

# ORIENTAL BANK OF COMMERCE

## Asset quality risks to stabilise; NPLs below 3% by FY14

India Equity Research | Banking and Financial Services



We recently met with the senior management of OBC to get an insight into their asset quality trends. Led by continuous focus and monitoring, the management believes they could contain slippages in the range of INR 30bn (2.5% - as against 2.8% in FY13). Recovery efforts continue to be on track and the bank aims to bring down NPLs closer to 3% (3.2% currently) and improve provisioning coverage to 67-68%. The management reiterated its guidance of improving margins to 2.9% by FY14. On SEB restructuring, the management highlighted there would be no NPV hit on conversion of loan exposure to bonds. At current valuations of 0.5x FY15 adj. book and lower wholesale rates seen in FY14 coupled with slippages moderating, we maintain 'BUY' with TP of INR350.

### Stringent risk management practice to aid asset quality

Stringent controls and focus – The management believes slippages would be contained at around INR 30bn (INR32bn in FY13). It has a target recovery set at around INR20-22bn. On specific exposure - INR1.75bn NAFED has been fully provided for and written off. Recoveries are tracking at similar levels of the previous year – however, on a comparable basis income from written would be lower as Q1FY13 was characterized by lumpy recoveries. The bank's endeavour is to bring down NPL closer to 3% and provisioning coverage to 67-68%.

### Loan growth to be in line with industry growth

Through focus on agriculture, retail, SME, the management is targeting loan growth of 15-16% in FY14. Unlike other PSU peers, OBC has been able to meet its priority sector lending targets.

### Outlook & valuations: Risk-reward favorable; maintain 'BUY'

Led by clarity on asset quality, stable-to-improving margins we expect the bank to deliver 28% CAGR in earnings over FY13-15 with the ROE profile improving from ~11% in FY13 to 15.4% in FY15E. At valuation of 0.5x FY15, we believe risk are adequately priced in. We maintain 'BUY/Sector Outperformer'.

#### Financials

Year to March	FY12	FY13	FY14E	FY15E
Net revenues (INR mn)	54,560	63,559	73,528	85,003
Net rev growth (%)	6.2	16.5	15.7	15.6
Net profit (INR mn)	11,416	13,280	17,785	21,815
Shares outstanding (mn)	292	292	292	292
EPS (INR)	39.1	45.5	61.0	74.8
EPS growth (%)	(24.0)	16.3	33.9	22.7
PE (x)	6.1	5.2	3.9	3.2
Price to book (x)	0.6	0.6	0.5	0.5
ROE (%)	10.7	11.5	14.1	15.4

#### EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Equalweight

#### MARKET DATA (R: ORBC.BO, B: OBC IN)

CMP	: INR 237
Target Price	: INR 350
52-week range (INR)	: 368 / 207
Share in issue (mn)	: 291.8
M cap (INR bn/USD mn)	: 69/ 1,198
Avg. Daily Vol.BSE/NSE('000)	: 768.7

#### SHARE HOLDING PATTERN (%)

	Current	Q3FY13	Q2FY13
Promoters *	58.0	58.0	58.0
MF's, FI's & BK's	25.2	26.0	25.4
FII's	9.6	9.3	9.5
Others	7.2	6.7	7.1
* Promoters pledged shares (% of share in issue)			NIL

#### PRICE PERFORMANCE (%)

	Stock	Nifty	EW Banks and Financial Services Index
1 month	(11.0)	(5.5)	2.3
3 months	(14.1)	(0.4)	6.0
12 months	(2.2)	13.8	33.1

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### SEB restructuring :Bonds adequately priced to mark down any NPV hit

The management reiterated that there would be no NPV hit on bond conversion. OBC is the principal banker for Haryana restructuring. As per the terms of restructuring: bank will undertake loss funding of 100% in FY13, 75% in FY14, and 50% in FY15. In the initial leg, bonds will be issued by the SEB which will be taken over by the state government over the next 3-5 years. As per the RBI notification on bond pricing, the bond will be priced at yield on 5-year central government bonds + average spread for state government over last 10 years +25 mark up for non-SLR status and 20bps for capital charge. Once the special securities get issued by the state government, the pricing will be remaining tenor + state govt spread. For MTM, bond valuation will be G-sec + 75 bps and for special securities it will be 50 bps. OBC total discom exposure is INR 67bn.

