

**Rahul Jain** (+91 22 6639 9124, rahul.jain@alchemyonline.com)

**Shashin Upadhyay** (+91 22 6639 9157, shashin.upadhyay@alchemyonline.com)

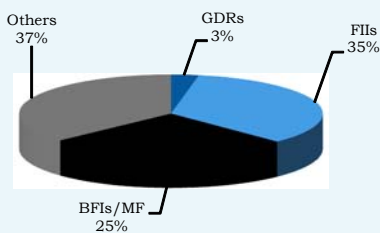
#### Key points

- Topline was in-line with estimates
- Net profit growth was muted due to higher provisioning
- Asset quality slips during the quarter

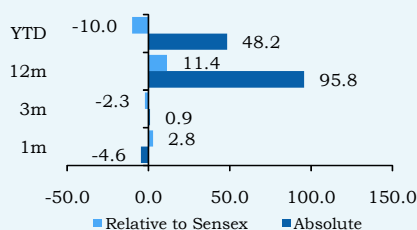
#### CMP **Rs240**

Reuters code	FED.BO
Bloomberg code	FB IB
Shares o/s (mn)	171
Mkt Cap	Rs41bn/US\$0.9bn
52 wk high / Low	Rs270/111
Avg daily trad vol	0.89(mn shs)
BSE Sensex	15,896
Nifty	4,712

#### Shareholding pattern



#### Performance



#### Share price movement



#### Mixed bag

Outlook	
Revenue	We estimate NII to grow ~9% CAGR over FY09-11E
Margins	Margins to remain stable over the coming quarters
Asset quality	Asset quality concerns remains. Building in Gross NPLs at 4.3% by FY11
Valuations	Attractive valuations. Maintain Accumulate.

Federal Bank reported a decline in net profit by ~12% YoY and ~26% QoQ, mainly on account of higher loan loss provisioning and higher opex. To our surprise, asset quality slipped sharply as gross NPLs rose 25% QoQ to 3%; restructured assets also increased during the quarter. Despite higher provisioning, coverage ratio dropped to ~83% - still one of the highest in the system. The topline grew ~14% QoQ - in-line with our estimates, on account of sequential expansion in margins. Federal Bank has healthy asset quality (lowest proportion of bad loans) and one of the best margins in the system; with an estimated ROE of ~12% in FY11, Federal Bank can trade at 0.9x FY11 book. Maintain Accumulate with a price target of Rs267/share.

#### Asset quality was a negative surprise

Federal Bank has reported a sequential increase in gross NPLs by 25% QoQ to 3% of advances (v/s 2.7% in 1QFY10), mainly due to a slippage in one large account and further slippages in SME and retail portfolio. Moreover, the restructured accounts has also flowed in during the quarter to the tune of Rs450m, taking the total restructured accounts to 1.5%; the proportion of total bad loans stood at ~4.5% - one of the lowest in the system. The loan loss provisioning during the quarter increased ~70% YoY (~2.5% of adv. v/s 1.6% in 1QFY10 - annualized), despite that the coverage ratio has declined 680bps QoQ to ~83% - still the highest within system. However, we expect the slippages to peak out as macro economic scenario showing signs of improvement.

#### Improving business mix leads to expansion in margins

After a slowdown in loan book growth in last two quarters, Federal Bank has registered an improvement in the loan book growth which stood at 21% YoY leading to a rise in credit-deposit (CD) ratio by 380bps to 77%. On the back of improving business mix and drop in cost of funds (down by 23bps QoQ), the bank has registered a sequential expansion in margins by ~40bps to 3.7%; proportion of CASA went down YoY while it remained flat QoQ at ~26% contrary to the general industry trend, due to aggressive growth in term deposits (up 30% YoY and ~6% QoQ).

