27 September 2010

Vijaya Bank

Focus on profitability; initiate with Buy

Rating: Buy
Target Price: ₹107
Share Price: ₹82

We initiate coverage on Vijaya Bank with Buy and price target of ₹107/share. We expect prudent business growth and improving liability mix to support the expanding core income. The Bank is likely to register 23.4% earnings CAGR over FY10-13e, driven by higher NIM and improved productivity.

- **Prudent business growth; higher NIM.** We expect Vijaya Bank to grow its business in a prudent manner (19.8% CAGR over FY10-13e) with greater emphasis on higher-yielding loans. NIM expansion to 2.8% in FY13e from 2.3% in FY10 will be led by altered liability mix – higher CASA share and lower wholesale deposits.
- **Improving productivity.** Focus on enhancing employee skills and technology would help boost productivity. We expect cost-to-income to improve to 48% by FY13e from 49.8% in FY10, despite branch expansion and additional provisions (which were on account of higher gratuity and pension).
- **Asset quality concerns allaying.** GNPAs have steadily declined over the past three quarters, from 2.94% in 1QFY10 to 2.32% in 1QFY11. We expect current capital infusion of ₹7bn (CAR: 14.7%; tier-1 capital: 10.1%) to support future growth and adequately capitalise the Bank for additional loan defaults.
- **Valuation and risks.** At our target price of ₹107, Vijaya Bank would trade at 1.5x FY12e and 1.2x FY13e ABV. Our target is based on the two-stage DDM (CoE: 16.2%; beta: 1.3; Rf: 7.5%). Risks are higher-than-expected credit cost and change in management.

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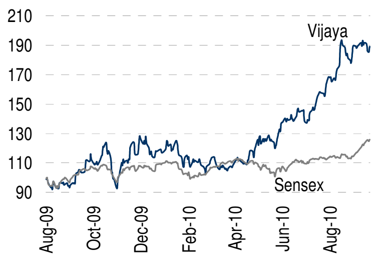
Key data	VJYBK IN/VJBK.BO
52-week high/low	₹87.9/41
Sensex/Nifty	19861/5960
3-m average volume	US$8.2m
Market cap	₹35.7bn/US$789m
Shares outstanding	433.5m
Free float	45.4%
Promoters	53.6%
Foreign Institutions	4.6%
Domestic Institutions	13.8%
Public	22.0%

Key financials

Year end 31 Mar	FY09	FY10	FY11e	FY12e	FY13e
Net interest income (₹m)	11,248	14,491	19,495	24,193	29,040
Net profit (₹m)	2,625	5,073	6,380	7,690	9,535
EPS (₹)	6.1	11.7	14.7	17.7	22.0
Growth (%)	(27.3)	93.1	25.8	20.5	24.0
PE (x)	13.5	7.0	5.6	4.6	3.7
PABV (x)	1.8	1.7	1.4	1.2	1.0
RoE (%)	10.3	18.0	20.1	21.1	22.5
RoA (%)	0.4	0.8	0.8	0.8	0.9
Dividend yield (%)	1.2	3.0	3.3	3.9	4.8
Net NPA (%)	0.8	1.4	1.1	0.9	0.7

Source: Company, Anand Rathi Research

Relative price performance



Source: Bloomberg

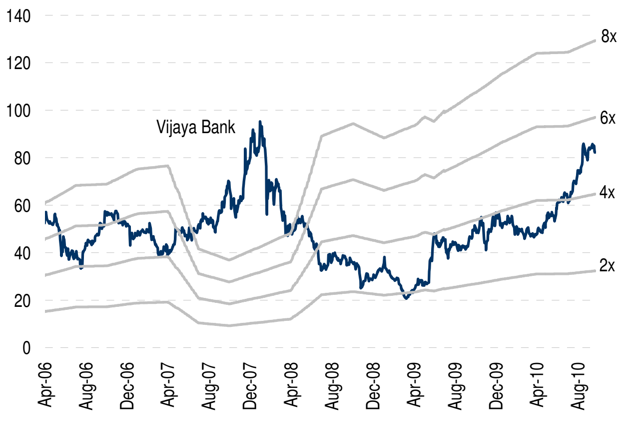
Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year end 31 Mar	FY09	FY10	FY11e	FY12e	FY13e
Net interest income	11,248	14,491	19,495	24,193	29,040
NII growth (%)	21.6	28.8	34.5	24.1	20.0
Non-interest inc	7,534	7,035	7,156	7,310	7,936
Total income	18,782	21,525	26,651	31,503	36,976
Total income growth (%)	28.4	14.6	23.8	18.2	17.4
Op. expenses	9,247	10,716	13,326	15,436	17,748
Operating profit	9,535	10,810	13,326	16,066	19,227
Operating profit growth (%)	25.3	13.4	23.3	20.6	19.7
Provisions	4,158	3,798	3,902	4,537	4,932
PBT	5,377	7,012	9,424	11,529	14,295
Tax	2,752	1,939	3,044	3,839	4,760
PAT	2,625	5,073	6,380	7,690	9,535
PAT growth (%)	(27.3)	93.3	25.8	20.5	24.0
FDEPS (₹/share)	6.1	11.7	14.7	17.7	22.0
DPS (₹/share)	1.0	2.5	2.8	3.3	4.0

