Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Federal Bank

Business momentum remained strong, but CASA growth below par

Banks	Sharekhan code: FEDERALBNK

Reco/View: Buy	↔	CMP: Rs. 138	Price Target: Rs. 165	↔

↑ 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 Oct 08, 2022

Severe Risk

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

Source: Morningstar

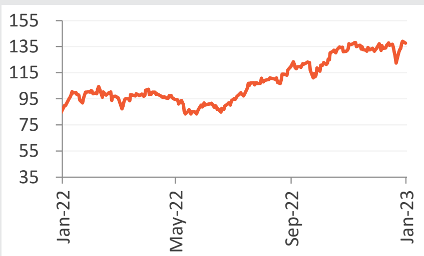
Company details

Market cap:	Rs. 29,154 cr
52-week high/low:	Rs. 142 / 82
NSE volume: (No of shares)	139.9 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Free float: (No of shares)	211.3 cr

Shareholding (%)

Promoters	-
FII	26.4
DII	44.3
Others	29.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	3.8	19.0	45.3	58.6
Relative to Sensex	5.7	10.7	30.0	52.8

Sharekhan Research, Bloomberg

Summary

- Federal Bank released its Q3FY2023 business update, wherein gross advances grew by healthy 19.1% y-o-y to Rs. 1.71 trillion. However, advances growth moderated sequentially to 4.3% vs. 6.2% in Q2FY2023 but still remains healthy.
- Retail credit grew by 19.1% YoY, while wholesale book also posted strong ~19% y-o-y growth. With this, the share of retail in the total loan mix stands at 54% in Q3FY2023.
- Total deposits grew by 14.8% y-o-y/6.5% q-o-q to Rs. 2.0 trillion. Total customer deposits grew by 12.8% y-o-y/5.1% q-o-q, while CASA grew by 7.2% y-o-y/0.2% q-o-q. As a result, CASA ratio declined by 216 bps q-o-q to 34.2%. Growth in term deposit came in at 16.1% y-o-y/8.1% q-o-q vs. 7.2% y-o-y/2.0% q-o-q in Q2FY2023.
- At the CMP, the stock trades at 1.3x/1.2x/1.0x its FY2023E/FY2024E/FY2025E BV. We expect ~1.2% ROA/~14% ROE in FY2025E. We maintain Buy with an unchanged PT of Rs. 165.

Federal Bank posted healthy growth in advances in Q3FY2023, aided by strong growth at the system level. Traction in deposits was also encouraging mainly through term deposits, given stiff competition among banks to garner incremental deposits. However, CASA growth was below par, which led to a decline in CASA ratio to 34.2% vs. 36.4% QoQ. Certificate of deposit grew by 110% YoY, while interbank deposits grew by 43% YoY. CD ratio for the bank declined by ~180 bps QoQ to 84.9% vs. 86.7% in Q2FY2023 due to higher sequential growth in term deposits and other wholesale deposits vs. advances.

- **Strong liability franchise likely to support healthy loan growth:** The bank is targeting ~20% growth in loan book for FY2023E. Loan growth is expected to be broad-based across retail, agri, SME, and corporate segments. CASA and retail TD (less than Rs. 2 crore) constitute ~94% of total deposits. Overall deposits growth has started picking up mainly driven by term deposits and other wholesale deposits. However, CASA growth is still below par at 7.2% y-o-y. The bank aims to strengthen its CASA share by leveraging fintech partnerships and improve the government's business. The bank also has a strong NRI franchise, which enables the bank to build low-cost CASA. The bank is actively engaging in partnerships with neo banks (Epifi and Jupiter), which should help the bank to garner incremental deposits. The bank has guided that it expects these partnerships to contribute ~25% to incremental deposit acquisitions during FY2023.
- **Asset-quality outlook remains stable:** NPL ratios for the bank have improved to multi-year low levels. GNPL and NNPL ratios are at 2.5% and 0.8%, respectively. Provision coverage ratio is at ~69%. Slippage ratio stood at ~1.3% (annualised calculated as a percentage of 12M trailing loans) for H1FY2023. This run-rate is in line with management's guidance. Slippages in the corporate segment have been negligible in the past few quarters. The bank has been building its loan mix towards higher-rated corporates and secured retail loans over the past years. However, the restructured book stands higher compared to peers at ~2.4% of loans. The bank has ~20% coverage on the restructured book.

Our Call

Valuation – Maintain Buy rating on Federal Bank with an unchanged PT of Rs. 165: At the CMP, the stock currently trades at 1.3x/1.2x/1.0x its FY2023E/FY2024E/FY2025E BV. Factors such as focus to build 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 micro credit are expected to augur well for the bank's growth going ahead. Asset quality should remain stable due to the benign credit cycle. Focus on growing assets and liabilities in a granular manner along with an improved return ratio augur well for the bank going ahead. We believe now consistent steady performance could drive re-rating in the stock. Potential value unlocking in Fed Fina (NBFC subsidiary) via an IPO could be an additional catalyst for the stock.

