Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Federal Bank

Nearing normalcy

Banks & Finance	Sharekhan code: FEDERALBNK	Company Update

Stock Update

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		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 68**	
Price Target: **Rs. 85**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Company details

Market cap:	Rs. 13,651 cr
52-week high/low:	Rs. 97/36
NSE volume: (No of shares)	252.1 lakh
BSE code:	500469
NSE 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	20.8	26.1	46.9	-20.5
Relative to Sensex	14.9	7.6	7.7	-33.4

Sharekhan Research, Bloomberg

Summary

- Our interaction with Federal Bank's management reveals that the bank's growth forecast is more stable with asset quality outlook improving.
- The management indicated that collection efficiency has been improving m-o-m, which is encouraging and the bank has neared normalisation with a ~95% collection efficiency.
- Federal Bank trades at 0.78x/0.7x FY22E/FY23E BVPS, which we believe is reasonable.
- We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 85.

We interacted with Federal Bank management to understand their business scenario, asset quality and growth outlook. The management indicated that the collection efficiency has been improving m-o-m, which is encouraging and the bank is near normal levels with a ~95% collection efficiency. The bank is well-placed on the asset quality front, with a manageable level of restructuring and adequate provision cover. The growth outlook too is stable. The management expects restructuring of Rs. 3,500 crore or lower for FY2021E and the appetite for the same has been manageable. Deposit traction was positive and modest growth in both retail and NRE deposit is expected, which will be in line with credit growth. However, the bank expects a further decline in cost of funds (albeit incrementally marginal) due to ample liquidity. Going forward, the bank maintains its guidance to clock credit growth that is 2-3% higher than system levels and incrementally the growth may be seen in retail, gold loans, etc. So far, the bank has able to lend Rs. 2,500 crore under the government's ECLGS scheme and sees an opportunity in this segment. Corporate lending rates are falling and hence the bank is looking to maintain its yields. Credit cards will launch by FY2021 end. Going forward, we expect that credit cost likely to be ~1.2% for H2FY2021E for Federal Bank. The bank indicated that in Q3 a single large account (exposure of Rs. 190 crore, already done provision of Rs 34 crores) may turn into an NPA, but as the same is close to settlement hence may see recovery/upgrades in the medium term. Bulk of stress is provided for and there is a possibility of write-backs. The bank is well-capitalised (Tier 1 ratio at 13.33%) and the expected Capital burn (expected to be around 20-25 bps per quarter or lower) will suffice. The management may go for equity fundraising in early FY22. We believe that the asset quality picture has improved incrementally (collections efficiency at 95% during September), even though these are still early stages of recovery. We have fine-tuned our estimates and the target multiple, in light of the improved outlook. We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 85.

Our Call

Valuation: Federal Bank trades at 0.78x/0.7x FY22E/FY23E BVPS which we believe is reasonable. Factors such as increasing retail focus, being adequately capitalised (Tier-1 at 13.33%), and incremental lending to better-rated borrower(s) are positives. The management indicated growth may return in Q4 FY21E, and we believe that the asset quality outlook has improved, which augurs well. We have fine-tuned our estimates and the target multiple, in light of the improved outlook. We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 85.

Key risk

Uncertainty over loan restructuring and delay in economic recovery poses risks to bank's profitability in the near to medium term.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Net interest income	4,176.4	4,648.9	5,111.5	6,066.1	6,858.1
Net profit	1,243.9	1,542.8	1,431.9	1,993.5	2,363.7
EPS (Rs)	6.3	7.7	7.4	10.3	12.2
PE (x)	10.9	8.8	9.2	6.6	5.6
Book value (Rs/share)	65.6	71.5	79.3	87.2	96.5
P/BV (x)	1.04	0.95	0.86	0.78	0.70
RoE (%)	9.7%	11.1%	9.5%	12.2%	13.1%
RoA (%)	0.78%	0.85%	0.70%	0.84%	0.85%

Source: Company; Sharekhan estimates

Asset quality wise bank is well placed

Federal Bank has witnessed sharp improvement in collection efficiency that has returned to pre-COVID levels. The bank has provided additional standard assets.Covid-19 related provision held till Q1FY21 was Rs 186 crore in addition of the Rs. 402 crore during Q2FY21.

