

UBS Investment Research

State Bank of India

Q2 FY08: strong net profit, but weak NII

■ Stronger than expected net profit but weak NII

SBI's net profit at Rs16bn in Q2 FY08 grew 36% YoY and 13% QoQ around 17% higher than consensus and our estimates. The stronger-than-expected growth was driven by higher trading gains and write back of loan loss provisions against our expectation of a provisioning charge. While net profit was strong, earnings quality disappointed with pressure on NIM and declining provisioning cover. NII grew 6% YoY and declined 10% QoQ. Fees were healthy, up 12% YoY and 7% QoQ but growth has decelerated. Provisioning cover declined to 45%.

■ NIM fell to 2.63% in Q2 FY08 from 3.1% last quarter

The sharp decline in NIM was driven by: 1) decline in CASA to 39.5% from 41% last quarter; 2) deposit growth exceeded loan growth and the excess liquidity was parked in low yielding bonds; and 3) higher rates on term deposits. Management has guided towards an improvement in both NIMs and loan growth in H2 FY08.

■ Despite weak NII stock may hold up

While Q2 was mixed, the stock may hold up due to management's focus on new growth areas; namely, the launch of general insurance by April 2008 and of private equity by January 2008. Management hopes to raise at least Rs100bn as fresh equity by March 2008. The chairman is optimistic about RBI approval for the holding company and government approval for the equity issue.

■ Valuation: PT of Rs2,015 based on sum of parts.

Excluding the value of non-bank subsidiaries, SBI is trading at 1.7x P/BV FY09E. We see upside potential to our earnings estimates.

Highlights (Rsm)	03/06	03/07	03/08E	03/09E	03/10E
Revenues	230,243.24	218,234.53	261,240.15	296,871.91	337,557.39
Pre-tax profits	69,062.10	75,360.87	80,413.28	91,565.96	108,425.42
Net income	44,067.30	45,413.07	53,072.77	61,349.19	72,645.03
EPS (UBS, Rs)	83.73	86.29	93.00	107.50	127.29
Net DPS (UBS, Rs)	14.00	16.00	18.00	18.00	18.00

Profitability & Valuation	5-yr hist av.	03/07	03/08E	03/09E	03/10E
ROE %	-	15.4	15.3	15.0	15.7
P/Op x	2.5	5.3	9.0	7.7	6.7
P/BVPS x	1.1	1.7	3.1	2.7	2.4
PE (UBS) x	6.3	11.6	22.4	19.4	16.4
Net dividend yield %	2.5	1.6	0.9	0.9	0.9

Source: Company accounts, Thomson Financial, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of Rs2,083.95 on 26 Oct 2007 23:39 BST

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Global Equity Research

India

Banks, Ex-S&L

12-month rating **Buy ***
Unchanged

12m price target **Rs2,015.00/US\$102.23**
Unchanged

Price **Rs2,083.95/US\$119.00 (ADR)**

RIC: SBI.BO BBG: SBIN IN

29 October 2007

Trading data (local/US\$)

52-wk range	Rs2,083.95-914.40/US\$119.25-54.90
Market cap.	Rs1,097bn/US\$31.3bn
Shares o/s	526m (ORD)/263m (ADR)
ADR ratio	1 ADR:2 ORD
Free float	41%
Avg. daily volume ('000)	683/35
Avg. daily value (Rsm)	1,158.2/3.9

Balance sheet data 03/08E

Shareholders' equity	Rs383bn
P/BVPS x	3.1
Tier one capital ratio	7.6%

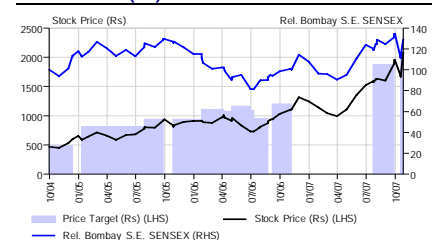
Forecast returns

Forecast price appreciation	-3.3%
Forecast dividend yield	0.9%
Forecast stock return	-2.4%
Market return assumption	11.9%
Forecast excess return	-14.3%

