Daiwa Capital Markets

Company

Financials / India
25 September 2013

The 10-second briefing

Yes Bank
YES IN

Target (INR): **585.00 → 532.00**
Upside: **69.2%**
25 Sep price (INR): **314.50**

Upgrading: doing much better than the market thinks

- Market concerns over Yes Bank's funding issues since the RBI's recent liquidity-tightening moves appear overdone
- Yes Bank is less exposed to risky infrastructure loans than its peers and hence should trade at a higher PBR
- Upgrading to Buy, as we expect the funding environment to improve given the recent return of foreign-exchange stability

1 Buy (from Outperform)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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■ What's new
We expect the funding environment for Yes Bank to improve post the return of some stability in the foreign-exchange market since mid-September, and especially following the RBI's latest 75bps reduction in the rate on the marginal standard facility (MSF). Also, we believe the market has been unduly pessimistic about Yes Bank's short-term NIM outlook. Further, we expect the bank's asset quality to stay healthy over FY14-15, despite a possible slowdown in its loan growth.

■ What's the impact
Investors seem concerned that Yes Bank may have to resort to high-cost certificates of deposit (CD) to fund its balance sheet since the tightening measures were announced. But, we note that the bank has not used this source of funding much in the past couple of months. As it implemented a 25bp base-rate hike on 1 August, we estimate any NIM compression for 2Q FY14 will be manageable, at 5-8bps QoQ at most.

Another concern is the perceived mark-to-market (MTM) losses in the bank's sizeable corporate-bond portfolio. However, management has stated that the bank's portfolio is making much less of a loss than the market believes.

We cut our net profit forecasts by 10% for FY14 and 8% for FY15 to factor in our expectations of lower loan growth and a flat NIM (vs. NIM expansion we assumed previously).

■ What we recommend
We lower our Gordon Growth Model-derived six-month target price to INR532 (from INR585), now equivalent to a 2.7x FY14E PBR (previously 2.9x), to factor in the difficult domestic macro climate. However, we upgrade our rating to Buy (1) from Outperform (2), as we believe Yes Bank will continue to deliver an ROE of 24-27% for FY15, the highest level in our coverage universe, assuming no equity dilution. Renewed Rupee weakness would be the main risk to our call.

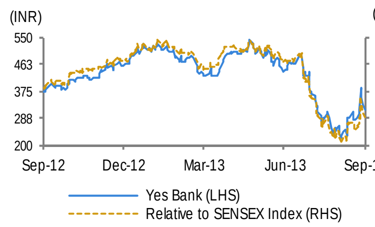
■ How we differ
Our EPS forecasts are higher than consensus by 3.4% for FY14 and 15.5% for FY15, as we think we have more faith in the bank's management to deliver strong results despite the difficult macro environment.

Forecast revisions (%)

Year to 31 Mar	14E	15E	16E
PPOP change	(6.8)	(2.8)	n.a.
Net profit change	(10.4)	(7.7)	n.a.
Core EPS (FD) change	(11.8)	(9.1)	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	225.90-542.60
Market cap (USDbn)	1.80
3m avg daily turnover (USDm)	69.24
Shares outstanding (m)	359
Major shareholder	Madhu Kapur Group (9.8%)

Financial summary (INR)

Year to 31 Mar	14E	15E	16E
Total operating income (m)	43,529	58,063	75,848
Pre-provision operating profit(m)	26,180	35,510	46,528
Net profit (m)	15,578	21,121	27,810
Core EPS (fully-diluted)	43.440	58.896	77.547
EPS change (%)	18.8	35.6	31.7
Daiwa vs Cons. EPS (%)	3.4	15.5	n.a.
PER (x)	7.2	5.3	4.1
Dividend yield (%)	2.4	3.0	3.7
DPS	7.500	9.500	11.500
PBR (x)	1.6	1.3	1.0
ROE (%)	24.2	26.7	28.1

Source: FactSet, Daiwa forecasts

1 Buy (from Outperform)
2 Outperform
3 Hold
4 Underperform
5 Sell

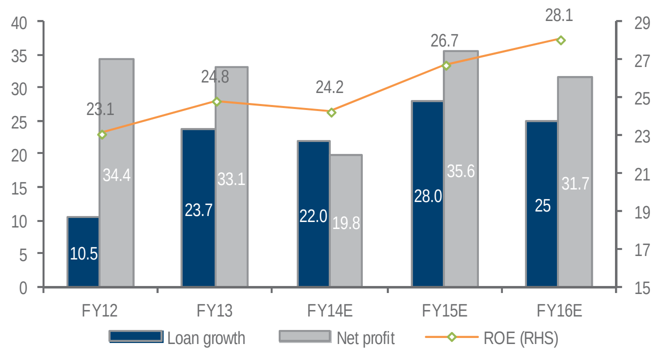
How do we justify our view?

- Growth outlook ✓ ✓ ✓ ✓ ✓
- Valuation ✓ ✓ ✓ ✓ ✓
- Earnings revisions ✓ ✓ ✓ ✓ ✓

Growth outlook ✓ ✓ ✓ ✓ ✓

Driven by our projection of a 25% loan CAGR for FY13-16 and steady margins, we forecast a net-profit CAGR of 29% for the period. This, coupled with low credit costs, should lead to ROE expansion of nearly 330bps over the period, from 24.8% for FY13 to 28.1% for FY16E.

