ARIHANT capital markets ltd.

Date: 9th June 2010

Andhra Bank Ltd.

ACCUMULATE

CMP: Rs. 138 | **Target price: Rs. 155** | **Industry: Finance-Banking**

Stock Info	
Market Capital	Rs. 6690 cr
Equity Capital	Rs. 485 cr
Avg Trading Vol.	1891124(Qtly)
52 WK High/Low	140/74
Face Value	Rs 10

BSE Group	A
BSE Code	532418
NSE Symbol	ANDHRABANK
Bloomberg	ANDB IN
Reuters	ADBK.BO
BSE Sensex	16617
NSE Nifty	4982

Shareholding Pattern (As on 31st March, 2010)	
Government	51.6
Foreign Institutions	13.7
Domestic Institutions	18.7
Corporate	3.0
Public & Others	13.7

Key Investment Positives

- **Consistent Healthy Asset Portfolio –** This has been one of the most comforting factors for the bank. AB has managed to maintain the defaults at one of the lowest levels in the industry since long time in the past. As at end of FY10, the gross NPA of the bank was as low as 0.87% as against the sector average of 2%. The average delinquencies have been ~ 0.5%. However the restructuring in FY09 and FY10 was much high and as at end of FY10 it stood at nearly 5% of the outstanding advance. On relating concerns we have built in a slightly higher stress for the bank in FY11E.

- **High Cushion of Provisions –** Low levels of gross defaults have allowed the bank to maintain high coverage ratio since quite some years. The bank has brought down the same from the highs of 89% to 80% in FY10 but considering the eligibility to consider technical write off's, it stands strong at 91%. We expect the bank to maintain the same going forward.

- **Expanding and Diversifying into Profitable verticals –** The bank has performed very well in the past two years by adopting a strategy to concentrate on different verticals, keep tight monitoring and expanding pan India. Further it plans to focus on margins rather than volumes by expanding in the MSME, Infra and retail segments. We expect the advances to grow at a CAGR of 25% over the next two years, which is more than manageable given the economic prospects of India and smaller base.

- **Margins to remain Healthy –** The average NIM of AB in last four years has been quite healthy at ~3.2%. As per management the bank has always restrained from giving sub-PLR loans and will follow the same strategy going forward. In future the bank plans to concentrate more on margin accretive segments like MSME. This will improve the margins going forward, though the maintaining asset quality will be key challenge. We expect that the base rate and increased interest rates will keep the margins flat in FY11, post which we expect it to improve to 3.25%.

- **Capital Infusion to Improve Tier I Cushion –** Though comfortable with a CRAR of 13.9%, the bank wants to maintain the Tier I above 8% and has therefore requested Govt for Rs 600-700 cr. As there is no further clarity we have not built up the same in our projections.

- **Valuation –** Net NPA of 0.2%, provision coverage of 80%, average NIM of 3.2%, RoA of 1.2% and RoE of 25%, indicates the sturdy financial health of the bank. Its recent performance makes us believe that the bank is adopting proper strategies which will help in sustaining a healthy growth in future. The bank is tech savvy and has done well to invest in future income stream through its life insurance venture. The bank however needs to arrest declining CASA and improve its fee income while the other concern arises from the high levels of restructuring in its books. **Considering its strong fundamentals, we initiate coverage with a price target of Rs 155 over a period of six months.** In fact the stock price of the bank has risen by almost 35% since the beginning of the March 2010. However, the stock is still at attractive levels as it trades at 1.25 times of its adjusted price to book value of FY11E. **At our target price the stock would trade at a FY10E P/ABV of 1.4 with RoAA of 1.2%.**

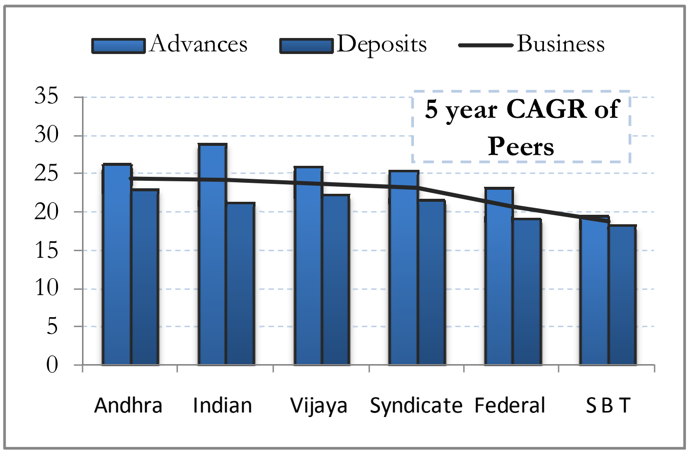
Valuation Summary

Year	FY09	FY10P	FY11E	FY12E
				(Rs. in crore)
Net Interest Income	1,627	2,195	2,782	3,616
Net profits	653	1,045	1,198	1,577
NIMs (%)	3.0	3.1	3.1	3.2
EPS(in Rs)	13.5	21.6	24.7	32.5
RoAA (%)	1.0	1.3	1.2	1.3
RoAE (%)	18.9	26.0	24.6	26.4
PE (x)	10.0	6.4	5.6	4.2
P/BV (x)	2.0	2.02	1.80	1.48
PABV (x)	1.82	1.5	1.24	1.00
Gross NPAs (%)	0.8	0.9	0.9	0.9
Net NPAs (%)	0.2	0.2	0.2	0.2

