Sharekhan by BNP PARIBAS

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Kotak Mahindra Bank

Better times ahead

Banks & Finance	Sharekhan code: KOTAKBANK	Company Update

Summary

- Kotak Mahindra Bank (KMB) is well-positioned to grow at a healthy rate as credit demand picks up and as it has a clean balance sheet (capital adequacy of 24.7%; Tier I capital at 22.8%), strong liability franchise (industry leading CASA at 60.2%) and improving trend on asset quality side.
- In Q1, slippages were elevated amid wave-2 of COVID-19. However, KMB's COVID-related provisions (0.6% of loans) and restructuring was low at 0.25% during the quarter.
- In Q2, we expect slippages to decline as collection efficiency improves. Consequently, GNPA ratio is expected to be at ~3.3% in Q2, down from 3.56% in Q1. NII is also likely to grow by ~15% with better recoveries and an increase in credit growth during the quarter.
- We expect the bank's subsidiaries such as Kotak Securities and Kotak Asset Management to perform well amid a buoyant equity market. Valuations are attractive after adjusting for subsidiary valuations of Rs. 571/share. We retain a Buy rating on the stock with revised SOTP-based price target of Rs 2,428 - valuing the standalone bank at 4.5x FY23 book value.

- **NII growth and asset quality expected to improve in Q2:** We expect asset quality to get better in Q2FY22 with GNPA ratio likely to be at 3.3% versus 3.56% in Q1FY22 led by lower slippages and better recovery. Recoveries and collections were weak in April-May 2021 amid wave-2 of the COVID-19 pandemic. Despite being well capitalised and having the highest capital adequacy ratio, the bank's loan book growth has been lagging private sector peers. We expect credit growth to pick up in Q2FY22 and accordingly NII is likely to grow by 15% y-o-y in Q2FY22.
- **Improvement in subsidiaries to boost consolidated PAT:** In Q1, the loss of Rs. 243 crore reported by its life insurance subsidiary and elevated provisions (standalone operations) led to sequential decline in consolidated profits. However, in Q2, the life insurance subsidiary is expected to turn around, while Kotak Securities and Kotak Prime are expected to maintain their healthy growth trend.

Our Call

Valuation–Maintain Buy with a revised PT of Rs. 2,428: We value Kotak Mahindra Bank on a standalone basis at ~4.5x its FY2023E book value and its subsidiaries at ~Rs. 571 per share. The bank's strong operating metrics, prudent and agile leadership team. It is well-positioned to grow at a healthy rate as credit demand picks up, as it has a clean balance sheet (capital adequacy of 24.7%; Tier I capital at 22.8%), strong liability franchise (industry leading CASA at 60.2%) and as asset quality improves. We recommend a Buy on the stock with an SOTP-based PT of Rs. 2,428.

Key Risks

Any delay in an economic pick-up may elongate the recovery trajectory, resulting in consequent rise in risk of NPAs affecting profitability.

Valuation Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
NII	15,340	16,617	19,053	22,317
PPoP	12,215	13,605	15,534	18,234
PAT	6,965	7,993	9,482	10,719
EPS (Rs)	35.1	40.3	47.8	56.3
BVPS (Rs)	321.6	361.6	408.9	481.1
PE (x)	57.8	50.4	42.5	36.1
PBV (x)	6.3	5.6	5.0	4.2
RoE (%)	10.9	11.2	11.7	11.7
RoA (%)	1.8	1.8	1.9	1.9

Source: Company; Sharekhan estimates

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 2,031**	
Price Target: **Rs. 2,428**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

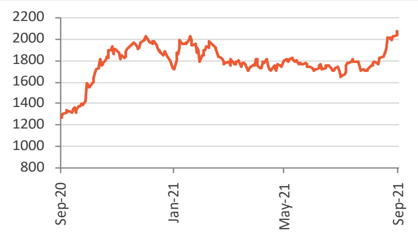
Company details

Market cap:	Rs. 402,742 cr
52-week high/low:	Rs. 2071/1252
NSE volume: (No of shares)	34.2 lakh
BSE code:	500247
NSE code:	KOTAKBANK
Free float: (No of shares)	378.22 cr

Shareholding (%)

Promoters	26
FII	42.7
DII	14.4
Others	16.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	15.8	19.1	16.1	60.7
Relative to Sensex	12.5	6.0	-5.8	4.3

Sharekhan Research, Bloomberg

Formidable liability franchise

Kotak Mahindra Bank's strategy for deposit growth and market share has primarily revolved around offering higher deposit/savings rates versus its competitors. The strategy has worked well until now; in the 10-year period ending FY21, the bank's deposit base clocked a 25% CAGR. Growth declined to 14% in FY17, mainly due to integration-related issues, but rebounded to 21% in FY18. Kotak Mahindra Bank has been able to improve its CASA ratio to 60% in FY21 (from 29% in FY13) backed by strong deposit growth.

