Axis Bank – Rs. 702.90

HDFC securities

Stock Note

October 6, 2008

Key Triggers
- Growing Low cost liability business to counter cost pressure
- Retail Advances growing steadily despite interest rate concerns
- Steady growth in Non-fund income due to cross sell & branch expansion
Key Risks
- Rising Interest rates to keep NIMs under pressure
- Increasing Forex derivative contracts leading to MTM losses

3 month stock view vis-a-vis	
Nifty	Outperform
Bank Index	Outperform
Expected price range – 3 Months	Rs. 649- Rs. 776
Post Breakout Levels	
Support	Rs. 534
Resistance	Rs. 930

Background & Business

Axis Bank was the first of the new private banks to have begun operations in 1994. The Bank was promoted jointly by the Administrator of the specified undertaking of the Unit Trust of India (UTI - I), Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC) and other four PSU insurance companies, i.e. National Insurance Co Ltd., The New India Assurance Co Ltd., The Oriental Insurance Co Ltd. and United India Insurance Co Ltd. Presently, the Bank has a very wide network of more than 713 branch offices and Extension Counters and a network of over 2904 ATMs. It offers a complete range of retail and corporate services, including retail loans, corporate and business credit, forex and trade finance services, investment banking, depository services and investment advisory services. In FY08, the bank changed its name from UTI Bank to Axis Bank, which helped it in transforming the image of being a public sector bank to a high class private sector bank. The deposit base stands at over Rs. 88,900 crores with over 99 lakh accounts in FY08 as compared to 59 lakh accounts in FY07.

Key Highlights

Strong Performance in Q1 FY09 led by growth in Advances and healthy NIMs

Axis has been one of the better performers in the private banking space over the past 1-2 years, however due to rising interest rate scenario coupled with credit concerns and slight corrosion in the asset quality led to a rather mild growth in Q1 FY09. Axis reported a y-o-y growth of 92.4% in the net interest income from Rs. 421 crs in Q1 FY08 to Rs. 810 crs in Q1 FY09. This was on account of a steady growth in the net advances by 48% and healthy growth on the margin front. The Net interest margin (NIM) improved from 2.56% in Q1 FY08 to 3.35% in Q1 FY09. This improvement in the NIM was mainly due to decline in the cost of funds. But, sequentially, the NIM fell by 58 bps due to rise in the cost of deposits, inspite of a rise in the yield on advances (Q4 NIMs are typically the best). The non-fund income also recorded strong growth of 82.5% mainly led by growth in the fee-based income, which rose by 80% and corporate fees, which has witnessed a spurt of 93% y-o-y. The CASA as a % of total deposits further improved from 38% in June 08 to 40% in Jun 09, but on a q-o-q basis, the CASA as a % of deposits fell by 568 bps (CASA ratio typically is high in Q4). This was mainly on account of Current account deposits falling by 11.4% sequentially as against a 12.4% increase in term deposits and seasonality in deposits as deposit base improves significantly in March quarter. Axis is expected to maintain CASA ratio at 40-43% levels, despite fall in this ratio in Q1 FY09. The operating expenses were up by 50.3% y-o-y at Rs. 633 crs, but sequentially, it fell by 4.4% due to a higher base effect and re-branding exercise conducted in FY08.

Particulars (In Crs)	Q1 FY09	Q1 FY08	% Chg
Total Advances	61160	41285	48.1
- Retail	14638	9661	51.5
- Corporate, SME & Agri	46522	40165	15.8
Credit - Deposit Ratio (%)	68.74	67.58	
Total Deposits	88973	61091	45.6
- CASA	35449	23062	19.1
- Term Deposits	53524	38029	40.8
CASA Ratio (%)	39.8	37.8	
Cost of Funds (%)	6.1	6.4	
Net Interest Income	810.5	420.9	92.6
NIM (%)	3.4	2.6	
Non-Interest Income	624.8	368.2	69.7
Net Profit	330.1	175.0	88.7

