# AMBIT RESULTS INSIGHTS

19 January 2018

**DAILY**

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# HDFC Bank

## In-line results; retail boosts loan growth

**Net profit grew by 20% YoY to Rs46.4bn (in line with our and consensus estimates). Operating profit, up 28% YoY, grew strongly again, thanks to the momentum in NII (up 24% YoY) and fee income (up 32% YoY) and controlled opex (up 18% YoY). Loan growth of 28% YoY was driven by retail (up 30% YoY; 68% of loans). While CASA growth slowed to 7% YoY, change in loan mix towards higher-yielding retail loan supported NIM of 4.3%. Asset quality saw some challenges, led by agri book, keeping credit cost (up 87bps) higher than the historical average of 60-70bps. We expect some moderation in loan growth (19% CAGR over FY19-20E) and gradual normalisation in credit costs (70bps average over FY19-20E). Thus, EPS growth would likely stay at current levels (18% CAGR over FY19-20E). Current valuation of 24.8x FY19E P/E and 4.3x FY19E P/B (~56% premium to peers), leave investors with little margin of safety. We retain our SELL stance with a TP of Rs1,380 (14.6x one-year forward EPS).**

**Results overview:** HDFC Bank delivered net profit growth of 20% YoY to Rs46.4bn (in line with our and consensus estimates). Loan book growth picked up to 28% YoY, but asset growth was lower at 15% YoY. With NIM of 4.3% (up 20bps YoY), NII grew by 24% YoY. Core fee income growth of 32% YoY was strong. With controlled opex growth (18% YoY), operating profit grew by 28% YoY. Credit costs were elevated at 87bps (vs 58bps in 3QFY17) driving net profit growth of 20% YoY. Agri portfolio has been a key driver of NPA growth and credit cost in recent quarters.

**Retail portfolio driving loan growth pick-up:** In 3QFY18, loan growth inched up to 28% YoY (vs average growth of 23% YoY in 1HFY18). Retail (68% of total loans) grew by 30% YoY (vs 25% YoY growth in 1HFY18). Personal & credit card loans now form 16% of total loans and grew by 44% YoY. Business banking (16% of loans) and auto loans (21% of loans) grew strongly too, at 40% YoY and 25% YoY, respectively. Corporate loans (32% of loans) grew by 23% YoY (vs average growth of 19% YoY in 1HFY18).

**CASA growth slows – Better loan yields and balance sheet structure support margins:** After demonetisation-related CASA spurt in the base, CASA deposits growth slowed down to 7% YoY. However, total deposits also grew slowly at 10% YoY (vs 17% YoY growth n 1HFY18). Corresponding to this, balance sheet growth was thus much slower at 15% YoY vs loan growth of 28% YoY. As a result of increase in credit-to-deposit ratio (90% vs 88% in 2Q) and changing loan mix in favour of higher-yielding retail loans, NIM was stable QoQ (up 20bps YoY) at 4.3% in 3QFY18. NII grew by 24% YoY.

Core fee income growth of 32% YoY drove non-interest income growth of 23% YoY. Treasury income was at Rs2.6bn (vs Rs4.0bn in 3QFY17). The bank continued to tightly control its operating expenses (up 18% YoY), with declining cost-to-income ratio (40.4% vs 41.5% in 2QFY18). Thus, operating profits grew by 28% YoY.

**Asset quality – Agri book driving NPAs and credit cost:** In 3QFY18, gross NPA grew by 7% QoQ. The management highlighted continued stress in the bank's agri portfolio, where gross NPA ratio has risen by ~200bps YoY to 5-6%. Credit cost, at 87bps (1HFY18: 105bps), stayed high compared to the bank's credit cost experience of 60-70bps in recent years.

A large corporate slippage (Rs17bn) arose due to the RBI's risk-based supervision (RBS) during 3QFY18, which was regularised within the quarter itself. Contingent provisions of Rs7bn that the bank made in 2QFY18 for this account were classified as floating provisions and contingent provision for the bank's agri portfolio in 3QFY18. Outstanding floating provisions of Rs130bn stand at 0.2% of the loan book and 16% of gross NPA. Other two accounts assessed as NPA in RBS amounted to just Rs2.9bn (4% of gross NPA) and had been classified as NPA during 1HFY18.

# SELL

## Result Update

### Stock Information

| | |
|---|---|
| Bloomberg Code: | HDFCB IN |
| CMP (Rs): | 1,952 |
| TP (Rs): | 1,380 |
| Mcap (Rs bn/US$ bn): | 5,056/79.2 |
| 3M ADV (Rs mn/US$ mn): | 3,090/48.4 |

### Stock Performance (%)

| | 1M | 3M | 12M | YTD |
|---|---|---|---|---|
| Absolute | 4 | 6 | 58 | 4 |
| Rel. to Sensex | (1) | (4) | 28 | (0) |

*Source: Bloomberg, Ambit Capital research*

### Ambit Estimates (Rs bn)

| | FY17 | FY18E | FY19E |
|---|---|---|---|
| NII | 331.4 | 410.6 | 497.5 |
| Net profit | 145.5 | 174.9 | 206.4 |
| EPS (Rs) | 56.8 | 67.3 | 78.6 |

*Source: Bloomberg, Ambit Capital research*

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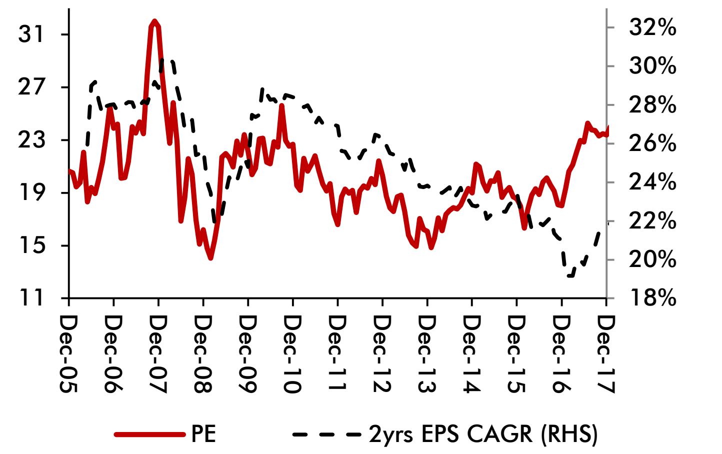
### Where do we go from here?

