# Federal Bank Ltd.

# EQUITY REPORT

**December 24th, 2014**

| **BSE Code:** | **500469** | **NSE Code:** | **FEDERALBNK** | **Reuters Code:** | **FED.NS** | **Bloomberg Code:** | **FB:IN** |
|---|---|---|---|---|---|---|---|

**Federal Bank Ltd (erstwhile Travancore Federal Bank Limited) was incorporated with an authorised capital of ₹5,000 in 1931 under the Travancore Companies Act. In 1947, the name of the bank was changed to Federal Bank. Currently, the lender is a major Indian commercial bank in the private sector headquartered at Aluva, Kerala having more than thousand branches and ATMs spread across different States in India. It is the fourth largest bank in India in terms of capital base. The bank operates in four segments: treasury operations, wholesale banking, retail banking, and other banking operations. Bank's products and services include working capital, term finance, trade finance, specialized corporate finance products and structured finance.**

## Investment Rationale

**Improved Q2FY15 performance -** During Q2FY15, the bank delivered improved performance with higher other income growth coupled with stable NIM and better asset quality. Revival in advances growth across segment as well as better traction in newer geographies provides better growth visibility. For FY15E, the bank expects credit growth of 20%. We believe that the bank's improving business mix, better cost efficiency coupled with higher focus on core-fee income generation to result in better return ratios going forward.

**Asset quality risk continues to remain at healthy level -** Federal Bank has continued to show consistent improvement on asset quality front, with gross and net NPA declining from past five quarters. During Q2FY15, both gross and net NPAs declined by 12 and 2 bps QoQ to 2.1% and 0.66% respectively. Surprise came with ₹0.07 billion decline in fresh impairments on QoQ basis coupled with improvement in provision coverage ratio, which remained strong at 85%. We expect that the bank's improved back-end processes and risk management systems will continue to reduce asset quality woes on lower slippages and better recoveries.

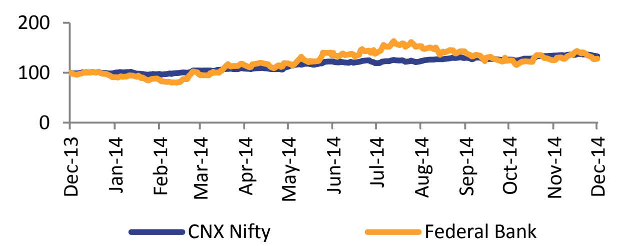
**Low cost deposit and focus on branch expansion to drive CASA growth -** The bank's continued focus to enlarge its distribution network by widening its geographic reach is likely to boost its low-cost CASA deposit base, thereby providing a much needed boost to the bank's NIM. The bank added 11 branches during Q2FY15 taking the total strength to 1,214 domestic branches and extension counters. The bank's management is focusing on better efficiency of its existing branches to improve its CASA accretion instead of aggressive branch expansion, which will keep Cost/income (C/I) at ~46-48% in FY15-16E. Thus, we expect that the bank's focus on branch efficiency will yield results, leading to significant gains in CASA share.

| Market Data | |
|---|---|
| **Rating** | **BUY** |
| **CMP (₹)** | 147 |
| **Target (₹)** | **175** |
| **Potential Upside** | 19% |
| **Duration** | Long Term |
| Face Value (₹) | 2.0 |
| 52 week H/L (₹) | 152.9/72.5 |
| Adj. all time High (₹) | 153 |
| Decline from 52WH (%) | 3.9 |
| Rise from 52WL (%) | 102.8 |
| Beta | 2.1 |
| Mkt. Cap (₹bn) | 125.7 |
| Book value (₹bn) | 69.5 |

**Fiscal Year Ended**

| Y/E | FY13A | FY14A | FY15E | FY16E |
|---|---|---|---|---|
| NII (₹bn) | 19.7 | 22.3 | 25.7 | 31.5 |
| Net Profit (₹bn) | 8.4 | 8.4 | 9.6 | 11.9 |
| Share Capital (₹bn) | 1.7 | 1.7 | 1.7 | 1.7 |
| EPS (₹) | 9.8 | 9.8 | 11.2 | 14.0 |
| P/E (x) | 15.0 | 15.0 | 13.1 | 10.5 |
| P/BV (x) | 2.0 | 1.8 | 1.6 | 1.4 |
| ROA (%) | 1.3 | 1.2 | 1.2 | 1.3 |
| ROE (%) | 13.9 | 12.6 | 12.8 | 13.9 |

