Initiating coverage

IDFC SSKI

INDIA RESEARCH

21 October 2009

BSE Sensex: 17009

SECTOR: FINANCIALS

IndusInd Bank

Rs136

OUTPERFORMER

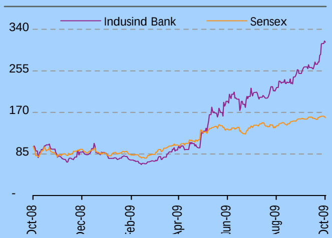
Set to soar!

Mkt Cap: Rs56.0bn; US$1.2bn

Stock data

Reuters	INBK.BO
Bloomberg	IIB IN
1-yr high/low (Rs)	146/26
1-yr avg daily volumes ('000)	3.31
Free Float (%)	74.4

Price performance



Performance (%)

	3-mth	6-mth	1-yr	3-yr
IndusInd	49.6	209.3	213.5	190.7
Sensex	12.9	56.1	59.2	33.5

At IndusInd Bank (IndusInd), an era of renewed vigour has been ushered in, engineered by a new management. The past six quarters symbolize a marked improvement in IndusInd's operating metrics, as evident in a 140bp expansion in NIM to 2.9% in Q2FY10, 5.5% increase in CASA ratio to 21.2% and steep drop in C/I ratio – all converging into an impressive RoA expansion of 80bp to 1.1%. With focus on fortifying the liability profile and adding fee based revenue streams, we expect the bank to exhibit a 66% CAGR in earnings over FY09-11. Led by RoA expansion to ~1.15% by FY11E, we see a strong case for re-rating of the stock on market cap to assets metric, where it lags peers by 40-50%. We expect the stock to outperform the 20% CAGR in assets estimated over FY09-11. Current valuations of 2.4x FY11E adjusted book offer an attractive entry point. Initiating coverage with Outperformer.

A turnaround…: The management's enhanced strategic clarity and execution capabilities are reflected in consistent uptick in the bank's operating metrics for the last six quarters. Shrugging off past tribulations, IndusInd now has streamlined systems and processes to grow ahead of the industry average. Network expansion, improvement in CASA & retail deposit share, traction in fee income and stable provisioning requirements are expected to converge into margin expansion (~115bp over FY09-11E) and strong earnings growth in the near term.

…and subsequently a high growth trajectory…: A stronger liability franchise and expanding footprint would drive rapid growth in the bank's loan book. Well entrenched in the CV financing industry, IndusInd would also benefit from receding competition. The bank is equipped to gain market share, and derive operating leverage from better productivity of the existing network.

…make a case for stock's re-rating: Growth momentum would gather pace and correction in asset-liability pricing is expected to ease the pressure on margins. Driven by a 66% CAGR in earnings over FY09-11E, we expect IndusInd's RoA to increase from 0.58% in FY09 to ~1.15% by FY11. Current valuations of 2.7x FY10E and 2.4x FY11E adjusted book appear attractive in view of the strong earnings growth and improving return ratios. With substantial RoA expansion in the offing, we expect the stock to be re-rated on the market cap to assets parameter, where it lags peers by 40-50%.

Key valuation metrics

Year to 31 March	FY07	FY08	FY09	FY10E	FY11E
Net profit (Rs mn)	682	750	1,483	3,109	4,106
yoy growth	85.3	10.0	97.7	109.6	32.1
Weighted shares in issue (mn)	320	320	338	410	410
EPS (Rs)	2.1	2.3	4.4	7.6	10.0
EPS growth (%)	68.3	10.0	87.4	72.5	32.1
PE (x)	64.0	58.2	31.1	18.0	13.6
Adjusted Book value (Rs/share)	27.7	29.3	37.2	48.4	54.9
P/ Adj Book (x)	4.9	4.7	3.7	2.7	2.4
RONW (%)	7.1	6.9	11.7	17.6	18.3

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INVESTMENT ARGUMENT

Improving return ratios suggest that a turnaround is underway at IndusInd. The change in fortunes is being steered by a strong management. Since FY09, the strategic emphasis has been on strengthening the liability profile (higher share of retail deposits), re-pricing of asset book and cross-selling of fee-based products. We expect a 66% CAGR in the bank's earnings over FY09-11, with RoA estimated to improve from 0.58% in FY09 to 1.15% by FY11 which, in turn, should lead to a re-rating of the stock. At 2.7x FY10E and 2.4x FY11E adjusted book, valuations appear attractive. We initiate coverage on IndusInd with an Outperformer rating.

❑ New management orchestrating a turnaround…

New management brings enhanced clarity and strong execution capabilities to the bank

In IndusInd's recent makeover (February 2008), a new top management has been brought on board from ABN Amro Bank. This has imparted enhanced strategic clarity and strong execution capabilities to the bank. Notably, performance-linked incentives have been rolled out and ESOPs given to the management across cadres and in critical roles. Currently, granted options constitute ~3.5% of the outstanding capital with approval to scale up to 7% of the outstanding share capital (to be maintained at this level). With management bandwidth in place, the bank is well-placed to capitalize on the opportunities offered by ~20% CAGR expected in the banking industry and the economic recovery.

Exhibit 1: Management bandwidth

Management team	Designation	Previous assignments
Romesh Sobti	Managing Director & CEO	• Prior to this he was Executive Vice President – Country Executive, India and Head, UAE and sub-continent at ABN AMRO Bank N.V. • Has been associated with ANZ Grindlays Bank plc and State Bank of India in his 33 year career
Paul Abraham	Chief Operating Officer	• MD of ABN Amro Central Enterprise Services • Earlier he was COO of ABN Amro Bank in India
Sumant Kathpalia	Head-Consumer Banking	• Head-Consumer Banking – ABN Amro Bank India
Suhail Chander	Head - Corporate & Commercial Banking	• Head - Consumer & Commercial Banking – ABN Amro Malaysia & Singapore
K S Sridhar	Chief Risk Officer	• Senior VP & Country risk officer – ABN Amro India
J Moses Harding	Head – Global Markets Group	• In charge of treasury, international & capital markets since 2003. Additional responsibility as corporate banking head since 2005 • Has been associated with State Bank and Centurion Bank as well
S V Parthasarathy	Head – Consumer Finance	• Earlier Executive director of Ashok Leyland Finance • Has been associated with ALFL since 1991
Ramesh Ganesan	Head Transaction Banking	• Executive director and Head Transaction Banking at ABN Amro India
S V Zaregaonkar	Chief Financial Officer and Investor Relations	• Over 30 yrs experience in the banking industry and joined IndusInd in 1995 • Has worked in various segments as credit, operations & finance
Suresh N Pai	Head – Corporate Services and Communication	• MBA and experienced banker associated with Corporation Bank at various senior positions • Joined IndusInd in 1996 and currently heads non-finance support functions of the bank
Zubin Mody	Head – Human Resources	• HR head at ICICI Lombard

Source: Company, IDFC-SSKI Research

❑ …after a turbulent history

Past was plagued with low NIMs and RoA

IndusInd commenced operations as a corporate bank in 1994 with presence restricted to metro cities. Given its limited reach, the bank had to borrow through CDs and from cash-rich corporates, which led to high cost of funds and thereby had little scope to book profits. In the aftermath of the economic slowdown of late 1990s, NPAs soared from 2% in FY97 to 7% by FY99, while NIM plummeted from 4.1% in FY96 to 1.9% by FY00 and RoA from 3.3% to a measly 0.8%.

Merger with ALFL brought significant competencies to the table

Over FY00-04, the bank focused on consolidation and made cumulative provisions of Rs6.75bn to clean up its books using the gains on the investment portfolio. Subsequently in FY04, IndusInd amalgamated with Ashok Leyland Finance (ALFL) to gain a retail distribution and asset franchise. However, the bank was still dependent on low-maturity bulk deposits to fund a largely fixed rate book. Exposed to the vagaries of market conditions, NIM further dipped to ~1.4% and RoA to ~0.3% over FY07-08.

Exhibit 2: Profitability under pressure

As % of average assets	Mar-05	Mar-06	Mar-07	Mar-08
Net interest margin	2.71	1.90	1.41	1.36
Non-interest income	1.67	1.39	1.64	1.34
Of which: core fee revenues	*0.30*	*0.31*	*0.45*	*0.59*
Operating expenses	1.73	1.90	1.78	1.82
Provisions	0.96	1.02	0.70	0.37
PBT	1.70	0.36	0.56	0.52
RoA	1.37	0.22	0.35	0.34

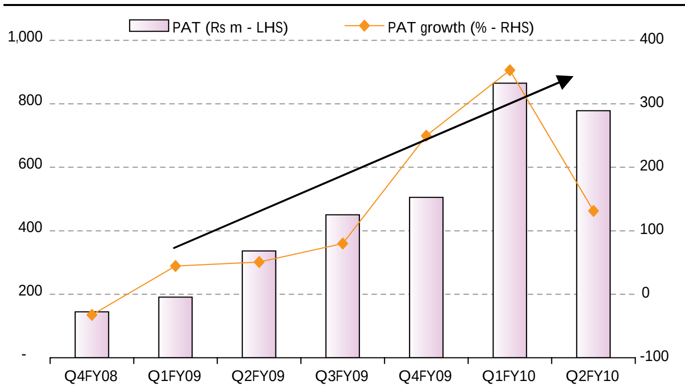
Source: IDFC- SSKI Research, Company

❑ Marked improvement in fundamentals over the past six quarters

IndusInd begins to see a turnaround from FY09; fundamentals rebound

With induction of a new management, the focus has shifted to profitability as also balance sheet health (correction of pricing anomalies in the balance sheet). Over the past six quarters, IndusInd has seen a consistent expansion in profits, strong rebound in CASA and margins, traction in fee income and decline in NPAs.

Exhibit 3: Improvement in fundamentals evident in the past few quarters



%	Q4 FY08	Q1 FY09	Q2 FY09	Q3 FY09	Q4 FY09	Q1 FY10	Q2 FY10
NIMs*	1.49	1.56	1.71	1.83	2.15	2.42	2.88
Cost/Net rev.	68.4	70.9	65.5	58.3	51.8	48.8	54.4
ROA*	0.25	0.32	0.55	0.71	0.75	1.25	1.07
RoE*	5.2	6.2	9.9	12.9	14.1	23.5	17.3
CASA	15.7	17.6	17.9	18.4	19.2	20.2	21.2
Gross NPA	3.04	3.22	3.00	1.82	1.61	1.46	1.50

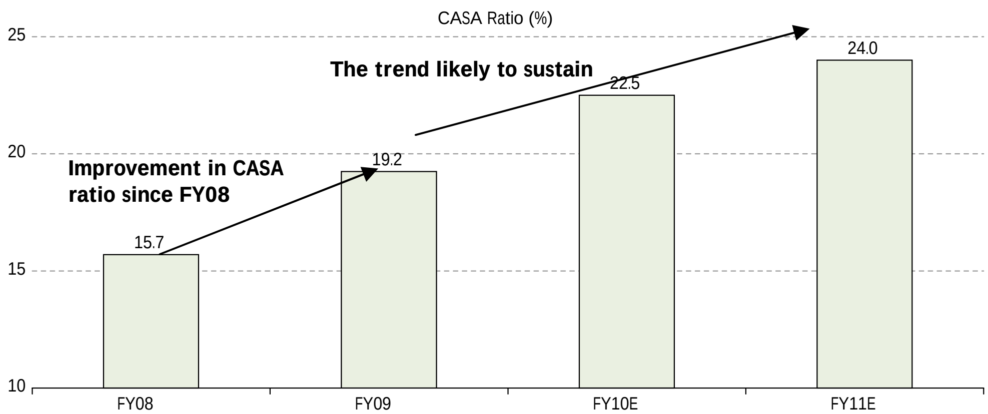
*Source: Company, IDFC-SSKI Research; * Calculated on quarterly average balances*

Sharp focus on building a steady low cost liability franchise

❑ Fortifying the liability franchise

The new management has placed due emphasis on strengthening IndusInd's liability franchise by increasing the share of core (retail and low-cost CASA) deposits. In accordance, the bank's share of CASA deposits has increased to 21.2% in Q2FY10 from 15.7% in FY08. Also, the bank plans to open 30 new branches in FY10; this is likely to accelerate the pace of accretion of CASA deposits. While the continued focus on core deposits augurs well for margins, execution of the liability strategy would remain a key monitorable given the intense competition for CASA deposits.

Exhibit 4: Strategic emphasis on increasing the low cost deposit base



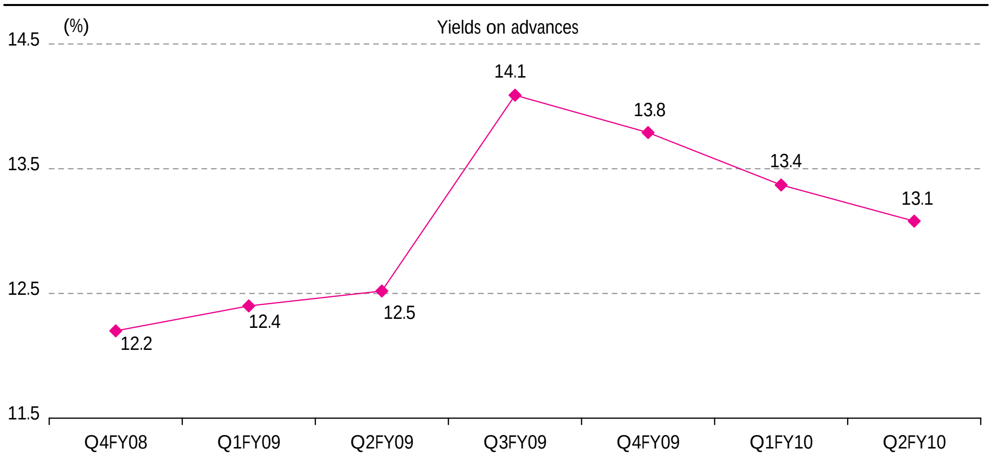
Source: Company, IDFC-SSKI Research

Pricing anamoly corrected in the balance sheet; loan yields increase sharply in the last fiscal

❑ Re-pricing of loans at elevated yields

IndusInd is striving to correct pricing on both sides of the balance sheet. In FY09, a significant expansion in loan yields has been achieved and sizable proportion of high-cost corporate loans re-priced through differentiated risk-based pricing. Notably, 43% of IndusInd's book comprises vehicle (mainly CV) loans that offer an attractive yield of ~15% against 8-8.5% for earlier loans. The phasing out of lower-yield loans from the book has also been instrumental in improving yields. In addition, the bank plans to move away from low-yielding loans against deposits and redeem the outstanding Rural Infrastructure Development Fund (RIDF) bonds as soon as possible so as to achieve higher margins.

Exhibit 5: Rising yields

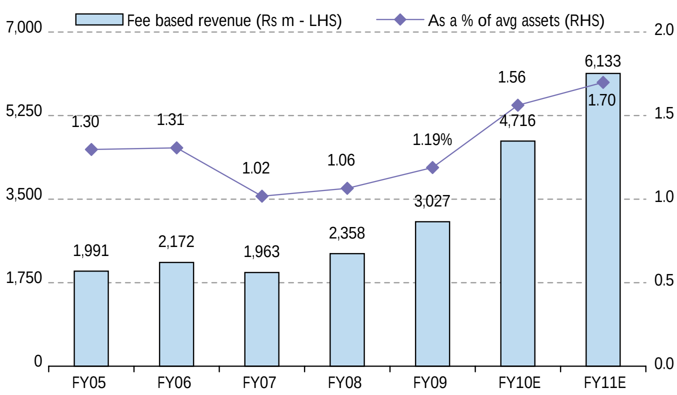


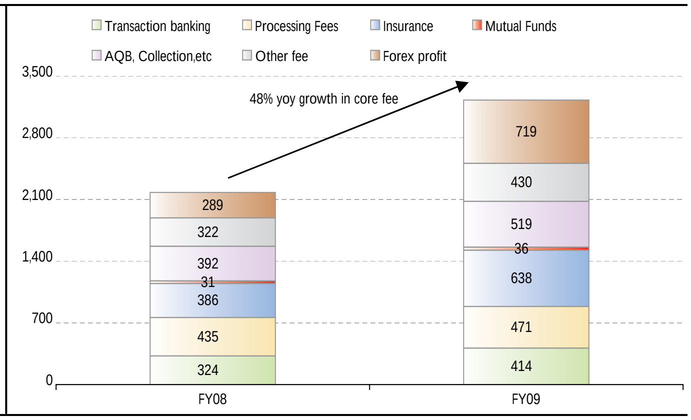
Source: Company

❑ Rebound in fee income

As IndusInd grappled with legacy issues, specifically an inadequate product suite, there was limited focus on growing the fee income streams prior to FY09. Consequently, the proportion of fee income to average assets, at 1.1% in FY08, was lower than for peers. Since then, the management has aggressively invested resources to develop a comprehensive suite of fee products, and streamline processes and systems. The emphasis on cross-selling has fructified with FY09 witnessing a 28% yoy growth in non-trading non-fund based income (34% in H1FY10); this has been aided by the addition of transaction banking to the bank's fold. We expect the momentum to sustain on the back of new product launches and accelerated customer acquisition.

