

Company Results Review

9 May 2007 | 9 pages

Kotak Mahindra Bank (KTKM.BO)

Hold: 4Q07 Results - Growth and Profitability

- **Growth with margins** — Kotak's 4Q07 profits were in-line with expectations and rose 30% yoy (flat qoq). Margins, however, expanded to 5.2% (5.1% earlier) along with strong loan growth of 49% yoy — a positive exception to the quarter. Deposit growth was also strong (+72%) with an improvement in mix of low-cost deposits. Overall an impressive performance given high exposure to consumer lending and a tight funding environment.
- **Broking business steady** — Broking remains steady after a strong 3Q07 and continues to grow market shares. Management suggests pressures on yields contained, though some slip-offs in profitability qoq due to large carry incomes on PMS portfolio previous quarter.
- **Fee income, asset quality remain healthy** — Core fee income growth remains healthy though some slowdown due to a higher base effect on high MF distribution income in 4Q06. Asset quality also showed signs of improvement despite higher regulatory provisions and a challenging quarter for the sector. High retail exposure, however, suggests provisioning pressures could likely increase.
- **Capital comfort** — One of the few banks suggesting that additional capital is not required for the next 12 months despite high growth; even more aggressive growth plans and tighter regulatory requirements.
- **Maintain Hold (2M)** — Kotak's business mix is improving with strong asset growth, margin expansion, improving deposit mix and healthy fee income; however, valuations remain high and limit potential upsides. We maintain Hold (2M).

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	1,709	5.62	-3.9	95.3	4.5	12.7	0.1
2006A	7,297	23.56	318.9	22.8	7.4	39.3	0.1
2007E	5,293	16.66	-29.3	32.2	5.4	19.4	0.1
2008E	6,466	19.88	19.3	27.0	4.5	18.4	0.2
2009E	7,712	23.71	19.3	22.6	3.8	18.4	0.2

Source: Powered by dataCentral

See Appendix A-1 for Analyst Certification and important disclosures.

Hold/Medium Risk	2M
Price (09 May 07)	Rs536.00
Target price	Rs512.00
Expected share price return	-4.5%
Expected dividend yield	0.1%
Expected total return	-4.3%
Market Cap	Rs174,819M
	US\$4,301M

Price Performance (RIC: KTKM.BO, BB: KMB IN)



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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	95.3	22.8	32.2	27.0	22.6
P/E reported (x)	95.3	22.8	32.2	27.0	22.6
P/BV (x)	4.5	7.4	5.4	4.5	3.8
P/Adjusted BV diluted (x)	11.3	7.4	5.4	4.6	3.8
Dividend yield (%)	0.1	0.1	0.1	0.2	0.2
Per Share Data (Rs)					
EPS adjusted	5.62	23.56	16.66	19.88	23.71
EPS reported	5.62	23.56	16.66	19.88	23.71
BVPS	118.94	72.65	99.04	118.01	140.69
Tangible BVPS	118.94	72.65	99.04	118.01	140.69
Adjusted BVPS diluted	47.43	72.43	98.75	117.67	140.28
DPS	0.50	0.60	0.70	0.88	1.00
Profit & Loss (RsM)					
Net interest income	4,475	6,649	9,532	12,022	15,290
Fees and commissions	3,910	8,347	10,623	12,643	14,617
Other operating Income	1,745	4,672	2,765	3,736	5,037
Total operating income	10,130	19,669	22,920	28,400	34,944
Total operating expenses	-6,856	-11,728	-13,673	-17,001	-21,266
Oper. profit bef. provisions	3,274	7,941	9,247	11,399	13,678
Bad debt provisions	-178	-512	-1,229	-1,629	-2,058
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	3,096	7,428	8,018	9,770	11,620
Tax	-1,157	-2,130	-2,803	-3,343	-3,882
Extraord./Min. Int./Pref. Div.	-230	1,999	78	39	-26
Attributable profit	1,709	7,297	5,293	6,466	7,712
Adjusted earnings	1,709	7,297	5,293	6,466	7,712
Growth Rates (%)					
EPS adjusted	-3.9	318.9	-29.3	19.3	19.3
Oper. profit bef. prov.	-3.9	142.5	16.4	23.3	20.0
Balance Sheet (RsM)					
Total assets	114,455	179,673	217,834	299,565	409,496
Avg interest earning assets	98,588	134,321	186,805	251,735	344,082
Customer loans	71,772	104,847	155,721	205,457	265,137
Gross NPLs	372	651	1,103	1,687	2,395
Liab. & shar. funds	114,455	179,673	217,834	299,565	409,496
Total customer deposits	38,326	56,167	103,594	153,474	212,253
Reserve for loan losses	325	648	1,446	2,549	3,949
Shareholders' equity	14,668	22,471	32,119	38,271	45,627
Profitability/Solvency Ratios (%)					
ROE adjusted	12.7	39.3	19.4	18.4	18.4
Net interest margin	4.54	4.95	5.10	4.78	4.44
Cost/income ratio	67.7	59.6	59.7	59.9	60.9
Cash cost/average assets	6.5	8.0	6.9	6.6	6.0
NPLs/customer loans	0.5	0.6	0.7	0.8	0.9
Reserve for loan losses/NPLs	87.5	99.6	131.2	151.1	164.8
Bad debt prov./avg. cust. loans	0.3	0.6	0.9	0.9	0.9
Loans/deposit ratio	187.3	186.7	150.3	133.9	124.9
Tier 1 capital ratio	11.0	8.2	8.6	7.2	6.4
Total capital ratio	14.2	12.7	11.3	9.7	8.5

