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# Bank of Baroda (BOB)

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***On a strong footing…***

Bank of Baroda (BOB) is the third largest public sector bank (PSB) in India in terms of asset size and the fourth largest bank in terms of branches. The bank has strong domestic presence with 5,382 branches and 10,404 ATM's across the country. BOB is also known as the international bank of India as it has one of the largest branch networks in foreign countries. BOB has presence in over 27 countries with 139 overseas branches/offices, which generates close to 27% of its total business.

## Investment Rationale

- **Focus towards higher yielding loans to offset subdued credit growth:** Given the continued macro-economic uncertainty, BOB continues to consolidate its balance sheet. However, we expect advances to grow at a moderate pace of 8% CAGR over FY17-19E as the bank continues to lend selectively and reshuffle its portfolio towards more profitable assets.

- **Getting stronger on a retail liability franchise:** The bank has decided to move away from high cost bulk term deposits to low cost retail term deposits to reduce its cost of funds. Thus, the bank's share of retail deposits to total deposits increased to ~74% as on FY16 from 63% in FY15. We expect strong traction in retail deposits to continue driven by high accretion of CASA deposit post demonetization coupled with decline in bulk deposits. Hence, we forecast 7% CAGR in deposits over FY17-19E.

- **Margin improvement to aid profitability:** BOB reported net loss of Rs5,396cr in FY16 on account of higher credit cost as a result of significant deterioration in asset quality. However, the bank has taken several measures to address the concern. Therefore, we expect return ratios will start improving backed by better margins, improving efficiency and declining credit cost. As a result, we expect the bank to report RoA of 0.5% and RoE of 7.7% by FY19E.

- **Asset quality trend to improve:** Although BOB's asset quality deteriorated significantly over the last 5 years due to slowdown in economy, fresh NPA generation for the bank has already peaked out and on a declining trend. We expect slippages to decline gradually and witnessed remarkable improvement from FY18E. Hence, we expect Gross NPA/Net NPA to remain around 7%/3% by FY19E.

- **Low risk to dilution on the back of healthy capital and liquidity position:** The Bank's capital adequacy ratio (CAR) as per Basel III norms continues to remain strong at 13.2% with Tier-I capital ratio of 10.8%. BOB has one of the strongest capital positions among its peers. Further, the bank has no plans to raise capital over the next one year, thus removing the overhang of capital dilution.

**Valuation:** Although we expect consolidation in the loan book to continue for the next couple of quarters, we continue to like the bank owing to improvement in the bank's core operating performance, able management and higher provision coverage ratio. Further, the bank has enough room to achieve higher business growth as it is well capitalized among PSU banks. Overall, BOB is on the right track. We recommend BUY rating with a TP of Rs195 valuing the bank at P/ABV of 1.3x for FY19E.

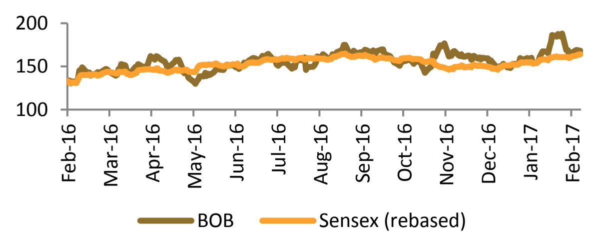
### Market Data

| | |
|---|---|
| **Rating** | **BUY** |
| **CMP (Rs.)** | 168 |
| **Target (Rs.)** | 195 |
| **Potential Upside** | 16% |
| **Duration** | Long Term |
| Face Value (Rs.) | 2 |
| 52 week H/L (Rs.) | 192/127 |
| Adj. all time High (Rs.) | 228 |
| Decline from 52WH (%) | 12.5 |
| Rise from 52WL (%) | 32.3 |
| Beta | 1.6 |
| Mkt. Cap (Rs.Cr) | 38,744 |

