ING VYSYA BANK

All set to roll

April 7, 2010

Reuters : VYSA.BO Bloomberg : VYSB IN

We recently met the management of ING VYSYA Bank (VYSB) to understand its future growth plans and get clarity on the NPL progression. Following are key takeaways:

Building blocks in place; growth set to accelerate

Preferring prudence over balance sheet growth, VYSB consciously slowed down its asset growth. Now, with a sizeable branch network, receding asset quality concerns (with rundown in unsecured portfolio) and strong capital position, coupled with the able guidance of Mr. Shailendra Bhandari, the bank expects to switch from consolidation to growth mode. The bank's return of confidence reflects in its 7% Q-o-Q growth in Q3FY10. Loan growth is expected to track industry run-rate over a few more quarters before the bank ups the ante and gains market share.

Asset quality slippages to peak by Q4FY10

Deterioration in the asset quality over the past few quarters was owing to VYSB's conservative restructuring policy and also slippages from the unsecured loan book. Slippages are expected to remain high till Q4FY10, post which they will decline significantly given the rundown in unsecured loan book. Loan loss provisions are likely to remain at elevated levels with a downward bias for a few quarters, to meet 70% coverage norm by Q2FY11.

Cost–to-income ratio to move closer to 50%

Cost–to-income ratio has come off to 58% in Q3FY10 from 66% in FY09. With the traction in income and productivity gains, cost-income ratio could lower further to 50% over the next two years. Over the next 3-5 years, with improvement in productivity, cost-to-income will reach the mid 40 levels.

Outlook and valuations: Shifting gears; maintain **'BUY'**

With return of growth, and decline in opex ratio and credit costs, earnings over the next two years are expected to post 27% CAGR. This will push ROA to closer to 1% by FY12E. This, together with better leverage of 14-15x, will drive ROEs to 14-15%. At CMP, the stock is trading at 1.3x FY12 book and 8.4x earnings. We maintain **'BUY'** on the stock and rate it **'Sector Outperformer'** on relative basis.

Financials

Year to March	FY09	FY10E	FY11E	FY12E
Revenues (INR mn)	11,973	14,050	15,680	18,532
Rev growth (%)	*30.6*	*17.4*	*11.6*	*18.2*
Net int. income (INR mn)	6,496	8,216	9,296	11,301
Net profit (INR mn)	1,888	2,454	2,896	3,956
Diluted EPS (INR)	18.4	20.6	24.3	33.1
EPS growth (%)	*20.1*	*11.8*	*18.0*	*36.6*
Diluted P/E (x)	15.2	13.6	11.5	8.4
Price to adj. book (x)	2.0	1.6	1.4	1.3
Price to PPOP (x)	7.5	6.4	5.1	4.0
ROAE (%)	12.5	12.9	12.4	15.0

EDELWEISS 4D RATINGS	
Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	High
Sector Relative to Market	Overweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA		
CMP	:	INR 280
52-week range (INR)	:	326 / 128
Share in issue (mn)	:	120.0
M cap (INR bn/USD mn)	:	33.6 / 756.2
Avg. Daily Vol. BSE/NSE ('000)	:	324.7

SHARE HOLDING PATTERN (%)		
Promoters*	:	44.4
MFs, FIs & Banks	:	14.8
FIIs	:	19.4
Others	:	21.4
* *Promoters pledged shares (% of share in issue)*	:	*Nil*

PRICE PERFORMANCE (%)	Stock	Nifty	EW BFSI Index
1 month	(1.8)	5.6	6.3
3 months	(4.0)	2.1	4.3
12 months	112.6	65.0	105.8

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Building blocks in place; growth to accelerate

Initially, VYSB followed a conservative strategy on loan growth (17% CAGR in FY05-09) owing to management restructuring. Preferring prudence and stable asset quality over balance sheet growth, management had slowed down advances growth to 14% (against 20% in FY08) in FY09 and for the first two quarters of FY10 (growth of 3.3% Y-o-Y).

