Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

Equity Research

Industry: Banking
Date: May 13, 2011

KOTAK MAHINDRA BANK LTD.

Analyst Recommendation: Buy

Buy	Accrue	Hold	Ease	Sell

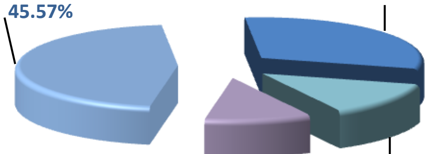
BSE Code:	500247	NSE Code:	KOTAKBANK	Reuters:	KTKM.BO	Bloomberg Code:	KMB@IN

CMP:	**₹420.7**
3 month Target:	**₹496**
SL:	**₹389**

EPS (₹)	21.3
P/E (X)	19.8
Interest Income (₹mn)	61,414.4
EBITDA (₹mn)	23,950.0
EBITDA Margin (%)	28.8
EV/EBITDA (X)	32.7

Market Cap (₹mn)	310,001.9
Free Float Mar Cap (₹mn)	168,734
52 week high/low	529.5/333.3
Total Debt (₹mn)	493,863.0
Enterprise Value (₹mn)	782,779.4
Book Value per Share	132.4
P/BV	3.2

Shareholding pattern as on March 31, 2011



Striking Q4 performance by Kotak Bank

Kotak Mahindra Bank (KMB) reported strong consolidated PAT of ₹4.9 billion, which grew moderately by 17.4% YoY, led by firm lending operations and comeback in investment banking business during the period. Deposits rose by 22.5% YoY and 3.4% QoQ and the advances increased by 39% YoY to ₹412,420 million. However, the normalised NIM for FY11 stood at 5.6%. The Non-interest income increased by 15.7% QoQ on account of a strong 85.9% QoQ increase in income from treasury operations. Asset management and securities businesses remained under pressure during the quarter. Improving asset quality and lower loan loss provisioning has boosted profitability during the quarter, resulting into a steep decline in net NPAs at ₹2,426.7 million. The bank added 23 branches during the quarter, taking total branches to 321. The CASA deposits stood at ₹87,905 million, comprising 30% of total deposits in contrast to 27.8% in the Q3FY11.

Kotak's contribution towards growth in FY11

- Kotak reported strong consolidated PAT of ₹4.9 billion, which grew substantially by 17.4% YoY, led by firm lending operations and comeback in investment banking business during the period.
- The NBFC and investment banking arm has witnessed a rebound in the fourth quarter.
- Kotak is planning to increase in branch network with a target of 500 branches by 2013.
- Net Interest Income for the FY11 grew at a substantial rate of 24% and 8.8% q-o-q for FY11Q4, attributed by strong advances growth which increased 38.7% annually.
- The bank was able to grow higher yielding loans such as those in the commercial vehicle and construction equipment segment faster than corporate and home loans.

₹Million	FY09A	FY10A	FY11A	FY12E
Interest Income	43,665.6	46,011.6	61,414.4	79,838.7
EBITDA	12,773.6	24,135.9	23,950.0	32,041.5
Net Profit	6,523.9	13,070.0	15,667.5	21,694.5
Share Capital	3,456.7	3,481.4	3,684.4	3,684.4
EPS (₹)	9.4	19.1	21.3	29.5
PE (x)	44.6	22.1	19.8	14.3
P/BV (x)	4.4	3.7	3.2	2.6
EV/EBITDA (x)	42.2	26.1	32.7	28.3
ROE (%)	9.9	16.7	16.1	18.1
ROA %	1.6	2.4	2.2	2.5

