

INDUSTRY	BANKS
CMP (as on 19 Jan 2017)	Rs 77
Target Price	Rs 93
Nifty	8,435
Sensex	27,309

KEY STOCK DATA

Bloomberg	FB IN
No. of Shares (mn)	1,721
MCap (Rs bn) / (\$ mn)	133/1,947
6m avg traded value (Rs mn)	690

STOCK PERFORMANCE (%)

52 Week high / low	Rs 86/41		
	3M	6M	12M
Absolute (%)	9.2	28.0	58.8
Relative (%)	11.6	29.7	47.2

SHAREHOLDING PATTERN (%)

Promoters	-
FIs & Local MFs	30.4
FIIIs	46.7
Public & Others	22.9

Source : BSE

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Cruising ahead

Federal Bank's (FB) 3Q performance was positive. Earnings beat (NII/PAT was 10/7% ahead of estimates) was led by strong broad-based loan growth (+32%), healthy CASA growth (33%), steady NIM (3.3%) and stable asset quality.

However, opex (13% QoQ) saw a steep rise due to pension provisions of Rs 170mn and one-off demonetisation related expenses of Rs 430mn, resulting in a 300bps rise in C-I ratio. While slippages were stable QoQ, utilisation of RBI's dispensation lowered them by Rs 350-400mn (23bps ann.)

FB has made incremental progress in reviving growth and pulling back on asset quality; slippages are at a 7-quarter low, while loan growth is accelerating. For opev to play out, costs must now be pegged. We have raised estimates by 9/5% for FY17E/18e. Our BUY is based on growth and asset quality recovery, for which FB is now well poised. Our revised TP of Rs 93 (1.7x Dec-17 ABV of Rs 55) faces upside risk from a positive surprise on costs and efficiency.

FINANCIAL SUMMARY

(Rs mn)	3QFY17	3QFY16	YoY (%)	2QFY17	QoQ (%)	FY16	FY17	FY18E	FY19E
Net Interest Income	7,914	6,052	30.8%	7,262	9.0%	25,042	29,935	35,137	40,812
PPOP	4,749	3,255	45.9%	4,750	0.0%	14,238	18,620	21,035	24,034
PAT	2,057	1,627	26.4%	2,013	2.1%	4,757	7,850	9,848	12,016
EPS (Rs)	1.2	0.9	26.1%	1.2	2.0%	2.8	4.6	5.7	7.0
ROAE (%) (ex revaluations)						6.0	9.3	10.8	12.1
ROAA (%)						0.55	0.77	0.81	0.84
Adj. BVPS (Rs)						41.5	44.3	50.6	56.3
P/ABV (x)						1.86	1.74	1.52	1.37
P/E (x)						27.9	16.9	13.5	11.0

Source : Source: Company, HDFC sec Inst Research

Highlights of the quarter

- Slippages at Rs 2.7bn (1.63%) were led by retail (Rs 860mn) and corporate (Rs 550mn). FB utilised RBI dispensation which lowered slippages by Rs 350-400mn (23bps ann.). With lower W/Os, GNPA jumped ~7% QoQ to Rs 19.5bn (2.77%). Our comfort on asset quality is derived from a smaller watch list, lower proportion of restructured books and a focus on better-rated corporates (despite strong growth).
- Led by corp. (+53/14% YoY/QoQ) and retail (+27/7% YoY/QoQ), loans grew ~32/8%. Healthy CASA growth (+33/19% YoY/QoQ) led to ~360bps rise in CASA ratio to ~34.7%. With a strong branch network and superior CRAR, we estimate ~22% loan CAGR FY16-FY19E.
- While NII was higher than estimates, a steep rise in opex (+25/13% YoY/QoQ) led to rise in C-I by ~300bps QoQ. The sharp rise includes one-off expenses of Rs 430mn due to demonetisation. We have conservatively factored steady C-I ratio of ~54% over FY17-19E.

