# Federal Bank

11 June 2018

Reuters: FED.BO; Bloomberg: FB IN

Management Meet Update

## Several Good Things in Store

**We recently met the CEO of Federal Bank (FBL), Mr Shyam Srinivasan and gleaned incremental insight into the performance and outlook for FBL. (Also, see Detailed Management Meeting Takeways on page 2). Given its outlook and FY19E/20E RoE profile of 11%/12.8%, FBL is a prime re-rating candidate, currently trading at 1.1x FY20E P/BV. It may, also, be noted that 4QFY18 results were mispriced by the market (See results note). Also, see our Initiating Coverage Report. We retain Buy rating on FBL with a target price to Rs116, valuing the stock at 1.5x FY20E P/BV.**

- The CEO explained that the **pensioning cost** of Federal Bank is on the higher side since most of their employees are still on Defined Benefit Plan. The impact of this will not fade off till FY22/FY23. From 1st April 2010 onwards, new employees are on NPS, which is a Defined Contribution Plan.
- The bank aspires to reach a **CASA Ratio** of ~40% without offering SA interest rate premium.
- While the bank aims to improve Trade Finance business, the CEO explained that the advantage gleaned from doing **Non-fund business** would reduce under the IndAS regime. Under IndAS, risk-adjusted return or RoRWA will be key.
- As far as **FedFina** is concerned, the construction finance book is being unwound and the incremental focus areas will be smaller-ticket loan against property and also, gold loans. Fedfina has a ~Rs 14.5bn book and ~Rs 0.3bn PAT. Rs 1bn of capital has been injected.
- The CEO stated that Federal Bank had been making more provisions than that mandated by IRAC norms earlier and are now providing as per IRAC. The bank aims to have a **PCR of 65-70%** including technically written off accounts.
- The bank aims to have an **RoA of 1.2-1.3%** by FY20. The target for **RoE** would be around mid teens. In FY19, an RoA of 1-1.1% and RoE of 10.5-11% could be achieved.
- The CEO explained the 12th February Circular mandates concerted action by banks with regard to **consortium loans**. Independent exposure to the same entity does not warrant concerted action. There is little participation in consortium lending by Federal Bank incrementally. There is about Rs 20bn exposure to legacy consortium loans which are standard and these are not stressed as such.
- For any sale of **IDBI Federal Life**, partners IDBI Bank and Ageas need to be on the same page. Ageas has right of first refusal. However, a deal is expected to be struck in due course. The market could value IDBI Federal Life, of which Federal Bank owns 26%, at about Rs 60bn.
- The CEO envisages **gross slippages** of about Rs 11-12 bn for the bank over FY19. Retail, SME and Agri are expected to contribute about Rs 2bn each and the balance Rs 5-6bn from corporate book. Recoveries could average about Rs 2.25bn over 3QFY19-4QFY19
- About 50% of exposure to 2 key **steel sector NCLT accounts** could be recovered.
- 85% of loan book has transitioned to **MCLR**.
- The CEO does not expect **bond gains** in FY19. Currently, the duration is on the lower side at about 2.5 years. The CEO sees interest rates on the higher side.
- Breakup of **transaction value** in the bank: Branches: 37%, ATM: 17%, Other Digital (including Internet, Mobile, etc): 46%.
- Federal Bank's market share in **Remittances** has risen from ~7% to ~15%. This, the CEO states, is a moat for Federal Bank. Federal Bank has been at the forefront in adopting new technology and they have implemented a **blockchain**-based money movement platform to further augment Remittance business.
- On **Fee Income** growth, the CEO states that, if credit growth would be ~25%, the fee income growth would be ~28%. A new Head of Treasury Sales has been recruited, who has about 20 years of experience with a foreign bank. This is with a view to augment fee income.
- The rationale for acquiring Equirius was that Federal Bank did not quite have the internal skills for **capital markets business**. At the moment, Federal Bank has taken a 19.9% stake and could, potentially, take majority stake in the future.
- The CEO stated that his **current term** ends in September 2019. He is hoping that it will be renewed. He stated that he has returned his Options back to the bank because he did not wish to hold ~1% stake in the bank.
- According to the CEO, the next **capital requirement** for the bank would only come in FY21. The bank is consuming about 30 bps of capital per quarter and they will look to raise when capital levels fall to ~12%.

