Deutsche Bank

12 September 2007

YES Bank

Reuters: **YESB.BO** Bloomberg: **YES IN** Exchange: **BSE** Ticker: **YESB**

Expectations running too high; initiate with a Sell

Suresh Ganapathy
Research Associate
(91) 22 6658 4211
suresh.ganapathy@db.com

Dipankar Choudhury
Research Analyst
(91) 22 6658 4212
dipankar.choudhury@db.com

Krista Yue, CFA
Research Analyst
(852) 2203 6251
krista.yue@db.com

Too much to pay for this franchise
We initiate on YES Bank with Sell and a TP of INR155 implying 17% downside. Our strong non-consensus stand – the only Sell on the street – is based on our concerns about margin volatility, an inadequate deposit network and doubts about the effective rollout of the retail business. On franchise value too, the bank is the most expensive amongst peers; indeed, it is the most expensive in the DB Indian banks universe. Consensus appears to be inappropriately emphasising growth to the exclusion of these issues.

Volatility in margins to persist due to pressure on resource mobilisation
We believe that the targeted 80%+ loan growth will face a stiff bottleneck in inability of low-cost deposits (CASA) to keep pace and will necessitate regular recourse to wholesale deposits, keeping NIMs volatile. A loan-to-deposit ratio as high as ~73% does not leave much room for maneuvering margins. The low-cost mix trend has been inconsistent and even the arguably aggressive branch expansion assumptions result in CASA reaching just 12.4% by FY10E from 6.6% in Jun-07, as against 20-30% for the comparable peer banks today.

Launch of mass affluent retail unlikely to be a major value driver
We demonstrate that the bank's retail banking business does not bolster overall profitability on a risk-adjusted basis due to increased competition in wealth management, high funding cost, higher loss rates and higher regulatory capital. Hence the likely jump in margins due to retail asset yields being higher than corporate assets should not be viewed as an increase in profitability. Moreover, retail is being launched at a time when the sector itself is slowing down rapidly. Rising NPLs – an inevitable consequence of exposure to this segment – may appear starker for YES Bank as it is currently a zero-NPL bank.

TP at INR155; faster low-cost deposit mobilisation the key risk
Our TP of INR155 is based on a two-stage Gordon growth model, which results in a baseline value of INR123 and a 'deal premium' of 27% as a proxy for the franchise value over and above the business (pg 14). This is despite a fairly generous normalized RoE assumption of 18.2%. Key risks: i) Greater-than-expected scale-up of CASA deposits and ii) faster-than-targeted branch openings.

Forecasts and ratios

Year End Mar 31	2006A	2007A	**2008E**	2009E	2010E
EPS (INR)	2.20	3.46	**5.29**	7.97	11.33
EPS growth (%)	–	57.5	**52.9**	50.6	42.2
PER (x)	32.9	31.6	**34.8**	23.1	16.2
Price/book (x)	4.73	5.01	**4.31**	2.91	2.14
ROE (%)	14.1	13.9	**14.7**	14.7	14.9

Source: Deutsche Bank estimates, company data

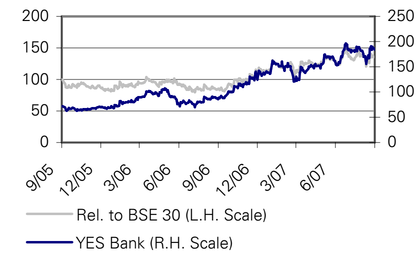
[1]) DB EPS is fully diluted and excludes non-recurring items 2) Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Initiation of Coverage

Sell

Price at 11 Sep 2007 (INR)	**183.95**
Price target - 12mth (INR)	**155.00**
52-week range (INR)	**196.40 - 87.90**
BSE 30	**15,597**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*1.1*	*14.0*	*114.3*
BSE 30	*4.9*	*10.7*	*35.0*

Stock data

Market cap (INRm)	**55,111**
Market cap (USDm)	**1,356**
Shares outstanding (m)	**286.5**
Major shareholders	**Founders (35%)**
Free float (%)	**33**

Key indicators (FY1)

ROE (%)	**14.7**
Loan/deposit ratio (%)	**72.5**
Book value/share (INR)	**42.67**
Price/book (x)	**4.3**
NPL/total loans (%)	**0.0**
Net int margin (%)	**2.42**

DB vs. consensus (INR, FY08E)

	EPS	TP	
Mean	6.20	218	
DB	5.11	155	
	BUY	SELL	HOLD
No. of ratings (ex-DB)	5	0	1

Source: Bloomberg, DB

Related recent research	Date
Indian Banks - What to do amid political turbulence	30 Aug 2007
Preference shares for banks	22 Aug 2007
Indian Banks - Smell the Coffee	16 Apr 2007

Model updated:11 September 2007

Running the Numbers

Asia Pacific

India

Diversified Banks

YES Bank

Reuters Code	YESB.BO

Sell

Price as of 10 September	INR 185.95
Price Target	INR 155.00

Web Site
http://www.yesbank.co.in

Company Description

Yes Bank is amongst India's new age private sector bank promoted by Rana Kapoor and Ashok Kapur with financial assistance of Rabobank. The promoters hold around 36% stake with Rabobank holding around 20% stake in the bank. It is the only bank to be granted Greenfield banking license in the last 10 years. The bank holds exposure to varied service lines including corporate and institutional banking, financial markets, investment banking, business and transactional banking, retail and private banking business lines. The bank completed its US$75mn IPO in July 2005.

Research Team

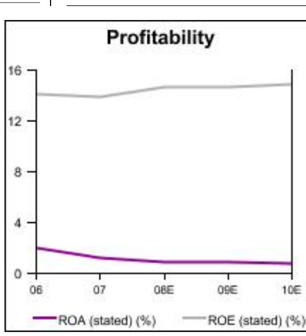
Suresh Ganapathy
+91-22-66584211 suresh.ganapathy@db.com

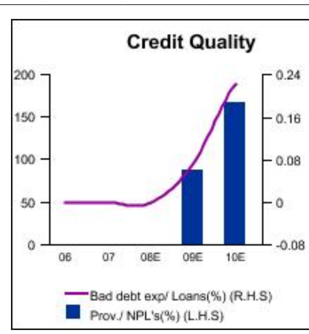
Dipankar Choudhury
+91-22-6658 4212 dipankar.choudhury@db.com

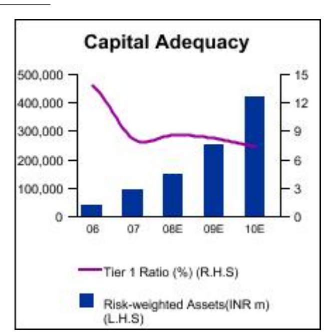
Absolute Price Return	1m	3m	12m
	2.2%	17.6%	111.9%
52-week Range			INR 87.90 - 196.40
Market Cap			INR 55,711 m
			USD 1,371 m

