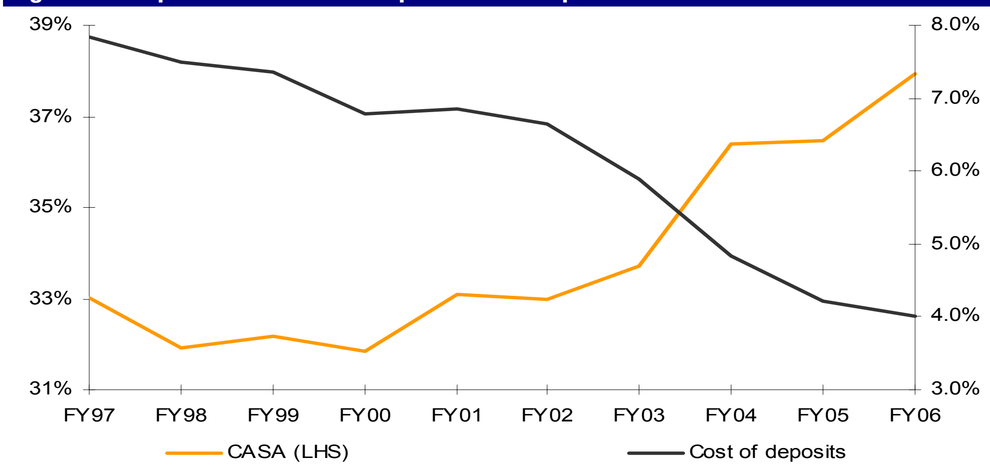
Source: Company data, Deutsche Bank

Stable NIM, operating costs

The market has been taken aback by the sharp decline in margins in Q2FY07 – H1FY07 NIM was 3.11% vs. 3.37% in H1FY06. We believe that further declines will be rare because of the following reasons:

- At 61% YoY, the Q2FY07 growth in international lending was extraordinarily high and will clearly moderate during the course of the year. International margins are comparatively lower. The flip side is that operating expenses in the international business are also much lower.
- Some high-coupon bonds redeemed during Q2FY07 and thus caused a depression in the investment yields that re-priced downwards. The timing of this kind of an event is difficult to estimate in the absence of data on investment portfolio, but the management has mentioned that the redemption losses expected in H2FY07 will be modest.
- BoB's deposit franchise remains rock solid, and in the process of reviving the farm credit business, the rural deposit network also has been reactivated in a big way. This can turn out to be an effective tool in the fight against cost of funds.

Figure 26: Improved CASA has helped cost of deposits

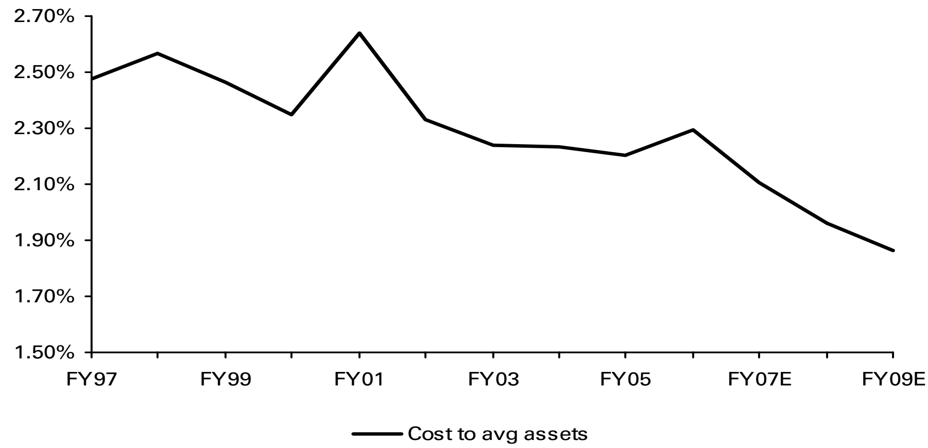


Source: Company data, Deutsche Bank

In the three years to FY06, BoB has managed to keep operating expenses at 2.2-2.3% of average assets, but this is not a satisfactory number even by peer standards. The last wage agreement (effective Nov'02 but actually concluded in Aug'05) was the main culprit behind lack of improvement in this ratio. We believe that the areas that contributed to this increase would wane from H2FY07 – large technology expenses would come down, the re-branding exercise would be completed and a major portion of the new product portfolio would be rolled out. Also, FY06 had seen a Rs1bn one-off translation loss on foreign assets and liabilities (to conform to a new accounting standard), which was essentially one-time in nature.

We do acknowledge that the next wage agreement is due Nov'07, but this time around the impact is likely to be milder. During the last wage increase period, BoB's loan growth was weak, but now it has completely swung to the other end. Hence, most of the wage increase should be made up by increase in assets.

Figure 27: Cost ratios expected to decline



Source: Company data, Deutsche Bank

Some indication of the above is visible from the H1FY07 results: operating expenses were up 8.4%, within which the major one – employee cost – was up only 3.8% and another large item advertisement and publicity was down 32.8%.

NPLs, bond losses falling

Though asset quality improvement has been a system-wide phenomenon for banks in India, for BoB it merits mention because it took longer to get into a comfortable position in this regard. The precipitous decline in absolute levels of NPL provisioning (with write-backs) that has added to profitability of banks in recent years has not been particularly pronounced for BoB. There were two key reasons for this: the bank did see some chunky corporate slippages, and the management also made adequate provisions for some doubtful cases even before they slipped. With net NPLs now (Sep'06) at just 0.77%, further charges on a regular basis should decline. Figure 5 indicates the extent of the expected gains from NPL charge reduction.

Figure 28: NPL provision reduction leading to higher profitability

(Rs m)	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E
NPL provisions	4,640	9,679	4,294	3,400	2,396	2,309	3,214
Net profit	7,728	9,670	6,768	8,270	9,842	12,924	15,691

Source: Company data, Deutsche Bank

However, since the loan growth in the last few quarters has been exceptionally high, the bank has to watch out for deterioration of the improved delinquency position.

A much larger benefit to reported profit is likely to accrue from the bond depreciation side. At the peak, BoB had 20% of its liabilities in excess government securities over and above the statutory minimum 25%. Worse still, till February 2005 the bank had followed the policy of keeping all securities under available-for-sale, and depreciation hit to the bank that followed on interest rate increases was debilitating. As of now 20% of government securities are under Held to Maturity (not subject to investment depreciation) and the excess is barely 4%. We also believe that the available-for-sale portion is also protected from depreciation till the 10-yr benchmark reaches an estimated 8% (currently around 7.6%).

The swing in NPL and investment provision charges combined is expected to contribute substantially to RoA in the coming years.

Figure 29: Provision reduction a major contributor to RoA

	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E
Provisions to avg assets	0.74%	1.18%	1.60%	0.88%	0.65%	0.51%	0.47%
RoA	1.05%	1.20%	0.75%	0.79%	0.80%	0.91%	0.96%

Source: Company data, Deutsche Bank

GEMS: Asia India
Banking/Finance Banks

4 January 2007

Canara Bank

Reuters: **CNBK.BO** Bloomberg: **CBK IN**

NIM & asset quality blues; downgrade to Sell

Awkwardly positioned

This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We downgrade from Hold to Sell and lower the target price from Rs270 to Rs209.

Weak margin trend likely to continue

Despite being a large bank (in the top five in assets), Canara Bank has had a persistent problem of a low CASA ratio (low-cost deposits to total deposits) of around 33%. Banks with such large networks in India usually sport a 40-50% CASA. The bank has been pushing up deposit growth to satisfy high loan growth, primarily through large-scale recourse to wholesale deposits, hurting margins.

Question marks on fee income, operating expenses, asset quality

Fee-to-total income and fee-to-average assets have declined from 9.9% and 46bps, respectively, in FY02 to 8.7% and 35bps in FY06. With increases in the wage bill and technology costs we expect the cost income ratio to rise. We are particularly concerned about Canara Bank's current high loan growth because of its unsatisfactory track record of slippages. For the last four years, Canara Bank's slippages (addition to gross NPLs as a % of opening loans) have been in the 2.3-4.7% range, whereas other large banks have managed between 1.5-3.5%.

Valuations do not factor in the negatives

Canara Bank acquires a premium during declining interest rates because of 60% of its securities being under the held-to-maturity category and gets hit when rates harden. That apart, recognition of sticky low margins and pressure on RoA from insufficient fee income could de-rate the stock. Our (RoE – g)/(CoE – g)-based target price is Rs209 (see p. 3). The main risks to our call are significantly better asset quality, improvement in pricing power and better leveraging of technology.

Forecasts and ratios

Year End Mar 31	2005A	2006A	2007E	2008E	2009E
Provisioning (INRm)	8,068.9	6,351.9	**4,656.0**	5,454.9	6,355.3
Pre-prov profit (INRm)	20,864.0	21,784.1	**19,701.6**	23,641.8	27,486.6
Net profit (INRm)	11,095.1	13,432.2	**12,187.0**	12,730.8	14,791.9
EPS (INR)	27.06	32.76	**29.72**	31.05	36.08
EPS growth (%)	-17.1	21.1	**-9.3**	4.5	16.2
PER (x)	6.1	6.9	**9.7**	9.3	8.0
Price/book (x)	1.34	1.53	**1.47**	1.32	1.18
DPS (net) (INR)	5.50	6.60	**7.00**	7.50	9.00
Yield (net) (%)	3.4	2.9	**2.4**	2.6	3.1

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

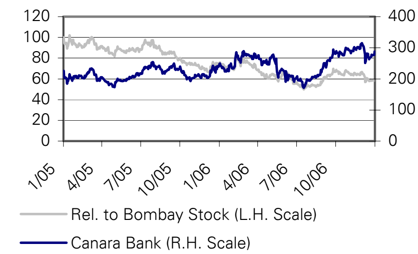
Sell

Price at 3 Jan 2007 (INR)	**287.40**
Price target - 12mth (INR)	**209.00**
52-week range (INR)	**314.85 - 171.30**
Bombay Stock Exchange (BSE 30)	**13,942**

Key changes

Rating	Hold to Sell ↓	
Price target	270.00 to 209.00 ↓	**-22.6%**
Provisioning (FYE)	11,049.6 to 4,656.0 ↓	**-57.9%**
Net int margin (FYE)	3.08 to 2.88 ↓	**-6.6%**
Net profit (FYE)	13,644.4 to 12,187.0 ↓	**-10.7%**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-7.6*	*2.3*	*19.4*
Bombay Stock Exchange (BSE 30)	*0.7*	*12.7*	*46.2*

Stock data

Market cap (INRm)	**117,834**
Market cap (USDm)	**2,663**
Shares outstanding (m)	**410.0**
Major shareholders	**Govt of India (73.2%)**
Free float (%)	**27**

Key indicators

ROE (%)	**16.1**
Loan/deposit ratio (%)	**71.9**
Book value/share (INR)	**195.72**
Price/book (x)	**1.5**
NPL/total loans (%)	**2.1**
Net int margin (%)	**2.88**

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

Canara Bank

Reuters code	CNBK.BO
Sell	
Price as at 02-Jan	Rs277.30
Target Price	Rs209.00

Company Website
http://www.canbankindia.com

Company description

Canara Bank Ltd. provides a full range of banking services throughout India. The Group's activities include retail banking, commercial and personal banking, investment management, treasury & NRI services, cash management and assorted ATM facilities. Canara Bank has over 2,400 branches throughout India.

Research Team

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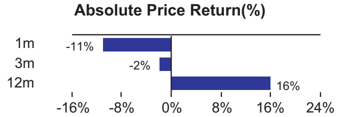
Absolute Price Return(%)



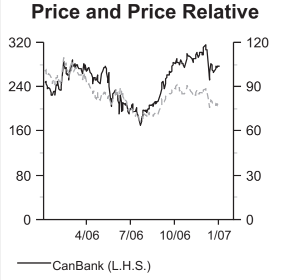
52-week Range:	Rs171.30 - Rs314.85
Market Cap (m):	Rs 113,693 US$ 2,575

Company identifiers

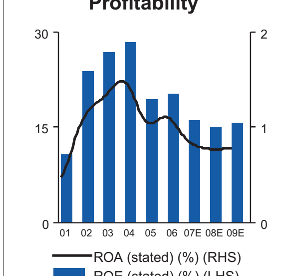
Bloomberg	CBK IN
Cusip	NA
SEDOL	6580012

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	5.04	12.93	20.63	32.63	27.06	32.76	29.72	31.05	36.08
EPS FD (stated) (Rs)	5.04	12.93	24.85	32.63	27.06	32.76	29.72	31.05	36.08
EPS FD (DB adj.) (Rs)	5.04	12.93	24.85	32.63	27.06	32.76	29.72	31.05	36.08
Growth Rate - EPS (stated) (%)	17.8	156.6	59.6	58.2	-17.1	21.1	-9.3	4.5	16.2
DPS	0.99	1.38	3.50	5.00	5.50	6.60	7.00	7.50	9.00
BVPS (stated) (Rs)	48.70	60.07	101.19	128.09	149.00	173.96	195.72	218.25	244.11
BVPS (DB adj.) (Rs)	22.76	35.22	62.25	91.11	118.30	149.37	174.02	197.95	225.13
Average market cap (Rs m)	nm	nm	30,146	48,797	67,216	92,492	113,693	113,693	113,693
Shares in issue (m)	578	578	410	410	410	410	410	410	410
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	na	na	3.0	3.6	6.1	6.9	9.3	8.9	7.7
P/E FD (stated)	nm	nm	2.5	3.6	6.1	6.9	9.3	8.9	7.7
P/E FD (DB adj.)	na	na	2.5	3.6	6.1	6.9	9.3	8.9	7.7
P/B (stated)	nm	nm	0.70	1.13	1.34	1.53	1.42	1.27	1.14
P/B (DB adj.)	nm	nm	1.14	1.59	1.69	1.79	1.59	1.40	1.23
ROE (stated) (%)	10.8	23.8	26.7	28.5	19.5	20.3	16.1	15.0	15.6
ROA (stated) (%)	0.48	1.08	1.32	1.47	1.06	1.10	0.85	0.77	0.79
Dividend yield (%)	nm	nm	5.73	4.20	3.35	2.93	2.52	2.70	3.25
Dividend cover (x)	5.10	9.34	5.89	6.53	4.92	4.96	4.25	4.14	4.01
Payout ratio (%)	19.6	10.7	14.1	15.3	20.3	20.1	23.5	24.2	24.9
PROFIT & LOSS (Rs m)									
Net interest income	18,830	18,203	22,671	27,388	31,505	35,815	39,892	46,711	54,256
Non-interest income	9,162	14,217	14,780	20,165	10,854	10,071	7,503	8,415	9,265
Fees & Commissions	3,227	3,222	3,595	3,808	4,109	4,308	4,653	4,978	5,227
Trading revenue	3,175	7,797	7,731	13,020	2,300	-1,040	-2,511	-1,883	-1,247
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	300	538	532	457	862	608	656	709	766
Other revenue	2,459	2,660	2,922	2,880	3,584	6,195	4,705	4,611	4,519
Total revenue	27,992	32,420	37,451	47,553	42,359	45,886	47,395	55,126	63,521
Total Operating Costs	19,183	17,992	19,497	18,486	21,495	24,102	27,694	31,484	36,034
Pre-Provision profit / (loss)	**8,809**	**14,428**	**17,953**	**29,066**	**20,864**	**21,784**	**19,702**	**23,642**	**27,487**
Bad debt expense	3,988	3,857	4,762	12,386	8,069	6,352	4,656	5,455	6,355
Operating Profit	4,821	10,571	13,192	16,680	12,795	15,432	15,046	18,187	21,131
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	4,821	10,571	13,192	16,680	12,795	15,432	15,046	18,187	21,131
Tax	1,910	3,100	3,003	3,300	1,700	2,000	2,859	5,456	6,339
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**2,911**	**7,471**	**10,189**	**13,380**	**11,095**	**13,432**	**12,187**	**12,731**	**14,792**
DB adj. core earnings	**2,911**	**7,471**	**10,189**	**13,380**	**11,095**	**13,432**	**12,187**	**12,731**	**14,792**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	368,257	412,036	493,978	580,079	717,802	880,710	1,129,637	1,321,529	1,525,855
Interest-earnings assets	620,355	683,490	781,524	948,548	1,066,005	1,285,945	1,487,303	1,714,795	1,970,086
Total loans	278,318	331,267	412,249	490,763	615,551	802,647	978,063	1,149,818	1,341,771
Total deposits	590,695	640,300	720,948	863,446	969,084	1,168,032	1,359,540	1,556,285	1,783,142
Stated Shareholder Equity	28,145	34,715	41,488	52,516	61,090	71,322	80,245	89,481	100,086
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	28,908	32,180	36,011	45,304	50,292	58,925	79,147	88,418	99,059
Tier 1 ratio (%)	7.31	8.07	7.85	7.81	7.29	7.81	7.01	6.69	6.49
Tangible equity / total assets (%)	4.24	4.81	5.06	5.28	5.54	5.37	5.22	5.09	4.99
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	8.06	6.38	6.00	6.37	3.85	2.23	2.12	1.98	2.03
Provisions / NPLs (%)	39.99	39.01	41.25	55.92	52.53	50.96	63.03	68.72	75.73
Bad debt chg / Avg loans (%)	1.55	1.27	1.28	2.74	1.46	0.90	0.52	0.51	0.51
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	31.0	-3.3	24.5	20.8	15.0	13.7	11.4	17.1	16.2
Growth in fee income (%)	1.0	-0.2	11.6	5.9	7.9	4.8	8.0	7.0	5.0
Growth in non-interest income (%)	8.2	55.2	4.0	36.4	-46.2	-7.2	-25.5	12.2	10.1
Growth in revenues (%)	22.6	15.8	15.5	27.0	-10.9	8.3	3.3	16.3	15.2
Growth in costs (%)	27.3	-6.2	8.4	-5.2	16.3	12.1	14.9	13.7	14.5
Pre-provision earnings growth (%)	**13.3**	**63.8**	**24.4**	**61.9**	**-28.2**	**4.4**	**-9.6**	**20.0**	**16.3**
Growth in bad debts (%)	-2.5	-3.3	23.5	160.1	-34.9	-21.3	-26.7	17.2	16.5
Growth in RWA (%)	13.7	11.9	19.9	17.4	23.7	22.7	28.3	17.0	15.5
Growth in loans (%)	18.2	19.0	24.4	19.0	25.4	30.4	21.9	17.6	16.7
Growth in deposits (%)	23.1	8.4	12.6	19.8	12.2	20.5	16.4	14.5	14.6
Loan-to-deposits ratio (%)	47.1	51.7	57.2	56.8	63.5	68.7	71.9	73.9	75.2
Net int. margin (%)	3.34	2.65	2.95	3.57	3.41	3.36	2.88	2.92	2.94
Cost income ratio (%)	68.5	55.5	52.1	38.9	50.7	52.5	58.4	57.1	56.7
Cost asset ratio (%)	3.2	2.6	2.5	2.0	2.0	2.0	1.9	1.9	1.9
Trading income / Total Rev (%)	11.3	24.1	20.6	27.4	5.4	-2.3	-5.3	-3.4	-2.0

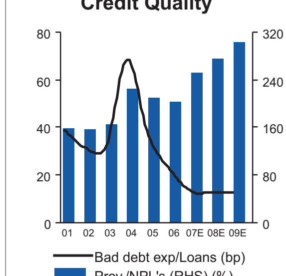
Price and Price Relative



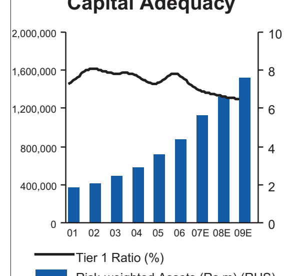
Profitability



Credit Quality



Capital Adequacy



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

We believe that Canara Bank, at least for the next 1-2 years, would have to take large-scale recourse to wholesale deposits, at rates much higher than published rates. According to the management, very few depositors pay the card rates. Despite being a large bank (in the top five in assets), Canara Bank has had a persistent problem of a low CASA ratio (low-cost deposits to total deposits) of around 33%. Other peer banks State Bank of India, Punjab National Bank and Bank of Baroda report a 40-50% CASA ratio, thereby winning on cost of funds. Margins could remain under pressure as opportunities to do something exceptional to change the asset mix are also limited.

Delay in maturing of core technology implementation and lack of concerted focus on third party distribution have led to sedate growth in fee income. Fee-to-total income and fee-to-average assets have declined from 9.9% and 46bps, respectively, in FY02 to 8.7% and 35bps in FY06. We estimate these to fall further to 7.8% and 28bps, respectively, in FY09E. With increases in the wage bill and technology costs we expect the cost income ratio to rise even as cost-to-assets stays stable.

Despite present loan portfolios of banks being more widely diversified than before, we are particularly concerned about Canara Bank's current high loan growth because of its unsatisfactory track record of slippages. For the last four years, Canara Bank's slippages (addition to gross NPLs as % of opening loans) have been in the 2.3-4.7% range, whereas other large banks have managed between 1.5-3.5%. Though in % terms we are expecting slippages to decline, this assumption could be at risk.

Valuation

We set our target price at Rs209/share based on the (RoE – g)/(CoE – g) model (resulting P/BV from formula multiplied by Mar'09E adjusted book value) and downgrade from Hold to Sell. RoE figure used is 14.4% - result of 70% weightage to schematic RoE of 13.8% and 30% to Mar'09E RoE of 15.8%. CoE turns out to be 15.3%, based on DB estimates of risk-free (9.8%), market risk premium (4.4%) and Bloomberg β (1.24), g is taken at 4% for all banks. Canara Bank tends to acquire a premium in times of interest rates declining because it has 60% of its securities under held-to-maturity category. We believe that recognition of sticky low margins and pressure on RoA from insufficient fee income could de-rate the stock.

