

4 May 2019

Federal Bank

Another strong quarter; retaining a Buy

Higher non-interest income, stable margins and lower credit cost led to a strong earnings growth for Federal Bank in Q4 FY19. Slippages were below 1% of the loan book and credit cost came at 51bps. We expect the strong momentum in its balance sheet to persist and, now, with lower stable credit costs, profitability would gradually improve in the medium term. Despite headwinds due to floods and higher costs, the bank has achieved an exit RoA of 1%. We retain our positive view on the bank, given the strong business growth outlook, steady margins and stable credit costs. We retain our Buy recommendation, at a higher TP of 115 (earlier ₹105).

Asset quality stabilises. Slippages eased to ~0.92% of the loan book (a many-year low) aided by sizable reductions in delinquencies in its SME, corporate and retail books. Credit cost softened to 51bps, and management guided to 60bps for FY20. Stressed assets (GNPA + standard restructured loans) continued declining and are now ~3.47% of loans. We have factored in a 1.6% slippage over FY20-21 (though more than management talked of) due to the accelerated recognition from the residual stressed portfolio.

Core operating performance fairly sound. PPOP increased ~28% y/y, driven by a stable NIM, strong fee income growth and lower opex growth. Management continues to guide to NIM at current levels in FY20; however, we expect NIM to decline slightly from present levels given the rising interest rates and lag in pass-through of higher costs.

Valuation. Our May'20 sum-of-parts target price (1.4x FY21e adj. book value, ₹13 a share for Fedfina and IDBI-Federal Life) works out to ₹115 a share. **Risk:** Lumpy slippages from the corporate book.

Key financials (YE Mar)	FY17	FY18	FY19	FY20e	FY21e
Net interest income (₹ m)	30,526	35,828	41,764	49,588	59,941
Pre-provisioning profit (₹ m)	19,249	22,910	27,631	32,966	39,688
Provisions (₹ m)	6,184	9,472	8,559	11,464	12,987
PAT (₹ m)	8,308	8,788	12,439	14,191	17,622
EPS (₹)	4.8	4.5	6.3	7.2	8.9
NIM (%)	3.3	3.1	3.0	3.0	3.0
Cost-Income (%)	53.4	51.7	50.0	49.3	48.8
RoE (%)	9.8	8.3	9.8	10.3	11.7
RoA (%)	0.8	0.7	0.8	0.8	0.8
Advances growth (%)	26.2	25.4	19.9	22.0	22.0
GNPA (%)	2.3	3.0	2.9	2.9	2.9
CAR (%)	12.4	14.7	14.1	13.7	12.7
P / E (x)	18.9	20.2	14.3	12.5	10.1
P / BV (x)	1.8	1.5	1.3	1.2	1.1
P / ABV (x)	1.9	1.6	1.5	1.4	1.3

Source: Company, Anand Rathi Research

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Rating: **Buy**

Target Price: ₹115

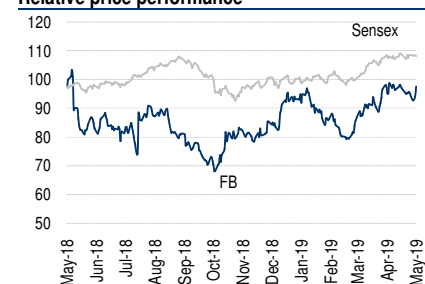
Share Price: ₹98

Key data	FB IN / FED.BO
52-week high / low	₹105 / 67
Sensex / Nifty	38963 / 11712
3-m average volume	\$15.3m
Market cap	₹194bn / \$2800.4m
Shares outstanding	1985m

Shareholding pattern (%)	Mar '19	Dec '18	Sep '18
Promoters	-	-	-
- of which, Pledged	-	-	-
Free float	100.0	100.0	100.0
- Foreign institutions	37.2	37.3	36.2
- Domestic institutions	29.7	29.9	30.0
- Public	33.0	32.7	33.9

Estimates revision (%)	FY19e	FY20e
NII	(2.0)	(1.5)
EPS	(3.3)	0.5
RoE	1.3	4.8

Relative price performance



Source: Bloomberg

Yuvraj Choudhary, CFA
Research Analyst

Mayank Agarwal
Research Associate

Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹ m)

Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
Net interest income	30,526	35,828	41,764	49,588	59,941
<i>NII growth (%)</i>	21.9	17.4	16.6	18.7	20.9
Non-interest income	10,818	11,591	13,510	15,490	17,541
Income	41,344	47,419	55,274	65,078	77,482
<i>Income growth (%)</i>	25.6	14.7	16.6	17.7	19.1
Operating expenses	22,095	24,509	27,643	32,112	37,795
PPOP	19,249	22,910	27,631	32,966	39,688
<i>PPOP growth (%)</i>	35.2	19.0	20.6	19.3	20.4
Provisions	6,184	9,472	8,559	11,464	12,987
PBT	13,065	13,439	19,073	21,502	26,700
Tax	4,757	4,650	6,634	7,311	9,078
PAT	8,308	8,788	12,439	14,191	17,622
<i>PAT growth (%)</i>	74.7	5.8	41.5	14.1	24.2
FDEPS (₹ / sh)	4.8	4.5	6.3	7.2	8.9
DPS (₹ / sh)	0.9	1.0	1.4	1.4	1.8

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
Share capital	3,448	3,944	3,970	3,970	3,970
Reserves & surplus	85,976	1,18,158	1,28,760	1,40,113	1,54,211
Deposits	9,76,646	11,19,925	13,49,543	16,19,452	19,43,342
Borrowings	58,973	1,15,335	77,813	1,01,157	1,31,504
Minority interests	0	0	0	0	0
Total liabilities	11,49,769	13,83,140	15,93,400	19,09,819	22,92,510
Advances	7,33,363	9,19,575	11,02,230	13,44,720	16,40,558
Investments	2,81,961	3,07,811	3,18,245	3,75,529	4,43,124
Cash & bank bal	45,766	51,328	64,192	77,030	92,436
Fixed & other assets	4,895	4,574	4,720	4,838	4,959
Total assets	11,49,769	13,83,140	15,93,400	19,09,819	22,92,510
No. of shares (m)	1,747	1,972	1,972	1,972	1,972
<i>Deposits growth (%)</i>	23.4	14.7	20.5	20.0	20.0
<i>Advances growth (%)</i>	26.2	25.4	19.9	22.0	22.0

Source: Company, Anand Rathi Research

Fig 3 – Ratio analysis

Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
NIM	3.3	3.1	3.0	3.0	3.0
Other inc. / total inc.	26.2	24.4	24.4	23.8	22.6
Cost-income	53.4	51.7	50.0	49.3	48.8
Provision coverage	43.7	43.5	50.1	45.4	45.0
Dividend payout	18.9	22.4	22.2	20.0	20.0
Credit-deposit	75.1	82.1	81.7	83.0	84.4
Investment-deposit	28.9	27.5	23.6	23.2	22.8
Gross NPA	2.3	3.0	2.9	2.9	2.9
Net NPA	1.3	1.7	1.5	1.6	1.6
BV (₹)	51.2	61.9	67.3	73.1	80.2
Adj. BV (₹)	47.4	56.4	61.5	65.4	70.9
CAR	12.4	14.7	14.1	13.7	12.7
- Tier 1	11.8	14.2	13.4	12.9	11.9
RoE	9.8	8.3	9.8	10.3	11.7
RoA	0.8	0.7	0.8	0.8	0.8

Source: Company, Anand Rathi Research

Fig 4 – Price-to-Book band


Source: Bloomberg

Fig 5 – One-year-forward price-to-book value


Source: Company, Anand Rathi Research

Fig 6 – Price movement


Source: Bloomberg

Key Highlights

Conference-call takeaways

Guidance

- a) **RoA:** 1.25% by FY21 (10bps-12bps per year – exit quarter).
- b) **C/I:** 250bp improvement by FY21.
- c) **Loan growth:** 20-22% in the medium term, with intent to rebalance corporate and retail book 50:50.
- d) **NIM:** 3.2% in FY20.
- e) **Credit cost:** 55bps-60bps for FY20.
- f) **Branches:** 80-100 outside Kerala in the next two years.
- g) **Other income and recovery:** same run-rate as in FY19.