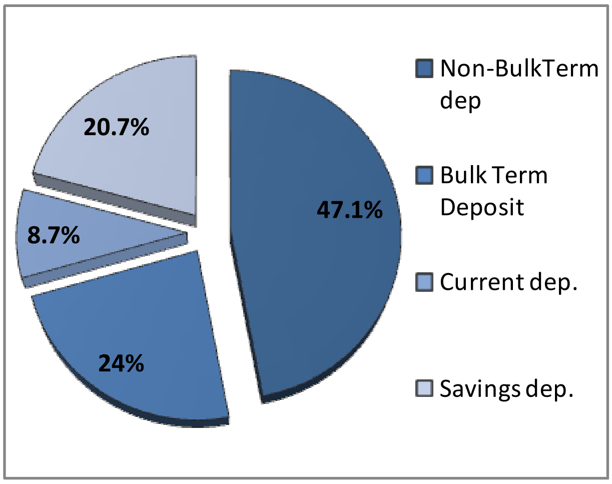
Strong Growth Over Years With Improved Outlook for Future –

Andhra bank has grown faster in the last 5 years with its business growing at a robust 24% CAGR; this being one of the best amongst its peers. In FY09 the bank surpassed Rs 1 lakh crore of business and by the end of FY10 it stood close to Rs 1,34,000 cr of which deposits constituted nearly Rs 78,000 cr and advances at Rs 56,000 cr. We expect the bank to grow at a CAGR of 25% over the next two years.

AB is not an aggressive player but low base allowed the bank to post higher growth ratio. The same low base will help the bank to continue posting better than sector average growth. The outstanding sanction pipeline of the bank is around Rs 16000 cr. Also the bank has shown adequate growth in branch expansion as well as technology platform that can help grow its business.



Expects to grow better than Industry Average

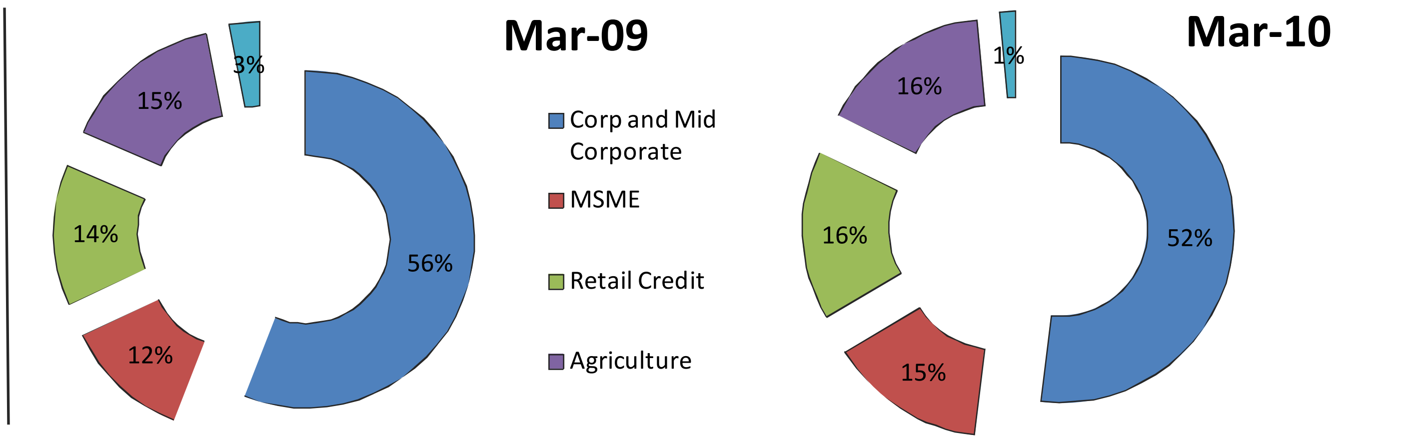


CASA- Declining Share

The growth has been faster in the deposit segment. Deposit increase was not only due to an increase in branches but deposits per branch also doubled over the last five years to Rs 50 cr/branch. A high deposit figure signifies a bank's brand equity, branch network and deposit mobilisation strength. But CASA accretion could not maintain the same pace and though the CA has been sustained at near 9% of total deposits but SA has seen a decreasing trend leading to decrease in CASA from 36% in FY05 to 29% in FY10. Bank is however targeting to reach 30-31% in FY11. Current deposits for FY10 grew 29.5% YoY to Rs 6,746 crore and savings bank deposits were at Rs 16,118 crore. Non-bulk, term deposits too increased by 27% to Rs 36,568 crore from Rs 28,772 crore in 2008-09. Bank is now focusing more on retail deposits rather than bulk deposits. Despite the increase in the deposits, the CD ratio for the bank has improved in lines with the industry from 53% levels in FY04 to 73% now.

