Sharekhan
by BNP PARIBAS

Federal Bank

Improving asset quality outlook

Sector: Banks & Finance
Result Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 93**	
Price Target: **Rs. 110**	↑

↑ Upgrade ↔ No change ↓ Downgrade

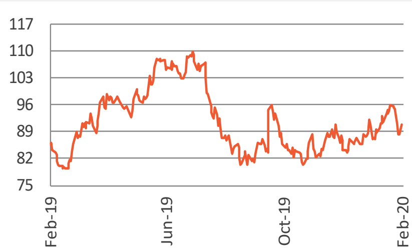
Company details

Market cap:	Rs. 18,420 cr
52-week high/low:	Rs. 110/78
NSE volume: (No of shares)	122.9 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Sharekhan code:	FEDERALBNK
Free float: (No of shares)	195.2 cr

Shareholding (%)

Promoters	0.0
FII	37.5
DII	37.12
Others	25.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-2.8	2.7	1.3	3.9
Relative to Sensex	1.1	3.5	-5.9	-6.0

Sharekhan Research, Bloomberg

Federal Bank posted strong results for Q3 FY20 with a sharp decline in net stressed loans to ~2.3% of loans (down by 14 BPS q-o-q) in Q3 FY20, helped by the resolution of a large restructured account in the airline sector.The management has guided slippages to reduce and indicated it has no residual stress in corporate loans (above Rs 100 cr) due to which credit costs are expected to be under control at ~65-70 BPS over the next two years. Margins are expected to stabilize on back of the changing asset mix changing (higher yield retail proportion rising) and moderating pace of slippages. During Q3 FY20, Net interest income (NII) grew by 7.2% y-o-y (we expected 10% y-o-yg rowth). Other income grew smartly by 18% y-o-y because of 11% y-o-y growth in core fee income. Net interest margin (NIM) for the quarter was steady on q-o-q basis to 3.0% helped by lower retail slippages, but interest reversals and weak loan growth (on account of the management's cautious stance on corporate book) were drags. The GNPA and NNPA were at 2.99% and 1.63% respectively, down by 8BPS and 4 BPS on a sequential Basis. The Slippages from Retail Banking (<5 Crores Business) were at a multi quarter low and there was improvement in stressed assets book which resulted in strong asset quality performance. We have introduced FY22E earnings and accordingly roll over the price target. We believe that the stock trades at inexpensive valuations (<1x FY22E BV) and offers scope of re-rating as the earnings cycle recovers. We maintain our Buy rating with a revised target price of Rs 110.

Key positives

- The management has guided slippages to reduce further with no residual stress in corporate loans (above Rs 100 cr).
- FB's overall stressed asset book has come down to an all-time low at about 1.59% and the overall SMA book are also of a relatively small size.

Key negatives

- Slower loan book growth guidance as well as cautious growth performance in Q3 indicates that the bank may see delayed recovery.

Our Call

Valuation: Factors such as increasing retail focus, decent capitalisation levels (Tier-1 at 12.6%), and incremental lending to better-rated borrower(s) augurs well. Loan growth was below expectations and was in line with the management's already stated strategy to be cautious in corporate book growth. We believe overall asset-quality performance and growth are likely to be key monitorables. We introduce FY22E earnings and accordingly roll over the price target. We believe that the stock trades at inexpensive valuations (<1x FY22E BV) and offers scope of re-rating as the earnings cycle recovers. We maintain our Buy rating with a revised target price of Rs 110.

