

Federal Bank

Loan growth to remain decent, albeit lower pace seen in the last two quarters: In Q1FY17, the bank reported 19% loan growth, which further accelerated to 27% in Q2FY17, backed by 47% jump in corporate loan book. Retail loans also were strong. Gold loan, which had been under pressure and also saw degrowth in previous quarters, saw a comeback thus contributing to the growth. While the process of demonetization is likely to have an impact and loan growth might slow down in Q3 & Q4FY17, we expect Federal Bank to bounce back to 17-18% YoY loan growth trajectory in FY18.

Deposit growth will get a further boost, CASA to remain high: Deposit growth for the banking industry witnessed some improvement in Q2FY17. Federal bank reported a jump of 17% in deposit base on top of 12.5% growth in Q1FY17. We have already seen rush in bank deposits amid the demonetization move, this will further accelerate the growth in deposit base. Though interest rates will further come down, the banking industry including Federal Bank will continue to see surge in deposits in the months to come.

Asset quality stress has started stabilizing: High slippages and resultant credit cost had dented the profitability of Federal Bank in FY16. However in the last two quarters, the slippages have been under control. Q2FY17 slippages of ₹266cr was the lowest in the last five quarters. Total stressed asset at 4.8% (NNPAs 1.61% + Restructured 3.2%) is not alarming. While it's too early to say that the trouble is over, the initial signs are encouraging. Further quantifying the impact of demonetization is a challenging task, but it is a fact that SMEs do have large cash transactions either for input or for finished goods. While there could be some incremental pressure on asset quality in the near term, the relatively improving corporate loan book of Federal Bank gives us comfort.

High credit cost dented the return ratios so far, expect RoE to bounce back in FY18: Higher slippages dented the RoE both due to reversal of interest and rise in provisions. However, the lower slippages expected in the coming years would normalize the return ratios and we expect RoE to scale back to 10% trajectory by FY18. Further, accelerated loan growth should also support higher fees income and consequently RoE.

Outlook and valuation: Federal Bank has already recognized large part of the troubled assets as NPAs. While there could be incrementally some degree of stress on the SME book, we believe gradually there should be overall improvement in the asset quality backed by the corporate loan book. At the CMP, the stock is trading at 1.4x its FY18 Adj BV. **We upgrade the stock to BUY with a target price of ₹85.**

Key financials (Standalone)

Y/E March (₹ cr)	FY2015	FY2016	FY2017E	FY2018E
Nil	2,380	2,504	2,899	3,292
% chg	6.8	5.2	15.8	13.6
Net profit	1,006	476	746	958
% chg	19.9	(52.7)	56.8	28.4
NIM (%)	3.0	2.9	3.0	3.0
EPS (₹)	11.7	2.8	4.3	5.6
P/E (x)	6.0	25.3	16.1	12.6
P/ABV (x)	0.8	1.7	1.5	1.4
RoA (%)	1.3	0.5	0.8	0.9
RoE (%)	13.0	5.9	8.5	10.1

Source: Company, Angel Research; Note: CMP as of November 30, 2016

BUY

CMP	₹71
Target Price	₹85

Investment Period	12 Months
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Stock Info

Sector	Banking
Market Cap (₹ cr)	12,156
Beta	1.3
52 Week High / Low	86 / 41
Avg. Daily Volume	515,000
Face Value (₹)	2
BSE Sensex	25,850
Nifty	7,976
Reuters Code	FED.BO
Bloomberg Code	FB@IN

Shareholding Pattern (%)

Promoters	0.0
MF/ Banks / Indian Fis	32.8
FII/ NRI/ OCBs	43.7
Indian Public / Others	23.5

