Sharekhan
by BNP PARIBAS

Federal Bank

Operationally strong quarter, but medium-term headwinds stay

Sector: Banks & Finance
Result Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 50**	
Price Target: **Rs. 60**	↔

↑ Upgrade ↔ No change ↓ Downgrade

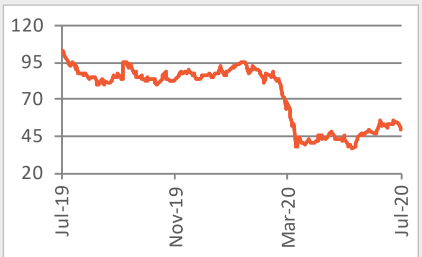
Company details

Market cap:	Rs. 9,932 cr
52-week high/low:	Rs. 109/36
NSE volume: (No of shares)	252.1 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	6.4	18.0	-46.4	-51.7
Relative to Sensex	-1.2	3.9	-32.4	-44.4

Sharekhan Research, Bloomberg

Federal Bank (FB) posted operationally strong performance for Q1FY2020 with net interest income (NII) and PAT better than expectations. Operational performance was helped mainly by treasury gains, cost control and lower slippages, which helped offset elevated provisions and lower fee income. The moratorium book (net) now stands at 24%, which is a positive. During the quarter, FB saw NII of Rs. 1,296 crore, up 12.3% y-o-y, which was better than expectations. However, non-interest income grew to Rs. 488 crore, up 25% y-o-y, driven by higher investment/treasury gains of Rs. 304 crore, but tepid growth in fee income at Rs. 171 crore (down 34% y-o-y) was a dampener. Still, healthy treasury gains helped cushion the impact of elevated provisions, which came at Rs. 395 crore (including COVID-19 related provision of Rs. 93 crore and standard provision of Rs. 37 crore for the expected haircut in a large corporate account). Cost-to-income ratio improved to 47.76%, down 246 bps q-o-q, which was lowest the in the last 25 quarters. Consequently, PAT was of Rs. 400 crores, up 4.3% y-o-y, ahead of estimates. GNPAs increased sequentially (mainly due to one large corporate account slipping to NPAs although fully provided for) even as NNPAs declined sequentially and stood at multi-quarter low. Management indicated that though the medium term may see dwindling of moratorium book, the last ~10% odd amount may be difficult and may cause rise in NPAs in Q3. FB is likely to maintain liquidity on the balance sheet and remain cautious on credit growth for the medium term. However, the bank is better placed in terms of book quality, with SMA book at reasonable <1% and ~79% of wholesale borrowers rated A and above by external ratings. There was also improvement in provision coverage to 58.54% (from 53.39% q-o-q). Due to COVID-19 induced weak global economic outlook, inward remittances are likely to be vulnerable for countries, including India. FB has significant dependence on inward remittances (NRE deposits ~39% of total deposits) and, therefore, the behaviour of this liability stream will be a key monitorable. However, so far, the increase in CASA and NRE deposits has been healthy. Considering the impact of COVID-19 and the resultant (still dynamic) business scenario, at least for the medium term, we believe the outlook still has headwinds for the bank. We maintain our Buy rating on the stock with an unchanged price target (PT) of Rs. 60.

Key positives

- Fresh slippages came much lower in Q1FY2021 at Rs. 184 crore, from Rs. 283 crore in Q4FY2020 and ~Rs. 450 crore per quarter for the preceding three quarters.
- NIMs have expanded by 3 bps q-o-q to 3.07% (but were down by 8 bps y-o-y). CASA and NRE deposits have increased by 19% each y-o-y, which is positive.

Key negatives

- Tepid growth in fee income at Rs. 171 crore (down 34% y-o-y) was a dampener, especially since advances growth at 9% y-o-y to Rs. 1,23,437 crore, was reasonable, with retail and agri book growing faster by 16% and 14% y-o-y.
- Gross NPA increased sequentially by 12 bps to 2.96% (despite moratorium benefits); tepid recovery as well at Rs. 66 crore (was Rs. 227 crore in Q4).

