

Kotak Mahindra Bank

4 December 2019

Reuters: KTKM.BO; Bloomberg: KMB IN

Best-in-class risk-adjusted NIM and a strong franchise

We think that Kotak Mahindra Bank's (KMB) valuation (3.6x 1HFY22E BV) reflects, amongst other qualities, its superior risk-adjusted margin. Our analysis across key peers reveals that KMB's risk-adjusted margin, at 3.65-3.70%, is at par with HDFC Bank (HDFCBK). Even during the most testing times, the bank's asset quality has held up very well, which has also helped the bank to maintain low credit costs through the cycle (10-year avg: 61bps). Liability franchise management has been excellent. Despite reducing overall cost of deposits by ~220bps over the last 6 years, CASA ratio has expanded substantially, to 52.5% (FY19). A strong balance sheet (low NPAs + strong CAR), supported by an enviable liabilities franchise, should help generate 18% CAGR in loan assets over FY19-22E. Apart from the standalone banking entity, we are of the view that subsidiaries hold immense potential for value creation as they scale up. A cross-sell culture at the bank would help generate business and earnings growth for the subsidiaries. We forecast consolidated PAT (bank + key subs) to register a 24% CAGR over FY19-22E and we expect consolidated BV to compound at 17% over the same period. We estimate the standalone bank to deliver ROE of 14.2-15.3% over FY20-22E. Rich valuation for the bank is expected to sustain. Based on our SOTP valuation framework, we value the stock at Rs1,781, which implies a multiple of 3.9x 1HFY22E BV. Subsidiaries account for 24% of our SOTP-based target price. We change our rating to ACCUMULATE. Our rating change is purely an outcome of valuation concerns; we do not foresee any business related challenges.

Prudent underwriting combined with relentless focus on profitability: Our analysis across comparable peers reveals that KMB's risk-adjusted margin is best-in-class at 3.66% (FY19), second only to HDFCBK's 3.67%. This can be attributed to a host of factors such as relatively low share of corporate loans and prudent underwriting which has helped to keep asset quality healthy, thereby containing credit costs at relatively low levels. Adjusting for the year of ING-acquisition, gross slippage has averaged 1.3% over nearly a decade. This reinforces our views about strong underwriting standards at KMB. Over the last 12 months, when the banking sector has gone through immense asset quality headwinds, KMB's asset quality has held up very well, with GNPA ratio at 2.32% (2QFY20; +13bps QoQ). Among the stressed corporate names that have surfaced, we find that KMB's presence in such cases has been negligible. We forecast GNPA's of 2.3%/2.2%/2% over FY20/21/22E for KMB. SMA o/s as of 2QFY20 was 0.20% of net advances (Rs4.31bn). We expect credit cost to be at ~60bps for FY20, which is 20bps higher than last 8-year average. Secured retail asset quality remains stable, though we would watch out for stress signals on the unsecured retail portfolio.

Running an enviable liability franchise: KMB has grown its deposits at a CAGR of 18% over FY16-19. At the same time, CASA deposits have grown at a CAGR of 31%, implying increasing share of low-cost funds. As of 2QFY20, CASA ratio stood at 53.6% (+1553bps since FY16). Further, CASA + TDs < Rs10mn ("retail deposits") account for more than 80% of the total deposits, thus providing a stable and granular funding base. We find the liability franchise scale up commendable, in light of the bank being able to reduce its cost of deposits by ~221bps (since FY13) to 5.26%. Additionally, the bank's digital offering, 811, has been instrumental too. Overall, we think that there is a greater degree of stickiness as far as KMB's deposit accounts are concerned. Our rationale is the bouquet of in-house products/services offered by KMB.

Low NPAs + strong CAR = strong balance sheet: KMB's standalone tier I ratio of 17.6% and a high quality liability base provide comfort from a funding perspective. This, combined with relatively low NPAs and a PCR of 64%, positions the balance sheet on a strong footing. Our view takes into account absence of any meaningful asset quality challenges and KMB's strong ability to raise capital.

