

29 July 2008 | 9 pages

# Andhra Bank (ADBK.BO)

 Rating change   
 Target price change   
 Estimate change   
 Results 

## Buy: 1Q09 Results; Under Pressure, but High Dividend Yield

- 1Q09 profits down 45% YoY; 30% below estimates** — Andhra's 1Q09 results were weaker operationally. Margins contracted significantly over the year and its relatively mid-market loan book is increasingly at risk. There were positives as well – continued strength in fee income growth, likely stabilization of margins and its high loan loss coverage levels.
- Margins under pressure; fees are healthy** — Net Interest Margins contracted 70bps to 276bps in 1Q09. Andhra's NIMs are now in line with most peers – historically its higher margins have been a key support to its above-industry profitability. While QoQ margins were stable; Andhra's relatively lower CASA ratio suggests that margins will continue to be under pressure. Key positive for the quarter though was the sustained growth in fee incomes (+28% YoY).
- Asset quality: increased pressure** — While NPLs have increased a little (+5.5% QoQ); reported asset quality is still fine with Gross NPLs at 1.2% and over 90% loan-loss coverage levels. However, Andhra's loan book is relatively more exposed to agriculture and mid-market focused; we expect pressures to increase in these segments and thus have a more cautious outlook.
- Superior return profile, strong dividend support** — While Andhra is relatively exposed to a higher interest rate environment; it has a superior return profile (16-18% ROEs), strong dividend support (7% yields) and capital cushion (8%+ Tier1 on Basle 2). We reduce target to Rs76 (from Rs121) on 22-32% lower earnings (higher bond and loan-loss charges) and adjust Risk rating to Medium (from Low). Maintain Buy; Andhra is our top pick among small PSU banks.

<b>Buy/Medium Risk</b>	<b>1M</b>
<i>from Buy/Low Risk</i>	
Price (28 Jul 08)	Rs55.85
Target price	Rs76.00
<i>from Rs121.00</i>	
Expected share price return	36.1%
Expected dividend yield	7.5%
<b>Expected total return</b>	<b>43.6%</b>
Market Cap	Rs27,087M
	US\$637M

### Price Performance (RIC: ADBK.BO, BB: ANDB IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	5,379	11.09	1.1	5.0	0.9	17.8	6.8
2008A	5,755	11.87	7.0	4.7	0.8	18.0	7.2
2009E	5,588	11.52	-2.9	4.8	0.8	16.4	7.5
2010E	6,970	14.37	24.7	3.9	0.7	18.4	7.9
2011E	8,391	17.30	20.4	3.2	0.6	19.5	8.2

