

Kotak Mahindra Bank

Kotak Mahindra Bank (KMB) provides banking services to consumers, corporations, and commercial businesses. It sells life and general insurance. It provides asset and wealth management services. It has a net worth of 51k crore rupees, loan book of 2.1 trillion rupees, and total assets of 3.4 trillion rupees in FY18.

Suppose you were lucky to have Uday Kotak as your friend. It was November 1985, and Uday Kotak knocks on your door and offers you to invest one lakh rupees with him. Knowing him personally, you decided to partner with him. How much would that one lakh be worth today? It is worth 2,000 crore rupees translating to a CAGR of 45% in 33 years. Hindsight is 20/20.

How did Uday manage to create a valuable franchise worth billions of dollars from ground zero? What challenges did he and his bank face during its journey? There is only one way to find out. Let's time travel and study KMB through the lens of business, management, and risks.

Business

Lending business is one of the oldest business in human civilization. It is a business of managing spreads. A casual observer might think that one can't innovate much in the lending business until he learns about how Uday earned his spread during the 80s.

In the 80s, Nelco, a Tata company, used to borrow money at 17% from banks to manage its working capital. Uday saw his friends making 6% on their bank savings deposits. He offered his friends 12% return if they were willing to take Tata risk. He offered money to Nelco at 16%. The idea worked. Uday earned a spread of 4%, which coincidentally happens to be the same as what KMB is earning today.

Back in the late 80s buying a car had to be done with cash. Citi was the only bank offering car loans and charged 13% flat interest. Uday offered the same 13%, and customers borrowed from him. Why would a customer go with Uday for the same 13% instead of a brand like Citi? In those days it would take up to 6 months to get a Maruti car. Uday booked 5,000 Maruti cars in advance and offered them to customers instantly.

Live today fight tomorrow [FY97 to FY01]

Kotak was an NBFC during this period. Money was a scarce commodity and companies were raising money through 17% debentures. There was a sharp increase in credit risk arising from unforeseen defaults or delays even from clients with a hitherto enviable track record. Kotak was experiencing higher provisioning costs and impacted its profitability. Sensing danger, Uday started shrinking the loan book, revised the lending policies, and focused on recovering money.

Asian crisis followed in 1997. Can you guess how many NBFCs went bust during this period? We used to have over 4,000 non-banking financial services in 1997. Out of them, only 20 survived, and Kotak is one of the survivors. It translates to a survival rate of 0.5%. With the benefit of hindsight, we can write stories on winners and multibaggers without considering base rates.

	Standalone				
(in crores)	1997	1998	1999	2000	2001
Gross Income	361	310	248	281	258
Profit after tax	30	21	12	61	50
Net NPA	3%				0.6%

During the downturn, it learned a lot about dealing with non-performing assets. This experience taught Kotak to enter into Asset Reconstruction business. While shrinking the loan book, Uday formed a JV with Goldman Sachs to do investment banking. It created a partnership with Ford Credit International to finance both Ford and non-Ford cars.

The idea of foreign companies providing capital to get some equity stake and Kotak providing intellectual capital is an interesting symbiosis. From the beginning, Kotak setup several subsidiaries to focus on specific businesses. The economy started to recover, and Kotak grew both its top line and profits. By surviving and fixing its processes, Kotak came out stronger and started taking advantage of the upturn in the economy.

NBFC to Bank [FY02 to FY07]

Kotak got its banking license in FY02. Do you know how much wholesale borrowing it had on its balance sheet? Around 87% of the borrowings came from banks and mutual funds. It was a big lender to commercial vehicles, and CV loans constituted 35% of its total advances.

How did Kotak differentiate itself with bigger players like HDFC and ICICI Bank? It was a period of declining interest rates, and customers were looking for higher yields. Kotak distinguished itself by operating on two simple principles; convenience and becoming a solution provider.

Kotak provided convenience by picking up the tab from customers home. Most banks don't talk about investments and capital markets. Kotak ran an ad campaign "Think Investments, Think Kotak" and it became a solution provider for customers.

It partnered with UTI to access its 800 ATMs nationwide without any charges. The role of technology gave it a considerable advantage where it had the reach immediately by tapping into ATMs without taking decades for opening new physical branches. India had 93 scheduled commercial banks when Kotak became a bank. In two years it became one among the top 10 banks.

Kotak started diversifying away from CV loans into personal, home and corporate loans. It became a solution provider to customers instead of just lending money. It reduced its dependence on wholesale borrowing and started building the CASA base. Unlike other players, it avoided infrastructure lending.

