Stock Update

Federal Bank Ltd.

November 08, 2021

RETAILRESEARCH

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Federal Bank Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Banks	Rs.101.1	Buy at LTP of Rs.101.1 & add more on dips of Rs.90.25	Rs.111.5	Rs.124	2 quarters

HDFC Scrip Code	FEDBAN
BSE Code	500469
NSE Code	FEDERALBNK
Bloomberg	FB:IN
CMP Nov 4, 2021	101.1
Equity Capital (Rs mn)	4203
Face Value (Rs)	2
Equity Share O/S (mn)	2101.5
Market Cap (Rs bn)	212.4
ABook Value (Rs)	73
Avg. 52 Wk Volumes	27568829
52 Week High	107.65
52 Week Low	51.30

Share holding Pattern % (Sept, 2021)	
Promoters	-
Institutions	68.45
Non Institutions	31.55
Total	100.00

* Refer at the end for explanation on Risk Ratings

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Our Take:

Federal Bank is one of the best placed mid-tier old private sector bank. 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. Federal Bank is changing itself into next-gen private sector bank with digital tie-ups across assets, liabilities, and payments segments. This will not only increase the reach of the business but it will also improve the Cost to Income (C/I) ratio. It is also diversifying into high margin business like retail products, Commercial Vehicle /Construction Equipment loan, micro-credit, credit cards etc. Digital channel adoption and CASA enabling products are improving the CASA ratio of the bank (in Q2FY22, it reported highest ever CASA ratio). The bank has recently hired many senior level leaders across key verticals.

Moreover, the extension of Shyam Srinivasan as the MD & CEO for further three years by RBI has removed the overhang and brought the management stability which many peers lack. NBFC of the bank, Fedfina, is gradually scaling up its loan book and could bring value unlocking for the bank in long run. The bank is trading at comfortable valuations of 1.1x P/ABV FY23E and looking at Bank's growth strategy the stock warrants re-rating. In last few years, it has focused on accelerating growth in the non-corporate segment and has moderated growth in the large corporates. It has been increasing its focus on higher growth in the retail, SME and agri-gold loan segments. It had also launched its credit card to existing-to-bank customers in the month of May 2021, which can possibly drive fee income and margin improvement in the long run. The bank also plans to scale up its vehicle financing book in the medium term. However, on the retail side, the widening of product basket across high-yield products with adequate size and seasoning will be the key moniterable for improvement in the margin profile in the medium-to-long term.

We had issued Stock update on Federal Bank on 24th May, 2021 and recommended Buy at LTP Rs.85.1 and add on dips to Rs.75 band, for base case target of Rs.94 and bull case target of Rs.103 over the next two quarters. The bull case target of Rs.103 was achieved on 22nd October 2021, yielding return of 21%.

Link for the report:
https://www.hdfcsec.com/hsl.research.pdf/Federal%20Bank%20Ltd-Stock%20Update-%2024052021.pdf

Valuation & Recommendation:

Federal bank has posted decent Q2FY22 results with strong operating performance and lower provisions due to lower loan loss write-backs. On the back of a granular wholesale portfolio and its secured retail franchise, it has reported an impressive asset quality with slippages at 1.1% and steady early stage delinquencies. NPA % is now at a 5 year low. We have envisaged 14% CAGR in Net Interest Income and 24% CAGR in net profit over FY21-FY24E. Further, we have estimated that the loan book would grow at 12.9% CAGR over this period. We expect asset quality and NIM to improve gradually over FY21-24E. There could be higher recoveries in the next two-three years than slippages. The management has guided for Rs.18-20 bn of slippages for FY22. Further, it has guided for Cost to income ratio of 52-53% in FY22 and ~50% by FY23. For RoA, guidance of 1% is by FY22 and 1.25% over the next two years. Potential value unlocking in 74% subsidiary FedFina (balance 26% held by True North) adds to the margin of safety. Fedfina is focused exclusively on small ticket size credits; LAP, gold loans, small business lending. Their lending book is now at Rs.51 bn (vs Rs.44.92 bn as on March 31, 2021) and they are expected to grow at 25-30% a year or more. The net profit of the Company grew by 48% to Rs. 586 mn for the year ended March 31, 2021 as against Rs.395.4 bn for the year ended March 31, 2020. Federal Bank is among the early adopters using FinTech partnerships to build new growth avenues in its effort to boost its profitability, as reflected in recent productivity gains (daily account opening and deployment run rate).

