KARUR VYSYA BANK LTD.

Analyst Recommendation: Buy

Buy | Accrue | Hold | Ease | Sell

BSE Code:	590003	NSE Code:	KARURVYSYA	Reuters Code:	KARU.NS	Bloomberg Code:	KVB:IN

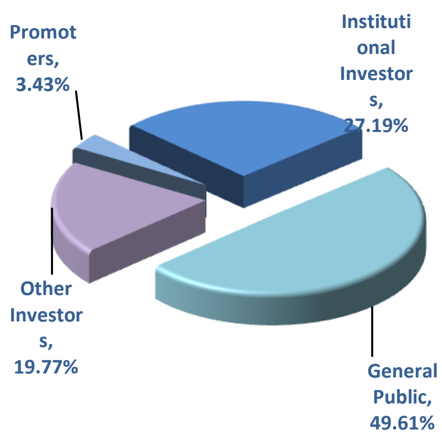
CMP:	**₹412**
3 month Target:	**₹473**
SL:	**₹391**

EPS (₹)	35.5
P/E (X)	11.6
Revenue (₹mn)	22,176.9
Operating Profit (₹mn)	6,005.8
Operating Margin (%)	27.1
EV/Interest Income (X)	12.8
Market Cap (₹mn)	48,179.3
Free Float Mar Cap (₹mn)	46,526.7
52 week high/low	508/280
Total Debt (₹mn) (FY10)	252,517.4
Enterprise Value (₹mn)	283,898.3
Book Value per Share	182.7
P/BV	2.3

Investors Rationale

- Karur Vysya Bank (KVB) has recorded an impressive 28.7% growth in its Net Interest Income (NII) at ₹2.11 billion during Q4FY11 on y-o-y basis, backed by higher interest income from firm growth in advances due to high priority sector lending.
- The asset quality of KVB has shown significant improvement in the Q4FY11, as net non-performing assets (NPA) slipped 16 basis points to 0.07% of net advances from 0.23% in the same period prior year. With better risk management strategies and higher provisioning, KVB is expected to maintain high asset quality in the coming quarters.
- With increasing emphasis to improve its CASA deposit base, KVB intends to cushion it's NIM in the coming quarters by the reaping the advantage of its low interest rates in a rate hike scenario.
- Intends to grow its loan portfolio by 30% during FY11 and thereby raise its business level to ₹550 billion in FY12.
- Stands firm with a capital adequacy ratio of 14.41% under Basel II as against the regulatory minimum level of 9%.
- Aims to achieve a network of 450 branches by the end of FY12 and is planning to scale up its business in Northern India to develop a pan India presence, thereby de-risk its balance sheet.

Shareholding pattern as on March 31, 2011

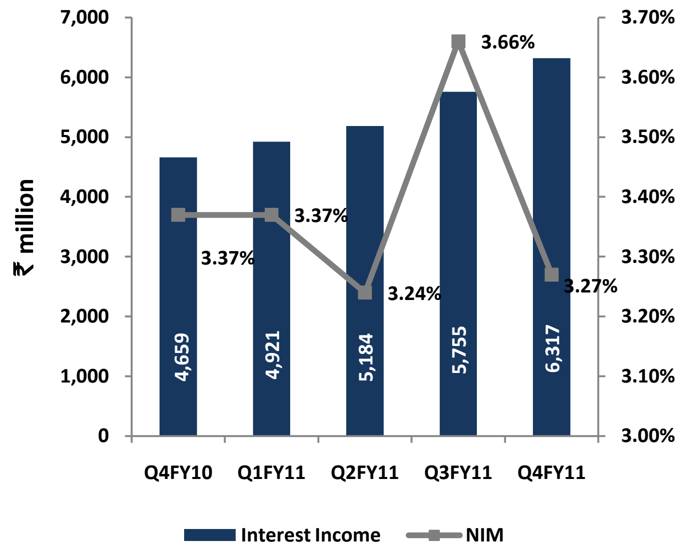


₹Million	FY10A	FY11A	FY12E	FY12E
Operating Income	17,579.4	22,176.9	28,164.7	36,614.1
Operating Profit	4,632.2	6,005.8	7,908.3	10,720.1
Net Profit	3,360.3	4,155.9	5,437.5	7,398.3
Share Capital	544.4	1,169.4	1,169.4	1,169.4
EPS (₹)	61.7	35.5	46.5	63.3
PE (x)	6.7	11.6	8.9	6.5
P/BV (x)	1.4	2.3	1.9	1.5
EV/Operating Profit (x)	44.9	47.3	44.6	41.5
ROE (%)	20.7	19.4	21.4	23.6
ROA %	1.5	1.5	1.5	1.6

