

October 22, 2012

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Rating	BUY
Price	Rs488
Target Price	Rs550
Implied Upside	12.7%
Sensex	18,793
Nifty	5,717

(Prices as on October 22, 2012)
Trading data

Market Cap. (Rsbn)	83.4
Shares o/s (m)	171.0
3M Avg. Daily value (Rs m)	331.4

Major shareholders

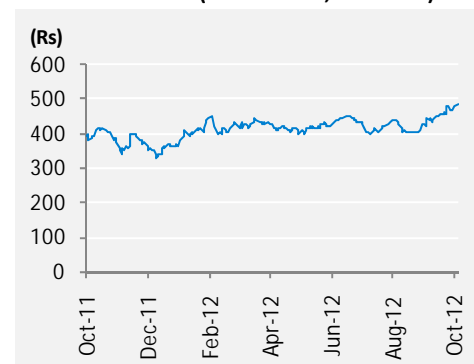
Promoters	0.00%
Foreign	43.79%
Domestic Inst.	20.80%
Public & Other	35.41%

Stock Performance

(%)	1M	6M	12M
Absolute	9.2	13.6	27.2
Relative	9.0	5.4	15.2

How we differ from Consensus

EPS (Rs)	PL	Cons.	% Diff.
2013	49.8	49.8	-0.1
2014	57.3	59.1	-3.0

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


Source: Bloomberg

Federal Bank's (FB's) Q2FY13 results highlight structural improvement in asset quality though some lumpy legacy risks remain. Operating metrics has been marginally weak but with SME/Retail growth picking up and bulk of the network expansion done, we expect FB to start delivering on PPOP growth from H2FY13. With improving asset quality and operating metrics, we expect ROEs to move up to ~16% over FY13-15 after being stick in a narrow band of 12-14% for last five years and thus, maintain our 'BUY' rating and Sep-13 PT of Rs540/share (1.3x FY14 book).

- Structural improvement in asset quality despite some lumpy risks:** Q2FY13 highlights structural improvement in asset quality, especially in retail and large corporates. SME asset quality remained volatile in Q2FY13 but management expects further improvement on SME slippages as well. Some lumpy slippages risks remain like NAFED (Rs2bn exposure) + ~Rs5bn of large accounts on management watchlist but overall slippages trend indicate structural improvement in credit.
- Cost income spike a temporary blip:** Cost income has spiked to ~45% from ~38% in four quarters as FB has expanded branch network by ~35% over the last four quarters. Management believes they are almost at the end of rapid network expansion drive and will calibrate branch addition after FY13 and concentrate on monetising on their network expansion largely through growth in SME/Retail segments. We factor in C/I to spike to ~43% in FY13 and moderate considerably to <40% over FY13-15.
- Some improvement required in operating metrics:** Operating metrics disappointed in Q2FY13, with contraction in loan book and weak trends on SA deposits and core fees. Loan book contraction was largely related to de-bulking and with strong growth in Retail/SME segments, mgt expects to deliver +16% growth even in FY13. Significant branch additions to aid in SA growth but fee income is possibly an area where we see some risks to operating performance.

Key financials (Y/e March)	2011	2012	2013E	2014E
Net interest income (Rs m)	17,466	19,534	21,734	25,316
Growth (%)	23.8	11.8	11.3	16.5
Operating profit (Rs m)	14,273	15,065	15,703	18,777
PAT (Rs m)	5,871	7,768	8,514	9,802
EPS (Rs)	34.3	45.4	49.8	57.3
Growth (%)	26.4	32.3	9.6	15.1
Net DPS (Rs)	8.5	9.0	10.5	12.0

Profitability & Valuation	2011	2012	2013E	2014E
NIM (%)	3.67	3.49	3.34	3.34
RoAE (%)	12.0	14.4	14.1	14.6
RoAA (%)	1.23	1.39	1.31	1.29
P / BV (x)	1.6	1.5	1.3	1.2
P / ABV (x)	1.6	1.4	1.3	1.2
PE (x)	14.2	10.7	9.8	8.5
Net dividend yield (%)	1.7	1.8	2.2	2.5