We feel that investors can buy Federal bank at the LTP of Rs.101.1 (1.02x Sep-23E ABV) and add on dips to Rs.90.25 (0.91x Sep-23E ABV) band. We expect the Base case fair value of Rs.111.5 (1.12x Sep-23E ABV) and the Bull case fair value of Rs.124 (1.25x Sep-23E ABV) over the next 2 quarters.

Financial Summary

Particulars (Rs bn)	Q2 FY22	Q2 FY21	YoY (%)	Q1FY21	QoQ (%)	FY20	FY21	FY22E	FY23E	FY24E
NII	14.8	13.8	7.2	14.2	4.2	46.5	55.3	62.0	71.5	82.8
PPP	8.6	10.1	-14.9	11.4	-24.6	32.0	37.9	42.1	47.1	55.0
PAT	4.6	3.1	49.5	3.7	25.2	15.4	15.9	19.8	24.7	30.5
EPS (Rs)						7.7	8.0	9.4	11.7	14.5
ABV						59.1	72.9	81.6	91.9	106.5
P/E (x)						13.1	12.7	10.7	8.6	7.0
P/ABV (x)						1.7	1.4	1.2	1.1	0.9
RoAA (%)						0.9	0.8	0.9	1.1	1.2

(Source: Company, HDFC sec)

Recent Developments

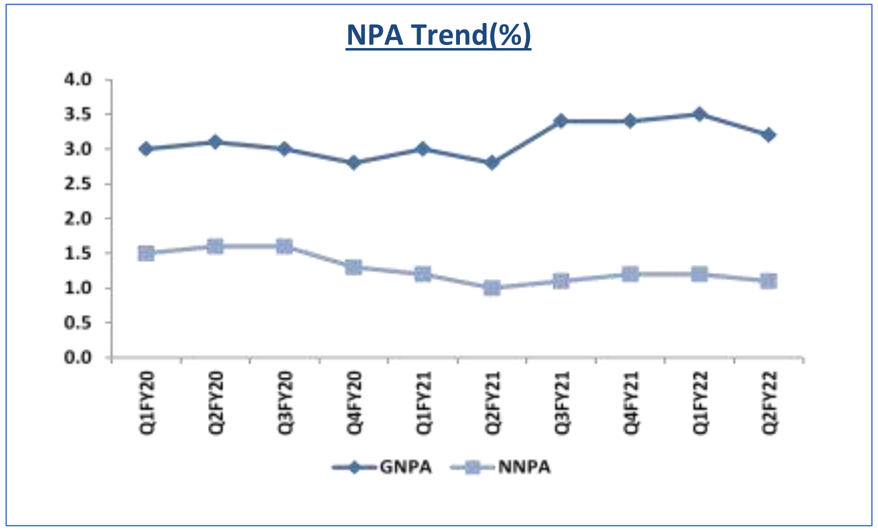
Q2FY22 Result Update

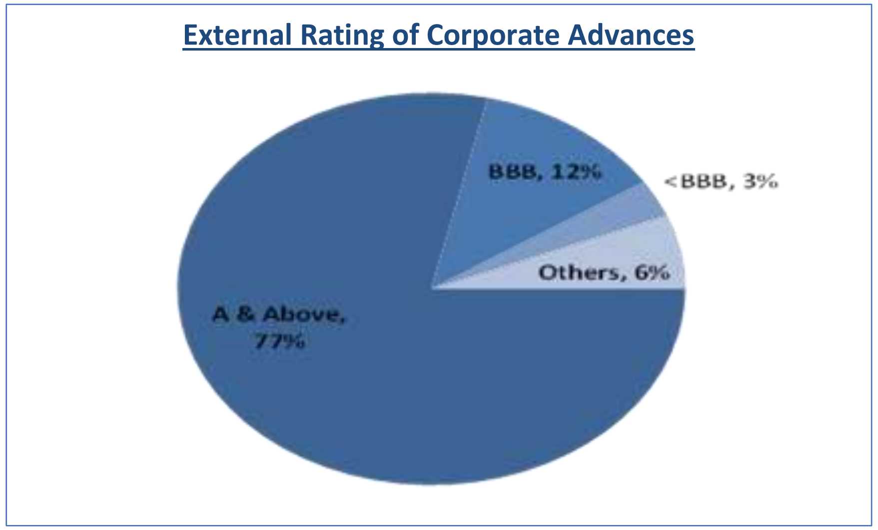
The bank has reported overall better than expected numbers in Q2FY22. The Net Interest Income (NII) was up 7.2% YoY and 4.3% QoQ. The strong traction in fee income (+30% YoY) and lower provisions (0.8% of loans) has helped the net profit growth of 50% YoY and 25% QoQ. Improved funding cost and steady asset yields with changing asset mix have aided the NIMs (up 5bps QoQ at 3.2%). Employee expense was high due to pension costs going up because of regulations related to purchasing annuity. The bank had to make higher provisions for the family pension scheme (amortized over five years with a total liability of Rs180 cr). CASA grew by 18% YoY and CASA Ratio came at all time high level of 36.16%. Overall deposits grew 10% YoY and 1.5% QoQ. Advances for the quarter grew by a 6 quarter high of 10%YoY and 3.4% QoQ. (Agri was up 20% YoY, business banking up 11.9% YoY, commercial banking up 11.6% and retail was up 11.6%). Gold Loans registered a growth of 25.88% to reach Rs.159.76 bn. Recovery from DHFL during the quarter aided the PAT.