During the last quarter, asset quality performance was encouraging as the bank incurred a credit cost of 0.55% and clocked a risk-adjusted NIM at 2.74%. Fed Bank has 79% of corporate book comprises of A & above which has been maintained over the last few quarters and we believe that this indicates strong book quality. Provision Coverage ratio has also increased to 64.65%, an increase of 611 bps q-o-q.

External Rating of Corporate Advances

Rating	Q2 FY2021	Q1 FY2021
A& above	79%	79%
BBB	10%	10%
< BBB	5%	4%
Others	6%	7%

Source: Company, Sharekhan Research

Internal Rating of "Others" (from the above)

Rating	Q2 FY2021	Q1 FY2021
FBR1	12%	2%
FBR2 / FBR3	1%	1%
FBR4	25%	33%
Below FBR4 and unrated	61%	64%

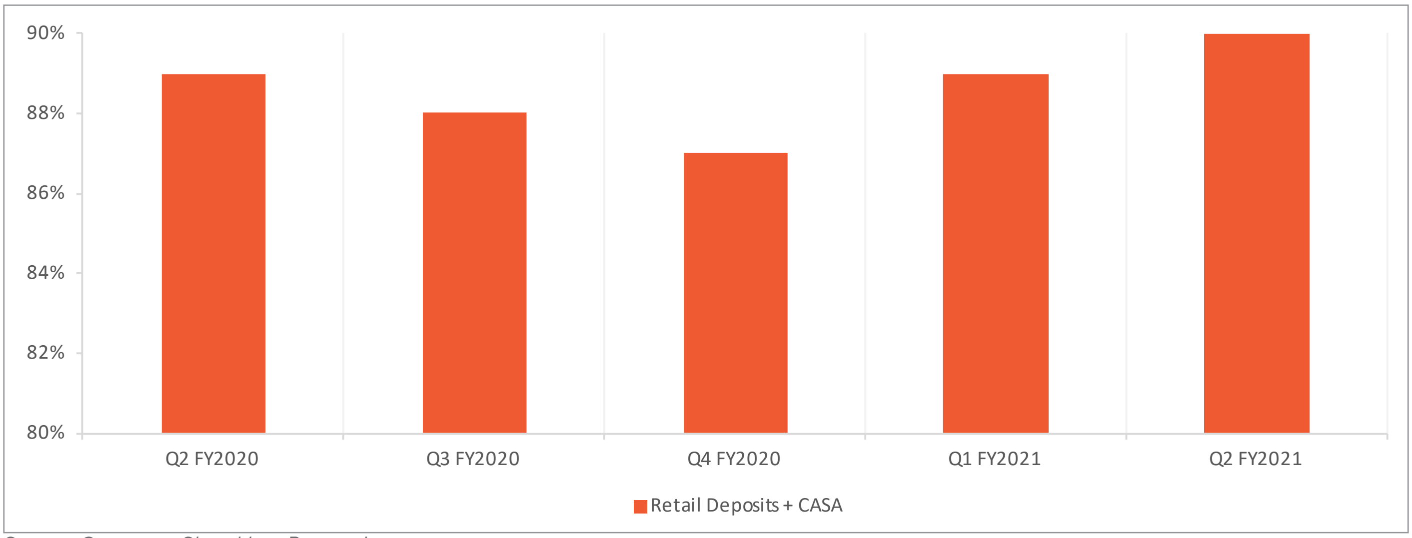
Source: Company, Sharekhan Research

Asset quality performance improved with GNPA/NNPA falling to 2.84%/0.99%, with negligible slippages (due to the court order). Going forward, in Q3 there may be some impact of a spill-over of Q2 resulting in higher slippages. During Q2 bank made an additional provision of Rs. 402 crores (Rs. 93 crore in Q1) for COVID-19 impact. We believe that the bank is better placed in terms of book quality, with a special mention account (SMA) book at reasonable <1% and ~79% of wholesale borrowers rated 'A and above' by external ratings.