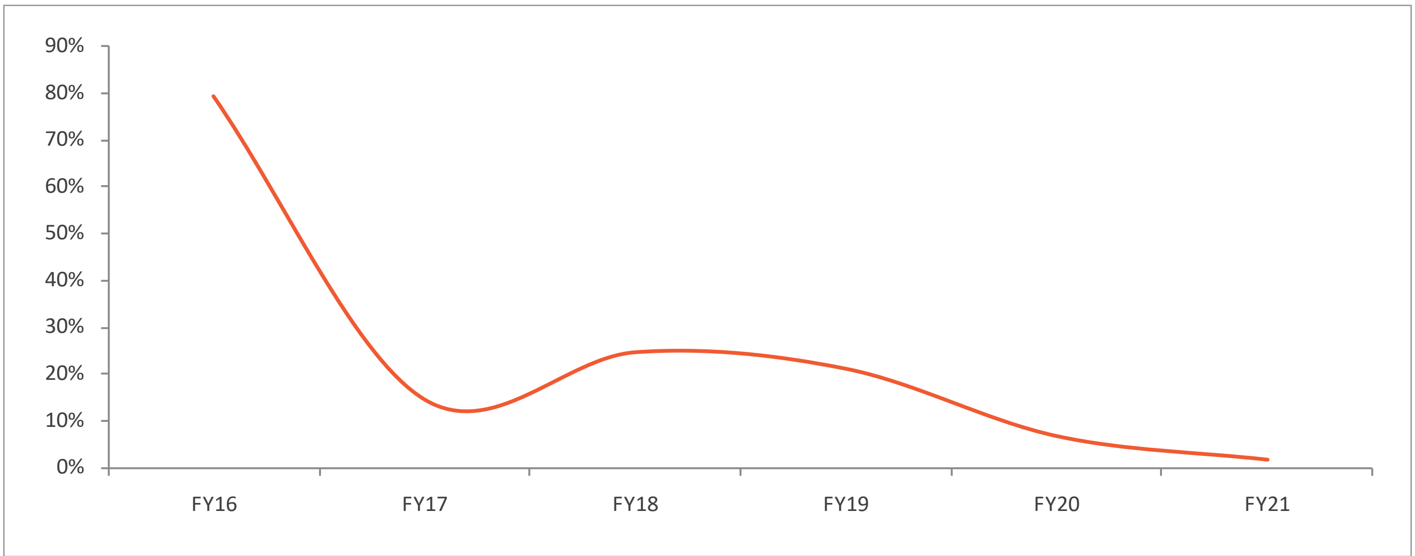
Best CASA franchise among peers

KMB has clearly been in a league of its own in terms of fortifying its liability franchise – the bank has ramped up share of CASA deposits from 37% in FY16 to 60% n FY19 and successfully closed the gap with larger peers. In fact, at 60% as on Q1FY22, KMB now has the highest CASA ratio in the industry, well ahead of peers. In our view, a series of strategies ranging from the acquisition of ING Vysya Bank to its digital banking initiative '811' have worked in KMB's favour to create a strong liability franchise.

Calibrated, cautious growth in loan book with focus on strong underwriting

Kotak Mahindra Bank's loan book clocked a CAGR of 22% in the 10-year period ending March 2021 (before the merger with ING in FY16). Integration challenges and demonetisation resulted in loan growth falling to 15% in FY17. After successful integration of ING Vysya, Kotak Mahindra Bank restored its growth (in FY18) with the loan book rising by 21%. Due to the pandemic, loan growth slowed down to 1.8% in FY21 from 21% y-o-y in FY19.

