Stock Update

Federal Bank Ltd.

24-May-2021

RETAIL RESEARCH

Federal Bank Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Bank	Rs.85.1	Buy at LTP and add more at Rs.75	Rs.94	Rs.103	2 quarters

HDFC Scrip Code	FEDBAN
BSE Code	500469
NSE Code	FEDERAL
Bloomberg	FB:IN
CMP May 21, 2021	85.1
Equity Capital (Rsmn)	3,992
Face Value (Rs)	2
Equity Share O/S (mn)	1,996
Market Cap (Rs bn)	169. 8
Adj. Book Value (Rs)	73
Avg. 52 Wk Volumes	36906604
52 Week High	92.40
52 Week Low	36.85

Share holding Pattern % (Mar, 2021)	
Promoters	-
Institutions	67.80
Non Institutions	32.20
Total	100.0

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Our take

Federal Bank is one of the best placed mid-tier old private sector bank. Even during the tough times i.e. COVID-19 stress; the bank has been able to manage asset quality well and reported its highest-ever quarterly net profit in Q4FY21. The bank has strong granular liability franchise and comfortable capital positioning which can act as a cushion against any probable uncertain eventuality of asset quality shocks. Management's new strategy for long term sustainable growth of focusing on increasing retail book size and slowing down the wholesale segment will fetch higher profitability and maintain asset quality as these are relatively less risky and high margin businesses. The branch-light distribution-heavy business model and focus on digitization might help it bring down cost sustainably in the longer run. The bank has hired many senior level leaders across key verticals who bring significant amount of experience and knowledge with them but rejection by RBI of the re-appointment of Shyam Srinivasan as MD & CEO, remains a risk.

We had issued Initiating Report on Federal Bank on 23rd July, 2020 and recommended Buy at LTP and add on dips to Rs.49-52 band, for base case target of Rs.64 and bull case target of Rs.67.5 over the next two quarters. The stock achieved our Bull case target of Rs.67.5 yielding return of 26% on 7th December, 2020.
https://www.hdfcsec.com/hsl.research.pdf/Federal%20Bank-Initiating%20Coverage-23072020.pdf

Valuation and recommendation:

We have envisaged 13% CAGR in Net Interest Income and 25% CAGR in net profit over FY21-FY23E. Further, we have estimated that the loan book would grow at 12.6% CAGR over this period. The bank has utilized its entire surplus COVID buffer, shoring up its PCR to ~66%. We believe that a lack of provisioning buffer is likely to keep credit costs elevated in the near-term. However, the management has guided for normalized credit costs for its portfolio going forward. The gold loan growth could normalize in coming quarters and new focus segments such as MFI, CV portfolio, and Credit Cards might gradually aid in margin. The stock is currently trading at a 1.0x and 0.9x FY22E and FY23E ABV. RoAA is estimated at 1.1% for FY23. The bank has a relatively low exposure to unsecured segments.

We believe that investors can buy Federal Bank at LTP and add more at Rs.75 (0.8xFY23E ABV) for the base case fair value of Rs.94 (1.0xFY23E ABV) and for the bull case fair value of Rs.103 (1.1xFY23E ABV) over the next two quarters.

Federal Bank Ltd.

Financial Summary

Particulars (Rs.bn)	Q4FY21	Q4FY20	YoY-%	Q3FY21	QoQ-%	FY19	FY20	FY21	FY22E	FY23E
NII	14.2	12.2	16.4	14.4	-1.4	41.8	46.5	55.3	62.7	70.6
PPP	8.9	9.6	-7.3	9.6	-7.3	27.6	32.0	37.9	43.5	47.1
PAT	4.8	3.0	60.0	4.0	20.0	12.4	15.4	15.9	21.8	25.0
EPS (Rs)						6.3	7.7	8.0	10.9	12.5
ABV						58.5	59.1	72.9	81.9	93.6
P/E (x)						7.2	11.0	10.7	7.8	6.8
P/ABV (x)						1.5	1.4	1.2	1.0	0.9
RoAA (%)						0.8	0.9	0.8	1.0	1.1