HDFC Bank outperformed the Bankex by 17% in the past one year as the bank reported relatively stable numbers despite some hiccups in asset quality when most corporate banks are still struggling with corporate asset quality issues. The bank continues to do well in terms of superior loan growth (28% vs 10-11% for the banking system) and maintaining strong net interest margins at 4.3%. However, the recent growth has arisen from high-yielding retail assets, such as personal loans, credit card, business banking and vehicle finance.

In 9MFY18, high credit costs (~100bps) have not allowed strong operating profit growth (29% YoY in 9MFY18) to translate into similar EPS growth, which has been relatively subdued (19% YoY in 9MFY18 and 17% YoY in FY17). EPS growth averaged >25% YoY over most part of the last decade. With our expectation of some normalisation in loan growth, pressure on NIMs due to weak CASA growth and our expectations of pick-up in delinquencies in retail/SME loans, we do not expect pick-up in EPS growth for the bank from the current levels. We expect standalone EPS CAGR of ~18% over FY19-20E. Moreover, the transition to new accounting norm, Ind-AS, could also impact the EPS in terms of high employee expenses and lower fee income.

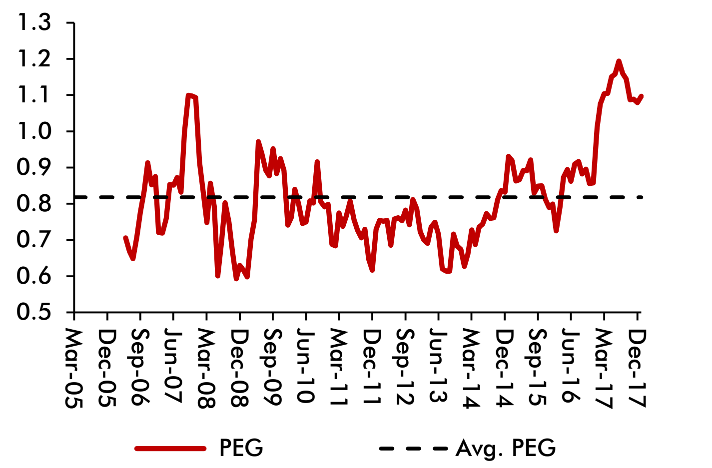
Whilst the EPS growth for the bank has slowed down to ~18% over the last 2-3 years (from a decade of >25% EPS growth over FY04-14) and consensus EPS estimates have been on a downward trend over this period, valuation multiple has expanded during this period (exhibits below). The current valuation multiples of 24.8x FY19E P/E and 4.3x FY19E P/B, ~56% premium to peers, more than adequately capture superior earnings growth of the bank in the medium term and leave investors with little margin of safety. We retain our SELL stance with a TP of Rs1,380, valuing the bank at 14.6x one-year forward EPS and 2.7x one-year forward BVPS.

**Exhibit 1: Consensus' two-year forward EPS CAGR and P/E multiple (one-year forward)**




*Source: Company, Bloomberg, Ambit Capital research*

**Exhibit 2: HDFC Bank's PEG ratio (price-to-2-years' EPS CAGR) is at historical high**




*Source: Company, Bloomberg, Ambit Capital research*

**Exhibit 3: Quarterly results snapshot**

| Earnings Table (Rs mn) | 3QFY17 | 2QFY18 | 3QFY18 | YoY (%) | QoQ (%) | 3QFY18E | A/E (%) |
|---|---|---|---|---|---|---|---|
| **NII** | **83,091** | **97,521** | **103,143** | **24%** | **6%** | **100,786** | **2%** |
| **Non-Interest income** | **31,427** | **36,059** | **38,692** | **23%** | **7%** | **35,454** | **9%** |
| **Total Income** | **114,518** | **133,580** | **141,835** | **24%** | **6%** | **136,240** | **4%** |
| Employee Cost | 16,886 | 17,158 | 16,913 | 0% | -1% | 17,844 | -5% |
| Other Operating Expenses | 31,539 | 38,243 | 40,410 | 28% | 6% | 37,885 | 7% |
| Total Operating Expenses | 48,425 | 55,401 | 57,322 | 18% | 3% | 55,729 | 3% |
| **Operating Profit** | **66,093** | **78,179** | **84,513** | **28%** | **8%** | **80,511** | **5%** |
| **Total Provisions** | **7,158** | **14,762** | **13,514** | **89%** | **-8%** | **10,434** | **30%** |
| PBT | 58,935 | 63,417 | 70,999 | 20% | 12% | 70,077 | 1% |
| Tax | 20,281 | 21,907 | 24,573 | 21% | 12% | 23,826 | 3% |
| **Reported Profit** | **38,653** | **41,510** | **46,426** | **20%** | **12%** | **46,251** | **0%** |
| **Balance sheet (Rs bn)** | | | | | | | |
| Deposits | 6,347.0 | 6,893.5 | 6,990.3 | 10% | 1% | 7,203.7 | -3% |
| Net Advances | 4,950.4 | 6,048.7 | 6,312.1 | 28% | 4% | 6,078.9 | 4% |
| **Total Assets** | **8,280.2** | **9,336.4** | **9,490.8** | **15%** | **2%** | **9,635.1** | **-1%** |
| Loan-Deposit ratio (%) | 78.0% | 87.7% | 90.3% | | | | |
| **Key Ratios** | | | | | | | |
| **Credit Quality** | | | | | | | |
| Gross NPAs (Rs mn) | 52,323 | 77,028 | 82,349 | 57% | 7% | 83,308 | -1% |
| Net NPAs (Rs mn) | 15,643 | 25,968 | 27,737 | 77% | 7% | 27,766 | 0% |
| Gross NPA (%) | 1.05% | 1.26% | 1.29% | | | 1.36% | |
| Net NPA (%) | 0.32% | 0.43% | 0.44% | | | 0.46% | |
| Loan Loss Provisions (%) | 0.58% | 1.00% | 0.87% | | | 0.69% | |
| Coverage Ratio (%) | 70.1% | 66.3% | 66.3% | | | 66.7% | |
| **Capital Adequacy** | | | | | | | |
| Tier I (%) | 13.80% | 13.30% | 13.60% | | | | |
| CAR (%) | 15.90% | 15.10% | 15.50% | | | | |
| **Du-pont Analysis** | | | | | | | |
| NII / Assets (%) | 4.11% | 4.26% | 4.38% | | | 4.25% | |
| Non-Interest Inc. / Assets (%) | 1.55% | 1.58% | 1.64% | | | 1.50% | |
| Operating Cost / Assets (%) | 2.40% | 2.42% | 2.44% | | | 2.35% | |
| Operating Profits / Assets (%) | 3.27% | 3.42% | 3.59% | | | 3.40% | |
| Provisions / Assets (%) | 0.35% | 0.65% | 0.57% | | | 0.44% | |
| **ROA (%)** | **1.91%** | **1.82%** | **1.97%** | | | **1.95%** | |

