Company

Global Markets Research

GEMS: Asia India
Banking/Finance Banks

Deutsche Bank

16 April 2007

Karnataka Bank

Reuters: **KBNK.BO** Bloomberg: **NKBL IN** Exchange: **BSE** Ticker: **KBNK**

Efficiency counts; initiate with a Buy

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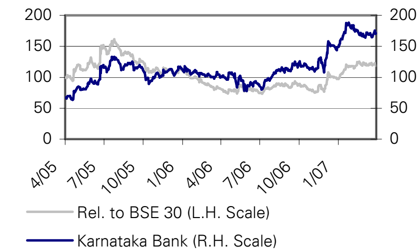
Initiation of Coverage

Buy

Price at 13 Apr 2007 (INR)	**171.30**
Price target - 12mth (INR)	**220.00**
52-week range (INR)	**188.15 - 77.90**
BSE 30	**13,384**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*0.7*	*15.1*	*71.7*
BSE 30	*3.1*	*-4.8*	*19.1*

Stock data

Market cap (INRm)	**20,774**
Market cap (USDm)	**489**
Shares outstanding (m)	**121.3**
Major shareholders	**Oppenheimer Funds (5%)**
Free float (%)	**100**

Key indicators (FY1)

ROE (%)	**18.7**
Loan/deposit ratio (%)	**67.6**
Book value/share (INR)	**106.18**
Price/book (x)	**1.6**
NPL/total loans (%)	**4.1**
Net int margin (%)	**2.75**

Lean, progressive and attractive franchise

We initiate coverage on Karnataka Bank (KBL) with a Buy and price target of Rs220. Our recommendation is predicated on KBL's conscious strategy of profitable growth, continued operating efficiency and a large, technically developed --- although still underutilised --- franchise. Credible efforts to scale up low-cost deposits and fee income add to the flavour.

Commendable example of growth with stability

We like KBL's strategy of controlled loan growth, effective use of excess SLR securities and shedding of high-cost liabilities – features which further much-needed stability in the current volatile interest rate scenario, and potentially continued good asset quality. A flurry of new fee-generating product launches, although belated, characterizes the efforts to use the network better.

Stable margins, continued efficiency and rising leverage to maintain RoE

With asset yield increases in line with the rise in cost of funds, we estimate stable margins ~2.75%. Cost to average assets ratio is likely to remain around the current, industry-beating low levels ~1.5%, with modest branch additions and core banking solution costs already absorbed. Capital adequacy being largely accounted for by Tier I capital implies substantial unutilized headroom for leverage. Net result could be a ~18% RoE in the coming years.

Price target Rs220/share; high level of treasury income the key risk

Our single-stage Gordon Growth model, topped by a baseline premium of 27% – average of bank deals in Asia recently – and an additional premium of 5% based on an attractiveness scorecard, leads to a PT of Rs220 (p.12 for further details). Key risks: current high dependence on treasury income and a low CASA ratio. The stock is thinly covered by the street and headroom exists for foreign investors.

Forecasts and ratios

Year End Mar 31	2005A	2006A	**2007E**	2008E	2009E
Provisioning (INRm)	1,004.6	592.0	**330.0**	414.8	464.9
Pre-prov profit (INRm)	3,410.1	3,284.3	**3,677.5**	4,141.5	4,644.0
Net profit (INRm)	1,471.5	1,760.3	**2,242.8**	2,496.8	2,800.7
EPS (INR)	34.06	14.52	**18.49**	20.59	23.09
EPS growth (%)	3.4	-57.4	**27.4**	11.3	12.2
PER (x)	1.6	7.1	**9.3**	8.3	7.4
Price/book (x)	0.88	1.09	**1.61**	1.41	1.23
DPS (net) (INR)	5.61	3.00	**3.50**	3.50	4.00
Yield (net) (%)	10.6	2.9	**2.0**	2.0	2.3

Source: Deutsche Bank estimates, company data

[1] DB EPS is fully diluted and excludes non-recurring items
[2] Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Deutsche Bank AG/Hong Kong

Model updated:10 April 2007

Running the Numbers

Asia Pacific

India

Diversified Banks

Karnataka Bank

Reuters Code	KBNK.BO

Buy

Price as of 13 April	INR 171.30
Price Target	INR 220.00

Web Site
http://www.karnatakabank.com

Company Description

Established in 1924, Karnataka Bank is one of the oldest private sector bank based out of Mangalore and has an asset base of US$3.5 bn. The bank primarily has a high exposure towards SME & Retail sector, which constitutes almost 60% of loan book. Post implementation of CBS in 2000, the bank has come a long way with 97% of the business under CBS. The bank has a network of 405 branches with ~67% of the branches in Karnataka alone. The bank has a free-float of 100% with a much diversified shareholding pattern.

Research Team

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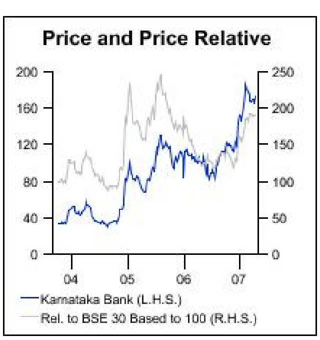
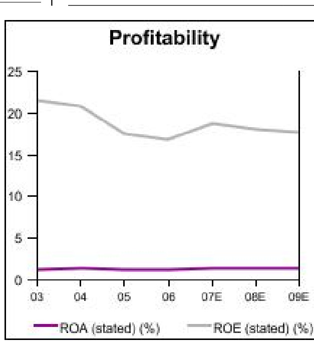
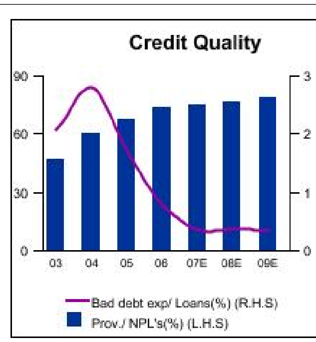
Absolute Price Return	1m	3m	12m
	2.0%	15.1%	71.7%
52-week Range	INR 77.90 - 188.15		
Market Cap	INR 20,774 m		
	USD 489 m		

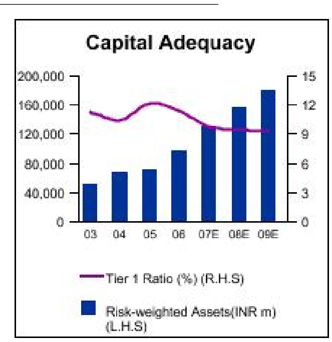
Company Identifiers	
Bloomberg	NKBL IN
Cusip	–
SEDOL	6130064