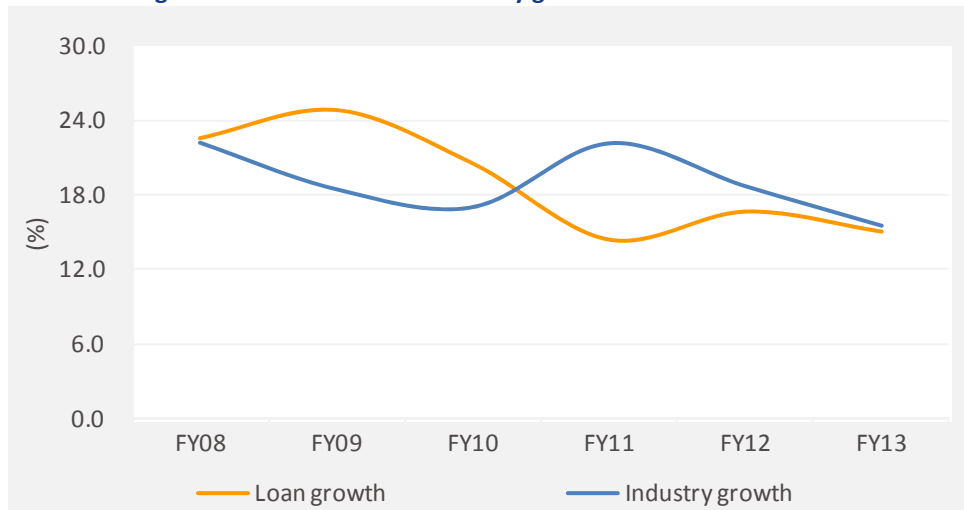
### Robust treasury performance to provide fillip to earnings

The bank's treasury operations have been good as against last year's where it shifted securities to HTM based on the view of higher yields, this time around there is a positive gain. Last year the share of AFS was reduced to 14% in Q1FY13 due to shifting of securities to HTM which was increased to 22%. This coupled with rising duration should aid a favorable performance in treasury.

### Key highlights of annual report

- ALM profile- Widened mismatch within 1 year maturity bucket
- Bank was able to meet PSL requirement –unlike other PSU peers
- Segment wise NPLs : Sharp decline in NPLs in services segment
- Expected return on plan asset increased sharply; salary escalation assumptions brought in line with peers

**Chart 1: Loan growth to be in line with industry growth**



Source: Company

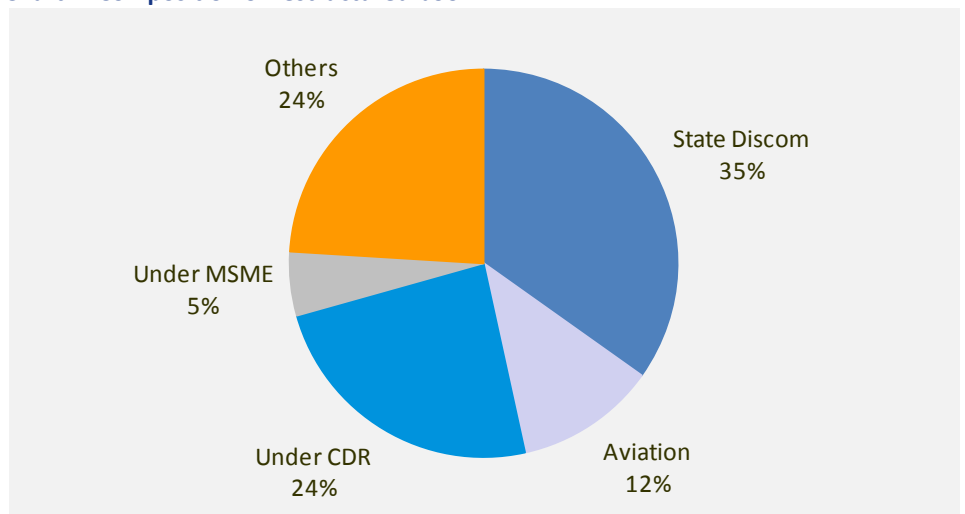
**Table 1: Slippage likely to be contained within INR30bn (2.5%)**

