investor's eye

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Index

- Stock Update >> Punjab National Bank
- Viewpoint >> Bharat Forge

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
3i Infotech	06-Oct-05	132	**173**	244
Elder Pharma	26-Apr-06	298	**320**	410
Subros	26-Apr-06	206	**224**	370
TVS Motor	03-Apr-06	140	**122**	210
WS Industries	02-Dec-05	51	**58**	112

Punjab National Bank

Ugly Duckling

Stock Update

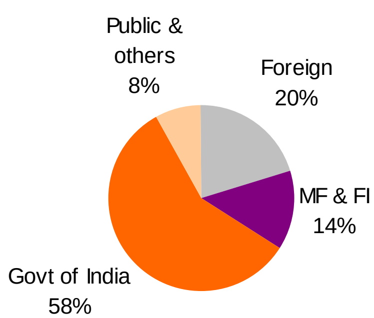
Disappointing results

Buy; CMP: Rs416

Company details

Price target:	Rs500
Market cap:	Rs13,356 cr
52 week high/low:	Rs496/364
NSE volume: (No of shares)	6.8 lakh
BSE code:	532461
NSE code:	PNB
Sharekhan code:	PUNBANK
Free float: (No of shares)	13.3 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-6.0	-2.5	-1.9	8.6
Relative to Sensex	4.5	-7.8	-21.9	-35.4

Result highlights

- Punjab National Bank (PNB) reported disappointing results for Q4FY2006 with its net interest income (NII) and fee income recording a tepid growth and operating expenses increasing substantially.
- PNB's NII grew by a low 10.1% year on year (yoy) as the interest income on the investments and the balances with the Reserve Bank of India (RBI) and the other banks declined. The NII in fact declined by 2.5% quarter on quarter (qoq).
- While PNB's total assets have grown by 16% yoy and 9% qoq, the NII has grown at much slower pace, which implies that the bank is facing pressure on its net interest margin (NIM).
- The core fee income declined by 2.5% for Q4FY2006. The bank is facing the heat of competition from the other players in the market. Its total other income grew by 11.7%, as it stepped up recoveries.
- The operating profit adjusted for the extraordinary items and treasury profit fell by 6.5% as the operating expenses grew by 32.4% coupled with a very low growth in the total income.
- The provision of Rs600 crore on account of the mark-to-market (MTM) losses on its "available for sale" (AFS) bond portfolio further pulled down the net profit, which declined by 77%, adjusted for the extraordinary items.
- PNB has transferred securities worth Rs6,200 crore to the "held till maturity" (HTM) portfolio to cut its MTM losses. The bank has also indicated that further investments in bonds will be in the HTM portfolio only. However, PNB's exposure to interest risk remains high as the yield on its investments is falling while the duration of the bond portfolio is high.
- The net non-performing asset (NPA) as a percentage of the net advances has gone up marginally by nine basis points yoy to 0.29%.
- We have downgraded our FY2007E earnings per share (EPS) estimate for PNB by 14% from Rs64.8 to Rs55.8 to take into account the lower fee income, higher operating expenses and rising provisioning requirements.

Result table Rs (cr)

Particulars	FY2006	FY2005	% yoy chg	Q4FY2006	Q4FY2005	% yoy chg
NII	4,666.7	4,006.7	16.5	1,180.2	1,072.1	10.1
Other income	1,231.2	1,675.7	-26.5	421.5	377.4	11.7
Net income	5,897.8	5,682.4	3.8	1,601.7	1,449.4	10.5
Total operating expenses	3,022.9	2,975.2	1.6	603.1	922.4	-34.6
Operating profit	2,875.0	2,707.2	6.2	998.6	527.0	89.5
Provisions	839.9	802.5	4.7	611.1	52.7	1,059.7
Taxes	595.5	494.6	20.4	98.5	113.7	-13.4
Net profit	1,439.5	1,410.1	2.1	289.0	360.7	-19.9

- At the current market price of Rs416, the stock is trading at 6.4x its FY2008E EPS and 1.1x its FY2008E adjusted book value. We maintain our Buy recommendation on the stock with the price target of Rs500.

NII grows by a tepid 10% yoy...

PNB's NII for Q4FY2006 saw a lower growth of 10% yoy (and declined by 2.3% qoq) on account of a lower interest income from its investments and a lower income from the balances with the other banks including the RBI. The interest income from the investments declined as the bank has trimmed the size of the investment portfolio by 20% over last year.

The NIM for FY2006 was 4% compared with 3.87% in FY2005. While PNB's total assets have grown by 16% yoy and 9% qoq for Q4FY2006, the NII has grown at a much slower pace, which implies that the bank is facing pressure on its NIM.