Abs. (%)	3 m	1 yr	3 yr
Sensex	(6.9)	0.9	26.4
Federal Bank	1.2	19.3	74.4

3-year price chart



Source: Company, Angel Research

Siddharth Purohit

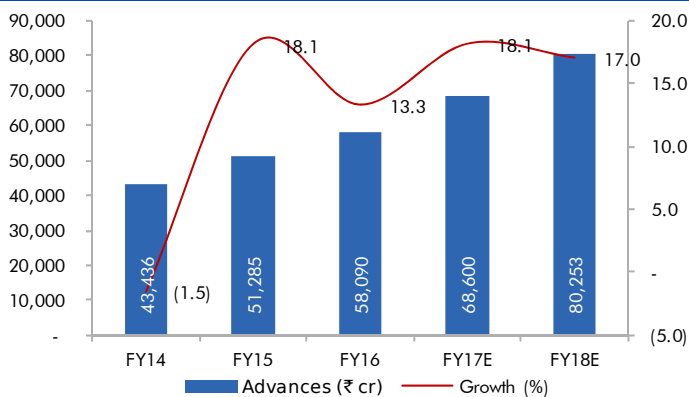
022 – 3935 7800 Ext: 6828

siddharth.purohit@angelbroking.com

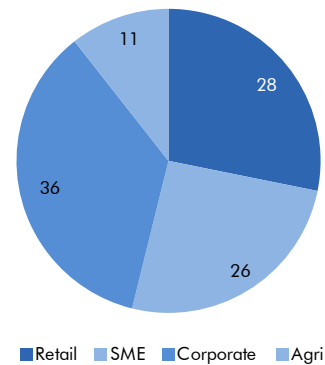
Loan growth to remain decent, albeit lower pace seen in the last two quarters;

Federal Bank has reported decent loan growth over the last two years. In Q1 and Q2 of FY17, the bank has seen further acceleration in the loan growth by 19% and 27%, respectively. The phenomenally high growth in Q2FY17 was backed by 47% jump in loan book from the corporate loan book. Historically, SME has been a growth driver for Federal Bank and accounts for ~25% of the loan book. Corporate loans have also been witnessing strong growth in the last few quarters and now account for 35% of the book compared to 30% in Q1FY16.

While it is difficult to quantify the effect of demonetization on banking space, it is fair to assume a slowdown in the SME and Corporate segment. The smaller and micro enterprises depend on cash to large extent both for their input and selling their final output, and hence there could be a moderation in the loan growth in the coming two quarters. However, the interest rate regime in India is likely to remain low for many quarters to come and this should help better credit growth after a pause that we are likely to see in the next two quarters.

Exhibit 1: Loan Book growth (%)


Source: Company, Angel Research

Exhibit 2: Loan Book Composition (%)


Source: Company, Angel Research

Exhibit 3: Loan Composition Trend

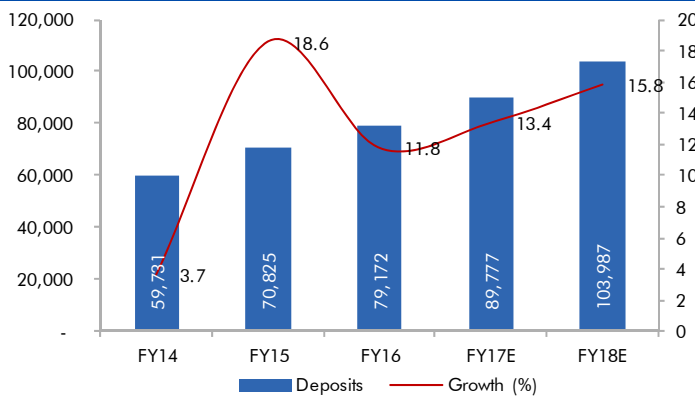
Loan Composition (₹ Cr)	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17
Retail	16,035	16,392	14,265	14,987	15,133	17,795
SME	13,011	13,875	14,033	15,172	15,325	16,235
Corporate	15,130	15,272	16,668	19,652	20,693	22,451
Agri	6,159	6,137	6,062	6,636	6,445	6,700
Total	50,335	51,676	51,028	56,447	57,596	63,181
Loan Composition (%)						
Retail	31.9	31.7	28.0	26.6	26.3	28.2
SME	25.8	26.8	27.5	26.9	26.6	25.7
Corporate	30.1	29.6	32.7	34.8	35.9	35.5
Agri	12.2	11.9	11.9	11.8	11.2	10.6

