Company Results Review

19 October 2006 | 9 pages

Kotak Mahindra Bank (KTKM.BO)

2Q07 Results: The Bank's Ok, Brokerage Is Not

- **Up 12% yoy, down 11%qoq, and 6% lower than our expectations** — KTKM has expectedly had a relatively modest quarter; the performance, however, is a little weaker than expectations. The brokerage is where the pain is; the bank's doing fine and has made up a lot of the slack. We see near-term earnings keenly sensitive to the capital markets –with earnings risks to the downside.
- **Securities pain; market volumes, but also possibly some market share** — Kotak's broking volumes have suffered with the market (down 30% qoq) – but an adverse business mix change (in-line with market), some market share losses, and inherent leverage, have impaired profitability. Management sees recent pickup – but the pressures could well sustain.
- **Per management, Goldman buyout not hurting institutional** — Management categorical business is holding, client base has widened, alternative product arrangements in place, and Kotak's market positioning better defined. Remains early to judge- a weaker market (Volume and Value), probably the judge.
- **Bank's doing fine - profitability, growth - but not ahead of expectations** — Banking rollout continues as expected – balance sheet growth is 45-50%, loan mix is broadening, deposit mix improving, and profitability sustaining. The wealth management thrust – asset management, product creation, and geography, also continues. Generally impressive, but not spectacular.
- **More aggression ahead?** — Management suggests more aggression– branches, products, distressed assets, capital markets investments. This currently shows in costs; if executed well, could provide the revenue and scale upsides.

Hold/Medium Risk	2M
Price (19 Oct 06)	Rs339.85
Target price	Rs355.00
Expected share price return	4.5%
Expected dividend yield	0.2%
Expected total return	4.7%
Market Cap	Rs110,642M US$2,442M

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

Figure 1. Statistical Abstract

Year to March	Net Profit (Rs Mils.)	FD EPS (Rs)	EPS Growth (%)	P/E (X)	P/BV (X)	ROAE (%)	ROAA (%)	Div Yld (%)
FY05	1709.1	5.6	-4%	60.4	7.1	12.7	1.8	0.1
FY06	7297.5	23.6	319%	14.4	4.7	23.4	3.6	0.2
FY07E	4173.2	13.1	-44%	25.9	3.6	15.6	2.1	0.2
FY08E	5212.7	16.0	22%	21.2	3.1	15.6	2.1	0.3
FY09E	6921.2	21.3	33%	16.0	2.6	17.7	2.2	0.3

Source: Company Reports and Citigroup Investment Research

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E (x)	60.4	14.4	25.9	21.2	16.0
P/E - reported (x)	60.4	14.4	25.9	21.2	16.0
P/BV (x)	2.9	4.7	3.6	3.1	2.6
P/Adjusted BV (x)	2.9	4.7	3.6	3.1	2.6
Dividend yield (%)	0.1	0.2	0.2	0.3	0.3
Per Share Data (Rs)					
EPS (adjusted)	5.62	23.56	13.13	16.03	21.28
EPS (reported)	5.62	23.56	13.13	16.03	21.28
BVPS	118.94	72.65	95.59	110.70	130.94
Tangible BVPS	118.94	72.65	95.59	110.70	130.94
Adjusted BVPS	47.43	72.43	95.31	110.37	130.56
DPS	0.50	0.60	0.70	0.88	1.00
Profit & Loss (RsM)					
Net interest income	4,475	6,649	8,244	10,245	12,850
Fees and commissions	3,910	8,347	9,953	11,760	13,846
Other operating Income	1,745	4,672	2,712	3,852	5,116
Total operating income	**10,130**	**19,669**	**20,908**	**25,857**	**31,812**
Total operating expenses	-6,856	-11,728	-13,442	-16,441	-20,326
Oper. profit bef. provisions	**3,274**	**7,941**	**7,466**	**9,416**	**11,486**
Bad debt provisions	-178	-512	-1,137	-1,560	-1,081
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**3,096**	**7,428**	**6,329**	**7,856**	**10,404**
Tax	-1,157	-2,130	-2,234	-2,631	-3,405
Extraord./Min. Int./Pref. Div.	-230	1,999	78	-13	-78
Attributable profit	**1,709**	**7,297**	**4,173**	**5,213**	**6,921**
Reported net income	**1,709**	**7,297**	**4,173**	**5,213**	**6,921**
Adjusted earnings	1,709	7,297	4,173	5,213	6,921
Growth Rates (%)					
EPS (adjusted)	-3.9	318.9	-44.3	22.0	32.8
Oper. profit bef. prov.	-3.9	142.5	-6.0	26.1	22.0
Balance Sheet (RsM)					
Total assets	**114,455**	**179,673**	**212,115**	**279,719**	**361,787**
Avg Interest earning assets	98,588	134,321	180,988	232,270	300,368
Customer loans	71,772	104,847	142,882	184,005	219,849
Gross NPLs	372	651	1,038	1,593	2,168
Liab. & shar. funds	**114,455**	**179,673**	**212,115**	**279,719**	**361,787**
Total customer deposits	38,326	56,167	91,701	131,229	165,582
Reserve for loan losses	325	648	1,354	2,404	2,850
Shareholders' equity	14,668	22,471	31,000	35,898	42,463
Profitability/Solvency Ratios (%)					
ROE adjusted	12.7	39.3	15.6	15.6	17.7
Net interest margin	4.5	5.0	4.6	4.4	4.3
Cost/income ratio	67.7	59.6	64.3	63.6	63.9
Cash cost/average assets	6.5	8.0	6.9	6.7	6.3
NPLs/customer loans	0.5	0.6	0.7	0.9	1.0
Reserve for loan losses/NPLs	87.5	99.6	130.5	150.9	131.5
Bad debt prov./avg. cust. loans	0.3	0.6	0.9	1.0	0.5
Loans/deposit ratio	187.3	186.7	155.8	140.2	132.8
Tier 1 capital ratio	11.0	8.2	9.2	7.6	7.3
Total capital ratio	14.2	12.7	12.7	10.4	9.4

