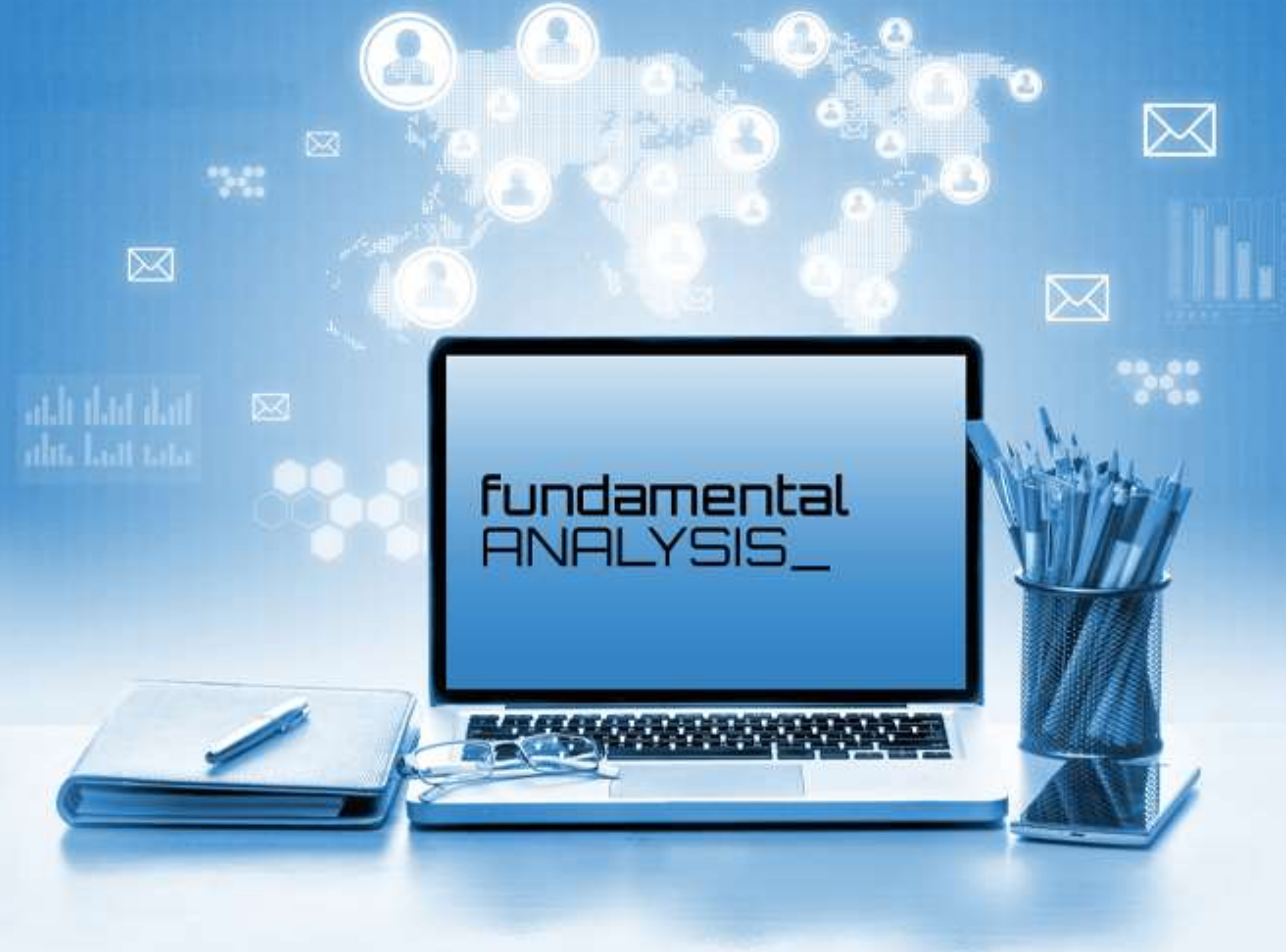
Stock Update

Federal Bank Ltd.

Aug 01, 2022



RETAILRESEARCH

Federal Bank Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Banks	Rs.106.7	Buy between Rs.108-104 & add more on dips to Rs.93	Rs.119	Rs.129	2 quarters

HDFC Scrip Code	FEDBAN
BSE Code	500469
NSE Code	FEDERALBNK
Bloomberg	FB:IN
CMP July 29, 2022	106.7
Equity Capital (Rs mn)	4205
Face Value (Rs)	2
Equity Share O/S (mn)	2103.5
Market Cap (Rs bn)	224.3
Adj Book Value (Rs)	82.8
Avg. 52 Wk Volumes	27568829
52 Week High	109.4
52 Week Low	77.5

Share holding Pattern % (Jun, 2022)	
Promoters	-
Institutions	68.3
Non Institutions	31.7
Total	100.00

