

## Union Bank of India

STOCK INFO.	BLOOMBERG
BSE SENSEX: 12,462	UNBK IN
	REUTERS CODE
S&P CNX: 3,693	UNBK.BO

8 May 2006

Buy

*Previous Recommendation: Buy*

Rs132

		YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
		END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
Equity Shares (m)	505.1	3/06A	29,994	6,752	13.4	-14.5	9.9	1.6	11.4	16.3	0.8	1.8
52-Week Range	149/99	3/07E	33,477	8,761	17.3	29.8	7.6	1.4	11.2	17.5	0.9	1.5
1,6,12 Rel.Perf.(%)	0/-36/-66	3/08E	38,724	10,278	20.3	17.3	6.5	1.2	10.9	18.0	0.9	1.3
M.Cap. (Rs b)	66.8											
M.Cap. (US\$ b)	1.5											

4QFY06 earnings declined 40% YoY to Rs1.4b due to lower 7% YoY net interest income (NII) growth and higher provisioning (mark-to-market impact on the non-SLR book). Also, on a QoQ basis, asset quality deteriorated sharply with gross NPAs increasing 10% to Rs21b and net NPAs rising 50% to Rs8.3b, as the bank wrote back floating provisions. For FY06, the bank reported 6% earnings decline due to lower treasury income and higher tax provisions compared with FY05.

- ✍ Strong growth in loans and deposits
- ✍ Margins declined in 4QFY06 and FY06
- ✍ Non-interest income declined as treasury profits fell sharply
- ✍ Asset quality disappointing
- ✍ Investment 'hits' on the bank's non-SLR book

Union Bank has been one of the fastest growing state-owned banks in our banking universe. It has already created a strong technology platform and now has 75% of its business under core banking solutions (CBS). This should help the bank maintain strong growth going forward. However, margin pressure and Tier I capital adequacy ratio (CAR) of just 7.3% (post-capital raising) are key concerns. The stock trades at 1.2x FY08E BV and 6.5x FY08E EPS. Maintain **Buy**.

**QUARTERLY PERFORMANCE**

(RS MILLION)

	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Income	11,658	11,931	12,888	13,221	13,578	14,202	15,135	15,723	49,698	58,638
Interest Expense	6,992	7,363	7,092	7,606	8,230	8,179	8,741	9,744	29,052	34,894
<b>Net Interest Income</b>	<b>4,667</b>	<b>4,568</b>	<b>5,796</b>	<b>5,615</b>	<b>5,347</b>	<b>6,023</b>	<b>6,394</b>	<b>5,979</b>	<b>20,646</b>	<b>23,743</b>
% Change (Y-o-Y)	6.4	8.2	28.0	32.9	14.6	31.9	10.3	6.5	18.9	15.0
Other Income	2,348	1,611	1,914	1,788	1,337	1,403	1,390	2,122	7,661	6,251
<b>Net Income</b>	<b>7,015</b>	<b>6,179</b>	<b>7,709</b>	<b>7,403</b>	<b>6,684</b>	<b>7,426</b>	<b>7,784</b>	<b>8,100</b>	<b>28,307</b>	<b>29,994</b>
% Change (Y-o-Y)	27.1	-1.1	22.1	-2.5	-4.7	20.2	1.0	9.4	10.2	6.0
Operating Expenses	3,085	3,094	3,774	2,622	3,153	3,855	3,501	3,515	12,575	14,024
<b>Operating Profit</b>	<b>3,930</b>	<b>3,085</b>	<b>3,936</b>	<b>4,781</b>	<b>3,531</b>	<b>3,571</b>	<b>4,283</b>	<b>4,585</b>	<b>15,732</b>	<b>15,970</b>
Other Provisions	1,006	658	4,145	3,806	647	2,690	1,302	2,384	9,616	7,024
Tax Provisions	820	320	-800	-1,415	480	270	690	755	-1,075	2,195
<b>Net Profit</b>	<b>2,104</b>	<b>2,107</b>	<b>591</b>	<b>2,389</b>	<b>2,404</b>	<b>611</b>	<b>2,291</b>	<b>1,446</b>	<b>7,191</b>	<b>6,752</b>
% Change (Y-o-Y)	35.0	24.0	-60.6	1.1	14.3	-71.0	287.8	-39.5	1.0	-6.1
Cost to Income Ratio (%)	44.0	50.1	49.0	35.4	47.2	51.9	45.0	43.4	44.4	46.8
Interest Expense/Interest Income (%)	60.0	61.7	55.0	57.5	60.6	57.6	57.8	62.0	58.5	59.5
Other Income/Net Income (%)	33.5	26.1	24.8	24.2	20.0	18.9	17.9	26.2	27.1	20.8

