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Initiating Coverage

Kotak Mahindra Bank Ltd

05-October-2020

RETAIL RESEARCH

Kotak Mahindra Bank Ltd

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Private sector Bank	Rs.1305.05	Buy at LTP and add further on dips to Rs.1177-1183	Rs.1425	Rs.1507	2 quarters

HDFC Scrip Code	KOTMAH
BSE Code	500247
NSE Code	KOTAKBANK
Bloomberg	KMB
CMP Oct 01, 2020	1305
Equity Capital (Rsbn)	9.57
Face Value (Rs)	5
Equity Share O/S (bn)	1.91
Market Cap (Rsbn)	2582.96
Book Value (Rs)	240
Avg. 52 Wk Volumes	4874937
52 Week High	1,739.95
52 Week Low	1,000.35

Share holding Pattern % (Jun, 2020)	
Promoters	26.07
Institutions	57.42
Non Institutions	16.51
Total	100.0

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Our Take:

Over the years, Kotak Mahindra Bank (KMB) has transformed itself into one of the leading financial powerhouse in India. On the banking side, it has a strong liability franchise with a clear focus on consistent and sustainable growth, resulting in best in class return ratios. Stringent underwriting standards and focus on risk adjusted returns has helped the bank in maintaining stable asset quality across the cycles. We believe KMB is fundamentally one of the strongest banks. It has a diversified business model, which could help in hedging against downturns in specific segments and gives access to multiple growth avenues. The bank is trading at comparatively high valuations and implementation of regulations in the discussion paper released by the RBI on tenures of CEOs could lead to a sharp de-rating for the stock. Uday Kotak, being the promoter of the bank, has already served 10 years as CEO/whole time director. His term is expiring on Dec. 31, 2020.

We like KMB for the long term because of its strong fundamentals (1) sufficient capital (CRAR 21%; Tier 1 20.6%) (2) Strong, granular liability franchise - best-in-class CASA ratio (Q1FY21-56.7%) (3) Superior asset quality (NNPA 0.9%) backed by prudent and consistent Management track record.

Valuations & Recommendation:

Management sounded cautious on the business prospects in the near term and remained selective on the growth front. We have envisaged ~11% CAGR growth for topline and 9% CAGR for bottom line over FY20-22E. ROAA and ROAE for FY22E are estimated at 1.7% and 11.1% respectively. We anticipate non-tax provisions of 1.24% of average assets over FY21-22E. Due to superior asset quality, beat-in-class NIMs, ROEs and ROAs of KMB we feel that the stock is trading at rich valuation. Despite a 21.1% Tier 1 ratio in the bank and significant excess liquidity, the bank remains extremely risk-averse. This could lead to lower sustainable RoEs for the bank.

We feel that investors can buy KMB at LTP of Rs.1305 (3.1xFY22E core ABV + value of subsidiaries post holding company discount) and add further in the Rs.1177-1183 band (2.7xFY22E core ABV + value of subsidiaries post holding company discount) for SOTP based Base case fair value of Rs.1425 (3.45xFY22E core ABV + value of subsidiaries post holding company discount) and the Bull case fair value of Rs.1507 (3.7xFY22E core ABV + value of subsidiaries post holding company discount) over next 6 months.

Kotak Mahindra Bank Ltd

Financial Summary

Particulars (Rsmn)	Q1FY21	Q1FY20	YoY-%	Q4FY20	QoQ-%	FY19	FY20	FY21E	FY22E
NII	37,239	31,730	17%	35,597	5%	1,12,590	1,34,997	1,50,681	1,65,640
PPOP	26,237	23,989	9%	27,253	-4%	83,482	1,00,208	1,13,071	1,21,001
PAT	12,445	13,602	-9%	12,666	-2%	48,653	59,472	62,776	71,171
EPS						25.5	31.1	31.7	36
ROAE (%)						13	13.9	11.8	11.1
ROAA (%)						1.7	1.78	1.66	1.7
Adj. BVPS						201	232	287	328
P/ E (x)						38.4	33.2	33	28.1
P/Adj B (x)						4.9	4.4	3.7	3.1

(Source: Company, HDFC sec)

Recent Developments

The events at YES and various other Co-operative Banks have impacted depositor sentiments, causing them to become more risk-averse. This will lead to deposit polarization towards large private banks and PSBs. KMB with established brand name, management quality and widespread branch network is likely to benefit. This was also evident in the Q1 results where, deposits registered a ~12% YoY rise, driven by 26% CASA growth. Consequently, the CASA ratio rose 600 bps YoY to 56.7%. KMB has the highest CASA in the industry.