*NBIE Values your patronage- Vote for The Team in the Asia Money poll 2018. Click Here*

## BUY

**Sector:** Banking

**CMP:** Rs87

**Target Price:** Rs116

**Upside:** 33%

**Shivaji Thapliyal**
Research Analyst
shivaji.thapliyal@nirmalbang.com
+91-22-6273 8068

**Key Data**

| | |
|---|---|
| Current Shares O/S (mn) | 1,972.9 |
| Mkt Cap (Rsbn/US$bn) | 175.2/2.6 |
| 52 Wk H / L (Rs) | 128/80 |
| Daily Vol. (3M NSE Avg.) | 14,166,770 |

**Price Performance (%)**

| | 1 M | 6 M | 1 Yr |
|---|---|---|---|
| Federal Bank | (1.4) | (18.0) | (24.0) |
| Nifty Index | 0.3 | 5.0 | 12.1 |

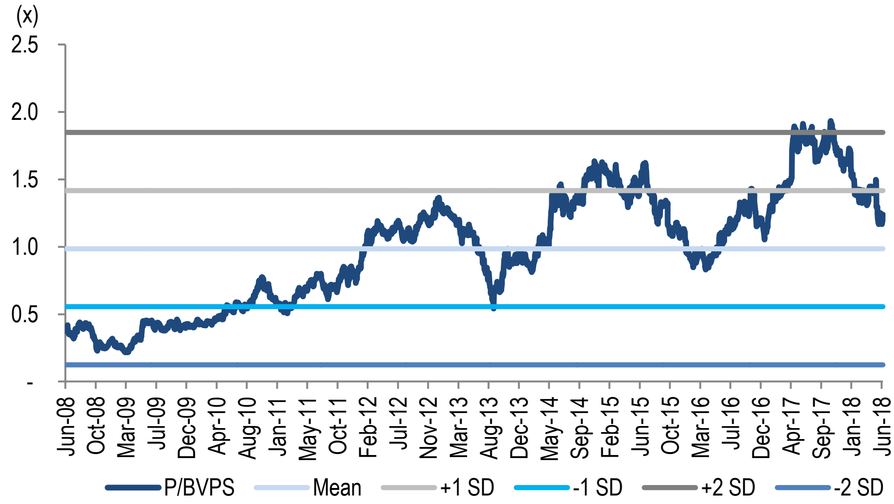
*Source: Bloomberg*

## Detailed Management Meeting Takeaways

- The CEO explained that the **pensioning cost** of Federal Bank is on the higher side since most of their employees are still on Defined Benefit Plan. The impact of this will not fade off till FY22/FY23. From 1st April 2010 onwards, new employees are on NPS, which is a Defined Contribution Plan.
- While getting the **retail fee income** engine moving remains a key aspiration, the CEO explained that strong retail brand take time to fructify and, in this regard, the new version of Federal Bank is 7 years old.
- In this regard, banks with a larger **Deposits base** are at an advantage since they naturally obtain a larger Mutual Fund float, for example, an concomitant third party fee income from the same.
- The bank aspires to reach a **CASA Ratio** of ~40% without offering SA interest rate premium.
- While the bank aims to improve Trade Finance business, the CEO explained that the advantage gleaned from doing **Non Fund business** would reduce under the IndAS regime. Under IndAS, risk-adjusted return or RoRWA will be key.
- The CEO stated that Federal Bank has never had any instance of **Divergence** with RBI or was insignificant in quantum.
- As far as **FedFina** is concerned, it initially began with Gold Loans. Its three areas of focus areas subsequently have been (1) providing distribution for Federal Bank (2) construction finance and (3) loan against property. Currently, the construction finance book is being unwound and the incremental focus areas will be smaller-ticket loan against property and also, gold loans. Fedfina has a ~Rs 14.5bn book and ~Rs 0.3bn PAT. Rs 1bn of capital has been injected into it.
- The CEO stated that Federal Bank had been making more provisions than that mandated by IRAC norms earlier and are now providing as per IRAC. The bank aims to have a **PCR of 65-70%** including technically written off accounts.
- The bank aims to have an **RoA of 1.2-1.3%** by FY20. The target for **RoE** would be around mid teens. In FY19, an RoA of 1-1.1% and RoE of 10.5-11% could be achieved.
- The CEO explained the 12th February Circular mandates concerted action by banks with regard to **consortium loans**. Independent exposure to the same entity does not warrant concerted action. There is little participation in consortium lending by Federal Bank incrementally. There is about Rs 20bn exposure to legacy consortium loans which are standard and these are not stressed as such.
- The CEO stated that there could be pain for the banking system in **1QFY19** as well.
- For any sale of **IDBI Federal Life**, partners IDBI Bank and Ageas need to be on the same page. Ageas has right of first refusal. However, a deal is expected to be struck in due course. The market could value IDBI Federal Life, of which Federal Bank owns 26%, at about Rs 60bn.
- The CEO envisages **gross slippages** of about Rs 11-12 bn for the bank over FY19. Retail, SME and Agri are expected to contribute about Rs 2bn each and the balance Rs 5-6bn from corporate book. Recoveries could average about Rs 2.25bn over 3QFY19-4QFY19
- About 50% of exposure to 2 key **steel sector NCLT accounts** could be recovered.
- 85% of loan book has transitioned to **MCLR**.
- The salaries of employees below Scale 4 are as per the **IBA**. These are the unionised employees but are less of an issue now.
- The hit due to increase in **Gratuity Limit** increase is about Rs 1.2bn.
- The CEO does not expect **bond gains** in FY19. Currently, the duration is on the lower side at about 2.5 years. The CEO sees interest rates on the higher side.
- Breakup of **transaction value** in the bank: Branches: 37%, ATM: 17%, Other Digital (including Internet, Mobile, etc): 46%.

