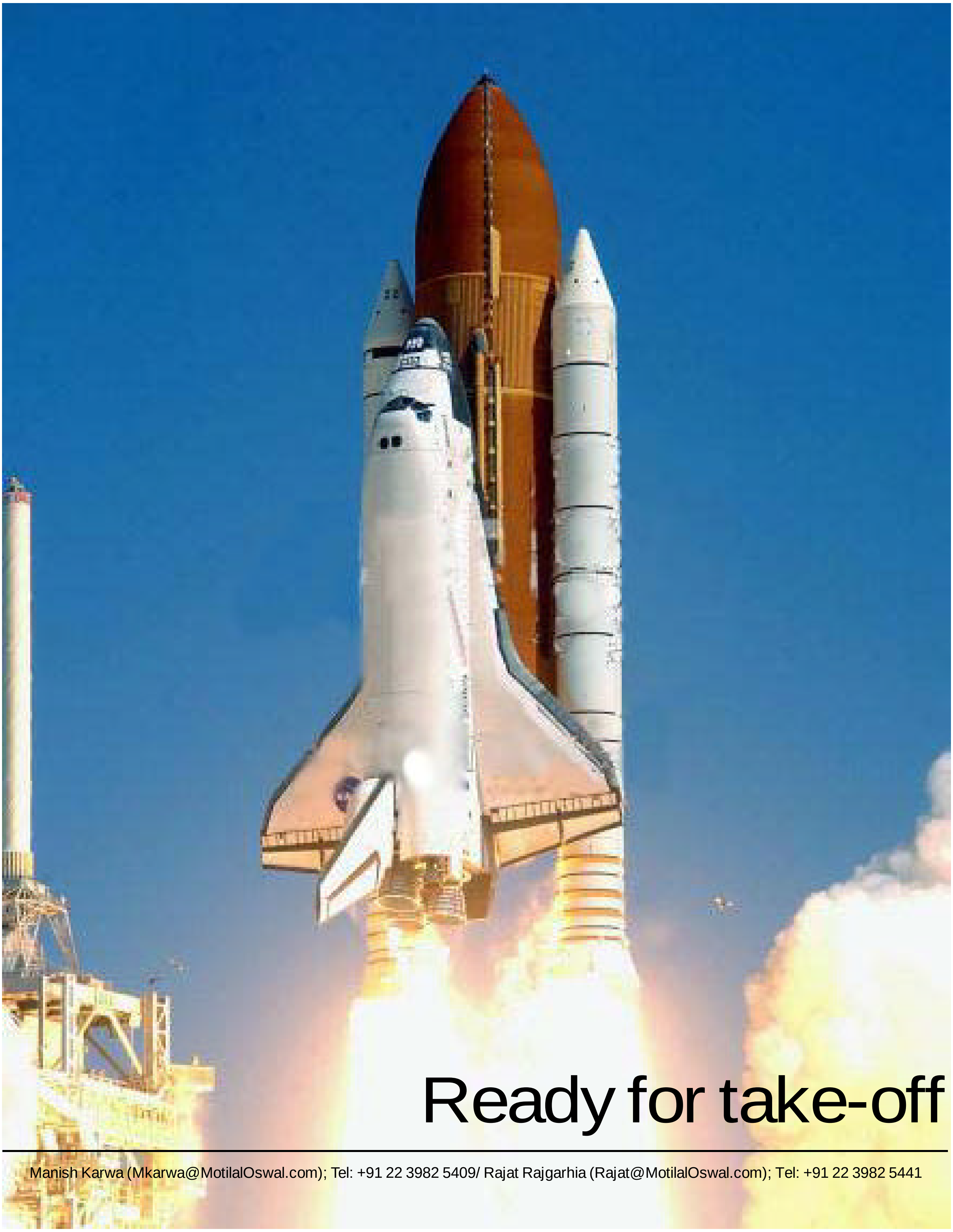
Detailed Report

SECTOR: BANKING

Federal Bank



Ready for take-off

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Federal Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,631	FB IN
	REUTERS CODE
S&P CNX: 3,942	FED.BO

11 January 2007

Buy

Initiating Coverage

Rs237

RS BILLION	2005	2006	2007E	2008E
NII (Rs b)	5.0	6.0	6.8	7.9
OP (Rs b)	4.0	4.5	5.3	6.2
NP (Rs b)	0.9	2.3	2.8	3.3
EPS (Rs)	13.7	26.3	32.3	38.2
EPS Growth (%)	-78.1	91.6	22.9	18.2
BV/Share (Rs)	110.3	145.6	173.5	206.2
P/E (x)	17.3	9.0	7.3	6.2
P/BV (x)	2.2	1.6	1.4	1.2
ABV (Rs)	91.0	137.2	169.3	204.7
P/ABV (x)	2.6	1.7	1.4	1.2
RoE (%)	13.1	22.9	20.3	20.1
ROA (%)	0.6	1.2	1.2	1.3

KEY FINANCIALS	
Shares Outstanding (m)	85.8
Market Cap. (Rs b)	20.4
Market Cap. (US$ b)	0.5
Past 3 yrs Operating Income Growth (%)	8.8
Past 3 yrs NP Growth (%)	29.1
Dividend Payout (%)	13.3
Dividend Yield (%)	18.8
P/E to Growth (x)	3.7

STOCK DATA	
52-W High/Low Range (Rs)	241/137
Major Shareholders	(%)
Domestic Institutions	8.8
Foreign	62.9
Public	28.4
Average Daily Turnover	
Volume ('000 shares)	417.6
Value (Rs million)	81.5
1/6/12 Month Rel. Performance (%)	11/11/-13
1/6/12 Month Abs. Performance (%)	13/39/33

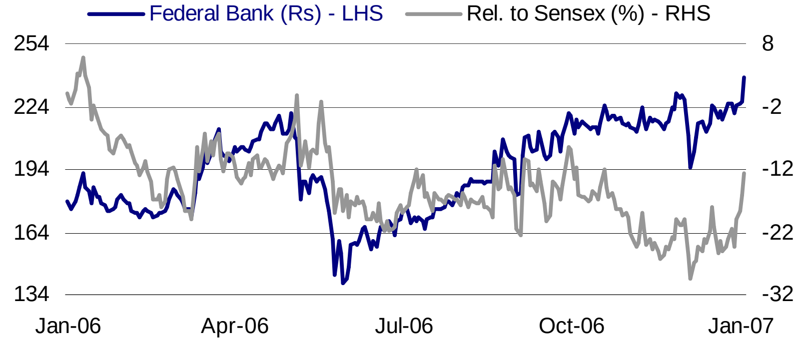
Federal Bank is the largest old-generation private sector bank, with dominance in the southern and western parts of India. It is a mid-sized bank, with a network of 532 branches and a balance sheet size of Rs240b (FY07E). Federal Bank offers a strong play on stable margins, clean asset book, strong recoveries and sector consolidation.