Source: Company, Angel Research

Deposit growth will get a further boost, CASA to remain high

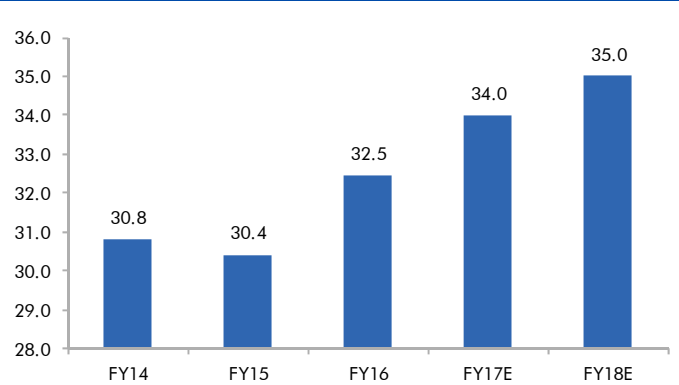
The deposit growth for the banking industry witnessed some improvement in Q2FY17. Federal bank reported a jump of 17% in deposit base on top of 12.5% growth in Q1FY17. We have already seen rush in bank deposits amid the demonetization move, this will further accelerate the growth in deposit base. Though interest rates will further come down, the banking industry including Federal Bank will continue to see surge in deposits in the months to come.

Exhibit 4: Deposit growth trend (₹ Cr)



Source: Company, Angel Research

Exhibit 5: CASA Ratio (%)



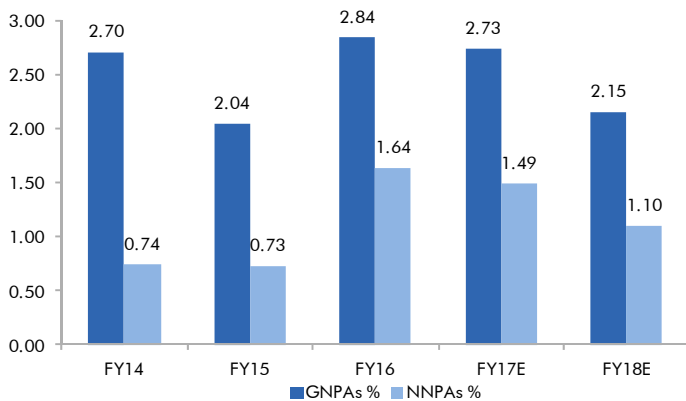
Source: Company, Angel Research

Asset quality stress has started stabilizing

Slippages had been relatively higher for Federal Bank for all the quarters in FY16. However in 1Q and 2Q of FY17, the bank delivered meaningful control over slippages and this was an encouraging sign. In absolute terms, the slippages were ₹280cr and ₹266cr vs. ₹571cr in Q3FY16 and ₹536cr in Q4FY16. While it's too early to say that the trouble is over, the initial sign has been clear and that is incrementally there could be lower slippages.

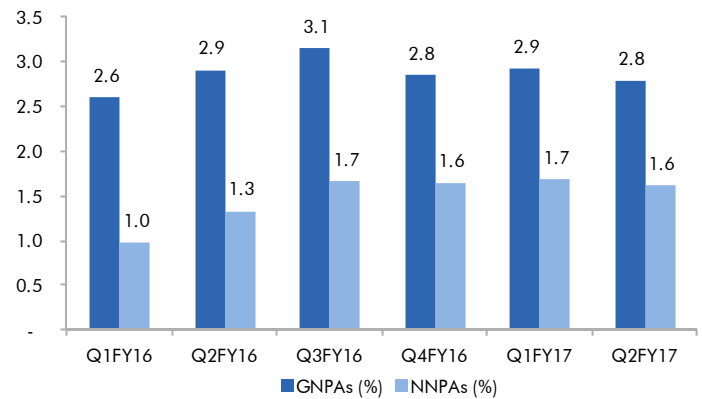
While it is difficult to quantify the impact of demonetization on the industry, SME segment do have large exposure to the cash form of business either for input or for the finished goods that they deal with. However, it is safe to assume some incremental stress on the SME.

