Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Federal Bank

Delivering strong earnings growth; Return ratios at 8-year high

Banks	Sharekhan code: FEDERALBNK
Reco/View: Buy ↔	CMP: Rs. 140 / Price Target: Rs. 170 ↑

↑ 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 Updated Oct 08, 2022	42.26

Severe Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 29,645 cr
52-week high/low:	Rs. 143 / 83
NSE volume: (No of shares)	150.5 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Free float: (No of shares)	211.4 cr

Shareholding (%)

Promoters	-
FII	26.4
DII	44.3
Others	29.4

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	2.9	6.1	41.4	40.0
Relative to Sensex	7.1	2.3	28.9	41.8

Sharekhan Research, Bloomberg

Summary

- Federal Bank reported PAT of Rs. 804 crore (up 54% y-o-y/14% q-o-q), led by strong operating profit growth of 39% y-o-y and a 7% decline in provisions. The bank reported strong return ratio of 1.3% RoA and 15.9% RoE, which is currently at its 8-year high.
- NII growth was solid at 27% y-o-y/11% q-o-q, driven by strong loan growth (19.5% y-o-y/4.3% q-o-q) and margin improvement. NIM increased by 19 bps q-o-q to ~3.49%, led by higher loan yields.
- Annualized slippages ratio (calculated as a % of 12M trailing advances) were at 1.17% vs. 1.16% in the past quarter. Annualized core credit cost (% of average advances) stood at 38 bps versus 53 bps last quarter. GNPA/NNPA ratios were stable at 2.43%/0.73%. PCR improved to ~70%, while restructured book stood at Rs. 3,735 crore (2.2% of loans versus 2.4% in the last quarter).
- We believe the bank is well poised to sustain ROA of 1.2-1.3% over the medium term. A few more quarters of steady performance can help justify a marginally lower cost of equity, thereby implying a re-rating of the stock. At the CMP, the stock trades at 1.4x/1.2x/1.0x its FY2023E/FY2024E/FY2025E BV estimates. We maintain our Buy rating on the stock with a revised PT of Rs. 170.

Federal Bank reported strong performance in Q3FY2023, which was above consensus/our estimates. Net interest income (NII) grew robustly by 27% y-o-y and 11% q-o-q, driven by healthy loan growth of 19.5% y-o-y/ 4.3% q-o-q and improvement in NIMs by 19 bps q-o-q reported at 3.49%. Core fee income grew by 32% y-o-y/0.6% q-o-q. Total operating expenses were higher by 10% y-o-y/5% q-o-q. Opex to average assets was stable q-o-q and stood at 2%. Operating profit (PPoP) grew robustly by 39% y-o-y/5% q-o-q. Total provisions were down by 7% y-o-y/26% q-o-q. Core credit cost was reported at 38 bps vs. 53 bps in the last quarter. PBT grew by 54% y-o-y/14% q-o-q on account of strong operating profit and lower credit cost. Net advances grew by 19.5% y-o-y/4.3% q-o-q. Retail advances grew by 19.2% y-o-y vs. 18.7% in the last quarter; and among retail loans, housing, business banking (SME), and agri-loan books constituting 67% of the total retail loans grew by 17% y-o-y, 18% y-o-y, and 20% y-o-y, respectively. Under the wholesale segment, commercial banking grew by 18% y-o-y, while other wholesale corporate book grew by 19% y-o-y. Deposits growth outpaced advances growth this quarter, which was a key positive. Overall deposits grew by 14.8% y-o-y/6.5% q-o-q, while CASA growth was tepid at 7.2% y-o-y/0.1% q-o-q. CASA ratio stands at 34.2% vs. 36.4% in the last quarter. Slippages were up 5.6% q-o-q at Rs. 412 crore, largely from the retail segment (i.e., from restructured book). The restructured book stood at 2.2% of average loans vs. 2.4% q-o-q. The bank's asset quality remained stable during the quarter, with GNPA and NNPA ratios reported at 2.43% and 0.73%. PCR at ~70% vs. ~69% in the last quarter.

Key positives

- Strong NII growth driven by healthy loan growth and margin expansion.
- Deposits growth outpaced advances growth.
- Return ratio improved; RoA ~1.3%; RoE ~15.9%.

