INDIAN OVERSEAS BANK

June 18, 2012

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Indian Overseas Bank (IOB), the Chennai based state-run lender is one of the pioneering organisation in the banking industry with the twin objectives of specializing in foreign exchange business and overseas banking. However, its stock has seen sharp correction in the past 1 year on investors' concern about declining asset quality and margin pressure under a high interest rate scenario. With the anticipated rate cut by RBI in its monetary policy on 18th Jun'12, we expect IOB to stand out as one of the major beneficiaries.

Investor's Rationale

- IOB has managed to strike a comfortable 13bps rise in its Q4FY12 NIM despite accelerated growth in interest expenses due to rising cost of deposits. However, with increased emphasis of the lender in building stronger CASA base, better asset quality, an expected early reduction in cash reserve ratio (CRR) accompanied by a cut in the key policy rates by RBI, we expect IOB's NIM to stay uptrend in FY13E.

- IOB's asset quality has stayed under pressure during FY12 primarily because higher exposure in distressed sectors, slippages from the restructured pool and presence of a few chunky accounts. Though an expected fall in interest rates and higher provisioning are likely to bring some relief to the net NPA of the bank, we anticipate Gross NPA level of IOB to stay slightly high in FY13E on expected further restructuring of loans.

- IOB has also been struggling to increase its CASA portfolio in the past 1 year despite extending its pan India presence by the opening of 447 branches in FY12. However, with the proposed structure of the bank to open additional 400 branches across the nation in FY13, we expect CASA ratio of the bank to see mild growth aided by the expected new customer base, providing the much needed cost advantage to keep NIM afloat.

- After recording an impressive business growth of ~25% in FY12, IOB aims at achieving 18-20% deposit growth and 16-18% credit growth in FY13E. We expect C/D ratio of the bank to stay above 78% by the end of the current fiscal, supporting IOB growth strategy to achieve a total business of around ₹3,850-4,000 billion in the current fiscal.

- Though the proposed recruitment of 3,500 employees in FY13E is likely to lift the cost-to-income ratio of the bank, we expect additional interest income generated in the proposed 400 branches and expected cut in key policy rates to mitigate the risk of higher operating expenses.

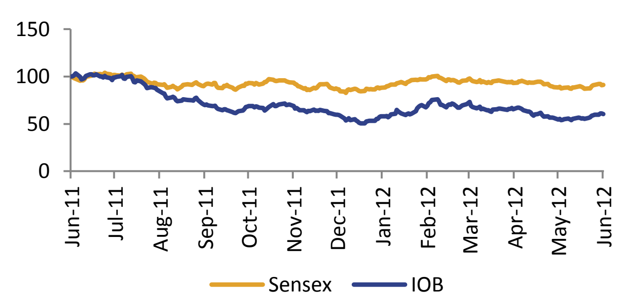
Market Data

Rating	**BUY**
CMP (₹)	89
Target (₹)	**109**
Potential Upside	~23%
Duration	Long Term
52 week H/L (₹)	72.85/152.30
All time High (₹)	201.85
Decline from 52WH (%)	41.6
Rise from 52WL (%)	22.2
Beta	1.4
Mkt. Cap (₹ bn)	55.0

Fiscal Year Ended

	FY11A	FY12A	FY13E	FY14E
Revenue (₹mn)	121,015	178,971	201,879	230,142
Net Profit(₹mn)	10,725	10,501	12,932	17,544
Share Capital	6,187	7,970	7,970	7,970
EPS (₹)	17.3	13.2	16.2	22.0
P/E (x)	5.1	6.8	5.5	4.0
BVPS	150.7	149.7	163.6	179.0
P/BV (x)	0.6	0.6	0.5	0.5
ROE (%)	11.50	8.80	9.92	12.30
ROCE (%)	0.60	0.48	0.50	0.57

One year Price Chart



Shareholding Pattern

	Mar'11	Dec'11	Diff
Promoters	69.7	65.8	3.9
FII	3.7	5.5	(1.8)
DII	14.3	12.7	1.6
Others	12.3	16.0	(3.7)

