Equity Research
June 22, 2018
BSE Sensex: 35432

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Banking

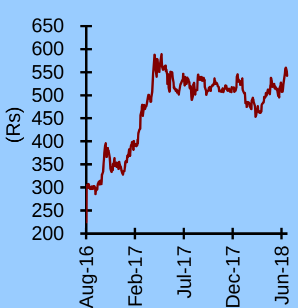
Target price Rs780

Shareholding pattern

	Sep '17	Dec '17	Mar '18
Promoters	0.0	0.0	0.0
Institutional investors	26.0	30.7	32.5
MFs and UTI	7.9	11.9	12.8
FIs/Banks	0.4	0.4	0.4
Insurance Cos.	0.2	0.4	0.4
FIIs	17.5	18.0	18.9
Others	74.0	69.3	67.5

Source: CMIE

Price chart



Research Analysts:

Sachin Sheth
sachin.sheth@icicisecurities.com
+91 22 6637 7572

Sandeep Joshi
Sandeep.joshi@icicisecurities.com
+91 22 6637 7658

INDIA

RBL Bank

BUY

Opportunity knocks

Rs538

Reason for report: Initiating coverage

Investing in a high-growth stock like RBL Bank (RBL) at a time when system loan growth is near historic lows may appear to be a contradiction, but it is allayed by: 1) RBL's relatively small market share of less than 0.5%, 2) the large opportunity presented by the space being vacated by several PSU banks, and 3) the considerable opportunity for RBL to improve its RoA to similar levels as peers. We do not see too many similar instances of small, well-run, high-growth private banks with reasonable assurance of improving RoA. Hence, we initiate coverage on RBL with a BUY rating and a target price of Rs780, implying a robust upside of 45%.

- **What excites us about RBL:** 1) Top quality professional management from diverse banking backgrounds dedicated to grow the bank's profitably; 2) no significant legacy issues for the team to deal with; 3) significant opportunity for RBL to not only grow at a reasonably fast clip, but also to maintain growth sustainably for at least a few years given its below-peer RoA levels at 1.2%; 4) its relatively high risk-adjusted retail yields, which bode well for margin expansion given its lower than peer CASA mix of 28%; and 5) Experience of turnaround in peer banks like IIB demonstrate the opportunity ahead for RBL for a well-run bank with a cohesive management team.

- **Turnaround comparison:** A comparison of RBL's then new team, which came on board in FY11 can be compared to similar situations in IndusInd Bank and DCB Bank around that period to compare how those banks strategised their growth and profitability path. While not entirely similar situationally (those peer banks were saddled with asset quality issues and were much larger than RBL), we can see with reasonable clarity where RBL can reach in terms of its key financial parameters a few years from now, and the picture we see is bright in terms of both growth and profitability.

- **Earnings outlook:** Consequently, we estimate 37% CAGR in RBL's loan growth up to FY20E aided by improving RoA on the back of higher margins and lower credit costs causing RoA and RoE to improve to 1.4% and 16% respectively by then; this implies a 43% CAGR in EPS growth up to FY20E.

- **Valuations and target price:** RBL trades at 3.2x P/ABV and 25x P/E 1-year forward. However, on a growth-adjusted P/E ratio basis (PEG), it is more reasonably valued at well under 1. We benchmark its target PEG at the 5-year average of peer banks at ~0.75 leading to an implied trailing P/E target multiple of 33x – not out of sync with its trading history – and a fair value of Rs780. Based on our DDM model, we arrive at a similar target price of Rs780, implying a 45% upside to the stock from current levels. We initiate coverage with a **BUY** rating.

Market Cap	Rs227bn/US$3.3bn
Reuters/Bloomberg	RATB.BO / RBK IN
Shares Outstanding (mn)	420.6
52-week Range (Rs)	560/454
Free Float (%)	100.0
FII (%)	18.9
Daily Volume (US$'000)	9,073
Absolute Return 3m (%)	16.6
Absolute Return 12m (%)	5.6
Sensex Return 3m (%)	7.4
Sensex Return 12m (%)	14.7

Year to Mar	FY17	FY18P	FY19E	FY20E
NII (Rs Bn)	12.2	17.7	24.2	32.4
Net Profit (Rs Bn)	4.5	6.4	9.0	13.0
EPS (Rs)	11.9	15.1	21.5	31.0
% Change YoY	32.0	27.4	41.8	44.5
P/E (x)	45.3	35.5	25.0	17.3
P/BV (x)	4.7	3.4	3.0	2.6
P/ABV (x)	4.9	3.5	3.2	2.7
Impaired loans (%)	1.5	1.4	1.3	1.2
RoA (%)	1.0	1.2	1.2	1.4
RoE (%)	12.2	11.5	12.7	16.2

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Three turnaround stories, and RBL's prospects

Formerly Ratnakar Bank, now RBL Bank (RBL), was founded in 1943 making it a 75-year-old bank, the past eight years of which have seen its dramatic transformation from a small, regional bank to a thriving, new-age bank led by Mr. Vishwavir Ahuja, who came on board in 2010. The mission was to transform Ratnakar Bank from an old private sector bank to a new-age bank, complete with all the products and technology that any modern Indian bank has to offer. Bringing in fresh faces from foreign and private sector banks, capital from reputed investors and contemporary products/services and technology, Mr Ahuja and his team are well on the path to making RBL a sustainably high-growth and high-profitability banking institution on par with the best of its peers.

We could compare RBL's 'turnaround' with that of two other banks that have seen a turnaround led by new CEOs and their teams – IndusInd Bank and DCB – both around the same time – IIB in FY08 and DCB in FY10 *vs* RBL in FY11. Thus, we compare RBL's key financial metrics with these two banks and judge where RBL is placed currently and how much potential remains ahead of it. However, we must point out that at the time of RBL's transition in FY11, it was a much smaller bank vis-à-vis the other two, with DCB being about double its size and IIB being already 14x.

Table 1: Comparison of RBL with peers

Rs mn	RBL	DCB	IIB	YES	Kotak	HDBK
Total assets - FY11	32,297	73,723	456,358	590,070	508,507	2,773,526
Multiple of RBL		2	14	18	16	86
Total assets - FY18	618,509	302,221	2,216,262	3,124,456	2,649,334	10,639,343
Multiple of RBL		0.5	4	5	4	17
FY18 CASA	24.4	24.3	44.0	36.5	50.8	43.5
FY18 NIMs	3.3	4.0	4.0	3.1	4.2	4.4
FY18 RoA	1.2	0.9	1.8	1.6	1.7	1.8
EPS CAGR – 5-yr trailing (FY13-FY18)	32.9	50.5	22.9	20.6	2.5	19.0

Source: Company data, I-Sec research

A brief word on what IndusInd and DCB banks' new managements strategised at the time of transition around FY10 is highlighted below followed by some observations on RBL's profitability and growth path since the turnaround began.

IndusInd Bank: Mr Sobti and his team announced their strategy for IndusInd Bank in Q4FY08 (*vs* FY10 for RBL's new team). He took charge of a bank that had high NPLs, an asset liability mismatch and low employee and customer morale. The new team's ambition was to be amongst the top three leaders in the private bank space in three years in terms of productivity, profitability and efficiency, with focus on RoA/RoE, margins, revenue per employee and reduction in NPLs. The effort and challenges involved broad-basing the retail deposit franchise to reduce funding costs by expanding branches, ATMs, internet banking and increasing the number of products/services.

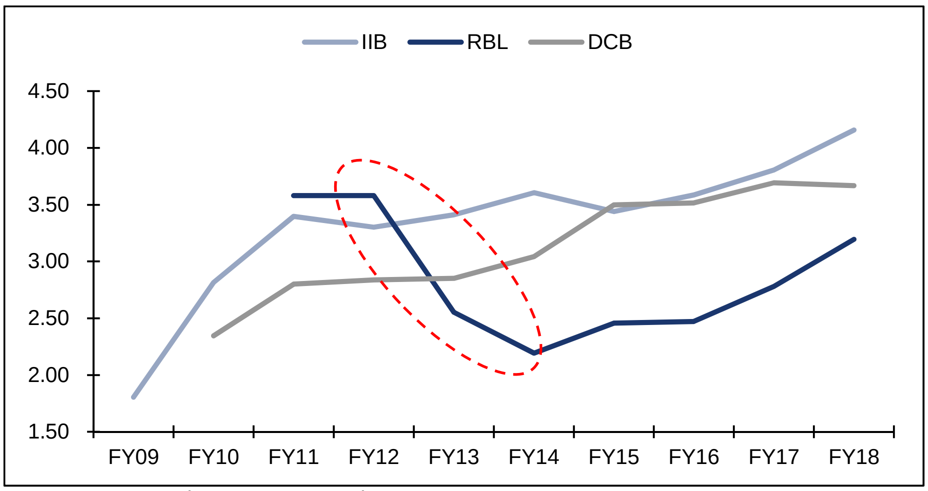
DCB Bank: Mr Natarajan joined the DCB Bank in Q1FY10 inheriting a bank with severe asset quality problems. The strategy adopted by management initially was to curtail further lending in the unsecured retail space (especially CV/CE) itself and some corporate relationships. After mitigating loan losses, DCB Bank focused on secured retail loans, retail deposits including CASA by positioning itself as the neighborhood bank and fee sources such as wealth management and cash management.

How has Mr. Ahuja's team coped with the effort in transforming RBL? To answer this, we now walk through a pictorial analysis of the past eight years at RBL. While we have also shown IndusInd and DCB banks' ratios to provide a perspective of how RBL fared *vs* these two banks, our commentary focuses on RBL. With FY11 being the year Mr Ahuja and his team joined RBL, the period we focus on is post-FY12.

RBL's path since its 'turnaround' – Key observations

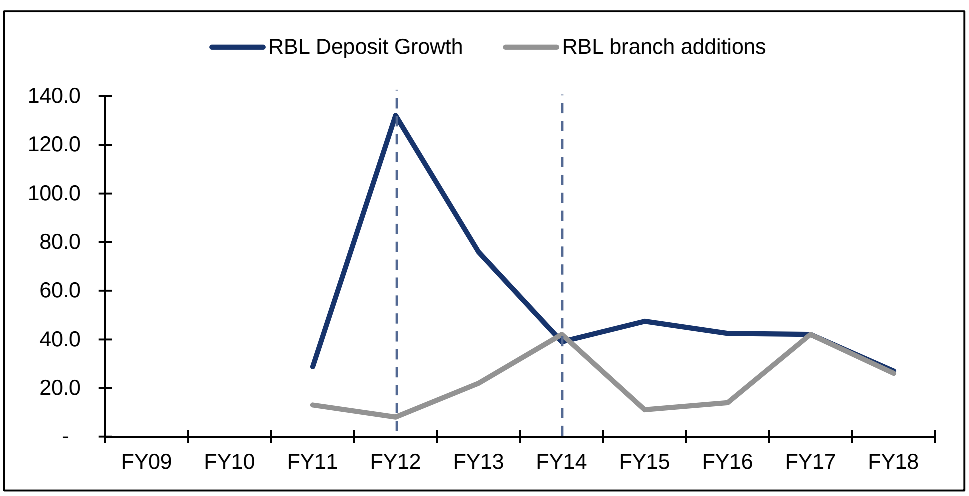
- Margins fell in FY13 and FY14 partly as a result of the tight liquidity situation prevailing in those years and partly as the bank ramped up deposit growth and distribution, resulting in CASA falling from 35% in FY11 (off a small deposit base) falling to 20% FY13 and FY14. However, after that, as these adverse factors waned, CASA and retail loan mix bottomed out and started rising. RBL's cost of funding declined by a cumulative ~150bps from FY14 right up to FY18 leading to ~100bps increase in margins over the same period.

