

**COMPANY UPDATE**

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**IDFC BANK****PRICE: Rs.57****TARGET PRICE: Rs.83****RECOMMENDATION: BUY****FY17E P/E: 17.7x; P/ABV: 1.4x**

We expect IDFC bank to deliver moderate return ratios (RoA: 1.0-1.2%; RoE: 7-10%) during first two years of operations (FY17/18E). Bank has consciously built-up strong FX book (Rs.338.2 bn) as against the regulatory requirement of maintaining SLR at Rs.107 bn (Q3FY16). NIM is expected to be ~2% in FY16/17E which is likely to improve to 2.6% in FY18E. We believe NIM would be impacted due to strategy of aggressively building-up of investment book where income flows through non-interest line item while borrowing cost flows through NII.

We are valuing banking business at Rs.83 (2.0x FY17E ABV; Rs.89 earlier) which has started banking operation on strong footing (provision buffer of ~10%). Its premium valuation given the modest return ratios (7-10% in FY17/18E) is justified by the strong capital position (19.6% Tier-I capital), strong growth trajectory and FII ownership headroom.

**Summary table**

(Rs mn)	FY16E	FY17E	FY18E
Interest Income	37471	96611	130425
Interest expenses	30160	75750	98476
NII	7311	20860	31949
Growth (%)		53.2%	
Non-Int Income	4234	9886	11143
Total Income	11545	30746	43092
Operating Profit	6561	16965	24488
PAT	4215	10901	15820
Growth (%)		45.1	
Gross NPA (%)	3.3	4.0	3.9
Net NPA (%)	1.4	1.4	1.3
NIMs (%)	2.0	2.1	2.6
RoA (%)	-	1.0	1.2
RoE (%)	-	7.6	10.1
DPS (Rs)	-	-	-
EPS (Rs)	1.24	3.22	4.67
BV (Rs)	40.6	43.8	48.4
Adj. BV (Rs)	38.8	41.4	45.5
P/E (x)	NM	17.7	12.2
P/ABV (x)	1.5	1.4	1.3

Source: Kotak Securities - Private Client Research

**Banking operation started on strong footing**

IDFC Bank is cruising ahead along with its execution plan. It has three distinct businesses - commercial & wholesale bank, rural bank and consumer bank and efforts continues to build a universal bank in next 5-7 years. As of today, bank has 24 branches - 16 are rural branches in Hoshangabad, Khandwa and Harda districts of MP while rest are in bigger cities. Management has been guiding that their strategy would continue to be light on branches (vis-à-vis well established banks of today) and rely more on digital infrastructure. They would continue focusing on investment in technology and re-engineering processes for better customer experience.

IDFC bank reported RoA at 1.2% during Q3FY16 as against the guidance of 1.0-1.1% during initial phase. Management has guided that C/I ratio would be inverted U-shaped and will rise further from here onwards (35.6% in Q3FY16). RoA trough is likely to be seen during FY17 at 1.0-1.1% before it would witness improvement.

Bank has built-up strong investment book to maintain balance sheet liquidity as well as to benefit from the yield curve movement. Its investment book grew 32.5% QoQ and stands at Rs.338.2 bn (Q3FY16) while SLR requirement is only Rs.107 bn. It has also reported outstanding credit (including credit substitutes) of Rs.462.7 bn comprising of Rs.430 bn of net advances, Rs.9.3 bn of NCDs and Rs.23.4 bn of LC/BGs. Bharat bank book is very small at Rs.543 mn (~1% of loan book).

Reported PAT (Rs.2.42 bn) for IDFC bank was largely aided by strong treasury gains (Rs.1.72 bn) while NII came at Rs.4.04 bn. Its NIM came at 2% while NIM for loan portfolio was at 3.2%. Overall NIM is lower because of build-up of investment book where income flows through non-interest income line item while funding cost flows through interest expense line.

**Retail banking strategy**

Management has been targeting to grow its loan book 3x to ~Rs.1.5 tn in next 5 years, covering 50 districts in 5 states (MP, Karnataka, Maharashtra, Rajasthan and Gujarat). Bank's strategy would be to pick up a district and saturate it using MFI delivery model. Its rural branch strategy would deliver through micro ATMs, which will do everything except credit products. Micro ATMs would be hooked to Aadhar data base and can be authenticated using biometric information. They

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will also form partnerships with MFIs/BCs. Management has also indicated that >70% branches will be operating in rural segment. Although it would be a small part of overall book, it would be profitable on the standalone basis.

Urban retail banking strategy would be branch light focusing more on digital space. IDFC bank has opened 5 retail branches till date and would focus on affluent class using segmentation strategy e.g. younger and self-employed.

### **Liability strategy - not offering pricing advantage:**

IDFC's liability strategy has been to focus on CA rather than SA to build sticky deposit franchise at a reasonable cost. Management has indicated that they are not offering any price advantage for attracting SA deposits but would offer cash discount/cashback if one transact using IDFC bank account. As per the management's earlier guidance, CASA is likely to touch ~10% in next 5-6 years.

At the end of Q3FY16, bank has mobilized CASA of Rs.3.2 bn (CA: Rs.2.93 bn, SA: Rs.0.3 bn) and TDs of Rs.13.2 bn. It is small as compared to the size of B/S - 0.7% of core funds. We expect gradual build-up to liability franchise and by FY18 it is likely to be 7.5% of core funds. We believe building strong liability franchise would be most daunting task for the management. Intense competition in the saving deposit segments as well as limited branch presence of IDFC would limit the quick ramp-up the saving account franchise. However, it can leverage its strong relationship with the wholesale customers to mobilize current account floats as well as fee-income through cross-selling.

### **Asset quality - strong counter-cyclical provisioning provides more comfort**

Management had indicated earlier that loan worth Rs.88 bn (Rs.50 bn as per regulatory definition) out of Rs.430 bn of loan book is facing stress. Out of this Rs.30 bn comes from gas based exposure. However, IDFC bank has already provided Rs.50 bn and recognizing income on cash basis only from the stressed portfolio. They have also appointed dedicated team for recovery from this segment. We believe ~10% of contingency provision buffer provides sufficient cushion to its future earnings against any negative surprise on its asset quality. Any resolution on gas price pooling would significantly reduce the stress on its gas exposure.

### **Valuation and Recommendation**

IDFC has aggressively built-up buffer provisions over past several quarters which is touching ~10%. So, even in the worst case scenario, if 13-14% of its stressed assets turn into NPLs, provision coverage ratio would remain healthy at 50-55%. IDFC's BV/Share is Rs.40 and bank is well capitalized (CAR: 20.3%; Tier I: 19.4%) amongst the private sector banks. Its asset quality remained stable - GNPA and NNPA at 3.1% and 1.0%, respectively (Q3FY16). As they have already created provision buffer of Rs.50 bn, Q3FY16 saw only marginal fresh provisioning (Rs.123 mn).

**We recommend BUY on  
IDFC Bank with a price  
target of Rs.83**

Management has guided for trough RoA of 1% for IDFC bank, which we expect in FY17. We are modeling RoA to come at 1% in FY17E which is likely to improve to 1.2% in FY18E. We expect IDFC bank to deliver moderate return ratios (RoA: 1.0-1.2%; RoE: 7-10%) during first two years of operations (FY17/18E).

We are valuing banking business at Rs.83 (2.0x FY17E ABV; Rs.89 earlier) which has started banking operation on strong footing (provision buffer of ~10%). Its premium valuation given the modest return ratios (7-10% in FY17/18E) is justified by the strong capital position (19.6% Tier-I capital), strong growth trajectory and FII ownership headroom.