Now, with a sizeable branch network, receding asset quality concerns (with rundown in unsecured portfolio), strong capital position, and the able guidance of Mr. Shailendra Bhandari, the bank expects to switch from consolidation to growth mode. Return of confidence reflects in the bank's 7% Q-o-Q growth in Q3FY10. Loan growth is expected to track industry run-rate over a few more quarters before VYSB ups the ante and gains market share.

Management expects growth to kick in from the following:

a) Entry into consortium lending, leveraging parent's balance sheet; already made inroads into large conglomerates.

b) Entry into car/CV finance business on selective basis. The bank has recruited a team from HDFC Bank and eCBOP to undertake CV lending on a pilot basis.

c) Business banking focused on consumption and mortgages via loan against property (LAP), an area where the bank is witnessing increased momentum.

At end of Q3FY10, VYSB's loan book stood well-diversified with the wholesale book contributing ~43%, SME ~24%, consumer ~23% (housing ~19%), and agriculture the balance 10%.

Chart 1: Loan book growth

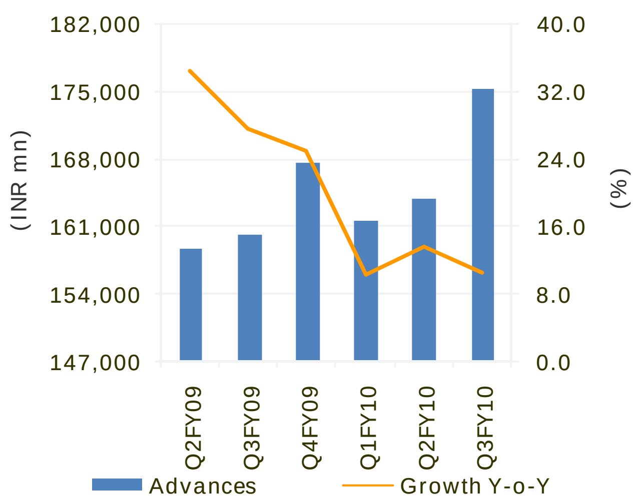
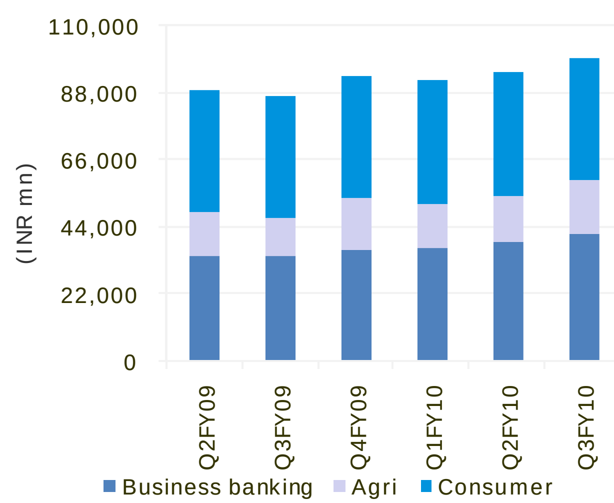


Chart 2: Retail book break up



Source: Company, Edelweiss research

Proactive approach behind headline asset quality deterioration

Despite strong focus on SME and retail, VYSB's cautious approach on loan growth in FY09 has paid off with lower impact on asset quality (slippage and restructuring at **4.7%** compared with the industry average of 6%. Headline asset quality deteriorated from 1.44% in Q2FY09 to 2.68% in Q3FY10, whereas net NPA increased from 0.78% to 1.7%. Key reasons cited by the management for NPAs (higher than industry average) were:

(a) The bank has followed a conservative restructuring policy, wherein it restructured assets (including restructuring under RBI dispensation) of about 2% (by end of Q3FY10), preferring to up-fronting problem assets as NPAs rather than postponing via restructuring.