Key negatives

- CASA growth tepid

Management Commentary

- Federal Bank is well poised to sustain RoA of 1.2-1.3% over the medium term. For FY2024E, RoA expectations are in the range of 1.25-1.35%. There could be some moderation in NIM from current levels. The bank has guided for ~3.35% NIM for FY2023E and ~3.35-3.40% in FY2024E.
- The bank is also expected to sustain high mid-teens growth in advances in FY2024E. Fintech and digital platforms are expected to help in gaining more traction in the card business, personal loans, CV/CE, gold loans, and micro loans.

Revision in estimates – We have increased our FY2023E earnings estimates, factoring in higher margins and lower credit cost.

Our Call

Valuation – Maintain Buy rating on Federal Bank with a revised PT of Rs. 170: We believe the bank is well poised to sustain RoA of 1.2-1.3% over the medium term. A few more quarters of steady performance can help justify a marginally lower cost of equity, thereby implying a re-rating of the stock. We believe now the bank has fewer levers to surprise positively from here on except on the operating leverage. However, a reversal in return ratios is unlikely and asset-quality outlook is stable for the sector. Hence, we are probably reaching closer to peak RoEs for the bank. At the CMP, the stock currently trades at 1.4x/ 1.2x /1.0x its FY2023E/ FY2024E/FY2025E BV estimates. 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 due to which slower loan growth and higher-than-anticipated credit cost; slower growth in retail liability; and lower margins than expected.

Valuation (Standalone) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Net Interest Income	5,962	7,443	8,514	9,406
Net profit	1,890	2,999	3,423	3,992
EPS (Rs.)	9.1	14.3	16.3	19.0
P/E (x)	15.5	9.8	8.6	7.4
P/BV (x)	1.6	1.4	1.2	1.0
RoE	10.8	14.8	14.6	14.7
RoA	0.9	1.3	1.3	1.3

Source: Company; Sharekhan estimates

Key result highlights

- **Robust NII growth driven by margin improvement and healthy loan growth:** NII grew by 27.1% y-o-y/11.1% q-o-q, led by healthy net advances growth of 19.5% y-o-y/4.3% q-o-q and NIM improvement. NIM improved by 19 bps q-o-q to 3.49%, driven by higher yields. The bank has guided for ~3.35% margins for FY2023E and 3.35-3.40% margin band for FY2024E. Core fee income grew by 32% y-o-y.
- **Asset quality continues to be stellar:** The bank has guided for stable asset-quality outlook going ahead. Asset quality remained stable during the quarter with GNPA and NNPA ratios reported at 2.43% and 0.73%, respectively. Total slippages stood at Rs. 412 crore (1.17%) vs. Rs. 390 crore q-o-q, up by 5.6% q-o-q, mainly due to higher slippages from the retail segment in the restructured book. Asset quality is holding up well across retail, commercial banking, and corporate banking. Upgrades and recovery amounted to Rs. 287 crore versus Rs. 329 crore in the past quarter. Write-offs stood at Rs. 80 crore versus Rs. 185 crore q-o-q. PCR stood at ~70% vs. 69% in the past quarter. Restructured book stood at Rs. 3,735 crore (~2.2% of advances) versus Rs. 3,892 crore (~2.4% of advances) in the past quarter.
- **Loan growth solid and broad-based:** Net advances grew by 19.5% y-o-y/4.3% q-o-q. Retail advances grew by 19.2% y-o-y; and among retail, housing, business banking (SME), and agri constituting 67% of total retail loans grew by 17% y-o-y, 18% y-o-y, and 20% y-o-y, respectively. Under the wholesale segment, commercial banking grew by 18%, while corporate book grew by 19% y-o-y. Demand continues to remain upbeat on the retail front. On the corporate side, growth was broad based across working capital loan and capex-led term loans. Fintech partnership and digital ecosystem are helping in gaining more traction in new segments such as the card business, personal loans, CV/CE, gold loans, and micro loans.
- **CASA mobilisation was slower; however, overall deposits growth outpaced advances growth:** Deposits grew by 14.8% y-o-y. Deposits grew sequentially by 6.5% versus 4.3% advances growth sequentially. CASA growth was muted at 7.2% y-o-y/0.1% q-o-q. CASA ratio stood at ~34.2%. The bank intends to grow liability in a granular manner focusing on branch expansion to garner low-cost deposits along with fintech partnership to help in building a retail liability franchise. The bank has a strong granular liability franchise with retail deposits making up ~94% of overall deposits.
- **Return ratio ahead:** The bank has affirmed RoA expectations for FY2024E to be in the range of 1.25-1.35% versus earlier guidance of ~1.25% in FY2024E.

