Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Federal Bank

Steering towards growth with digital initiatives

Banks & Finance	Sharekhan code: FEDERALBNK

Reco/View: Buy	↔	CMP: Rs. 82	Price Target: Rs. 139	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 42.26

Updated Oct 08, 2021

Severe Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

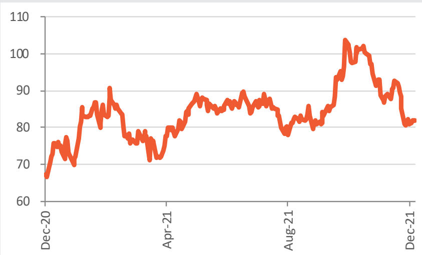
Company details

Market cap:	Rs. 17,218 cr
52-week high/low:	Rs. 108 / 66
NSE volume: (No of shares)	256.4 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Free float: (No of shares)	207.3 cr

Shareholding (%)

Promoters	-
FII	25.9
DII	42.5
Others	31.55

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-5.4	-1.3	-5.7	22.1
Relative to Sensex	-6.7	0.4	-15.9	1.0

Sharekhan Research, Bloomberg

Summary

- Post the recent correction of 24% from its peak, Federal Bank's valuations have turned attractive at 0.8x its FY2023 estimated book value.
- Federal Bank is better placed as compared to mid-size private sector banks in terms of granular liability franchise, a well-diversified loan book, and capital positioning. Moreover, the bank is way ahead of its peers in terms of digitisation and fintech landscape.
- Hence, we maintain our Buy rating on Federal Bank with a revised PT of Rs. 139.

Federal Bank is well ahead of its peers in terms of digitisation. The bank is transforming and establishing itself as a next-generation bank among private mid segment. The bank has been spearheading digital initiatives with tie-ups with various payments platforms, neo banks, and fintech companies across its assets and liabilities. This enables the bank to lower its costs and enhance revenue. Further, the bank has a well-diversified loan book with continued focus on increasing the retail mix. Retail loans constitute ~54% of total advances and are less risky, which carry higher margins. The bank's advances grew by 9.7% y-o-y in Q2FY2022, aided by agri, business banking, commercial banking, and retail personal portfolio. Apart from this, Federal Bank has a granular liability franchise with CASA plus retail term deposits constituting over 90% of the total deposits. The bank's asset quality has been stable over the quarters. In Q2FY2022, its asset quality improved by lower slippages and higher recoveries. The bank's GNPA declined by 26 bps q-o-q to 3.24%. Further, the re-appointment of Mr. Shyam Srinivasan as the MD and CEO of the bank for a period of three years with effect from September 23, 2021, would be positive for the bank, as he has been with the bank for a decade for now and would bring in stability with focus on the bank's long-term strategy.

- **Constantly adapting to digitisation:** Federal Bank has been strengthening its digital foot print. The bank was among the first five banks to launch UPI payments; and since 2016, it focused on digital migration from branch channels to digital channels. Currently, 87.5% of the transactions are being conducted through the digital platform and digital transactions have witnessed 34% y-o-y growth in Q2FY2022. The bank has partnered with PineLabs, Bill Desk, and PayU to offer EMI loans. The bank has also tied up with Jupiter, DGV, and epiFi to offer savings account. Likewise, the bank has also partnered with Rupeek to source gold loans. This is likely to reduce the incremental cost of acquisition and better horizon for revenue in the long run. Although, cost to income (C/I) ratio increased by 750 bps q-o-q and 680 bps y-o-y to 55% in Q2FY2022, management guided that the bank would exit FY2022 with a C/I ratio of ~52%.
- **Better product mix:** The bank stands better in terms of product mix, with retail constituting ~54% of total advances. There has been continuous shift in the focus from wholesale to increasing the retail mix in the overall portfolio. The retail segment, which contributed 46% in FY2019, has increased to 54.3% in Q2FY2022. This equips the bank with less risky assets in its loan portfolio and, at the same time, these assets also carry higher margins. The bank's gold loan portfolio has also been gaining strength. The book grew by 26% y-o-y to Rs. 15,976 crore (~12% of total advances) in Q2FY2022. The bank intends to increase the share of high-yielding assets primarily through segments – business banking, commercial banking, credit cards, and commercial vehicles.
- **Asset quality and funding profile:** The bank's asset quality has remained stable. In Q2FY2022, its asset quality improved because of lower slippages and higher recoveries. The bank's GNPA declined by 26 bps q-o-q to 3.24%. Slippages moderated significantly to Rs. 320 crore in Q2FY2022 (~1% of loans) and its restructured book increased to ~2.6% of loans (~1.9% in Q1FY2022), which demonstrates that the bank has best underwriting practices given the environment and Reserve Bank of India's (RBI) dispensation. Further, Federal Bank has a granular liability franchise with CASA plus retail term deposits constituting over 90% of the total deposits. The bank has one of the lowest cost of funds among its peers, which gives the bank a competitive edge. With a high market share in the non- resident external deposits in Kerala, the bank has better funding mix than its peers.