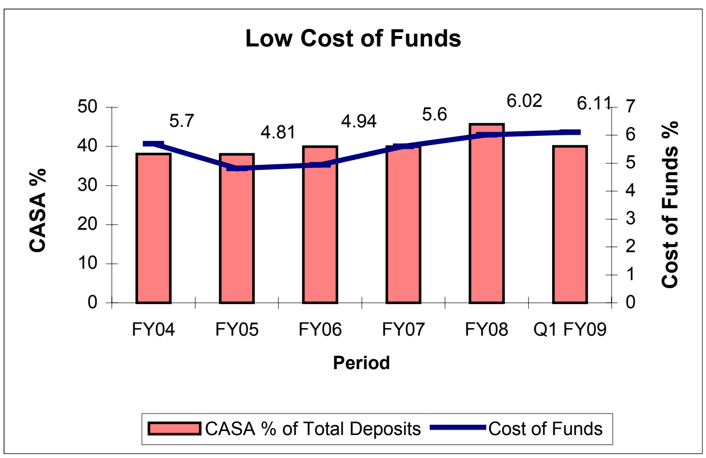
Total Assets	113660	79109	43.7
Gross NPA (%)	0.9	1.01	
Net NPA (%)	0.5	0.6	
Capital Adequacy Ratio (%)	13.3	11.5	
Return on Equity (%)	15.4	21.2	
Return on Assets (%)	1.2	0.9	

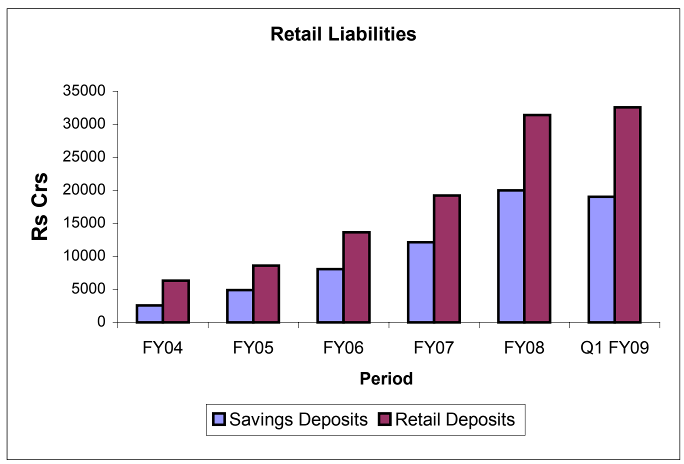
(Source: Company Press Release, HDFC Sec)

The Gross NPA witnessed a surge of about Rs. 143 crs sequentially and Rs. 155 crs y-o-y and this was mainly on account of delinquencies in the credit card advances. Although the NPA levels have been in control at 0.47% of total advances, but a rise by 11 bps sequentially indicates that the defaults have been on the rise. Axis reported an excellent bottom line growth of 89% y-o-y from Rs. 175 crs in Q1 FY08 to Rs. 330.1 crs in Q1 FY09. Axis has also been quite aggressive on its branch expansion network from 671 in Mar 08 to 713 as on June 08. Axis has obtained licences from RBI for 232 branches (30 old pending licences) and could add 400-450 ATM in FY09.

Sustainable growth in low cost liability business to counter cost pressure

Axis enjoys one of the best CASA to total deposit ratio in the banking industry. The overall deposit base recorded a growth of 46% from Rs. 61091 crs in Q1 FY08 to Rs. 88973 crs in Q1 FY09. Out of this, the demand deposits have accounted for 40% of the deposits and the rest being contributed by term deposits. Axis has witnessed a 200 bps improvement in the CASA ratio y-o-y, but sequentially it dipped by 568 bps. With aggressive branch expansion and focus on growing the retail deposit base, Axis should be in a better position to sustain the CASA ratio in the 40-43% band. Moreover, the retail proportion on the term deposits has increased from 20% in FY07 to 25% in FY08. This indicates that with the retail customer reach Axis is planning, it would be able to counter the cost pressure and also sustain margins. The implementation of Customer Relationship Management (CRM) solution could enable Axis to improve its cross-selling penetration among its customer base. Axis also enjoys a healthy account acquisition growth rate in the range of 20-25% and there has been consistent improvement in the quality of accounts sourced, which lends further strength to the CASA ratio and cross selling opportunities.





