India Equity Research

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Hemindra Hazari
HHazari@askrj.com

BANK OF BARODA

Rating: BUY **Price: Rs41**

Banking on Change

India's second largest bank, Bank of Baroda (BoB) is planning several initiatives that will transform it into a vibrant, technologically advanced institution, responding quickly to customer needs. The bank enjoys a strong brand name and is strategically located in the economically advanced areas of western India. Its large client base is hungry for products, which the bank plans to deliver once its information technology plan is implemented. At current valuations, the bank is an extremely attractive investment.

52-week range	**Rs86-34**		**Market Capitalisation**	**Rs12,172mn**
Reuters code	**BOB.BO**			**(US$266mn)**
Price Movement	Absolute	Relative	Exchange Rate	US$1 = Rs45.68
Last 30 days (%)	2.3	(4.9)	Shares in issue	296mn
Last 90 days (%)	5.5	6.8	Free float (%)	34
Last year (%)	(71.5)	(71.0)	Av. daily vol. (3 months)	20,000 shares
12-month target	Rs80		BSE Sensex	4562

Year to 31 March	1999	2000	2001E	2002E	CAGR (%)*
EPS (Rs)	14.2	17.0	20.4	25.0	20.9
Dividend (Rs/share)	3.0	4.0	4.0	4.0	
Book value at period end (Rs/share)	88.2	100.0	116.1	136.7	14.8
Adjusted value at period end (Rs/share)	36.3	44.7	58.1	76.1	26.5
Net Profit (Rs mn)	4,214	5,028	6,015	7,351	20.9
ROE (%)	17.1	18.2	18.9	19.8	
PE (x)	2.9	2.4	2.0	1.7	
Price to book value (x)	0.5	0.4	0.4	0.3	
Price to adjusted book value (x)	1.1	0.9	0.7	0.5	
Dividend yield (%)	7.2	9.7	9.7	9.7	

** 2 years*

- **Huge market potential:** BoB is restructuring its operations by investing in a comprehensive technology plan, which can cater to its client base of 20mn retail accounts and the top 100 corporate accounts. Once that plan is implemented, the bank can roll out a multitude of products to cater to this lucrative client base.
- **Committed management team:** The bank is fortunate in that, recently appointed for a five-year term, is its dynamic chairman and managing director, who is planning to restructure the organisation. The employee unions fully support the senior management in that transformation. One of the most profitable of the government banks, BoB required a dynamic leader to steer it to its full potential and we believe that its present leader, backed by the rank and file, will deliver on his promises.
- **Valuation:** We value BoB at R80 based on a conservative FY2001 PER of 3.9x. At its present valuation, after factoring in the bank's future profitability and plans for transformation, the stock is going for a song. Buy now.

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Investment Argument

India's second largest bank is transforming itself under its chairman and managing director (CMD), P S. Shenoy, into a technologically advanced bank, capable of adapting to changes in the financial sector. The CMD has the full support of the employees' union as well as the rank and file. Fresh initiatives are being launched to bring out new products such as retail lending, cash management services and capital market related activities. We believe that the stock market has not factored in these developments and we recommend a strong BUY.

Technology is the Key

BoB focusing on implementing IT plan

The bank is fully aware that it can no longer let the information technology (IT) revolution pass it by. The CMD has given technology top priority and a general manager has been appointed with the sole responsibility of handling IT. We expect 70% of the business handled by its branches to be computerised by December 2000. A global technology consultant will be appointed by October and the bank is expected to roll out its IT plan by February 2001. 500 key branches are to be networked by FY2002. In the next three years, the networked branches will operate as a modern bank; the rural branches will operate in the traditional manner. Once the major branches are networked and a centralised database established, online banking will become a reality and the bank can then launch a host of new products—internet banking, retail lending, and the like. We believe that BoB will be at the head of the band of the larger government banks in getting its IT act together.

Management and unions are committed

Cooperation between management and unions is excellent

The CMD is totally committed to transforming BoB into a modern, technologically efficient one that can respond to changes in the market. P.S. Shenoy has a five-year term in which to implement these changes and, more importantly, will shoulder the final responsibility for this development. Unlike other government banks, BoB has a highly responsible employees' union, which fully supports the senior management. The union also regularly monitors operational performance and pressurises its members to increase the level of business. Such proactive measures are rare among Indian bank unions.

Ability to absorb shocks

BoB's size provides comfort

Being India's second largest bank, with diverse earnings streams, BoB can withstand economic downturns or sudden shocks much better than smaller banks. Its large retail network enables it to obtain a significant supply of low-cost reliable deposits, while its lending relationships range from thousands of individuals to many of India's major corporates.

Strong earnings growth

Net earnings to increase at a CAGR of 21%

On the back of the proactive management, which is implementing measures to increase business and profitability, we expect the bank's earnings to increase by a CAGR of 21%. BoB's earnings growth, unlike other banks, will not be affected by the more stringent NPL norms introduced in FY2001, since the bank has already been incorporating the new norms from FY1999. Furthermore, at current government securities prices, BoB will not have to provide for any depreciation on investments

Attractive dividend yield

Tax-free dividend yield of 9.7%

BoB trades at an extremely attractive dividend yield of 9.7%. We believe that it is capable of maintaining its dividend of Rs4 a share this year, since its earnings growth is estimated at 21% and dividend payout, a conservative 20%.