There were two changes in accounting policy as per new RBI norms. One is that recovery from written off asset which earlier used to be accounted under other income, now has to be netted off against the provision for NPL. Also, any provision or depreciation for standard investments which was earlier accounted under provision and contingency is now netted off against other income.

Asset Quality

Fresh slippages were less than the recoveries and upgrades this time. Fresh slippages came at Rs. 3.2 bn (1.1%), while recoveries and upgrades were Rs.4.21 bn (1.3%). This has led to reduction in NPA numbers. GNPA stood at 3.2% vs 3.5% QoQ and NNPA came at 1.1% vs 1.2% QoQ. The Provision coverage ratio improved to 65.43% vs 65% QoQ. Incremental slippages were largely from the non-corporate portfolio. The restructured book increased 70bps sequentially to 2.6% of loans and comprises secured retail (home loans and LAP) and SME loans. Going forward, the restructured book will be a key monitorable as the Covid provision (0.37% of book) seems inadequate although a large part of restructured book is secured. Almost 80% of the restructured book has >75% security coverage. 73% of this has >100% security cover. Collection efficiencies for the quarter stood at 96%. Total SMA 1 and 2 book together is ~2% while SMA 0 is ~1.8%. The management has guided for Rs.18-20 bn of slippages for FY22, which suggests that total slippage for H2FY22 will be same or lower than H1FY22 (Rs.6.40 bn in Q1+ Rs.3.2 bn Q2). Further recoveries and upgrades are expected to be Rs.3-3.5 bn per quarter for H2FY22.