Year	EPS	BPVS	Net NPA
2002	2.8	31.9	0.01%
2003	2.4	34.8	0.11%
2004	5.7	40.7	0.17%
2005	5.5	47.6	0.37%
2006	11.0	72.7	0.21%
2007	16.5	99.1	0.17%
	43%	25%	0.17%

Along with lending, it grew its non-lending businesses like life insurance, asset management, and broking. Helped by the buoyant capital markets non-lending business generated 60% of profit after tax creating operating leverage. Profits grew faster than the balance sheet; 43% vs. 25%. It managed to do this without taking a lot of risks, which is evident from an average net NPA of 0.17%.

Navigating the financial crisis [FY08 to FY10]

Lehman Brothers folded. Merrill Lynch was acquired by Bank Of America. Goldman Sachs and Morgan Stanley converted themselves into commercial banks. Banking landscape has undergone a sea of changes. Kotak was prudent enough to focus on the balance sheet and made the P&L wait. It slowed down the retail loans like personal, CV, and credit cards on purpose. Also it cut down on its stressed assets portfolio.

Banking Advances (in crores)	2008	2009	2010	CAGR
CV & CE	3,629	3,335	3,693	1%
Personal Loans	2,896	2,262	1,315	-33%
Home Loans	2,640	3,166	4,712	34%
Agriculture Finance	1,664	2,365	3,089	36%
Corporate Banking	2,387	2,774	6,476	65%
Others	2,337	2,724	1,490	-20%
	15,552	16,625	20,775	16%

It realized the challenges on personal loans without collateral, and it started slowing down before the black swan event stuck. For example, it had a credit cards target of 350k, but it slowed down to 100k.

Many banks including KMB took a hit on derivatives. It made an early call to stop derivatives. Business like investment banking and broking is susceptible to capital market cycles, and this is evident when 90% of FY09 profits evaporated from the investment banking business. Multiliniers like Kotak can navigate the cycles better than the monoliniers.

Sector-wise NPAs

Sr. No.	Sector	Percentage of NPAs to Total Advances in that sector
1.	Agriculture & Allied activities	1.49%
2.	Industry (Micro & small, Medium and Large including corporate stressed assets purchased)	5.81%
3.	Services	1.96%
4.	Personal Loans including Credit Cards and retail stressed assets purchased	9.61%

Kotak lost money on retail liabilities, which is the right thing to do in the long term to build low-cost CASA funds. The decision to invest heavily in unglamorous branching banking is not an easy one. In hindsight, this appears to be a wise decision.

The shift from sole reliance on wholesale funds to a more diversified portfolio including retail deposits is the best decision. Look at what's happening now with IL&FS and other NBFCs today. It navigated the financial crisis well with earnings per share and book value per share growing at 13% and 16%. It managed to do this without taking a lot of risks, which is evident from an average net NPA of 1%.

Building a diversified financial services franchise [FY11 to current]

Kotak has a dozen subsidiary businesses including the parent bank. Grouping them into lending and non-lending helped me to handle the complexity. On the lending side it has the bank and two NBFC; Prime and Investments. On the non-lending side, it has life insurance, general insurance, investment banking, asset-and-wealth management, and retail brokerage.