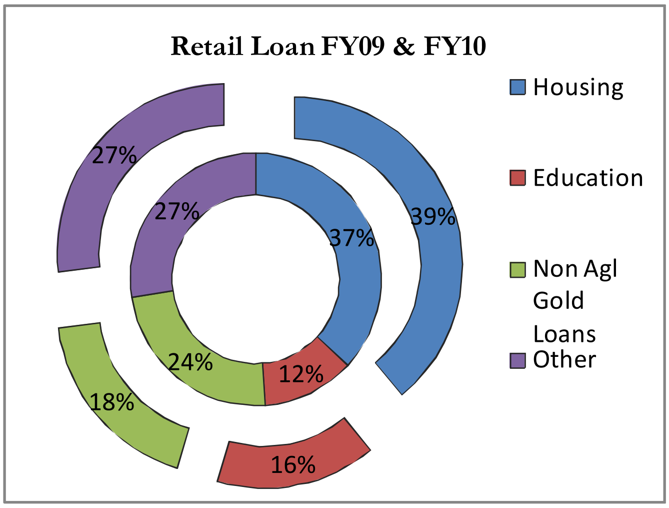
Well Diversified Portfolio with Renewed Focus on Non Corporate Segment -

The credit portfolio of the bank is tilted towards corporate and mid corporate sector, but is still quite diversified helping its growing income streams. The retail, Micro, Small and Medium Enterprises (MSME) and agriculture portfolio has been fluctuating in the range of 44-46% and in the wake of economic slowdown in FY09, the same was reduced to 41%. However it has been increased to 47% as the bank plans to give more emphasis on these sectors in the current scenario. In last four years MSME has grown fastest at a CAGR of 37%.



Diversifying Towards Margin Accretive Segments Like MSME

……. The retail portfolio of the bank is well spread and concentrated in safer mortgage backed loans like housing and gold. Bank has also been doing a lot of education loans and the same has increased in proportion from 12% to 16% post a CAGR growth of 134% in last three years. Housing is also increasing at a decent pace of 32% CAGR and forms 40% of the total retail portfolio. The bank plans to focus more on the retail segment going forward as the yields in the segment are much better and the bank has a well spread network to tap the business. The retail, Micro, Small and Medium Enterprises (MSME) and agriculture portfolio is expected to increase in proportion to nearly 50% in FY11 from present 47%.



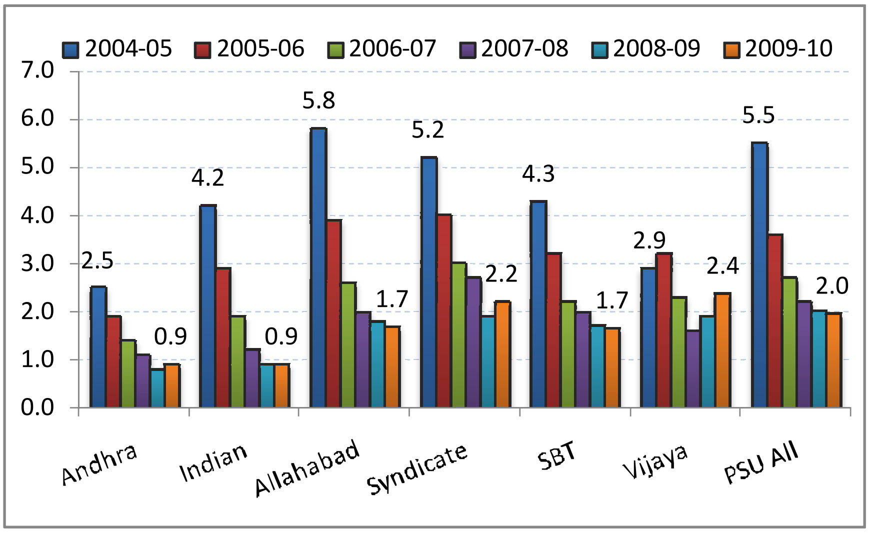
Source: Arihant Research, Bank
(Inner circle is FY09)

