Kotak Institutional Equities

Banks/Financial Institutions

India

NEUTRAL

JULY 17, 2014

UPDATE

BSE-30: 25,561

New bank format appears to be less of a risk. RBI has issued draft guidelines on two new formats of banks: (1) small banks and (2) payment banks. Small banks would operate in a specified area while payment banks would be involved in mobilizing deposits. Minimum capital adequacy ratio (15%) and high capital to begin (₹1 bn) could hamper the economics of the model. We don't see any impact from these banks for existing players as they are unlikely to provide serious competition and believe that a few banks could look at even promoting these types of banks, as it serves their PSL requirements.

Small banks and payment banks: two niche banking formats introduced

RBI has issued draft guidelines on two new banking formats: (1) small banks and (2) payment banks. The primary objective of small banks is to play an important role in credit supply to MSME, agriculture and banking services in unbanked and under-banked regions in the country. The primary objective of payment banks would be to provide small savings/current accounts and provide a platform for high-volume, low-value payments/remittance services. There is a big focus on reaching out to the customer through a strong technological platform. The guidelines have been fairly silent on mergers and acquisitions.

Return ratios and scalability appear to be a challenge

Niche banking comes with niche problems; however, we construe that small banks can be more profitable but payment banks can give better growth. Small banks, given their charter, may have issues on scalability and events like a debt waiver, impact of high interest rate in MFI and the consequence of being involved in the vagaries of regional growth can result in volatile earnings performance. On the other hand, payment banks may be constrained in lending as they will be allowed to invest only in G-Sec portfolios. It does appear that profitability will be a function of their cost of deposits, operating expenses model and fee income on the high-volume transactions.

Collaborators and not competitors for now

We don't see these new banks emerging as a major threat to the frontline banks, at least in the short term, as they will be working in a tight environment with defined objectives that do not overlap with each other. Besides, we think that banks, especially private banks, would act as promoters rather than competitors of the payment banks, as these banks are allowed to act as banking correspondents (BCs) for offering credit products to their customers. These customers could help reduce PSL requirements of the banks.

Are we giving up on the existing structure?

We like the minimum capital required of ₹1 bn and the restrictions in the business model (scalability and profitability) as it would probably attract very serious players in this space. There are quite a few pre-paid instrument providers and financial inclusion-focused NBFCs like FINO and Eko, which are now eligible to convert into banks.

It does appear that RBI is disappointed with the banking sector as financial inclusion is yet to reach the entire country. Hence, it believes that the objective can be achieved by companies that are currently working in these specific areas.

However, we would have been a lot more comfortable if RBI were to give a definite roadmap on the cooperative banks landscape. Currently, we have >95,000 credit cooperatives in India, of which 1,606 pertain to urban cooperatives that have a large share of credit. As of FY2013, these banks (consolidated) delivered RoAs of 1.1%, RoEs of 9.7% and gross NPLs of 6%.

QUICK NUMBERS

- Two new banking formats: small banks and payment banks
- No immediate threat to existing players

M.B. Mahesh, CFA
mb.mahesh@kotak.com
Mumbai: +91-22-4336-0886

Nischint Chawathe
nischint.chawathe@kotak.com
Mumbai: +91-22-4336-0887

Geetika Gupta
geetika.gupta@kotak.com
Mumbai: +91-22-4336-0888

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-4336-0000

Payment banks—profitability is a serious question

The primary objective of payment banks would be to provide (1) small savings/current accounts and (2) high-volume, low-value payments/remittance services to migrant labor force, low-income households, small business, unorganized sector entities and others. Existing non-bank pre-paid instrument issuers, NBFCs, banking correspondents, mobile telephone companies, super-market chains, companies, cooperatives and PSUs are eligible to apply. Even banks can take a stake in these banks. They need to open 25% of their access points in rural areas.

The maximum balance per customer would be ₹0.1 mn. KYC (Know Your Customer) norms can be relaxed if (1) total credits in a financial year do not exceed ₹0.1 mn, (2) aggregate withdrawals and transfers do not exceed ₹10,000/month and (3) balance at any time does not exceed ₹50,000.

These banks would (1) have to maintain the regulatory charges of CRR and (2) not have the option to lend but would have to invest in G- Sec/T Bills with a maximum of 1-year maturity. The minimum capital required to start the bank would be ₹1 bn and the bank would have to have a minimum capital adequacy ratio of 15%. These banks would be governed by a simple leverage ratio of 20X (assets to net worth) as they don't have loans.

