Sharekhan
by BNP PARIBAS

Federal Bank

Headwinds cloud outlook

Sector: Banks & Finance
Result Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 43**	
Price Target: **Rs. 60**	↓

↑ Upgrade ↔ No change ↓ Downgrade

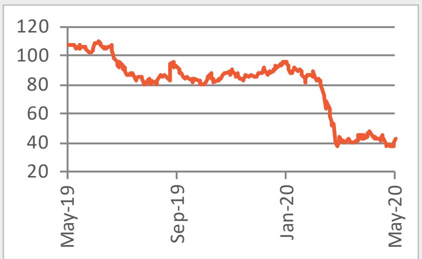
Company details

Market cap:	Rs. 8,516 cr
52-week high/low:	Rs. 110/36
NSE volume: (No of shares)	35.6 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Sharekhan code:	FEDERALBNK
Free float: (No of shares)	199.3 cr

Shareholding (%)

Promoters	0.0
FII	33.3
DII	37.1
Others	29.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-8.1	-50.2	-51.5	-60.3
Relative to Sensex	-6.5	-34.3	-29.0	-41.8

Sharekhan Research, Bloomberg

Federal Bank (FB) posted strong results for Q4FY2020 with in-line topline growth, but treasury gains helped offset the steep rise in provisions. In addition, sequentially improved asset quality (GNPAs down by 8BPS) is a positive. During the quarter, FB saw NII of Rs. 1,216 crore, up 10.9% y-o-y, which was in line with expectations. However, non-interest income grew to Rs. 711 crore, up 72.7% y-o-y, driven by higher investment/treasury gains of Rs. 369 crore in Q4FY2020 (was Rs. 65 crore in Q3). Higher other income (OI) partially helped cushion the impact of the steep rise in provisions, which at Rs. 567 crore (including COVID-19 related provision of Rs. 93 crore) increased by ~2x y-o-y. Consequently, PAT came in at Rs. 301 crore, below expectations. Management indicated that the environment was still fluid in terms of credit cost and quality; hence, FB would like to maintain liquidity and would be cautious on credit growth for the medium term. Even though GNPA and NNPA came down to 2.84% and 1.31%(down 15 bps and 32 bps q-o-q, respectively), the same would have been stable if not for moratorium. Without moratorium, GNPA would have been higher by 23 bps or by Rs. 303 crore. Going forward, we expect credit cost and provision burden to keep a check on growth in the medium term. However, the bank is better placed in terms of book quality, with SMA book at reasonable 0.7% and ~78% of wholesale borrowers rated A and above by external ratings. There was also improvement in provision coverage to 53.39% from 45.30% q-o-q. The bank has ~35% of total loans by value under moratorium, which relative to peers is reasonable. COVID-19 has increased downward risks to the global economic outlook; hence, inward remittances are likely to be vulnerable for countries, including India. FB has significant dependence on inward remittances (NRE deposits ~37% of total deposits) and, therefore, the behavior of this liability stream will be a key monitorable. Considering the impact of COVID-19 and the resultant (still dynamic) business scenario, at least for the medium term, we have fine tuned our estimates for FY2021E and FY2022E and revised our target multiple. We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 60.

Key positives

- GNPA and NNPA were at 2.84% and 1.31%, down 15 bps and 32 bps q-o-q, respectively, while the SMA book at 0.7% was reasonable.
- Despite the lockdown and a tepid business environment, fee income grew by 13% y-o-y, ahead of the 11% y-o-y growth in advances.

Key negatives

- Fresh slippages at Rs. 284 crore would have been still elevated (if moratorium benefit of Rs. 303 crore is added back), indicating asset-quality picture is yet to improve.
- Risk-adjusted NIMs in Q4FY2020 fell to 2% from 2.37% in Q3FY2020.

Our Call

Valuation: Factors such as increasing retail focus, being adequately capitalised (Tier-1 at 13.3%), and incremental lending to better-rated borrower(s) are positives. However, for the medium term, we expect loan growth to slow down due to the lockdown impact and management's already-stated strategy to be cautious in the corporate segment. We maintain our Buy rating on the stock with a revised PT of Rs. 60.

Key Risks

Extension of the lockdown and delay in economic revival will cause further risk of slippages, especially in the business banking and corporate segments.