Source: Company Data; PL Research

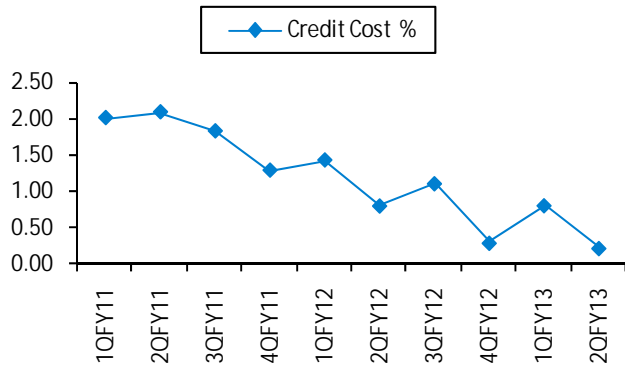


Exhibit 1: Q2FY13 Summary-Positively surprised on credit costs

	2QFY12	1QFY13	2QFY13	YoY	QoQ	
Interest earned	13,678	15,367	15,256	11.5%	-0.7%	
<i>Sequential decline in advances leads to sequential decline in NII</i>	Interest expended	8,934	10,451	10,197	14.1%	-2.4%
	Net interest income	4,744	4,916	5,059	6.6%	2.9%
<i>Other income excluding investment gains-almost constant YoY</i>	Other Income	1,170	1,243	1,394	19.2%	12.1%
	Total income	5,914	6,160	6,453	9.1%	4.8%
<i>Branch expansion lead to the jump in operating cost, going forward, a more calibrated branch expansion planned</i>	Operating Expenses	2,301	2,695	2,957	28.5%	9.7%
	Staff costs	1,283	1,524	1,594	24.3%	4.6%
	Other operating expenses	1,019	1,171	1,362	33.8%	16.4%
	Operating profit	3,613	3,465	3,496	-3.2%	0.9%
<i>Steep drop in provisioning cost surprise positively</i>	Other Provisions & Contingencies	722	628	305	-57.8%	-51.5%
	PBT	2,891	2,837	3,192	10.4%	12.5%
	Provision for Taxes	979	934	1,041	6.3%	11.5%
	Net Profit	1,912	1,904	2,151	12.5%	13.0%
	Tax rate (%)	33.9%	32.9%	33.0%	-0.9%	0.1%
	Balance Sheet					
<i>De-bulking of balance sheet by running down on corporate book leads to QoQ decline in Advances</i>	Advances	336,067	380,429	362,992	8.0%	-4.6%
	Deposits	472,635	505,581	495,180	4.8%	-2.1%
	Current	23,020	23,565	25,980	12.9%	10.2%
	Savings	101,830	119,767	117,580	15.5%	-1.8%
	CASA ratio (%)	26.4	28.4	28.7	2.3	0.4
	Gross NPAs	12,503	14,089	14,353	14.8%	1.9%
	Net NPAs	1,957	2,362	2,450	25.2%	3.8%
	Provision coverage (%)	84.3%	83.2%	82.9%	-1.4%	-0.3%
	Credit costs	0.80	0.80	0.22	-0.58	-0.59
	Restructured assets	14,463	26,150	28,460	96.8%	8.8%
<i>QoQ increase in margins supported; largely in line with expectations</i>	% of loans	4.30	6.87	7.84	3.5	1.0
	Reported Margins	3.77	3.42	3.58	-0.19	0.16
	CD Ratio	71.1	75.2	73.3	2.20	-1.94
	Branches	757	978	1,010	33.4%	3.3%
	ATMs	832	1,041	1,100	32.2%	5.7%