The promoters would have to progressively reduce their stake. The promoters would need to have at least 40% for the first five years while progressively reducing any excess beyond 40% within three years of commencement of business. The stake should be further reduced to 30% within a period of 10 years and to 26% within 12 years of commencement of business.

Profitability is a serious question

As compared to conventional banks, we are not too sure if we can understand the profitability of these banks. The severe restriction on lending makes the business model extremely challenging.

The exhibit below shows illustrations of a possible payment bank. We have created a few scenarios to highlight our concern. Our base-case scenario assumes (1) average RoEs of 14% in this business, (2) investment yield at 8%, (3) fee income of 1% and (4) cost of operations of 1%.

What does appear from this exercise is that there are two key parameters to make this business a viable proposition: (1) interest on deposits and (2) cost of operations. We think the offerings of these banks are unlikely to provide 4% on savings accounts and see it a lot lower as the spreads of the business are too thin. If possible, they need to link the cost of savings to the underlying interest rate on yields to reduce the volatility of returns, though it comes at the cost of the borrower. Cost of operations depends on the business model (tech-heavy initially or a cost/transaction platform) and the pace of expansion.

Exhibit 1: Scenario analysis to deliver RoE of 14% for payment banks

	Yield on investments			Cost of operations			Leverage			Fee income		
	7.0%	**9.0%**	**6.0%**	**0.5%**	**2.5%**	**1.0%**	**Peak**	**Lower**	**Average**	**Peak**	**Lower**	**Average**
Yield on investments	7.0	9.0	6.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Cost of funds	4.1	6.1	3.1	5.6	3.6	6.1	5.3	4.6	5.1	5.1	6.1	8.1
Net interest income	**2.9**	**2.9**	**2.9**	**2.4**	**4.4**	**1.9**	**2.7**	**3.4**	**2.9**	**2.9**	**1.9**	**(0.1)**
Fee and others	0.5	0.5	0.5	0.5	0.5	1.5	0.5	0.5	0.5	0.5	1.5	3.5
Total income	**3.4**	**3.4**	**3.4**	**2.9**	**4.9**	**3.4**	**3.2**	**3.9**	**3.4**	**3.4**	**3.4**	**3.4**
Cost of operations	1.0	1.0	1.0	0.5	2.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Pre-provisioning op. profit	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.2**	**2.9**	**2.4**	**2.4**	**2.4**	**2.4**
Provisions	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Profit before tax	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.1**	**2.8**	**2.4**	**2.4**	**2.4**	**2.4**
Tax	1.6	1.6	1.6	1.6	1.6	1.6	1.4	1.9	1.6	1.6	1.6	1.6
RoA	**0.8**	**0.8**	**0.8**	**0.8**	**0.8**	**0.8**	**0.7**	**0.9**	**0.8**	**0.8**	**0.8**	**0.8**
Leverage	18.0	18.0	18.0	18.0	18.0	18.0	20.0	15.0	18.0	18.0	18.0	18.0
RoE	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**	**14.0**

Source: Kotak Institutional Equities Estimates

Exhibit 2: Current pre-paid instrument players in India

	Name of the entity		Name of the entity
1	Airtel M Commerce Services	19	Pyro Telecommunications
2	Atom Technologies	20	QwikCilver Solutions
3	Citrus Payment Solutions	21	Reliance Payment Solution
4	DigitSecure India	22	Smart Payment Solutions
5	Edenred (India) – nee Accor Services	23	Sodexo SVC India
6	GI Technology	24	Tech Mahindra
7	Idea Mobile Commerce Services	25	Transaction Analysts (India)
8	India Transact Services	26	UAE Exchange & Financial Services
9	Itz Cash Card	27	UTI Infrastructure Technology and Services
10	MMP Mobi Wallet Payment Systems	28	Y-Cash Software Solutions
11	Mobile Commerce Solutions	29	ZipCash Card Services
12	Muthoot Vehicle & Asset Finance	30	BTI Payments
13	My Mobile Payments	31	Muthoot Finance
14	One97 Communications	32	Prizm Payment Services
15	One Mobikwik Systems	33	RiddiSiddhi Bullions
16	Oxigen Services (India)	34	SREI Infrastructure Finance
17	PayMate India	35	Tata Communications Payment Solutions
18	Pay Point India Network	36	Vakrangee

Source: RBI, Companies, Kotak Institutional Equities

Small local banks—scalability an issue

The primary objective is to play an important role in the supply of credit to micro and small enterprises, agriculture and banking services in unbanked and under-banked regions in the country. Their area of operations would be restricted to contiguous districts but would be allowed to neighboring states, making it challenging to build a scalable business model.

