

# Canara Bank

Rs246

UPGRADE TO OUTPERFORMER

## MANAGEMENT UPDATE

Mkt Cap: Rs100.8bn; US\$2.1bn

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We recently met the management of Canara Bank and came back convinced about the bank's ability to deliver a high RoE over the next couple of years. We expect the RoE improvement to be driven by: (i) an improving core performance; and (ii) receding pressure on asset quality. The bank is well poised to accelerate its credit growth, which along with the calibrated strategy of lower growth in FY08, has led to an uptrend in CASA, NIMs and NII (albeit some base effect). Besides the pick-up in credit growth, renewed focus on cross-selling would also contribute to fee income growth. In Q4FY09, the bank surprised positively on asset quality and reported a decline in Gross NPAs, while restructured assets hovered at the industry average. The bank has de-risked its investment book over the year, with AFS proportion in investment book now at 27.5% (duration of ~2 years) from ~37% in FY08. A lower AFS proportion in the investment book implies lesser volatility in earnings going forward. We expect Canara Bank to report 14% CAGR in net profit over FY09-11, with an average RoE of ~21% over the next couple of years. Stock is currently trading at ~1x FY10 adjusted book. We upgrade our recommendation on the stock to Outperformer with a 12-month price target of Rs350.

### Key valuation metrics

Year to 31 March	2007	2008	2009	2010E	2011E
Net profit (Rs m)	14,208	15,650	20,724	23,635	26,940
yoy growth	10.9	10.1	32.4	14.0	14.0
Shares in issue (m)	410	410	410	410	410
EPS (Rs)	34.7	38.2	50.5	57.6	65.7
EPS growth (%)	10.9	10.1	32.4	14.0	14.0
PE (x)	7.1	6.4	4.9	4.3	3.7
Book value (Rs/share)	197.8	202.3	244.9	295.5	354.2
Adj. Book value (Rs/share)	186.1	190.8	224.0	247.7	271.1
P/ Adj. Book (x)	1.3	1.3	1.1	1.0	0.9
RONW (%)	18.8	19.1	22.6	21.3	20.2

## MANAGEMENT UPDATE

The key takeaways from our meeting with Canara Bank management are:

### □ Growth strategy – foot on the accelerator!

- Credit growth in FY08 was restricted to ~9% as the bank's strategy was to consolidate rather than grow aggressively (28% CAGR over FY05-07).
- Since July/ Aug '08 (when the new Chairman took over the running of the bank), the focus has been on returning to growth. In FY09, the bank grew its deposits by ~21% and advances by ~29%.
- In FY10, credit growth is expected to moderate to 20-22%, in line with RBI guidelines.

### ❑ Outlook for margins – stable!

- NIMs improved by 36bp qoq to ~2.8% in Q4FY09, as loan spreads expanded with a higher rise in yield on advances than cost of deposits. Management expects NIMs to stabilize around 2.8%.
- Lending rates are not expected to fall by more than 50-100bp from here unless cost of funds also falls by a similar extent. We believe there is limited scope for reduction in cost of funds, which as fixed deposits would then become unattractive for investors.

### ❑ Gross NPAs contained; restructuring at 1.5%

- Gross NPAs have come down from Rs25bn in Dec'08 to ~Rs21.7bn in Mar'09 on the back of strong recoveries. The bank's entire Rs4bn Ratnagiri exposure continues to be a part of its Gross NPAs.
- While provision coverage ratio of ~31% looks low, Canara Bank management reaffirms that including Rs40bn of write-offs by the bank, coverage ratio stands at 77- 78%.
- The bank has restructured Rs20.6bn of loans during FY09, bulk of which are payment deferment and not haircut on interest. As of April'09, applications for restructuring worth Rs20bn are still pending, of which the bank does not expect to restructure more than Rs10bn.

### ❑ Expansion plans

- 200 new branches are expected to be opened this year. Around 77% of all branches are CBS compliant, with a target to reach 100% by March-April'10.
- Alongside productivity initiatives for the bank's workforce, about 1,800 young people are expected to be hired to lower the age profile of the employees.

## HIGHLIGHTS OF Q4FY09 RESULTS

Canara Bank ('CNBK') reported strong PAT growth of ~55% yoy to Rs7.2bn in Q4FY09, surpassing our estimates. The outperformance was driven by robust NII growth and stellar treasury gains.

