Kotak Institutional Equities

DCB Bank (DCBB)

Banks/Financial Institutions

BUY

DECEMBER 08, 2014

UPDATE

Coverage view: Attractive

Price (₹): 106

Target price (₹): 120

BSE-30: 28,458

Delivering on growth expectations. Our recent interaction with the management of DCBB offers comfort that implementation is broadly on track with what was indicated earlier. With a healthy tier-1 ratio, low impairment-related issues and a stable revenue profile, the bank has been steadily growing its balance sheet by ~25% CAGR in recent years with a large part of revenue invested back in expanding the bank's presence. We like the bank's execution skills and maintain it as our preferred small-cap idea despite strong outperformance. Maintain BUY with target price changed to ₹120 from ₹105.

Company data and valuation summary

DCB Bank

Stock data			
52-week range (Rs) (high,low)			109-49
Market Cap. (Rs bn)			29.7
Shareholding pattern (%)			
Promoters			18.4
FIIs			14.8
MFs			10.1
Price performance (%)	**1M**	**3M**	**12M**
Absolute	12.5	25.1	104.9
Rel. to BSE-30	10.2	20.1	51.2

Forecasts/Valuations	2014	2015E	2016E
EPS (Rs)	6.0	6.6	7.7
EPS growth (%)	48.2	9.4	16.8
P/E (X)	17.5	16.0	13.7
NII (Rs bn)	3.7	5.2	5.8
Net profits (Rs bn)	1.5	1.9	2.2
BVPS	42.1	52.3	58.8
P/B (X)	2.5	2.0	1.8
ROE (%)	14.8	14.1	13.2
Div. Yield (%)	0.0	0.0	0.0

Meeting update: progress broadly on track

Loan growth is likely to remain close to current levels with greater emphasis on retail and the large corporate segment. Changes in lending in the SME portfolio is hurting growth though there should be a gradual increase in contribution over the next few years. Within retail, mortgages will continue to grow and recent branch expansion has helped the bank to disburse other retail products, especially those compliant with priority-sector loans.

In an investment phase we don't see low-cost liability ratio improving in the medium term

We believe that expecting an improvement in CASA ratio at this stage of the growth cycle would be quite premature as there is sharper focus on the assets side of the balance sheet and investing a large share of revenue back in the business. We are factoring a decline in CASA ratio in the medium term. However, building a strong liability franchise would require a much higher scale, size of net worth and products/services, especially for the current account, while the bank would have to invest in the brand, especially for retail customers. We shall closely monitor (1) risk-adjusted NIM, (2) relative movement of the cost of liabilities with growth in CASA on an absolute basis and (3) loan mix to understand risk.

Maintain BUY as we believe implementation will remain strong

We maintain our BUY rating on the bank and value it at ₹120 (from ₹105) reflecting changes and roll forward of earnings (September 2016). At our target price we value the bank at 1.9X book and 14X EPS for RoEs of 13-14% but strong earnings growth of 17-20% CAGR over the next few years. Despite the recent outperformance, we think DCBB is a good bank to own. The scope for valuation expansion is high apart from good earnings compounding over the long term. We don't see RoEs expanding in the medium term as the bank would continue to keep cost growth at relatively high levels. Apart from a strong tier-1 ratio, low impairment risks and high growth phase of the bank, our positive view is primarily driven by the effective execution of the current management, which we think is one of the best among peers. DCBB remains our preferred mid-cap pick.

Growth likely to stay strong; contribution from SME to increase over time

We expect DCBB to grow its balance sheet by 25% CAGR over FY2015-17. Unlike most other banks, there is little concern about the balance sheet and the bank has done exceeding well on impairment ratios with gross NPLs declining to ~2% of loans from 9% a few years ago.

On the retail side, the management indicated that growth would continue to be driven by the mortgage segment. The portfolio has a mix of LAP (70%) and housing loans but there is greater emphasis in LAP in recent years with over 90% of the customers coming from the retail business segment. A large part of the acquisition is in-house as reported (see Exhibit 2). We understand that the portfolio has a healthy mix of self-occupied residential and commercial property with LTV (valued at the time of origination) at very comfortable levels. The bank is actively looking at loans of the ticket size of ₹5 mn to reduce any risk as this segment would see the lowest delinquency if the cycle were to remain weak for an extended period. Also, the bank is looking at building a diversified client base so that there is no sector or industry-related risk impacting customers of this portfolio. Yields in this portfolio, unlike in most other banks, have not yet declined.