*Source: Company, Ambit Capital research*

### Balance sheet

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Networth | 726,778 | 894,624 | 1,028,821 | 1,187,121 | 1,376,159 |
| Deposits | 5,464,242 | 6,436,397 | 7,130,069 | 8,342,181 | 9,843,774 |
| Borrowings | 849,690 | 740,289 | 1,203,231 | 1,423,116 | 1,685,939 |
| Other Liabilities | 367,251 | 567,093 | 652,157 | 749,981 | 862,478 |
| **Total Liabilities** | **7,407,961** | **8,638,402** | **10,014,279** | **11,702,399** | **13,768,350** |
| Cash & Balances with RBI & Banks | 389,188 | 489,521 | 478,936 | 559,835 | 659,443 |
| Investments | 1,958,363 | 2,144,633 | 2,094,678 | 2,369,059 | 2,697,584 |
| Advances | 4,645,940 | 5,545,682 | 6,943,361 | 8,204,368 | 9,761,740 |
| Other Assets | 414,470 | 458,566 | 497,303 | 569,136 | 649,583 |
| **Total Assets** | **7,407,961** | **8,638,402** | **10,014,279** | **11,702,399** | **13,768,350** |

*Source: Company, Ambit Capital research*

### Income statement

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Interest Income | 602,214 | 693,060 | 799,615 | 926,461 | 1,079,973 |
| Interest Expense | 326,299 | 361,667 | 399,794 | 460,068 | 536,852 |
| **Net Interest Income** | **275,915** | **331,392** | **399,821** | **466,392** | **543,121** |
| Total Non-Interest Income | 107,517 | 122,965 | 148,921 | 169,149 | 197,048 |
| **Total Income** | **383,432** | **454,357** | **548,742** | **635,541** | **740,170** |
| Total Operating Expenses | 169,797 | 197,033 | 225,793 | 262,655 | 306,475 |
| Employees expenses | 57,022 | 64,837 | 69,801 | 78,584 | 89,271 |
| Other Operating Expenses | 112,775 | 132,197 | 155,992 | 184,071 | 217,204 |
| **Pre Provisioning Profits** | **213,635** | **257,324** | **322,949** | **372,886** | **433,695** |
| Provisions | 27,256 | 35,933 | 56,807 | 58,870 | 58,684 |
| PBT | 186,379 | 221,391 | 266,143 | 314,016 | 375,011 |
| Tax | 63,417 | 75,894 | 91,236 | 107,647 | 128,556 |
| **PAT** | **122,962** | **145,496** | **174,907** | **206,369** | **246,455** |

*Source: Company, Ambit Capital research*

### Key ratios

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Credit-Deposit (%) | 85.0% | 86.2% | 97.4% | 98.3% | 99.2% |
| CASA ratio (%) | 43.8% | 48.3% | 50.7% | 50.3% | 49.6% |
| Cost/Income ratio (%) | 44.3% | 43.4% | 41.1% | 41.3% | 41.4% |
| Gross NPA (Rs mn) | 43,928 | 58,857 | 89,587 | 102,441 | 116,356 |
| Gross NPA (%) | 0.94% | 1.05% | 1.28% | 1.24% | 1.18% |
| Net NPA (Rs mn) | 13,204 | 18,440 | 29,564 | 32,781 | 34,907 |
| Net NPA (%) | 0.28% | 0.33% | 0.43% | 0.40% | 0.36% |
| Provision coverage (%) | 69.9% | 68.7% | 67.0% | 68.0% | 70.0% |
| NIMs (%) | 4.40% | 4.37% | 4.52% | 4.52% | 4.48% |
| Tier-1 capital ratio (%) | 13.2% | 12.8% | 12.8% | 12.8% | 12.7% |

*Source: Company, Ambit Capital research*

### Du-pont analysis

| Year to March | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| NII / Assets (%) | 4.1% | 4.1% | 4.3% | 4.3% | 4.3% |
| Other income / Assets (%) | 1.6% | 1.5% | 1.6% | 1.6% | 1.5% |
| Total Income / Assets (%) | 5.8% | 5.7% | 5.9% | 5.9% | 5.8% |
| Cost to Assets (%) | 2.6% | 2.5% | 2.4% | 2.4% | 2.4% |
| PPP / Assets (%) | 3.2% | 3.2% | 3.5% | 3.4% | 3.4% |
| Provisions / Assets (%) | 0.4% | 0.4% | 0.6% | 0.5% | 0.5% |
| PBT / Assets (%) | 2.8% | 2.8% | 2.9% | 2.9% | 2.9% |
| Tax Rate (%) | 34.0% | 34.3% | 34.3% | 34.3% | 34.3% |
| ROA (%) | 1.85% | 1.81% | 1.88% | 1.90% | 1.94% |
| Leverage | 9.9 | 9.9 | 9.7 | 9.8 | 9.9 |
| ROE (%) | 18.3% | 17.9% | 18.2% | 18.6% | 19.2% |

