21 Feb 2025 14:29:33 ET | 28 pages

Federal Bank (FED.BO)

Unveils 'Breakthrough Phase' Strategy; Execution Key

CITI'S TAKE

At Federal Bank Analyst Day, new CEO Mr. Manian unveiled the strategy of embarking on '***Breakthrough Phase***' to modernize and inch closer to top private banks with a universal bank vision and national franchise. It benchmarked itself to 'Next 3'/'Best 3' private banks cohort and envisioned outcome to at least better 'Next 3' cohort by FY28 on various metrics (incl NIM of 3.5-4.4%, RoA of 1.4-2.2%, RoE of 13-16%). ***What's encouraged:*** **[1]** enhancing profitability/RoA while sustaining growth, instilling P&L culture in business heads, concentrated/phased state specific expansion beyond Kerala, refining/modernizing branches, rebranding (bank of choice). **[2]** Emphasized focus (in order of preference) on rationalizing CoDs (through CA), reshaping product mix to optimize yields and enhance fees. **[3]** Targeted segments – mass affluent/MSME/mid-corporate/NR/next gen. ***Key to monitor:*** **[a]** Strategy execution amidst competitive intensity, volatile environment. **[b]** near-term headwinds may outweigh medium-term aspirations. Valuations at 1.1x FY27E book appear reasonable. Maintain Buy.

RoA improvement levers — [1] ***Rationalize CoDs*** – Scale up CA to 10% by FY28 through product innovation, penetration (not easy given CA discipline guideline and peers too aggressive on garnering CA), enhance engagement with capital markets for better fee and float (no ready existing customer base), enhance NR Beyond the GCC/Kerala, position as Primary Banker through customized offerings (all pvt banks targeting this), granular focus on CASA/RTD, LCR efficiency. **[2] Reshape advance mix to optimize yields -** scaling up medium-yield assets (from 31% to 34%), deepen high-yield assets (from 5% to 8%), targeting mid-market corporate lending, applying RAROC and tenor-based pricing. [3] ***Expanding product portfolio*** - Scale-up Used Vehicle Finance (CV/CE, Car Loans), expand offerings for Micro-LAP, tractor finance, EMI business loans, affordable housing, real estate financing. [4] ***Fee enhancement through product origination and cross-sell targeted at mass affluent/NR, MSME, mid-market*** – Trade/forex income, wealth mgmt.., bancassurance, credit cards, CMS. **[5]** ***Cost Efficiency*** **–** enhanced productivity, low-cost sales channel, leverage Fedserv, centralize/regionalize processes, AI/automation.

Product portfolio dynamics — Will grow business banking, commercial banking, mid-corporate, used vehicle, etc. and will enhance profitability in credit card, agri, micro loans, etc.

Earnings Summary

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2023A	30,106	14.26	55.2	12.6	1.8	15.1	na
2024A	37,206	16.34	14.5	11.0	1.5	14.7	na
2025E	40,163	16.39	0.3	11.0	1.4	13.2	1.8
2026E	43,685	17.78	8.5	10.1	1.2	13.1	2.0
2027E	50,571	20.59	15.8	8.7	1.1	13.6	2.3

Source: Powered by dataCentral

Buy

Price (21 Feb 25 15:30)	Rs179.50
Target price	Rs242.00
Expected share price return	34.8%
Expected dividend yield	1.7%
Expected total return	36.5%
Market Cap	Rs440,753M
	US$5,090M

Price Performance
(RIC: FED.BO, BB: FB IN)



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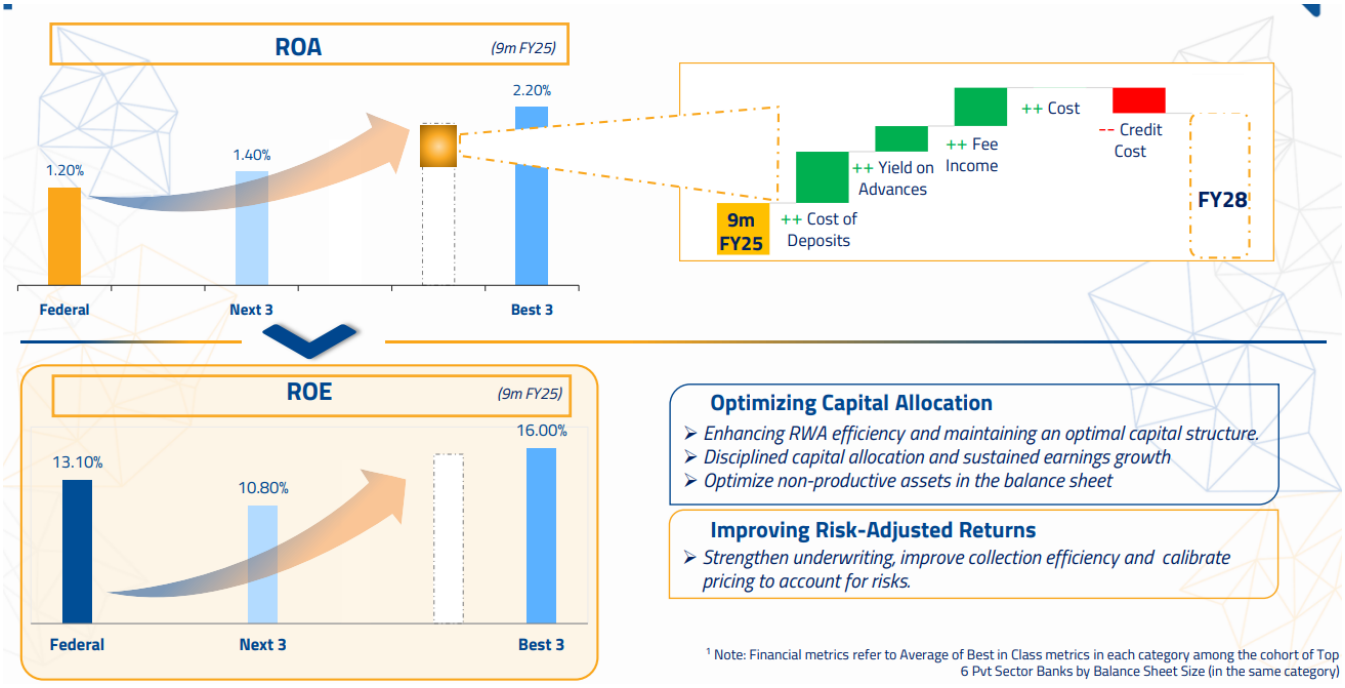
See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliations.

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'Free the branch' Initiative; add 400-450 branches till FY28 - Concentrated and phased branch expansion strategy focusing on selective top 10 GSDP states prioritizing TN, KA, MH. It will primarily target Tier-2 cities and have pin code level strategies for metros. Bank will add 400-450 branches over 3 years. Branch model needs transformation with: i) 'Free the branch' initiative – take away operational work and spend more time engaging with customer, ii) Act as a point of acquisition, servicing, engagement, iii) Eliminate redundancies, Automate, centralize, regionalize the activities, iv) Dedicated RMs for personal banking and business banking, v) Refocusing BM on growth, customer engagement and market expansion.

Execution will be key – i) 150 projects identified – 50 key projects (high impact initiatives aligned with strategic priorities) and 100 Ancillary Projects: Supporting initiatives to enhance overall efficiency. ii) Clear KRA/ownership established for each project and dedicated teams (Resources) allocated to drive progress. Execution marshals are deployed dynamically to address progress gaps. iii) Milestone Mapping (defining timelines and deliverables for each project) and Performance Tracking (implementing real -time dashboards and structured oversight to ensure alignment with efficiency goals).