Valuation

Particulars	FY19	FY20	FY21E	FY22E
Net interest income	4,176.4	4,648.9	5,111.5	5,866.7
Net profit	1,243.9	1,542.8	1,478.3	1,902.1
EPS (Rs.)	6.3	7.7	7.6	9.8
PE (x)	6.8	5.5	5.6	4.3
Book value (Rs./share)	65.6	71.5	79.5	87.0
P/BV (x)	0.7	0.6	0.5	0.5
RoE (%)	9.7%	11.1%	9.8%	11.6%
RoA (%)	0.8%	0.9%	0.7%	0.8%

Source: Company; Sharekhan estimates

COVID-19 Impact: Management was able to respond fast to the COVID-19 lockdown. Business momentum wise, we believe till about the first week of March, the bank's business was coursing well on focus areas in credit quality and recovery. FB had some treasury profits and other gains, which were utilised in Q4FY2020.

Portfolio Quality: Around 35% of the book is under moratorium (at present), but the outcome is not predictable right now. Stressed asset portfolio is low at 1.28%. FB has been focusing on the retail and gold segment for growth in the new scenario. Moreover, the bank is cross-selling to existing customers; and examining the government guarantees schemes where risks are considered to be low. SMA book is 0.7% or Rs. 840 crore. Management will look to substantially build up provisions during the year. CRAR was benefited due to no dividend outflow.

Moratorium book: Management expects to get better visibility in Q2and is not in a position to comment on the quality at present. Due to the Reserve Bank of India's (RBI) extension of moratorium, the view is not clear, the bank believes in July month, the picture will be more clear. We expect 35% proportion will likely be stable. The peak was at 38% in April. Of the retail loans, 5-6% is vulnerable, and unsecured loans were sold to own customers but how they will behave over 6-9 months is not clear as of now. Corporate book under moratorium (to NBFCs) is only 27% and is small.

Retail Moratorium: Within retail, 38% under moratorium is high (given that almost 50% of the book is home loans). Irrespective of the borrower class, moratorium customers are being prudent on maintaining the balance, and it is not that all of them are stressed. Home Loan + LAP is Rs. 12,000 crore portfolio, of which Rs. 3,000 crore is from NR customers. More than 70% of retail customers have more than 1 EMI balance in their accounts.

Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE): Bank will pursue the scheme very closely. However, FB knows that the time of recovery may take a long course (even if around 3/4th of the money is coming within a certain time, remaining tenure may be unclear).

SME/MSME (business banking and commercial banking) impact of credit guarantee scheme: Management indicates that Incremental lending will be based on projection and viability of the unit; it will be decided considering the viability of the remaining loan which will not be under credit guarantee.

Liability franchise: When there is instability, remittance picks up as people send more money home. Hence, in times of distress, near-term remittance picks up, to fall later. However, customers are resilient and opportunities exist on worldwide scale, which can be accessed.

Digital channel: Transaction volume for both retail and corporate picked up in digital. Loan disbursement through Fintech enabled digital gold and micro lending platforms crossed Rs 1,000 crore.

Extension of MD tenure: Management is still waiting to hear from the RBI. The letter was sent to the RBI two months back, but so far it is not clear about their decision.

Employee Cost: Future liability will depend on yields movement. Generally, pension cost is captured in real time, but treasury movement may or maynot be booked then and there. Hence, both the line items while are dependent on interest rates, the actual incidence may not coincide every time. The bank has provided Rs. 45 crore for wage revision.

Floating Provisions: Very small number of Rs. 2 crore is presently carried on books.

Portfolio eligible for credit guarantee: Rs.16,000 crore-18,000 crore book will be eligible for the scheme.

Total gold loan portfolio: Rs. 9,300 crore size (including agri). FB will share traction numbers and the strategy for the gold loan bookin Q1FY2021.

Cost control: Except wage costs, every other cost line is flexible.

LGD: LGD at total portfolio is at 38-40%. Retail is lower and corporate is higher. Probability of default (PD) wise the corporate book looks reasonably under control. One name, a middle east client, is vulnerable and FB has been building provision against that.

Rise in liquidity levels: There was a feeling that smaller banks will not get deposits. Hence, FB curtailed advances growth and did some increased borrowings, which resulted in liquidity being built up. NRE is granular and stable; and hence, retail deposits are growing well, bulk deposits bank had chosen to let go.

