Angel Securities
Institutional Investment Services

Initiating Coverage | Banking

March 5, 2010

Federal Bank

Value Buy

Federal Bank is an old, private sector bank with a large network of 669 branches, concentrated in semi-urban areas in the southern states. The Bank's strong Capital Adequacy, Operating Efficiency and technologically up-to-date network represent an attractive standalone franchise. The Bank's deposit base includes a niche, low-cost NRI deposit base that contributes a meaningful 16.5% of total deposits and gives it a distinguishing cost advantage over several of its peers. At the CMP, the stock is trading at attractive valuations of 0.8x FY2012E Adjusted Book Value (ABV) - similar to South Indian Bank, its closest peer, compared to a 5-year average premium of 15%. While lower leverage is leading to low RoEs at present, at the core RoA level, the bank's earnings quality is one of the best among peers. **We recommend a Buy, assigning a multiple of 1.0x FY2012E ABV to arrive at a 12-month Target Price of Rs342.**

Healthy Deposit Mix: Federal Bank's CASA deposits grew at a CAGR of 20.6% during FY2005-2009, leading to a stable 25% CASA ratio. Moreover, low-cost NRI deposits, a key differentiator, constitute 16.5% of the total deposits. Thus, effectively, low-cost deposits constitute 41% of the total, which is expected to underpin NIMs of about 3.3% in the next 2 years, even as the bank grows faster than the industry (23% credit growth in FY2011E) to leverage its large networth.

Concerns over Catholic Syrian Bank (CSB) and Dubai Crisis Overdone: The proposed CSB acquisition, which was partly responsible for the stock's underperformance during the last 11 months, is now unlikely to fructify, as the asking price substantially exceeds Federal Bank's assessment. The stock has also been an underperformer due to concerns over the impact of the Dubai Crisis on the bank's business model, which benefits from Middle-eastern NRI clients. However, as per the Management, the Bank has a very low direct loan exposure of about Rs350cr (1.3% of loan book) to NRIs dependent on Dubai. Hence, the impact of the crisis on asset quality is expected to be within manageable limits.

Key Financials

Y/E March (Rs cr)	FY2009	FY2010E	FY2011E	FY2012E
NII	**1,315**	**1,412**	**1,617**	**1,921**
% chg	*51.5*	*7.3*	*14.6*	*18.7*
Net Profit	**500**	**548**	**606**	**802**
% chg	*36.0*	*9.5*	*10.5*	*32.3*
NIM (%)	3.8	3.4	3.3	3.2
EPS (Rs)	**29.3**	**32.1**	**35.4**	**46.9**
P/E (x)	9.0	8.2	7.4	5.6
P/ABV (x)	1.0	0.9	0.9	0.8
RoA (%)	1.4	1.3	1.2	1.3
RoE (%)	12.4	12.3	12.1	14.4

Source: *Company, Angel Research*

BUY

CMP	Rs261
Target Price	Rs342
Investment Period	12 months

Stock Info	
Sector	Banking
Market Cap (Rs cr)	4,468
Beta	0.7
52 Week High / Low	288/116
Avg. Daily Volume	142588
Face Value (Rs)	10
BSE Sensex	16,994
Nifty	5,089
Reuters Code	FED.BO
Bloomberg Code	FB@IN

Shareholding Pattern (%)	
Promoters	0.0
MF / Banks / Indian FIs	37.0
FII / NRIs / OCBs	41.9
Indian Public / Others	21.1

Abs. (%)	3m	1yr	3yr
Sensex	(0.6)	107.3	36.9
Federal Bk	7.7	118.3	70.7

Vaibhav Agrawal
+91 22 4040 3800 Ext: 333
Email: vaibhav.agrawal@angeltrade.com

Amit Rane
+91 22 4040 3800 Ext: 326
Email: amit.rane@angeltrade.com

Investment Arguments

Healthy Deposit Mix

Federal Bank has access to low-cost NRI deposits due to its structural advantage of branch concentration in Kerala. Presently, out of the Total retail deposits, 28% are NRI deposits, and the low-cost NRI deposits constitute 16.5% of total deposits. Thus, effectively, the low-cost deposits as a proportion of total deposits for the bank stand at around 41% (CASA deposits of 25% + NRI Low-Cost deposits of 16.5%).

At present, out of the total deposits, 23% are Certificates of Deposit and Bulk deposits (those which are Rs5cr and above); these deposits command a lower cost than retail deposits. Although the CASA deposits grew by a CAGR of 20.6% during FY2005-2009, their proportion to total deposits remained stable at 25%. The YTD growth in CASA deposits stood at 13.4% in 9MFY2010. With the expected loan book growth at 4-5% above industry average, the bank's CASA ratio is expected to be under pressure, going forward. We expect the bank to grow its CASA deposits by 15% each for the next two years. However, low-cost NRI deposits at 16.5% of total deposits are expected to provide a cushion to the bank's NIMs. As per our estimates, the bank is expected to deliver an NIM in excess of 3.2%, going forward.

During FY2009, the bank had the highest spread (Yield on Average Interest Earning Assets - Cost of Funds) among its peers, of 3.6%, on the back of its advantage of one of the lowest cost of funds (refer to exhibit).