Y/E 31 March	2003	2004	2005	2006	2007E	2008E	2009E
Data Per Share							
EPS (stated) (INR)	27.24	32.93	34.06	14.52	18.49	20.59	23.09
EPS FD (stated) (INR)	27.24	32.93	34.06	14.52	18.49	20.59	23.09
EPS FD (DB adj.) (INR)	27.25	32.96	34.10	14.52	18.49	20.59	23.09
Growth rate - EPS (stated) (%)	NM	20.9	3.4	-57.4	27.4	11.3	12.2
DPS (INR)	2.20	4.00	5.61	3.00	3.50	3.50	4.00
BVPS (stated) (INR)	144.31	172.66	80.66	91.62	106.18	121.76	139.29
BVPS (DB adj.) (INR)	73.55	115.43	193.20	84.08	97.56	113.76	131.99
Average market cap (INRm)	0	1,629	6,442	12,474	20,774	20,774	20,774
Shares in Issue (m)	40	40	121	121	121	121	121
Valuation Ratios & Profitability Measures							
P/E (stated)	–	1.2	1.6	7.1	9.3	8.3	7.4
P/E FD (stated)	–	1.2	1.6	7.1	9.3	8.3	7.4
P/E FD (DB adj.)	–	1.2	1.6	7.1	9.3	8.3	7.4
P/B (stated)	–	0.31	0.88	1.09	1.61	1.41	1.23
P/B (DB adj.)	–	0.46	0.37	1.19	1.76	1.51	1.30
ROE (stated) (%)	21.5	20.8	17.6	16.9	18.7	18.1	17.7
ROA (stated) (%)	1.29	1.34	1.27	1.28	1.41	1.37	1.33
Dividend yield(%)	–	9.93	10.56	2.92	2.04	2.04	2.34
Dividend cover(x)	12.38	8.24	6.07	4.84	5.28	5.88	5.77
Payout ratio (%)	8.1	12.1	16.5	20.7	18.9	17.0	17.3
Profit & Loss (INRm)							
Net interest revenue	1,549	2,137	3,169	3,660	4,231	4,924	5,737
Non interest income	2,393	2,705	2,214	1,669	1,772	1,818	1,898
Fees & Commissions	482	533	605	628	709	816	938
Trading Revenue	1,859	2,103	1,524	925	924	865	815
Insurance revenue	0	0	0	0	0	0	0
Dividend income	0	0	0	0	0	0	0
Other revenue	53	69	85	116	138	137	144
Total revenue	3,942	4,841	5,383	5,329	6,003	6,742	7,635
Total operating costs	1,407	1,542	1,973	2,045	2,326	2,600	2,991
Pre-provision profit/(loss)	2,535	3,300	3,410	3,284	3,677	4,141	4,644
Bad debt expense	812	1,283	1,005	592	330	415	465
Operating Profit	1,723	2,016	2,406	2,692	3,347	3,727	4,179
Goodwill	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0
Extraordinary & Other Items	-1	-2	-3	-1	0	0	1
Pre-tax profit	1,722	2,015	2,403	2,691	3,347	3,727	4,180
Tax	621	683	931	931	1,105	1,230	1,379
Minorities	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0
Stated net profit	1,101	1,332	1,471	1,760	2,243	2,497	2,801
DB adj. core earnings	1,102	1,333	1,473	1,761	2,243	2,497	2,800
Key Balance Sheet Items (INRm) & Capital Ratios							
Risk-weighted assets	51,950	66,809	70,621	97,639	131,620	155,586	180,898
Interest-earning assets	89,243	102,523	121,660	144,750	162,683	188,723	217,322
Total loans	41,536	50,279	66,264	80,965	101,578	122,069	142,624
Total deposits	82,917	94,069	108,371	132,432	150,198	174,716	201,746
Stated shareholders equity	5,834	6,982	9,780	11,111	12,876	14,765	16,891
Preference share capital	–	–	–	–	–	–	–
Tier 1 capital	5,834	6,982	8,580	11,111	12,876	14,765	16,891
Tier 1 ratio (%)	11.23	10.45	12.15	11.38	9.78	9.49	9.34
Tangible equity/ total assets (%)	6.30	6.60	7.81	7.43	7.63	7.56	7.51
Credit Quality							
Gross NPLs / Total loans (%)	12.95	11.90	7.57	5.13	4.10	3.41	2.93
Provisions / NPLs (%)	47.20	60.15	67.55	73.45	74.89	76.73	78.80
Bad debt exp/ Avg loans (%)	2.09	2.80	1.72	0.80	0.36	0.37	0.35
Growth Rates & Key Ratios							
Growth in net interest income (%)	NM	38.0	48.3	15.5	15.6	16.4	16.5
Growth in fee income (%)	–	10.6	13.6	3.8	13.0	15.0	15.0
Growth in non-interest income (%)	–	13.0	-18.1	-24.6	6.1	2.6	4.4
Growth in revenues (%)	NM	22.8	11.2	-1.0	12.7	12.3	13.2
Growth in costs (%)	NM	9.6	28.0	3.6	13.8	11.8	15.0
Pre-provision earnings growth (%)	–	30.2	3.3	-3.7	12.0	12.6	12.1
Growth in bad debts (%)	NM	58.1	-21.7	-41.1	-44.3	25.7	12.1
Growth in RWA (%)	NM	28.6	5.7	38.3	34.8	18.2	16.3
Growth in loans (%)	–	21.0	31.8	22.2	25.5	20.2	16.8
Growth in deposits (%)	–	13.4	15.2	22.2	13.4	16.3	15.5
Loan-to-deposits ratio (%)	50.1	53.4	61.1	61.1	67.6	69.9	70.7
Net int. margin (%)	1.89	2.23	2.83	2.75	2.75	2.80	2.83
Cost income ratio (%)	35.7	31.8	36.7	38.4	38.7	38.6	39.2
Cost asset ratio (%)	1.7	1.6	1.7	1.5	1.5	1.4	1.4
Trading income/ Total Rev (%)	47.2	43.4	28.3	17.4	15.4	12.8	10.7









Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

Control on loan growth, effective use of excess SLR securities for funding and unwinding of high-cost wholesale deposits underpin KBL's strategy of profitable growth

Control on loan growth, effective use of excess SLR securities for funding and unwinding of high-cost wholesale deposits underpin KBL's strategy of profitable growth. We also expect fee income growth to accelerate with the launch of several new or rejuvenated products such as debit cards, demat services and insurance distribution. This could also have the attendant benefit of scaling up a low CASA ratio progressively.