(b) Slippages from the unsecured portfolio also contributed to the deterioration in asset quality.

Pace of NPLs formation is expected to peak by end of Q4FY10. Unsecured loan book (stop fresh disbursal) that stood at INR 5.4 bn at peak is witnessing decline in NPL formation to the tune of 50% Q-o-Q. The unsecured loan book is expected to rundown over the next 18 months.

Provision coverage, remained low at 40% by end of Q3FY10, including the technical write-off coverage levels that inched up to 45%. Loan loss provisions will continue to remain at elevated levels for the next couple of quarters with a downward bias, to meet RBI's guideline of 70% provision coverage by H1FY11E. Post H2FY11, with a rundown unsecured loan book and incremental lending in the secured asset class, management expects provisioning levels to trend down significantly by FY12. This is likely to aid ROA improvement.

Chart 3: GNPL, NNPL and prov. coverage

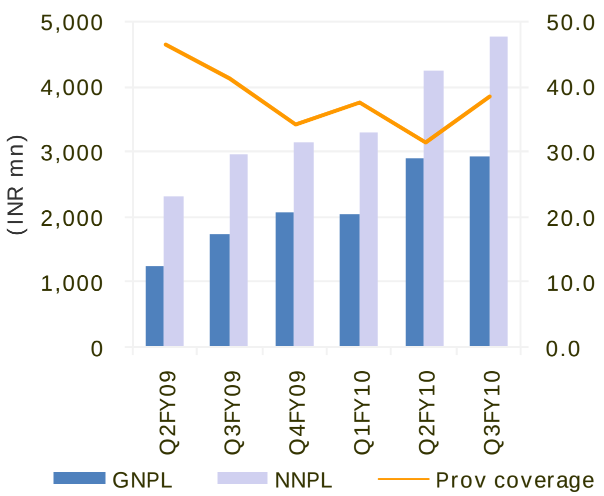
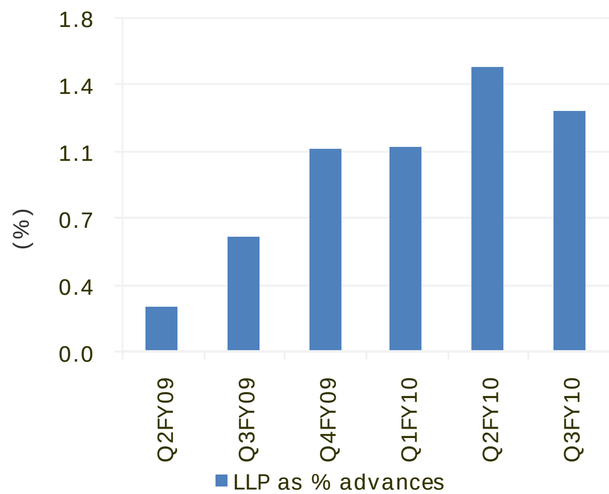


Chart 4: LLP as % advances



Source: Company, Edelweiss research

- **Opex to trend down with rapid branch expansion**

One of the major impediments for VYSB to deliver higher ROA and RoAE, despite strong revenues, has been the high cost structure the bank has deployed. We believe the bank has the ability to generate revenues at much lower costs (driving RoE expansion consistently). True to this, the bank steadily reduced its opex–to-assets ratio from 3.5% in FY06 to 2.9% in FY09. Also, the cost-income ratio has been steadily declining from ~80% in FY05 to 65% in FY09, which fell further to 58% in Q3FY10. The industry however, operates at much efficient operating ratios. Though VYSB's pace of **cost build has more or less stabilised in FY10, income needs to grow faster for the efficiency gains to kick in.**

VYSB has licenses to open another 60 branches in North and West in FY11. Given the expansion plans, cost-income ratio is expected to move closer to 50% over FY11-12E. Over the next 3-5 years, with improvement in productivity, cost-to-income will reach the mid 40 levels.

