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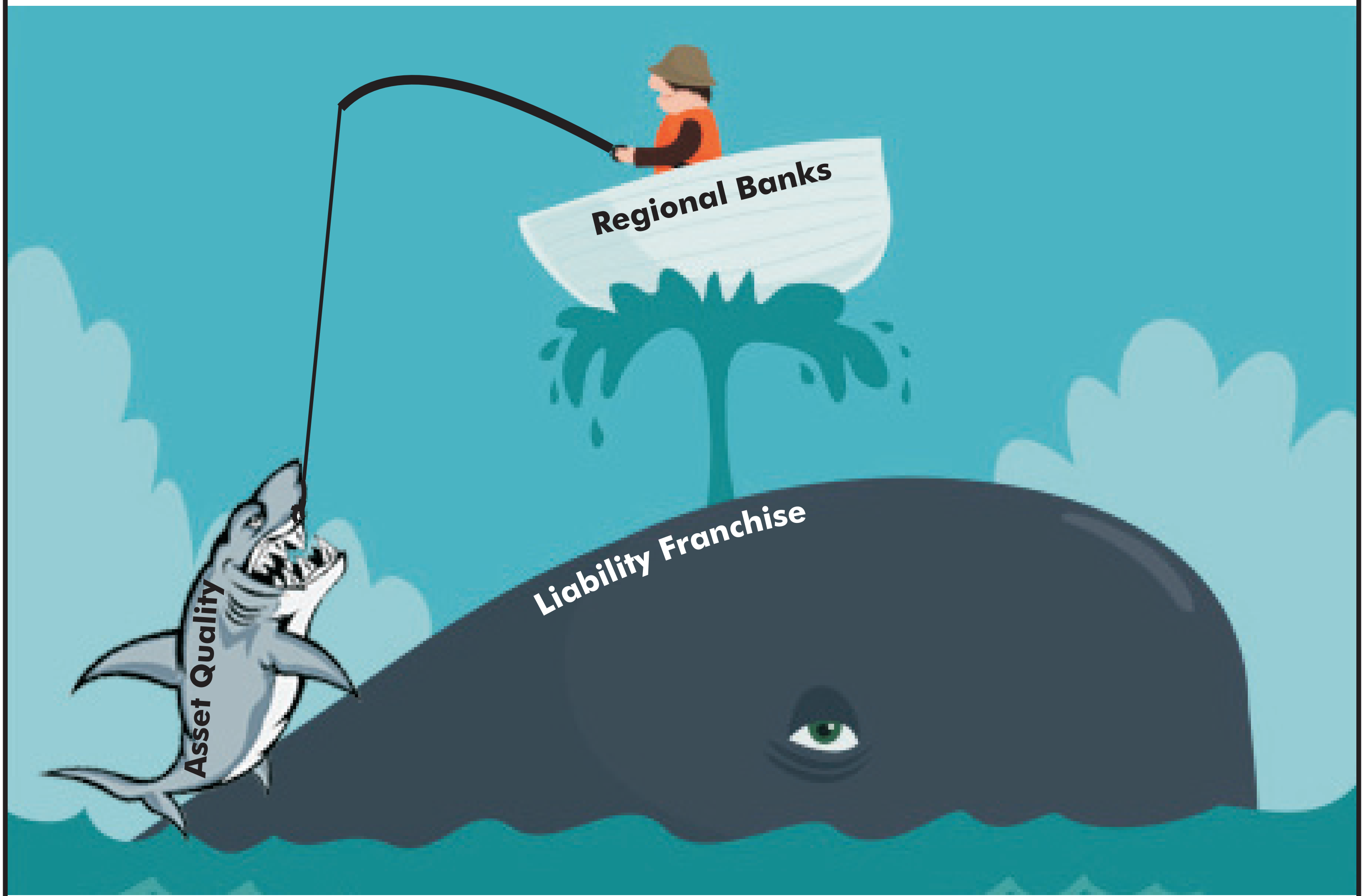

REGIONAL BANKS The search for a pan-India franchise

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Regional Banks

THEMATIC

The search for a pan-India franchise

Regional banks have differentiated themselves from PSU banks on asset quality and now trade at a premium to PSU banking stocks. Their profitability and valuation differential to large private sector banks has, however, persisted, owing to higher cost of funds, low fee income generation and higher cost to income. The improvement on all these three parameters, we find, is related to the quality of the liability franchise, for which geographical diversification is the only lasting solution. The evolution of ING Vysya Bank (IVB) also proves the significance of geographical diversification. Even as Federal Bank (FB), Karur Vysya Bank (KVB) and South Indian Bank (SIB) manage their asset quality risks, their operating performance would remain constrained due to their liability franchise. City Union Bank (CUB), on the other hand, has done better under similar constraints and looks likely to outperform its peers on growth and profitability.

Improving the liability franchise is key: A comparison of large private sector banks and PSU banks with regional banks shows that regional banks have been able to differentiate themselves from PSU banks on asset quality (FY13 credit costs of ~60 bps vs PSU banks' 114bps); however, they continue to lag large private sector banks on the cost of funds (due to lower CASA), fee income generation and operational efficiency. Given that primary banking relationships deliver 2-3x more business than secondary banking relationships in India and given that the liability relationship (rather than the lending relationship) is the determinant of a primary banking relationship, the improvement in the quality of the liability franchise would be a key driver for regional banks to bridge the profitability gap vis-à-vis large private banks.

Geographical diversification proving to be a necessary evil: Geographical diversification is crucial for regional banks if they are to improve their liability franchises. IVB has set a good example in this regard, but the other regional banks remain laggards on this metric and this affects their operational performance. Regional banks' operating profits have recorded 15% CAGR (in FY11-13) vs large private banks' 22%.

Asset quality is a key near-term risk: The asset quality outlook for these banks is rather bleak, with rising delinquencies and higher credit costs looming large. Our scenario analysis shows that IVB and FB are better cushioned on provision coverage and capital ratios.

Recommend BUY on IVB, FB and CUB, SELL on KVB and SIB: We initiate coverage with a BUY stance on IVB (due its proven competitive advantages). We retain our BUY stance on CUB (due to its strong growth and profitability trends) and FB (as structural concerns on operating performance seem discounted). We initiate coverage with a SELL stance on KVB and we change our stance to SELL on SIB due to pressure on their profitability ratios from deterioration in operating performance as well as due to asset quality risks.

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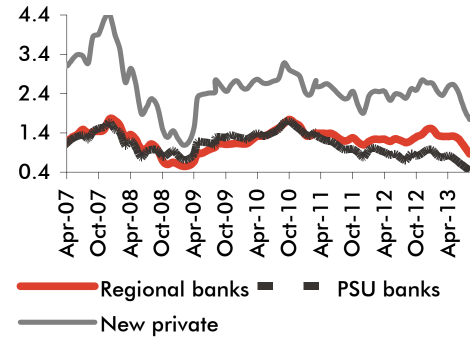
Relative valuation (P/B) for bank groups



Source: Bloomberg, Ambit Capital research

Summary valuation table

Bank	Competitive mapping	Stance	TP (₹)	Upside/ Downside	Mcap (US$ bn)	P/B (FY14E)	P/B (FY15E)	P/E (FY14E)	P/E (FY15E)	RoA (FY14)	RoE (FY14)	EPS CAGR (FY13-15)
ING Vysya Bk		BUY	626	50%	1.1	1.11	1.00	10.3	8.4	1.25%	12.1%	12%
Federal Bk		BUY	312	21%	0.6	0.63	0.57	5.3	4.5	1.08%	12.5%	8%
Karur Vysya Bk		SELL	320	3%	0.5	0.97	0.86	6.1	5.4	1.06%	16.7%	6%
South Indian Bk		SELL	20	3%	0.4	0.79	0.69	5.0	4.3	0.96%	17.0%	10%
City Union Bk		BUY	66	59%	0.3	1.02	0.84	5.3	4.2	1.45%	20.6%	21%

Source: Bloomberg, Ambit Capital; Note: : inferior; : below average; : above average; : superior positioning

Summary of stock-specific investment cases

ING Vysya Bank (VYSB IN, Mkt Cap US$1.1bn, BUY)

ING Vysya Bank differentiates itself from other regional banks based on its: (1) strength of the liability franchise, which supports healthy margins, (2) better asset quality trends and larger buffer in provision coverage and capital ratios, which help it to withstand asset quality shocks, (3) superior fee income generation, and (4) the branch network, which supports a moderation in its cost ratios. We expect the decline in the opex/assets ratio to 2.22% in FY15 from 2.51% in FY13 to drive a RoA improvement to 1.3% in FY15 from 1.2% in FY13. The recent correction in the stock price means that the stock is trading at a 16% discount to its historical average 12-month forward P/B multiple. **We initiate coverage with a BUY stance and a target price of ₹626 (50% upside)**.

Federal Bank (FB IN, Mkt Cap US$0.6bn, BUY)

We have been toning down our expectation on Federal Bank (FB)'s operating performance even, even as there has been a tangible improvement in the bank's asset quality, particularly for retail and SME books. Our analysis of FB's geographical concentration and its impact on FB's liability franchise, fee income generation and cost efficiency show that any improvement from hereon would be gradual, and the process could test the management's and investors' patience. However, in the last three months, the stock has underperformed the Bankex by 11% and current valuation of 0.63x FY14 BV seems to discount these long-term structural concerns. **Our target price of ₹312, valuing FB at 0.75x FY14 BV, implies 21% upside.** The 47% drop in our valuation is driven by a ~25% downward revision in our EPS estimates. The reduction in earnings estimates is driven by lower loan book growth, lower NIM and higher cost-to-income estimates as compared to our earlier estimates. Our downbeat expectations on an improvement in profitability due to structural challenges on liability franchise also lead to a lower valuation multiple.

Karur Vysya Bank (KVB IN, Mkt Cap US$0.5bn, SELL)

Karur Vysya Bank's (KVB) RoAs have declined to 1.3% in FY13 from an average of 1.6% over FY06-11, due to constraints on its liability side, rising cost ratios and increasing credit costs. KVB continues to seek growth amidst a slowing macro-economic environment. We believe unabated pressure on margins, cost ratios and asset quality would lead RoAs to decline further. The stock is trading at inexpensive valuations of 1.0x FY14 BV but near-term positive catalysts are scarce. **We initiate coverage with a SELL stance and a target price of ₹320 (3% upside).**

South Indian Bank (SIB IN, Mkt Cap US$0.4bn, SELL)

South Indian Bank (SIB) has a plateful of challenges, with little diversification outside its home state Kerala, a weak liability franchise, no improvement on fee income generation, slowing asset growth and rising credit costs. The bank has a 57% exposure to corporate loans and a coverage ratio of 29%. Hence, it has very little room for error on asset quality. We expect SIB's financial performance to be volatile and we expect RoAs to fall below 1% in the near term. **We change our stance to SELL with a target price of ₹20 (3% upside) vs ₹29 earlier.** The 31% drop in our valuation is driven by lower loan growth expectation (from above 30% growth earlier to 18-19% loan CAGR) and subdued expectation of any recovery in the bank's profitability in the near term.

City Union Bank (CUB IN, Mkt Cap US$0.3bn, BUY)

City Union Bank (CUB) emerges as one of the most robust regional bank franchises in our analysis. Its strong income generation (NII and fee income to assets of 4.6% vs peer average of 4.2%), controlled cost base and healthy asset quality more than offset the weakness on the liabilities side. Hence, superior RoAs of 1.5-1.6% are the best among regional banks and are closer to the new private sector banks. In the near term, we expect the bank to maintain its margins in the current tight liquidity environment, given that the duration of the loan book is lower than the duration of its borrowings. CUB would deliver net profit CAGR of 20% in FY13-15. The stock is trading at 1.1x FY14 BV, which is an attractive entry point. We retain our BUY stance **with a target price of ₹66 (59% upside).**

Development Credit Bank (DCB IN, Mkt Cap US$0.1bn, NOT RATED)

Following unbridled loan book growth in FY07-08 (48% CAGR), particularly in the unsecured personal loans and CV/CE segments, with sub-par risk management, credit losses shot up in FY09-10. As the bank then shrunk its balance sheet, the bloated cost base led to the bank sliding into the red. A new management team took charge in FY10 and initiated a recovery plan under regular monitoring by the RBI. The new management team has steadied the ship and focused on de-risking the balance sheet, cementing its niche (of western India-based MSME/mortgage lending), strengthening its liability franchise and bolstering risk management. These efforts, along with a controlled cost base, have resulted in the RoA improving from -1.31% in FY10 to 1.03% in FY13. With the ingredients for a scale up in place, operating leverage could kick in and drive RoA expansion. Instances of other similar management-driven turnaround stories in the sector suggest that a rerating should follow as evidence emerges of a sustained improvement in profitability and asset quality.

NOTE: Ambit currently owns 4.43% of DCB's outstanding shares.

Regional banks in India

The Indian banking system comprises 46 domestic banks divided across three banking groups—26 PSU banks (including SBI and its associate banks), 7 new private sector banks and 13 old private sector banks. In addition, 41 foreign banks also have their branches in India.

The new private sector banks came into existence through two rounds of banking licences granted by the RBI in 1993 and 2004. PSU banks and old private sector banks have a long history of operations, extending beyond 6-7 decades. Excluding the State Bank of India (SBI) and its associate banks, 20 PSU banks operated as private sector banks before they were nationalised by the Government of India through two rounds of nationalisation in 1969 and 1980.

The banks that were not nationalised, owing to their small size and highly concentrated geographical presence, continued to operate as old private sector banks.

Historically, PSU banks have catered more to large and mid-corporates, and new private banks have built their business around retail banking. On the other hand, old private sectors have evolved around catering to local SMEs and small industries in their respective geographies.

Old private sector banks have a larger presence in south India, where their market share (based on loans, deposits or branches) at the regional level is roughly double of that at the national level.

Despite their small balance sheet sizes, old private sector banks have been able to survive by focusing on their niche segments and by offering relationship-based banking services to their long-term traditional clientele.

Exhibit 1: Banking groups in India - Market share (FY12)

	Branches	Loans	Gross NPLs	Restructured loans	Key segments of higher relative presence
SBI Group	23.4%	22.4%	33.9%	12.7%	Large and mid-corporate loans
Other PSU banks	59.8%	53.7%	48.5%	80.2%	Large and mid-corporate loans
New private sector banks	9.8%	13.9%	10.2%	3.9%	Retail loans
Old private sector banks	6.6%	5.0%	3.0%	2.9%	SME loans
Foreign banks	0.4%	5.0%	4.4%	0.3%	Non-agricultural diversified lending
Total	**100%**	**100%**	**100%**	**100%**	

Source: Company, Industry, RBI, Ambit Capital research

Comparison of regional banks with the rest of the banking system

We have compared six regional banks, namely ING Vysya Bank (IVB), Federal Bank (FB), Karur Vysya Bank (KVB), South Indian Bank (SIB), City Union Bank (CUB) and Development Credit Bank (DCB) with the seven largest PSU banks (namely, State Bank of India, Punjab National Bank, Bank of Baroda, Canara Bank, Bank of India, Oriental Bank of Commerce and Union Bank of India) and the six largest private sector banks (namely, HDFC Bank, ICICI Bank, Axis Bank, IndusInd Bank, Yes Bank and Kotak Mahindra Bank).

We first take a look at how things currently stand and then, in the next section, we analyse how the trends have evolved over the years. The key points in this section are:

- Regional banks lag their larger peers on the quality of liability franchise, fee income generation and cost efficiency.
- Healthy asset yields and contained asset quality have helped regional banks offset some impact of the above-mentioned weaknesses.
- Regional banks deliver better RoAs than PSU banks. Regional banks' RoAs are lower than large private sector banks, but higher leverage leads to in line RoEs.

Key takeaways from our comparative analysis

Weaker liability base: The weakness of regional banks on the low-cost deposit franchise means that they rely disproportionately more on high-cost term deposits and have structurally higher cost of funds (see the exhibit below).

Exhibit 2: Comparison of regional banks with PSU banks and large private sector banks on liability franchise (FY13)

	PSU banks	Large private banks	Regional banks	Comments
Current accounts deposits to total deposits	7%	16%	9%	Except for IVB and DCB, the current account franchise of regional banks is similar to PSU banks
Savings accounts deposits to total deposits	27%	19%	16%	Except for FB (which benefits from NRI deposits), the savings franchise of regional banks is significantly weaker
CASA ratio	**34%**	**35%**	**24%**	
Term deposits to IBL*	52%	50%	70%	Weaker low-cost franchise means that regional banks rely relatively more on term deposits
Borrowings to IBL	9%	21%	8%	Regional banks and PSU banks lag behind new private sector banks on using borrowings to fund their balance sheet
Cost of deposits	**6.5%**	**6.9%**	**7.5%**	**Weaker low-cost franchise results in structurally higher cost of deposits**

*Source: Company, Ambit Capital research; *IBL = Interest-bearing liabilities*

Higher concentration on SME loans: Regional banks have a relatively higher proportion of SME loans on their books (see Exhibit 3 below). However, due to a higher risk perception for this client set and due to a better-entrenched relationship banking model, regional banks drive healthy risk-adjusted yields on their advances, which are in line with that for new private sector banks (see exhibit 3 on the next page).

Also, the loan growth of these regional banks in recent years has held up better than that for PSU banks, owing to lower exposure to segments, such as large corporate loans, infra loans and project finance loans, which have been affected by the investment-led macro-economic slowdown. Regional banks have relied more on their niche segments (see exhibit 3 on the next page).

Exhibit 3: Comparison of regional banks with PSU banks and large private sector banks on assets mix and income generation (FY13)

	PSU banks	Large private banks	Regional banks	Comments
Asset base				
Loans CAGR (FY08-11)	24.2%	14.8%	20.1%	New private sector banks and regional banks are sustaining loan growth by acquiring market share from PSU banks.
Loans CAGR (FY11-13)	15.9%	19.3%	21.7%	
Loans mix				
Corporate	48%	42%	38%	Compared with PSU banks and large private sector banks, the loan book of regional banks have a higher concentration towards SME loans. Smaller balance sheets mean that regional banks have lower exposure to corporate loans as compared to PSU and large private sector banks.
SME	14%	9%	21%	
Agri	12%	6%	11%	
Retail	14%	35%	19%	
International	11%	8%	0%	
Others	2%	0%	3%	
Yield on advances	**9.81%**	**12.21%**	**12.11%**	**Loans/client mix has supported the yields of regional banks.**
Cost of deposits	**6.48%**	**6.93%**	**7.50%**	
NIM (calculated)	**2.7%**	**3.6%**	**3.0%**	
Non-interest income				
Fee income to assets	0.76%	1.66%	0.98%	Regional banks have a 'middle-of-the-road' fee income franchise.
Non-int. inc. to total inc.	26%	35%	28%	

Source: Company, Ambit Capital research

Lower operational efficiency: The cost base (measured in cost to assets) of regional banks depends upon the branch mix, services offered and geographic focus; however, the cost-to-income ratio for regional banks, in general, is relatively higher. The lower income productivity of the branch network, due to high geographical concentration and/or rapid expansion amidst a weak macro-economic environment, has created near-term challenges for the cost ratios of these banks. However, branch expansion in a strategic and geographically diverse manner is also a key medium-term opportunity for these banks to strengthen their liability franchise.

Exhibit 4: Comparison of regional banks with PSU banks and large private sector banks on cost ratios (FY13)

	PSU banks	Large private banks	Regional banks	Comments
Operating costs				
Cost-to-assets	1.65%	2.28%	1.98%	Regional banks' lower productivity (as compared to large private sector banks) has led to a wider gap on cost-to-income even though their cost-to-assets is lower than large private sector banks.
Cost-to-income	45.3%	44.8%	49.1%	

Source: Company, Ambit Capital research

Better-than-expected asset quality trends: The asset quality performance (NPLs, restructured asset and credit cost trends) of regional banks has been in line or better than the broader banking system (see exhibit 5 on the next page). Factors that have helped these banks in the current downturn are: **(i)** introduction of better risk management systems and de-risking of balance sheets after the previous economic downturn (2007-08), and in some cases, a concurrent change at the senior management level; **(ii)** core focus on traditional niche segment where the product/client understanding is better; and **(iii)** relatively lower exposure to stressed segments, such as infra and project finance.

Exhibit 5: Comparison of regional banks with PSU banks and large private sector banks on asset quality trends (FY13)

	PSU banks	Large private banks	Regional banks	Comments
Asset quality				
Gross NPLs	3.8%	1.8%	2.0%	Regional banks have, so far, delivered better-than-expected asset quality under current business conditions, owing to a better understanding of their clients and lower exposure to large corporates. Low credit costs in the current business environment have been the key support to regional banks' better profitability than PSU banks.
Net NPLs	2.0%	0.4%	0.6%	
Provision coverage ratio	48%	76%	71%	
Restructured to total loans	~3-10%	~0.2-2.2%	~1-5%	
Credit costs	**1.14%**	**0.62%**	**0.53%**	

Source: Company, Ambit Capital research

Better profitability: Despite the weakness on the liability franchise and operating efficiency, the strength on asset yields and contained asset quality trends have helped regional banks deliver decent RoAs of ~1.2-1.3% as compared to ~0.9% for PSU banks. Although regional banks' average RoAs are lower than large private sector banks' average RoAs of 1.7%, better use of capital has allowed regional banks to maintain higher financial leverage. As a result, regional banks' average RoEs are in line with that of large private sector banks.

Exhibit 6: Comparison of regional banks with PSU banks and large private sector banks on leverage and profitability (FY13)

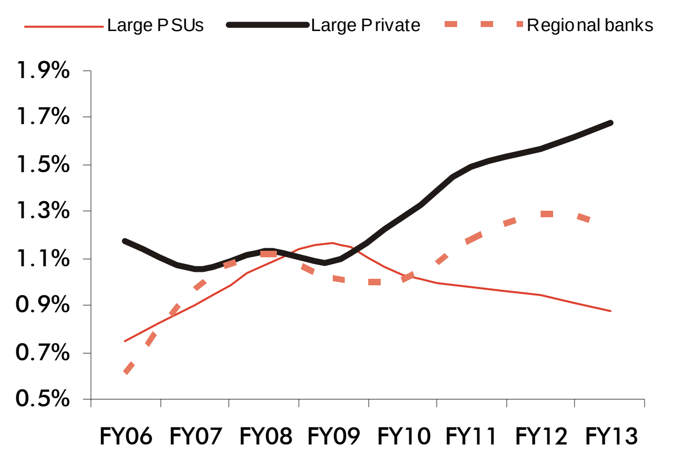
	PSU banks	Large private banks	Regional banks	Comments
Capital adequacy				
RWA/assets	63%	77%	60%	After a spate of capital raises, capital adequacy of regional banks is comfortable. Further, due to the smaller size of the non-fund based business and the larger size of the gold loan book (in some cases), regional banks have been able to lever more for similar tier-1 ratios. Their average risk weight on assets is lower than other bank groups.
Tier-1 ratio	9.5%	12.2%	12.4%	
CRAR	12.7%	17.6%	13.9%	
Profitability				
RoA - FY13	**0.88%**	**1.68%**	**1.25%**	Regional banks have delivered RoAs better than PSU banks but below that of the large private sector banks. But, with better use of capital, they deliver RoEs that are in line with those of large private sector banks.
Leverage - FY13 (x)	17.0	9.8	13.1	
RoE - FY13	**14.9%**	**16.5%**	**16.4%**	

Source: Company, Ambit Capital research

Have regional banks closed the profitability and valuation gap?

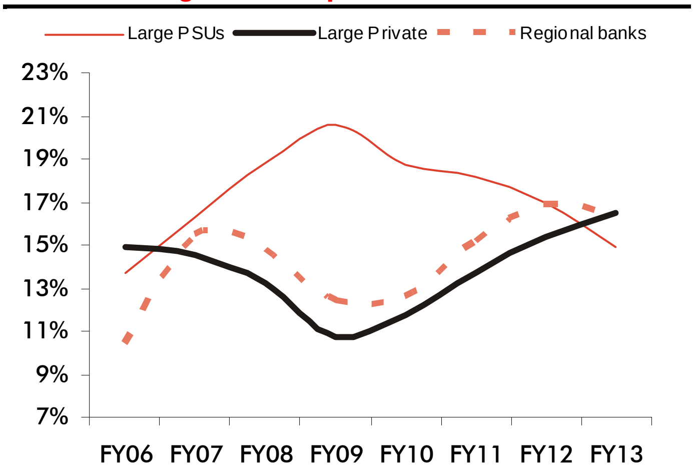
A historical comparison of profitability among PSU banks, large private banks and regional banks (see Exhibit 7 below) shows that regional banks resembled PSU banks on RoA trends until FY10. However, regional banks have shown better RoAs vs PSU banks in FY10-13. Compared with large private sector banks, regional banks have not been able to close the gap on RoAs, as private sector banks improved their RoAs at a much faster rate than regional banks. However, regional banks have maintained comparable RoEs with large private sector banks, owing to higher balance sheet leverage (vs private sector banks).

Exhibit 7: Comparison of RoA trends between regional banks and large PSU and private sector banks



Source: Company, Ambit Capital research

Exhibit 8: Comparison of RoE trends between regional banks and large PSU and private sector banks



Source: Company, Ambit Capital research

Stable long-term NII trend in regional banks

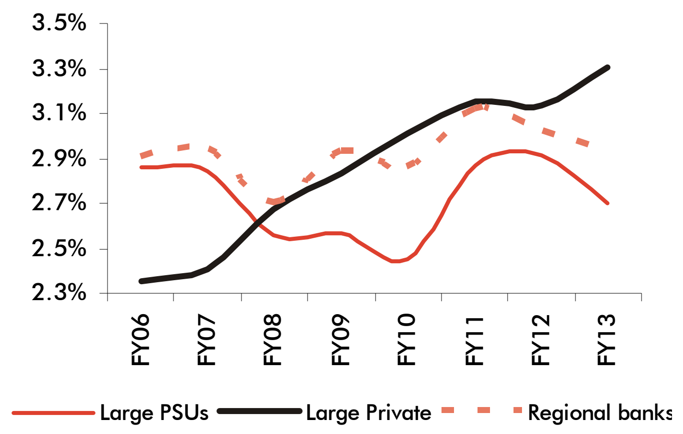
We look further to analyse the components of the profitability trends for these banking groups. Exhibit 9 on the next page shows that regional banks have historically delivered healthy NII to assets, in line with large private sector banks. Despite the limitations on the liability franchise, regional banks have delivered healthy NIMs thanks to high yields (supported by SME lending).

The overall decline in regional banks' NIMs in FY13 was driven entirely by Federal Bank. The NIMs declined due to de-risking of its balance sheet (in favour of higher-rated but lower-yielding corporate loans) and rise in interest rate on non-resident deposits after the interest rate deregulation. The overall decline in regional banks' NIMs also led to some widening in the RoA gap between regional banks and large private sector banks in FY13 (see Exhibit 7 above).

Fee income franchise remains weak

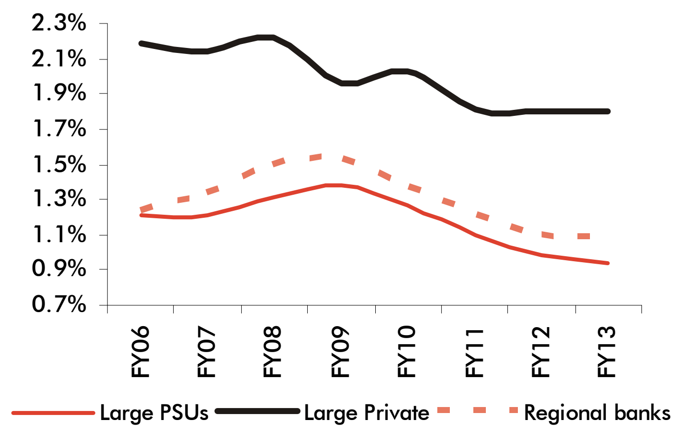
The non-interest income franchise of regional banks mirrors that of the PSU banks and lags significantly behind that of the large private sector banks. We discuss the factors behind this trend later on pages 13-15.

Exhibit 9: The trend in 'NII to assets' for regional banks as compared to large PSU banks and large private sector banks



Source: Company, Ambit Capital research

Exhibit 10: The trend in 'non-interest income to assets' for regional banks as compared to large PSU and private sector banks

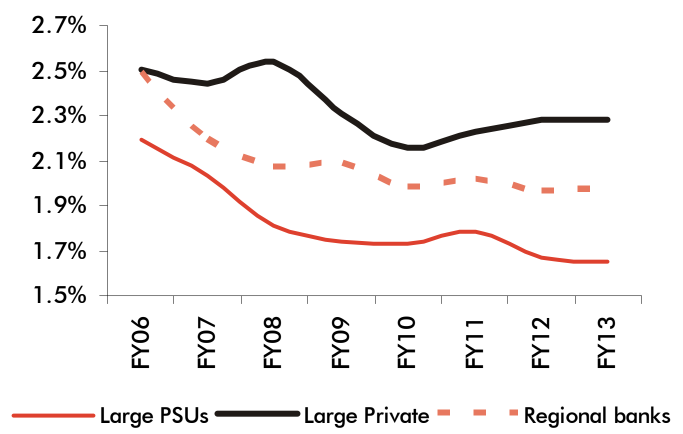


Source: Company, Ambit Capital research

Lower cost to assets but low productivity leads to higher cost-to-income ratio at regional banks

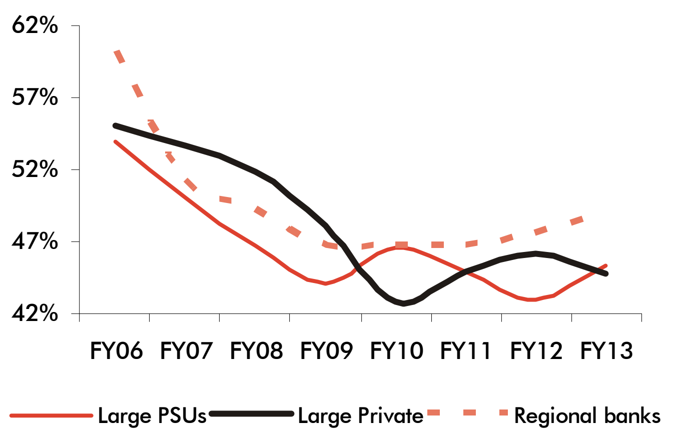
The regional banks have a lower cost-to-assets ratio than private sector banks. Despite this, regional banks have a higher cost-to-income ratio than private sector banks. This dichotomy can be explained by the fact that large private banks generate higher fee income than regional banks, owing to their higher investments in their branch network and employees. Hence, despite a lower cost-to-assets ratio, a lower income generation from assets (driven mostly by lower non-interest income) means that regional banks have higher cost-to-income ratios than large private sector banks.

Exhibit 11: The trend in 'cost to assets' for regional banks compared with large PSU banks and private sector banks



Source: Company, Ambit Capital research

Exhibit 12: The trend in 'cost to income' for regional banks compared with large PSU banks and private sector banks

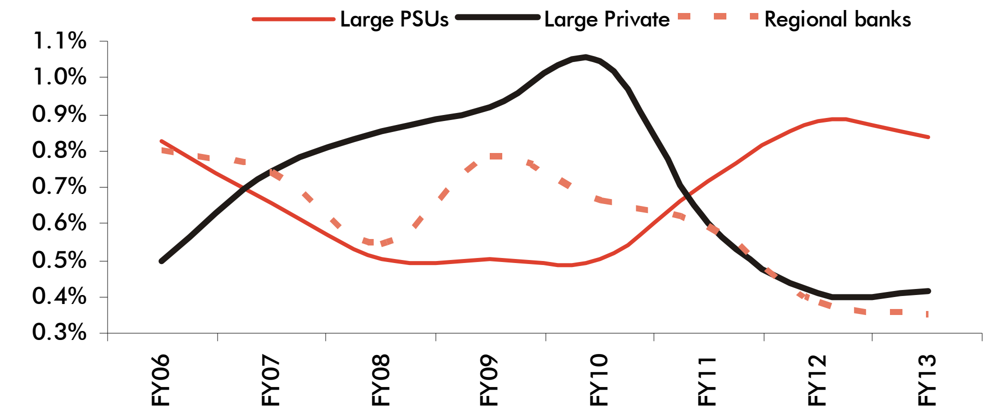


Source: Company, Ambit Capital research

Regional banks have performed well on asset quality

Regional banks have performed well on asset quality in the current downcycle after a sharp rise in credit costs during the post-Lehman crisis period. However, in the current slowdown, credit costs have remained low and are in line with new private sector banks. The regional banks have been conservative in their risk management by focusing on their core competencies in SME lending and by minimising risk from unsecured personal loans or large corporate loans.

Exhibit 13: Regional banks have kept their credit costs in check



Source: Company, Ambit Capital research

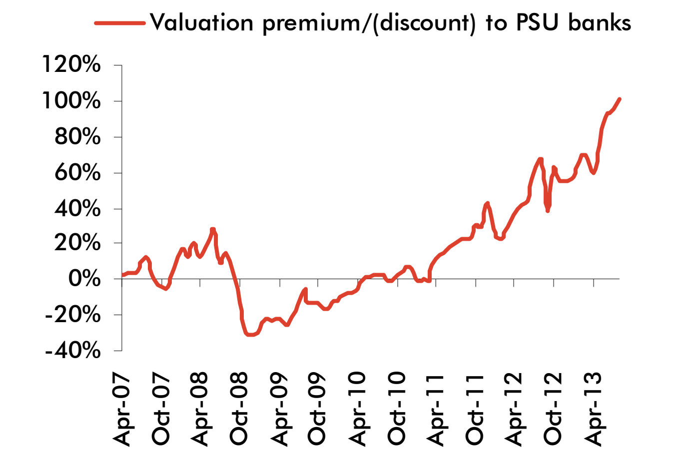
Valuations of regional banks highlights the profitability gap

Overall, regional banks' superior performance on asset quality has helped them differentiate themselves from PSU banks and deliver better RoAs in the last two years. However, regional banks continue to lag large private sector banks on RoAs due to:

- Constraints on the liability side (lower CASA and higher cost of deposits), which mean that regional banks' higher yield on assets does not lead to superior NIM;
- Weakness on fee income generation; and
- Higher cost to income.

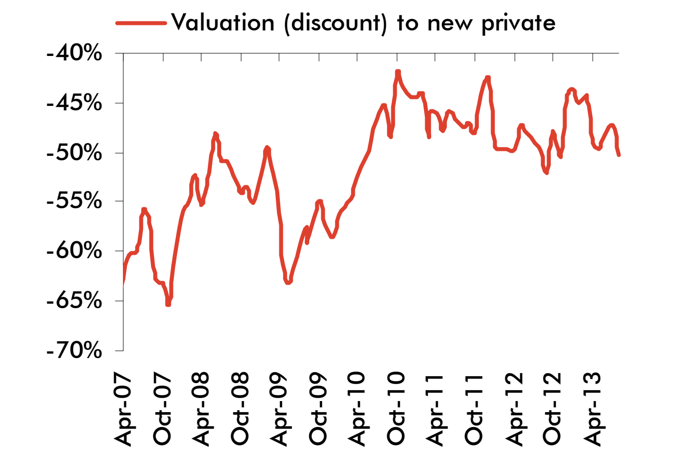
The valuation of regional banks also reflects this trend, as regional banks have closed the valuation discount to PSU banks and they are now trading at a premium to PSU banks (see Exhibit 14 below). Regional banks' valuation discount to large private sector banks has narrowed but the discount continues to persist due to the RoA gap.

