Sharekhan
by BNP PARIBAS

Federal Bank

Headwinds cloud the outlook

Sector: Banks & Finance
Company Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 45**	
Price Target: **Rs. 80**	↓

↑ Upgrade ↔ No change ↓ Downgrade

Company details

Market cap:	Rs. 8,952 cr
52-week high/low:	Rs. 110.35/35.7
NSE volume: (No of shares)	12.2 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Sharekhan code:	FEDERALBNK
Free float: (No of shares)	199.2 cr

Shareholding (%)

Promoters	0.0
FII	37.5
DII	37.12
Others	25.4

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	12.0	-52.5	-46.1	-52.9
Relative to Sensex	-10.7	-29.5	-27.6	-34.5

Sharekhan Research, Bloomberg

The COVID-19led lockdown is a significant event impacting the Indian as well as the global economy. The resultant lockdown is expected to cause simultaneous weakening of consumer demand and a slowdown across sectors. Initial signs indicate that the Coronavirus outbreak may result in higher delinquencies and lower credit offtake for banking, financial services and insurance (BFSI) companies, including Federal Bank.Federal Bank has a 51% wholesale book, mainly comprising business banking and SME/MSME segment which are expected to see COVID-19 related impact on their business and cash-flows. Hence we expect Federal Bank's asset quality and growth too, to be impacted in the medium term. Management had earlier indicated having minimal residual stress in corporate loans (above Rs. 100 cr), due to which we expect legacy book credit costs to be manageable. The provisional Q4 figures indicate the pace of deposits and advances has slowed down to multi-quarter lows which is likely to have near-term moderating impact on NIM. Asset-quality wise, the three-month moratorium by the regulator will maintain the status quo; but going forward, credit cost and provision burden are expected to keep a check on growth. According to Global Institutions' estimates, inward remittances are likely to slow down for countries, including India. Federal Bank has significant dependence on inward remittances (NRE deposits ~37% of total deposits) and therefore, may be impacted. However, the present soft interest rate regime is likely to soften the impact. We have fine tuned our estimates for FY2021E and FY2022E, considering the impact of COVID-19 and the resultant (still dynamic) business scenario, at least for the medium term. We have also revised our target multiple in light of the dynamic environment. However, post market correction, we believe most negatives are factored in the valuations, which make risk return favorable for long-term investors. We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 80.

Q4FY2020 (provisional) figures indicate slowing business trajectory: Federal Bank shared its Q4FY2020 provisional numbers. Business growth has slowed with deposits increasing by12.9% y-o-y and 5.3%q-o-q and advances increasing by 11% y-o-yand 2.7% q-o-q. CASA ratio at 30.5% has declined on a sequential basis from 31.5% in Q3FY2020. The provisional numbers indicate a slowing business growth trend in terms of both deposits and advances.

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) 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 have fine tuned our estimates for FY2021E and FY2022E, considering the impact of COVID-19 and the resultant (still dynamic) business scenario and accordingly revised our target multiple. However, post market correction, we opine most negatives are factored in the valuations and risk return has turned favorable for long-term investors. Therefore, we maintain our Buy rating on the stock with a revised PT of Rs. 80.

Key Risks

Further risk of slippages in the corporate segment as well as slow growth may hamper profitability.

Valuation Rs cr

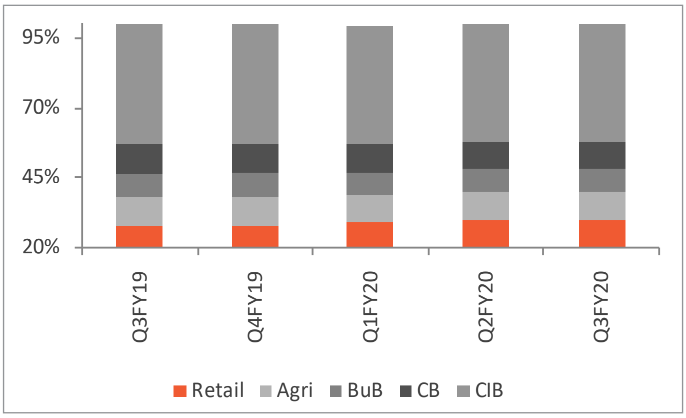
Particulars	FY19	FY20E	FY21E	FY22E
Net interest income	4,176.4	4,909.3	5,487.4	6,125.4
Net profit	1,243.9	1,758.3	1,818.3	2,328.0
EPS (Rs.)	6.3	9.1	9.4	12.0
PE (x)	7.2	5.0	4.8	3.7
Book value (Rs./share)	65.6	74.5	81.7	90.9
P/BV (x)	0.7	0.6	0.6	0.5
RoE (%)	9.7%	12.6%	11.8%	13.7%
RoA (%)	0.8%	1.0%	0.9%	1.0%