HDFCsec Retail research stock rating meter

for details about the ratings, refer at the end of the report

* Refer at the end for explanation on Risk Ratings

Fundamental Research Analyst

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Our Take:

Federal Bank is one of the best placed mid-tier old private sector banks. The bank has strong granular liability franchise and comfortable capital positioning which can act as a cushion against any uncertain eventuality of asset quality shocks. Recently, the bank has redesigned its growth strategies and now is planning to change itself into next-gen private sector bank with digital tie-ups across assets, liabilities, and payments segments. The bank's FinTech partnerships is in line with its branch-light, distribution-heavy strategy which is RoA accretive and can bring productivity and efficiencies. We are constructive on Federal Bank's ability to monetize these partnerships and build scalable profit pools. Further, it is also diversifying into high margin business like retail products, Commercial Vehicle /Construction Equipment loan, micro-credit, credit cards etc. In Q1FY23 numbers the incremental growth from these verticals were visible. The bank is also planning to expand its reach by adding new branches. Management has guided that between FY23-25, they are planning to add 200-25 new branches.

NBFC subsidiary (FedFina) IPO could bring add momentum in the stock price due to value unlocking and help the bank shore up receding capital adequacy levels. The bank holds 74% stake in this subsidiary while balance 26% is held by True North. The bank is trading at comfortable valuations of 1x P/ABV FY24E.

We had issued Stock update on Federal Bank on 8th November, 2021 and recommended Buy at LTP of Rs.101.1 & add more on dips of Rs.90.25 band, for base case target of Rs.111.5 and bull case target of Rs.124 over the next two quarters. (Link)

Valuation & Recommendation:

Federal bank has posted strong Q1FY23 result on the back of strong loan growth (+17% YoY), incrementally better margins (+6bps QoQ) and negligible treasury losses. The NPAs are now at multi year low. The loan portfolio quality stands superior with high share of secured retail loans and higher rated corporates loans mix. We have envisaged 18% CAGR in Net Interest Income and 30% CAGR in net profit over FY21-FY24E. Further, we have estimated that the loan book would grow at 16% CAGR over this period. We expect asset quality and NIM to improve gradually over FY21-24E. The management has guided for Rs.18 bn of slippages and around 1.10-1.15% of RoAA for FY23.

We feel that investors can buy Federal Bank between Rs.108-104 (1.x FY24E ABV) and add more on dips to Rs.93 (0.9x FY24E ABV) band. We expect the Base case fair value of Rs.119 (1.15x FY24E ABV) and the Bull case fair value of Rs.129 (1.25x FY24E ABV) over the next 2 quarters.

Financial Summary

Particulars (Rs bn)	Q1 FY23	Q1 FY22	YoY (%)	Q4 FY22	QoQ (%)	FY20	FY21	FY22	FY23E	FY24E
NII	16.0	14.2	*13.1%*	15.3	*5.2%*	46.5	55.3	59.6	70.8	82.9
PPOP	9.7	11.4	*-14.3%*	8.0	*21.9%*	32.0	37.9	37.6	46.6	56.2
PAT	6.0	3.7	*63.6%*	5.4	*11.1%*	15.4	15.9	18.9	26.4	31.9
EPS (INR)	2.8	1.8	*54.6%*	2.6	*11.0%*	7.7	8.0	9.0	12.5	15.2
ROAE (%)						11.1	10.4	10.8	13.3	14.3
ROAA (%)						0.9	0.8	0.9	1.1	1.2
ABVPS (INR)						64.8	72.9	82.8	92.3	103.8
P/ABV (x)						1.6	1.5	1.3	1.2	1.0
P/E (x)						13.9	13.3	11.9	8.5	7.0

(Source: Company, HDFC sec)