Exhibit 6: Rebound in fee income





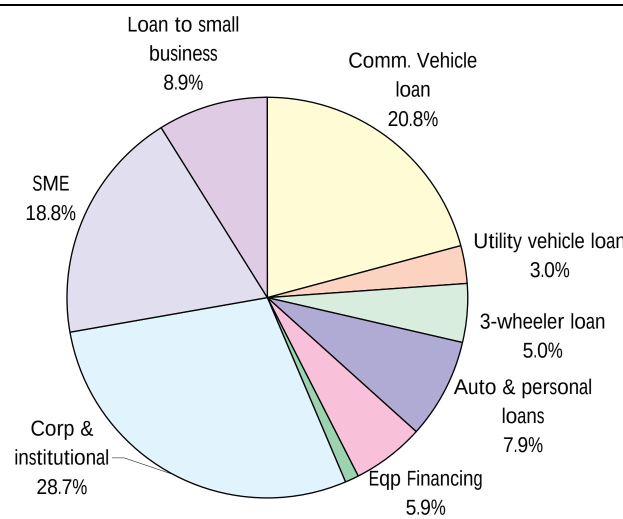
Source: Company, IDFC-SSKI Research

❑ Robust asset book with strong competencies in vehicle financing

Well entrenched player in vehicle financing with scale

IndusInd's loan book is split largely evenly into corporate and retail. This balance provides a natural hedge to yields in case of rapid movement in interest rates. The consumer finance division finances a range of vehicles along with some construction equipment. Being an offshoot of ALFL, the division has huge competencies in the form of strong domain knowledge, a wide distribution network, personal contact with customers and good understanding of the dynamics of the CV business.

Exhibit 7: Composition of loan book



Source: IDFC-SSKI Research; Company; As of September 2009

Strong domain expertise has ensured profitability as other large players exit the market

Consumer finance – strong business profile

The consumer finance portfolio generates attractive average yield of ~15%. As loans are sourced by own branches and agents, and not through DSAs, and 70%+ of the loans are given to existing customers, the asset quality risk is mitigated. Also, integrated sales and collection efforts, and a strong team have ensured profitable operations in a difficult market. In FY09, the bank, driven by recapitalization (and exit of a few large banks), could also reclaim the market share lost due to sluggish growth in the consumer finance book over the past few years.

❑ Expansion in branch network…

Increase in branch network to expedite retail deposit accretion

Over the past few years, IndusInd's network had remained stagnant at 180 branches. The bank has received licenses to open 30 new branches, planned to be rolled out in H2FY10. IndusInd has further applied for a substantial number of additional licenses and expects to receive these in due course of time. Expansion in branch network (expected to touch ~300 in FY11) is likely to expedite retail deposit accretion and bolster margins.

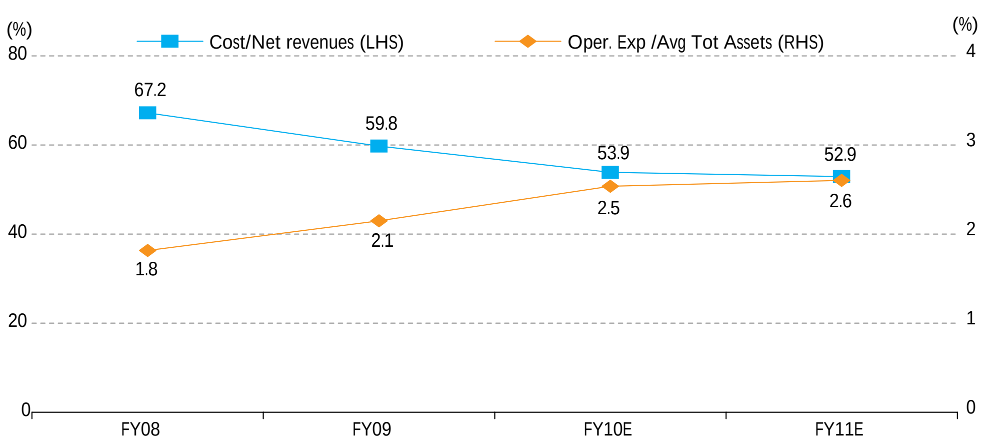
❑ …and productivity gains to drive operating efficiencies

Productivity improvement in the offing; C/I ratio to decline from 60% in FY09 to ~53% in FY11

IndusInd's existing network is under-leveraged in the absence of organizational focus in the past. Employee costs are high due to the bank's aggressive recruitment drive in the past fiscal. To keep a check on quality, the bank prefers to employ the sales force on its own rolls rather than outsourcing the same. Productivity improvement is in the offing as the new management team has introduced performance linked compensation.

As IndusInd attains scale, we expect benefits of operating leverage to flow in. We, however, expect the benefits to be limited as IndusInd looks to scale up its branch network. We expect the cost to income ratio to decline to ~53% in FY11 as against 60% in FY09 (67% in FY08), with the operating expenses to average assets ratio hovering at 2.6%.

Exhibit 8: Productivity gains to accrue



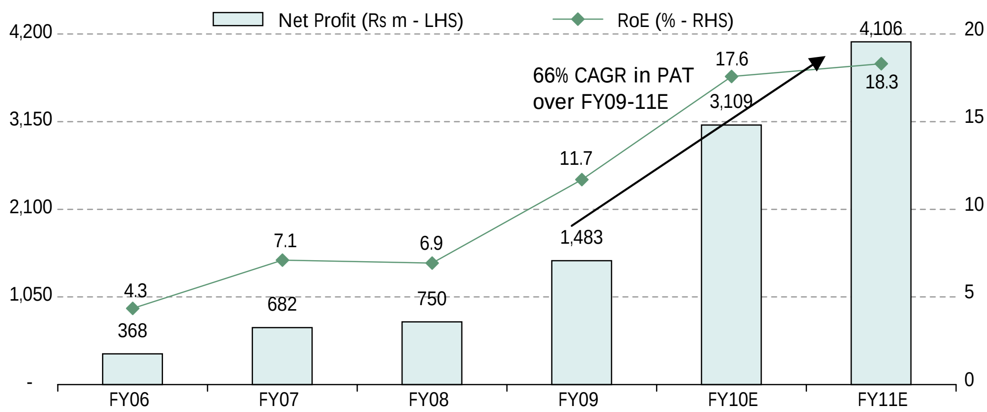
Source: IDFC-SSKI Research; Company

❑ Acceleration in earnings to drive return ratios

Earnings traction and expansion in RoE expected as fundamentals strengthen

We expect a 66% CAGR in IndusInd's net profit over FY09-11, driven by robust growth in NII and fee income, and steady provisioning expenses. As margins expand and operating efficiency improves, we expect the bank's RoA to expand from 0.58% in FY09 to 1.15% by FY11. We also expect RoE to improve to ~18% by FY11.

Exhibit 9: Earnings traction ahead



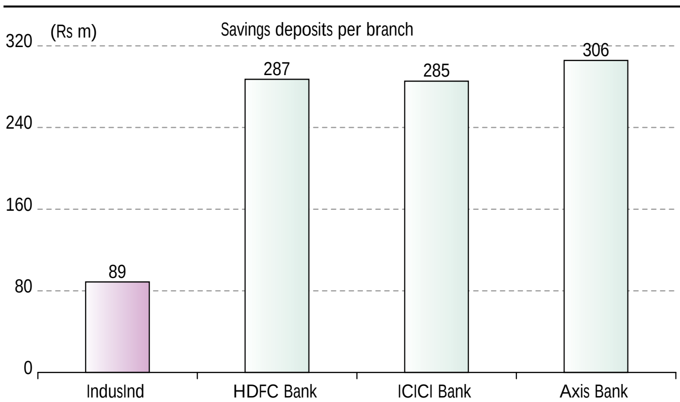
Source: IDFC-SSKI Research; Company

❑ Attractive valuations; we recommend 'Outperformer'

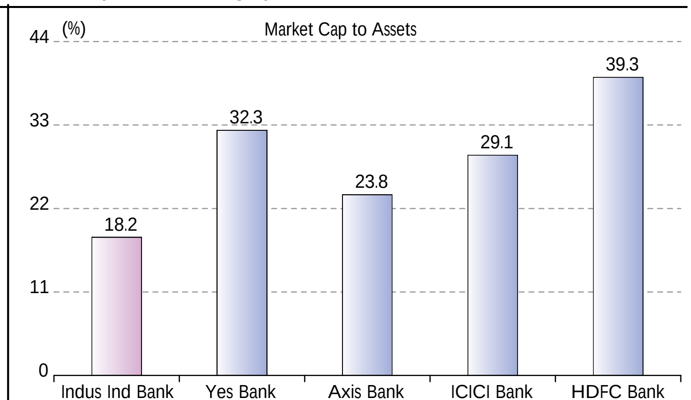
The stock lags peers in terms of market cap/ assets valuation; re-rating ahead with improving core performance

Given a capable management at the helm of affairs and improving core performance, IndusInd is expected to generate higher RoA in the medium term. We expect earnings to gain traction and RoA to touch 1.15% by FY11 as IndusInd extracts higher utilization from its franchise. We believe market cap to assets is a suitable valuation metric to value the bank– IndusInd lags peers by a gap of 40-50% on this parameter.

Exhibit 10: Ample scope to increase branch productivity



Market cap to assets lags peers



Source: IDFC-SSKI Research; Company

We expect 27% growth in loan book, 66% CAGR in earnings and ~95% rise in RoA over FY09-11 to lead to a re-rating of the stock.

TRANSFORMATION UNDERWAY

Since FY09, IndusInd has been clearly recovering from its past tribulations as focus shifted to profitability, steered by a new management team. The management has been working on (i) reorganizing business verticals to enhance customer orientation, (ii) rationalizing the product portfolio, (iii) fortifying the liability profile and garnering core deposits to ease pressure on margins; and iv) diversifying the revenue streams by reviving fee income streams. The efforts have fructified – as is evident in the consistent expansion in profits, strong revival in CASA, higher margins, traction in fee income and decline in NPAs.

A TUMULTUOUS PAST

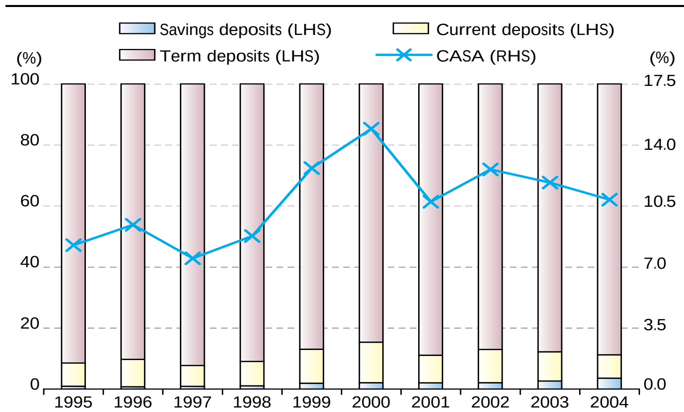
IndusInd started operations in 1994 as a corporate bank with presence only in metros. In the face of high-cost wholesale borrowings and significant exposure to mid-tier corporates, the bank witnessed a huge build-up of NPAs during the industrial slowdown of the late-1990s. Subsequently, the bank used trading gains to clean up the books while consolidating its operations. In FY04, the bank merged with ALFL, and got access to a strong retail asset franchise. The merger was aimed at acquiring and developing a strong retail liability franchise and, in turn, driving down the cost of funds. However, failure to achieve synergies led to continued dependence on bulk deposits.

❑ Genesis as a corporate bank with high funding costs and NPAs

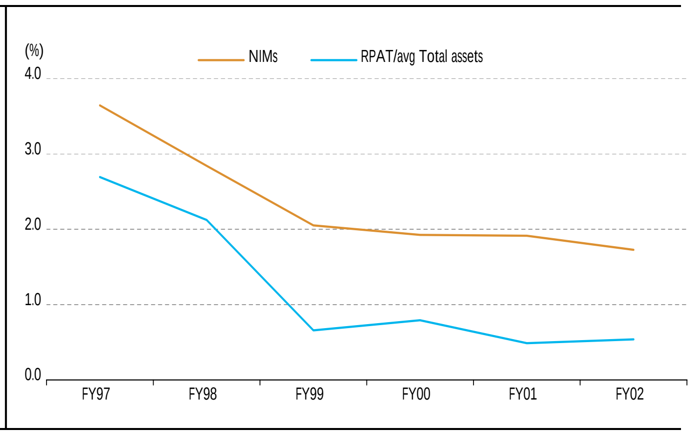
The bank suffered due to high-cost wholesale borrowings, elevated NPAs, and low return ratios

As a corporate bank, IndusInd borrowed through CDs and from corporates; this led to a weak CASA deposit base (15.5% at the peak in FY00). Therefore, the bank's cost of funds soared which, coupled with high operating expenses and provisions, offered little scope for booking core profits. High costs forced IndusInd to lend to high-yielding tier II clients to earn spreads, which led to NPAs soaring from 2% in FY97 to 7% by FY99. Along with the already deteriorating margins, high NPAs exerted considerable pressure on profitability. NIMs fell from a high of 4.1% in FY96 to 1.9% by FY00 and RoA from 3.3% to a meager 0.8%.

Exhibit 11: Low CASA Ratio



NIM and RoA – downhill



Source: Company

Book cleaned up with trading gains on securities

❑ Trading gains used to clean up the book

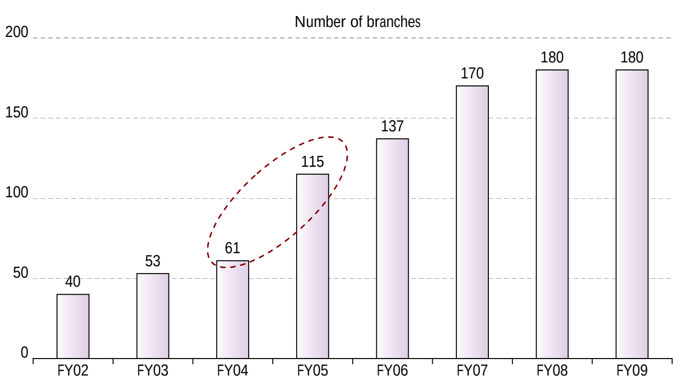
IndusInd got its act together with a thrust on consolidation and clean-up over FY99-00 rather than expansion. Strict restrictions were imposed on fresh sanctions and the bank had a low CD ratio with investments in long duration G-Secs and corporate bonds. The bank booked cumulative gains on these securities of Rs6.3bn during FY00-04 and made cumulative provisions of Rs6.8bn to clean up its books.

A moderate rise in CASA base till FY08

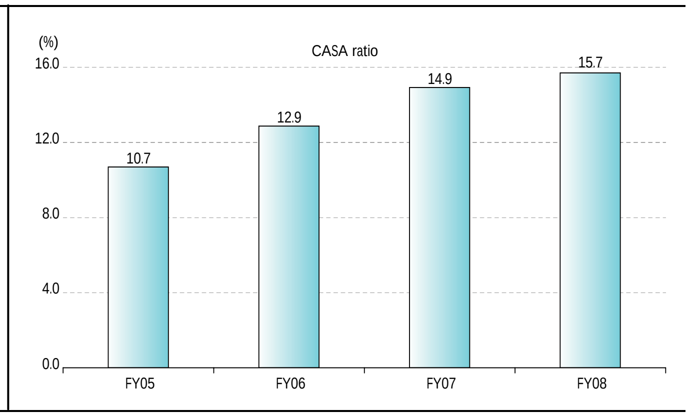
❑ Merger with ALFL – a seemingly perfect match

IndusInd's merger with ALFL in FY04 was aimed at adding value in terms of retail asset franchise, CV financing competencies and expansion of reach. Pre-merger, ALFL was constrained by lack of low-cost funds, making it uncompetitive vis-à-vis banks. Thus, the merger was presumed to emerge as a win-win association for both the entities. However, the increase in CASA ratio was limited to ~16% in FY08 as against 11% in FY05, making it extremely vulnerable to changes in the market environment.