Stable Q4FY11 net profit growth, NIM to see uptrend in FY13E

Higher interest expenses incurred due to rise in deposit rate pulled back NII of IOB during Q4FY12

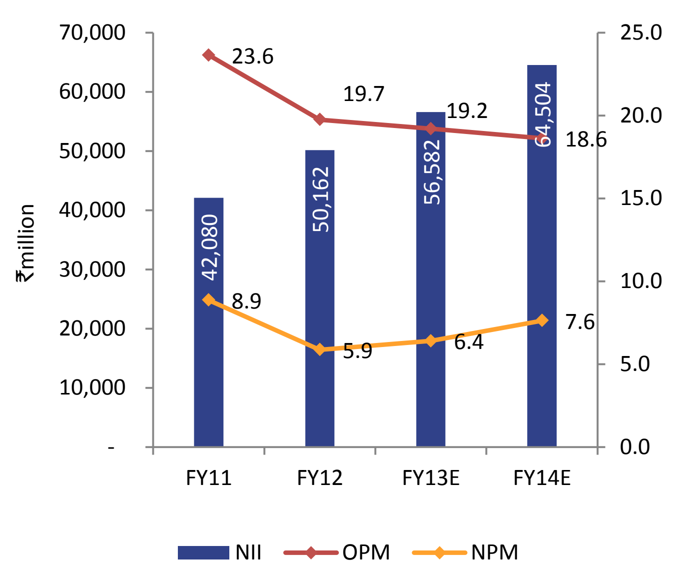
During Q4FY'12, IOB recorded a marginal growth of 10% in its Net Interest Income (NII) at ₹13.40 billion from ₹12.15 billion in the same period prior year as high interest expended on deposit base pulled back net interest earnings momentum of the bank. Spike in the cost of deposits owing to increase in the interest rates on term deposits accelerated interest expenses of IOB by 54% to ₹35.70 billion from ₹23.16 billion a year ago while Interest earned improved 39% to ₹49.11 billion, aided by 43% increase in Interest earned on advances at ₹37.40 billion and 26% growth in the credit book. Increased employee expenses due to new staff recruitment for the newly launched branches lifted the cost to income ratio of IOB by 670 bps to 45.6% and thereby retarding growth in operating profit to marginal 3% at ₹10.02 billion. However, with lower provisioning towards NPA and lower tax rate, IOB managed to clock a net profit growth of 22% for the quarter at ₹5.28 billion on y-o-y basis.

IOB's NIM for the quarter improved on sequential basis to 2.74% against 2.61% in quarter ended December 11 and 3.16% in quarter ended March 11. With increased emphasis of the lender in growing its low cost CASA base, we expect IOB's NIM to stay uptrend in FY13E. Persistent efforts to maintain higher asset quality is also expected to boost interest income of the bank and hence support in building better NIM for IOB.

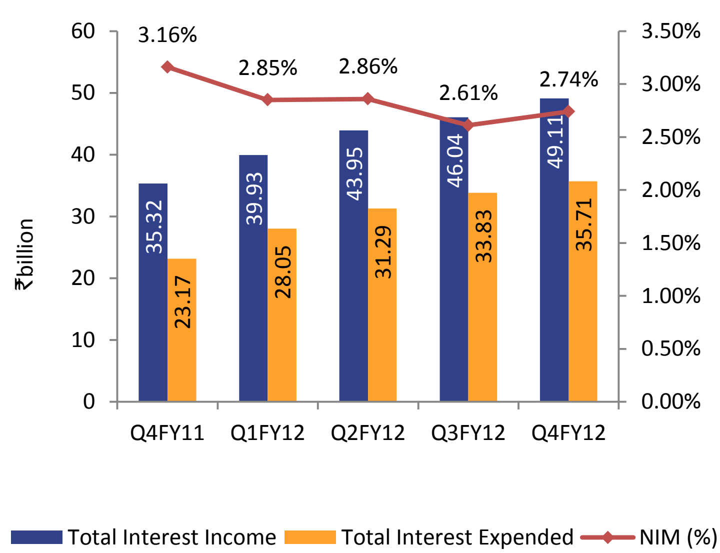
The much expected cut in CRR and repo rate by RBI in Jun'12 monetary policy, is likely to bring the much needed relief to the lenders in sustaining margins

