ICICI Bank (ICBK.BO)

Strategic Direction – Finally?

- **Strategic direction – signs of a more prudent, and return-oriented one** — ICBK does appear to be following in deeds (and words) a more prudent, return-oriented and 'market palatable' strategic direction. This is showing through in better margins, lower/negative growth, signs of asset quality and balance-sheet mix management, and apparently greater respect for capital (while not closing out the growth option). There are gaps – off-shore strategy remains debatable, asset risks/funding gaps could widen and the new strategy could be environment induced (reverts, when economy turns); but combined with a meaningful management revamp, we are more positively biased than skeptical.

- **Asset deterioration continues, but is not worsening** — ICBK continues to see almost 2.5%pa deterioration; poor and lags industry, but retail appears to be stabilizing (in-line with industry trends). There is 1.5% of new restructured loans (not a big surprise); we do see further deterioration (management cautious on outlook), but would not expect ICBK to lag industry here-on.

- **P&L disappoints, but there are positives** — 4Q09 profits are down 35%, and 12% below our estimates; primarily on weak fee incomes (-30% yoy, flat qoq), and possibly suggesting some recent franchise damage. But margins have bounced 20bps qoq, and management has put out a robust medium-term outlook (well grounded too); ICBK's core profitability problem being addressed?

- **Maintain Buy, High Risk** — If ICBK were to continue down its espoused strategic path (with some tweaks and changes), and gets support from the economy; it could well retrieve more of its lost profitability and valuations.

Buy/High Risk	**1H**
Price (24 Apr 09)	Rs432.50
Target price	Rs489.00
Expected share price return	13.1%
Expected dividend yield	2.5%
Expected total return	**15.6%**
Market Cap	Rs481,481M US$9,648M

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	12.5	1.6	13.4	2.3
2008A	41,572	36.93	7.2	11.7	1.0	11.7	2.6
2009E	35,240	31.31	-15.2	13.8	1.0	7.4	2.5
2010E	34,096	30.29	-3.2	14.3	1.0	6.9	2.5
2011E	43,654	38.78	28.0	11.2	0.9	8.4	2.7

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)	12.5	11.7	13.8	14.3	11.2
P/E reported (x)	12.5	11.7	13.8	14.3	11.2
P/BV (x)	1.6	1.0	1.0	1.0	0.9
P/Adjusted BV diluted (x)	1.6	1.0	1.0	1.0	0.9
Dividend yield (%)	2.3	2.6	2.5	2.5	2.7
Per Share Data (Rs)					
EPS adjusted	34.46	36.93	31.31	30.29	38.78
EPS reported	34.46	36.93	31.31	30.29	38.78
BVPS	273.27	417.64	435.54	452.41	477.30
Tangible BVPS	273.27	417.64	435.54	452.41	477.30
Adjusted BVPS diluted	269.34	412.82	430.51	447.18	471.79
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	62,780	72,824	85,933
Other operating Income	26,321	32,735	26,490	20,685	21,567
Total operating income	**126,000**	**161,829**	**175,394**	**186,990**	**214,437**
Total operating expenses	-66,907	-81,544	-84,846	-89,605	-99,329
Oper. profit bef. provisions	**59,094**	**80,286**	**90,548**	**97,385**	**115,108**
Bad debt provisions	-21,844	-28,423	-42,566	-47,918	-48,738
Non-operating/exceptionals	-770	-1,303	-5,000	-4,000	-4,000
Pre-tax profit	**36,479**	**50,559**	**42,981**	**45,467**	**62,370**
Tax	-5,378	-8,984	-7,737	-11,368	-18,713
Extraord./Min. Int./Pref. Div.	-4	-3	-3	-3	-4
Attributable profit	**31,098**	**41,572**	**35,240**	**34,096**	**43,654**
Adjusted earnings	31,098	41,572	35,240	34,096	43,654
Growth Rates (%)					
EPS adjusted	22.5	7.2	-15.2	-3.2	28.0
Oper. profit bef. prov.	24.6	35.9	12.8	7.6	18.2
Balance Sheet (RsM)					
Total assets	**3,446,580**	**3,997,951**	**3,768,052**	**3,847,512**	**4,112,505**
Avg interest earning assets	2,799,421	3,505,124	3,644,795	3,574,109	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**	**3,768,052**	**3,847,512**	**4,112,505**
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**	**488,115**	**506,884**	**534,587**
Profitability/Solvency Ratios (%)					
ROE adjusted	13.4	11.7	7.4	6.9	8.4
Net interest margin	2.01	2.08	2.36	2.62	2.85
Cost/income ratio	53.1	50.4	48.4	47.9	46.3
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	10.1	10.1	10.1
Total capital ratio	9.8	14.3	12.9	13.0	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: 4Q09 Key Financial Highlights (Rupees Million, Percent)