On the SME front, the bank decided to reduce the ticket size by half in this segment from ₹50 mn previously and hence, the churn rates have been quite high. While the portfolio is stable on an absolute basis, client acquisition rates and disbursements have been quite high. The management indicated we may see growth resuming in this portfolio though it is likely to trail overall growth over the next few quarters, as well.

It appears from our discussion that the large corporate segment may see higher growth than the SME segment in the medium term. The bank is still quite cautious from a ticket size and economic size perspective but the quantum (absolute basis) required to show strong growth for the bank at this stage is extremely small compared to the market size. It appears the focus on building the large corporate segment is to increase the share of fee income business as this has been one of the slowest growing segments for the bank. The key products would remain in the short-term working-capital segment with negligible exposure in the infrastructure portfolio. The bank made some recent changes in the top management with the hiring of Mr. Agarwal who was previously managing director and group head of corporate and financial institutions at RBS.

The bank's last leg of growth is coming from other retail or priority-sector lending products. Select portfolios grew by a strong 50-80% yoy in the previous quarter albeit from a small base but this is a key focus area for the bank as it is helping the bank to meet priority sector lending requirements without taking a material impact on earnings. The bank is building a network both organically (new branches) or with business correspondents to reach this customer segment. These are still early days and one should wait for a few more years to understand the strength of underwriting though the management indicated that the portfolio was not showing signs of stress beyond expected levels and the bank is relying on its early-warning signals to understand the behavior of customers.

Exhibit 1: Retail and trade are the main focus areas for the bank
Break-up of loans, March fiscal year-ends, 2010-2QFY15 (%)

	2010	2011	2012	2013	2014	1QFY15	2QFY15
Corporate banking	32.0	26.0	22.6	23.8	25.7	23.9	23.7
SME and MSME	17.0	24.0	27.2	22.6	16.6	16.2	15.2
Retail	26.0	30.0	35.1	42.0	43.5	45.5	48.6
Mortgage loans	12.0	25.0	29.4	36.4	38.4	40.0	41.7
Vehicle loans	8.0	2.0	2.1	1.7	2.1	2.3	2.4
Others	3.0	2.8	3.7	3.9	3.0	3.1	4.4
Agriculture	25.0	20.0	15.2	11.6	14.2	14.5	12.6

Source: Company, Kotak Institutional Equities

Exhibit 2: Share of loans acquired on the decline
Break-up of loans acquired and self-originated in mortgage, March fiscal year-ends, 2010-2QFY15 (%)

	2009	2010	2011	2013	2014	1QFY15
Mortgages sourced by DCB (Rs bn)	2	3	7	15	24	26
Mortgages acquired (Rs bn)	1	1	4	9	8	8
Total loans (Rs bn)	**3**	**4**	**11**	**24**	**31**	**33**
Mortgages sourced by DCB (% of total loans)	*81*	*71*	*64*	*64*	*75*	*77*
Mortgages acquired (% of total loans)	*19*	*29*	*37*	*36*	*25*	*23*

Source: Company, Kotak Institutional Equities

Exhibit 3: Rise in NPLs in the corporate and SME segments
Segment-wise NPLs, March fiscal year-ends, 2010-2QFY15 (%)

	2010	2011	2012	2013	2014	1QFY15	2QFY15
Vehicle loans				24.1	2.4	2.6	3.1
Corporate loans	5.9	5.7	6.0	3.3	0.9	0.7	1.3
SME loans	2.2	1.3	1.0	3.8	6.2	6.7	6.7
Mortgage		1.3	0.6	0.9	0.8	0.9	0.9
Gross NPLs	8.7	5.9	4.4	3.2	1.7	1.8	1.9
Net NPLs	3.1	1.0	0.6	0.7	0.9	1.0	1.1
Provision coverage ratio	66.3	84.4	87.5	77.6	46.5	46.1	44.1
Provision coverage ratio (including technical write-		—	91.2	85.7	80.5	79.1	76.8

Source: Company, Kotak Institutional Equities

CASA ratio may decline in the medium term, in our view

We are not too excited about the bank's CASA ratio. We think the probability of it declining is a lot higher than it improving. One of the reasons to remain negative is that the bank does not have the strength or the brand to improve savings account balances aggressively. An increase in interest rates on savings accounts would require significantly higher costs (interest on savings as well as any marketing costs associated with the change) to be absorbed, which the earnings of the bank may not support. On current accounts, the bank is actively building a strong SME base and the exit of a few large corporate accounts a few years ago slowed growth initially. At this stage, the bank is looking at strengthening its service teams, building new products and client acquisition to drive growth in current account balances.