High priority sector lending fuels impressive interest income growth in Q4FY11

KVB has recorded an impressive 28.7% growth in its Net Interest Income (NII) at ₹2.11 billion during Q4FY11 on y-o-y basis. Interest income has increased by 35.7% to ₹6.31 billion on y-o-y basis. The higher interest earnings of the bank were mainly driven by a firm growth in advances due to high priority sector lending. Other income also recorded a buoyant growth of over 19.4% on y-o-y basis at ₹636.3 million, primarily helped by strong 12.6% increase treasury operations at ₹1.38 billion from ₹1.22 billion a year ago. Despite frequent hike in interest rates by RBI, the bank managed to block its operating cost with better cost control strategies at ₹1.29 billion. At the end of the quarter, the bank stood firm with a net profit of ₹1.15 billion, reflecting an increase of 16.69% over the corresponding quarter ended March, 2010. NIM for the period stood at 3.27%.

Q4FY11 NIM stays at adequate levels despite higher provisioning

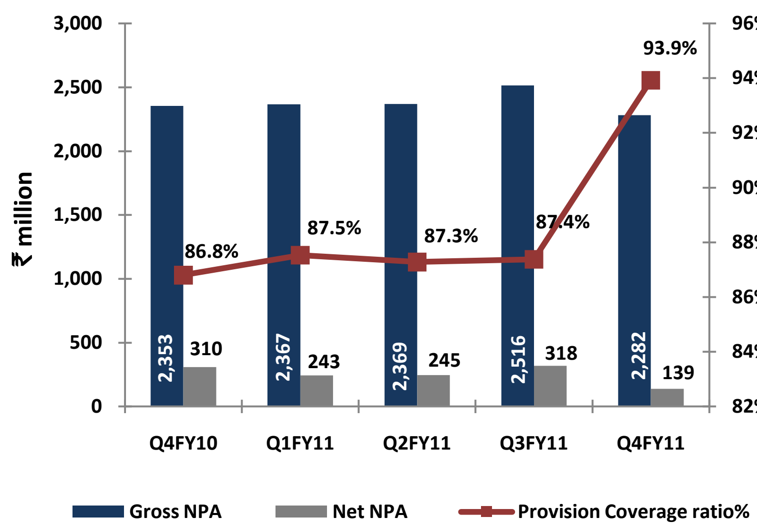


Source: Company

Better risk management strategies to boost asset quality further

The asset quality of KVB has shown significant improvement in the Q4FY11, as net non-performing assets (NPA) slipped 16 basis points to 0.07% of net advances from 0.23% in the same period prior year. Though the KVB has constantly maintained adequate asset quality in every quarter of FY11, the remarkable growth in the Q4FY11 has been fuelled by increasing provisions for bad loans at 93.9% of advances, as against the regulatory stipulation of 70%. During the quarter, KVB's Gross NPAs to Gross Advances ratio also declined to 1.26% from 1.72% on y-o-y basis. KVB further intends to keep its gross NPAs below 2% and net NPAs below 1% in the coming quarters by increasing its focus on recovery and retail segment.

Asset quality sustained with higher provisioning to offset rate hike concerns



Source: Company

To curb the rising inflation, RBI has raised its policy rates 8 times in FY11, followed by higher-than-expected rate actions in May 2011. As a result, higher rates could stress the asset quality of the bank by affecting borrower's repayment capacity and thereby deteriorating the health of the bank's balance sheet. However, strong domestic growth environment, improved corporate credit profiles, increasing emphasis on strong retail portfolio, better risk management and less exposure to high risk sectors will help the lender to boost the share of secured loans in the coming quarters, cushioning against probable asset quality risks. Apart from this, better provisioning policies will also help the bank to maintain its present asset quality standard.