Subsidiaries are of significant value: Besides the standalone banking entity, we also take cognizance of the value creation that could potentially come from the subsidiaries. The bank holds 100% stake in all of its meaningful subsidiaries – Kotak Life Insurance, Kotak Prime, Kotak AMC, Kotak Securities and Kotak Investments. We believe that Kotak Life (FY19 GWP: Rs81.68bn) and Kotak AMC (FY19 AUM: Rs1382bn), both of which contribute 15% together to our SOTP fair value, have significant room to grow in terms of revenues as well as profits. Kotak Securities, one of the largest broking firms in the country, is expected to deliver PAT CAGR of 19% over FY19-22E. We expect a 17% CAGR in consolidated BVPS and a 24% CAGR in consolidated PAT over FY19-22E.

Valuation/outlook: As per our SOTP valuation framework, we value the stock at Rs1,781, which implies a multiple of 3.9x 1HFY22E BV. Subsidiaries account for 24% of our SOTP-based target price. We change our rating to ACCUMULATE. Our rating change is purely an outcome of valuation concerns; we do not foresee any business challenges for the bank.

ACCUMULATE

Sector: Banking

CMP: Rs1,649

Target Price: Rs1,781

Upside: 8%

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Key Data

Current Shares O/S (mn)	1,910.0
Mkt Cap (Rsbn/US\$bn)	3,001.4/41.8
52 Wk H / L (Rs)	1,684/1,171
Daily Vol. (3M NSE Avg.)	2,714,777

Price Performance (%)

	1 M	6 M	1 Yr
Kotak Mahindra Bank	0.0	2.6	28.2
Nifty Index	0.1	(0.6)	9.9

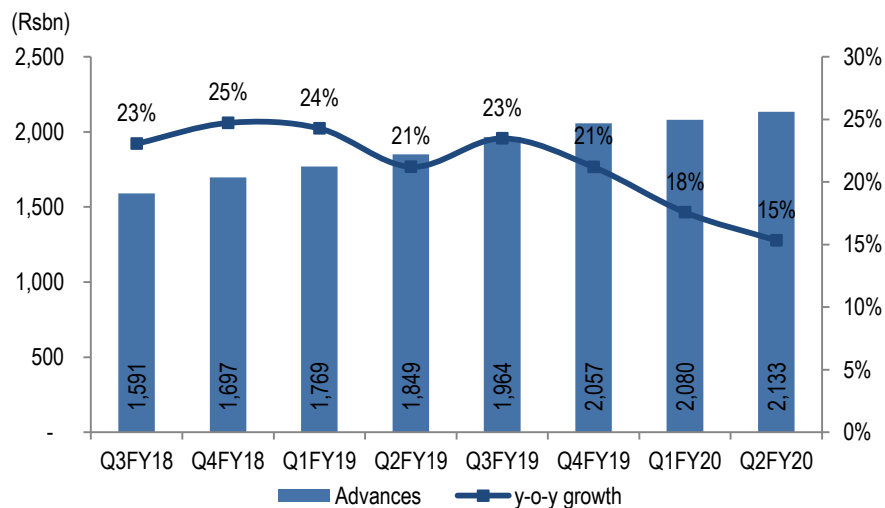
Source: Bloomberg

Kotak Mahindra Bank - SOTP valuation

Entity	Valuation methodology	Holding	Value per share (INR)
			H1FY22E
Kotak Mahindra Bank - standalone	4x 1HFY22E BV	100.0%	1,352
Kotak Life Insurance	2.2x 1HFY22E GWP	100.0%	183
Kotak AMC	35x 1HFY22E EPS	100.0%	83
Kotak Prime	2x 1HFY22E BV	100.0%	87
Kotak Securities	20x 1HFY22E EPS	100.0%	66
Kotak Investments	2.5x 1HFY22E BV	100.0%	31
Kotak General Insurance	5x 1HFY22E NWP	100.0%	12
Kotak Capital	20x 1HFY22E EPS	100.0%	6
Others	1x BV	100.0%	9
Holding co. discount (%)			10%
Value of subs			429
Value of total			1,781
Upside (%)			8%
Parent's contribution to total value per share (%)			76%
Contribution by subsidiaries (%)			24%