	4Q09	4Q08	YoY %	3Q09	QoQ%	CIRA Comments
Interest Income	75,297	80,293	-6.2	78,361	-3.9	
Interest Expense	(53,909)	(59,498)	-9.4	(58,457)	-7.8	Further gains ahead, as wholesale deposits
Net Interest Income	21,388	20,795	2.9	19,904	7.5	A positive surprise and ahead of expectations, driven primarily by funding side gains
Fee-Based Income	13,430	19,280	-30.3	13,470	-0.3	Disappointing, and weaker than low expectations - possibly the recent franchise damage, though possibly reduced risk taking too
Treasury	2,140	1,640	30.5	9,760	-78.1	Relatively normal quarter, though substantially more modest than the previous one
Other non-interest income	1,167	2,697	-56.7	1,915	-39.1	
Non Interest Income	16,737	23,617	-29.1	25,145	-33.4	
Operating Income	**38,125**	**44,411**	**-14.2**	**45,050**	**-15.4**	
Employee Expenses	(4,574)	(4,666)	-2.0	(5,030)	-9.1	Keeping a tight leash on costs, in spite of an ongoing distribution expansion
Other Operating Expenses	(11,996)	(16,838)	-28.8	(12,311)	-2.6	Further reduction, though primarily a run off of asset expansion costs
Pre-Provision Profit	21,555	22,907	-5.9	27,708	-22.2	
Charges for Bad Debts	(10,845)	(9,475)	14.5	(10,077)	7.6	Lower than expectations, though underlying deterioration has maintained previous quarters pace, unlike our and possibly the markets expectation
Pre-Tax Profit	10,709	13,432	-20.3	17,631	-39.3	
Tax	(3,272)	(1,933)	69.2	(4,910)	-33.4	Normalized tax break, as more core income than capital gains/dividends driven
Net Profit	**7,438**	**11,498**	**-35.3**	**12,722**	**-41.5**	**12% lower than expectations**
EPS	6.7	10.3	-35.4	11.4	-41.5	
DPS	11.00	11.00	0.0	-	NM	
Customer Loans	2,183,110	2,256,161	-3.2	2,125,210	2.7	Some growth over the quarter, though primarily agri-driven; could expect further deceleration over the year
Customer Deposits	2,183,480	2,444,311	-10.7	2,090,650	4.4	Relatively impressive growth in the last quarter in terms of deposit mix - relatively easy funding environment could well see ICBK make more gains over the near-medium term
AIEA	3,298,204	3,465,833	-4.8	3,350,508	-1.6	
AIBL	3,096,435	3,211,175	-3.6	3,131,925	-1.1	
Total Assets	3,793,010	3,997,951	-5.1	3,744,100	1.3	Off-shore assets also shrink, though largely on account of currency depreciation
Avg Assets	3,768,555	3,882,473	-2.9	3,796,900	-0.7	
Gross Non-Performing Loans (NPL) excluding W/off	96,493	75,795	27.3	89,881	7.4	Deterioration maintains its app 2.5% deterioration pace, which is probably a little better than expectations. Management suggests some sort of peaking in retail deterioration (bulk from that segment in this quarter too), but is now more wary of the corporate assets
Restructured Loans	61,000	48,500	25.8	50,000	22.0	Big but lower than expected jump in restructured assets - though management suggests caution on the domestic book, and potentially the offshore one too
Loan Loss Reserves (LLR)	(50,954)	(40,890)	24.6	(45,879)	11.1	
Shareholders' Funds	495,330	464,702	6.6	494,843	0.1	
Book Value Per Share	444.9	417.9	6.5	444.5	0.1	
Key Ratios (%)	**4Q09**	**4Q08**	**Bps Δ YoY**	**3Q09**	**Bps Δ QoQ**	
ROAA (annualized)	0.79	1.18	-40	1.34	-55	
ROAE (annualized)	6.01	9.90	-389	10.28	-428	
Net Interest Margin (bps)	259	240	19	238	22	Impressive highlight of the quarter - a bump up in margins, with a positive medium term bias (pressure likely in 1QFY10 though)
Fee Inc/Operating Income	35.2	43.4	-819	29.9	533	Disappointment in the quarter, and potentially a structural pressure point
Other Non-Interest Inc/Op Inc	43.9	53.2	-928	55.8	-1192	
Op. Cost/ Operating Income	43.5	48.4	-496	38.5	497	Management has made meaningful gains on costs - and will at some stage provide earnings leverage, whenever growth comes back
Loan-to-Deposit Ratio (LDR)	100.0	92.3	768	101.7	-167	
NPL/Loan Ratio	4.4	3.4	106	4.2	19	Better than expected, but risks still out there
LLR/NPL Ratio	53	54	-114	51	176	

Source: Citi Investment Research and Analysis

Strategic Direction – Finally?

