

State Bank of India

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,871	SBIN IN
	REUTERS CODE
S&P CNX: 2,983	SBI.BO

28 January 2006

Buy
Previous Recommendation: Buy
Rs913

		YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROAE	ROAA	P/ABV
		END	(RS B)	(RS B)	(RS)	GROWTH (%)	RATIO	(X)	(%)	(%)	(%)	RATIO
Equity Shares (m)	526.3	3/05A	210.6	43.0	81.8	17.0	11.2	2.0	12.5	19.4	1.0	2.3
52-Week Range	962/553	3/06E	220.9	46.3	87.9	7.5	10.4	1.7	12.0	17.8	1.0	1.9
1,6,12 Rel. Perf.(%)	-4/-12/-7	3/07E	229.3	54.3	103.1	17.2	8.9	1.5	11.5	17.9	1.0	1.6
M.Cap. (Rs b)	480.7											
M.Cap. (US\$ b)	10.9											

3QFY06 results were below our expectations. Earnings grew only 1.4% YoY; the bigger disappointment was a decline in NII of 10% YoY (adjusted for tax refunds, IMD gains). Earnings growth was hit by higher operating expenses and higher tax provisions.

The quarter had a substantial number of one-offs, which were also large in number. Given this, it is difficult to compute normalized earnings as the IMD impact itself played out for the entire quarter. To mobilize liquidity for the IMD, the bank would have not only earned negative NII, the profitable growth was also missing. Besides, higher operating expenses (Rs3.1b for wage arrears), Rs1.4b (pensions) and an additional Rs2b (exit scheme) provided by SBI to its employees, were also one-offs.

Substantial reduction in net NPAs to 1.67%, we believe is a significant achievement for the size of SBI's balance sheet. Tax rate was also high during the quarter, as SBI is known to have erratic tax rates on a quarterly basis.

Most significantly core business trends improved—yield on advances were higher and cost of deposits, lower. We expect this trend to drive earnings going forward. Absence of one-offs should also result in strong earnings hereon. Moreover, it should benefit from slow growth in opex and lower provisioning requirements going forward. We expect SBI to report consolidated EPS of Rs115 in FY06 and Rs135 in FY07. The consolidated book value for these years would be Rs710 and Rs840. The stock trades at P/E of 6.8x and P/BV of 1.1x FY07 earnings. We maintain **Buy**.

QUARTERLY PERFORMANCE

(Rs Million)

	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Interest Income	76,666	80,848	80,291	86,476	91,663	85,614	95,582	89,779	324,280	362,637
Interest Expenses	47,125	47,050	43,690	46,969	49,131	49,535	53,383	50,643	184,834	202,691
Net Interest Income	29,541	33,798	36,601	39,507	42,532	36,079	42,199	39,136	139,446	159,947
% Change (Y-o-Y)	10.0	40.0	32.0	19.2	44.0	6.8	15.3	-0.9	24.7	14.7
Other Income	15,387	16,525	22,380	16,907	15,766	12,946	18,404	13,803	71,199	60,919
Bond Gains	1,499	4,679	9,476	2,098	1,307	2,467	1,298	928	17,753	6,000
Net Income	44,928	50,323	58,981	56,414	58,298	49,026	60,603	52,939	210,645	220,865
% Change (Y-o-Y)	1.2	-0.7	51.4	4.5	29.8	-2.6	2.8	-6.2	12.1	4.9
Operating Expenses	24,214	24,274	25,081	27,173	23,903	29,197	34,607	32,759	100,742	120,466
Operating Profit	20,714	26,049	33,900	29,241	34,395	19,829	25,996	20,179	109,904	100,399
% Change (Y-o-Y)	-18.0	-8.9	88.3	23.6	66.0	-23.9	-23.3	-31.0	15.0	-8.6
Other Provisions	3,287	7,574	17,105	16,722	17,666	8,175	4,698	6,461	44,688	37,000
Provision for Taxes	6,843	7,656	5,801	1,866	4,501	-500	10,147	2,970	22,166	17,118
Net Profit	10,584	10,819	10,994	10,653	12,228	12,154	11,151	10,748	43,050	46,281
% Change (Y-o-Y)	17.6	9.4	19.5	22.1	15.5	12.3	1.4	0.9	17.0	7.5
Cost to Income Ratio	53.9	48.2	42.5	48.2	41.0	59.6	57.1	61.9	47.8	54.5
Interest Exp / Interest Earned	61.5	58.2	54.4	54.3	53.6	57.9	55.9	56.4	57.0	55.9
Other Income / Net Income	34.2	32.8	37.9	30.0	27.0	26.4	30.4	26.1	33.8	27.6