#### Fee income tad lower; operating efficiency improves

Despite a pick up in credit offtake, the fee income growth at 9% YoY was a tad lower. On the back of lower employee expenses and higher core operating income, the operating efficiency improved as the cost/income ratio (ex treasury) dropped 460bps QoQ. Bank is expanding its distribution network as it has opened 20 new branches during the quarter (mainly o/s Kerala) and it plans to open 25 more branches in the next quarter, which will further put pressure on cost/income ratio.

#### One of the best operating matrix; Maintain Accumulate

Given its healthy asset quality as bad loans are amongst the lowest while coverage ratio is amongst the highest and strong margins, we believe Federal Bank has one of the best operating matrix in the system. With an estimated ROE of ~12% in FY11, Federal Bank can trade at 0.9x FY11 adjusted book. Maintain Accumulate.

#### Financial summary

Year end march (Rs.mn)	FY07	FY08	FY09	FY10E	FY11E
Operating income	10,191	12,630	18,312	18,652	21,898
Net Profit	2,927	3,680	5,005	5,003	6,320
EPS RS	34	22	29	29	37
Earnings growth (%)	30.0	(37.1)	36.0	(0.0)	26.3
P/E(x)	7.0	11.2	8.2	8.2	6.5
ROAA(%)	1.3	1.3	1.4	1.2	1.3
ROE(%)	21.3	13.6	12.1	11.1	12.8
P / ABV	1.4	1.1	1.0	0.9	0.8

Source: Alchemy, Company, Bloomberg

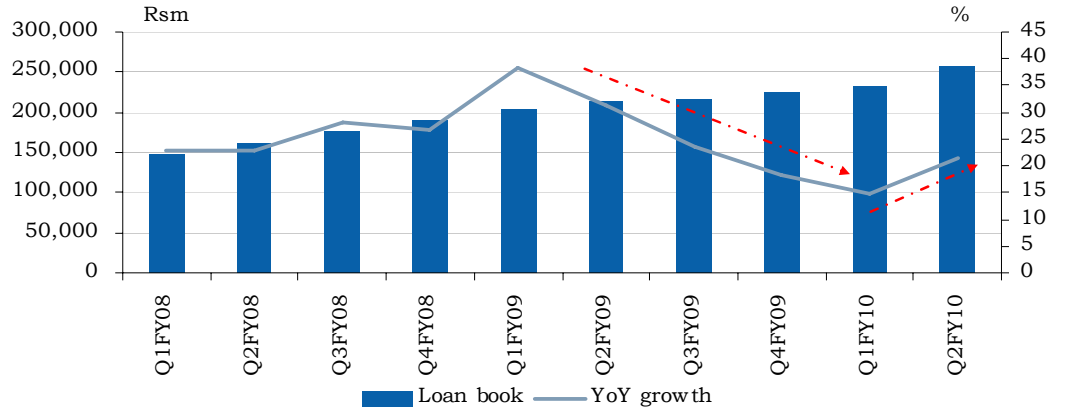
**Exhibit 1 - Quarterly results summary**