Valuation

In the banking sector, a few small banks are valued as priceless gems and the giants are reduced to pygmies. Two small ones—HDFC Bank and ICICI Bank—substantially capture the valuation of the sector, and stalwarts such as State Bank of India and Bank of Baroda are valued as stars of yesteryear. BoB's valuation is particularly harsh, considering it is India's second largest bank and does not have any major non-performing assets (NPAs) or labour problems. The problem we believe is the "public sector" label, the perceived lack of innovation and technology in BoB and an inability to market its strengths.

What ails BoB's valuation?

Government label single most important factor affecting BoB's valuation

- The government of India enterprise discount – the single largest contributor to BoB's discount. Investors perceive the government to be the greatest value destroyer and its policies, designed to protect the politician-bureaucrat nexus.
- Earnings in BoB have been despite its management, not because of it. This is the fate of many government enterprises for managements do not implement any strategies to improve profitability.
- Future earnings of BoB will collapse. The general perception is of reported earnings to be fictitious (which we don't believe, though for some other banks that is a distinct possibility).
- BoB is lagging in technology and, as a result, customers will flock to the new private banks.

Why we believe the low valuation is not justified

The chairman has a sufficiently long tenure to make an impact

CEO just starting on his five-year tenure

Steering BoB, P. S. Shenoy was appointed chairman and managing director on May 20, 2000, for a term of five years. Prior to his appointment as chairman, he was the executive director (ED). Therefore, unlike other government banks, which will have CMDs of short tenures with no prior inside experience, Shenoy is an exception, since, during his tenure as the ED, he was part of the culture, work ethic and systems of BoB. Furthermore, we believe that Shenoy is a dynamic individual who has major plans for the bank.

Labour unions are working together with senior management

Cordial relations between management and unions

In contrast with other government banks where management-union relations are tenuous at best, in BoB relations between the management and the unions are extremely cordial. The labour unions are aware that the bank needs to be transformed into one technologically savvy enough to adapt to change; else, its future is bleak. The labour unions therefore are fully supportive of the management's initiatives.

BoB's earnings are robust

Earnings to increase 20% in FY2001

BoB is one of the few government banks where we are confident about the quality and robustness of its earnings and its balance sheet. In Q1FY2001, BoB's profit before provisions increased by a healthy 18% to Rs2.8bn and net profit, by a respectable 16.5% to Rs1.5bn. More importantly, unlike other banks, BoB will not have to provide for any depreciation on its investment in government securities at current levels. In FY2001, we expect earnings to increase by 20% to Rs6bn and in FY2002, by a further 22% to Rs7.3bn.

BoB has major plans in IT

Core banking solution in 600 key branches by FY2002

At present, BoB has short-listed a few global IT consultants and we expect by October 2000 an announcement about the one it has selected. By December 2000, 600 branches, accounting for 70% of its business, will be computerised. And by June 2001 the key 600 branches will have been inter-connected and Internet banking launched. The core banking solution in 500 branches is expected to be in place by March 2002. The importance that the bank has given to IT is evident in that a general manager has been appointed solely to monitor and execute its IT plan. BoB therefore has definite procedures to overcome this deficiency.

It is apparent that the senior management in BoB is aware of the problem and is adapting to the changing environment. Given that it is India's second largest bank with 600 key branches, the change will be slower than that in the likes of HDFC Bank and ICICI Bank. But we believe that the market has not factored in its capability to make a quantum change. At these valuations, we believe that BoB is an extremely attractive investment.

Valuation

	State Bank of India	HDFC Bank	HDFC	ICICI Bank	Bank of Baroda	Corporation Bank	Weighted Average
RIC	**SBI.BO**	**HDBK.BO**	**HDFC.BO**	**ICBK.BO**	**BOB.BO**	**CRBK.BO**	
Recommendation	**SELL**	**BUY**	**BUY**	**BUY**	**BUY**	**SELL**	
Share Price (Rs)	**199**	**226**	**510**	**155**	**41**	**72**	
Market Cap (Rs mn)	104,779	54,979	60,705	30,566	12,172	8,321	
Market Cap (US$mn)	2,289	1,201	1,326	668	266	182	
EPS (Rs)							
FY2000	39.0	4.7	31.7	6.4	17.1	17.2	
FY2001E	34.3	7.8	37.7	8.1	20.4	20.7	
FY2002E	43.8	11.5	44.6	16.8	25.0	25.5	
FY00-02 CAGR (%)	6.0	56.9	18.6	61.9	20.9	21.8	
P/E (x)							
FY2000	5.2	54.7	12.0	40.6	2.6	4.4	8.0
FY2001E	5.8	28.8	13.5	19.2	2.0	3.5	8.0
FY2002E	4.5	19.6	11.4	9.3	1.7	2.8	6.1
Capital Adequacy (%)							
FY2000	11.6	12.2	12.9	19.6	12.1	13.1	
FY2001E	10.6	10.7	13.1	14.9	10.8	11.8	
FY2002E	10.4	10.5	12.2	14.3	10.5	11.2	
Tier-I Capital Adequacy (%)							
FY2000	8.3	9.6	12.9	17.4	8.9	13.0	
FY2001E	7.8	7.4	13.1	13.4	8.1	11.7	
FY2002E	8.0	7.3	12.2	10.4	8.3	11.1	
Dividend Yield (%)							
FY2000	2.5	0.6	4.9	0.6	8.9	5.3	
FY2001E	2.5	0.9	2.0	1.1	9.7	6.3	
FY2002E	2.5	1.1	2.0	1.3	9.7	7.6	

Contd...

