KEYNOTE

Federal Bank Ltd.

17th April 2023

Empowering Progress: Fueling Growth through Digital Partnerships

Established in 1931 as 'Travancore Federal Bank', the Bank was renamed 'Federal Bank Limited (FBL)' in 1949 and became a scheduled commercial Bank in 1970. Over the years, the Bank grew steadily and expanded its operations beyond Kerala to other parts of India. FBL is evolving into a more prolific franchise driven by its impressive balance sheet size, quality growth trajectory, extensive pan-India presence, unique branch light distribution heavy model, and strategic digital/fintech partnerships. The Bank's fintech strategy is yielding incremental benefits, including higher deposit growth, cost control, and improved fee income. In 9MFY23, the Bank showcased an all-around performance with strong growth in the loan book. In the last four quarters, there has been an improvement in the cost-to-income ratio, which, coupled with the improvement in asset quality, resulted in the highest-ever profit. This translates into an improvement in return ratios. We believe FBL will maintain its performance going forward. We initiate coverage on Federal Bank Ltd. with a BUY rating and a target price of Rs. 164 (1.5x FY24 Adj. Book Value).

Loan growth to drive earnings, leading to improvement in return ratios

In the last decade, FBL grew its loan book at a CAGR of 14% from FY12 to FY22, while the PAT has grown at a slower rate of 9%. The low growth in PAT is due to increased cost-to-income ratio and provisions over the years. While in the 9MFY23, there was a significant rise in earnings growing at 56% Y-o-Y. This growth is driven by strong growth in loan book growing at 19% Y-o-Y in 9MFY23. Going forward, the Bank has guided to increase loan book by 18-20%, maintaining a NIM margin of 3.35-3.40%, improving the cost-to-income ratio, and improving provisions. All these factors will lead to better asset quality and higher growth in earnings and return ratios.

Increasing pan India presence

Mr. Shyam Srinivasan took over as MD & CEO of the Bank in Sep 2010, and his key focus area was to increase the brand visibility outside Kerala. He spearheaded this strategy of pan-India presence over FY10-22. The Bank added 610 branches, of which 66% were opened outside Kerala (as of FY22 1282 branches). FBL aims to add 80-100 branches every year over the next three years. Most of these new branches will be established outside the Kerala region.

Digital/ Fintech partnership to drive growth

The Bank is continuously leveraging its fintech partnership to enhance its reach and attract new clients who have traditionally not been the Bank's clients. FBL has been aggressive in fintech partnerships, resulting in increased loan growth and an expanded customer base. The Bank has indicated that it will continue to expand its partnerships to boost loan growth. The Bank will adopt a hyper-personalized approach to cater to the individual needs of its customers.

View & Valuation

We initiate coverage on Federal Bank with a BUY rating and a target price of Rs. 164 (1.5x FY24 Adj. Book Value). We believe that FBL is set to grow its loan book at 18-20% with stable NIM of 3.35%. Improvement in the cost-to-income ratio and provision will lead to the normalization of asset quality. All these factors will improve profitability growth, leading to improved return ratios.

BUY

CMP Rs. 131.3

TARGET Rs. 164 (+24.9%)

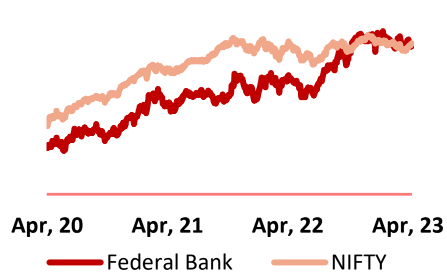
Company Data

MCAP (Rs. Mn)	2,81,984
O/S Shares (Mn)	2,115
52w High/Low	143 / 82
Face Value (in Rs.)	2
Liquidity (3M) (Rs. Mn)	1508

Shareholding Pattern %

	Dec 22	Sep 22	Jun 22
Promoters	0.0	0.0	00
FIIs	27.72	26.39	26.20
DIIs	42.33	44.22	42.12
Non-Institutional	29.97	29.39	31.68

Federal Bank vs. Nifty



Source: Keynote Capitals Ltd.

Key Financial Data

(Rs Mn)	FY22	FY23E	FY24E
NII	59,620	76,152	85,928
PPOP	37,579	51,916	59,819
Net Profit	18,898	32,232	37,610
Advances	14,49,283	17,74,800	20,94,264
ROE (%)	10.1%	15.1%	15.4%
ROA (%)	0.9%	1.2%	1.2%

Source: Company, Keynote Capitals Ltd.

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Banking Sector

The Reserve Bank of India (RBI) regulates and supervises the banking sector. Over the years, the banking sector has undergone several reforms to promote a diversified, efficient, and competitive financial market. Some reforms are

- Merging public sector banks
- Introducing the Prompt Corrective Action (PCA) framework
- Refining supervisory practices
- Tightening risk weights/provisioning norms (for sectors witnessing high credit growth)
- Mandating best international practices and norms such as Basel III
- Issuing guidelines to deal with overall asset-liability mismatches

These measures have strengthened the banking system, increased depositors' confidence, and aided financial stability.

Over the past decade, financial inclusion has been one of the Government's and banks' key priorities. Pradhan Mantri Jan Dhan Yojana (PMJDY), launched in August 2014, aims to ensure affordable access to financial services. As on March 31, 2022, 450 Mn PMJDY accounts had been opened.

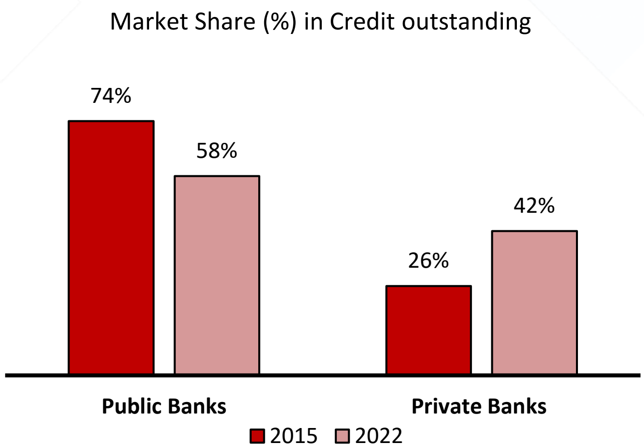
In FY21, to deal with the impact of the pandemic, the government and the RBI took several initiatives to provide relief to borrowers. The crucial initiatives included the Emergency Credit Line Guarantee Scheme (ECLGS), the provision of a loan moratorium, and the option to restructure corporates, MSMEs, and retail loans under the restructuring framework (One-time restructuring OTR 1.0 and 2.0).

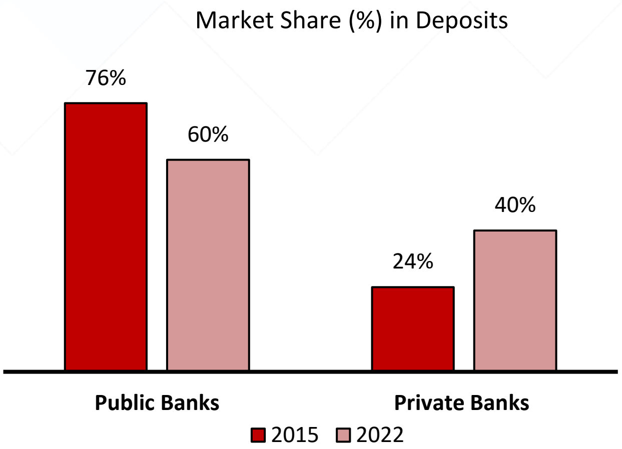
After nine years, the industry is seeing a sign of strength in loan growth, which grew at 15.5% YoY in Feb'23. The credit growth is expected to remain strong, led by continued traction in the Retail and SME segment. The Corporate segment is also reviving due to improved working capital requirements.

Industry Trends

Private Banks gaining market share

Traditionally, Public Sector Banks (PSUs) have accounted for most of the banking credit outstanding and deposits. However, in the past few years, low profitability, weak capital position, low operational efficiency, and increased stressed loans led to a slowdown in their loan growth. As a result, private banks gained market share, which were relatively well-capitalized and had a higher degree of operational efficiency.





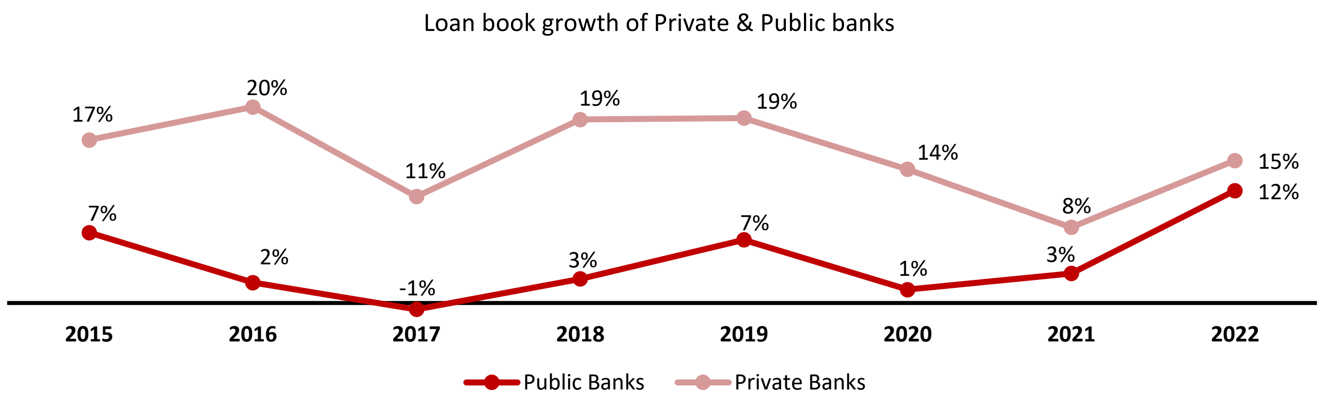
Source: RBI, Keynote Capitals Ltd.

Loan growth to accelerate

In FY22, loan book (all Banks) grew by 11.5% on a YoY basis due to pent-up demand and normalization in the economy. Due to the COVID impact in FY21, the Indian economy witnessed the sharpest contraction. However, it bounced back swiftly, and the loan growth accelerated to ~15.5% YoY in 11MFY23.

Credit growth has generally been trending upward throughout FY23. It is expected to be in the mid-teens, driven by the retail and agriculture segments and supported by a recovery in services and industrial credit. The recovery will be led by private sector banks, which are expected to grow at a higher rate, 15-17%, leading to further market share gains.

Corporate sector profitability has improved in the last few years, leading to the companies' de-leveraged balance sheets. As we advance, we will see a new leg of the investment cycle.



Source: RBI, Keynote Capitals Ltd.

Asset quality of banks to improve steadily

Post FY18, the Government and the RBI took various measures to restrain the deterioration in asset quality. As we advance, the overall asset quality of banks continues to improve steadily.

Asset Quality									
Particulars	All Banks			Public Banks			Private Banks		
	GNPA	NNPA	PCR	GNPA	NNPA	PCR	GNPA	NNPA	PCR
FY18	11.6%	6.1%	48.1%	15.6%	8.6%	47.1%	4.0%	2.0%	51.0%
FY19	9.3%	3.8%	60.6%	12.6%	5.2%	60.8%	3.7%	1.6%	57.0%
FY20	8.4%	2.9%	66.2%	10.8%	4.0%	64.2%	5.1%	1.4%	72.6%
FY21	7.4%	2.4%	68.9%	9.5%	3.1%	68.4%	4.8%	1.5%	70.0%
FY22	5.9%	1.7%	70.9%	7.6%	2.3%	69.5%	3.7%	1.0%	74.7%

Note: GNPA – Gross Non-Performing Asset; NNPA – Net Non-Performing Asset; PCR – Provision Coverage Ratio

Source: RBI, Keynote Capitals Ltd.

With better recoveries across the segments, especially in the industrial and agriculture segment, asset quality in the banking sector started improving. GNPAs of all Banks have improved from a high of ~12% in FY18 to ~6% in FY22; PCR has also increased from ~48% to ~71%. While Private Banks are comparatively doing better than the industry, the GNPAs have remained in the range of 3-5% between FY18-22, and they have significantly improved the provision coverage ratio, which reduces the risk of asset quality deterioration. We expect the improvement in asset quality across lenders to continue.

The banking sector is well-placed

The Indian banking system is well positioned to support economic growth, with bank credit growing double-digits after a long hiatus and GNPAs of all Banks declining to their lowest level in last six years. A new leg of the investment cycle led by improving trends in capacity utilization and rapid expansion of credit aided by new loan accounts in the industrial and service sector will drive growth opportunities.

About Federal Bank Ltd.

Federal Bank Ltd. (FBL) is a private-sector commercial Bank in India. It was established in 1931 and was initially called the Travancore Federal Bank. In 1944, the Bank was acquired by a group of entrepreneurs led by a young 28-year-old lawyer, Shri K.P. Hormis. The Bank's initial focus was to cater to the banking needs of the local business community of Kerala. The Bank grew steadily over the years and expanded its operations beyond Kerala to other parts of India. In 1947, the Bank became a scheduled commercial bank and was granted a banking license under the Banking Companies Act of 1949. Under the visionary leadership of Shri K.P. Hormis, the Bank rapidly expanded its operations and grew from a single-branch to a 285-branch Bank by the time he retired in 1979.

From the 1980s to 2000, the Bank crossed deposits of Rs. 35 Bn, roped in ICICI group as a shareholder through private placement, and tapped the capital market with a public issue in March 1994. The size of the balance sheet exceeded Rs. 110 Bn, and inaugurated the 400th branch in 1999.

From 2000 onwards, the Bank commenced internet banking with software support from Infosys technologies and started anywhere banking in Bangalore, connecting all branches; all the branches were fully computerized, introducing real-time transaction alerts, which are first-of-its-kind services among traditional banks in India. In 2004, the Bank launched co-branded credit cards with ICICI Bank. FBL become the first Bank in India to implement a Real-Time Gross Settlement (RTGS) facility in all its branches.

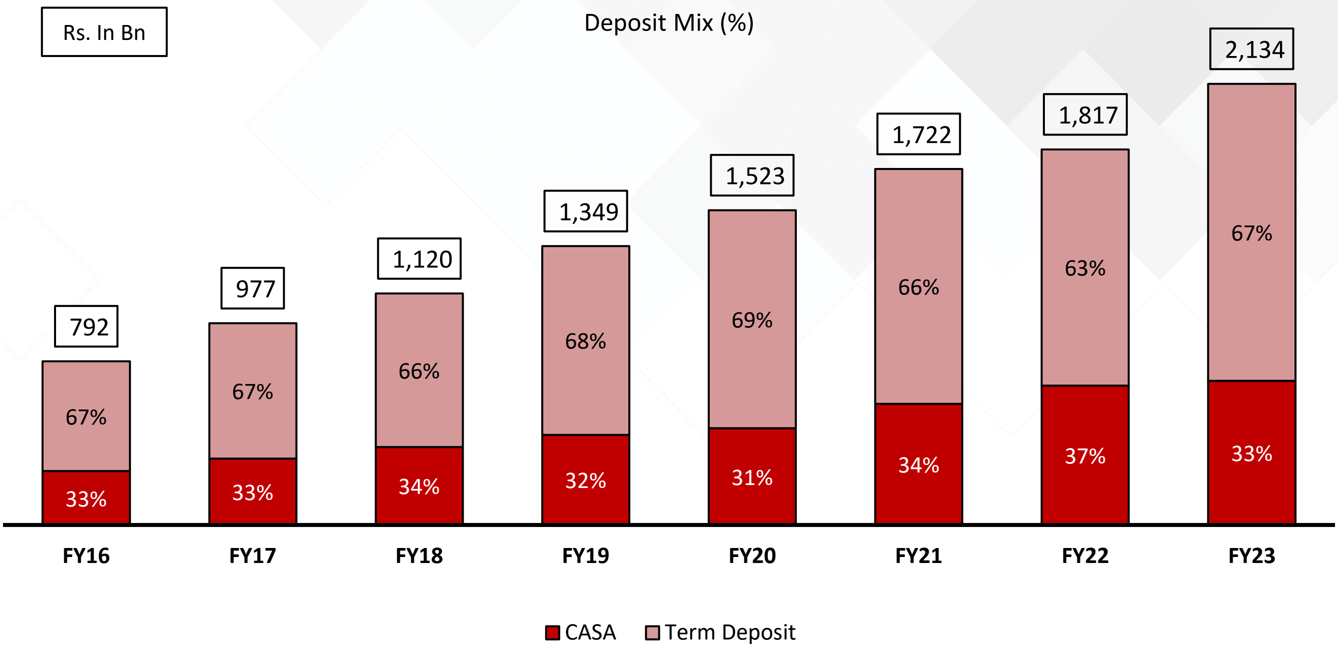
In 2006 the Bank crossed 500 branches, and in 2007 Bank formed a centralized processing center for centralizing the account opening process to make it quick and efficient, leading to cross a loan book size of Rs. 25 Bn in 2009.

