



Federal Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 19,243	FB IN
S&P CNX: 5,702	REUTERS CODE
	FED.BO

26 October 2007

Buy

Previous Recommendation: Buy

Rs388

Equity Shares (m)	85.8
52-Week Range	411/188
1,6,12 Rel.Perf.(%)	-9/25/28
M.Cap. (Rs b)	33.3
M.Cap. (US\$ b)	0.8

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
3/07A	10,191	2,927	34.2	30.0	11.3	2.2	13.4	21.3	1.3	2.3
3/08E	11,836	3,751	43.8	28.1	8.8	1.8	18.5	22.5	1.3	1.9
3/09E	13,974	4,691	54.8	25.1	7.1	1.5	12.4	23.1	1.4	1.5

- Federal Bank's NII grew strongly by 23% YoY v/s our estimate of 21% growth. Margins declined marginally to 3.15% as yields on advances improved to offset rising cost of funds. Management's conscious strategy to stay away from high cost deposits during 4QFY07 and 1QFY08 has enabled it to contain its cost of deposits during 1HFY08.
- Advances growth was strong 27% YoY while deposits grew 32%. SME and retail continue to be drivers of credit growth. CASA grew 13% YoY and CASA ratio decreased to 23.5%. Term deposits increased 15% QoQ.
- Other income growth was slower as expected at ~ 6% YoY. Treasury income decreased from Rs323m in 2QFY07 to Rs180m in 2QFY08. Non-treasury other income grew strongly by 46% YoY in 2QFY08. With 100% CBS implemented by the bank, we expect fee income should show higher growth going forward.
- Asset quality remained strong with gross NPAs down to 2.85% and net NPAs down to 0.43%. The bank is carrying significant excess provisions than mandated by regulations.
- Rights issue (1:1) priced at Rs250 per share would increase bank's net worth to USD1b by FY08. However, this capital infusion made at near book value is significantly return dilutive over the next three years.
- Consistency in delivering strong operating profits, fast asset growth with margin stability and clean asset book are highlights of Federal Bank. 100% CBS implementation and fast branch expansion (to cross 600) by FY08 would ensure further improvement in its operating results going forward. The stock trades at 7.1x FY09E earnings and 1.5x FY09E book value. Reiterate **Buy**.

QUARTERLY PERFORMANCE

(RS MILLION)

	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Interest Income	4,083	4,337	4,441	5,313	5,592	5,982	6,173	6,409	18,174	24,156
Interest Expense	2,497	2,662	2,676	3,033	3,665	3,918	4,013	4,029	10,850	15,626
Net Interest Income	1,586	1,675	1,766	2,280	1,928	2,063	2,160	2,379	7,324	8,530
% Change (Y-o-Y)	10.0	25.0	18.1	32.4	21.5	23.2	22.3	4.4	22.1	16.5
Other Income	543	726	545	1,054	1,005	769	700	832	2,867	3,306
Net Income	2,129	2,401	2,310	3,333	2,932	2,832	2,860	3,212	10,191	11,836
% Change (Y-o-Y)	14.2	26.0	16.8	37.8	37.8	18.0	23.8	-3.6	24.8	16.1
Operating Expenses	991	1,011	973	1,086	1,048	1,066	1,129	1,388	4,061	4,631
Operating Profit	1,137	1,390	1,337	2,247	1,884	1,766	1,731	1,824	6,130	7,205
Prov for Tax	176	170	196	388	545	265	350	298	1,055	1,459
Provisions and Contingencies	559	526	321	867	670	548	400	377	2,148	1,995
Net Profit	402	695	820	993	669	953	981	1,148	2,927	3,751
% Change (Y-o-Y)	-17.5	28.2	14.5	95.6	66.6	37.2	19.5	15.7	30.0	28.1
Cost to Income Ratio (%)	46.6	42.1	42.1	32.6	35.7	37.6	39.5	43.2	39.8	39.1
Interest Expense/Interest Income (%)	61.2	61.4	60.2	57.1	65.5	65.5	65.0	62.9	59.7	64.7
Other Income/Net Income (%)	25.5	30.2	23.6	31.6	34.3	27.2	24.5	25.9	28.1	27.9