Company Identifiers	
Bloomberg	YES IN
Cusip	–
SEDOL	B06LL92

Y/E 31 March	2006	2007	2008E	2009E	2010E
Data Per Share					
EPS (stated) (INR)	2.20	3.46	5.29	7.97	11.33
EPS FD (stated) (INR)	2.13	3.34	5.11	7.71	11.00
EPS FD (DB adj.) (INR)	2.13	3.34	5.11	7.71	11.00
Growth rate - EPS (stated) (%)	NM	57.5	52.9	50.6	42.2
DPS (INR)	0.00	0.00	0.00	0.00	0.00
BVPS (stated) (INR)	21.21	28.11	42.67	63.13	85.83
BVPS (DB adj.) (INR)	22.75	28.86	44.62	67.15	91.36
Average market cap (INRm)	19,499	30,571	55,711	55,711	55,711
Shares in Issue (m)	270	280	300	330	363
Valuation Ratios & Profitability Measures					
P/E (stated)	32.9	31.6	35.1	23.3	16.4
P/E FD (stated)	34.0	32.7	36.4	24.1	16.9
P/E FD (DB adj.)	34.0	32.7	36.4	24.1	16.9
P/B (stated)	4.73	5.01	4.36	2.95	2.17
P/B (DB adj.)	4.41	4.88	4.17	2.77	2.04
ROE (stated) (%)	14.1	13.9	14.7	14.7	14.9
ROA (stated) (%)	2.04	1.24	0.94	0.85	0.78
Dividend yield(%)	0.00	0.00	0.00	0.00	0.00
Dividend cover(x)	NM	NM	NM	NM	NM
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0
Profit & Loss (INRm)					
Net interest revenue	881	1,714	3,114	6,184	11,344
Non interest income	898	1,915	2,735	3,894	5,409
Fees & Commissions	419	1,116	1,785	2,857	4,285
Trading Revenue	417	345	404	448	488
Insurance revenue	0	0	0	0	0
Dividend income	0	0	0	0	0
Other revenue	61	454	545	589	636
Total revenue	1,779	3,628	5,849	10,078	16,753
Total operating costs	934	2,192	3,586	6,278	10,371
Pre-provision profit/(loss)	845	1,437	2,263	3,800	6,382
Bad debt expense	0	0	0	119	623
Operating Profit	845	1,437	2,263	3,681	5,759
Goodwill	0	0	0	0	0
Pre-tax associates	0	0	0	0	0
Extraordinary & Other Items	0	0	0	0	0
Pre-tax profit	844	1,437	2,263	3,681	5,759
Tax	291	493	747	1,215	1,900
Minorities	0	0	0	0	0
Preference dividends	0	0	0	0	0
Stated net profit	553	944	1,516	2,466	3,858
DB adj. core earnings	553	944	1,516	2,466	3,858
Key Balance Sheet Items (INRm) & Capital Ratios					
Risk-weighted assets	41,562	95,988	148,509	251,409	418,708
Interest-earning assets	39,719	106,482	200,412	347,170	591,407
Total loans	24,071	62,897	119,269	207,381	350,222
Total deposits	29,104	82,204	164,408	295,934	503,088
Stated shareholders equity	5,727	7,871	12,785	20,804	31,113
Preference share capital	–	–	–	–	–
Tier 1 capital	5,727	7,871	12,785	20,804	31,113
Tier 1 ratio (%)	13.78	8.20	8.61	8.27	7.43
Tangible equity/ total assets (%)	13.76	7.09	6.07	5.64	5.03
Credit Quality					
Gross NPLs / Total loans (%)	0.00	0.00	0.00	0.07	0.11
Provisions / NPLs (%)	NM	NM	NM	88.35	166.51
Bad debt exp/ Avg loans (%)	0.00	0.00	0.00	0.07	0.22
Growth Rates & Key Ratios					
Growth in net interest income (%)	NM	94.5	81.7	98.6	83.4
Growth in fee income (%)	–	166.2	60.0	60.0	50.0
Growth in non-interest income (%)	–	113.2	42.8	42.4	38.9
Growth in revenues (%)	NM	104.0	61.2	72.3	66.2
Growth in costs (%)	NM	134.6	63.7	75.0	65.2
Pre-provision earnings growth (%)	–	70.1	57.5	67.9	67.9
Growth in bad debts (%)	NM	NM	NM	NM	422.2
Growth in RWA (%)	NM	131.0	54.7	69.3	66.5
Growth in loans (%)	–	161.3	89.6	73.9	68.9
Growth in deposits (%)	–	182.5	100.0	80.0	70.0
Loan-to-deposits ratio (%)	82.7	76.5	72.5	70.1	69.6
Net int. margin (%)	2.96	2.79	2.42	2.69	2.88
Cost income ratio (%)	52.5	60.4	61.3	62.3	61.9
Cost asset ratio (%)	3.4	2.9	2.2	2.2	2.1
Trading income/ Total Rev (%)	23.5	9.5	6.9	4.4	2.9







Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

Our Sell call on YES Bank hinges on margin volatility due to a relatively weak deposit franchise, very high growth rates requiring frequent doses of capital and high-cost resources, and concerns about the retail business rollout. The bank is also the most expensive in our Indian banks coverage universe, both in P/BV terms and franchise value indicators such as market cap to branches or market cap to deposits. In that sense, YES Bank would appear less attractive as its peers with bigger franchises are currently trading at lower multiples.

Typically, the bank's margins fall sharply at the start of the fiscal year as the bank bunches up short-term low-yielding priority sector assets towards 4Q whose impact is actually felt in 1Q – in terms of lower yield on advances – and then recovers towards the later part of the year. However, we believe that even the CASA ratio has been very volatile across quarters and not just due to yield variation on advances.

There are also some questions on the intended retail banking rollout targeting mass-affluent customers. First of all, the bank is launching retail banking when retail itself is slowing down due to higher interest rates. Past examples have shown that retail banking targeting affluent customers has not been very profitable in India. And with the launch of unsecured retail lending, NPLs and consequently provisioning requirements are expected to pick up.

Valuation

We have used a two-stage P/BV Gordon Growth model as the conventional single-stage model does not capture the high growth that the bank is likely to enjoy for some time. Based on that, we arrive at a P/BV of 1.84x on a normalised RoE of 18.2%. Multiplying this by FY09E BV results in a core business value of Rs123/share. Other assumptions: risk-free rate of 7% (DB estimate for India), risk premium of 4.5%, beta of 1.1 (Bloomberg), growth rate for the first 8 years at 30%, perpetual growth rate of 4%, and perpetual payout of 25%. We also factor in a baseline premium of 27% which is the average of the deal premiums observed for M&A transactions across the Asia-Pac region. Thus we get a final target price of INR155/share.

Risks

Our hypothesis about volatility in margins rests on the premise that 80%+ growth can be achieved only by taking major recourse to bulk deposits. Any rapid increase in CASA deposits to fund this loan growth is one of the key risks to our argument. Other key risks include fee to average assets surprising us on the upside and faster-than-targeted branch openings.

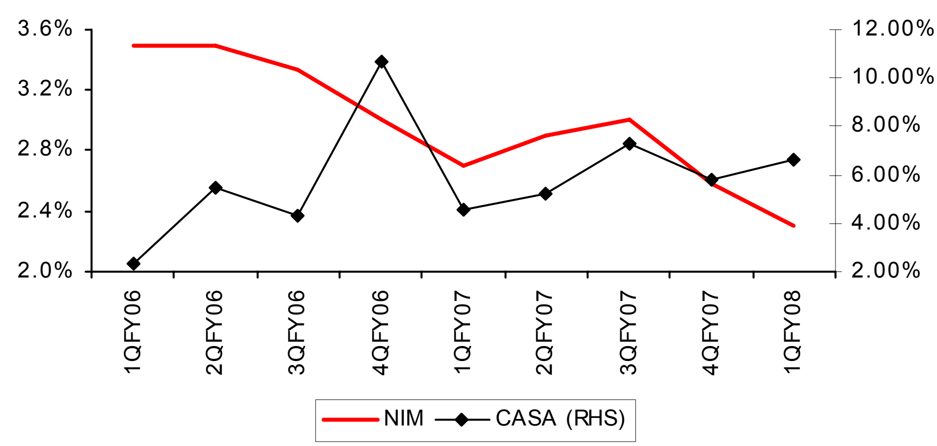
Table of Contents

Margin volatility to continue

High growth rates make NIM management difficult

YES Bank's margin trends have been quite volatile as demonstrated in Figure 1. Typically, the bank's margins fall sharply at the start of the fiscal year as the bank bunches up short-term low-yielding priority sector assets towards 4Q whose impact is actually felt in 1Q in terms of lower yield on advances and then recovers towards the later part of the year. However, we believe that even the CASA ratio has been very volatile across quarters and not just due to variations in yield on advances (Figure 1).