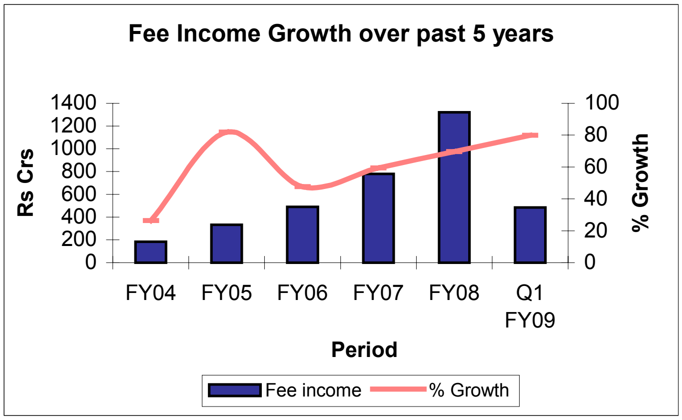
(Source: Company Presentation, HDFC Sec)

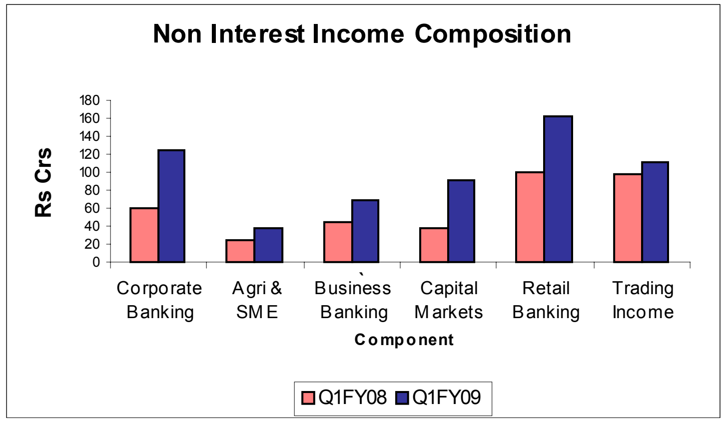
Rising Distribution Network to drive business growth

Axis has a wide presence through its 713 Branches & Extension Counters and 2,904 ATMs across 433 cities and towns. In Q1 FY09, it added 42 Branches and 140 ATMs. Axis has received 232 licences for branches (30 old pending licences) from RBI and will be adding about 400-500 ATMs in FY09. Most of the licenses were applied in the Tier II cities, which enabled faster nod from the Regulator. In terms of ATMs, Axis has about 4.1 ATMs per branch. Due to foray into alternative channels like ATM network, Internet banking, mobile banking and phone banking, the customers have been increasing using such channels for convenience. This in turn also helps the banks to reduce the walk-ins in branches for petty transactions like cash withdrawal, balance enquiry, chequebook request, fund transfer, card-to-card transfer, etc. With more use of alternate channels, banks will be able to reduce the customer service cost. Axis has also been increasing its foray into Northeastern region (17 branches) and it has planned to scale up its operations in the small and medium enterprises in the northeastern region.

Non-fund income to taper following the current turmoil in global markets and foreign derivative transactions

The non-interest income and treasury income has been a significant revenue driver for Axis. A major part of the fee-based income is contributed from regular banking activities. The balance is contributed by capital market transactions. The non-interest income grew by 82.5% y-o-y and 12.3% q-o-q to Rs. 624.8 crs. This growth was on account of growth in the core fee based income, which rose by 80% y-o-y to Rs. 484 crs in Q1 FY09. The treasury income grew by 14.5% y-o-y to Rs. 111 crs in Q1 FY09. The major contributors to the fee based income were fee from capital market transactions, corporate banking transactions and retail banking transactions - growing by 149%, 105% and 60% respectively. A diagrammatic representation of the fee based transaction and treasury income is as follows:





(Source: Analyst Presentation, HDFC Sec)