	Particulars (Rs mn)	Q2FY09	Q3FY09	Q4FY09	Q1FY10	Q2FY10
<b>Core spreads expands 40bps QoQ</b>	<b>NII</b>	<b>3,318</b>	<b>3,846</b>	<b>3,209</b>	<b>2,901</b>	<b>3,300</b>
	YoY growth (%)	61	89	58	4	(1)
	QoQ growth (%)	19	16	(17)	(10)	14
<b>Fee income growth was modest at 9% YoY</b>	Other Income	1,042	1,648	1,505	1,474	1,364
	<b>Net Income</b>	<b>4,360</b>	<b>5,494</b>	<b>4,714</b>	<b>4,375</b>	<b>4,664</b>
<b>Core op. income growth was higher than our estimates at 15% QoQ</b>	YoY growth (%)	54	90	63	17	7
	QoQ growth (%)	16	26	(14)	(7)	7
	<b>Operating Expenses</b>	<b>1,331</b>	<b>1,650</b>	<b>1,526</b>	<b>1,592</b>	<b>1,631</b>
<b>C/I (ex treasury) was declined 460bps QoQ</b>	YoY growth (%)	25	36	26	32	23
	QoQ growth (%)	10	24	(8)	4	2
	<b>PPP</b>	<b>3,029</b>	<b>3,844</b>	<b>3,189</b>	<b>2,783</b>	<b>3,032</b>
<b>Deteriorating asset quality led to higher provisioning</b>	Provisions and Contingencies	1,569	500	875	520	1,501
	YoY growth (%)	186	45	153	(70)	(4)
	QoQ growth (%)	(9)	(68)	75	(41)	189
<b>PAT growth was lower than estimates</b>	<b>Profit before Tax</b>	<b>1,461</b>	<b>3,344</b>	<b>2,314</b>	<b>2,263</b>	<b>1,531</b>
	Tax	318	1,306	1,172	900	520
	<b>Profit after Tax</b>	<b>1,143</b>	<b>2,039</b>	<b>1,141</b>	<b>1,364</b>	<b>1,010</b>
	YoY growth (%)	20	98	11	100	(12)
	QoQ growth (%)	68	78	(44)	19	(26)
	<b>Other details:</b>					
<b>Advances growth was led by corporate</b>	Advances	213,264	215,530	223,919	232,708	257,790
	YoY growth (%)	31	23	18	15	21
	QoQ growth (%)	5	1	4	4	11
<b>Proportion of retail deposits declined to 140bps to 76%</b>	Deposits	264,300	272,580	321,981	317,407	334,392
	YoY growth (%)	10	17	24	18	27
	QoQ growth (%)	(2)	3	18	(1)	5
	Low cost deposits (%)	28.0	27.4	24.5	26.1	25.8
	YoY chg. (bps)	28.0	27.4	24.5	26.1	(2.2)
	QoQ chg. (bps)	28.0	(0.6)	(2.9)	1.6	(0.3)
<b>Margins improve due to stable yield on investments and improving core spreads</b>	Net interest margins (%)	4.1	4.4	4.3	3.3	3.7
	YoY chg. (bps)	4.07	4.38	4.25	3.27	(0.39)
	QoQ chg. (bps)	4.06	0.31	(0.13)	(0.97)	0.40
<b>Asset quality deteriorates due to a slippage of a large corporate and SME &amp; retail</b>	Gross NPLs (Rs mn)	5,719	6,257	5,895	6,312	7,892
	YoY growth (%)	21	26	26	15	38
	QoQ growth (%)	4	9	(6)	7	25
	Net NPLs (Rsm)	853	706	681	673	1,379
	YoY growth (%)	22	37	58	(28)	62
	QoQ growth (%)	(9)	(17)	(4)	(1)	105
	Gross NPLs (%)	2.62	2.83	2.57	2.65	2.99
	Net NPLs (%)	0.4	0.33	0.3	0.29	0.54
	Coverage ratio (%)	85.1	88.7	88.4	89.3	82.5

Source: Alchemy Research, Company

**Loan book grew 11% QoQ**

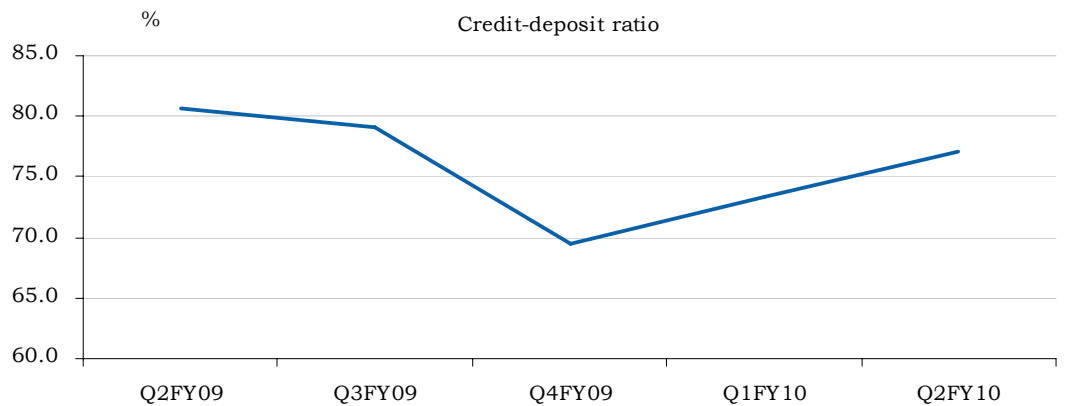
**Exhibit 2 - Loan book growth picks up...**