- **Strong loan growth:** The overall loan growth remained strong at 32/7% YoY/QoQ, as aggression in the corporate segment (53/14% YoY/QoQ) continued. The ratings mix for corporates shows a 100bps QoQ gain in AAA, BBB and < BBB buckets while the share of A bucket declined 300bps. Strong growth of ~27/7% YoY/QoQ in the retail portfolio was positively led by higher growth in the non-Kerala branches (52% YoY). **With the bank's aggression in the corporate and retail segments, a widespread network, higher CRAR and a positive guidance on gold loans, we have revised our loan CAGR to 22% vs. 20% earlier.**
- FB's CASA ratio jumped ~360bps QoQ to 34.7%, led by strong SA growth of 32/19% YoY and a 38/22% growth in CA. While SA growth was expected, we are positively surprised with the CA growth.
- **Stable asset quality:** Slippages were stable QoQ at Rs 2.7bn (1.63% ann. vs. 1.72% QoQ) with drops in SME (Rs 1.2bn) and agri (Rs 140mn). However, retail (Rs 860mn, +37% QoQ) and corporate (Rs 550mn; +31% QoQ) were higher sequentially. **FB utilised RBI dispensation which lowered slippages by Rs 350-400mn. With lower W/Os of Rs 460mn, GNPA** jumped ~7% QoQ to Rs 19.5bn (2.77%). **With stable PCR of 71%, NNPA jumped ~6% QoQ to Rs 11bn.**
- Considering the relatively smaller restructured book at 2.1% and a focus on better rated corporates (despite strong growth), we estimate slippages of ~1.9% over FY16-19E.
- **Stable margins:** Reported margins were stable QoQ at 3.32% (+28bps YoY) with a ~14bps fall in CoF and yields each. NIM includes a 8-9bps one-off income due to demonetisation. With a focus towards high-rated corporates, normalisation of CASA deposits and capital consumption, we estimate NIMs of 3.2% over FY16-19E.
- **Cost ratios deteriorate:** While the core earnings (Rs 7.9bn, +31/9% YoY/QoQ) were higher than estimates, the steep surge in opex (Rs 5.8bn, +25/13% YoY/QoQ) led to a deterioration in C-I ratio (55%, +300bps QoQ). The steep surge in opex was caused by pension provisions of Rs 170mn and a one-off cost to the tune of Rs 430mn due to demonetisation. We have conservatively factored steady C-I ratio of ~54% over FY17-19E - provides upside risk to earnings.

Five Quarters At A Glance

Rs mn	3QFY16	4QFY16	1QFY17	2QFY17	3QFY17	YoY Growth	QoQ Growth
Net Interest Income	6,052	6,859	6,927	7,262	7,914	30.8%	9.0%
Non-interest Income	1,833	2,269	2,370	2,616	2,633	43.7%	0.6%
Treasury Income	230	410	830	860	860	273.9%	0.0%
Operating Income	7,885	9,128	9,297	9,878	10,547	33.8%	6.8%
Operating Expenses	4,630	5,183	5,039	5,128	5,798	25.2%	13.1%
Pre-provision Profits	3,255	3,945	4,259	4,750	4,749	45.9%	0.0%
Provisions And Contingencies	751	3,886	1,685	1,684	1,588	111.4%	-5.7%
NPA Provisions	390	2,720	1,260	980	1,040	166.7%	6.1%
PBT	2,504	59	2,574	3,066	3,161	26.2%	3.1%
Provision For Tax	877	(44)	901	1,053	1,104	26.0%	4.9%
PAT	1,627	103	1,673	2,013	2,057	26.4%	2.1%
Balance Sheet items/ratios							
Deposits (Rs bn)	748	792	811	863	922	23.3%	6.9%
CASA Deposits (Rs bn)	240	257	266	268	320	33.2%	19.4%
Advances (Rs bn)	528	581	591	647	696	32.0%	7.6%
CD ratio (%)	70.5	73.4	72.9	75.0	75.5	496 bps	53 bps
CAR (%)	14.3	13.9	13.6	12.9	12.3	-204 bps	-57 bps
Tier I (%)	13.7	13.4	13.0	12.2	11.6	-211 bps	-59 bps
Profitability							
Yield On Advances (%)	10.7	10.6	10.4	10.1	10.2	-48 bps	8 bps
Cost Of deposits (%)	7.2	7.2	6.8	6.6	6.7	-50 bps	15 bps
NIM (%)	3.0	3.3	3.3	3.3	3.3	28 bps	1 bps
Cost-Income Ratio (%)	58.7	56.8	54.2	51.9	55.0	-375 bps	306 bps
Tax Rate (%)	35.0	(74.5)	35.0	34.3	34.9	-7 bps	60 bps
Asset Quality							
Gross NPA (Rs bn)	16.8	16.7	17.5	18.2	19.5	15.9%	7.2%
Net NPA (Rs bn)	8.8	9.5	9.9	10.4	11.0	25.8%	6.0%
Gross NPAs (%)	3.2	2.8	2.9	2.8	2.8	-38 bps	-1 bps
Net NPAs (%)	1.7	1.6	1.7	1.6	1.6	-8 bps	-3 bps
Delinquency Ratio (%)	4.4	3.9	1.9	1.7	1.6	-278 bps	-9 bps
Coverage Ratio (%)	48.0	43.0	43.1	42.9	43.5	-447 bps	65 bps
Coverage ratio (%) Reported	71.7	72.1	72.1	71.7	71.0	-64 bps	-69 bps