Yes Bank: loan growth, net-profit growth (YoY %) and ROE (%)

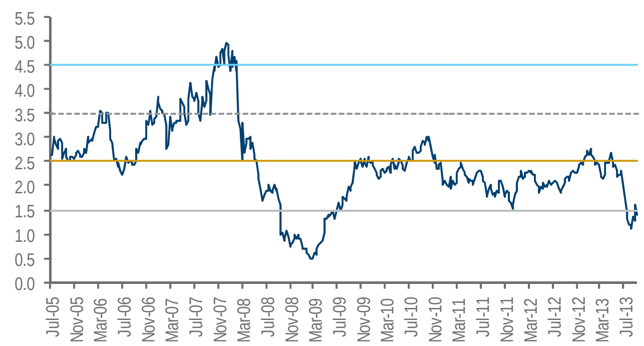


Source: Company, Daiwa forecasts

Valuation ✓ ✓ ✓ ✓ ✓

The stock is trading currently at a one-year rolling-forward PBR of 1.4x, which is at a significant discount to its respective past-three-year and past-five-year trading average PBRs of 2.2x and 2x. However, as we believe Yes Bank's asset quality is the best in its sector and we forecast it to deliver the highest ROE for FY14-15 in our coverage universe, we believe its current valuations are attractive.

Yes Bank: one-year rolling forward PBR bands (x)

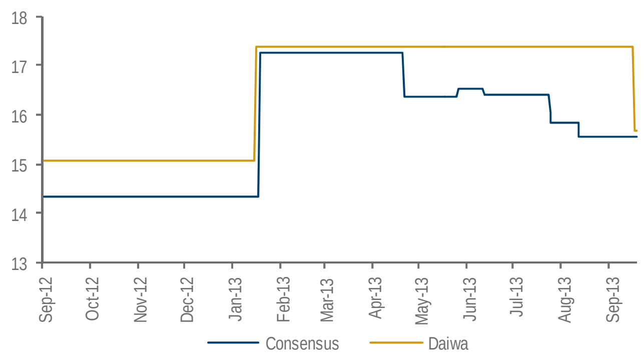


Source: Bloomberg, Daiwa forecasts

Earnings revisions ✓ ✓ ✓ ✓ ✓

We are cutting our FY14 net-profit forecast by 10% as we are lowering our loan-growth forecast for the period to 22% YoY (formerly 26% YoY) and now assume a flat NIM (vs. NIM expansion previously) to factor in the tight liquidity conditions. Over the past few years, Yes Bank has consistently beaten the Bloomberg consensus earnings forecasts. Thus, though the consensus net profit forecasts have been reduced by 6% over the past three months to factor in the tough macro environment, over the past 12 months the consensus net profit forecasts have still risen by 4%.

Yes Bank: Daiwa vs. consensus net profit for FY14E (INRbn)



Source: Bloomberg, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Loan growth (YoY%)	31.5	78.9	54.8	10.5	23.7	22.0	28.0	25.0
Deposit growth (YoY%)	21.8	65.7	71.4	7.0	36.2	24.2	30.1	31.7
Average yield on advances (%)	13.6	10.2	10.6	12.2	12.7	12.6	12.0	11.9
Average cost of deposits (%)	8.3	5.8	6.3	8.1	7.9	7.7	6.8	6.6

Profit and loss (INRm)

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Net-interest income	5,093	7,880	12,469	16,156	22,188	28,037	38,069	50,016
Net fees & commission	2,258	3,791	5,870	7,677	10,762	13,453	17,488	22,735
Trading and other income	2,111	1,964	363	894	1,812	2,040	2,506	3,097
Net insurance income	0	0	0	0	0	0	0	0
Total operating income	9,462	13,635	18,702	24,727	34,762	43,529	58,063	75,848
Personnel expenses	(2,180)	(2,569)	(3,623)	(4,752)	(6,555)	(8,522)	(11,079)	(14,402)
Other expenses	(2,005)	(2,433)	(3,175)	(4,574)	(6,790)	(8,827)	(11,475)	(14,918)
Total expenses	(4,185)	(5,002)	(6,798)	(9,325)	(13,345)	(17,349)	(22,554)	(29,320)
Pre-provision operating profit	5,277	8,633	11,904	15,402	21,417	26,180	35,510	46,528
Total provision	(617)	(1,368)	(982)	(902)	(2,160)	(2,929)	(3,985)	(5,021)
Operating profit after prov.	4,660	7,265	10,922	14,500	19,257	23,251	31,524	41,507
Non-operating income	0	0	0	0	0	0	0	0
Profit before tax	4,660	7,265	10,922	14,500	19,257	23,251	31,524	41,507
Tax	(1,621)	(2,488)	(3,650)	(4,730)	(6,251)	(7,673)	(10,403)	(13,697)
Min. int./pref. div./other items	0	0	0	0	0	0	0	0
Net profit	3,039	4,777	7,271	9,770	13,007	15,578	21,121	27,810
Adjusted net profit	3,039	4,777	7,271	9,770	13,007	15,578	21,121	27,810
EPS (INR)	10.253	15.008	21.174	27.908	36.556	43.440	58.896	77.547
EPS (adjusted) (INR)	10.253	15.008	21.174	27.908	36.556	43.440	58.896	77.547
EPS (adjusted fully-diluted) (INR)	10.253	15.008	21.174	27.908	36.556	43.440	58.896	77.547
DPS (INR)	0.000	1.500	2.500	4.000	6.000	7.500	9.500	11.500