Exhibit 12: Rapid rollout of distribution network



Limited improvement in CASA ratio



Source: IDFC- SSKI Research, Company

Profitability remained under pressure post merger, as high cost funds were borrowed under tight liquidity conditions

❑ Restricted wholesale relationships leading to stress on profitability

Even on the wholesale side, IndusInd's depositor base was highly clustered with ~60% of total deposits coming from ~30 depositors, primarily in metros. This exposed the bank to high concentration risk. Moreover, as there was no tenor-mapping, the bank had to borrow high-cost funds during tight liquidity conditions. Further, there was a structural mismatch in the bank's asset-liability profile as a high proportion of fixed-rate loans were financed largely through rate-sensitive, short-term bulk deposits. While this led to significant margin compression over FY06-08, lack of proper branch utilization chipped at fee income. As expense ratios remained high, profitability was hammered.

Exhibit 13: Poor profitability at IndusInd over FY06-08

As a % of average assets	Mar-05	Mar-06	Mar-07	Mar-08
NIMs	2.71	1.90	1.41	1.36
Non interest income	1.67	1.39	1.64	1.34
Of which: core fee revenues	*0.30*	*0.31*	*0.45*	*0.59*
Operating Expenses	1.73	1.90	1.78	1.82
Provisions	0.96	1.02	0.70	0.37
PBT	1.70	0.36	0.56	0.52
RoA	1.37	0.22	0.35	0.34

Source: IDFC- SSKI Research, Company

TRANSITION SPEARHEADED BY A NEW MANAGEMENT

Over the past year, a new top management has taken charge, which has led to improvement in the bank's key profitability metrics. The new management – headed by Mr Romesh Sobti from ABN Amro – is rejuvenating the bank with renewed focus on magnifying future growth and profitability.

Exhibit 14: Management bandwidth

Management team	Designation	Previous assignments
Romesh Sobti	Managing Director & CEO	• Prior to this he was Executive Vice President – Country Executive, India and Head, UAE and sub-continent at ABN AMRO Bank N.V. • Has been associated with ANZ Grindlays Bank plc and State Bank of India in his 33 year career
Paul Abraham	Chief Operating Officer	• MD of ABN Amro Central Enterprise Services • Earlier he was COO of ABN Amro Bank in India
Sumant Kathpalia	Head-Consumer Banking	• Head-Consumer Banking – ABN Amro Bank India
Suhail Chander	Head - Corporate & Commercial Banking	• Head - Consumer & Commercial Banking – ABN Amro Malaysia & Singapore
K S Sridhar	Chief Risk Officer	• Senior VP & Country risk officer – ABN Amro India
J Moses Harding	Head – Global Markets Group	• In charge of treasury, international & capital markets since 2003. Additional responsibility as corporate banking head since 2005 • Has been associated with State Bank and Centurion Bank as well
S V Parthasarathy	Head – Consumer Finance	• Earlier Executive director of Ashok Leyland Finance • Has been associated with ALFL since 1991
Ramesh Ganesan	Head Transaction Banking	• Executive director and Head Transaction Banking at ABN Amro India
S V Zaregaonkar	Chief Financial Officer and Investor Relations	• Over 30 yrs experience in the banking industry and joined IndusInd in 1995 • Has worked in various segments as credit, operations & finance
Suresh N Pai	Head – Corporate Services and Communication	• MBA and experienced banker associated with Corporation Bank at various senior positions • Joined IndusInd in 1996 and currently heads non-finance support functions of the bank
Zubin Mody	Head – Human Resources	• HR head at ICICI Lombard

Source: Company, IDFC-SSKI Research

New management's interests aligned with attractive incentive schemes

❑ Management team strengthened…

Restructuring has been underway at IndusInd since early FY09. A new team is in place with key management personnel brought on board from ABN Amro Bank to orchestrate the turnaround. The bank is now headed by Mr Romesh Sobti who has rich experience in the financial services space. The bank's enhanced strategic clarity and execution capabilities are reflected in the consistent progress in key operating metrics over the last few quarters.

❑ …and well incentivized

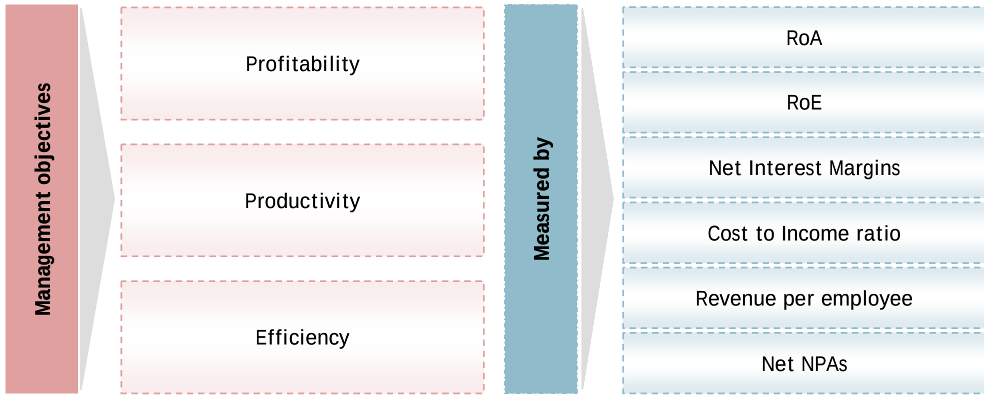
The management's interests are well-aligned with an attractive ESOP scheme across cadres. IndusInd has increased the attractiveness of its ESOP plan; the currently granted ESOPs constitute ~3.5% of the total outstanding equity capital, with approval to scale up to ~7% and maintain at this level at all times.

Measurable targets designed through a three-pronged strategy

❑ Setting up measurable targets

The management has decided to deploy a three-pronged strategy encompassing profitability, productivity and efficiency to be evaluated using six key metrics (Exhibit 17). The management has set three-year targets for these parameters and aspires to be 'best-in-class' in a period of three years.

Exhibit 15: Three-pronged strategy with measurable targets



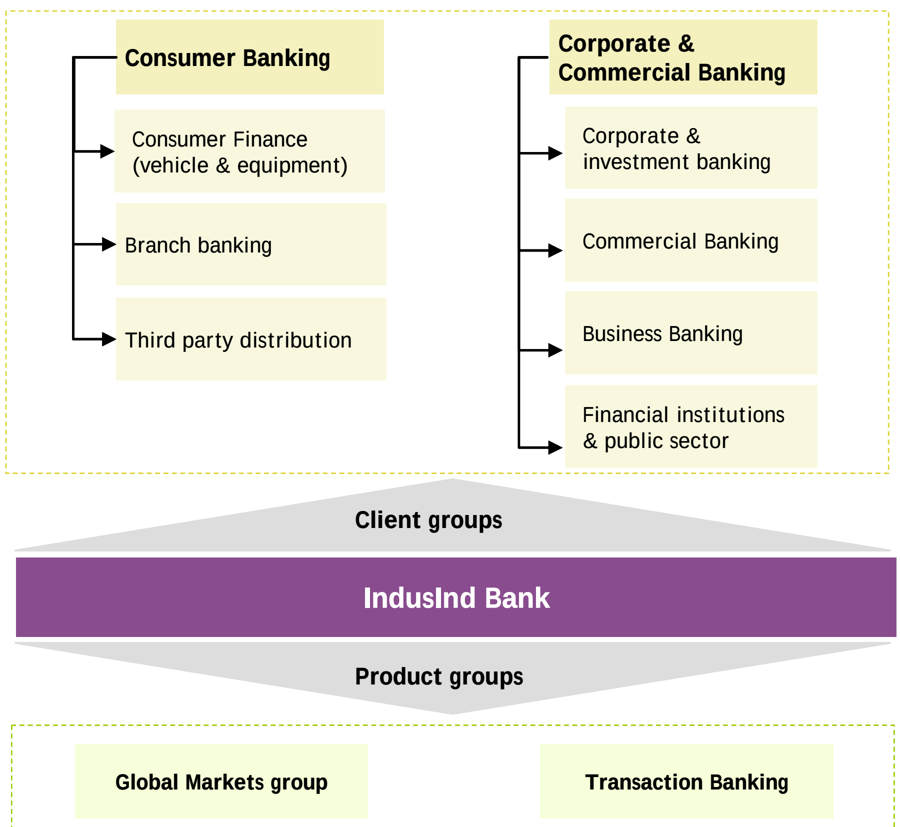
Source: Company, IDFC-SSKI Research

❑ Reorganization of business segments

Business structure reorganized into four client-based units

With the objective to enhance focus and customer orientation, the new management has undertaken IndusInd's reorganization into client-based units – consumer banking, consumer financing, and corporate and commercial banking. Within each segment, initiatives have been adopted to enhance customer acquisition and visibility. Further, each vertical is headed by competent personnel with extensive experience. In addition, there are product groups – global markets, transaction banking and financial restructuring – and reconstruction groups that work across client groups.

Exhibit 16: Business segments reorganized



Source: Company, IDFC - SSKI Research

❑ Galvanizing the branch network

Plans to open 30 branches in FY10; the bank seeking 140 more licenses

Over the past few years, IndusInd's network has remained at 180 branches. The bank has recently obtained licenses to open 30 new branches, planned in FY10. IndusInd has applied for 140 additional licenses and expects to receive them in due course of time.

Moreover, despite its pan-India presence, IndusInd's CASA deposit ratio remained low at ~15.7% in FY08 due to underutilization of the network as well as lack of proper accountability and supervision structure. The new management has focused on rejuvenating the branches by empowering the branch managers. In line, their accountabilities have been increased to include origination of retail business including loans, servicing standards, employee engagement and operations.

❑ Change in lower cadres as well

Net addition of ~1550 people in FY09; revamp of customer facing teams

The change in the IndusInd team has not been limited to the top order only. In FY09, the bank's employee strength increased to 4,250 from 2,700 a year ago – a net increase of 1,550 people. The bank, however, recruited ~2,100 employees over the period across verticals, reflecting a new employee force. In addition, teams having customer interface have been revamped competently, with >60% of the employee workforce recruited over the last year.

Further, the new management has established more stringent evaluation parameters for the staff and remuneration has been linked to performance (reflected in an increase in variable component of pay from 7-8% in FY08 to 20-25% in FY09). The variable compensation has also been linked to contribution to the bottomline as against topline earlier.

'BALANCING' THE BALANCE SHEET

Addressing the liability side of the balance sheet had assumed top priority for IndusInd's new management. Efforts are being targeted to build CASA, increase the retail proportion in term-deposits, broad-base the wholesale depositors and reduce dependence on funds from large corporates and inter-bank participants.

❑ Broad-basing the wholesale deposit pie

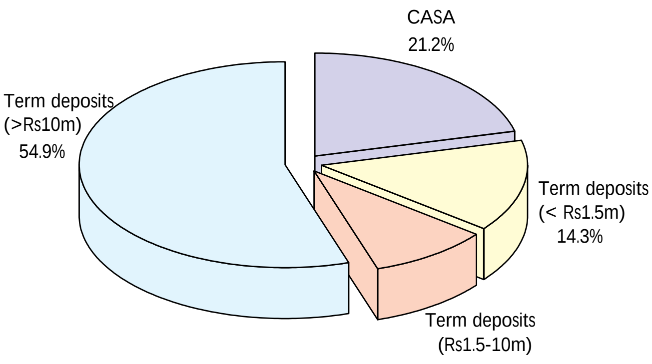
Enhanced focus on diversifying the deposit base

In FY08, IndusInd's wholesale depositors were highly concentrated with ~60% of total deposits coming from ~30 depositors, primarily in metro regions. The new management has set up teams to tap cooperative banks and state PSUs to increase the client base for such deposits; the bank now has more than 150 cooperative banks and a client base of 400 wholesale depositors. Consequently, the top 30 depositors account for less than ~30% of the total deposits, which is expected to drop further.

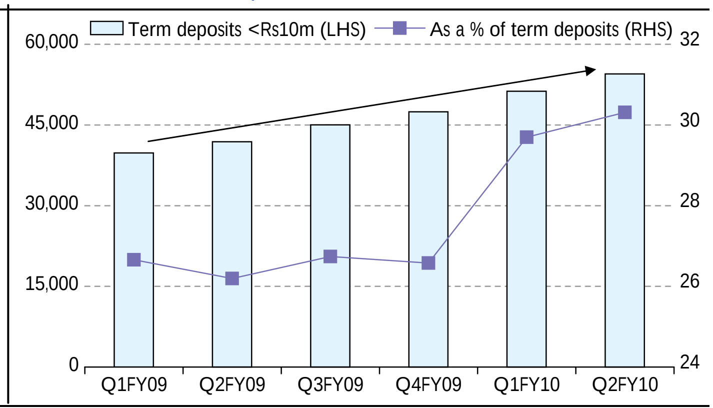
❑ Building retail liabilities…

Recognizing that building a CASA franchise would be a time-consuming process, the management is working on escalating the retail proportion in term deposits and broad-basing the wholesale depositors. To reduce the incremental cost of funding, term deposits are being 'retailized'. Retail term deposits (defined as deposits less than Rs10m) have grown at ~30% yoy over the past fiscal and now constitute ~30% of IndusInd's term deposit base.

Exhibit 17: Composition of deposits...



...movement in retail deposits



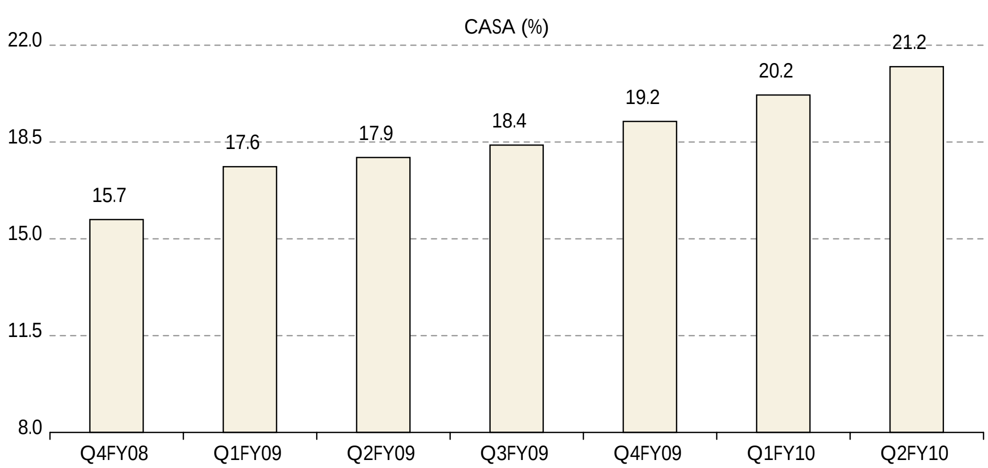
Source: IDFC-SSKI Research; Company; Data as of September 2009

New products to accelerate CASA accretion – reflected by increase in ratio to 21.2% in Q2FY10

❑ … and increasing the share of CASA…

To drive margin expansion, IndusInd's new management is striving to enhance the share of low-cost CASA deposits. The bank has launched new products to accelerate the CASA momentum – evident in the rise in CASA ratio from 15.7% in FY08 to 21.2% in Q2FY10. Further, the bank has focused on self-employed and small businesses for shoring up its CASA deposit base.

