

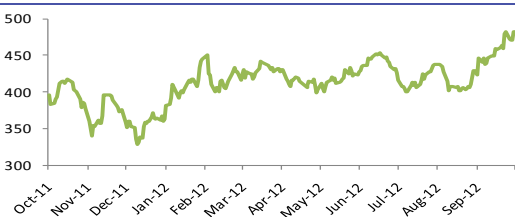
Federal Bank Ltd

Recommendation	HOLD
CMP (23/10/2012)	Rs. 488
Target Price	Rs.525
Sector	Banking

Stock Details

BSE Code	500469
NSE Code	FEDERALBNK
Bloomberg Code	FB IN
Market Cap (Rs crs)	8343
Free Float (%)	100%
52- wk HI/Lo (Rs)	494.7/322.1
Avg. volume BSE (Quarterly)	220169
Face Value (Rs)	10.0
Dividend (FY 12)	90%
Shares o/s (Cr)	17.10

Relative Performance	1Mth	3Mth	1Yr
Ing Vysya Bank	12.5%	13.0%	21.8%
Sensex	1.0%	8.1%	10.3%



Shareholding Pattern	30 th Sept 12
Promoters Holding	-
Institutional (Incl. FII)	62.34%
Corporate Bodies	14.16%
Public & others	23.50%

Silky Jain
(022 3926 8178)
silky.jain@nirmalbang.com

Research Analyst

Operational Restructuring leads to subdued growth

Federal Bank (FB) results were below expectations primarily due to lower NII. NII witness a subdued growth as the Management took conscious efforts to de bulk its book and reduced its corporate book exposure from 44% in Q2FY12 to 39% in Q2FY13. However, growth across SME and retail continued to show good traction. Net profit of the bank increased 13.0% QoQ and 12.5% YoY to Rs 215 cr on account of lower provisions.

Going forward, we believe that the management's strategy to strengthen the book and focus more on better rated corporates will have a positive impact on the performance of the bank. H1FY13 was overall subdued in terms of advance growth, NIMs and non interest income, higher cost to income ratio. However, with most of the things in place, Management is aiming a higher growth in advances and total income. With most of the branches nearing break even operational efficiency is set to be achieved by the bank. On the asset quality front, Management does expect some stress on corporate accounts (NAFED etc) but expects no major stress on SME and retail book. **Given the improvement in the bank's earnings and the structural improvements in the balance sheet, we expect the bank's profitability to grow at 11.2% CAGR over FY12-FY14E.**

At CMP, the stock is trading at 1.35x and 1.21x FY13E and FY14E Adj BVPS and 9.93x and 8.7x FY13E and FY14E EPS respectively. **We had recommended the stock in our report dated 7th August 2012 at Rs 410 with a target price of Rs 510. As the stock has already appreciated 18.8% since then we have downgraded our rating from BUY to HOLD with a revised target price of Rs 525 (1.3x FY14E Adj BV) indicating an upside of 7.6% from current levels.**

- NII increased 6.6% on YoY basis and 2.9% on QoQ basis to Rs 506 cr. Growth was subdued YoY mainly due to slower growth in the advances. NIM saw an improvement of 16 bps QoQ but a decline of 19 bps YoY and stood at 3.58%.
- The share of non interest income as a % of total income increased to 21.6% in Q2FY13 vs 20.2% in Q1FY13 and 19.8% in Q2FY12.
- Cost to income ratio stood at 45.8% for Q2FY13 vs 43.7% in Q1FY13.
- Advances growth was muted at 8.0% YoY (decline of 4.6% QoQ) led by corporate book declining by 15.9% on QoQ basis owing to run off of certain large corporate accounts. However, SME and Retail book continued to show healthy growth and increased by 4.8% and 4.2% QoQ respectively.
- Provisions stood at Rs 30.5 cr, resulting in a fall of 57.8% on sequential basis.
- CASA improved to 29% in Q2FY13 vs 28.7% in Q1FY13 & 27.4% in Q2FY12.
- Asset quality was well under control with minimal increase in gross NPAs. Slippages declined on QoQ basis (Rs147 cr in Q2FY13 vs Rs279 cr in Q1FY13) with no slippages from the large corporates and slippages from the retail and SME segments also showed an improvement.
- GNPA ratio and NNPA ratio were at 3.83% and 0.68% respectively in Q2FY13.
- The bank restructured Rs 230 cr of advances in Q2FY13, taking the total restructured standard advances to Rs 1,956 cr (5.4% of the total loans).