Our Call

Valuation – We maintain our Buy rating on Federal Bank with a revised PT of Rs. 139. At the CMP, the stock currently trades at 0.8x its FY2023E P/BV, which we believe is at attractively lower valuations and a value buy at current levels. Factors such as its digital initiatives and changing itself to a next-generation private bank and continued focus to increase its retail mix with higher-yielding businesses such as commercial vehicles, credit cards, and micro credit, are expected to augur well for the bank's growth going ahead. The bank's asset quality is also holding up well with better underwriting practices. Additionally, the well-experienced management team has brought in management stability to drive long-term strategy of the bank.

Key Risks

Any prolonged economic slowdown and higher-than-expected asset quality deterioration may impact its growth.

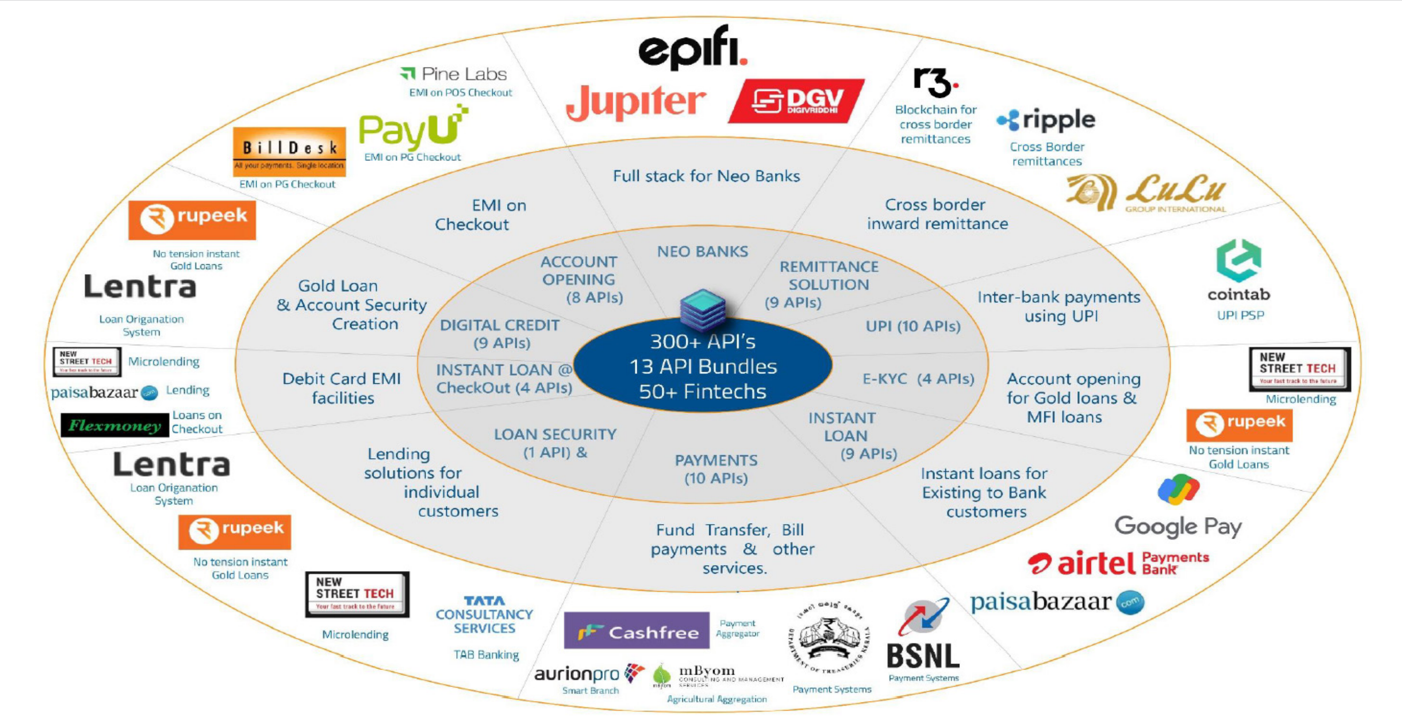
Valuation Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
NII	5,534	6,089	6,986	7,954
PAT	1,590	1,987	2,560	2,917
EPS (Rs)	8.0	9.5	12.2	13.9
P/E (x)	10.2	8.6	6.6	5.8
P/BV (x)	1.0	0.9	0.8	0.7
RoA (%)	0.8	0.9	1.1	1.1
RoE (%)	10.4	11.4	12.8	12.8