Other Highlights

- IL&FS exposure: 1) ₹2.46bn exposure toward three completed annuity projects. 2) A ₹2.1bn account: servicing being done regularly. This account is in “Amber” category. 3) Two other accounts are also being serviced regularly; however, cash-flows are not being released from escrow. 4) Made a ₹210m provision on the whole exposure. 5) Management expects nil LGD on the whole exposure.
- Received one-time ₹180m interest on an income-tax refund.
- Real-estate exposure. The bank has a 4.2% exposure (of the corporate book) toward this sector. Of this, 90% is LRD. Management doesn't expect any negative surprises from this book.
- Has sufficient capital for the next ~18 months.
- Dispensation for MSME in the current quarter: ₹117m.
- Has 700 RM across verticals.
- SME classification: Business banking - >₹50m, Commercial banking - ₹50m-250m.
- Housing portfolio ticket size: Metro - ₹8m, Rest of India - ₹4m-5m.
- Of the ₹15bn written off pool, ₹5bn is less than three years. Management expects 25% annual recovery from the recent pool of NPAs.
- 10% of total deposit origination done through digital channels (without the bank's assistance)

Fig 7 – Segment-wise results – GNPA

(₹ m)	Q1 FY17	Q2 FY17	Q3 FY17	Q4 FY17	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19
Opening balance	16,678	17,473	18,197	19,516	17,271	18,679	19,490	21,612	27,956	28,688	31,845	33,612
Slippages	2,800	2,660	2,740	2,440	4,250	2,840	4,120	8,720	4,600	4,770	4,270	2,560
Retail	670	630	860	550	970	1,060	1,500	700	1,090	1,200	1,080	670
Agri	340	260	140	300	450	510	420	560	540	650	710	920
SME	1,340	1,350	1,190	1,220	1,140	1,070	1,220	1,420	900	1,690	1,920	970
Wholesale	450	420	550	370	1,690	200	980	6,040	2,070	1,230	560	-
Recovery	2,005	1,936	1,422	4,685	2,841	2,030	1,998	2,376	3,868	1,613	2,503	3,566
Closing balance	17,473	18,197	19,516	17,271	18,679	19,490	21,612	27,956	28,688	31,845	33,612	32,607
GNPA (%)	2.92	2.78	2.77	2.33	2.42	2.39	2.52	3.00	3.00	3.11	3.14	2.92
Gross slippage ratio (%)	1.81	1.59	1.52	1.26	2.13	1.35	1.85	3.74	1.93	1.87	1.60	0.92

Source: Company, Anand Rathi Research

Fig 8 – Segment-wise results – Loan Book

(%)	Q1 FY17	Q2 FY17	Q3 FY17	Q4 FY17	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19
Corporate (large & mid)	36.8	37.6	39.7	40.9	42.1	41.4	42.2	42.4	42.9	43.8	43.5	42.5
SME	24.7	22.4	21.3	21.2	20.1	21.0	20.7	20.2	19.6	19.1	18.8	18.9
Retail	28.0	29.8	29.6	28.2	27.9	27.7	27.2	27.6	27.4	27.2	27.8	28.4
Housing Loans	13.0	12.5	11.9	11.8	11.8	12.0	12.1	12.5	12.8	13.3	13.6	13.8
Gold loans	3.7	3.4	2.9	2.7	2.5	2.3	2.1	2.1	1.9	1.7	1.5	1.5
Mortgages	5.3	5.2	5.0	5.0	5.1	5.0	5.0	5.1	5.1	5.0	5.0	5.4
Others	6.1	8.7	9.8	8.7	8.5	8.4	8.1	7.8	7.6	7.2	7.6	7.7
Agriculture	10.4	10.2	9.4	9.7	10.0	10.0	9.8	9.8	10.2	9.9	9.9	10.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Company, Anand Rathi Research