The Indian banking system, saddled with high-cost, long-term deposits and narrowing profit margins, is hoping to see an early reduction in cash reserve ratio (CRR) accompanied by a cut in the key policy rates in FY13E, which in turn is expected to bring the much needed relief to the domestic lenders by lowering cost of funds and allowing them to ease deposit and lending rates. Increased focus towards fee based income, is also expected to help banks in maintaining the profitability to some extent. However, due to aggressive competition from other investment instruments like tax free bonds, corporates bonds etc, that are giving high rate of returns, domestic lenders might not opt for an immediate cut in deposit rate after the expected rate cut materialisation. Hence, we expect IOB to maintain profitability with around ₹2 billion lowered provisions towards NPA while maintaining stability in margins during FY13E.

Margins to gain stability by FY14E



Q4FY12 NIM rises 13 bps negating rise in cost of funds



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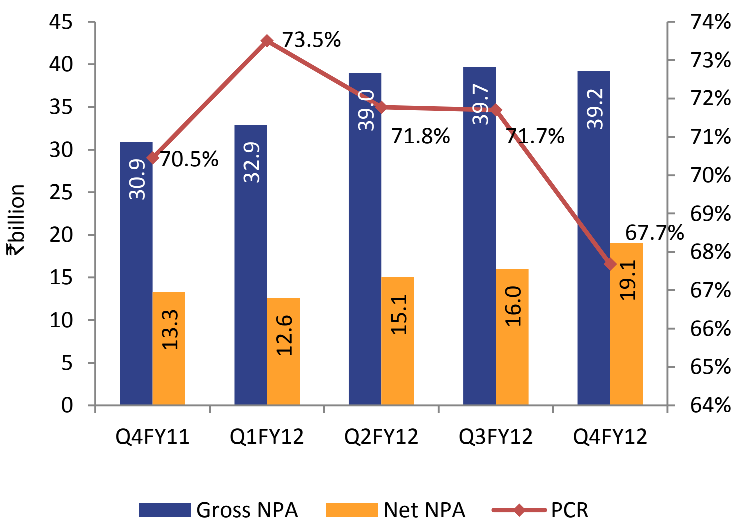
Asset quality concern continues in Q4FY12

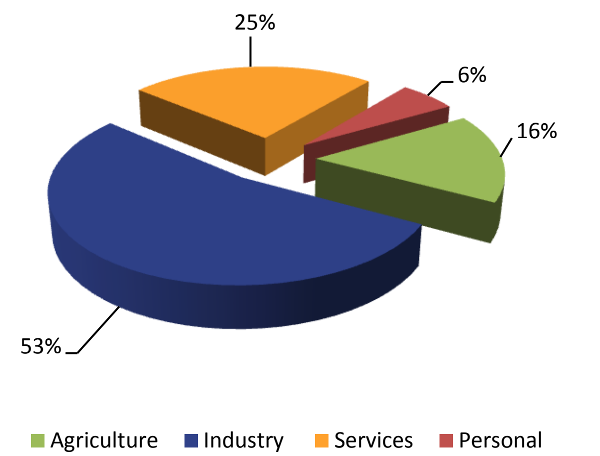
Asset quality stands as a major concern for IOB with one of the highest restructured books in the Industry

IOB's asset quality stayed under pressure during FY12 primarily because of higher non-performing assets (NPA) in agri-sector, slippages from the restructured pool and presence of a few chunky accounts. During Q4FY12, higher bad loan recovery of ₹2.3 billion followed by up gradations of ₹2.1 billion and write off of ₹6.2 billion brought down the gross NPA levels of IOB to 2.74% from 3.0% in 3QFY2012. But with elevated slippages of ~₹10.1 billion primarily from engineering, metals, textile and agricultural sector as well as lower provisioning, net NPA ratio of the lender came in higher at 1.35% from 1.23% in the prior quarter. The slippages during Q4FY12 were higher over 48% higher from ₹6.8 billion in Q3FY12 while Bank provisioning for NPA, standard assets and restructured assets decreased by 37.3% qoq to ₹3.5 billion, reflecting lower provision coverage ratio (PCR) of 67.68% for the period. Beside, addition of ₹31.7 billion restructured portfolio lifted the overall restructured book of IOB to ₹126 billion, which is around 9% of its total loan book.