Some Action, Some Words

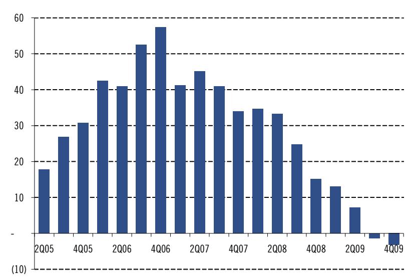
ICBK has been simultaneously loved and hated for its aggressive growth, market share and 'expansionary but returns later' strategy over the years; and this has intermittently given its shareholders high returns, and cost them dear (in the past, and most recently). There has also always been a contra view (much espoused by the analyst community, and yours truly), that a more sedate and balanced growth/return (and more modest risk) approach would provide sustainable, higher returns (and lesser volatility, apart from misgivings) for investors.

So, what's changing, and what's the strategy?

We believe the most important is the fact that the bulk of ICBK's actions (with some results in 4Q09), actually speak louder than managements words (which were a little understated, relative to what we were expecting). That is to say, on key strategic thrusts, ICBK has actually made strides – and it does not appear to be over-committing itself to what it will do, or its ability to manage or control its books and returns. Here are the specifics, as we interpret them:

1. **Do not grow the loan book, and start doing so only when it can fund it off a stable and modest cost deposit base**

Figure 2. ICBK – Loan Growth (%)

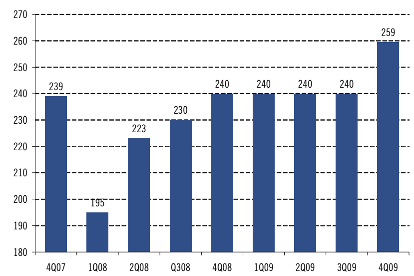


Source: Company Reports

ICBK's loan book has contracted over the year (though grown a bit over the quarter – driven by agricultural loans). Management seeks to specifically de-grow the retail portfolio – the share is down already, and could well see a meaningful drop over the current year.

Management has set for itself a specific 33% CASA deposit ratio as benchmark before it expects to target net growth (currently at 28%), and this appears to rule out growth at least for a year. While it has stated it would 'position itself for the next phase of growth', which could be construed as a license to change its benchmark when the market turns, we believe it only appropriate that ICBK does not close out the option of growth for itself, which we would argue is the other end of conservatism, and could prove to be misguided. While management did not spell out any other specific benchmark/hurdles/criterion before it grew, it did not seem to be positioning itself for a quick or early reversal (toward higher growth).

Figure 3. Net Interest Margins (bps)



Source: Company Reports

2. Profitability on the back of margins, costs, while continuing to roll out on distribution

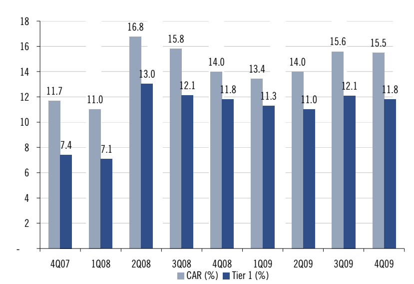
The 4th Quarter's surprise was on margins, which moved up 20bps qoq, were ahead of expectations, and reflected the benefits of lower growth and an improving deposit mix (meaningful improvement in incremental deposit mix in quarter). We also believe management outlook on margins – albeit cautious over the immediate quarter due to specific portfolio composition issues, were unabashedly confident (and for the right reasons).

More fundamentally, we believe the ongoing distribution rollout should provide significant improvement in funding costs – ICBK has doubled its distribution in the current year because of an acquisition (some of the benefits are already in), and more important, will add another 500+ branches (40% expansion) in the current year. This could be material, particularly if ICBK keeps loan growth negative to low.

In addition, ICBK is seeking to keep operating costs flat despite its distribution expansion - it has done well on costs in the last year, and if it sticks to its targets, this should provide significant support to the core profitability.