Year	NII (Rs crs)	Growth (%)	PBP (Rs crs)	Margin (%)	PAT (Rs crs)	EPS (Rs)	PE (x)	Adj BVPS (Rs)	P/ABV (x)	RoE
FY11A	1,747	23.8%	1,428	63.1%	588	34.35	14.20	291.2	1.68	12.0%
FY12A	1,953	11.8%	1,506	60.6%	777	45.41	10.75	325.8	1.50	14.4%
FY13E	2,166	10.9%	1,581	57.3%	840	49.12	9.93	361.9	1.35	13.9%
FY14E	2,500	15.4%	1,825	57.4%	960	56.11	8.70	403.7	1.21	14.3%

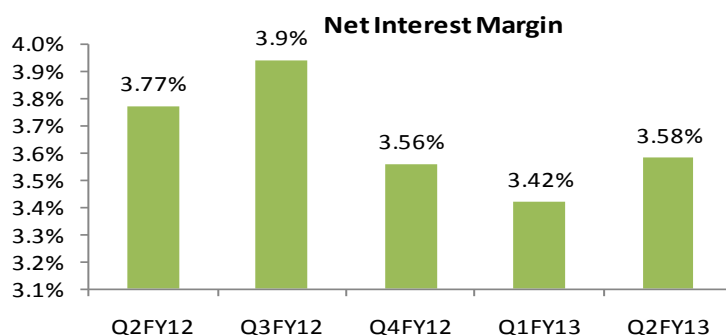
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NIM's show flattish growth

Net Interest Income increased 6.6% on YoY basis and 2.9% on QoQ basis to Rs 506 cr, backed by 9.8% YoY growth in Interest on advances and 14% growth in interest on investments. NII was subdued mainly due to a slower growth in the advances. Net Interest Margin (NIM) saw an improvement of 16 bps QoQ but a decline of 19 bps YoY and stood at 3.58%. During the quarter, the yield on the advances increased by 23 bps QoQ to 12.75% whereas the cost of deposits increased by 6 bps QoQ to 7.61%.

In Q1FY13, the decline in NIM was on account of one time MTM adjustment on the forex borrowing (of Rs 19 crore), and interest reversal of ~Rs 10 cr on slippages.

Management has guided for margins to be in the range of 3.55%-3.6% for FY13 and expects margins to improve in H2FY13. We expect NIMs to be at 3.5% for FY13E and 3.4% for FY14E.



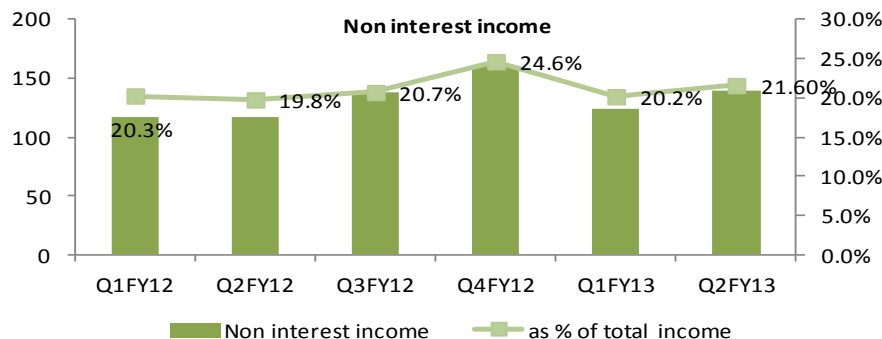
Source: Company data, Nirmal Bang Research

Non-interest income shows some traction

Non interest income increased by 19.2% on YoY basis and 12% QoQ to Rs 139.4 crs in Q2FY13 driven by growth in commission and brokerage income (+10.2% QoQ and 6.5% YoY) and treasury income and recovery from written off accounts. The bank reported treasury profit of Rs 35.8 cr vs Rs 14.1 cr in Q2FY12.