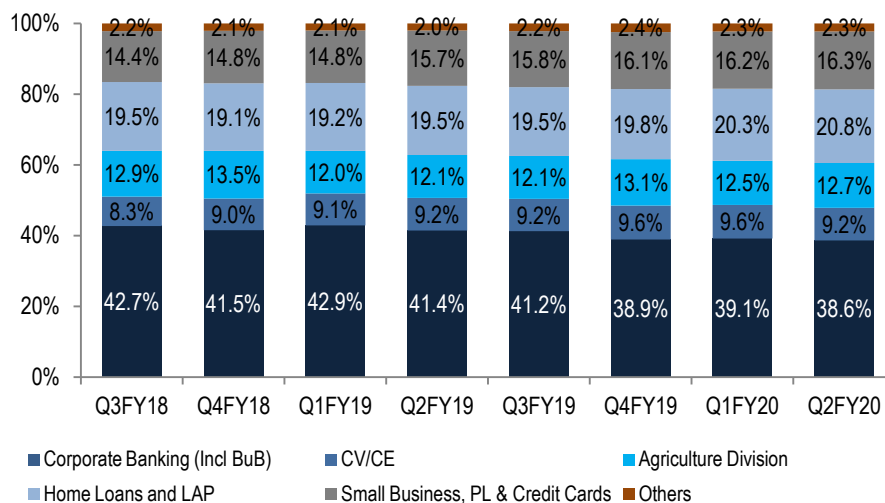
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 1: Loan Book Growth (Rsbn)



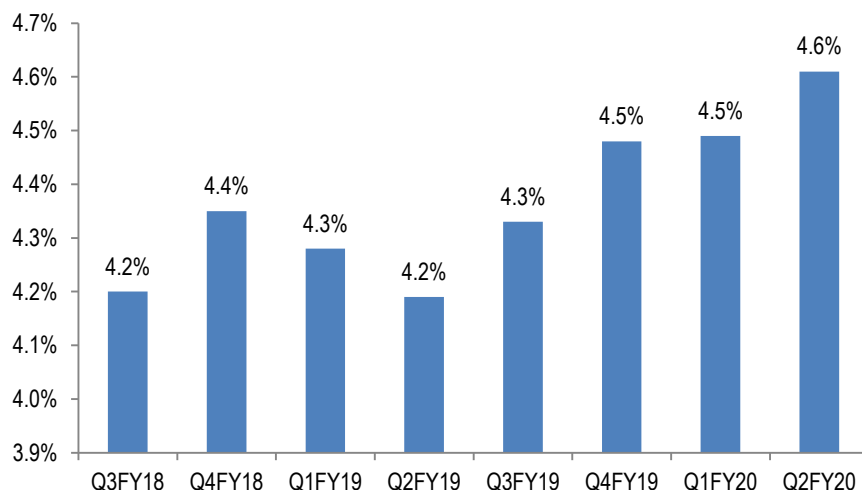
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Loan Book Mix (%)