Risks

The main risk to our call is better margins and better asset quality, but only if sustained for a reasonable period of time. It is important to distinguish between flash-in-the-pan kind of performance in a quarter or two (possibly assisted by factors generally benefiting the whole sector) and a more fundamental change. Also, if Canara Bank is able to expedite its technology rollout and focus aggressively on product distribution, our fee income estimates could be exceeded.

Asset quality patchy

Canara Bank, like most other Indian banks, has been accelerating in terms of loan growth over the last two years. However, the choice of assets appears to be less judicious, as NPL provisions have historically eaten away a large chunk of pre-provision profits. The other interesting fact to note from the following chart is that prior to FY04 (the year of transition to the 90-day rule, requiring higher provisioning) other banks used to make higher provisions than Canara Bank, possibly utilizing treasury profits better. Post FY04, it is the other way round.

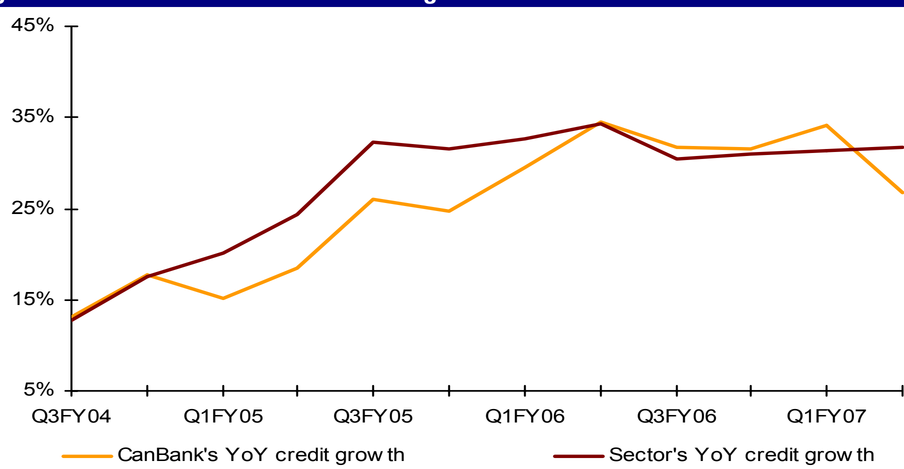
Figure 30: High drain on profits

(NPL provision to pre-provision profit)	FY02	FY03	FY04	FY05	FY06
State Bank of India	35.6%	33.3%	38.7%	11.0%	1.3%
Punjab National Bank	26.6%	20.4%	12.9%	7.0%	0.0%
Bank of India	45.5%	33.6%	28.3%	21.8%	27.5%
Bank of Baroda	32.1%	27.0%	38.9%	18.7%	16.7%
Canara Bank	23.3%	23.8%	43.3%	31.2%	24.3%

Source: Company data, Deutsche Bank

The loan growth has not really followed a sector-beating trend so as to make the asset quality problem particularly acute, though of late they have come close.

Figure 31: Canara Bank and sector loan growth



Source: Company data, RBI, Deutsche Bank

Looked at in another way, Canara Bank's track record of fresh slippages needs to improve. The comparison with other large banks is not favourable. That makes us more skeptical about the upshot of such high levels of loan growth in Canara Bank of late.

Figure 32: Slippages not sufficiently controlled of late

(Slippages to opening loans)	FY02	FY03	FY04	FY05	FY06
State Bank of India	3.67%	3.88%	4.15%	2.71%	2.16%
Punjab National Bank	4.21%	4.50%	2.60%	1.52%	1.49%
Bank of India	4.21%	3.20%	2.82%	1.65%	1.27%
Bank of Baroda	2.19%	1.25%	1.64%	0.90%	0.68%
Canara Bank	2.34%	3.71%	4.67%	2.77%	2.33%

Source: Company data, Deutsche Bank

Relatively weak NIM outlook

It is surprising that despite being a large bank, Canara Bank has a CASA ratio of around 33% -- size is usually associated with a much higher CASA. Peer banks State Bank of India, Punjab National Bank and Bank of Baroda sport a CASA ratio of 40-50%. Bank of Baroda and Bank of India's reported CASA appearing low due to the large component of international business, but domestic CASA ratios are much higher.

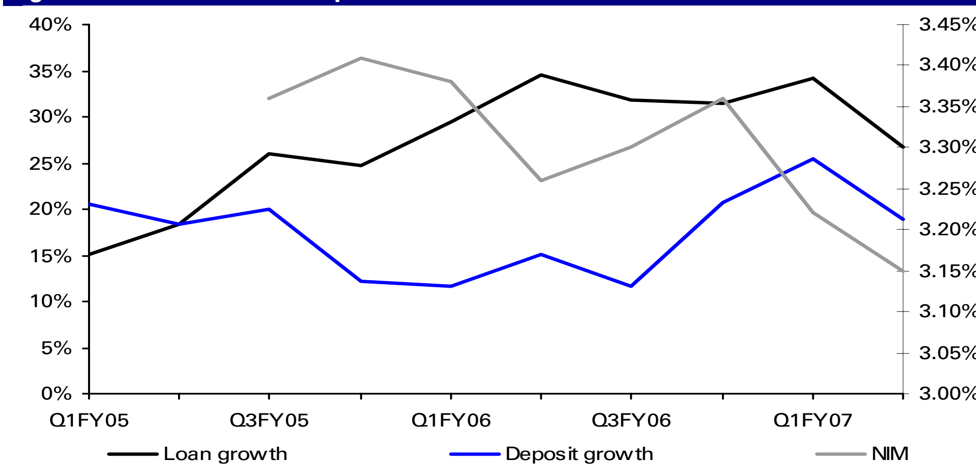
Figure 33: CASA ratio remains a weak spot

(CASA ratio)	FY02	FY03	FY04	FY05	FY06
State Bank of India	36.5%	37.3%	40.8%	41.3%	47.6%
Punjab National Bank	44.3%	46.9%	45.9%	46.3%	49.0%
Bank of India	33.6%	31.7%	33.4%	34.5%	35.0%
Bank of Baroda	33.0%	33.7%	36.4%	36.5%	37.9%
Canara Bank	33.8%	34.8%	33.8%	33.9%	33.3%

Source: Company data, Deutsche Bank

Till Canara Bank had excess holdings of government securities that could be sold to fund loan growth, margins were not disturbed beyond a point. Thereafter Canara Bank has been seeking to push up deposit growth through large-scale recourse to wholesale deposits, which is telling on margins.

Figure 34: Acceleration in deposit costs

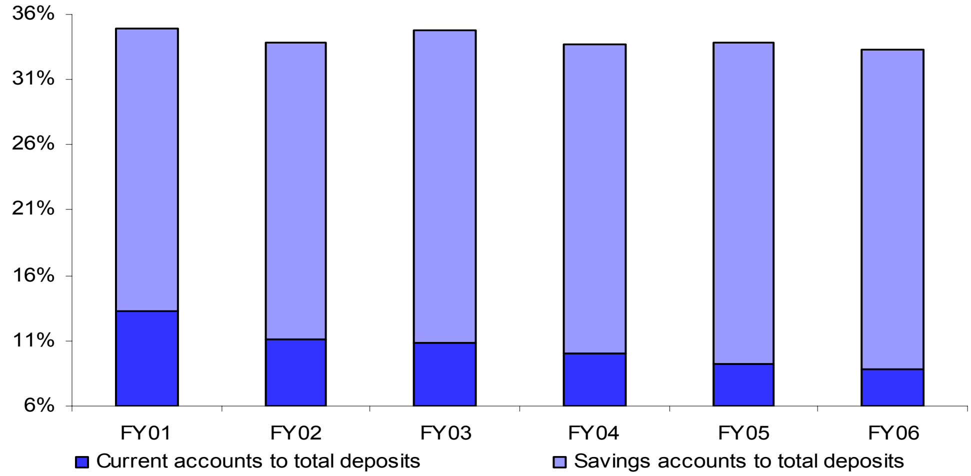


Source: Company data, Deutsche Bank

Expected moderation in loan growth should take care of the problem to some extent, like for many other banks. However, the low CASA appears to be a more long-term structural problem and will take a long time to address.

One pointer to the reason behind the persistently low CASA is its composition. Whereas savings accounts have grown well, current accounts have suffered. This shows that the bank has done reasonably well in terms of retail accounts, and hence utilized its network well, if not to the full potential. However, it has progressively lost out on transactional balances which arise out of float funds. Our explanation is that the product strategy and technology have been lacking in depth.

Figure 35: Current accounts losing out even as savings accounts do well



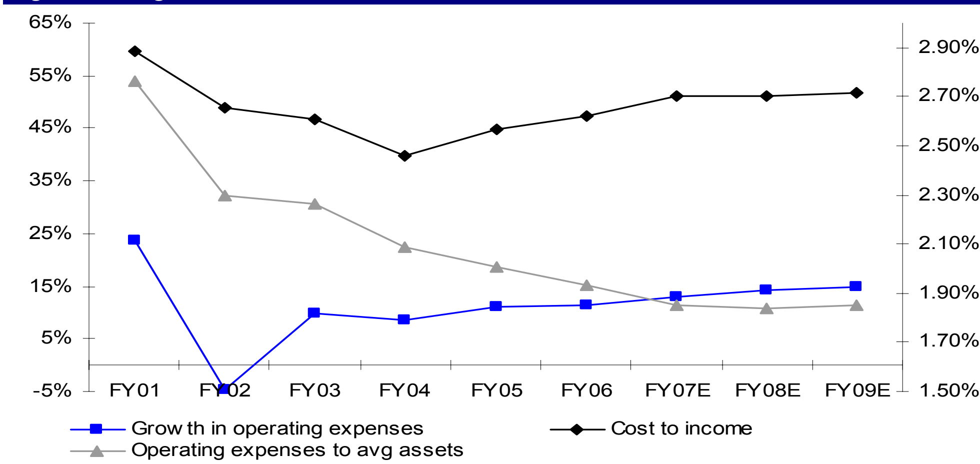
Source: Company data, Deutsche Bank

Financials

In FY06 and FY07E Canara Bank has benefited on operating expenses in a big way with the cessation of the amortization of early separation charges in FY05 – a large amount of Rs1.9bn a year, nearly 10% of total operating costs. It did cease similarly for all state-owned banks, but in case of Canara Bank the relative magnitude was much higher. However, Canara Bank's provisioning for wage increases was not conservative enough. Indeed the wage increase was effective Nov'02, but when the agreement actually concluded in FY06, the FY06 per-employee cost shot up by 28.4%, and negated all the benefits of the cessation of amortization charges.

The key reason why operating expenses are likely to increase faster than before, apart from another wage revision due in Nov'07, is core technology implementation. To quote a similar case, ever since Bank of Baroda embarked on big-ticket technology implementation in March 2005, operating expenses have increased significantly. Hence Canara Bank's current operating cost ratios may be unsustainably low. Though we are estimating cost-to-assets to remain stable, cost-to-income is likely to increase.

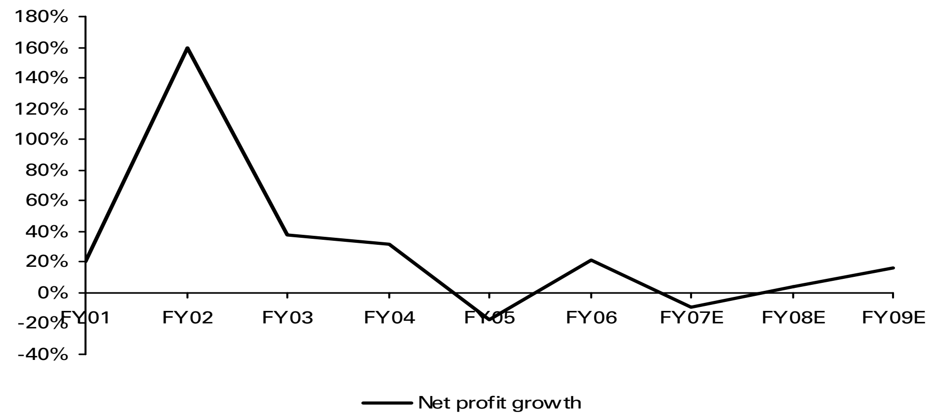
Figure 36: Higher cost ratios estimated



Source: Company data, Deutsche Bank

After two years of savings, we expect NPL provisioning to rise from FY08E. We also expect Canara Bank's unsustainably low tax rate to increase – in the last few years the bank has enjoyed tax reversals and benefits through aggressive writeoff of NPLs. In sum, we expect a net profit decline in FY07E followed by modest increases in FY08E and FY09E.

Figure 37: Lacklustre growth in net profit



Source: Company data, Deutsche Bank

GEMS: Asia India
Banking/Finance Banks

4 January 2007

HDFC Bank

Reuters: **HDBK.BO** Bloomberg: **HDFCB IN**

High quality warrants a price; upgrading to Buy

Sustained strength

This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We raise our target price from Rs740 to Rs1260 and upgrade from Hold to Buy.

End of wait for branch licences spells good for sustaining margins

Regardless of the movement in interest rates, shift in the asset mix towards relatively higher risk retail assets and more of SMEs is expected to keep yield on advances firm. With the wait for new branch licences over, HDFC Bank should not have a problem in maintaining high levels of CASA (45%+), thereby keeping margins also high at around ~4% till FY09E.

Income from fees a major contributor to RoA improvement

We expect fees to stay at 1.7% of average assets. With limited operating expenses and no credit charges, this income stream is extremely profitable and a major contributor to RoA improvement (1.39% in FY06 to 1.52% in FY09E). The bank's rapidly accelerated provisioning policy prepares it adequately for credit losses in its admittedly high-risk portfolio. In FY06, the bank's NPL provisioning was as much as 1.2% of average assets (excluding risk-free securities) and 4.7% of incremental assets. This also shows that the P&L account does not reflect supernormal profits.

Premium valuations justified

We upgrade HDFC to a Buy with a P/E-based price target of Rs1,260/share. The squeaky-clean asset quality, a large fee component in income and high margins have historically led the bank to enjoy a premium (at 22x 09E diluted EPS), which we believe should continue (see p. 3). Any delay in branch rollout and erosion in systemic floats due to new transaction technologies are key risks.

Forecasts and ratios

Year End Mar 31	2005A	2006A	**2007E**	2008E	2009E
Provisioning (INRm)	1,762.2	4,797.6	**6,661.6**	7,578.0	9,855.1
Pre-prov profit (INRm)	11,558.1	17,335.9	**23,474.6**	29,739.8	37,400.6
Net profit (INRm)	6,655.6	8,708.0	**11,601.0**	15,291.6	19,006.4
EPS (INR)	22.92	27.95	**36.98**	48.64	60.46
EPS growth (%)	27.7	22.0	**32.3**	31.6	24.3
PER (x)	19.0	23.6	**28.8**	21.9	17.6
Price/book (x)	3.73	4.57	**5.31**	4.41	3.64
DPS (net) (INR)	22.92	0.00	**0.00**	0.00	0.00
Yield (net) (%)	5.3	0.0	**0.0**	0.0	0.0

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

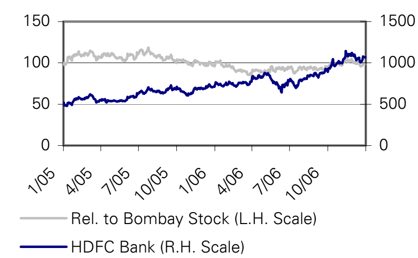
Buy

Price at 3 Jan 2007 (INR)	**1,065.80**
Price target - 12mth (INR)	**1,260.00**
52-week range (INR)	**1,144.75 - 641.65**
Bombay Stock Exchange (BSE 30)	**13,942**

Key changes

Rating	Hold to Buy ↑	
Price target	740.00 to 1,260.00 ↑	**70.3%**
Provisioning (FYE)	6,622.0 to 6,661.6 ↑	**0.6%**
Net int margin (FYE)	4.08 to 4.07 ↓	**-0.2%**
Net profit (FYE)	10,916.8 to 11,601.0 ↑	**6.3%**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-4.9*	*15.7*	*49.4*
Bombay Stock Exchange (BSE 30)	*0.7*	*12.7*	*46.2*

Stock data

Market cap (INRm)	**335,043**
Market cap (USDm)	**7,573**
Shares outstanding (m)	**313.7**
Major shareholders	**HDFC (21.9%)**
Free float (%)	**78**

Key indicators

ROE (%)	**20.0**
Loan/deposit ratio (%)	**68.8**
Book value/share (INR)	**200.73**
Price/book (x)	**5.3**
NPL/total loans (%)	**1.5**
Net int margin (%)	**4.07**

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

HDFC Bank

Reuters code HDBK.BO

Buy

Price as at 02-Jan	Rs1,068.70
Target Price	Rs1,260.00

Company Website
http://www.hdfcbank.com

Company description

HDFC Bank Ltd. offers a wide range of services to the global corporate sector. The Bank provides corporate banking and custodial services and is active in the treasury and capital markets. HDFC also markets project advisory services and capital market products such as Global Deposit Receipts, Euro currency loans, and Euro currency bonds.

Research Team

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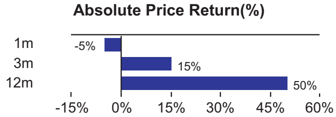
Absolute Price Return(%)



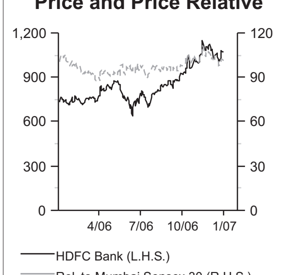
52-week Range:	Rs641.65 - Rs1,144.75
Market Cap (m):	Rs 336,800
	US$ 7,629

Company identifiers

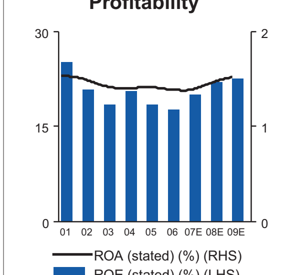
Bloomberg	HDFCB IN
Cusip	NA
SEDOL	6100131