The share of non interest income as a percentage of total income increased to 21.6% in Q2FY13 as compared to 20.2% in Q1FY13 and 19.8% in Q2FY12.

Going forward Management expects fee income growth to improve based on the various initiatives taken which are likely to yield results. We expect 11% growth in non interest income for FY13E and 15% growth for FY14E as compared to 3.0% growth in FY12.



Source: Company data, Nirmal Bang Research

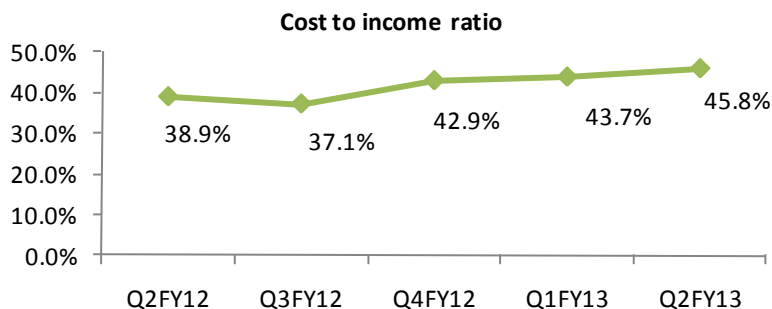


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Higher cost to income ratio; improvement expected

Cost to income ratio of the bank stood at 45.8% for Q2FY13 vs 43.7% in Q1FY13 and 38.9% in Q2FY12. Employee expenses increased 4.6% QoQ and 24.3% YoY whereas other opex increased 16.4% QoQ and 33.8% YoY leading to 9.7% QoQ and 28.5% YoY increase in the total operating cost of the bank.

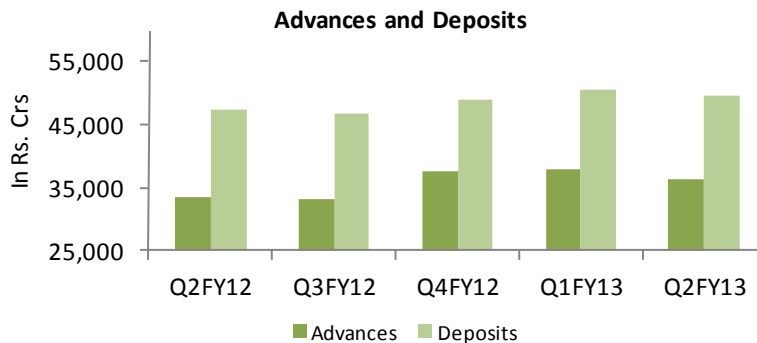
The bank has added 187 branches and 254 ATM's since Oct 2011 taking the overall branch and ATM network to 1,010 branches and 1100 ATM's. Consequently, cost to income ratio stands high at 45.8%. Moreover, higher increase in operating expenses offset the growth in total income. Management expects the cost to income ratio to improve going forward as most of the branches are close to breakeven which will result in cost efficiencies and also expects income growth to be substantial in 2HFY13. Management does not expect any new branch addition till March 2013 and expects net employee addition of 500 by FY13. We expect cost to income ratio to come down to 42.7% in FY13E and 42.6% in FY14E.