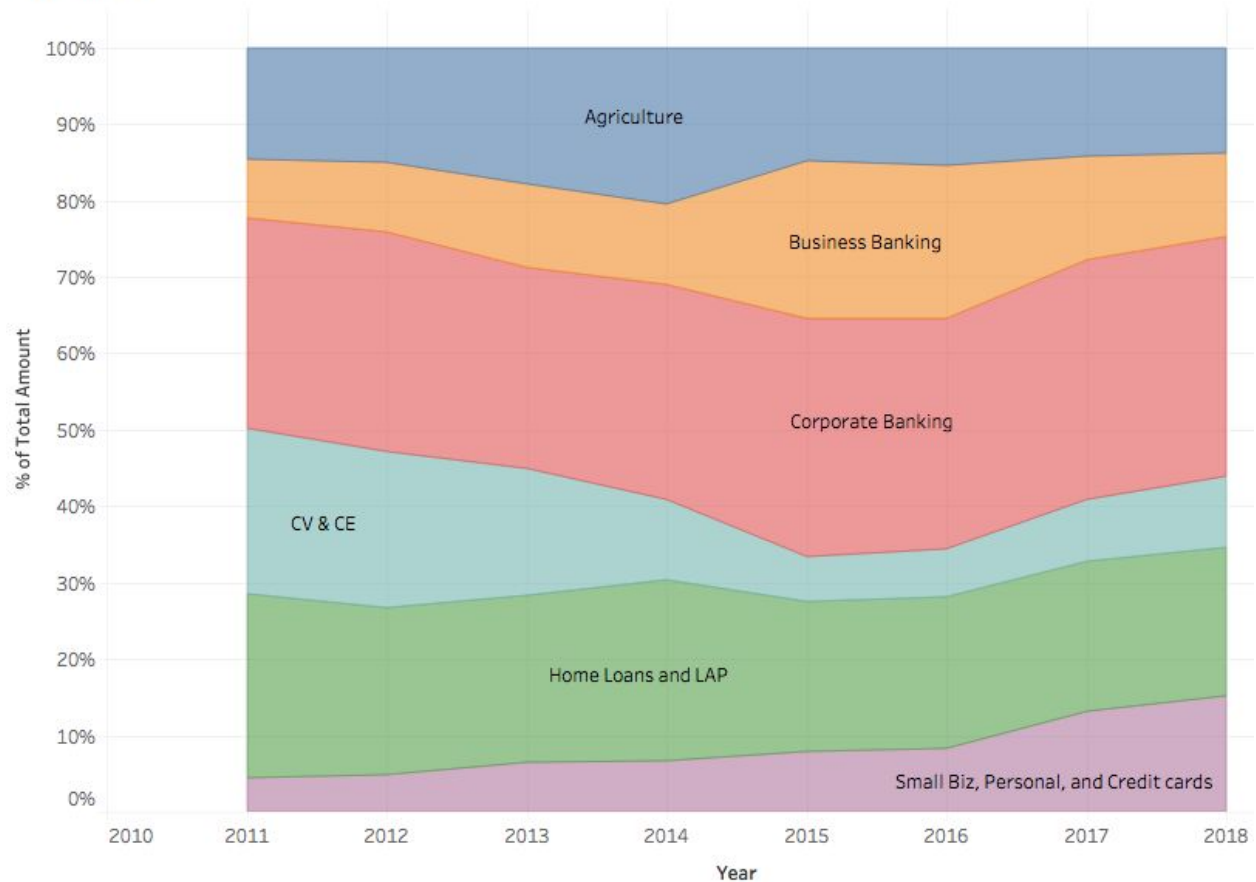
Lending

Have you ever driven a car inside a well-managed apartment complex? You have to drive very slowly and carefully. Plus there will be many speed breakers to prevent you from driving fast. Such caution is needed to avoid the car from running over a playing child. Lending business is similar to driving a car inside an apartment. You need to sense what's happening on the ground by kicking the tires and applying the brakes before it blows up. It's ok to sacrifice the P&L to protect the balance sheet.

Is there any evidence of Kotak applying brakes to protect the balance sheet? Take a look at the chart below showing the advances of the bank over the last seven years. What do you see? KMB was among the first ones to smell the trouble in CV and CE segment and started slowing down the loan book.

It continued lending only to healthy customers. It didn't shut the shop nor close the branches. It kept the machinery active to capitalize on cycle upturn. It was ready to take the pain in P&L to protect the balance sheet. We can find a similar pattern of a slowdown in agriculture lending due to weak monsoon.

Advances



During the financial crisis, Kotak shrank the personal and credit card loans. However, during this period it started increasing the lending to personal and credit loans. What changed? Between 2008 and now it made significant structural changes to get a lot more personal loans collateralized. Developments like CIBIL scores made people lot more conscious about their credit. Not being dogmatic and adapting to the reality is an essential skill for a good lending institution.