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	8.64	11.01	13.75	17.95	22.92	27.95	36.98	48.64	60.46
EPS FD (stated) (Rs)	7.65	9.88	12.41	16.17	21.41	26.23	34.95	46.06	57.25
EPS FD (DB adj.) (Rs)	7.65	9.88	12.41	16.17	21.41	26.23	34.95	46.06	57.25
Growth Rate - EPS (stated) (%)	59.5	27.4	24.9	30.6	27.7	22.0	32.3	31.6	24.3
DPS	8.64	11.01	13.75	17.95	22.92	0	0	0	0
BVPS (stated) (Rs)	37.48	69.03	79.59	94.52	145.86	169.24	200.73	241.50	292.96
BVPS (DB adj.) (Rs)	28.85	15.59	13.54	11.30	7.35	6.43	5.43	4.49	3.68
Average market cap (Rs m)	58,600	61,298	61,305	85,695	127,368	205,366	336,800	336,800	336,800
Shares in issue (m)	244	281	282	285	310	313	314	314	314
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	27.9	20.6	15.8	16.8	19.1	23.6	28.9	22.0	17.7
P/E FD (stated)	31.5	23.0	17.5	18.7	20.5	25.1	30.6	23.2	18.7
P/E FD (DB adj.)	31.5	23.0	17.5	18.7	20.5	25.1	30.6	23.2	18.7
P/B (stated)	6.14	3.41	2.94	4.00	3.73	4.57	5.32	4.43	3.65
P/B (DB adj.)	7.97	15.09	17.26	33.48	74.10	120.22	196.87	238.09	290.13
ROE (stated) (%)	25.2	20.8	18.5	20.6	18.5	17.7	20.0	22.0	22.6
ROA (stated) (%)	1.54	1.51	1.43	1.40	1.42	1.39	1.39	1.46	1.52
Dividend yield (%)	3.59	4.85	6.32	5.94	5.23	0	0	0	0
Dividend cover (x)	1.00	1.00	1.00	1.00	1.00	nm	nm	nm	nm
Payout ratio (%)	23.2	23.7	21.9	19.6	21.0	19.8	17.6	14.4	13.2
PROFIT & LOSS (Rs m)									
Net interest income	5,057	6,293	8,217	13,379	17,779	25,458	32,432	40,905	49,006
Non-interest income	1,722	3,141	4,151	3,868	4,633	8,788	13,221	15,816	19,916
Fees & Commissions	1,341	1,645	2,364	3,204	6,050	10,451	14,422	17,594	21,465
Trading revenue	234	1,238	1,266	77	-1,627	-1,979	-1,546	-2,158	-1,967
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	0	0	0	0	0	0	0	0	0
Other revenue	147	258	522	588	210	317	345	380	418
Total revenue	6,779	9,433	12,368	17,247	22,412	34,247	45,653	56,721	68,922
Total Operating Costs	3,096	4,320	5,771	8,267	10,854	16,911	22,178	26,981	31,522
Pre-Provision profit / (loss)	**3,683**	**5,113**	**6,597**	**8,980**	**11,558**	**17,336**	**23,475**	**29,740**	**37,401**
Bad debt expense	530	858	884	1,783	1,762	4,798	6,662	7,578	9,855
Operating Profit	3,153	4,256	5,713	7,197	9,796	12,538	16,813	22,162	27,545
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	3,153	4,256	5,713	7,197	9,796	12,538	16,813	22,162	27,545
Tax	1,052	1,285	1,837	2,102	3,140	3,830	5,212	6,870	8,539
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**2,101**	**2,970**	**3,876**	**5,095**	**6,656**	**8,708**	**11,601**	**15,292**	**19,006**
DB adj. core earnings	**2,101**	**2,970**	**3,876**	**5,095**	**6,656**	**8,708**	**11,601**	**15,292**	**19,006**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	105,102	156,522	209,177	277,738	412,710	602,176	832,719	1,072,524	1,275,848
Interest-earnings assets	143,468	221,631	281,455	404,047	490,365	698,665	896,191	1,115,854	1,293,452
Total loans	47,628	70,087	119,860	180,717	259,503	354,327	479,103	624,237	770,266
Total deposits	124,133	185,448	222,371	306,686	349,994	537,677	696,277	873,636	1,033,115
Stated Shareholder Equity	9,131	19,423	22,448	26,919	45,199	52,995	63,102	75,918	92,095
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	9,129	16,925	19,850	22,297	39,622	51,499	65,102	77,918	94,095
Tier 1 ratio (%)	8.69	10.81	9.49	8.03	9.60	8.60	7.82	7.26	7.38
Tangible equity / total assets (%)	5.85	8.17	7.38	6.36	8.79	7.21	6.74	6.58	6.85
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	3.08	3.18	2.21	1.86	1.69	1.44	1.54	1.55	1.62
Provisions / NPLs (%)	85.90	87.48	87.06	97.48	87.45	72.98	74.36	85.56	118.79
Bad debt chg / Avg loans (%)	1.27	1.46	0.93	1.19	0.80	1.56	1.60	1.37	1.41
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	65.5	24.4	30.6	62.8	32.9	43.2	27.4	26.1	19.8
Growth in fee income (%)	61.2	22.6	43.7	35.5	88.8	72.7	38.0	22.0	22.0
Growth in non-interest income (%)	44.0	82.5	32.2	-6.8	19.8	89.7	50.4	19.6	25.9
Growth in revenues (%)	59.4	39.2	31.1	39.5	29.9	52.8	33.3	24.2	21.5
Growth in costs (%)	75.3	39.5	33.6	43.3	31.3	55.8	31.1	21.7	16.8
Pre-provision earnings growth (%)	**48.2**	**38.8**	**29.0**	**36.1**	**28.7**	**50.0**	**35.4**	**26.7**	**25.8**
Growth in bad debts (%)	-1.2	62.0	3.1	101.7	-1.2	172.3	38.9	13.8	30.0
Growth in RWA (%)	33.4	48.9	33.6	32.8	48.6	45.9	38.3	28.8	19.0
Growth in loans (%)	34.3	47.2	71.0	50.8	43.6	36.5	35.2	30.3	23.4
Growth in deposits (%)	25.2	49.4	19.9	37.9	14.1	53.6	29.5	25.5	18.3
Loan-to-deposits ratio (%)	38.4	37.8	53.9	58.9	74.1	65.9	68.8	71.5	74.6
Net int. margin (%)	3.89	3.12	3.22	3.82	3.94	4.10	4.07	4.07	4.07
Cost income ratio (%)	45.7	45.8	46.7	47.9	48.4	49.4	48.6	47.6	45.7
Cost asset ratio (%)	2.3	2.2	2.1	2.3	2.3	2.7	2.7	2.6	2.5
Trading income / Total Rev (%)	3.4	13.1	10.2	0.4	-7.3	-5.8	-3.4	-3.8	-2.9

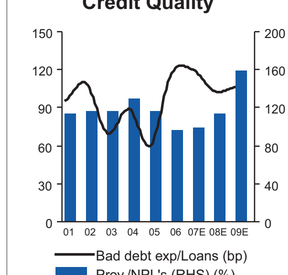
Price and Price Relative



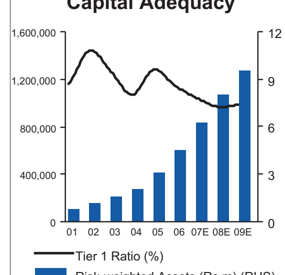
Profitability



Credit Quality



Capital Adequacy



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

The secret of HDFC Bank's success has been very low, sector-beating cost of funds, without being anywhere close to the large branch network that the state-owned banks possess. We believe that this comparative advantage should continue with the help of HDFC Bank's transactional businesses, acquisition of salary accounts and increased SME banking. We upgrade the rating on the stock from Hold to Buy. We estimate margins to stay steady at a high level of ~4% till FY09E. Fee income, driven by retail assets and third-party distribution, should continue the momentum, and be the key reason for the RoA improving from an already high level of 1.39% in FY06 to 1.52% in FY09E.

Since HDFC Bank has for the last year or so taken a conscious decision to ramp up its sub-prime business, its rapidly accelerated provisioning policy prepares the bank for the worst. Though these loans (personal loans, two wheeler finance, credit cards) have inherently higher credit losses, they are short-duration loans and it is reasonable to assume that by now the bank would be having a good idea of statistical default rates. In FY06, the bank's NPL provisioning was as much as 1.2% of average assets (excluding risk-free securities) and 4.7% of incremental assets. This also shows that the P&L account does not reflect supernormal profits.

Valuation

We choose to value HDFC Bank on P/E rather than the more common (RoE – g)/(CoE – g) formula adopted by us for state-owned banks. Firstly, the CoE-based formula works on the basis of a perpetual growth rate, and becomes unsuitable for a bank like HDFC which has delivered around 30% growth over the last four years without a break and has potential to repeat that. Secondly, HDFC Bank has demonstrated foresight in provisioning and building the highest CASA in the sector without a wide branch network.

Our price target of Rs1,260 is based on a P/E of 22x on FY09E diluted EPS. The 3-year CAGR EPS growth of 30% till FY09E places the PE/growth ratio at around 0.7x. The reason we have taken this a notch lower than what we have assumed for other private banks is that HDFC Bank already trades at a substantial premium to others, which should narrow as the bank becomes larger and relatively less flexible than before. To put this in perspective, the (RoE – g)/(CoE – g) model would have led to a fair value of Rs863.

Risks

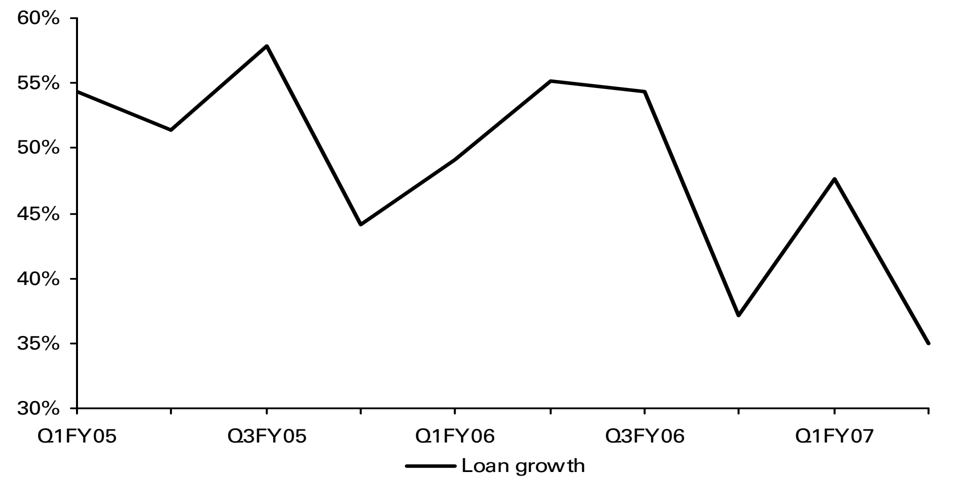
A high-growth bank like HDFC is critically dependent on the spread of the branch network to keep cost of liabilities low. Any obstacle in that path can mean that margins slip or asset growth slows. In the last one-year several banks, including HDFC have had difficulties in getting their branch licences from the RBI on time.

Erosion of float funds in the system can also be a risk for HDFC Bank's low-cost deposits. Interestingly, unlike all other banks where savings account balances are twice the current accounts', it is nearly equal in the case of HDFC Bank. Some of the 'lazy float' in the system could disappear with technologies such as Real Time Gross Settlement.

Recent loan growth: Features

During FY06, reported outstanding loan growth accelerated because the bank had to go slow on securitization after the RBI mandated capital to be set aside for credit enhancements. Thus, the bank kept most of the loans originated in its books as against the active sell-down in the earlier years. Thereafter, loan growth has moderated towards the sector average.

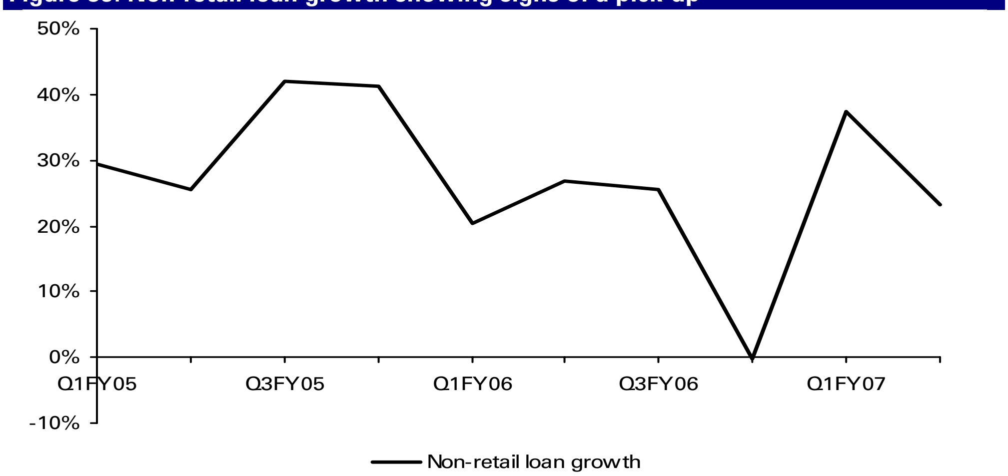
Figure 38: Loan growth cooling off due to reduced securitization



Source: Company data, Deutsche Bank

There are signs that even as retail lending growth maintains its traction, non-retail lending is also picking up for HDFC Bank.

Figure 39: Non-retail loan growth showing signs of a pick-up



Source: Company data, Deutsche Bank

The fact that the bank has been changing its loan mix towards more high-risk loans can be borne out from Figure 3. Data is up to FY06, we suspect that in FY07 the trend would have become more pronounced.

Figure 40: Retail loan profile moving to higher-yielding but riskier loans

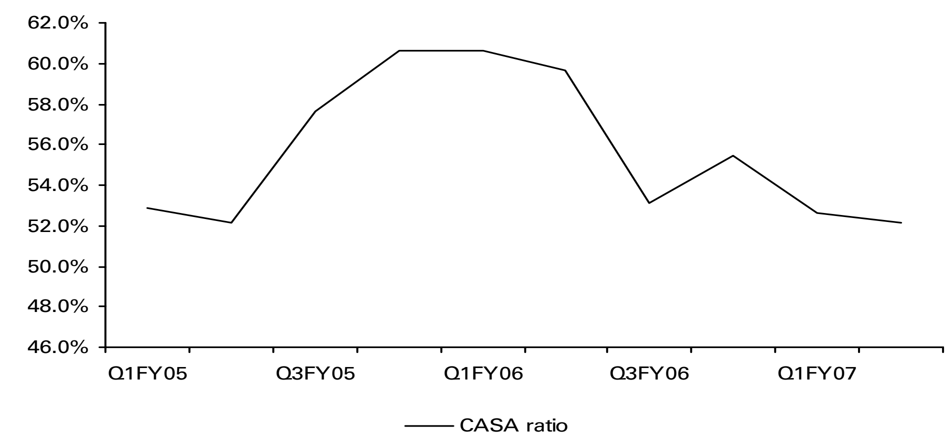
	FY03	FY04	FY05	FY06
Loans against securities	16.2%	12.8%	11.0%	7.7%
Auto loans	47.5%	38.7%	18.7%	22.3%
Personal loans	15.6%	14.4%	18.2%	20.8%
Two wheeler loans	3.3%	5.9%	9.2%	8.6%
Retail business banking	0.0%	3.6%	9.8%	12.8%
CV loans	8.1%	16.6%	19.5%	19.0%
Credit cards	2.4%	3.4%	6.1%	6.0%
Other retail loans	6.9%	4.6%	7.5%	2.8%

Source: Company data, Deutsche Bank

Branch licences back

It is instructive to dwell on this oft-mentioned issue of latency in granting branch licences by the RBI to some banks, HDFC Bank included. In the last four quarters, HDFC Bank has barely added branches. Never before in the past has HDFC Bank gone through this situation for so long. However, the bank has managed admirably well within this serious constraint, particularly on the liabilities side. Firstly, the very high CASA ratio has come off only a tad.

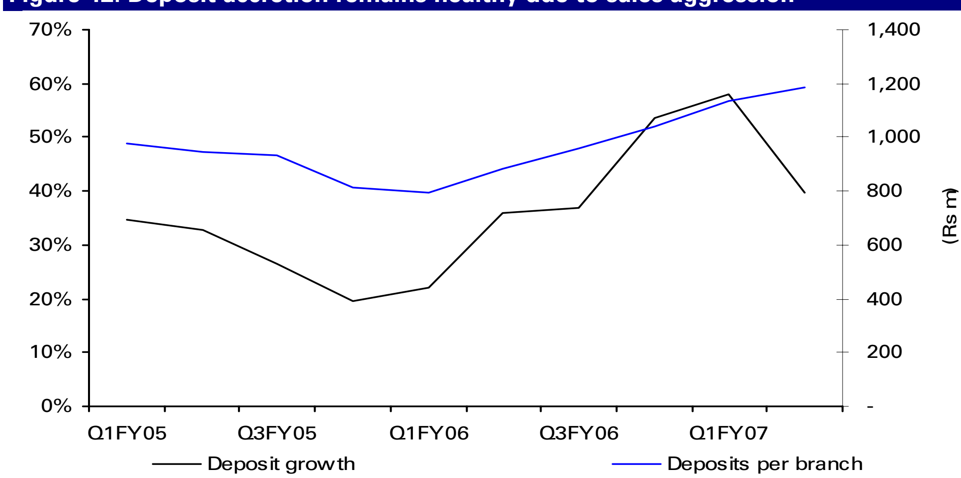
Figure 41: CASA ratio not suffered much even without branch licences



Source: Company data, Deutsche Bank

Deposit growth has come off in Q2FY07, but it still remains above the levels prevailing during FY06. Deposits per branch have risen, reflecting a better utilisation of the network.

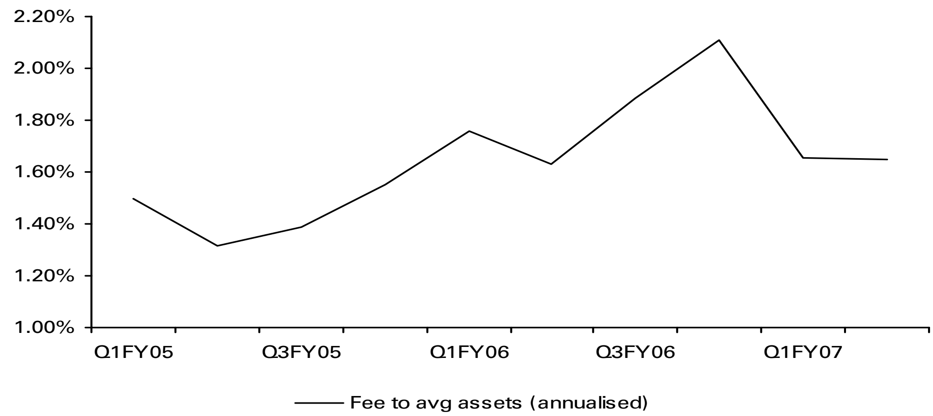
Figure 42: Deposit accretion remains healthy due to sales aggression



Source: Company data, Deutsche Bank

Even fee income (not totally dependent on the branch network though) has been barely affected.

Figure 43: Fee income stream continues to be strong



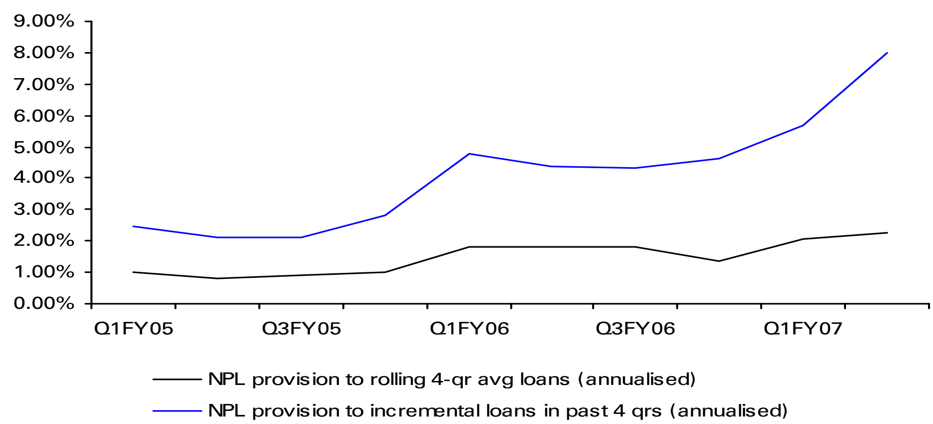
Source: Company data, Deutsche Bank

The bank has now got a fresh round of licences and is on its way to expand the network again.

Pre-emptive provisioning

In order to adequately reflect the change in risk profile of incremental assets, HDFC Bank has been ramping up provisioning charges. For example, in FY06 itself, the bank made a provision of 1.24% of average assets and 4.73% of incremental assets. Figure 7 shows the same data on a quarterly basis – provision charges were ramped up from FY06 onwards when the risk profile change became more pronounced.

Figure 44: Adequate provisioning for the increasing risk profile



Source: Company data, Deutsche Bank

The substantially increased provisioning also ensures that the P&L account does not have any froth i.e. does not depict supernormal profits. It is reasonable to expect that eventually these provisions will be well in excess of requirements for actual credit losses. This is because the riskier loans are also short-duration ones, and the statistical behaviour of credit history should be well established and understood by the bank now.

GEMS: Asia India
Banking/Finance Banks

4 January 2007

OBC

Reuters: **ORBC.BO** Bloomberg: **OBC IN**

Margin worries in the price

Suffering nearly over - cutting target price but retaining Buy

This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We are adjusting our target price down from Rs300 to Rs283, but maintaining Buy.

Amalgamation – harvest time after pain

The amalgamation with Global Trust Bank (eGTB) has turned out to be fruitful in terms of remarkably accelerated growth in loans and fees – it is unusual to observe a public sector bank growing fees at above 25% a year. Recoveries from the mountain of NPLs inherited from eGTB have also been very healthy.

Improving asset quality and comfortable capital position are key positives

We expect OBC to return to its fully-provided NPL position by FY08E. With an estimated Tier I ratio of 11.0% by March 2007 and plenty of perpetual debt headroom available, fuel for growth and government ownership already at the minimum 51% are not immediate concerns.

Valuations appear to have factored in the margin outlook

From being traded at a substantial premium to the sector due to its pristine asset quality, OBC has now been relegated to the lowest rung of the valuation spectrum after the eGTB amalgamation and subsequent onslaught on interest margins. Our (RoE – g)/(CoE – g)-based price target is Rs283/share. Estimated RoEs taken for the price target exclude the chargeoff of goodwill on amalgamation, which is temporary. The key risk is margins weakening further; OBC is yet to start working seriously on CASA. Cost of funds in the near future can be reined in only by moderation in asset growth, which is what we believe should happen.

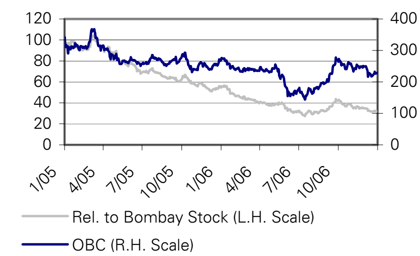
Buy

Price at 3 Jan 2007 (INR)	**229.55**
Price target - 12mth (INR)	**283.00**
52-week range (INR)	**277.30 - 144.05**
Bombay Stock Exchange (BSE 30)	**13,942**

Key changes

Price target	300.00 to 283.00	↓	**-5.7%**
Provisioning (FYE)	2,564.0 to 167.9	↓	**-93.5%**
Net int margin (FYE)	2.96 to 2.75	↓	**-6.8%**
Net profit (FYE)	7,492.6 to 8,691.7	↑	**16.0%**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-8.5*	*-14.4*	*-14.1*
Bombay Stock Exchange (BSE 30)	*0.7*	*12.7*	*46.2*

Stock data

Market cap (INRm)	**57,511**
Market cap (USDm)	**1,300**
Shares outstanding (m)	**250.5**
Major shareholders	**Govt of India (51.9%)**
Free float (%)	**49**

Key indicators

ROE (%)	**16.0**
Loan/deposit ratio (%)	**74.3**
Book value/share (INR)	**226.60**
Price/book (x)	**1.0**
NPL/total loans (%)	**4.4**
Net int margin (%)	**2.75**

Forecasts and ratios

Year End Mar 31	2005A	2006A	**2007E**	2008E	2009E
Provisioning (INRm)	1,538.0	-2,560.4	**167.9**	416.2	492.0
Pre-prov profit (INRm)	9,868.0	7,084.3	**11,170.1**	13,676.6	15,887.5
Net profit (INRm)	9,720.7	8,031.7	**8,691.7**	9,680.1	10,776.8
EPS (INR)	50.49	32.91	**34.69**	38.64	43.01
EPS growth (%)	41.7	-34.8	**5.4**	11.4	11.3
PER (x)	5.5	7.9	**6.6**	5.9	5.3
Price/book (x)	1.80	1.14	**1.01**	0.92	0.83
DPS (net) (INR)	3.00	5.19	**3.50**	4.00	4.50
Yield (net) (%)	1.1	2.0	**1.5**	1.7	2.0

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

OBC

Reuters code	ORBC.BO

Buy

Price as at 02-Jan	Rs228.05
Target Price	Rs283.00

Company Website
http://www.obcindia.com

Company description

Oriental Bank of Commerce is a banking company which operates through a branch network of approximately 915 banks throughout India, as well as through roughly five banks overseas. The Bank provides a broad range of financial services, including savings and loans, merchant banking, credit assistance, lead banking and management and foreign exchange.