	Q212	Q312	Q412	Q113	Q213	Q313	Q413
Incremental slippage (%)	6.1	2.7	4.8	2.5	2.3	2.8	3.4
Gross NPA (INR mn)	31.1	32.3	35.8	33.8	34.7	36.9	41.8
Growth Q-o-Q	52.9	3.9	10.8	(5.7)	2.6	6.5	13.4
Gross NPA (%)	3.0	2.9	3.2	3.0	2.9	3.0	3.2
Net NPA (INR mn)	19.8	20.6	24.6	23.1	23.9	26.1	29.0
Growth Q-o-Q	86.8	4.2	19.3	(6.2)	3.8	9.1	11.2
Net NPA (%)	1.9	1.9	2.2	2.1	2.0	2.1	2.3
Provision coverage	36.4	36.2	31.3	31.7	30.9	29.3	30.6

**Table 2: Exposure composition to various state SEBs**

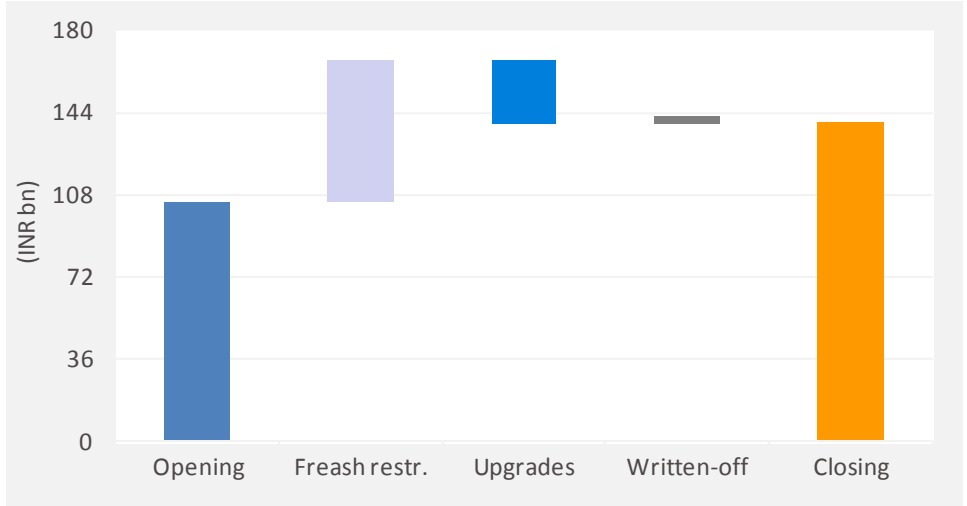
(INR Mn)	Generation	Transmission	Distribution	Total
Rajasthan	480	2,250	24,770	27,500
Haryana	2,630	0	12,420	15,050
Uttar Pradesh	0	0	17,800	17,800
Gujarat	8,970	3,720	0	12,690
Punjab	0	0	11,860	11,860
Tamil Nadu	1,270	0	0	1,270
Maharastra	0	2,070	0	2,070
Andhra Pradesh	260	480	0	740
Other States	220	770	240	1,230
<b>TOTAL</b>	<b>13,830</b>	<b>9,290</b>	<b>67,090</b>	<b>90,210</b>