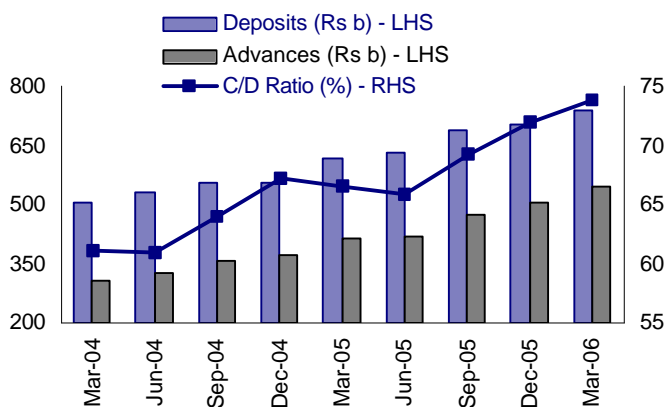
E: MOST Estimates

4QFY06 earnings declined 40% YoY to Rs1.4b due to lower 7% YoY NII growth and higher provisioning (mark-to-market impact on the non-SLR book). Also, on a QoQ basis, asset quality deteriorated sharply with gross NPAs increasing 10% to Rs21b and net NPAs rising 50% to Rs8.3b, as the bank wrote back floating provisions. For FY06, the bank recorded 6% earnings decline due to lower treasury income and higher tax provisions compared with FY2005.

**Strong loan and deposit growth**

The bank’s loan book has grown 33% to Rs546b. Deposits grew 20% to Rs741b. Union Bank is probably one of the few state-owned banks that has been successful in raising deposits even in the current scenario, wherein deposit raising is becoming challenging. Demand Deposit portfolio has grown by 18.7% to Rs240b in FY06. Demand Deposits account for 32.4% of total deposits.

STRONG LOAN AND DEPOSIT GROWTH



Source: Company / Motilal Oswal Securities

Retail Loans during the year grew from Rs85b to Rs115b, representing an increase of 35% YoY. Retail Loans now account for 21.1% of total advances. Home Loans saw healthy growth during the year and the portfolio is now at Rs.46b, with growth of 49% over the previous year’s level of Rs31b.

Priority Sector Lending stood at Rs222b in FY06 compared with Rs186b (FY05) recording growth of 20%. Agriculture Lending stood at Rs81b as on FY06 compared with Rs61b

(FY05), registering growth of 32%. Advances to small and medium enterprises (SME) stood at Rs68b as of FY06 compared with Rs55b (FY05), registering growth of 23%.

**Margins decline in 4QFY06 and FY06**

Net interest income grew by a modest 6.5% YoY to Rs5.98b in 4QFY06 on a reported basis, as funding costs for the bank increased due to (1) a liquidity squeeze in the system and (2) re-pricing of the investment book. However, both in 4QFY05 and 4QFY06, the bank had a one-off interest (on income-tax refund) of Rs510m and Rs179m; respectively. Adjusting for this, NII growth in 4QFY06 on YoY basis was a healthy 14%.