Figure 1: Margins have been very volatile across quarters



Source: Company Data, Deutsche Bank

Funding costs significantly high

Interest rates offered on deposits are amongst the highest on the street

Currently, YES Bank offers the highest deposit rate for 1-2 yrs at 9.5%. Though there are some banks which offer the same rate, YES Bank offers this across the entire tenor while most of them offer it only at specific points of 390days, 590days, etc. In fact, in 1Q08 the bank was offering 10.25% for 1yr deposits which they reduced to 9.5% in July (Figure 2).

Figure 2: Deposit rates – comparison among some private sector banks

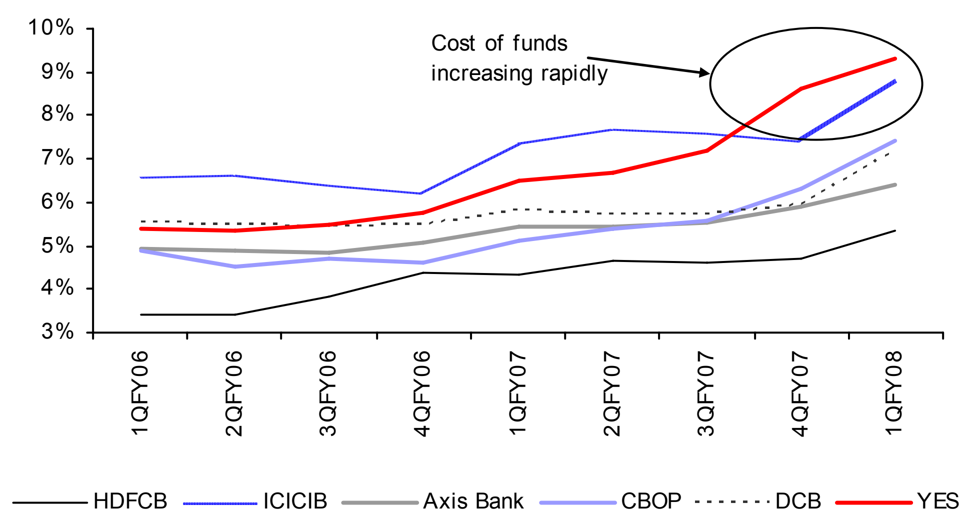
Banks	Deposit rates (1-2 Yrs)
ICICI Bank	366-389 days - 6.25%, 390 days - 9.5%, 391to 589 days - 6.25%, 590 days - 9.5%, 591days to 2yrs -6.25%
HDFC Bank	366-389 days - 8%, 390 days - 9%, 391days - 2 Yrs - 8%
Axis Bank	9%
CBOP	366 to 410 days - 8.5%, 411days - 9.25%, 412 days to 2 yrs- 8.25%
DCB	390 & 570 days - 9.5%, Otherwise it is 8.3-8.6%
Kotak Mahindra Bank	9% across the entire tenure
YES Bank	**9.5% across the entire tenure (Earlier it was 10.25%)**

Source: Company website, Deutsche Bank

Cost of funds moving at a rapid pace compared to other banks

It's quite palpable that beyond a certain point growth can be achieved only by taking recourse to high-cost bulk deposits. YES Bank is by far the most affected as cost of funds has increased 280bps yoy compared to most others who have registered 100-200bps increase in cost of funds (Figure 3).

Figure 3: YES Bank – Cost of funds increasing rapidly



Source: Company data, Deutsche Bank

CASA likely to remain very low even by FY10E

Despite being aggressive in our assumption of CASA/branch going from Rs118mn currently to Rs250mn by FY2010 (Figure 4), we expect CASA ratio to reach just 12.4% by FY10E.

Figure 4: Comparison of CASA/branch

	CASA (INR m)		CASA (%)		Branches		CASA/branch (INR m)	
Banks	**FY07**	**FY09E**	**FY07**	**FY09E**	**FY07**	**FY09E**	**FY07**	**FY09E**
CBOP	45,507	83,408	30.6%	30.8%	279	436	163	191
DCB	12,517	26,248	28.3%	30.5%	72	120	174	219
Kotak Mahindra	29,964	NA	27.2%	NA	105	NA	285	NA
Karnataka Bank	32,805	47,492	23.4%	25.2%	410	440	80	108
HDFC Bank	393,967	578,299	57.7%	55.6%	684	759	576	762
ICICI Bank	502,144	866,660	21.8%	22.6%	755	1,120	665	774
Axis Bank	234,302	364,537	39.9%	38.2%	508	708	461	515
YES Bank	**4,739**	**31,500**	**5.8%**	**10.6%**	**40**	**175**	**118**	**180**

Source: Deutsche Bank

A comparison with HDFC Bank, ICICI Bank and Axis Bank during their initial years suggests that our assumption of CASA per branch is more or less in line with CASA per branch existing at that time (after assuming inflation of 7%, Rs145mn per branch of CASA translates into Rs250mn today). A ball park comparison suggests that a CASA of Rs146mn per branch in FY1999 yielded a low-cost mix of 11-15%. Moreover, credit growth was also very high (75%+) in FY99, which indicates the level of CASA that roughly funded strong credit growth. Note that HDFC Bank is an exception since it always had a higher CASA due to float money from brokers (Figure 5).

As YES Bank starts adding more branches, penetrates further into un-banked areas and begins to develop its retail franchise, the scope for increasing CASA widens. Nevertheless, to sustain an 80%+ growth rate for the next 3 years, the bank needs to take recourse to high-cost bulk/term deposits, which is likely to affect the quality of franchise.

Figure 5: YES Bank CASA/branch assumptions

CASA per branch	FY97	FY98	FY99
HDFC Bank	95	128	146
Axis Bank	163	124	146
ICICI Bank	165	143	144
	FY08E	**FY09E**	**FY10E**
YES Bank	140	180	250

Source: Deutsche Bank

Figure 6: YES Bank's low-cost mix (%) to remain low

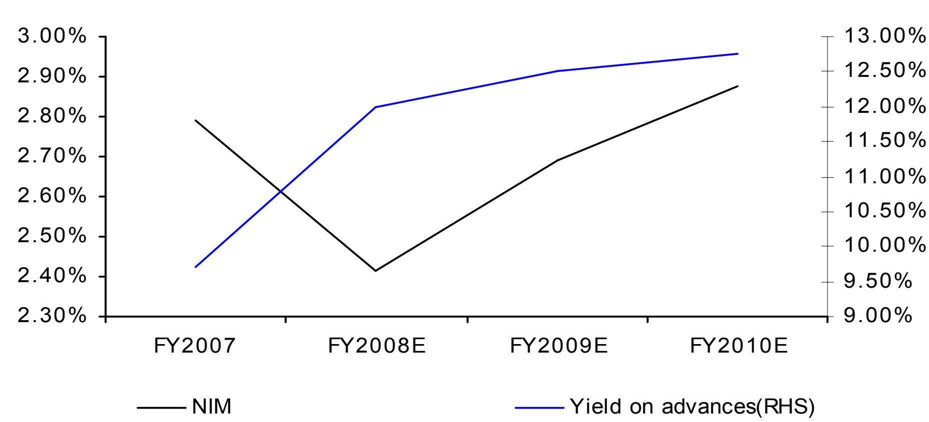
CASA (%)	FY97	FY98	FY99	FY00
HDFC Bank	37%	39%	46%	46%
Axis Bank	14%	11%	17%	17%
ICICI Bank	27%	18%	13%	21%
CASA (%)	**FY07**	**FY08E**	**FY09E**	**FY10E**
YES	6%	9%	11%	12%

Source: Deutsche Bank

Projected NIM increase on shift in mix; not an indicator of higher profitability

As the bank expands its retail book and penetrates further into other cities, some relief should be seen in margins as the retail portfolio (predominantly personal loans to begin with) is likely to see some traction on yield on advances. We expect margins to be in the range of 2.6-2.9% for the next three years (Figure 7). This is an indicator of change in asset mix and not an intrinsic increase in profitability. In other words, this does not necessarily lead to higher RoEs, as we explain the next section.

