

BUY

TP: Rs 180 | ▲ 23%

FEDERAL BANK

| Banking

| 19 October 2023

Strong growth with improving returns

- Continued healthy business momentum in Q2, with reported PAT rising 35% YoY on lower provisions
- NIM flat with guidance of 3.25% for FY24 vs. 3.3% earlier; sharp improvement in credit cost (calc.) to 9bps vs. 68bps in Q2FY23
- FY24/FY25 PAT estimates raised 10%/3% for a new TP of Rs 180 (vs. Rs 165), set at 1.4x FY25E ABV (vs. 1.3x); retain BUY

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Strong business growth: FB's deposit growth (23.1%/4.7% YoY/QoQ) outpaced its loan growth (19.6%/5.1%) led by an increase in term deposits, causing a 67bps QoQ decline in CASA ratio to 31.2%. Loan growth was backed by a healthy rise in retail (+6% QoQ), commercial (+7%) and agri (+8%) business. Further, CV/CE and MFI fared well, growing 11% and 27% QoQ respectively, although on a lower base. Management reiterated its loan and deposit growth guidance of 18-20% for FY24. We raise our respective estimates by 1.5%/2.1% and 2.4%/4% for FY24/FY25.

NIM dips QoQ: Despite upward deposit repricing, FB's NII grew 7.2% QoQ (16.7% YoY) and reported NIM improved 1bps to 3.16%. Management has lowered its NIM guidance for FY24 to 3.25% from 3.3% to bake in a likely increase in deposit cost by 18-20bps. Other income was healthy at Rs 7.3bn and the bank expects the same run-rate going ahead. The C/I ratio climbed to 52.5% in Q2 vs. 50.9% in Q1, and FB expects operational cost to remain elevated as it has decided to front-load investments toward network expansion and branding to leverage volumes.

Slippages up QoQ but asset quality stable: Slippages were under control at Rs 3.6bn (81bps) vs. Rs 5bn (115bps) in Q1. As a result, GNPA/NNPA improved to 2.3%/0.6% from 2.4%/0.7% in Q1 with a PCR of 72.3%. Credit cost dropped to one of the lowest levels in the sector at 9bps vs. 35bps in Q1 and 68bps in Q2FY23, resulting in above-estimated PAT growth of 12% QoQ (35% YoY). Considering the Q2 print and credit cost guidance of ~40bps for FY24, we revise our FY24/FY25 estimates to 36bps/49bps from 60bps and raise our PAT forecast by 10%/3%.

Maintain BUY: FB's conservative approach towards asset quality versus asset pricing over the past year is paying off. At current valuations of 1.1x FY25E P/ABV, the bank is one of the cheapest among large-cap peers due to its relatively low return ratios. We expect strong growth with stable margins and a focus on risk-adjusted returns to raise ROE/ROA to 15%/1.2% by FY25, gradually narrowing the gap with peers. Alongside upward estimate revision, we now value the stock at 1.4x FY25E ABV (vs. 1.3x) based on the Gordon Growth Model for a revised TP of Rs 180 (vs. Rs 165). BUY.

Key changes

Target	Rating
▲	◀ ▶

Ticker/Price	FB IN/Rs 147
Market cap	US\$ 3.8bn
Free float	100%
3M ADV	US\$ 26.9mn
52wk high/low	Rs 153/Rs 121
Promoter/FPI/DII	0%/29%/44%

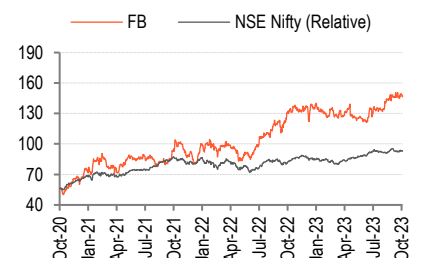
Source: NSE | Price as of 19 Oct 2023

Key financials

Y/E 31 Mar	FY23A	FY24E	FY25E
Net interest income	72,322	84,940	96,809
NII growth (%)	21.3	17.4	14.0
Adj. net profit (Rs mn)	30,106	36,413	38,597
EPS (Rs)	14.3	17.2	18.2
Consensus EPS (Rs)	14.3	16.0	18.5
P/E (x)	10.3	8.5	8.1
P/BV (x)	1.4	1.3	1.1
ROA (%)	1.3	1.3	1.2
ROE (%)	14.9	15.9	14.9