Source: Company, Anand Rathi Research

Fig 4 – PE Band



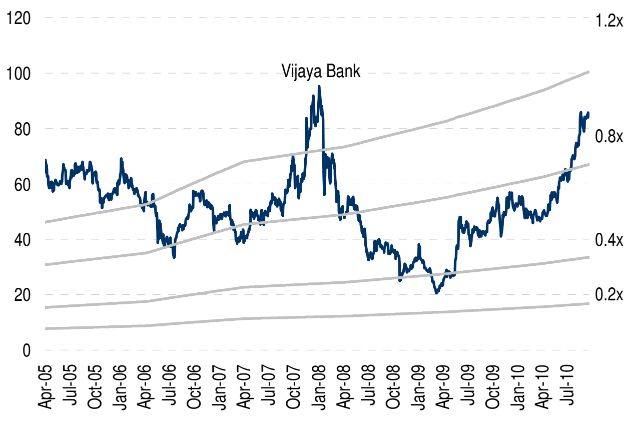
Source: Bloomberg, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year end 31 Mar	FY09	FY10	FY11e	FY12e	FY13e
Share capital	4,335	4,335	4,335	4,335	4,335
Reserves & surplus	27,158	30,416	41,537	46,690	53,308
Deposits	545,354	619,317	733,632	877,402	1,046,490
Borrowings	46,979	48,152	51,317	56,799	63,129
Minority interests	-	-	-	-	-
Total Liabilities	623,826	702,221	830,821	985,226	1,167,262
Advances	354,681	415,217	500,337	605,407	732,543
Investments	173,877	211,074	242,098	280,769	334,877
Cash & Bank Bal	76,722	55,493	64,292	71,463	67,742
Fixed & Other Assets	18,546	20,437	24,094	27,586	32,100
Total Assets	623,826	702,221	830,821	985,226	1,167,262
No. of shares (m)	434	434	434	434	434
Deposits growth (%)	13.7	13.6	18.5	19.6	19.3
Advances growth (%)	11.9	17.1	20.5	21.0	21.0

