

APRIL 13, 2011

UPDATE

Coverage view: **Attractive**

Price (Rs): **419**

Target price (Rs): **500**

BSE-30: **19,263**

Better times ahead. We expect Federal Bank to see all round improvement, with a pick-up in loan growth, improving fee income profile and a sharp improvement in asset quality. This is likely to propel very strong earnings momentum – expect 30% CAGR growth over FY2011-13E and expect RoEs to improve to about 16% by FY2013E. The new management is working hard on improving processes, front end, and service quality, while keeping the interests of the employee unions in mind. Federal Bank is our top pick in the mid-cap space with a target price of ₹500.

Company data and valuation summary

Federal Bank

Stock data

52-week range (Rs) (high,low) 501-267

Market Cap. (Rs bn) 71.6

Shareholding pattern (%)

Promoters 0.0

FIs 40.3

MFs 15.5

Price performance (%)

	1M	3M	12M
Absolute	14.7	11.4	48.5
Rel. to BSE-30	8.2	11.0	38.2

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	34.0	44.9	57.0
EPS growth (%)	24.9	32.3	26.9
P/E (X)	12.3	9.3	7.3
NII (Rs bn)	17.6	19.2	22.7
Net profits (Rs bn)	5.8	7.7	9.8
BVPS	292.4	328.1	375.0
P/B (X)	1.4	1.3	1.1
ROE (%)	11.8	14.1	15.9
Div. Yield (%)	1.5	2.0	2.5

Trends on slippages turning positive with changed processes and improving macros

The slippages trend should see further improvement over the coming few quarters - improving over the performance showed in the past three quarters thanks to recent initiatives taken by the management and a gradual recovery in economic conditions. The past three quarters have seen slippages (annualized) from the retail and SME loans declining to about 2.5% from over 4.5% in 1QFY11. (1) Call centers (outsourced model) are actively monitoring 'past due' portfolios unlike the earlier mechanism to recover only after slipping into NPLs; (2) management has deployed resources at the senior level specifically to monitor the slippages/recovery trend; and (3) loan origination is moving through a hub-and-spoke delivery model. Initial results from these changes appear encouraging and sustained improvement could result in lower loan loss provisions than our current estimates. We are building slippages of 2.3% in FY2012-13E and loan loss provisions of 1.2% as compared to slippages of 4% and loan loss provisions of 1.8% in FY2011.

Focus on process and credit delivery; results to reflect from FY2012E

The management highlighted that changes made at the margin should result in a better earnings profile (1) Credit delivery: The hub-and-spoke model (13 centers) is fully functional as against a decentralized model earlier. Branches to act as originating agents for nearly all products; (2) training has been completed for more than 120 employees on credit appraisal; (3) branch managers are being trained on fee income products; and (3) medium-term projects have been given to consultants to improve scoring models on loan appraisal and streamline process delivery.

M B Mahesh
mb.mahesh@kotak.com
Mumbai: +91-22-6634-1231

Manish Karwa
manish.karwa@kotak.com
Mumbai: +91-22-6634-1350

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Working on an effective model; keeping interests of all stakeholders in mind

The management highlighted that large scale changes are unlikely at all levels, which is positive for Federal Bank given the strength of the employees in the decision making processes. However, the bank is likely to fill few key roles from external sources, especially in risk, corporate and treasury departments – mainly to build expertise in these areas. The bank is hiring to meet its growth requirements and replace retired employees (average age to be reduced, currently near 41 years). Investments will continue on training employees to improve cross sell ratios. The bank is also likely to complete its ESOP program (5% of capital) in FY2012, which will be given across the board and unlikely to be top heavy.

Loan growth ahead of industry; NIMs may moderate gradually

We expect Federal Bank to gradually shift focus to loan growth in FY2012E from managing slippages – which should help to leverage its excess capital better.