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE



Fig 1 – Quarterly snapshot: Income statement

(Rs mn)	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24	YoY (%)	QoQ (%)
Income Statement							
Interest Income	32,227	35,849	37,974	40,396	43,555	35.1	7.8
Income on investments	6,674	7,207	7,780	8,149	8,940	34.0	9.7
Int. on bal. with RBI & inter-bank funds & Others	1,307	1,277	1,453	1,701	2,058	57.5	21.0
Interest income	40,208	44,333	47,207	50,245	54,553	35.7	8.6
Interest expense	22,590	24,767	28,115	31,059	33,989	50.5	9.4
Net interest income	17,618	19,565	19,093	19,186	20,564	16.7	7.2
Growth YoY (%)	19.1	27.1	25.2	19.6	16.7	(237bps)	(285bps)
Non-interest income	6,095	5,340	7,339	7,324	7,304	19.8	(0.3)
Growth YoY (%)	37.2	10.3	57.8	61.8	19.8	(1,733bps)	(4,198bps)
Total income	23,714	24,905	26,432	26,510	27,868	17.5	5.1
Growth YoY (%)	23.3	23.1	32.8	28.9	17.5	(5,74bps)	(1,135bps)
Staff expenses	5,156	5,608	5,972	6,167	6,263	21.5	1.6
Other operating expenses	6,435	6,555	7,114	7,319	8,361	29.9	14.2
Operating expenses	11,591	12,163	13,086	13,487	14,624	26.2	8.4
Pre-Provisioning Profit (PPoP)	12,122	12,742	13,346	13,024	13,245	9.26	1.7
Growth YoY (%)	40.2	39.4	67.2	33.8	9.3	(3,092bps)	(2,454bps)
Provisions	2,679	1,987	1,167	1,556	439	(83.6)	(71.8)
PBT	9,444	10,755	12,179	11,468	12,806	35.6	11.7
Tax	2,407	2,719	3,153	2,930	3,267	35.8	11.5
PAT	7,037	8,036	9,026	8,537	9,538	35.5	11.7
Growth YoY (%)	52.9	54.0	67.0	42.1	35.5	(1735bps)	(659bps)
Per Share							
FV (Rs)	2.0	2.0	2.0	2.0	2.0	0.0	0.0
EPS (Rs)	3.3	3.8	4.3	4.0	4.2	24.9	3.5
Book Value (Rs)	93	97	101	105	111	19.0	5.4

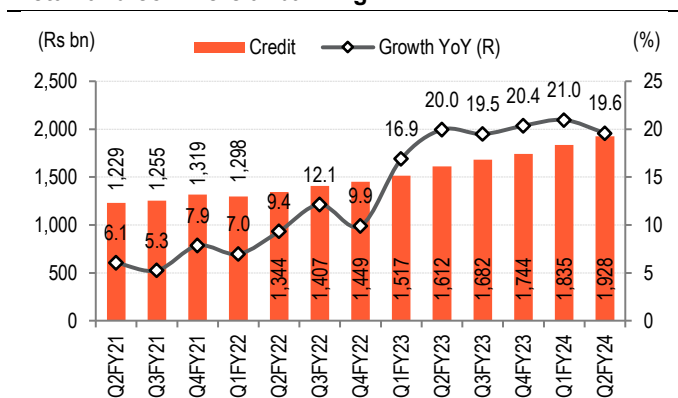
Source: BOBCAPS Research, Company

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

(Rs mn)	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24	YoY (%)	QoQ (%)
Deposits	1,891,457	2,014,080	2,133,860	2,224,960	2,328,684	23.1	4.7
Growth YoY (%)	10.0	14.8	17.4	21.3	23.1	1,314bps	177bps
Advances	1,612,403	1,681,730	1,744,469	1,834,870	1,928,167	19.6	5.1
Growth YoY (%)	20.0	19.5	20.4	21.0	19.6	(38bps)	(138bps)
Investment	435,713	462,650	489,834	519,420	551,691	26.6	6.2
Equity	201,707	210,110	219,295	228,000	265,892	31.8	16.6
Assets	2,371,124	2,504,720	2,603,418	2,741,960	2,874,260	21.2	4.8
Growth YoY (%)	14.6	19.9	17.8	21.7	21.2	660bps	(46bps)
Yield (%)							
Yield on Funds	7.50	7.84	7.98	8.11	8.35	85bps	24bps
Cost of Funds	4.42	4.60	4.96	5.22	5.49	106bps	27bps
Spread	3.08	3.24	3.02	2.89	2.86	(22bps)	(3bps)
Net Interest Margin	3.29	3.46	3.23	3.10	3.15	(14bps)	5bps
Ratios (%)							
Other Income / Net Income	25.7	21.4	27.8	27.6	26.2	51bps	(142bps)
Cost to Income ratio	48.9	48.8	49.5	50.9	52.5	360bps	160bps
CASA ratio	36.4	34.2	32.7	31.8	31.2	(524bps)	(67bps)
C/D ratio	85.2	83.5	81.8	82.5	82.8	(245bps)	33bps
Investment to Assets	18.4	18.5	18.8	18.9	19.2	82bps	25bps
Assets Quality							
GNPA	40,311	41,479	41,838	44,348	44,361	10.0	0.03
NNPA	12,624	12,286	12,050	12,746	12,298	(2.6)	(3.5)
Provision	27,687	29,193	29,788	31,602	32,062	15.8	1.5
GNPA (%)	2.46	2.43	2.36	2.38	2.26	(20bps)	(12bps)
NNPA (%)	0.78	0.73	0.69	0.69	0.64	(14bps)	(5bps)
Provision (%)	68.7	70.4	71.2	71.3	72.3	359bps	102bps
Slippages (%)	1.0	1.0	1.1	1.1	0.8	(22bps)	(34bps)