E: MOST Estimates

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Reported NII up 15% YoY, adjusted NII declines 10% YoY

On a reported basis, the NII grew 15% YoY, which was marked by a tax refund of Rs9.5b and net IMD gain of Rs3b (adjusted in interest expenses). Adjusting for these one-off expenses, NII has declined by 10% YoY.

ADJUSTED NII DECOMPOSITION (RS B)

	REPORTED	ADJUSTED	
Interest Income	95.6	86.1	Rs9.52b tax refund adjusted
Interest Expenses	53.4	56.4	Rs3b net effect of IMD gain
NII	42.2	29.7	
NII 3QFY05	36.6	32.9	Rs3.71b tax refund adjusted
YoY Growth (%)	15.3	-9.8	

Source: Company/Motilal Oswal Securities

We believe the growth was significantly impacted by aggressive mobilization of bulk deposits during 2Q and 3Q, which had been invested in T-bills and were earning negative spreads for the whole of 3QFY06 (as IMDs were redeemed on 29 December 2005). SBI has repaid over Rs300b of deposits in December 2005, which were raised at a cost of 8.5%.

At the same time, the overall investment book is getting repriced downward, resulting in lower yields on investment and lower margins.

Other income declines 18%

While total other income declined by 18%, excluding treasury and the one-off IMD gain (Rs5.3b), the decline was 9%. This decline was on account of lower commissions from the government business, as the method of computation had changed from 2QFY06, resulting in lower commissions. Forex income also declined by 10% on account of lower margins. Treasury income declined to Rs1.3b from Rs9.5b.

Given the lower fee income from the government business, we believe that even during 4Q, commissions from the government business could pull down the core fee income. However from 1QFY07 onward, on back of a lower base, we expect fee income to once again start witnessing steady growth.

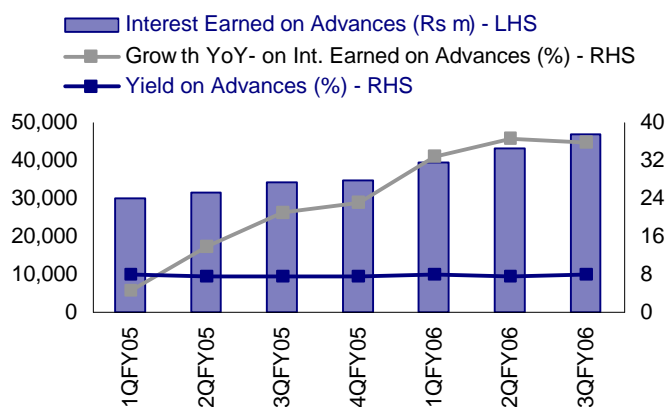
Operating expenses up 20%

Of the total operating expenses, wage bills constitute 73%, which has gone up by Rs8.3b (49% YoY). While from 2QFY06 onward, SBI started charging the wage increments in employee expenses, rather than the earlier practice of charging them in provisions, in 3QFY06 it also made additional provisions of Rs3.1b on account of the shortfall in the wage arrears and an additional 1.4b on account of pensions. Also, during 3QFY06, the bank initiated an exit scheme for its employees, wherein 2,000 staff have been laid off. The entire charge of Rs2b has been charged off during 3QFY06. This is likely to continue during 4QFY06 also and another 2,000 employees are expected to be laid off. Thus during FY06, in all >8,000 (>4,000 natural attrition) (4% of the workforce) employees are likely to go off the books, which should help SBI contain operating expenses from FY07 onward.