Mr. Shyam Srinivasan's appointment as the MD and CEO in 2010 marked the beginning of a progressive growth phase for the Bank. Over the next five years, FBL embarked on an ambitious expansion drive, emphasizing broadening its reach beyond Kerala. The number of branches doubled from 672 to 1,247, and the employee count increased significantly to support this growth. The expansion led to an increase in the Bank's cost-to-income ratio. FBL took steps to tighten its lending norms and realign its business mix to mitigate any negative impact on profitability.

Over time, the Bank has expanded its footprint in regions such as Gujarat, Tamil Nadu, Maharashtra, Karnataka, and certain parts of Uttar Pradesh. As evidenced by its loan mix across different geographies, the Bank is no longer solely focused on Kerala. The non-Kerala portfolio has experienced rapid growth due to its small base, with a CAGR of 24% compared to a 15% CAGR in Kerala between FY10-15.

In the following years, the Bank invested in people and processes and put many building blocks in place. FBL has invested in building the relationship manager (RM) team to grow in each segment depending on the opportunity, be it retail/ SME/ corporate.

FBL – Granular & retail focused liability mix



Source: Company, Keynote Capitals Ltd.

FBL has a retail-focused deposit franchise that ranks among the top quartile and is characterized by high granularity. As of 9MFY23, ~77% of the total deposits were granular (deposits < Rs. 10 Mn). CASA and retail term deposits (TD) represent ~88% of total deposits. In 9MFY23, the retail deposit constituted 90% of the total deposits, with 62% being from Kerala.

Current Account (CA) and Savings Account (SA) (CASA) – CASA is a function of the money supply and phases of the economy. CA is the cheapest form of borrowing, while SA is the second most. CASA has been the preferred form of deposit for the Bank. It has raised the CASA ratio from ~ 32% in FY19 to ~33% in FY23.

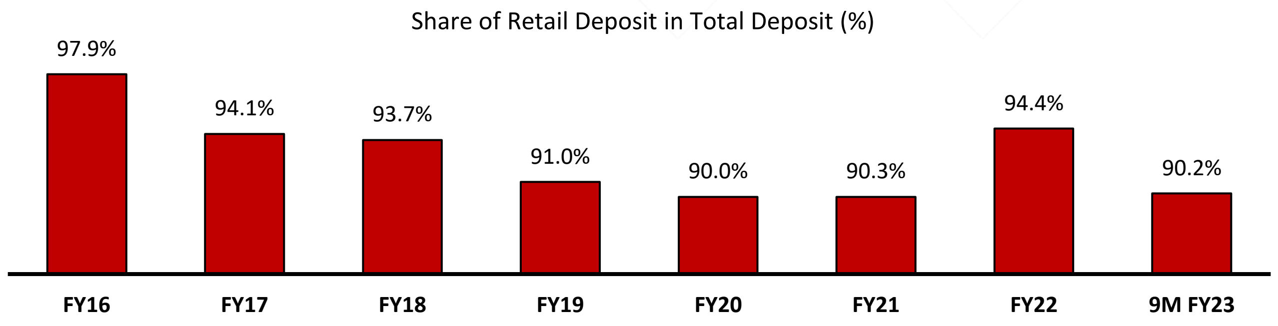
The split between premium (SA balance more than Rs. 1,50,000) and non-premium used to be 50:50 as of Dec '19. With the advent of the Bank's HNI relationship growing 1.5 times in the past three years, the ratio has changed to 62:38, favoring premium customers. The Bank's debit card spending have grown at ~13% CAGR in the past three years to reach ~Rs. 13 Bn for 12 months ending Dec '22. In the said year, the Bank outperformed the industry by ~18% and the top 5 private banks by ~16% in terms of debit card spending and amassed ~5% market share. Customers using debit cards are favorable for the Bank as they maintain a balance twice the average monthly balance of an active user.

The savings accounts contributed by fintech partners have grown by ~20 times, and their CASA balance has increased ~17 times over the past two years.

The management has steered the Bank remarkably towards Digital and new-age methods of operations. This can be ascertained because Digital, which contributed ~11% of SA onboarding in FY19, now accounts for ~96% in 9M FY23.

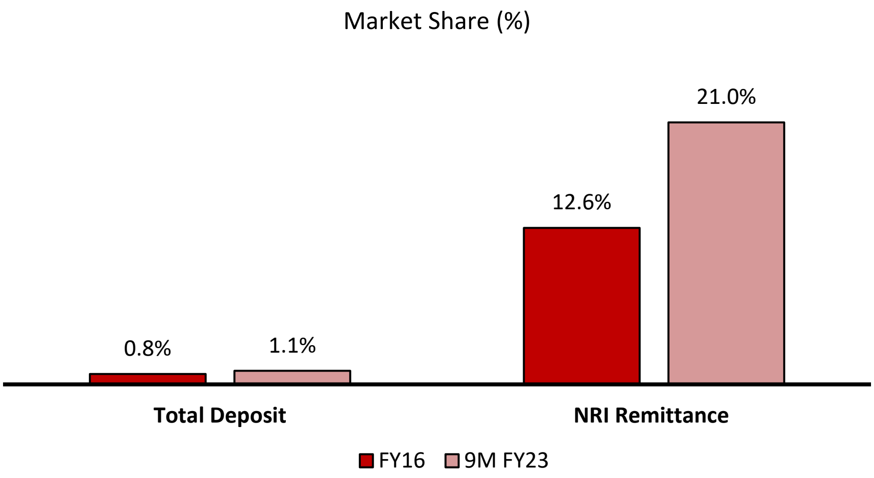
Over the recent years, the Bank has formed fintech partnerships with more than 75 fintech companies for several different business operations, one of which being liability origination. The Bank has guided that the fintech partnerships with Fi and Jupiter will be responsible for 25% of the incremental growth in deposits. For 9MFY23, they've performed to open around ~8,000-15,000 accounts per day. These customers are salaried millennials who are digitally native for their financial activities like savings, investing, and borrowing. However, they tend to maintain balances lower than normal. FBL, organically and via its two fintech partnerships, is able to convert ~18,000 customers daily.

Moreover, the fintech partnership was responsible for 10% of incremental growth in term deposit and 19% for SA.



Source: Company, Keynote Capitals Ltd.

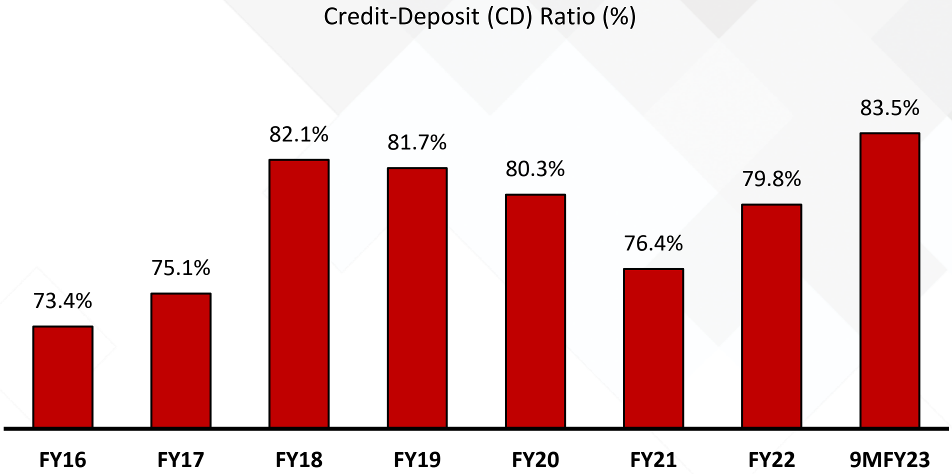
The Bank leads the inward remittances sent by Non-Resident Indians (NRI) to India with ~21% market share in 9MFY23. In NRI deposits, the Bank has ~7% market share.



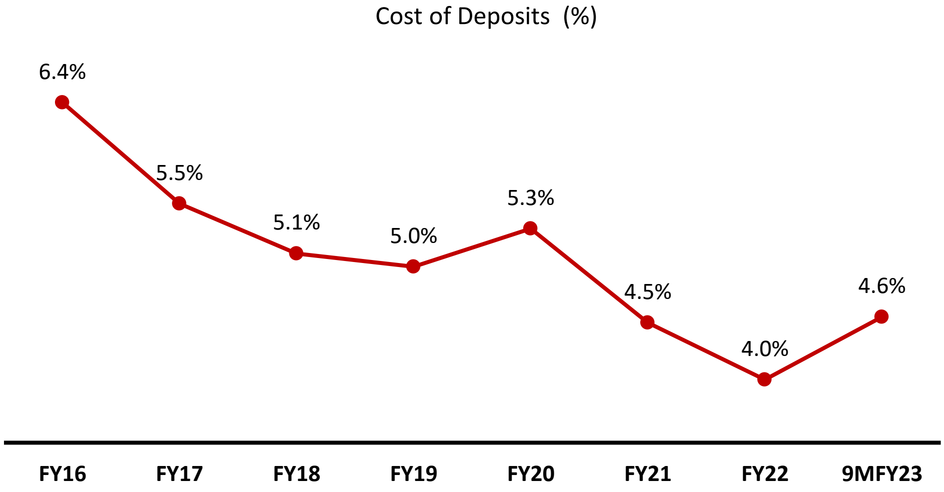
Source: Company, Keynote Capitals Ltd.

Term Deposit (TD) – TD, the most expensive deposit form, accounted for ~ 67% in FY23.

The growth drivers for deposit are fintech partnerships, growth in non-Kerela states, and adding 80-100 branches every year by 2025. The deposit book is guided to reach a 39% CASA ratio from the current 34% in Q3FY23.

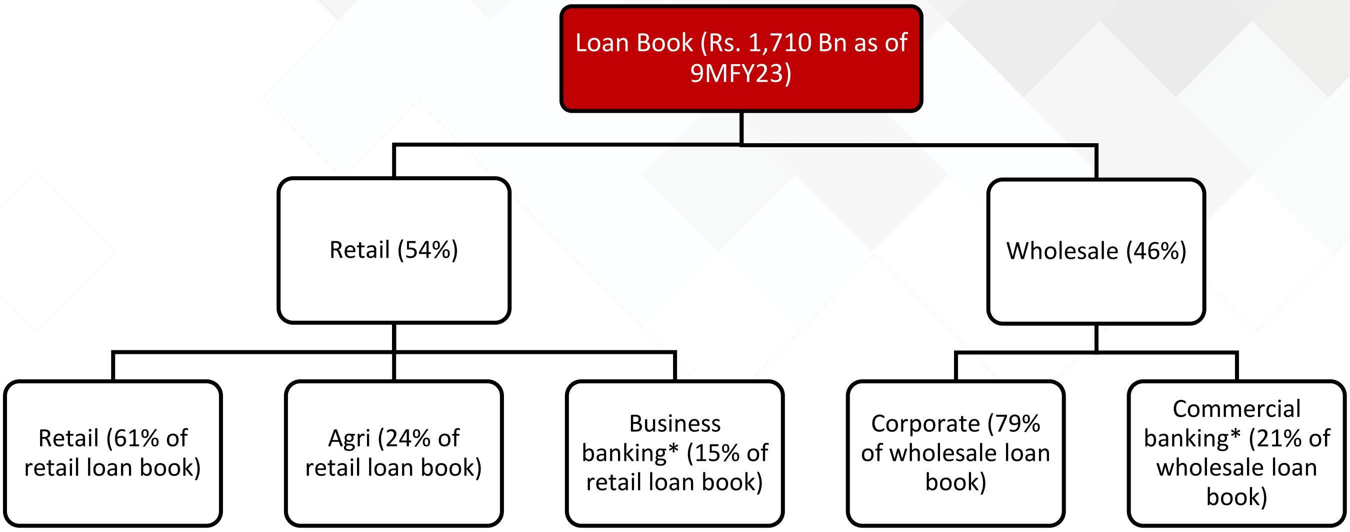


Source: Company, Keynote Capitals Ltd.



Source: Company, Keynote Capitals Ltd.

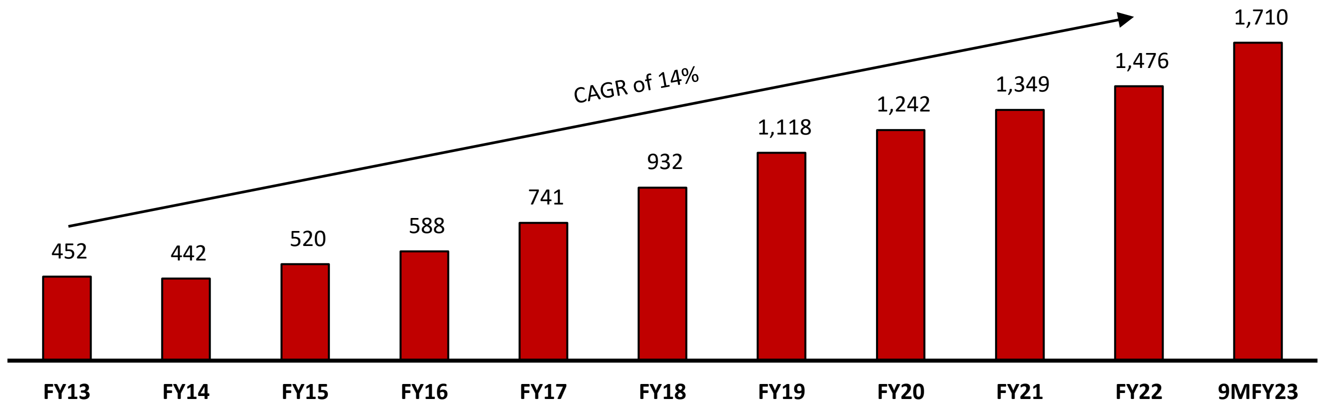
Loan Book – Well-diversified loan mix



Source: Company, Keynote Capitals Ltd.

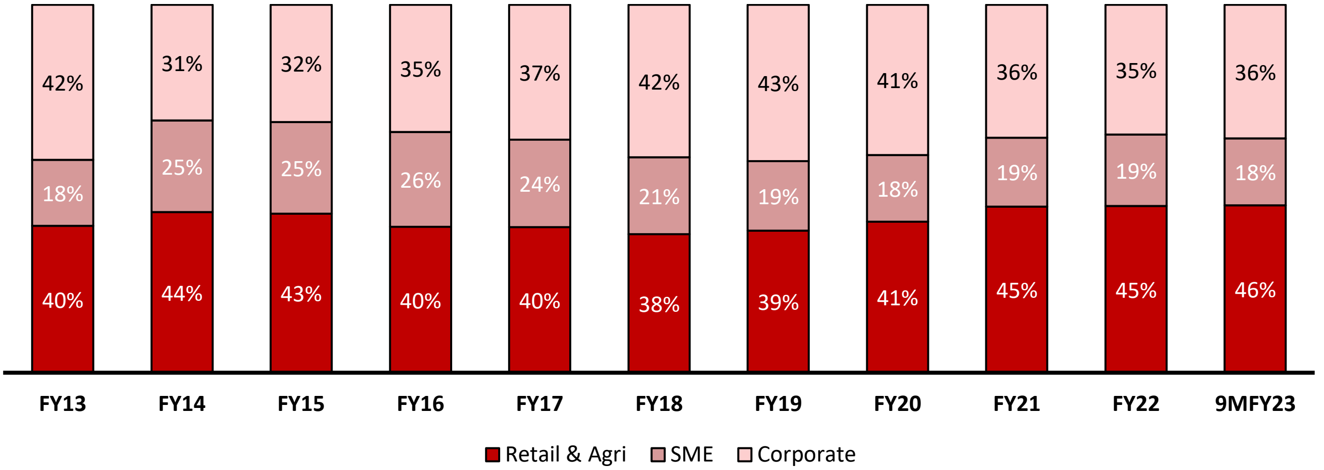
*Note: * Business banking & Commercial banking forms the SME segment*

Loan Book (Rs. Bn)



Source: Company, Keynote Capitals Ltd.