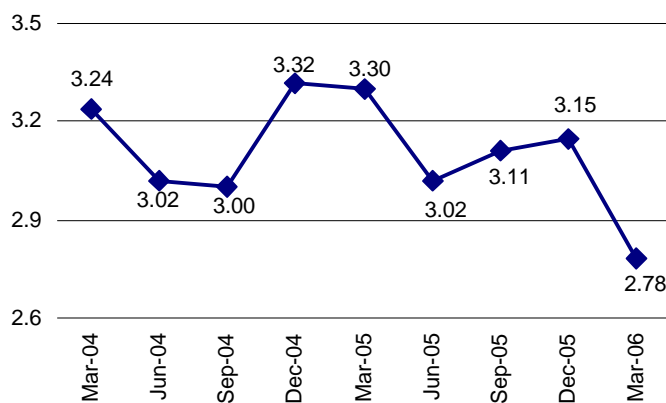
MARGINS (%)

	4QFY05	4QFY06	FY05	FY06
Yield on Advances	8.08	7.88	8.33	8.18
Yield on Investments	8.31	7.76	8.20	7.84
Cost of Deposits	5.08	5.19	4.97	4.75
NIMs	3.30	2.78	3.31	3.03

Source: Company / Motilal Oswal Securities

Margin pressure, as can be seen in the table above, is more visible in 4QFY06, as liquidity in the system was low and UBI not only faced downward pressure on the asset yields but cost of deposits also increased, resulting in YoY margins falling by 52bp to 2.78%. With the bank’s SLR ratio close to the statutory minimum requirement of 25% (UBI’s SLR is 26%), the bank did not have adequate flexibility to raise funds by selling/borrowing against excess SLR. This led to further margin pressure in 4QFY06.

TREND IN NIMS (%)



Source: Company / Motilal Oswal Securities

We believe that as currently, liquidity pressure has eased, funding costs are unlikely to increase for UBI, at least in the shorter term. Further with the bank already having effected a PLR hike, yield on loans are likely to improve. This could result in improvement in margins going forward, on the base of 4QFY06. Management expects to at least maintain the FY06 margins of 3.03% in FY07 as well.

### Non-interest income declines as treasury profits fall sharply

Treasury income was substantially impacted in 4QFY06 as well as in FY06, as yields hardened. Treasury income fell 38% YoY to Rs200m in 4QFY06 and by 63% in FY06 to Rs950m.

Overall, in FY06, non-interest income declined 18% to Rs6.25b due to a sharp fall in treasury income; non-interest income excluding treasury profits grew merely 4.7% to Rs5.3b in FY06. Core fee income in FY06 has grown by 23% to Rs3.62b.

### Asset quality disappoints

The key negative in 4QFY06 was sharp deterioration in asset quality. Gross NPAs increased QoQ to 3.84% from 3.75%; the rise in net NPAs was even higher as it increased 1.6%, as against 1.15% in 3QFY06. The bank has reversed some floating provision to minimize the mark-to-market impact on the non-SLR investment book.

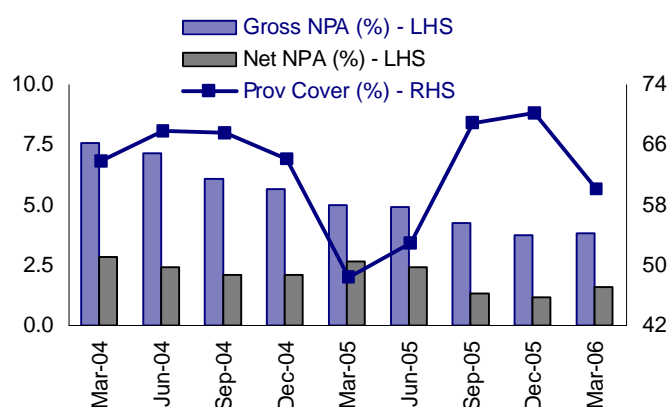
However, according to management, most of these NPAs are technical in nature and hence are likely to get reversed in the first couple of quarters of FY07. Management has also stated that the bank has written-off some Rs12.5b worth of NPAs in FY06 and they expect to recover substantial NPAs in FY07.