### Fiscal Year Ended

| Y/E | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|
| Net Interest Income (Rs. Cr) | 12,740 | 13,470 | 15,069 | 16,547 |
| Pre-Pro Profit (Rs. Cr) | 8,816 | 10,602 | 11,976 | 12,429 |
| Net Profit (Rs. Cr) | (5,396) | 1,901 | 3,138 | 3,307 |
| EPS | (23.4) | 8.2 | 13.6 | 14.3 |
| P/E (x) | -- | 20.4 | 12.4 | 10.9 |
| P/BV (x) | 1.0 | 0.9 | 0.9 | 0.8 |
| P/ABV (x) | 1.9 | 1.7 | 1.4 | 1.1 |
| ROE (%) | -- | 4.6 | 7.3 | 7.7 |
| ROA (%) | -- | 0.3 | 0.4 | 0.5 |

### One-year Price Chart




| Shareholding Pattern | Dec-16 | Sep-16 | Chg. |
|---|---|---|---|
| Promoters (%) | 59.2 | 59.2 | - |
| Public (%) | 40.8 | 40.8 | - |

## Bank of Baroda (BOB) - Company Overview

*Bank of Baroda (BOB) is the third largest* public sector bank in India. (*in terms of asset size as of FY16)*

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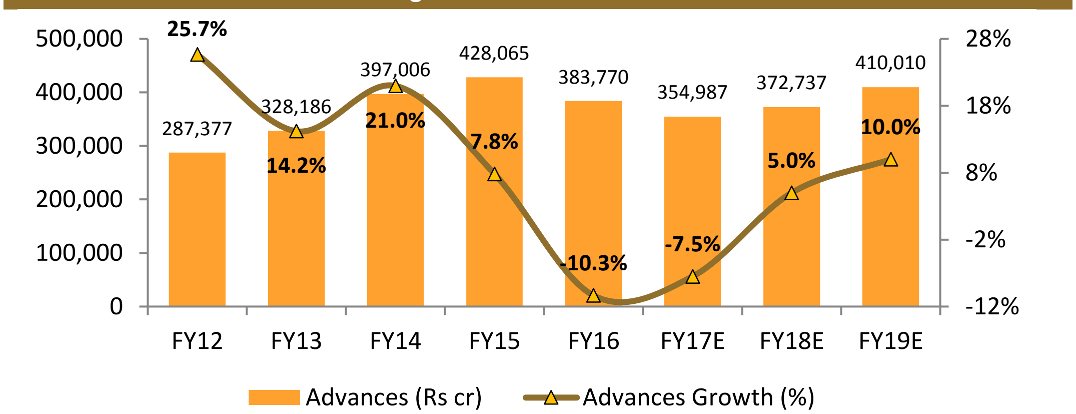
## Focus towards higher yielding loans to offset subdued credit growth

BOB consistently showed impressive advances growth by registering 20% CAGR over FY10-15. The growth was largely led by the overseas loan book, which increased at a strong pace of 26% CAGR (32% of total advances) whereas domestic advances registered a healthy CAGR of 17%. Of the total domestic advances, large corporate formed 49% while the share of SME and retail were 21% and 18%, respectively as of FY15.

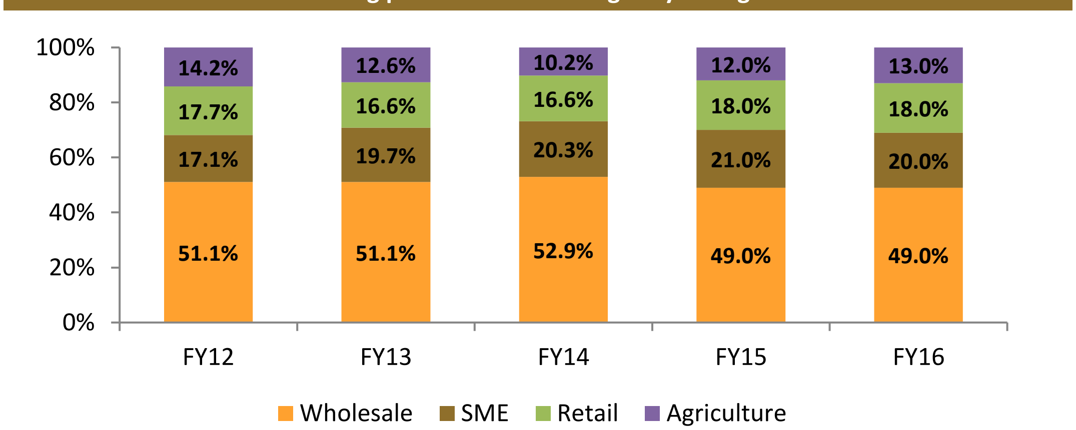
**Advances to grow at a CAGR of 8% over FY17-19E**