**Chart 2: Composition of restructured book**

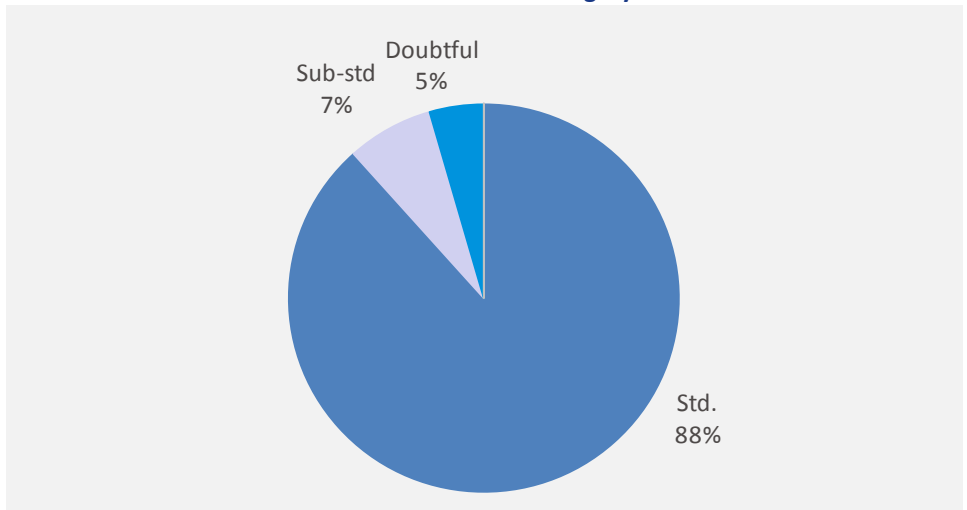


Source: Company

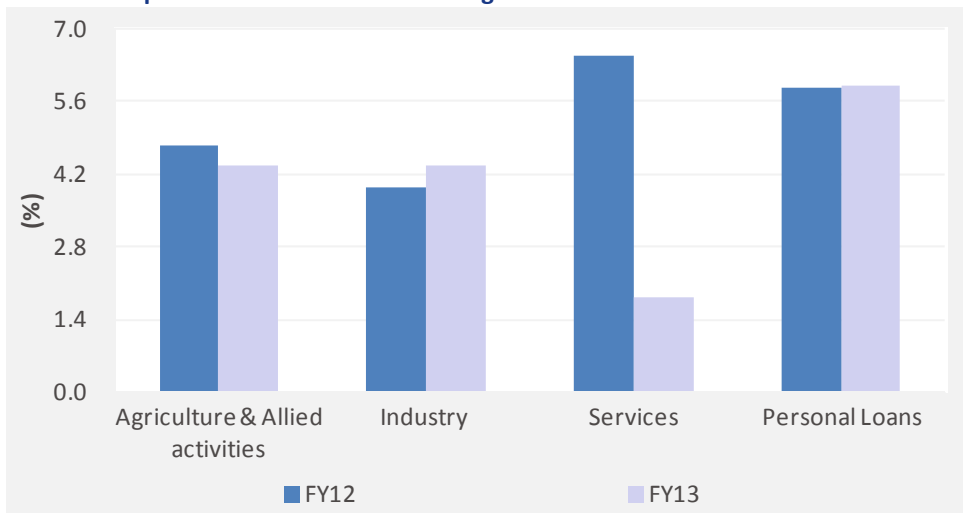
**Chart 3: Movement of restructured book in FY13; higher upgrades aids performance**



