

South Indian Bank

 BSE code: 532218
 NSE code: SOUTHBANK

CMP: Rs 140
Target: Rs 175
BUY

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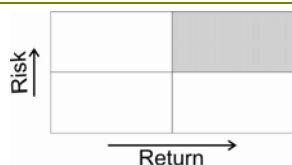
Company data

Particulars	
Market cap (Rs bn / US\$ mn)	9.9/ 243.4
Outstanding equity shares (mn)	70.4
52-week high/low (Rs)	146/56
Quarterly average daily volume	58,334

Financial snapshot

Particulars	FY07	FY08E	FY09E
NII (Rs bn)	3.7	4.3	5.0
Growth (%)	18.5	16.9	16.5
Adj net profit (Rs bn)	1.0	1.4	1.7
Growth (%)	50.6	31.3	27.3
FDEPS (Rs)	14.8	16.2	20.6
Growth (%)	50.6	9.4	27.3
P/ABV (x)	1.6	1.3	1.1
RoE (%)	15.3	15.8	16.2

Risk-return profile



Shareholding pattern

(%)	Jun-07	Mar-07
Promoters	-	-
FIs	43.2	41.8
Banks & FIs	7.9	6.7
Public	48.9	51.5

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
South Ind Bk.	140	36.9	46.1	49.0
Sensex	14,911	5.5	13.7	6.1
BSE Bankex	8,089	8.5	25.0	18.4

Heading north

Steady margins, rising recoveries and CBS implementation to strengthen earnings

Investment rationale

- ❖ Regional Kerala-based player with strong network of 484 branches; has clocked 18% CAGR in business growth over FY03-FY07 to Rs 206bn, with 21% growth targeted for FY08, along with geographical expansion.
- ❖ Proposes to raise capital through a fresh equity issue of up to 20mn shares to sustain credit growth and meet Basel II norms.
- ❖ Issue proceeds and strong base of low-cost funds in terms of CASA and NRI deposits would sustain net interest margins at ~3%.
- ❖ Implementation of Core Banking Solution across all branches (only bank with 100% coverage), roll out of remittance business and focus on third-party product distribution to strengthen fee income.
- ❖ Asset quality improving substantially on the back of a strong thrust on debt recovery; Management targets recoveries of Rs 1.3bn in FY08.

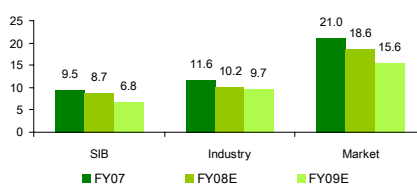
Key concerns

- ❖ Growth in fee income has been inconsistent. Any delay in scaling up of fee-based revenues could hurt profitability.
- ❖ CAR to rise from 11.1% to 13% post-issue. Inability to leverage capital leading to further dilution would lower RoE and depress valuations.

Valuation

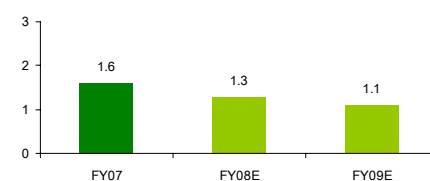
- ❖ Stock currently trades at a P/ABV of 1.3x and 1.1x on FY08E and FY09E. Based on DDM, we have a target of Rs 175 assuming sustainable RoE of 16.5%. Target represents potential upside of 25%; initiate coverage with Buy.

P/E multiple (x)



Source: Religare Research

P/ABV multiple (x)



Source: Religare Research

Business overview

Network of 484 branches; first bank to have 100% CBS coverage

Regional Kerala-based player with strong branch network

South Indian Bank (SIB) is a regional player based in Kerala with a network of 484 branches. It is the first bank in India to have all its branches covered under the Core Banking Solution (CBS), which will greatly enhance operational efficiency. SIB is now focusing on expanding its presence to other states and has obtained approval for opening 16 more branches, most of which will be outside Kerala.

Targets over 20% business growth to Rs 250bn for FY08

Over the last five years, the bank's business has logged an 18% CAGR to Rs 206bn, with almost 50% coming from Kerala. SIB now targets business of over Rs 250bn in FY08. This will be aided by higher fee income following CBS implementation, as well as its foray into the remittance business and a greater focus on third-party product distribution. The bank also plans to raise debt recoveries and has set a target of recovering Rs 1.3bn during FY08.

