

Company Results Review

29 January 2007 | 7 pages

Federal Bank (FED.BO)

Buy: Strong and Steady Quarter...but Challenges Ahead

- Operationally strong quarter; profits slightly below expectations** — Federal Bank's 3Q07 profits were 4% below expectations on lower trading gains. Balance sheet growth was slightly muted, and we expect slight pressure on margins. However, operationally it was a good quarter with improvements in NIMs as well as asset quality - both continue to be above peers. Maintain Buy/Medium Risk with Rs285 target price.
- Higher margins but possible caution** — Federal has managed to improve yields and NIMs over the quarter by about 7-8bps by controlling its cost of funds. However, its deposit growth meaningfully lags the industry average, balance sheet liquidity has almost run out (about 3% excess SLR) and additional liquidity will incrementally cost meaningfully more. We expect pressure on margins in the next quarter.
- Operationally a strong quarter with steady growth** — Operating parameters this quarter have been steady with pre-provision profits ex-trading gains 17% higher over the quarter. Costs have been contained despite one-offs items and fee growth remains healthy and in-line with peers. With deposits growing at just about 13%; sustaining advances growth will be a challenge.
- Asset quality remains strong** — Absolute NPLs have continued to decline in the quarter and despite provisions declining in the absolute; coverage levels trend higher and at 85% coverage remain meaningfully above peers.

Buy/Medium Risk	1M
Price (29 Jan 07)	Rs250.55
Target price	Rs285.00
Expected share price return	13.7%
Expected dividend yield	1.2%
Expected total return	15.0%
Market Cap	Rs21,346M US\$483M

Price Performance (RIC: FED.BO, BB: FB IN)



Figure 1. Statistical Abstract

Year to	Net Profit	FD EPS	EPS Growth	P/E	P/BV	RoAE	ROAA	Div Yld
March	(Rs Mils.)	(Rs)	(%)	(X)	(X)	(%)	(%)	(%)
FY05	901	13.8	(34.1)	18.3	2.3	13.1	0.6	1.0
FY06	2,252	29.8	116.4	8.5	1.7	22.8	1.2	1.1
FY07E	2,698	31.5	5.8	8.0	1.4	19.7	1.2	1.2
FY08E	3,121	36.5	15.7	6.9	1.2	19.2	1.2	1.4
FY09E	3,609	42.2	15.7	6.0	1.0	18.7	1.2	1.4

Source: Citigroup Investment Research

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	18.2	8.4	7.9	6.9	5.9
P/E reported (x)	18.2	8.4	7.9	6.9	5.9
P/BV (x)	2.3	1.7	1.4	1.2	1.0
P/Adjusted BV diluted (x)	2.3	1.7	1.4	1.2	1.0
Dividend yield (%)	1.0	1.1	1.2	1.4	1.4
Per Share Data (Rs)					
EPS adjusted	13.77	29.79	31.52	36.46	42.16
EPS reported	13.77	29.79	31.52	36.46	42.16
BVPS	110.26	146.02	173.98	206.41	244.55
Tangible BVPS	110.26	146.02	173.98	206.41	244.55
Adjusted BVPS diluted	110.26	146.02	173.98	206.41	244.55
DPS	2.51	2.80	3.10	3.50	3.50
Profit & Loss (RsM)					
Net interest income	5,023	5,998	6,691	7,599	8,700
Fees and commissions	657	699	804	925	1,064
Other operating Income	1,561	1,632	1,714	1,989	2,249
Total operating income	7,240	8,329	9,209	10,513	12,013
Total operating expenses	-3,139	-3,646	-4,083	-4,573	-5,122
Oper. profit bef. provisions	4,102	4,683	5,126	5,940	6,891
Bad debt provisions	-1,388	-1,557	-1,080	-1,305	-1,578
Non-operating/exceptionals	-1,553	-319	-350	-300	-300
Pre-tax profit	1,161	2,808	3,696	4,334	5,013
Tax	-260	-556	-998	-1,214	-1,404
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	901	2,252	2,698	3,121	3,609
Adjusted earnings	901	2,252	2,698	3,121	3,609
Growth Rates (%)					
EPS adjusted	-34.1	116.4	5.8	15.7	15.7
Oper. profit bef. prov.	-6.3	14.2	9.5	15.9	16.0
Balance Sheet (RsM)					
Total assets	168,210	206,429	242,204	282,218	328,977
Avg interest earning assets	157,901	185,315	221,352	258,567	301,257
Customer loans	93,282	122,349	150,090	179,188	212,524
Gross NPLs	6,780	5,631	6,628	7,915	9,432
Liab. & shar. funds	168,210	206,429	242,204	282,218	328,977
Total customer deposits	151,929	178,787	210,925	246,794	288,783
Reserve for loan losses	5,056	4,984	5,840	6,873	8,104
Shareholders' equity	7,233	12,500	14,893	17,669	20,934
Profitability/Solvency Ratios (%)					
ROE adjusted	13.1	22.8	19.7	19.2	18.7
Net interest margin	3.2	3.2	3.0	2.9	2.9
Cost/income ratio	43.4	43.8	44.3	43.5	42.6
Cash cost/average assets	2.0	1.9	1.8	1.7	1.7
NPLs/customer loans	7.3	4.6	4.4	4.4	4.4
Reserve for loan losses/NPLs	74.6	88.5	88.1	86.8	85.9
Bad debt prov./avg. cust. loans	1.6	1.4	0.8	0.8	0.8
Loans/deposit ratio	61.4	68.4	71.2	72.6	73.6
Tier 1 capital ratio	6.3	9.7	9.6	9.6	9.7
Total capital ratio	11.2	13.7	13.0	12.5	12.1

