Stock Update

Company Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

# Federal Bank

## Business momentum gaining traction, valuation reasonable

| Banks | Sharekhan code: FEDERALBNK |
|---|---|

| Reco/View: Buy | ↔ | CMP: **Rs. 117** | Price Target: **Rs. 140** | ↑ |
|---|---|---|---|---|

↑ 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 July 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. 24,621 cr |
| 52-week high/low: | Rs. 118 / 78 |
| NSE volume: (No of shares) | 137 lakh |
| BSE code: | 500469 |
| NSE code: | FEDERALBNK |
| Free float: (No of shares) | 200 cr |

### Shareholding (%)

| | |
|---|---|
| Promoters | - |
| FII | 26.0 |
| DII | 43.3 |
| Others | 30.7 |

### Price chart


### Price performance

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 9.3 | 30.0 | 20.6 | 44.4 |
| Relative to Sensex | 5.9 | 23.5 | 14.8 | 39.8 |

*Sharekhan Research, Bloomberg*


**Summary**

- Federal Bank expects to sustain healthy performance led by an improved loan growth outlook (16-18%), steady asset quality performance, and in turn lower core credit cost. The bank has guided for credit cost ~60 bps.
- The bank indicated that the loan growth is expected to be broad-based across Retail, Agri, Corporate & SME. The focus is to maintain a strong granular liability franchise.
- A higher mix of floating loans, improving credit-deposit (CD) ratio and higher retail deposits will support margins in a rising interest rate environment.
- At CMP, the stock trades at 1.2x and 1.1x its FY2023E and FY2024E ABV, which we believe is reasonable, given the improved return ratio outlook. We maintain Buy with a revised PT of Rs. 140.


**Our interaction with the management of Federal Bank reaffirmed our expectations of sustaining healthy performance going ahead, led by an improved loan growth outlook, steady asset quality performance, and in turn lower core credit costs. The bank has guided for credit costs at ~60 bps. With a higher-rated corporate book and continued focus to increase its retail mix with higher-yielding businesses such as commercial vehicles, credit cards, personal loans, and microcredit are expected to augur well for the bank's growth going ahead. Asset quality should improve further with better risk management practices (tighten after the pandemic) and higher collection efficiencies across segments. On the margin front, bank believes that higher mix of floating loans, improving CD ratio and higher CASA will support margin in a rising interest rate environment. Fintech partnership & digital platforms are helping in gaining more traction in the card business, and personal loans. CV/CE, gold loans and microloans.**

**Margins expected to improve:** We expect improvement in net interest margin in the near to medium term driven by – a. Floating rate loans to reprice faster (the share of floating rate loans and repo-linked loans within that has improved sharply for the bank – EBLR -48%; MCLR- 28% & 28% fixed rate loans) and also they are repriced at T+1 interval, while liabilities are expected to reprice with lag and with less quantum; b. Improvement in low-cost granular deposit base; c. Gradual traction in high-margin, unsecured segments. Bank has guided for a 3.25-3.27% margin band for FY23E.

**Steady asset quality performance & in turn lower credit cost:** Over the past years, the bank has been building its loan mix towards higher-rated corporates and secured retail loans. The share of 'A and above' rated loans has risen to 78% in 1QFY23 as compared to 73% in FY19. However, restructured book stands higher compared to peers at ~2.2% of loans and there were higher slippages, especially from the retail segment which was a concern. Bank had earlier guided that expected slippages from the restructured book could be ~20-25%. Management guided that they are witnessing a significant reduction in expected slippages assumptions which they took earlier, and they are witnessing healthy recoveries from the same. There are no chunky or large stressed exposures in a corporate segment which are yet to be recognized. They are also witnessing improvement in collection efficiency across segments. This should prevent a sharp rise in slippages and in turn lower credit costs.

### Our Call

**Valuation – Maintain Buy rating on Federal Bank with a revised PT of Rs. 140:** At the CMP, the stock currently trades at 1.2x and 1.0x its FY2023E and FY2024E BV, which we believe is reasonable. Factors such as better digital capabilities, sustaining healthy loan growth outlook, stable asset 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 microcredit are expected to augur well for the bank's growth going ahead. Asset quality should improve further with better risk management practices and higher collection efficiencies across segments. Focus on growing assets and liabilities in a granular manner along with an improved return ratio outlook should augur well for the bank going ahead. key monitorable would be slippages from the restructured book.

