Federal Bank

11 December 2014

Reuters: FED.BO; Bloomberg: FB IN

Initiating Coverage

Firing On All Cylinders!

After successful consolidation, Federal Bank (FBL) is well placed to capitalise on the likely macro-economic recovery. FBL has addressed most of its critical problems. Balance sheet consolidation is now behind and the management is targeting a credit growth of ~20%. Favourable asset-liability mix will help in improving net interest margin or NIM. The cautious approach has helped in containing slippage. Improvement in operating efficiency in branches opened recently will also aid in a significant improvement in the cost-to-income ratio. We expect a 23% earnings CAGR over FY14-FY17E. We expect RoA/RoE to improve 32bps/420bps to 1.5%/16.8%, respectively, by FY17E. We have assigned Buy rating to FBL with a target price of Rs183 based on residual income model, implying 1.6x FY17E P/ABV.

Consolidation phase is behind: On account of tough economic and macro-economic conditions, FBL took a conscious approach to slow down its loan growth, particularly in the large corporate segment, With the asset quality problem easing; the management is now targeting a credit growth of ~20% for the next couple of years. On the liability side, it has been able to increase CASA (current account savings account) deposit ratio and retail deposits, thereby lowering the dependence on bulk deposits.

NIM expected to move northwards: NIM has gone through peak compression - from 4.0% in FY09 to 3.3% in FY14 - on account of deregulation of interest rates on non-resident Indian (NRI) deposits, rebalancing of portfolio towards less risky assets and reversal of interest on a marked increase in loan slippage/restructuring. With a push towards high-yield segments like SME (small and medium enterprise) and LAP (loan against property), improvement in the deposit mix and asset quality problem easing, we expect a gradual improvement of 15bps in NIM over the next three years.

Asset quality – cautious approach yields results: A cautious approach towards corporate lending has started yielding results. Average loan slippage ratio eased from 3%-4% earlier to 1%-2% over the past five quarters, with improvement registered across segments. Reduction in loan slippage is more appreciative as the bank did not increase its loan book size in FY14. We expect loan slippage to ease from 1.5% in FY15E to 1.1% in FY17E.

Cost-to-income ratio to move closer to historical level: Improvement in operating efficiency in recently opened branches (63% expansion over FY11) and muted branch expansion plans ahead, we expect cost-to-income ratio to improve to 44% in FY17E.

RoA poised to recover: A combination of NIM compression, lower balance sheet growth, higher branch expansion-related costs and elevated credit costs adversely impacted FBL's RoA, which fell significantly from 1.39% in FY12 to 1.15% in FY14. With the above mentioned determinants improving, RoA is likely to rise 32bps to 1.47% in FY17E.

Outlook and valuation: With RORWA (return on risk-weighted assets) expected to improve from 1.9% in FY14 to 2.2% in FY17E, it will be at a 20% premium to old generation private banks (avg.) and its discount to new generation private banks (avg.) will come down from 20% currently to 10%. We believe the stock can re-rate to 1.6x P/ABV FY17E. We have assigned Buy rating to FBL with a target price of Rs183, up 30% from the CMP.

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Net interest income	19,747	22,287	24,290	28,616	34,314
Pre-provision profit	14,596	14,804	16,504	21,354	26,511
PAT	8,382	8,389	9,828	12,623	15,773
EPS (Rs)	9.8	9.8	11.5	14.8	18.4
ABV (Rs)	69.4	77.5	85.1	95.7	111.2
P/E	14.9	14.9	12.7	9.9	7.9
P/ABV	2.1	1.9	1.7	1.5	1.3
Gross NPAs (%)	*3.4*	*2.5*	*2.0*	*1.8*	*1.5*
Net NPAs (%)	*1.0*	*0.7*	*0.8*	*0.9*	*0.7*
RoA (%)	*1.3*	*1.2*	*1.2*	*1.4*	*1.5*
RoE (%)	*13.9*	*12.6*	*13.4*	*15.3*	*16.8*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs141

Target Price: Rs183

Upside: 30%

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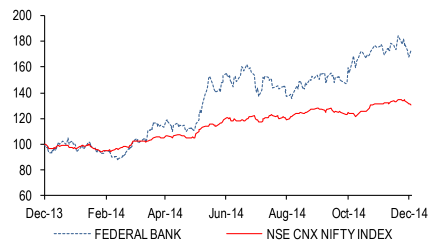
Key Data

Current Shares O/S (mn)	855.5
Mkt Cap (Rsbn/US$bn)	121.8/2.0
52 Wk H / L (Rs)	153/72
Daily Vol. (3M NSE Avg.)	4,587,151

Shareholding (%)	4QFY14	1QFY15	2QFY15
Promoter	0.0	0.0	0.0
FII	48.3	44.3	43.0
DII	23.2	25.5	27.1
Corporate	9.0	10.2	9.5
Others	19.6	20.0	9.5

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Federal Bank	(2.8)	12.7	76.8
Nifty Index	(0.8)	8.7	31.5

Source: Bloomberg

Valuation

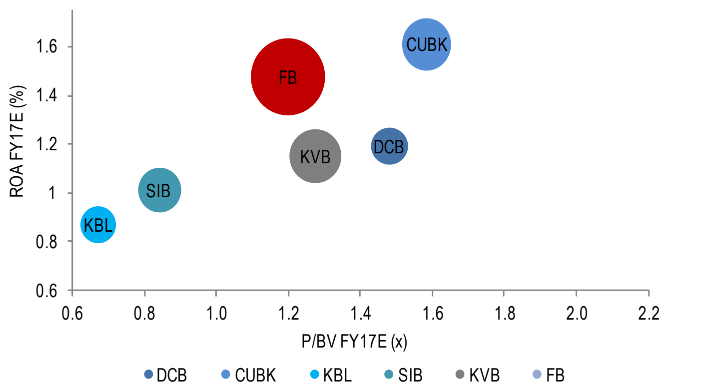
With a likely higher balance sheet growth, expansion in NIM, improvement in operational efficiency, better liability profile and the ability to maintain asset quality, we have factored in earnings CAGR of 23% over FY14-FY17E. We expect its RoA to rise 32bps over FY14-FY17E. FBL stock currently trades at a PABV of 1.5x P/ABV FY16E and 1.3x P/ABV FY17E.

RoA is expected to improve to 1.47% in FY17E as against an average of 1.23% in the past five years. Similarly, RoRWA is expected to improve to 2.2% against an average of 2.0% in the past five years. RoE is depressed because of higher Tier-I capital and lower financial leverage. We expect RoE to improve by 420bps to 16.8% over FY14-17E. We have assigned Buy rating to FBL with a target price of Rs183 based on residual income model, implying 1.6x FY17E P/ABV.

Exhibit 1: Price/ABV

Source: Bloomberg, Nirmal Bang Institutional Equities Research

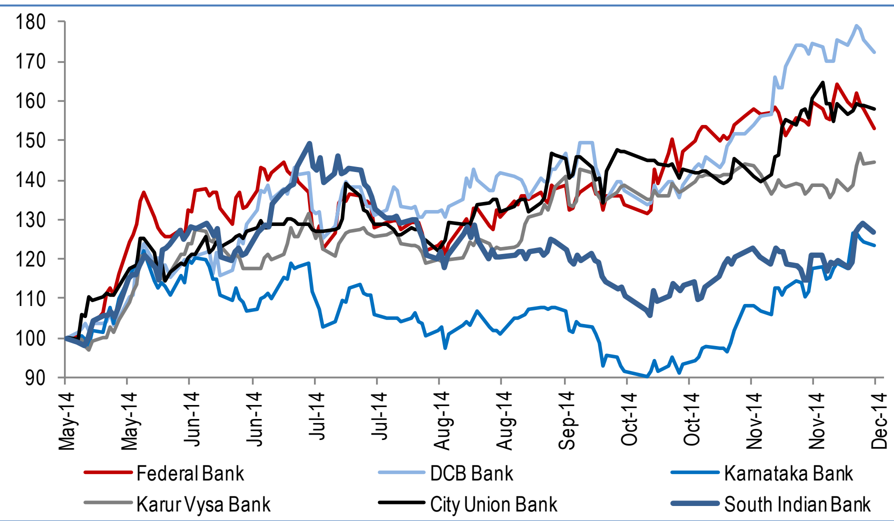
Exhibit 2: RoA versus P/ABV



Source: Company, Bloomberg, Nirmal Bang Institutional Equities Research

Note: DCB - DCB Bank, CUBK - City Union Bank, KBL - Karnataka Bank, SIB - South Indian Bank, KVB - Karur Vysya Bank

Exhibit 3: Decent rally across old generation private banks over the past six months



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 4: Our net profit estimates versus Bloomberg consensus estimates

