Kotak Mahindra Bank Limited

February 26, 2019

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Infrastructure Bonds/NCD Programme	1,500.00	1,500.00	[ICRA]AAA (Stable); reaffirmed
Lower Tier II Bonds Programme	150.00	150.00	[ICRA]AAA (Stable); reaffirmed
Lower Tier II Bonds Programme	35.80	-	[ICRA]AAA (Stable); withdrawn
Total	**1,685.80**	**1,650.00**	

Rationale

The highest credit quality rating for Kotak Mahindra Bank Limited (KMBL) is supported by the bank's long track record, its experienced senior management team and its strong financial and operational performance over the years. The rating continues to reflect the strong growth in advances in the credit portfolio with the bank maintaining the asset quality, granularity and quality of incremental fresh exposures. Further, the rating draws comfort from KMBL's healthy capitalisation levels, which continue to be supported by strong internal capital generation. Most of KMBL's subsidiaries remain self-sufficient and profitable with limited capital requirements in the medium term.

The rating also factors in the healthy resource profile, with the bank continuing to grow the same at a strong pace while maintaining the granularity of deposits. This is driven partly by the bank's comparatively higher interest rate strategy, its strong retail franchise and its digital initiatives. However, against the backdrop of deposit accretion and lagging credit growth in the banking system, KMBL's ability to maintain deposit growth and granularity remains to be seen. The rating also positively factors in the stringent underwriting standards, along with strong risk management systems, that have helped the bank maintain a healthy asset quality through cycles. The asset quality of the corporate loan book remains comfortable, supported by a diversified presence across top corporate groups, while the stock of SMA2[1] remains at manageable levels on an overall basis. KMBL has adopted a cautious approach in lending to the small and medium enterprises (SMEs) and agri segments lately, with the share of these segments to total advances trending downward. Meanwhile, the bank's unsecured loan book has grown at a faster pace, driven largely by exposure to the small business, personal loans and credit cards segment, which, due to their inherent nature, could expose the bank to high losses on default.

As per Reserve Bank of India (RBI) requirements, the promoter stake in the bank needs to be progressively brought down to 20% of paid up capital as on December 31, 2018 and further to 15% of paid up capital before March 31, 2020. The matter on promoter stake dilution is currently subjudice. Going forward, if the bank decides to follow the acquisition route to achieve meaningful dilution in promoter stake, the operational and financial profile of the entity being acquired would remain a key rating sensitivity.

[1] *SMA2 accounts are loan accounts overdue by 61 days but less than 90 days*

Outlook: Stable

ICRA expects KMBL to grow at a healthy pace, supported by strong capitalisation, while maintaining comfortable asset quality. The bank's ability to maintain the granularity of the assets and liabilities will remain a key monitorable. Further, updates on the dilution of the promoter stake and ability to maintain strong capital cushions while achieving growth will remain key sensitivities.

Key rating drivers

Credit strengths

Healthy growth in advances while maintaining granularity and strong asset quality – KMBL's credit portfolio registered a strong growth of ~25% in FY2018, which was higher than the private sector bank average. The credit portfolio stood at Rs. 1,69,718 crore as on March 31, 2018 compared to Rs. 1,36,082 crore as on March 31, 2017 and grew further by 23% (YoY) to Rs. 1,96,432 crore as on December 31, 2018. The share of corporate loans in overall advances remained largely stable over the years and stood at 32% as on December 31, 2018 against 31% as on March 31, 2017. The quality of incremental advances and overall corporate advances remains comfortable with limited stressed exposures.

During the last few years, the bank has adopted a cautious approach in lending to the SME/business banking segment as well as the agricultural segment. As a result, the share of advances to these segments reduced to 9% and 12%, respectively, as on December 31, 2018 from 13% and 14%, respectively, as on March 31, 2017. This was offset by higher growth in other segments like personal loans/credit card loans, housing/loan against property, and commercial vehicles, whereby the share of these segments rose to 16%, 20% and 9%, respectively, as on December 31, 2018 from 13%, 19% and 8%, respectively, as on March 31, 2017. Despite the increasing scale and the strong growth in advances, the bank has been able to maintain granularity of its exposures with the top 20 exposures accounting for ~9% of exposures as on March 31, 2018. ICRA expects KMBL's credit growth to remain healthy in the medium term, supported by strong capitalisation and comfortable asset quality, even though liability mobilisation at competitive costs while maintaining granularity can be a challenge for growth.