Investment highlights:

- Expect earnings CAGR of 20% over FY06-08, on back of stable margins and steady balance sheet growth
- Recoveries could provide signficant upsides
- Sector consolidation can act as a re-rating trigger
- Valuations at 1.2x FY08E BV, with 20% RoE are attractive

While core earnings growth remains strong, we believe that reported profits can see further upsides in case of higher recoveries. With consolidation in the sector gaining pace amongst private sector banks, we believe Federal Bank offers value at current levels. The stock has underperformed in the last 12 months and we believe that valuations are very attractive. The stock is trading at 6x FY08E earnings and 1.2x FY08E book value. Based on the bank's sustainable RoE of >20%, we believe that the stock could trade at 1.6x FY08E adjusted book value. As earnings momentum remains strong, we believe the stock is ready for take-off as there lie several catalysts ahead. We recommend **Buy** with a 12-month target price of Rs330 (upside of 39%). Key risks to our positive stance would be any deterioration in asset quality or slowdown in NRI deposits.

STOCK PERFORMANCE (1 YEAR)



Expect earnings CAGR of 20% (FY06-08)

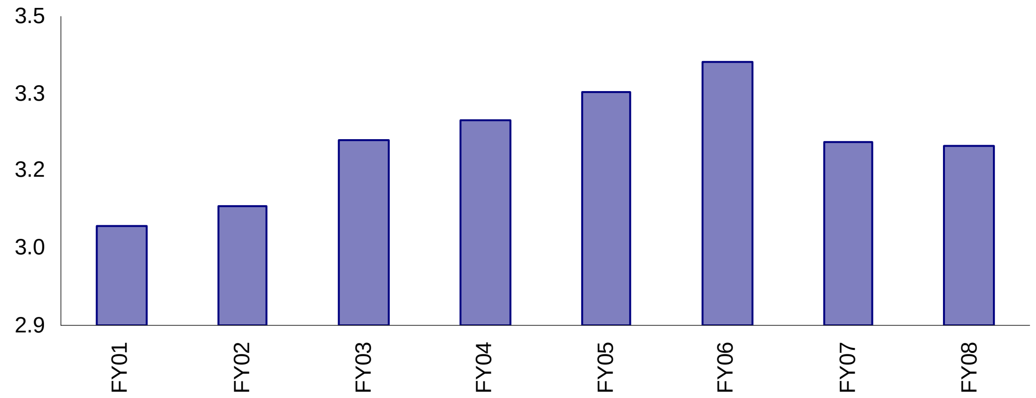
We believe that stable margins, coupled with steady balance sheet growth and decline in cost to income ratios will drive core earnings for Federal Bank. We expect earnings growth of 21% in FY07, followed by 20% growth in FY08. Our estimates can see further upside in the event of stronger recoveries. Upside from recoveries could be significant. We initiate coverage with a **Buy** rating and a target price of 330 (1.6x FY08E BV).

Margins to be maintained in a challenging environment

The bank will likely maintain healthy margins in a competitive scenario

Federal Bank witnessed margin improvement in FY05 and FY06 on the back of deposit repricing and a rise in credit/deposit ratio. With deposit costs now on a rise, we expect margins to be maintained in a range of 3-3.2% (margins in 2QFY07 were 3.2%). The bank has raised its PLR to counter the rising deposit costs (raised PLR by 25bp to 12.5% in January 2007). We believe with the larger banks willing to raise lending rates, Federal Bank will also raise rates to prevent any threat to its margins.

TREND IN NIMS (%)



Source: Company/ Motilal Oswal Securities

NRI deposits — the key differentiator for Federal Bank

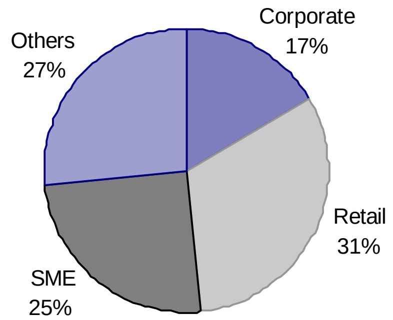
NRI deposits – the key differentiator: NRI deposits constitute nearly 31% of the bank's total deposits. Most depositors are members of the Keralite community who are working in the Gulf region. Consequently, Federal Bank, which has been servicing them since the last 70 years, enjoys the trust of this NRI community.

These NRI deposits have not only been a stable source of funds for the bank but profitable as well. The average blended cost for NRI funds currently is close to 5% while the bank earns a gross spread of nearly 3% on these deposits. As interest rates on NRI deposits are regulated, there is no rate war in garnering these deposits. We believe that service levels, positioning within depositors and presence in a particular region is key for garnering such deposits. The bank has remittance arrangements with 18 exchange houses and 8 banks in the Gulf region.

The bank intends to increase its share of SME loans

Focus on SMEs: Loan growth is diversified with the retail, corporate and infrastructure segments growing the fastest. Currently the bank classifies loans of higher than Rs100m as corporate loans which constitute 32% of its book, whilst retail loans constitute 27%. Other loans, primarily SME constitute 46%. Management intends to increase its SME loans ratio, as incremental yields in this segment are 150bp higher versus corporate loans and 80bp-90bp higher versus pure retail loans. In the current scenario, the bank has been able to raise interest rates and protect its margins at 3-3.2%

BREAK-UP OF LOAN BOOK (%)



Souorce: Company/ Motilal Oswal Securities

Excess SLR of Rs6b

The bank has Rs6b of additional SLR securities, which it can use for funding its loans. Its SLR as a percentage of NDTL is 29%. As lending yields are ~300bp higher, it can shift its additional SLR to fund loans. Alternatively, it need not put funds into SLR and maintain a high incremental C/D ratio. Its incremental C/D ratio for FY06 was 108% and for 1HFY07, it was 119%. Thus the additional SLR would provide a cushion against any margin dips.

Fee income — core focus area

Fee-based income is the core focus area

Federal Bank has begun to utilize its distribution network to distribute insurance policies, mutual funds, credit cards etc. It has tied up with a host of players for bill collection, which has helped the bank increase its fee income as well as float income. Since the bank's strengths includes its NRI clientele base, it is one of the prominent players of foreign exchange operations and has been witnessing strong growth in this area in recent years.