Research Team

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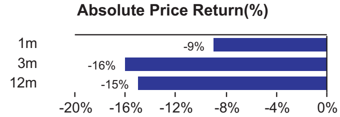
Absolute Price Return(%)



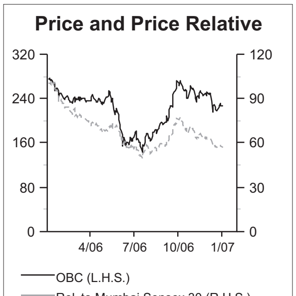
52-week Range:	Rs144.05 - Rs277.30
Market Cap (m):	Rs 57,136 US$ 1,294

Company identifiers

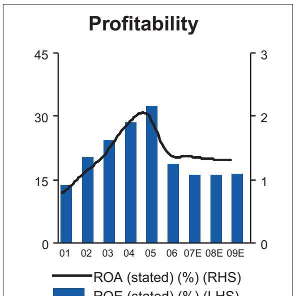
Bloomberg	OBC IN
Cusip	NA
SEDOL	6121507

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	10.54	16.65	23.73	35.63	50.49	32.91	34.69	38.64	43.01
EPS FD (stated) (Rs)	10.54	16.65	23.73	35.63	50.49	32.06	34.69	38.64	43.01
EPS FD (DB adj.) (Rs)	10.54	16.65	23.73	35.63	50.49	32.06	34.69	38.64	43.01
Growth Rate - EPS (stated) (%)	-27.2	58.0	42.6	50.1	41.7	-34.8	5.4	11.4	11.3
DPS	3.50	3.50	4.50	5.00	3.00	5.19	3.50	4.00	4.50
BVPS (stated) (Rs)	80.43	84.12	109.55	139.03	172.80	206.39	226.60	250.06	277.16
BVPS (DB adj.) (Rs)	80.43	84.12	109.55	139.03	121.91	177.10	207.14	240.41	277.16
Average market cap (Rs m)	6,643	6,871	8,991	38,035	53,279	63,622	57,136	57,136	57,136
Shares in issue (m)	193	193	193	193	193	251	251	251	251
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	3.3	2.1	2.0	5.5	5.5	7.9	6.6	5.9	5.3
P/E FD (stated)	3.3	2.1	2.0	5.5	5.5	8.1	6.6	5.9	5.3
P/E FD (DB adj.)	3.3	2.1	2.0	5.5	5.5	8.1	6.6	5.9	5.3
P/B (stated)	0.50	0.46	0.58	2.17	1.80	1.14	1.01	0.91	0.82
P/B (DB adj.)	0.50	0.46	0.58	2.17	2.55	1.33	1.10	0.95	0.82
ROE (stated) (%)	13.6	20.2	24.5	28.7	32.4	18.9	16.0	16.2	16.3
ROA (stated) (%)	0.79	1.08	1.38	1.83	2.04	1.42	1.37	1.33	1.30
Dividend yield (%)	10.14	9.81	9.64	2.53	1.08	1.99	1.53	1.75	1.97
Dividend cover (x)	3.01	4.76	5.27	7.13	16.83	6.34	9.91	9.66	9.56
Payout ratio (%)	33.2	21.0	19.0	14.0	5.9	16.2	10.1	10.4	10.5
PROFIT & LOSS (Rs m)									
Net interest income	7,906	9,721	12,048	14,558	15,237	16,051	16,621	19,302	22,726
Non-interest income	2,433	4,700	5,400	7,217	2,939	3,040	4,906	5,816	6,208
Fees & Commissions	960	1,019	1,063	1,136	1,565	2,043	2,595	3,062	3,368
Trading revenue	991	3,181	3,923	5,581	989	313	875	1,103	1,123
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	163	86	96	0	0	0	0	0	0
Other revenue	319	415	318	500	385	684	1,435	1,651	1,717
Total revenue	10,339	14,420	17,447	21,775	18,175	19,091	21,527	25,118	28,934
Total Operating Costs	5,033	7,336	6,762	9,430	8,307	12,006	10,357	11,441	13,047
Pre-Provision profit / (loss)	**5,306**	**7,084**	**10,685**	**12,345**	**9,868**	**7,084**	**11,170**	**13,677**	**15,887**
Bad debt expense	2,491	1,390	3,330	890	1,538	-2,560	168	416	492
Operating Profit	2,815	5,694	7,355	11,456	8,330	9,645	11,002	13,260	15,395
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	2,815	5,694	7,355	11,456	8,330	9,645	11,002	13,260	15,395
Tax	786	2,489	2,786	4,595	-1,391	1,613	2,310	3,580	4,619
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**2,029**	**3,206**	**4,570**	**6,861**	**9,721**	**8,032**	**8,692**	**9,680**	**10,777**
DB adj. core earnings	**2,029**	**3,206**	**4,570**	**6,861**	**9,721**	**8,032**	**8,692**	**9,680**	**10,777**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	162,716	197,408	207,171	246,623	293,271	382,567	493,436	574,156	637,773
Interest-earnings assets	258,125	310,149	327,717	398,656	509,101	556,006	651,313	748,303	849,793
Total loans	112,651	146,559	165,982	208,917	274,849	355,306	434,256	509,002	586,099
Total deposits	246,804	284,884	298,091	356,735	478,503	501,975	584,715	670,634	759,931
Stated Shareholder Equity	15,487	16,197	21,093	26,768	33,270	51,708	56,773	62,650	69,439
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	18,631	18,951	22,209	24,342	15,895	44,799	54,396	62,732	71,939
Tier 1 ratio (%)	11.45	9.60	10.72	9.87	5.42	11.71	11.02	10.93	11.28
Tangible equity / total assets (%)	5.72	5.02	6.21	6.53	6.15	8.77	8.32	8.05	7.92
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	5.20	6.49	6.91	5.80	9.14	5.96	4.45	2.88	1.90
Provisions / NPLs (%)	32.21	52.32	80.35	100.00	86.98	92.30	93.60	115.78	138.82
Bad debt chg / Avg loans (%)	2.40	1.07	2.13	0.47	0.64	-0.81	0.04	0.09	0.09
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	10.9	22.9	23.9	20.8	4.7	5.3	3.6	16.1	17.7
Growth in fee income (%)	0.4	6.1	4.3	6.9	37.8	30.6	27.0	18.0	10.0
Growth in non-interest income (%)	9.9	93.2	14.9	33.7	-59.3	3.4	61.4	18.6	6.7
Growth in revenues (%)	10.7	39.5	21.0	24.8	-16.5	5.0	12.8	16.7	15.2
Growth in costs (%)	7.5	45.8	-7.8	39.4	-11.9	44.5	-13.7	10.5	14.0
Pre-provision earnings growth (%)	**13.8**	**33.5**	**50.8**	**15.5**	**-20.1**	**-28.2**	**57.7**	**22.4**	**16.2**
Growth in bad debts (%)	95.4	-44.2	139.6	-73.3	72.9	-266.5	nm	147.9	18.2
Growth in RWA (%)	nm	21.3	4.9	19.0	18.9	30.4	29.0	16.4	11.1
Growth in loans (%)	18.4	30.1	13.3	25.9	31.6	29.3	22.2	17.2	15.1
Growth in deposits (%)	11.7	15.4	4.6	19.7	34.1	4.9	16.5	14.7	13.3
Loan-to-deposits ratio (%)	45.6	51.4	55.7	58.6	57.4	70.8	74.3	75.9	77.1
Net int. margin (%)	3.22	3.42	3.78	4.01	3.36	3.01	2.75	2.76	2.84
Cost income ratio (%)	48.7	50.9	38.8	43.3	45.7	62.9	48.1	45.6	45.1
Cost asset ratio (%)	2.0	2.5	2.0	2.5	1.7	2.1	1.6	1.6	1.6
Trading income / Total Rev (%)	9.6	22.1	22.5	25.6	5.4	1.6	4.1	4.4	3.9

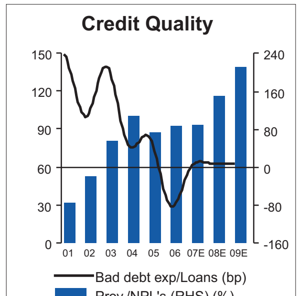
Price and Price Relative



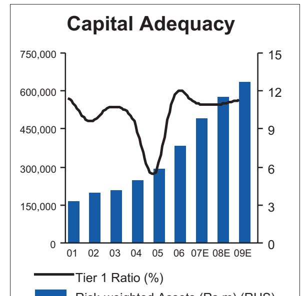
Profitability



Credit Quality



Capital Adequacy



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

The amalgamation with eGTB has turned out to be fruitful in terms of remarkably accelerated growth in loans and fees, although with a lag of a year or so – it is unusual to observe a public sector bank growing fees at above 25% a year. We estimate fee income to grow at 18.1% CAGR during FY06-FY09E and reach 0.41% of average assets in FY09E from 0.36% in FY06. Operating expenses, which saw a spike in FY06 due to one-time separation charges paid to eGTB staff, are expected to decline and be 1.53% of average assets by FY09E.

We expect OBC to return to its fully-provided NPL position by FY08E, as recoveries from the mountain of NPLs inherited from eGTB have been very healthy. With an estimated Tier I ratio of 11.0% by March 2007 and plenty of perpetual debt headroom available, fuel for growth and government ownership already at the statutory minimum are not immediate concerns.

OBC is yet to start working seriously on CASA – the limited branch network coupled with a financially savvy trader/SME clientele is making the job harder. Cost of funds in the near future can be reined in only by moderation in asset growth, which is what we believe should happen. The good news is that at 2.5%, NIMs have little downside, except possibly due to run-off of the 'free' funds adding to spreads.

Valuation

At the peak of its valuation cycle, OBC used to trade at 1.9x one year forward book value, the premium being for its then high margins and pristine asset quality (it was the first bank in India to report zero net NPLs in September 2004). However, the de-rating after the eGTB amalgamation was swift; even as the concern over mounting bad debts receded, it was superseded by the concern of sharply falling margins.

Based on our (RoE – g)/(CoE – g) model, our price target works out to Rs283/share (resulting P/BV from the formula multiplied by Mar'09E adjusted book value). We believe that the margin decline has been factored into the price adequately and further downside should be limited. With stabilizing margins, momentum in fee income continuing and operating efficiencies being maintained, the stock could be re-rated.

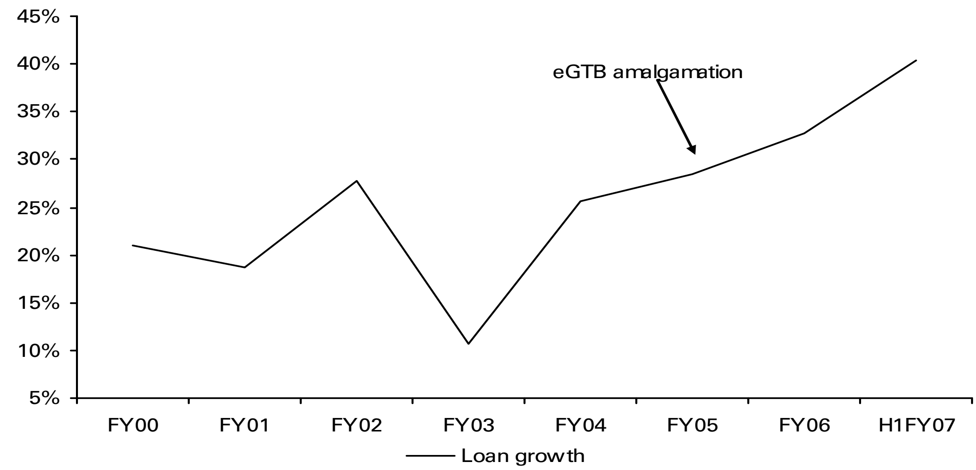
Risks

The robustness of OBC's balance sheet, due to which it could withstand the tumultuous merger with eGTB without much problem, lies in its capital position, asset quality, operating efficiency and fee income traction. Among these, we perceive asset quality and operating efficiency to be at greatest risk because of high loan growth and employee cost increases. The other serious risk could be further weakening of the already low net interest margins.

eGTB positives emerging

Growth and scale benefits have definitely accrued to OBC with the eGTB franchise coming in. In loan growth, OBC typically lagged the sector before the amalgamation but accelerated thereafter, particularly in retail assets. The sales force was sufficiently augmented with OBC absorbing some of the outsourced marketing agents into its rolls as a part of the integration process.

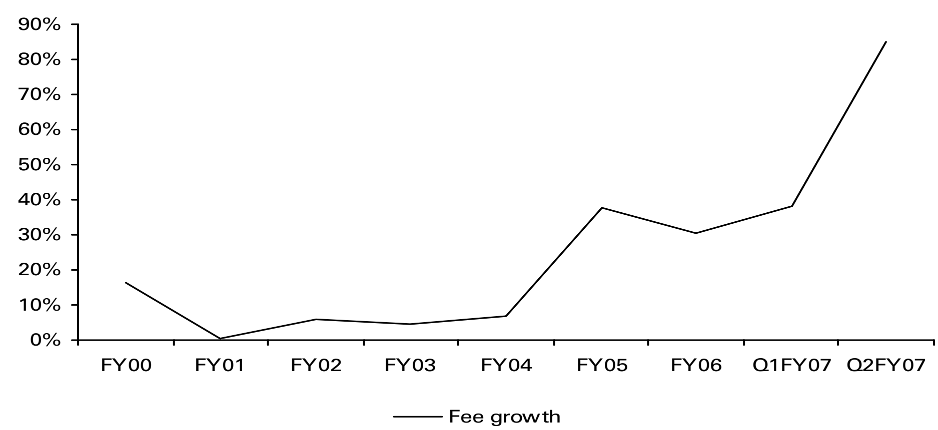
Figure 45: Accelerating loan growth, particularly after eGTB amalgamation



Source: Company data, Deutsche Bank

The more remarkable benefit has been fee income. Fee growth was anaemic till FY04 and took off after the eGTB network brought in a suite of products on the retail side that were capable of adding to OBC's fee income stream almost off a zero base. Simultaneously the technology platform also matured and it was possible to offer more products.

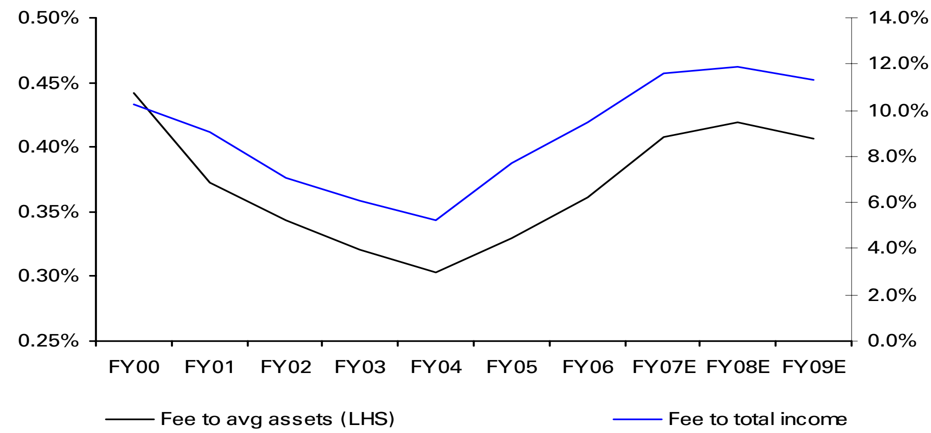
Figure 46: Major impetus to fee growth after eGTB amalgamation



Source: Company data, Deutsche Bank

We expect fee income to become even more important in future.

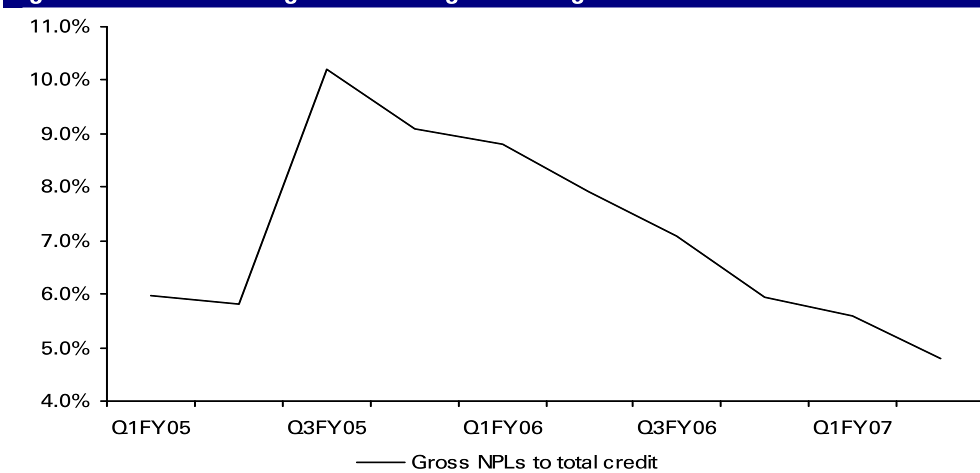
Figure 47: Fees to increase in importance



Source: Company data, Deutsche Bank

OBC has also been able to tide over the initial shock of NPLs in eGTB that turned out to be much more than estimated. For the last few quarters, not only has it stabilized the NPL position but has been enjoying healthy recoveries.

Figure 48: NPLs declining after the surge on amalgamation

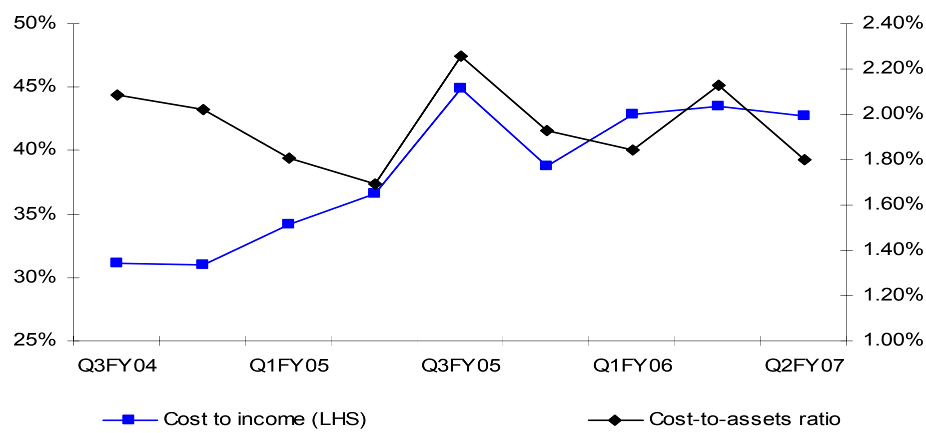


Source: Company data, Deutsche Bank

High operating efficiencies

OBC claims to drive the maximum business per branch among public sector banks. With the lack of a large legacy branch network and the acquired eGTB franchise being very efficient (like most new generation private banks), OBC continues to post enviable cost ratios. OBC had only 1,148 branches and 14,962 employees as at March 2006. The cost-to-income ratio and cost-to-assets ratio in FY06 were 44.8% and 1.71%, respectively, making it one of the most efficient, and thus has sustained over many years. A spurt was observed in Q3FY05 which was the first quarter of amalgamation with eGTB, wherein additional costs were absorbed but business was not there. Thereafter it has normalized.

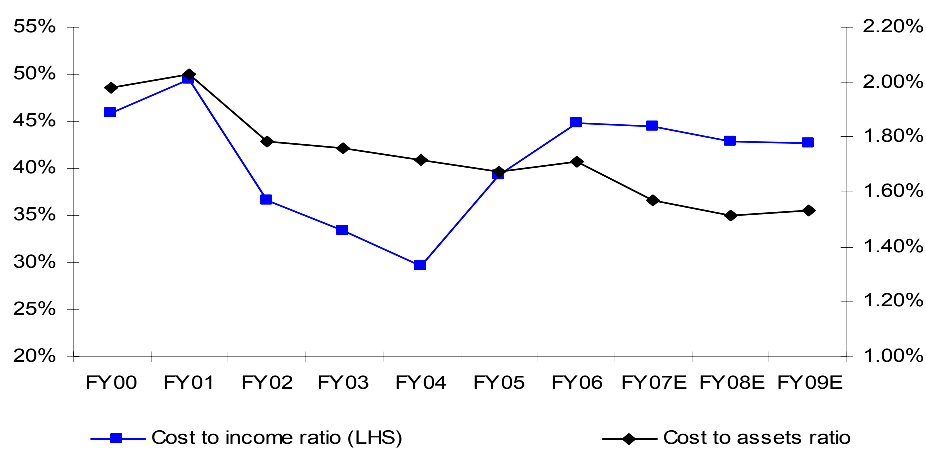
Figure 49: Cost ratios steadily declining



Source: Company data, Deutsche Bank

We expect OBC will be able to keep its operating efficiency high in the coming years.