Figure 1. ROA improvement levers available, optimize capital allocation to boost RoE

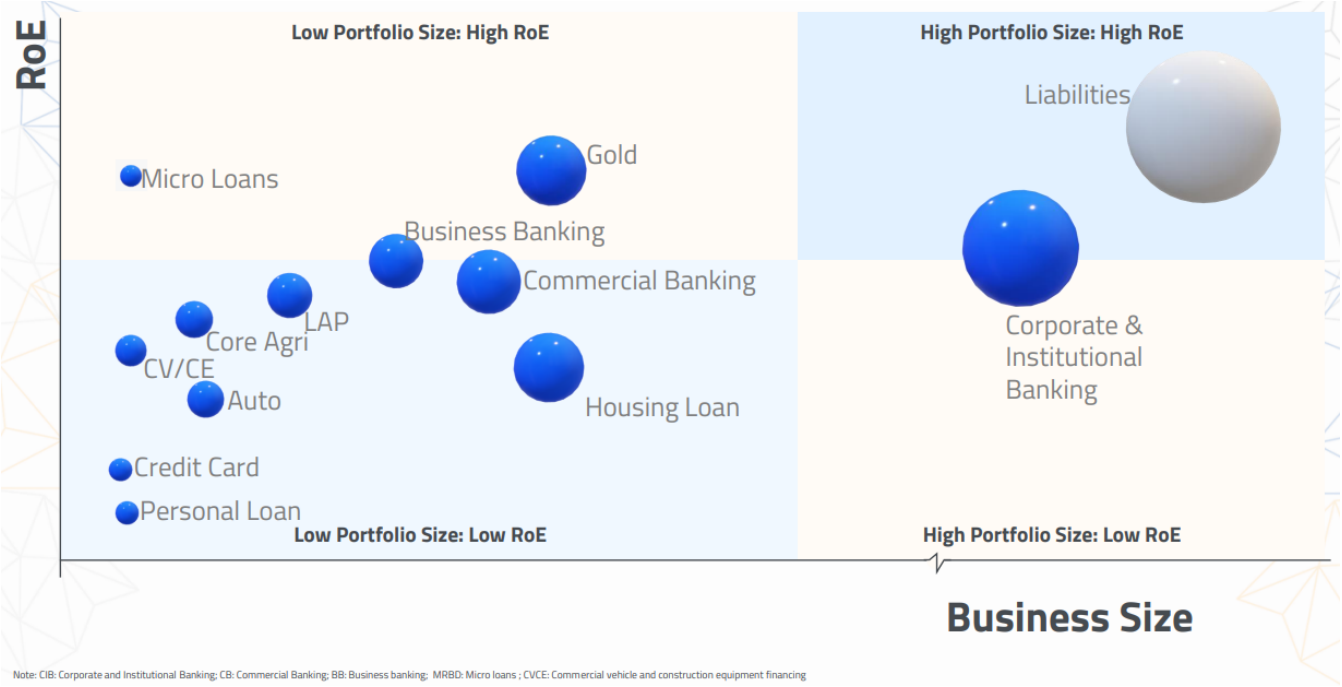


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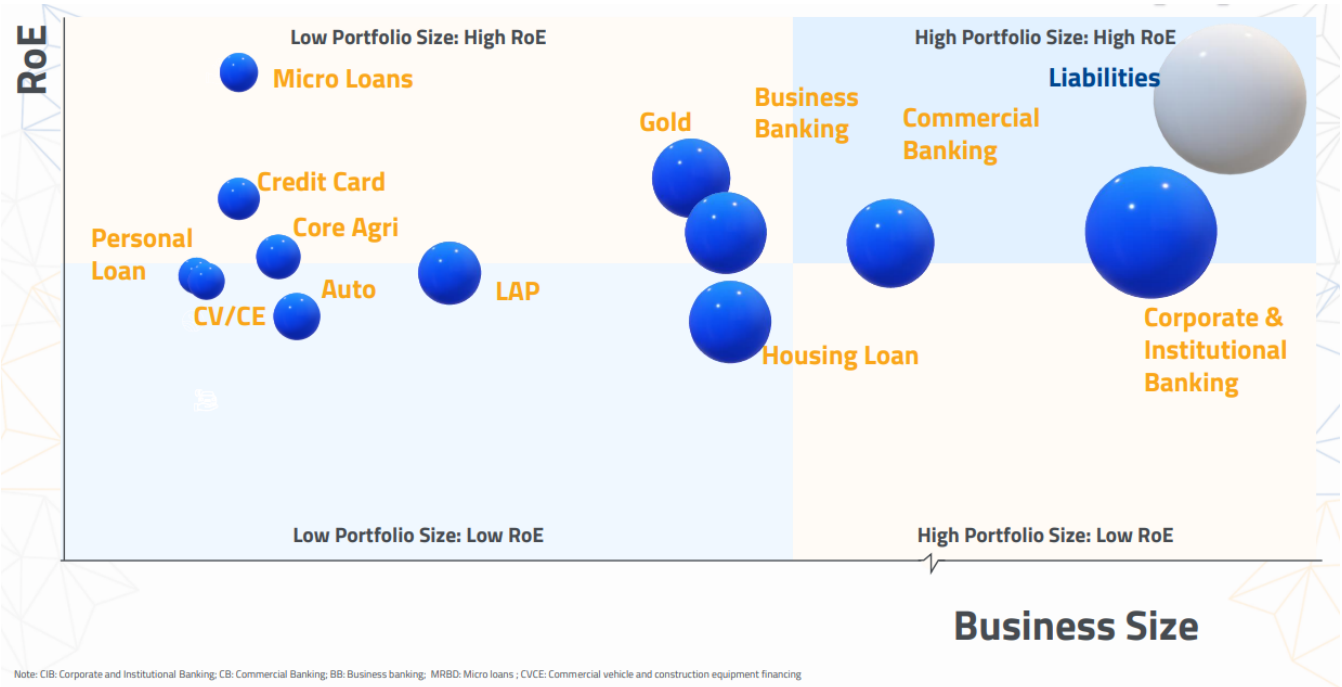
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Figure 2. Product portfolio dynamics FY25



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Figure 3. Product portfolio dynamics FY28E



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Universal Bank

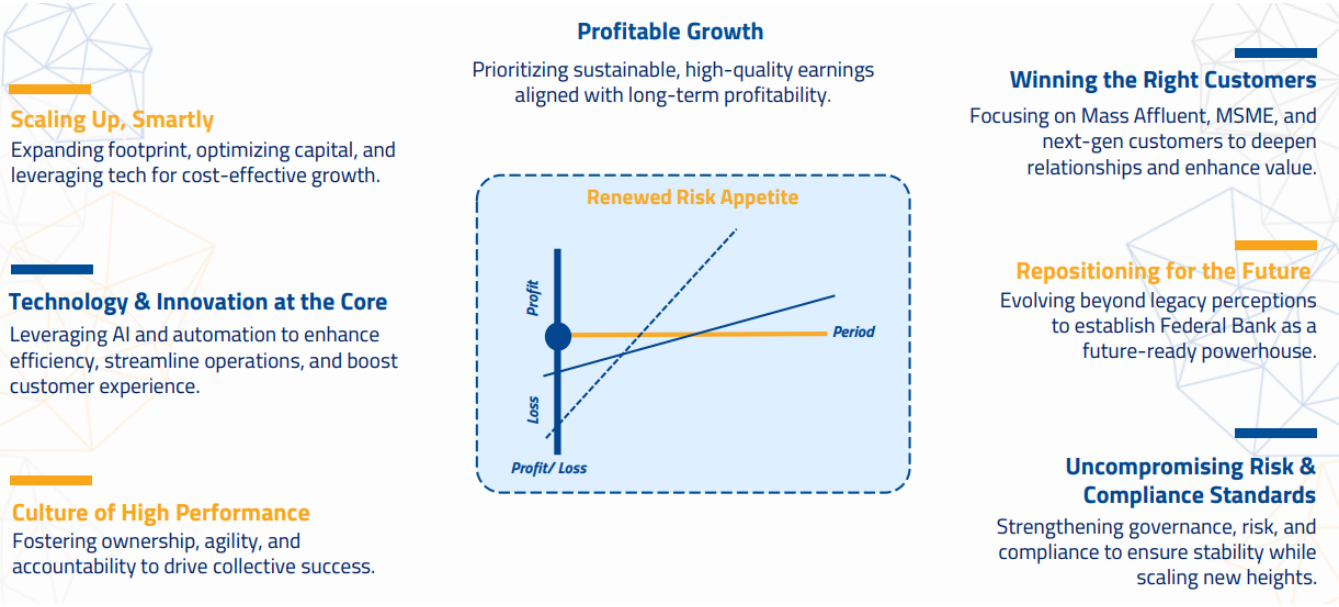
Figure 4. Foundation Pillars/Principles to be followed