Liquidity and LCR Outlook: Will look to maintain higher liquidity till clarity on COVID-19 emerges. Management will look to increase credit portfolio once the situation stablises (sixmonths approximately), which will take care of liquidity. LCR will also be maintained at higher than 160% for the period.

NIMs: FB has cut deposit rates of late, and expects NIM will hold for Q1 and Q2. Growth in Gold loan business (higher margin) is also positive for margins.

Discount rate and rate of return of the plan: Discount rate considered at 6.5% for average gratuity and pension payment.

NCGTC scheme (MSME portfolio): Out of the universe of ~Rs. 18,000 will review and have selected clients will disburse around Rs. 2,000 crore over a period of 6-8 months.

MCLR versus repo benchmark Loans: Proportion of loans under the External benchmark rate are 25% of the total portfolio, MCLR linked loans are 40%, around 5% at base rate, and the rest are fixed rate loans.

Cost saving: Travel costs, rent re-negotiating etc. can be rationalized to contain cost. Compensation structure is such that for higher levels (AVP level and above) the fixed salary component is around Rs. 1200 crore per year, and the other part is variable cost. The bank will look to hire RMs, but will go slow on branch expansion. The bank will look to deliver products/services at the doorstep or online; hence, it may see lesser expansion on new branches.

Branches: The bank had opened 12-15 branches in FY2020, but now it has frozen new additions.

Contingent and floating loan provisions: The bank will look to provide in H1, since provisions will likely be higher than the normal run-rate in Q1 and Q2 of FY21E.

NR remittance: One part is a must-send home category, where FB has majority of the proportion. This may continue, and even if there are job losses, there may be initial increase. Moreover, people are resilient and may make adjustments.

Margin Outlook: ROA outlook guidance will not be given. Business mix and slippages will determine ROA. So far, credit book is developing well, but it is too early to predict for FY2021E.

Total pension provision done for FY2020: The bank has done Rs. 220 crore for FY2020, of which the additional part is of around Rs. 80 crore. Normalised rate for pension liability will be around Rs. 150 crore (for full year), assuming interest rates are same.

Wage revision: The bank has already provided for 15% rise of requirement so far.

Fee income: Lost lot of fees due to the last few days of the lockdown. The next 3-6 months are hard to predict.

IDBI Federal: FB hasboard approval to increase the ownership in IDBI Federal by 4%, from 26% to 30%.

Results Rs cr

Particulars	Q4FY20	Q4FY19	YoY %	Q3FY20	QoQ %
Interest earned	3,396.8	3,032.3	12.0	3,330.4	2.0
Interest expended	2,180.8	1,935.8	12.7	2,175.4	0.2
Net interest income	**1,216.0**	**1,096.5**	**10.9**	**1,154.9**	**5.3**
Non-interest income	711.1	411.7	72.7	407.9	74.3
Net total income	1,927.1	1,508.3	27.8	1,562.8	23.3
Operating expenses	967.8	753.5	28.4	819.0	18.2
Pre-provisioning profit	**959.3**	**754.8**	**27.1**	**743.8**	**29.0**
Provisions	567.5	177.8	219.3	160.9	252.8
Profit before tax	391.8	577.0	-32.1	583.0	-32.8
Tax	90.6	195.5	-53.7	142.3	-36.3
Profit after tax	**301.2**	**381.5**	**-21.0**	**440.6**	**-31.6**