E: MOST Estimates

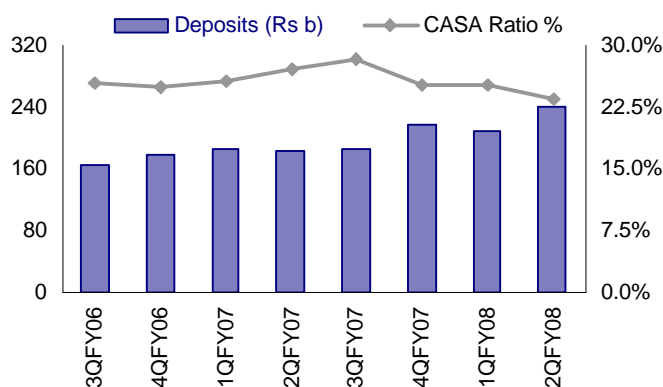
NII grows 23% YoY; margins decline marginally

Federal Bank reported 23% YoY growth in net interest income (NII) for 2QFY08. Margins declined marginally to 3.12% in 1HFY08 from 3.19% in 1HFY07 and 3.21% in 1QFY08. Margins for 2QFY08 were 3.15%. Management reports margins on the base of terminal balance sheet figures rather than averages. The key reason of the sustained high margins has been containment of deposit cost by the bank as it has not resorted to high cost deposits during past two quarters. Deposit costs increased from 5.14% in 1HFY07 to 6.63% in 1HFY08, while loan yields increased from 9.90% to 11.46% YoY and investment yields declined YoY from 7.48% to 7.32%. Management has delivered on its focus on keeping NIM high and still maintaining strong business growth.

Loans up 27%; deposits grow 32%

Deposits have grown 32% YoY to Rs241b. However, CASA deposits growth was slower (savings deposits up 12% YoY and current deposits up 19% YoY). The share of CASA has decreased 351bp YoY to 23.5%. Higher interest rates offered on term deposits have led to shift of deposits from savings to term deposits for the bank.

TREND IN DEPOSITS AND CASA RATIO



Source: Company/Motilal Oswal Securities

Loans have increased 27% YoY to 162b, with retail and SME loans driving growth. Retail advances occupy 30% of the loan book for the bank. Management aims at 25% business growth for FY08 - reaching a level of Rs480b (deposits + advances) by March 2008.

Treasury profits decline; other non-interest income grows 46% YoY

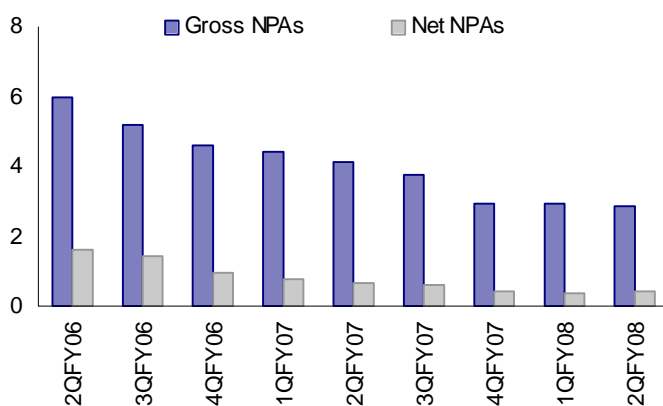
Other income growth was slower as expected at ~ 6% YoY. Treasury income decreased from Rs323m in 2QFY07 to Rs180m in 2QFY08. 2QFY07 treasury profits included Rs240m of profit on sale of stake in Bharat Overseas Bank. While recoveries were modest at Rs120m in 2QFY08, core fee income growth was strong during the quarter. Non-treasury other income grew by 46% YoY in 2QFY08. With 100% CBS implemented by the bank, we expect fee income should show higher growth going forward.

Improving asset quality: Net NPAs decline to 0.43%

The bank has maintained its trend of improving NPAs. Net NPAs have declined to 0.43% (24bp decline YoY) during 2QFY08. Gross NPA ratio reduced to 2.85% from 4.13% in 2QFY07 and 2.92% in 1QFY08. Even on an absolute basis, net NPAs have declined almost 12% YoY to Rs0.7b YoY.