*Source: Company, Ambit Capital research*

### Valuation

| Year to March | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| EPS (Rs) | 48.6 | 56.8 | 67.3 | 78.6 | 92.9 |
| EPS growth (%) | 16% | 17% | 18% | 17% | 18% |
| BVPS (Rs) | 287.5 | 349.1 | 395.6 | 452.0 | 518.8 |
| P/E (x) | 40.1 | 34.4 | 29.0 | 24.8 | 21.0 |
| P/BV (x) | 6.79 | 5.59 | 4.93 | 4.32 | 3.76 |

*Source: Company, Ambit Capital research*

# ITC

# BUY

## Result Update

## Return to double-digit EBIT growth is encouraging

**ITC returned to double-digit EBIT growth of 10% YoY after 7 quarters as margin gains (90bps YoY) offset disappointment on cigarette sales growth (2% QoQ vs our expectation of 8%). While cigarette volumes continued to decline by ~3-4% YoY (we expected it to be flat) post price hikes in July, 8% YoY EBIT growth was encouraging. FMCG sales grew 16% YoY and profits continued to improve with EBIT of Rs470mn (vsRs197mn loss). Agri exports were the key disappointment with flat growth as shortage of leaf tobacco in Andhra hurt business. We expect ITC to further build on double-digit EBIT growth as volume growth in cigarettes start to recover. We have cut our FY18-20E Sales/EPS CAGR by 1% resulting in new DCF-based TP of Rs370 (Rs375 earlier). Maintain BUY as we believe ITC's current 45% discount to FMCG sector is unwarranted given we expect ITC to deliver 17% EPS CAGR over FY17-20E compared to 16% for the sector.**

**Results overview:** ITC's net sales grew 6% YoY which was disappointing mainly due to lower-than-expected sales growth for cigarettes (up 2% QoQ vs our expectation of 8% QoQ) and flat agri export sales. Also, while FMCG sales growth of 16% YoY looks encouraging, given a slew of new launches across several categories, we had expected higher (25% YoY) growth. Disappointment on sales growth was offset to some extent by 90bps gain in EBITDA margin (vs our expectation of 60bps gain) which led to ITC reporting double-digit EBIT growth after 7 quarters. However, reported PAT (before exceptional) grew by +7% YoY as lower other income impacted growth. The company also reported an exceptional post-tax income of Rs2.7bn on one-time tax refund from Tamil Nadu. Therefore, on reported basis, PAT grew 17% YoY.

### Stock Information

| | |
|---|---|
| Bloomberg Code: | ITC IN |
| CMP (Rs): | 273 |
| TP (Rs): | 370 |
| Mcap (Rs bn/US$ bn): | 3,333/52.2 |
| 3M ADV (Rs mn/US$ mn): | 2934.7/45.96 |

### Stock Performance (%)

| | 1M | 3M | 12M | YTD |
|---|---|---|---|---|
| Absolute | 4 | 1 | 9 | 4 |
| Rel. to Sensex | (1) | (7) | (20) | 0 |

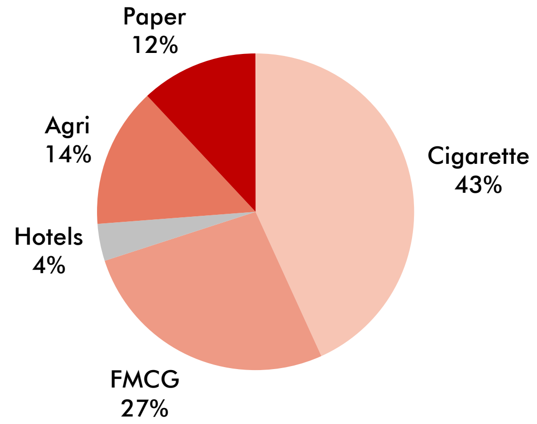
*Source: Bloomberg, Ambit Capital research*

### Ambit Estimates (Rs bn)

| | FY17 | FY18E | FY19E |
|---|---|---|---|
| Revenues | 400.9 | 411.0 | 479.3 |
| EBITDA | 145.8 | 157.9 | 181.4 |
| EPS (Rs) | 8.4 | 9.0 | 10.4 |

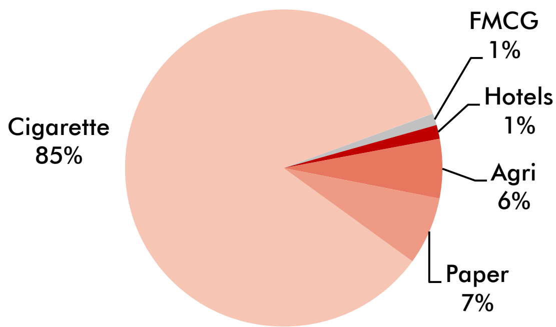
*Source: Ambit Capital research*

**Exhibit 1: Cigarettes contribute 43% of net sales...**




*Source: Company, Ambit Capital research*

**Exhibit 2: ...but 85% of EBIT**




*Source: Company, Ambit Capital research*

### Cigarettes – 3-4% volume decline; EBIT growth of 8% YoY

We believe ITC's cigarette volumes declined by ~3-4% YoY in 3QFY18 as consumer demand does not seem to have recovered from increase in prices to mitigate tax hikes post-GST implementation. However, on account first full quarter of price hikes, profit growth was 8% YoY which is an improvement over 2% YoY growth in 2QFY18. We expect cigarette volume growth to recover in coming quarters especially if no tax hikes are announced in the Union Budget. However, we prefer tax hikes to be announced as that would: 1) end uncertainty around timing and extent of next tax hike; and 2) allow ITC to take price hikes which may lead to miss on our volume growth but is likely to be made up through higher-than-expected margin gains.