Healthy growth in Retail business is positive

Retail advances grew 13% y-o-y to Rs. 39,649 crore where agri-loans grew by 20% to Rs 14,915 crore, while Business Banking segment grew by 13% to 11,134 crore.

Granular deposit base (Retail Deposits + CASA, in %)

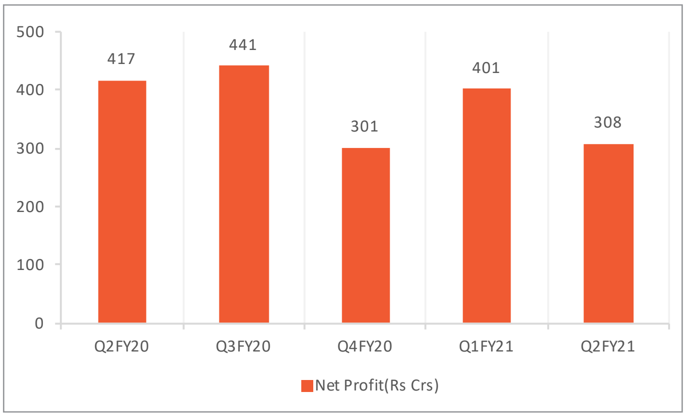


Source: Company, Sharekhan Research

The CASA ratio improved by 213 bps to 33.68%. CASA deposit stood of 20% to Rs 52,786 crore. NRE deposits too increased by 17% to Rs. 61,560 crore. Retail deposit too grew by 14% to Rs. 145,783 crore. Mobile banking monthly volumes stood at ~Rs. 8000 crore, registering a growth of 75.32% y-o-y.

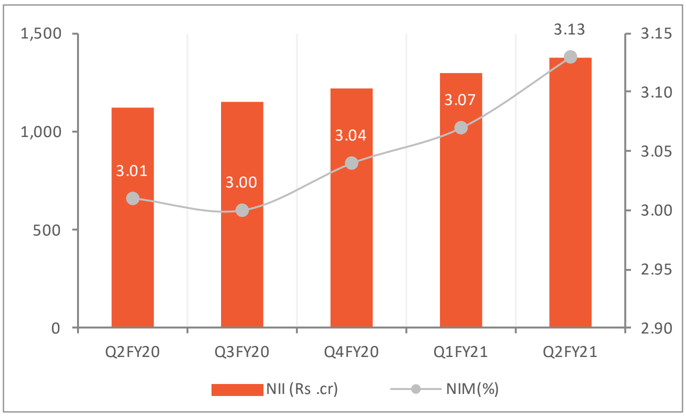
Financials in charts

Net Profit (Rs Crs)



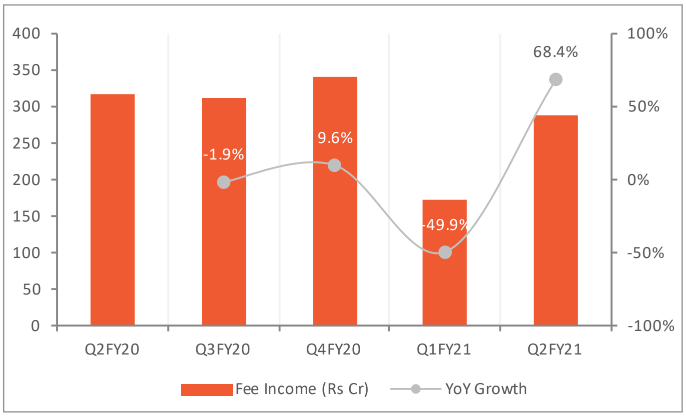
Source: Company, Sharekhan Research

NII & NIM (%)



