Monday 19 June 2006

Change of price target

Kotak Mahindra Bank

Changing gears

Changed Indian capital market conditions could cap expectations of KMB's earnings growth. However, we see upside on the growing significance of the commercial banking and life insurance businesses. We raise our target price to Rs306 and maintain Buy.

Key forecasts

	FY05A	FY06A	FY07F	FY08F	FY09F
Reported PTP (Rsm)	3128.9	6184.8	7189.9▲	8409.5▲	9837.9
Reported net profit (Rsm)	1709.1	3108.0	4920.1▲	5714.7▲	6743.5
Reported EPS (Rs)	5.70	9.99	15.0▲	17.3▲	20.4
Normalised EPS (Rs)	5.70	9.99	15.0▲	17.3▲	20.4
Dividend per share (Rs)	0.50	0.62	0.63▼	0.75▼	0.97
Normalised PE (x)	42.2	24.1	16.0▼	13.9▼	11.8
Price/book value (x)	4.92	3.33	2.48	2.13	1.81
Dividend yield (%)	0.21	0.26	0.26	0.31	0.40
Return on avg equity (%)	12.6	16.7	18.1▲	16.5▲	16.6

Source: Company data, ABN AMRO forecasts
Accounting Standard: Local GAAP
year to Mar, fully diluted

Earnings set to show 24% CAGR during FY06-09F

We believe swift changes in capital market conditions might have affected market earnings growth expectations for KMB. This is reasonable, in our view, given the dominance of capital market revenues and profits in the bank's performance so far. However, we believe medium-term earnings prospects could benefit from the build-up of the commercial banking and life insurance franchises and the restructuring of minority interests in various subsidiaries. We forecast a 24% earnings CAGR during FY06-09F. Significant improvement in the quality of earnings and reduced concerns about execution risks of the growth strategy should drive up confidence on KMB's growth prospects.

Seems to be migrating towards a less volatile earnings profile

KMB's commercial banking and life insurance businesses should play a dominant role in shaping earnings for FY07 through FY09. Consumer bank distribution should achieve critical mass by FY07, based on the bank's expansion targets. We expect the deposit franchise and wealth management to gain significant momentum thereafter. Demand for new loans remains strong. We believe the life insurance business will continue to expand its distribution, leading to strong growth in first-year premiums (FYP). Capital markets should continue to contribute significantly to consolidated revenues and earnings but their dominance is set to decline over the medium term, in our view.

Maintain Buy; target raised by 33% to Rs306

Sustained earnings momentum, rising confidence in future earnings growth and reduced concerns about execution risks should drive KMB's stock price performance higher. We maintain our Buy recommendation on the stock and raise our target price to Rs306 (from Rs230), with 27% potential upside from the current price. Our target price upgrade reflects value accruing from the buyout of minority interests by KMB in its subsidiaries as well as the upgrade to earnings. We have upgraded our earnings forecasts for FY07 and FY08 by 56% and 38%, respectively. Key risks to our recommendation, forecast and target price include a sharp decline in revenues and profits from capital markets and volatility inherent to the life insurance business.

83/84 Sakhar Bhawan, Nariman Point, Mumbai 400 021, India

Buy

Absolute performance

n/a
Short term

Underweight
Market relative to region

Banks
India

Price
Rs240.65

Target price
Rs306.00 ▲

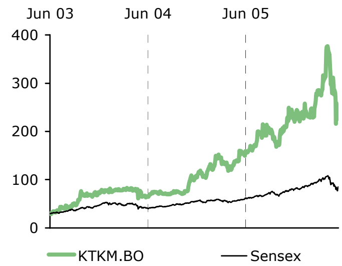
Market capitalisation
Rs74.41bn (US$1.62bn)

Avg (12mth) daily turnover
Rs46.18m (US$1.03m)

Reuters	Bloomberg
KTKM.BO	KMB IN

Asset allocation	
Equities	Underweight
Cash	Overweight
Bonds	Overweight

Price performance	(1M)	(3M)	(12M)
Price (Rs)	359.0	246.9	152.7
Absolute %	-33.0	-2.6	57.6
Rel market %	-19.5	7.3	10.0
Rel sector %	-25.8	2.3	23.4



Stock borrowing: Difficult
Volatility (30-day): 101.46%
Volatility (6-month trend): ↑
52-week range: 400.00-147.62
Sensex: 9884.51
BBG AP Banks: 147.56

Source: ABN AMRO, Bloomberg

Analysts

Sampath S K Kumar
ABN AMRO Bank N.V. (India)
India
+91 22 2285 4363 ext 306
sampath.s.k.kumar@in.abnamro.com

Simon Ho, CFA
Hong Kong
+852 2700 5160
simon.ho@hk.abnamro.com

www.abnamroresearch.com

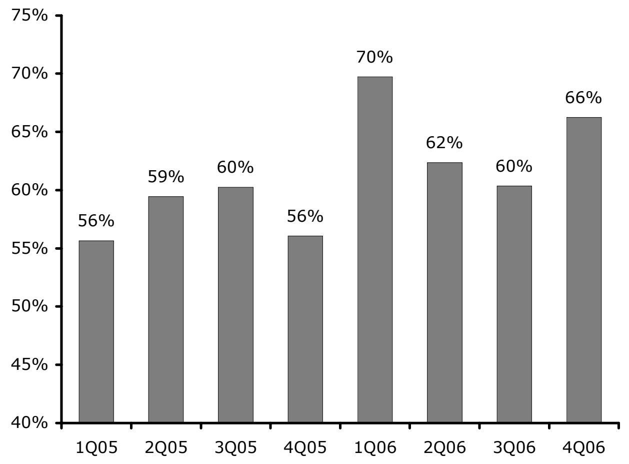
Changing gears

Changed conditions in the Indian equity market look likely to cap market consensus expectations of KMB. We disagree. We see more upside to the consensus driven by core banking and lending activities.

Earnings set to show 24% CAGR during FY06-09F

Market consensus would probably expect KMB's earnings growth prospects to change in FY07, given the volatility in the Indian equity capital markets since May 2006. This expectation would seem reasonable, given the dominance of the capital markets in KMB's performance over the last two years. Capital-market operations contributed 64% of consolidated earnings before minority interests in FY06 up from 57.5% a year ago. KMB's earnings grew 90% in FY06, but earnings from capital-markets operations grew 129%. The dominance has been so overwhelming it would seem logical to expect an adverse impact if the market sees significant volatility with declining volumes.

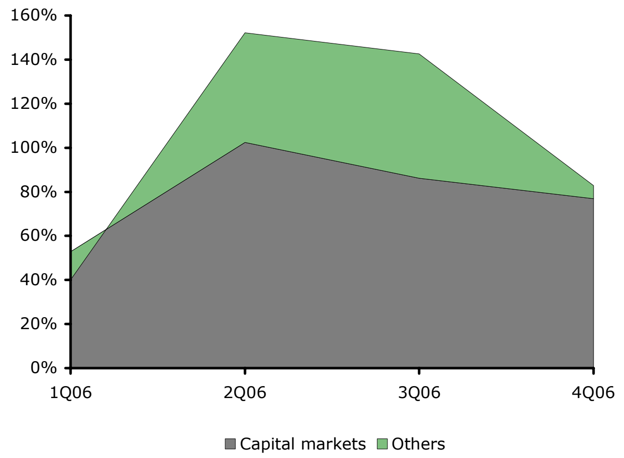
Chart 1 : KMB - capital market/consolidated earnings*



** w/o exceptionals*

Source: Company

Chart 2 : KMB – source of earnings growth in FY06

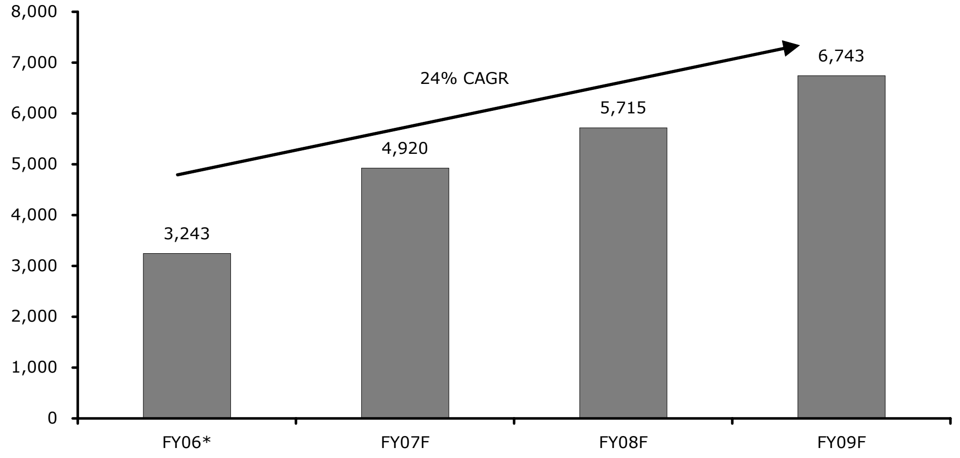


** w/o exceptionals*

Source: Company

However, we believe there will be upside to the current street estimates. This should surprise market expectations positively. We believe KMB's consolidated earnings will show a 24% CAGR from FY07 through FY09. Earnings are set to rise 56.5% in FY07F and should show a 17% CAGR during FY08-09F.