KBL's business model has been and will continue to be driven by very high levels of operating cost efficiency, resulting in one of the lowest cost ratios in the sector. The bank has not added to its staff strength in five years, branches are in low- or medium-cost locations and it plans to add just 20-25 branches a year to its base of approximately 400. Since 97% of the business runs on core technology, the bank has already absorbed the cost increases normally associated with large-scale technology implementation.

KBL's balance sheet has significant leverage potential as most of its capital adequacy from Tier I – Tier II headroom is hardly used. There is also the opportunity to do a further top-up of Tier I through non-dilutive perpetual debt.

To summarise, our Buy call is predicated on: i) control on loan growth leading to stable margins, ii) accelerated growth of fee income with the launch of new products, iii) continued control on operating costs and thus the low cost ratios, and iv) attractiveness of KBL's franchise as a target in case acquisitions become widespread in 2009 as anticipated now.

Valuation

Our core valuation for KBL is based on the single-stage P/BV = (RoE – g)/(CoE – g) formula adopted for PSU banks – KBL is an old private bank and demonstrates the steady-growth characteristics conducive to this model. As usual, we apply 70% weight to the schematic RoE and 30% to FY09E RoE. Assumptions: risk-free rate 9.8% (DB country estimate), risk premium 4.4% (DB), perpetual growth 4%, beta 0.99 (Bloomberg), normalised RoE 15.1%.

On top of the theoretical value arrived at using this formula, we apply a baseline 'deal premium' of 27% (average of recent bank deal premiums in Asia and India) and an additional premium of 5% (based on a qualitative score, proprietary). The deal premiums are applied to factor in our view that KBL can be a coveted (and feasible) acquisition candidate in an industry where leading players are actively on the lookout for attractive franchises. The final price target coming out of this process is Rs220/share.

Risks

KBL's dependence on treasury income – 14.6% of total income in FY06 and 12.6% in FY07E – is still high by the standards of peer banks, most of whom have fallen to the 0-5% level. This makes the P&L account relatively more volatile. We, however, expect this to drop to 8% by FY09E, and have factored in zero treasury income in our normalised RoE calculations. Secondly, KBL's CASA ratio at ~22% is still quite low and makes it vulnerable to the rising cost of funds.

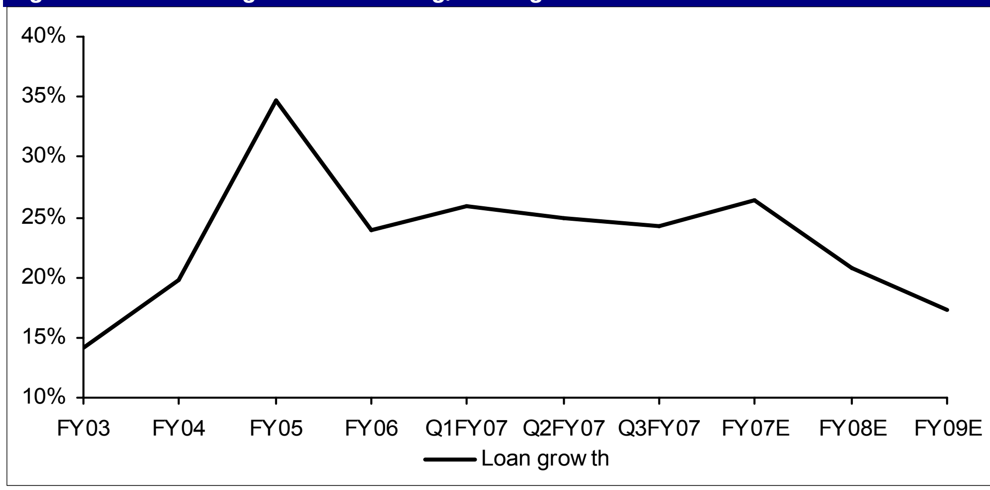
Focus on profitable growth

Consciously controlled loan growth a positive

Historically higher cost of funds and comparatively lower margins have led to the bank controlling its growth

Except for a small uptick in FY05, KBL has consciously stayed away from showing high growth rates on the balance sheet despite having sufficient capital for growth. The initial driver could have been asset quality control – KBL had some chunky delinquencies on its balance sheet till two years back – but that does not explain the last two years. Neither does branch capacity explain it. The truth is that historically higher cost of funds and comparatively lower margins have led to the bank controlling its growth. Whereas at the time of high growth in the sector this policy was being chastised, it is becoming some kind of a virtue today when every bank is bracing for a slowdown (Figure 1).

Figure 1: Controlled growth in lending, cooling off a bit in line with the sector



Source: Company data, Deutsche Bank

There are two positive implications of the above – firstly, the sector slowdown should not hit KBL as much as it would hit some other high-growth banks. In our estimates, we have factored in loan growth going down to 17.2% in FY09E, which is conservative enough. Secondly, it is reasonable to assume that as a result of this focus, KBL should not have added too many assets that are susceptible to high delinquencies.

KBL's direction of growth also leads to considerable geographical diversification. It plans to add 20-25 branches every year, but predominantly outside Karnataka. The dependence on Karnataka has already reduced – the state accounts for 70% of the bank's branches but 50% of the business.

Stable margin outlook despite rising cost of funds

Despite increasing cost of funds (for the entire system and hence KBL), we believe that KBL's margins should be steady in the coming years if not improving (Figure 2). And there are more reasons than just the control on growth.

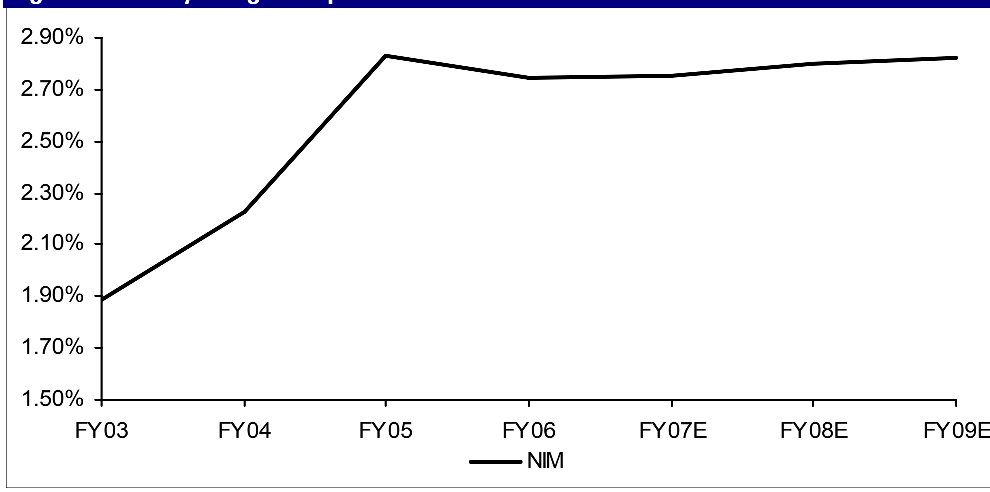
Like the few remaining banks that have excess SLR securities, so does KBL – to the extent of about 4%, the absolute amount being nearly Rs5bn. Technically, for this amount of funds, the cost is capped at the repo rate – currently at 7.75% – as the bank can pledge excess SLR with RBI and borrow at the repo rate.