**Chart 4: ~12% of the restructured book is in NPL category**

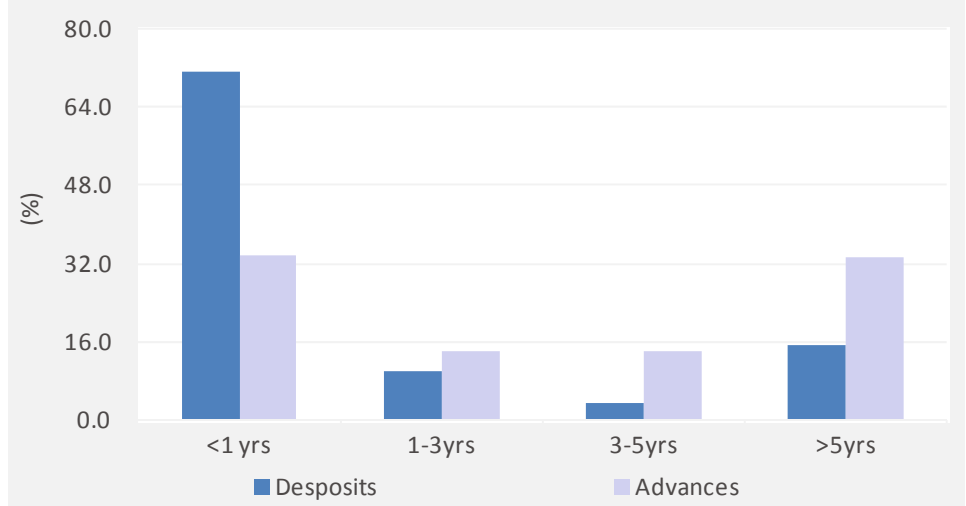


**Chart 5: Sharp decline in NPLs in services segment**



Source: Company

**Chart 6: ALM profile- Widened mismatch within 1 year maturity bucket**



**Table 3: Able to meet PSL requirement –unlike other PSU peers**

(%)	FY12	FY13
Priority Sector	42.3	41.8
Agri Priority Advances	16.1	15.9
-Direct Agri Advances	12.4	12.4
Weaker Section	9.1	10.3
Minority Community	15.0	15.8
Women Beneficiaries	5.01	5.73

**Table 4: Expected return on plan asset increased sharply; salary escalation assumptions brought in line with peers**

(%)	OBC			PSU peers		
	FY11	FY12	FY13	FY11	FY12	FY13
Discount Rate	8.50	8.50	8.50	8.45-8.50	8.50-8.80	8.00-8.50
Expected Rate of return on Plan Asset	8.05	8.50	9.13	8.00-8.60	8.00-8.60	8.00-9.20
Salary Escalation	6.00	6.00	5.50	4.00-5.00	4.00-6.00	4.00-5.50

**Table 5: Stable exposure to likely stressed segments renders comfort**

(%)	FY12	FY13
Power	12.4	12.5
Roads and Poarts	4.8	4.1
Telecom	2.3	2.2
Infrastructure	18.9	18.6
Textile	4.7	5.2
Basic Metals	7.4	7.7
Construction	2.0	1.2
Gems and Jewellery	0.4	0.2

Source: Company

### Company Description

Oriental Bank of Commerce is a mid-sized PSU bank, with the 11th largest branch network and 10th largest asset book among Indian banks. Historically, the bank had a strong presence in northern and western India and the merger of Global Trust Bank (then roughly 15% of the size of OBC) provided it the southern presence. The bank has over 2000 branches across India, all of which are under core banking solution. Government ownership in the bank is at minimum 58%; FII holding in the bank is at 9.6%.

### Investment Theme

Surprises on asset quality and a moderation of wholesale rates led to higher earnings. While restructuring may continue for a while, we expect slippages to moderate to 2.6%. Led by clarity on asset quality, stable-to-improving margins we expect the bank to deliver 29% CAGR in earnings over FY13-15 with the ROE profile improving from ~11% in FY13 to 15.6% in FY15E.

### Key Risks

Mid size PSU banks have high risk of NPL, considering their weak risk management system. Exposed bond book makes it vulnerable to rising interest rates.

## Financial Statements

### Key Assumptions

Year to March	FY12	FY13	FY14E	FY15E
<b>Macro</b>				
GDP(Y-o-Y %)	6.2	5.0	6.0	7.0
Inflation (Avg)	8.9	7.4	5.2	6.0
Repo rate (exit rate)	8.5	7.5	6.8	6.0
USD/INR (Avg)	48.0	54.5	55.0	53.0
<b>Sector</b>				
Credit growth	17.1	14.7	15.0	16.0
Deposit growth	13.4	13.5	15.0	16.0
CRR	4.8	4.3	4.0	4.0
SLR	24.0	23.0	23.0	23.0
G-sec yield	8.5	7.8	7.6	7.5
<b>Company</b>				
Operating metric assumptions (%)				
Yield on advances	11.6	11.4	10.3	9.8
Yield on investments	6.8	6.8	6.6	6.5
Yield on asset	9.6	9.6	8.8	8.5
Net interest margins	2.6	2.5	2.7	2.7
Cost of funds	7.3	7.3	6.4	6.1
Cost of deposits	7.6	7.5	6.6	6.2
Cost of borrowings	7.1	8.1	7.5	7.0
Spread	2.3	2.3	2.4	2.5
Tax rate (%)	19.6	13.5	25.0	25.0
Balance sheet assumption (%)				
Credit growth	16.6	15.0	15.9	17.8
Deposit growth	12.2	12.8	15.4	17.5
SLR ratio	24.8	24.4	25.0	25.0
Low-cost deposits	24.1	24.6	25.0	25.0
Gross NPA ratio	3.2	3.2	3.0	2.8
Net NPA ratio	2.2	2.3	1.9	1.7
Provision coverage	31.3	30.6	37.6	40.2
Incremental slippage	4.0	2.8	2.6	2.2
Net NPA / Equity	22.2	24.4	21.4	20.0
Capital adequacy	12.7	12.0	11.0	10.3

