

Jammu & Kashmir Bank

STOCK INFO.	BLOOMBERG
BSE SENSEX: 13,879	JKBK IN
	REUTERS CODE
S&P CNX: 4,111	JKBK.BO

7 May 2007

Buy

Previous Recommendation: Buy

Rs695

Equity Shares (m)	48.5
52-Week Range	757/306
1,6,12 Rel.Perf.(%)	3/37/34
M.Cap. (Rs b)	33.7
M.Cap. (US\$ b)	0.8

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	RATIO
3/07A	9,281	2,745	56.6	55.2	12.3	1.7	13.2	14.4	1.0	1.8
3/08E	10,703	3,337	68.8	21.6	10.1	1.5	12.1	15.7	1.0	1.6
3/09E	12,914	4,080	84.1	22.2	8.3	1.3	11.6	16.9	1.1	1.4

J&K Bank reported a growth of 99% YoY in its net profit for 4QFY07 due to improved operational performance and aided by lower provision on account of investment depreciation. The results were, however, below our expectations, due to lower asset growth and higher tax provision. NII for the quarter increased by 7% YoY to Rs2b, as margins expanded by 32bp YoY to 3.23% and overall advances increased by 18%. Adjusted other income rose 51% YoY to Rs701m in 4QFY07 on back of robust fee income growth and higher treasury profits. Asset quality deteriorated, with gross NPAs rising 25% QoQ and net NPAs increasing 78% QoQ.

- Advances up 18%; deposits up 7% YoY
- Margins improve YoY but decline QoQ
- Robust growth in core fee income
- Asset quality worsens – net NPAs increase to 1.1%

With strong latent demand in the state of J&K and post the bank's business restructuring, we expect J&K Bank's loan growth to remain healthy. Current margins (3%) might see some pressure, as the bank wishes to grow advances at a rapid pace in FY08. Fee income is also likely to improve further, as the bank is focused on selling third-party products and undertakes more J&K state related businesses. Post the 4QFY07 results, we have downgraded our earnings estimate by 7% for each of FY08 and FY09 to factor margin pressures and higher NPA provisions. The stock trades at 8.3x FY09E EPS and 1.3x FY09E BV. We maintain **Buy**.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Interest Income	4,278	4,168	4,148	4,468	4,547	4,621	4,631	5,210	17,063	18,993
Interest Expenses	2,773	2,532	2,538	2,582	2,760	2,688	2,680	3,187	10,425	11,315
Net Interest Income	1,505	1,636	1,610	1,887	1,786	1,933	1,951	2,024	6,637	7,679
% Change (Y-o-Y)	5.8	5.9	0.7	35.1	18.7	18.2	21.2	7.3	11.3	15.7
Other Income	170	212	264	464	219	354	329	701	1,109	1,602
Net Income	1,675	1,848	1,874	2,350	2,005	2,287	2,279	2,725	7,746	9,281
Operating Expenses	767	835	868	982	829	908	888	1,094	3,453	3,724
Operating Profit	907	1,013	1,006	1,368	1,176	1,378	1,392	1,631	4,293	5,556
% Change (Y-o-Y)	-21.2	30.7	2.7	87.2	29.6	36.1	38.4	19.2	20.8	29.4
Prov. & Contingencies	256	243	219	957	291	194	298	621	1,682	1,404
Profit before Tax	651	770	787	411	886	1,185	1,094	1,010	2,611	4,152
Provision for Taxes	167	220	280	183	260	340	250	557	843	1,407
Net Profit	484	550	507	228	626	845	844	453	1,768	2,745
% Change (Y-o-Y)	2.6	n.a.	-29.6	-50.3	29.2	53.7	66.6	98.6	53.7	55.2
Cost to Income	45.8	45.2	46.3	41.8	41.3	39.7	39.0	40.1	44.6	40.1
Int.Expense/Int. Earned	64.8	60.8	61.2	57.8	60.7	58.2	57.9	61.2	61.1	59.6
Cost to Net Int.Income	51.0	51.0	53.9	52.1	46.4	47.0	45.5	54.0	52.0	48.5

E: MOST Estimates

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Advances up 18%; deposits up 7% YoY

While advances grew 18% YoY to Rs171b, deposit growth was muted at just 7% YoY to Rs252b. However, deposits grew 24% QoQ, as the bank garnered term deposits during the quarter. CASA ratio improved YoY from 34% to 37%; however, it came off from 40% in December 2006.

