

BUY

TP: Rs 165 | ▲ 28%

FEDERAL BANK

| Banking

| 14 July 2023

Strong business growth but margins under pressure

- High-yield retail assets drove 42% YoY PAT growth; NIM (calc) dipped 13bps QoQ to 3.1% on a higher cost of funds
- Management confident of margin improvement from Q2FY24; full-year NIM guidance retained at 3.3%
- Strong growth, stable asset quality and focus on other income likely to aid return ratios; maintain BUY with TP unchanged at Rs 165

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Strong business growth: FB's advances increased 21% YoY (+5% QoQ) in Q1FY24 with broad-based growth across segments. Retail and wholesale loans both grew ~20% YoY (~5% QoQ), with retail growth backed by recent high-yield launches such as personal loans (+62% YoY), credit cards (+267% YoY), microfinance (+245% YoY) and commercial vehicles/construction equipment (+72% YoY). Deposits swelled 21% YoY (+4% QoQ) driven by term deposits. Management reiterated its loan and deposit growth guidance of 18-20% YoY for FY24.

NIM dips sequentially: The bank's CASA ratio declined 84bps QoQ and 500bps YoY to 31.8%. As the cost of funds increased 20bps QoQ vs. an 8bps rise in loan yields, NIM (Calc.) softened by 13bps QoQ to 3.1%. Management is confident of margin improvement from Q2 as a bulk of the deposit repricing is complete while a better loan mix should aid yields. FB thus maintained its NIM target at 3.3% for FY24. Q1 PAT grew 42% YoY to Rs 8.5bn (-5% QoQ) backed by strong other income and stable opex.

Slippages up QoQ but asset quality stable: Gross slippages increased from Rs 4.4bn in Q4FY23 (1.7% of loans) to Rs 5bn (1.9%) in Q1, mainly from the restructured book. GNPA/NNPA ratios were stable QoQ while reported credit cost stood at 41bps. We build in credit cost at 60bps for FY24 and FY25 with stable PCR.

Improving growth prospects: Over the past year, FB's conservative approach towards asset quality vs. asset pricing has resulted in lower margins than peers and ultimately lower ROA. Going forward, we expect the bank's focus on shoring up other income along with gradual operational leverage to aid better return ratios (ROA of 1.2% by FY24E). In line with management guidance, we expect business growth to remain strong in the high teens in FY24 along with NIM at 3.3%.

Maintain BUY: The stock is trading at 1x FY25E ABV. We expect FB to gradually improve its return ratios, narrowing the gap with peers and aiding a rerating. We retain BUY with an unchanged TP of Rs 165, set at 1.3x FY25E ABV (Gordon Growth Model).

Key changes

Target	Rating
◀ ▶	◀ ▶

Ticker/Price	FB IN/Rs 129
Market cap	US\$ 3.3bn
Free float	100%
3M ADV	US\$ 21.0mn
52wk high/low	Rs 143/Rs 96
Promoter/FPI/DII	0%/27%/73%

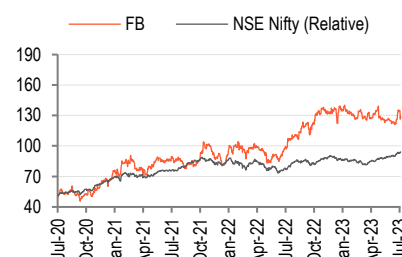
Source: NSE | Price as of 14 Jul 2023

Key financials

Y/E 31 Mar	FY23P	FY24E	FY25E
Net interest income	72,322	84,473	95,642
NII growth (%)	21.3	16.8	13.2
Adj. net profit (Rs mn)	30,106	33,137	37,552
EPS (Rs)	14.3	15.7	17.7
Consensus EPS (Rs)	14.3	16.0	18.5
P/E (x)	9.1	8.3	7.3
P/BV (x)	1.3	1.1	1.0
ROA (%)	1.3	1.2	1.2
ROE (%)	14.9	14.5	14.6