Over the last four years, fee-based income has been increasing at 15% CAGR. We expect this growth to further accelerate (CAGR of 20%) over the next three years, on the back of management's increased thrust on generating fee-based income. Fee income has been constant at 0.9% of the bank's average assets over the last 2-3 years. Going forward, we expect fee income to move at a faster pace versus asset accretion, which should help Federal Bank improve its RoE.

The bank is keenly widening its product range

Federal Bank has entered into alliances with various entities for distribution of third party products like insurance and mutual funds by leveraging its client base of over 4m customers. It also offers various merchant banking services, such as depository and other capital market-related services. We believe expansion of its geographical footprint would support Federal Bank's growth over the next three to four years.

PRODUCT OFFERINGS

Life Insurance product	Marketing ICICI Prudential's Life Insurance product (largest player in the private life insurance market)
Non- Life Product	Marketing United Insurance's product (One of the four large state owned players in non life market)
Debit Card	Strong client base of around 0.7m
Distribution of Third Party products	Arrangement with 12 MF's, contribution to revenues growing fast

Source: Company / Motilal Oswal Securities

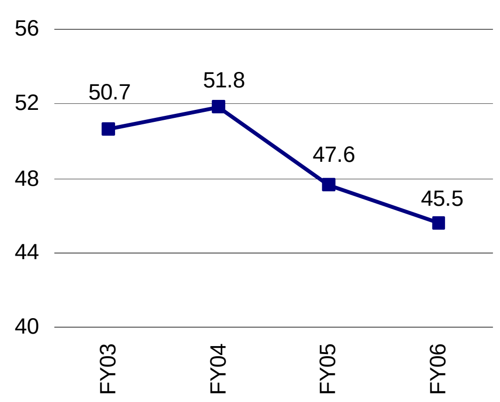
Cost/ Income ratio on a declining trend

Cost/ Income ratio is on a decline

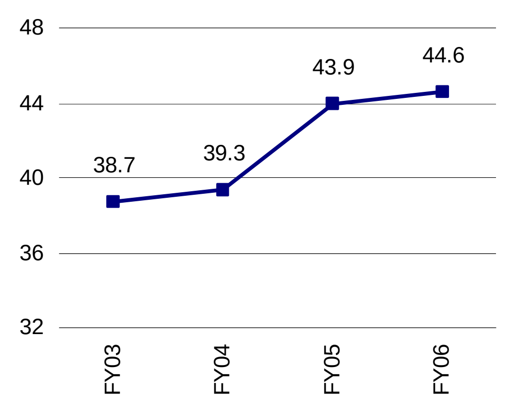
Federal Bank has been conservative with regard to making provisions for future contingencies. The bank has already provided for all employee wage arrears. During 2QFY07, it provided a sum of Rs150m as pension liabilities and is hence totally AS-15 complaint. Further, it has provided Rs200m toward VRS expenditure (180 employees opting for VRS). As the bank has provided for pension liabilities fully until date, it does not foresee any incremental provisioning in this area going forward.

Thus, going forward, while the bank continues to witness steady growth on the core income front, growth in non-operating costs is likely to be minimal. Additionally, from FY07, owing to staff retirements and VRS implementation, we expect employees' cost to grow at a slower pace.

COST/ INCOME RATIO, EXL. TRADING GAINS (%)



COST / INCOME (EXCL. TRADING GAINS) (%)



Source: Company/ Motilal Oswal Securities

Opex to be slow paced

Employee expenses in control, we expect opex to be slow paced

With employee expenses likely to grow at a normalized rate of 8-10% coupled with normal increase in other expenses, we expect overall operating expenses to grow at slower rates. We expect opex to grow at 12% CAGR over the next three years.

VRS implemented in FY07: Federal Bank implemented its VRS in 1HFY07, wherein about 180 employees opted for VRS. The total cost of Rs200m for this expense has already been charged in 2QFY07. Almost all the employees who accepted VRS were above 50 years of age. Further, management expects several more of the older employees to retire over the next few years; they are likely to be replaced by younger employees. Even as we believe that Federal Bank might replace most of these employees, the cost of replacement is likely to be significantly lower versus the average cost-to-company of the retiring employee. We expect substantial cost savings in terms of employees' cost from FY07 onwards.

With regard to non-wage expenses, the bank has taken care to computerize 100% of its branch network and already has 100% networking in place. In the circumstance, incremental cost for non-wage expenses will arise only if the bank should set up newer branches, ATMs and the CBS platform. We have assumed an increase of 15%-17% in non-wage expenses over FY07 and FY08.

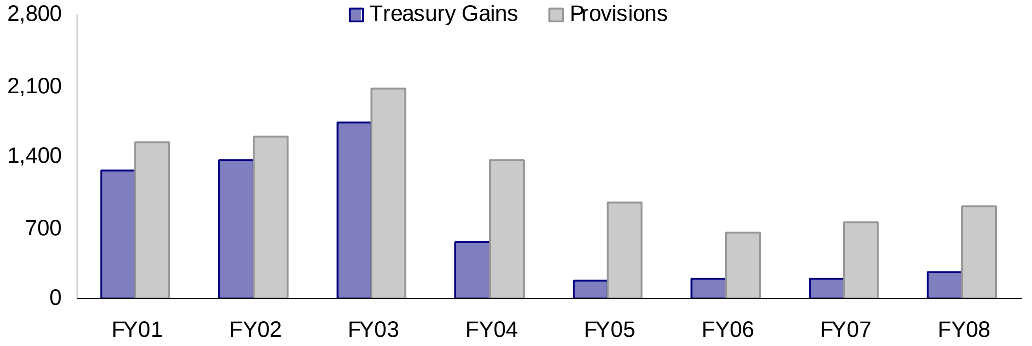
Lower the treasury profits .... lower will be the provisioning

We expect lower treasury profits ahead

In line with the overall interest rate movement, we expect lower treasury profits for Federal Bank going forward. We expect treasury profits to decline from 39% of the operating profit in FY04 to a mere 5% by FY07. Thus core income is expected to drive growth from hereon and reliance on treasury gains would reduce significantly.

However, Federal Bank has utilized treasury gains over the last three years to make aggressive provisioning. With net NPA ratios at 0.7% at the end of September 2006 and lower delinquency ratio, we do not expect any need for making large provisioning. Thus, we expect the incidence of provisioning to reduce going forward.