### Key Risks

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

**Valuation (Standalone)** Rs cr

| Particulars | FY21 | FY22 | FY23E | FY24E |
|---|---|---|---|---|
| NII | 5,534 | 5,962 | 7,206 | 8,403 |
| PAT | 1,590 | 1,890 | 2,559 | 2,918 |
| EPS (Rs) | 7.9 | 9.1 | 12.2 | 13.9 |
| P/E (x) | 14.7 | 12.9 | 9.6 | 8.4 |
| P/ABV (x) | 1.4 | 1.3 | 1.2 | 1.1 |
| RoE (%) | 10.4 | 10.8 | 12.7 | 12.8 |
| RoA (%) | 0.8 | 0.9 | 1.1 | 1.1 |

*Source: Company; Sharekhan estimates*

## Key takeaways from management interaction

**Improved loan growth outlook:** The bank is targeting a 16-18% growth in loan book for FY2023E versus 10% in FY2022. The loan growth is expected to be broad-based across Retail, Agri, SME and Corporate segment. Bank guided that credit growth has been picking up well and it is broad-based. On the corporate side, demand for credit has picked up due to more capacity utilization & inflationary pressure. The demand trajectory is expected to be strong going forward. Fintech & digital platforms to help in gaining more traction in the card business, personal loans, CV/CE, gold loans and microloans. The unsecured segment is expected to grow after the cautious stance earlier.

**Building strong granular and low-cost Liability franchise:** CASA and Retail TD (less than Rs. 2 Crore) constitutes ~94% of total deposits. CASA ratio improved from 32% in FY19 to 37% in FY22. CASA grew at a CAGR of 15% in FY19-22. However, term deposit growth has been muted. The bank is confident to improve term deposit growth (some part of growth may be attributable to rate hikes) going ahead and the focus is to cross-sell liability products in the Corporate and SME segment to garner low-cost CASA. The bank also intends to grow its liability franchise in a granular manner focusing on branch expansion to garner low-cost deposits.

**Better positioned to manage margins in a rising interest rate cycle:** We expect improvement in net interest margin in the near to medium term driven by – a. Floating rate loans to reprice faster (the share of floating rate loans and repo-linked loans within that has improved sharply for the bank – EBLR -48%; MCLR- 28% & 28% fixed rate loans) and also they are repriced at T+1 interval, while liabilities are expected to reprice with lag (except saving account balances which get repriced at T+1 interval but with less quantum) and with less quantum; b. Improvement in low-cost granular deposit base; c. Gradual traction in high-margin, unsecured segments. Bank has guided for a 3.25-3.27% margin band for FY23E.

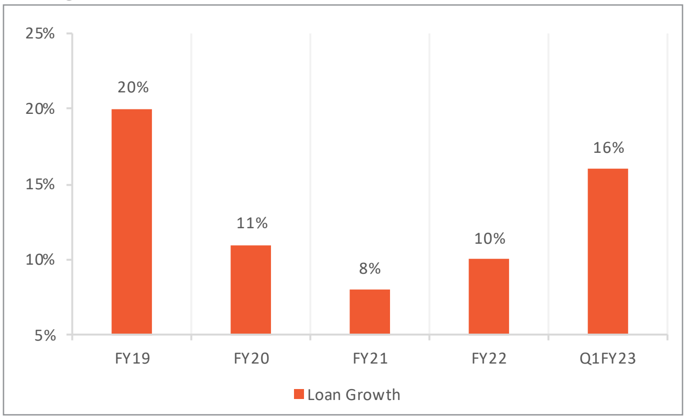
**Steady asset quality performance & in turn lower credit cost:** Over the past years, the bank has been building its loan mix towards higher-rated Corporates and secured Retail loans. The share of 'A and above' rated loans has risen to 78% in 1QFY23 as compared to 73% in FY19. However, restructured book stands higher compared to peers at ~2.2% of loans and there were higher slippages, especially from retail segment which was a concern. Bank had earlier guided that expected slippages from the restructured book could be ~20-25%. Management guided that they are witnessing a significant reduction in expected slippage assumptions which they took earlier, and they are witnessing healthy recoveries from the same. There are no chunky or large stressed exposures in a corporate segment which are yet to be recognized. They are also witnessing improvement in collection efficiency across segments. This should prevent a sharp rise in slippages and in turn lower credit cost

**Accelerated investments for future growth:** The bank continues to make significant investments in building digital and new-age tech capabilities along with fintech partnerships. Bank`s strategy on asset-light branch model, distribution-heavy strategy, and FinTech partnerships are focused on productivity and efficiency gains. Bank has guided for the cost-to-income ratio to moderate to ~48% over 3 years vs currently ~53% which would be ROA accretive as most of the investments are already done. We believe accelerated investments in building digital capabilities and branch networks with asset-light model would bode well for future growth and moderation in cost-to-income ratio over the medium term is positive as it would be ROA accretive.

