

Takeaways from meeting with the CEO; Reiterate Buy

Key Takeaways from meeting with the CEO of Federal Bank

We met with Mr. Shyam Srinivasan, CEO of Federal Bank. **Key takeaways:**

- FB looking at loan growth of +21-22% in FY12 (vs. ~18% in FY11). Loan growth to be driven by SME, Mid-corporate and Retail. FB looking at deposit growth of ~25% in FY12 driven by CASA and low-cost NRI deposits (~7% of total deposit)
- Mgmt. confident of bringing down slippages (gross) at ~Rs2.2bn levels vs. ~Rs2.9bn in 4Q. Mgmt. does not see any stress in Retail, SME. The only issue remains is large-ticket corporate loans, wherein they are part of a consortium, which can swing the slippages numbers
- There is visible pricing power in retail and SME, but again in corporate, FB cannot command pricing power as mostly they are part of a syndicate
- FB is restructuring its operating matrix such that a regional head will now look at ~25-30 branches vs. earlier +50-60, which will help better manage operations.
- The biggest challenge is managing extremes of workforce: ~3000 employees are +30 yrs of experience, while ~3000 employees are <30 years of age
- FB looking to add another ~250 new branches (taking total to ~1000) by Dec'2012, ~150 of new additions will be outside of Kerala State

Preferred mid-cap pick; Reiterate Buy and PO of Rs510

We believe post FY11 B/s consolidation and adopting of new strategy by FB, RoA to rise to +1.5% by FY12 (vs. 1.2% in FY11), with return of growth and unwinding of credit costs in FY12. This is turn should help earnings growth of +40/28% in FY12E/13E and RoEs rising to 15% in FY12E (+17% in FY13E) vs. 12% in FY11.

Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	5,005	4,645	5,871	8,219	10,501
EPS	29.26	27.16	34.32	48.05	61.39
EPS Change (YoY)	2.0%	-7.2%	26.4%	40.0%	27.8%
Dividend / Share	5.00	5.00	8.50	11.00	14.00
Pre-exceptional EPS	29.26	27.16	34.32	48.05	61.39
Pre-exceptional EPS Change (YoY)	137.0%	-7.2%	26.4%	40.0%	27.8%
Book Value / Share	248.94	266.71	287.52	317.62	358.00

Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	14.8x	15.9x	12.6x	9.0x	7.0x
Dividend Yield	1.16%	1.16%	1.96%	2.54%	3.24%
Pre-exceptional PE	14.78x	15.93x	12.61x	9.00x	7.05x
Price / Book	1.71x	1.58x	1.45x	1.29x	1.14x
RoE / PB	7.09x	6.53x	8.27x	11.74x	15.10x
Price / Pre-Provision Profit	5.87x	5.85x	5.19x	4.53x	3.86x

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Stock Data

Price	Rs432.65
Price Objective	Rs510.00
Date Established	9-May-2011
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs301.15-Rs501.00
Mrkt Val / Shares Out (mn)	US\$1,645 / 171.0
Average Daily Volume	567,348
BofAML Ticker / Exchange	XFDRF / BSE
Bloomberg / Reuters	FB IN / FED.BO
ROE (2011E)	12.0%
Total Dbt to Cap (Mar-2010A)	NA
Est. 5-Yr EPS / DPS Growth	25.0% / 25.0%
Free Float	74.0%

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Refer to important disclosures on page 6 to 8. Analyst Certification on Page 3. Price Objective Basis/Risk on page 3. Link to Definitions on page 3. 11053313

23 May 2011

iQprofileSM Federal Bank

Key Income Statement Data (Mar)	2009A	2010A	2011E	2012E	2013E
(Rs Millions)					
Net Interest Income	13,155	14,108	17,466	20,243	23,921
Net Fee Income	1,013	1,050	1,144	1,259	1,385
Securities Gains / (Losses)	829.92	1,080	457.60	451.09	451.09
Other Income	3,315	3,179	3,566	4,130	4,783
Total Non-Interest Income	5,158	5,309	5,168	5,840	6,619
Total Operating Income	18,312	19,417	22,634	26,082	30,540
Operating Expenses	(5,715)	(6,769)	(8,361)	(9,743)	(11,357)
Pre-Provision Profit	12,598	12,648	14,273	16,339	19,183
Provisions Expense	(3,542)	(4,131)	(4,889)	(3,422)	(2,909)
Operating Profit	9,056	8,517	9,384	12,917	16,274
Non-Operating Income	(1,126)	78.10	(365.90)	(650.47)	(600.47)
Pre-Tax Income	7,930	8,595	9,018	12,267	15,674
Net Income to Comm S/Hold.	5,005	4,645	5,871	8,219	10,501
Adjusted Net Income (Operating)	5,005	4,645	5,871	8,219	10,501