Concentrated In Safer Mortgage Backed Loans

Consistently Healthy Asset Quality – One of the Strongest Positive

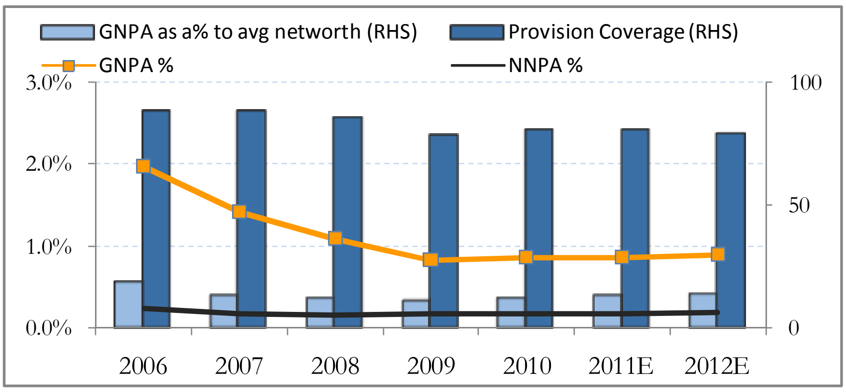
The credit assessment of the bank has been strong as compared to its peers and is getting better as the bank has reduced its gross NPA form 2.5% to 0.9%. This is despite the rapid growth in loans. The delinquency for the bank has been less than 1% and in FY09 it was s low as 0.5% before rising back to 0.7%. Going forward one of the main focus areas for the bank is tighter credit monitoring.

In FY10, the major defaults came from the MSME segment and sector wise slippage was mainly observed from the Infrastructure and Steel. The intention of the bank to expand in MSME raises concerns on the asset quality. But with the economy regaining its lost strength, we can adopt a positive a positive bias.



GNPA% Was Least And Remains Least

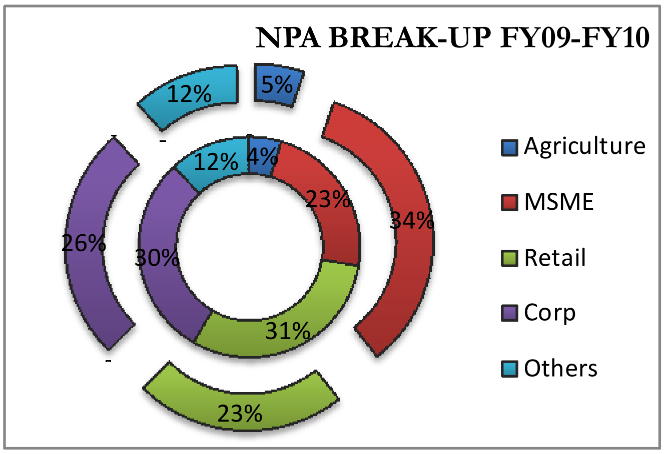
The outstanding restructured portfolio stands at Rs 2967 cr which is rather high at 5.3% of the closing advance. The main sectors include Textile, infra, power, commercial real estate (CRE), housing, metals etc. However as per bank the textile loans are mainly pertaining to spinning and weaving which have recovered faster from the slow down. As regards CRE, the bank has already slowed down in further exposure.

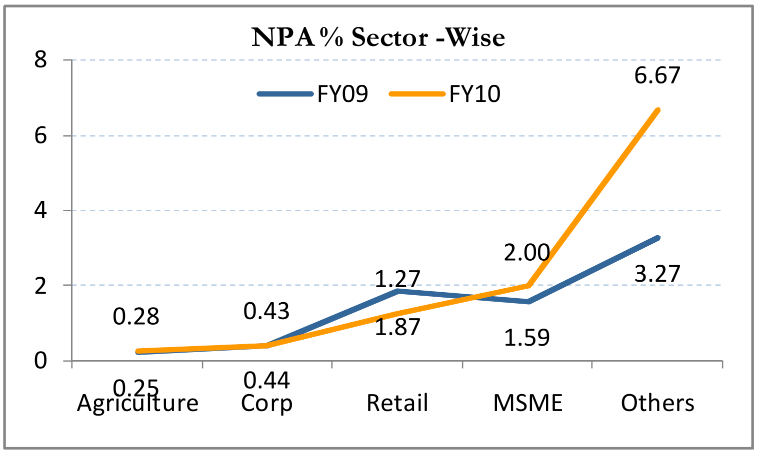


Controlled Delinquencies With High Coverage

High on provision coverage, the net NPA has been below 1% from FY2004 onwards. The coverage of the bank has been above 85% since FY05, though the same was brought down to ~80% in FY10. This is still very comfortable, considering the fact that the coverage including technical write-off is much above at 92%.