Change in NIM (%)

Particulars	FY2006	FY2005	Change in basis points
Yield on advances	8.31	8.10	21.0
Yield on investments	8.17	8.24	-7.0
NIM	4.00	3.87	13.0

Slow growth in core fee income raises concern

PNB's core fee income has grown by a disappointing 9% in FY2006 and actually declined by 2.5% yoy for Q4FY006. We believe that the slow growth in the core fee income is a small cause for concern, as the same has not grown commensurate with the rising operating expenses and the growing size of the bank.

...but at the same time core business grows strongly

PNB's interest income from the advances for Q4FY2006 grew by 35% yoy, reflecting a strong growth in its core business of lending activities. The advances grew by a strong 23% yoy to Rs74,627.0 crore on account of a robust growth of 53% yoy in the retail advances. The retail advances now contribute 24% of the overall advance portfolio.

PNB further consolidated its low cost deposits during the quarter, with its current and savings account (CASA) deposits growing by 23% compared with a lower growth of 16% in the overall deposits. The CASA deposits contributed 49% of the total deposits at the end of March 2006 compared with a 46% contribution at the end of March 2005.

Adjusted operating profit declines by 6.5%

The reported operating profit grew by 89.5% as the operating expenses declined by 34.6% yoy. However, in Q4FY2005 PNB had accounted for an extraordinary expense of Rs297 crore compared with a write-back of Rs225 crore in Q4FY2006. Adjusted for these extraordinary items and the treasury gains, the operating profit actually declined by 6.5%.

Particulars	Q4FY2006	Q4FY2005	% yoy change
Reported operating profit	998.6	527.0	89.5
Add:			
VRS expenses		120.0	
IPO expenses		29.0	
Excess pension provision		148.0	
Less: Write-back of pension provisions	225.0		
Adjusted operating profit	773.6	824.0	-6.1
Less: Treasury profits	136.0	142.0	
Operating profit adjusted for extraordinaries and treasury gains	637.6	682.0	-6.5

MTM losses pull down the profits further

The provision of Rs600 on account of the MTM losses on its AFS bond portfolio further pulled down the net profit, which declined by 77%, adjusted for the extraordinary items.

Particulars	Q4FY2006	Q4FY2005	% yoy change
Reported net profit	289.0	360.7	-19.9
Add: Extraordinary expenses/(income)*	-157.5	207.9	
Adjusted net profit	131.5	568.6	-76.9

*(Adjusted for taxes)

Taking steps to reduce MTM losses

PNB's AFS bond portfolio, which constitutes nearly 57% of its investment portfolio, has duration of more than four years. PNB transferred securities worth Rs6,200 crore to the HTM category in April 2006. The AFS bond portfolio now stands at 39% of the total bond portfolio. The bank has also indicated that further investments in bonds will be made in the HTM portfolio only. Thus, the proportion of the AFS bond portfolio will decrease further over the next year.

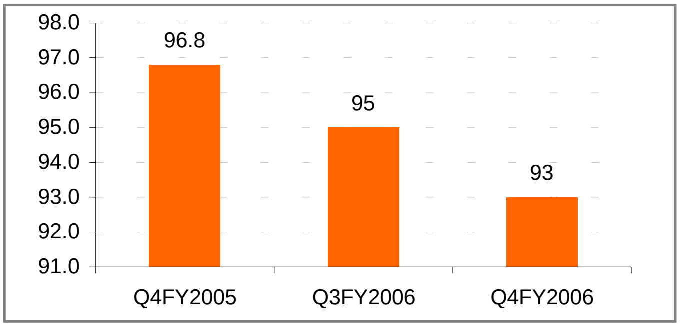
However, PNB's exposure to interest risk remains high as the yield on investments is falling while the duration of the bond portfolio is high.

Asset quality—albeit best in the industry, provision cover declining

The net NPA as a percentage of the net advances has gone up marginally by nine basis points yoy to 0.29%. The net NPA ratio has gone up partly because of a lower provisioning and the write-back of the floating provisions. As on March 31, 2006 PNB still had floating provisions worth Rs980 crore.

While an efficient recovery of bad loans as reflected in the higher other income has helped PNB to reduce its gross NPAs, the movement in the net NPA is a cause for concern as the provision cover has also been gradually declining.

Provision coverage ratio (%)



Source: Company

Valuation and view—downgrading earnings

We are downgrading our FY2007 EPS estimate for PNB by 14% from Rs64.8 to Rs55.8 to take into account the bank's

- lower fee income,
- higher operating expenditure, and
- higher provisioning on account of MTM losses and amortisation.

