

## FEDERAL BANK

INR 251

Unsung hero

BUY



Federal Bank's net profit (at INR 838 mn) was 17% higher Y-o-Y, above our expectations. The net interest income (NII) growth of 19%, was however, in line with our expectations. Pre-provisioning operating profit during Q3FY07 grew 14% Y-o-Y.

Key highlights of the quarter were: 1) net interest margins (NIMs) improved to 3.4% with CASA at 27%, 2) robust business growth with 30% growth in advances, 3) Sluggish fee income but higher trading gains, and 4) Network expanded to reach 524 branches.

We maintain our FY07E and FY08E EPS estimates at INR 30 and INR 35, respectively. We introduce our FY09E EPS estimate of INR 40. The stock currently trades at 1.3x FY08E book, we maintain 'BUY'.

#### \* Robust operating performance

The bank registered healthy 30% Y-o-Y and 7% Q-o-Q growth in advances, led by 54% Y-o-Y growth in retail advances that formed 29% of the total advances in December 2006. Deposits grew 13% Y-o-Y with marginal improvement in CASA ratio to 27% in December 2006 from 26% in September 2006. Further, bank's focus on branch expansion aided its robust operating performance. The bank added 15 branches during this quarter, taking the total number of branches to 524 as on December, 2006. It intends to open another 15 branches during Q4FY07. We expect the bank to attain 21% CAGR in the loan book over FY06-09E. The bank is also looking at inorganic growth opportunities among small private sector banks, which is not factored in our estimates.

#### \* Improved margins

NIMs grew 19% Y-o-Y on account of robust growth in advances (7% Q-o-Q) and controlled cost of funds. Further, NIM sequentially improved to 3.4% in Q3FY07, as the bank reduced its dependence on bulk deposits that contained its cost of deposits at 5.47 against 5.49 as on September 2006. The bank relied on its excess statutory liquidity ratio (SLR) to fund its growth and focus on better quality deposits. Its excess SLR as on December is ~INR 7 bn, which amounts to 4% above the minimum requirement. Yield on advances also improved to 10.0 in Q3FY07 as against 9.9 in Q2FY07. With improvement in CASA deposits, we expect NIMs to be at 3.3% for FY07E as against our estimate of 3.2% earlier.

#### \* Fee-based income still sluggish

Non-interest income grew at 13% Y-o-Y to INR 455 mn and profit on sale of investments was INR 90 mn during this quarter. The fee-based income that remained more or less at the Q3FY06 levels, is however, expected to improve in FY07-09E. We expect the bank to generate 10% CAGR in fee income over FY07-09E.

#### Financials

Year to March	Q3FY07	Q3FY06	growth %	Q2FY07	growth %	FY07E	FY08E
Net int. inc. (INR mn)	1,784	1,495	19.3	1,675	6.5	6,909	7,955
Net profit (INR mn)	838	715	17.3	695	20.7	2,575	2,972
B/V per share (INR)						171.4	201.7
EPS (INR)	9.8	10.9	(10.3)	8.1	20.7	30.1	34.7
Price/ Book (x)						1.5	1.3
Price/ PPOP (x)						4.5	3.8
Price/ Earnings (x)						8.4	7.3

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Bloomberg : FB IN

#### Market Data

52-week range (INR) : 274 / 137  
Share in issue (mn) : 83.6  
M cap (INR bn/USD mn) : 20.9 / 473.7  
Avg. Daily Vol. BSE/NSE ('000) : 409.0

#### Share Holding Pattern (%)

Promoters : 0.0  
MFs, Fls & Banks : 8.8  
Fils : 37.3  
Others : 54.0

\* **Network expansion**

Apart from adding 32 branches of Ganesh Bank of Kurundwad, the bank added 20 new branches and 45 ATMs in this fiscal. This has taken the bank's total network to 524 branches and 368 ATMs spread over all important centres across 24 states in India. Further, the bank intends to open another 15 branches before March 31, 2007, of which, four are in Kerala and the rest outside the state.