NII grew 17.4/4.6% YoY/QoQ aided by a reduction in interest expenses. PPOP grew 9.4% YoY, but dipped 3.7% QoQ, due to a sharp 48.1% QoQ fall in non-interest income. NIM moderated at 4.4% (down 40bps QoQ). Loan growth was down 7% QoQ. ~9.7% of KMB's portfolio was under moratorium, vs. ~26% as of April. Also 95% of the portfolio under the second moratorium came from the first one. The management indicated that the bank was more stringent while offering the second moratorium and it would recognize stress upfront rather than defer such recognition. The bank has further indicated that ~80% of the moratorium book is secured. Management continues to remain cautious as regards growth, and has chosen to take the more prudent step with respect to offering moratorium to only viable accounts/customers. We expect slippages of ~2.8% over FY21-22E. The management indicated that they are witnessing a gradual recovery in the business. However, the focus will be on growing in areas which do not require capital. The bank sees a huge opportunity in fee and distribution related businesses. Bank remains well capitalized with Tier 1 Capital of 13.5% and CAR of 17.5% as of Jun-20. This will act as a cushion against further asset quality shocks and lower CASA growth. In July 2nd board meeting, also the board has approved the proposal relating of funds raise up to Rs.15,000 cr via permissible modes at an appropriate time.

The bank has raised Rs 74bn via QIP in end May 2020. Now the capital base stands at Tier 1 Capital of 21.7% and CAR of 21.1%. The bank intends to use the net proceeds to augment its capital base and strengthen its balance sheet, which would assist it in dealing with contingencies or financing business opportunities (which may be organic or inorganic), or both, which may arise pursuant to the economic events driven by the outbreak of COVID, or otherwise.

RBI's one-time restructuring of loans to help borrowers manage the stress caused by the Covid-19 pandemic was a big positive for banking sector. The restructuring of loans has been allowed for retail, MSME and corporate loans. We expect the asset quality concerns and tail risk on earnings for the banks to reduce. Economy is recovering gradually and no major job losses have occurred in the formal sectors. Moratorium-2 numbers for the whole industry have reduced drastically.

Long term Triggers

Across the credit cycles, KMB has remained consistent performer both in terms of growth and maintaining asset quality. It has created best in class return ratios & margin profile for its investors. The management has kept stringent underwriting standards and focus has always been towards risk adjusted returns. This has helped the bank in maintaining stable asset credit across the cycles.

The Bank is an integrated financial services conglomerate with a diversified business model, which helps inhedging against downturns in specific segments and to access multiple growth avenues. Over the years, bank has expanded access to low cost liabilities and focus on retail banking by growing distribution network, optimizing digital channels and offering differentiated products. Despite robust growth history, the bank has managed to maintain asset quality even in the challenging environment by superior underwriting practices. It provides risk adjusted returns by continuously identifying, assessing and managing risks well in time to allocate capital amongst businesses appropriately.

The top management comprises of industry veterans with majority of them having experience of about two decades within the KMB group signaling establishment of organizational culture and stability. This vast history gives us the confidence of the vision of the management. Even while talking regarding the RBI discussion paper on CEO Timelines, the management highlighted that the bench of the bank is very strong and deep and committed to the long-term interests of the bank. Ultimately, the culture of the bank will be driven by the management as well as the board, which would comprise the promoter family as well.

The 811 digital banking strategy of KMB will help the bank in this challenging social distancing time. In fact, this is the best time for the bank to strengthen their digital core and make remote banking an integral part of the customer experience. KMB has one of the highest digital adoption rates amongst Indian banks with a bouquet of offerings and facilities for digital banking.