Source: Company, Bloomberg, BOBCAPS Research | P – Provisional

Stock performance



Source: NSE



Fig 1 – Quarterly snapshot: Income statement

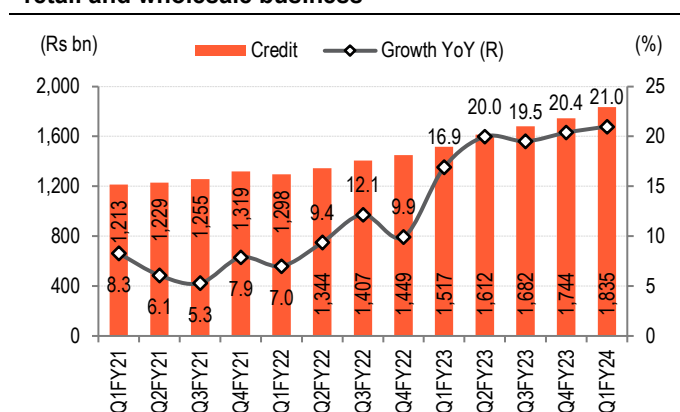
(Rs mn)	Q1FY24	Q1FY23	Q2FY23	Q3FY23	Q4FY23	YoY (%)	QoQ (%)
Income Statement							
Interest Income	40,396	28,868	32,227	35,849	37,974	39.9	6.4
Income on investments	8,149	6,295	6,674	7,207	7,780	29.4	4.7
Int. on bal. with RBI & inter-bank funds & Others	1,701	1,126	1,307	1,277	1,453	51.1	17.1
Interest income	50,245	36,289	40,208	44,333	47,207	38.5	6.4
Interest expense	31,059	20,244	22,590	24,767	28,115	53.4	10.5
Net interest income	19,186	16,045	17,618	19,565	19,093	19.6	0.5
Growth YoY (%)	19.6	13.1	19.1	27.1	25.2	646bps	(561bps)
Non-interest income	7,324	4,526	6,095	5,340	7,339	61.8	(0.2)
Growth YoY (%)	61.8	(18.0)	37.2	10.3	57.8	7,979bps	400bps
Total income	26,510	20,571	23,714	24,905	26,432	28.9	0.3
Growth YoY (%)	28.9	4.4	23.3	23.1	32.8	2,446bps	(394bps)
Staff expenses	6,167	4,993	5,156	5,608	5,972	23.5	3.3
Other operating expenses	7,319	5,844	6,435	6,555	7,114	25.2	2.9
Operating expenses	13,487	10,838	11,591	12,163	13,086	24.4	3.1
Pre-Provisioning Profit (PPoP)	13,024	9,734	12,122	12,742	13,346	33.80	(2.4)
Growth YoY (%)	33.8	(6.1)	40.2	39.4	67.2	3,992bps	(3,340bps)
Provisions	1,556	1,667	2,679	1,987	1,167	(6.7)	33.4
PBT	11,468	8,067	9,444	10,755	12,179	42.2	(5.8)
Tax	2,930	2,060	2,407	2,719	3,153	42.2	(7.1)
PAT	8,537	6,007	7,037	8,036	9,026	42.1	(5.4)
Growth YoY (%)	42.1	63.5	52.9	54.0	67.0	(2,140bps)	(2,485bps)
Per Share							
FV (Rs)	2.0	2.0	2.0	2.0	2.0	0.0	0.0
EPS (Rs)	4.0	2.9	3.3	3.8	4.3	40.9	(5.6)
Book Value (Rs)	105	92	93	97	101	14.7	3.8

Source: BOBCAPS Research, Company

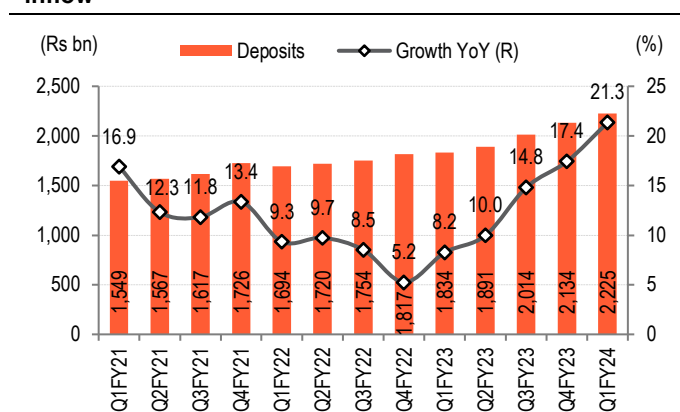
Fig 2 – Quarterly snapshot: Key balance sheet parameters & ratios

