Company Focus

28 October 2008 | 13 pages

ICICI Bank (ICBK.BO)

Rating change ☑
Target price change ☑
Estimate change ☑

Correction: 2Q FY09 Results – A Long Way From Home

- Corrects numbers in Figure 1 on Page 3, as highlighted.
- **Trying 2Q: Gets through with 1% profit growth, head seems above water** — 2Q profits were well ahead of our -25% estimate. Balance-sheet quality and de-growth as well as international business pressures were largely as feared. We highlight what we believe are fundamental issues for ICBK and the stock.
- **What's good** — Reasonable mix: a) Operating cost cuts, with more expected; b) Stable margins, with hope of at least near-term stability; c) Balance-sheet de-growth – management is not explicit, but a distinct possibility of reductions in 6-18 months; d) Better deposit mix – expanded branches improve scope.
- **What's not** — Fundamental issues that need to be fixed, in our view: a) Liquidity and asset quality pressures on offshore loan books (Indian corporate FX borrowings) in the near/medium-term; b) International subsidiary strategy – still seeking to build internet/retail deposit-based businesses; we know the risks ($120m in capital in 2Q09), not the business logic; c) Domestic asset quality pressures – still seeking the bottom, but broader economic environment not comforting; d) Domestic mini run: people do not forget quickly – should set deposit mobilization/franchise back 12-24 months. We cut our estimates.
- **Still a Buy, but with lower returns and higher risk** — We cut our target to Rs554 from Rs820 and raise the risk profile to High from Low given the bank's low returns, risks and a modest record of late. Why a Buy? ICBK has franchise, a massive customer base, a large capital book, subsidiary businesses, and a strong market position in a financial sector that we think offers significant longer-term returns and opportunities. The stock also looks cheap.

Buy/High Risk	**1H**
from Buy/Low Risk	
Price (27 Oct 08)	Rs316.30
Target price	Rs554.00
from Rs820.00	
Expected share price return	75.2%
Expected dividend yield	3.5%
Expected total return	**78.6%**
Market Cap	Rs352,121M
	US$7,075M

Price Performance (RIC: ICBK.BO, BB: ICICIBC IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	31,098	34.46	22.5	9.2	1.2	13.4	3.2
2008A	41,572	36.93	7.2	8.6	0.8	11.7	3.5
2009E	30,389	27.00	-26.9	11.7	0.7	6.4	3.5
2010E	37,223	33.07	22.5	9.6	0.7	7.6	3.5
2011E	47,102	41.84	26.5	7.6	0.7	9.1	3.6