EPS (UBS, Rs)

	03/08E	03/07
	UBS	Cons. Actual
Q1E	23.25	- 21.57
Q2E	23.25	- 21.57
Q3E	23.25	- 21.57
Q4E	23.25	- 21.57
03/08E	93.00	93.00
03/09E	107.50	107.50

Performance (Rs)



Source: UBS

www.ubs.com/investmentresearch

This report has been prepared by UBS Securities India Private Ltd

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 7. * Exception to core rating bands; See page9

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SBI Q2 FY08: Disappointing NII but management promises a better H2

Summary: Stronger-than-expected net profit on higher trading gains and lower provisions: SBI's net profit at Rs16bn in Q208 grew 36% YoY and 13% QoQ. Net profit was ahead of our estimate due to significantly higher trading gains and write-back of loan-loss provisions, against our expectation of a provision charge. While net profit was strong, earnings quality disappointed due to pressure on NIM and declining provisioning cover. NII grew slower than expected at 6% YoY and declined 10% QoQ. The pressure on NII was on account of: 1) decline in CASA to 39.5% in Q2 FY08 against 41% in Q1 FY08. 2) Higher cost on retail term deposits. 3) Excess liquidity on the balance sheet. As deposit mobilisation was much stronger than loan growth, the excess liquidity was parked in low-yielding bonds. The SLR to deposit ratio has moved up to 29%. As a result NIM (adjusted for amortisation expenses) declined to 2.6% in Q2 FY08 from 3.1% in Q1 FY08 and 3% last year. Fee growth was healthy at 12% YoY and 7% QoQ, though a bit weaker than expected.

At the operating level, the pressure on NII was offset by contained growth in operating expenses that grew 8% YoY and 4% QoQ. Core operating profit grew 8% YoY and 7% QoQ. SBI wrote-back loan loss provisions of Rs165m. The write-back relates to a government guaranteed account. There were no new loan provisions made during the quarter as a result of which the provisioning cover declined to 45%—the lowest among state banks. While low provisioning cover is disappointing, asset quality remains healthy with stable gross NPLs QoQ. Loan growth was strong at 26% YoY and 5% QoQ driven by 18% growth in retail loans, 28% growth in farm loans and a strong 76% growth in international loans.

Chairman guides to a better H2: While Q2 disappointed in terms of margins, management believes H2 will be better as it expects credit to pick in H2. Management has seen good growth in sanctions in H1 and believes these will be utilised by corporates in H2. Management also explained that substantial growth in deposits was deliberate to avoid the H2 rush where banks bid aggressively for deposits and rates move up. With a good cushion of excess liquidity, the deposit mobilisation will be slower in H2. This, coupled with a good pick up in credit and management's focus on running off low yielding loans, will likely improve margins in H2.

New growth areas will be positive on sentiment, stock may hold well despite mixed 2Q: Despite weak Q2, the stock should hold up because of new growth areas and a better H2: Management's guidance on a better H2 and identification of new growth areas—mainly the launch of general insurance by April 2008 and launch of private equity by January 2008 should offset the negative sentiment from lower-than-expected core profit for SB in Q2 FY08, in our view.

Management guidance on new issue, holding company and AS-15: Apart from identifying new growth areas, the chairman also mentioned that he is optimistic about getting approval from RBI for the holding company. The bank plans to issue new shares of at least Rs100bn by March 2008 and believes the

government will clarify its position on this shortly. On the retirement liability under AS-15, management clarified that it recently received the notification under which it has the option to write-off the cumulative shortfall from reserves or amortise it through the P/L for five years. A part of the new issue will be used to write-off the shortfall at one shot. As for the increase in the annual retirement liability, management has not made any additional provisions, unlike other state banks that have. However, management believes it has been conservative under the old norms. So even under the new norm, their annual retirement benefit provision will not increase too much from the current level.