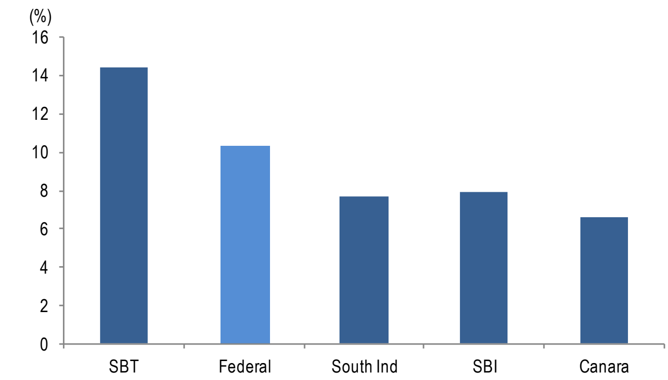
Description (Rsmn)	FY15E			FY16E			FY17E		
	Our estimate	Bloomberg estimate	*Variation (%)*	Our estimate	Bloomberg estimate	*Variation (%)*	Our estimate	Bloomberg estimate	*Variation (%)*
Net profit	9,828	8,389	*17.2*	12,623	11,848	*6.5*	15,773	14,192	*11.1*

Source: Bloomberg, Nirmal Bang Institutional Equities Research

Dominant player in Kerala

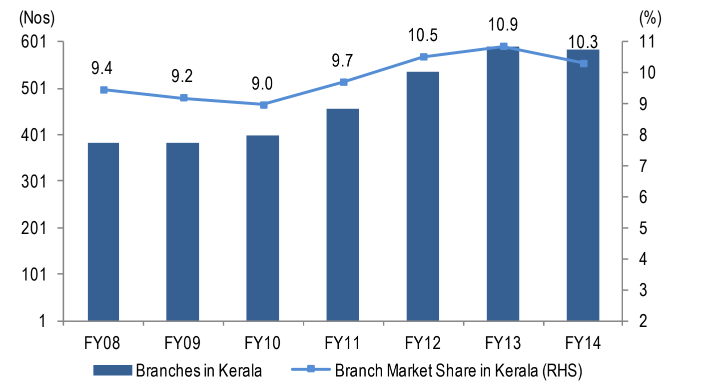
FBL is a strong player in its home state of Kerala. Out of its branch network of1,214 branches, 587are in Kerala. FBL's dominance is on the rise as it is constantly gaining market share over the past few years. Currently, it is No.2 after State Bank of Travancore. It has a decent market share of 12% in the business, with 13% in deposits and 10% in advances in Kerala. Success of its hub and spoke model has helped in regain market share in credit disbursal.

Exhibit 5: Branches -market share in Kerala



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: FBL touch-points in Kerala

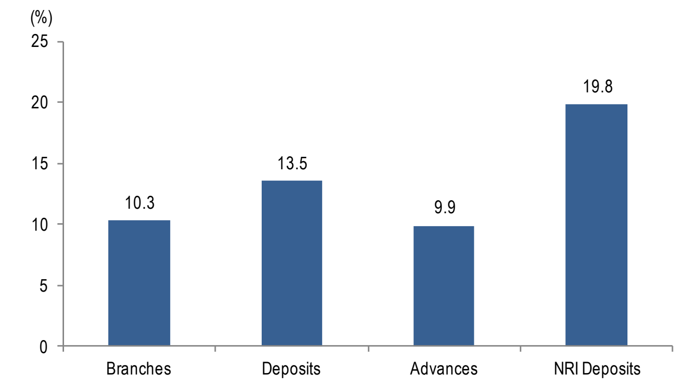


Source: Company, Nirmal Bang Institutional Equities Research

NRI customers are its key strength

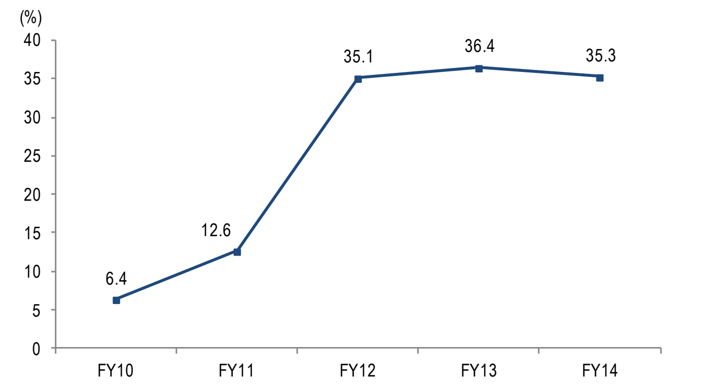
FBL is a strong player in inward remittances on account of high presence of NRIs in its home state. It has a market share of 8.6% in India's inward remittances and 19.8% in Kerala's NRI deposits. It offers a range of asset and liability products to its NRI customers. Also, its branches in Tamil Nadu, Karnataka, Maharashtra, Gujarat and Punjab are in the NRI region, which helps the bank to maintain the momentum. NRI deposits have posted a CAGR of ~30% over the past four years. However, on the asset side, 20% of the retail book comprises NRIs, largely in the home loan segment.

Exhibit 7: FBL's market share in Kerala



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Healthy growth in NRI deposits



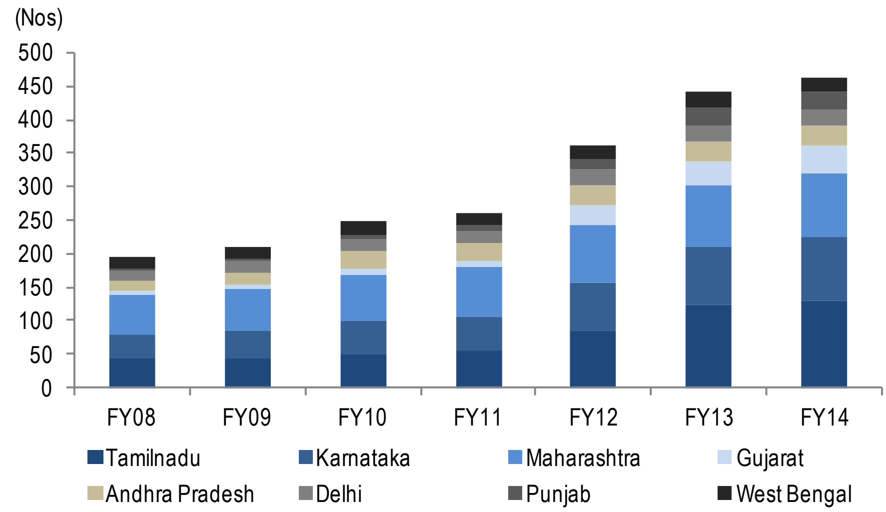
Source: Company, Nirmal Bang Institutional Equities Research

Incremental expansion outside Kerala

As FBL already has a good footprint and a healthy market penetration across Kerala, it is incrementally focusing on expansion outside the state. It has strategically opened branches in SME/non-resident Indian or NRI-rich regions of Tamil Nadu, Karnataka, Maharashtra, Gujarat and Punjab.

Such a strategy has helped the bank to continue its momentum in the SME segment. Besides, these branches also attract high NRI flows, in which FBL specialises in, and as a result, NRI deposits have posted more than a 35% CAGR over the past two years. It also helped in managing growth in savings account deposits at 18% and in current account deposits at 16% CAGR over the past two years.

Exhibit 9: FBL's presence outside Kerala

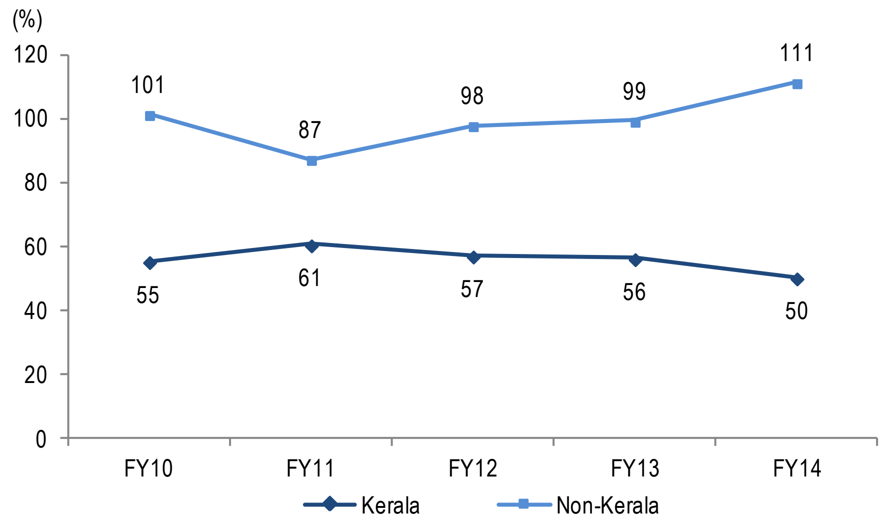


Source: Company, Nirmal Bang Institutional Equities Research

Liability focus in Kerala and asset focus outside the state

FBL continues its focus of garnering deposits from its home state, also supported by healthy momentum in NRI deposits. More than 60% of its total deposits are sourced from Kerala. However, non-Kerala branches contribute higher to its loan book growth. Around 40% of its loans are in Kerala. Credit-deposit ratio in Kerala is hovering slightly above 50%, whereas outside the state it is ~100%.