Chart 5: ING Vysya - Cost-income ratio

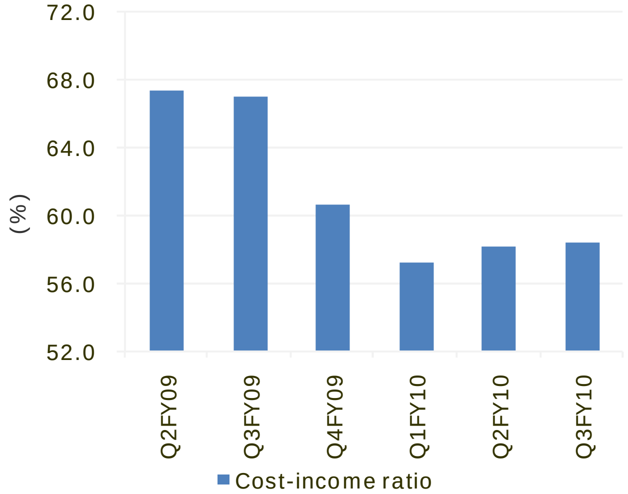
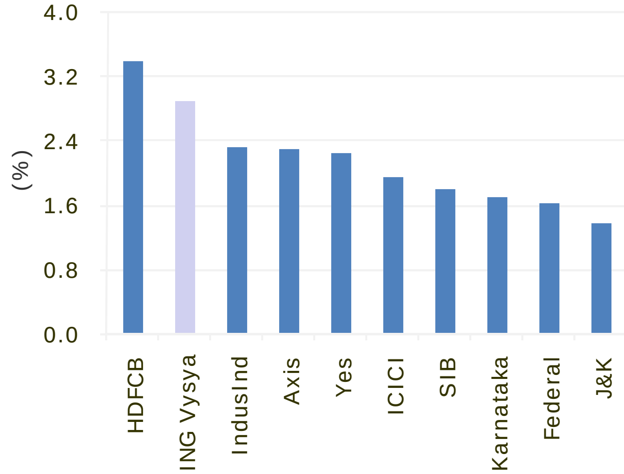


Chart 6: Opex/Assets (FY09)



Source: Company, Edelweiss research

- **Contribution from fee income already on higher side**

  At 2% of average assets for the past two years (which has doubled since FY05), VYSB's fee income to assets is comparable with the best in the industry. Relative to most banks, VYSB does not rely on volatile treasury income (~16bps as percentage of assets in FY09).

Chart 7: Contribution of fees to assets ratio (FY09)

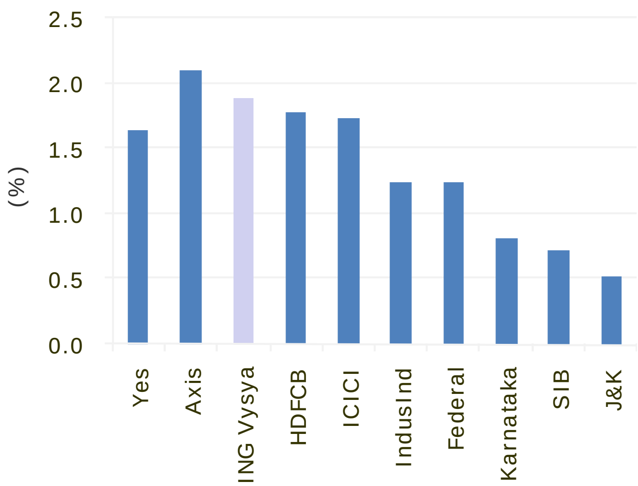
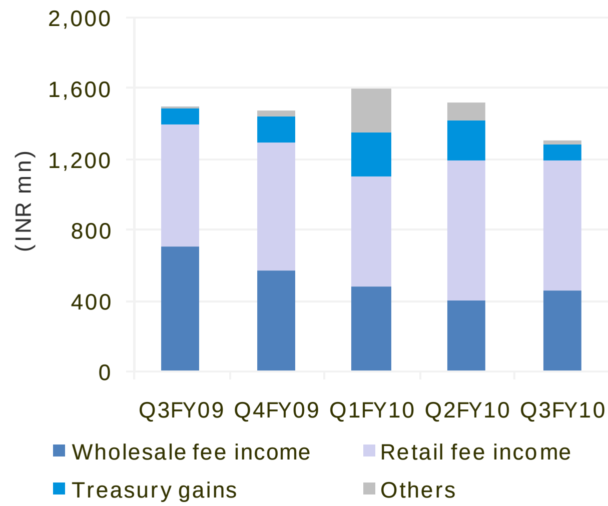


