

Company

28 July 2009 | 10 pages

Kotak Mahindra Bank (KTKM.BO)

Equity ☒

Sell: 1Q10 Results – Transition Time

- **Strong 43% YoY profits – qualitative questions** — The strong capital markets environment was always going to benefit KTKM: 43% profit growth (14% ahead of our expectations) reflects as much. This quarter, however, does raise questions: on asset quality, the likely asset mix ahead and how management will evolve its business model in the face of what it sees as a changing operating and regulatory environment. Transition time ahead.
- **P&L – markets, margins and costs, but loan provisions** — P&L is a mix of positives – significant broking momentum (though there is share and yield loss), margins that remain impressively high at 6% (though moderate QoQ) and meaningful operating cost control (-20%yoy). There are negatives, loan loss provisions jump (4.6x YoY), the P&L reflects the leverage to markets and management's fundamentally sharp eye on profitability. Markets will continue to drive P&L direction – margins, cost and provisioning trends likely muted.
- **Balance sheet – pain, and some change** — KTKM's asset quality has faced bunched up pressure – a near doubling of NPAs (QoQ), limited asset growth, large provisions and questions on the portfolio retail bias. Management suggests a peaking of asset pressures, a transition to more wholesale assets (will remain predominantly retail) and that it will grow about 15% for the year. All fair, but market will likely watch the transition, for ability, time and any pain.
- **Watch the transition (from the sidelines) – Maintain Sell** —KTKM continues to execute cautiously and well – but between balance-sheet transition, capital markets (though we believe KTKM's market leverage has reduced– not necessarily visible in this quarter) and relatively full valuations, we would sit on the sidelines for now.

Statistical Abstract

| Year to | Net Profit | Diluted EPS | EPS growth | P/E | P/B | ROE | Yield |
|---------|------------|-------------|------------|------|-----|------|-------|
| 31 Mar | (RsM) | (Rs) | (%) | (x) | (x) | (%) | (%) |
| 2008A | 9,912 | 29.47 | 74.5 | 22.5 | 3.9 | 21.9 | 0.1 |
| 2009A | 6,524 | 18.87 | -35.9 | 35.1 | 3.5 | 10.6 | 0.1 |
| 2010E | 9,434 | 27.30 | 44.6 | 24.3 | 3.1 | 13.7 | 0.1 |
| 2011E | 10,453 | 30.24 | 10.8 | 21.9 | 2.7 | 13.3 | 0.1 |
| 2012E | 12,708 | 36.77 | 21.6 | 18.0 | 2.4 | 14.1 | 0.2 |

Source: Powered by dataCentral

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

| | |
|------------------------------|--------------|
| Sell/High Risk | 3H |
| Price (28 Jul 09) | Rs662.15 |
| Target price | Rs639.00 |
| Expected share price return | -3.5% |
| Expected dividend yield | 0.1% |
| Expected total return | -3.4% |
| Market Cap | Rs229,480M |
| | US\$4,763M |