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Figure 5. Key Strategic Area



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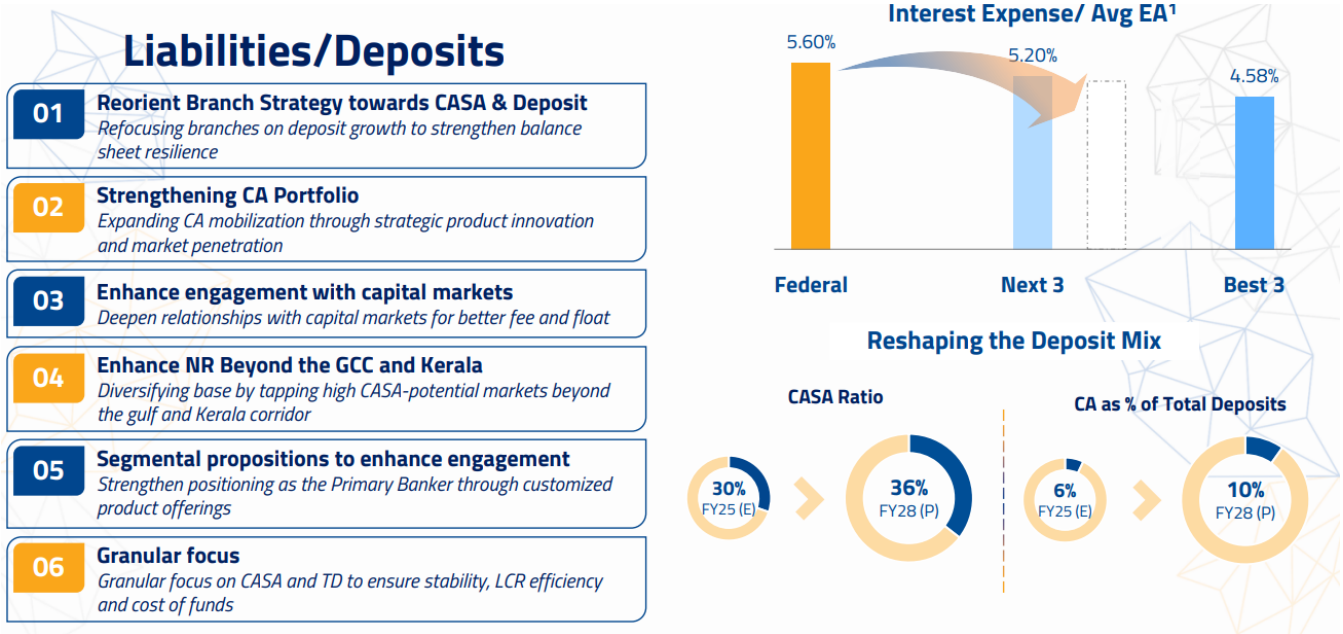
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Theme 1 – NIM Improvement

- Liability side impact on NIM is important than asset side. Expects cost of funds to be closer to 5% vs 5.6% currently
- Focus on reorienting branch strategy towards CASA through strategic product innovation, proposition, and market penetration
- Expects to drive CASA from 30% to 36% with 4% delta flowing from CA and rest 2% from SA
- On asset side, focus is on medium yielding assets such as – LAP, Business Loans, and CV
- Expects to increase the share of medium, high, and very high yielding advances from 36% currently to 42%
- It has also implemented RaROC and tenor-based pricing strategy to enhance lending margins
- Expects NIMs to be between 3.5-4.4%

Figure 6. Rationalize CoDs



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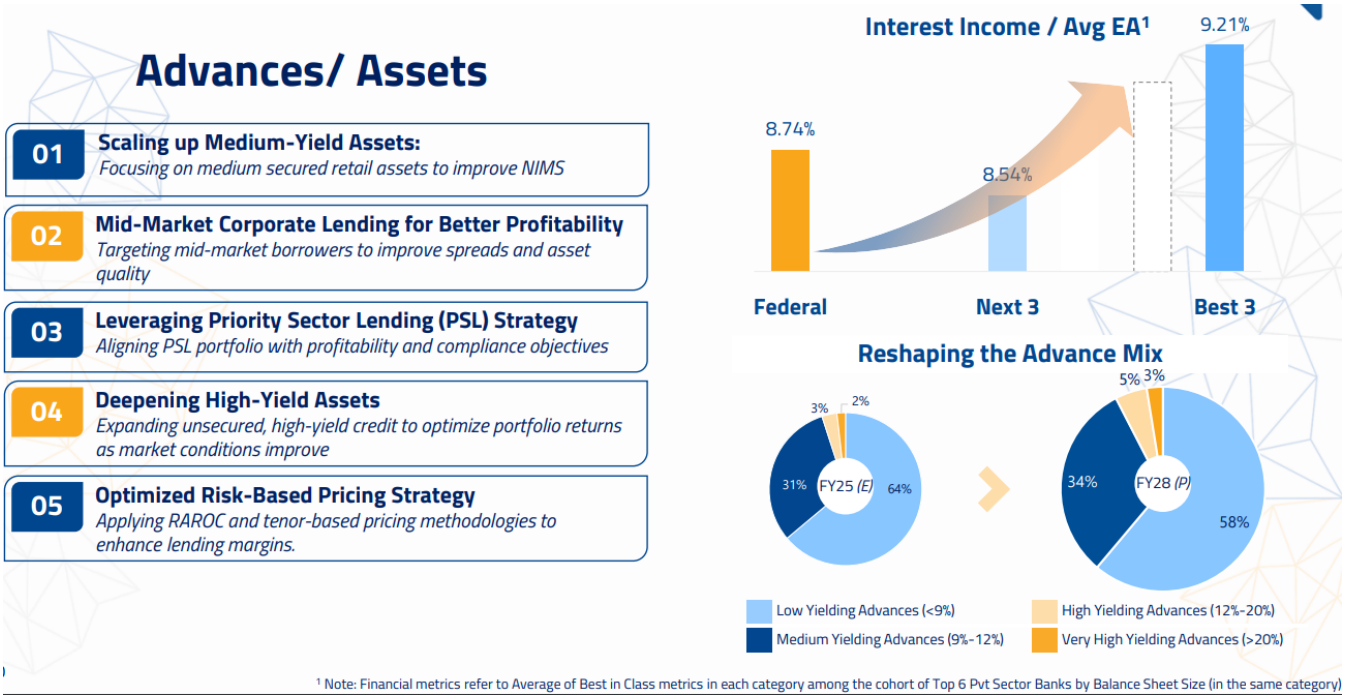
¹ Note: Financial metrics refer to Average of Best in Class metrics in each category among the cohort of Top 6 Pvt Sector Banks by Balance Sheet Size (in the same category)