Key Risks

Further slippages in the corporate segment may hamper profitability

Valuation Rs cr

Particulars	FY18	FY19	FY20E	FY21E
Net interest income	4,176.4	4,574.9	5,655.6	6,654.2
Net profit	1,243.9	1,556.2	2,130.8	2,643.1
EPS (Rs)	6.3	8.0	11.0	13.7
PE (x)	13.1	10.2	7.4	6.0
Book value (Rs/share)	65.6	73.0	81.4	91.9
P/BV (x)	1.2	1.1	1.0	0.9
RoE (%)	9.8%	11.3%	14.0%	15.5%
RoA (%)	0.8%	0.8%	0.9%	1.0%

Source: Company; Sharekhan estimates

Key concall highlights

- Federal bank (FB) had earlier identified two large corporates, as potential challenges. The overall slippages apart from these two accounts are at a multi-quarter low and are holding well.
- A calibrated focus on retail is working well and retail traction on most products including secured lending is continuing well, and the bank is gaining market share. ,
- In the corporate segment (Rs 5 crore and above exposures) which includes commercial banking has cooled off partly by choice and partly by some significant repayment (in Q3 FB saw both repayments and one large restructured account setting itself and write-off).
- FB's overall stressed asset book has come down to an all-time low at about 1.59% and the overall SMA book are of an insignificant size.
- FB's largest restructured account (aviation co, total exposure was Rs 200 cr), was fully settled during Q3 and is out of its portfolio,
- FB has not seen formation of any new large credit that is of stress. It has no exposure to some of the talked about accounts (telecom co etc). Unless there are collateral outcomes that start hurting the industry at a significant level, FB is protected.
- FB has been more biased to the secured and the higher rated (both corporate or the individual) book and are making a conscious trade-off between price versus quality.
- The slippage was higher due to two accounts. The bank saw interest reversal in those accounts of Rs ~20 crores.
- Of the total corporate advances, 88% is BBB and above, 77% is of A and above and 11% is BBB. The breakup of others is given separately through internal ratings. In that you have FB1, FB2, FB3 all put together, these are corporate ones but because these have not been rated, they are coming under others, so it is not 12% which is under risk.
- Corporate slippages is comprising of 2 largest HFCs.
- Earlier FB had guided credit growth of 18-20% for FY20E which they expect it will come down to 16 –17 %.
- The quantum of large slippages in the corporate is Rs ~320 odd crores. These two accounts were the primary ones.
- Exposure to a beleaguered Infrastructure Finance conglomerate exposure are still standard. However, it is technically a NPA and amount is lying in the escrow account. , When the issue is resolved, it will come back to the bank.
- FB has maintained guidance of 1.1% ROA and 1.25% in FY20E / FY21E.
- Added 10 branches in Q3. There are plans to add about 25 branches in FY20E and 40 in FY21E.
- The bank will look for capital raising opportunity in early FY21.
- The bank has provided ~25% on the Entertainment account (currently NPA)
- Credit growth guidance is16% for FY20E and 18-20% for FY21E if economic situation improves.
- Telecom exposure of Rs 870 crores. is to the best player.
- Exposure to SMA1 and 2 total is between ~2.5%
- Regarding continuation of leadership, the bank has not received any response from the RBI.

Results Rs cr

Particulars	Q3FY20	Q3FY19	YoY %	Q2FY20	QoQ %
Interest earned	3,330.4	2,954.4	12.7	3,254.3	2.3
Interest expended	2,175.4	1,877.1	15.9	2,130.5	2.1
Net interest income	**1,154.9**	**1,077.3**	**7.2**	**1,123.8**	**2.8**
Non-interest income	407.9	345.6	18.0	420.9	-3.1
Net total income	1,562.8	1,422.8	9.8	1,544.7	1.2
Operating expenses	819.0	715.0	14.5	825.9	-0.8
Pre-provisioning profit	**743.8**	**707.8**	**5.1**	**718.8**	**3.5**
Provisions	160.9	190.1	-15.4	251.8	-36.1
Profit before tax	583.0	517.7	12.6	467.0	24.8
Tax	142.3	184.1	-22.7	50.3	182.8
Profit after tax	**440.6**	**333.6**	**32.1**	**416.7**	**5.7**
Gross NPA (%)	2.99	3.14	-15 bps	3.07	-8 bps
Net NPA (%)	1.63	1.72	-9 bps	1.59	4 bps

