Company In-Depth

24 January 2007 | 9 pages

Kotak Mahindra Bank (KTKM.BO)

Hold: 3Q07 Results - Broking Leading a Strong Show

Rating change ☐
Target price change ☑
Estimate change ☑

- **Strong 110%+ growth – well ahead of expectations**— Kotak has had a bumper quarter – profits are over 60% ahead of our expectations, are robust across business segments, but are led by last quarter disappointment – its core stock broking business. We raise estimates to reflect this momentum.
- **Aggressive pullback by broking**— The quarter is led by the broking business – volumes up 60% qoq and yoy, market share gains, and some performance-linked asset management gains carry the day. This is a strong comeback, after meaningful market share loss in the previous quarter. While this business is inherently cyclical –a near 10% market share does provide a key cash pipe.
- **Banking business also does well**— Banking business remains robust – 78% asset expansion, stable and high margins in a challenging market, and its measured distribution rollout continues. The asset mix diversifies toward lower-yield assets, asset quality remains stable, and management stresses on meaningful unrealized gain on its distressed asset portfolio.
- **Funding outlook appears tough, and market sensitivity remains high**— Kotak has surprised with the resilience of its margins; we do, however, believe if the currently tight funding environment sustains, high margins should erode. We do see this as a potential profit dampener, and could constrain the current high-growth levels.
- **Raising estimates, target price – Maintain Hold** — We are raising estimates 27%-11%, to reflect strong profit performance (broking driven), and we are also raising our target price to Rs512 (from Rs355) – Maintain Hold/Medium Risk, given valuations and potential business challenges.

See page 7 for Analyst Certification and important disclosures.

Hold/Medium Risk	2M
Price (23 Jan 07)	Rs462.20
Target price	Rs512.00
from Rs355.00	
Expected share price return	10.8%
Expected dividend yield	0.2%
Expected total return	**10.9%**
Market Cap	Rs150,677M
	US$3,415M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	1,709	5.62	-3.9	82.2	3.9	12.7	0.1
2006A	7,297	23.56	318.9	19.6	6.4	39.3	0.1
2007E	5,293	16.66	-29.3	27.7	4.7	19.4	0.2
2008E	6,466	19.88	19.3	23.2	3.9	18.4	0.2
2009E	7,712	23.71	19.3	19.5	3.3	18.4	0.2

Source: Powered by dataCentral

Aditya Narain, CFA[1]
+91-22-6631-9879
aditya.narain@citigroup.com

Manish Chowdhary, CFA[1]
+91-22-6631-9853
manish.chowdhary@citigroup.com

Himani Shah[1]
himani.shah@citigroup.com

[1]Citigroup Global Market India Private Limited

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	82.2	19.6	27.7	23.2	19.5
P/E reported (x)	82.2	19.6	27.7	23.2	19.5
P/BV (x)	3.9	6.4	4.7	3.9	3.3
P/Adjusted BV diluted (x)	9.7	6.4	4.7	3.9	3.3
Dividend yield (%)	0.1	0.1	0.2	0.2	0.2
Per Share Data (Rs)					
EPS adjusted	5.62	23.56	16.66	19.88	23.71
EPS reported	5.62	23.56	16.66	19.88	23.71
BVPS	118.94	72.65	99.04	118.01	140.69
Tangible BVPS	118.94	72.65	99.04	118.01	140.69
Adjusted BVPS diluted	47.43	72.43	98.75	117.67	140.28
DPS	0.50	0.60	0.70	0.88	1.00
Profit & Loss (RsM)					
Net interest income	4,475	6,649	9,532	12,022	15,290
Fees and commissions	3,910	8,347	10,623	12,643	14,617
Other operating Income	1,745	4,672	2,765	3,736	5,037
Total operating income	**10,130**	**19,669**	**22,920**	**28,400**	**34,944**
Total operating expenses	-6,856	-11,728	-13,673	-17,001	-21,266
Oper. profit bef. provisions	**3,274**	**7,941**	**9,247**	**11,399**	**13,678**
Bad debt provisions	-178	-512	-1,229	-1,629	-2,058
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**3,096**	**7,428**	**8,018**	**9,770**	**11,620**
Tax	-1,157	-2,130	-2,803	-3,343	-3,882
Extraord./Min. Int./Pref. Div.	-230	1,999	78	39	-26
Attributable profit	**1,709**	**7,297**	**5,293**	**6,466**	**7,712**
Adjusted earnings	1,709	7,297	5,293	6,466	7,712
Growth Rates (%)					
EPS adjusted	-3.9	318.9	-29.3	19.3	19.3
Oper. profit bef. prov.	-3.9	142.5	16.4	23.3	20.0
Balance Sheet (RsM)					
Total assets	**114,455**	**179,673**	**217,834**	**299,565**	**409,496**
Avg interest earning assets	98,588	134,321	186,805	251,735	344,082
Customer loans	71,772	104,847	155,721	205,457	265,137
Gross NPLs	372	651	1,103	1,687	2,395
Liab. & shar. funds	**114,455**	**179,673**	**217,834**	**299,565**	**409,496**
Total customer deposits	38,326	56,167	103,594	153,474	212,253
Reserve for loan losses	325	648	1,446	2,549	3,949
Shareholders' equity	**14,668**	**22,471**	**32,119**	**38,271**	**45,627**
Profitability/Solvency Ratios (%)					
ROE adjusted	12.7	39.3	19.4	18.4	18.4
Net interest margin	4.5	5.0	5.1	4.8	4.4
Cost/income ratio	67.7	59.6	59.7	59.9	60.9
Cash cost/average assets	6.5	8.0	6.9	6.6	6.0
NPLs/customer loans	0.5	0.6	0.7	0.8	0.9
Reserve for loan losses/NPLs	87.5	99.6	131.2	151.1	164.8
Bad debt prov./avg. cust. loans	0.3	0.6	0.9	0.9	0.9
Loans/deposit ratio	187.3	186.7	150.3	133.9	124.9
Tier 1 capital ratio	11.0	8.2	8.6	7.2	6.4
Total capital ratio	14.2	12.7	11.3	9.7	8.5