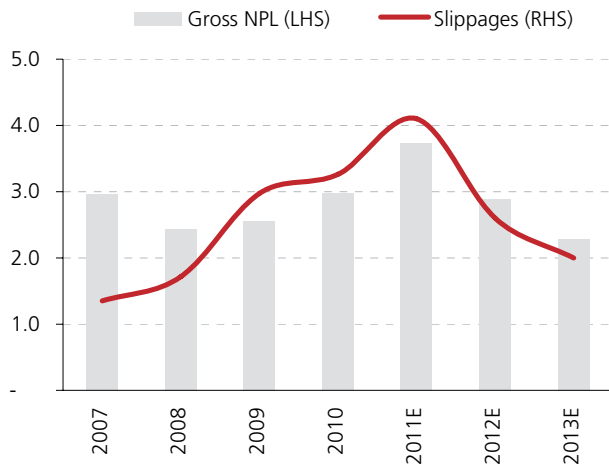
- ▶ Loan growth is likely to be ahead of the industry average - we are modeling a 23% CAGR for FY2011-13E.
- ▶ Focus to continue in retail and SME space.
- ▶ Within retail, apart from housing, the bank would build a marginally higher share in gold loans given the large opportunity within Kerala and Tamilnadu (acts as a substitute for personal loans).
- ▶ Large corporate lending is likely to be through consortium lending or for top rated corporates.

Contribution from fee income to improve sharply in FY2012-13E

Federal Bank is likely to see stronger contribution from fee income to overall revenues post significant investments, especially on training, made in recent months.

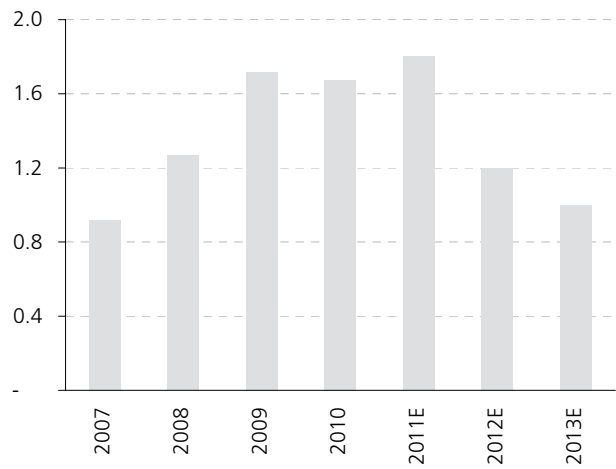
- ▶ NRI business will be a primary driver as they are likely to capture a better share of fee income through wealth management products (rather than only forex commissions) within India (once money is transferred) and outside.
- ▶ Lateral hires in corporate banking and treasury should enable the bank generate higher fee income from these segments too.
- ▶ We are building fee income to grow by 35% CAGR for FY2011-13E (primarily on the back of a lower base as contribution of fee income to assets is about 1% of assets in FY2011).

Gross NPL to decline on the back of lower slippages
Gross NPL and slippages ratio, March fiscal year-ends, 2007-13E (%)



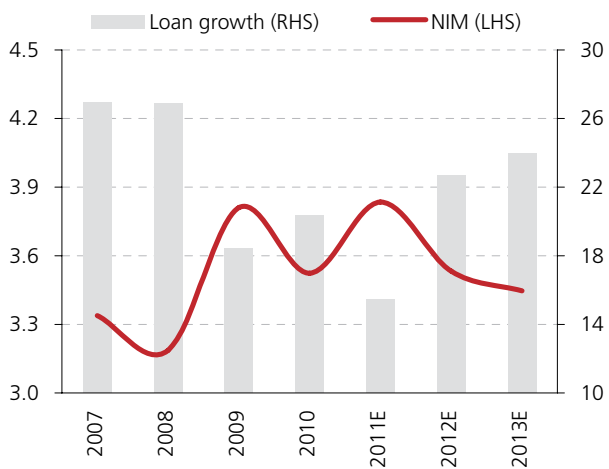
Source: Company, Kotak Institutional Equities estimates

Provisions to decline sharply in FY2012E
Loan loss provisions, March fiscal year-ends, 2007-13E (%)



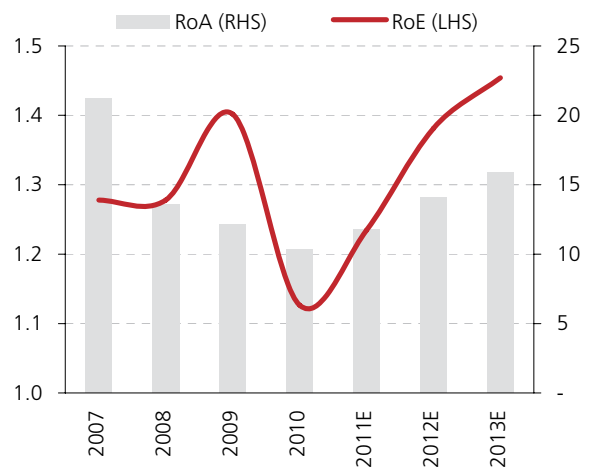
Source: Company, Kotak Institutional Equities estimates