Source: Company; Sharekhan estimates

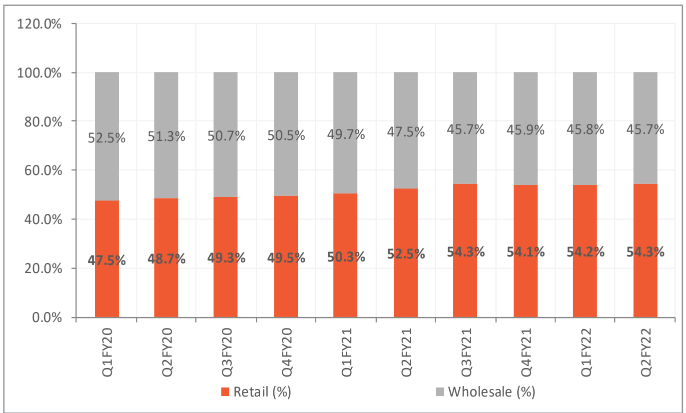
Key Charts

Fintech Landscape



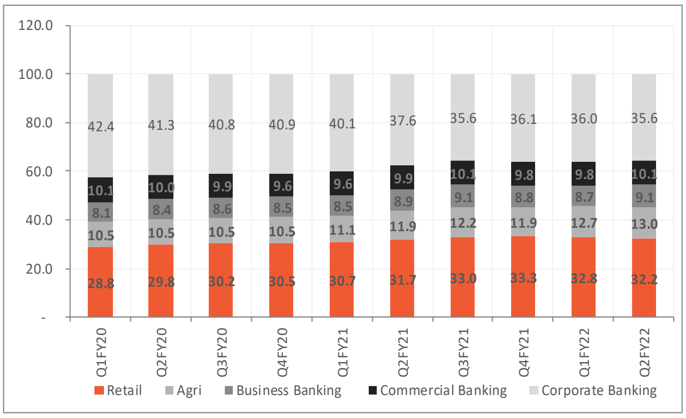
Source: Company, Sharekhan Research

Loan book mix improving towards retail



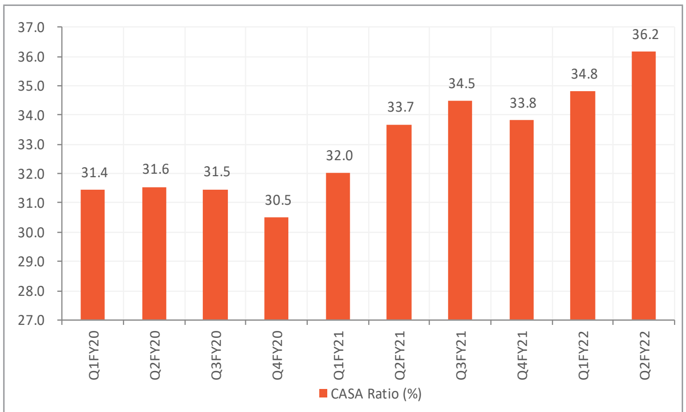
Source: Company, Sharekhan Research

Loan Book Mix (%)