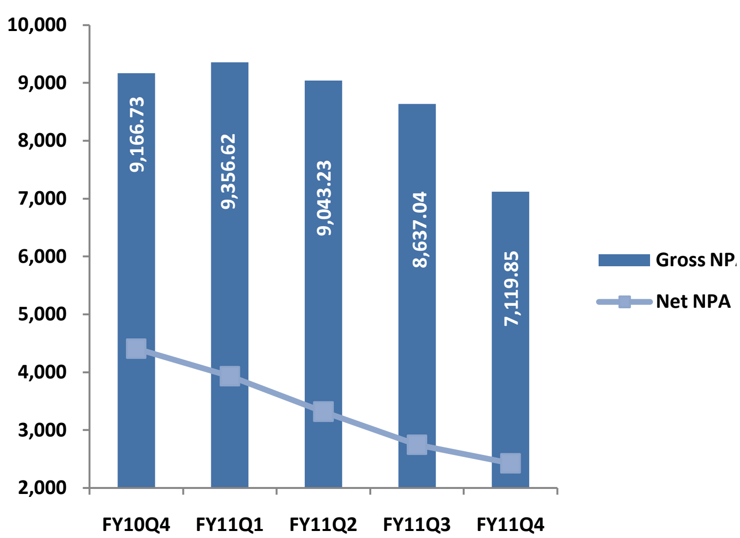
Bank's expectations in the coming year

After reporting impressive fourth quarter results in FY11, Kotak disclosed its future plans for the FY12. The bank has mentioned that it is unlikely to raise any further capital, since it strongly capitalised at the present times. As the NBFC and investment banking arm has witnessed a rebound in the fourth quarter, the bank is expecting to report much better numbers in coming quarters. Further, life insurance business also crossed the hurdle of the transformation post the policy guidelines. Going ahead, as bank deposits and fixed income instruments, the core of banking business are getting a lot more returns, indicating Indian savers have moved away significantly from the equity market. Kotak is planning to increase in branch network with a target of 500 branches by 2013. The bank added 23 branches during the quarter, taking total branches to 321. Also, it will focus on the corporate and the commercial banking space. The bank operates in a three player segments, wholesale bank, commercial bank and consumer bank – to drive significant current account growth, improving the CASA ratio.

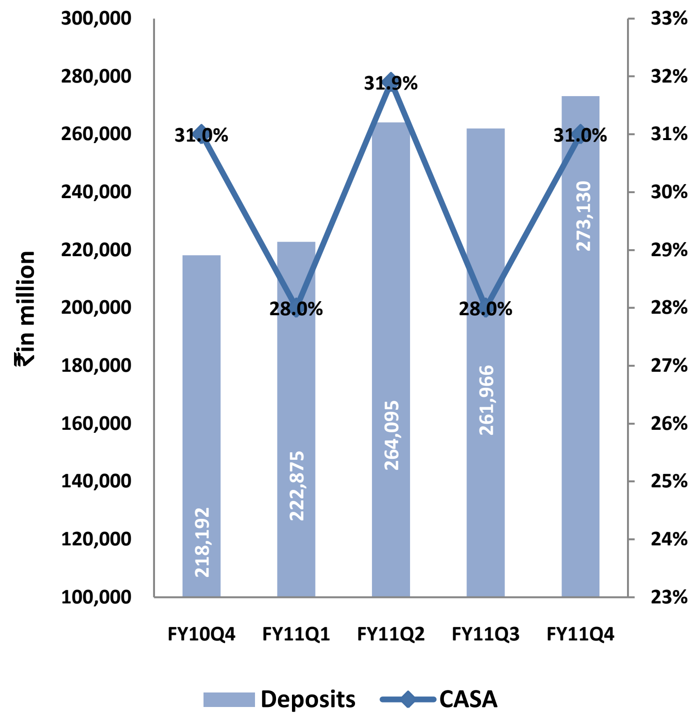
Improving asset quality

During the fourth quarter, the gross NPAs declined to 2.0% from 2.5% in Q3FY10 and decreased 21.4% y-o-y from 3%. Sequentially, NPA fell by 18.91% (QoQ) and 21.4% (YoY) to ₹603 crore, displaying improving macro-economic environment. Provision coverage ratio stood at 65% excluding technical write offs. The positive thing in asset quality was that provision was written back in Q4FY11 against ₹534 million NPA provisions in Q3FY11. Going ahead, the low credit costs will auger to negate the margin pressure.