Change in loan mix (%)

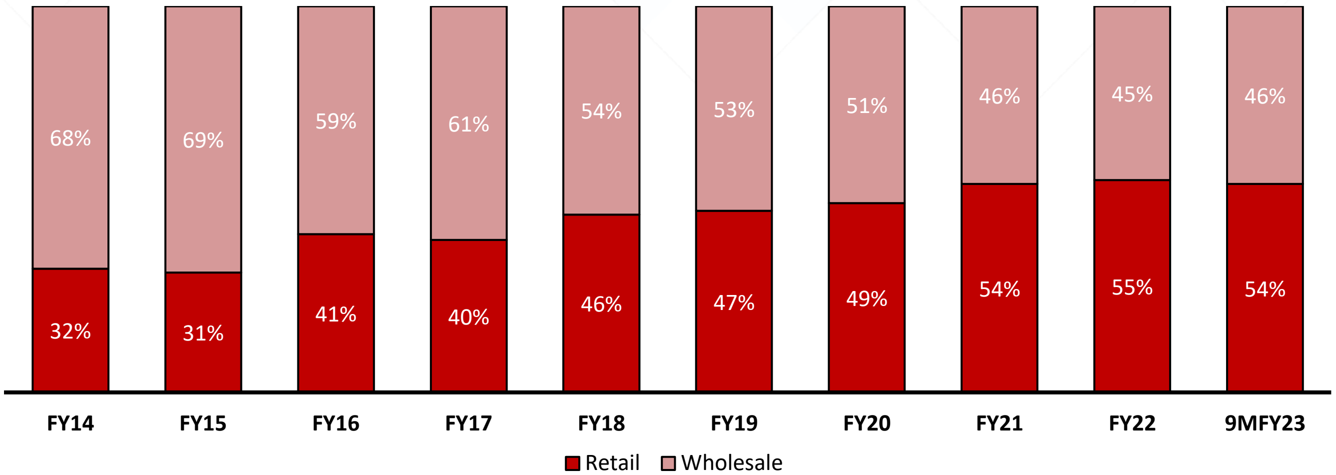


Source: Company, Keynote Capitals Ltd.

Shift towards non-corporate segments

Prior to the restructuring in FY12, FBL's loan book was majorly driven by a highly volatile corporate book. The higher concentration of the large corporate segment and the deterioration in asset quality significantly impacted the Bank's risk profile. Thereafter, the Bank went through a consolidation phase from FY12 to FY14 and changed its business mix by increasing the share of retail and SME segments to mitigate the risks arising from the large corporate segment.

Loan book mix (%)



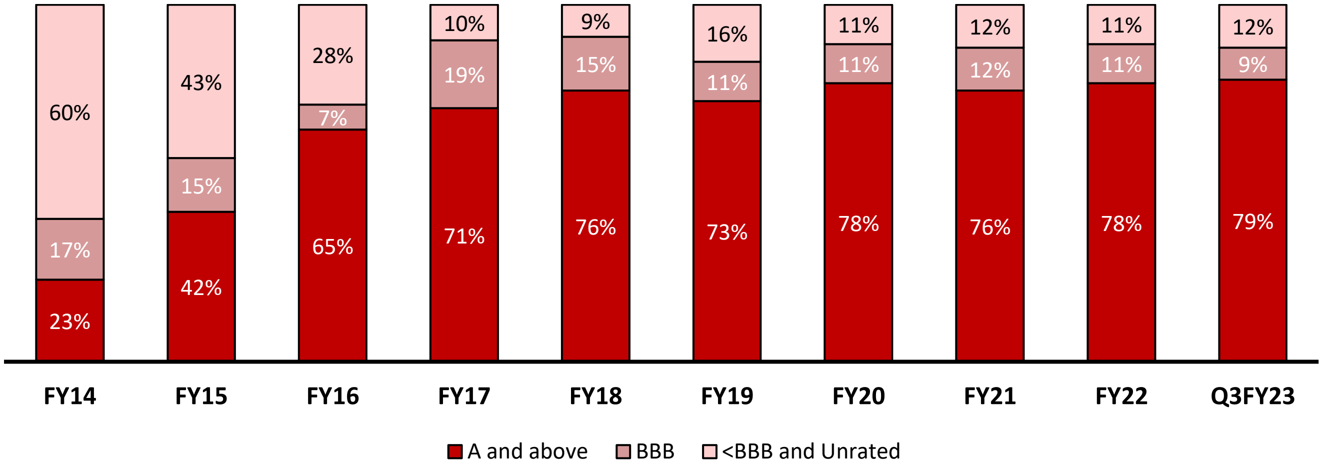
Source: Company, Keynote Capitals Ltd.

Corporate Loan Segment

Any loan above Rs. 250 Mn qualifies as a corporate loan, and this segment contributes 36% to total credit as of 9MFY23. Since FY17, the Bank has embarked on a journey of risk-adjusted profitable growth.

The Bank targets high-rated clients, which is visible from the expansion of A & above-rated portfolio, which used to be 23% of the mix in FY14 and later increased to 79% in Q3FY23.

Increasing A and above corporate loan mix (%) risk rating



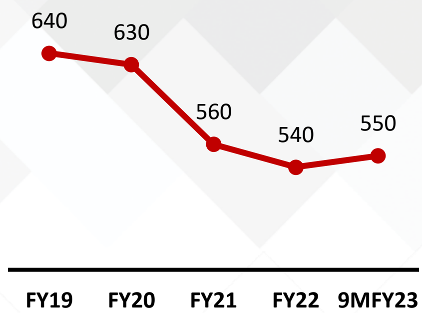
Source: Company, Keynote Capitals Ltd.

FBL has identified a favourable niche market in the corporate and mid-corporate sectors, where certain geographic areas present challenges for larger public sector banks to lend.

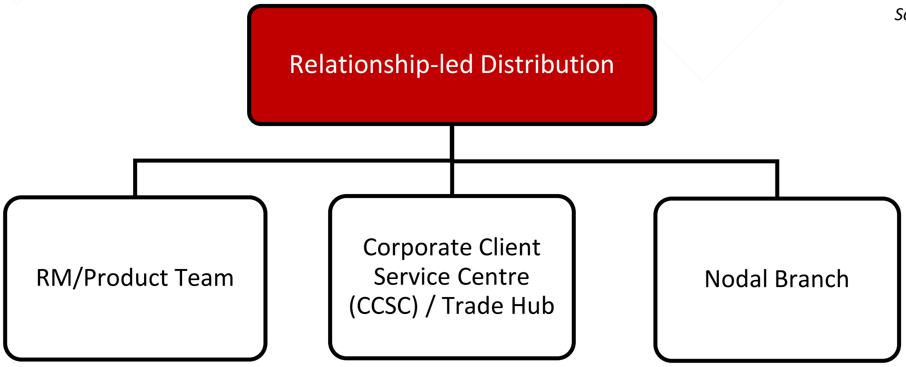
The Bank has transitioned from a self-originating approach to a relationship-based wholesale banking model, strengthening existing relationships and acquiring new clients. Additionally, FBL has made consistent efforts to granularize the loan book.

The Bank also anticipates an increase in the share of commercial banking in its wholesale banking book and plans to capitalize on cross-selling opportunities in this segment, which remain largely untapped.

Granular Ticket Size - Corporate loan book (Rs. Mn)



Source: Company, Keynote Capitals Ltd.



Source: Company, Keynote Capitals Ltd.

SME loan segment

The SME segment for FBL can be defined as loans having a ticket size of Rs. 50 -250 Mn. The Bank portfolio from Kerala contributed 56% in FY16, which has been coming down Y-o-Y with management's endeavor to grow the segment outside Kerala, owing to slow growth in the state and desired improvement of the portfolio's credit quality. The Non-Kerala SME loan segment is growing upwards of 20%, which contributed 54% in FY20 compared to 44% in FY16.

The SME segment contributes 18% of the loan book in 9MFY23, which grew at 15% CAGR from FY13 to FY22. Since Q1FY19, the SME segment has been bifurcated into commercial and business banking.

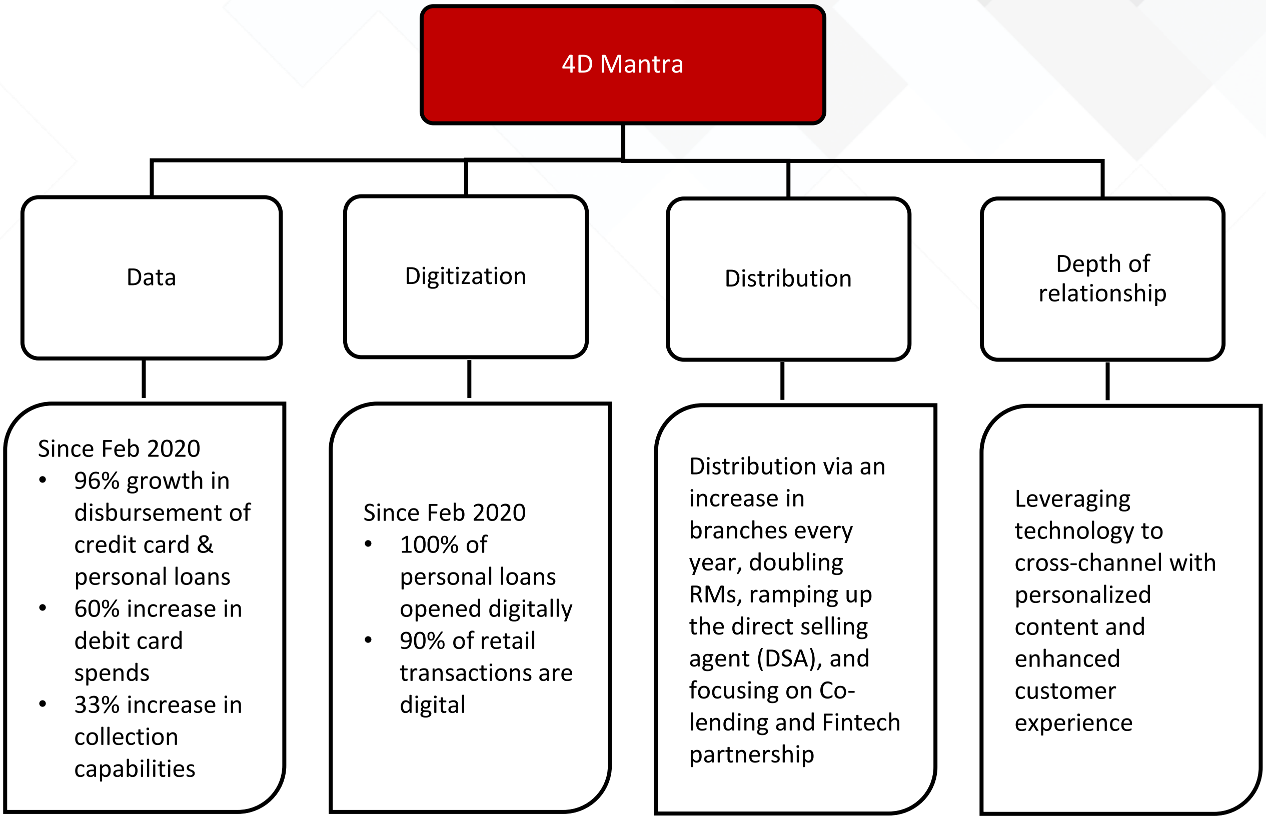
The Bank expects a huge opportunity in the business banking space, which has an untapped market potential of Rs. 36 Trn; out of this, only 15% is through formal finance. FBL is targeting enhanced access to Tier 2 and 3 cities through digitization.

> 60% of FBL's branches are in Semi-urban and Rural areas.

FBL is committed to doubling its SME portfolio within the next three years by utilizing calibrated risk models and analytics and enhancing digital lending capabilities. This growth will be driven by a three-fold increase in the overall customer base and leveraging partnerships. In the MFI segment, the Bank holds a 0.5% market share. The Bank expects a significant uptick in market share and contributions to the Bank's RoA.

Retail loan segment

The retail segment contributed 46% of the loan book in 9MFY23, which grew at a 16% CAGR from FY13 to FY22. Going forward, the Bank has planned to embark on the '4D mantra' in retail banking.



Source: Company, Keynote Capitals Ltd.

High-margin Retail Loan Segments

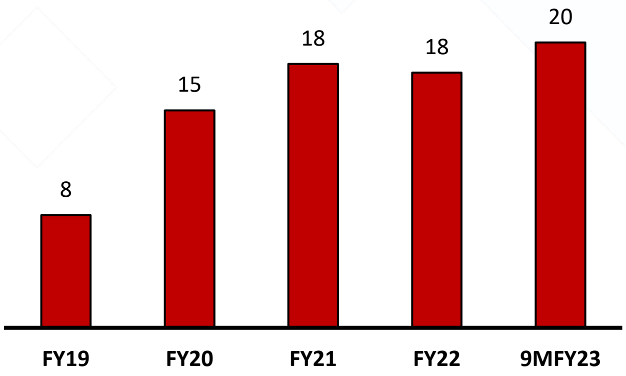
The strategy post-Covid pandemic is to increase growth by concentrating on specific high-margin segments such as credit cards, personal loans, MSME funding, commercial and construction vehicle financing, gold loans, and microfinance and additionally, expanding the customer base through a light-branch heavy distribution network and leveraging digital/ fintech partnerships.

The Bank has shifted its focus toward a higher-yielding retail loan segment, and management is expecting to double the loan book over the next 2-3 years.

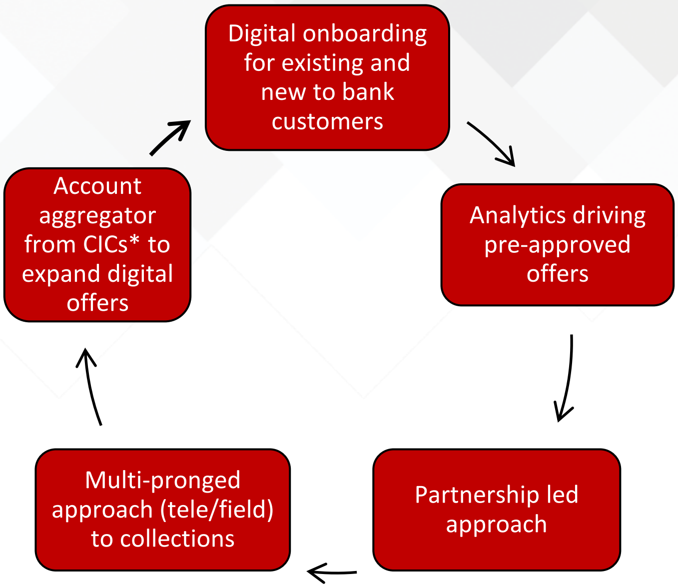
The share of the unsecured loan portfolio in the total loan book has increased from 3% in FY19 to 7% in 9MFY23.

Personal Loan: The target customer has been so far towards cross-selling to existing customers. In 9MFY23, the book size of the personal loan segment is Rs. 19.6 Bn, which is expected to double in the next two years.

Personal loan segment (Rs. Bn)



Source: Company, Keynote Capitals Ltd.



Source: Company, Keynote Capitals Ltd.