Key Balance Sheet Data

Total Assets	388,509	436,756	514,566	618,220	739,421
Average Interest Earning Assets	345,243	400,442	461,680	550,302	660,957
Weighted Risk Assets	234,221	294,090	354,850	395,320	488,281
Total Gross Customer Loans	223,919	269,501	319,532	388,886	468,839
Total Customer Deposits	321,982	360,580	430,150	521,367	628,193
Tier 1 Capital	43,148	46,796	55,499	55,338	63,206
Tangible Equity	43,148	46,796	55,499	55,338	63,206
Common Shareholders' Equity	43,259	46,904	51,087	57,236	65,103

Key Metrics

Net Interest Margin	3.81%	3.52%	3.78%	3.68%	3.62%
Tier 1 Ratio	18.4%	15.9%	15.6%	14.0%	12.9%
Effective Tax Rate	36.9%	46.0%	34.9%	33.0%	33.0%
Loan / Assets Ratio	57.6%	61.7%	62.1%	62.9%	63.4%
Loan / Deposit Ratio	69.5%	74.7%	74.3%	74.6%	74.6%
Oper Leverage (Inc Growth - Cost Growth)	23.1%	-12.4%	-7.0%	-1.3%	0.5%
Gearing (Assets / Equity)	9.0x	9.3x	10.1x	10.8x	11.4x
Tangible Common Equity / Assets	11.1%	10.7%	10.8%	9.0%	8.5%
Tangible Common Equity / WRAs	18.4%	15.9%	15.6%	14.0%	12.9%
Revenue Growth	45.0%	6.0%	16.6%	15.2%	17.1%
Operating Expense Growth	21.9%	18.5%	23.5%	16.5%	16.6%
Provisions Expense Growth	65.3%	16.6%	18.3%	-30.0%	-15.0%
Operating Revenue / Average Assets	5.1%	4.7%	4.8%	4.6%	4.5%
Operating Expenses / Average Assets	1.6%	1.6%	1.8%	1.7%	1.7%
Pre-Provision ROA	3.5%	3.1%	3.0%	2.9%	2.8%
ROA	1.40%	1.13%	1.23%	1.45%	1.55%
Pre-Provision ROE	30.5%	28.1%	29.1%	30.2%	31.4%
ROE	12.1%	10.3%	12.0%	15.2%	17.2%
RoTE	11.6%	9.9%	10.6%	14.9%	16.6%
RoWRAs	2.1%	1.6%	1.7%	2.1%	2.2%
Dividend Payout Ratio	20.0%	21.5%	27.2%	25.2%	25.1%
Efficiency Ratio (Cost / Income Ratio)	32.7%	36.9%	37.7%	38.0%	37.7%
Total Non-Interest Inc / Operating Inc	28%	27%	23%	22%	22%
Market-Related Revenue / Total Revenues	7.3%	7.9%	4.6%	4.4%	4.2%
Provisioning Burden as % of PPP	28.1%	32.7%	34.3%	20.9%	15.2%
NPLs plus Foreclosed Real Estate / Loans	2.6%	3.0%	3.6%	3.4%	3.2%
Loan Loss Reserves / NPLs	113.0%	102.0%	96.9%	90.9%	86.5%
Loan Loss Reserves / Total Loans	3.1%	3.2%	3.6%	3.2%	2.8%
Provisions Expense / Average Loans	1.7%	1.6%	1.6%	0.9%	0.7%

Other Metrics

Income / Employee	2.52	2.46	2.74	2.94	3.19
(Operating Expenses) / Employee	(0.787)	(0.857)	(1.01)	(1.10)	(1.19)
Pre-Provision Profit / Employee	1.74	1.60	1.73	1.84	2.00
Net Profit / Employee	0.690	0.588	0.710	0.927	1.10