**One year Price Chart**




| Shareholding Pattern | Sep'14 | Jun'14 | Diff. |
|---|---|---|---|
| Promoters | - | - | - |
| FII | 37.6 | 38.8 | (1.2) |
| DII | 27.1 | 25.5 | 1.6 |
| Others | 35.3 | 35.7 | (0.4) |

## Federal Bank - the country's mid-size private sector lender

*The bank operates primarily in four segments: treasury operations, wholesale banking, retail banking, and other banking operations.*

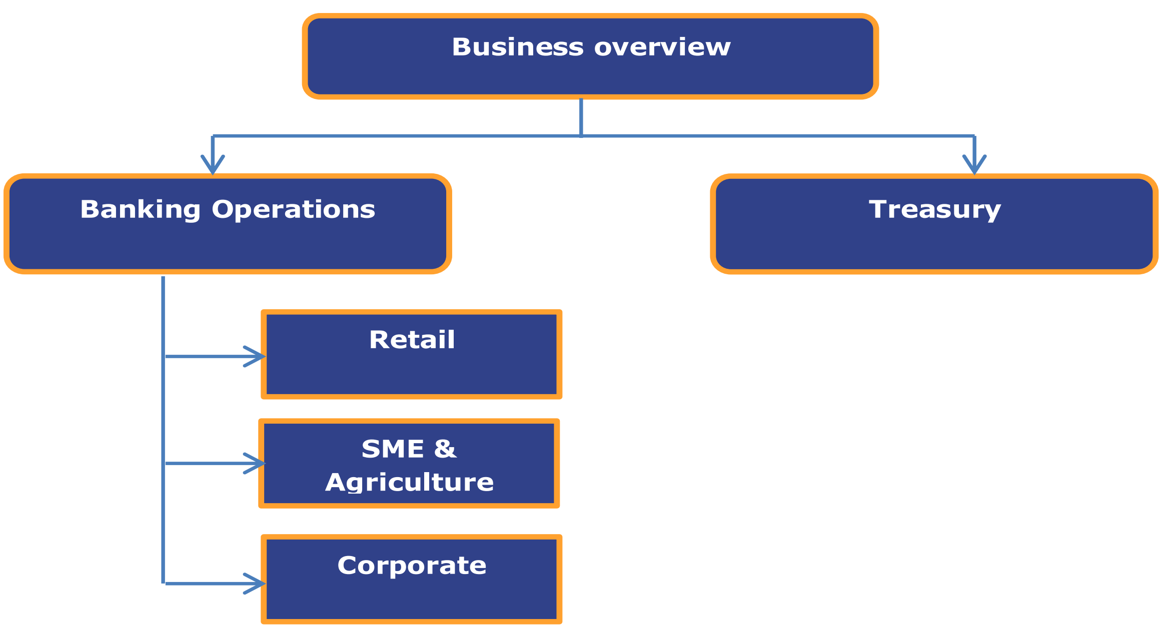
Federal Bank is a major Indian commercial bank in the private sector headquartered at Aluva, Kerala having more than thousand branches and ATMs spread across different states in India. Federal bank is the fourth largest bank in India in terms of capital base and can easily boast of a Capital Adequacy Ratio of 15.14 %, one of the highest in the industry, engaged in the banking business. The bank operates primarily in four segments: treasury operations, wholesale banking, retail banking, and other banking operations. Bank's products and services include working capital, term finance, trade finance, specialized corporate finance products, structured finance, foreign exchange, syndication services, and electronic banking requirements.

In challenging economic conditions, the bank registered a sustained growth during FY14. Total Income grew by 11.83% from ₹68.32 bn to ₹76.40 bn, while operating profit of the bank grew from ₹14.55 bn to ₹14.80 bn. The bank also showed significant improvement in the asset quality during the year. On a YoY basis, the gross NPA of the bank came down from ₹15.54 bn to ₹10.87 bn, while net NPA reduced from ₹4.32 bn to ₹3.22 bn, a decrease from 0.98% to 0.74%.