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Figure 1. Earnings Revision Summary

	Net Profit			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
2007E	4,173	5,293	26.8%	13.1	16.7	26.8%	0.7	0.7
2008E	5,213	6,466	24.0%	16.0	19.9	24.0%	0.9	0.9
2009E	6,921	7,712	11.4%	21.3	23.7	11.4%	1.0	1.0

Source: Citigroup Investment Research

Figure 2. 3Q07 Results: Highlights

	3Q07	3Q06	YoY %	2Q07	QoQ%	Citigroup Investment Research Comments
Interest Income	5,278	2,985	76.8	4,337	21.7	Does push through rate increases in spite of a relatively lower yield loan mix; we do however see a cap coming up, in the event funding cost rise further
Interest Expense	(2,668)	(1,348)	97.9	-2,137	24.8	
Net Interest Income	2,610	1,637	59.5	2,200	18.6	Relatively strong performance; margins hold, in a potentially challenging environment
Fee-Based Income	3,154	2,080	51.6	1,926	63.7	Well ahead of expectations - driven by broking commissions, but supported by distribution revenues. Asset management revenue share support profitability. International asset management and revenue share, boost returns in the quarter
Insurance Premium	2,093	1,178	77.7	1,616	29.5	Insurance business maintains momentum, though we do not see market share gains
Other Non-Interest Income	**1,381**	**293**	**371.2**	**1,155**	**19.6**	
Non Interest Income	6,628	3,551	86.7	4,698	41.1	
Operating Income	9,238	5,187	78.1	6,898	33.9	
Operating Expenses	(6,323)	(3,682)	71.7	(5,357)	18.0	Continues buildout, and cost pressures, likely to keep expense growth high
Pre-Provision Profit	2,914	1,505	93.6	1,541	89.2	
Charges for Bad Debts	(513)	(40)	1171.8	(207)	147.6	Sharp increase on account of regulatory provisioning on stresses asset portfolio - underlying asset health remains strong
Operating Profit	2,401	1,465	63.9	1,333	80.1	
Pre-Tax Profit	2,401	1,465	63.9	1,333	80.1	
Tax	(772)	(501)	54.3	(484)	59.5	
Minorities	67	(146)	NM	90	-25.7	
Net Profit	**1,696**	**818**	**107.3**	**939**	**80.6**	**70% ahead of expectations - alround performance, with surprise driven by broking performance**
EPS	5.17	2.65	95.1	2.86	80.6	
Customer Loans	137,139	89,866	52.6	120,671	13.6	Growth continues, though skew toward corporate and mortgages which are primary growth drivers
Customer Deposits	85,000	59,155	43.7	68,756	23.6	Modest momentum contjnues, but no mix improvement
AIEA	199,131	123,546	61.2	170,145	17.0	
Total Assets	216,568	130,000	66.6	181,693	19.2	
Avg Assets	199,131	126,500	57.4	173,347	14.9	Asset expansion continues to be aggressive, in spite of what would appear a challenging funding environment
Shareholders' Funds	30,793	17,583	75.1	29,097	5.8	
Book Value Per Share	95	57	67.0	90	5.8	
Key Ratios (%)	**3Q07**	**3Q06**	**Bps Δ YoY**	**2Q07**	**Bps Δ QoQ**	**Citigroup Investment Research Comments**
ROAA (annualized)	3.13	2.52	62	2.07	107	
ROAE (annualized)	22.03	18.61	342	12.91	912	
Net Interest Margin (bps)	524	530	-6	517	7	Impressive performance, in light of a very tight funding market, which should have left Kotak relatively exposed
Fee Inc/Operating Income	34.1	40.1	-596	27.9	621	Sharp improvement qoq, after company pulls back from a weak quarter
Other Non-Interest Inc/Op Inc	14.9	5.6	930	16.7	-179	
Op. Cost/ Operating Income	68.5	71.0	-253	77.7	-921	
Loan-to-Deposit Ratio (LDR)	161.3	151.9	942	175.5	-1417	
NPL/Loan Ratio	2.3	0.8	154	0.7	164	NPA increase on account of accounting for stressed asset portfolio - core portfolio remains comfortable with net NPA's at 0.22% - management see significant unrecognized value in its distressed debt portfolio, but does not quantify