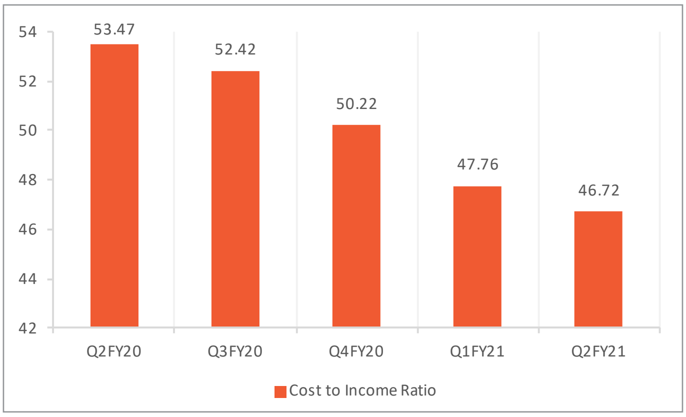
Source: Company, Sharekhan Research

Fee Income (Rs Cr)



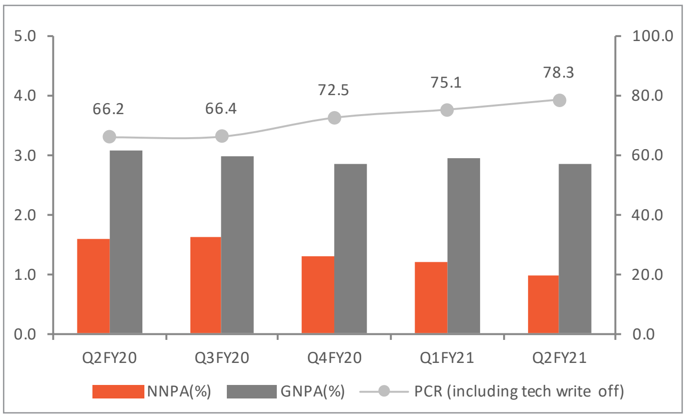
Source: Company, Sharekhan Research

Cost to Income Ratio



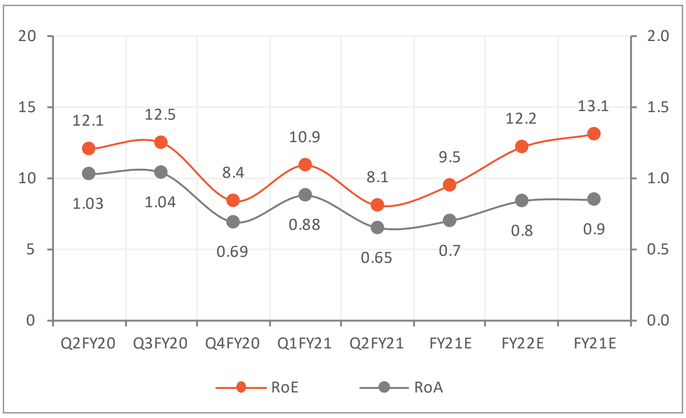
Source: Company, Sharekhan Research

Asset quality



Source: Company, Sharekhan Research

RoA and RoE



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Credit growth yet to pick up, private banks placed better

Even though at the system level bank's credit offtake is still tepid, with a credit growth of sub 6%, we believe that Private banks (PBs) with their better capital position, strong business case and lower competition in most segments for PSU Banks, are well placed to grow and gain market share. The accommodative stance of the RBI resulting in surplus liquidity, provides succour in terms of lower cost of funds for banks and financials. The loan moratorium has duly ended, which is a relief, and going forward, the collection efficiency is likely to be a function of book quality, client profile as well as economic pickup. At present, we believe that the banking sector is likely to see gradual return to normalcy in business, led by PBs with tactical market share gains for well-placed players. We believe that private banks, with improved capitalisation and strong asset quality (with high coverage, provisions buffers) are structurally better placed to take-off once the situation normalises.