*Source: Company, In-house research*

However, considering the continued macro-economic uncertainty coupled with persistent asset quality issues, management has adopted a conscious strategy of curtailing its exposure to large corporate loans. Moreover, BOB continues to consolidate its balance sheet with selective lending and greater thrust on profitable customers. As a result, BOB's loan growth is on a decline from last 5 quarters and the bank reported 10% YoY decline in advances in FY16. Going forward, we expect advances to grow at a moderate pace of 8% CAGR over FY17-19E as the bank continues to consolidate its balance sheet and reshuffles its portfolio towards more profitable (higher yielding) assets.

**Reshuffling portfolio towards higher yielding assets**

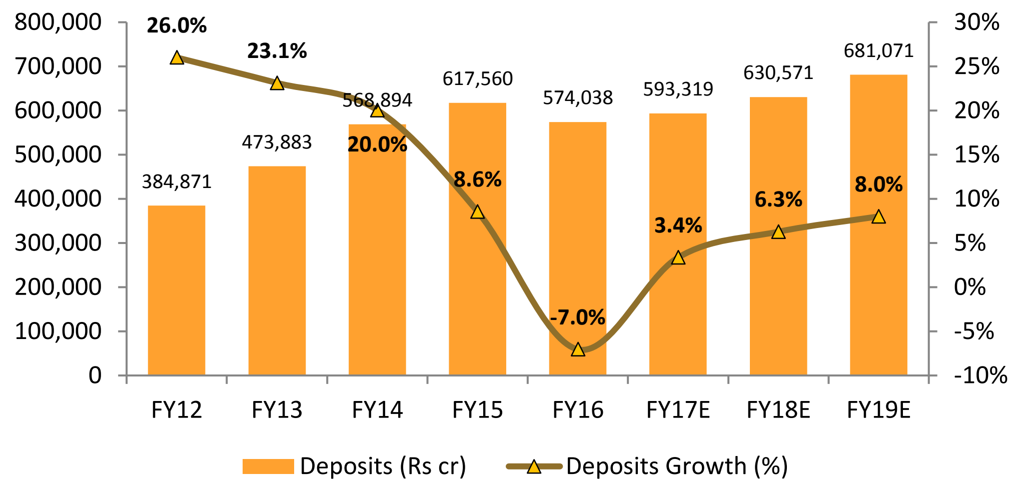



*Source: Company, In-house research*

## Getting stronger on a retail liability franchise

BOB has registered a healthy CAGR of 21% in deposits over FY10-15 mainly led by 30% CAGR in overseas deposits (33% of total deposits) while domestic advances registered a CAGR of 17%. However, the bank reported 7% YoY decline in deposits in FY16 as the bank has decided to move away from high cost bulk term deposits to low cost retail term deposits to reduce cost of funds. As a result, the bank's share of retail deposits to total deposits increased to 74% as on FY16 from 63% in FY15. We expect the strong traction in retail deposits to continue while bulk deposits are expected to decline going forward. Hence, we forecast 7% CAGR in deposits over FY17-19E.