Worst behind; improving trends in core business Loan yields improving; deposit costs still trending down

We believe the most important trend of the results is its growth in advances and yield on these loans. Advances have grown by 27% YoY, while deposits have grown by a mere 12%.

INTEREST EARNED ON ADVANCES



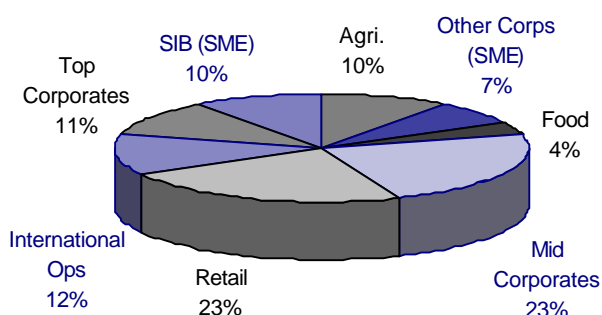
Source: Company/Motilal Oswal Securities

COMPOSITION OF NIIS (%)

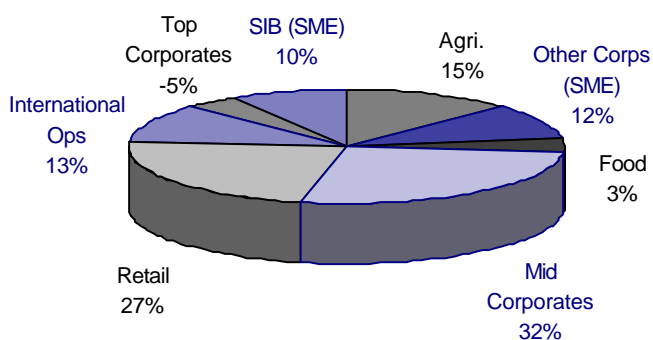
	1QFY05	1HFY05	9MFY05	FY05	1QFY06	1HFY06	9MFY06
Avg Yield on Advances	7.82	7.78	7.75	7.68	7.80	7.81	7.87
Yield on Investments	8.03	8.04	7.94	7.94	7.76	7.40	7.09
Cost of Deposits (ex IMD)	4.96	4.80	4.74	4.70	4.55	4.64	4.52
Cost of Deposits (incl IMD)	5.42	5.31	5.10	5.11	4.82	4.77	4.79
NIMs (adjusted)	2.99	3.10	3.12	3.20	3.14	3.13	3.01

Source: Company/Motilal Oswal Securities

COMPOSITION OF BANK'S LOAN BOOK AS ON DECEMBER 2005



CONTRIBUTION TO LOAN GROWTH BY DIFFERENT SEGMENTS (APRIL TO DECEMBER 2005)



Source: Company/Motilal Oswal Securities

Within advances the focus of the bank has been on the higher yielding segment, in fact exposure to top corporates has declined in the first 9 months, while that to mid-corporates and retail is going up.

The yield on advances has improved by 12bp YoY and has been showing strong improvement for the last couple of