Chart 3 : KMB - forecast trend in earnings and its growth (Rs m)



** w/o exceptionals*

Source: Company data, ABN AMRO forecast

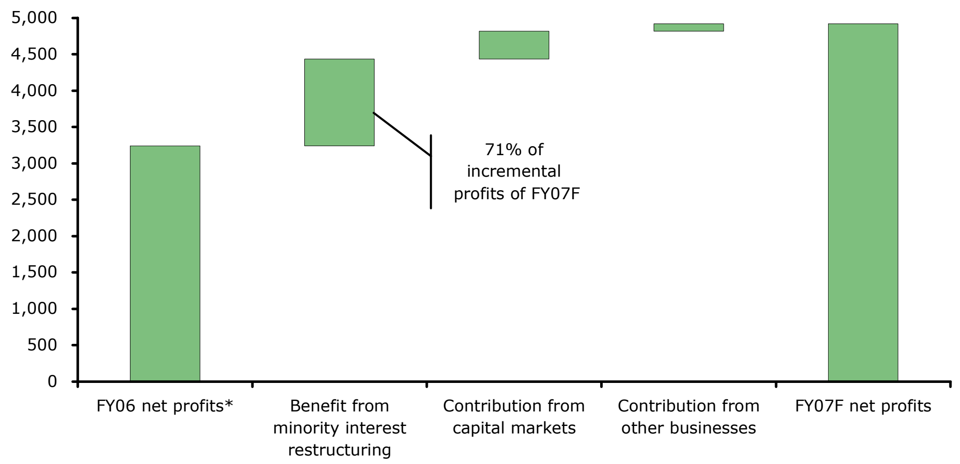
The key reasons why we expect earnings to rise strongly in FY07 are:

- The current secondary market trading volumes appear depressed compared to those seen from March-May 2006, but they are significantly higher than those seen during 1H06. We expect this to yield further upside in terms of revenue and profits in FY06 for the securities business.

- Restructuring minority interests (JVs with Goldman Sachs and Ford Credit) should yield upside to consolidated earnings after minority interests. The minority interest attributable to the JV partner in the capital markets businesses amounted to Rs731m in FY06. This should accrue fully to KMB shareholders now. The buyout of Ford Credit's interest in the auto financing company should enable KMB to improve returns from the capital employed. We estimate this will yield upside of Rs460m to KMB shareholders.

- While the strong performance of the capital-markets businesses attracted attention and overshadowed the performance of other businesses, the profits of lending, commercial banking and life insurance have grown 49% in FY06. We expect the commercial banking and life insurance businesses to show strong traction in their operating performance. We forecast profits from these businesses will rise by 45%. .

Chart 4 : KMB - sources of incremental earnings in FY07 (Rs m)

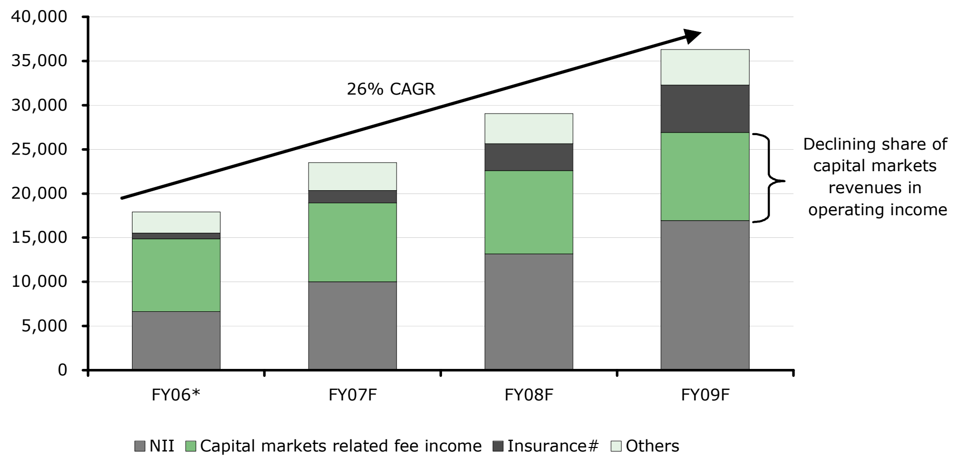


** w/o exceptionals*

Source: Company data, ABN AMRO forecast

The declining significance of the capital-markets businesses should lower the volatility of future earnings. We believe the improvement in the quality of earnings that we expect should raise confidence in KMB's earnings prospects.

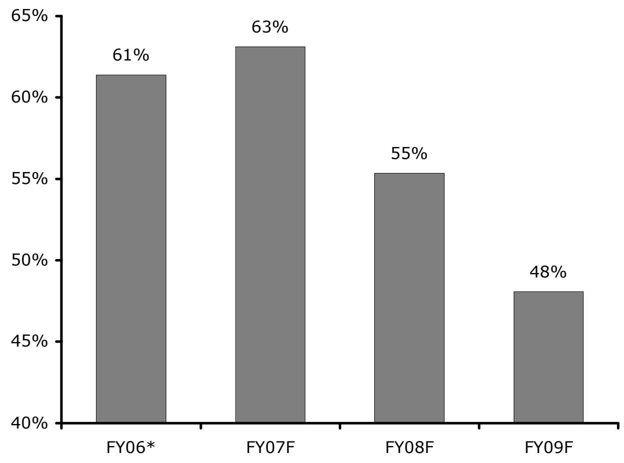
Chart 5 : KMB - forecast trend in operating revenue (Rs m)



Source: Company data, ABN AMRO forecast

We expect earnings from the capital markets businesses to peak by FY07 and the dominance of these businesses in revenues and profits to decline thereafter. We forecast earnings from the capital-markets businesses will grow 2-3% during FY08-09 and we see profits from lending, commercial banking and life insurance growing strongly (41% in FY08 and 37% in FY09).

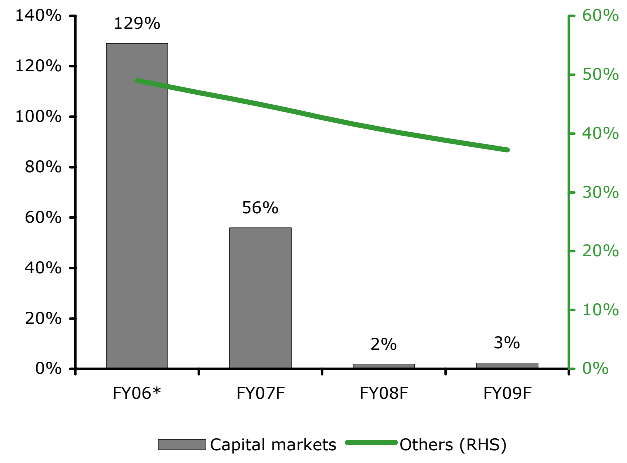
Chart 6 : KMB – capital markets/consolidated earnings forecast trend



* *w/o exceptionals*

Source: Company data, ABN AMRO forecast

Chart 7 : KMB – forecast trend in earnings growth



* *w/o exceptionals*

Source: Company data, ABN AMRO forecast

The key risk to our expectation would be a sharp downturn in capital markets businesses. We rate this risk as low.

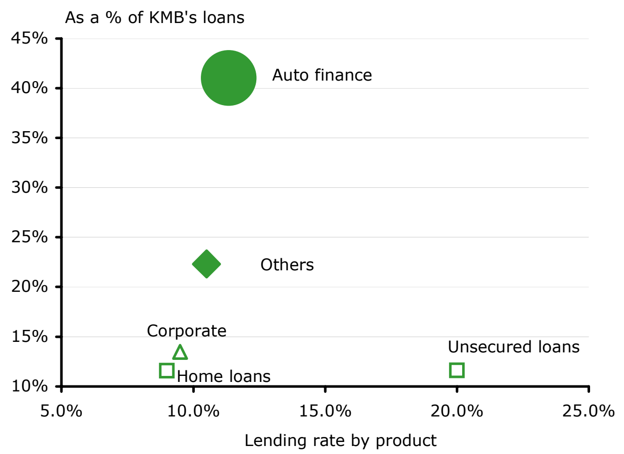
Seems to be migrating towards a less volatile earnings profile

The key upside to KMB's prospects would come from commercial banking and lending, which, we believe would offset the modest growth likely in the capital markets businesses. In our view, expanding distribution and maintaining niche are key attributes for a successful transformation of the bank. We examine these issues in the following section.