Source: Company, Anand Rathi Research

Fig 5 – Price-to-Book Band



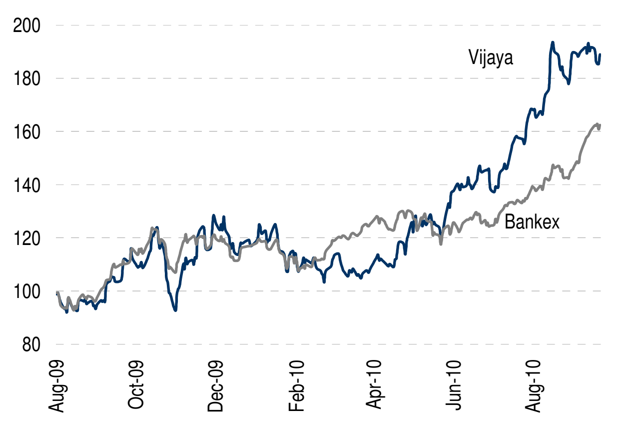
Source: Bloomberg ,Anand Rathi Research

Fig 3 – Ratios

Year end 31 Mar	FY09	FY10	FY11e	FY12e	FY13e
Interest spread (%)	1.5	1.9	2.1	2.2	2.3
NIM (%)	2.0	2.3	2.6	2.7	2.8
Other inc / Total inc (%)	40.1	32.7	26.9	23.2	21.5
Cost-Income (%)	49.2	49.8	50.0	49.0	48.0
Provisions / Loans (%)	58.2	62.9	72.3	72.8	76.3
Dividend Payout (%)	16.5	21.4	19.0	18.6	18.2
Credit-Deposit (%)	65.0	67.0	68.2	69.0	70.0
Investment-Deposit (%)	31.9	34.1	33.0	32.0	32.0
Gross NPA (%)	2.0	2.4	2.3	1.9	1.8
Net NPA (%)	0.8	1.4	1.1	0.9	0.7
BV (₹)	61.1	68.6	78.1	90.0	105.3
Adj BV (₹)	46.7	48.0	58.7	70.8	86.1
CAR (%)	13.1	12.5	13.0	12.0	11.2
- Tier 1 (%)	7.7	7.7	8.8	8.1	7.7
Dividend Yield (%)	1.2	3.0	3.3	3.9	4.8

Source: Company, Anand Rathi Research

Fig 6 – Bankex vs Vijaya



Source: Bloomberg

Investment Argument and Valuation

We expect steady business CAGR of 19.8% over FY10-13e and improving liability mix to support expanding core income. The Bank's 23.4% earnings CAGR over FY10-13e is likely to be driven by higher NIM and improved productivity.

Prudent business growth; higher NIM

We expect Vijaya Bank to grow its business in a prudent manner (19.8% CAGR over FY10-13e) with greater emphasis on higher-yielding loans. NIM expansion to 2.8% in FY13e from 2.3% in FY10 will be led by altered liability mix – higher CASA share and lower wholesale deposits.

Improving productivity

Focus on enhancing employee skills and technology would help boost productivity. We expect cost-income ratio in the 48-50% range during FY11-13e, despite branch expansion and additional provisions (which were on account of higher gratuity and pension).

Asset quality concerns allaying

GNPAs have steadily declined over the past three quarters, from 2.94% in 1QFY10 to 2.32%in 1QFY11. We expect current capital infusion of ₹7bn (CAR: 14.7%; tier-1 capital: 10.1%) to support future growth and adequately capitalise it for additional loan defaults. We have factored additional slippages in our estimates on account of expected Agri NPAs.

Valuation

We value Vijaya Bank at ₹107 (1.5x FY12e ABV), based on the two-stage dividend-discount model (CoE: 16.2%; beta: 1.3; Rf: 7.5%).

To arrive at a fair price/book value multiple, we have used the single-stage Gordon growth model (RoE-g/CoE-g):

(P/B) = (RoE-g/CoE-g), where g = perpetual growth rate; CoE = cost of equity; RoE = normalised return on equity.

Risks to our target price

- We have factored in a modest rise in the Bank's NPAs for our earnings estimates. Further deterioration in asset quality, more than our estimates, could be a downside risk to our target price.
- Change in management is a risk to our target price as Albert Tauro, the Bank's Chairman & MD, is due for retirement by Mar '11.

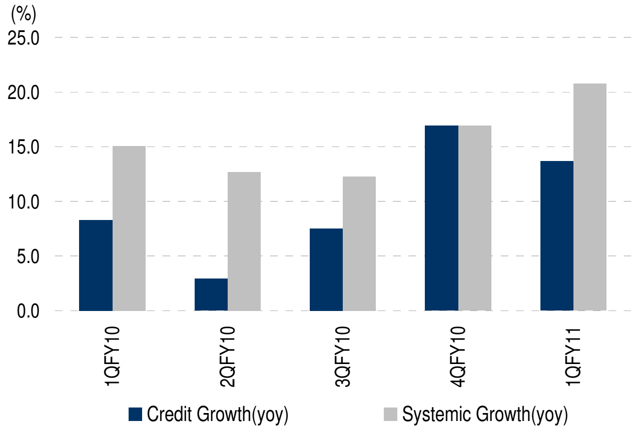
Prudent business growth; higher NIM

We expect Vijaya Bank to grow its business in a prudent manner (19.8% CAGR over FY10-13e) with greater emphasis on higher-yielding loans. We estimate NIM to expand to 2.8% in FY13 from 2.3% in FY10, led by altered liability mix – higher CASA share and lower wholesale deposits to drive earnings CAGR of 23.5% over FY10-13e.

Prudent business growth

Vijaya Bank's business growth has been sluggish (CAGR of 14.5% over FY08-10) compared with the system (19.2%), over the past two years, with management following a risk-aversion strategy. But, over the past six months, Vijaya Bank has streamlined its processes, strengthened its credit appraisal system and reintroduced several retail & SME products that would aid advances growth over the coming years. The Bank has mindfully not participated in the low-margin 3G auction loans.