Figure 50: Cost ratios expected to decline further

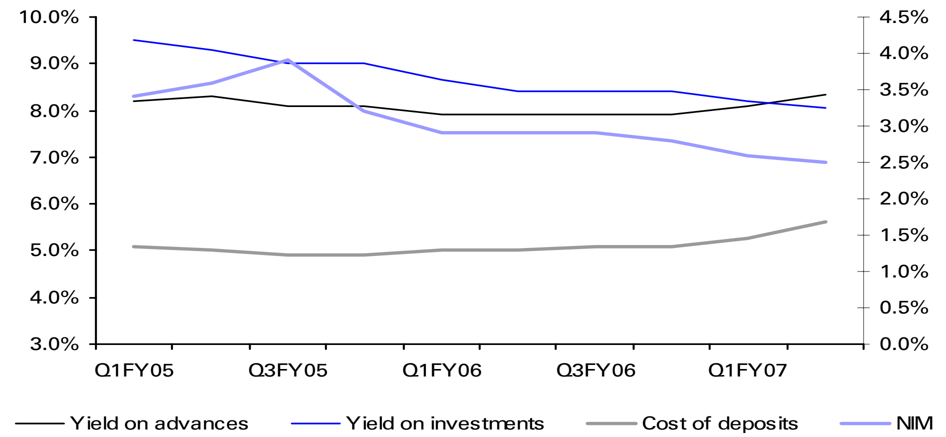


Source: Company data, Deutsche Bank

Valuations factor in NIMs

OBC's recent NIM problem stems not only from a comparatively weak deposit franchise but also poor yield on the non-performing investments inherited from eGTB. The latter will sort itself out over the next few quarters, but CASA can be improved only with a lot of effort and is time consuming. Fortunately, of late, OBC has been able to improve the yield on advances at least. However, the rise in cost of deposits and fall in yield on investments have negated the benefit.

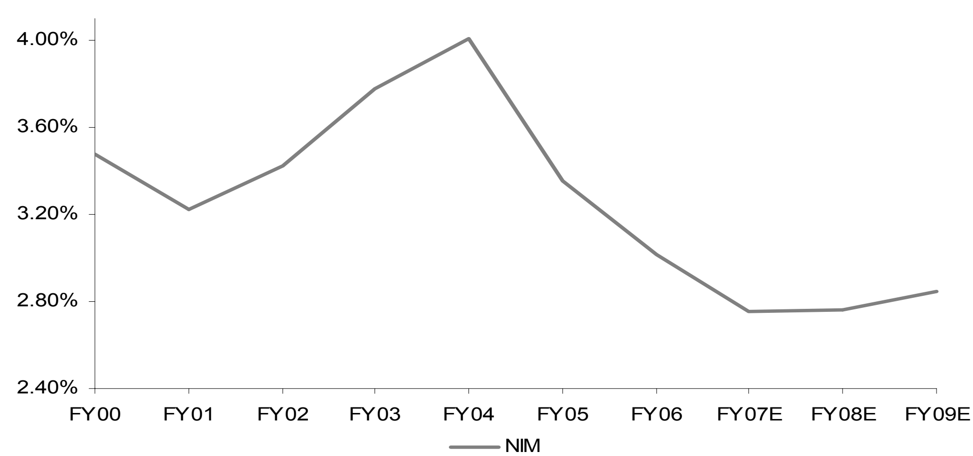
Figure 51: Declining NIMs



Source: Company data, Deutsche Bank

On an annual basis, we expect margins to stabilize after a significant decline in FY07E. We believe that in the near term the bank will work this out through a moderation in loan growth, thereby accessing less wholesale funds. Investment yield correction, if at all, is likely to be limited as most high coupon bonds have already been redeemed and OBC carries a small portfolio of excess securities.

Figure 52: NIMs now estimated to stabilize



Source: Company data, Deutsche Bank

However, valuations have taken a sufficient beating to factor in the severe decline in margins. From being traded at a substantial premium to the state-owned banks universe till FY05, OBC has been relegated to the bottom of the trading range. We set our 12m price target at Rs283/share based on the (RoE – g)/(CoE – g) model; note that the estimated RoEs used for the price target ignore the amortization charges for the goodwill arising out of the eGTB amalgamation – this is of a temporary nature.

GEMS: Asia India
Banking/Finance Banks

4 January 2007

PNB

Reuters: **PNBK.BO** Bloomberg: **PNB IN**

Recent panic reaction an opportunity

Quality of deposit franchise the mark of superiority
This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We are maintaining the Buy rating and increasing target price from Rs515 to Rs675.

Among the better-placed to grow net interest income
With a combination of dexterity in balance sheet management and franchise strength, PNB has delivered gravity-defying margins even when the rest of the sector was reeling under pressure. While excess securities – one key lever for increasing margins – cannot last indefinitely, the famed high CASA of ~48% and not-so-aggressive loan growth targets should continue to keep margins high. We have, however, factored in a correction from the present very high NIM.

Prior years' pension backlog nearly cleared
With accelerated provisioning for pension during FY05 and FY06, PNB has managed to close most of the gap between the current and future unit methods, for prior years. That makes it relatively better placed than most other state-owned banks. Also, there are nascent signs of (relatively) more conservative loan provisioning returning, and we expect that from 0.2% of incremental risk assets in FY06, annual provisioning is estimated to go up to 3.45% in FY09E.

Can retain premium valuations on high sustainable RoE
Our schematic RoE (part of the input for the price target calculation) is very close to current and estimated RoE – while we assume lower sustainable margins and higher provisions, there are improvements in cost ratios and non-interest income. Our price target based on (RoE – g)/(CoE – g) is Rs675/share. Inability to hold onto current low levels of funding costs and higher bad loan provisioning are key risks.

Forecasts and ratios

Year End Mar 31	2005A	2006A	2007E	2008E	2009E
Provisioning (INRm)	1,680.0	0.0	**4,477.6**	4,526.5	5,331.6
Pre-prov profit (INRm)	22,151.7	20,338.9	**32,147.0**	37,701.3	44,141.5
Net profit (INRm)	14,102.1	14,393.3	**18,815.2**	22,558.8	26,390.8
EPS (INR)	52.94	45.65	**59.67**	71.55	83.70
EPS growth (%)	26.7	-13.8	**30.7**	19.9	17.0
PER (x)	6.1	9.2	**8.6**	7.2	6.2
Price/book (x)	1.52	1.58	**1.49**	1.28	1.09
DPS (net) (INR)	6.54	9.00	**10.00**	11.00	12.00
Yield (net) (%)	2.0	2.1	**1.9**	2.1	2.3

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

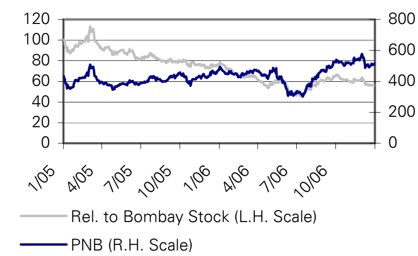
Buy

Price at 3 Jan 2007 (INR)	**515.80**
Price target - 12mth (INR)	**675.00**
52-week range (INR)	**576.80 - 303.45**
Bombay Stock Exchange (BSE 30)	**13,942**

Key changes

Price target	515.00 to 675.00	↑	**31.1%**
Provisioning (FYE)	3,127.0 to 4,477.6	↑	**43.2%**
Net int margin (FYE)	3.71 to 3.68	↓	**-0.7%**
Net profit (FYE)	16,404.7 to 18,815.2	↑	**14.7%**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-7.0*	*-1.7*	*8.9*
Bombay Stock Exchange (BSE 30)	*0.7*	*12.7*	*46.2*

Stock data

Market cap (INRm)	**162,633**
Market cap (USDm)	**3,676**
Shares outstanding (m)	**315.3**
Major shareholders	**Govt of India (57.8%)**
Free float (%)	**42**

Key indicators

ROE (%)	**18.6**
Loan/deposit ratio (%)	**69.0**
Book value/share (INR)	**345.48**
Price/book (x)	**1.5**
NPL/total loans (%)	**3.4**
Net int margin (%)	**3.68**

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

PNB

Reuters code	PNBK.BO

Buy

Price as at 02-Jan	Rs511.00
Target Price	Rs675.00

Company Website
http://pnbindia.com

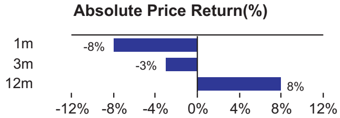
Company description

Punjab National Bank Limited operates over 3,879 bank branches in India. The Group's banks provide corporate and personal banking, industrial finance, agricultural finance, financing of trade and international banking.

Research Team

Dipankar Choudhury
+91 22 6658 4212 dipankar.choudhury@db.com

Absolute Price Return(%)



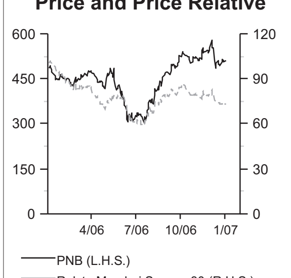
52-week Range:	Rs303.45 - Rs576.80
Market Cap (m):	Rs 161,120
	US$ 3,649

Company identifiers

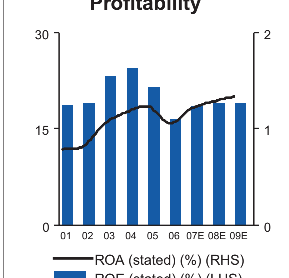
Bloomberg	PNB IN
Cusip	NA
SEDOL	6526759

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	21.84	26.50	31.75	41.79	52.94	45.65	59.67	71.55	83.70
EPS FD (stated) (Rs)	21.84	26.50	31.75	41.79	44.73	45.65	59.67	71.55	83.70
EPS FD (DB adj.) (Rs)	21.84	26.50	31.75	41.79	44.73	45.65	59.67	71.55	83.70
Growth Rate - EPS (stated) (%)	13.6	21.3	19.8	31.6	26.7	-13.8	30.7	19.9	17.0
DPS	2.50	3.00	3.50	4.00	6.54	9.00	10.00	11.00	12.00
BVPS (stated) (Rs)	125.76	151.53	152.01	188.91	258.84	297.38	345.48	404.33	474.21
BVPS (DB adj.) (Rs)	21.27	50.32	82.04	159.89	245.14	281.12	331.14	395.22	465.58
Average market cap (Rs m)	nm	nm	14,836	50,717	86,127	132,704	161,120	161,120	161,120
Shares in issue (m)	212	212	265	265	315	315	315	315	315
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	na	na	1.8	4.6	6.1	9.2	8.6	7.1	6.1
P/E FD (stated)	nm	nm	1.8	4.6	7.2	9.2	8.6	7.1	6.1
P/E FD (DB adj.)	na	na	1.8	4.6	7.2	9.2	8.6	7.1	6.1
P/B (stated)	nm	nm	0.67	1.77	1.52	1.58	1.48	1.26	1.08
P/B (DB adj.)	nm	nm	1.24	2.09	1.60	1.68	1.54	1.29	1.10
ROE (stated) (%)	18.8	19.1	23.2	24.5	21.4	16.4	18.6	19.1	19.1
ROA (stated) (%)	0.79	0.82	1.06	1.18	1.23	1.06	1.21	1.29	1.33
Dividend yield (%)	nm	nm	6.26	2.09	2.02	2.14	1.96	2.15	2.35
Dividend cover (x)	8.74	8.83	9.07	10.45	8.09	5.07	5.97	6.50	6.97
Payout ratio (%)	11.4	11.3	11.0	9.6	12.4	13.1	16.8	15.4	14.3
PROFIT & LOSS (Rs m)									
Net interest income	20,384	22,953	31,237	36,247	40,067	46,668	54,855	61,808	70,745
Non-interest income	7,583	10,129	11,176	18,977	17,241	3,412	9,130	10,231	11,170
Fees & Commissions	4,193	4,340	4,800	5,519	6,913	7,526	8,731	9,604	10,564
Trading revenue	2,904	5,072	5,645	12,554	5,429	-5,570	-1,064	-913	-1,015
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	30	280	237	303	186	113	122	132	142
Other revenue	456	437	493	601	4,713	1,342	1,342	1,409	1,479
Total revenue	27,968	33,082	42,413	55,224	57,308	50,080	63,984	72,039	81,915
Total Operating Costs	18,959	21,555	25,847	33,519	35,157	29,741	31,837	34,338	37,774
Pre-Provision profit / (loss)	**9,009**	**11,528**	**16,566**	**21,705**	**22,152**	**20,339**	**32,147**	**37,701**	**44,141**
Bad debt expense	3,258	3,913	4,730	4,010	1,680	0	4,478	4,527	5,332
Operating Profit	5,751	7,614	11,836	17,695	20,472	20,339	27,669	33,175	38,810
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	5,751	7,614	11,836	17,695	20,472	20,339	27,669	33,175	38,810
Tax	1,114	1,990	3,414	6,608	6,370	5,946	8,854	10,616	12,419
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**4,636**	**5,624**	**8,422**	**11,087**	**14,102**	**14,393**	**18,815**	**22,559**	**26,391**
DB adj. core earnings	**4,636**	**5,624**	**8,422**	**11,087**	**14,102**	**14,393**	**18,815**	**22,559**	**26,391**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	nm	493,375	565,824	657,388	813,376	940,295	1,212,778	1,513,108	1,746,611
Interest-earnings assets	587,956	682,439	817,065	974,715	1,215,190	1,397,202	1,581,351	1,775,966	1,999,269
Total loans	296,322	363,530	432,805	510,756	637,116	771,634	935,188	1,099,841	1,282,782
Total deposits	561,311	641,235	758,135	879,164	1,031,669	1,196,849	1,356,041	1,536,100	1,740,820
Stated Shareholder Equity	26,692	32,162	40,330	50,118	81,613	93,764	108,930	127,486	149,519
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	nm	31,280	40,230	46,083	72,146	94,594	106,008	124,665	146,799
Tier 1 ratio (%)	nm	6.34	7.11	7.01	8.87	10.06	8.74	8.24	8.40
Tangible equity / total assets (%)	4.20	4.41	4.68	4.90	6.46	6.45	6.60	6.86	7.14
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	11.68	11.39	11.51	9.14	5.87	4.07	3.37	3.05	2.89
Provisions / NPLs (%)	45.92	47.91	61.29	82.46	88.17	80.81	94.92	99.84	101.47
Bad debt chg / Avg loans (%)	1.22	1.19	1.19	0.85	0.29	0	0.52	0.44	0.45
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	26.1	12.6	36.1	16.0	10.5	16.5	17.5	12.7	14.5
Growth in fee income (%)	9.9	3.5	10.6	15.0	25.3	8.9	16.0	10.0	10.0
Growth in non-interest income (%)	3.1	33.6	10.3	69.8	-9.1	-80.2	167.6	12.1	9.2
Growth in revenues (%)	18.9	18.3	28.2	30.2	3.8	-12.6	27.8	12.6	13.7
Growth in costs (%)	16.9	13.7	19.9	29.7	4.9	-15.4	7.0	7.9	10.0
Pre-provision earnings growth (%)	**23.5**	**28.0**	**43.7**	**31.0**	**2.1**	**-8.2**	**58.1**	**17.3**	**17.1**
Growth in bad debts (%)	65.0	20.1	20.9	-15.2	-58.1	-100.0	nm	1.1	17.8
Growth in RWA (%)	nm	nm	14.7	16.2	23.7	15.6	29.0	24.8	15.4
Growth in loans (%)	24.6	22.7	19.1	18.0	24.7	21.1	21.2	17.6	16.6
Growth in deposits (%)	18.2	14.2	18.2	16.0	17.3	16.0	13.3	13.3	13.3
Loan-to-deposits ratio (%)	52.8	56.7	57.1	58.1	61.8	64.5	69.0	71.6	73.7
Net int. margin (%)	3.73	3.61	4.17	4.23	3.87	4.00	3.68	3.68	3.75
Cost income ratio (%)	67.8	65.2	60.9	60.7	61.3	59.4	49.8	47.7	46.1
Cost asset ratio (%)	3.2	3.2	3.2	3.6	3.1	2.2	2.1	2.0	1.9
Trading income / Total Rev (%)	10.4	15.3	13.3	22.7	9.5	-11.1	-1.7	-1.3	-1.2

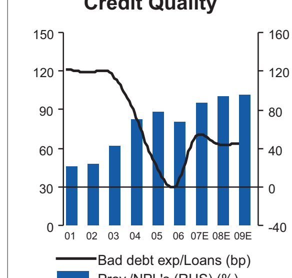
Price and Price Relative



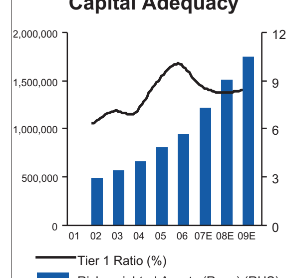
Profitability



Credit Quality



Capital Adequacy



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

PNB has delivered gravity-defying margins even when the rest of the sector was reeling under pressure. It has demonstrated a very effective combination of choosing a level of deposit growth to match credit demand, keeping the use of excess holdings of securities in mind, unmatched high CASA and increasing yield on loans. While excess securities – one key lever for increasing margins – cannot last indefinitely, the famed high CASA of ~48% and not-so-aggressive loan growth targets should continue to keep margins high. We have, however, factored in a correction from the present very high NIM, partly also due to the increased leverage. After a breather in FY06, fee income performance has shot back into prominence in FY07, and should be a key top-line driver as well.

With accelerated provisioning for pension during FY05 and FY06 – manifested in outsized opex ratios during these years – PNB has managed to close most of the gap between the current and future unit methods of accounting for pension liabilities, for prior years. It is, however, yet to begin the higher provisioning for future years, but nevertheless it is relatively better placed than most other state-owned banks. Excluding the added pension provisioning as and when it comes, the bank would enjoy major savings in opex from FY07E onwards compared with FY05/FY06.

Among large banks, PNB has managed to execute the most rapid improvement in asset quality to bring it to a level (gross NPLs 3.7%, net NPLs 0.2%) that is manageable enough and conducive to somewhat higher risk-taking. Provisioning charges have fallen with asset quality improvement, but perhaps PNB was also constrained in making high provisions in the last few quarters due to increased investment depreciation. With the treasury portfolio now corrected, brought down in absolute terms, and normal level of profitability returning, we expect conservatism in provisioning to increase: from 0.2% of incremental risk assets in FY06, annual provisioning is estimated to go up to 3.45% in FY09.

Valuation

Our schematic RoE (part of the input for the price target calculation) is very close to current and estimated RoE – while we assume lower sustainable margins and higher provisions, there are improvements in cost ratios and non-interest income. Our price target based on (RoE – g)/(CoE – g) is Rs675/share; we assume coverage with a Buy rating. PNB's price target also benefits from the low β of 1.09. The bank is comfortably capitalized – we expect Tier I to be 8.7% by Mar'07, as also enough government holding headroom to issue equity as and when required. A very high quality deposit franchise and conservatism in pension accounting have justifiably led to the stock trading at a premium to the state-owned banks sector.

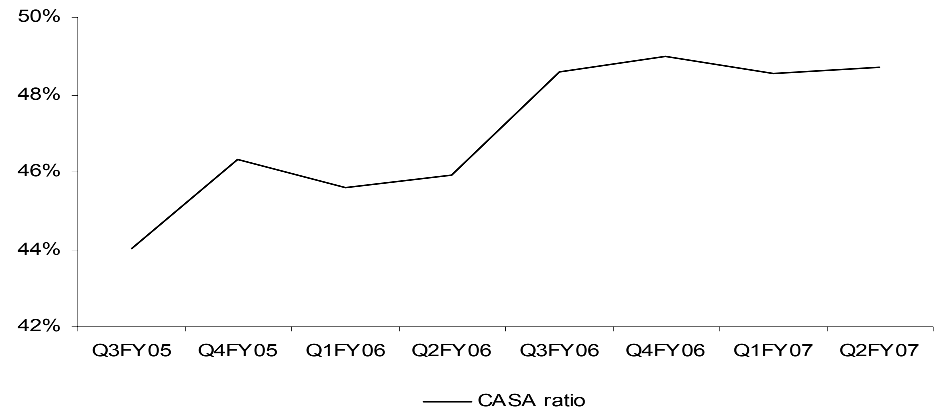
Risks

Inability to hold on to current low levels of funding costs, higher bad loan provisioning and miscalculation of the pension gap are key risks. Additionally, since PNB enjoys a low β of 1.09, increased stock volatility can be a risk – the stock tends to become more volatile in times of interest rate turmoil.

Franchise quality & NIMs

The quality of PNB's deposit network can be judged from the fact that when term deposit rates were *rising*, the CASA ratio also *increased*. This is a key, sustainable strength that will guard PNB against an uncontrolled increase in deposit costs if the liquidity situation were to worsen. Indeed, the cost of deposits has not gone anywhere in the last four quarters.

