Federal Bank | BUY

JM FINANCIAL

Margins sustain ; fee growth surprises

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Federal Bank reported profit of INR 2.66bn in 2QFY19 (flat YoY, 2.7% above JMFe). While NII was broadly in-line with our estimates, a strong performance on core fees (+34% YoY) resulted in a PPoP beat of 19%. Provisions for the quarter were, however, elevated (specific credit cost at 0.9%) as gross slippages came at 2.1%. Slippages (INR 4.8bn) were elevated on account of the floods in Kerala (c.10% of slippage).Management disclosed that FB has an overall exposure of c.INR 2bn to the IL & FS Group (0.2% of loans), spread across 3 operational projects, where it does not expect significant stress. Management expects slippages on account of Kerala floods to be contained at INR 1.5bn in FY19. We now build slippages of INR 15.4bn (1.7% delinquency) in FY19, resulting in a cut in our PAT estimates by 3.4% for FY19. We believe FB can deliver RoA/ RoE of 1% / 13% in FY20E.

- **Strong core fee growth drives PPoP:** FB posted 14% YoY NII growth (on an unfavourable base, QoQ growth of 4.3%), as NIM expanded marginally to 3.15% (+3bps QoQ) and loan growth was strong at (+25% YoY). Core fees growth was strong (+34% YoY), driven by strong growth in loan processing charges (+51% YoY) and forex income (+49% YoY). Cost-to-income fell sharply on account of outperformance in fees (down 365bps QoQ to 48%), as opex growth was flattish QoQ. Management expects to maintain cost-to-income at this level for the rest of FY19E. Further, it expects NIMs to further expand to 3.2% by 4QFY19 driven by lower interest reversals and better asset mix. We build 3.1% / 3.15% NIMs over FY19E/ 20E with cost-to-income at 49% / 47%.

- **Strong loan growth driven by corporate loans:** Overall loan growth of 24% was driven by strong trends in the corporate (+33% YoY) and agri (+21% YoY) loan books. Retail loan growth was also strong at 20% YoY. Growth in retail loans was largely driven by housing loans (+35% YoY) and mortgages (+21% YoY). Management indicated that c.45% of loans for FB are MCLR-linked and expects margins to inch up further as MCLR-based loans get re-priced.

- **Expects stress on Kerala loans to be contained:** Management reiterated its guidance of INR 14.5bn gross slippages in FY19E. While gross slippages in 1HFY19 are already at 66% of this target, management expects slippages as a result of the Kerala floods to be contained at INR 1.5 bn for FY19. FB has an exposure of c.INR 15bn to the 12 flood affected districts of Kerala and expects c. INR 5 bn of these loans to be stressed. Against these stressed loans, FB has availed of the RBI dispensation for natural calamities to carve out and restructure INR 0.3bn of loans In 2QFY19. Management expects this to further reach c. INR 1bn by 3QFY19 (0.1% of loans). Management disclosed that FB has an overall exposure of INR 2bn to the IL & FS Group (0.2% of loans), spread across 3 operational projects, where it does not expect significant stress. Total stressed book for FB (Net NPLs + other stress) is now at 2% of loans (down 86bps YoY). We build specific credit costs of 0.75% / 0.65% over FY19E / FY20E.

Recommendation and Price Target	
Current Reco.	BUY
Previous Reco.	BUY
Current Price Target (12M)	120
Upside/(Downside)	47.0%
Previous Price Target	120
Change	0.0%

Key Data – FB IN	
Current Market Price	INR82
Market cap (bn)	INR161.8/US$2.2
Free Float	88%
Shares in issue (mn)	1,972.1
Diluted share (mn)	
3-mon avg daily val (mn)	INR1,348.3/US$18.4
52-week range	128/67
Sensex/Nifty	35,162/10,585
INR/US$	73.5

Price Performance

%	1M	6M	12M
Absolute	4.9	-17.0	-34.6
Relative*	13.6	-19.0	-39.3

* To the BSE Sensex

Financial Summary (INR mn)

