The Path of Prudence

TWENTY FOURTH ANNUAL REPORT 2008 - 2009

kotak
Kotak Mahindra Bank

Think Investments. Think Kotak.

The bank of the future will have three defining qualities

Simplicity, Humility and Prudence

A turning point in world history

Dear Shareholder

It was the worst of times and it was the worst of times.

That sums up a year when everything that could possibly go wrong, did go wrong. The world reeled under the collective assault of a financial market contagion, a flu epidemic, corporate fraud and the new reality of terrorist attacks. Nothing was more certain than uncertainty.

But it was not all dark clouds. The silver lining was represented by landmark elections in the world's two greatest democracies: voters in the USA opted for a harbinger of change and we, the people of India, voted decisively for stability and steady reform.

In my letter of last year, I had written that global financial institutions have become money juggernauts with excessive leverage, where proprietary trading, in many cases, far outstrips client businesses.

Over one eventful month last year, Lehman Brothers folded, Merrill was acquired by Bank of America; and Goldman Sachs and Morgan Stanley converted themselves into commercial banks.

The banking landscape has undergone a sea change and I believe the bank of the future will have three distinguishing qualities: simplicity, humility and less leverage.

This is a proud moment for Indian democracy and a historic opportunity for India to lead the world.

India At A Tipping Point

After the UPA government swept the polls in the most decisive Indian election since the early nineties, I penned a piece for The Economic Times, parts of which bear repeating and are reproduced here:

"This is a proud moment for Indian democracy and a historic opportunity for India to lead the world. Mr Manmohan Singh and his new government are at a turning point in world history. In terms of priorities, the agenda for the new government should comprise reviving growth in a steady manner, building infrastructure, further strengthening the financial sector, reinforcing civil institutions and uprooting corruption from Indian society. These initiatives will have to be done in the backdrop of ensuring fiscal stability in a very adverse global situation.

The new government has the opportunity to unshackle itself from the baggage which the Indian system has carried: to make India a very open and responsible society where merit is rewarded and cronyism is demolished. The pillars of civil society — whether it is the judiciary, the police, educational institutions, or the tax and the revenue administration — have come under increasing pressure as institutions. We need to transform and strengthen each of these institutions of civil society to build India for the next 100 years.

In the financial sector, our prudence over the last five years has held us in good stead. Let us now consolidate our gains, take appropriate steps of reform, based on our convictions and not necessarily on dogmas of Western financial systems. In particular, we need to spread Indian banking and insurance to every nook and corner of our country. We must develop modern day debt markets with all the checks and balances. The exchange traded mechanisms across equity, debt, commodities, currencies and interest rates must be given wings to make India, and Mumbai in particular, a national and an international financial centre.

Infrastructure is our primary need and in the next five years true 'Bharat Nirman' must take place. Roads, ports, airports, power, access to clean water are our priority. "

The Lessons Of History

On the first day of every calendar year, I write a note to all employees at Kotak. In my letter of 1st January 2008, I had cautioned against irrational exuberance, going so far as to say that the capital markets had witnessed turmoil in 1992 and in 2000, and since crises are cyclical and markets seemed to be overheating, caution was the order of the day.

We were a young NBFC in 1992 but we already had a culture of conservatism that is not normally associated with the heady flush of youth. This very conservatism stood us in good stead during the NBFC debacle of 1996 when over 95% of NBFCs went out of business on the back of indiscriminate lending.

When the tech boom rolled in at the turn of the century, venture capital was a fashionable business to be in but we chose to steer clear of the dotcom rainbow as the pot of gold was notional and elusive.

Most of our senior management has been with the company through the aforementioned crises and has the instinctive ability to hunker down and navigate a crisis. But there is another instinct we value as highly if not more: the ability to anticipate and pre-empt a crisis thereby limiting the extent of damage.

No business is immune to the effects of a financial crisis that has been ranked at par with the Great Depression of the 1930's. But here is how we have so far negotiated the choppy waters and rough weather.