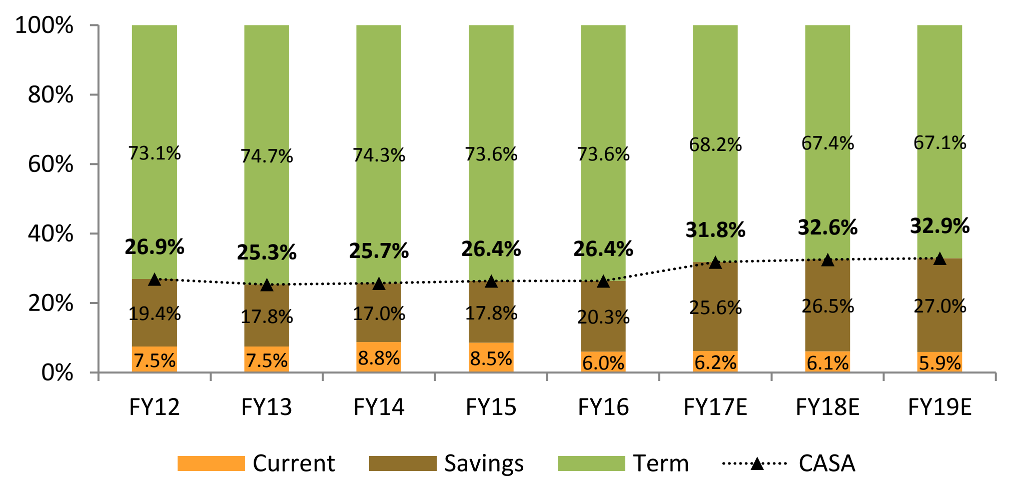
**Deposits to grow at a CAGR of 7% over FY17-19E**




*Source: Company, In-house research*

BOB has one of the strongest liability franchises, after SBIN (within the PSB space) with strong presence in CASA rich Western, Central and Northern region. Further, continuous investment in branch expansion and technology has enabled the bank to build strong retail liability franchise. Thus, CASA ratio of the bank has been consistently increasing over the last four years. Going forward, we expect this trend to continue over FY17-19E driven by high accretion of CASA deposit post demonetization coupled with decline in bulk deposits.

**CASA ratio to improve further to 33% by FY19E**

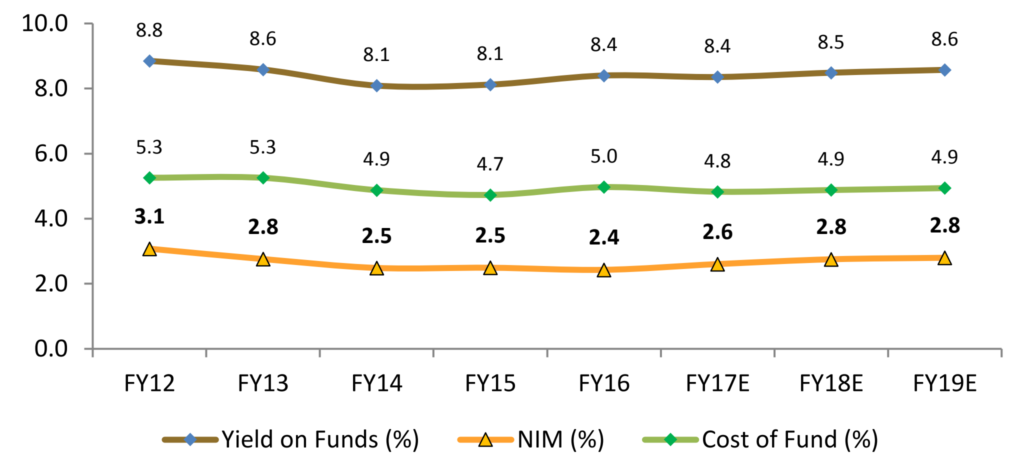



*Source: Company, In-house research*

## Change in business mix to drive Net Interest Margin (NIM)

Higher NPA recognition coupled with focus on the balance sheet growth (led by international business) in the past has impacted NIMs and core profitability of the bank. Hence, NIM decline to 2.4% in FY16 from 3.1% in FY12. However, the bank's NIM is on the verge of improvement and we expect bank's NIM to improve to 2.8% by FY18E on the back of (1) replacement of low yielding overseas loans with a better yielding local credit (2) run-down of high cost bulk deposits with low cost retail deposits and (3) strategic pricing (preferably in the retail portfolio) to improve loan yields. Efforts taken by management to reduce bulk deposits and thin margin business have already started yielding results as the bank's NIM has improved to 2.5% in 9MFY17.