Exhibit 10: Credit-deposit ratio far higher outside Kerala



Source: Company, Nirmal Bang Institutional Equities Research

Consolidation phase is behind

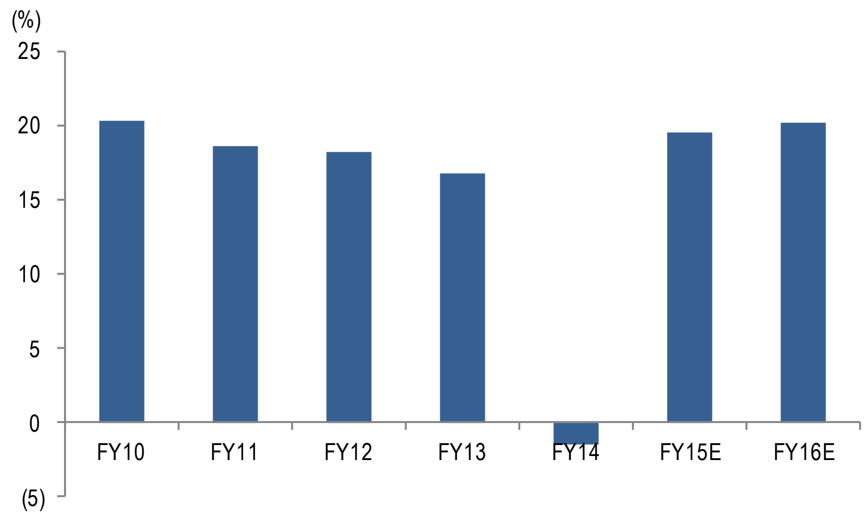
On account of tough macro-economic conditions in the recent past, FBL took a conscious approach to slow down its loan growth so as to protect itself from adverse asset quality problem.

FBL has grown its advances book at a CAGR of only 7% over FY12-FY14. The prime reason for such a sluggish loan book is a 22% decline in large corporate loans in FY14 over its FY12 book. FBL has consciously allowed a run-off and did not renew a few of its big-ticket size corporate accounts where the management was not comfortable with the quality or adequacy of security on those assets.

Origination of corporate loans is a lot more strategic now and aimed at building a long-term relationship, while retail and SME segments are witnessing traction from the hub and spoke business model.

With reasonable amount of optimism building in the segment and a lower base, the management is targeting a decent credit growth of 20% in FY15. It has already grown the loan book by 11.5% in 1HFY15 over FY14 with a major push form the large corporate segment which has grown 16%. FBL has moved away from bulk business that it used to book at the end of a quarter and now plans to have more of a spread-out growth. The management is targeting a growth of 20% in large corporate business over the next couple of years.

Exhibit 11: Credit growth likely to pick up

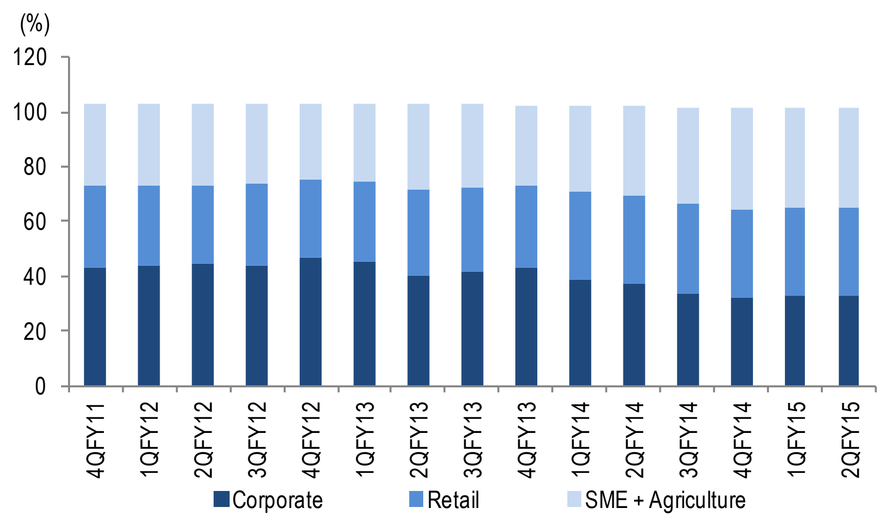


Source: Company, Nirmal Bang Institutional Equities Research

Loan book realignment largely over

Required realignment in the loan book has largely been completed. From being heavy in large corporate accounts, the loan book has now diversified equitably into other segments. The management has given guidance that portfolio composition will largely remain stable for two or three years, and after that the SME segment is expected to outpace overall balance sheet growth.

Exhibit 12: Corporate segment de-bulking is complete

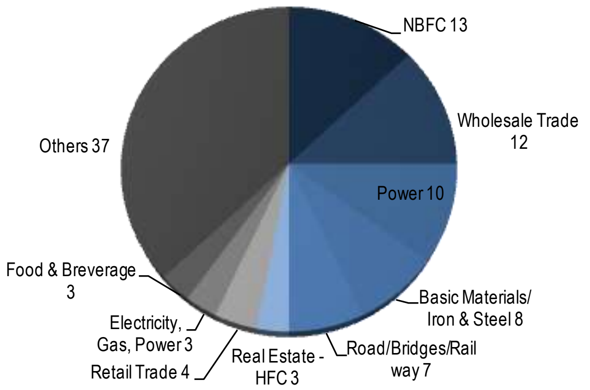


Source: Company, Nirmal Bang Institutional Equities Research

All business segments well diversified

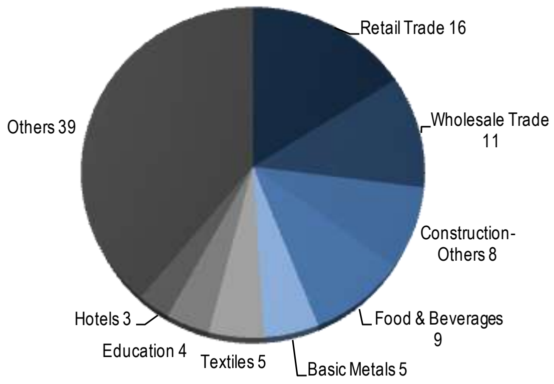
FBL's corporate loan book, comprising large corporates as well as SME, is well diversified. Such a diversification should limit the risk of large-scale delinquency.

Exhibit 13: Corporate loan book break-up



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: SME loan book break-up

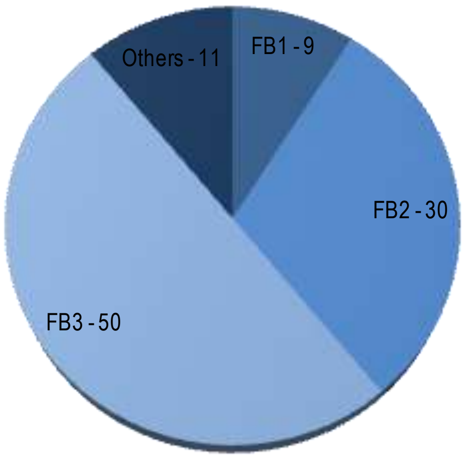


Source: Company, Nirmal Bang Institutional Equities Research

SME segment to continue to be a key growth driver in the long run

SME segment has been the strength of the bank, which has grown 26% in 1HFY15 and now forms 24% of overall loan book. Growth has been robust, both in Kerala and outside the state. Currently, 70%-80% of the SME business comes from repeat clients, indicating the strength of the relationship which the bank maintains with its customers. It has strategically opened branches outside Kerala in SME-rich regions outside the state, helping the bank to sustain its momentum in the segment. Currently, 75%-80% of total lending to the SME segment is for meeting working capital requirement. The management believes that there is scope for improving market share outside Kerala and is confident of growing its SME loan book at more than 20% over the next three years. FBL has strong skill set and products in the SME segment and has, over the years, reduced its exposure to risky SMEs.