Y/E March	FY16A	FY17A	FY18A	FY19E	FY20E
Net Profit	4,757	8,308	8,788	13,622	18,883
Net Profit (YoY) (%)	-52.7%	74.7%	5.8%	55.0%	38.6%
Assets (YoY) (%)	14.2%	21.6%	20.3%	19.7%	20.4%
ROA (%)	0.5%	0.8%	0.7%	0.9%	1.0%
ROE (%)	6.0%	9.8%	8.3%	10.7%	13.3%
EPS	2.8	4.8	4.5	6.9	9.6
EPS (YoY) (%)	-52.9%	74.1%	-7.5%	55.0%	38.6%
PE (x)	**29.6**	**17.0**	**18.4**	**11.9**	**8.6**
BV	47	52	62	68	76
BV (YoY) (%)	4.2%	10.2%	19.4%	9.4%	12.5%
P/BV (x)	**1.74**	**1.58**	**1.32**	**1.21**	**1.08**

Source: Company data, JM Financial. Note: Valuations as of 16/Oct/2018

Federal Bank 2Q19: Key quarterly trends

Exhibit 1. FB 2Q19 : Key quarterly trends

Earnings Table (Rs. mn.)	2Q'18	1Q'19	2Q'19	YoY (%)	QoQ (%)
NII	**8,989**	**9,801**	**10,225**	**13.7%**	**4.3%**
Fee based Income	1,540	1,600	2,000	29.9%	25.0%
P/L on Exchange Transactions	410	470	610	48.8%	29.8%
Trading Profits	750	490	510	-32.0%	4.1%
Recoveries of Advances W/O	170	140	110	-35.3%	-21.4%
Misc Income	2	9	-1	-150.0%	-112.8%
Non-Interest income	**2,872**	**2,709**	**3,229**	**12.4%**	**19.2%**
Total Income	**11,861**	**12,509**	**13,454**	**13.4%**	**7.5%**
Employee Cost	3,127	3,450	3,089	-1.2%	-10.5%
Other Operating Expenses	2,902	3,030	3,388	16.8%	11.8%
Total Operating Expenses	6,029	6,480	6,478	7.4%	0.0%
Operating Profit	**5,832**	**6,029**	**6,976**	**19.6%**	**15.7%**
Total Provisions	**1,768**	**1,992**	**2,888**	**63.4%**	**45.0%**
PBT	4,064	4,038	4,088	0.6%	1.2%
Tax	1,427	1,411	1,427	0.0%	1.2%
Reported Profit	**2,637**	**2,627**	**2,660**	**0.9%**	**1.3%**
Balance sheet (Rs. bn.)					
Deposits	972.1	1,112.4	1,181.8	21.6%	6.2%
Net Advances	806.5	943.0	1,009.4	25.2%	7.0%
Total Assets	**1,217.6**	**1,366.8**	**1,444.1**	**18.6%**	**5.7%**
Loan-Deposit ratio (%)	83.0%	84.8%	85.4%	2.5%	0.6%
Key Ratios					
Credit Quality					
Gross NPAs (Rs. mn.)	19,490	28,688	31,845	63.4%	11.0%
Net NPAs (Rs. mn.)	10,664	16,202	17,963	68.4%	10.9%
Gross NPA (%)	2.39%	3.00%	3.11%	0.72%	0.11%
Net NPA (%)	1.32%	1.72%	1.78%	0.46%	0.06%
Loan Loss Provisions (%)	0.88%	0.79%	1.01%	0.13%	0.22%
Coverage Ratio (%)	45.3%	43.5%	43.6%	-1.7%	0.1%
Capital Adequacy					
CAR (%)	14.63%	14.50%	13.29%	-1.34%	-1.21%
Du-pont Analysis					
NII / Assets (%)	3.02%	2.85%	2.91%	-0.11%	0.06%
Non-Interest Inc. / Assets (%)	0.96%	0.79%	0.92%	-0.05%	0.13%
Operating Cost / Assets (%)	2.02%	1.89%	1.84%	-0.18%	-0.04%
Operating Profits / Assets (%)	1.96%	1.75%	1.99%	0.03%	0.23%
Provisions / Assets (%)	0.59%	0.58%	0.82%	0.23%	0.24%
ROA (%)	**0.89%**	**0.76%**	**0.76%**	**-0.13%**	**-0.01%**