Marginally higher than estimates with robust loan growth and 28bps YoY improvement in NIM

Fees grew ~25% YoY; Fx income jumped ~74%

Pension impact of Rs 170mn and demonetisation impact of Rs 430mn

SA grew (32/19% YoY/QoQ); CASA ratio jumped 360bps QoQ to 34.7%

Driven by corp (+53%) and retail (+27%);

Includes one-off impact of 8-9bps

Led by one-off expenses related to demonetisation

Led by lower W/Os; FB utilised RBI dispensation which lowered slippages by Rs 350-400mn

Segment wise slippage: Corp – Rs 550mn, SME – Rs 1.2bn; Retail – Rs 860mn and Agri – Rs 140mn

Change In Estimates

(Rs mn)	FY17E			FY18E		
	Old	New	Change	Old	New	Change
NII	28,421	29,935	5.3%	34,024	35,137	3.3%
PPOP	17,883	18,620	4.1%	20,813	21,035	1.1%
PAT	7,185	7,850	9.3%	9,408	9,848	4.7%
Adj. BVPS (Rs)	44.4	44.3	-0.2%	50.1	50.6	0.9%

Source: HDFC sec Inst Research

Strong loan growth was led by the corp (+53/14% YOY/QoQ) and retail segment (+27/7% YoY/QoQ)

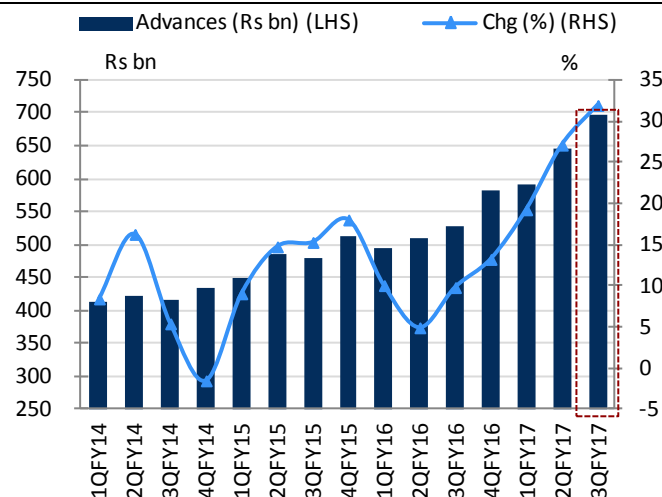
SME growth was flat QoQ

CASA ratio jumped ~360bps QoQ to 34.7% led by ~19% QoQ growth in SA and 22% in CA

Overall Retail Deposit ratio improved to 96.2% as against 94.5%.

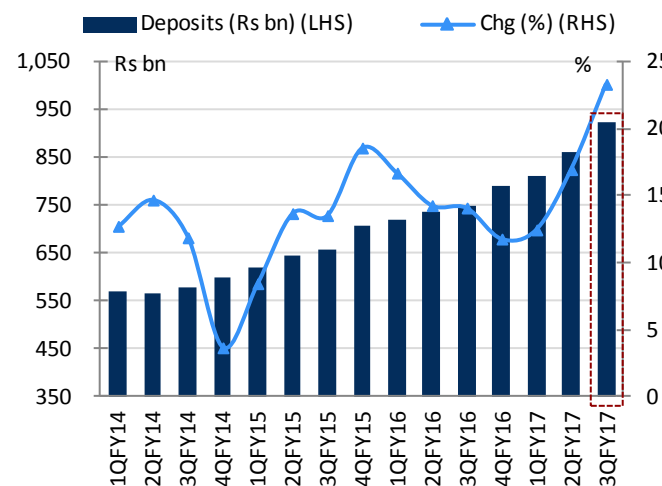
Management expects 1/3rd of the incremental CASA flow to remain sticky