Result Table Rs cr

Particulars	3QFY23	3QFY22	2QFY23	Y-o-Y	Q-o-Q
Interest Inc.	4,433	3,443	4,021	29%	10%
Interest Expenses	2,477	1,904	2,259	30%	10%
Net Interest Income	**1,957**	**1,539**	**1,762**	**27.1%**	**11.1%**
NIM (%)	3.49	3.27	3.3	7%	6%
Core Fee Income	543	412	540	31.8%	0.6%
Other Income	-9	72	70	-112%	-113%
Net Income	**2,491**	**2,023**	**2,371**	**23%**	**5%**
Employee Expenses	561	583	516	-4%	9%
Other Opex	655	526	643	25%	2%
Total Opex	**1,216**	**1,109**	**1,159**	**10%**	**5%**
Cost to Income Ratio	48.8%	54.8%	48.9%		
Pre-Provision Profits	**1,274**	**914**	**1,212**	**39%**	**5%**
Provisions & Contingencies – Total	199	214	268	-7%	-26%
Profit Before Tax	**1,076**	**700**	**944**	**54%**	**14%**
Tax	272	179	241	52%	13%
Effective Tax Rate	25%	26%	25%		
Reported Profits	**804**	**522**	**704**	**54%**	**14%**
Basic EPS (Rs.)	3.8	2.5	3.3	53%	14%
Diluted EPS (Rs.)	3.8	2.5	3.3	52%	13%
RoA (%)	1.3	1.0	1.2		
Advances	**1,68,173**	**1,40,743**	**1,61,240**	**19.5%**	**4.3%**
Deposits	**2,01,408**	**1,75,432**	**1,89,146**	**14.8%**	**6.5%**
Gross NPA	**4,148**	**4,401**	**4,031**	**-6%**	**3%**
Gross NPA Ratio (%)	2.43	3.06	2.46		
Net NPA	**1,229**	**1,471**	**1,262**	**-16%**	**-3%**
Net NPAs Ratio (%)	0.73	1.05	0.78		
PCR – Calculated	**70.4%**	**66.6%**	**68.7%**		

Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Deposits mobilisation to be in focus; Top private 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 but momentum is expected to moderate, and margins are expected to peak out by H1FY2024. 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 few years, lenders have been cautious about lending to the 'BB & 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, strong deposit franchise, 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 displaying improving asset-quality trend along with healthy operating profit trends. 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 believe the bank is well poised to sustain RoA of 1.2-1.3% over the medium term. A few more quarters of steady performance can help justify a marginally lower cost of equity, thereby implying a re-rating of the stock.

■ Valuation – Maintain Buy rating on Federal Bank with a revised PT of Rs. 170

We believe the bank is well poised to sustain RoA of 1.2-1.3% over the medium term. A few more quarters of steady performance can help justify a marginally lower cost of equity, thereby implying a re-rating of the stock. We believe now the bank has fewer levers to surprise positively from here on except on the operating leverage. However, a reversal in return ratios is unlikely and asset-quality outlook is stable for the sector. Hence, we are probably reaching closer to peak RoEs for the bank. At the CMP, the stock currently trades at 1.4x/ 1.2x / 1.0x its FY2023E/FY2024E/FY2025E BV estimates. 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	140	29,645	9.8	8.6	1.4	1.2	14.8	14.6	1.3	1.3
IndusInd Bank	1,239	96,089	13.4	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 1,333 branches 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 focusing on increasing the retail mix. 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 and has been focusing on increasing the retail mix. 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; slower growth in liability; and lower margin than expected.

Additional Data

Key management personnel

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

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI PRUDENTIAL ASSET MANAGEMENT CO LTD	5.35
2	HDFC ASSET MANAGEMENT CO LTD	4.39
3	FRANKLIN RESOURCES LTD	3.78
4	KADER YUSUFFALI M V A	3.56
5	MIRAE ASSET GLOBAL INVESTMENTS CO LTD	2.90
6	HDFC LIFE INSURANCE CO	2.77
7	JHUNJHUNWALA RAKESH	2.59
8	VANGUARD GROUP INC	2.32
9	KOTAK MAHINDRA ASSET MANAGEMENT CO LTD	2.16
10	SBI FUNDS MANAGEMENT LTD	2.15

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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