

Federal Bank

21 May 2019

Reuters: FED.BO; Bloomberg: FB IN

Asset Quality Has Turned A Corner

We recently met with Mr. Shyam Srinivasan, CEO of Federal Bank (FBL) and gleaned incremental insight into the strategy of the company. *We share our detailed takeaways below. We revise our estimates for FY20/FY21 and retain Buy rating, revising our target price to Rs135 (from Rs134 earlier), valuing the stock at 1.5x FY21E (or 1.8x FY20E) P/BV. FBL remains one of our top picks in the banking sector.*

Asset quality

- The 55-60 bps credit cost guidance for FY20 factors in exposures to all key stressed corporates that are currently being discussed in the media.
- The stressed pool of corporate accounts amounts to ~Rs 6bn. Within this, the bank has exposures, which are currently standard, to
 - An NBFC that faced allegations from an investigative media company
 - The housing finance entity of a diversified conglomerate
 - A structure with the diversified financial services holding company of the latter conglomerate.
- If most of the corporate stressed pool slips, the credit cost for FY20 would be closer to the upper end of the guidance at 60-62 bps.
- For retail, SME and agri slippages taken together, the bank is looking at a slippage run rate of Rs 2-2.5bn per quarter.
- On the NPA flow, the bank intends to provide a 50% provision cover. The credit cost guidance of 55-60 bps also factors in an improvement in PCR.
- The bank has a PCR of ~50% without technically written off (TWO) accounts and ~67% including TWO.
- The bank is working on taking over the loans of the end customers of the NBFC that faced allegations. This could potentially reduce the exposure by half.

Business and loan growth

- **Corporate lending**
 - The slowdown in corporate lending is deliberate and not related to the departure of Ganesh Sankaran, former ED, handling corporate lending.
 - The corporate business was already verticalised and Harsh Dugar was already having direct large corporate client coverage. The bank is therefore not looking for any replacement for Ganesh Sankaran.
 - The bank has deliberately run down NBFC portfolio worth ~Rs 10bn as a matter of prudent caution.
- **Microfinance**
 - The bank remains interested in growing in the microfinance segment including via the inorganic route but no acquisition has materialized so far since the bank feels the better microfinance institutions are expensive and, furthermore, at this point, Federal Bank stock is also cheap.
 - The intention is not to buy something big but a book of Rs 20-30bn would be manageable for the bank.

(The takeaways are continued from page 2 onwards).

BUY

Sector: Banking

CMP: Rs103

Target Price: Rs135

Upside: 31%

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Key Data

Current Shares O/S (mn)	1,985.4
Mkt Cap (Rsbn/US\$bn)	204.6/2.9
52 Wk H / L (Rs)	107/67
Daily Vol. (3M NSE Avg.)	14,083,200

Price Performance (%)

	1 M	6 M	1 Yr
Federal Bank	6.2	24.2	27.4
Nifty Index	0.9	11.8	12.7

Source: Bloomberg

- **Microfinance (continued from page 1)**
 - The preferred area of operation would be Tamil Nadu and other parts of South India. South-based NBFC-MFIs are tightly run and this is something the bank can vouch for, having seen entities closely on a non-disclosure agreement basis.
 - However, based on the due diligence carried out Equirius, the bank has not zeroed in on any deal due to reasons explained earlier.
 - The bank has developed significant digital capability for running an efficient microfinance operation that can disburse Rs 500-600mn per month.
 - Direct lending to NBFC-MFIs is not large and would be about Rs 2bn.
- **Other general**
 - The retail to corporate mix in the overall loan book would be about 50:50 in 2 years.
 - All the unsecured retail lending (personal loans, credit cards) has been to captive customers only.
 - The NBFC crisis has not really reduced competitive pressure significantly as the strong NBFCs are stepping up by dropping prices.

Fedfina

- There are no liquidity issues at Fedfina and the NBFC has bank lines from Federal Bank itself, HDFC Bank, DCB Bank, Karur Vysya Bank and Karnataka Bank, to name a few.
- Fedfina has high quality management and the CEO, Anil Kothuri is the ex-CEO of Edelweiss Housing Finance and previously, was the MD of Citicorp Maruti Finance.