Chart 1: Net interest income/Average assets (%)



Source: Company data, I-Sec research

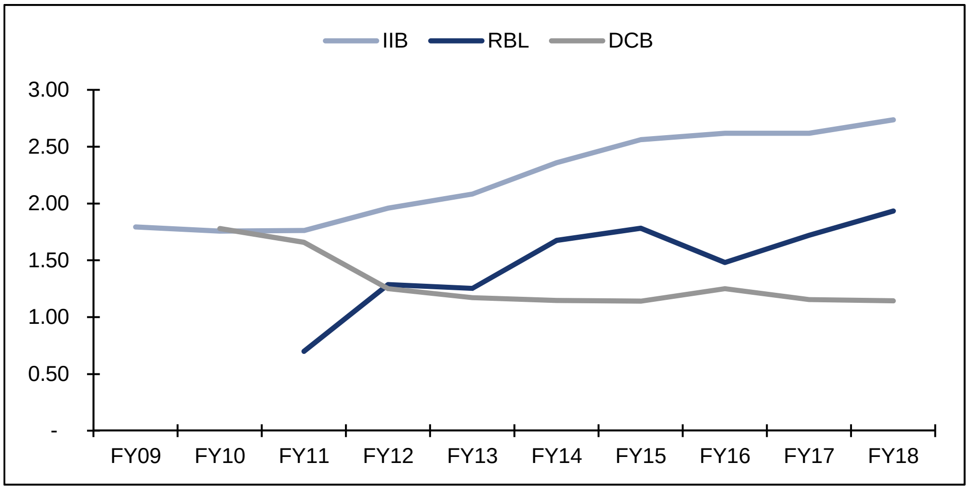
Chart 2: RBL – Deposit growth (%) and branch additions



Source: Company data, I-Sec research

Other income (mainly fees) as percentage of assets recovered from FY14 onward, cushioning the impact of falling margins and core revenues.

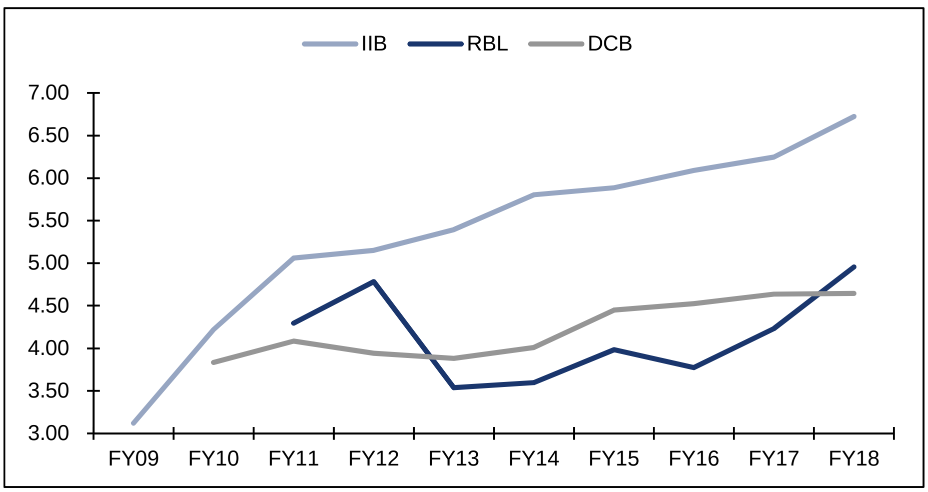
Chart 3: Other income / Average assets (%)



Source: Company data, I-Sec research

Thus, while RBL's margins bottomed out in FY14, revenues had bottomed out in FY13 aided by sharp improvement in fee profitability.

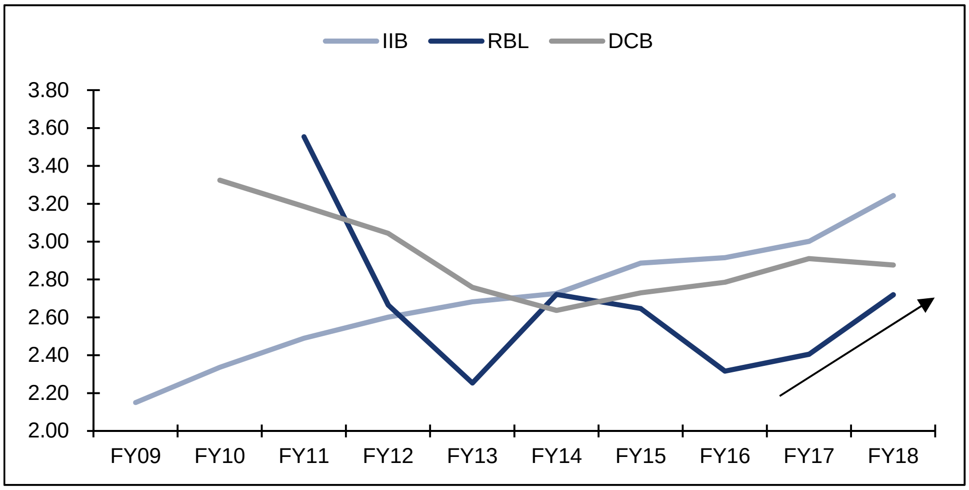
Chart 4: Revenues / Average assets (%)



Source: Company data, I-Sec research

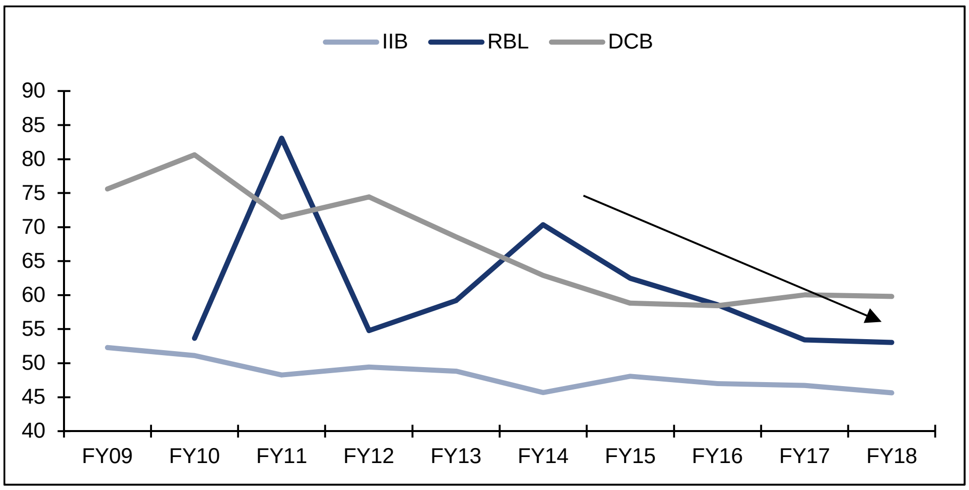
On the cost front, while RBL's cost/assets ratio has been fluctuating within a range of 2.2-2.8%, it seems to be on a rising trend for the past two years. On the other hand, the cost-income ratio appears to be on a continuous downtrend over the past several years. Why this discrepancy?

Chart 5: Cost / Average assets



Source: Company data, I-Sec research

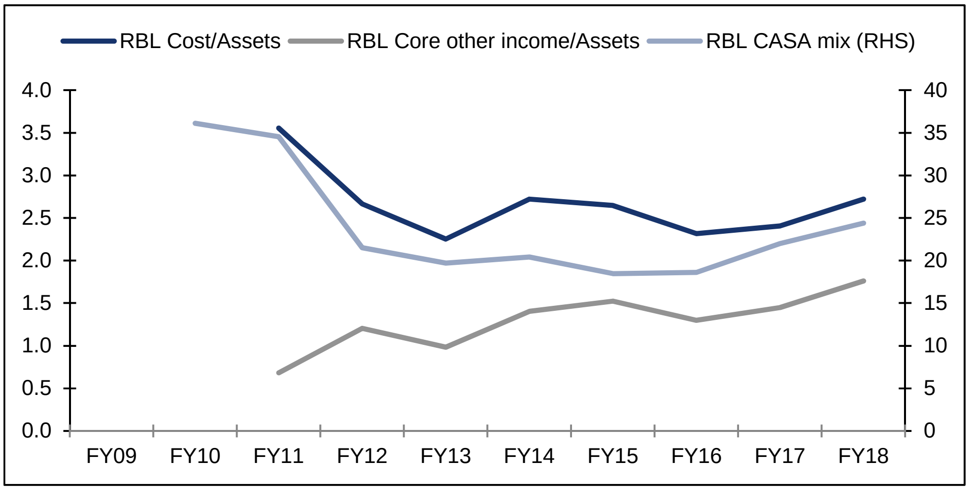
Chart 6: Cost-Income ratio



Source: Company data, I-Sec research

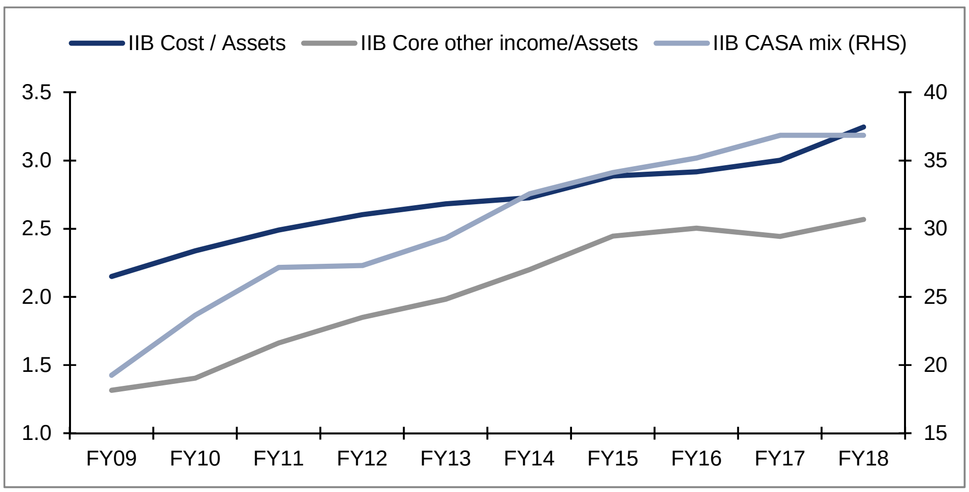
We believe the cost-income ratio is on a downtrend because not all costs are aimed toward generating assets. Also, many business segments have to bear new business costs upfront (e.g. credit cards) while revenues may be lagged. A scheduled commercial bank can typically do many businesses that a non-bank cannot – mainly, raise CASA deposits and do some types of fee generating businesses (e.g. cash management, documentary credits, payments, etc.). Hence, all costs do not necessarily result in asset generation but do generate income. We examine this hypothesis in the case of the three banks under discussion – RBL, IIB and DCB. We look for some degree of correlation of the cost-assets ratio with asset building (i.e. CASA mix) as well as fee generation propensity of assets (fee/assets).