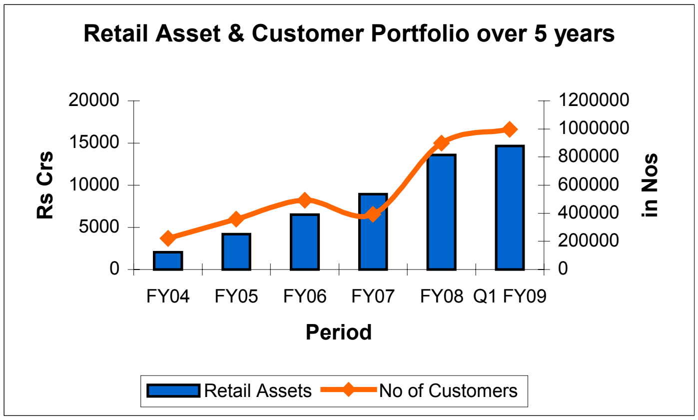
The fee-based income has been growing quite rapidly over the past 5 years and the growth momentum is expected to continue despite fears of a local/global economic slowdown. The income from capital market transactions could witness a slowdown following the weak stock market conditions, but Axis expects to continue its leadership position in the debt syndication business. Moreover, Axis could also improve its non-interest income by increasing growth in fee-based income from the regular banking transactions due to branch expansion and cross selling opportunities.

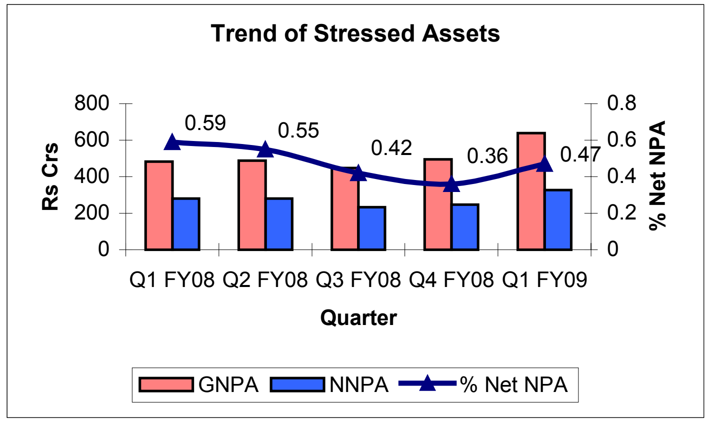
Losses in Derivative Contracts – A pertinent risk

One of the recent concerns that banks need to take utmost care is the derivative transactions, which has led to MTM losses for many corporates who had entered into such contracts with these banks. In Q1 FY09, Axis had to provide towards MTM forex losses on behalf of corporates of Rs. 72 crs. These provisions were due to dispute by 2 corporates. Even though Axis was not required to provide and/or disclose this MTM loss separately, it chose to disclose the entire derivatives situation on behalf of the corporates and chose to provide the entire amount. Later RBI came out with detailed guidelines on how derivative MTM losses should be accounted by banks. Axis has won 1 out of the 2 cases filed by corporates and as a result of new guidelines, it will be able to write back a large chunk in Q2 FY09 from Rs. 72 crs provided in Q1 FY09.

Advances base growth to continue, but asset quality especially exposure to Mid-corporate and SMEs could affect asset quality

