Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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. 77**	
Price Target: **Rs. 95**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

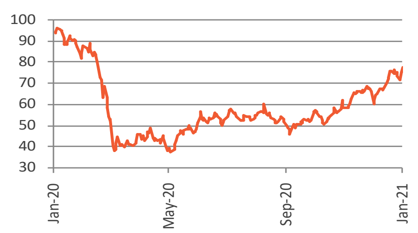
Company details

Market cap:	Rs. 15,420 cr
52-week high/low:	Rs. 97/36
NSE volume: (No of shares)	370.3 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	28.1	35.7	42.0	-17.6
Relative to Sensex	18.8	13.4	10.7	-37.5

Sharekhan Research, Bloomberg

Stock Update

Federal Bank

Better times ahead

Banks & Finance | Sharekhan code: FEDERALBNK | Result Update

Summary

- Q3FY21 numbers were encouraging, with healthy operational numbers (helped by sequentially lower provisions) and steady asset quality.
- GNPA/NNPA fell to 2.71% / 0.6% (from 2.84%/0.99% in Q2FY21), with negligible slippages (due to the SC order). Including proforma slippages, GNPA and NNPA ratios would have been at 3.38% and 1.14%, respectively.
- We believe that the bank is better placed in terms of book quality, with a 95% collection efficiency and as ~76% of wholesale borrowers are rated 'A & above'. Credit cost outlook appear to be manageable
- We maintain a Buy on the stock with a revised price target (PT) of Rs. 95.

Federal Bank posted encouraging numbers in Q3FY21, with healthy operational numbers (helped by sequentially lower provisions) and steady asset quality. Net interest income (NII) was highest ever and grew 24% YoY, against credit growth of 6%; stood at Rs. 1,437 crore and was in line with expectations. Pre-provision operating profit (PPOP) exceeded expectations at Rs. 962.9 crore, dropping marginally by 4% on account of higher employee costs and other expenses. It was helped by healthy other income. A 6% y-o-y growth in advances was in line with system growth, with segments like gold loans continuing their impressive run (up 67% y-o-y). Retail advances rose by 16% y-o-y, while business banking rose by 13% y-o-y. However, PAT stood at Rs. 408 crore, impacted by a significant rise in provisions, taken on a prudential basis. Net interest margin (NIMs) expanded to 3.22% (to the best in the past five quarters) helped by a CASA Ratio of 34.5%. Strong income performance dragged down the cost to Income (C/I) ratio to 49.82%, down 258 bps YoY. Asset quality performance was steady, with GNPA/NNPA declining to 2.71% / 0.6% (from Q2 FY21 2.84%/0.99%), with negligible slippages (due to court order). including the proforma slippages, GNPA & NNPA ratio would have been 3.38% & 1.14% respectively. During Q3FY21, the bank strengthened provision coverage ratio (PCR) to 77.10%, an increase of 1245 bps q-o-q; PCR including proforma slippages would have been 66.12%. We believe that the bank is better placed in terms of book quality, with 95% collection efficiency, and ~76% of wholesale borrowers rated 'A and above' by external ratings. We believe that the asset quality picture has improved incrementally and going forward we expect credit cost outlook to be manageable, 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. 95.

Key positives

- Improvement in Granular Liability Franchise with Retail Deposits now is at 92% of Total Deposits; CASA grew by 23% YoY and CASA Ratio improved to 34.48%;
- NIMs expanded y-o-y by 22 bps to 3.22%, indicating benefits of CASA traction
- NII rose by 24% y-o-y to a record high of Rs. 1,437 crore, much higher as compared to a loan growth of 6% y-o-y

Key negatives

- Credit costs sharply rose by 69 bps q-o-q to 1.24% due to large corporate account

Our Call

Valuations: Federal Bank trades at 0.9x/0.8x FY22E/FY23E BVPS which we believe is reasonable. Factors such as a rising focus on retail book, adequate capitalisation (Tier-1 at 13%), and incremental lending to better-rated borrower(s) are positives. The management indicated growth may return in Q4 FY21E, and we believe that 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. 95.