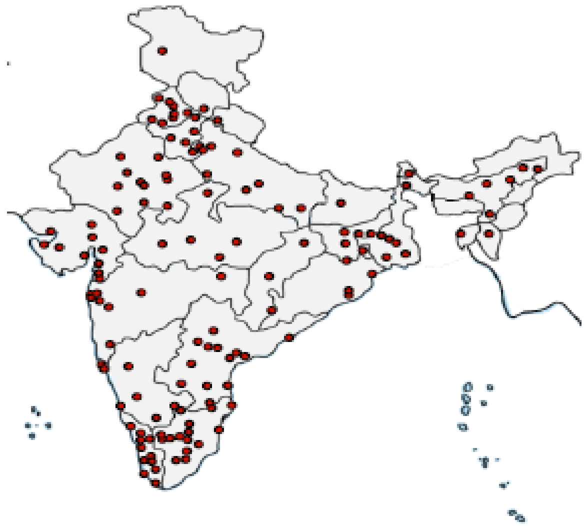
Exhibit 18: Steady upward traction in CASA deposits

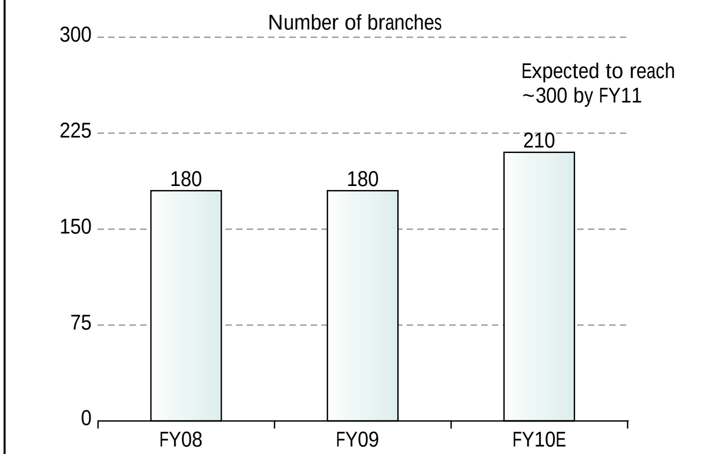


Source: IDFC-SSKI Research; Company

IndusInd expects its 30 new branches (licenses obtained recently) to become operational in H2FY10; it has also applied for more branch licenses. We expect a wider distribution network and consistent focus to accelerate the pace of CASA accretion for the bank.

Exhibit 19: Pan India Branch network...likely to expand at a robust pace





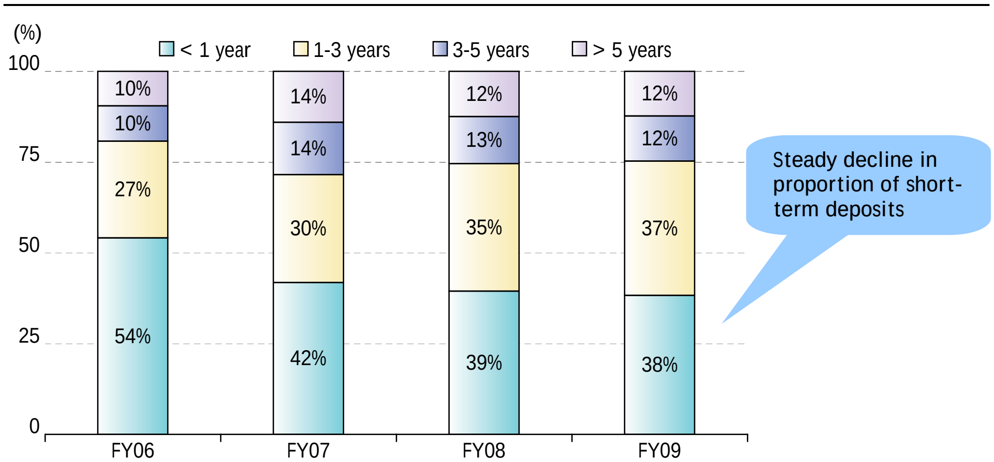
Source: IDFC-SSKI Research; Company

Lack of tenor mapping led to the bank borrowing wholesale funds at elevated rates

❑ …with continued focus on tenor mapping

There is a structural mismatch in IndusInd's asset-liability profile as a high proportion of fixed-rate loans are financed largely through rate-sensitive and short-term bulk deposits; this had led to significant margin compression over FY06-08. Moreover, as there was no tenor-mapping, during tight liquidity conditions the bank had to borrow at elevated rates. The management is endeavoring to correct this discrepancy by gradually strengthening its retail liability franchise.

Exhibit 20: Maturity profile of deposits



Source: IDFC-SSKI Research; Company

Focus on correcting the asset-liability pricing to yield rich returns

❑ Re-pricing the asset book to correct the risk-reward equation

Over the past fiscal year, IndusInd has attained significant improvement in loan yields through differentiated risk-based loan pricing for its customer segments. Previously, the bank determined its lending rates on the basis of collateral, irrespective of the borrower's risk profile. Pricing power was low owing to an inadequate product suite. As a result, even though the bank lent to mid tier corporates (bulk of which were rated 'BBB' or 'A'), yields were in line with that of an 'AAA' rated asset book. Over

FY09, the bank has re-priced a significant portion of loans at higher risk based rates, leading to a sharp rise in yields.

❑ Vehicle finance division gaining market share

Market share regained in vehicle financing business driven by recapitalization and diluted competition

Strong understanding of customers and regional dynamics in the vehicle financing industry has ensured profitable operations for IndusInd. All vehicle loans are sourced via IndusInd's own branches and agents under IndusInd Marketing and Financial Services Private Limited (IMFSL), rather than through the DSA route; this has aided asset quality preservation. Growth, however, was restricted over the past few years due to lack of capital, which led market share loss. In FY09, recapitalization, coupled with the exit of a few large banks, enabled IndusInd to regain part of the lost market share.

FEE INCOME GAINING MOMENTUM

The new management is committed to broaden the fee income base and increase its contribution to the bank's bottomline. Over the past fiscal year, the bank has witnessed considerable acceleration transactional services fees, third party distribution fees, trade and foreign exchange fees as well as basic services like loan processing charges and average quarterly balance penalties. The momentum is likely to be sustained through enhanced focus on the third party distribution space in the consumer segment and on non-fund based services to the corporate segment.

❑ Introduction of new products…

Prior to FY08, IndusInd did not enjoy pricing power in the absence of a wide product range. The new management, owing to its rich experience in a foreign bank, has added a gamut of new products across customer segments. New product groups have been set up to address the lacunae in the bank's product suite:

New products added in customer segments and product groups set up to win new customers

- Transaction banking – dedicated product vertical to provide cash management, trade and financing, supply chain financing, global remittances, commodity financing, and electronic banking services to clients across business groups.
- Global markets group – provides services pertaining to corporate forex, proprietary trading, and money and capital market activities. The objective of the group is to pull cross-border transactions of customers through the bank.

Thrust on cross-selling to existing client base

While new products were designed to leverage reach and distribution, the bank delved into cross-selling opportunities and tapped the existing customer base. In FY09, the bank aimed to enhance customer engagement through better alignment of relationship managers with product groups.

❑ ..and stimulating the existing product suite…

IndusInd has realigned the pricing on its basic products – such as demand drafts and lockers – and focused on building momentum in third party sales of insurance and mutual funds. Today, the bank is the largest third party distributor for Aviva in the life insurance space and for Cholamandalam in the general insurance segment. Despite the market slowdown, fees from insurance sales jumped by 65% in FY09.

Concerted efforts lead to 48% yoy growth in fee income in FY09

❑ ..driving robust traction in fee income

IndusInd, in FY09, witnessed significant traction in fees from transactional services including bank guarantees, letters of credit, third party distribution fees from selling mutual funds and insurance products, trade and foreign exchange fees, and loan processing charges.

Exhibit 21: Traction in fee income

(Rs m)	FY08	FY09	yoy growth (%)
L/C, BG, FIBC/ FOBC	324	414	27.7
Processing fees	435	471	8.2
Insurance	386	638	65.3
Mutual funds	31	36	17.4
AQB, collection, etc	392	519	32.4
Others	322	430	33.6
Total CEB	**1,890**	**2,509**	**32.7**
Foreign exchange profit	289	719	148.8
Total core fee	**2,179**	**3,227**	**48.1**

Source: IDFC-SSKI Research; Company

ACHIEVING EFFICIENCY TO BOOST PROFITABILITY

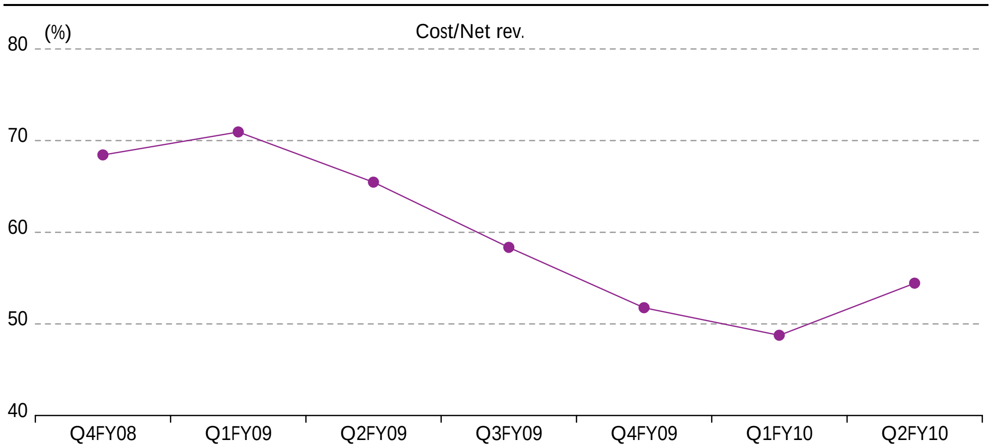
IndusInd strives to improve productivity and efficiency of its core operations by standardising the operating processes and revamping the compensation structure. Centralized and robust risk functions and systems are likely to arrest delinquencies. We expect net NPAs to remain restricted at ~1%.

Centralized operations and distribution rationalization to improve efficiency

❑ Reining in costs and improving productivity

IndusInd has adopted revenue per employee and efficiency (cost to income ratio) as key monitorables and is striving to improve upon them. Since FY08, cost to income ratio has improved steadily on the back of centralization of operations and rationalization of distribution channels. Standard operating processes for the full branch network have been consolidated into the hubs located in Chennai and Mumbai. Consequently, cost to income ratio has dipped consistently since the new management took over.

Exhibit 22: Improving operating efficiency

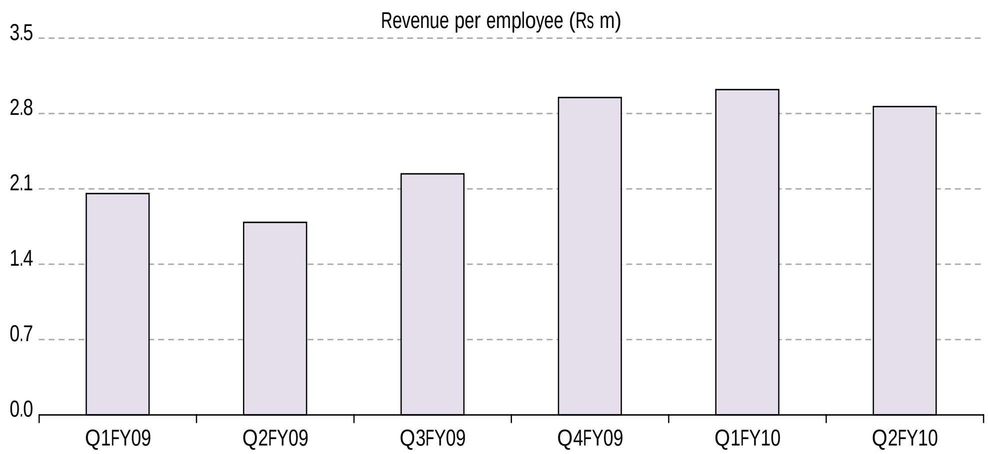


Source: IDFC-SSKI Research; Company

Encouraging performance oriented culture to drive productivity

A performance-oriented culture has been introduced at IndusInd. The compensation structure at the bank has been re-engineered to a variable pay structure, auguring well for performance targets. As a part of the restructuring, employees have been re-deployed or retrained for suitable job roles to improve capabilities. Consequently, the bank has achieved a 30% rise in revenue per employee since FY08. Rationalization of organizational structure and motivation through ESOPs has also aided improvement in the bank's productivity.

Exhibit 23: Revenue per employee



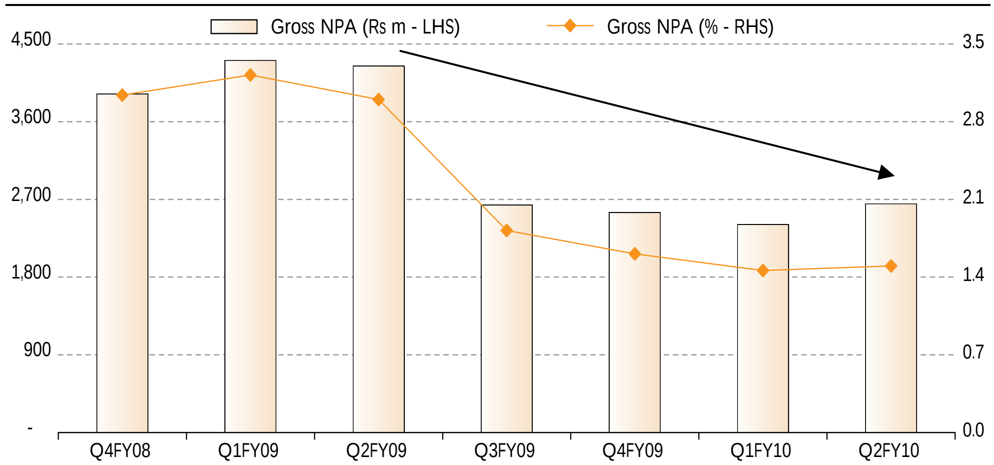
Source: IDFC-SSKI Research; Company

❑ Reduction in NPAs and strong recoveries

Gross NPAs drop from 3.1% in FY08 to 1.6% in FY09

Driven by centralized and more robust risk systems, the bank has been able to rein in delinquencies. The management has succeeded in bringing down gross NPAs from 3.1% in FY08 to 1.6% in FY09 (further down to 1.5% in Q2FY10). To that end, the bank has resorted to accelerated provisioning and settled a large corporate account.

Exhibit 24: Reduction in Gross NPAs



Source: IDFC-SSKI Research; Company

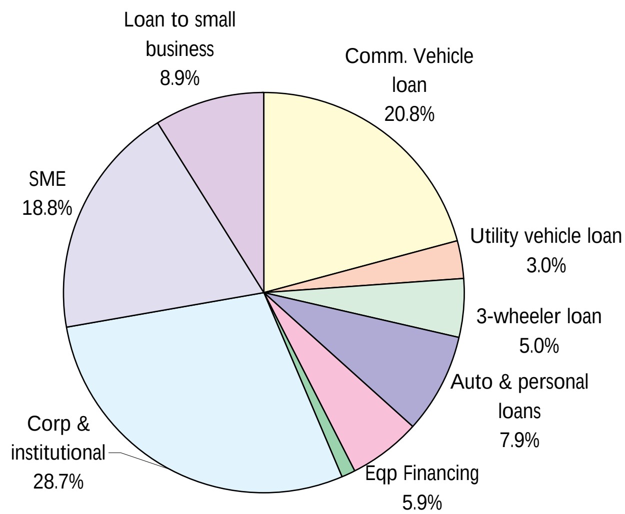
INDUSIND: THE ROAD AHEAD

Profitability and efficiency are the core objectives on IndusInd's future roadmap. While FY09 was dedicated to streamlining back-end operations, FY10 is likely to be a year focused on customers. Given the emphasis on strengthening its liability profile and enhancing brand visibility, IndusInd is likely to step up loan growth in the near term. Redemption of RIDF bonds is also expected to aid profitability. Simultaneously, fee income growth is likely to gain momentum as the bank expands coverage and its product suite. Execution and ability to raise capital when required is the key risk to growth projections.

LOAN BOOK TO REMAIN WELL DISTRIBUTED

As of September 2009, corporate loans contribute ~57% to IndusInd's overall loan book, with the remaining ~43% coming in from the retail segment. The loan book is likely to remain evenly balanced with proportion of corporate book pegged at 55-60%.