Declining trend of Gross and Net NPA (in ₹ million)



Consistent growth in Deposits maintaining firm CASA ratio

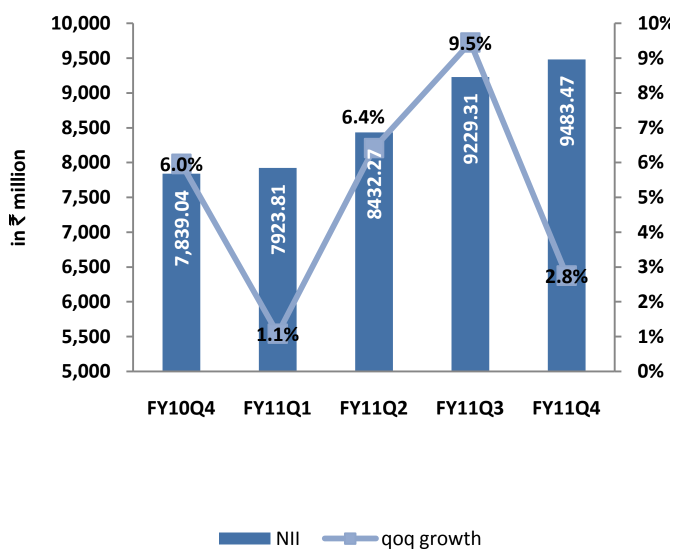


Kotak Mahindra Bank raises lending rate by 50 bps

The private lender has recently raised base rate or minimum lending rate and fixed deposit rates by up to 50 basis points in response to policy rate hike by Reserve Bank of India (RBI). The base rate has been raised by 50 basis points from 8.75% to 9.25%, with effect from May 10, 2011. Kotak also stated that all categories of loans (other than the exceptions permitted by RBI) will henceforth be priced with reference to the revised Base Rate. Further, it hiked its Benchmark Prime Lending Rate (BPLR) upwards by 50 basis points making loans expensive for the existing borrowers. Besides, the bank has expanded its deposit rates across tenor buckets by up to 50 basis points. On tandem with Reserve Bank's decision to raise short-term key rates including the repo and reverse repo by 50 basis points in its Annual Credit Policy on May 3, 2011. The repo rate and reverse repo rate now stand at 7.25 and 6.25 basis points, respectively. On the other hand, RBI also upped the savings bank deposit interest rate to 4% from 3.5%.

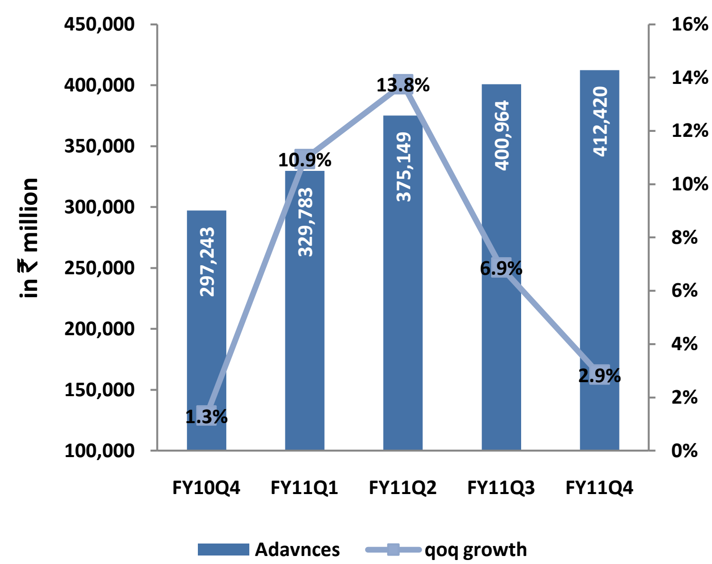
Persistent rise in NIIs; indicating strong growth

The Net Interest Income for the FY11 grew at a substantial rate of 24% and 8.8% q-o-q for FY11Q4, attributed by strong advances growth which increased 38.7% annually. The bank maintained its growth trajectory over the past quarters and shown its resilience during tough times. As the Indian economy is expected to expand further, so will be the banking industry. The QoQ growth was at its peak during Q3FY11 at 9.5%. However it has gone down to 2.8% during the recent quarter, nonetheless it will drive higher in coming quarters on higher growth in loans.