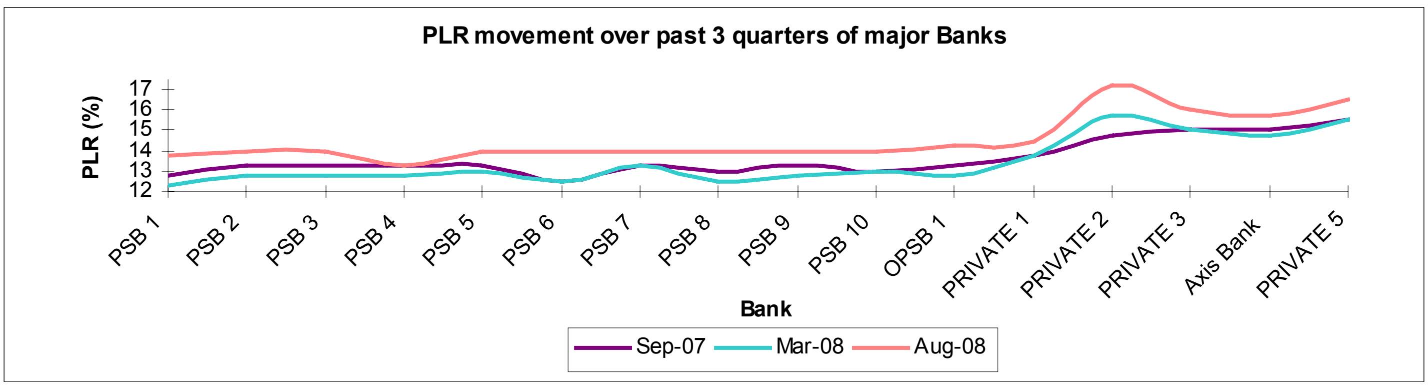
Axis has developed a very strong asset base over the past few years due to concentration towards housing, real estate, auto and export oriented sectors like textiles, gems & jewellery, etc. The net advances book grew by 48% y-o-y to Rs. 61160 crs in Q1 FY09 and this growth was led by robust demand in the retail and SME segment. Axis has always had a special focus on SME lending, which generates higher returns for the bank, although with an element of added risk. Axis had set up 24 specialised SME centres in June 08 as against 20 in June 07 and 39 agri-clusters in June 08 as against 28 clusters in June 07 to push SME and Agri business. The Retail Assets grew by 52% y-o-y to Rs. 14638 crs in the June 09 quarter and Retail advances as a % of Total advances increased from 23% in Q1 FY08 to 24% in Q1 FY09. This growth was driven primarily by business through the Retail Asset Centres (RAC). Despite unsteadiness in the real estate business and auto business coupled by rising interest rate scenario, the housing loan segment was the major constituent to Retail Advances (59%) and the auto loans contributed to 15% of total advances. Axis had an industry market share of 2.64% in advances in FY08.





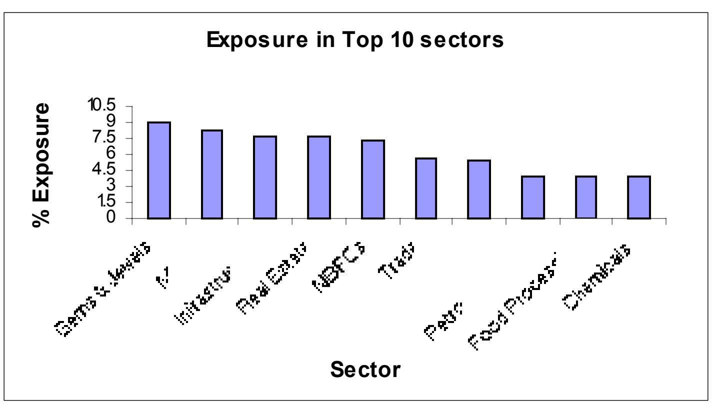
(Source: Annual Report, Analyst Presentation, HDFC Sec)

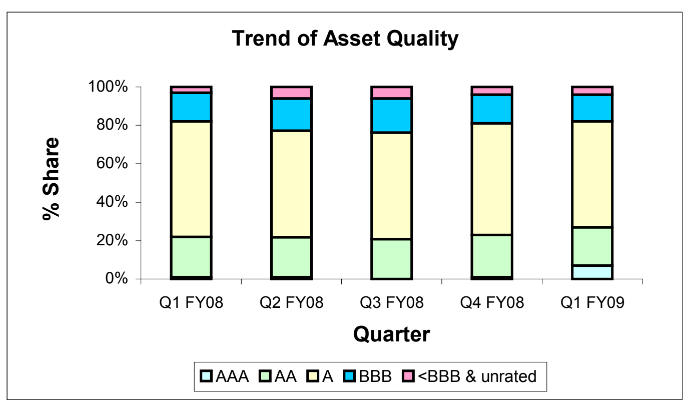
The current interest rate situation could slow the growth in retail asset business, as home and vehicle loans are getting dearer by the day. Moreover tight liquidity situation may force banks to do away with the Sub PLR rates, thereby raising the lending rates to the range of 14-17%. A pictorial representation of the PLR rates of few public sector and private sector banks is as follows:



PSB – Public Sector Bank, OPSB – Other Public Sector Bank

The sub prime crisis and rising Gross NPA levels has forced the banks to go slow on giving credit and one could see Axis continuing to grow, but a slower pace as compared to previous years. The rise in interest rates could adversely impact advances, thereby eating into bank's profits and slowing down the supply of credit. Rising rates typically spell lower margins for banks because banks have more of short-term deposits than short-term loans. They could also lead to capital losses on bank's investment portfolio. Axis has high exposure to lenders with high risk and high returns like SMEs and Mid-sized corporates. Aggressive lending to such entities over the past 1-2 years has led to increasing delinquencies and this has led to higher provisioning of NPAs. Axis on a sequential basis saw a substantial increase of Rs. 144 crs incremental GNPA, whereas the % GNPA saw an improvement of 9 bps to 0.92% in Q1 FY09 as compared to 1.01% in Q1 FY08. The credit card business comprises the highest portion of the GNPA and the credit card defaults accounts for about 13% of the total credit card portfolio.



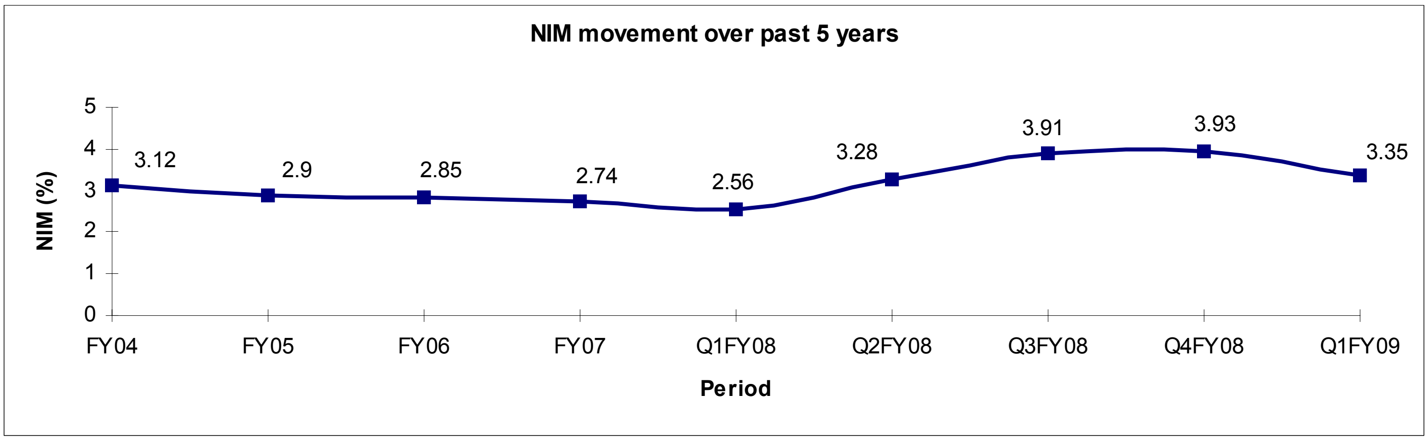


(Source: Analyst Presentation, HDFC Sec)

However, on the asset quality front, about 82% of the corporate advances have a rating of atleast 'A' as on June 08, which depicts that the loan portfolio seems quite comfortable. Axis has maximum exposure to export oriented segments and financial companies. The gems & jewellery segment is majorly backed by cash margins (upto 76%) and trades are of shorter duration. The NBFCs take loans for fulfilling their priority sector transactions. The total exposure to Gems & Jewellery, Real Estate and Financial sector amounts to 24% of total advances.