Source: Alchemy Research, Company

**CD ratio expanded ~400bps QoQ**

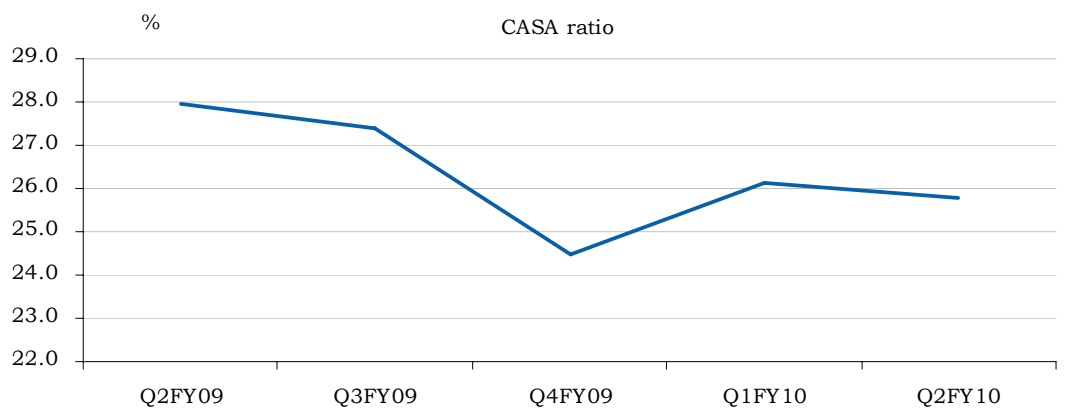
**Exhibit 3 - ...leading to an improvement in business mix**



Source: Alchemy Research, Company

**Including low cost NRI deposits, CASA ratio stood at ~33%**

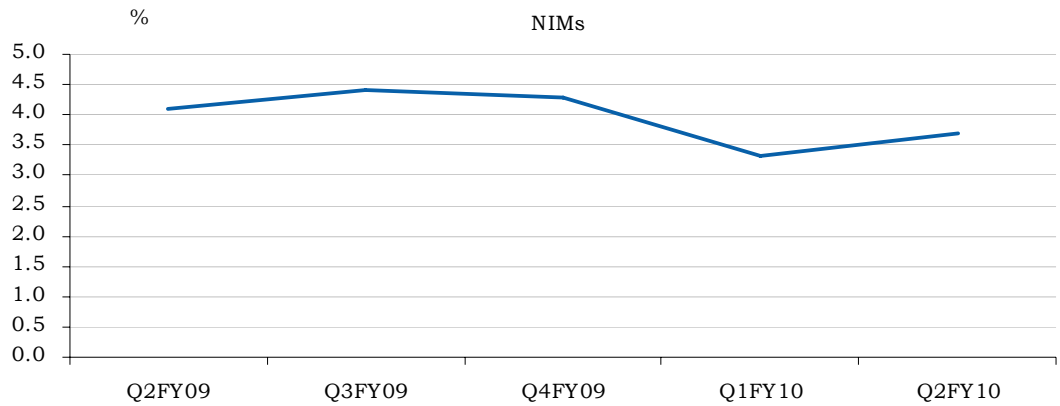
**Exhibit 4 - While CASA ratio dipped sequentially**