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Figure 7. Optimize Yields

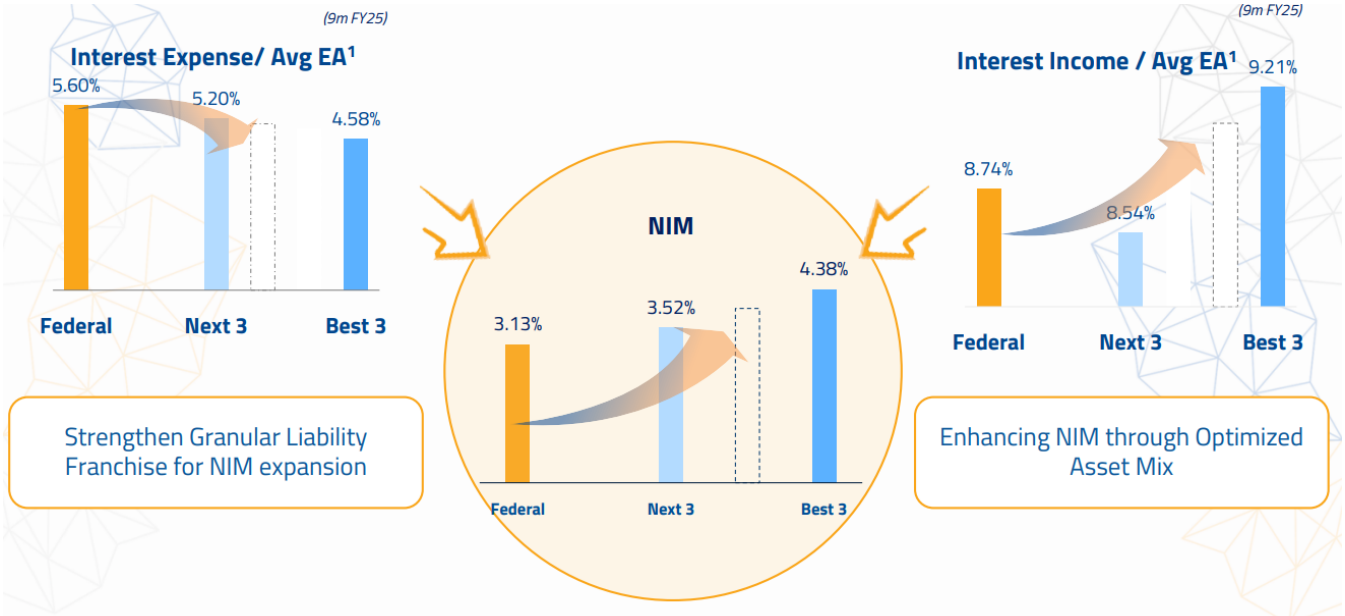


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Figure 8. NIM Improvement levers



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Theme 2 – Expanding Product Portfolio

- FB sees itself lagging vs peers on wealth products currently and attempt will be to gain that wallet share
- Increase the share of used CV/CE and car loans which are secured but slightly higher risk products
- Opportunity to create secured Micro LAP product
- Given its current BuB and CoB customers, EMI-based unsecured Business loans could be well positioned, which could support yields as well
- Real Estate – expects the product has become safer and could be grown judiciously
- Correspondent banking, Syndication and IB, and Capital Market Services could improve the quality of corporate offerings

Figure 9. Expanding product portfolio



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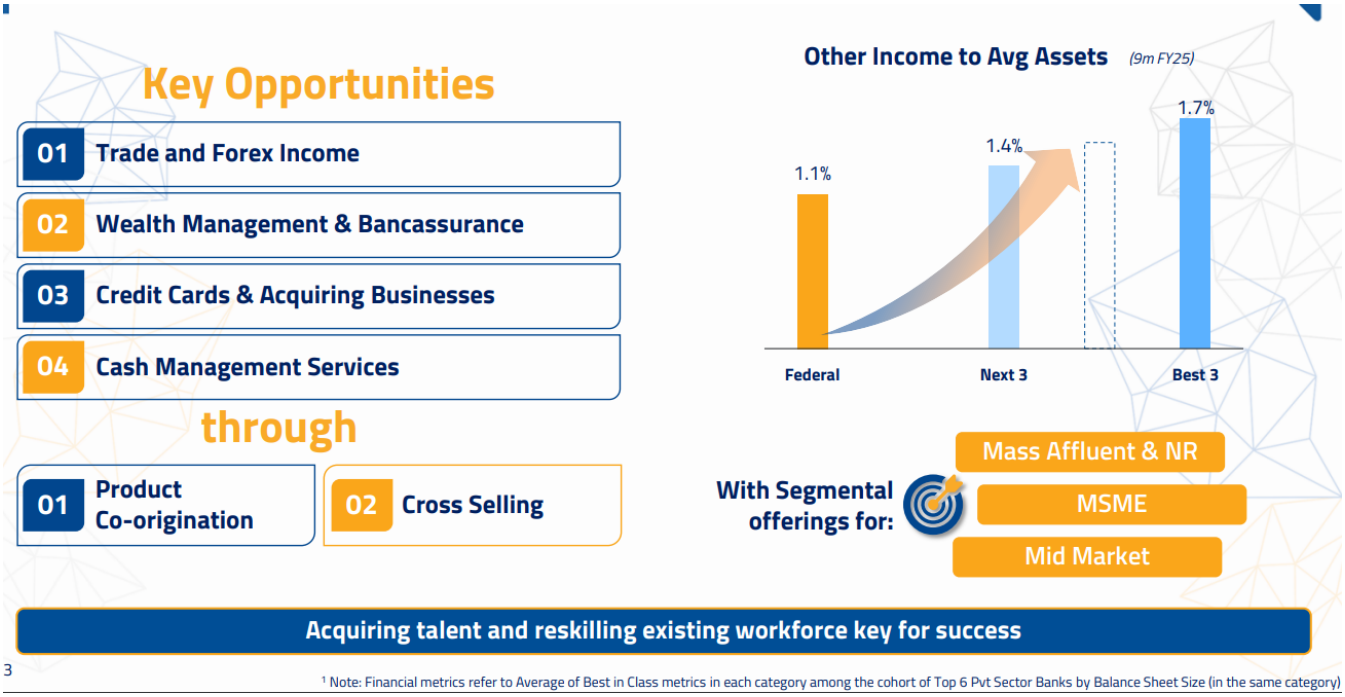
Theme 3 – Fee Enhancement

- Sees great potential to increase fee income from current 1.1% of assets to >1.4%
- It will target trade and forex income, wealth and banca, credit cards and acquiring business, and CMS to generate additional fees

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– It also guided for multiple product origination to enhance productive fee income

Figure 10. Enhancing fee profile



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Theme 4 – Branch Strategy for Scalable Growth

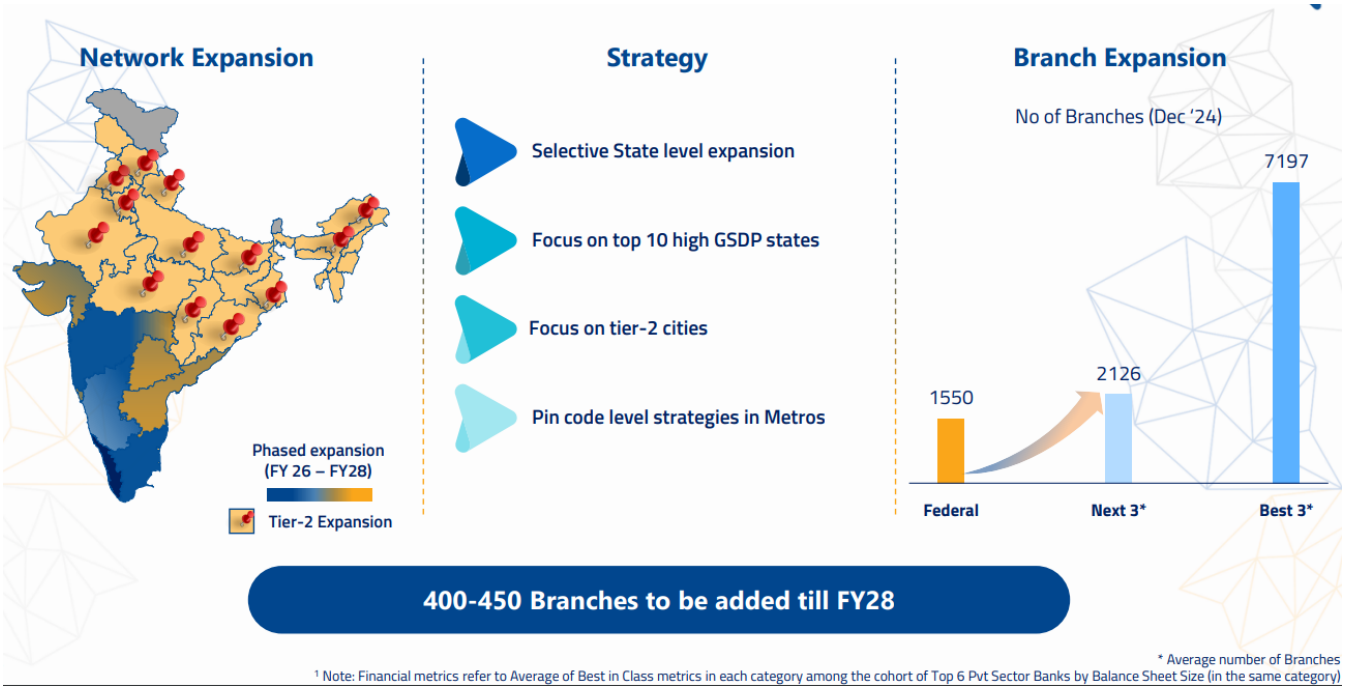
– Looking at more concentrated strategy of phased network expansion. It will deeply penetrate one location before moving to next state.