Change (YoY %)

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Net-interest income	54.1	54.7	58.2	29.6	37.3	26.4	35.8	31.4
Non-interest income	21.1	31.7	8.3	37.5	46.7	23.2	29.1	29.2
Total operating income	36.9	44.1	37.2	32.2	40.6	25.2	33.4	30.6
Total expenses	22.7	19.5	35.9	37.2	43.1	30.0	30.0	30.0
Pre-provision operating profit	50.7	63.6	37.9	29.4	39.1	22.2	35.6	31.0
Total provisions	41.6	121.7	(28.2)	(8.1)	139.4	35.6	36.1	26.0
Operating profit after provisions	52.0	55.9	50.3	32.8	32.8	20.7	35.6	31.7
Profit before tax	52.0	55.9	50.3	32.8	32.8	20.7	35.6	31.7
Net profit (adjusted)	51.9	57.2	52.2	34.4	33.1	19.8	35.6	31.7
EPS (adjusted, FD)	47.6	46.4	41.1	31.8	31.0	18.8	35.6	31.7
Gross loans	31.4	78.5	55.4	10.5	23.5	22.2	28.0	25.0
Deposits	21.8	65.7	71.4	7.0	36.2	24.2	30.1	31.7
Total assets	34.9	58.9	62.2	24.8	34.5	24.0	28.0	29.6
Total liabilities	35.8	56.5	65.8	24.9	35.2	24.2	28.2	29.8
Shareholders' equity	23.1	90.2	22.8	23.3	24.2	21.4	24.3	26.2
Avg interest-earning assets	40.0	49.8	63.3	37.1	29.1	26.9	24.2	27.0
Avg risk-weighted assets	35.8	30.5	56.1	38.6	25.3	25.2	25.3	26.3

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (INRm)

As at 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Cash & equivalent	19,227	26,732	34,960	35,855	40,658	36,592	40,251	44,276
Investment securities	71,170	102,099	188,288	277,574	429,760	524,308	671,114	872,448
Net loans and advances	124,031	221,931	343,636	379,886	469,996	573,395	733,945	917,432
Fixed assets	1,311	1,155	1,324	1,771	2,296	2,525	2,778	3,055
Goodwill	0	0	0	0	0	0	0	0
Other assets	13,269	11,907	21,861	41,535	48,332	92,149	124,752	201,163
Total assets	229,008	363,825	590,070	736,621	991,041	1,228,969	1,572,839	2,038,374
Customers deposits	161,694	267,986	459,389	491,517	669,556	831,533	1,082,046	1,425,407
Borrowing	21,891	25,639	33,330	93,432	141,483	169,780	203,736	244,483
Debentures	15,126	21,852	33,579	48,133	67,738	81,286	89,415	98,356
Other liabilities	14,055	17,453	25,831	56,773	54,187	75,862	110,000	159,500
Total liabilities	212,766	332,930	552,129	689,855	932,965	1,158,460	1,485,196	1,927,746
Share capital	2,970	3,397	3,472	3,530	3,586	3,586	3,586	3,586
Reserves & others	13,272	27,499	34,469	43,237	54,491	66,922	84,057	107,042
Shareholders' equity	16,242	30,895	37,941	46,766	58,077	70,508	87,643	110,628
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	229,008	363,826	590,070	736,621	991,041	1,228,969	1,572,839	2,038,374
Avg interest-earning assets	188,818	282,819	461,822	633,198	817,514	1,037,550	1,288,681	1,636,588
Avg risk-weighted assets	168,567	219,926	343,251	475,628	596,075	746,279	935,067	1,181,138
BVPS (INR)	54.691	90.958	109.292	132.486	161.945	196.610	244.391	308.482

Key ratios (%)

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Loan/deposit	76.6	82.5	74.8	77.2	70.0	68.9	67.8	64.3
Tier-1 CAR	9.5	12.9	9.7	9.9	9.5	8.7	8.2	8.0
Total CAR	16.6	20.6	16.5	17.9	18.3	16.7	15.0	13.9
NPLs/gross loans	0.7	0.3	0.2	0.2	0.2	0.4	0.6	0.8
Total loan-loss prov./NPLs	51.5	78.4	88.6	79.1	92.6	80.0	80.0	80.0
ROAA	1.5	1.6	1.5	1.5	1.5	1.4	1.5	1.5
ROAE	20.7	20.3	21.1	23.1	24.8	24.2	26.7	28.1
Net-interest margin	2.7	2.8	2.7	2.6	2.7	2.7	3.0	3.1
Gross yield	10.6	8.4	8.8	10.0	10.1	10.4	9.8	9.8
Cost of funds	8.6	6.2	6.6	8.1	8.0	8.1	7.2	7.0
Net-interest spread	2.0	2.2	2.1	1.9	2.1	2.3	2.6	2.8
Total cost/total income	44.2	36.7	36.3	37.7	38.4	39.9	38.8	38.7
Effective tax	34.8	34.2	33.4	32.6	32.5	33.0	33.0	33.0
Dividend-payout	0.0	10.0	11.8	14.3	16.4	17.3	16.1	14.8

Source: FactSet, Daiwa forecasts

Company profile

Yes Bank is a private-sector bank with total assets of INR1008bn as at the end of June 2013. Established in 2004, it is a new private-sector bank, as classified by the Reserve Bank of India. The company has 475 branches across India. It is primarily a wholesale bank catering to the lending needs of corporates.