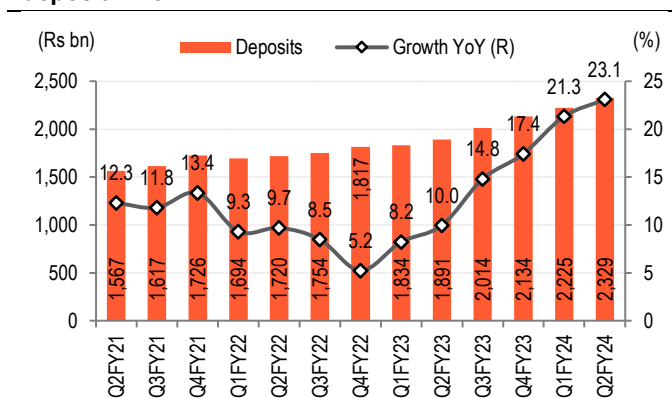
Source: Company, BOBCAPS Research

Fig 3 – Credit grew 20% YoY in Q2FY24 driven by both retail and commercial banking



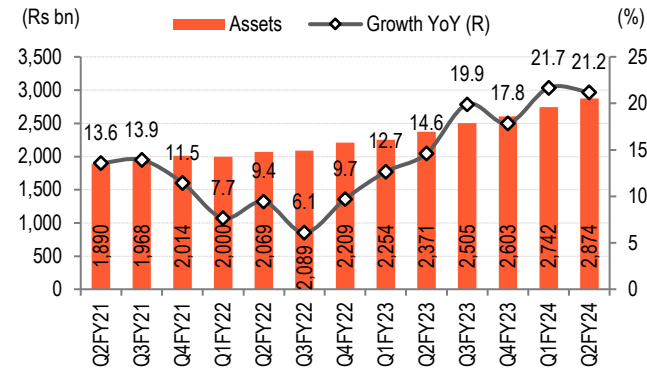
Source: Company, BOBCAPS Research

Fig 4 – Deposits rose 23% YoY on the back of term deposit inflow



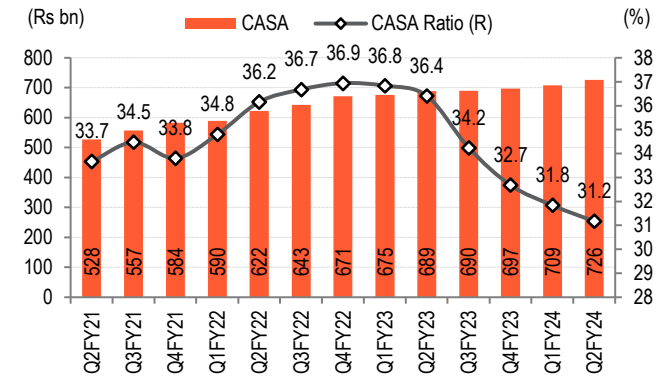
Source: Company, BOBCAPS Research

Fig 5 – Assets grew 21% YoY



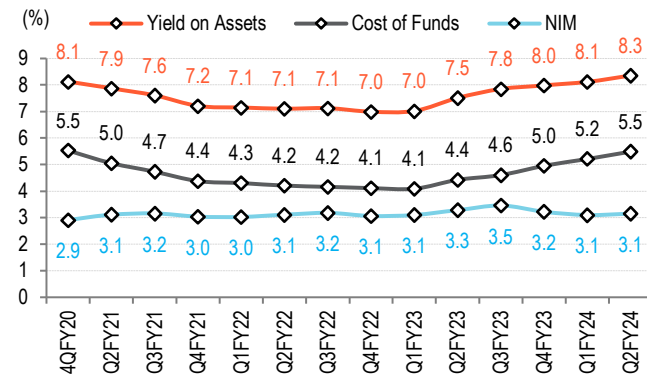
Source: Company, BOBCAPS Research

Fig 6 – CASA declined due to subdued SA mobilisation



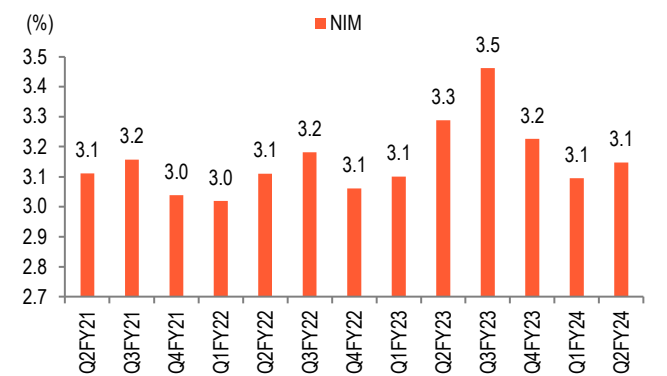
Source: Company, BOBCAPS Research

Fig 7 – NIM (calc.) remained flat despite higher cost of funds



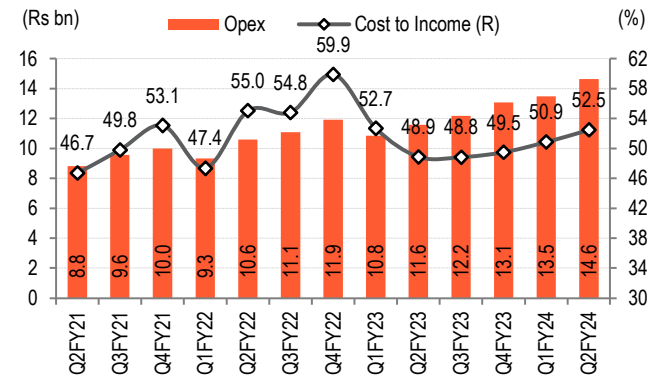
Source: Company, BOBCAPS Research

Fig 8 – NIM guidance revised to 3.25% vs 3.3% for FY24



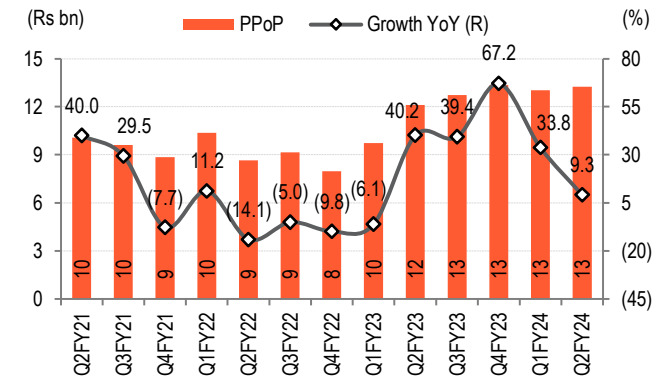