We see upside potential to our earnings estimates: Our one year price target is Rs2,015. We see upside potential to our earnings estimates for SBI given the stronger growth in non-core income in Q2 FY08.

Table 1: Profit and Loss Summary

Rs m	2QFY08	2QFY07	% Y/Y	% Q/Q	1HFY08	% Y/Y
Interest on Advances	83,651	59,067	42	5	163,536	44
Int on Resources Operations	32,496	28,895	12	5	63,500	8
Others Sundry Interest	16	34	(52)	4	32	(14)
Total Interest Income	116,163	87,996	32	5	227,068	31
Interest on Deposits	66,874	46,418	44	14	125,470	39
Interest on Borrowings	7,582	2,957	156	11	14,411	94
Others Sundry Interest	4,077	3,219	27	18	7,544	66
Total Interest Expenses	78,534	52,593	49	14	147,425	44
Net Interest Income	37,629	35,403	6	(10)	79,643	13
of which amortization expenses	2,670			(10)		(100)
Commission, Exc. Brokerage	9,445	8,445	12	7	18,304	14
Profit on sale of Investments	4,347	82	5,175	58	7,097	224
Forex Income	2,642	1,267	108	167	3,629	72
Profit / Loss on Revaluation of Investments	83	-		(101)	(7,035)	8
Dividend	9	136	(93)	(99)	1,723	(52)
Income From Leasing	136	360	(62)	(18)	302	(56)
Others Other Income	3,758	4,087	(8)	(7)	7,785	10
Total Non-Interest Income	20,419	14,377	42	79	31,805	26
Payment to Employees	16,177	16,207	(0)	(7)	33,535	4
Contribution for Employees	3,776	3,340	13	30	6,681	0
Total Staff Expenses	19,952	19,547	2	(2)	40,216	4
Rent, Taxes, Lighting	2,419	2,167	12	18	4,474	10
Depreciation on Property	1,598	1,744	(8)	6	3,113	(14)
Others	6,947	5,197	34	17	12,898	25
Total Overhead Expenses	10,964	9,108	20	15	20,486	14
Total Operating Expenses	30,916	28,655	8	4	60,702	7
Operating Profit	27,132	21,125	28	15	50,747	30
Income Tax Provisions	10,166	6,067	68	31	17,929	32
Loan Loss Provisions	(165)	1,161	(114)	(103)	4,898	70
Investment Depreciation	8	634	(99)	(100)	(3,760)	(375)
Standard Assets Provision	662	1,400	(53)	108	980	(39)
Other Provisions	348	18	1,790	(1,839)	328	(379)
Total Provisions	11,018	9,280	19	18	20,374	(39)
Net Profit	16,114	11,845	36	13	30,372	53
Core operating profit	22,785	21,043	8	9	43,649	18

Source: Company data

Table 2: Trend in NIM, %

	2QFY08	1HFY08	1QFY08	1HFY07	FY07
Yield on loans	9.8	9.8	9.8	8.6	8.7
Yield on resource operations adjusted for amortization	5.8	6.2	5.8	6.3	6.9
Cost of deposits	5.6	5.5	5.4	4.5	4.8
Loan-deposit spread	4.3	4.4	4.5	4.0	3.9
Investment-deposit spread	0.2	0.7	0.5	1.8	2.1
Combined spread	2.8	3.07	3.05	3.26	3.40
Core NIM	2.6	2.8	3.09	3.02	3.3

Source: Company data

Table 3: Loan growth is strong, but deposit growth is stronger

Rs bn	2QFY08	1QFY08	2QFY07	4QFY07	% Y/Y	% Q/Q
Deposits	4,841	4,497	3,926	4,355	23	7.6
Advances	3,588	3,388	2,831	3,373.4	27	5.9
Gross NPLs	106	108	97	99.98	10	(1.6)
Net NPLs	58	55	48	52.6	21	5.5