Exhibit 15: SME loan book credit rating

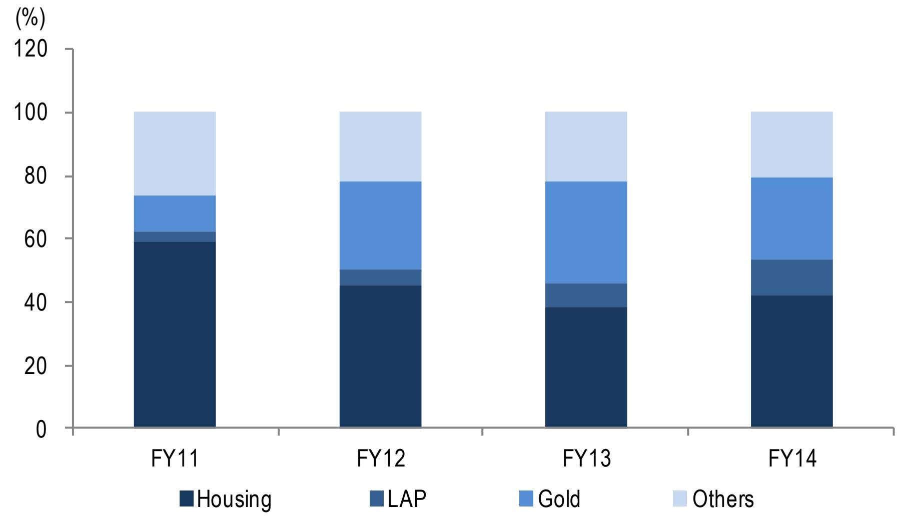


Source: Company, Nirmal Bang Institutional Equities Research

Retail book to be driven by mortgage and gold loans

The management believes the retail business is much more sustainable and predictable business. FBL's retail loan book is again moving toward less risky mortgage loans. Within mortgage, high yielding loan against property (LAP) expanded by over 800bps in the past three years, to 11.7%. The management has given guidance of a decent 15%-20% credit growth in the retail segment.

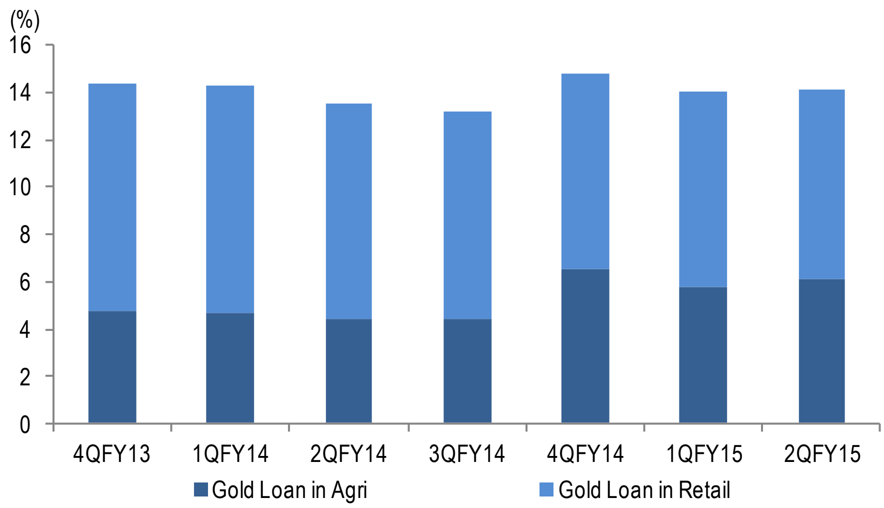
Exhibit 16: Retail loans primarily comprise mortgage and gold loans



Source: Company, Nirmal Bang Institutional Equities Research

Gold loan is another important segment for the bank. Amid volatility in gold prices and operating conditions, the bank had significantly slowed down incremental lending to it. With receding volatility in gold prices, FBL is looking forward to expand its gold loan portfolio. However, the bank prefers to be not very aggressive in this segment. FBL has given guidance that its overall gold loan portfolio (agriculture + non-agriculture) will not exceed 15.0% of overall loan book, which currently stands at 14.1%

Exhibit 17: Gold loan segment well calibrated



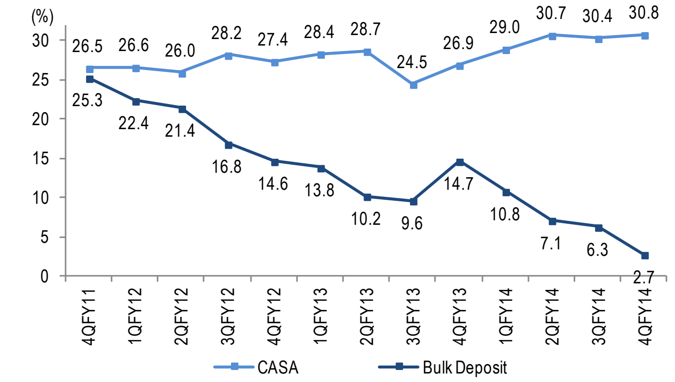
Source: Company, Nirmal Bang Institutional Equities Research

Improvement in deposit mix expected to continue

FBL's deposit mix has been consistently improving, with a better traction witnessed in CASA deposits and retail term deposits. The bank has been able to beautifully contain wholesale/bulk deposits. Although overall deposits posted a muted CAGR of 12% over the past three years, CASA deposit ratio managed to register a decent CAGR of 17% over the same period. As a result, CASA deposit ratio improved 460bps over the past three years, to 30.6%. Aided by substantial branch addition since FY11, the growth in the bank's savings deposits has been strong, notwithstanding higher interest rates offered by many other private banks since deregulation.

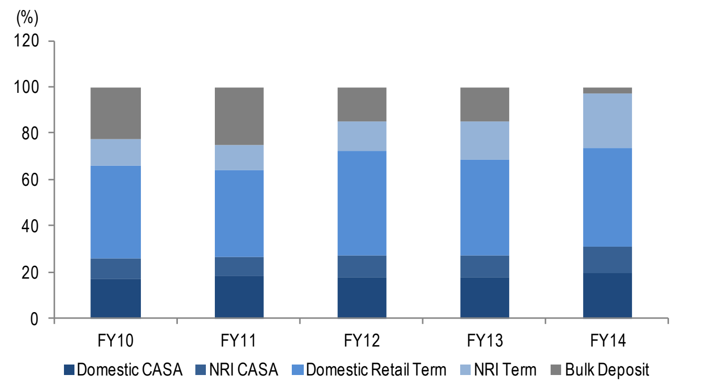
On the other hand, retail term deposits witnessed good traction and bulk deposit growth substantially declined from 25.3% in FY11 to 1.2% in 1HFY15.

Exhibit 18: CASA deposits replacing bulk deposits



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 19: Healthy traction in domestic retail & NRI deposits

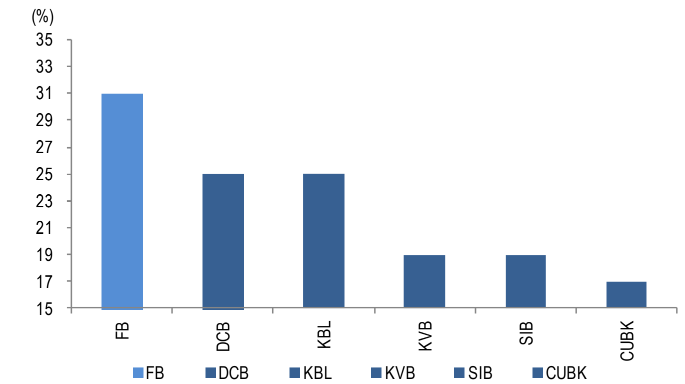


Source: Company, Nirmal Bang Institutional Equities Research

FBL has the best CASA deposit ratio among peers, which helped it to contain the cost of deposits. It has garnered strong momentum in NRI deposits, which grew more than 35% over the past two years. FBL has appointed business development managers in all zones across India, as a part of its strategy to have its focus beyond Kerala. The representative office at Abu Dhabi acts as the bank's gateway to GCC (Gulf Co-operation Council) countries, offering service and support to NRI customers in that region. In addition, it has a strong market share of ~8% in inward rupee remittances. Higher flow in NRI CASA deposits and NRI term deposits has helped the bank to bring down its bulk deposits substantially.

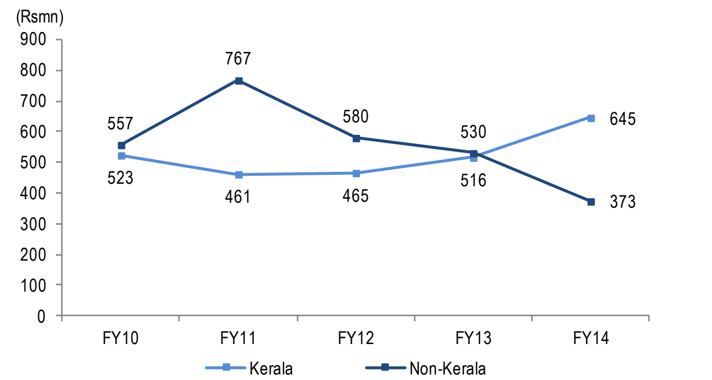
Deposits per branch improved steadily in Kerala, but deposits per branch outside the state deteriorated significantly on account of huge expansion in branches. As those branches get older, deposit per branch is expected to go back to its original level.