The Group's subsidiaries have been an important driver of consolidated results and they contributed ~31% to the Group's consolidated profit after tax for the year FY20. All subsidiaries are 100% beneficially owned by the Bank. Kotak Mahindra Prime (KMP) is primarily engaged in vehicle financing; financing of retail customers of passenger cars, Multi-Utility Vehicles (MUVs) and term funding to car dealers. KMP finances new and used cars under retail loan, hire purchase and lease contracts. KMP is also engaged in finance against securities, corporate loans, developer finance, two-wheeler finance and other lending. For FY20, NII stood at Rs.12295mn while PAT was Rs.6731mn. Kotak Securities (KS) is one of the leading broking service providers. The Average Daily Volumes of the company in cash market was as at Rs.35.62bn and Rs.155.71bn for derivative market in FY 2020. The overall market share stood at 1.7% in FY20. The revenue for the same year was Rs.16.9 bn. The life insurance business operates through 245 life insurance outlets across 152 locations. The company has 124,690 life advisors, 40 Bancassurance partners and 201 brokers and corporate agency tie-ups. The gross written premium was at Rs.103.4 bn with embedded value of Rs. 84bn for FY20. The asset management arm Kotak AMC has 23.1 lac unique investors and a market share of 11.1% as of FY20. The AAUM size is Rs.1733.94bn with PAT of Rs. 2.9bn.

Banks with a strong retail franchise and high-quality human resources could sustain profitable growth. Employees of Kotak Bank among others are the most satisfied with their organisations and have the most favourable business outlooks.

What could go wrong?

- Recent COVID-19 breakout is likely to have multiple order and far reaching impact on the banking sector. Credit growth is already heading southwards and given the extensive nature of the lockdown, asset quality issues are likely to spread many more sectors. On-going stress in Corporate and SME segment might accelerate and in fact retail loan segment might emerge as new source of stress.

- Lower than expected loan growth and greater than expected deterioration in asset quality remains key risk to our thesis. its loan exposure to potentially vulnerable sectors like commercial vehicles, construction equipment, unsecured personal loans (including small business loans), as well as auto and two-wheeler (2W) loans could increase asset quality stress in the next 18-24 months.
- Slower than expected growth of subsidiaries can impact consolidated profitability of the bank.
- The bank is trading at comparatively high valuations; so margin for disappointment in earning is low. Any small deterioration in performance can lead to a sharp price correction.
- Board has approved the renewal of Mr. Uday Kotak and Mr. Deepak Gupta for a period of 3 years starting from 21 Jan ’21 and application has been made to RBI. Non approval by RBI will be a huge negative for the bank. Also recently RBI had released a discussion paper on governance at commercial banks in which they have mentioned a potential cap of tenure for Chief Executive Officers (CEOs) who are promoters or large shareholders. We see this is one of the key risks to our thesis.

Company Profile:

Kotak Mahindra Bank Limited (KMB) commenced banking operations in the year 2003 when Kotak Mahindra Finance Limited received a license to carry on banking business thereby becoming the first non-banking finance company to get a banking license in the country. Over the years on account of its bold organic and inorganic growth strategies, it has grown to be one amongst the fastest growing banks and the most admired financial institutions in India. As of 31st March 2020, the Bank had 1600 branches in the country and 2519 ATMs across the country. The company, through its subsidiaries and other group companies, offers the complete range of financial solutions. Kotak Mahindra Group is one of India’s leading financial services conglomerates, providing a wide span of solutions across banking (consumer, commercial, corporate), credit and financing, equity broking, wealth and asset management, insurance (general and life), and investment banking.

In 1996, the company entered into two key joint ventures, one with Goldman Sachs for investment banking & stock broking and the other one with Ford Credit for car financing. KMB acquired INGV Bank in FY15, which has allowed it to gain significant scale and provided synergistic benefits.

By selling 2.83% stake worth over Rs 68bn in the Kotak Bank in June 2020, Uday Kotak has brought down his stake to the RBI-mandated 26%.

Kotak Mahindra Bank Ltd

SoTP Valuation:

	Base Case	Bull Case	Rationale
Kotak Mahindra Bank - Banking Business	1132	1214	3.45x & 3.7x Mar-22E core ABV of Rs 328
Kotak Mahindra Prime - Car Finance	68.2	68.2	2.0x Mar-22E core NW
Kotak Mahindra Investments - LAS	29.8	29.8	2.0x Mar-22E core NW
Kotak Securities - Broking	52.9	52.9	18x Mar-22E Earnings
Kotak Mahindra AMC	65.6	65.6	8% of FY22E AUM
Kotak Life	133.8	133.8	FY21 EV + 21x FY22E VNB
KMCC - Investment Banking Business	5.7	5.7	2.0x Mar-22E core NW
Kotak Alternative Assets	5.4	5.4	7.5% of FY22E AUM
Off Shore Funds	5.5	5.5	5% of FY22E AUM
Total Value of Sub	**366.9**	**366.9**	
Less : 20% Holding discount	73.4	73.4	
Total Value	**1425**	**1507**	

