

Raise PO to capture rising positives; Buy

Raise earnings and PO to capture rising positives

We raise PO on Fed Bk to Rs575 to capture the increase in our EPS estimates (+1%/4% for FY11/12 respectively) post their strong 2Q operational results. We estimate earnings growth of +34/40% in FY11/12 driven by margins sustaining at +3.8-3.9% and credit costs falling to <100bps by FY12 (vs. ~160bps in FY11E). After our recent upgrade (see- [Federal Bank, 18 October 2010](#)), we are growing confident of Fed Bk's ability to deliver on return ratios (RoA's to ~1.5% vs 1.1% in FY10 and RoEs to +15.5% by FY12 vs. ~10% in FY10). Hence, we believe the stock can trade up to +1.7-1.8x FY12 book. Preferred mid-cap pick.

2Q11: reported earnings miss est.; but core +10% ahead

While Fed Bk reported earnings of Rs1.4bn, 39% yoy growth, they were +5-6% below est. on higher provisions (pension costs and investments). But operating level earnings were strong (10% ahead) driven by topline (margins). Fed Bk's loan growth down to 7% yoy as bank is in consolidation phase. Topline (3% ahead) grew 33% yoy on expanding margins (up 74bps yoy to 4.4%). Fee growth muted (5% yoy growth), but other income was +30% ahead on higher cash recoveries.

NPL rise stemmed; Mgmt. confident of further improvement

Headline gross NPLs rose by 5% qoq, but net down 7%; coverage at +82% (+92% incl. w/o's). What is comforting is that net NPL formation (net of recoveries and upgradation) also declined qoq to Rs1.3bn (vs. Rs2.3bn in 1Q); +75% from SME and retail. Further, mgmt. also guiding for qoq decline ahead vs. earlier high formation level sustaining. We are estimating net formation to decline in 2HFY11 (factoring in higher recoveries / upgrades in 2H) to +Rs2.8bn vs. Rs3.6bn in 1H.

Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	5,005	4,645	6,081	8,598	11,039
EPS	29.26	27.16	35.55	50.27	64.55
EPS Change (YoY)	2.0%	-7.2%	30.9%	41.4%	28.4%
Dividend / Share	5.00	5.00	6.50	9.00	11.75
Pre-exceptional EPS	29.26	27.16	35.55	50.27	64.55
Pre-exceptional EPS Change (YoY)	137.0%	-7.2%	30.9%	41.4%	28.4%
Book Value / Share	248.94	266.71	287.00	328.59	382.37

Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	16.8x	18.0x	13.8x	9.8x	7.6x
Dividend Yield	1.02%	1.02%	1.33%	1.84%	2.40%
Pre-exceptional PE	16.75x	18.05x	13.79x	9.75x	7.59x
Price / Book	1.94x	1.79x	1.62x	1.43x	1.24x
RoE / PB	6.26x	5.76x	7.61x	10.90x	14.09x
Price / Pre-Provision Profit	6.66x	6.63x	5.42x	4.75x	4.04x

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Stock Data

Price	Rs490.20
Price Objective	Rs575.00
Date Established	1-Nov-2010
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs218.00-Rs495.00
Mkt Val / Shares Out (mn)	US\$1,887 / 171.0
Average Daily Volume	1,008,376
BofAML Ticker / Exchange	XFDRF / BSE
Bloomberg / Reuters	FB IN / FED.BO
ROE (2011E)	12.3%
Total Dbt to Cap (Mar-2010A)	NA
Est. 5-Yr EPS / DPS Growth	25.0% / 25.0%
Free Float	74.0%

Key Changes

(Rs)	Previous	Current
Price Obj.	525.00	575.00
2011E EPS	35.14	35.55
2012E EPS	48.57	50.27
2013E EPS	63.52	64.55

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Refer to important disclosures on page 6 to 8. Analyst Certification on Page 4. Price Objective Basis/Risk on page 4. Link to Definitions on page 4. 10988834

*iQprofile*SM Federal Bank

Key Income Statement Data (Mar)