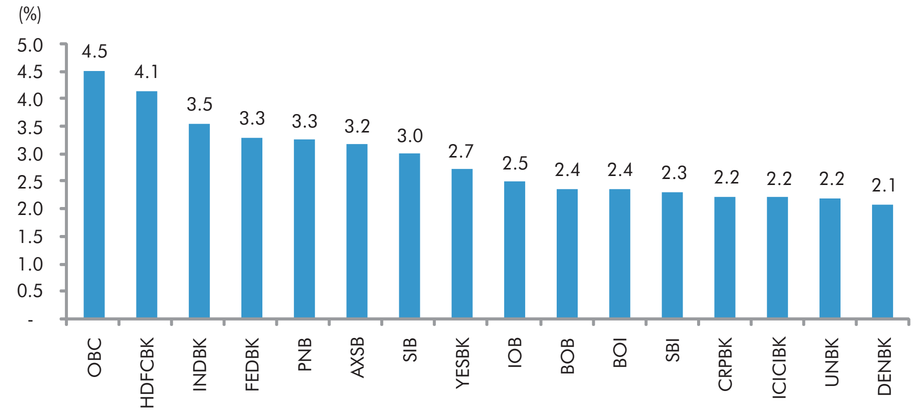
Exhibit 1: Lower Cost of Funds compared to Peers

	YoIEA (I)			CoF (II)			Spread (I-II)		
(%)	FY07	FY08	FY09	FY07	FY08	FY09	FY07	FY08	FY09
City Union Bank	9.5	10.7	10.9	5.6	7.1	7.7	3.9	3.6	3.3
Dhanalaksh.Bank	8.9	9.5	9.5	5.2	6.2	6.6	3.8	3.3	3.0
Federal Bank	**8.6**	**9.6**	**10.2**	**5.2**	**6.6**	**6.6**	**3.4**	**3.0**	**3.6**
Lak. Vilas Bank	8.6	9.2	10.0	6.2	6.9	7.6	2.4	2.2	2.4
South Ind.Bank	8.7	9.1	9.7	5.5	6.6	6.9	3.2	2.5	2.8

Source: Company, Angel Research

During 9MFY2010, Federal Bank generated NII/Assets of 3.3%, which was among the highest for the banks under our coverage during this period.

Exhibit 2: Higher-than-average NII/Assets



Source: Company, Angel Research

Well-capitalised to support a High-Growth Phase

Federal Bank has a very high capital adequacy ratio of 18.5%, with Tier-1 capital adequacy of 17.1% (92.5% of the total CAR). With such a high CAR in place, the bank is well-equipped to leverage its balance-sheet as the economy continues to recover, going forward.

The year-to-date growth in loans of the bank was at 16.2% at the end of 3QFY2010, and exceeded industry credit growth of 7.2% during the same period). Going forward, the bank is expected to end the current fiscal with loan growth of 22% yoy. After FY2010E, as the economy recovers fully, we expect the bank to grow its loan book 4-5% above industry growth; accordingly, we expect the loan book to grow at 23-24% over FY2010-2012E.

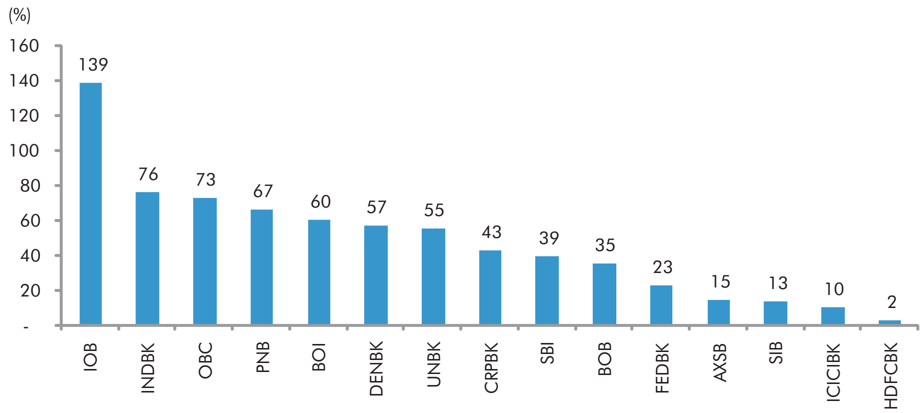
The loan book of Federal Bank as on 9MFY2010 constitutes 35% and 30% of SME and Retail loans, respectively. This makes the loan book more vulnerable to asset-quality shocks, though Gross NPAs (2.97%), Net NPAs (0.56%) and the restructuring (4.0% of advances) done so far do not indicate any such possibilities. However, we believe that the robust capital adequacy of the bank provides sufficient margin of safety on the asset-quality front.

Stable Asset Quality, with High Provision Coverage

The Gross and Net NPA ratios of the bank stand at 2.97% and 0.56%, respectively, at the end of 3QFY2010, with a healthy coverage ratio of 81%. Federal Bank has very low exposure to sensitive sectors. As on 3QFY2010-end, loans to commercial real estate and capital markets were 1.8% and 1.4% of the total loans, respectively.