*Bank's products and services include working capital, term finance, trade finance, specialized corporate finance products, structured finance, foreign exchange, syndication services, and electronic banking requirements.*

Inflation remained the key determinant for calibrating monetary and fiscal policies, including setting of policy interest rates. Headline consumer price index (CPI) inflation is likely to meet the RBI glide path to 8% by January 2015. A consolidation of the fiscal environment might provide additional space for modest monetary policy stimulus. Interest rates across the yield curve are likely to move down from current levels. It is expected that both the gradual expected downward shift in inflation and moderating fiscal stress might allow RBI to ease its tight monetary policy stance later in the year. Thus, we believe that financial savings are likely to improve with economic recovery and moderating inflation. This will push up bank deposits in FY15E. We expect deposit growth in the range of 14-15% and credit growth of 20% in FY15E. Despite a challenging environment facing the Indian banking sector and slowdown in the economy, the bank has maintained consistent performance in FY14, which is reflected in the steady growth of its customer base, widening reach through multiple channels, healthy revenue growth, and stable asset quality.

## Business Overview



## Showcased improved performance in Q2FY15

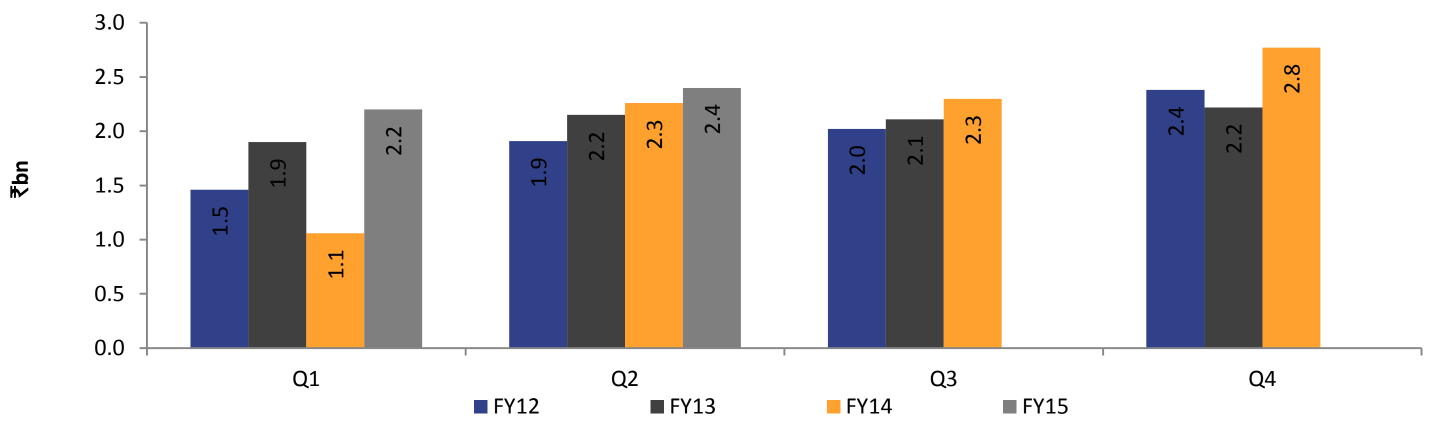
*Federal bank's Q2FY15 performance was in line with expectations which were largely from better NII and non-interest income.*

Continuing its consistent performance over the last few quarters, the bank registered steady growth in business volume and operating metrics apart from further strengthening its asset quality in Q2FY15. On standalone basis, Federal Bank has reported a 6.4% YoY rise in net profit to ₹2.4 bn in the July-September quarter as compare to ₹2.3 bn in the same quarter of the previous financial year, helped by higher net interest income and other income. However, the growth in profit was limited on YoY basis mainly due to higher provisions which were up by 50% to ₹1.69 bn in Q2FY15 as compared to ₹1.13 bn in Q2FY14.

The net interest income (NII) of the bank during Q2FY15 increased 10% to ₹6.1 bn from ₹5.5 bn in Q2FY14 driven by healthy credit growth of 20% YoY & strong margins of 3.93%. Operating expenditure of the bank grew by 6% QoQ and 16% YoY as compared to balance-sheet growth of 3% QoQ and 10% YoY. This has led to cost to average assets remaining high at 2%. However, with controlled branch expansion and improvement in balance-sheet growth we expect operating leverage to accrue.

Non-interest income of the bank grew 36.6% YoY and 25.1% QoQ to ₹1.96 bn, led by a strong growth in the treasury income (₹0.42 bn vs ₹0.07 bn in Q2FY14). The foreign exchange (forex) income increased by 14.3% YoY to ₹0.35 bn while the fee income grew by 14% YoY to ₹1.36 bn. Going ahead, the management of the bank expects fee income growth to outpace loan growth by 2-3%, which in turn would drive an improvement in the return on asset (RoA).