Source: Company data, Nirmal Bang Research

De-bulking balance sheet growth

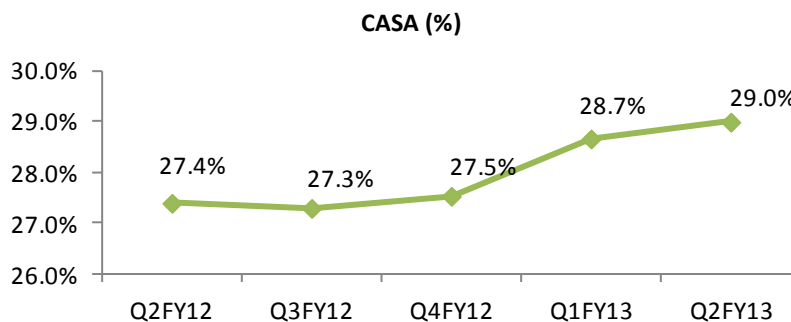
Advances growth was muted at 8.0% YoY (decline of 4.6% QoQ) led by corporate book declining by 15.9% on QoQ basis owing to run off of certain large corporate accounts. However, SME and Retail book continued to show healthy growth and increased by 4.8% and 4.2% QoQ respectively. Gold loans increased by 95% YoY and 18% QoQ to Rs 5,000 cr and constituted 13.8% of advances. Going forward Management expects advance book to grow in the range of 16-18% for FY13E. We expect 17% growth in advances in FY13E and 18.4% in FY14E.



Source: Company data, Nirmal Bang Research

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Deposits grew 4.77% YoY whereas declined of 2.06% on sequential basis. The sequential decline was due to decline in bulk deposits which constituted 11% of total deposits. Loan to deposit ratio of the bank stood at 73.3% in Q2FY13. CASA ratio of the bank improved to 29% in Q2FY13 as compared to 28.7% in Q1FY13 and 27.4% in Q2FY12. CA deposits improved by 3.3% sequentially while SA deposits declined QoQ by 1.8%. We expect CASA ratio to remain flat in at 33.1% in FY13E and 33.5% in FY14E. NRE deposits reported robust growth of 62% YoY and 7% QoQ at Rs 13,120 cr. Going forward, the increased branch network will add to the CASA momentum and result in an improvement in the ratio. We expect CASA ratio to be at 28.8% for FY13E and 29.6% for FY14E.



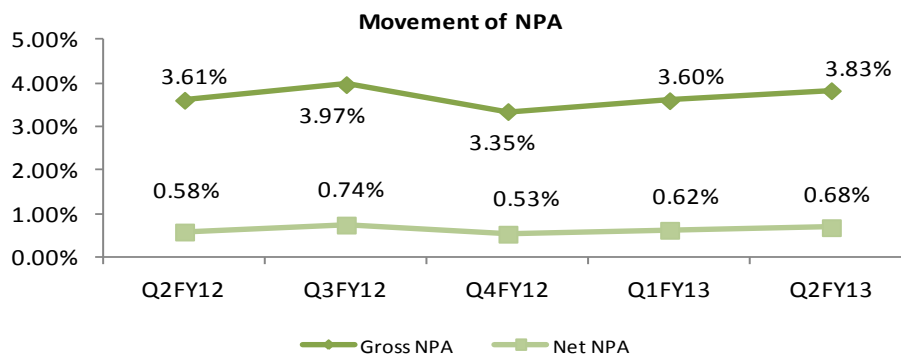
Source: Company data, Nirmal Bang Research

Asset quality shows marked improvement

The asset quality was well under control with minimal increase in gross NPAs. Slippages declined on QoQ basis (Rs147 cr in Q2FY13 vs Rs279 cr in Q1FY13) with no slippages from the large corporates and slippages from the retail and SME segments also showed an improvement. The bank restructured Rs 230 cr of advances, taking the total restructured standard advances to Rs 1,956 cr (5.4% of the total loans). The total gross restructured book stood at Rs 2,900 cr (8% of total advances). According to the management, some account (NAFED) and others are under review. Barring this asset quality outlook remains stable.