Quarterly snapshot**Fig 9 – Segment-wise results – Income Statement**

(₹ m)	Q1 FY17	Q2 FY17	Q3 FY17	Q4 FY17	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19
Interest income	20,138	20,663	22,814	23,160	23,241	23,796	25,012	25,480	26,674	27,649	29,544	30,323
Interest expense	13,211	13,401	14,900	14,736	15,234	14,807	15,512	16,148	16,873	17,425	18,771	19,358
Nil	6,927	7,262	7,914	8,424	8,007	8,989	9,500	9,332	9,801	10,225	10,773	10,965
Y/Y growth (%)	14.5	19.4	30.8	22.8	15.6	23.8	20.0	10.8	22.4	13.7	13.4	17.5
Non-interest income	2,370	2,615	2,633	2,821	3,291	2,872	2,286	3,142	2,709	3,229	3,456	4,117
Trading profits	830	860	860	540	1,120	750	290	220	490	510	550	740
Income	9,297	9,877	10,547	11,245	11,298	11,861	11,786	12,474	12,509	13,454	14,228	15,083
Y/Y growth (%)	16.4	24.9	33.8	23.2	21.5	20.1	11.7	10.9	10.7	13.4	20.7	20.9
Operating expenses	5,039	5,128	5,798	5,753	5,719	6,029	6,172	6,588	6,480	6,478	7,150	7,535
Of which staff cost	2,894	2,916	3,197	2,630	2,985	3,127	3,005	3,308	3,450	3,089	3,537	3,702
PPOP	4,259	4,749	4,749	5,492	5,579	5,832	5,614	5,886	6,029	6,976	7,078	7,548
Y/Y growth (%)	16.0	41.1	45.9	39.2	31.0	22.8	18.2	7.2	8.1	19.6	26.1	28.2
Total provisions	1,685	1,684	1,588	1,227	2,364	1,768	1,624	3,715	1,992	2,888	1,901	1,778
PBT	2,574	3,065	3,161	4,265	3,214	4,064	3,990	2,170	4,038	4,088	5,177	5,770
Tax	901	1,053	1,104	1,699	1,113	1,427	1,390	721	1,411	1,427	1,841	1,955
PAT	1,673	2,012	2,057	2,566	2,102	2,637	2,600	1,450	2,627	2,660	3,336	3,815
Y/Y growth (%)	18.4	24.8	26.4	2,400.9	25.6	31.0	26.4	(43.5)	25.0	0.9	28.3	163.1

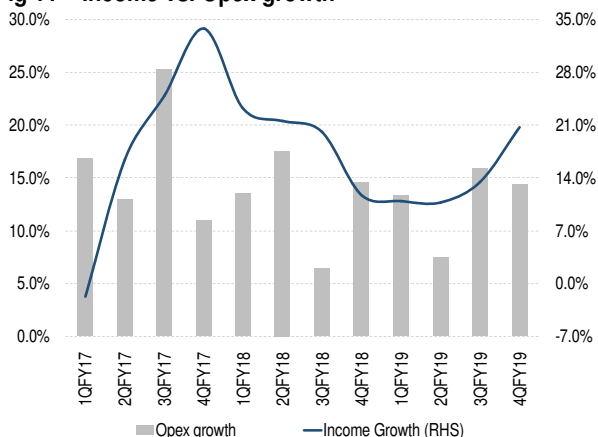
Source: Company, Anand Rathi Research

Fig 10 – Segment-wise results – Balance Sheet

(₹ m)	Q1 FY17	Q2 FY17	Q3 FY17	Q4 FY17	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19
Equity capital	3,440	3,441	3,440	3,448	3,880	3,909	3,930	3,944	3,960	3,961	3,970	3,970
Reserves & Surplus	79,160	81,217	83,340	85,976	1,12,390	1,13,423	1,16,480	1,18,158	1,21,030	1,21,452	1,24,900	1,28,760
Deposits	8,11,320	8,62,991	9,22,360	9,76,646	9,58,390	9,72,108	10,05,370	11,19,925	11,12,420	11,81,824	12,34,570	13,49,543
Borrowings	17,290	26,554	62,320	58,973	58,330	87,332	1,08,400	1,15,335	94,700	88,735	84,090	77,813
Other Liabilities	26,690	30,556	43,520	24,727	31,370	40,807	48,030	25,777	34,700	48,117	50,260	33,313
Equity and Liabilities	9,37,900	10,04,759	11,14,980	11,49,769	11,64,360	12,17,579	12,82,210	13,83,140	13,66,810	14,44,090	14,97,790	15,93,400
Deposits y/y growth (%)	12.5	17.0	23.3	23.4	18.1	12.6	9.0	14.7	16.1	21.6	22.8	20.5
Deposits q/q growth (%)	2.5	6.4	6.9	5.9	-1.9	1.4	3.4	11.4	-0.7	6.2	4.5	9.3
Assets												
Cash and cash balance	64,270	59,869	68,710	74,522	74,520	87,751	72,060	92,034	75,480	81,477	77,760	1,00,668
Advances	5,91,180	6,46,869	6,96,300	7,33,363	7,63,070	8,06,459	8,49,530	9,19,575	9,42,970	10,09,409	10,55,500	11,02,230
Investments	2,28,510	2,41,522	2,85,200	2,81,961	2,66,910	2,63,175	2,97,750	3,07,811	2,83,120	2,82,139	2,92,000	3,18,245
Other assets	53,940	56,499	64,770	59,924	59,860	60,195	62,870	63,720	65,240	71,065	72,530	72,258
Total Assets	9,37,900	10,04,759	11,14,980	11,49,769	11,64,360	12,17,579	12,82,210	13,83,140	13,66,810	14,44,090	14,97,790	15,93,400
Advances y/y growth (%)	19.3	27.2	32.0	26.2	29.1	24.7	22.0	25.4	23.6	25.2	24.2	19.9
Advances q/q growth (%)	1.8	9.4	7.6	5.3	4.1	5.7	5.3	8.2	2.5	7.0	4.6	4.4