Chart 7: RBL: Cost-assets ratio *vs* CASA mix and fees/assets



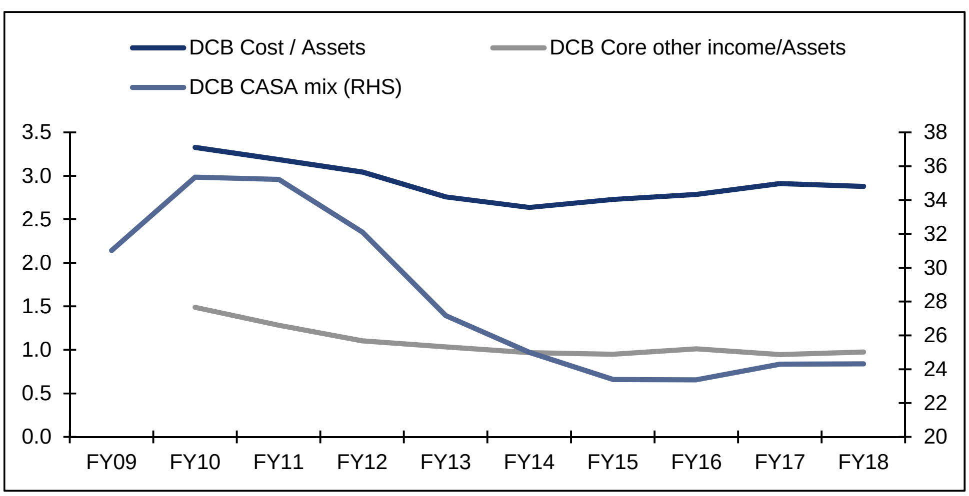
Source: Company data, I-Sec research

Chart 8: IIB: Cost-assets ratio *vs* CASA mix and fees/assets



Source: Company data, I-Sec research

Chart 9: DCB: Cost-assets ratio *vs* CASA mix and fees/assets

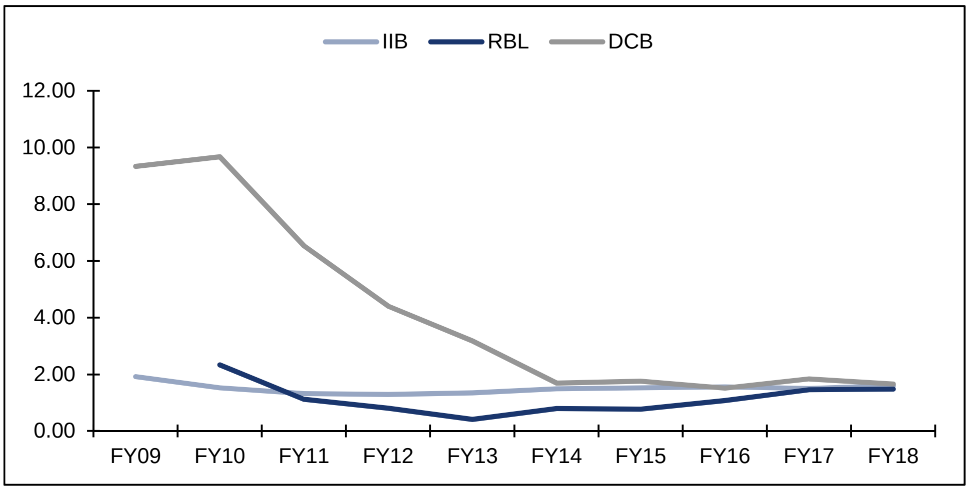


Source: Company data, I-Sec research

As can be seen in all the three banks, there is a fair degree of correlation of cost-assets ratio with the other two indicators. For RBL in particular, as the cost/assets ratio rises, so does its CASA mix as does its fee profitability resulting in higher income generation *vs* expenses, and thus a lower cost-income ratio. Generally, as a private bank invests more in its distribution and products, its cost-income trends downwards as can be seen for the other two banks (IIB and DCB).

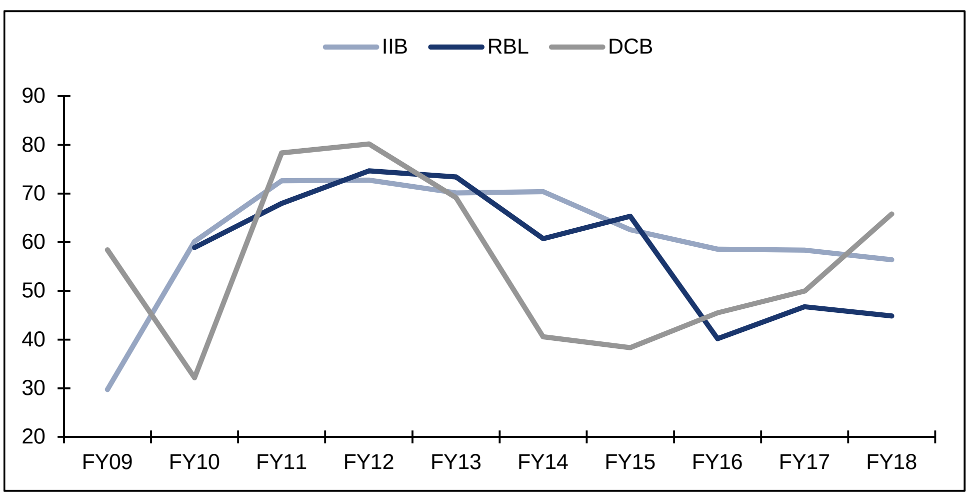
Asset quality appears to be quite a non-issue on an overall basis for RBL with its total impaired loan ratio at 1.45% and provisioning coverage ratio at 45%. With 4.7% of RBL's net worth exposed to unprovided NPLs, it doesn't pose a risk to the bank's capital position. RBL has a fair amount of exposure to potentially risky segments including agri, micro banking, unsecured personal loans, etc., but has managed the latter two segments well with NPLs for retail assets declining in FY18 to 1.26% and micro banking NPLs declining to 2.84%. Agri NPLs have increased to 4.15%, which the bank has now defocused from.

Chart 10: Impaired loan ratio (%)



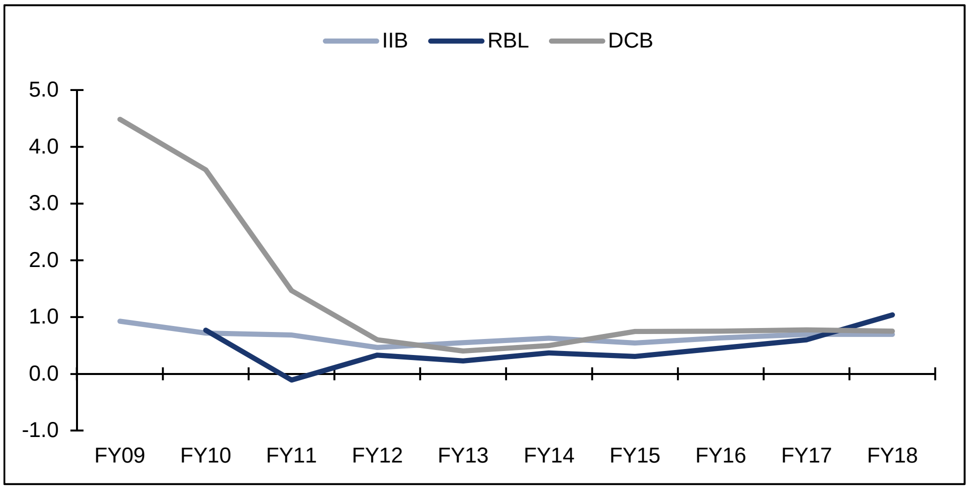
Source: Company data, I-Sec research

Chart 11: Provisioning coverage ratio (%)



Source: Company data, I-Sec research

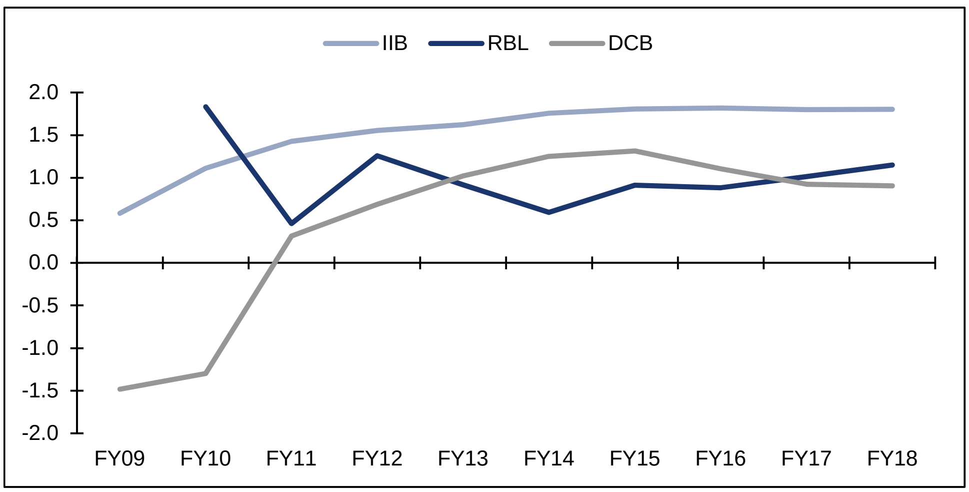
Chart 12: Credit costs (%)



Source: Company data, I-Sec research

And finally, coming to the bottomline, RBL's RoA has shown a rising trend for the past four years now, holding out promise to improve even further going ahead.

Chart 13: Return on Assets



Source: Company data, I-Sec research

Company background and management

RBL Bank (RBL) is one of India's oldest banks, which was set up in Kolhapur in 1943 by Babgonda Patil, an advocate in Sangli, and Gangaram Choughale, a merchant from Kolhapur. The bank received its scheduled bank status in 1959. However, till 2010 the bank operations were largely sleepy and with limited presence.

In order to transform an old-age private bank into a new-generation private bank, the board revamped majority of the senior management team, with Mr. Vishwavir Ahuja taking over as MD & CEO in 2010. As at FY10, the bank had a business of Rs28bn, which over the years has increased at a CAGR of 53% to Rs841bn by FY18.

The journey of transformation was full of difficulties as there was no core banking system in place, technology was old and did not offer scalability, most staff were retired officials from PSU banks, etc.