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### FMCG business – We are underwhelmed by headline growth of 16% YoY

ITC's FMCG segment's sales grew by 16% YoY which is just 2% QoQ growth. We had expected higher FMCG growth given the low base of 3QFY17 which was disrupted by demonetisation, ITC's higher rural reach and a slew of new launches across several categories. Some of the new launches include new flavours in packaged snacks, confectionary, chocolates and juices, scaling up of dairy whitener and ghee in more launch States and new variants in soaps, shower gels and deodorants. Two new manufacturing facilities in West Bengal and Punjab were also commissioned during the quarter. Encouragingly, despite acceleration in new launches and commissioning of new facilities, the FMCG business reported an EBIT of Rs470mn during the quarter vs a loss of Rs197mn in 3QFY17.

### Hotels – 10% top-line growth supported by removal of ban on sale of liquor near highways in cities

ITC witnessed all-round improvement in performance of Hotels business as core operations benefited from improvement in average room rate and Food & Beverages business benefited from removal of ban on sale of alcohol near highways within cities. Improved realisation and operating leverage has led to a sharp improvement in margins as EBIT growth came in at 30% YoY. We expect similar performance to continue in 4Q as well.

### Agri business – Weak performance continues

Drought in Andhra Pradesh continued to impact the quality of leaf tobacco produce and fewer opportunistic exports of agri commodities affected sales. We are not concerned about the weak performance of this segment as we appreciate that the performance of this segment tends to be volatile depending upon availability of opportunistic exports. Reported sales declined by 8% YoY and EBIT declined by 1% YoY.

### Paperboards, Paper & Packaging – Affected by weak cigarettes sales

Sales growth was impacted due to weak performance of cigarettes business. Also, over capacity in the industry combined with cheaper imports from ASEAN and China are hurting sales growth of the segment, which declined 4% YoY. Encouragingly, due to benign input costs, structural cost-saving initiatives like import substitution of some key raw materials helped ITC report EBIT growth of 9% YoY.

### Where do we go from here?

### Continued recovery in earnings growth to mitigate pessimism around regulatory issues

We understand investor concerns over unpredictability of tax changes for cigarettes post cess hike. But we believe pessimism is overdone given: 1) higher tax hikes have historically boosted margin gains for ITC; 2) being a dominant player, ITC has emerged stronger than peers after tax/regulatory tightening; and 3) global comparison shows cigarettes in India are already highly regulated, hence impact of further tightening is likely to be low.

### We expect investors to appreciate improving cash generation by ITC

ITC's capital intensity across its businesses is declining as seen by capex/sales coming down from 9% to 5% over FY12-17. This led to FCF CAGR (14%) outpacing EPS CAGR (11%) in the past five years. ITC continues to be the highest cash generator in our coverage (FCF/Sales of 22% vs sector average of 10%) with its FCF being 2.5x of HUL for similar market cap. Also, for future capex, shift in focus to F&B is positive as: 1) we prefer F&B within FMCG given low penetration and shift from unorganised to organised; 2) ITC's sourcing and R&D synergies with agri-commodities and hotels business.

### Relative outperformer in the near term; reiterate BUY

ITC's 45% discount to the FMCG sector (10-year average discount, 15%) and reduced premium of 44% to global tobacco (10-year average premium, 74%) are a result of over-pessimism. As ITC delivers 24%/17% FCF/EPS CAGR over FY17-20 and investor confidence is restored, we see a re-rating hereon. Also, lower valuation premium to global tobacco and improving cash generation could attract global investors. Our DCF-based TP of Rs370 (Rs375 earlier) implies 35% upside and 31x FY19E P/E, a 25% discount to FMCG. Near-term concerns around unexpected tax hike risks will keep the discount to FMCG higher than the historical average.

**Exhibit 3: Quarterly snapshot (Rs mn)**

| Rs mn | 3QFY18 | 3QFY17 | 2QFY18 | YoY | QoQ | Ambit estimate | Divergence |
|---|---|---|---|---|---|---|---|
| **Net Sales** | **97,720** | **92,484** | **103,141** | **6%** | **-5%** | **112,751** | **-13%** |
| Total COGS | 35,810 | 33,766 | 43,564 | 6% | -18% | 40,827 | -12% |
| **Gross Profit** | **61,910** | **58,718** | **59,578** | **5%** | **4%** | **71,924** | **-14%** |
| *Gross margin* | *63.4%* | *63.5%* | *57.8%* | ***(14)*** | ***559*** | *63.8%* | ***(44)*** |
| Employee costs | 5,950 | 5,723 | 6,065 | 4% | -2% | 7,203 | -17% |
| *% of sales* | *6.1%* | *6.2%* | *5.9%* | *(10)* | *21* | *6.4%* | *(30)* |
| Other expense | 16,915 | 17,531 | 15,897 | -4% | 6% | 20,809 | -19% |
| *% of sales* | *17.3%* | *19.0%* | *15.4%* | *(165)* | *190* | *18.5%* | *(115)* |
| **EBITDA** | **39,045** | **35,464** | **37,615** | **10%** | **4%** | **43,912** | **-11%** |
| *EBITDA margin* | *39.2%* | *38.3%* | *36.5%* | *89* | *276* | *38.9%* | *29* |
| Depreciation | 2,908 | 2,665 | 2,824 | 9% | 3% | 2,600 | 12% |
| **EBIT** | **36,138** | **32,799** | **34,791** | **10%** | **4%** | **41,312** | **-13%** |
| *EBIT margin* | *37.0%* | *35.5%* | *33.7%* | *152* | *325* | *36.6%* | *34* |
| Finance cost | 240 | 136 | 290 | 77% | -17% | 100 | 140% |
| Other Income | 6,269 | 6,879 | 4,942 | -9% | 27% | 7,000 | -10% |
| **PBT** | **42,167** | **39,542** | **39,443** | **7%** | **7%** | **48,212** | **-13%** |
| Tax | 13,965 | 13,075 | 13,045 | 7% | 7% | 16,392 | -15% |
| *as % of PBT* | *33.1%* | *33.1%* | *33.1%* | *5* | *5* | *34.0%* | *(88)* |
| **PAT before exceptional items** | **28,202** | **26,467** | **26,398** | **7%** | **7%** | **31,820** | **-11%** |