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Figure 1. 4Q07 Results: Key Highlights (Rupees Million, Percent)

	4Q07	4Q06	YoY %	3Q07	QoQ%	Citigroup Investment Research Comments
Interest Income	6,373	3,693	72.6	5,278	20.7	Stronger than expected expansion on high loan growth and improving yields
Interest Expense	(3,083)	(1,580)	95.1	(2,668)	15.5	Deposit cost increases largely reflecting the tighter funding environment and lower than industry low cost deposit ratio
Net Interest Income	3,290	2,112	55.8	2,610	26.0	Strong show - expansion in margins to 5.2% in a challenging environment; NII is 23% ahead of expectations
Fee-Based Income	2,972	3,269	-9.1	3,154	-5.8	Some slowdown overall due to large base effects both qoq and yoy; core fee income growth remains healthy
Insurance Premium	4,581	3,618	26.6	2,092	119.0	
Other Non-Interest Income	339	673	-49.6	1,381	-75.5	
Non Interest Income	7,892	7,559	4.4	6,628	19.1	
Operating Income	11,182	9,671	15.6	9,238	21.0	
Operating Expenses	(8,283)	(7,188)	15.2	(6,323)	31.0	Slightly higher than expectations on continued investments on insurance and branch banking businesses; expense growth likely to remain high
Pre-Provision Profit	2,899	2,483	16.7	2,914	-0.5	
Charges for Bad Debts	(598)	(164)	264.0	(513)	16.7	Provisioning pressures contained despite one-off regulatory provisions in the quarter of about Rs310m; expect some pressure from the retail loans about 2-3 quarters down the line
Operating Profit	2,300	2,318	-0.8	2,401	-4.2	
Pre-Tax Profit	2,300	2,318	-0.8	2,401	-4.2	
Tax	(657)	(755)	-12.9	(772)	-14.9	Lower than expected due to write back of excess tax provisioning pertaining to earlier years
Minorities	61	(255)	NM	67	-9.0	
Net Profit	1,703	1,308	30.2	1,696	0.4	Overall in-line with expectations; growth along with margins
EPS	5.22	4.23	23.4	5.23	-0.2	
Customer Loans	155,734	104,214	49.4	137,139	13.6	Loan growth continues to be strong and all round with strong growth in both retail and corporate loans despite a challenging environment
Customer Deposits	96,610	56,167	72.0	97,100	-0.5	Continues to grow strongly though some pressures in the last quarter, overall mix improvement with low cost deposit ratio improving to about 22% from 19% in 4Q06
AIEA	231,794	141,462	63.9	199,131	16.4	
Total Assets	247,019	144,300	71.2	216,568	14.1	
Avg Assets	231,794	137,150	69.0	199,131	16.4	
Shareholders' Funds	32,330	22,471	43.9	30,793	5.0	
Book Value Per Share	99	73	36.3	95	4.3	
Key Ratios (%)	4Q07	4Q06	Bps Δ YoY	3Q07	Bps Δ QoQ	Citigroup Investment Research Comments
ROAA (annualized)	2.76	3.63	-87	2.07	69	
ROAE (annualized)	21.08	23.29	-221	12.91	817	
Net Interest Margin (bps)	525	512	13	524	1	Improvement in margins over the year, higher than expected despite tight liquidity and resultant cost pressures
Fee Inc/Operating Income	26.6	33.8	-722	27.9	-135	
Other Non-Interest Inc/Op Inc	3.0	7.0	-393	16.7	-1371	
Op. Cost/ Operating Income	74.1	74.3	-25	77.7	-359	Costs are likely to remain high with the aggressive expansion plans suggested by management
Loan-to-Deposit Ratio (LDR)	161.2	185.5	-2434	175.5	-1431	
NPL/Loan Ratio	0.4	0.5	-6	0.7	-22	Strong improvement over the quarter despite a high proportion of retail assets; expect some pressure going forward
LLR/NPL Ratio	62	55	751	69	-643	