Exhibit 6: GNPA's & NNPA's Ratio yearly trend



Source: Company, Angel Research;

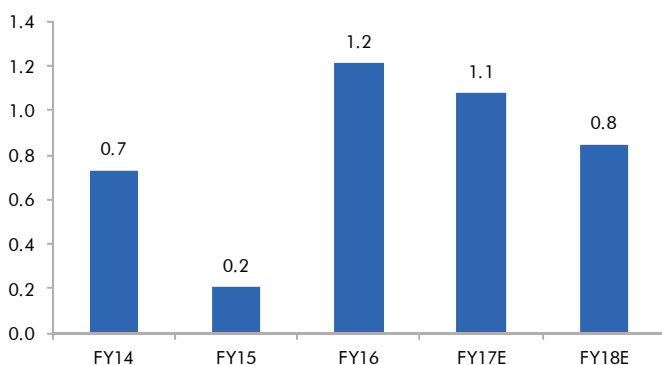
Exhibit 7: GNPA's & NNPA's Ratio quarterly trend



Source: Company, Angel Research

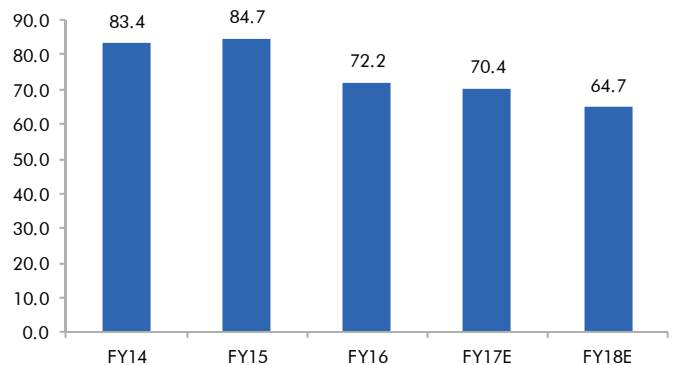
Credit cost remained elevated for FY16; however, we have started witnessing some moderation in the same. Accordingly, we expect credit cost top fall to 110bps in FY17 and further to 80bps in FY18. The bank might take higher provisions in order to improve its PCR. However, on a like to like basis we don't expect sharp rise in provisioning.

Exhibit 8: Credit Cost (%)



Source: Company, Angel Research

Exhibit 9: PCR (%)

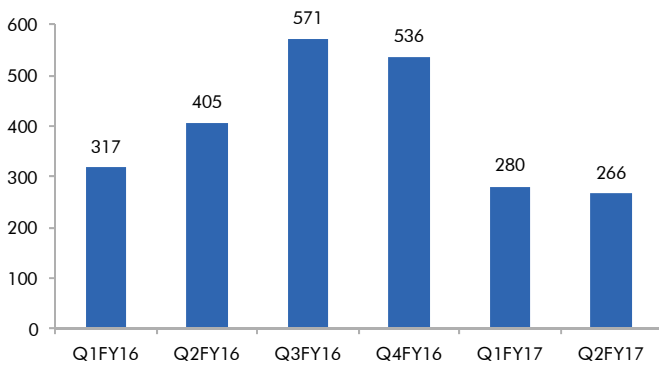


Source: Company, Angel Research

Slippages from SME could see some stress post demonetization, but improvement in corporate book gives comfort

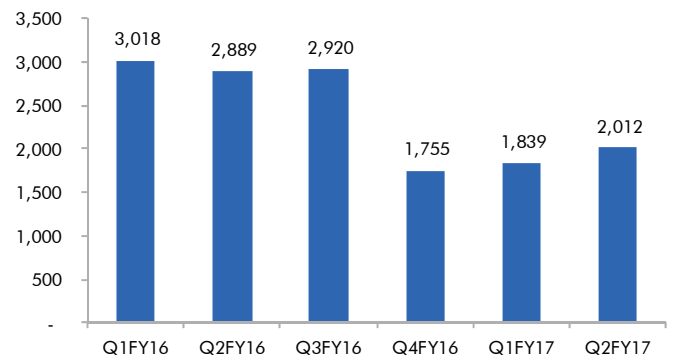
Federal Bank’s pipeline of accounts with potential stress was relatively lower and was one of the lowest in recent quarters, when they declared their Q2FY17 results. The expected slowdown in the economy post demonetization could put some pressure on the SME loan book. However, we don’t expect material deterioration in the corporate loan book segment for the bank. While in Q2FY17, the bank witnessed some incremental restructuring, we don’t expect large accounts to come forward for restructuring in the near term. Further there are a couple of accounts which should get upgraded from the restructured book in the quarters to come.

