



## Federal Bank

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,212	FB IN
S&P CNX: 4,124	REUTERS CODE
	FED.BO

29 January 2007

Buy

Previous Recommendation: Buy

Rs252

Equity Shares (m)	85.8
52-Week Range	274/137
1,6,12 Rel.Perf.(%)	12/12/-5
M.Cap. (Rs b)	21.7
M.Cap. (US\$ b)	0.5

YEAR	NET INCOME	PAT	EPS	EPS	P/E	P/BV	CAR	ROE	ROA	P/ABV
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	(%)	(X)
3/06A	8,173	2,258	26.3	91.6	9.6	1.7	13.8	22.9	1.2	1.8
3/07E	9,378	2,776	32.3	22.9	7.8	1.5	12.0	20.3	1.2	1.5
3/08E	10,767	3,314	38.6	19.4	6.5	1.2	12.0	20.3	1.3	1.2

With steady loan book growth and improving margins, Federal Bank reported steady net interest income (NII) growth at 18%. Margins improved 15bp QoQ to 3.44%. For the 9mFY07, margins improved 5bp YoY to 3.25%. Deposits have grown by 13% YoY whilst CASA has increased 300bp YoY to 28.4%. Loans have increased by 30% YoY with retail and SME loans driving growth. Asset quality continues to improve; net NPAs are currently at 0.58%.

- ✍ NII grows by 18% YoY; margins improve QoQ
- ✍ Loans up by 28%; deposits grew by 13%
- ✍ Improving asset quality: net NPAs decline to 0.58%
- ✍ Comfortable CAR; Tier I at 9.8%

While core earnings growth remains strong, we believe that reported profits can see further upside in the event of higher recoveries. With consolidation in the sector gaining pace amongst private sector banks, we believe Federal Bank offers value at current levels. The stock is trading at 6.5x FY08E earnings and 1.2x FY08E book value. Reiterate **Buy** with a 12-month target price of Rs330 (upside of 39%).

### QUARTERLY PERFORMANCE

(RS MILLION)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Interest Income	3,473	3,365	3,625	3,903	4,083	4,337	4,441	4,262	14,365	17,123
Interest Expense	2,031	2,025	2,130	2,181	2,497	2,662	2,676	2,399	8,367	10,234
<b>Net Interest Income</b>	<b>1,442</b>	<b>1,340</b>	<b>1,494</b>	<b>1,722</b>	<b>1,586</b>	<b>1,675</b>	<b>1,766</b>	<b>1,863</b>	<b>5,998</b>	<b>6,889</b>
% Change (Y-o-Y)	12.4	0.3	16.0	54.2	10.0	25.0	18.1	8.2	19.4	14.9
Other Income	422	566	484	697	543	726	545	675	2,170	2,489
<b>Net Income</b>	<b>1,864</b>	<b>1,906</b>	<b>1,978</b>	<b>2,420</b>	<b>2,129</b>	<b>2,401</b>	<b>2,310</b>	<b>2,538</b>	<b>8,168</b>	<b>9,378</b>
% Change (Y-o-Y)	-4.3	7.2	14.3	43.5	14.2	26.0	16.8	4.9	14.4	14.8
Operating Expenses	913	888	853	992	991	1,011	973	1,028	3,646	4,003
<b>Operating Profit</b>	<b>951</b>	<b>1,018</b>	<b>1,126</b>	<b>1,427</b>	<b>1,137</b>	<b>1,390</b>	<b>1,337</b>	<b>1,510</b>	<b>4,522</b>	<b>5,375</b>
Prov for Tax	133	105	211	107	176	170	196	287	556	829
Provisions and Contingencies	332	371	199	813	559	526	321	364	1,714	1,770
<b>Net Profit</b>	<b>487</b>	<b>542</b>	<b>716</b>	<b>507</b>	<b>402</b>	<b>695</b>	<b>820</b>	<b>859</b>	<b>2,252</b>	<b>2,776</b>
% Change (Y-o-Y)	8.1	1,597.8	496.5	69.9	-17.5	28.2	14.5	69.3	150.0	23.2
Cost to Income Ratio (%)	49.0	46.6	43.1	41.0	46.6	42.1	42.1	40.5	44.6	42.7
Interest Expense/Interest Income (%)	58.5	60.2	58.8	55.9	61.2	61.4	60.2	56.3	58.2	59.8
Other Income/Net Income (%)	22.6	29.7	24.5	28.8	25.5	30.2	23.6	26.6	26.6	26.5

