

Federal Bank

2 May 2016

Reuters: FED.BO; Bloomberg: FB IN

One-off Provisioning Hurts Profitability

Federal Bank reported miniscule PAT of Rs0.1bn for 4QFY16 as it voluntarily made higher provisioning of Rs1.9bn for accounts showing signs of weakness. Overall loan slippage was relatively lower at 3.9% (Rs5.4bn) against 4.4% in the previous quarter. As much as 30% of the slippage was from restructured accounts. Slippage mainly took place in corporate segment at 5.6% against 9.3% in the previous quarter. Slippage in SME or small and medium enterprise segment increased to 4.2% from 3.3% in the previous quarter. However, slippage in retail and agriculture segments was at manageable level of 2.0% and 2.7%, respectively. After adjusting for sale of non-performing assets or NPAs worth Rs1.3bn to an asset restructuring company or ARC and write-off of Rs3.1bn, gross non-performing assets or GNPA's eased 30bps sequentially to 2.8%. Net non-performing assets or NNPA's were flattish sequentially at 1.6%. Provision coverage ratio improved 40bps sequentially to a strong 72.1%. Restructured loans (excluding those to State Electricity Boards or SEBs) stood at 2.6% of loan book. Federal Bank did not do 5/25 refinancing or SDR. The management has given guidance of loan slippage easing going forward. Net interest income grew 10% on the back of credit growth of 13% and net interest margin or NIM of 3.3%. NIM has an one-off element of interest on tax refund accounting for 30bps. The management gave NIM guidance in the range of 3.10%-3.15%. Non-interest income dipped 26% YoY on lower treasury gains and bad debt recovery of Rs0.4bn and Rs0.2bn, respectively. Fee income positively surprised by growing 17%. Opex growth was contained at 13% as branch expansion remained muted. Deposits grew at a healthy rate of 12%, with CASA (current account savings account) deposit ratio improving 200bps YoY to 32.5%. NRE deposits rose 27%, shrugging off market fears in this regard. Credit off-take stood at 13% YoY, but its 2HFY17 annualised credit growth is seen at 30%. The management gave guidance of 18%-20% growth in credit for FY17. Given the uncertain economic environment, we have increased our loan slippage estimate by 20bps/70bps to 2.2% for FY17/FY18, respectively. We have cut ABV estimate by 7%/13% for FY17/FY18, respectively. We have valued Federal Bank at 1.5x (20% discount to Axis Bank & ICICI Bank) P/ABV FY18E financials with a revised target price of Rs67 (Rs77 earlier) and retained Buy rating on it.

Valuation and outlook: Federal Bank revamped its top management. It has inducted a new executive director, Mr. Ganesh Sankaran (from HDFC Bank) and chief operating officer, Ms. Shalini Warriar, (also from Standard Chartered Bank). The change brought in by these new officials is already witnessed in healthy QoQ corporate credit growth. The management plans to focus on better-rated corporates and secured retail segment. Share of corporate credit to entities with BBB rating and above increased to 72% from 57% earlier. Its liability franchise strengthened further with CASA deposit ratio at 33% and strong deposit flow in NRE accounts. The bank has improved its market in NRE remittance by 400bps to 12%. It has never resorted to 5/25 refinancing and SDR and has limited exposure to highly leveraged groups. The management gave guidance of loan slippage easing going forward. The bank is well placed to take advantage of likely macro-economic recovery, being already better capitalised with its Tier-I capital ratio at 13.4%. It is unlikely to raise capital for at least the next three years. Balance sheet consolidation is behind and the bank is now set to grow at the rate of 18%-20%. Better operating efficiency at branches set up recently is also expected to result in a significant improvement in overall operating efficiency.

BUY

Sector: Banking

CMP: Rs46

Target Price: Rs67

Upside: 45%

Hatim Broachwala, CFA

hatim.broachwala@nirmalbang.com

+91-22-3926 8068

Key Data

Current Shares O/S (mn)	1,717.9
Mkt Cap (Rsbn/US\$b)	78.8/1.2
52 Wk H / L (Rs)	80/41
Daily Vol. (3M NSE Avg.)	5,431,190

Price Performance (%)