Source: Powered by dataCentral

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<sup>1</sup>Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
<b>Valuation Ratios</b>					
P/E adjusted (x)	5.0	4.7	4.8	3.9	3.2
P/E reported (x)	5.0	4.7	4.8	3.9	3.2
P/BV (x)	0.9	0.8	0.8	0.7	0.6
P/Adjusted BV diluted (x)	0.9	0.8	0.8	0.7	0.6
Dividend yield (%)	6.8	7.2	7.5	7.9	8.2
<b>Per Share Data (Rs)</b>					
EPS adjusted	11.09	11.87	11.52	14.37	17.30
EPS reported	11.09	11.87	11.52	14.37	17.30
BVPS	65.08	67.00	73.60	82.83	94.75
Tangible BVPS	65.08	67.00	73.60	82.83	94.75
Adjusted BVPS diluted	65.08	67.00	73.60	82.83	94.75
DPS	3.80	4.00	4.20	4.40	4.60
<b>Profit &amp; Loss (RsM)</b>					
Net interest income	14,175	14,199	16,298	18,701	21,419
Fees and commissions	1,816	2,124	2,358	2,617	2,905
Other operating Income	3,409	4,492	4,345	4,569	5,030
<b>Total operating income</b>	<b>19,400</b>	<b>20,815</b>	<b>23,001</b>	<b>25,888</b>	<b>29,354</b>
Total operating expenses	-9,332	-9,443	-10,149	-10,908	-11,724
<b>Oper. profit bef. provisions</b>	<b>10,068</b>	<b>11,372</b>	<b>12,852</b>	<b>14,980</b>	<b>17,630</b>
Bad debt provisions	-1,386	-1,237	-2,211	-3,576	-4,106
Non-operating/exceptionals	-914	-955	-2,300	-1,000	-1,000
<b>Pre-tax profit</b>	<b>7,768</b>	<b>9,181</b>	<b>8,341</b>	<b>10,404</b>	<b>12,524</b>
Tax	-2,389	-3,425	-2,753	-3,433	-4,133
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
<b>Attributable profit</b>	<b>5,379</b>	<b>5,755</b>	<b>5,588</b>	<b>6,970</b>	<b>8,391</b>
Adjusted earnings	5,379	5,755	5,588	6,970	8,391
<b>Growth Rates (%)</b>					
EPS adjusted	1.1	7.0	-2.9	24.7	20.4
Oper. profit bef. prov.	20.7	12.9	13.0	16.6	17.7
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>475,410</b>	<b>565,924</b>	<b>659,042</b>	<b>764,960</b>	<b>886,559</b>
Avg interest earning assets	429,120	509,849	599,811	700,282	815,450
Customer loans	283,638	347,071	409,260	476,276	554,108
Gross NPLs	3,970	3,724	7,302	9,665	12,111
<b>Liab. &amp; shar. funds</b>	<b>475,410</b>	<b>565,924</b>	<b>659,042</b>	<b>764,960</b>	<b>886,559</b>
Total customer deposits	414,540	494,365	581,994	680,936	794,013
Reserve for loan losses	4,748	4,687	6,683	9,287	12,401
Shareholders' equity	<b>31,563</b>	<b>32,493</b>	<b>35,698</b>	<b>40,172</b>	<b>45,953</b>
<b>Profitability/Solvency Ratios (%)</b>					
ROE adjusted	17.8	18.0	16.4	18.4	19.5
Net interest margin	3.30	2.78	2.72	2.67	2.63
Cost/income ratio	48.1	45.4	44.1	42.1	39.9
Cash cost/average assets	2.1	1.8	1.7	1.5	1.4
NPLs/customer loans	1.4	1.1	1.8	2.0	2.2
Reserve for loan losses/NPLs	119.6	125.9	91.5	96.1	102.4
Bad debt prov./avg. cust. loans	0.5	0.4	0.6	0.8	0.8
Loans/deposit ratio	68.4	70.2	70.3	69.9	69.8
Tier 1 capital ratio	10.5	9.1	8.5	8.3	8.2
Total capital ratio	12.2	12.2	11.2	10.6	10.1

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Figure 1. Andhra Bank: 1Q FY09 Results – Highlights (Rupees Million, Percent)