(

Source: Company, HDFC sec)

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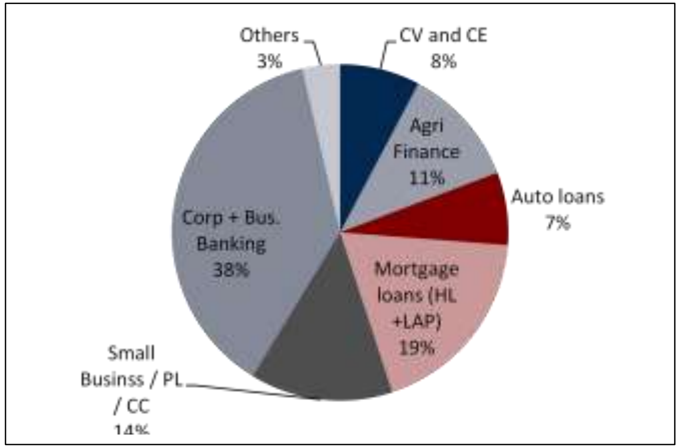
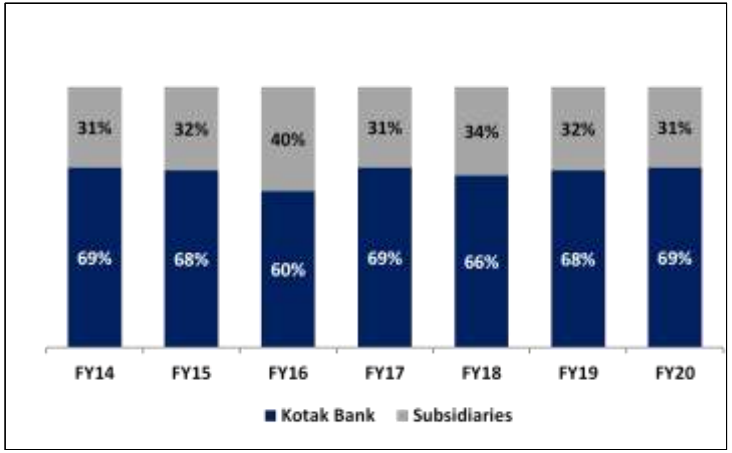
Kotak Mahindra Bank Ltd

