

JV CAPITAL SERVICES PVT. LTD

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PNB

CMP: 990

BUY

INDUSTRY: Banking

RISK PROFILE— Low

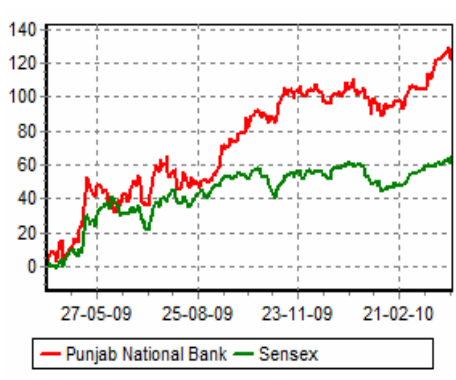
TARGET:1300

CMP(Rs)	990
Target price(Rs)	1300
Upside (%)	31
52 Week h/l (Rs)	1044/435
Market cap (Rs. Cr)	31696
6m Avg vol ('000Nos)	406
No. of o/s shares (mn)	315
FV (Rs)	10
NSE code	PNB

Punjab National Bank is the second-largest public sector bank in the country, with a loan book size of Rs.1.72 lakh crore that grew by ~28% over FY06-09. It has one of the best liability franchises with a CASA of ~40% leading to a relatively high NIMs among PSU banks. It has a gross NPA of 1.8% and NPA coverage of ~89% (excluding impact of debt relief). PNB is headed by Mr. Kamath who joined in Nov 09 and was the ex-CMD of Allahabad Bank.

Key Investment Themes

Relative Performance Analysis



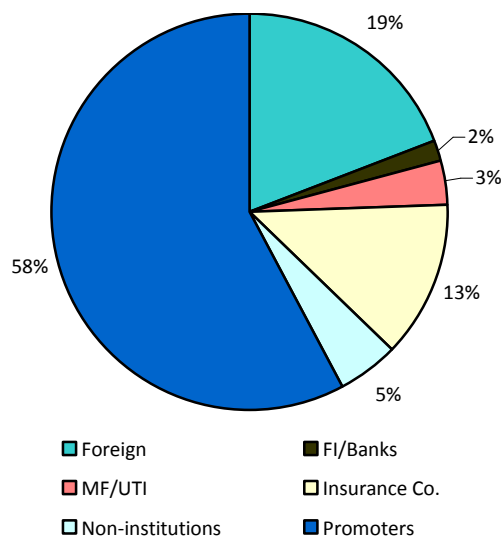
Well positioned to benefit from the buoyancy in loan growth

PNB, the second largest public sector bank is well poised to capture the uptick in economic environment due to a) large size of the balance sheet, b) strong franchise, c) robust loan loss coverage ratio of 89% and, d) strong low cost deposit base which will protect margins in a rising interest rate environment.

Growth expected to be better than peers

Credit growth for PNB had been slow in line with the broad industry trends. This was due to credit substitution, with corporates accessing the commercial paper market to benefit from the lower interest rates rather than due to slowing of economic activity. However, we believe the worst is behind us and credit demand has picked up in last couple of months. This trend is sustainable. The management also is of the view that its growth would be a shade above the industry growth.

Shareholding Pattern



NPA likely to peak by Jun10, Restructured accounts likely to come down

We do not expect the gross NPL ratio to exceed 2%. The company's conservative provisioning policy provides it with significant cushion against adverse developments. We expect the company's RoE to remain healthy at around 22-25% over the next few years.