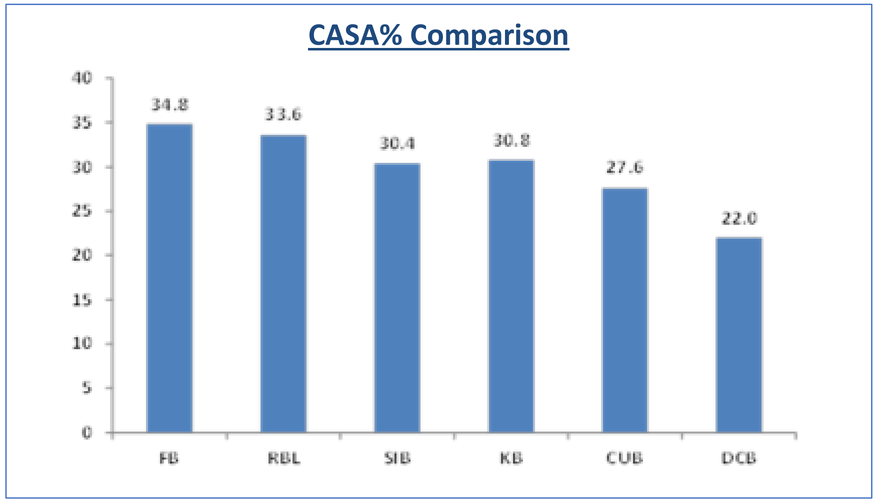


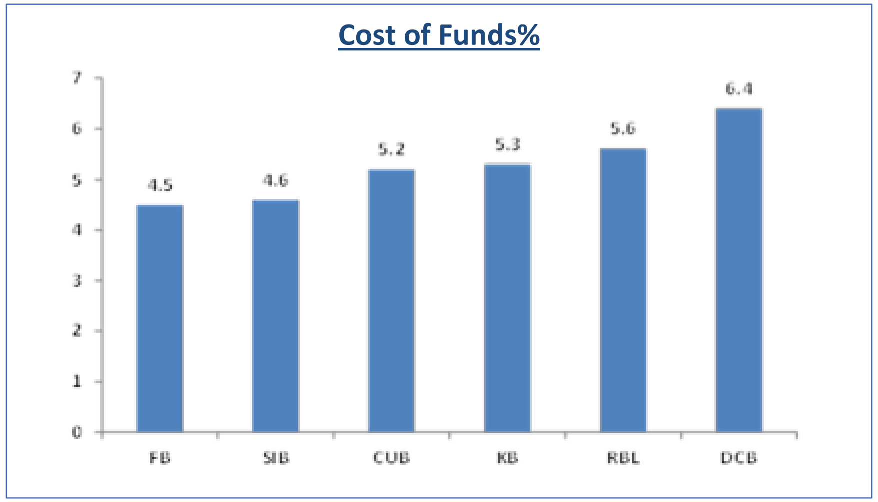


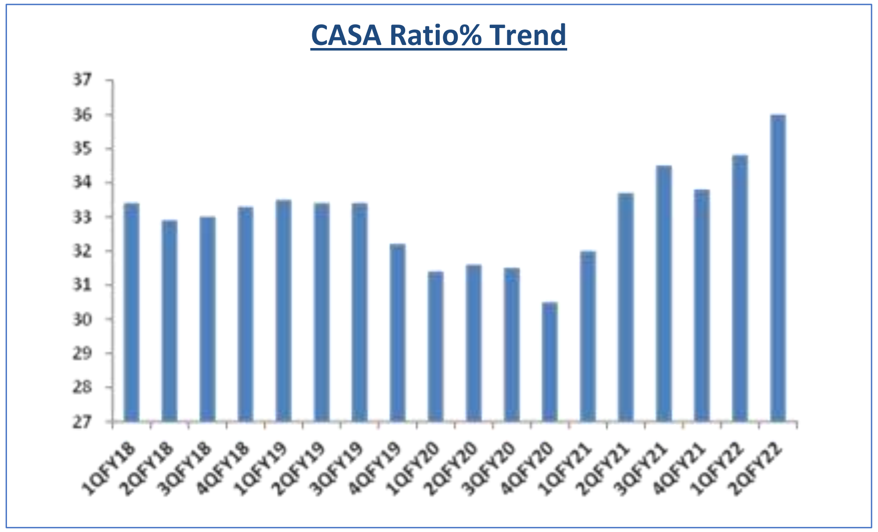
Improving CASA profile

The bank has strong and granular funding profile. CASA + retail TD constitutes over 90% of total deposits - one of the highest in the banking industry. Federal Bank has one of the lowest cost of funds 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. In the Q2FY22, the bank has reported highest ever CASA ratio of 36.16%. CASA during the quarter grew by 18% YoY. Inward Remittances also remained a strong forte with a market share for the bank standing at 20.54% level. All these will continue to aid margins for the bank over long run. The bank also has comfortable capitalization level. The capital adequacy ratio stood at 14.97% level with Tier 1 Capital of 14.09%. This could act as a cushion against any probable uncertain eventuality of asset quality shocks or fall in CASA.

We have taken Q1FY22 numbers for the comparison with peer banks for comparing it like to like.