The new management team adopted three main pillars to bring about a generational leap for RBL:

- High-quality equity base – as capital being the fuel for modernisation and growth
- Strong employee and management cadre that is highly motivated and can continuously adapt to a dynamic environment
- Highly respected and experienced board of directors that can support and shape the overall vision and provide the required governance to balance the interests of all stakeholders

High-quality capital base

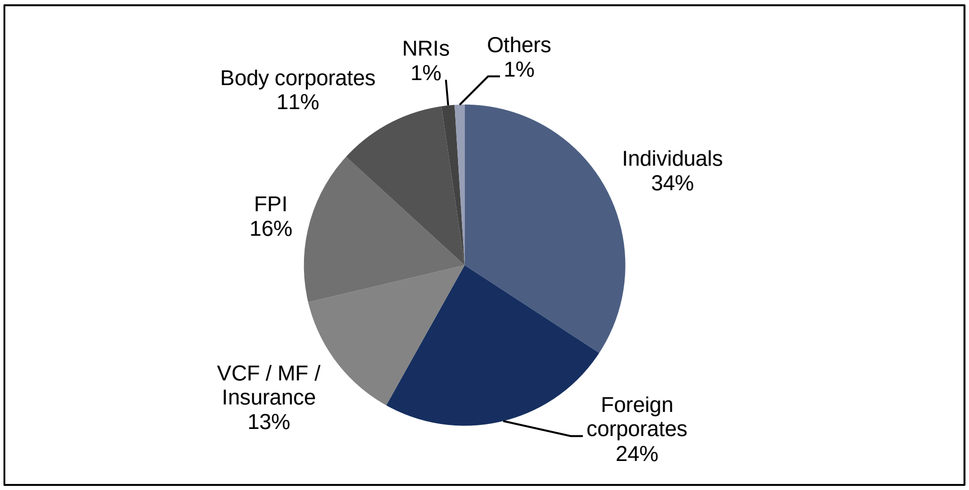
In order to fund its expansion plans, RBL required capital to be injected at regular intervals. The bank, on the back of its sustainable execution of strategy, has been able to raise capital from several investors as necessary from time to time.

Table 2: Capital raising by RBL Bank

Year	Amt of capital (Rs mn)	Investors
FY12	7,000	HDFC, Gaja Capital, Norwest Venture, Samara Capital, Beacon Private Equity, Faering Capital, TVS Shriram and Cartica Capital etc
FY13	3,760	International Finance Corporation, Ascent Capital, Aditya Birla Private Equity, Faering Capital, IDFC SPICE Fund, ICICI's Emerging India Fund etc
FY14	3,280	CDC, Asia Capital etc
FY16	4,880	Asian Development Bank, CDC Group Plc, family offices and long-only funds such as DVI Fund (Mauritius) Ltd and Rimco (Mauritius) Ltd.
FY17	8,325	IPO
FY18	16,800	CDC Group, HDFC Standard Life Insurance, CICI Lombard General Insurance, Steadview Capital Mauritius, Multiples Private Equity and Global Ven ures

Source: Company data, I-Sec research

Chart 14: Current shareholding pattern



Source: Company data, I-Sec research

Employee and management cadre with ESOPS

Granting ESOPS was one of RBL's major strategies as it desired employees too to benefit by walking along the transformation path. Till FY13, 67% of bank's employees were covered under ESOPS plans from 0% in FY10.

As at FY17, directors and key management personnel hold 5.1% of the bank's total share outstanding.

Significant Board transformation

At the cusp of its transformation journey, RBL's Board of directors cherry-picked reputed and experienced bankers from Bank of America and other private and foreign banks. The board then on a regular basis kept recruiting specialized professionals to spearhead its new business verticals.

Table 3: Board of directors

Names & designation	Experience
Mr. Vishwavir Ahuja Managing Director and CEO	Mr. Ahuja holds a Master's degree in business administration from IIM - Ahmedabad and an MS degree in International Finance from the University of Michigan, US. Prior to joining RBL Bank, Mr. Ahuja was the Managing Director & CEO of Bank of America, India, from 2001 to 2009. Mr. Ahuja joined RBL Bank in 2010 when it was a small, regional, southern Maharashtra based old-age private sector bank.
Mr. Narayan Ramachandran Chairman	Mr. Ramachandran holds a bachelor's degree in technology from IIT Mumbai and a management degree from the University of Michigan; he is a certified financial analyst. Prior to joining RBL Bank, he was the country head and chief executive officer of Morgan Stanley India. Earlier, he was the co-head of the emerging markets division of Morgan Stanley Investment Management. He has been a Director with RBL Bank since May 20, 2010.
Mr. Jairaj Purandare Independent Director	Mr. Purandare is a chartered accountant and has about 33 years of experience in financial services and taxation. He is the chairman of JMP Advisors Private Limited, a consulting and tax services provider. Previously, he was associated with Pricewaterhouse Coopers Private Limited as a regional managing partner. Mr. Purandare was earlier chairman of Ernst & Young India and country head of tax and regulatory practice of Arthur Andersen and Co in India. Mr. Purandare has been a Director with RBL Bank since September 16, 2011.
Mr. Prakash Chandra Independent Director	He holds a bachelor's degree in law from the University of Allahabad and a diploma in development policy from the University of Glasgow. He is currently a practising lawyer with focus on taxation matters and is a member of the Supreme Court Bar Association. Mr. Chandra was previously a member of the Indian Revenue Service and retired as member/chairman of the Central Board of Direct Taxes (CBDT) on July 31, 2011. He has over 40 years of experience in the field of taxation. Mr. Chandra has been a Director with RBL Bank since January 25, 2016.
Mr. Ishan Raina Independent Director	Mr. Raina holds post graduate diploma in management from IIM Calcutta. He is currently an advanced leadership fellow at Harvard University, Cambridge, US. He was associated with Out-of-Home Media (India) Private Limited as its managing director and chief executive officer as well as with Euro RSCG Advertising Private Limited as its managing director. Mr. Raina has been a Director with RBL Bank since April 30, 2016.
Mr. Palepu Sudhir Rao Independent Director	Mr. Rao is a chartered accountant and has about 31 years of experience in the financial services sector. He is a founder of IndusAge Advisors Limited, an enterprise development advisory services organisation. Mr. Rao was also one of the first directors of Karvy Investor Services Limited and was also a director on the Board of Bank of Punjab Limited. He is currently associated with a number of corporates in India, including as a director on the Board of Aditya Birla Money Limited and Radhakrishna Foodland Private Limited. Mr. Rao has been a Director with RBL Bank since January 30, 2012.
Ms. Rama Bijapurkar Independent Director	Ms. Bijapurkar holds a postgraduate diploma in management from IIM Ahmedabad. She has wide experience in the field of market research, market strategy and management consulting and presently manages her own consultancy practice. She has been a director in several companies in the financial services sector and is also a member of the governing council of the Banking Codes and Standards Board of India, the Insurance Information Bureau of India, and a member of the eminent person advisory group of the Competition Commission of India. Ms. Bijapurkar has been a Director with RBL Bank since March 27, 2014.
Mr. Sivanandhan Dhanushkodi Independent Director	Mr. Dhanushkodi holds a master's degree in economics from the University of Madras. He was previously the director general of police of the State of Maharashtra and is currently a part time security advisor to the Reserve Bank of India. Mr. Dhanushkodi has been a Director with RBL Bank since December 18, 2012.
Mr. Vimal Bhandari Independent Director	Mr. Bhandari is a qualified chartered accountant and has extensive experience in the financial services industry. He is currently the chief executive officer and managing director of IndoStar Capital Finance, a wholesale credit institution. He was previously the country head of AEGON NV, a Dutch financial services entity. Mr. Bhandari has also been a member of the executive committee and the listing committee of NSE and is currently a member of the executive committee of FICCI. He has been a Director with RBL Bank since September 14, 2010.
Mr. Rajeev Ahuja Independent Director	Mr. Ahuja has experience of over 28 years in the financial services industry. He holds a Masters in Business Administration from IIM, Ahmedabad. Prior to joining RBL Bank, Mr. Ahuja was Managing Director - Investor Sales Business (South Asia) with Citigroup, India. During this time, he established Citi's Fixed Income Capital Markets business with a broad product platform across INR and G3 bonds/loans, structured debt and mezzanine capital.

Source: Company data, I-Sec research

Table 4: Key management personnel

Names & designation	Experience
Mr. Vishwavir Ahuja Managing Director and CEO	Mr. Ahuja holds a master's degree in business administration from IIM Ahmedabad and an MS degree in International Finance from the University of Michigan, US. Prior to joining RBL Bank, Mr. Ahuja was the Managing Director & CEO of Bank of America, India, from 2001 to 2009. He joined RBL Bank in 2010 when it was a small, regional, southern Maharashtra-based old-age private sector bank.
Mr. Rajeev Ahuja Independent Director	Mr. Ahuja has an experience of over 28 years in the financial services industry. Rajeev holds a Masters in Business Administration from IIM Ahmedabad. Prior to joining RBL Bank, he was Managing Director - Investor Sales Business (South Asia) with Citigroup, India. During this time, Mr. Ahuja established Citi's Fixed Income Capital Markets business with a broad product platform across INR and G3 bonds/loans, structured debt and mezzanine capital.
Mr. Brijesh Mehra Head of Corporate, Institutional and Transaction Banking	Mr. Mehra has over 30 years of experience across several capacities including overseeing businesses across India and multiple South Asian geographies. He is an MBA from IIM Ahmedabad and B.Com Honors from Delhi University. Prior to joining RBL Bank, Mr. Mehra was Country Executive, India, and the Corporate and Institutional Banking Head at Royal Bank of Scotland (RBS).
Mr. Vincent Valladares Head of Commercial Banking	Mr. Valladares has 22 years of experience in financial services across sales, relationship management and credit. He holds a B.Tech. in petrochemical engineering and a Masters in Management Studies from JBIMS, Mumbai. Mr. Valladares overlooks the Commercial Banking (CB) coverage franchise which includes the SME and mid-corporate segments. Prior to joining RBL Bank, he held various roles at Citibank India and UAE.
Mr. Harjeet Toor Head of Retail, Inclusion and Rural Business	Mr. Toor has an experience of over 23 years, 21 of which have been in consumer banking across NBFCs and banks spanning Fullerton India Credit Company Ltd. (FICCL), RBS, ABN AMRO Bank and Bank of America. He has worked in leadership roles across varied functions in marketing, product management, sales & distribution, branch banking and finance. Mr. Toor is an engineer and a management graduate from Faculty of Management Studies, Delhi.
Mr. Jaideep Iyer Head – Strategy	Mr. Iyer has an experience of over 20 years in the financial sector across verticals such as finance, strategy, investor relations, corporate banking and financial markets. He is in charge of RBL Bank's finance, strategy and investor relations. Prior to joining RBL, Mr. Iyer was the Group President and Deputy CFO at Yes Bank for nine years and was responsible for finance & accounting, taxation, secretarial, business & management Information systems, investor relations and financial strategy. Mr. Iyer holds a Masters in Business Administration from IIM Ahmedabad and a bachelor's degree in engineering.
Mr. R. Gurumurthy Head – Risk	Mr. Gurumurthy is a certified associate of the Indian Institute of Bankers. He has about 30 years of experience in the banking sector and was previously associated with Standard Chartered Bank, Bank of America, Credit Lyonnais and State Bank of India. He has been associated with RBL Bank since July, 2011. As the Head – Risk & Governance of RBL Bank, he is responsible for managing the quality of the bank's credit portfolio, market risks, operational risks, etc.