- **Strong NII performance...as margins & CD ratio held up:** NII came in above our estimates at Rs13.1bn, an increase of ~42% yoy (albeit on a lower base) and 5% qoq. NII growth was buoyed by an improving CD ratio led by strong growth in volumes (Exhibit 1 and 2).
- **Robust treasury gains; traction in core fee income:** Other income grew by ~19% yoy to Rs8.5bn on the back of strong treasury gains of Rs3.5bn (27% of operating profit). Core fee income (CEB) gained ground, up 21% yoy – buoyed primarily by trade credit i.e. LCs & guarantees (Exhibit 3).
- **Positive surprise on asset quality, incremental restructurings at 1.5% of net advances:** Gross NPAs declined by 38bp qoq to 1.56% (Rs3.5bn decline in absolute terms), indicated to be due to strong recoveries and up-gradations. Advances worth Rs20.7bn (1.5% of loans) were restructured in FY09 – primarily in Q4, classified predominantly as standard. Pending restructurings amount to ~Rs20bn, ~1.5% of net advances. (Exhibit 5).
- **Provisioning expenses in line; coverage drops:** The bank made Rs2.5bn of NPA provisions in Q4FY09, amounting to 70% of total non-tax provisions. Coverage declined by ~380bp qoq to 33.9%. Further, the bank booked MTM depreciation of Rs200m – primarily on equity book (Exhibit 6).
- **Strong deposit growth; CASA slips:** Deposit growth remained strong at ~21% yoy and 7% qoq with ~56% of incremental deposits being term deposits. CASA ratio slipped by 30bp qoq to 30.7%.
- **Stable loan mix:** Credit grew by ~29% yoy to Rs1,382bn. Retail as proportion of outstanding loan book has reduced to ~14% from 16.5% in Q4FY08 due to management's conscious decision of slower growth in this portfolio. During the quarter, the bank had announced special schemes to spur demand in segments like mortgages and auto loans (Exhibit 4).
- **Capital adequacy; government holding still high:** During the quarter, the bank raised Rs2.4bn of Tier-II bonds, which led to Tier-1 ratio improving to 8.01% from 7.5% in Q3FY09. The bank's overall CRAR is at 14.1%, with government holding of ~73% leaving substantial headroom for dilution.

## Exhibit 1: Margins held up...

	Q4FY08	Q3FY09	Q4FY09	yoy change (bps)	qoq change (bps)
	(%)	(%)	(%)	(%)	(%)
<b>Calculated</b>					
Yield on advances	10.19	11.23	10.71	51.2	(52.2)
Yield on investments	7.59	8.31	7.65	6.3	(65.6)
Blended yields	9.34	10.37	9.82	47.3	(55.6)
Cost of deposits	7.27	7.42	7.04	(23.7)	(38.4)
Loan spreads	2.92	3.81	3.67	74.9	(13.8)
NIM (calculated)	2.14	2.49	2.47	33.2	(2.0)
<b>Reported</b>					
Yield on advances	10.22	10.69	10.79	57.0	10.0
Cost of funds	6.24	6.23	6.87	63.0	64.0
NIM	2.42	2.75	2.78	36.0	3.0

- Whilst loan spreads contracted sequentially reflecting shifting pricing power, as deposits also re-priced at lower rates, NIMs held up

## Exhibit 2: ...so does CD ratio

(Rs m)	Q4FY08	Q3FY09	Q4FY09
Advances	1,072,380	1,289,200	1,382,190
yoy growth (%)	8.9	30.9	28.9
Deposits	1,540,720	1,748,390	1,868,930
yoy growth (%)	8.2	20.2	21.3
CD ratio (%)	69.6	73.7	74.0

- Strong growth in advances led to CD ratio improving on a yoy basis

## Exhibit 3: Fee income break up (Rs m)

Rs m	Q4FY08	Q3FY09	Q4FY09	yoy gwth (%)	qoq gwth (%)
CEB	1,640	1,370	1,980	20.7	44.5
Treasury profits	1,010	3,440	3,490	245.5	1.5
Forex	1,140	850	140	(87.7)	(83.5)
Misc	1,823	1,915	2,855	56.6	49.1
Recoveries from written-off accounts	1,150	800	990	(13.9)	23.8
Core fee income	6,133	2,220	2,120	(65.4)	(4.5)
<b>Total other income</b>	<b>7,143</b>	<b>7,575</b>	<b>8,465</b>	<b>18.5</b>	<b>11.8</b>

- Strong treasury gains (27% of operating profit) bolstered bottom-line
- CEB gained momentum on the back of credit volumes, while recoveries slowed reflecting economic environment

## Exhibit 4: Composition of advances book (Rs bn)

(Rs bn)	Q4FY08	% of Q3FY09 Total	Q4FY09	YoY gwth (%)	% of Total
Retail	176.7	16.5	180	198	12.1
of which mortgages	66.6	6.2	66.7	79.0	18.6
Agricultural	180.0	16.8	189	201	11.9
SME	186.0	17.3	214	238	28.1
Others	529.8	49.4	706	745	40.5
<b>Total</b>	<b>1072.4</b>	<b>100.0</b>	<b>1,289</b>	<b>1,382</b>	<b>28.9</b>