(Rs Millions)	2009A	2010A	2011E	2012E	2013E
Net Interest Income	13,155	14,108	18,019	21,243	25,326
Net Fee Income	1,013	1,050	1,260	1,537	1,875
Securities Gains / (Losses)	829.92	1,080	684.22	635.51	635.51
Other Income	3,315	3,179	3,701	4,127	4,780
Total Non-Interest Income	5,158	5,309	5,645	6,300	7,291
Total Operating Income	18,312	19,417	23,664	27,543	32,617
Operating Expenses	(5,715)	(6,769)	(8,188)	(9,894)	(11,866)
Pre-Provision Profit	12,598	12,648	15,476	17,649	20,751
Provisions Expense	(3,542)	(4,131)	(5,164)	(3,615)	(3,073)
Operating Profit	9,056	8,517	10,312	14,034	17,678
Non-Operating Income	(1,126)	78.10	(1,237)	(1,201)	(1,201)
Pre-Tax Income	7,930	8,595	9,075	12,833	16,477
Net Income to Comm S/Hold.	5,005	4,645	6,081	8,598	11,039
Adjusted Net Income (Operating)	5,005	4,645	6,081	8,598	11,039

Key Balance Sheet Data

Total Assets	388,509	436,756	509,656	613,410	749,592
Average Interest Earning Assets	345,243	400,442	460,093	547,217	665,588
Weighted Risk Assets	234,221	294,090	306,490	374,484	460,363
Total Gross Customer Loans	223,919	269,501	317,150	390,094	482,477
Total Customer Deposits	321,982	360,580	422,965	513,269	633,897
Tier 1 Capital	43,148	46,796	49,865	56,770	65,599
Tangible Equity	43,148	46,796	49,865	56,770	65,599
Common Shareholders' Equity	43,259	46,904	51,762	58,667	67,496

Key Metrics

Net Interest Margin	3.81%	3.52%	3.92%	3.88%	3.81%
Tier 1 Ratio	18.4%	15.9%	16.3%	15.2%	14.2%
Effective Tax Rate	36.9%	46.0%	33.0%	33.0%	33.0%
Loan / Assets Ratio	57.6%	61.7%	62.2%	63.6%	64.4%
Loan / Deposit Ratio	69.5%	74.7%	75.0%	76.0%	76.1%
Oper Leverage (Inc Growth - Cost Growth)	23.1%	-12.4%	0.9%	-4.4%	-1.5%
Gearing (Assets / Equity)	9.0x	9.3x	9.8x	10.5x	11.1x
Tangible Common Equity / Assets	11.1%	10.7%	9.8%	9.3%	8.8%
Tangible Common Equity / WRAs	18.4%	15.9%	16.3%	15.2%	14.2%
Revenue Growth	45.0%	6.0%	21.9%	16.4%	18.4%
Operating Expense Growth	21.9%	18.5%	21.0%	20.8%	19.9%
Provisions Expense Growth	65.3%	16.6%	25.0%	-30.0%	-15.0%
Operating Revenue / Average Assets	5.1%	4.7%	5.0%	4.9%	4.8%
Operating Expenses / Average Assets	1.6%	1.6%	1.7%	1.8%	1.7%
Pre-Provision ROA	3.5%	3.1%	3.3%	3.1%	3.0%
ROA	1.40%	1.13%	1.28%	1.53%	1.62%
Pre-Provision ROE	30.5%	28.1%	31.4%	32.0%	32.9%
ROE	12.1%	10.3%	12.3%	15.6%	17.5%
RoTE	11.6%	9.9%	12.2%	15.1%	16.8%
RoWRAs	2.1%	1.6%	2.0%	2.3%	2.4%
Dividend Payout Ratio	20.0%	21.5%	20.1%	19.7%	20.0%
Efficiency Ratio (Cost / Income Ratio)	32.7%	36.9%	35.6%	36.8%	37.1%
Total Non-Interest Inc / Operating Inc	28%	27%	24%	23%	22%
Market-Related Revenue / Total Revenues	7.3%	7.9%	5.3%	4.8%	4.4%
Provisioning Burden as % of PPP	28.1%	32.7%	33.4%	20.5%	14.8%
NPLs plus Foreclosed Real Estate / Loans	2.6%	3.0%	4.0%	3.6%	3.1%
Loan Loss Reserves / NPLs	113.0%	102.0%	91.8%	96.2%	101.4%
Loan Loss Reserves / Total Loans	3.1%	3.2%	3.8%	3.6%	3.2%
Provisions Expense / Average Loans	1.7%	1.6%	1.7%	1.0%	0.7%