Deposits in the state of J&K are growing at a much faster pace. However, the management continues to shed high cost deposits outside J&K, resulting in muted deposit growth. The management has indicated that 62% of its current deposits are from the J&K state and aims to increase this proportion to 68% in the coming years. Growing government business and overall improvement in the economy of the J&K state would help the bank to grow its core deposits from the state.

Advances growth of 18% YoY was lower than our estimate of 20%. About 34% of these advances pertain to the state of J&K. The management reiterated that it would like to increase its loan portfolio in J&K, as the returns are much higher there. It aims to grow this ratio to 40% by growing advances in J&K at a rapid pace of 35-40% YoY. The compositional shift in the bank's deposits and advances portfolios in the J&K state has led to improvement in the CD ratio from 62% in FY06 to 68% in FY07.

Despite deposits growing at 7% YoY, J&K Bank's demand deposits are growing at a much faster pace. Low-cost

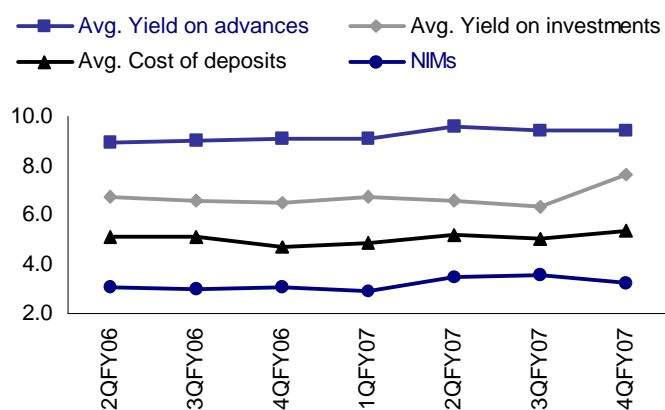
deposits have grown at 16% YoY and now constitute 37% of total deposits.

The management expects to increase CASA ratio to 40-42% in the next two years, as the bank further improves its CASA ratio in the state of J&K. This should enable J&K Bank to lower its cost of deposits, further.

Margins improve YoY but decline QoQ

J&K Bank's NII grew by a mere 7% YoY to Rs2b in 4QFY07. It mopped up term deposits (up 31% QoQ) and the cost of deposits increased from 4.72% in 4QFY06 and 5.04% in 3QFY07 to 5.32% in 4QFY07. However, for the full year, cost of deposits was contained at 4.5% against 4.55% in FY06. While yield on advances remained stable QoQ at 9.4% (improved 32bp YoY), yield on investments shot up from 6.3% in 3QFY07 to 7.6% in 4QFY07. We believe that the bank invested in short-term paper during the quarter to reap benefits of higher interest rates prevailing in call markets.

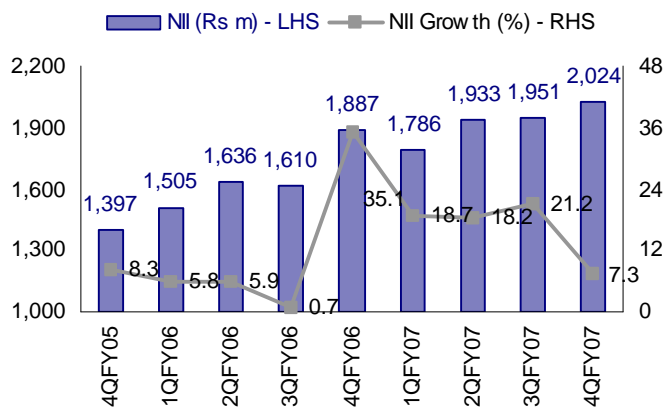
TREND IN NIMS (%)



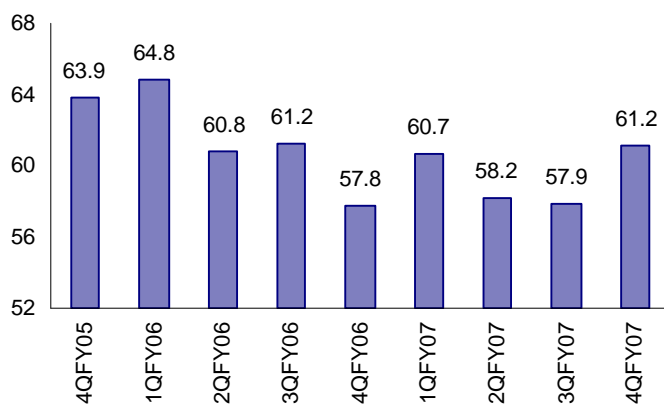
Source: Company/Motilal Oswal Securities

