



3R MATRIX

	+	=	-
Right Sector (RS)	✓	■	■
Right Quality (RQ)	✓	■	■
Right Valuation (RV)	✓	■	■

+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS	■	↔	■
RQ	■	↔	■
RV	■	↔	■

ESG Disclosure Score

NEW

ESG RISK RATING

Updated Aug 08, 2023

42.26

Severe Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

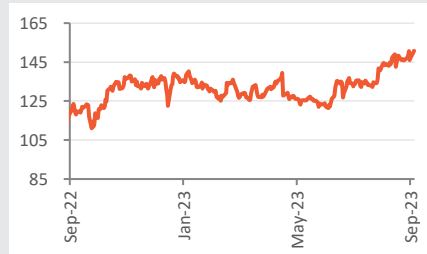
Company details

Market cap:	Rs. 34,683 cr
52-week high/low:	Rs. 152 / 119
NSE volume: (No of shares)	145.9 lakh
BSE code:	500469
NSE code:	FEDERALBNK
Free float: (No of shares)	235.1 cr

Shareholding (%)

Promoters	-
FII	28.0
DII	43.9
Others	28.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4.2	12.9	12.0	23.1
Relative to Sensex	4.6	13.0	1.9	8.5

Sharekhan Research, Bloomberg

Federal Bank Ltd

On a strong footing

Banks	Sharekhan code: FEDERALBNK		
Reco/View: Buy	↔	CMP: Rs. 147	Price Target: Rs. 170 ↔
	↑ Upgrade	↔ Maintain	↓ Downgrade

Summary

- We reiterate a Buy on Federal bank with an unchanged PT of Rs. 170. The bank is likely to sustain a RoA of over ~1.2% led by strong loan growth, healthy fee income and benign credit cost despite NIM pressure in near term, which should translate into normalised RoE of ~15%.
- The bank reported solid loan growth of 20% y-o-y/5% q-o-q in Q2FY24 and loan growth has been broad based across retail (22% y-o-y) and wholesale (17% y-o-y) segment which is a key positive.
- Deposits grew by 23% YoY/5% q-o-q mainly led by strong growth in retail term deposits and wholesale deposits. CASA growth remained tepid, grew by 5% YoY/3% QoQ. CASA ratio at 31.17% vs 36.41% y-o-y. Retail term deposits grew by 28.1% YoY/ 4.9% q-o-q. Wholesale deposits grew by 15.4% q-o-q.
- NIMs are expected to bottom out in H1FY24 and expected to see gradually rebound in H2FY2024. At the CMP, the stock trades at 1.2x/1.1x its FY2024E/FY2025E BV estimates. Valuations are still reasonable and the stock remains our top pick in mid-tier private banks along with IndusInd Bank.

Federal Bank reported strong business performance in Q2FY2024 in terms of loan growth as well as deposit growth. Near-term business trends look comfortable for the bank except NIMs and the franchise is looking towards a more predictable performance. The bank has a strong granular liability franchise with retail deposits making up ~82% of overall deposits and asset quality outlook continues to remain stable to positive, thus reversal in return ratios & growth is unlikely. The bank is likely to sustain RoA of over ~1.2% led by strong loan growth, healthy fee income and benign credit cost despite NIMs pressure in near term which should translate into normalised RoE of ~15%. Valuations are reasonable for such RoE trajectory. Potential value unlocking in Fed Fina (the NBFC subsidiary) via an IPO is likely as suggested by media reports.