Loan growth to improve but NIMs to decline in FY2012E
Loan growth and NIMs, March fiscal year-ends, 2007-13E (%)



Source: Company, Kotak Institutional Equities

RoA and RoE to improve on the back of lower provisions
RoE and RoA, March fiscal year-ends, 2007-13E (%)



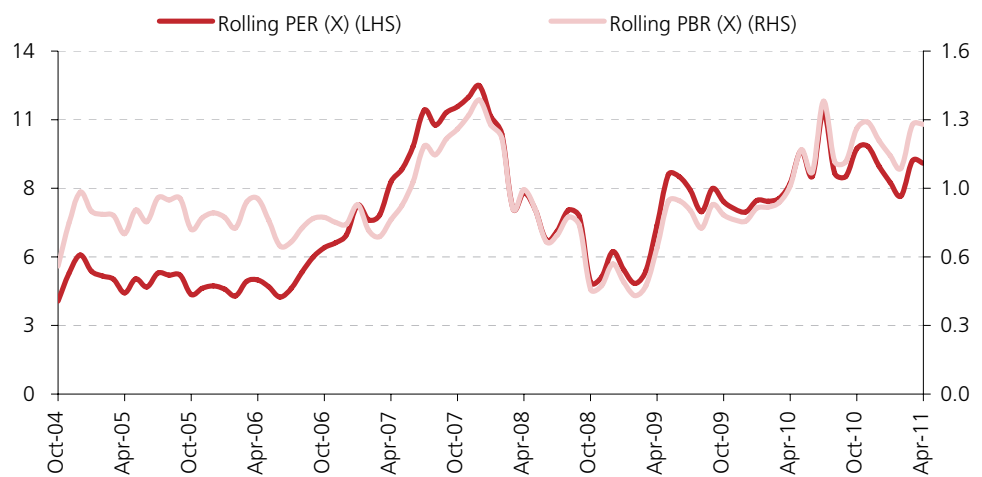
Source: Company, Kotak Institutional Equities

We marginally change our near-term earnings estimates
Old and new estimates

	Old estimates			New estimates			% change		
	2011E	2012E	2013E	2011E	2012E	2013E	2011E	2012E	2013E
Net interest income	17,421	19,420	22,539	17,559	19,194	22,660	0.8	(1.2)	0.5
NIM (%)	3.8	3.6	3.5	3.8	3.5	3.4			
Loan growth (%)	11.1	20.8	20.6	15.5	22.7	24.0			
Loan loss provisions	5,263	4,297	4,785	5,226	4,158	4,276	(0.7)	(3.2)	(10.6)
Other income	5,367	6,081	6,942	5,367	6,544	7,930	—	7.6	14.2
Fee income	1,158	1,332	1,531	1,158	1,563	2,110	—	17.4	37.8
Treasury income	500	600	600	500	700	700	—	16.7	16.7
Operating expenses	8,191	9,406	10,909	8,381	9,563	11,208	2.3	1.7	2.7
Employee expenses	4,750	5,192	5,728	4,940	5,350	5,793	4.0	3.0	1.1
Net profit	5,871	7,615	8,967	5,807	7,683	9,752	(1.1)	0.9	8.8
PBT-treasury+provisions	13,896	15,294	17,772	13,894	15,325	18,531	(0.0)	0.2	4.3

Source: Kotak Institutional Equities, Company

Federal Bank: Rolling PER (X) and PBR (X)
October 2004-April 2011 (X)



Source: Kotak Institutional Equities

Federal Bank growth rates and key ratios
 March fiscal year-ends, 2008-2013E (%)