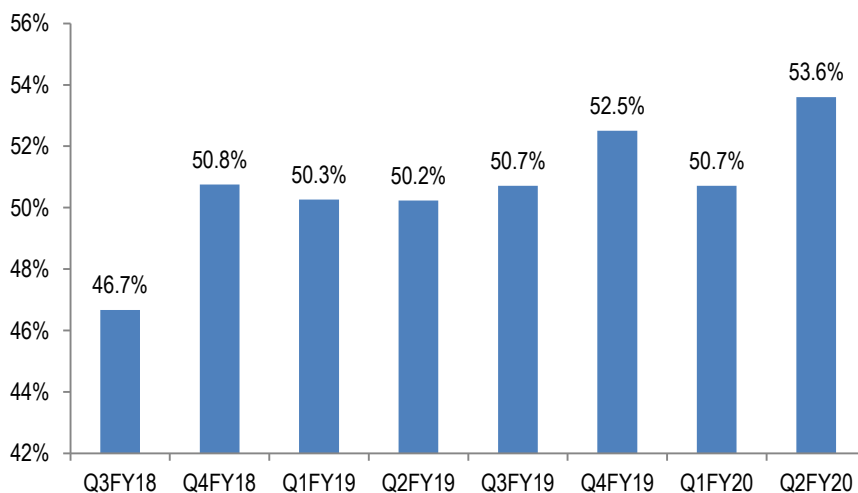
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: NIM – Reported – Standalone



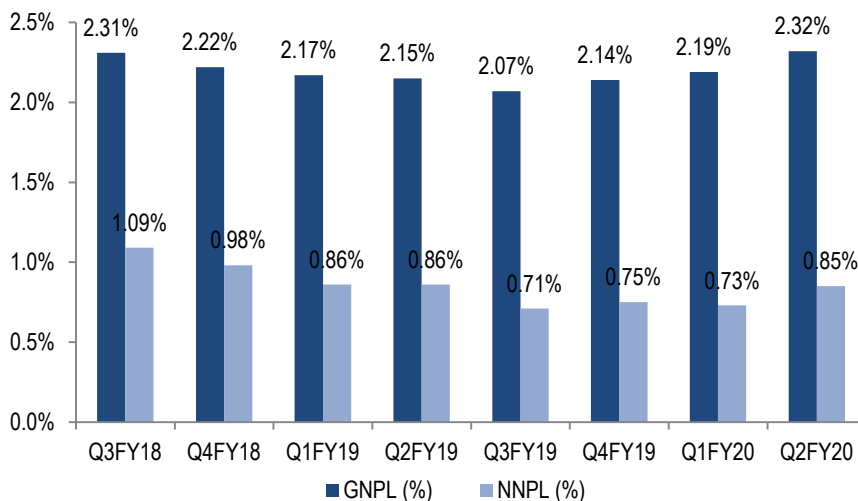
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: CASA Ratio (%)



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Asset Quality (Standalone)



Source: Company, Nirmal Bang Institutional Equities Research

Kotak Mahindra Life Insurance (Kotak Life): Kotak Life is one of the largest life insurance companies in the country with NBP of Rs39.77bn during FY19 (grew at 26% CAGR over FY14-19). Renewals growth has been healthy too, at 24% over the same period. We think that given Kotak Life's current size of operations, there is significant room to scale up. Over FY14-19, opex ratio has reduced from 21.6% to 16.3% (a reduction of 530bps). We expect this trend to continue as the company pursues growth opportunities. In terms of product mix, par/non-par/ULIPs account for 35%/40%/25%, respectively, as of FY19. In terms of channel mix, banca accounts for 48% of the business. For FY19, the company reported IEV of Rs73.06bn (+26% YoY) and a VNB margin of 36.9%. We value Kotak Life at 2.2x 1HFY22E GWP.

Kotak Life (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
NBP	34,042	39,771	52,931	70,453	93,787
Renewals	31,945	41,912	51,784	66,483	86,296
PAT	4,134	5,072	5,502	6,636	7,331
AUM	2,49,973	3,02,214	3,79,222	4,75,960	5,98,345

Kotak Mahindra Asset Management (Kotak AMC): Kotak AMC is the 6th largest AMC by AUM, with a market share of 6.5% (+287bps since FY14). As of FY19, the company had an average AUM of Rs1,382bn, having grown at a CAGR of >31% over FY14-19. For FY19-22E, we expect an AUM CAGR of 20%. Share of equity AUM has increased from 8.7% in FY14 to 39.7% in FY19. Given the AMC industry opportunity as well as KMB's distribution reach, we expect Kotak AMC to be one of the foremost beneficiaries. We value Kotak AMC at 35x 1HFY22E EPS.