Q1FY08 Result highlights

Quarterly results

(Rs mn)	Q1FY08	Q1FY07	% Chg YoY	Q4FY07	% Chg QoQ
Int on Advances	2,145.0	1,495.2	43.5	2,005.8	6.9
Inc on Invest	647.2	510.5	26.8	586.0	10.4
Int on Bal with RBI	184.9	123.3	50.0	240.1	(23.0)
Interest income	2,977.1	2,129.0	39.8	2,831.9	5.1
Interest expenses	(2,004.1)	(1,299.8)	54.2	(1,713.4)	17.0
Net interest income	973.0	829.2	17.3	1,118.5	(13.0)
Other income	242.6	141.3	71.7	254.0	(4.5)
Total Income	1,215.6	970.5	25.3	1,372.5	(11.4)
Operating expenses	(677.2)	(550.2)	23.1	(596.9)	13.5
Provisions and W/off	(75.3)	(190.7)	(60.5)	(503.4)	(85.0)
PBT	463.1	229.6	101.7	272.2	70.1
Taxes	(159.4)	(79.1)	101.5	(46.6)	242.1
PAT	303.7	150.5	101.8	225.6	34.6
Cost/ Income Ratio (%)	55.7	56.7	-	43.5	-

Source: Company Religare Research

NII up 17%; Margin stable at 2.95%

Net interest income (NII) increased 17.3% YoY to Rs 973mn led by an expanding balance sheet size. Total business grew by 26% YoY to Rs 213.4bn as at the end of Q1FY08. Net interest margin (NM) for the quarter remained flat at 2.95% compared to 2.93% a year ago, as the increase in interest rates raised the cost of funds.

Near doubling of PAT led by strong recoveries

Net profit for the quarter almost doubled to Rs 303mn, on the back of strong recoveries of Rs 390mn, well ahead of the bank's target of Rs 195mn. For the next nine months SIB is targeting recoveries in excess of Rs 900mn. With higher recoveries, gross NPAs and net NPAs at the end of the quarter declined to 3.7% and 0.8% respectively.

Q1FY08 PAT almost doubled to Rs 303mn led by strong recoveries

Business update

Equity issue of up to 20mn shares planned; We expect 20% dilution

Fresh equity issue planned

The bank's capital adequacy ratio (CAR) stood at 11.6% at the end of Q1FY08, with tier-I capital constituting 9.1%. The management expects the implementation of Basel II norms to lower CAR by 0.18% at the end of FY07. SIB has sufficient room to raise tier-II capital to keep CAR above the mandatory requirements. However, considering the higher cost of subordinated debt, the bank proposes to raise capital through a fresh equity issue of up to 20mn shares. This would result in a maximum equity dilution of 28% on the existing capital base. We have built in dilution to the extent of 20% for our estimates.

Loans to high-yield retail and SME segments to drive growth

SIB's business has logged 26% YoY growth to Rs 213.4bn at the end of Q1FY08. Advances have witnessed a 22% CAGR over FY03-FY07 compared to deposit growth of 16%. The bank's loan book is mainly concentrated on the high-yield retail and SME segments. These constitute around 60% of total advances with an average yield of around 10.5%. Going forward, the focus would remain on the SME segment. SIB has targeted business of over Rs 250bn in FY08 compared to Rs 206bn achieved in FY07.

Reliance on deposits to decline

With SLR investments dipping to the mandatory 25% level in FY07, SIB was compelled to raise deposit intake in order to fund loan growth. Consequently, deposits increased at a faster pace than credit growth during the fiscal. Now, with the infusion of funds from the proposed equity offering, SIB may be able to reduce its reliance on deposit acceptance. The bank could also focus on increasing the percentage of low-cost CASA deposits, which have a current share of 23.7%.

SIB also has a strong base of NRI deposits, which constitute around 25% of the total. Apart from being a constant source of funds, these are also low-cost deposits. The average cost of NRI deposits is around 5.5% at present.

NIM expected to sustain at 3%

Even with the substantial base of low-cost deposits, NIM remained stagnant for FY07 as the increase in interest rates during the fourth quarter resulted in a higher cost of funds. The average cost of deposits stood at 6.37% at the end of Q1FY08. SIB's BPLR currently stands at 15%, with 50% of its advances linked to this rate. With the availability of capital from the equity issue, we expect the cost of funds to remain low, going ahead. This will keep NIMs at around 3% even after accounting for the absence of interest income on CRR balance. For FY07, SIB received Rs 70mn towards this.

Remittance business to strengthen fee income...

