INDIA RESEARCH

Canara Bank

Rs399
NEUTRAL

MANAGEMENT MEETING NOTE

Mkt Cap: Rs163.5bn; US$3.49bn

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We recently met the management of Canara Bank. The management expects to deliver strong earnings growth in the coming years led by healthy core performance. The bank is poised to step up the pace of credit expansion which, along with a healthy CASA ratio, would support margins. Also, focus on fee-based revenue streams would contribute to the bottom-line growth. Concerns around an outsized rise in provisions have dissipated with the recent RBI notification which allows inclusion of technical write-offs to calculate provision coverage (76.16% for Canara Bank as of September 2009). Notably, the bank has maintained healthy asset quality In H1FY10 and reported a decline in Gross NPAs, while restructured assets have hovered at industry average. We expect Canara Bank to report 24% CAGR in net profit with an average RoE of 24% over FY09-11. However, G-Sec yields on the 10 year bond have risen by 40bp in the past month to 7.6% and, with a likely monetary tightening ahead, we see further upside to yields. Despite a positive outlook on core performance, we believe Canara Bank will find it difficult to outperform in a bearish G-sec market. At 1.3x FY10E and 1.1x FY11E adjusted book, we maintain Neutral on the stock.

Key valuation metrics

Year to 31 March	2007	2008	2009	2010E	2011E
Net profit (Rs m)	14,208	15,650	20,724	27,993	31,723
yoy growth (%)	*10.9*	*10.1*	*32.4*	*35.1*	*13.3*
Shares in issue (m)	410	410	410	410	410
EPS (Rs)	34.7	38.2	50.5	68.3	77.4
EPS growth (%)	*10.9*	*10.1*	*32.4*	*35.1*	*13.3*
PE (x)	11.5	10.4	7.9	5.8	5.2
Book value (Rs/share)	197.8	202.3	244.9	303.8	371.8
Adj. Book value (Rs/share)	186.1	190.8	224.0	297.6	377.4
P/Adj. Book (x)	2.1	2.1	1.8	1.3	1.1
RoNW (%)	18.8	19.1	22.6	24.9	22.9

KEY TAKEAWAYS

❑ Credit growth to remain ahead of the industry

- Canara Bank has witnessed a healthy loan book expansion of 6% in H1FY10 despite sluggish credit off-take for the banking system. The management indicated that other than large corporate advances, all credit segments have witnessed significant revival in the past few months.
- The bank intends to grow its advances ahead of the industry in the medium term. The management envisages a credit growth of 15-16% for the industry and, in this context, intends to grow at 18-19% over the fiscal.
- Aggressive branch expansion (~300 branches to be opened in FY10) and renewed credit demand from corporates are likely to aid growth. Notably, the bank was earlier targeting a loan growth of ~27% – in line with RBI's credit

growth projection of 20%. With system growth likely to be higher in FY11, Canara Bank's advance growth is also likely to pick up.

❑ Margins expected to be stable

- Despite volatile interest rates and sluggish credit off-take, Canara Bank has maintained NIMs between 2.7-2.8% over the past 4-5 quarters. Going forward, the management expects margins to remain largely steady at 2.8-3.0%.
- The bank's cost of deposits is likely to fall by 50-60bp in H2FY10 as high-cost term deposits garnered in FY09 stand re-priced. However, lower loan yields – a function of surplus liquidity and low credit demand in the system – as also a lower CD ratio are likely to cap margins.
- The bank has a healthy CASA ratio (29.2% as of September 2009). While CASA deposits are likely to grow at a robust pace, the management sees the ratio remaining stable at ~30%.

❑ Apprehensions over coverage ratio disperse; limited slippages from restructured accounts

- Canara Bank's lower provisioning coverage ratio at ~28% has been a key concern, exacerbated by RBI's directive to maintain minimum provisioning coverage ratio of 70% by September 2010. However, RBI's recent decision to allow technical write-off in the calculation of provisioning cover, the bank's cover stands tall at 76.2% as of September 2009, thereby alleviating concerns around outsized rise in provisioning costs.
- Driven by strong recoveries, gross NPAs have come down to ~Rs23.5bn in September 2009 from Rs25bn a year ago.
- The bank has restructured advances of ~Rs52bn, bulk of which are payment deferment and not haircut on interest. Notably, these advances are performing well currently. The management does not see more than ~10% of the restructured loans eventually slipping into NPAs.

❑ Fee income growth to remain healthy

- The bank strives to maintain momentum in fee-based income and aims to achieve growth of 20-25% over the medium term. Primary sources of fee income for the bank are LCs & guarantees, commissions, service charges and third party distribution fees.
- Core fee income witnessed a robust growth of 26% yoy in H1FY10. The management expects core fee income to gain traction in H2FY10 and to track the growth in advances in FY11.
- Rising G-Sec yields have given rise to concerns around potential MTM losses of PSU banks. However, Canara Bank management sees limited impact of rising G-Sec yields MTM in the near term. The bank's AFS portfolio is protected from MTM losses up to 10 year G-Sec yield of 7.55%. Further, the bank has un-booked MTM provision write-back of Rs2.9bn, which is expected to insulate it from losses in the near term.

❑ Operating costs to remain stable; shortfall in wage hike to be provided for

- At 38%, Canara Bank's cost to income ratio was among the lowest in the industry in H1FY10 with the outperformance partly attributable to substantial trading profits registered over the period. Even after adjusting for one-off trading gains, the bank's expense ratios remains among the lowest among PSU banks driven by tight cost control measures adopted by the management over the past few quarters. The management expects the ratio to remain stable in the near term owing to sustained focus on expense control and enhanced productivity.
- The bank had provided for wage revision assuming a 15% hike. However, owing to the settlement of negotiations at 17.5%, it will have to provide for an additional amount of ~Rs1bn. The management intends to make provisions for this amount in Q3FY10.

