IDBI Limited

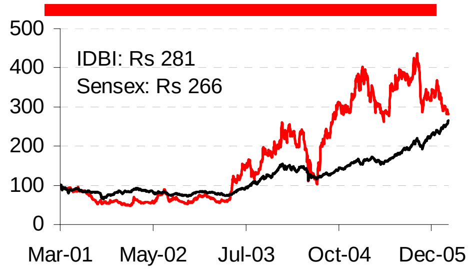
Hold | **Target price: Rs 110**

Market data

Current price	Rs 83 (BSE)
Market cap	Rs 60,067 m
Face value (Rs)	10.0
FY05 Div/share	0.7
NSE symbol	IDBI
No of shares	723.7 m
Free float	47.2%
52 week H/L	Rs 131 / 74

Share price chart

Rs 100 invested is worth



Shareholding

Category	(%)
Government	52.8
MFs and UTI	1.3
Banks/Fis	14.2
FIIs	14.3
Public	13.5
Others	3.9
Total	100.0

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Investment Rationale

- **Merger synergies:** The merger of IDBI Bank with IDBI was effective from October 1, 2004 wherein the merged entity had total employee strength of over 5,000 people and network of 234 branches and 334 ATMs. The government (holding 58% stake) has allotted the PSU bank a dual role of carrying on consumer banking operations and retaining the role of a DFI (development finance institution). For this, the management has taken a conscious decision to segregate the business of the DFI (IDBI) and consumer banking (erstwhile IDBI Bank) into two distinct business units. The synergies that the bank is envisaging post merger include:
  - Lowering the cost of funds by garnering a significant proportion of low cost deposits (10% of total funding in FY05 as against 40% for other banks)
  - Garnering fee income through its additional branches
  - Benefiting from the technology support of erstwhile IDBI Bank
- **Benign SASF:** Stressed Asset Stabilisation Fund (SASF) is a special purpose trust, set up by the government, with a budgetary provision of Rs 90 bn to enable IDBI improve its asset quality. IDBI invested the entire Rs 90 bn in 20 year interest-free special GSecs and transferred its NPAs worth Rs 90 bn (book value Rs 130 bn less write offs) to SASF. The transfer of bad loans to SASF had led to IDBI's net NPAs falling to 1.4% in 9mFY06 from 14.2% in FY04. A dedicated supervision of the said funds and containment of incremental delinquencies (with the use of Fractal credit appraisal model) may augur well for the bank's asset quality in the long run (retail NPAs 0.2% in 9mFY06). We expect the bank's net NPA levels to come down to 1% by FY08.
- **NIMs to improve:** IDBI currently has the lowest NIMs (0.2% in FY06E) across banks in both the PSU and private segments. While legacy of high cost borrowings and downward re-pricing of assets continue to ail the bank, the following factors support the bank's argument of an upside to the net interest margins (NIMs).
- **Offloading costly debt:** Of the high cost debts that IDBI was carrying in its books at the end of 1HFY06, borrowings to the tune of Rs 35 bn (with interest liability at the rate of 11% to 14%) and Rs 60 bn (with interest liability at the rate of 10% to 13%) will get repaid in FY06 and FY07 respectively. With this, the bank will not have any borrowings with interest rates above 10% p.a. in its books. We expect the average borrowing cost to come down to 7% in FY08E from 8% in FY05.
- **Restructured assets:** On the asset side (advances), most of the high yielding loans have already got re-priced and will not reduce the bank's yields significantly any further.

Such loans were earlier 'restructured' under the CDR (Corporate Debt Restructuring) mechanism.

- **SASF windfall:** Of the Rs 90 bn SASF, cases worth Rs 44 bn have been resolved until 9mFY06. Of this, Rs 8 bn was recovered in FY05 and recoveries to the tune of Rs 10 bn and Rs 15 bn are expected in FY06E and FY07E respectively. The said recoveries from SASF will lead to the GSecs in IDBI's books of equivalent value getting freed and will be available for productive usage. Thus, the bank will have zero cost liquidity to that extent which will directly filter into its NIMs. However, the above facts being subject to a deal of uncertainty, we have not factored them in our projections. Nevertheless, possibility of upside to NIMs remains to that extent.

- **Other income filtering into NIMs:** IDBI had earlier lent to corporates in consideration for their equity shares. The profit on sale of such shares is booked as other income and therefore do not reflect in NIMs despite being income on advances. On sale of such assets, the resultant liquidity is now being lent and will reflect in NIMs going forward.

- **Additional branches:** The bank is envisaging adding 200 branches by FY08 to grow its retail asset base and garner deposits. The same will help it derive better spreads and therefore improve its NIMs.

  Considering the above facts, even if interest rates remain firm, the bank's net interest margins will only improve going forward and we expect the same to go up to 0.6% by FY08E.