Kotak AMC (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Revenues	5,125	6,742	8,045	9,455	11,098
PAT	813	2,290	3,711	4,171	4,864
AAUM (Rsbn)	1,154	1,382	1,659	1,990	2,388

Kotak Mahindra Prime (Prime): Prime is a vehicle finance NBFC, 100% owned by Kotak Mahindra Bank. The NBFC primarily focuses on financing PVs with vehicle financing forming 67.9% of the total loan book (FY19), followed by 27.6% accounted for by structured loans. Customer segment, specific to the NBFC, comprises largely of self-employed. For FY19, Prime delivered a NIM of 4% (calculated) and ROE of 9.6%; GNPA stood at 1.23% with a PCR of 57%. Given the current environment in the auto sector, we expect loan book growth to be muted for FY20 and gradually pick up in FY21/22. We value Prime at 2x 1HFY22E BV.

Kotak Prime (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
NII	10,320	11,389	11,675	12,093	12,760
PPOP	9,774	10,118	9,991	10,814	11,871
PAT	6,059	5,904	6,618	7,215	7,962
Shareholders' funds	57,364	65,477	72,095	79,310	87,272
Advances	2,79,457	2,84,535	2,88,700	2,97,278	3,18,404
NIM (%)	3.9	4.0	4.1	4.1	4.1
ROE (%)	11.7	9.6	9.6	9.5	9.6

Kotak Securities (KSEC): KSEC is the broking arm of KMB. As of 1HFY19, the company reported a cash market share of 9.4%. As of FY19, the company reported revenue of Rs17.25bn and PAT of Rs4.08bn. We value KSEC at 20x 1HFY22E EPS.

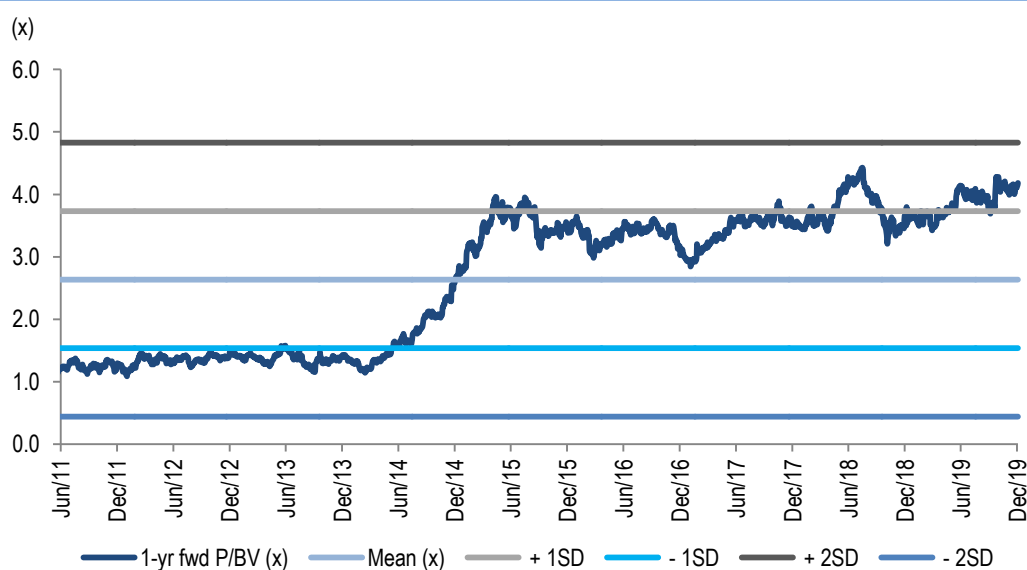
Kotak AMC (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Revenues	17,186	17,256	17,481	19,912	22,745
PAT	4,986	4,076	4,840	5,737	6,808