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



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| Fiscal year end 31-Mar | 2008 | 2009 | 2010E | 2011E | 2012E |
|--|----------------|----------------|----------------|----------------|----------------|
| Valuation Ratios | | | | | |
| P/E adjusted (x) | 22.5 | 35.1 | 24.3 | 21.9 | 18.0 |
| P/E reported (x) | 22.5 | 35.1 | 24.3 | 21.9 | 18.0 |
| P/BV (x) | 3.9 | 3.5 | 3.1 | 2.7 | 2.4 |
| P/Adjusted BV diluted (x) | 3.9 | 3.5 | 3.1 | 2.7 | 2.4 |
| Dividend yield (%) | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |
| Per Share Data (Rs) | | | | | |
| EPS adjusted | 29.47 | 18.87 | 27.30 | 30.24 | 36.77 |
| EPS reported | 29.47 | 18.87 | 27.30 | 30.24 | 36.77 |
| BVPS | 168.97 | 187.15 | 213.72 | 243.15 | 279.02 |
| Tangible BVPS | 168.97 | 187.15 | 213.72 | 243.15 | 279.02 |
| Adjusted BVPS diluted | 168.50 | 186.63 | 213.13 | 242.48 | 278.25 |
| DPS | 0.75 | 0.75 | 0.80 | 0.90 | 1.00 |
| Profit & Loss (RsM) | | | | | |
| Net interest income | 18,319 | 23,741 | 25,303 | 26,687 | 31,381 |
| Fees and commissions | 14,385 | 6,747 | 14,866 | 17,049 | 20,454 |
| Other operating Income | 14,297 | 10,684 | 9,258 | 13,802 | 17,299 |
| Total operating income | 47,002 | 41,173 | 49,427 | 57,537 | 69,135 |
| Total operating expenses | -29,292 | -27,713 | -31,223 | -37,153 | -43,871 |
| Oper. profit bef. provisions | 17,709 | 13,460 | 18,205 | 20,384 | 25,263 |
| Bad debt provisions | -3,630 | -3,298 | -3,998 | -4,641 | -6,018 |
| Non-operating/exceptionals | 0 | 0 | 0 | 0 | 0 |
| Pre-tax profit | 14,079 | 10,162 | 14,207 | 15,743 | 19,246 |
| Tax | -4,492 | -3,635 | -4,720 | -5,238 | -6,486 |
| Extraord./Min. Int./Pref. Div. | 325 | -3 | -52 | -52 | -52 |
| Attributable profit | 9,912 | 6,524 | 9,434 | 10,453 | 12,708 |
| Adjusted earnings | 9,912 | 6,524 | 9,434 | 10,453 | 12,708 |
| Growth Rates (%) | | | | | |
| EPS adjusted | 74.5 | -35.9 | 44.6 | 10.8 | 21.6 |
| Oper. profit bef. prov. | 90.2 | -24.0 | 35.3 | 12.0 | 23.9 |
| Balance Sheet (RsM) | | | | | |
| Total assets | 405,972 | 405,540 | 457,839 | 545,757 | 635,977 |
| Avg interest earning assets | 321,898 | 363,418 | 372,809 | 435,634 | 513,484 |
| Customer loans | 222,785 | 226,483 | 263,439 | 323,612 | 383,976 |
| Gross NPLs | 4,347 | 6,886 | 9,774 | 12,952 | 16,337 |
| Liab. & shar. funds | 405,972 | 405,540 | 457,839 | 545,757 | 635,977 |
| Total customer deposits | 136,919 | 156,449 | 171,950 | 210,547 | 247,035 |
| Reserve for loan losses | 2,938 | 5,223 | 7,818 | 10,484 | 13,895 |
| Shareholders' equity | 58,239 | 64,504 | 73,663 | 83,806 | 96,169 |
| Profitability/Solvency Ratios (%) | | | | | |
| ROE adjusted | 21.9 | 10.6 | 13.7 | 13.3 | 14.1 |
| Net interest margin | 5.69 | 6.53 | 6.79 | 6.13 | 6.11 |
| Cost/income ratio | 62.3 | 67.3 | 63.2 | 64.6 | 63.5 |
| Cash cost/average assets | 8.5 | 6.8 | 7.2 | 7.4 | 7.4 |
| NPLs/customer loans | 2.0 | 3.0 | 3.7 | 4.0 | 4.3 |
| Reserve for loan losses/NPLs | 67.6 | 75.9 | 80.0 | 80.9 | 85.0 |
| Bad debt prov./avg. cust. loans | 1.9 | 1.5 | 1.6 | 1.6 | 1.7 |
| Loans/deposit ratio | 162.7 | 144.8 | 153.2 | 153.7 | 155.4 |
| Tier 1 capital ratio | 14.5 | 14.9 | 12.9 | 10.8 | 9.3 |
| Total capital ratio | 18.7 | 19.5 | 17.3 | 15.0 | 13.3 |