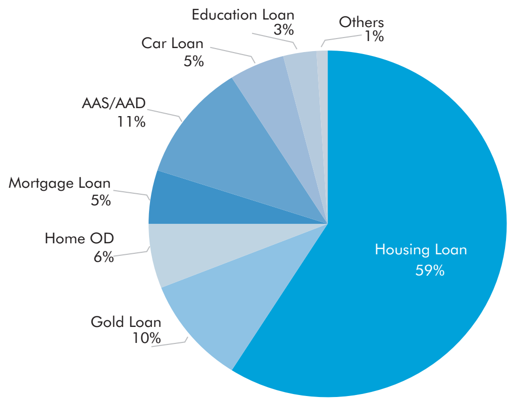
Out of the retail loans, 59% are home loans. The bank has a 10% exposure to gold loans out of its total retail loans; these are high-yielding and secured loans. Only 1% of the retail loans are personal loans. During 9MFY2010, the bank has observed slippages of Rs636cr, implying an annualised slippage ratio of 3.8%. About 45% of this Rs636cr was from the retail segment. As on 9MFY2010, the bank has cumulatively restructured advances of Rs1,031cr, constituting 4% of Advances and 23% of the networth, which is higher than the Private Banks' average (11%) but lower than that of PSU banks (64%). During 3QFY2010, restructured advances of Rs45cr (4.4% of Restructured loans) slipped into NPAs. Going forward, the Asset Quality pressure for the bank is expected to ease, with an improvement in the economic environment. However, compared to an average slippage ratio of 2.1% during the last five years, we have conservatively factored-in a higher slippage ratio of 3.1% during FY2011E, which leaves considerable scope for a positive surprise.

Exhibit 3: Cumulative Restructuring/Networth as on 9MFY2010



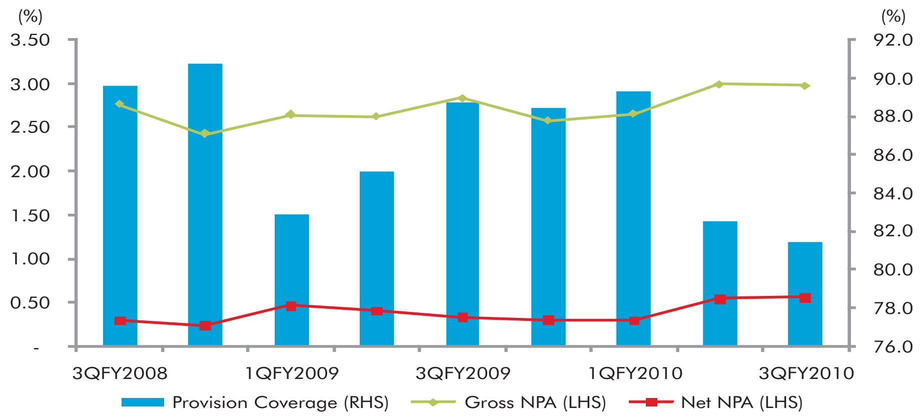
Source: Company, Angel Research

Exhibit 4: Retail Loan Mix



Source: Company, Angel Research

Exhibit 5: High Provision Coverage Provides Asset-Quality Comfort



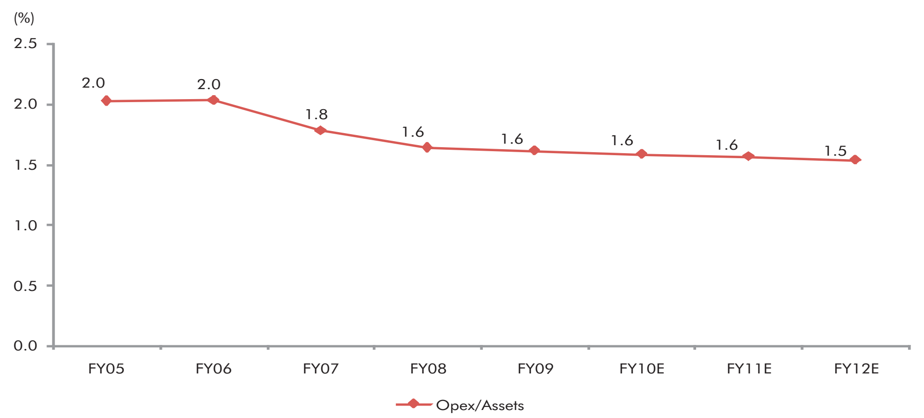
Source: Company, Angel Research

Operating Efficiency: among the Best in the Sector

Although Federal Bank enjoys customer loyalty spanning over many years, it has ensured that it remains sufficiently in step with product, technology and service level developments in the industry. The Bank was one of the first among its peers to have its network on the Core Banking platform and currently offers its clients standard products and channel options, including net banking. As a result, Federal Bank has one of the lowest cost-to-income ratios (of 35%) in the entire sector. This was achieved despite the addition of 57 branches and 500 employees over the past one year. The bank plans to add another 75 branches during FY2011E. In order to support its branch expansion plans, it will be adding 1,000 staff at the clerical and middle levels. We expect the cost-to-income ratio of the bank to be above 36% during FY2010-12E.

The bank has a very low operating expense to average assets ratio of 1.60% (compared to an average of 2.0% for peer banks). Further, the bank has been continuously focusing on improving the operating efficiencies and has appointed the Boston Consulting Group (BCG), to review its existing working methods and to formulate new strategies to improve upon this. Some of the suggested strategies have been implemented and are expected to bring in improvement, going forward. The bank is also recruiting new talent and is concentrating on recruiting local manpower, in line with the branch expansion.