TREASURY GAINS & PROVISIONS DONE OVER THE LAST 3 YEARS

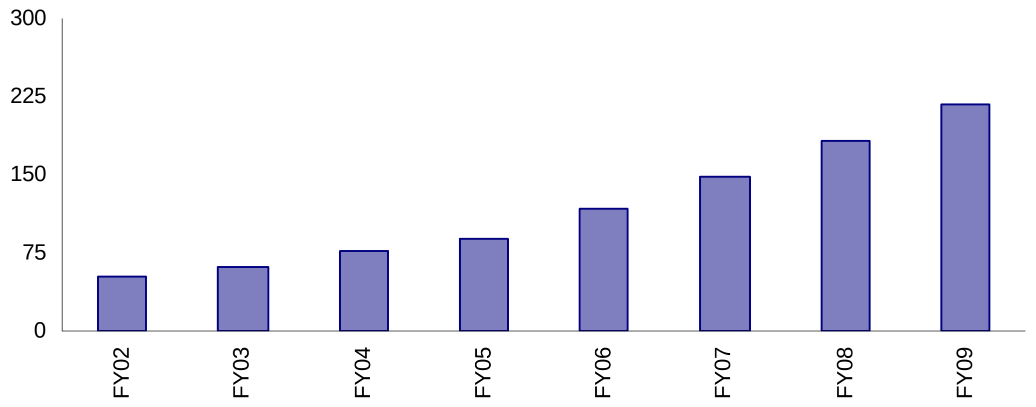


Source: Company/ Motilal Oswal Securities

Balance sheet to grow at a consistent pace

Federal Bank has been consistent in its balance sheet growth rates over the last few years. Between FY01-FY06 (CAGR), the bank has witnessed growth of 18% in deposits and 19% growth in advances.

TREND IN LOAN BOOK (RS M)



Source: Company/ Motilal Oswal Securities

Balance sheet growth has been healthy over FY01-FY06

The bank continues to focus on raising deposits and uses the excess SLR to fund its loan growth. Management expects advances to increase by 30%, and deposits to increase by 20% in FY07. The bank has about 4.5% (Rs6b) excess SLR on its books, which it has been using to grow its loan book. We expect an incremental C/D ratio of 110% for the bank in FY07, with the overall C/D ratio increasing to 71%.

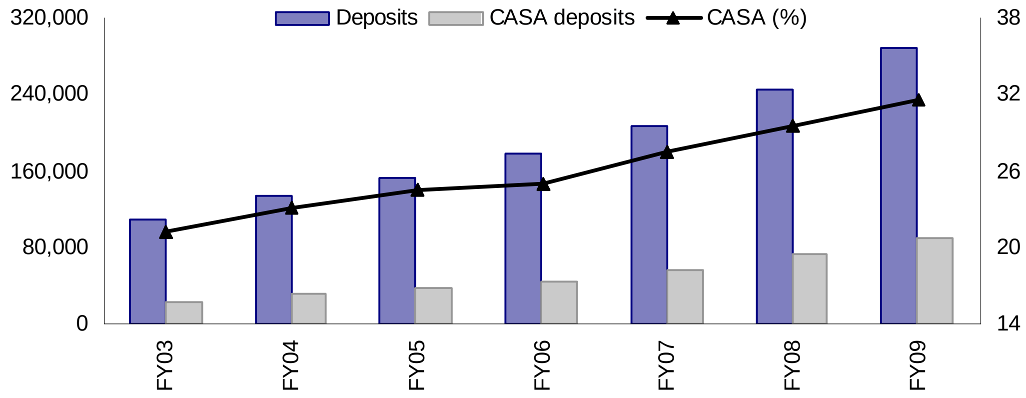
The bank is also focused on growing its agricultural loans and expects to achieve its target of 18% loans to this segment. To achieve this, the bank has been targeting plantation companies, self help groups and reputed NGOs. According to management, the risk of NPAs in Kerala is lower, as land value is relatively higher in Kerala and thereby land, as a security, incorporates greater value.

Deposits too witness a steady trend – CASA growing faster

CASA deposits have shown steady and strong growth

Federal Bank has been able to grow its deposit base consistently — at a CAGR of 18% over FY01-FY06. On the back of increased and aggressive marketing efforts by management and putting in place the required technology, CASA deposits have recorded a strong pace of growth at 22% CAGR over FY02-FY06. CASA deposits, in percentage terms, have increased from 21% in FY03 to 25% in FY05 and 26% currently (September 2006). Management aims to grow its CASA deposit base to 35% by FY09.

TREND IN DEPOSITS AND CASA DEPOSITS (RS M)



Source: Company/ Motilal Oswal Securities

Investment book – well protected

Federal Bank has already transferred a major portion of its SLR book to HTM in 1QFY07 and has thus protected its portfolio from losses. Currently it has nearly 60% of its SLR holdings in the HTM portfolio. Further on the remaining AFS portfolio, the bank has a cushion of 25bp. However, AFS duration is 3.6 years and the overall duration is 5.6 years.

Loans and core income will drive the bank's revenues

The bank had already taken a hit of Rs700m in 1QFY07 on account of transfer to the HTM basket and due to fall in its equity investments. With incremental C/D ratio expected to be in excess of 100% in FY07, we believe that loan book and core income to drive revenue growth for the bank, rather than treasury income being at center stage.

INVESTMENT BOOK PROFILE

	RS. M	% TO THE TOTAL BOOK	DURATION (YRS)
AFS	2,200	40	3.6
HTM	3,300	60	
Total SLR book	**5,500**		**5.6**

Source: Company/ Motilal Oswal Securities

Core earnings to witness steady growth

NII should witness 12% growth in FY07 and 16% growth in FY08

On back of a robust growth in advances coupled with steady margins, we expect net interest income to witness growth of 12% and 16% in FY07 and FY08. We expect a drop in treasury income in line with the industry trend, even as fee income growth is expected to grow at 20% over the FY06-FY08 period. The drop in treasury income is likely to be compensated by a declining trend in provisioning going forward as net NPAs are already below 0.7% by September 2006. On the contrary, higher-than-expected recoveries out of its gross and written off NPAs could provide significant upside.