\* **Operating expenses in line with balance-sheet growth**

Staff expenses increased by 16% Y-o-Y on the back of provisions of INR 150 mn due to revised AS-15 norms. Operating expenses, however, declined sequentially. We expect the operating expenses to increase by 19% in FY07E with network expansion.

\* **Improved asset quality**

Gross NPA ratio improved to 3.76% in December 2006 (from 4.13% in September 2006) and absolute gross NPA decreased to INR 5.28 bn in December 2006. Net NPA ratio improved to 0.58% in December 2006 from 0.67% in September 2006. We believe that the asset quality is in control, as bank improved its provision coverage from 82% in September 2006 to 84% in December 2006.

\* **Capital adequacy comfortable at 14.6%**

Capital adequacy, at 14.6% as on December 2006, seems sufficient to sustain the growth in loan book and comply with Basel II norms. The bank's plan to set up a life insurance company with Fortis and IDBI is likely to increase its capital requirements, going forward [(the bank holds 26% in the joint venture (JV)].

\* **Attractive valuations: 1.3x FY08E book**

The bank is showing continuous improvement in its fundamentals, which we believe would lead to re-rating in valuations. During last 24 months the stock has underperformed the banking index and broader market by 39% and 56% respectively. We believe that the stock is attractively valued at 1.3x FY08E book relative to its 18%+ RoE and M&A possibilities (post 2009). We maintain 'BUY'.

Financials snapshot						(INR mn)		
Year to March	Q3FY07	Q3FY06	Growth (%)	Q2FY07	Growth (%)	FY06	FY07E	FY08E
Interest on advances	3,200	2,371	35.0	3,010	6.3	9,160	12,525	16,047
Interest on investments	1,207	1,199	0.7	1,176	2.6	4,582	4,711	4,992
Interest on other resources	25	49	(49.3)	142	(82.5)	624	391	487
Interest income	4,441	3,625	22.5	4,337	2.4	14,365	17,628	21,526
Interest expenses	2,658	2,130	24.8	2,662	(0.2)	8,367	10,719	13,572
Net interest income	1,784	1,495	19.3	1,675	6.5	5,998	6,909	7,955
Fee income	545	482	13.0	726	(25.0)	2,354	2,369	2,027
Operating expenses	973	852	14.2	1,011	(3.7)	3,319	3,962	4,249
Staff expense	602	518	16.2	656	(8.2)	2,284	2,527	2,680
Other opex	371	334	11.1	355	4.6	1,036	1,435	1,569
Pre prov profit	1,355	1,125	20.5	1,390	(2.5)	5,033	5,315	5,733
Investment gains	90	18	411.4	330	(72.7)	355	500	50
Provisions	196	199	(1.6)	526	(62.7)	2,202	1,788	1,605
Loan loss provisions	197	51	289.3	376	(47.7)	956	1,068	1,082
Others	(1)	149	(100.5)	150	(100.5)	1,246	720	523
Profit before tax	1,159	926	25.2	864	34.2	2,831	3,528	4,127
Provision for tax	321	211	52.1	170	89.2	606	953	1,156
Profit after tax	838	715	17.3	695	20.7	2,225	2,575	2,972
EPS (INR)	9.8	10.9	(10.3)	8.1	20.7	26.0	30.1	34.7
<b>Ratios</b>								
NII / GII	40.2	41.2		38.6		41.8	39.2	37.0
Cost - income	40.2	42.7		37.0		38.1	40.5	42.4
Provisions / PPP	14.5	17.7		37.8		43.8	33.6	28.0
Tax rate	27.7	22.8		19.6		21.4	27.0	28.0

## Company description

Federal Bank is an old private sector bank based in Kerala. It has an asset base of over INR 200 bn, branch network of over 524 branches (80% branches in Kerala), and 368 ATMs. SME and retail lending are the bank's focus areas and constitute 34% and 30%, respectively, of its loan book. The bank's recent merger with Ganesh Bank has added 32 branches to its existing network, increasing its foothold in the western India. IFC Washington has ~8% equity holding in Federal bank.