Source: Company, BOBCAPS Research

Fig 9 – C/I ratio likely to remain elevated at 52%



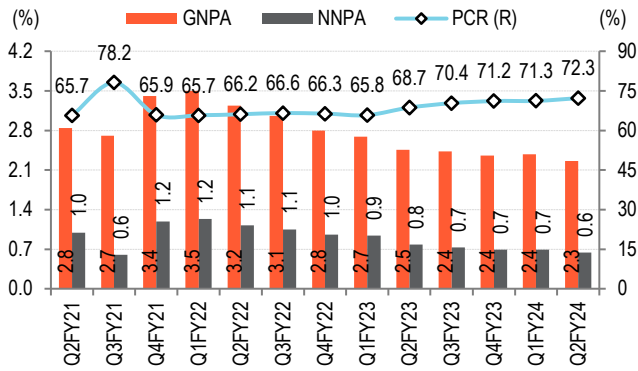
Source: Company, BOBCAPS Research

Fig 10 – Higher other income led to healthy PPOp



Source: Company, BOBCAPS Research

Fig 11 – Stable asset quality and PCR



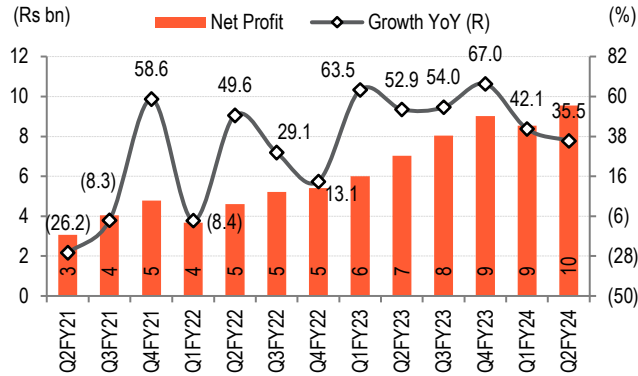
Source: Company, BOBCAPS Research

Fig 12 – Sustained low credit cost aided profit



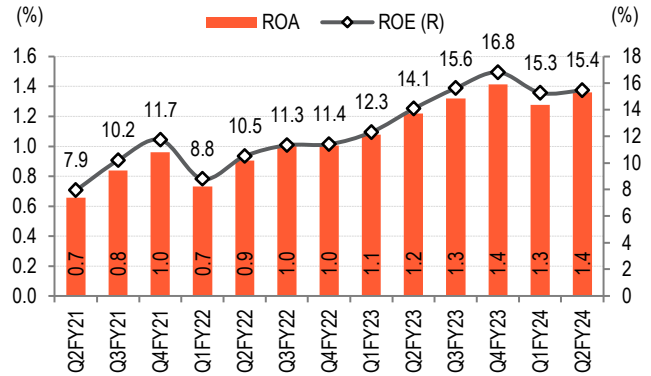
Source: Company, BOBCAPS Research

Fig 13 – Higher other income and lower provisions led to 35.5% YoY PAT growth



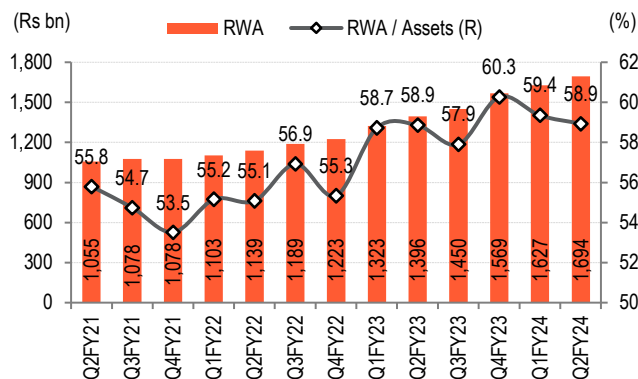
Source: Company, BOBCAPS Research

Fig 14 – Return ratios expected to improve



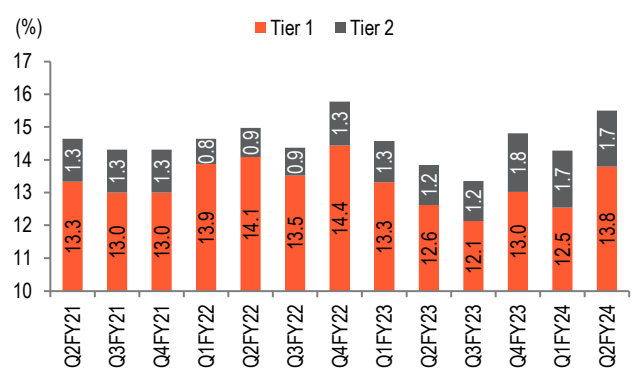
Source: Company, BOBCAPS Research

Fig 15 – RWA continues to improve with better lending quality



Source: Company, BOBCAPS Research

Fig 16 – CAR increased 122bps QoQ



Source: Company, BOBCAPS Research

Earnings call highlights

Guidance

- FB is confident of maintaining growth momentum and reiterated its guidance of an 18-20% YoY rise in both loans and deposits for FY24.
- Management lowered FY24 NIM guidance to 3.25% from 3.3%.
- Bank continued with its credit cost guidance for FY24 at 40bps.
- ROA is guided at 1.4% for FY25.
- The bank aims to achieve a C/I ratio of ~50% by FY25, which is likely to remain elevated due to ROA expansion.
- FB plans to add 100 branches during FY24.

Asset quality

- Slippages during Q2FY24 remained low at Rs 3.6bn vs. Rs 5bn in Q1FY24, while upgrades and recoveries stood at Rs 3.6bn.
- GNPA and NNPA stood at 2.3% and 0.6% respectively with PCR at 72.3% (vs. 71.3% in Q1).
- FB's SMA book is at its lowest and the bank is focusing on A-rated customers for lending.