Healthy Loan Growth Across Segments



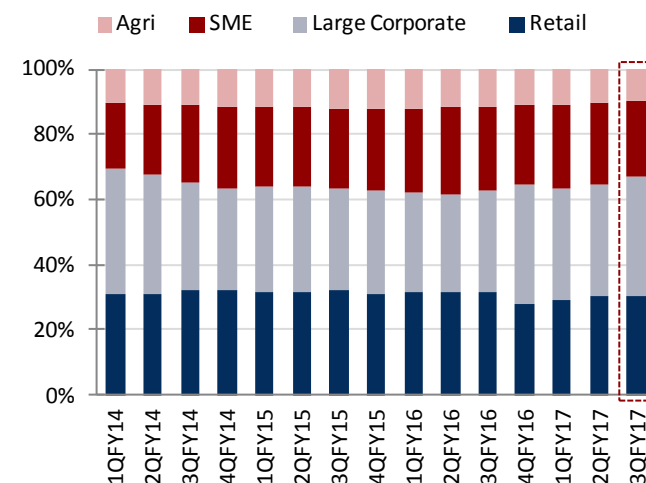
Source: Company, HDFC sec Inst Research

Deposit Growth Led BY Low Cost Deposits



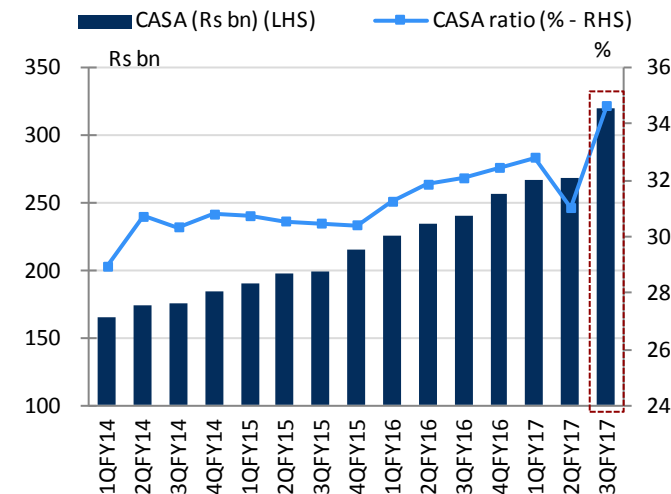
Source: Bank, HDFC sec Inst Research

Corporate Share Inches To ~36.5%, Up 220Bps QoQ



Source: Company, HDFC sec Inst Research

CASA grew 33/19% YoY/QoQ



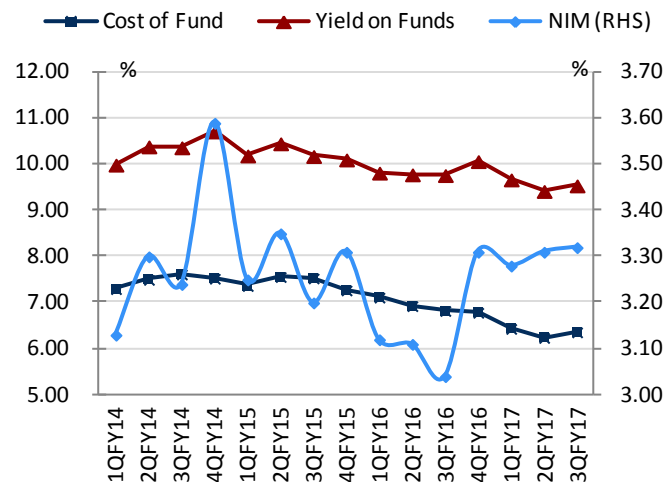
Source: Bank, HDFC sec Inst Research

NIM stable QoQ; albeit it includes 8-9bps of one off

C-I ratio deteriorated with an additional cost of Rs 430mn due to demonetisation

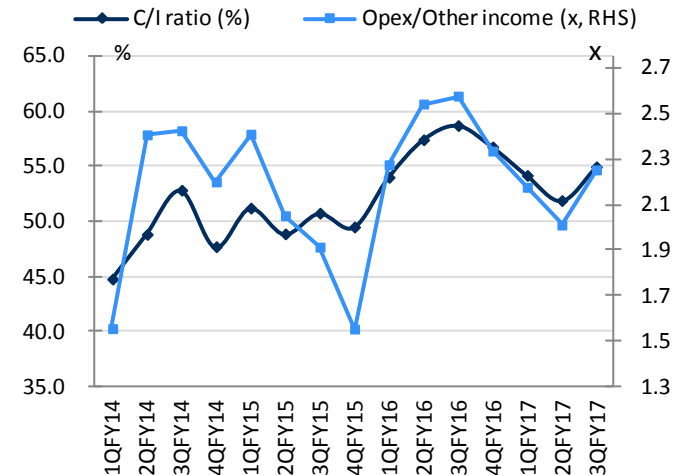
Staff cost also includes Rs 170mn towards pension provisions

NIMs Stable QoQ



Source: Bank, HDFC sec Inst Research

Core C-I Ratio Deteriorates QoQ



Source: Bank, HDFC sec Inst Research

Non-interest Income: Core Fees Income Growth (+25% YoY)