Liabilities and Liquidity

- The macro is somewhat concerning since NR remittances have slowed since after February.
- However, the bank does not see macro impacting them much as they see themselves at still a modest overall market share in the overall banking system as such and see their market share moving up.
- The bank has seen some improved success in garnering current account balance. The bank has invested heavily in creating a CA franchise.
- SA traction has been reasonably good within the remittances-led SA segment.
- SA book at the premium SA rate of 6% is relatively small at about Rs 3-4bn.
- The bank is looking at ~18-20% overall deposits growth.
- Management guides for a CASA ratio of 33-33.5% as of FY20-end.
- **Liquidity**
 - The bank has the highest liquidity ratio with an LCR of 142% of March end.
 - While this showcases the bank's high level of safety from a liquidity standpoint, it would like to have a lower LCR than this.

Leadership

- The CEO stated that he looks forward to an extension in his current role.
- The CEO explained that the parameters on which he is judged include RoA, RoE, CASA, Cost to Income Ratio and Compliance and the vesting of ESOPs is linked to this.

Capital adequacy

- The management stated that they are well capitalized right now and would hit the capital market for an equity capital raise likely only in 4QFY21.

Exhibit 1: Change in our estimates

	Revised estimate		Earlier estimate		% Revision	
	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
Net interest income (Rsmn)	51,697	65,322	51,697	65,307	-	0.02
NIM (%)	3.16	3.22	3.16	3.22	-	-
Operating profit (Rsmn)	37,209	48,092	37,209	48,077	-	0.03
Profit after tax (Rsmn)	17,816	23,979	17,776	23,920	0.2	0.2

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: One-year forward P/BV


Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 3: Income statement

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Interest income	84,460	97,529	114,190	140,049	173,678
Interest expenses	56,248	61,701	72,427	88,352	108,356
Net interest income	28,212	35,829	41,764	51,697	65,322
Fee income	7,731	9,211	11,220	15,103	18,894
Other Income	3,088	2,380	2,290	3,010	3,844
Net revenues	39,031	47,420	55,274	69,810	88,060
Operating expenses	22,095	24,509	27,643	32,601	39,969
-Employee expenses	11,638	12,425	13,778	14,941	16,909
-Other expenses	10,457	12,084	13,865	17,660	23,060
Pre-provisioning operating profit	16,936	22,911	27,631	37,209	48,092
Provisions	6,184	8,955	8,559	10,215	11,760
-Loan loss provision	4,836	8,455	7,260	9,715	11,260
-Provision for investment	242	-	1,240	-	-
-Other provisions	1,106	500	58	500	500
PBT	10,752	13,956	19,073	26,994	36,332
Tax	4,757	4,650	6,634	9,178	12,353
PAT	5,995	9,306	12,439	17,816	23,979

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Balance sheet

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Equity capital	3,488	3,944	3,970	3,970	4,169
Reserves & surplus	85,977	118,158	128,760	147,252	182,537
Shareholder's Funds	89,465	122,102	132,730	151,222	186,706
Deposits	976,646	1,119,925	1,349,543	1,581,012	1,889,096
Borrowings	58,973	115,335	77,813	214,376	307,076
Other liabilities	24,685	25,777	33,313	34,275	37,202
Total liabilities	1,149,769	1,383,140	1,593,400	1,980,885	2,420,080
Cash/Equivalent	74,530	92,034	100,668	133,370	164,178
Advances	733,363	919,575	1,102,230	1,333,698	1,641,782
Investments	281,952	307,811	318,245	434,334	526,688
Fixed Assets	4,895	4,574	4,720	5,192	5,712
Other assets	55,029	59,146	67,537	74,291	81,720
Total assets	1,149,769	1,383,140	1,593,400	1,980,885	2,420,080