#### NPA MOVEMENT (RS M)

	FY05	FY06
Opening Gross NPA	23,470	20,580
Total Reduction	7,980	7,120
Recovery Upgradation	4,900	4,340
Write-off	3,080	2,780
Slippages	5,090	7,520
Net Reduction	2,890	-400
Closing Gross NPA	20,580	20,980
Net NPA	10,600	8,340
Gross NPA Ratio (%)	5.0	3.8
Net NPA Ratio (%)	2.6	1.6
Provision Cover Ratio (%)	48.5	60.2

Source: Company / Motilal Oswal Securities

#### MOVEMENT OF NPAS (%)



Source: Company / Motilal Oswal Securities

### Investment hits on non-SLR book

While Union Bank has been one of the best positioned banks in a rising interest rate environment (95% of its SLR book is in the held-to-maturity HTM, category), it also had to provide for a mark-to-market hit of Rs820m in 4QFY06 on its non-SLR (corporate bond) book as yields moved up sharply in the last fortnight of FY06. Currently, 95% of the bank's SLR book is in HTM. The bank has a cushion of 30bp (from 31 March 2006 levels) on the available-for-sale (AFS) category, with a modified duration of 2.66 years.

**UBI hikes PLR by 50bp**

Union Bank has recently raised its PLR by 50bp to 11.75%. We believe that this increase in PLR will ease the downward asset yield pressure that the bank has been witnessing for some time now.

**Tier I still at 7.3%**

Even post-capital raising, Tier I capital is a mere 7.3%. After accounting for Basel II norms, we believe that Tier I capital could reduce to 6.5%. Whilst management has ruled out any dilution in the near term, as it would first avail capital

through hybrid instruments, we believe the bank might require capital during the latter part of the year.

**Strong business momentum, Maintain Buy**

Union Bank is one of the fastest growing state-owned banks in our banking universe. It has already created a strong technology platform and now has 75% of its business under CBS, which should help the bank maintain strong growth ahead. However margin pressure and Tier I CAR of just 7.3% (post-capital raising) are key concerns. The stock trades at 1.2x FY08E BV and 6.5x FY08E EPS. We maintain **Buy**.

## Union Bank of India: an investment profile

### Company description

Union Bank is amongst the large state-owned banks with a balance sheet size of over Rs800b+. While the bank is based in western India, its branch network of over 2,082 branches and 473 ATMs is well spread countrywide. 718 branches and 60 extension counters (EC) located in 213 centers are designated to be part of CBS, which contributes to around 75% of the bank's total business.

### Key investment arguments

- ✍ Strong focus on loan growth, with an incremental loan/deposit ratio of over 90%
- ✍ Has networked 718 branches under core banking solution (2<sup>nd</sup> highest after PNB)
- ✍ Strong and expanding technology platform to ensure robust fee income going forward

### Key investments risks

- ✍ Tier-1 capital adequacy of 7.3% constrains significant asset expansion.

### Recent developments

- ✍ Post recent public issue of 45m shares through 100% book-building route, government's stake has come down to 55.43%.
- ✍ Dena Bank chairman and managing director M. V. Nair has taken over as CMD of UBI on 1 April 2006.
- ✍ UBI recently introduced a Rs4b Tier-II capital bond issue, with a greenshoe option of Rs4b. This was oversubscribed by the participants.

### Valuation and view

- ✍ We expect earnings to grow 30% in FY07 and 17% in FY08. Stronger momentum in core earnings will result in better valuations for the stock.
- ✍ The stock is trading at 1.2x FY08E BV of 6.5x FY08E earnings. The bank has declared total dividend of Rs3.5 per share in FY06.