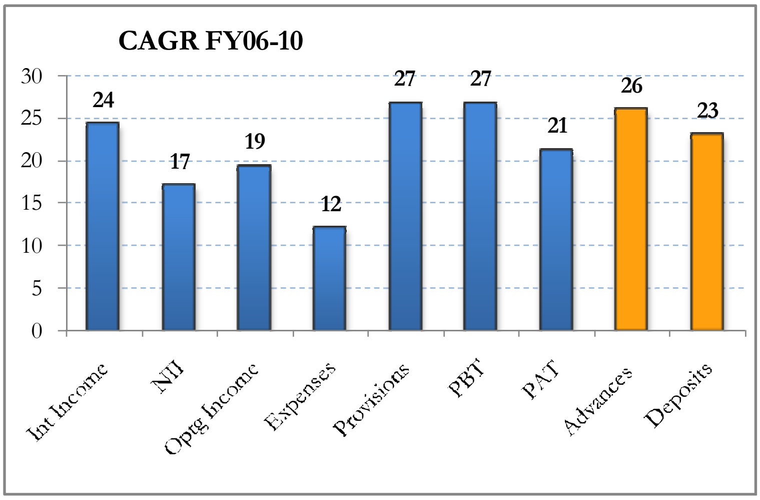
We expect the asset quality to strain a bit with some defaults coming from the restructured portfolio. The bank is expected to maintain its coverage at 78-80% level.





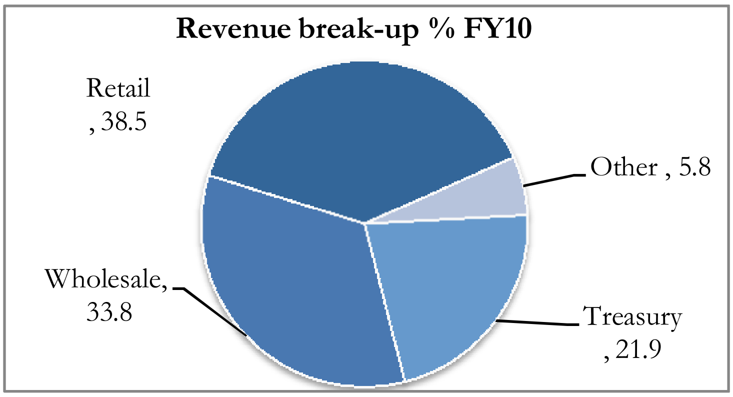
Increased NPA Coming From MSME

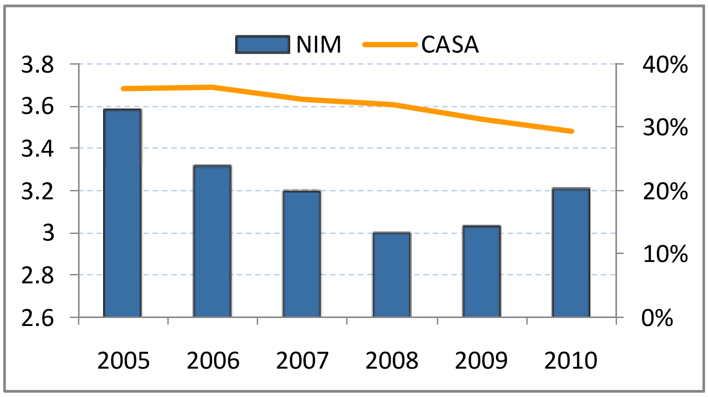
Consistently Profitable With Healthy Margins



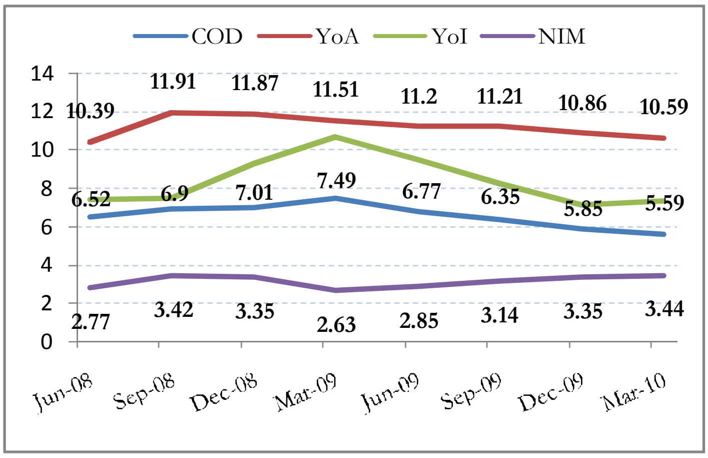
The bank has performed extremely well over the last two years in terms of profitability. In FY10 Bank crossed the Rs 1,000 cr net profit mark which is more than double the profit earned by bank in the year it came out with its IPO in 2006. We expect the bank to perform better over FY10-12E.

Despite being mainly focused on Corporates, AB reported reasonable net interest margin of above 3% over the years. However it has gradually come off from the highs of 3.6% to 3.2% one reason being the decreasing CASA levels. Going forward the bank is expected to maintain its margins despite increasing interest rates, due to focus on higher margin accretive segments like MSME and retail. However bank is expected to continue its non-aggressive profit oriented approach by focusing more on interest margins rather than volumes.