- The CEO says that while there certainly efficiency gains driven by **technology**, he also cautions against expecting outsized gains driven by technology. He cites, for example, upward revision of technology charges from software vendors.
- Federal Bank's market share in **Remittances** has risen from ~7% to ~15%. This, the CEO states, is a moat for Federal Bank. Federal Bank has been at the forefront in adopting new technology and they have implemented a **blockchain**-based money movement platform to further augment Remittance business.
- On **Fee Income** growth, the CEO states that, if credit growth would be ~25%, the fee income growth would be ~28%. A new Head of Treasury Sales has been recruited, who has about 20 years of experience with a foreign bank. This is with a view to augment fee income.
- The rationale for acquiring Equirius was that Federal Bank did not quite have the internal skills for **capital markets business**. At the moment, Federal Bank has taken a 19.9% stake and could, potentially, take majority stake in the future.
- The CEO stated that his **current term** ends in September 2019. He is hoping that it will be renewed. He stated that he has returned his Options back to the bank because he did not wish to hold ~1% stake in the bank.
- According to the CEO, the next **capital requirement** for the bank would only come in FY21. The bank is consuming about 30 bps of capital per quarter and they will look to raise when capital levels fall to ~12%.
- The bank tends to operate in 5-year plans. In the first 5-year plan which started in 2010 when the current CEO was appointed, the broad goal was to become more **pan-Indian**. During that phase, the bank opened about 600 branches.
- About Rs 24bn of capital was raised on 15th January 2008 at the peak of the stockmarket. That led to some risk-taking on the asset side back then but all these **legacy issues** have, finally, been dealt with.
- While **SME growth** in Kerela has been stunted at ~10%, SME growth outside Kerela has been strong at ~28%. Some Cashew accounts in Kerela are in stress. A hit of Rs 1.1bn has been taken.

