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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 41.69

Updated Jan 08, 2022

Severe Risk

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

Source: Morningstar

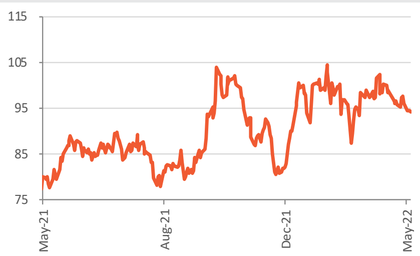
Company details

Market cap:	Rs. 19,065 cr
52-week high/low:	Rs. 108 / 77
NSE volume: (No of shares)	162.5 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Free float: (No of shares)	199.0 cr

Shareholding (%)

Promoters	-
FII	26.0
DII	43.3
Others	30.7

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-7.1	-8.1	-9.9	15.2
Relative to Sensex	-2.8	-2.9	0.1	1.8

Sharekhan Research, Bloomberg

Stock Update

Result Update

Federal Bank

Weak operational performance

Bank	Sharekhan code: FEDERALBNK		
Reco/View: Buy ↔	CMP: Rs. 91	Price Target: Rs. 110 ↓	

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Federal Bank reported weak operating performance; PAT at Rs. 541 crore was in line with consensus and our estimates mainly due to lower total credit cost (0.2% of average advances) for Q4FY2022.
- Net interest income grew mutedly by 7% y-o-y and declined by 1% q-o-q, trailing advances growth of 10% y-o-y, mainly due to reduction in NIM (by 11 bps q-o-q) reported at 3.16%. NIMs reduced due to fall in advances yield by 12 bps q-o-q.
- Core operating profit grew by only 1% y-o-y and declined by 7% q-o-q due to higher opex (3.3% of average advances) and lower NII. Asset quality improved with GNPA/NNPA declining by 26bps/9bps q-o-q to 2.80%/3.06% due to higher write-offs.
- The stock currently trades at 1.1x and 1.0x its FY2023E and FY2024E ABV, which we believe is reasonable, given the return profile. We maintain Buy with a revised PT of Rs. 110.

Federal Bank reported weak operating performance for Q4FY2022. Net interest income (NII) witnessed muted growth of 7% y-o-y and declined by 1% q-o-q mainly due to net interest margin (NIM) reducing by 11 bps q-o-q reported at 3.16%. NIM reduction was led by a 12-bps q-o-q decline in advances yield. Core fee income grew robustly by 25% y-o-y and 10% q-o-q. Other income was lower by 84% y-o-y due to lower treasury gains and loss on revaluation of security receipts. Total operating expenses grew by 19% y-o-y/8% q-o-q due to higher staff cost (21% y-o-y) impacted by family pension cost, increasing tech spends, and higher business volumes. Cost-to-income ratio was reported at 60% in Q4FY2022 versus 55% in Q3FY2022. Core PPoP grew by only 1% y-o-y and declined by 7% q-o-q due to higher opex and muted NII. Provisions were lower by 65% y-o-y. Core credit cost was reported at 0.27% in Q4FY2022 versus 0.22% in Q3FY2022. PAT grew by 13% y-o-y and 4% y-o-y on account of lower total credit cost. Advances and deposits grew by 10% y-o-y/5% y-o-y and 3% q-o-q/4% q-o-q. Retail (excluding agri and BB), agri, and business banking (SME) grew by 6% y-o-y, 20% y-o-y, and 15% y-o-y, respectively. Wholesale book grew by 8% y-o-y. The bank's asset quality improved during the quarter, with GNPA ratio and NNPA ratio declining by 26 bps q-o-q and 9 bps q-o-q, respectively, to 2.80% and 0.96% due to higher write-offs.

Key positives

- CA and SA grew by 18% y-o-y and 14% y-o-y. CASA ratio stood at 37% in FY2022 versus 34% in FY2021.

Key negatives

- Muted NII and higher opex led to below-par growth in core PPoP.
- Loan growth at par/slightly below the industry's growth rate.

Management Commentary

- Management expects higher opex growth to normalize in FY2023E, targeting C/I ratio at 50-51% versus 54% in FY2022.
- The bank is targeting mid-teen growth (~15%) in loan book for FY2023E versus 10% in FY2022. Management focuses to grow retail faster in a granular manner along with targeting CASA growth of 17-18%.