**NIM to improve to 2.8% by FY18E**

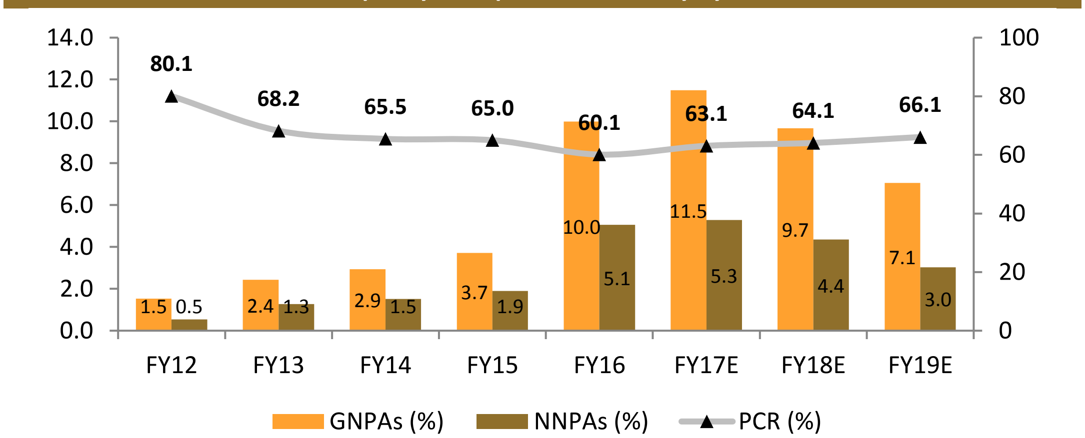



*Source: Company, In-house research*

## Asset quality trend to improve

BOB's asset quality deteriorated significantly over the last 5 years on account of slowdown in economy along with implementation of asset quality review (AQR) by the RBI. Hence, BOB's Gross/Net NPA increased to 10.0%/5.1% in FY16 from 1.5%/0.5% in FY12. However, fresh NPA generation for the bank has already peaked out and has been on a declining trend. Given the proactive accounting of bad assets and higher efforts on recovery, BoB could see sharp improvement in asset quality on the backdrop of improving macro-economic scenario. Therefore, we expect slippages to decline gradually and asset quality to improve remarkably from H2FY18. Hence, we expect Gross NPA and Net NPA to remain around 7% and 3% by FY18E. Besides, high provisioning coverage ratio (PCR) of 60%+ provides further comfort.

**Asset quality to improve remarkably by FY19E**

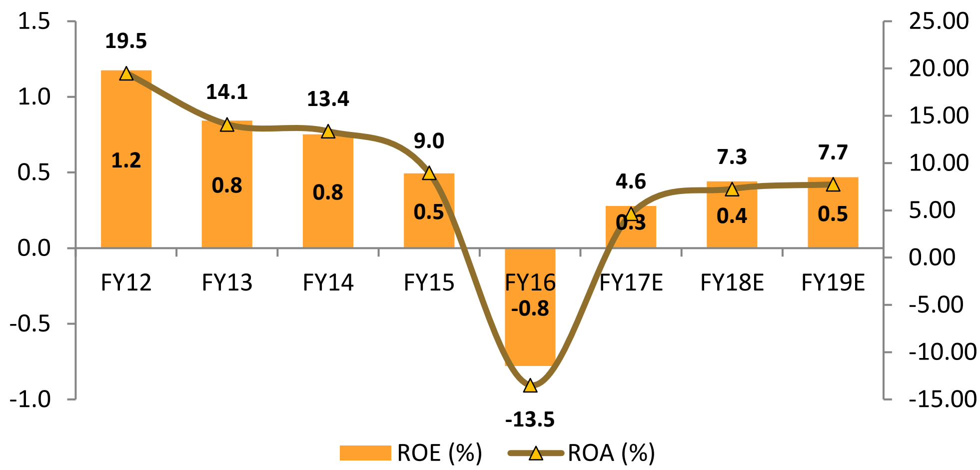



*Source: Company, In-house research*

## Margin improvement to aid profitability

BOB's return ratios declined mainly on account of higher credit cost as a result of significant deterioration in asset quality. Hence, BOB reported net loss of Rs5,396cr in FY16. However, the bank has taken several measures to address the concern. Therefore, we expect credit costs to decline from hereon given the declining trend in delinquencies. Moreover, return ratios will start improving backed by better margins and improving efficiency. As a result, we expect the bank to report RoA of 0.5% and RoE of 7.7% by FY19E.