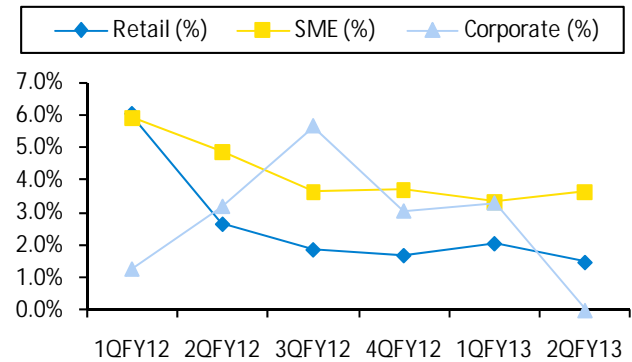
Source: Company Data, PL Research

Exhibit 2: Credit cost surprises positively



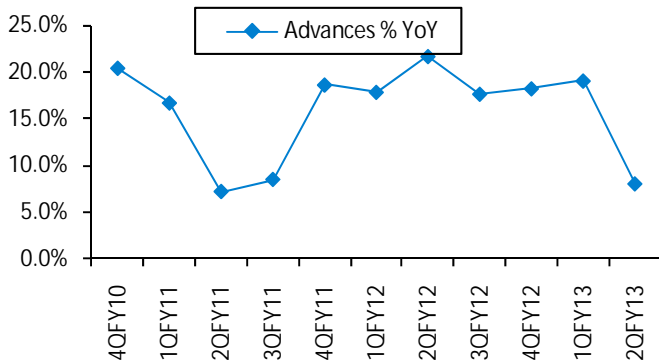
Source: Company Data, PL Research

Exhibit 3: Surprise lead by retail/ Corporate; SME remains volatile



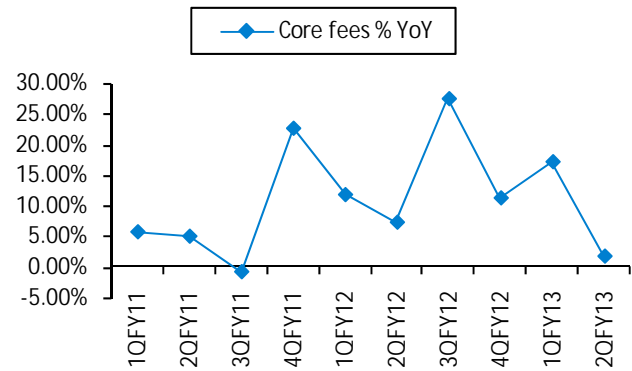
Source: Company Data, PL Research

Exhibit 4: De-bulking of balance sheet leads to muted growth



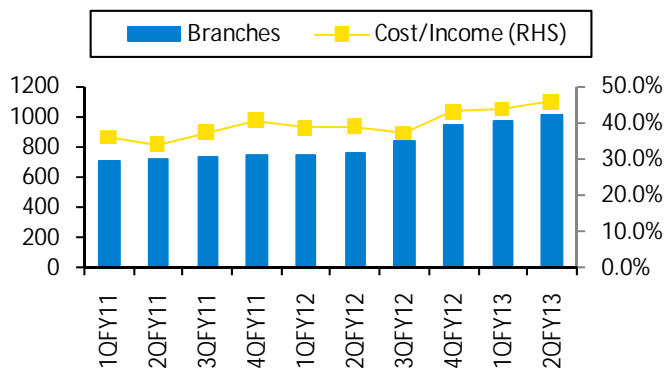
Source: Company Data, PL Research

Exhibit 5: Core fees growth comes in weak



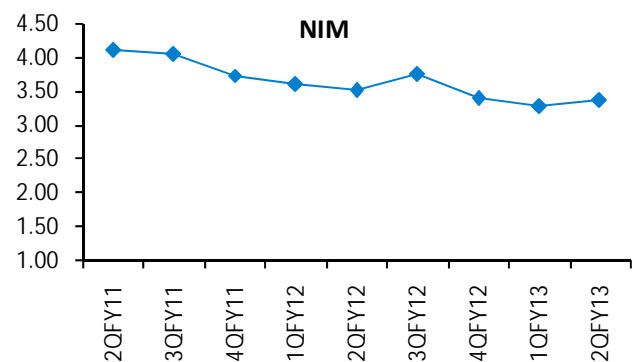
Source: Company Data, PL Research

Exhibit 6: Rapid branch expansion leads to rising Cost/Income ratio



Source: Company Data, PL Research

Exhibit 7: Sequential uptick in NIMs on expected lines



Source: Company Data, PL Research

Exhibit 8: De-bulking of balance sheet seems largely from AAA rated book

	4Q11	1Q12	2Q12	4Q12	1Q13	2Q13
Large Corporates	129,532	129,446	139,637	173,753	162,089	134,212
AAA/AA	30.0%	23.1%	21.1%	36.0%	33.1%	22.8%
A	8.0%	13.3%	9.9%	7.0%	5.6%	9.1%
BBB	14.0%	13.1%	12.6%	17.0%	14.1%	14.3%
< BBB	6.0%	6.5%	8.1%	8.0%	11.4%	15.7%
Unrated	42.0%	44.0%	48.2%	32.0%	35.8%	38.1%
AAA/AA	38,860	29,928	29,463	62,551	53,700	30,614
A	10,363	17,203	13,796	12,163	9,045	12,267
BBB	18,135	16,957	17,650	29,538	22,838	19,219
< BBB	7,772	8,362	11,366	13,900	18,494	21,018
Unrated	54,404	56,995	67,347	55,601	57,995	51,094
	95,640	95,860	99,700	101,866	109,180	115,030
FB1	9.0%	9.1%	7.9%	18.0%	14.6%	8.0%
FB2	24.0%	22.6%	26.6%	21.0%	27.0%	26.6%
FB3	48.0%	29.2%	37.2%	40.0%	34.7%	37.6%
Others	19.0%	39.2%	28.3%	21.0%	23.7%	27.9%
FB1	8,608	8,723	7,836	18,336	15,929	9,145
FB2	22,954	21,636	26,480	21,392	29,479	30,586
FB3	45,907	27,972	37,128	40,746	37,885	43,205
Others	18,172	37,529	28,255	21,392	25,887	32,093