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	9.2	8.6	11.7	9.6	7.6
P/E reported (x)	9.2	8.6	11.7	9.6	7.6
P/BV (x)	1.2	0.8	0.7	0.7	0.7
P/Adjusted BV diluted (x)	1.2	0.8	0.7	0.7	0.7
Dividend yield (%)	3.2	3.5	3.5	3.5	3.6
Per Share Data (Rs)					
EPS adjusted	34.46	36.93	27.00	33.07	41.84
EPS reported	34.46	36.93	27.00	33.07	41.84
BVPS	273.27	417.64	431.18	450.86	478.85
Tangible BVPS	273.27	417.64	431.18	450.86	478.85
Adjusted BVPS diluted	269.34	412.82	426.20	445.65	473.32
DPS	10.13	11.03	11.00	11.00	11.50
Profit & Loss (RsM)					
Net interest income	56,371	73,041	86,124	93,480	106,937
Fees and commissions	43,309	56,053	66,143	76,726	90,536
Other operating Income	26,321	32,735	21,211	20,954	21,890
Total operating income	**126,000**	**161,829**	**173,477**	**191,160**	**219,363**
Total operating expenses	-66,907	-81,544	-84,846	-89,605	-99,329
Oper. profit bef. provisions	**59,094**	**80,286**	**88,631**	**101,555**	**120,034**
Bad debt provisions	-21,844	-28,423	-42,566	-47,918	-48,738
Non-operating/exceptionals	-770	-1,303	-9,000	-4,000	-4,000
Pre-tax profit	**36,479**	**50,559**	**37,065**	**49,637**	**67,296**
Tax	-5,378	-8,984	-6,672	-12,410	-20,190
Extraord./Min. Int./Pref. Div.	-4	-4	-4	-4	-3
Attributable profit	**31,098**	**41,572**	**30,389**	**37,223**	**47,102**
Adjusted earnings	31,098	41,572	30,389	37,223	47,102
Growth Rates (%)					
EPS adjusted	22.5	7.2	-26.9	22.5	26.5
Oper. profit bef. prov.	24.6	35.9	10.4	14.6	18.2
Balance Sheet (RsM)					
Total assets	**3,446,580**	**3,997,951**	**3,763,201**	**3,845,788**	**4,114,230**
Avg interest earning assets	2,799,421	3,505,124	3,642,369	3,570,821	3,752,996
Customer loans	2,017,661	2,329,796	2,372,642	2,484,399	2,656,596
Gross NPLs	41,260	75,795	134,531	177,397	203,888
Liab. & shar. funds	**3,446,580**	**3,997,951**	**3,763,201**	**3,845,788**	**4,114,230**
Total customer deposits	2,305,102	2,444,311	2,315,095	2,451,701	2,737,137
Reserve for loan losses	34,377	54,764	89,814	126,294	161,496
Shareholders' equity	**246,533**	**468,202**	**483,263**	**505,160**	**536,311**
Profitability/Solvency Ratios (%)					
ROE adjusted	13.4	11.7	6.4	7.6	9.1
Net interest margin	2.01	2.08	2.36	2.62	2.85
Cost/income ratio	53.1	50.4	48.9	46.9	45.3
Cash cost/average assets	2.2	2.2	2.2	2.4	2.5
NPLs/customer loans	2.0	3.3	5.7	7.1	7.7
Reserve for loan losses/NPLs	83.3	72.3	66.8	71.2	79.2
Bad debt prov./avg. cust. loans	1.2	1.3	1.8	2.0	1.9
Loans/deposit ratio	87.5	95.3	102.5	101.3	97.1
Tier 1 capital ratio	7.4	11.2	10.0	10.1	10.1
Total capital ratio	9.8	14.3	12.8	12.9	12.9

For further data queries on Citi's full coverage universe please contact CIR Data Services Asia Pacific at CIRDataServicesAsiaPacific@citi.com or +852-2501-2791

Powered by: dataCentral

Figure 1. ICICI Bank: 2Q FY09 Results – Highlights (Rupees Million, Percent)