Focusing on attractive lending markets

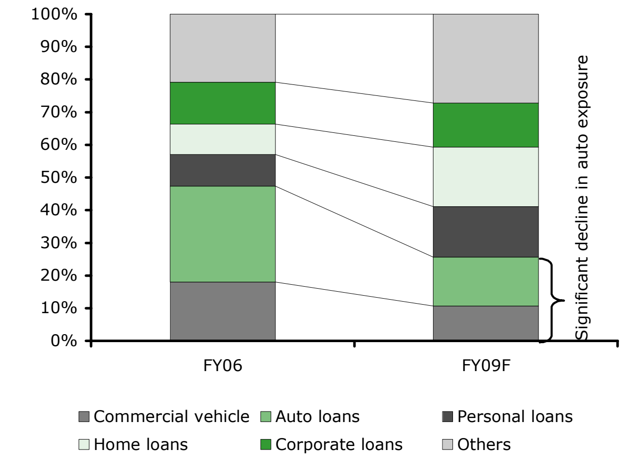
In our previous report on KMB, *Gaining momentum*, dated 4 November 2005, we highlighted that KMB had to consider a mid-course change in its strategy due to a squeeze in lending margins, mainly in auto financing. We had forecast the bank's exposure to auto finance would decline to 32% by FY08. It declined to 47% in FY06 (60% in FY05). We believe auto finance is less attractive than other consumer lending products despite a 200bp increase in lending rates over the last 18 months. We foresee no change in KMB's lending strategy and forecast its auto loan exposure will decline to 26% of total loans by FY09.

Chart 8 : Relative attractiveness of various lending markets



Source: Company, ABN AMRO estimates

Chart 9 : KMB – forecast trend in loan book composition

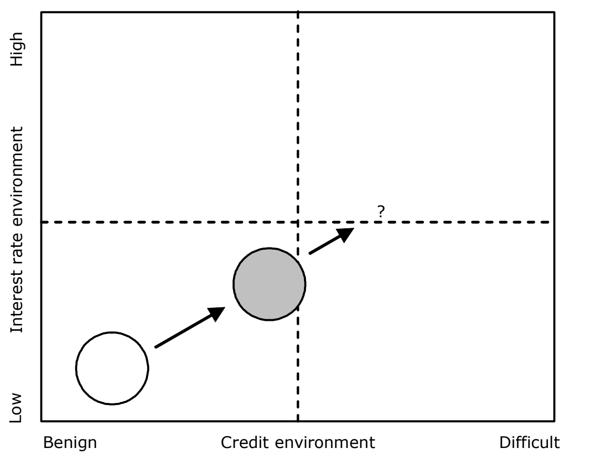


Source: Company data, ABN AMRO forecast

We expect unsecured lending and home loans to lead KMB's growth, diversifying the bank's loan portfolio, which was earlier concentrated on auto finance. This would require no significant new investment in distribution, as the bank is scaling up its existing operation. Despite an increase in the proportion of unsecured loans, we believe the risk profile of the loan portfolio will remain unchanged, given the corresponding increase in the home loan portfolio. We believe the credit environment for banks will largely remain benign and KMB's bad-debt charge-off rate will likely remain unchanged over the next three years.

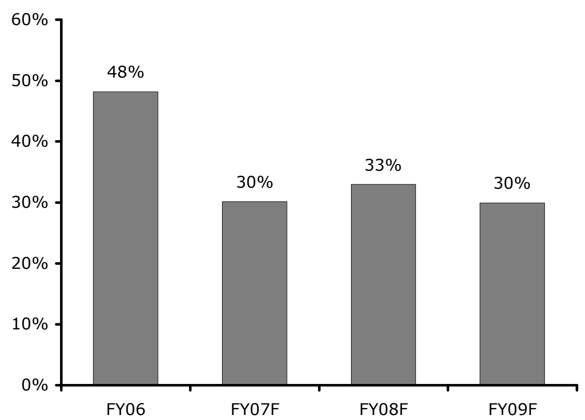
Buoyant demand for loans lifted KMB's FY06 loan growth to 48%, ahead of our expectations and despite a 200bp rise in interest rates over the last 18 months. Continued strong demand for new loans suggests the trend has not yet reached an inflection point when growth would likely be affected by a rising trend in interest rates. We forecast a 31% loan CAGR from FY06-09. We believe lending rates will rise further over the next 12 months, although moderately. However, we also believe we are likely to reach an inflexion point soon, after which further increases in lending rates would affect demand for new loans. We rate this risk as moderate.

Chart 10 : Trend in lending rates (%)



Source: Company, ABN AMRO Forecast

Chart 11 : KMB's loan-growth forecast

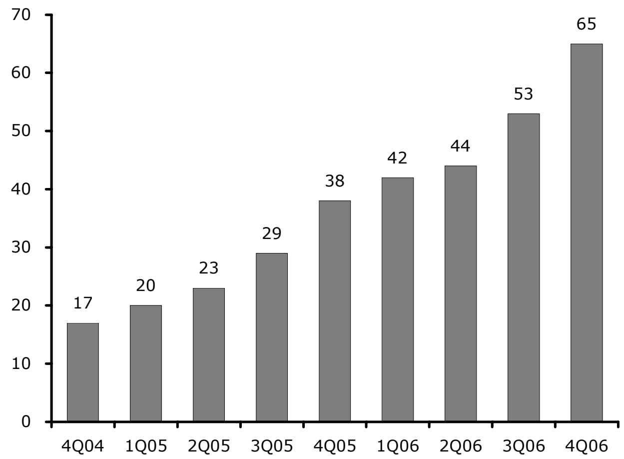


Source: Company, ABN AMRO forecast

Critical mass in distribution by FY07

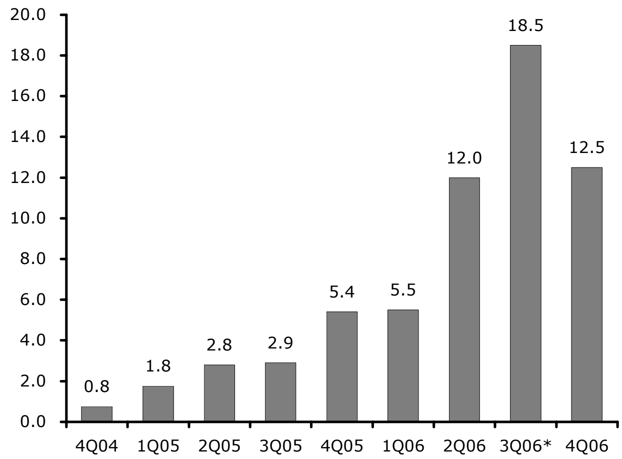
In a low interest-rate environment, collecting deposits to finance growth is less of a challenge for banks. The cycle reverses under a rising interest environment, particularly for those with inadequate scale in distribution. KMB, thus far, has relied on wholesale funding to grow its assets, mainly because of its lack of distribution. Achieving a critical mass is key to creating a stronger deposit franchise. KMB has been investing aggressively in FY05 and FY06 to expand its distribution and by end-March 2006, had 65 branches covering 43 cities and towns.

Chart 12 : KMB – trend in branch network



Source: Company

Chart 13 : KMB – trend in CASA deposits (Rs bn)



Source: Company

Even with its lack of distribution, KMB has begun to acquire a significant deposit franchise. We measure banks' deposit franchise by the ratio of low-cost deposits, known as CASA deposits. Low-cost deposits constituted 19% of KMB's total deposits as of 31 March 2006 up from 12% a year ago. This compares favourably with some of the bank's peers, given it began commercial banking only three years ago.