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Figure 2. Federal Bank 3Q07 Result highlights (Rupees Million, Percent)

	3Q07	3Q06	YoY %	2Q07	QoQ%	Citigroup Investment Research Comments
Interest Income	4,441	3,625	22.5	4,337	2.4	Growth in interest income with improvement in yield on advances to about 10% in the quarter
Interest Expense	-2,658	-2,130	24.7	-2,662	-0.2	Cost of deposits contained at 5.5% - in line with the previous quarter; has managed to shed wholesale deposits while growing low cost deposits
Net Interest Income	1,784	1,494	19.3	1,675	6.5	Improvement in NII due to strong loan growth in the quarter - well managed growth bodes well for margin protection in the next quarter
Fee-Based Income	480	408	17.6	436	10.0	Fee income growth at a healthy clip for the quarter
Other Non-Interest Income	65	76	-14.8	290	-77.6	
Non Interest Income	545	484	12.5	726	-25.0	
Operating Income	2,328	1,978	17.7	2,401	-3.0	Decline largely due to a significant reduction in trading income over the quarter
Operating Expenses	(973)	(853)	14.1	(1,011)	-3.7	Operating expenses contained in the quarter - despite inclusion of Rs160mn in the quarter for one-time employee related provisions for VRS and pensions
Pre-Provision Profit	1,355	1,126	20.4	1,390	-2.5	
Pre-Provision Profit ex-trading gains	1,290	1,050	22.9	1,100	17.3	Stronger show at the operating level and ex-trading gains
Charges for Bad Debts	(197)	(51)	289.3	(377)	-47.8	
Other Operating Items	1	(148)	NM	(149)	NM	
Pre-Tax Profit	1,159	927	25.0	864	34.1	
Tax	(321)	(211)	52.2	(170)	89.2	
Net Profit	838	716	17.0	695	20.7	Profits 4% below expectations - mostly due to lower trading gains in the quarter
EPS	9.79	10.9	-10.3	8.11	20.7	
Customer Loans	136,202	105,152	29.5	127,143	7.1	Loan growth in line with the industry - strong show in the quarter helping to increase growth rates significantly from around 9% in the last quarter
Customer Deposits	185,658	164,476	12.9	182,883	1.5	Deposit growth continues to lag the industry; excess SLR has reduced to less than 4%; lagging industry deposit rate hikes in the last 3 months; could be difficult to sustain growth momentum in absence of competitive pricing
AIEA	207,389	178,354	16.3	199,030	4.2	
AIBL	194,832	171,452	13.6	192,903	1.0	
Total Assets	211,579	188,305	12.4	208,452	1.5	
Avg Assets	210,015	177,007	18.6	209,505	0.2	
Non-Performing Loans (NPL)	5,283	5,653	-6.6	6,233	-15.2	Continued improvement in asset quality at an absolute as well as relative level
Loan Loss Reserves (LLR)	(4,499)	(4,177)	7.7	(5,137)	-12.4	
Shareholders' Funds	14,451	8,904	62.3	13,889	4.0	
Book Value Per Share	169	136	24.4	162	4.0	
Key Ratios (%)	3Q07	3Q06	Bps Δ YoY	2Q07	Bps Δ QoQ	Citigroup Investment Research Comments
ROAA (annualized)	1.59	1.52	6	1.33	25	
ROAE (annualized)	23.21	32.18	-898	20.00	320	
Net Interest Margin (bps)	344	335	9	337	7	Improvement in margins - a key positive from the quarter; though will be challenging to maintain this in a potentially challenging quarter ahead
Fee Inc/Operating Income	20.6	20.6	-1	18.2	244	
Other Non-Interest Inc/Op Inc	23.4	24.5	-107	30.2	-685	
Op. Cost/ Operating Income	41.8	43.1	-130	42.1	-31	
Loan-to-Deposit Ratio (LDR)	73.4	63.9	943	69.5	384	
NPL/Loan Ratio	3.8	5.2	-142	4.7	-96	
LLR/NPL Ratio	85	74	1,128	82	275	Strong asset quality momentum continues; coverage levels significantly ahead of industry averages