Lower Provisioning lifts Q4FY12 Net NPA



Sector-wise break up of domestic NPA



High distressed sector exposure to keep FY13 Gross NPA higher

Asset quality pressure likely to continue in FY13 due to high exposure in distressed sectors

At a juncture, when piling up of bad loans from restructured advances to sick firms is emerging as a night mare for the ₹76 trillion banking sector of the country, the Indian government has gone another step further by directing the domestic banks to restructure ~₹1,300 billion of loans to power distribution companies (discoms) and ₹350 billion to the textiles sector. Hence, increasing the restructuring burden on banks and forcing them to either give these companies more time to pay back loans or reduce their interest rate. According to rating agency Crisil Ltd, with rising number of loan recasts across sectors and visible stress coming from sectors like power, textile, airline, and iron and steel in a gloomy economy, the amount of restructured loans by the Indian banking system is likely to reach 3.5% of total advances and hence lift average gross NPAs of the banks to 3.2% by March 2013 from 2.9% as of December 2011.

Distressed sectors like Infrastructure (12.97%), Airways (10.82%), Power (10.57%), Trade (10.17%), Telecom (9.63%), Iron and Steel (8.48%) and Textile (8.42%) occupies a major part of IOB's restructured book. Hence, we expect IOB's gross NPA to stay higher in FY13 on the back of rise in further loan restructuring and hence additional slippages from restructured loan books. However, an expected fall in interest rates and easing of policy logjam followed by bounce in PCR are likely to keep the net NPA level of the bank at manageable level.

Increased emphasis to build CASA deposit likely to give cost advantage in terms of lower interest rates on saving accounts

New customer base to lift CASA in FY13E

During Q4FY12, the low cost CASA ratio of the bank stayed flat 26.4% on q-o-q basis due to sluggish growth in CASA deposit against growth in yield on deposits. CASA deposit of IOB grew 8% to ₹471.5 billion owing to 5% growth in the Savings account deposits at ₹348.6 billion while current deposit grew 19% to ₹122.8 billion on q-o-q basis. The strong asset management of the bank is primarily helped by higher constituent of Current and Savings account (CASA) deposit in its loan portfolio, which is almost one-fourth of its total deposit base. The greater is CASA mix, higher will be the cushion against the NIM. The lower interest rate attached to the CASA accounts in comparison to the term deposit account always creates a cost advantage for the bank, restricting imbalance in the cost structure even in a rate hike scenario. Going further, we expect, CASA ratio of the bank to see mild growth aided by the expected new customer base in the proposed 400 branches in FY13E.

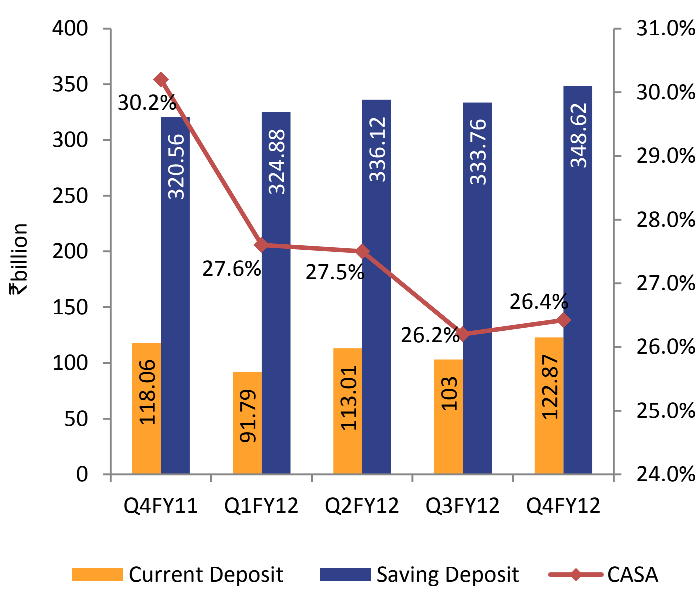
High C/D ratio likely to support IOB's strategy to achieve ₹4 trillion business in FY13E