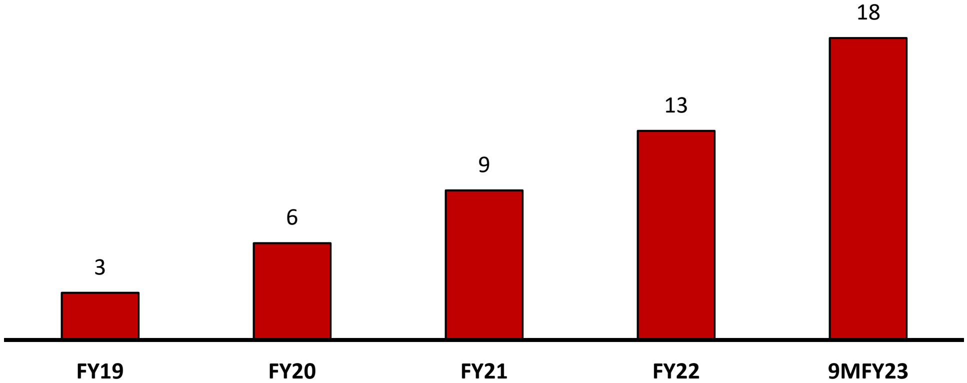
*Note: * CICs – Customer information control system*

Credit card: The Bank started a credit card business in May 2021 in partnership with One card. FBL issued 0.5 Mn CIF (Card-In-Force) as of Jan'23 and holds a 0.6% market share. The Bank intends to be the top 7 credit card player by 2024.

Commercial and construction vehicle finance (CV/ CE): The CV/ CE financing sector was adversely affected by COVID-19 as freight and cargo movement was disrupted worldwide. While the sector has regained its growth momentum, the industry is expected to grow by 14% in FY23 due to government spending on infrastructure, construction, and mining and scrappage policy, which offers a significant potential market of over 1 Mn vehicles that need replacement. FBL anticipates that CV/CE disbursements will double in FY23 due to strong on-ground demand. Similarly, the management predicts that the CV/CE book will double in the next two years. The Bank plans to adequately support its growth by leveraging its branch network and activating approximately 85% of its branches with an experienced team. The Bank has tie-ups with all major OEMs.

The portfolio is granular, with an average ticket size of Rs. <2.5 Mn.

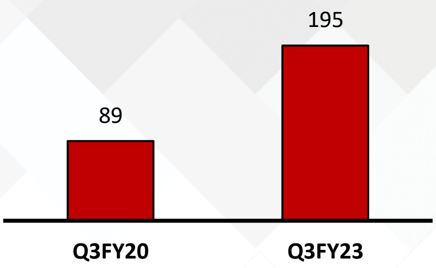
CV/ CE loan Book (Rs. Bn) has grown 4.4x over FY19 to FY22



Source: Company, Keynote Capitals Ltd.

Gold loan: Over the last three years, the gold loan portfolio has more than doubled from De'19 to Dec'22, significantly contributing to the Bank's fee income. The Bank aims to become the largest private bank engaged in gold financing and double its loan book over the next three years. To achieve this goal, FBL has devised a six-touchpoint distribution model, including expanding the number of branches offering gold loans by 25%, collaborating with fintech companies to access new customers and markets, increasing reach through co-lending, generating leads through contact centers, converting leads into sales through the sales team, and utilizing online channels.

Gold loan (Rs. Bn) portfolio up 2.2x



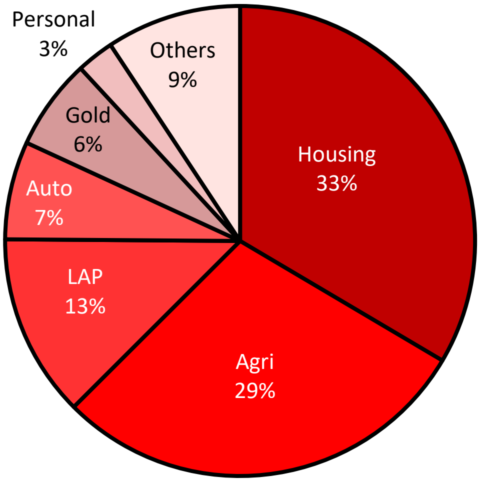
Source: Company, Keynote Capitals Ltd.

Housing loan: A housing loan is considered a low-yielding asset for the Bank and forms 33% of the retail loan book as of 9MFY23, growing at 16% CAGR from FY13 to FY22. FBL's overall market share in home loans stands at 0.92% and 5.5% among private banks as of Q3FY23.

The Bank is gaining market share in chosen geographics outside of Kerala and focusing on Metros such as:

- Mumbai – 3% incremental share in the home loan and 9% among Private banks
- Chennai – 1.5% incremental share in the home loan and 8.5% among Private banks
- Bangalore - 1.5% incremental share in the home loan and 9% among Private banks

Retail loan book mix (%) as of 9MFY23



Source: Company, Keynote Capitals Ltd.

FBL – Diversified loan book

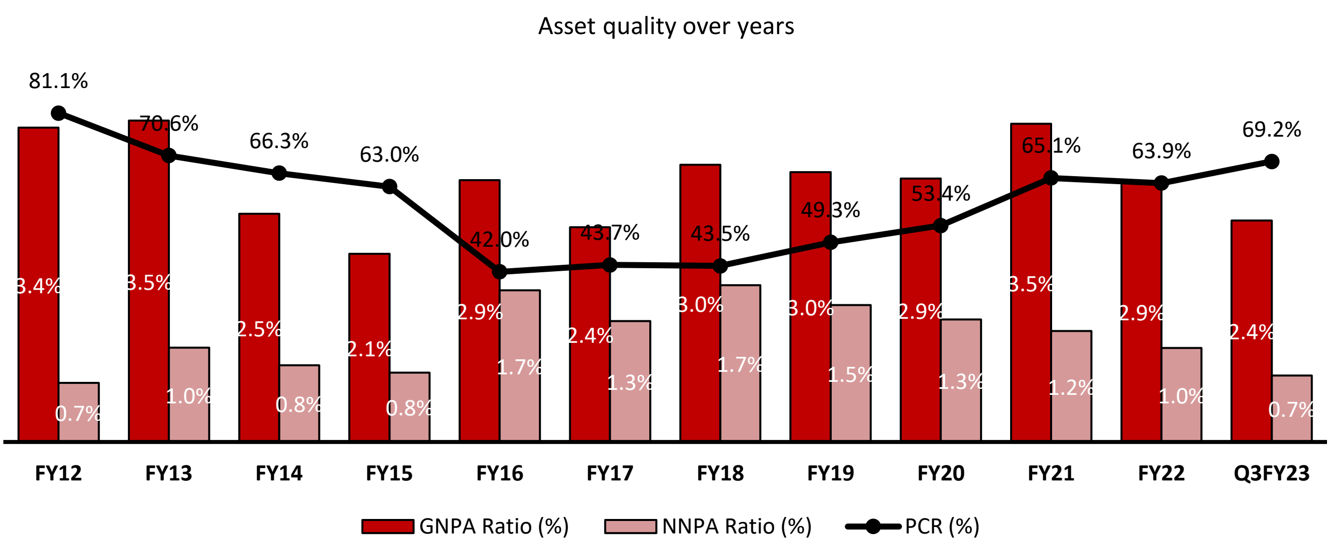
The Bank has a well-diversified advances portfolio across segments, comprising corporates (9MFY23: 36.4%; FY22: 35.3%), retail (31.5%; 32.4%), small and medium-sized enterprises (SMEs; 18.1%; 18.4%) and agriculture (12.3%; 13%). FBL expects the loan growth to be higher than the industry growth and maintain a momentum of high double-digit growth going forward. In the future, management indicates strong growth in high-yielding products, the share of which has increased from 17.4% in Q3FY20 to 20.5% in Q3FY23 and aims to double the loan book over the next three years.

Asset quality

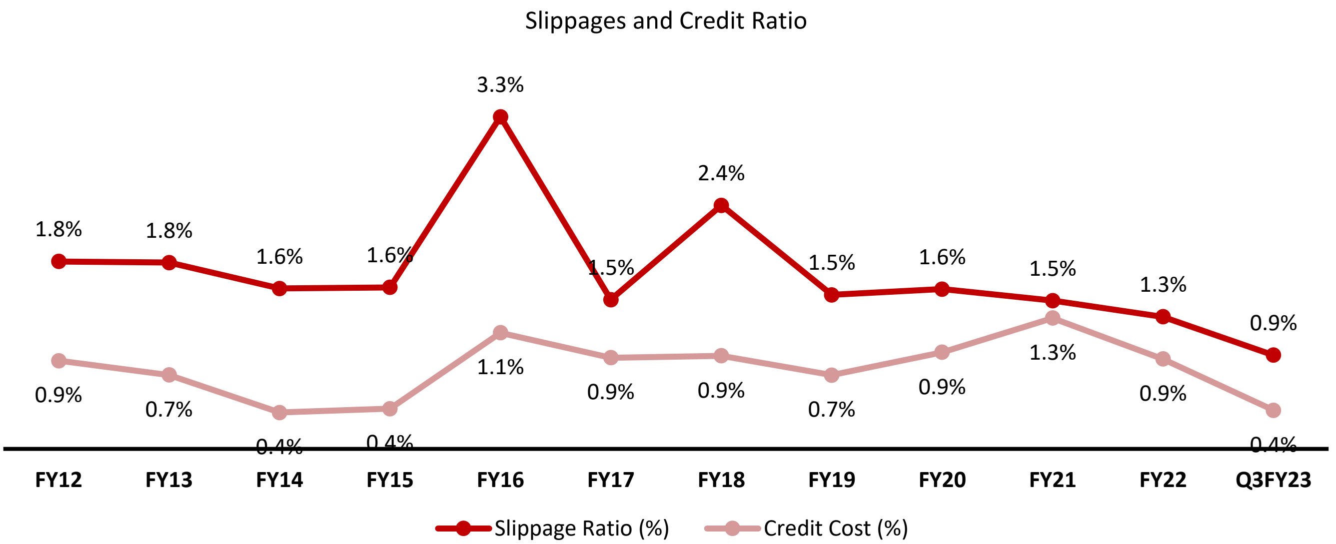
The Bank's asset quality has remained stable over the years, with GNPA ranging close to ~3% from FY12 to FY22. While NNPA has remained elevated since FY16 due to a lower PCR and increase in slippages during FY16 & FY17 mainly due to delinquencies in a corporate account, in FY18, slippages remain elevated due to the revised framework by RBI. Since FY18, the Bank PCR started improving, and in FY22 NNPA ratio improved from 1.7% in FY16 to 1.0% in FY22.

The stress test of asset quality of the Bank has seen during the period of the Covid-19 pandemic, where the Bank reported almost flattish slippages, while the GNPA ratio has increased by ~60 bps from FY21 to FY20, the NNPA ratio has improved by 13 bps due to improving in PCR ratio.

In Q3FY23, the asset quality improved further; GNPA stands at 2.4% lowest in the last 21 quarters, and PCR increased from 64% in FY22 to 69% in Q3FY23, resulting in a sharp improvement in the NNPA ratio from 1.0% in FY22 to 0.7% in Q3FY23.



Source: Company, Keynote Capitals Ltd.



Source: Company, Keynote Capitals Ltd.

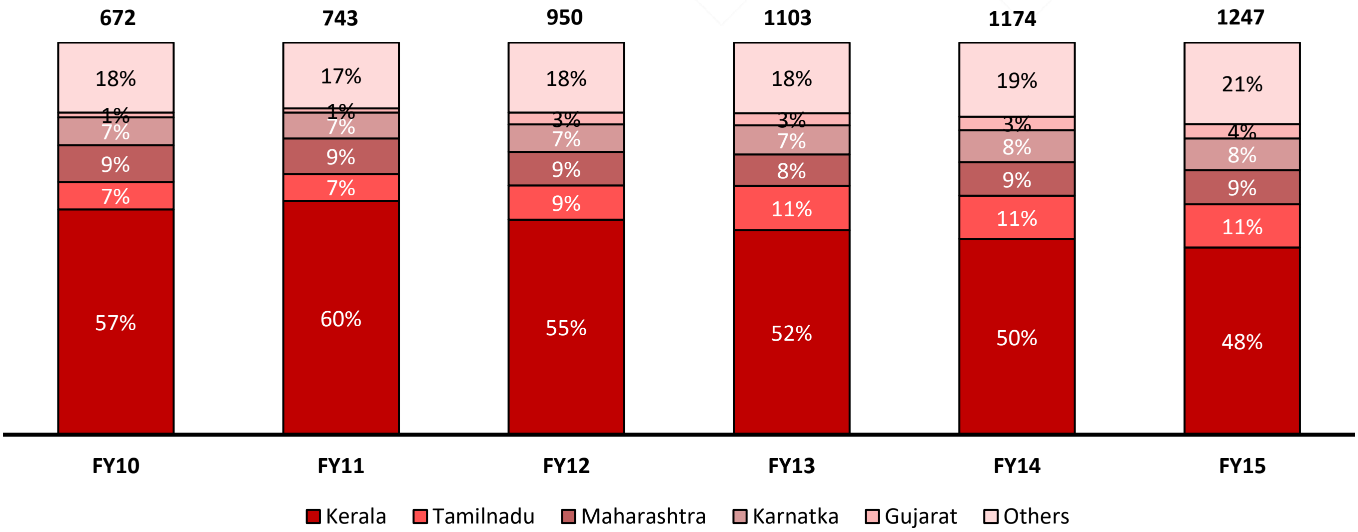
KEYNOTE

State-specific to pan India presence

Mr. Shyam Srinivasan took over as MD & CEO of the Bank in Sep 2010, and his key focus area was to increase the brand visibility outside Kerala. The Bank already has a sizeable presence in Kerala, and expanding the footprint outside Kerala will reduce concentration risk and could provide better brand visibility. He spearheaded this strategy of pan-India presence over FY10-15. The Bank added 575 branches, of which 64% were opened outside Kerala.

The Bank consciously scaled up and decided to focus on geographies like Tamilnadu, Karnataka, Maharashtra, Gujarat, Delhi, and Punjab & Haryana.

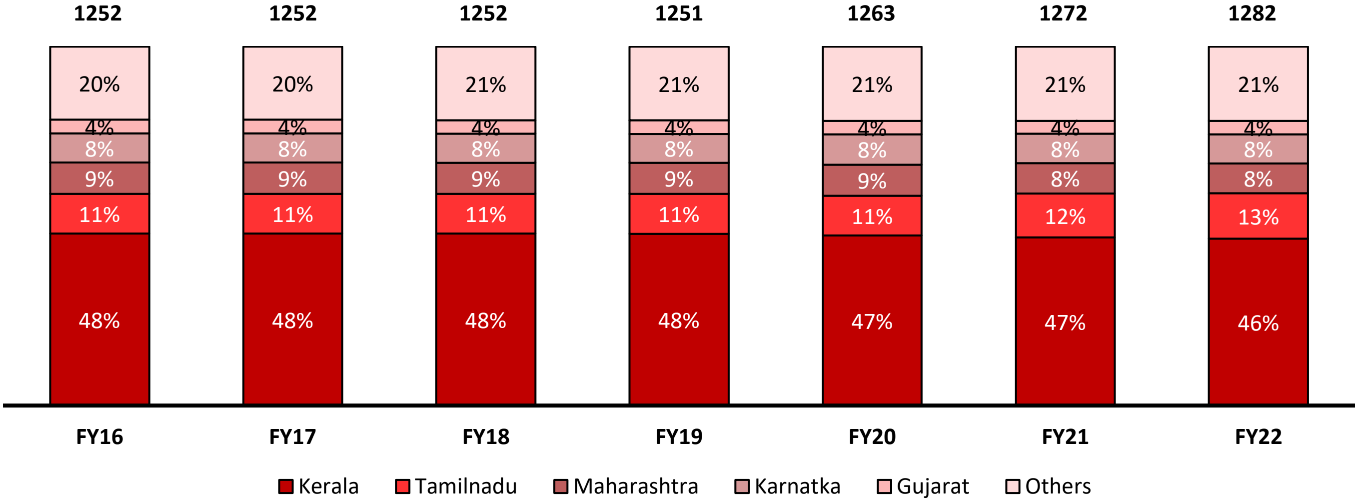
Branches increasing outside Kerala



Source: Company, Keynote Capitals Ltd.

After FY15, the Bank's focus has been shifted to get value from the expansion before they decide to expand further, and hence we can see that from FY15-22, FBL has just opened 35 new branches. At the same time, the Bank has increased its bandwidth to focus more on digital and relationship-led business structures.

Shift in focus from branch expansion to digital/ fintech and RM



Source: Company, Keynote Capitals Ltd.