Exhibit 14: Regional banks' one-year forward P/B valuation premium/(discount) to PSU banks



Source: Company, Ambit Capital research

Exhibit 15: Regional banks' one-year forward P/B valuation premium/(discount) to large private banks



Source: Company, Ambit Capital research

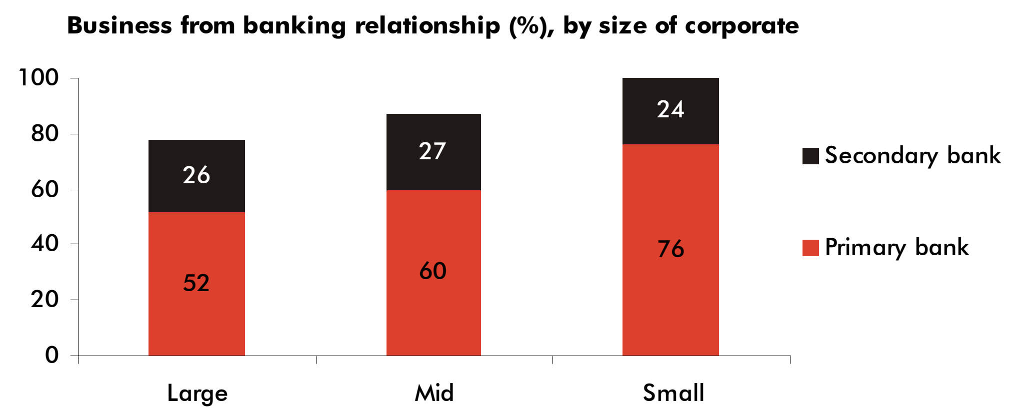
A strong liability franchise is the answer to regional banks' maladies

Regional banks have improved their performance in the current downturn by better control of their asset quality. But what more can these banks do to close the gap with large private sector banks? As discussed in the previous section, regional banks fall behind private sector banks on three parameters—cost of funds, fee income generation, and cost to income. We believe performance on these three factors is inter-related and linked to the quality of a bank's liability franchise.

A bank's cost to deposits has a direct relationship with the quality of the liability franchise (share of low-cost deposits); however, the relationship between fee income and cost efficiency is slightly indirect.

A report released by BCG (Boston Consulting Group) in association with FICCI (Federation of Indian Chambers of Commerce and Industry) and IBA (Indian Bank's Association) in August 2013 titled, 'Consistency, Quality and Resilience: The Next Frontier for Productivity Excellence' (http://goo.gl/npXdis) highlights that a corporate's primary bank in India (a bank with the maximum share of a corporate's banking business) receives 2-3x more business than the secondary bank (which has the second-highest share of business). For smaller corporates, the ratio is even higher at close to 3x (see Exhibit 16 below).

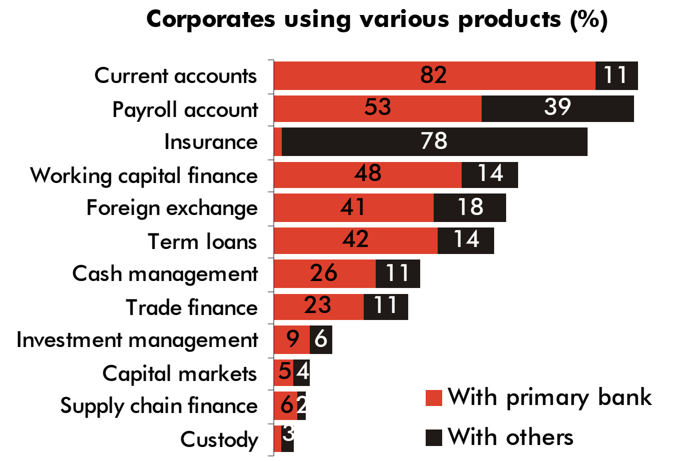
Exhibit 16: The primary banks receive 2-3x more business share than the secondary banks



Source: BCG, FICCI, IBA

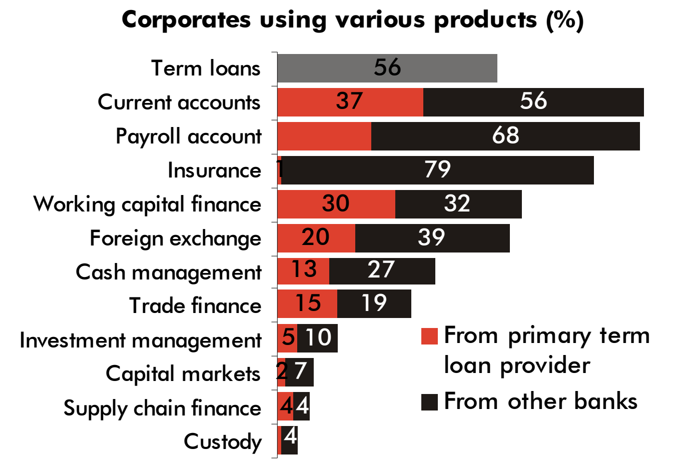
Further, the report also highlights that it is the 'current accounts' relationship (vs lending relationship) that determines whether a bank is a primary bank for the corporate. The report highlights that almost 90% of corporates keep current accounts with a bank that is considered as an overall primary bank. Only 48% of Indian corporates surveyed in the research showed a working capital finance relationship with their primary lenders.

Exhibit 17: Current accounts determines primary banking relationships



Source: BCG, FICCI, IBA

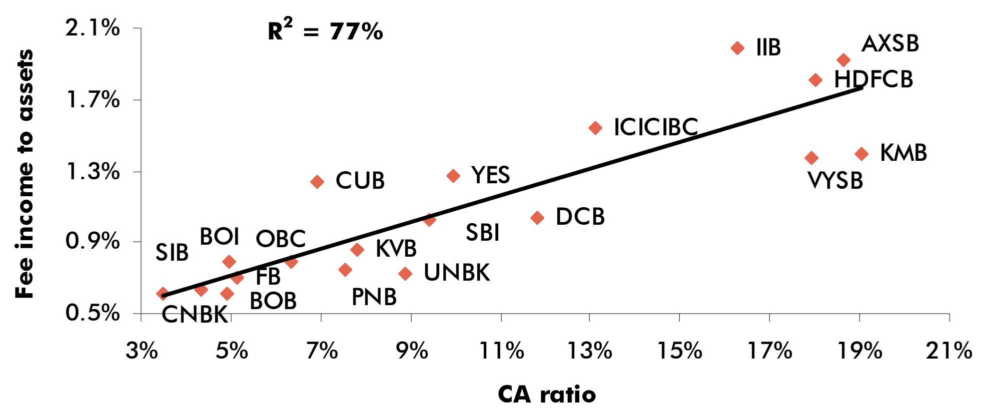
Exhibit 18: Lending is not enough to be considered as a primary bank



Source: BCG, FICCI, IBA

Thus, a better quality liability franchise, of which current account mobilisation is a key element, drives not only the cost of funds lower but also maximises income generation from cross-selling services, such as payroll, forex, cash management and trade finance (see Exhibit 17 above). Exhibit 19 on the next page shows a strong correlation between Indian banks' CA ratio and fee income generation. Better income generation on investments then leads to lower cost to income, as seen in the differential of the cost efficiency performance of large private sector banks vis-à-vis regional banks (see Exhibits 11 and 12 on page 11).

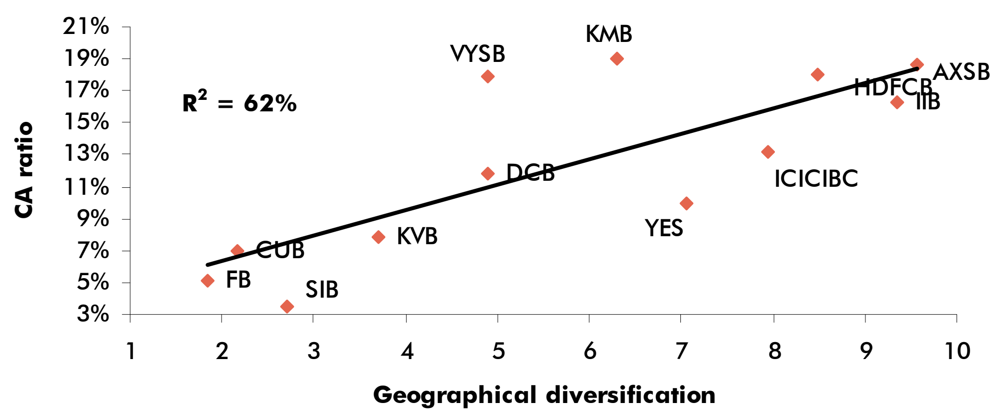
Exhibit 19: The correlation between Indian banks'* CA ratio (current account deposits to total deposits) and fee income to assets (both as at end-FY13)



*Source: Company, Ambit Capital research. Note: *The banks used for analysis are the seven largest PSU banks, the six largest private sector banks and the six regional banks*

To improve the quality of the liability franchise, we believe geographical diversification is the key. In the context of the discussion above (about the significance of being a primary bank for maximising revenue share of corporate borrowers), we believe expansion concentrated in a specific geography alone limits the number of potential corporate borrowers that a bank can target. Thus, the degree of geographical diversification and CA ratio between all private sector banks (regardless of whether they are large or regional) have a significant correlation (see exhibit 20 below). As we will discuss in the following section, geographical diversification is also a necessity for small regional banks to graduate into a mid- to large-sized bank.

Exhibit 20: The correlation between Indian private sector banks' geographical diversification and CA ratio**



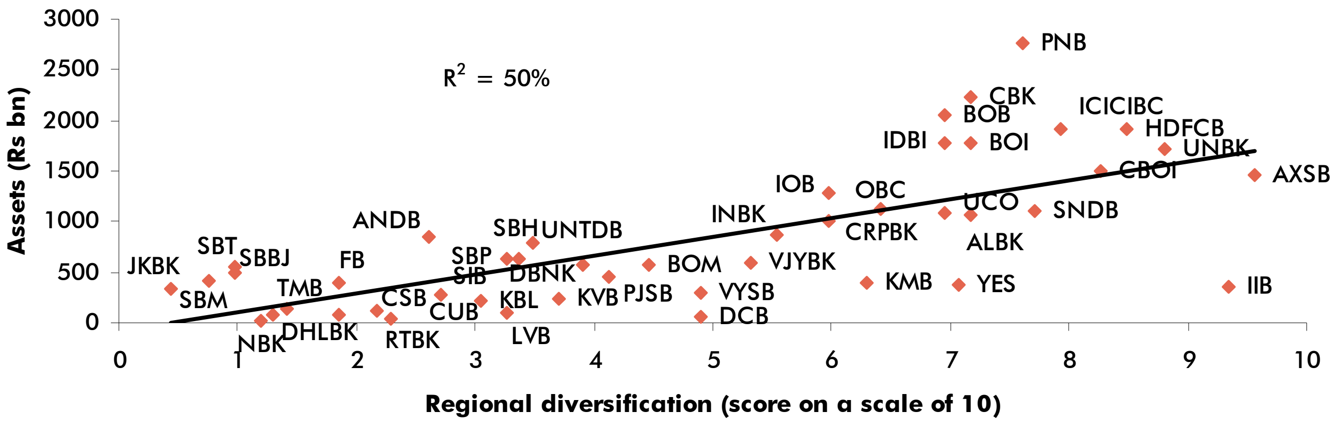
*Source: Company, RBI, Ambit Capital research. Note: ** Please see the next section and appendix for our definition and calculation of banks' geographical diversification scores*

How crucial is regional diversification?

Given that the regional banks almost by definition have a regional concentration, will these banks need to diversify for their next leg of growth?

An analysis of the size and regional diversification score of all Indian domestic banks shows a broad positive relationship between a bank's size and its regional diversification (see Exhibit 21 below). Note that we have scored banks on regional diversification by using their geographical branch distribution as at end-FY12 (see Appendix). The analysis excludes State Bank of India (SBI), which is an outlier due to its enormous size. Due to unavailability of more recent data, we have used banks' branch network distribution and asset size as at end-FY12.

Exhibit 21: Correlation of banks' asset size and their regional diversification (FY12)



Source: Company, RBI, Ambit Capital research; Note: See Exhibit 1 in the Appendix for the banks' names and their tickers.

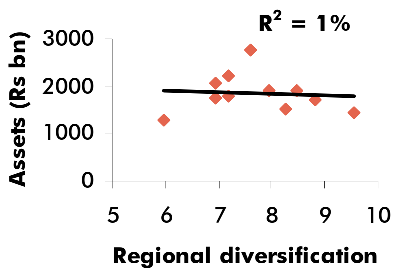
Further, we have classified all the banks into three groups (namely, large-sized banks, mid-sized banks and regional banks), and then carried out a similar analysis between the size and regional diversification score in each group. Our analysis shows an almost non-existent relationship (between size and diversification) among large-sized banks and regional banks. However, the mid-sized banks show a significant relationship (R squared = 65%).

The large-sized bank group used in our analysis consists of the 11 largest Indian banks by asset size (excluding State Bank of India, which is an outlier in the analysis due to its size), including three large private sector banks (whilst the rest are PSU banks). The mid-sized bank group consists of 17 banks, all of which are PSU banks. The regional banks group consists of 14 old private sector banks.

Despite the limitations of the sample size and our methodology, we believe the most probable explanations for the correlation trends visible in Exhibits 22-24 are that: (1) an inflection point exists, beyond which regional diversification begins to support a bank's size, and (2) up to a limit, diversification contributes to the size of the bank (beyond which it is not a main contributor).

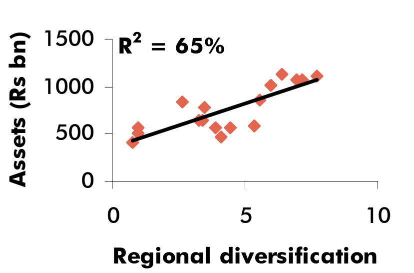
Hence, we believe that regional diversification is necessary for a regional bank to graduate to a mid-sized bank.

Exhibit 22: The large-sized banks (FY12)



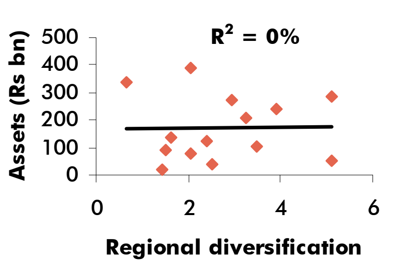
Source: Company, RBI, Ambit Capital research; Note: The banks in this chart are PNB, CBK, BOB, ICICIBC, HDFCB, BOI, IDBI, UNBK, CBOI, AXSB and IOB. See Exhibit 1 in the Appendix for the full form of the banks' names.

Exhibit 23: The mid-sized banks (FY12)



Source: Company, RBI, Ambit Capital research; Note; The banks in this chart are OBC, SNDB, UCO, ALBK, CRPBK, INBK, ANDB, SBH, SBP, UNTDB, VJYBK, DBNK, BOM, SBT, SBBJ, PJSB and SBM. See Exhibit 1 in the Appendix for the full form of the banks' names.

Exhibit 24: The regional banks (FY12)

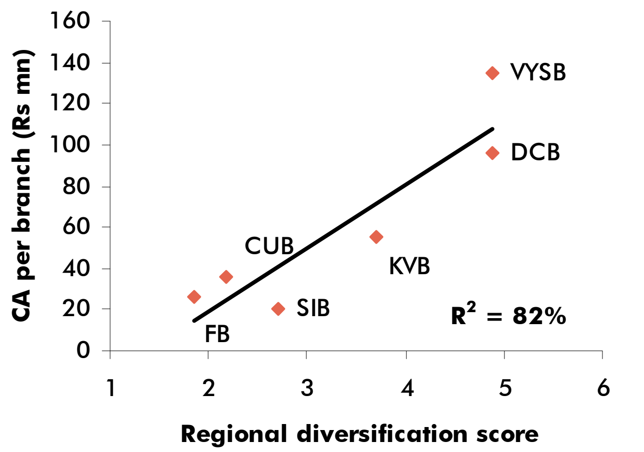


Source: Company, RBI, Ambit Capital research; Note: The banks in this chart are FB, JKBK, VYSB, SIB, KVB, KBL, TMB, CUB, LVB, DHLBK, CSB, DCB, RTBK and NBK. See Exhibit 1 in the Appendix for the full form of the banks' names.

Furthermore, regional diversification is crucial to strengthen a regional banks' liability base, owing to a direct relationship between regional banks' geographic diversification and per branch deposit mobilisation (see Exhibits 25 and 26 below).

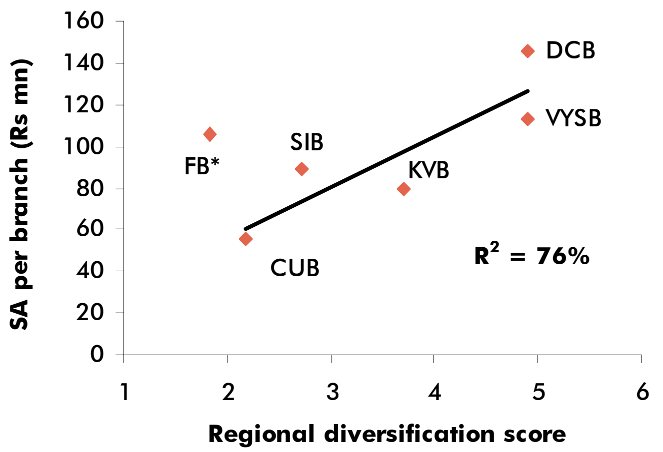
For regional banks, a high geographical concentration in the branch network in a particular area tends to cap the assets and deposit mobilisation per branch, which lowers the productivity of the bank. A geographically concentrated presence also makes it difficult for banks to target large corporate salary accounts and government businesses, which otherwise contribute significantly towards the liability franchise of large private sector banks and large PSU banks.

Exhibit 25: Savings account balances per branch (FY13)



Source: Company, RBI, Ambit Capital research. Note: Please refer to the Appendix to see our methodology on arriving at the regional diversification score

Exhibit 26: Current account balances per branch (FY13)



Source: Company, RBI, Ambit Capital research. Note: Federal Bank excluded from regression analysis, as it disproportionately benefits from Kerala's NRI clientele.

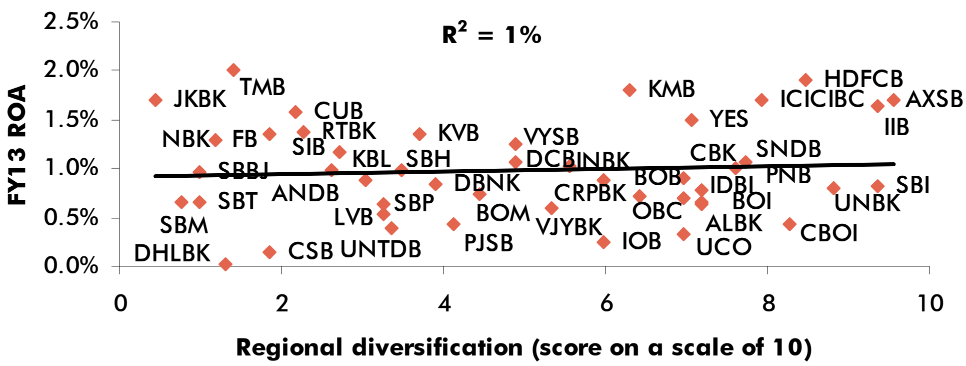
However diversification alone does not automatically lead to profitability

However, the pursuit of regional diversification outside home state(s) comes with significant execution risk, owing to challenges on the required management bandwidth, support of the promoter/parent, the need for adequate capital, sensible expansion strategies and the need for investments in building a brand. Hence, banks need to weigh their current profitability in their home states against future growth opportunities.

Hence, we believe the rationale for pursuing regional diversification should be judged on a case-to-case basis, taking into account the preparedness of the bank and the competitive landscape in the home state(s). For example, and as discussed later in this report, Kerala-based banks have been more keen to expand outside the state than Tamil-Nadu-based regional banks due to the difference in competitive intensity and opportunities in the respective states.

Here, note that Indian domestic banks' regional diversification and profitability do not have a direct relationship (see Exhibit 27 below). Thus, geographical diversification does lead to better CASA, greater assets, higher branch productivity and more cross-selling opportunities, but other significant factors of profitability are not directly related to regional diversification. One such example is asset quality, which does not improve with geographical diversification. Hence, overall, just becoming geographically diversified does NOT ensure high RoAs. In fact some regional banks, such as City Union Bank, run highly profitable franchise with little regional diversification.

Exhibit 27: Correlation of banks' RoAs and their regional diversification



Source: Company, RBI, Ambit Capital research; Note: See Exhibit 1 in the Appendix for the banks' names and their tickers.

How to differentiate among regional banks?

We have compared six regional banks (IVB, FB, KVB, SIB, CUB and DCB) based on their liability base, assets base, components of profitability and asset quality trends (see the exhibit on the next page). The objective is to identify the key strengths and weaknesses of individual banks and to develop a framework to assess the overall attractiveness of these franchises from a long-term perspective.

The comparison among regional banks shows three key long-term structural challenges that regional banks face:

1. **Liability challenges** – building a low-cost retail deposit base;
2. **Asset challenges** – meeting the challenges on SME banking and diversifying into retail; and
3. **Operating cost** – investment and payoff dynamics.

The progress of individual regional banks on these parameters differentiates one regional bank from the other.

However, in the near term, the asset quality performance and net interest margin performance are likely to be key movers of the stock prices of these banks, owing to the weak economic environment and developments on liquidity from the RBI's actions.

Exhibit 28: Comparative analysis of six regional banks (based on FY13/1QFY14 financials, as applicable)

Latest, as available for FY13 or 1QFY14	National leader	IVB	FB	KVB	SIB	CUB	DCB
Market Cap (₹ bn/US$ bn)	**HDFCB (1,343/20)**	**78/1.1**	**44/0.6**	**33/0.5**	**26/0.4**	**22/0.3**	**10/0.1**
Strength of the liability franchise		**High**	**Medium**	**Low**	**Low**	**Low**	**High**
Branches	SBI (14,816)	542	1,103	553	753	375	101
Home states		KN, AP	KRL, KN	TN, AP	KRL, TN	TN, AP	MH, GJ
Share of home states in total branches		55%	60%	72%	72%	77%	57%
Deposits per branch (₹mn)	YES (1,557)	*763*	*522*	*699*	*579*	*541*	*824*
CA (Current accounts) to total deposits	KMB (19.0%)	17.7%	4.8%	11.4%	3.8%	6.6%	10.8%
SA (Savings accounts) to total deposits	SBI (35.4%)	14.8%	22.1%	7.9%	16.7%	10.2%	16.4%
CASA to total deposits	**HDFCB (47.9%)**	**32.5%**	**26.9%**	**19.3%**	**20.5%**	**16.8%**	**27.2%**
Cost of deposits	HDFCB/SBI (6.0%)*	6.7%	7.2%	8.0%	7.6%	8.2%	7.3%
Strength on the asset side		**High**	**Medium**	**Medium**	**Low**	**Medium**	**Medium**
FY08-11 loan book CAGR	YES (54%)	17.2%	19.1%	23.7%	25.1%	26.8%	1.6%
FY11-13 loan book CAGR	IIB (30%)	16.0%	17.5%	28.6%	24.6%	28.3%	24.2%
Loan mix at FY13 end:							
Corporate	IDBI (75%)	38%	42%	38%	58%	21%	21%
SME	CUB (44%)	33%	17%	32%	14%	44%	22%
Agri	KMB (17%)	9%	11%	18%	7%	16%	12%
Retail	IIB (51%)	19%	29%	12%	21%	19%	45%
Performance on margins		**High**	**Medium**	**Medium**	**Low**	**High**	**Medium**
Yield on assets	IIB (14.1%)	10.0%	9.7%	10.7%	10.1%	10.7%	9.6%
Cost of funds	SBI (5.9%)*	7.5%	7.2%	8.2%	7.6%	7.7%	7.3%
Net Interest Spreads	HDFCB (3.7%)	2.48%	2.43%	2.41%	2.45%	3.05%	2.32%
NIM – reported	**KMB (4.6%)**	**3.52%**	**3.37%**	**3.03%**	**3.21%**	**3.35%**	**3.34%**
Fee/avg assets	**IIB (2.0%)**	**1.37%**	**0.70%**	**0.86%**	**0.62%**	**1.29%**	**1.04%**
Net revenues as a % avg assets	**HDFCB (6.4%)**	**4.89%**	**4.07%**	**3.89%**	**3.83%**	**3.64%**	**4.38%**
Operational efficiency		**Low**	**Medium**	**Medium**	**Medium**	**High**	**Low**
Cost to assets	CBK (1.3%)	2.51%	1.79%	1.81%	1.71%	1.81%	2.77%
Cost to income	YES (38.4%)	56.2%	44.7%	47.3%	47.5%	41.7%	68.6%
Ability to manage asset quality		**High**	**Low**	**Medium**	**Low**	**Medium**	**Medium**
Gross NPAs (%)	YES (0.2%)	1.75%	3.50%	0.96%	1.57%	1.06%	3.41%
Net NPAs (%)	YES (0.01%)	0.19%	0.91%	0.37%	1.12%	0.45%	0.84%
Provisioning coverage	YES (93%)	89%	75%	62%	29%	58%	76%
Restructured loans to total loans	HDFCB (0.2%)	1.2%	4.6%	3.7%	5.2%	1.7%	0.5%
Loan loss provision	VYSB (0.29%)	0.29%	0.58%	0.53%	0.56%	0.81%	0.34%
Tax rate		32%	30%	24%	22%	18%	0%
ROA (FY13)	**HDFCB (1.8%)**	**1.21%**	**1.27%**	**1.30%**	**1.12%**	**1.56%**	**1.03%**
Leverage		12.1	10.9	14.6	18.4	14.3	11.3
ROE (FY13)	**YES (24.8%)**	**14.6%**	**13.9%**	**19.0%**	**20.5%**	**22.3%**	**11.7%**
Capital Adequacy		**High**	**High**	**High**	**Medium**	**High**	**High**
Tier - 1 capital ratio (Basel II)	KMB (14.9%)	13.5%	14.1%	13.1%	11.9%	13.3%	13.1%

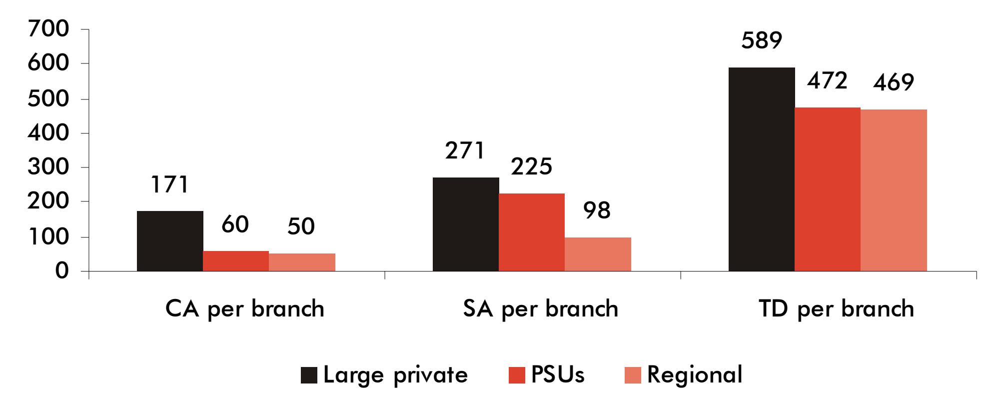
Source: Company, Ambit Capital research; Note: KN=Karnataka, AP=Andhra Pradesh, KRL=Kerala, TN=Tamil Nadu, MH=Maharashtra, GJ=Gujarat, GO=Goa; SBI=State Bank of India, KMB=Kotak Mahindra Bank, YES=Yes Bank, IIB=IndusInd Bank, CBK=Canara Bank * We have not mentioned Bank of Baroda, as its cost of funds is optically low due to its large share of foreign deposits.

1. Liability challenge

Regional diversification of the branch network is the key

As discussed earlier as well, regional banks lag their larger peers on the share of low-cost deposits in total deposits and, thus, they rely more on high-cost term deposits and bulk deposits. This limitation on the regional banks' liabilities franchise emanates from the high geographical concentration of the branch network, which caps branch productivity (see Exhibit 29 below). The higher geographical diversification allows banks to expand their universe of target borrowers with whom they can form primary relationships, which is crucial to maximise banks' productivity, including branch deposits productivity (see discussion on pages 13-15). The discussion on pages 16-17 shows that geographic diversification supports the growth of the bank in size and graduation to a mid-sized bank. The larger size allows banks to better tap large corporate salary accounts and government businesses, which form a significant share of large private sector banks' low-cost deposits.

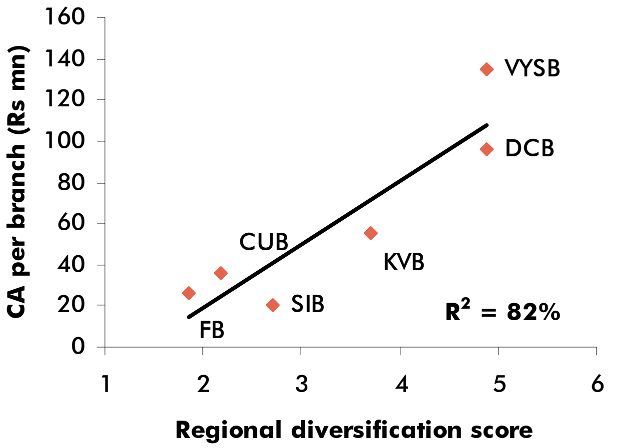
Exhibit 29: Deposit mobilisation per branch for bank groups (₹ mn, FY13)



Source: Company, Ambit Capital research; Note: CA=Current Accounts, SA=Savings Account, TD=Term Deposits

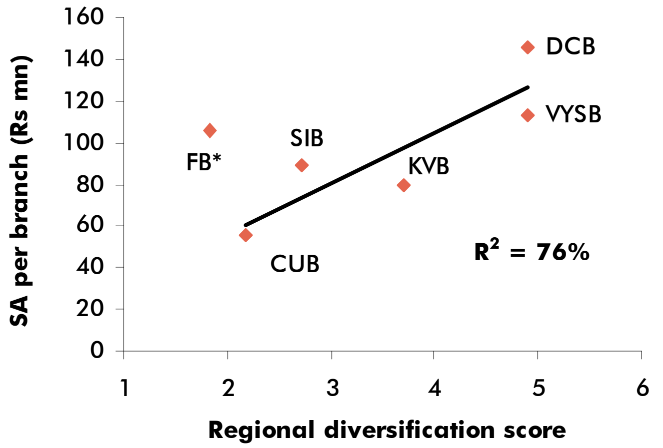
As shown in Exhibits 30 and 31 below, regional diversification and per branch deposit mobilisation for regional banks have a direct relationship. Hence, regional banks' successful foray outside their home states is imperative for a strong liability franchise. ING Vysya Bank and Development Credit Bank currently fare the best on this metric. The other four banks (KB, KVB, SIB and CUB) continue to be concentrated in their home states. FB has made relatively more progress than the other three banks, (in FY13, it opened 27% of its branches in Tamil Nadu, which currently accounts for 11% of its total branches) but Kerala continues to dominate with a 52.3% share in branches (vs 55.3% in FY12).

Exhibit 30: Savings account balances per branch (FY12)



Source: Company, RBI, Ambit Capital research; Note: Refer to the Appendix to see our methodology to arrive at the regional diversification score

Exhibit 31: Current account balances per branch (FY12)



Source: Company, RBI, Ambit Capital research. Note: Federal Bank excluded from regression analysis, as it disproportionately benefits from Kerala's NRI clientele.

2. Asset base – the mix and income generation

As at end-FY13, corporate loans (along with international loans) formed 50-60% of PSU banks' as well as large private sector banks' loan books. Owing to a regional focus and smaller balance sheets, regional banks' loan books instead have a larger share of SME loans (see Exhibit 32 below). This also ties up well with the entrenched positions of regional banks in local markets where they can offer an effective relationship-banking model to compete with the transaction banking model of large banks.

For SME borrowers, which are relatively 'informationally opaque', a relationship-banking model allows regional banks to accumulate information over the long term beyond the data available in the financial statements. Large banks' transactional-banking model relies on financial information that is readily available mainly at the time of origination. In SME lending, regional banks also have an edge over larger banks which find it difficult to transmit 'soft' information through the communication channels of large organisations.

Exhibit 32: Loan book mix of bank groups (based on FY13 financials)

	Corp	SME	Agri	Retail	International	Other	Yield on assets
Large PSUs	43%	15%	11%	14%	15%	2%	**8.7%**
Mid-sized PSUs	57%	12%	13%	13%	4%	1%	**NA**
Large private	42%	9%	6%	35%	8%	0%	**10.0%**
Regional banks	38%	21%	11%	19%	0%	3%	**10.1%**

Source: Company, Ambit Capital research

Differentiated assets offering – healthy risk-adjusted margins

However, the relatively higher share of SME loans helps to slightly offset regional banks' weakness on the liability franchise. The higher risk perception of SME loans leads to healthy yield on assets for regional banks, almost in line with those for new private sector banks. The average calculated NIMs for regional banks, at ~3.0%, thus compares with ~2.7% for PSU banks and ~3.6% for large private banks. Despite the presence in higher-yielding assets, credit costs, however, have been contained, delivering healthy risk-adjusted margins of ~2.5% for the regional banks as compared to 3.0% for the large private banks. Among regional banks, IVB and DCB have delivered better risk-adjusted margins, thanks to their relatively stronger liability franchises and low credit costs.

Exhibit 33: Peer group comparison - cost of funds, yields on asset, margins and risk-adjusted margins

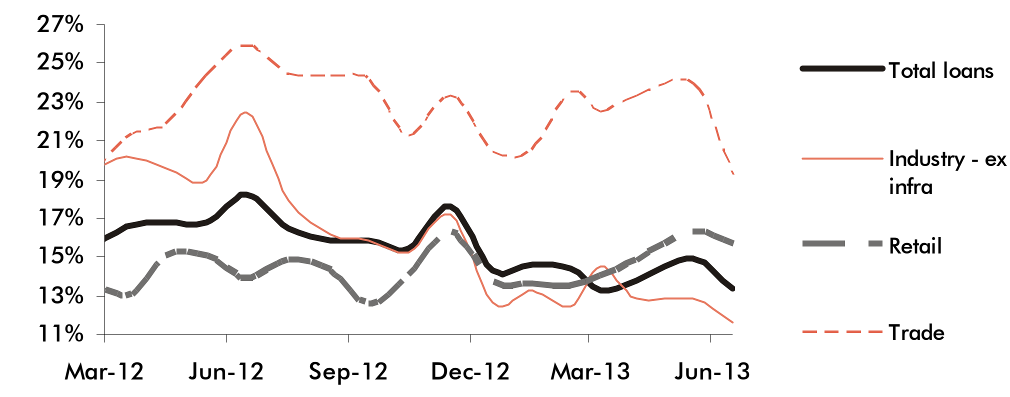
FY13	PSU banks	Large private	Regional banks	IVB	FB	KVB	SIB	CUB	DCB
Cost of funds	6.40%	7.20%	7.70%	7.49%	7.23%	8.24%	7.63%	7.66%	7.28%
Yield on assets	8.67%	10.03%	10.13%	9.97%	9.66%	10.65%	10.08%	10.71%	9.60%
NIM (calc.)	2.66%	3.63%	3.04%	3.22%	3.13%	2.84%	2.95%	3.11%	2.98%
Credit costs	1.14%	0.62%	0.53%	0.29%	0.58%	0.53%	0.56%	0.89%	0.34%
Yield on assets - risk adj.	7.53%	9.41%	9.60%	9.68%	9.08%	10.12%	9.52%	9.82%	9.26%
NIM (calc.) - risk adj.	1.51%	3.00%	2.51%	2.93%	2.55%	2.31%	2.40%	2.22%	2.64%

Source: Company, Ambit Capital research

SME - a competitive advantage; retail - an incremental opportunity

We believe regional banks will sustain their competitive advantage in SME banking; however, retail banking will offer incremental opportunities in the future. The sectoral credit growth trends (see Exhibit 34 below) show that overall credit growth has been slowing down mainly due to a slowdown in industry credit growth (ex-infra). However, loan growth to the trade sector and retail loans have been relatively steady. We believe that regional banks can perform better than PSU banks in retail loans due to their experience in similar-to-retail, individual-based SME banking and relationship banking.