Balance sheet (Rs mn)	Q1FY24	Q1FY23	Q2FY23	Q3FY23	Q4FY23	YoY (%)	QoQ (%)
Deposits	2,224,960	1,833,550	1,891,457	2,014,080	2,133,860	21.3	4.3
Growth YoY (%)	21.3	8.2	10.0	14.8	17.4	1310bps	391bps
Advances	1,834,870	1,516,890	1,612,403	1,681,730	1,744,469	21.0	5.2
Growth YoY (%)	21.0	16.9	20.0	19.5	20.4	407bps	59bps
Investment	519,420	411,860	435,713	462,650	489,834	26.1	6.0
Equity	223,760	193,930	197,488	205,880	215,062	15.4	4.0
Assets	2,741,960	2,253,520	2,371,124	2,504,720	2,603,418	21.7	5.3
Growth YoY (%)	21.7	12.7	14.6	19.9	17.8	902bps	384bps
Yield (%)							
Yield on Funds	8.11	7.01	7.50	7.84	7.98	109bps	13bps
Cost of Funds	5.22	4.09	4.42	4.60	4.96	113bps	26bps
Spread	2.89	2.93	3.08	3.24	3.02	(4bps)	(13bps)
Net Interest Margin	3.10	3.10	3.29	3.46	3.23	(1bps)	(13bps)
Ratios (%)							
Other Income / Net Income	27.6	22.0	25.7	21.4	27.8	563bps	(14bps)
Cost to Income ratio	50.9	52.7	48.9	48.8	49.5	(181bps)	136bps
CASA ratio	31.8	36.8	36.4	34.2	32.7	(499bps)	(84bps)
C/D ratio	82.5	82.7	85.2	83.5	81.8	(26bps)	72bps
Investment to Assets	18.9	18.3	18.4	18.5	18.8	67bps	13bps
Assets Quality							
GNPA	44,348	41,553	40,311	41,479	41,838	6.7	6.0
NNPA	12,746	14,203	12,624	12,286	12,050	(10.3)	5.8
Provision	31,602	27,351	27,687	29,193	29,788	15.5	6.1
GNPA (%)	2.38	2.69	2.46	2.43	2.36	(31bps)	2bps
NNPA (%)	0.69	0.94	0.78	0.73	0.69	(25bps)	0bps
PCR (%)	71.3	65.8	0.7	70.4	71.2	544bps	6bps

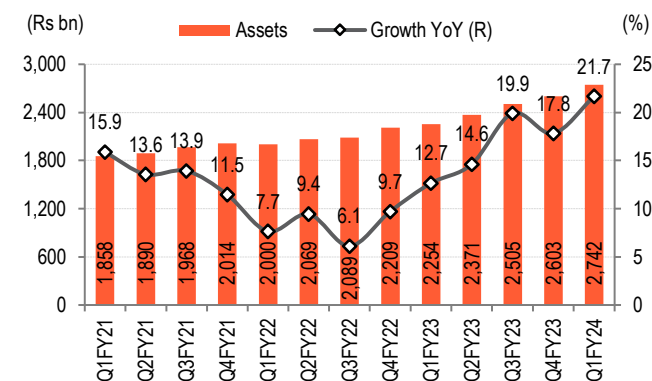
Source: Company, BOBCAPS Research

Fig 3 – Credit grew 21% YoY in Q1FY24 driven by both retail and wholesale business