	2Q09	2Q08	YoY %	1Q09	QoQ%	Citi Investment Research Comments
Interest Income	78,350	75,165	4.2	78,918	-0.7	Moderate expansion, as balance sheet degrowth continues
Interest Expense	(56,874)	(57,305)	-0.8	(58,021)	-2.0	Benefits of an improving deposit mix, and portfolio contraction
Net Interest Income	21,476	17,860	20.2	20,898	2.8	A little ahead of expectations, as management holds onto margins, in spite of a challenging deposit mobilization environment for ICBK
Fee-Based Income	18,760	14,858	26.3	19,580	-4.2	Maintains relatively strong growth, though expect it to start tapering off
Treasury	(1,530)	1,750	NM	(5,340)	-71.3	Portfolio valuation pressures, and a weak market
Other non-interest income	1,540	4,111	-62.5	1,142	34.9	
Non Interest Income	18,770	20,719	-9.4	15,382	22.0	
Operating Income	**40,246**	**38,579**	**4.3**	**36,279**	**10.9**	
Employee Expenses	(4,881)	(5,199)	-6.1	(5,232)	-6.7	
Other Operating Expenses	(12,520)	(14,509)	-13.7	(13,907)	-10.0	
Pre-Provision Profit	22,846	18,871	21.1	17,140	33.3	
Charges for Bad Debts	(9,235)	(6,445)	43.3	(7,925)	16.5	Slight step-up in provisioning, though we expect more pressure ahead
Operating Profit	13,611	12,427	9.5	9,215	47.7	
Tax	(3,472)	(2,401)	44.6	(1,935)	79.4	
Net Profit	**10,139**	**10,026**	**1.1**	**7,280**	**39.3**	**Well ahead of our -25% growth expectation**
EPS	9.1	11.2	-19.0	6.5	39.2	
Customer Loans	2,219,850	2,071,210	7.2	2,241,460	-1.0	Management continues to shrink its balance-sheet, particularly on the retail front
Customer Deposits	2,234,020	2,283,070	-2.1	2,344,610	-4.7	Contraction over the quarter, though deposit mix improves with CASA at a record 30% - driven in part by a run down in term deposits
AIEA	3,579,367	3,209,374	11.5	3,489,206	2.6	
AIBL	3,232,675	3,014,807	7.2	2,394,460	35.0	
Total Assets	3,849,700	3,649,442	5.5	3,941,560	-2.3	
Avg Assets	3,895,630	3,609,382	7.9	3,969,755	-1.9	
Gross Non-Performing Loans (NPL) excluding W/off	95,015	59,315	60.2	85,114	11.6	Large deterioration continues - though remains consistent with previous quarter: incremental deterioration remains concentrated in retail, with relatively large unsecured NPLs a meaningful part of the pool
Loan Loss Reserves (LLR)	(52,686)	(29,606)	78.0	(44,778)	17.7	Coverage moves up - on the back of stronger than average P&L coverage
Shareholders' Funds	482,121	447,520	7.7	471,982	2.1	
Book Value Per Share	433.1	402	7.6	424	2.1	A large $100m capitalisation of UK subsidiary continues to eat into capital at hand - though capital adequacy pushes beyond 14% at the aggregate
Key Ratios (%)	**2Q09**	**2Q08**	**Bps Δ YoY**	**1Q09**	**Bps Δ QoQ**	
ROAA (annualized)	1.04	1.11	-7	0.73	31	
ROAE (annualized)	8.41	8.96	-55	6.17	224	Remains a substantially low return bank - and we see little increase in returns over the near term
Net Interest Margin (bps)	240	223	17	240	0	Holds its own in spite of deposit challenges - though lags the sector which has witnessed a broad-based expansion in margins
Fee Inc/Operating Income	46.6	38.5	810	54.0	-736	Fee income growth moderates, but surprises positively given asset degrowth, and increases operational and competitive challenges
Other Non-Interest Inc/Op Inc	46.6	53.7	-707	42.4	424	
Op. Cost/ Operating Income	31.1	37.6	-650	38.3	-722	
Loan-to-Deposit Ratio (LDR)	99.4	90.7	865	95.6	377	
NPL/Loan Ratio	4.3	2.9	142	3.8	48	NPLs continue to rise - we see more pressure on retail book, with risks from the international book also rising
LLR/NPL Ratio	55	50	554	53	284	A pick up, but remains relatively modest, particularly given large share of unsecured retail NPA's

Source: Company and Citi Investment Research

Head Above Water?

What's the problem?

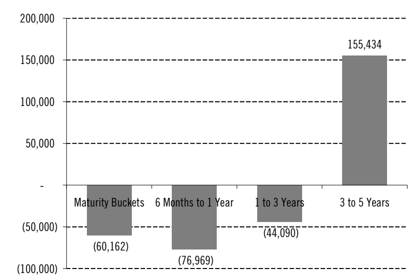
ICBK's rather modest stock performance suggests that there is a problem — probably more than one. We agree. We also believe the fundamental issues are a mix of a) Challenges – immediate and pressing, b) Strategy, and c) Perception – in the deposit and lending markets, not necessarily the stock market (actually, that too). We try and address them.

A. Challenges ahead

Liquidity: On offshore book (own B/S, other than UK/Canada subsidiaries)

The loan book is estimated at $12bn, with $1.4bn net refinancing in the next 6 months and $2bn in the next 2 years. As Figure 2 shows, ICBK is mismatched for the next 4.5 years – and unless global credit markets take a U-turn (and ICBK's own fortunes an even more dramatic U-turn given its 1600bps+ CDS spread), ICBK will be faced with refinancing/repaying its wholesale liabilities.