Increasing focus on CASA to cushion NIM in coming quarters

As on 31st March 2011, the current account, savings account (CASA) ratio of KVB stood at 23.28%, which is one of the lowest in the industry. During FY11, CASA deposits grew by 26.90% from ₹4.53 billion to ₹5.75 billion due to consistent focus on improving the deposit base of the low cost segment. KVB intends to cushion it's NIM in the coming quarters with a higher CASA mix further.

The lower interest rate attached to the CASA accounts in comparison to the term deposit account always creates a cost advantage for the banks, restricting imbalance in the cost structure even in a rate hike scenario. The funds in the CASA deposit can be increased based on many factors like if there are transactional flows from IPOs or any happening that supports inflow into the current accounts. KVB's strategy to enhance its retail portfolio and expand its branch network for the current fiscal will help the bank to improve its CASA mix.

KVB aims a network strength of 450 branches in FY12

As on 31st March 2011, KVB had a network of 370 branches and 488 ATMs. Going forward, the management plans to increase the toll to 450 branches by the end of FY12, to ramp up its expansion drive. In a bid to increase its footprint, KVB has opened an average of 22-23 branches every year in the past 3 year. Traditionally, KVB's deposit base and branch network have been concentrated in the urban centers of South India. But the bank is now looking forward to expand its presence in northern and western India. KVB presently has 22 branches in Maharashtra and 12 in Gujarat. It is planning to scale up its business in those regions to develop a pan India presence, thereby de-risk its balance sheet.

Fee Income to grow backed by bullion trading approval

KVB has been generating healthy fee income at an average of around22% for the past 5 years. In Q4FY11, the revenue of the bank from its treasury operations has grown by 13% at ₹1.38 billion from ₹1.22 billion in the same period prior year. With the expansion of branch network and RBI's approval for bullion business, the bank's core fee income is expected to grow by 22-24% in the coming quarters.

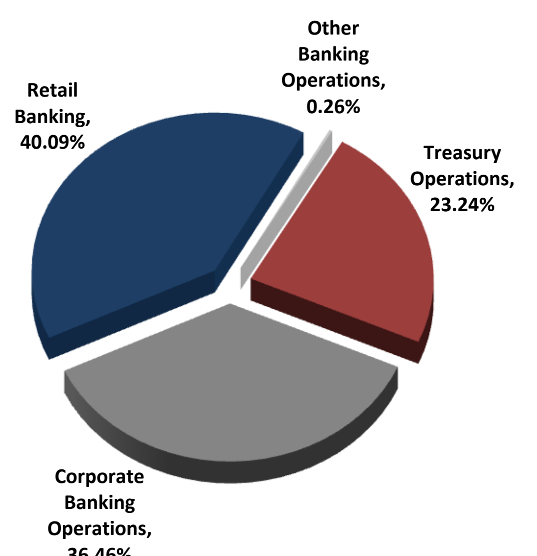
Strong CAR and fresh capital raising ensures sustainable growth

As on 31st March 2011, the capital Adequacy of KVB stood at 14.41% under Basel II requirement as against the regulatory minimum level of 9%. Besides, the bank's Net worth stood at ₹21.36 billion. KVB also received 50% of the funds augmented through rights issue in the ratio 2:5. The application money of Rs.75/- was fully received in FY11 which has strengthened the CAR of the bank. KVB expects to receive the reaming 50% of the right issue, worth around ₹2.5 billion by way of first call and second call in FY12.

KVB aims over 65% growth in business in FY12 backed by 30% growth in loan book

During FY11, aggregate business level of KVB rose to ₹427.74 billion from ₹329.46 billion, registering a growth of 29.83%. This growth of the bank was mainly fuelled by 32.01% growth in gross advances at ₹180.52 billion on y-o-y basis. Priority sector advances during the year occupied 41% of total advances of KVB and the agricultural advances reached its best levels at 18.83%. KVB intends to grow its loan portfolio by 30% during FY11 and thereby raise its business level to ₹550 billion in FY12 and further increase it to ₹1,250 billion by FY17.