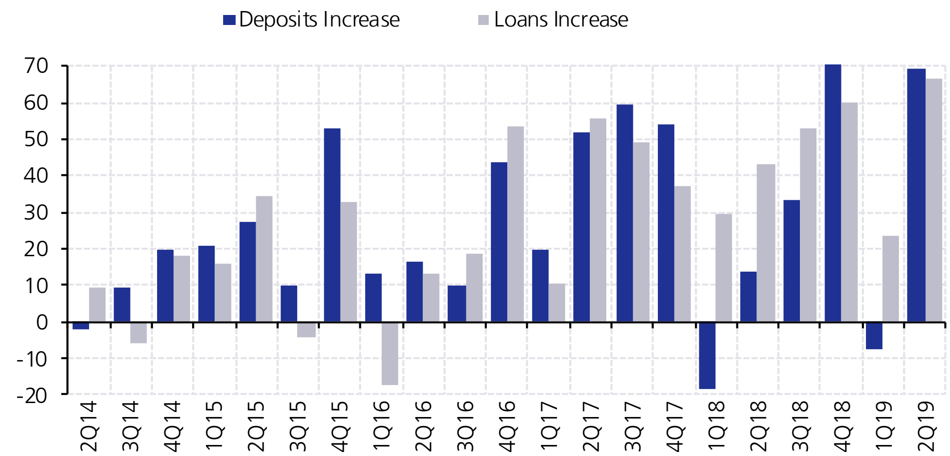
Source: Company, JM Financial

Exhibit 2. FB 2Q19 : Deposits composition

Deposits Composition (Rs bn)	2Q'18	1Q'19	2Q'19	YoY (%)	QoQ (%)
Current	49	56	66	34.6%	17.8%
Saving	272	317	329	21.2%	3.9%
CASA	**320**	**372**	**395**	**23.2%**	**6.0%**
Time	652	740	787	20.8%	6.4%
Total Deposits	**972**	**1,112**	**1,182**	**21.6%**	**6.2%**
Mix(%)					
Current	5.0%	5.0%	5.5%	0.5%	0.5%
Saving	27.9%	28.5%	27.8%	-0.1%	-0.6%
CASA	**32.9%**	**33.5%**	**33.4%**	**0.5%**	**-0.1%**
Time	67.1%	66.5%	66.6%	-0.5%	0.1%
Total Domestic Deposits	**100%**	**100%**	**100%**		

Source: Company, JM Financial

Exhibit 3. FB 2Q19: Trends in accretion to loans and deposits



Source: Company, JM Financial

Exhibit 4. FB 2Q19 : Loan mix and growth

Advances Break-up (Rs bn)	2Q'18	1Q'19	2Q'19	YoY (%)	QoQ (%)
Corporate	347.8	428.7	462.4	33.0%	7.9%
SME	176.5	186.8	195.2	10.6%	4.5%
Agri	84.2	97.0	101.8	20.9%	4.9%
Retail	232.6	261.3	278.1	19.6%	6.4%
Total Gross Advances	**841.0**	**973.8**	**1,037.6**	**23.4%**	**6.5%**
Mix(%)					
Corporate	41.4%	44.0%	44.6%	3.2%	0.5%
SME	21.0%	19.2%	18.8%	-2.2%	-0.4%
Agri	10.0%	10.0%	9.8%	-0.2%	-0.2%
Retail	27.7%	26.8%	26.8%	-0.8%	0.0%
Total Gross Advances	**100%**	**100%**	**100%**		