Figure 2. Asset Liability Mismatch in Foreign Currency



Source: Company Reports

While we share management's view that the current credit market is probably an 'over the top' reflection of the challenges, we do not share its optimism that it is readily manageable. We believe this refinancing will carry its own challenges, will damage returns, and will continue to lend uncertainty to this business. We believe that at least in the near term, it will probably have to be financed with domestic resources, on a contingency basis.

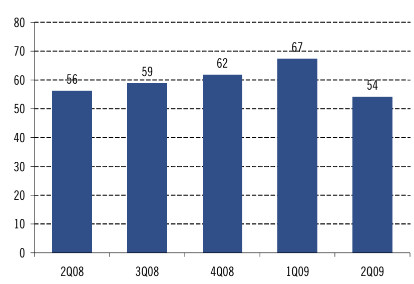
We believe this risk could well get exaggerated by the Indian corporates which have borrowed in FX from ICBK. These corporates could well face certain liquidity and asset quality pressures themselves (the INR has depreciated 25% from its peak). At least a segment of these borrowers will not be at the top end of the credit spectrum (that's why they are borrowing offshore from ICBK rather than directly), and alternative funding options appear very limited for now.

The bottom line is that in the current credit and asset market environment, ICBK's large offshore asset book of Indian corporates, residing on its own balance sheet and wholesale funded, could be a further source of strain for ICBK – predominantly liquidity, but also return and asset risk.

Asset quality

ICBK's loan book continues to deteriorate – only marginally slower than in 1Q FY09. The pressure remains predominantly in the retail space but does not appear to have bottomed, and should remain a source of pressure. That it rests largely in the unsecured space remains an added pressure point. Recovery is relatively low, therefore the longer it sits on ICBK's books the less is the likelihood of recovery. Given regulatory restrictions on recovery agencies (applies to the entire industry), we believe loss levels will tend to be high. That the economic and consumer environment in India appears to be faltering would likely further add to pressure. We see more retail NPA pressure ahead and higher provisioning and loss charges.

Figure 3. Deterioration in Asset Quality as Ratio of Opening Loans (bps)



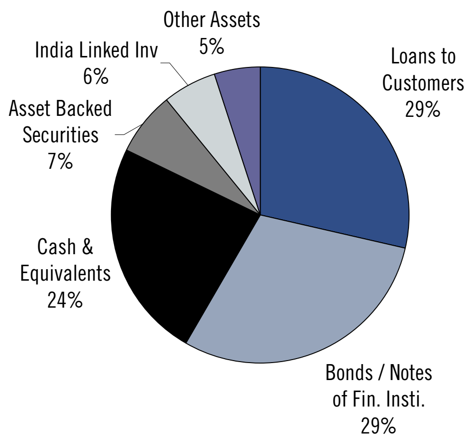
Source: Company and Citi Investment Research

While ICBK's corporate loan exposure remains, we would be watchful about asset risks in its offshore loan book to Indian corporates (as highlighted above). We believe a 25% depreciation in the currency could well hurt some borrowers. While some would have covered their FX exposures and others could well have ongoing $ inflows, which limit currency risk, we do believe a reasonable section of borrowers would not fall in either of these segments. Bottom line, we do believe this is a segment – and a large part of ICBK's asset book – that could face more pressure than the average domestic corporate would.

B. Strategy – Continued growth strategy in UK/Canada?

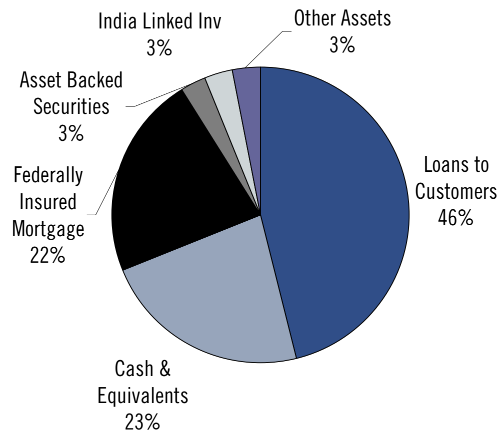
ICBK wrote down about $120m in its UK subsidiary in 2Q09; it had to provision/write off over $100m in FY08, in the same business. While this is a business loss, we believe that in the past, and in fairness to management, it was largely on account of international credit market movements, which few could have anticipated.

