Axis Bank

Emerging Star

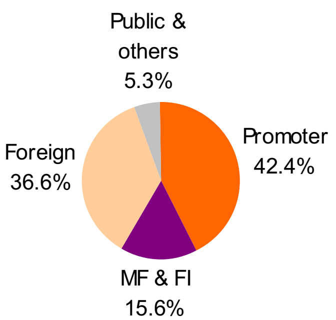
Stock Update

Court rules in favour of Axis Bank

Buy; CMP: Rs710

Company details	
Price target:	Rs901
Market cap:	Rs25,447 cr
52 week high/low:	Rs1,291/561
NSE volume: (No of shares)	21.3 lakh
BSE code:	532215
NSE code:	AXISBANK
Sharekhan code:	AXISBANK
Free float: (No of shares)	20.6 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-3.3	-6.5	-14.8	10.0
Relative to Sensex	-2.0	-3.3	-9.9	13.3

Favourable ruling for Axis Bank in forex lawsuit

A Ludhiana district court has ruled the foreign exchange (forex) derivative lawsuit involving Axis Bank and Nahar Industrial in favour of the former. The ruling implies that Axis Bank can now proceed with the recovery of dues from Nahar Industrial. The verdict favouring Axis Bank is also a positive development for many other banks that are facing multiple similar lawsuits in courts across India.

Background

Earlier this year, many private banks (including Axis Bank, ICICI Bank, HDFC Bank, Kotak Mahindra Bank and Yes Bank) had been dragged to various courts by their mid-size corporate clients alleging "mis-selling" of exotic forex derivatives. The exotic forex contracts (largely involving Swiss Franc [CHF] and Japanese Yen [JPY]) had been structured to maximise the benefit of low interest costs. However, the structure created significant exposure if CHF and JPY breached their historical levels--considered a low probability event then. Consequently, when the CHF and JPY actually breached their historical levels, the clients suffered huge losses. Eventually, we saw a string of lawsuits being filed against banks with clients obtaining a stay on the recovery of dues by the banks.

Bank	Aggrieved clients
ICICI Bank	Sundaram Multi Pap., Garg Acrylite, NC Sugars, Sabare International
Axis Bank	Nahar Industrial, Rajhshree Sugars
HDFC Bank	Himatsingka Siede,
Kotak Mahindra Bank	Precot Meridian, Sundaram Brake Linings

Legal arguments

Since the surfacing of the forex derivative trouble, both banks and their corporate clients have claimed to have a strong case. Corporates have alleged that banks have been selling complex derivatives without disclosing the risks involved. Some corporates have also been arguing that the derivative contracts are *void ab initio*

Key financials

Particular	FY06	FY07	FY08	FY09E	FY10E
Net profit (Rs cr)	485.1	659.0	1071.0	1371.7	1768.6
Shares in issue (cr)	27.9	28.2	35.8	35.8	35.8
EPS (Rs)	17.4	23.4	29.9	38.3	49.4
EPS growth (%)	42.4	34.4	28.0	28.1	28.9
PE (x)	40.8	30.3	23.7	18.5	14.4
P/PPP (x)	19.9	15.8	11.4	8.6	6.7
Book value (Rs/share)	103.1	120.5	245.1	274.5	312.3
P/BV (x)	6.9	5.9	2.9	2.6	2.3
Adj book value (Rs/share)	95.2	111.0	238.2	259.2	290.2
P/ABV (x)	7.5	6.4	3.0	2.7	2.4
RoNW (%)	18.2	20.9	16.4	14.8	16.9

(illegal since entered), as the contracts do not merit to be derivative contracts and that the contracts are wagers or speculatory in nature, which is considered illegal under the Indian Contracts Act (except if traded on exchange). On the other hand, banks hold that they are protected by the terms of agreements duly entered into by their corporate clients. It is important to note that the Reserve Bank of India (RBI) puts the onus on banks to ensure that a client enters into a derivative contract for genuine business needs and not for speculation.

RBI's stance

Considering the gravity of the matter, RBI had issued revised guidelines on off-balance sheet exposures. Under the revised guidelines, the RBI has nearly doubled the risk weight on the exchange rate contracts. Besides that, marked-to market losses on derivative contracts would be treated as loans and attract provisioning (akin to standard assets). Also, unpaid derivative transactions would be categorised as non-performing assets (NPAs) and attract suitable provisioning requirements. These guidelines imply a higher provisioning requirement for banks as they generally enter into back-to-back derivative contracts to hedge themselves against the exposures arising from selling derivative contracts to their corporate clients.

Impact analysis

End of forex derivative problem?

The ruling in favour of Axis Bank raises a pertinent question: Will all the other banks facing similar lawsuits get a favorable judgment? It seems it is too early to arrive at such a conclusion owing to two reasons: One, the nature of forex contract agreements vary across banks; and two, clients may decide to appeal the judgment in the higher courts. Effectively, we will need to watch out for the outcome of each lawsuit.

Financial implications

Axis Bank had provided Rs72 crore during Q4FY2008 for potential default losses from its aggrieved customers. Any recovery of dues from Nahar industrial will add to the bank's bottom line. While the amount is not significant for Axis Bank, the favorable ruling should help improve sentiments towards the stock a bit.

Conclusion

We do not expect the ruling to have any significant impact on the financials of Axis Bank and hence maintain our estimates. At the current market price of Rs710, Axis Bank trades at 18.5x its FY2009E earnings per share (EPS), 8.6x its FY2009E pre-provisioning profit (PPP) and 2.6x its FY2009E book value. We maintain our Buy recommendation on the stock with a price target of Rs901.

The author doesn't hold any investment in any of the companies mentioned in the article.