**Net profit growth remained consistent over the years**




## Healthy returns to withstand current growth

*Higher composition of low cost CASA deposit provided certain stability to the bank's funding patterns, making it less vulnerable to the volatility in interest rates.*

Federal Bank has generated consistently superior shareholding returns with Return on Assets (RoA) growing more than 1.1% and Return on Equity (RoE) more than 12% in H1FY15. Higher composition of low cost CASA deposit provided certain stability to the bank's funding patterns, making it less vulnerable to the volatility in interest rates.

This in turn has helped the lender to excel the profitability parameters and report higher return ratios. Thus, with significant improvement in return ratio on the back of healthy profitability growth, we expect the bank's RoE and RoA to surge to ~14% and ~1.3%, respectively in FY16E.

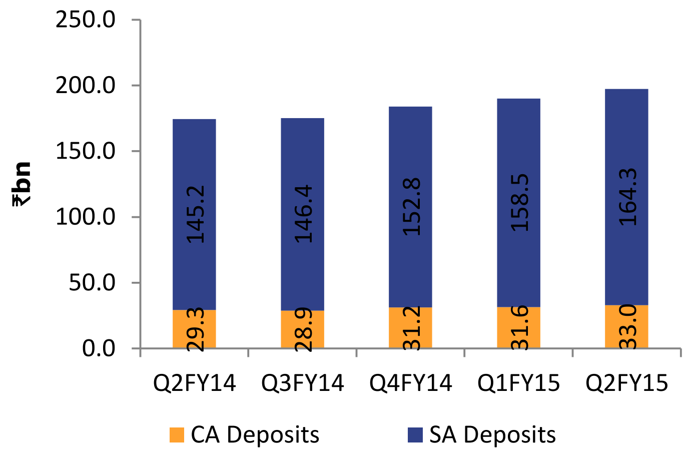
## Increasing retail deposit base to drive CASA growth

*We expect deposits to grow by ~15% over FY15-16E. Also, likely improvements in the macroeconomic environment could improve CASA traction.*

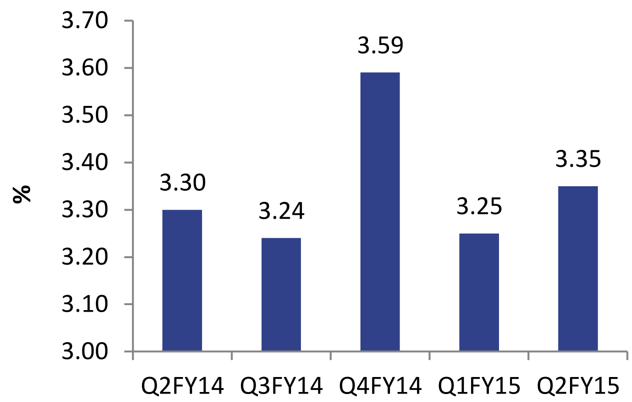
Backed by a strong 26.46% growth in NRE deposits and an 18% growth in Resident SB portfolio, the total deposits of the bank grew by 13.68% from ₹567.9 bn in Q2FY14 to ₹645.6 bn in Q2FY15. Within deposits, the bank witnessed steady growth of 13.1% YoY in its CASA deposits to ₹197.33 bn during Q2FY15, mainly due to 13.1% YoY and 12.9% YoY increase in its saving and current account deposits, respectively. Consequently, the CASA ratio remained steady at 30.6% as compared to 30.7% in Q2FY14. Retail deposits as a percentage of the bank's total deposits increased to 94.90% as at the end of Q2FY15 from 92.30% in Q2FY14. The bank has reduced its dependence on bulk deposits, with 1.2% of overall deposits as compared to 1.53% in Q1FY15 and 7.11% in Q2FY14. Saving deposits of the bank form 25% of total deposit, while NRI deposits constitute ~32.7% of total deposits as on Q2FY15.

Focus to increase low cost deposits also played well for Federal bank with CASA ratio improving to 31% in FY14 from 26% in FY10 mainly driven by SA deposits (19% CAGR in FY10-14) while current account deposit ratio was largely stable at 5%. In FY14 as well, the bank continued its strong traction in CASA deposits especially in home region of Kerala which has resulted in growth of 19% YoY in FY14. As a result of increasing focus on CASA franchise, the proportion of high cost bulk deposits have come down consistently from 25% in FY11 to 2.7% in FY14. We believe there is still scope for CASA ratio to improve marginally to 31.3% by FY16E. CASA deposits growth for Federal bank has shown a consistent increase and higher growth in past few years as against very volatile growth for closest peers.