Secondly, for about 75% of KBL's lending, re-pricing is quite fast – loans are either linked to PLR or the floating rate. Aggressive loan re-pricing by bigger banks has made the job relatively easier for KBL.

Thirdly, KBL has been able to unwind its portfolio of wholesale (bulk) deposits to a great extent. At the peak, the bank had 40% of its term deposits from bulk sources but now it is below 20%.

Indeed, in the last one year, both yields and costs have moved up by 50bps, indicating that the bank is able to maintain spreads.

Figure 2: Steady margins expected



Source: Deutsche Bank

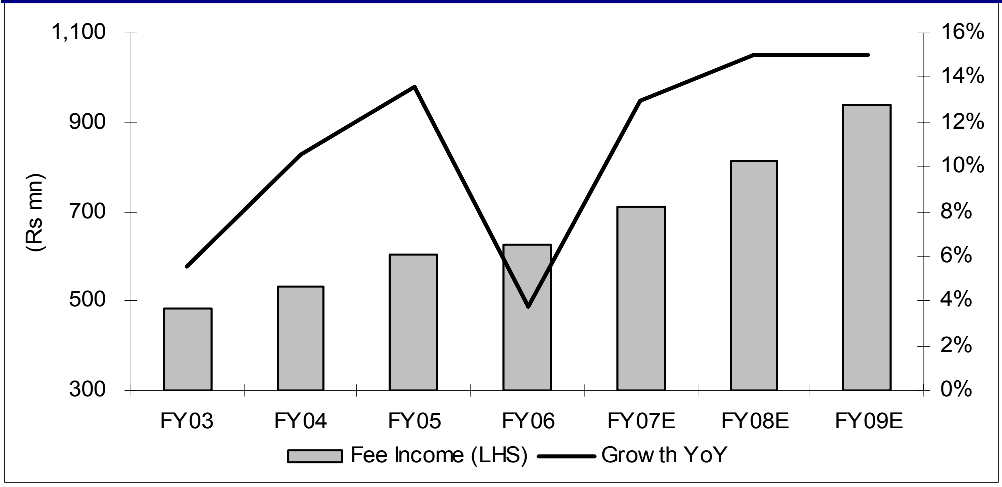
Upside possibilities in fee income, and attendant CASA benefits

At ~45bps of assets, KBL's fee income is good by PSU bank standards but falls woefully short of private bank standards. One reason for this – and this is not going to change soon – is that its retail assets focus has been low. However, the bank has been fully computerized and nearly fully networked for a while now, so it is not the technical capability that has been holding back the accelerated fee growth.

Management has realized that substantive gaps in its product portfolio have been the key reason for not showing a high fee income. In other words, the typical fee-generating products have been traditionally absent from its offering. Another way to look at it is that current accounts – one measure of scale in corporate fees – are just ~6.8% of total deposits. The bank has started correcting this lacuna through products that depend on cash transactions – cash management services, real-time gross settlements, utility bill payments, debit cards and demat services.

The bank has also made a small beginning with third-party products distribution. For example, it sells insurance for Metlife India and Bajaj Allianz General Insurance. At 400+ branches, KBL's network is not small but, from the perspective of products distribution, grossly underutilised. That and further new product launches in the future can accelerate fee income growth (Figure 3).

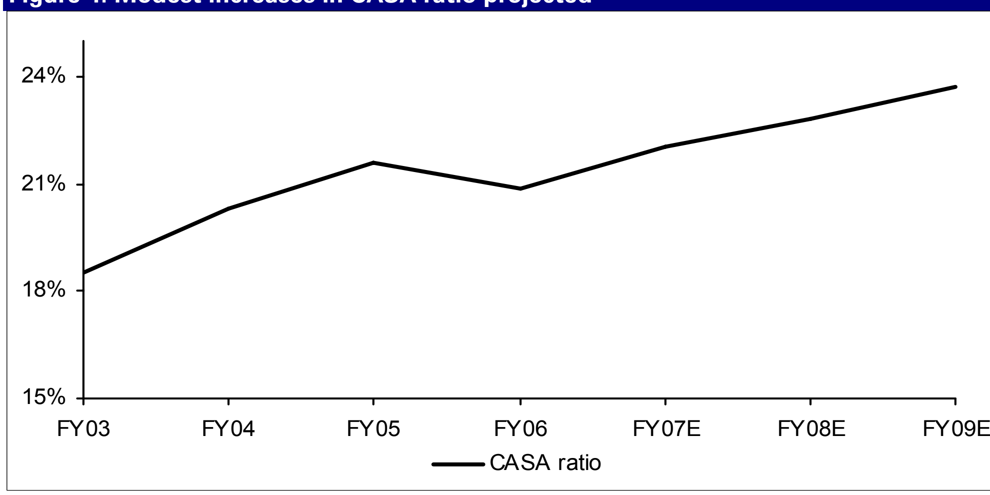
Figure 3: Fee income growth expected to accelerate



Source: Company data, Deutsche Bank

By corollary, the above measures should also help KBL in improving its unsatisfactory CASA of ~22%, though we are building into our estimates only modest increases (Figure 4).

Figure 4: Modest increases in CASA ratio projected



Source: Company data, Deutsche Bank

Commendable expense ratios

Business model driven by branch-level efficiency

For an old generation private bank (resembling PSU banks in more ways than one), KBL's operating efficiency is commendable, to say the least. In FY06 for example, the cost to income ratio was 38.4% and cost to average assets was 1.49% - even other efficient banks clock 40%+ and 1.8%+.