Loans and Deposits

- Management expects broad-based loan growth across segments and indicated that its strategy of targeting growth in high-yielding newly launched businesses is working well.
- The loan book mix by benchmark is as follows: EBLR-linked 51%, fixed 26%, MCLR 13%, forex-linked 3%, IBPC 1% and staff loan 1.5%.
- Deposits jumped 23.1% YoY in Q2 led by term deposits (up 33.3% vs. CASA growth of 5.4%). Management indicated structural changes in deposit mobilisation towards term deposits due to rate repricing (as non-resident business shifted towards consumption).
- Current accounts grew 20.2% YoY (10.8% QoQ) while savings accounts were up 1.9% YoY (0.4% QoQ). As result, CASA declined to 31.2% from 31.8% in Q1FY24.
- NRE term deposits, where the bank has 8.4% market share, grew 10.1% YoY.
- FB is not a significant player in the NRO and FCNR segments but is working on expanding its presence.
- LCR for the quarter stood at 121%.

NII and NIM

- NII growth was healthy at 7.2% QoQ driven by higher yielding asset paying off (+16.7% YoY) despite higher interest expenses as deposit cost went up. FB expects growth in NII and variable expenses to remain at these levels.
- In line with management expectation, yield on advances inched up to 9.3% in Q2FY24 vs. 9.2% in Q1FY24. FB expects a further rise of 18-20bps in cost of deposits.
- Other income was flat sequentially at Rs 7.3bn, and the bank expects the same run-rate for upcoming quarters.
- Opex grew due to volume-related expenses and marketing spends. Further, FB made a conscious choice to front-load some investments and variable costs to garner more business.

Valuation methodology

Considering FB's strong growth momentum in Q2FY24, we raise our FY24/FY25 loan estimates by 1.5%/2.1% and deposit estimates by 2.4%/4%. NIM is projected to hover in the range of 3.2-3.3%, in line with management guidance. We now factor in a CASA ratio of 33% considering the structural change in deposit mix in a high-rate environment.

In terms of operating expenses, FB is continuing with its branch expansion target of 100 branches per year (73 in FY23) while expecting to frontload network and brand investments, which is likely to keep operating cost elevated. Further, the bank estimates additional variable cost toward new business acquisition. Accordingly, we raise our FY24/FY25 C/I ratio forecast by 75bps/168bps to 51%/52% and bake in a slight reduction in PPOP growth to 16%/13% (on a higher base).

We believe FB's focus on risk-adjusted margins coupled with controlled slippages and higher recoveries will support stable asset quality and continue to bake in GNPA/NNPA/PCR of 2.1%/0.6%/73% over FY25. As against the 40bps credit cost guidance, we estimate 36bps/49bps for FY24/FY25 considering the growing unsecured book. FB's CAR improved to 15.5% from 14.3% in Q1FY24 wherein tier-1 was at 13.8% – at the lower end when compared to peers which could pose a challenge to growth.

The bank's conservative approach towards asset quality versus asset pricing over the past year is paying off. Also, a focus on other income should boost profits. At current valuations of 1.1x FY25E P/ABV, FB is one of the cheapest stocks among large-cap peers due to its relatively low return ratios. We expect strong growth with stable margins and a focus on risk-adjusted returns to raise ROE/ROA to 15%/1.2% by FY25, gradually narrowing the gap with peers. We now value the stock at 1.4x FY25E ABV (vs. 1.3x) based on the Gordon Growth Model for a revised TP of Rs 180 (vs. Rs 165). Retain BUY.

Fig 17 – Revised estimates

(Rs mn)	New		Old		Change (%)	
	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E
Loan	2,074,173	2,430,931	2,042,773	2,379,831	1.5	2.1
Deposits	2,498,751	2,918,541	2,441,136	2,807,307	2.4	4.0
Assets	3,045,405	3,535,652	3,003,558	3,455,434	1.4	2.3
NII	84,940	96,809	84,473	95,642	0.6	1.2
PPOP	55,710	62,915	55,804	63,740	(0.2)	(1.3)
Provision	6,874	11,038	11,362	13,268	(39.5)	(16.8)
PAT	36,413	38,597	33,137	37,552	9.9	2.8

Source: BOBCAPS Research

Fig 18 – Key operational assumptions

(%)	FY23A	FY24E	FY25E	FY26E
Advances growth	20.4	18.9	17.2	16.5
NII growth	21.3	17.4	14.0	17.6
PPoP growth	27.6	16.2	12.9	19.3
PAT growth	59.3	21.0	6.0	17.3
NIM	3.3	3.3	3.2	3.2
GNPA	2.3	1.9	1.8	1.8
CAR	14.8	13.8	13.3	12.9