## Investment rationale

SME and retail loans, which constitute a bulk of the bank's loan book, are likely to continue to lead its growth in future. Loan book is expected to grow at 22% CAGR over next three years through network expansion. With the implementation of core banking solutions (CBS) in FY07, we expect the bank's fee income to grow at 11% CAGR over the next two years. Federal Bank is well-positioned to grow its fee business due to its thick geographical presence in Kerala that is amongst the largest recipients of NRI remittances.

## Key risks

The bank's high dependence on the NRI segment (30% of its deposits come from NRI segment) exposes it to regulatory risks.

Execution risk of its transition to CBS platform.

## Financial Statements

<b>Income statement</b>					<b>(INR mn)</b>
<b>Year to March</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Interest income	11,910	14,365	17,628	21,526	25,841
Interest expenses	6,888	8,367	10,719	13,572	16,756
Net Interest income	5,023	5,998	6,909	7,955	9,085
Non interest income	2,241	2,354	2,369	2,027	2,281
- <i>Fee &amp; forex income</i>	957	1,121	1,233	1,376	1,537
- <i>Misc. income</i>	637	878	636	600	672
- <i>Investment profits</i>	647	355	500	50	72
Net revenues	7,263	8,352	9,278	9,981	11,366
Operating expense	3,139	3,319	3,962	4,249	4,757
- <i>Employee exp</i>	1,858	2,284	2,527	2,680	3,031
- <i>Other opex</i>	1,281	1,036	1,435	1,569	1,726
Preprovision profit	4,125	5,033	5,315	5,733	6,609
Provisions	2,941	2,202	1,788	1,605	1,649
- <i>Loan loss provisions</i>	1,358	956	1,068	1,082	1,274
- <i>Investment depreciation</i>	1,337	109	310	523	374
- <i>Other provisions</i>	246	1,137	410	0	0
PBT	1,184	2,831	3,528	4,127	4,960
Taxes	260	606	953	1,156	1,538
PAT	924	2,225	2,575	2,972	3,423
Reported PAT	924	2,225	2,575	2,972	3,423
EPS	14.1	26.0	30.1	34.7	40.0
DPS	2.5	3.5	3.5	4.0	4.5
Payout ratio (%)	17.7	13.5	11.6	11.5	11.3

<b>Growth ratios (%)</b>					
<b>Year to March</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Nil growth	19.1	19.4	15.2	15.1	14.2
Fees growth	16.1	17.2	10.0	11.6	11.6
Opex growth	10.9	5.8	19.4	7.2	12.0
PPOP growth	29.9	34.5	2.9	18.0	15.0
PPP growth	(6.7)	22.0	5.6	7.9	15.3
Provisions growth	29.8	(25.1)	(18.8)	(10.2)	2.7
PAT growth	(34.3)	140.7	15.8	15.4	15.2

<b>Operating ratios (%)</b>					
<b>Year to March</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Yield on advances	9.4	8.9	9.4	9.7	9.9
Yield on investments	6.8	7.7	7.7	7.7	7.8
Yield on assets	7.8	8.0	8.4	8.9	9.0
Net interest margins	3.3	3.3	3.3	3.3	3.2
Cost of funds	4.5	4.7	5.3	5.9	6.2
Cost of deposits	4.6	4.8	5.3	5.9	6.2
Cost of borrowings	6.7	5.9	6.6	7.6	7.6
Spread	4.8	4.1	4.0	3.8	3.7
Cost-income	43.2	39.7	42.7	42.6	41.9
Tax rate	21.9	21.4	27.0	28.0	31.0