FBL aims to add around 80-100 branches per year over the next three years. Most of these new branches will be established outside the Kerala region, and the Bank will select new branch locations based on the potential of high-yielding products in those areas.

During 9MFY23, the Bank opened 58 branches, and the Bank is targeting to add 75 branches in FY23. FBL plans to add another 15-17 branches in Q4FY23.

The Bank intends to have a 'Lite branch heavy distribution model' in the future, focusing on breaking even faster. It currently takes about 18 months for a new branch to become profitable.

Hired new talent to improve the underwriting process

Over the past 5-6 years, the top management has undergone a dramatic makeover with talented people from across the banking system on-boarded.

Name & Designation	Joining date	Profile
Mr. Ganesh Sankaran (Executive Director)	Sep-15	Mr. Sankaran has over 20 years of work experience in relationship and risk function and was associated with HDFC Bank before joining FBL. Mr. Sankaran has now left the bank to join Axis Bank in March 2019 as the group executive of Wholesale Banking.
Ms. Shalini Warrier (Executive Director)	Nov-15	Ms. Warrier has around 26 years of work experience and was associated with Standard Charted Bank before joining the FBL. Her responsibility is operational excellence and digital innovation. In May 2019, she took on additional responsibility as the business head of Retail Banking Products. She is currently the Executive Director of the Bank.
Mr. Harsh Dugar (Group President & Country Head - Corporate Banking)	2016	Mr. Dugar has around two decades of work experience and was associated with HDFC Bank before joining FBL. He currently heads the wholesale Banking of the bank and is a nominee director on the board of Equirus Capital Pvt. Ltd.
Mr. Sumit Kakkar (Chief Credit Officer)	Aug-16	Mr. Kakkar has over 20 years of work experience in credit underwriting of commercial and institutional lending and was associated with Yes Bank & HDFC Bank before joining FBL. Mr. Kakkar left the Bank in March 2020 to pursue other opportunities.
Mr. Divakar Dixit (EVP & Head Credit – CB, BuB, Retail and Agri)	May-17	Mr. Dixit has over 20 years of work experience in credit risk and relationship management and was associated with HDFC Bank before joining FBL. He is currently EVP and head of credit risk in commercial banking & business banking and retail segments.
Mr. Pitchai Mahalingam (SVP & Internal Auditor)	May-17	Mr. Mahalingam has work experience in Transaction banking and was associated with Intellect Design and DBS before joining FBL. He is currently the SVP & Internal Auditor of the Bank.
Mr. Kapil Bhatia (EVP & Head – Commercial Banking)	Jun-17	Mr. Bhatia has over 18 years of work experience in commercial banking and was associated with HDFC Bank and BNP Paribas before joining FBL. He join as a VP for Commercial and Institutional Banking of North & East geography and currently holds EVP & Head of Commercial Banking segment.
Mr. Sanjesh Kumar (EVP & Head Credit – CIB)	Jan-18	Mr. Kumar has over a decade of work experience in the corporate credit risk division and was associated with HDFC Bank before joining FBL. He currently heads Credit risk in mid and large corporate segments.

Mr. V Lakshmanan (SVP & Head – Treasury)	Apr-18	Mr. Lakshmanan has over 17 years of work experience in selling treasury products and was associated with BNP Paribas before joining FBL. He currently heads the treasury department of the Bank.

Source: Company, Keynote Capitals Ltd

The bank has made significant changes to enhance its capabilities and improve risk management by hiring highly qualified and experienced personnel. In the past 5-6 years, the Bank has achieved growth by focusing on the quality of its assets. A key part of this strategy involves separating the loan origination and underwriting processes and conducting underwriting through various credit hubs.

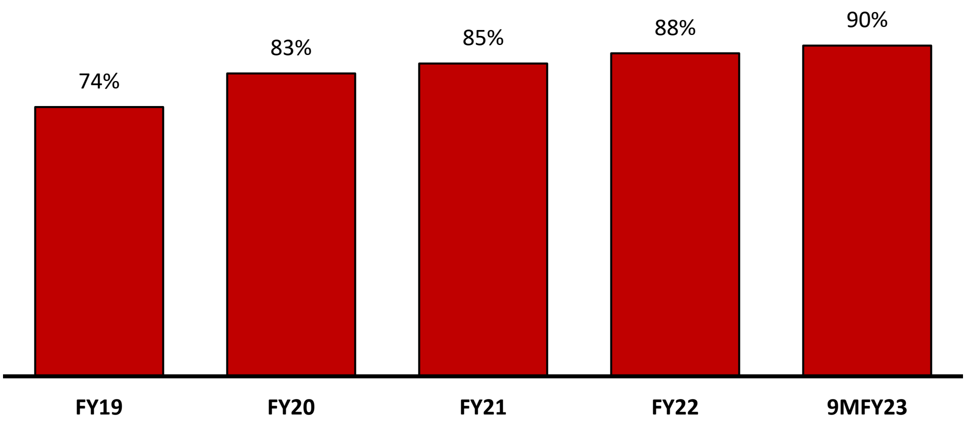
FBL mantra – 'Digital at the fore: Human at the core'

Over the years, the Bank has been at the forefront of technology and digital banking with the rise in product innovation and customer adoption of digital technology.

FBL has launched many innovative digital products in the market, be it the online passbook, account opening on the smartphone, pre-approved online personal loan, UPI-based app, digital-first credit card in 3 clicks, easy access to credit for farmers through digital kisan credit card, online account opening for current account, etc.

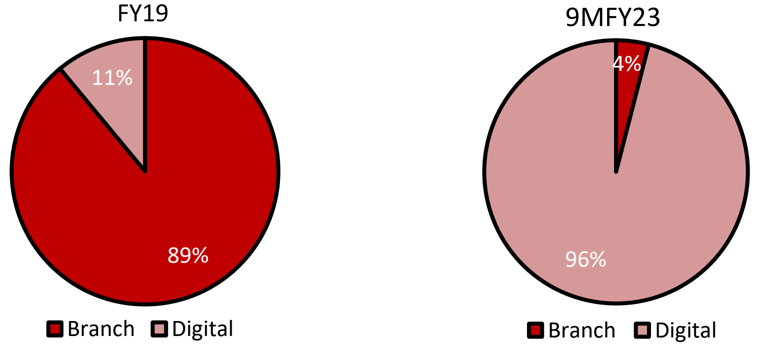
The continuous focus on enhancing digital innovation has improved the total transaction from a digital share from 73.5% in FY19 to 90.3% in 9MFY23.

The share of digital transaction is increasing Y-o-Y



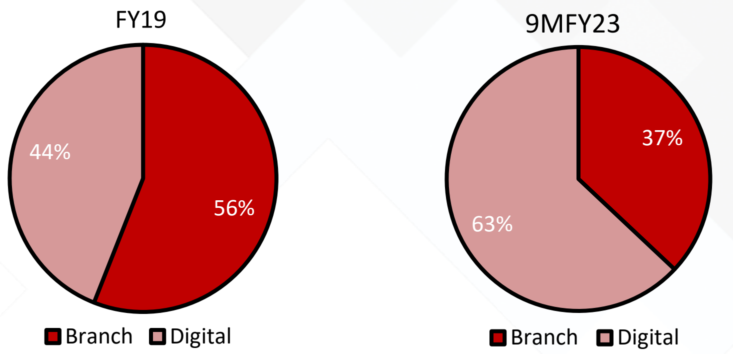
Source: Company, Keynote Capitals Ltd

Significant rise in digital onboarding of savings account



Source: Company, Keynote Capitals Ltd

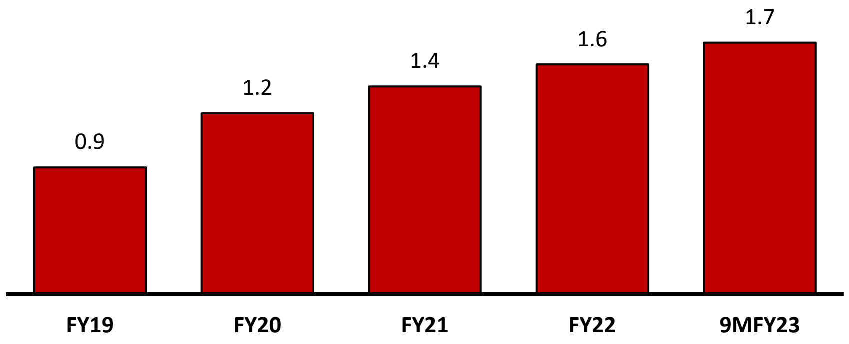
Lending through a digital medium is increasing



Source: Company, Keynote Capitals Ltd

During FY19 to 9MFY23, the loan book per branch increased from Rs. 894 Mn to Rs. 1283 Mn leading to branch productivity through a digital medium.

Increase in mobile banking active users (Mn) Y-o-Y



Source: Company, Keynote Capitals Ltd

The Bank offers several digital platforms for retail (FedNet, Lotza, and FedMobile), corporate, and SME (FedCorp, Corporate FedNet, Paylite, and Fed EBiz) customers to enhance their banking experience.

Further, FBL plans to increase the share of digital lending across retail products by FY26. The aim is to increase the percentage of digital lending in MFI to 100% vs. 90% in 9MFY23, 25% in Gold loans vs. 10% in 9MFY23, and 20% in Agri loans vs. 3% in 9MFY23.

Fintech Partnership

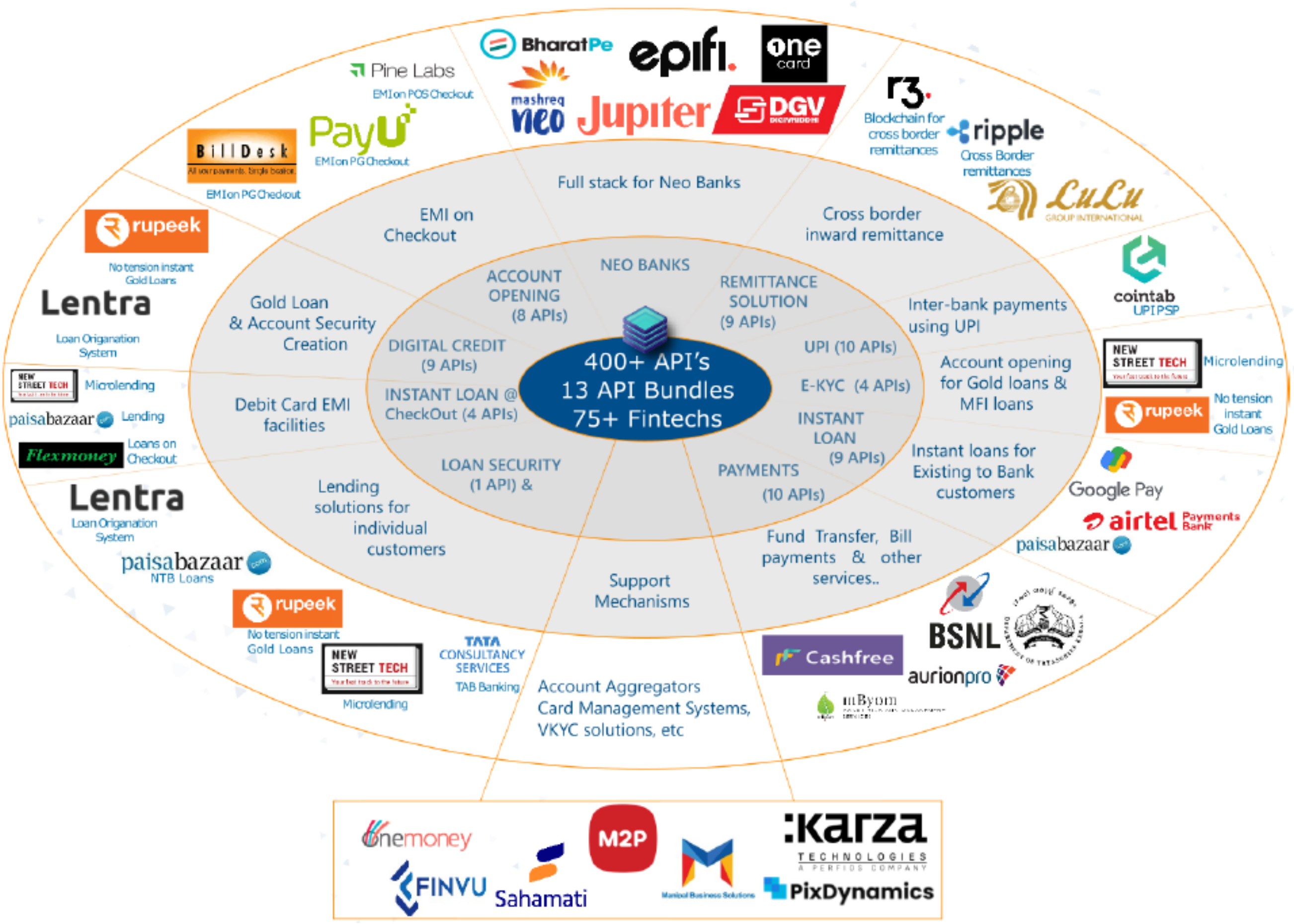
To strengthen the fintech distribution network, the Bank will add ten fintech on the asset side and four fintech partnerships on the deposit side.

Since 2017, FBL has been actively investing in open banking and has now established itself as a prominent API banking provider with over 400 APIs, 13 API bundles, and over 75 fintech partnerships. FBL's open banking platform operates on a plug-and-play model, allowing partners to access APIs, utilize the Sandbox, and refer to the documentation to develop their desired products.

The Bank is continuously leveraging its fintech partnership to enhance its reach and attract new clients who have traditionally not been the Bank's clients. The Bank's fintech strategy is incrementally benefitting through higher deposit growth, controlled cost, and improving fee income.

FBL has been aggressive in fintech partnerships, resulting in increased loan growth and an expanded customer base. The Bank has indicated that it will continue to expand its partnerships to boost loan growth. The Bank will adopt a hyper-personalized approach to cater to the individual needs of its customers.

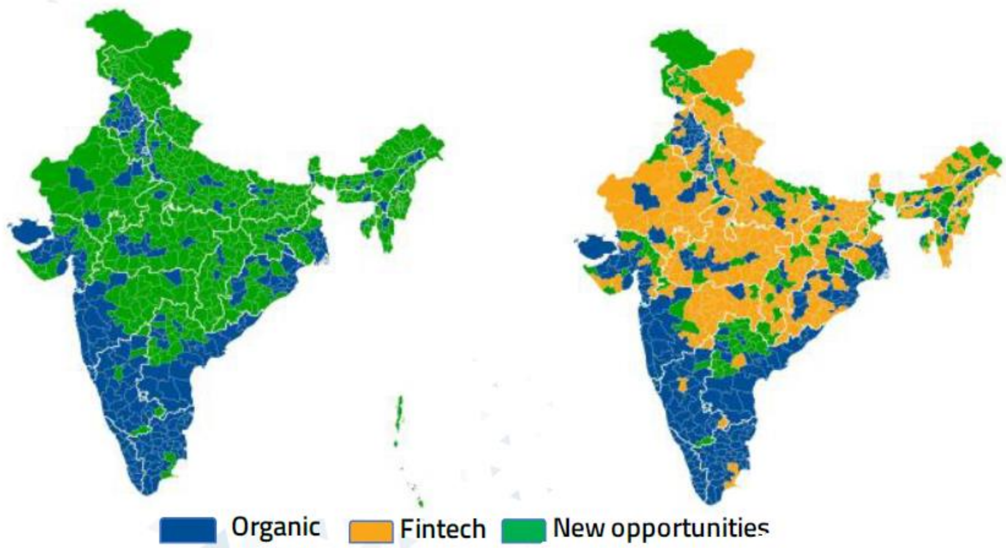
Unleashing unique fintech partnership



Source: Company, Keynote Capitals Ltd

Through partnerships with fintech firms, the Bank is significantly expanding its reach to new geographical locations to tap the diverse customer segments.