Recent Developments

Q1FY23 Result Update

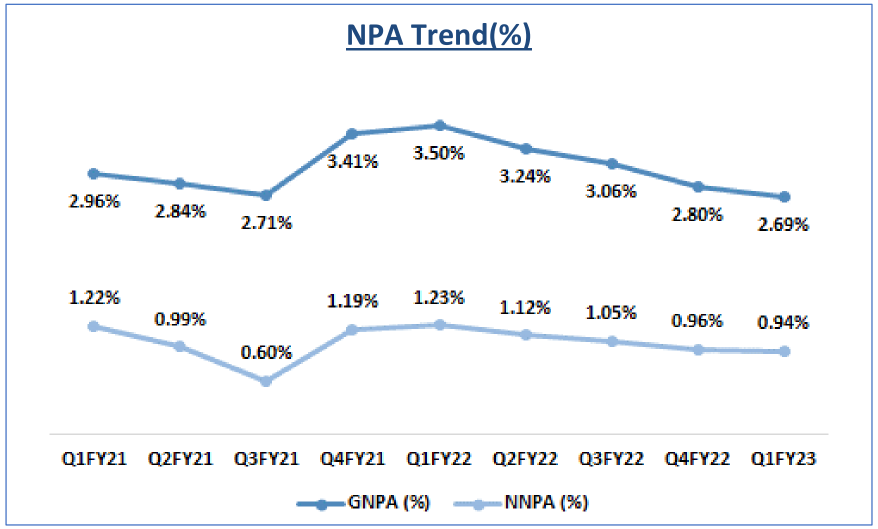
Historically, Q1 is seasonally a weak quarter for the bank, however, this year the trend was broken with the bank reporting good set of all round performance. The bank has reported highest ever NII of Rs.16 bn, up 13%/5% YoY/QoQ. Stable QoQ CASA ratio has helped the bank improve NIM by ~6 bps QoQ to 3.2%. Fee Income grew by 73% YoY, while other income was impacted by lower treasury gains and loss on revaluation of investments. Cost to Income at 52.68%, reduced by 721bps sequentially (positive impact of pension cost). Provisions were more than doubled QoQ, while it was down by 69% YoY, this has resulted in net profit growth of 64% YoY and 11% QoQ.

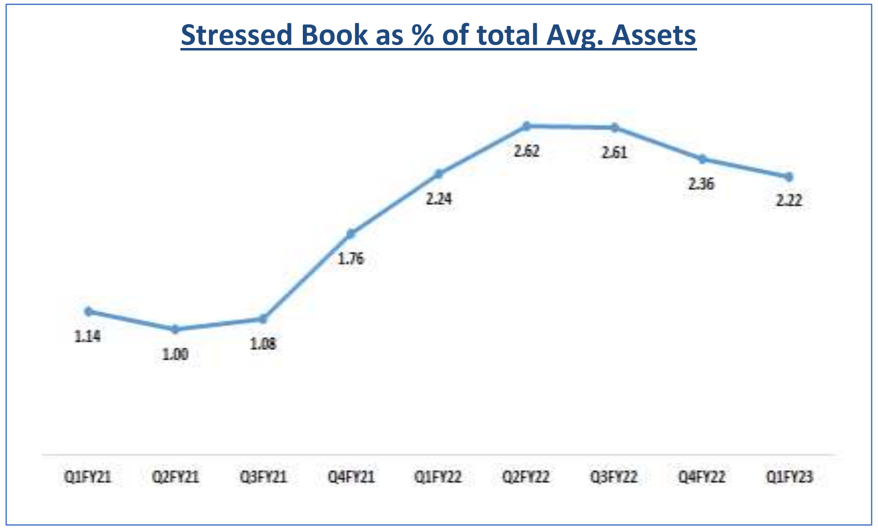
Management guidance

- The bank had added only 20 branches in past 5-6 years as it wanted to first make sure they are all productive and performing. On the branch expansion plan going ahead, the management has stated that 10 branches were added in Q1FY23 and plan to add 65 branches in FY23. Further, between FY23-25, the total branch addition could be around 200-250 branches. By doing so, the bank plans to create 2-3 more geographies where it has quite potent and dominant share
- The NIMs are expected to be in the range of 3.25-3.27%.
- The management expects that FY23 ROA could be around 1.10-1.15% while for FY24 it could improve further around 1.25%.
- The bank is estimating that the credit growth for FY23 could be around 18% and liability growth to be more granular.
- Slippages for both FY21 and FY22 was around Rs.18 bn and the management expects the same kind of amount for FY23 also while the credit cost is expected ~50 bps in FY23.

Stable Asset quality

Overall GNPA moderated 11bps QoQ to 2.7%, while NNPA was down by 2 bps QoQ at 0.94%. Strengthened collection and recovery mechanism helped robust recovery/ upgradation of Rs.2.81 bn. Provision Coverage Ratio is maintained at 65%. Slippages remained elevated ~1.2% of loans. It was mainly from retail and BuB (Business Banking) portfolio. 25% of the slippages were from the restructured book (43% of the portfolio has emerged out of moratorium). The bank has guided that slippages could be around Rs.18 bn in FY23E. We build in credit costs at ~60bps for FY23/FY24 each on the back of a highly-secured, granular portfolio.