Growth pattern in loans has seen a veered trend

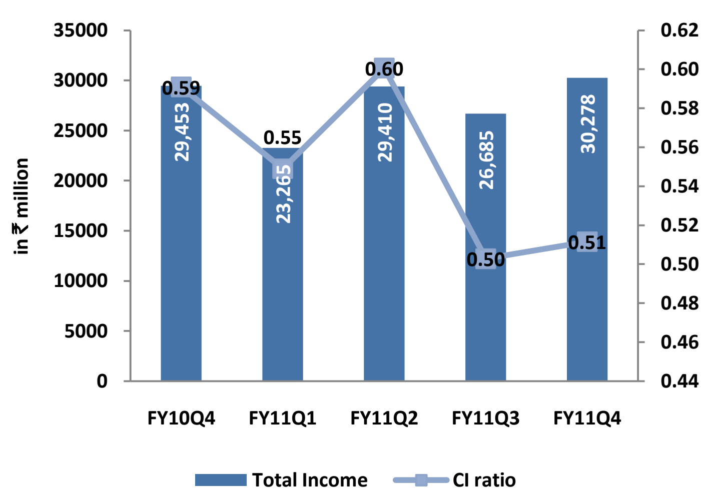
The bank was able to grow higher yielding loans such as those in the commercial vehicle and construction equipment segment (the non-banking financial company arm) faster than corporate and home loans. The bank was able to deploy cash from maturing securities at higher yields. Kotak's consolidated loans grew 3% from the December quarter, less than the industry average. Mortgage loan reported the strongest growth YoY of 44.3% to ₹68.77 billion while personal loans declined by 3.5% to ₹13.07 billion. Also, auto loans grew strongly by 30.7% and it accelerated the most in the recent quarter by 7%. Total advances and investments increased by 33.8% to ₹595.21 billion in comparison to the previous year's ₹444.87 billion.



Improved CI ratio in recent quarters

For the quarter ended FY11Q4, Kotak bank has registered the strongest total income of ₹30,278 million as against ₹26,685 million in the previous subsequent quarter. The Cost to income ratio (CI Ratio) has been improving as well, registering at 0.51 in fourth quarter as compared to 0.59 in the same period last year. During FY11, the CI Ratio was the lowest at the end of the September quarter. The reason behind the fall in the ratio was the decline in the operating expenses in the previous two quarters. Operating expense on FY11Q4 stood at ₹15,489 million as compared to ₹17,405 million in FY10Q4, a decline of 11%, while during FY11Q3 it stood at ₹13,417 million.

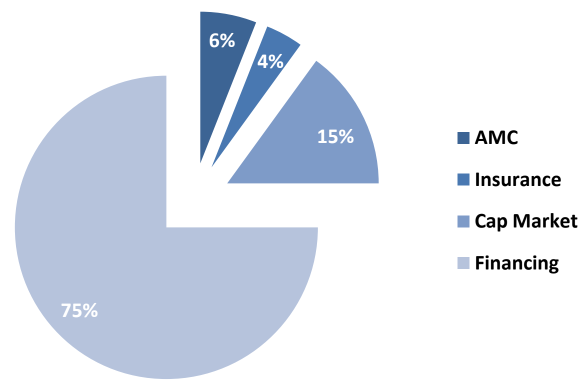
Total income trend in past 5 quarters with CI ratio



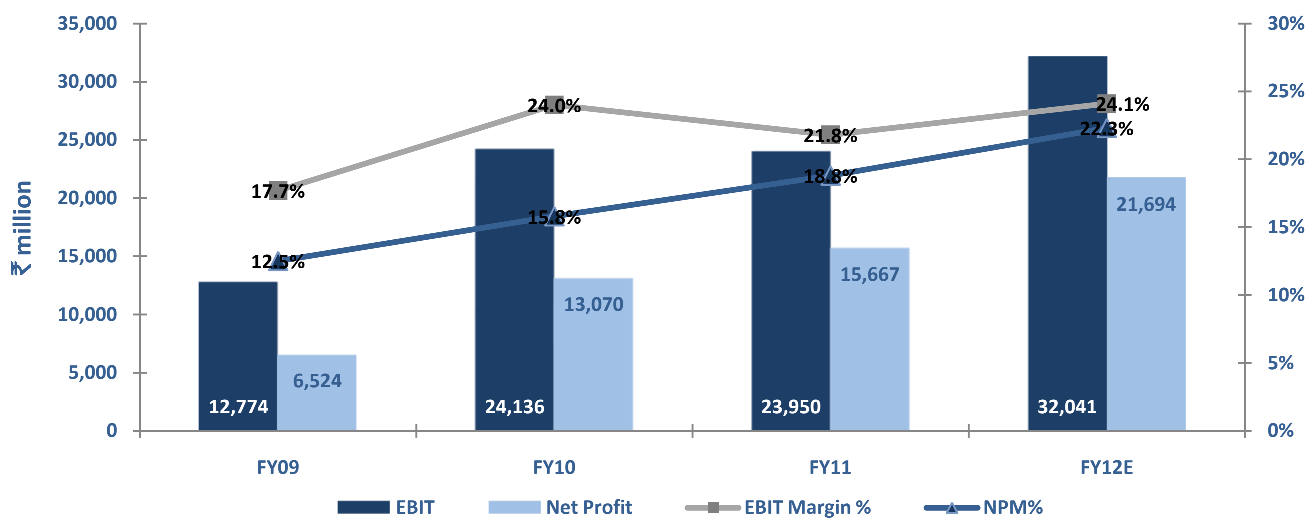
Financing segment remains the stronghold of the bank