Source: Company Reports and Citigroup Investment Research

Federal Bank

Company description

Federal Bank is an 'old' private-sector bank. It, along with other old private-sector banks, is positioned between the well-valued as well as popular new private-sector banks, and the scaled and profitable but modestly valued government banks. Old private-sector banks exhibit, in some measure, characteristics of private ownership, returns, service levels and relatively aggressive management. But due to their own vintage, old staff and beginnings in a government-controlled sector, they carry some of the operational and structural rigidity of the government banks. The old private-sector banks represent a modest 8% of the sector and account for around 20 of the medium-scale banks. Federal Bank is the second-largest bank in this profitable segment and is among the largest. In the old private-sector banks segment, we expect consolidation will be driven by scale, and geography and capital considerations.

Investment thesis

We rate Federal Bank as Buy/Medium Risk (1M) with a target price of Rs285. Federal Bank has characteristics of a regional bank: it is geographically concentrated in Kerala and is a major beneficiary of the strong non-resident-Indian community from the state. The bank also has high asset yields and a low-cost structure compared with the industry average, and generates margins in line with the industry's. Its asset book and recent operating performance have been encouraging. We estimate a sustainable ROE of more than 18% and healthy FY06-08 pre-provision profit (ex-trading revenues) growth of 18%. We expect earnings to be driven by healthy loan growth (with moderating margins, though) and lower provisioning.

Valuation

We value Federal Bank at 1.5x one-year forward P/BV, on a par with the target multiples for the larger, good quality government banks and at a slight premium to the average multiple for the government banks segment. We believe 1.5x P/BV is warranted given Federal Bank's higher returns, private ownership and attractiveness as an acquisition target. We also benchmark our target price to an EVA-based fair value, which gives us a valuation of Rs225. We have based our target price on P/BV because we believe it better factors in the potential value of the bank's branches and its acquisition prospects.

Risk

Our quantitative risk-rating system, which tracks 260-day historical share-price volatility, rates Federal Bank as Medium Risk. The key specific risks for the stock, along with industry issues, include: a) small size and geographical concentration; b) high dependence on the NRI business, which is exposed to regulatory and competitive risk; c) a bond portfolio that could depreciate if interest rates rise; d) management and ownership control (there was a public boardroom dispute in 2004); e) aggressive acquisitions; and f) a technology platform in transition. If any of these risks has a greater impact than we expect, the stock could have difficulties achieving our target price.

Analyst Certification Appendix A-1

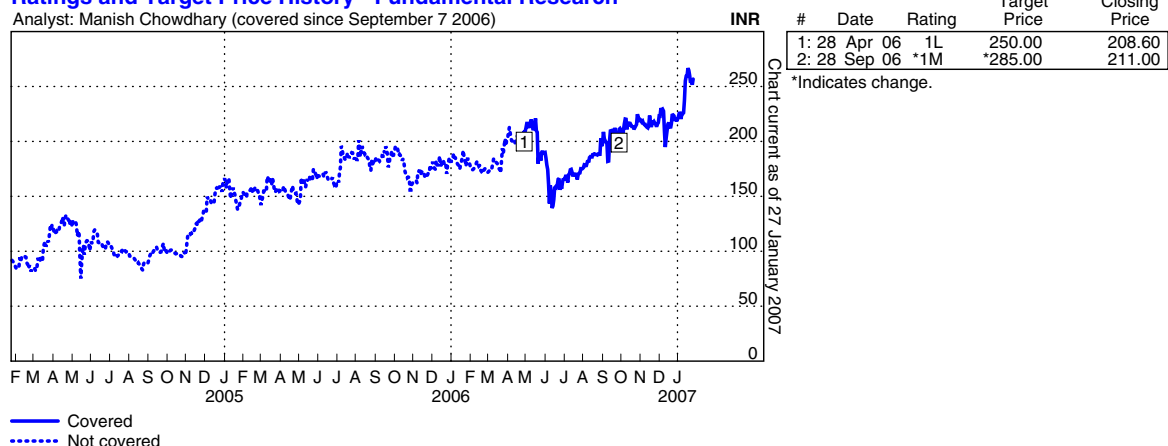
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Ratings and Target Price History - Fundamental Research

Analyst: Manish Chowdhary (covered since September 7 2006)



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