*Source: Company, Ambit Capital research*

## Balance sheet

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Net Worth | 356,779 | 371,673 | 409,841 | 450,517 | 498,146 |
| Total Debt | 294 | 180 | 180 | 180 | 180 |
| Others | 18,958 | 19,728 | 19,728 | 19,728 | 19,728 |
| Current Liabilities | 124,281 | 150,579 | 144,773 | 167,390 | 195,188 |
| **Total Liabilities** | **500,313** | **542,160** | **574,522** | **637,814** | **713,242** |
| Fixed Assets | 164,301 | 184,173 | 193,244 | 204,308 | 217,497 |
| Investments | 133,245 | 185,853 | 185,853 | 185,853 | 185,853 |
| Current Assets | 202,766 | 172,134 | 195,424 | 247,653 | 309,892 |
| **Total Assets** | **500,313** | **542,160** | **574,522** | **637,814** | **713,242** |

*Source: Company, Ambit Capital research*

## Income statement

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Net Income | 365,827 | 400,887 | 411,001 | 479,272 | 556,439 |
| % Growth | 0% | 10% | 3% | 17% | 16% |
| Gross Profit | 231,327 | 241,124 | 233,498 | 271,774 | 315,442 |
| EBITDA | 137,146 | 145,780 | 157,905 | 181,370 | 215,357 |
| PBIT | 144,832 | 155,259 | 166,654 | 191,049 | 223,626 |
| PBT | 144,341 | 155,030 | 166,154 | 190,549 | 223,126 |
| PAT | 93,284 | 102,009 | 109,662 | 125,762 | 147,263 |
| EPS | 7.7 | 8.4 | 9.0 | 10.4 | 12.1 |
| EPS Growth | -3% | 9% | 7% | 15% | 17% |

*Source: Company, Ambit Capital research*

## Cash flow statement

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| EBIT | 144,832 | 155,259 | 166,654 | 191,049 | 223,626 |
| Depreciation | 10,007 | 10,380 | 12,250 | 13,822 | 15,731 |
| Others | (48,906) | (52,481) | (56,992) | (65,287) | (76,363) |
| Change in working capital | (20,900) | 28,010 | (9,455) | (2,019) | (48) |
| Cash flow from operations | 85,033 | 141,169 | 112,457 | 137,565 | 162,947 |
| Cash flow from investments | (60,573) | (82,859) | (21,322) | (24,885) | (28,920) |
| Cash flow from financing | (43,955) | (87,229) | (71,494) | (85,087) | (99,634) |
| Change in cash | (19,494) | (28,919) | 19,641 | 27,593 | 34,393 |
| Free cash flow | 73,651 | 110,917 | 91,135 | 112,679 | 134,027 |

*Source: Company, Ambit Capital research*

## Ratio analysis / Valuation parameters

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Gross margin (%) | 63.2% | 60.1% | 61.0% | 61.3% | 61.6% |
| EBITDA margin (%) | 37.5% | 36.4% | 38.4% | 37.8% | 38.7% |
| Net profit margin (%) | 25.5% | 25.4% | 26.7% | 26.2% | 26.5% |
| Net debt: equity (x) | (0.5) | (0.6) | (0.6) | (0.6) | (0.6) |
| RoCE (%) | 26.7% | 26.6% | 26.8% | 28.0% | 29.9% |
| RoE (%) | 28.1% | 28.0% | 28.1% | 29.2% | 31.0% |
| P/E (x) | 32.9 | 29.8 | 27.2 | 24.2 | 20.7 |
| Price/Sales (x) | 8.5 | 7.8 | 7.6 | 6.5 | 5.6 |
| EV/EBITDA (x) | 21.4 | 20.0 | 18.4 | 15.8 | 13.1 |

*Source: Company, Ambit Capital research*

# Kotak Mahindra Bank

## Subsidiaries steal the show

**The bank reported standalone/consolidated EPS growth of ~15%/24% YoY. Pick-up in loan growth (up 23% YoY), controlled opex (cost-to-income down 140bps), stable credit costs (at 55bps) and strong performance from subsidiaries supported PAT growth. However, NIM further compressed by 13bps QoQ after 27bps compression in 1HFY18 (despite the positive impact of capital raise in 1QFY18) due to pressure on loan yields. Subsidiaries' strong performance with 48% YoY PAT growth was led by stock broking and investment banking businesses. We continue to believe that when KMB accelerates its loan growth to utilise its excess equity, profitability will come under pressure given pressure on NIM due to higher leverage and pressure on yields. The bank should deliver an average consolidated RoE of 13.5% with EPS CAGR of 18% over FY19-20E. Hence, we find the current valuations (consolidated) of 3.5x FY19E P/B and 28.3x FY19E P/E expensive. We remain SELLers with a TP of Rs689 (35% downside).**

**Results overview:** Kotak Mahindra Bank reported standalone/consolidated EPS growth of ~15%/24% YoY. Whilst standalone profits were 2% lower than our expectations, consolidated profits were 6% above our expectations due to stronger-than-expected performance of capital market related subsidiaries. Acceleration in loan book growth continued with 23% YoY growth (vs 21%/18% in 2QFY18/1QFY18). However, NIM further compressed ~13bps QoQ after ~27bps compression 1HFY18 resulting in NII growth of 17% YoY. Some gains on operational efficiency and stable asset quality helped the bank to report standalone PAT growth of 20% YoY. The PAT growth of subsidiaries was strong at 48% YoY and hence consolidated profit was up 28% YoY (in line with our estimate). Given stock dilution in 1QFY18, EPS growth was lower than PAT growth.

Loan growth was driven by a strong growth in retail segment (41% of the loans; up 27% YoY) led by strong traction in small business, personal loans and credit cards (14% of the loans; up 45% YoY) and commercial vehicle/CE Financing (8% of the loans; up 37% YoY). However, the growth in business banking (11% of the loans; up 8% YoY) remained muted as management continued to sound cautious on the outlook of SME businesses given multiple disruptions around GST, demonetisation, etc. The management expects to maintain >20% loan growth and yet stay watchful, with emphasis on improving the quality of credit underwriting.