Exhibit 34: System credit growth (YoY) for industry (ex-infra), retail, trade and total loans



Source: Company, Industry, RBI, Ambit Capital research

Need to further diversify - regional banks exploiting retail opportunity through mortgage and gold loans

Gold loans and mortgage loans have emerged as products of choice for regional bank trying to scale up their retail loan books. Banks based in south India, such as Karur Vysya Bank (KVB), South Indian Bank (SIB), City Union Bank CUB (and increasingly Federal Bank), have focused on gold loans due to better demand of the product in that region. ING Vysya Bank (IVB) and Development Credit Bank (DCB), on the other hand, have used mortgages as the key product to build their retail books. Both these banks have leveraged their existing record in MSME/SME lending to develop the LAP (loans against property) product.

Exhibit 35: Share of retail loans, gold loans, housing loans and vehicle loans in total loans for the six regional banks (based on FY13 financials)

FY13 Loan mix:	IVB	FB	KVB	SIB	CUB	DCB
Retail loans as a % of loan book	19%	31%	12%	21%	19%	45%
Housing/Mortgages/LAP	15%	15%	5%	6%	5%	40%
Gold loans (distributed across retail, SME and agri)	1%	14%	26%	22%	23%	NA
Vehicle loans	1%	NA	4%	NA	NA	2%

Source: Company, Ambit Capital research

Regulatory scrutiny vis-à-vis gold loans and the credit quality concerns on LAP have increased, but so far regional banks have demonstrated adequate risk management in these products.

However, given that both LAP and gold loans are exposed to asset price risks, a significantly higher exposure to these asset classes could in fact be negative in a stressed environment. This was visible in the de-growth/slower growth of the gold loan books of most NBFCs/banks during 1QFY14 and higher loans losses for some NBFCs due to the fall in gold prices in the quarter.

Hence, these banks would have to diversify beyond gold loans and mortgages to truly diversify their retail loan books. An expanded and geographically diversified branch network is crucial for progress on this parameter as well.

Strong liability base - solution to challenges on the assets side as well

In the future, regional banks would face three key challenges:

(1) Rising competition for SME loans: With limited growth opportunities available for PSU banks, they are increasingly targeting the SME segment. Supported by their relatively low-cost deposits base, their first port of call is to compete on low pricing.

(2) Scaling up of the retail asset franchise to benefit from the existing business' strengths in SME lending/relationship banking.

(3) Diversifying the retail loan mix to minimise asset quality risk.

These challenges demand a strong and wider low-cost retail liability franchise to absorb the pressure on yields (which would arise from competitive pressure on SME loans) and to better cross-sell retail assets and diversify into other retail products, such as home loans, auto loans and credit cards. We believe ING Vysya Bank and Development Credit Bank are better placed than the other regional banks owing to their stronger liability franchises.

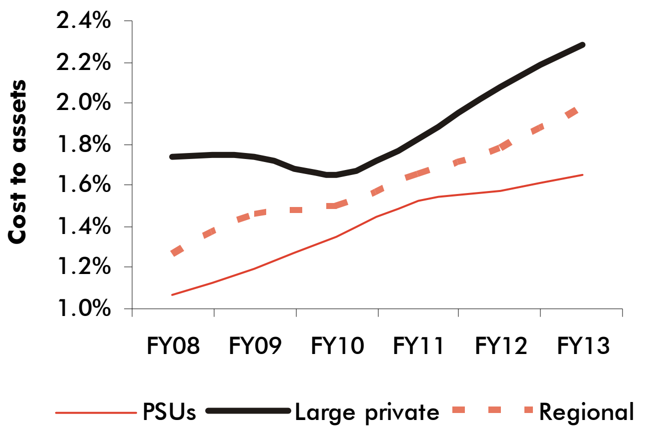
3. Cost efficiency – Timing the expansion wrong

Investments and payoff dynamics

Regional banks' performance on cost efficiency has two aspects: **(1)** the bank's cost base in the context of branch mix, geographic location, extent of investment in branches, staffing and salary levels, and **(2)** the level of income productivity in view of the cost base.

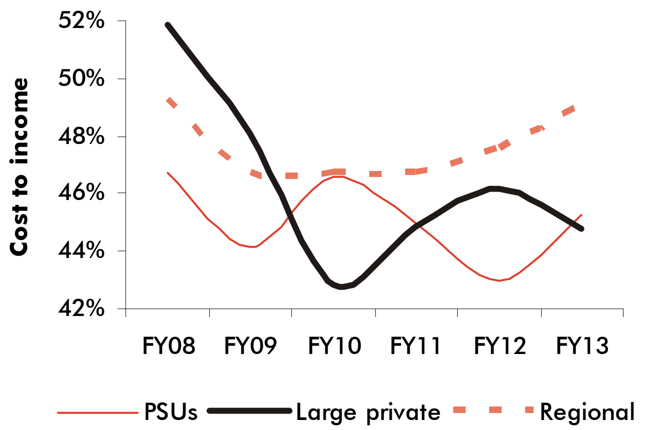
Large private sector banks, in general, have higher cost to assets (see Exhibit 36 below) due to their urban and metro focus and investments in people and systems. On this metric, regional banks lie between large private sector banks and PSU banks. However, as large private sector banks are able to deliver higher income on their assets, mainly in the form of non-interest income, their cost-to-income ratio is below ~45% (see Exhibit 37 below).

Exhibit 36: Comparison of bank groups (cost to assets)



Source: Company, Ambit Capital research

Exhibit 37: Comparison of bank groups (cost to income)



Source: Company, Ambit Capital research

Among regional banks, the cost to assets for IVB and DCB is in line with many of the large private sector banks (see Exhibit 39 on the next page), due to their branch mix, which is geared towards a higher share of metro and urban branches (see Exhibit 38 below). This also reflects in the relatively higher headcount per branch, salary levels and other opex per branch (see Exhibit 38 below).

Exhibit 38: Branch mix by population centres (FY12) and cost metrics (FY13)

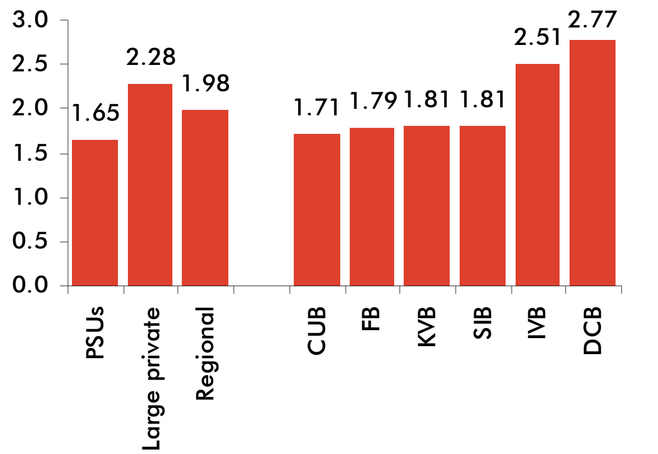
	PSUs	Large private	IVB	FB	KVB	SIB	CUB	DCB
Metro	20%	31%	35%	17%	23%	17%	20%	63%
Urban	21%	27%	31%	21%	32%	23%	31%	13%
Semi-urban	26%	33%	18%	56%	37%	48%	34%	19%
Rural	33%	9%	16%	7%	9%	12%	14%	6%
Metro+urban	**41%**	**58%**	**66%**	**37%**	**54%**	**40%**	**52%**	**76%**
Employees per branch	12.3	22.0	18.3	9.2	12.4	8.5	11.4	24.0
Employee cost per branch (₹ '000)	825	654	751	666	554	771	391	646
Other opex per branch (₹ mn)	6.1	22.7	9.6	5.4	8.4	4.1	6.6	15.4

Source: Company, RBI, Ambit Capital research

On the other hand, cost to assets for FB, KVB, SIB and CUB are similar to PSU banks, which highlight the similar nature of their branch network and investments. However, except for CUB, all other regional banks have a high cost-to-income ratio; the weaker performance of regional banks on income productivity (particularly fee income) explains this divergence. For example, higher investments in headcount per branch and salary levels support ING Vysya Bank's superior fee income to assets (~1.4% as compared to peers' 0.7-1.0%), thus closing some of the gap in the cost-to-income ratio between ING Vysya Bank and its peers.

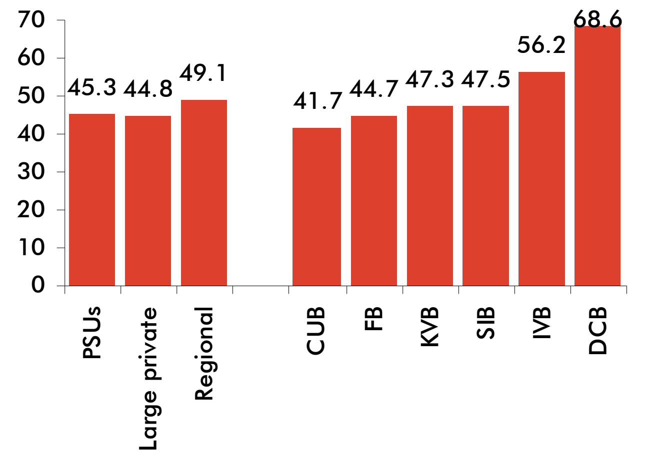
Thus, in the long term, the key to improve cost efficiency of regional banks is to drive the productivity gain in line with investments in branches and staff. Our discussion on page 13-14 shows that the key for this is to form as many primary relationships with their borrowers as possible to maximise income. Given that the primary relationships of banks are determined by the relationships on the liability side (see Exhibit 17 on page 14), higher focus on the liability franchise is required to address cost to income as well.

Exhibit 39: FY13 cost to assets (%)



Source: Company, Ambit Capital research

Exhibit 40: FY13 cost to income (%)

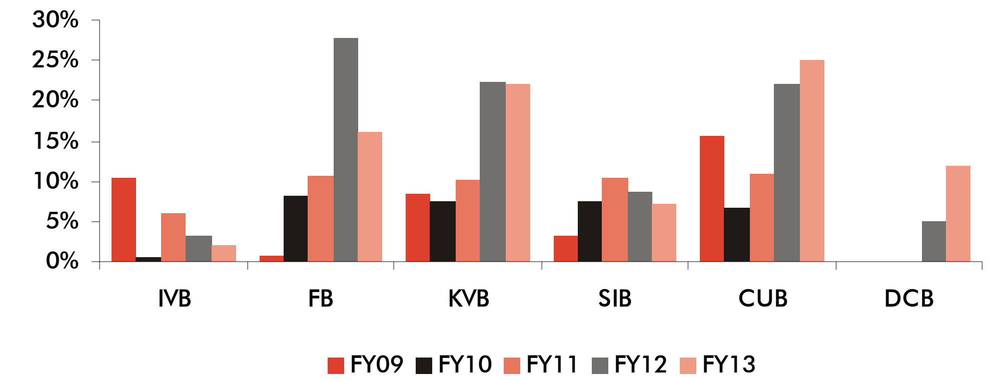


Source: Company, Ambit Capital research

Branch network expansion amid a slowdown comes at a cost

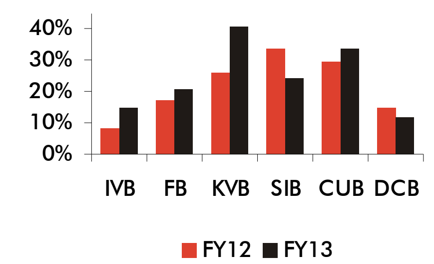
Some regional banks (such as Federal Bank, Karur Vysya Bank and City Union Bank) were slow on branch expansion until FY11, but these banks have accelerated their branch expansion during FY12 and FY13 (see Exhibit 41 below). They had consolidated their niches and delivered relatively healthy asset quality and profitability prior to FY12. Since then the objective of these banks has clearly been to bolster the liability franchise and to pursue a scale-up.

Exhibit 41: Growth (YoY) in the number of branches



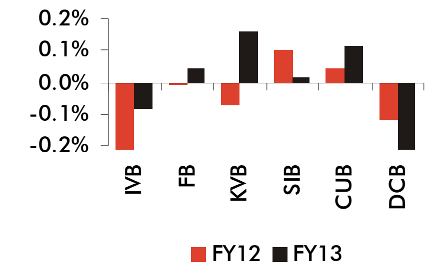
Source: Company, Ambit Capital research

Exhibit 42: Opex growth (YoY)



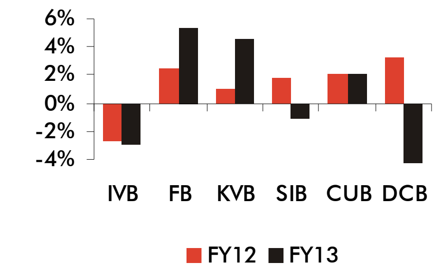
Source: Company, Ambit Capital research

Exhibit 43: Change in cost/assets



Source: Company, Ambit Capital research

Exhibit 44: Change in cost/income



Source: Company, Ambit Capital research

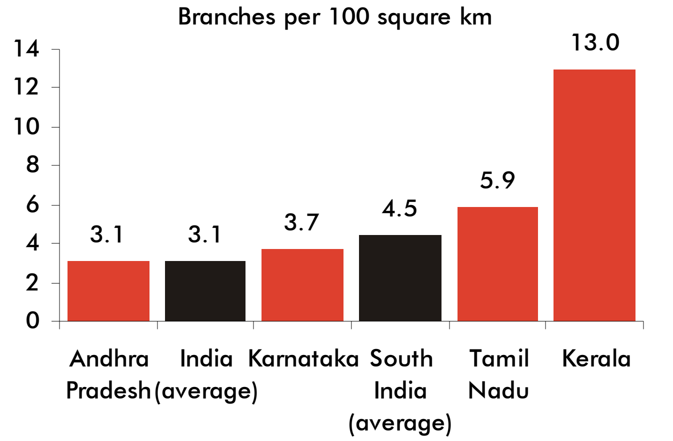
The accelerated expansion in the branch network at these banks led to higher operating expenses (see Exhibit 42 above). ING Vysya Bank and Development Credit Bank have, however, been conservative on the pace of network expansion, as they already had a relatively bloated cost base. The external macroeconomic environment turned adverse in FY12 and FY13 and the banks' asset growth slowed down at a time when growth in the number of branches accelerated. As a result, cost efficiency ratios, for FB, KVB and CUB, were adversely affected (see Exhibits 43 and 44 above). Given that the economic environment is likely to remain subdued in the near term, we expect banks to be cautious on the rate of their branch expansion and focus on improving the productivity of the existing network.

Nature of branch expansion to determine future benefits

The two key parameters to analyse branch network expansion of regional banks are: (1) the mix of new branches in the home and non-home states; and (2) the mix of new branches across urban/rural centres.

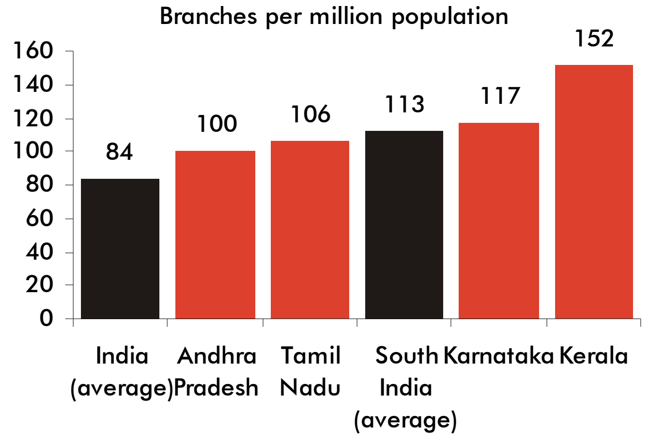
The competitive intensity in home state(s) is a key determinant of a bank's choice to expand beyond its home state. As seen in Exhibits 45 and 46 below, Kerala is the most competitive and highly penetrated south Indian state whereas Tamil Nadu continues to offer relatively lucrative opportunities for banking.

Exhibit 45: Bank branch penetration by geographical area (FY12)



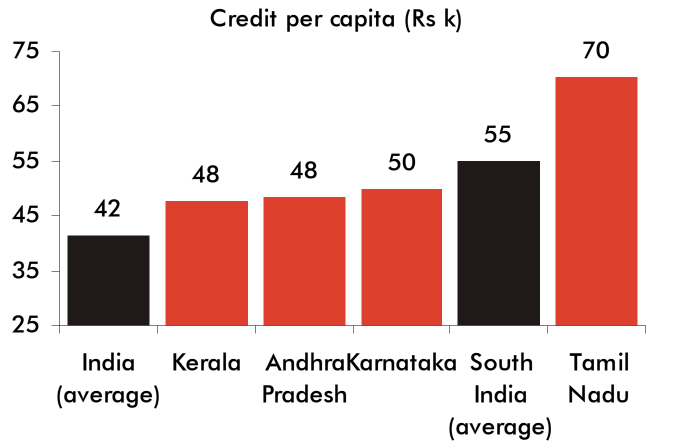
Source: RBI, Ambit Capital research

Exhibit 46: Bank branch penetration by population (as at the end of December 2012)



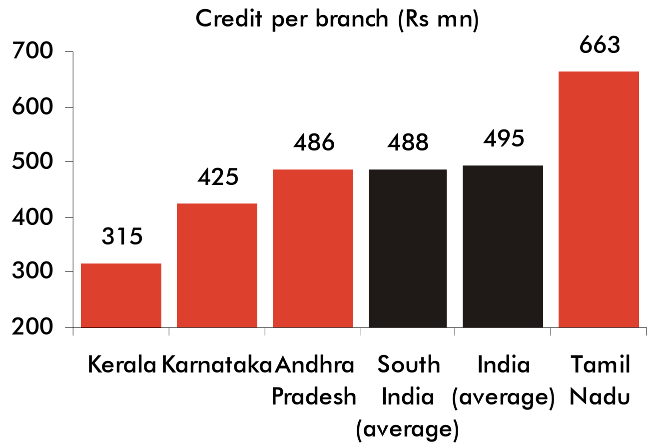
Source: RBI, Ambit Capital research. Note: We have used population data from the 2011 Census.

Exhibit 47: Credit per capita, by geography (December 2012)



Source: RBI, Ambit Capital research; Note: We have used population data from the 2011 Census.

Exhibit 48: Credit per branch, by geography (December 2012)



Source: RBI, Ambit Capital research

In this context, the strategy of Kerala-based regional banks (such as FB and SIB) to seek expansion outside Kerala and the strategy of Tamil-Nadu-based banks (such as KVB and CUB) to remain focused on Tamil Nadu appears to be logical. The change in regional banks' geographical branch mix during the last three years shows that ING Vysya Bank has been the most successful in expansion outside its home states (see Exhibit 49 on the next page). Although Federal Bank has shown some expansion outside Kerala, it remains heavily concentrated in Kerala, which is a relatively small state by size.

Exhibit 49: Proportion of branches in home states

	Home states	FY10	FY13
ING Vysya Bank	Andhra Pradesh	36%	31%
	Karnataka	26%	24%
Federal Bank	Kerala	58%	53%
	Tamil Nadu	7%	11%
South Indian Bank*	Kerala	55%	55%
	Tamil Nadu	18%	17%
City Union Bank	Tamil Nadu	63%	66%
	Andhra Pradesh	13%	13%
Karur Vysya Bank	Tamil Nadu	53%	51%
	Andhra Pradesh	22%	21%

*Source: Company, Industry, RBI, Ambit Capital research. Note: * Latest available state-wise mix for South Indian Bank is that for FY12.*

The challenges and implications for regional banks' branch network strategy, in our view, are:

- **For FB and SIB**, expansion outside Kerala is imperative to ward off intense competition in Kerala. The expansion outside the home states, however, comes with significant execution risk due to limited brand equity, management bandwidth and lack of a supportive external climate. Federal Bank has pursued more effective diversification outside Kerala than South Indian Bank (see Exhibit 49 above) but a lot has to be done for the bank to meaningfully diversify outside Kerala.

- **For KVB and CUB**, the management's focus continues to be on a scale-up within Tamil Nadu itself. However, continued regional concentration will limit their low-cost deposits franchise. During this macro-economic slowdown, the weakness in the liability franchise could constrain the asset growth of these banks. The key challenge continues to be income productivity at new branches in a difficult external environment, which could add pressure on cost ratios and affect profitability.

- **For ING Vysya Bank**, the branch expansion has been muted in recent years but the key highlight is that 94% of the new branches were opened outside south India in FY09-13. Similarly, 67% and 20% of new branches in FY09-12 were opened in metro and urban centres, respectively (see Exhibit 50 below). A more diversified branch network has helped IVB to maintain a better liability franchise. Also, given that urban and metro branches have a longer break-even time (up to three years), we believe IVB stands to gain from improving productivity gain in the coming years, which will help sustain the trend of moderating cost ratios.

Exhibit 50: The branches opened in the last three years (FY10-12) - mix by population centres

	IVB	FB	KVB	SIB	CUB
Rural	0%	7%	6%	9%	6%
Semi-urban	13%	62%	50%	56%	46%
Urban	20%	12%	21%	16%	25%
Metro	67%	18%	24%	18%	23%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Company, Industry, RBI, Ambit Capital research

IVB, the strongest among regional banks; SIB, the weakest

In our regional banks' comparison, ING Vysya Bank emerges as the strongest franchise, owing to its strengths on better regional diversification, stronger liability franchise, better risk-adjusted margins, fee income generation, stable asset quality and better-than-system assets growth. Operating efficiency is a challenge but its cost ratios have gradually been improving and they continue to be the bank's key focus.

On the other hand, South Indian Bank appears the weakest due to its weak scores on most of the parameters of our framework.

Exhibit 51: Long-term attractiveness of the franchise

	IVB	FB	KVB	SIB	CUB	DCB
Geographical diversification	●	◔	◔	◔	◔	◕
Strength of liability franchise	●	◑	◑	◔	◑	●
Risk adjusted margins	●	●	◑	◕	◕	●
Fee income generation	●	◔	◑	◔	●	◕
Cost efficiency	◑	◑	◑	◑	●	
Asset quality	●	◑	◑	◔	◕	◕
Assets growth	●	◑	◕	◔	◕	●
Average	●	◑	◑	◔	◕	◕
Summary						
Relative strengths	**Most areas**	**NIMs**	**Growth**	**Cost efficiency**	**Fee income, Cost efficiency**	**Liability franchise, Margins**
Relative weaknesses	**Cost efficiency**	**Fee income Geographical diversification**	**Geographical diversification**	**Most areas**	**Geographical diversification**	**Geographical diversification**

Source: Company, Ambit Capital research; Note: ◔: inferior; ◑: below average; ◕: above average; ●: superior positioning

Positioning on near-term catalysts

Asset quality: Who has the best buffers?

As discussed previously in this note, the asset quality performance of regional banks in the last two years has been in line or better than the broader banking system. The factors that have helped these banks in the current downturn are: **(1)** introduction of better risk management systems and de-risking of balance sheets following the previous economic downturn (2007-08), and in some cases, concurrent changes at the senior management level, **(2)** core focus on the traditional niche where product/client understanding is better, and **(3)** a relatively lower exposure to stressed segments, such as infra and project finance. The divergence among regional banks has also been driven mostly by their relative exposure to riskier segments (see the exhibit below).

Exhibit 52: Loan mix and asset quality comparison for regional banks

(FY13)	IVB	FB	KVB	SIB	CUB	DCB
Loan mix:						
Corporate	38%	42%	38%	58%	21%	21%
SME	33%	17%	32%	14%	44%	22%
Agri	9%	11%	18%	7%	16%	12%
Retail	19%	29%	12%	21%	19%	45%
Other	1%	0%	0%	0%	0%	0%
Asset quality trends						
Loan loss provision	0.29%	0.58%	0.53%	0.56%	0.89%	0.34%
Gross NPL	1.75%	3.50%	0.96%	1.57%	1.06%	3.41%
Net NPL	0.19%	0.91%	0.37%	1.12%	0.45%	0.84%
Provision coverage ratio	89%	75%	62%	29%	58%	76%
Restructured loans to total loans	1.2%	4.6%	3.7%	5.2%	1.7%	0.5%
Tier-I capital ratio	13.5%*	14.1%	13.1%	11.9%	13.3%	13.1%

Source: Company, Ambit Capital research; Note: * Estimates post capital raise in July 2013.

For example, at the better end of the range, ING Vysya Bank has benefited from its high exposure to trade-based collateralised SME lending and minimal exposure to stressed sectors of the Indian industry (such as infrastructure and project finance). On the other hand, Federal Bank has suffered from its exposure to stressed areas (such as Aviation and state electricity boards) and to legacy corporate exposure through consortium lending with sub-par risk management.

We expect asset quality risks to remain elevated in the near to medium term (Exhibit 53) and we expect all banks to see elevated slippages in the absence of a meaningful macroeconomic recovery in the coming quarters.

However, a comparison of the banks on the protective buffers in the form of provision coverage ratio and capital ratio to withstand asset quality shocks shows that IVB, DCB and FB are better placed to face any adverse asset quality shocks.

Stress scenario analysis – high provision coverage and capital cushion the blows for IVB and FB

We have built in elevated slippages and credit cost trends in our earnings estimates for all regional banks. However, the external environment continues to be uncertain, as highlighted in the management commentary of all the regional banks (see Exhibit 53). We have carried out a stress test scenario analysis for regional banks to assess the worst-case impact on these banks' profitability and capital ratio from very high slippages (2-3x historical peak values). The conclusion from the analysis is that ING Vysya Bank and Federal Bank are in a better position to face any adverse asset quality shocks due to their currently high provision coverage and capital ratios.

Exhibit 53: The recent management commentary (post 1QFY14 results) on asset quality outlook

Bank	Management commentary on asset quality from recent analyst conference calls
ING Vysya Bank (23 July 2013)	"In terms of the asset quality, in a way I feel vindicated, because now for the last four, five quarters I have come on these calls and said that things are going to get worse and every time I've been foolish. I think I'm not happy about this. But in a way what I can say is that, yes, <u>distress in the system, to some extent, we did see an impact of it on our books</u>. We saw a couple of medium-sized companies fall into NPAs this quarter."
Federal Bank (22 July2013)	"SME remains reasonably OK for now. But I would <u>worry for the large corporate. If the environment doesn't pick up, one day they will face stress</u>. But right now, they are reasonably effort elastic only because of the fact that the bank, on a client basis, is relatively well embedded into local industries."
Karur Vysya Bank (8 August 2013)	"Earlier, during the course of the quarter, we thought there would be an improvement, but the <u>situation worsened by the end of the quarter</u>." "The bank faced <u>problems for the loans given in consortium</u>." "NPLs mainly occurred in the mid-corporate segment, but <u>we cannot withdraw due to long-term relationships</u>."
City Union Bank (31 July 2013)	"On asset quality, <u>things are getting worse</u>. Though stress has been building up, this has <u>not materialised into slippages</u> so far, as borrowers were selling assets to avoid defaults. If things don't improve, the <u>situation may become difficult by 4QFY14 and 1QFY15</u>."

Source: Company, Bloomberg, Ambit Capital research

Exhibit 54: Regional banks' stress test from elevated delinquencies

	FY12	FY13	FY14E	FY15E	FY14E	FY15E
ING Vysya Bank			Base case		Stress case	
Gross delinquencies	0.74%	0.68%	1.00%	1.00%	3.00%	3.00%
Net delinquencies	0.20%	0.14%	0.53%	0.44%	1.50%	1.32%
Gross NPL	1.93%	1.76%	1.82%	1.79%	2.64%	3.14%
Provision coverage ratio	91%	98%	86%	80%	70%	70%
Net NPL	0.18%	0.03%	0.26%	0.36%	0.81%	0.96%
Credit costs	0.42%	0.29%	0.31%	0.33%	1.27%	1.36%
RoA	1.06%	1.21%	1.25%	1.30%	1.13%	1.05%
RoE	14.3%	14.6%	12.1%	12.5%	11.0%	10.3%
Tier-1 capital ratio	11.2%	10.5%	13.4%	12.5%	13.3%	12.1%
Federal Bank						
Gross delinquencies	2.19%	2.15%	2.20%	1.80%	4.40%	3.80%
Net delinquencies	0.99%	1.13%	1.13%	0.95%	3.33%	2.48%
Gross NPL	3.35%	3.44%	3.43%	3.39%	5.21%	5.93%
Provision coverage ratio	85%	72%	67%	66%	60%	60%
Net NPL	0.53%	0.98%	1.16%	1.18%	2.15%	2.46%
Credit costs	0.74%	0.58%	0.79%	0.74%	1.73%	1.63%
RoA	1.39%	1.27%	1.08%	1.09%	0.69%	0.72%
RoE	14.4%	13.9%	12.5%	13.4%	8.2%	9.4%
Tier-1 capital ratio	15.9%	14.1%	13.0%	12.0%	12.4%	11.1%
Karur Vysya Bank						
Gross delinquencies	0.98%	0.84%	1.20%	1.20%	3.00%	3.00%
Net delinquencies	0.61%	0.43%	0.91%	0.83%	2.03%	2.03%
Gross NPL	1.33%	0.96%	1.47%	1.77%	2.38%	3.39%
Provision coverage ratio	75%	62%	64%	64%	60%	60%
Net NPL	0.33%	0.37%	0.54%	0.64%	0.96%	1.38%
Credit costs	0.23%	0.53%	0.70%	0.67%	1.24%	1.32%
RoA	1.52%	1.30%	1.06%	1.01%	0.82%	0.72%
RoE	20.8%	19.0%	16.7%	17.0%	13.1%	12.8%
Tier-1 capital ratio	13.1%	13.1%	11.9%	10.9%	11.5%	10.1%
South Indian Bank						
Gross delinquencies	0.84%	1.95%	1.25%	1.25%	3.50%	3.50%
Net delinquencies	0.19%	1.14%	0.70%	0.58%	2.19%	2.04%
Gross NPL	0.97%	1.36%	1.62%	1.74%	2.84%	3.87%
Provision coverage ratio	71%	42%	50%	60%	50%	50%
Net NPL	0.28%	0.78%	0.81%	0.70%	1.44%	1.97%
Credit costs	0.25%	0.56%	0.56%	0.60%	1.24%	1.10%
RoA	1.10%	1.12%	0.99%	0.95%	0.68%	0.73%
RoE	21.6%	20.5%	17.4%	17.3%	12.4%	14.3%
Tier-1 capital ratio	11.5%	12.1%	11.4%	10.7%	10.9%	9.9%
City Union Bank						
Gross delinquencies	1.57%	1.85%	2.00%	2.00%	5.00%	5.00%
Net delinquencies	0.68%	1.25%	1.41%	1.18%	4.00%	3.03%
Gross NPL	1.06%	1.16%	1.61%	1.87%	3.65%	4.46%
Provision coverage ratio	58%	46%	46%	46%	45%	45%
Net NPL	0.45%	0.63%	0.87%	1.02%	2.04%	2.50%
Credit costs	0.65%	0.81%	0.94%	0.80%	1.96%	1.83%
RoA	1.70%	1.56%	1.41%	1.51%	0.86%	0.96%
RoE	24.9%	22.3%	20.1%	22.0%	12.8%	15.6%
Tier-1 capital ratio	11.7%	13.3%	12.6%	12.3%	11.8%	10.7%

Source: Company, Ambit Capital research

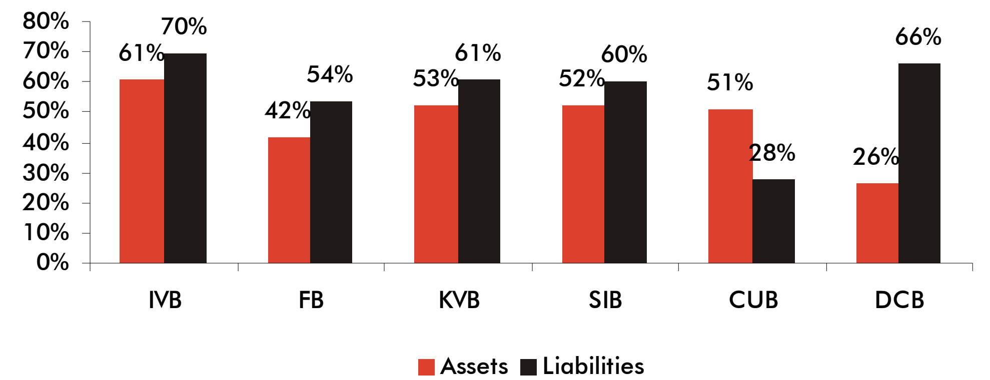
Interest rate environment: Who has the better ALM?

Over the past month, the Reserve Bank of India (RBI) tightened the systemic liquidity through a series of measures in its bid to arrest the volatility in the foreign exchange market. In light of the RBI's tone in the monetary policy review on 30 June, it is evident that the liquidity squeeze is likely to remain in place at least through 2QFY14. In such a scenario, the banks that are disproportionately dependent on short-term liabilities are likely to face refinancing pressures, which could eventually hurt margins as well. Exhibit 55 below highlights the share of liabilities within the 'less that one year' maturity bucket as at end-FY13.

From this perspective, DCB appears to be the most exposed. However, unlike the larger new private sector bank peers (which have a high exposure to wholesale funding, in line with the larger corporate exposure on the assets side), the funding base of regional banks consists of a higher share of retail term deposits. DCB, for example, has 80% of its deposits in the form of retail deposits (retail term deposits: 52%, retail CASA: 28%).

City Union Bank, on the other hand, could enjoy a margin benefit, as assets could re-price faster than liabilities in the high interest rate environment.

Exhibit 55: Share of asset and liabilities in the 'less that one year' maturity bucket



Source: Company, Ambit Capital research

Conclusion: Positioning on near-term catalysts

To summarise the above analysis, City Union Bank and ING Vysya Bank look better placed to meet near-term catalysts from tight liquidity, asset quality concerns and acquisition-related speculations.

Exhibit 56: Regional banks' relative positioning on key near-term catalysts

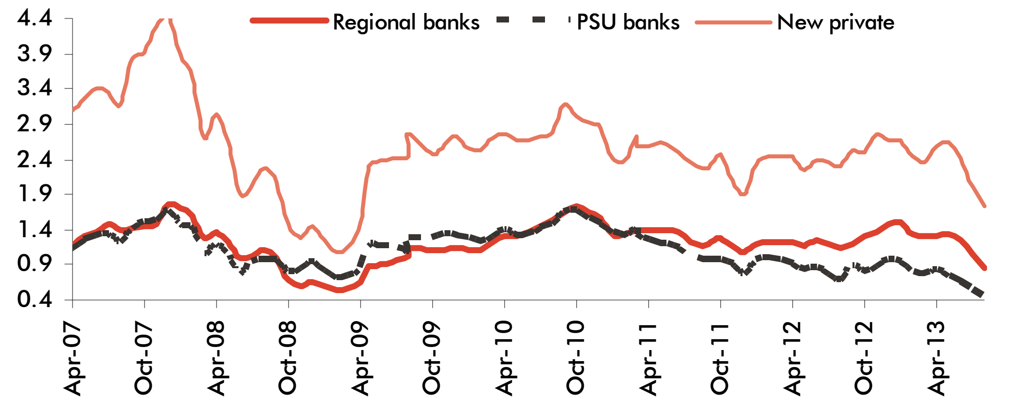
	IVB	FB	KVB	SIB	CUB	DCB
Liquidity tightening	◑	◑	◑	◑	●	◔
Asset Quality pressures	●	◑	◕	◑	◕	◕
Average	◕	◑	◑	◑	◕	◑

Source: Company, Ambit Capital research; Note: ◔: inferior; ◑: below average; ◕: above average; ●: superior positioning

Valuation – regional banks trending between PSUs and new private sector banks

Historically, regional banks' valuation has trended in line with PSU banks; however, in the last two years, regional banks have delivered better growth and asset quality whereas PSU banks have struggled. Thus, regional banks' valuations have rerated vis-à-vis PSU banks. However, large private sector banks continue to trade at a significant premium to regional banks, in line with the premium in our profitability and growth estimates.