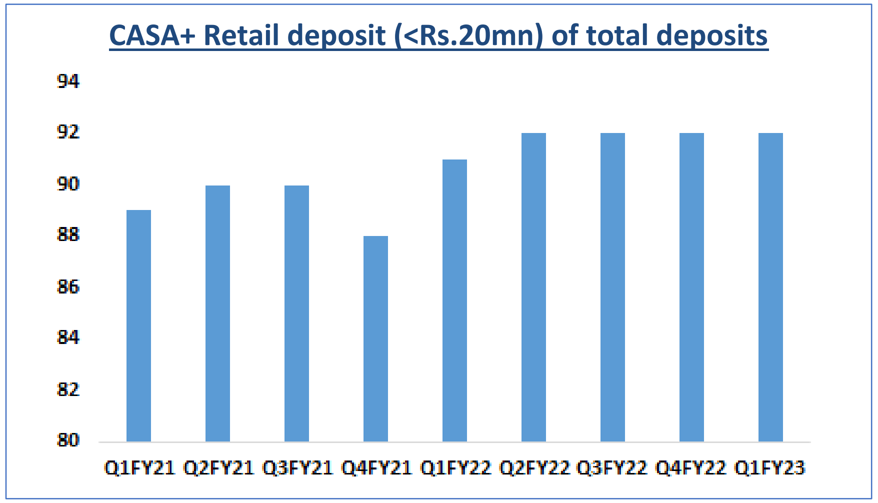


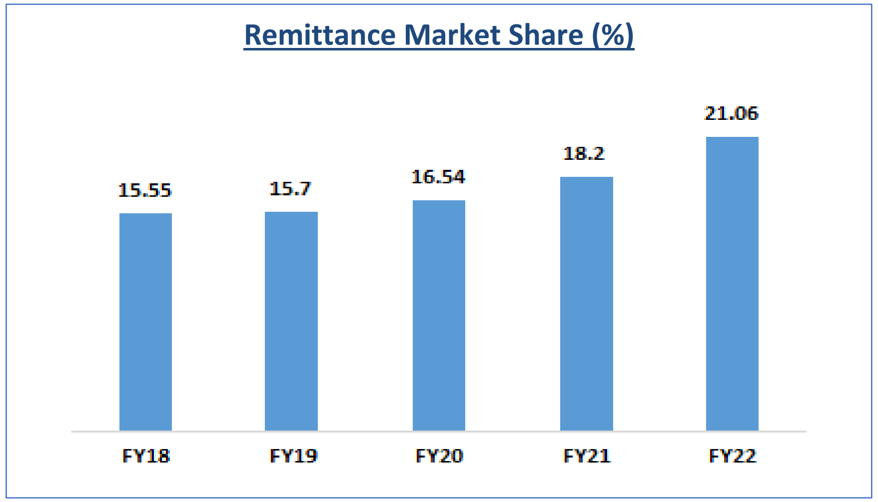
NPA Segment wise:

Rs.bn	Fresh Slippages		GNPA	
	Q4 FY22	Q1 FY23	Q4 FY22	Q1 FY23
Retail	0.86	2.04	10.97	11.31
Agri	1.47	0.89	8.91	9.16
BuB	0.68	1.07	9.03	9.58
CV/CE	0.02	0.02	0.08	0.10
CoB	0.55	0.42	7.68	6.96
Corporate	0.00	0.00	4.70	4.45
Total	3.58	4.44	41.37	41.56

Liabilities traction

We like federal bank's granular liability franchise. As of Q1FY23, retail deposits stood at 94% of total deposits. This has resulted in the one of the lowest cost of funds for the bank among the peer mid-size Banks. This gives the bank a competitive advantage. The bank has high market share in the non-resident external deposits in Kerala (especially from the Middle Eastern countries), which is one of the main reasons for better funding mix. This along with digital channel adoption and CASA enabling products (trade and transaction products) are improving the CASA ratio of the bank. CASA ratio during the quarter remained steady QoQ at 36.8% on the back of SA growth (12% YoY) and with the rising interest rates, the management expected this momentum to continue. CASA grew by 15% YoY. CASA+Retail term constitutes ~92% of total deposits. The cost of deposit in Q1FY23 decreased by 25 bps YoY, however, the bank has increased SA and TD rates upwards and this could result in increase in CoD.