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Figure 1. Kotak Mahindra: 1Q FY10 Highlights (Rupees Million, Percent)

| | 1Q10 | 1Q09 | YoY % | 4Q09 | QoQ% | CIRA Comments |
|---------------------------------------|---------------|---------------|------------------|---------------|------------------|--|
| Interest Income | 10,627 | 10,419 | 2.0 | 11,045 | -3.8 | |
| Interest Expense | -4,377 | -4,658 | -6.0 | -4,768 | -8.2 | |
| Net Interest Income | 6,251 | 5,761 | 8.5 | 6,276 | -0.4 | Holds high margins - above expectations, and bucking distinct downward pressure witnessed by the broader system |
| Fee-Based Income | 2,999 | 2,891 | 3.7 | 2,124 | 41.2 | Sharp bounce-back in capital markets - no big surprise, though still off peaks, and market share on a trend basis remain under pressure |
| Insurance Premium | 4,268 | 3,924 | 8.8 | 8,977 | -52.5 | New business premium growth down - a little ahead of industry; overall growth a reflection of renewal premium which also reflects the increased maturity of the business |
| Insurance Reval | 4,162 | -2,555 | NM | -383 | NM | Clearly a gain quarter for policy holders - all passed through to insurance policy holders, so no effective gain on the P&L |
| Other Non-Interest Income | 1,385 | 2,747 | -49.6 | 217 | 537.1 | Treasury environment remains strong - a likely mix of actual gains and portfolio revaluation |
| Non Interest Income | 12,814 | 5,638 | 127.3 | 10,936 | 17.2 | |
| Operating Income | 19,064 | 11,399 | 67.2 | 17,212 | 10.8 | |
| Other Operating Expenses | -5,765 | -7,921 | -27.2 | -6,249 | -7.7 | Very impressive show - and management suggests there is some more to come - though if capital market markets remain strong, employee cost pressures should start rising |
| Insurance Reval | -7,607 | -446 | 1606.6 | -6,709 | 13.4 | |
| Operating Expenses | -13,372 | -8,366 | 59.8 | -12,958 | 3.2 | |
| Pre-Provision Profit | 5,692 | 3,033 | 87.7 | 4,253 | 33.8 | |
| Charges for Bad Debts | -1,908 | -412 | 362.6 | -1,347 | 41.6 | Significant increase - asset quality pressures clearly visible, and along with the relatively higher unsecured loan bias, P&L pressures are higher |
| Pre-Tax Profit | 3,784 | 2,620 | 44.4 | 2,906 | 30.2 | |
| Tax | -1,070 | -933 | 14.7 | -1,094 | -2.2 | |
| Minorities | -3 | 105 | NM | -102 | -97.2 | |
| Extraordinary Items | -150 | 0 | NM | 0 | NM | |
| Net Profit ex Insurance | 2,561 | 1,793 | 42.9 | 1,710 | 49.8 | |
| Insurance loss | 11 | -398 | NM | 397 | -97.2 | A second quarter of gain - lower growth helps, but Kotak Life has been at the forefront of seeking absolute returns from this business |
| Net Profit including insurance | 2,572 | 1,395 | 84.4 | 2,107 | 22.1 | |
| EPS | 7.4 | 5.2 | 42.9 | 4.9 | 50.4 | |
| Customer Loans | 232,731 | 231,695 | 0.4 | 224,976 | 3.4 | Some growth - but all in wholesale long; management seeking to transition to a more whole-sale, and secured loan book |
| Customer Deposits | 156,477 | 143,730 | 8.9 | 138,228 | 13.2 | |
| AIEA | 416,705 | 384,052 | 8.5 | 358,021 | 16.4 | |
| AIBL | 263,552 | 257,294 | 2.4 | 257,414 | 2.4 | |
| Total Assets | 355,083 | 308,491 | 15.1 | 321,598 | 10.4 | |
| Avg Assets | 338,341 | 340,983 | -0.8 | 358,021 | -5.5 | |
| Non-Performing Loans (NPL) | 10,659 | 2664 | 300.0 | 5,489 | 94.2 | The key disappointment - management suggests this is the peak and incremental pressures are deteriorating, but market expectations of management were higher - the retail bias in the loan portfolio clearly showing, and management will probably continue to cut large parts of the unsecured lending book |
| Loan Loss Reserves (LLR) | (5,842) | -1576 | 270.8 | (2,835) | 106.1 | |
| Shareholders' Funds | 67,993 | 59,974 | 13.4 | 65,226 | 4.2 | |
| Book Value Per Share | 197 | 174 | 12.9 | 189 | 4.2 | Remains very well capitalized - over 18% in Tier 1, and we would expect KTKM to remain defensively positioned on capital |
| Key Ratios (%) | 1Q10 | 1Q09 | Bps Δ YoY | 4Q09 | Bps Δ QoQ | |
| ROAA (annualized) | 3.03 | 2.10 | 93 | 1.91 | 112 | |
| ROAE (annualized) | 15.07 | 11.96 | 311 | 10.49 | 458 | |
| Net Interest Margin (bps) | 600 | 600 | 0 | 701 | -101 | Moderates over quarter, though remains high - should start moderating, as management seeks to raise the whole-sale bias of its portfolio, where gross spreads should be markedly lower |
| Fee Inc/Operating Income | 15.7 | 25.4 | -964 | 12.3 | 339 | |
| Other Non-Interest Inc/Op Inc | 67.2 | 49.5 | 1775 | 63.5 | 368 | |
| Op. Cost/ Operating Income | 70.1 | 73.4 | -325 | 75.3 | -515 | |
| Loan-to-Deposit Ratio (LDR) | 148.7 | 161.2 | -1247 | 162.8 | -1403 | |
| NPL Ratio | 4.6 | 1.2 | 343 | 2.4 | 214 | Sharp jump - key negative, with pressures predominantly in the retail unsecured space: management suggests a peaking, but the quarter jump an unexpected surprise |
| LLR/NPL Ratio | 55 | 59 | -433 | 52 | 316 | |