Table 1 : CASA deposits/total deposits - Peer group comparison (Rs bn & %)

	CASA Deposits	CASA deposits/total deposits
KMB	13	19%
ICICIB	370	22%
CBK	389	33%
UTIB	160	40%
SBI	1807	48%
HDFCB	309	55%

Source: Companies

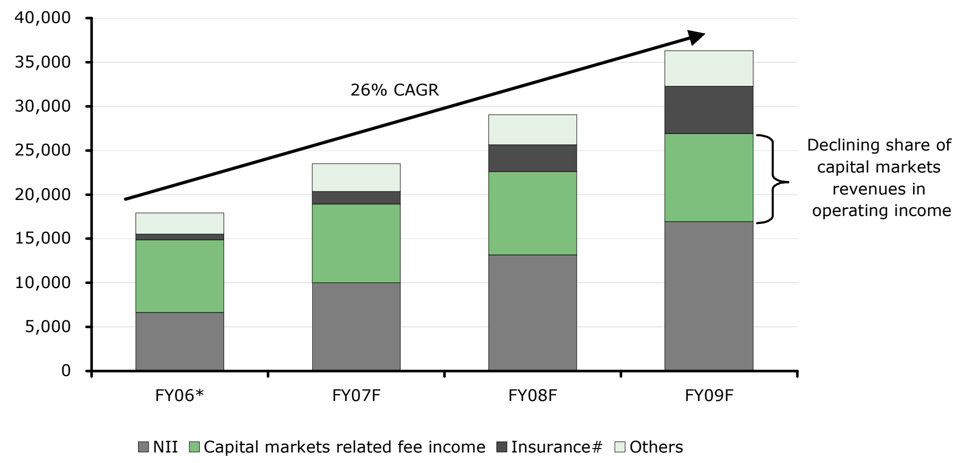
KMB's results so far are largely attributable to the investments it made during the first 18-24 months of its foray into branch banking. From our discussions with various banks, we understand that deposits grow exponentially during the first 18-24 months from the time a branch is set up. A branch achieves a critical mass in deposit accumulation during the first 18-24 months and migrates to more sustainable growth rate thereafter. Over the last 18 months, the bank has added 42 branches. The results of this addition will likely be felt over the next 12-18 months. We expect KMB to sustain its strong growth momentum for low-cost deposits during this period and forecast the low-cost deposit mix will touch 27% of total deposits by FY08. We forecast a 54% deposit CAGR during this period.

KMB has guided that it will add 35 new branches in FY07. This would take its tally to 110 branches covering 65 cities and towns. With this, we believe the bank will have covered most of its target market segments. We believe it will continue to expand its distribution, but further additions will likely focus on deepening penetration where KMB is already present. We reach this conclusion because peer banks such as HDFCB and UTIB have higher branch density per centre even though they focus on mass retail segments. KMB believes over 50% of its target customers are concentrated in six cities, hence the argument for higher branch density. We expect the incremental costs of adding new branches will be lower in a centre where the bank already has a presence. Thus, the investment cost for new branches from FY08 should decline.

Commercial banking is key to sustaining revenue growth momentum

KMB's focus on attractive lending markets and the rollout of a stronger franchise should drive revenues from core lending robustly. NII is set to show a 36% CAGR during FY06-09F. An expected moderation in capital markets revenue should highlight the significance of the growth in the commercial banking franchise. We expect this to raise investor confidence in the sustainability of growth and to reduce volatility arising from the capital markets businesses.

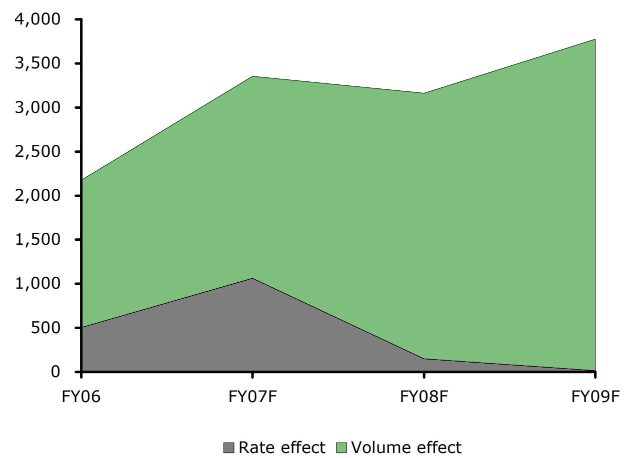
Chart 14 : KMB - forecast trend in operating revenue (Rs m)



Source: Company data, ABN AMRO forecast

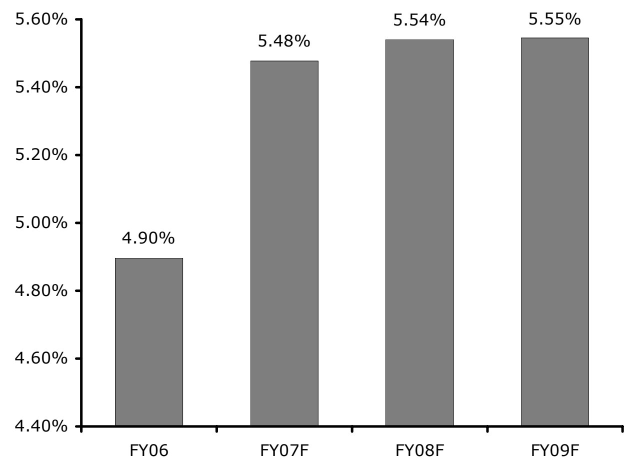
We forecast the net interest margin (NIM) will improve in FY07 from FY06, driven mainly by higher free funds benefit. We expect net interest spread (NIS) to remain unchanged in FY07. Thus far all banks including KMB have raised lending rates by 200bp to pass on the increased funding cost they have seen since 2H05. As such, lending rate hikes should have no significant impact on NIS, in our view. We believe changes in the composition of KMB's lending portfolio will likely improve its NIS in FY08 and FY09. However, NIM will likely remain unchanged, as we expect a decline in the free funds benefit to offset gains from improving lending spreads.

Chart 15 : KMB – volume, rate change analysis (Rs m)



Source: Company data, ABN AMRO forecast

Chart 16 : KMB – trend in NIM



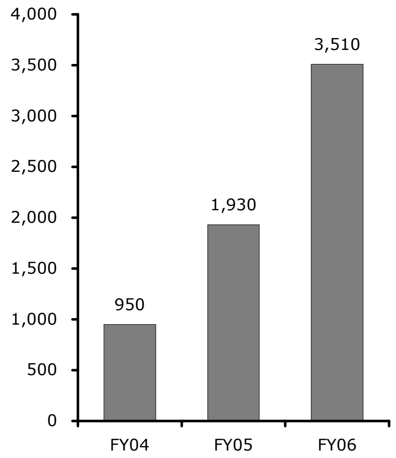
Source: Company data, ABN AMRO forecast

Life insurance business seems to be gaining momentum…

… but break-even looks some time away

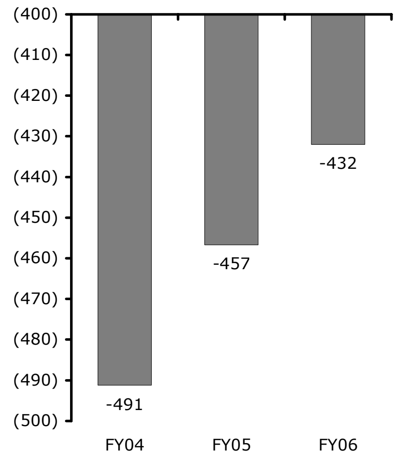
KMOM (Kotak Mahindra Old Mutual), KMB's life insurance subsidiary, made significant progress in FY06. Its FYP, including single premiums, grew 82%. Growth in regular premiums was even sharper, albeit coming from a small base. The company expanded its distribution significantly by adding 7,170 life advisors (a 123% increase). The efficiency ratio, measured as operating expenses as a ratio of premiums income less 90% of single premiums, fell to 23% in FY06 from 38% in FY05. Losses fell moderately to Rs432m in FY06 from Rs457m in FY05.

Chart 17 : Trend in FYP (Rs m)



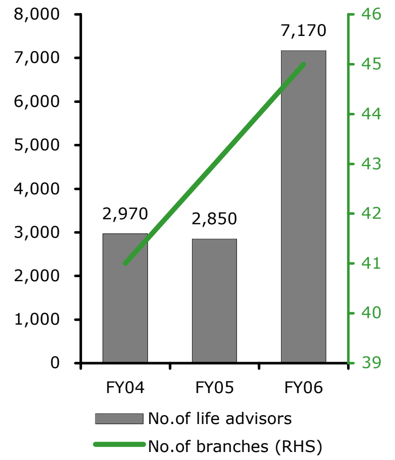
Source: Company

Chart 18 : Trend in losses (Rsm)



Source: Company

Chart 19 : Trend in distribution, no

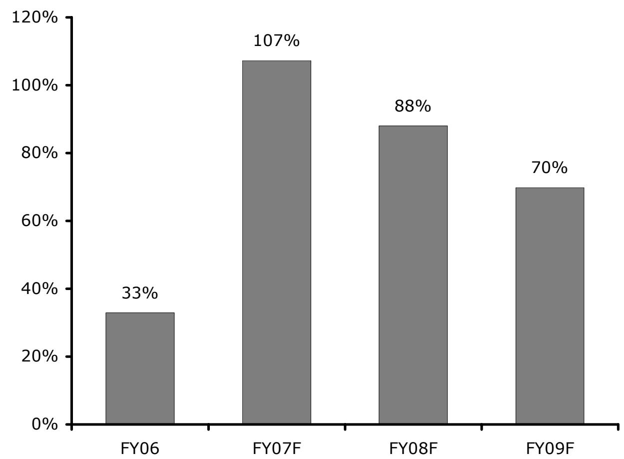


Source: Company

Encouraged by all-round improvements in FY06, the company aims to push ahead with new investments. KMOM is ranked by the Insurance Regulatory and Development Authority the sixth largest private-sector insurer in terms of premiums sold and had roughly 5% of the private players' retail market in FY06. The company has room to make significant strides in its market position by strengthening its distribution and brand identity, in our view.