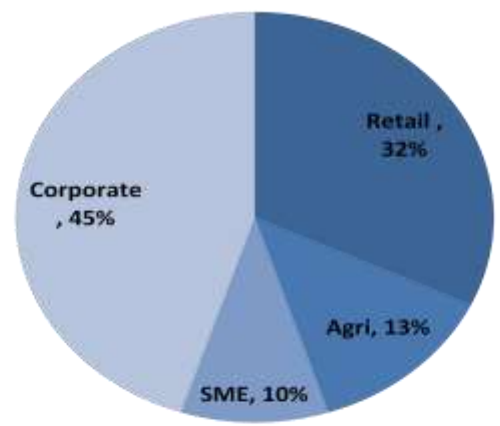




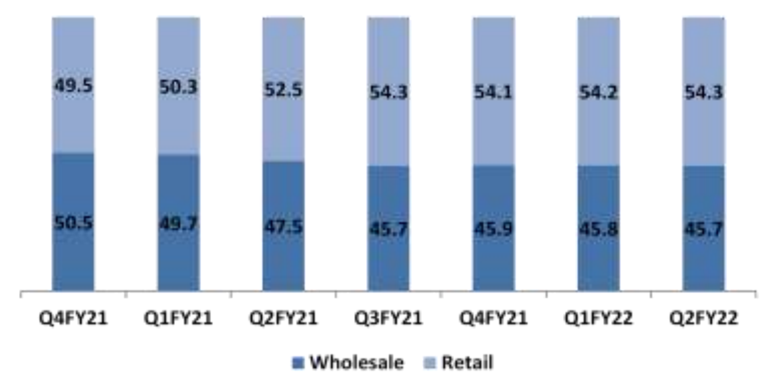
Change in product mix to drive better margins

Federal Bank has a well-diversified loan book mix. And as mentioned in the earlier report, the management is changing focus towards increasing retail mix in the overall portfolio. Retail loans are comparatively less risker and provides higher margin. The efforts are also evident from the change of mix; retail segment has increased from 40% in FY17 to 54% as of Q2FY22. Further, the gold loan portfolio is also growing at a good pace. During the quarter, the gold loans registered a growth of 25.88% reaching Rs. 159.76 bn. The bank has launched credit card to existing-to-bank customers in May-21. The concern regarding the suspension of MasterCard by the RBI is now behind as the bank launched credit cards with Rupay/Visa and has also tied up with One Card to source cards. The management informed that it is planning to increase the share of unsecured lending with a cap at 5% of the total assets under management in products such as credit cards, personal loan, fintech tie-ups and microfinance. We expect high growth in the retail products Commercial Vehicle /Construction Equipment loan, micro-credit, credit cards.

Loan Book Mix (%)



Improving Retail Mix%



The bank continues to build MFI organically and is on the lookout for inorganic acquisition as business normalizes. Its BC Micro-lending platform FedMi went live in Q2 and should help in sourcing high-margin MFI business.

New Management Team

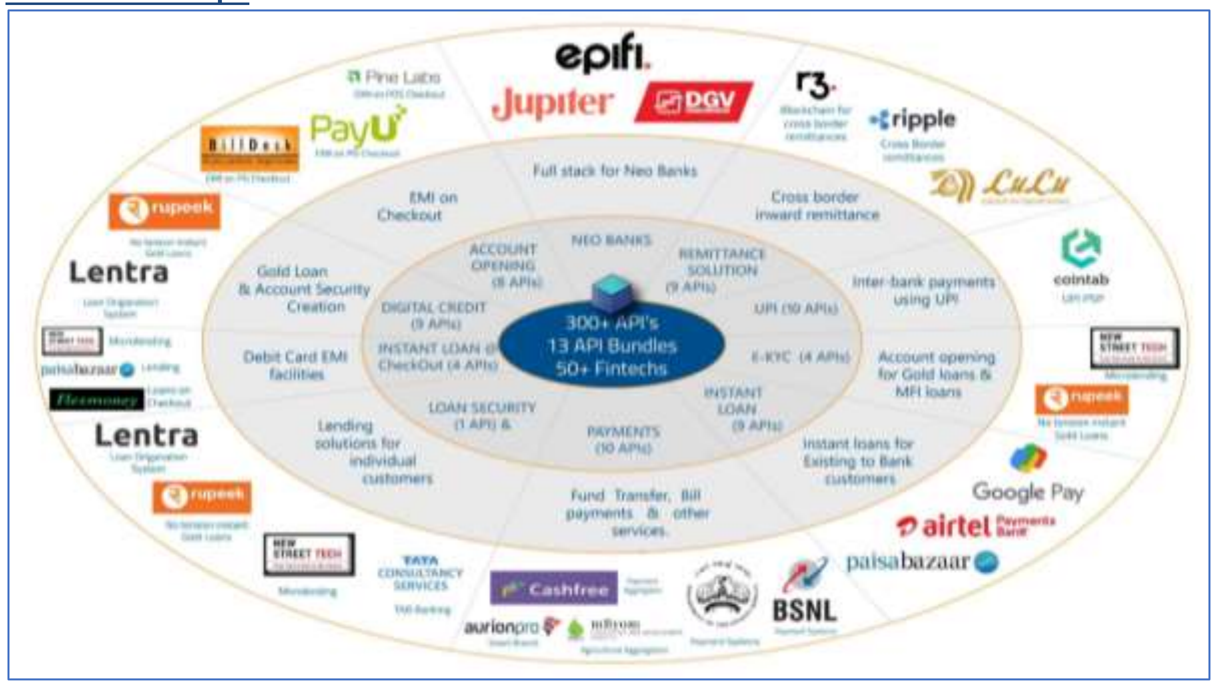
The bank has hired many senior level leaders across key verticals who bring significant amount of experience and knowledge with them. Recently, Venkatraman Venkateswaran has been hired as Chief Financial Officer with effect from 18th May'21 and Ashutosh Khajuria, Executive Director and CFO, would be 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. Now again in July-21, the Reserve Bank of India has given the permission for re-appointment of Shyam Srinivasan as the MD & CEO of the bank for a period of three years with effect from September