	1Q09	1Q08	YoY %	4Q08	QoQ%	Citi Investment Research Comments
Interest Income	11,574	9,895	17.0	11,692	-1.0	
Interest Expense	-8,111	-6,273	29.3	-8,263	-1.8	
Net Interest Income	3,463	3,621	-4.4	3,429	1.0	Absolute reduction in NII over the year; 7% below estimates due to sharp contraction in YoY margins
Fee-Based Income	1,197	922	29.8	1,513	-20.9	Fee based incomes are still healthy - a key positive for Andhra - has also started to gain traction in third party distribution fees
Other Non-Interest Income	-10	203	NM	320	NM	
Non Interest Income	1,187	1,125	5.5	1,833	-35.3	About 9% below estimates; largely due to lower treasury gains
<b>Operating Income</b>	<b>4,649</b>	<b>4,746</b>	<b>-2.0</b>	<b>5,262</b>	<b>-11.7</b>	
Operating Expenses	(2,597)	(2,512)	3.4	(2,131)	21.8	Sharp QoQ jump in expenses - low base effect due to a write back in employee expenses in 4Q08 (about Rs350m)
Pre-Provision Profit	2,053	2,234	-8.1	3,131	-34.4	Significantly lower than expected; +2%yoy growth in pre-provisioning (ex-trading gains) - about 24% below estimates
Charges for Bad Debts	(357)	(197)	81.0	(430)	-17.1	Increased pressure; Andhra's relatively mid-market portfolio will likely be hurt relatively more; 1Q09 though in-line with estimates
Other Operating Items	(870)	104	NM	(483)	80.1	Again in-line (includes Rs100m on account of equity losses)
<b>Pre-Tax Profit</b>	<b>826</b>	<b>2,141</b>	<b>-61.4</b>	<b>2,218</b>	<b>-62.8</b>	
Tax	(50)	(730)	-93.2	(975)	-94.9	Adhoc payment for the quarter - will be adjusted going forward
<b>Net Profit</b>	<b>776</b>	<b>1,411</b>	<b>-45.0</b>	<b>1,243</b>	<b>-37.6</b>	<b>30% below estimates - sharp decline in margins have hurt core profitability</b>
EPS	1.60	2.91	-45.0	2.56	-37.6	
Customer Loans	340,810	277,070	23.0	345,560	-1.4	Healthy loan growth - focus continues to be on agri and SME
Customer Deposits	491,750	407,590	20.6	494,370	-0.5	Management indicates a reduction in high cost bulk deposits in the quarter
AIEA	502,664	417,149	20.5	497,452	1.0	
Total Assets	558,430	465,358	20.0	569,413	-1.9	
Avg Assets	563,922	515,641	9.4	543,531	3.8	
Non-Performing Loans (NPL)	3,928	4,207	-6.6	3,724	5.5	Some slippages in the quarter; though still very comfortable. Has written back Rs150mn of NPLs on implementation of agri loan waiver
Loan Loss Reserves (LLR)	(3,577)	(3,696)	-3.2	(3,187)	12.2	Rs30m reduction on agri NPLs written back; provision levels continue to be high
Shareholders' Funds	33,269	35,729	-6.9	32,493	2.4	Tier 1 capital adequacy of 9% - management estimates further 50-100bps impact on shifting to Basle 2
Book Value Per Share	68.59	73.67	-6.9	67.00	2.4	
<b>Key Ratios (%)</b>	<b>1Q09</b>	<b>1Q08</b>	<b>Bps Δ YoY</b>	<b>4Q08</b>	<b>Bps Δ QoQ</b>	
ROAA (annualized)	0.55	1.09	-54	0.91	-36	
ROAE (annualized)	9.33	15.80	-646	15.30	-597	
Net Interest Margin (bps)	276	347	-72	276	0	Stable QoQ; though stark reduction over the year has put pressure on its relatively higher historical profitability; expect pressures to remain
Fee Inc/Operating Income	25.7	19.4	631	28.8	-302	QoQ decline partly due to reduction in recoveries (strong in 4Q08)
Other Non-Interest Inc/Op Inc	25.5	23.7	183	34.8	-931	
Op. Cost/ Operating Income	55.8	52.9	291	40.5	1535	normalisation of base after a low 4Q08 (due to expense write backs)
Loan-to-Deposit Ratio (LDR)	69.3	68.0	133	69.9	-59	
NPL/Loan Ratio	1.2	1.5	-37	1.1	7	Amongst the lowest in the industry; little signs of immediate pressure - though remains a little more exposed on its larger mid-market portfolio
LLR/NPL Ratio	91	88	322	86	547	Amongst the highest relative to peers - provides comfort in a difficult environment

Source: Citi Investment Research

Figure 2. Estimates Revisions Summary

	Net Profit			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
FY09E	7,181.6	5,588	-22.2	14.8	11.5	-22.2	4.2	4.2
FY10E	8,415.7	6,970	-17.2	17.4	14.4	-17.2	4.2	4.4
FY11E	12,388.6	8,391	-32.3	25.5	17.3	-32.3	4.2	4.6

Source: Citi Investment Research estimates

## Andhra Bank

### Company description

Andhra is the 18<sup>th</sup>-largest Indian Bank, and 15<sup>th</sup>-largest among government banks. This broadly positions it as a small bank, even among government banks, with a deposit market share of about 1.6%. Andhra is less than one-third the size of larger government banks. Over 70% of its branches are in the state of Andhra Pradesh in southern India. Its business is also concentrated- about 58% of its loans and 64% of deposits are in the state, with the rest spread across the country.