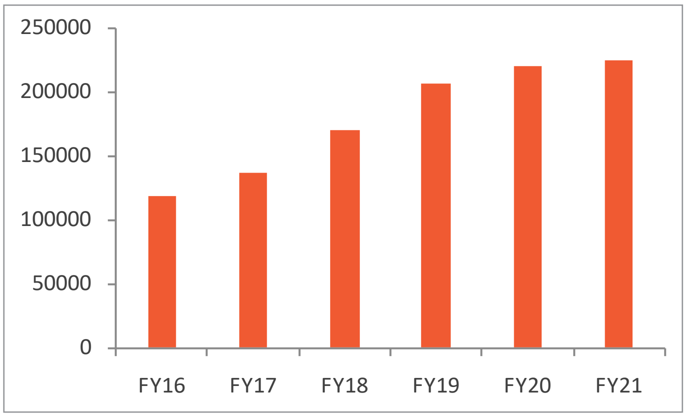
Loans clocked 13.5% CAGR during FY16-FY21



Source: Bank, Sharekhan Research

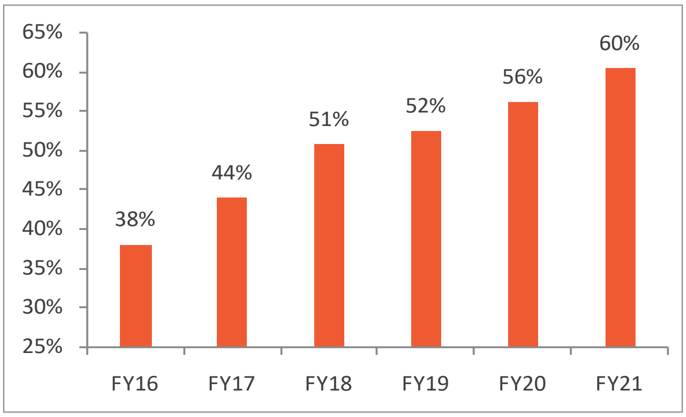
Financials in charts

Loans clocked 13.5% CAGR during FY16-FY21



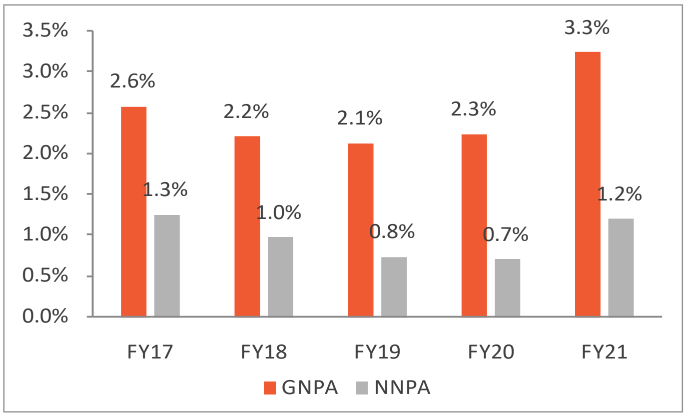
Source: Bank, Sharekhan Research

Highest CASA ratio among all banks



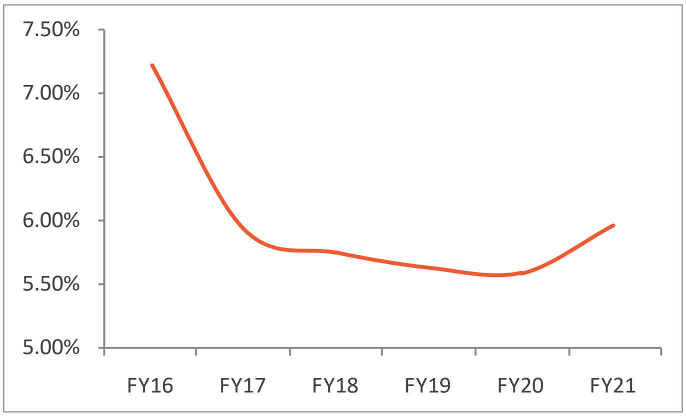
Source: Bank, Sharekhan Research

Trends in Asset Quality



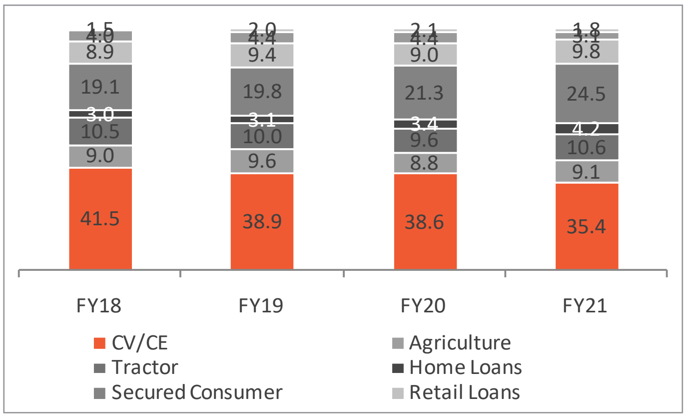
Source: Bank, Sharekhan

NIMs has stabilised from its high of 7%



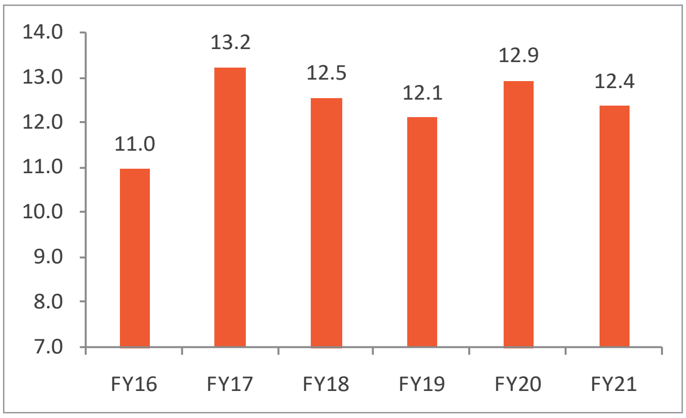
Source: Bank, Sharekhan

Loan Portfolio: Decline in CV/CE book



Source: Bank

ROEs has been in the range of 12-13%



Source: Bank

Outlook and Valuation

■ Sector view - Credit growth yet to pick up, stronger banks placed better

System-level credit offtake remains sedate, growing by 6.7% y-o-y in the fortnight ending Sep 10, 2021. On the other hand, deposits rose by 9.3%. Moreover, the RBI's accommodative monetary policy stance, resulting in surplus liquidity, provides succour in terms of easy availability of funds and lower cost of funds for banks and financials. The end of the loan moratorium is a relief. Going forward, corporate exposure is likely to be a function of asset quality, client profile, as well as economic recovery. At present, we believe that the banking sector is likely to see increased risk-off behaviour, with tactical market share gains for well-placed players. We believe that large banks, with a strong capital base and strong asset quality (with high coverage and provision buffers), are better placed to take off once the situation normalises.