Exhibit 57: Average P/B (12-month forward) for the three banking groups

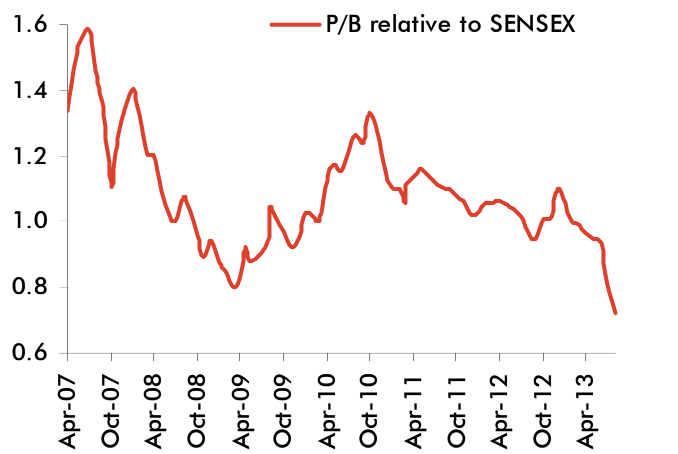


Source: Company, Bloomberg, Ambit Capital research

Regional banks inexpensive after the recent sell-off

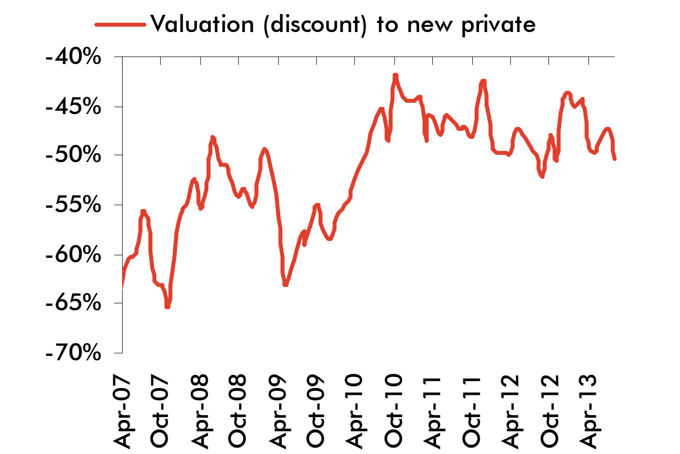
In the last two months, regional banks, along with the wider sell-off in financial services' stocks, have underperformed the broader market. In the last two months, the stock prices of regional banks are down 24% as compared to an 7% decline in the Sensex. The regional banks' valuation, relative to the Sensex, is now at levels similar to those prevalent during the FY09 crisis.

Exhibit 58: Regional banks' average P/B (12-month forward) relative to Sensex (rebased at April 2007)



Source: Company, Bloomberg, Ambit Capital research

Exhibit 59: Regional banks' P/B valuation discount to large new private sector banks



Source: Company, Bloomberg, Ambit Capital research

Exhibit 60: Regional banks – relative valuation (based on consensus estimates)

	KVB		CUB		FB		SIB		DCB		IVB	
Consensus estimates	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**
RoA	1.19%	1.22%	1.50%	1.49%	1.14%	1.18%	1.00%	1.00%	1.13%	1.16%	1.28%	1.35%
Leverage	15.0	16.4	13.9	13.5	11.3	11.9	17.8	17.8	11.7	12.1	10.7	10.1
RoE	17.8%	19.9%	20.8%	20.1%	12.9%	14.1%	17.8%	17.9%	13.1%	14.1%	13.7%	13.6%
EPS CAGR (FY13-15E)	16%		17%		10%		13%		33%		15%	
P/B (x)	0.96	0.83	1.05	0.88	0.63	0.56	0.82	0.70	0.90	0.78	1.14	1.01
P/E (x)	5.6	4.4	5.3	4.6	5.1	4.2	4.7	4.1	7.1	5.8	9.5	7.8

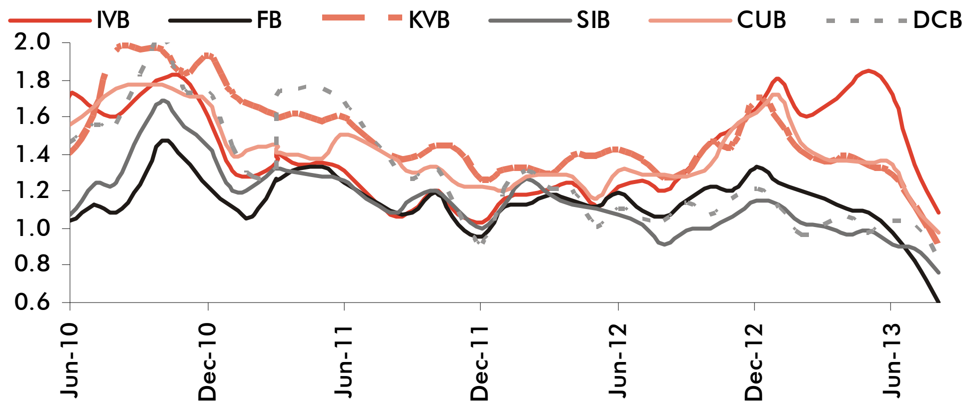
Source: Company, Bloomberg, Ambit Capital research

Exhibit 61: Regional banks – relative valuation (based on our estimates)

	KVB		CUB		FB		SIB		IVB	
Based on Ambit estimates	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**
RoA	1.06%	1.01%	1.45%	1.51%	1.08%	1.09%	0.96%	0.95%	1.25%	1.30%
Leverage	15.7	16.9	14.2	14.5	11.6	12.3	17.7	18.3	9.7	9.6
RoE	16.7%	17.0%	20.6%	21.9%	12.5%	13.4%	17.0%	17.4%	12.1%	12.5%
EPS CAGR (FY13-15E)	6%		21%		8%		10%		12%	
P/B (x)	0.97	0.86	1.02	0.84	0.63	0.57	0.79	0.69	1.11	1.00
P/E (x)	6.1	5.4	5.3	4.2	5.3	4.5	5.0	4.3	10.3	8.4

Source: Company, Bloomberg, Ambit Capital research

Exhibit 62: P/B (12-month forward) for regional banks



Source: Company, Bloomberg, Ambit Capital research

ING Vysya Bank

Bloomberg: VYSB IN EQUITY
Reuters: VYSB.BO

BUY

AMBIT
Acumen at work

Accounting: GREEN
Predictability: GREEN
Earnings momentum: GREEN

Proven competitive advantages

ING Vysya Bank (IVB) has proven its competitive advantages over other regional banks through better geographical diversification, low-cost deposits franchise, better fee income generation capability and better asset quality. These advantages have led to a stock rerating. We expect its valuation gap with private sector banks to narrow further over the next two years. Moderation in the cost-to-asset ratio and containment of credit costs would lead to an RoA improvement of 10bps by FY15, at a time when most of IVB's peers would face RoA declines. Moreover, IVB is well placed to face any adverse asset quality shocks in the near term, owing to its less risky loan book, high provision coverage ratio and high capital ratio. We initiate coverage with a BUY stance.

Competitive position: MODERATE **Changes to this position: STABLE**

Continued RoA improvement over the last four years: After a muted RoA performance until FY09, IVB has improved its RoAs by 55bps in FY09-13 and has delivered a 29% EPS CAGR during this period. The company de-risked its loan book by: (1) increasing the proportion of collateralised SME loans, (2) realigning its balance sheet towards higher interest earning assets, and (3) improving its operational efficiency in terms of bringing down the cost-to-income ratio by ~830bps. Thus, its RoAs have improved in FY09-13.

Narrowing the valuation gap to new private sector banks: A favourable loan mix change towards higher-yielding assets, a pick up in low-cost CASA deposits and improving productivity of urban and metro branches that were opened in recent years would lead to an RoA improvement of 10bps by FY15. This improvement will take place at a time when most peer banks would see RoA compression. This, we believe, would further narrow down the valuation gap to new private sector banks (currently at 35% vs 52% in August 2011).

Strong buffer to protect from any asset quality shocks: Negligible exposure to stressed sectors in the corporate book and a well-performing SME book, provision coverage and capital ratio mean that IVB is relatively better placed vs its peers to absorb system-wide asset quality shocks vs its peers.

Initiate with BUY stance and a target price of ₹626: We initiate coverage with a BUY stance and a target price of ₹626 (implied one-year forward P/B of 1.6x and one-year forward P/E of 14.0x) based on the EVA approach. Our EVA model assumes sustainable steady-state RoAs of 1.4% beyond the next three years and a cost of equity of 14%. The main catalysts for IVB are stable asset quality and pick up in branch expansion with contained cost ratios. The key risk to our BUY stance is the higher-than-expected weakness in the macro-economic environment which would affect the credit quality of SME borrowers.

Key financials (standalone)

Year to March	FY11	FY12	FY13	FY14E	FY15E
Net Revenues (₹ mn)	16,615	18,781	22,655	26,188	30,480
Operating Profits (₹ mn)	6,355	7,679	9,927	12,149	14,859
Net Profits (₹ mn)	3,186	4,563	6,130	7,501	9,177
EPS (₹)	26.3	30.4	39.6	40.6	49.6
RoA (%)	0.88%	1.06%	1.21%	1.25%	1.30%
RoE (%)	13.5%	14.3%	14.6%	12.1%	12.5%
P/B (x)	2.00	1.61	1.42	1.11	1.00

Source: Company, Ambit Capital research

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Recommendation

CMP:	₹416
Target Price (12 month):	**₹626**
Upside (%)	*50%*
ABVPS (FY14E):	₹376

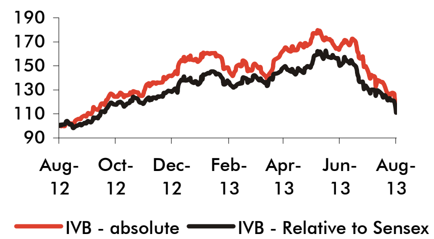
Stock Information

Mkt cap:	₹78bn/US$1.2bn
52-wk H/L:	₹667/361
3M ADV:	₹112mn/US$1.7mn
Beta:	1.0x
BSE Sensex:	17,996
Nifty:	5,285

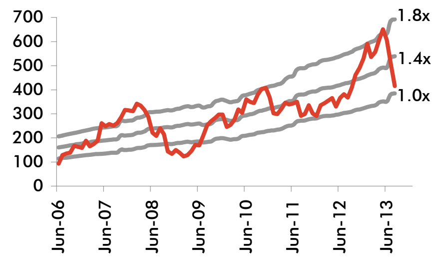
Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(24)	(34)	13	(21)
Rel. to Sensex	(15)	(23)	11	(14)

Performance (%)



One-year forward P/B



Source: Bloomberg, Ambit Capital research

Company Financial Snapshot

Profit and Loss (standalone, ₹ mn)

	FY13	FY14E	FY15E
Net Interest Income	15,386	18,131	21,167
Other Income	7,269	8,057	9,313
Total Income	22,655	26,188	30,480
Operating Expenditure	12,728	14,039	15,622
Operating Profit	9,927	12,149	14,859
Write-offs & Provisions	912	1,118	1,363
PBT	9,014	11,031	13,495
Tax	2,885	3,530	4,318
PAT (pre Ins. & MI)	6,130	7,501	9,177
EPS (₹)	39.6	40.6	49.6
BVPS (₹)	292.1	376.4	415.5
PAT Growth	34.3%	22.4%	22.3%
EPS Growth	30.2%	2.5%	22.3%
ROA	1.21%	1.25%	1.30%
ROE	14.6%	12.1%	12.5%

Company Background

ING Vysya Bank (IVB) is a private sector bank with a significant presence in Andhra Pradesh and Karnataka. Business banking (SME) has emerged as the core strength of the bank. IVB also has a significant presence in corporate banking, where international relationships are sourced with the help of the ING Group.

Year	Event
1930	Incorporation of Vysya Bank
1995	Forms strategic alliance with Bank Bruxelles Lambert (BBL), with BBL taking a 5% stake in Vysya Bank, which is raised further to 10%
1998	ING Group acquires BBL and all its interests in Vysya Bank
2002	Formal merger of Vysya Bank with ING Group, creating IVB
2005	Rights issue of ₹3.1bn
2007	Capital raise of ₹3.5bn through a QIP
2009	Capital raise of ₹4.2bn through a QIP
2011	Capital raise of ₹9.7bn through a QIP
2013	Capital raise of ₹18.4bn through a QIP

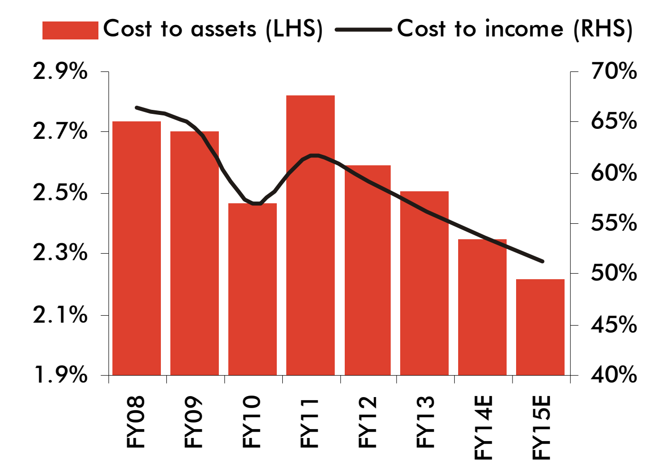
Balance Sheet (consolidated, ₹ mn)

	FY13	FY14E	FY15E
Sources of funds			
Equity Capital	1,549	1,849	1,849
Reserves & Surplus	43,683	67,733	74,963
Deposits	413,340	479,474	565,780
Borrowings (Incld. Sub Debt)	65,113	73,794	86,571
Other Liabilities	23,653	27,199	31,278
Total Liabilities	**547,337**	**650,049**	**760,440**
Investments	182,782	212,396	248,349
Net Advances	317,720	368,591	434,782
Cash & Equivalents	28,335	37,381	44,011
Fixed Assets	3,968	4,388	4,753
Other Assets	14,531	27,293	28,546
Total Assets	**547,337**	**650,049**	**760,440**

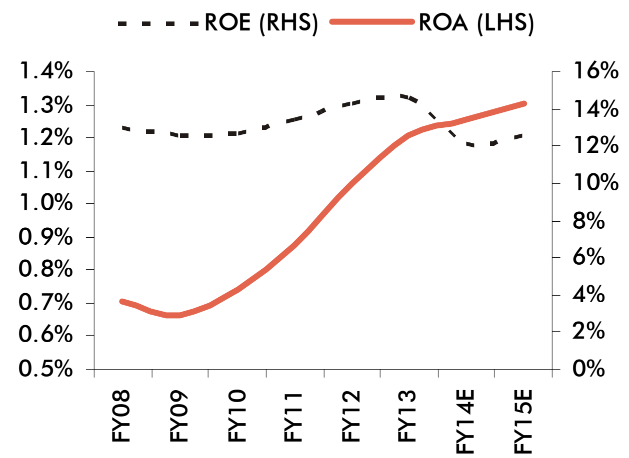
Key Ratios (consolidated)

	FY13	FY14E	FY15E
Net Interest spreads	2.48%	2.38%	2.37%
NIMs	3.15%	3.14%	3.15%
Non Interest Income/Avg assets	1.43%	1.35%	1.32%
Opex to Avg Assets	2.51%	2.34%	2.22%
Cost to income	56.2%	53.6%	51.3%
Credit Costs	0.29%	0.31%	0.33%
Gross NPAs (%)	1.76%	1.82%	1.79%
Provisioning coverage (%)	98%	86%	80%
Tier – I ratio	10.5%	13.4%	12.5%
P/B (x)	1.42	1.11	1.00
P/E (x)	10.5	10.3	8.4

Cost ratios continue to moderate



RoAs have seen a structural improvement



Source: Ambit Capital research

Exhibit 1: SWOT analysis for ING Vysya Bank (IVB)

Strengths	Weaknesses
▪ IVB has one of the strongest liability franchises among mid-sized Indian banks, which has helped it maintain lower cost of funds. ▪ The bank has a formidable business banking franchise that caters to the trading community (the traditional stronghold of the bank). This has helped the bank deliver better-than-system loan growth, superior yields and healthy asset quality. ▪ With the ING Group as the parent company, the bank is able to attract a better profile of corporate customers, thereby sourcing healthy fee income and attracting and retaining quality management. ▪ IVB has a negligible exposure to stressed sectors such as power, infra, aviation and textiles.	▪ Despite a relatively better geographical diversification in recent years, IVB's branch network remains concentrated in south India (67% of total branches). This hinders productivity improvement and exposes the bank to state-specific risks. ▪ IVB's cost ratios are higher than its peers, which affect its profitability despite a strong performance on fee income generation and asset quality.
Opportunities	**Threats**
▪ IVB has the opportunity to further strengthen its liability franchise by increasing its CASA deposits by judiciously accelerating its branch network expansion. ▪ The deregulation of the savings rate by the RBI gives IVB an opportunity to tap new customers and strengthen its savings account base. ▪ The bank has an opportunity to increase productivity in branches that have been opened in metro and urban centres in recent years. ▪ IVB can use global relationships sourced through the ING Group to further broaden its customer profile.	▪ Continued weakness in the macro-economic environment poses asset quality risk to IVB's corporate and SME loan book. ▪ Continued liquidity tightening, due to the RBI's action to contain INR weakness, could affect the bank's cost of funds. ▪ Given the high current cost ratios, an accelerated branch expansion could further negatively affect profitability.

Source: Ambit Capital research

Structural improvement in profitability

ING Vysya Bank (IVB) was founded in 1930 as Vysya Bank. The bank, in its current form, was created in 2002 when Vysya Bank merged with the Dutch financial company, the ING Group. In 1998, the ING Group acquired a Belgian bank, Bank Bruxelles Lambert (BBL), which had a long-term strategic alliance with the erstwhile Vysya Bank. The ING Group currently has a 42% shareholding in IVB and has five directors among the 12 directors on the board of the bank.

After a muted performance until FY09 (with average RoAs of 0.3% over FY05-09), the bank's performance began to improve from FY09 onwards. In FY09-13, IVB improved its RoAs from 0.7% in FY09 to 1.2% in FY13 and its RoEs from 12.5% in FY09 to 14.6% in FY13. The improvement in profitability was due to: **(1)** NIM improvement from 2.84% in FY09 to 3.52% in FY13, **(2)** decline in the cost-to-income ratio from 65% in FY09 to 56% in FY13, and **(3)** containment of credit costs (see Exhibit 2 below).

Exhibit 2: Improving RoAs and RoEs

	FY09	FY10	FY11	FY12	FY13
Net Interest Income	2.27%	2.53%	2.77%	2.82%	3.03%
Other Income	1.92%	1.80%	1.80%	1.56%	1.43%
Total Income	**4.19%**	**4.33%**	**4.57%**	**4.38%**	**4.46%**
Operating Expenses	2.70%	2.47%	2.82%	2.59%	2.51%
Pre-provisioning profits	**1.49%**	**1.87%**	**1.75%**	**1.79%**	**1.95%**
Provisions	0.46%	0.83%	0.42%	0.27%	0.18%
PBT	**1.03%**	**1.04%**	**1.33%**	**1.53%**	**1.77%**
Tax	0.37%	0.30%	0.45%	0.46%	0.57%
PAT – RoA	**0.66%**	**0.74%**	**0.88%**	**1.06%**	**1.21%**
Leverage (x)	19.0	17.2	15.3	13.4	12.1
RoE	**12.5%**	**12.7%**	**13.5%**	**14.3%**	**14.6%**

Source: Company, Ambit Capital research

Multiple drivers for NIM improvement

NIM improvement from 2.27% in FY09 to 3.03% in FY13 has been one of the main drivers behind the improvement in RoAs and RoEs over FY09-13.

The improvement in NIM has been driven by three factors: **(1)** Change in the loan mix in favour of higher-yielding SME loans, whose share in total loans increased from 23% in FY09 to 33% in FY13. **(2)** Better deployment of funds, as the share of interest earning assets in total assets increased from 93% in FY09 to 97% in FY13. **(3)** Higher share of equity capital in liabilities after three rounds of capital raising.

The lending to business banking (SME) has been a traditional strength for the bank, with higher yields of 13-14% than the overall yields of 11-11.7% on assets. The proportion of these SME loans increased from 23% in FY09 to 33% in FY13, which led to an improvement in yields on interest earning assets of the bank from 9.7% in FY10 to 11.7% in FY13.

Moreover, an alignment of the balance sheet towards interest earning assets further boosted the yields of the bank over FY09-13. The share of non-interest earning/low interest assets (cash, SLR, RIDF/NABDARD bonds and fixed assets) decreased from 46.3% in FY09 to 37.3% in FY13.

Exhibit 3: Increasing share of interest earning assets and high-yield SME loans

	FY09	FY10	FY11	FY12	FY13
Cash and equivalents	7.2%	9.0%	6.5%	6.9%	5.2%
Investments	33.1%	31.0%	28.4%	27.1%	33.4%
of which: RIDF/NABARD	2.9%	6.2%	6.8%	6.7%	5.8%
SLR	29.2%	24.3%	21.1%	19.1%	22.9%
Others	1.0%	0.5%	0.5%	1.3%	4.7%
Advances	52.8%	54.8%	60.7%	61.3%	58.0%
of which: Consumer	13.2%	12.6%	13.5%	12.3%	10.9%
SME	**12.1%**	**13.7%**	**17.1%**	**19.4%**	**19.7%**
Agri	5.3%	5.5%	4.4%	3.4%	4.8%
Wholesale	22.2%	23.0%	25.6%	26.1%	22.6%
Fixed and other assets	7.0%	5.2%	4.4%	4.7%	3.4%
Total Assets	**100%**	**100%**	**100%**	**100%**	**100%**
Interest earning assets/assets	**93.0%**	**94.8%**	**95.6%**	**95.3%**	**96.6%**
Yield on interest earning assets*	8.35%	7.26%	7.79%	9.42%	9.97%
Interest Income/avg assets**	7.83%	6.82%	7.41%	8.99%	9.57%

*Source: Company, Ambit Capital research. Note: * Interest income as a percentage of average interest earning assets. ** Interest income as a percentage of average assets.*

On the liabilities side, leverage has declined from 20x in FY09 to 12x in FY13 owing to three capital raises by the bank in FY09-13. Thus, interest bearing liabilities decreased from 95% in FY09 to 92% in FY13. Also, the share of low-cost CA deposits increased from 10.4% in FY09 to 13.4% in FY13.

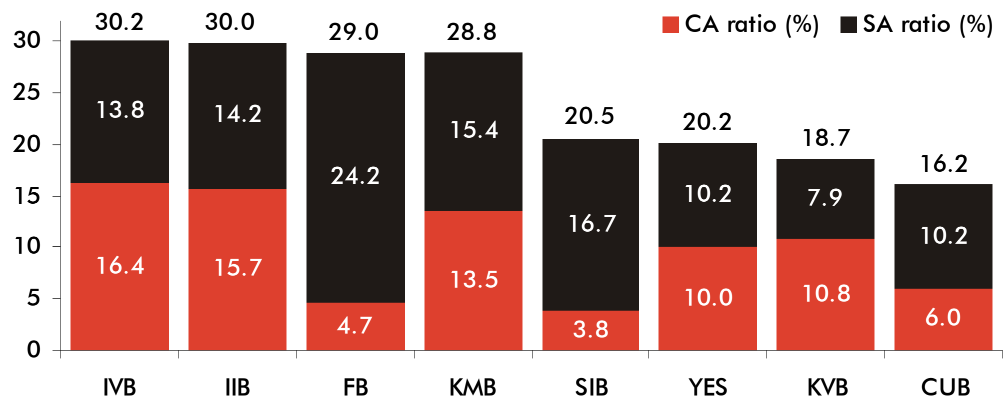
Exhibit 4: Improving CA balances and decreasing leverage on the balance sheet

	FY09	FY10	FY11	FY12	FY13
Net Worth	5.0%	6.6%	6.5%	8.3%	8.3%
Deposits	78.4%	76.6%	77.6%	75.1%	75.5%
of which: CASA	**21.1%**	**25.0%**	**26.9%**	**25.7%**	**24.5%**
of which: Current Account (CA)	10.4%	12.1%	13.1%	13.7%	13.4%
Savings Account (SA)	10.7%	12.8%	13.8%	12.0%	11.2%
Term Deposits	57.3%	51.6%	50.7%	49.4%	51.0%
Borrowings	10.0%	10.9%	10.7%	12.2%	11.9%
Other Liabilities and Provisions	6.6%	6.0%	5.3%	4.5%	4.3%
Total Liabilities	**100%**	**100%**	**100%**	**100%**	**100%**
Interest Earning liabilities/total Liabilities	95.0%	93.4%	93.5%	91.7%	91.7%
Cost of funds	6.33%	4.87%	5.28%	7.04%	7.49%

Source: Company, Ambit Capital research

IVB has a stronger low-cost deposits franchise than its mid-sized peer private sector banks. As shown in Exhibit 5 below, IVB's superiority on its low-cost franchise is driven by its higher current account deposit base. The management attributes this to the nature of its customer base (MSE/SME customers) which tends to maintain higher current account balances. As discussed in the thematic section (see Exhibit 38 of Thematic section), we believe a branch network which is a relatively more diversified than that of its peers would also help IVB in maintaining a superior deposits profile.

Exhibit 5: IVB's comparison with peers on a low-cost deposits franchise

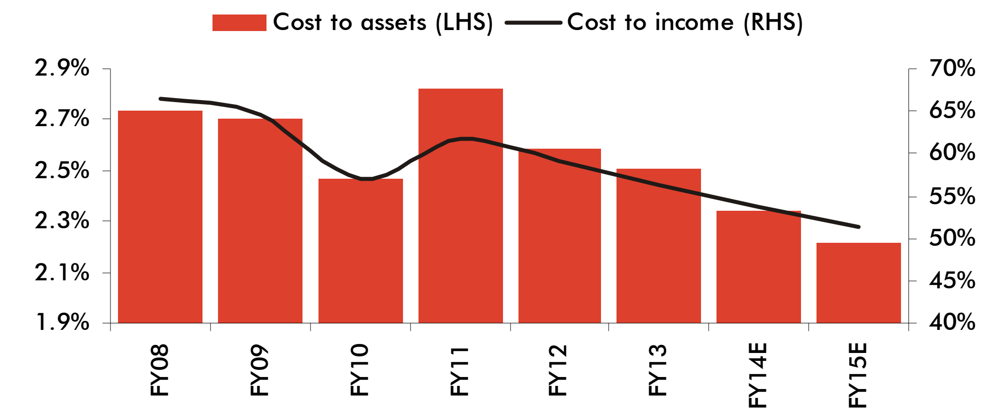


Source: Company, Ambit Capital research

Cost efficiency – traversed some path but some more to cover

IVB's cost-to-income ratio of 2.5% and cost-to-assets ratios of 56% in FY13 are higher than the regional banking peers' average of 1.8% and 45% respectively. However, the bank's cost-to-income ratio and cost-to-assets ratio have consistently declined from 3.3% and 86% in FY06, respectively.

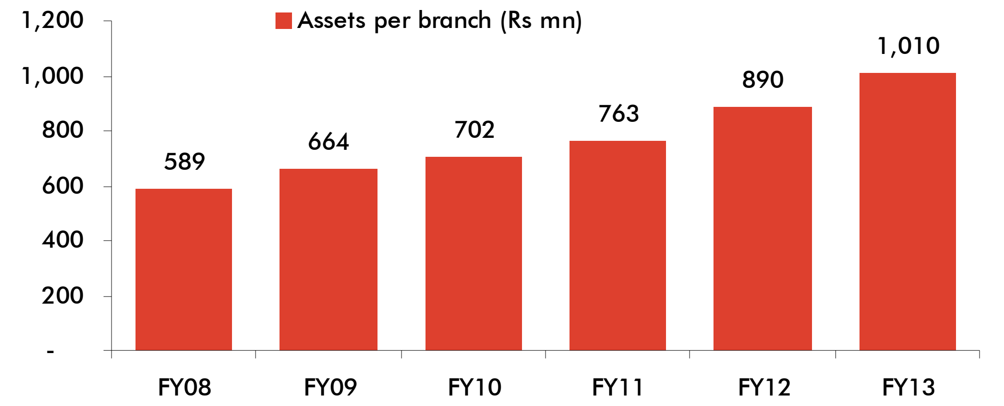
Exhibit 6: IVB's cost ratios have continued to decline



Source: Company, Ambit Capital research

The improvement has been driven by a rise in branch productivity. Assets per branch have increased from ₹664mn in FY09 to ₹1,010mn in FY13. In FY09-13, the number of IVB's branch additions recorded a 3% CAGR, with 15% asset CAGR during the same period. This improvement in branch productivity led to a moderation in the cost-to-assets ratio to 2.5% in FY13 from 2.7% in FY09. Furthermore, improvement in the income-to-assets ratio, due to NIM expansion and steady non-interest income, led to a faster decline in the cost-to-income ratio from 65% in FY09 to 56% in FY13.

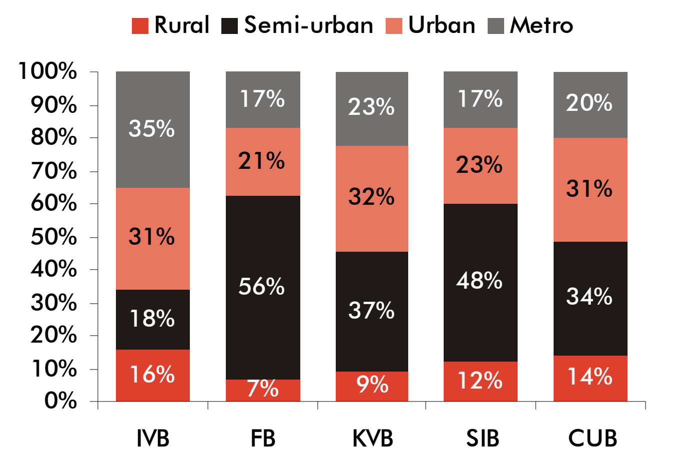
Exhibit 7: IVB's improving branch productivity



Source: Company, Ambit Capital research

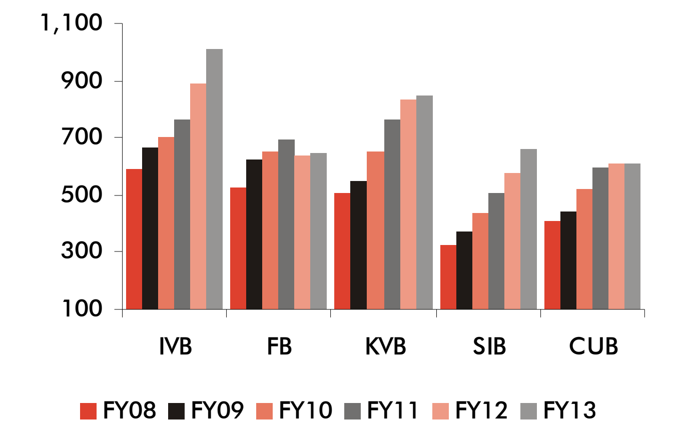
IVB has the highest assets/branch ratio among its peers, but IVB still has a higher scope of improving its branch productivity than its peers. Note that IVB has a higher proportion of urban/metro branches vs its peers (see Exhibit 8 below) and urban/metro branches have higher assets per branch than rural/semi-urban branches.

Exhibit 8: ING has a higher share of urban/metro branches than its peers



Source: RBI, Company, Ambit Capital research

Exhibit 9: Faster improvement in productivity vs peers - assets per branch (₹ mn)

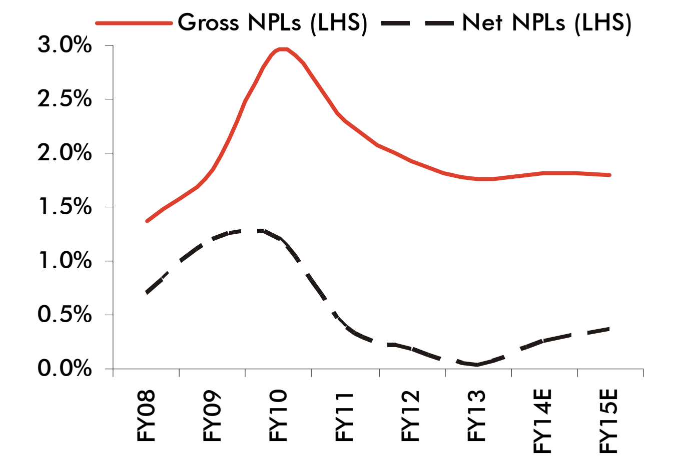


Source: Company, Ambit Capital research

Improved asset quality amid difficult macroeconomic conditions

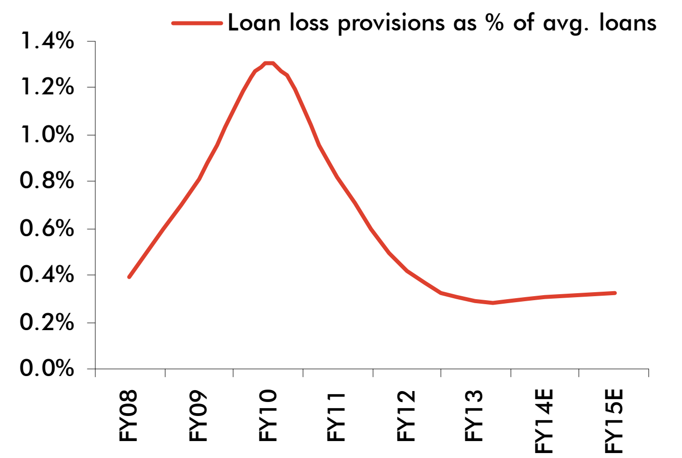
IVB's loan loss provision reduced from an average of ~100bps over FY09-11 to 42bps in FY12 and 29bps in FY13. The lower net delinquencies of ~20bps over FY12-13 were significantly lower than IVB's average of ~110bps over FY09-11 and regional banking peers' average of ~75bps in FY13. These lower net delinquencies have been the key driver of reduced loan loss provisions.

Exhibit 10: Decreasing gross and net NPAs



Source: RBI, Company, Ambit Capital research

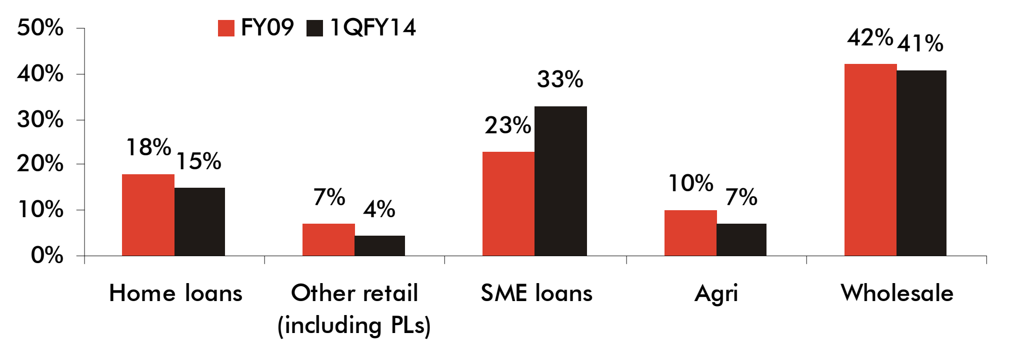
Exhibit 11: Decreasing credit costs



Source: Company, Ambit Capital research

In FY08-10, IVB's higher exposure to the unsecured personal loans and mid-corporate segment led to higher NPAs and hence higher credit costs. However, IVB de-risked its loan book in FY09-13 in favour of collateralised relationship-based SME lending, secured consumer finance and short-term working capital corporate loans, which have benefited the bank in the current economic downturn.