**Balance sheet**

Year to March	FY05	FY06	FY07E	FY08E	FY09E
<b>Liabilities</b>					
Equity capital	656	856	856	856	856
Reserves	6,578	11,644	13,889	16,483	19,482
<b>Net worth</b>	<b>7,234</b>	<b>12,429</b>	<b>14,674</b>	<b>17,269</b>	<b>20,267</b>
Sub bonds/pref cap	2,700	2,700	3,700	3,700	3,700
Deposits	151,929	178,787	198,552	234,660	277,160
Borrowings	1,859	6,105	6,780	8,013	9,464
Other liabilities	4,800	6,337	2,024	2,392	2,825
<b>Total</b>	<b>168,521</b>	<b>206,429</b>	<b>225,800</b>	<b>266,104</b>	<b>313,487</b>
<b>Assets</b>					
Loans	88,226	117,365	150,227	180,272	212,721
Investments					
<i>Gilts</i>	<i>50,846</i>	<i>56,879</i>	<i>54,223</i>	<i>61,103</i>	<i>72,153</i>
<i>Others</i>	<i>7,146</i>	<i>5,845</i>	<i>7,242</i>	<i>8,488</i>	<i>9,863</i>
Cash & equi	15,559	18,725	11,044	13,052	15,416
Fixed assets	1,854	1,739	1,187	931	675
Other assets	4,890	5,877	1,877	2,218	2,620
<b>Total</b>	<b>168,521</b>	<b>206,429</b>	<b>225,800</b>	<b>266,066</b>	<b>313,449</b>
<b>Balance sheet ratios</b>					
Credit growth	9.3	29.5	28.0	20.0	18.0
Deposit growth	12.7	17.7	11.1	18.2	18.1
EA growth	11.5	22.9	12.0	18.0	18.0
SLR ratio	33.1	30.8	27.3	26.0	26.0
C-D ratio	61.5	67.8	78.1	79.3	79.2
Low-cost deposits	24.5	25.0	27.0	27.3	27.6
Gross NPA ratio	7.4	4.6	3.4	3.2	3.2
Net NPA ratio	2.2	1.0	0.6	0.4	0.4
Provision coverage	80.2	82.3	71.4	57.7	44.4
Incremental slippage	2.4	2.1	1.8	2.0	2.2
Capital adequacy	11.3	13.8	12.0	11.1	10.9
- Tier 1	6.4	9.7	9.9	9.5	9.5

**Ratios**

Year to March	FY05	FY06	FY07E	FY08E	FY09E
<b>ROA decomposition (%)</b>					
Net interest income/Assets	3.3	3.3	3.3	3.3	3.2
Fees/Assets	1.0	1.1	0.9	0.8	0.8
Investment profits/Assets	0.4	0.2	0.2	0.0	0.0
Net revenues/Assets	4.7	4.6	4.4	4.1	4.0
Operating expense/Assets	(2.0)	(1.8)	(1.9)	(1.7)	(1.7)
Provisions/Assets	(1.9)	(1.2)	(0.8)	(0.7)	(0.6)
Taxes/Assets	(0.2)	(0.3)	(0.5)	(0.5)	(0.5)
Total costs/Assets	(4.1)	(3.4)	(3.2)	(2.9)	(2.8)
ROA	0.6	1.2	1.2	1.2	1.2
Equity/Assets	4.5	5.5	6.4	6.6	6.5
ROE	13.5	22.6	19.0	18.6	18.2

**Valuation metrics**

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS	14.1	26.0	30.1	34.7	40.0
<i>EPS growth (%)</i>	<i>(78.2)</i>	<i>84.5</i>	<i>15.8</i>	<i>15.4</i>	<i>15.2</i>
Book value per share	110.3	145.2	171.4	201.7	236.8
Adjusted book value/share	89.5	136.1	163.7	195.9	230.2
Price/Earnings	18.0	9.7	8.4	7.3	6.3
Price/ BV	2.3	1.7	1.5	1.3	1.1
Price/ ABV	2.8	1.9	1.5	1.3	1.1
Dividend yield (%)	<i>1.0</i>	<i>1.4</i>	<i>1.4</i>	<i>1.6</i>	<i>1.8</i>
Price to income	5.8	7.1	6.6	6.1	5.5
Price to PPOP	4.8	4.6	4.5	3.8	3.3

**Edelweiss Securities**

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<b>Buy</b>	Expected to appreciate more than 20% over a 12-month period	<b>Reduce</b>	Expected to depreciate up to 10% over a 12-month period
<b>Accumulate</b>	Expected to appreciate up to 20% over a 12-month period	<b>Sell</b>	Expected to depreciate more than 10% over a 12-month period
<b>Trading Buy</b>	Expected to appreciate more than 10% over a 45-day period	<b>Trading Sell</b>	Expected to depreciate more than 10% over a 45-day period

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