Figure 4. UK Subsidiary: Asset Profile



Source: Company Reports

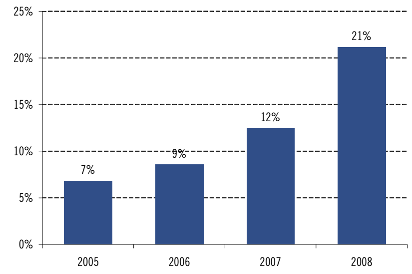
Figure 5. Canada Subsidiary: Asset Profile



Source: Company Reports

Our concern has been with the basic strategy of trying to build a deposit base in the UK/Canada or any other global market, with the objective of targeting business in the local market, in international markets, or India-related businesses. We are not sure how ICBK can be meaningfully competitive in this space or better placed than local banks to judge risk, or can ever build up a business of any scale. Moreover, these businesses will invariably need to be better capitalized than local banks, would always need more liquidity than competition, and will fundamentally be low return or high risk ventures, in our view. A look at the balance sheets of both these subsidiaries reflects the sub-optimal nature of these balance sheets (though possibly exaggerated currently because of the need for liquidity). Bottom line, we are not sure what value these businesses (in the current size and capital demands) offer in a best-case scenario while remaining exposed to events like the current market scenario.

Figure 6. Advances Disbursed Outside India as a Ratio of Total Advances (%)



Source: Company and Citi Investment Research

While management was not particularly explicit on the long-term strategy of these businesses, it did suggest that it would pursue a growth strategy, given strong deposit momentum. While this could be driven by ICBK's pressing need for offshore liquidity (as argued previously), we believe these business are a drag on returns, raise risks, and effectively drain capital that could be deployed more competitively and safely in the domestic market.

C. Mini run will hurt

ICBK faced a mini run towards end-September, its second over the past couple of years. While management, with the backing of the government and monetary authorities, stepped in to stem rumors and depositor withdrawals, we believe the franchise has been hurt and ICBK's deposit raising and retaining ability over the near to medium term would be dented.

While it remains difficult to quantify the damage, the quantifiable element is only the net reductions in deposits over the period (which is not large, and management suggests is largely by design given that relatively large wholesale deposits are the ones that have reduced), we believe it comes at an inopportune time. This is because ICBK has only recently doubled its branch network, and was seeking to accelerate its build-out in low-cost and stable retail deposits. The mini run will make this harder – and costlier – as we believe ICBK will need to offer competitive rates rather than reach and brand name, and we also believe ICBK will tend to be more challenged in getting longer-term deposits, if it seeks them. Our sense is – and this is only a simplistic assumption – this effectively sets back ICBK's deposit franchise build-out by 12-24 months – apart from keeping ICBK more exposed than most other banks to any adverse public or other developments.

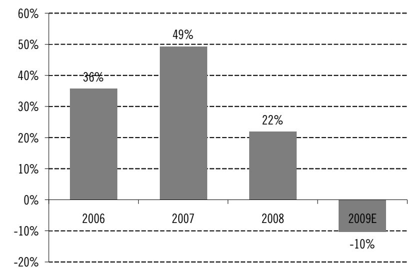
Where is ICBK doing relatively fine

ICBK has made significant gains too, some of which are visible in the current quarter. These are areas that management could build on, and if done well, could fairly rapidly transform the business outlook.

Operating costs – Reductions, with possibly more to come

ICBK has lowered operating costs by 12% yoy. While a large part of this is driven by a reduction in retail asset acquisition costs, management has been able to operate an almost twice expanded branch network, at lower costs. It also seems to be a focus, and given how rapidly ICBK had built its businesses on the way up, we believe there could be more cost reductions ahead.

