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Updates

Banks/Financial Institutions: RBI discussion paper does not favour intermediary companies for subsidiaries; may adversely impact sentiment on ICICI Bank and SBI

News Roundup

Corporate

- Delhi-based real estate developer Parsvnath Developers Ltd on Monday said it has applied to the department of telecommunications for a unified access service licence for 22 telecom circles across the country. *(FE)*
- According to dealers in the corporate bond market, the restriction on domestic expenditure of funds borrowed through the external borrowing (ECB) route is prompting Indian companies to consider rupee borrowing. Yet another reason is the widening spread for Indian credit due to an overall risk aversion to emerging markets following the subprime mortgage market crisis. *(BS)*
- Hotels major EIH Ltd, part of the Oberoi Group, will be expanding capacity by 66% by building 2,700 rooms in new properties over the next five years in India and abroad. *(FE)*
- The Board of Control for Cricket in India (BCCI) managed to sell the ground sponsorship rights and title naming rights for a total of 55 matches to be played in India till March 2010 to the Singapore-based sports marketing firm Wroeld Sports Group (WSG) for a whopping US\$17.3 million. *(ET)*

Economic and political

- The Empowered Group of Ministers (EGoM) on Monday failed to reconcile the share of inter-ministerial differences on the price of gas to be sold by Reliance Industries Ltd (RIL) from its D6 as field in the Krishna Godavari basin. *(FE)*
- Assets under management (AUM) for debt schemes have grown more than the assets for equity schemes in the period from January to July 2007. *(BS)*
- Concerned by the sudden decision by Uttar Pradesh and Kerala to order corporate retail chains to close their outlets, the Centre has asked these states to explain why the stores have been shut. *(FE)*
- India's telemarketing industry is likely to see a 25% slowdown in hiring and turnover growth in the coming months as the do-not-call registry goes live from September 1. *(ET)*

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, BL = Business Line.

EQUITY MARKETS

India	Change, %			
	27-Aug	1-day	1-mo	3-mo
Sensex	14,842	2.9	(2.6)	3.1
Nifty	4,303	2.7	(3.2)	1.1
Global/Regional indices				
Dow Jones	13,322	(0.4)	0.4	(1.4)
Nasdaq Composite	2,561	(0.6)	(0.0)	0.2
FTSE	6,220	0.4	0.1	(5.3)
Nikkei	16,332	0.2	(5.5)	(7.1)
Hang Seng	23,632	0.2	4.7	15.1
KOSPI	1,819	0.9	(3.4)	9.7
Value traded - India				
		Moving avg, Rs bn		
	27-Aug	1-mo	3-mo	
Cash (NSE+BSE)	123.9	157.4	154.5	
Derivatives (NSE)	527.5	657.8	425.3	
Deri. open interest	851.6	726.0	663.3	

Forex/money market

	Change, basis points			
	27-Aug	1-day	1-mo	3-mo
Rs/US\$	41.0	-	48	53
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.0	1	6	(22)

Net investment (US\$m)

	24-Aug	MTD	CYTD
FIs	103	(2,205)	8,030
MFs	38	640	383

Top movers -3mo basis

Best performers	Change, %			
	27-Aug	1-day	1-mo	3-mo
Chambal Fert	47	1.5	35.2	39.8
Thermax	606	1.0	(4.7)	25.9
Reliance Energy	762	3.6	(0.2)	38.4
BHEL	1,816	3.7	9.3	33.3
Crompton Greaves	291	5.7	3.3	21.1
Worst performers				
Escorts	79	3.1	(24.0)	(37.9)
Polaris	111	2.9	(9.2)	(33.2)
Balrampur Chini	53	2.1	(22.8)	(29.1)
Punjab Tractors	229	2.8	(14.5)	(26.0)
Raymond	257	0.9	(8.0)	(21.8)

Banking

Sector coverage view

Neutral

Company	Rating	Price, Rs	
		27-Aug	Target
SBI	IL	1,557	1,450
HDFC	IL	1,973	1,700
HDFC Bank	IL	1,121	1,250
ICICI Bank	OP	884	1,000
Corp Bk	IL	322	360
BoB	OP	263	330
PNB	OP	464	610
OBC	IL	200	240
Canara Bk	IL	234	250
LIC Housing	OP	186	240
Axis Bank	U	577	570
IOB	OP	117	150
Shriram Transf	OP	161	200
SREI	IL	93	110
MMFSL	IL	225	265
Andhra	OP	82	120
IDFC	IL	120	120
PFC	U	176	125