Customer geographical distribution - Organic	Customer geographical distribution – Organic + Fintech



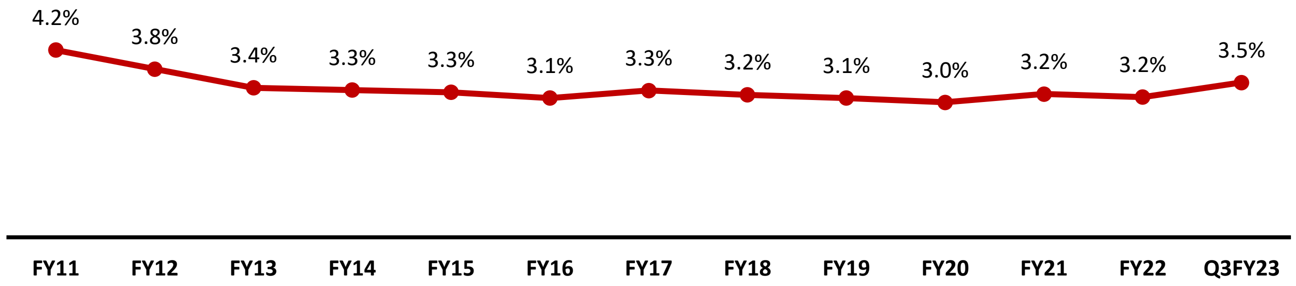
Source: Company, Keynote Capitals Ltd

Profit & loss statement

Over the FY11-22 period, the Bank's net interest margin (NIM) has remained in the 3-3.3% range, except for the initial two years, where NIM was ~4%. The decrease in NIM can be attributed to the rising cost of deposits, as the low-cost CASA shares experienced minimal growth, indicating that term deposits drove most deposit growth at a higher cost.

During Q3FY23, the Bank's NIM experienced an improvement attributed to increased high-margin business in areas such as credit cards, personal loans, MSME, CV/CE, Gold, and MFI. The management has indicated its intention to maintain NIM within the range of 3.35% to 3.40%. This target considers factors such as the mix of business, credit quality, pricing on assets and deposits, incremental credit flow, and the quality of the loan book, as well as factors that could positively or negatively impact NIM, such as higher or lower slippages.

Guided NIM (%) to be in the range of 3.35% to 3.40% going forward



Source: Company, Keynote Capitals Ltd

Fee and other income

The fee and other income of the Bank have grown at the same CAGR of ~14%, with loan book growth from FY12 to FY22. The fee and other income ratios to total income have improved from 8.7% in FY12 to 13.3% in FY22. At the same time, the core fee income ratio to total income doubled from 4.1% in FY12 to 8.1% in FY22. The core fee income for the Bank is a loan processing fee and exchange, commission, brokerage & other income.

Over the last five years, the Bank is continuously expanding product basket to cross-sell the customers. The Bank has introduced different services and partnerships on the demat account opening, insurance space, wealth management, mutual fund, credit card, etc.

The fee income to average advances stands at ~90 bps in FY22, and Bank plans to improve the ratio by 10 bps every year. Going forward, the Bank expects the fee income growth to be higher than the loan growth by 2%.

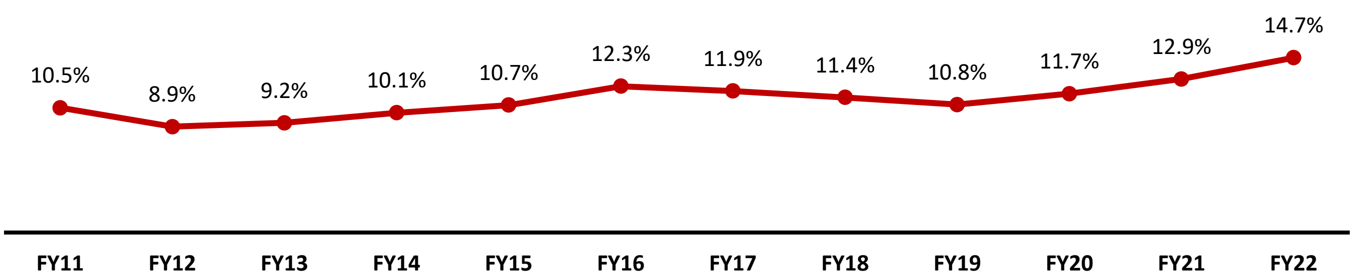
Cost-to-income ratio

The Bank cost-to-income ratio has increased from FY12 due to a significant increase in branches over FY10 to FY15. After that, the cost-to-income ratio has remained elevated due to a rise in relationship managers (RM), an increase in employee stock option schemes, and a focus on expanding digital/ fintech partnerships.

In the last three years, from Dec-22 to Dec-20, RM has significantly increased by 8.3x from 113 to 937.

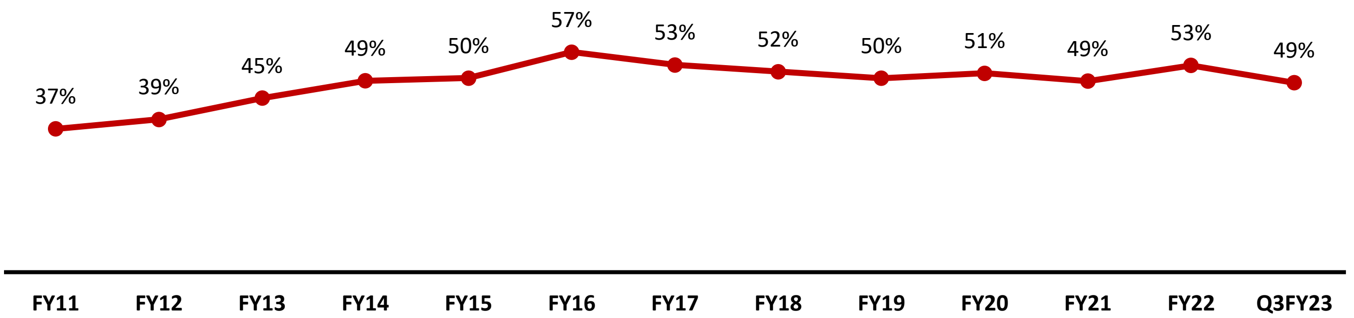
During Q3FY23, the cost-to-income ratio demonstrated a significant 597 bps improvement on a Y-o-Y basis. The management anticipates further enhancement in the cost-to-income ratio, targeting a range of 47.5%-48% for FY24. The Bank's partnerships with fintech firms are expected to play a crucial role in increasing overall business volume, as they enable the Bank to deepen relationships with existing customers and attract New-to-Bank customers. By leveraging these partnerships, the Bank aims to build a scalable franchise while driving cost efficiencies.

Rise in employee cost (%) as a % of total income due to increased in employee stock options



Source: Company, Keynote Capitals Ltd.

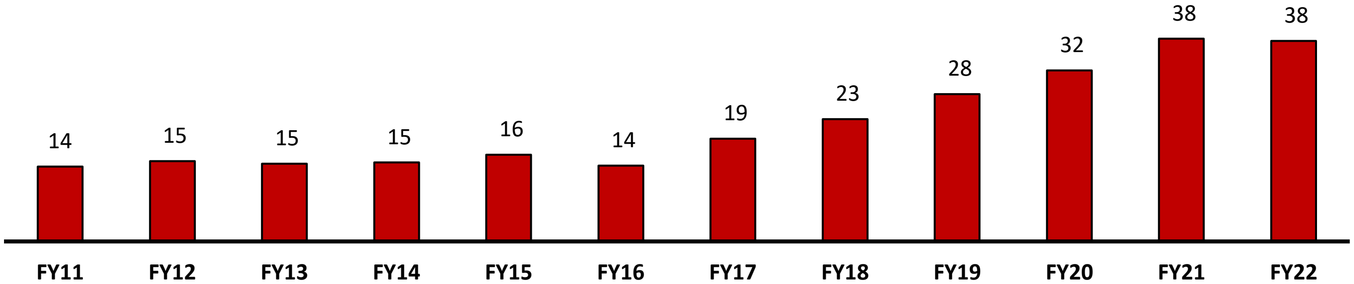
Increased in the cost-to-income ratio (%) and targeting a range of 47.5%-48%



Source: Company, Keynote Capitals Ltd.

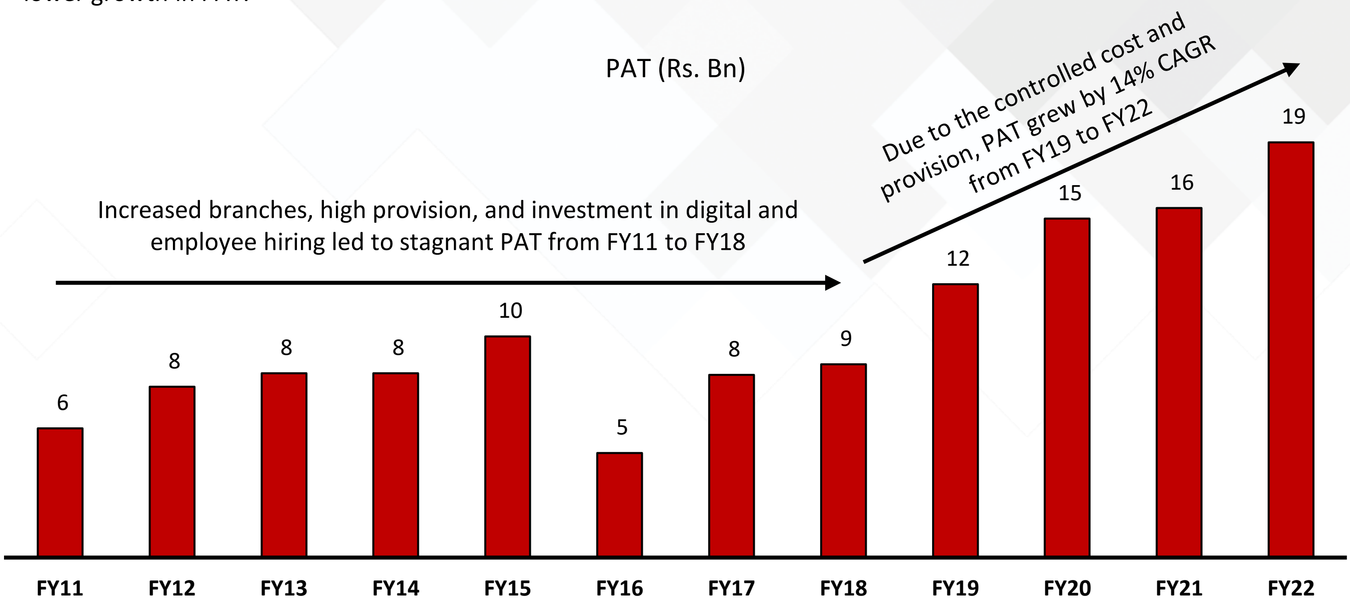
Due to the increase in the cost-to-income ratio, Pre-Provisioning Operation Profit (PPOP) has seen a CAGR of 9% from FY11 to FY22.

Slower growth in PPOP (Rs. Bn)



Source: Company, Keynote Capitals Ltd.

The provision has increased at a CAGR of 14% from FY12 to FY22, leading to lower growth in PAT.



Source: Company, Keynote Capitals Ltd.

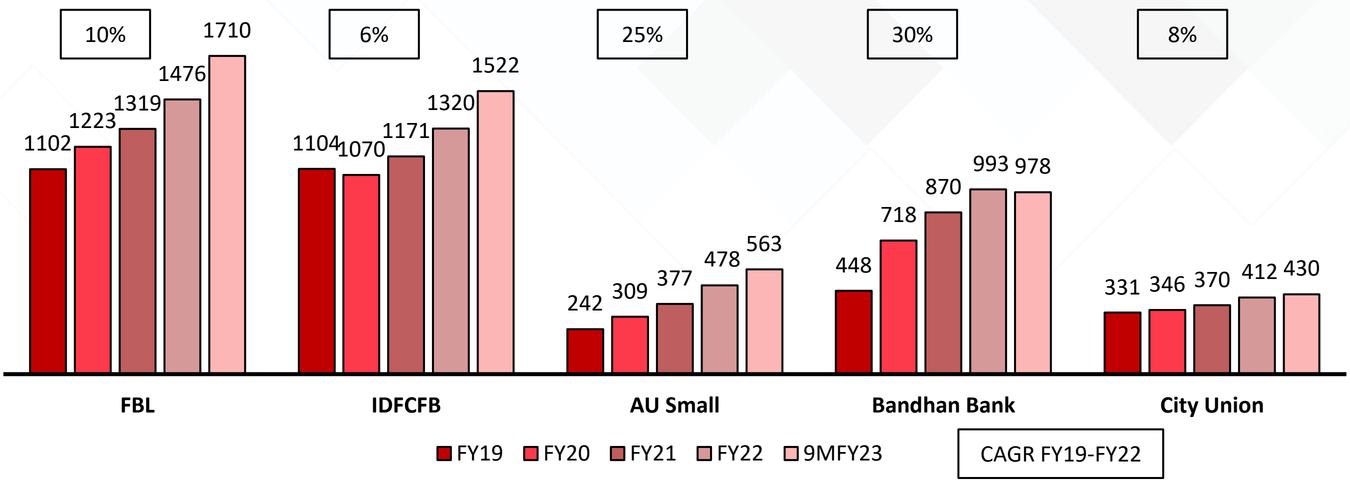
The Bank has faced the turbulent times reasonably well and is now on the path to sustained growth momentum with various enablers in place. In Q3FY23, the Bank posted the highest-ever net profit supported by strong loan growth, an increase in NIM, an improvement in the cost-to-income ratio, and a high provision created, leading to improved asset quality.

Going forward, the Bank has guided to grow loan book by 17-18%, maintaining a NIM margin of 3.35-3.40% and improving the cost-to-income ratio. All these factors will lead to better asset quality and higher growth in earnings.

Peer Comparison

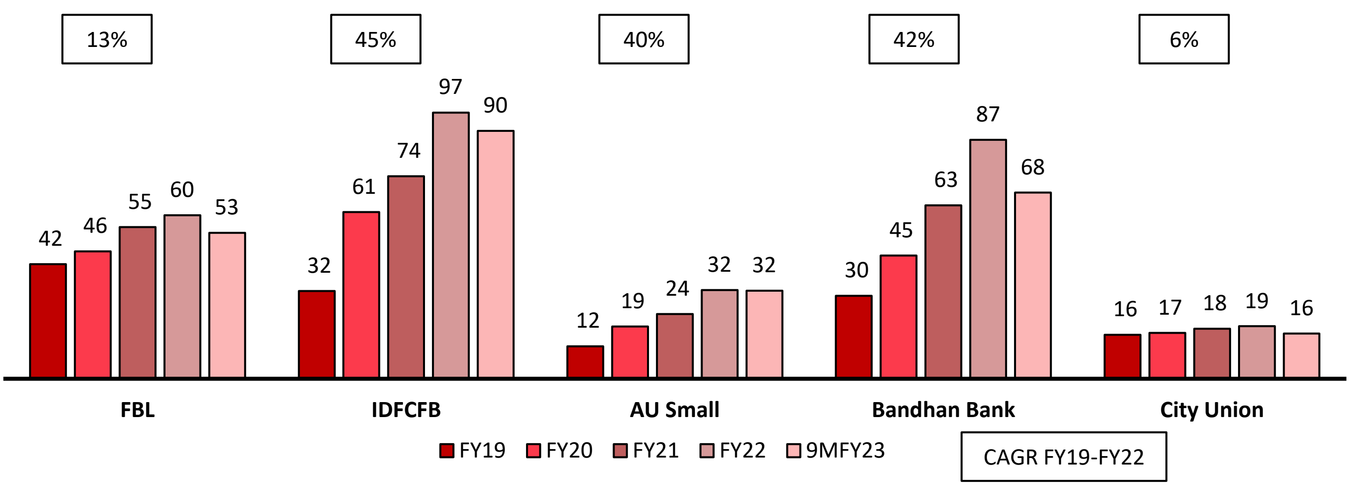
We reviewed FBL against its closest peers, IDFCFB, AU Small, Bandhan Bank, and City Union.