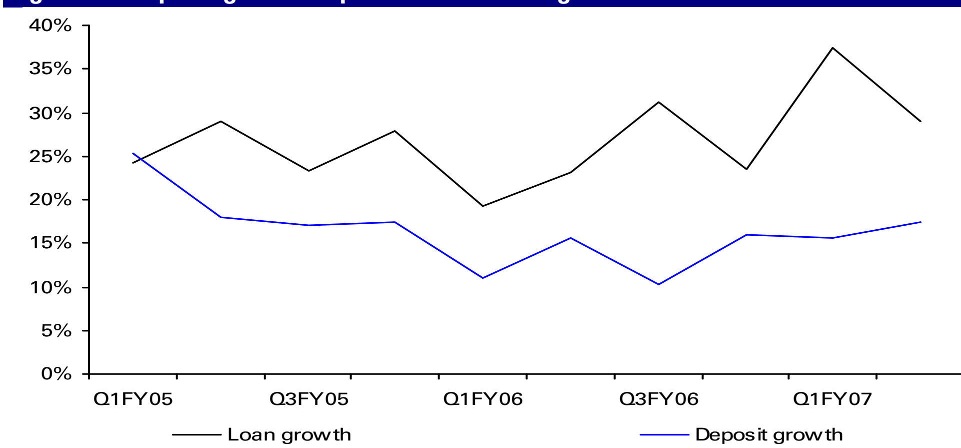
Figure 53: Rising low-cost deposit ratio



Source: Company data, Deutsche Bank

Further, to rein in cost of funds, PNB kept a gap between advances and deposit growth rates, because there was a buffer of excess holdings in government securities available. Though excess securities holdings were there among all large state-owned banks, not all were as adept at using them to increase lending profitably.

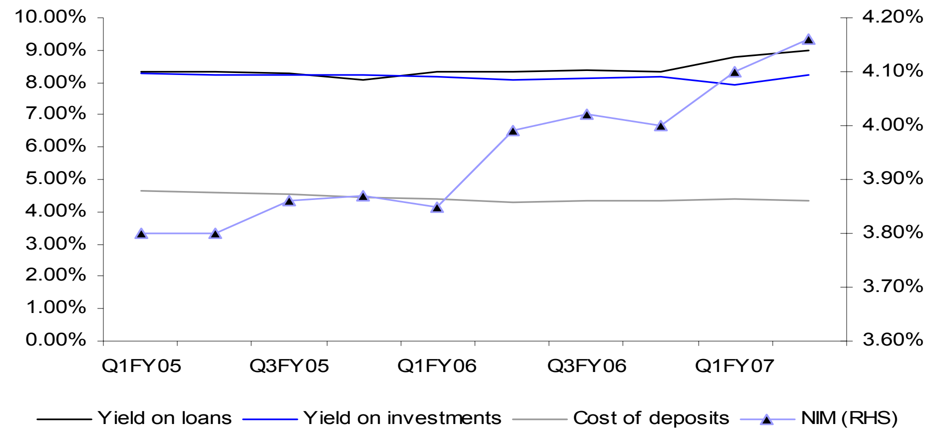
Figure 54: Deposit growth kept lower than loan growth due to excess securities



Source: Company data, Deutsche Bank

Also, fortunately for PNB, as yield on investments was falling due to a reduction in the high-interest bearing investments, simultaneously loan yields also started to rise, with changes in the asset mix as well as an increase in lending rates by all banks. A combination of all the above pushed up the NIMs to beyond everyone's expectations.

Figure 55: Control on funding costs and rise in lending rates improved NIMs



Source: Company data, Deutsche Bank

Relief in operating costs

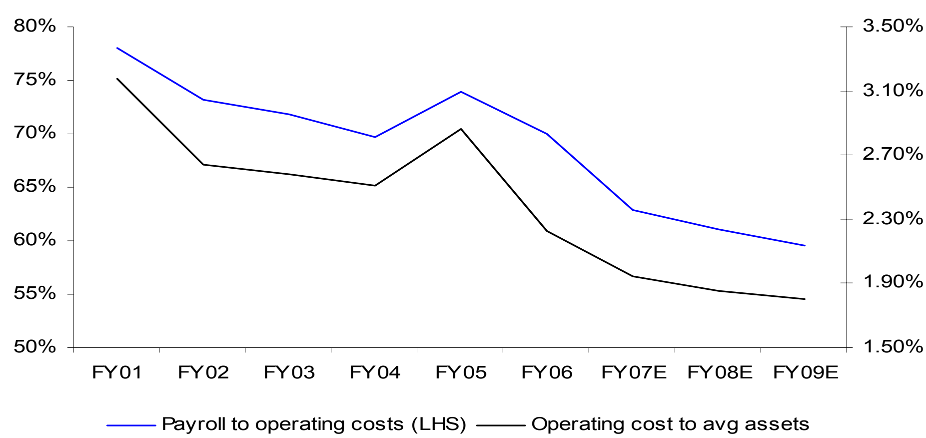
There were three key reasons for PNB's cost ratios being far too high compared with other state-owned banks, in the past. Firstly, not as many employees (as a % of total) took up the early separation proposal in FY01 as in other PSU banks. Secondly, PNB's rural branch network is nearly 50% of its total branches, as against 30-40% for other banks. Thirdly, in FY05 and FY06, PNB accelerated the pension liabilities provisioning to bring the Indian GAAP accounts compliant with the future unit method as against the permitted current unit method.

The excess employees problem, like for other PSU banks, will be alleviated naturally – assets are growing rapidly every year, but the employee strength has not moved an inch in the last six years – that situation should stay for 2-3 years more. The rural network is here to stay – it provides PNB will unparalleled cost of funds benefits even though that comes at an additional cost.

Through the additional provisioning in the last two fiscal years, PNB has been able to close most of the pension liability gap for the previous years. Like all other state-owned banks, it is yet to start providing as per the future unit method for the future years. The transition to the new accounting norm has not been made mandatory as yet, but this is expected to follow soon. As the gap in the system is very substantial, banks may be allowed a transition period (say five years).

In Q4FY06, PNB's auditors suggested the use of balance sheet reserves instead of the P&L account to cover the prior years' pension gap. As a result, even if some gap remains for prior years, it will be taken through the balance sheet rather than charged to profits. Hence if we were to ignore the additional provisioning required for the future years (which would have to await the RBI's directive), then the operating cost ratios are likely to decline.

Figure 56: Operating cost ratios expected to decline

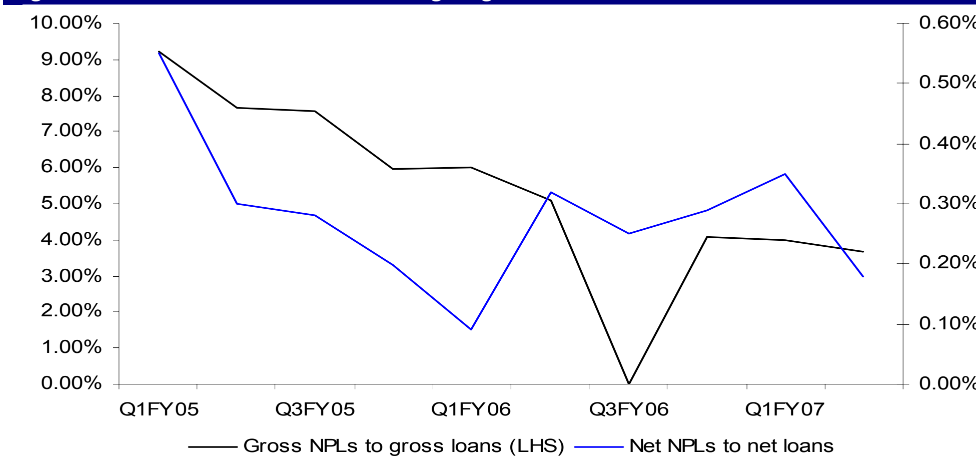


Source: Company data, Deutsche Bank

Commendable asset quality

PNB has nearly fully provided for its NPLs – the net NPLs as of September 2006 were 0.2%. Even gross NPLs at 3.7% is a low figure for such a large bank – in balance sheet terms, PNB is the third largest bank in India. Large banks, with legacy problem assets, have taken more time to bring NPLs to manageable levels. The decline in gross NPLs from 11.6% in March 2003 is particularly remarkable. For the last three years, the *absolute* value of gross NPLs has fallen.

Figure 57: Low NPL levels considering large size

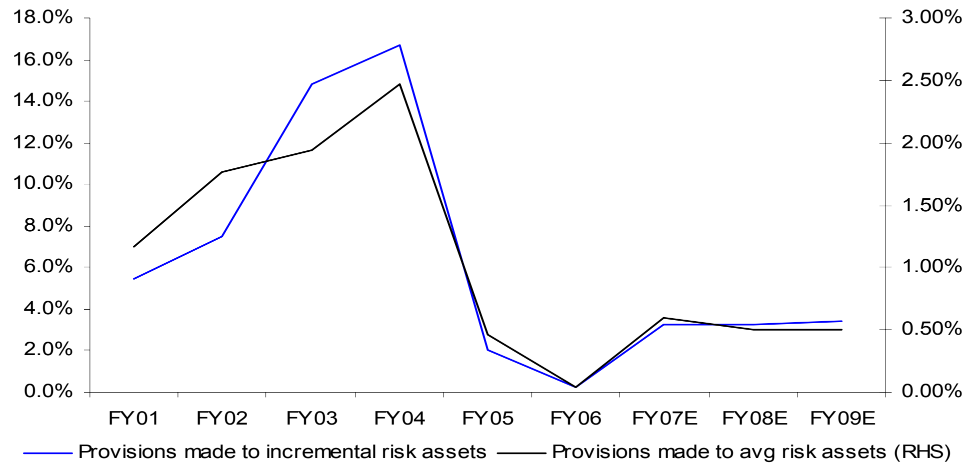


Source: Company data, Deutsche Bank

Of late, PNB (like other banks) has been seeing some releases of provisions and write-backs due to recoveries and upgradations. As a consequence, its per year provisioning levels have fallen. Some investors have expressed concern that going by PNB's size and the recent rapid loan growth, the bank may not be building enough cushion. There are nascent signs that this is likely to change. It was not as though the bank intended to report supernormal profits but we believe that PNB was constrained by bond hits in the recent past. With the treasury portfolio reduced and structurally amended, it is now in a better position to return to conservative provisioning. Perhaps it is not a mere coincidence that in Q2FY06 when the interest rate environment was very favourable, PNB ratcheted up NPL provisioning.

The provision charges to incremental and average risk assets, which reached a peak in FY04 – the year of mandated transition to the 90-day NPL recognition rule – have fallen to lowest-ever levels in FY06. From 0.2% and 0.04%, respectively, in FY06, our estimates factor in these parameters reaching 3.45% and 0.51%, respectively, in FY09E.

Figure 58: Conservative loan provisioning may return



Source: Company data, Deutsche Bank

GEMS: Asia India
Banking/Finance Banks

4 January 2007

Union Bank Of India

Reuters: **UNBK.BO** Bloomberg: **UNBK IN**

Concern on margins; downgrade to Hold

Downgrade on valuations and stagnation in margins
This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We are reducing the target price from Rs145 to Rs127, and downgrading from Buy to Hold.

Weak deposit franchise inhibits margin recovery
Lack of excess government securities for most part of the last year coupled with a comparatively weaker deposit franchise has driven interest margins down from 3.11% in H1FY06 to 2.85% in H1FY07. The CASA ratio at 33.5% is not good enough to drive high levels of growth profitably. Moreover, nearly 20% of the term deposits are on wholesale rates which are 50-100bps higher than retail rates.

Structurally very good on operating costs, fees rising rapidly
Union Bank's operating expenses to average assets ratio remains exemplary – 1.74% in FY06 and 1.62% in FY07E, with increases likely to be controlled by the upcoming centralised back office. On the basis of an estimated pension liability gap of Rs3bn (it is one of few banks declaring this number), the bank has already started making provisions assuming a 5-year amortisation period. Fee income performance, primarily driven by the highly profitable third-party distribution, has been stellar – it rose 23% YoY in FY06 and 30% in H1FY07.

Hold on valuations
We set our 12-month target price at Rs126/share, based on the (RoE – g)/(CoE – g) model. As a result, we downgrade the stock to Hold. The bank's leverage is poised to increase through effective utilisation of perpetual debt and reluctance to raise equity due to limited government ownership headroom. The main upside risk to our case is better margins due to improved cost of funds. A key downside risk is not being able to sustain the current momentum of fee growth.

Forecasts and ratios

Year End Mar 31	2005A	2006A	**2007E**	2008E	2009E
Provisioning (INRm)	2,164.6	1,555.0	**1,334.5**	1,963.8	2,310.6
Pre-prov profit (INRm)	8,280.5	10,176.9	**13,362.1**	16,598.3	19,265.7
Net profit (INRm)	7,190.6	6,751.9	**7,938.2**	9,805.1	11,359.9
EPS (INR)	15.63	14.58	**15.72**	19.41	22.49
EPS growth (%)	1.0	-6.7	**7.8**	23.5	15.9
PER (x)	7.2	8.1	**7.8**	6.3	5.4
Price/book (x)	1.44	1.35	**1.20**	1.05	0.92
DPS (net) (INR)	3.50	3.50	**3.80**	4.20	4.20
Yield (net) (%)	3.1	3.0	**3.1**	3.4	3.4

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

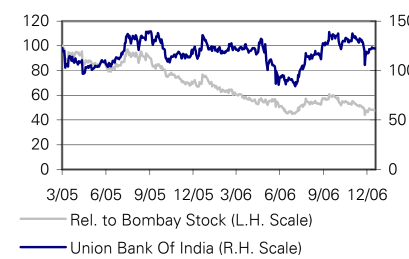
Hold

Price at 3 Jan 2007 (INR)	**122.25**
Price target - 12mth (INR)	**127.00**
52-week range (INR)	**138.90 - 84.15**
Bombay Stock Exchange (BSE 30)	**13,942**

Key changes

Rating	Buy to Hold ↓	
Price target	145.00 to 127.00 ↓	**-12.4%**
Provisioning (FYE)	4,256.7 to 1,334.5 ↓	**-68.6%**
Net int margin (FYE)	3.10 to 2.76 ↓	**-11.2%**
Net profit (FYE)	9,320.2 to 7,938.2 ↓	**-14.8%**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-7.7*	*-9.2*	*0.6*
Bombay Stock Exchange (BSE 30)	*0.7*	*12.7*	*46.2*

Stock data

Market cap (INRm)	**61,751**
Market cap (USDm)	**1,396**
Shares outstanding (m)	**505.1**
Major shareholders	**Govt of India (55.4%)**
Free float (%)	**45**

Key indicators

ROE (%)	**16.4**
Loan/deposit ratio (%)	**75.8**
Book value/share (INR)	**101.50**
Price/book (x)	**1.2**
NPL/total loans (%)	**2.7**
Net int margin (%)	**2.76**

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

UNBK

Reuters code UNBK.BO

Hold

Price as at 02-Jan	Rs122.35
Target Price	Rs127.00

Company Website
http://www.unionbankofindia.com

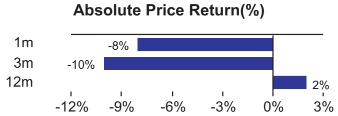
Company description

Union Bank of India Limited provides a full range of banking services throughout India. The Group's activitiies include retaill banking, commercial and personal banking, investment management, treasury and NRI services, cash management and assorted ATM facilities. The Group has over 2,000 branches throughout India.

Research Team

Dipankar Choudhury
+91 22 6658 4212 dipankar.choudhury@db.com

Absolute Price Return(%)

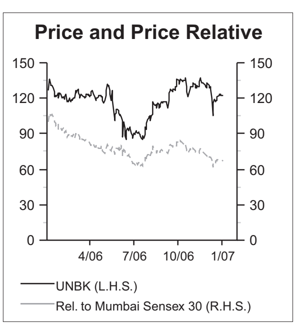


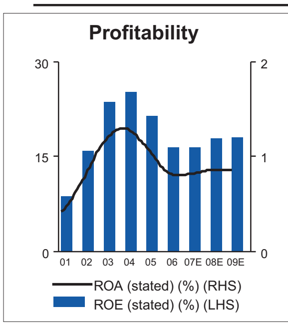
52-week Range:	Rs84.15 - Rs138.90
Market Cap (m):	Rs 61,801
	US$ 1,400

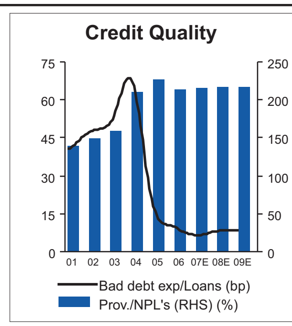
Company identifiers

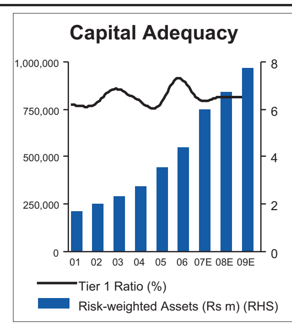
Bloomberg	UNBK IN
Cusip	NA
SEDOL	6579634

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	4.60	9.29	13.85	15.48	15.63	14.58	15.72	19.41	22.49
EPS FD (stated) (Rs)	4.60	9.29	12.01	15.48	15.63	13.37	15.72	19.41	22.49
EPS FD (DB adj.) (Rs)	4.60	9.29	12.01	15.48	15.63	13.37	15.72	19.41	22.49
Growth Rate - EPS (stated) (%)	53.6	102.1	49.0	11.7	1.0	-6.7	7.8	23.5	15.9
DPS	0.92	1.33	2.10	3.50	3.50	3.50	3.80	4.20	4.20
BVPS (stated) (Rs)	54.70	62.34	55.79	67.09	78.55	90.24	101.50	116.00	133.58
BVPS (DB adj.) (Rs)	3.88	7.79	17.79	38.19	45.19	64.51	80.06	95.38	113.58
Average market cap (Rs m)	nm	nm	7,968	19,598	37,756	55,004	61,801	61,801	61,801
Shares in issue (m)	338	338	460	460	460	505	505	505	505
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	na	na	1.4	2.8	5.3	8.1	7.8	6.3	5.4
P/E FD (stated)	nm	nm	1.7	2.8	5.3	8.9	7.8	6.3	5.4
P/E FD (DB adj.)	na	na	1.7	2.8	5.3	8.9	7.8	6.3	5.4
P/B (stated)	nm	nm	0.45	0.79	1.44	1.35	1.21	1.05	0.92
P/B (DB adj.)	nm	nm	1.41	1.38	2.50	1.89	1.53	1.28	1.08
ROE (stated) (%)	8.6	15.9	23.7	25.2	21.5	16.5	16.4	17.9	18.0
ROA (stated) (%)	0.42	0.75	1.16	1.30	1.10	0.84	0.82	0.86	0.86
Dividend yield (%)	nm	nm	10.52	8.22	4.27	2.95	3.11	3.43	3.43
Dividend cover (x)	5.00	6.98	6.60	4.42	4.47	4.17	4.14	4.62	5.35
Payout ratio (%)	20.0	14.3	17.5	22.6	22.4	26.2	24.2	21.6	18.7
PROFIT & LOSS (Rs m)									
Net interest income	12,190	13,366	14,977	17,362	20,646	23,743	25,665	30,194	35,412
Non-interest income	2,940	4,827	8,336	8,569	1,980	3,199	4,914	5,592	5,834
Fees & Commissions	1,213	1,292	1,425	1,555	1,769	2,178	2,505	2,805	3,142
Trading revenue	1,063	2,577	5,839	5,793	-1,411	-601	555	748	448
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	0	0	0	0	0	0	0	0	0
Other revenue	664	958	1,072	1,221	1,623	1,621	1,854	2,040	2,244
Total revenue	15,130	18,193	23,313	25,931	22,626	26,942	30,579	35,787	41,246
Total Operating Costs	10,488	10,416	10,848	11,295	14,345	16,765	17,217	19,188	21,980
Pre-Provision profit / (loss)	**4,643**	**7,777**	**12,465**	**14,636**	**8,281**	**10,177**	**13,362**	**16,598**	**19,266**
Bad debt expense	2,308	3,216	4,175	6,436	2,165	1,555	1,334	1,964	2,311
Operating Profit	2,335	4,561	8,290	8,200	6,116	8,622	12,028	14,634	16,955
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	2,335	4,561	8,290	8,200	6,116	8,622	12,028	14,634	16,955
Tax	780	1,420	2,763	1,080	-1,075	1,870	4,089	4,829	5,595
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**1,555**	**3,141**	**5,527**	**7,121**	**7,191**	**6,752**	**7,938**	**9,805**	**11,360**
DB adj. core earnings	**1,555**	**3,141**	**5,527**	**7,121**	**7,191**	**6,752**	**7,938**	**9,805**	**11,360**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	211,246	248,575	294,198	342,823	443,622	550,563	749,230	839,845	967,494
Interest-earnings assets	363,453	415,355	486,224	555,633	693,001	854,910	1,007,088	1,172,486	1,353,278
Total loans	183,605	224,654	266,509	303,984	415,053	547,250	666,120	781,348	906,115
Total deposits	348,881	397,939	447,486	505,589	618,306	740,943	878,984	1,037,847	1,206,656
Stated Shareholder Equity	18,488	21,070	25,668	30,871	36,144	45,581	51,267	58,592	67,472
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	13,076	15,312	20,182	22,181	26,928	40,301	47,894	54,812	63,265
Tier 1 ratio (%)	6.19	6.16	6.86	6.47	6.07	7.32	6.39	6.53	6.54
Tangible equity / total assets (%)	4.74	4.75	5.03	5.29	4.99	5.11	4.88	4.79	4.80
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	11.20	10.77	8.96	7.72	4.96	3.83	2.67	2.19	1.81
Provisions / NPLs (%)	41.58	44.71	47.58	62.92	68.03	64.11	64.79	65.19	65.09
Bad debt chg / Avg loans (%)	1.35	1.58	1.70	2.26	0.60	0.32	0.22	0.27	0.27
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	27.4	9.7	12.0	15.9	18.9	15.0	8.1	17.6	17.3
Growth in fee income (%)	6.5	6.5	10.3	9.1	13.7	23.1	15.0	12.0	12.0
Growth in non-interest income (%)	-4.5	64.2	72.7	2.8	-76.9	61.5	53.6	13.8	4.3
Growth in revenues (%)	19.6	20.2	28.1	11.2	-12.7	19.1	13.5	17.0	15.3
Growth in costs (%)	11.4	-0.7	4.1	4.1	27.0	16.9	2.7	11.5	14.6
Pre-provision earnings growth (%)	**43.4**	**67.5**	**60.3**	**17.4**	**-43.4**	**22.9**	**31.3**	**24.2**	**16.1**
Growth in bad debts (%)	14.8	39.3	29.8	54.2	-66.4	-28.2	-14.2	47.2	17.7
Growth in RWA (%)	18.7	17.7	18.4	16.5	29.4	24.1	36.1	12.1	15.2
Growth in loans (%)	16.8	22.4	18.6	14.1	36.5	31.9	21.7	17.3	16.0
Growth in deposits (%)	12.2	14.1	12.5	13.0	22.3	19.8	18.6	18.1	16.3
Loan-to-deposits ratio (%)	52.6	56.5	59.6	60.1	67.1	73.9	75.8	75.3	75.1
Net int. margin (%)	3.43	3.31	3.20	3.24	3.31	3.03	2.76	2.77	2.80
Cost income ratio (%)	69.3	57.3	46.5	43.6	63.4	62.2	56.3	53.6	53.3
Cost asset ratio (%)	2.8	2.5	2.3	2.1	2.2	2.1	1.8	1.7	1.7
Trading income / Total Rev (%)	7.0	14.2	25.0	22.3	-6.2	-2.2	1.8	2.1	1.1









Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

Union Bank's loan growth has been at the higher end of the sector for the last two years. Lack of excess government securities for most part of the last year coupled with a comparatively weaker deposit franchise has driven interest margins down from 3.11% in H1FY06 to 2.85% in H1FY07. Union Bank's CASA ratio at 33.5% (Sep'06) is not good enough to drive high levels of growth profitably. Moreover, nearly 20% of the term deposits are on 'bulk' (wholesale) rates which are 50-100bps higher than retail rates. The bank's depositor base comprises, *inter alia*, traders, who generally do not keep idle balances for too long.