Fig 7– Credit growth lower than system

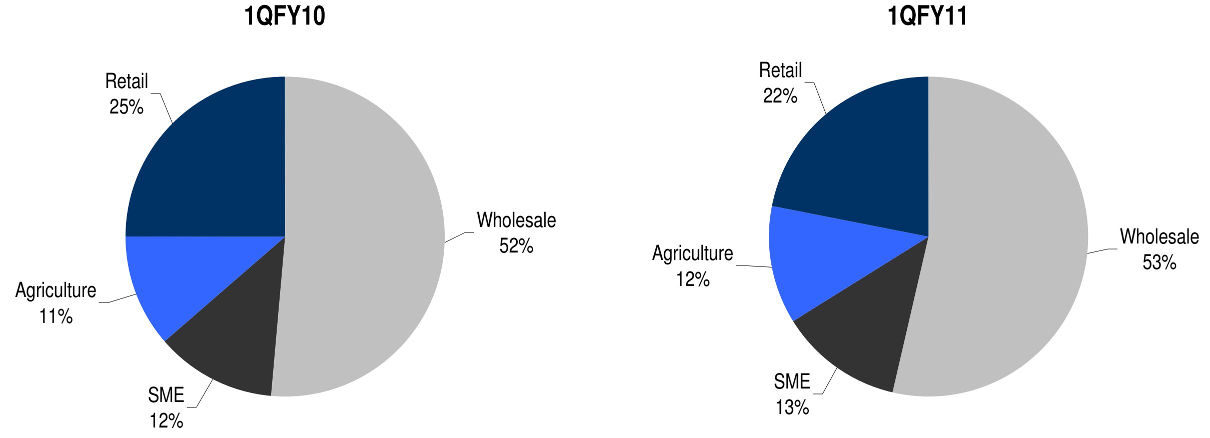


Source: Company, RBI, Anand Rathi Research

Loan book

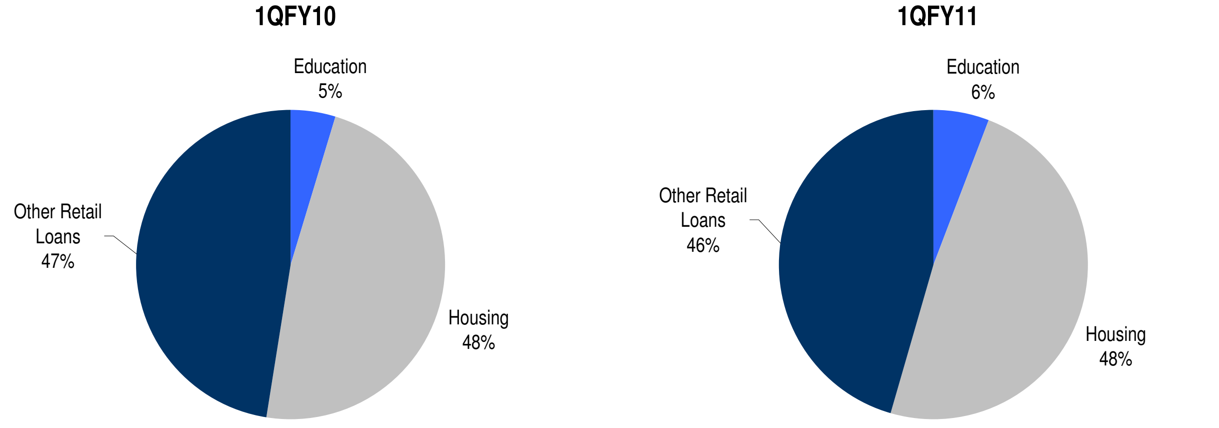
At end-1QFY11, the Bank's lending to infrastructure advances stood at 24%, over 40% of which was towards State Electricity Boards. The Bank intends increasing share of corporate loans. Although the share of Retail has declined to 22% in 1QFY11 from 25% in 1QFY10, exposure to mortgage and education has improved in the retail advances mix. The Bank has reintroduced a few retail products after resolving discrepancies and higher underwriting standards; such improved products are likely to boost credit growth.