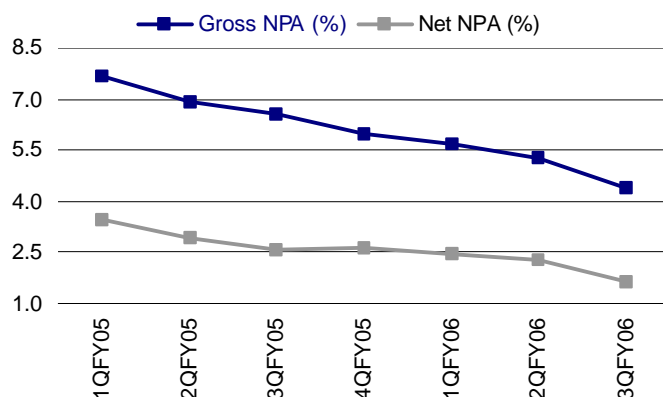
quarters. The strong growth in loans along with higher yields have resulted in a 36% growth in interest on loans. This trend is very positive as the bank has a higher focus on loans, which will offset the impact of low yield on investments. Moreover, with IMD historical now, overall cost of deposits should also fall.

As seen from the table, margin pressure for SBI has been mainly on account of falling yields on its investment book. However, with yields on investment already at 7.1%, we do not expect any significant decline from these levels. This coupled with the faster growing loan yields should result in better margins going forward.

Net NPAs down to 1.67%; Dabhol upgraded

SBI has upgraded Dabhol in 3Q and as net NPAs have declined from 2.27% at September 2005 to 1.67% as of December 2005. Even gross NPAs have declined to 4.41% from 5.26% QoQ. This should also positively impact NIMs as SBI will start accruing income from this asset now. Overall, we expect net NPAs to fall further to 1.6% by March 2006 and to near 1% by March 2007.

TREND IN ASSET QUALITY



Source: Company/Motilal Oswal Securities

Tier-1 capital of 8.5%, full IFR yet to be adjusted; hybrid capital norms positive for SBI

Currently SBI has a total capital adequacy of 12.5% with a Tier-1 of 8.5%. Including IFR as Tier-1, we believe that Tier-1 can inch closer to 10%. This will ensure smooth compliance with the Basel II norms and will also enable the bank to grow its loan book comfortably without any capital dilution.

Further, the current hybrid capital allowance by the RBI is positive for the larger state-owned banks. SBI is likely to be a key beneficiary, as it is best placed to raise resources through perpetual debt / preference shares at competitive rates. Our calculation suggests that SBI can increase 200bp-300bp of capital adequacy without diluting its core capital. This can more than take care of its growth going forward. This should result in higher leverage and higher RoE ahead.

HTM is 65% of SLR book

Post redemption of IMD funds, HTM has increased to 65%

of the total SLR book. Of the AFS book, the duration of the portfolio is two years. However, we believe that SBI will be at risk, if the interest rates were to move up from current levels and will have to take mark-to-market hits on its AFS portfolio.

Valuation and view

The most significant feature of the earnings has been an improvement in core business trends, whereby the yield on advances has further improved and cost of deposits has gone down. We expect this trend to drive earnings going forward. Absence of one-offs should also result in strong earnings hereon. Moreover, SBI will benefit from the slow growth in operating expenses and lower provisioning requirements going forward. We expect SBI to report consolidated EPS of Rs115 in FY06 and Rs135 in FY07. The consolidated book value for these years would be Rs710 and Rs840. The stock trades at P/E of 6.8x and P/BV of 1.1x FY07 earnings. We maintain **Buy**.

State Bank of India: an investment profile

Company description

State Bank of India (SBI) is the largest commercial bank in India, with a balance sheet size of over Rs4,700b. The bank, along with associate banks, has a network of over 13,000 branches across India and controls over 25% of the banking business. The government owns 57% of the bank, with FIIs owning 20% (maximum permissible is 20%). Over the last couple of years, SBI has been focusing drawing significant synergies through an internal consolidation of its associate banks.

Key investment arguments

- ✍ Proxy to Indian economy; will benefit from uptick in loan growth.
- ✍ Significant repricing of funds will result in stable margins
- ✍ Associate banks have been performing well and add significant value.
- ✍ Natural attrition will pull down operating costs significantly over the next 3-4 years.

Key investment risks

- ✍ Significant rise in interest rates. The bank currently has 35% of its SLR investment book in AFS.
- ✍ Delay in technology upgradation could result in loss of market share.