	2008	2009	2010	2011E	2012E	2013E
Growth rates (%)						
Net loan	26.9	18.4	20.4	15.5	22.7	24.0
Customer assets	26.2	19.8	19.9	14.7	22.1	23.5
Investments excld. CPs and debentures	30.4	5.9	11.7	22.3	23.5	18.1
Net fixed and leased assets	25.1	20.6	3.2	5.8	15.3	1.1
Cash and bank balance	18.7	25.2	(20.8)	18.9	19.1	19.1
Total Asset	29.6	19.5	12.4	15.4	20.7	20.5
Deposits	20.1	24.3	12.0	14.4	23.8	22.9
Current	20.4	(1.5)	26.9	17.8	23.8	22.9
Savings	19.1	28.0	18.1	14.4	22.3	21.4
Fixed	20.3	25.2	9.5	14.1	24.2	23.3
Net interest income	20.7	48.9	7.3	24.5	9.3	18.1
Loan loss provisions	75.1	65.3	16.6	26.5	(20.4)	2.8
Total other income	30.8	30.4	3.0	1.1	21.9	21.2
Net fee income	9.4	11.9	3.9	10.0	35.0	35.0
Net capital gains	52.3	10.6	29.8	(53.6)	40.0	—
Net exchange gains	11.0	51.0	(12.5)	10.0	25.0	25.0
Operating expenses	27.3	22.3	7.0	23.8	14.1	17.2
Employee expenses	22.6	19.5	(4.1)	34.9	8.3	8.3
Key ratios (%)						
Yield on average earning assets	9.1	9.6	9.2	8.9	9.4	9.6
Yield on average loans	10.8	12.4	11.6	11.0	11.2	11.4
Yield on average investments	7.7	6.5	6.4	6.2	7.3	7.4
Average cost of funds	6.6	6.6	6.4	5.7	6.6	6.8
Interest on deposits	6.4	6.4	6.4	5.5	6.4	6.7
Difference	2.6	3.0	2.8	3.2	2.8	2.8
Net interest income/earning assets	3.2	3.8	3.5	3.8	3.5	3.4
New provisions/average net loans	1.3	1.7	1.7	1.8	1.2	1.0
Interest income/total income	69.1	71.9	72.7	76.6	74.6	74.1
Fee income to total income	7.1	5.5	5.4	5.1	6.1	6.9
Fees income to PBT	18.1	12.8	12.2	13.4	13.6	14.5
Net trading income to PBT	8.7	7.5	23.9	5.8	6.1	4.8
Exchange income to PBT	6.8	6.4	5.2	5.7	5.3	5.3
Operating expenses/total income	40.4	34.5	34.9	36.6	37.2	36.6
Operating expenses/assets	1.8	1.8	1.6	1.8	1.7	1.7
Operating profit /AWF	1.5	2.1	1.9	1.8	2.0	2.1
Tax rate	26.4	36.9	45.9	33.0	33.0	33.0
Dividend payout ratio	18.6	17.1	18.4	18.4	18.4	18.4
Share of deposits						
Current	5.7	4.5	5.1	5.2	5.2	5.2
Fixed	74.9	75.5	73.8	73.7	73.9	74.2
Savings	19.4	20.0	21.1	21.1	20.9	20.6
Loans-to-deposit ratio	73.0	69.5	74.7	75.5	74.8	75.4
Equity/assets (EoY)	12.1	11.1	10.7	10.2	9.5	8.9
Asset quality trends (%)						
Gross NPL	2.4	2.6	3.0	3.7	2.8	2.2
Net NPL	0.2	0.3	0.5	0.7	0.6	0.4
Slippages	1.7	3.0	3.3	4.1	2.6	2.0
Provision coverage	90.8	88.4	84.3	80.5	79.6	83.3
Dupont analysis (%)						
Net interest income	3.1	3.7	3.4	3.7	3.5	3.4
Loan loss provisions	0.7	1.0	1.0	1.1	0.7	0.6
Net other income	1.4	1.4	1.3	1.1	1.2	1.2
Operating expenses	1.8	1.9	1.9	1.9	1.8	1.7
Invt. depreciation	0.1	0.1	(0.2)	—	—	—
(1- tax rate)	73.6	63.1	54.1	67.0	67.0	67.0
ROA	1.3	1.4	1.1	1.2	1.4	1.5
Average assets/average equity	10.6	8.6	9.2	9.6	10.2	10.9
ROE	13.6	12.1	10.3	11.8	14.1	15.9

Source: Kotak Institutional Equities, Company

Federal Bank income statement and balance sheet
March fiscal year-ends, 2008-2013E (₹ mn)