	State Bank of India	HDFC Bank	HDFC	ICICI Bank	Bank of Baroda	Corporation Bank	Weighted Average
Net Interest Margin (%)							
FY2000	3.12	4.19	3.12	2.05	3.28	3.03	
FY2001E	3.17	4.11	3.11	2.61	3.33	2.93	
FY2002E	3.01	3.93	3.12	2.27	3.22	2.81	
ROA (%)							
FY2000	0.85	1.50	2.62	1.11	0.91	1.30	
FY2001E	0.64	1.46	2.57	1.07	0.97	1.30	
FY2002E	0.72	1.67	2.54	1.48	1.05	1.28	
ROE (%)							
FY2000	18.2	21.8	18.5	14.6	18.2	19.5	18.4
FY2001E	14.0	23.7	19.9	13.3	18.9	20.0	15.7
FY2002E	15.6	28.7	20.5	23.5	19.8	21.1	18.0
Net NPA (%)							
FY2000	6.4	0.8	0.0	1.1	6.9	1.9	
FY2001E	5.6	0.8	0.0	1.0	5.9	2.3	
FY2002E	5.0	0.7	0.0	0.8	5.2	2.2	
DPS (Rs)							
FY2000	5.00	1.60	18.50	1.50	4.00	4.00	
FY2001E	5.00	2.00	10.00	1.70	4.00	4.50	
FY2002E	5.00	2.40	10.00	2.00	4.00	5.50	
Price to Book Value (x)							
FY2000	0.87	8.28	2.16	4.53	0.45	0.79	1.34
FY2001E	0.77	6.20	2.53	2.43	0.36	0.65	1.19
FY2002E	2.06	2.50	0.00	0.82	0.30	0.55	1.01
Price to Adjusted Book Value (x)							
FY2000	1.29	7.88	1.16	4.69	0.95	0.91	1.66
FY2001E	1.10	6.01	1.44	2.53	0.71	0.76	1.45
FY2002E	0.89	4.90	1.32	2.05	0.54	0.64	1.20

Historic valuations at year end prices

Investment Concerns

Economic downturn

Vulnerable to slowdown in the economy

Banking is an integral part of the economy, since the sector provides vital liquidity for most economic activity. Therefore, if the economy slides into a recession, banks will be adversely affected through a lack of lending opportunities and increasing NPAs. We believe that the economy will grow at a modest pace of 6-6.5% a year. In this context we do not expect any significant adverse impact on BoB.

Interest rate hike could depress net earnings

Significant hike in interest rates could depress net profits

At present, unlike most banks, BoB does not have to provide for depreciation on its pool of government securities, since it has an unrealised gain of around Rs1bn. If interest rates rise sharply from present levels, BoB will have to provide for depreciation on investments. We estimate that a 100 basis point increase in government yield will result in a Rs4bn depreciation in BoB's investments. Since it already has an unrealised gain of Rs1.2bn and an investment fluctuation reserve of Rs650mn, it will have to provide for a net depreciation of Rs2.15bn. We believe that a further 100 bp rise in government yields is unlikely in FY2001, since the exchange rate is now stable and government yields have been declining.

Lack of ability to change

Changing the mindset is critical for the bank

If the management is unable to put in place its IT plan effectively or to change the prevalent work culture, BoB's future earnings would be in jeopardy. Altering the mindset of its employees is critical for the success of BoB. Senior management and the employees' union are devoting a considerable amount of their time to re-shape the organisation and we believe that their attempts will be successful. BoB has recently finalised a plan of creating a cadre of employees whose responsibility will be to bring about the change in work culture and to improve the bank's performance.

Government ownership

Management has the capability to withstand undue government pressure

The main problem with government banks is that the authorities meddle in the management and instruct banks to take decisions that may turn out to be harmful to minority shareholders. While this remains a concern with BoB, we believe that the CMD and his senior mangers have the capability to withstand undue pressures from the government.

Sector Overview

In the short term, although credit growth has been strong, there are concerns about depreciation on investments, which affect banks' net profits. In the long term, the stock market is rejecting banks that have remained attached to their traditional business models and are looking at banks that have invested in technology and are adapting to changes in the market by offering new non-traditional products.

Credit growth to be strong in FY2001

Growth in credit indicates a pick-up in the economy

In FY2001, credit growth has been extremely strong, with credit, including credit substitutes, increasing 22% yoy to Rs4,943bn. In Q1 and Q2 of FY2001, there appears to have been a pick-up in the economy. From end-March till end-August 2000, credit has increased by Rs228bn compared with an increase of only Rs58bn for the corresponding period of 1999. Credit growth in Q3 and Q4 could be even stronger since normally credit picks up in these quarters.

Deposit growth not as strong as credit growth

Liquidity could become a constraint

So far deposits, increasing only 15% to Rs8,610bn, have not picked up to the same extent as credit. If the latter continues to grow and deposits do not pick up, banks could be confronted with a liquidity problem in the latter part of the year.

Profit before provisions should be healthy

Increase in interest rates and in credit to benefit banks pre-provision profits

On account of the sharp increase in credit and banks revising their interest rates upwards, profit before provisions should report healthy increases. A hike in interest rates results in an expansion in banks' net interest margin, since only new and renewed deposits get re-priced, while the bilk of lending gets re-priced. For Q1FY2001, large banks such as SBI and BoB showed healthy increases in profits before provisions.