DUPONT ANALYSIS

FEDERAL BANK	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E
Net interest income/avg assets (%)	3.0	3.1	3.1	3.2	3.0	3.0	3.0
Fee income/avg assets (%)	0.9	0.9	1.0	1.1	1.0	1.0	0.9
Treasury Income/ avg assets (%)	1.2	1.3	0.3	0.1	0.1	0.1	0.1
Total revenue/avg assets (%)	5.1	5.3	4.5	4.4	4.2	4.1	4.0
Operating costs/ income (%)	38.7	39.3	43.9	44.6	43.1	41.7	39.5
Operating costs/ avg assets (%)	2.0	2.1	2.0	1.9	1.8	1.7	1.6
-Emp Costs/ avg assets (%)	1.2	1.3	1.2	1.2	1.1	1.0	0.9
-Other Exp / avg Assets (%)	0.7	0.8	0.8	0.7	0.7	0.7	0.7
Pre-provision profits/ avg assets (%)	3.1	3.2	2.5	2.4	2.4	2.4	2.4
Loan-loss-provisions/avg assets (%)	1.4	1.5	0.9	0.5	0.3	0.3	0.3
Other provisions/avg assets (%)	0.1	0.1	0.9	0.4	0.4	0.3	0.4
Tax/avg assets (%)	0.6	0.5	0.2	0.3	0.4	0.5	0.5
ROAA (%)	0.9	1.0	0.6	1.2	1.2	1.3	1.3
Leverage (x)	22.8	23.2	23.3	19.0	16.3	16.0	15.9
ROAE (%)	21.5	23.1	13.1	22.9	20.3	20.1	20.2

Source: Company/ Motilal Oswal Securities

One-offs in 2QFY07, expect strong earnings traction ahead

One-time expenses are unlikely in future quarters

During 2QFY07, the bank had been impacted by various one-time expenses, which are unlikely to recur in future quarters. The bank had taken a big hit on account of VRS expenses of Rs210m. Further it provided Rs153m towards AS-15 (the management claims to be fully complaint with AS-15). Also, the bank had excessively provided Rs241m towards contingency requirements. It also had gains of Rs250m on account of the Bharat Overseas Bank stake sale.

Recoveries could be substantial

Gross NPAs at Rs5.4b; 80% have collaterals: We expect strong recoveries to continue, even though provisioning could be lower going forward. As of September 2006, the bank has Rs5.4b of gross NPAs, which are bound by collateral securities besides primary security, the value of which is nearly 80%. In most cases, the security is real estate, which has appreciated significantly over the last 2-3 years and thus the probability of recoveries is high.

Written-off accounts at Rs5b: Federal Bank over the years, have been prudential in writing off bad loans. Currently it has ~Rs5b of written-off accounts (mainly in NBFCs and SMEs). Management expects to recover at least 20% of written-off accounts plus the accrued interest.

In fact, once an account is classified as an NPA/written-off, a bank does not accrue any interest in its books. However it continues to accumulate interest along with penalty on the asset. Thus recovery could be robust for Federal Bank. Over the last couple of years, the bank has recovered Rs1.5b out of interest recoveries alone. The management is optimistic about the overall recovery prospects of the bank. Even assuming a 7% interest charge on bad loans (total: Rs10.4b; i.e. Rs5.4b as gross NPAs and Rs5b as written-off accounts), Federal Bank is charging (Rs0.7b annually) in the suspense account, which is not shown in the books.

HUGE RECOVERIES EXPECTED

	(AMT RS.B)	EXP RECOVERY (%)	RECOVERY
Gross NPAs (as of Sep-06)	5.4	80	4.3
Written off accounts	5.0	20	1.0
			5.3
Additional Recovery from Int (assumed)			1.5
Total expected Recovery (over next 3 years)			6.8
Expected aggregate profits (FY07-09)			9.7

Source: Company/ Motilal Oswal Securities

Recovery potential is substantial; recoveries also offer positive surprises

In our projections, we are factoring in modest recoveries going forward (Rs0.6m-Rs0.8m annually). However, the recovery potential is substantial and we believe recoveries offer positive surprises.

Systems put in place to check fresh delinquencies

Federal Bank has succeeded in containing NPAs and improving asset quality. Historically, the bank's NPAs were high and were mainly in the steel and the NBFC sectors. During FY01 gross NPAs stood at Rs6.4b (12.8%) and net NPAs amounted to Rs4.9b (10.1%).

Since, management has focused primarily on containing fresh slippages and recovering bad loans. It has put in place an extremely rigid credit appraisal mechanism owing to which over the last 36 months, incremental delinquencies have been contained to a large extent.

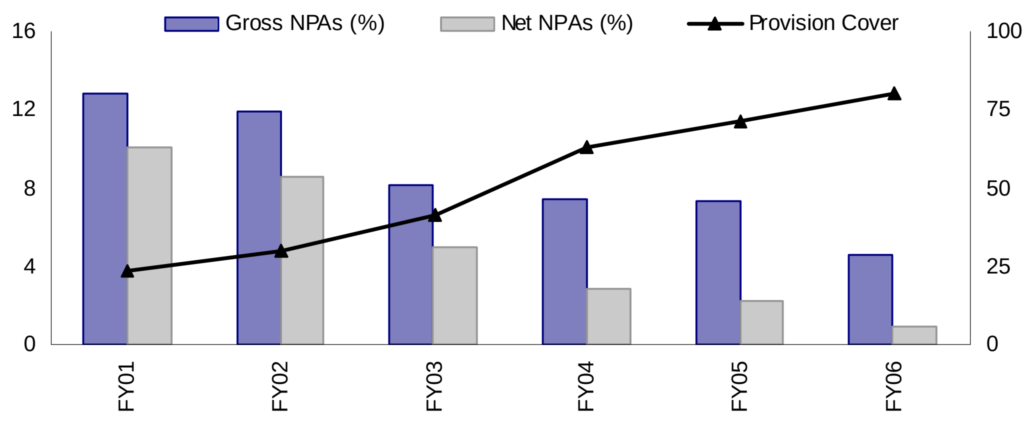
Further, of the loans disbursed over the past 12 months, we note, delinquencies are negligible. A majority of the bad loans, mainly in the steel and NBFC sectors, have been written off fully. Over the last three years, the bank has resorted to substantial provisioning, in lieu of strong treasury gains booked. Thus, net NPAs have declined to Rs1.1b (1.4%) as at March 2006. They have further reduced to Rs0.8b (0.7%) as on September 2006. The provision cover has also shot up to 82% as on September 2006.

The bank has consciously put several systems in place over 2 years

Systems the bank has put in place in the last 24 months:

- All funded and non-funded exposure exceeding Rs0.2m will have to be internally rated both at the time of sanction and renewals
- Pricing of loans disbursed based on credit rating devised by the bank on a scientific basis
- Migration studies conducted for credit exposure of Rs50m and above
- Quarterly review mechanism of bank's risk profile put in place

TREND IN GROSS AND NET NPA



Source: Company/ Motilal Oswal Securities

Sector consolidation — key re-rating catalyst

Intention to acquire other banks

We believe Federal Bank is amongst the best candidates for any consolidation in the sector. Management's stated plans of being open to any acquisitions in order to attain scale are well known. Currently Federal Bank has a branch network of 532 (including Ganesh Bank of Kurundwad, Maharashtra) branches and 270 ATMs. It already has a presence in the top 80 banking centers in India.