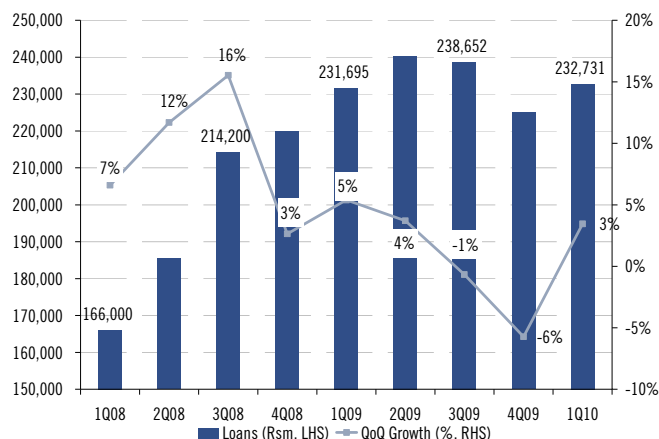
Source: Citi Investment Research and Analysis

Figure 2. Kotak Mahindra Bank: 1Q10 Results – Key Business Segments (Rupees Million, Percent)

| | 1Q10 | 1Q09 | YoY % | 4Q09 | QoQ% | |
|---|---------|---------|-------|---------|--------|---|
| Consolidated Revenue Mix | | | | | | |
| Financing Activities | 8,294 | 8,173 | 1.5 | 8,931 | -7.1 | |
| Core Fee income | 2,999 | 2,891 | 3.7 | 2,123 | 41.3 | Broking (rather than investment banking) rebound - market share losses however continue, and effective yields decline as the market volume mix continues to become more low margin |
| Premium on Insurance | 4,268 | 3,924 | 8.8 | 8,977 | -52.5 | |
| Treasury | 3,218 | 1,491 | 115.8 | 2,052 | 56.8 | |
| Others | 512 | 949 | -46.0 | 677 | -24.4 | |
| Total | 19,291 | 17,428 | 10.7 | 22,760 | -15.2 | |
| Kotak Mahindra Bank - standalone | | | | | | |
| Operating profit before branch banking losses | 1,656 | 1,537 | 7.7 | 2,008 | -17.5 | |
| Branch banking losses | (388) | (718) | -46.0 | (406) | -4.4 | Credit card losses remain high - disappointing, given that the market had already turned when product was launched |
| PBT | 1,268 | 819 | 54.8 | 1,602 | -20.8 | |
| PAT | 903 | 545 | 65.7 | 1,026 | -12.0 | A strong show, but boosted by trading gains |
| Kotak Mahindra Capital Company | | | | | | |
| Total PBT | 77 | 153 | -49.7 | (53) | NM | Management suggests a large pipeline, but profitability a little modest given the relative scale of activity in quarter |
| Total PAT | 48 | 96 | -50.0 | (38) | NM | |
| Kotak Securities | | | | | | |
| Average Daily volumes | 41,000 | 39,000 | 5.1 | 26,000 | 57.7 | Very healthy pickup - market driven, but market share is structurally lower than in previous years |
| AUM - PMS | 26,000 | 31,000 | -16.1 | 23,000 | 13.0 | |