Key Risks

Uncertainty 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	6,130.8	7,072.2
Net profit	1,243.9	1,542.8	1,431.9	2,041.9	2,511.9
EPS (Rs)	6.3	7.7	7.4	10.6	13.0
PE (x)	12.3	10.0	10.4	7.3	6.0
Book value (Rs/share)	65.6	71.5	79.3	87.4	97.3
P/BV (x)	1.2	1.1	1.0	0.9	0.8
RoE (%)	9.7%	11.1%	9.5%	12.5%	13.9%
RoA (%)	0.78%	0.85%	0.70%	0.86%	0.90%

Source: Company; Sharekhan estimates

Key Concall Highlights:

- Fee Income grew owing to higher business banking, corporate banking, fee derived from arrangement with Equirus and cross selling of products such as insurance, mutual funds
- SMA 1&2 was 60-70 bps higher than the pre-COVID levels (of 2.5%)
- Restructuring book has improved significantly due to withdrawal of request from customer. Amount of loans to be restructured decreased by ~55% to Rs. 1800 crore on y-o-y basis.
- Management guidance for NIM hovered at 3.15-3.30% in near future. Any expansion in NIMs in future would be on account of higher margin business such as credit cards and microfinance business.
- Proforma slippages stood at Rs. 73 crore, while normal slippages would touch Rs. 400 crore at year-end with a quarterly run rate of Rs. 100 crore.
- Collection efficiency remained intact at 95%
- A phenomenal jump in gold loans was the highlight of the quarter; indicator grew by 67% y-o-y and 15.76% q-o-q.
- Large portion of restructuring would be secured portfolio comprises of home loan & loan against properties in ratio of 55% & 45% respectively. Most of the home loan customer is a salaried person hence to maintain liquidity they have opted for restructuring.
- Asset quality has seen improvement with GNPA & NNPA at 2.71% and 0.6% while on proforma basis it has slightly increased to 3.38% /1.14 respectively.
- Management contemplates to grow at a rate of 8-10% in the near term on backdrop of economic recovery. Gold loan would be the key driver along with segment. Credit card business to operationalise by March-April 2021.
- Management is cautious about building corporate book at this moment due to stretch working capital cycle of corporate and opaqueness in earnings cycle.
- Disbursement through ECLGS stood at Rs. 2600 crore mainly driven by the ECLGS 1 scheme.
- Provision is likely to be 15-20% on restructured book.
- Employee cost increased by Rs. 30 crore during the quarter on account of retiring employees.
- No immediate fund-raising plans; however, management may plan to mop up funds during second half of 2021. Capital adequacy ratio is quite comfortable.
- CASA to remain between 33.5% and 34%

Results — Rs cr

Particulars	Q3FY21	Q3FY20	YoY (%)	Q2FY21	QoQ (%)
Interest earned	3459.52	3330.36	3.9	3487.9	-0.8
Interest expended	2022.48	2175.43	-7.0	2108.05	-4.1
Net interest income	1437.04	1154.93	24.4	1379.85	4.1
Non-interest income	481.84	407.86	18.1	509.33	-5.4
Net total income	1918.88	1562.79	22.8	1889.18	1.6
Operating expenses	955.98	818.97	16.7	882.65	8.3
- Employee cost	525.64	414.76	26.7	487.46	7.8
- Other Costs	430.34	404.21	6.5	395.19	8.9
Pre-provisioning profit	962.9	743.82	29.5	1006.53	-4.3
Provisions	420.62	160.86	161.5	592.06	-29.0
Profit before tax	542.28	582.96	-7.0	414.47	30.8
Tax	138.18	142.32	-2.9	106.85	29.3
Profit after tax	404.1	440.64	-8.3	307.62	31.4
Gross NPA (%)	2.71	3.07	-36 bps	2.84	-13 bps
Net NPA (%)	0.6	1.59	-99 bps	0.99	-39 bps

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 ~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 an 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.