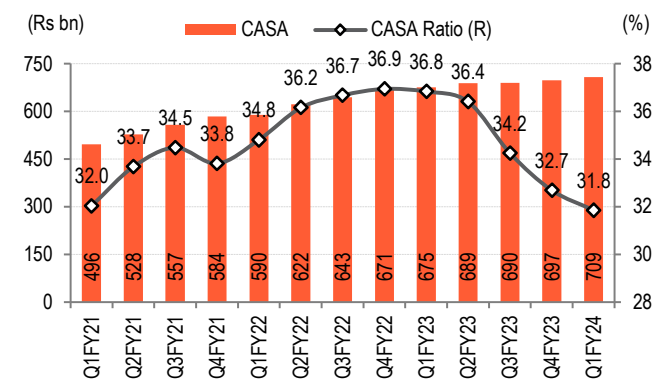
Source: Company, BOBCAPS Research

Fig 4 – Deposits rose 21.3% YoY driven by term deposit inflow

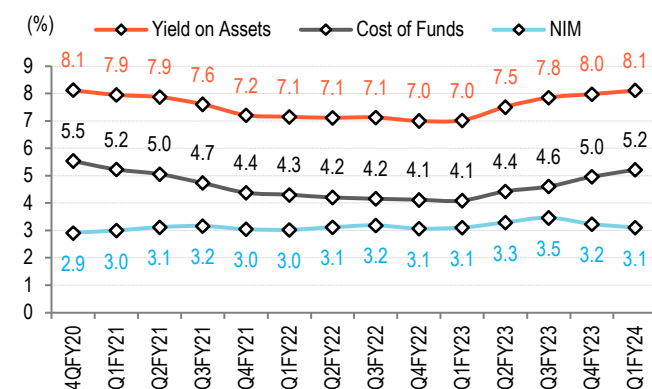
Source: Company, BOBCAPS Research

Fig 5 – Assets grew 21.7% YoY

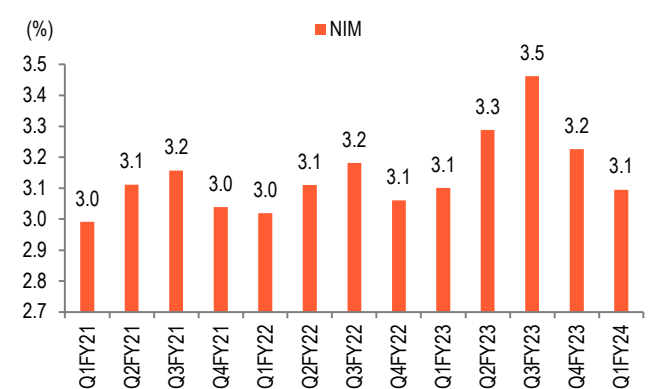
Source: Company, BOBCAPS Research

Fig 6 – CASA declined due to subdued SA mobilisation

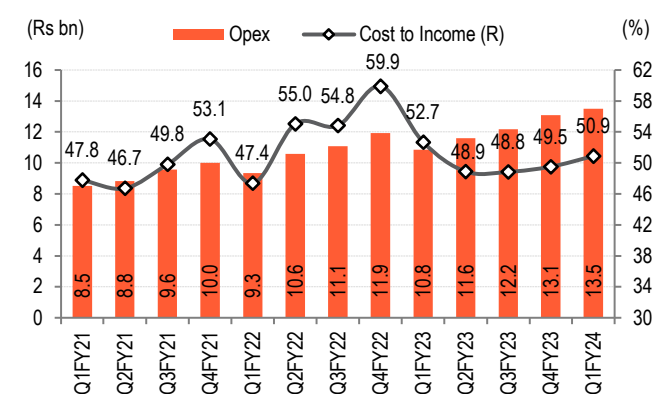
Source: Company, BOBCAPS Research

Fig 7 – NIM (calc.) down 13bps QoQ on higher cost of funds

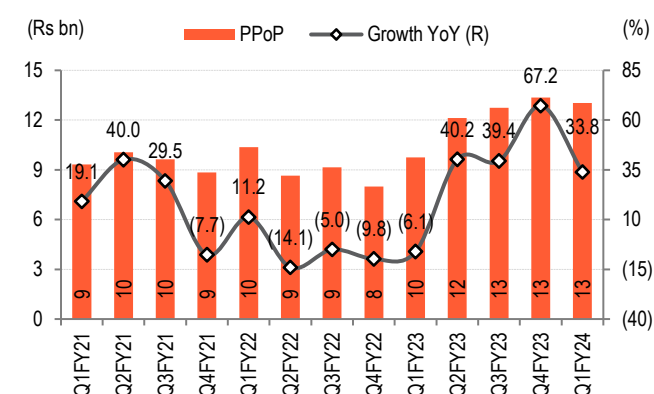
Source: Company, BOBCAPS Research

Fig 8 – NIM (calc) expected at 3.3% for FY24E

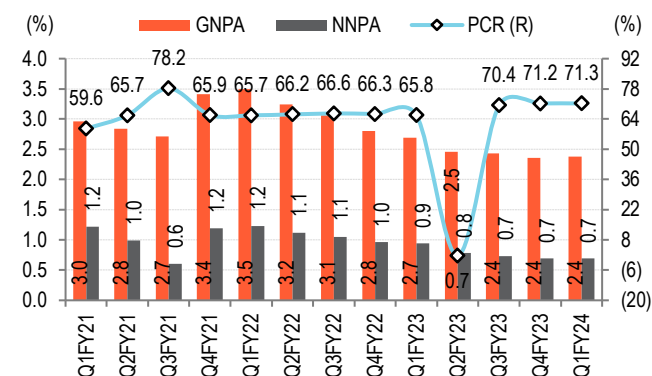
Source: Company, BOBCAPS Research

Fig 9 – C/I ratio likely to remain elevated at 50%

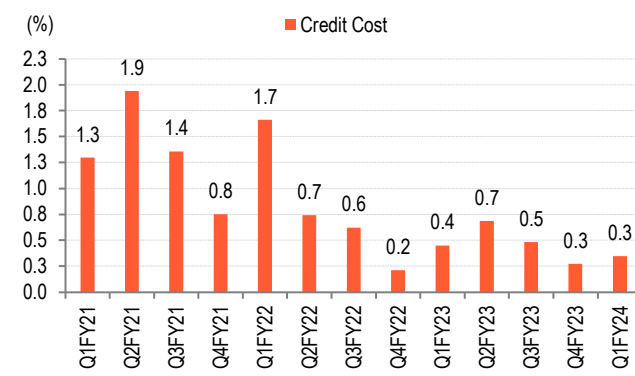
Source: Company, BOBCAPS Research

Fig 10 – Higher other income and lower provisions led to healthy PPOP

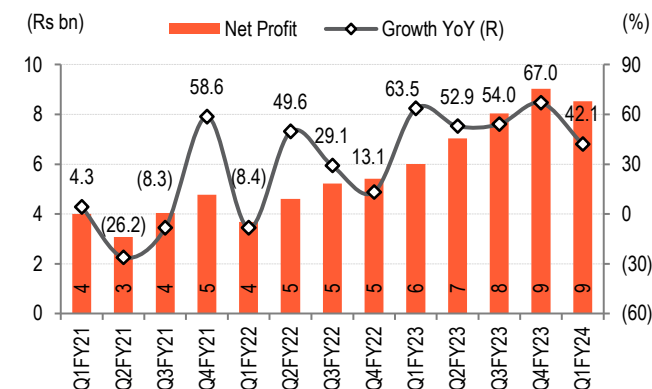
Source: Company, BOBCAPS Research

Fig 11 – Stable asset quality and PCR

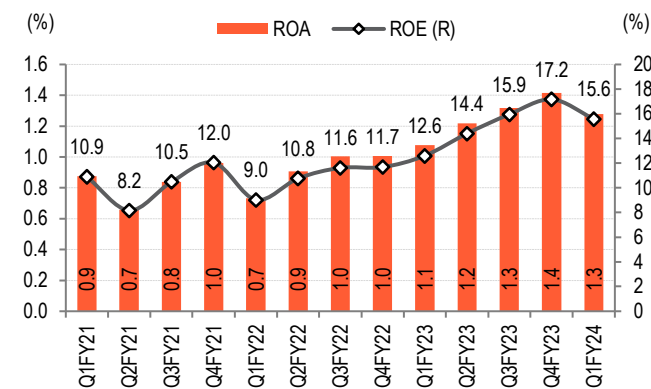
Source: Company, BOBCAPS Research

Fig 12 – Sustained low credit cost aided profit

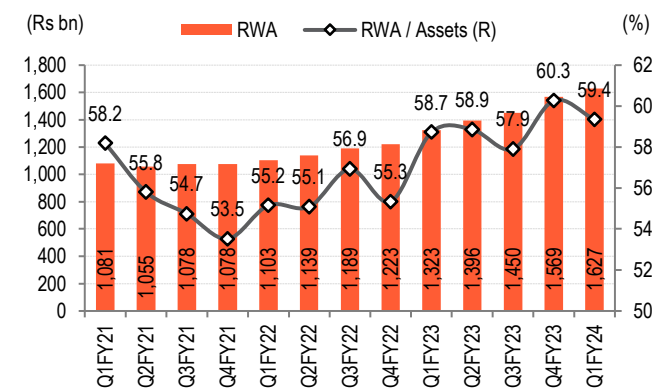
Source: Company, BOBCAPS Research