**CASA Deposits**




**NIM trend**




## NIM to remain intact +3.2% in FY15E

*At the end of 30th September 2014, the NIM for the bank improved by 10bps QoQ to 3.35% on account of one off related to interest on income tax refund of `0.27 bn.*

With a strong focus on raising the low-cost CASA deposits and reducing dependence on wholesale funds, the bank has been able to narrow the gap vis-à-vis its peers in terms of liability franchise. This should help to sustain the net interest margin at healthy levels going ahead.

At the end of 30th September 2014, the NIM for the bank improved by 10bps QoQ to 3.35% on account of one off related to interest on income tax refund of ₹0.27 bn. Adjusted for the one off, NIM remained stable QoQ at 3.2%. We believe that the decline in yield on retail and SME loans will further keep the NIM under little stress as the bank cut its base rate by 35bps to 10.2% in the mid-June. However, the structural improvement in liability profile (reduction in bulk deposits – 1.2% of deposits v/s 14.7% in FY13), traction in CASA and improvement in loan growth will provide cushion to NIM. The management of the bank guided NIM to remain stable at 3.2-3.3% in FY15E. Thus, we believe that improvement in asset liability profile and strong focus on retail & SME segment to result in significant gain CASA share and keep the NIM stable.

## Loan book to grow by 20% in FY15E

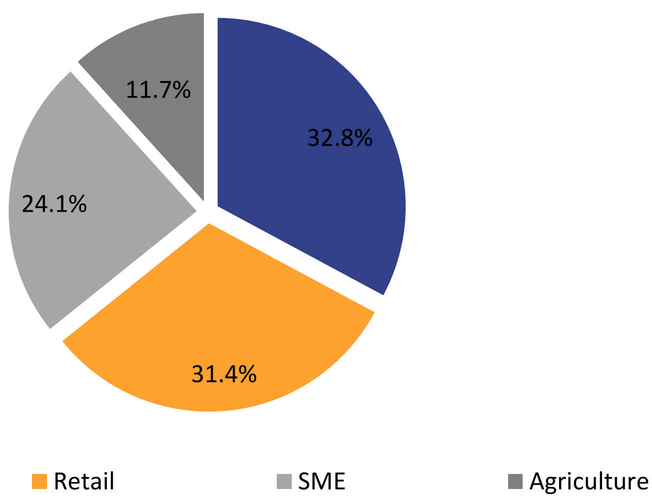
*SME & Agri continue to support loan growth, retail book also doing well led by mortgage & housing loans.*

During Q2FY15, advances of Federal Bank witnessed a further improvement with 14.8% YoY growth at ₹491.5 bn after seeing growth of 10.7% YoY in Q1FY15. The loan book of the bank has been growing at a modest pace of 12.7% CAGR since the last five years (FY10-14). All sectors including corporate, retail, SME and agri have contributed to overall credit growth. The bank has shifted its focus to the retail and SME segments over the last two years. The corporate loan book, which was 44% of total loans two years ago, was down to 32.8% as on September 2014. On the other hand, the retail segments, which accounted for about 27% of total loans, increased its share to 31.4% in Q2FY15. SME & Agriculture contribution to total loans rose to 24.1% and 11.7% in Q2FY15 from 22% and 11% in Q2FY14, respectively. In FY14, besides the corporate loan book that declined 27%, gold loan portfolio fell 14%. The retail gold loan portfolio, which grew nearly four times between 2011 and 2013, shrank in 2014; this was the result of the bank going cautious due to volatility in gold prices.

However, during Q2FY15, the gold and corporate portfolio of the bank witnessed a significant improvement of 8.6%, and 9.5% on sequential quarter basis. However, on YoY basis, corporate loan book grew marginally by 1.8%, while gold loan grew robust by 19.8% YoY. Retail and SME loans grew by 15.7% YoY and 25.9% YoY, respectively. The housing segment, which constitutes more than 40% of the retail loans, has been consistently growing at above 18% YoY.