Upgrading: doing much better than the market thinks

We believe Yes Bank's valuations already factor in pressure on its NIM and other potential negatives.

Why are we positive on Yes Bank at current share-price levels?

We analyse some of the key investor concerns surrounding Yes Bank and explain our positive stance on the stock. Some of the concerns regarding Yes Bank are as follows:

1.) NIM: With wholesale funding accounting for 62% of Yes Bank's outstanding deposits as of 1Q FY14, won't its NIM come under considerable pressure following the recent spike in short-term interest rates?

2.) Loan growth: With the bank keen on protecting margins going forward, won't credit growth suffer, leading to a rise in the bank's operating costs and cost/income ratio, given its aggressive branch expansion policy over the past 24 months?

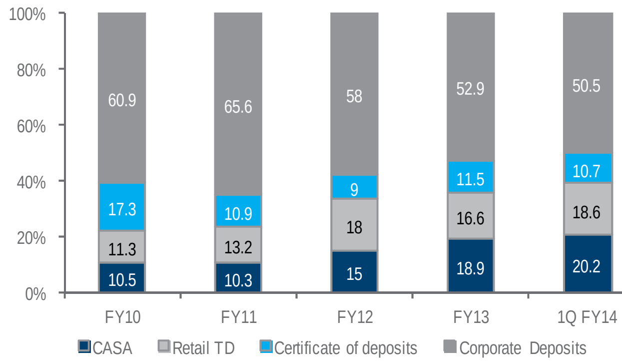
3.) Corporate bond portfolio: The bank has a sizeable corporate bond portfolio (INR90bn as at end-June 2013), which could see significant MTM losses if high yields become the norm in the near to medium term.

4.) Asset quality: Asset quality, which at Yes Bank remains the best in its sector, in our view, could deteriorate following concerns of a possible reversal in the interest-rate cycle, stretched working-capital cycles, and a worsening of macro conditions.

Market expectations of NIM pressure look overdone

As Yes Bank's liabilities profile is primarily wholesale in nature, there have been widespread investor concerns about possible NIM compression for the bank following the spike in short-term interest rates after the RBI's tightening measures in July 2013. Although we estimate that Yes Bank's NIM could contract by a mere 5-8bps QoQ, if at all, in 2Q FY14, base-rate hikes should protect its NIM going forward, in our view.

■ Yes Bank: breakdown of deposits



Source: Company
*Note: *TD: Term deposits*

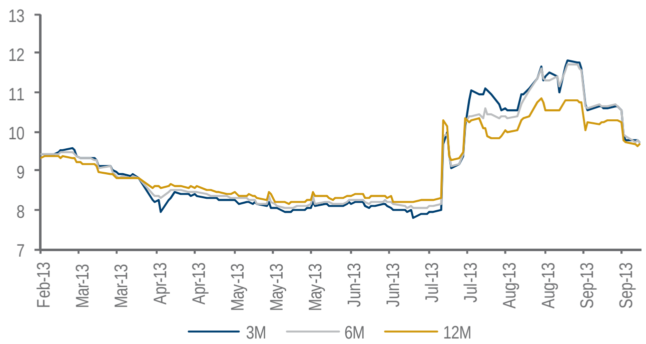
Incremental cost of funds is higher, but base rate hikes and RBI's partial reversal of liquidity-tightening measures should provide a cushion

Following the measures announced by the RBI on 15 July, the incremental cost of deposits for Yes Bank has gone up by around 120-130bps to 9.8-9.9%, compared with its overall outstanding blended cost of deposits of 8.6%. According to management, about one-quarter of the bank's deposit base (leaving aside the CASA [current and savings account] proportion of 20%) is expected to come up for re-pricing every quarter. Hence, looking at 2Q FY13, we expect the cost of deposits to increase by 20-25bps. Further, we forecast the bank's borrowing costs to increase by 5-10bps during 2Q FY14, leading to an overall increase of 30-35bps in its cost of funds.

In response to the increase in the cost of funding, Yes Bank raised its base rate by 25bps to 10.75% with effect from 1 August. As such, the immediate upward re-pricing of around 75% of the bank's outstanding loan book should help to protect its NIM. Management expects the NIM to come under slight pressure in 2Q FY14; we estimate a NIM contraction for the quarter of 5-8bps QoQ, if at all.