Fig 13 – Higher other income and lower provisions led to 42% YoY PAT growth

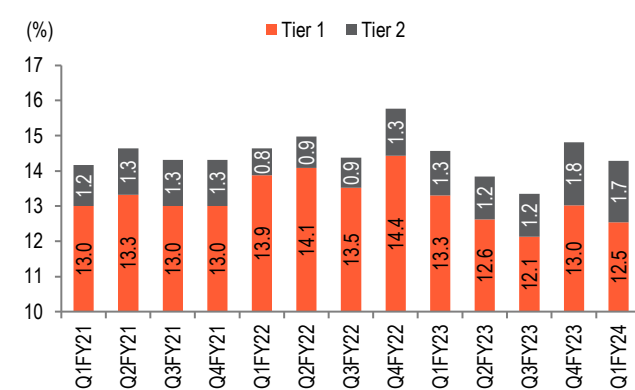
Source: Company, BOBCAPS Research

Fig 14 – Return ratios likely to improve in Q2FY24

Source: Company, BOBCAPS Research

Fig 15 – RWA higher YoY on change in regulatory requirement

Source: Company, BOBCAPS Research

Fig 16 – CAR at lower end of peer matrix

Source: Company, BOBCAPS Research

Earnings call highlights

Guidance

- FB reiterated its guidance of 18-20% YoY growth in both loans and deposits for FY24.
- Management expects a pickup in NIM from Q2FY24 as a bulk of the deposit repricing is over. FY24 NIM guidance has thus been retained at 3.3%. The guidance does not factor in benefits from a capital raise.
- Credit cost is guided to remain broadly stable at current levels of ~40bps.

Asset quality

- Despite higher slippages at Rs 5bn in Q1FY24 (mainly from the retail business; 1.92% annualised) vs. Rs 4.4bn in Q4FY23, FB's asset quality remains stable. About 30% of retail slippages are from the restructured book which has come out of moratorium after two years, as indicated by the RBI.
- GNPA and NNPA stood at 2.4% and 0.7% respectively with PCR at 71.3% (vs. 71.2% in Q4).
- Reported credit cost for the quarter stood at 41bps.