Our broad understanding based on our discussion appears to be that the bank is more focused on keeping NIMs attractive and is not so particular about the source of liabilities. In other words, lack of CASA ratio improvement is not inhibiting the bank from growing the balance sheet as long as the NIM (risk adjusted) does not materially fall below internal threshold levels. Ideally, this strategy works well in the initial leg of the economic cycle or when banks are in their early stages of growth, but this could turn negative if the focus drops in building a low cost sticky retail liability franchise.

At this stage, while we are comfortable with the strategy adopted we would be disappointed if growth in CASA deposits on absolute basis were to drop below 15% levels and don't see a steady uptick in growth over the next few years closer to balance sheet levels in the medium term and better-than-balance sheet growth over the long term. In the initial leg, we think the bank is likely to achieve greater success on current account as compared to savings account growth.

Exhibit 4:The share of CASA and retail deposits has fallen over the past year
Break-up of retail deposits, March fiscal year-ends, 2010-2QFY15 (%)

	2010	2011	2012	2013	2014	1QFY15	2QFY15
Current	16.2	15.8	13.2	10.8	9.3		
Savings	19.2	19.4	18.9	16.4	15.7		
CASA	**35.4**	**35.2**	**32.1**	**27.2**	**25.0**	**25.4**	**25.5**
Term deposits	64.6	64.8	67.9	72.8	75.0	74.6	74.5
NRI deposits			4.9	6.2	8.0	8.5	—
Retail deposits	81.5	81.2	84.4	77.4	77.0	78.8	82.8
Wholesale deposits	18.5	18.8	15.6	22.6	23.0	21.2	17.2

Source: Company, Kotak Institutional Equities

Exhibit 5: Maharashtra has been the driver of deposits for the bank
Break-up of retail deposits, March fiscal year-ends, 2010-2QFY15 (%)

	2009	2010	2011	2013	2014	1QFY15
Maharashtra	28	27	32	47	56	55
Delhi	3	7	6	10	9	11
Gujarat	4	4	4	7	9	9
Orissa				0	1	NA
Paschim Banga				6	7	7
Telangana	4	4	4	6	7	7
Others	7	6	10	9	15	16
Total deposits	46	48	56	84	103	106

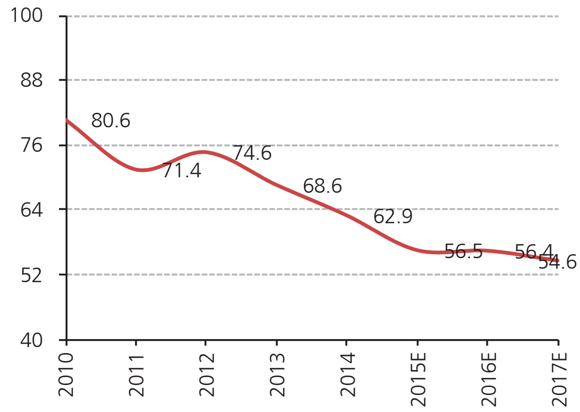
Source: Company, Kotak Institutional Equities

Cost-income ratio to improve but over time

We are not building a strong decline in cost structure at this stage and we build it to improve to ~55% by FY2016. We think the management has shifted focus towards expanding infrastructure as compared to consciously declining it to <50% levels. The bank has a long way towards building a strong bank from a liability side and this is likely to be a greater focus for the management.