- **Capital rich:** IDBI has sufficient capital and its capital adequacy ratio (CAR) stood at 16% in 9mFY06. Besides investing in its retail foray (the bank is envisaging CAGR of 40% in retail credit over the next 3 years), the bank is also embarking on several plans for its subsidiaries.
  - It has initiated steps to reposition the IT subsidiary IDBI Intech (which is very much in line with what ICICI Bank has done with 3i Infotech).
  - It is planning to incorporate an asset management company for entry into the mutual fund business through its wholly owned subsidiary IDBI Caps.

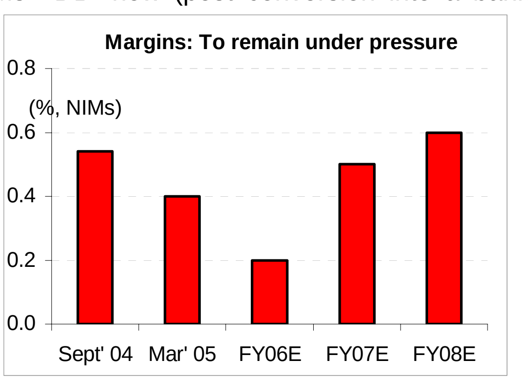
- **Acquisitions on the anvil:** IDBI is envisaging a foray into the insurance business in collaboration with a foreign player. The bank is in the final stage of negotiations with 3 overseas life insurance companies and will also rope in a third partner for the insurance joint venture (as the RBI guidelines do not permit banks to hold more than 50% stake in an insurance company). Expansion through overseas acquisitions is also included in the bank's future business plan. The bank has cited that it is poised to acquire a bank that has a network of 1,000 to 1,200 branches and a good overseas presence.

Comparative Valuations

(9mFY06, Rs m)	IDBI	SBI	HDFC Bank
Return on assets	0.4%	1.0%	1.5%
Return on equity	5.9%	18.5%	18.3%
Net interest margin	0.2%	3.3%	3.9%
Net NPA/Advances	1.4%	2.3%	0.4%
Cost/income	52.0%	47.8%	29.8%
Business/employee	109.9	32.6	84.0
Business/branch	2,799.0	728.0	1,382.8
Profits per employee	0.8	0.3	0.8
Valuations			
Price to earnings	15.9	9.4	26.2
Price to adjusted BV	1.0	2.2	4.7
Dividend yield	0.8%	1.5%	0.8%

Investment Concerns

- **Lowest margins in the sector:** Having said that, we believe there is a certain upside to IDBI's net interest margins (NIMs) in the wake of redemption of high cost borrowings, we would also like to emphasise on the caveat that even after such debt burden going off its books, the bank will continue to lag its peers in terms of NIMs. IDBI now (post conversion into a bank)



also needs to comply with the SLR and CRR requirements (not mandatory for DFIs), which is forcing it to park its funds in low yielding assets. Further, even though the bank garnered a decent share of low cost deposits (low cost deposits accounted for 31% of total deposits in 9mFY06), cost of deposits is not getting significantly marginalised due to hardening of interest rates. Given the pressure on cost of funds due to the necessity of higher deposit mobilisation, we do not see the NIMs crossing the 1% level by FY08. The lower NIMs are also likely to have a dampening effect on the bank's asset growth.

- **Priority lending mandate:** The RBI is of the view that IDBI, post conversion into a bank, should keep lending 50% of its fresh disbursements to the priority sector. This should continue till the time it sees 40% of its total outstanding loans disbursed to the priority sector. Given the low spread available on the same, especially on the 18% farm lending mandation, the bank's margins will remain compressed to that extent.
- **Cost constraints:** While IDBI has one of the lowest number of branches amongst PSU banks, it has the largest number of employee per branch (26 in FY06E). IDBI's cost to income ratio (50% in 9mFY06) does not seem to justify any operating efficiency and the same is expected to bloat further once the bank increases its size and scale (the bank is targeting branch strength of 500 by FY08). This will dampen the entity's profit margins in the longer term.

Comparatives

FY06E	IDBI	SBI	OBC	ICICI
Assets (Rs bn)	840	5,165	611	2,053
Branches (nos.)	178	9,134	1,187	618
Employees (nos.)	4,539	203,871	14,636	20,700
Cost / Income	50.0%	50.0%	45.0%	53.0%
Emp/branch	26	22	12	33

- **Lax provisioning:** IDBI's provision coverage, despite rising from 35% in FY05 to 45% in FY06, lies way below that of its peers. The bank had made a floating provision of Rs 20 bn in 4QFY05 as per the RBI recommendations. The said provision has been fully utilised by 9mFY06 for making specific provisions and the bank has also made provision reversal for unrealized income on such NPAs. Hence, the probability of reversal of extra provisioning, which could have boosted the bank's networth going forward is minimal.