Our Call

Valuation – We maintain our Buy rating on Federal Bank with a revised PT of Rs. 110: At the CMP, the stock currently trades at 1.1x and 1.0x its FY2023E and FY2024E ABV, which we believe is reasonable. Factors such as its digital initiatives and improving loan book quality with higher-rated corporate book 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 should improve further with better risk management practices and higher collection efficiencies across segments. Focus to grow assets and liability in a granular manner with calibrated risk approach should augur well for the bank going ahead.

Key Risks

Economic slowdown due to which slower loan growth and higher-than-anticipated credit cost especially from the retail book and SME portfolio could affect earnings.

Valuation Rs cr

Particulars	FY21	FY22	FY23E	FY24E
NII	5,534	5,962	6,986	7,954
PAT	1,590	1,890	2,560	2,917
EPS (Rs.)	7.9	9.1	12.2	13.9
P/E (x)	11.5	10.0	7.5	6.5
P/BV (x)	1.3	1.2	1.1	1.0
RoA (%)	0.8	0.9	1.1	1.1
RoE (%)	10.4	10.8	13.0	13.0

Source: Company; Sharekhan estimates

Key result highlights

- **Muted NII growth, however robust core fee income:** NII witnessed muted growth of 7% y-o-y and declined by 1% q-o-q mainly due to 11-bps q-o-q reduction in NIM reported at 3.16%. NIM reduction was led by 12-bps q-o-q fall in advances yield. There was an interest reversal in agri portfolio due to GNPA (impact was 5-6 bps on yields). Core fee income grew robustly by 25% y-o-y and 10% q-o-q. Higher core fee income accrued from higher product distribution business during the quarter. Other income was lower by 84% y-o-y due to lower treasury gains and loss on revaluation of security receipts.
- **Higher opex to normalise in the medium term:** Total operating expenses grew by 19% y-o-y/8% q-o-q due to higher staff cost (21% y-o-y), which was impacted by one-off item (Pension cost ~Rs. 140 crore), increasing tech spends, and higher business volumes. C/I ratio during the quarter was reported at 60% versus 55% in Q3FY2022. The bank guided that opex cost (ex-one off) would normalise over the medium term. C/I ratio guided for FY2023E is 50-51% versus 54.3% in FY2022.
- **Lower credit cost reported:** Total provisions were lower by 65% y-o-y on account of net standard account provisions write-back after adjusting write-off at Rs. 40 crore. Core credit cost for FY2022 was 45 bps. The bank expects to manage credit cost at current levels.
- **Asset quality improves due to higher write-offs:** The bank's asset quality improved during the quarter with GNPA ratio and NNPA ratio declining by 26 bps q-o-q and 9 bps q-o-q, respectively, to 2.80% and 0.96% in Q4FY2022 mainly due to higher write-offs during the quarter at Rs. 246 crore versus Rs. 7 crore in Q3FY2022. Gross slippages stood at Rs. 399 crore versus Rs. 453 crore. Slippages were higher in agri portfolio on q-o-q. Upgrades and recovery amounted to Rs. 417 crore in Q4FY2022 versus Rs. 491 crore in Q3FY2022. PCR stood at 66%. Restructuring book stood at Rs. 3,536 (~2.44% of advances) versus Rs. 3,723 (~2.65% of the loan book) in Q3FY2022.
- **Advances growth at par/slightly below industry growth:** Advances grew by 10% y-o-y/3% q-o-q. Retail (excluding agri and BB), agri, and business banking (SME) grew by 6% y-o-y, 20% y-o-y, and 15% y-o-y, respectively. Wholesale corporate book grew by 8% y-o-y. The bank is targeting mid-teen growth (~15%) in loan book for FY2023E versus 10% in FY2022. The bank is cautious on corporate loans because of intense pricing competition. Management focuses to grow retail book faster in a granular manner led by mortgages. Fintech engagement is higher.
- **Deposits:** Deposits grew by 5% y-o-y/4% q-o-q. CA and SA grew by 18% y-o-y and 14% y-o-y. CASA ratio stood at 37% in FY2022 versus 34% in FY2021. The bank intends to grow retail liability in a granular manner along with targeting CASA growth of 17-18%.
- **Return profile ahead:** The bank has guided ROA for FY2023E to be ~1.1% versus 0.94% in FY2022.