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: Key ratios

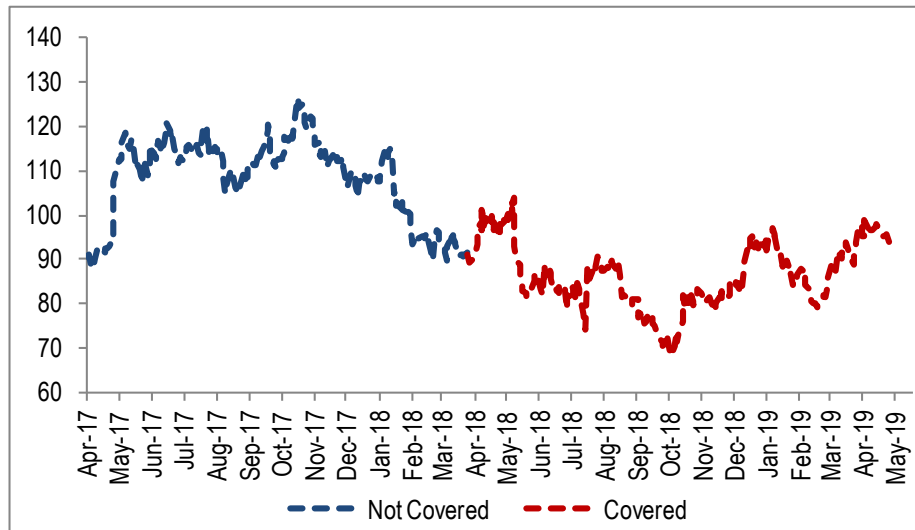
Y/E March	FY17	FY18	FY19	FY20E	FY21E
Growth (%)					
NII growth	12.7	27.0	16.6	23.8	26.4
Pre-provision profit growth	19.0	35.3	20.6	34.7	29.2
PAT growth	26.0	55.2	33.7	43.2	34.6
Business (%)					
Deposit growth	23.4	14.7	20.5	17.2	19.5
Advances growth	26.2	25.4	19.9	21.0	23.1
Business growth	24.6	19.3	20.2	18.9	21.1
CD	75.1	82.1	81.7	84.4	86.9
CASA deposit	32.8	33.5	32.2	33.7	34.4
Operating efficiency (%)					
Cost-to-income	56.6	51.7	50.0	46.7	45.4
Cost-to-assets	2.1	1.9	1.9	1.8	1.8
Productivity (Rsmn)					
Business per branch	1,365.8	1,629.0	1,959.9	2,240.4	2,637.9
Business per employee	147.5	175.2	199.8	240.9	283.6
Profit per branch	4.8	7.4	9.9	13.7	17.9
Profit per employee	0.5	0.8	1.0	1.5	1.9
Spread (%)					
Yield on advances	10.0	9.1	9.0	9.1	9.2
Yield on investments	6.8	6.5	6.5	6.7	6.7
Cost of deposits	6.1	5.7	5.6	5.6	5.6
Yield on assets	8.9	8.4	8.4	8.5	8.6
Cost of funds	6.0	5.4	5.4	5.5	5.4
NIM	3.0	3.1	3.1	3.2	3.2
Capital adequacy (%)					
Tier-I	11.8	14.2	13.4	12.5	12.5
Tier-II	0.6	0.5	0.8	0.7	0.9
Total CAR	12.4	14.7	14.1	13.3	13.4
Asset quality (%)					
Gross NPAs	2.3	3.0	2.9	2.5	2.1
Net NPAs	1.3	1.7	1.5	1.0	0.7
Specific provision coverage	43.7	44.4	50.1	61.5	65.5
Slippage	1.6	2.4	1.6	1.2	1.0
Credit costs	0.6	0.9	0.6	0.7	0.6
Return ratios (%)					
RoE	7.0	8.8	9.8	12.5	14.2
RoA	0.6	0.7	0.8	1.0	1.1
RoRWA	0.9	1.2	1.4	1.7	1.9
Per share (Rs)					
EPS	3.4	4.7	6.3	9.0	11.5
BV	51.3	61.9	66.9	76.2	89.6
ABV	45.7	54.0	58.7	69.6	83.8
Valuation (x)					
P/E	30.1	21.9	16.5	11.5	9.0
P/BV	2.0	1.7	1.5	1.4	1.2
P/ABV	2.3	1.9	1.8	1.5	1.2

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
21 May 2019	Buy	98	135

Rating track graph



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BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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