NIMs sustenance to be under pressure in this rising interest rate scenario

Axis has been able to record one of the best NIMs among the private sector banks at 3.35% in Q1 FY09 as against 2.56% in Q1 FY08 due to decline in the cost of funds from 6.43% in June 07 quarter to 6.11% in June 08 quarter. This increase is despite the fact that liquidity scenario has been quite tight coupled by rising inflation leading to hike in the CRR to curb liquidity in the markets. However, sequentially the NIMs fell by about 58 bps due to rise in the cost of deposits as compared to previous quarter (5.82%), which overshadowed the rise in the yield in advances. The fall in cost of funds was mainly due to fall in the CASA deposits sequentially. The NIMs in the first quarter is generally the lowest as compared to the other quarters. Axis's ability of maintaining a high CASA ratio of 45.68% in FY08 (just below merged HDFC Bank's 49% in FY08 in private sector banks) has translated into higher NIM for Axis Bank. The CASA ratio is very important for improvement in NIM as normally a 100 bps increase in CASA expands NIMs by 10 bps.



(Source: Analyst Presentation, HDFC Sec)

Going forward, Axis may find it difficult to maintain NIMs following future credit and interest rate concerns. But concerted focus towards raising low cost deposits could help Axis to reduce the negative impact on margins to some extent. Due to present financial crisis in most markets, banks could defer aggressive growth in advances for atleast 1-2 years, which could put the NIMs under pressure. However, there could be some respite due to high proportion of floating rate advances – almost the entire mortgage retail advances portfolio is on floating rate and about 2/3rd of the Corporate & SME portfolio is on floating rate.

Expanding Overseas Operations

Axis has been an avid player in the international markets and currently has presence in Singapore, Hong Kong, Dubai and Shanghai. It has entered into strategic alliances with banks and exchanges in the Gulf and is planning to have a presence pan-Asia. The total assets in the overseas branches accounts for about 6% of the total advances which is about US $1.80 bn as on June 08. Some of the segments covered in the international business are corporate banking, trade finance products, debt syndication and liability business. Axis is quite confident on increasing asset base internationally and branch expansion is also a possibility to improve liability business.

SUUTI Stake Sale

The Special Undertaking of UTI (SUUTI) has started the process of selling most of its stake in Axis Bank. SUUTI, which was formed to take over the assets of US-64, has appointed JPMorgan Chase & Co., Citibank NA and ICICI Securities Ltd to advise it on the sale of a 21% stake in Axis Bank Ltd. The 21% stake would be worth $1.24 billion (Rs 5,433 crore). Though SUUTI owns 27% stake in Axis, the other 6% stake cannot be sold, as there is a lock-in clause on 6% of equity, following an earlier QIP. The players who could be the possible buyers in the stake sale are FIIs, domestic insurance companies, private equity funds, etc. The offloading of stake could increase the float and trading volumes as the stakes could get distributed among many institutions, but the timing is not certain.

Increase in Capital

Axis had raised Tier I capital in July 07 in the form of a Global Depository Receipt (GDR) issue, a Qualified Institutional Placement (QIP) and a preferential allotment of equity shares to the promoters of the Bank. It had raised Rs.873.83 crs through the allotment of 1,41,32,466 GDRs at the price of US $ 15.43 per GDR. It also raised Rs. 1752.43 crs by issuing 2,82,64,934 equity shares under QIP at a price of Rs. 620 per share. Moreover, to maintain the % shareholding of Axis's promoters at the pre GDR/QIP offering level, the Administrator of SUUTI, LIC, GIC and 3 government-owned general insurance companies participated in a preferential offer by subscribing to 3,06,95,129 equity shares at a price of Rs. 620 per share. In this preferential allotment, the bank raised Rs. 1903.10 crs. Overall, the bank raised an equity capital of Rs, 4,534.36 crs under GDR/QIP and preferential allotment. The equity capital as on 30th June 08 stands at 357.7 crs. The bank now has a capital adequacy ratio of 13.73% as on March 08, out of which the Tier I capital amounted to 10.17% and Tier II Capital is 3.56%. This could impact the Return ratios in the near term till the assets are profitably deployed. As bank's assets are growing fast, it will have to keep diluting its equity at intervals to meet the capital adequacy norms.