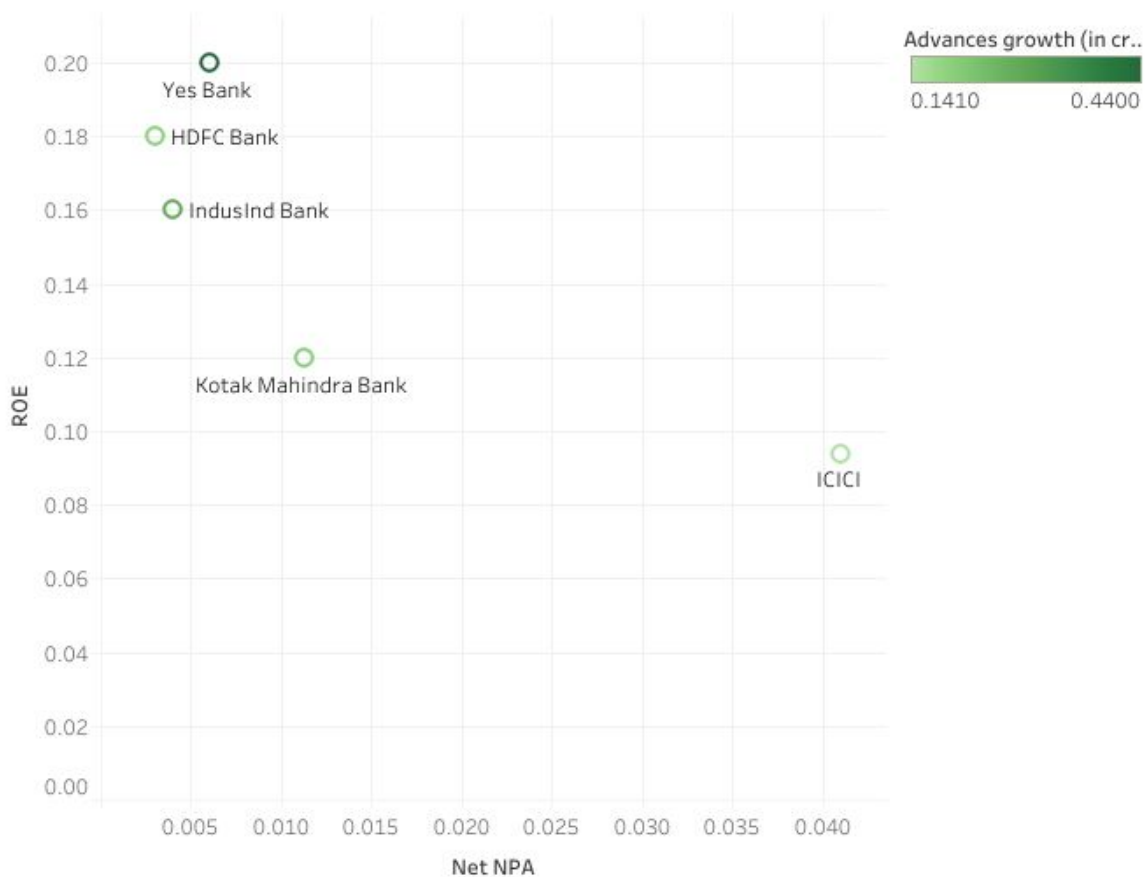
	2011	2016	2018
CASA	30%	38%	51%
Customers after 811 launch		8,000,000	13,000,000

From the beginning, Uday was steadfast in building a low-cost liability franchise. Fortune favors the prepared. Financial business is highly regulated. Rules of the game change regularly. Uday Kotak capitalized on every opportunity to acquire customers and build the CASA base.

1. The Reserve Bank of India on October 2011 announced deregulation of the interest rate on savings bank deposits. KMB was the first bank to announce a rate hike from 4% to 5.5% for deposits up to one lakh and 6% for deposits above one lakh.

2. KMB acquired ING Vysya Bank in FY16. It helped KMB to double its branch network in south India. ING had a 4% interest rate, and their CASA was growing at 15-20% before the acquisition. The moment Kotak gave them 6% interest the saving account started growing at 35% plus.
3. Demonetization got announced on November 8th, 2016. Uday Kotak saw an enormous opportunity to acquire customers through the digital channel. He launched 811 which is India's first mobile-based account opening platform using Aadhaar OTP, where customers can open an account with their Aadhaar details. Time taken to onboard a customer came down from days to minutes. In less than 18 months the total customer base went up by 62.5%.