Source: Company, BOBCAPS Research

Fig 19 – Valuation assumptions (Gordon Growth Model)

Parameter	Assumptions
Cost of equity (%)	12.8
Blended ROE (%)	14.3
Initial high growth period (yrs)	10.0
Payout ratio of high-growth phase (%)	20.0
Long-term growth (%)	6
Long term dividend payout ratio (%)	60
Justified P/BV Multiple (x)	1.4

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	37.1	991	1,155	BUY
DCB Bank	DCBB IN	0.5	121	144	BUY
Federal Bank	FB IN	3.8	147	180	BUY
HDFC Bank	HDFCB IN	139.0	1,515	1,929	BUY
ICICI Bank	ICICIB IN	79.5	936	1,015	HOLD
Indusind Bank	IIB IN	13.7	1,450	1,755	BUY
Kotak Mahindra Bank	KMB IN	42.0	1,738	2,122	HOLD
RBL Bank	RBK IN	1.8	246	233	HOLD
State Bank of India	SBIN IN	62.0	571	729	BUY

Source: BOBCAPS Research, NSE | Price as of 19 Oct 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	NRE	Non-Resident (External) Account
C/I	Cost-Income Ratio	NRO	Non-Resident Ordinary Account
CV/CE	Commercial Vehicle/Construction Equipment	PCR	Provision Coverage Ratio
EBLR	External Benchmark-based Lending Rate	PPOP	Pre-Provision Operating Profit
ECL	Expected Credit Loss	PSU	Public Sector Unit
FCNR	Foreign Currency Non-Resident Account	RWA	Risk-weighted Assets
GNPA	Gross Non-Performing Assets	SA	Savings Account
LCR	Liquidity Coverage Ratio	SLR	Statutory Liquidity Ratio
MCLR	Marginal Cost of Funds-based Lending Rate	SMA	Special Mention Account
MFI	Microfinance Institution	SME	Small and Medium-sized Enterprises

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY22A	FY23A	FY24E	FY25E	FY26E
Net interest income	59,620	72,322	84,940	96,809	113,868
NilI growth (%)	7.7	21.3	17.4	14.0	17.6
Non-interest income	20,891	23,310	28,809	34,551	41,333
Total income	80,510	95,632	113,749	131,360	155,201
Operating expenses	42,932	47,678	58,039	68,445	80,158
PPOP	37,579	47,954	55,710	62,915	75,043
PPOP growth (%)	(1.1)	27.6	16.2	12.9	19.3
Provisions	12,218	7,499	6,874	11,038	14,210
PBT	25,361	40,455	48,836	51,878	60,833
Tax	6,463	10,339	12,423	13,281	15,573
Reported net profit	18,898	30,106	36,413	38,597	45,260
Adjustments	0	0	0	0	0
Adjusted net profit	18,898	30,106	36,413	38,597	45,260

Balance Sheet

Y/E 31 Mar (Rs mn)	FY22A	FY23A	FY24E	FY25E	FY26E
Equity capital	4,205	4,232	4,232	4,232	4,232
Reserves & surplus	183,733	210,830	239,961	270,838	307,046
Net worth	187,938	215,062	244,193	275,071	311,279
Deposits	1,817,006	2,133,860	2,498,751	2,918,541	3,400,100
Borrowings	153,931	193,193	214,637	240,394	269,241
Other liab. & provisions	50,588	61,303	87,824	101,647	138,037
Total liab. & equities	2,209,463	2,603,418	3,045,405	3,535,652	4,118,656
Cash & bank balance	210,103	176,887	192,717	209,107	243,900
Investments	391,795	489,833	567,050	651,828	757,939
Advances	1,449,283	1,744,469	2,074,173	2,430,931	2,832,035
Fixed & Other assets	158,282	192,229	211,465	243,786	284,783
Total assets	2,209,463	2,603,418	3,045,405	3,535,652	4,118,656
Deposit growth (%)	5.2	17.4	17.1	16.8	16.5
Advances growth (%)	9.9	20.4	18.9	17.2	16.5

Per Share

Y/E 31 Mar (Rs)	FY22A	FY23A	FY24E	FY25E	FY26E
EPS	9.2	14.3	17.2	18.2	21.4
Dividend per share	1.8	2.8	3.4	3.6	4.3
Book value per share	89.4	101.6	115.4	130.0	147.1