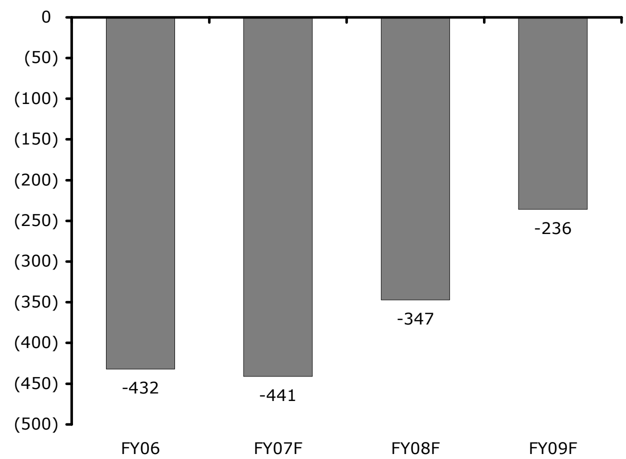
Increasing KMOM's market share would imply KMB needs to push for growth aggressively. This would call for further investment as higher growth in FYP would imply higher losses in the first year of underwriting life policies. As a result, the time horizon for achieving break-even would likely be pushed back further. We forecast a 70% CAGR in FYP during FY06-09. A sustained improvement in the efficiency ratio would reduce losses by FY09. However, this would be a function of the growth rate. Should growth rate exceed our expectations, losses would trend higher.

Chart 20 : KMOM – trend in premium income



Source: Company data, ABN AMRO forecasts

Chart 21 : KMOM – trend in losses



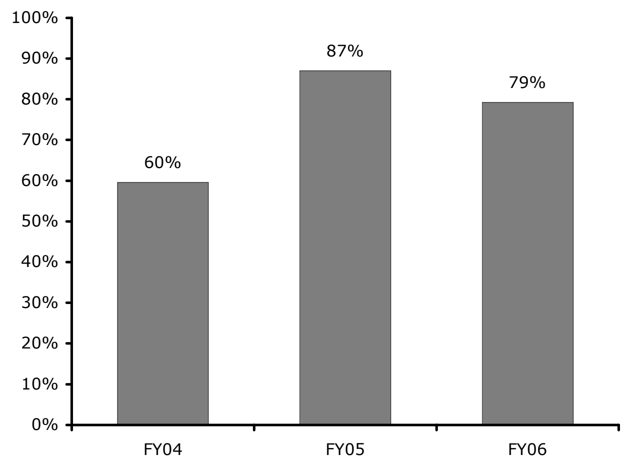
Source: Company data, ABN AMRO forecasts

The key risk to our expectation is a change in the growth dynamics of private life insurers in India. We believe their growth strategies are inherently volatile. They are selling more domestic equity exposure than traditional protection or savings policies. The fast growth of FYP seems to be correlated to the recent strong rise in the Sensex rather than true penetration in the insurance sector. We expect FYP from investment-linked products to fall sharply for private life insurers in the event of a steep decline in return on policyholders' investments. Private life insurers would then have to make new investments in selling the traditional endowment and risk products. KMOM is not immune to this risk. For a more detailed discussion of the above, refer to our Asia Moneyscope report *Indian insurance: all about Sensex?*, dated 10 April 2006.

Capital markets: pre-eminence set to decline

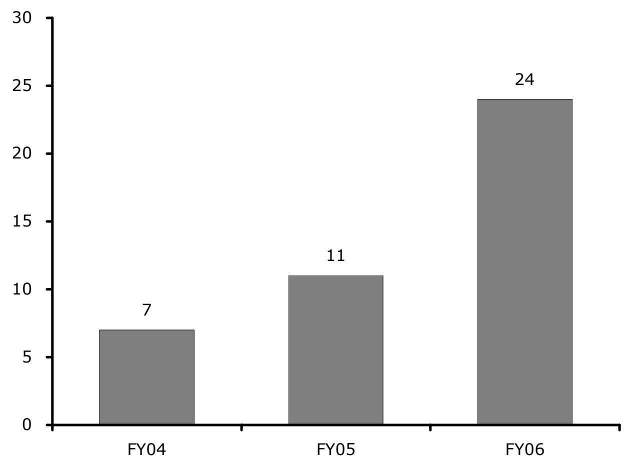
KMB has benefited significantly from a buoyant capital market for a long while now. Other businesses continued to show robust growth, but capital markets rose strongly over the last two years to contribute 64% of consolidated earnings in FY06. The brokerage subsidiary, Kotak Securities (KS), registered higher volume growth (118% on yoy basis) in FY06. The pipeline of mandates for equity placement and advisory services in the investment banking business grew substantially.

Chart 22 : KS – trend in earnings growth



Source: Company

Chart 23 : KS – trend in average daily trading volume (Rs bn)

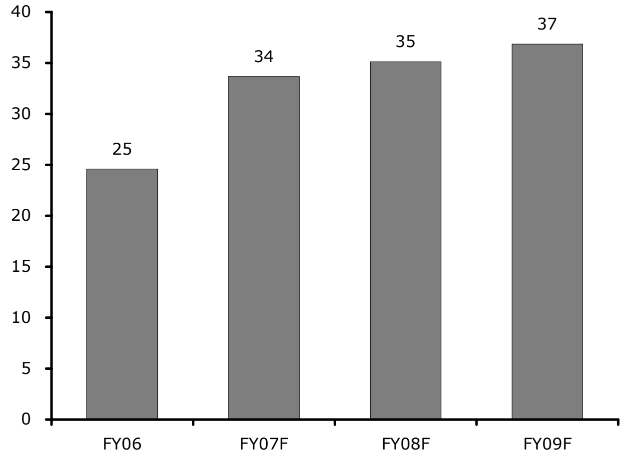


Source: Company

Secondary market trading volumes saw a frantic increase between March and May 2006. This raised the prospects for a stronger pipeline of mandates for investment banking and higher revenues for the brokerage subsidiary. The volatility seen in the Indian equity markets in early June 2006 must have raised market concerns about the prospects for the capital markets businesses.

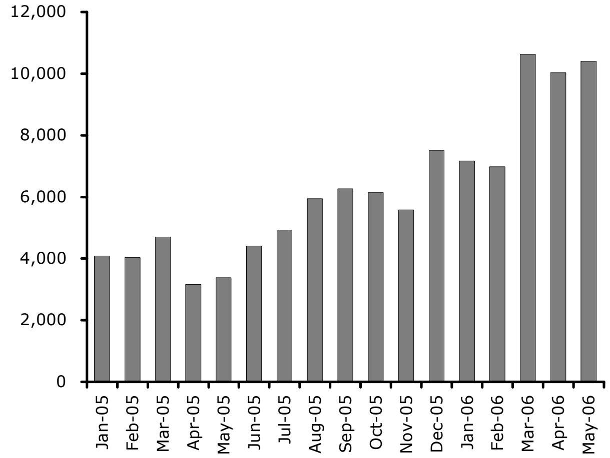
The volume of shares traded has declined significantly compared to the heady levels seen from March-May 2006, but they offer upside on a yoy basis for the brokerage subsidiary. Assuming volumes in the secondary market trading do not decline significantly from the levels seen in June 2006, we expect KS to show robust growth, given the higher base effect that it is likely to see on a yoy basis during the first nine months of FY07. We forecast revenues and profits for the brokerage business will rise 36% and 26%, respectively, while the investment banking profits will decline yoy in FY07. We forecast modest upside to revenues and profits in the capital markets businesses for FY08 and FY09. With all this, we expect the dominance of capital markets in KMB's consolidated earnings to decline. The key assumption is an orderly unwinding of the pre-eminence.

Chart 24 : KS – forecast trend in average daily trading volume (Rs bn)



Source: Company data, ABN AMRO forecasts

Chart 25 : Secondary market trading volume (Rs bn)



Source: BSE & NSE

Upgrading estimates for FY07 and FY08

What does all this mean for KMB? We upgrade our consolidated earnings forecast for the bank by 56% for FY07 and by 38.5% for FY08, given the changes in the operating businesses and the buyout of minority interests. As discussed elsewhere in this note, the upside to our FY07 expectations arises mainly from the restructuring of the ownership of KMB's key subsidiaries. The upside to our FY08 expectation comes from stronger performance in commercial banking and lending.