Recent developments

- ✍ Has divested 37% stake of its fully owned subsidiary, SBI Funds Management Pvt. Ltd. realizing a profit of Rs1.4b.
- ✍ SBI has appointed Infosys to network its overseas branches and TCS is networking the domestic branch network.
- ✍ The bank has made clear its intention of acquiring banks both locally and overseas to strengthen its position.

Valuation and view

- ✍ We expect loan growth, stable margins to drive earnings growth over the next few quarters. Cost efficiency and NPA recovery will be the next big triggers for earnings growth.
- ✍ The stock trades at P/E of 6.8x and P/BV of 1.1x FY07 earnings. We maintain **Buy**.

Sector view

- ✍ Loan growth of 30% at the beginning of capex cycle.
- ✍ Volatility in interest rates will impact bond gains.
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an Overweight stance on the sector.

COMPARATIVE VALUATIONS

		SBI	PNB	BOB
P/E (x)	FY06E	10.4	8.7	11.5
	FY07E	8.9	7.4	9.0
P/ABV (x)	FY06E	1.9	1.6	1.3
	FY07E	1.6	1.3	1.2
RoE (%)	FY06E	17.8	18.9	12.2
	FY07E	17.9	19.0	12.7
RoA (%)	FY06E	1.0	1.2	0.8
	FY07E	1.0	1.3	0.9

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	59.7	59.7	59.7
Domestic Institutions	12.0	12.3	11.7
FIIs/FDIs	19.8	19.8	19.8
Others	8.5	8.2	8.8

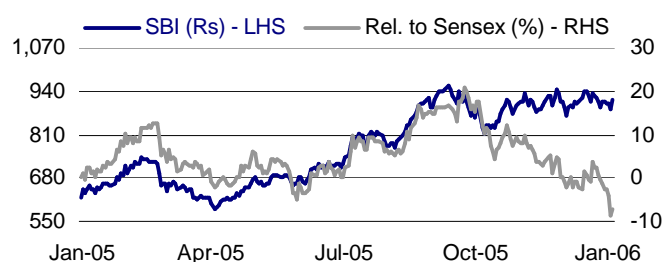
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	87.9	86.7	1.4
FY07	103.1	102.2	0.9

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
913	1,100	20.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Billion)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Interest Income	304.6	324.3	362.6	394.4	455.8
Interest Expended	192.7	184.8	202.7	226.5	263.3
Net In. Income	111.9	139.4	159.9	167.9	192.5
Change (%)	12.1	24.7	14.7	4.9	14.7
Other Income	76.1	71.2	60.9	61.5	67.8
Net Income	188.0	210.6	220.9	229.3	260.4
Change (%)	19.6	2.1	4.9	3.8	13.5
Operating Expenses	92.5	100.7	120.5	128.0	141.7
Operating Income	95.5	109.9	100.4	101.4	118.7
Change (%)	22.9	15.0	-8.6	1.0	17.1
Other Provisions	46.3	44.7	37.0	26.0	31.0
PBT	49.3	65.2	63.4	75.4	87.7
Tax	12.4	22.2	17.1	21.1	24.5
Tax Rate (%)	25.3	34.0	27.0	28.0	28.0
PAT	36.8	43.0	46.3	54.3	63.1
Change (%)	18.6	17.0	7.5	17.2	16.3
Proposed Dividend	5.3	6.3	7.4	7.9	7.9