Protect The Balance Sheet, P&L Can Wait

Unsecured lending: Let me start with retail lending, a business we have been in since over two decades. It is a business that has traditionally grown at 35-40% year-on-year. As of March 2008, we had notched up 40% growth over the previous year. Even in 2008-09, if you look at the first half, we were growing at a little over 20% (the growth in the first quarter was even higher). But the figure for the year ended March 2009 stands at 8%.

The slowdown is not because of fewer applications. We anticipated turmoil and decided to slow down on lending. We took a call that it was time to be cautious. Mind you, this was a time when you could pick and choose borrowers and lend at the rate you want. And though we could push interest rates, we took a call not to lend as it would potentially create a problem later. This was not a time to blindly chase yields, it was a time to protect one's balance sheet. If you only chase P&L at a time like this, you

Our business model works towards lower risk while retaining the ability to provide high returns.

During the liquidity crunch of October 2008, Kotak Mahindra Bank was a net lender.

could end up with a problem on your balance sheet.

For a financial institution, the most important thing is reputation. But immediately after reputation comes protection of capital. The area where you can lose a lot of capital, aside from exotic structured products, is in the lending space.

We began with cutting down on unsecured personal loans since the fastest drop in credit quality was happening in small-ticket loans. Despite that, we had our share of problems with collections. But an early call helped limit the extent of damage.

In 2007, when we got into the business of unsecured personal loans, there were large players lending money at 35%+ and the market was throwing up huge growth numbers across the gamut of NBFCs, private banks and foreign banks. Rather than step up lending, the business head took a call that we should complete one cycle from lending to collection, see the pattern and then take a call. That approach held us in good stead.

Which brings me to Kotak Credit Cards. As a bank, this was the missing piece in our product suite. We launched credit cards in April 2008 with an initial target of 350,000 cards. Of course, we were quick to realize this is an area where people are not paying and so we slowed down dramatically to end the year with just over 100,000 cards.

We took a call to discontinue outsourced acquisition and only source customers through internal sources or referrals. Ours woes are not as bad as the rest of the industry's (credit cards are less than 1% of our book) but there were problems and some valuable lessons learned early on.

Agri business: One area we have not shied away from lending is the agricultural sector. The net interest margin is good, the delinquencies low and the segment is holding up very well even in this economic environment.

Corporate lending: Since a lot of the problems in the lending business stemmed from the retail end, we placed a greater focus on lending to corporate clients. There was a time when retail lending made up 89% of our book. Today, that number is 80%. The number will not fall dramatically as the term is three years but on an incremental basis, corporate lending is much higher.

Among small and medium corporates, we chose to work with companies that have a track record for raising capital. And among larger corporates, we worked with large companies (most of whom had raised money at attractive rates from overseas markets) and PSUs.

In this segment, the yield is lower but the customer profile is in keeping with our emphasis on protecting the balance sheet. Besides, what we may lose in yield is made up through growing the corporate banking relationship as clients count on us for transaction flows, LCs, guarantees, pay orders, DDs, transaction fees and so on. In many cases, we go on to sign up salary accounts, which helps build depositors.

Secured lending: Let's start with commercial vehicles and construction equipment: April to September 2008 saw the commercial vehicle segment chugging along. October to December 2008 witnessed an alarming drop in business and the largest spike in NPAs. The scare was, if this trend continued for two more quarters, there would be a glut of bad loans.

Fortunately, things picked up in the last quarter. I'm not saying there are no more bad loans but the trend is vastly reduced.

As far as construction equipment goes, we were focused on large, reputed players with secured contracts.

Car finance was not much of a problem area. October to December 2008 was slow and registered negative numbers. But the last quarter saw very strong numbers and delinquency was reasonably contained.

Home finance held steady, we grew the book (advances were Rs 3,166.42 crore as of 31st March 2009), underwriting is stricter and delinquencies are low given that most home loans are consumed by residents (as opposed to investors).