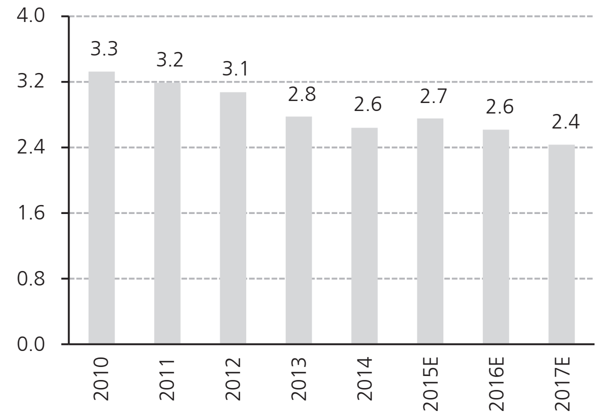
We expect the bank to increase its physical footprint by ~20% CAGR over the next few years with a 15-20% CAGR in employee base. One of the biggest challenges that DCBB would continue to face would be to identify talent though the management has indicated that it is looking at multiple sector approach and not restricting merely from the banking channel to acquire talent.

Exhibit 6: Cost-income ratio to decline to ~55% over FY2015-16
Cost-income ratio, March fiscal year-ends, 2010-17E (%)



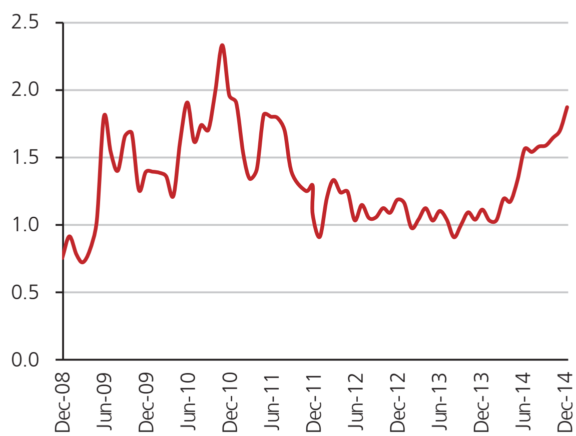
Source: Company, Kotak Institutional Equities estimates

Exhibit 7: We expect operating leverage to continue
Operating expenses to assets, March fiscal year-ends, 2010-17E (%)



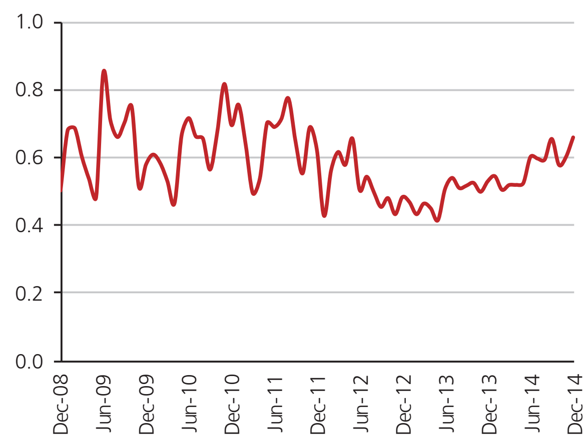
Source: Company, Kotak Institutional Equities estimates

Exhibit 8: DCB trades at 1.8X one-year forward book (adjusted)
One-year forward PBR, 2010-14 (X)



Source: Company, Bloomberg, Kotak Institutional Equities estimates

Exhibit 9: DCB trading at premium to peers
DCB trading premium to private banks, 2010- 2014 (X)



Source: Company, Bloomberg, Kotak Institutional Equities estimates

Exhibit 10: DCB - change in estimates

March fiscal year-ends, 2015-17E (₹ mn)

	New estimates			Old estimates			% change		
	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2016E
Net loan growth (%)	24.0	26.5	26.1	24.0	26.5	26.1			
Loans (Rs bn)	101	128	161	101	128	161	—	—	—
Total income	6,787	7,866	9,410	6,693	7,743	9,292	1.4	1.6	1.3
Net interest income	5,193	5,834	6,848	5,100	5,758	6,817	1.8	1.3	0.5
NIM (%)	3.8	3.5	3.3	3.8	3.5	3.3			
Other income	1,593	2,032	2,562	1,593	1,984	2,475	—	2.4	3.5
Fee income	1,193	1,455	1,775	1,193	1,408	1,689	—	3.4	5.1
Treasury income	225	345	495	225	345	495	—	—	—
Operating expenses	3,834	4,435	5,133	3,834	4,435	5,133	—	—	—
Employee expenses	1,930	2,198	2,494	1,930	2,198	2,494	—	—	—
Other cost	1,904	2,237	2,639	1,904	2,237	2,639	—	—	—
Loan loss provisions	638	400	577	638	400	577	—	—	—
PBT	2,265	2,971	3,629	2,171	2,817	3,491	4.3	5.5	3.9
Tax	408	802	1,089	391	761	1,047	4.3	5.5	3.9
Net profit	**1,857**	**2,169**	**2,540**	**1,780**	**2,057**	**2,444**	**4.3**	**5.5**	**3.9**
% growth yoy	22.7	16.8	17.1	17.6	15.5	18.8			
PBT-treasury+provisions	2,728	3,086	3,782	2,634	2,963	3,664	3.6	4.2	3.2