**Return ratios to improve significantly over FY17-19E**

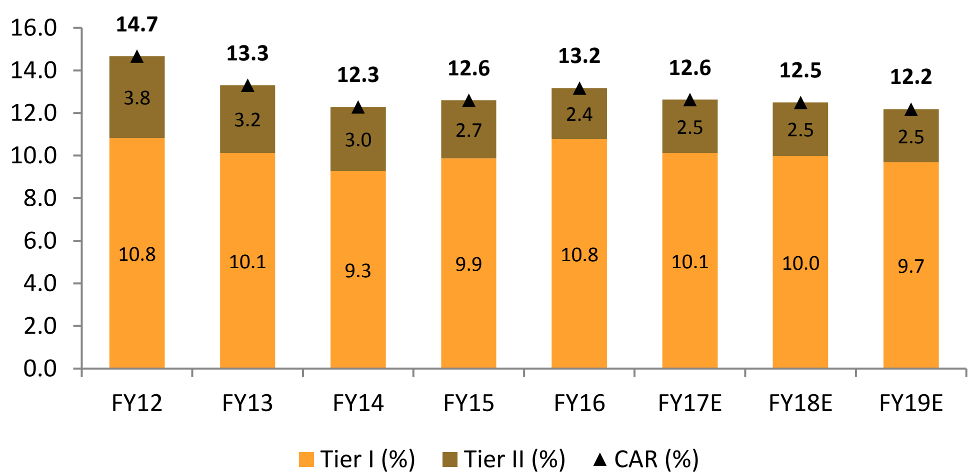



*Source: Company, In-house research*

## Low risk to dilution on the back of healthy capital and liquidity position

The Bank's capital adequacy ratio (CAR) as per Basel III norms continues to remain strong at 13.2% with Tier-I capital ratio of 10.8%. BOB has one of the strongest capital positions among its peers. This is important aspect as many PSU banks are about to witness heavy dilution over the next 2-3 years due to the new Basel III requirements. Further, the bank has no plans to raise capital over the next one year, thus removing the overhang of capital dilution. We believe that BOB's high base and improving core profitability will prevent the bank from the infusion of fresh capital over the next couple of years.

**Well capitalized to support growth momentum over FY17-19E**




*Source: Company, In-house research*

## Outlook and Valuation

Large clean-up over the past few quarters removes the overhang of significant deterioration in asset quality in ensuing quarters. However, we believe that worst seems to be over. Although we expect consolidation in the loan book to continue for the next couple of quarters, we continue to like the bank owing to improvement in the bank's core operating performance, able management and higher provision coverage ratio. Further, the bank has enough room to achieve higher business growth as it is well capitalized among PSU banks. Overall, BOB is on the right track. We recommend BUY rating on the stock with target price of Rs195 valuing the bank at P/ABV of 1.3x for FY19E.

## Key Risks:

- **Lower growth than expected:** We expect loan growth of 8% over FY17-19E largely led by higher growth in retail assets. While our assumptions are base case, any major change in our assumption will pose risk to our earnings estimates.
- **Increase in slippages:** We have factored in slippages of 3.0% and 2.0% for FY17E and FY18E, respectively. Increase in slippages beyond our estimates can result into increase in credit cost and hence it may affect the profitability of the bank.
- **Spike in Interest rates:** We expect the interest rate (repo rate) to reduce over FY16-18E. However, any further increase in interest rates may affect the margins of the bank and hence the operating matrix. Additionally, it will have a negative impact on investments and in capex, which may also impact asset quality of the bank adversely.