In terms of squeezing out efficiencies, KBL works more like a modern private sector bank. The employee strength has remained stagnant for the last five years. Most of KBL's infrastructure costs are sunk – several branches are in low-cost locations. Even in metro areas, the bank is conspicuously absent in the expensive areas – this balance has given rich dividends because KBL cannot compete on scale and, hence, there is no point in increasing operating costs.

The following table shows that KBL is very lean at the branch level and can possibly squeeze out some more efficiency (Figure 5).

Figure 5: Efficiency parameters of some small and large banks

(FY06, Rs m)	Business/branch	Operating cost/branch
Karnataka Bank	533	5.18
Oriental Bank	730	8.41
Union Bank	612	6.74
Jammu & Kashmir Bank	730	6.64
Dena Bank	337	5.00
State Bank of India	699	12.76
ICICI Bank	5,069	72.96

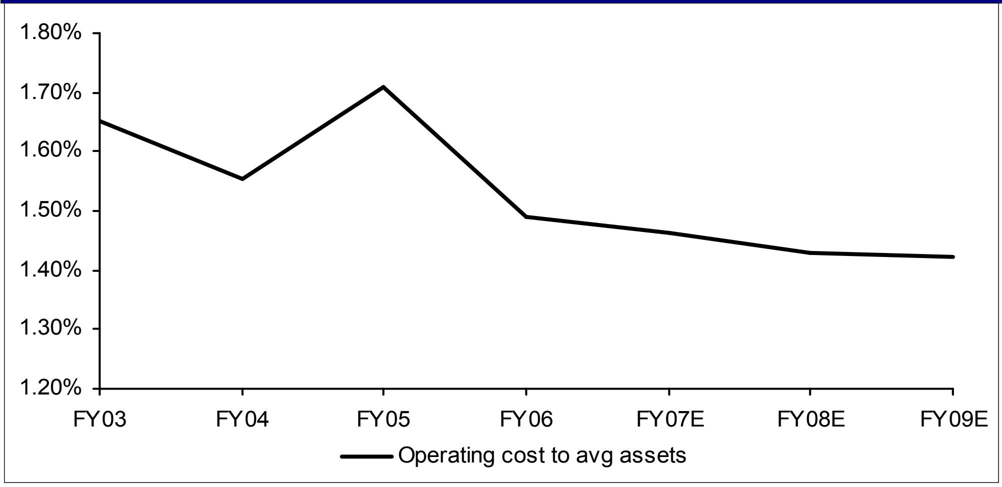
Source: Company data, Deutsche Bank Note: business is defined as loans plus deposits

Employee union issues that have plagued other old generation private banks (particularly from Kerala state) have been comparatively less in KBL. A major wage increase is not expected in the next two years.

Modest growth plans to help maintain efficiency ratios

The bank is not planning any major recruitment soon. Branch additions planned are also at 20-25 a year over the base of nearly 409. The planned asset growth can get comfortably accommodated by this growth of infrastructure. Also, KBL has not been or will not be into high growth of retail assets that leads to a lot of attendant operating expenses such as dealer/marketing commissions. Also, as mentioned before, since FY05 saw a significant wage increase, another hike will not happen in the immediate future. Hence, it is likely that the bank will be able to maintain its exemplary low cost ratios (Figure 6).

Figure 6: Cost efficiency expected to remain healthy



Source: Company data, Deutsche Bank

Note that we place greater faith in cost to assets rather than cost to income as the income in the latter is distorted by treasury profits.

Technologically complete, negative surprises on costs unlikely

One reason to be justifiably skeptical about a low cost to assets ratio is the state of technology of the bank. We have seen several examples of banks reporting low expense ratios that eventually went out of hand when core technology was implemented. That is definitely not the case with KBL – in fact, it was one of the first to go in for core-banking solution implementation and now has 97% of the business within that platform. Hence, there is no understatement of the costs relative to the steady state.

Comfortable capital position

Modest capital adequacy hides enormous leverage potential

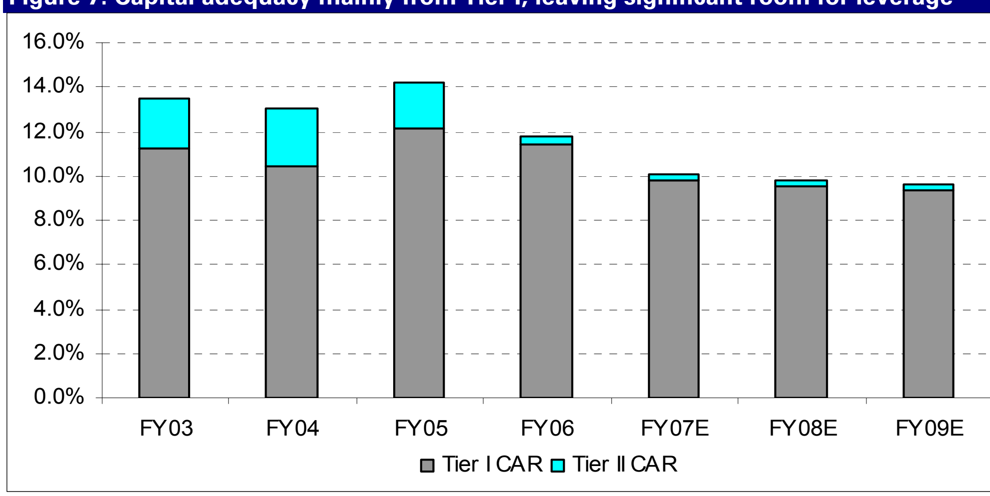
Significant leveraging likely: KBL's asset mix does not contain substantial high-risk loans

KBL's capital adequacy ratio of 11.83% (December 31, 2006) looks low in the context of capital demand due to growth, higher risk weights stipulated by RBI from time to time and Basel II. However, the total hides the fact that the predominant portion of the CAR is through Tier I. We estimate that out of the March 2007E CAR of 10.1%, 9.78% is through Tier I capital (equity). Arguably, KBL's capital management in the last few years has been less than satisfactory, as the bank pretty much went in for a rights offer whenever it needed capital instead of subordinated debt.

We believe that KBL is unlikely to follow the policy of 'rewarding' shareholders through below-market rights offers any longer and will resort to leveraging. Due to the above reasons (which, however, apply to all banks), capital requirements will increase so much that banks will not be able to maintain under-leveraged positions for too long. Also, it is now possible for banks to raise perpetual debt for Tier I capital. These thoughts should gain currency as KBL climbs out of its community bank mould and professionalises more (Figure 7).