### Investment strategy

We rate Andhra Bank shares Buy / Medium Risk (1M). We believe Andhra has three key things going for it: 1) Strong and consistent profitability, driven by high margins thanks to high loan yields, embedded low-cost deposit franchise, consistently strong returns on the bond portfolio and a relatively low provision requirement, given low NPL levels. We expect ROE to decline, but remain at about 16-18%, which is significantly ahead of most industry peers, despite the challenging environment. 2) It has a strong balance sheet with low gross and net NPLs - 1.2% and 0.15% respectively. 3) It is well capitalized with a Tier 1 ratio of 9% currently (over 8% on Basle 2) – a positive and a contrast to most peers. 4) Adequate scale, a sufficient distribution network, and some surplus balance sheet liquidity. In addition Andhra also offers a strong dividend yield (7%) at current price levels.

### Valuation

We reduce our target price to Rs76 (from Rs121) on 22-32% lower earnings (higher bond and loan-loss charges) and other assumptions revisions. Our target price of Rs76 is based on Citi's EVA model, which captures long-term business value, and is a standard valuation measure for our India Banking coverage. We factor a risk-free rate of 9.0% (previously 7.5%). We also factor in industry average longer-term margins (220bps) and capital ratio (6%). We benchmark our target price on a 1.0x 1-year-forward P/BV multiple (1.4x FY09E), which accounts for the cautious outlook on asset quality and operating environment. This translates to a fair value of Rs76 per share. Our target multiple remains at a discount to larger public sector banks like SBI and PNB. We believe this discount is warranted – despite Andhra's above-sector average RoEs and margins, and lower gross and net NPLs – to factor in possible risks of its relatively small balance sheet size, and regional concentration. We use the EVA measure as we believe it better adjusts for the relatively dynamic cost of capital, and better captures the long-term value of the business.

## **Risks**

We now rate Andhra Bank shares Medium Risk even though our quantitative risk-rating system, which tracks 260-day historical share-price volatility, suggests Low Risk. We believe Andhra is relatively more exposed to a higher interest rate environment due to its relatively concentrated agriculture and mid-market lending, lower CASA ratios and relatively high bond trading gains.

Key downside risks to Andhra Bank shares are largely industry risks: 1) A continued sharp deterioration in loan growth and asset quality environment - Andhra does carry some mid-market, geographic concentration and specific industry risk; 2) Sharp increases in bond yields - only a small part of the portfolio, with low duration, is exposed; and 3) Government ownership - as the primary shareholder, the government's interests and decisions could be at odds with minority shareholder interests. These risks could impede the stock from reaching our target price.

# Appendix A-1

## Analyst Certification

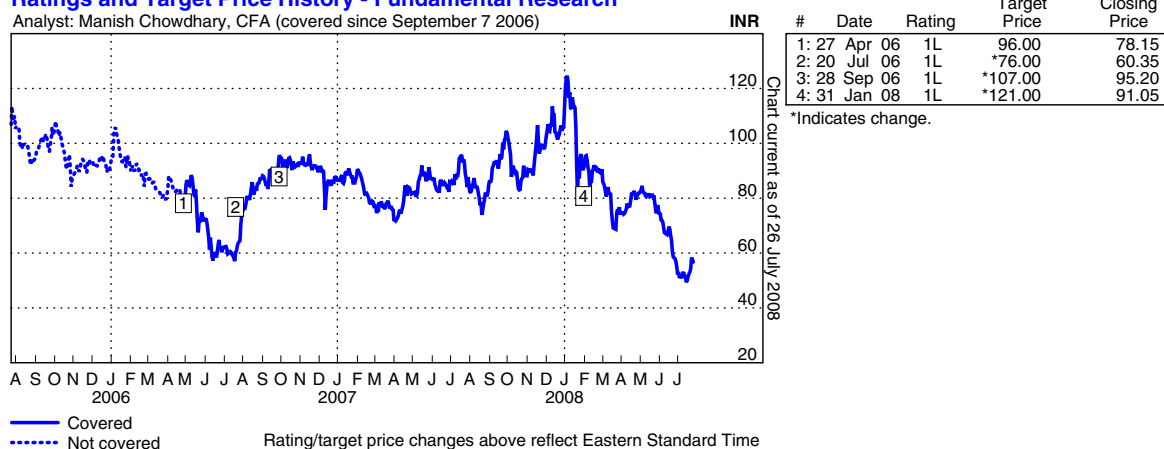
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Analyst: Manish Chowdhary, CFA (covered since September 7 2006)



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