NIMs further declined by ~13bps QoQ (30bps YoY) after ~27bps compression in 1HFY18. KMB's NIMs have been declining over the last three quarters despite positive kicker from capital raise done in the middle of 1QFY18. This indicates that loan growth acceleration is coming at the expense of NIMs. Average CASA growth of 46% YoY remained strong, with savings deposits growing at 60% YoY leading to overall CASA ratio of 46.7% at the end of the quarter. However, NIMs still contracted as lending yield contraction was higher than the trends shown by rest of the banks. We still maintain our view that higher loan growth for KMB would come at the expense of lower NIMs due to higher leverage and incremental growth coming at lower spreads. Hence, NII growth would continue to lag loan growth for the next couple of years.

Fee income growth slowed down to 14% due to a higher base in 3QFY17. With higher base coming into play and rising bond yields, we expect non-interest income growth to lag NII growth. The cost-to-income ratio moderated to 47% in 3QFY18 (vs 48.4% in 3QFY17).

**Stable asset quality:** Gross NPAs (down 2.6% QoQ) reduced QoQ by 15bps to 2.31%. Provisioning costs at Rs2.1bn were up 10% YoY with annualised credit cost at 55bps, in line with management guidance. The management sees some stress in the SME space wherein they will be watchful while underwriting credits. In the last 3-4 quarters, they have seen increased slippages from the SME pool.

# SELL

## Result Update

### Stock Information

| | |
|---|---|
| Bloomberg Code: | KMB IN |
| CMP (Rs): | 1,061 |
| TP (Rs): | 689 |
| Mcap (Rs bn/US$ bn): | 2,020/31.6 |
| 3M ADV (Rs mn/US$ mn): | 2,276/35.7 |

### Stock Performance (%)

| | 1M | 3M | 12M | YTD |
|---|---|---|---|---|
| Absolute | 4 | (2) | 46 | 5 |
| Rel. to Sensex | (1) | (11) | 16 | 1 |

*Source: Bloomberg, Ambit Capital research*

### Ambit Estimates (Rs bn)

| | FY17 | FY18E | FY19E |
|---|---|---|---|
| NII | 81.3 | 95.1 | 112.0 |
| PAT – stand. | 34.1 | 42.0 | 49.1 |
| PAT – consol. | 49.4 | 60.9 | 71.3 |
| EPS (Rs)-consol. | 26.9 | 32.0 | 37.5 |

*Source: Bloomberg, Ambit Capital research*

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**Strong performance from subsidiaries:** Net profit of subsidiaries grew 48% YoY driven by strong performance from stock broking (PAT up 81% YoY), investment banking (up 4x YoY), asset management (up 1.4x YoY) and life insurance (up 43% YoY). However, NBFC Kotak Prime's performance remained weak with just 1% YoY growth in PAT despite 22% YoY growth in loan book.

**Where do we go from here?**

As highlighted in our note 'Higher growth ≠ higher RoE', we believe that as KMB accelerates its loan growth to utilise its excess equity (tier-1 of 18.0%), incremental growth would come at lower profitability given: (i) KMB would have to compromise yields to quickly expand its balance sheet; (ii) CASA growth won't match high balance sheet growth, pressuring funding cost; and (iii) NIMs would compress with increased leverage as debt replaces equity. Moreover, we believe that the Government's announcement of recapitalisation of PSU banks means that accelerating growth for the bank would not be easy. Therefore, we expect average consolidated RoE of 13.5% with EPS CAGR of 18% over FY19-20E. We find the current valuations of 3.5x/28.3x FY19E consolidated PB/PE expensive. We are SELLers on KMB with a target price of Rs689, implying 35% downside.

**Exhibit 1: Quarterly snapshot (Standalone, unless mentioned)**

| **Earnings Table (Rs mn)** | **3QFY17** | **2QFY18** | **3QFY18** | **YoY (%)** | **QoQ (%)** | **3QFY18Est.** | **A/E (%)** |
|---|---|---|---|---|---|---|---|
| Net Interest Income | **20,503** | **23,127** | **23,937** | **17%** | **4%** | **24,171** | **-1%** |
| Non-Interest income | **9,102** | **9,539** | **10,398** | **14%** | **9%** | **10,877** | **-4%** |
| Total Income | **29,605** | **32,665** | **34,335** | **16%** | **5%** | **35,048** | **-2%** |
| Employee Cost | 6,974 | 7,230 | 7,342 | 5% | 2% | 7,591 | -3% |
| Other Operating Expenses | 7,354 | 8,188 | 8,793 | 20% | 7% | 8,422 | 4% |
| Total Operating Expenses | 14,328 | 15,417 | 16,135 | 13% | 5% | 16,013 | 1% |
| Operating Profit | **15,277** | **17,248** | **18,201** | **19%** | **6%** | **19,035** | **-4%** |
| Total Provisions | **1,921** | **2,165** | **2,128** | **11%** | **-2%** | **3,021** | **-30%** |
| PBT | 13,356 | 15,083 | 16,073 | 20% | 7% | 16,013 | 0% |
| Tax | 4,558 | 5,140 | 5,541 | 22% | 8% | 5,284 | 5% |
| Reported Profit | **8,798** | **9,943** | **10,532** | **20%** | **6%** | **10,729** | **-2%** |
| Consolidated PAT | **12,668** | **14,413** | **16,242** | **28%** | **13%** | **15,289** | **6%** |
| **Balance sheet (Rs bn)** | | | | | | | |
| Deposits | 1,493.5 | 1,656.7 | 1,808.3 | 21% | 9% | 1,706.4 | 6% |
| Net Advances | 1,292.6 | 1,525.7 | 1,590.7 | 23% | 4% | 1,602.0 | -1% |
| Total Assets | **2,017.9** | **2,369.7** | **2,486.5** | **23%** | **5%** | **2,464.5** | **1%** |
| Loan-Deposit ratio (%) | 86.5% | 92.1% | 88.0% | | | | |
| Key Ratios | | | | | | | |
| Credit Quality | | | | | | | |
| Gross NPAs (Rs mn) | 31,779 | 38,142 | 37,150 | 17% | -3% | 39,884 | -7% |
| Net NPAs (Rs mn) | 13,791 | 19,188 | 17,280 | 25% | -10% | 18,960 | -9% |
| Gross NPA (%) | 2.42% | 2.47% | 2.31% | | | 2.46% | |
| Net NPA (%) | 1.07% | 1.26% | 1.09% | | | 1.18% | |
| Loan Loss Provisions (%) | 0.60% | 0.59% | 0.55% | | | 0.77% | |
| Coverage Ratio (%) | 56.6% | 49.7% | 53.5% | | | 52.5% | |
| **Capital Adequacy** | | | | | | | |
| Tier I (%) | 16.5% | 18.7% | 18.0% | | | | |
| CAR (%) | 17.6% | 19.4% | 18.7% | | | | |
| **Du-pont Analysis** | | | | | | | |
| NII / Assets (%) | 4.13% | 3.99% | 3.94% | | | 4.00% | |
| Non-Interest Inc. / Assets (%) | 1.83% | 1.65% | 1.71% | | | 1.80% | |
| Operating Cost / Assets (%) | 2.89% | 2.66% | 2.66% | | | 2.65% | |
| Operating Profits / Assets (%) | 3.08% | 2.98% | 3.00% | | | 3.15% | |
| Provisions / Assets (%) | 0.39% | 0.37% | 0.35% | | | 0.50% | |
| **ROA (%)** | **1.77%** | **1.72%** | **1.74%** | | | **1.78%** | |