E: MOST Estimates

With steady loan book growth and improving margins, Federal Bank reported steady net interest income growth at 18%. Margins improved 15bp QoQ to 3.44%. For the 9mFY07, margins improved 5bp YoY to 3.25%. Deposits have grown by 13% YoY whilst CASA has increased 300bp YoY to 28.4%. Loans have increased by 30% YoY with retail and SME loans driving growth. Asset quality continues to improve with net NPAs currently at 0.58%.

### **NII grows 18% YoY; margins improve QoQ**

Federal Bank reported 18% YoY growth in net interest income (NII) for 3QFY07. Margins improved QoQ to 3.44% in 3QFY07 from 3.29% in 2QFY07. For 9mFY07, margins improved 5bp YoY to 3.25%. The key reason of this margin improvement has been containment of deposit cost by the bank as it has not resorted to high cost deposits. Further, NRI deposits (31% of total deposits) has not witnessed a rate increase as in the case of domestic deposits. Deposit costs actually declined from 5.12% in 9mFY06 to 4.5% in 9mFY07, while loan yields increased from 9.86% to 9.9% YoY and investment yields remained flat YoY at 7.5%. Federal Bank has increased lending rates from January 2007 onward, which is likely to increase the lending yields by 15bp in 4Q over 3Q. Management is confident of maintaining margins at least at the current levels over next few quarters as deposit cost is largely contained.

### **Loans up by 28%; deposits grow by 13%**

Deposits have grown by 13% YoY to Rs186b. However, CASA deposits have grown much faster (savings deposits up 24% YoY and current deposits up 33% YoY). The share of CASA has increased 300bp YoY to 28.4%. Loans have increased by 30% YoY to 136b, with retail and SME loans driving growth. The bank continues to have excess SLR deposits of Rs7b as of December, which it can use to grow its loan book.

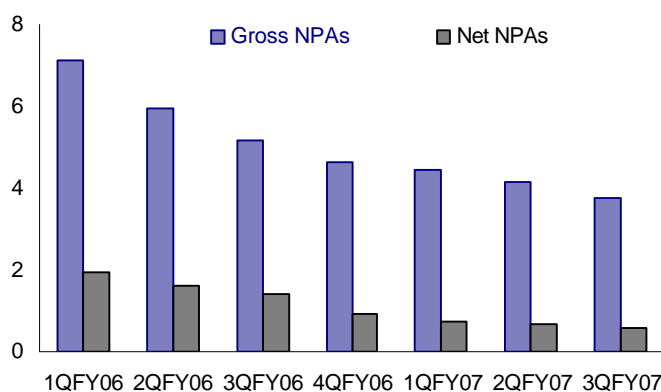
### **Flat treasury profits; core other income grows by 17% YoY**

Trading profits were flat YoY at Rs60m in 3QFY07. Core other income was up by 17% to Rs485, contributed by higher recoveries from written-off accounts and core fee income which grew by 18% YoY. Core fee income grew by 25% YoY over 9mFY07.

### **Improving asset quality: Net NPAs decline to 0.58%**

The bank has maintained its trend of improving NPAs QoQ. Net NPAs have declined to 0.58% (9bp decline QoQ) during 3QFY06 from 1.41% in 3QFY06 and 0.95% at FY06. Even on an absolute basis, net NPAs have declined by almost 47% YoY to Rs0.8b YoY. With management expecting good recovery in 4Q, we believe that NPAs are likely to decline further going forward. With absolute net NPAs at just Rs784m, recoveries could serve as strong earnings drivers for Federal Bank and can provide upside to our earnings.