Exhibit 6: Increasing Operating Leverage with better cost efficiency

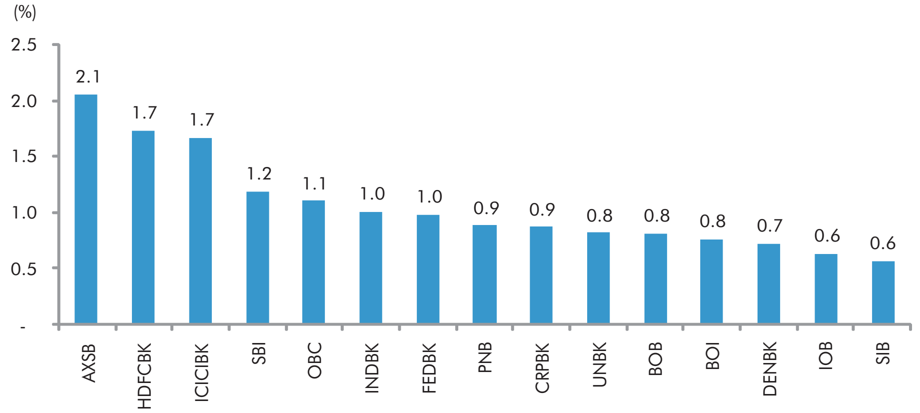


Source: Company, Angel Research

Core Non-Interest Income likely to be linked to Credit Growth

Federal Bank's Core Non-interest Income / Assets at 1.0% (9MFY2010) leaves further scope for improvement, partially due to the limited opportunities to extend Fee Income services, especially in the newer segments, due to the typical profile of the Bank's customer base.

Exhibit 7: Core Non-Interest Income/Assets



Source: Company, Angel Research

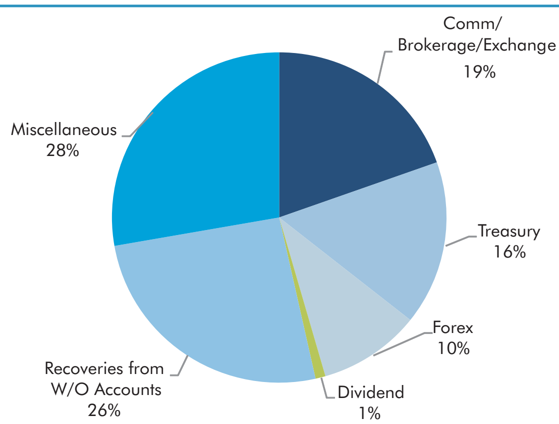
The Core Non-interest Income, (i.e. excluding treasury gains), has grown at a CAGR of 33.2% during FY2005-09. Due to RBI regulations of a ceiling on cheque collection charges, coupled with a replacement of the draft business by RTGS/NEFT, the fee income from remittances has dried up for the bank. However, it has made efforts to diversify these income streams through third-party distribution (has tied up with 15 AMCs), Cash Management Services (has 32 CMS arrangements with corporate and institutional clients), an Online Equity trading facility and Bullion Banking.

The bank has also entered a joint venture with IDBI Fortis for Life Insurance services, with a 26% share. With a strong retail and NRI customer base, coupled with a large network of 669 branches, it has started selling life insurance since March 2008. The first year premium underwritten by this JV has increased by 25% yoy to Rs219cr upto December 2009 from Rs176cr upto December 2008.

At the end of 9MFY2010, Federal Bank had written off accounts worth Rs750cr, from which bank has a quarterly recovery run rate of about Rs25cr. On a conservative basis, we expect this stream to contribute about Rs120cr per annum during FY2010-12E, resulting in a 0.2-0.3% contribution to the RoA of the bank.

For FY2011E and FY2012E, we believe that growth from core non-interest income is likely to be linked to credit growth; hence, we expect the overall non-interest income to grow at around a 13.2% CAGR during FY2010-12E.

Exhibit 8: Composition of Non-interest Income (FY2009)



Source: Company, Angel Research

Concerns over CSB and Dubai Crisis Overdone

During April 2009 till date, Federal Bank's scrip has underperformed its peers, which posted 135% average returns, compared to 80% posted by Federal Bank (an underperformance of 55%). The proposed CSB acquisition, which was partly responsible for the stock's underperformance during the last 11 months, is now unlikely to fructify, as the asking price substantially exceeds Federal Bank's assessment of the bank's value.

The stock has also been an underperformer due to concerns over the impact of the Dubai Crisis on the bank's business model, which benefits meaningfully from Middle-eastern NRI clients. However, as indicated by the Management, the Bank has a very low direct loan exposure of about Rs350cr (1.3% of loan book) to NRIs dependent on Dubai. Hence, the impact of the crisis on asset quality is expected to be within manageable limits.

Details of Investment Book

The bank has a total investment book of Rs12,563cr, of which Rs9,167cr is invested in SLR securities. On the overall investment book, 71% is in HTM, 23% in AFS and the rest is in HFT. The modified duration of the overall investment book stood at 5.1 years at the end of 9MFY2010.

Attractive Relative Valuations vis-à-vis the Fundamentals

Due to the excess networth of the bank, the RoE is subdued at 12.4%; however, the RoA (Return on Assets) of the bank continues to be strong at 1.4% (although the bank maintains a higher Provisions/Assets ratio). We expect RoAs to remain above 1.2% (average during FY2010-12E). Going forward, any improvement in the RoE will be a direct function of an increase in the leverage of the bank.