(Source: Company, HDFC sec)

Recent Developments

Q4FY21 Result Update

Federal Bank reported its highest-ever quarterly net profit of Rs.4.8 bn (up 58.6% YoY) in the fourth quarter of FY21. Net Interest Income grew by 17% YoY, along with healthy fee income traction. NIMs remained stable at 3.23% vs. 3.22% on a QoQ basis aided by lower cost of funds. Pre Provision Operating Profit declined by 7.7% YoY. Cost to Income ratio stood at 53.1% vs 49.8% in Q4FY21. Loan book grew by 8%/5% YoY/QoQ driven by Retail (19% YoY) and Agri segment (25% YoY). The gold loan portfolio's robust growth of 70% YoY is evenly distributed between the retail, agri and MSME segments. Total deposit grew 13% YoY on the back of 26% growth in CASA. CASA ratio stood at 33.8% compared to 30.5% last year same quarter. Retail deposits stood at 90%. The bank has partnered with fintech epiFi to offer neo banking services, with DGV (Retail Neo Banking platform aimed at transforming farmers & micro enterprises) to automate the payment life cycle of GCMMF (Gujarat Cooperative Milk Marketing Federation Ltd.) covering 36 lakh farmers who are supplying milk to Amul and has also partnered with Mashreq Bank to ease remittances to the country.

The bank has introduced proprietary credit cards and has gone live with cards for staff (over 80% of its staff has been carded). Towards the end of this calendar year, management expects that they will be live with their existing customers and then look outside.

Stable Asset Quality

Even during the challenging time, the bank has able to manage asset quality well. In Q4FY21, asset quality remains robust with Gross NPA at 3.41% vs. 3.38% proforma in Q3. Net NPA of 1.19% placed the bank amongst the best in the industry. FY21 gross slippages were at ~1.5% compared to 1.65% in FY20. This is the best-in-class even compared to the larger private sector banks. The restructured portfolio stood at ~1.2% of loans, well within management guidance. Incremental slippages during the quarter were driven by non-corporate portfolio (SME: 3.5%; Retail: 3%) with zero fresh slippages from the corporate book. With a granular and largely secured portfolio (~85%), we expect slippages to remain range-bound for FY22 as well.

Capital Adequacy

The bank remains well capitalized with Tier 1 Capital of 13.85% and CAR of 14.62% as of Mar-21. This has improved in FY21 without any capital raise. This will act as a cushion against any probable uncertain eventuality of further asset quality shocks and fall in CASA. Management has indicated that capital raise could happen in the second half of CY21.

New Management Team

The bank has hired many senior level leaders across key verticals who bring significant amount of experience and knowledge with them. Recently, Venkatraman Venkateswaran has been hired as Chief Financial Officer with effect from 18th May'21 and Ashutosh Khajuria, Executive Director and CFO, would be responsible for Treasury, credit & collections, strategic initiatives and establish the ESG journey of the bank. Last year, the RBI has approved the re-appointment of Shyam Srinivasan as MD & CEO of the bank till September 22, 2021. He has completed a decade in the post through multiple re-appointments. Rejection by RBI for the re-appointment, remains a risk of disruption in the event of a change in guard at the managing director level.

Long Term Growth Strategy

Recently the management has adopted a new strategy for long term sustainable growth. Now the bank has started strongly focusing on increasing retail book size, while consciously slowing down in the wholesale segment due to the current challenging environment. The bank has invested and focused on building high-margin product portfolios like business banking and select retail lending segments (Commercial Vehicle /Construction Equipment loan, micro-credit, credit cards). These are relatively less risky and high margin businesses. During this tough time, the bank's strategy to focus on gold loans has augured well. The gold loan portfolio is now almost 12% of total loan book, reported growth of robust growth of 70% YoY in Q4FY21. For better credit practices, the bank separated loan origination and underwriting processes and moved from a self-origination model to a relationship-based wholesale banking model.