TREND IN NPAs



Source: Company/Motilal Oswal Securities

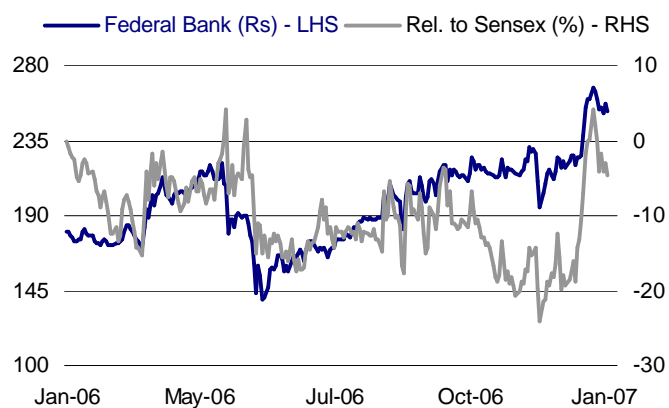
### **Comfortable CAR; Tier I at 9.8%**

Federal Bank has a capital adequacy ratio at 14.6% that is comfortable, whilst Tier I CAR has increased to 9.8%. In fact, the bank also carries IFR of about 1.5%, which the bank classifies as Tier II, which we believe could be classified as Tier I capital.

### Valuation and view

Whilst core earnings growth remains strong, we believe reported profits can witness further upside in the event of higher recoveries. With consolidation in the sector gaining pace amongst private sector banks, we believe Federal Bank offers value at current levels. The stock is trading at 6.5x FY08E earnings and 1.2x FY08E book value. Reiterate **Buy** with a 12-month target price of Rs330 (upside of 39%).

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(RS MILLION)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Interest Income	11,910	14,371	17,123	20,596	25,325	
Interest Expended	6,888	8,367	10,234	12,594	15,852	
<b>Net Interest Income</b>	<b>5,023</b>	<b>6,004</b>	<b>6,889</b>	<b>8,002</b>	<b>9,472</b>	
Change (%)	19.1	19.5	14.7	16.2	18.4	
Other Income	2,120	2,169	2,489	2,765	3,034	
- Fee income	1,571	2,000	2,289	2,565	2,784	
- Treasury Income	548	169	200	200	250	
<b>Net Income</b>	<b>7,143</b>	<b>8,173</b>	<b>9,378</b>	<b>10,767</b>	<b>12,507</b>	
Change (%)	-0.7	14.4	14.7	14.8	16.2	
Operating Expenses	3,139	3,646	4,003	4,464	4,917	
<b>Operating Income</b>	<b>4,004</b>	<b>4,528</b>	<b>5,375</b>	<b>6,303</b>	<b>7,589</b>	
Change (%)	-8.3	13.1	18.7	17.3	20.4	
- Employee Expenses	1,858	2,284	2,460	2,690	2,856	
- Other Exp	1,281	1,362	1,543	1,774	2,062	
Other Provisions	2,843	1,672	1,770	1,700	2,050	
- NPA provisions	1,359	956	695	800	900	
- Other provisions	1,485	716	1,075	900	1,150	
<b>PBT</b>	<b>1,161</b>	<b>2,856</b>	<b>3,605</b>	<b>4,603</b>	<b>5,539</b>	
Tax	260	598	829	1,289	1,551	
Tax Rate (%)	22.4	20.9	23.0	28.0	28.0	
<b>PAT</b>	<b>901</b>	<b>2,258</b>	<b>2,776</b>	<b>3,314</b>	<b>3,988</b>	
Change (%)	-33.9	150.7	22.9	19.4	20.3	
Proposed Dividend	164	300	386	472	558	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Capital	656	858	858	858	858	
Reserves & Surplus	6,577	11,642	14,032	16,874	20,304	
<b>Net Worth</b>	<b>7,233</b>	<b>12,501</b>	<b>14,890</b>	<b>17,732</b>	<b>21,163</b>	
<b>Deposits</b>	<b>151,929</b>	<b>178,787</b>	<b>207,393</b>	<b>244,724</b>	<b>288,774</b>	
Change (%)	12.7	17.7	16.0	18.0	18.0	
- Savings Deposits	28,647	35,342	43,553	55,063	69,306	
- Current Deposits	8,611	9,383	13,481	17,131	21,658	
- Term Deposits	114,671	134,063	150,360	172,530	197,810	
Borrowings	4,559	8,804	10,124	11,643	14,554	
Other Liabilities & Prov.	4,488	6,337	6,970	7,667	8,434	
<b>Total Liabilities</b>	<b>168,209</b>	<b>206,428</b>	<b>239,378</b>	<b>281,766</b>	<b>332,924</b>	
Current Assets	15,559	18,725	13,020	14,670	17,179	
Investments	57,992	62,724	67,741	73,161	87,793	
Change (%)	5.3	8.2	8.0	8.0	20.0	
<b>Advances</b>	<b>88,226</b>	<b>117,365</b>	<b>150,227</b>	<b>184,779</b>	<b>218,039</b>	
Change (%)	14.6	33.0	28.0	23.0	18.0	
Net Fixed Assets	1,855	1,739	2,043	2,302	2,511	
Other Assets	4,578	5,877	6,347	6,855	7,403	
<b>Total Assets</b>	<b>168,209</b>	<b>206,428</b>	<b>239,378</b>	<b>281,767</b>	<b>332,925</b>	