Background

Established in 1964 with the passing of the IDBI Act, Industrial Development Bank of India (IDBI) functioned as a Development Financial Institution (DFI) until FY04. Repeal of the IDBI Act by the Parliament in September 2004 endorsed the much-awaited transformation of IDBI into a bank. Post merger with IDBI Bank, the government holding in the entity stands at 58%.

Merger of IDBI and IDBI Bank was largely anticipated to be a win-win situation for both the entities. The erstwhile IDBI Bank, given its clean assets and impressive fundamentals, offered valuable growth prospects to IDBI through access to low cost deposits and extended reach, which could enable the consolidated entity to seek better returns. The bank is currently functioning with two SBUs handling the development finance and banking businesses separately. It has two subsidiaries namely IDBI Housing Finance and IDBI Capital Services. Although the merged entity is in the league of the largest banks in the country in terms of asset size, its lackadaisical rate of growth leaves it way behind its peers in terms of performance.

Industry Prospects

The Union Budget 2006 – 07 has offered 'sweetened pills' to the banking sector. While on the one hand, inclusion of long term FDs under tax exemptions and conversion of non-tradable GSecs into tradable SLRs provides greater liquidity to the sector (sweeteners), on the other hand, forced lending to agricultural sector coupled with compromised margins (NIMs) could dampen profits. Also, given that the tax exemptions are offered only on high cost (long term) FDs, the measure is not expected to significantly pare cost of deposits for banks. Service tax on fee income (for collection services) may further marginalise the other income component. Amendments to the Banking Regulation Act are yet to be 'tabled' and the reforms expected therein will be subject to their subsequent approval. Enhanced lending to agriculture and priority sectors will require banks (especially PSU banks) to exercise more caution on the NPA front.

While we expect structural factors such as credit growth (20% YoY) and quality improvements to continue, cyclical ones such as margins pressures and liquidity constraints remain possible deterrents to the sector's growth.

Valuations

Our recent meeting with the management highlighted some of the causes that were ailing the bank and put into perspective the reasons as to why a recovery should be expected. While our stance continues to remain cautious on the bank, given the fact that IDBI is proactively working on expanding its franchise and retail portfolio along with its well experienced corporate lending business, an upside to the stock cannot be ruled out.

Even if we do not take the bank's outlook by the word, we do expect some turnaround in the entity. Nevertheless, we need to emphasise on the caveat that it would require atleast 2 years for the valuations to reflect the same. We would therefore advise investors having similar investment horizon to HOLD* on to the stock, to reap the benefits once the merger synergies start filtering in. At the current price of Rs 83, the stock is trading at 0.9 times our FY08 estimated adjusted book value. We estimate a 2-year target price of Rs 110 for the stock.

**By this recommendation of HOLD, what we mean is that existing shareholders would be better off holding onto the stock with a long-term perspective. However, if an investor would like to BUY this stock, then the upside from the current levels is about 14% CAGR. Investors could take the investment decision based on this premise.*

Valuation table

(Rs m)	FY05	FY06E	FY07E	FY08E
Total Revenues	8,428	11,521	15,288	18,556
Net Profit	3,186	3,778	4,367	4,771
EPS (Rs)	4.4	5.2	6.0	6.6
Adjusted BV (Rs)	75.3	80.0	84.0	88.2
P/E (x)	18.9	15.9	13.8	12.6

Financials at a glance

(Rs m)	FY05	FY06E	FY07E	FY08E
Interest income	27,205	48,143	47,578	52,196
Interest expense	25,097	46,250	43,233	46,689
Net interest income	2,108	1,893	4,345	5,507
Other income	6,319	9,629	10,943	13,049
Other expenses	4,687	5,991	8,408	11,133
Provisions and contingencies	725	1,553	312	248
Profit before tax	3,015	3,977	6,567	7,175
Tax	(171)	199	2,200	2,403
Profit after tax/(Loss)	3,186	3,778	4,367	4,771
Net profit margin (%)	11.7%	7.8%	9.2%	9.1%
No of shares (m)	723.7	723.7	723.7	723.7
Diluted earnings per share (Rs)	4.4	5.2	6.0	6.6

Balance Sheet				
Advances	463,269	498,931	546,624	605,801
Investments	247,281	249,465	245,981	272,610
Fixed assets	9,142	9,690	10,078	10,279
Cash and balance with RBI	23,764	24,919	27,411	25,218
Balance with other banks	33,132	34,887	32,894	33,624
Other assets	53,406	42,725	38,452	36,530
Total assets	**829,994**	**860,617**	**901,440**	**984,063**
Net worth	62,381	65,026	68,308	71,994
Deposits	151,026	166,129	182,742	210,153
Borrowings	511,909	415,322	522,119	567,981
Other liabilities	104,678	214,140	128,270	133,935
Total liabilities	**829,994**	**860,617**	**901,440**	**984,063**

Important Notice: Quantum Information Services Limited (Equitymaster) is an Independent Equity Research Company.

Disclosure: The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.