Net profits will be hit

Depreciation on securities portfolio to hit net profits

Providing for depreciation on investments will depress net profits. Since yields on government securities have increased by around 50-75 bp across various maturities, banks' net profits will be hard hit. We believe that banks Q2FY2001 profits will show how badly they have been affected. For some of the smaller banks, reporting a net profit may be difficult. The direction of interest rates will depend on the stability of exchange rate, the government borrowing programme and demand for commercial credit.

Stock market rewarding banks venturing into future growth areas

Stock market rejecting banks' traditional business model

The stock market is clearly distinguishing between banks that are engaged in traditional banking and those that are venturing into future growth areas such as Internet banking, capital market related activities and retail loans. To successfully venture into these new areas, requires banks to have modern, centralized technology systems. As a result, banks such as HDFC Bank and ICICI Bank, trade at a significant premium to other banks.

HDFC Bank—the role model

HDFC Bank emerging as a role model

Today, nearly every bank is copying HDFC Bank's model of keeping its cost of funds low, lending only to quality clients and venturing into capital market related activities such as depository services and loans against shares, and having plans for internet banking. The growth prospects of these new lines of business with the appropriate risk management systems in place are regarded as far superior to the existing business areas of banks.

Banks that are changing their business model will be rewarded

Even some of the relatively new private banks have recognized that their business models must change if they are to remain successful. For the larger government banks, such realization has yet to dawn, and implementing the required change remains a far cry. Bank of Baroda is one such exception, as we believe that the bank is making efforts to re-position itself as a modern, technologically savvy bank.

Fresh Initiatives

BoB is in the process of launching several fresh initiatives that will transform it into a modern, technologically advanced bank. It has an ambitious technology roadmap that will lead to online banking in the next two years. The management has the full support of the employees' union and is planning forays into retail lending, cash management services and capital market related activities.

Information Technology

Comprehensive technology package envisaged

The key to its future success depends on BoB's ability to implement its information technology plan, by which the lion's share of its business is computerized and interconnected to a centralized data network. In FY2001, BoB plans to invest Rs2bn for IT, of which Rs1bn has been allocated for branch computerisation, Rs500mn for a wide-area network (WAN) and Rs500mn for new products. On the operational side, it will be moving away from mere branch automation to total bank automation through the introduction of core banking solutions. On the delivery front, it will move from branch centric channels to customer-managed delivery channels.

Computerisation of branches on track

Senior official appointed solely for technology

In FY2000, of its 2,614 domestic branches, only 162 were fully computerized. (This has now increased to 250.) 600 domestic branches manage around 65% of its business and the IT plan envisages computerizing these critical 600 branches for better management information services (MIS), quick fund transfers and efficient customer service. Of these, we expect 450 to be fully computerized by end-December 2000. The importance BoB has given to its IT transformation can be seen in that it has appointed a general manager whose sole responsibility is IT and that there is a daily briefing with the CMD to discuss developments.

Global technology consultant to be appointed by October 2000

With a view to implementing the new IT plan in a systematic and planned manner, BoB is in the process of appointing a foreign, global consultant, who will advise and assist the bank. We expect an IT consultant to be announced by October 2000.

IT plan to be ready by February 2001

We expect the IT consultant to finalise the bank's IT plan by February 2001, and hardware implementation to be undertaken between June and December 2001. By FY2002 around 500 branches will have core-banking solutions in place and by FY2003, an additional 500 branches. Once the majority and key branches are networked to the central database, BoB can launch a series of products such as Internet banking, online depository services and others.

Intra-city connectivity prevalent in two cities on an experimental basis

At present, BoB has intra-city connectivity on an experimental basis in Chennai (27 branches) and in Ahmedabad (11 branches). Customers here can transact their business through any of BoB's branches within the city. Tele-banking has also been launched in these two cities under the *DialBoB* brand name. The bank plans to launch this service next in Bangalore and follow it up in the major metros—Mumbai, Calcutta and Delhi.

Significant ATM expansion in the next two years

BoB plans 500 ATMs by FY2002

In FY2000, the bank had only 24 ATMs. It is intentionally going slow in this respect, since it does not have a core banking solution in place. But once the technology consultant is appointed and online connectivity of branches commences, BoB plans to expand its ATMs to 500 in the next two years. It may also consider tying up with an outside vendor to increase its ATM presence, since the capital cost of owning a large ATM network can be expensive.

'Modern' bank will co-exist with the traditional one in the medium term

Bank within a bank

BoB's IT plan moving into high gear will create two "banks" within the organization, a modern one with the latest technology innovations, concentrated in metropolises, which account for the bulk of the business, and the traditional one, which will cover areas where business potential is lower. As technology engulfs BoB's vast network, the modern "bank" will expand and the traditional one, contract.

Labour relations

Bank has fewer employees than other banks of similar size

Employee size not a major constraint

Although BoB is India's second largest bank, with FY2000 credit of Rs244bn, it has 47,054 employees (14,029 officers) in contrast with Bank of India, which has credit of Rs252bn and 51,962 employees (officers: 12,229). Not only does it have a smaller number of employees but its labour relations also have always been cordial.

Benefit of responsible bank unions

BoB's unions an asset

Government bank unions are traditionally regarded as a major problem, constraining banks from raising productivity and hindering banking operations form being computerised. BoB's union is a notable exception. Not only has the bank enjoyed cordial relations with its unions, but also its employees union is noted for setting performance targets for its members to increase business and profitability.