- Steady growth outlook:** The bank is upbeat about credit growth outlook and has guided for ~18-20% credit growth in FY2024E. It is seeing broad-based traction in assets. The bank is focusing on scaling up the share of higher yielding assets in its loan book, primarily through business banking, commercial banking, commercial vehicles, and credit cards along with steady traction in existing segment provides a decent visibility on the loan growth front for near to medium term. Also, the bank has a strong retail liability franchise, which would also support healthy loan growth momentum.
- NIMs to gradually rebound in H2FY2024:** The bank is confident of rebound in NIMs in H2FY24 and continues to guide for NIMs at ~3.3% in FY2024E. The bank guided that a majority of the repricing in cost of deposits has already been factored in. Going forward, higher incremental yield would likely offset the marginal rise in cost of funds as the bank is expected to reprice its floating asset book by 10-15 bps and improving loan mix towards high-yielding products would also partially support NIMs.
- Asset-quality outlook stable:** Asset quality is holding up well across the portfolio except some seasonality seen in Agri portfolio. NPL ratios for the bank have improved to multi-year low levels. GNPL and NNPL ratios are at 2.4% and 0.7%, respectively. Provision coverage ratio is at ~71%. Net slippage ratio stood at ~67 bps (annualised calc. as a % of 12-month trailing loans) for Q1FY2024. This run-rate is in line with management's guidance. Slippages in the corporate segment have been negligible in the past few quarters. Over the past years, the bank has been building its loan mix towards higher-rated corporates and secured retail loans. However, the restructured book stands higher compared to peers at ~1.9% of loans. Credit cost is expected at 40-50 bps in FY2024E.

Our Call

Valuation – Maintain Buy rating on Federal Bank with an unchanged PT of Rs. 170: We believe the bank is well poised to sustain RoA of over 1.2% in the near term despite margin headwinds. Strong asset quality and in turn lower credit costs are likely to support return ratios and reversal in return ratio is unlikely. We believe the bank still has levers to surprise positively from here on, led by operating leverage and higher core fee income. At the CMP, the stock currently trades at 1.2x /1.1x its FY2024E/ FY2025E BV estimates.

Key Risks

An economic slowdown due to which slower loan growth and higher-than-anticipated credit cost; slower growth in retail deposits; and lower margins than expected.

Valuation (Standalone)

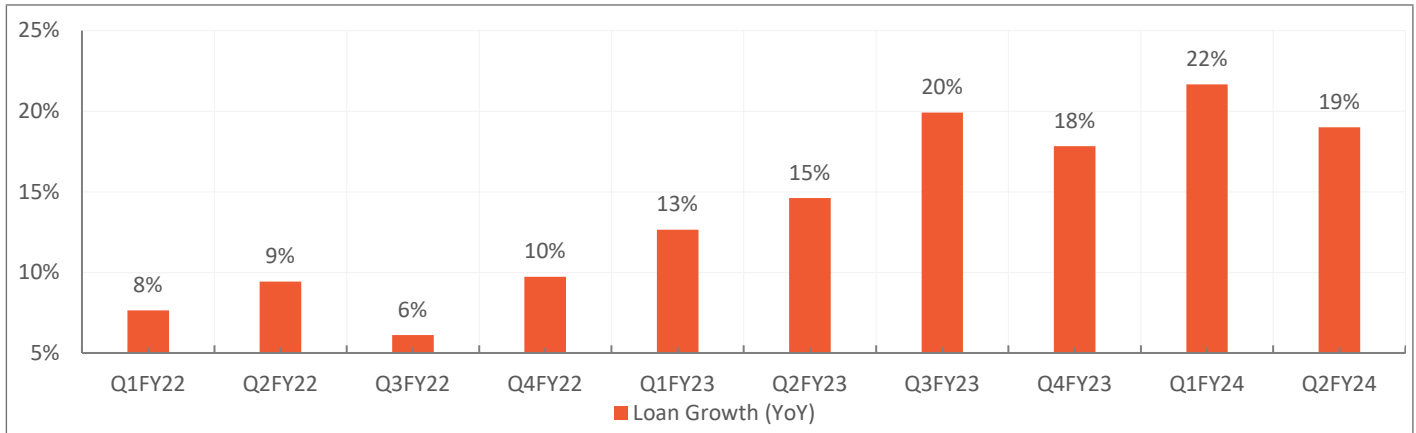
Particulars	Rs cr			
	FY22	FY23	FY24E	FY25E
Net Interest Income	5,962	7,232	8,219	9,207
Net profit	1,890	3,011	3,637	4,156
EPS (Rs.)	9.1	14.1	17.2	19.6
P/E (x)	16.2	10.4	8.6	7.5
P/BV (x)	1.6	1.4	1.2	1.1
RoE	10.8	14.9	15.6	15.3
RoA	0.9	1.3	1.3	1.3