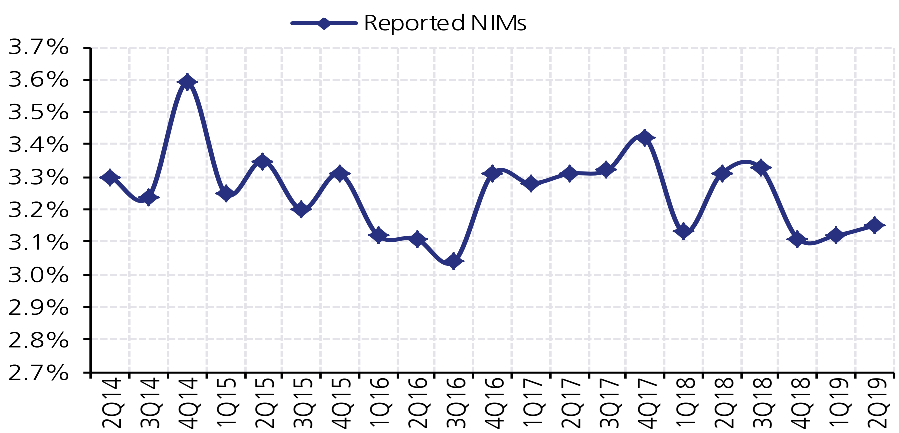
Source: Company, JM Financial

Exhibit 5. FB 2Q19 : Retail loans mix and growth

Retail loans Break-up (Rs bn)	2Q'18	1Q'19	2Q'19	YoY (%)	QoQ (%)
Housing loans	100.8	122.1	135.8	34.7%	11.2%
Mortgage loans	42.2	48.6	51.1	21.1%	5.1%
Gold loans	19.2	18.3	17.3	-9.7%	-5.3%
Others	70.4	72.3	73.9	5.0%	2.2%
Total gross retail advances	**232.6**	**261.3**	**278.1**	**19.6%**	**6.4%**
Mix(%)					
Housing loans	43%	47%	49%	5.5%	2.1%
Mortgage loans	18%	19%	18%	0.2%	-0.2%
Gold loans	8%	7%	6%	-2.0%	-0.8%
Others	30%	28%	27%	-3.7%	-1.1%
Total gross retail advances	100%	100%	100%		