Superior quality loan book

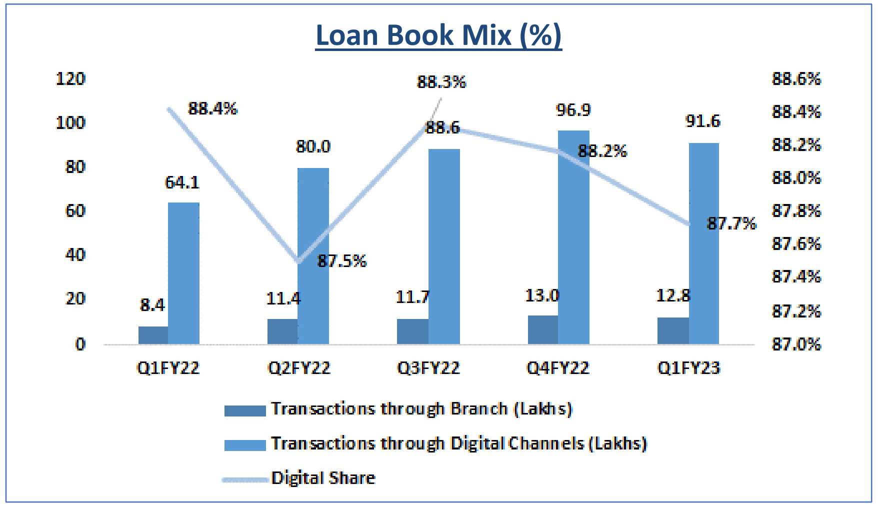
The bank has diversified loan book mix. On the back of conscious efforts by the management, the bank's loan book portfolio is now tilted towards secured retail loans and high rated corporates loans. This improvement in loan book ensures that the asset quality deterioration will be lower. In the corporate book the A & Above rated book stands at 78% and the retail book as compared to total book stands at 54%. Of total loan book – 48% is EBLR (External Benchmark Lending rates), 17% is MCLR (Marginal cost of funds based lending rate) and 26% is fixed. Large proportion of floating rate book ensures transition of hike in rates.

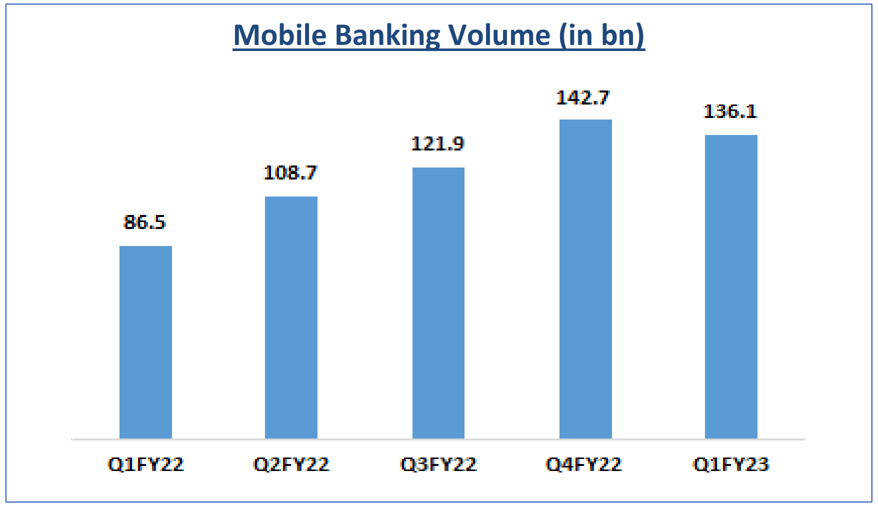
In Q1FY23, the loan growth (+17% YoY) surprised positively with balanced contribution across segments, including a selective pick-up in corporate lending. Business Banking & Commercial Banking grew at 18% and 20% YoY respectively, while Auto and Gold loan reported 24%

and 17% YoY growth respectively. New businesses like credit cards, personal loans, micro finance, commercial vehicle, commercial equipment, have all started seeing traction. Federal bank appears to be well-placed to drive market share gains, including gradual traction in high-margin, unsecured segments. Market share in Advances stands at 1.21% and that for deposits stands at 1.08%. Market share remained at all-time high of 21.06% for Individual Inward Remittance.

Digital innovation and FinTech Collaboration

The bank has adopted 'Digital at the Fore, Human at the Core' strategy. It has been continually building novel digital solutions to enable customers' services and gain a competitive advantage in the industry. Federal bank offer several digital platforms for retail, (FedNet, Lotza and FedMobile) corporate and SME (FedCorp, Corporate FedNet, Paylite and Fed EBiz). During the FY22, the company has launched as many as 14 new digital initiatives such as Feddy Live Agent, GoNoGo- digital Car Loan platform, Careerbook- platform for educational institutions etc. These platforms are redefining banking experience across their lifecycles. As a result of this, almost 88% of the transactions were done by digital means. In Q1FY23, digital transaction has seen 43% YoY growth. Mobile banking volume stood at Rs.136.13 bn and so far it has crossed Rs.443.74 bn transaction volume in the corporate digital products.





For the credit card business, the bank has adopted a 'Digital First' card approach by issuing an instant credit card, through a three-click approach. The launch of the product was aligned with the bank's strategy to improve unsecured, high-yielding book and completes the suite of banking products. It is now the fifth largest private sector bank in the country in terms of monthly debit card spends.

During the year, the bank has carved out FinTech partnerships as a separate unit with an exclusive team in-line with the Bank's strategy of 'Branch-light, Distribution heavy' and pursue the partnership opportunities to build and deliver better propositions and services to its customers. The main FinTech segments will be focusing on high-margin lending products such as unsecured loans, personal loans, credit cards etc. and also expanding the granular liabilities. So far the bank has partnered with more than 50 FinTechs. Two major partners includes Epifi & Jupiter. More than 4.5 lakh accounts are being opened every month by these two. This collaborative model could help the bank widen the reach to newer segments of the markets as well as help the bank reach out to a myriad of emerging market segments such as new to workforce, new to category, under banked or unorganized segments of the market.