Fig 8–Loan book – Share of Retail book declines



Source: Company

Fig 9 – Higher share of mortgage and education in Retail

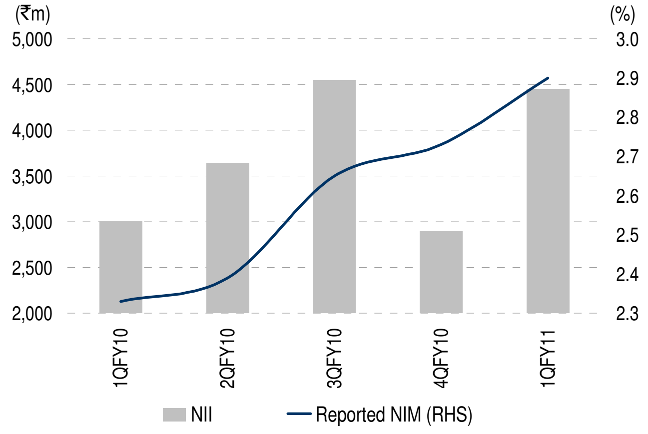


Source: Company

Higher NIM

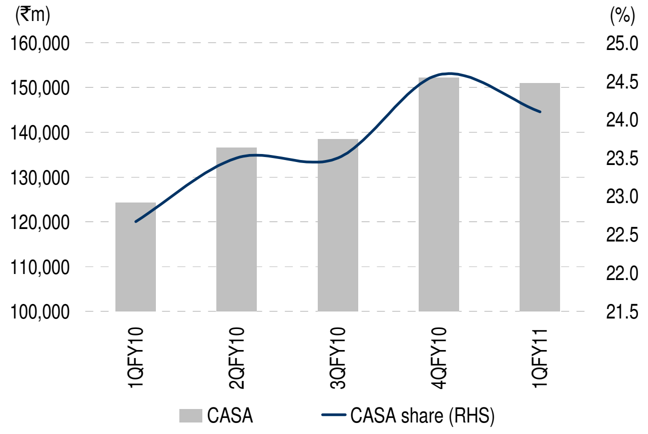
The Bank has consistently improved its margins over the past five quarters. NIM for 1QFY11 stood at 2.9%, higher 57bps yoy. We expect margin to improve to 2.8% from 2.3% over FY10-13e, driven by rising CASA share and exposure to higher-yielding loans. CASA growth is mainly driven by renewed focus on savings account and diversification of branches to northern and western Indian states.

Fig 10– Improving margins



Source: Company

Fig 11 – Rising CASA share

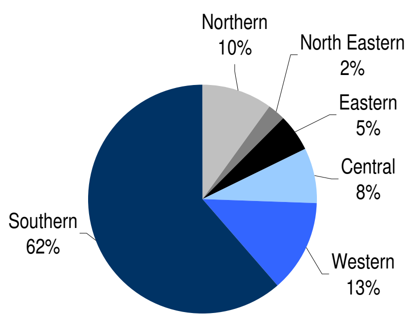


Source: Company

Incremental branch network to aid CASA growth

The Bank has a large branch network of 1,164 branches with ~60% branches in the South. It intends adding 65-70 branches in FY11, of which more than 50 are targeted in the North and the western region. With higher CASA share in these regions, we expect incremental branch network to aid CASA accretion.

Fig 12 – Geographical distribution of branches (1QFY11)



Source: Company

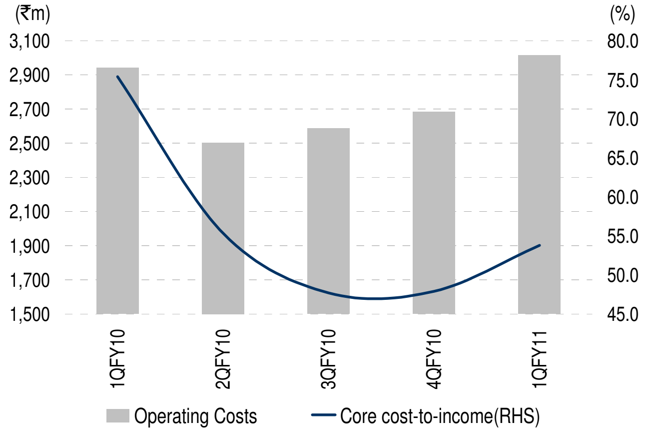
Improving productivity

Focus on enhancing employee skills & technology, improvement in processes and addition of fresh talent are likely to boost productivity. We expect cost-to-income to improve to 48% by FY13e from 49.8% in FY10, despite branch expansion and additional provisions on account of higher gratuity and pension.

Improving productivity

The Bank's productivity has already shown improvement – Cost-income ratio rose to 49% in 1QFY11 compared with 58.4% in 1QFY10, despite providing for increase in gratuity level to ₹1m from ₹0.3m.