Furthermore, as the RBI has partially reversed its liquidity-tightening measures announced in July by reducing the rate on the MSF by 75bps over the past week, and indicated that the rate could be reduced further once more exchange-rate stability is attained, we believe the incremental funding environment has improved for Yes Bank. The CD Rate Index (which is a good proxy for wholesale rates in India) has already corrected by 190-200bps over the past month, as the following chart shows.

■ India: CD Rate Index (%)

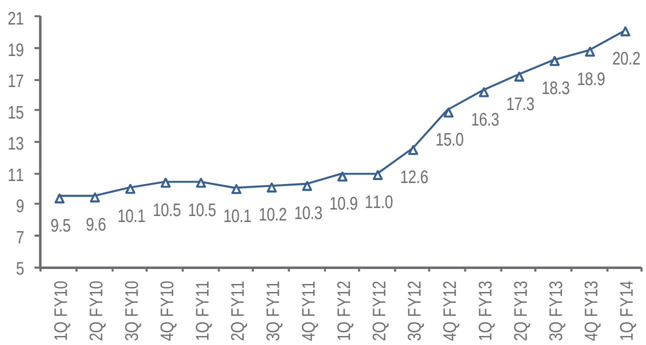


Source: Bloomberg

Improving CASA profile should also help to protect margins

Following the deregulation of interest rates on savings accounts in October 2011, Yes Bank is one of the few banks in India offering a rate on its savings accounts that is 2-3pp above the 4% rate offered by most large banks. This policy has allowed Yes Bank to increase the amount of savings accounts at a much faster rate than the rate at which its overall deposits have expanded, and as a result its CASA accounted for 20.2% of its deposits as of 1Q FY14 (vs. 10.9% in 1Q FY12). This improving liabilities franchise help further to protect the bank's NIM going forward, in our view.

■ Yes Bank: CASA (% of deposits)



Source: Company

Though we expect the RBI's liquidity-tightening measures to be temporary in nature, Yes Bank's management has indicated that if the measures were to continue for a sustained period, the bank is ready to implement base-rate hikes at regular intervals in order to protect its margin.

As the retail-liability franchise of the bank remains small, some investors seem to think that Yes Bank might have to raise high-cost CDs in the money markets in order to meet its short-term balance-sheet funding requirements. However, management has clarified that the bank is not using this source of funding much on an incremental basis.

New RBI measures should also help keep cost of funds in check

Following the appointment of the new governor in early September, in a bid to curtail exchange-rate volatility, the RBI announced several measures on the currency front.

1.) **Foreign borrowings:** The RBI has allowed banks to raise foreign borrowings amounting to 100% of their Tier-1 capital (previously this limit was 50%) and swap these into local currency at 100bps below the prevailing market rates.

2.) **Foreign currency non-resident bank FCNR (B) deposits:** The RBI has offered a window to banks to swap their fresh FCNR (B) dollar deposits, for a minimum duration of three years or more, at a fixed concessional rate of 3.5% per year (versus the current market rate of around 6-7%). Both of the above-mentioned facilities are available until 30 November 2013 for now.

Yes Bank became the first bank in India to make use of the swap facility benefits offered by the RBI on foreign borrowing. On 18 September, it announced that it had raised USD255m (USD180m and EUR58m) in foreign borrowing with a maturity of one and two years (with a major portion in the latter). According to management, the cost of the borrowing in Rupee terms after using the swap facility would work out to be close to 8.5-8.75%, which is around 100-150bps lower than the prevailing market rates for similar maturities.

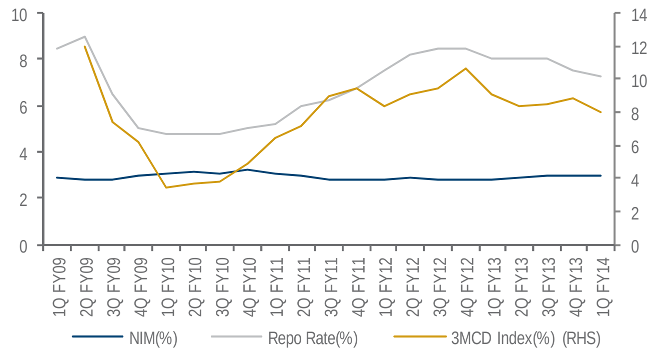
NIM outlook

Despite a rise in short-term interest rates at various points of time during the previous interest-rate cycle (2Q FY09-4Q FY12), the bank was able to maintain its NIM, and there is no reason for us to believe that it will see any substantial pressure on the NIM in the current environment as well.

As can be seen from the following chart, Yes Bank has demonstrated its ability to maintain its NIM across interest-rate cycles. At the end of 4Q FY12, when the repo rate stood at 8.5% and the 3M CD Index was trading at 10.7%, Yes Bank was still able to maintain a NIM of 2.8%. Moreover, it is worth noting that at the end of 4Q FY12, wholesale deposits (including CDs) formed 67% of the total deposit base of Yes Bank, a ratio which at the end of 1Q FY14 stood at 62%.

The bank's NIM at the end of 1Q FY14 was 3%.While management is confident of restricting the NIM contraction to a maximum 10-15bps YoY for FY14, even if the RBI's liquidity-tightening measures continue for longer than expected, we estimate a flat NIM for FY14.