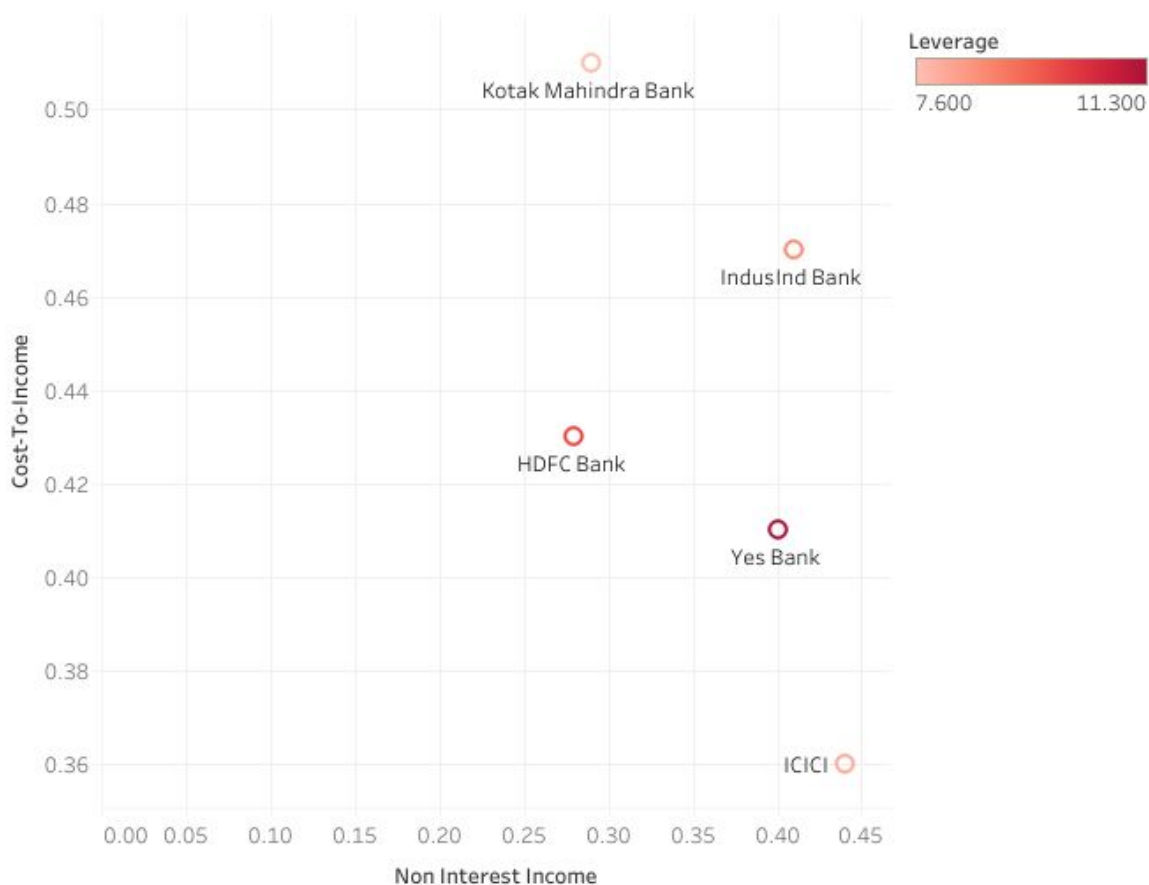
ROE, NPA, Advances Growth



Kotak Mahindra Bank has an ROE of 13% in FY18. This is low compared to HDFC Bank which commands an ROE of 18%. Why is there a big difference? To answer that question take a look at the chart below. Kotak spends close to 50% on the cost-to-income ratio. It is much higher than what other private banks spend.

Why does KMB spend so much? Customers acquired today will turn out profitable in the future. Think about it like customer acquisition costs in SaaS companies. It is a defensive strategy to prevent small and payment banks to attract its customers. KMB spends 1,000+ crore on higher savings rate and customer acquisitions costs. If Tom Russo reads these lines, he would tell that KMB has the capacity to suffer.

Cost-to-income, Non-interest income, and Leverage



KMB has two wholly owned subsidiary NBFCs that does lending. Asset quality of both the NBFC is top notch. Why does it lend through NBFC instead of the parent bank? By keeping them separate allows them to focus on a specific niche. Also, NBFC has the advantage of not having to set aside capital for CRR-and-SLR. Plus it is not forced to do priority sector lending.

1. Kotak Prime is primarily into car financing which includes financing of retail customers of passenger cars, multi-utility vehicles and term funding to car dealers. Around 72% of advances go towards car loans, and the balance is for the loan against securities, corporate loans, and developer financing. There is a lot of competition in car loans. With the increase of Uber and Ola it might have to deal with a different kind of customer base.

Prime	2012	2016	2018	CAGR
PAT	385	502	590	7.4%
Net NPA	0.2%	0.4%	0.4%	
RoA	2.9%	2.3%	2.0%	
RoE	22.3%	13.3%	11.6%	

- Kotak Investments is primarily engaged in finance against securities, lending to real estate and other activities such as holding long-term strategic investments. It also does structured finance for corporate clients and acts as a solution provider.