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Figure 2. Statistical Abstract (Rupees Million)

	2Q07	2Q06	YoY %	1Q07	QoQ%	Citigroup Investment Research Comments
Interest Income	4,337	2,829	53.3	3,976	9.1	
Interest Expense	(2,137)	(1,196)	78.7	-1,876	13.9	
Net Interest Income	2,200	1,633	34.8	2,100	4.8	Relatively strong performance; holds margins in a competitive quarter with some support from new capital
Fee-Based Income	1,926	1,914	0.7	2,478	-22.2	Securities businesses take an expected hit - though yield and profitability impact a little ahead of expectations. Yield erosion a market phenomenon - market share erosion a disappointment. Boosted by trading gains in the fixed income market
Insurance Premium	1,616	756	113.7	1,214	33.2	Very robust insurance growth - a distinct pickup in the current year
Other Non-Interest Income	1,155	700	64.9	98	1075.0	
Non Interest Income	4,698	3,370	39.4	3,790	24.0	
Operating Income	6,898	5,003	37.9	5,890	17.1	
Operating Expenses	(5,357)	(3,254)	64.7	(3,910)	37.0	More aggressive branch and business buildout under way; large and ahead of expectation cost pressures - management expects investment returns 12-24 months
Pre-Provision Profit	1,541	1,749	-11.9	1,980	-22.2	
Charges for Bad Debts	(207)	(237)	-12.4	(228)	-9.0	Asset quality remains comfortable; management suggests asset environment continues to hold and no meaningful signs of any pressure
Operating Profit	1,333	1,513	-11.8	1,752	-23.9	Capital markets weakness primary driver of weakness
Pre-Tax Profit	1,333	1,513	-11.8	1,752	-23.9	
Tax	(484)	(541)	-10.4	(628)	-22.9	
Minorities	90	(138)	NM	(80)	NM	
Extraordinary Items		0	NM		NM	
Net Profit	**939**	**834**	**12.7**	**1,044**	**-10.1**	**Expectedly weak, but about 6% lower than our expectations**
EPS	2.86	2.70	6.0	3.22	-11.3	
Customer Loans	120,671	81,333	48.4	106,526	13.3	Build out remains relatively robust - management suggests there remains more than adequate asset demand in the market space
Customer Deposits	68,756	49,315	39.4	59,307	15.9	Steady growth - which management hopes to more than sustain, through relatively aggressive branch roll out; overall, deposit growth has been at best in line with expectations, rather than being ahead of it.
AIEA	170,145	113,228	50.3	158,598	7.3	
AIBL	125,835	88,506	42.2	116,306	8.2	
Total Assets	181,693	123,000	47.7	165,000	10.1	
Avg Assets	173,347	123,000	40.9	701,339	-75.3	
Non-Performing Loans (NPL)	800	594	34.7	662	20.8	Asset quality remains in check in spite of a greater unsecured - consumer and mid market exposure. Management suggests they have yet to generate gains from the stressed assets market, where they have sizeable investments.
Loan Loss Reserves (LLR)	(550)	(426)	29.1	(387)	42.1	
Shareholders' Funds	29,097	15,981	82.1	28,158	3.3	
Book Value Per Share	90	52	73.6	87	3.3	
Key Ratios (%)	2Q07	2Q06	Bps Δ YoY	1Q07	Bps Δ QoQ	Citigroup Investment Research Comments
ROAA (annualized)	2.07	2.71	-64	2.53	-46	
ROAE (annualized)	12.91	20.86	-795	14.84	-193	
Net Interest Margin (bps)	517	577	-60	530	-12	Remain relatively comfortable, and management suggests the asset market is improving from an asset pricing perspective, and offers upsides
Fee Inc/Operating Income	27.9	38.3	-1033	42.1	-1414	Weak capital market revenues very much in evidence
Other Non-Interest Inc/Op Inc	16.7	14.0	275	1.7	1507	
Op. Cost/ Operating Income	77.7	65.0	1263	66.4	1128	Cost and revenue driven - leverage to revenues increases much more markedly
Loan-to-Deposit Ratio (LDR)	175.5	164.9	1058	179.6	-411	
NPL/Loan Ratio	0.7	0.7	-7	0.6	4	Excludes stressed asset portfolio that has been aggressively built up
LLR/NPL Ratio	69	72	-297	58	1,029	

