

Federal Bank

05 September, 2022

Reuters: FED.BO; Bloomberg: FB IN

Risk-reward very attractive

We think that Federal Bank continues to offer attractive risk-reward despite stock return of ~25% in the last six months and 41% run-up since June'22 low. The stock is currently trading at 1.1x/1x FY24E/FY25E ABVPS while we think it has potential to deliver 1.2% ROA and ~14% ROE over the next 2-3 years. The bank had last delivered >13% ROE in FY15, post which its return profile has declined due to deterioration in NIMs and higher credit cost. Some of the most notable concerns around the bank have been its ability to improve NIMs and control lumpy & unpredictable slippages. Up to FY25E, we estimate the bank's NIMs to expand by 23bps cumulatively on the back of larger share of margin-accretive retail loans. 65% linkage to floating rates also augurs well from margin standpoint. We expect annual credit cost of ~60bps over FY24-25E, led by improving asset quality amid a more stable domestic environment. The corrective measures taken by the bank, such as lower corporate loan ticket sizes, are worth noting. However, we believe that investors would be more comfortable if the bank can build a higher contingent buffer. The bank is well known for its granular and stable liability profile, which translates into a highly competitive cost of funds (CoF). Tier-I capital currently stands at 13.31% and the bank has no plans to raise fresh equity capital as of now. In the last 12 years, the bank has reduced branch share of Kerala to 46% (it was 60% in FY11), indicating efforts taken to diversify geographically. Our key thesis on Federal Bank is premised upon improving financial performance and undemanding valuation. We roll over our valuation basis to 1HFY25E and increase our target price (TP) to Rs149 (1.3x 1HFY25E ABVPS).

Nearly there on NIM guidance, but what next? In 1QFY23, the bank reported NIM of 3.22% (+7bps YoY, +6bps QoQ), nearly reaching the bank's guidance of 3.25-3.27% for FY23. Given the bank's stated guidance, we expect it to report further margin improvement in the coming quarters. Higher floating rate linkage in the asset portfolio (total: 65%, EBLR: 48%, MCLR: 17%), in light of the 140bps cumulative repo rate hike so far, will be one of the key drivers of yield improvement. Given the improving asset profile and increasing share of retail loans, we believe there is a good case for NIMs to expand further. We note that the bank is looking to build some margin-accretive businesses such as CV/CE, unsecured personal loans, credit cards etc. Subjectively, we assess that the management's growth mindset indicates pursuit of growth in high-margin products. We believe that a highly competitive CoF would support competitive pricing while ensuring that underwriting standards are not compromised for growth.

Higher share of retail loans augurs well: The share of retail loans has increased considerably, from 46% in FY18 to ~55% in 1QFY23. The improvement in the share of retail loans has been rather gradual and is expected to continue given the various new product initiatives planned by the bank. For instance, the bank is targeting supernormal growth in unsecured personal loans. Until now, it had been sourcing unsecured customers internally, but it is now slowly opening up to customers sourced through fintech partnerships. CV/CE loans, started three years ago, are also expected to benefit from the anticipated pick-up in infrastructure activities. Latest commentary from the bank indicates that momentum in retail loans has improved further since early July'22. Mortgage remains a steady performer. Business Banking (BuB) is also expected to do well on the back of a stronger sourcing engine (increased RM team). In its latest commentary, the bank has increased its FY23 loan growth guidance to 18%.

Don't see risk to credit cost: We expect Federal Bank to deliver annual credit cost of ~60bps over FY24-25E. In the past, risky exposure to the corporate segment had resulted in elevated credit cost, especially over FY16-20. During FY18-20/21, corporate GNPA had averaged 1.9-2%, but the same reduced to 0.81% as of 1QFY23. Over FY18-21, the corporate segment had contributed 24-45% to total gross slippages per annum, but this declined to 7% in FY22 given the clean-up in the preceding years. In the last couple of years, the bank has taken corrective measures in corporate banking, such as reducing average ticket sizes, avoiding consortium loans etc. For instance, since 1QFY21, the average ticket size in corporate banking is down 11%. Further, the share of <BBB rated corporate accounts has also shrunk to 3%. The management had previously stated that 15-20% of the restructured pool could slip into NPA; and, therefore, we may see elevated retail slippages for 1-2 more quarters. Given that most of the retail restructuring was in mortgages, the LGD on these loans was very low. For FY23, the bank is guiding for Rs18bn of slippages, which includes the slippages from the restructured portfolio.