The minimum capital required to start the bank would be ₹1 bn and the bank would have to have a minimum capital adequacy ratio of 15%. The promoters would have to progressively reduce their stake. The promoters would need to have at least 40% for the first five years while progressively reducing any excess beyond 40% within three years of commencement of business. The stake should be further reduced to 30% within a period of 10 years and to 26% within 12 years of commencement of business.

These banks would have to maintain all the regulatory requirements like CRR (cash reserve ratio), SLR (statutory liquidity ratio) and PSL (priority-sector loans). The loan portfolio has to be well-diversified within its area of operations though we are not sure if the diversification risk has been reduced.

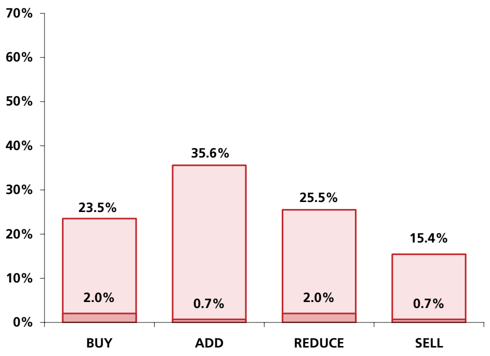
15% of capital funds would be the maximum that can be lent to individuals or groups. At least 50% of the loans have to be below ₹2.5 mn.

We are not sure if a single promoter would be allowed to open multiple small banks to address the (1) scalability of the business model and (2) concentration risk as lending could be due to the progress of a particular local industry and would be impacted by the vagaries of economic growth.

"I, M.B. Mahesh, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Percentage of companies covered by Kotak Institutional Equities, within the specified category.

Percentage of companies within each category for which Kotak Institutional Equities and or its affiliates has provided investment banking services within the previous 12 months.

* The above categories are defined as follows: Buy = We expect this stock to deliver more than 15% returns over the next 12 months; Add = We expect this stock to deliver 5-15% returns over the next 12 months; Reduce = We expect this stock to deliver -5-+5% returns over the next 12 months; Sell = We expect this stock to deliver less than -5% returns over the next 12 months. Our target prices are also on a 12-month horizon basis. These ratings are used illustratively to comply with applicable regulations. As of 30/06/2014 Kotak Institutional Equities Investment Research had investment ratings on 149 equity securities.

Source: Kotak Institutional Equities

As of June 30, 2014

Ratings and other definitions/identifiers

Definitions of ratings

BUY. We expect this stock to deliver more than 15% returns over the next 12 months.

ADD. We expect this stock to deliver 5-15% returns over the next 12 months.

REDUCE. We expect this stock to deliver -5-+5% returns over the next 12 months.

SELL. We expect this stock to deliver <-5% returns over the next 12 months.

Our target prices are also on a 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.

NC = Not Covered. Kotak Securities does not cover this company.

RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.

NA = Not Available or Not Applicable. The information is not available for display or is not applicable.

NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office

Kotak Securities Ltd.
27 BKC, Plot No. C-27, "G Block"
Bandra Kurla Complex, Bandra (E)
Mumbai 400 051, India
Tel: +91-22-43360000

Overseas Offices

Kotak Mahindra (UK) Ltd
8th Floor, Portsoken House
155-157 Minories
London EC3N 1LS
Tel: +44-20-7977-6900

Kotak Mahindra Inc
50 Main Street, Ste. 890
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

1. Note that the research analysts contributing to this report may not be registered/qualified as research analysts with FINRA; and
2. Such research analysts may not be associated persons of Kotak Mahindra Inc and therefore, may not be subject to NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.
3. Any U.S. recipients of the research who wish to effect transactions in any security covered by the report should do so with or through Kotak Mahindra Inc and (ii) any transactions in the securities covered by the research by U.S. recipients must be effected only through Kotak Mahindra Inc at nilesh.jain@kotak.com.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advise to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund. Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMInc). However KMInc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.

This report is distributed in Singapore by Kotak Mahindra (UK) Limited (Singapore Branch) to institutional investors, accredited investors or expert investors only as defined under the Securities and Futures Act. Recipients of this analysis / report are to contact Kotak Mahindra (UK) Limited (Singapore Branch) (16 Raffles Quay, #35-02/03, Hong Leong Building, Singapore 048581) in respect of any matters arising from, or in connection with, this analysis / report. Kotak Mahindra (UK) Limited (Singapore Branch) is regulated by the Monetary Authority of Singapore.