Source: Company data

Table 4: Deposit mix – CASA has deteriorated to 39%

Rs bn	Sep-07	Sep-06	Jun-07	% Y/Y	% Q/Q
CASA	1,798	1,575	1,745	14.2	3.0
Savings deposits	1,389	1,239	1,359	12.1	2.2
Current deposits	409	215	385	89.9	6.1
Term deposits	3,043	2,352	2,752	29.4	10.6
Total deposits	4,841	3,926	4,497	23.3	7.6
CASA, %	39	41	41	0	0

Source: Company data

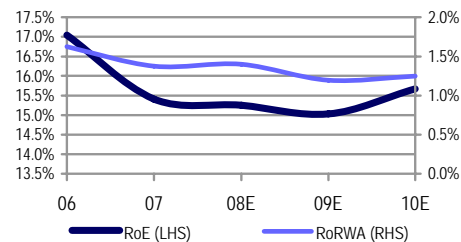
State Bank of India

Per share (Rs)	3/06	3/07	3/08E	3/09E	3/10E
EPS (stated)	83.73	86.29	93.00	107.50	127.29
EPS (UBS adjusted)	83.73	86.29	93.00	107.50	127.29
GOPS	214.69	190.00	231.55	268.92	312.63
DPS	14.00	16.00	18.00	18.00	18.00
BVPS (stated)	525.25	594.69	670.91	759.43	865.63
BVPS (adjusted)	432.03	494.85	552.73	640.87	731.10
Profit & Loss (Rsm)					
Net interest income	155,891.22	160,542.05	182,736.84	205,530.98	236,056.70
Other income	74,352.02	57,692.49	78,503.31	91,340.94	101,500.70
Total revenues	230,243.24	218,234.53	261,240.15	296,871.91	337,557.39
Expenses	(117,250.44)	(118,235.17)	(129,093.21)	(143,398.03)	(159,140.63)
Operating profit	112,992.80	99,999.36	132,146.93	153,473.88	178,416.77
Provisions and other items	(43,930.70)	(24,638.49)	(51,733.65)	(61,907.92)	(69,991.35)
Profit before tax	69,062.10	75,360.87	80,413.28	91,565.96	108,425.42
Pre-exceptional net income	44,067.30	45,413.07	53,072.77	61,349.19	72,645.03
Capital dynamics (Rsm)					
Risk-weighted assets	2,926,931.79	3,683,387.99	4,678,485.94	5,592,226.45	6,059,585.76
Tier one capital	274,358.33	287,985.56	357,885.56	408,405.56	469,015.56
Total capital	329,034.05	472,184.46	626,822.15	733,234.99	855,972.39
Tier one ratio	9.4%	7.8%	7.6%	7.3%	7.7%
Total capital ratio	11.2%	12.8%	13.4%	13.1%	14.1%
Net profit after tax	44,067.30	45,413.07	53,072.77	61,349.19	72,645.03
<i>Tier 1 requirement</i>					
Less: Working capital requirement					
Less: Dividends	7,368.18	7,368.18	10,272.58	10,272.58	10,272.58
Surplus capital generated					
Surplus capital generation ratio					
Balance sheet (Rsm)					