Lower asset growth with rising cost of deposits put pressure on the bank's margins. Resultantly, NII growth was a mere 7.3% and interest expense/interest income ratio increased to 61.2% from 57.9% in 3QFY07 and 57.8% in 4QFY06.

TREND IN NII



TREND IN INTEREST EXPENSE/INTEREST INCOME



Source: Company/Motilal Oswal Securities

Robust growth in core fee income

Reported other income grew 3% YoY to Rs539m in 4QFY07. However, on an adjusted basis (for reclassification of HTM investments), other income growth was 51% YoY to Rs701m. Commission exchanges income grew by 40% YoY to Rs0.5b while insurance commission increased 29% YoY to Rs48m. On a reported basis, treasury incurred a loss of Rs143.2m in 4QFY07, against a profit of Rs17.8m in 4QFY06. However, this loss includes Rs0.2b of charge on account of amortization of HTM investments. Adjusted treasury profits increased from Rs18m in 4QFY06 to Rs77m in 4QFY07.

Overall, the bank expects non-interest income, excluding treasury, to increase in the coming quarters, as it continues to forge alliances with reputed insurance companies and

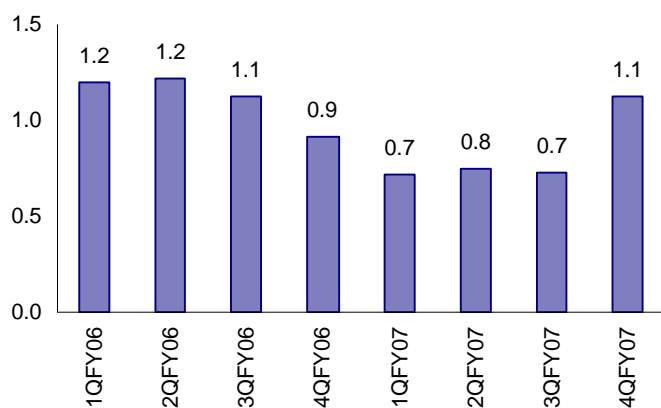
mutual fund companies for selling third-party products. Also the bank being the sole investment banker to the J&K government would result in rising non-interest income.

Asset quality worsens – net NPAs increase to 1.1%

A negative surprise was the sharp deterioration in asset quality during the quarter; the bank recognized some legacy accounts as NPAs. Gross NPAs increased by Rs1b (25% growth QoQ). Net NPAs increased by Rs0.8b. Gross NPA ratio increased from 2.5% in FY06 and 2.7% in 3QFY07 to 2.9% in FY07 while net NPA ratio increased to 1.13% in FY07 from 0.9% a year ago.

The bank abstained from making higher provisions towards these newly recognized NPAs, resulting in a decrease in coverage ratio to 61% from 64% a year ago and 73% in the previous quarter. The management has guided improvement in asset quality and provision coverage over the next two quarters, as upgradations / recoveries take place.

TREND IN NET NPAs (%)



Source: Company/Motilal Oswal Securities

Key trigger – uptrend in J&K economy

We believe that the uptrend in J&K’s economy would be a key trigger for J&K Bank. Since it is the banker to the state government and also boasts a wide state network, it would be the biggest beneficiary of any new projects coming up in the state. Already, tourist flows have begun to improve (management has stated that the tourist flows are the

highest over the last 15 years) and a couple of power projects have taken off in the state. Further, positive news flow regarding the Indo-Pak peace process would also provide greater business opportunities and lead to better perception of the bank, in turn leading to higher valuations.

Valuation and view

With strong latent demand in the state of J&K and post the bank's business restructuring, we expect J&K Bank's loan

growth to remain healthy. Current margins (3%) might see some pressure, as the bank wishes to grow advances at a rapid pace in FY08. Fee income is also likely to improve further, as the bank is focused on selling third-party products and undertakes more J&K state related businesses. Post the 4QFY07 results, we have downgraded our earnings estimate by 7% for each of FY08 and FY09 to factor margin pressures and higher NPA provisions. The stock trades at 8.3x FY09E EPS and 1.3x FY09E BV. We maintain **Buy**.