Our estimates do not build in significant leveraging but this could be likely. The primary reason is that KBL's asset mix does not contain substantial amounts of high-risk loans like real estate, which require a 150% risk weight. We are also awaiting clarity on how exactly RBI wants to implement Basel II – if the recent discussion paper released by RBI is to be believed, KBL is likely to start augmenting capital through leverage rather than equity.

Figure 7: Capital adequacy mainly from Tier I, leaving significant room for leverage



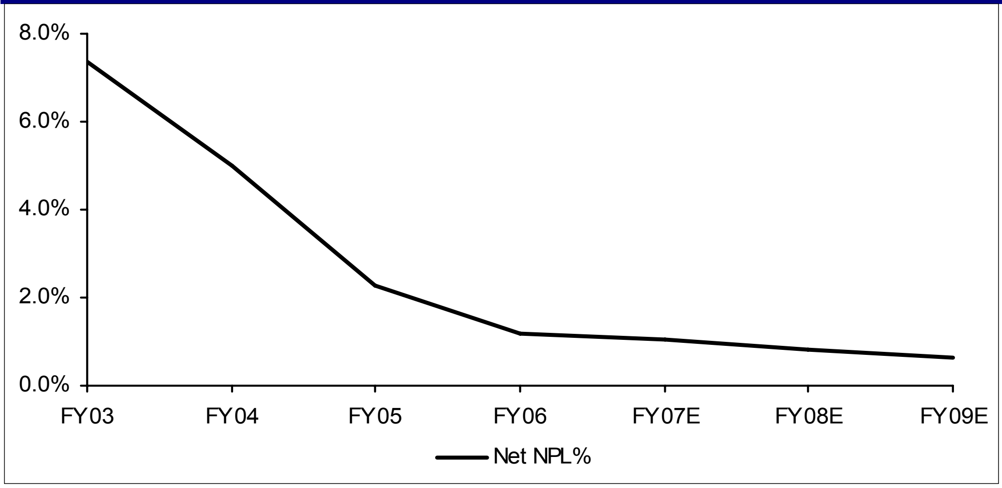
Source: Company data, Deutsche Bank

Asset quality unlikely to put significant pressure on capital

Two key reasons why KBL's asset quality could be relatively less adversely affected if and when lending slows down are: i) controlled asset growth in the last few years, and ii) comparatively less aggression in retail lending, where the growth has been driven predominantly by mortgages. Moreover, due to substantive networking of its branches early on, KBL is presumably not as vulnerable to frauds as some PSU banks have been. Lastly, with the credit bureau now functional and having attained a critical mass, banks are in a better position to check individual indebtedness and take appropriate action.

In the last asset quality downturn cycle in the sector, KBL faced some chunky large industrial delinquencies, and the bank has come out of that to a great extent. In fact, the bank is still enjoying significant recoveries that should continue to buttress overall asset quality (Figure 8).

Figure 8: Asset quality likely to be maintained



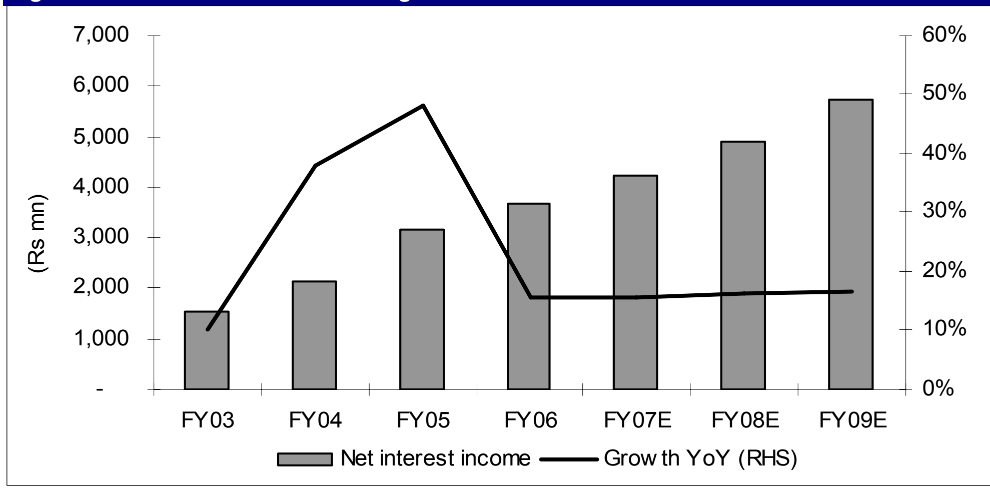
Source: Deutsche Bank

Financials & valuation

Net interest income CAGR of 16.4% estimated for FY07E-FY09E

With a loan CAGR of 19% estimated during FY07E-FY09E and steady margins, we estimate a 16.4% CAGR in net interest income during the same period (Figure 9).

Figure 9: Net interest income and growth



Source: Company data, Deutsche Bank

With a slight drop in treasury profits but fee income growth accelerating somewhat, we expect total income to rise to a 12.8% CAGR between FY07E and FY09E. As explained before, we expect operating cost ratios to stay as healthy as currently, thereby driving a 12.6% and 12.2% growth in pre-provision profit in FY08E and FY09E, respectively, (Figure 10), in line with income growth.

Figure 10: Cost ratios and growth in operating profits

	FY04	FY05	FY06	FY07E	FY08E	FY09E
Cost to income	31.9%	36.7%	38.4%	38.7%	38.6%	39.2%
Cost to avg assets	1.55%	1.71%	1.49%	1.46%	1.43%	1.42%
Pre-provision profit growth	30.2%	3.3%	-3.6%	12.0%	12.6%	12.2%

Source: Company data, Deutsche Bank

Conservatively increasing provision estimates

We have built in very high provisioning estimates despite the fact that KBL does not have much of the high-risk assets that warrant higher regulatory provisions. This is indeed the strategy we have followed for all banks, in varying measures, to account for the creation of a buffer for less benign times for asset quality. Of course, part of the reason is higher regulatory provisions. This is what pulls down the earnings growth estimate in FY08E and FY09E to 11.3% and 12.2%, respectively. Note also that KBL pays tax at the full marginal rate.

We have also estimated rising investment provisions due to the existence of excess SLR and a relatively high duration (>3 years).

Normalised RoE estimate adjusts for the high treasury income

Our normalized (schematic) RoE estimate is significantly less than the current or estimated RoE due to two key reasons: we throw out treasury profits from normalized RoE and increase provisioning substantially. This approach is arguably sufficiently conservative (Figure 11).