Valuation is attractive: The stock is currently trading at 1.1x/1x FY24E/25E ABVPS, which looks inexpensive for a large and stable balance sheet size of Rs2.5tn. ROA/ROE are expected to improve to 1.1-1.2%/13-14% over the next two years. The bank is clearly displaying a pro-growth mindset with a sharper focus on margin-accretive products such as CV/CE, unsecured retail loans etc. At the same time, the bank has been very clear about not compromising margins/credit quality for growth in the corporate segment. It also has a highly competitive CoF, which should support competitive pricing.

BUY

Sector: Banking

CMP: Rs120

Target Price: Rs149

Upside: 19%

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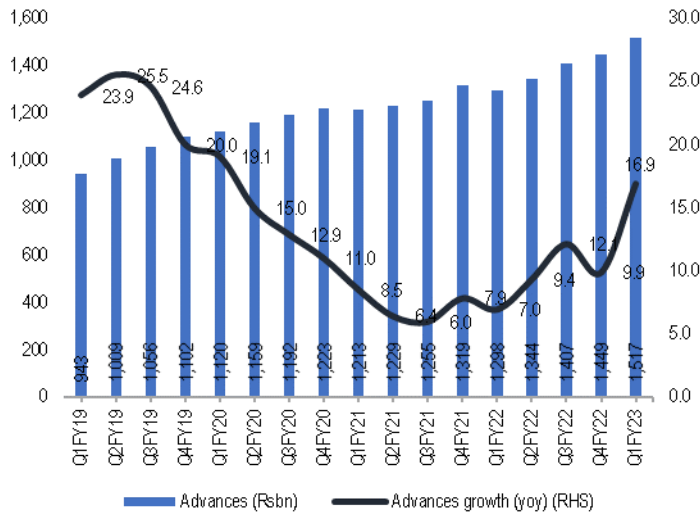
Key Data

Current Shares O/S (mn)	2,105.4
Mkt Cap (Rsbn/US\$bn)	251.7/3.2
52 Wk H / L (Rs)	123/78
Daily Vol. (3M NSE Avg.)	13,232,170

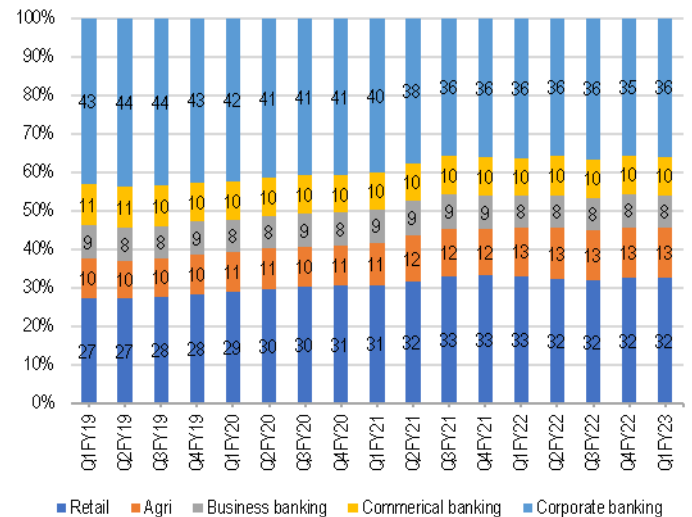
Price Performance (%)