Source: Company data, I-Sec research

Table 5: Timeline of events

Year		Achievement
1943	G	• Ratnakar Bank established
1959	G	• Bank was conferred with scheduled bank status
1980	G	• The bank achieves a target of Rs250mn deposits
2010	G	• The Board of Directors take an important strategic decision to transform the bank from an old private sector bank to a new-age bank with induction of Mr. Vishwavir Ahuja as managing director & CEO in July 2010
	G	• The Board is revamped to include eminent professionals from banking, finance, agriculture and other related fields
	G	• The path to transformation commences. A high calibre management team with an excellent track record forms the bank's top management
2011	C	• Recognising the need to build scale and strengthen the balance sheet, the bank raises Tier-I capital of over Rs7bn taking the total capital base to Rs11bn (approx.)
	P	• Launched ATM cards, prepaid cards and internet banking; obtained an authorised dealer license to commence foreign exchange and International trade business; implemented a comprehensive treasury dealing and settlement system
	P	• Revamped risk management framework and credit administration processes; focused on SME, retail and agri banking, and financial inclusion
	P	• Commercial banking division launched *Ratna Business*, a schematic SME credit product, expanding into new industry and trade segments
	P	• Agri banking and financial Inclusion verticals introduced Ratna Group Loans, a focused credit product for small and marginal farmers, artisans and women borrowers
	G	• Implemented 100% Core Banking System (CBS) across rural and semi-urban branches; centralised backoffice banking operations for all major locations
2012	G	• Bank starts upgrading its CBS to Finacle from Infosys
	G	• IT infrastructure is revamped with significant investments for ensuring resilience, security and robustness
2013	C	• Raised tier-I capital of over Rs3760mn, taking the total capital base to around Rs1,6000mn
2014	G	• Rebranded its identity from 'Ratnakar Bank' to 'RBL Bank'
	P	• Acquired business banking, credit card and mortgage businesses of the Royal Bank of Scotland (RBS) in India
	C	• Completed third round of capital infusion to the tune of Rs3280mn from leading global investors including CDC and Asia Capital
2015	P	• Launched the bank's first ever currency chest in Kolhapur
2016	C	• Successfully raised Rs4,880mn as pre-IPO preferential placement from global and domestic investors augmenting the bank's Tier-1 capital to meet future capital needs
2017	C	• Successfully concluded its initial public offering (IPO), which was oversubscribed ~70 times.

Source: Company data, I-Sec research
C: Capital raising event, P: New Product / service launch event, G: General event

Business analysis and financials

While we have discussed the trend of RBL's key financial metrics in the foregoing, we now take a quick look at its loan and deposit book mix followed by the earnings outlook.

RBL's balance sheet is moving toward greater retail orientation. Eight years into the new management, the CASA mix has moved up from 18% to 24% over the past three years. Similarly, the retail loan book mix (excluding microbanking) has moved up from 16% to 22% during the same period. A snapshot of its loanbook mix, growth trend and description is tabulated below. As can be seen, most of the higher yield business is also high-growth and fairly low-risk implying that if the bank can continue to manage these credit costs, its RoAs are likely to move up fairly quickly.

Table 6: Loanbook profile

Segment	**Characteristics**						
	Description	**Yield**	**Risk (FY18 credit cost)**	**Current share of loan book - FY18**	**FY18 Growth**	**Competition**	**Cross-sell opportunities**
Agribusiness Banking (AB), Development Banking & Financial Inclusion (DB&FI)	**AB:** Capture requirements across agri value chain - pre & post-harvest, agri infra, corporate agri business & commodities. **DB&FI:** Aim to build a local financial ecosystem at village or ward level using a mix of branches, BCs, mobile banking, etc. Products include JLG & SHG finance, micro housing loan, basic savings accounts, payments products and small business banking.	Overall retail yields including agri and DB&FI was 13.40% in FY18 *vs* 13.38% in FY17; this represents 41% of the loanbook	AB - 132bps, DB&FI - 120bps	18.90%	AB -8%; DB&FI 38% (within which Micro bkg 65%, IFI - 5%, MSME 76%)	**AB:** All PVT & PSU banks; Value chain lending model - not standalone farmer loans; **DB&FI:** SFBs, Bandhan, BhaFin, unlisted MFIs	Will open up once business scales up
Retail Banking - includes branch & business banking (BBB)	**BBB**: New segment established in 2015. Focus on individual and business accounts. Business accounts focus on SME and MSME clients with high volume transaction requirements (cross border capital flow, FX, CMS, WC, TL, TF). Sector examples include IT, ITES, shipping, hospitals, educational institutions, telecom equipment, auto ancillaries, travel & tourism companies, embassies, trusts & clubs; Retail loans, credit cards & personal loans; PL is not a large part given cost of origination and tenure.		157bps - Risk mitigation through diversification, credit bureau data, tech-backed rule engine for cards and personal loans	22.10%	66%	Yields higher than larger PVT banks; Competing more with PSU and NBFCs; LAP ticket sizes = 1-1.25cr - similar to NBFCs (LAP is based on CF evaluation for asset purchase; Hence LTV is in mid-60s as it is dependent on CFs of biz rather than asset value; For 97% of book, collateral is primary place of residence or biz.	Significant provider of CASA, fee income.
Corporate & Institutional Banking (C&IB), Commercial Banking (CB)	**CB:** SMEs (turnover Rs350mn-2,500mn) and mid-sized corporates (Rs2.5bn-15bn). Focus on newer, fast growing segments – logistics, e-commerce,	CB and C&IB together had an average yield of 8.76 in FY18 *vs*	CB - 116bps	18.70%	36%	large PVT banks + a few PSUs; Some NBFCs at lower end	Wealth management and other banking services to the promoter and their

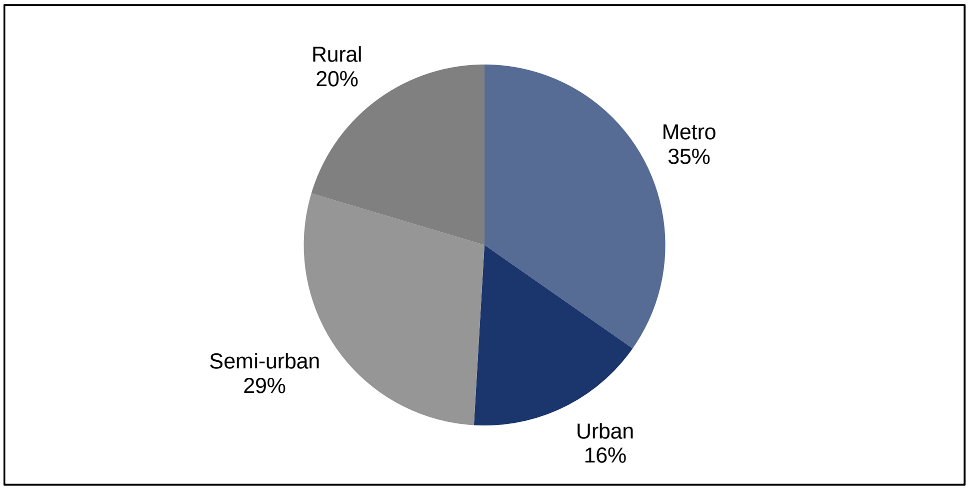
Segment	Characteristics						
	Description	**Yield**	**Risk (FY18 credit cost)**	**Current share of loan book - FY18**	**FY18 Growth**	**Competition**	**Cross-sell opportunities**
	consumer services & organised retail. Lending + transaction banking (cash, trade & fx). Footprint of CB is in key commercial centres across Tier-1&2 cities.	9.89% in FY17; C&IB yields would be a little below this average; MCLR was hiked by 45bps – full impact likely by Q1&Q2FY19.					families
	C&IB: Large corporates (turnover >Rs15bn); mainly working capital, fee business opportunity (DCs, CMS, FX), CASA opportunity) – operating out of eight major commercial centres		C&IB - 46bps	40.30%	32%	Large private banks + a few PSUs	Cross-sell opportunities to promoter, employees for wealth management, salary accounts, retail loan products
A note on the credit card business							
Credit cards - Bajaj finserv tie-up + RBL's own card origination (part of retail loans business mentioned above)	Bajaj finserv tie-up – 5-year exclusivity for both partners (started last year); RBL gives Bajaj an origination cost, a collection cost and a share of spend; Balance sheet resides with RBL; RBL selects a pool of about 5mn customers to target, from Bajaj's customer base of ~13mn. Run analytics on these customers for customised products. Some will be from Tier-1 cities, some will be salaried, etc. Construct a portfolio based on this. Customer then gets a pre-approved card through Bajaj finserv online (as originator). RBL pays Bajaj origination fee. As and when customer starts using the card, some spend is shared with Bajaj (some part of the interchange fee goes to Bajaj). If customer goes bad, there is a collection cost fee paid to Bajaj.		Bureau scores + own models (propensity to spend, etc.); credit costs are lower *vs* industry cost of 4.7% despite customers being predominantly new to bank. Aggressive write-off policy (70% in 90 days and 100% in 180 days); Industry average revolve is 45-55% *vs* RBL at 51%; 20% yields; high fee streams; spend shares on par with industry	Bajaj card customers are about half of RBL's total card customers but 30% of card o/s as partnership is only a year old and AUM will get built up to an equal proportion in next couple of years. RoAs on both Bajaj and RBL's card customers is roughly equal now, and much higher than the bank's overall RoA (typically, credit costs of Bajaj card customers is lower than RBL's own card customers). But real operating leverage will come once RBL crosses the 3mn-4mn customer mark. Adding roughly outstanding card base each year, so higher upfront costs of acquisition. break-even point is 15 months. A good card portfolio would give 5-8% RoA – and that is the target.		Most card customers are new to the bank (but not new to credit) under the Bajaj tie-up; For non-Bajaj customers, tie-ups include partners like Bookmyshow, Hypercity, Moneytap. More than 70% of cards are 'paid' cards which implies greater engagement of customer and greater spends. RBL is among the top 5 card issuer in terms of spends.	

Source: Company data, I-Sec research

In terms of geography, ~65% of RBL's loans are to customers in West and North India and 68% of its loanbook is secured. Both these metrics were similar in FY17.

In terms of its reach and deposit franchise, RBL's CASA mix at 24% is still 'young' and is built on a distribution base of 4.5mn customers across 265 branches (with 49% in semi-urban and rural areas). About 46% of the bank's branches are located in Maharashtra and Gujarat. As mentioned earlier, as RBL invests more in its distribution channels, its CASA mix is likely to increase.