– Focus continues to be on top 10 high GSDP states along with penetrating tier-2 cities within those states

– Looking at adding 400-450 branches till FY28, on current base of 1,550 branches

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Figure 11. Concentrated and phased states specific branch expansion strategy



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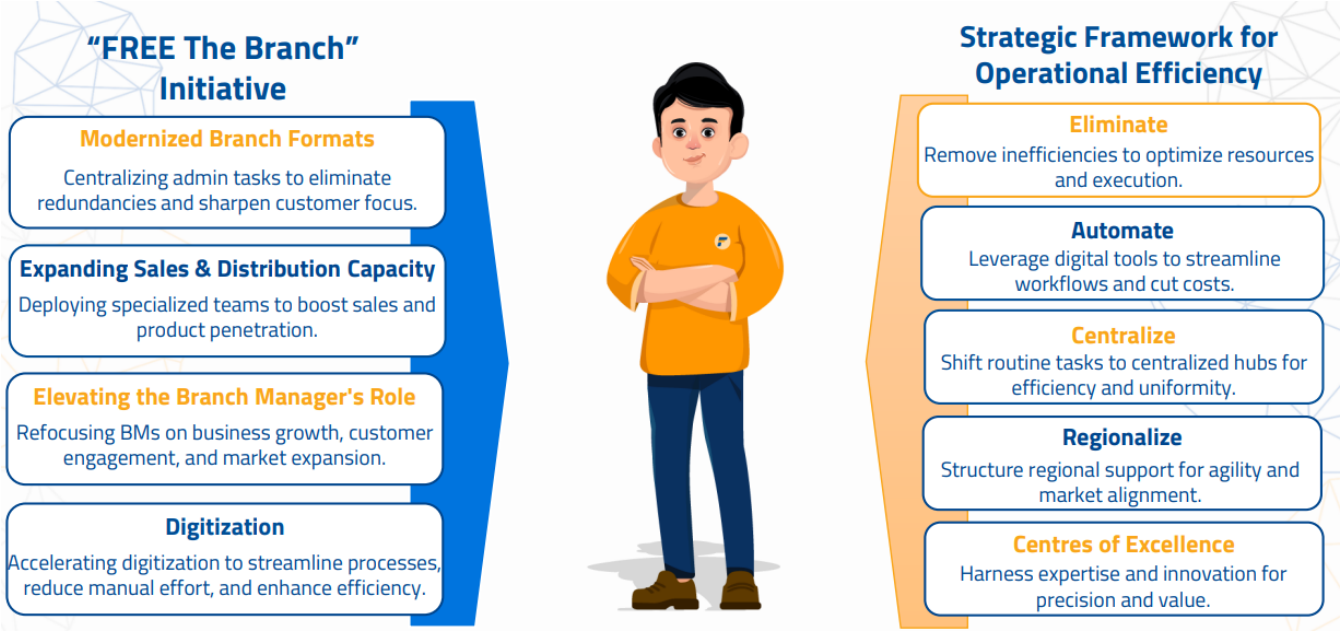
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Theme 5 – Branch Transformation

- Freeing the branches of operational workload so employees are more focused on servicing/acquiring customers
- It sees other functions could be done faster and cheaper at centralized locations
- Focus on adding specialized RM/team to drive more business

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Figure 12. Branch transformation



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Theme 6 – Brand Transformation

- Sees a lot of work on branding is to be done outside Kerala. It scores heavily on most brand metrics in the state of Kerala
- Focus is to contemporize for new generation clients along with positioning to small businesses and mass affluent segments

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Figure 13. Brand transformation



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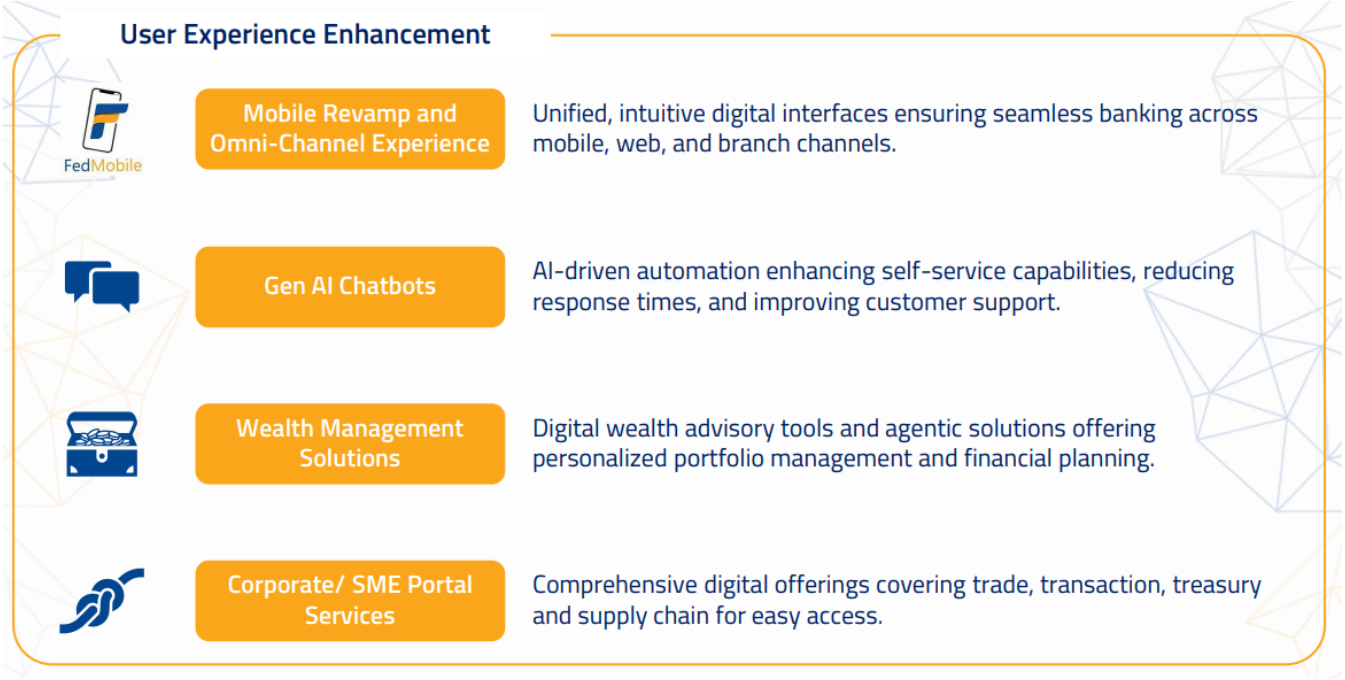
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Theme 7 – Digital at Fore, Human at Core