Beyond Conventional Statistics

Like I said earlier, no one has been spared the ramifications of last year's global crisis. The damage was universal, only the extent of damage varied. Here are a few key learnings in the lending space:

1) Parameterized credit and conventional statistics are not a substitute for having your ear to the ground. For instance, regular parameters will not tell you people are losing jobs. You need to have signals in place. You may rate a customer on today's credit score but he may borrow from three other lenders so that score needs careful watching.

2) Once you recognize there is a problem, accept the borrower is an NPA and take him on your books. Any form of procrastination will only serve to compound the problem.

3) In late 2007, a lot of banks, including us, had a problem with FX derivatives. Around October 2007, we took a call that we would stop derivatives. A number of other banks realized there was a problem only around late January, early February. By taking an early call, we were able to limit our losses.

Branch banking: Our initial target was to touch 260 plus branches by the end of the year. The eventual number was 217. We initially slowed down since rentals were falling really fast and we wanted to get better rates considering most branch leases are typically signed for nine-year periods. The slowdown call then continued due to the economic climate.

While we will continue to grow our branch network, it is worth noting that 16% of our customers actively use the online banking channel. In a young country, this number will only increase and we will relentlessly work to make this channel simpler and more secure to use.

While income from equity mutual funds was affected, it was partly compensated by income from debt funds (Rs 44 billion) and new life insurance premium collection (Rs 2.6 billion). Non-Resident and TASC (trusts, associations, societies, cooperatives) business grew as did the corporate salary book.

During the year, we crossed the 1-million mark in customer deposits.

Wholesale banking: In keeping with our focus on corporate business, 200 new clients were added during the year. In October 2008, when liquidity was rapidly drying up, we were one of the few banks that were lending money, and we took the opportunity to initiate and expand relationships. Going forward, we will bring increased product emphasis particularly on transaction banking, debt capital markets, working capital products, and supply-chain initiatives.

We continue to focus on the customer. Kotak Mahindra Bank has over 1 million customer deposits. Kotak Life Insurance has over 2 million policyholders. Kotak Mutual Fund, over 1 million investors.

Life insurance: Kotak Life Insurance grew new business at 25%, which is significantly higher than the growth in the private sector. Capital deployed per rupee of premium stands at 0.43, among the lowest in the industry. Going forward, we see slower growth on the back of economic developments in the last year; equally, we foresee no capital infusion in FY 2010.

Kotak Life reported a profit for the year but, more importantly, renewal premium is closer to first-year premium and the bancassurance model is very strong (28% of the individual premium came through Kotak group distribution channels).

Broking and investment banking: Kotak Securities and Kotak Investment Banking were expectedly the worst hit by the downturn in capital markets. However, we occupy leadership positions in both businesses and the focus was on hunkering down through the downturn while protecting the franchise in readiness for the upturn.

After prolonged crises, markets are known to make a V-turn so it is important to prepare for the upswing. Witness the 2,111-point gain on 18th May after the election results delivered a decisive mandate in favor of political and economic stability. While this is clearly as much of a black swan event (albeit a positive one) as the election results that caused it, it demonstrates the mercurial nature of the market and the need to be equipped for its peaks and troughs

Asset Management: Over $6.7 billion of assets are managed / advised through mutual funds, insurance, portfolio management and offshore funds (including alternate assets).

Kotak Mutual Fund crossed two milestones (Rs250 billion AUM and 1 million investors) and was ranked 5th in the private sector.

Alternate assets (private equity and realty fund) have total commitments of $1.3 billion.

And our international subsidiaries manage / advise equity assets to the tune of $1 billion (including an Australian listed fund, SICAV fund and a Shariah-compliant fund).

People Power

The Hewitt Best Employer Survey 2009 ranks Kotak Mahindra Bank number 19. We are the only bank in the top 20.

Among the many awards, rankings and distinctions we have earned, (last year's list is detailed on the 'Year at a glance' page later in this report) the ones for best employer and best workplace are possibly closest to my heart since they reflect our people culture.

Technology and infrastructure are very important and we continue to invest in these areas but at the end of the day, technology and infrastructure are enablers and tools. In a scenario where everyone has the same technology and infrastructure, it is the people who make the difference.