■ **Yes Bank: NIM (%), repo rate (%), 3M CD Index (%)**



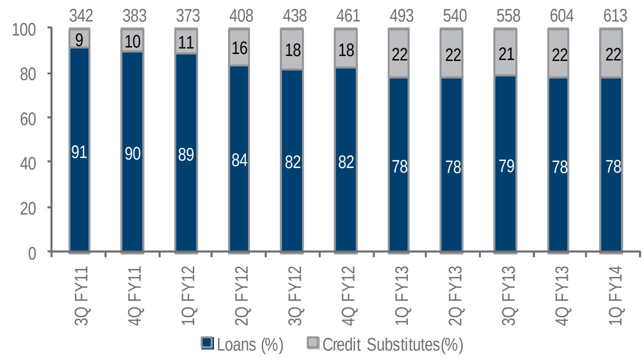
Source: Bloomberg, Bank

Slowdown in loan growth not a negative in current environment

While some slowdown in loan growth is generally a natural consequence of a focus on NIM and a tough macro environment, some slowdown in loan growth for Yes Bank in a bid to protect its NIMs would not be a negative in the current macro climate, in our view. Management is confident of maintaining loan growth of at least 20% YoY for FY14.

Given the recent rise in short-term interest rates, we believe corporates would prefer traditional loan products, rather than credit substitutes like commercial paper (CP), for their funding requirements.

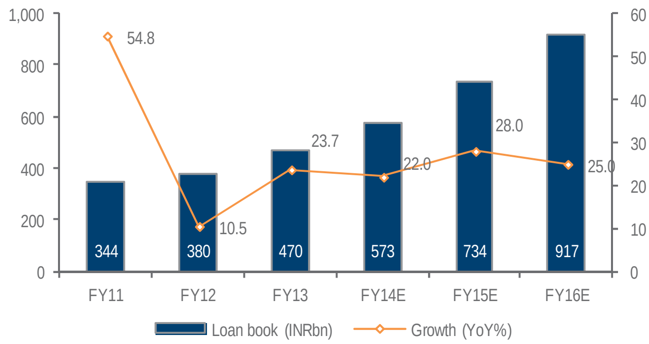
■ **Yes Bank: total customer assets (INRbn)**



Source: Company

Some 22% of Yes Bank's total customer assets are currently in the form of credit substitutes, and we expect a substantial portion of these products to shift to short-term loans over the next 3-6 months. Consequently, though we expect some slowdown in the rate of loan growth compared to FY13, we forecast loan growth of 22% YoY for Yes Bank for FY14.

■ **Yes Bank: loan book (INRbn) and loan growth (YoY %)**



Source: Daiwa forecasts

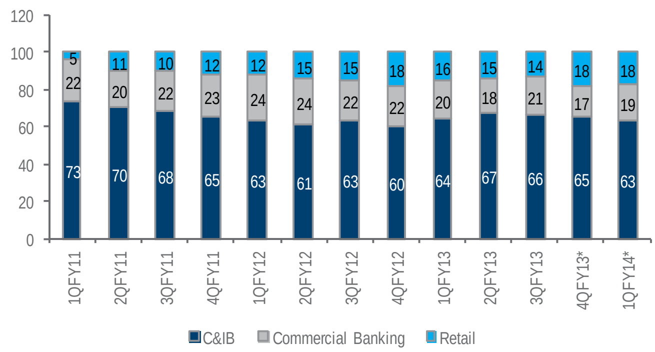
Corporate & institutional banking (turnover of over INR10bn): The corporate and institutional banking division caters to large corporates, with annual turnover in excess of INR10bn. While we expect some slowdown in loan growth here, owing to the slowdown in corporate activities, the asset quality of this portfolio, which comprises about 63% of the bank's total loan book, should remain strong. Though this segment's loans represent a substantial proportion of the bank's overall loan book, most of these segmental loans are put towards corporates' working-capital requirements, and thus are less risky and less prone to becoming NPLs or being restructured. Furthermore, Yes Bank has low exposure to risky infrastructure project loans – a key positive, in our opinion.

Commercial banking (turnover of INR1-10bn): The commercial banking division caters to mid-sized corporates with a turnover of INR1-10bn. Here again, since the focus is on working capital and other short term loans, asset quality is expected to remain stable.

Of Yes Bank's total corporate and commercial banking portfolio, around 80% of the loans belong to the working capital segment.

Retail banking (including MSME): Yes Bank's retail banking division, which comprises 18% of its overall customer assets (loans + credit substitutes), includes the MSME sector, self-originated retail loans and priority sector loan (PSL) buyouts. Of the total 18% of retail banking loans, around 7% belong to the MSME sector, 7% to PSL buyouts and about 2% comprise self-originated retail loans. We believe this portfolio will also remain healthy in terms of asset quality.

■ **Yes Bank: breakdown of customer assets**



Source: Bank

Some investors argue that given the rapid pace of branch expansion and employee additions witnessed by Yes Bank over the past five years, a possible fallout of slower growth in customer assets would be the reverse impact of operating leverage playing out, leading to an increase in operating costs and its cost-to-income ratio.