The other income of the bank is quite low, forming around 20% of the total operating income and covering less than 40% of the operating expenses. However the non funded business is growing and was around Rs 11,000 cr as against Rs 6,600cr a year ago, allowing improved sources of fee based income and other income. Treasury has also been quite active over the last two years.



We feel that bank has good scope to exploit its wide network of branches, customer base and its IT setup. Its retail expansion and other ventures like life insurance foray will help in increasing its other income. Though the high base effect of MTM reversal in last year may keep down the treasury gains in FY11, FY12 will be better. But we have not build in any major improvement which if happens will be a potential upside.

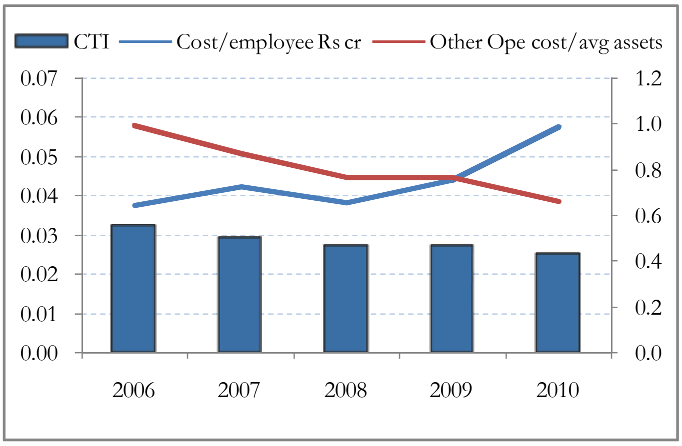
The return ratios for the bank are robust. The RoA has been maintained at above 1% even in the slowdown of FY09. The RoE has been continuously improving and reached more than 23% in FY10. The bank has reduced the dividend payout to 23% after maintaining it at 33% over the last two years. Despite this the dividend yield remains high at 3.6%.

Improving Operating Efficiency –

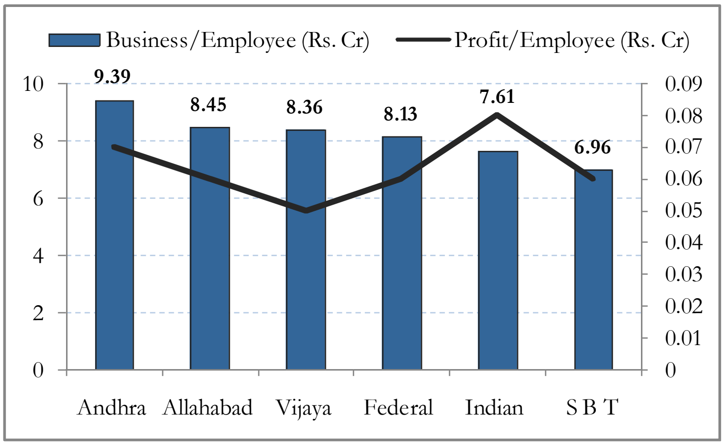
Bank has exercised control on its expenses and has been bettering it over the years. The cost to income ratio of the bank which stood at near 55% in FY06, has been gradually brought down to near 43% in FY10. This is despite branch expansion. Infact migration to CBS has also reduced the operating expenses for the banks.

Due to wage revision and revised AS-15, the employee expenses have shot up in the last two years and we expect it to stabilize at this level in future till next revision.

The cost to income ratio has reduced despite low non-interest income of the bank which covers less than 70% of the operating expenses, Furthermore, the bank will have to consistently focus to develop its existing product lines and improve cross-sales to achieve the continued growth.



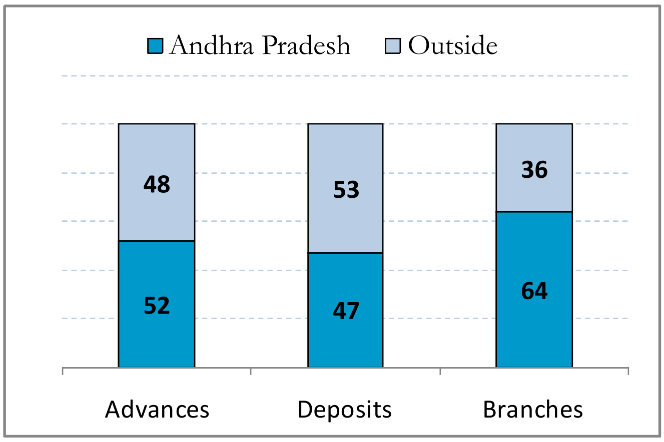
Improved Earnings and Cost Efficiency



Efficient Use Of Manpower Resources

Wide Reach with Regional Focus-

AB had a total of 1557 branches (100% CBS) and 859 ATMs as at end of 31st March 2010. It has relatively strong presence in South India with its diversified loan portfolio and growing income streams. However being in Andhra allowed the bank to capitalise on the various infra related companies which bank with AB even for the projects carried out of the State. The bank is well positioned to sustain its operations with rapidly growing branch network and ability to expand its operations out of Andhra. The bank has made moves to extend beyond the regional area, and now lends more than 48% of its loans outside Andhra Pradesh. In FY11 bank has guided to open more than 100 branches pan India. However it has a long way to go for a true pan India presence and come out of the image of "Regional Bank". This concentration restricted the valuation of the bank putting it behind its peers despite having better parameters.