At the banking level, all-India bank unions had agreed that a branch handling less than 750 vouchers a day would not be computerized, but BoB's clerical union led by Nadkarni waived this requirement. We believe that it is because of the unions' co-operation that BoB's computerization of branches will be more successful than other large government banks.

Unions monitor performance targets

Pro-active union leaders

The general secretary of the officers' union, K. K. Nair, is a pro-active and dynamic union leader. He has been on the board of directors—from 1984 to 1998 as a representative of the officers, and from November 1999, representing shareholders. He has been instrumental in insulating the bank from the sort of union problems that plague the sector.

Many a time, the officers' union has exhorted its members to increase the business of the bank. "We should leave no stone unturned to mobilize low-cost savings and current deposits, as also forge a concerted drive for retail lending, particularly consumer durables loans, car loans and housing loans," reads once such recent circular to its members. The union, independent of the management, also regularly monitors performance. Achieving the business target is an item on the agenda for discussion between the employees' union and the management.

Unions aware of competitive pressure

The bank's union is fully aware that unless BoB adapts to the constantly and fast-changing environment, its future is bleak. It is therefore working with the management to improve the bank's business and profitability. We believe that BoB's employees' union is an asset to the bank and will play a pro-active role in furthering the spread of the IT revolution in-house.

Creating a separate cadre to institutionalise change

Agents of change

To shake up the organization, tap creative ideas and implement innovation, the bank has decided to create a cadre of 500 agents of change. In a circular dated May 3, 2000, 500 volunteers were called for to perform additional duties and "concretise new ideas, evolve appropriate systems and methods, design suitable products and organize marketing strategies so as to enable the branches to contribute in a much larger way to the efficient business growth of the bank." Areas where they would be required to generate ideas are in retail banking, cash management, capital market related business, wholesale and corporate banking and strategic planning.

The response to this scheme was overwhelming and such agents of change are now being finalised. The main purpose of the scheme is to push through the management's directives to increase business and improve profitability. No doubt, in doing so, conflict could arise within the present reporting system and tension could be created within the organization but we believe that such a strategy is eminently required to revolutionize the culture in a government bank.

Retail lending

Targeting 5% of total credit

Looking for opportunities in retail finance

In FY2000, retail loans (housing, consumer durables, automobiles, educational and personal) formed 3% of total credit. BoB is concentrating on the retail segment, since the mid-size corporate segment is considered high-risk. By FY2001, it plans to increase its retail lending to 5% of credit.

Tie-up with multinational consumer finance company soon

Foreign company will provide the systems and BoB, the client base

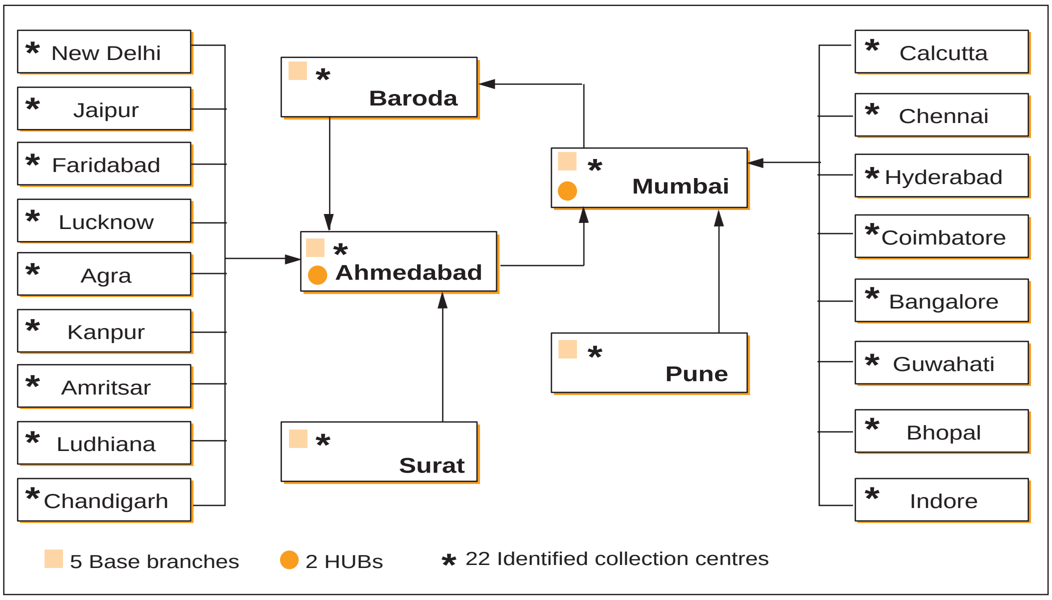
BoB will shortly announce a tie-up with a large, foreign retail finance company now in India. The venture will concentrate on 20 centres where BoB is aiming at retail finance, and an initial disbursal of Rs1bn is being considered. The tie-up will benefit both parties, since BoB will provide the client base and the foreign company, the systems and processes that are extremely important for retail finance.

Huge potential for BoB in retail finance

A retail client base of 20mn

The potential of BoB to undertake retail finance is considerable. At present, BoB has approximately 20mn accounts. Assuming it manages to market loans of Rs500,000 to merely 1% (200,000) of its customer base, such retail loans would total Rs100bn. More importantly, BoB will not have to incur marketing costs on these, since they are already captive customers. What is needed is that BoB identify and sell loan products to its present customers, which is possible once its technology backbone is in place and its management proactive. Such a customer base would be low-risk and low-cost.