Assets	4,938,695.52	5,665,649.20	6,887,385.47	8,034,257.95	9,255,618.60
Customer loans	2,616,415.34	3,373,364.94	4,216,706.17	4,975,713.28	5,871,341.67
Customer deposits	4,106,873.00	4,752,244.25	5,605,148.85	6,553,108.42	7,540,981.30
Funds under management					
Loans : assets	53.0%	59.5%	61.2%	61.9%	63.4%
Deposits : assets	83.2%	83.9%	81.4%	81.6%	81.5%
Loans : deposits	63.7%	71.0%	75.2%	75.9%	77.9%
Shareholders funds : assets	5.60%	5.52%	5.56%	5.39%	5.34%
Asset quality (Rsm)					
Non-performing assets	96,282.70	99,983.50	105,704.07	115,171.37	136,782.78
Total risk reserves	47,171.50	47,438.10	43,506.91	52,772.68	65,975.94
NPLs : loans	3.68%	2.96%	2.51%	2.31%	2.33%
NPL coverage	49%	47%	41%	46%	48%
Provision charge : average loans	0.24%	0.67%	0.99%	0.98%	0.98%
Net NPLs : shareholders' funds	17.8%	16.8%	16.2%	14.4%	14.3%
Profitability					
Net interest margin (avg assets)	3.27%	3.03%	3.09%	2.75%	2.73%
Provisions : operating profit	38.9%	24.6%	39.1%	40.3%	39.2%
RoE	17.0%	15.4%	15.3%	15.0%	15.7%
RoAdjE	17.0%	15.4%	15.3%	15.0%	15.7%
RoRWA	1.62%	1.37%	1.40%	1.19%	1.25%
RoA	0.92%	0.86%	0.85%	0.82%	0.84%
Productivity					
Cost : income ratio	50.9%	54.2%	49.4%	48.3%	47.1%
Costs : average assets	2.5%	2.2%	2.2%	1.9%	1.8%
Compensation expense ratio	41.8%	44.2%	38.7%	37.1%	35.5%
Momentum					
Revenue growth	+9.3%	-5.2%	+19.7%	+13.6%	+13.7%
Operating profit growth	+8.2%	-11.5%	+32.1%	+16.1%	+16.3%
Net profit growth	+14.7%	+3.1%	+16.9%	+15.6%	+18.4%
Dividend growth	+12.0%	+14.3%	+12.5%	+0.0%	+0.0%
Value*					
UBS bank valuation					
Leveraged P/E					
Risk tendency P/E					
Merger P/E					
Market capitalisation (Rsm)	428,743.08	526,749.62	1,096,782.86	1,096,782.86	1,096,782.86
Conventional valuation					
Market cap./Revenues	4.8x	5.0x	4.2x	3.7x	3.2x
Market cap./Operating profit	9.7x	11.0x	8.3x	7.1x	6.1x
P/E (stated)	24.9x	24.2x	22.4x	19.4x	16.4x
P/E (UBS adjusted)	24.9x	24.2x	22.4x	19.4x	16.4x
Dividend yield (net)	0.67%	0.77%	0.86%	0.86%	0.86%
P/BV (stated)	4.0x	3.5x	3.1x	2.7x	2.4x
P/BV (adjusted)	4.8x	4.2x	3.8x	3.3x	2.9x