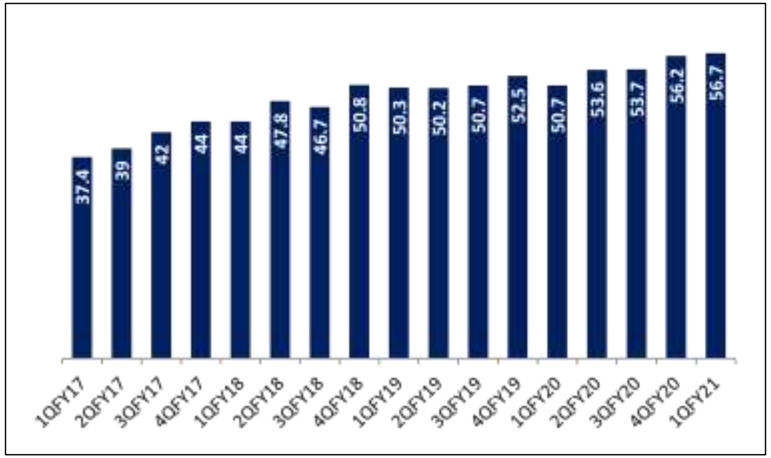
Composition of PAT%



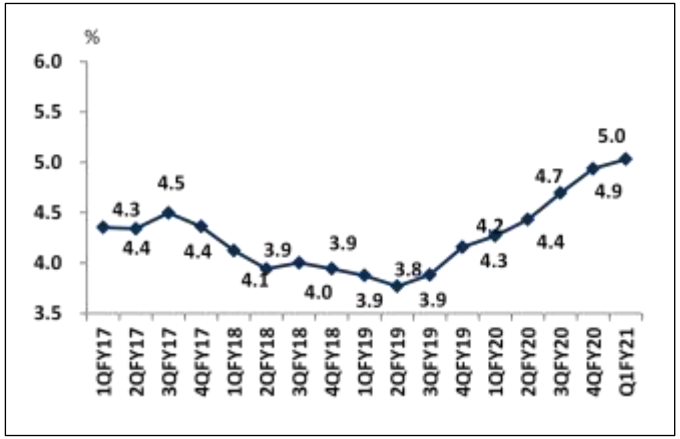
Composition of PAT%



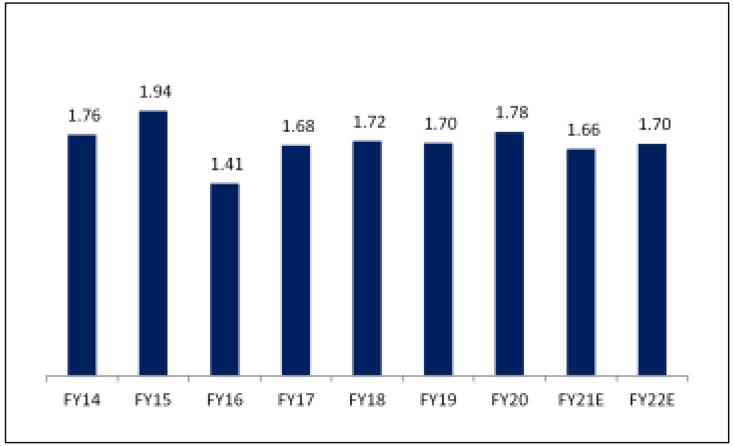
Improving CASA%



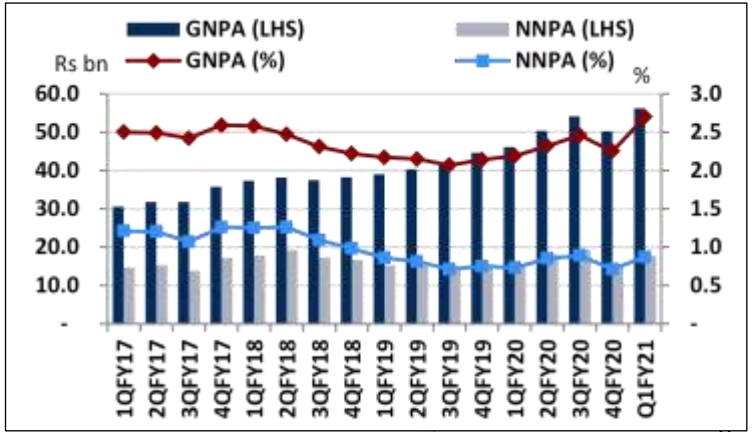
Net Interest Margin %



ROAA %



Asset Quality Trend



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Kotak Mahindra Bank Ltd

Financials

Income Statement (in Mn)

	FY19	FY20	FY21E	FY22E
Interest Earned	2,39,432	2,69,296	2,89,631	3,14,422
Interest Expended	1,26,842	1,34,299	1,38,950	1,48,782
Net Interest Income	**1,12,590**	**1,34,997**	**1,50,681**	**1,65,640**
Other Income	46,040	53,721	52,958	58,191
Fee Income (CEB)	33,908	37,793	36,936	41,447
Treasury Income	709	4,831	4,250	3,250
Total Income	1,58,630	1,88,718	2,03,638	2,23,831
Total Operating Exp	75,148	88,509	90,567	1,02,830
Employee Expense	31,836	39,111	40,589	46,647
PPOP	**83,482**	**1,00,208**	**1,13,071**	**1,21,001**
Provisions & Contingencies	9,624	22,162	29,180	25,891
Prov. for NPAs (incl. std prov.)	9,589	14,759	30,180	27,691
PBT	73,858	78,047	83,892	95,111
Provision for Tax	25,205	18,575	21,116	23,939
PAT	**48,653**	**59,472**	**62,776**	**71,171**

Balance Sheet (in Mn)