Source: Company; Sharekhan Research

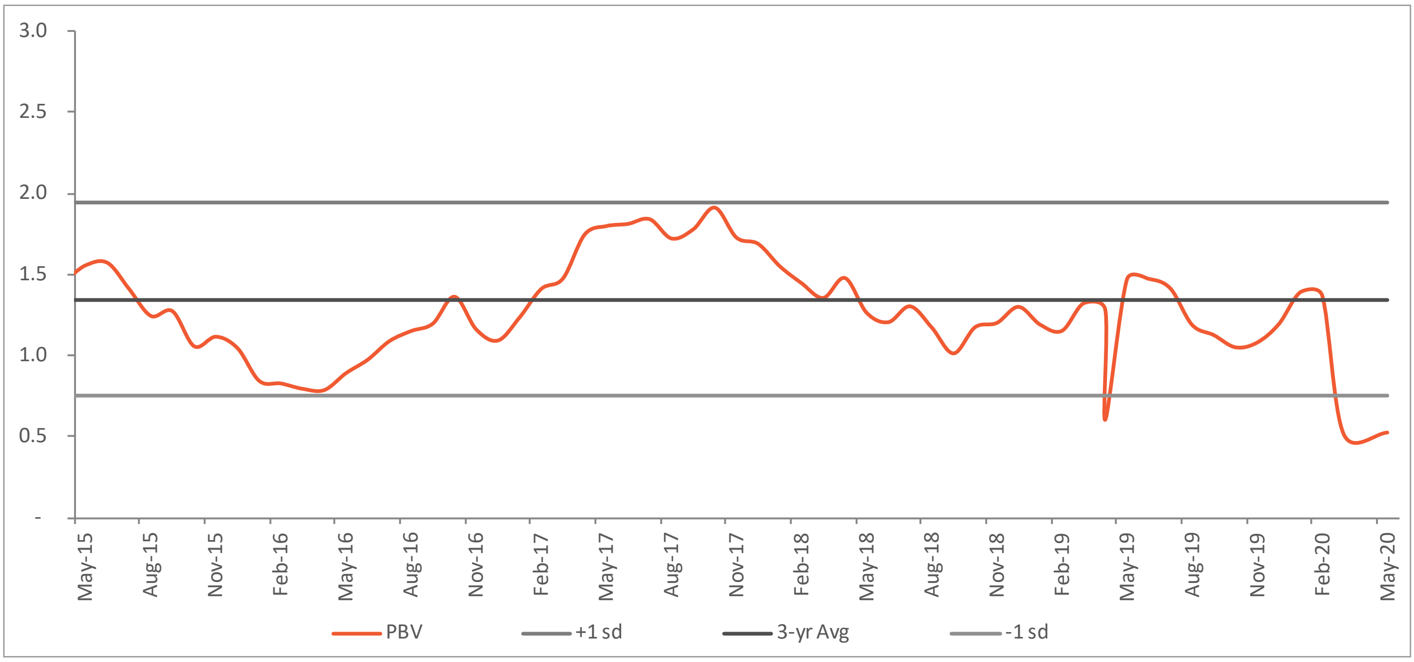
Outlook

The Coronavirus-led lockdown is a significant event impacting the Indianas well as the global economy. The resultant lockdown is expected tocause simultaneous weakening of consumer demand and a slowdown across sectors. Initial signs indicate that the Coronavirus outbreak mayresult in higher delinquencies and lower creditofftake for BFSI companies, including FB. However, there are some positives such as changing asset mix (higher yield retail proportion rising) and entry into new segments, whichare likely to be supportivefor yields over time.We believe incremental loans to better-rated borrowers (~78% of corporate borrowers are rated "A and above" by external rating), and highprovision coverage are positives. However, management has indicated a cautious stance on loan growth and indicated it may choose to maintain high liquidity on books (till clarity emerges), which though is positive for solvency, but will be a drag for near-term margins. However, since FB has a significant business banking and the SME/MSME segment exposure, which isexpected to be impacted by the lockdown and economic scenario, we expect asset-quality performance and margins will continue to be key monitorables for the medium term.

Valuation

Factors such as increasing retail focus, adequately capitalised(Tier-1 at 13.3%), and incremental lending to better-rated borrower(s) are positives. However, for the medium term, we expect loan growth to slow down due to the lockdown impact and management's already-stated strategy to be cautious in the corporate segment. We maintain our Buy rating on the stock with a revised PT of Rs. 60.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	CMP	P/BV(x)		P/E(x)		RoA (%)		RoE (%)	
	Rs/Share	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Federal Bank	43	0.5	0.5	5.6	4.4	0.7	0.8	9.8	11.6
IndusInd Bank	387	0.7	0.6	5.5	4.3	1.5	1.8	13.3	14.9
City Union Bank	129	1.7	1.5	10.8	9.9	1.6	1.6	15.0	15.2

Source: Company, Sharekhan research, Bloomberg estimates.