	1 M	6 M	1 Yr
Federal Bank	9.7	28.2	44.3
Nifty Index	0.8	8.0	1.2

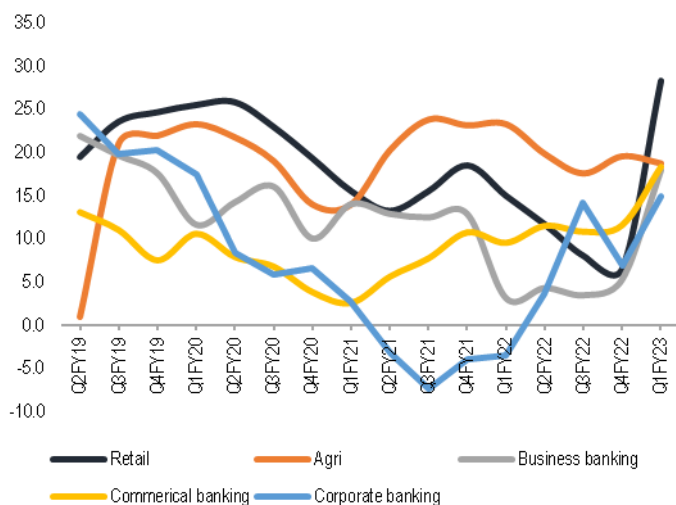
Source: Bloomberg

Exhibit 1: Credit growth


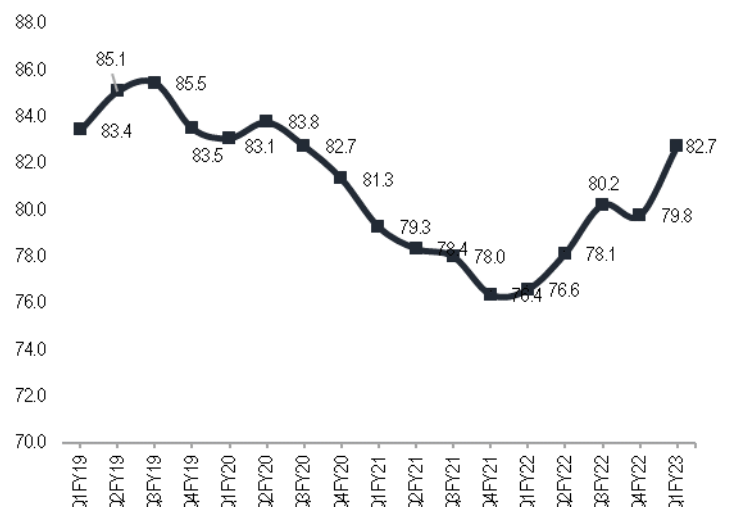
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Loan book mix (%)


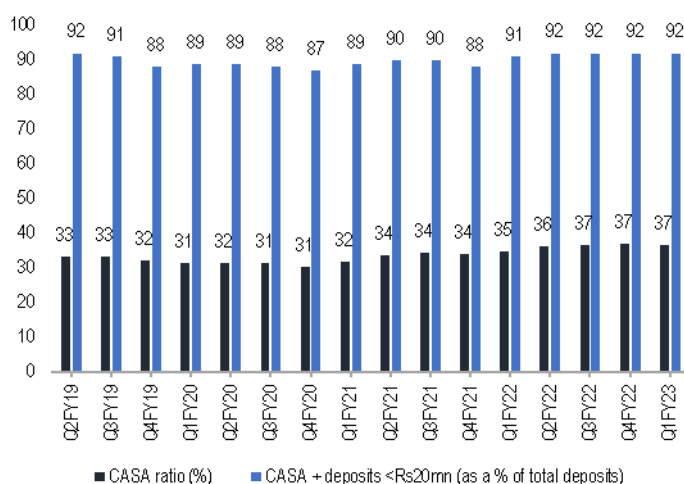
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Segment-wise loan book growth (YoY, %)


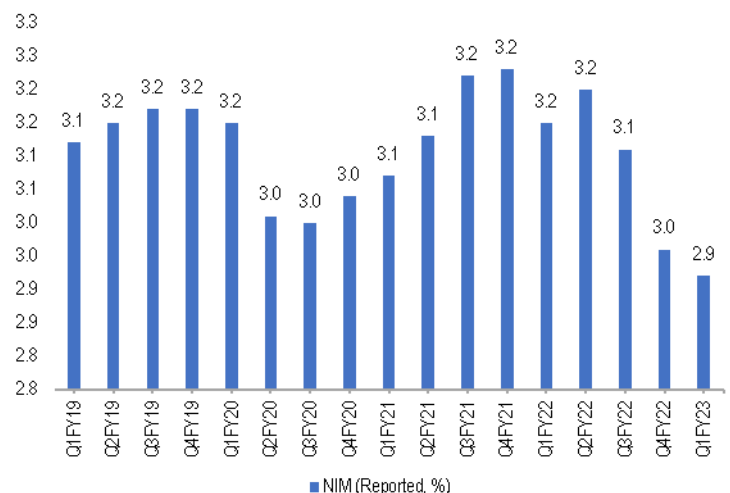
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: Credit/deposit ratio (%)