Source: Company; Sharekhan estimates

Fed Fina (the NBFC subsidiary) IPO

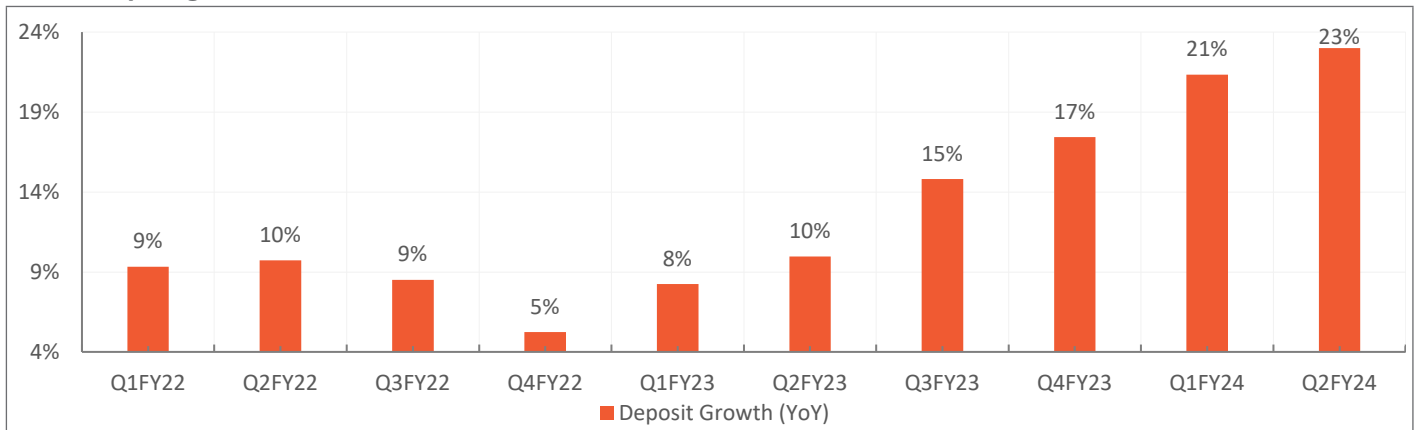
Potential value unlocking in Fed Fina (the NBFC subsidiary) via an IPO is likely as suggested by media reports. Fedbank Financial Services (FedFina), the NBFC arm of Federal Bank is planning for an initial public offering. Currently bank holds 73.2% stake in the company. The IPO will be undertaken by way of fresh issues/ offer for sale (OFS) and is expected to be undertaken in H2FY24. FedFina would continue to be a subsidiary of Federal Bank after IPO.