Value unlocking via listing of NBFC-arm

Fedbank Financial Services Ltd. (FedFina) is a Systematically important NBFC (ND) whereby Federal Bank owns a 73.3% stake. FedFina has grown its gross loan book by 2.8 times in the last 3 years to Rs.5,645 crore as of FY22 from 2019 crore as on March 31, 2019. The Loan Book majorly comprises of Gold Loans (~42.50% as of Q2FY22) followed by LAP (~38% as of Q2FY22). The Gold Loans have a shorter average tenure (6 months) while the LAP have an average tenure of 12-13 years. The company posted an ROA of 1.2% for H1FY22. As on Mar. 31, 2022, The GS3 and NS3 assets stood at 2.23% and 1.75%, respectively. The company boasts of a healthy CRAR of 23.04% as of FY22 on account of regular fund infusions from the parent Federal Bank Ltd as well as True North LLP which is holding about 26% stake. The company has filed DRHP for raising Rs.900 cr. of fresh equity along with an OFS of 4.57 crore shares. The listing of FedFina may result in value unlocking for Federal Bank Ltd.

Risks & Concerns

- A higher-than-expected deterioration in the asset quality could result in the erosion of the Tier I capital. Fresh formation of bad loans could keep provisioning high and return ratios compressed for a longer time. Further, any delay in the recovery, higher than expected haircuts or sharp rise in the slippage could impact the profitability and business growth prospects.
- The bank has high regional presence in Southern part of India especially Kerala. As on June 30, 2022, out of the total branches, Kerala alone accounted for 46% followed by Tamil Nadu at 13%, Karnataka at 8% and Maharashtra at 7%.
- Although the current capital adequacy of the Bank at 14.6% (including 13.3% Tier-I) is comfortable, need for additional provisioning may push the Bank over the next few quarters to raise capital which may be dilutive. The management in the Q1FY23 earnings call informed that they will plan to raise capital once capital adequacy dips below 13-13.5%.
- The Bank is aggressively launching new products, the success and delinquencies there needs to be monitored.
- Return ratios for Federal Bank remained low due to higher credit cost, high operating cost and lower yield on advances. Management has taken several steps like focusing on high yield products, building up digital infrastructure, giving incremental loans to higher-rated corporate and secured retail loan etc. which could improve the return ratios going ahead.

- A sudden decline in the market price of gold may adversely affect the bank's financial condition, cash flows and earnings as it may be unable to realise the full value of its pledged gold, which exposes the bank to a potential loss.
- The rise in interest rates may impact the loan growth; the bank has high retail facing loan book and high interest rates negatively impacts the demand. Also the rise in G-sec yields could lead to MTM losses for the banking sector.

Company Background:

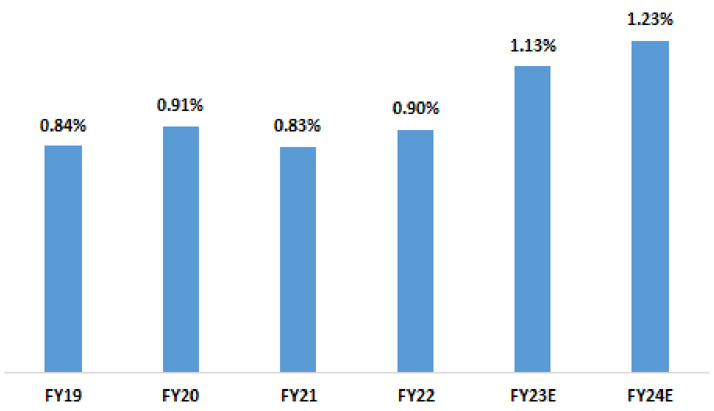
Federal Bank Limited was incorporated in 1931 as Travancore Federal Bank Limited. It provides retail and corporate banking, para banking activities such as debit card, third party product distribution etc., treasury and foreign exchange business. The bank has a strong retail funding franchise, including a stable base of NRI deposits, largely contributed by remittances from the expatriate Indian community in the Middle East.

It has major investments in four companies namely – Federal Operations & Services Limited (FedServ) - a wholly owned subsidiary, which provides operational & technology oriented services to Federal Bank, FedBank Financial Services (73.3% stake), Ageas Federal Life Insurance Company of India Limited wherein the bank holds 26% (a joint venture with Ageas (49%) and IDBI Bank (25%)) and Equirus Capital Private Limited, an unlisted investment banking firm, where the bank holds 19.89% stake.