About company

FB is an old generation private sector bank headquartered at Aluva, Kerala. The bank operates in four segments: treasury operations, wholesale banking, retail banking, and other banking operations. The bank has 1,250+ branches and 1,900+ ATMs/Recyclers and it also has its representative offices at Abu Dhabi and Dubai and an IFSC Banking Unit (IBU) in Gujarat International Finance Tec-City (GIFT City). FB has been building incremental addition in better-rated borrowers and has been successful in bringing down the stressed pool. FB'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

FB has been able to maintain a consistent and stable deposit franchise (helped by overseas remittance flow to Kerala) with high proportion of retail deposits with lower branch spread. This idiosyncrasy allows it access to cost-effective low cost funds, crucial to not only maintain its loan growth but also sustain its margins. On the assets side, with a focused approach, the bank has been building incremental addition in better-rated corporate borrowers, which has helped bring down the stressed pool. Although the bank's cautious approach to loan growth was there, the impact of COVID-19 and the resultant lockdown impact pose risks to borrowers' cash flows and, therefore, may result in higher credit cost in the near to medium term and slower growth. However, factors such as strong capitalization levels and a dependable liability franchise are positive factors for long-term investors.

Key Risks

Extension of lockdown, delay in economic revival will cause further risk of slippages, especially in the business banking and corporate segment.

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	6.14
2	Reliance Capital Trustee Co Ltd	3.85
3	YUSUFFAL MUSALIAM VEETIL	3.76
4	HDFC Asset Management Co Ltd	3.49
5	Jhunjhunwala Rakesh	2.87
6	Franklin Resources Inc	2.76
7	DSP BLACKROCK	2.74
8	FMR LLC	2.60
9	EAST BRIDGE CAPITAL	2.43
10	AMANSA HOLDINGS	2.73

Source: Bloomberg

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Disclaimer: This document has been prepared by Sharekhan Ltd. (SHAREKHAN) and is intended for use only by the person or entity to which it is addressed to. This Document may contain confidential and/or privileged material and is not for any type of circulation and any review, retransmission, or any other use is strictly prohibited. This Document is subject to changes without prior notice. This document does not constitute an offer to sell or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. Though disseminated to all customers who are due to receive the same, not all customers may receive this report at the same time. SHAREKHAN will not treat recipients as customers by virtue of their receiving this report.

The information contained herein is obtained from publicly available data or other sources believed to be reliable and SHAREKHAN has not independently verified the accuracy and completeness of the said data and hence it should not be relied upon as such. While we would endeavour to update the information herein on reasonable basis, SHAREKHAN, its subsidiaries and associated companies, their directors and employees ("SHAREKHAN and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent SHAREKHAN and affiliates from doing so. This document is prepared for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. Recipients of this report should also be aware that past performance is not necessarily a guide to future performance and value of investments can go down as well. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. We do not undertake to advise you as to any change of our views. Affiliates of Sharekhan may have issued other reports that are inconsistent with and reach different conclusions from the information presented in this report.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject SHAREKHAN and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

The analyst certifies that the analyst has not dealt or traded directly or indirectly in securities of the company and that all of the views expressed in this document accurately reflect his or her personal views about the subject company or companies and its or their securities and do not necessarily reflect those of SHAREKHAN. The analyst further certifies that neither he or its associates or his relatives has any direct or indirect financial interest nor have actual or beneficial ownership of 1% or more in the securities of the company at the end of the month immediately preceding the date of publication of the research report nor have any material conflict of interest nor has served as officer, director or employee or engaged in market making activity of the company. Further, the analyst has also not been a part of the team which has managed or co-managed the public offerings of the company and no part of the analyst's compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this document. Sharekhan Limited or its associates or analysts have not received any compensation for investment banking, merchant banking, brokerage services or any compensation or other benefits from the subject company or from third party in the past twelve months in connection with the research report.

Either SHAREKHAN or its affiliates or its directors or employees / representatives / clients or their relatives may have position(s), make market, act as principal or engage in transactions of purchase or sell of securities, from time to time or may be materially interested in any of the securities or related securities referred to in this report and they may have used the information set forth herein before publication. SHAREKHAN may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall SHAREKHAN, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind.

Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

Registered Office: Sharekhan Limited, 10th Floor, Beta Building, Lodha iThink Techno Campus, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400042, Maharashtra. Tel: 022 - 61150000. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183;

Disclaimer: Client should read the Risk Disclosure Document issued by SEBI & relevant exchanges and the T&C on www.sharekhan.com; Investment in securities market are subject to market risks, read all the related documents carefully before investing.