Source: Company; Sharekhan estimates

Business banking and SME segments to face headwinds: COVID-19 impact is likely to be significantly stressful for business banking and the SME/MSME portfolio due to working capital stress in this segment. Moreover, we believe issues of supply chain disruption, labor issues, leverage, fixed cost, low demand are concerns that can affect the players due to the disruption caused by the pandemic and the lockdown.

According to industry estimates, ~75 million MSME units may face closure in about a quarter, if the lockdown is prolonged. While the three-month moratorium will provide relief, the resumption/normalisation of business is likely to be the key monitorable, which shall be of help.

Advances break-up



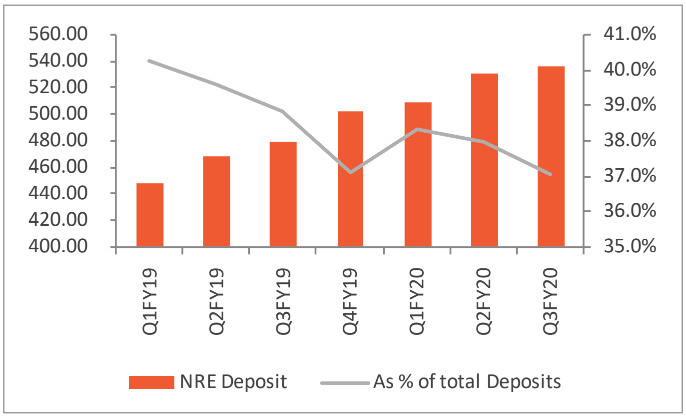
Source: Company, Sharekhan Research

Federal Bank has around 51% share of wholesale advances, of which a significant portion is business banking and SME. We expect the bank to grow cautious in the segment in FY2021E and may see elevated levels of stress from the segment.

Global remittance may slow down and impact the bank, which has considerable NRI deposits: As per Global Institution's estimates, Global Remittances sent home by migrants from lowand middle-income countries are expected to drop by ~20% this year amid the global economic slowdown caused by the Coronavirus.

The flow of remittances to poorer countries in Europe and Central Asia is expected to drop by 27.5%, followed by sub-Saharan Africa with 23.1%, South Asia at 22.1%, the Middle East and North Africa at 19.6%, Latin America and the Caribbean with 19.3%, and East Asia and Pacific with 13%.

NRE deposits as a proportion of total deposits



Source: Company, Sharekhan Research

Federal Bank has ~37% of deposits from NRE deposits, which is an important cushion for its margins. Going forward, while we donot envisage a decline at this time, we believe the pace of accretion may slow down a tad. However, with the present trend of easing cost of funds in India, with expectedly slow demand for credit, we expect the impact to be manageable.