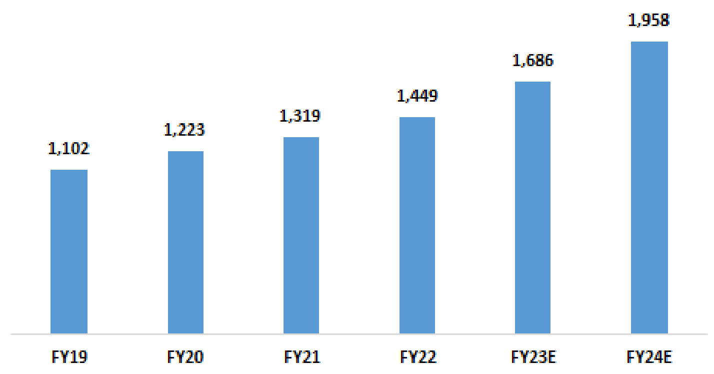
Peer Comparison:

	CMP	P/ABV			P/E			FY22						
		FY22P	FY23E	FY24E	FY22P	FY23E	FY24E	ROAE (%)	ROAA (%)	NIM %	GNPA %	NNPA %	CASA %	Loan Book (Rs. Bn)
FB	106.7	1.3	1.2	1.0	11.9	8.5	7	10.8	0.9	3.2	2.85	0.96	37.1	1,449
CUB	160.7	2.2	1.9	1.6	15.6	12.9	10.3	12.2	1.3	3.98	4.7	2.95	32.6	370
DCB	89.2	0.8	0.7	0.6	9.7	6.4	5.6	7.4	0.7	3.56	4.32	1.97	26.8	291

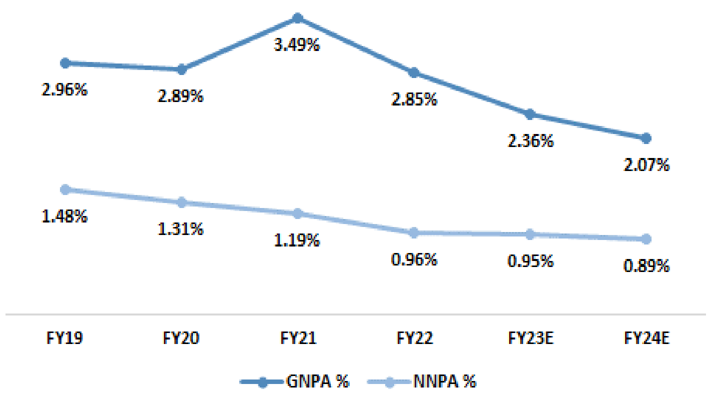
RoAA (%)



Loan book (in Rs. Bn) could grow by 16% CAGR over FY22-24E



NPA Trend



Financials

Income Statement

(Rs mn)	FY20	FY21	FY22	FY23E	FY24E
Interest earned	1,32,108	1,37,579	1,36,607	1,66,270	1,90,822
Interest expended	85,618	82,242	76,988	95,436	1,07,885
Net interest income	**46,489**	**55,337**	**59,619**	**70,834**	**82,937**
Other income	19,314	19,449	20,890	20,716	23,125
Treasury income	6,078	6,088	3,842	3,909	4,191
Total income	65,803	74,786	80,509	91,549	1,06,062
Operating expenditure	33,756	36,917	42,928	44,907	49,875
Pre-provisioning profit	**32,047**	**37,869**	**37,581**	**46,643**	**56,186**
Non-tax provisions	11,722	16,496	12,217	11,232	13,414
-NPA provisions	10,158	15,157	6,111	9,733	11,246
Profit before tax	**20,325**	**21,373**	**25,364**	**35,410**	**42,772**
Tax expenditure	4,898	5,470	6,463	9,030	10,907
Profit after tax	**15,428**	**15,903**	**18,901**	**26,381**	**31,865**

Balance Sheet

(Rs mn)	FY20	FY21	FY22	FY23E	FY24E
Share capital	3,985	3,992	4,205	4,205	4,205
Reserves and surplus	1,41,191	1,57,244	1,83,732	2,05,908	2,31,466
Net worth	1,45,176	1,61,236	1,87,937	2,10,113	2,35,671
Deposits	15,22,901	17,26,445	18,17,005	20,48,877	23,07,280
CASA	4,67,743	5,87,126	6,74,709	7,65,597	8,70,006
Borrowings	1,03,724	90,685	1,53,931	1,49,517	1,45,675
Other liabilities and provisions	34,579	35,308	50,587	44,877	51,415
Total equity and liabilities	**18,06,380**	**20,13,674**	**22,09,460**	**24,53,384**	**27,40,039**
Cash and cash equivalents	1,25,746	1,95,914	2,10,103	1,81,310	1,47,429
Investments	3,58,927	3,71,862	3,91,795	4,76,971	5,09,219
Government securities	3,17,607	3,27,826	3,48,661	4,17,695	4,41,532
Advances	12,22,679	13,18,786	14,49,282	16,86,396	19,57,932
Fixed assets	4,800	4,911	6,339	6,656	6,988
Other assets	94,229	1,22,201	1,51,942	1,02,052	1,18,471
Total assets	**18,06,380**	**20,13,674**	**22,09,460**	**24,53,384**	**27,40,039**