Jammu and Kashmir Bank: an investment profile

Company description

J&K Bank is a private sector bank, with the J&K government holding 53% of the bank's equity. With a balance sheet size of Rs286b, the bank has a network of 520+ branches and 180+ATMs. J&K Bank is the banker to the state government and also holds the agency to transact central government business in the state of Jammu & Kashmir.

Key investment arguments

- ✍ Loan growth is accelerating, after remaining subdued for the last few quarters. Margins have improved over past few quarters and the management is firm on maintaining them at 3%+ levels.
- ✍ With AFS portfolio concentrated in short-dated securities, the bank is largely insulated from fluctuations in G-sec rate swings.
- ✍ Fee income is expected to grow with new initiatives such as insurance product distribution, equity trading, depository services, bill collection and increased volumes of government business.
- ✍ Best suited to benefit from the emerging business opportunities in J&K.

Key investment risks

- ✍ Any adverse political development in the state of J&K could adversely affect the bank's growth opportunity.

Recent developments

- ✍ Mr Haseeb A Drabu, an eminent economist, is now the Chairman and Managing Director (CMD) of the bank after Mr MY Khan has retired.
- ✍ J&K Bank will partner with four other banks, viz., Central Bank of India, Oriental Bank of Commerce, Union Bank of India and Standard Chartered Bank in a proposed asset reconstruction company.

Valuation and view

- ✍ The bank will benefit from increased economic activity in the state of J&K.
- ✍ The stock trades at 8.3x FY09E EPS and 1.3x FY09E BV. We maintain **Buy**.

Sector view

- ✍ YTD loan growth of 28%.
- ✍ Volatility in interest rates would impact treasury income
- ✍ Benefits of significant improvement in asset quality not yet factored in earnings, valuations.
- ✍ We maintain an overweight stance on the sector.

COMPARATIVE VALUATIONS

		J&K BK	FEDERAL BK	KARNA. BK
P/E (x)	FY08E	10.1	6.7	8.8
	FY09E	8.3	5.7	7.9
P/ABV (x)	FY08E	1.6	1.2	1.5
	FY09E	1.4	1.0	1.3
RoE (%)	FY08E	15.7	19.5	17.2
	FY09E	16.9	19.7	16.8
RoA (%)	FY08E	1.0	1.2	1.3
	FY09E	1.1	1.2	1.3

SHAREHOLDING PATTERN (%)

	MAR.07	DEC.06	MAR.06
Promoter	53.2	53.2	53.2
Domestic Inst	1.3	1.4	2.2
Foreign	34.6	33.9	30.4
Others	10.9	11.5	14.2

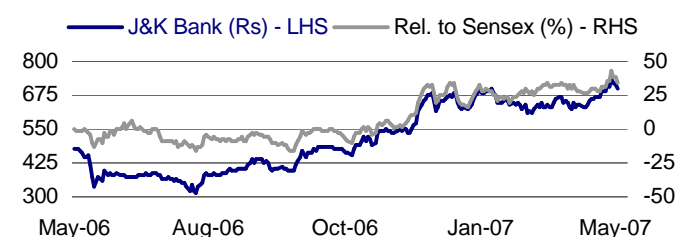
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VIATION (%)
FY08	68.8	70.3	-2.1
FY09	84.1	97.1	-13.4

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
695	742	6.7	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007	2008E	2009E
Interest Income	15,492	17,063	18,993	22,902	28,776
Interest Expended	9,530	10,425	11,315	14,207	18,355
Net Interest Income	5,962	6,637	7,679	8,695	10,422
Change (%)	-3.8	11.3	15.7	13.2	19.9
Other Income	820	1,109	1,602	2,007	2,492
Net Income	6,783	7,746	9,281	10,703	12,914
Change (%)	-26.4	14.2	19.8	15.3	20.7
Operating Expenses	3,228	3,453	3,724	4,335	5,114
Operating Income	3,555	4,293	5,556	6,368	7,800
Change (%)	-43.4	20.8	29.4	14.6	22.5
Other Provisions	2,195	1,682	1,404	1,600	1,800
PBT	1,359	2,611	4,152	4,768	6,000
Tax	209	843	1,407	1,430	1,920
Tax Rate (%)	15.3	32.3	33.9	30.0	32.0
PAT	1,151	1,768	2,745	3,337	4,080
Change (%)	-71.7	53.7	55.2	21.6	22.2
Proposed Dividend	439	442	641	669	781