Exhibit 20: Best CASA deposit ratio among peers



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 21: Strong potential to improve deposit per branches outside Kerala



Source: Company, Nirmal Bang Institutional Equities Research

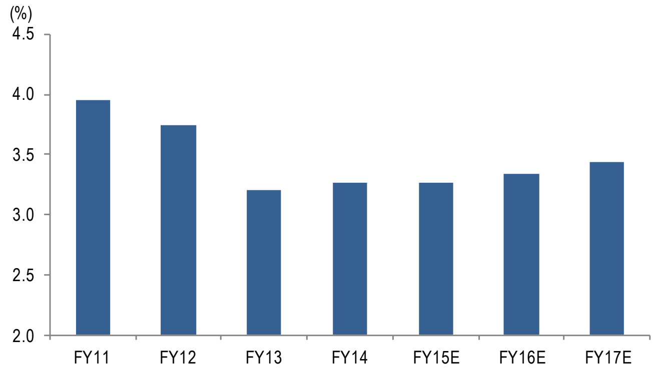
The management is confident of improving CASA deposit ratio on the back of expected optimisation of branches opened over the past three years, success of its product - FedBook - launched earlier, improved focus on capturing cash management business, and the introduction of a new technology platform which will enable it to acquire merchant business.

NIM growth revival on track

FBL's NIM witnessed a steep correction over the past couple of years on account of the dual impact of deregulation of interest rates on NRI deposits and rebalancing of portfolio towards less risky assets. The yield on advances was also been hit by significant interest rate reversals because of a marked increase in loan delinquency and restructuring. With a push towards high-yield segments like SME and LAP, improvement in the deposit mix and asset quality problems expected to ease, we expect a gradual improvement of 15bps in NIM over the next three years.

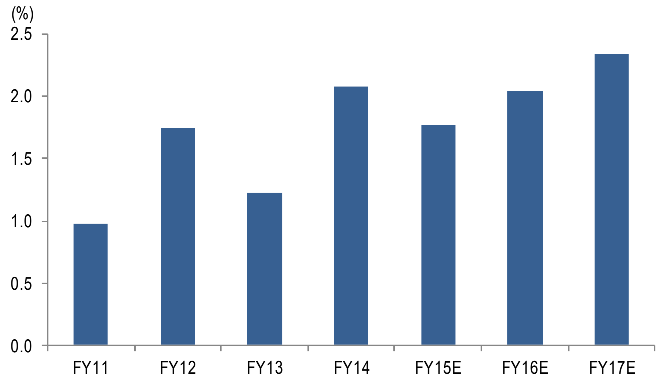
NIM witnessed a declining trend over the past few years. However, risk-adjusted NIM (adjusting for loan slippage) is showing a recovery trend. With loan slippage expected to ease further, we expect risk-adjusted NIM to improve further by ~25bps at 2.3% in the next three years.

Exhibit 22: NIM to improve by 15bps over the next three years



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 23: Risk-adjusted NIM healthy

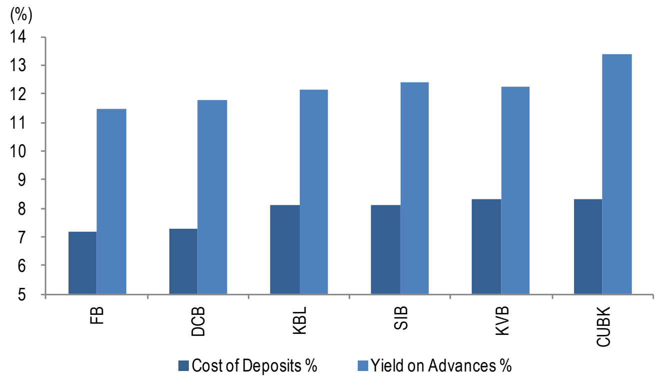


Source: Company, Nirmal Bang Institutional Equities Research

Cost advantage aiding decent NIM

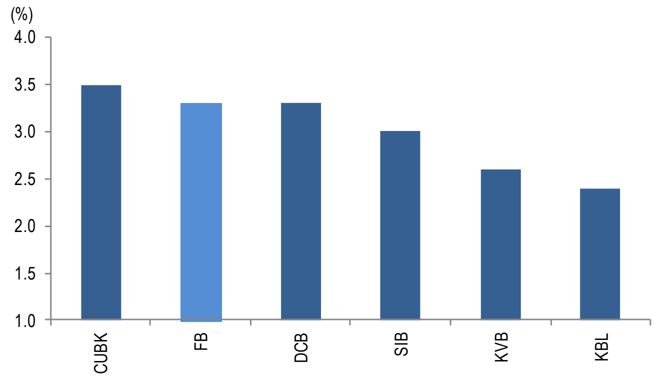
FBL has taken a hit on its yields on advances on account of rebalancing of the portfolio towards less risky assets and reversal of interest on slippage in a few big-ticket loans. However, it is still able to maintain one of the best NIMs on account of its cost advantage. Backed by its healthy CASA deposit franchise, the bank maintains cost of deposits at one of the lowest levels compared to peers.

Exhibit 24: Cost advantage not exerting pressure on lending yields



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: One of the highest NIMs compared to peers

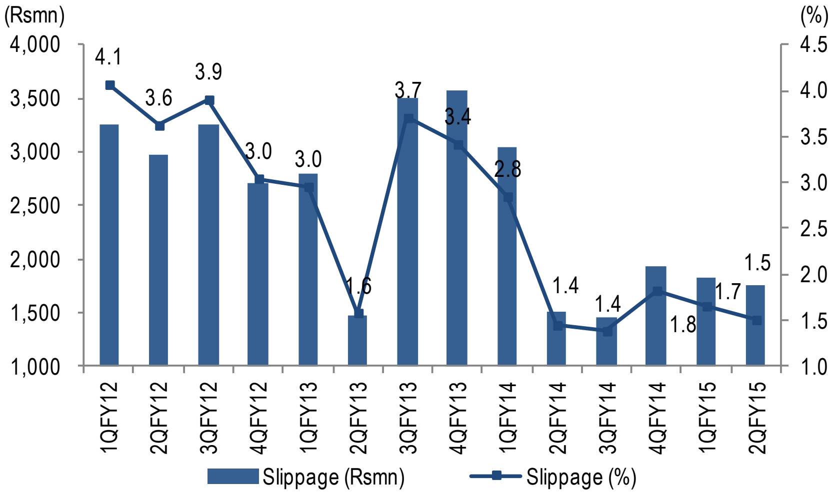


Source: Company, Nirmal Bang Institutional Equities Research

Asset quality – cautious approach yields results

FBL's cautious approach towards corporate lending, which led to major stress in the past, has started yielding results. Overall loan slippage significantly declined and has been down for the past five quarters. Average slippage ratio, which was earlier in the range of 3%-4%, declined to 1%-2% over the past five quarters. Reduction in slippage is more appreciable as the bank had not grown its loan book in FY14. The management highlighted that improvement in slippage is a reflection of concerted efforts on improving the underwriting standards over the past couple of years. FBL will be one of the biggest beneficiaries among private banks post economic recovery on account of substantial corporate and SME loans. We expect loan slippage to ease from 1.5% in FY15 to 1.1% in FY17E.

Exhibit 26: loan slippage trend a lot better for the past five quarters



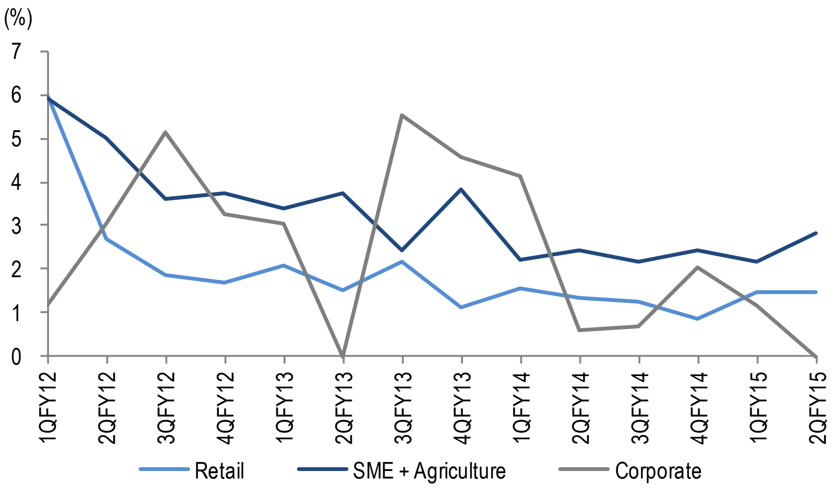
Source: Company, Nirmal Bang Institutional Equities Research

Turnaround likely across sectors

Significant amount of improvement is likely in loan slippage in the corporate segment. Such an improvement is despite the decline witnessed in its corporate loans. There was no slippage in corporate loans in 2QFY15. As the macro-economic environment improves gradually, the stress in corporate loan book is expected to abate further. FBL is closely monitoring three large accounts amounting to ~Rs3.0bn-Rs3.5bn.

Slippage in retail loan segment has been consistently low and is expected to remain in this range. Retail loan book (ex-gold loan book) comprises largely mortgages, which is unlikely to deteriorate unless there is a steep correction in property prices. After having made necessary adjustments and operating dynamics along with stability in gold prices, the gold loan portfolio should also do well. Slippage in SME segment has shown a declining trend over the past one year and hovers in the range of 2%-3%. Its ticket size in SME loans is Rs2.7mn and in mortgage segment it is Rs1.3mn, relatively on the lower side.