**Exhibit 1: One-year forward P/BV**




*Source: Company, Nirmal Bang Institutional Equities Research*

## Financials

### Exhibit 2: Income statement

| Y/E March (Rsmn) | FY16 | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|---|
| Interest income | 77,447 | 84,460 | 97,529 | 117,918 | 142,078 |
| Interest expenses | 52,406 | 56,248 | 61,701 | 74,109 | 88,937 |
| **Net interest income** | **25,041** | **28,212** | **35,829** | **43,808** | **53,141** |
| Fee income | 5,703 | 7,731 | 9,211 | 12,304 | 14,998 |
| Other Income | 2,161 | 3,088 | 2,380 | 2,719 | 3,265 |
| Net revenues | 32,905 | 39,031 | 47,420 | 58,831 | 71,404 |
| Operating expenses | 18,668 | 22,095 | 24,509 | 29,687 | 34,465 |
| -Employee expenses | 10,529 | 11,638 | 12,425 | 14,307 | 16,342 |
| -Other expenses | 8,139 | 10,457 | 12,084 | 15,380 | 18,123 |
| **Pre-provision profit** | **14,237** | **16,936** | **22,911** | **29,144** | **36,939** |
| Provisions | 7,041 | 6,184 | 8,128 | 7,794 | 9,282 |
| -Loan loss provision | 5,848 | 4,836 | 7,628 | 7,294 | 8,782 |
| -Provision for investment | 801 | 242 | - | - | - |
| -Other provisions | 392 | 1,106 | 500 | 500 | 500 |
| PBT | 7,196 | 10,752 | 14,782 | 21,350 | 27,657 |
| Tax | 2,440 | 4,757 | 4,650 | 7,259 | 9,403 |
| **PAT** | **4,756** | **5,995** | **10,132** | **14,091** | **18,254** |

*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 3: Key ratios

| Y/E March | FY16 | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|---|
| **Growth (%)** | | | | | |
| NII growth | 5.2 | 12.7 | 27.0 | 22.3 | 21.3 |
| Pre-provision profit growth | (12.5) | 19.0 | 35.3 | 27.2 | 26.7 |
| PAT growth | (52.7) | 26.0 | 69.0 | 39.1 | 29.5 |
| **Business (%)** | | | | | |
| Deposit growth | 11.8 | 23.4 | 14.7 | 23.6 | 21.4 |
| Advances growth | 13.3 | 26.2 | 25.4 | 23.0 | 21.0 |
| Business growth | 12.4 | 24.6 | 19.3 | 23.3 | 21.2 |
| CD | 73.4 | 75.1 | 82.1 | 81.7 | 81.4 |
| CASA deposit | 32.9 | 32.8 | 32.5 | 32.5 | 32.5 |
| **Operating efficiency (%)** | | | | | |
| Cost-to-income | 56.7 | 56.6 | 51.7 | 50.5 | 48.3 |
| Cost-to-assets | 2.1 | 2.1 | 1.9 | 1.9 | 1.9 |
| **Productivity (Rsmn)** | | | | | |
| Business per branch | 1,096.3 | 1,365.8 | 1,629.0 | 1,931.9 | 2,255.8 |
| Business per employee | 117.0 | 147.5 | 175.2 | 207.7 | 242.6 |
| Profit per branch | 3.8 | 4.8 | 8.1 | 10.8 | 13.5 |
| Profit per employee | 0.4 | 0.5 | 0.9 | 1.2 | 1.5 |
| **Spread (%)** | | | | | |
| Yield on advances | 10.4 | 10.0 | 9.1 | 9.0 | 8.9 |
| Yield on investments | 7.1 | 6.8 | 6.5 | 6.5 | 6.5 |
| Cost of deposits | 6.7 | 6.1 | 5.6 | 5.5 | 5.4 |
| Yield on assets | 9.5 | 8.9 | 8.4 | 8.4 | 8.3 |
| Cost of funds | 6.7 | 6.0 | 5.4 | 5.4 | 5.3 |
| NIM | 3.1 | 3.0 | 3.1 | 3.1 | 3.1 |
| **Capital adequacy (%)** | | | | | |
| Tier-I | 13.4 | 11.8 | 14.2 | 11.3 | 10.5 |
| Tier -II | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 |
| Total CAR | 13.9 | 12.4 | 14.7 | 11.8 | 10.9 |
| **Asset quality (%)** | | | | | |
| Gross NPAs | 2.1 | 2.3 | 3.0 | 2.8 | 2.7 |
| Net NPAs | 1.6 | 1.3 | 1.7 | 1.5 | 1.5 |
| Provision coverage | 24.3 | 43.7 | 44.4 | 45.5 | 46.5 |
| Provision coverage (Incl. tech w/o) | 68.2 | 70.0 | 64.4 | 65.1 | 64.8 |
| Slippage | 3.5 | 1.6 | 2.4 | 1.7 | 1.7 |
| Credit costs | 1.0 | 0.6 | 0.8 | 0.6 | 0.6 |
| **Return ratios (%)** | | | | | |
| RoE | 6.0 | 7.0 | 9.6 | 11.0 | 12.8 |
| RoA | 0.5 | 0.6 | 0.8 | 0.9 | 1.0 |
| RoRWA | 0.9 | 0.9 | 1.3 | 1.4 | 1.5 |
| **Per share (Rs)** | | | | | |
| EPS | 2.8 | 3.4 | 5.1 | 7.1 | 9.3 |
| BV | 47.1 | 51.3 | 61.9 | 68.2 | 76.4 |
| ABV | 41.5 | 45.7 | 54.0 | 59.5 | 66.1 |
| **Valuation (x)** | | | | | |
| P/E | 31.5 | 25.4 | 17.0 | 12.2 | 9.4 |
| P/BV | 1.9 | 1.7 | 1.4 | 1.3 | 1.1 |
| P/ABV | 2.1 | 1.9 | 1.6 | 1.5 | 1.3 |