Source: Company Reports and Citigroup Investment Research estimates

Figure 3. Kotak Mahindra Bank –Key Business Segments

	2Q07	2Q06	YoY %	1Q07	QoQ%	Citigroup Investment Research Comments
Consolidated Revenue Mix						
Financing Activities	3,404	2,372	43.5	3,043	11.8	Average and expected performance
Core Fee income	1,914	2,043	-6.3	2,465	-22.3	Weak, and below par, in the quarter
Premium on Insurance	1,617	756	113.7	1,214	33.2	Ahead of expectations
Treasury	1,884	865	117.9	725	159.9	Strong performance; key support for profitability that has been under strain
Others	217	164	32.2	319	-32.1	
	9,035	6,199	45.7	7,766	16.3	
Kotak Mahindra Bank - standalone						
Operating profit before branch banking losses	607	498	21.9	399	52.0	Relatively positive performance; underlying yoy performance stronger than stated numbers, given accounting change
Branch banking losses	(94)	(25)	282.0	(28)	241.8	Accelerated branch roll out could likely see branch cost pressures being pushed out further
PBT	513	473	8.3	372	38.0	
PAT	348	312	11.6	239	45.5	
Kotak Mahindra Capital Company						
PBT - PD business	98	17	488.0	85	15.5	Strong show - after a weak year; meaningful profit support
PBT - Franchise business	107	98	9.3	86	24.1	Relatively stable show; management suggests a meaningful pipeline ahead
Total PBT	205	115	78.7	171	19.9	
Total PAT	154	82	89.2	130	19.1	
Kotak Securities						
Average Daily volumes	26,300	23,000	14.3	40,400	-34.9	Volumes largely reflect the market - but with a gap; market share pressures
AUM - PMS	23,400	25,600	-8.6	20,900	12.0	
Total Income	1,479	1,517	-2.5	2,141	-30.9	Revenue drop a little ahead of our expectations
PAT	314	521	-39.7	688	-54.3	High operating leverage of the broking business on view
Kotak Mahindra Primus						
Total income	957	706	35.5	962	-0.5	Accounting shift - car finance remains relatively low on profitability - recent asset pricing push not in evidence yet
PBT before royalty	158	138	14.4	163	-3.1	
PAT	109	14	674.5	112	-2.2	
OM Kotak Mahindra Life Insurance						
Premium income	1,679	777	116.1	1,237	35.7	Aggressive growth in the quarter
PAT	(169)	(149)	13.3	(138)	22.9	
Kotak Mahindra Asset Management						
AUM	117000	82200	42.3	110100	6.3	
Total Income	136.2	101.7	33.9	136.2	0.0	
PAT	34.5	26.8	28.7	21	64.3	Some profitability showing

Source: Company Reports and Citigroup Investment Research Estimates.

Kotak Mahindra Bank

Company Description

Kotak is a private-sector bank in which Mr. Uday Kotak, the promoter, and his associates have a 60% 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 top management team, which 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 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. Based on our EVA valuation, we value Kotak at Rs355.

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 Rs324. This is benchmarked off one-year forward estimates. We benchmark our target multiple off our EVA valuation of Rs355. This is our preferred methodology, given that we think it better captures the value of fee incomes.

Risks

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, 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.

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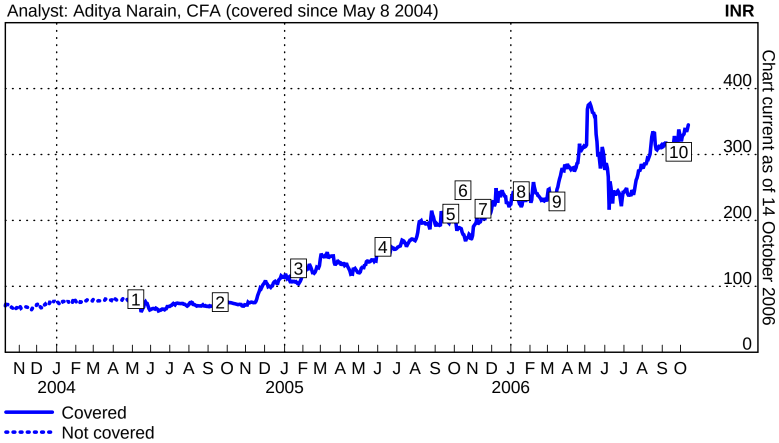
Kotak Mahindra Bank Ltd (KTKM.BO)

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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Data current as of 30 September 2006	Buy	Hold	Sell
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% of companies in each rating category that are investment banking clients	52%	65%	38%

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