Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Federal Bank

Strong Quarter

Banks	Sharekhan code: FEDERALBNK
Reco/View: Buy ↔	CMP: **Rs. 130**
Price Target: **Rs. 155** ↑	

↑ 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 August 08, 2022

Severe Risk

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

Source: Morningstar

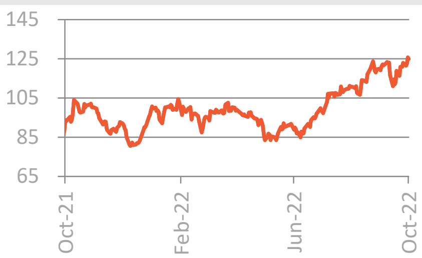
Company details

Market cap:	Rs. 27,468 cr
52-week high/low:	Rs. 130 / 79
NSE volume: (No of shares)	136.7 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Free float: (No of shares)	200.3 cr

Shareholding (%)

Promoters	-
FII	26.2
DII	42.1
Others	31.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	7.4	34.0	31.3	39.8
Relative to Sensex	11.5	25.6	32.0	45.3

Sharekhan Research, Bloomberg

Summary

- Q2FY23 performance was strong with Federal Bank reporting a PAT of Rs. 704 crore (up 53% y-o-y/ 17% q-o-q), which was above consensus and our estimates (+11) driven by healthy loan growth (20% y-o-y / 6% q-o-q), margin expansion (10 bps y-o-y/ 8 bps q-o-q) and higher core fee income growth (45% y-o-y/ 22% q-o-q).
- Operating profits grew robustly by 40.2% y-o-y /24.5% q-o-q aided by strong net interest income (NII) growth (19% y-o-y/ 10% q-o-q) and higher core fee income despite higher opex (2% of Avg. assets versus 1.9% in last quarter).
- Slippages stood at Rs.390 crore down 15.8% qoq, led by 40% QoQ reduction in retail segment. Asset quality sharply improved with GNPAs/NNPAs ratio declining by 23 bps/16 bps q-o-q to 2.46%/0.78%. PCR stood at ~68.7% vs 65.8% QoQ while restructured book remained flat QoQ at Rs. 3,892 crore (2.4% of loans).
- At CMP, the stock trades at 1.3x and 1.1x its FY2023E and FY2024E BV, which we believe is reasonable, given the improved return ratio outlook. We maintain Buy with a revised PT of Rs. 155.

Federal Bank reported strong performance for Q2FY2023, which were above consensus/ our estimates. Net interest income (NII) grew robustly by 19% y-o-y and 10% q-o-q, driven by healthy net advances growth of 20% y-o-y/ 6% QoQ and improvement in NIMs by 8 bps QoQ/ 10 bps y-o-y reported at 3.3%. Core fee income grew by 45% y-o-y / 22% q-o-q supported by cards business and strong business activity. Healthy loan growth is supporting fee income across corporate & retail. Other income dropped 3% y-o-y. Total operating expenses were higher by 9% y-o-y /7% q-o-q. Opex to Avg. assets stood at 2.0% versus 1.9% in the past quarter. Operating Profits (PPoP) grew robustly by 40% y-o-y and 25% q-o-q led by healthy NII and core fee income growth. Total Provisions were up by 9% y-o-y/ 61% QoQ. Core credit cost reported at 52 bps vs 40 bps in Q1FY23. PBT grew by 52% y-o-y and 17% q-o-q on account of healthy PPoP and contained core credit cost. Net advances grew by 20% y-o-y/6.3% q-o-q. Retail advances grew by 18.7% y-o-y vs 16.5% in last quarter and among retail loans, housing, business banking (SME) and agri-loan books constituting 67% of the total retail loans, grew by 18% y-o-y, 17% y-o-y & 18% y-o-y respectively. Under the wholesale segment, Commercial banking grew by 19% while corporate book grew by 21% y-o-y. Deposits growth trailed advances growth. Overall Deposits grew by 10% y-o-y/ 3.2% QoQ while CASA balance grew by 10.7% y-o-y vs 14.6% y-o-y in last quarter. CASA ratio stands at 36.4% vs 36.2% in Q2FY22. Slippages reported were down by 15.8% q-o-q at Rs. 390 crore. The restructured book stood at 2.4% of Avg loans vs 2.6% q-o-q. The bank's asset quality improved during the quarter, with GNPA and NNPA ratios declining by 23 bps q-o-q and 16 bps q-o-q, respectively, to 2.46% and 0.78% led by modest slippages, higher recoveries, upgrades and coupled with higher write-offs. PCR at ~69% vs ~66% in last quarter.

Key positives

- Strong loan growth along with improvement in margins with healthy NII growth and higher core fee income growth.
- Slippages were lower 16% q-o-q. Asset quality improved sharply sequentially.
- Return ratio improved; ROA touched ~1.2%.