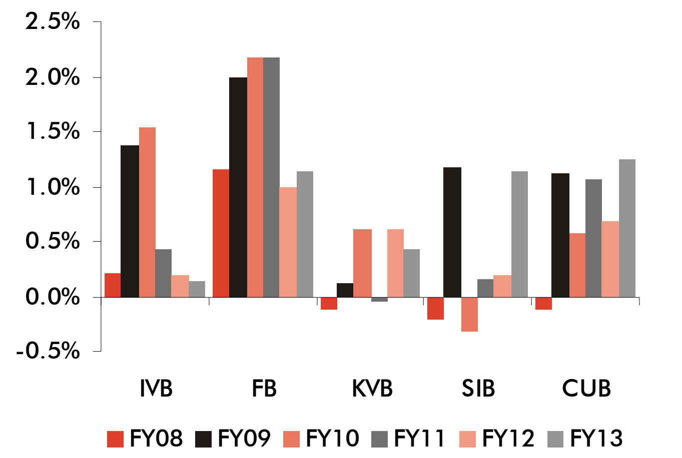
Exhibit 12: Share of individual segments in total loans – collateralised SME lending has gained the most share



Source: Company, Ambit Capital research

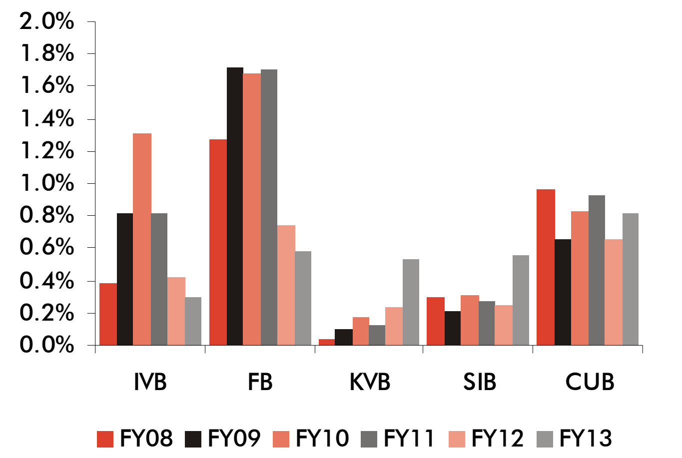
The de-risking of the loan book coupled with negligible exposure to the stressed sectors of the economy (e.g. infrastructure loans and project finance loans) has led to a better asset quality performance than its peers.

Exhibit 13: The trends in net delinquency



Source: Company, Ambit Capital research

Exhibit 14: The trend in credit costs (loan loss provisions)



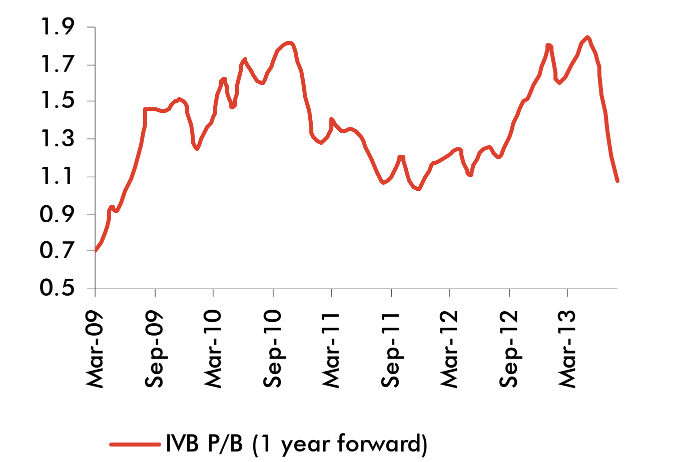
Source: Company, Ambit Capital research

A consistent execution led to rerating

Consistent trends of improved asset quality along with a structural improvement in RoAs/RoEs over the last three years in a tough economic environment led to a substantial rerating of IVB during the last year. In last three months however, valuation has declined in-line with wider sell off in financial stocks.

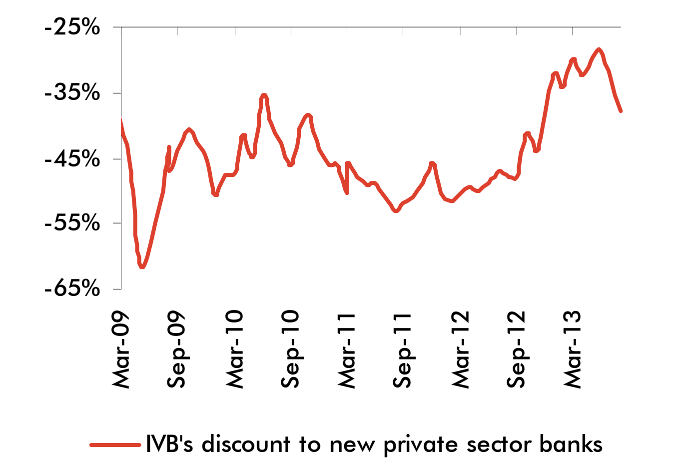
More importantly, the difference between IVB's P/B multiple and private sector banks' average P/B multiple has narrowed over the last one year, whereas IVB's P/B multiple vs the rest of the regional banks has expanded.

Exhibit 15: Rerating of the stock over the last four years



Source: Company, Ambit Capital research

Exhibit 16: IVB's valuation (P/B) discount to new private sector banks



Source: Company, Ambit Capital research

Can the bank bridge the gap to new private sector banks?

Over the last one year, IVB has bridged some of the valuation gap to new private sector banks, as its structural trends of improving profitability, resilient asset quality and better-than-system assets growth became increasingly visible.

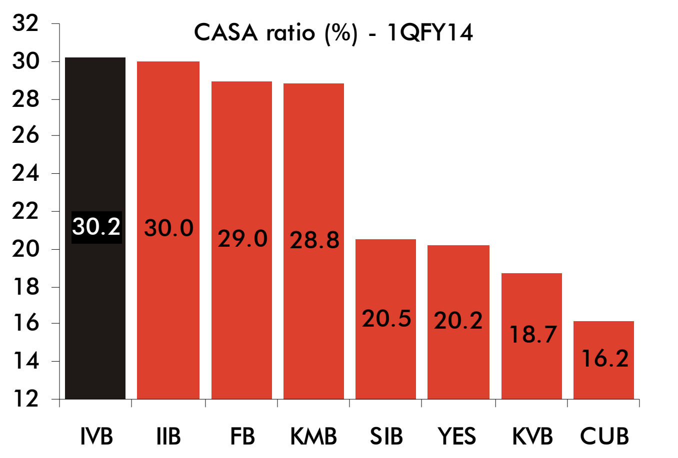
As the external environment for banks has continued to deteriorate (as reflected in slowing GDP growth, rising delinquencies and restructuring for the wider banking system and now the sharp increase in wholesale rates), the below-mentioned three key factors would determine whether ING Vysya Bank can bridge the gap to private sector banks in terms of profitability and hence valuation multiples:

1. Improvement in the quality of its liability franchise
2. Containment of asset quality risks
3. Improvement of the cost ratios

1. Liability franchise – branch expansion to strengthen the liability franchise

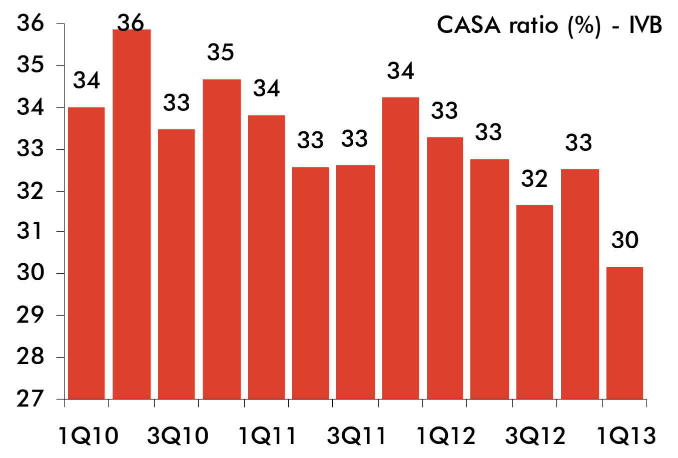
With a CASA ratio of 30.2% as at June 2013, IVB has one of the strongest low-cost deposits franchise among mid- and small-sized banks in India. The trend in the CASA ratio has, however, deteriorated gradually in recent quarters (see Exhibit 18).

Exhibit 17: CASA ratio at end-1QFY14



Source: Company, Ambit Capital research

Exhibit 18: IVB – the trend in CASA ratio



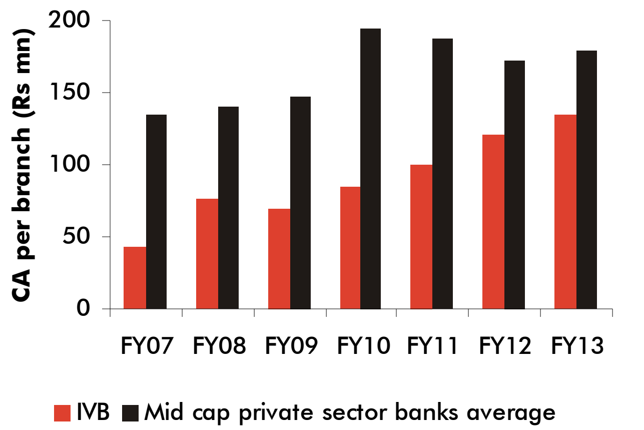
Source: Company, Ambit Capital research

IVB was focused on raising the productivity of its existing branch network, and thus, it has been slow on branch expansion in recent years. Moreover, the existing network had limited opportunities to improve savings accounts productivity. Thus, the CASA ratio has weakened in recent times.

Exhibits 19 and 20 below show IVB's progress on raising branch productivity. On current account (CA) balances per branch, IVB has closed the gap with mid-cap private banks' average from 68% in FY07 to 25% at end-FY13. Given that a large share of branch network is still geographically concentrated (67% in south India), we believe further progress on CA productivity would be limited, and the bank would now begin expanding its branch network.

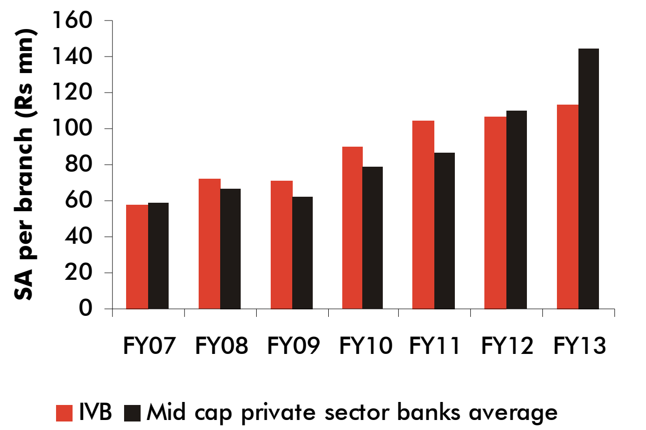
On savings account (SA) balances per branch, IVB has been very competitive vis-à-vis its mid-cap private sector bank peers (see Exhibit 20 below). However, since the deregulation of savings bank deposit interest rates in October 2011, followed by increases in the savings deposits interest rate by Kotak Mahindra Bank, Yes Bank and IndusInd Bank, IVB has fallen behind these mid-cap private sector bank peers in savings account mobilisation per branch in FY13 (see Exhibit 20 below).

Exhibit 19: The current account (CA) balances per branch – IVB vs three mid-cap private banks' average



Source: Company, Ambit Capital research; Note: Kotak Mahindra Bank, Yes Bank and IndusInd Bank have been considered.

Exhibit 20: The savings account (SA) balances per branch – IVB vs three mid-cap private banks' average



Source: Company, Ambit Capital research; Note: Kotak Mahindra Bank, Yes Bank and IndusInd Bank have been considered.

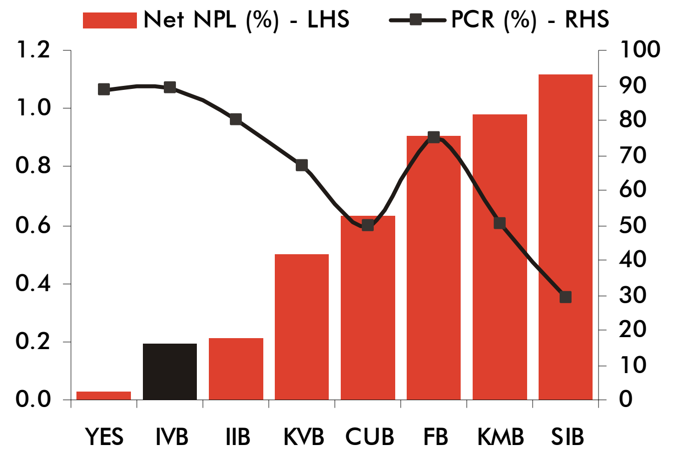
Thus, a slowdown in savings account mobilisation has led to a moderation in the CASA ratio. The bank has been slow on branch network expansion and the existing network has shown limited opportunities to improve the penetration of savings accounts. However, this has been slightly offset by rising branch CA productivity, which has moderated the decline in the CASA ratio.

Given that IVB has closed most of the gap on CA productivity with its peers and is looking to expand the branch network now, we expect SA mobilisation to pick up. We expect IVB to open ~70 new branches in FY14 and FY15 combined (as against management's guidance of adding ~40 branches per annum on average). IVB currently has 547 branches. The bank has not indicated any increase in interest rates on savings deposits so far. However, as IVB opens new branches and tries to close the gap with its peers on the savings balances productivity of its branches that were opened up during FY13, the bank could actively consider raising the savings deposit rates. We have not built in an increase in the savings deposits interest rate in our estimates, as of now. We expect IVB to deliver average CASA ratio of 31% over FY14-15 (vs 32.5% in FY13).

2. Containing asset quality risks

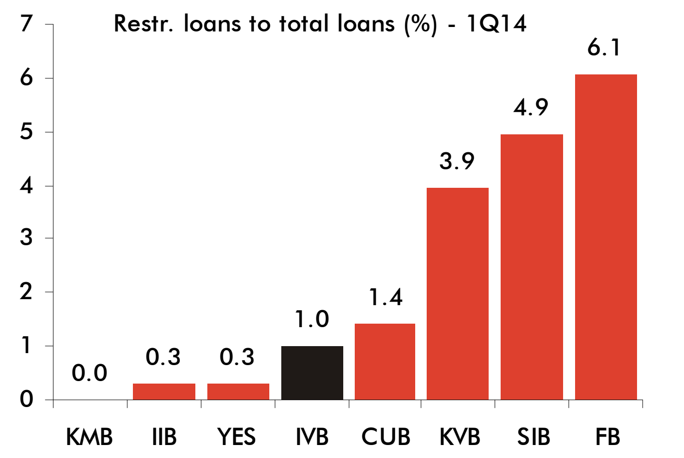
A comparison of ING Vysya Bank with other mid-sized private sector banks and regional banks highlights IVB's superior asset quality profile on low NPL ratios, high provision coverage ratio and low levels of restructured loans (see Exhibits 21 and 22). After the capital raise of ₹18.4bn in July 2013, the bank's tier-I ratio is strong at 14%, second only to Kotak Mahindra Bank's 16.9%.

Exhibit 21: NPL ratio comparison (1QFY14)



Source: Company, Ambit Capital research

Exhibit 22: Restructured loans



Source: Company, Ambit Capital research

However, external business conditions continue to be challenging due to the macroeconomic slowdown. In 1QFY14, IVB's net delinquencies, at 168bps, increased as compared to the less than 50bps recorded in the last three years. Two chunky slippages in the mid-corporate segment accounted for ~82% of fresh slippages in 1QFY14. Business banking (SME) and consumer finance, accounting for 52% of consumer assets, maintained their superior asset quality.

We build in elevated net slippages of 45-50bps over FY14-15E (vs 14bps in FY13 and 20bps in FY12). The high provision coverage ratio (currently at 89%), however, moderates the P&L impact, as we expect credit costs to remain stable at 30-35bps over FY14-15E.

As asset quality performance is also contingent upon external factors, we have built in a stress-case scenario to visualise the worst-case impact on profitability and capital ratios of the bank. For the stress case, we assume FY14 gross delinquency of 3% (as against the FY11-13 average of 0.7-1.3%) and FY14 net delinquencies of 1.5% (as against FY11-13 peak of 0.1-0.4%). IVB's coverage ratio in FY09 was, however, at 36% as compared to 89% in end-1QFY14. Our stress-case scenario shows that IVB can deliver average RoAs/RoEs of 1.0%/10% versus our base-case estimate of 1.3%/12%. Under the stress-case scenario, the tier-I capital ratio at end-FY15 is 12.1%, which is comfortable and does not indicate any capital risk.

Exhibit 23: Stress test from elevated delinquencies

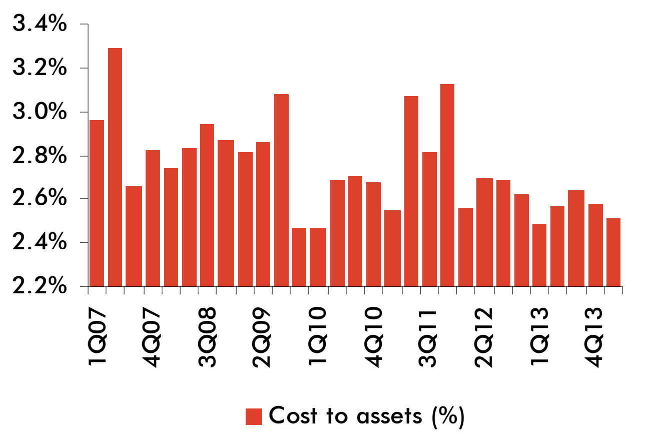
	FY12	FY13	FY14E	FY15E	FY14E	FY15E
			Base case		Stress case	
Gross delinquencies	0.74%	0.68%	1.00%	1.00%	3.00%	3.00%
Net delinquencies	0.20%	0.14%	0.53%	0.44%	1.50%	1.31%
Gross NPL	1.93%	1.76%	1.82%	1.79%	2.64%	3.12%
Provision coverage ratio	91%	98%	86%	80%	70%	70%
Net NPL	0.18%	0.03%	0.26%	0.36%	0.81%	0.96%
Credit costs	0.42%	0.29%	0.31%	0.33%	0.62%	0.97%
RoA	1.06%	1.21%	1.25%	1.30%	1.13%	1.05%
RoE	14.3%	14.6%	12.1%	12.5%	11.0%	10.4%
Tier-1 capital ratio	11.2%	10.5%	13.4%	12.5%	13.3%	12.1%
BVPS (₹)	258.1	292.1	376.4	415.5	372.5	402.1

Source: Company, Ambit Capital research

3. Improving the cost ratios

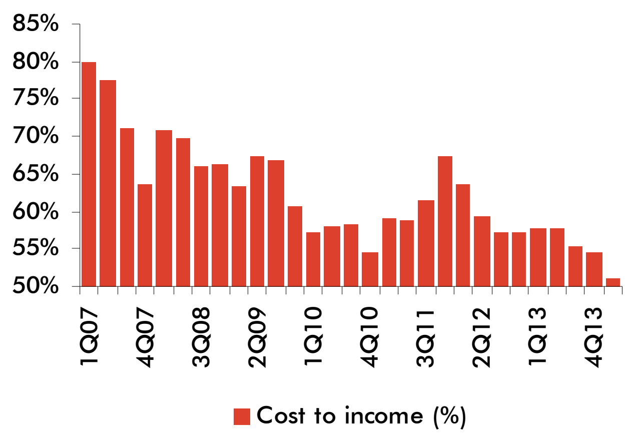
As discussed earlier, IVB's cost-to-assets ratio has improved (see Exhibit 24 below) owing to rising productivity of its branches. The improvement in its cost-to-income ratio (see Exhibit 25 below), has been even better supported by the improvement in income generation of assets. But it remains to be seen if the bank can sustain this trend in the future.

Exhibit 24: Cost-to-assets trend



Source: Company, Ambit Capital research

Exhibit 25: Cost-to-income trend



Source: Company, Ambit Capital research

Nature of branch expansion to support further productivity gains

ING Vysya Bank's branch expansion has been muted in recent years. But 94% of the new branches were opened outside south India in FY09-13. Similarly, 67% and 20% of new branches in FY09-12 were opened in metro and urban centres, respectively (see Exhibit 26). The relatively more diversified branch network has helped IVB to maintain a relatively better liability franchise. Also, given that urban and metro branches have a longer break-even time (up to three years), we believe IVB stands to gain from improving productivity gains over the coming years, which will help sustain the trend of moderating cost ratios.

Exhibit 26: The branches opened in three years (FY10-12) - mix by population centres

	IVB	FB	KVB	SIB	CUB
Rural	0%	7%	6%	9%	6%
Semi-urban	13%	62%	50%	56%	46%
Urban	20%	12%	21%	16%	25%
Metro	67%	18%	24%	18%	23%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Industry, Company, RBI, Ambit Capital research

The management has guided to accelerate its branch network expansion (with 40 new branches in a year, on average). We believe IVB would be initially cautious in accelerating network expansion and would watch out for any deterioration in the cost ratios amid a difficult macro-economic environment. The cost ratios of several regional banks, such as Federal Bank and Karur Vysya Bank, have increased sharply, as their pay-off on branch expansion has lagged the investments made. We expect IVB to open ~20 branches in FY14 and open another 50 branches in FY15. We estimate its cost-to-income ratio to improve to 51% by FY15.

Hence, we expect IVB's RoAs to improve by 10bps over the next two years to 1.3% (vs the current new private sector average of 1.7%), at a time when most peer banks are likely to see RoA compression. We believe this would further narrow the valuation gap between IVB and new private sector banks.

Key assumptions and estimates

Exhibit 27: Key assumptions and estimates for IVB (all figures in ₹mn unless otherwise mentioned)

	FY11	FY12	FY13	FY14E	FY15E	Comments
Assumptions						
YoY loan growth	28%	22%	11%	16%	18%	Loan book CAGR of 17% in FY13-15 owing to continued strength in business banking and rising contribution from consumer finance and agri banking.
Net Interest margin (%)	2.91%	2.95%	3.15%	3.14%	3.15%	We expect stable NIMs of ~3.15% in FY14-15 as decrease in yields due to intense competition would be offset by improvement in loan mix and proceeds from the capital raise. Pick up in branch expansion will sustain healthy CASA deposits.
Opex/Avg Asset ratio (%)	2.82%	2.59%	2.51%	2.34%	2.22%	With measured branch expansion, cost to assets would continue to improve.
Credit costs as a % of Average loan book	0.82%	0.42%	0.29%	0.31%	0.33%	Even though we assume elevated slippages during FY14 and FY15, the current high provision coverage ratio will help to contain the credit costs. However, we do not see any significant deterioration in credit quality due to the bank's low exposure to stressed sectors such as power, infra and telecom and due to its proven risk management performance in the SME book.
Key output						
NII (₹ mn)	10,065	12,084	15,386	18,131	21,167	FY13-15 CAGR of 17% vs FY10-13 CAGR of 23%
Oper. profit (₹ mn)	6,355	7,679	9,927	12,149	14,859	FY13-15 CAGR of 22% vs FY10-13 CAGR of 18%
Profit after tax (₹ mn)	3,186	4,563	6,130	7,501	9,177	FY13-15 CAGR of 22% vs FY10-13 CAGR of 40%
Diluted EPS (₹)	26.3	30.4	39.6	40.6	49.6	FY13-15 CAGR of 12% vs FY10-13 CAGR of 25%
ROA (%)	0.88%	1.06%	1.21%	1.25%	1.30%	
ROE (%)	13.5%	14.3%	14.6%	12.1%	12.5%	

Source: Company, Ambit Capital research

Ambit vs consensus

Exhibit 28: Ambit vs consensus

(₹ mn)	Consensus	Ambit	% gap
Net interest income			
FY14E	19,104	18,131	-5
FY15E	18,131	21,167	-7
Net profit			
FY14E	7,622	7,501	-2
FY15E	9,396	9,177	-2

Source: Bloomberg, Ambit Capital research

Our NII estimates for FY14 and FY15 are lower than consensus estimates, as we build in the impact of tight liquidity on the cost of funding and the relatively downward sticky yield on loans due to a weak demand environment. Our net profit estimates, however, are largely in line with consensus estimates, as we expect the moderation in the cost ratios to lead to improvement in profitability.

Valuation and recommendation

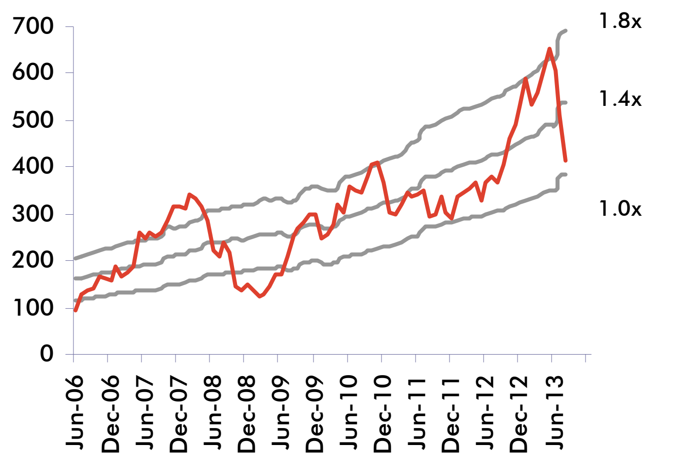
We have valued IVB using the excess return to equity model, which is *'net profit – (cost of equity x average net worth)'* for all the future years **discounted back to August 2014** using cost of equity, and we have added this to net worth at August 2014.

- We have explicitly forecast the net profit for FY14 and FY15 based on the assumptions in Exhibit 27.
- After FY15, we have assumed a sustainable RoA of 1.4% (vs FY14-15 average of 1.25%) and a sustainable leverage of 11.9x (vs average leverage of ~14x over the last four years).
- We have assumed a cost of equity of 14% and terminal growth of 5%.

Based on these assumptions our 'excess return model' gives a one-year forward **target price of ₹626/share**. Our target price **implies one-year forward P/B of 1.6x and one-year forward P/E of 14.0x)**, implying a **50% upside** from current levels.

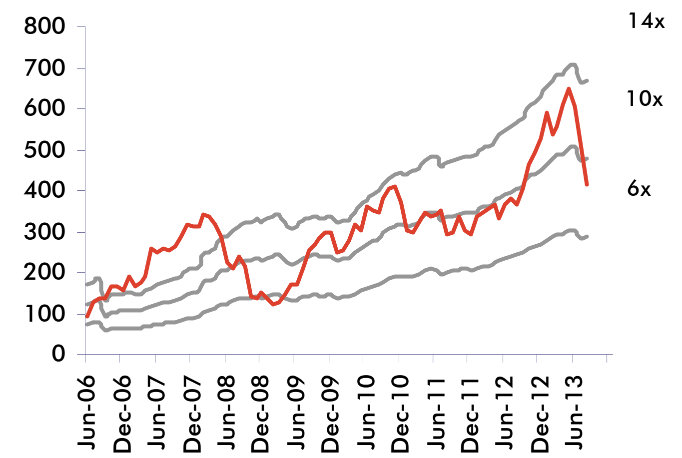
Cross-cycle valuations

Exhibit 17: One-year forward P/B band



Source: Bloomberg, Ambit Capital research.

Exhibit 18: One-year forward P/E band



Source: Bloomberg, Ambit Capital research.

Based on consensus valuations, at 1.1x 12-month forward P/B, IVB is currently trading at a 23% discount to its average cross-cycle P/B of 1.4x P/B. At a valuation of 8.7x 12-month forward earnings, the stock is trading at a 13% discount to its average cross-cycle P/E of 10.0x.

RoA improvement over the last two years led to a rerating of the stock, before the sell-off over the last three months. Given that the bank's RoAs are likely to improve further over the next two years, at a time when RoAs of most peers would decline, we expect the stock to rerate from hereon.

Key risks to our investment thesis

The key risks to our BUY stance on ING Vysya Bank are:

1. Higher-than-expected weakness in the macro-economic environment would affect the credit quality of SME and corporate clients.

2. Continued liquidity tightening would also affect IVB through a higher-than-expected increase in its cost of funds.

Exhibit 19: Explanation for our flags on the cover page

Segment	Score	Comments
Accounting	**GREEN**	We did not find anything unusual in the accounts of the bank and we believe that the reported numbers are a true reflection of the profitability of the bank.
Predictability	**GREEN**	A stable management team, a well-thought vision and strategy by the management and negligible exposure to large ticket-sized loans in stressed sectors ensure that the bank does not throw any negative surprises going forward.
Earnings Momentum	**GREEN**	We expect earnings CAGR of 22% in FY13-15.

Source: Ambit Capital research

Income Statement (Standalone)

Year to March (₹ mn)	FY11	FY12	FY13	FY14E	FY15E
Net Interest Income	**10,065**	**12,084**	**15,386**	**18,131**	**21,167**
Profit on Investments	819	123	308	300	400
Exchange Income	1,021	1,471	1,680	1,932	2,222
Fee & Other Income	4,709	5,104	5,281	5,825	6,691
Non-Interest Income	**6,550**	**6,698**	**7,269**	**8,057**	**9,313**
Total Income	**16,615**	**18,781**	**22,655**	**26,188**	**30,480**
Operating Expenses	10,260	11,102	12,728	14,039	15,622
Pre-provisioning Profits	**6,355**	**7,679**	**9,927**	**12,149**	**14,859**
Loan Loss Provisions	1,718	1,096	880	1,068	1,313
Provisions on Investments	12	-4	87	0	0
Other Provisions	-214	45	-55	50	50
Total Provisions	**1,516**	**1,137**	**912**	**1,118**	**1,363**
PBT	**4,839**	**6,542**	**9,014**	**11,031**	**13,495**
Tax	1,652	1,979	2,885	3,530	4,318
PAT (Pre-Extra ordinaries)	**3,186**	**4,563**	**6,130**	**7,501**	**9,177**
Reported Profits	**3,186**	**4,563**	**6,130**	**7,501**	**9,177**
Dividend	422	796	990	1,514	1,947
Retained Profits	**2,765**	**3,767**	**5,140**	**5,987**	**7,230**

Source: Company, Ambit Capital research.

Balance Sheet (Standalone)

Year to March (₹ mn)	FY11	FY12	FY13	FY14E	FY15E
Equity Capital	1,210	1,501	1,549	1,849	1,849
Reserves & Surplus	23,972	37,246	43,683	67,733	74,963
Deposits	301,942	351,954	413,340	479,474	565,780
Borrowings (Incld. Sub Debt)	41,469	56,965	65,113	73,794	86,571
Other Liabilities	20,504	21,136	23,653	27,199	31,278
Total Liabilities	**389,097**	**468,803**	**547,337**	**650,049**	**760,440**
Investments	110,583	127,155	182,782	212,396	248,349
Net Advances	236,021	287,214	317,720	368,591	434,782
Cash & Equivalents	25,214	32,306	28,335	37,381	44,011
Fixed Assets	3,986	3,974	3,968	4,388	4,753
Other Assets	13,293	18,155	14,531	27,293	28,546
Total Assets	**389,098**	**468,803**	**547,337**	**650,049**	**760,440**

Source: Company, Ambit Capital research

Ratio analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Growth (YoY) (%)					
Deposits	16.7%	16.6%	17.4%	16.0%	18.0%
Advances	27.5%	21.7%	10.6%	16.0%	18.0%
Total Assets	15.2%	20.5%	16.8%	18.8%	17.0%
NII	21.3%	20.1%	27.3%	17.8%	16.7%
Non-Interest Income	11.1%	2.3%	8.5%	10.8%	15.6%
Operating Expenses	27.0%	8.2%	14.6%	10.3%	11.3%
Operating Profits	4.0%	20.8%	29.3%	22.4%	22.3%
Core Operating Profits	4.1%	36.5%	27.3%	23.2%	22.0%
Provisions	-43.9%	-25.0%	-19.8%	22.5%	21.9%
Reported PAT	31.6%	43.2%	34.3%	22.4%	22.3%
Yields / Margins (%)					
Interest Spread (%)	2.50%	2.38%	2.48%	2.38%	2.37%
NIM (%)	2.91%	2.95%	3.15%	3.14%	3.15%
Profitability (%)					
Non-IR to Income (%)	39.4%	35.7%	32.1%	30.8%	30.6%
Cost to Income (%)	61.8%	59.1%	56.2%	53.6%	51.3%
ROA (%)	0.88%	1.06%	1.21%	1.25%	1.30%
ROE (%)	13.5%	14.3%	14.6%	12.1%	12.5%

Source: Company, Ambit Capital research

Asset quality (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Slippages (%)	1.29%	0.74%	0.68%	1.00%	1.00%
Gross NPAs (%)	2.30%	1.93%	1.76%	1.82%	1.79%
Net NPAs (%)	0.39%	0.18%	0.03%	0.26%	0.36%
Provision Coverage (%)	83.4%	90.7%	98.4%	86.0%	80.0%
Specific LLP (%)	0.74%	0.31%	0.28%	0.24%	0.25%
Net NPAs / Networth (%)	3.64%	1.35%	0.20%	1.37%	2.06%

Source: Company, Ambit Capital research

Du-pont analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
NII / Assets (%)	2.77%	2.82%	3.03%	3.03%	3.00%
Other income / Assets (%)	1.80%	1.56%	1.43%	1.35%	1.32%
Total Income / Assets (%)	4.57%	4.38%	4.46%	4.37%	4.32%
Cost to Assets (%)	2.82%	2.59%	2.51%	2.34%	2.22%
PPP / Assets (%)	1.75%	1.79%	1.95%	2.03%	2.11%
Provisions / Assets (%)	0.42%	0.27%	0.18%	0.19%	0.19%
PBT / Assets (%)	1.33%	1.53%	1.77%	1.84%	1.91%
Tax Rate (%)	34.1%	30.2%	32.0%	32.0%	32.0%
ROA (%)	0.88%	1.06%	1.21%	1.25%	1.30%
Leverage (%)	15.3	13.4	12.1	9.7	9.6
ROE (%)	13.5%	14.3%	14.6%	12.1%	12.5%

Source: Company, Ambit Capital research

Valuation (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Shares in issue (mn)	121.0	150.1	154.9	184.9	184.9
EPS (₹.)	26.3	30.4	39.6	40.6	49.6
EPS (YoY) (%)	30.5%	15.4%	30.2%	2.5%	22.3%
PE (x)	15.8	13.7	10.5	10.3	8.4
BV (₹.)	208.1	258.1	292.1	376.4	415.5
BV (YoY) (%)	12.5%	24.0%	13.2%	28.9%	10.4%
P/BV (x)	2.00	1.61	1.42	1.11	1.00
DPS (₹.)	3.0	4.5	5.5	7.0	9.0
Div. yield (%)	0.7%	1.1%	1.3%	1.7%	2.2%

Source: Company, Ambit Capital research

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Banking, Financial Services & Insurance | August 29, 2013

Federal Bank

Bloomberg: FB IN EQUITY
Reuters: FED.BO

BUY

Accounting: GREEN
Predictability: AMBER
Earnings momentum: RED

Structural concerns discounted

We have been toning down our expectation on Federal Bank (FB)'s operating performance even as there has been a tangible improvement in the bank's asset quality, particularly for retail and SME books. Our analysis of FB's geographical concentration and its impact on FB's liability franchise, fee income generation and cost efficiency show that any improvement from hereon would be gradual, and the process could test the management's and investors' patience. However, in the last three months, the stock has underperformed the Bankex by 11% and current valuation of 0.63x FY14 BV seems to discount these long-term structural concerns. Our target price of ₹312, valuing FB at 0.75x FY14 BV, implies 21% upside.