| Total Income | 2,234 | 2,218 | 0.7 | 1,266 | 76.5 | |
| PAT | 743 | 435 | 70.8 | 180 | 312.8 | High operating leverage in evidence, though we do believe some customer franchise has eroded |
| Kotak Mahindra Prime | | | | | | |
| Total income | 2,239 | 2,375 | -5.7 | 2,546 | -12.1 | Auto business continues to do well - along with mortgages a growth area |
| PBT | 299 | 635 | -52.9 | 725 | -58.8 | |
| PAT | 189 | 413 | -54.2 | 470 | -59.8 | Profitability pressures on the unsecured book; unwinding profitability |
| Kotak Mahindra Old Mutual Life | | | | | | |
| Premium income | 4,334 | 4,002 | 8.3 | 9,059 | -52.2 | |
| PAT | 11 | (398) | NM | 397 | -97.2 | Profitability is well managed, but growth has gone |
| Kotak Mahindra Asset Management | | | | | | |
| AUM | 256,000 | 190,000 | 34.7 | 159,000 | 61.0 | |
| Total Income | 373 | 177 | 110.7 | 254 | 46.9 | |
| PAT | 139 | -4 | NM | 71 | 95.8 | AMC businesses doing well on growth, and translating into profitability |
| Kotak Investment Advisors Limited | | | | | | |
| AUM | 55,000 | 57,000 | -3.5 | 66,000 | -16.7 | |
| Total Income | 255 | 282 | -9.6 | 299 | -14.7 | |
| PAT | 118 | 130 | -9.2 | 102 | 15.7 | |
| International Subs | | | | | | |
| AUM (USD mn) | 1,600 | 1,800 | -11.1 | 1,100 | 45.5 | |
| PBT | 261 | 118 | 121.2 | 31 | 741.9 | |
| PAT | 231 | 89 | 159.6 | 19 | 1115.8 | |

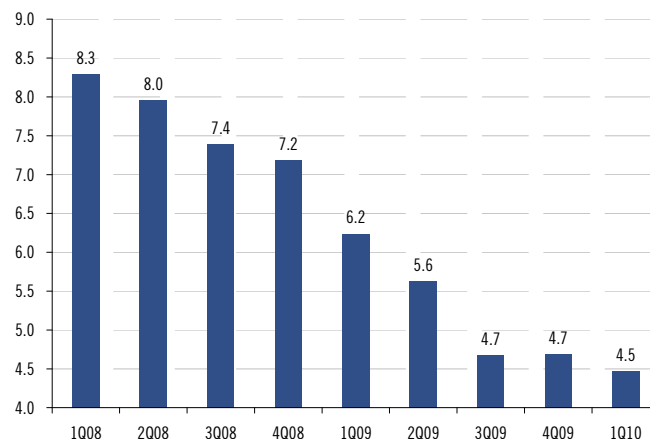
Source: Citi Investment Research and Analysis

Figure 3. Loans (Rsm) and its QoQ Growth (%)



Source: Citi Investment Research and Analysis

Figure 4. Broking Market Share (%)



Source: Citi Investment Research and Analysis

Kotak Mahindra Bank

Company description

KTKM is a private-sector bank in which Mr. Uday Kotak, the major shareholder, and his associates have a 52% 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 strategy