I have already shared with you in this report, and in earlier reports, how our key people know what it takes to navigate a downturn and prepare for an ensuing upturn. And how our culture is one of conservatism and professional entrepreneurship, one that draws and retains people who can start, nurture and grow businesses

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At the time of this writing, all indications are the worst is over for India. As for Kotak, whether it is our ability to manage the downside or our capacity to capture the upside, the point is we are in a state of preparedness (group capital adequacy is at 23%).

I would like to reinforce the uniqueness of our business model. Banking, insurance and asset management provide a steady stream of growing annuity base. Businesses like broking and investment banking are more cyclical in nature and have the ability to capture upside when the economy and markets recover. Our strategic goal is to minimize downside while capturing the upside.

In sum, it is a business model that works towards lower risk while retaining the ability to provide high returns. Verily a business for all seasons.

Uday Kotak
Executive Vice Chairman
and Managing Director

Year at a glance

April 2008 I Launch of Kotak Credit Cards

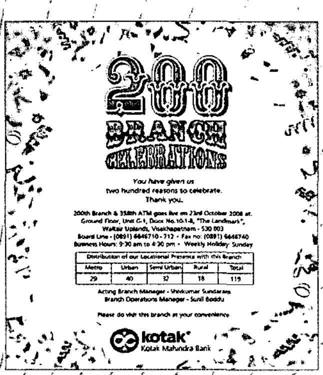
Quarter 1

- Kotak Credit Cards launched.
- Kotak Investment Banking awarded "Best Investment Bank in India" by Global Finance in 2008.
- Kotak Mahindra Bank rated "Best Workplaces in India 2008" (study by The Great Places to Work Institute India).
- Kotak Investment Banking acts as the exclusive financial advisor to Mahindra & Mahindra Ltd for preferential allotment to Goldman Sachs PIA, investment involving issuance of FCDs during turbulent and volatile market conditions.
- Kotak Investment Banking & Kotak Securities jointly awarded "Best Equity House in India" by Asiamoney in 2008.
- Kotak Investment Banking is lead manager for the KSK Energy Ventures Ltd Rs 8.3 billion IPO.

May 2008 I Kotak Mahindra Bank continues to remain an employer of choice.

Quarter 2

- Kotak Investment Banking awarded "Best Investment Bank in India" by FinanceAsia in 2008.
- Kotak Investment Banking awarded "Best Equity House in India" by FinanceAsia in 2008.
- Kotak Investment Banking acts as the manager to the buyback by Abbott India Ltd.
- Kotak Mahindra Bank wins Technology Senate Emerson Uptime Championship Award 2008 in the BFSI category.
- Kotak Securities is selected "Business Superbrand India 2008" by Superbrands Council of India.
- Kotak Investment Banking is the exclusive financial advisor to Mahindra & Mahindra Ltd to form a joint venture with the third largest tractor maker in China – Jiangsu Yueda Yancheng Tractor Manufacturing Co. Ltd.
- Kotak Investment Banking is the exclusive financial advisor to Voltas Ltd for acquisition of majority stake in Rohini Industrial Engineers, an EPC company with all-India presence in the electro-mechanical space.
- Kotak Mahindra Bank becomes a CASHnet member.



October 2008 I Kotak Mahindra Bank: 200 branches and growing.

Quarter 3

- Kotak Mahindra Bank crosses 200-branch milestone.
- Kotak Investment Banking is the exclusive financial advisor to Wilo SE for delisting of Mather and Platt Pumps Ltd.
- Kotak Securities voted the "Best Brokerage in India" and Sanjeev Prasad ranked "India's Best Analyst" by investors in the Asiamoney 2008 Brokers Poll.
- Kotak Investment Banking wins "Best Domestic Investment Bank 2008" award from Triple A Asset Asian Awards.
- Kotak Life Insurance - Kotak Platinum Advantage Plan awarded 1st rank in Type II ULIPs category by Outlook Money.
- Kotak Long Life Wealth Plus Plans awarded 4th rank in the Type I ULIPs category by Outlook Money, concluding that "Kotak Life has a product portfolio which delivers what customers want".