Table 2 : Earnings forecast revision

	FY07F			FY08F		
	Old	New	%	Old	New	%
Rs m	**estimate**	**estimate**	**change**	**estimate**	**estimate**	**change**
Pre-provision profits	6,255	7,984	27.7	8,090	9,202	13.7
Net profits	3,150	4,920	56.2	4,127	5,715	38.5
EPS (Rs)	9.2	15.0	63.5	11.0	17.3	57.6
EPS growth rate (%)	25	51		19	15	
Growth rate						
Loans	33.6%	38.1%		30.0%	33.0%	
Profitability						
Spreads	3.7%	3.2%		3.9%	3.6%	
NIM	5.1%	5.5%		5.0%	5.5%	
Cost/income ratio	70.0%	70.3%		72.0%	76.3%	
Pre-provision profitability	3.5%	4.0%		3.5%	3.5%	
RoA	2.0%	2.4%		2.0%	2.1%	
RoE	12.2%	18.1%		12.2%	16.5%	

Source: ABN AMRO forecasts

We are ahead of consensus estimates by 25% for FY07 and 17% for FY08. We believe the current IBES consensus estimate does not reflect fully the benefits from the restructuring of the ownership of key subsidiaries.

Table 3 : Versus consensus (Rs m)

	ABN AMRO	Consensus	% difference
FY07F	4920	3943	25%
FY08F	5715	4884	17%

Source: ABN AMRO forecast, IBES

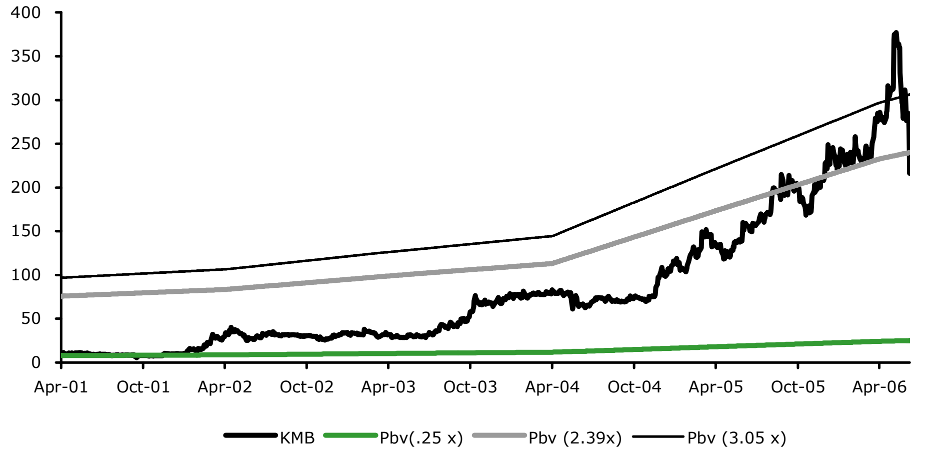
Buy KMB with 27% potential upside

We have a positive outlook for earnings growth despite a difficult operating environment. We maintain our Buy rating but raise our target price to Rs306 with potential upside of 27%.

From euphoria to sustainability

The euphoria in capital markets lifted KMB's performance too in 2006 after two successive years of outperformance of its peer banks as well as the broader market. KMB has returned 7% to shareholders YTD in 2006, even after a decline in capital markets activity in June 2006.

Chart 26 : Rolling PBV one-year forward



Source: ABN AMRO Forecast, Bloomberg

The focus of the market has shifted to sustainability of revenues and profits. Therefore, we advise investors to focus on the following issues:

- Earnings will likely surprise expectations on the upside, driven by positive changes in the business mix of core lending and banking activity. The market may believe KMB's prospects will be adversely affected with the changes in capital market conditions, without discounting the positive changes in the bank's other businesses. With a decline in the volatile constituent of earnings, the sustainability of growth rates should be less of a concern. Despite a challenging operating environment, KMB's prospect should compare favourably to those of its peers.
- Our medium-term outlook for ROE has improved from 12-13% forecast earlier to about 16-16.5% now. The upside to the return ratios arises mainly from restructuring the ownership structure of key subsidiaries. We believe the bank has more capacity to gear the balance sheet and boost returns. However, its ability to alter its capital structure seems constrained in the medium term.
- KMB has the potential to deliver an ROE of well over 22-24% in the long run, in our view, through the optimal utilisation of excess capital available within the group. We estimate the bank's excess capital was around Rs7bn as of 31 March

2006. Without going into details, excess capital available can be estimated from the following:

- Proceeds realised from sale of KMB's interest in Hutchison Essar Telecom amounting to Rs3.8bn; the proceeds are currently invested in capital gains tax-saving bonds and have a lock-in of three years.
- We estimate the excess capital available with the investment bank and the securities company to be Rs3bn-3.5bn. Currently, this is being utilised for arbitrage trading. Clearly, the capital could be put to optimal use by bringing it up to the parent level.

Excess capital available within the group should further increase as the capital markets continue to generate strong returns without requiring significant investment. Management has many times affirmed its commitment to improve the ROE of the consolidated entity. We believe the buyout of minority interests in key subsidiaries and the sale of non-strategic investments shows management's commitment. Further restructuring over the medium term could be constrained by regulatory conditions, which we believe could ease in the next three to five years.

Maintain Buy; target set at Rs306

We value KMB at Rs306 using a three-stage DDM methodology, assuming a COE of 13.6% (R_f of 7.5%, MRP of 5.5% and stock beta of 1.1x), a dividend payout ratio of 10% and a terminal growth rate of 12% beyond the explicit growth period. Our assumptions about a sustainable growth rate take into account the strong position KMB enjoys in the capital markets businesses, the bank's ability to achieve economies of scale in commercial banking and life insurance and access to capital the group has to fund future growth. Our target yields 27% potential upside from the current prices.

Table 4 : Dividend discount model (DDM) valuation

Cost of Capital Assumptions		Name	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
Beta	**1.1**									
Equity Premium	**5.5%**	Earnings per share	5.7	23.5	15.0	17.3	20.5	22.9	25.6	28.7
Risk Free Rate	**7.5%**	Dividend per share (LCY)	0.5	0.6	0.6	0.8	1.0	2.3	2.6	2.9
Cost of Equity	**13.6%**	*Payout ratio*	*0.1*	*0.03*	*10%*					
Terminal Multiple Assumption	**1.0**	EPS growth rate (CAGR)		311%	12%					
Terminal Multiple Assumption	**2.0**	Dividend growth rate (CAGR)		25%						
Terminal Multiple Assumption	**2.8**	NTA per share	47.5	72.5	97.3	113.9	133.2	153.8	176.8	202.7
		NPV of Dividends			28.1					
		Terminal value of stock			96.4					
		NPV of the stock @ 1 times book			124.5					
		NPV of the stock @ 2 times book			220.9					
		NPV of the stock @ 2.8 times book			298.0					
		Target price (Rs)			306.0					

Source: Company data, ABN AMRO forecasts

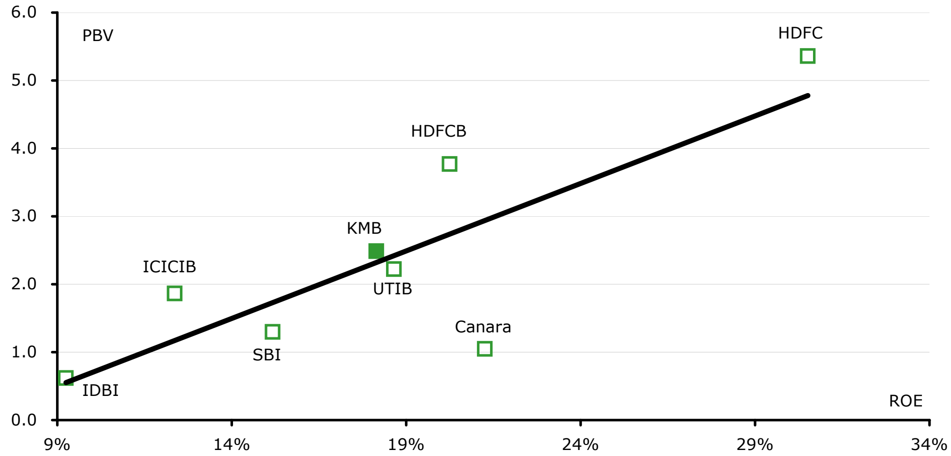
Conventional valuation metrics seem to suggest KMB's stock price is closer to fair value territory. KMB's ROE is capped in the medium term for two well-known reasons:

- The bank has excess capital that cannot be leveraged fully over the medium term due to regulatory constraints; and,

- KMOM will likely continue to incur losses through FY09. Investments are being made, but returns can only be earned when the life business achieves critical mass. We expect positive returns only after FY09. While value is being created in the life-insurance business, we are not recognising this value under Indian GAAP. At break-even levels, ROE would be 9% higher. If we were to consider positive returns for the life insurance business, ROE would be significantly higher.