Rs mn	3QFY14	4QFY14	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	2QFY17	3QFY17
Fee	810	917	808	1,010	920	1,080	860	1,040	1,010	1,250	1,150	1,250	1,260
% Avg Loans	0.77	0.86	0.73	0.86	0.76	0.87	0.68	0.83	0.78	0.90	0.78	0.81	0.75
FX	410	269	262	350	300	260	410	330	190	370	270	270	330
Treasury	180	400	400	420	770	960	380	260	230	410	830	860	860
Recovery	93	140	57	75	195	1,060	290	190	410	240	130	240	180
Total	1,563	1,784	1,565	1,959	2,199	3,060	1,939	1,823	1,833	2,269	2,370	2,616	2,633
growth % (YoY)	-23%	-9%	-27%	37%	41%	72%	24%	-7%	-17%	-26%	22%	44%	44%

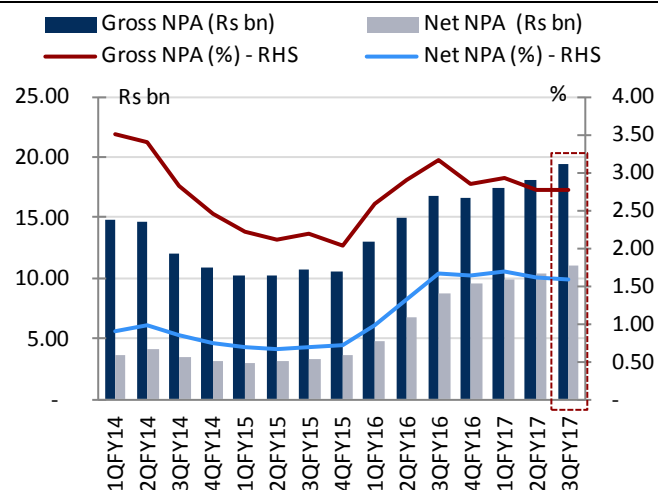
Source: Bank

Retail slippages: Rs 0.86bn vs. Rs 0.63bn QoQ, corporate – Rs 0.55bn vs. Rs 0.42bn and SME – Rs 1.2bn vs. Rs 1.4bn

FB utilised RBI dispensation for asset classification which lowered slippages by ~Rs 350-400mn

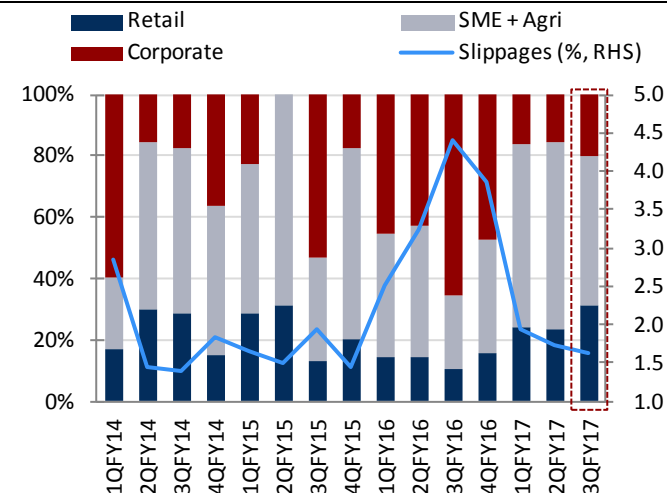
Restructured book stable QoQ at Rs 14.5bn (2.1% of loans)