Figure 7. YoY Growth (%) of Operating Expenses



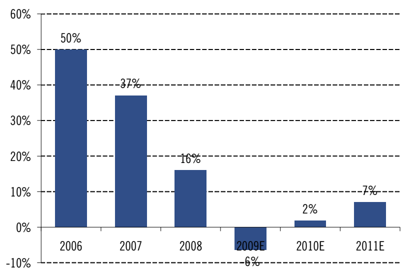
Source: Company and Citi Investment Research estimates

Asset de-growth: Domestic and global, and a more stable deposit mix

ICBK's balance sheet has contracted over the last two quarters – a mix we believe of circumstances and design. We view this as a necessity: with more de-growth needed, so that ICBK can shed its more marginal assets and liabilities, which have primarily caused pain across its businesses. This should bolster returns, lower risks and free up capital, which has often in the past been put into low return assets. We also believe this would give management the time to consolidate and take a closer look at the business, and raise returns and also moderate risk. While we are of the view that it is the offshore business which should be markedly scaled down from current levels, we need to see if management continues on this path (or reverses course, if the markets become growth conducive once again).

A primary benefit of balance-sheet de-growth is the deposit franchise; evidence of this is in the improved deposit mix over the last quarter (should over time translate into lower cost and more stable funds). The same holds true for offshore funding and business; ICBK's CDS' spreads are a good 1000bps above SBI – in reasonable measure (not the only one, though) because of the large amount of a ICBK paper floating around in the international credit markets.

Figure 8. YoY Growth (%) of Total Assets

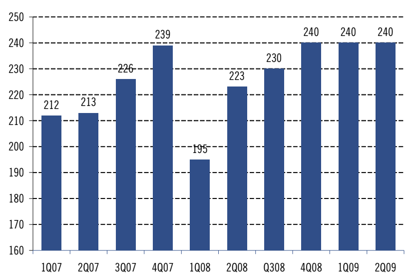


Source: Citi Investment Research

Margins – holding out, in spite of funding and asset quality pressures

ICBK margins are about the lowest in the system. They have consistently been so and are also an ongoing source of disappointment. While the current quarter brings little cheer – given that they have only held their level even as peers have meaningfully expanded their margins – there are positives. And it's a fact that ICBK has held onto margins in spite of the severe liquidity pressures it would have faced in a tight domestic markets. The quarter's NII growth was a little ahead of our expectations; and while our outlook on margins remains relatively muted, we do see evidence of asset pricing which suggests ICBK is a little more margin conscious than in the past. It's early days; and management has disappointed in the past, but a mix of asset de-growth, an improved deposit mix, and better loan pricing augurs well. The international business remains a risk. We do believe liquidity pressures could exert downward pressures but the outlook on domestic margins could well be a little more optimistic than in the past.

Figure 9. Net Interest Margin (bps)



Source: Company Reports

Figure 10. ICICI Bank: Earnings Revision Summary

	Net profit (RsM)			EPS (Rs)			Dividend	
	Old	New	% change	Old	New	% change	Old	New
FY09E	34,391	30,389	(12)	30.6	27.0	(12)	11.0	11.0
FY10E	48,699	37,223	(24)	43.3	33.1	(24)	11.0	11.0
FY11E	60,043	47,102	(22)	53.3	41.8	(22)	11.5	11.5

Source: Citi Investment Research estimates

We are revising down our estimates to reflect the latest results and the challenging macro environment.

ICICI Bank

Company description

ICICI Bank was founded in 1994 by ICICI Ltd., which was then the country's leading development finance institution. It is a leader in retail lending, with more than 30% market share in all consumer-finance segments. ICICI Bank has international banking operations as its key focus area.

Investment strategy

Our Buy/High Risk rating is premised on ICBK's: (1) low absolute valuations; (2) strong and broad base in the Indian banking and financial sector space; (3) value of its subsidiary businesses; and (4) market position on account of its large size and its exposure to a wide range of lending and services businesses in the broader banking market.