Loans and Deposits

- Management expects broad-based loan growth across segments driven by newly launched, high-yield lending towards commercial vehicles/construction equipment (CV/CE), personal loans, credit cards and microfinance, although on a lower base.
- FB is targeting a retail-to-wholesale loan mix of 55:45 wherein the focus would be on credit cards, personal loans, CV loans and microfinance within retail. In addition, the bank is targeting unsecured loans of not more than 10% of the total book and segmental concentration of not more than 15% of the loan book.
- The loan book mix by benchmark is as follows: repo linked 49%, fixed 27%, MCLR 14%, staff loan 5.5%, and the rest at base rate/foreign currency.
- On the liability side, deposits jumped 21.3% YoY in Q1FY24 led by term deposits (up 31% vs. CASA growth of 5%). The bank spurred the flow into wholesale deposits with competitive pricing and ensured higher granularity to fund the assets. Current accounts grew 25.5% YoY (-0.7% QoQ) while savings accounts were up 0.8% YoY (+2.2% QoQ). As result, retail deposits plus CASA have come down from 92% to 82% of total deposits in Q1FY24.
- About 40-45% of the total deposits came from outside FB's core market of Kerala.
- About 15% of the incremental deposits (Rs 8bn-10bn) came from fintech partners and were spread over 18,000 pin codes across the country (India has 19,000 pin codes in all).

NII and NIM

- NII growth remained flat at 0.5% QoQ (+20% YoY) due to higher interest expenses as deposit cost went up. The cost of incremental term deposits would be ~6.5% as against outstanding cost of 6.4% which is likely to impact overall deposit cost going ahead. The blended savings account rate at 3.2% for Q1FY24 is broadly similar to that in Q4FY23.
- FB expects yield on advances to inch up to 9.27% in Q2 from 9.21% in Q1, while cost of deposits could rise to 5.4% from 5.32%. This would raise NIM by 7-8bps QoQ in Q2 (mainly due to a change in mix and without considering any capital rise).
- Other income remained flat sequentially (-0.2% QoQ) at Rs 7.3bn, largely comprising fee income along with the sale of priority sector lending certificates (PSLC) of Rs 520mn.
- The breakup of other income is as follows: core fee income Rs 505mn, profit on sale of investment Rs 330mn, forex income Rs 300mn, NPA recovery gain Rs 250mn, dividend income Rs 150mn, revaluation of investment Rs 120mn, and PSLC sale Rs 520mn. FB is optimistic of further PSLC gains and indicated that this would be a recurring phenomenon but would occur annually rather than quarterly.

Valuation methodology

FB's Q1FY24 performance was healthy, supported by non-core income and lower provisions. The bank plans to maintain a retail-to-wholesale portfolio mix of 55:45 wherein it will continue to focus on retail business, specifically the unsecured book, to maintain margins. Management has retained its FY24 guidance of 3.3% NIM and 1.4% ROA with 100bps improvement in C/I ratio each year over FY24/FY25.

We maintain our estimates of an 18% credit CAGR and 16% deposit CAGR during FY22-FY25, leading to a CD ratio of 85% over our forecast period. NIM is projected to hover in the range of 3.2-3.3%, a tad below management guidance considering the sticky, high cost of deposits. The current rate environment does not point to an uptick in low-cost CASA deposits – we factor in a CASA ratio of 33-34%, in line with FB's three-year average.

In terms of operating expenses, the bank is guiding for higher branch network expansion (100 branch additions in FY24 vs. 73 in FY23), which is likely to keep operating cost elevated. Though management expects 100bps improvement in C/I ratio each for FY24 and FY25, we have factored in a flat 50% for these years. PPOP is estimated to post a 19% CAGR over FY22-FY25.

We believe FB's focus on risk-adjusted margins coupled with controlled slippages and higher recoveries will support stable asset quality, and bake in GNPA/NNPA/PCR of ~2.3%/0.7%/71% over FY24-FY25. As against the 40bps credit cost guidance, we conservatively estimate 60bps each for FY24 and FY25 considering the growing unsecured book.

FB's CAR stood at 14.3% in Q1FY24 wherein tier-1 was at 12.54% – at the lower end when compared to peers which could pose a challenge to growth. However, the bank has board approval in place for fund raising which could aid capitalisation. Considering a healthy business growth and asset quality outlook, we estimate higher ROE/ROA of 14.5%/1.2% in FY25 vs. 11%/1% clocked in FY22.

At current valuations of 1x FY25E P/ABV, the stock is one of the cheapest among the large-cap peer basket due to its relatively lower return ratios. We expect higher growth and a focus on risk-adjusted returns to take return ratios above FB's historical average, gradually narrowing the gap with peers. We thus maintain our BUY recommendation with an unchanged TP of Rs 165, valuing the stock at 1.3x FY25E ABV based on the Gordon Growth Model. The bank's ability to generate capital internally without dilution would be key to watch.