Chart 8: VYSB - Quarterly trend in fee income



Source: Company, Edelweiss research

Non-volatile core fees income has remained flat over the past four quarters. Management attributes the subdued performance to:

(a) Overall decline in trade flows, impacting the trade linked fees.

(b) Revenue from the cash management stream getting routed through NII route (where clients maintained current account with bank providing float income rather than paying a fees).

c) Fees income tracking balance sheet growth, going forward; initially, due to business development activities related to fees (and strong focus on de-risking), fees income grew faster than balance sheet.

Wholesale banking fees

In the wholesale segment, key product capabilities include financial management, trade, payments and cash management. While in investment banking, the bank is active in select segments and is focused on servicing existing relationships, the management is keen on developing its cash management services, going forward.

Retail banking fees

A key strength of the ING Group has been its presence in wealth management, servicing its high net worth clients (local and NRI) through private banking services. The bank generated fees of >1.5% on assets under management. Near-term weakness due to changes in guidelines in insurance and mutual funds could, however, impact fee income. However, given the opportunity, management expects strong contribution from private banking. Going forward, on retail side, management is focused on growing liability related fees.

- ## ROA/ROAE trajectory

The bank, under the new management, has improved RoE to ~13% and RoAs to 0.8% (from -0.3% in FY05), in FY09. In Q2FY10, the bank raised INR 4.2 bn in equity, which has helped it improve tier-1 capital from 7.4% in Q1FY10 to 9.7%.

Going forward: (a) improvement in NIMs, along with decline in opex ratio and credit costs, will push ROA to >1.0% by FY12E; and (b) this, coupled with better leverage of 15-16x, will drive ROEs to 15-16%.

Chart 9: Steady improvement in RoA / RoEs

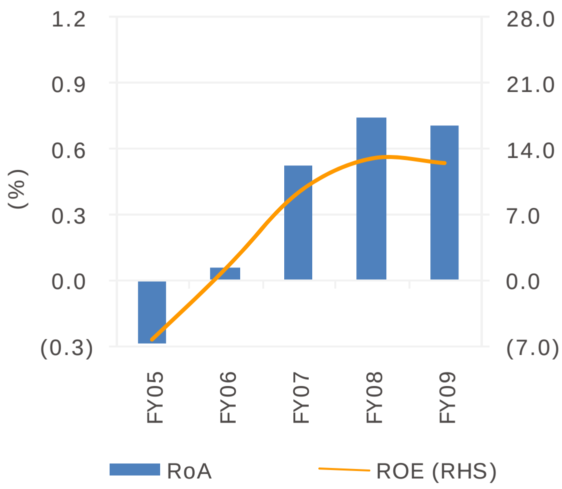
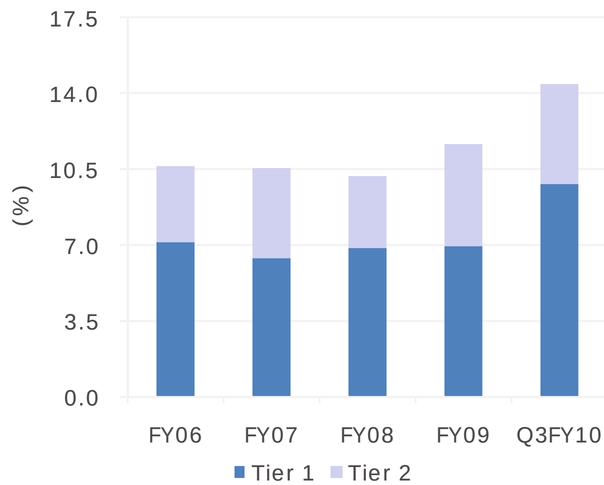