- Enhanced user experience to be driven by revamping mobile application, introducing Gen AI Chatbots, adding Wealth Management Solutions, and Corporate and SME portal services

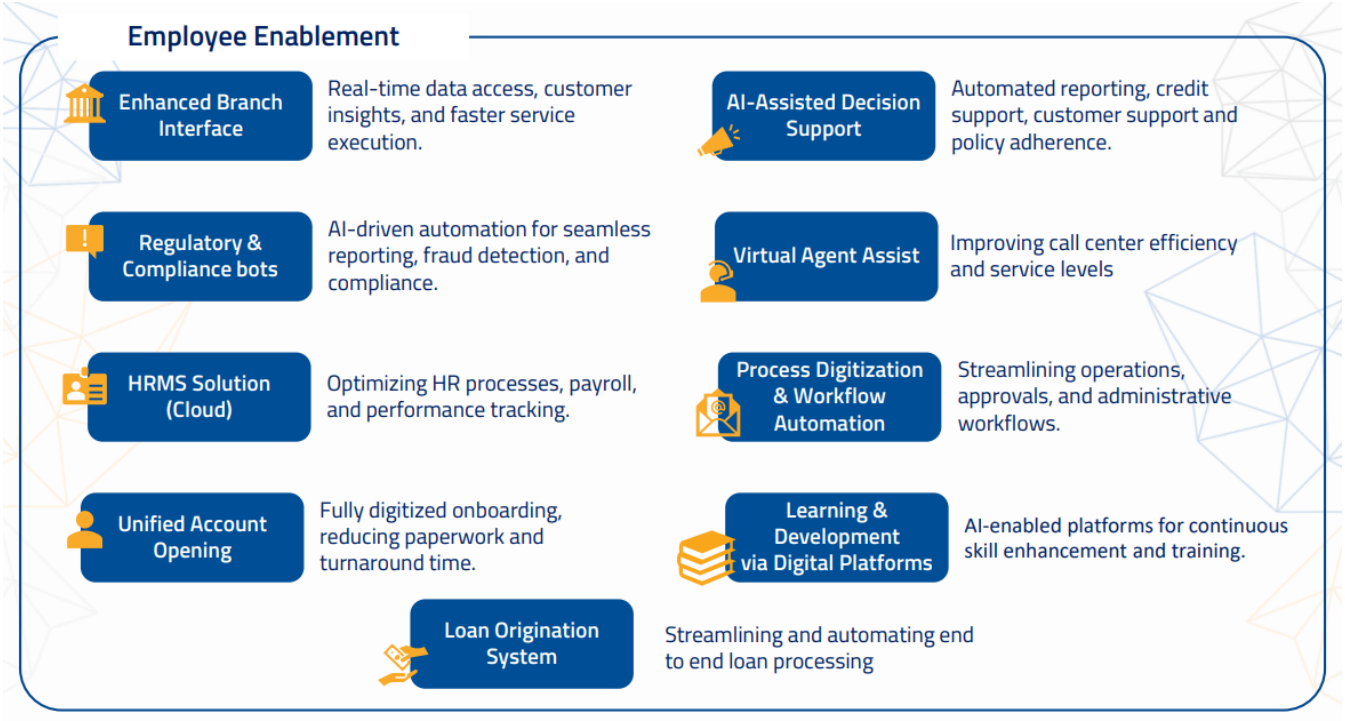
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Figure 14. Digital initiatives



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Figure 15. Digital



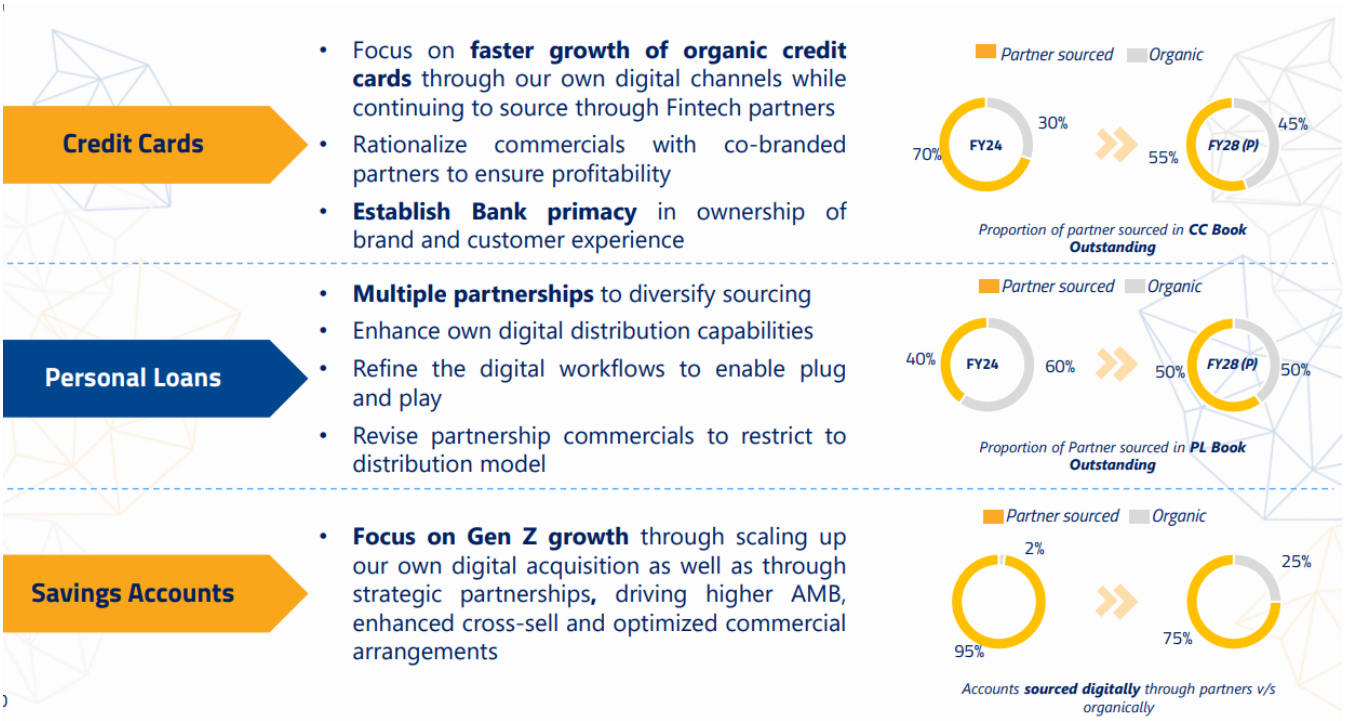
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Theme 8 – Digital Distribution Strategy

- Going forward, looking to create in-house capability for acquiring digital products vs sourcing through digital partners
- Almost 70% of credit cards sourced through partners as of FY24, which is expected to fall to 55% by FY28
- However, through diversifying sourcing across multiple partnerships in PL, share of partner sourced PL is expected to increase to 50%
- Savings account is largely fintech based and would want to have 25% own sourcing from 2% currently

Figure 16. Digital Distribution Strategy



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Source: Citi Research, Company Reports

Theme 9 – People and Culture

- To instill the culture of thinking through P&L into the organization
- To identify talent gaps and close as soon as possible

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Figure 17. People and Culture