Valuation

Our target price of Rs554 is based on our EVA model. We use EVA as our primary methodology for the Indian banking universe because we believe it better adjusts for the relatively dynamic cost of capital and better captures the long-term value of a business. We have revised our target price down on account of the following changes: a) Value of subsidiary businesses Rs153 (previously Rs240); b) risk-free rate of 8.5% (9%); c) Long-term loan loss ratio of 160bps (150bps); d) New earnings estimates; and e) higher beta of 1.35 (1.05).

As a reference, our sum-of-the-parts methodology gives a fair value of Rs545. We value ICICI Bank's domestic banking business on 1.25x one-year forward PBV and international business at 0.8x, based on the risk profile of these businesses. This translates into 1.1x one-year forward PBV for the entire business. While this appears on the higher side given ICBK's sub cost of capital and ROE, we believe its large presence in the market, its capital position and the inherent leverage of the business should enable it to return to higher profitability and thereafter higher valuations.

In addition, we factor in Rs153 as the value of its subsidiaries: life insurance at Rs113/share (12x FY09E NBAP, vs. 14x previously); general insurance at Rs10/share (10x FY09E P/E); AMC at Rs10/share (5% of AUM); ICICI Securities at Rs10/share (10x FY09E), and venture fund at Rs10/share (10% of FY09E AUM). The subsidiaries are valued based on industry benchmarks.

Risks

Our risk rating is being raised to High based on the significantly higher business risk that ICBK faces on the international front as well as on the domestic deposits front. Our quants risk-rating system, which tracks 260-day historical share price volatility, suggests Low Risk. Downside risks that could impede the shares from reaching our target price include: (1) continued deterioration in asset quality; (2) low margins, with a limited cushion if there is further downside pressure; (3) aggressive growth in a range of business areas raises the risk of some failures; (4) aggressive international operations where returns appear low and risk levels relatively high; (5) inability to leverage capital, which keeps ROEs low; and 6) Depositor concerns, or a run on deposits, domestic or international.

Appendix A-1

Analyst Certification

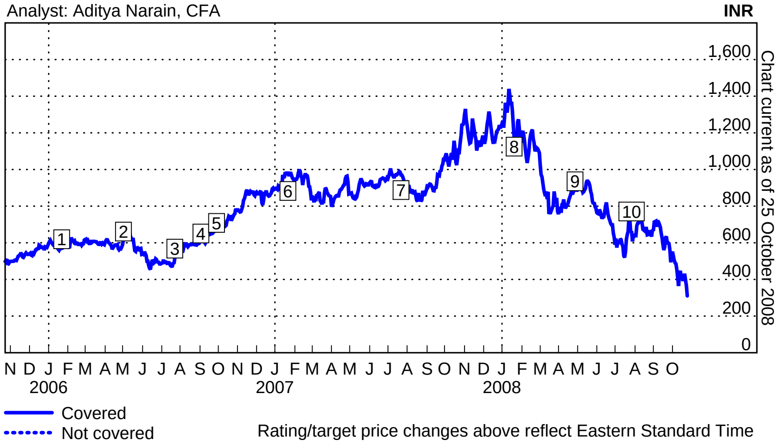
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst 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

ICICI Bank (ICBK.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Aditya Narain, CFA



#	Date	Rating	Target Price	Closing Price
1:	22 Jan 06	*3L	*550.00	569.75
2:	2 May 06	*1L	*700.00	621.95
3:	23 Jul 06	1L	*650.00	514.90
4:	4 Sep 06	1L	650.00	620.75
5:	28 Sep 06	1L	*795.00	708.40
6:	22 Jan 07	1L	*1,125.00	977.20
7:	22 Jul 07	1L	*1,235.00	970.05
8:	21 Jan 08	1L	*1,510.00	1,173.20
9:	28 Apr 08	1L	*1,185.00	894.95
10:	27 Jul 08	1L	*820.00	663.45

*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients	48%	48%	40%

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