Chart 10: Capital adequacy



Source: Company, Edelweiss research

- ## Other highlights

Most securities in the AFS category have duration of less than one year, implying minimum risk of MTM losses.

Tier I ratio stood at 9.85% at end of Q3FY10.

Company Description

VYSB was incorporated on March 29, 1930, and is headquartered in Bangalore. Subsequent to acquisition of stake in the bank by the global financial powerhouse ING Group in August 2002, the name of the bank was changed from The Vysya Bank to ING Vysya Bank. The bank has market cap of INR 33bn with balance sheet size of ~INR 310 bn as on H1FY10. It has 460 branches, 14 extension counters, and 357 ATMs across India and services ~1.5 mn customers as on December, 09.

Investment Theme

Over the past three years, VYSB has built a strong platform delivering consistent and improved performance in key ratios reaffirming a turnaround in the bank. The bank has improved its fee income contribution in line with the leaders, leveraged its balance sheet at lower cost and hence, improved RoEs to ~13% in FY09. Given the credit crisis and the subsequent impact on global economies, including India, the bank's conscious cautious strategy benefited with lower impact on asset quality (including restructuring). The ING Group remains committed to India and has participated in the bank's equity as well as debt capital issues. We believe the stage is set under the new CEO for the bank to leverage its turnaround and deliver RoE above ~16% on a long term basis.

Key Risks

Though the bank is making an effort to branch out to other parts of the country and reduce the share of South India in its business mix, still, a major part of the business will continue to be driven from South India where competition is higher.

Systemic deterioration in asset quality will post a threat to the bank's portfolio quality.

Management attrition, particularly among senior management, is a big risk as the successful turnaround, which began in FY08, depends on VYSB's ability to hire and retain senior talent.

Financial Statements

Income statement (INR mn)

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Interest income	16,804	22,399	22,500	26,390	33,129
Interest expenses	11,820	15,903	14,284	17,094	21,828
Net Interest income	4,984	6,496	8,216	9,296	11,301
Non interest income	4,186	5,477	5,834	6,385	7,231
- Fee & forex income	3,337	4,404	4,712	5,655	6,673
- Misc. income	696	637	506	480	458
- Investment profits	152	436	615	250	100
Net revenues	9,170	11,973	14,050	15,680	18,532
Operating expense	6,095	7,725	8,177	8,876	10,116
- Employee exp	3,024	3,922	4,405	4,894	5,741
- Other opex	3,071	3,802	3,772	3,981	4,375
Preprovision profit	3,075	4,248	5,873	6,805	8,416
Provisions	560	1,302	2,210	2,483	2,511
- Loan loss provisions	518	1,271	2,110	2,383	2,411
- Investment depreciation	(96)	(46)	0	0	0
- Other provisions	139	77	100	100	100
PBT	2,515	2,947	3,663	4,322	5,905
Taxes	945	1,059	1,209	1,426	1,949
PAT	1,569	1,888	2,454	2,896	3,956
Reported PAT	1,569	1,888	2,454	2,896	3,956
EPS	15.3	18.4	20.6	24.3	33.1
DPS	1.5	2.0	2.5	3.0	4.0
Payout ratio (%)	11.5	12.7	14.2	14.5	14.1

Growth ratios (%)