Fee income has shown disappointing growth during FY07. However, with technological upgrades (100% CBS implementation), roll-out of the remittance business (SIB Express) and a renewed thrust on third-party product distribution, the bank expects fee income to strengthen. The recently launched remittance business has already attracted a strong base of NRI clients. SIB is thus expecting sizeable income from this source.

...and higher recoveries to keep non-interest income stable

Apart from fee income, higher recoveries would also shore up non-interest income. During FY07, SIB sold its stake in Bharat Overseas Bank at a profit of over Rs 200mn, thereby boosting treasury gains for the year. During FY08, we expect the higher growth in fee income and stronger recoveries to offset the impact of lower treasury gains. This will keep total non-interest income relatively stable.

Recently launched remittance business has attracted a strong base of NRI clients

Mix of higher recoveries and lower delinquencies has improved asset health

Substantial improvement in asset quality

Asset quality has improved substantially over the past few years driven by a mix of higher recoveries and lower delinquencies. SIB is targeting net NPAs of under 0.5% of total advances by the end of FY08 as compared to 0.83% at the end of Q1FY08. The bank expects to achieve this goal through higher recoveries, with a target of total recoveries in excess of Rs 1.3bn during the fiscal.

Improving asset quality

(%)	2003	2004	2005	2006	2007	Q1FY08
Net NPAs	6.0	4.5	3.8	1.86	1.00	0.8
Gross NPAs	9.3	7.6	6.4	4.9	3.9	3.7

Source: Company, Religare Research

Expansion of branch network

SIB has a strong network of 484 branches; however, since 274 of these are located in Kerala alone, the bank is categorised as a regional player. SIB is now focusing on expanding its presence to other states and has already obtained approval for opening 16 more branches, most of which will be outside Kerala.

CBS coverage to enhance operational efficiency

The branch network is further strengthened by the implementation of CBS across all branches. The 100% CBS coverage has enabled SIB to achieve operational efficiency, evident from the gradual decline in operating expenses as a percentage of total business and total income.

Well hedged investment portfolio

The bank's investment portfolio is adequately hedged against any adverse movement in interest rates. Investments in the AFS category constitute 38.3% of the total and consist mainly of liquid securities. The duration of the AFS portfolio is six months. A higher composition of securities in the HTM category and lower duration of AFS investments will result in lower mark-to-market losses in case of adverse interest rate movement. However, amortisation expenses for the year would continue in the range of Rs 180-190mn.

Higher composition of HTM securities at 61.7% to result in lower MTM losses

Valuation

Return ratios to improve as SIB leverages on fresh equity capital

We expect the consistent balance sheet expansion coupled with steady margins and rising NPA recoveries to strengthen the bank's earnings, going forward. We have factored a 20% equity dilution into our estimates. This issue would raise the tier-I capital ratio to around 11% by the end of FY08 and eliminate the need for fresh capital infusion for the next 2-3 years at least. Thus, while RoE is likely to decline to 15.8% at the end of FY08, we expect an improvement thereafter as SIB leverages on its capital.

Tier-I capital ratio to improve to around 11% by the end of FY08 from 9.1% at present

Comparative valuation - FY07

Particulars	SIB	Federal Bk	Karur Vysya	Karnataka Bk	City Union Bk
Net NPA (%)	1.0	0.4	0.2	1.4	1.1
Cost-to-Income ratio	46.5	39.8	41.3	40.0	40.7
RoE (%)	16.2	21.4	16.5	15.1	22.0
Net interest margin (%)	3.1	3.4	3.3	2.8	3.8
ABV (Rs/share)	88.8	167.1	211.6	91.3	130.7
P/ABV (x)	1.6	1.9	1.6	2.0	1.7
Tier- I CAR (%)	8.8	8.9	14.0	10.5	10.9

Source: Company, Religare Research

Target price of Rs 170 reflects a potential upside of 25%; Buy

Initiate coverage with Buy

At the current price the bank is trading at a P/ABV of 1.3x and 1.1x on FY08E and FY09E adjusted book value. We have valued SIB on the basis of the dividend discount model (DDM), assuming a sustainable RoE of 16.5%. We thus arrive at a target price of Rs 170 which reflects a potential upside of 25% from the current levels. We initiate coverage with Buy.