Asset Quality Marginally Deteriorates



Source: Bank, HDFC sec Inst Research

Higher Slippages Led By Retail & Corp Segment



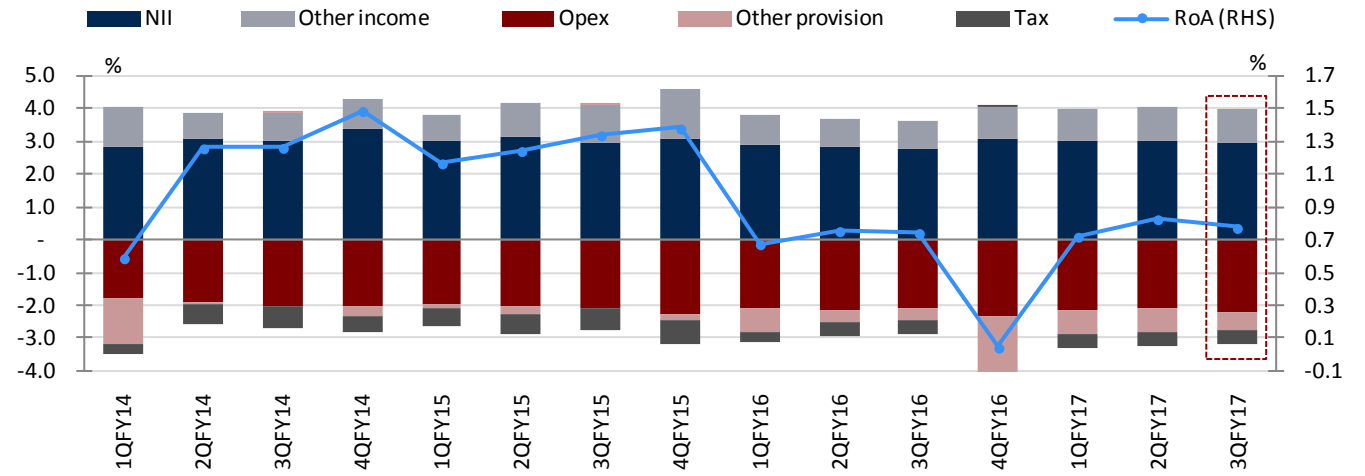
Source: Bank, HDFC sec Inst Research

Provision Break-up

Rs mn	3QFY14	4QFY14	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	2QFY17	3QFY17
LLP	105	240	540	660	550	280	1,170	1,270	390	2,720	1,260	980	1,040
%, Ann.	0.10	0.23	0.49	0.56	0.46	0.23	0.93	1.01	0.30	1.96	0.86	0.63	0.62
Other	(782)	(70)	1	(273)	22	88	(129)	(137)	201	896	425	704	548
Tax	1,185	877	1,092	1,238	1,335	1,488	727	880	877	(44)	901	1,053	1,104
Tax rate (%)	34%	24%	33%	34%	34%	35%	34%	35%	35%	-74%	35%	34%	35%

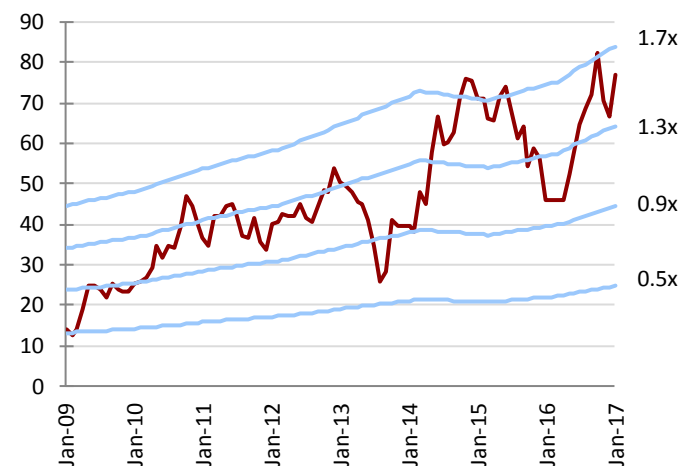
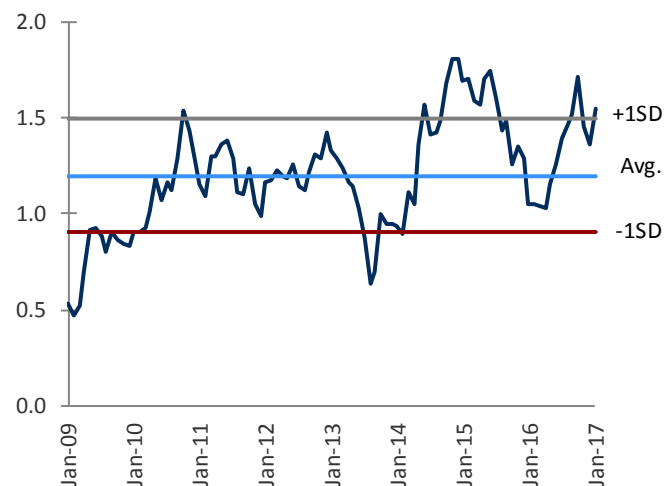
Source: Bank