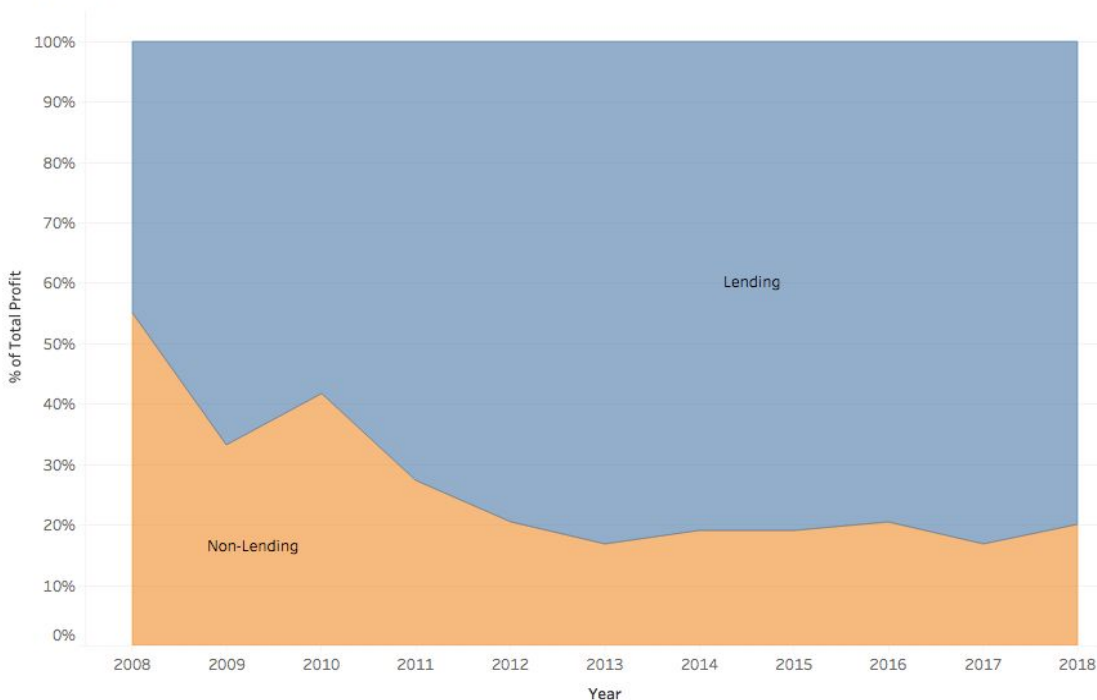
Investments	2015	2016	2018	CAGR
PAT	106	154	245	32%
Net NPA	0.13%	0.05%	0.01%	
RoA	3.9%	3.4%	3.0%	
RoE	20.7%	19.4%	17.2%	

- Why did Investments grow faster than Prime? In the past, Kotak Prime was dealing with all kinds of loans including car loans. Recently Prime is focusing on car loans, and Kotak Investments handle other loan types. The combined average RoE of both the NBFCs in FY18 comes to 15%.

Non-Lending

Lending businesses contributed to 80% of FY18 profits, and non-lending business contributed to the remaining 20%. There is a significant value migration that is happening from physical assets like gold and real estate to financial assets. Uday Kotak noticed this trend in FY13, and he wrote that money would start flowing into fixed income first and gradually moving into equities. JAM Trinity, Demonetization, and RERA are going to accelerate the value migration.

Profit Mix

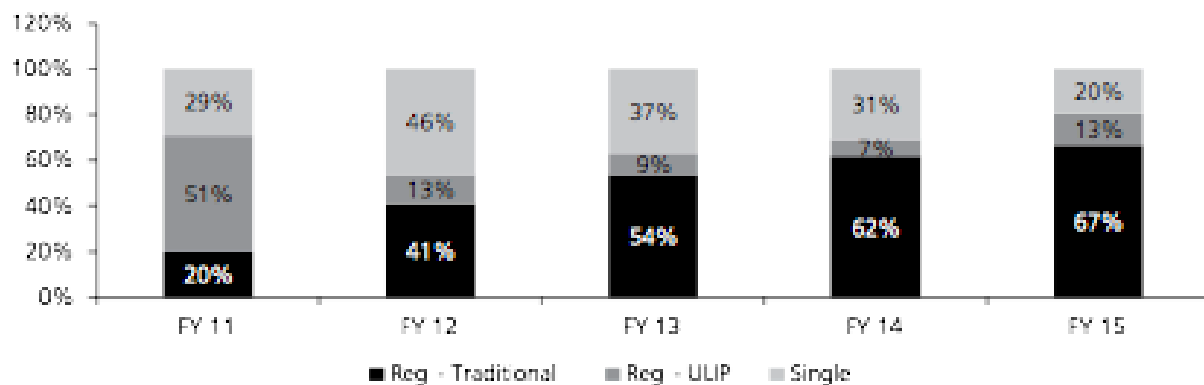


In the last one year, the non-lending businesses have grown at 48% compared to lending business growth of 19%. The parent company owns 100% stake in all the non-lending subsidiaries which is a massive advantage for the shareholders. Investors get exposure to the entire financial ecosystem. Life Insurance and Kotak Securities generate 80% of non-lending profits. Let's focus on them instead of looking at every non-lending subsidiary.