Source: Company; Sharekhan Research

Outlook

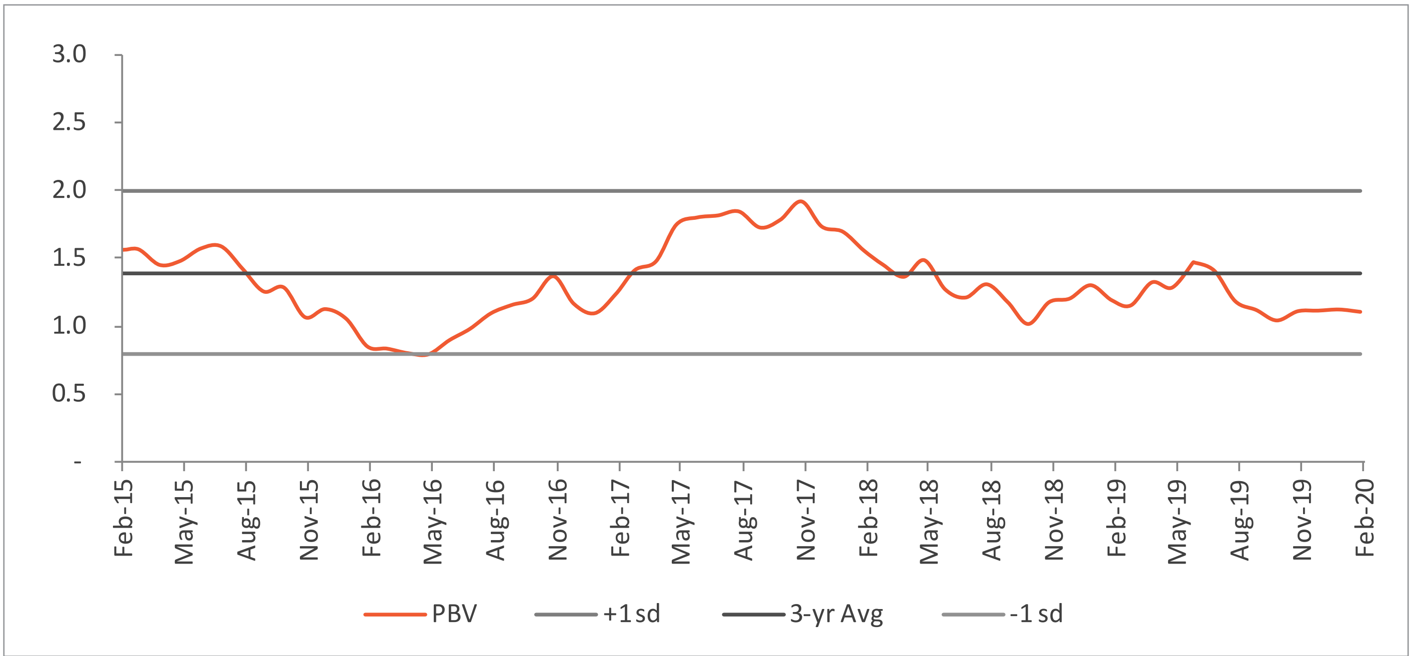
Federal Bank posted strong results for Q3 FY20 with a sharp decline in net stressed loans to ~2.3% of loans (down by 14 BPS q-o-q) in Q3 FY20, helped by the resolution of a large restructured account in the airline sector. NIMs were impacted due to lower T-bill yields and interest reversals impact which resulted in ~5bps impact q-o-q. FB has maintained FY20 NIM exit guidance at 3.1% which is stable. Going forward, the expected entry into new segments is likely to help yields over time.Management has guided slippages to reduce further with no residual stress in corporate loans above Rs 100 cr due to which credit cost are expected to be ~65-70 BPS over next two years. Changing asset mix (higher yield retail proportion rising) and moderating slippages pace would provide support to margins.