Retail Banking Operations contributed major chunk of revenues in FY11

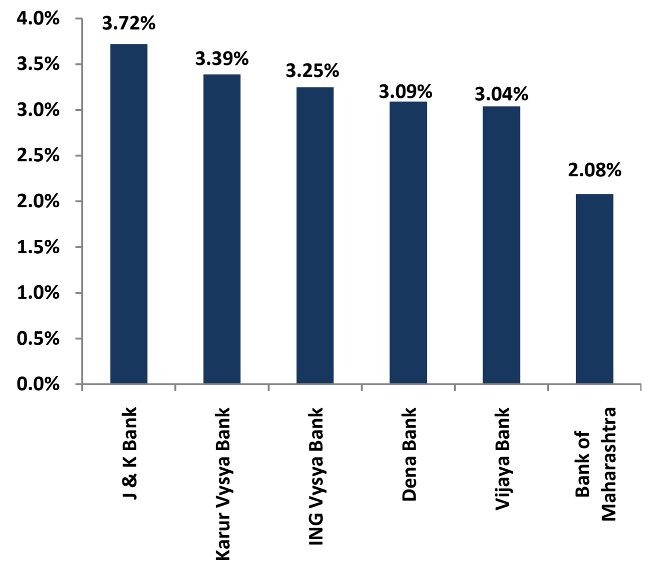


Source: Company

Risk Factors

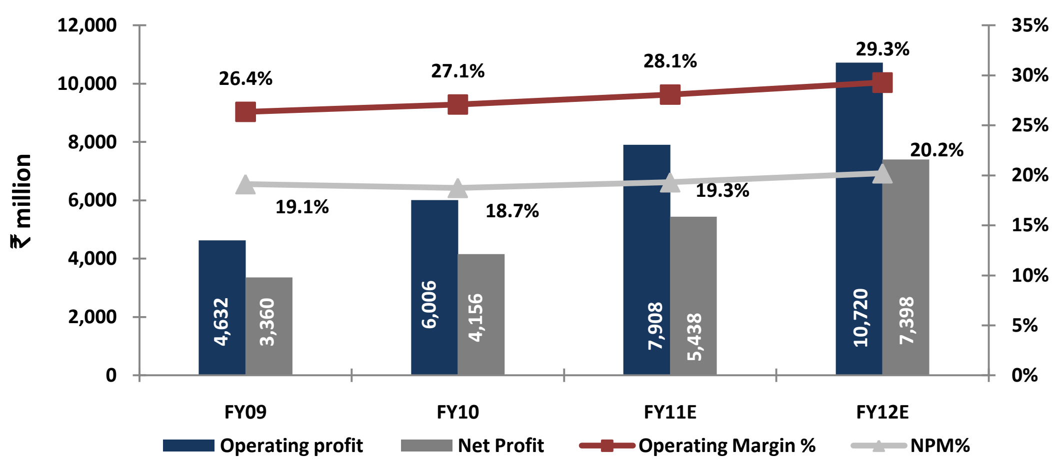
- The Banking industry is struggling to maintain its margins weighed by rising borrowing cost and inability to increase the lending rates due to concerns of moderation in loan growth.
- Higher rate hike action by RBI to curb the rising inflation could stress the asset quality of the bank by affecting borrower's repayment capacity and thereby deteriorating the health of its balance sheets.
- The CASA ratio of the bank is far below the industry standard, which if not raised to adequate levels in the coming years can strain the cost structure of the bank.
- Opening up of the industry is also increasing the competition from foreign peers.

NIM of KVB stands firm among peers (as on 31st Mar'11)



Source: Research Desk

Margins likely to stay elevated supported by higher interest earnings



Source: Research Desk

Business Overview

Karur Vysya bank Ltd (KVB), incorporated in 1916 is one of the oldest private sector banks of India, established to inculcate the habit of savings and provide financial assistance to traders and small agriculturists in and around Karur, Tamil Nadu. KVB is one of the earliest banks in the country to achieve full networking of its branches under core banking solutions. The bank has the tie ups with Bajaj Allianz general insurance company and Birla sun life insurance Company for all types of general insurance and life insurance respectively. The bank has a network of 370 branches and 488 ATMs, as on 31st March 2011. KVB plans to improve the branch network to 450 by the end of the financial year 2011-12.