Capitalisation supported by healthy internal accruals – KMBL's overall capitalisation levels remain strong with a capital adequacy ratio of 18.1% and a Tier I ratio at 17.6%, as on December 31, 2018[2]. Apart from healthy internal capital generation with return on equity of 12.5% in FY2018 (11.8% - annualised in 9M FY2019), the capital ratios were further boosted by the raising of fresh equity of ~Rs. 5,800 crore in FY2018. In FY2019, the bank issued perpetual non-cumulative preference shares (PNCPS) to the tune of Rs. 500 crore, which added to its Tier I capital. KMBL's solvency (Net NPA/Net Worth) remained comfortable at 3.37% as on December 31, 2018, which was significantly below the private sector bank average. This increases the bank's ability to absorb asset quality shocks, if any.

In ICRA's view, KMBL's current capital position provides it with adequate room to scale up its lending operations while maintaining a sufficient buffer over the regulatory capital requirement in the medium term. The bank has other subsidiaries that are in the lending, insurance, asset management and broking businesses, at present. On a consolidated basis too, KMBL's capitalisation remains comfortable with a Tier I ratio of 18.3% and CRAR of 18.7%. The subsidiaries are self-sufficient, in terms of capital requirements. Capital infusion towards the subsidiaries is expected to remain limited, in relation to the bank's overall profits, to the general insurance and infrastructure debt fund entities. As per regulatory requirements, banks are expected to shift to Indian Accounting Standards (IND-AS) from April 1, 2019, under which they will be required to provide for expected credit losses (ECL) on loan assets and changes in the fair value of other assets.

[2] *Against a regulatory requirement of 10.875% and 8.875%, respectively, as on March 31, 2019 including capital conservation buffer of 1.875%*

Given the comfortable asset quality and sufficient provision for stressed assets, as well as the limited impact on the fair valuation of the investment portfolio, ICRA does not expect the transition to IND-AS to have a major impact on KMBL's capitalisation levels. The bank is self-sufficient, in terms of capital, for meeting its growth over the next few years. Moreover, raising of capital in the near term, if any, will be driven by the need to comply with the RBI's norms for dilution in the promoter stake.

Strengthening retail franchise with improving CASA deposit base; reducing reliance on wholesale funding – Despite strong YoY growth of ~18.2% in total deposits as on December 31, 2018, KMBL continues to improve its current account and savings account (CASA) liabilities as well as the share of low-ticket deposits. The CASA deposits balance stood at 50.71% as on December 31, 2018 compared to 46.67% as on December 31, 2017, with YoY growth of 28.5%. The bank continues to follow the higher savings interest rate strategy for deposits less than Rs. 1 crore to mobilise granular savings deposits. The improvement in CASA was supported by the strengthening retail franchise of the bank following its merger with ING Vysya Bank Limited as well as its increasing branch presence and initiatives like the 811 scheme, which allows the online opening of bank accounts. The focus on granular deposits has also supported a decline in wholesale funding with CASA and term deposits (<Rs. 5 crore) increasing to 80% of the overall deposits as on December 31, 2018 from 63% as on March 31, 2014. With the increase in CASA and the other developments, as highlighted above, the difference in the bank's cost of interest-bearing funds has been declining and was ~0.3-0.5% above its peer rated private banks as on December 31, 2018 compared to over 1% as on March 31, 2014.

KMBL is expected to continue with the differentiated interest rate strategy for its savings accounts over the medium term to maintain granularity and deposit accretion while pursuing credit growth. Hence, the cost of interest-bearing funds is expected to remain marginally higher than peer banks though the resultant earnings pressure is expected to be offset by the bank's comfortable asset quality.

Asset quality expected to remain comfortable – KMBL's asset quality remains stable with GNPA and NNPA at 2.07% and 0.71%, respectively, as on December 31, 2018. Moreover, the asset quality is comfortable in comparison with its peers. The share of stressed loans in the overall corporate loan portfolio as well as the quality of incremental corporate loans remains comfortable. The diversification across the top corporate groups has also been maintained while achieving growth. The provision coverage ratio (excluding technical write-offs) was comfortable at 66.16% as on December 31, 2018. Further, the stock of stressed assets remains relatively more granular and the share of SMA2 outstanding of Rs. 344 crore (0.18% of net advances), as on December 31, 2018, remains limited. The ability of the bank to maintain its asset quality and granularity in top exposures, while growing at a healthy pace, will remain a key rating sensitivity.

Healthy profitability, supported by stable NIMs and controlled credit costs – With a declining interest rate environment till Q2 FY2018, the yields on average earning assets for KMBL also declined in FY2018 but were better than the average yields of private sector banks. This was on account of the relatively lower NPA levels, which led to higher income earning assets. The yield on assets was also impacted by an increase in the asset base, driven by an increase in KMBL's investment book, whereby it increased its holdings of short-tenor government securities for carry trade. As a result, the yields on average earning assets declined to 8.70% in 9M FY2019 compared to 9.21% in FY2017 (8.63% in FY2018).