Exhibit 10: Slippages (₹ Cr)



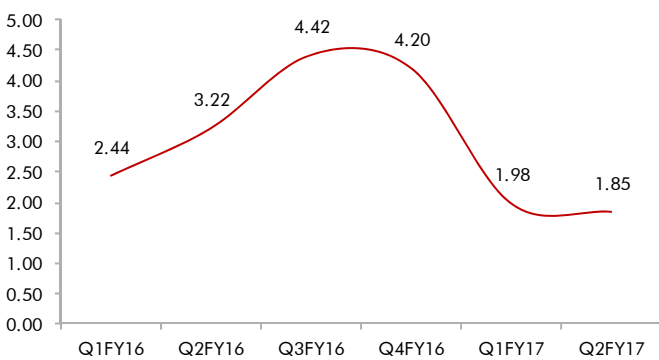
Source: Company, Angel Research;

Exhibit 11: Restructured Loan (₹ Cr)



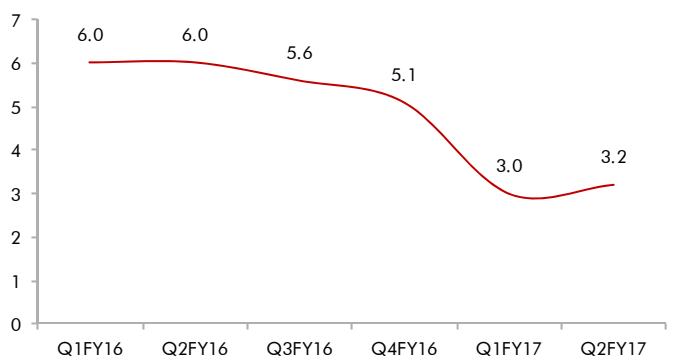
Source: Company, Angel Research

Exhibit 12: Slippages Ratio (%)



Source: Company, Angel Research;

Exhibit 13: Restructured Loan (%)

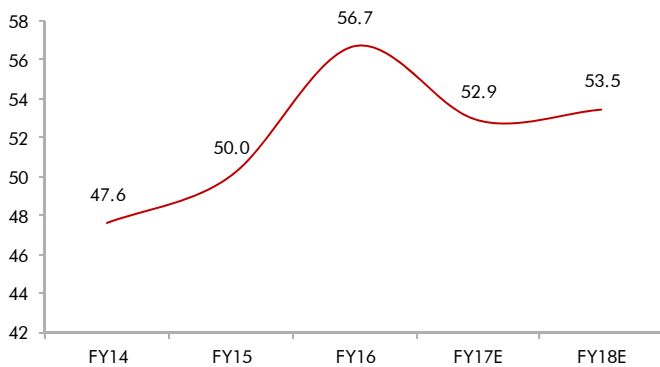


Source: Company, Angel Research

High credit cost dented the return ratios so far, expect RoE to bounce back in FY18:

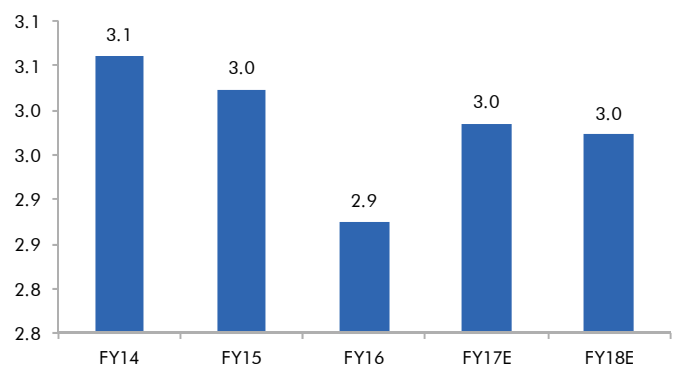
Higher slippages dented the RoE both due to reversal of interest and rise in provisions. However, the lower slippages expected in the coming years, would normalize the return ratios and we expect RoE to scale back to 10% trajectory by FY18. Further, accelerated loan growth should also support higher fees income and consequently RoE