IOB's aims 20% growth in total business in FY13E

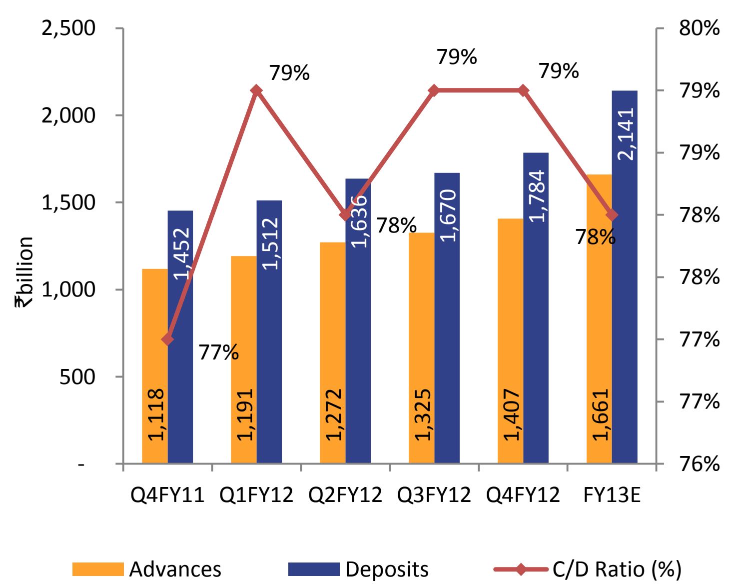
During FY12, IOB recorded 24.2% growth in its total business at ₹2,590 billion on y-o-y basis, powered by strong growth momentum in overall deposits and advances of the bank. IOB's global deposits grew 22.8% from to ₹1,784.34 billion on y-o-y basis; mainly led by 22.6% growth in domestic deposits at ₹1,722.19 billion. Meanwhile, advances grew at a healthy rate of 23% to ₹1,784.3 billion, to which domestic advances contributed ₹1,722.2 billion. On the other hand, overseas advances grew 28% to ₹62.1 billion. Agri credit grew 21% to ₹194.2 billion, SME credit grew 40% to ₹166.0 billion and retail credit grew 21% to ₹94.3 billion. Consequently CD ratio for the bank improved from 80.29% at the yearend against 78.35% in the prior period.

The bank's management aims at 18-20% deposit growth and 16-18% credit growth in FY13E and hence we expect C/D ratio of the bank to stay above 78% by the end of the current fiscal, supporting IOB in achieving a business of around ₹3,850-4,000 billion. The credit-deposit ratio helps to find out if the bank has sufficient liquidity to support its loan growth and hence it is always wiser for banks to have higher credit-deposit ratio.

CASA ratio sees gradual fall in FY12



C/D Ratio to stay above 78% in FY13E



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IOB expects recapitalisation worth ₹95 billion by FY18E

With the early implementation of Basel III, PSU banks likely to feel to need for higher capitalization