### Income statement

(INR mn)

Year to March	FY12	FY13	FY14E	FY15E
Interest income	158,149	177,048	186,572	209,528
Interest expended	115,991	130,036	130,566	143,194
Net interest income	42,158	47,012	56,005	66,334
Non interest income	12,403	16,547	17,523	18,669
- Fee & forex income	9,033	9,368	10,773	12,669
- Misc. income	1,639	5,495	4,500	4,000
- Investment profits	1,731	1,685	2,250	2,000
Net revenue	54,560	63,559	73,528	85,003
Operating expense	23,155	26,652	30,824	35,476
- Employee exp	13,568	15,761	18,910	22,311
- Other opex	9,587	10,891	11,914	13,165
Preprovision profit	31,406	36,907	42,704	49,526
Provisions	17,204	21,546	18,991	20,440
Loan loss provisions	10,787	18,838	17,241	18,190
Investment depreciation	2,854	(742)	250	250
Other provisions	3,563	3,450	1,500	2,000
Profit before tax	14,202	15,361	23,713	29,086
Provision for tax	2,787	2,081	5,928	7,272
Profit After Tax	11,416	13,280	17,785	21,815
Reported PAT	11,416	13,280	17,785	21,815
Diluted EPS (INR)	39.1	45.5	61.0	74.8
Dividend per share (INR)	7.9	8.2	11.0	13.5
Dividend payout (%)	23.5	21.1	21.1	21.1

### Growth ratios (%)

Year to March	FY12	FY13	FY14E	FY15E
NII growth	0.9	11.5	19.1	18.4
Fees growth	19.1	3.7	15.0	17.6
Opex growth	22.4	15.1	15.7	15.1
PPOP growth	(6.4)	18.7	14.9	17.5
PPP growth	(3.2)	17.5	15.7	16.0
Provisions growth	42.4	25.2	(11.9)	7.6
Net profit	(24.0)	16.3	33.9	22.7

### Operating ratios

Year to March	FY12	FY13	FY14E	FY15E
Yield on advances	11.6	11.4	10.3	9.8
Yield on investments	6.8	6.8	6.6	6.5
Yield on assets	9.6	9.6	8.8	8.5
Net interest margins	2.6	2.5	2.7	2.7
Cost of funds	7.3	7.3	6.4	6.1
Cost of deposits	7.6	7.5	6.6	6.2
Cost of borrowings	7.1	8.1	7.5	7.0
Spread	2.3	2.3	2.4	2.5
Cost-income	42.4	41.9	41.9	41.7
Tax rate	19.6	13.5	25.0	25.0