Exhibit 27: Loan slippage easing across segments

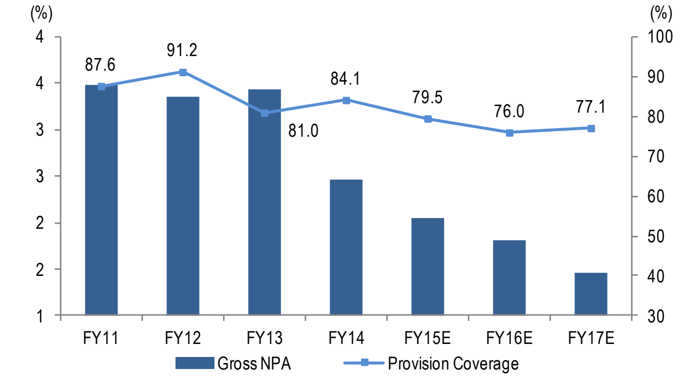


Source: Company, Nirmal Bang Institutional Equities Research

Healthy provision coverage ratio even in most difficult times

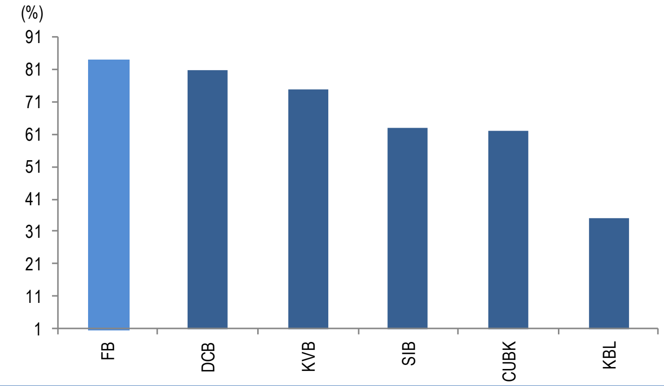
FBL has never shied away from making accelerated provisioning in order to protect its provision coverage ratio. Even in most difficult times, the bank ensured that its provision coverage ratio never fell below 80%. It has the best provision coverage ratio among peers. Gross non-performing assets or GNPAs eased by over 180bps from their peak on the back of healthy loan recovery/upgradation and sale of assets to asset reconstruction company or ARC. It sold cumulative assets in the past three years amounting to Rs5.6bn. The pace of loan write-off has come off a bit and loan recovery/upgradation improved. With slippage easing over the past few quarters, we feel credit costs are manageable at the current level. We have factored in GNPAs improving further to 1.6% in FY17E from 2.1% in 1HFY15.

Exhibit 28: Asset quality expected to improve further



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 29: Provision coverage ratio highest among peers

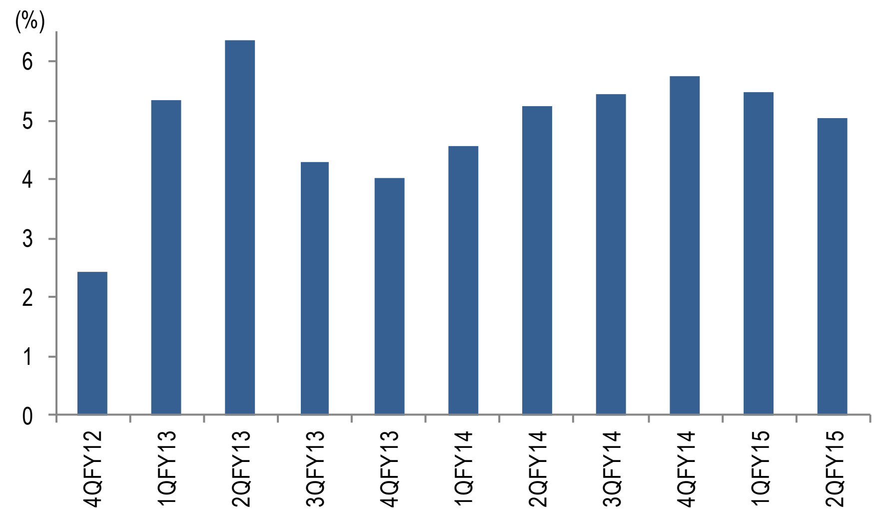


Source: Company, Nirmal Bang Institutional Equities Research

Restructured assets declining from peak

Restructured assets have been an area of concern for FBL. Standard restructured loans increased from 2.4% of loan book in FY12 to 5.8% in FY14. Since then, their proportion to loan book has fallen to 5%, as the restructured loan book on absolute basis is flattish. Excluding state electricity boards or SEBs and Air-India, standard restructured loans account for 2.6% of loan book. Most of the growth came from a few big-ticket size corporate accounts. With significant caution adopted by the bank in increasing its large corporate loans, we feel the restructured assets are nearing their peak.

Exhibit 30: Standard loan restructuring

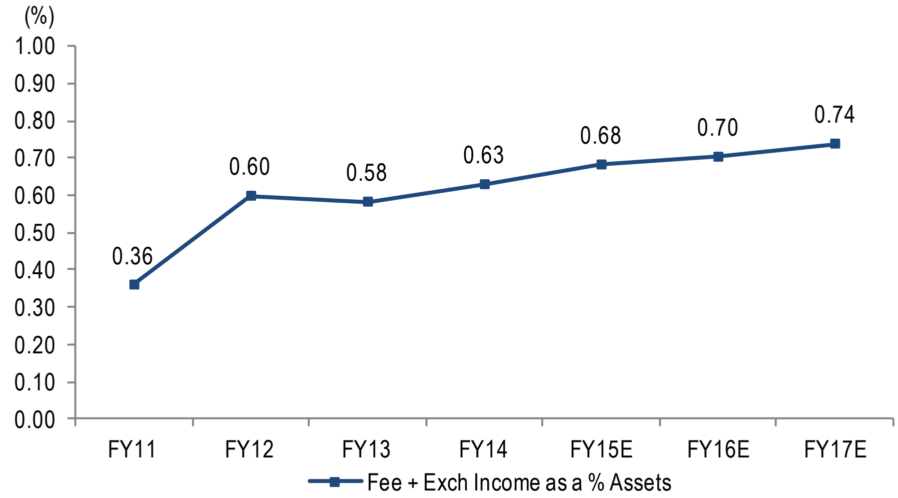


Source: Company, Nirmal Bang Institutional Equities Research

Scope to improve fee income

The management admitted that growth in fee income has been weak for the bank and there is lot of scope to improve it. FBL is taking various measures to improve its fee income by aligning commission rates in a few areas with other banks, improving cross-sales of its products, tapping non-fund business and improve lending-linked fees as the bank is targeting higher growth in credit disbursal.

Exhibit 31: Lot of scope to improve fee income



Source: Company, Nirmal Bang Institutional Equities Research

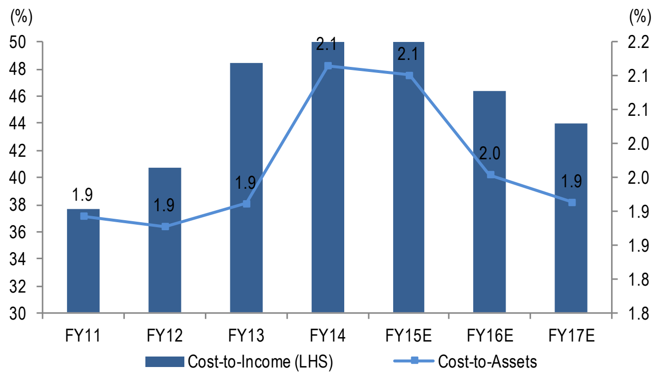
Cost-to-income ratio expected to move closer to historical level

Cost-to-income ratio deteriorated from 37.7% in FY11 to 52.2% in FY14 on account of interest income reversal on NPAs and restructuring, huge increase (63%) in branch network from 743 in FY11 to 1,214 in 1HFY15, employee base rising from 8,087 to 10,866 during the same period, provisioning relating to pending wage hike of Rs0.8bn in FY14, muted growth in balance sheet, compression in NIM and lower traction in fee income

With significant expansion in branches already achieved, the management will go slow in opening new branches. The management is targeting to set up 70 new branches in FY15E and 50 new branches in FY16E. It expects a huge improvement in operating efficiency in branches opened over the past two-three years, which are expected to achieve break-even now. With the likely improvement in balance sheet growth, NIM and fee income along with controlling expenses, the management is targeting cost-to-income ratio of 45% in FY16E.