RBI discussion paper does not favour intermediary companies for subsidiaries; may adversely impact sentiment on ICICI Bank and SBI

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- **RBI is not in favour of the creation of intermediate holding companies within banks. Suggests the possibility of creating banks or financial holding companies instead (BHC/FHC)**
- **If RBI maintains this stance, it will derail plans of divestment in the insurance subsidiaries of both ICICI Bank and SBI**
- **We advise investors to buy ICICI Bank, given attractive valuations**

The RBI has released a discussion paper titled 'Holding Companies in Banking Groups' in response to applications made by ICICI Bank and SBI for setting up intermediary holding companies for their key non-bank operations. The regulator will accept comments on this paper over the next three weeks before finalizing its policy on the subject. The RBI is not in favour of banks creating intermediate holding companies and has suggested exploring the possibility of creating banks or financial holding companies (BHC/FHC) on the lines of financial structure operating in the US. However, this would call for considerable change in regulatory norms (which could take years) and this is a non-option for the banks at present. If the RBI maintains this stance, it will derail the plans of divestment in the insurance subsidiaries of both ICICI Bank and SBI.

Nevertheless, we believe there is significant value within the insurance business of both these companies and believe that investors should buy into ICICI Bank on any weakness due to this development. Besides, after the recent capital raising, ICICI Bank will likely be able to fund the insurance business in the immediate term. Our sensitivity analysis shows that ICICI Bank trades at attractive valuations of 1.2X FY2009 (standalone), even assuming lower valuation for the financial subsidiary.

The reasons cited by the regulator for not being in favor of an intermediate holding company within a bank are as follows:

- According to RBI, if a bank in India creates an intermediate holding company that confines its investments to the shares of group companies and does not carry out any other financial activities, it would not require registration under Section 45-I A of RBI Act, and will thus not be a regulated entity. This implies that RBI is concerned that an unregulated entity might do any of the following:
 - Take excessive risks and expose the bank to greater risks.
 - Refrain from providing critical information from the intermediary holding company, making it difficult for RBI to enforce prudential behavior by such an entity.

Based on our understanding of the act, RBI permission is required for setting up a NBFC, and therefore this will be a regulated entity. We believe the intention of SBI and ICICI Bank to divest stake and list the entities was to reduce financial burden on the banks and therefore reduce risk. Further, most financial entities in India will comply with RBI reporting requirements and RBI could provide restricted activity license to intermediate holding companies.

- Companies using this route circumvent legal restrictions on foreign ownership in sectors like insurance. As per current regulations, foreign ownership in Indian insurance companies cannot exceed 26%. However, when the holding company is a bank, foreign holding in the bank is not considered for calculating the 26% holding limit. According to the RBI, when a bank creates an intermediate holding company, which in turn holds an insurance company, such an exemption is not well defined in the statute. Even if the concerned regulator does provide an exemption for such a holding company, RBI believes the issue could still be open to legal review.

The direct foreign holding in insurance companies in India is limited at 26%—excluding foreign portfolio investment in the Indian holding/parent company. This is currently the case for both banks and non-banks, i.e. ICICI Bank, Bajaj Auto, HDFC Ltd, Max India and Aditya Birla Nuvo. In our view, this argument should be a non-issue as long as the JV partner (in the parent company) does not hold stock in the NBFC's intermediary holding company. This restriction is followed by HDFC Ltd.

RBI suggests floating of holding company. Instead of a bank creating an intermediate company within itself, the RBI has suggested creation of a bank holding company/ financial holding company. Under existing regulations, a bank's aggregate investments in financial services companies including subsidiaries are limited to 20% of paid up capital and reserves of the bank. In a BHC/FHC model, this restriction will not apply as the investment in subsidiaries and associates will be made directly by the BHC/FHC, releasing capital for the bank. However, this will require several regulatory changes:

- Banking Regulation Act, 1949 has to be modified to allow the creation of BHC
- A separate legislation would be required for companies to function as FHC
- Government holding in public banks through a BHC/FHC is not possible under the current regulations and this too will need to be incorporated in the Act
- Currently, the voting rights are restricted to a maximum of 10% in private banks and 1% in PSU banks. These threshold limits will have to be redefined in India
- Internationally, the key difference between a BHC and FHC is as follows: a BHC is allowed to make only limited investments in the non-banking companies, whereas FHC can invest in banking and non-banking financial entities
- The RBI will have to be given the power to regulate such entities

SOTP valuation of ICICI Bank

	ICICI Share (%)	Assuming ICICI Financial Services value at US\$7 bn	Ascribing 20% discount on ICICI Financial Services valuation - US\$8.8 bn	Assuming ICICI Financial Services value at US\$11 bn	Valuation methodology adopted
Value of ICICI standalone	100	546	546	546	Based on Residual growth model
Subsidiaries					
ICICI Financial Services	94	256	306	382	
ICICI Prudential Life	74*	203			
General Insurance	74*	37			
Mutual Fund	51*	16			
Other subsidiaries/associates					
ICICI Securities Ltd	100	25	25	25	PER of 45X FY2007 EPS
ICICI Securities Primary Delaer	100	19	19	19	PBR of 5X FY2007 BVPS
ICICI Homes Ltd	100	6	6	6	PBR of 2X FY2007 BVPS
ICICI Bank UK	100	14	14	14	PBR of 2X FY2007 BVPS
ICICI Bank Canada	100	6	6	6	PBR of 2X FY2007 BVPS
ICICI Bank Euroasia	100	4	4	4	PBR of 2X FY2007 BVPS
3i	11.18	2	2	2	Market value
Venture capital/MF	100	19	19	19	15% of AUM FY2009E of US\$2.6bn
ICICI One Source	25	11	11	11	20% premium over Market value
NCDEX	8	1	1	1	Valued at US\$300 mn based on last transaction
ARCIL	29.7	2	2	2	Based on value assigned by IDFC at Rs7.15bn
NSE	5.5	6	6	6	Based on value assigned by recent divestment to FT. NSE valued @ Rs125 bn
Value of subsidiaries		371	421	497	
Value of company		917	966	1,043	

Source: Company, Kotak Institutional Equities estimates.

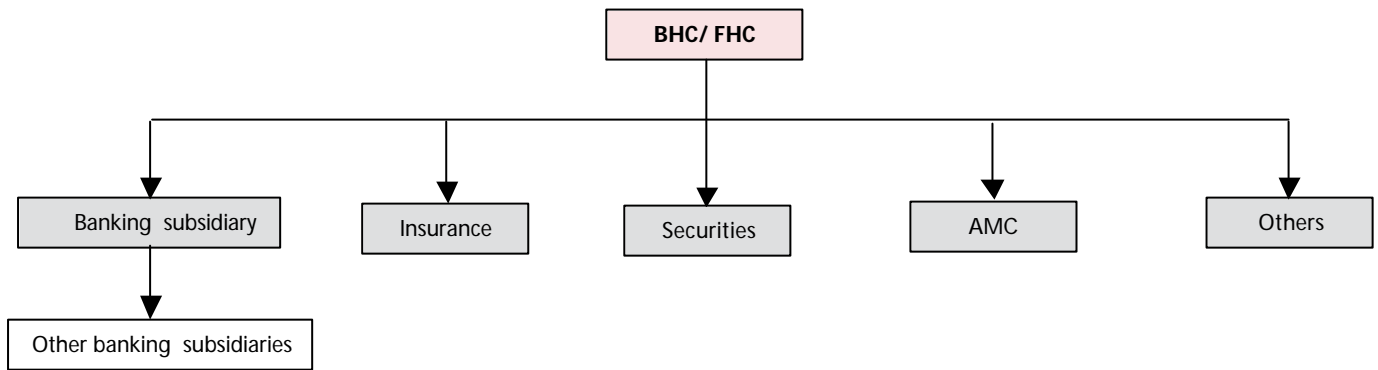
Forecasts and valuation for ICICI Bank

March fiscal year-ends, 2005-2010E.