Key negatives

- Opex was higher. Opex to average assets reported at 2.0% vs 1.9% in last quarter.
- CASA growth moderated and overall deposits growth is trailing the advances growth.

Management Commentary

- The bank has affirmed ROA expectations for FY2023E to be ~1.25% vs earlier of ~1.15% and expect >~ 1.25% in FY24E. The bank has already touched an ROA of ~1.2% in Q2FY23. The bank is guiding for NIMs to be in the range of 3.25%-3.27% and overall credit cost to be at 50-55 bps for FY23E
- Bank is also expected to sustain high mid-teens growth in advances & low mid-teens growth in deposits for FY23E. Fintech & digital platforms are expected to help in gaining more traction in card business, personal loans. CV/CE, gold loans and micro loans.

Revision in estimates – We have increased our FY2023E/24E earnings estimates factoring in higher margins & higher core fee income. Moreover, we have introduced FY25E numbers.

Our Call

Valuation – Maintain Buy rating on Federal Bank with a revised PT of Rs. 155: Federal Bank reported strong beat in performance in Q2FY23 driven by strong NII growth, margin expansion and core fee income . 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 and an improved return ratio outlook should augur well for the bank going ahead. At the CMP, the stock currently trades at 1.3x and 1.1x its FY2023E and FY2024E BV, which we believe is reasonable. Key monitorables would-be slippages from the restructured book and low-cost deposit mobilization.

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	FY22	FY23E	FY24E	FY25E
Net Interest Income	5,962	7,285	8,421	9,406
Net profit	1,890	2,793	3,132	3,638
EPS (Rs)	9.1	13.3	14.9	17.3
P/E (x)	14.3	9.8	8.7	7.5
P/BV (x)	1.5	1.3	1.1	1.0
RoE	10.8	13.8	13.5	13.7
RoA	0.9	1.2	1.2	1.2

Source: Company; Sharekhan estimates

Key result highlights

Strong NII growth led by margin improvement and accelerated loan growth: Net interest income (NII) grew by 19.1% y-o-y and 9.8% q-o-q led by healthy net advances growth of 20.0% y-o-y/ 6.3% QoQ and improvement in NIMs. Net interest margins improved by 10 bps y-o-y/ 8 bps q-o-q to 3.3%. Bank has guided for 3.25-3.3% margin band for FY23E. Core fee income grew by 45% y-o-y / 22.4% QoQ driven by healthy loan growth across wholesale and retail segment.

Core Credit cost guidance: Core credit cost reported for the quarter was 52 bps vs 40 bps sequentially. Bank has guided for 50 -55 bps core credit cost for FY2023E. Core credit cost was higher as coverage has increased by 300 basis points q-o-q.

Asset quality expected to be stable: Bank guided for asset quality outlook to remain stable going forward. Asset quality improved during the quarter with GNPA and NNPA ratios declining by 23 bps q-o-q and 16 bps q-o-q, respectively, to 2.46% and 0.78%. Total slippages stood at Rs. 390 crore (1.0% of average advances) vs Rs. 463 crore q-o-q down by 16% q-o-q. Overall, in H2FY23, the bank expects ~Rs. 1,000 crore slippages. Asset quality is holding up well across retail, commercial banking & corporate banking. Upgrades and recovery amounted to Rs.329 crore versus Rs. 281 crore in the past quarter. Write offs stood at Rs.185 crore versus Rs.163 crore q-o-q. PCR stood at ~69% vs 66% in the past quarter. Restructured book stood at Rs. 3,892 crore (~2.4% of advances) versus Rs. 3,900 crore (~2.6% of advances) in Q1FY2023.

Bank expect to sustain high mid-teens growth in advances: Net Advances grew by 20.0% y-o-y/6.3% q-o-q. Retail advances grew by 18.7% y-o-y and among retail, housing, business banking (SME) and agri constituting 67% of total retail loans grew by 18% y-o-y, 17% y-o-y & 18% y-o-y, respectively. Under the wholesale segment, Commercial banking grew by 19% while corporate book grew by 21% y-o-y. Bank said that, credit growth has been picking up well and it is broad based. On the corporate side, there is clear uptick in capex (broad based across sector) & working capital loan demand remain healthy, on the back of which corporate loan is going to sustain ahead. Pricing parity is coming in corporate loans compared to previous period. Demand trajectory is expected to be strong going forward. Fintech & digital platforms to help in gaining more traction in card business, personal loans. CV/CE, gold loans and micro loans. Bank has also started credit card business with NTB customers from September 2022. Credit growth is going to sustain in next 3-4 quarters despite muted growth in deposits due to excess liquidity and some wholesale borrowings.