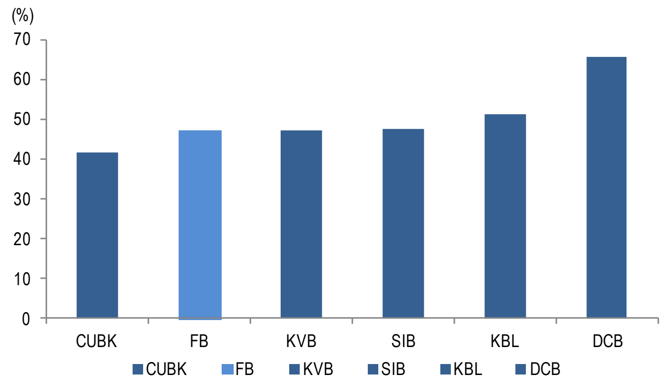
FBL will also be calibrating its promotional expenses, but the management claims it has helped the bank in improving business volume.

Exhibit 32: Cost-to-income ratio to improve



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 33: Cost-to-income ratio comparable to peers

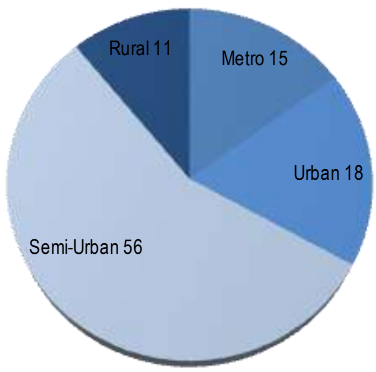


Source: Company, Nirmal Bang Institutional Equities Research

It has one of the best cost-to-income ratios among peers, which is attributable to lower number of employees per branch and lower costs per employee.

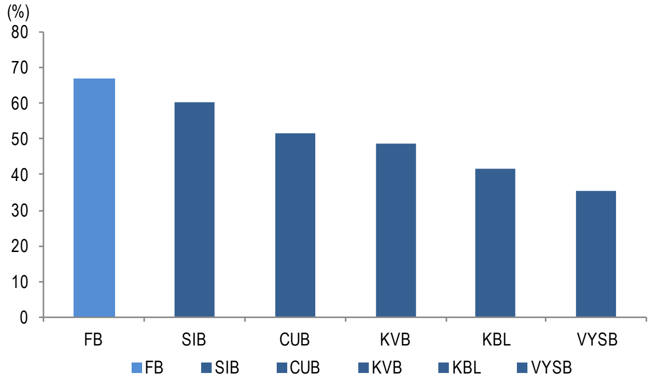
It has the fourth largest network of branches among private banks. Higher number of branches in rural and semi-urban areas has helped the bank to manage its costs below that of peers.

Exhibit 34: Branch composition (%)



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 35: Percentage of branches in rural/semi-urban areas

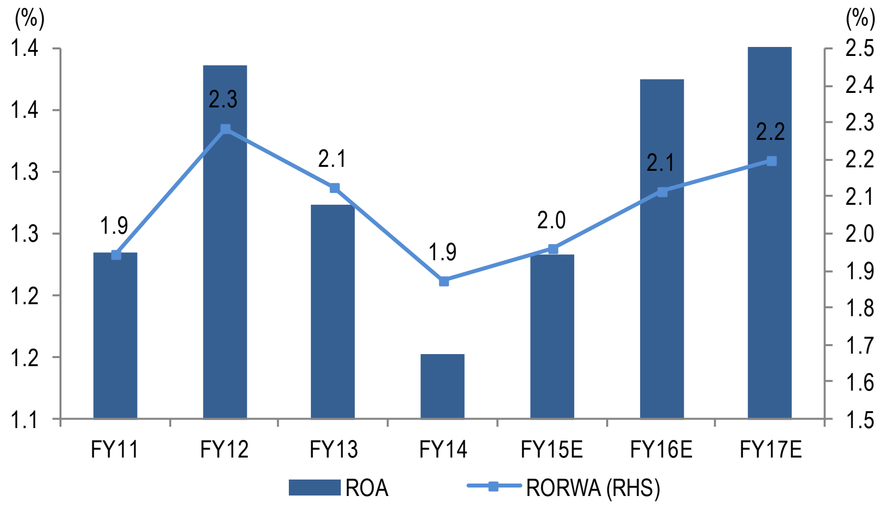


Source: Company, Nirmal Bang Institutional Equities Research

RoA poised to recover

A combination of NIM compression, lower balance sheet growth, higher branch expansion-related costs and elevated credit costs adversely impacted FBL's RoA, which declined significantly from 1.39% in FY12 to 1.15% in FY14. With the above mentioned determinants started improving, RoA is likely to improve significantly. We have estimated RoA to recover by 32bps over the next three years to 1.47% by FY17E.

Exhibit 36: RoA expected to bounce back



Source: Company, Nirmal Bang Institutional Equities Research

Although FBL's RoA is lower than some of its peers, its RoRWA (return on risk-weighted assets) is comparable to most of its peers.

Exhibit 37: Return on average RWA comparison

Bank (Rsmn)	FY11	FY12	FY13	FY14
Axis Bank	2.0	2.0	2.1	2.3
HDFC Bank	2.3	2.4	2.5	2.6
ICICI Bank	1.6	1.7	2.0	2.1
Yes Bank	2.1	2.1	2.2	2.2
IndusInd Bank	2.2	2.3	2.3	2.3
ING Vysya Bank	1.4	1.5	1.6	1.5
Federal Bank	**2.0**	**2.3**	**2.1**	**1.9**
DCB	0.5	1.0	1.5	1.9
Karur Vysya Bank	5.1	2.7	2.5	1.7
City Union Bank	2.9	3.0	2.9	2.7
Karnataka Bank	1.0	1.1	1.4	1.1
South Indian Bank	2.1	2.3	2.4	2.0

Source: Company, Nirmal Bang Institutional Equities Research

RoA drivers change

Although RoA earlier and currently are looking somewhat similar, there is a sea change in composition of RoA. NIM fell as the bank adopted a lower risk model. Similarly, provisioning came off, with a declining trend in loan slippage. Fee income improved with better cross-sales and introduction of better products. Other income was higher earlier, mainly driven by healthy recovery from written-off accounts, which is expected to revive once the economic environment improves. Operating expenses inched upwards on account of higher branch expansion.

Going forward, NIM should improve on the back of change in asset-liability mix and lower interest reversals on NPAs/restructured loans. With the management giving guidance of muted expansion of branches in the next two years, operating expenses ratio should return to earlier levels.

Exhibit 38: RoA decomposition

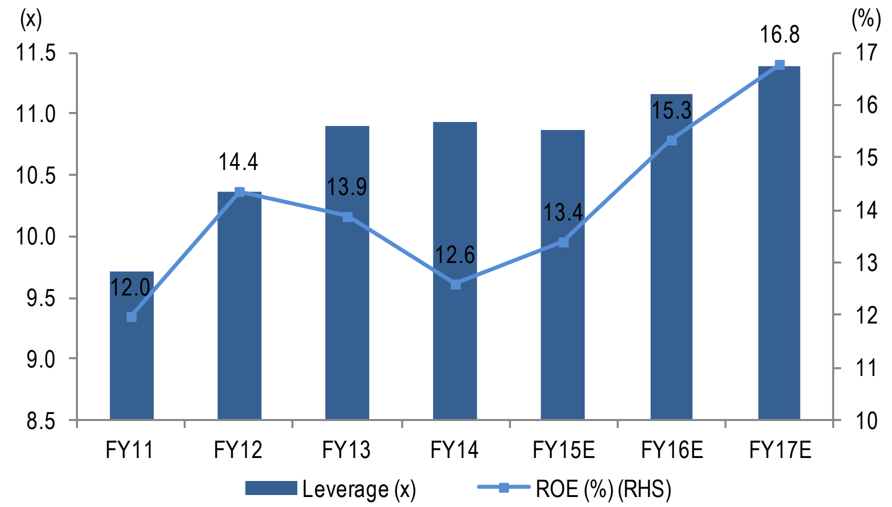
(%)	FY09	FY10	FY11	FY12	FY13	FY14	FY15E	FY16E	FY17E
Net Int. income/assets	3.69	3.42	3.67	3.49	3.00	3.06	3.05	3.12	3.21
Fees/assets	0.28	0.26	0.24	0.45	0.46	0.46	0.50	0.52	0.56
Other income/assets	0.93	0.77	0.75	0.35	0.23	0.28	0.27	0.29	0.29
Investment profit/assets	0.23	0.26	0.10	0.15	0.31	0.22	0.21	0.22	0.20
Net revenue/assets	5.13	4.71	4.76	4.44	4.01	4.01	4.03	4.15	4.26
Op expenses/assets	(1.60)	(1.64)	(1.76)	(1.75)	(1.79)	(1.98)	(1.96)	(1.82)	(1.79)
Provision/assets	(1.31)	(0.98)	(1.10)	(0.60)	(0.40)	(0.37)	(0.26)	(0.33)	(0.34)
Taxes/assets	(0.82)	(0.96)	(0.66)	(0.70)	(0.54)	(0.51)	(0.58)	(0.62)	(0.66)
RoA	1.40	1.13	1.23	1.39	1.27	1.15	1.23	1.38	1.47

Source: Company, Nirmal Bang Institutional Equities Research

Improvement in financial leverage to lead to improvement in RoE

Apart from lower operating leverage impacting profits, even lower financial leverage also exerted pressure on RoE. FBL enjoys a very high Tier-I capital ratio of 14.6% versus regulatory requirement of a minimum 6.0%. With efficient utilisation of capital and higher leverage, the bank's RoE will get a major boost going forward.