Fig 13 – Improvement in core cost-to-income (ex trading gains)



Source: Company

Focus on enhancing employee skills and technology

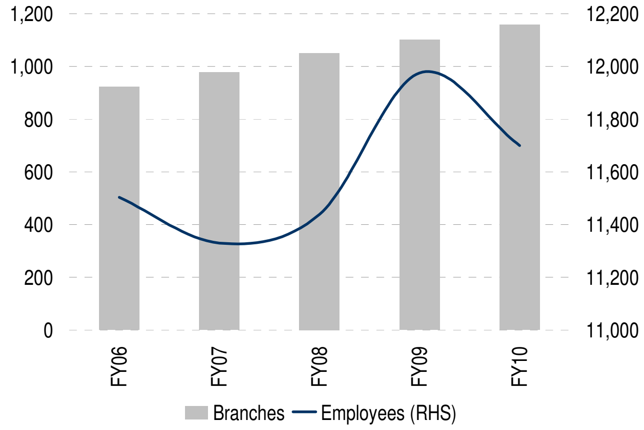
Management focuses on improving employee skills, streamlining processes and resolving discrepancies in its credit processes. The Bank is 100% CBS, but lacks the effective usage of technology in decision-making processes compared with other PSUs or private-sector banks. Although the gap is narrowing between the Bank and such peers, there remains scope for improvement.

Subdued branch and employee addition

Subdued branch and employee additions have helped Vijaya Bank manage its costs better. The Bank added 57 branches in FY10, implying 5% branch expansion. Further, the Bank added only 197 employees (or 1.7% increase) in FY06. Going forward, the Bank does not have aggressive branch expansion plans or huge employee requirements.

We believe that employee skill enhancements and technology improvements are likely to materialise into better operating leverage. We expect the cost-income ratio to fall to 48.5% by FY13e from 49.8% in FY10 and cost-to-assets to remain stable at 1.6% on the back of better business growth, rising core income and operating cost control. We have factored increased provisioning due to gratuity in our estimates.

Fig 14 – Subdued branch and employee additions (Nos)



Source: Company

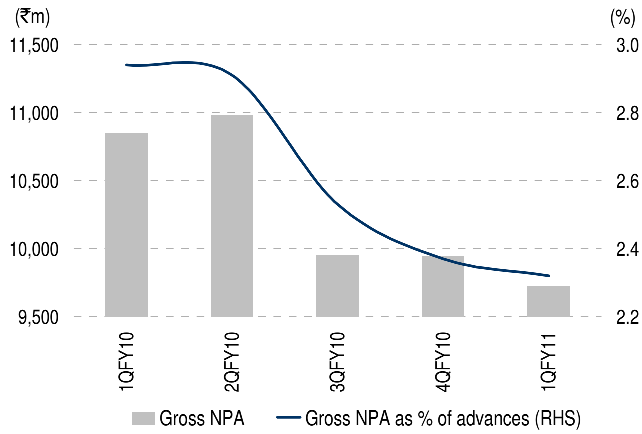
Asset quality concerns allaying

GNPAs have steadily declined over the past three quarters, from 2.94% in 1QFY10 to 2.32%in 1QFY11. We expect current capital infusion of ₹7bn (CAR: 14.7%; tier-1 capital: 10.1%) to support future growth and sufficiently capitalise it for additional loan defaults.

Declining NPAs and slippages

In FY10, the Bank witnessed one of the highest slippages ever, mainly owing to a weak economic environment. However, gross NPAs as a percentage of advances have seen steady decline since 1QFY10 and stand at 2.32% of advances as at end-1QFY11. This was on account of better monitoring and improved use of technology. We have factored in additional slippages owing to Agri NPAs in the impending quarter.

Fig 15 – Gross NPA – Declining trend



Source: Company

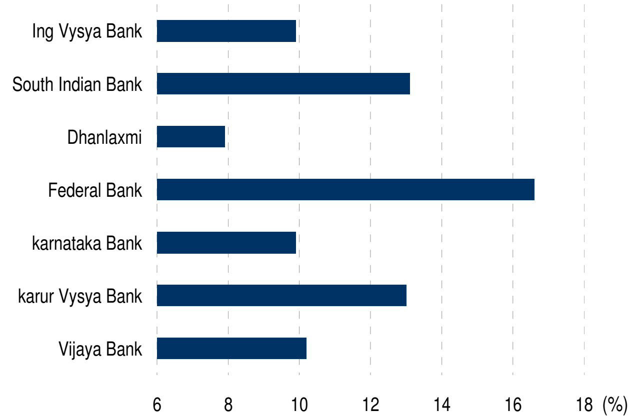
Reported provisioning coverage ratio at 42.3% in 1QFY11 is quite low. However, including technical write-offs, the coverage ratio is equivalent to 64.8% in 1QFY11. The Bank has applied for extension, up to Mar '11, to the RBI and is awaiting instruction.