Year to March	FY08	FY09	FY10E	FY11E	FY10E
NII growth	11.9	30.3	26.5	13.1	21.6
Fees growth	88.2	32.0	7.0	20.0	18.0
Opex growth	20.7	26.7	5.9	8.5	14.0
PPOP growth	49.0	30.4	37.9	24.7	26.9
PPP growth	35.9	38.2	38.2	15.9	23.7
Provisions growth	(48.5)	145.6	65.9	12.4	1.1
PAT growth	76.5	20.3	30.0	18.0	36.6

Operating ratios (%)

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Yield on advances	9.7	11.1	9.7	9.8	9.9
Yield on investments	6.5	5.6	5.0	5.5	5.7
Yield on assets	8.0	8.3	7.5	8.0	8.2
Net interest margins	2.4	2.4	2.8	2.8	2.8
Cost of funds	5.6	5.9	4.7	5.1	5.3
Cost of deposits	5.8	6.2	4.8	5.3	5.6
Cost of borrowings	8.4	7.7	7.2	7.3	6.8
Spread	2.4	2.5	2.8	2.8	2.8
Cost-income	66.5	64.5	58.2	56.6	54.6
Tax rate	37.6	35.9	33.0	33.0	33.0

Balance sheet (INR mn)

As on 31st March	FY08	FY09	FY10E	FY11E	FY12E
Liabilities					
Equity capital	1,025	1,026	1,194	1,194	1,194
Reserves	13,237	14,915	21,010	23,487	26,885
Net worth	14,261	15,941	22,204	24,680	28,078
Sub bonds/pref cap	4,969	10,329	10,829	11,330	11,831
Deposits	204,576	248,899	250,869	301,520	383,626
Borrowings	12,498	21,524	21,695	26,075	33,175
Other liabilities	17,999	20,789	19,285	23,179	29,491
Total	**254,304**	**317,482**	**324,882**	**386,785**	**486,201**
Assets					
Loans	146,495	167,509	189,286	236,607	300,491
Gilts	*48,827*	*92,587*	*78,368*	*84,427*	*106,458*
Others	*14,107*	*12,368*	*14,523*	*14,873*	*15,344*
Cash & equi	31,848	22,823	19,597	23,555	29,969
Fixed assets	2,897	3,284	3,604	3,881	4,114
Other assets	10,131	18,911	19,504	23,442	29,825
Total	**254,304**	**317,482**	**324,882**	**386,785**	**486,201**
Balance sheet ratios (%)					
Credit growth	20.4	14.2	13.0	25.0	27.0
Deposit growth	32.7	21.7	0.8	20.2	27.2
EA growth	33.3	22.4	2.2	19.1	25.8
SLR ratio	22.5	34.2	31.2	28.0	27.8
C-D ratio	72.2	67.8	76.0	79.1	78.9
Low-cost deposits	31.5	27.0	30.0	31.5	32.2
Gross NPA ratio	1.4	1.9	2.6	2.3	1.9
Net NPA ratio	0.7	1.2	1.4	0.8	0.7
Provision coverage	49.2	34.2	46.6	66.5	66.4
Incremental slippage	1.6	2.2	3.0	2.1	1.4
Net NPA / Equity	7.2	12.9	11.7	7.3	7.0
Capital adequacy	10.2	11.7	14.5	11.8	10.9
- Tier 1	6.8	6.9	9.2	8.0	7.6
Book value	139	155	186	207	235

ROA decomposition (%)

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Net interest income/Assets	2.4	2.4	2.8	2.8	2.8
Fees/Assets	1.9	1.9	1.7	1.9	1.8
Investment profits/Assets	0.1	0.2	0.2	0.1	0.0
Net revenues/Assets	4.3	4.5	4.7	4.7	4.6
Operating expense/Assets	(2.9)	(2.9)	(2.7)	(2.7)	(2.5)
Provisions/Assets	(0.3)	(0.5)	(0.7)	(0.8)	(0.6)
Taxes/Assets	(0.4)	(0.4)	(0.4)	(0.4)	(0.5)
Total costs/Assets	(3.6)	(3.8)	(3.9)	(3.9)	(3.6)
ROA	0.7	0.7	0.8	0.9	1.0
Equity/Assets	5.7	5.6	6.4	7.1	6.5
ROAE	13.0	12.5	12.9	12.4	15.0