Exhibit 25: Composition of the loan book (as of September 2009)



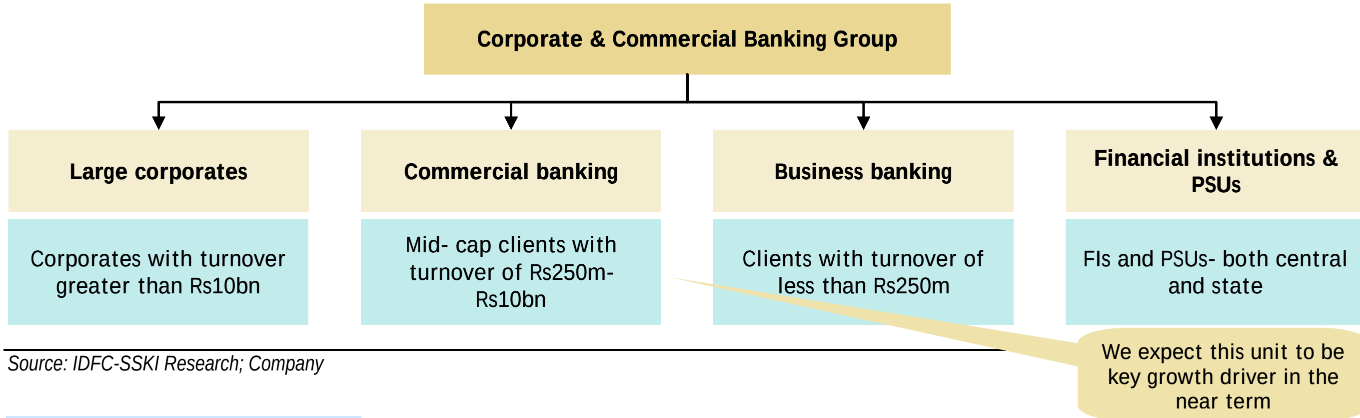
Source: Company

CORPORATE BOOK TO REMAIN FOCUSED ON MIDDLE SEGMENT

Corporate group reorganized from a branch-based model to a business unit in FY09

In light of the management's focus on client-orientation, the group transitioned from a branch-based model to a business unit model during FY09. The group is now organized into four broad heads with each unit responsible for maximizing the proceeds from its clients. Over the fiscal year, each group was shored up with a team of competent relationship managers and succeeded in strengthening business from relevant focus areas. As the teams are fortified with competent personnel, the group is well-placed to benefit from an uptrend in corporate activity.

Exhibit 26: Organization of the corporate and commercial bank group



Source: IDFC-SSKI Research; Company

Well-placed to benefit from economic recovery and huge industry opportunity

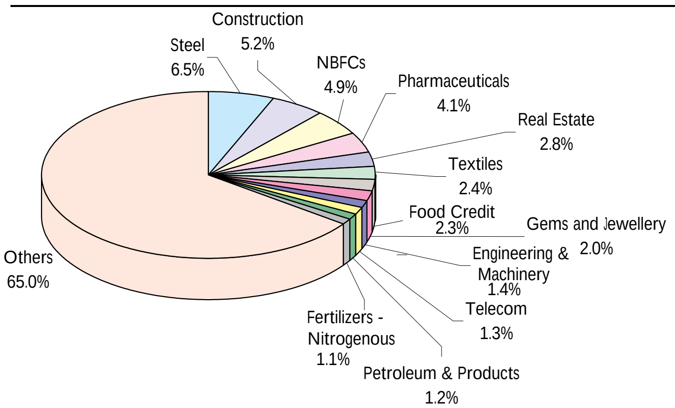
❑ Well-placed to benefit from revival in economic growth

With a strong management, the group is well-placed to benefit from a revival in the economic cycle. Growth is likely to be driven by the 'commercial banking group' as this would typically comprise the fast growing SME and mid-market segment companies that form the largest pie of the corporate accounts. Further, these clients, comprising 40-50% of the corporate loan book, provide an opportunity to earn higher yields than a large corporate and there are significant opportunities to cross-sell to this segment.

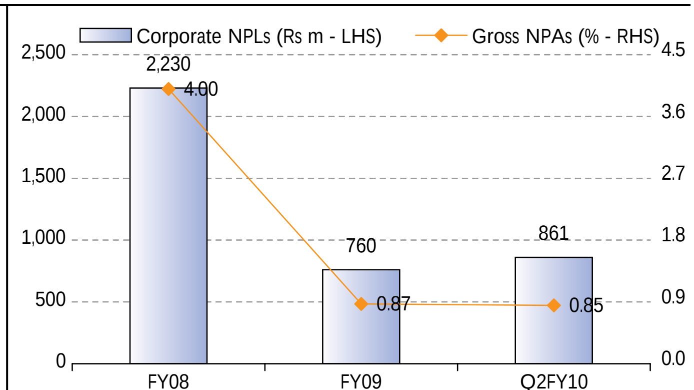
A well-diversified book; sharp improvement in asset quality

A well-diversified corporate loan book reduces the industry concentration risk for IndusInd. Further, gross NPAs on the corporate book have come off sharply from 4% in FY08 to 0.85% in September 09, as the bank succeeded in settling a large corporate account during FY09. Going forward, the management aims to maintain NPAs at low levels.

Exhibit 27: Well diversified corporate loan book (Q2FY10)



Sharp reduction in NPAs



Source: IDFC-SSKI Research; Company

RETAIL DISBURSEMENTS EXPECTED TO PICK UP

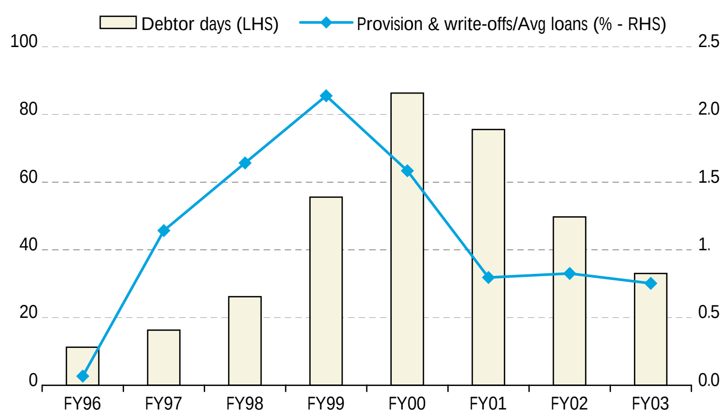
We expect IndusInd's consumer finance segment to grow by ~20% over FY09-11 after a slowdown witnessed in FY09. With integrated sales and collection efforts and over 70% of the business generated through repeat customers, the segment's NPAs and credit costs are likely to be flat.

❑ Retail book dominated by CV financing

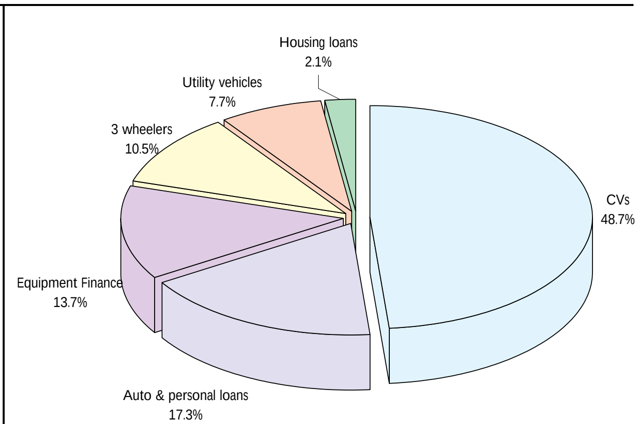
Vehicle financing dominates the retail loan book

The consumer finance division finances heavy commercial vehicles, cars, three-wheelers and two-wheelers. Besides, it also funds specialty construction equipment and has a small home loan and personal loan book. Being an offshoot of ALFL, the division has huge competencies and understands the dynamics of the CV business extremely well. ALFL had strong competencies in CV financing stemming from its market knowledge and strong customer relationships, further augmented by robust risk management systems, MIS and processes. Notably, provisions and write-offs never exceeded 2.1% of total loans and average debtor days did not exceed 90 days.

Exhibit 28: ALFL had an excellent delinquency track record



Current composition of the retail loan book*



*Source: IDFC-SSKI Research; Company; * As of September 2009*

❑ The book characterized by high yields

Attractive yield of ~15% on consumer finance book augur well for margins

IndusInd's consumer finance portfolio is characterized by attractive average yields of ~15%. The bank finances up to 90% of the chassis of a CV (~70% of the CV price). Further, with the vehicle loan book being primarily fixed in nature, in a benign interest rate environment, we expect the bank to score over peers with better yields.

Exhibit 29: Higher yields of the vehicle financing book

	Portfolio (Rs m)	Approx. yield (%)	Typical LTV (%)	Average tenure (yrs)
CVs	36,890	14.5	70	3-4
Equipment Finance	10,350	14.0	75	2
3 wheelers	7,970	22.0	70-80	2-3
Auto & personal loans	13,110	13.0*	80*	3-4*
Utility vehicles	5,840	14.0	70-80	2-3
Total vehicle financing bk	**74,160**	**15.1**		**~3**
Housing loans	1,600	11.0		~15

*Source: IDFC-SSKI Research; * on Auto loans*

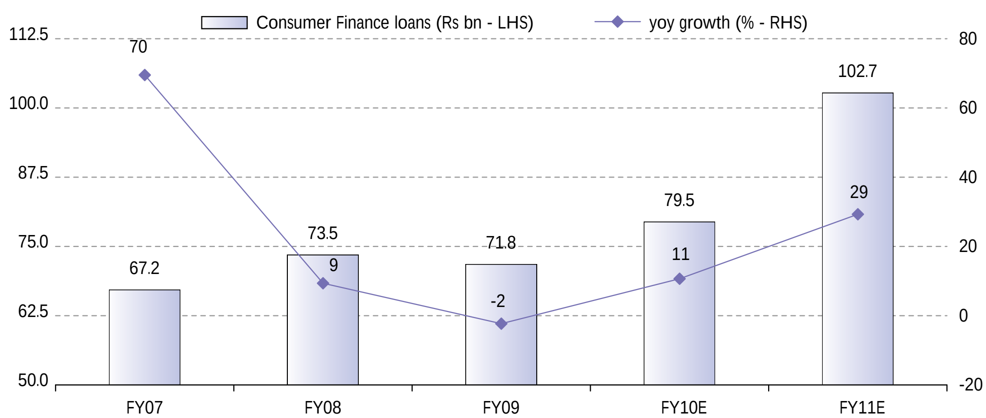
❑ Growth likely to gain momentum

IndusInd's disbursements suffered in FY09 on account of the general slowdown and lower sales in the automobile segment. We, however, expect growth to pick up in the near term driven by:

Consumer finance to see growth as auto loans pick up

- **Auto loans business:** Retraction of a few large banks from vehicle financing has offered better growth prospects to other players. IndusInd hopes to capitalize on this opportunity and accelerate the growth rate in the near term.
- **Mortgages:** The bank sees a large untapped demand of re-financing in the sub-Rs3m mortgage category, specifically in Tier-II cities. It intends to capitalize on this unaddressed demand over the next few years.
- **High-end credit card transactions:** To augment its product suite, the bank plans to offer credit cards to select high-end customers. It intends to distribute credit cards only through branches to maintain tight control on asset quality.
- **Loan against securities:** IndusInd plans to foray into lending against securities such as property, gold, mutual funds and insurance. The bank sees a substantial potential for the product in Tier-II cities.

Exhibit 30: Expected growth in CFD book



Source: IDFC-SSKI Research; Company

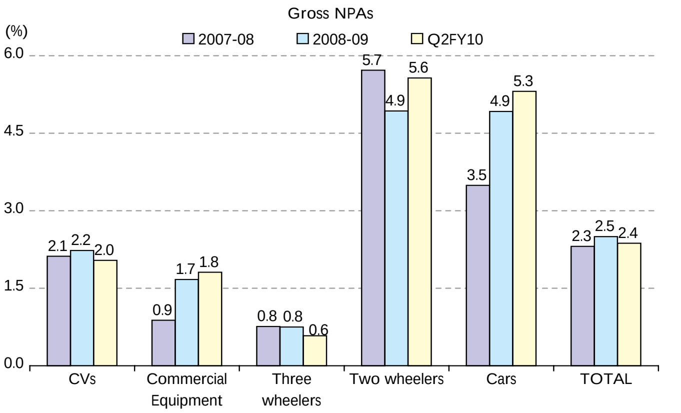
❑ Credit costs to remain under check…

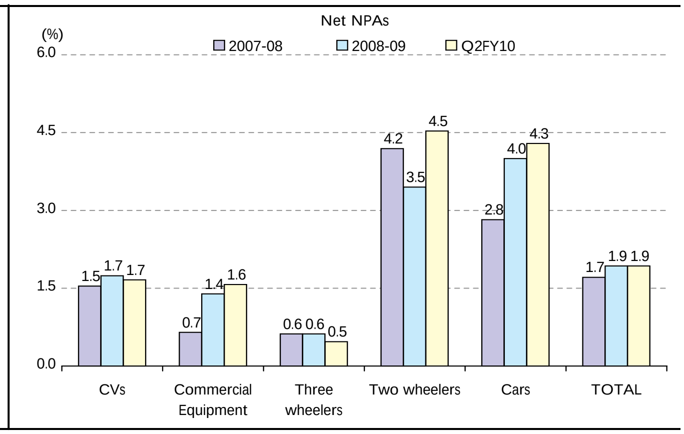
Rapid churn seen in the CFD Gross NPAs

IndusInd's robust domain knowledge in the vehicle financing industry has enabled it to strengthen sourcing as well as asset quality preservation. Average life of a commercial vehicle loan ranges between 3-4 years; for commercial equipment, the duration stands at 2-3 years. All vehicle loans are sourced by IndusInd's own branches and agents under IMFSL rather than through the DSA route. Moreover, as >70% of the loans are given to repeat customers, the asset quality risk is mitigated substantially.

A default in the segment is usually a function of delays in revenue collection; consequently, gross NPAs inch up in a bad credit cycle (on a 90 days past due basis). However, there is an active churn in gross NPAs; therefore, the proportion of such loans turning delinquent is low (pegged at ~20%). Also, IndusInd's sales and collection efforts are integrated with the sales person being responsible for collections in the first year. This further insulates the portfolio from defaults.

Exhibit 31: Credit costs to remain low





Source: Company

❑ …despite seemingly low provision coverage

The provision coverage ratio of the consumer finance book at ~20% (as of September 2009) has been generally perceived to be low. However, with the portfolio being fully backed by assets (which can be repossessed and sold), initial LTV of ~70% and loss given default of ~25%, loan loss coverage ratio seems reasonable.

SCALING UP THE RETAIL LIABILITY FRANCHISE

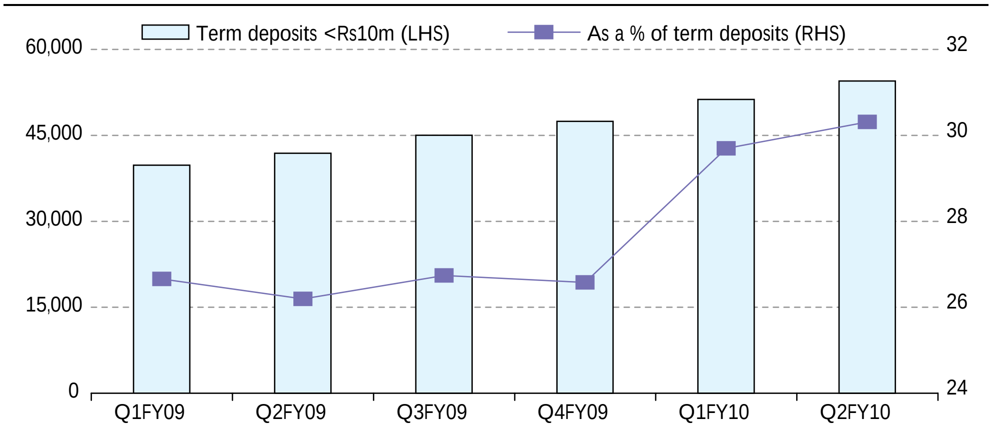
IndusInd's focus on increasing the share of core deposits to bolster its liability profile is evident from the rapid 42% yoy growth in CASA deposits in FY09 (up 350bp+). Branch expansion and brand building initiatives are likely to expedite the accretion of CASA deposits. The emphasis on low-cost deposits also bodes well for margins.

❑ Liabilities to remain the key focus area…

Concentrated efforts to shore up low cost deposits

Increasing the share of low-cost CASA deposits is the key focus area. With deployment of dedicated employees and introduction of several new products, CASA ratio has increased to 21.2% in Q2FY10 from 15.7% in FY08. Further, the bank is concentrating on self-employed and small businesses to garner CASA deposits, and increasing the retail fraction of term deposits. Retail term deposits (>Rs10m) have increased at ~30% in FY09 and constitute ~30% of IndusInd's term deposit base.