Figure 7: Recovery in margins expected



Source: Deutsche Bank

Concerns on retail banking rollout

Mass-affluent focus – the path less travelled

YES Bank plans to initially focus on the "mass affluent" category and then slowly scale it up to the HNI category level by FY09 (refer Figure 8).

Figure 8: Target client base in the retail segment

Category	Target Client base
YES Prosperity	Mass affluent segment - income b/w INR 0.5 and 2.5mn
YES First	Affluent segment - income b/w INR2.5mn and INR20mn
YES Private	INR20mn upwards

Source: Company Data, Deutsche Bank

The target segment that YES Bank is planning to cater to is conceptually similar to what Kotak Mahindra Bank caters to now. HDFC Bank also initially started off by focusing on this segment and then eventually had to end up being a mass bank. For Kotak Mahindra, the cost of servicing this customer has been relatively high and the segment per se hasn't been very profitable so far, as seen in FY04 to FY07 RoE (Figure 9). It is important to observe that though the RoA is high, the leverage potential in the personal loans business is much less due to higher regulatory capital requirements, as a result of which the RoE gets depressed (also see Figure 13).

Figure 9: Kotak Mahindra Bank – Historical DuPont analysis

	FY04	FY05	FY06	FY07
Net interest income/ avg. total avg. total assets	4.28%	3.66%	4.55%	4.35%
Non-interest income/ avg. total assets	2.40%	2.15%	2.61%	1.89%
Non-operating profit/ avg. total assets	6.68%	5.81%	7.17%	6.24%
Operating expenses/ avg. total assets	**3.50%**	**3.64%**	**4.64%**	**4.07%**
Operating profit/ avg. total assets	3.17%	2.16%	2.52%	2.17%
Provisions/ Avg. total assets	0.14%	0.24%	0.44%	0.81%
(1 - tax rate)	65.17%	71.70%	68.11%	69.55%
Minority interest/ avg. total assets	0.00%	0.00%	0.00%	0.00%
Return on avg. total assets	1.98%	1.38%	1.42%	0.94%
Avg. total assets/ average equity (x)	6.9x	9.1x	10.4x	12.1x
Return on equity	13.73%	12.52%	14.74%	11.37%

Source: Company data, Deutsche Bank

Similarly, when HDFC Bank started with the intention of focusing on the "mass affluent" segment, its expenses were high. It was only after its acquisition of TimesBank in 2000 that the focus changed to mass banking and the bank started expanding its book aggressively. We believe that for YES Bank, as it plans to enter into the personal loans category, the RoE could stay low due to higher cost of funds and increase in the already-high operating expenses.

Difficult to deliver niche banking in India

Significant regulatory impositions to overcome

There are so many 'percentages' to be fulfilled by banks in India (statutory liquidity, cash reserve, priority sector, agricultural lending, loans to weaker sections etc) that banks have limited asset-side flexibility. Moreover, some banks have recently told us that an overt priority banking strategy does not go down well with the RBI as it appears to be in conflict with the central bank's idea of financial inclusion. Hence the mass-affluent operation can only be incremental and not core, and thus incapable of making a meaningful difference.

Do not underestimate competition

Yes Bank is not the first bank to have woken up to the mass-affluent opportunity. More importantly, competition is intensifying. The large private banks have set up aggressive wealth management divisions. This is the main business of foreign banks, most of whom have taken the decision to intensify their market presence in this area (after a few abortive attempts to buy Indian banks). Indian banks do score over them in branch presence, but this segment – unlike retail liabilities – is not so critically dependent on branch strength.

Retail unlikely to be more profitable than the corporate business

On a risk-adjusted basis, retail loans are no more profitable than corporate loans as demonstrated in our RoE analysis of loan categories (Figure 10). The higher provisions on personal loan book and much higher operating expenses required in servicing the "mass affluent" category makes this segment less attractive.

Figure 10: ROE of various loan categories

	Personal loans - YES Bank	Corp Loans - YES Bank	Personal Loans –Other banks
Yield on asset	20.00%	12.00%	20.00%
CASA cost	1.9%	1.9%	1.9%
% of CASA (Incremental CASA)	20.0%	20.0%	35.0%
Term deposit cost	9.00%	9.00%	9.25%
% of term deposits	80.0%	80.0%	65.0%
Weighted avg cost of funds	7.58%	7.58%	6.68%
Spread	12.42%	4.42%	13.32%
Operating expenses	**5.00%**	**1.50%**	**4.00%**
Normalised credit loss over cycle	5.00%	1.00%	5.00%
Profit before tax	2.42%	1.92%	4.32%
Tax rate assumed	33%	33%	33%
Profit after tax (RoA)	1.62%	1.29%	2.90%
Targeted equity component of Tier I	7.00%	7.00%	7.00%
Risk weight	125%	100%	125%
Hence Normalised leverage (x)	11.4	14.3	11.4
RoE	**18.5%**	**18.4%**	**33.1%**

Source: Deutsche Bank

Moreover, we believe it will be difficult for the bank to scale up its retail business as retail loan growth for the system as a whole is expected to slow down. Retail is still expected to be an insignificant contributor to the overall loan pie of YES Bank and as a result we don't expect retail loans to create any meaningful impact on RoE for the next three years. The incremental RoE derived here is in line with the normalised RoE that we have used to value YES Bank (refer to the Financials and Valuations section).

NPLs likely to pick up

Currently, the bank reports no NPLs primarily because the loan portfolio is just two years old and loans were originated at a benign phase of corporate profitability. But as the loan portfolio becomes more seasoned and the bank starts expanding its retail loan portfolio driven by non-collateralised loans, we expect some slippages to happen and we have factored around 11bps and 12bps slippage in FY09E and FY10E. Consequently, we have also factored higher loan-loss provisions and standard asset provisions (personal loans have a standard asset provisioning of 200bps) into our model.