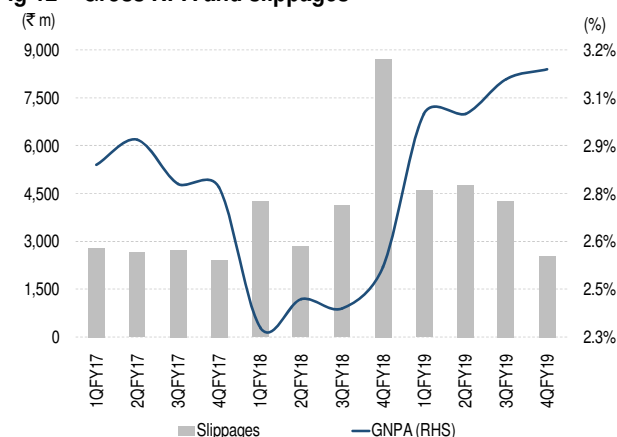
Source: Company, Anand Rathi Research

Fig 11 – Income vs. Opex growth



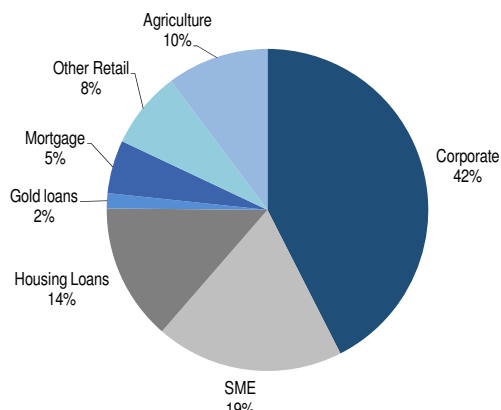
Source: Company, Anand Rathi Research

Fig 12 – Gross NPA and slippages



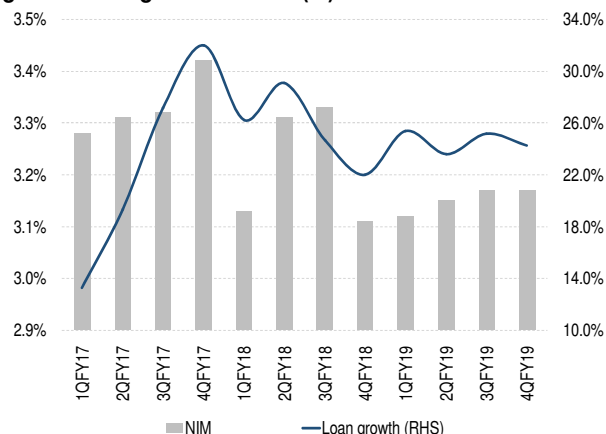
Source: Company, Anand Rathi Research

Fig 13 – Loan break-up



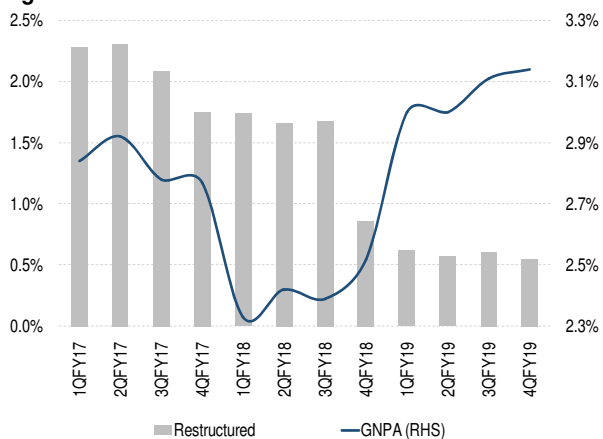
Source: Company, Anand Rathi Research

Fig 14 – Credit growth vs. NIM (%)