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007	2008E	2009E
Capital	485	485	485	485	485
Reserves & Surplus	16,169	17,510	19,602	22,059	25,225
Net Worth	16,654	17,995	20,087	22,544	25,710
Deposits	216,450	234,846	251,943	314,929	377,914
Change (%)	16.0	8.5	7.3	25.0	20.0
Borrowings	4,065	3,509	6,202	6,512	6,838
Other Liabilities & Prov.	7,633	8,135	8,233	8,645	9,077
Total Liabilities	244,802	264,486	286,465	352,629	419,539
Current Assets	31,783	22,874	36,138	42,015	44,891
Investments	90,892	90,020	73,922	85,010	100,312
Change (%)	7.6	-1.0	-17.9	15.0	18.0
Advances	115,171	144,831	170,799	218,623	266,720
Change (%)	24.0	25.8	17.9	28.0	22.0
Net Fixed Assets	2,024	1,946	1,835	2,832	3,052
Other Assets	4,931	4,814	3,772	4,149	4,564
Total Assets	244,802	264,486	286,465	352,630	419,539

ASSUMPTIONS					
(%)					
Deposit Growth	16.0	8.5	7.3	25.0	20.0
Advances Growth	24.0	25.8	17.9	28.0	22.0
Investments Growth	7.6	-1.0	-17.9	15.0	18.0
Dividend	80.0	80.0	115.0	120.0	140.0
CRR	5.0	5.0	5.0	5.0	5.0

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Spreads Analysis (%)					
Avg. Yield - Earning Asset:	7.0	6.9	7.1	7.4	7.6
Avg. Cost-Int. Bear. Liab.	4.6	4.5	4.6	4.9	5.2
Interest Spread	2.4	2.4	2.6	2.5	2.4
Net Interest Margin	2.7	2.7	2.9	2.8	2.8

Profitability Ratios (%)					
RoE	7.1	10.3	14.4	15.7	16.9
RoA	0.5	0.7	1.0	1.0	1.1
Int. Expended/Int. Earned	61.5	61.1	59.6	62.0	63.8
Other Inc./Net Income	12.1	14.3	17.3	18.8	19.3

Efficiency Ratios (%)					
Op. Exps./Net Income	47.6	44.6	40.1	40.5	39.6
Empl. Cost/Op. Exps.	55.4	55.7	59.1	57.8	57.0
Busi. per Empl. (Rs m)	48.3	52.0	55.7	63.3	75.5
NP per Empl. (Rs lac)	1.7	2.6	3.8	4.4	5.2

Asset-Liability Profile (%)					
Adv./Deposit Ratio	53.2	61.7	67.8	69.4	70.6
Invest./Deposit Ratio	42.0	38.3	29.3	27.0	26.5
G-Sec/Invest. Ratio	64.4	71.0	73.5	73.5	73.5
Gross NPAs to Adv.	2.7	2.5	2.9	2.7	2.7
Net NPAs to Adv.	1.4	0.9	1.1	0.8	0.7
CAR	15.2	12.1	13.2	12.1	11.6
Tier 1	12.5	11.8	12.6	11.5	11.0

VALUATION					
Book Value (Rs)	343.4	371.1	414.2	464.9	530.2
Price-BV (x)	2.0	1.9	1.7	1.5	1.3
Adjusted BV (Rs)	321.6	353.1	388.3	441.6	503.7
Price-ABV (x)	2.2	2.0	1.8	1.6	1.4
EPS (Rs)	23.7	36.5	56.6	68.8	84.1
EPS Growth (%)	-71.7	53.7	55.2	21.6	22.2
Price-Earnings (x)	29.3	19.1	12.3	10.1	8.3
OPS (Rs)	73.3	88.5	114.6	131.3	160.8
OPS Growth (%)	-43.4	20.8	29.4	14.6	22.5
Price-OP (x)	9.5	7.9	6.1	5.3	4.3

E: MOST Estimates

N O T E S



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Disclosure of Interest Statement

Jammu & Kashmir Bank

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|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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