Competitive position: WEAK | **Changes to this position: NEGATIVE**

Deep-rooted inertia: As discussed earlier (page 13-15), geographical diversification is the key to a bank's liability franchise, as it leads to low cost of funds, better income generation and cost efficiencies. FB's management has been focused on addressing asset quality issues but the need to evolve into a more geographically diversified franchise has been neglected. For a bank of FB's size, its concentration in a small state (Kerala) has led to weak operating performance - a low CA ratio (stuck at around 5% for the last 11 years), and a meagre fee income to assets ratio of 0.6%. Weak income generation has led to deterioration in cost ratios (cost to income of 35% in FY09 vs 45% in FY13). The recent exit of a non-executive director suggests a degree of disenchantment in the Boardroom with the bank's progress (http://goo.gl/NC7455). We believe further signs of discontent in the Boardroom of FB cannot be ruled out and could be an overhang on the stock

Lacks levers for profitability improvement: The bank's NIMs are already structurally down (from 4.3% in FY09 to 3.4% in FY13), owing to: (1) de-risking to lower-yielding assets; and (2) deregulation of the non-resident deposits interest rates. The geographical concentration of the branch expansion will hinder low-cost deposit mobilisation and limit the decline in the cost of funds. Fee income to assets would remain subdued at ~0.6%, as opportunities remain limited due to branch concentration. The pressure on income generation, we believe, will keep cost to income at ~45%. Medium-term trends in retail and SME asset quality have indeed improved but the corporate loan segment remains a key risk in the current environment. We build in FY14-15 average credit costs of ~75bps (vs 58bps in FY13 and 74bps in FY12). Profitability will, hence, decline, with RoAs of ~1.1% in FY14-15 (vs 1.3% in FY13 and 1.4% in FY12).

Valuation and stance: The stock has underperformed the Bankex by 11% and current valuation of 0.63x FY14 BV seems to discount these long-term structural concerns. We cut our FY14/15 estimates by 25% and cut our TP by 47% to **₹312**. Our TP implies 0.8x FY14 P/B and 6.5x FY14 P/E.

Key financials (standalone)

Year to March	FY11	FY12	FY13	FY14E	FY15E
Net Revenues (₹ mn)	22,634	24,858	26,391	29,778	33,912
Operating Profits (₹ mn)	14,273	15,065	14,596	16,246	18,816
Net Profits (₹ mn)	5,871	7,768	8,382	8,376	9,865
EPS (₹)	34.3	45.4	49.0	49.0	57.7
RoA (%)	1.23%	1.39%	1.27%	1.08%	1.09%
RoE (%)	12.0%	14.4%	13.9%	12.5%	13.4%
P/B (x)	0.86	0.77	0.69	0.63	0.57

Source: Company, Ambit Capital research

COMPANY INSIGHT

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Recommendation

CMP:	₹257
Target Price (12 month):	**₹312**
Upside (%)	*21%*
EPS (FY14):	₹49.0
Change from previous (%)	*-25%*
Variance from consensus (%)	*-3%*

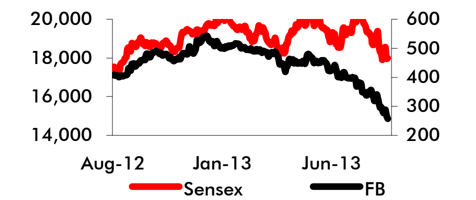
Stock Information

Mkt cap:	₹44bn/US$0.7bn
52-wk H/L:	₹571/239
3M ADV:	₹203mn/US$3.1mn
Beta:	1.1x
BSE Sensex:	17,996
Nifty:	5,285

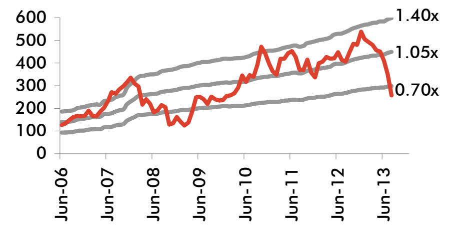
Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(26)	(43)	(36)	(52)
Rel. to Sensex	(17)	(33)	(38)	(45)

Performance (%)

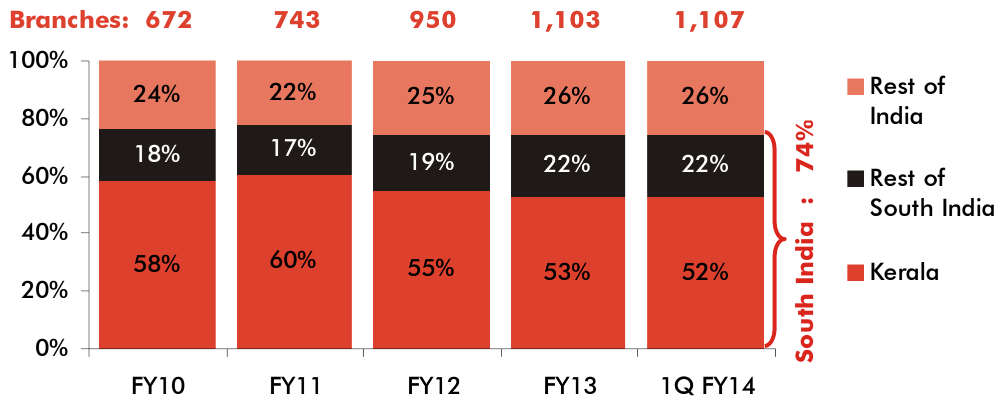


One-year forward P/B



Source: Bloomberg, Ambit Capital research

Exhibit 1: FB's branch mix, by geography in the last four years



Source: Company, Ambit Capital research

Exhibit 2: Key assumptions and estimates for FB (all figures in ₹ mn unless otherwise mentioned)

	New Estimates		Old Estimates		Change (bps/%YoY)		Comments
Assumptions	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	
YoY loan growth (%)	17.1%	18.1%	25%	25%	-790	-690	We build credit growth marginally higher than system credit growth
Net interest margins (%)	2.98%	2.96%	3.38%	3.31%	-40	-35	Our NIM assumptions are lower due to higher cost of funds in a tight liquidity environment.
Opex/avg loan book ratio (%)	45.44%	44.51%	43.50%	42.20%	194	231	We expect cost-to-income ratio to be elevated due to weak income generation.
Provisions as a % of average loan book	0.79%	0.74%	0.81%	0.82%	-2	-8	We have maintained our conservative credit cost estimates,
Outputs (₹ mn)	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	
Net revenues	29,778	33,912	34,489	42,561	-14%	-20%	
Operating profit	16,246	18,816	20,462	25,487	-21%	-26%	
Net Profit	8,376	9,865	11,104	13,344	-25%	-26%	
Diluted EPS (₹)	49.0	57.7	64.9	78	-25%	-26%	
RoE (%)	12.5%	13.4%	16.0%	16.4%	-346	-302	

Source: Company, Ambit Capital research

Ambit vs consensus

Exhibit 3: Ambit vs consensus

(₹ mn)	Consensus	Ambit	% difference
Net interest income			
FY14E	22,713	22,354	-2%
FY15E	27,203	26,031	-4%
Net profit			
FY14E	8,529	8,376	-2%
FY15E	10,517	9,865	-6%

Source: Bloomberg, Ambit Capital research

Our FY14 estimates are largely in line with consensus estimates, but we expect weaker recovery in years beyond FY14 due to the underlying structural issue related to FB's slow progress on geographical diversification.

Absolute valuation

We have valued FB using the excess return to equity model, which is *'net profit – (cost of equity x average net worth)'* for all the future years **discounted back to August 2014** using cost of equity, and added this to net worth at August 2014.

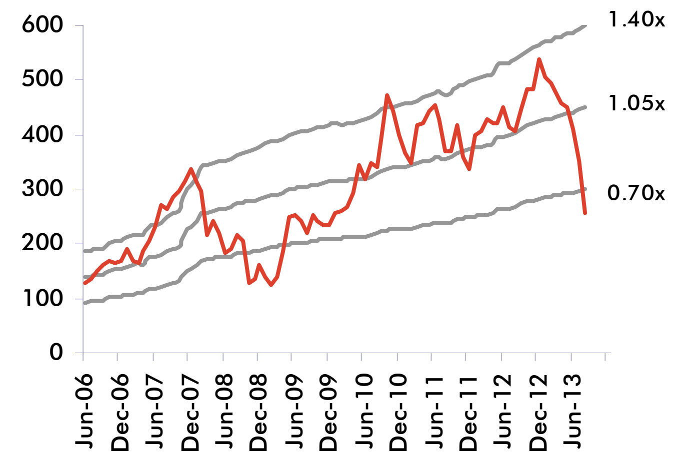
- We have explicitly forecasted net profit for FY14 and FY15 based on the assumptions in Exhibit 2.
- After FY15, we have assumed a sustainable RoA for the bank at 1.0% (vs FY03-15E average of 1.3%) and a sustainable leverage of 13.1x (vs average leverage of ~10.0x over the last six years).
- We have assumed a cost of equity of 15% and terminal growth of 5%.

Based on these assumptions our 'excess return model' gives a one-year forward **target price of ₹312/share** (vs ₹585/share earlier), implying a **21% upside** from current levels. Our target price **implies one-year forward P/B of 0.75x and one-year forward P/E of 6.0x).**

The 47% drop in our valuation is driven by a ~25% downward revision in our EPS estimates. The reduction in earnings estimates is driven by lower loan book growth, lower NIM and higher cost to income estimates as compared to our earlier estimates. Our downbeat expectations on improvement in profitability due to structural challenges on liability franchise also lead to lower valuation multiples.

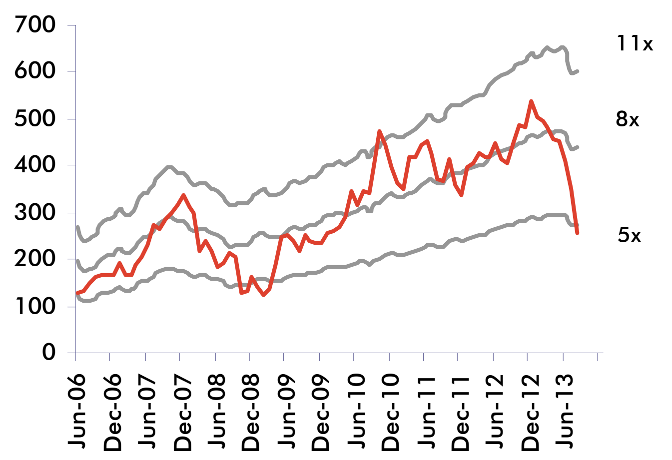
Cross-cycle valuations

Exhibit 17: One-year forward P/B band



Source: Bloomberg, Ambit Capital research

Exhibit 18: One-year forward P/E band



Source: Bloomberg, Ambit Capital research

Based on consensus estimates, at 0.6x 12-month forward P/B and 4.7x 12-month forward earnings, the stock is trading at trough valuations on its average cross-cycle valuation range. Given that the bank's RoAs would continue to moderate, we expect the bank's valuation multiples to remain subdued.

Key risks to our investment thesis

A key risk to our BUY stance is continued pressure on operating performance along with worse-than-expected negative asset quality surprises. Any evidence of discontent in FB's Boardroom about the pace of the bank's progress will also affect the investors' sentiment.

Exhibit 19: Explanation for our flags on FB's main page

Segment	Score	Comments
Accounting	GREEN	We did not find anything unusual in the accounts of the bank and we believe that the reported numbers are a true reflection of the profitability of the bank.
Predictability	AMBER	Deterioration of operating performance and asset quality risk from external environment mean financial performance could be volatile.
Earnings Momentum	RED	Consensus earnings estimates for the bank have been downgraded by ~10% over the last three months.

Source: Ambit Capital research

Income Statement (Standalone)

Year to March (₹ mn)	FY11	FY12	FY13	FY14E	FY15E
Net Interest Income	**17,466**	**19,534**	**19,747**	**22,354**	**26,031**
Profit on Investments	458	821	2,058	1,800	1,200
Exchange Income	572	842	794	992	1,171
Fee & Other Income	4,138	3,661	3,793	4,632	5,509
Non-Interest Income	**5,168**	**5,323**	**6,644**	**7,424**	**7,880**
Total Income	**22,634**	**24,858**	**26,391**	**29,778**	**33,912**
Operating Expenses	8,361	9,793	11,795	13,532	15,095
Pre-provisioning Profits	**14,273**	**15,065**	**14,596**	**16,246**	**18,816**
Loan Loss Provisions	5,032	2,582	2,386	3,779	4,159
Provisions on Investments	111	349	-415	0	0
Other Provisions	111	439	687	150	150
Total Provisions	**5,254**	**3,370**	**2,658**	**3,929**	**4,309**
PBT	**9,018**	**11,695**	**11,938**	**12,317**	**14,507**
Tax	3,147	3,927	3,556	3,942	4,642
PAT (Pre-Extraordinaries)	**5,871**	**7,768**	**8,382**	**8,376**	**9,865**
Reported Profits	**5,871**	**7,768**	**8,382**	**8,376**	**9,865**
Dividend	1,690	1,789	1,801	2,001	2,302
Retained Profits	**4,181**	**5,979**	**6,580**	**6,374**	**7,563**

Source: Company, Ambit Capital research.

Balance Sheet (Standalone)

Year to March (₹mn)	FY11	FY12	FY13	FY14E	FY15E
Equity Capital	1,710	1,710	1,711	1,711	1,711
Reserves & Surplus	49,320	55,299	61,884	68,258	75,822
Deposits	430,148	489,371	576,149	679,855	802,229
Borrowings (Incld. Sub Debt)	18,884	42,410	51,870	61,784	73,681
Other Liabilities	14,446	17,423	18,831	22,220	26,220
Total Liabilities	**514,507**	**606,214**	**710,444**	**833,828**	**979,662**
Investments	145,377	174,025	211,546	245,446	285,793
Net Advances	319,532	377,560	440,967	516,369	609,840
Cash & Equivalents	37,483	35,326	37,200	46,951	55,446
Fixed Assets	2,842	3,207	3,923	4,437	5,017
Other Assets	9,273	16,096	16,808	20,625	23,566
Total Assets	**514,507**	**606,214**	**710,444**	**833,828**	**979,662**

Source: Company, Ambit Capital research

Ratio analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Growth (YoY) (%)					
Deposits	19.3%	13.8%	17.7%	18.0%	18.0%
Advances	18.6%	18.2%	16.8%	17.1%	18.1%
Total Assets	17.8%	17.8%	17.2%	17.4%	17.5%
NII	23.8%	11.8%	1.1%	13.2%	16.5%
Non-Interest Income	-2.7%	3.0%	24.8%	11.7%	6.1%
Operating Expenses	13.5%	17.1%	20.5%	14.7%	11.6%
Operating Profits	18.5%	5.6%	-3.1%	11.3%	15.8%
Core Operating Profits	25.9%	3.1%	-12.0%	15.2%	21.9%
Provisions	52.2%	-35.9%	-21.1%	47.8%	9.7%
Reported PAT	26.4%	32.3%	7.9%	-0.1%	17.8%
Yields / Margins (%)					
Interest Spread (%)	3.13%	2.85%	2.43%	2.35%	2.39%
NIM (%)	3.76%	3.59%	3.09%	2.98%	2.96%
Profitability (%)					
Non-IR to Income (%)	22.8%	21.4%	25.2%	24.9%	23.2%
Cost to Income (%)	36.9%	39.4%	44.7%	45.4%	44.5%
ROA (%)	1.23%	1.39%	1.27%	1.08%	1.09%
ROE (%)	12.0%	14.4%	13.9%	12.5%	13.4%

Source: Company, Ambit Capital research

Asset quality (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Slippages (%)	3.27%	2.19%	2.15%	2.20%	1.80%
Gross NPAs (%)	3.49%	3.35%	3.44%	3.43%	3.39%
Net NPAs (%)	0.60%	0.53%	0.98%	1.16%	1.18%
Provision Coverage (%)	83%	85%	72%	67%	66%
Specific LLP (%)	1.66%	0.64%	0.46%	0.68%	0.64%
Net NPAs / Networth (%)	3.74%	3.49%	6.79%	8.56%	9.28%

Source: Company, Ambit Capital research

Du-pont analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
NII / Assets (%)	3.67%	3.49%	3.00%	2.90%	2.87%
Other income / Assets (%)	1.09%	0.95%	1.01%	0.96%	0.87%
Total Income / Assets (%)	4.76%	4.44%	4.01%	3.86%	3.74%
Cost to Assets (%)	1.76%	1.75%	1.79%	1.75%	1.66%
PPP / Assets (%)	3.00%	2.69%	2.22%	2.10%	2.08%
Provisions / Assets (%)	1.10%	0.60%	0.40%	0.51%	0.48%
PBT / Assets (%)	1.90%	2.09%	1.81%	1.60%	1.60%
Tax Rate (%)	34.9%	33.6%	29.8%	32.0%	32.0%
ROA (%)	1.23%	1.39%	1.27%	1.08%	1.09%
Leverage (%)	9.7	10.4	10.9	11.6	12.3
ROE (%)	12.0%	14.4%	13.9%	12.5%	13.4%

Source: Company, Ambit Capital research

Valuation (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Shares in issue (mn)	171.0	171.0	171.1	171.1	171.1
EPS (₹.)	34.3	45.4	49.0	49.0	57.7
EPS (YoY) (%)	26.4%	32.3%	7.9%	-0.1%	17.8%
PE (x)	7.5	5.7	5.3	5.3	4.5
BV (₹.)	298.3	333.3	371.8	409.0	453.2
BV (YoY) (%)	8.9%	11.7%	11.5%	10.0%	10.8%
P/BV (x)	0.86	0.77	0.69	0.63	0.57
DPS (₹.)	8.4	8.9	9.0	10.0	11.5
Div. yield (%)	3.3%	3.5%	3.5%	3.9%	4.5%

Source: Company, Ambit Capital research

Banking, Financial Services & Insurance

August 29, 2013

Karur Vysya Bank

Bloomberg: KVB IN EQUITY
Reuters: KVB.BO

SELL

Accounting: GREEN
Predictability: AMBER
Earnings momentum: RED

Losing momentum

Karur Vysya Bank's (KVB) RoAs have declined to 1.3% in FY13 from an average of 1.6% over FY06-11, due to constraints on its liability side, rising cost ratios and increasing credit costs. KVB continues to seek growth amidst a slowing macro-economic environment. We believe unabated pressure on margins, cost ratios and asset quality would lead to a further decline in RoAs. The stock is trading at inexpensive valuations of 1.0x FY14 BV but near-term positive catalysts are scarce. We initiate coverage with a SELL stance.

Competitive position: MODERATE   **Changes to this position: STABLE**

Losing momentum: KVB delivered average RoAs of 1.6% along with asset CAGR of 26% in FY06-11. However, its RoAs have moderated to 1.3% in FY13, owing to: (1) continued weakness in its liability franchise (CASA to borrowed funds declined from 23% in FY11 to 17% in FY13), (2) increase in the cost-to-income ratio (from 42% in FY11 to 47% in FY13), and (3) rising credit costs (from 13bps in FY11 to 53bps in FY13).

RoA moderation to continue: RoAs would decline by 30bps to 1% over the next two years, owing to: **(i)** continued geographical concentration of branches, which means that the CASA ratio would remain weak and put pressure on margins amidst the phase of tight liquidity; **(ii)** the management's continued branch expansion plans, which would put pressure on cost ratios, as productivity of the new branches would remain limited in the weak economic environment; and **(iii)** credit costs that have been rising from the trough levels (average 13bps in FY08-12 to 53bps in FY13) would remain elevated given the 69% loan exposure to the corporate and commercial segments. A significant chunk of these loans are towards the mid-corporate and consortium loan corporate segments. KVB's delinquency levels have increased in recent quarters owing to this exposure.

Initiate with SELL stance and a target price of Rs320: We initiate coverage with a SELL stance and a valuation of Rs320 (implied FY14E P/ABV of 1.0x and FY14 P/E of 6.3x) based on the EVA approach. Our EVA model assumes sustainable steady-state RoEs of 15% beyond the next three years and a cost of equity of 15%. The rise in credit cost will be the main driver of RoA moderation but the geographically concentrated nature of the rapid branch expansion will affect the operating performance of the bank as well. Key risks to our SELL stance are a better-than-expected economic recovery, particularly in Tamil Nadu, and a reversal in its current strategy of pursuing rapid growth in favour of productivity improvement.

Key financials (standalone)

Year to March	FY11	FY12	FY13	FY14E	FY15E
Net Revenues (₹ mn)	10,312	12,673	16,110	19,507	22,985
Operating Profits (₹ mn)	6,006	7,257	8,488	9,993	11,546
Net Profits (₹ mn)	4,156	5,017	5,503	5,440	6,199
EPS (₹)	44.0	46.8	51.3	50.8	57.8
RoA (%)	1.66%	1.52%	1.30%	1.06%	1.01%
RoE (%)	22.3%	20.8%	19.0%	16.7%	17.0%
P/B (x)	1.39	1.23	1.08	0.97	0.86

Source: Company, Ambit Capital research

INITIATING COVERAGE

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Recommendation

CMP:	₹310
Target Price (12 month):	**₹320**
Upside (%)	*3%*
EPS (FY14):	₹51
Variance from consensus (%)	*-14%*

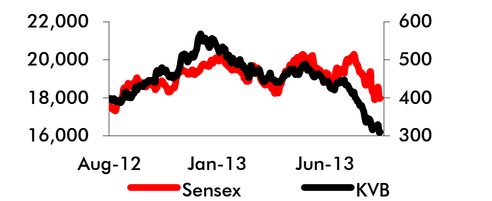
Stock Information

Mkt cap:	₹33bn/US$0.5bn
52-wk H/L:	₹592/298
3M ADV:	₹34mn/US$0.5mn
Beta:	0.7x
BSE Sensex:	17,996
Nifty:	5,285

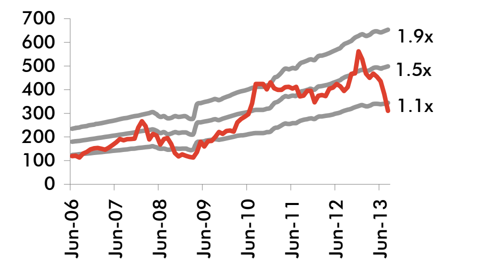
Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(21)	(34)	(22)	(45)
Rel. to Sensex	(12)	(23)	(24)	(37)

Performance (%)



1-year forward P/BV



Source: Bloomberg, Ambit Capital research

Company Financial Snapshot

Profit and Loss (standalone, ₹ mn)

	FY13	FY14E	FY15E
Net Interest Income	11,585	13,735	16,561
Other Income	4,526	5,772	6,424
Total Income	16,110	19,507	22,985
Operating Expenditure	7,622	9,514	11,439
Operating Profit	8,488	9,993	11,546
Write-offs & Provisions	1,234	2,331	2,690
PBT	7,254	7,662	8,856
Tax	1,751	2,222	2,657
PAT (pre Ins. & MI)	5,503	5,440	6,199
EPS (₹)	51.3	50.8	57.8
BVPS (₹)	287.8	321.1	360.2
PAT Growth	9.7%	-1.1%	14.0%
EPS Growth	9.7%	-1.1%	14.0%
RoA	1.30%	1.06%	1.01%
RoE	19.0%	16.7%	17.0%

Company Background

Karur Vysya Bank (KVB) is an old private sector bank, with a business concentration in two south Indian states—Tamil Nadu and Andhra Pradesh (accounting for 65% of the loan book). The trading communities from these two states form the bank's core client base. The bank largely advances working-capital-based loans against collateral.

Year	Event
1916	Incorporation of KVB in Karur, a textile town in Tamil Nadu
2006	Issue of bonus share in the ratio of 1:1
2007	Rights issue of Rs1.3bn
2009	Appointment of BCG to revamp business plans and drive restructuring
2010	Issue of bonus share in the ratio of 2:5
2011	Rights issue of Rs4.6bn

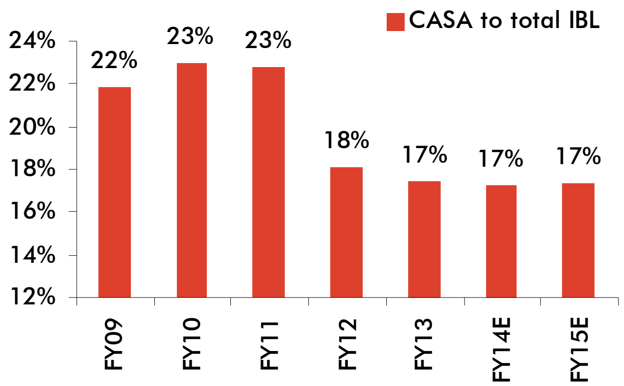
Balance Sheet (standalone, ₹ mn)

	FY13	FY14E	FY15E
Sources of funds			
Equity Capital	1,072	1,072	1,072
Reserves & Surplus	29,780	33,339	37,532
Deposits	386,530	463,836	556,603
Borrowings (Incl Sub Debt)	39,993	49,617	61,646
Other Liabilities	9,958	11,751	13,866
Total Liabilities	**467,333**	**559,614**	**670,719**
Investments	138,373	162,890	192,621
Net Advances	294,801	356,037	430,093
Cash & Equivalents	17,960	21,845	26,573
Fixed Assets	3,221	3,717	4,288
Other Assets	12,978	15,124	17,143
Total Assets	**467,333**	**559,614**	**670,719**

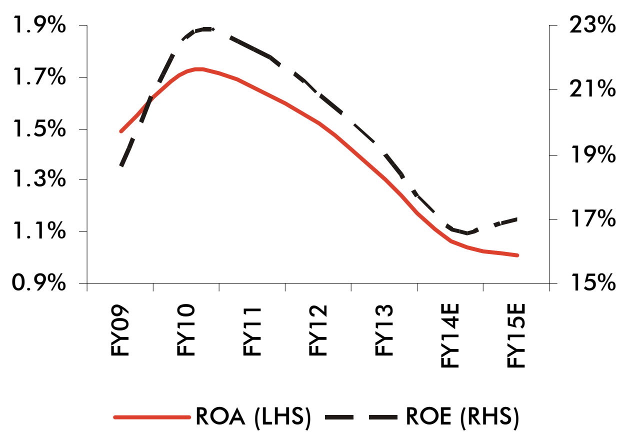
Key Ratios (standalone)

	FY13	FY14E	FY15E
Net Interest spreads	2.36%	2.34%	2.39%
NIMs	2.84%	2.77%	2.78%
Non Interest Income/Avg assets	1.07%	1.12%	1.04%
Opex to Avg Assets	1.81%	1.85%	1.86%
Cost to income	47.3%	48.8%	49.8%
Credit Costs	0.53%	0.70%	0.67%
Gross NPAs (%)	0.96%	1.47%	1.77%
Provisioning coverage (%)	62%	64%	64%
Tier – I ratio	13.1%	11.9%	10.9%
P/B (x)	1.08	0.97	0.86
P/E (x)	6.0	6.1	5.4

Appears constrained on liabilities side



RoA/RoE moderation to continue



Source: *Ambit Capital research*; IBL = Interest Bearing Liabilities

Exhibit 1: SWOT analysis for Karur Vysya Bank (KVB)

Strengths	Weaknesses
▪ The 96-year history of operations in the state of Tamil Nadu has helped the bank build long-term relationship banking with niche SME clientele. Thus, the bank has healthy yields and better control on asset quality. ▪ Strong capital position (tier-I capital ratio of 13.1%) allows the bank to pursue branch expansion and provides a capital cushion in a difficult external environment.	▪ KVB has a weak liability franchise. Its CASA ratio (at only 19% of its total deposits and 17% of its total borrowings) is weaker than its peers. ▪ KVB has a weak presence in retail loans. (It is essentially an SME bank on the 'assets' side of the balance sheet.)
Opportunities	**Threats**
▪ Tamil Nadu offers a relatively lucrative opportunity in south India for KVB due to the lower penetration of banking in this state. ▪ Using its experience in long-term relationship banking, KVB could strengthen its retail banking franchise.	▪ The bank faces rising competition from large PSU and private sector banks for SME loans. ▪ Geographical concentration in one state exposes the bank to a state-specific economic slowdown. ▪ Similarly, exposure to corporate loans through consortium lending exposes the bank to asset quality risks

Source: Ambit Capital research

Losing momentum

Karur Vysya Bank has a 96-year history of operations in the state of Tamil Nadu, which accounts for 51% of its branches and 44% of its total business (deposits and advances combined). KVB had a record of superior profitability. It delivered average RoAs of 1.6% over FY06-11. However, RoAs have moderated to 1.3% in FY11-13, owing to: (1) constraints on the liability franchise putting pressure on the cost of funds, (2) deterioration in operational efficiency, and (3) increase in credit costs on a low base.

Exhibit 2: RoA/RoE trend

	FY09	FY10	FY11	FY12	FY13
Net Interest Income	2.59%	2.90%	3.06%	2.79%	2.75%
Other Income	1.68%	1.27%	1.05%	1.06%	1.07%
Total Income	**4.19%**	**4.33%**	**4.57%**	**4.38%**	**3.82%**
Operating Expenses	1.63%	1.79%	1.72%	1.64%	1.81%
Pre-provisioning profits	**2.64%**	**2.38%**	**2.39%**	**2.20%**	**2.01%**
Provisions	0.55%	0.19%	0.16%	0.28%	0.29%
PBT	**2.09%**	**2.18%**	**2.24%**	**1.92%**	**1.72%**
Tax	0.60%	0.46%	0.58%	0.40%	0.42%
PAT – RoA	**1.49%**	**1.72%**	**1.66%**	**1.52%**	**1.30%**
Leverage (x)	12.5	13.1	13.4	13.7	14.6
RoE	**18.6%**	**22.6%**	**22.3%**	**20.8%**	**19.0%**

Source: Company, Ambit Capital research

Liability franchise has weakened

The quality of KVB's liability franchise has deteriorated over the last two years, with the share of low-cost CASA deposits in total interest-bearing liabilities falling from 23% in FY11 to 17% in FY13.

To counter this, KVB accelerated its branch expansion over the last two years and opened 185 new branches (around a third of its total branches of 554). However, the bank's focus continues to be on the state of Tamil Nadu, which accounted for 45% of these new branches. As discussed in the thematic section, this geographical concentration of branches is a hindrance in improving the quality of its liability franchise.

Exhibit 3: Liabilities breakup

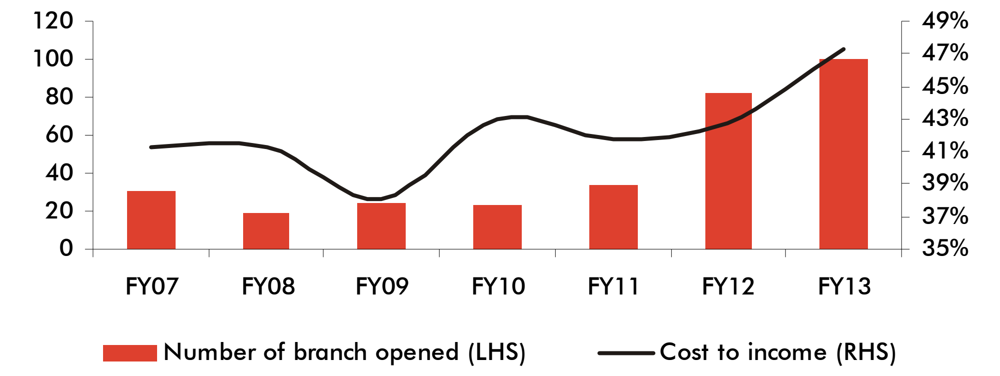
	FY09	FY10	FY11	FY12	FY13
Net Worth	7.9%	7.4%	7.5%	7.2%	6.6%
Deposits	88.5%	87.9%	87.6%	85.3%	82.7%
of which: CASA	**19.4%**	**20.7%**	**20.4%**	**16.3%**	**15.9%**
of which: Current Account	8.8%	9.3%	8.9%	6.6%	6.5%
Savings Account	10.6%	11.3%	11.5%	9.8%	9.4%
Term Deposits	69.1%	67.2%	67.2%	69.0%	66.8%
Borrowings	0.1%	2.2%	1.9%	5.2%	8.6%
Other Liabilities and Provisions	3.4%	2.6%	3.0%	2.2%	2.1%
Total Liabilities	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Company, Ambit Capital research

Cost ratio under pressure due to branch expansion in a difficult environment

Over FY07-11, KVB delivered a low cost-to-income ratio of 41%, which was a key driver of healthy RoAs of ~1.6%. In the last two years, KVB has accelerated its branch expansion (see Exhibit 4 below). However, due to delayed gains in income productivity amidst the macro-economic slowdown, the cost-to-income ratio has deteriorated (see Exhibit 4 below).

Exhibit 4: KVB's branch expansion and cost-to-income ratio

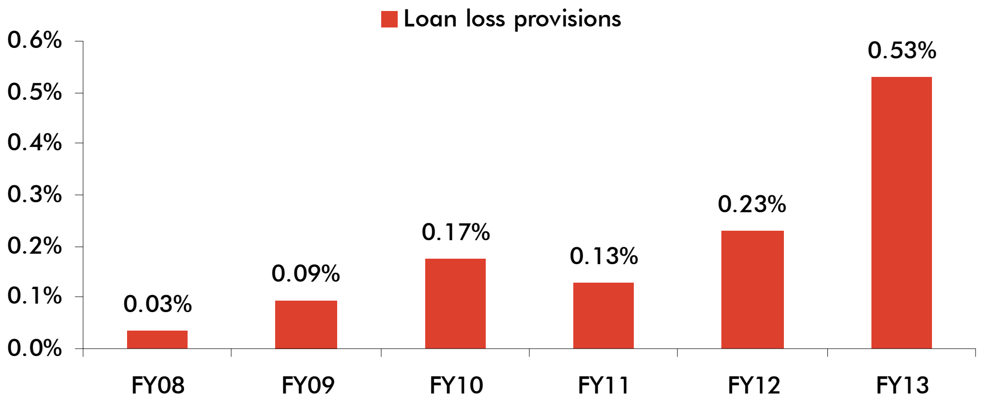


Source: Company, Ambit Capital research

Credit costs rising on a low base

The bank delivered average credit costs of only ~21bps in FY06-12. KVB has seen incremental stress on its asset quality, with credit costs rising to 53bps in FY13 and 200bps in 1QFY14. The mid-corporate and SME segments have seen higher delinquencies in recent quarters.