Source: Company Reports and Citigroup Investment Research

Figure 3. 3Q Results: Highlights (Key Associates and Subsidiaries)

	3Q07	3Q06	YoY %	2Q07	QoQ%	Citigroup Investment Research Comments
Consolidated Revenue Mix						.
Financing Activities	4,167	2,304	80.8	3,463	20.3	Broad-based performance
Core Fee income	3,105	1,924	61.4	1,914	62.2	
Premium on Insurance	2,093	1,178	77.7	1,617	29.5	
Treasury	2,306	1,000	130.6	1,884	22.4	
Others	235	130	80.5	157	49.2	
Total	11,905	6,536	82.1	9,035	31.8	
Kotak Mahindra Bank - standalone						
Operating profit before branch banking losses	775	495	56.7	607	27.8	
Branch banking losses	(83)	(54)	54.4	(94)	-12.1	Strong distribution fees support a strong performance at the bank level
PBT	693	441	56.9	513	35.1	Longer-term Branch expansion targets yet to be announced
PAT	454	326	39.1	348	30.5	
Kotak Mahindra Capital Company						
PBT - PD business	40	151	-73.4	98	-59.0	Investment banking not keeping pace with overall business
PBT - Franchise business	231	107	116.2	107	116.2	
Total PBT	271	258	5.3	205	32.6	
Total PAT	189	183	3.7	154	22.8	
Kotak Securities						
Average Daily volumes	40,000	25,000	60.0	26,300	52.1	Very sharp rebound after a weak quarter - market share gains, and a strong market
AUM - PMS	21,300	24,300	-12.3	23,400	-9.0	
Total Income	2,386	1,429	66.9	1,479	61.3	
PAT	804	490	64.0	314	155.8	High operating leverage of business on view - profit sharing gains likely boost returns
Kotak Mahindra Primus						
Assets	32,900	28,600	15.0	31,300	5.1	
Total income	1,150	748	53.8	957	20.1	
PBT before royalty	155	135	14.9	158	-2.0	Car financing business remains a relatively low profit one
PAT	109	86	26.2	109	-0.4	
OM Kotak Mahindra Life Insurance						
Premium income	2,133	1,210	76.3	1,679	27.1	Momentum, but not gaining market
PAT	(176)	(121)	45.8	(169)	4.0	
Kotak Mahindra Asset Management						
AUM	126900	74000	71.5	117000	8.5	Managed account biz however records de-growth in AUM's
Total Income	137.5	103.4	33.0	136.2	1.0	
PAT	12	7.1	69.0	34.5	-65.2	

Source: Company Reports and Citigroup Investment Research

Kotak Mahindra Bank

Company description

Kotak is a private-sector bank in which Mr. Uday Kotak, the promoter, and his associates have a 56% stake. Main businesses of the bank are consumer lending, retail broking, investment banking, asset management, and rapidly growing life insurance. Its focus is to develop a niche wealth-management platform.

Investment thesis

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

Valuation

Our target price for Kotak is Rs512 (previously Rs355). Its relatively high share of securities fees suggests a valuation benchmark of an investment bank. However, there are no such comparables in the Indian market, and Kotak is much smaller than its global peers. Hence, we use EVA and a sum-of-the-parts to value Kotak.

