Company Background

IDBI was incorporated as a Development Financial Institution in 1964 and was a wholly-owned subsidiary of the Reserve Bank of India (RBI). In 1976, the RBI surrendered its 100% stake to the government. In 2005, IDBI transformed itself into a full-service commercial bank after merging its commercial banking arm, IDBI Bank, into itself. More recently, the amalgamation of United Western Bank (UWB) with IDBI Bank gave the latter the much needed branch network to enhance its retail presence.

IDBI is one the leading public sector banks of India. At the end of June 2009, IDBI has 566 branches and 972 ATMs and intends to set up more branches over the next year, thus taking its total number of branches to 750 by March 2010. IDBI Bank has four wholly owned subsidiaries: IDBI Capital Market Services (ICMS), IDBI Home Finance, IDBI Gilts and IDBI Intech. In FY09, IDBI reported a total consolidated income of Rs. 13,346.9 cr, up 34% y-o-y; operating expenses increased 40% y-o-y to Rs. 12,041 cr and PAT for the year stood at Rs. 766.5 cr, up 2.7% y-o-y. This is lower than the Rs. 859 cr PAT recorded on a standalone basis.

IDBI Capital Market Services Limited offers a full suite of financial products and services to institutional, corporate and retail clients. Its businesses include Stock Broking, Distribution of Financial Products, Merchant Banking, Corporate Advisory Services, Debt Arranging & Underwriting, Portfolio Management of Pension / PF Funds & Research Services. Next, IDBI Homefinance commenced its business with the acquisition of Tata Homefinance Limited in September 2003. The company, since its inception, initiated series of measures to expand its retail reach, strengthen its brand image, improve its asset quality and excel its business growth.

IDBI Intech Limited (IDBI Intech) was incorporated in March 2000, as a wholly-owned subsidiary of IDBI Bank to undertake the IT related activities of the Bank. The major business activities of the Company are Information Technology Services, Information Security Practice, Knowledge Management Services, National Contact Center and Outbound Sales Team (OBST). Moreover, IDBI Gilts Limited (IDBI Gilts) was set up as a wholly owned subsidiary of your Bank to undertake Primary Dealer [PD] Business with paid up capital of Rs.100 crore. IDBI Gilts commenced its operations as Primary Dealer w.e.f. July 24, 2007. The company presently focuses on Bond trading, underwriting in auctions of primary issuance of government dated securities and treasury bills.

IDBI Fortis Life Insurance Company Limited (48% holding) is a joint venture of IDBI Bank Limited, Federal Bank Limited and Fortis Insurance International. The company commenced operations in March 2008 and the current year is the first full year of operations. IDBI Fortis entered the market with several innovative products consisting of WealthsuranceTM - an insured wealth plan, BondsuranceTM - an insurance plan with guaranteed returns, HomesuranceTM - an insurance plan for home loans and RetiresuranceTM - a retirement plan. The performance of all the above mentioned entities has been summarized below.

(Rs cr)	IDBI Capital Market		IDBI Homefinance		IDBI Intech Ltd		IDBI Gilts Ltd		IDBI Fortis Insurance	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Total Income	34.1	45.0	71.2	72.4	21.6	105.2	19.9	20.3	11.9	319.0
PAT	1.5	11.2	29.9	32.1	5.4	2.0	0.9	-19.8	-25.5	-110.2

(**Source:** Company Annual Report)

As of June 2009, the Government has a 52.7% stake in the bank, FIIs (5.4%), Indian financial institutions (16.4%), public (14.7%) and others (10.8%).

Investment Rationale

Growth in business - IDBI has the eighth-largest loan book in India, mainly because its role as a DFI makes it the preferred partner in lending to huge infrastructure projects. Currently, it is the lead arranger to syndicate debt of around Rs. 13,300 cr for the Krishnapatnam ultra-mega power project. Given the Government focus on infrastructure, IDBI could benefit on this front. IDBI plans to securitize some of its infrastructure loans, which could help release capital. As of June 2009, total deposits stood at Rs. 1,15,554 cr and advances at Rs. 97,955 cr. Going forward, the management has targeted a growth of 25-28% y-o-y in advances, which, could be achievable, given the strong pick up in demand in the infrastructure segment, where IDBI is well positioned due to its established client relationships and strong appraisal skills. The management has targeted a growth of 32-35% y-o-y in deposits for FY10.