- Credit growth (29% yoy) driven by loans to SMEs
- The bank consciously continues to grow retail at a slower pace

## Exhibit 5: Positive surprise on asset quality

	Q4FY08	Q3FY09	Q4FY09	yoy gwth (%) / chg (bp)	qoq gwth (%) / chg (bp)
Gross NPA	14,156	25,155	21,680	53.2	(13.8)
Gross NPA (%)	1.31	1.94	1.56	25.0	(38.0)
Net NPA	8,990	16,542	15,073	67.7	(8.9)
Net NPA (%)	0.84	1.28	1.09	25.0	(19.0)
Coverage	36.5	34.2	30.5	(601.3)	(376.1)

- Gross NPAs declined by ~40bp qoq, on the back of higher recoveries
- Rs20.7bn of incremental restructuring (1.5% of net advances), with another Rs20bn worth of applications outstanding

## Exhibit 6: Break up of provisions (Rs m)

	Q4FY08	Q3FY09	Q4FY09
Provision for NPA	3,130	3,570	2,500
Investment depreciation	280	-74	200
<b>Total provisions</b>	<b>3,751</b>	<b>3,526</b>	<b>3,538</b>

- NPA provisions to average loans declined from 1.22% in Q4FY08 to 0.75% in Q4FY09 (1.15% in Q3FY09)

## VALUATIONS & VIEW

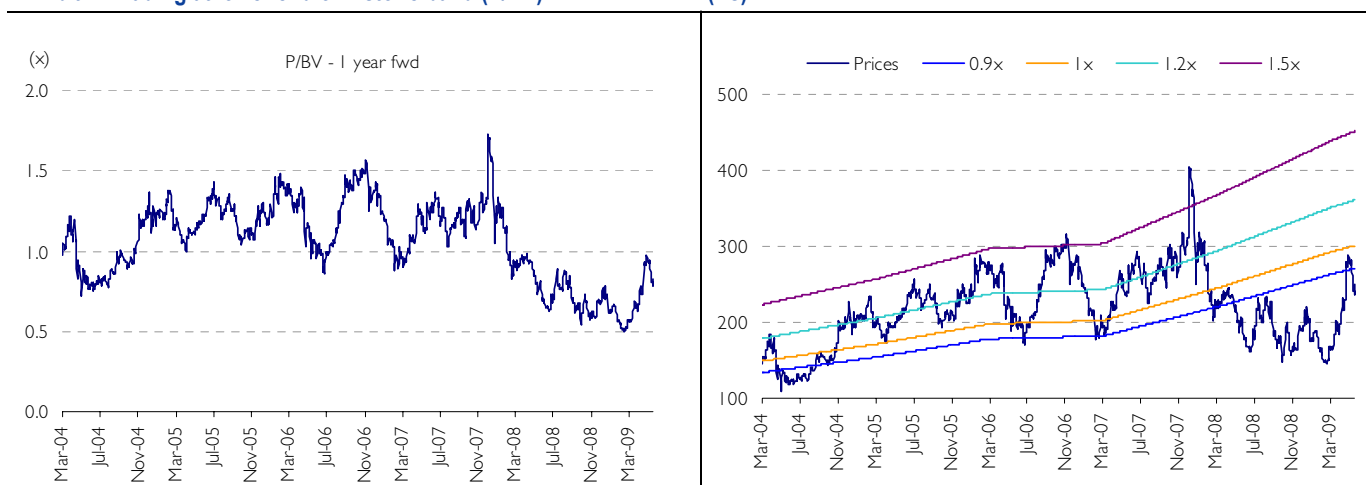
Given the signs of recovery in the core performance, receding asset quality pressures and new strategic orientation under the new chairman, we expect Canara Bank to improve RoE from an average of ~19% over FY06-08 to ~21% over FY09-11E. The market has rewarded the positive surprise on asset quality in Q4; however, we see room for further appreciation in the stock price. We expect Canara Bank to report 14% CAGR in net profit over FY09-11, which amounts to ~22% CAGR in core earnings (excluding treasury gains) during the period. At ~1x FY10E adjusted book, we upgrade the stock to Outperformer with a price target of Rs350.

### Trading at lower end of its historic band

Concerns around the bank's core operating performance, and more significantly asset quality, have driven a correction in the stock price. Canara Bank currently trades at the lower end of its own historic P/BV band

Exhibit 7: Trading at lower end of historic band (P/BV)

(Rs)



Source: Bloomberg; IDFC-SSKI Research

### Comparative valuations stack up

We expect Canara Bank to improve RoE from an average of ~19% over FY06-08 to ~21% over FY09-11E, with CAGR in core earnings (excluding treasury gains) estimated at ~22% during the period. On comparison, Canara Bank is trading at a 15-20% discount to PSU peers of similar balance sheet size.