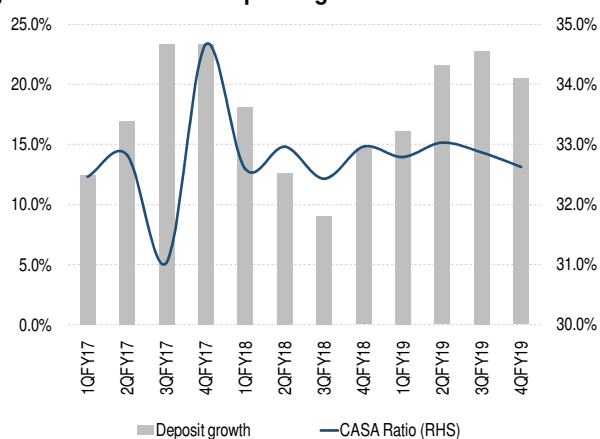
Source: Company, Anand Rathi Research

Fig 15 – Restructured assets vs. GNPA



Source: Company, Anand Rathi Research

Fig 16 – CASA ratio vs. Deposits growth



Source: Company, Anand Rathi Research

Valuation

- Our May'20 target is based on a sum-of-parts valuation (1.44x FY21e adj. book value, and ₹13 a share for Fedfina and IDBI-Federal Life), which works out to ₹115 a share.
- We are confident of the bank's loan growth potential, largely driven by the corporate loan book.

Fig 17 – Change in estimates

	Original Estimates		Revised Estimates		Change (%)	
	FY20e	FY21e	FY20e	FY21e	FY20e	FY21e
Net interest income (₹ m)	50,598	60,830	49,588	59,941	(2.0)	(1.5)
RoE (%)	10.6	11.6	10.3	11.7	(3.3)	0.5
RoA (%)	0.8	0.8	0.8	0.8	1.3	4.8

Source: Anand Rathi Research

Risks

- Any lumpy delinquencies from the corporate loan book could harden our credit cost estimates, manifesting in lower return ratios.
- Lower-than-expected loan growth could distort our estimates.

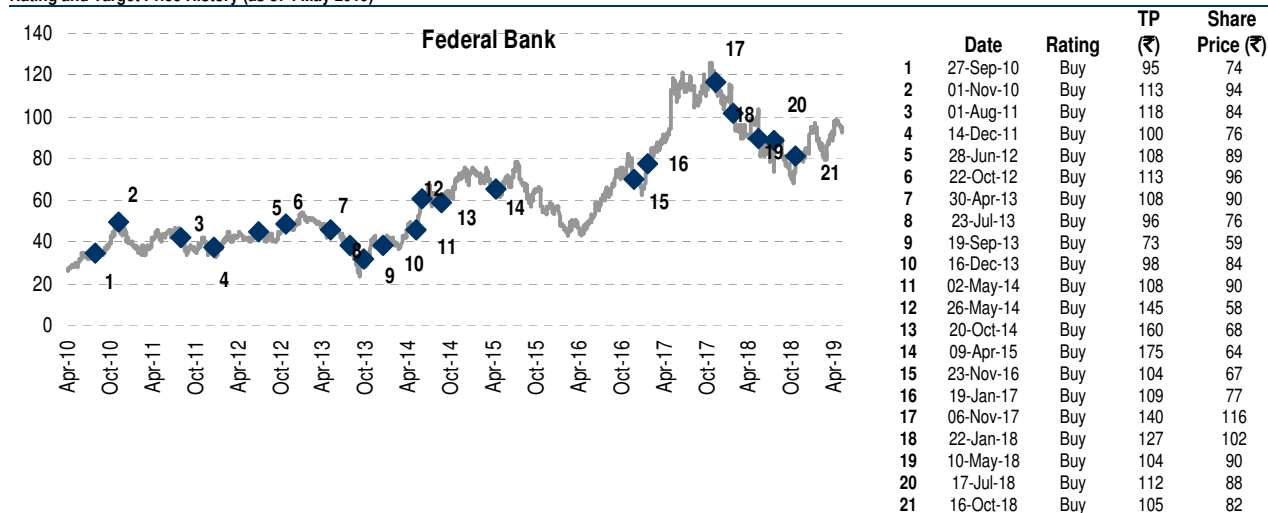
Appendix

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Rating and Target Price History (as of 4 May 2019)



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Ratings Guide (12 months)

	Buy	Hold	Sell
Large Caps (>US\$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US\$1bn)	>25%	5-25%	<5%

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ARSSBL registered address: 4th Floor, Silver Metropolis, Jaicoach Compound, Opposite Bimbisar Nagar, Goregaon (East), Mumbai - 400 063.
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