Government capital infusion - Adequate capital is essential to sustain high credit growth. With CAR of 11.6% and tier-1 capital (Basel I) of 6.8% at the end of FY09, IDBI's capital adequacy is not adequate to support high business growth. While it is above the regulatory requirement it is below the preferred level of 12%. IDBI Bank has approached the government for infusion of Rs. 8,000 cr to recapitalise it and fund its growth in the next two to three years. Once the capital is provided, the bank plans to make a preferential allotment of shares so that the government holding in the company goes up. This will give the bank a leeway to come out with a follow on public offer. IDBI Bank has applied for permission from the RBI to open 300 branches. With the government making clear its intention to recapitalize public sector banks and the World Bank approving a loan for the same, we expect capital infusion in IDBI soon. Capital infusion could lead to a re-rating of the stock as it would enable IDBI to chive higher growth and profitability.

Improvement in key indicators – The management has taken a number of initiatives to improve the bank's productivity and return on equity (RoE). Over the last one and half year, there has been an improvement across most of IDBI's key indicators. The RoE improved from 9.65% in FY07 to 12.11% in FY09, while business per employee increased from Rs.13.9 cr in FY07 to Rs.21.1 cr in FY09. Cost-income could fall from 49.3% in FY09 to about 45-46% in FY11 led by improved business growth. In Q1FY10, IDBI reported a cost to income of 29.5%.

Improvement in operating performance – IDBI has been operating on wafer thin net interest margins (NIM) of around 1% in the past. However, this could change going ahead. NIMs could rise from 1.06% in FY09 to about 1.2% in FY11. NIM stood at 0.81% in Q1FY10, up from 0.32% recorded in Q1FY09. This is primarily because about 69% of IDBI's deposits are likely to get re-priced at lower rates in the current fiscal. The bank is also substituting its high-cost borrowings with deposits in order to contain its cost of funds. Further, the bank intends to increase its share of high-yielding retail loans. The share of the bank's retail advances has gone up from 15.7% in FY2007 to 21% in FY2009. Thus, the bank's operating performance is expected to improve in FY10 even in the face of challenges like low CASA and weak margins.

Strong investment portfolio – IDBI's DFI legacy enabled it to build a large investment portfolio. The unlisted entities in which it has equity stakes include The National Stock Exchange (NSE), The Stock Holding Corporation of India (SHCIL), The Small-Industries-Development Bank of India (SIDBI), Care Ratings, The Clearing Corp. of India (CCIL), The Asset Reconstruction Co. of India (ARCI). Some of the listed companies it has investments in are The Industrial Finance Corporation of India (IFCI), Bartronics India, Ispat Industries, HFCL Infotel, GKW, PNB Gilts and Indian Metals & Ferro Alloys. IDBI intends to utilize the unrealized gains on its equity portfolio by writing off its loan loss or investment-depreciation provisions. This would insulate it, to an extent, against future asset quality shocks. The current market value of listed investments is ~Rs. 4,000 cr, with its top ten holdings accounting for 81%. Further, IDBI has a 48% stake in IDBI Fortis Insurance, which recorded a gross premium collection of Rs. 319 cr in FY09. IDBI could also unlock value via a stake sale in this joint venture. Its balance sheet for FY09 displays investments of Rs. 50,048 cr (incl G-Sec of Rs.40,717 cr, shares of Rs.2,923 cr, investment in subsidiaries Rs. 650 cr and others Rs.5,758 cr).

Worst for restructuring loans may be out of the way - At end-FY09 IDBI's restructured assets stood at 3% of advances, in line with its peers. Additional restructuring in the first quarter of this fiscal (of about Rs. 5,100 cr) has taken total stressed assets to over 9% of the loan book, including gross NPAs. Although this figure is one of the highest in the sector, the restructuring in Q1FY10 was less than the quantum pending at end-FY09. In addition, unlike for other banks, two large corporate accounts (Dabhol and Ispat) accounted for 57% of IDBI's restructured assets done so far. IDBI subsequently decided to sacrifice higher interest rates on these restructured assets and has made provisions for them. Further NPA provisioning is likely to be lower, which would restrict the negative impact on profitability.

International foray - IDBI has decided to foray into the overseas markets and is trying to leverage its domestic banking strength to offer competitive products internationally. The RBI has given approval to IDBI for setting up a wholesale bank branch at Bahrain, an offshore banking unit at Singapore, a category-I branch at Dubai International Financial Centre (DIFC) and a representative office at Shanghai.

Recent Financial Performance

In Q1 FY10, IDBI's net interest income increased by 247% y-o-y, but declined 34% sequentially to Rs. 316 cr (partly seasonal). The yield on total assets increased by 42 bps sequentially and 119 bps y-o-y to 9.76%. Cost of funds declined 60 bps sequentially and 34 bps y-o-y to 7.82%. Non-interest income increased by 122% y-o-y and 60% sequentially to Rs.756 cr at the end of the quarter. This included Rs. 465 cr as profit on sale of investment as against Rs. 141 cr in Q1FY09 and Rs. 410 cr in FY09. The investment gains booked by the bank are not recurring in nature and could vary from quarter to quarter leading to some volatility in earnings.