Trend in Loan growth



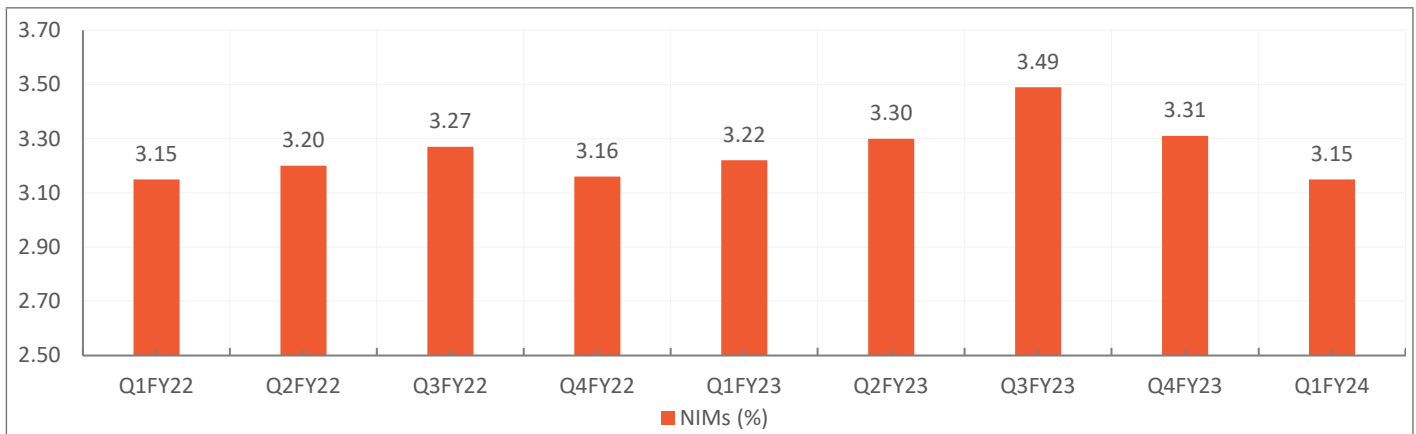
Source: Company, Sharekhan Research

Trend in Deposit growth



Source: Company, Sharekhan Research

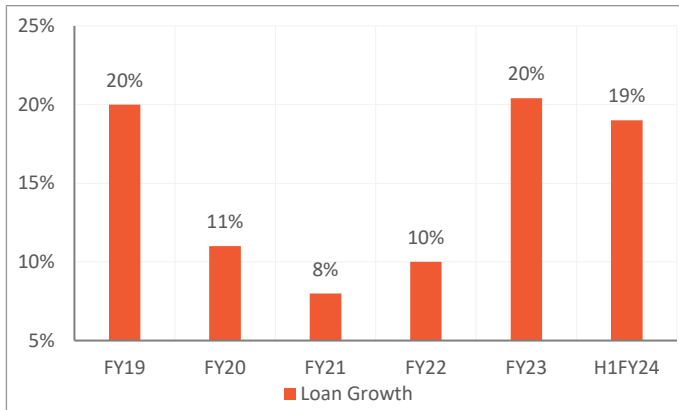
Trend in NIMs



Source: Company, Sharekhan Research

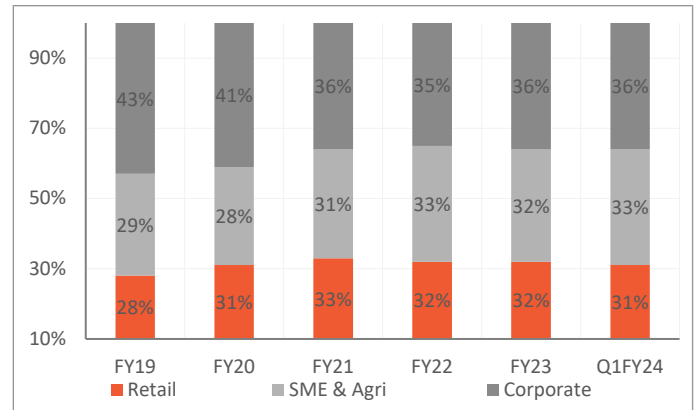
Financials in charts

Trend in Loan growth



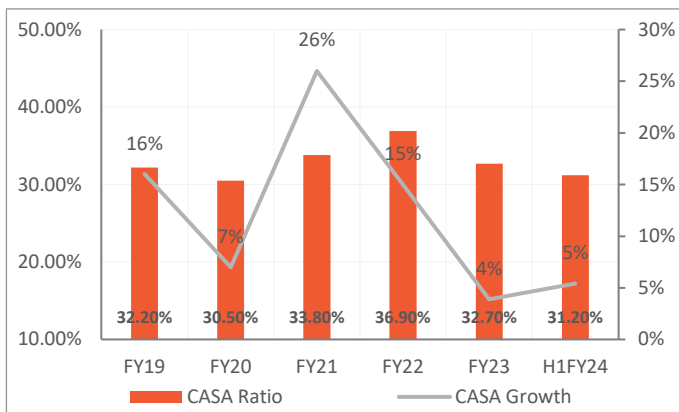
Source: Company, Sharekhan Research

Trend in Loan Mix



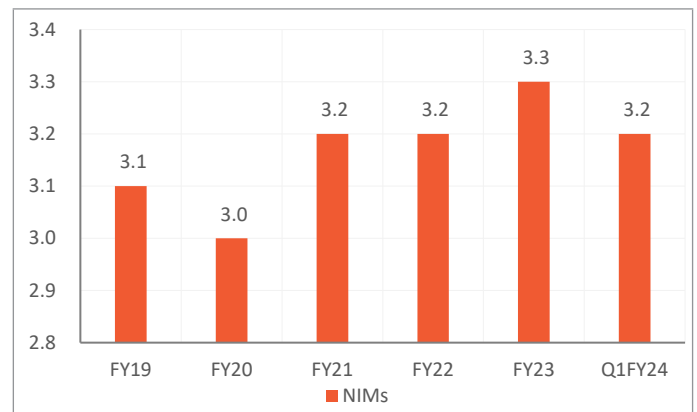
Source: Company, Sharekhan Research

Trend in CASA



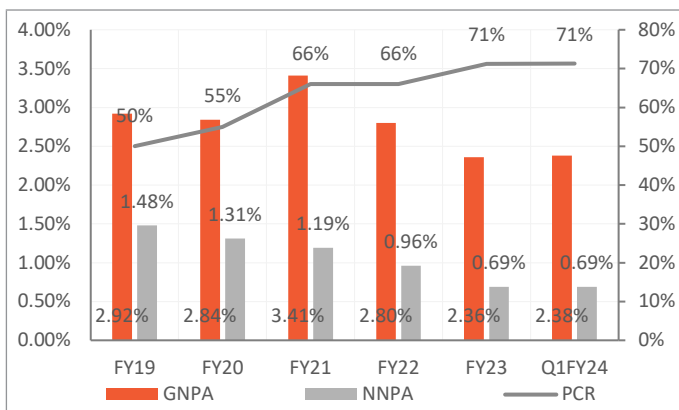
Source: Company, Sharekhan Research

Trend in NIMs



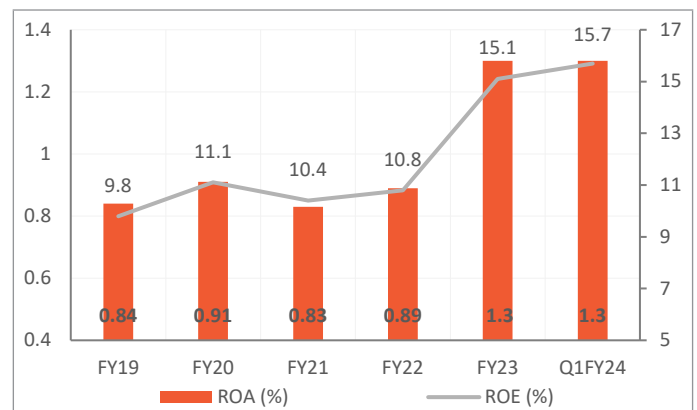
Source: Company, Sharekhan Research

Trend in asset quality



Source: Company, Sharekhan Research

Trend in return ratio



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector Outlook – Deposit mobilisation to be in focus; banks with a superior liability franchise placed better

System-level credit offtake grew by ~19.7% y-o-y in the fortnight ending August 11, 2023, indicating loan growth has been sustaining, given distinct signs of an improving economy, revival of investments, and strong demand. On the other hand, deposits rose by ~13.5%. The gap between advances and deposits growth is narrowing and is expected to further narrow as real deposit rates increase gradually. We should see some moderation in loan growth due to a higher base in FY2024, but loan growth is expected to remain healthy. Margins have likely peaked out in Q4FY2023. The overall asset-quality outlook stays stable to positive for the sector. We believe banks with a robust capital base, strong deposit franchise, and asset quality (with high coverage and provision buffers) are well-placed to capture growth opportunities.