Financials

Profit and Loss statement

(Rs bn)	FY06	FY07	FY08E	FY09E
Interest earned	7.6	9.8	12.1	14.7
Interest expended	4.5	6.1	7.8	9.6
Net interest income	3.1	3.7	4.3	5.0
Growth (%)	20.7	18.5	16.9	16.5
Non-interest income	0.9	1.0	1.0	1.1
Comm, Exchange & Brokerage	0.3	0.2	0.3	0.3
Growth (%)	(11.6)	14.0	(2.8)	10.1
Operating expenses	2.3	2.2	2.3	2.6
Pre-provisioning profits	1.7	2.5	3.0	3.5
Growth (%)	1.4	44.2	18.7	18.5
Provisions & contingencies	0.9	1.1	1.0	1.1
PBT	0.9	1.5	2.0	2.5
Income tax, Interest tax	0.2	0.4	0.6	0.7
Net profit	0.7	1.0	1.4	1.7
Growth (%)	694.6	50.6	31.3	27.3

Source: Company, Religare Research

Balance sheet

(Rs bn)	FY06	FY07E	FY08E	FY09E
Cash in hand & bal with RBI	5.5	7.0	10.4	12.7
Balance with banks, Money at call	8.0	12.5	8.8	9.3
Investments	27.4	34.3	42.9	51.3
Advances	63.7	79.2	98.6	120.8
Fixed assets (net)	0.9	0.9	0.9	0.9
Other assets	2.8	2.7	2.9	3.1
Total assets	108.3	136.5	164.5	198.0
Equity capital	0.7	0.7	0.8	0.8
Reserves & surplus	5.7	6.5	9.2	10.6
Net worth	6.4	7.2	10.0	11.5
Deposits	95.8	122.4	146.8	178.4
Current deposits (a)	5.6	6.2	7.4	8.8
Savings bank deposits (b)	19.7	23.1	28.1	34.4
Term deposits (c)	70.5	93.1	111.2	135.2
Borrowings (incl sub-ord bonds)	2.0	2.1	2.1	2.2
Other liabilities & provisions	4.1	4.8	5.6	6.0
Total liabilities	108.3	136.5	164.5	198.0

Source: Company, Religare Research

Recommendation history

Date	Event	Target (Rs)	Reco
12-Jul-07	Initiating Coverage	175	Buy

Source: Religare Research

Key ratios

Year-end March	FY06	FY07E	FY08E	FY09E
Per share data				
Shares outstanding (bn)	70.4	70.4	84.5	84.5
FDEPS (Rs)	9.8	14.8	16.2	20.6
DPS (Rs)	1.8	2.5	2.8	3.3
Book value (Rs)	91.0	102.8	118.8	135.7
Adjusted book value	71.4	88.8	110.6	126.8

Valuation ratios

P/E (x)	14.3	9.5	8.7	6.8
P/BV (x)	1.5	1.4	1.2	1.0
P/ABV (x)	2.0	1.6	1.3	1.1

Earnings quality (%)

Net interest margin	3.2	3.1	2.9	2.8
Yield on advances	9.4	9.7	9.8	9.8
Yield on investments	6.4	7.1	7.3	7.2
Cost of funds	4.9	5.5	5.7	5.9
Cost/Income	56.4	46.5	43.6	42.0
Average RONW	12.6	15.3	15.8	16.2
Average RoA	0.6	0.8	0.8	0.9

Growth ratios (%)

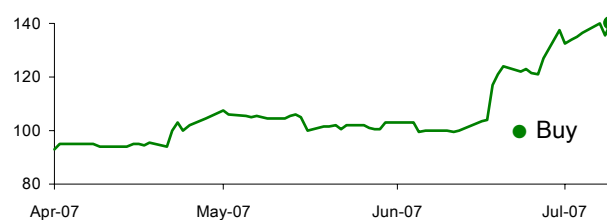
Net interest income	20.7	18.5	16.9	16.5
Other income	(11.6)	14.0	(2.8)	10.1
Total income	11.5	17.5	12.6	15.3
Pre-provisioning profit	1.4	44.2	18.7	18.5
Net profit	694.6	50.6	31.3	27.3
Advances	18.7	24.3	24.5	22.5
Deposits	12.8	27.8	19.9	21.6

Asset quality

Proportion of low-cost	26.4	23.9	24.2	24.2
Credit-Deposit ratio (x)	66.5	64.7	67.2	67.7
Investment/Deposit (%)	28.6	28.0	29.2	28.7
Net NPA ratio	1.9	1.0	0.6	0.5
CAR	13.0	11.1	13.1	12.4
Tier-I ratio	8.4	8.8	11.5	9.8

Source: Company, Religare Research

Stock performance



Source: Religare Research

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