Exhibit 9: DuPont Analysis : Peer Comparison

% FY2009	CUBK	DHLBK	FB	LVB	SIB
NII	2.9	2.5	3.7	2.1	2.8
(-) Prov. Exp.	0.6	0.2	1.3	0.4	0.3
Adj NII	2.3	2.3	2.4	1.7	2.5
Treasury	0.5	0.2	0.2	0.4	0.2
Int. Sens. Inc.	2.8	2.5	2.6	2.1	2.7
Other Inc.	1.0	1.5	1.2	1.0	0.7
Op. Inc.	3.8	4.0	3.8	3.1	3.4
Opex	1.7	2.3	1.6	2.0	1.8
PBT	2.1	1.6	2.2	1.1	1.6
Taxes	0.7	0.5	0.8	0.4	0.6
RoA	1.5	1.2	1.4	0.7	1.0
Leverage (x)	13.5	16.2	8.8	17.0	15.2
RoE	19.9	19.3	12.4	11.5	15.8

Source: Company, Angel Research

Outlook and Valuation

We rate the bank's peer group (old private sector banks) broadly at par with mid-sized PSU banks in terms of their RoA and growth potential. Additionally, Federal Bank's core profitability (refer to exhibit above) and growth outlook are above average as compared to its peers.

At the CMP, the stock is trading at attractive valuations of 0.8x FY2012E Adjusted Book Value (ABV) - similar to South Indian Bank, its closest peer. We believe that these valuations provide a reasonable margin of safety from the inherent and cyclical asset-quality pressures, as well as from structural competitive pressures from larger private sector banks (which are increasingly penetrating deeper into Tier-II and Tier-III towns).

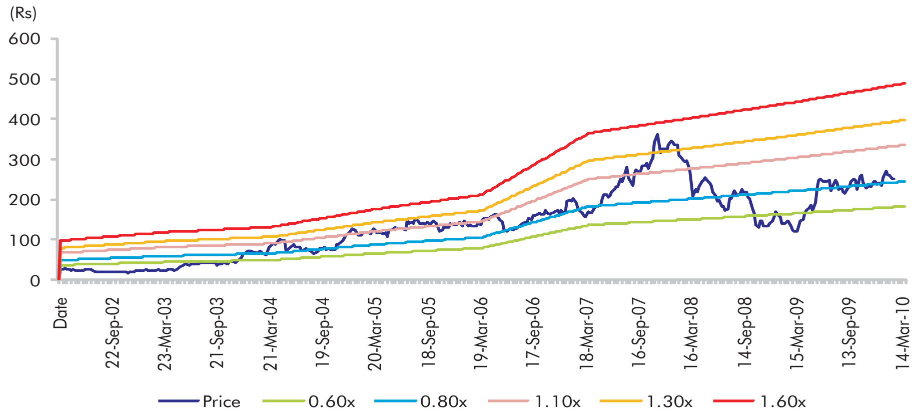
Historically, the stock has traded in the range of 0.7-1.2x its 1-year forward P/ABV multiple, with a 5-year median of 0.8x. We have assigned a Target FY2012E P/ABV multiple of 1.0x to Federal Bank, considering the bank's potential to grow above the industry average, going forward.

Accordingly, we value Federal Bank at 1.0x its FY2012E ABV, to arrive at a Target Price of Rs342 per share. Hence, we Initiate Coverage on Federal Bank with a Buy recommendation.

Exhibit 10: Comparative Valuation

		P/ABV (x)			P/E (x)			EPS Growth (%)			RoA (%)			RoE (%)		
	CMP	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
Federal Bank	261	0.9	0.9	0.8	8.2	7.4	5.6	9.5	12.4	34.2	1.3	1.2	1.4	12.3	12.3	14.8
SIB	150	1.1	1.0	0.8	6.2	5.5	4.4	40.5	11.7	24.3	1.2	1.2	1.2	19.6	18.8	19.9

Exhibit 11: P/ABV Band



Source: Company, Angel Research

Investment Concerns

Asset-quality pressures

The bank's asset quality improved substantially from FY2002 onwards, in line with industry trends, underpinned by the strong economic growth and improving recovery mechanism. Over FY2005-09, particularly, the bank's gross NPAs came down from 7.7% to 2.6%, while Net NPAs dropped from 2.2% to 0.4%. However, due to the sensitive nature of its loan book, the slippage rate of the bank has increased to 3.0% in FY2009 from 1.8% in FY2008. Going forward, we believe that the bank may continue to face asset-quality pressures for the next few quarters, in line with industry trends. However, with the economic outlook improving, asset quality should start stabilising from 2011E onwards.