*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 4: Balance sheet

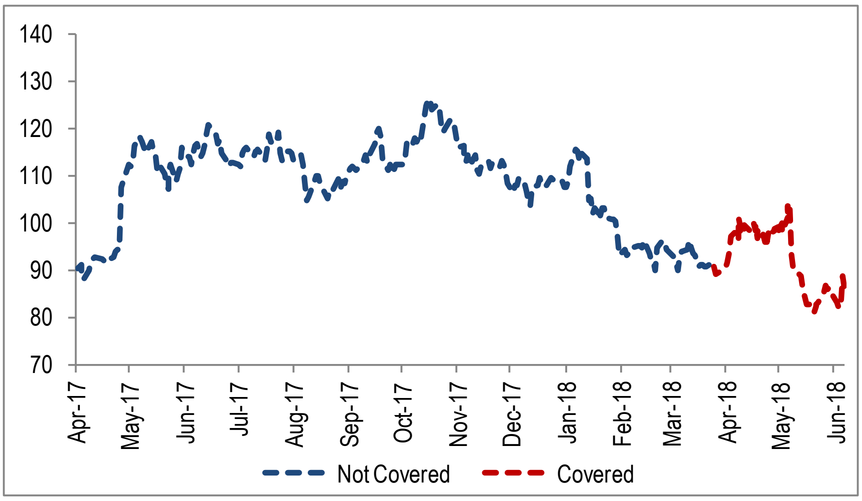
| Y/E March (Rsmn) | FY16 | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|---|
| Equity Capital | 3,438 | 3,488 | 3,944 | 3,944 | 3,944 |
| Reserves & Surplus | 77,476 | 85,977 | 118,158 | 130,580 | 146,696 |
| **Shareholder's Funds** | **80,914** | **89,465** | **122,102** | **134,524** | **150,640** |
| **Deposits** | **791,717** | **976,646** | **1,119,925** | **1,384,303** | **1,681,210** |
| Borrowings | 51,145 | 58,973 | 115,335 | 137,070 | 160,373 |
| Other liabilities | 19,898 | 24,685 | 25,777 | 30,443 | 34,449 |
| **Total liabilities** | **943,674** | **1,149,769** | **1,383,140** | **1,686,341** | **2,026,672** |
| Cash/Equivalent | 54,199 | 74,530 | 92,034 | 113,108 | 136,860 |
| Advances | 580,901 | 733,363 | 919,575 | 1,131,077 | 1,368,603 |
| Investments | 251,548 | 281,952 | 307,811 | 372,064 | 444,108 |
| Fixed Assets | 5,200 | 4,895 | 4,574 | 5,031 | 5,534 |
| Other assets | 51,826 | 55,029 | 59,146 | 65,061 | 71,567 |
| **Total assets** | **943,674** | **1,149,769** | **1,383,140** | **1,686,341** | **2,026,672** |

*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 |
| 11 June 2018 | Buy | 87 | 116 |

### Rating track graph



## DISCLOSURES

This Report is published by Nirmal Bang Equities Private Limited (hereinafter referred to as “NBEPL”) for private circulation. NBEPL is a registered Research Analyst under SEBI (Research Analyst) Regulations, 2014 having Registration no. INH000001436. NBEPL is also a registered Stock Broker with National Stock Exchange of India Limited and BSE Limited in cash and derivatives segments.

NBEPL has other business divisions with independent research teams separated by Chinese walls, and therefore may, at times, have different or contrary views on stocks and markets.