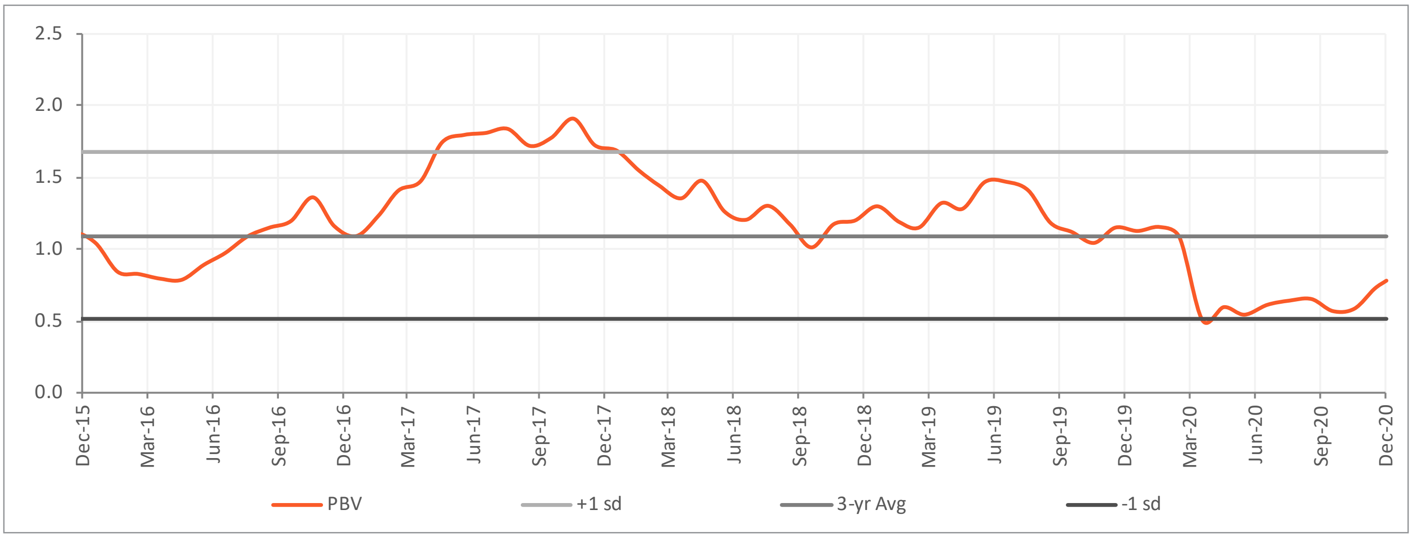
■ Company Outlook – Promising outlook

Federal Bank remains a strong business franchise with robust capitalisation and displays a stable trend in asset quality. The focus has been on de-bulking and better risk management has reflected positively on asset-quality trends so far. However, we believe that the COVID-19 pandemic will lead to a delay in recovery and improvement in profitability further. While it is still dynamic, intuitively, in response to challenges, lenders such as Federal Bank are responding well and are now seeing early glimmers of recovery, helped by headroom provided by buffers on provisions and focusing on collection efficiency. 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. We find the bank attractive in the medium to long term.

■ Valuation – Maintain Buy, with revised PT of Rs 85

Federal Bank trades at 0.78x/0.7x FY22E/FY23E BVPS which we believe is reasonable. Factors such as increasing retail focus, being adequately capitalised (Tier-1 at 13.33%), and incremental lending to better-rated borrower(s) are positives. The management indicated growth may return in Q4 FY21E, and we believe that the asset quality outlook has improved, which augurs well. We have fine-tuned our estimates and the target multiple, in light of the improved outlook. We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 85.

One-year forward P/BV (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	68	0.9	0.8	9.2	6.6	0.7	0.8	9.5	12.2
City Union Bank	185	2.4	2.1	25.9	18.3	1.0	1.3	9.3	11.9
Indusind Bank	921	1.7	1.6	23.0	13.6	1.0	1.4	7.9	11.9

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

Uncertainty over loan restructuring, and delay in economic recovery poses risks to bank's asset quality and profitability in near to medium term.

Additional Data

Key management personnel

Mr. Shyam Srinivasan	Managing Director & 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	Franklin Resources Inc	6.85
2	ICICI Prudential Asset Management	6.61
3	ICICI PRUDENTIAL ASSET MGM	4.79
4	Life Insurance Corp of India	4.53
5	YUSUFFAL MUSALIAM VEETIL	3.89
6	Jhunjhunwala Rakesh	3.13
7	HDFC Life Insurance Co Ltd	3.09
8	Reliance Capital Trustee Co Ltd	2.53
9	Vanguard Group Inc/The	2.53
10	HDFC Asset Management Co Ltd	2.52

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

Sharekhan

by BNP PARIBAS

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