Life Insurance: I got my first life insurance policy from LIC when I was 18 years old. Back then Indian Government is yet to open the insurance industry to domestic private players. Till the year 2000 LIC was the only life insurance company in India. The insurance industry got opened up in 1998, and in three years there were 13 companies. Kotak entered life insurance by doing a JV with Old Mutual in FY01.

Life insurance is a push product sold through agents. It is an emotional product, and brand recall is essential for selling life insurance. A bank is at the center of a person's financial needs. This is the reason why insurance companies have chosen banks as a distribution channel. The trade name for this channel is bancassurance. Kotak sells 53% of insurance through this channel, which is inline with other private players share from the bancassurance channel.

What happens when you have agents with incentives that are not aligned with customers needs? Fiasco. For the five years ending 2010, in line with the booming economy and soaring stock markets, ULIPs grew leaps and bounds encouraged by the launch of new linked products and aggressive marketing by private players. In 2010, IRDA released new guidelines which capped upfront charges, returns, and commissions that affected the business dynamics of ULIP products.



Kotak got affected as indicated by the ULIP share above which came down from 51% in FY11 to 7% in FY14. Life insurance industry got affected, and the growth in premium got stagnated as the players were adjusting to the new regulations and adapting to changes. The table below shows that it took 3+ years to surpass the highs established in 2011.

(in crores)	2011	2012	2013	2014	2015
Gross premium income	2975	2937	2778	2700	3038

The new regulations made the industry to focus on value addition to the customer instead of mindless growth. What are some life insurance products that Kotak sells? There are three categories of products in the Life Insurance business: Unit Linked Products (ULIP), Participatory Products, and Non-Participatory Traditional Products. Kotak is focusing more on the traditional Non-Participatory Insurance Products.

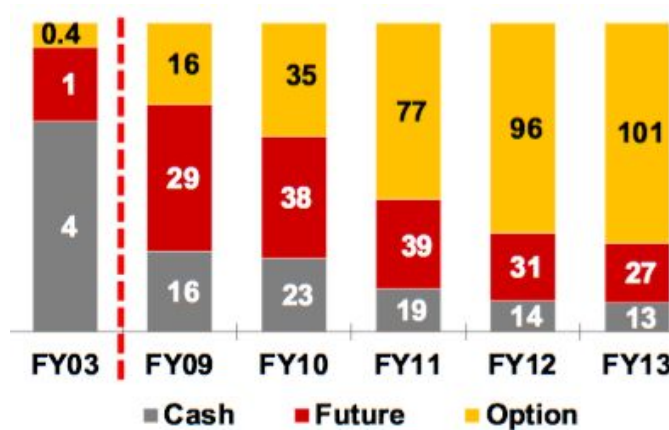
Kotak has a ULIP share of 36% compared the private industry share of 55%. Kotak is doing an excellent job by not over concentrating on ULIP. Why combine life insurance with investing and expose customers to the vagaries of the capital markets? Kotak has a better persistency ratio and new business margin compared to other big players. It has a profitable life insurance business with an RoE of 18.5%.

	Kotak	HDFC	ICICI	SBI
VNB Margin	29.3%	23.2%	16.5%	16.2%
Persistency 61st month	62%	51%	56%	58%

Securities: Kotak Securities is a leading secondary market broking firm offering services to retail and institutional investors. It has a full-fledged research division engaged in macroeconomic studies, industry, and company-specific equity research. Securities business is prone to capital market cycles. It gets benefited when the capital market is in a positive mood. Operating leverage kicks in with scale, and the top line directly flows to profits. Why did Securities business losing market share?

	2011	2015	2018
Market share	3.4	2.8	1.9

There are two segments that you can trade in the stock markets in India. One is the futures-and-options segment and the other is the cash segment. Kotak Securities focuses on the cash segment for retail investors. Margins on the cash segment are higher than the future-and-options segment. Over the years industry structure changed with traders becoming a more significant part of the market with futures and options. Even the so-called investors are becoming more and more futures traders.



I would not worry much about the market share loss. The business generates a decent average RoE of 16%. The management is continuing the invest in the Securities business. The tailwind of value migration from physical to financial assets will help this business grow at a decent rate over the long term.

Management

Unlike the investment business, errors of commission in banking are far more expensive than errors of omission. Why is that? When you lend money, your upside is limited. The downside is your equity and the debt you need to repay. Keep in mind that banks are 8-10 times leveraged.