3. Conserve Capital – It's ICBK's cushion, and there appear to be no meaningful investments in the pipeline

Figure 4. Capital Adequacy Ratios (%)



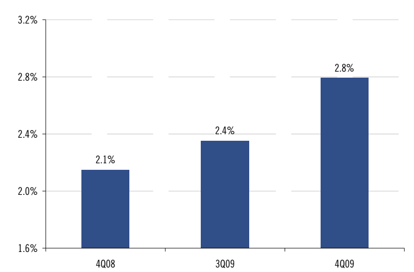
Source: Company Reports

ICBK's capital profligacy over previous cycles has probably been among its most indefensible strategic thrusts. The quarter itself brings some cheer with a capital adequacy jump to 15%+ (on account of shift to Basel 2, and limited growth). While ICBK has invested more in its international businesses, its insurance requirements have eased, and management appears to have spelt out a meaningful dearness for capital.

With the Insurance business likely to grow slower, capital commitments should be meaningfully lower. We would argue ICBk's capital adequacy over the year should actually scale up, bar any accidents it has to cover for, over the year. While we do believe the next real test will come when/if the markets are stronger and capital is available easily and at higher valuations - will ICBK be able to stay away from capital raising then? Management's current intent on capital caution did appear to extend beyond the immediate term.

4. Asset quality – Exposed to the environment, but not worsening, and the balance-sheet pulling back some of the skew

Figure 5. Restructuring – As % of Loan Book



Source: Citi Investment Research and Analysis

While we believe ICBK's existing book is meaningfully exposed to the environment – and while it's a little late in the day to correct past mistakes, management does appear to be balancing the portfolio better, by moderating a) the riskiest asset classes, b) the skew toward retail assets, and c) credit lines across a slew of retail borrowers. Management has also reiterated robustness in mortgage and auto segments – but not much growth (even though the market seems to be showing signs of reasonable growth), suggests ICBK is not again at the outer edge of growth.

Does this mean the worst is over? No, though we would argue that between management and market feedback, the retail asset portfolio has probably hit the peak on asset pressures. The corporate credit portfolio remains vulnerable – ICBK has witnessed restructurings 1.5% of portfolio (3% of corporate loans), and also suggests a cautious outlook. We would, however, believe ICBK's risk on this portfolio is more in-line with the broader banking sector (unlike its consumer book, where it was meaningfully greater), and its portfolio smaller, for it to cause disproportionate damage.

We remain cautious on asset quality, as does management - more so than in the past (more realistic now), but do not believe the balance sheet is staring into an abyss.

5. Management revamp – Could it change the way things are done?

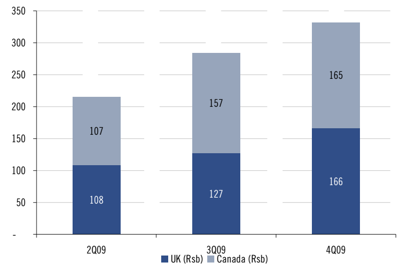
There has been a fairly sweeping change in the entire top management team across the ICBK group – and while all the new leaders are from within the group, we do believe the current time provides the opportunity to make more of a break from the past. Still early to call, but timing, environment and new faces do provide the opportunity to ICBK to change.

Where are the strategy Gaps?

While we view the overall strategic direction fairly positively, we believe there remain some strategic and balance sheet issues that remain questionable in the objectives, and the risks they pose to operating business, and value. These are:

1. Scale and objective of the international business

Figure 6. UK and Canada Loan Books (Rsb)



Source: Company Reports

ICBK's international business continues to account for 25% of the loan book, and at aggregate it continues to grow. We believe: a) This is too large (10-15% would be appropriate) to be profitable (we don't believe these businesses can sustainably generate even 1% NIMs without taking disproportionate risk); b) They are too diversified and distant (and sub-scale in their local markets) to be adequately risk managed; and most important, c) We don't see any franchise or add-on value, at that size of the business. Bottom line, beyond 10-15% of the loan book, it is an injudicious use of capital, through a full cycle.

We are particularly chary of the subsidiary business ICBK runs in the UK and Canada (in its current scale), where ICBK is using high-cost deposits (relative to local peers) to fund local and some Indian businesses. Here too, we do not see the sustainability or scalability (beyond a point, which we think ICBK has passed) of these operations. While we do believe it provides FX liquidity (which ICBK is currently in need off and so raising aggressively) to ICBK; the value of this business relative to the risks it carries (rather sharply highlighted in the recent credit turmoil) remains very questionable.