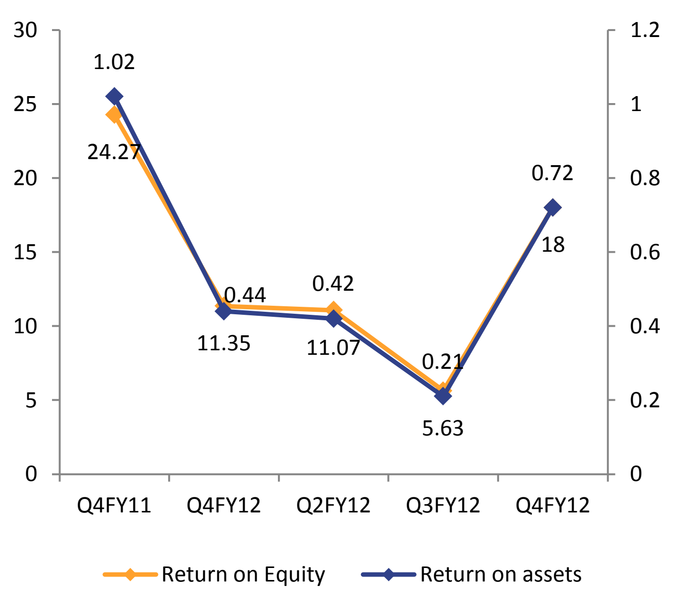
The Capital Adequacy Ratio of IOB as per Basel II norms came in at 13.32% by the end of FY12 against 14.55% in the prior period. During FY12, the lender received a combined capital infusion worth of ₹17.4 billion from the Indian government and Life Insurance Company (LIC) that shored up the bank's tier-I capital to 8.35%. The government infused capital to the tune of ₹14.4 billion while LIC injected capital worth ₹3.0 billion respectively.

However, in view of certain expansion plans of the Bank, consequent capital charge and the implementation of BASEL III norms, the management of IOB estimates the need of an additional ₹95 billion capital till 2017-18 based on an estimation of 20% credit growth during the period. And the bank intends to keep various options like QIP (Qualified Institutional Placement), follow-on issue or qualified equity, open to raise funds to meet the requirement.

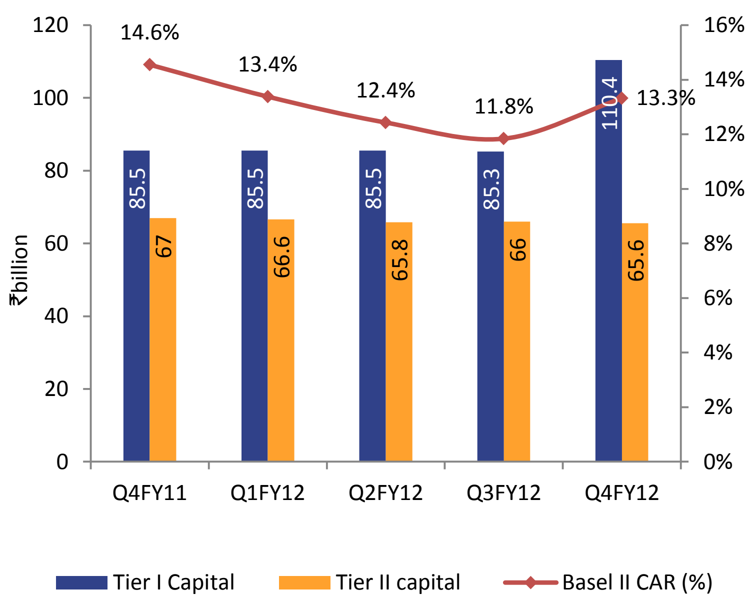
According to the RBI guidelines on Basel III (likely to come into effect from 1 Jan'13), which seeks Indian banks to maintain a minimum 5.5% in common equity by March 31, 2015 against 3.6% now, apart from creating a capital conservation buffer consisting of common equity of 2.5% by 31 March, 2018. It also hiked the minimum overall capital adequacy to 11.5% by 31 March, 2018 against present 9% requirement.

As for Indian banks like IOB, it wouldn't be very tough to make the transition to a stricter capital requirement regime than some of their international counterparts since the regulatory norms set by RBI on capital adequacy are already very stringent. However, the lenders might need to raise more money than under the current Basel II norms because several capital instruments are likely to be excluded under Basel III definition. Perpetual debt, for instance, now qualifies as a tier-I instrument which will be excluded under Basel III, forcing banks to raise more equity. So the challenge for banks is not in transitioning to Basel III, but in their capital-raising ability, as the proposed norms are likely to force banks to plough back a larger chunk of their profit into the balance sheet, which could impact their return on equity.