## Banking and Financial Services

Balance sheet		(INR mn)			
As on 31st March	FY12	FY13	FY14E	FY15E	
Equity capital	2,918	2,918	2,918	2,918	
Reserves & surplus	107,932	116,263	130,302	147,523	
Net worth	110,850	119,180	133,220	150,440	
Sub bonds/pref cap	22,000	27,974	30,474	32,974	
Deposits	1,559,649	1,758,975	2,030,605	2,386,578	
Borrowings	30,591	48,820	60,627	72,686	
Other liabilities	49,637	43,448	51,067	61,241	
<b>Total liabilities</b>	<b>1,772,727</b>	<b>1,998,397</b>	<b>2,305,992</b>	<b>2,703,918</b>	
Loans	1,119,777	1,289,551	1,495,879	1,765,137	
Cash and equivalents	87,270	85,896	93,749	110,193	
Gilts	394,168	447,097	523,489	615,496	
Others	126,845	138,449	151,182	165,154	
Fixed assets	5,631	3,699	3,539	4,298	
Other Assets	39,036	33,705	38,154	43,640	
<b>Total assets</b>	<b>1,772,727</b>	<b>1,998,397</b>	<b>2,305,992</b>	<b>2,703,918</b>	
Credit growth	16.6	15.0	15.9	17.8	
Deposit growth	12.2	12.8	15.4	17.5	
EA growth	10.0	13.5	15.5	17.3	
SLR ratio	24.8	24.4	25.0	25.0	
C-D ratio	73.2	74.6	74.9	75.1	
Low-cost deposits	24.1	24.6	25.0	25.0	
Gross NPA ratio	3.2	3.2	3.0	2.8	
Net NPA ratio	2.2	2.3	1.9	1.7	
Provision coverage	31.3	30.6	37.6	40.2	
Incremental slippage	4.0	2.8	2.6	2.2	
Net NPA / Equity	22.2	24.4	21.4	20.0	
Capital adequacy	12.7	12.0	11.0	10.3	
- Tier 1	10.1	9.2	8.5	7.8	

RoE decomposition (%)					
Year to March	FY12	FY13	FY14E	FY15E	
Net interest income/assets	2.6	2.5	2.7	2.7	
Fees/Assets	0.6	0.8	0.7	0.7	
Investment profits/Assets	0.1	0.1	0.1	0.1	
Net revenues/assets	3.3	3.4	3.5	3.5	
Operating expense/assets	(1.4)	(1.4)	(1.5)	(1.4)	
Provisions/assets	(1.0)	(1.2)	(0.9)	(0.8)	
Taxes/assets	(0.2)	(0.1)	(0.3)	(0.3)	
Total costs/assets	(2.6)	(2.7)	(2.6)	(2.6)	
ROA	0.7	0.7	0.8	0.9	
Equity/assets	6.5	6.2	6.0	5.8	
ROAE (%)	10.7	11.5	14.1	15.4	

Valuation parameters					
Year to March	FY12	FY13	FY14E	FY15E	
Diluted EPS (INR)	39.1	45.5	61.0	74.8	
Y-o-Y growth (%)	(24.0)	16.3	33.9	22.7	
Book value per share (INR)	379.9	408.5	456.6	515.6	
Adjusted book value per share	320.9	338.8	388.1	443.4	
Diluted PE (x)	6.1	5.2	3.9	3.2	
Price/ Adj. BV (x)	0.7	0.7	0.6	0.5	
Dividend yield (%)	3.3	3.5	4.6	5.7	
Price to income (x)	3.4	2.7	2.5	2.3	

### Peer comparison valuation

Name	Market cap (USD mn)	Diluted PE (X)		Price/ Adj. BV (X)		ROAE (%)	
		FY14E	FY15E	FY14E	FY15E	FY14E	FY15E
Oriental Bank Of Commerce	1,198	3.9	3.2	0.6	0.5	14.1	15.4
Allahabad Bank	968	3.1	2.4	0.6	0.5	15.9	18.2
Axis Bank	10,555	9.5	7.8	1.6	1.4	18.2	18.9
Bank of Baroda	4,635	4.7	3.7	0.8	0.7	17.3	18.6
Federal Bank	1,258	7.8	6.5	1.1	1.0	14.1	15.1
HDFC Bank	27,556	19.6	15.7	3.8	3.2	20.7	21.8
ICICI Bank	22,069	13.9	12.4	2.1	1.9	13.1	13.3
IndusInd Bank	4,375	19.0	15.2	3.0	2.6	16.8	18.1
ING Vysya	1,719	12.9	10.3	1.9	1.7	15.7	17.1
Karnataka Bank	457	6.2	5.2	0.9	0.8	14.1	15.2
Punjab National Bank	4,546	4.7	4.0	0.9	0.7	16.8	17.3
South Indian Bank	572	5.8	4.8	1.0	0.9	18.5	19.1
State Bank of India	24,280	9.4	7.9	1.5	1.3	14.3	15.1
Union Bank Of India	2,199	6.1	5.3	0.8	0.7	15.1	15.6
Yes Bank	2,984	10.5	8.5	2.4	2.0	25.4	25.4
Median	-	7.0	5.9	1.1	0.9	15.8	17.2
AVERAGE	-	8.9	7.3	1.5	1.3	16.1	17.1