Competitive pressures

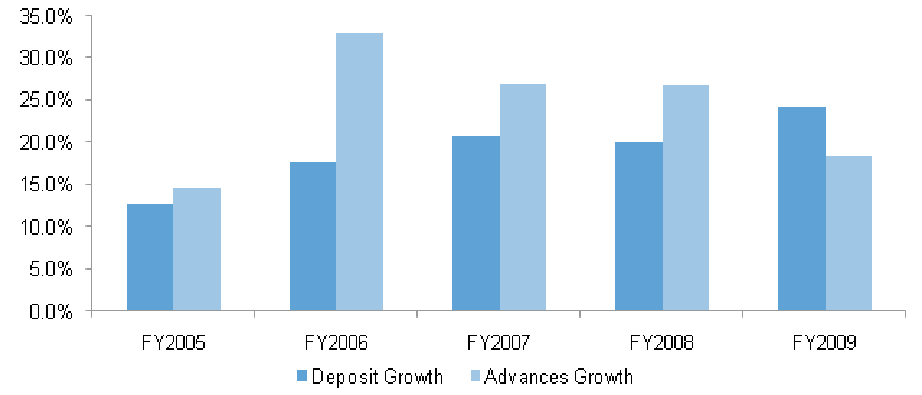
We expect structural competition from newer private banks and regional PSU banks to be substantial in the medium-term. However, the bank's overall strategy and execution has been creditable in the past few years, with the bank maintaining its market share even in CASA deposits. While we expect a loss in market share for the peer group that the bank belongs to, based on the bank's track record, and keeping in mind the importance of customer loyalty in the banking industry, we have factored in a much lower rate of loss in market share for the bank over the medium-term.

Company Background

Federal Bank is a Kerala-based, old-generation private sector bank, with an asset size of more than Rs38,850cr and a network of over 669 branches and 670 ATMs. The bank has the experience of conducting business in the state of Kerala for over 78 years, which gives the bank a competitive advantage in this state and enables it to be in a better position to understand the local market requirements. The total business of Federal Bank touched Rs60,617cr as on Dec 31, 2009, with deposits in excess of Rs34,500cr and advances of Rs26,000cr. The credit-deposit ratio of the bank stood at 75.3% in 3QFY2010. The bank has consistently delivered a RoA in excess of 1.20% for the last four consecutive years.

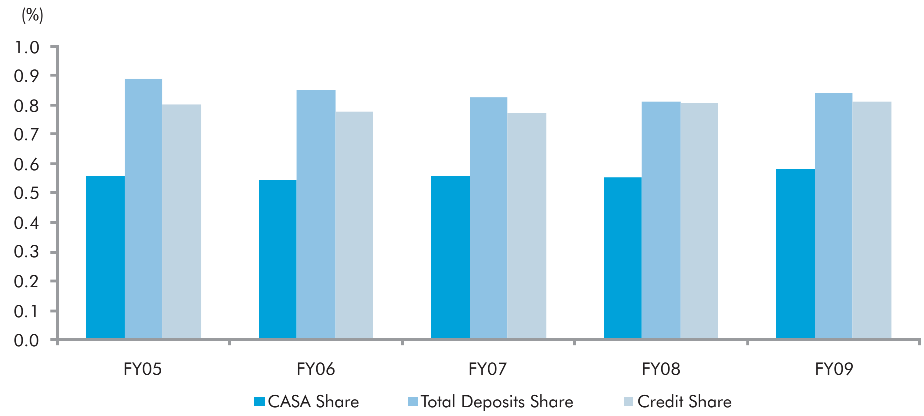
The bank's deposits and advances have grown at CAGR of 20.6% and 26.2%, respectively, during FY2005-09. It has achieved an advances growth of 18.4% yoy and a deposits growth of 24.3% yoy in FY2009. The bank mainly focuses on SME and Retail lending, with both forming more than 60% (combined) of the advances portfolio of the bank. The bank's key strength is the access to low-cost NRI deposits (which constitute around 17% of the total deposits), thereby reducing the cost of funds. The Capital Adequacy Ratio of the bank stands at 18.5% at the end of 3QFY2010, with a high Tier-1 capital of 17.1%.