Source: Company, Kotak Institutional Equities estimates

Exhibit 11: DCB - key financial ratios and growth rates
March fiscal year-ends, 2012-17E (%)

	2012	2013	2014	2015E	2016E	2017E
Growth rates (%)						
Net loan	23.7	24.6	23.6	24.0	26.5	26.1
Total Asset	17.5	30.0	14.6	16.6	25.6	23.7
Deposits	12.9	32.0	23.5	18.6	28.9	26.1
Current	(5.3)	7.2	6.7	5.9	25.0	26.1
Savings	9.7	14.8	18.2	11.1	24.5	21.6
Net interest income	20.4	24.9	29.5	41.0	12.3	17.4
Loan loss provisions	(45.0)	(27.8)	78.9	80.3	(37.3)	44.3
Total other income	(8.4)	13.9	18.5	14.9	27.6	26.1
Net fee income	19.1	13.5	13.2	18.0	22.0	22.0
Net capital gains	(53.5)	18.2	61.5	-	53.4	43.5
Net exchange gains	21.0	21.0	21.0	35.0	35.0	30.0
Operating expenses	14.6	11.6	15.9	20.1	15.7	15.7
Employee expenses	17.1	10.7	13.9	22.9	13.9	13.5
Key ratios (%)						
Yield on average earning assets	9.4	9.6	9.7	10.3	10.0	9.8
Yield on average loans	11.2	12.0	11.8	12.0	11.7	11.4
Yield on average investments	7.2	6.7	7.0	6.8	6.7	6.7
Average cost of funds	6.9	7.2	7.1	7.1	7.1	7.1
Interest on deposits	6.8	7.3	7.1	7.1	7.1	7.1
Spread	**2.5**	**2.4**	**2.6**	**3.2**	**2.9**	**2.8**
Net interest income/earning assets	**3.0**	**3.0**	**3.2**	**3.8**	**3.5**	**3.3**
Spreads on lending business	4.3	4.8	4.7	4.9	4.6	4.4
Spreads on lending business (incl. fees)	6.0	6.3	6.1	6.2	5.9	5.6
New provisions/average net loans	**0.6**	**0.3**	**0.5**	**0.7**	**0.4**	**0.4**
Total provisions/gross loans	3.8	2.5	0.8	1.3	1.3	1.4
Interest income/total income	68.9	70.8	72.7	76.5	74.2	72.8
Other income / total income	31.1	29.2	27.3	23.5	25.8	27.2
Fee income to total income	23.8	22.3	19.9	17.6	18.5	18.9
Fee income to advances	1.6	1.5	1.4	1.3	1.3	1.2
Fees income to PBT	142.8	87.5	66.8	52.7	49.0	48.9
Net trading income to PBT	19.8	14.0	15.0	9.5	11.3	13.4
Exchange income to PBT	12.6	7.1	3.7	3.4	3.5	3.7
Operating expenses/total income	74.6	68.6	62.9	56.5	56.4	54.6
Operating expenses/assets	3.1	2.8	2.6	2.7	2.6	2.4
Operating profit /AWF	0.6	0.9	1.1	1.5	1.6	1.5
Tax rate	0.1	0.0	—	18.0	27.0	30.0
Dividend payout ratio	—	—	—	—	—	—
Share of deposits						
Current	18.9	16.4	15.7	14.7	14.2	13.7
Fixed	67.9	72.8	75.0	77.0	77.8	78.3
Savings	18.9	16.4	15.7	14.7	14.2	13.7
Loans-to-deposit ratio	83.4	78.7	78.8	82.4	80.9	80.9
Equity/assets (EoY)	9.9	8.9	8.9	10.5	9.5	8.8
Loan impairment ratios (%)						
Gross NPL	4.4	3.2	1.7	1.7	1.6	1.7
Net NPL	0.6	0.7	0.9	1.0	1.2	1.2
Slippages	1.5	1.4	1.4	1.4	1.3	1.2
Loan-loss provisions	—	77.1	46.5	43.9	26.9	29.3
Dupont analysis (%)						
Net interest income	2.8	2.9	3.0	3.7	3.4	3.2
Loan loss provisions	0.3	0.2	0.3	0.5	0.2	0.3
Net other income	1.3	1.2	1.1	1.1	1.2	1.2
Operating expenses	3.1	2.8	2.6	2.8	2.6	2.5
(1- tax rate)	99.9	100.0	100.0	82.0	73.0	70.0
ROA	**0.7**	**1.0**	**1.3**	**1.3**	**1.3**	**1.2**
Average assets/average equity	11.7	11.4	11.8	10.6	10.4	11.3
ROE	**8.0**	**11.6**	**14.8**	**14.1**	**13.2**	**13.5**