Valuation metrics

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Diluted EPS	15.3	18.4	20.6	24.3	33.1
EPS growth (%)	*56.6*	*20.1*	*11.8*	*18.0*	*36.6*
Book value per share (INR)	139	155	186	207	235
Adjusted book value/share (INR)	132	141	171	196	224
Diluted P/E (x)	18.3	15.2	13.6	11.5	8.4
Price/ BV (x)	2.0	1.8	1.5	1.4	1.2
Price/ ABV (x)	2.1	2.0	1.6	1.4	1.3
Dividend yield (%)	*0.5*	*0.7*	*0.9*	*1.1*	*1.4*
Price to income (x)	4.0	3.2	3.7	3.3	2.9
Price to PPOP (x)	9.8	7.5	6.4	5.1	4.0

RATING & INTERPRETATION

Company	Absolute reco	Relative reco	Relative risk
Federal Bank	Buy	SO	M
ING Vysya Bank	Buy	SO	H
LIC housing finance	Buy	SO	M
Oriental Bank Of Commerce	Buy	SO	H
Power Finance Corp	Buy	SP	L
South Indian Bank	Buy	SO	H
SREI Infrastructure Finance	Buy	SO	H
Syndicate Bank	Buy	SU	H
Union Bank Of India	Buy	SO	L
Yes Bank	Buy	SO	M
Axis Bank	Buy	SO	M
Allahabad Bank	Buy	SO	H
HDFC Bank	Hold	SP	L
ICICI Bank	Buy	SO	L
Kotak Mahindra Bank	Buy	SP	M
Punjab National Bank	Buy	SO	L
State Bank of India	Buy	SP	L
HDFC	Hold	SU	L
Indian Overseas Bank	Hold	SU	H
IDFC	Reduce	SU	M
Karnataka Bank	N R	N R	N R
Reliance Capital	Hold	SU	M
Shriram City Union Finance	Buy	SP	H
Bank of Baroda	Buy	SO	L

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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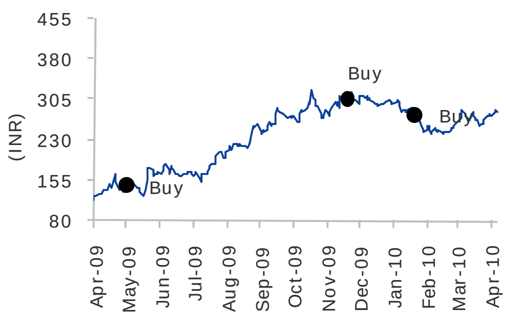
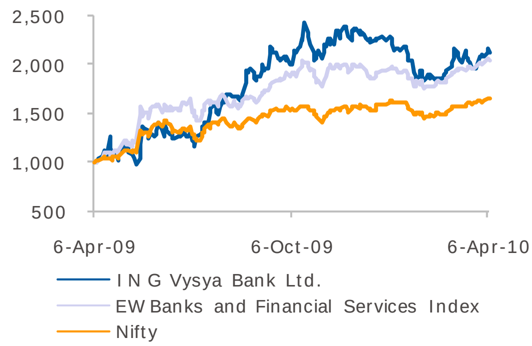
Coverage group(s) of stocks by primary analyst(s): Banking

Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC Bank, ICICI Bank, IOB, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

ING Vysya Bank



EW Indices



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	101	56	9	169

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	103	53	13

Recent Research

Date	Company	Title	Price (INR)	Recos
10-Mar-10	**BFSI**	Ready for take-off go private; *Sector Update*		
24-Feb-10	**South Indian Bank**	Consistent performer; *Visit Note*	139	Buy
19-Feb-10	**Rural Electrification Corproation**	Power play; *Initiating Coverage*	214	Buy

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