In addition, the bank reduced its base rate by 35bps in June 2014 to attract more business. Going ahead, with a strong capital position and increasing market share within and outside the home state of Kerala, the bank is likely to post a healthy growth in the advances. Going ahead, we estimate 19% credit CAGR during F14-16E in line with management guidance.

**Loan mix as on 30th Sep'14**



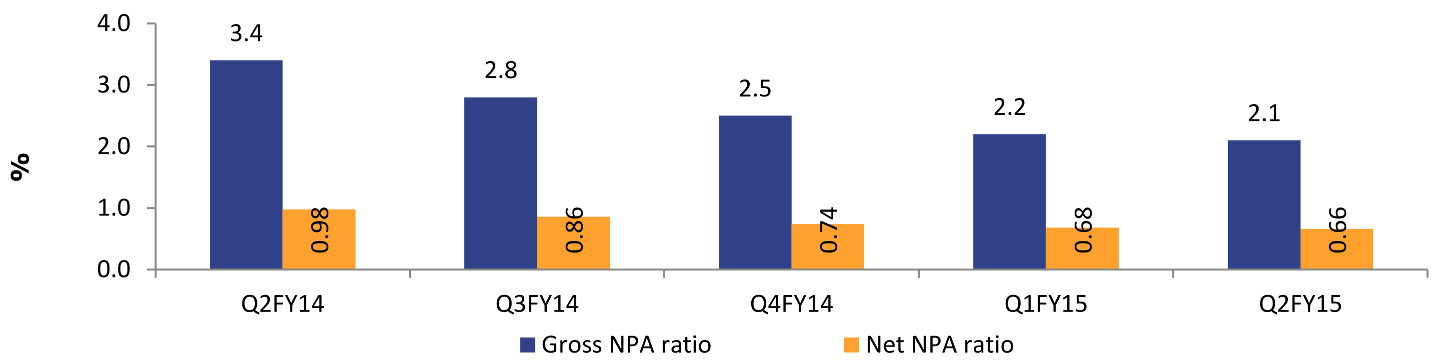
*Improved back-end processes and risk management systems to tackle asset quality issues, yielded results with slippages in SME and retail segment continuously trending down.*

## Better risk management will continue to reduce asset quality stress

The asset quality trend of the bank has been improving from the last five quarters, with tight control on corporate slippages. As on 30th September, 2014, the asset quality of the bank improved with the gross non-performing asset (GNPA) and net non-performing asset (NNPA) ratio coming down by 129 bps YoY and 32 bps YoY to 2.1% and 0.66%, respectively. Provision coverage ratio increased to 85.13% from 81.23% during the corresponding period in the previous fiscal.

Over slippages were restricted to ₹1.76 bn as compared to ₹1.83 bn in Q1FY15. Slippages in the SME segment were higher at ₹1.05 bn during the quarter as compared to ₹0.60-0.80 billion in the previous quarters. Slippages from the retail segment amounted to ₹0.55 bn, while slippages from the Agri segment stood at `0.16 billion. Surprise came after slippages in the corporate segment stood nil during the quarter, which in turn resulted in improved asset quality. Corporate slippages in last few quarters were contained, and reported NPAs dropped sharply helped by lower slippages and better recoveries/upgrades. Expected improvement in economic growth and consolidation in corporate segment reduces risk of significant increase in slippages from this segment. Meanwhile, the bank restructured advances worth ₹0.68 bn during the quarter; the outstanding restructured book for the bank now stands at ₹29.0 bn. With contained slippages from the corporate segment, the management is confident of better recovery in H2FY15E.

**Stable asset quality**




*The lender has expanded its branches to 1,214 as on 30th September, 2014 from 950 in 2012.*

## Branch network expansion to drive further growth

Strong traction in liability franchise specially CASA deposits is a result of 15% CAGR in branch increase since FY10. Earlier, Federal Bank perceived as a regional lender, but now days, in an effort to position itself as a national bank, Federal Bank is reaping the benefits of expanding outside Kerala with advances outside the state now comprising a major share of the private bank's assets. The bank's strategy to expand in states such as Maharashtra, Gujarat, Tamil Nadu, Punjab, and Bengal has led to robust growth in loans to small and medium units. Out of the total branch network of 1,214 branches, 75% of branches are in semi urban and urban areas. The lender has expanded its branches to 1,214 as on 30th September, 2014 from 950 in 2012. Of this, more than 625 are in the rest of the country. With 589 branches of Federal Bank, Kerala leads in terms of the absolute number of deposits, the rate of growth from the other regions is catching up. In FY14, savings deposit outside the state grew 18%, which was close to the 21% deposits growth coming from Kerala. For FY15, the bank is planning to add 60-70 branches, which in turn would further help in strengthening its low-cost deposit base.