Other Metrics

Income / Employee	2.52	2.46	2.82	3.06	3.36
(Operating Expenses) / Employee	(0.787)	(0.857)	(0.975)	(1.10)	(1.22)
Pre-Provision Profit / Employee	1.74	1.60	1.84	1.96	2.14
Net Profit / Employee	0.690	0.588	0.724	0.956	1.14

Company Description

Federal Bank is a traditional private-sector bank with a 719-branch network and a dominant presence in the southern Indian state of Kerala. Relative to its traditional private-bank peers, Federal Bank offers its customers a better value proposition in terms of superior technology, a wider product range and a stronger network. It plans to become a regional player in the South by expanding its distribution network and acquiring some smaller banks.

Investment Thesis

We rate Fed Bk a Buy, owing to a strong presence in the South, an improving asset-quality profile and a strong capital base. Fed Bk is likely to deliver on growth, driven by strong SME relationships leading to higher-than-industry-average margins. Additionally, a focus on low-cost deposits should ensure margins sustaining at current levels.

Stock Data

Price to Book Value 1.6x

2QFY11 Result Summary

Table 1: 2QFY11 Result Snapshot

Income Statement	2Q10	2Q11	yoy grth	Remarks
Interest earned	9,011	9,783	9%	
- on Advances / Bills	7,080	7,722	9%	Growth in loan book down to 7% yoy as the bank remains in consolidation phase
- Income on investments	1,855	2,038	10%	
- on bal with RBI	71	15	-79%	
- Others	5	9	81%	
Interest Expended	5,711	5,400	-5%	CASA at 29% (up 350bps yoy); COD at 5.9% vs. 6.8% in 2QFY10
Net Interest Income	3,300	4,384	33%	NII growth on margin expansion (up 74bps yoy) to +4.4%
Other income	1,364	1,440	6%	
- Fees and commissions	1,074	1,299	21%	Core fee income growth surprise with +20% yoy growth
- Treasury gains	290	141	-51%	
Operating income	4,664	5,824	25%	
Employee expenses	898	1,208	35%	
Other Operating exp.	734	766	4%	New branch additions (77 branches yoy)
Total operating exp	1,631	1,974	21%	
Operating profit	3,032	3,850	27%	
Provisions	1,501	1,703	13%	Rs1.4bn towards NPLs, includes Rs160mn for pension provisions (taken through this line); Pension prov. est. at Rs1.5bn (5yr.)
- NPL Provisions	1,580	1,430	-10%	Provision cover of +82%, including w/o's at -92%. Gross NPLs rise 5% qoq but net down 7% qoq, net NPL formation down to Rs1.3bn (vs. Rs2.3bn in 1Q). Gross and net NPLs at 3.8% and 0.7%.
PBT	1,531	2,147	40%	
Provision for Tax	520	743	43%	
PAT	1,011	1,404	39%	6% below est. on higher provisions (partly pension related), but core earnings 10% ahead of estimates on topline
PPP, ex treasury	2742	3,709	35%	Core earnings (PPP, ex treasury) were 11% ahead of estimates

Source: BoFA Merrill Lynch Global Research Estimates

Price objective basis & risk

Federal Bank (XFDRF)

Our PO on Federal Bank is Rs575. We believe the bank can command a P/B multiple of +1.7x by FY12E, which is at a 30% premium to the Gordon model, owing to 1) higher earnings growth of +30/41% over FY11/12 vs. contraction / moderation over FY08-10, 2) upgrading risk-management systems, 3) changing loan profile that should drive RoAs to 1.5% and, 4) being well-capitalized for growth (Tier 1 at +16.0%). Risks stem from a higher-than-expected rise in NPLs.

Link to Definitions

Financials

Click [here](#) for definitions of commonly used terms.