Cash Management Services



BoB's cash management services poised for launch

BoB is currently testing its cash management system—*BoB Cash Reach*—and already 10 of its corporate clients have evinced interest. BoB plans to offer this service in 25 key cities in India, the main processing centres being in Mumbai, Ahmedabad and Baroda. Being India's second largest bank and having a commanding presence in the industrial centres of Maharashtra and Gujarat, BoB has access to many corporate clients and, given its vast branch network, this product could be successful if efficiently managed. BoB has completed phase-I in which five base branches (BBs) and 22 identified collection centres (ICCs) have been set up. Phase-II is now in process and will cover another 10 BBs and 36 ICCs. In phase III, to be operational by October 2001, the product will be offered in 200 ICCs and 50 BBs.

Capital Market Related Activities

Expanding its depository services to other cities

Launching its depository services at one branch near the Bombay Stock Exchange in Mumbai to facilitate holding and trading of securities in de-materialized form, BoB now has around 10,000 depository accounts. Still, it lags behind the industry leader, HDFC Bank, and so will open depository services in Baroda and Delhi and three more branches in Mumbai. We expect the bank to make inroads in Gujarat, where it enjoys a strong brand name, because of the equity culture in Gujarat, especially in Ahmedabad, Baroda and Surat.

BoB's asset management subsidiary needs to be revamped

BoB has an asset management subsidiary, which, unfortunately, has been unable to make an impact, primarily because of its inability to pay market-related salaries. Therefore, BoB should revamp its subsidiary or sell off its majority stake, as it can then cash in on its brand name to increase the assets under management.

Financial Projections

The increased growth in credit volumes and the relatively constant interest margin will influence any projections about BoB. We do not expect any depreciation on investments to affect net earnings in FY2001. We also believe that in the future the provisions for bad debts will not be higher than those for FY2000. We expect BoB earnings to increase at a CAGR for FY2002-FY2000 of 21%.

Deposits to increase at a CAGR of 15%

BoB's capital adequacy can sustain deposit growth

We estimate that, to maintain its tier-I capital adequacy of 8% without equity dilution, the bank's deposits should increase at 15% a year. We believe that BoB can sustain a 15% growth rate in future.

Credit to increase at a CAGR of 21%

We expect credit growth to rise from earlier levels, since the present management plans to increase the bank's market share, which had been eroded in the past due to delay in taking decisions. BoB plans to increase credit in the areas of housing, consumer durables and retail finance.

Net interest margin to remain relatively constant at 3.2%

At 3.28%, BoB's net interest margin in FY2000 compares favourably with market leader SBI's 3.1%. That higher margin is primarily due to its lower cost of funds at 7.1% compared with SBI's at 7.95%. In FY2001, margins are expected to remain constant, or may even improve slightly in the wake of interest rates increasing. BoB's thrust into depository services, we believe, should boost the number of savings account deposits. The yield on credit should be higher because of interest rates rising and because gross NPLs will increase at a more modest pace than in earlier years.

Other operating income to increase at a CAGR of 12%

Not factoring in any voluntary retirement scheme

Since BoB is aiming at augmenting its income from fees, which in the past had been low, we expect fee income to increase by 20% a year. Earlier, BoB had lost out on a share of its corporate clients' non-fund based income. Now, however, the senior management is utilizing BoB's funds leverage to obtain clients non-fund based business.

Overheads to increase at a CAGR of 10%

In our estimates, we have not factored in any voluntary retirement scheme (VRS), though the bank is currently evaluating one such. It may either offer this scheme to its employees or may transfer some of them to its proposed life insurance venture, still under consideration.

No depreciation on investments forecast for FY2001

We have not factored in any depreciation on investments in FY2000. Though 10-year government paper has increased by around 80 bp, BoB has unrealised gains of about Rs1.1bn. It also has an investment fluctuation reserve of Rs650mn, which could be utilized for depreciation on investments. If interest rates across maturities rise by 100bp over levels of FY2001, the bank will have to provide for a net depreciation of Rs2.25bn. The net profit would decline by 25% from our forecast to Rs4.49bn (EPS: Rs15.3, book value: Rs119, adjusted book value: Rs61). We believe BoB can absorb a further 44bp increase in government yields from their levels now without affecting net earnings.

Bad debt provisions to be around Rs3bn every year

We expect BoB's provisions for bad debts to remain around Rs3bn every year. We do not expect any significant increase over FY2000 since we believe such bad debt provisions have peaked in FY2000. Also, in FY2001 the bank will not have to make a higher provision for doubtful loans, as will most other banks, since it has already been providing for such loans from FY1999 onwards.

Background

92 years old and a consistent record of profitability

Founded on July 20, 1908, in Baroda by the then maharaja, Sir Sayajirao Gaekwad III, BoB's first branch was opened in Ahmedabad in 1910. The bank moved into international banking in 1953 and has since established banking relationships with institutions in several countries, including Australia, Japan, Germany, Italy, the USA and the UK. It was nationalized in July 1969. In 1996, it came out with a public issue priced at Rs85. In its 92-year history, the bank has always been profitable.

India's second largest bank, with Rs513bn in deposits and 2,614 c branches in India

Today, it is India's second largest bank after The State Bank of India and, among Indian banks, has the second largest network of overseas branches. It has diversified into merchant banking, asset management, housing finance and credit cards.