Exhibit 39: RoE expected to improve with leverage

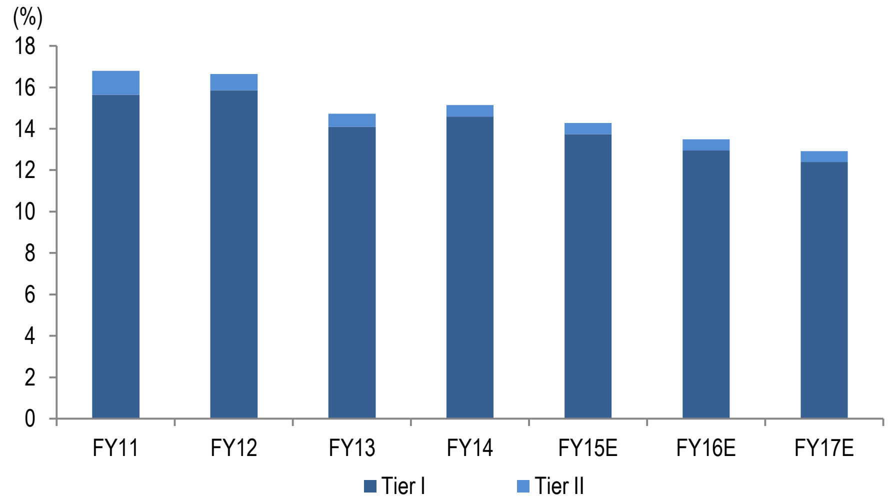


Source: Company, Nirmal Bang Institutional Equities Research

FBL adequately capitalised – ensures higher growth

FBL is adequately capitalised with Tier-I capital of 14.6% and total CRAR of 15.1%. With capital already in place, it can grow its balance sheet at a desired rate without raising capital for the next three years.

Exhibit 40: FBL is sufficiently capitalised



Source: Company, Nirmal Bang Institutional Equities Research

Key risks

Delay in economic revival

Our assumptions on FBL are based on our holistic take on the macro-economic environment, which indicates that the worst is behind and that things will improve from here on, with industry sentiment and investments expected to head northwards. If the headwinds persist longer than expected, our earnings, credit and asset quality assumptions are likely to undergo a change.

Higher wage hike settlement under IBEA (Indian Bank Employees Association)

FBL has its entire workforce under IBEA. The bipartite wage hike agreement expired in November 2012. The bank has been assuming a wage hike of 10% and provided Rs1bn per annum for it. If the wage agreement settles at a much higher level, then the bank will have to provide one-time ad hoc provisioning for the same.

Stronger Indian rupee can dampen NRI flows

FBL has witnessed huge NRI remittances as Kerala's economy is highly dependent on inward remittances and has benefited from a weak Indian rupee. A strong currency may have an adverse impact on NRI flows to FBL.

Company background

FBL is one of the leading private sector banks headquartered at Aluva, Kerala. The bank has been classified as an old generation private sector bank. FBL has strong dominance in its home state of Kerala, whereas incrementally it is expanding outside the state targeting Andhra Pradesh, Karnataka, Maharashtra, Gujarat and Punjab.

NRI customers are its key strength as everyone out of six Keralites is settled abroad. It has also a high focus on SME and retail loan products, especially mortgage and gold loans

Financials

Exhibit 41: Income statement

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Interest income	61,676	69,461	74,320	84,832	97,834
Interest expense	41,929	47,174	50,030	56,216	63,520
Net interest income	**19,747**	**22,287**	**24,290**	**28,616**	**34,314**
Fees	3,047	3,338	4,006	4,807	6,008
Other income	1,538	2,025	2,120	2,628	3,134
Net revenue	24,332	27,650	30,416	36,051	43,456
Operating expenses	11,795	14,421	15,616	16,736	19,117
-Employee expenses	6,265	7,715	8,239	8,474	9,616
-Other expenses	5,530	6,706	7,377	8,262	9,501
Operating profit	**12,537**	**13,229**	**14,800**	**19,315**	**24,339**
Investment profit	2,059	1,575	1,704	2,039	2,172
Pre-provision profit	**14,596**	**14,804**	**16,504**	**21,354**	**26,511**
Provisions	2,658	2,684	2,050	3,060	3,651
-Loan loss provisions	2,386	2,409	2,766	2,860	3,451
-Provisions for investment	(368)	1,116	(316)	-	-
-Other provisions	640	(841)	(400)	200	200
PBT	11,938	12,120	14,453	18,294	22,860
Taxes	3,556	3,731	4,625	5,671	7,086
PAT	**8,382**	**8,389**	**9,828**	**12,623**	**15,773**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 43: Balance sheet

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Equity capital	1,711	1,711	1,711	1,711	1,711
Reserves & surplus	61,937	67,796	75,422	85,643	98,814
Shareholders' funds	**63,648**	**69,507**	**77,133**	**87,354**	**100,525**
Deposits	**576,149**	**597,313**	**686,910**	**810,554**	**956,453**
-Current deposits	29,090	33,796	38,276	44,458	51,753
-Savings deposits	127,432	152,843	179,722	216,815	260,585
-Term deposits	419,627	410,674	468,912	549,280	644,115
Borrowings	51,870	56,879	58,671	61,144	64,062
-Subordinate debt	2,300	2,300	2,658	3,153	3,737
Other liabilities	18,830	22,244	25,195	28,714	31,704
Total liabilities	**710,497**	**745,943**	**847,910**	**987,766**	**1,152,744**
Cash/cash equivalent	37,200	45,294	54,185	66,549	81,139
Advances	440,967	434,361	519,478	624,575	755,885
Investments	211,546	241,179	245,659	264,205	278,795
Fixed assets	3,975	4,250	4,600	4,850	5,200
Other assets	16,809	20,859	23,988	27,586	31,724
Total assets	**710,497**	**745,943**	**847,910**	**987,766**	**1,152,744**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 42: Key ratios

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Growth (%)					
NII growth	1.1	12.9	9.0	17.8	19.9
Pre-provision profit growth	(3.1)	1.4	11.5	29.4	24.1
PAT growth	7.9	0.1	17.2	28.4	25.0
Business (%)					
Deposit growth	17.7	3.7	15.0	18.0	18.0
Advances growth	16.8	(1.5)	19.6	20.2	21.0
Business growth	17.3	1.4	16.9	19.0	19.3
CD	76.5	72.7	75.6	77.1	79.0
CASA	27.2	31.2	31.7	32.2	32.7
Operating efficiency (%)					
Cost-to-income	48.5	52.2	51.3	46.4	44.0
Cost-to-assets	1.9	2.1	2.1	2.0	1.9
Productivity (Rsmn)					
Business per branch	922.1	878.8	969.8	1109.1	1255.4
Business per employee	101.1	98.6	111.5	129.7	150.0
Profit per branch	7.6	7.1	7.9	9.8	11.6
Profit per employee	0.8	0.8	0.9	1.1	1.4
Spread (%)					
Yield on advances	11.3	11.4	11.3	11.1	10.8
Yield on investments	7.6	7.8	7.9	7.9	7.9
Cost of deposits	7.2	7.2	7.0	6.8	6.5
Yield on assets	10.0	10.2	10.0	9.9	9.8
Cost of funds	7.0	7.1	6.9	6.7	6.5
NIM	3.2	3.3	3.3	3.3	3.4
Capital adequacy (%)					
Tier I	14.1	14.6	13.7	12.9	12.4
Tier II	0.6	0.6	0.5	0.5	0.5
Total CAR	14.7	15.1	14.3	13.5	12.9
Asset quality (%)					
Gross NPAs	3.4	2.5	2.0	1.8	1.5
Net NPAs	1.0	0.7	0.8	0.9	0.7
Provision coverage	72.2	70.4	59.7	52.1	51.6
Provision coverage (Incl. W/o)	81.0	84.1	79.5	76.0	77.1
Slippage	2.0	1.2	1.5	1.3	1.1
Credit costs	0.5	0.5	0.5	0.4	0.4
Return ratios (%)					
RoE	13.9	12.6	13.4	15.3	16.8
RoA	1.3	1.2	1.2	1.4	1.5
RoRWA	2.1	1.9	2.0	2.1	2.2
Per share					
EPS	9.8	9.8	11.5	14.8	18.4
BV	74.4	81.2	90.2	102.1	117.5
ABV	69.4	77.5	85.1	95.7	111.2
Valuation (x)					
P/E	14.3	14.3	12.2	9.5	7.6
P/BV	1.9	1.7	1.6	1.4	1.2
P/ABV	2.0	1.8	1.6	1.5	1.3

Source: Company, Nirmal Bang Institutional Equities Research

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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