Gross NPA ratio and Net NPA ratio were at 3.83% and 0.68% respectively in Q2FY13. We expect the bank's Gross NPAs to come down to 3.6% and 3.5% in FY13E and FY14E whereas Net NPAs to be at 0.6% and 0.6% in FY13E and FY14E respectively.

Provisions for the quarter stood at Rs 30.5 cr, declining 57.8% on sequential basis. Provision coverage ratio remained healthy at 80%.



Source: Company data, Nirmal Bang Research

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Income Statement	Q2FY13	Q2FY12	YoY (%)	Q1FY13	QoQ (%)
Interest Earned	1,526	1,368	11.5%	1,537	(0.7%)
Interest Expended	1,020	893	14.1%	1,045	(2.4%)
Net Interest Income	506	474	6.6%	492	2.9%
Other Income	139	117	19.2%	124	12.1%
Total Income	645	591	9.1%	616	4.8%
Payment to employees	159	128	24.3%	152	4.6%
Other operating expenses	136	102	33.8%	117	16.4%
Total operating expenses	296	230	28.5%	269	9.7%
Profit before provisioning	350	361	(3.2%)	347	0.9%
Provisions	30	72	(57.8%)	63	(51.5%)
Profit before tax	319	289	10.4%	284	12.5%
Tax	104	98	6.3%	93	11.5%
Profit after tax	215	191	12.5%	190	13.0%
EPS	12.6	11.2	12.5%	11.1	13.0%

Source: Company data, Nirmal Bang Research

- Net Profit has shown a growth of 13% QoQ and 12.5% YoY at Rs 215 cr mainly due to 19.2% increase in non-interest income and 57.8% YoY decrease in provisions.
- EPS for Q2FY13 stood at Rs 12.6 while for Q2FY12, it was Rs 11.2.
- As on September 2012, the Bank has a total of 1010 branches and extension counters, 1100 ATMs.
- Capital Adequacy Ratio (CAR) of the Bank as on Q2FY13 stood at 15.79%.

Valuation and Recommendation

Going forward, we believe that the management's strategy to strengthen the book and focus more on better rated corporates will have a positive impact on the company's performance. H1FY13 was overall subdued in terms of advance growth, NIMs and non interest income, higher cost to income ratio. However, with most of the things in place, Management is aiming a higher growth in advances and total income. With most of the branches nearing break even operational efficiency is set to be achieved by the bank. Given the improvement in the bank's earnings and the structural improvements in the balance sheet, we expect the bank's profitability to grow at 11.2% CAGR over FY12-FY14E.

At CMP, the stock is trading at 1.35x and 1.21x FY13E and FY14E Adj BVPS and 9.93x and 8.7x FY13E and FY14E EPS respectively. **We had recommended the stock in our report dated 7th August 2012 at Rs 410 with a target price of Rs 510. As the stock has already appreciated 18.8% since then we have downgraded our rating from BUY to HOLD with a revised target price of Rs 525 (1.3x FY14E Adj BV) indicating an upside of 7.6% from current levels.**

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Financials

Profitability (Rs. Crs)	FY11	FY12	FY13E	FY14E
Interest earned	4,053	5,558	6,342	7,363
Interest expended	2,305	3,605	4,176	4,863
Net interest income	1,747	1,953	2,166	2,500
Non interest income	517	532	591	680
Total income	2,264	2,486	2,757	3,180
Operating expenses	836	979	1,176	1,355
Staff costs	480	544	641	718
Other Op Exp	356	435	536	637
Operating profit	1,428	1,506	1,581	1,825
Provisions	525	337	327	392
Profit before tax	902	1,169	1,254	1,433
Taxes	315	393	414	473
Net profit	588	777	840	960

Quarterly (Rs. Crs)	Dec.11	Mar.12	June.12	Sept.12
Net interest income	528	491	492	506
Non interest income	138	161	124	139
Total income	666	652	616	645
Operating expenses	247	279	269	296
Operating profit	419	372	347	350
Provisions	115	16	63	30
Profit before tax	303	357	284	319
Taxes	102	119	93	104
Net profit	202	238	190	215