Exhibit 6: Financial summary

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Net interest income	95,318	1,12,590	1,35,552	1,60,740	1,90,788
Pre-provisioning Operating profit	71,583	83,482	1,03,146	1,25,421	1,49,934
PAT	40,845	48,653	65,413	81,650	98,882
EPS (Rs) (consol.)	32.5	37.7	46.8	57.2	67.2
BV (Rs) (consol.)	264.9	305.3	364.0	419.5	506.8
P/E (x)	50.7	43.7	35.2	28.8	24.5
P/BV (x)	6.2	5.4	4.5	3.9	3.3
Gross NPAs (%)	2.2	2.1	2.3	2.2	2.0
Net NPAs (%)	1.0	0.8	0.8	0.7	0.6
RoA (%)	1.7	1.7	1.9	2.1	2.1
RoE (%)	12.5	12.1	14.2	15.4	15.3

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: One-year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financial statements (standalone)

Exhibit 8: Income statement

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Interest income	1,97,486	2,39,432	2,82,802	3,33,347	3,93,618
Interest expenses	1,02,168	1,26,842	1,47,250	1,72,607	2,02,830
Net interest income	95,318	1,12,590	1,35,552	1,60,740	1,90,788
Non-interest income	40,521	46,040	54,202	63,559	74,667
Total income	1,35,840	1,58,630	1,89,754	2,24,299	2,65,455
Operating expenses	64,256	75,148	86,608	98,878	1,15,521
Pre-Provisioning Operating profit	71,583	83,482	1,03,146	1,25,421	1,49,934
Provisions	9,399	9,624	15,731	16,306	17,792
PBT	62,184	73,858	87,415	1,09,114	1,32,142
Taxes	21,339	25,205	22,002	27,464	33,260
PAT	40,845	48,653	65,413	81,650	98,882

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 10: Balance sheet

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Share capital	9,528	14,544	14,544	14,544	14,689
Reserves & surplus	3,65,287	4,14,440	4,77,236	5,55,621	7,05,403
Shareholders' funds	3,74,816	4,28,984	4,91,780	5,70,164	7,20,091
Deposits	19,26,430	22,58,804	26,42,800	31,05,290	36,48,716
-Current deposits	3,22,457	3,89,010	4,55,141	5,37,067	6,33,739
-Saving deposits	6,55,290	7,96,847	9,32,311	10,90,804	12,76,241
-Term deposits	9,48,683	10,72,947	12,55,348	14,77,420	17,38,737
Borrowings	2,51,541	3,22,483	3,80,530	4,49,025	5,29,850
Other liabilities	1,10,330	1,06,126	1,11,692	1,17,496	1,23,536
Total liabilities	26,49,329	31,21,721	36,53,531	42,91,293	50,42,068
Cash/Equivalent	1,96,201	2,46,755	2,68,945	3,16,010	3,71,312
Advances	16,97,179	20,56,948	24,27,199	28,64,095	33,79,632
Investments	6,45,623	7,11,891	8,45,696	9,93,693	11,67,589
Fixed & others assets	1,10,330	1,06,126	1,11,692	1,17,496	1,23,536
Total assets	26,49,332	31,21,720	36,53,531	42,91,293	50,42,068