Capital Adequacy

Year to 31st March	1998	1999	2000	2001E	2002E
Tier-I Capital (Rs mn)	**22,769**	**23,969**	**27,206**	**29,125**	**34,877**
General Provisions	772	383	0	0	0
Subordinate Debt	4,000	9,000	7,989	6,800	6,800
Investment write-back reserve	0	473	650	650	650
Revaluation Reserve	1,444	1,401	1,305	1,242	1,174
Tier II Capital	**6,216**	**11,257**	**9,944**	**8,692**	**8,624**
Total Capital	**28,985**	**35,226**	**37,150**	**37,816**	**43,501**
Tier I Capital (%)	9.5	9.1	8.9	8.1	8.3
Tier II Capital (%)	2.6	4.3	3.2	2.4	2.1
Total Capital (%)	**12.1**	**13.4**	**12.1**	**10.5**	**10.4**
Risk-Weighted Assets	**240,345**	**263,705**	**307,132**	**358,676**	**420,242**
Growth (%)	22.6	9.7	16.5	16.8	17.2

Tier-I capital to remain more than 8%

Assuming a 17% growth in risk-weighted assets, the bank is adequately capitalized, its tier-I capital remaining over 8%, well above the minimum 4.5% stipulation. We do not visualize the bank raising equity from the capital market unless it plans to augment its risk-weighted assets beyond our estimates.

Issue of additional subordinate debt can further enhance tier-II capital

Although the bank's total capital adequacy in the near future is about 10%, one percentage point higher than the minimum, it yet has the capacity to increase subordinate debt. In our estimates, we have assumed such debt to remain at the FY2000 level.

Non-performing assets

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Opening Gross NPAs	31,160	31,293	36,856	38,972	41,310
Additions	9,250	11,616	8,285	7,000	6,000
Upgrading	(770)	(740)	(1,163)	(900)	(850)
Compromise / Write-off	(4,190)	(1,980)	(1,093)	(1,000)	(1,000)
Recovery	(4,160)	(3,330)	(3,913)	(2,762)	(2,084)
Closing Balance Gross NPAs	31,293	36,856	38,972	41,310	43,376
Growth (%)	0.4	17.8	5.7	6.0	5.0
Provisions	18,389	20,750	22,109	23,547	24,724
Net NPAs	12,904	16,106	16,863	17,763	18,652
Growth (%)	5.3	24.8	4.7	5.3	5.0
Coverage (%)	58.8	56.3	56.7	57.0	57.0
Gross NPAs (%)	14.5	15.9	14.6	12.7	11.3
Net NPAs (%)	6.5	7.6	6.9	5.9	5.2

By industry standards and given its legacy, the bank has a reasonable level of NPAs. The sluggish economic environment has led to gross and net NPAs increasing, mainly from large and medium-sized industries, agriculture and small-scale industries. We are satisfied with BoB's accounting for its NPAs, quite unlike with some other government banks. Its coverage ratio (accumulated provisions to gross NPAs) is also at a prudent 57%. Looking ahead, we do not expect its NPAs to increase sharply; also additional credit growth should compensate for the rise in NPAs.

Income Statement

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Net Interest Income	13,334	15,735	17,135	19,573	21,492
Other Income	5,432	5,785	6,415	6,872	8,057
Total Income	**18,766**	**21,520**	**23,550**	**26,445**	**29,549**
Salaries	(7,385)	(8,451)	(8,965)	(9,862)	(10,848)
Other expenses	(3,321)	(3,616)	(4,068)	(4,501)	(5,059)
Total Overheads	**(10,706)**	**(12,067)**	**(13,033)**	**(14,363)**	**(15,907)**
Profit Before Provisions	8,060	9,453	10,517	12,082	13,642
Bad Debt Provisions	(3,226)	(3,613)	(3,328)	(3,233)	(3,005)
Provisions for standard assets	0	0	(90)	(132)	(136)
Investment Provisions	2,452	(150)	(54)	0	0
Others	(123)	0	384	0	0
Tax	(2,576)	(1,473)	(2,401)	(2,702)	(3,150)
Total Provisions	(3,473)	(5,236)	(5,489)	(6,067)	(6,291)
Net Profit	**4,587**	**4,217**	**5,028**	**6,015**	**7,351**
Dividend	(916)	(986)	(1,363)	(1,413)	(1,295)
DPS	3.00	3.00	4.00	4.00	4.00
EPS (Rs)	**15.7**	**14.2**	**17.0**	**20.4**	**25.0**
EPS Growth (%)	159.9	(9.1)	19.3	20.3	22.2
Net Interest Margin (%)	3.4	3.4	3.3	3.3	3.2
Cost-to-Income (%)	55.2	54.2	53.1	52.0	51.5
Average Tax Rate (%)	36.0	25.9	34.1	31.0	30.0
Payout (%)	20.0	23.4	27.1	23.5	17.6
Net NPA (%)	6.5	7.7	6.9	5.9	5.2
Provisions/Gross NPA (%)	58.8	56.3	56.7	57.0	57.0