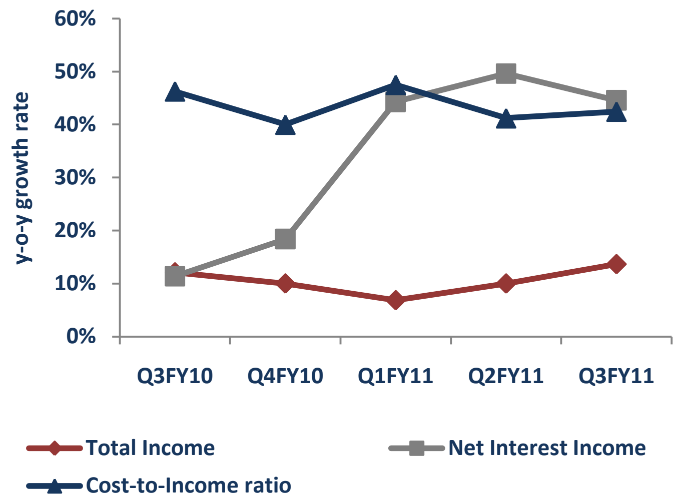
Indian Banking Industry

The Indian Banking Industry has played a vital role in the sectoral growth as well as overall development of the Indian economy in the past decade. The collective net profit of the industry registered an eight-fold growth to ₹571 billion in 2010 from ₹71 billion in 2001. Meanwhile, bad asset as a percentage of loans retreated to 1% in 2010 from 6.83% a decade ago. With enhanced profitability, efficiency and productivity, return on assets of the industry has increased from 0.57% in 2001 to 1.05% by 2010. Empowered by strong financial fundamentals and notable efforts of the policy makers like RBI, Ministry of Finance etc, the Indian Banking sector has emerged as one of the toughest and sound banking systems worldwide, during the global financial turmoil.

9MFY11 profitability improves on higher core interest income

In the first nine months of FY11, the total income and net interest income of the industry has increased by 13.67% and 44.57% on y-o-y basis, respectively, with hefty contribution of core interest income from the PSU banks. Cost-to-Income ratio during the period declined to 42.46% from 46.26% a year ago due to significant improvement in the cost-to-income ratios among state-run lenders owing to improved their top-line and robust growth in NII accompanied by moderate growth in operating costs. Provisioning expenses rose by 54.48% on y-o-y basis in 9MFY11 on back of higher amount set aside by banks to achieve the RBI mandated 70% NPA provision coverage. Though PSU banks rose their provisioning significantly, private lenders eased it off with the reduced stress on its asset quality.

Slight moderation in y-o-y growth of operating cost helps to improve NII growth rate in Q3FY11



Source: Research Desk

Credit growth exceeds target numbers owing to broad based demand across different sectors

Bank credit during FY10, registered a modest growth of around 16.7% on y-o-y basis on the back of lower capital expenditure by the industries as well as the apprehension of the banking sector to issue credit. However, the same has managed to pick up momentum in FY11 with around 25% growth till Dec'10 on y-o-y basis against a forecasted 20% for the fiscal, on the back of accelerated credit growth across all major sectors of the economy. In the first nine months of 2011, the PSU banks like SBI & its associate banks together recorded an average credit growth of around 13% on y-o-y basis while private sector banks exhibited a higher credit off-take of around 19% on a y-o-y basis, partly influenced by the lower base rates. As on 31st Dec'10, total bank credit for Scheduled Commercial Banks (SCBs) including Regional Rural Banks (RRBs) stood at ₹37,632 billion highly driven by credit extension to the telecom companies during the 3G and broadband wireless auctions, low base rate and broad based demand for credit across different sectors.