Exhibit 14: Cost/ Income (%)



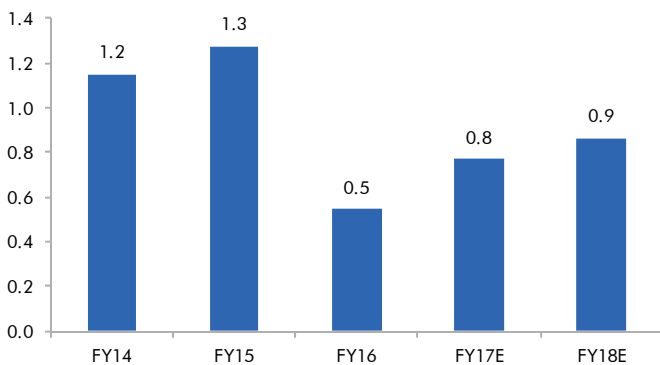
Source: Company, Angel Research;

Exhibit 15: NIM Trend (%)



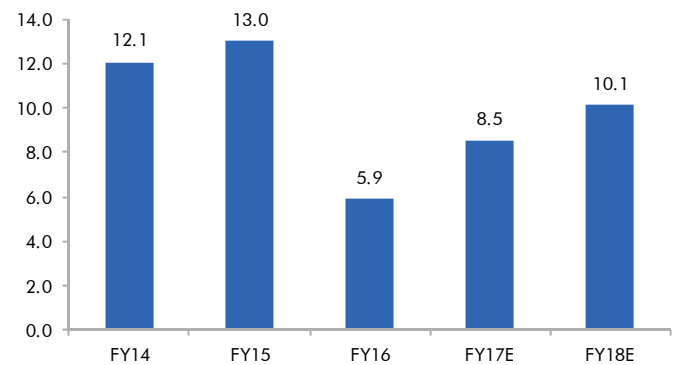
Source: Company, Angel Research

Exhibit 16: ROA (%)



Source: Company, Angel Research;

Exhibit 17: ROE (%)



Source: Company, Angel Research

Outlook and valuation

Federal Bank has already recognized large part of the troubled assets as NPAs. While there could be incrementally some degree of stress on the SME book, we believe gradually there should be overall improvement in the asset quality, backed by corporate loan book. Post Q1FY17 results, when the outlook changed towards asset quality, the stock appreciated sharply; but subsequently has corrected amid concerns over slowdown and stress on the SME book. At the CMP, the stock is trading at 1.4x its FY18 Adj BV. **We upgrade the stock to BUY with a target price of ₹85.**

Income statement (Standalone)

Y/E March (₹ cr)	FY14	FY15	FY16	FY17E	FY18E
Net Interest Income	2,229	2,380	2,504	2,899	3,292
- YoY Growth (%)	12.9	6.8	5.2	15.8	13.6
Other Income	694	878	786	1,030	1,107
- YoY Growth (%)	4.4	26.6	(10.5)	31.0	7.5
Operating Income	2,922	3,259	3,291	3,929	4,399
- YoY Growth (%)	10.7	11.5	1.0	19.4	12.0
Operating Expenses	1,392	1,631	1,867	2,079	2,352
- YoY Growth (%)	18.0	17.2	14.5	11.4	13.1
Pre - Provision Profit	1,530	1,628	1,424	1,849	2,047
- YoY Growth (%)	4.9	6.4	(12.5)	29.9	10.7
Prov. & Cont.	318	107	704	739	679
- YoY Growth (%)	19.8	(66.5)	559.6	4.9	(8.1)
Profit Before Tax	1,212	1,521	720	1,111	1,368
- YoY Growth (%)	1.5	25.5	(52.7)	54.3	23.2
Prov. for Taxation	373	515	244	365	410
- as a % of PBT	4.9	38.1	(52.6)	49.5	12.5
PAT	839	1,006	476	746	958
- YoY Growth (%)	0.1	19.9	(52.7)	56.8	28.4

Balance sheet (Standalone)