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

1.4x

Price objective basis & risk

Federal Bank (XFDRF)

Our PO on Federal Bank is Rs510. We believe the bank can command a P/B multiple of 1.6x by FY12E, which is at a +50% premium to the Gordon model, owing to 1) higher earnings growth of +40/28% over FY12/13 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	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	Bank of India	XDIIF	BOI IN	Rajeev Varma
	Corporation Bank	XCRRF	CRPBK IN	Veekesh Gandhi
	Federal Bank	XFDRF	FB IN	Veekesh Gandhi
	HDFC	HGDFF	HDFC IN	Rajeev Varma
	HDFC Bank	XHDF	HDFCB IN	Rajeev Varma
	HDFC Bank	HDB	HDB US	Rajeev Varma
	ICICI Bank	ICIJF	ICICBC IN	Rajeev Varma
	ICICI Bank - A	IBN	IBN US	Rajeev Varma
	IndiaBulls Financial Services	IBLFF	IBULL IN	Veekesh Gandhi
	Indian Bank	INDIF	INBK IN	Rajeev Varma
	LIC Housing Finance, Ltd.	LHFLF	LICHF IN	Veekesh Gandhi
	Manappuram	XMGPF	MGFL IN	Veekesh Gandhi
	Max India	MXXIF	MAX IN	Rajeev Varma
	ORBC	ORBCF	OBC IN	Rajeev Varma
	Punjab	PUJBF	PNB IN	Rajeev Varma
	Reliance Capital	RLCCF	RCAPT IN	Veekesh Gandhi
	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
	Union Bank India	UBOIF	UNBK IN	Rajeev Varma
UNDERPERFORM				
	Canara Bank	CNRKF	CBK IN	Rajeev Varma
	IDBI	XDBIF	IDBI IN	Veekesh Gandhi
	Infrastruct Dev	IFDFF	IDFC IN	Rajeev Varma
RSTR				
	Power finance corporation Ltd	PWFEF	POWF IN	Veekesh Gandhi

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iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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	Net Debt = 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	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

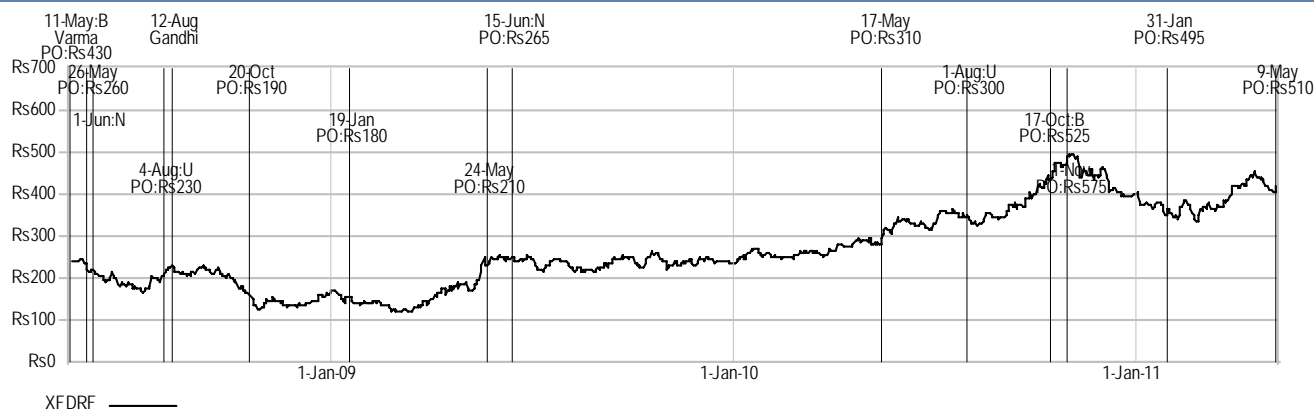
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XFDRF Price Chart



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

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of April 30, 2011 or such later date as indicated.

Investment Rating Distribution: Banks Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	122	48.80%	Buy	50	49.02%
Neutral	69	27.60%	Neutral	33	58.93%
Sell	59	23.60%	Sell	25	44.64%

Investment Rating Distribution: Global Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2009	53.66%	Buy	912	49.89%
Neutral	955	25.51%	Neutral	439	50.93%
Sell	780	20.83%	Sell	257	35.11%

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