The operating income increased by 149% y-o-y and 12% sequentially, with the noninterest income constituting 70% of the operating income. Operating expenses increased by 49% y-o-y, but declined 33% sequentially to Rs.316 cr in Q1FY10. Employee expenses were up 37% y-o-y, but down 47% sequentially to Rs.119 cr bn. Other operating expenses increased by 58% y-o-y, but declined 20% sequentially to Rs.197 cr at the end of the quarter. With the growth in operating expenses being lower than the growth in the operating income the operating profit increased by 245% y-o-y to Rs.756 cr in Q1 FY10. As a result, cost to income also dropped from 49.21% in Q1FY09 to 29.47% in Q1FY10.

Provisions and contingencies increased significantly from Rs.37 cr in Q1 FY09 to Rs.560 cr in Q1FY10, as against Rs.111 cr in Q4FY09, largely due to an increase of 106% y-o-y in provisioning for NPAs to Rs.37 cr. IDBI reported a PAT of Rs. 172 cr for the quarter, up 8% y-o-y and down 45% q-o-q.

Total loans and advances grew 25% y-o-y, but were down 5% sequentially to Rs.97,955 cr. Total deposits grew 59% y-o-y and 3% sequentially to Rs.1,15,554 cr at the end of Q1 FY10. The proportion of CASA deposits, as a percentage of the overall deposits, declined 293 bps y-o-y and 304 bps sequentially to 11.74% at the end of the quarter. The gross NPA ratio declined 21 bps y-o-y, but increased by 39 bps sequentially to 1.77 % in Q1 FY10. The net NPA ratio was down 13 bps y-o-y, but up 31 bps sequentially to 1.23%. Return on assets (RoA) declined 10 bps y-o-y to 0.40%, while the RoE declined 15 bps y-o-y to 9.18% in Q1 FY10. IDBI's capital adequacy ratio improved by 28 bps y-o-y to 12.30% at the end of Q1 FY10, out of which, Tier 1 Capital stood at 7.11%.

Concerns

Increase in NPAs due to slowdown in economy - Any disappointment on the economic recovery front may lead to a surge in the bank's non-performing assets (NPAs) as the bank has exposure to most industrial sectors and hence needs to make higher provisions. This, in turn, could affect the bank's future profitability.

Investment gains protect bottomline in Q1FY10 – IDBI booked profit on sale of investments to the tune of Rs. 465 cr in Q1FY10 as against Rs. 141 cr in Q1FY09 and Rs. 410 cr in FY09. The investment gains booked by the bank are not recurring in nature and could vary from quarter to quarter leading to some volatility in earnings. In addition, during the quarter provisions and contingencies increased sharply (up 890% y-o-y) but the investment gains to a certain extent cushioned the impact on bottomline.

Fall in CASA ratio - The low cost deposits as a percentage of the bank's overall deposits is lesser than that of the other government owned banks, mainly due to the different focus of the entity in its role as a DFI. Other players in the banking space have a current account and savings account (CASA) ratio in the range of 25-40% while IDBI Bank's CASA ratio is much lower at ~15%. In Q1FY10, the bank reported a CASA ratio of 11.74%. Thus to a certain extent, IDBI is sacrificing profitability in order to attain size. However, in the long run unless the bank improves its CASA ratio, profits could be impacted adversely.

In dire need of a makeover –IDBI Bank is in great need to change its work culture from the style of a DFI to the style of a bank, which has focused targets for CASA, retail advances, fee based income and active treasury management.

Exposure to capital market volatility - Any adverse movement in the capital markets may affect the expected valuation and earnings from IDBI's investment portfolio.

Rise in interest rates - Due to the government's huge borrowing programme to fund the ballooning fiscal deficit of the country and a possible surge in inflation during H2FY2010 interest rates may harden again. Such an event would have a significant impact on the bank's profitability as the bank relies heavily on wholesale deposits of shorter maturities.

High proportion of restructured loans - IDBI's NPAs need to be monitored, as the bank's restructured loans stood at Rs.3,100 cr in FY09 and another Rs.5,100 cr of loans were restructured in Q1 FY10, thus taking its total amount of restructured loans to over 9% of its total loans & advances. IDBI's provision coverage also declined 102 bps y-o-y and 279 bps sequentially to 31.11% in Q1 FY10. While the worst could be over, any adverse developments could impact IDBI's performance. Given below is a table summarizing the same.