Figure 11: Normalised and estimated RoE

	Normalized	Remarks	FY2009E
Net interest income/ avg. total assets	2.70%	Roughly stable margins	2.73%
Non-interest income/ avg. total assets	0.80%	Stripping off treasury gains, factoring in better fee income	0.90%
Total income/ avg. total assets	3.50%		3.63%
Operating expenses/ avg. total assets	1.40%	Stable operating expense structure	1.42%
Operating profit/ avg. total assets	2.10%		2.21%
Provisions/ Avg. total assets	0.60%	Conservative assumption due to generally rising risk levels in lending	0.22%
(1 - tax rate)	67.00%		67.00%
Return on avg. total assets	1.01%		1.33%
Avg. total assets/ average equity (x)	15.0x	Current asset composition, normative 8% Tier I ratio	13.3x
Return on equity	15.09%		17.69%

Source: Deutsche Bank

Price target of Rs220/share

Core valuation at Rs163/share

Our core valuation methodology is the single-stage (RoE – g)/(CoE – g) model we have used for PSU banks with 70% weight given to schematic (normalized) RoE and 30% to FY09E RoE. The normalized RoE comes to 15.1% and on multiplying the blended RoE with the FY09E adjusted book, we get Rs163/share.

Applying a 'deal premium' to account for franchise attractiveness

We believe that KBL cannot be valued in isolation just on the basis of current fundamentals. Being a private bank with no identifiable founder or large shareholder, with 400+ branches fairly distributed between metros and rural areas and a fully technologically scaled network, it is but rational to look at it as a potential acquisition target. Though we are not aware of it being targeted at any time, in view of the RBI's roadmap for private bank ownership norms in 2009, we cannot rule out the possibility.

We apply a baseline premium of 27%, which is the average of recent deal premiums in Asia and the premiums paid for the few bank deals in India in the past (Figure 12).

Figure 12: Deal premiums for actual bank deals

Target Name	Acquirer Name	Deal Premium
H&CB	Kookmin Bank	0.2%
Overseas Union Bank	United Overseas Bank Ltd	26.8%
DBS Bank Hong Kong	Dbs Group Holdings Ltd	61.4%
Taipeibank	Fubon Financial Holding Co	46.0%
Chohung Bank	Shinhan Financial Group Ltd	7.0%
Chohung Bank	Shinhan Financial Group Ltd	22.1%
Chohung Bank	Shinhan Financial Group Ltd	5.2%
Ufj Holdings Inc	Mitsubishi UFJ Financial	35.8%
Ufj Holdings Inc	Mitsubishi UFJ Financial	35.8%
Bank Nisp Pt	Oversea-Chinese Banking Corp	5.1%
Prudential Bank	Bank Of Philippine Islands	95.6%
Equitable PCI Bank	Banco De Oro Universal Bank	15.2%
Bank Buana Indonesia	United Overseas Bank Ltd	0.9%
Farmers Bank Of China	Taiwan Cooperative Bank	5.3%
Momiji Holdings Inc	Yamaguchi Bank Ltd	-28.2%
Southern Bank Berhad	Bumiputra-Commerce Hldgs	6.8%
Average		21%
Centurion Bank	Bank of Punjab	4.6%
ICICI Bank	Bank of Madura	100.0%
HDFC Bank	Times Bank	8.1%
IDBI	United Western Bank	21.0%
Average		33%
Combined average		27%

Source: Bloomberg, Deutsche Bank

The additional deal premium that we apply is 5%, based on the following scorecard (Figure 13). This is proprietary to us and not an industry standard. Highest score in any category is 5 and lowest 1.

Figure 13: Justification for additional premium

Parameters	Scores	Remarks
No of Branches	5	More branches imply larger network and hence more scalability
Deposit Franchise	3	Predominantly CASA mix
Geographical Location	2	Pan-India presence, more weight for richer regions like Punjab
Technology	4	Core Banking, Extent to which IT platform is leveraged
Ease of consolidation	1	Existence of ESOPs, concentration of shareholding
Asset quality	4	Gross NPAs at 2009
Product mix/suite	2	Ability to generate fee income, higher margin/ROE products
Total Score	21	
Attributed premiums:		
Total score	Premium	
0-20	0%	
21-25	5%	
26-30	10%	
30+	15%	

Source: Deutsche Bank estimates

Though a prospective buyer will definitely covet KBL's network, there are two reasons why we are keeping the extra premium low:

- The ease of consolidation factor is low for KBL as the management has been expressing some diffidence over the issue of consolidation, and in any case there are no large shareholders who can sell out and make the task easier.
- The general risk of the more liberalised banking environment in 2009 not materialising due to political pressures, lack of reciprocity by central banks of other countries where Indian banks seek to operate and the highly sensitive nature of banking as an industry. However, we believe that even though the entry of foreign banks in a big way could be delayed, Indian banks may be active consolidators since an effective liabilities network has become paramount for all Indian banks too.

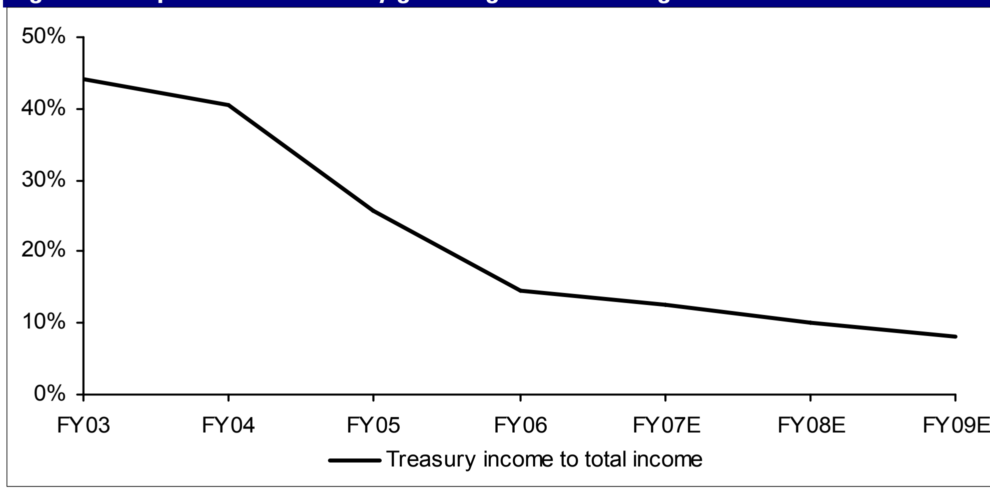
Topping the core value up with the baseline and additional deal premiums, we get a price target of Rs217/share, rounded off to Rs220.