As at March	FY19	FY20	FY21E	FY22E
SOURCES OF FUNDS				
Share Capital	9,544	9,565	9,890	9,890
Reserves	4,14,440	4,75,588	6,08,508	6,75,229
Shareholder's Funds	4,23,984	4,85,153	6,18,398	6,85,119
Savings	7,96,847	10,46,086	12,02,999	13,53,374
Current	3,89,010	4,30,127	4,45,182	4,60,763
Term Deposit	10,72,947	11,51,992	12,01,814	13,25,784
Total Deposits	22,58,804	26,28,205	28,49,995	31,39,921
Borrowings	3,27,504	3,84,962	4,23,455	4,55,212
Other Liabilities & Prov	1,11,430	1,04,197	1,14,617	1,26,078
Total Liabilities	**31,21,721**	**36,02,517**	**40,06,464**	**44,06,330**
APPLICATION OF FUNDS				
Cash & Bank Balance	2,46,755	5,32,923	6,66,585	7,28,898
Investments	7,11,891	7,50,515	8,98,439	9,41,610
G-Secs	5,80,630	6,19,056	7,69,499	8,00,680
Advances	20,56,948	21,97,482	23,08,496	25,90,435
Fixed Assets	16,516	16,231	17,043	17,895
Other Assets	89,611	1,05,365	1,15,902	1,27,492
Total Assets	**31,21,721**	**36,02,517**	**40,06,464**	**44,06,330**

(Source: Company, HDFC sec)

Kotak Mahindra Bank Ltd

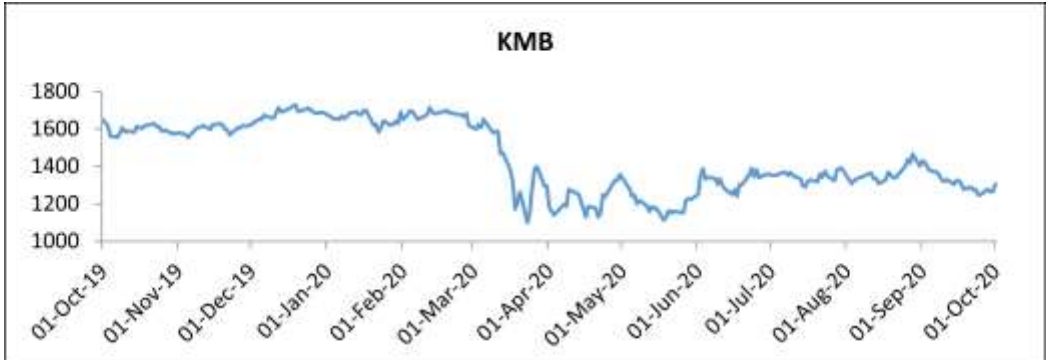
Key Ratios

	FY19	FY20	FY21E	FY22E
Valuation ratios				
EPS	25.5	31.1	31.7	36
Earnings growth (%)	19.1	22.2	5.6	13.4
BVPS (ex reval.)	208.9	239.9	307.4	341.1
Adj. BVPS (Core)	200.8	231.8	286.6	328.2
ROAA (%)	1.7	1.78	1.66	1.7
ROAE (%)	13	13.9	11.8	11.1
ROAE (%) (Core)	13	13.9	11.8	11.1
P/E (x)	38.4	33.2	33.0	28.1
P/ABV (x)	4.9	4.4	3.7	3.1
Dividend Yield (%)	0.1	-	0.1	0.1
PROFITABILITY				
Yield on Advances (%)	9.79	9.87	9.62	9.46
Yield on Investment (%)	7.18	7.19	7.2	7.2
Cost of Funds (%)	5.32	4.8	4.42	4.33
Cost of Deposits (%)	5.26	4.94	4.26	4.18
NIM (%)	4.2	4.29	4.25	4.24
OPERATING EFFICIENCY				
Cost/Avg. Asset Ratio (%)	2.6	2.6	2.4	2.4
Cost- Income Ratio	47.6	48.1	45.4	46.6

(Source: Company, HDFC sec)

	FY19	FY20	FY21E	FY22E
BALANCE SHEET STRUCTURE RATIOS				
Loan Growth (%)	21.2	6.8	5.1	12.2
Deposit Growth (%)	17.3	16.4	8.4	10.2
C/D Ratio (%)	91.1	83.6	81	82.5
CASA (%)	52.5	56.2	57.8	57.8
Total Capital Adequacy Ratio (CAR)	17.5	17.9	19.9	19.5
Tier I CAR	16.9	17.3	19.6	19.3
ASSET QUALITY				
Gross NPLs (Rs bn)	44.7	50.3	97.9	91.6
Net NPLs (Rs bn)	15.4	15.6	41.2	25.6
Gross NPLs (%)	2.1	2.3	4.2	3.5
Net NPLs (%)	0.8	0.7	1.8	1
Coverage Ratio (%)	65.4	69	57.9	72
Provision/Avg. Loans (%)	0.5	0.69	1.34	1.13

One Year Prie Chart



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