Too high a franchise value

Expensive on branches and deposits

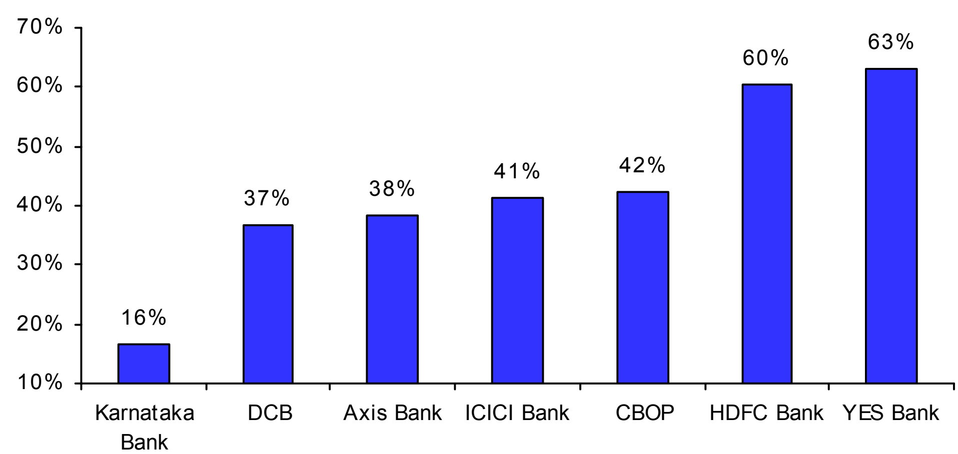
We believe the market is factoring in too much optimism on YES Bank's growth story. Clearly in terms of market capitalisation per branch and market cap to deposits, which we believe are indicators of franchise value, YES Bank's franchise is by far overvalued compared to the other smaller banks like CBOP, DCB and Karnataka Bank. Note that the Mcap-to-branch ratio has been calculated based on the number of FY09E branches, which factors in the aggressive rollout of branches by YES Bank (Figure 11 and Figure 12).

Figure 11: Mcap/branch (FY09E) – YES Bank clearly overvalued

Banks	Mcap (INR m)	Branches (FY09E)	Value per branch (INR m)
Karnataka Bank	23,124	440	53
DCB	16,247	120	135
CBOP	63,007	436	145
YES Bank	**51,786**	**175**	**296**
Axis Bank	225,576	708	319
HDFC Bank	412,298	759	543
ICICI Bank	950,761	1,120	849

Source: Bloomberg, Deutsche Bank

Figure 12: Market cap to deposits – YES Bank is the most expensive



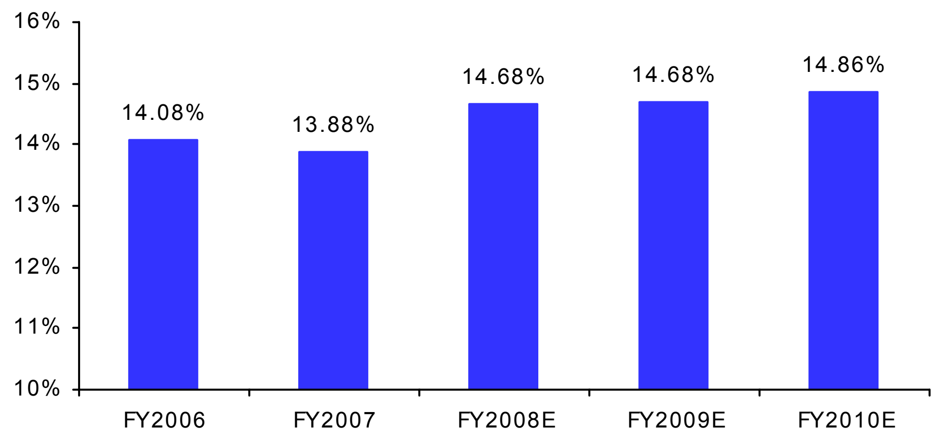
Source: Bloomberg, Deutsche Bank

We believe the market does not value these banks purely on a P/E or P/BV basis as it is difficult to justify such valuations for the small banks purely on fundamentals. The market does look at a franchise value and possibly a takeover candidate after 2009 when the sector is expected to be liberalised further. Even Indian banks themselves have demonstrated their appetite for inorganic growth. In the preference hierarchy, we believe YES Bank will appear the least attractive candidate in valuation terms considering that its peers with bigger franchises are currently valued at lower multiples.

Frequent dilution may keep RoE muted

Assuming a 20% incremental RoE and a nil payout ratio, any bank can only support a 20% growth in assets. However, with YES Bank intending to grow at 80%+ (we have assumed a CAGR of 77% for the next three years), we believe the bank will frequently require capital, as a result of which we have assumed 7%, 10% and 10% equity dilution for the next three years (Figure 13).

Figure 13: YES Bank – RoE to hover around 14-15%



Source: Deutsche Bank

We expect a 48% EPS CAGR (F2007-F2010E), driven primarily by strong fee income growth. However, not too much emphasis should be given to CAGR since the base is very low.

TP downside of ~17% even with much higher normalised RoE

We believe the conventional single-stage Gordon Growth model does not capture the high growth that the bank is likely to enjoy for quite some time and hence we have used a two-stage P/BV Gordon Growth model. Our two-stage Gordon Growth model for calculating the fair P/BV can be represented by the following:

$$P/BV = RoE * \{(p(1+g) * (1- (1+g)^n/(1+r)^n)) + (p_n(1+g)^n(1+g_n))/((r-g_n)(1+r)^n)\},$$

where:

- g=growth rate for the first n (high-growth period) years,
- p=payout ratio in the first n years,
- g_n=perpetual growth rate,
- p_n=perpetual payout ratio,
- RoE=normalized (sustainable) RoE.

Note that by using a normalised RoE which happens to be about 350bps over the current RoE, we are giving due credit to potential longer-term improvement, as we have done in the case of other growing small banks (Figure 14). The normalised RoE is also in line with the RoE (refer to page 8) we have derived for the bank's retail business. Even then our core business value arrives at Rs123/share.

Figure 14: YES Bank – Normalized RoE

DuPont analysis	Normalized	Remarks	FY08E	FY09E
NII/ avg. total assets	2.75%	NIM to gravitate towards a more typical sector value	1.94%	2.13%
Non-int income/avg. assets	1.30%	High fee income to continue	1.73%	1.37%
Op expenses/avg. assets	1.80%		2.09%	1.99%
Provisions/ avg. assets	0.65%	In line with its loan mix trend	0.16%	0.24%
(1 - tax rate)	67.00%		67.00%	67.00%
RoA	1.07%		0.94%	0.85%
Leverage (x)	17.0x	As capital is used progressively better	15.6x	17.3x
Return on equity	18.19%		14.68%	14.68%

Source: Company data, Deutsche Bank

We apply a premium of 27%, which is the average of the deal premiums for bank transactions in the Asia-Pac region (Figure 15).

Figure 15: Deal premiums for actual bank deals over the last 4 years

Target Name	Acquirer Name	Deal Premium
H&CB	Kookmin Bank	0.2%
Overseas Union Bank	United Overseas Bank Ltd	26.8%
DBS Bank Hong Kong	DBS Group Holdings Ltd	61.4%
Taipeibank	Fubon Financial Holding Co	46.0%
Chohung Bank	Shinhan Financial Group Ltd	7.0%
Chohung Bank	Shinhan Financial Group Ltd	22.1%
Chohung Bank	Shinhan Financial Group Ltd	5.2%
Ufj Holdings Inc	Mitsubishi UFJ Financial	35.8%
Bank Nisp Pt	Oversea-Chinese Banking Corp	5.1%
Prudential Bank	Bank Of Philippine Islands	95.6%
Equitable PCI Bank	Banco De Oro Universal Bank	15.2%
Bank Buana Indonesia	United Overseas Bank Ltd	0.9%
Farmers Bank Of China	Taiwan Cooperative Bank	5.3%
Momiji Holdings Inc	Yamaguchi Bank Ltd	-28.2%
Southern Bank Berhad	Bumiputra-Commerce Hldgs	6.8%
Average		**21%**
Centurion Bank	Bank of Punjab	4.6%
ICICI Bank	Bank of Madura	100.0%
HDFC Bank	Times Bank	8.1%
IDBI	United Western Bank	21.0%
Average		**33%**
Combined average		**27%**

Source: Bloomberg, Deutsche Bank

Finally, we arrive at a target price of Rs155. Currently, YES Bank trades at ~4.2x FY08E book – the most expensive in our banking universe. At our target price, the stock would trade at 3.6x. We believe the stock deserves to trade at lower valuations than most of its peers on account of its smaller franchise and consequently lower level of attractiveness, volatile margins and uncertainty surrounding the scaling up of the retail business.