Source: Company Data, PL Research

Exhibit 9: Sep-13 PT at Rs 550/Share

Risk free rate	8.0%
Equity Risk Premium	6.0%
Beta	1.25
Cost of Equity	15.5%
Terminal growth	5.0%
Normalised ROE	16.9%
Stage 2 growth	15.0%
Sep-13 PT	550
Implied Mar-14 P/B	1.33
Implied Mar-14 P/E	9.6

Source: Company Data, PL Research

Income Statement (Rs m)

Y/e March	2011	2012	2013E	2014E
Int. Earned from Adv.	31,688	41,898	49,358	56,311
Int. Earned from Inv.	8,680	13,157	15,094	16,915
Others	152	529	565	608
Total Interest Income	40,520	55,584	65,017	73,834
Interest expense	23,054	36,050	43,283	48,518
NII	17,466	19,534	21,734	25,316
<i>Growth (%)</i>	<i>23.8</i>	<i>11.8</i>	<i>11.3</i>	<i>16.5</i>
Treasury Income	461	824	1,100	1,100
NTNII	4,707	4,499	4,681	5,508
Non Interest Income	5,168	5,323	5,781	6,608
Total Income	45,688	60,907	70,798	80,442
<i>Growth (%)</i>	<i>8.7</i>	<i>33.3</i>	<i>16.2</i>	<i>13.6</i>
Operating Expense	8,361	9,793	11,811	13,147
Operating Profit	14,273	15,065	15,703	18,777
<i>Growth (%)</i>	<i>12.8</i>	<i>5.6</i>	<i>4.2</i>	<i>19.6</i>
NPA Provisions	5,032	2,582	2,885	4,020
Investment Provisions	111	349	—	—
Total Provisions	5,254	3,370	2,885	4,020
PBT	9,018	11,695	12,819	14,757
Tax Provisions	3,147	3,927	4,304	4,955
<i>Effective Tax Rate (%)</i>	<i>34.9</i>	<i>33.6</i>	<i>33.6</i>	<i>33.6</i>
PAT	5,871	7,768	8,514	9,802
<i>Growth (%)</i>	<i>26.4</i>	<i>32.3</i>	<i>9.6</i>	<i>15.1</i>

Balance Sheet (Rs m)

Y/e March	2011	2012	2013E	2014E
Par Value	10	10	10	10
No. of equity shares	171	171	171	171
Equity	1,710	1,710	1,710	1,710
Networth	51,030	57,009	63,422	70,823
Adj. Networth	48,970	54,554	60,528	67,254
Deposits	430,148	489,371	553,772	656,792
<i>Growth (%)</i>	<i>19.3</i>	<i>13.8</i>	<i>13.2</i>	<i>18.6</i>
Low Cost deposits	115,541	134,759	152,287	181,274
<i>% of total deposits</i>	<i>26.9</i>	<i>27.5</i>	<i>27.5</i>	<i>27.6</i>
Total Liabilities	514,507	606,214	693,741	823,122
Net Advances	319,532	377,560	434,194	521,033
<i>Growth (%)</i>	<i>18.6</i>	<i>18.2</i>	<i>15.0</i>	<i>20.0</i>
Investments	145,377	174,025	195,662	226,008
Total Assets	514,507	606,214	693,741	823,122

Source: Company Data, PL Research.