23, 2021 till September 22, 2024. Now the overhang of change of management at the helm is out of the way, the bank can focus on the long term strategy it has laid out for growth.

Cost to income ratio will gradually improve with digital tie ups

Long back, the bank had adopted a branch-light distribution-heavy business model where it is focusing on opening less branches and investing more on brand building, digital initiatives etc. To strengthen the digital footprint, the bank has been constantly trying different ways, which will make them technology-led financial service provider. It has partnered with leaders like Pine Labs, PayU to offer EMI loans. It is already sourcing gold loans via Rupeek, with book large book size and negligible delinquencies. To adopt a digital sourcing model which reduces the cost of acquisition, the bank has partnered with neo banks like epiFi, Jupiter, DGV, etc. 50% of the bank's new acquisition and of its new clients were done from fintech. Federal Bank said on October 22 that it has opened more than 3 Lakh accounts with neo-banking partners. This will give the bank access to a new set of clients, reduce the incremental cost of business and garner better fees/revenues in the long run. Further, GPay, Airtel Payment Bank, Paisa Bazaar etc. are partnered with to source loans. The management has guided for Cost to income ratio of 52-53% in FY22 and it is planning to further reduce it to ~50% by FY23.

Fintech Landscape



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. Recent floods in Kerala could result in a temporary spike in NPA creation.
- The bank has high regional presence in Southern part of India especially Kerala. As on September 30, 2021, out of the total branches, Kerala alone accounted for 47% followed by Tamil Nadu at 12%, Karnataka at 8% and Maharashtra at 8%.
- Although the current capital adequacy of the Bank at 14.97% (including 14% Tier) is comfortable, need for additional provisioning may push the Bank over the next few quarters to raise capital at prices that may be dilutive.
- 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. Management has guided for RoA of 1% by FY22 and further aims to increase RoA to 1.25% over the next two years.
- 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.

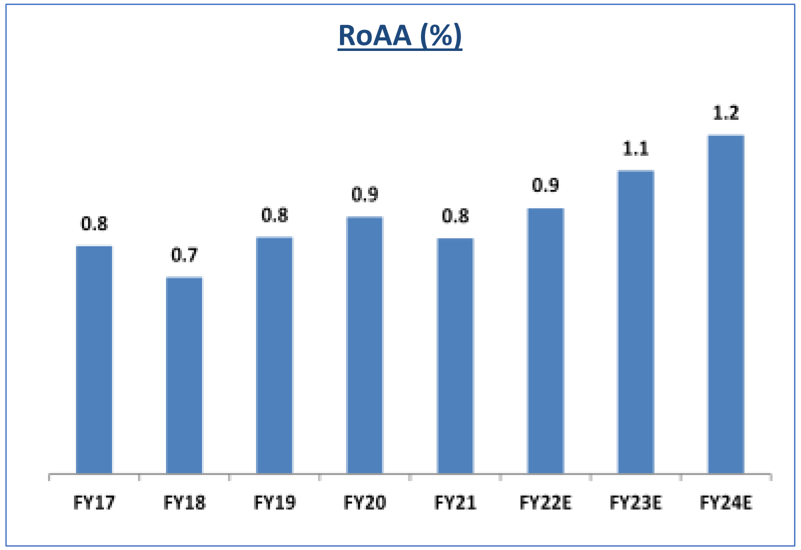
Company Background:

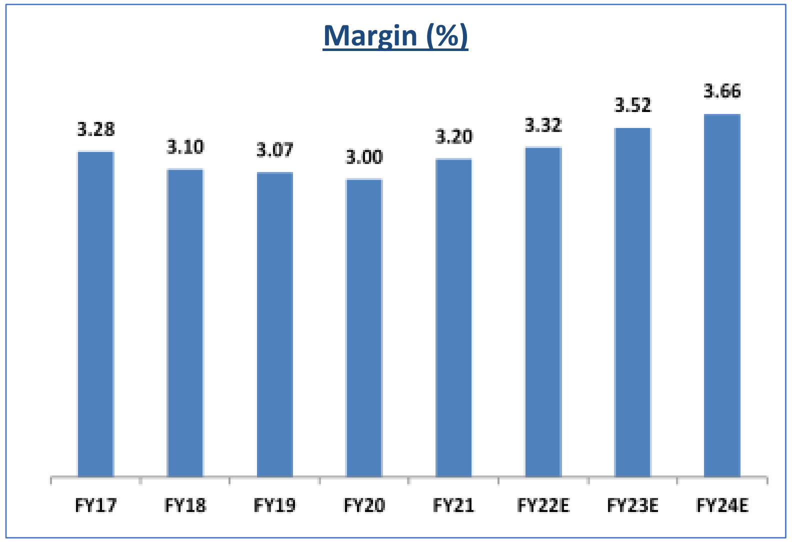
Federal Bank Limited was incorporated in 1931 as Travancore Federal Bank Limited. It provides retail and corporate banking, para banking activities such as debit card, third party product distribution etc., treasury and foreign exchange business. The bank has a strong retail funding franchise, including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

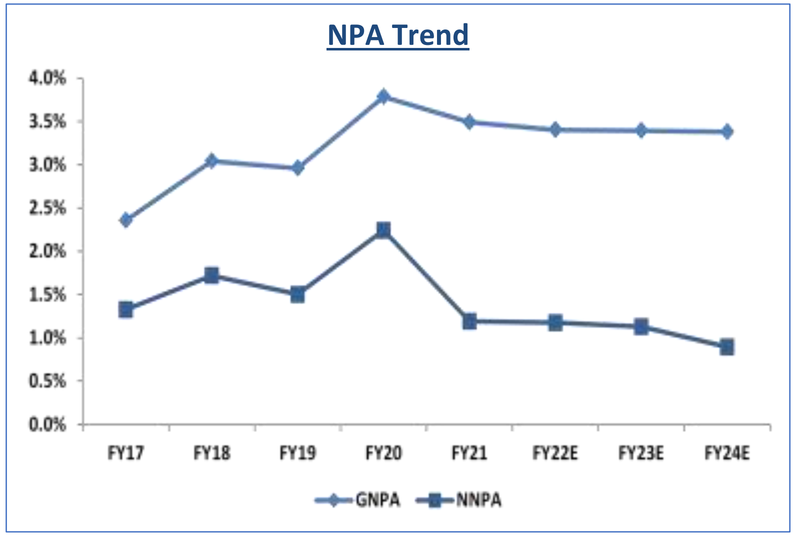
It has major investments in four companies namely – Federal Operations & Services Limited (FedServ) - a wholly owned subsidiary, which provides operational & technology oriented services to Federal Bank, FedBank Financial Services (74% stake), Ageas Federal Life Insurance Company of India Limited wherein 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			FY21						
		FY21	FY22E	FY23E	FY21	FY22E	FY23E	ROAE (%)	ROAA (%)	NIM %	GNPA %	NNPA %	CASA %	Loan Book (Rs. Bn)
FB	101.1	1.4	1.2	1.1	12.7	10.7	8.6	10.4	0.8	3.2	3.50%	1.20%	34%	1,319
CUB	174.2	2.7	2.2	1.9	21.8	16.9	13.4	10.6	1.15	3.9	5.11	2.97	29.1	362
DCB	99.1	1	0.9	0.8	9.2	9.8	6.9	9.4	0.9	3.6	4.1	2.3	22.8	260
RBL	203.5	1.1	1.1	1	23.9	75.4	11.1	4.4	0.5	4.2	4.3	2.1	31.8	586







Financials

Income Statement

(Rs mn)	FY20	FY21	FY22E	FY23E	FY24E
Interest Income	132108	137579	155828	175182	199555
Interest Expenses	85618	82242	93783	103634	116798
Net Interest Income	**46489**	**55337**	**62045**	**71548**	**82757**
Non-interest income	19314	19449	20870	24088	24944
Operating Income	**65803**	**74786**	**82915**	**95636**	**107701**
Operating Expenses	33756	36917	40863	48495	52684
PPP	32047	37870	42052	47140	55017
Prov & Cont	11722	16496	15671	14261	14404
Profit Before Tax	20325	21373	26380	32879	40613
Tax	4898	5470	6595	8220	10153
PAT	**15428**	**15904**	**19785**	**24659**	**30460**