A branch-light distribution-heavy business model and continuous focus on digitization should help the bank in improvement of the C/I (Cost to Income ratio) going ahead. The bank claims to have digital adoption trends which are higher compared to industry standards. This will be the key differentiation strategy for growth. The bank is observing more and more transactions shifting to digital channels & RM intensive model.

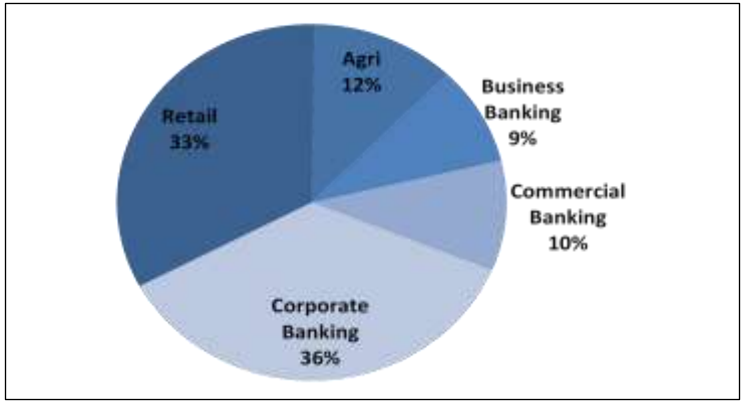
Federal Bank has strong liability base, which should shield it against liability-side stress. The bank's retail deposits are 90% of overall deposits- one of the highest in the banking industry. The bank also has a healthy rollover rate of deposits which further strengthens the bank's liquidity profile. Federal Bank has a market share of 17.5% in personal inward remittances to India. This will continue to aid margin for the bank over long run. It has high market share in loans and deposits in Kerala (~11% and ~17% market share in loans and CASA deposits, respectively) and has expanded its presence outside Kerala over the past decade.

Risks and concerns

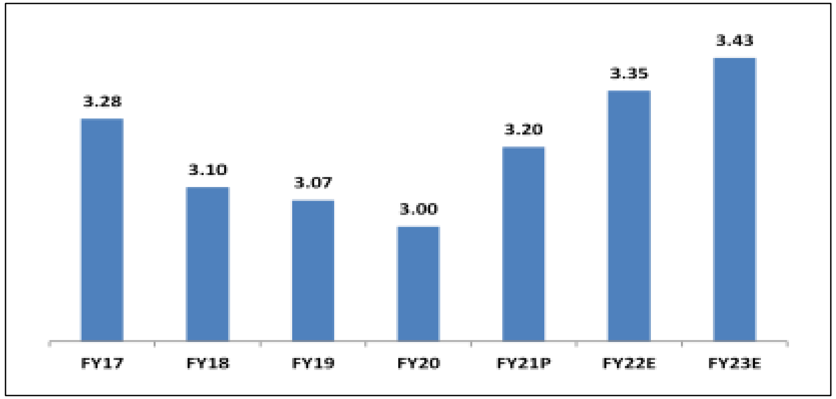
- Federal Bank utilized its entire surplus COVID buffer, shoring up its Provision Coverage Ratio (PCR) to ~66%. While the management is optimistic of normalized credit costs for its portfolio going forward, we believe that a lack of provisioning buffer is likely to keep credit costs elevated in the near-term.
- Slower-than-expected pick-up in the economy could impact the growth of the business. The key risks to our thesis are lower-than-expected loan growth and more-than-expected asset quality deterioration. Recent call by state CM to halt collections in the wake of Covid-19-induced disruption and cyclone can impact asset quality in the near term.
- The second wave has already started impacting the collection efficiencies. Overall collection efficiency for the bank was 95%. But it stood in the range of about 88-91% in April-May, which is similar as peers; however any significant deterioration could hurt the business.
- The other risk for the stock is future execution of the management strategy i.e. weaker than expected execution in ramping up of higher-margin loan portfolios. Failure to abide by it could impact financial performance which in turn could erode value for shareholders.