As of 30 June 2009	(Rs .cr)
Gross Advances	98498
Gross NPAs	1748
Gross NPA as % of Gross Advances	1.77
Total Provisions held	544
Net Advances	97955
Net NPAs	1204
Net NPAs as a % of Net Advances	1.23
Provision Coverage Ratio	31.12

(Source: Company Presentation)

Conclusion

The management has targeted a growth of 25-28% in advances, which, we believe, is achievable, given the strong pick up in demand in the infrastructure segment, where IDBI is well positioned due to its established client relationships and strong appraisal skills. The management has targeted a growth of 32-35% in deposits for FY10. IDBI's NIM could rise from 1.06% recorded in FY09 to about 1.2% in FY11, led by a changing liability mix – increase in CASA share and repayment of high cost borrowings. The bank's focus on low-cost deposits (CASA) is expected to continue. Its present CASA share is 11.4%, and management aims to take it to 15%. The bank could also benefit from falling wholesale-deposit costs.

IDBI currently trades at a forward P/E multiple of 8.2 x FY10 consensus earnings of Rs. 14.1 and a forward P/B multiple of 0.86x FY10 consensus book value of Rs. 134, as against an average of 5.9x and 1.0x for public sector banks. More importantly, IDBI has a number of strategic investments (apart from the investments in subsidiaries that have significant potential value) that could fetch additional value above its BV. We expect IDBI's improving return ratios to assign higher multiples to the stock and therefore, recommend a buy on the stock with sequential price targets of Rs. 133 and Rs. 144.

Financials

(Rs cr)	Q1FY10	Q1FY09	% chg y-o-y	Q4FY09	% chg q-o-q	FY09	FY08	% chg y-o-y
Interest income	3463	2416	43%	3262	6%	11545	7630	51%
Interest expenses	3147	2326	35%	2781	13%	10306	7364	40%
Net Interest Income	316	91	247%	481	-34%	1239	266	366%
Other Income	756	340	122%	473	60%	1476	1992	-26%
Total Income	1072	431	149%	954	12%	2715	2258	20%
Operating expenses	316	212	49%	470	-33%	1338	959	40%
- Employee cost	119	87	37%	223	-47%	583	390	49%
- Other operating expenses	197	125	58%	247	-20%	755	569	33%
Operating profit	756	219	245%	484	56%	1378	1299	6%
Provisions & Contingencies	584	59	890%	170	244%	519	570	-9%
- NPAs	37	18	106%	43	-14%	144	134	7%
- Others (Invst, Std Assets etc)	4	19	-79%	68	-94%	249	343	-27%
- Tax	24	22	9%	59	-59%	127	93	37%
PAT	172	160	8%	314	-45%	859	729	18%
Equity	725	725		725		725	725	
EPS	2.4	2.2		4.3		11.8	10.1	

Key Ratios	Q1FY10	Q1FY09	FY09	FY08
NIM (%)	0.81	0.32	1.06	0.71
Return on Assets (%)	0.40	0.50	0.62	0.67
Return on Equity (%)	9.18	9.33	12.11	11.19
Cost of all liabilities (%)	7.28	7.23	7.39	6.75
Yield on total assets (%)	9.76	8.57	9.34	8.82
Cost to income ratio (%)	29.47	49.21	49.26	42.46
CASA (%)	11.74	14.67	14.78	16.56
Net NPA ratio (%)	1.23	1.36	0.92	1.30
CRAR (%)	12.30	12.02	11.57	11.95
CRAR - Tier I	7.11	7.48	6.81	7.42
CRAR - Tier II	5.19	4.54	4.76	4.53

(**Source:** Company Press Release, HDFC Sec)