Source: Company Reports and Citigroup Investment Research

Figure 2. 4Q07 Results: Key Business Segments (Rupees Million)

	4Q07	4Q06	YoY %	2Q07	QoQ%	Citigroup Investment Research Comments
Consolidated Revenue Mix						
Financing Activities	4,772	3,007	58.7	4,326	10.3	Continued strong growth and management suggests pricing power Stripped of high base effects - core fee income growth remains steady
Core Fee income	2,972	3,268	-9.1	3,165	-6.1	
Premium on Insurance	4,581	3,618	26.6	2,093	118.9	
Treasury	1,906	1,288	48.0	2,306	-17.3	
Others	34	70	-51.6	16	113.2	
Total	14,265	11,251	26.8	11,906	19.8	
Kotak Mahindra Bank - standalone						
Operating profit before branch banking losses	675	282	139.4	775	-13.0	
Branch banking losses	(219)	232	NM	(83)	165.4	Expected doubling of branches in 12-15 months to keep losses continuing even as the earlier branches start to break even
PBT	455	514	-11.4	693	-34.3	
PAT	373	347	7.3	454	-17.9	
Kotak Mahindra Capital Company						
PBT - PD business	70	51	36.5	40	74.8	
PBT - Franchise business	222	299	-25.7	231	-3.8	
Total PBT	292	351	-16.6	271	7.7	
Total PAT	206	267	-23.1	189	8.6	
Kotak Securities						
Average Daily volumes	42,000	35,700	17.6	40,000	5.0	Improvement in market share slightly; management suggests pressure on yields contained
AUM - PMS	23,000	25,900	-11.2	21,300	8.0	
Total Income	2,333	2,228	4.7	2,386	-2.2	High base effect due to large carry income on PMS in the previous quarter
PAT	751	804	-6.6	804	-6.6	
Kotak Mahindra Primus						
Disbursements			NM		NM	
Assets	36,000	30,300	18.8	32,900	9.4	
Total income	1,368	907	50.8	1,150	19.0	
PBT before royalty	367	138	166.3	155	137.5	
PAT	244	95	156.1	109	124.1	High growth as part of the lending business also done through this entity
OM Kotak Mahindra Life Insurance						
Premium income	4,668	3,640	28.2	2,133	118.9	Growth is lower than industry; management suggests focusing only on higher value transactions
PAT	(101)	(12)	722.0	(176)	-42.5	
Kotak Mahindra Asset Management						
AUM	121000	104100	16.2	126900	-4.6	
Total Income	138.4	108	28.1	137.5	0.7	
PAT	0.8	2.5	-68.0	12	-93.3	

Source: Company Reports and Citigroup Investment Research

Kotak Mahindra Bank

Company description

Kotak is a private-sector bank in which Mr. Uday Kotak, the promoter, and his associates have a 60% stake. Main businesses of the bank are consumer lending, retail broking, investment banking, asset management, and rapidly growing life insurance. Its focus is to develop a niche wealth-management platform.

Investment thesis

Kotak is a high-quality play on the growing financial services market in India. It is backed by a management team that has a track record of managing market and credit risk well, and of being conservative in its approach. We see Kotak as a leveraged play on: 1) Ongoing disintermediation - with a shift from traditional bank-deposit-type savings instruments to more market-oriented ones. Kotak is a direct provider of these services - asset management, life insurance and equity investing - and looks well positioned to capture the distribution potential of these services. 2) Consumer lending in India - strong market positions in consumer lending, robust and specialized distribution, and it is among probably just two players with experience in consumer credit cycles. Kotak is also highly leveraged to this segment - over 80% of its asset book is in consumer lending. We think its portfolio is well managed, mature and profitable. 3) Direct exposure to growth in the capital market - Kotak is a leader in the primary and secondary markets, which is backed by an extensive and independent distribution franchise. However, its high dependence on the capital market raises the risk of business cyclicality, and is an investment characteristic of Kotak. This risk appears more pronounced in the near term, given the recent market upswing. We rate Kotak Hold/Medium Risk, as we believe that near-term returns will be muted after recent strong stock performance.