(Source: Company, HDFC sec)

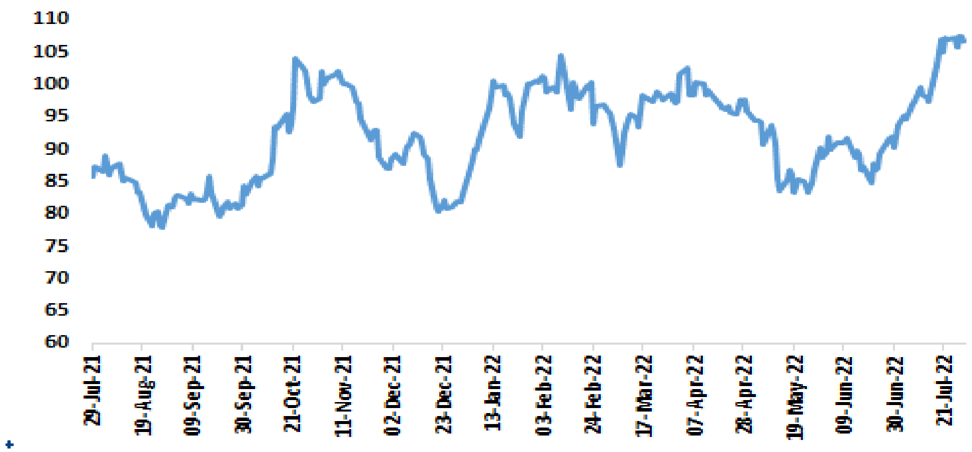
Key Ratio

	FY20	FY21	FY22	FY23E	FY24E
Valuation metrics					
EPS (Rs.)	7.7	8.0	9.0	12.5	15.2
BVPS(Rs.)	73	81	89	100	112
ABVPS(Rs.)	65	73	82.8	92.3	103.8
RoAA	0.91%	0.83%	0.90%	1.13%	1.23%
RoAE	11.1%	10.4%	10.8%	13.3%	14.3%
P/E (x)	13.9	13.3	11.9	8.5	7.0
P/ABV (x)	1.6	1.5	1.3	1.2	1.0
P/PPOP (x)	6.5	5.5	5.5	4.5	3.7
Profitability ratios					
Yield on advances	9.2%	8.5%	7.8%	8.3%	8.4%
Cost of funds	5.6%	4.8%	4.1%	4.6%	4.6%
Cost of deposits	5.6%	4.8%	4.1%	4.5%	4.6%
Core spread	3.5%	3.7%	3.7%	3.8%	3.8%
Net interest margin	3.0%	3.2%	3.2%	3.4%	3.5%
Operating efficiency ratios					
Cost-average assets	2.0%	1.9%	2.0%	1.9%	1.9%
Cost-income	51.3%	49.4%	53.3%	49.1%	47.0%

Key Ratios

	FY20	FY21	FY22	FY23E	FY24E
Balance sheet structure ratios					
Loan growth	10.9%	7.9%	9.9%	16.4%	16.1%
Deposit growth	12.8%	13.4%	5.2%	12.8%	12.6%
C/D ratio	80.3%	76.4%	79.8%	82.3%	84.9%
CASA	30.7%	34.0%	37.1%	37.4%	37.7%
CRAR	14.8%	14.6%	15.8%	14.6%	14.6%
Tier 1	13.8%	13.8%	14.4%	13.5%	13.6%
Asset quality metrics					
Gross NPA	35,308	46,024	41,367	39,745	40,586
Net NPA	16,072	15,693	13,926	16,003	17,521
PCR	54.5%	65.9%	66.3%	59.7%	56.8%
GNPA %	2.89%	3.49%	2.85%	2.36%	2.07%
NNPA %	1.31%	1.19%	0.96%	0.95%	0.89%
Slippages	1.65%	1.51%	1.36%	1.20%	1.23%
Credit costs	0.87%	1.19%	0.44%	0.62%	0.62%

One Year Price Chart



NISHABEN PARESHBHAI SHANKHALA

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HDFC Sec Retail Research Rating description

Green Rating stocks
This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks
This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks
This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

Disclosure:

I, Nisha Shankhala, Research Analyst, MBA, authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. SEBI conducted the inspection and based on their observations have issued advise/warning. The said observations have been complied with. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.
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