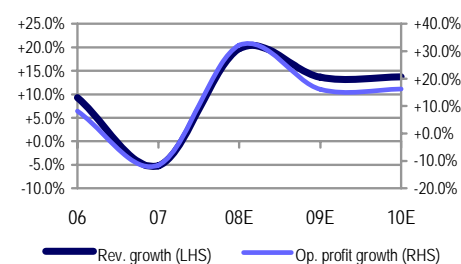
Source: UBS estimates, * Historical, current, & future valuations are based on a share price of Rs2,083.95 as at close on 26 Oct 2007



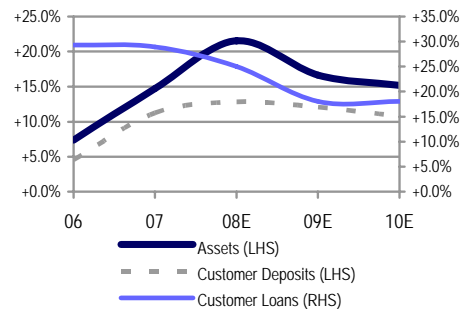
Profitability (RoE & RoRWA)



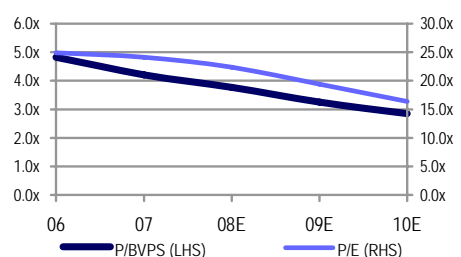
Momentum (Revenue & Operating profit growth)



Balance Sheet Growth



Value (P/Adj. BVPS & P/Adj. EPS)



■ State Bank of India

State Bank of India (SBI), formerly known as the Imperial Bank, traces its origins to 1806. SBI was constituted through an Act of Parliament on 1 July 1955. It is India's largest commercial bank with a deposit market share of 18.6% and a credit market share of 20%. With 8,996 domestic branches, it has the largest branch network in India. The banking regulator, the Reserve Bank of India, is the single largest shareholder, owning 59.7% of the shares in issue. The Government of India directly appoints the chairman and the two managing directors.

■ Statement of Risk

A faster than expected increase in interest rates is the key risk to our earnings and PT for SBI.

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

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UBS Investment Research: Global Equity Rating Allocations

UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	55%	40%
Neutral	Hold/Neutral	36%	35%
Sell	Sell	9%	22%
UBS Short-Term Rating	Rating Category	Coverage ³	IB Services ⁴
Buy	Buy	0%	29%
Sell	Sell	0%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 September 2007.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned or Company Disclosure table in the relevant research piece.

Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
State Bank of India	SBI.BO	Buy (CBE)	N/A	Rs2,083.95	26 Oct 2007

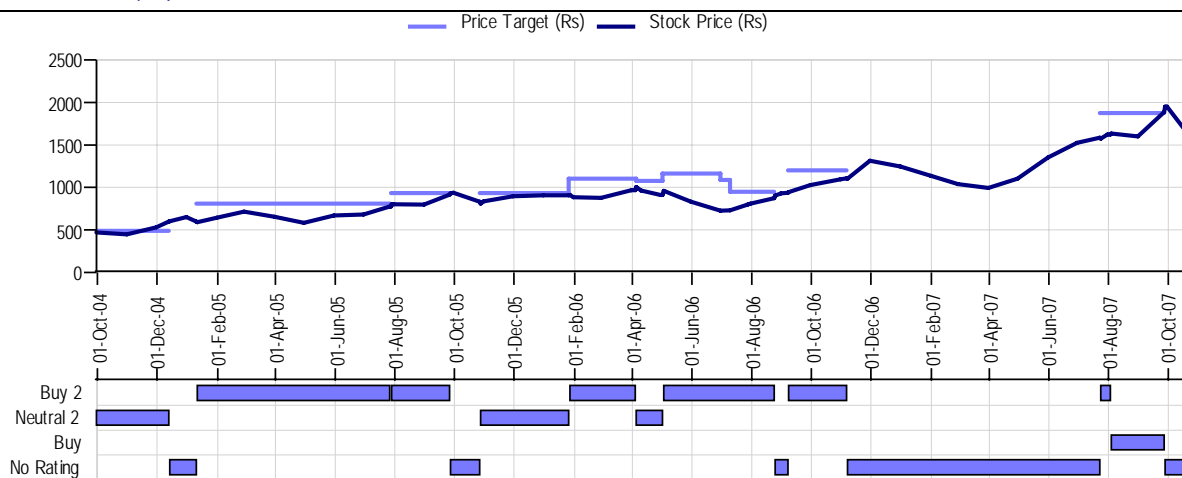
Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

This report was sent to the issuer prior to publication solely for the purpose of checking for factual accuracy, and no material changes were made to the content based on the issuer's feedback.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

State Bank of India (Rs)



Source: UBS; as of 26 Oct 2007

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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