Balance Sheet

(Rs mn)	FY20	FY21	FY22E	FY23E	FY24E
Share Capital	3985	3992	4203	4203	4203
Reserves & Surplus	141191	157244	184511	207699	236688
Shareholder funds	**145176**	**161236**	**188714**	**211902**	**240891**
Deposits	1522900	1726445	1863629	2033575	2231713
Borrowings	103724	90685	102470	116508	151926
Other Liab & Prov.	34580	38601	43233	48853	56181
SOURCES OF FUNDS	**1806380**	**2016967**	**2198046**	**2410839**	**2680712**
Cash & Bank Balance	125746	195914	129442	111658	108349
Investment	358927	371862	409048	445863	477073
Advances	1222679	1318786	1463852	1664400	1899081
Fixed Assets	4800	4911	5402	5834	6301
Other Assets	94229	125494	190301	183084	189908
TOTAL ASSETS	**1806381**	**2016967**	**2198046**	**2410839**	**2680712**

(Source: Company, HDFC sec)

Federal Bank Ltd.

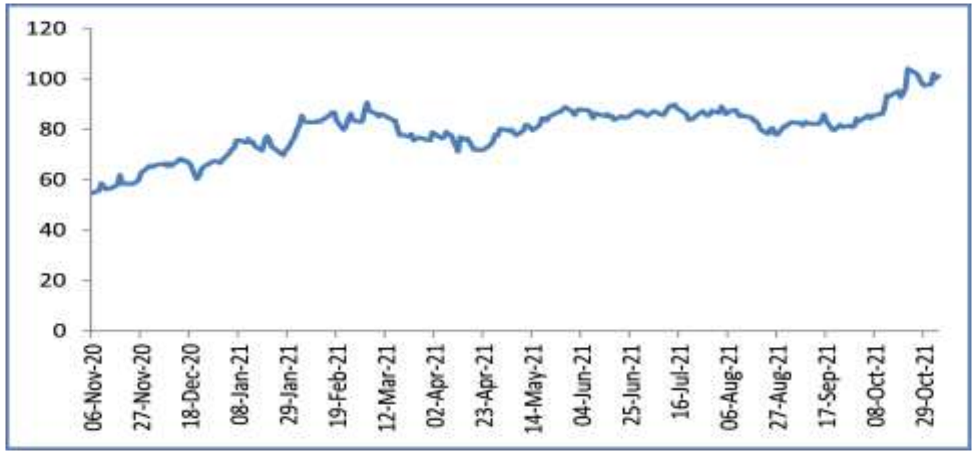
Key Ratio

	FY20	FY21	FY22E	FY23E	FY24E
Return Ratios					
Calc. Yield on adv	11.4%	10.8%	11.2%	11.2%	11.2%
Calc. Cost of funds	5.6%	4.8%	4.8%	4.8%	4.9%
NIM	3.0%	3.2%	3.3%	3.5%	3.7%
RoAE	11.1%	10.4%	11.3%	12.3%	13.5%
RoAA	0.9%	0.8%	0.9%	1.1%	1.2%
Asset Quality Ratios					
GNPA	3.8%	3.5%	3.4%	3.4%	3.4%
NNPA	2.2%	1.2%	1.2%	1.1%	0.9%
PCR	40.7%	65.9%	65.5%	66.7%	73.5%
Growth Ratios					
Advances	10.9%	7.9%	11.0%	13.7%	14.1%
NII	11.3%	19.0%	12.1%	15.3%	15.7%
PAT	24.0%	3.1%	24.4%	24.6%	23.5%

Key Ratios

	FY20	FY21	FY22E	FY23E	FY24E
Valuation Ratios					
EPS	7.7	8.0	9.4	11.7	14.5
P/E	13.1	12.7	10.7	8.6	7.0
Adj. BVPS	59.1	72.9	81.6	91.9	106.5
P/ABV	1.7	1.4	1.2	1.1	0.9
Dividend per share	0.0	0.7	0.7	0.7	0.7
Other Ratios					
Cost-Income	51.3	49.4	49.3	50.7	48.9
CASA	30.7	34.0	34.2	34.3	34.7
CAR	14.3	14.6	15.2	15.6	15.9
Tier 1	13.3	13.8	14.5	14.9	15.3

One Year Price Chart



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:

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