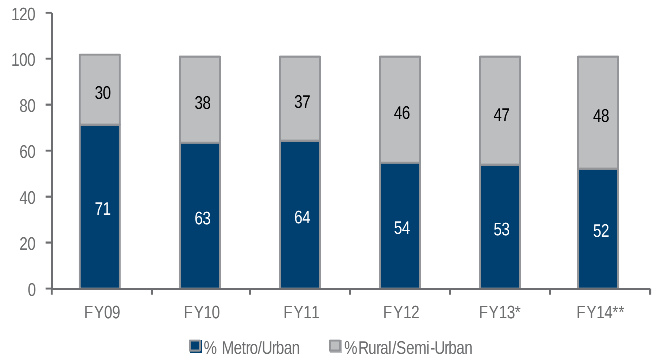
■ **Yes Bank: growth in number of branches and employees**

Yes Bank	FY09	FY10	FY11	FY12	FY13	CAGR, FY09-13 (%)
Branches	117	150	214	356	430	38
YoY %		*28*	*43*	*66*	*21*	
Employees	2,671	3,034	3,929	5,642	7,024	27
YoY %		*14*	*29*	*44*	*24*	

Source: Company

While we see some merit to the above argument, we think these concerns are overdone, as a large part of the new branch expansion has actually taken place in low cost rural/non-urban centres, and hence would not pose a major risk to the bank's cost-to-income ratio. At the end of FY09, 71% of Yes Bank's branches were present in metro/urban areas. This ratio has fallen to 52% currently. We forecast the bank's cost/income ratio to rise from 38.4% recorded for FY13 to 39.9% in FY14.

■ **Yes Bank: breakdown of no. of rural vs. urban branches (%)**



Source: Company
*Note: * Daiwa's estimate, ** as at 15 August 2013*

Even though a major portion of this increased rural/semi-urban thrust has been driven by regulatory requirements, as the RBI (in May 2011) made it mandatory for domestic banks to open 25% of their new branches every year in 'unbanked' rural areas, this increased focus on rural/semi-urban areas has benefited Yes Bank in terms of improving its priority sector lending targets, and also provided new opportunities to increase its retail asset and liability franchise. For FY13, Yes Bank was able to meet the RBI's overall priority sector target even though it missed the sub-sector target of direct agriculture by INR8-9bn.

Positives of the corporate bond portfolio outweigh the negatives

Against the current background of high volatility in yields of securities, Yes Bank's corporate bond portfolio has attracted investor scrutiny on account of the expected MTM losses due to the rising yields. According to management, however, for a relatively new bank like Yes Bank, these corporate bonds act as important instruments for forming new corporate relationships, the benefits of which later accrue in both interest and non-interest income gains (especially fee income). The building up of these corporate bonds in the balance sheet has helped the bank forge many new blue-chip corporate relationships, such as with Mukesh Dhirubhai Ambani Group (MDAG), Tata Steel, Hindalco, and Mahindra & Mahindra.

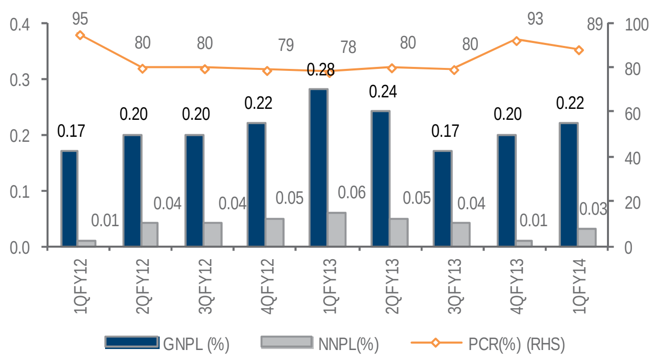
As of 1Q FY14, Yes Bank's corporate bond portfolio stood at INR85bn with an AFS duration of 3 years and an average blended yield of 10.55%. Most of its investments in corporate bonds have taken place over the past two years when yields were high. Our discussion with management suggests that the bank was sitting on substantial MTM gains before 15 July, which have since been neutralised post the RBI tightening measures. However, even if the current regime of high yields were to prevail for longer than expected, management has ruled out any substantial MTM loss on these investments. Moreover, the asset quality of these investments continues to be pristine, with a median rating of AA+, and the weighted average rating being even higher.

It is worth noting that a negligible portion of Yes Bank's government bonds portfolio is currently in the available for sale/held for trading category, and hence the bank should be well protected from any MTM losses arising out of the hardening yields.

Asset quality to remain healthy

Yes Bank's restructuring pipeline remains negligible, and management does not expect any negative surprise on fresh NPLs either. The bank has solid risk management capabilities in place and we expect it to maintain best-in-sector asset quality – notwithstanding the temporary tightening measures of the RBI.

■ **Yes Bank: GNPLs (%), NNPLs (%) and PCR (%)**



Source: Company

As of 1Q FY14, Yes Bank had a provisioning-coverage ratio of 89%, one of the best within our coverage universe, underpinning our conviction in the bank's asset quality. It has been concentrating on working-capital loans and other short-term loans while having negligible exposure to long-term project loans, which have been the major source of stress for most public-sector banks and many private sector banks as well.

Thus, despite India's challenging economic environment over the past 18 months, Yes Bank has been able to maintain strong asset quality. Given its very good track record, the bank's guidance of a 50-60bps credit cost for FY14 appears manageable to us.