Deposits Growth struggle to achieve target despite rise in rates

On the other side of the flip, aggregate deposits with SCBs have grown at 16.6% to reach ₹49,714 billion on 31st December, 2010, which is lower than the 19.5% growth observed last year and a RBI targeted growth of 17% for FY11, despite raising the deposit rates by most of the banks by over 150 basis points. Much of the deposit growth occurred during Q1FY11 while Q2FY11 witnessed a mere 1.6% q-o-q growth. Deposit growth paced up again in Q3FY11 registering a q-o-q growth of 5.61% as under tight liquidity conditions most banks enhanced their deposit mobilisation efforts by offering attractive interest rates on time deposits. But still, under persistent inflationary pressure, customers preferred alternative investment avenues such as gold and equities especially IPOs of public sector companies, due to comparative lower return from deposits. In the first nine months of FY11, public sector banks together recorded an average 13.7% y-o-y growth in deposits.

High Credit deposit ratio signaling asset liability mismatch

The increasing mismatch between credit and deposit growth rates may result in shortage of funds in the industry to finance high-value projects that have repayment schedules of up to 15 years compared with most deposits maturing in one-three years. As on September, 2010, the top 100 centres of the total 34,850 banked centres of Scheduled Commercial Banks in India accounted for 68.8% of the total deposits and 78% of total credit in the industry. Due to accelerated growth in credit demand against the available deposit to source them, the incremental credit-to-deposits ratio of the industry at end of 9MFY11 has widened to 107.8% on Dec'10, enhancing the probability of destabilisation in the banking and financial system of the country.

Accelerated growth in credit demand fuels higher incremental CD ratios (%)

	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11
SBI	122	145	213	132	118
PNB	78	81	107	106	93
Canara Bank	53	65	73	67	80
ICICI Bank	291	227	147	13	137
HDFC Bank	210	110	114	95	106
Axis Bank	116	95	82	72	92

Domestic growth to support shrinking asset quality

The total assets size of the industry grew five-fold at CAGR of 18% from US$ 250 billion to more than US$1.3 trillion over a term of 10 years. On year on year basis, the overall Gross nonperforming assets (NPAs) as a ratio to gross advances for SCBs accelerated to 2.5% in FY10 against 2.25% in FY09. On the other hand in the first nine months of FY11, the gross NPA level of the industry rose by 23.8% y-o-y basis to ₹896 billion with Public Sector banks, accounting for almost 80% of the same. However, during this period, overall Gross NPAs as a % of advances has reduced to 2.39% against 2.41% as on Dec'09, owing to improved recovery levels across banks. Besides, the overall NPA Provision Coverage Ratio (PCR) improved across most banks to around 70% level, mandated by the RBI to be achieved by September 30, 2010.

Higher-than-expected rate actions likely to pressurize margins

In FY10, NIM of the Indian banks dipped from 2.61% in FY09 to 2.5% as the banking industry struggled to maintain its margins owing to RBI's consecutive rate hike decision to curb the growing inflation numbers, signalling not only the end of margin expansion for Indian banks but actual margin compression. And with Reserve Bank of India (RBI)'s recent decision to adopt higher-than-expected rate actions, particularly after raising policy rates 8 times in FY10, Indian banks are likely to witness some additional shrinkage in margins weighed by rising borrowing cost and inability to increase the lending rates due to concerns of moderation in loan growth. However, the banks are trying to mitigate some pressure on margins by raising the base rate and benchmark lending rates across different segments.

Outlook

The banking sector business has grown at a CAGR of around 23% between FY05 to FY10 owing to lower capital expenditure by the banks. But with increasing apprehension of the industry to issue credit under higher inflation scenario has moderated its growth in FY10 to around 16.7% on y-o-y basis. In FY11, due to higher growth in credit take off, the growth numbers of the sector improved to around 20% y-o-y till October 2010. Going further, with the inflation seemingly out of control and monetary policy very clearly coming down hard on inflation, the growth momentum of the industry in the coming months are likely to witness some moderation. However, the profitably of the sector is expected to garner some support from higher credit growth due to growing demand across various sectors coupled with improving asset quality, owing to strong domestic growth environment, improved corporate credit profiles, better risk management and less exposure to high risk sectors. Apart from this, with Government's initiative to infuse a sum of ₹60 billion to the under-capitalized public sector banks to ensure strong capital base among PSU banks by FY12 will go a long way in helping to banks to strengthen their financial position and stay firm under tight liquidity conditions.