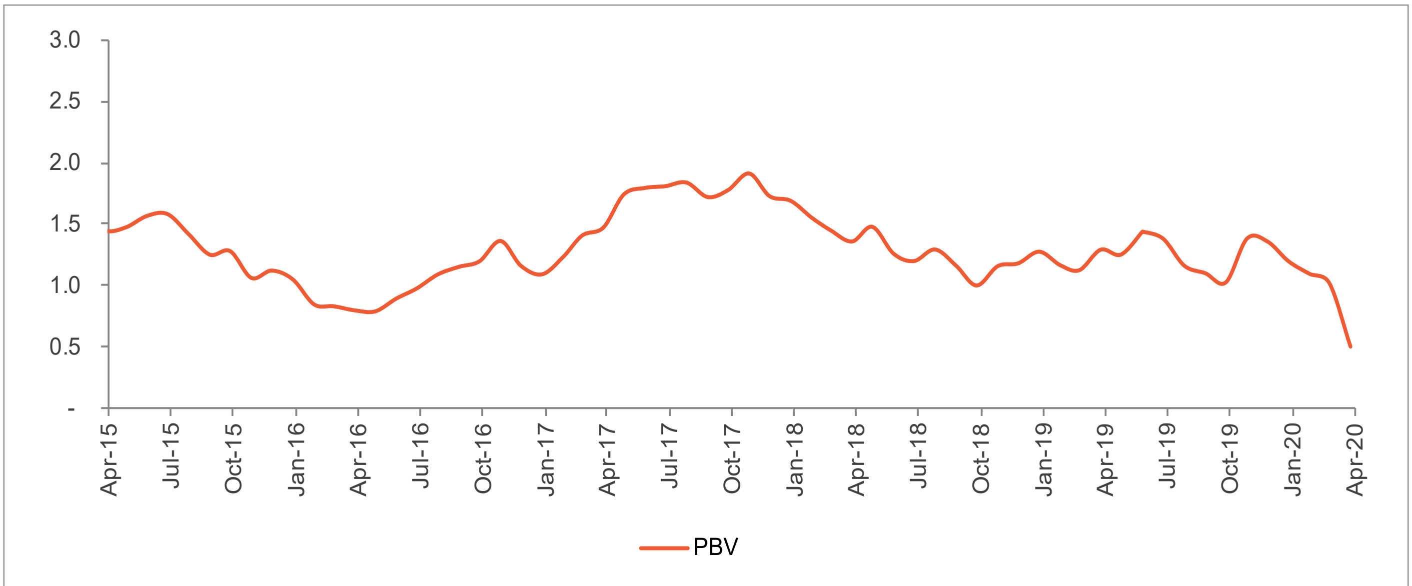
Outlook

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 slowdownacross sectors. Initial signs indicate that the Coronavirus outbreak mayresult in higher delinquencies and lower credit offtake for BFSI companies, including Federal Bank.However, there are some positives such asthe changing asset mix (higher yield retail proportion rising) and entry into new segments, whichare likely to be supportive for yields over time.We believe incremental loans to better-rated borrowers, no addition to the stressed pool, and highprovision coverage are positives too. Management's indicated minimal residual stress in corporate loans above Rs. 100 crore makes us believe that credit cost from the legacy book may be manageable. However, since Federal Bank has a significant business banking and SME/MSME segment exposure, which is expected to be impacted by the lockdown, we expect asset-quality performance and margins willcontinue to be key monitorables for the medium term for Federal Bank.

Valuation

Factors such as increasing retail focus, decent capitalisation levels (Tier-1 at 12.6%), 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 have fine tuned our estimates for FY2021E and FY2022E, considering the impact of COVID-19 and the resultant (still dynamic) business scenario and accordingly revised our target multiple. However, post market correction, we opine most negatives are factored in the valuations and risk return has turned favorable for long-term investors. Therefore, we maintain our Buy rating on the stock with a revised PT of Rs. 80.

One year forward P/BV (x) band



Source: Company, 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	45	0.6	0.6	5.0	4.8	1.0	0.9	12.6	11.8
IndusInd Bank	410	0.8	0.7	5.1	4.0	1.8	1.9	17.3	18.2
City Union Bank	125	1.7	1.5	12.0	10.7	1.6	1.6	14.7	14.6

Source: Sharekhan Research, Bloomberg estimates.

About company

Federal Bank Limited 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). Federal Bank has been building incremental addition in better-rated borrowers and 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 consistent and 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 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 poses risks to borrowers' cash flows and therefore may result in higher credit cost in near to medium term and slower growth. However, factors like strong capitalization levels and a dependable liability franchise are positive factors for long term investors.

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

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