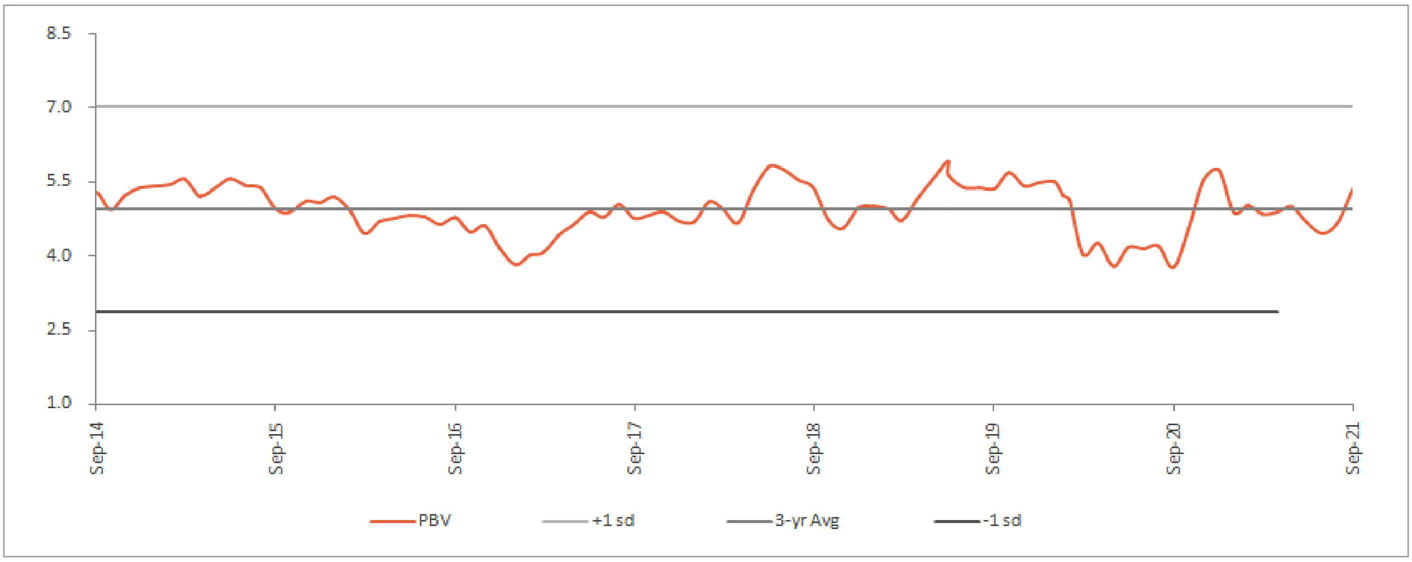
■ Company outlook

We believe with KMB's strong retail positioning along with a mass-affluent customer base, the bank is likely to see fewer asset quality issues from the retail segment, and its strategy of front-loading of provisions and recognitions has resulted in an improving NPA position on a sequential basis. The bank is entering FY2022E with a relatively clean/normalised book quality. KMB has one of the highest CASA ratios in the industry (at over 60% as on June 2021), which has helped the bank in reducing Cost of Funds, which will enable it to grow its business in a risk-calibrated manner. The current capitalisation and provision coverage ratio indicate a long growth runway for the bank. KMB has a diversified and integrated financial service offering that helps it balance against market cycles, hedge against downturns in specific segments and access to multiple growth avenues. The broad product spectrum helps meet customers' diverse financial and investment requirements, thus enhancing overall customer experience. We believe that its strength on the liability side, along with strong book quality and robust capital position provide it with strong fundamentals.

■ Valuation - Maintain Buy with a revised PT of Rs. 2,428

We value KMB on a standalone basis at ~4.5x its FY2023E book value and its subsidiaries at ~Rs. 571 per share. The bank's strong operating metrics, prudent and agile leadership team, well-capitalised balance sheet, as well as the quality of its subsidiaries (formidable players in their own segments) provide long-term value to the franchises. The stock is available at 5.6x/5.0/4.2x its FY2022E/FY2023E/FY2024E BVPS. With the recent QIP and capital issue, the bank is comfortably placed with a tier-1 capital ratio of 23.6% (standalone) and has the wherewithal for capitalising on opportunities. We recommend a Buy on the stock with an SOTP-based PT of Rs. 2,428.

One-year forward P/B (x) band



Source: Company; Sharekhan Research

SOTP Valuation

ENTITY	Stake	Valuation Parameter	Value Per share
Kotak Mahindra Bank	Parent Bank	4.5xFY23E BVPS	1,857
Kotak Securities Ltd	100%	27x PAT FY23E	197
Kotak Mahindra Asset Management Company Ltd	100%	5% of FY23E AUM	77
Kotak Mahindra Life Insurance Ltd	100%	Trailing EV for FY21	297
Kotak Mahindra Prime	100%	28x PAT FY22E	102
Others	100%		40