**Return profile ahead:** The bank has affirmed ROA expectations for FY2023E to be ~1.1-1.15% in the range and expects ~1.25% in FY24E. Bank has already touched ROA of ~1.1% in Q1FY23.

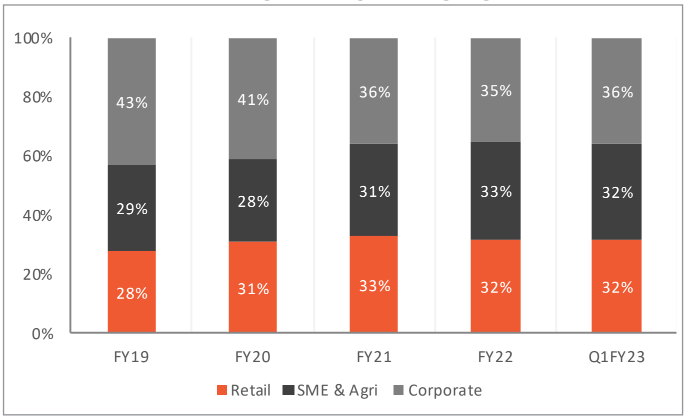
## Financials in charts

### Loan growth has picked up and has been broad based



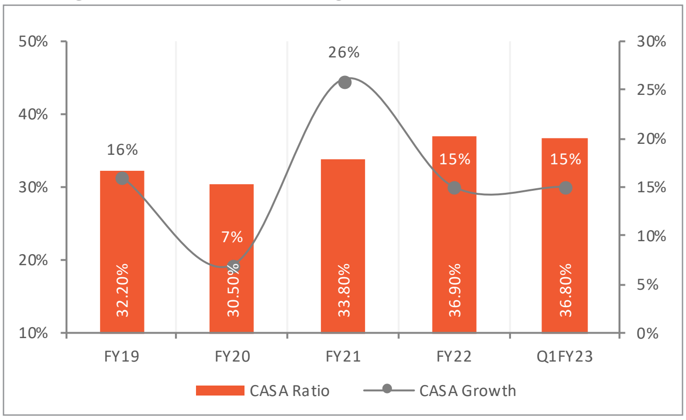

Source: Company, Sharekhan Research

### Share of Retail loans is gradually inching higher



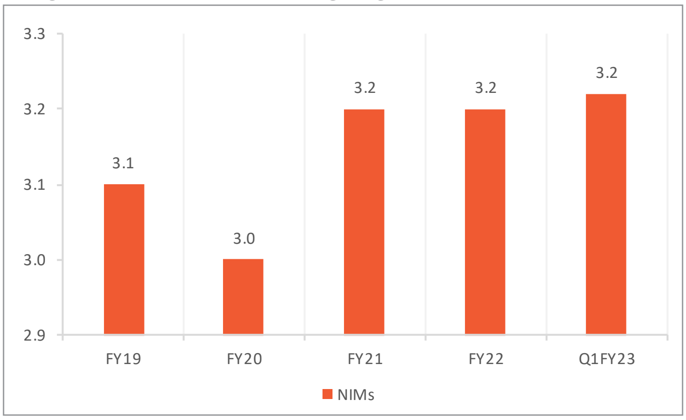

Source: Company, Sharekhan Research

### CASA growth has been healthy



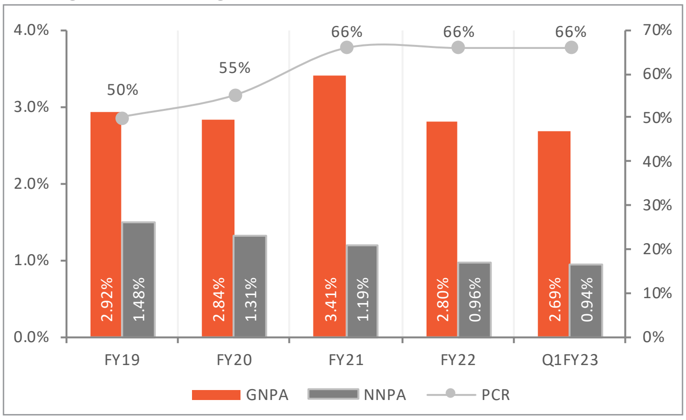

Source: Company, Sharekhan Research

### Margins expected to improve going forward



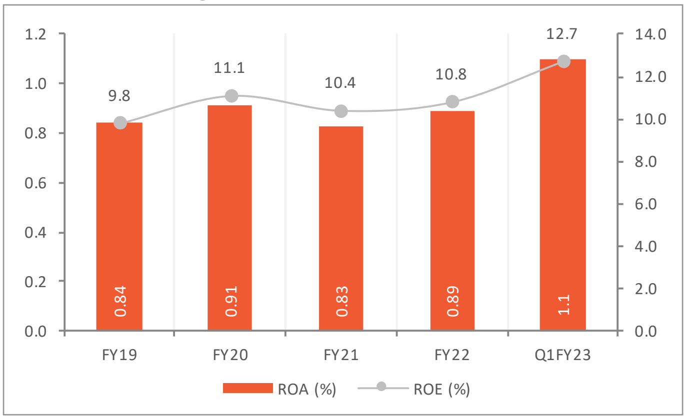

Source: Company, Sharekhan Research

### Steady asset quality




Source: Company, Sharekhan Research

### Return ratios likely to improve from here on




Source: Company, Sharekhan Research

## Outlook and Valuation

### ■ Sector View – Credit growth accelerating; Top private banks placed better

System-level credit offtake grew by ~15.3% y-o-y in the fortnight ending August 12 2022, indicating loan growth has been sustaining given the distinct signs of improving economy and revival of investments and loan demand. On the other hand, deposits rose by ~8.8%, which also reflects a healthier economic scenario but deposit growth was tepid and trailing advances growth. Bottom-up story is intact, we should see loan growth acceleration, and margins would continue to expand in a higher interest rate cycle. Asset quality is not a big issue from the corporate loans end as only deleveraging is being observed and from the retail side, there could be some pressure but nothing significant. Asset quality remains stable except the MFI segment. Banks are in a sweet spot in terms of fundamentals & reasonable valuations. Ithe n past two years, banks have been cautious on lending to BB & below, thus general risk that they are carrying on the corporate portfolio is low. On the retail loans front, due to COVID-19, banks have already seen one downcycle. Most of the exposure have been taken into credit cost. In terms of MSME, we need to be watchful. At present, we believe the banking sector is likely to see higher risk-off behavior, with tactical market share gains for well-placed players. We believe that 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