We rate KTKM Sell/High Risk (3H) with a target price of Rs639. KTKM, in our view, is a play on the 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 believe the current economic and market environment plays to KTKM's business mix and model through: 1) Capitals markets and broking related revenue, 2) Its financial services diversifications - Insurance, Asset Management and Wealth management, all face the same capital markets tailwinds; and 3) Banking platform gains on easier funding, and lesser asset quality pressures. While all these augur well for the business, we believe over the last 18 months Kotak has moderated its leverage and risks to the market and economic environment - and to that extent, will be less of a beneficiary of the rising capital markets tide. While we expect it will gain meaningfully, it may not be to the extent the market and stock price currently extrapolates. We believe the banking business benefits from its ability to build the funding side more aggressively and stability, but that value will only be realised over the medium-term, which compares to the capital market value we believe is being attributed to KTKM over the immediate-term.

Valuation

Our target price of Rs639 is based on our valuation of KTKM's different businesses via the sum-of-the-parts methodology. This values the banking business at Rs273 per share 2.25x PBV 1-year fwd, the investment banking and broking business at 15x 1-year Fwd PE or Rs157, the insurance subsidiary at Rs90 at 14x FY10E NBAP, and we attribute Rs45 to the AMC business (5% of AUM for MF, and 8% for Portfolio and alternative assets). While our target multiples are relatively conservative in the historical India scenario, they are not worst-case scenarios, and only factor in a continued weak economic and market outlook, rather than one with significant deterioration.

Risks

We rate KTKM as High Risk. We believe the High Risk rating is justified on account of revenue pressures, its relatively small balance sheet, and on account of the global uncertainty surrounding financial institutions. Our quantitative risk rating system which tracks the 260-day share price volatility of the stock suggests Speculative risk, but the broad-based nature of the businesses, high capital levels and conservative management of the company, moderate the risk levels of the business. Upside risks to the stock and business would be: a) Strong bounce-back in the capital markets; b) Its large capital position - which positions it at a distinct advantage to competitor and peer banks; and c) Less than anticipated pressures on the banking business, and its quality. These risks could prevent the stock from achieving our target price.

Appendix A-1

Analyst Certification

Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Kotak Mahindra Bank (KTKM.BO)

Ratings and Target Price History

Fundamental Research

Analyst: Aditya Narain, CFA

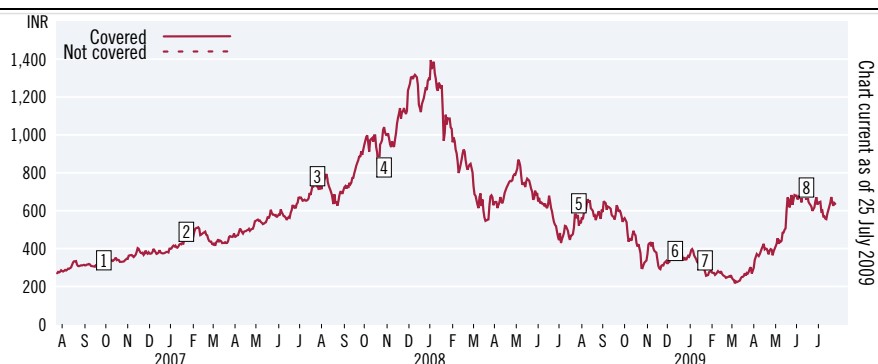


Chart current as of 25 July 2009

| | Date | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 1 | 28-Sep-06 | 2M | *355.00 | 338.00 |
| 2 | 23-Jan-07 | 2M | *512.00 | 462.20 |
| 3 | 26-Jul-07 | 2M | *825.00 | 730.55 |

| | Date | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 4 | 29-Oct-07 | 2M | *1,110.00 | 1,041.20 |
| 5 | 29-Jul-08 | 2M | *635.00 | 521.00 |
| 6 | 11-Dec-08 | 2M | *400.00 | 380.05 |

| | Date | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 7 | 22-Jan-09 | *3H | *282.00 | 276.65 |
| 8 | 14-Jun-09 | 3H | *639.00 | 671.50 |

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citi Investment Research Ratings Distribution

Data current as of 30 Jun 2009

| | Buy | Hold | Sell |
|--|-----|------|------|
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| % of companies in each rating category that are investment banking clients | 46% | 45% | 39% |

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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or

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