Chart 15: Branch distribution of RBL

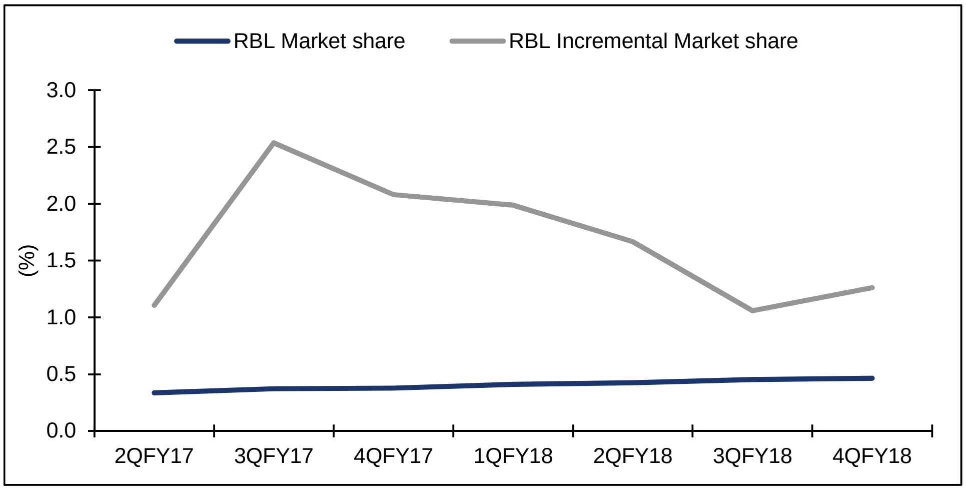


Source: Company data, I-Sec research

Opportunity knocks

We estimate RBL's loan growth to remain robust in the 35-40% range, especially given the relatively small size of its balance sheet (less than 0.5% system market share) and the opportunity arising from PSU banks loss of share. As a result, RBL's incremental share at 1.26% is more than double its outstanding share of system loans.

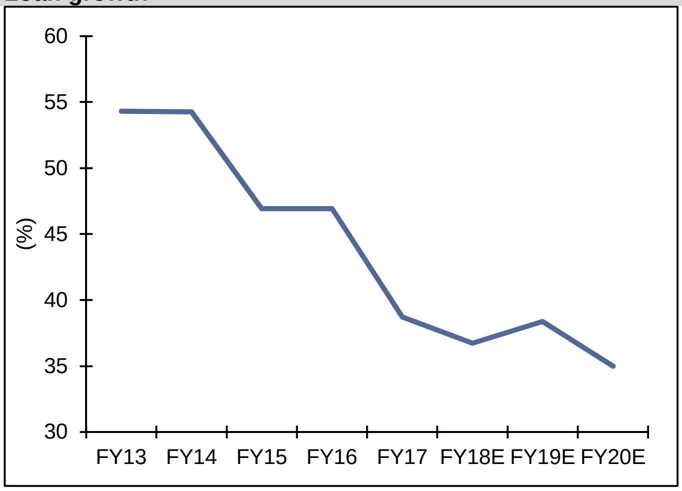
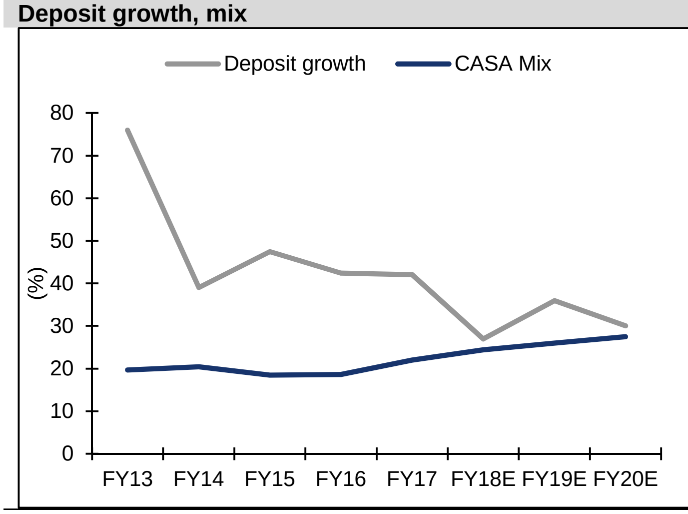
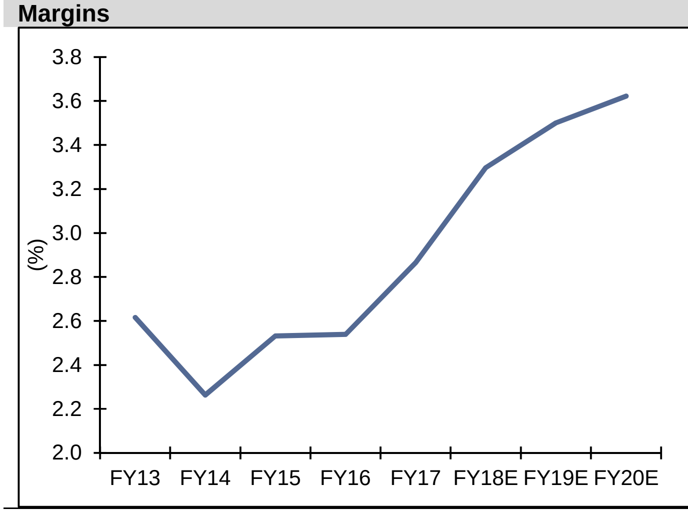
Chart 16: RBL – Market share of loans



Source: RBI, I-Sec research

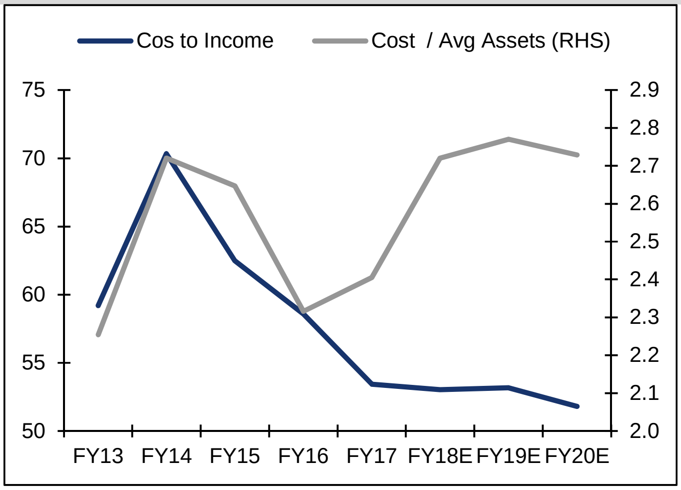
With CASA mix as well as retail mix is set to increase (e.g. the tie-up with Bajaj finserv for cards is only about 18 months old), we see margins improving by ~30bps to 3.6% by FY20E. We also expect fee growth to trend broadly in line with asset growth until RBL attains a certain minimum size of balance sheet, enough to penetrate larger corporates and obtain a reasonable share of their fee business. On the expenses side, as mentioned earlier, we expect the cost income ratio to steadily decline even as the cost-assets ratio remains flattish. With the worst of the asset quality issues behind us, we expect RBL's NPL ratios to decline, coverage ratio to improve and credit cost to decline, resulting in RoA improving by 22bps to 1.37% in FY20E (we compute RoA using the simple average of opening and closing assets for each year). Consequently, RoE is expected to cross 16% by then, but Tier-1 is estimated to fall to ~10% by then, which implies RBL could think of raising fresh equity in FY20.

Earnings outlook

The picture	The story	The outlook FY18P	FY19E	FY20E
Growth				
Loan growth				
	• Historically, the bank has shown robust loan growth on the back of small base. Going ahead, we expect bank's loan book to grow in the range of 35-38%.	37%	38%	35%
Deposit growth, mix				
	• Historically loan growth has been largely financed by deposit growth. Over past 5 year, avg CD ratio stood at 86.7%. • Increasing CASA is one of the core strategy of the bank to guide margins ahead. We expect CASA to increase by ~1.5% every year as guided by the bank.			
	Deposit growth (%)	27	36	30
	CASA mix (%)	24.4	26.0	27.5
Profitability				
Margins				
	• Historically bank's margin had increased on the back of higher growth in retail and microfinance portfolio which was aided by sudden increase in CASA due to demonetization. Going ahead we expect margins will be largely driven by increase in CASA deposits and secondly by increase in retail and microfinance lending..	3.3%	3.5%	3.6%

The picture	The story	The outlook		
		FY18P	FY19E	FY20E

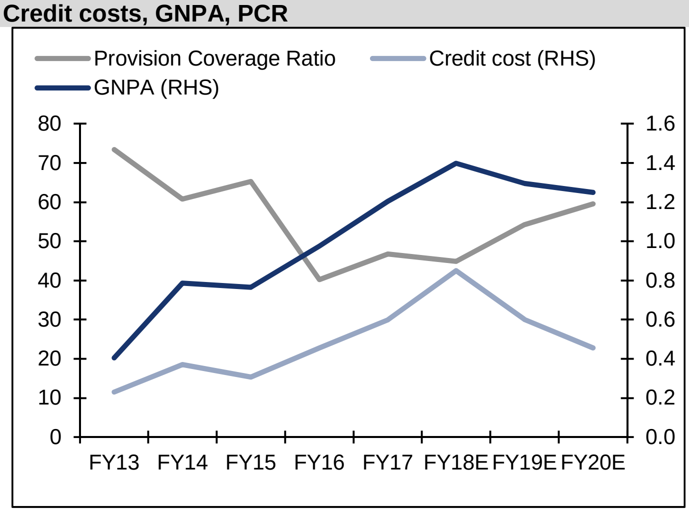
Costs



- After material investment in technology and infrastructure in FY14, the bank's cost to Income ratio has been continuously trending down. We expect cost ratios to trend down going forward.

	FY18P	FY19E	FY20E
Cost to Income (%)	53.0	53.2	51.8
Cost / Avg assets (%)	2.7	2.8	2.7

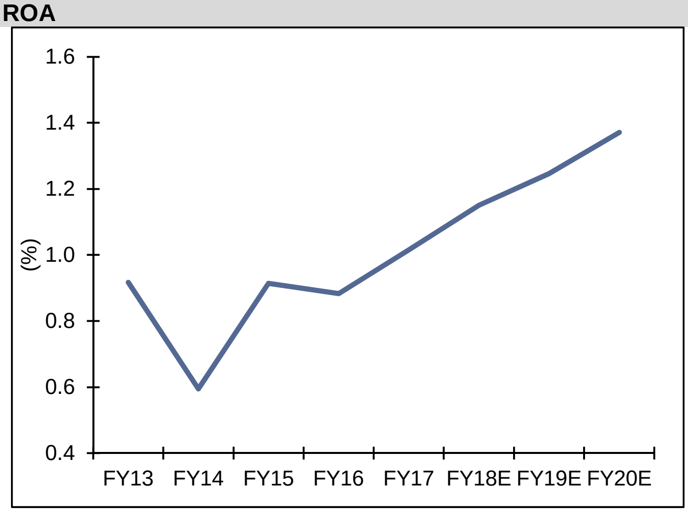
Credit costs, GNPA, PCR



- We do not expect any negative surprise w.r.t asset quality and expect GNPA to continually improve with lower slippages and continuous recoveries. We also expect coverage ratio to continuously increase going ahead.