Source: Company, Nirmal Bang Institutional Equities Research

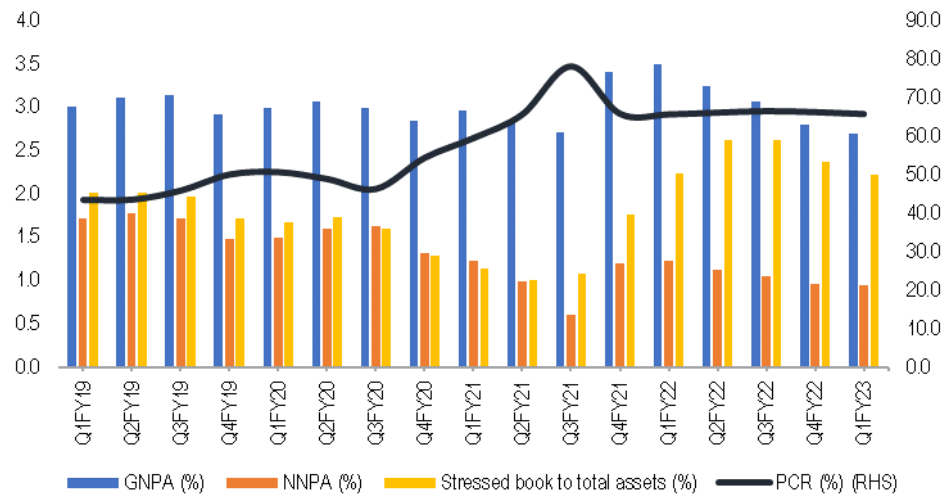
Exhibit 5: Deposits profile


Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: NIM (%) (reported)


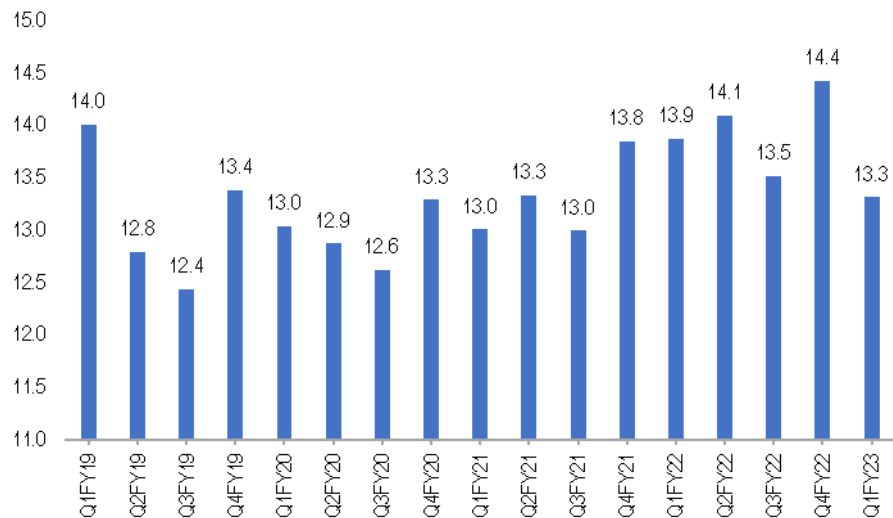
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Stressed assets and provision coverage



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Tier-1 capital ratio (%)



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Financial summary

Y/E March (Rsmn)	FY21	FY22	FY23E	FY24E	FY25E
Net interest income	55,337	59,620	70,257	81,041	92,366
Operating profit	37,869	36,141	43,393	49,925	58,342
PAT	15,903	18,898	24,369	29,852	35,201
EPS (Rs)	8.0	9.0	11.6	14.2	16.7
BV (Rs)	80.8	89.4	100.0	113.1	128.5
P/E (x)	15.1	13.4	10.4	8.5	7.2
P/BV (x)	1.5	1.3	1.2	1.1	0.9
GNPAs (%)	3.4	2.8	2.6	2.3	2.2
NNPAs (%)	1.2	1.0	0.9	0.7	0.6
RoA (%)	0.8	0.9	1.0	1.1	1.2
RoE (%)	10.4	10.8	12.2	13.3	13.9