Scores better than or is on par with most private sector banks that are larger and older on various parameters

As compared to large private sector banks, Axis scores on various financial parameters as under:

Parameters (FY08)	Axis Bank	Rank	Closest Bank	Financials	Rank
Business Per Employee (Rs lac)	1117.0	1	ICICI Bank	1008.0	2
Profit Per Employee (Rs lac)	8.4	2	ICICI Bank	10.0	1
Cost of Funds (%)	4.8	1	HDFC Bank	5.3	2
CASA Ratio (%)	46.0	2	HDFC Bank	49.0	1
NII (Rs Crs)	2585.4	3	ICICI Bank	7304.1	1
NIM (%)	3.5	2	HDFC Bank	4.6	1
CAR (%)	14.0	2	ICICI Bank	14.0	1
ROE (%)	17.6	1	HDFC Bank	16.8	2
ROA (%)	1.2	2	HDFC Bank	1.3	1
NPA % of Advances	0.4	1	HDFC Bank	0.5	2
P/BV (x)	3.0	1	HDFC Bank	4.2	2

(Source: RBI, Analyst Presentations, HDFC Sec)

Conclusion

Commoditisation of traditional banking products and need to invest in technology, marketing and product innovation has made size and scale critical success factors in the banking industry. Axis, by growing aggressively over the past few years has achieved critical mass and size and the branch/ATM permissions that it has in hand, could maintain the growth rate going forward. While consolidation in the industry seems imminent in the next few years, Axis is placed quite well to take advantage of that emerging situation.

Axis has recorded a better than expected result in the 1st quarter, but due to financial mayhem in the global markets currently, one could witness some pressure on the margins and credit growth. Moreover, maintaining the low cost deposits (CASA) in the current ratio could be a challenge considering the rising inflation, which is prompting customers to park their funds in fixed income securities (debt) and term deposits, wherein they enjoy better yield on their investments. But, Axis with its various initiatives in the form of new products and branch expansion could try to maintain the CASA ratio in the 40-43% range. Capital market transactions could control the rapid growth in the fee-based income. The higher provisioning for assets could lead to slowdown in the asset business and there could be possibilities of higher delinquencies due to exposure in mid-sized corporates and SMEs. With the recent brand makeover, Axis could be in the fast growth lane and could continue to grow at a fair pace and prepare itself for the liberalisation Phase post 2009. However, the growth rate could be lower than 40%+ seen over the last few years due to higher base. On a P/ABV basis, Axis trades at 2.7 its FY09 (E) adjusted book value.

Financials

Particulars (Rs in Crs)	FY06	FY07	FY08	FY09 (E)^
Interest Earned	2888.8	4461.7	7005.3	9837.1
Interest Expended	1810.6	2993.3	4420.0	6417.4
CASA as a % of Deposits	40%	40%	46%	43%
Net Interest Income	1078.2	1468.3	2585.4	3419.7
Net Interest Margin (%)	2.8	2.7	3.5	3.2
Net Profit	485.1	656.2	1071.1	1317.4

Interest Spread (%)	3.7%	4.1%	4.7%	4.5%
Total Average Assets	43,765.4	61,494.2	91,417.5	124,502.3
Average Interest Earnings Assets	37,857.0	53,591.0	74,589.0	106,873.9
NPA % of Net Advances	0.3	0.7	0.4	0.6
Return On Assets (%)	1.1	1.1	1.2	1.1
Return on Equity (%)	18.2	20.8	17.6	14.2
EPS (Rs.)	17.4	23.3	29.9	36.8
P/E (x)	40.4	30.2	23.5	19.1
P/ABV (x)	7.4	6.3	3.0	2.7
Equity capital	278.7	281.6	357.7	357.7
Total Reserves	2593.5	3,111.6	8,410.8	9,410.7
Face Value (Rs.)	10.0	10.0	10.0	10.0
Adjusted Book Value (Rs.)	95.2	111.0	238.2	263.6

^ - Quick Estimates (Source: Annual Report, HDFC Sec Estimates)

Technical Supports/Resistances

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