Exhibit 12: Business growth



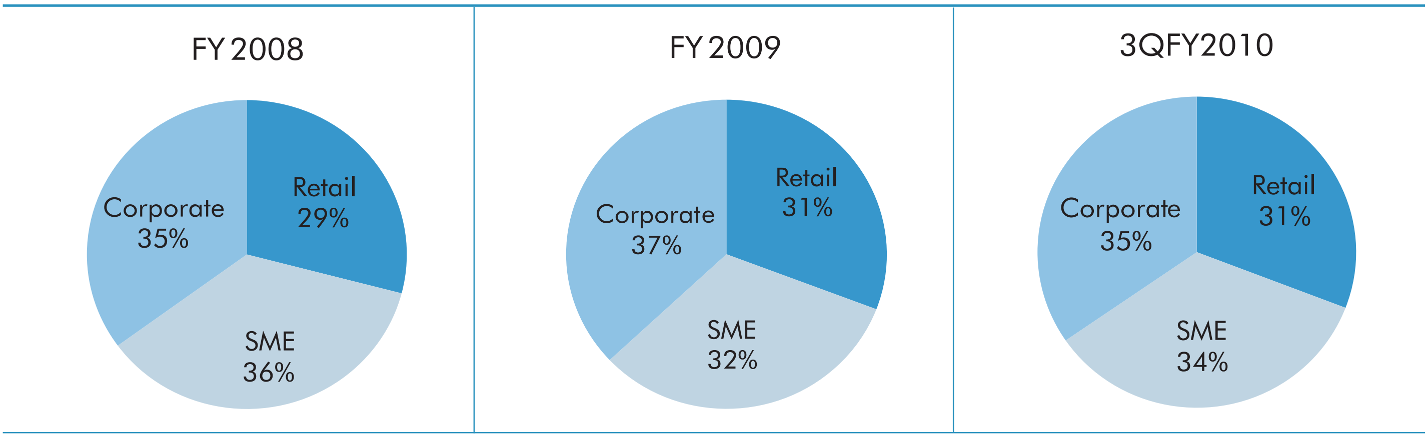
Source: Company, Angel Research

Exhibit 13: Key Market Share



Source: Company, Angel Research

Exhibit 14: Loan Book Mix



Source: Company, Angel Research

Profit & Loss Statement

Rs crore

Y/E March	FY2009	FY2010E	FY2011E	FY2012E
Net Interest Income	**1,315**	**1,412**	**1,617**	**1,921**
YoY Growth (%)	*51.5*	*7.3*	*14.6*	*18.7*
Other Income	**383**	**510**	**544**	**661**
YoY Growth (%)	*(3.0)*	*33.2*	*6.6*	*21.6*
Operating Income	**1,698**	**1,922**	**2,161**	**2,582**
YoY Growth (%)	*34.5*	*13.1*	*12.5*	*19.5*
Operating Expenses	**571**	**665**	**787**	**938**
YoY Growth (%)	*21.9*	*16.3*	*18.4*	*19.2*
Pre - Provision Profit	**1,127**	**1,257**	**1,374**	**1,644**
YoY Growth (%)	*41.9*	*11.5*	*9.3*	*19.6*
Prov. & Cont.	**334**	**426**	**456**	**429**
YoY Growth (%)	*13.6*	*27.6*	*7.0*	*(6.0)*
Profit Before Tax	**793**	**831**	**918**	**1,215**
YoY Growth (%)	*58.6*	*4.8*	*10.5*	*32.3*
Prov. for Taxation	**293**	**282**	**312**	**413**
as a % of PBT	*36.9*	*34.0*	*34.0*	*34.0*
PAT	**500**	**548**	**606**	**802**
- YoY Growth (%)	*36.0*	*9.5*	*10.5*	*32.3*

Balance Sheet

Rs crore

Y/E March	FY2009	FY2010E	FY2011E	FY2012E
Share Capital	**171**	**171**	**171**	**171**
Reserve & Surplus	4,155	4,593	5,079	5,721
Deposits	32,198	37,672	46,336	57,457
Growth (%)	*24.3*	*17.0*	*23.0*	*24.0*
Borrowings	749	876	1,065	1,305
Tier 2 Capital	470	470	564	677
Other Liab. & Prov.	1,057	1,614	1,957	2,278
Total Liabilities	**38,800**	**45,396**	**55,173**	**67,609**
Cash balances	2,214	2,497	2,317	2,873
Bank balances	1,223	1,431	1,739	2,131
Investments	**12,119**	**13,163**	**16,328**	**19,498**
Advances	22,392	27,318	33,601	41,666
Growth (%)	*18.4*	*22.0*	*23.0*	*24.0*
Fixed Assets	281	319	376	447
Other Assets	572	669	813	996
Total Assets	**38,800**	**45,396**	**55,173**	**67,609**
Growth (%)	*19.7*	*17.0*	*21.5*	*22.5*

Key Ratios

Y/E March	FY2009	FY2010E	FY2011E	FY2012E
Per Share Data (Rs)				
NIMs	3.8	3.4	3.3	3.2
Cost to Income ratio	33.6	34.6	36.4	36.3
RoA	1.4	1.3	1.2	1.3
RoE	12.4	12.3	12.1	14.4
B/S ratios (%)				
CASA ratio	24.5	23.9	22.1	20.3
Credit/Deposit ratio	69.5	72.5	72.5	72.5
CAR	20.2	18.1	16.6	15.4
- Tier I	18.4	16.7	15.2	14.0
Asset Quality (%)				
Gross NPAs	2.6	3.0	2.9	2.5
Net NPAs	0.3	0.6	0.8	0.7
Slippages	3.0	3.5	3.1	2.6
NPA prov. / avg. assets	30.7	35.1	31.6	24.4
Provision coverage	88.4	78.7	74.2	71.8
Per Share Data (Rs)				
EPS	29.3	32.1	35.4	46.9
ABVPS (75% Cover.)	252.6	278.2	306.1	342.1
DPS	5.0	5.5	6.0	8.0
Valuation Ratios				
P/E (x)	9.0	8.2	7.4	5.6
P/ABVPS (x)	1.0	0.9	0.9	0.8
Dividend Yield (%)	1.9	2.1	2.3	3.0
DuPont Analysis				
NII	3.7	3.4	3.2	3.1
(-) Prov. Exp.	0.9	1.0	0.9	0.7
Adj. NII	2.8	2.3	2.3	2.4
Treasury	0.2	0.2	0.1	0.1
Int. Sens. Inc.	3.0	2.6	2.4	2.5
Other Inc.	0.8	1.0	1.0	1.0
Op. Inc.	3.8	3.6	3.4	3.5
Opex	1.6	1.6	1.6	1.5
PBT	2.2	2.0	1.8	2.0
Taxes	0.8	0.7	0.6	0.7
RoA	1.4	1.3	1.2	1.3
Leverage	8.8	9.4	10.1	11.0
RoE	12.4	12.3	12.1	14.4

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Disclosure of Interest Statement	Federal Bank
1. Analyst ownership of the stock	No
2. Angel and its Group companies ownership of the stock	No
3. Angel and its Group companies' Directors ownership of the stock	No
4. Broking relationship with company covered	No

Note: We have not considered any Exposure below Rs 5 lakh for Angel, its Group companies and Directors.