At the current market price of Rs416, the stock is trading at 6.4x its FY2008E EPS and 1.1x its FY2008E adjusted book value. We maintain our Buy recommendation on the stock with price target of Rs500.

Valuation table

Year to 31 March	2005	2006P	2007E	2008E
Net profit (Rs cr)	1,410.1	1,439.5	1,756.7	2,057.5
Shares in issue (cr)	31.5	31.5	31.5	31.5
EPS (Rs)	44.8	45.7	55.8	65.3
EPS growth (%)	9.5	2.1	22.0	17.1
P/E (x)	9.3	9.1	7.5	6.4
Adj bv (Rs/share)	266.9	287.0	336.8	396.1
RoE (%)	19.3	16.5	17.9	17.8
Price/ adj book (x)	1.6	1.4	1.2	1.1

The author doesn't hold any investment in any of the companies mentioned in the article.

Bharat Forge

Viewpoint

Margins take a hit

Buy; CMP: Rs354

Q4 and FY2006 results—margins decline due to higher input costs

The revenues of Bharat Forge Ltd (BFL) grew by 21.4% in Q4FY2006 to Rs438.4 crore from Rs361.3 crore in Q4FY2005. The revenue growth was driven by a 24.2% growth in the exports year on year (yoy) while domestic sales grew by only 19.4% by capacity constraints. During the quarter, the operating profit margin (OPM) reduced by about 70 basis points to 24% primarily due to a higher cost of raw materials and costs associated with new product development. The raw material cost as a percentage of sales increased from 45.8% to 50.2% in Q4FY2006. Since the rise in the raw material prices is passed on to customers with a time lag of one quarter, the margins took a hit in Q4. Consequently, the operating profit increased by 18.1% yoy to Rs105.3 crore. The interest cost rose to Rs15.5 crore due to a capacity expansion programme undertaken by the company. The profit after tax (PAT) rose by 9.6% to Rs53 crore in the same period.

For the full year, BFL increased its net sales by 29.4% to Rs1,577.9 crore. The OPM for the year reduced by 210 basis points to 24.7% due to a rise in its raw material cost. For the full year the raw material cost as a percentage of sales increased from 43% to 46.3%.

The consolidated revenues of BFL for the full year grew by 54.1% to Rs3,085 crore, with the domestic revenues (including the other income) growing by 36.2% and the global revenues rising by 64.1%. The earnings before interest, depreciation, tax and amortisation (EBIDTA) margin came down sharply to 19.1% in FY2006 from 21.5% last year, marking a decline of almost 250 basis points. The consolidated margins were lower on account of two acquisitions made by BFL during the year: Imatra Kilsta AB in Sweden and Federal Forge in the USA. Imatra Kilsta has an EBIDTA margin of around 10% while Federal Forge is coming out of bankruptcy. To add to the lower profitability of these two companies, there were certain one-time costs associated with the acquisitions which reduced the consolidated margin.

The consolidated profit before tax (PBT) for the year grew by 19.3% due to higher interest and depreciation costs. The interest costs rose as a result of increased borrowings

Result table Rs (cr)

Particulars	Q4FY2006	Q4FY2005	% change	FY2006	FY2005	% change
Net sales	438.4	361.3	21.4	1,577.9	1,219.1	29.4
Total expenditure	333.1	272.1		1,188.3	892.3	
Consumption of RM	226.0	160.6		-29.5	-27.8	
Increase/ decrease in stock	-6.0	4.8		759.8	551.8	
Manufacturing costs	67.5	53.8		253.5	192.7	
Staff cost	20.9	17.7		91.7	69.3	
Other expenditure	24.7	35.3		112.8	106.4	
Operating profits	105.3	89.2	18.1	389.6	326.8	19.2
Other income	14.4	2.1		53.1	7.4	
EBIDTA	119.7	91.3		442.7	334.2	
Interest	15.5	8.4		54.8	33.6	
PBDT	104.2	82.9		387.9	300.6	
Depreciation	21.4	13.5		73.0	52.6	
PBT	82.8	69.3		314.9	248.1	
Tax	29.8	21.0		107.9	86.4	
PAT	53.0	48.4	9.6	207.0	161.6	28.0
EPS	2.4	2.2	9.6	9.3	7.3	28.0
Margins						
OPM (%)	24.0	24.7		24.7	26.8	
EBIDTAM (%)	27.3	25.3		28.1	27.4	
PATM (%)	12.1	13.4		13.1	13.3	

of the company while the depreciation costs increased owing to the ongoing capacity expansion plan of the company.