Valuation

Our target price for Kotak is Rs512. Its relatively high share of securities fees suggests a valuation benchmark of an investment bank. However, there are no such comparables in the Indian market, and Kotak is much smaller than its global peers. Hence, we use EVA and a sum-of-the-parts to value Kotak. EVA methodology: We use a 800bp risk-free rate to calculate cost of equity, in line with the other banks, and a market beta of 1. We are not consolidating the insurance subsidiary's financials. Instead, we account for it on a per-share basis as an associate (Rs78). Based on our EVA valuation, we value Kotak at Rs512. Sum-of-parts valuation: Given KTKM's spread of businesses, we believe a sum-of-parts valuation is also an appropriate benchmark. Based on this, we estimate fair value of Kotak at Rs442. This is benchmarked off FY08 estimates. This sum-of-parts valuation incorporates a value of Rs96 for the bank (3X FY08 PBV), Rs172 for brokerage (16X PE FY08), Rs78 for Life Insurance (15x NBAP FY08), and fair market multiples for its other business lines. We are not factoring in any value for its stressed asset business given the relative lack of data - though we believe that offers additional valuation support. We benchmark our target multiple off our EVA valuation of Rs512. This is our preferred methodology, given that we think it better captures the value of fee incomes, as well as the longer-term value creation by the franchise.

Risks

We rate Kotak as Medium Risk, though our quantitative model now suggests a Low Risk rating. We believe a higher risk rating is justified in part because of strong stock performance over the recent past, but also in view of Kotak's relatively small balance sheet size. This extends to the business mix and drivers, including: a) Wholesale funding: b) Execution risk: Kotak is growing aggressively, is evolving a new operating structure, and is rapidly building a branch network. The pace of change amid Kotak's conservatism and the competitive business environment could create execution risks. c) Capital

market cyclicality: Kotak generates more revenues from the capital markets than any other bank in India, and its profitability in the recent past has been significantly boosted by strong equity markets. The cyclical nature of these capital markets, particularly after a strong performance, is a key risk to earnings and valuations. Upside risks to our rating and target price include: a) Strong primary and secondary capital markets: Kotak's strong position in the capital markets and relatively high earnings reliance could significantly boost earnings and valuations. b) Stronger-than-expected performance and benchmark valuations for the unlisted life insurance venture. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

Analyst Certification

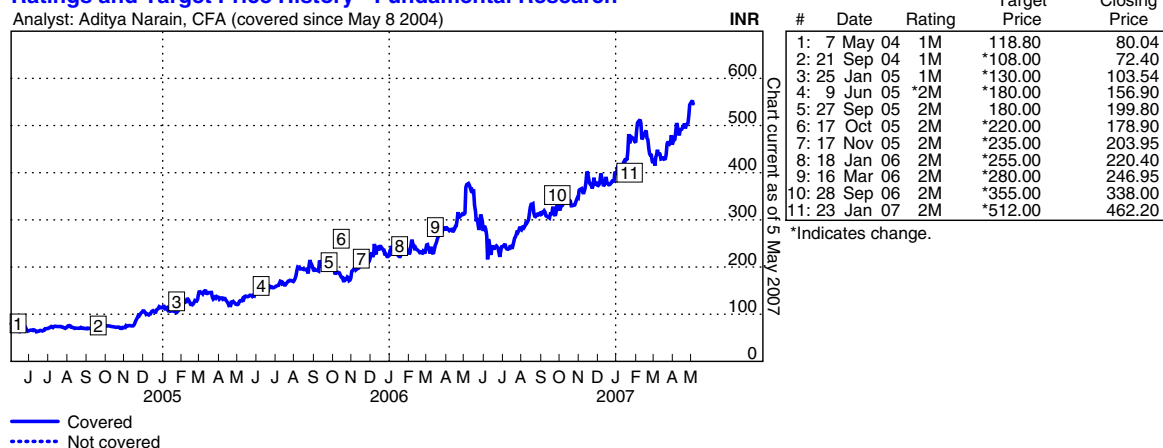
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Kotak Mahindra Bank (KTKM.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Aditya Narain, CFA (covered since May 8 2004)



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