

## Company Flash

18 March 2008 | 7 pages

# ICICI Bank (ICBK.BO)

## ICICI- Prudential Life; Margin Disconnect

- JV partner reports a lower profit margin for India business** — ICICI's JV venture partner in its Life insurance business, Prudential (PRU.L), in its financial release, reported that ICICI-Pru generated a New Business Achieved Profit (NBAP) margin of 12% in 2007; this sharply contrasts ICICI-Pru's declared margins of about 19%. Prudential suggests ICICI-Pru's margins have almost halved over the year (from 23% in 2006), and that NBP growth was -13% in 2007. Prudential's Indian biz margins, incidentally, are its lowest in Asia.
- Expense accounting the apparent reason** — ICICI-Pru's management and Prudential's release suggest Prudential has changed its accounting of expenses – effectively attributing a larger share of expenses to current years business (rather than spreading a larger share over future business), hurting current profitability. With ICICI-Pru formally reiterating its 19% margins, which one is the right one? We think the disconnect is probably some reflection of differences between the partners on longer-term growth and distribution leverage expectations. A conservative margin probably lies somewhere in between, but that possibly suggests at least a small step down from ICICI-Pru's current margin levels.
- Bigger question - how accurate, predictable and transparent are margin releases and estimates** — ICICI-Pru is the only Indian Insurance company that has formally and consistently released its NBP margin; the current disconnect notwithstanding, this measure is relatively opaque, potentially volatile and hard to predict (companies included). This is particularly so in India, where the industry is new, growth high, disclosures moderate and competition high. In effect, this is probably the first of a few surprises to come in the Indian Life insurance space. We have sought to detail some of these issues, and margin components, in our report "The Equity of Indian Life: What It Means for a Few". <https://www.citigroupgeo.com/pdf/SAP10070.pdf>
- Will hurt value, though growth and investment returns are also meaningful margin drivers** — We estimate a 1% drop in margins will hurt value by 5%. If we take margins at 12% instead of 19%, impact can be significant. However margins are also significantly influenced by growth (+/-5% impacts value 17%), and investment returns. We maintain our Rs246per share value of Life business for ICICI-Pru. Expense pressures and investment returns are sources of downside risk, while higher than expected growth rates provide some upside risk. We also detail value sensitivities in this note.

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

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<sup>1</sup>Citigroup Global Markets India Private Limited

<b>Buy/Low Risk</b>	<b>1L</b>
Price (17 Mar 08)	Rs754.10
Target price	Rs1,510.00
Expected share price return	100.2%
Expected dividend yield	1.4%
<b>Expected total return</b>	<b>101.6%</b>
Market Cap	Rs839,023M
	US\$20,740M

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



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**Figure 1. ICICI Prudential Life Insurance Valuation Range**

	<b>Bull case</b>		<b>Base Case</b>	<b>Bear Case</b>	
Growth - 5 yr CAGR	47	42	37	32	27
Margins	21.2	20.2	19.2	18.2	17.2
Value to firm	553320	457233	376127	298532	243571
NBAP Multiple - Derived	21.4	19.4	18.1	16.3	15.2
Value USD m	13833	11431	9403	7463	6089
Change in value	47%	22%	0%	-21%	-35%

Source: Citi Investment Research estimates

**Figure 2. Sensitivity on Each of the Value Components (Rs Million, %)**

<b>Sensitivity</b>	<b>Bull Case</b>		<b>Base case</b>	<b>Bear Case</b>	
<b>Growth Sensitivity -5 yr CAGR</b>	<b>47</b>	<b>42</b>	<b>37</b>	<b>32</b>	<b>27</b>
Value	504155	436190	376127	313168	268153
Change	34	16	0	-17	-29
<b>Terminal Growth Sensitivity</b>	<b>6</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>
Value	416548	394317	376127	360969	348143
Change	11	5	0	-4	-7
<b>Margin sensitivity</b>	<b>21.2</b>	<b>20.2</b>	<b>19.2</b>	<b>18.2</b>	<b>17.2</b>
Value	411956	394041	376127	358212	340298
Change	10	5	0	-5	-10
<b>Cost of capital</b>	<b>13</b>	<b>14</b>	<b>15</b>	<b>16</b>	<b>17</b>
Value	462426	414805	376127	344138	317280
Change	23	10	0	-9	-16