Ratings (Returns) :	Buy (> 15%)	Accumulate (5% to 15%)	Neutral (-5 to 5%)
	Reduce (-5% to -15%)	Sell (< -15%)	

Address: Acme Plaza, 'A' Wing, 3rd Floor, M.V. Road, Opp. Sangam Cinema, Andheri (E), Mumbai - 400 059.
Tel : (022) 3952 4568 / 4040 3800

Research Team

Fundamental:

Hitesh Agrawal	Head - Research	hitesh.agrawal@angeltrade.com
Sarabjit Kour Nangra	VP-Research, Pharmaceutical	sarabjit@angeltrade.com
Vaibhav Agrawal	VP-Research, Banking	vaibhav.agrawal@angeltrade.com
Vaishali Jajoo	Automobile	vaishali.jajoo@angeltrade.com
Shailesh Kanani	Infrastructure, Real Estate	shailesh.kanani@angeltrade.com
Anand Shah	FMCG , Media	anand.shah@angeltrade.com
Deepak Pareek	Oil & Gas	deepak.pareek@angeltrade.com
Puneet Bambha	Capital Goods, Engineering	puneet.bambha@angeltrade.com
Sushant Dalmia	Pharmaceutical	sushant.dalmia@angeltrade.com
Rupesh Sankhe	Cement, Power	rupeshd.sankhe@angeltrade.com
Param Desai	Real Estate, Logistics, Shipping	paramv.desai@angeltrade.com
Sageraj Bariya	Fertiliser, Mid-cap	sageraj.bariya@angeltrade.com
Viraj Nadkarni	Retail, Hotels, Mid-cap	virajm.nadkarni@angeltrade.com
Paresh Jain	Metals & Mining	pareshn.jain@angeltrade.com
Amit Rane	Banking	amitn.rane@angeltrade.com
Rahul Jain	IT	rahul.j@angeltrade.com
Jai Sharda	Mid-cap	jai.sharda@angeltrade.com
Sharan Lillaney	Mid-cap	sharanb.lillaney@angeltrade.com
Amit Vora	Research Associate (Oil & Gas)	amit.vora@angeltrade.com
V Srinivasan	Research Associate (Cement, Power)	v.srinivasan@angeltrade.com
Aniruddha Mate	Research Associate (Infra, Real Estate)	aniruddha.mate@angeltrade.com
Shreya Gaunekar	Research Associate (Automobile)	shreyap.gaunekar@angeltrade.com
Mihir Salot	Research Associate (Logistics, Shipping)	mihirr.salot@angeltrade.com
Chitrangda Kapur	Research Associate (FMCG, Media)	chitrangdar.kapur@angeltrade.com
Vibha Salvi	Research Associate (IT, Telecom)	vibhas.salvi@angeltrade.com
Pooja Jain	Research Associate (Metals & Mining)	pooja.j@angeltrade.com

Technicals:

Shardul Kulkarni	Sr. Technical Analyst	shardul.kulkarni@angeltrade.com
Mileen Vasudeo	Technical Analyst	vasudeo.kamalakant@angeltrade.com
Krunal Dayma	Technical Analyst	krunal.dayma@angeltrade.com

Derivatives:

Siddarth Bhamre	Head - Derivatives	siddarth.bhamre@angeltrade.com
Jaya Agarwal	Jr. Derivative Analyst	jaya.agarwal@angeltrade.com

Institutional Sales Team:

Mayuresh Joshi	VP - Institutional Sales	mayuresh.joshi@angeltrade.com
Abhimanyu Sofat	AVP - Institutional Sales	abhimanyu.sofat@angeltrade.com
Nitesh Jalan	Sr. Manager	niteshk.jalan@angeltrade.com
Pranav Modi	Sr. Manager	pranavs.modi@angeltrade.com
Sandeep Jangir	Sr. Manager	sandeepp.jangir@angeltrade.com
Jay Harsora	Sr. Dealer	jayr.harsora@angeltrade.com
Meenakshi Chavan	Dealer	meenakshis.chavan@angeltrade.com

Production Team:

Bharathi Shetty	Research Editor	bharathi.shetty@angeltrade.com
Dharmil Adhyaru	Assistant Research Editor	dharmil.adhyaru@angeltrade.com
Bharat Patil	Production	bharat.patil@angeltrade.com
Dilip Patel	Production	dilipm.patel@angeltrade.com

Angel Broking Ltd: BSE Sebi Regn No : INB 010996539 / CDSL Regn No: IN - DP - CDSL - 234 - 2004 / PMS Regn Code: PM/INP000001546 Angel Securities Ltd:BSE: INB010994639/INF010994639 NSE: INB230994635/INF230994635 Membership numbers: BSE 028/NSE:09946
Angel Capital & Debt Market Ltd: INB 231279838 / NSE FNO: INF 231279838 / NSE Member code -12798 Angel Commodities Broking (P) Ltd: MCX Member ID: 12685 / FMC Regn No: MCX / TCM / CORP / 0037 NCDEX : Member ID 00220 / FMC Regn No: NCDEX / TCM / CORP / 0302