Acquisition of Ganesh Bank of Kurundwad

Acquisition of Ganesh Bank in line with Federal Bank's strategy

Federal Bank acquired Ganesh Bank of Kurundwad in FY07. The main attraction was the 32 branches of Ganesh Bank, concentrated in Sangli and the Konkan belt of the state of Maharashtra (Federal Bank had 20 branches in Maharashtra earlier). The branches of Ganesh Bank make a good fit, in line with the bank's growth strategy. The acquisition would result in a greater thrust to the bank's policy of increased agricultural and SME advances. The merger will help Federal Bank step up its agriculture and retail portfolio. Whilst the bank did not incur any cost for the acquisition, it had to take over the net liabilities of Ganesh Bank (Rs80m).

Could emerge as a key takeover target

Federal Bank could be a key takeover target

On the contrary, we also believe that Federal Bank could emerge as a key takeover target by the MNC banks whenever the government allows this. In our opinion, the bank offers scale (relative to other 'traditional' private sector banks), stable asset quality and superior technology. While we agree that most of the government banks and traditional private sector banks have their share of efficiency and staffing issues, they do have a strong deposit franchise in India by virtue of their wide distribution network

Wide distribution franchisee network

Federal Bank's has a franchisee network of 520 branches (December 2006), which is mainly concentrated in Kerala. This apart, it has a reasonable network of branches in Maharashtra, Tamil Nadu, Karnataka, Delhi, West Bengal, etc. Further, all the branches being fully computerised and networked. It has the largest branch network, compared with other old generation private sector banks.

BRANCH NETWORK OF THE BANK IN TERMS OF STATE (DEC-06)

Kerala	346	Second largest after State Bank of Travancore
Maharashtra	47	Includes 32 branches of Ganesh Bank
Tamil Nadu	31	Present in important locations
Karnataka	24	Present in important locations
West Bengal	12	Present mainly in Kolkatta
Delhi	13	
Others	47	
Total	**532**	

Source: Company/ Motilal Oswal Securities

Expanding its branch network

Federal Bank is consistently growing its branch network. Post acquisition of Ganesh Bank, Kurundwad, in Maharashtra, it now has 520 branches, which are likely to increase to 532 branches by March 2007. Thereafter management intends to open 35-40 branches each year. The bank aims to expand in the western, central and northern regions of India.

Rapid technology implementation

Significant investments have gone into setting up technologically advanced systems

Over the past 3-4 years, Federal Bank has made significant investments in technology. It was the first 'traditional' private sector bank to computerize all its branches and amongst the first bank (across all banks) to implement Real Time Gross Settlement (RTGS) in all branches. At present, all of Federal Bank's branches are networked and offer 'Anywhere Banking' facilities to its customers. This has given Federal Bank an edge over other banks in terms of customer satisfaction, service quality and efficiency. In fact, we believe this investment in technology has helped the bank to sustain strong growth over the last four years.

The bank is also implementing core banking solutions (CBS) that would help integrate all its branches on to a common centralized platform (it currently uses internally developed distributed branch software) over the next 6-12 months. This could improve its competitive advantage and operational efficiency. The whole CBS implementation is expected to be complete by September 2007 and the bank is likely to spend merely Rs160m in this effort. Since the bank has already networked its branches, implementation of the CBS platform could occur rapidly. Further the bank intends to improve its delivery channels by setting up additional ATMs and enter into ATM sharing arrangements with more banks.

We expect the bank to continually invest in technology, given its focus on retaining technology as a competitive advantage. We believe this edge should enable the bank to gain share as it expands to reaches in southern India, particularly in the area of fees, retail lending and acquisition of liability customers.

Valuations –attractive versus takeover deals

Valuations are very attractive

The sector benchmark for bank acquisitions has been in the range of 20%-25% of deposit franchisees. Even in the Indian context, OBC (Oriental Bank of Commerce) had taken over GTB (Global Trust Bank) at 25% of its franchisee value. Currently, Federal Bank's market capitalization is just 9% of its FY07E deposit franchisee. In terms of deposit franchisee, it is one of the cheapest stocks in its universe.

Federal Bank's market capitalization as a percentage of the aggregate balance sheet size is one of the lowest in the Indian banking sector. This is in spite of the bank having a highly sophisticated technological platform, superior quality of advances, robust margins and growing fee-based income. An acquisition could result in a significant re-rating of the stock, owing to unlocking of value of its distribution network and customer franchise. A strategic investment by a foreign bank could also boost the growth trajectory, further driving a case for re-rating.

MARKET CAP/ DEPOSITS OF VARIOUS BANK(%)

STATE OWNED BANKS	MCAP/DEP-% (FY06)
State Bank of India	15.7
Corporation Bank	13.9
Punjab National Bank	12.9
Andhra Bank	12.2
Indian Overseas Bank	11.8
Oriental Bank of Commerce	10.7
Bank of India	9.9
Canara Bank	9.2
Bank of Baroda	8.9
Union Bank (I)	8.3
Vijaya Bank	7.4
Private Sector - New Generation	
Kotak Mahindra Bank	200.9
Yes Bank	130.9
HDFC Bank	56.4
ICICI Bank	47.8
Centurion Bank	47.0
UTI Bank	32.4
Private Sector - Old Generation	
Karur Vysya Bank	18.1
Karnataka Bank	13.2
Federal Bank	10.8

Source: Company/ Motilal Oswal Securities

Valuation

Trades at 1.2x FY08E BV, 20% RoE; Buy

We believe that at 1.2xFY08E book value and 6x FY08E EPS, the bank offers reasonable valuation upside from current levels. Based on its FY07 ROE of ~20%, we believe that the stock could trade at 1.6x FY08E book value. We recommend **Buy** with an 18-month price target of Rs330 (upside of 39%).

COMPARATIVE VALUATIONS (FY08E)

	FEDERAL	KARNATAKA	KARUR VYSYA	ANDHRA	VIJAYA
CMP (Rs)	237	144	260	86	48
Equity (Rs m)	858	1,213	540	4,850	4,335
Net Worth (Rs m)	17,696	14,532	11,460	36,977	21,935
Mkt Cap (Rs m)	20,377	17,460	14,013	41,880	20,700
Net Profit (Rs m)	3,279	2,320	1,800	6,518	3,992
Growth Rate (%)	*18.2*	*15.4*	*15.5*	*15.5*	*24.6*
EPS (Rs)	38.2	19.1	33.4	13.4	9.2
Growth Rate (%)	*18.2*	*15.4*	*15.5*	*15.5*	*24.6*
Bookvalue (Rs)	206.2	119.8	212.3	76.2	50.6
ABV for NPAs (Rs)	204.7	116.6	208.5	75.2	47.8
ROE (%)	20.1	17.0	16.5	18.7	19.5
ROA (%)	1.3	1.3	1.6	1.3	1.0
Net NPA (%)	0.1	0.5	0.4	0.2	0.7
Cost to Income Ratio (%)	42	39	45	48	45
P/E (x)	6.2	7.5	7.8	6.4	5.2
P/Book (x)	1.2	1.2	1.2	1.1	0.9
P/ Ad. Book (x)	1.2	1.2	1.2	1.1	1.0

Source: Motilal Oswal Securities

Well capitalized to sustain its growth

Currently the total capital adequacy of Federal Bank is 12%, with Tier I of 9.5%. Given the healthy ROE of ~20%, the bank is unlikely to have any constraints on capital front over the next couple of fiscals.