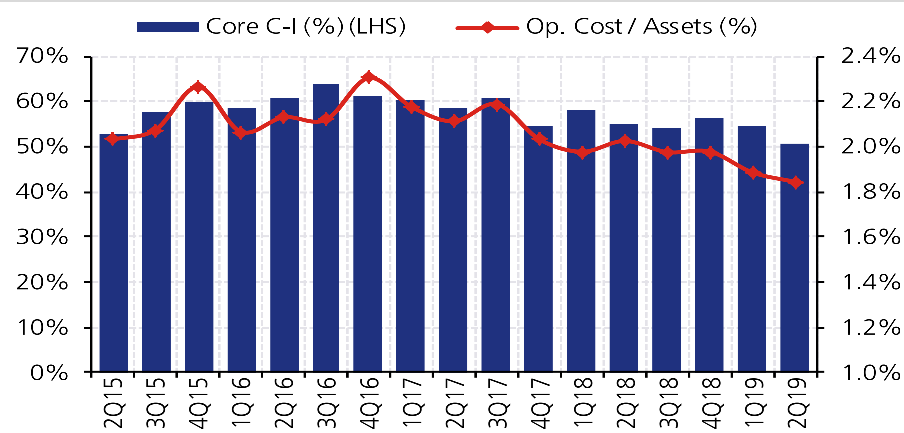
Source: Company, JM Financial

Exhibit 6. FB 2Q19 : Margin trends



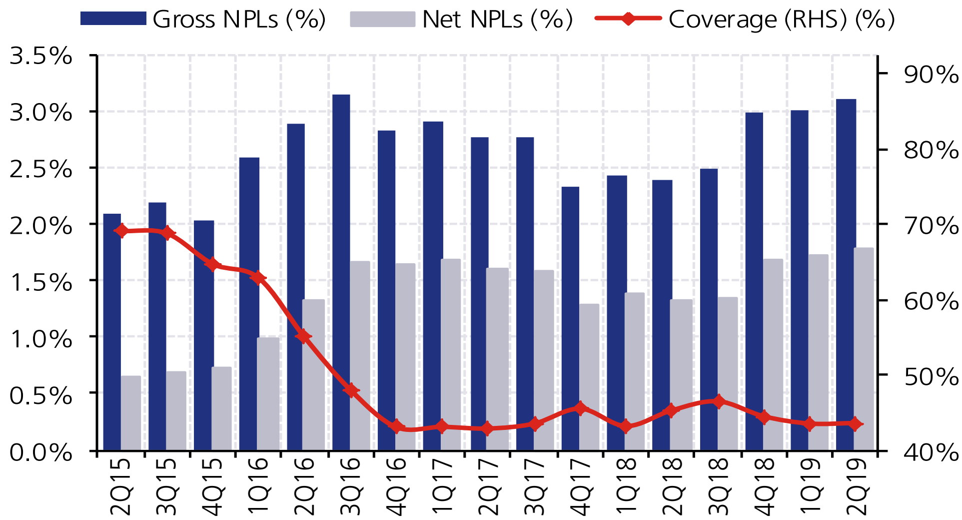
Source: Company, JM Financial

Exhibit 7. FB 2Q19 : Trends in cost ratios



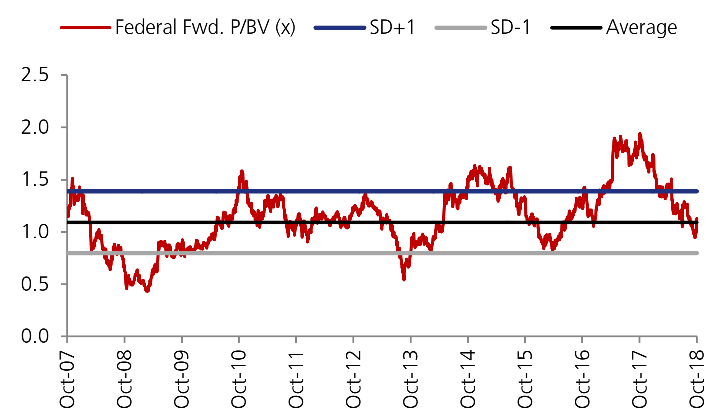
Source: Company, JM Financial

Exhibit 8. FB 2Q19 : Trends in NPLs and provision coverage



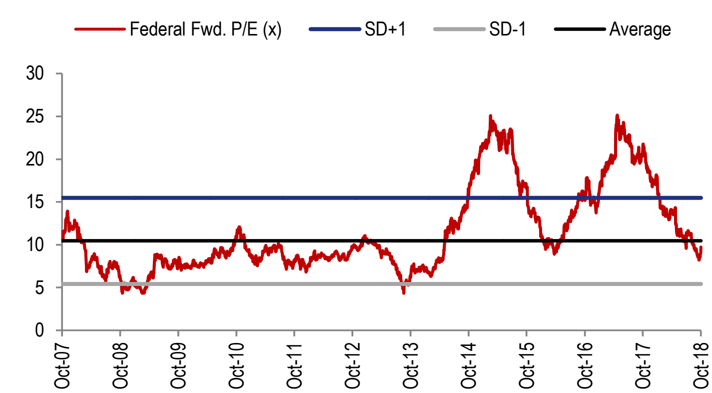
Source: Company, JM Financial

Exhibit 9. FB: One-year forward P/BV



Source: JM Financial, Company

Exhibit 10. FB: One-year forward P/E



Source: JM Financial, Company

Valuation

We value Federal Bank using 2-stage Gordon Growth model. Our assumptions and target price are given below:

Exhibit 11. Federal Bank : Valuation Summary

Initial no of years	10
Growth rate for the first 10 years (%)	12.4%
Payout ratio for the first 10 years (%)	20.0%
Perpetual growth rate (%)	3.6%
Perpetual payout ratio (%)	77.0%
K1	1.98
K2	8.76
Fully adjusted FY20E BVPS (Rs)	72.5
Target P / Fully Adj BV (x)	1.7x
Fair value (rounded off)	**120**

Source: Company, JM Financial

Financial Tables (Standalone)