Focusing on Pan India Operations

As a part of its global drive, the bank has opened a Representative Office in Dubai and New Jersey. Also bank is in the process of forming a Joint Venture in Malaysia in association with Bank of Baroda and Indian Overseas Bank.

Life Insurance Venture -

The Bank's life insurance joint venture "India First Life" in association with Bank of Baroda and Legal & General Group of UK, commenced its operation in January this year. Since then this JV has raised a premium of Rs 50 cr and in FY 11, bank expects to earn Rs 250 cr. Distribution of LIC policies were stopped since June 09 and from distribution of India First Life policies AB earned an income of Rs 4 cr through commission. Initially the AB has infused about Rs. 100 Crore as its share of capital into this JV and in FY11 we can expect another 30-40cr of infusion.

Capital Adequacy Ratio –

Bank had a comfortable capital adequacy ratio of 13.9% under Basel-II as at end of FY10 with Tier I at 8.2% and Tier II at 5.7%. The bank has headroom to raise around Rs 1300 cr of Tier II capital and Rs 2750 cr of Tier I. Bank is confident of maintaining the CAR at comfortable level with the help of internal accruals for the coming two years at least. However to maintain a Tier I of more than 8%, AB has sought Rs 600-700 cr capital from the government which is expected to come over next year . As there is no clarity on the amount, form and time of this infusion, we have not built it up in our projection. The Govt holding is very low at 51.6% and this leaves very little scope for the bank to try other forms of raising capital.

Succession Matter –

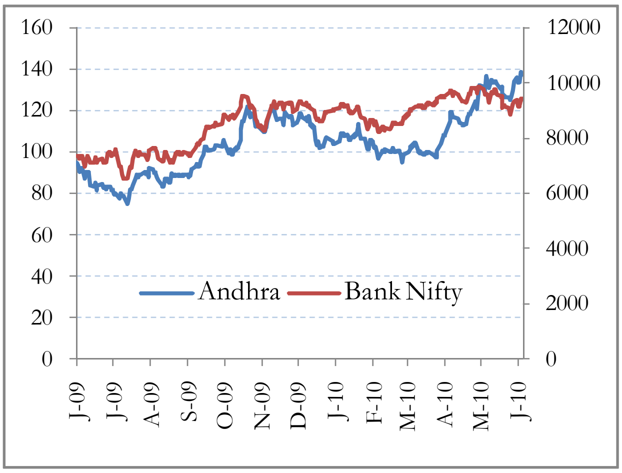
The current Chairman of the bank Mr. Reddy will retire by August 2010. The new head is expected to continue with the strategies as the same enough left to be explored and have yielded positive results till now.

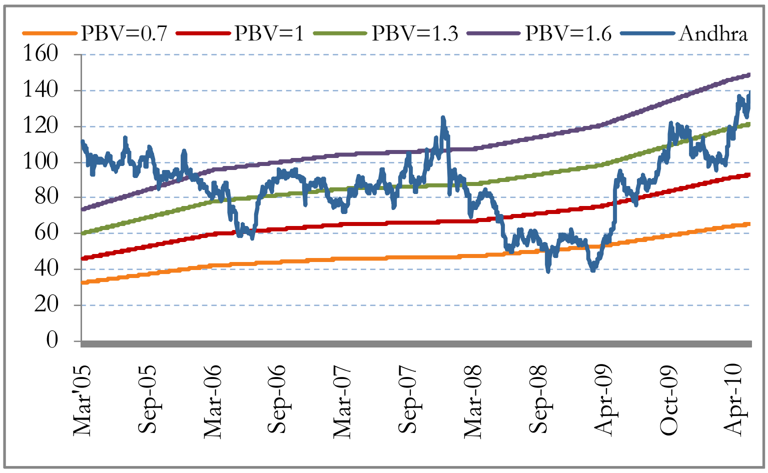
Interest Rate Exposure

With 85% of the investments in HTM (Held to Maturity Category) and modified duration of just 2.3 years of AFS (Available For Sale) portfolio, the interest rate risk is reduced to a large extent. Any sharp increases in bond yields will affect only a small part of the portfolio with a low duration.
Even the base rate is expected to be less erratic because as per the bank there is very negligible amount of sub-PLR loans in its portfolio.