2% dividend yield attractive

The stock offers a dividend yield of 2% at current levels. Over the last 3 years, the bank's payout has been in the range of 12-18%. With the bank sufficiently capitalized and earnings streams likely to be robust, there is a possibility of the payout increasing.

Earnings progression to remain strong; initiate coverage with Buy rating

We believe that a steady growth in balance sheet, coupled with sustained margins and lower provisioning requirement will drive earnings for the bank going forward. We expect earnings growth of 21% in FY07, followed by a growth of 20% in FY08. We initiate coverage with a **Buy** rating and a target price of Rs330 (1.6xFY08E BV)

Concerns

Tax on NRI deposits could slow down deposit growth

About 30% of the deposits arise from NRIs (mainly Keralites working in the Gulf). There have been media reports about the returns on these deposits being taxed at source. Should this occur, it could slow down the flow of these deposits. However, in the last couple of fiscals, the finance minister has not opted for such measures; we too do not anticipate any changes for NRI deposits in the forthcoming budget this fiscal.

Delinquency could increase in case of an economic slowdown

Federal Bank has higher exposure to the SME and retail segments (60% of its advances). While we expect these segments to generate higher margins for the bank, we believe that in the event of an economic slowdown, it could have a negative effect on the bank's asset quality. This is as delinquencies in this segment could rise at the fastest rate. However, given our current outlook on the economy, we do not foresee such a situation to arise at least for the next 2-3 years.

Company background and description

Federal Bank is a mid-sized Kerala-based bank, with balance sheet size of Rs240b (FY07E). The bank has a network of 519 branches and more than 250 ATMs with dominance in the state of Kerala. Over the past four years (FY02-FY06), its balance sheet has grown at a CAGR of 19% while profits have grown at 45% CAGR between FY02-FY06. Also, during this period, the bank has been able to lower its net NPAs from 10% in FY01 to 0.7% as on September 2006.

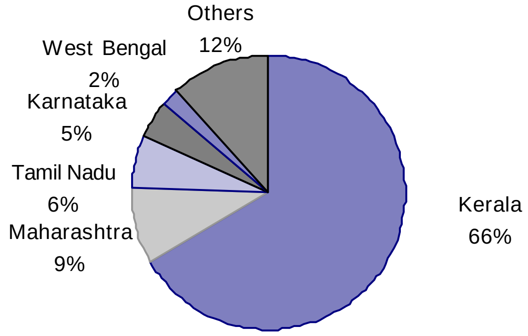
The bank is one of the fast growing private sector banks with strong technology focus. However, the current valuations also do justify the same. Amongst our universe, the bank is the cheapest on the parameter of market cap/deposit basis.

Historical background

Incorporated in 1931 as Travancore Federal Bank by a small group of local citizens, the Federal Bank acquired its present name in 1949. It is one of the older private sector banks and has a steady client network in Kerala. The operations of the bank were confined to Kerala until 1972, after which, the bank expanded operations to all metropolitan centers. During the same year, it was authorized to deal in foreign exchange. Its merchant banking operations have been active since 1989.

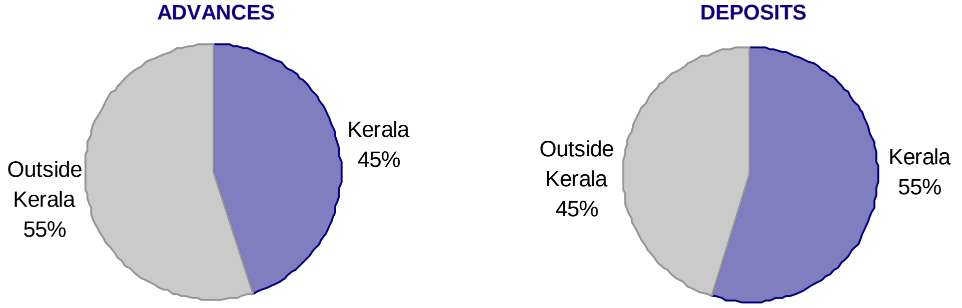
Apart from the traditional business of banking, the bank caters particularly to a large number of NRIs. Its thrust areas are corporate finance, merchant banking and export finance. The bank's strength is the household sector. Another significant segment is that of NRIs, which contributes about 32% of the total deposits. The bank had a strategic alliance with ICICI and I-Sec, apart from a large shareholder base, which includes its employees also. It tapped the capital market with a highly successful public issue in March 1994, followed by a successful rights issue in 1996. Recently, the bank also introduced a GDR issue, which was also highly successful among international investors.

BRANCH NETWORK OF THE BANK IN TERMS OF STATE (DEC-06))



Source: Company/ Motilal Oswal Securities

BUSINESS OF THE BANK



Source: Company/ Motilal Oswal Securities

Management structure

Federal Bank is headed by experienced bankers such as Mr. Venugopalan (Chairman and CEO) and Mr. K. S. Harshan (ED). Mr. Venugopalan (Chairman and CEO from May 2005) has over 40 years of experience in various streams of banking. Prior to joining Federal Bank, he was the CMD of Bank of India.

Mr. Harshan (ED from November 2004) was the General Manager at ICICI Bank and has varied experience of more than 30 years in the banking industry.

Federal Bank's Tier II management predominantly comprises employees who have over three decades of experience at the bank, handling banking operations across all regions in India. The combination of a competent top management and age-old employees, ingrains a sense of professionalism in the management team that maintains its control over grassroot realities.