Source: Company, Kotak Institutional Equities estimates

Exhibit 12: DCB: Key financial statements - P&L and balance sheet
March fiscal year-ends, 2012-17E (₹ mn)

	2012	2013	2014	2015E	2016E	2017E
Income statement						
Total interest income	7,170	9,161	11,283	13,941	16,473	20,177
Loans	5,362	7,118	8,679	10,968	13,410	16,498
Investments	1,725	1,963	2,453	2,539	2,913	3,510
Cash and deposits	83	80	151	435	151	169
Total interest expense	4,893	6,317	7,599	8,748	10,639	13,329
Deposits from customers	4,081	5,346	6,649	8,053	10,014	12,664
Net interest income	**2,277**	**2,844**	**3,684**	**5,193**	**5,834**	**6,848**
Loan loss provisions	274	198	354	638	400	577
Net interest income (after prov.)	2,003	2,646	3,330	4,555	5,434	6,271
Other income	1,027	1,170	1,387	1,593	2,032	2,562
Net fee income	787	893	1,011	1,193	1,455	1,775
Net capital gains	118	139	225	225	345	495
Net exchange gains	69	72	57	76	103	134
Operating expenses	2,466	2,753	3,191	3,834	4,435	5,133
Employee expenses	1,246	1,379	1,571	1,930	2,198	2,494
Depreciation on investments	8	(4)	(2)	10	10	10
Other provisions	5	46	14	40	50	60
Pretax income	551	1,021	1,514	2,265	2,971	3,629
Tax provisions	0	0	—	408	802	1,089
Net profit	**551**	**1,021**	**1,514**	**1,857**	**2,169**	**2,540**
% growth	157	85	48	23	17	17
PBT - Treasury + Provisions	721	1,122	1,655	2,728	3,086	3,782
% growth	19	56	47	65	13	23
Balance sheet						
Cash and bank balance	4,566	8,833	6,896	6,901	8,150	9,595
Cash	857	906	849	891	936	983
Balance with RBI	3,218	2,882	4,202	4,165	5,368	6,767
Net value of investments	25,178	33,587	36,342	38,436	47,945	56,821
Govt. and other securities	20,219	24,332	28,072	30,205	39,749	48,657
Shares	—	2	—	—	—	—
Debentures and bonds	30	30	391	352	317	285
Net loans and advances	52,844	65,861	81,402	100,938	127,703	160,975
Fixed assets	1,846	2,394	2,386	1,710	2,181	2,725
Net Owned assets	1,846	2,394	2,386	1,710	2,181	2,725
Other assets	2,335	2,114	2,205	2,646	3,175	3,810
Total assets	**86,768**	**112,788**	**129,231**	**150,631**	**189,154**	**233,927**
Deposits	63,356	83,638	103,252	122,492	157,896	199,035
Borrowings and bills payable	12,561	16,693	10,854	8,720	9,681	10,785
Other liabilities	2,238	2,426	3,587	3,587	3,587	3,587
Total liabilities	**78,155**	**102,758**	**117,692**	**134,799**	**171,163**	**213,406**
Paid-up capital	2,407	2,501	2,503	2,808	2,808	2,808
Reserves & surplus	6,207	7,529	9,036	13,025	15,183	17,713
Total shareholders' equity	**8,614**	**10,031**	**11,540**	**15,832**	**17,990**	**20,521**

Source: Company, Kotak Institutional Equities estimates