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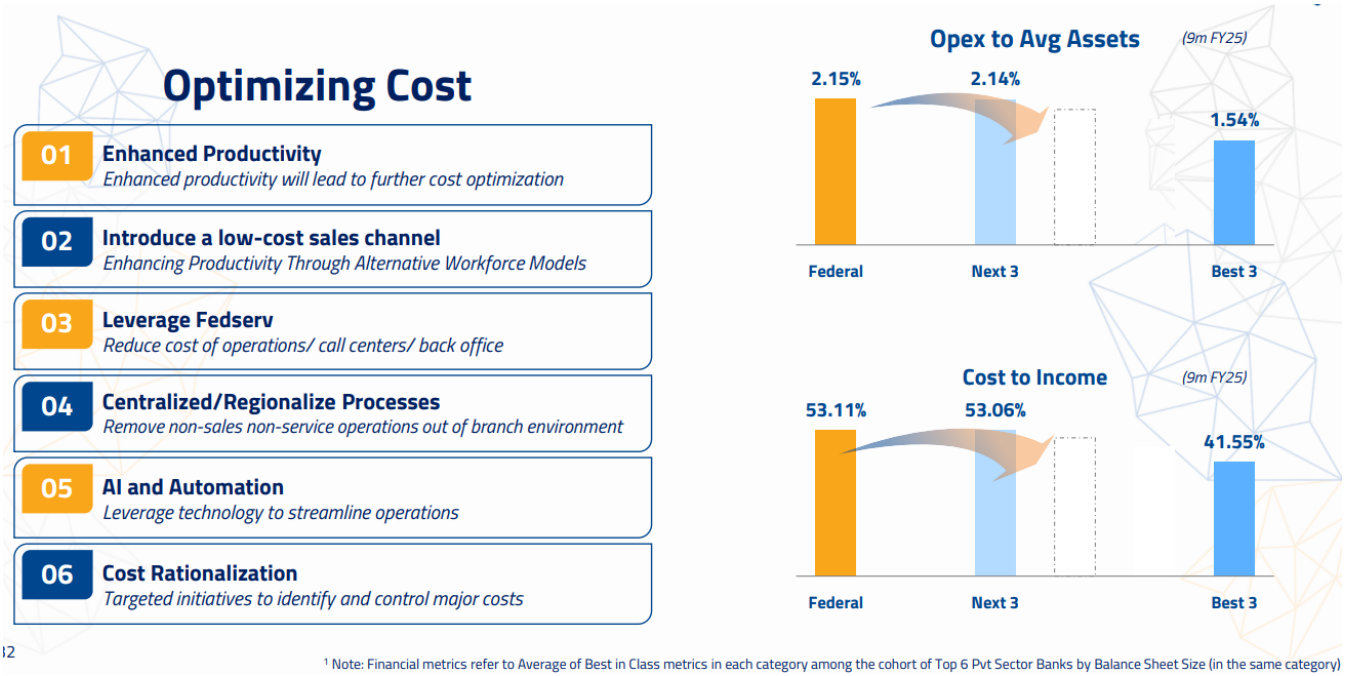
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Theme 10 – Cost Optimization

- Working on employee and branch scorecard to enhance productivity
- Leveraging FedServ to further reduce the cost of operations
- Expects to drive opex to assets below 2.14% and cost to income below 53%

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Figure 18. Optimizing cost



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Theme 11 – Strengthening Assurance Functions

– Will not compromise on compliance, risk, and audit functions

Figure 19. Assurance functions



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Theme 12 – Evolution towards Universal Bank

– Open for inorganic opportunities as well

Figure 20. Universal bank

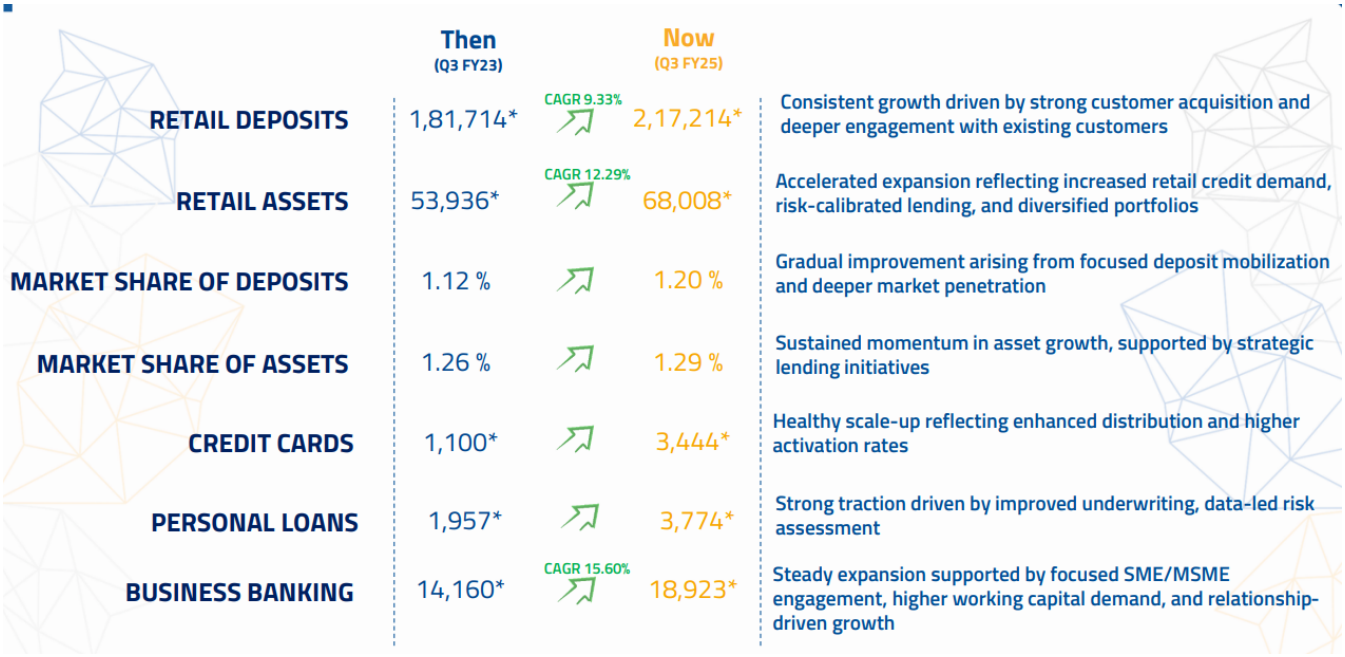


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Retail

Figure 21. Retail portfolio



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Branch Banking – Key initiatives include "Free the branch" by moving non-customer facing activities to regional/central locations and automate document management. It will also look to expand capacity for sales with focus on NTB, improvise RM models, and expand DIY tools. Branch head roles will be made more attractive, and to sharpen performance management protocols.

Deposits – Key initiative is to expand CA offerings be developing products and bespoke solutions, strengthen NR proposition, increase share of digital onboarding and originating multiple products along with leveraging analytics for growth (predictive analytics for focused cross-sell).

Wealth and Insurance Distribution – Focus is to enhance the product co-origination and cross-sell using analytics for pre-approved insurance. To enhance wealth management proposition for affluent and mass affluent segments.

Credit Cards – To have more feet on street, partnerships, and co-originations leading to expand distributions and market reach. To leverage AI and analytics and deploy data-led, profile-based sourcing models, and modernize collections.

Personal Loans – To broaden partnerships and leverage branch relationship and RM network. Driving new product adoptions, it will launch credit on UPI and develop co-origination journeys.

Auto Loans – Focus is on scaling up used car financing, expand loan against car products, to cross-sell credit cards and SA. Distribution expansion to be driven by

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multi-channel sourcing and alternate networks, digitization, etc. Furthermore, centralized underwriting could optimize cost and enhance profitability.