Figure 16: YES Bank the most expensive in our Indian banks coverage universe

	EPS Growth (%)			P/E			P/BV			ROE (%)		
Banks	**FY07**	**FY08E**	**FY09E**	**FY07**	**FY08E**	**FY09E**	**FY07**	**FY08E**	**FY09E**	**FY07**	**FY08E**	**FY09E**
Bank of Baroda	4.0	29.3	24.3	9.9	7.6	6.1	1.2	1.0	0.9	12.4	14.5	15.9
Canara	5.8	-5.5	8.9	7.4	7.8	7.2	1.3	1.2	1.1	16.5	12.6	12.6
Centurion Bank of Punjab	20.6	18.0	48.4	48.3	40.9	27.6	4.5	3.7	3.3	10.6	9.9	12.6
Development Credit Bank	NM	196.9	147.6	155.0	52.2	21.1	4.9	2.9	2.5	3.0	6.7	12.7
HDFC Bank	38.1	29.3	23.4	33.2	25.7	20.8	5.9	3.6	3.1	19.5	17.3	16.2
ICICI Bank	7.2	20.0	16.3	26.2	21.8	18.7	3.4	2.1	2.0	13.4	11.7	10.9
Karnataka Bank	0.4	30.4	11.9	13.7	10.5	9.4	2.0	1.7	1.5	15.1	17.4	17.2
Oriental Bank	-7.8	21.4	48.4	9.8	8.1	5.4	1.1	1.0	0.8	10.8	12.0	12.3
Punjab National Bank	7.0	30.9	25.7	10.1	7.7	6.1	1.5	1.3	1.1	16.0	18.4	19.8
SBI	15.1	15.1	19.8	13.6	11.8	9.8	2.1	1.8	1.5	16.6	16.9	16.6
Union Bank	15.7	16.4	17.1	8.8	7.3	6.3	1.6	1.4	1.2	19.2	19.8	19.7
Axis Bank	34.2	19.4	27.4	28.5	22.4	18.7	5.4	3.4	3.0	21.0	18.9	17.4
YES Bank	57.0	53.2	50.9	55.7	36.4	24.1	6.4	4.2	2.8	13.9	14.7	14.7

Source: Deutsche Bank

A strongly non-consensus call

We are well below the street in terms of our EPS estimates and target price, and the only Sell. We believe the consensus is not factoring in the frequent equity dilution that is required to sustain 80% growth. There is also too much optimism built into the growth story of YES Bank, much of which is already factored into the stock price, in our view. The stock has doubled in the past year vs. 55% for Bankex and 35% for Sensex, and we believe this is an opportune moment to book profits.

Figure 17: Comparison – DB vs. Consensus

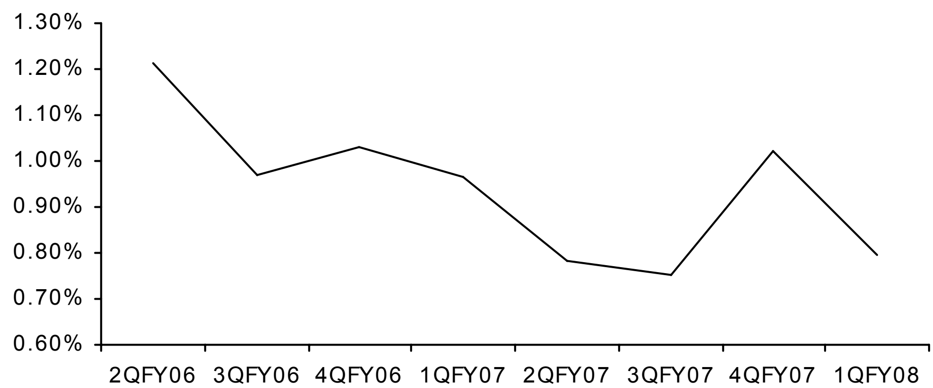
	FY2008E	FY2009E	FY2010E
EPS			
Mean	6.20	10.00	16.63
DB	**5.11**	**7.71**	**11.00**
Deviation from mean	-18%	-23%	-34%
TP			
Mean	218		
High	233		
Low	190		
DB	**155**		
Current Rating Mix			
Buys	5		
Hold	1		
Total	6		

Source: Deutsche Bank, Bloomberg

Counter-arguments

"Fee income growth is stellar; this will help maintain high profitability"
We believe the market is just looking at fee income growth without looking at the fee-to-average-assets ratio. Though fee income has been growing at a scorching pace, fee to average assets has not been increasing, which implies that the fee income growth by itself is unlikely to be a swing factor for RoE.

Figure 18: YES Bank – Non interest income to average assets (rolling)



Source: Company data, Deutsche Bank
Note: For YES Bank, non interest income includes negligible treasury income and as such can be taken as a proxy for fee income

"HDFC Bank trades at high valuations: why not YES Bank?"
At ~4.2x FY08E book, after factoring in 7% dilution for FY08, YES Bank is even more expensive than HDFC Bank and clearly more expensive than comparable small cap peers like CBOP, DCB and Karnataka Bank which have much bigger franchises. Comparing YES Bank with the likes of HDFC Bank is not justifiable in our view considering the latter's 50%+ CASA, negligible NPL levels after being in existence for more than 10 years and ability to consistently maintain its sector-beating margins and consequently profitability.

"Banks such as HDFC Bank used to trade at much higher multiples when they were young"
Inappropriate comparison, in our view. In those days, the banking market itself was more consolidated and less competitive. Secondly, HDFC Bank and ICICI Bank were the only two private banks of reckoning, and provided a welcome change from public sector banks. Thirdly, the internet was just emerging and these two banks, with the best possible technology and customer service, creamed off the top layer of customers. Fourthly, they spearheaded the creation of the retail assets market. Today's scenario is very different – the banking product suite is more or less complete and differentiation on the asset side is very difficult. And we have already explained that YES Bank is not in a position to differentiate on liabilities.

"With retail banking being launched, margins and consequently RoEs are expected to improve"
We believe that this is not likely to be the case for YES Bank in the immediate future. Please refer to the section where we have highlighted that on a risk-adjusted basis the profitability of retail loans is the same as corporate loans. Though margins are higher, higher provisioning and operating expenses coupled with lower leverage (as personal loans require more regulatory capital to be kept aside), RoEs broadly remain the same. Further, overall slowdown

in the retail business raises some concerns about the timing of the launch of this business and the bank's ability to scale up significantly to create any meaningful impact on the asset mix by FY10E.

"Margins have bottomed out at 2.30%; now they can only recover"
Margins may have indeed bottomed out, but the expected recovery in margins will be driven by the higher yield on the retail loan portfolio. As we have already explained, this does not necessarily translate into higher RoEs. And the path to higher margins can be very volatile due to swings in cost of funds.

"Approval for branch licenses would be the key trigger for re-rating"
This bank has never faced a branch licence crunch like, say, ICICI Bank and HDFC Bank which had a hiatus in 2006. Hence more branch licences cannot be a trigger. The assumption of 170-180 branches by FY09 and around 250 branches by FY10 seems reasonable and unlikely to be beaten; these have been factored into our estimates. RBI has already approved 56 branch licenses and YES Bank is well on track to reach its targeted figure. A trigger could be branch openings well above management targets.