While on QoQ basis, Gross NPAs increased 7% and Net NPAs increased 29% in absolute numbers, bank is carrying significant excess provisions than mandated by regulations. Considering management's conservative accounting policy towards NPA provisions, we believe Federal Bank's balance sheet is well strengthened. Bank carries about Rs2.1b of NPA provisions over and above required by regulations. With recoveries expected to be strong in 2HFY08, an annual trend for the bank, asset quality can further improve.

TREND IN NPAS



Source: Company/Motilal Oswal Securities

Rights Issue at Rs250 per share

Federal Bank has a capital adequacy ratio at 13.1% with Tier I CAR at 9.2%.

Bank has priced its 1:1 rights issue at Rs250 (1.43x FY07 BV) per share. The capital raising would amount to Rs21.4b – amount higher than the current net worth of the bank. The intent behind the capital raising was to increase the net worth of the bank to US\$1b by FY08 and create scale of a strong net worth bank.

We believe the surplus net worth would enable the bank to be an “acquirer” in the consolidation process. The bank acquired Ganesh Bank of Kurundwad in FY07 and was a bidder for UWB and Lord Krishna Bank. Management has always highlighted its inorganic growth strategy in past. We believe the management wants to equip itself with liquidity and strong networth for further M & A going forward.

However, this capital infusion made at near book value is significantly return dilutive over the next three years.

Branch expansion, technology ramp up would further boost business and profits

Bank plans to add 66 branches during 2HFY08 to take total number of its branches to 600+. While the target appears audacious, we believe in management’s capability in

delivering on their promises. 2/3rd of these branches would be outside Kerala with a focus on western and northern India. Bank has completed 100% CBS implementation in its 541 branches in less than one year. We believe the bank would be significantly benefited in growing its CASA base, fee income and further increase in operational efficiencies from the technological ramp up.

Valuation and view

Though core earnings growth remains strong, we believe reported profits can witness further upside in the event of higher recoveries. Consistency in delivering strong operating profits, fast asset growth with margin stability and clean asset book are highlights of Federal Bank. 100% CBS implementation and fast branch expansion (to cross 600) by FY08 would ensure further improvement in its operating results going forward.

Factoring in the rights issue, the stock is trading at 12.4x FY09E earnings and 1.5x FY08E book value. While RoAs would continue to remain high for the bank at 1.4-1.5% over next two years, RoEs would drop significantly to ~15% in FY08 and ~13% in FY09 on account of the capital raising.

Without considering right issue, the stock trades at 7.1x FY09E EPS, 1.5x FY09E B/V. RoA would remain at 1.3-1.4% and RoE ~23% over the next two years. Reiterate **Buy**.

INCOME STATEMENT		(RS MILLION)				
Y/E MARCH	2005	2006	2007	2008E	2009E	
Interest Income	11,910	14,371	18,174	24,156	29,994	
Interest Expended	6,888	8,367	10,850	15,626	19,748	
Net Interest Income	5,023	6,004	7,324	8,530	10,246	
Change (%)	19.1	19.5	22.0	16.5	20.1	
Other Income	2,120	2,169	2,867	3,306	3,727	
Net Income	7,143	8,173	10,191	11,836	13,974	
Change (%)	-0.7	14.4	24.7	16.1	18.1	
Operating Expenses	3,139	3,646	4,061	4,631	5,358	
Operating Income	4,004	4,528	6,130	7,205	8,615	
Change (%)	-8.3	13.1	35.4	17.5	19.6	
Other Provisions	2,843	1,672	2,148	1,995	2,100	
PBT	1,161	2,856	3,982	5,210	6,515	
Tax	260	598	1,055	1,459	1,824	
Tax Rate (%)	22.4	20.9	26.5	28.0	28.0	
PAT	901	2,258	2,927	3,751	4,691	
Change (%)	-33.9	150.7	29.6	28.1	25.1	
Proposed Dividend	164	300	342	428	514	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006	2007	2008E	2009E	
Capital	656	858	856	856	856	
Reserves & Surplus	6,577	11,643	14,166	17,417	21,507	
Net Worth	7,233	12,501	15,022	18,273	22,363	
Deposits	151,929	178,787	215,844	269,805	329,163	
Change (%)	2.7	17.7	20.7	25.0	22.0	
Borrowings	4,559	8,804	12,402	14,882	17,859	
Other Liabilities & Prov.	4,488	6,337	7,631	8,394	9,233	
Total Liabilities	168,209	206,429	250,899	311,354	378,618	
Current Assets	15,559	18,725	23,131	29,932	35,909	
Investments	57,992	62,724	70,327	84,392	97,895	
Change (%)	5.3	8.2	12.1	20.0	16.0	
Advances	88,226	117,365	148,991	187,729	234,661	
Change (%)	14.6	33.0	26.9	26.0	25.0	
Net Fixed Assets	1,855	1,739	1,861	2,185	2,468	
Other Assets	4,578	5,877	6,589	7,116	7,686	
Total Assets	168,209	206,428	250,899	311,354	378,618	