### Balance Sheet (Standalone)

| Y/E (₹mn) | FY13A | FY14A | FY15E | FY16E |
|---|---|---|---|---|
| Paid up capital | 1,711 | 1,711 | 1,711 | 1,711 |
| Total reserve & surplus | 61,936 | 67,795 | 77,965 | 90,217 |
| Deposit | 576,149 | 597,313 | 686,910 | 789,946 |
| Borrowings | 51,870 | 56,880 | 64,274 | 72,630 |
| Other liabilities | 18,664 | 22,243 | 24,912 | 28,649 |
| **Total Equity & Liabilities** | **710,329** | **745,941** | **855,771** | **983,153** |
| Cash & Balance with RBI | 27,425 | 31,043 | 35,122 | 40,039 |
| Money call & short notice | 9,775 | 14,251 | 16,388 | 18,847 |
| Investments | 211,546 | 241,179 | 253,237 | 260,835 |
| Advances | 440,967 | 434,361 | 521,233 | 627,565 |
| Fixed assets | 3,999 | 4,250 | 4,759 | 5,331 |
| Other assets | 16,618 | 20,859 | 25,030 | 30,537 |
| **Total Assets** | **710,329** | **745,941** | **855,771** | **983,153** |

### Profit & Loss Account (Standalone)

| Y/E (₹mn) | FY13A | FY14A | FY15E | FY16E |
|---|---|---|---|---|
| Interest income | 61,676 | 69,461 | 75,712 | 89,340 |
| Interest expense | 41,929 | 47,175 | 50,005 | 57,856 |
| **Net Interest Income** | **19,747** | **22,286** | **25,707** | **31,485** |
| Non-interest income | 6,644 | 6,938 | 7,632 | 8,396 |
| Operating income | 26,391 | 29,225 | 33,339 | 39,880 |
| Operating expenses | 11,845 | 14,421 | 16,151 | 18,574 |
| **Profit before provisions** | **14,546** | **14,804** | **17,188** | **21,306** |
| Provisions | 2,608 | 2,684 | 2,952 | 3,484 |
| Tax | 3,556 | 3,731 | 4,669 | 5,881 |
| **Net Profit** | **8,382** | **8,389** | **9,566** | **11,941** |

### Key Ratios (Standalone)

| Y/E | FY13A | FY14A | FY15E | FY16E |
|---|---|---|---|---|
| Avg. cost of deposits(%) | 2.2 | 2.5 | 2.5 | 2.5 |
| ROA | 1.3 | 1.2 | 1.2 | 1.3 |
| ROE | 13.9 | 12.6 | 12.8 | 13.9 |
| Interest Expense/ Interest Income | 68.0 | 67.9 | 66.0 | 64.8 |
| Investment/Deposit | 36.7 | 40.4 | 36.9 | 33.0 |
| Cost-Income Ratio (%) | 44.9 | 49.3 | 48.4 | 46.6 |
| C-D Ratio (%) | 76.5 | 72.7 | 75.9 | 79.4 |
| BVPS | 74.4 | 81.3 | 93.2 | 107.5 |
| P/ BV | 2.0 | 1.8 | 1.6 | 1.4 |
| EPS | 9.8 | 9.8 | 11.2 | 14.0 |
| P/E | 15.0 | 15.0 | 13.1 | 10.5 |

## Valuation and view

Federal Bank continued to focus on enhancing its financial performance through increasing branch efficiency, superior cost efficiency, stable NIM and asset quality trends. With strong emphasis on retail & SME segment, we expect loan growth of ~20% over the next two years. Increasing proportion of retail (ex-gold) loans and SME along with strong traction in low cost deposits will help margins going forward. Thus, we believe that better visibility of profitable growth along with stable asset quality & improving return ratios instils further confidence in the stock. Hence considering the improving fundamentals & strong growth prospects, we remain positive on the stock.

At a current CMP of ₹147, the stock trades at a p/v of 1.6x FY15E and 1.4x FY16E, book value. We recommend 'BUY' with a target price of ₹175, arrived at FY16E book value which implies potential upside of 19% to the CMP from a long term perspective.

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