Margins to remain better than peer average

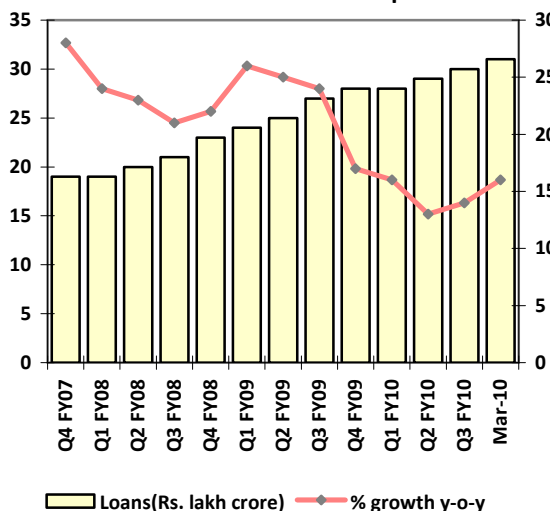
PNB's ability to limit sub-PLR loans to less than 30% and the re-pricing of deposits, coupled with high CASA (about 40%), should sustain margins going forward. The impact to PNB of the change in savings rate (to daily average basis) calculation is likely to be limited to about 8-9bps.

Strong liability franchise

CASA make up about 40% of total deposits resulting in a low cost of deposits. Strong presence in North India, which has a strong deposit base, should see strong earnings growth. PNB would also be a big beneficiary of return in growth in agriculture.

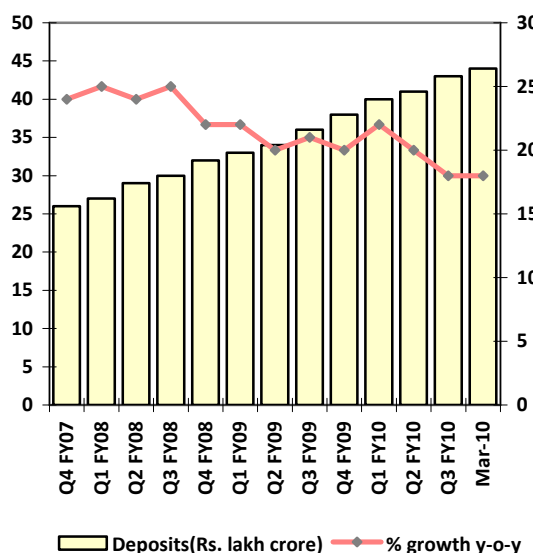
Shaurya Priya
research@jvfinancial.com

Loan Growth Picks up



After falling down the loan growth has picked up in since the beginning of 2010

Deposit Growth Slows

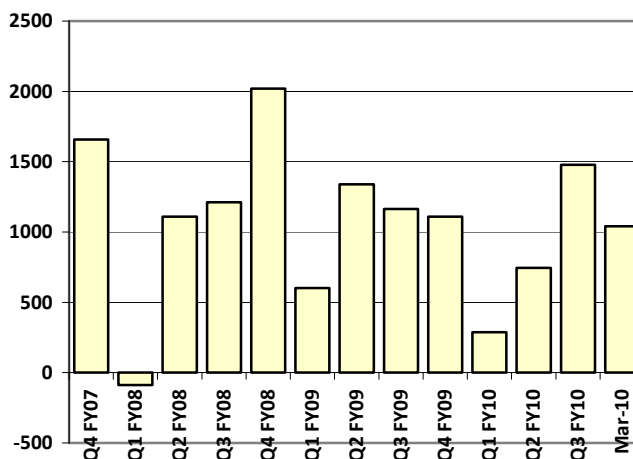


Deposit growth has slowed down, indicating rise in risk appetite

Loan growth to recover significantly; to clock ~20% CAGR over FY11-12E

- After the slowdown in credit off take, we believe credit growth for the banking system is set to pick up driven by improving macro-economic outlook, increasing business confidence levels and comfortable liquidity conditions. After falling to a thirteen year low, the loan growth rate has bounced back significantly and we believe the buoyancy to continue.
- While for FY10, the loan growth remained tepid at ~16% y-o-y, it will increase in FY11 and FY12 driven by infrastructure and capex projects. We estimate systemic credit growth at 18-20% CAGR over FY11-12E. The growth for PNB is likely to well outstrip the .
- The proportion of infra and capex related credit is likely to expand by more than 200bps to ~22% while that of retail is likely to remain stable. The demand for working capital loans is also likely to pick up due to increase in commodity prices.