Exhibit 32: Increase in retail deposits



Source: IDFC-SSKI Research; Company

❑ …aided by expanding geographical coverage…

Currently, IndusInd has a pan-India presence with 180 branches. With 30 new branches likely to be opened in H2FY10 and application for 140 more pending approval with the RBI, IndusInd's geographical coverage is likely to see significant expansion over the medium term. This, we believe, would accelerate the pace of CASA growth.

Brand building to support CASA expansion

Focus on enhancing brand visibility to translate into CASA accretion

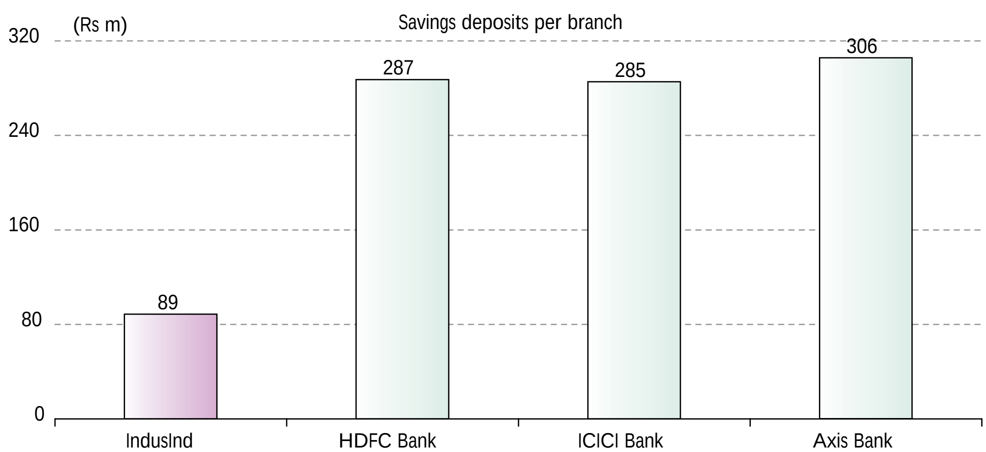
IndusInd's management is investing in building a pan-India brand. Over the past fiscal, all the branches and offsite branding colours were changed to improve the visibility of brand. Additionally, many of the ATMs are being relocated. The management intends to focus on enhancing brand awareness and repositioning the bank in FY10. The enhanced brand visibility through signage changes, relocations, refurbishment of branches and electronic and print campaigns should translate into productivity gains for the bank, and provide a fillip to accretion of CASA deposits.

❑ … and increased branch utilization

IndusInd's branch productivity – in terms of savings deposits per branch – lags that of private peers with a considerable margin. Consequently, given the ample scope to enhance branch efficiency, the bank is directing its efforts towards the purpose. Increased network, coupled with enhanced productivity, is bound to propel the CASA momentum going forward.

Trails private sector peers in terms of branch productivity by a wide margin

Exhibit 33: Ample scope to increase branch productivity



Source: IDFC-SSKI Research; Company

❑ Redemption of RIDF bonds to support margins

Over the last few years, IndusInd was unable to fulfill its priority sector targets set by the RBI; therefore, it had to invest the shortfall in Rural Infrastructure Development Fund (RIDF) bonds held by NABARD – a total of Rs16.6bn in FY09. These bonds, typically yielding in the range of ~4%, have been a drag on IndusInd's profitability. The bank fulfilled its priority sector targets in FY09 (though some contribution pertaining to past years was made) and expects to redeem a bulk of these bonds in the next three years.

Financial Analysis: Earnings to expand

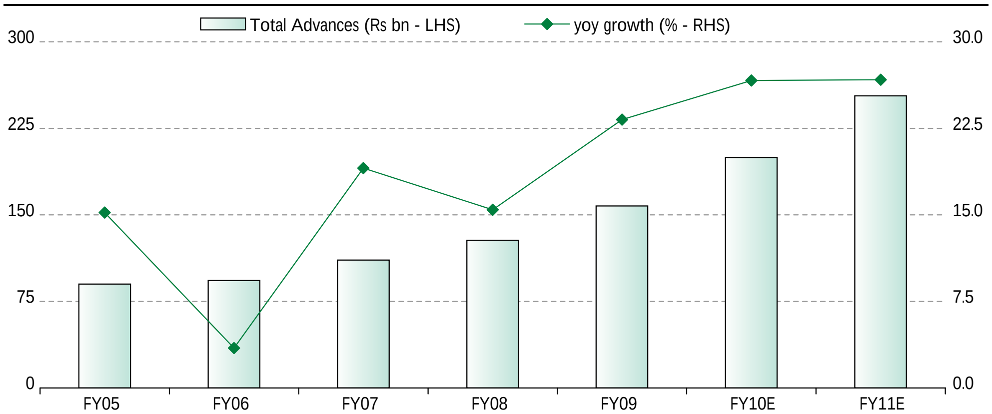
Over FY09-11, we expect IndusInd to record 27% CAGR in advances, primarily driven by a balanced growth in corporate and consumer finance loans. Build-up of low-cost deposits would drive a 70-80bp decline in cost of funds, leading to a ~115bp expansion in NIM to 2.9%, and a 52% CAGR in NII over FY09-11. Fee income is estimated to grow briskly as the bank taps its existing customers with an enhanced product repertoire. Despite higher productivity, operating expenses are likely to remain elevated as the bank rapidly rolls out its branches and ATMs to expand distribution network. Robust growth in fee income and stable provisioning requirements would drive a strong 66% CAGR in earnings with an average 18% RoE over FY09-11E.

❑ Loan growth likely to gain momentum

Expect 27% CAGR in loan book over FY09-11; supported by deeper penetration in SME and corporate segments

With stronger processes and risk management systems in place, IndusInd is all set to step on the growth momentum. We estimate a 27% CAGR in its loan book over the next two years, well ahead of the industry average. Deeper penetration in the SME and corporate segments via introduction of new products and entry into new geographies would provide the necessary impetus. The bank is well-positioned to recoup its lost market share. Between FY06-08, IndusInd's advances portfolio registered a modest 11% CAGR due to profitability and capital constraints.

Exhibit 34: Strong growth ahead



Source: IDFC - SSKI Research, Company

❑ Yields to remain elevated

Limited competition from private banks and domain expertise to support yields

About 43% of IndusInd's loan book, attributable to vehicle financing with yields of ~15%, is largely fixed in nature. We, therefore, expect the bank to sustain yields at elevated levels even in a benign interest rate environment. As one of the few vehicle financiers in several rural and semi-urban locations, IndusInd is able to command high yields across these product verticals. The bank faces limited competition as private banks and monoline financiers find business in remote locations unsustainable, given the higher costs and limited single product volumes.

Declining bulk funding costs to support margins in FY10

❑ Declining wholesale costs…

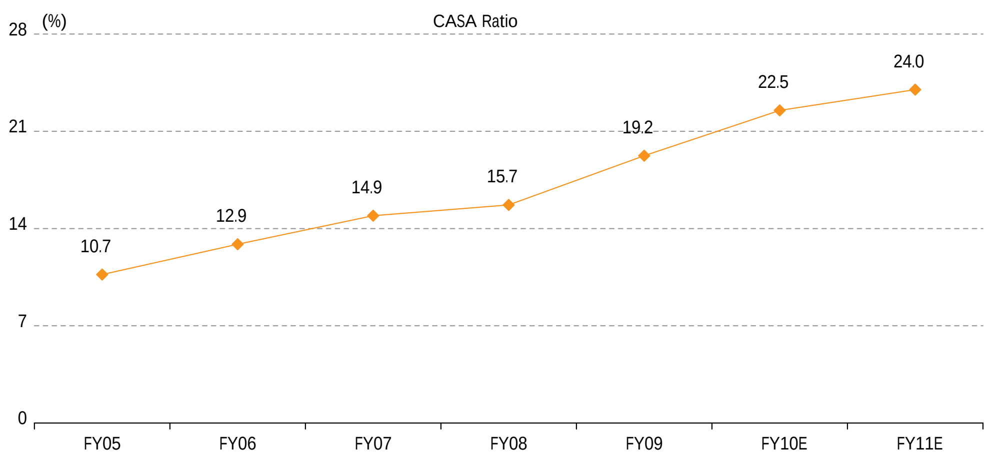
Bulk funding costs have recorded a steep decline over the past few months – evident in the sharply lower certificate of deposits (CD) and commercial paper rates. With 21% of IndusInd's deposits in CASA, bulk of the liabilities are highly sensitive to interest rate movements. With wholesale funding costs on a steep downtrend, the bank will be a natural beneficiary of the same. As liabilities get re-priced at lower rates over the next 12 months, the bank's margins are likely to expand in FY10.

Improved productivity and network expansion to drive CASA ratio to 24% by FY11

❑ …coupled with expansion in CASA…

We expect increased branches, coupled with improving productivity levels at existing branches, to drive CASA expansion to 24% by FY11. In FY09, beating an industry-wide decline, the bank's CASA deposits grew at a healthy pace of 42% yoy led by a 64% rise in current accounts and 10% increase in savings account deposits.

Exhibit 35: Improving CASA…



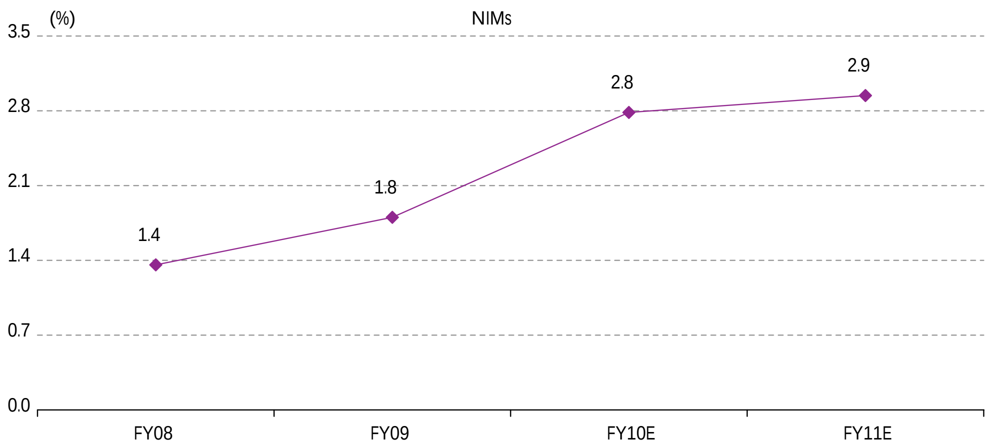
Source: IDFC - SSKI Research, Company

Margins to expand by 115bps over FY09-11E

❑ …to drive down the cost of funds and lead to margin expansion

Focus on optimizing the liability mix is likely to drive an uptick in margins from 1.8% in FY09 (calculated on average assets) to ~2.9% by FY11. In the past few months, wholesale funding costs have come off sharply and IndusInd's incremental cost of borrowing is indicated to be less than 7%. As the bank has a large proportion of wholesale funds, we expect the benefits of lower borrowing rates to accrue over FY10. Re-pricing of loan book, achieved in FY09, will also lead to higher yields, and support margin expansion. Overall, we expect margins to expand by ~100bp in FY10 and ~15bp in FY11.

Exhibit 36: ...to drive margin expansion *



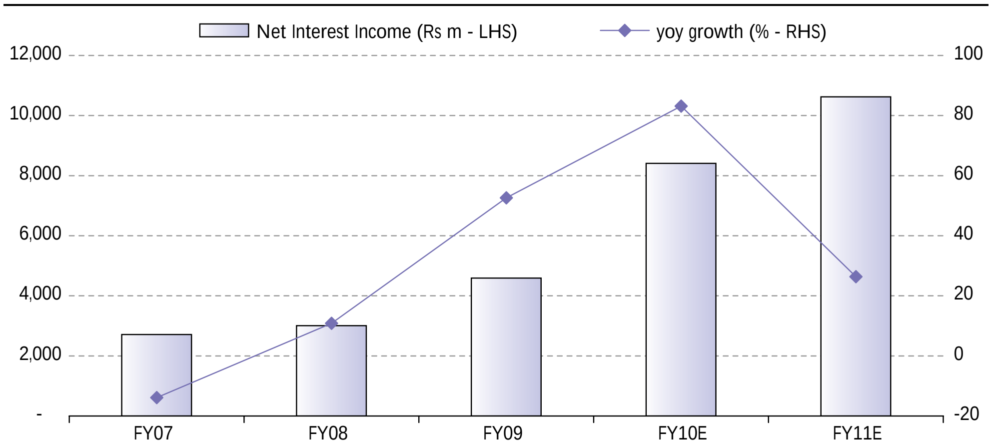
*Source: IDFC - SSKI Research, Company; * Calculated on average balances*

❑ NII growth expected to remain robust

NII to register 52% CAGR over FY09-11E led by traction in loan book and margin expansion

IndusInd has exhibited a healthy 53% growth in its NII in FY09, driven by balance sheet expansion and margin improvement. We expect the momentum to be sustained and the bank to register a 52% CAGR in NII over FY09-11, led by the continued traction in loan growth and expansion in margins.

Exhibit 37: NII growth expected to remain strong



Source: IDFC - SSKI Research, Company

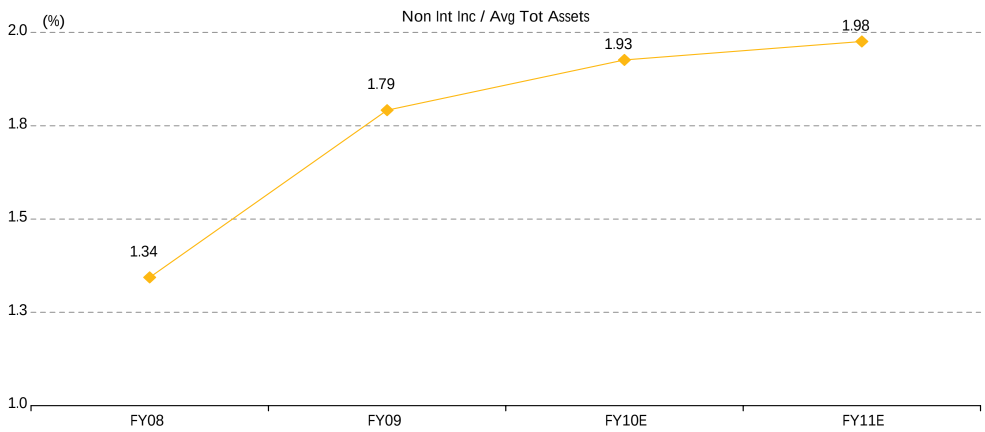
❑ New initiatives to drive growth in fee income

Fee income to see ~50% CAGR over FY09-11

The proportion of IndusInd's fee income to average assets is on the rise and aligning with that for peers. As the bank adds fee-based products like capital market advisory to its portfolio, and expands the scope of wealth management services, fee income is expected to show healthy traction. The bank has set up an investment banking team that would cater to the mid market segment. New products are on the anvil such as end-to-end remittance management. Additionally, the bank intends to scale up its transaction banking business.

We expect fee income to register ~50% CAGR over the next two years with non-trading income to average assets increasing to 1.7% by FY11 from 1.2% in FY09. This would contribute significantly to the bank's RoA expansion.

Exhibit 38: Fee income expected to scale up



Source: IDFC - SSKI Research, Company

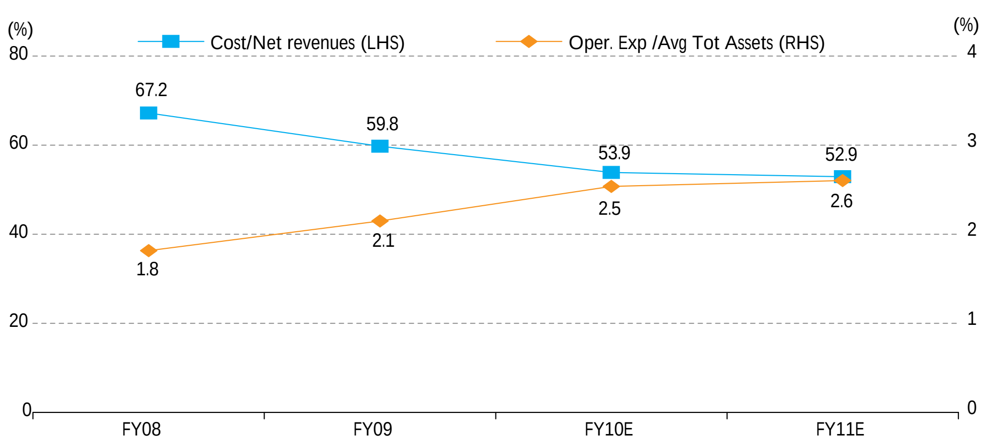
❑ Rise in efficiency reflected by declining expense ratios

Management intends to reduce CI ratio by ~5% each year; we remain more conservative

IndusInd's cost to income ratio (C/I) is running high at ~60% – a function of the restructuring in business. However, the ratio came off a high of 67% in FY08 to 60% in FY09 as the bank took corrective steps to address legacy issues. Expenses associated with an underleveraged network weigh heavily on cost ratios.