Key Risks

Economic slowdown leading to slower loan growth and higher-than-anticipated credit cost.

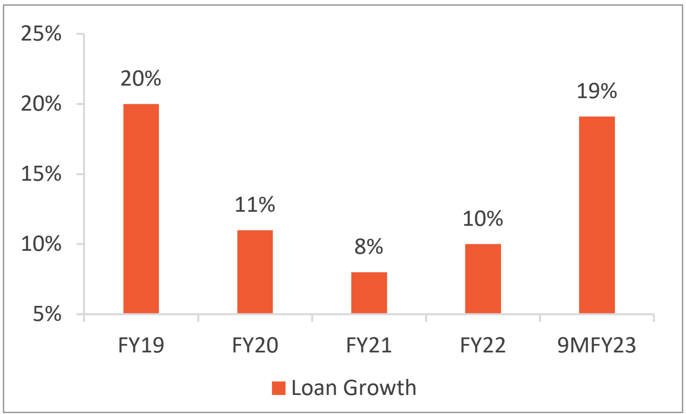
Valuation (Standalone) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
NII	5,962	7,285	8,421	9,406
PAT	1,890	2,793	3,132	3,638
EPS (Rs.)	9.1	13.3	14.9	17.3
P/E (x)	15.1	10.3	9.2	7.9
P/BV (x)	1.5	1.3	1.2	1.0
RoE (%)	10.8	13.8	13.5	13.7
RoA (%)	0.9	1.2	1.2	1.2