Conservatism is vital in the banking business. You need management that focuses on protecting the balance sheet and willing to take the short-term pain on the P&L. Are there signs of management being conservative? Technology is eating the world. Resting on one's laurels is a sure path to the graveyard. Are there signs of management sacrificing the short term P&L to grow the future moat?

1. When KMB acquired ING Vysya Bank, it immediately identified bad assets and moved that almost entirely into a separate distressed asset division. It represented 6% of the ING Vysya book and 2.5% of the combined book. The management was not afraid to take a hit on the P&L. Later in FY18, twelve accounts across all the banks were taken into insolvency and bankruptcy. Of that Kotak had four accounts and all of them were inherited from ING Vysya Bank that was already identified as bad during acquisition.
2. Never take NPA figures put forth by management in their presentation at face value. NPA comes in different shades of gray. Take a look at the table below. Can we conclude that banks with lesser NPA have better assets than KMB? Of course not. It depends on how much CDR, security receipts, and off balance conversion they have. KMB restructured assets are close to zero and they are conservatively calculated. I will write a detailed post soon on different shades of NPA comparing different lending companies.

Bank	Net NPA (3 year avg)
HDFC Bank	0.3%
IndusInd Bank	0.4%
Yes Bank	0.6%
Kotak Mahindra Bank	1.1%
ICICI	4.1%

3. KMB takes a 1,000+ crore hit on the P&L for initiatives like 811 and 6% savings rate. It does this to acquire customers today so that they will turn profitable in the future. It is a defensive strategy to prevent small and payment banks to attract its customers. KMB is keeping a close

eye on technology and regulatory and positioning itself to be relevant. One example is the JV with Bharti Airtel and KMB took 20% stake in the payment bank venture.

Risks

Lending companies needn't worry about growth. It's there. To take advantage of this growth companies should first survive. For that, they should keep their underwriting costs low. They should know how to evaluate and manage risks. Even a slight complacency would get their heads chopped. I would highly recommend watching the scene from Indiana Jones and The Last Crusade.



By being penitent Indiana Jones recovered the holy grail. To capture the growth (holy grail) lending companies should focus on asset quality (penitent) and not chase it. Here are some questions that an investor should ask before investing in KMB.

1. Can KMB maintain the culture of risk-adjusted returns for a long time in the future? Would they be willing to take the pain in the P&L to protect the balance sheet? Will the culture of investing in the future at the expense of short-term earnings continue?
2. Uday Kotak thinks for the very long term. He tells that if what you create does not outlive you, then you have failed. He built KMB over the last 35+ years account by account. Can KMB maintain the culture of risk-adjusted returns in his absence? Is there a key man risk?

- Technology is eating the world. Digital explosion is happening in the financial sector. With small and payment banks entering the scene there is going to be competition for high volume low-value transactions. Also, some of the non-lending business like asset management might face competition in the future from passive investing and ETFs. When there is no alpha why pay fees? Can technology automate credit assessment to a large extent and put pressure on NIMs?

Closing Thoughts

What is the intrinsic value of KMB? Take it as a homework assignment and find out the intrinsic value. Before concluding this post, I would like to leave you all with a closing thought. Lucius Annaeus Seneca was a philosopher who happened to be the wealthiest person in the Roman Empire. Seneca often started his journeys with almost the same belongings he would have if he were shipwrecked, which included a blanket to sleep on the ground. Why would he do that? To answer that question, take a look at the annotated chart.



I wanted to check the IRR an investor would have got by holding Kotak Mahindra Bank for the last 18 years. It is a mind-blowing 30%, but there is one catch. One should have to handle a drawdown of 80+ percent. It is easier said than done. How should one stay equanimous to such a significant drop?

Recently I met an accomplished investor from India. He has been operating in the Indian markets for almost three decades with a CAGR of over 30%. During 2008-2009 his portfolio was down by 80%. Apart from his property he had most of his net worth invested in equities. How did he sleep well at night?

He had the habit of mentally counting only 20% of his net worth. It helped him a lot to stomach the drawdown, and he slept peacefully at night. As an investor, we will have to experience a 50-80% drop in

the markets. The current IL&FS crisis is giving us a live opportunity. Like Seneca and the experienced investor from India have the habit of mentally writing down helps navigate the present and the future crisis.

Disclaimer: I own shares of Kotak Mahindra Bank. This is not a recommendation to buy, sell, or hold. I am not a SEBI registered analyst. I wrote this document to organize my thoughts and deepen my understanding about the company and the industry. I am sharing it so that you can learn something from this.

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