Kotak's stronghold has been the financing segment in the past and it is still has been the case. The segment contributed 75% of the group's Profit Before Tax (PBT) in FY11. The financing segment has performed strongly as compared to a 59% contribution to group's PBT in FY10. This happened at the cost of decline in the asset management and capital market business of which reported a contribution of 6% and 15% respectively to the PBT. During FY10 both segments contributed 14% and 23% respectively. Besides, the private lender is expecting its AMC segment to improve in coming quarters as it has started recovering. However, the bank is mainly emphasising in organic growth of the banking services.

Segment Summary FY11 – PBT Mix



Maintaining strong margin growth with higher rise in interest income



Business Overview

Kotak Mahindra Bank Ltd. which is known to be one of the fast growing commercial banks of the country that provides its customers with all the banking facilities. There are four business sections in which the bank has expanded itself since 1985 (the year of inception). These four segments include: Treasury and Balance Sheet Management Unit (BMU), Retail Banking, Corporate Banking and Branch Banking. With 321 branches spread across India, the Bank has its registered office at Nariman Bhavan, Nariman Point, Mumbai. In the present scenario, more than 20,000 workers are employed by the bank.

Indian Banking Industry

The Indian Banking Industry has played a vital role in the sectoral growth as well as overall development of the Indian economy in the past decade. The collective net profit of the industry registered an eight-fold growth to ₹571 billion in 2010 from ₹71 billion in 2001. Meanwhile, bad asset as a percentage of loans retreated to 1% in 2010 from 6.83% a decade ago. With enhanced profitability, efficiency and productivity, return on assets of the industry has increased from 0.57% in 2001 to 1.05% by 2010.

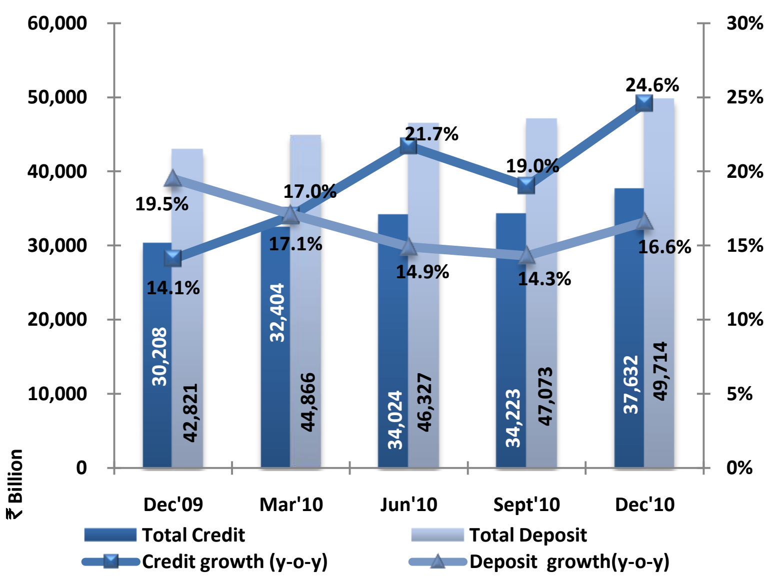
Credit growth exceeds target numbers owing to broad based demand across different sectors