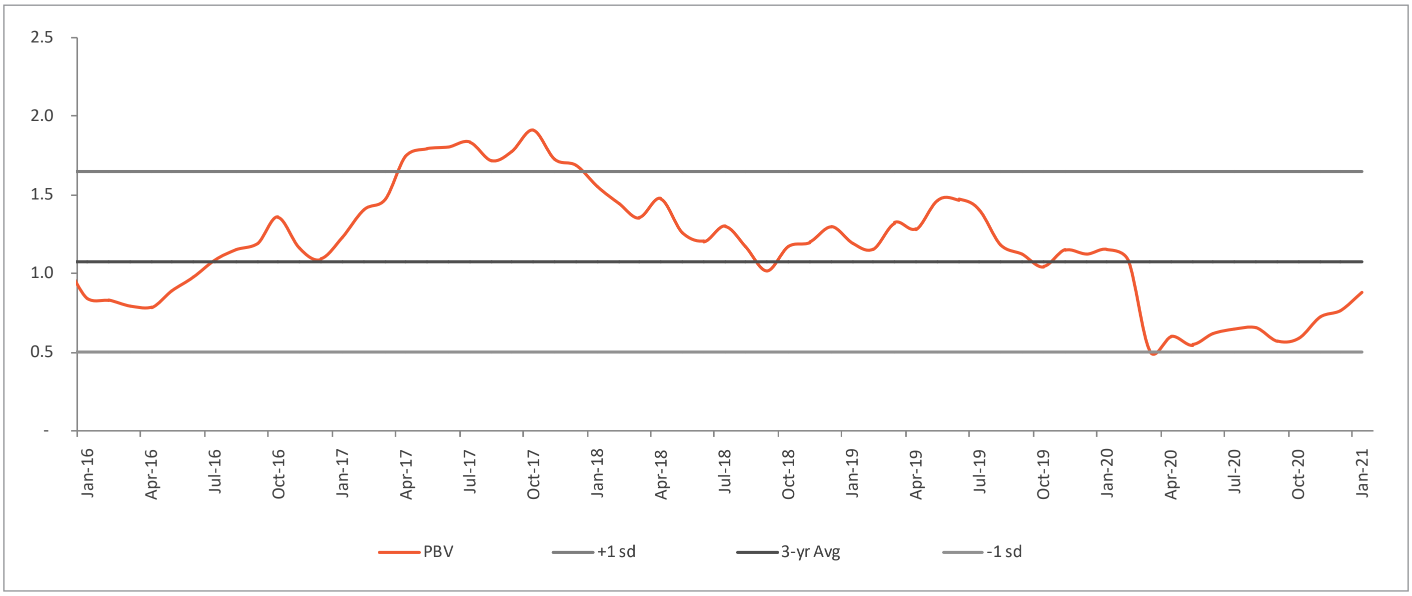
Company outlook - Promising outlook

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. 95

Federal Bank trades at 0.9x/0.8x FY22E/FY23E BVPS which we believe is reasonable. Factors such as a rising focus on retail book, adequate capitalisation (Tier-1 at 13%), and incremental lending to better-rated borrower(s) are positives. The management indicated growth may return in Q4 FY21E, and we believe that 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. 95.

One-year forward P/BV (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP	P/BV (x)		P/E (x)		RoA (%)		RoE (%)	
		FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Federal Bank	77	1.0	0.9	10.4	7.3	0.7	0.9	9.5	12.5
City Union Bank	175	2.2	1.9	23.4	16.6	1.0	1.3	9.9	12.6
Indusind Bank	948	1.8	1.6	23.8	13.6	0.9	1.5	7.9	12.3
RBL Bank	254	1.2	1.1	26.2	12.7	0.6	1.1	4.8	8.8

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 and delay in economic recovery poses risks to bank's profitability in the 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. Baby K P	Exec VP/Head :Treasury
Mr. Ashutosh Khajuria	Executive Director

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Franklin Resources Inc	6.8
2	ICICI Prudential Asset Management	6.1
3	ICICI PRUDENTIAL ASSET MGM	4.8
4	Life Insurance Corp of India	4.5
5	YUSUFFAL MUSALIAM VEETIL	3.9
6	HDFC Life Insurance Co Ltd	3.1
7	Jhunjhunwala Rakesh	2.7
8	Vanguard Group Inc/The	2.6
9	HDFC Asset Management Co Ltd	2.5
10	East Bridge Capital Master Fund	2.4

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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