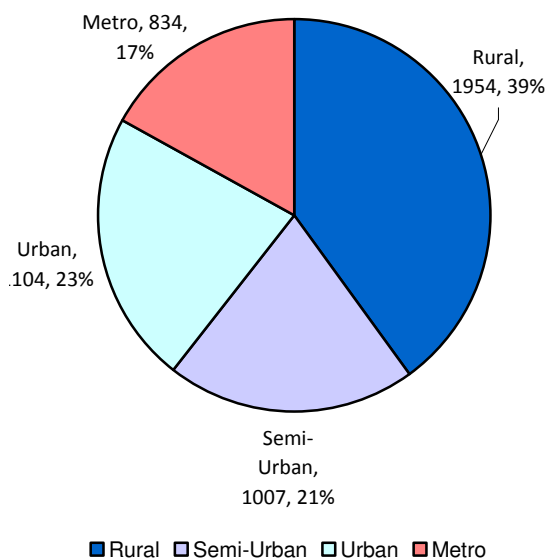
Loan Additions



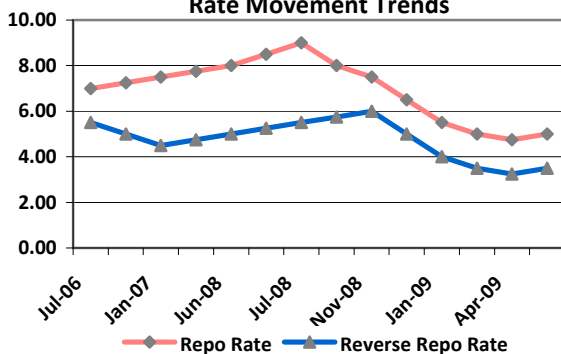
Slippage to rise in near term but long-term outlook remains healthy

- While the outlook for asset quality has improved on the back of improving macroeconomic parameters and easy liquidity conditions, near term rise in slippages is imminent.
- The risk of a rise in near term slippages stems from sluggish economic recovery (sectors that are still under pressure account for 15% of the loan book) and higher amount of restructuring (Rs.78,000crore of advances) done by the banks.
- We estimate gross NPLs to still grow at 35% CAGR over FY09-12E to 3.5% of advances even though we assume GDP growth to pick up from here. We factor in delinquency ratio cf.2.6% over FY09-12E for banks under our coverage.

Branch break-up



Rate Movement Trends



RBI has started hiking rates to curb inflation, indicates rise in lending rates in coming days

Improving business mix to provide support to earnings

Despite the near term headwinds to earnings due to lower trading gains (or MTM losses), muted fee income and higher credit cost, we believe PSU banks will still realize the earnings growth of 15% CAGR over FY09-12E.

- The key earnings drivers will be a) improving business mix, b) pick up in fee related income and c) improving operating efficiency. We estimate PSU banks to register net interest income growth of 18-20% over FY09-12E and core operating profit of 20-22%.
- Indian banks are a direct play on the domestic economic upswing and PSU banks' +70% market share makes them among the biggest beneficiaries of this upturn. We prefer banks with strong fundamentals including healthy asset quality, strong coverage ratio and robust core capital (tier 1).