Return ratios bounces in Q4FY12



Q4FY12 CAR improves on equity capital infusion



Proposed 400 new branches in FY13 to facilitate larger customer base

Well spread branch network across the country for strategic reach towards all sections of society

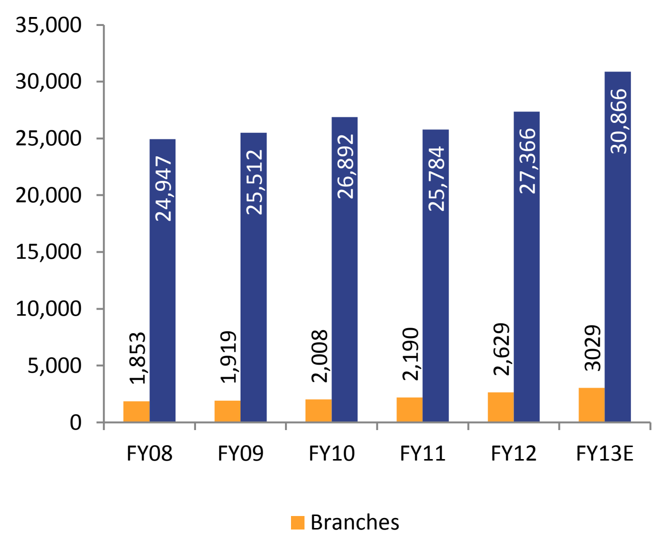
With more than 2,500 branches as on 31st March 2012, IOB emerged as an owner of one of the largest branch networks in the country. Multiple branch launches over the years has not only strengthened its customer base with deeper penetration but has also gone a long way in augmenting its total business. Meanwhile, as a part of its strategy to reach out to all the sections of society, the branch network of the bank has remained well spread across various cities and regions. As on 31st March 2012, the Bank had 2,629 domestic branches that comprised of 731 Rural branches (27.81% of total branches), 738 Semi Urban (28.07%), 599 Urban (22.78%) and 561 Metropolitan branches (21.34%). Besides, the Bank had 3 Extension counters and 20 Satellite Offices, 45 Regional offices, 18 City Back Offices and 6 Inspectorates.

Under its expansion strategy, IOB intends to extend its presence by opening around 400 branches and 9 regional offices across the country in FY13 to strengthen its structure. Presently, IOB has 6 overseas branches, 2 remittance centres and 4 representative offices. To exploit rising trade between the nations and soaring consumerism, the bank plans to open its second branch in Bangkok, and also upgrade its representative offices in China, Vietnam and Dubai to branches. Of the proposed lot of 400 branches, 10 branches are likely to be opened in the north-east, with its higher focus on financial inclusion and uplift of rural areas. The bank generates a business of ₹13.7 billion from 30 branches in the north eastern states, which reflects a minimal 0.5% accountability from the region. Hence, wider penetration in the region not only ensures wider reach and customer base but also enhanced business growth.

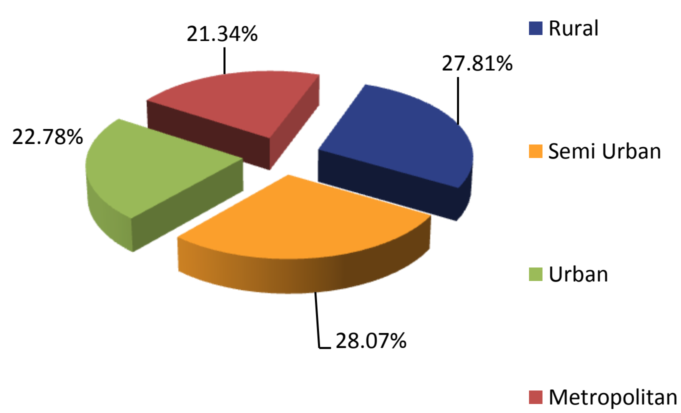
Proposed Recruitment of 3,500 people goes hand in hand with branch expansion plan

Under the bank's thrust for extended reach in the rural areas of the country and avail credit to small and micro enterprises, the bank plans to also eyes to 32 such micro branches in the rural areas and include more villages and towns under its rural development schemes, under which it takes care of health requirements of elders, provide scholarships to students, set up libraries and other amenities. In order to support its massive expansion plan, the bank also plans to recruit 3,500 people in the official, clerical and specialist categories.