Source: Alchemy Research, Company

**Exhibit 5 - ...margins expanded**

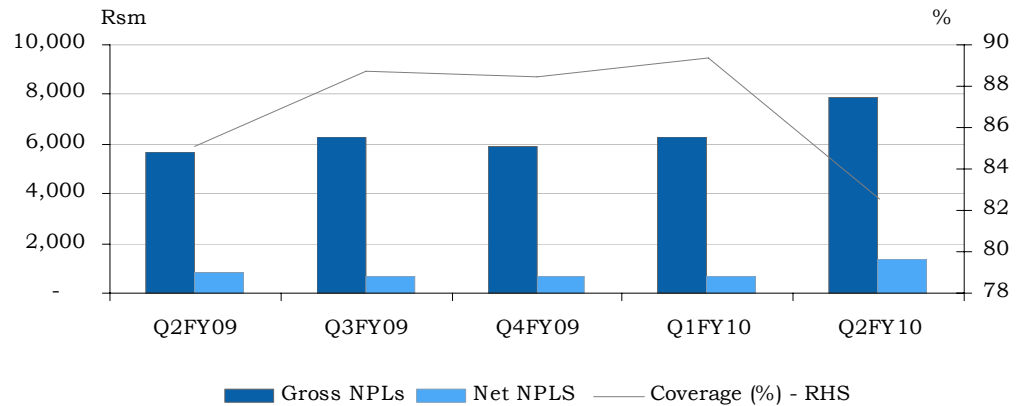
**Margins expanded 40bps QoQ**



Source: Alchemy Research, Company

**Exhibit 6 - Asset quality slips**

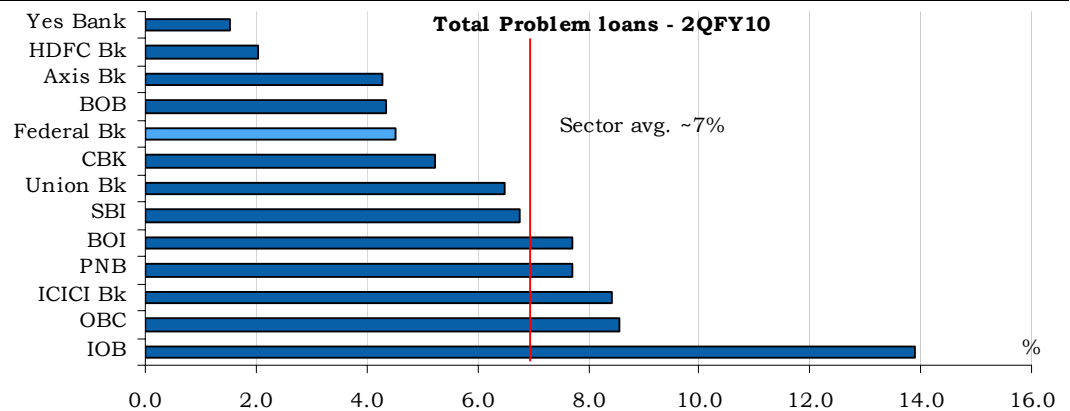
**Gross NPLs increased 25% QoQ**



Source: Alchemy Research, Company

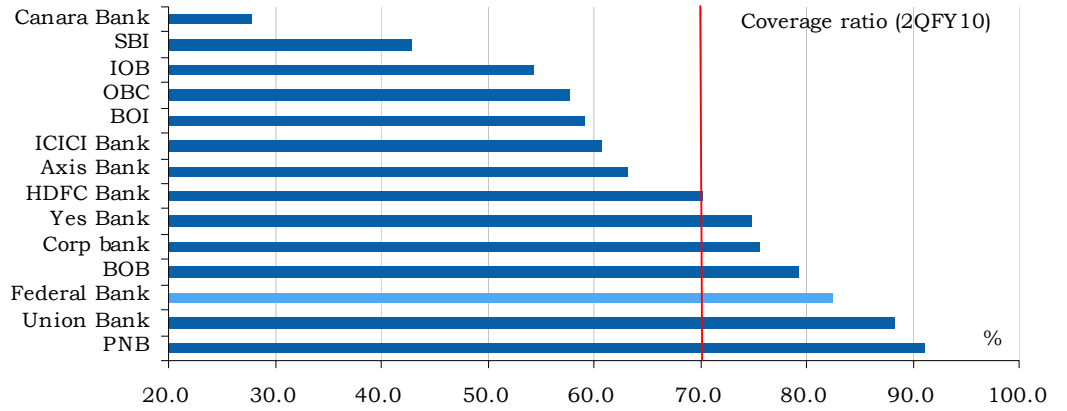
**Exhibit 7 - Federal Bank's problem loans are lower than that of the sector average**