	1 M	6 M	1 Yr
Federal Bank	(2.3)	(19.9)	(29.9)
Nifty Index	3.3	(3.2)	(4.7)

Source: Bloomberg

Y/E March (Rsmn)	4QFY16	4QFY15	3QFY16	YoY (%)	QoQ (%)
Interest income	20,265	19,083	19,028	-	-
Interest expenses	13,406	12,851	12,976	-	-
Net interest income	6,859	6,232	6,052	10.1	13.3
NIM (%)	3.3	3.3	3.0	-	27bps
Non-interest income	2,268	3,060	1,833	-	-
Operating income	9,127	9,292	7,885	(1.8)	15.8
Staff costs	2,930	2,487	2,586	-	-
Other operating expenses	2,252	2,114	2,044	-	-
Total operating expenses	5,182	4,601	4,630	-	-
Cost-to-income (%)	56.8	49.5	58.7	-	-
Pre-provision profit	3,945	4,691	3,255	(15.9)	21.2
Provisions	3,886	398	751	-	-
PBT	59	4,293	2,504	(98.6)	(97.6)
Tax	(44)	1,488	877	-	-
-Effective tax rate	(74.6)	34.7	35.0	-	-
PAT	103	2,805	1,627	(96.3)	(93.7)
EPS (Rs)	0.1	1.6	0.9	-	-
BV (Rs)	47.1	45.2	47.9	-	-
Deposits	7,91,717	7,08,250	7,47,920	11.8	5.9
Advances	5,80,901	5,12,850	5,27,530	13.3	10.1

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 1: Financial summary

Y/E March (Rsmn)	FY14	FY15	FY16	FY17E	FY18E
Net interest income	22,287	23,804	25,042	27,273	31,913
Pre-provision profit	14,804	16,278	14,238	17,690	21,078
PAT	8,389	10,058	4,757	8,502	10,711
EPS (Rs)	4.9	5.9	2.8	4.9	6.2
ABV (Rs)	38.7	43.0	41.5	43.1	44.9
P/E (x)	9.4	7.8	16.6	9.3	7.4
P/ABV (x)	1.2	1.1	1.1	1.1	1.0
GNPAs (%)	2.5	2.0	2.8	2.9	2.9
NNPAs (%)	0.7	0.7	1.6	1.9	2.1
RoA (%)	1.2	1.3	0.5	0.9	0.9
RoE (%)	12.6	13.7	6.0	10.1	11.8

Source: Company, Nirmal Bang Institutional Equities Research

Healthy traction in deposits, also decent traction in credit growth sequentially

Deposits grew at a healthy rate of 12%, with CASA deposit ratio improving 200bps YoY to 32.5%. NRE deposits rose 27%, shrugging off market fears in this regard. Credit off-take rose 13% YoY, but was up 10% QoQ, driven by corporate loan segment's growth of 18% QoQ. On YoY basis, corporate, retail, SME and agriculture segments grew 18%, 7%, 17% and 5%, respectively.

Guidance

The management gave credit growth guidance of 18%-20% with equal focus on corporate, SME and retail segments. The management also gave guidance about NIM normalising at 3.1%-3.15% as it has increased the focus on secured retail segment and better-rated corporates. Operating expenses growth is likely to be contained to single-digit. Loan slippage is expected to ease from the current level.

Operating efficiency expected to improve

Total operating expenses grew 13% during the quarter. With the rise in operating efficiency at recently opened branches (69% expansion over FY11) and muted branch expansion plan going forward, we expect the cost-to-income ratio to improve significantly.

Exhibit 2: Actual performance versus our estimates

(Rsmn)	4QFY16	4QFY15	3QFY16	YoY (%)	QoQ (%)	4QFY16E	Devi. (%)
Net interest income	6,859	6,232	6,052	10.1	13.3	6,258	9.6
Pre-provision profit	3,945	4,691	3,255	(15.9)	21.2	3,715	(5.9)
PAT	103	2,805	1,627	(96.3)	(93.7)	1,858	(94.4)

Source: Company, Nirmal Bang Institutional Equities Research

Net interest income above expectations can be attributed to one-off interest income on income tax refund. Pre-provision profit was below expectations on account of lower non-interest income and higher operating expenses. Profitability was significantly below expectations on account of one-off higher provisioning.

Exhibit 3: Change in our estimates

	Revised estimate		Earlier estimate		% Revision	
	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
Net Interest Income (Rsmn)	27,273	31,913	28,841	33,900	(5.4)	(5.9)
NIMs	3.0	3.0	3.0	3.1	-	(5)bps
Operating profit (Rsmn)	16,031	19,737	17,198	20,206	(6.8)	(2.3)
Profit after tax (Rsmn)	8,502	10,711	10,662	12,399	(20.3)	(13.6)
EPS (Rs)	4.9	6.2	6.2	7.2	(20.5)	(13.9)
ABV (Rs)	43.1	44.9	46.0	51.5	(6.5)	(12.8)

Source: Company, Nirmal Bang Institutional Equities Research

We have reduced our NII and operating profit estimates on account of lower growth in interest-earning assets during the quarter. In line with the guidance, we have factored in lower NIM going forward. We have also factored in loan slippage increasing by 20bps/70bps in FY17E/FY18E, respectively, to 2.2%.