Restructured assets under control. Outstanding restructured accounts were ₹15.2bn (3.6% of advances) of the cumulative restructured assets worth ₹25.4bn. Slippages were contained at 6.5% of outstanding restructured assets. Management does not expect major slippages in this portfolio, going forward.

Adequate tier-1 capital

Adequate capital is essential to sustain high credit growth. With capital infusion of ₹7bn in 1QFY11 in the form of preference capital, the Bank's capital increased to 14.7%, with tier-1 capital at 10.1%. Also, on the back of government support to provide adequate capital support, we estimate that current capital will sustain Vijaya Bank's expected credit growth as well as sufficiently capitalise it for additional loan defaults.

Fig 16 – Tier-1 capital (1QFY11) – Peer comparison



Source: Company

Financials

We expect Vijaya Bank to witness 26.1% NII CAGR and 23.4% net profit CAGR over FY10-13e. The Bank's RoE would expand to 22.5% in FY13e from 18.0% in FY10, while its RoA would gradually improve to 0.9% from 0.77% over the same period.

Business growth to be steady

We expect the Bank to register business growth of 19.3% in FY11e and 20.2% in FY12e. During FY10-13e, we expect 20.8% CAGR in advances and 19.1% in deposits. Credit growth is likely to be led by SME and Retail lending, which is likely to improve yields.

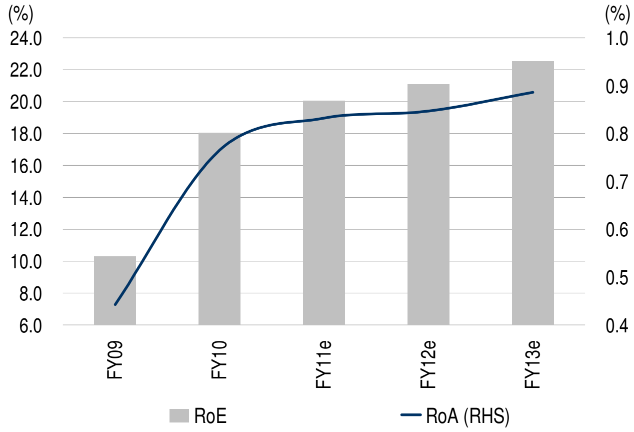
NIM to improve

In 1QFY11, the Bank's reported NIM improved to 2.9% yoy from 2.3% in 1QFY10, driven by lower cost of liabilities. The focus on low-cost deposits (CASA) is expected to continue. CASA share is 24.1% at present and management aims to increase it to ~25% by Fy13e. We factor-in NIM improvement of 34bps yoy in FY11e to 2.65% and of 10bps in FY12e to 2.75%.

Asset quality likely to worsen in 2QFY11, but be manageable

We have factored-in 15.5% yoy increase in gross NPAs in FY11, to factor additional delinquencies in the Agri sector. We expect loan-loss provisions, at ~0.73% over FY11-13e compared with 0.68% over FY06-10, to account for additional provisioning to reach the 70% mark. We expect coverage ratio at ~72% in FY11e and FY12e, with net NPAs at 1.06% in FY11e.