Bank credit during FY'10, registered a modest growth of around 16.7% on y-o-y basis on the back of lower capital expenditure by the industries as well as the apprehension of the banking sector to issue credit. However, the same has managed to pick up momentum in FY'11 with around 25% growth till Dec'10 on y-o-y basis against a forecasted 20% for the fiscal, on the back of accelerated credit growth across all major sectors of the economy. In the first nine months of 2011, the public sector banks like SBI & its associate banks together recorded an average credit growth of around 13% y-o-y basis while Private Sector banks exhibited a higher credit off-take of around 19% on a y-o-y basis, partly influenced by the lower base rates.

Deposits Growth struggle to achieve target despite rise in rates

On the other side of the flip, aggregate deposits with SCBs have grown at 16.6% to reach ₹49,714 billion on 31st December, 2010, which is lower than the 19.5% growth observed last year and a RBI targeted growth of 17% for FY'11, despite raising the deposit rates by most of the banks by over 150 basis points. Much of the deposit growth occurred during Q1FY11 while Q2FY11 witnessed a mere 1.6% q-o-q growth. Deposit growth paced up again in Q3FY11 registering a q-o-q growth of 5.61% as under tight liquidity conditions most banks enhanced their deposit mobilisation efforts by offering attractive interest rates on time deposits. But still, under persistent inflationary pressure, customers preferred alternative investment avenues such as gold and equities especially IPOs of public sector companies, due to comparative lower return from deposits.

Higher y-o-y credit growth leading towards asset-liability mismatch in the industry



Credit deposit ratio

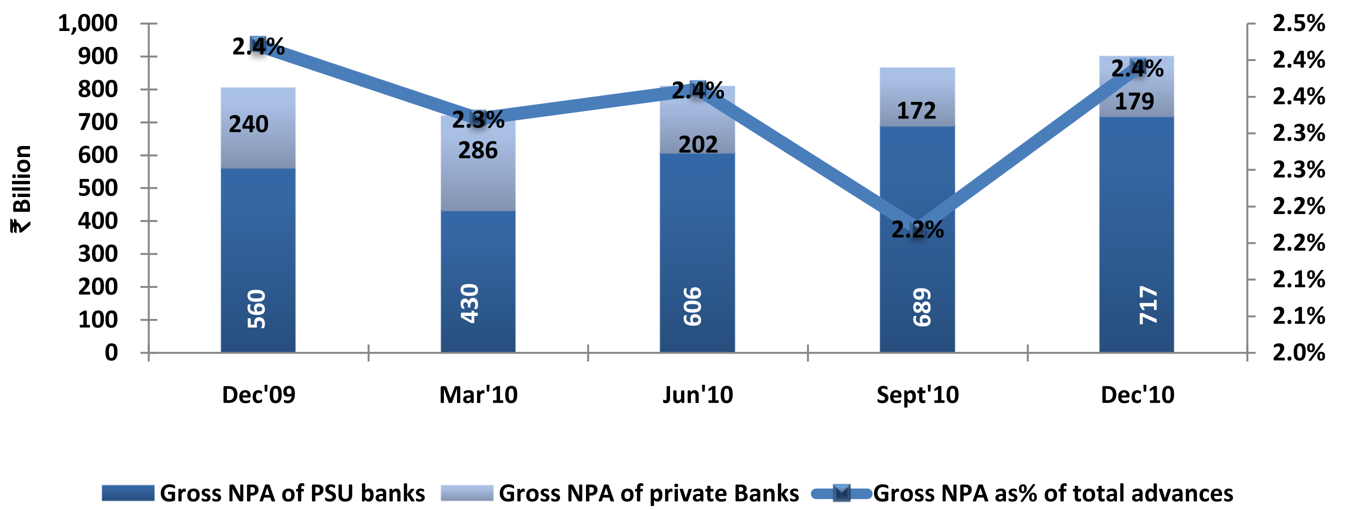
The increasing mismatch between credit and deposit growth rates may result in shortage of funds in the industry to finance high-value projects that have repayment schedules of up to 15 years compared with most deposits maturing in one-three years. As on September, 2010, the top 100 centres of the total 34,850 banked centres of Scheduled Commercial Banks in India accounted for 68.8% of the total deposits and 78% of total credit in the industry. Due to accelerated growth in credit demand against the available deposit to source them, the overall credit-to-deposits ratio of the industry has widened to 78.1% on Dec'10 from 74% a year-ago, enhancing the probability of destabilisation in the banking and financial system of the country.