Source: Citi Investment Research estimates

**Figure 3. ICICI Pru Financial Highlights (Rs million, FY05-07)**

<b>Key Financials</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07</b>
Total premium (Rs Mn)	23638	42610	79130
First year premium (Rs Mn)	15843	26025	51621
Growth in New premium (%)	111%	64%	98%
Single premium of New premium (%)	9%	12%	15%
Group Premium of New premium (%)	7%	11%	17%
Annualised premium equivalent (APE)	16127	23244	44498
Growth in APE (%)	129%	44%	91%
Persistency ratio (%)	90	74	70
Commission Ratio (%)	7.5	6.7	6.6
Expenses incl comm of Total premium (%)	27	24	26
Expenses ex commission of Total Premium (%)	20	17	19
Surrenders of lagged AUM (%)		4%	7%
ULIP of total Premium (%)	86.5	89.9	90.2
AUM (Rs Mn)	37796	88210	158180
Equity Exposure		52%	60%
Total assets (net of losses)	37,394	86,157	156,909

Source: Company reports, Citi Investment Research

## 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/Low Risk (1L) rating is premised on: (1) ICBK's broad exposure to the strong momentum in the Indian economy, and its strong market position in the Indian market; (2) a broad asset mix, which should reduce the risk and profitability strain from concentration; (3) the growing value of its subsidiary businesses; (4) the bank, in our view, offers one of the best exposures to the consumer finance and financial services opportunity in India, and has been at the forefront of building market leadership in most products; and (5) its strong and deep management team. ICICI Bank also offers large exposure to the corporate lending and capex cycle, which should be viewed against the economy's bright prospects.

### Valuation

Our target price of Rs1,510 is based on our EVA model. Our target price incorporates Rs386 for its securities unit ; b) risk free rate – we factor in 7.75%. Our EVA methodology is a standard valuation measure for our India banking universe. Our target price is premised on the following: (1) a risk-free rate of 7.75%; (2) a long-term loan loss of 100bps; and (3) subsidiary value of Rs386 per share.

We also use the sum of parts methodology, benchmarking valuations to individual businesses. On our sum-of-the-parts methodology, our fair value for ICICI Bank is Rs1,383. We value ICICI Bank's banking business on a 2.25x FY09E PBV, reflecting the leverage potential of the business as also peer company valuations, but also factor in the ROE, which is currently below its cost of capital. In addition, we are factoring in Rs386 as the value of its subsidiaries – specifically, these are; Life insurance Business at Rs246 per share (18X FY09E NBAP), General Insurance at Rs40per share (20X FY09E PE), AMC at Rs27 per Share (8% of AUM), ICICI securities at Rs55 per Share (20X FY09E), Venture Fund at Rs21per share (15% of FY09E AUM).

We prefer to use EVA as our primary methodology as we believe it better adjusts for the relatively dynamic cost of capital and better captures the long-term value of the business.

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Our risk rating is Low based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. The 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, and (5) inability to leverage capital, which keeps ROEs low.

# Appendix A-1

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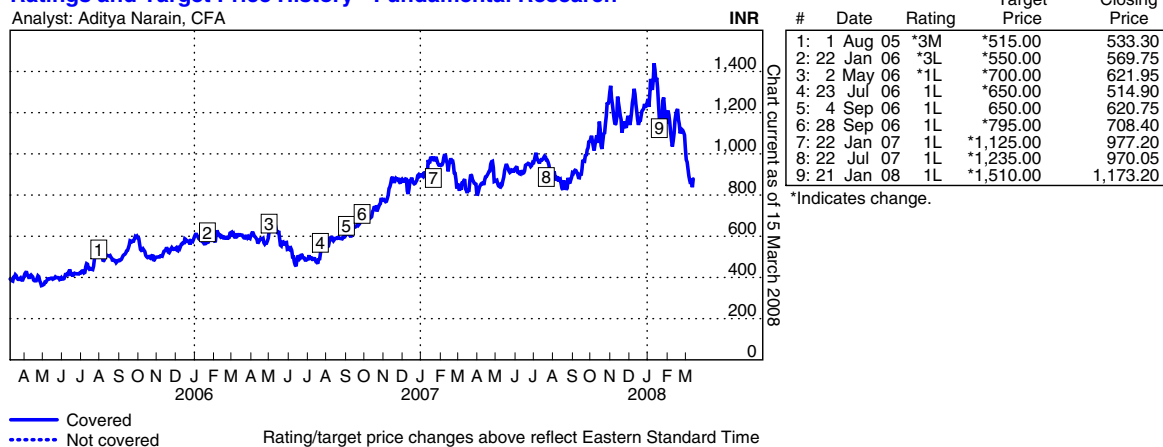
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Analyst: Aditya Narain, CFA



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