Exhibit 5: KVB's loan loss provisions have risen from the trough levels

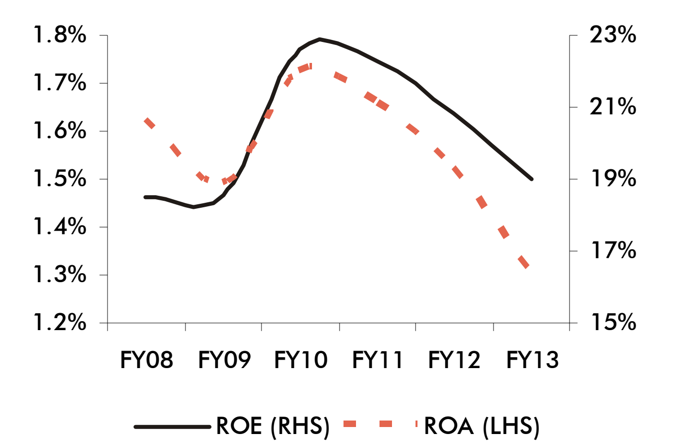


Source: Company, Ambit Capital research

The decline in profitability has led to stock price underperformance

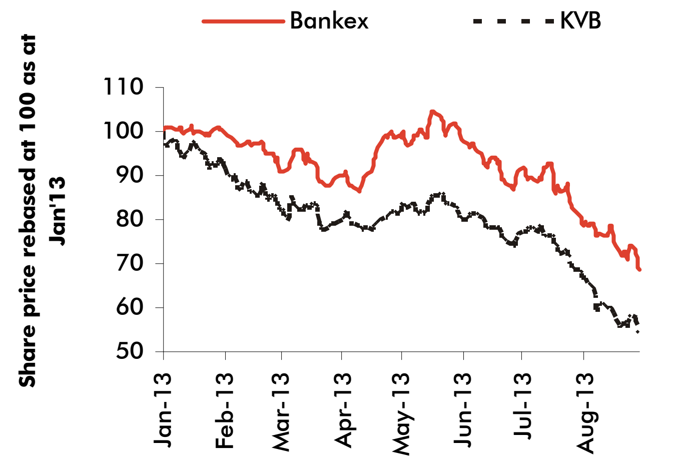
KVB's stock has underperformed the Bankex by 14% in 2014 YTD. As the pressure on KVB's profitability has become increasingly evident, the stock's relative performance to the broader banking benchmark has suffered.

Exhibit 6: KVB's RoAs and RoEs have been moderating in the last three years



Source: Company, Ambit Capital research

Exhibit 7: Decline in profitability has resulted in the recent underperformance to the Bankex



Source: Company, Bloomberg, Ambit Capital research

RoAs to moderate further

Karur Vysya Bank stands at the proverbial cross-roads. The management can choose to keep pursuing the rapid scale-up, which comes with significant risks on asset quality and deterioration in operational efficiency. (In the last two years, it has opened 182 branches with 29% asset CAGR.) On the other hand, the management could chose to shift focus on raising productivity of the existing network after two years of rapid expansion.

Recent management commentary, however, suggests that branch expansion (60-70 branches in a year) is likely to continue, with Tamil Nadu and Andhra Pradesh continuing to be the key focus states. The management also expects its loans and deposits to record a 25% CAGR over the next couple of years.

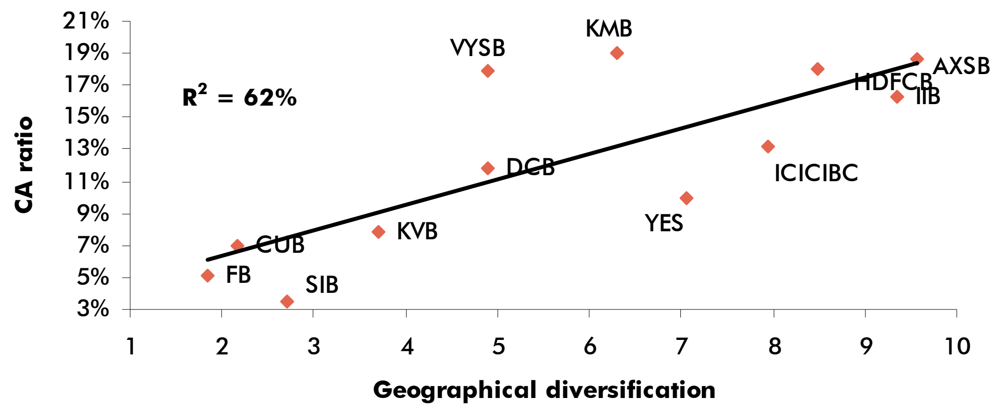
We believe that the pursuit of this level of growth in the current environment will lead to the current trend of RoA moderation to continue over the next two years. RoAs would moderate to ~1.0% over FY14-15 (vs RoAs of 1.3% in FY13). The main drivers of this moderation are:

- Continued margin compression due to constraints on the liability franchise
- Elevated cost to assets
- Rise in loan loss provisions

Margins to remain suppressed due to constraints on the liabilities side

As discussed earlier (on page 15), our analysis of Indian banks' quality of liability franchise (measured in current accounts to total deposits ratio (CA ratio)) and geographical diversification shows the significance of geographical diversification for a better CA ratio. A better geographical diversification, in turn, leads to lower cost of funds as well as better fee income and lower cost-to-income ratio.

Exhibit 8: The correlation between Indian private sector banks' geographical diversification* and CA ratio

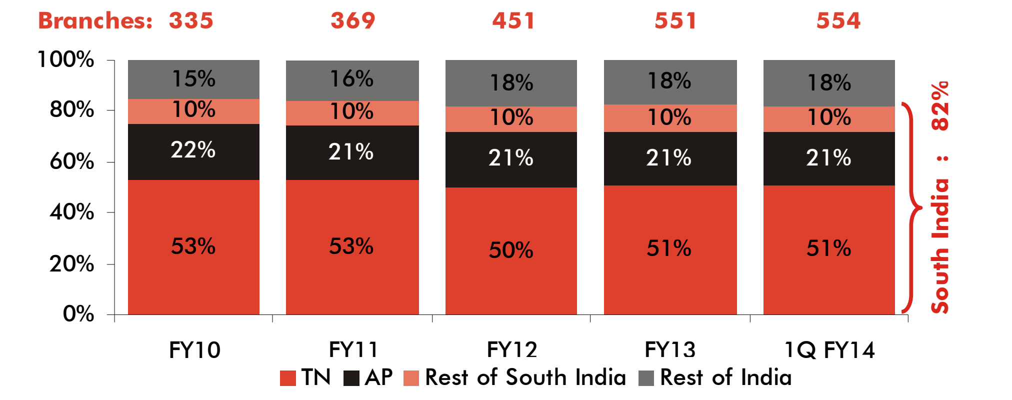


*Source: Company, RBI, Ambit Capital research. Note: * Please see the Appendix for our definition and calculation of banks' geographical diversification score*

KVB has rapidly expanded its branch network since FY11 (see Exhibit 9 below) but the geographical mix has remained largely unchanged and it still has a very high 82% of its branches in south India.

A comparison of four south Indian states (turn to page 28) shows that Tamil Nadu indeed offers better opportunities due to the lower penetration of banks as compared to other states. Hence, KVB's focus on Tamil Nadu is understandable. This provides sufficient opportunities on the assets side for KVB, but improvement on the liability side will continue to be minimal in the absence of any meaningful diversification outside Tamil Nadu.

Exhibit 9: KVB's branch mix, by geography, in the last four years



Source: Company, Ambit Capital research

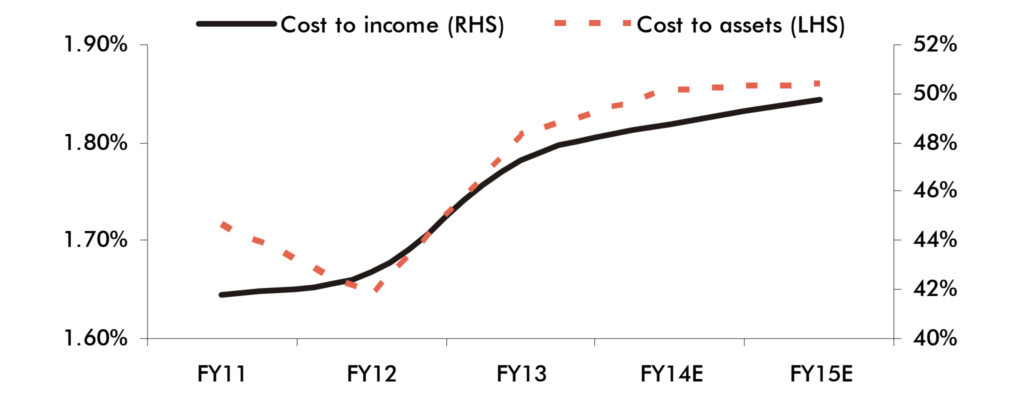
Given that the management strategy on future branch expansion also remains geared to Tamil Nadu, we do not expect the CASA ratio to materially improve in the near term. We build in a flat CASA ratio of ~19% over FY14-15.

The impact of weakness in the liability franchise is likely to be more acute in the current environment of liquidity tightening. Hence, we expect cost of deposits to rise in FY14, faster than yields on assets. In FY12 and FY13, NIMs declined to 3.0% as compared to 3.23-3.3% earlier. We expect no immediate recovery in NIM and expect it to further decline by 5-10bps over FY14-15.

Cost-to-income ratio could rise to ~50%

The bank's cost-to-income ratio has risen from 42% to 47% in FY11-13, as investments in the new branch network and hiring have not been accompanied by income growth during this period. With continued branch expansion amidst weak macro-economic conditions, the cost ratios are likely to remain elevated. We expect the cost-to-income ratio to rise to 50% in FY15, putting further pressure on profitability.

Exhibit 10: Cost ratios to remain elevated



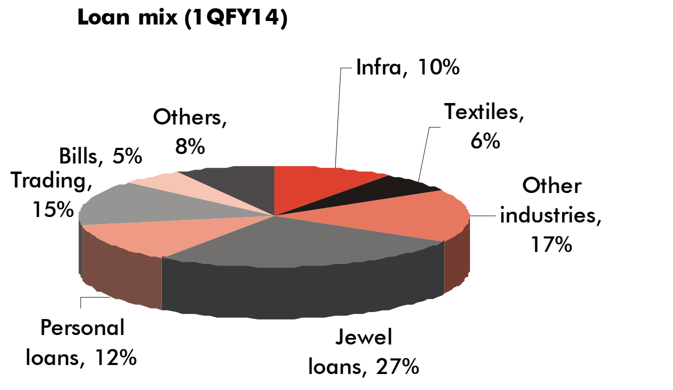
Source: Company, Ambit Capital research

Asset quality – credit cost to remain elevated

Historically, KVB's asset quality has been supported by: (a) its traditional niche in known clients (traders and SMEs in Tamil Nadu), and (b) its conservative approach to lending, as reflected in the high share of secured lending and working capital loans (see Exhibit 12). Hence, historically, KVB's asset quality has been better vs its regional peers, with average credit cost of only 20bps in FY08-13 vs peer average of ~98bps during the same period (see Exhibit 13 below).

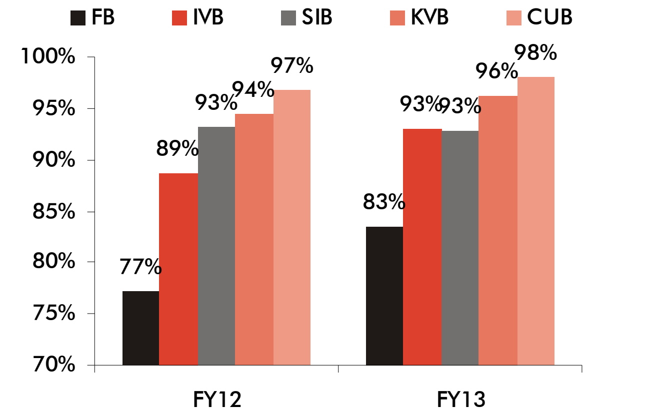
However, the trends have worsened in recent quarters, with credit costs rising from the low levels of 10-15bps in FY08-11 to 53bps in FY13 due to increasing delinquencies in the mid-corporate segment.

Exhibit 11: KVB's loan mix as at end-1QFY14



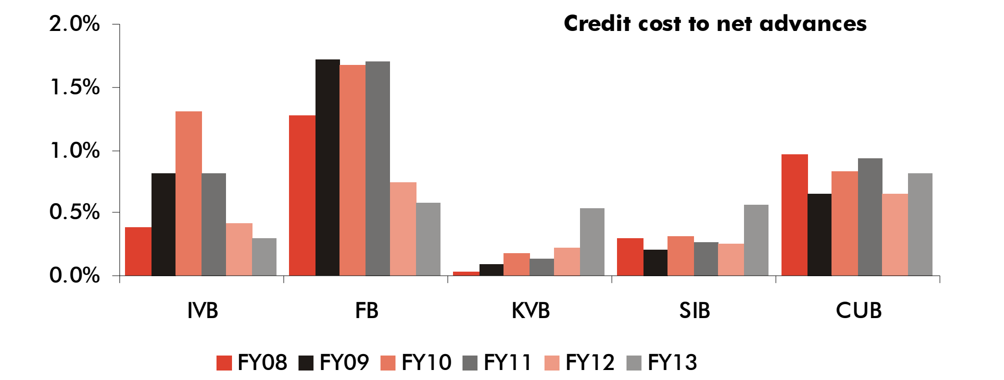
Source: Company, Ambit Capital research

Exhibit 12: Share of secured loans in total loans



Source: Company, Ambit Capital research

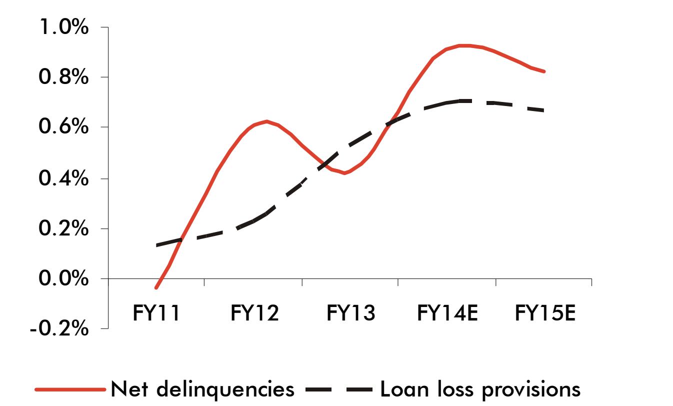
Exhibit 13: KVB has historically delivered lower credit costs than its peers



Source: Company, Ambit Capital research

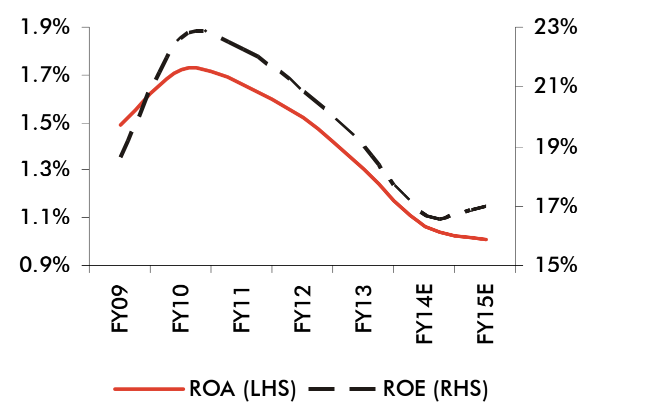
However, given a significant exposure of the bank to the infra segment and other industry loans (see Exhibit 11 above), we expect gross NPLs to rise to 1.5% in FY14 and 1.8% in FY15 (vs 1.0% in FY13) and credit costs to average at 65-70bps (vs 53bps in FY13). Our credit cost estimates are the primary drivers of the moderation in RoAs and RoEs in FY14 and FY15.

Exhibit 14: High slippages to keep credit costs high



Source: Company, Ambit Capital research

Exhibit 15: Profitability to decline further in FY14-15



Source: Company, Ambit Capital research

Key assumptions and estimates

Exhibit 16: Key assumptions and estimates for KVB (all figures in ₹mn unless otherwise mentioned)

	FY11	FY12	FY13	FY14E	FY15E	Comments
Assumptions						
YoY loan growth	32%	34%	23%	21%	21%	Loan book to record a CAGR of 21% in FY13-15 driven by retail loans and gold collateralised loans.
Net Interest margin (%)	3.16%	2.87%	2.84%	2.77%	2.78%	We expect NIMs to remain subdued at ~2.8% as constraints on the liability side would affect the cost of funds amidst liquidity tightening.
Opex/Avg Asset ratio (%)	1.72%	1.64%	1.81%	1.85%	1.86%	We expect cost-to-assets ratio to remain elevated due to continued branch expansion.
Credit costs as a % of Average loan book	0.13%	0.23%	0.53%	0.70%	0.67%	Credit costs to be higher as compared to the historical levels, as corporate and commercial loans continue to see slippages in the slowing economy.
Key output						
NII (` mn)	**7,669**	**9,171**	**11,585**	**13,735**	**16,561**	FY13-15 CAGR of 20% vs FY11-13 CAGR of 27%
Oper. profit (` mn)	**6,006**	**7,257**	**8,488**	**9,993**	**11,546**	FY13-15 CAGR of 17% vs FY11-13 CAGR of 22%
Profit after tax (` mn)	**4,156**	**5,017**	**5,503**	**5,440**	**6,199**	FY13-15 CAGR of 6% vs FY11-13 CAGR of 18%
Diluted EPS (`)	44.0	46.8	51.3	50.8	57.8	FY13-15 CAGR of 6% vs FY11-13 CAGR of -4%
ROA (%)	1.66%	1.52%	1.30%	1.06%	1.01%	RoA moderation to continue
ROE (%)	22.3%	20.8%	19.0%	16.7%	17.0%	Average RoEs of 17% over FY14-15

Source: Company, Ambit Capital research.

Ambit vs consensus

Exhibit 17: Ambit vs consensus

(₹ mn)	Consensus	Ambit	% change
Net interest income			
FY14E	14,436	13,735	-5
FY15E	18,036	16,561	-8
Net profit			
FY14E	6,427	5,440	-15
FY15E	7,983	6,199	-22

Source: Bloomberg, Ambit Capital research

Our NII estimates for FY14 and FY15 are lower than consensus estimates, as we build in the effects of tight liquidity on the cost of funding and the relatively downward sticky yield on loans amidst weak demand. Further pressure on cost ratios and credit costs means that our net profit estimates are significantly lower than consensus estimates.

Valuation and recommendation

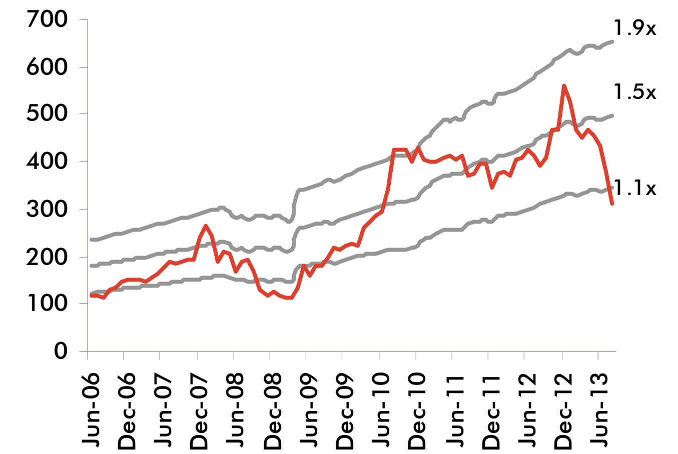
We have valued KVB using the excess return to equity model, which is *'net profit – (cost of equity x average net worth)'* for all the future years **discounted back to August 2014** using cost of equity, and added this to net worth at August 2014.

- We have explicitly forecasted net profit for FY14 and FY15 based on the assumptions in Exhibit 16.
- After FY15, we have assumed a sustainable RoA for the bank at 1.0% (vs FY013-15E average of 1.1%) and a sustainable leverage of 15.4x (vs average leverage of ~13.7x over the last five years).
- We have assumed a cost of equity of 15% and terminal growth of 5%.

Based on these assumptions our 'excess return model' gives a one-year forward **target price of Rs320/share**. Our target price **implies one-year forward P/B of 0.95x and one-year forward P/E of 6.0x)**, implying a **3% upside** from current levels.

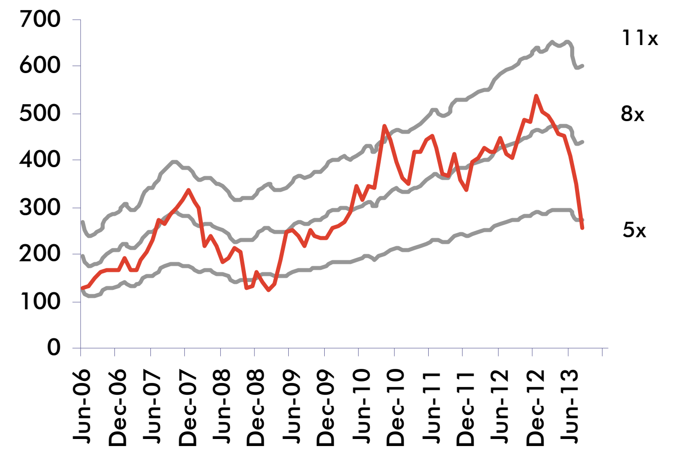
Cross-cycle valuations

Exhibit 17: One-year forward P/B band



Source: Bloomberg, Ambit Capital research.

Exhibit 18: One-year forward P/E band



Source: Bloomberg, Ambit Capital research.

Based on consensus estimates, at 0.9x 12-month forward P/B and 4.7x 12-month forward earnings, KVB's stock is currently trading at the bottom end of its average cross-cycle valuation range. However KVB's RoAs are also likely to moderate to 1.1% as compared to the average of 1.6% in FY06-11 and 1.3% in FY13. This will lead to subdued valuation multiples in the near term.

Key risks to our investment thesis

Key risks to our SELL stance are a better-than-expected economic recovery, particularly in Tamil Nadu, and a reversal in its current strategy of pursuing rapid growth in favour of productivity improvement.

Exhibit 19: Explanation for our flags on the cover page

Segment	Score	Comments
Accounting	GREEN	We did not find anything unusual in the accounts of the bank and we believe that the reported numbers are a true reflection of the profitability of the bank.
Predictability	AMBER	Despite the moderation in profitability, management team looks averse to adjusting the strategy by slowing down the growth. This poses risk of deterioration in operating performance at a time when asset quality outlook is uncertain. Financial performance may hence become volatile in coming quarters.
Earnings Momentum	RED	We expect earnings CAGR of 6% in FY13-15 compared to earning CAGR of 25% in FY09-13.

Source: Ambit Capital research

Income Statement (Standalone)

Year to March (` mn)	FY11	FY12	FY13	FY14E	FY15E
Net Interest Income	**7,669**	**9,171**	**11,585**	**13,735**	**16,561**
Profit on Investments	377	262	883	1,400	1,200
Exchange Income	141	368	210	273	328
Fee & Other Income	2,125	2,871	3,432	4,099	4,896
Non-Interest Income	**2,643**	**3,501**	**4,526**	**5,772**	**6,424**
Total Income	**10,312**	**12,673**	**16,110**	**19,507**	**22,985**
Operating Expenses	4,306	5,416	7,622	9,514	11,439
Pre-provisioning Profits	**6,006**	**7,257**	**8,488**	**9,993**	**11,546**
Loan Loss Provisions	202	479	1,413	2,281	2,640
Provisions on Investments	193	413	-413	0	0
Other Provisions	-1	45	234	50	50
Total Provisions	**393**	**938**	**1,234**	**2,331**	**2,690**
PBT	**5,613**	**6,320**	**7,254**	**7,662**	**8,856**
Tax	1,457	1,302	1,751	2,222	2,657
PAT (Pre-Extra ordinaries)	**4,156**	**5,017**	**5,503**	**5,440**	**6,199**
Reported Profits	**4,156**	**5,017**	**5,503**	**5,440**	**6,199**
Dividend	1,495	1,744	1,756	1,881	2,006
Retained Profits	**2,661**	**3,273**	**3,748**	**3,559**	**4,193**

Source: Company, Ambit Capital research.

Balance Sheet (Standalone)

Year to March (`mn)	FY11	FY12	FY13	FY14E	FY15E
Equity Capital	945	1,072	1,072	1,072	1,072
Reserves & Surplus	20,200	26,010	29,780	33,339	37,532
Deposits	247,219	321,116	386,530	463,836	556,603
Borrowings (Incld. Sub Debt)	5,299	19,726	39,993	49,617	61,646
Other Liabilities	8,586	8,425	9,958	11,751	13,866
Total Liabilities	**282,248**	**376,349**	**467,333**	**559,614**	**670,719**
Investments	77,318	105,061	138,373	162,890	192,621
Net Advances	178,145	239,492	294,801	356,037	430,093
Cash & Equivalents	17,745	20,354	17,960	21,845	26,573
Fixed Assets	2,106	2,448	3,221	3,717	4,288
Other Assets	6,936	8,993	12,978	15,124	17,143
Total Assets	**282,248**	**376,349**	**467,333**	**559,614**	**670,719**

Source: Company, Ambit Capital research

Ratio analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Growth (YoY) (%)					
Deposits	28.3%	29.9%	20.4%	20.0%	20.0%
Advances	32.5%	34.4%	23.1%	20.8%	20.8%
Total Assets	28.7%	33.3%	24.2%	19.7%	19.9%
NII	35.8%	19.6%	26.3%	18.6%	20.6%
Non-Interest Income	7.0%	32.5%	29.2%	27.5%	11.3%
Operating Expenses	23.5%	25.8%	40.7%	24.8%	20.2%
Operating Profits	29.7%	20.8%	17.0%	17.7%	15.5%
Core Operating Profits	38.3%	24.3%	8.7%	13.0%	20.4%
Provisions	5.2%	138.5%	31.6%	88.9%	15.4%
Reported PAT	23.7%	20.7%	9.7%	-1.1%	14.0%
Yields / Margins (%)					
Interest Spread (%)	2.68%	2.32%	2.36%	2.34%	2.39%
NIM (%)	3.16%	2.87%	2.84%	2.77%	2.78%
Profitability (%)					
Non-IR to Income (%)	25.6%	27.6%	28.1%	29.6%	27.9%
Cost to Income (%)	41.8%	42.7%	47.3%	48.8%	49.8%
ROA (%)	1.66%	1.52%	1.30%	1.06%	1.01%
ROE (%)	22.3%	20.8%	19.0%	16.7%	17.0%

Source: Company, Ambit Capital research

Asset quality (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Slippages (%)	0.40%	0.98%	0.84%	1.20%	1.20%
Gross NPAs (%)	1.27%	1.33%	0.96%	1.47%	1.77%
Net NPAs (%)	0.08%	0.33%	0.37%	0.54%	0.64%
Provision Coverage (%)	94%	75%	62%	64%	64%
Specific LLP (%)	0.03%	0.09%	0.39%	0.57%	0.52%
Net NPAs / Networth (%)	0.66%	2.91%	3.52%	5.54%	7.17%

Source: Company, Ambit Capital research

Du-pont analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
NII / Assets (%)	3.06%	2.79%	2.75%	2.67%	2.69%
Other income / Assets (%)	1.05%	1.06%	1.07%	1.12%	1.04%
Total Income / Assets (%)	4.11%	3.85%	3.82%	3.80%	3.74%
Cost to Assets (%)	1.72%	1.64%	1.81%	1.85%	1.86%
PPP / Assets (%)	2.39%	2.20%	2.01%	1.95%	1.88%
Provisions / Assets (%)	0.16%	0.28%	0.29%	0.45%	0.44%
PBT / Assets (%)	2.24%	1.92%	1.72%	1.49%	1.44%
Tax Rate (%)	26.0%	20.6%	24.1%	29.0%	30.0%
ROA (%)	1.66%	1.52%	1.30%	1.06%	1.01%
Leverage (%)	13.4	13.7	14.6	15.7	16.9
ROE (%)	22.3%	20.8%	19.0%	16.7%	17.0%

Source: Company, Ambit Capital research

Valuation (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Shares in issue (mn)	94.5	107.2	107.2	107.2	107.2
EPS (Rs.)	44.0	46.8	51.3	50.8	57.8
EPS (YoY) (%)	-28.7%	6.4%	9.7%	-1.1%	14.0%
PE (x)	7.1	6.6	6.0	6.1	5.4
BV (Rs.)	223.8	252.7	287.8	321.1	360.2
BV (YoY) (%)	-24.8%	12.9%	13.9%	11.5%	12.2%
P/BV (x)	1.39	1.23	1.08	0.97	0.86
DPS (Rs.)	13.5	13.9	14.0	15.0	16.0
Div. yield (%)	4.4%	4.5%	4.5%	4.8%	5.2%

Source: Company, Ambit Capital research

Banking, Financial Services & Insurance

August 29, 2013

South Indian Bank

Bloomberg: SIB IN EQUITY
Reuters: SIBK.BO

SELL

Accounting: AMBER
Predictability: AMBER
Earnings momentum: RED

Multiple challenges

South Indian Bank (SIB) has a plateful of challenges, with little diversification outside its home state Kerala, a weak liability franchise, no improvement on fee income generation, slowing asset growth and rising credit costs. The bank has a 57% exposure to corporate loans and a coverage ratio of 29%, and thus, it has a small margin of error on asset quality. We expect SIB's financial performance to be volatile and we expect RoAs to fall below 1% in the near term. We change our stance to SELL.

Competitive position: WEAK **Changes to this position: NEGATIVE**

Fares poorly in comparison to peers: As discussed in the thematic section, SIB emerges as the weakest franchise among its regional bank peers. A high geographical concentration in the intensely competitive state of Kerala had led to a weak liability franchise (CA: 3.5%, CASA: 21%). SIB has made little progress on its longstanding weakness in fee income generation (fee income to assets below 60bps). With a 57% exposure to corporate loans and a low provision coverage ratio of 29%, SIB is weakly cushioned to any adverse asset quality shocks.

Growth slowdown with subdued profitability: SIB's FY13 loan growth has slowed down to 17% from an average of 28% in FY08-12. Excluding gold loans, growth is even weaker at ~12%. With gold loan growth coming to a halt, we expect further weakness in growth going forward. We do not expect any near-term improvement in NIM, as the liability franchise would show no improvement. Similarly, we expect credit costs to remain elevated at ~68bps (vs 56bps in FY13 and average 27bps in FY08-12) due to a difficult external environment and high exposure to corporate loans.

Management change due in September 2014: The six-year tenure of the current MD & CEO, Dr. V. A. Joseph, will end in September 2014. In the year ahead, the uncertainty on the new MD & CEO and change in strategy post the transition would add further risk to this franchise.

SELL stance with a target price of ₹20: We change our stance to SELL with a valuation of ₹20 (implied FY14E P/ABV of 0.75x and FY14 P/E of 5.0x) as we expect profitability to remain subdued (average RoA of ~0.95% over FY14-15), with slowing asset growth (19% CAGR in FY13-15 vs 25% CAGR in FY10-13). Our previous valuation for SIB was ₹29. The 31% drop in our valuation is driven by lower valuation multiples due to our concerns on multiple structural issues faced by the bank. Key risks to our SELL stance are a better-than-expected recovery in the macro-economic environment and takeover interest from an incumbent or a new banking licence recipient looking to expand in south India.

Key financials (standalone)

Year to March	FY11	FY12	FY13	FY14E	FY15E
Net Revenues (₹ mn)	9,878	12,688	16,158	18,938	22,064
Operating Profits (₹ mn)	5,253	6,515	8,486	9,986	11,894
Net Profits (₹ mn)	2,926	4,017	5,023	5,222	6,113
EPS (₹)	2.6	3.5	3.8	3.9	4.6
RoA (%)	1.01%	1.10%	1.12%	0.96%	0.95%
RoE (%)	18.5%	21.6%	20.5%	17.0%	17.4%
P/B (x)	1.30	1.09	0.91	0.79	0.69

Source: Company, Ambit Capital research

CHANGE IN STANCE

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Recommendation

CMP:	₹19.5
Target Price (12 month):	**₹20.0**
Upside (%)	*3%*
EPS (FY14):	₹3.9
Change from previous (%)	*+2%*
Variance from consensus (%)	*-6%*

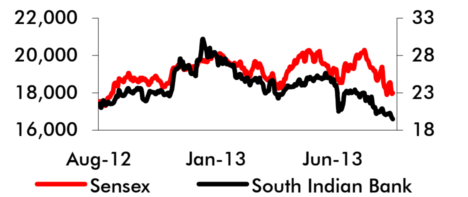
Stock Information

Mkt cap:	₹26bn/US$0.4bn
52-wk H/L:	₹31/19
3M ADV:	₹40mn/US$0.6mn
Beta:	1.0x
BSE Sensex:	17,996
Nifty:	5,285

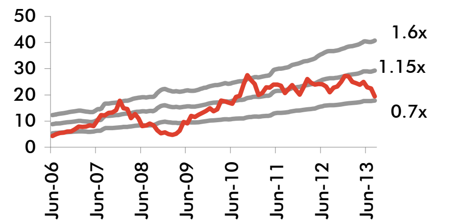
Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(13)	(23)	(11)	(28)
Rel. to Sensex	(4)	(12)	(13)	(21)

Performance (%)



One-year forward P/B



Source: Bloomberg, Ambit Capital research

Exhibit 1: Key assumptions and estimates for South Indian Bank (all figures in ₹ mn unless otherwise mentioned)

	New Estimates		Old Estimates		Change (bps/%YoY)		Comments
Assumptions*	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	
YoY loan growth (%)	18.0%	18.9%	33%	NA	-1,462	NA	The decrease in our loan growth assumptions factors in lower system growth.
Net interest margins (%)	2.82%	2.87%	NA	NA	NA	NA	
Opex/avg loan book ratio (%)	1.65%	1.57%	1.66%	NA	-1	NA	We broadly maintain our expectations of FY14 cost ratio.
Provisions as a % of average loan book	0.69%	0.67%	0.32%	NA	37	NA	We have increased our credit cost estimates to account for deterioration in the external environment.
Outputs (₹ mn)							
Net revenues	14,929	17,874	14,130	NA	6%	NA	
Operating profit	9,986	11,894	9,252	NA	8%	NA	
Net Profit	5,222	6,113	5,143	NA	2%	NA	
Diluted EPS (₹)	3.9	4.6	3.8	NA	2%	NA	
ROA (%)	0.96%	0.95%	0.91%	NA	5	NA	
ROE (%)	17.0%	17.4%	19.7%	NA	-274	NA	

Source: Company, Ambit Capital research.

Ambit vs consensus

Exhibit 2: Ambit vs consensus

(₹ mn)	Consensus	Ambit	% difference
Net interest income			
FY14E	14,731	14,929	1%
FY15E	17,633	17,874	1%
Net profit			
FY14E	5,443	5,222	-4%
FY15E	6,508	6,113	-6%

Source: Bloomberg, Ambit Capital research

Our FY14/FY15 NII estimates are broadly in line with consensus estimates but our net profit estimate is lower due to higher credit cost estimates.

Absolute valuation

We have valued SIB using the excess return to equity model, which is *'net profit – (cost of equity x average net worth)'* for all the future years **discounted back to August 2014** using cost of equity. We have added this to net worth at August 2014.

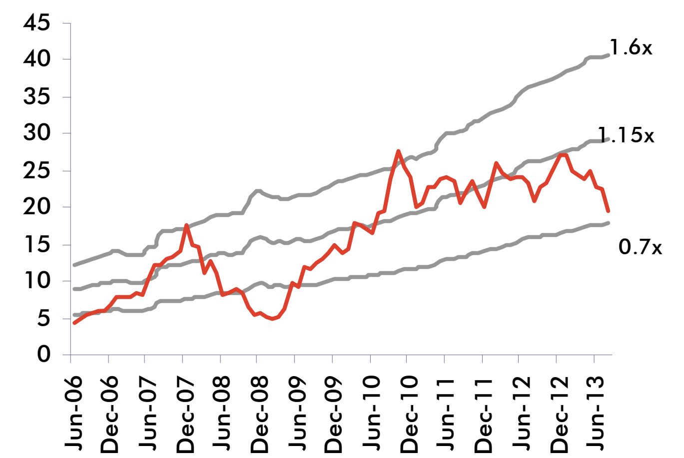
- We have explicitly forecasted net profit for FY14 and FY15 based on the assumptions in Exhibit 1.
- After FY15, we have assumed a sustainable RoA for the bank at 0.9% (vs FY11-13 average of 1.1%) and a sustainable leverage of 16x (vs average leverage of ~18x over the last six years).
- We have assumed a cost of equity of 15% and terminal growth of 5%.