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Key ratios

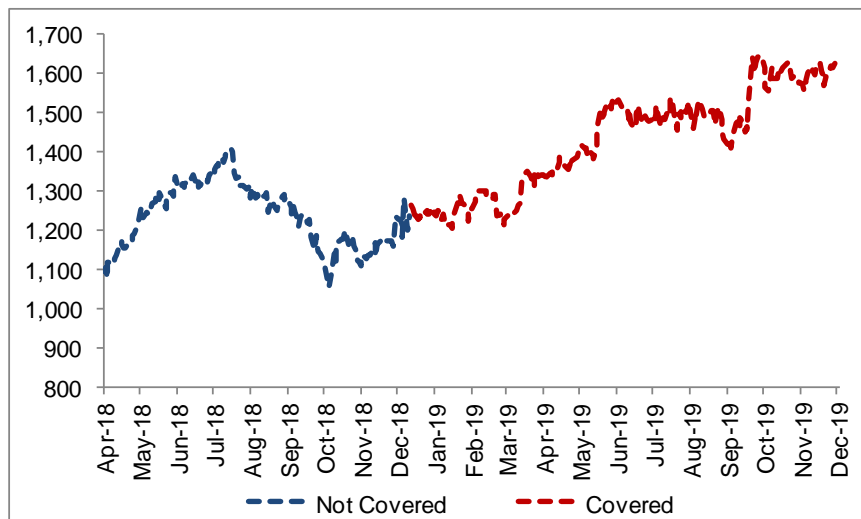
Y/E March	FY18	FY19	FY20E	FY21E	FY22E
Growth (%)					
NII growth	17.3	18.1	20.4	18.6	18.7
Pre-provision profit growth	19.6	16.6	23.6	21.6	19.5
PAT growth	19.7	19.1	34.4	24.8	21.1
Business (%)					
Deposit growth	22.4	17.3	17.0	17.5	17.5
Advance growth	24.7	21.2	18.0	18.0	18.0
CD	87.4	89.7	91.5	92.1	92.4
CASA	50.8	52.5	52.5	52.4	52.3
Operating efficiency (%)					
Cost-to-income	47.3	47.4	45.6	44.1	43.5
Cost-to-assets	2.7	2.6	2.6	2.5	2.5
Spread (%)					
Yield on advances	9.6	9.8	9.9	9.9	9.9
Yield on investments	7.2	7.2	6.9	6.8	6.8
Cost of deposits	5.1	5.3	5.2	5.2	5.2
Yield on assets	8.6	8.6	8.6	8.6	8.7
Cost of funds	5.2	5.3	5.3	5.2	5.2
NIMs	4.2	4.1	4.1	4.2	4.2
Capital adequacy (%)					
Tier I	17.6	16.9	15.7	15.3	16.2
Tier II	0.7	0.5	0.5	0.5	0.4
Total CAR	18.2	17.5	16.2	15.8	16.6
Asset quality (%)					
Gross NPAs	2.2	2.1	2.3	2.2	2.0
Net NPAs	1.0	0.8	0.8	0.7	0.6
PCR	56.5	65.4	67.0	68.5	69.7
Net slippage	0.2	0.4	0.6	0.3	0.2
Credit-cost	0.4	0.4	0.6	0.5	0.5
Return (%)					
RoE	12.5	12.1	14.2	15.4	15.3
RoA	1.7	1.7	1.9	2.1	2.1
Per share					
EPS (consol.)	32.5	37.7	46.8	57.2	67.2
BV (consol.)	264.9	305.3	364.0	419.5	506.8
ABV (consol.)	256.2	297.2	354.2	409.1	496.1
Valuation (x)					
P/E (consol.)	50.7	43.7	35.2	28.8	24.5
P/BV (consol.)	6.2	5.4	4.5	3.9	3.3
P/ABV (consol.)	6.4	5.5	4.7	4.0	3.3

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
13 December 2018	Buy	1,237	1,558
22 January 2019	Buy	1,267	1,559
8 April 2019	Buy	1,336	1,561
2 May 2019	Buy	1,387	1,638
8 July 2019	Buy	1,517	1,751
23 July 2019	Buy	1,454	1,676
7 October 2019	Buy	1,563	1,830
23 October 2019	Buy	1,629	1,905
4 December 2019	Accumulate	1,649	1,781

Rating track graph



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BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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