Profit & Loss					(INR mn)
Y/E March	FY16A	FY17A	FY18A	FY19E	FY20E
Net Interest Income	25,042	30,526	35,828	45,157	55,959
Profit on Investments	1,275	3,087	2,389	2,200	2,000
Exchange Income	1,305	1,277	1,695	2,203	2,864
Fee & Other Income	5,284	6,455	7,507	9,318	11,131
Non-Interest Income	**7,864**	**10,818**	**11,591**	**13,721**	**15,995**
Total Income	**32,906**	**41,344**	**47,419**	**58,877**	**71,954**
Operating Expenses	18,668	22,095	24,509	28,711	33,832
Pre-provisioning Profits	**14,238**	**19,249**	**22,910**	**30,167**	**38,123**
Loan-Loss Provisions	5,848	4,836	7,951	8,774	9,511
Provisions on Investments	802	296	1,729	800	0
Others Provisions	392	1,052	-209	0	0
Total Provisions	**7,041**	**6,184**	**9,472**	**9,574**	**9,511**
PBT	**7,197**	**13,065**	**13,439**	**20,593**	**28,611**
Tax	2,440	4,757	4,650	6,971	9,728
PAT (Pre-Extraordinaries)	**4,757**	**8,308**	**8,788**	**13,622**	**18,883**
Extra ordinaries (Net of Tax)	0	0	0	0	0
Reported Profits	**4,757**	**8,308**	**8,788**	**13,622**	**18,883**
Dividend paid	1,450	1,864	2,377	2,169	2,169
Retained Profits	**3,306**	**6,443**	**6,411**	**11,452**	**16,714**

Source: Company, JM Financial

Balance Sheet					(INR mn)
Y/E March	FY16A	FY17A	FY18A	FY19E	FY20E
Equity Capital	3,438	3,448	3,944	3,944	3,944
Reserves & Surplus	77,424	85,926	1,18,108	1,29,560	1,46,274
Deposits	7,91,717	9,76,646	11,19,925	13,32,711	15,72,598
Borrowings	51,146	58,973	1,15,335	1,62,702	2,42,553
Other Liabilities	22,039	24,727	25,777	27,066	28,420
Total Liabilities	**9,45,764**	**11,49,719**	**13,83,089**	**16,55,984**	**19,93,790**
Investments	2,51,555	2,81,961	3,07,811	3,62,435	4,33,650
Net Advances	5,80,901	7,33,363	9,19,575	11,40,273	14,02,535
Cash & Equivalents	54,198	74,522	92,034	1,00,180	1,22,607
Fixed Assets	5,150	4,845	4,524	7,526	8,464
Other Assets	53,959	55,029	59,146	45,570	26,534
Total Assets	**9,45,764**	**11,49,719**	**13,83,089**	**16,55,984**	**19,93,790**

Source: Company, JM Financial

Key Ratios					
Y/E March	FY16A	FY17A	FY18A	FY19E	FY20E
Growth (YoY) (%)					
Deposits	11.8%	23.4%	14.7%	19.0%	18.0%
Advances	13.3%	26.2%	25.4%	24.0%	23.0%
Total Assets	14.2%	21.6%	20.3%	19.7%	20.4%
NII	5.2%	21.9%	17.4%	26.0%	23.9%
Non-interest Income	-10.5%	37.6%	7.1%	18.4%	16.6%
Operating Expenses	14.5%	18.4%	10.9%	17.1%	17.8%
Operating Profits	-12.5%	35.2%	19.0%	31.7%	26.4%
Core Operating profit	-5.5%	24.7%	27.0%	36.3%	29.2%
Provisions	559.7%	-12.2%	53.2%	1.1%	-0.7%
Reported PAT	-52.7%	74.7%	5.8%	55.0%	38.6%
Yields / Margins (%)					
Interest Spread	2.50%	2.79%	2.66%	2.73%	2.76%
NIM	2.96%	3.09%	2.97%	3.09%	3.14%
Profitability (%)					
Non-IR to Income	23.9%	26.2%	24.4%	23.3%	22.2%
Cost to Income	56.7%	53.4%	51.7%	48.8%	47.0%
ROA	0.54%	0.79%	0.69%	0.90%	1.03%
ROE	6.0%	9.8%	8.3%	10.7%	13.3%
Assets Quality (%)					
Slippages	3.72%	1.88%	3.04%	1.70%	1.30%
Gross NPA	2.84%	2.33%	3.00%	2.90%	2.63%
Net NPAs	1.64%	1.28%	1.69%	1.54%	1.23%
Provision Coverage	43.0%	45.5%	44.5%	47.6%	54.0%
Specific LLP	1.02%	0.62%	0.91%	0.75%	0.65%
Net NPAs / Networth	11.7%	10.5%	12.7%	13.2%	11.4%
Capital Adequacy (%)					
Tier I	13.36%	11.81%	14.18%	12.54%	11.65%
CAR	13.93%	12.39%	14.70%	13.43%	12.54%