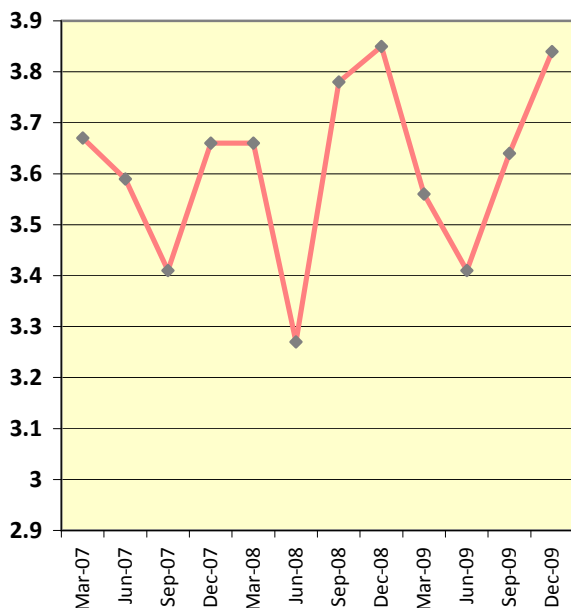
Government, RBI's efforts helped economy to maintain growth

Both RBI and government took various steps to stimulate the economy and ease liquidity conditions. RBI lowered policy rates by 275-425bps and infused liquidity of Rs5.6tn - 9% of GDP while, fiscal measures taken by the government contributed around 1.8- 2.3% of the GDP during FY09 and 1HFY10.

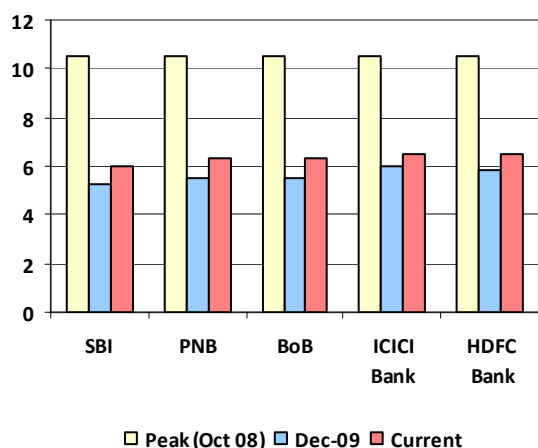
Management has a well defined vision

With appointment of Mr. Kamath as the CMD the uncertainty over the leadership is not there. He is expected to have a tenure of more than five years which leads to stability at the top. The management highlighted its strategy over the next few years to focus on steady business growth, (likely to outdo industry growth) with a continued focus on sustaining margins at current levels of 3.5%. Focus on the Indo-Gangetic basin is likely to continue - with a vision of Rs.10,00,000 crore in business (loans + deposits) by March 2013, from Rs.4,00,000 crore of business as of December 2009. The targeted customer base is 15 lakh from the current levels of ~5 lakh customers by 2013. PNB already has 100% of its branches under CBS and is working on financial inclusion projects in the Indo Gangetic belt (mainly in the states of Rajasthan and Uttar Pradesh). The focus is largely on customer acquisition by expanding branches / touch-points in the un-banked / under-banked areas. It intends to have 1 lakh touch-points (branches, ATMs, kiosks and business correspondents) by 2013. This would help PNB garner retail deposits, CASA deposits and also enhance fee-based revenues over time.

NIM Trends



Deposit Rate Trends



Deposit rates have started rising again as liquidity conditions tighten

Focus is on sustaining margins

Despite slower industry growth and increasing competition on the lending side, the focus of the bank would continue to be on sustaining its current margin at 3.5%. The bank is willing to grow at a somewhat slower rate, but would not like to compromise on margins. The current strategy is similar - not to grow the balance sheet from short tenure loans, the bank is not comfortable lending below its PLR of 11%. PNB currently has the lowest PLRs amongst public banks, but the proportion of sub PLR loans is low. Even over the past few quarters, when most public banks had seen a sharp reduction in their margins, PNB managed its margins through better ALM management. The management highlighted that it would like to sustain margins at 3.5% and would increase the lending rates if its funding costs move up. With ~40% CASA franchisee and superior lending yield (on back of its loan mix in favor of SMEs and agriculture), we believe sustaining a 3.5% margins might not be a very difficult task for PNB.