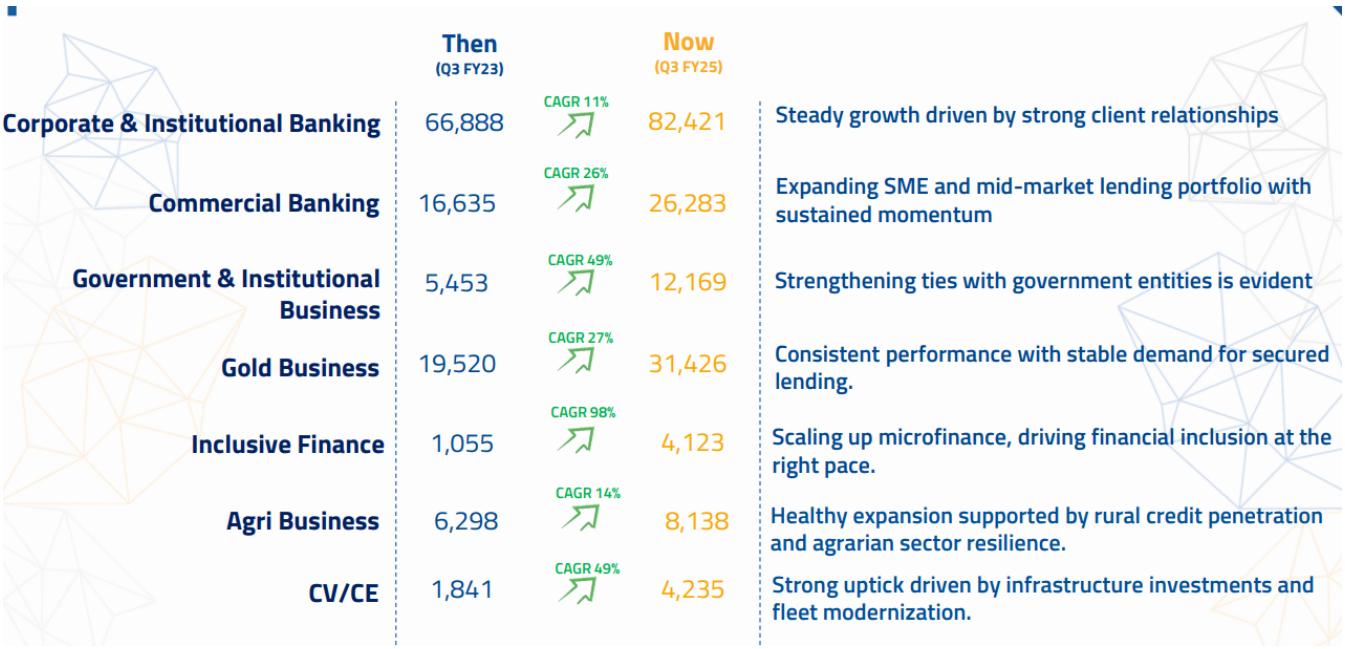
LAP – Key initiatives are to develop specialist channels for LAP, generate fee income opportunities by cross-sell, improve TAT and deploy manpower. To use hub and spoke arrangements for market penetration and leverage low LGD to improvise collections.

Home Loan – While pricing is the lever for industry, the focus is on cross-selling SA; 85% of HL customers have SA account with higher balance. It will also explore affordable housing to drove higher yields.

Business banking - Yield are attractive, collateralized (90%) and PSL benefits. Requirement of Forex and trade is the focus. Business instalment loan market on pre-approved basis. To implement customized underwriting based on inherent risk and to deliver best in class TAT.

Wholesale

Figure 22. Wholesale



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Corporate & Institution Banking – Looks to target mid-market corporate clients and thrust on deeper geographies for higher wallet share and income. To focus on bespoke corporate banking solutions and accelerate digital banking.

Commercial Banking – Granular asset book supports portfolio stability. It enjoys sole banking relationships with ~67% of clients. Focus is on penetrating in deeper geographies, lower TAT to enhance credit delivery, improve CA driven self-funding, scale SC finance and to expand client servicing centers.

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Government and Institutional business – Empaneled with CBTD and CBEC for tax collections, for agency business and non-agency business with central and state govt to drive expansion. Focus is on local authorities, bespoke digital solutions to government departments, etc.

Gold Loans – Has largest gold loan portfolio among private banks and is a high ROE business with high fee income and profitability. To further scale the business through BCs and sales channels and focus on branding and marketing.

Agri Business – Forms 80% of PSL portfolio. Focus is to expand market reach and distribution and optimize collections and recoveries.

CV/CE – 80% of CV/CE qualifies as PSL. Focus is to expand to tier-2 and 3 markets and scale ETB and NTB client base. Leverage AI for early warnings and thrust on quicker repossession and sale.

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Federal Bank

Company description

Federal Bank is a private-sector bank with its home market in the state of Kerala, which accounts for ~70% of CASA deposits and ~35% of loans. It has gradually expanded beyond Kerala and is changing its business mix to include higher-quality corporate and SME loans.

Investment strategy

We rate Federal Bank shares as Buy.GIven FB's better growth profile compared to peers and <5% unsecured lending book (CC/PL/MFI) risk to credit cost is expected to be low. Mgmt uncertainty is settled with RBI recently appointing Mr. KVS Manian as MD&CEO wef Sep'24. We now factor in lower transition risk and better medium-term growth profile.

Valuation

We value Federal Bank using a two-stage Gordon growth model. Key assumptions are: cost-of-equity of 12.7%, normalized RoE of 14%, growth during stage one 17%, and steady-state growth 4%. This gives us a target multiple of 1.7x, which we multiply by +2y Adjusted BVPS (adjusted for Net NPLs) to get to our target price of Rs242.

Risks

Downside risks that could mean the Federal Bank stock trades below our TP include: a) lower-than-expected NIMs for FY25/FY26E; b) higher-than-expected credit costs; and c) an overall lower-than-expected returns profile.

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Appendix A-1

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Federal Bank (FED.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Kunal Shah



	Date	Rating	Target Price	Closing Price
1	17-Jul-22 15:55:48	1	*123.00	98.70
2	07-Sep-22 12:13:16	1	*135.00	118.75
3	19-Oct-22 03:13:02	1	*153.00	131.30
4	16-Jan-23 13:13:05	1	*165.00	140.15
5	05-May-23 11:52:42	1	*160.00	128.20
6	16-Oct-23 11:00:43	1	*170.00	148.70
7	16-Jan-24 02:45:50	*3	*135.00	149.70
8	02-May-24 12:32:53	3	*155.00	167.70
9	24-Jul-24 22:59:59	*1	*231.00	202.50
10	01-Jan-25 05:30:35	1	*242.00	200.35

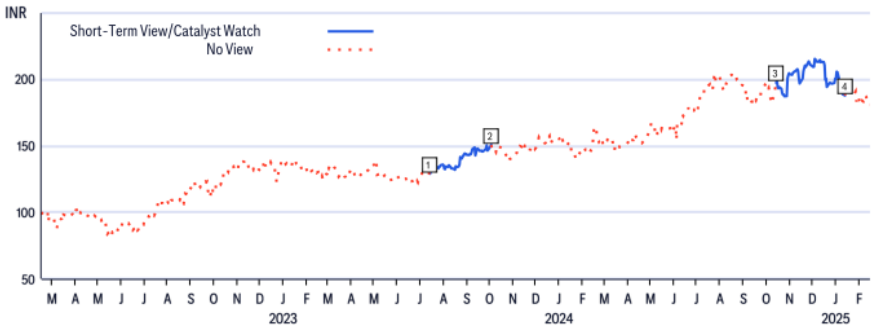
*Indicates Change

Rating/target price changes above reflect Eastern Time

Federal Bank (FED.BO)

Short-Term View/Catalyst Watch Research

Analyst: Kunal Shah



	Date	Action	Expected Direction	Duration	Closing Price
1	14-Jul-23 11:15:08	Add CW	Upside	90 Days	129.10
2	03-Oct-23 13:32:22	Remove CW	Upside	90 Days	150.65
3	14-Oct-24 02:55:47	Add CW	Upside	90 Days	197.55
4	13-Jan-25 00:28:29	Remove CW	Upside	90 Days	187.95

CW - Catalyst Watch , STV - Short-Term View

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