### Sector view

- ✍ Loan growth of 30% in FY06. Likely to remain strong in FY07.
- ✍ Volatility in interest rates would impact treasury.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

#### COMPARATIVE VALUATIONS

		UBI	BOI	VIJAYA BANK
P/E (x)	FY07E	7.6	8.8	9.1
	FY08E	6.5	7.3	7.1
P/ABV (x)	FY07E	1.5	1.6	1.3
	FY08E	1.3	1.3	1.2
RoE (%)	FY07E	17.5	16.4	14.2
	FY08E	18.0	17.3	16.5
RoA (%)	FY07E	0.9	0.7	0.7
	FY08E	0.9	0.7	0.8

#### SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	55.4	60.9	60.9
Domestic Institutions	6.6	5.1	4.2
FII's/FDIs	20.0	18.4	18.3
Others	18.0	15.6	16.6

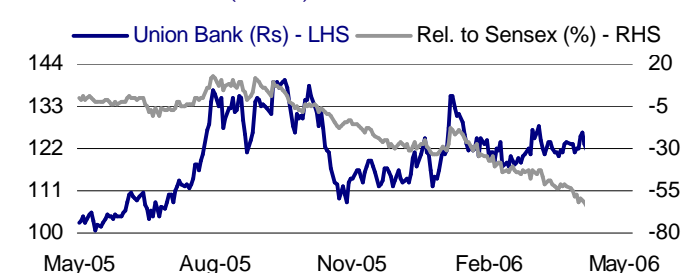
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	17.3	20.3	-14.8
FY08	20.3	24.3	-16.3

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
132	156	18.0	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E March	2004	2005	2006E	2007E	2008E
Interest Income	45,163	49,698	58,638	71,472	83,886
Interest Expended	27,801	29,052	34,894	44,056	52,169
<b>Net Interest Income</b>	<b>17,362</b>	<b>20,646</b>	<b>23,743</b>	<b>27,415</b>	<b>31,717</b>
Change (%)	15.9	18.9	15.0	15.5	15.7
Other Income	8,315	7,661	6,251	6,062	7,007
<b>Net Income</b>	<b>25,677</b>	<b>28,307</b>	<b>29,994</b>	<b>33,477</b>	<b>38,724</b>
Change (%)	10.6	10.2	6.0	11.6	15.7
Operating Expenses	10,846	12,575	14,024	15,896	17,784
<b>Operating Income</b>	<b>14,831</b>	<b>15,732</b>	<b>15,970</b>	<b>17,581</b>	<b>20,940</b>
Change (%)	13.7	6.1	15	10.1	19.1
Other Provisions	6,630	9,616	7,024	5,900	7,050
<b>PBT</b>	<b>8,200</b>	<b>6,116</b>	<b>8,946</b>	<b>11,681</b>	<b>13,890</b>
Tax	1,080	-1,075	2,195	2,920	3,611
Tax Rate (%)	13.2	-17.6	24.5	25.0	26.0
<b>PAT</b>	<b>7,120</b>	<b>7,191</b>	<b>6,752</b>	<b>8,761</b>	<b>10,278</b>
Change (%)	28.8	1.0	-6.1	29.8	17.3
Proposed Dividend	1,817	1,821	2,020	2,273	2,526