EVA methodology: We use a 800bp risk-free rate to calculate cost of equity, in line with the other banks, and a market beta of 1. We are not consolidating the insurance subsidiary's financials. Instead, we account for it on a per-share basis as an associate (Rs78). Based on our EVA valuation, we value Kotak at Rs512. The upwards revision in target price is based on the revised earnings estimates which incorporate stronger fee growth expectations, a slightly higher spread level over the longer term, and higher asset yields given the firmer interest rate environment.

Sum-of-parts valuation: Given KTKM's spread of businesses, we believe a sum-of-parts valuation is also an appropriate benchmark. Based on this, we estimate fair value of Kotak at Rs442 (raised from Rs332 previously. This is benchmarked off FY08 estimates (previously 1 yr Fwd). This sum of parts valuation incorporates a value of Rs96 for the bank (3X FY08 PBV), Rs172 for brokerage (16X PE FY08), Rs78 for Life Insurance (15x NBAP FY08), and fair market multiples for its other business lines. We are not factoring in any value for its stressed asset business given the relative lack of data – though we believe that offers additional valuation support. We benchmark our target multiple off our EVA valuation of Rs512. This is our preferred methodology, given that we think it better captures the value of fee incomes, as also the longer term value creation by the franchise.

Risk

We rate Kotak as Medium Risk, though our quantitative model now suggests a Low Risk rating. We believe a higher risk rating is justified in part because of strong stock performance over the recent past, but also in view of Kotak's relatively small balance sheet size. This extends to the business mix and drivers, including: a) Wholesale funding: While Kotak is in the process of building up branch distribution and retail deposits, its funding is almost entirely wholesale and is likely to remain so in the medium term. If rates were to increase further or liquidity were to tighten, Kotak's funding costs would increase disproportionately compared with its peers. This could impact growth, and potentially profitability. b) Execution risk: Kotak is growing aggressively, is evolving a new operating structure, and is rapidly building a branch network. The pace of change amid Kotak's conservatism and the competitive business environment could create execution risks. c) Capital market cyclicality: Kotak generates more revenues from the capital markets than any other bank in India, and its profitability in the recent past has been significantly boosted by strong equity markets. The cyclical nature of these capital markets, particularly after a strong performance, is a key risk to earnings and valuations. Upside risks to our rating include: a) Strong primary and secondary capital markets: Kotak's strong position in the capital markets and relatively high earnings reliance could significantly boost earnings and valuations. b) Stronger-than-expected performance and benchmark valuations for the unlisted life insurance venture.

Analyst Certification Appendix A-1

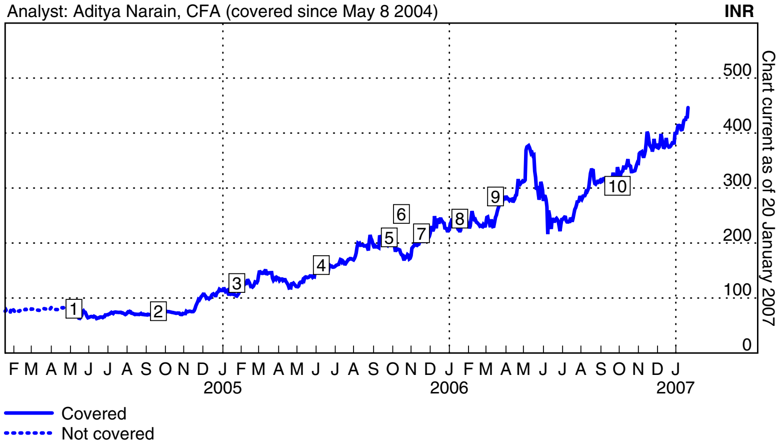
We, Aditya Narain, CFA and Manish Chowdhary, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Kotak Mahindra Bank Ltd (KTKM.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	7 May 04	1M	118.80	80.04
2:	21 Sep 04	1M	*108.00	72.40
3:	25 Jan 05	1M	*130.00	103.54
4:	9 Jun 05	*2M	*180.00	156.90
5:	27 Sep 05	2M	180.00	199.80
6:	17 Oct 05	2M	*220.00	178.90
7:	17 Nov 05	2M	*235.00	203.95
8:	18 Jan 06	2M	*255.00	220.40
9:	16 Mar 06	2M	*280.00	246.95
10:	28 Sep 06	2M	*355.00	338.00

*Indicates change.

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Citigroup Investment Research Global Fundamental Coverage (3106)	43%	41%	15%
% of companies in each rating category that are investment banking clients	45%	41%	34%
India -- Asia Pacific (118)	58%	14%	28%
% of companies in each rating category that are investment banking clients	48%	50%	39%

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