Credit-to-deposit ratio, or the proportion of loans lent from deposits received, is an indication of the asset liability mismatch of banks, indicating if the bank has sufficient liquidity to support its loan growth. Though it is always advisable for the banks to maintain a higher credit-deposit ratio of around 65-70%, a number in excess of 100% could result in liquidity crisis, as banks will not have enough funds to support the loan book growth. As on 31st Dec'10, ICICI Bank and HDFC bank had a credit-to-deposit ratio of 95% and 82%, respectively.

Domestic growth to improve shrinking asset quality

The total assets size of the industry grew five-fold at CAGR of 18% from US$250 billion to more than US$1.3 trillion over a term of 10 years. On year on year basis, the overall Gross nonperforming assets (NPAs) as a ratio to gross advances for SCBs accelerated to 2.5% in FY10 against 2.25% in FY09. On the other hand in the first nine months of FY11, the gross NPA level of the industry rose by 23.8% y-o-y basis to ₹896 billion with Public Sector banks, accounting for almost 80% of the same. However, during this period, overall Gross NPAs as a % of advances has reduced to 2.39% against 2.41% as on Dec’09, owing to improved recovery levels across banks. Besides, the overall NPA Provision Coverage Ratio (PCR) improved across most banks to around 70% level, mandated by the RBI to be achieved by September 30, 2010. To curb the rising inflation, RBI has raised its policy rates 8 times in FY11, followed by higher-than-expected rate actions in May 2011. As a result, higher rates could stress the asset quality of the bank by affecting borrower’s repayment capacity and thereby deteriorating the health of its balance sheets. Most of the restructured loans are due for redemption by Mar’11 and some of which could turn non-performing, this could accelerate the bad loan ratios for the fiscal. However, strong domestic growth environment, improved corporate credit profiles, better risk management and less exposure to high risk sectors could go a long way in easing asset quality concerns for a large part of banks' loan portfolios. Apart from this, better provisioning policies will also help the bank to maintain its present asset quality standard.

Higher Proportion of Bad loans in PSU banks pressurizes asset quality



Future Outlook

The banking sector business has grown at a CAGR of around 23% between FY05 to FY10 owing to lower capital expenditure by the banks. But with increasing apprehension of the industry to issue credit under higher inflation scenario has moderated its growth in FY10 to around 16.7% on y-o-y basis. In FY11, due to higher growth in credit take off, the growth numbers of the sector improved to around 20% y-o-y till October 2010. Going further, with the inflation seemingly out of control and monetary policy very clearly coming down hard on inflation, the growth momentum of the industry in the coming months are likely to witness some moderation. However, the profitably of the sector is expected to garner some support from higher credit growth due to growing demand across various sectors coupled with improving asset quality, owing to strong domestic growth environment, improved corporate credit profiles, better risk management and less exposure to high risk sectors. Apart from this, with Government's initiative to infuse a sum of ₹60 billion to the under-capitalized public sector banks to ensure strong capital base among PSU banks by FY12 will go a long way in helping to banks to strengthen their financial position and stay firm under tight liquidity conditions.

Balance Sheet (Consolidated)