Our Call

Valuation: Factors such as increasing retail focus, being adequately capitalised (Tier-1 at 13%), and incremental lending to better-rated borrower(s) are positives. However, for the medium term, we expect loan growth to slow down due to management's already-stated strategy to be cautious in the corporate segment. We believe asset quality headwings to persist for medium term. We maintain our Buy rating on the stock with an unchanged 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 Rs cr

First page financial	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)	8.0	6.4	6.5	5.1
Book value (Rs/share)	65.6	71.5	79.5	87.0
P/BV (x)	0.8	0.7	0.6	0.6
RoE (%)	9.7%	11.1%	9.8%	11.6%
RoA (%)	0.8%	0.9%	0.7%	0.8%

Source: Company; Sharekhan estimates

Asset-quality performance sequentially strong, but headwinds continue: Asset-quality wise, GNPAs have increased sequentially to 2.96% (from 2.84% in Q4FY2020) mainly as one large corporate account was recognized as NPA and was fully provided for during the quarter. Total stressed book to total average assets reduced to 1.14%. The bank carries COVID-19 provision of Rs. 186 crore (was Rs. 93 crore in Q4FY2020) and has created standard asset provision of Rs. 37 cr for the expected hair cut in a large corporate account.

Fresh slippages were much lower in Q1FY2021, coming in at Rs. 184 crore, which was Rs. 283 crore in Q4 and ~Rs. 450 crore per quarter for the preceding three quarters. However, fresh slippages were helped by the moratorium and may not be reflecting the true state of affairs. Going forward, for Q2 as well, we expect fresh slippages' pace to be slow as well.

While gross moratorium amount continues to be at 35% of total advances (same from May 25 levels), net moratorium (Gross Moratorium – loans which cleared all interest/EMI demands till June 2020 – gold loans/ loans against liquid securities) as on July 12 stood at 24%.

Key result highlights from Concall

- **Operationally strong quarter:** Management viewed it as a strong quarter with improvement in NIMs over the last two quarters, CASA improved, and C/I improved. Moreover, its retail deposits (SA and NRE deposits too) have improved sequentially.
- **Gold loans performing strong:** The recently launched gold loan segment is doing strong traction and was up 10% q-o-q and 36% y-o-y.
- **Provisions:** The bank took standard asset provision for Rs. 186 crore for COVID-19, treasury gains helped balance the provisions for large corporate. Going forward, its exposure to erstwhile infrastructure finance conglomerate and the potential impact of haircut of Rs. 30 crore have now been fully provided.
- **Moratorium:** Moratorium has become 24% of the total. Further, a large number of customers are keeping deposits with the bank, which is an encouraging sign. The 24% is the net figure of people who have paid in full the amount due to them. Around 12% of customers have not paid any EMI due.
- **Credit cost:** The Credit cost for Q1 was 83 bps, which was 100+ bps in Q1FY2020. However, the situation is dynamic. Management did not provide any guidance but stated that December quarter end will provide clarity on asset quality.
- **Best and worst hit sector:** Those dependents on local consumption are seeming better, but travel/ hospitality etc. are vulnerable, but do not have significant exposure to hospitality and aviation sector.
- **NRI deposits:** The management stated that they believe It is hard to gauge as of now whether NRI deposits will slow going forward, but so far in the early weeks of Q2 they are also looking fine. Normally the first five months of the year are best in terms of accretion, but the situation is dynamic. The bank is confident that it will be able to do well on SA and NR-SA will continue to do well.
- **Capital Raising:** The bank doesn't foresee a need to raise Equity capital for CY20 and mid of CY2021. This is assuming there is no material unforeseen exigency. CET 1 is 13% at present, but if the bank adds the retained Q1 profits, it will be higher by ~50 bps for Q1.
- **Credit growth:** Credit growth was 8.5% y-o-y in Q1 and is expected to do reach 10-12% in H2FY2021. Gold loans have done very well in Q1 and are expected to grow well.
- **PCR Outlook:** The bank has increased coverage ratio, but expects Q3 to be a very challenging quarter for the industry. The bank would like to keep PCR at 50-55%.
- **MFI:** Management may take time to think over the MFI business and is right now focusing on the existing business. There are no plans to enter the microfinance business, for at least the next one-two quarters.
- **Stress test results for FB:** As part of quarterly inspections, all banks including FB were asked to do a risk-based stress assessment by the Reserve Bank of India (RBI). The bank has already done the stress test and did not have anything material to share on the same.
- **Recovery of NPAs:** Recovery normally would be Rs. 200 crore-250 crore per quarter, but it is unclear due to the present situation. Recovery was Rs. 67 crore in Q1 and the bank expects ~Rs. 100 crore in Q2. It will see improvement in Q3 only.