"If liquidity eases, YES Bank will benefit significantly"
True, but this applies by and large to all private sector banks as they are generally more liquidity-constrained than PSU banks. It must also be noted that as systemic credit growth is low, a tendency to pass on lower cost of funds is emerging. Being a small bank, YES Bank has to be mostly a price-taker. Hence it is unrealistic to expect lower cost of funds to result in higher margins on a consistent basis. We have factored in a reduction in deposit rates with lending rates kept firm for FY08 and FY09 – so in fact, our estimates give YES Bank the benefit of doubt; arguably, there is more downside than upside to this.

Risks to our stand

Rapid scale-up of CASA deposits

Our main hypothesis about volatility in margins rests on the premise that 80%+ growth can be achieved only by taking recourse to bulk deposits. As a result we have estimated CASA to reach just 12.4% by FY10E. Any rapid increase in CASA deposits could release pressure on cost of funds and will thereby result in some stability in margins.

Faster-than-targeted branch openings

Though management has targeted opening around 170-180 branches by FY09, we believe faster-than-targeted branch openings will be one of the key risks to our hypothesis.

Fee to average assets – surprising us on the upside

Any upside in fee income to average assets should result in the expansion of ROAs/ROEs and is a major risk to our negative view.

Appendix A: Company background

Business description

YES Bank is among India's new-age private sector banks, founded by Mr Rana Kapoor and Mr Ashok Kapur with financial assistance from internationally renowned Rabobank (of The Netherlands). The founders hold an around 35% stake and Rabobank has a c19% stake in YES Bank. It is the only bank to be granted a greenfield banking license by the RBI in the last 10 years. The bank has exposure to varied service lines including financial markets, corporate & investment banking, and transactional banking, along with the traditional retail and private banking. The bank currently has an asset base of US$2.5bn with a network of 54 branches spread across the country. At June 2007, YES Bank had 2,792 employees, an increase of 160% over the previous year. The bank successfully completed its US$75mn IPO in July 2005 (Figure 19).

Figure 19: Key milestones

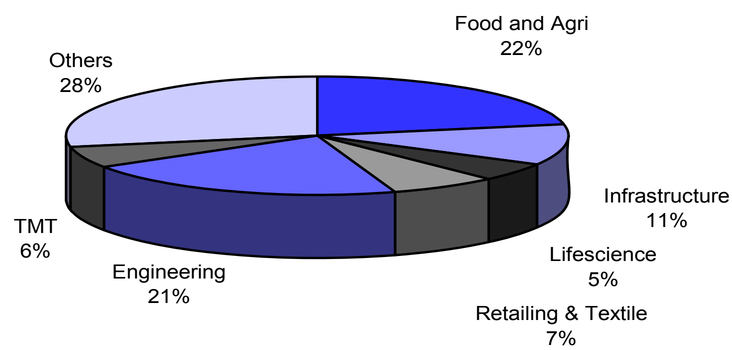
Period	Key Events
2003	Yes Bank was incorporated by Mr Rana Kapoor in financial assistance with Rabobank
2004	The bank received the license to commence commercial branching and opened its first branch at Nehru centre on Aug 16, 2004
2005	The bank came out with its IPO to raise Rs 3.15bn. The was subscribed over 30 times thus showing the confidence of the people in the bank. As a result, Rabobank's original FDI ownership of 20% was diluted to 14.8%
2005	Rabobank got the approval of the finance ministry to increase its stake in Yes Bank to 20%
2005	Yes Ban Financial Markets was ranked second in the 'Best for Currency Strategy' and 'Best for Technical Analysis' categories at the 'Asiamoney2005 Foreign Exchange Poll for India'
2006	The bank completed its Swiss Re equity transaction of Rs 1.2bn at a premium of Rs 110 per share on the face value of Rs10. As a result the stake of Rabobank was reduced to 19.3%
2006	Yes Bank was ranked no.3 in India by the Business world Survey
2007	Yes bank planned to roll out aggressive plans to increase its presence in the retail and wealth management business. The bank expects the retail and wealth management business to contribute over 30% in the long run
2007	Yes Bank became the first bank to launch the world's first Wi –Fi branch banking networking collaboration withy Intel

Source: Company data, Deutsche Bank

Business mix

YES Bank's portfolio is oriented towards corporate banking and business banking which constitute around 99% of the loan portfolio. Retail constitutes the balance 1% of the loan portfolio. YES Bank specialises in knowledge banking whereby it concentrates on a few specific sectors in which it has in-depth knowledge. The Food and Agriculture sector contributes to around 22% of total lending to the corporate sector. The other sectors include Engineering at 21% followed by Infrastructure at 11% (Figure 20). The bank plans to scale up its retail banking business in future.

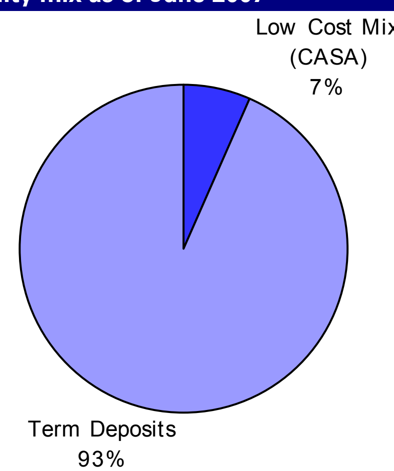
Figure 20: Corporate loan mix (June 07)



Source: Company Data, Deutsche Bank

On the liabilities side, the proportion of low-cost deposits, i.e. CASA, remains fairly low at 6.6% with the balance being term deposits (Figure 21).

Figure 21: YES Bank – Liability mix as of June 2007

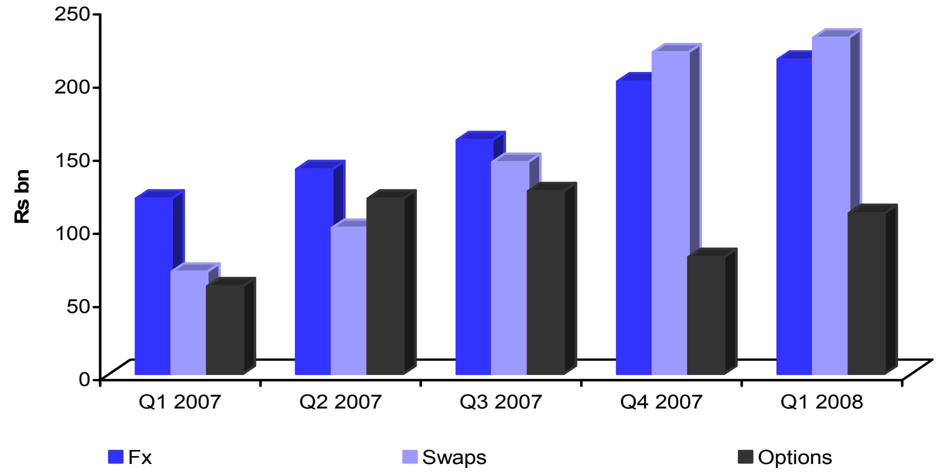


Source: Company data, Deutsche Bank

Significant presence in financial markets and transaction banking

Yes Bank has significant presence in the financial markets industry. The bank offers a wide spectrum of products ranging from plain vanilla FX spot/forward to structured currency/interest rate swaps and risk solutions. The bank has an integrated sales team with a single-point contact for clients. The bank was the first to launch the electronic FX trading service for its corporate clients on Reuters Trading for the Foreign Exchange platform.