Increasing global presence

During the year, the company increased its global presence by making a number of acquisitions. In Europe, it acquired a Sweden-based company called Imatra Kilsta AB and a Scotland-based company named Scottish Stampings. Bharat Forge Kilsta is the leading manufacturer of heavy-duty diesel engine crankshafts for the European and Scandinavian truck market. These two acquisitions have given BFL a strong presence in Europe to cater to the high demand for forging products from that region. The company also acquired Federal Forge Inc in the USA in FY2006.

In China, BFL has formed a joint venture with FAW Corporation where it has a 52% stake. The joint venture will initially focus on meeting the requirement of the Chinese automotive industry. Eventually it can be positioned as a competitive cost producer of high-end forging for the global automotive industry. The Chinese operation has a huge forging capacity of 100,000 tonne and can be further scaled up without incurring much capital expenditure. However BFL would raise the capacity utilisation of the Chinese venture from the present 2% before going for a capacity expansion.

Capacity expansion plan

Currently the company has a forging capacity of 160,000 tonne. The capacity would be increased to 200,000 tonne by June 2006 and to 240,000 tonne by October 2006. Also, the capacity of crankshafts shall be increased from the present 463,000 units to 513,000 units by June 2006 and to 650,000 units by October 2006. The total capex cost in FY2006 was around Rs600 crore. The company does not have any more capacity expansion plans at the moment.

Non-automotive business to grow

BFL aims to increase the contribution of its non-automotive business to 25% in three to five years from the current level of about 17%. In the non-automotive business, the company has its presence in the areas of oil & gas exploration activity, construction equipment, railway components and heavy engineering components.

Valuation and view

BFL is now in the process of integrating and consolidating all the recently acquired companies and that remains the key challenge for the company at present. The company aims to become a $1-billion company by FY2008. Also, it plans to significantly increase the revenue contribution of its non-automotive business and improve the profitability of the newly acquired companies. The company has definitely managed to de-risk its business model and over the years has built state-of-the-art manufacturing capabilities. Going forward, BFL plans to enhance the competitiveness of its global subsidiaries and ramp up its Chinese operations. Following this we expect the consolidated margins to improve in the coming years. At the current market price of Rs354, the stock discounts its FY2006 earnings by 38x.

The author doesn't hold any investment in any of the companies mentioned in the article.

Sharekhan Stock Ideas

Evergreen

- HDFC Bank
- Infosys Technologies
- Reliance Industries
- Tata Consultancy Services

Apple Green

- Aditya Birla Nuvo
- Associated Cement Companies
- Bajaj Auto
- Balrampur Chini Mills
- Bharat Bijlee
- Bharat Heavy Electricals
- Corporation Bank
- Crompton Greaves
- Godrej Consumer Products
- Elder Pharmaceuticals
- Grasim Industries
- Hindustan Lever
- Hyderabad Industries
- ICICI Bank
- Indian Hotel Company
- ITC
- Mahindra & Mahindra
- Marico Industries
- Maruti Udyog
- MRO-TEK
- Lupin
- Nicholas Piramal India
- Omax Auto
- Ranbaxy Laboratories
- Satyam Computer Services
- Sintex Industries
- SKF India
- State Bank of India
- Sundaram Clayton
- Tata Motors
- Tata Tea
- Unichem Laboratories

Cannonball

- Cipla
- Gateway Distriparks
- International Combustion (India)
- JK Cements
- Madras Cement
- Shree Cement
- Transport Corporation of India

Emerging Star

- 3i Infotech
- Aarvee Denim and Exports
- Aban Loyd Chiles Offshore
- Alok Textile Industries
- Alphageo India
- Cadila Healthcare
- KSB Pumps
- Marksans Pharma
- Navneet Publications (India)
- New Delhi Television
- Orchid Chemicals & Pharmaceuticals
- ORG Informatics
- Solectron Centum Electronics
- Television Eighteen India
- Thermax
- Tube Investments of India
- TVS Motor Company
- UTI Bank
- Welspun Gujarat Stahl Rohren
- Welspun India

Ugly Duckling

- Ashok Leyland
- Deepak Fertilisers & Petrochemicals Corporation
- Genus Overseas Electronics
- HCL Technologies
- ICI India
- Jaiprakash Associates
- JM Financial
- KEI Industries
- Nelco
- NIIT Technologies
- Punjab National Bank
- Ratnamani Metals and Tubes
- Sanghvi Movers
- Saregama India
- Selan Exploration Technology
- Subros
- Sun Pharmaceutical Industries
- Surya Pharmaceuticals
- UltraTech Cement
- Union Bank of India
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- Wockhardt

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- Orient Paper and Industries
- WS Industries India

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