The bank's operating expenses to average assets ratio remains exemplary – 1.74% in FY06 and 1.62% in FY07E, with increases likely to be controlled by the upcoming centralised back office. In the last six years to FY06, the bank's branch and employee strength have reduced by 2.5% and 16.3% respectively, and loans have risen 256%. On the basis of an estimated pension liability gap of Rs3bn (it is one of few banks declaring this number), the bank has already started making provisions assuming a 5-year amortization period.

Fee income performance, primarily driven by the highly profitable third-party distribution, has been stellar – it rose 23% YoY in FY06 and 30% in H1FY07.

The bank is poised to enjoy higher leverage in the coming years through effective utilisation of perpetual debt and reluctance to raise equity due to limited government ownership headroom (though this strategy cannot be extended indefinitely). Our computations show that taking only the perpetual debt raised in Oct'06 into consideration, factoring in operational risk and some top-ups of Tier II capital, Union Bank's total CAR is still likely to be 12.0% by March'08. Expected moderation in loan growth also reduces capital needs.

Valuation

We set our 12-month target price at Rs127/share, based on the (RoE – g)/(CoE – g) model (resulting P/BV from the formula multiplied by Mar'09E adjusted book value). Except very recently, Union Bank traded at a slight premium to peer banks as recognition of its superior operating expenses profile and the relatively higher leverage which drives the RoE up. Controlling further erosion to margins is the key to sustaining these valuations.

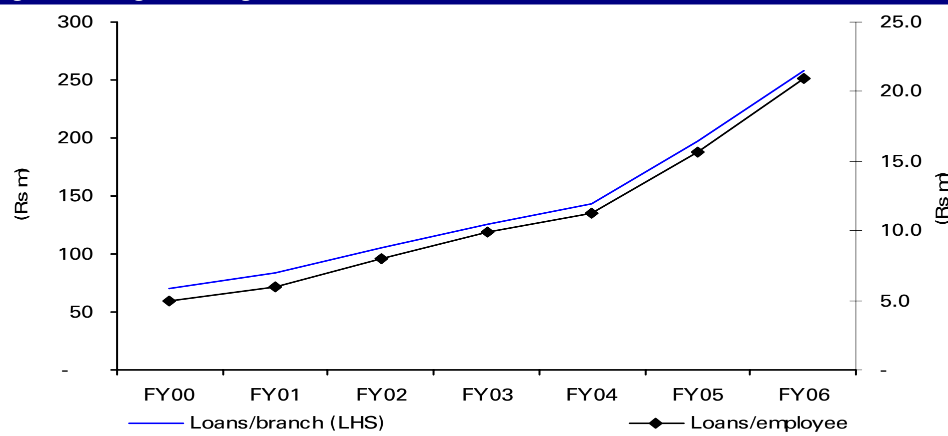
Risks

Substantially faster-than-current rates of growth in new accounts, moderation of asset growth and better margins due to improved cost of funds are upside risks to our case. A key downside risk is not being able to sustain the current momentum of fee growth, if distribution fees were to decline due to a fall in the financial markets. The present CEO is slated to be there for the next four years or until further directive from the government – management instability could de-rate the stock.

Noteworthy cost structure

Union Bank's operating cost ratios have improved consistently over the last 5 years, even in FY06 which saw the conclusion of a wage agreement (involving payment of higher wages and arrears pertaining to earlier years). This has been the result of dogged pursuit of higher volumes of business with the existing (actually reducing) resources. From FY00 to FY06, loans outstanding grew by 256%, whereas number of branches fell by 2.5%. The more remarkable decline has been in the number of employees over the same period – 16.3%. Union Bank was also one of the earlier ones among PSU banks to roll out core technology applications which could have facilitated cost reduction. These have resulted in cost to average assets ratio falling from 2.61% in FY00 to 1.74% in FY06.

Figure 59: Significant growth within the same infrastructure

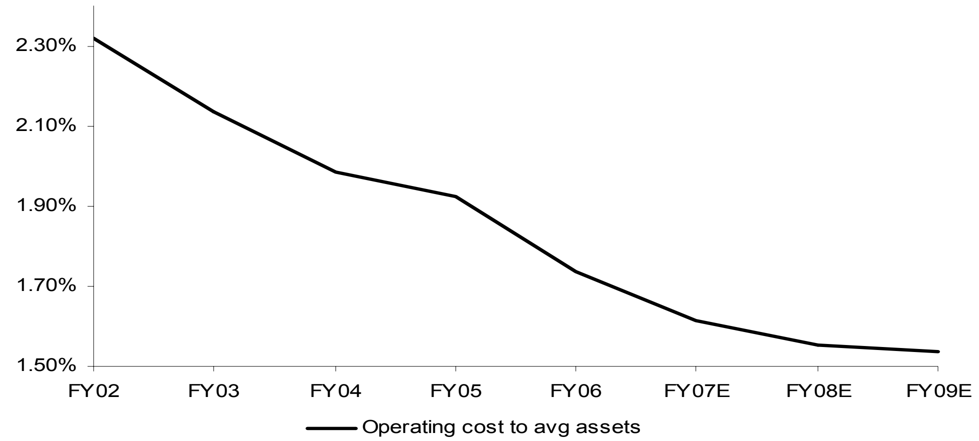


Source: Company data, Deutsche Bank

Of course, the flip side of stagnation in the branch network has been inability to scale up low cost deposits to higher levels, required for profitable growth. The good news is that the bank is seeking to leverage technology for more float products and increase the number of new accounts opened per branch to rectify this problem, instead of increasing the infrastructure per se.

The management has informed us that they are in the process of setting up a centralised back office in central Mumbai to shift clerical work out of branches, a process that has been delayed considerably. This should keep a further check on operating costs – or rather free up employee time to do more value added work.

Figure 60: Steady decline in operating cost to assets



Source: Company data, Deutsche Bank

Liabilities need robustness

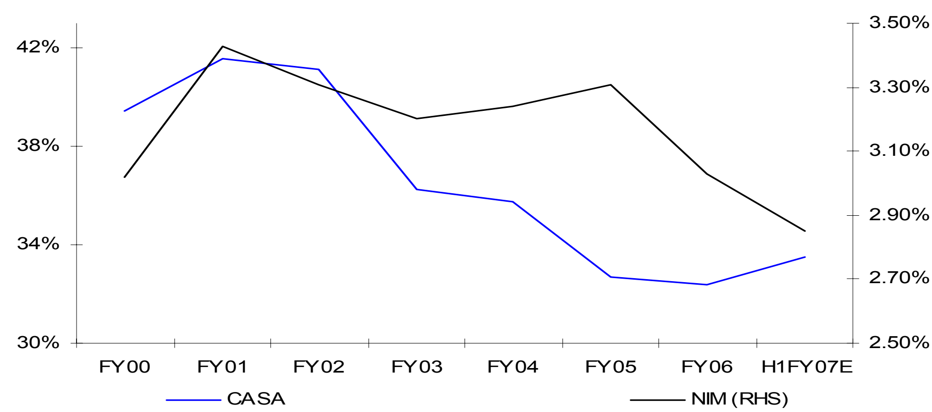
Excess holdings of government securities which could be sold to feed credit growth and high yields on long tenor bonds had kept Union Bank's margins healthy in the region of 3.25% during FY02-FY05. Thereafter NIM declined to 3.03% in FY06 and 2.85% in H1FY07, the latter being at the lower end of the sector. During this period, investment yields declined due to maturity of high coupon bonds, excess investments were wound down to low levels and deposit costs rose.

Union Bank needs to work very hard on its liabilities franchise to sustain and improve these margins. Being a small bank, it is generally a price-taker on the asset side. Its CASA ratio at 33.5% (Sep'06), though marginally up over the last year, is not satisfactory enough to drive high levels of growth in the ensuing difficult environment for deposits. Moreover, 20% of the term deposits are at wholesale rates which are 50-100bps higher than the card rates. Some relief may come during H2FY07 due to the impact of the redemption of the 12.5% subordinated debt, but that was just Rs6bn and not a long-lasting relief.

The fact that not much focus has gone into the liabilities franchise over the years is evident from a steady decline in CASA.

We do understand that the management has taken this task very seriously and the CEO is monitoring the progress of CASA himself regularly. However, building out CASA is a time-consuming exercise and results will be visible in years, not months. Notwithstanding that, asset growth moderation in the interim should relieve some of the pressure. For example, we expect loan to deposit ratio to stabilise around 74% as against the unsustainably high 80% reported in Q2FY07.

Figure 61: Weak CASA has been a major cause for lower NIMs

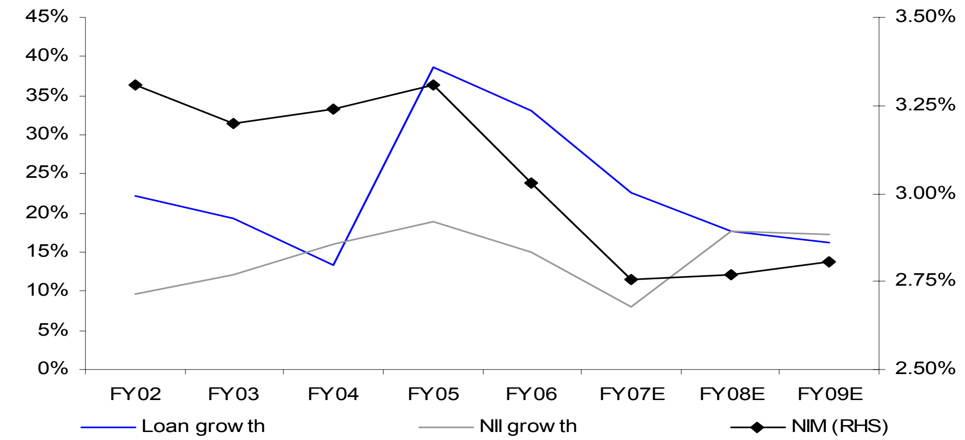


Source: Company data, Deutsche Bank

Financials

An 18.8% CAGR in loans and modest recovery in margins are expected to drive NII by 14.3% CAGR over FY06-09E. NII growth is likely to resume its double digit course of the last four years in FY08E after a likely break in FY07E due to fall in margins.

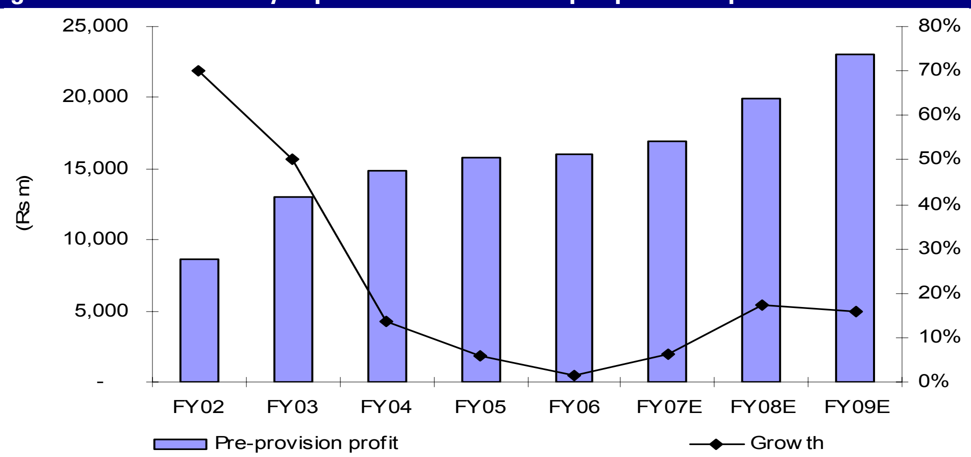
Figure 62: Loan growth the mainstay of NII growth



Source: Company data, Deutsche Bank

We believe the control on operating costs like in the past should sustain – more so since the bank has already started making provisions for the transition to future liability based pension accounting. We estimate a 13.0% CAGR in pre-provision profits during FY06-FY09E.

Figure 63: Some recovery expected in the trend of pre-provision profits

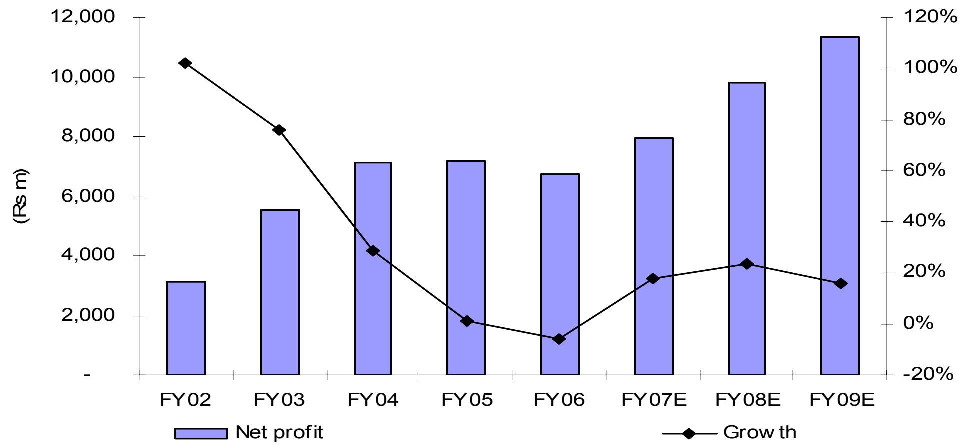


Source: Company data, Deutsche Bank

A major fillip to net profit is expected to come from reduced investment provisioning since Union Bank no longer maintains excess securities that need to be kept as available-for-sale and become vulnerable to investment depreciation.

Finally, we expect a net profit CAGR of 18.9% between FY06-FY09E. Note that we expect the effective tax rate to move towards the marginal rate of 33%, now that the bank is unlikely to get substantial savings out of investment losses, infrastructure lending and the irregular tax writebacks that it has enjoyed in the past.

Figure 64: Net profit growth to recover marginally



Source: Company data, Deutsche Bank

GEMS: Asia India
Banking/Finance

4 January 2007

UTI Bank

Reuters: **UTBK.BO** Bloomberg: **UTIB IN**

Great growth traction; initiate with Buy

Solid standing built in a relatively short period of time
We initiate coverage on UTI Bank with a Buy and target price of Rs530. UTI Bank is the third-largest private sector bank in India with a predominantly retail focus. Within a relatively short period of time, the bank has built up an impressive deposit network as well as augmented its loan origination capabilities.

High quality resource profile built within a short time
UTI Bank's single-minded pursuit of a retail-driven business model has enabled it to scale up CASA from 23% to 40% in just three years, through increased ATMs, float-generating government business and rising throughput of the cash management business. Like HDFC Bank, UTI Bank has also adopted the product route to CASA, in the absence of a large branch network. From 1.68% in FY02, NIM has reached 2.85% in FY06 and 2.92% in Q2FY07.

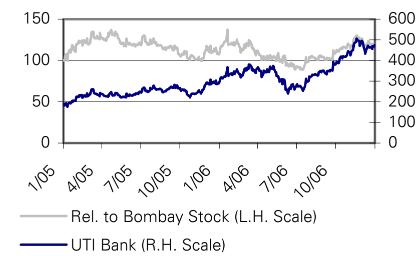
Adding more growth engines to the ones already faring well
After attaining a retail focus, UTI Bank worked on 'normalising' the retail asset composition which was initially truck finance-dominated, but now mortgages top the list. Car finance, which the bank was doing rather diffidently due to excessive competition, has once again become viable, with better pricing. Traction on fee income (41.5% CAGR during FY02-FY06) shows no sign of a slowdown. Farm credit and the international business – Singapore is already functional – will be added growth drivers now.

Strong earnings momentum; succession the key risk
We initiate coverage with a Buy and price target of Rs530 based on a FY09E P/E of 18x (ie Mar 09E diluted EPS multiplied by 18x). The greatest valuation risk is a less dynamic, government-appointed CEO taking over after the incumbent retires in July'07, as the major shareholder SUUTI, has the power to nominate a CEO. It is however likely that the Board will oppose such a move, going by the track record of its past decisions.