Balance Sheet (Standalone)

(₹million)	FY10A	FY11A	FY12E	FY13E
Equity Capital	544.4	1,169.4	1,169.4	1,169.4
Reserves & Surplus	15,655.4	20,200.5	24,234.7	30,229.8
Shareholders' Fund	16,199.8	21,369.9	25,404.1	31,399.2
Deposits	192,718.5	247,218.5	318,911.9	414,585.4
Borrowings	4,758.8	5,298.9	5,563.8	5,842.0
Other Liabilities & Provisions	5,670.3	8,361.1	9,197.2	10,116.9
Capital Employed	**219,347.4**	**282,248.4**	**359,077.1**	**461,943.6**
Cash and Balances with RBI	11,984.9	16,798.4	20,158.1	24,189.7
Money at call and short notice	365.7	946.2	1,230.1	1,599.1
Investments	66,021.6	77,317.6	95,040.5	116,662.4
Advances	134,470.0	178,144.6	231,588.0	305,946.1
Fixed Assets	1,378.1	2,105.7	2,737.4	3,558.6
Other Assets	5,127.1	6,935.9	8,323.1	9,987.7
Capital Deployed	**219,347.4**	**282,248.4**	**359,077.1**	**461,943.6**

Profit & Loss Account (Standalone)

(₹million)	FY10A	FY11A	FY12E	FY13E
Interest Income	17,579.4	22,176.9	28,164.7	36,614.1
Interest Expended	11,930.5	14,508.4	18,425.7	23,953.4
Net Interest Income	5,648.9	7,668.5	9,739.0	12,660.7
Growth (%)		35.8	27.0	30.0
Other Income	2,469.8	2,643.3	3,098.1	4,540.1
Operating Income	8,118.7	10,311.8	12,837.1	17,200.8
Growth (%)		27.0	24.5	34.0
Operating Expenses	3,486.5	4,306.0	4,928.8	6,480.7
Operating Profit	4,632.2	6,005.8	7,908.3	10,720.1
Growth (%)		29.7	31.7	35.6
Operating Margins (%)	26.4	27.1	28.1	29.3
Provisions and Contingencies	373.5	393.1	499.2	649.0
Tax	898.4	1,456.8	1,971.5	2,672.8
Net Profit	3,360.3	4,155.9	5,437.5	7,398.3

Key Ratios & Valuations (Consolidated)

	FY10A	FY11A	FY12E	FY13E
Operating Profit Margin (%)	26.4	27.1	28.1	29.3
PAT Margin (%)	19.1	18.7	19.3	20.2
Cost to Income Ratio (%)	42.9	41.8	38.4	37.7
ROE	20.7	19.4	21.4	23.6
ROCE	2.2	2.2	2.3	2.4
ROA	1.5	1.5	1.5	1.6
EPS	61.7	35.5	46.5	63.3
P/E ratio (x)	6.7	11.6	8.9	6.5
Book Value	297.6	182.7	217.2	268.5
P/BV ratio (x)	1.4	2.3	1.9	1.5
EV/Interest Income (x)	11.8	12.8	12.5	12.1
EV/Operating Profit (x)	44.9	47.3	44.6	41.5
EV/CE (x)	44.9	47.3	44.6	41.5

Valuation

KVB has recorded an impressive interest income growth in Q4FY11 backed by firm growth in advances due to high priority sector lending. The asset quality of KVB has also shown significant improvement due to higher NPA provisioning and with better risk management strategies KVB is expected to maintain high asset quality in the coming quarters. With increasing emphasis to improve its CASA deposit base, KVB also intends to cushion its NIM in future. Besides, the bank is planning to grow its loan portfolio by 30% during FY11 and thereby raise its business level to ₹550 billion in FY12. Further, the bank is on expansion spree and aims to achieve a network of 450 branches by the end of FY12. Considering the above aspects, we rate the stock as ‘BUY’ at the current market price of ₹412. At the current market price, the stock is trading at a 1.9x FY12E BV and 1.5x FY13E BV.

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