Branch expansion to witness 10% CAGR between FY08-13



Strategic reach out to all the sections of society



Balance Sheet (Consolidated)

(₹million)	FY11A	FY12A	FY13E	FY14E
Equity Capital	6,187.5	7,970.0	7,970.0	7,970.0
Reserves & Surplus	87,061.8	111,306.5	122,437.2	134,680.9
Shareholders' Fund	93,249.3	119,276.5	130,407.2	142,650.9
Deposits	1,452,287.5	1,784,341.8	2,141,210.1	2,612,276.3
Borrowings	193,554.0	236,138.5	250,306.8	265,325.2
Other Liabilities & Provisions	48,751.9	56,725.0	63,532.0	71,155.8
Capital Employed	**1,787,842.8**	**2,196,481.8**	**2,585,456.1**	**3,091,408.3**
Cash and Balances with RBI	100,108.9	101,989.1	110,148.3	121,163.1
Money at call and short notice	20,077.6	60,621.9	66,684.0	82,688.2
Investments	486,104.5	555,658.8	670,011.1	809,028.1
Advances	1,118,329.8	1,407,244.4	1,660,548.4	1,992,658.1
Fixed Assets	16,811.1	17,440.5	19,184.5	21,103.0
Other Assets	46,410.8	53,527.0	58,879.7	64,767.7
Capital Deployed	**1,787,842.8**	**2,196,481.8**	**2,585,456.1**	**3,091,408.3**

Profit & Loss Account (Consolidated)

(₹million)	FY11A	FY12A	FY13E	FY14E
Interest Income	121,014.7	178,970.8	201,879.1	230,142.2
Interest Expended	78,934.4	128,809.1	145,296.7	165,638.2
Net Interest Income	42,080.3	50,161.7	56,582.4	64,504.0
Growth (%)	-	19.2	12.8	14.0
Other Income	12,251.0	16,810.4	17,651.0	18,533.5
Operating Income	54,331.3	66,972.2	74,233.4	83,037.5
Growth (%)	-	23.3	10.8	11.9
Operating Expenses	25,724.9	31,630.7	35,467.6	40,176.4
Operating Profit	28,606.3	35,341.5	38,765.8	42,861.1
Growth (%)	-	23.5	9.7	10.6
Operating Margins (%)	23.6	19.7	19.2	18.6
Provisions and Contingencies (including tax)	17,880.9	24,840.2	25,833.8	25,317.1
Net Profit	10,725.4	10,501.3	12,932.0	17,543.9
Net Profit Margin (%)	-	(2.1)	23.1	35.7

Key Ratios

	FY11A	FY12A	FY13E	FY14E
Avg. Cost of deposits (%)	5.4	7.2	6.8	6.3
ROE	11.50	8.80	9.92	12.30
ROA	0.60	0.48	0.50	0.57
Interest Expense/ Interest Income	65.2	72.0	72.0	72.0
Investment/Deposit	0.33	0.31	0.31	0.31
Cost-Income Ratio (%)	47.35	47.23	47.78	48.38
C-D Ratio (%)	77.0	79	78	76
BVPS	150.7	149.7	163.6	179.0
P/BV	0.6	0.6	0.5	0.5
EPS	17.3	13.2	16.2	22.0
P/E	5.1	6.8	5.5	4.0

Valuation and view

Higher loan growth, strong expansion plans and high fee income stands in testimony to IOB's persistent efforts match the industry leaders in all key growth parameters. We expect IOB to outline its strong story further with strong FY13E performance with 20% growth in total business. With expected reversal in RBI's rate hike action, the re-payment pressures on the borrowers are likely to ease and hence the emerging lender is expected to reports stable margins in the coming years. At CMP ₹89 IOB is trading at P/BV multiple of 0.5x its FY14E BV of ₹179. We reiterate BUY on IOB with an upside potential of 23% and an investment horizon of 12 months.

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