Financials

Exhibit 4: Income statement

Y/E March (Rsmn)	FY14	FY15	FY16	FY17E	FY18E
Interest income	69,461	74,195	77,447	85,432	98,642
Interest expenses	47,174	50,391	52,405	58,159	66,730
Net interest income	22,287	23,804	25,042	27,273	31,913
Fee income	3,338	3,811	4,160	4,784	5,502
Other Income	2,025	2,413	2,423	3,518	4,248
Net revenue	27,650	30,028	31,625	35,575	41,662
Operating expenses	14,421	16,309	18,667	19,544	21,925
-Employee expenses	7,715	8,920	10,528	10,591	11,898
-Other expenses	6,706	7,389	8,139	8,953	10,027
Operating profit	13,229	13,719	12,958	16,031	19,737
Investment profit	1,575	2,559	1,280	1,659	1,341
Pre-provision profit	14,804	16,278	14,238	17,690	21,078
Provisions	2,684	1,067	7,041	4,808	4,850
-Loan loss provision	2,409	2,584	5,351	4,293	4,335
-Provision for investment	1,116	(806)	660	-	-
-Other provisions	(841)	(711)	1,030	515	515
PBT	12,120	15,211	7,197	12,882	16,228
Tax	3,731	5,153	2,440	4,380	5,518
PAT	8,389	10,058	4,757	8,502	10,711

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Balance sheet

Y/E March (Rsmn)	FY14	FY15	FY16	FY17E	FY18E
Equity capital	1,711	1,713	3,438	3,438	3,438
Reserves & surplus	67,796	75,669	77,474	83,284	91,095
Shareholders' funds	69,507	77,382	80,912	86,722	94,533
Deposits	5,97,313	7,08,250	7,91,717	9,10,475	10,74,360
-Current deposits	33,796	40,566	42,830	48,768	56,962
-Savings deposits	1,52,843	1,77,269	2,14,220	2,55,785	2,96,756
-Term deposits	4,10,674	4,90,415	5,34,667	6,05,922	7,20,641
Borrowings	56,879	22,782	21,766	36,017	39,295
-Subordinate debt	2,300	2,000	2,177	5,027	5,682
Other liabilities	22,244	19,791	19,905	31,738	46,227
Total liabilities	7,45,943	8,28,205	9,14,300	10,64,951	12,54,415
Cash/equivalent	45,294	47,801	54,198	66,442	82,830
Advances	4,34,361	5,12,850	5,80,901	6,81,845	8,12,953
Investments	2,41,179	2,44,092	2,22,175	2,51,864	2,84,641
Fixed assets	4,250	4,666	5,200	5,200	5,450
Other assets	20,859	19,096	51,826	59,600	68,540
Total assets	7,45,943	8,28,505	9,14,300	10,64,951	12,54,415

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Key ratios

Y/E March	FY14	FY15	FY16	FY17E	FY18E
Growth (%)					
NII growth	12.9	6.8	5.2	8.9	17.0
Pre-provision profit growth	1.4	10.0	(12.5)	24.2	19.2
PAT growth	0.1	19.9	(52.7)	78.7	26.0
Business (%)					
Deposit growth	3.7	18.6	11.8	15.0	18.0
Advances growth	(1.5)	18.1	13.3	17.4	19.2
Business growth	1.4	18.4	12.4	16.0	18.5
CD	72.7	72.4	73.4	74.9	75.7
CASA deposit	31.2	30.8	32.5	33.4	32.9
Operating efficiency (%)					
Cost-to-income	52.2	54.3	59.0	54.9	52.6
Cost-to-assets	2.1	2.2	2.3	2.2	2.1
Productivity (Rsmn)					
Business per branch	878.8	979.2	1,096.3	1,271.8	1,449.5
Business per employee	98.6	111.2	117.0	135.7	157.5
Profit per branch	7.1	8.1	3.8	6.8	8.2
Profit per employee	0.8	0.9	0.4	0.7	0.9
Spread (%)					
Yield on advances	11.4	11.5	10.4	10.2	10.0
Yield on investments	7.8	7.6	7.8	7.7	7.7
Cost of deposits	7.2	7.1	6.7	6.5	6.4
Yield on assets	10.2	10.1	9.7	9.5	9.4
Cost of funds	7.1	7.1	6.6	6.4	6.2
NIM	3.3	3.2	3.1	3.0	3.0
Capital adequacy (%)					
Tier-I	14.6	14.8	13.4	12.3	11.4
Tier-II	0.6	0.7	0.6	1.1	1.1
Total CAR	15.1	15.5	13.9	13.4	12.5
Asset quality (%)					
Gross NPAs	2.5	2.0	2.8	2.9	2.9
Net NPAs	0.7	0.7	1.6	1.9	2.1
Provision coverage	70.4	64.7	43.0	35.8	28.2
Provision coverage (Incl. Tech w/o)	84.1	83.9	72.1	67.5	61.8
Slippage	1.2	1.7	3.3	2.2	2.2
Credit-cost	0.5	0.4	0.9	0.6	0.5
Return ratios (%)					
RoE	12.6	13.7	6.0	10.1	11.8
RoA	1.2	1.3	0.5	0.9	0.9
RoRWA	1.9	2.1	0.9	1.3	1.4
Per share (Rs)					
EPS	4.9	5.9	2.8	4.9	6.2
BV	40.6	45.2	47.1	50.4	55.0
ABV	38.7	43.0	41.5	43.1	44.9
Valuation (x)					
P/E	9.4	7.8	16.6	9.3	7.4
P/BV	1.1	1.0	1.0	0.9	0.8
P/ABV	1.2	1.1	1.1	1.1	1.0