Financials: strong growth in earnings over next two years

Driven by our forecast for a 25% loan CAGR for FY13-16 and steady margins, we expect Yes Bank's net profit to rise by a 29% CAGR for FY13-16. The stable margins that we expect should, in turn, be led by an improving liability mix. Combined with low credit costs, we believe this should lead to ROE expansion of nearly 330bps over the period, from 24.8% in FY13 to 28.1% for FY16. However, we believe the bank may need to raise capital as and when stock market conditions improve.

■ **Yes Bank: ROE matrix (%)**

	FY10	FY11	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	8.0	8.5	9.5	9.6	9.7	9.0	8.8
Interest expended	5.3	5.9	7.1	7.0	7.2	6.3	6.1
Gross Interest Spread	2.7	2.6	2.4	2.6	2.5	2.7	2.8
Other Income	1.9	1.3	1.3	1.5	1.4	1.4	1.4
- Fee Income	1.5	1.4	1.2	1.3	1.3	1.3	1.3
- Treasury Income	0.3	(0.1)	0.1	0.2	0.2	0.1	0.1
- Provisioning for Investments	0.1	(0.0)	0.0	(0.0)	0.0	0.0	0.0
-Others	0.1	0.0	0.0	(0.0)	(0.0)	(0.0)	(0.0)
Net Income	4.5	3.9	3.7	4.0	3.9	4.1	4.2
Operating expenses	1.7	1.4	1.4	1.5	1.6	1.6	1.6
-Staff Cost	0.9	0.8	0.7	0.8	0.8	0.8	0.8
-Other operating expenses	0.8	0.7	0.7	0.8	0.8	0.8	0.8
Operating profit	2.9	2.5	2.3	2.5	2.4	2.5	2.6
Provisions	0.4	0.2	0.1	0.3	0.3	0.3	0.3
PBT	2.5	2.3	2.2	2.2	2.1	2.3	2.3
Tax	0.8	0.8	0.7	0.7	0.7	0.7	0.8
ROA	1.6	1.5	1.5	1.5	1.4	1.5	1.5
Leverage(x)	12.6	13.9	15.7	16.5	17.3	17.7	18.2
ROE	20.3	21.1	23.1	24.8	24.2	26.7	28.1

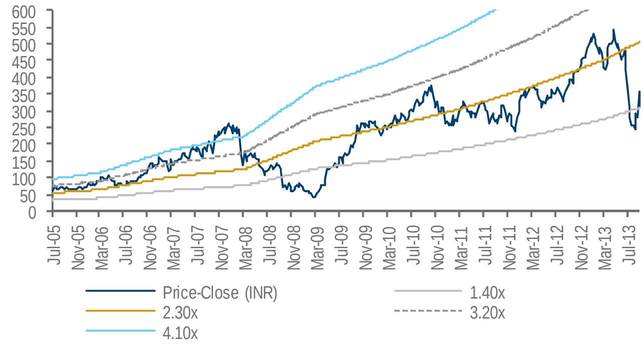
Source: Company, Daiwa forecasts

Valuation

The stock is trading currently at a one-year rolling forward PBR of 1.4x, which is at a substantial discount to its respective past-three-year and past-five-year trading average PBRs of 2.2x and 2x.

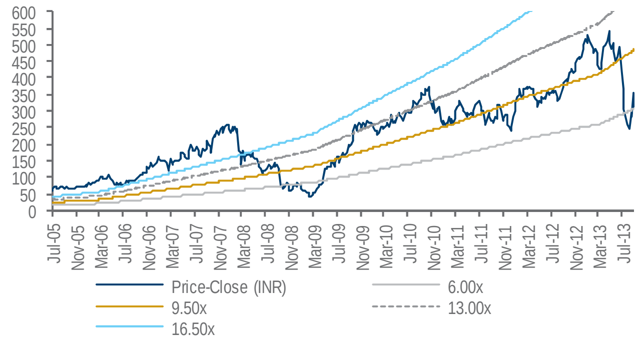
In the short term, as it is a very high beta stock, the fortunes of Yes Bank's share price are likely to continue to remain linked to the performance of the currency, in our view. However, given that we believe Yes Bank's asset quality is the best in its sector and forecast it to deliver the highest ROE for FY14-15 within our coverage universe, we believe its current valuation multiples are attractive.

■ **Yes Bank: PBR bands (1-year rolling forward)**



Source: Bloomberg, Daiwa estimates

■ **Yes Bank: PER bands (1-year rolling forward)**



Source: Bloomberg, Daiwa forecasts

Key risks

Persistence of exchange-rate volatility: We have assumed that the RBI's liquidity-tightening measures are temporary in nature (a maximum of 3-4 months) and should be reversed once exchange rate stability is achieved. However, in a scenario where the exchange rate were to remain volatile in the country, and these liquidity tightening measures were to become the norm for a long duration of time, the stock may continue to languish at current valuation levels.

Weakening of asset quality: Yes Bank has been able to maintain exemplary asset quality despite the tough macro environment. A possible reversal of the interest-rate cycle and a further deterioration in macro conditions could result in weakening asset quality for the bank.

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