Source: Company, NirmalBang Institutional Equities Research

Exhibit 10: Change in our estimates

	Revised Estimate		Earlier Estimate		% Revision	
	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
Net Interest Income (Rsmn)	70,257	81,041	69,251	80,147	1.5	1.1
Operating Profit (Rsmn)	43,393	49,925	42,387	49,031	2.4	1.8
Provisions (Rsmn)	10,788	10,032	10,788	10,032	0.0	0.0
Profit after tax (Rsmn)	24,369	29,852	23,616	29,183	3.2	2.3
Loan book (Rsbn)	1,687	1,913	1,687	1,913	0.0	0.0
ABVPS (Rs)	93.0	106.7	92.7	106.1	0.3	0.6

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: One-year forward P/ABV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 12: Income statement

Y/E March (Rsmn)	FY21	FY22	FY23E	FY24E	FY25E
Interest Income	1,37,579	1,36,608	1,56,237	1,82,041	2,06,188
Interest expense	82,242	76,988	85,980	1,01,000	1,13,822
Net interest income	55,337	59,620	70,257	81,041	92,366
Non-interest income	19,449	19,453	18,914	20,283	23,748
Net Revenue	74,786	79,073	89,171	1,01,324	1,16,114
Operating Expense	36,917	42,932	45,777	51,399	57,772
-Employee Exp	20,342	23,206	20,580	22,276	24,113
-Other Exp	16,575	19,727	25,197	29,122	33,659
Operating profit	37,869	36,141	43,393	49,925	58,342
Provisions	16,496	10,780	10,788	10,032	11,301
PBT	21,373	25,361	32,605	39,893	47,041
Taxes	5,470	6,463	8,237	10,041	11,840
PAT	15,903	18,898	24,369	29,852	35,201

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: Balance sheet

Y/E March (Rsmn)	FY21	FY22	FY23E	FY24E	FY25E
Share capital	3,992	4,205	4,207	4,207	4,207
Reserves & Surplus	1,57,244	1,83,733	2,06,133	2,33,616	2,66,001
Shareholder's Funds	1,61,236	1,87,938	2,10,340	2,37,823	2,70,208
Deposits	17,26,445	18,17,006	20,63,781	23,22,234	26,13,261
Borrowings	90,685	1,53,931	1,54,084	1,77,803	2,10,434
Other liabilities	35,308	50,588	73,212	84,318	91,573
Total liabilities	20,13,674	22,09,463	25,01,416	28,22,178	31,85,476
Cash/Equivalent	1,95,914	2,10,104	2,06,261	2,32,503	2,62,604
Advances	13,18,786	14,49,283	16,86,678	19,13,070	21,69,850
Investments	3,71,858	3,91,795	4,33,394	4,87,669	5,48,785
Fixed Assets	4,911	6,339	6,913	6,903	7,200
Other assets	1,22,201	1,51,942	1,68,170	1,82,032	1,97,038
Total assets	20,13,674	22,09,463	25,01,416	28,22,178	31,85,476