Making allowance for both of the above would put KMB in value territory. While benefit may not accrue to shareholders in the medium term, the direction is one of positive change.

Chart 27 : ABN AMRO Indian banks universe – ROE vs PBV, FY07F



Source: ABN AMRO forecast, Bloomberg

Risks central to our scenario

Key risks central to our scenario include:

- A significant decline in capital markets businesses affecting the earnings outlook adversely; and,
- Volatility in Indian equity markets affecting the growth dynamics of the life-insurance business. For a more detailed discussion, refer to the previous section.

DISCLOSURES

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 3% or more and a Trading Sell indicates downside of 3% or more. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For listed property trusts (LPT) or real estate investment trusts (REIT) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more, a Hold 5-10% and a Sell less than 5%. For Scandinavian mid- and small-caps a Buy/Sell implies upside/downside of 15% or more, an Add/Reduce 5-15% and a Hold less than 5%. For other European mid- and small-caps a Buy/Sell implies upside/downside of 10% or more, an Add/Reduce 5-10% and a Hold less than 5%.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Sector relative to market: The sector view relative to the market is the responsibility of the strategy team. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Asset allocation: The asset allocation is the responsibility of the economics team. The recommended weight (Over, Neutral and Under) for equities, cash and bonds is based on a number of metrics and does not relate to a particular size change in one variable.

Stock borrowing rating: The stock borrowing rating is the subjective view and responsibility of the ABN AMRO equity finance team: Easy implies ready availability. Moderate implies some availability. Hard implies availability is tight. Impossible implies no availability.

Distribution of recommendations

The tables below show the distribution of ABN AMRO's recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where ABN AMRO has an investment banking relationship.

Long Term recommendations (as at 19 Jun 2006)

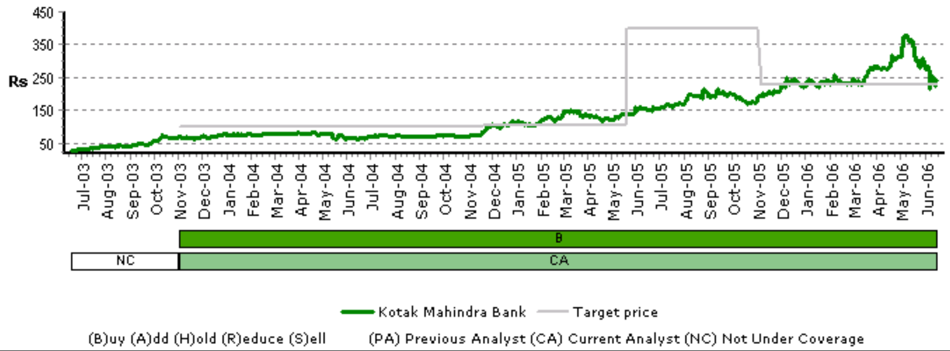
	Global total (IB%)	Asia / Pacific total (IB%)
Buy	571 (22)	341 (3)
Add	82 (34)	5 (0)
Hold	469 (16)	260 (4)
Reduce	29 (7)	2 (0)
Sell	119 (6)	84 (0)
Total (IB%)	**1270 (19)**	**692 (3)**

Trading recommendations (as at 19 Jun 2006)

	Global total (IB%)	Asia / Pacific total (IB%)
Trading Buy	25 (52)	4 (0)
Trading Sell	3 (33)	1 (0)
Total (IB%)	**28 (50)**	**5 (0)**

Kotak Mahindra Bank

Stock performance, recommendations and coverage (as at 18 Jun 2006)



Sampath S K Kumar started covering this stock on 3 Nov 03
Moved to new recommendation structure between 1 November 2005 and 31 January 2006

Trading recommendation history (as at 19 Jun 2006)

Date	Rec	Analyst
	n/a	

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KOTAK MAHINDRA BANK: KEY FINANCIAL DATA

Income statement

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Net interest income	4474.7	6649.1	10003.4	13163.8	16938.1
Non-interest income	5265.8	11267.0	13493.6	15894.5	19346.2
Total income	**9740.6**	**17916.1**	**23497.0**	**29058.4**	**36284.3**
Operating costs	-6011.7	-10634	-15513	-19857	-25417
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	-454.9	-607.1	0.00	0.00	0.00
Pre-prov operating profit	**3273.9**	**6674.7**	**7983.9**	**9201.6**	**10867.6**
Provisions charges	-185.2	-462.4	-794.0	-792.0	-1029.7
Post-prov op prof	**3088.8**	**6212.3**	**7189.9**	**8409.5**	**9837.9**
Associates (pre-tax)	40.1	-27.5	0.00	0.00	0.00
Exceptionals (pre-tax)	n/a	n/a	n/a	n/a	n/a
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**3128.9**	**6184.8**	**7189.9**	**8409.5**	**9837.9**
Taxation	-1156.7	-2130.0	-2372.7	-2775.1	-3148.1
Minority interests	-263.0	-946.8	102.9	80.3	53.7
Preference dividends	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	**1709.1**	**3108.0**	**4920.1**	**5714.7**	**6743.5**

Source: Company data, ABN AMRO forecasts ***year to Mar***

Balance sheet

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Net loans to customers	69608.5	104214	143621	190965	248131
Other int earn assets	36229.2	61117.0	84424.5	112285	145970
Goodwill	34.2	34.2	34.2	34.2	34.2
Oth non-int earn assets	8582.6	14265.8	20054.6	26735.3	34889.5
Total assets	**114455**	**179631**	**248135**	**330019**	**429025**
Total customer deposits	38326.3	56167.0	96233.7	132404	178273
Oth int-bearing liabs	38073.0	57979.0	61743.3	82032.2	104476
Non int-bearing liab	19787.6	40305.3	55782.1	75718.1	99839.3
Total liabilities	**96186.9**	**154451**	**213759**	**290155**	**382588**
Share capital	1233.2	3092.9	3262.0	3262.0	3262.0
Reserves	13435.2	19378.1	28507.8	34077.2	40703.5
Total equity (excl min)	**14668.5**	**22471.1**	**31769.8**	**37339.2**	**43965.5**
Minority interests	3599.2	2708.6	2605.8	2525.4	2471.7
Total liab & sh equity	**114455**	**179631**	**248135**	**330019**	**429025**
Risk weighted assets	49722.6	85470.0	118036	118280	118598
Est non-perf loans	375.0	520.0	570.0	670.0	720.0
Specific provisions	-173.0	-285.0	-493.0	-666.2	-1094.9
General provisions	0.00	0.00	-236.1	-354.8	-355.8

Source: Company data, ABN AMRO forecasts ***year ended Mar***

Capital

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Risk weighted assets	49722.6	85470.0	118036	118280	118598
Reported net profit	1709.1	3108.0	4920.1	5714.7	6743.5
Opening risk assets	0.00	0.00	0.00	0.00	0.00
Closing risk assets	0.00	0.00	0.00	0.00	0.00
Change in risk assets	0.00	0.00	0.00	0.00	0.00
Capital required	0.00	0.00	0.00	0.00	0.00
Free capital flow	1709.1	3108.0	4920.1	5714.7	6743.5
Ordinary dividend paid	n/a	n/a	n/a	n/a	n/a
Share buy back/spec div	n/a	n/a	n/a	n/a	n/a
Equity / preference issue	n/a	n/a	n/a	n/a	n/a
Cash flow from financing	0.00	0.00	0.00	0.00	0.00
Net capital flow	1709.1	3108.0	4920.1	5714.7	6743.5
Tier 1 capital	5031.0	6934.7	12002.1	9438.9	8220.4
Tier 1 capital ratio (%)	10.1	8.11	10.2	7.98	6.93

Lines in bold can be derived from the immediately preceding lines. ***year to Mar***
Source: Company data, ABN AMRO forecasts