❑ Branch expansion plans

- The bank is in the process of setting up ~300 new branches this year, which will take the network up to 3,000 branches. Thereafter, the bank intends to open ~300 new branches every year.
- Around 90% of the business is done through CBS compliant branches, with a target to reach 100% by March-April 2010.

❑ Optimistic on consolidation

- Canara Bank management remains optimistic on the possibility of consolidation among PSU banks in the medium term. The bank strives to achieve geographical synergy through consolidation. The management is looking to intensify the bank's presence in the western region of the country (primarily Maharashtra and Gujarat). Canara Bank sees Dena Bank fitting the bill owing to the latter's large presence in Maharashtra and Gujarat.

Earnings model (Rs m)

Year to 31 March	FY07	FY08	FY09	FY10E	FY11E
Net interest income	**40,268**	**35,378**	**47,178**	**55,093**	**64,183**
yoy growth (%)	*12.4*	*(12.1)*	*33.4*	*16.8*	*16.5*
Other income	14,509	22,129	23,112	25,475	23,965
yoy growth (%)	*10.3*	*52.5*	*4.4*	*10.2*	*(5.9)*
Trading profits	737	3,407	6,746	6,500	3,000
Non trading income	13,772	18,721	16,366	18,975	20,965
Net revenue	**54,778**	**57,507**	**70,290**	**80,568**	**88,148**
yoy growth (%)	*11.9*	*5.0*	*22.2*	*14.6*	*9.4*
Operating expenses	25,653	27,913	30,653	31,964	35,304
yoy growth (%)	*9.3*	*8.8*	*9.8*	*4.3*	*10.4*
Operating profit	29,125	29,594	39,638	48,604	52,844
yoy growth (%)	*14.2*	*1.6*	*33.9*	*22.6*	*8.7*
Provisions	12,417	10,544	13,914	13,613	13,191
Of which: NPA Provisions	4,580	8,750	9,000	12,108	11,193
PBT	**16,708**	**19,050**	**25,724**	**34,991**	**39,653**
yoy growth (%)	*12.8*	*14.0*	*35.0*	*36.0*	*13.3*
Provision for tax	2,500	3,400	5,000	6,998	7,931
PAT	**14,208**	**15,650**	**20,724**	**27,993**	**31,723**
yoy growth (%)	*10.9*	*10.1*	*32.4*	*35.1*	*13.3*

Source: IDFC - SSKI Research

Balance sheet (Rs mn)

As on 31 March	FY07	FY08	FY09	FY10E	FY11E
Advances	985,057	1,072,380	1,382,194	1,650,677	1,983,337
yoy growth (%)	*24.0*	*8.9*	*28.9*	*19.4%*	*20.2*
Customer assets	866,677	939,511	1,040,602	1,237,351	1,479,079
yoy growth (%)	*24.1*	*8.4*	*10.8*	*18.9*	*19.5*
SLR portfolio	379,652	433,568	513,202	563,872	647,507
Cash & bank balances	163,739	178,780	166,598	183,258	192,420
Total assets	1,659,610	1,805,286	2,196,458	2,535,329	2,960,012
Networth	81,111	82,956	100,396	124,552	152,437
Deposits	1,423,815	1,540,724	1,868,930	2,168,740	2,539,244
- Current %	8.7	8.6	7.7	8.0	8.3
- Savings %	22.8	22.9	22.4	22.0	22.7
- Term %	68.5	68.5	69.9	70.0	69.0
Borrowings	15,744	25,172	70,566	71,977	73,417

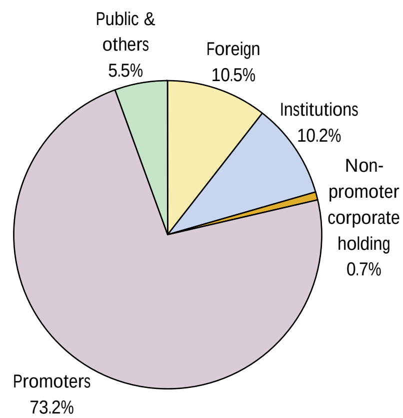
Source: IDFC - SSKI Research

Ratio analysis

Year to 31 March (%)	FY07	FY08	FY09	FY10E	FY11E
Net int. margin/Avg assets	2.7	2.0	2.4	2.3	2.3
Non-fund rev./Avg assets	0.9	1.2	1.1	1.0	0.8
Operating exp./Avg assets	1.7	1.6	1.5	1.4	1.3
Cost/Income	46.8	48.5	43.6	39.7	40.1
Prov./Avg customer assets	0.5	0.9	0.7	0.8	0.6
PBT/Average assets	1.1	1.1	1.3	1.5	1.4
RoA	1.0	0.9	1.0	1.2	1.2
RoE	18.8	19.1	22.6	24.9	22.9
Tax/PBT	15.0	17.8	19.4	20.0	20.0
Tier I Capital	7.2	7.0	8.0	7.2	7.4
Gross NPA s	1.5	1.3	1.3	1.6	1.8
Growth in customer assets	24.1	8.4	10.8	18.9	19.5
Growth in advances	24.0	8.9	28.9	19.4	20.2
Growth in deposits	21.9	8.2	21.3	16.0	17.1
SLR Ratio	26.7	28.1	27.5	26.0	25.5
CASA ratio	31.5	31.5	30.1	30.0	31.0

Source: IDFC - SSKI Research

Shareholding pattern



As of September 2009

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2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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