We believe incremental loans to better-rated borrowers, and no addition to the stressed pool, and high provision coverage are clear positives. However, we believe that asset-quality performance and margins will continue to be key monitorables for the medium term for Federal Bank. Overall, we believe that outlook has stabilized and looking to improve in FY21E for the bank.

Valuation

Factors such as increasing retail focus, decent capitalisation levels (Tier-1 at 12.6%), and incremental lending to better-rated borrower(s) augurs well. Loan growth was below expectations and was in line with the management's already stated strategy to be cautious in corporate book growth. We believe overall asset-quality performance and growth are likely to be key monitorables. We introduce FY22E earnings and accordingly roll over the price target. We believe that the stock trades at inexpensive valuations (<1x FY22E BV) and offers scope of re-rating as the earnings cycle recovers. We maintain our Buy rating with a revised target price of Rs 110.

One year forward P/BV (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	CMP	P/BV (x)		P/E (x)		RoA (%)		RoE (%)	
	Rs/Share	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
Federal Bank	93	1.3	1.1	11.6	8.4	0.9	0.9	11.7	14.0
IndusInd Bank	1335	2.6	2.2	16.5	12.8	1.8	1.9	17.3	18.2
City Union Bank	233	3.1	2.7	22.4	19.6	1.6	1.6	14.6	14.8

Source: Company, Sharekhan research

About company

Federal Bank Limited is an mid-sized old generation private sector bank headquartered at Kerala. The bank has 1,251 branches and 1,934 ATMs/Recyclers. The bank also has its Representative Offices at Abu Dhabi and Dubai and an IFSC Banking Unit (IBU) in Gujarat International Finance Tec-City (GIFT City). Federal Bank has been building incremental addition in better-rated borrowers; it has also been successful in bringing down the stressed pool. Federal Bank's efforts to diversify its income source by investments in related businesses, adding new streams to fee and other income are also bearing fruits, albeit slowly

Investment theme

Federal Bank has been able to maintain a consistently stable deposit franchise (helped by the overseas remittance flow to the state of Kerala) with high proportion of retail deposits with relatively lower branch spread. This idiosyncrasy allows it access to cost effective access to low cost funds, crucial to not only maintain its loan growth but also sustain its margins as well. On the Assets side, with a focused calibrated approach, the Bank has been building incremental addition in better-rated corporate borrowers, and thus has brought down the stressed pool, which is a significant positive. FEDBK's cautious approach to loan growth over the past few years is now beginning to result in improving risk-adjusted NIMs. Retail loan book now constitutes 50+% of overall loan book, which have better incremental yields which also helps the blended yield for the bank. Strong capitalization levels and a robust liability franchise, and improved Assets profile, in light of waning competitive pressures enabling Federal Bank to gain market share in both corporate and retail segments are factors favourably placed for investors in coming years.

Key Risks

Further slippages in the corporate segment may hamper profitability

Additional Data

Key management personnel

Mr. Shyam Srinivasan	Managing Director & CEO
Ms. Shalini Warrier	Chief Operating Officer
Mr. Sumit Kakkar	Chief Credit Officer
Mr. Girish Kumar Ganapathy	Company Secretary
Mr. Ashutosh Khajuria	Executive Director

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Asset Management	5.12
2	Reliance Capital Trustee Co Ltd	4.06
3	YUSUFFAL MUSALIAM VEETIL	3.76
4	HDFC Asset Management Co Ltd	3.39
5	Jhunjhunwala Rakesh	2.87
6	Franklin Resources Inc	2.75
7	Vanguard Group Inc/The	2.52
8	EAST BRIDGE CAPITAL MASTER FUND	2.43
9	Amansa Holdings Pvt Ltd	2.37
10	Aditya Birla Sun Life Trustee Co P	2.15

Source: Bloomberg

Sharekhan

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