Stable RoAA QoQ



Source: Bank, HDFC sec Inst Research

P/ABV Band Chart



Source: Bank, HDFC sec Inst Research

Peer Valuation

BANK	Mcap (Rs bn)	CMP (Rs)	Rating	TP (Rs)	ABV (Rs)			P/E (x)			P/ABV (x)			ROAE (%)			ROAA (%)		
					FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
ICICIB #	1,570	270	BUY	312	118	134	154	12.1	10.5	8.6	1.86	1.56	1.30	10.9	11.0	11.8	1.38	1.36	1.39
KMB	1,334	728	BUY	905	136	155	177	33.1	26.2	20.5	4.37	3.68	3.08	12.9	14.4	15.4	1.58	1.64	1.68
AXSB	1,155	484	NEU	486	188	223	263	29.1	14.6	11.2	2.58	2.17	1.84	7.2	13.2	15.3	0.69	1.17	1.31
IIB	726	1,220	BUY	1,329	325	379	443	24.7	19.5	16.0	3.75	3.22	2.75	15.9	17.4	18.3	1.88	1.92	1.89
FB	133	77	BUY	93	44	51	56	16.9	13.5	11.0	1.74	1.52	1.37	9.3	10.8	12.1	0.77	0.81	0.84
CUB	84	140	BUY	157	53	60	70	16.4	14.3	12.2	2.66	2.32	2.01	15.6	15.7	16.1	1.51	1.47	1.47
DCBB	34	119	BUY	143	64	73	82	17.2	14.4	11.5	1.85	1.63	1.46	10.7	11.4	12.5	0.93	0.90	0.91
SBIN #	2,006	258	BUY	284	112	131	154	13.0	9.8	7.5	1.69	1.41	1.10	8.3	10.0	11.1	0.48	0.56	0.60
BOB	370	160	BUY	195	88	121	158	17.6	9.8	7.1	1.82	1.32	1.02	5.7	9.6	12.1	0.30	0.51	0.63
Ujjivan	42	353	BUY	515	148	163	184	15.1	21.0	15.3	2.38	2.17	1.92	18.5	10.5	12.9	3.74	1.83	1.81

Source: Company, HDFC sec Inst Research, # Adjusted for subsidiaries value

Income Statement

(Rs mn)	FY15	FY16	FY17E	FY18E	FY19E
Interest Earned	74,195	77,447	87,837	103,210	120,661
Interest Expended	50,391	52,404	57,902	68,073	79,849
Net Interest Income	23,804	25,042	29,935	35,137	40,812
Other Income	8,783	7,864	10,328	10,572	11,349
Fee Income (CEB)	3,811	4,155	4,846	5,759	6,824
Treasury Income	2,557	1,275	3,000	2,000	1,500
Total Income	32,587	32,906	40,263	45,709	52,161
Total Operating Exp	16,309	18,668	21,644	24,674	28,127
Employee Expense	8,920	10,529	12,081	13,857	15,828
PPOP	16,278	14,238	18,620	21,035	24,034
Provisions & Contingencies	1,067	7,041	5,929	5,718	5,769
Prov. for NPAs (incl. std prov.)	2,043	5,553	4,567	5,067	5,114
PBT	15,210	7,197	12,691	15,317	18,265
Provision for Tax	5,153	2,440	4,841	5,469	6,249
PAT	10,057	4,757	7,850	9,848	12,016

Source: Bank, HDFC sec Inst Research,

Balance Sheet

(Rs mn)	FY15	FY16	FY17E	FY18E	FY19E
SOURCES OF FUNDS					
Share Capital	1,713	3,438	3,441	3,441	3,441
Reserves	75,668	77,474	83,625	91,341	100,826
Shareholders' Funds	77,381	80,912	87,066	94,782	104,267
Savings	177,269	214,222	267,776	314,635	369,695
Current	40,566	46,304	53,249	56,977	62,675
Term Deposits	490,415	531,191	610,870	733,044	879,674
Total Deposits	708,250	791,717	931,895	1,104,656	1,312,043
Borrowings	23,082	21,766	75,438	86,721	99,684
Other Liabilities & Provs	19,791	19,905	23,119	26,859	29,545
Total Liabilities	828,505	914,300	1,117,518	1,313,018	1,545,540
APPLICATION OF FUNDS					
Cash & Bank Balance	47,800	54,198	68,048	60,485	80,263
Investments	205,688	222,175	266,372	303,717	349,418
G-Secs	168,761	170,040	207,347	240,263	282,745
Advances	512,850	580,901	723,222	885,947	1,049,848
Fixed Assets	4,666	5,200	5,460	5,733	6,019
Other Assets	57,500	51,826	54,416	57,136	59,992
Total Assets	828,505	914,300	1,117,518	1,313,018	1,545,540