Source: Company; Sharekhan estimates

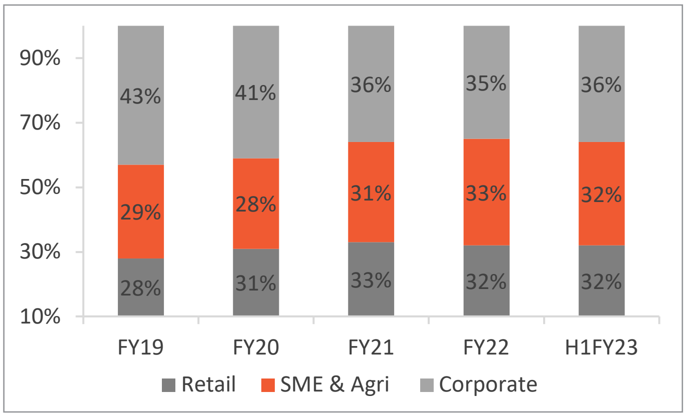
Financials in charts

Trend in Loan growth



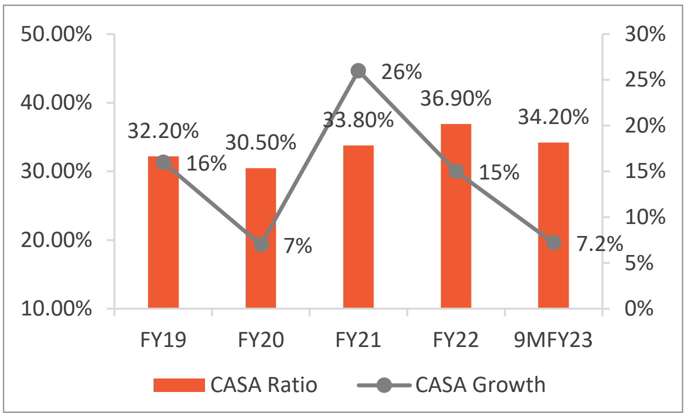
Source: Company, Sharekhan Research

Trend in Loan Mix



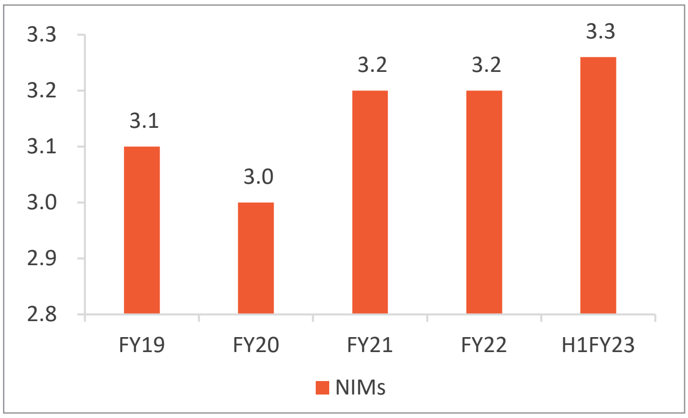
Source: Company, Sharekhan Research

Trend in CASA



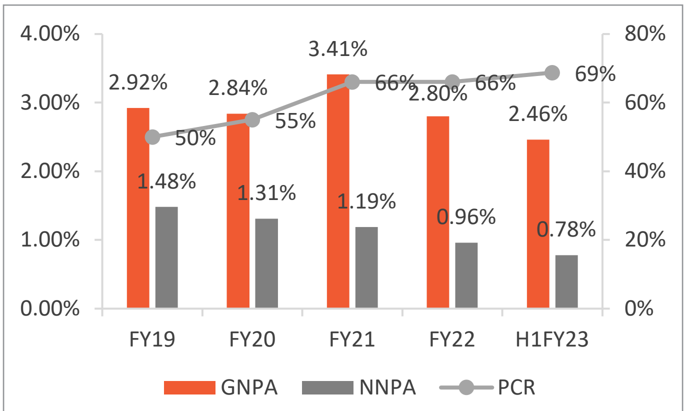
Source: Company, Sharekhan Research

Trend in Margins



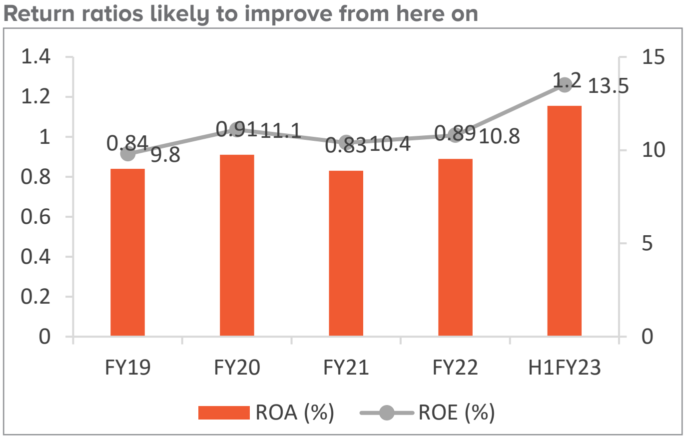
Source: Company, Sharekhan Research

Steady asset quality



Source: Company, Sharekhan Research

Return ratios likely to improve from here on



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Strong credit offtake; Top banks placed better

System-level credit offtake grew by ~17.4% y-o-y in the fortnight ending December 16, 2022, indicating loan growth has been sustaining, given distinct signs of an improving economy and revival of investments and loan demand. On the other hand, deposits rose by ~9.4% but are trailing advances growth. We should see loan growth acceleration sustaining. Margins are likely to improve and peak out by Q4FY2023. Asset quality is not a big issue on the corporate lending end, as only de-leveraging is 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. In the past two years, lenders have been cautious about 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 steady improvement in 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 its 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 for 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 an unchanged PT of Rs. 165

At the CMP, the stock currently trades at 1.3x/1.2x/1.0x its FY2023E/FY2024E/FY2025E BV. Factors such as focus to build 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 micro credit are expected to augur well for the bank's growth going ahead. Asset quality should remain stable due to the benign credit cycle. Focus on growing assets and liabilities in a granular manner along with an improved return ratio augur well for the bank going ahead. We believe now consistent steady performance could drive re-rating in the stock. Potential value unlocking in Fed Fina (NBFC subsidiary) via an IPO could be an additional catalyst for the stock.

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	138	29,154	10.3	9.2	1.3	1.2	13.8	13.5	1.2	1.2
IndusInd Bank	1,241	96,210	13.5	11.2	1.8	1.5	13.9	14.5	1.7	1.7

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 1,305 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 a 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 could lead to slower loan growth and higher-than-anticipated credit cost.

Additional Data

Key management personnel

Mr. Shyam Srinivasan	Managing Director and CEO
Mr. Ashutosh Khajuria	Executive Director
Ms. Shalini Warrier	Executive Director

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI PRUDENTIAL ASSET MANAGEMENT CO. LTD.	5.82
2	HDFC ASSET MANAGEMENT CO. LTD.	4.48
3	FRANKLIN RESOURCES INC.	4.20
4	YUSUFFAL MUSALIAM VEETIL	3.56
5	NIPPON LIFE INDIA ASSET MANAGEMENT LTD.	3.41
6	HDFC LIFE INSURANCE CO. LTD.	2.77
7	VANGUARD GROUP INC.	2.69
8	JHUNJHUNWALA RAKESH	2.59
9	KOTAK MAHINDRA ASSET MANAGEMENT CO. LTD.	2.59
10	MIRAE ASSETS GLOBAL INVESTMENT CO. LTD.	2.41

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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