Source: Company, JM Financial

Dupont Analysis					
Y/E March	FY16A	FY17A	FY18A	FY19E	FY20E
NII / Assets	2.82%	2.91%	2.83%	2.97%	3.07%
Other Income / Assets	0.89%	1.03%	0.92%	0.90%	0.88%
Total Income / Assets	3.71%	3.95%	3.74%	3.87%	3.94%
Cost / Assets	2.10%	2.11%	1.94%	1.89%	1.85%
PBP / Assets	1.60%	1.84%	1.81%	1.99%	2.09%
Provisions / Assets	0.79%	0.59%	0.75%	0.63%	0.52%
PBT / Assets	0.81%	1.25%	1.06%	1.36%	1.57%
Tax rate	33.9%	36.4%	34.6%	33.9%	34.0%
ROA	0.54%	0.79%	0.69%	0.90%	1.03%
RoRWAs	0.87%	1.27%	1.13%	1.45%	1.63%
Leverage	11.7	12.9	11.3	12.4	13.3
ROE	6.0%	9.8%	8.3%	10.7%	13.3%

Source: Company, JM Financial

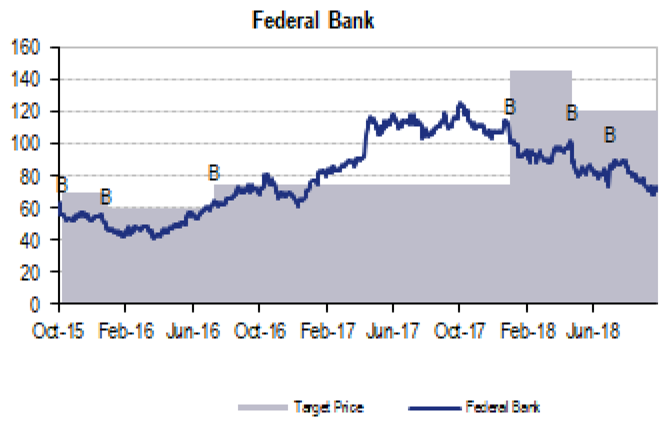
Valuations					
Y/E March	FY16A	FY17A	FY18A	FY19E	FY20E
Shares in Issue	1,718.9	1,724.0	1,972.1	1,972.1	1,972.1
EPS (INR)	2.8	4.8	4.5	6.9	9.6
EPS (YoY) (%)	-52.9%	74.1%	-7.5%	55.0%	38.6%
PER (x)	29.6	17.0	18.4	11.9	8.6
BV (INR)	47	52	62	68	76
BV (YoY) (%)	4.2%	10.2%	19.4%	9.4%	12.5%
ABV (INR)	44	50	58	63	72
ABV (YoY) (%)	-0.7%	11.6%	16.7%	9.4%	14.3%
P/BV (x)	1.74	1.58	1.32	1.21	1.08
P/ABV (x)	1.84	1.65	1.42	1.29	1.13
DPS (INR)	0.8	1.1	1.2	1.1	1.1
Div. yield (%)	1.0%	1.3%	1.5%	1.3%	1.3%

Source: Company, JM Financial

History of Earnings Estimate and Target Price

Date	Recommendation	Target Price	% Chg.
23-Oct-15	Buy	70	
13-Jan-16	Buy	60	-14.3
28-Jul-16	Buy	75	25.0
16-Jan-18	Buy	145	93.3
9-May-18	Buy	120	-17.2
17-Jul-18	Buy	120	0.0

Recommendation History



APPENDIX I

JM Financial Institutional Securities Limited

(formerly known as JM Financial Securities Limited)

Corporate Identity Number: U67100MH2017PLC296081
Member of BSE Ltd., National Stock Exchange of India Ltd. and Metropolitan Stock Exchange of India Ltd.
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Definition of ratings	
Rating	Meaning
Buy	Total expected returns of more than 15%. Total expected return includes dividend yields.
Hold	Price expected to move in the range of 10% downside to 15% upside from the current market price.
Sell	Price expected to move downwards by more than 10%

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