ASSUMPTIONS	(%)				
Deposit Growth	12.7	17.7	20.7	25.0	22.0
Advances Growth	14.6	33.0	26.9	26.0	25.0
Investments Growth	5.3	8.2	12.1	20.0	16.0
Dividend	25.1	34.9	40.0	50.0	60.0

E: M0St Estimates

RATIOS						
Y/E MARCH	2005	2006	2007	2008E	2009E	
Spreads Analysis (%)						
Avg. Yield - Earning Assets	7.8	8.0	8.3	8.9	9.0	
Avg. Cost-Int. Bear. Liab	4.6	4.9	5.2	6.1	6.3	
Interest Spread	3.2	3.2	3.1	2.8	2.8	
Net Interest Margin	3.3	3.4	3.3	3.2	3.1	

Profitability Ratios (%)						
RoE	13.1	22.9	21.3	22.5	23.1	
RoA	0.6	1.2	1.3	1.3	1.4	
Int. Expended/Int. Earned	57.8	58.2	59.7	64.7	65.8	
Other Inc./Net Income	29.7	26.5	28.1	27.9	26.7	

Efficiency Ratios (%)						
Op. Exps./Net Income	43.9	44.6	39.8	39.1	38.3	
Empl. Cost/Op. Exps.	59.2	62.6	64.1	63.8	64.1	
Busi. per Empl. (Rs m)	34.9	42.0	50.0	57.1	65.5	
NP per Empl. (Rs lac)	1.4	3.5	4.4	5.2	6.0	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	58.1	65.6	69.0	69.6	71.3	
Invest./Deposit Ratio	38.2	35.1	32.6	31.3	29.7	
G-Sec/Invest. Ratio	87.7	90.7	86.0	73.5	71.5	
Gross NPAs to Adv.	7.3	4.6	3.0	2.5	2.4	
Net NPAs to Adv.	2.2	1.0	0.4	0.2	0.4	
CAR	11.3	13.8	13.4	18.5	12.4	
Tier 1	6.4	9.7	8.9	7.4	7.4	

VALUATION						
Book Value (Rs)	110.3	144.8	174.7	212.7	260.5	
Price-BV (x)	3.5	2.7	2.2	1.8	1.5	
Adjusted BV (Rs)	91.0	136.4	169.8	209.2	253.2	
Price-ABV (x)	4.3	2.8	2.3	1.9	1.5	
EPS (Rs)	13.7	26.3	34.2	43.8	54.8	
EPS Growth (%)	-34.3	91.6	30.0	28.1	25.1	
Price-Earnings (x)	28.2	14.7	11.3	8.8	7.1	
OPS (Rs)	61.0	52.7	71.6	84.2	100.6	
OPS Growth (%)	-8.8	-13.6	35.8	17.5	19.6	
Price-OP (x)	6.4	7.4	5.4	4.6	3.9	

E: M0St Estimates

N O T E S



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motiloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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Federal Bank

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| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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