Risks

Still high dependence on treasury income

There is some froth in the P&L due to a high treasury income that is intrinsically volatile and less predictable. Though the steep fall of 44% in profit on sale of investments from FY05 to FY06 brought down treasury gains as % of total income from 25.6% to 14.6%, the latter is still high by peer standards. A fall in treasury profits in a quarter may make the reported results look poor. Of course, we do expect this number to fall to 8.0% in FY09E (Figure 14).

Figure 14: Importance of treasury gains high but declining



Source: Company data, Deutsche Bank

Low CASA can make margins vulnerable

KBL's CASA is still low at ~22%, though it has been rising over the years. Abnormal increases in cost of funds can hit it hard, as we have observed for some other low-CASA banks. In these circumstances, the only practical route available to the bank for maintaining profitability is to bring down growth sharply. However, with the recent thrust on new products that can potentially generate the floats needed for a higher CASA, the bank is addressing the issue, though it may take a long time before it is really comfortable.

Company background

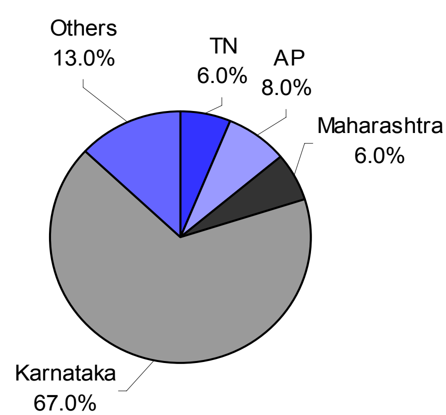
History

Karnataka Bank, a private sector bank, was incorporated on February 18, '24 at Mangalore in the state of Karnataka, south India. Over the years, the bank grew with the merger of Sringeri Sharada Bank, Chitladurg Bank and Bank of Karnataka. The bank has a pan-India presence with a network of over 400 branches and over 50 ATMs across 19 states and 2 Union Territories. Approximately 67% of the branches are in Karnataka.

Business mix

Though Karnataka state – the birthplace of the bank – accounts for 67% of the branch strength, it gives 50% of the bank's business. Despite the bank not having achieved a visible pan-Indian status, efforts in that direction are probably the most credible amongst old generation private banks (Figure 15).

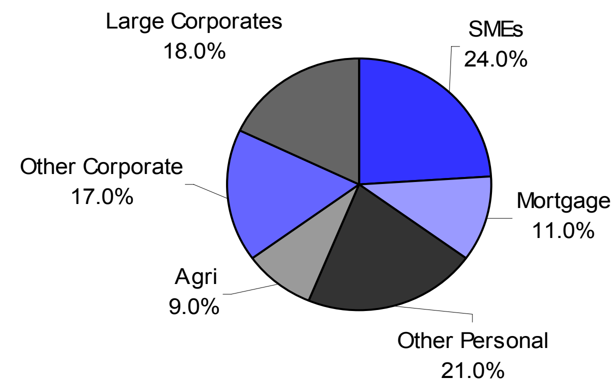
Figure 15: Geographical location breakup



Source: Company data, Deutsche Bank

SMEs and retail constitute the bulk of the bank's lending (Figure 16).

Figure 16: Breakdown of lending portfolio



Source: Company data, Deutsche Bank

Management

The bank has no identifiable promoter or founder today, and is managed by a team of professionals. Mr Ananthakrishna, the Chairman & CEO, has been at the helm of affairs since July '00. He is a career banker with experience spanning over three decades across various functions. He is actively supported by a team of four general managers, who in turn are actively supported by 10 deputy general managers. Majority of the top management has been with the bank for over two decades. Mr Ananthakrishna, who has been with the bank for over three decades, is scheduled to be the CEO of the bank till July 2009.

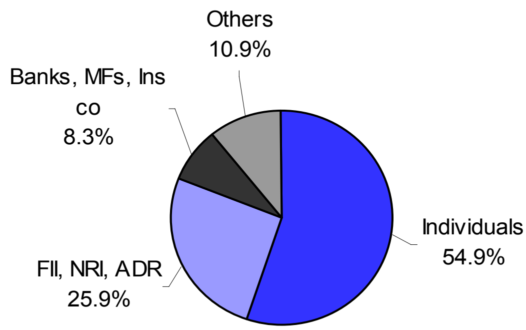
Capital history & shareholding pattern

Karnataka Bank's first tryst with the equity market was in October '95 with an initial public offering of 45mn equity shares of Rs10 each at a premium of Rs110 aggregating Rs5.4bn. A rights issue, of one share for every share held at a premium of Rs50 aggregating Rs492mn, immediately followed.

In March '03, the bank came out with yet another rights offering at a ratio of one share for every two shares held at a premium of Rs25 each aggregating Rs471mn. Subsequently, in February '05, Karnataka Bank came out with a rights issue offering two shares for one share held of Rs10 at a premium of Rs10. The capital mobilised through this issuance boosted the paid-up capital from Rs400mn as of March 31, '04 to Rs1.2bn, at present.

Technically, the bank has a free float of 100%. As on December 31, 2006, foreigners owned c26% of the equity, and are permitted to own a maximum of 49% (Figure 17).

Figure 17: Shareholding pattern



Source: Deutsche Bank

Appendix 1

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Company	**Ticker**	**Recent price***	**Disclosure**
Karnataka Bank	KBNK.BO	171.30 (INR) 13 Apr 07	6

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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Historical recommendations and target price: Karnataka Bank (KBNK.BO)

(as of 4/13/2007)

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Strong Buy
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Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

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1. 2.

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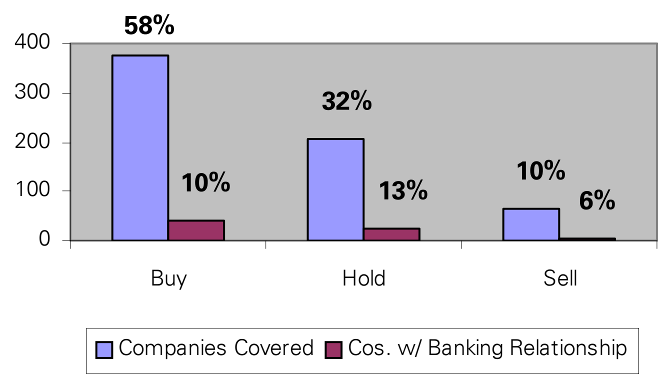

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