Yet ICBK does not seem particularly focused on unwinding parts of these businesses, and we think it remains a strategic strain

2. Liquidity gaps and Asset quality exposure

ICBK is about $1b short on FX liquidity over the current year on its international borrowings (so far its has met all requirements, without resorting to the back-stop facility available with the RBI), and its outstanding bonds in the international credit markets continue to trade at large spreads relative to other Indian paper (in part because there is so much ICBK paper in the market). While ICBK is tactically managing these payments, we have not seen enough fundamental changes in its stance on addressing this issue, and this could be an ongoing source of strain (particularly if markets weaken). While

ICBK could well be waiting for a more appropriate timing, we have not seen any long-term view of this issue.

ICBK also remains fairly vulnerable to restructurings/pressures on its asset book – on its domestic credit portfolio, its credit-linked notes to domestic credits, its loans to domestic businesses from its international subsidiaries. This is particularly so because the disclosures are inconsistent, accounting varied across jurisdictions and legal entities – and we believe ICBK's asset concentration could be higher, and cushion against an economic turn lower, than peers. We are not aware of ICBK having made any overt moves to de-risk some of these positions (though it is probably difficult in the current market environment), but we do believe ICBK is to some extent playing a waiting and hoping game, rather than in at least some cases, cutting or consolidating its losses. While we make this above point without any meaningful data backing or portfolio insights, management's suggestions that there could be some restructurings in its offshore book too seems to validate local market concerns that concentration levels for ICBK could well be higher than what the plain vanilla domestic portfolio analysis would suggest.

3. Could the strategy change if the market changes

Is the current strategy a reflection of environmental pressures rather than conviction, and could ICBK return to its high growth and low return model (and ultimately fairly modest stockholder return), if and when the economy reverts to high gear? We will need to wait for that, but we would give the benefit of doubt to the management, that they will stick to their current strategy of lowering risks, and raising returns, to a much more acceptable and meaningfully higher level from here.

Overall, more upside than downside

We would see more upside than downside for ICBK from here – on the stock, and on the outlook, even though we do see more asset pressures ahead (though probably a little less than expectations), and overall profitability remaining at moderate levels before they are in a position to operationally bounce-back.

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; (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 Rs489 (previously 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 use a risk-free rate of 6% (previously 8.5%); a long-term loan loss ratio of 160bps and a beta of 1.35. In addition, we factor in Rs120 as the value of its subsidiaries: life insurance at Rs82/share, general insurance at Rs7/share, AMC at Rs10/share, ICICI Securities at Rs3/share, primary dealer at Rs11/share and venture fund at Rs7/share. The subsidiaries are valued based on industry benchmarks. As a reference, our sum-of-the-parts methodology gives a fair value of Rs489. We value ICICI Bank's domestic banking business on 1.1x one-year forward PBV and international business at 0.8x, based on the risk profile of these businesses. This translates into 1.0x 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.

Risks

Our risk rating is High based on the increased business risk that ICBK faces on the international front and 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

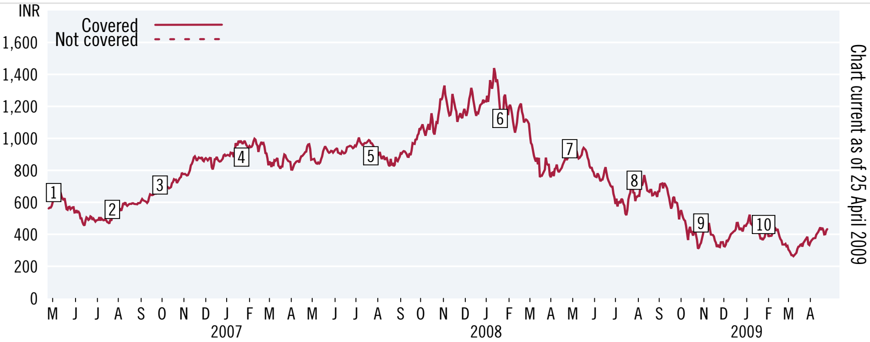
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst 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	2-May-06	*1L	*700.00	621.95
2	24-Jul-06	1L	*650.00	514.90
3	28-Sep-06	1L	*795.00	708.40
4	22-Jan-07	1L	*1,125.00	977.20
5	22-Jul-07	1L	*1,235.00	985.15
6	21-Jan-08	1L	*1,510.00	1,173.20
7	28-Apr-08	1L	*1,185.00	894.95
8	27-Jul-08	1L	*820.00	656.85
9	29-Oct-08	*1H	*554.00	345.75
10	25-Jan-09	1H	*489.00	364.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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