Federal Bank is evolving as a strong business franchise with displaying improving asset-quality trends and a healthy loan growth outlook. 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 a 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 – Maintain Buy rating on Federal Bank with a revised PT of Rs. 140

At the CMP, the stock currently trades at 1.2x and 1.1x its FY2023E and FY2024E BV, which we believe is reasonable. Factors such as better digital capabilities, sustaining healthy loan growth outlook, stable asset 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 microcredit are expected to augur well for the bank's growth going ahead. Asset quality should improve further with better risk management practices and higher collection efficiencies across segments. Focus on growing assets and liabilities in a granular manner along with an improved return ratio outlook should augur well for the bank going ahead. key monitorable would-be slippages from the restructured book.

**Peer Comparison**

| Companies | CMP (Rs / Share) | MCAP (Rs Cr) | P/E (x) | | P/B (x) | | RoE (%) | | RoA (%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | FY23E | FY24E | FY23E | FY24E | FY23E | FY24E | FY23E | FY24E |
| Federal Bank | 117 | 24,621 | 9.6 | 8.4 | 1.2 | 1.0 | 12.7 | 12.8 | 1.1 | 1.1 |
| IndusInd Bank | 1,107 | 85,806 | 13.1 | 10.7 | 1.6 | 1.4 | 12.9 | 13.7 | 1.5 | 1.6 |

*Source: Company, Sharekhan Research*

## About company

Federal Bank is a private sector bank headquartered in Aluva, Kerala. The bank operates in four segments: treasury operations, wholesale banking, retail banking, and other banking operations. The bank has 1,291 branches and 1,860 ATMs/Recyclers and has its representative offices in 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 restructured portfolio could affect earnings.

## Additional Data

**Key management personnel**

| | |
|---|---|
| Mr. Shyam Srinivasan | Managing Director & CEO |
| Mr. Ashutosh Khajuria | Executive Director |
| 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 |

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | ICICI Prudential Mutual Fund | 5.7 |
| 2 | Franklin Resources | 4.4 |
| 3 | HDFC Asset Management | 4.2 |
| 4 | Nippon Life India Asset Management | 3.8 |
| 5 | HDFC Life Insurance | 2.9 |
| 6 | Vanguard Group | 2.7 |
| 7 | Kotak Asset Management | 2.4 |
| 8 | SBI Fund Management | 2.3 |
| 9 | Tata AIA Life Insurance | 2.2 |
| 10 | DSP Investments | 2.1 |

*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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