ASSUMPTIONS	(%)				
Deposit Growth	12.7	17.7	16.0	18.0	18.0
Advances Growth	14.6	33.0	28.0	23.0	18.0
Investments Growth	5.3	8.2	8.0	8.0	20.0
Dividend	25.1	34.9	45.0	55.0	65.0

E: Most Estimates

RATIOS						
Y/E MARCH	2005	2006	2007E	2008E	2009E	
<b>Spreads Analysis (%)</b>						
Avg. Yield - Earning Assct	7.8	8.0	8.1	8.4	8.7	
Avg. Cost-Int. Bear. Liab	4.6	4.9	5.1	5.3	5.7	
Interest Spread	3.2	3.2	3.0	3.1	3.0	
Net Interest Margin	3.3	3.4	3.3	3.3	3.3	

Profitability Ratios (%)						
RoE	13.1	22.9	20.3	20.3	20.5	
RoA	0.6	1.2	1.2	1.3	1.3	
Int. Expended/Int. Earned	57.8	58.2	59.8	61.1	62.6	
Other Inc./Net Income	29.7	26.5	26.5	25.7	24.3	

Efficiency Ratios (%)						
Op. Exps./Net Income	43.9	44.6	42.7	41.5	39.3	
Empl. Cost/Op. Exps.	59.2	62.6	61.5	60.3	58.1	
Busi. per Empl. (Rs m)	34.9	40.8	49.2	58.5	68.9	
NP per Empl. (Rs lac)	1.4	3.4	4.2	4.9	5.9	

Asset-Liability Profile (%)						
Adv./Deposit Ratio	58.1	65.6	72.4	75.5	75.5	
Invest./Deposit Ratio	38.2	35.1	32.7	29.9	30.4	
G-Sec/Invest. Ratio	87.7	90.7	70.9	65.6	54.7	
Gross NPAs to Adv.	7.3	4.6	3.3	2.8	2.7	
Net NPAs to Adv.	2.2	1.0	0.4	0.1	0.0	
CAR	11.3	13.8	12.0	12.0	11.0	
Tier 1	6.4	9.7	9.5	9.0	8.5	

VALUATION						
Book Value (Rs)	110.3	145.6	173.5	206.6	246.6	
Price-BV (x)	2.3	1.7	1.5	1.2	1.0	
Adjusted BV (Rs)	91.0	137.2	169.3	205.4	246.2	
Price-ABV (x)	2.8	1.8	1.5	1.2	1.0	
EPS (Rs)	13.7	26.3	32.3	38.6	46.5	
EPS Growth (%)	-34.3	91.6	22.9	19.4	20.3	
Price-Earnings (x)	18.4	9.6	7.8	6.5	5.4	
OPS (Rs)	61.0	52.7	62.6	73.4	88.4	
OPS Growth (%)	-8.8	-13.6	18.7	17.3	20.4	
Price-OP (x)	4.1	4.8	4.0	3.4	2.9	

E: Most Estimates

**N O T E S**



For more copies or other information, contact

**Institutional:** Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

**Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021**

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOST*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

**Disclosure of Interest Statement**

**Federal Bank**

- |   |    |
|---|----|
| 1. Analyst ownership of the stock                       | No |
| 2. Group/Directors ownership of the stock               | No |
| 3. Broking relationship with company covered            | No |
| 4. Investment Banking relationship with company covered | No |

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.