Return on Assets

Year to 31st March (%)	1998	1999	2000	2001E	2002E
Net Interest Income	3.2	3.2	3.1	3.2	3.1
Other Income	1.3	1.2	1.2	1.1	1.1
Less Overheads	(2.6)	(2.5)	(2.4)	(2.3)	(2.3)
Less Provisions	(0.8)	(1.1)	(1.0)	(1.0)	(0.9)
ROA	1.14	0.86	0.91	0.97	1.05
ROE	22.9	17.1	18.2	18.9	19.8

Valuation

Year to 31st March (x)	1998	1999	2000	2001E	2002E
Price Earnings	6.7	3.2	2.4	2.0	1.7
Price to Book Value	1.31	0.52	0.41	0.36	0.30
Price to Adjusted BV	2.71	1.25	0.93	0.71	0.54
Dividend Yield (%)	2.9	6.6	9.7	9.7	9.7

(Historic at year end prices)

Balance Sheet

As at 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Cash with RBI	36,652	36,845	35,055	41,600	47,840
Cash at call	67,207	83,348	89,714	103,171	118,647
Total Cash	**103,859**	**120,193**	**124,769**	**144,771**	**166,487**
Investments	133,589	159,054	185,565	175,698	187,868
Advances	198,035	210,915	243,930	300,923	359,632
Net Block	5,810	5,974	6,078	6,382	6,701
Other assets	17,125	26,186	25,710	29,567	34,001
Assets	458,418	522,322	586,052	657,340	754,689
Demand Deposits	46,893	52,430	55,245	53,104	50,891
Savings Deposits	78,018	91,068	108,423	129,810	156,067
Term Deposits	266,347	302,641	349,414	407,131	471,593
Total Deposits	**391,258**	**446,139**	**513,082**	**590,044**	**678,551**
Other Borrowing	4,765	4,793	3,687	4,240	4,876
Subordinate Debt	5,000	11,000	10,989	11,000	11,000
Total Borrowing	9,765	15,793	14,676	15,240	15,876
Other liabilities	30,762	31,406	25,949	15,130	17,430
Equity	2,930	2,941	2,943	2,943	2,943
Reserves	23,703	26,043	29,403	33,983	39,889
Total Equity	**26,633**	**28,984**	**32,346**	**36,926**	**42,832**
Total Liab & Equity	**458,418**	**522,321**	**586,053**	**657,340**	**754,689**

Capital Adequacy

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Tier I Capital	22,769	23,969	27,206	29,125	34,877
Tier II Capital	6,216	11,257	9,944	8,692	8,624
Total Capital	**28,985**	**35,226**	**37,150**	**37,816**	**43,501**
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Tier I Capital (%)	9.4	9.1	8.9	8.1	8.3
Tier II Capital (%)	2.7	4.3	3.3	2.6	2.2
Capital Adequacy (%)	**12.1**	**13.3**	**12.2**	**10.8**	**10.5**

Adjusted Book Value

Year to 31st March (Rs mn)	1998	1999	2000	2001E	2002E
Book Value (Rs)	**79.9**	**88.2**	**100.0**	**116.1**	**136.7**
Equity	23,424	25,925	29,437	34,167	40,223
Net NPLs	(12,904)	(16,106)	(16,863)	(17,763)	(18,652)
General Provisions	772	383	0	0	0
Prudential Reserves	0	483	570	702	838
Adjusted Equity	11,292	10,685	13,144	17,106	22,409
Adjusted BV (Rs)	**38.5**	**36.3**	**44.7**	**58.1**	**76.1**

Price Movement

International Offices, Raymond James & Associates, Inc			E-Mail	Telephone
London	- India Trading	Danny Gordon	DGordon@askrj.rjf.com	+44 (171) 696 6170
New York	- India Sales & Trading	Prashant Kothari	PKothari@ecm.rjf.com	+ 1 (212) 297 5601
	- India Trading	Joann Farrell	JFarrell@ecm.rjf.com	+ 1 (212) 856 4385

India Sales & Dealing, Mumbai		E-Mail	Telephone
Head of Sales	Dick Mody	DMody@askrj.com	+91 (22) 498 5680
Foreign Institutional Investor	Parag Jhaveri	PJhaveri@askrj.com	+91 (22) 498 5680
Domestic Sales and Dealing	Bhavesh Jangla	BJangla@askrj.com	+91 (22) 498 5680
	Sudhir Padiyar	SPadiyar@askrj.com	+91 (22) 498 5680
	Smita Jain	SJain@askrj.com	+91 (22) 498 5680

India Research - Sector Allocations	Analyst	E-Mail	Telephone
Head of Broking/Research	Anand Tandon	ATandon@askrj.com	+91 (22) 498 5670
Joint Head of Research, Pharmaceuticals, Cement	Ashit Kothari	AKothari@askrj.com	+91 (22) 498 5670
Pharmaceuticals, Cement	Vikas Chauhan	VChauhan@askrj.com	+91 (22) 498 5670
Banking, Finance	Hemindra Hazari	HHazari@askrj.com	+91 (22) 498 5670
Consumer Goods, Media	Hozefa Topiwalla	HTopiwalla@askrj.com	+91 (22) 498 5670
Information Technology	Vijay Bhayani	VBhayani@askrj.com	+91 (22) 498 5670
Information Technology	Ajay Mathrani	AMathrani@askrj.com	+91 (22) 498 5670
Auto	Satish P Jain	SPJain@askrj.com	+91 (22) 498 5670
Editor	Anil Siqueira	ASiqueira@askrj.com	+91 (22) 498 5670
Production	Madhava Kumar	MKumar@askrj.com	+91 (22) 498 5670