However, supported by the declining cost of interest-bearing funds and a higher credit-deposit (CD) ratio, the net interest margins (NIMs), as a percentage of average total assets (ATA), stood comfortable at 3.92% in 9M FY2019 compared to 3.99% in FY2017 (3.98% in FY2018). Supported by strong fee income (1.59% of ATA in 9M FY2019; 1.69% in FY2018) and satisfactory cost-to-income ratios, the bank's operating profitability remains healthy with core operating profits (before credit provisions and treasury gains) of 2.89% of ATA (2.99% in FY2018). The credit costs have remained stable (0.35% of ATA in 9M FY2018 compared to 0.36% in FY2018). Accordingly, the return on assets was good at 1.65% in 9M FY2019, albeit below the FY2018 level of 1.70%. Moreover, with an increase in the equity base in FY2018, the RoE declined to 12.55% from 13.23% in FY2017. ICRA expects the bank's profitability to remain strong, driven by the growing scale of operations, increasing customer franchise and strong asset quality.

Credit challenges

Ability to maintain SA deposits while reducing interest rates remains to be seen – The bank's savings account (SA) deposits and growth in the same are being supported by the higher interest rate offered by KMBL on these accounts compared to peer rated private sector banks. The bank's ability to maintain its SA deposits in future, while reducing the interest rate on these deposits, remains to be seen. Moreover, as the deposit accretion in the banking system remains lower than credit growth, the ability to maintain granularity in the deposit base while pursuing deposit and credit growth will remain a challenge, going ahead. ICRA also notes that the bank has a high share of non-operational deposits among its peer banks, as financial sector entities are among the top few depositors of the bank. The ability to improve the depositors' profile further, in this respect, will also be a monitorable going forward.

Update on reduction in promoter stake, mode of stake dilution remains to be seen: The promoter group holds 30.01% of equity stake in the bank as on December 31, 2018, which declined from 32.08% as on March 31, 2017 after its QIP issue during May 2017. As per RBI requirement, promoter's stake in the bank has to reduce to 20% of its paid-up capital by December 31, 2018 and 15% before March 31, 2020. ICRA notes that if the bank was to pursue fresh capital raise as the mode of promoter stake dilution, the quantum of capital raise will be significantly large given its current market capitalisation. If the bank follows acquisition route by acquiring another entity, the scale and the operational and financial profile of such entity can be one area to watch out for. Recently, RBI has restricted the branch expansion and management compensation for one of the private banks which failed to comply with bank licensing norms related to promoter stake dilution. The bank has also moved to court and the matter is currently sub-judice.

Increasing share of unsecured advances – At a standalone level, unsecured advances increased to Rs. 39,153 crore as on March 31, 2018 from Rs. 30,820 crore as on March 31, 2017. Accordingly, the share of the unsecured loan book to total advances increased to 23.1% from 22.6% during the aforementioned period, which exposes the portfolio to losses if these borrowers were to default. KMBL has been increasing its exposure to small businesses, personal loans and credit cards (16% of net advances as on December 31, 2018 against 15% as on March 31, 2018) at a faster pace. To a large extent, this remains unsecured. Ability to manage the asset quality while growing these product segments will be critical for KMBL's profitability and solvency as the loss, in case of default in these segments, is expected to be high.

Liquidity position

The bank's liquidity remains comfortable with limited asset liability mismatches (as per structural liquidity statement as on September 30, 2018) across all short-term buckets. Supported by better asset quality across group entities thereby adding to healthy inflows from advances; the daily-average liquidity coverage ratio at the consolidated group was comfortable at 125%[3] for Q3FY2019 against the regulatory requirement of 100% as on January 01, 2019. ICRA expects KMBL will be able to retain and expand its depositor base with its increasing franchise and maintain comfortable liquidity,

[3] LCR at a consolidated level

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	[ICRA Rating Methodology for Banks](#)
Parent/Group Support	Not applicable
Consolidation/Standalone	For arriving at the rating, ICRA has considered the standalone financials of KMBL. However, in line with our limited consolidation approach, we have factored in the capital requirement of the key subsidiaries of the Group, going forward. In ICRA's view, KMBL's subsidiaries will largely remain self-sufficient in meeting their capital requirements in the near to medium term and the bank will continue to comfortably meet the regulatory capital requirements at a consolidated level

About the company

KMBL is the flagship company of the Kotak Group. It commenced operations in 1986 as a bill discounting and leasing non-banking financial company (NBFC), Kotak Mahindra Finance Limited, which was converted into a bank in 2003. Effective April 1, 2015, ING Vysya Bank merged with KMBL.