Valuations Ratios

Y/E 31 Mar (x)	FY22A	FY23A	FY24E	FY25E	FY26E
P/E	15.9	10.3	8.5	8.1	6.9
P/BV	1.6	1.4	1.3	1.1	1.0
Dividend yield (%)	1.3	1.9	2.3	2.5	2.9

DuPont Analysis

Y/E 31 Mar (%)	FY22A	FY23A	FY24E	FY25E	FY26E
Net interest income	2.8	3.0	3.0	2.9	3.0
Non-interest income	1.0	1.0	1.0	1.1	1.1
Operating expenses	2.0	2.0	2.1	2.1	2.1
Pre-provisioning profit	1.8	2.0	2.0	1.9	2.0
Provisions	0.6	0.3	0.2	0.3	0.4
PBT	1.2	1.7	1.7	1.6	1.6
Tax	0.3	0.4	0.4	0.4	0.4
ROA	0.9	1.3	1.3	1.2	1.2
Leverage (x)	12.1	11.9	12.3	12.7	13.1
ROE	10.8	14.9	15.9	14.9	15.4

Ratio Analysis

Y/E 31 Mar	FY22A	FY23A	FY24E	FY25E	FY26E
YoY growth (%)					
Net interest income	7.7	21.3	17.4	14.0	17.6
Pre-provisioning profit	(1.1)	27.6	16.2	12.9	19.3
EPS	15.6	54.8	20.6	6.0	17.3
Profitability & Return ratios (%)					
Net interest margin	3.1	3.3	3.3	3.2	3.2
Fees / Avg. assets	0.2	0.2	0.2	0.2	0.2
Cost-Income	53.3	49.9	51.0	52.1	51.6
ROE	10.8	14.9	15.9	14.9	15.4
ROA	0.9	1.3	1.3	1.2	1.2
Asset quality (%)					
GNPA	2.8	2.3	2.1	2.0	1.9
NNPA	1.0	0.7	0.6	0.6	0.5
Slippage ratio	1.4	1.2	1.2	1.2	1.2
Credit cost	0.9	0.5	0.4	0.5	0.5
Provision coverage	65.4	70.5	71.9	71.9	71.5
Ratios (%)					
Credit-Deposit	79.8	81.8	83.0	83.3	83.3
Investment-Deposit	21.6	23.0	22.7	22.3	22.3
CAR	15.8	14.8	13.8	13.3	12.9
Tier-1	14.4	13.0	12.5	12.1	11.8

Source: Company, BOBCAPS Research

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BUY – Expected return >+15%

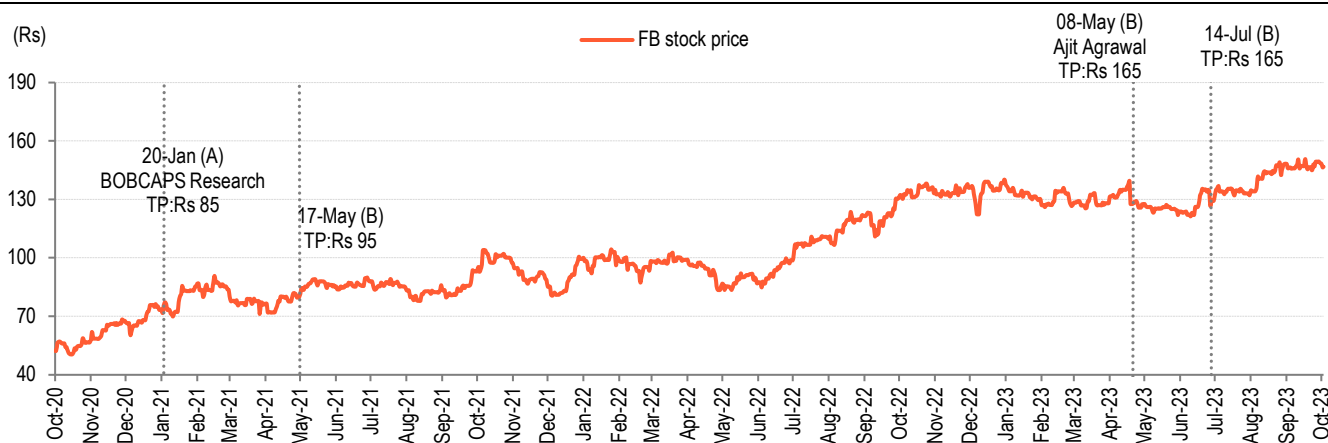
HOLD – Expected return from -6% to +15%

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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