## Profit & Loss Account (Standalone)

| Y/E (Rs. Cr) | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|
| Interest Income | 44,061 | 43,200 | 46,467 | 50,705 |
| Interest Expense | 31,321 | 29,730 | 31,398 | 34,158 |
| **Net Interest Income** | **12,740** | **13,470** | **15,069** | **16,547** |
| Non Interest Income | 4,999 | 6,149 | 6,640 | 7,271 |
| **Net Income** | **17,739** | **19,618** | **21,709** | **23,818** |
| Operating Expenses | 8,923 | 9,016 | 9,733 | 10,465 |
| **Total Income** | **49,060** | **49,349** | **53,107** | **57,976** |
| **Total Expenditure** | **40,245** | **38,747** | **41,131** | **44,623** |
| **Pre Provisioning Profit** | **8,816** | **10,602** | **11,976** | **13,354** |
| Provisions | 15,514 | 7,739 | 7,268 | 7,995 |
| **Profit Before Tax** | **(6,698)** | **2,863** | **4,708** | **5,358** |
| Tax | (1,303) | 962 | 1,570 | 1,796 |
| **Net Profit** | **(5,396)** | **1,901** | **3,138** | **3,562** |

## Balance Sheet (Standalone)

| Y/E (Rs. Cr) | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|
| **Liabilities** | | | | |
| Capital | 462 | 462 | 462 | 462 |
| Reserves and Surplus | 39,737 | 41,361 | 44,046 | 47,039 |
| Deposits | 574,038 | 593,319 | 630,571 | 681,071 |
| Borrowings | 33,472 | 30,745 | 32,055 | 39,361 |
| Other Liabilities and Provisions | 23,668 | 23,028 | 23,514 | 23,882 |
| **Total Liabilities** | **671,376** | **688,915** | **730,648** | **791,816** |
| **Assets** | | | | |
| Cash and Balances | 133,900 | 124,597 | 126,114 | 129,404 |
| Investments | 120,451 | 175,029 | 192,324 | 207,727 |
| Advances | 383,770 | 354,987 | 372,737 | 410,010 |
| Fixed Assets | 6,254 | 6,209 | 6,176 | 6,155 |
| Other Assets | 27,002 | 28,092 | 33,297 | 38,520 |
| **Total Assets** | **671,376** | **688,915** | **730,648** | **791,816** |

## Key Ratios (Standalone)

| Y/E | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|
| **Per share data (Rs.)** | | | | |
| EPS | (23.4) | 8.2 | 13.6 | 15.4 |
| DPS | 0.0 | 1.0 | 1.5 | 2.0 |
| BV | 174.0 | 181.0 | 192.6 | 205.6 |
| ABV | 90.0 | 99.9 | 122.4 | 151.7 |
| **Valuation (%)** | | | | |
| P/E | -- | 20.4 | 12.4 | 10.9 |
| P/BV | 1.0 | 0.9 | 0.9 | 0.8 |
| P/ABV | 1.9 | 1.7 | 1.4 | 1.1 |
| Div. Yield | 0.0 | 0.6 | 0.9 | 1.2 |
| **Capital (%)** | | | | |
| CAR | 13.0 | 12.6 | 12.5 | 12.2 |
| Tier I | 10.4 | 10.1 | 10.0 | 9.7 |
| Tier II | 2.6 | 2.5 | 2.5 | 2.5 |
| **Asset (%)** | | | | |
| GNPA | 10.0 | 11.5 | 9.7 | 7.1 |
| NNPA | 5.1 | 5.3 | 4.4 | 3.0 |
| PCR | 60.1 | 63.1 | 64.1 | 66.1 |
| **Management (%)** | | | | |
| Credit/ Deposit | 66.9 | 59.8 | 59.1 | 60.2 |
| Cost/ Income | 50.3 | 46.0 | 44.8 | 43.9 |
| CASA | 26.4 | 31.8 | 32.6 | 32.9 |
| **Earnings (%)** | | | | |
| NIM | 2.4 | 2.6 | 2.8 | 2.8 |
| ROE | -- | 4.6 | 7.3 | 7.7 |
| ROA | -- | 0.3 | 0.4 | 0.5 |

**Rating Criteria**

| Large Cap. | Return | Mid/Small Cap. | Return |
|---|---|---|---|
| **Buy** | More than equal to 10% | **Buy** | More than equal to 15% |
| **Hold** | Upside or downside is less than 10% | **Accumulate*** | Upside between 10% & 15% |
| **Reduce** | Less than equal to -10% | **Hold** | Between 0% & 10% |
| | | **Reduce/sell** | Less than 0% |

***** To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

***** Bank of Baroda is a large-cap bank.

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