Exhibit 8: Comparative Valuations

	Net Profit CAGR (09-11E)	ROE (%)			ROA (%)			P/BV (18th June)			Tier-1 CRAR (%)
		FY09	FY10E	FY11E	FY09	FY10E	FY11E	FY09	FY10E	FY11E	
Punjab National Bank	13.0	25.8	23.7	22.4	1.4	1.3	1.3	1.4	1.2	1.0	9.0
Bank of Baroda	13.9	19.2	20.0	19.6	1.1	1.0	0.9	1.4	1.2	1.0	8.5
Bank of India	14.8	30.1	27.1	24.7	1.5	1.4	1.4	1.5	1.1	0.9	8.9
Canara Bank	14.0	22.6	21.3	20.2	1.0	1.0	1.0	1.1	1.0	0.9	8.0
Union Bank of India	12.9	27.2	24.1	22.9	1.2	1.1	1.1	1.5	1.2	1.0	8.2

Source: Companies; IDFC-SSKI Research

**Earnings model**

Year to 31 March (Rs m)	2007	2008	2009	2010E	2011E
Net interest income	40,268	35,378	47,178	56,277	65,171
yoy growth (%)	12.4	-12.1	33.4	19.3	15.8
Other income	14,509	22,129	23,112	20,339	21,428
yoy growth (%)	10.3	52.5	4.4	-12.0	5.4
Trading profits	737	3,407	6,750	2,000	2,000
Net revenue	54,778	57,507	70,290	76,617	86,599
yoy growth (%)	11.9	5.0	22.2	9.0	13.0
Operating expenses	25,653	27,913	30,653	32,903	36,490
yoy growth (%)	9.3	8.8	9.8	7.3	10.9
Operating profit	29,125	29,594	39,638	43,714	50,109
yoy growth (%)	14.2	1.6	33.9	10.3	14.6
Provisions	12,417	10,544	13,914	14,170	16,434
Of which: NPA Provisions	4,580	8,750	9,000	12,471	14,544
PBT	16,708	19,050	25,724	29,544	33,675
yoy growth (%)	12.8	14.0	35.0	14.8	14.0
Provision for tax	2,500	3,400	5,000	5,909	6,735
PAT	14,208	15,650	20,724	23,635	26,940
yoy growth (%)	10.9	10.1	32.4	14.0	14.0

**Balance Sheet**

As on 31 March (Rs m)	2007	2008	2009	2010E	2011E
Advances	985,057	1,072,380	1,382,190	1,615,146	1,912,042
yoy growth (%)	24.0	8.9	28.9	16.9	18.4
Customer assets	866,677	939,511	1,182,909	1,379,994	1,629,859
yoy growth (%)	24.1	8.4	25.9	16.7	18.1
Total assets	1,659,610	1,805,286	2,196,460	2,503,948	2,879,123
Networth	81,111	82,956	100,401	121,166	145,236
Deposits	1,423,815	1,540,724	1,868,930	2,130,024	2,449,962
- Current	8.7	8.6	8.3	8.7	8.7
- Savings	22.8	22.9	22.4	22.8	22.8
Borrowings	15,744	25,172	25,676	26,189	26,713

**Ratio Analysis**

Year to 31 March (%)	2007	2008	2009	2010E	2011E
Net int. margin/avg assets	2.7	2.0	2.4	2.4	2.4
Non-fund rev./avg assets	0.9	1.2	1.1	0.8	0.7
Operating exp./avg assets	1.7	1.6	1.5	1.4	1.4
Cost/Income	46.8	48.5	43.6	42.9	42.1
Prov./avg customer assets	0.5	0.9	0.7	0.8	0.8
PBT/Average assets	1.1	1.1	1.3	1.3	1.3
RoA	1.0	0.9	1.0	1.0	1.0
RoE	18.8	19.1	22.6	21.3	20.2
Tax/PBT	15.0	17.8	19.4	20.0	20.0
GrossNPA	1.5	1.3	1.3	1.6	3.4
Net NPA	0.9	0.8	1.1	2.2	3.3
Provisioning coverage	37.9	36.5	30.5	34.5	34.8
Growth in customer assets	24.1	8.4	25.9	16.7	18.1
Growth in advances	24.0	8.9	28.9	16.9	18.4
Growth in deposits	21.9	8.2	21.3	14.0	15.0
SLR Ratio	26.7	28.1	26.0	26.0	25.5
CASA ratio	31.5	31.5	30.7	31.5	31.5

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