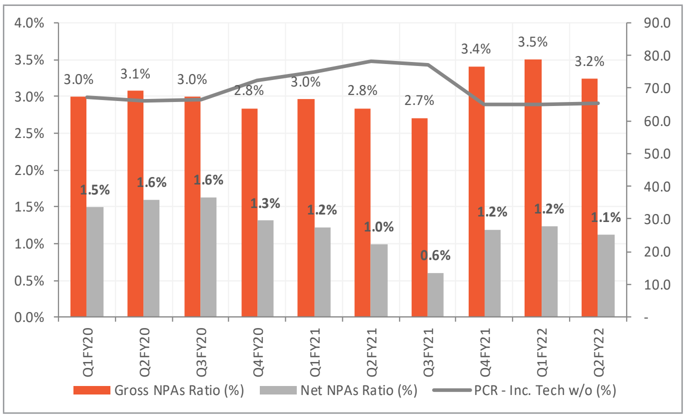
Source: Company, Sharekhan Research

CASA Ratio



Source: Company, Sharekhan Research

Asset quality trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view – Green shoots of credit growth, stronger banks placed better

System-level credit offtake grew by 7.51% y-o-y in the fortnight ending December 3, 2021, showing that credit growth held strong after the festive season. On the other hand, deposits rose by 9.4%, which indicate a healthier economic scenario. Moreover, the RBI's accommodative monetary policy stance, resulting in surplus liquidity, provides succor in terms of easy availability of funds and lower cost of funds for banks and financials. Going forward, corporate exposure is likely to be a function of asset quality, client profile, as well as an economic recovery. At present, we believe the banking sector is likely to see increased risk-off behaviour, with tactical market share gains for well-placed players. We believe large banks, with a strong capital base and asset quality (with high coverage and provision buffers), are better placed to take-off once the situation normalises.

■ Company outlook – Attractive play on gradual economic recovery

Federal Bank remains a strong business franchise with robust capitalisation and displays a stable trend in asset quality. The bank is transforming and establishing itself as a next-generation bank in the private mid segment. The bank has been spearheading digital initiatives through tie-ups with various payments platforms, neo banks, and fintech companies across its assets and liabilities. This enables the bank to lower its costs and enhance revenue. Further, the bank has a well-diversified loan book with continued focus on increasing the retail mix. We find Federal Bank to be an attractive franchise with a strong balance sheet and well-managed asset quality, which will help it tide over medium-term challenges.

■ Valuation – We maintain our Buy rating on Federal Bank with a revised PT of Rs. 139

At the CMP, the stock currently trades at 0.8x its FY2023E P/BV, which we believe is at attractively lower valuations and a value buy at current levels. Factors such as its digital initiatives and changing itself to a next-generation private bank and continued focus to increase its retail mix with higher-yielding businesses such as commercial vehicles, credit cards, and micro credit, are expected to augur well for the bank's growth going ahead. The bank's asset quality is also holding up well with better underwriting practices. Additionally, the well-experienced management team has brought in management stability to drive long-term strategy of the bank.

Peer Comparison

Particulars	CMP	MCAP	P/E (x)		P/B (x)		RoE (%)		RoA (%)	
	Rs/ Share	(Rs Cr)	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Federal Bank	82	17,218	8.6	6.6	0.9	0.8	11.4	12.8	0.9	1.1
City Union Bank	136	10,052	10.1	11.1	1.5	1.4	12.1	13.0	1.3	1.4
IndusInd Bank	885	68,528	13.2	8.4	1.4	1.3	11.4	15.9	1.4	2.0

Source: Sharekhan Research

About company

Federal Bank is a 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). Federal Bank has been building incremental addition in better-rated borrowers and has 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 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. Apart from this, the bank is rapidly adapting and transforming itself into a next-generation bank in the private mid segment.

Key Risks

Any prolonged economic slowdown and higher-than-expected asset quality deterioration may impact its growth.

Additional Data

Key management personnel

Mr. Shyam Srinivasan	Managing Director & CEO
Ms. Shalini Warrier	Executive Director
Mr. Divakar Dixit	Head - Credit (Commercial & Business Banking and Retail)
Mr. Lakshmanan V	Senior Vice President & Head Treasury
Mr. Ashutosh Khajuria	Executive Director

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Mutual Fund	5.6
2	Templeton Mutual Fund	4.7
3	Hdfc Mutual Fund	3.5
4	HDFC Life Insurance Company Limited	2.9
5	Nippon Life India Trustee Ltd	2.9
6	Kotak Mutual Fund	2.9
7	DSP Mutual Fund	2.7
8	Tata AIA Life Insurance Co Ltd	2.1
9	SBI Mutual Fund	1.9
10	IFC Emerging Asia Fund, LP	1.8

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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