Mobilisation of low-cost retail deposits is key to sustain asset growth: Deposits grew by 10% y-o-y largely trailing advances growth. CASA balance grew by 10.7% y-o-y. CASA ratio stood at ~36.4%. The bank intends to grow retail liability in a granular manner focusing on branch expansion to garner low-cost deposits along with fintech partnership to help in building retail liability franchise. Nearly 10-12% of incremental deposits coming from Fintech partnerships. The bank also guided that focus would be on pricing term deposits competitively rather than saving deposits.

Return profile ahead: The bank has affirmed ROA expectations for FY2023E to be ~1.25% versus earlier guidance of ~1.15% and expect > ~1.25% in FY24E. Bank has already touched ROA of ~1.2% in Q2FY23.

Results (Standalone) **Rs cr**

Particulars	2QFY23	2QFY22	1QFY22	Y-o-Y	Q-o-Q
Interest Inc.	4,021	3,379	3,629	19%	11%
Interest Expenses	2,259	1,900	2,024	19%	12%
Net Interest Income	**1,762**	**1,479**	**1,605**	**19%**	**10%**
NIM (%)	3.3	3.2	3.22	3%	2%
Core Fee Income	540	373	441	45%	22%
Other Income	70	71	12	-3%	498%
Net Income	**2,371**	**1,924**	**2,057**	**23%**	**15%**
Employee Expenses	516	572	499	-10%	3%
Other Opex	643	487	584	32%	10%
Total Opex	**1,159**	**1,059**	**1,084**	**9%**	**7%**
Cost to Income Ratio	48.9%	55.0%	52.7%		
Pre Provision Profits	**1,212**	**865**	**973**	**40%**	**25%**
Provisions & Contingencies - Total	268	245	167	9%	61%
Profit Before Tax	**944**	**619**	**807**	**52%**	**17%**
Tax	241	159	206	51%	17%
Effective Tax Rate	25%	26%	26%		
Reported Profits	**704**	**460**	**601**	**53%**	**17%**
Basic EPS (Rs)	3.3	2.2	2.9	50%	17%
Diluted EPS (Rs)	3.3	2.2	2.8	50%	17%
RoA (%)	1.2	0.9	1.1		
Advances	**1,61,240**	**1,34,405**	**1,51,689**	**20.0%**	**6.3%**
Deposits	**1,89,146**	**1,71,995**	**1,83,355**	**10.0%**	**3.2%**
Gross NPA	**4,031**	**4,446**	**4,155**	**-9%**	**-3%**
Gross NPA Ratio (%)	2.46	3.24	2.69		
Net NPA	**1,262**	**1,502**	**1,420**	**-16%**	**-11%**
Net NPAs Ratio (%)	0.78	1.12	0.94		
PCR - Calculated	**68.7%**	**66.2%**	**65.8%**		

Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Strong credit offtake; top private banks placed better

System-level credit offtake grew by ~16.3% y-o-y for the fortnight ending September 23, 2022, indicating loan growth has been sustaining, given distinct signs of an improving economy and revival of investments and capex demand. While deposits growth was lower at ~9% y-o-y versus 9.5% in last fortnight. We should see loan growth acceleration sustaining. Margins are likely to improve in a higher interest-rate cycle. Asset quality is not a big issue on the corporate lending end, as only de-leveraging is being observed. From the retail side, there could be some pressure, but nothing is significant. Asset quality is likely to remain stable in the medium term. Banks are in a sweet spot in terms of fundamentals and reasonable valuations. In the past two years, banks have been cautious on lending to the 'BB and below' category, thus the general risk, which 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 has been taken into credit costs. In terms of the MSME book, we need to be watchful. 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

Federal Bank is evolving as a strong business franchise with displaying improving asset-quality trend and 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 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. 155

Federal Bank reported strong beat in performance in Q2FY23 driven by strong NII growth, margin expansion and core fee income. 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 and an improved return ratio outlook should augur well for the bank going ahead. At the CMP, the stock currently trades at 1.3x and 1.1x its FY2023E and FY2024E BV, which we believe is reasonable. Key monitorables would-be slippages from the restructured book and low-cost deposit mobilization.

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	130	27,468	9.8	8.7	1.3	1.1	13.8	13.5	1.2	1.2
IndusInd Bank	1,181	91.572	12.8	10.7	1.7	1.4	13.9	14.5	1.7	1.7

Source: Company, Sharekhan Research

About the 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 1,305 branches and 1,876 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

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Asset Management Co Ltd	5.8
2	HDFC Asset Management Co Ltd	4.5
3	Franklin Resources Inc	4.2
4	Yusuffal Musaliam Veetil	3.6
5	Nippon Life India Asset Management Ltd	3.4
6	HDFC Life Insurance Co Ltd	2.8
7	Vanguard Group Inc	2.7
8	Jhunjhunwala Rakesh	2.6
9	Kotak Mahindra Asset Management Co Ltd	2.6
10	Mirae Assets Global Investment Co Ltd	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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by BNP PARIBAS

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