NBEPL or its associates have not been debarred / suspended by SEBI or any other regulatory authority for accessing / dealing in securities Market. NBEPL, its associates or analyst or his relatives do not hold any financial interest in the subject company. NBEPL or its associates or Analyst do not have any conflict or material conflict of interest at the time of publication of the research report with the subject company. NBEPL or its associates or Analyst or his relatives do not hold beneficial ownership of 1% or more in the subject company at the end of the month immediately preceding the date of publication of this research report.

NBEPL or its associates / analyst has not received any compensation / managed or co-managed public offering of securities of the company covered by Analyst during the past twelve months. NBEPL or its associates have not received any compensation or other benefits from the company covered by Analyst or third party in connection with the research report. Analyst has not served as an officer, director or employee of Subject Company and NBEPL / analyst has not been engaged in market making activity of the subject company.

**Analyst Certification:** I, Shivaji Thapliyal, the research analyst is the author of this report, hereby certifies that the views expressed in this research report accurately reflects my personal views about the subject securities, issuers, products, sectors or industries. It is also certified that no part of the compensation of the analyst was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views in this research. The analyst principally responsible for the preparation of this research report and has taken reasonable care to achieve and maintain independence and objectivity in making any recommendations.

## Disclaimer

**Stock Ratings Absolute Returns**

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. NBEPL is not soliciting any action based upon it. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any such transaction. In preparing this research, we did not take into account the investment objectives, financial situation and particular needs of the reader.

This research has been prepared for the general use of the clients of NBEPL and must not be copied, either in whole or in part, or distributed or redistributed to any other person in any form. If you are not the intended recipient you must not use or disclose the information in this research in any way. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. NBEPL will not treat recipients as customers by virtue of their receiving this report. This report is not directed or intended for distribution to or use by any person or entity resident in a state, country or any jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject NBEPL & its group companies to registration or licensing requirements within such jurisdictions.

The report is based on the information obtained from sources believed to be reliable, but we do not make any representation or warranty that it is accurate, complete or up-to-date and it should not be relied upon as such. We accept no obligation to correct or update the information or opinions in it. NBEPL or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. NBEPL or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

This information is subject to change without any prior notice. NBEPL reserves its absolute discretion and right to make or refrain from making modifications and alterations to this statement from time to time. Nevertheless, NBEPL is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.

Before making an investment decision on the basis of this research, the reader needs to consider, with or without the assistance of an adviser, whether the advice is appropriate in light of their particular investment needs, objectives and financial circumstances. There are risks involved in securities trading. The price of securities can and does fluctuate, and an individual security may even become valueless. International investors are reminded of the additional risks inherent in international investments, such as currency fluctuations and international stock market or economic conditions, which may adversely affect the value of the investment. Opinions expressed are subject to change without any notice. Neither the company nor the director or the employees of NBEPL accept any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. Here it may be noted that neither NBEPL, nor its directors, employees, agents or representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profit that may arise from or in connection with the use of the information contained in this report.



Our reports are also available on our website www.nirmalbang.com

**Access all our reports on Bloomberg, Thomson Reuters and Factset.**

| Team Details: | | | |
|---|---|---|---|
| **Name** | | **Email Id** | **Direct Line** |
| Rahul Arora | CEO | rahul.arora@nirmalbang.com | - |
| Girish Pai | Head of Research | girish.pai@nirmalbang.com | +91 22 3926 8017 / 18 |
| **Dealing** | | | |
| Ravi Jagtiani | Dealing Desk | ravi.jagtiani@nirmalbang.com | +91 22 3926 8230, +91 22 6636 8833 |
| Pradeep Kasat | Dealing Desk | pradeep.kasat@nirmalbang.com | +91 22 3926 8100/8101, +91 22 6636 8831 |
| Michael Pillai | Dealing Desk | michael.pillai@nirmalbang.com | +91 22 3926 8102/8103, +91 22 6636 8830 |

**Nirmal Bang Equities Pvt. Ltd.**

**Correspondence Address**
B-2, 301/302, Marathon Innova,
Nr. Peninsula Corporate Park,
Lower Parel (W), Mumbai-400013.
Board No. : 91 22 3926 8000/1; Fax. : 022 3926 8010