Less: Holdco Discount for subsidiaries	20%		570
SOTP VALUE			**2,428**

Source: Company; Sharekhan Research

About company

Established in 1985, Kotak Mahindra Group (Group) is one of India's leading financial services conglomerate. KMB has a national footprint of 1,600 branches and 2,573 ATMs. The Group offers a wide range of financial services that include commercial banking, stock broking, mutual funds, insurance, and investment banking. The Group caters to diverse financial needs of both individuals and the corporate sector. The bank has a well-diversified pan India (~30% each in North, West and South regions and 8% in Eastern India) and has one of the highest CASA ratios in the Industry.

Investment theme

We believe KMB continues to be an attractive business franchise, with a well-rounded products and services offering, shaping up well for the long term. Consistent performance across interest rate and asset cycles is a key differentiator and indicates the management's quality and strength of the franchise. The bank's subsidiaries are shaping up well; and while at present, they are relatively small, we believe each one has strong business strengths and are well on way to be a significant value contributor to the consolidated business in the long term. We find KMB to be an attractive franchisee with a strong balance sheet, with pan India reach and healthy capitalisation, which will help it tide over medium-term challenges.

Key Risks

Any delay in economic pickup may elongate the recovery trajectory, resulting in consequent rise in risk of NPAs affecting profitability.

Additional Data

Key management personnel

Mr Uday Kotak	Executive Vice Chairman and MD
Mr Deepak Gupta	Joint MD
Ms S Ekambaram	County Head – Consumer Banking
Mr K V S Manian	Country Head - Wholesale and Investment Banking
Mr. D. Kannan	Country Head – Commercial Banking

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Kotak Uday Suresh	25.77
2	Capital Group Cos Inc/The	2.3
3	Euro pacific growth fund	4.45
4	CANADA PENSION PLAN INVESTMENT B	6.37
5	Oppenheimer Funds Inc	3.3
6	Axis Mutual fund	1.55
7	SBI Funds Management Pvt Ltd	2.41
8	Life Insurance Corp of India	4.38
9	Sumitomo Mitsui Financial Group In	1.72
10	NEW WORLD FUND INC	1.98

Source: BSE

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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