The trend is likely to continue, albeit at a slower pace. While the management intends to reduce the C/I ratio by ~5% each year, the benefits of operating leverage are likely to be limited as the bank looks to scale up its branch network. We expect the ratio to trend down to ~53% by FY11, with the ratio of operating expenses to average assets hovering at ~2.6%.

Exhibit 39: Expense ratios headed south



Source: IDFC - SSKI Research, Company

❑ Steady asset quality to lead to stable provisioning requirements

Aggressive provisioning of FY09 is likely to limit provisions going forward

As part of the restructuring initiatives, the bank has aggressively cleaned up its asset book and scaled up risk management practices to rein in slippages. Also, the bank has cumulative restructured loans of Rs720m (0.41% of advances as of September 2009), which is one of the lowest among peers. This, coupled with aggressive provisioning, is likely to limit the provisioning requirement going forward.

An optically low provision coverage ratio

IndusInd's provision coverage ratio, at ~35% as of September 2009, is generally perceived to be low. However, on segmental basis provision coverage for corporate book stands at ~69%, which is comparable to peers. On the other hand, coverage for consumer finance book at ~19% in Q2FY10 is also adequate given the portfolio is fully secured by underlying assets (which can be repossessed and sold) and NPAs in this book see a rapid churn.

Provisioning costs to remain stable

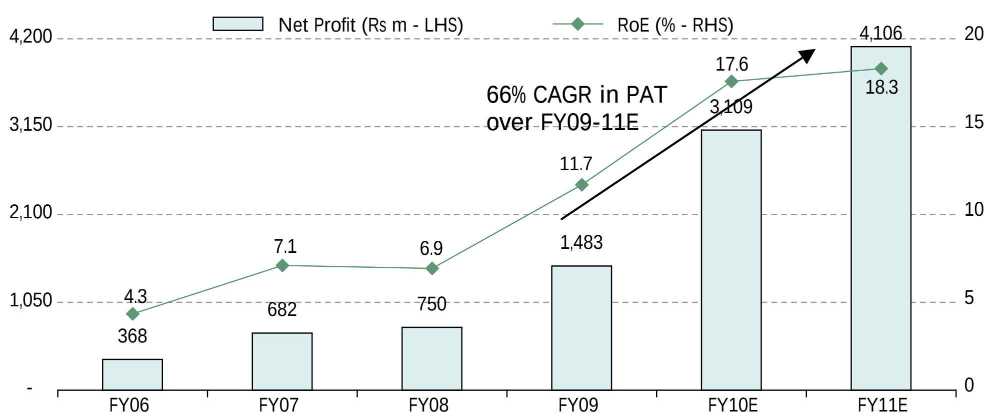
Despite our expectations of low slippages, we are building in stable provisioning levels owing to the bank's exposure to retail and SME segments. We expect provisions to average assets ratio to remain between 0.5-0.6% over FY10-11 (0.55% in FY09).

❑ Strong core performance to drive profitability and RoA

Strong growth in NII and fee income to drive 66% CAGR in earnings over FY09-11

We expect a 66% CAGR in IndusInd's net profit over FY09-11, driven by strong growth in NII and fee income. Even after the equity dilution of Q2FY10, We expect the bank's RoE to improve to ~18% by FY11 (not building in further equity dilution) from ~12% in FY09. In tandem with the increase in fee income and improvement in operating efficiency, the bank's RoA is likely to expand from 0.58% in FY09 to ~1.15% by FY11.

Exhibit 40: Earnings momentum ahead



Source: IDFC-SSKI Research; Company

❑ Equity raising offers comfort on growth sustenance

Well capitalized for near-term growth

IndusInd successfully concluded a QIP equity offering of Rs4.8bn in August 2009, taking the bank's net worth up to Rs4.1bn. The offering was priced at Rs87.5 per share and represented ~13% of the bank's post-offer equity capital. Post the issuance, capital adequacy ratio (CAR) has risen to a comfortable level of 14.91% with Tier-I ratio of 10.64% as per Basel-II norms (September 2009). We see such level of capital adequacy offering comfort on the bank's strong growth posture in the near term.

❑ Significant recovery possible from written-off NPAs

As part of its aggressive approach in recognizing and writing-off NPAs, IndusInd has cumulatively written-off NPAs of Rs16bn; of these, it has settled ~Rs8bn till date with recoveries of ~Rs4bn. Potential recovery from the remaining is not factored into our estimates and thus offers an upside to our numbers.

HIGHLIGHTS OF Q2FY10 RESULTS

IndusInd reported a PAT of Rs778m – up 131% yoy – in Q2FY10 wit growth driven by robust increase in NII as well as non-fund based income.

Robust core performance driven by 25% qoq rise in NII

- Strong NII growth; margins gallop: NII was up by 98% yoy and 25% qoq to Rs2.1bn, driven by a 26bp qoq and 100bp yoy expansion in margins to 2.86%. Improvement in NIMs was driven by 50bp qoq reduction in funding costs owing to a sharp decline in wholesale borrowing rates, which more than offset the impact of declining loan yields. (exhibit 41)
- Stellar fee income: Other income posted a 49% yoy rise to Rs1.3bn despite muted treasury income (Rs90m as against Rs868m in Q1FY10). On the other hand, core fee income rose by a stupendous 175% yoy and 37% qoq to Rs1.3bn. The bank continues to see traction in income from third party distribution (insurance as well as MF products). Transaction banking and processing fee also continued to display strength on the back of management focus to gain meaningful contribution from these heads. (exhibit 42)
- Healthy credit growth; CD ratio improves: IndusInd's loan book grew by 25% yoy and 7% qoq to ~Rs176bn. Growth was led by 60% yoy increase in corporate book. Growth in retail book also exhibited revival at 3% qoq. During the quarter, SME book grew by 16.5% qoq, with lending to large corporates increasing at 8%. At the same time, deposits grew by ~17% yoy to Rs228bn, leading to ~500bp yoy (100bp qoq) improvement in the CD ratio.

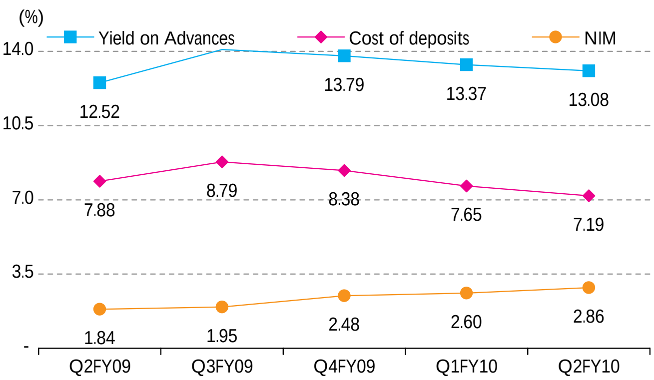
Rising CASA ratio to aid margins

- CASA inches up; growth in savings accounts picks up: CASA ratio improved by 1000bp qoq and 330bp yoy to 21.2%. Over the quarter, savings deposits displayed traction with growth accelerating to 16% qoq and 21% yoy. With current accounts growing by 49% yoy, the bank witnessed incremental CASA of 40% for the quarter. Given the corporate clientele, current deposits contribute 67% to CASA base. (exhibit 41)
- Higher capital adequacy fortifies comfort on growth: Owing to the capital raised during the quarter, Tier-I ratio improved to 10.64% (Basel-II) as against 8.3% in June 2009. Overall CRAR increased to 14.9% from 13.1% in Q1FY10.
- Gross NPAs stable; coverage improves: IndusInd's Gross NPAs were stable at 1.5% qoq (decline of 150bp yoy), while net NPAs came in marginally lower at 0.98% (1.01% in Q1FY10). The bank did not undertake any additional restructuring in the quarter, with total restructured advances being insignificant at 0.4% of the book. Coverage ratio has inched up to ~35% from 31% in Q1FY10. The increase is attributable to 69% coverage on the corporate book (61% in June 2009), while coverage on consumer finance book remains relatively low at ~19% (being a fully secured book). (exhibit 43)

Quarterly results

P&L (Rs m)	Q2FY09	Q3FY09	Q4FY09	Q1FY10	Q2FY10	FY09	FY10	FY11	Comments
Interest income	5,499	6,275	6,138	6,288	6,550	23,095	27,119	32,598	
Interest expense	4,446	5,109	4,695	4,615	4,465	18,504	18,712	21,974	
NII	**1,052**	**1,166**	**1,443**	**1,674**	**2,086**	**4,590**	**8,407**	**10,624**	Stellar growth of 25% qoq driven by margin expansion
yoy growth (%)	*37.4*	*29.9*	*65.9*	*80.1*	*98.2*	*52.6*	*83.2*	*26.4*	
Non-intt income	890	1,331	1,693	1,728	1,324	4,563	5,816	7,133	
yoy growth (%)		*79.1*	*124.4*	*166.1*	*48.8*	*53.3*	*27.5*	*22.6*	
Trading profits	25	447	795	868	91	1,216	1,100	1,000	Low in Q2 owing to volatile G-sec yields
Non-trading income	865	884	898	860	1,232	3,347	4,716	6,133	Strong traction in CEB as well as forex income
yoy growth (%)	*0.0*	*19.0*	*21.7*	*22.8*	*42.5*	*28.4*	*55.8*	*30.0*	
Net revenue	**1,942**	**2,497**	**3,136**	**3,401**	**3,409**	**9,153**	**14,223**	**17,757**	
Operating expense	1,271	1,457	1,623	1,658	1,856	5,470	7,660	9,398	30 new branches to come up in FY10
Staff	447	536	516	608	789	1,871	2,526	3,080	
Other operating expenses	824	921	1,107	1,050	1,067	3,599	5,133	6,318	
Operating profit	**671**	**1,040**	**1,513**	**1,743**	**1,553**	**3,682**	**6,564**	**8,359**	
Provisions	167	299	788	343	389	1,408	1,781	2,041	Coverage ratio shored up
yoy growth (%)	*19.3*	*5.5*	*183.2*	*123.1*	*132.9*	*71.8*	*26.5*	*14.6*	
PBT	504	741	725	1,400	1,165	2,275	4,783	6,317	
Tax	168	291	220	535	387	792	1,674	2,211	
PAT	**337**	**451**	**505**	**865**	**778**	**1,483**	**3,109**	**4,106**	Buoyed by strong NII and fee income
yoy growth (%)	*50.7*	*80.0*	*249.6*	*352.9*	*131.2*	*97.7*	*109.6*	*32.1*	
Ratios (%)									
NIM (reported)	1.84	1.95	2.48	2.60	2.86				Rapid re-pricing of liabilities more than offsets the decline in yields
NIM (calc)*	1.71	1.83	2.15	2.42	2.88	1.80	2.78	2.94	
NFR/Avg assets	1.44	2.08	2.52	2.49	1.83	1.79	1.93	1.98	
Core fee income/ avg assets	0.76	1.05	1.24	1.36	1.78	0.83	1.16	1.28	
Op exp/ avg assets	2.06	2.28	2.42	2.39	2.56	2.15	2.54	2.60	
Cost/Net rev.	65.45	58.34	51.76	48.75	54.44	59.77	53.85	52.93	
Prov/ avg assets	0.27	0.47	1.17	0.50	0.54	0.55	0.59	0.57	
PBT/Avg asets	0.82	1.16	1.08	2.02	1.61	0.89	1.58	1.75	
Tax/PBT	33.23	39.20	30.31	38.21	33.18	35.26	35.00	35.00	
RoA	0.55	0.71	0.75	1.25	1.07	0.58	1.03	1.14	stupendous yoy improvement witnessed
RoE	9.90	12.87	14.15	23.50	17.34	11.69	17.57	18.30	
CRAR	12.45	12.40	12.55	13.14	14.91				Rise due to equity raised during the quarter
Tier-I CRAR			7.65	8.26	10.64				
CD ratio	72.1	69.7	71.3	76.0	77.1				Uptick in CD ratio supports margins
CASA Ratio	17.9	18.4	19.2	20.2	21.2				Traction led by growth in savings accounts
Balance sheet (Rs bn)									
Credit	140	144	158	165	176	158	200	253	Corporate book continues to be growth driver; consumer finance picking up
yoy change (%)	*0.0*	*11.2*	*23.3*	*24.0*	*25.2*	*23.3*	*26.6*	*26.7*	
Deposits	195	206	221	216	228	221	262	323	
yoy change (%)	*0.0*	*5.4*	*16.1*	*19.4*	*17.1*	*16.1*	*18.4*	*23.5*	

Exhibit 41: Margins expand...



...aided by uptick in CASA

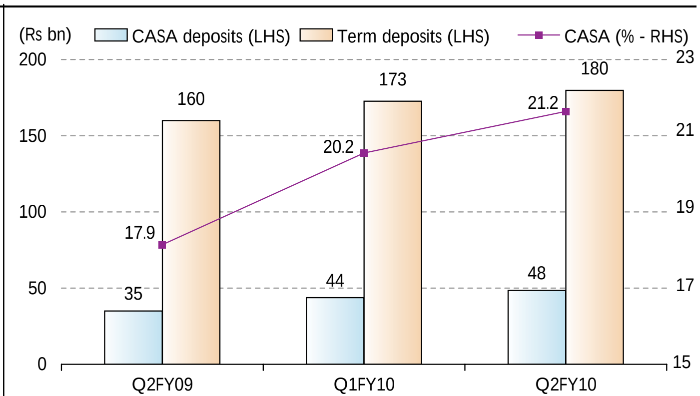
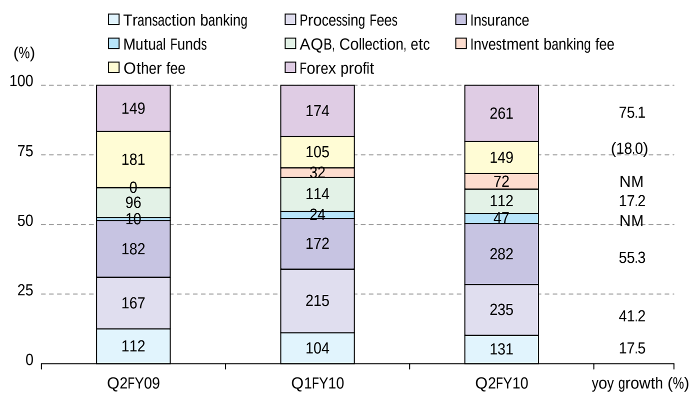


Exhibit 42: Fee income break up (Rs m)



Composition of advances book

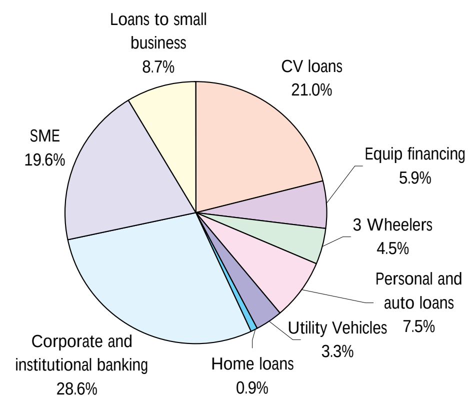


Exhibit 43: Gross NPAs decline

	Q2FY09	Q1FY10	Q2FY10	incremental qoq (Rs m/ bp)
Gross NPAs (Rs m)	4,245	2,411	2,651	240
Net NPAs (Rs m)	3,106	1,666	1,718	52
Gross NPAs (%)	3.00	1.46	1.50	4
Net NPAs (%)	2.21	1.01	0.98	(3)
Loan loss coverage (%)	26.83	30.92	35.21	429

Segmental NPAs

Rs m	Q2FY09	Q1FY10	Q2FY10	Incremental qoq (Rs m/ bp)
Corporate & commercial banking				
Gross NPA	2,261	564	861	297
Net NPA	1,661	221	265	44
Coverage (%)	26.6	60.8	69.2	846
Consumer Finance				
Gross NPA	1,985	1,847	1,790	(57)
Net NPA	1,446	1,444	1,453	9
Coverage (%)	27.1	21.8	18.8	(295)

Valuations & View: Room for upside

A turnaround story is underway at IndusInd. With strong focus on strengthening the liability franchise, the bank is striving to gain a foothold in the crowded banking space. Driven by a sound business model, we expect strong earnings growth for IndusInd. Also, we expect RoA to touch ~1.15% by FY11 as we believe the bank's franchise is significantly underutilized. With substantial RoA expansion ahead, we see market cap to assets (IndusInd lags peers by 40-50%) as a suitable metric to value the bank. We see a strong case for re-rating of the stock driven by the estimated 95% rise in RoA and ~20% growth in balance sheet growth over FY09-11.