About Andhra Bank Limited -

Andhra bank is the 18th largest PSU bank with business crossing beyond Rs 1.3 lakh core. An 87-year old south based bank, its credit market share stands at around 1.7%. Present in 23 states, AB is concentrated mainly in Andhra Pradesh with two third of the branches in the State itself but is now focusing on increased pan India operations. Bank's strength lies in its consistent healthy asset quality risk and high provision coverage. It has one of the highest dividend yields amongst banking stocks. New focus areas for the bank are concentrating on business through special verticals, tight monitoring and expansion outside Andhra Pradesh.





An Underperformer, Over Performing Since Past Three Months

1 Month	3 Months	6 Months	1 Year
6.3	34.8	17.4	49.4

Financial Information

Income Statement				
Year to 31st March (Rs. Cr)	**FY09**	**FY10P**	**FY11E**	**FY12E**
Interest Income	5375	6373	8321	10632
- Interest from advances / bills	4215	5161	6693	8586
Interest Expenses	3748	4178	5539	7016
Net Interest Income	**1627**	**2195**	**2782**	**3616**
- growth %	*21*	*64*	*71*	*30*
Fee-based Income	415	537	641	764
Treasury Income	273	383	324	388
Other Non-interest Income	78	44	64	78
Operating Income	**2392**	**3159**	**3810**	**4846**
- growth %	*22*	*61*	*59*	*27*
Operating Expenses	1104	1350	1609	1966
- Staff Cost	624	824	929	1102
- Other Operating Exp.	480	525	680	864
Gross Profits	**1288**	**1809**	**2200**	**2880**
- growth %	*22*	*71*	*71*	*31*
Provisions	390	374	438	561
Profit Before Taxes	**898**	**1435**	**1762**	**2319**
Taxes	245	390	564	742
Profit After Taxes	**653**	**1045**	**1198**	**1577**
- growth %	*13*	*60*	*15*	*32*

Statement of Affairs				
As on 31st March (Rs. Cr)	**FY09**	**FY10P**	**FY11E**	**FY12E**
Capital	485	485	485	485
Reserves & Surplus	3,162	3,924	4,839	6,132
Deposits	59,390	77,688	95,945	120,411
- growth %	*20.1*	*30.8*	*23.5*	*25.5*
Borrowings	1,511	3,032	3,032	3,639
Other liabilities & provisions	3,921	5,250	5,392	6,559
TOTAL LIABILITIES	**68,469**	**90,380**	**109,693**	**137,226**
Cash on hand & with RBI	4,853	6,699	7,419	9,133
Money at call and short notice	434	4,469	1,091	1,166
Advances	44,139	56,152	71,032	90,210
- growth %	*28.9*	*27.2*	*26.5*	*27.0*
Investments	16,911	20,881	27,523	33,697
- out of which SLR	15,311	19,781	26,385	32,511
Fixed assets	335	356	388	443
Other assets	1,796	1,825	2,241	2,577
TOTAL ASSETS	**68,469**	**90,380**	**109,693**	**137,226**

Ratio Analysis				
Year to 31st March	**FY09**	**FY10P**	**FY11E**	**FY12E**
Spread analysis (%)				
Yield on advances	10.8	10.3	10.5	10.7
Yield on investments	6.9	6.3	6.4	6.5
Yield on interest-earning assets	8.8	7.9	8.4	8.6
Cost of deposits	6.4	5.5	5.9	6.1
Cost of borrowings	24.8	16.6	13.7	12.5
Cost of funds	6.0	5.0	5.4	5.5
Spread	2.9	2.9	3.0	3.0
Net Interest Income to AWF	2.8	2.9	2.9	3.1
Non Interest Income to AWF	1.3	1.3	1.1	1.0
Operating Profit to AWF	2.2	2.4	2.3	2.5
Net Profit to AWF	1.1	1.4	1.3	1.3

Ratio Analysis				
Year to 31st March	**FY09**	**FY10P**	**FY11E**	**FY12E**
Basic Ratio (Rs.)				
EPS	13.5	21.6	24.7	32.5
Book Value per share	75	91	110	136
75% Adjusted Book Value	76	92	111	138
Dividend per share	4.5	5.0	5.0	5.0
Asset Quality (%)				
Gross NPAs	0.8	0.9	0.9	0.9
Net NPAs	0.2	0.2	0.2	0.2
NPA Coverage	78.5	80.4	79.1	78.4
Profitability ratios (%)				
RoAE	18.95	25.96	24.63	26.41
RoAA	1.04	1.32	1.20	1.28
NIM	2.95	3.10	3.10	3.25
Operating Profit Margin	21.0	24.7	23.5	24.3
Net Profit Margin	10.6	14.3	12.8	13.3
Cost to Income	46.2	42.7	42.2	40.6
Fee-based income to Operating Income	17.3	17.0	16.8	15.8

ARIHANT - Research Desk

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Stock Rating Scale

		Absolute Return
BUY	:	>20%
ACCUMULATE	:	12-20%
HOLD	:	5-12%
REDUCE	:	<5%