KOTAK MAHINDRA BANK: PERFORMANCE AND VALUATION

Standard ratios

Performance	Kotak Mahindra FY05A	FY06A	FY07F	FY08F	FY09F	HDFC Bank Ltd FY06F	FY07F	FY08F	UTI Bank FY06F	FY07F	FY08F
Non-int inc/gr op inc (%)	54.1	62.9	57.4	54.7	53.3	33.6	36.2	37.9	43.0	43.8	43.1
Cost/income (%)	70.2	65.2	70.3	76.3	82.2	47.7	47.8	47.6	44.9	43.9	43.3
Costs/average assets (%)	6.08	7.64	7.81	7.52	7.41	2.39	2.31	2.21	1.82	1.88	1.90
Net income growth (%)	-2.76	105.6	18.8	17.0	18.7	31.8	30.5	29.6	28.5	32.0	27.8
Net cust loan growth (%)	52.2	49.7	37.8	33.0	29.9	31.9	24.3	24.4	30.0	30.0	30.0
Cust deposit growth (%)	-9.19	46.5	71.3	37.6	34.6	28.1	29.4	28.3	18.5	22.7	25.2
Net interest margin (%)	4.52	4.90	5.48	5.54	5.55	3.43	3.17	2.97	2.51	2.62	2.72
Return on avg assets (%)	1.86	2.76	2.43	2.13	1.95	1.39	1.40	1.42	1.04	1.15	1.20
Return on avg equity (%)	12.6	16.7	18.1	16.5	16.6	20.8	20.2	22.1	16.4	18.6	20.4
RORWA (%)	4.32	4.60	4.84	4.84	5.69	2.07	2.07	2.08	1.41	1.41	1.50
					year to Mar			*year to Mar*			*year to Mar*

Valuation	Kotak Mahindra FY05A	FY06A	FY07F	FY08F	FY09F	HDFC Bank Ltd FY06F	FY07F	FY08F	UTI Bank FY06F	FY07F	FY08F
Normalised EPS growth (%)	-2.55	75.2	50.1	15.5	18.0	23.6	30.5	29.6	17.9	31.3	27.8
Reported PE (x)	42.2	24.1	16.0	13.9	11.8	25.9	19.8	15.3	16.8	12.8	9.98
Normalised PE (x)	42.2	24.1	16.0	13.9	11.8	25.9	19.8	15.3	16.8	12.8	9.98
Price/book value (x)	4.92	3.33	2.48	2.13	1.81	4.38	3.77	3.17	2.57	2.22	1.89
Price/adjusted BVPS (x)	n/a	n/a	n/a	n/a	n/a	4.40	3.74	3.15	n/a	n/a	n/a
Dividend yield (%)	0.21	0.26	0.26	0.31	0.40	0.89	1.16	1.37	1.15	1.53	1.91
					year to Mar			*year to Mar*			*year to Mar*

Per share data	FY05A	FY06A	FY07F	FY08F	FY09F
Tot adj dil sh, ave (m)	299.7	311.0	327.9	329.9	329.9
Pre-prov prof/share (INR)	10.9	21.5	24.3	27.9	32.9
Reported EPS (INR)	5.70	9.99	15.0	17.3	20.4
Normalised EPS (INR)	5.70	9.99	15.0	17.3	20.4
Book value per sh (INR)	48.9	72.2	96.9	113.2	133.3
Dividend per share (INR)	0.50	0.62	0.63	0.75	0.97
Dividend cover (x)	11.1	16.1	23.8	23.4	21.2
					year to Mar

Solvency	FY05A	FY06A	FY07F	FY08F	FY09F
Tier 1 capital ratio (%)	10.1	8.11	10.2	7.98	6.93
Total CAR (%)	12.8	11.3	12.8	10.1	8.90
Equity/assets (%)	12.8	12.5	12.8	11.3	10.2
Net cust loans/dep (%)	181.6	185.5	149.2	144.2	139.2
Rep NPL/gr cus adv (%)	0.54	0.50	0.39	0.35	0.29
Tot prov/rep NPLs (%)	7.69	-55.7	50.0	73.6	92.5
Bad debts/advances (%)	0.27	0.44	0.55	0.41	0.41
					year to Mar

Priced as follows: KTKM.BO - Rs240.65; HDBK.BO - Rs732.2; UTIB.BO - Rs261.6
Source: Company data, ABN AMRO forecasts

KOTAK MAHINDRA BANK: DDM METHODOLOGY

Cost of Capital Assumptions		Name	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
Beta	**1.1**									
Equity Premium	**5.5%**	Earnings per share	5.7	23.5	15.0	17.3	20.5	22.9	25.6	28.7
Risk Free Rate	**7.5%**	Dividend per share (LCY)	0.5	0.6	0.6	0.8	0.9	2.3	2.6	2.9
Cost of Equity	**13.6%**	*Payout ratio*	*0.1*	*0.03*	*10%*					
Terminal Multiple Assumption	**1.0**	EPS growth rate (cagr)		311%	12%					
Terminal Multiple Assumption	**2.0**	Dividend growth rate (cagr)		25%						
Terminal Multiple Assumption	**2.8**	NTA per share	47.5	72.5	97.3	113.9	133.2	153.8	176.8	202.7
		NPV of Dividends			28.1					
		Terminal value of stock			96.4					
		NPV of the stock @ 1 times book			124.5					
		NPV of the stock @ 2 times book			220.9					
		NPV of the stock @ 2.8 times book			298.0					
		Target price (Rs)			306.0					

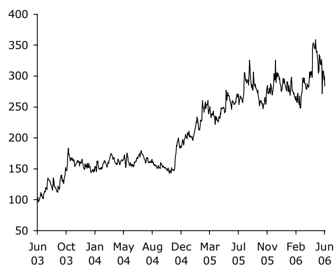
Source: Company data, ABN AMRO forecasts

Kotak Mahindra Bank

Company description — Buy

Kotak Mahindra Bank was previously a non-bank known as Kotak Mahindra Finance Company. The non-bank obtained a banking licence in FY03 and became a bank in March 2003. Kotak Mahindra, as a non-bank, had a strong franchise in retail lending activities. The retail lending franchise will likely receive a boost now with the banking licence. Apart from lending activities, Kotak has established a franchise in investment banking and brokerage. It has interests in life insurance and asset management where the company has a meaningful market share. However, it has yet to break into the top six players. Management is addressing the organisational and distribution issues associated with these businesses.

Price relative to country



Strategic analysis — Average SWOT company score: 3

Strengths — 4
Well-established businesses in retail lending, investment banking and securities provide a strong platform to expand market share by leveraging the banking franchise.

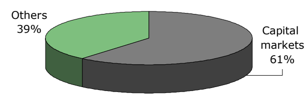
Weaknesses — 2
The lack of a strong brand identity and market share strength/scale economies in life insurance and asset management are the group's weak spots.

Opportunities — 4
New opportunity in the form of wealth management, intermediate risk in SMEs through the banking franchise and opportunity to capture more wallet share from customers through insurance and AMC.

Threats — 3
Increasing competition in the retail lending space pressuring return ratios and being relegated to a niche player in insurance are threats to the bank's business strategy.

Scoring range is 1-5 (high score is good)

Distribution of FY06 profits



Source: Company

Market data

Headquarters
36-38A Nariman Bhavan, 227 Nariman Point, Mumbai 400 021, India

Website
www.kotakmahindra.com

Shares in issue
309.2m

Freefloat
41%

Majority shareholders
Uday Kotak (50%), Kotak Trustee Co.Pvt. Ltd. (4%), FID Funds (3%)

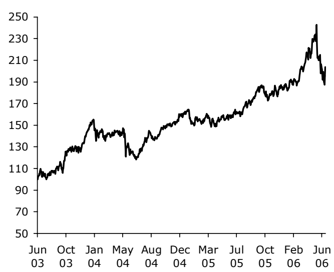
India

Country view — Underweight

We are concerned the Indian market is now significantly overvalued. We see a risk of a reversal in the strong liquidity flows into the market from local and foreign investors and with the earnings cycle becoming less clear due to the broadening of the corporate capex cycle and growing regulatory concerns in the local market. We believe the government is unlikely to engineer a meaningful slowdown in economic growth this fiscal year. We may see some fine-tuning in interest rates, but it should be mild and is unlikely to derail the growth momentum. We downgraded India in May 2006 from Neutral to Underweight.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia / Pacific



Competitive position — Average competitive score: 3-

Supplier power — 3-
Banks typically lack pricing power on the liability side in the long term as households can shift their preference among various financial instruments.

Barriers to entry — 3+
Distribution access, brand identity and high capital requirements for infrastructure investment as well as for growing the balance sheet.

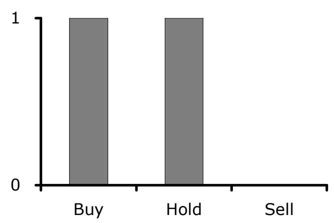
Customer power — 3-
Asset prices tend to be market-driven. Disintermediation in wholesale lending and competition in retail lending means no pricing power in the asset markets for banks.

Substitute products — 3-
Alternative financial savings pose a threat to the liability franchise. Similarly, disintermediation poses a threat to the asset franchise.

Rivalry — 2+
Internal rivalry tends to be intense, due to the fragmentation of the financial services market. Product innovation is duplicated easily and hence the lifecycle tends to be short.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse

Broker recommendations



Source: Bloomberg