Fig 17 – Key operational assumptions

Parameter (% Growth)	FY22	FY23P	FY24E	FY25E
Advances	9.9	20.4	17.1	16.5
Net Interest Income	7.7	21.3	16.8	13.2
PPoP	(1.1)	27.6	16.4	14.2
PAT	18.8	59.3	10.1	13.3
NIM	3.1	3.3	3.3	3.2
GNPA	2.8	2.3	2.3	2.3
CAR	15.8	14.8	13.8	13.5

Source: Company, BOBCAPS Research

Fig 18 – Valuation assumptions (Gordon Growth Model)

Parameter	Assumptions
Cost of equity (%)	12.3
Blended ROE (%)	13.5
Initial high growth period (yrs)	10.0
Payout ratio of high-growth phase (%)	20.0
Long-term growth (%)	5
Long term dividend payout ratio (%)	60
Justified P/BV Multiple (x)	1.3

Source: BOBCAPS Research

Key risks

Key downside risks to our estimates are:

- reversal in credit cycle, which can lead to higher deterioration in asset quality and thus overall profitability owing to higher provisions, and
- inability to manage cost of funds, which may drag down NIM as well as overall profitability.

Sector recommendation snapshot

Company	Ticker	Market Cap (US\$ bn)	Price (Rs)	Target (Rs)	Rating
Axis Bank	AXSB IN	35.8	957	1,111	BUY
Federal Bank	FB IN	3.3	129	165	BUY
HDFC Bank	HDFCB IN	111.7	1,645	1,956	BUY
ICICI Bank	ICICIB IN	81.6	960	1,015	HOLD
Indusind Bank	IIB IN	13.0	1,377	1,550	BUY
Kotak Mahindra Bank	KMB IN	45.2	1,869	2,122	HOLD
State Bank of India	SBIN IN	63.5	584	729	BUY

Source: BOBCAPS Research, NSE | Price as of 14 Jul 2023

Glossary

Glossary of Abbreviations			
AUCA	Advance Under Collection Account	MTM	Mark to Market
CASA	Current Account and Savings Account	NII	Net Interest Income
CAR	Capital Adequacy Ratio	NIM	Net Interest Margin
CET1	Common Equity Tier 1	NNPA	Net Non-Performing Assets
CD	Credit-Deposit Ratio	PCR	Provision Coverage Ratio
C/I	Cost-Income Ratio	PPOP	Pre-Provision Operating Profit
EBLR	External Benchmark-based Lending Rate	PSU	Public Sector Unit
ECL	Expected Credit Loss	RWA	Risk-weighted Assets
GNPA	Gross Non-Performing Assets	SLR	Statutory Liquidity Ratio
LCR	Liquidity Coverage Ratio	SMA	Special Mention Account
MCLR	Marginal Cost of Funds-based Lending Rate	SME	Small and Medium-sized Enterprises

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23P	FY24E	FY25E
Net interest income	55,337	59,620	72,322	84,473	95,642
NII growth (%)	19.0	7.7	21.3	16.8	13.2
Non-interest income	19,587	20,891	23,310	27,755	32,941
Total income	74,924	80,510	95,632	112,227	128,583
Operating expenses	36,917	42,932	47,678	56,423	64,843
PPOP	38,007	37,579	47,954	55,804	63,740
PPOP growth (%)	18.6	(1.1)	27.6	16.4	14.2
Provisions	16,634	12,218	7,499	11,362	13,268
PBT	21,373	25,361	40,455	44,442	50,473
Tax	5,470	6,463	10,339	11,305	12,921
Reported net profit	15,903	18,898	30,106	33,137	37,552
Adjustments	0	0	0	0	0
Adjusted net profit	15,903	18,898	30,106	33,137	37,552

Balance Sheet

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23P	FY24E	FY25E
Equity capital	3,992	4,205	4,232	4,232	4,232
Reserves & surplus	157,252	183,733	210,830	237,340	267,381
Net worth	161,245	187,938	215,062	241,572	271,613
Deposits	1,726,445	1,817,006	2,133,860	2,441,136	2,807,307
Borrowings	90,685	153,931	193,193	216,376	244,938
Other liab. & provisions	35,299	50,588	61,303	104,473	131,577
Total liab. & equities	2,013,674	2,209,463	2,603,418	3,003,558	3,455,434
Cash & bank balance	195,914	210,103	176,887	190,320	202,590
Investments	371,862	391,795	489,834	560,764	633,783
Advances	1,318,786	1,449,283	1,744,469	2,042,773	2,379,831
Fixed & Other assets	127,112	158,282	192,229	209,701	239,231
Total assets	2,013,674	2,209,463	2,603,418	3,003,558	3,455,434
Deposit growth (%)	13.4	5.2	17.4	14.4	15.0
Advances growth (%)	7.9	9.9	20.4	17.1	16.5