**Slippage in asset quality is a concern**



Source: Company, Alchemy Research

**Exhibit 8 - Federal has one of the highest coverage**



Source: Alchemy Research, Company

**Income Statement (Rs mn)**

Year	FY08	FY09	FY10E	FY11E
<b>Net interest income</b>	<b>8,680</b>	<b>13,155</b>	<b>12,881</b>	<b>15,589</b>
Other income	3,950	5,158	5,771	6,309
<b>Total income</b>	<b>12,630</b>	<b>18,312</b>	<b>18,652</b>	<b>21,898</b>
Operating expenses	4,689	5,715	6,614	7,657
<b>Pre-provision Profit</b>	<b>7,941</b>	<b>12,598</b>	<b>12,038</b>	<b>14,242</b>
Total Provision	2,940	4,668	4,572	4,809
<b>PBT</b>	<b>5,001</b>	<b>7,930</b>	<b>7,467</b>	<b>9,433</b>
Provision for Tax	1,321	2,925	2,464	3,113
<b>PAT</b>	<b>3,680</b>	<b>5,005</b>	<b>5,003</b>	<b>6,320</b>

**Balance Sheet (Rs mn)**

Year	FY08	FY09	FY10E	FY11E
Advances	189,047	223,919	280,078	347,496
Investments	100,266	121,190	136,481	155,934
Total Assets	325,064	388,509	448,107	531,174
<b>Shareholders' funds</b>	<b>39,257</b>	<b>43,259</b>	<b>46,960</b>	<b>51,979</b>
Deposits	259,134	321,982	373,646	446,327
Borrowings	7,920	7,489	10,061	13,517
Total Liabilities	325,065	388,509	448,107	531,174

Source: Company, Alchemy Research

**Ratios**

Year	FY08	FY09	FY10E	FY11 E
<b>Key ratios</b>				
EPS	21.5	29.3	29.3	37.0
Earnings growth	-37%	36%	0%	26%
CEPS	28.8	41.9	42.5	51.0
PPP / Share	46.4	73.7	70.4	83.3
BV / share	229.5	252.9	274.6	303.9
Adjusted BV / Share	227.0	248.9	264.5	286.1
ROAA	1.3%	1.4%	1.2%	1.3%
ROAE	13.6%	12.1%	11.1%	12.8%
NIM	3.10%	3.78%	3.43%	3.51%
Gross NPLs	2.4%	2.5%	3.6%	4.3%
Net NPLs	0.2%	0.3%	0.6%	0.8%
Coverage	91%	88%	84%	80%
Capital Adequacy Ratio	22.5%	20.2%	18.1%	16.2%
- Tier I CAR	19.1%	18.4%	16.6%	15.0%
C/D ratio	73.0%	69.5%	75.0%	77.9%
Cost-Income ratio (Excl Treasury)	39.5%	32.7%	36.9%	35.8%
Cost Asset Ratio	1.4%	1.5%	1.5%	1.4%
Loan Growth	27%	18%	25%	24%
Provision/ Loans	1.14%	1.68%	1.43%	1.20%
CASA	25.1%	24.5%	25.2%	24.8%
P/E	11.2	8.2	8.2	6.5
P/ BV	1.0	0.9	0.9	0.8
P/ABV	1.1	1.0	0.9	0.8