- **Decline in Moratorium:** Business banking etc. initially took moratorium option due to risk aversion and feeling they may get a waiver. However, once the customers realised the costs involved, many of them started repaying. It will be last 10-12% of the moratorium book, which may be problematic; management will come to know in Q3 only.
- **Operating Costs:** Other expenses fell sharply in Q3. Operating costs were lower due to variable costs (due to lower volume) and lower rentals etc. Took Rs. 35 crore impact on employee cost due to pension liability because of change in interest rates, still was able to keep employee costs low. Branch-led business has increased, due to which the incremental cost came lower.
- **SME Outlook:** On the SME guarantee loans, the bank expects to be doing around Rs. 1,200 crore disbursement till July. SME growth in FY2021E earlier was expecting ~15% growth but now 8-10% growth is expected.
- **Margins outlook:** Net interest margin has improved sequentially mainly due to high growth in retail loans and gold loans. Moreover, on the liability side, CASA rise helped in NIMs to rise.
- **Employee cost expected:** Management has provided pension-related provisions of Rs. 35 crore in Q1 and will continue for the next three quarters as well. If yields fall, there may be a further need to increase. It is calibrated on quarterly basis.
- **Moratorium interest:** Interest accruing of customers (not paying) can be converted to FITL loans, which will be of 8-10 months tenure. This will be for working capital loans. For EMI loans, non-payment will be only pushed further.
- **Treasury gains:** Even though the bank has booked treasury gains in Q1, the Yield on Investment (YoI) is higher in Q1 as compared to Q4 FY20.
- **Leadership:** There was no development on the present MD's tenure shared by the bank.

Results Rs cr

Particulars	Q1FY21	Q1FY20	YoY %	Q4FY20	QoQ %
Interest earned	3,444.2	3,229.3	6.7	3,396.8	1.4
Interest expended	2,147.7	2,075.1	3.5	2,180.8	-1.5
Net interest income	**1,296.4**	**1,154.2**	**12.3**	**1,216.0**	**6.6**
Non-interest income	488.4	391.5	24.7	711.1	-31.3
Net total income	1,784.8	1,545.7	15.5	1,927.1	-7.4
Operating expenses	852.4	762.9	11.7	967.8	-11.9
Pre-provisioning profit	**932.4**	**782.8**	**19.1**	**959.3**	**-2.8**
Provisions	394.6	192.0	105.5	567.5	-30.5
Profit before tax	537.8	590.7	-9.0	391.8	37.3
Tax	137.0	206.5	-33.7	90.6	51.2
Profit after tax	**400.8**	**384.2**	**4.3**	**301.2**	**33.0**
			bps		**bps**
Gross NPA (%)	2.96	2.99	-3	2.84	12
Net NPA (%)	1.22	1.49	-27	1.31	-9