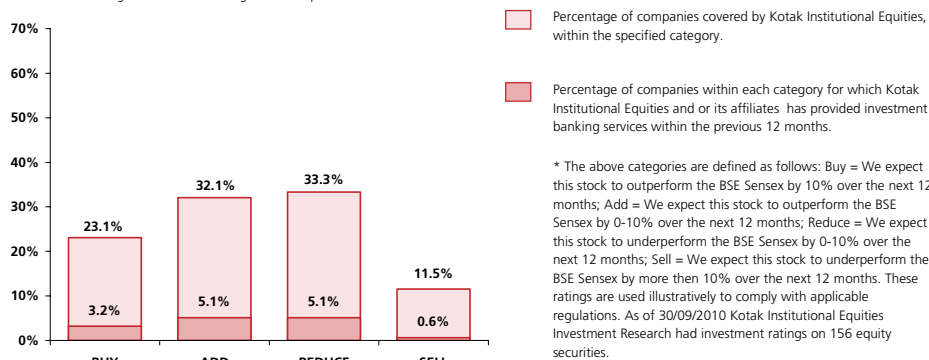
	2008	2009	2010	2011E	2012E	2013E
Income statement						
Total interest income	25,311	33,154	36,732	40,864	51,078	63,184
Loans	18,273	25,642	28,497	32,052	38,969	48,938
Investments	6,375	7,003	7,834	8,514	11,754	13,824
Cash and deposits	663	509	401	298	355	422
Total interest expense	16,474	19,999	22,624	23,306	31,884	40,524
Deposits from customers	15,259	18,732	21,683	21,379	29,613	38,253
Net interest income	8,837	13,155	14,109	17,559	19,194	22,660
Loan loss provisions	2,143	3,542	4,131	5,226	4,158	4,276
Net interest income (after prov.)	6,694	9,613	9,978	12,332	15,036	18,384
Other income	3,950	5,152	5,309	5,367	6,544	7,930
Net fee income	905	1,013	1,053	1,158	1,563	2,110
Net capital gains	750	830	1,077	500	700	700
Net exchange gains	338	510	446	491	613	767
Operating expenses	5,171	6,325	6,769	8,381	9,563	11,208
Employee expenses	3,194	3,817	3,661	4,940	5,350	5,793
Depreciation on investments	472	235	(977)	150	150	150
Other Provisions	-	280	897	500	400	400
Pretax income	5,002	7,930	8,598	8,668	11,467	14,556
Tax provisions	1,321	2,925	3,950	2,860	3,784	4,803
Net Profit	3,681	5,005	4,648	5,807	7,683	9,752
% growth	25.7	36.0	(7.1)	24.9	32.3	26.9
PBT - Treasury + Provisions	6,866	11,158	11,572	14,044	15,475	18,681
% growth	19.3	66.2	3.8	20.1	10.3	20.9
Balance sheet						
Cash and bank balance	27,455	34,371	27,234	32,370	38,566	45,913
Cash	2,405	2,205	2,769	2,908	3,053	3,206
Balance with RBI	21,152	19,939	20,420	25,417	31,468	38,662
Balance with banks	2,168	5,961	1,321	1,321	1,321	1,321
Net value of investments	100,266	121,190	130,546	150,918	177,855	203,487
Govt. and other securities	77,988	82,948	92,775	114,129	141,619	167,748
Shares	2,330	1,538	1,796	1,796	1,796	1,796
Debentures and bonds	3,107	6,202	6,498	5,523	4,971	4,474
Net loans and advances	189,047	223,919	269,501	311,178	381,847	473,300
Fixed assets	2,328	2,808	2,898	3,067	3,534	3,572
Other assets	5,969	6,221	6,577	6,577	6,577	6,577
Total assets	325,064	388,509	436,756	504,108	608,380	732,849
Deposits	259,134	321,982	360,580	412,413	510,592	627,328
Borrowings and bills payable	13,226	12,509	15,830	22,711	22,711	22,711
Other liabilities	13,448	10,759	13,442	17,475	17,475	17,475
Total liabilities	285,807	345,250	389,852	452,599	550,778	667,513
Paid-up capital	1,710	1,710	1,710	1,710	1,710	1,710
Reserves & surplus	37,547	41,548	45,194	49,799	55,892	63,625
Total shareholders' equity	39,257	43,259	46,904	51,510	57,602	65,336

Source: Kotak Institutional Equities, Company

"I, MB Mahesh, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of September 30, 2010

Ratings and other definitions/identifiers

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.

NC = Not Covered. Kotak Securities does not cover this company.

RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.

NA = Not Available or Not Applicable. The information is not available for display or is not applicable.

NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

Copyright 2011 Kotak Institutional Equities (Kotak Securities Limited). All rights reserved.

1. Note that the research analysts contributing to this report may not be registered/qualified as research analysts with FINRA; and
2. Such research analysts may not be associated persons of Kotak Mahindra Inc and therefore, may not be subject to NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund. Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMInc). However KMInc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.