Profitability Ratios	FY11	FY12	FY13E	FY14E
Cost / Income Ratio	36.9%	39.4%	42.7%	42.6%
Net profit margin	26.0%	31.2%	30.5%	30.2%
RONW	12.0%	14.4%	13.9%	14.3%

Growth Ratios	FY11	FY12	FY13E	FY14E
Advances Growth	18.6%	18.2%	17.0%	18.4%
Deposit Growth	19.3%	13.8%	16.5%	17.6%
NII Growth	23.8%	11.8%	10.9%	15.4%
PAT Growth	26.5%	32.2%	8.2%	14.2%
Pre prov growth	12.9%	5.5%	4.9%	15.4%
Non int income growth	-2.6%	3.0%	11.0%	15.0%

Valuation Ratios	FY11	FY12	FY13E	FY14E
P/BV	1.63	1.46	1.32	1.18
P/ABV	1.68	1.50	1.35	1.21
P/E	14.20	10.75	9.93	8.70

Balance Sheet (Rs. Crs)	FY11	FY12	FY13E	FY14E
Deposits	43,015	48,937	57,029	67,072
<i>(of which CASA)</i>	<i>(11,554)</i>	<i>(13,476)</i>	<i>(16,424)</i>	<i>(19,853)</i>
Borrowings	1,888	4,241	4,514	5,349
Other liab and prov	1,445	1,742	2,004	2,304
Total liabilities	46,348	54,920	63,547	74,725
Equity capital	171	171	171	171
Reserves and Surplus	4,938	5,535	6,175	6,915
Net worth	5,109	5,706	6,346	7,086
Total liab and equity	51,456	60,627	69,894	81,811
Cash and bank bal	3,748	3,533	3,526	3,721
Investments	14,538	17,402	20,076	23,444
Advances	31,953	37,756	44,162	52,304
Fixed assets	290	326	359	395
Other assets	927	1,610	1,771	1,948
Total assets	51,456	60,627	69,894	81,811

Key Ratios	FY11	FY12	FY13E	FY14E
Yield Ratios				
Avg Yield on Assets	8.8%	10.4%	10.2%	10.1%
Yield on Advances	10.8%	12.0%	11.8%	11.7%
Yield on Investments	6.3%	8.2%	7.9%	7.8%
Cost of Int Bearing Liab	5.6%	7.4%	7.3%	7.3%
Cost of Deposits	5.5%	7.3%	7.2%	7.1%
Net Interest Spread	3.2%	3.0%	2.9%	2.9%
NIM	3.8%	3.7%	3.5%	3.4%
Balance Sheet Ratios				
Gross NPA	3.5%	3.3%	3.6%	3.5%
Net NPA	0.6%	0.5%	0.6%	0.6%
Return on Assets	1.2%	1.4%	1.3%	1.3%
CASA	26.9%	27.5%	28.8%	29.6%
Loan-deposit ratio	74.3%	77.2%	77.4%	78.0%
Provision cov ratio	83.4%	81.0%	84.0%	84.0%
CAR	16.8%	16.6%	15.1%	14.0%
Per share data	FY11	FY12	FY13E	FY14E
EPS	34.4	45.4	49.1	56.1
BVPS	299	334	371	414
Adjusted BVPS	291	326	362	404
Dividend per share	8.5	9.0	10.0	11.0
Dividend yield	1.7%	1.8%	2.0%	2.3%

Source: Company data, Nirmal Bang Research

NOTES

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Nirmal Bang Research (Division of Nirmal Bang Securities Pvt. Ltd.)

B-2, 301/302, Marathon Innova,
Opp. Peninsula Corporate Park
Off. Ganpatrao Kadam Marg
Lower Parel (W), Mumbai-400013
Board No. : 91 22 3926 8000/8001
Fax. : 022 3926 8010