Source: Bank, HDFC sec Inst Research,

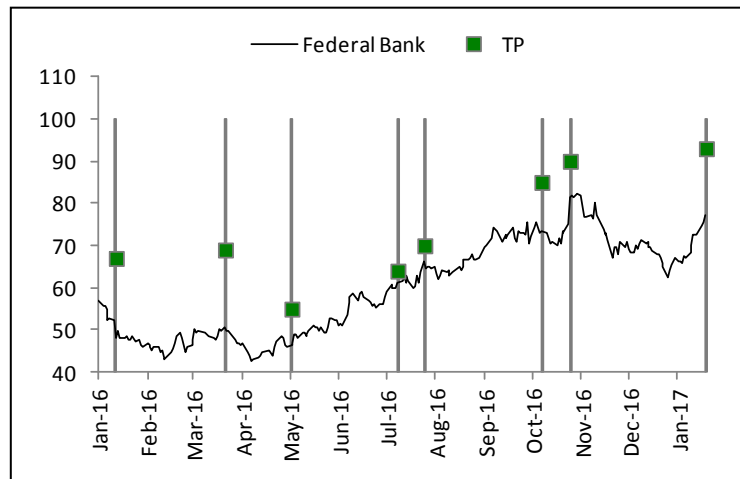
Key Ratios

	FY15	FY16	FY17E	FY18E	FY19E
VALUATION RATIOS					
EPS	5.9	2.8	4.6	5.7	7.0
Earnings Growth (%)	19.9	(52.7)	65.0	25.5	22.0
BVPS	45.1	47.1	50.6	55.1	60.6
Adj. BVPS	42.9	41.5	44.3	50.6	56.3
ROAA (%)	1.28	0.55	0.77	0.81	0.84
ROAE (%)	13.7	6.0	9.3	10.8	12.1
P/E (x)	13.1	27.9	16.9	13.5	11.0
P/ABV (x)	1.80	1.86	1.74	1.52	1.37
P/PPOP (x)	8.1	9.3	7.1	6.3	5.5
Dividend Yield (%)	0.7	0.9	1.1	1.4	1.6
PROFITABILITY					
Yield on Advances (%)	11.5	10.4	10.0	9.8	9.7
Yield on Investment (%)	7.4	8.2	8.0	7.8	7.7
Cost of Funds (%)	7.3	6.8	6.4	6.2	6.1
Cost of Deposits (%)	7.1	6.7	6.4	6.3	6.3
Core Spread (%)	4.2	3.6	3.7	3.6	3.5
NIM (%)	3.3	3.2	3.3	3.2	3.1
OPERATING EFFICIENCY					
Cost/Avg. Asset Ratio (%)	2.1	2.1	2.1	2.0	2.0
Cost-Income Ratio (Excl Treasury)	54.3	59.0	58.1	56.5	55.5
BALANCE SHEET STRUCTURE					
Loan Growth (%)	18.1	13.3	24.5	22.5	18.5
Deposit Growth (%)	18.6	11.8	17.7	18.5	18.8
C/D Ratio (%)	72.4	73.4	77.6	80.2	80.0
Equity/Assets (%)	9.3	8.8	7.8	7.2	6.7
Equity/Advances (%)	15.1	13.9	12.0	10.7	9.9
CASA (%)	30.8	32.9	34.4	33.6	33.0
Capital Adequacy Ratio (CAR, %)	15.5	13.9	12.3	11.4	10.6
W/w Tier I CAR (%)	14.8	13.4	11.8	11.0	10.2

	FY15	FY16	FY17E	FY18E	FY19E
ASSET QUALITY					
Gross NPLs (Rsm)	10,577	16,678	19,861	19,118	20,218
Net NPLs (Rsm)	3,733	9,500	10,860	7,796	7,483
Gross NPLs (%)	2.0	2.9	2.7	2.2	1.9
Net NPLs (%)	1.0	1.6	1.5	0.9	0.7
Coverage Ratio (%)	64.7	43.0	45.3	59.2	63.0
Provision/Avg. Loans (%)	0.43	1.02	0.70	0.63	0.53
ROAA TREE					
Net Interest Income	3.02%	2.87%	2.95%	2.89%	2.86%
Non-interest Income	1.12%	0.90%	1.02%	0.87%	0.79%
Treasury Income	0.32%	0.15%	0.30%	0.16%	0.10%
Operating Cost	2.07%	2.14%	2.13%	2.03%	1.97%
Provisions	0.14%	0.81%	0.58%	0.47%	0.40%
Provisions for NPAs	0.26%	0.64%	0.45%	0.42%	0.36%
Tax	0.65%	0.28%	0.48%	0.45%	0.44%
ROAA	1.28%	0.55%	0.77%	0.81%	0.84%
Leverage (x)	10.72	11.01	12.10	13.37	14.36
ROAE	13.69%	6.01%	9.35%	10.83%	12.07%

Source: Bank, HDFC sec Inst Research,

RECOMMENDATION HISTORY



Date	CMP	Reco	Target
13-Jan-16	48	BUY	67
21-Mar-16	50	BUY	69
2-May-16	46	BUY	55
8-Jul-16	60	BUY	64
25-Jul-16	64	BUY	70
7-Oct-16	73	BUY	85
26-Oct-16	81	BUY	90
20-Jan-17	77	BUY	93

Rating Definitions

BUY : Where the stock is expected to deliver more than 10% returns over the next 12 month period
NEUTRAL : Where the stock is expected to deliver (-)10% to 10% returns over the next 12 month period
SELL : Where the stock is expected to deliver less than (-)10% returns over the next 12 month period

Disclosure:

We, Darpin Shah, MBA, and Parul Gulati, MBA authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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