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2004	2005	2006	2007E	2008E	2009E
Interest Income	11,921	11,910	14,371	17,024	20,421	25,200
Interest Expended	7,703	6,888	8,367	10,234	12,544	15,852
Net Interest Income	**4,218**	**5,023**	**6,004**	**6,790**	**7,877**	**9,347**
Change (%)	*24.4*	*19.1*	*19.5*	*13.1*	*16.0*	*18.7*
Other Income	2,979	2,120	2,169	2,489	2,765	3,034
-Fee income	1,245	1,571	2,000	2,289	2,565	2,784
-Treasury Income	1,733	548	169	200	200	250
Net Income	**7,196**	**7,143**	**8,173**	**9,279**	**10,642**	**12,382**
Change (%)	*25.5*	*-0.7*	*14.4*	*13.5*	*14.7*	*16.3*
Operating Expenses	2,829	3,139	3,646	4,003	4,438	4,887
- Employee Expenses	1,782	1,858	2,284	2,460	2,690	2,856
- Other Exp	1,046	1,281	1,362	1,543	1,748	2,032
Operating Income	**4,367**	**4,004**	**4,528**	**5,276**	**6,204**	**7,495**
Change (%)	*24.3*	*-8.3*	*13.1*	*16.5*	*17.6*	*20.8*
Other Provisions	2,254	2,843	1,672	1,625	1,650	2,050
-NPA provisions	2,080	1,359	956	650	750	900
-Other provisions	175	1,485	716	975	900	1,150
PBT	**2,113**	**1,161**	**2,856**	**3,651**	**4,554**	**5,445**
Tax	750	260	598	876	1,275	1,524
Tax Rate (%)	*35.5*	*22.4*	*20.9*	*24.0*	*28.0*	*28.0*
PAT	**1,363**	**901**	**2,258**	**2,775**	**3,279**	**3,920**
Change (%)	*29.8*	*-33.9*	*150.7*	*22.9*	*18.2*	*19.5*
Proposed Dividend	172	164	300	386	472	558

E: MOSt Estimates

BALANCE SHEET						(RS MILLION)
Y/E MARCH	2004	2005	2006	2007E	2008E	2009E
Capital	218	656	858	858	858	858
Reserves & Surplus	6,271	6,577	11,642	14,031	16,838	20,200
Net Worth	**6,488**	**7,233**	**12,501**	**14,889**	**17,696**	**21,059**
Deposits	134,767	151,929	178,787	207,393	244,724	288,774
Change (%)	*23.1*	*12.7*	*17.7*	*16.0*	*18.0*	*18.0*
-Savings Deposits	24,118	28,647	35,342	43,553	55,063	69,306
-Current Deposits	7,002	8,611	9,383	13,481	17,131	21,658
-Term Deposits	103,646	114,671	134,063	150,360	172,530	197,810
Borrowings	5,017	4,559	8,804	10,124	11,643	14,554
Other Liabilities & Prov.	4,870	4,488	6,337	6,970	7,667	8,434
Total Liabilities	**151,143**	**168,209**	**206,428**	**239,377**	**281,730**	**332,820**
Current Assets	12,916	15,559	18,725	15,367	16,042	18,737
Investments	55,074	57,992	62,724	67,741	73,161	87,793
Change (%)	*21.0*	*5.3*	*8.2*	*8.0*	*8.0*	*20.0*
Advances	77,005	88,226	117,365	147,879	183,370	216,377
Change (%)	*23.9*	*14.6*	*33.0*	*26.0*	*24.0*	*18.0*
Net Fixed Assets	**1,757**	**1,855**	**1,739**	**2,043**	**2,302**	**2,511**
Other Assets	4,390	4,578	5,877	6,347	6,855	7,403
Total Assets	**151,143**	**168,209**	**206,428**	**239,377**	**281,730**	**332,820**

ASSUMPTIONS						(%)
Y/E MARCH	2004	2005	2006	2007E	2008E	2009E
Deposit Growth	23.1	12.7	17.7	16.0	18.0	18.0
Advances Growth	23.9	14.6	33.0	26.0	24.0	18.0
Investments Growth	21.0	5.3	8.2	8.0	8.0	20.0
Dividend	79.0	25.1	34.9	45.0	55.0	65.0

E: MOSt Estimates

RATIOS

Y/E MARCH	2004	2005	2006	2007E	2008E	2009E
Spreads Analysis (%)						
Avg. Yield - Earning Assets	9.2	7.8	8.0	8.1	8.4	8.7
Avg. Cost-Int. Bear. Liab.	6.2	4.6	4.9	5.1	5.3	5.7
Interest Spread	3.0	3.2	3.2	3.0	3.1	3.0
Net Interest Margin	3.2	3.3	3.4	3.2	3.2	3.2
Profitability Ratios (%)						
RoE	23.1	13.1	22.9	20.3	20.1	20.2
RoA	1.0	0.6	1.2	1.2	1.3	1.3
Int. Expended/Int.Earned	64.6	57.8	58.2	60.1	61.4	62.9
Other Inc./Net Income	41.4	29.7	26.5	26.8	26.0	24.5
Efficiency Ratios (%)						
Op. Exps./Net Income	39.3	43.9	44.6	43.1	41.7	39.5
Empl. Cost/Op. Exps.	63.0	59.2	62.6	61.5	60.6	58.4
Busi. per Empl. (Rs m)	30.1	34.9	40.8	49.0	58.3	68.6
NP per Empl. (Rs lac)	2.1	1.4	3.4	4.2	4.9	5.8
Asset-Liability Profile (%)						
Adv./Deposit Ratio	57.1	58.1	65.6	71.3	74.9	74.9
Invest./Deposit Ratio	40.9	38.2	35.1	32.7	29.9	30.4
G-Sec/Invest. Ratio	81.5	87.7	90.7	70.9	65.6	54.7
Gross NPAs to Adv.	7.4	7.3	4.6	3.3	2.8	2.7
Net NPAs to Adv.	2.9	2.2	1.0	0.4	0.1	0.1
CAR	11.5	11.3	13.8	12.0	12.0	11.0
Tier 1	6.3	6.4	9.7	9.5	9.0	8.5

VALUATION

Book Value (Rs)	99.4	110.3	145.6	173.5	206.2	245.3
Price-BV (x)	0.8	2.1	1.6	1.4	1.1	1.0
Adjusted BV (Rs)	77.2	91.0	137.2	169.3	204.7	244.2
Price-ABV (x)	1.0	2.6	1.7	1.4	1.2	1.0
EPS (Rs)	20.9	13.7	26.3	32.3	38.2	45.7
EPS Growth (%)	*-56.8*	*-34.3*	*91.6*	*22.9*	*18.2*	*19.5*
OPS (Rs)	66.9	61.0	52.7	61.5	72.3	87.3
OPS Growth (%)	-58.7	-8.8	-13.6	16.5	17.6	20.8
Price-OPS (x)	3.5	3.9	4.5	3.9	3.3	2.7

E: MOSt Estimates

N O T E S

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1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No