Analyst Certification

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India - Financials Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
BUY				
	Canara Bank	CNRKF	CBK IN	Rajeev Varma
	Corporation Bank	XCRRF	CRPBK IN	Veekesh Gandhi
	Federal Bank	XFDRF	FB IN	Veekesh Gandhi
	HDFC	HGDF	HDFC IN	Rajeev Varma
	HDFC Bank	HDB	HDB US	Rajeev Varma
	HDFC Bank	XHDF	HDFCB IN	Rajeev Varma
	ICICI Bank	ICIJF	ICICB IN	Rajeev Varma
	ICICI Bank - A	IBN	IBN US	Rajeev Varma

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India - Financials Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
	IndiaBulls Financial Services	IBLFF	IBULL IN	Veekesh Gandhi
	Indian Bank	INDIF	INBK IN	Rajeev Varma
	Max India	XXMIF	MAX IN	Rajeev Varma
	ORBC	ORBCF	OBC IN	Rajeev Varma
	Power finance corporation Ltd	PWFEF	POWF IN	Veekesh Gandhi
	Punjab	PUJBF	PNB IN	Rajeev Varma
	Rural Electrification Corporation Ltd	XULEF	RECL IB	Veekesh Gandhi
	SBI	SBINF	SBIN IN	Rajeev Varma
	SBI -G	SBKFF	SBID LI	Rajeev Varma
	Shriram Transport Finance	SHTFF	SHTF IN	Veekesh Gandhi
	Yes Bank Ltd	YESBF	YES IN	Veekesh Gandhi
NEUTRAL				
	Axis Bank	XAXSF	AXSB IN	Rajeev Varma
	Axis Bank - GDR	XBKSF	AXB LI	Rajeev Varma
	Bank of Baroda	BKBAF	BOB IN	Rajeev Varma
	Bank of India	XDIIF	BOI IN	Rajeev Varma
UNDERPERFORM				
	IDBI	XDBIF	IDBI IN	Veekesh Gandhi
	Infrastruct Dev	IFDFF	IDFC IN	Rajeev Varma
	LIC Housing Finance, Ltd.	LHFLF	LICHF IN	Veekesh Gandhi
	Reliance Capital	RLCCF	RCAPT IN	Rajeev Varma
	Union Bank India	UBOIF	UNBK IN	Rajeev Varma

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	$\text{Net Debt} = \text{Total Debt, Less Cash \& Equivalents}$	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	$\text{Market Cap.} = \text{Current Share Price} * \text{Current Basic Shares}$
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales}$	
EV / EBITDA	$\text{Enterprise Value} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	Basic EBIT + Depreciation + Amortization

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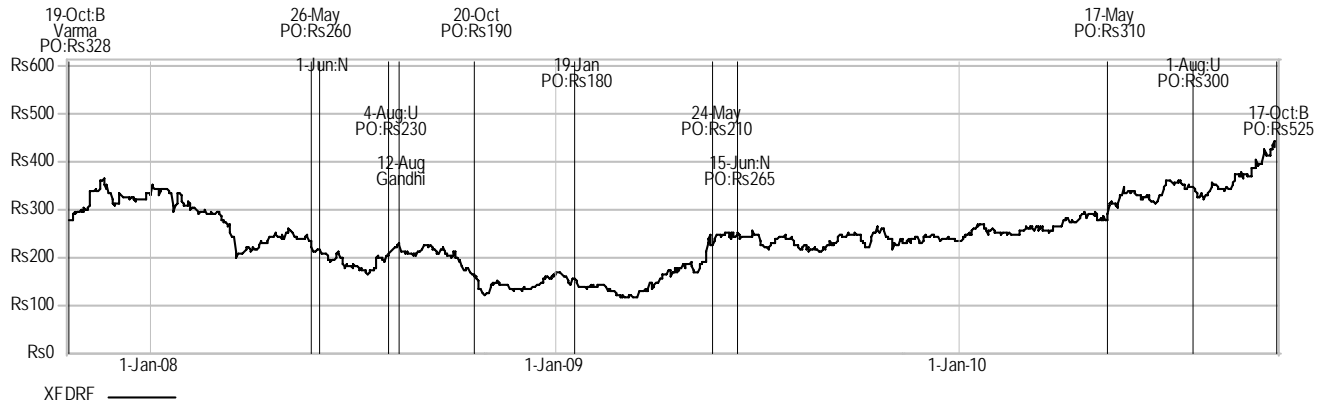
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XFDRF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR : No Rating

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Investment Rating Distribution: Banks Group (as of 01 Oct 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	123	52.56%	Buy	48	47.52%
Neutral	58	24.79%	Neutral	28	56.00%
Sell	53	22.65%	Sell	20	40.82%

Investment Rating Distribution: Global Group (as of 01 Oct 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1948	54.31%	Buy	821	46.73%
Neutral	891	24.84%	Neutral	397	49.07%
Sell	748	20.85%	Sell	259	37.16%

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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