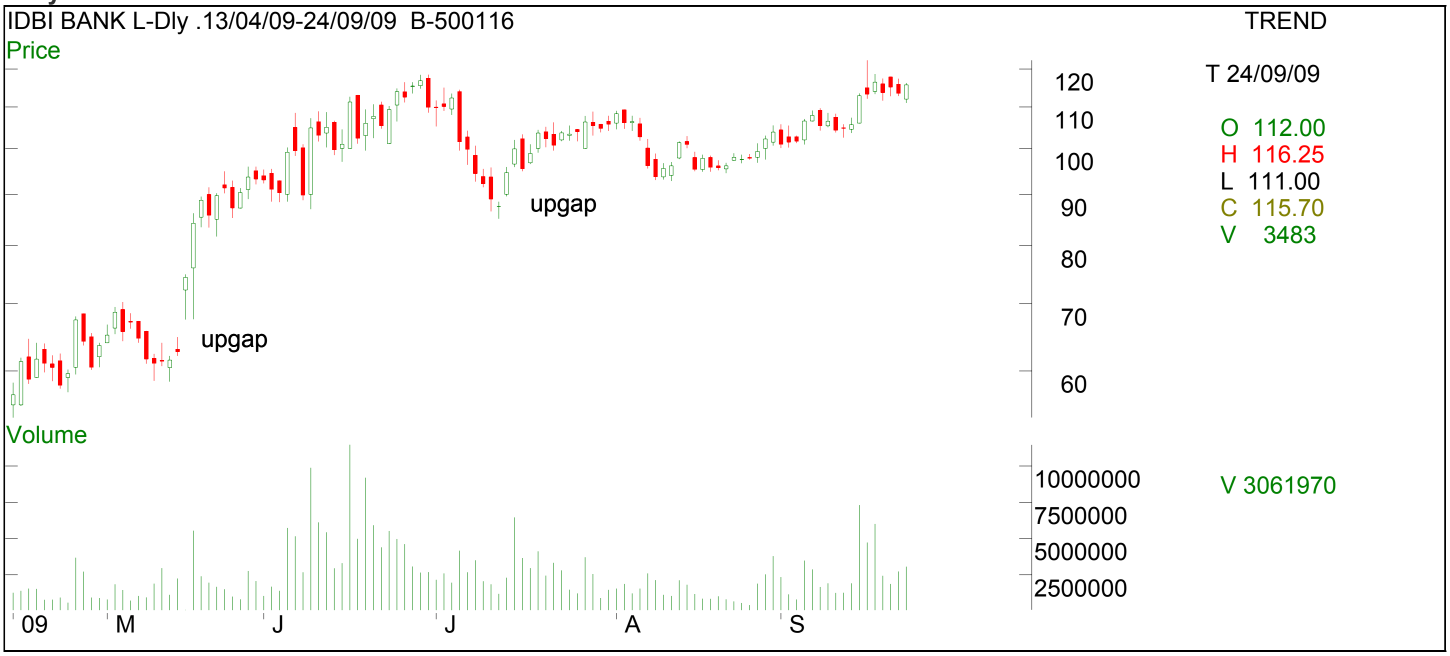
Technical Outlook

Weekly Chart

After touching a high of Rs.179.7 in the week ended 11 January 2008, IDBI Bank fell and created a low of Rs.39.75 in the week ended 13 March 2009. The stock also created a hammer like pattern on the weekly chart on that date and then started to rise. It decisively breached the downward sloping trendline connecting the previous tops in the week ended 17 April 2009 (log scale). Thereafter the stock continued its upward journey (with small corrections) and touched a high of Rs.118.5 in the week ended 3 July 2009. During its way up, the stock also created an upward gap between Rs.65.75 – Rs.67.5 as marked on the weekly chart. The gap remains unfilled till date which signifies the strength of the upmove.

The stock retraced the upmove from Rs.39.75 to Rs.118.5 by 38.2%. Thereafter, the stock has been moving sideways for the past 9 weeks. In the week ended 18 September 2009, the stock attempted to breach the high of Rs.118.5 and touched Rs.122.5. However, it failed to close above this level. This was accompanied by a close to 100% rise in volume compared to the average of the past few weeks. The stock has also formed a shaven bottom candlestick in the last week, which means that the open and low of the week was the same. The stock is trading above its 8 day and 13 day simple moving averages. Moreover, the 8 week SMA's current value is at Rs. 103.23 and the 13 week is at Rs. 103.45 indicating that a crossover is very likely in the days to come. All these factors indicate that the stock could be ready to break out of its consolidation range and start its next upmove.

Daily Chart



As can be seen from the daily chart, after failing to close above Rs. 118.50, the stock has been falling / moving sideways for the past two sessions. The oscillators are easing out. The stock could make another attempt to cross Rs. 118.50. On the daily chart, the stock has formed two upward gaps, which remain unfilled till date (Rs. 64.85-Rs.67.50 on 18 May, 2009 and Rs. 88.5-Rs.89.60 on 14 July, 2009).

Overall, in the banking space, IDBI Bank has been a laggard so far and could play catch up in the weeks to come. While the BSE Bankex has retraced more than 61.8% of its fall from its all time high created in January 2008, IDBI Bank has only retraced 58.5% of its downmove.

We expect IDBI Bank to cross the Rs. 118.5 level decisively in the days to come. **IDBI Bank could be bought at the CMP for sequential price targets of Rs. 133 and Rs. 144 in the next 4-6 weeks. Stop loss at Rs. 109 on a daily closing basis.**

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