Buy

Price at 3 Jan 2007 (INR)	**474.95**
Price target - 12mth (INR)	**530.00**
52-week range (INR)	**505.35 - 240.10**
Bombay Stock Exchange (BSE 30)	**14,015**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-3.4*	*24.9*	*64.1*
Bombay Stock Exchange (BSE 30)	*1.2*	*13.3*	*46.9*

Stock data

Market cap (INRm)	**132,364**
Market cap (USDm)	**2,984**
Shares outstanding (m)	**278.7**
Major shareholders	**SUUTI (27%)**
Free float (%)	**57**

Key indicators

ROE (%)	**18.9**
Loan/deposit ratio (%)	**63.3**
Book value/share (INR)	**119.66**
NPL/total loans (%)	**1.4**
Net interest margin (%)	**2.8**

Forecasts and ratios

Year End Mar 31	2005A	2006A	**2007E**	2008E	2009E
Provisioning(INRm)	30.4	1,270.6	**836.2**	1,252.2	1,623.5
Pre-prov profit (INRm)	5,067.4	8,583.6	**9,612.1**	11,668.6	14,042.8
Net profit (INRm)	3,345.8	4,850.9	**5,879.9**	6,979.0	8,320.9
EPS (INR)	14.38	18.94	**21.10**	25.04	29.86
PER (x)	11.1	14.5	**22.5**	19.0	15.9
Book value/share (INR)	87.96	103.06	**119.66**	139.64	163.87
DPS (net) (INR)	2.80	3.50	**4.00**	4.50	5.00
Yield (net)(%)	1.7	1.3	**0.8**	0.9	1.1

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Model updated: 3 January 2007

Equity Research

Asia

India

Banking/Finance

UTI Bank

Reuters code UTBK.BO

Buy

Price as at 02-Jan	Rs467.45
Target Price	Rs530.00

Company Website
http://www.utibank.com

Company description

UTI Bank is a new generation private sector bank set up in 1995

Research Team

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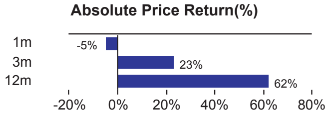
+91 22 6658 4212 dipankar.choudhury@db.com

Absolute Price Return(%)



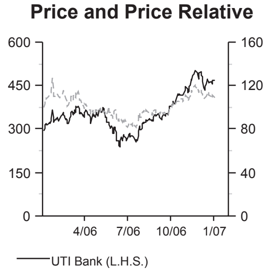
52-week Range:	Rs240.10 - Rs505.35
Market Cap (m):	Rs 131,317
	US$ 2,974

Company identifiers

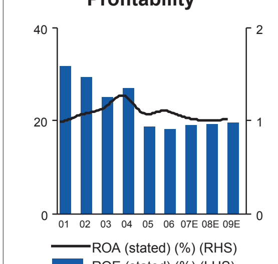
Bloomberg	UTIB IN
Cusip	NA
SEDOL	6136482

Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	6.53	8.29	9.11	12.05	14.38	18.94	21.10	25.04	29.86
EPS FD (stated) (Rs)	6.53	6.99	8.35	12.02	14.06	17.14	20.78	24.66	29.40
EPS FD (DB adj.) (Rs)	6.53	6.99	8.35	12.02	14.06	17.14	20.78	24.66	29.40
Growth Rate - EPS (stated) (%)	69.1	26.9	9.9	32.3	19.3	31.7	11.4	18.7	19.2
DPS	1.84	1.50	2.07	2.50	2.80	3.50	4.00	4.50	5.00
BVPS (stated) (Rs)	22.85	32.05	39.88	49.07	87.96	103.06	119.66	139.64	163.87
BVPS (DB adj.) (Rs)	9.10	22.38	32.85	44.23	78.67	95.25	110.96	131.89	157.72
Average market cap (Rs m)	5,045	4,905	8,216	20,452	37,275	70,016	131,317	131,317	131,317
Shares in issue (m)	132	192	230	232	274	279	279	279	279
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	5.9	3.7	4.3	7.3	11.1	14.4	22.2	18.7	15.7
P/E FD (stated)	5.9	4.3	4.7	7.4	11.4	15.9	22.5	19.0	15.9
P/E FD (DB adj.)	5.9	4.3	4.7	7.4	11.4	15.9	22.5	19.0	15.9
P/B (stated)	1.07	1.24	1.01	2.99	2.75	3.46	3.91	3.35	2.85
P/B (DB adj.)	2.70	1.78	1.22	3.32	3.08	3.74	4.21	3.54	2.96
ROE (stated) (%)	31.8	29.3	25.1	27.1	18.9	18.4	18.9	19.3	19.7
ROA (stated) (%)	0.99	1.07	1.13	1.27	1.08	1.11	1.04	1.00	1.02
Dividend yield (%)	4.80	4.94	5.32	2.82	1.75	1.28	0.86	0.96	1.07
Dividend cover (x)	3.56	5.53	4.39	4.82	5.14	5.41	5.27	5.56	5.97
Payout ratio (%)	28.1	21.4	24.8	23.5	26.2	23.2	21.3	20.2	18.8
PROFIT & LOSS (Rs m)									
Net interest income	983	1,995	3,224	5,771	7,312	10,782	14,718	18,141	21,854
Non-interest income	1,617	4,172	4,095	5,359	4,195	7,262	8,117	9,683	11,295
Fees & Commissions	863	976	1,438	1,824	3,305	4,889	6,845	8,556	10,267
Trading revenue	677	3,154	2,618	3,442	411	2,133	990	838	736
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	0	0	0	0	0	0	0	0	0
Other revenue	78	42	39	93	479	240	283	289	292
Total revenue	2,599	6,167	7,319	11,130	11,507	18,045	22,835	27,824	33,149
Total Operating Costs	1,339	2,114	3,417	4,401	6,439	9,461	13,223	16,155	19,106
Pre-Provision profit / (loss)	**1,260**	**4,053**	**3,902**	**6,730**	**5,067**	**8,584**	**9,612**	**11,669**	**14,043**
Bad debt expense	216	1,920	890	2,436	30	1,271	836	1,252	1,624
Operating Profit	1,045	2,134	3,012	4,294	5,037	7,313	8,776	10,416	12,419
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	1,045	2,134	3,012	4,294	5,037	7,313	8,776	10,416	12,419
Tax	183	792	1,090	1,511	1,691	2,462	2,896	3,437	4,098
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	**861**	**1,341**	**1,922**	**2,783**	**3,346**	**4,851**	**5,880**	**6,979**	**8,321**
DB adj. core earnings	**861**	**1,341**	**1,922**	**2,783**	**3,346**	**4,851**	**5,880**	**6,979**	**8,321**
KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	90,231	111,537	139,423	141,645	274,463	385,983	533,593	657,832	768,372
Interest-earnings assets	101,776	136,655	184,781	226,656	348,810	469,936	592,178	711,619	827,828
Total loans	48,655	54,490	72,468	95,255	156,972	224,709	322,488	409,092	488,492
Total deposits	90,922	122,872	169,647	209,539	317,120	401,135	509,749	606,532	703,060
Stated Shareholder Equity	3,015	6,148	9,181	11,364	24,082	28,721	33,347	38,915	45,668
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	5,269	7,161	8,979	9,122	24,345	28,022	37,557	43,125	49,878
Tier 1 ratio (%)	5.84	6.42	6.44	6.44	8.87	7.26	7.04	6.56	6.49
Tangible equity / total assets (%)	2.80	4.28	4.68	4.71	6.38	5.78	5.24	5.15	5.21
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	4.64	5.18	3.16	2.88	1.98	1.67	1.39	1.26	1.22
Provisions / NPLs (%)	19.66	34.29	29.23	59.15	30.30	41.86	46.05	58.23	71.13
Bad debt chg / Avg loans (%)	0.51	3.72	1.40	2.90	0.02	0.67	0.31	0.34	0.36
GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	8.7	103.1	61.6	79.0	26.7	47.5	36.5	23.3	20.5
Growth in fee income (%)	92.8	13.2	47.3	26.9	81.2	47.9	40.0	25.0	20.0
Growth in non-interest income (%)	77.3	158.0	-1.9	30.9	-21.7	73.1	11.8	19.3	16.7
Growth in revenues (%)	43.2	137.3	18.7	52.1	3.4	56.8	26.5	21.8	19.1
Growth in costs (%)	76.8	57.8	61.6	28.8	46.3	46.9	39.8	22.2	18.3
Pre-provision earnings growth (%)	**19.1**	**221.7**	**-3.7**	**72.5**	**-24.7**	**69.4**	**12.0**	**21.4**	**20.3**
Growth in bad debts (%)	-20.5	790.7	-53.6	173.7	-98.8	nm	-34.2	49.8	29.6
Growth in RWA (%)	47.0	23.6	25.0	1.6	93.8	40.6	38.2	23.3	16.8
Growth in loans (%)	37.6	12.0	33.0	31.4	64.8	43.2	43.5	26.9	19.4
Growth in deposits (%)	59.0	35.1	38.1	23.5	51.3	26.5	27.1	19.0	15.9
Loan-to-deposits ratio (%)	53.5	44.3	42.7	45.5	49.5	56.0	63.3	67.4	69.5
Net int. margin (%)	1.11	1.68	2.09	3.12	2.90	2.85	2.77	2.78	2.84
Cost income ratio (%)	51.5	34.3	46.7	39.5	56.0	52.4	57.9	58.1	57.6
Cost asset ratio (%)	1.5	1.7	2.0	2.0	2.1	2.2	2.3	2.3	2.3
Trading income / Total Rev (%)	26.0	51.1	35.8	30.9	3.6	11.8	4.3	3.0	2.2

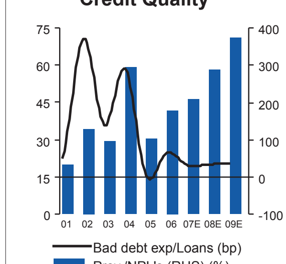
Price and Price Relative



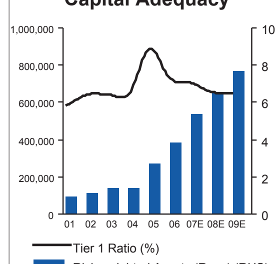
Profitability



Credit Quality



Capital Adequacy



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

For two years in a row now UTI Bank has evinced a penchant for loading up on short-term, low yielding assets in the first quarter, face a margin crunch, and steadily recover all of it during the course of the year. We believe this an opportunistic step and not a strategy. We are estimating a mild margin recovery in the coming years (intra-year volatility in margins has been quite high).

The key characteristic of the 29.5% CAGR loan growth (FY06-FY09E) that we are estimating is that the gap between retail and non-retail growth rates is likely to narrow. Firstly, the retail business is maturing on a relative basis, and there is some recovery of corporate demand. In the next three years, we expect SMEs, international business and farm credit to make significant contributions to growth.

Our financial projections are on the conservative side due to three reasons: the expected slowdown in lending across the sector, the requirement to top up Tier I capital from time to time (which can be done through non-dilutive perpetual debt) and increased provisioning. Net interest income is estimated to grow at 26.6% CAGR FY06-FY09E, fee income at 28.1%, and net profit CAGR a healthy 19.7% during FY06-FY09E.

Valuation

Our 12m price target of Rs530/share is based on a P/E of 18x on FY09E (Mar'09E) diluted EPS. In the light of 19.5% CAGR in diluted EPS estimated (FY06-FY09E), the P/E to growth ratio is a shade below 1.0x, like for other private banks in our universe. As with other fast growing new generation private banks, the Gordon Growth formula tends to understate the fair value. However, if that were to be used, the fair value would be Rs292.

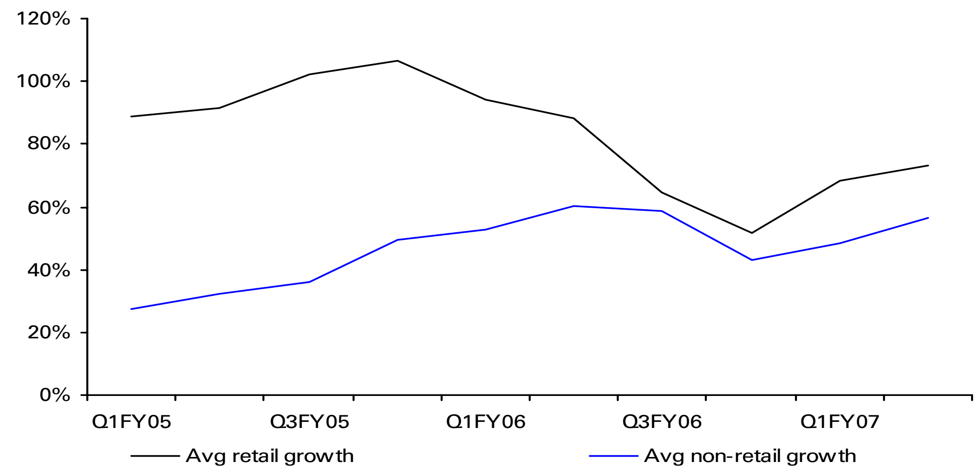
Risks

The succession issue is indeed the most prominent risk; if the current CEO were to continue then the stock's current rating can be easily sustained. Margin volatility is another risk – UTI Bank's margins have not been like the steady margins of HDFC Bank. The third risk is scaling up the international business – Indian banks have regularly faced regulatory roadblocks and country-specific obstacles in this process.

All-round growth

There are nascent signs of the loan growth becoming more broad-based. This is due to a recovery in corporate loan demand, more so from the non-AAA segments that the bank focuses on. This will gain momentum as UTI Bank scales up the international business and farm credit.

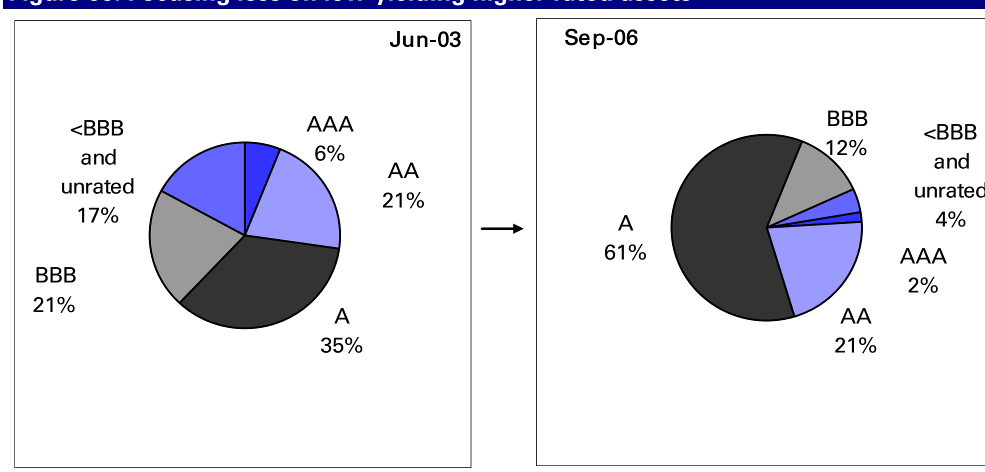
Figure 65: Loan growth no longer solely retail-driven



Source: Company data, Deutsche Bank

The strategic shift in the corporate asset composition is now almost complete. For this part of the business, UTI Bank is now less vulnerable to disintermediation than before.

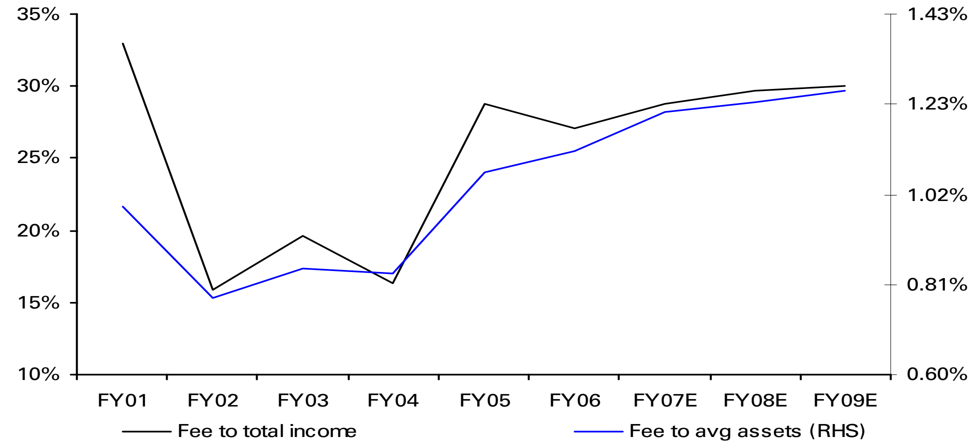
Figure 66: Focusing less on low-yielding higher-rated assets



Source: Company data, Deutsche Bank

Other than the regular retail assets and liabilities-linked fees, there are a few relatively recent products that will drive fee income in the coming years – government business and bancassurance.

Figure 67: Galloping fee income



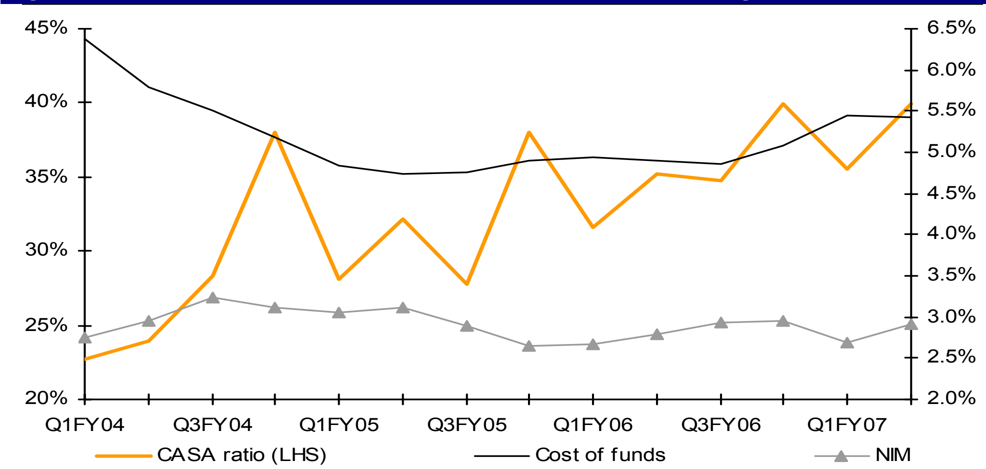
Source: Company data, Deutsche Bank

Both farm credit and international business will be big challenges for UTI Bank. The former is a regulatory necessity, and the bank has become too large to depend on purchase of farm assets at the end of the year to satisfy priority lending norms. UTI Bank is trying to do farm credit through the traditional brick-and-mortar way, which is cost-intensive but as a side benefit generates a lot of CASA. Perhaps the rural strategy (being an RBI priority) is one of the reasons UTI Bank has not faced a branch licencing problem in the recent past.

Stable profitability expected

Even without a large branch network, UTI Bank has been able to commendably increase its CASA in the last three years through the products route. More rural branches and increased volumes in the government business and bancassurance should help in maintaining this high CASA and keep funding cost increases under control. NIM volatility across quarters, which has been a consequence of opportunistic access to some short-term low-yielding assets from time to time, is likely to reduce going forward. Profitability will also be stabilized by faster growth of fee income which are more profitable than the asset business.

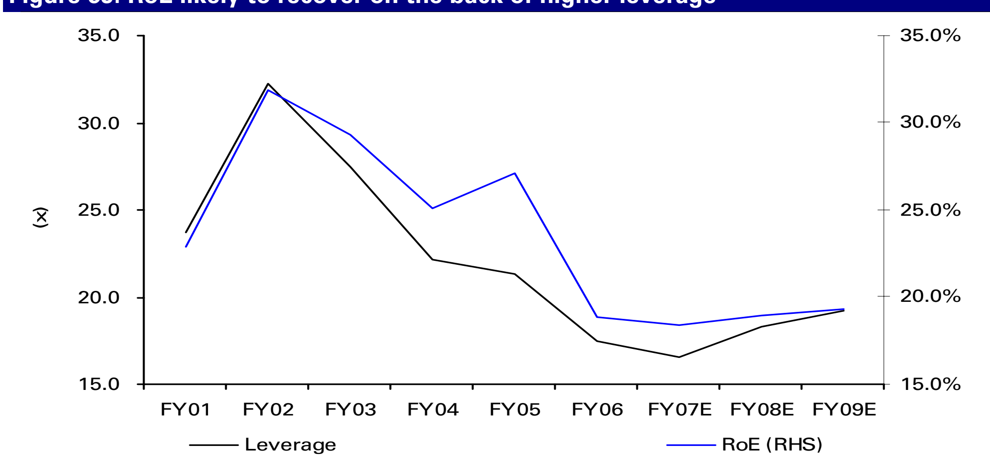
Figure 68: Remarkable rise in CASA has kept a control on funding costs



Source: Company data, Deutsche Bank

One reason for UTI Bank's RoE being constrained is the need to top up Tier I through equity from time to time. Now we expect the leverage to expand as the bank is likely to access perpetual debt (one issue already done). In a perverse sense, till the ownership issue is sorted out UTI Bank will find it difficult to raise equity and that benefits the leverage.

Figure 69: RoE likely to recover on the back of higher leverage



Source: Company data, Deutsche Bank

Who succeeds Dr Nayak?

Dr Nayak's term expires in July 2007, and it can be extended. Newspaper reports suggest that he is not interested in continuing, but going by the respect he enjoys in the organization, he could be persuaded to continue. In that case the issue closes.

Dr Nayak, who was originally a bureaucrat, has spent several years in the financial sector. His tenure of a decade in UTI Bank has seen the bank painstakingly but successfully moving from the rather fragile pure wholesale business model to retail (also assiduously adopted by ICICI Bank), so much so that at one point in time it topped the sector in the number of ATMs!

UTI Bank's shareholding and Board composition puts it in a peculiar position. While there are state-owned and private banks, this bank falls in the twilight zone. It was founded by the erstwhile UTI (then India's largest mutual fund, state-owned) and the state-owned insurance companies. The former, now in a transformed entity called SUUTI, holds the maximum equity stake of 27% and nominates three Board members. Life Insurance Corporation nominates one member and the rest of the Board is independent.

Though in every respect UTI Bank has functioned as a private sector bank, there have been occasional fissures at the top because of the ownership issue – a quasi-government status although not statutorily so. A year ago, there was a move to split the post of the Chairman and the Managing Director, both held by Dr Nayak. The Board showed exemplary support to the cause of the organization and the idea was dropped, but only after much media mudslinging. Of late too, there has been a war over the use of the UTI brand name.

The matter does not end there, more confusion can follow. As per the government's own assertion, the SUUTI will be wound up, and the stake in UTI Bank will be sold. Though the government is naturally inclined to sell it to a public sector entity, as per RBI norms no one can hold more than 10%, and one candidate LIC already owns about 9%. There is no timeline for this. The Articles of the bank state that *as long as* SUUTI is a shareholder, they will nominate three directors.

The bank's Articles stipulate that SUUTI will nominate the CEO, but the Board followed by the RBI would have to ratify the appointment. The possibility of a non-professional, government-appointed representative taking over as CEO cannot be precluded, though it is very likely that the Board will not support such a move. If it were to happen, it could imply serious de-rating, as the bank will then be seen as susceptible to government interference (an exaggerated parallel – but remember the valuation difference between private and PSU banks, and some years ago UTI Bank also traded near PSU bank valuations before being re-rated).

It is implausible that a person of Dr Nayak's vision did not think of succession planning (the Executive Director is also scheduled to retire shortly, indeed before Dr Nayak). The most rational explanation for that is that since the prerogative of nominating a CEO rests with SUUTI, an internal exercise of succession planning could not assume due importance.

Appendix 1

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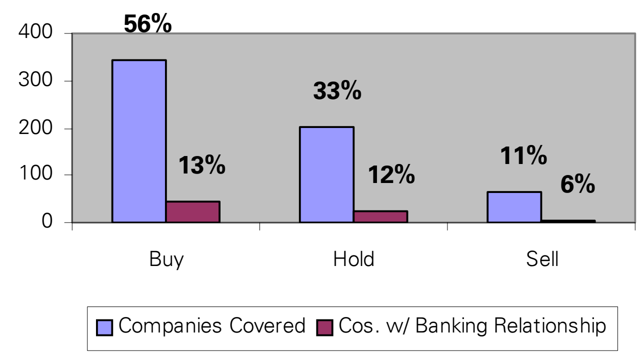

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