Source: Edelweiss research

## Additional Data

### Directors Data

S L Bansal	Chairman & Managing Director	V Kannan	Executive Director
Sreya Guha	Nominee (Govt)	B Srinivas	Nominee (RBI)
K H Pandey	Director (Workmen Employee)	S S Shishodia	Director (Officer Employee)
Chandraprakash Singh	Director(PartTime NonOfficial)	K S Sreenivasan	Director(PartTime NonOfficial)
T Valliappan	Director(Shareholders)	Abha chaturvedi	Director(Shareholders)
P B Santhanakrishnan	Director(Shareholders)		

Auditors - B Purushottam & Co

*\*as per last annual report*

### Holding – Top10

	Perc. Holding		Perc. Holding
Life Insurance Corporation	11.06	Reliance Capital Trust	3.03
HDFC Asset Management	2.17	UTI Asset Management	1.32
HDFC Life Insurance	1.24	Bank of New York Mellon	1.09
Birla Sun Life Asset Management	0.62	Blackrock	0.57
Dimensional Fund Advisors	0.52	Jupiter Asset Management	0.47

*\*in last one year*

### Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

*\*in last one year*

### Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

*\*in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Allahabad Bank	BUY	SP	M	Axis Bank	BUY	SO	M
Bank of Baroda	BUY	SP	M	Federal Bank	BUY	SO	L
HDFC	HOLD	SP	L	HDFC Bank	HOLD	SP	L
ICICI Bank	BUY	SO	L	Indian Overseas Bank	HOLD	SU	M
IndusInd Bank	BUY	SP	L	IDFC	BUY	SO	L
ING Vysya	BUY	SO	L	Karnataka Bank	BUY	SO	M
Kotak Mahindra Bank	REDUCE	SU	M	LIC Housing Finance	BUY	SO	M
Mahindra & Mahindra Financial Services	BUY	SO	M	Manappuram General Finance	BUY	SP	H
Multi Commodity Exchange of India	BUY	SO	M	Muthoot Finance	BUY	SO	M
Oriental Bank Of Commerce	BUY	SO	L	Power Finance Corp	BUY	SO	M
Punjab National Bank	HOLD	SU	M	Reliance Capital	BUY	SO	M
Rural Electrification Corporation	BUY	SO	M	Shriram City Union Finance	BUY	SO	M
South Indian Bank	HOLD	SP	M	State Bank of India	BUY	SO	L
Union Bank Of India	BUY	SO	M	Yes Bank	BUY	SO	M

## ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

## RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

## RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

## SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return



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**Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services**

Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC, HDFC Bank, ICICI Bank, Infrastructure Development Finance Co Ltd, IndusInd Bank, Indian Overseas Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, Multi Commodity Exchange of India, Manappuram General Finance, Mahindra & Mahindra Financial Services, Muthoot Finance, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, State Bank of India, Shriram City Union Finance, South Indian Bank, Union Bank Of India, ING Vysya, Yes Bank

**Recent Research**

Date	Company	Title	Price (INR)	Recos
17-Jun-13	<b>Punjab National Bank</b>	Consolidation on cards; asset quality key monitorable; <i>Visit Note</i>	742	Hold
05-Jun-13	<b>Banking</b>	Bank license: Sacrificing near term RoE for long term goals; <i>Sector Update</i>		
30-May-13	<b>MCX</b>	Dip in commodity prices, CTT levy key monitorables ; <i>Result Update</i>	889	Buy

**Distribution of Ratings / Market Cap**

**Edelweiss Research Coverage Universe**

	Buy	Hold	Reduce	Total
Rating Distribution*	120	49	17	186
* - stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	118	56	12	

**Rating Interpretation**

Rating	Expected to
<b>Buy</b>	appreciate more than 15% over a 12-month period
<b>Hold</b>	appreciate up to 15% over a 12-month period
<b>Reduce</b>	depreciate more than 5% over a 12-month period

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