Loan book (Rs. Bn) and CAGR for last three years



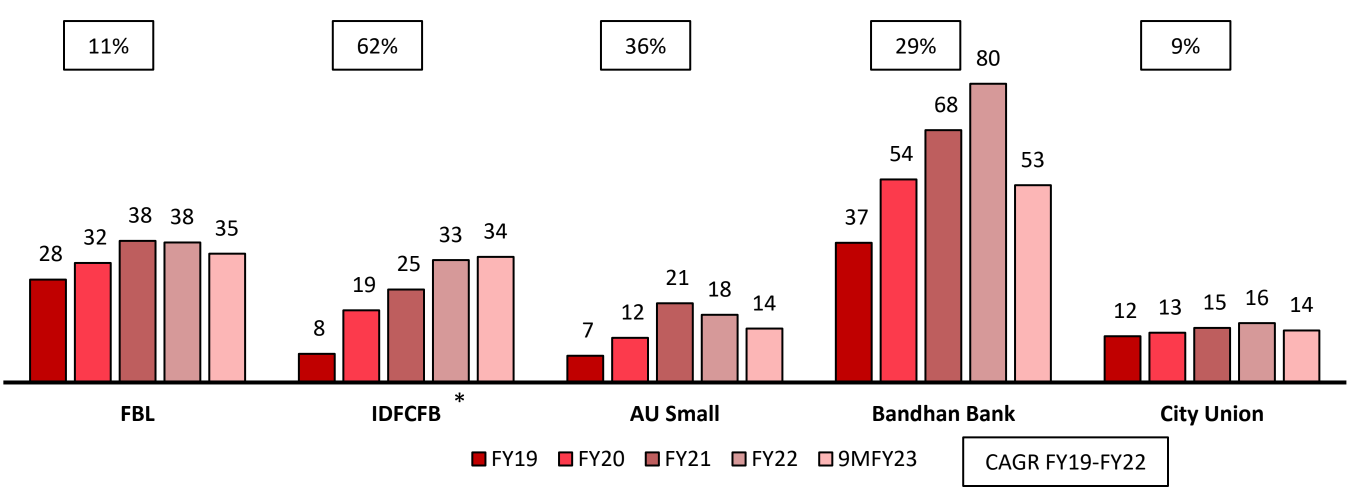
Source: Company, Keynote Capitals Ltd.,

NII (Rs. Bn) and CAGR for last three years



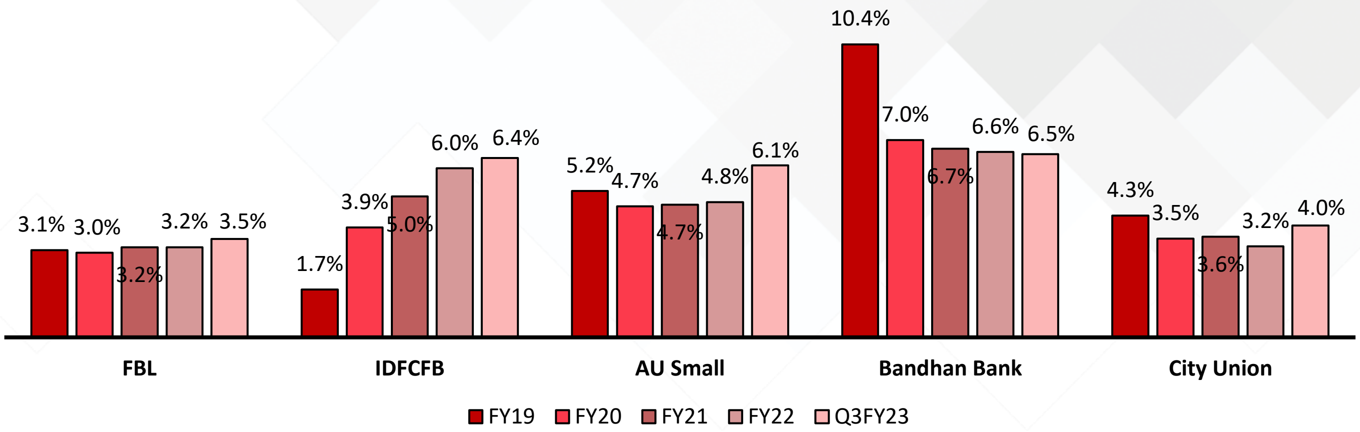
Source: Company, Keynote Capitals Ltd.

PPOP (Rs. Bn) and CAGR for last three years



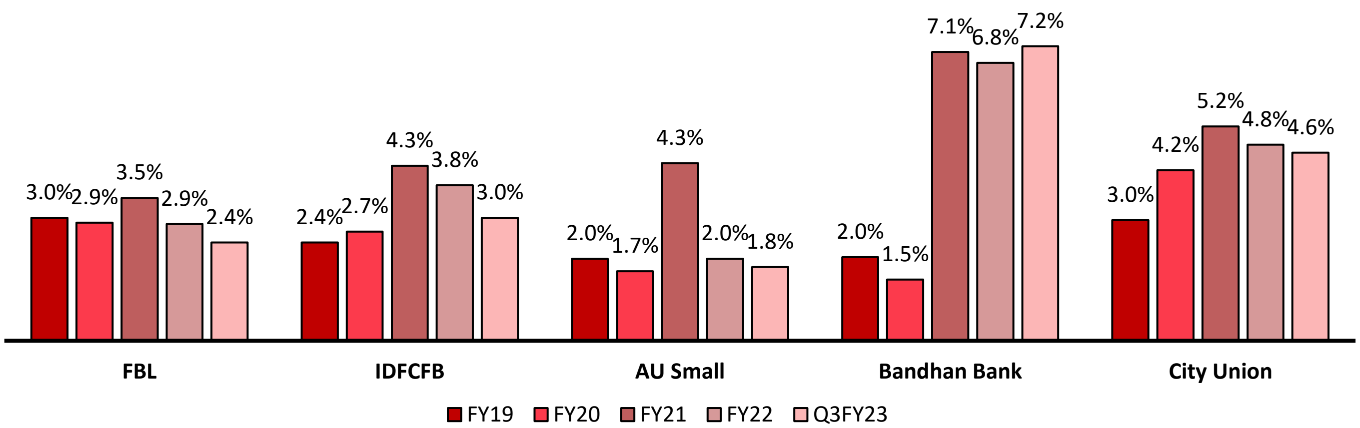
Source: Company, Keynote Capitals Ltd.

Stable NIM (%) for FBL as compared to peers



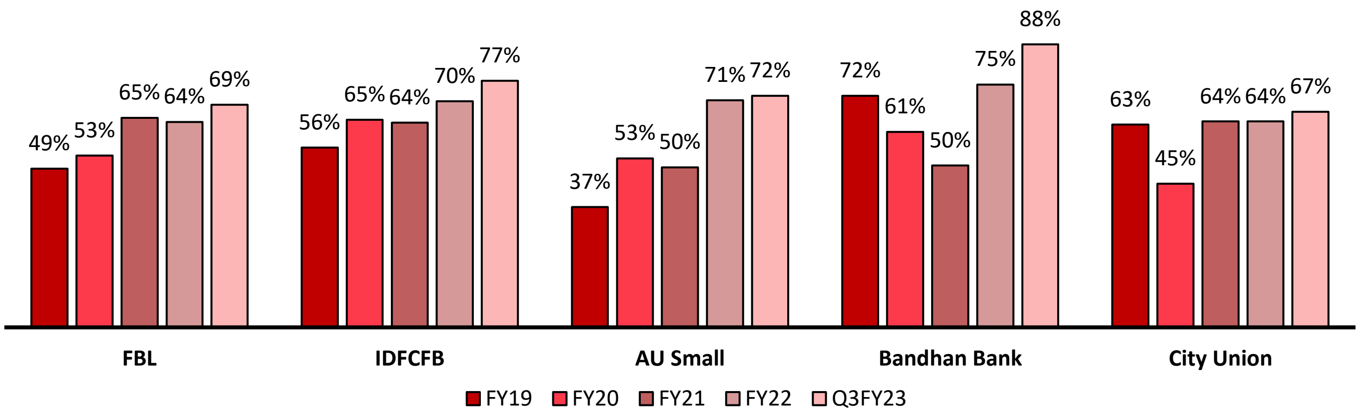
Source: Company, Keynote Capitals Ltd.

FBL GNPA ratio (%) improved over the years compared to peers



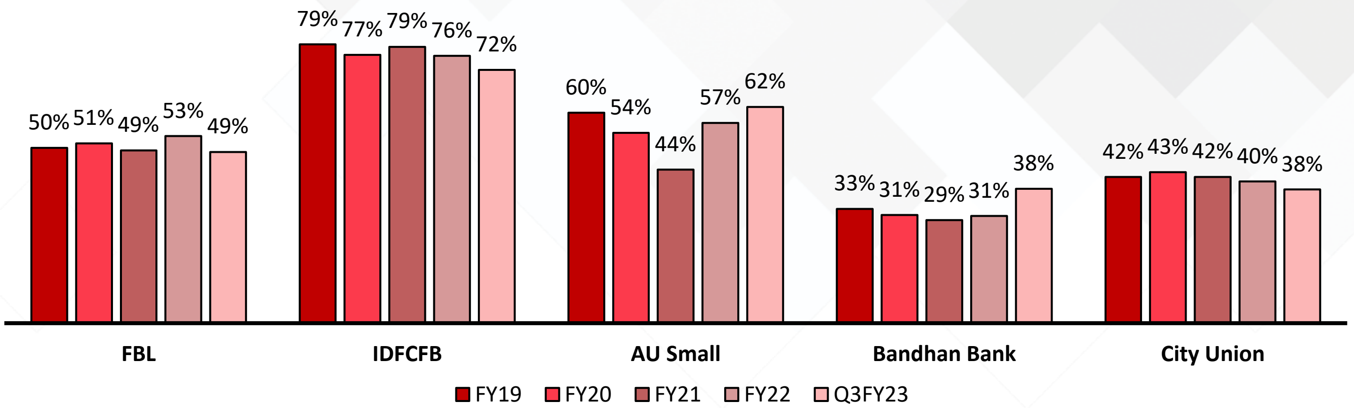
Source: Company, Keynote Capitals Ltd.

Improvement in PCR (%) across bank's



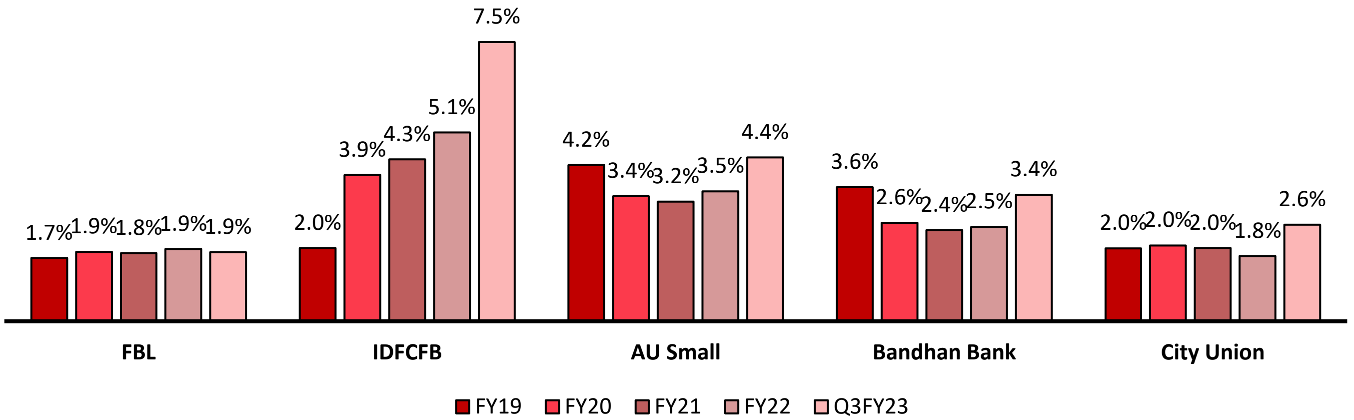
Source: Company, Keynote Capitals Ltd.

Stable cost-to-income ratio (%) for FBL and City Union



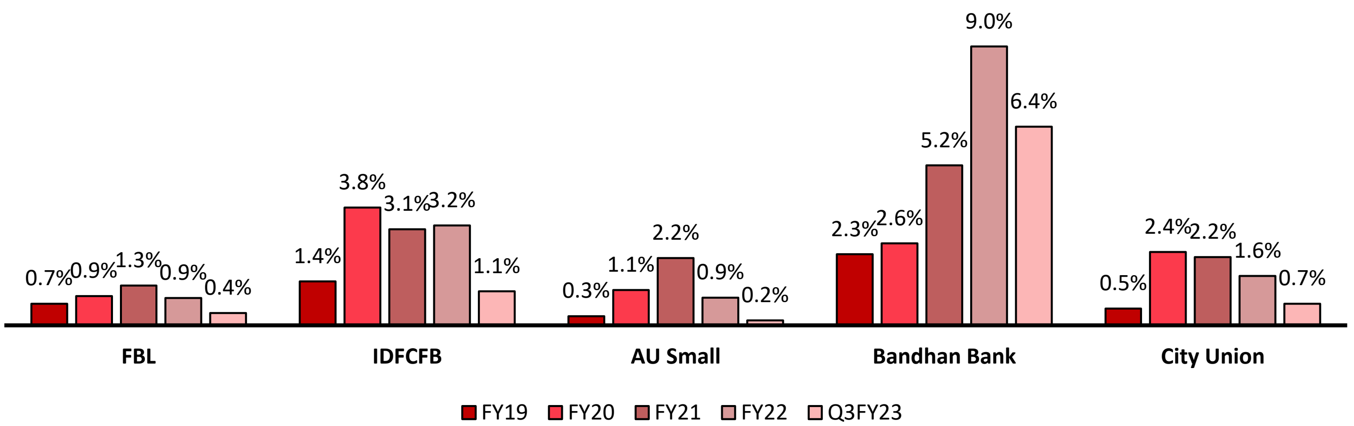
Source: Company, Keynote Capitals Ltd.

Stable and lowest cost-to-assets ratio (%) for FBL



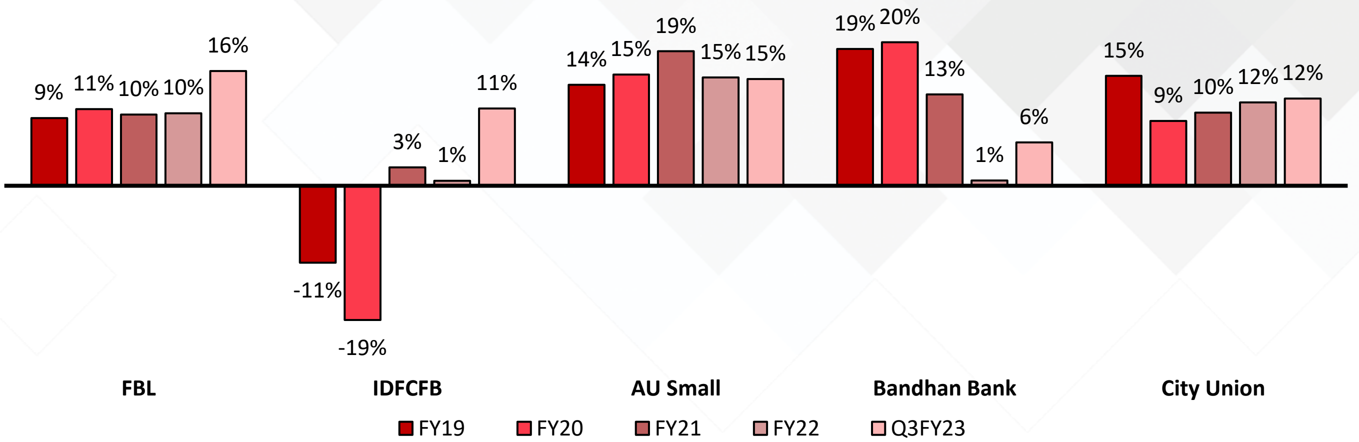
Source: Company, Keynote Capitals Ltd.