	FY18P	FY19E	FY20E
Credit cost (%)	0.85	0.60	0.45
GNPA (%)	1.5	1.3	1.2
Coverage ratio (%)	45	54	60

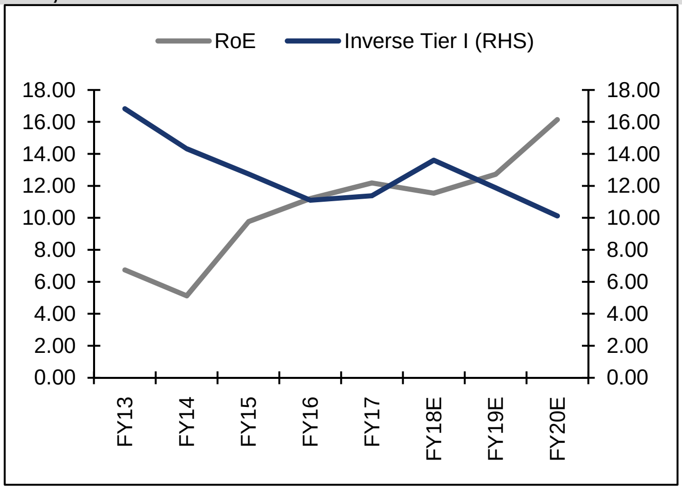
ROA



- Increase in retail lending, material scope of increase in CASA , declining cost / assets ratio with relatively lower credit cost will drive RoA to ~1.4% in FY20E.

	FY18P	FY19E	FY20E
RoA (%)	1.2	1.2	1.4

RoE, Tier-1



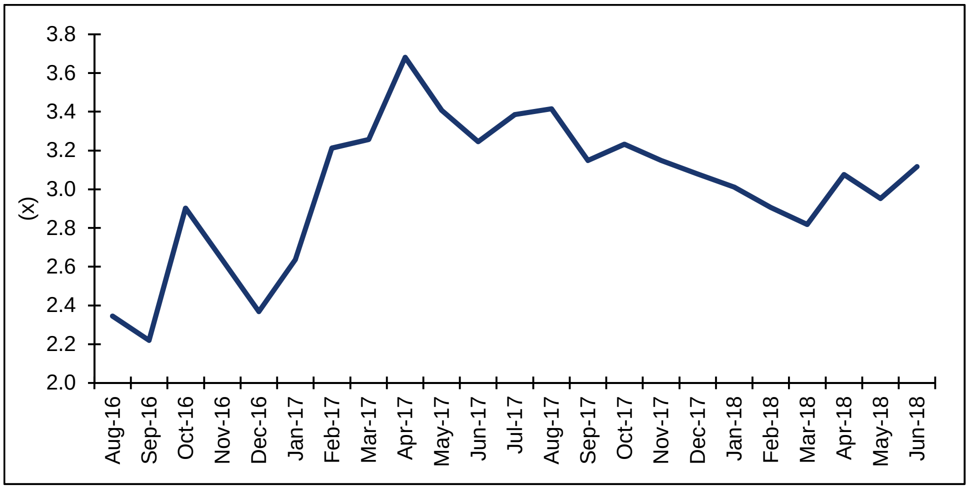
The picture	The story	The outlook		
		FY18P	FY19E	FY20E
RoE, Tier-1	• As per management, current capital is sufficient to fund credit growth upto FY20. However, we expect the bank to sort for next round of funding in FY20 to maintain healthy capital position.			
	RoE (%)	11.5	12.7	16.2
	Tier I (%)	13.6	11.9	10.1

Source: Company data, I-Sec research

Valuations and target price – A growth approach

To begin with, if we look at RBL's 1-year forward charts of P/Adj.book, it is hard to justify current valuations based on its current RoE (11.5% in FY18) or even FY20E RoE of ~16% *(chart 17)*.

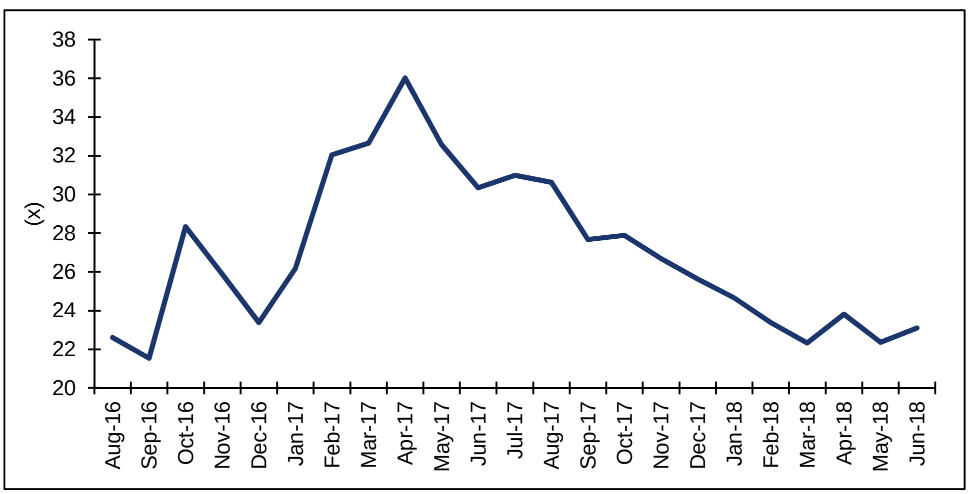
Chart 17: 1-year forward P/ABV



Source: Bloomberg, Company data, I-Sec research

However, it is easier to understand its P/E multiple given its high earnings growth trajectory *(chart 18)*.

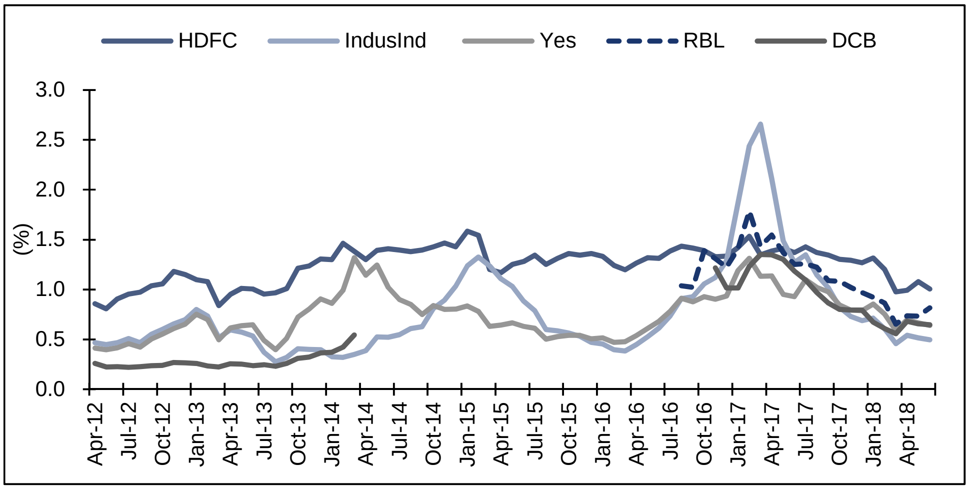
Chart 18: 1-year forward P/E



Source: Bloomberg, Company data, I-Sec research

As mentioned earlier, RBL's growth prospects appear bright given its small size and the large market opportunity. Hence, let us now look at earnings-adjusted P/E ratios. Here we use trailing P/E ratio and 1-year forward earnings growth. We compare a set of private banks that have historically had and prospectively continue to have high growth opportunities. First the conclusion *(chart 19)*:

Chart 19: Select private banks: PEG ratio

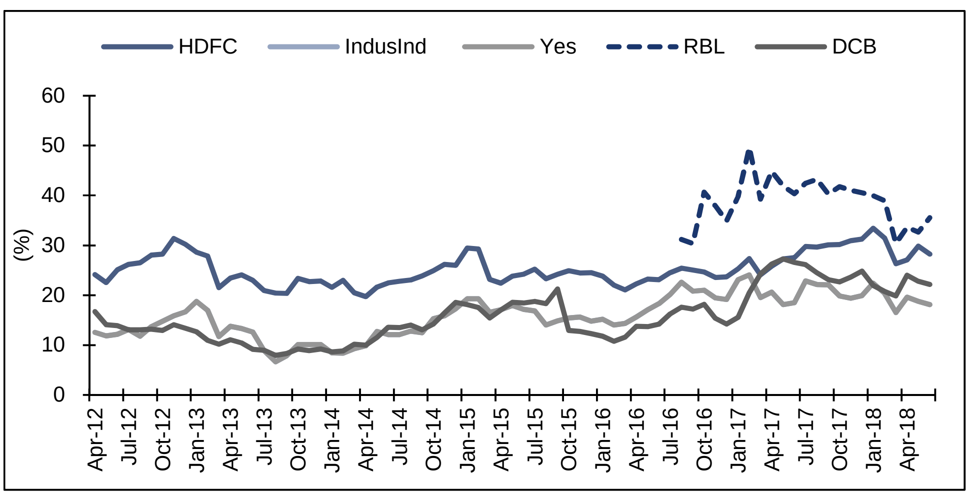


Source: Bloomberg, Company data, I-Sec research

While most of the banks except HDFC Bank are currently trading at PEGs of less than 1, let us take a look at their 5-year averages to get a better perspective of their cycle average PEG ratios.

The average of these private banks (excluding the outlier HDFC Bank could be used as a benchmark for RBL given that it would eventually gain that sort of share and earn similar RoA. Thus, if we use a target PEG of 0.75 for RBL and EPS growth of 43%, we arrive at an implied trailing P/E of ~33x and target price of Rs780, which implies an upside of ~45% from current levels. How does this trailing P/E measure up *vs* history? Based on the limited trading history, this 33x multiple is at the lower end of the 2-year trading range. *(chart 20)*

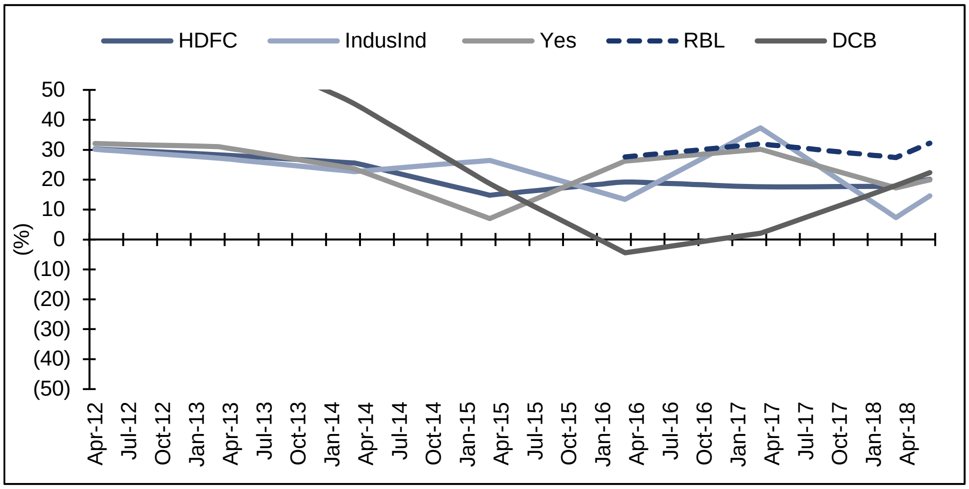
Chart 20: P/E trailing



Source: Bloomberg, Company data, I-Sec research

And then, let us compare this with EPS growth historically *(chart 21)*.