- The gold loan portfolio is now almost 12% of total loan book. A sudden decline in the market price of gold may adversely affect the bank's financial condition, cash flows and earnings. Further, it may be unable to realise the full value of its pledged gold, which exposes the bank to a potential loss.

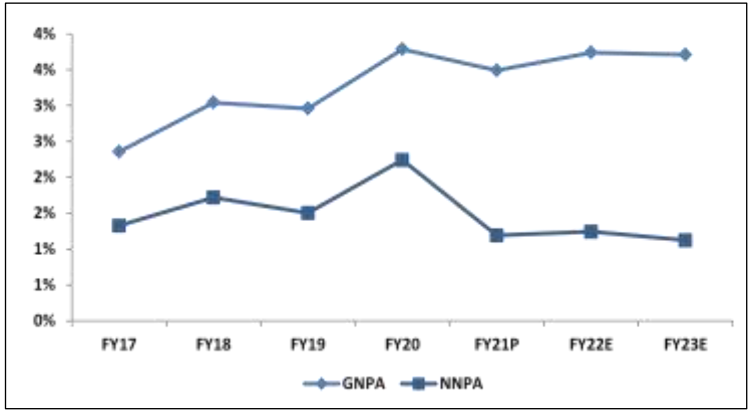
Loan Book Mix (%)



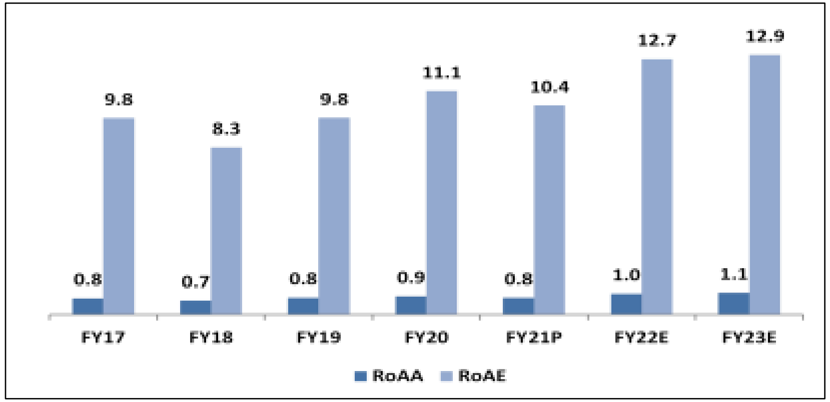
Gradual Improvement in NIM



Asset Quality Trend



Return Ratio



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Financials (Consolidated)

Income Statement

(Rs mn)	FY19	FY20	FY21	FY22E	FY23E
Interest Income	114190	132108	137579	156714	175002
Interest Expenses	72427	85618	82242	94008	104449
Net Interest Income	**41763**	**46489**	**55337**	**62706**	**70554**
Noninterest income	13510	19314	19449	20988	23649
Operating Income	55274	65803	74786	83694	94203
Operating Expenses	27643	33756	36917	40158	47100
PPOP	**27631**	**32047**	**37870**	**43537**	**47103**
Prov & Cont	8559	11722	16496	14517	13762
Profit Before Tax	19072	20325	21373	29020	33341
Tax	6634	4898	5470	7255	8335
PAT	**12439**	**15428**	**15904**	**21765**	**25006**

Balance Sheet

(Rs mn)	FY19	FY20	FY21	FY22E	FY23E
Share Capital	3970	3985	3992	3992	3992
Reserves & Surplus	128760	141191	157244	177812	201620
Shareholder funds	**132730**	**145176**	**161236**	**181804**	**205612**
Deposits	1349544	1522900	1726446	1867240	2053186
Borrowings	77813	103724	90685	103577	113799
Other Liab & Prov.	33313	34580	35308	38839	42723
SOURCES OF FUNDS	**1593400**	**1806380**	**2013675**	**2191460**	**2415319**
Cash & Bank Balance	100668	125746	195914	127130	118781
Investment	318241	358927	371862	416486	466464
Advances	1102230	1222679	1318786	1479678	1673516
Fixed Assets	4720	4800	4911	5402	5942
Other Assets	67541	94229	122201	162765	150616
TOTAL ASSETS	**1593400**	**1806380**	**2013675**	**2191460**	**2415319**

(Source: Company, HDFC sec Research)

Federal Bank Ltd.