NPAs expected to be contained to manageable levels

The management expects gross NPLs to be contained below 2% in a worst-case scenario (currently at 1.8% as of December 2009). Provision coverage remains a high 89% as of December 2009, which provides a fair amount of cushion against adverse credit shocks. Restructured loans are high at about 8% (6% excluding agri debt waiver) of its loan book. However we do not expect the asset quality to deteriorate materially further (delinquency out of its restructured assets may be less than 10%).

Operation costs to remain steady

Over the past couple of years, PNB has made provisions assuming a 20% wage-hike. The actual hike was finalised at 17.5% but was stalled by some banks' unions. However we don't expect it to be in excess of 20% and thus PNB is likely to have some write-back on its employee expenses over the next few years. The additional burden on account of the second pension option is likely to be about Rs.500 crore and could be spread over a five year period or PNB could utilise some of its excess provisions made in the past for funding this gap. Almost all of its CBS related expenses have already been incurred and is unlikely to increase from the current levels. Overall, the bank seems to have a fair cushion to manage its costs and could see operating leverage playing out over the next 2-3 years.

High return ratios & capital adequacy

PNB is the one of the very few banks, which has consistently maintained a high return ratio on its equity over the last 5 years of more than 20%. With sustained

margins at 3.5%, increased reliance on fee income, cushion on operating costs and high provision coverage ratio, the bank can easily sustain a RoA of more than 1% and RoEs of more than 20%, in our opinion. Given a healthy capital adequacy ratio of 14.56%, of which Tier I ratio is at 9.27% as of December 2009 along with a healthy RoE, the bank is unlikely to require additional capital for in the immediate term for funding its loan growth.

Valuation

Income Statement	FY 08	FY 09	FY 10 E	FY 11 E	FY 12 E
Net interest income	5534.2	7030.9	8220.5	10018.2	11682.3
Non-interest income	1997.6	2919.7	3283.6	3284.8	3822.6
Total income	7531.7	9950.6	11504.2	13302.9	15504.9
Operating costs	-3445.8	-4015.1	-4573.0	-5030.3	-5533.4
Other costs	-170.2	-191.1	-210.2	-231.2	-254.4
Pre- provisioning profit	3915.7	5744.4	6720.9	8041.4	9717.2
Provisioning charge	-619.8	-977.4	-1268.6	-1665.3	-2156.6
Operating Profit (post provisioning)	3295.9	4767.0	5452.4	6376.0	7560.5
Tax	-1247.2	-1676.0	-1772.0	-2072.2	-2457.2
Reported PAT	2048.8	3090.9	3680.3	4303.8	5103.4

We value the stock using DDM (Dividend discount model). Our assumption factors in the following- RoE of 24%, G of 7% and Cost of Equity of 15%. This gives us a targeted P/BV ratio of 2.125. At the FY11 adjusted book value of Rs.610 per share, this gives us a price target of Rs.1296 for a time horizon of 12-18 months.

Research Desk		Tel: 011- 41654860
Ashit Suri	Head of Research	ashit@jvfinancial.com
Shaurya Priya	Research Analyst	research@jvfinancial.com
Swati Saxena	Research Analyst	research@jvfinancial.com
Sanjeev Kapoor	Trading Desk	011-41654860
Narendra Singh	Trading Desk	011-41654861
Rajeev Kumar	Trading Desk	011-41654862
Satyendra Singh	Back Office	backoffice@jvfinancial.com
Bijaya Swain	Accounts Dept	011-41654874 / 75
General Enquiries		support@jvfinancial.com

RISK PROFILE:

Low Risk: Fundamentally Sound companies, with low beta. Expected market out-performance is 0–10%

Medium Risk: Expected market out-performance is 10 - 20%. Preferably for the Investors with a maximum time frame of 6 months.

High Risk: High Beta Stocks, expected market out-performance is more than 20%, Preferably for the investors willing to take advantage of market momentum and are aggressive in nature.

Disclosure Appendix

Analyst ownership of the stock: No

Company ownership of the stock: No

Disclaimer Appendix

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