Chart 21: EPS growth



Source: Bloomberg, Company data, I-Sec research

Again, RBL's higher growth bears out its higher P/E multiple. The other observation that emanates from chart-20 is that earnings stability also matters. Why does HDFC Bank get a higher P/E multiple than some of the other private banks whose earnings growth rates are higher – possibly because of the lack of volatility in earnings growth. With RBL being the smallest of the private banks in our comparative base, there is more than a reasonable chance that it too can demonstrate a relatively stable earnings growth trajectory causing it to deserve a higher valuation multiple.

Finally, we arrive at our final target price using the DDM model with the following assumptions.

We value the stock using a 3-period DDM model with the following key assumptions:

Sustainable RoE	17.0% (cycle average)
Cost of equity	12.5%

Three growth periods for earnings:

a)	High growth FY19-FY24:	34.5% with dividend payout at 10.7%
b)	Stable growth FY25-FY29:	7.0% with dividend payout increasing to 44%
c)	Terminal growth:	4.5% with dividend payout at 44%

Accordingly, we arrive at our target price of Rs780, which implies a 1-year forward P/ABV multiple of 4.6x and P/E of 36.0x.

Accordingly, we arrive at our target of Rs780 implying a robust 45% upside from current levels. We initiate coverage on RBL Bank with a **BUY** rating. Potential risk factors include: 1) unsecured loanbook resulting in higher than anticipated defaults and credit costs, 2) tie-ups with partners for retail lending and distribution not working out to RBL's advantage resulting in slower or less profitable growth, 3) higher than anticipated turnover in senior management putting at risk the high-growth path anticipated for the bank.

Financial summary

Table 7: Profit and Loss statement

(Rs mn, year ending Mar 31)

	FY13	FY14	FY15	FY16	FY17	FY18P	FY19E	FY20E
Net Interest Income	2,575	3,416	5,564	8,192	12,213	17,663	24,213	32,425
% Growth	38	33	63	47	49	45	37	34
Fee income	171	311	2,607	3,440	4,912	6,758	9,123	12,316
Add: Other income	1,093	2,299	1,427	1,465	2,642	3,924	4,358	5,308
Total Net Income	**3,840**	**6,026**	**9,598**	**13,097**	**19,768**	**28,345**	**37,695**	**50,050**
% Growth	51	57	59	36	51	43	33	33
Less: Operating Expenses	(2,273)	(4,239)	(5,997)	(7,673)	(10,564)	(15,034)	(20,039)	(25,926)
Pre-provision operating profit	**1,567**	**1,787**	**3,601**	**5,424**	**9,204**	**13,311**	**17,656**	**24,123**
NPA Provisions	**(121)**	**(301)**	**(374)**	**(816)**	**(1,524)**	**(2,980)**	**(2,900)**	**(3,000)**
Other provisions	(105)	(161)	(227)	(328)	(865)	(660)	(1,096)	(1,381)
PBT	**1,341**	**1,325**	**2,999**	**4,280**	**6,815**	**9,671**	**13,661**	**19,742**
Less: taxes	(416)	(399)	(928)	(1,355)	(2,354)	(3,315)	(4,645)	(6,712)
PAT	**925**	**926**	**2,072**	**2,925**	**4,460**	**6,356**	**9,016**	**13,030**
% Growth	41	0	124	41	52	43	42	45

Source: Company data, I-Sec research

Table 8: Balance sheet

(Rs mn, year ending Mar 31)

	FY13	FY14	FY15	FY16	FY17	FY18P	FY19E	FY20E
Capital	2,529	2,720	2,934	3,247	3,752	4,197	4,197	4,197
Reserve & Surplus	13,538	17,427	19,370	26,645	39,604	62,644	70,578	82,378
Deposits	83,405	115,986	170,993	243,487	345,881	439,023	597,071	776,192
Borrowings	27,373	38,955	69,627	105,362	79,798	92,614	126,740	168,544
Other liabilities	2,787	6,892	8,123	12,870	17,713	20,031	29,597	40,666
Total liabilities	**129,634**	**181,981**	**271,047**	**391,611**	**486,748**	**618,508**	**828,182**	**1,071,977**
Cash & Bank Balances	6,886	11,922	21,703	24,499	41,936	42,844	53,410	64,036
Investment	55,714	65,180	97,923	144,359	134,815	154,475	173,012	190,313
Advances	63,762	98,350	144,498	212,291	294,490	402,678	557,179	752,192
Fixed Assets	943	1,343	1,644	1,773	2,587	3,341	4,009	5,012
Other Assets	2,329	5,184	5,278	8,689	12,918	15,169	40,571	60,425
Total Assets	**129,634**	**181,981**	**271,047**	**391,611**	**486,748**	**618,508**	**828,182**	**1,071,977**
% Growth	79.9	40.4	48.9	44.5	24.3	27.1	33.9	29.4

Source: Company data, I-Sec research

Table 9: Dupont analysis

(%, year ending Mar 31)

	FY13	FY14	FY15	FY16	FY17	FY18P	FY19E	FY20E
Interest income	8.7	8.7	8.6	8.3	8.5	8.2	8.2	8.3
Interest expense	(6.2)	(6.5)	(6.2)	(5.8)	(5.7)	(5.0)	(4.9)	(4.9)
NII	**2.6**	**2.2**	**2.5**	**2.5**	**2.8**	**3.2**	**3.3**	**3.4**
Other income	1.3	1.7	1.8	1.5	1.7	1.9	1.9	1.9
Fee income	0.2	0.2	1.2	1.0	1.1	1.2	1.3	1.3
Total income	**3.8**	**3.9**	**4.2**	**4.0**	**4.5**	**5.1**	**5.2**	**5.3**
Operating expenses	(2.3)	(2.7)	(2.6)	(2.3)	(2.4)	(2.7)	(2.8)	(2.7)
Operating profit	**1.6**	**1.1**	**1.6**	**1.6**	**2.1**	**2.4**	**2.4**	**2.5**
NPA provision	**(0.1)**	**(0.2)**	**(0.2)**	**(0.2)**	**(0.3)**	**(0.5)**	**(0.4)**	**(0.3)**
Total provisions	(0.2)	(0.3)	(0.3)	(0.3)	(0.5)	(0.7)	(0.6)	(0.5)
PBT	1.3	0.9	1.3	1.3	1.6	1.7	1.9	2.1
Tax	(0.4)	(0.3)	(0.4)	(0.4)	(0.5)	(0.6)	(0.6)	(0.7)
PAT	**0.92**	**0.59**	**0.91**	**0.88**	**1.02**	**1.15**	**1.25**	**1.37**

Source: Company data, I-Sec research

Table 10: Key ratios

(Year ending Mar 31)

	FY13	FY14	FY15	FY16	FY17	FY18P	FY19E	FY20E
Per share data								
EPS – Diluted (Rs)	3.7	3.4	7.1	9.0	11.9	15.1	21.5	31.0
% Growth	19.6	-6.9	107.3	27.6	32.0	27.4	41.8	44.5
DPS (Rs)	-	-	-	-	1.80	2.10	2.20	2.50
Book Value per share (BVPS) (Rs)	63.5	74.0	76.0	92.0	115.5	159.3	178.2	206.3
% Growth	19.5	16.6	2.6	21.1	25.5	37.9	11.9	15.8
Adjusted BVPS (Rs)	63.2	72.9	74.7	88.2	110.5	151.8	170.2	197.2
% Growth	19.8	15.3	2.4	18.1	25.3	37.4	12.1	15.8
Valuations								
Price / Earnings (x)	147.2	158.0	76.2	59.7	45.3	35.5	25.0	17.33
Price / Book (x)	8.5	7.3	7.1	5.8	4.7	3.4	3.0	2.61
Price / Adjusted BV (x)	8.5	7.4	7.2	6.1	4.9	3.5	3.2	2.73
Asset Quality								
Gross NPA (Rs mn)	259	778	1,112	2,081	3,568	5,668	7,268	9,468
Gross NPA (%)	0.4	0.8	0.8	1.0	1.2	1.4	1.3	1.2
Net NPA (Rs mn)	69	305	386	1,245	1,900	3,126	3,327	3,827
Net NPA (%)	0.1	0.3	0.3	0.6	0.6	0.8	0.6	0.5
NPA Coverage ratio (%)	73	61	65	40	47	45	54	60
Gross Slippages (%)	1.0	1.0	0.5	1.4	2.5	1.9	1.4	1.0
Credit Cost (%)	0.23	0.37	0.31	0.46	0.60	0.85	0.60	0.45
Net NPL/Networth	0.4	1.5	1.7	4.2	4.4	4.7	4.4	4.4
Business ratios (%)								
RoAA	0.92	0.59	0.91	0.88	1.02	1.15	1.25	1.37
RoAE	6.7	5.1	9.8	11.2	12.2	11.5	12.7	16.2
Credit Growth	54	54	47	47	39	37	38	35
Deposits Growth	76	39	47	42	42	27	36	30
CASA	19.7	20.4	18.5	18.6	22.0	24.4	26.0	27.5
Credit / Deposit Ratio	76.4	84.8	84.5	87.2	85.1	91.7	93.3	96.9
Cost-Income ratio	59.2	70.3	62.5	58.6	53.4	53.0	53.2	51.8
Operating Cost / Avg. Assets	2.3	2.7	2.6	2.3	2.4	2.7	2.8	2.7
Earning ratios								
Yield on Advances	11.73	11.43	11.64	10.95	10.42	9.84	9.83	9.97
Yield on Earning Assets	8.93	8.96	8.89	8.51	8.71	8.42	8.60	8.84
Cost of Deposits	7.40	7.74	7.57	7.27	6.65	5.50	5.48	5.45
Cost of Funds	7.31	7.60	7.06	6.53	6.43	5.73	5.62	5.59
NIM	**2.6**	**2.3**	**2.5**	**2.5**	**2.9**	**3.3**	**3.5**	**3.6**
Capital Adequacy (%)								
RWA (Rs)	-	139,430	173,116	267,609	371,625	480,785	629,619	855,237
Tier I	16.8	14.3	12.7	11.1	11.4	13.6	11.9	10.1
CAR	17.1	14.6	13.1	12.9	13.7	15.3	12.5	10.7

Source: Company data, I-Sec research

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