Based on these assumptions our 'excess return model' gives a one-year forward **target price of ₹20/share** (vs ₹29/share earlier), implying a **0% upside** from current levels. Our target price **implies one-year forward P/B of 0.75x and one-year forward P/E of 5.0x.**

The 31% drop in valuation in our valuation is driven by our expectation of lower loan growth (from above 30% growth earlier to 18-19% loan CAGR) and subdued recovery in the bank's profitability in the near term (FY14-15 average RoA of 0.95% versus FY08-13 average RoA of 1.05%).

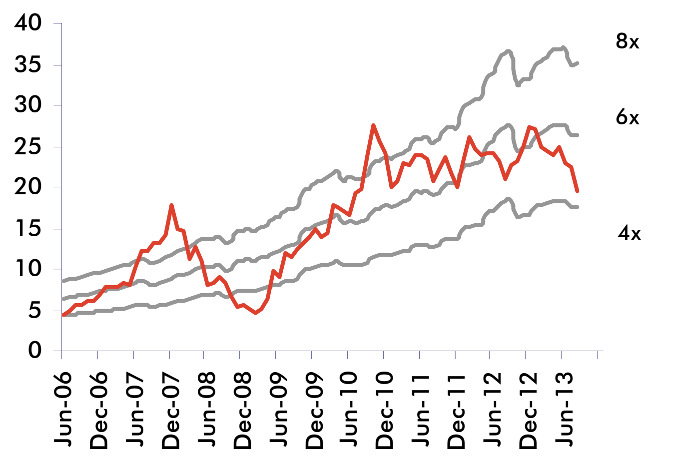
Cross-cycle valuations

Exhibit 17: One-year forward P/B band



Source: Bloomberg, Ambit Capital research.

Exhibit 18: One-year forward P/E band



Source: Bloomberg, Ambit Capital research.

Based on consensus estimates, at 0.76x 12-month forward BVPS and 6.5x 12-month forward earnings, SIB is currently trading closer to the trough of its cross-cycle valuation average. Given that the bank's RoEs would moderate to ~17-18% over the next couple of years (FY11-13 average of 20%), we expect the bank's valuation multiple to remain subdued.

Key risks to our investment thesis

Our SELL stance on the stock revolves around a weak competitive position in a deteriorating external climate. Hence, a better-than-expected recovery in the economic climate is a key risk to our SELL stance. Any takeover interest in South Indian Bank from an incumbent or a new bank licence recipient looking to expand in south India will also support the stock price.

Exhibit 19: Explanation for our flags on SIB's main page

Segment	Score	Comments
Accounting	**AMBER**	The bank has many instances of re-statement of financial statements and mis-reporting of financial information in the past. This leads to a relatively lower confidence regarding the accounting information of the bank.
Predictability	**AMBER**	Given the pressure on operating performance and asset quality risk from external environment, the bank's earnings trajectory has some amount of unpredictability.
Earnings Momentum	**RED**	Consensus earnings estimates for the bank have been downgraded by ~10% over the last three months.

Source: Ambit Capital research

Income Statement (Standalone)

Year to March (₹ mn)	FY11	FY12	FY13	FY14E	FY15E
Net Interest Income	**7,911**	**10,217**	**12,808**	**14,929**	**17,874**
Profit on Investments	394	408	577	800	500
Exchange Income	191	256	274	315	363
Fee & Other Income	1,383	1,807	2,498	2,893	3,327
Non-Interest Income	**1,967**	**2,471**	**3,349**	**4,009**	**4,190**
Total Income	**9,878**	**12,688**	**16,158**	**18,938**	**22,064**
Operating Expenses	4,625	6,173	7,672	8,952	10,170
Pre-provisioning Profits	**5,253**	**6,515**	**8,486**	**9,986**	**11,894**
Loan Loss Provisions	496	601	1,644	2,376	2,754
Provisions on Investments	94	141	112	50	50
Other Provisions	208	50	171	100	100
Total Provisions	**798**	**792**	**1,927**	**2,526**	**2,904**
PBT	**4,455**	**5,723**	**6,559**	**7,460**	**8,990**
Tax	1,529	1,707	1,536	2,238	2,877
PAT (Pre-Extra ordinaries)	**2,926**	**4,017**	**5,023**	**5,222**	**6,113**
Reported Profits	**2,926**	**4,017**	**5,023**	**5,222**	**6,113**
Dividend	657	791	1,094	1,096	1,253
Retained Profits	**2,269**	**3,225**	**3,929**	**4,126**	**4,861**

Source: Company, Ambit Capital research.

Balance Sheet (Standalone)

Year to March (₹mn)	FY11	FY12	FY13	FY14E	FY15E
Equity Capital	1,130	1,134	1,339	1,339	1,339
Reserves & Surplus	15,805	19,095	27,318	31,443	36,304
Deposits	297,211	365,005	442,623	522,295	616,308
Borrowings (Incl Sub Debt)	2,903	5,882	12,846	20,492	30,305
Other Liabilities	9,636	11,138	12,446	14,681	17,319
Total Liabilities	**326,686**	**402,254**	**496,571**	**590,251**	**701,575**
Investments	89,238	93,999	125,235	154,671	183,065
Net Advances	204,887	272,807	318,155	375,427	446,465
Cash & Equivalents	24,661	26,405	43,359	40,732	47,264
Fixed Assets	2,052	2,329	2,581	2,921	3,296
Other Assets	5,847	6,714	7,240	16,499	21,486
Total Assets	**326,686**	**402,254**	**496,571**	**590,251**	**701,575**

Source: Company, Ambit Capital research

Ratio analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Growth (YoY) (%)					
Deposits	29.2%	22.8%	21.3%	18.0%	18.0%
Advances	29.5%	33.1%	16.6%	18.0%	18.9%
Total Assets	28.0%	23.1%	23.4%	18.9%	18.9%
NII	39.2%	29.2%	25.4%	16.6%	19.7%
Non-Interest Income	-5.6%	25.6%	35.6%	19.7%	4.5%
Operating Expenses	26.3%	33.5%	24.3%	16.7%	13.6%
Operating Profits	27.9%	24.0%	30.2%	17.7%	19.1%
Core Operating Profits	46.1%	25.7%	29.5%	16.1%	24.0%
Provisions	84.4%	-0.7%	143.4%	31.1%	15.0%
Reported PAT	25.2%	37.3%	25.1%	4.0%	17.1%
Yields / Margins (%)					
Interest Spread (%)	2.40%	2.43%	2.45%	2.38%	2.52%
NIM (%)	2.78%	2.87%	2.91%	2.82%	2.87%
Profitability (%)					
Non-IR to Income (%)	19.9%	19.5%	20.7%	21.2%	19.0%
Cost to Income (%)	46.8%	48.7%	47.5%	47.3%	46.1%
ROA (%)	1.01%	1.10%	1.12%	0.96%	0.95%
ROE (%)	18.5%	21.6%	20.5%	17.0%	17.4%

Source: Company, Ambit Capital research

Asset quality (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Slippages (%)	0.68%	0.84%	1.95%	1.50%	1.40%
Gross NPAs (%)	1.11%	0.97%	1.36%	1.82%	1.96%
Net NPAs (%)	0.29%	0.28%	0.78%	0.92%	0.79%
Provision Coverage (%)	74%	71%	42%	50%	60%
Specific LLP (%)	0.15%	0.09%	0.45%	0.59%	0.57%
Net NPAs / Networth (%)	3.54%	3.78%	8.71%	10.53%	9.39%

Source: Company, Ambit Capital research

Du-pont analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
NII / Assets (%)	2.72%	2.80%	2.85%	2.75%	2.77%
Other income / Assets (%)	0.68%	0.68%	0.75%	0.74%	0.65%
Total Income / Assets (%)	3.40%	3.48%	3.60%	3.49%	3.42%
Cost to Assets (%)	1.59%	1.69%	1.71%	1.65%	1.57%
PPP / Assets (%)	1.81%	1.79%	1.89%	1.84%	1.84%
Provisions / Assets (%)	0.27%	0.22%	0.43%	0.46%	0.45%
PBT / Assets (%)	1.53%	1.57%	1.46%	1.37%	1.39%
Tax Rate (%)	34.3%	29.8%	23.4%	30.0%	32.0%
ROA (%)	1.01%	1.10%	1.12%	0.96%	0.95%
Leverage (%)	18.4	19.6	18.4	17.7	18.3
ROE (%)	18.5%	21.6%	20.5%	17.0%	17.4%

Source: Company, Ambit Capital research

Valuation (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Shares in issue (mn)	1,130	1,134	1,339	1,339	1,339
EPS (₹.)	2.6	3.5	3.8	3.9	4.6
EPS (YoY) (%)	25.2%	36.8%	5.9%	4.0%	17.1%
PE (x)	7.5	5.5	5.2	5.0	4.3
BV (₹.)	15.0	17.8	21.4	24.5	28.1
BV (YoY) (%)	15.5%	19.0%	20.0%	14.4%	14.8%
P/BV (x)	1.30	1.09	0.91	0.79	0.69
DPS (₹.)	0.5	0.6	0.7	0.7	0.8
Div. yield (%)	2.6%	3.1%	3.6%	3.6%	4.1%

Source: Company, Ambit Capital research

Banking, Financial Services & Insurance August 29, 2013

City Union Bank

Bloomberg: CUBK IN EQUITY
Reuters: CTBK.BO

BUY

Accounting: GREEN
Predictability: AMBER
Earnings momentum: GREEN

A sturdy franchise

City Union Bank (CUB) emerges as one of the most robust regional bank franchises in our analysis of regional banks. Its strong income generation (NII and fee income to assets of 4.6% vs peer average of 4.2%), controlled cost base and healthy asset quality more than offset the weakness on the liabilities side. Hence, superior RoAs of 1.5-1.6% are the best among regional banks and are closer to the new private sector banks. In the near term, we expect the bank to maintain its margins in the current tight liquidity environment, given that the duration of the loan book is lower than the duration of its borrowings. CUB would deliver net profit CAGR of 20% in FY13-15. The stock is trading at 1.0x FY14 BV, which is an attractive entry point. We retain our BUY stance.

Competitive position: MODERATE **Changes to this position: STABLE**

A robust franchise: City Union Bank emerges as one of the most robust regional bank franchises in our analysis. Its strong income generation (NII and fee income to assets of 4.6% vs peer average of 4.2%), controlled cost base and healthy asset quality more than offset the weakness on the liabilities side. This has helped CUB to deliver largely stable and high RoAs of 1.6% over the last eight years along with average asset growth of 27%.

Strong growth to continue: CUB has delivered better loan growth vs its peers (FY06-13 CAGR of 29%), owing to the relatively better lending opportunities in its home state, Tamil Nadu (discussed on page 28). We expect CUB to maintain its loan growth momentum, with a CAGR of 22% in FY13-15, owing to its continued focus on its core SME franchise and relative insulation to large corporate loans.

In a better position to manage RoAs: We expect CUB to maintain its RoAs at 1.45% over the next two years, as: **(i)** the duration of the loan book at 1.5 years is significantly lower than the 2-3-year duration of its deposits, which would help the bank to maintain its margins in an environment of tight liquidity; **(ii)** income growth keeps pace with cost growth, leading to a stable cost/income ratio of 42-43% over the next two years; and **(iii)** credit costs would peak at 94bps in FY14 (vs 81bps in FY13). Note that CUB's credit costs have been relatively high (FY08-13 average of 81bps) due to CUB's market positioning as a SME lender (reflected in high yields), but its asset quality trends have been among the least volatile (65-85bps in the last three years).

Valuation and stance: We cut our FY14 estimates by 14% due to lower NIM and higher credit cost estimates. We maintain our BUY stance, as at 0.9x one-year forward BV, the valuations are reasonable for a strongly profitable franchise. Our target price of **₹66/share** implies 1.45x FY14 P/B and 7.5x FY14 P/E. Higher-than-expected deterioration of asset quality is the key risk to our BUY stance.

Key financials (standalone)

Year to March	FY11	FY12	FY13	FY14E	FY15E
Net Revenues (₹ mn)	5,774	7,069	8,976	10,979	13,353
Operating Profits (₹ mn)	3,610	4,271	5,234	6,314	7,622
Net Profits (₹ mn)	2,151	2,803	3,220	3,696	4,690
EPS (₹)	5.3	6.9	6.8	7.8	9.9
RoA (%)	1.64%	1.70%	1.56%	1.45%	1.51%
RoE (%)	23.5%	24.9%	22.3%	20.6%	21.9%
P/B (x)	1.67	1.37	1.20	1.02	0.84

Source: Company, Ambit Capital research

COMPANY INSIGHT

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Recommendation

CMP:	₹42
Target Price (12 month):	**₹66**
Upside (%)	59%
EPS (FY14):	₹7.8
Change from previous (%)	*-14%*
Variance from consensus (%)	*-5%*

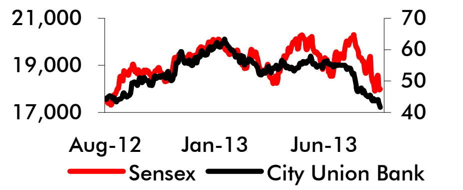
Stock Information

Mkt cap:	₹23bn/US$0.4bn
52-wk H/L:	₹66/41
3M ADV:	₹22mn/US$0.3mn
Beta:	0.6x
BSE Sensex:	17,996
Nifty:	5,285

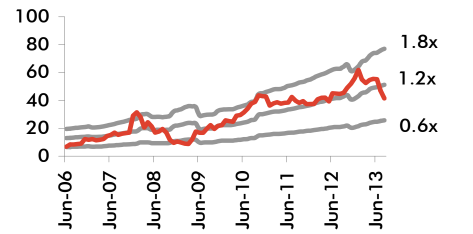
Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(11)	(26)	(7)	(26)
Rel. to Sensex	(3)	(16)	(9)	(18)

Performance (%)



One-year forward P/B



Source: Bloomberg, Ambit Capital research

Exhibit 1: Key assumptions and estimates for City Union Bank (all figures in ₹ mn unless otherwise mentioned)

	New Estimates		Old Estimates		Change		Comments
Assumptions	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	
YoY loan growth (%)	22.9%	22.4%	30%	NA	-710	NA	Building in growth at a lower premium to system growth
Net interest margins (%)	3.02%	3.10%	3.16%	NA	-14	NA	Building in the impact of tight liquidity and pressure on yields due to competition
Opex/avg loan book ratio (%)	1.83%	1.85%	1.66%	NA	17	NA	Branch expansion plan to drive cost to assets
Provisions as a % of average loan book	0.94%	0.80%	0.69%	NA	26	NA	Building in higher slippages due to deterioration in the external climate
Outputs (₹ mn)	**FY14E**	**FY15E**	**FY14E**	**FY15E**	**FY14E**	**FY15E**	
NII	7,492	9,438	8,212	NA	-9%	NA	Driven by lower loan growth and lower margins
Operating profit	6,314	7,622	7,070	NA	-11%	NA	Primarily reflects divergence at the NII level
Net Profit	3,696	4,690	4,273	NA	-13%	NA	Higher credit cost assumptions
Diluted EPS (₹)	7.8	9.9	9.0	NA	-14%	NA	
ROA (%)	1.45%	1.51%	1.64%	NA	-19	NA	
ROE (%)	20.6%	21.9%	25.4%	NA	-473	NA	

Source: Company, Ambit Capital research

Ambit vs consensus

Exhibit 2: Ambit vs consensus

(₹ mn)	Consensus	Ambit	% difference
Net Revenues			
FY14E	7,946	7,492	-6%
FY15E	10,027	9,438	-6%
Diluted EPS (₹)			
FY14E	3,890	3,696	-5%
FY15E	4,709	4,690	0%

Source: Bloomberg, Ambit Capital research

Our FY14/FY15 revenue and EPS estimates are ~5% below consensus estimates primarily because our NIM estimates are lower than consensus expectations.

Absolute valuation

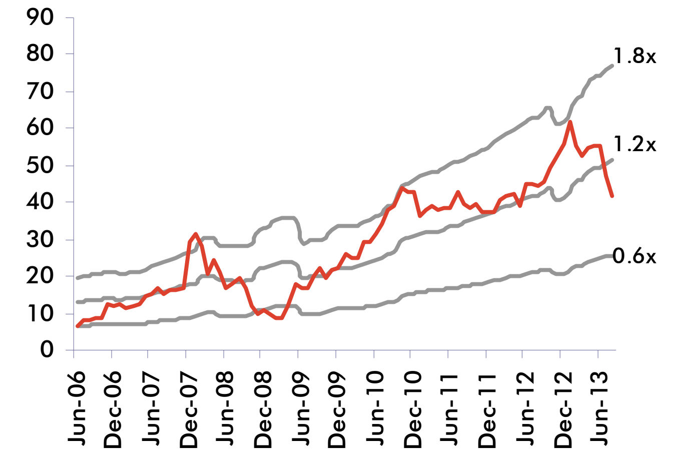
We have valued CUB using the excess return to equity model, which is *'net profit – (cost of equity x average net worth)'* for all the future years **discounted back to August 2014** using cost of equity. We have added this to net worth at August 2014.

- We have explicitly forecasted net profit for FY14 and FY15 based on the assumptions in Exhibit 1.
- After FY15, we have assumed a sustainable RoA of 1.33% (vs FY06-13 average of 1.5%) and a sustainable leverage of 13.8x (vs average leverage of ~14.4x over the last six years).
- We have assumed a cost of equity of 15% and terminal growth of 5%.

Based on these assumptions, our 'excess return model' gives a one-year forward **target price of ₹66/share** (vs ₹63/share earlier), implying a **59% upside** from current levels. Our target price **implies one-year forward P/B of 1.45x and one-year forward P/E of 7.5x)**.

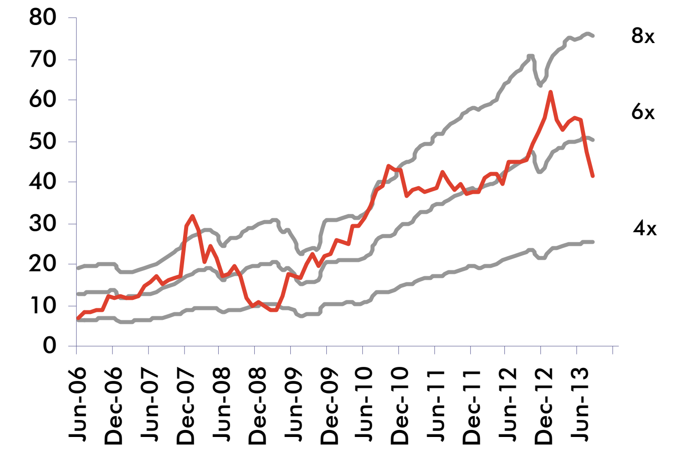
Cross-cycle valuations

Exhibit 3: One-year forward P/B band



Source: Bloomberg, Ambit Capital research.

Exhibit 4: One-year forward P/E band



Source: Bloomberg, Ambit Capital research.

Based on consensus estimates, at 1.0x 12-month forward P/B, CUB's stock is currently trading at a 19% discount to its average cross-cycle P/B of 1.2x P/B, the lowest multiple in the last four years. At a valuation of 5.0x 12-month forward earnings, the stock is trading at a 17% discount to its average cross-cycle P/E of 6.0x. Given that the bank's RoEs would remain at ~20-21% over the next couple of years (much ahead of that for its regional bank peer group), we expect the bank's P/B multiple to expand to ~1.45x over the next year.

Key risks to our investment thesis

Our BUY stance on the stock revolves around the relative competitive advantages of CUB on other regional banks, which will allow it to deliver superior profitability. The bank will continue to expand significantly, but we expect operating cost and credit costs to remain under control. Any worse-than-expected deterioration in asset quality is a key risk to our **BUY** stance, due to limited visibility on the timing of a macro-economic recovery. Any event in Tamil Nadu which could affect the paying capacity of CUB's borrowers is also another significant risk.

Exhibit 5: Explanation for our flags on CUB's main page

Segment	Score	Comments
Accounting	**GREEN**	We did not find anything unusual in the accounts of the bank. We believe that the reported numbers are a true reflection of the profitability of the bank.
Predictability	**AMBER**	Asset quality risk from an adverse external environment adds some element of unpredictability in the near-term financial performance.
Earnings Momentum	**GREEN**	Consensus earnings estimates for the bank have been stable over the last year.

Source: Ambit Capital research

Income Statement (Standalone)

Year to March (₹ mn)	FY11	FY12	FY13	FY14E	FY15E
Net Interest Income	**4,200**	**4,998**	**6,240**	**7,492**	**9,438**
Profit on Investments	66	78	171	400	200
Exchange Income	106	152	184	221	265
Fee & Other Income	1,402	1,841	2,382	2,867	3,450
Non-Interest Income	**1,574**	**2,071**	**2,736**	**3,487**	**3,915**
Total Income	**5,774**	**7,069**	**8,976**	**10,979**	**13,353**
Operating Expenses	2,164	2,798	3,742	4,665	5,731
Pre-provisioning Profits	**3,610**	**4,271**	**5,234**	**6,314**	**7,622**
Loan Loss Provisions	748	696	1,112	1,604	1,670
Provisions on Investments	76	74	3	0	0
Other Provisions	-34	68	90	90	90
Total Provisions	**790**	**838**	**1,204**	**1,694**	**1,759**
PBT	**2,821**	**3,433**	**4,030**	**4,620**	**5,863**
Tax	670	630	810	924	1,173
PAT (Pre-Extra ordinaries)	**2,151**	**2,803**	**3,220**	**3,696**	**4,690**
Reported Profits	**2,151**	**2,803**	**3,220**	**3,696**	**4,690**
Dividend	401	475	555	666	722
Retained Profits	**1,749**	**2,328**	**2,665**	**3,030**	**3,969**

Source: Company, Ambit Capital research.

Balance Sheet (Standalone)

Year to March (₹mn)	FY11	FY12	FY13	FY14E	FY15E
Equity Capital	405	408	474	474	474
Reserves & Surplus	9,661	12,023	15,932	18,962	22,931
Deposits	129,143	163,408	203,048	247,718	302,216
Borrowings (Incl Sub Debt)	1,862	3,487	4,767	5,859	7,224
Other Liabilities	4,845	4,181	5,549	6,826	8,395
Total Liabilities	**145,915**	**183,507**	**229,771**	**279,840**	**341,241**
Investments	36,162	45,862	52,668	64,637	79,964
Net Advances	92,555	121,375	152,461	187,374	229,336
Cash & Equivalents	12,863	11,361	17,705	21,341	25,722
Fixed Assets	685	977	1,413	1,651	1,928
Other Assets	3,650	3,932	5,525	4,837	4,292
Total Assets	**145,915**	**183,507**	**229,771**	**279,840**	**341,241**

Source: Company, Ambit Capital research

Ratio analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Growth (YoY) (%)					
Deposits	25.6%	26.5%	24.3%	22.0%	22.0%
Advances	35.4%	31.1%	25.6%	22.9%	22.4%
Total Assets	26.2%	25.8%	25.2%	21.8%	21.9%
NII	51.0%	19.0%	24.9%	20.1%	26.0%
Non-Interest Income	9.7%	31.6%	32.1%	27.4%	12.3%
Operating Expenses	30.5%	29.3%	33.7%	24.7%	22.8%
Operating Profits	41.1%	18.3%	22.6%	20.6%	20.7%
Core Operating Profits	63.8%	18.3%	20.8%	16.8%	25.5%
Provisions	30.5%	6.1%	43.7%	40.6%	3.9%
Reported PAT	40.8%	30.3%	14.9%	14.8%	26.9%
Yields / Margins (%)					
Interest Spread (%)	2.81%	2.56%	2.55%	2.42%	2.49%
NIM (%)	3.32%	3.12%	3.11%	3.02%	3.10%
Profitability (%)					
Non-IR to Income (%)	27.3%	29.3%	30.5%	31.8%	29.3%
Cost to Income (%)	37.5%	39.6%	41.7%	42.5%	42.9%
ROA (%)	1.64%	1.70%	1.56%	1.45%	1.51%
ROE (%)	23.5%	24.9%	22.3%	20.6%	21.9%

Source: Company, Ambit Capital research

Asset quality (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Slippages (%)	1.78%	1.57%	1.85%	2.00%	2.00%
Gross NPAs (%)	1.26%	1.06%	1.16%	1.61%	1.87%
Net NPAs (%)	0.52%	0.45%	0.63%	0.87%	1.02%
Provision Coverage (%)	59%	58%	46%	46%	46%
Specific LLP (%)	0.84%	0.53%	0.71%	0.86%	0.72%
Net NPAs / Networth (%)	4.81%	4.35%	5.88%	8.42%	9.97%

Source: Company, Ambit Capital research

Du-pont analysis (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
NII / Assets (%)	3.21%	3.03%	3.02%	2.94%	3.04%
Other income / Assets (%)	1.20%	1.26%	1.32%	1.37%	1.26%
Total Income / Assets (%)	4.42%	4.29%	4.34%	4.31%	4.30%
Cost to Assets (%)	1.66%	1.70%	1.81%	1.83%	1.85%
PPP / Assets (%)	2.76%	2.59%	2.53%	2.48%	2.45%
Provisions / Assets (%)	0.60%	0.51%	0.58%	0.66%	0.57%
PBT / Assets (%)	2.16%	2.08%	1.95%	1.81%	1.89%
Tax Rate (%)	23.8%	18.4%	20.1%	20.0%	20.0%
ROA (%)	1.64%	1.70%	1.56%	1.45%	1.51%
Leverage (%)	14.3	14.6	14.3	14.2	14.5
ROE (%)	23.5%	24.9%	22.3%	20.6%	21.9%

Source: Company, Ambit Capital research

Valuation (Standalone)

Year to March (%)	FY11	FY12	FY13	FY14E	FY15E
Shares in issue (mn)	405	408	474	474	474
EPS (₹.)	5.3	6.9	6.8	7.8	9.9
EPS (YoY) (%)	38.9%	29.3%	-1.1%	14.8%	26.9%
PE (x)	7.8	6.1	6.1	5.3	4.2
BV (₹.)	24.9	30.5	34.6	41.0	49.3
BV (YoY) (%)	20.3%	22.5%	13.6%	18.5%	20.4%
P/BV (x)	1.67	1.37	1.20	1.02	0.84
DPS (₹.)	0.8	1.0	1.0	1.2	1.3
Div. yield (%)	2.0%	2.4%	2.4%	2.9%	3.1%

Source: Company, Ambit Capital research

Appendix

Regional diversification of Indian banks

The Indian banking sector comprises 46 domestic banks across PSU and private (both old and new) sector banking. Using the geography-wise branch mix of these banks, we have ranked them on the regional nature of the branch network. We have used two parameters: (1) dispersion in branch-wise market share across all the Indian states and union territories, and (2) the number of states/UTs for a bank, where bank's branch market share is in line with the bank's size at the national level.

The top-five banks that are ranked the highest on regional diversification, in declining order, are Axis Bank, State Bank of India, IndusInd Bank, Union Bank and HDFC Bank. Regional small-cap private sector banks (such as Jammu & Kashmir Bank, Nainital Bank and Dhanlaxmi Bank) and SBI's subsidiary banks complete the tail end of the list.

Profiling regional diversification of regional banks

Our six sample regional banks are in the second half of 'regional diversification table' among the 46 domestic Indian banks. ING Vysya Bank ranks the highest, with one of the most-diversified branch networks among the regional banks. The most counterintuitive finding is Federal Bank's ranking, which is below South Indian Bank and City Union Bank. Based on the end-FY12 branch network, Federal Bank (FB) has a more concentrated branch network in a smaller state (Kerala) as compared to South Indian Bank (SIB) and City Union Bank (CUB) which have a significant number of branches in their 'second home state' (South Indian Bank in Tamil Nadu and City Union Bank in Andhra Pradesh). Note that Kerala-based SIB, despite being a smaller bank, had 121 branches in Tamil Nadu as compared to 81 branches for Kerala-based Federal Bank.

Exhibit 1: Ranking Indian domestic banks on the regional diversification score

Rank	Bank	Score	Rank	Bank	Score	Rank	Bank	Score
1	Axis Bank (AXSB)	9.6	17	Oriental Bank of Commerce (OBC)	6.4	33	Karnataka Bank (KBL)	3.0
2	State Bank of India (SBIN)	9.3	18	Kotak Mahindra Bank (KMB)	6.3	**34**	**South Indian Bank (SIB)**	**2.7**
3	IndusInd Bank (IIB)	9.3	19	Indian Overseas Bank (IOB)	6.0	35	Andhra Bank (ANDB)	2.6
4	Union Bank of India (UNBK)	8.8	20	Corporation Bank (CRPBK)	6.0	36	Ratnakar Bank (RTBK)	2.3
5	HDFC Bank (HDFCB)	8.5	21	Indian Bank (INBK)	5.5	**37**	**City Union Bank (CUB)**	**2.2**
6	Central Bank of India (CBOI)	8.3	22	Vijaya Bank (VJYBK)	5.3	**38**	**Federal Bank (FB)**	**1.8**
7	ICICI Bank (ICICIBC)	7.9	**23**	**ING Vysya Bank (VYSB)**	**4.9**	39	Catholic Syrian Bank (CSB)	1.8
8	Syndicate Bank (SNDB)	7.7	**24**	**Development Credit Bank (DCB)**	**4.9**	40	Tamilnad Mercantile Bank (TMB)	1.4
9	Punjab National Bank (PNB)	7.6	25	Bank of Maharashtra (BOM)	4.5	41	Dhanlaxmi Bank (DHLBK)	1.3
10	Canara Bank (CBK)	7.2	26	Punjab & Sind Bank (PJSB)	4.1	42	Nainital Bank (NBK)	1.2
11	Allahabad Bank (ALBK)	7.2	27	Dena Bank (DNBK)	3.9	43	State Bank of Travancore (SBT)	1.0
12	Bank of India (BOI)	7.2	**28**	**Karur Vysya Bank (KVB)**	**3.7**	44	State Bank of Bikaner & Jaipur (SBBJ)	1.0
13	Yes Bank (YES)	7.1	29	State Bank of Hyderabad (SBH)	3.5	45	State Bank of Mysore (SBM)	0.8
14	IDBI Bank (IDBI)	7.0	30	United Bank of India (UNTDB)	3.4	46	Jammu & Kashmir Bank (JKBK)	0.4
15	Bank of Baroda (BOB)	7.0	31	Lakshmi Vilas Bank (LVB)	3.3			
16	UCO Bank (UCO)	7.0	32	State Bank of Patiala (SBP)	3.3			

Source: Company, Industry, RBI, Ambit Capital research

Impact from new banking licence issuance

As discussed in our [16 July note on new bank licences](), after the new bank licences are granted, many of the new banks could choose to acquire an existing bank to save themselves from building a branch network and acquiring low-cost CASA deposits and priority sector assets from scratch. Hence, some small private sector banks could emerge as acquisition targets for some newly formed banks. Some existing banks may also look at the acquisition route to build scale in anticipation of rising competition in the coming years, as the number of new bank licence recipients expands.

As mentioned in our 16 July report, we believe that regional banks with: **(i)** a high percentage of branches in rural and semi-urban areas; **(ii)** a high proportion of CASA deposits; and **(iii)** a high proportion of priority sector assets, would be the preferred acquisition candidates by the newly formed banks.

Moreover, ease of acquiring the required shareholding to control the bank and ease of integration of the acquired bank with the existing operations would be other factors which would determine the attractiveness of these small private sector banks for the acquirer.

In the below table, we show the attractiveness of small private sector banks on each of these parameters:

Exhibit 2: Relative attractiveness of small-cap private sector banks as acquisition targets

	% of branches in		CASA Ratio	Priority sector loans as a % of total loans	Ease of acquiring the target (Nature of ownership)	Ease of integration (presence of union/work culture)	Overall attractiveness (score on a scale of 5)
	rural areas	rural + semi urban areas					
City Union Bank	14%	48%	16.8%	47%	Highly diffused	Unionised staff but small size and friendly union	3.0
Dhanlaxmi Bank	9%	48%	19.0%	31%	Highly diffused	Active unions with legacy issues	2.0
Federal Bank	7%	63%	26.9%	30%	Highly diffused	Active unions with legacy issues	2.5
ING Vysya	16%	34%	32.5%	38%	Concentrated with ING' holding of ~42%	~35% staff under union, more professional work culture	4.0
Karnataka Bank	19%	41%	24.9%	45%	Highly diffused	Unionised staff but small size should help	3.0
Karur Vysya bank	9%	46%	19.3%	42%	Highly diffused	Unionised staff but relatively friendly unions	2.5
Lakshmi Vilas Bank	14%	51%	14.5%	43%	Highly diffused	Unionised staff but relatively friendly unions	3.0
South Indian Bank	12%	60%	18.3%	31%	Highly diffused	Active staff unions	2.5
Development Credit Bank	6%	46%	27.2%	40%	Relatively concentrated	No staff union	3.5

Source: Bloomberg, Ambit Capital research. Note: We have scored these banks on five parameters as discussed in the table. The final score is based upon the weighted average—10% weightage to the PSL rating and 22.5% weightage to the rest of the parameters.

Based on the above parameters, ING Vysya Bank and Development Credit Bank are the most-attractive acquisition targets for new bank entrants. Note that the ING Group has shown no inclination to sell IVB. ING Vysya Bank scores higher on the share of rural branches, CASA ratio, relatively concentrated shareholding, and relative ease of integration. DCB also scores well on all parameters except the share of rural branches. The relatively elevated cost ratios for IVB and DCB should also provide cost synergy opportunities. These two banks are trading at valuations of 0.9x-1.1x FY14 P/B. The latest M&A transaction in the Indian banking system was the acquisition of the Bank of Rajasthan by ICICI Bank, where ICICI Bank paid ~4.0x P/B to acquire the Bank of Rajasthan.

Apart from new bank licence recipients looking for takeover candidates, the incumbent private sector banks may also seek to acquire a regional bank to build scale and to place themselves better amidst intensifying competition (after the grant of new banking licences). Note that the private banking sector has seen 14 mergers since 1994. Six of these were takeovers of PSU banks of a stressed entity. Dhanlaxmi Bank, which has been under significant financial stress, could see a similar takeover. In eight instances, however, a private sector bank acquired another private sector bank, where the strategic elements of entry into new geographic area, product segment or rural areas were among the key motivations.

Exhibit 3: Acquisition history of private sector banks

	Target	Acquirer	Acquirer bank type
1999	Times Bank	HDFC Bank	Private Sector Bank
1999	Bareilly Corporation Bank	Bank of Baroda	PSU Bank
2001	Bank of Madura	ICICI Bank	Private Sector Bank
2001	Benares State Bank	Bank of Baroda	PSU Bank
2002	Nedungadi Bank	Punjab National Bank	PSU Bank
2004	Global Trust Bank	Oriental Bank of Commerce	PSU Bank
2005	Bank of Punjab	Centurion Bank	Private Sector Bank
2006	Lord Krishna Bank	Centurion Bank of Punjab	Private Sector Bank
2006	Sangli Bank	ICICI Bank	Private Sector Bank
2006	United Western Bank	IDBI Bank	PSU Bank
2006	Ganesh Bank of Kurundwad	Federal Bank	Private Sector Bank
2007	Bharat Overseas Bank	Indian Overseas Bank	PSU Bank
2008	Centurion Bank of Punjab	HDFC Bank	Private Sector Bank
2010	Bank of Rajasthan	ICICI Bank	Private Sector Bank

Source: Company, Ambit Capital research

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E&C = Engineering & Construction

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>5%
Sell	≤5%

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