Quarterly Financials (Rs m)

Y/e March	Q3FY12	Q4FY12	Q1FY13	Q2FY13
Interest Income	14,668	14,790	15,367	15,256
Interest Expense	9,388	9,878	10,451	10,197
Net Interest Income	5,280	4,912	4,916	5,059
Non Interest Income	1,379	1,606	1,243	1,394
CEB	947	1,031	910	909
Treasury	156	364	262	358
Net Total Income	6,660	6,518	6,160	6,453
Operating Expenses	2,472	2,793	2,695	2,957
Employee Expenses	1,385	1,462	1,524	1,594
Other Expenses	1,088	1,331	1,171	1,362
Operating Profit	4,187	3,724	3,465	3,496
Core Operating Profit	4,031	3,361	3,203	3,138
Provisions	1,153	155	628	305
Loan loss provisions	—	—	—	—
Investment Depreciation	—	—	—	—
Profit before tax	3,035	3,569	2,837	3,192
Tax	1,016	1,193	934	1,041
PAT before EO	2,019	2,376	1,904	2,151
Extraordinary item	—	—	—	—
PAT	2,019	2,376	1,904	2,151

Key Ratios

Y/e March	2011	2012	2013E	2014E
CMP (Rs)	488	488	488	488
Equity Shrs. Os. (m)	171	171	171	171
Market Cap (Rs m)	83,403	83,403	83,403	83,403
<i>M/Cap to AUM (%)</i>	<i>16.2</i>	<i>13.8</i>	<i>12.0</i>	<i>10.1</i>
EPS (Rs)	34.3	45.4	49.8	57.3
Book Value (Rs)	298	333	371	414
Adj. BV (75%) (Rs)	303	338	376	421
P/E (x)	14.2	10.7	9.8	8.5
P/BV (x)	1.6	1.5	1.3	1.2
P/ABV (x)	1.6	1.4	1.3	1.2
DPS (Rs)	8.5	9.0	10.5	12.0
<i>Dividend Yield (%)</i>	<i>1.7</i>	<i>1.8</i>	<i>2.2</i>	<i>2.5</i>

Profitability (%)

Y/e March	2011	2012	2013E	2014E
NIM	3.7	3.5	3.3	3.3
RoAA	1.2	1.4	1.3	1.3
RoAE	12.0	14.4	14.1	14.6

Efficiency

Y/e March	2011	2012	2013E	2014E
<i>Cost-Income Ratio (%)</i>	<i>36.9</i>	<i>39.4</i>	<i>42.9</i>	<i>41.2</i>
<i>C-D Ratio (%)</i>	<i>74.3</i>	<i>77.2</i>	<i>78.4</i>	<i>79.3</i>
Business per Emp. (Rs m)	90	91	90	93
Profit per Emp. (Rs m)	7	8	8	8
Business per Branch (Rs m)	1,009	1,015	1,005	1,042
Profit per Branch (Rs m)	8	9	9	9

Asset Quality

Y/e March	2011	2012	2013E	2014E
Gross NPAs (Rs m)	11,483	13,008	15,337	18,910
Net NPAs (Rs m)	2,060	2,455	2,894	3,569
<i>Gr. NPAs to Gross Adv. (%)</i>	<i>3.6</i>	<i>3.4</i>	<i>3.5</i>	<i>3.6</i>
<i>Net NPAs to Net Adv. (%)</i>	<i>0.6</i>	<i>0.7</i>	<i>0.7</i>	<i>0.7</i>
<i>NPA Coverage (%)</i>	<i>82.1</i>	<i>81.1</i>	<i>81.1</i>	<i>81.1</i>

Source: Company Data, PL Research.

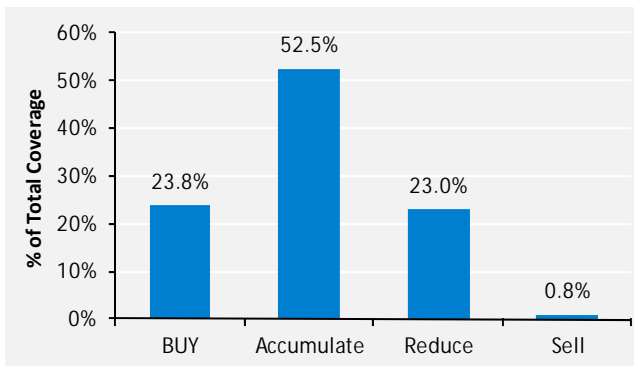


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Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	: Over 15% Outperformance to Sensex over 12-months	Accumulate	: Outperformance to Sensex over 12-months
Reduce	: Underperformance to Sensex over 12-months	Sell	: Over 15% underperformance to Sensex over 12-months
Trading Buy	: Over 10% absolute upside in 1-month	Trading Sell	: Over 10% absolute decline in 1-month
Not Rated (NR)	: No specific call on the stock	Under Review (UR)	: Rating likely to change shortly

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