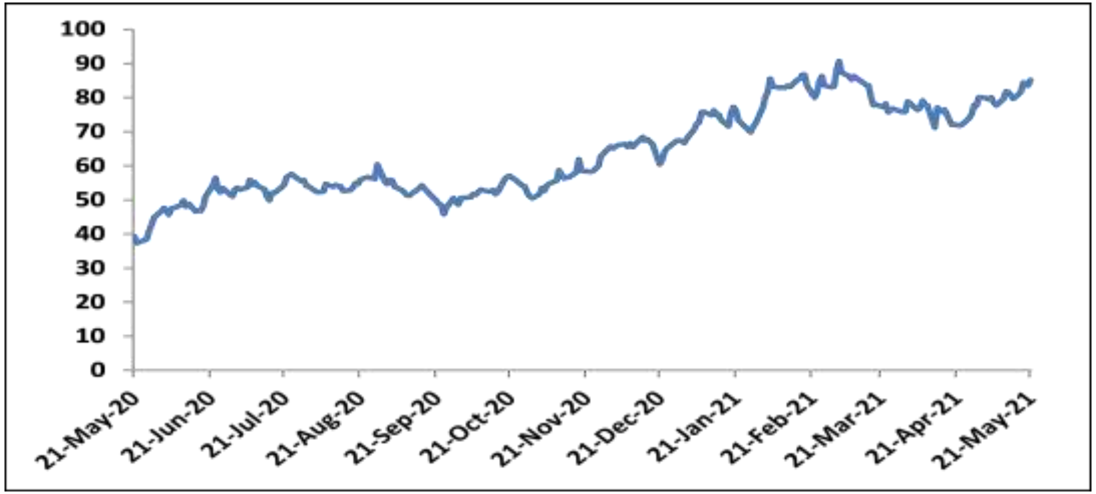
Key Ratios (%)

	FY19	FY20	FY21	FY22E	FY23E
Return Ratios					
Calc. Yield on adv	11.3%	11.4%	10.8%	11.2%	11.1%
Calc. Cost of funds	5.4%	5.6%	4.8%	4.8%	4.8%
NIM	3.1%	3.0%	3.2%	3.3%	3.4%
RoAE	9.8%	11.1%	10.4%	12.7%	12.9%
RoAA	0.8%	0.9%	0.8%	1.0%	1.1%
Asset Quality Ratios					
GNPA	3.0%	3.8%	3.5%	3.7%	3.7%
NNPA	1.5%	2.2%	1.2%	1.2%	1.1%
PCR	49.3%	40.7%	65.9%	66.7%	69.7%
Growth Ratios					
Advances	19.9%	10.9%	7.9%	12.2%	13.1%
NII	16.6%	11.3%	19.0%	13.3%	12.5%
PAT	41.5%	24.0%	3.1%	36.9%	14.9%

Key Ratios (%)

	FY19	FY20	FY21	FY22E	FY23E
Valuation Ratios					
EPS	6.3	7.7	8.0	10.9	12.5
P/E	7.2	11.0	10.7	7.8	6.8
Adj. BVPS	58.5	59.1	72.9	81.9	93.6
P/ABV	1.3	1.2	1.1	0.9	0.8
Dividend per share	1.4	0.0	0.7	0.6	0.6
Other Ratios					
Cost-Income	50.0	51.3	49.4	48.0	50.0
CASA	32%	31%	30%	29%	28%

One Year Price Chart



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