FBL has a lowest credit cost (%) compared to peers



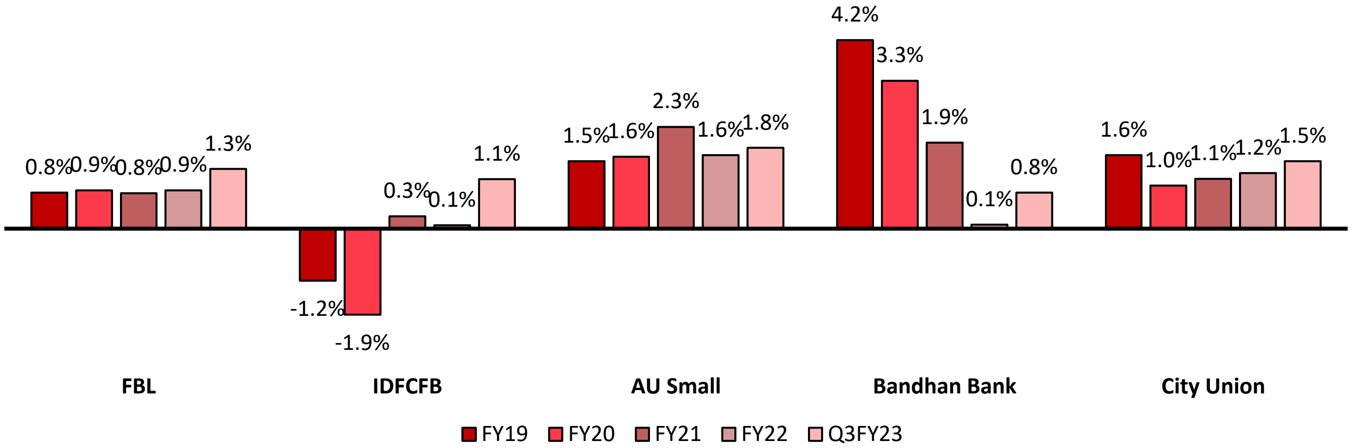
Source: Company, Keynote Capitals Ltd.

ROE (%)



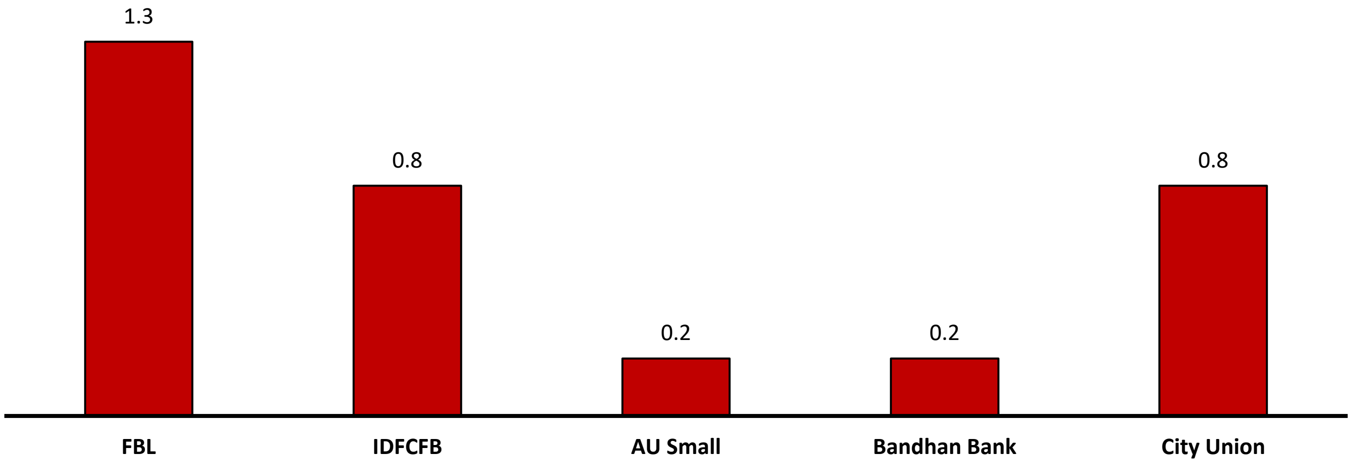
Source: Company, Keynote Capitals Ltd.

ROA (%)



Source: Company, Keynote Capitals Ltd.

FBL has a highest total operating revenue per employee in FY22 (Rs. Mn) compared to peers



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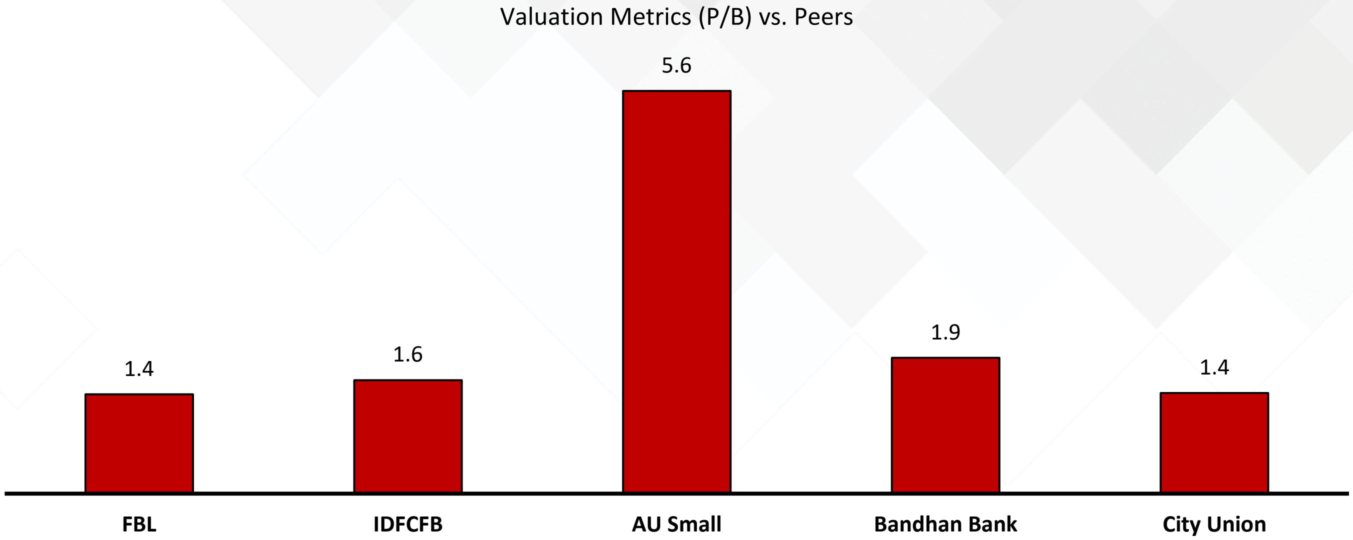


Source: Company, Keynote Capitals Ltd., CMP as of 13th April 2023

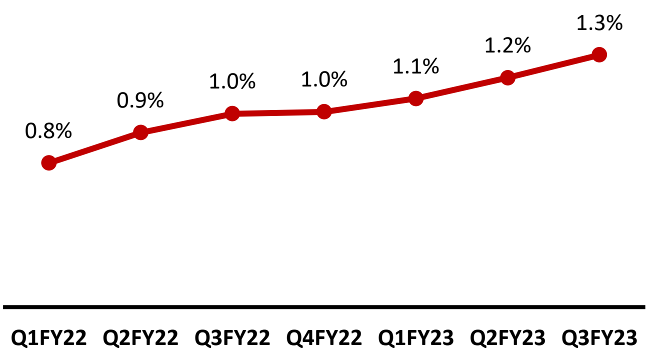
Opportunities

Loan growth to drive earnings leading to improvement in return ratios

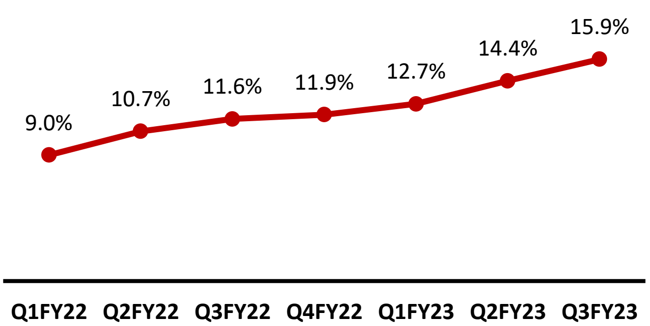
In the last decade, FBL grew its loan book at a CAGR of 14% from FY12 to FY22, while the PAT has grown at a slower rate of 9%. The low growth in PAT is due to increased cost-to-income ratio and provisions over the years. While in the 9MFY23, there was a significant rise in earnings growing at 56% Y-o-Y. This growth is driven by strong growth in loan book growing at 19% Y-o-Y in 9MFY23. In 9MFY23, there is a Q-o-Q improvement in NIM, cost-to-income ratio compared to last year, leading to rising in PPOP. The provision has increased Q-o-Q leading to improvement in asset quality.

FBL is posting robust performance for the last six quarters leading to improvement in return ratios Q-o-Q.

Q-o-Q improvement in ROA (%)



Q-o-Q improvement in ROE (%)



Source: Company, Keynote Capitals Ltd.

All these factors will lead to better asset quality and higher growth in earnings and return ratios.

Increasing pan India presence

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The Bank is diversifying away from Kerala, where its share in the overall advances has moderated to 31.8% in Q3FY23 from 42% in FY16.

The Bank consciously scaled up and decided to focus on geographics like Tamilnadu, Karnataka, Maharashtra, Gujarat, Delhi, and Punjab & Haryana.

FBL aims to add around 80-100 branches per year over the next three years. Most of these new branches will be established outside the Kerala region, and the Bank will select new branch locations based on the potential of high-yielding products in those areas.

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Digital/ Fintech partnership to drive growth

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FBL has been aggressive in fintech partnerships, resulting in increased loan growth and an expanded customer base. The Bank has indicated that it will continue to expand its partnerships to boost loan growth. The Bank will adopt a hyper-personalized approach to cater to the individual needs of its customers.

High-margin Retail Loan Segments

The strategy posts the Covid pandemic is to increase growth by concentrating on specific high-margin segments such as credit cards, personal loans, MSME funding, commercial and construction vehicle financing, gold loans, and microfinance and additionally, expanding the customer base through a light-branch heavy distribution network and leveraging digital/ fintech partnerships.

The Bank has shifted its focus toward a higher-yielding retail loan segment, and management is expecting to double the loan book over the next 2-3 years.

The share of the unsecured loan portfolio in the total loan book has increased from 3% in FY19 to 7% in 9MFY23.

Challenges

An increase in operating cost can impact the profitability

FBL’s cost-to-income ratio has increased from 50% in FY19 to 53% in FY22. while in Q3FY23, the cost-to-income ratio improved to 49%. However, the consistent rise in branches and employees through RM-led distribution can increase the cost, which can impact the profitability of the Bank.

Asset quality deterioration

FBL’s corporate loan book contributes 46% of the loan book, and in the past corporate loan book has remained volatile, which impacted the Bank’s asset quality. FBL is moving towards a high-yielding asset class and unsecured loan book, further providing risk to the asset quality.

Financial Statement Analysis

Profit & Loss

Y/E Mar, Rs. Mn	FY21	FY22	FY23E	FY24E	FY25E
Net Interest Income	**55,337**	**59,620**	**76,152**	**85,928**	**99,677**
Other Income	19,587	20,891	26,653	31,364	37,379
Net Income	74,924	80,510	1,02,805	1,17,291	1,37,056
Operating Expenses	36,917	42,932	50,888	57,473	66,472
Pre-Provision Operating Profit	**38,007**	**37,579**	**51,916**	**59,819**	**70,584**
Provisions	16,634	12,218	8,941	9,673	11,414
Profit Before Tax	**21,373**	**25,361**	**42,976**	**50,146**	**59,170**
Tax	5,470	6,463	10,744	12,537	14,792
Profit After Tax	**15,903**	**18,898**	**32,232**	**37,610**	**44,377**

Balance Sheet

Y/E Mar, Rs. Mn	FY21	FY22	FY23E	FY24E	FY25E
Share Capital	3,992	4,205	4,205	4,205	4,205
Reserves & Surplus	1,57,244	1,83,720	2,09,569	2,39,656	2,75,158
Networth	1,61,236	1,87,925	2,13,774	2,43,861	2,79,363
Deposits	17,26,445	18,17,006	21,33,840	24,63,840	26,86,121
Borrowings	90,685	1,53,931	2,17,672	2,18,636	3,86,876
Other Liabilities & Provisions	35,299	50,588	89,500	93,500	99,800
Total Liabilities	20,13,674	22,09,463	26,54,786	30,19,837	34,52,170
ASSETS					
Cash and Balance	1,95,914	2,10,103	1,79,443	1,76,372	1,75,340
Investments	3,71,862	3,91,795	5,10,721	5,29,117	5,55,243
Advances	13,18,786	14,49,283	17,74,800	20,94,264	24,71,232
Fixed Assets & Others	1,27,112	1,58,282	1,89,812	2,20,074	2,50,346
Total Assets	20,13,674	22,09,463	26,54,786	30,19,827	34,52,170

Ratios

	FY21	FY22	FY23E	FY24E	FY25E
Growth YoY (%)					
Advance Growth (%)	7.9%	9.9%	22.5%	18.0%	18.0%
Deposit Growth (%)	13.4%	5.2%	17.4%	15.5%	9.0%
NII Growth (%)	19.0%	7.7%	27.7%	12.8%	16.0%
PPOP Growth (%)	18.6%	-1.1%	38.2%	15.2%	18.0%
Ratios					
NIM (%)	3.1%	3.0%	3.4%	3.3%	3.3%
Cost to Income Ratio	49.3%	53.3%	49.5%	49.0%	48.5%
C/D Ratio	76.4%	79.8%	83.2%	85.0%	92.0%
CASA Ratio (%)	34.0%	37.1%	32.7%	34.2%	35.5%
ROE (%)	9.9%	10.1%	15.1%	15.4%	15.9%
ROA (%)	0.8%	0.9%	1.2%	1.2%	1.3%
Asset Quality					
GNPA	3.4%	2.9%	2.5%	2.2%	2.0%
NNPA	1.2%	1.0%	0.8%	0.6%	0.5%
PCR (%)	65.1%	63.9%	67.3%	72.7%	75.0%
Credit Cost (%)	3.1%	3.2%	1.5%	1.2%	1.0%
Valuation					
Book Value Per Share		88.6	100.8	115.0	131.8
Adjusted Book Value Per Share		82.2	94.4	109.4	126.3
P/BV (x)		1.5	1.3	1.1	1.0
Price-ABV (x)		1.6	1.4	1.2	1.0

Source: Company, Keynote Capitals Ltd.

Valuation based on Adj. P/B

Valuation	FY22	FY24E
Networth (Rs. Mn) – A	1,87,925	2,43,861
NNPA (Rs. Mn) – B	14,173	12,565
Adjusted Book Value (C = A - B)	1,73,752	2,31,296
No. of Shares (Mn) - D	2,115	2,115
Adj. Book Value Per Share (Rs.) – (E = C/D)	82.2	109.4
Adj. P/B – (CMP/E)		1.5
Target Price (Rs.)		164
CMP (Rs.)	131.3	
% Upside/Downside		24.9%

Source: Company, Keynote Capitals Ltd.

The Bank has a well-diversified advances portfolio across segments, comprising corporates (9MFY23: 36%), retail (32%), SMEs (18%), and agriculture (12%). The Bank has a strong liability franchise with amongst highest share of retail deposits. The Bank is set to grow its loan book at 18-20%, with a stable NIM of 3.35-3.40%. The constant decrease in the Cost-to-Income ratio will lead to growth in PPOP at a CAGR (FY22-24) of 26%, and given the management's guidance, a fall in Credit Cost will decrease provisioning by 11% from FY22 to FY24. The above assumptions will lead to a substantial 41% Net Profit CAGR over the same period. This will lead to a ~14% CAGR growth in Networth from FY22 to FY24.

We believe that the asset quality will further normalize. Therefore, we assume a 2.2% Gross NPA in FY24 from 2.9% in FY22.

Given Bank's overall improvement, we ascribe an adjusted P/B multiple of 1.5x (average Adj. P/B for FY10 to FY19) for FY24E Adj. Book Value, implying an upside of ~24.9% from the CMP.

DEVIN PRAMOD JOSHI

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Rating	Criteria
BUY	Expected positive return of > 10% over 1-year horizon
NEUTRAL	Expected positive return of > 0% to < 10% over 1-year horizon
REDUCE	Expected return of < 0% to -10% over 1-year horizon
SELL	Expected to fall by >10% over 1-year horizon
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