	EPS (Rs)	P/E (X)	BVPS (Rs)	P/B (X)	RoE (%)	P/E (standalone) (X)	BVPS (standalone) (Rs)	P/B (standalone) (X)	Assuming value of US\$11 bn for IFS		Assuming value of US\$7 bn for IFS	
									P/E (standalone) (X)	P/B (standalone) (X)	P/E (standalone) (X)	P/B (standalone) (X)
2005	27.2	32.5	170.3	5.2	19.5	26.8	142.3	3.3	22.4	2.7	29.7	3.6
2006	32.8	27.0	249.6	3.5	14.6	24.7	217.4	2.1	20.6	1.8	27.4	2.4
2007E	34.6	25.5	270.4	3.3	13.4	26.9	225.1	2.1	22.5	1.7	29.8	2.3
2008E	35.0	25.2	426.9	2.1	10.8	18.4	385.9	1.2	15.4	1.0	20.4	1.3
2009E	51.3	17.2	463.3	1.9	11.5	10.8	418.1	1.1	9.0	0.9	12.0	1.2
2010E	63.6	13.9	508.3	1.7	13.1	8.2	463.1	1.0	6.9	0.8	9.1	1.1

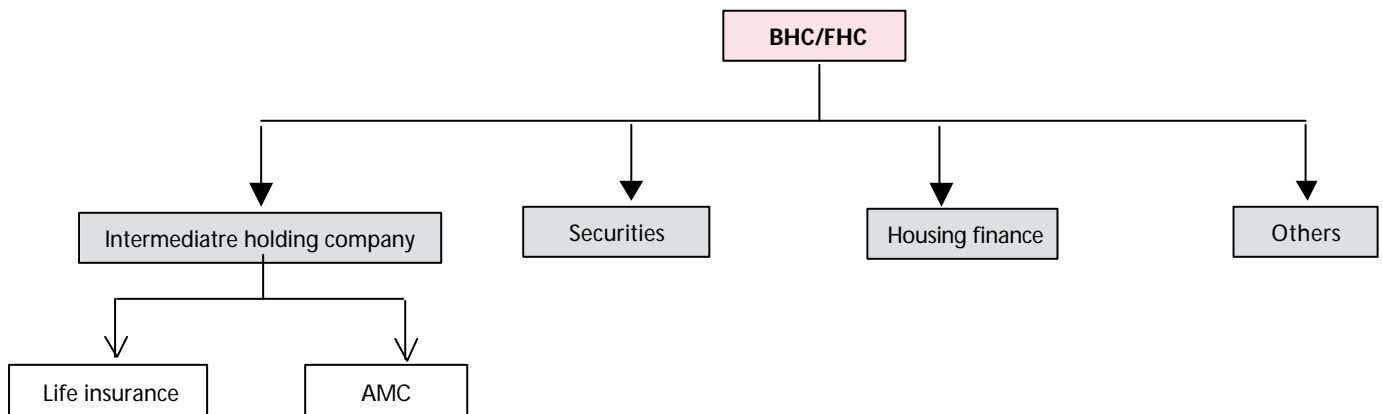
Source: Company, Bloomberg, Kotak Institutional Equities.

Illustration of a banking and financial holding company



Source: RBI.

Illustration of a banking and financial holding company with an intermediate holding company

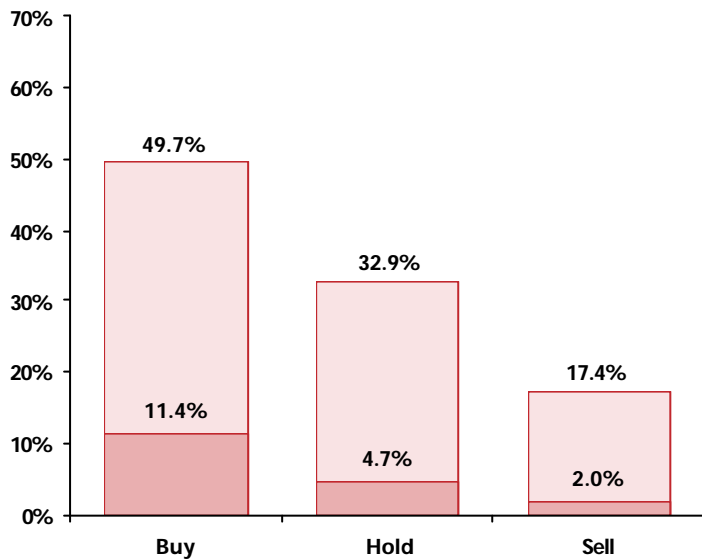


Source: RBI.

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Source: Kotak Institutional Equities.

As of June 30, 2007

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