Figure 22: YES Bank – outstanding derivative contracts



Source: Company Data, Deutsche Bank

Top-quality management

Experienced management

We believe the forte of Yes Bank is its experienced founders and management team with an excellent track record. Most of them have considerable experience having worked with foreign banks in the past (Figure 23).

Figure 23: Yes Bank – Management team

Management Personnel	Designation	Previous Work experience
Rana Kapoor	Managing Director & CEO	Rabo India Finance
Sunil Gulati	Group President – Corporate & Institutional Banking, Risk Mgmt & Corp. Development	GE Commercial Finance, ING Vyasa, Bank of America
Ajay Mahajan	Group President – Financial Markets, Institutions & Investment Management	Bank of America
Somak Ghosh	President - Corporate Finance and Development Banking	Rabo India Finance
Suhail Kazmi	President – Retail Banking & Wealth Management	ABN Amro
Suresh Sethi	President – Transaction Banking, Branch Operations	Citibank N.A.
Rajat Monga	CFO	Head of Treasury – Rabo India
Aditya Sanghi	MD – Investment Banking	ED – Rabo India

Source: Company data, Deutsche Bank

ESOPs to retain talent

The bank has given ESOPs to the top and middle layers of management and these ESOPs have an average vesting period of four years. Hence we believe that the issue of attrition is not too significant given a fairly high vesting period (Figure 24).

Figure 24: ESOPs of YES Bank management's currently " In the Money" (INR m)

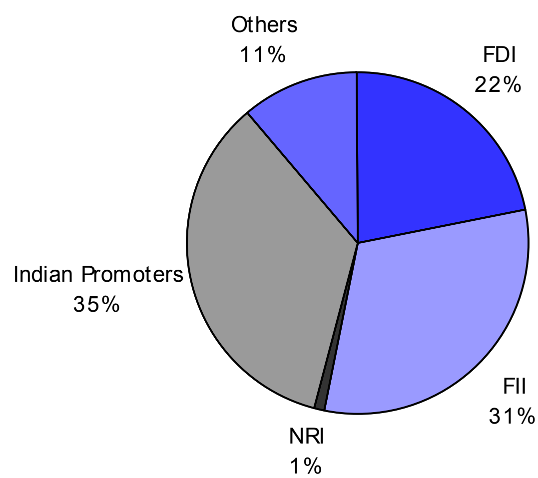
Management Personnel	ESOPs or Shareholding value at CMP (INR m)	ESOPs or Shareholding/Annual Sal	In the Money (INR m)
Ashok Kapur	10,959	3,414x	NA
Rana Kapoor	8,182	643x	NA
H Srikrishnan	184	23.8x	173.60
Aditya Sanghi	92	17.1x	86.80
Ajay Mahajan	184	15.0x	173.60
Rajat Monga	46	11.6x	43.40

Source: Company data, Deutsche Bank Note:

Shareholding pattern

The total foreign shareholding in Yes Bank stands at 54%. About 35% of the shareholding vests with the promoters, Mr Rana Kapoor and Mr Ashok Kapur. The bank was formed with financial assistance from Rabobank, which is also the largest foreign investor in the bank with a 19% stake (Figure 25).

Figure 25: Shareholding pattern (June'07)



Source: Company Data, Deutsche Bank

Figure 26: Yes Bank – Foreign shareholding (June'07)

Foreign Shareholding	% Holding
RaboBank International Holding BV	19.30%
Khazanah Nasional	4.99%
Chrys Capital II LLC	2.28%
Russell AIF Capital INC	5.36%
Swiss Re	3.57%
Others	18.50%
Total	**54.0%**

Source: Deutsche Bank

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist			
Company	**Ticker**	**Recent price***	**Disclosure**
YES Bank	YESB.BO	183.95 (INR) 11 Sep 07	6,SD11

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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Historical recommendations and target price: YES Bank (YESB.BO)

(as of 9/11/2007)

Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure as of September 9, 2002

1. 2.

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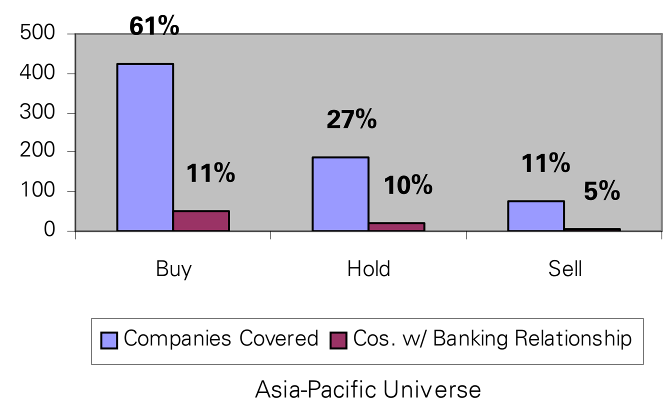

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Deutsche Bank AG/Hong Kong

Asia-Pacific locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234
Fax: (61) 2 8258 1400

Deutsche Bank AG
Level 55
Cheung Kong Center
2 Queen's Road Central
Hong Kong
Tel: (852) 2203 8888
Fax: (852) 2203 6921

Deutsche Equities India Pte Ltd
DB House, Ground Floor
Hazarimal Somani Marg
Fort, Mumbai 400 001
India
Tel: (91) 22 5658 4600
Fax: (91) 22 2201 9094

Deutsche Securities Inc.
Level 20, 2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6701
Fax: (81) 3 5156 6700

Deutsche Bank (Malaysia) Berhad
Level 18-20
Menara IMC
8 Jalan Sultan Ismail
Kuala Lumpur 50250
Malaysia
Tel: (60) 3 2053 6760
Fax: (60) 3 2026 3906

In association with
Deutsche Regis Partners, Inc.
Level 23, Tower One
Ayala Triangle, Ayala Avenue
Makati City, Philippines
Tel: (63) 2 894 6600
Fax: (63) 2 894 6638

Deutsche Securities Korea Co.
17th Floor, YoungPoong Bldg.,
33 SeoRin-Dong,
Chongro-Ku, Seoul (110-752)
Republic of Korea
Tel: (82) 2 316 8888
Fax: (82) 2 316 8998

Deutsche Securities Asia Ltd.
Singapore Branch
One Raffles Quay
#18-00 South Tower
Singapore 048583
Tel: (65) 6423 8001
Fax: (65) 6837 2167

Deutsche Securities Asia Ltd
Taiwan Branch
Level 6
296 Jen-Ai Road, Sec 4
Taipei 106
Taiwan
Tel: (886) 2 2192 2888
Fax: (886) 2 3707 8450

In association with
TISCO Securities Co., Ltd
TISCO Tower
48/8 North Sathorn Road
Bangkok 10500
Thailand
Tel: (66) 2 633 6470
Fax: (66) 2 633 6490

In association with
PT Deutsche Verdhana Indonesia
Deutsche Bank Building,
6th Floor, Jl. Imam Bonjol No.80,
Central Jakarta,
Indonesia
Tel: (62 21) 318 9541
Fax: (62 21) 318 9560

International locations

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000
Fax: (44) 20 7545 6155

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 0

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234
Fax: (61) 2 8258 1400

Deutsche Bank AG
Level 55
Cheung Kong Center
2 Queen's Road Central
Hong Kong
Tel: (852) 2203 8888
Fax: (852) 2203 6921

Deutsche Securities Inc.
Level 20, 2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6701
Fax: (81) 3 5156 6700

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