BALANCE SHEET					
(Rs Million)					
Y/E March	2004	2005	2006E	2007E	2008E
Capital	4,601	4,601	5,051	5,051	5,051
Reserves & Surplus	26,270	31,543	41,674	48,162	55,915
<b>Net Worth</b>	<b>30,871</b>	<b>36,144</b>	<b>46,725</b>	<b>53,213</b>	<b>60,966</b>
<b>Deposits</b>	<b>505,589</b>	<b>618,306</b>	<b>740,940</b>	<b>859,490</b>	<b>997,009</b>
Change (%)	13.0	22.3	19.8	16.0	16.0
Borrowings	9,342	20,210	26,272	32,052	38,463
Other Liabilities & Prov.	37,364	49,473	62,830	79,794	101,339
<b>Total Liabilities</b>	<b>583,167</b>	<b>724,131</b>	<b>876,766</b>	<b>1,024,549</b>	<b>1,197,776</b>
Current Assets	38,479	65,721	51,904	62,371	75,023
Investments	224,420	227,927	260,100	299,115	343,982
Change (%)	15.9	1.6	14.1	15.0	15.0
Advances	294,259	401,051	533,157	629,125	742,368
Change (%)	15.3	36.3	32.9	18.0	18.0
Net Fixed Assets	7,668	8,238	8,291	8,291	8,191
Other Assets	18,340	21,196	23,316	25,647	28,212
<b>Total Assets</b>	<b>583,167</b>	<b>724,132</b>	<b>876,768</b>	<b>1,024,550</b>	<b>1,197,777</b>

ASSUMPTIONS					
(%)					
Deposit Growth	13.0	22.3	19.8	16.0	16.0
Advances Growth	15.3	36.3	32.9	18.0	18.0
Investments Growth	15.9	1.6	14.1	15.0	15.0
Average PLR	10.0	10.0	10.0	10.0	10.0
Dividend	35.0	35.0	40.0	45.0	50.0
CRR	4.5	5.0	5.0	5.0	5.0

E: Most Estimates

RATIOS					
Y/E March	2004	2005	2006E	2007E	2008E
<b>Spreads Analysis (%)</b>					
Avg. Yield - Earning Assct	8.7	8.0	7.5	7.6	7.7
Avg. Cost-Int. Bear. Liab	5.8	5.0	5.0	5.3	5.4
Interest Spread	2.9	2.9	2.6	2.3	2.2
Net Interest Margin	3.3	3.3	3.0	2.9	2.9

Profitability Ratios (%)					
RoE	25.2	21.5	16.3	17.5	18.0
RoA	1.3	1.1	0.8	0.9	0.9
Int. Expended/Int. Earned	61.6	58.5	59.5	61.6	62.2
Other Inc./Net Income	32.4	27.1	20.8	18.1	18.1

Efficiency Ratios (%)					
Op. Exps./Net Income	42.2	44.4	46.8	47.5	45.9
Empl. Cost/Op. Exps.	66.5	64.1	61.8	59.6	58.6
Busi. per Empl. (Rs m)	28.6	34.6	45.6	55.5	66.1
NP per Empl. (Rs lac)	2.8	2.8	2.7	3.5	4.2

Asset-Liability Profile (%)					
Adv./Deposit Ratio	58.2	64.9	72.0	73.2	74.5
Invest./Deposit Ratio	44.4	36.9	35.1	34.8	34.5
G-Sec/Invest. Ratio	74.1	72.0	72.0	72.0	72.0
Gross NPAs to Adv.	7.6	5.0	3.9	3.3	2.9
Net NPAs to Adv.	2.9	2.6	1.6	1.2	0.8
CAR	12.3	12.1	11.4	11.2	10.9
Tier 1	6.5	6.1	7.3	6.7	6.6

VALUATION					
Book Value (Rs)	56.6	68.2	83.1	95.9	111.3
Price-BV (x)	2.3	1.9	1.6	1.4	1.2
Adjusted BV (Rs)	44.6	53.3	72.4	86.4	103.6
Price-ABV (x)	3.0	2.5	1.8	1.5	1.3
EPS (Rs)	15.5	15.6	13.4	17.3	20.3
EPS Growth (%)	28.8	1.0	-14.5	29.8	17.3
Price-Earnings (x)	8.5	8.5	9.9	7.6	6.5
OPS (Rs)	32.2	34.2	31.6	34.8	41.5
OPS Growth (%)	13.7	6.1	-7.5	10.1	19.1
Price-OP (x)	4.1	3.9	4.2	3.8	3.2

E: Most Estimates

**N O T E S**



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**Union Bank of India**

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