Fig 17 – Higher RoE and RoA



Source : Company, Anand Rathi Research

Fig 18– Income Statement

Year end 31 Mar (₹m)	FY09	FY10	FY11e	FY12e	FY13e
Interest Income	52,378	52,006	62,655	76,728	92,872
Interest Expended	41,130	37,516	43,160	52,535	63,832
Net Interest Income	**11,248**	**14,491**	**19,495**	**24,193**	**29,040**
Growth (%)	21.6	28.8	34.5	24.1	20.0
Non-interest Income	7,534	7,035	7,156	7,310	7,936
Total Income	**18,782**	**21,525**	**26,651**	**31,503**	**36,976**
Non-interest income / Total Income (%)	40.1	32.7	26.9	23.2	21.5
Operating Expenses	**9,247**	**10,716**	**13,326**	**15,436**	**17,748**
Employee Expenses	5,975	7,056	8,928	10,265	11,803
Other Expenses	3,272	3,660	4,397	5,171	5,946
Pre-provisioning profit	**9,535**	**10,810**	**13,326**	**16,066**	**19,227**
Growth (%)	25.3	13.4	23.3	20.6	19.7
Provisions	4,158	3,798	3,902	4,537	4,932
Profit Before Tax	**5,377**	**7,012**	**9,424**	**11,529**	**14,295**
Taxes	2,752	1,939	3,044	3,839	4,760
Tax Rate (%)	51.2	27.6	32.3	33.3	33.3
Profit After Tax	**2,625**	**5,073**	**6,380**	**7,690**	**9,535**
Growth (%)	(27.3)	93.3	25.8	20.5	24.0
Number of Shares (m)	434	434	434	434	434
Earnings Per Share (₹)	6.1	11.7	14.7	17.7	22.0

Source: Company, Anand Rathi Research

Fig 19 – Balance Sheet

Year end 31 Mar (₹m)	FY09	FY10	FY11e	FY12e	FY13e
Share Capital	4,335	4,335	4,335	4,335	4,335
Reserves and Surplus	27,158	30,416	41,537	46,690	53,308
Net Worth	**31,493**	**34,752**	**45,872**	**51,025**	**57,643**
Deposits	545,354	619,317	733,632	877,402	1,046,490
Other Liabilities & Provisions	46,979	48,152	51,317	56,799	63,129
Total Loans	**592,333**	**667,469**	**784,949**	**934,201**	**1,109,619**
Total Liabilities	**623,826**	**702,221**	**830,821**	**985,226**	**1,167,262**
Advances	354,681	415,217	500,337	605,407	732,543
Investments	173,877	211,074	242,098	280,769	334,877
Cash & Bank Balances	76,722	55,493	64,292	71,463	67,742
Fixed & Other Assets	18,546	20,437	24,094	27,586	32,100
Total Assets	**623,826**	**702,221**	**830,821**	**985,226**	**1,167,262**

Source: Company, Anand Rathi Research

Company Background & Management

Vijaya Bank has built a network of 1,158 branches, 46 extension counters and 435 ATMs, as of FY10. It spans across 28 states and four union territories in the country. During FY10, the Bank added 57 branches and three extension counters. Vijaya Bank branches are geographically concentrated in its home state of Karnataka.

Background

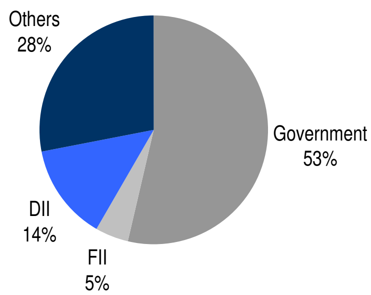
Vijaya Bank was founded on 23 Oct 1931 by late Shri AB Shetty and other enterprising farmers in Mangalore, Karnataka. The objective of the founders was to promote a banking habit, thrift and entrepreneurship among the farming community of Dakshina Kannada district in Karnataka. Vijaya Bank has steadily increased presence across India, with nine smaller banks merging with it during 1963-68. The Bank was nationalised in Apr 1980.

Management

Albert Tauro joined the Bank in Aug '08 as the **Chairman & MD** and has ~39 years of experience in various positions in banking. He was earlier the Executive Director at Central Bank of India. He has served on the Board of several committees such as IBA working group on Basel II and the advisory board of IDFC Private Equity Fund II.

Smt SA Panse joined as **Executive Director** in Nov '09. She has 33 years of banking experience in diverse disciplines such as credit management, recovery, and treasury and information technology at various levels in Bank of Maharashtra. She has been accredited with several rewards and recognition in diverse fields.

Fig 20 – Shareholding pattern



Source: BSE

Appendix 1

Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

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Anand Rathi Ratings Definitions

Analysts' ratings and the corresponding expected returns take into account our definitions of Large Caps (>US$1bn) and Mid/Small Caps (<US$1bn) as described in the Ratings Table below.

Ratings Guide

	Buy	Hold	Sell
Large Caps (>US$1bn)	>20%	5-20%	<5%
Mid/Small Caps (<US$1bn)	>30%	10-30%	<10%

Anand Rathi Research Ratings Distribution (as of 20 July 10)

	Buy	Hold	Sell
Anand Rathi Research stock coverage (114)	66%	14%	20%
% who are investment banking clients	8%	0%	0%

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