BALANCE SHEET					
(Rs Billion)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Capital	5.3	5.3	5.3	5.3	5.3
Reserves & Surplus	197.0	235.5	274.4	320.7	376.0
Net Worth	202.3	240.7	279.6	326.0	381.2
Deposits	3,186.2	3,670.5	3,817.3	4,351.7	4,961.0
Change (%)	7.6	15.2	4.0	14.0	14.0
Borrowings	134.3	191.8	214.9	240.6	269.5
Other Liabilities & Prov.	555.3	495.8	690.9	719.0	752.7
Total Liabilities	4,078.2	4,598.8	5,002.7	5,637.4	6,364.4
Current Assets	435.7	393.2	530.9	445.5	437.8
Investments	1856.8	1971.0	1701.8	1902.2	2,076.0
Change (%)	7.7	6.2	-13.7	11.8	9.1
Advances	1579.3	2,023.7	2,549.9	3,059.9	3,610.7
Change (%)	14.6	28.1	26.0	20.0	18.0
Net Fixed Assets	26.5	27.0	27.0	27.0	27.0
Other Assets	179.9	183.9	193.1	202.8	212.9
Total Assets	4,078.2	4,598.8	5,002.7	5,637.4	6,364.4

ASSUMPTIONS					
(%)					
Deposit Growth	7.6	15.2	4.0	14.0	14.0
Advances Growth	14.6	28.1	26.0	20.0	18.0
Investments Growth	7.7	6.2	-13.7	11.8	9.1
Average PLR	10.0	10.0	10.0	10.0	10.0
Chg. in Avg Dep. Rate	-0.5	-0.5	0.3	0.3	0.3
Dividend	110.0	125.0	140.0	150.0	150.0
CRR	4.5	5.0	5.0	5.0	5.0

E: M0St Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Spreads Analysis (%)					
Avg. Yield - Earning Asse	8.2	7.9	8.2	8.1	8.1
Avg. Cost-Int. Bear. Liab.	5.8	5.0	4.9	4.9	5.0
Interest Spread	2.5	2.9	3.3	3.2	3.1
Net Interest Margin	3.0	3.4	3.6	3.5	3.4

Profitability Ratios (%)					
RoE	19.7	19.4	17.8	17.9	17.8
RoA	0.9	1.0	1.0	1.0	1.1
Int. Expended/Int. Earned	63.3	57.0	55.9	57.4	57.8
Other Inc./Net Income	40.5	33.8	27.6	26.8	26.1

Efficiency Ratios (%)					
Op. Exps./Net Income	49.2	47.8	54.5	55.8	54.4
Empl. Cost/Op. Exps.	69.7	68.6	67.9	63.7	61.4
Busi. per Empl. (Rs m)	25.3	30.3	34.1	40.1	46.9
NP per Empl. (Rs lac)	2.0	2.3	2.5	2.9	3.5

Asset-Liability Profile (%)					
Adv./Deposit Ratio	49.6	55.1	66.8	70.3	72.8
Invest./Deposit Ratio	58.3	53.7	44.6	43.7	41.8
G-Sec/Invest. Ratio	87.2	81.5	80.0	80.0	80.0
Gross NPAs to Adv.	7.8	6.0	4.5	3.9	3.3
Net NPAs to Adv.	3.5	2.7	1.6	1.2	1.0
CAR	13.5	12.5	12.0	11.5	11.5
Tier 1	8.3	8.0	7.5	7.0	7.0

VALUATION					
Book Value (Rs)	384.4	457.4	531.3	619.4	724.3
Price-BV (x)	2.4	2.0	1.7	1.5	1.3
Adjusted BV (Rs)	317.2	391.3	481.4	573.1	678.0
Price-ABV (x)	2.9	2.3	1.9	1.6	1.3
EPS (Rs)	69.9	81.8	87.9	103.1	119.9
EPS Growth (%)	18.6	17.0	7.5	17.2	16.3
Price-Earnings (x)	13.1	11.2	10.4	8.9	7.6
OPS (Rs)	181.5	208.8	190.8	192.6	225.5
OPS Growth (%)	22.9	15.0	-8.6	1.0	17.1
Price-OP (x)	5.0	4.4	4.8	4.7	4.1

E: M0St Estimates

N O T E S



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State Bank of India

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|--|-----|
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| 2. Group/Directors ownership of the stock | Yes |
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