❑ Return ratios moving in the right direction

RoE likely to expand to ~18% by FY11

Low RoA, coupled with RoE of just 11.7% (in FY09) had been the primary reason for IndusInd's poor valuations. However, continued traction in the core operating income, steady provisioning costs and the benefit of operating leverage are expected to drive profitability over the next few years. Over FY09-11, we expect the bank's RoA to expand from 0.6% to 1.15%.

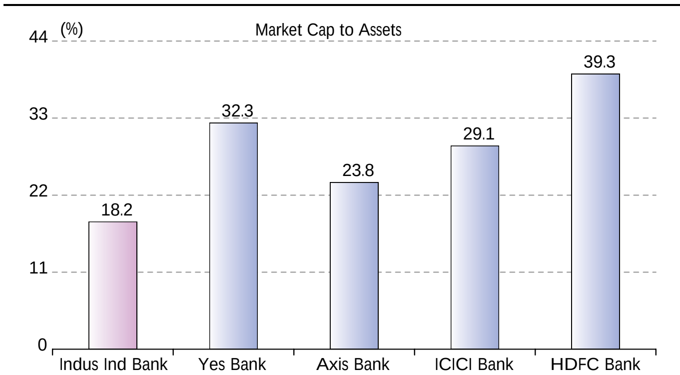
Improvement in net interest income, a stronger fee income and benefit of operating leverage are expected to translate into RoE of ~18% by FY11. The expansion in RoE, however, may be restricted due to the bank's aggressive growth posture which would force it to raise capital at frequent intervals.

❑ M Cap/ Assets – the preferred metric to value an underutilized franchise

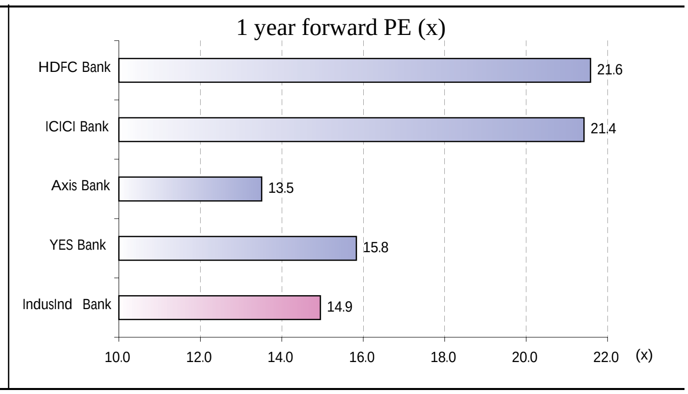
IndusInd trades below peers in terms of market cap to assets

IndusInd's network franchise efficiency is much lower than that of private peers. The bank's savings deposits per branch are significantly lower by 60-70% against that of peers and the management is directing its efforts towards enhancing network productivity. Given the underutilization, we believe market cap to assets is a suitable metric to value such a franchise. As the stock lags peers in terms of market cap to assets, we believe current valuations do not capture the potential from the step-up in network efficiency.

Exhibit 44: Lags peers in terms of Market cap to assets...



...as well as on PE basis



Source: IDFC-SSKI Research; Company

Enhanced profitability to drive investor interest

❑ Frequent capital infusion to sustain growth

IndusInd's capital adequacy position has improved over the past fiscal year through GDR as well as QIP issuance. As of September 2009, IndusInd's Tier I ratio and capital adequacy ratio stood at 10.6% and 14.9% respectively. Going forward, we expect IndusInd to require regular capital infusions to grow at above industry rates (higher than the rates sustainable by internal accruals). Further, consistent improvement in profitability metrics will translate into increased investor appetite and help the bank access capital at regular intervals to sustain credit growth momentum.

Rising RoA should drive a re-rating of the stock

❑ RoA expansion to yield disproportionate returns

In view of potential capital raising, IndusInd's RoE is likely to remain volatile. Concurrently, we believe RoA, rather than RoE, would be a more suitable metric to assess the bank's profitability. A consistent increase in RoA is expected to drive the stock performance. Given our estimate of ~95% improvement in RoA by FY11, we expect IndusInd to be rewarded with a re-rating and the stock returns to outpace asset growth.

Our belief that IndusInd would witness a re-rating is validated by the valuation history of HDFC Bank and Centurion Bank.

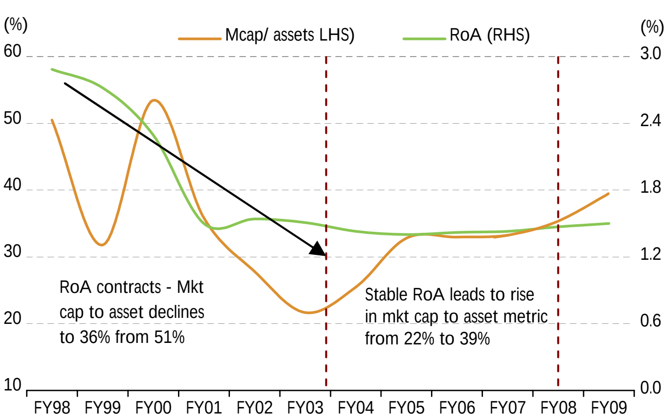
HDFC Bank's trading history proves the hypothesis…

Susutained delivery on profitability aided HDFC Bank's rich valuations

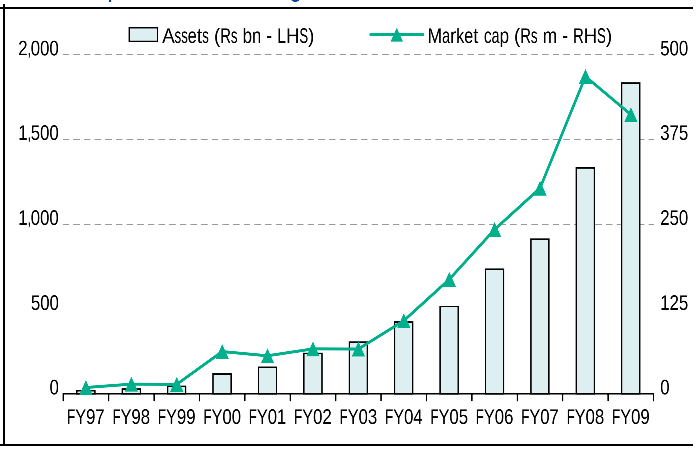
At 4-6x book, HDFC Bank was widely perceived to be expensive over FY01-02. However, the stock has held on to its premium valuations on the back of consistent delivery on profitability and superior return ratios with market cap rising at a CAGR of 30%+. This imparted investor confidence and facilitated capital infusion at rich valuations.

A close look at the stock's trading history also reveals that over the periods when its RoA was on a decline, the bank witnessed a drop in market cap to assets. Conversely, when RoA was stable/ rising, market cap to assets increased substantially. Also, the market cap increased at a faster pace than assets (refer to exhibit 45).

Exhibit 45: HDFC Bank's history proves the point…



Market cap tracks the asset growth



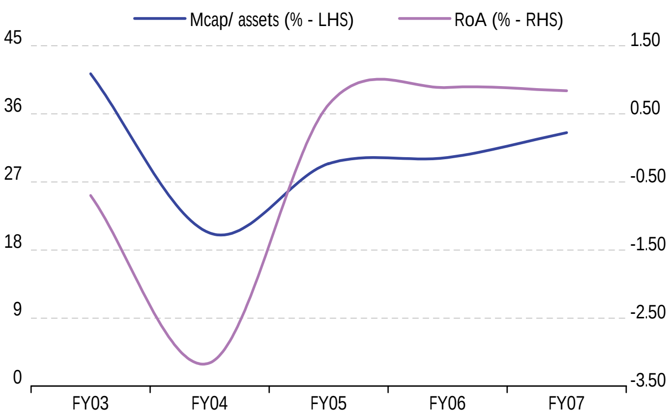
Source: Bloomberg, IDFC-SSKI Research

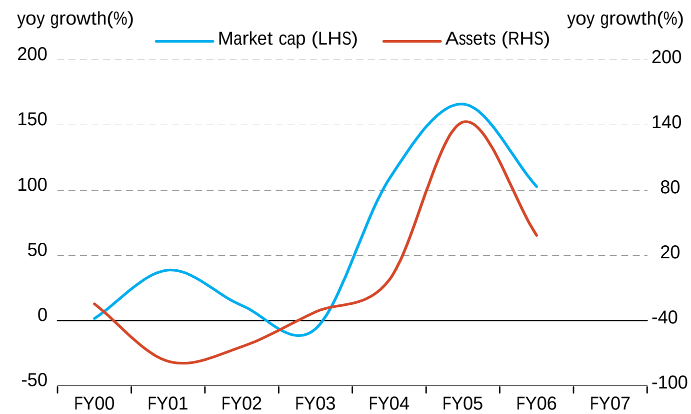
Post the management change in 2004, CBoP's market cap growth outpaced asset growth

…reiterated by Centurion Bank

Similarly, Centurion Bank also traded at rich valuations of 2-3x book in context of its subdued return ratios (RoE in the range of 8-10%). However, once the new management team started delivering on RoA, the stock sustained its rich valuations and market cap increased 18-20x over a period of five years.

Exhibit 46: Centurion Bank's mcap-to-assets moved in tandem with RoA… …market cap growth outpaced asset growth





Source: Bloomberg, IDFC-SSKI Research

KEY RISKS

❑ Execution risk

Though IndusInd has strong management credentials and a powerful promoter (Hinduja group), execution remains a key risk. Delays with respect to network expansion could limit the bank's ability to expand its low-cost deposit base. Attrition in key management personnel would be a monitorable, and any fallout of management with the promoters could impact the bank's strategic continuation.

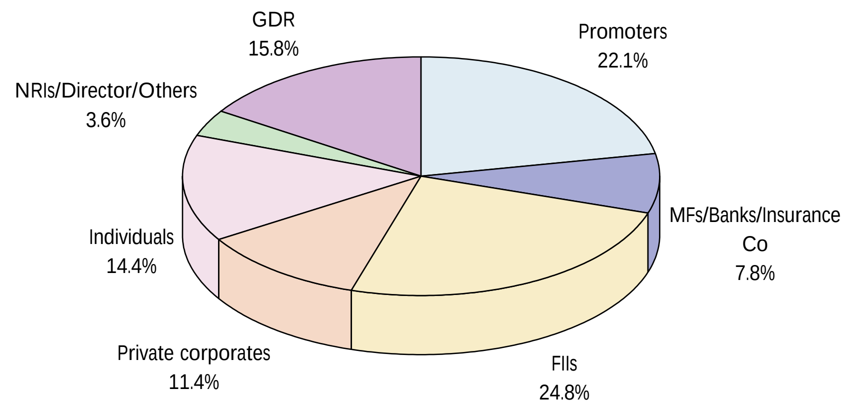
❑ Subdued RoE – frequent capital raising

IndusInd's RoE may display a muted trend due to capital raising at regular intervals. For future growth, the bank is bound to access capital opportunistically; this is a risk to returns for potential investors. RoE is projected to increase to an average of ~18% over FY09-11 (ignoring any further dilution).

❑ Promoter stake in excess of regulatory allowance

Currently, the promoter stake is more than the 10% regulatory cap. The process of reducing the promoter stake in line with the regulatory norms could be an overhang on the stock.

Exhibit 47: Shareholding pattern



Source: Company; As of September 2009

❑ Acceptance of brand and product innovation

IndusInd is embarking on rapid expansion in its network, but increased acceptance of the brand is critical to future business plans. Failure with respect to brand recognition could limit the bank's ability to expand its low-cost deposit base. Further, ability to innovate consistently and introduce new as well as competitive products remains a key monitorable.

Earnings model

Year to 31 March (Rs m)	2007	2008	2009	2010E	2011E
Net interest income	2,714	3,008	4,590	8,407	10,624
yoy growth (%)	(13.9)	10.8	52.6	83.2	26.4
Other income	3,157	2,976	4,563	5,816	7,133
yoy growth (%)	37.0	(5.8)	53.3	27.5	22.6
Trading profits	187	194	1,216	1,100	1,000
Non trading income	2,971	2,781	3,347	4,716	6,133
Net revenue	5,871	5,984	9,153	14,223	17,757
Operating expenses	3,440	4,022	5,470	7,660	9,398
yoy growth (%)	8.6	16.9	36.0	40.0	22.7
Operating profit	2,432	1,962	3,682	6,564	8,359
yoy growth (%)	6.2	(19.3)	87.7	78.2	27.3
Provisions	1,358	819	1,408	1,781	2,041
of which NPA provisions	559	609	1,253	1,563	1,778
PBT	1,074	1,143	2,275	4,783	6,317
Provision for tax	392	392	792	1,674	2,211
PAT	682	750	1,483	3,109	4,106
yoy growth (%)	85.3	10.0	97.7	109.6	32.1

Source: IDFC - SSKI Research

Balance sheet

As on 31 March (Rs m)	2007	2008	2009	2010E	2011E
Advances	110,842	127,953	157,706	199,732	253,073
yoy growth (%)	19.1	15.4	23.3	26.6	26.7
Customer assets	112,023	128,435	158,630	201,026	254,690
yoy growth (%)	18.5	14.6	23.5	26.7	26.7
SLR portfolio	48,546	54,395	62,981	69,368	80,836
Cash & bank balances	25,954	21,780	19,237	22,123	24,335
Total assets	209,718	233,193	276,147	327,749	394,349
Networth	10,568	11,094	14,276	21,100	23,769
Deposits	176,448	190,374	221,103	261,765	323,344
- Current %	9.7	9.5	13.4	15.0	16.0
- Savings %	5.2	6.2	5.9	7.5	8.0
- Term %	85.1	84.3	80.8	77.5	76.0
Borrowings	5,925	10,954	18,565	22,084	23,823

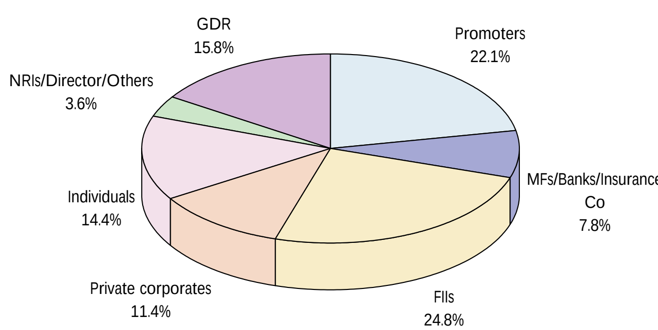
Source: IDFC - SSKI Research

Ratio analysis

Year to 31 March (%)	2007	2008	2009	2010E	2011E
Net int. margin/avg assets	1.4	1.4	1.8	2.8	2.9
Non-fund rev./avg assets	1.6	1.3	1.8	1.9	2.0
Operating exp./avg assets	1.8	1.8	2.1	2.5	2.6
Cost/Income	58.6	67.2	59.8	53.9	52.9
Prov./avg assets	0.7	0.4	0.6	0.6	0.6
PBT/Average assets	0.6	0.5	0.9	1.6	1.7
RoA	0.4	0.3	0.6	1.0	1.14
RoE	7.1	6.9	11.7	17.6	18.3
Tax/PBT	36.5	34.3	34.8	35.0	35.0
Gross NPA	3.1	3.1	1.6	2.1	2.5
Net NPA	2.5	2.3	1.1	0.9	0.9
Provisioning coverage	20.1	25.8	29.8	55.2	65.0
Growth in customer assets	18.5	14.6	23.5	26.7	26.7
Growth in deposits	17.6	7.9	16.1	18.4	23.5
SLR ratio	27.5	28.6	28.5	26.5	25.0
CASA ratio	14.9	15.7	19.2	22.5	24.0

Source: IDFC - SSKI Research

Shareholding pattern (As of September 2009)



Source: Company

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Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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