(₹million)	FY09A	FY10A	FY11E	FY12E
Share Capital	3,456.7	3,481.4	3,684.4	3,684.4
Employee Stock Options Outstanding	919.1	548.0	552.0	565.0
Reserves & Surplus	61,768.8	75,628.0	93,300.0	115,975.0
Shareholders' Fund	**66,144.5**	**79,657.5**	**97,536.4**	**120,224.4**
Minority Interest	628.6	808.6	1,072.1	1,347.1
Deposits	138,218.4	218,191.8	273,130.0	346,875.1
Borrowings	119,790.2	138,857.0	220,733.0	271,501.6
Policyholders' Funds	37,380.4	63,710.7	66,125.0	68,985.0
Other Liabilities & Provisions	40,176.2	49,922.6	60,406.3	67,051.0
Capital Employed	**402,338.4**	**551,148.1**	**719,002.8**	**875,984.1**
Cash and Balances with RBI	10,070.3	20,940.8	21,085.5	22,139.8
Money at call and short notice	4,304.7	4,127.3	5,922.0	6,722.0
Investments	133,130.3	194,847.8	242,791.0	297,070.1
Advances	224,976.2	297,242.9	412,420.0	509,338.7
Fixed Assets	3,383.4	6,104.1	6,517.0	7,070.9
Other Assets	26,439.4	27,851.0	30,233.1	33,608.4
Goodwill on Consolidation	34.2	34.2	34.2	34.2
Capital Deployed	**402,338.4**	**551,148.1**	**719,002.8**	**875,984.1**

Profit & Loss Account (Consolidated)

(₹million)	FY09A	FY10A	FY11A	FY12E
Interest Income	43,665.6	46,011.6	61,414.4	79,838.7
Interest Expended	19,923.9	17,728.6	26,345.5	35,566.4
Net Interest Income	23,741.7	28,283.0	35,068.9	44,272.2
Growth (%)	29.6	19.1	24.0	26.2
Other Income	28,517.0	54,521.4	48,223.0	53,045.3
Operating Income	52,258.7	82,804.4	83,291.9	97,317.6
Growth (%)	(10.9)	58.5	0.6	16.8
Operating Expenses	39,485.1	58,668.5	59,341.9	65,276.1
Operating Profit	12,773.6	24,135.9	23,950.0	32,041.5
Growth (%)	(27.9)	89.0	(0.8)	33.8
Operating Margins (%)	*24.4*	*29.1*	*28.8*	*32.9*
Provisions and Contingencies (including taxation)	6,246.9	10,862.3	8,257.6	10,322.0
PAT	6,526.7	13,273.6	15,692.4	21,719.5
Growth (%)	(31.9)	103.4	18.2	38.4
PAT Margin (%)	*12.5*	*16.0*	*18.8*	*22.3*
Less: Share of Minority Interest	37.3	180.0	263.5	275.0
Add: Share in profit/(loss) of Associates	34.4	(23.6)	238.6	250.0
Net Profit	6,523.9	13,070.0	15,667.5	21,694.5
Net Margin (%)	*12.5%*	*15.8%*	*18.8%*	*22.3%*

Key Ratios & Valuations (Consolidated)

	FY09A	FY10A	FY11E	FY12E
EBIT Margin (%)	24.4	29.1	28.8	32.9
Net Profit Margin (%)	12.5%	15.8%	18.8%	22.3%
Cost to Income Ratio (%)	75.6	70.9	71.2	67.1
ROE	9.9	16.7	16.1	18.1
ROCE	3.5	4.8	3.6	4.0
ROA	1.6	2.4	2.2	2.5
EPS	9.4	19.1	21.3	29.5
P/E ratio (x)	44.6	22.1	19.8	14.3
Book Value	95.7	114.4	132.4	163.2
P/BV ratio (x)	4.4	3.7	3.2	2.6
EV/Interest Income (x)	12.3	13.7	12.7	11.4
EV/EBITDA (x)	42.2	26.1	32.7	28.3
EV/CE (x)	1.5	1.3	1.2	1.1

Valuations

The ₹310 billion private lender, Kotak Mahindra Bank Ltd., continues to perform well in its lending operations. Sequentially stable margin was one of the key positives during the quarter. The strong consolidated earnings were driven by lending, investment banking and life insurance businesses during the quarter. The bank has been performing exceedingly well on the asset quality front as NPAs declined to 2.0% from 2.5% in Q3FY10 and decreased 21.4% y-o-y from 3%. Building quality franchise and stable margins are the major medium term earnings drivers for the bank. Integrated financial services business model, superior management track record, strong loan growth outlook, improving asset quality along with better CI ratio and sharper than expected earnings growth in capital market linked businesses are key value drivers for the stock. These all activities augur well for the company in the near future. At the current market price of ₹420.7, we rate the stock as 'BUY'. Further, at the current market price the stock is trading at 3.2x FY11 BV and 2.6x FY12E BV.

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