As on December 31, 2018, KMBL had a network of over 1,453 branches and its net advances stood at Rs. 1,96,432 crore. KMBL reported PAT of Rs. 4,084 crore in FY2018 against PAT of Rs. 3,412 crore in FY2017. In 9M FY2018, KMBL reported PAT of Rs. 3,458 crore. Its net worth stood at Rs. 41,426 crore as on December 31, 2018.

Kotak Group

The Kotak Group is one of India's leading full services financial conglomerate, with a significant presence in the securities and investment banking space. The Group is currently growing its banking, asset management and insurance businesses. It derives synergies from its various platforms, given their presence across the financial spectrum. Other than KMBL, the key subsidiaries of the Kotak Group include Kotak Mahindra Prime Limited (car financing; rated [ICRA]AAA(Stable)/A1+), Kotak Securities Limited (retail and institutional broking and portfolio management services), Kotak Mahindra Investments Ltd. (commercial real estate lending and securities-based lending; rated [ICRA]AAA(Stable)/A1+), Kotak Mahindra Capital Company (investment banking), Kotak Mahindra Life Insurance Company Ltd. (life insurance), Kotak Mahindra General Insurance Company Ltd. (general insurance) and Kotak Mahindra Asset Management Company (asset management business).

At the consolidated group level, KMBL's advances constituted 84% of the overall advances of Rs. 2,32,756 crore of the Group as on December 31, 2018. On a consolidated group basis, the Kotak Group reported PAT of Rs. 6,201 crore in FY2018 compared to Rs. 4,940 crore in FY2017. For 9M FY2019, the Group reported PAT of Rs. 5,166 crore. The Group's consolidated net worth stood at Rs. 56,186 crore, as on December 31, 2018.

Key financial indicators (audited) – Standalone

For the period	FY2017	FY2018	9M FY2018	9M FY2019
Net interest income	8,126	9,532	6,952	8,211
Profit before tax	5,148	6,218	4,507	5,275
Profit after tax	3,412	4,084	2,960	3,458
Net advances	1,36,082	1,69,718	1,59,071	1,96,432
Total assets (adjusted for revaluation reserves)	2,14,590	2,64,933	2,48,646	2,94,198
% Tier 1	15.90%	17.60%	18.00%	17.60%
% CRAR	16.80%	18.20%	18.70%	18.10%
% Net interest margin/Average total assets	3.99%	3.98%	4.00%^	3.92%^
% Net profit/Average total assets	1.68%	1.70%	1.70%^	1.65%^
% Return on net worth	13.23%	12.55%	12.35%^	11.76%^
% Gross NPAs	2.59%	2.22%	2.31%	2.07%
% Net NPAs	1.26%	0.98%	1.09%	0.71%
% Provision coverage ratio excl. technical write-offs	51.99%	56.47%	53.49%	66.16%
% Net NPA/Net worth	6.22%	4.44%	4.76%	3.41%

Amounts in Rs. crore; All ratios are as per ICRA calculations. ^ Ratios are annualised for the 9-month periods

Source: KMBL, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Current Rating (FY2019)				Chronology of Rating History for the past 3 years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)		FY2018	FY2017	FY2016
					Feb 2019	Jan 2018	Sep 2016	-
1	Infrastructure Bonds/NCD	Long Term	1,500.00	962.00	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)
2	Lower Tier II Bonds	Long Term	150.00	150.00	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)
3	Lower Tier II Bonds	Long Term	35.80	-	[ICRA] AAA (Stable) withdrawn	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)	[ICRA] AAA (Stable)

Source: KMBL

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
Unutilised	Infrastructure Bonds	-	-	-	538.00	[ICRA]AAA(stable)
INE237A08908	Infrastructure Bonds	12-08-2014	9.36%	12-08-2021	262.00	[ICRA]AAA(stable)
INE237A08924	Infrastructure Bonds	14-01-2015	8.72%	14-01-2022	500.00	[ICRA]AAA(stable)
INE237A08932	Infrastructure Bonds	30-03-2015	8.45%	30-03-2022	200.00	[ICRA]AAA(stable)
INE237A08890	Lower Tier II Bonds	07-04-2011	9.31%	07-04-2021	150.00	[ICRA]AAA(stable)

Source: KMBL

ANALYST CONTACTS

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Anil Gupta
+91 124 4545 314
anilg@icraindia.com

Aashay Choksey
+91 22 6114 3430
aashay.choksey@icraindia.com

Neha Parikh
+91 22 6114 3426
neha.parikh@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar
022 6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai	+ (91 22) 24331046/53/62/74/86/87
Chennai	+ (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata	+ (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
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