Per Share

Y/E 31 Mar (Rs)	FY21A	FY22A	FY23P	FY24E	FY25E
EPS	8.0	9.2	14.3	15.7	17.7
Dividend per share	0.7	1.8	1.0	3.1	3.5
Book value per share	80.8	89.4	101.6	114.2	128.3

Valuations Ratios

Y/E 31 Mar (x)	FY21A	FY22A	FY23P	FY24E	FY25E
P/E	16.2	14.0	9.1	8.3	7.3
P/BV	1.6	1.4	1.3	1.1	1.0
Dividend yield (%)	0.5	1.4	0.8	2.4	2.7

DuPont Analysis

Y/E 31 Mar (%)	FY21A	FY22A	FY23P	FY24E	FY25E
Net interest income	2.9	2.8	3.0	3.0	3.0
Non-interest income	1.0	1.0	1.0	1.0	1.0
Operating expenses	1.9	2.0	2.0	2.0	2.0
Pre-provisioning profit	2.0	1.8	2.0	2.0	2.0
Provisions	0.9	0.6	0.3	0.4	0.4
PBT	1.1	1.2	1.7	1.6	1.6
Tax	0.3	0.3	0.4	0.4	0.4
ROA	0.8	0.9	1.3	1.2	1.2
Leverage (x)	12.5	12.1	11.9	12.3	12.6
ROE	10.4	10.8	14.9	14.5	14.6

Ratio Analysis

Y/E 31 Mar	FY21A	FY22A	FY23P	FY24E	FY25E
YoY growth (%)					
Net interest income	19.0	7.7	21.3	16.8	13.2
Pre-provisioning profit	18.6	(1.1)	27.6	16.4	14.2
EPS	2.8	15.6	54.8	9.7	13.3
Profitability & Return ratios (%)					
Net interest margin	3.1	3.1	3.3	3.3	3.2
Fees / Avg. assets	0.1	0.2	0.2	0.2	0.2
Cost-Income	49.3	53.3	49.9	50.3	50.4
ROE	10.4	10.8	14.9	14.5	14.6
ROA	0.8	0.9	1.3	1.2	1.2
Asset quality (%)					
GNPA	3.4	2.8	2.3	2.3	2.3
NNPA	1.2	1.0	0.7	0.7	0.7
Slippage ratio	1.6	1.4	1.2	1.3	1.4
Credit cost	1.3	0.9	0.5	0.6	0.6
Provision coverage	64.7	65.4	70.4	70.3	70.3
Ratios (%)					
Credit-Deposit	76.4	79.8	81.8	83.7	84.8
Investment-Deposit	21.5	21.6	23.0	23.0	22.6
CAR	14.6	15.8	14.8	13.8	13.5
Tier-1	13.9	14.4	13.0	12.5	12.2

Source: Company, BOBCAPS Research

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Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

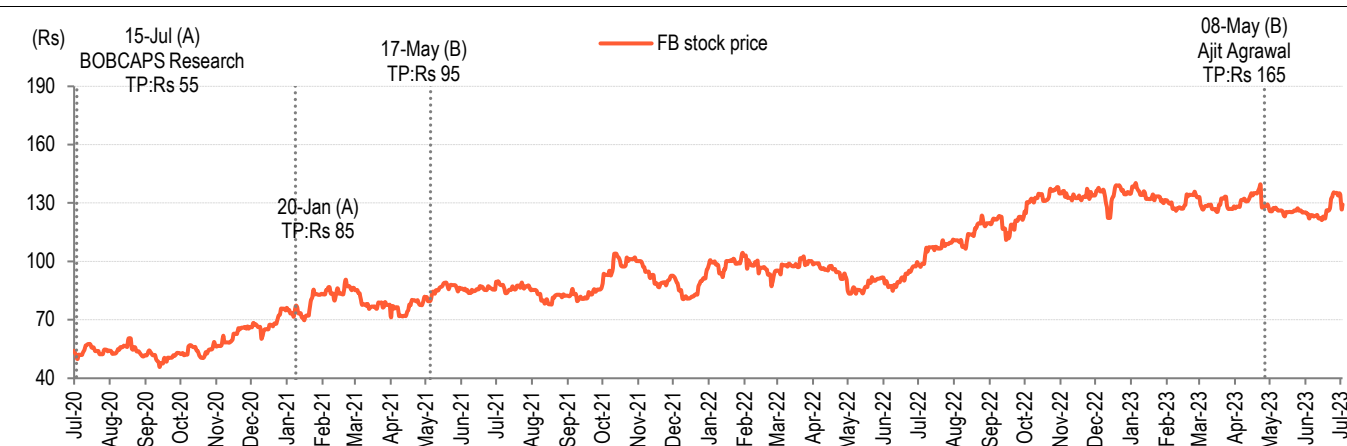
HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Ratings and Target Price (3-year history): FEDERAL BANK (FB IN)



B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

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