Results Rs cr

Particulars	4Q FY22	4Q FY21	3Q FY22	Y-o-Y %	Q-o-Q %
Interest Inc.	3,483	3,366	3,443	3%	1%
Interest Expenses	1,958	1,946	1,904	1%	3%
Net Interest Income	**1,525**	**1,420**	**1,539**	**7%**	**-1%**
NIM (%)	3.16	3.23	3.27	-2%	-3%
Core Fee Income	453	362	412	25%	10%
Other Income	12	74	72	-84%	-83%
Net Income	**1,990**	**1,856**	**2,023**	**7%**	**-2%**
Employee Expenses	637	525	583	21%	9%
Other Opex	555	475	526	17%	6%
Total Opex	**1,192**	**1,001**	**1,109**	**19%**	**8%**
Cost to Income Ratio	59.9%	53.9%	54.8%		
Pre-Provision Profits	**798**	**856**	**914**	**-7%**	**-13%**
Provisions & Contingencies - Total	75	213	214	-65%	-65%
Profit Before Tax	**723**	**643**	**700**	**12%**	**3%**
Tax	182	165	179	11%	2%
Effective Tax Rate	25%	26%	26%		
Reported Profits	**541**	**478**	**522**	**13%**	**4%**
Basic EPS (Rs.)	2.57	2.4	2.5	8%	4%
Diluted EPS (Rs.)	2.55	2.4	2.5	7%	4%
RoA (%)	1.0	1.0	1.04		
Advances	1,44,928	1,31,879	1,40,743	10%	3%
Deposits	1,81,701	1,72,644	1,75,432	5%	4%
Gross NPA	**4,137**	**4,602**	**4,401**	**-10%**	**-6%**
Gross NPA Ratio (%)	2.8	3.41	3.06		
Net NPA	**1,393**	**1,569**	**1,471**	**-11%**	**-5%**
Net NPAs Ratio (%)	0.96	1.19	1.05		
PCR - Calculated	66.3%	65.9%	66.6%		

Source: Company; Sharekhan Research

Outlook and Valuation

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

System-level credit offtake grew by ~10% y-o-y in the fortnight ending April 8, 2022, indicating a gradual pick up in loans given the distinct signs of improved economy and revival of investments and loan demand. On the other hand, deposits rose by ~9%, which reflect a healthier economic scenario. Moreover, the RBI's accommodative monetary policy stance, resulting in surplus liquidity, provides succour in terms of easy availability of funds. 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 higher 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 well placed to capture growth opportunities.

■ Company outlook – Evolving as a strong business franchise over the long term

Federal Bank is evolving as a strong business franchise with higher capitalisation and is displaying improving asset-quality trend. 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 payment platforms, neo banks, and fintech companies across its assets and liabilities. This enables the bank to lower its acquisition costs and increase revenue share. 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 building a strong balance sheet and improving asset quality, which will help it tide over future challenges.

■ Valuation – We maintain our Buy rating on Federal Bank with a revised PT of Rs. 110.

At the CMP, the stock currently trades at 1.1x and 1.0x its FY2023E and FY2024E ABV, which we believe is reasonable. Factors such as its digital initiatives and improving loan book quality with higher-rated corporate book 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 should improve further with better risk management practices and higher collection efficiencies across segments. Focus to grow assets and liability in a granular manner with calibrated risk approach should augur well for the bank going ahead.

Peer valuation

Particulars	CMP (Rs / Share)	MCAP (Rs Cr)	P/E (x)		P/B (x)		RoE (%)		RoA (%)	
			FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
Federal Bank	91	19,065	7.5	6.5	1.1	1.0	13.0	13.0	1.1	1.1
City Union Bank	126	9,308	9.2	8.0	1.3	1.2	14.2	13.9	1.6	1.7
IndusInd Bank	917	71,011	8.2	6.9	1.3	1.1	15.9	17.2	2.0	2.2

Source: Company, Sharekhan estimates

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 1,282 branches and 1,885 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

Economic slowdown due to which slower loan growth and higher-than-anticipated credit cost especially from the retail book and SME portfolio could affect earnings.

Additional Data

Key management personnel

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