Y/E March (₹ cr)	FY14	FY15	FY16	FY17E	FY18E
Share Capital	171	171	344	344	344
Reserve & Surplus	6,780	7,567	7,747	8,405	9,123
Net Worth	6,951	7,738	8,091	8,749	9,467
Deposits	59,731	70,825	79,172	89,777	1,03,987
- Growth (%)	3.7	18.6	11.8	13.4	15.8
Borrowings	5,688	2,308	2,177	1,796	3,120
Other Liab. & Prov.	2,224	1,979	1,991	2,461	2,164
Total Liabilities	74,594	82,850	91,430	1,02,782	1,18,738
Cash Balances	3,104	3,380	3,775	4,040	4,679
Bank Balances	1,425	1,400	1,645	1,796	2,080
Investments	24,118	20,569	22,217	23,342	25,997
Advances	43,436	51,285	58,090	68,600	80,253
- Growth (%)	(1)	18	13	18	17
Fixed Assets	425	467	520	515	530
Other Assets	2,086	5,750	5,183	4,489	5,199
Total Assets	74,594	82,850	91,430	1,02,782	1,18,738
- Growth (%)	5.0	11.1	10.4	12.4	15.5

Ratio analysis (Standalone)

Y/E March	FY14	FY15	FY16	FY17E	FY18E
Profitability ratios (%)					
NIMs	3.1	3.0	2.9	3.0	3.0
Cost to Income Ratio	47.6	50.0	56.7	52.9	53.5
RoA	1.2	1.3	0.5	0.8	0.9
RoE	12.1	13.0	5.9	8.5	10.1
B/S ratios (%)					
CASA Ratio	30.8	30.4	32.5	34.0	35.0
Credit/Deposit Ratio	72.7	72.4	73.4	76.4	77.2
CAR	15.3	15.5	13.9	13.2	12.4
- Tier I	14.6	14.8	13.4	12.7	11.9
Asset Quality (%)					
Gross NPAs	2.70	2.04	2.84	2.73	2.15
Net NPAs	0.74	0.73	1.64	1.49	1.10
Slippages	1.14	1.82	3.62	2.07	1.55
Loan Loss Prov. /Avg. Assets	0.7	0.2	1.2	1.1	0.8
Provision Coverage	83.4	84.7	72.2	70.4	64.7
Per Share Data (₹)					
EPS	9.8	11.7	2.8	4.3	5.6
BVPS	81.3	90.3	47.1	50.9	55.1
ABVPS	77.5	86.0	41.5	45.2	49.9
DPS	1.0	1.1	0.7	1.1	1.3
Valuation Ratios					
PER (x)	7.1	6.0	25.3	16.1	12.6
P/ABVPS (x)	0.9	0.8	1.7	1.5	1.4
Dividend Yield	1.4	1.6	1.0	1.6	1.9
DuPont Analysis					
Interest Income	9.5	9.4	8.9	8.5	8.1
Interest Expenses	6.5	6.4	6.0	5.5	5.1
NII	3.1	3.0	2.9	3.0	3.0
Non Interest Income	1.0	1.1	0.9	1.1	1.0
Total Revenues	4.0	4.1	3.8	4.0	4.0
Operating Cost	1.9	2.1	2.1	2.1	2.1
PPP	2.1	2.1	1.6	1.9	1.8
Total Provisions	0.4	0.1	0.8	0.8	0.6
PreTax Profit	1.7	1.9	0.8	1.1	1.2
Tax	0.5	0.7	0.3	0.4	0.4
ROA	1.2	1.3	0.5	0.8	0.9
Leverage	10.5	10.2	10.8	11.1	11.7
RoE (%)	12.1	13.0	5.9	8.5	10.1

Research Team Tel: 022 - 39357800

 E-mail: research@angelbroking.com

 Website: www.angelbroking.com

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Federal Bank

1. Financial interest of research analyst or Angel or his Associate or his relative	No
2. Ownership of 1% or more of the stock by research analyst or Angel or associates or relatives	No
3. Served as an officer, director or employee of the company covered under Research	No
4. Broking relationship with company covered under Research	No

Ratings (Based on expected returns over 12 months investment period):

Buy (> 15%)

Accumulate (5% to 15%)
Reduce (-5% to -15%)

Neutral (-5 to 5%)
Sell (< -15)