■ Company Outlook – Evolving as a strong business franchise

Federal Bank is evolving as a strong business franchise displaying better asset-quality trends and healthy operating profit trends. We would have to overlook temporary volatility in the performance, led by cyclical variables. The bank is transforming and establishing itself as a next-generation bank in the private mid-segment. The bank has been spearheading digital initiatives through tie-ups with various payment platforms, neo banks, and fintech companies across its assets and liabilities. This enables the bank to lower its acquisition costs and increase revenue share. Further, the bank has a well-diversified loan book with a continued focus on increasing the retail mix. We believe the bank is well poised to sustain RoA of over 1.2% over the medium term.

■ Valuation – Maintain Buy rating on Federal Bank with an unchanged PT of Rs. 170

We believe the bank is well poised to sustain RoA of over 1.2% in the near term despite margin headwinds. Strong asset quality and in turn lower credit costs are likely to support return ratios and reversal in return ratio is unlikely. We believe the bank still has levers to surprise positively from here on, led by operating leverage and higher core fee income. At the CMP, the stock currently trades at 1.2x /1.1x its FY2024E/FY2025E BV estimates.

Peer valuation

Particulars	CMP (Rs / Share)	MCAP (Rs Cr)	P/E (x)		P/B (x)		RoE (%)		RoA (%)	
			FY24E	FY25E	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E
Federal Bank	147	34,683	8.6	7.5	1.2	1.1	15.6	15.3	1.3	1.3
IndusInd Bank	1,402	1,08,904	12.0	10.3	1.7	1.5	15.4	15.4	1.9	1.9

Source: Company, Sharekhan estimates

About company

Federal Bank is a private-sector bank headquartered in Aluva, Kerala. The bank operates in four segments: treasury operations, wholesale banking, retail banking, and other banking operations. The bank has 1,366 branches and has its representative offices in Abu Dhabi and Dubai and an IFSC Banking Unit (IBU) in Gujarat International Finance Tec-City (GIFT City). Federal Bank has been building incremental addition in better-rated borrowers and has been focusing on increasing the retail mix. Federal Bank's efforts to diversify its income source by investments in related businesses, adding new streams to fee, and other income are also bearing fruits, albeit slowly.

Investment theme

Federal Bank is evolving as a strong business franchise displaying better asset-quality trends and healthy operating profit trends. The bank has been building incremental addition in better-rated corporate borrowers and has been focusing on increasing the retail mix and diversifying into higher-yield segments. The bank is rapidly adapting and transforming itself into a next-generation bank in the private mid-segment, which is a key positive. We believe the bank is well poised to sustain RoA of over 1.2% in the near to medium term.

Key Risks

Economic slowdown due to which slower loan growth and higher-than-anticipated credit cost; slower growth in retail deposits; and lower margin than expected.

Additional Data

Key management personnel

Shyam Srinivasan	Managing Director and CEO
Shalini Warriar	Executive Director
Harsh Dugar	Executive Director
V. Venkateshwaran	CFO

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC AMC CO LTD	4.58
2	KADER YUSUFFALI M V A	3.55
3	MIRAE ASSET GLOBAL INVESTMENTS CO LTD	3.51
4	IFC Financial Institutions Growth Fund	3.47
5	FRANKLIN RESOURCES INC	2.77
6	HDFC LIFE INSURANCE CO	2.76
7	ICICI Prudential AMC Ltd	2.50
8	VANGUARD GROUP INC	2.33
9	Nippon Life AMC Ltd	2.29
10	Rakesh Jhunjunwala	2.28

Source: Bloomberg

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Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and deteriorating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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