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
11 December 2014	Buy	141	183
8 January 2015	Buy	147	183
16 January 2015	Buy	145	183
4 May 2015	Buy	131	183
21 July 2015*	Buy	71	89
21 October 2015	Buy	65	83
13 January 2016	Buy	48	77
2 May 2016	Buy	46	67

* After adjusting for 1:1 bonus issue of shares

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

This report is published by Nirmal Bang's Institutional Equities Research desk. Nirmal Bang group has other business units with independent research teams separated by Chinese walls, and therefore may, at times, have different or contrary views on stocks and markets. Reports based on technical and derivative analysis may not match with reports based on a company's fundamental analysis. This report is for the personal information of the authorised recipient and is not for public distribution. This should not be reproduced or redistributed to any other person or in any form. This report is for the general information for the clients of Nirmal Bang Equities Pvt. Ltd., a division of Nirmal Bang, and should not be construed as an offer or solicitation of an offer to buy/sell any securities.

We have exercised due diligence in checking the correctness and authenticity of the information contained herein, so far as it relates to current and historical information, but do not guarantee its accuracy or completeness. The opinions expressed are our current opinions as of the date appearing in the material and may be subject to change from time to time without notice.

Nirmal Bang or any persons connected with it do not accept any liability arising from the use of this document or the information contained therein. The recipients of this material should rely on their own judgment and take their own professional advice before acting on this information. Nirmal Bang or any of its connected persons including its directors or subsidiaries or associates or employees or agents shall not be in any way responsible for any loss or damage that may arise to any person/s from any inadvertent error in the information contained, views and opinions expressed in this publication.

Nirmal Bang Equities Private Limited (hereinafter referred to as "NBEPL") is a registered Member of National Stock Exchange of India Limited, Bombay Stock Exchange Limited. NBEPL has registered with SEBI as a Research Entity in terms of SEBI (Research Analyst) Regulations, 2014. (Registration No: INH000001436 - 19.08.2015 to 18.08.2020).

NBEPL or its associates including its relatives/analyst do not hold any financial interest/beneficial ownership of more than 1% in the company covered by Analyst.

NBEPL or its associates/analyst has not received any compensation from the company covered by Analyst during the past twelve months. NBEPL /analyst has not served as an officer, director or employee of company covered by Analyst and has not been engaged in market-making activity of the company covered by Analyst.

The views expressed are based solely on information available publicly and believed to be true. Investors are advised to independently evaluate the market conditions/risks involved before making any investment decision.

Access all our reports on Bloomberg, Thomson Reuters and Factset.

Team Details:			
Name		Email Id	Direct Line
Rahul Arora	CEO	rahul.arora@nirmalbang.com	-
Girish Pai	Head of Research	girish.pai@nirmalbang.com	+91 22 3926 8017 / 18
Dealing			
Ravi Jagtiani	Dealing Desk	ravi.jagtiani@nirmalbang.com	+91 22 3926 8230, +91 22 6636 8833
Pradeep Kasat	Dealing Desk	pradeep.kasat@nirmalbang.com	+91 22 3926 8100/8101, +91 22 6636 8831
Michael Pillai	Dealing Desk	michael.pillai@nirmalbang.com	+91 22 3926 8102/8103, +91 22 6636 8830
Umesh Bharadia	Dealing Desk	umesh.bharadia@nirmalbang.com	+91-22-39268226

Nirmal Bang Equities Pvt. Ltd.

Correspondence Address

B-2, 301/302, Marathon Innova,
 Nr. Peninsula Corporate Park,
 Lower Parel (W), Mumbai-400013.
 Board No. : 91 22 3926 8000/1; Fax. : 022 3926 8010