Source: Company; Sharekhan Research

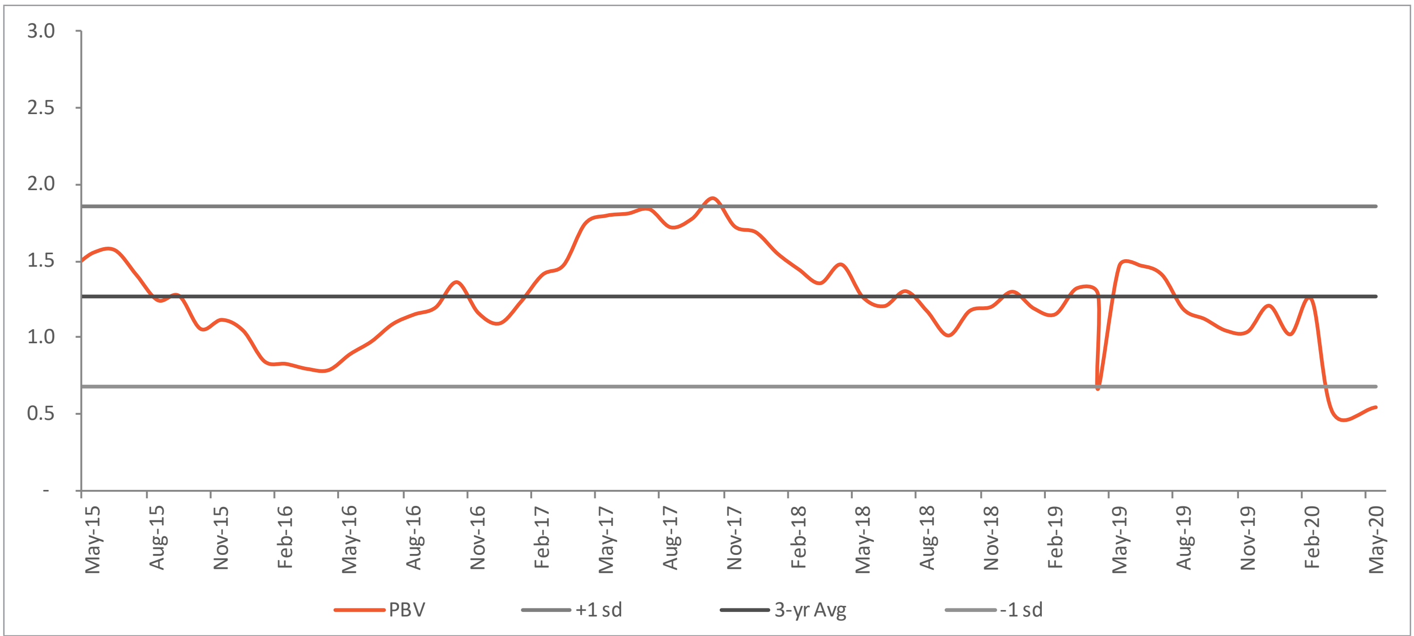
Outlook

The coronavirus-led lockdown is a significant event impacting the Indian as well as the global economy. The resultant lockdown has caused simultaneous weakening of consumer demand and a slowdown across sectors. We believe incremental loans to better-rated borrowers (~79% of corporate borrowers are rated 'A and above' by external rating) and high provision 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. The coronavirus outbreak may result in higher delinquencies and lower credit offtake for BFS companies, including FB. Measures to alleviate the impact have helped somewhat, but asset-quality picture is still uncertain and Q3 FY21 may see a significant rise in NPAs for banks, including FB. While the changing asset mix (higher yield retail proportion rising) and entry into new segments, are likely to be supportive for yields over time, for the time being we expect headwinds to growth and profitability to continue. FB has a significant business banking and the SME/MSME segment exposure, which is expected to be vulnerable. We expect asset-quality performance and margins to be key monitorables for the medium term.

Valuation

Factors such as increasing retail focus, being adequately capitalised (Tier-1 at 13%), and incremental lending to better-rated borrower(s) are positives. However, for the medium term, we expect loan growth to slow down due to management's already-stated strategy to be cautious in the corporate segment. We believe asset quality headwings to persist for medium term. We maintain our Buy rating on the stock with an unchanged PT of Rs. 60.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	CMP (Rs / Share)	P/BV (x)		P/E (x)		RoA (%)		RoE (%)	
		FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Federal Bank	50	0.6	0.6	6.5	5.1	0.7	0.8	9.8	11.6
IndusInd Bank	504	0.9	0.8	9.8	6.9	1.1	1.4	9.5	12.3
City Union Bank	121	1.5	1.4	17.3	12.1	0.9	1.3	8.7	11.8
RBL Bank	165	0.8	0.7	14.6	7.7	0.6	1.1	5.2	8.9

Source: Company, Sharekhan research, Bloomberg estimates

About company

Federal Bank (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 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 capitalisation levels and a dependable liability franchise are positive factors for long-term investors.

Key Risks

Extension of lockdown and 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 and CEO
Ms. Shalini Warrier	Chief Operating Officer
Mr. Sumit Kakkar	Chief Credit Officer
Mr. Samir Pravinbhai Rajdev	Company Secretary
Mr. Ashutosh Khajuria	Executive Director

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Asset Management	6.3
2	ICICI PRUDENTIAL ASSET MGM	4.8
3	Reliance Capital Trustee Co Ltd	4.0
4	YUSUFFAL MUSALIAM VEETIL	3.9
5	Franklin Resources Inc	3.5
6	HDFC Asset Management Co Ltd	3.4
7	Jhunjhunwala Rakesh	3.0
8	HDFC Life Insurance Co Ltd	2.8
9	Vanguard Group Inc/The	2.5
10	EAST BRIDGE CAPITAL MASTER FUND	2.4

Source: Bloomberg

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