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 13: Key ratios

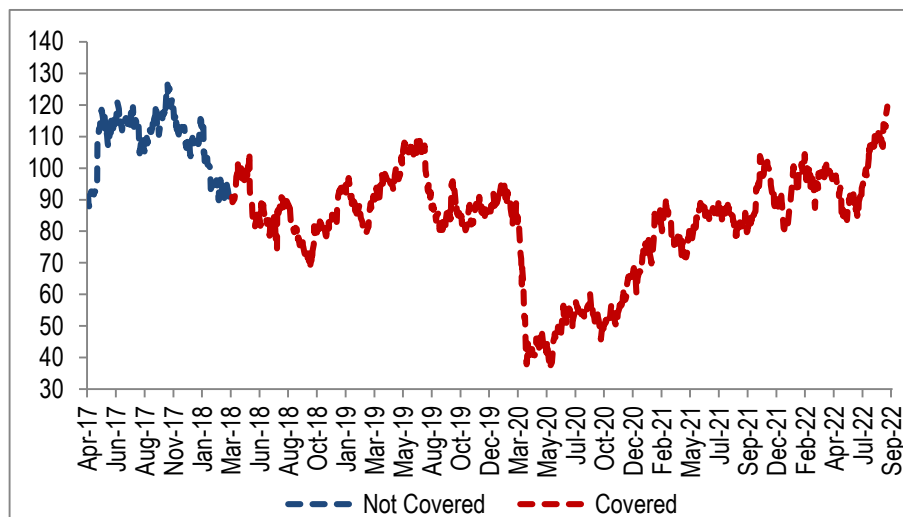
Y/E March	FY21	FY22	FY23E	FY24E	FY25E
Growth (%)					
NII growth	19.0	7.7	17.8	15.4	14.0
Pre-provision profit growth	18.2	-4.6	20.1	15.1	16.9
PAT growth	3.1	18.8	28.9	22.5	17.9
Business (%)					
Deposit growth	13.4	5.2	13.6	12.5	12.5
Advance growth	7.9	9.9	16.4	13.4	13.4
CD	76.4	79.8	81.7	82.4	83.0
CASA	34.0	36.9	36.4	36.5	36.6
Operating efficiency (%)					
Cost-to-income	49.4	54.3	51.3	50.7	49.8
Cost-to-assets	1.9	2.0	1.9	1.9	1.9
Spreads (%)					
Yield on advances	8.5	7.8	8.0	8.2	8.2
Yield on investments	6.4	6.1	6.1	6.1	6.1
Cost of deposits	4.8	4.2	4.2	4.4	4.4
Yield on assets	7.7	6.9	7.1	7.3	7.3
Cost of funds	4.8	4.1	4.1	4.3	4.3
NIMs	3.1	3.0	3.2	3.3	3.3
Capital adequacy (%)					
Tier I	13.8	15.4	15.3	15.0	14.9
Tier II	0.8	1.3	1.3	1.3	1.3
Total CAR	14.6	16.7	16.6	16.4	16.2
Asset Quality (%)					
Gross NPA	3.4	2.8	2.6	2.3	2.2
Net NPA	1.2	1.0	0.9	0.7	0.6
Provision coverage	65.1	66.3	66.6	70.6	72.8
Slippage	1.6	1.4	1.5	1.5	1.5
Credit-cost	1.3	0.8	0.7	0.6	0.6
Return (%)					
ROE	10.4	10.8	12.2	13.3	13.9
ROA	0.8	0.9	1.0	1.1	1.2
RORWA	1.5	1.6	1.9	2.0	2.1
Per share					
EPS	8.0	9.0	11.6	14.2	16.7
BV	80.8	89.4	100.0	113.1	128.5
ABV	72.9	82.8	93.0	106.7	122.1
Valuation					
P/E	15.1	13.4	10.4	8.5	7.2
P/BV	1.5	1.3	1.2	1.1	0.9
P/ABV	1.6	1.4	1.3	1.1	1.0

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
26 March 2018	Buy	91	112
10 May 2018	Buy	101	116
18 July 2018	Buy	88	119
9 October 2018	Buy	70	115
17 October 2018	Buy	82	117
18 January 2019	Buy	89	122
8 April 2019	Buy	99	123
6 May 2019	Buy	98	134
8 July 2019	Buy	107	134
17 July 2019	Buy	107	135
7 October 2019	Buy	86	124
17 October 2019	Buy	82	115
8 January 2020	Buy	87	111
21 January 2020	Buy	94	109
27 March 2020	Buy	43	59
9 April 2020	Buy	41	59
29 May 2020	Buy	43	57
9 July 2020	Buy	54	65
16 July 2020	Accumulate	51	57
23 September 2020	Accumulate	49	55
7 October 2020	Accumulate	52	54
19 October 2020	Buy	52	63
26 November 2020	Buy	59	72
8 January 2021	Buy	76	89
21 January 2021	Buy	77	91
21 February 2021	Buy	83	111
17 May 2021	Buy	82	112
25 July 2021	Buy	85	111
26 September 2021	Buy	81	119
24 October 2021	Buy	103	124
26 January 2022	Buy	96	127
07 May 2022	Buy	92	120
15 July 2022	Buy	99	119
5 September 2022	Buy	120	149

Rating track graph



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BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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