Source: Company, Ambit Capital research

## Balance sheet – standalone

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Networth | 239,591 | 276,161 | 375,543 | 422,955 | 478,979 |
| Deposits | 1,386,430 | 1,574,259 | 1,827,166 | 2,235,712 | 2,705,212 |
| Borrowings | 209,753 | 210,955 | 225,829 | 248,412 | 300,579 |
| Other Liabilities | 86,824 | 84,525 | 112,933 | 130,435 | 157,823 |
| **Total Liabilities** | **1,922,598** | **2,145,900** | **2,541,472** | **3,037,515** | **3,642,592** |
| Cash & Balances with RBI & Banks | 108,797 | 225,720 | 210,753 | 228,820 | 276,872 |
| Investments | 512,602 | 450,742 | 523,406 | 633,321 | 766,318 |
| Advances | 1,186,653 | 1,360,821 | 1,683,456 | 2,024,561 | 2,404,632 |
| Other Assets | 114,546 | 108,616 | 123,857 | 150,813 | 194,769 |
| **Total Assets** | **1,922,598** | **2,145,900** | **2,541,472** | **3,037,515** | **3,642,592** |

*Source: Company, Ambit Capital research*

## Income statement – standalone

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Interest Income | 163,842 | 176,989 | 197,884 | 233,250 | 275,941 |
| Interest Expense | 94,838 | 95,728 | 102,798 | 121,261 | 146,575 |
| **Net Interest Income** | **69,004** | **81,261** | **95,086** | **111,988** | **129,365** |
| Total Non-Interest Income | 26,122 | 34,772 | 41,065 | 48,166 | 56,546 |
| **Total Income** | **95,126** | **116,033** | **136,151** | **160,154** | **185,911** |
| Total Operating Expenses | 54,715 | 56,185 | 64,061 | 73,640 | 84,297 |
| Employees expenses | 28,170 | 27,685 | 31,523 | 36,106 | 41,177 |
| Other Operating Expenses | 26,546 | 28,500 | 32,538 | 37,534 | 43,120 |
| **Pre Provisioning Profits** | **40,411** | **59,848** | **72,090** | **86,514** | **101,614** |
| Provisions | 9,174 | 8,367 | 8,703 | 12,383 | 14,201 |
| PBT | 31,237 | 51,481 | 63,387 | 74,131 | 87,413 |
| Tax | 10,339 | 17,366 | 21,382 | 25,006 | 29,487 |
| **PAT** | **20,898** | **34,115** | **42,005** | **49,125** | **57,927** |
| **Consolidated PAT** | 34,534 | 49,405 | 60,871 | 71,313 | 84,051 |

*Source: Company, Ambit Capital research*

## Ratio analysis – standalone bank

| Year to March (Rs mn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Credit-Deposit (%) | 86% | 86% | 92% | 91% | 89% |
| Cost/Income ratio (%) | 57.5% | 48.4% | 47.1% | 46.0% | 45.3% |
| Gross NPA (Rs mn) | 28,381 | 35,786 | 38,267 | 46,288 | 55,844 |
| Gross NPA (%) | 2.36% | 2.59% | 2.25% | 2.26% | 2.29% |
| Net NPA (Rs mn) | 12,620 | 17,181 | 17,220 | 19,441 | 22,338 |
| Net NPA (%) | 1.06% | 1.26% | 1.02% | 0.96% | 0.93% |
| Provision coverage (%) | 55.5% | 52.0% | 55.0% | 58.0% | 60.0% |
| NIMs (%) | 3.95% | 4.33% | 4.27% | 4.22% | 4.08% |
| Tier-1 capital ratio (%) | 15.3% | 15.9% | 17.9% | 16.6% | 15.5% |

*Source: Company, Ambit Capital research*

**Du-pont analysis – standalone bank**

| Year to March | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| NII / Assets (%) | 3.8% | 4.0% | 4.1% | 4.0% | 3.9% |
| Other income / Assets (%) | 1.4% | 1.7% | 1.8% | 1.7% | 1.7% |
| Total Income / Assets (%) | 5.2% | 5.7% | 5.8% | 5.7% | 5.6% |
| Cost to Assets (%) | 3.0% | 2.8% | 2.7% | 2.6% | 2.5% |
| PPP / Assets (%) | 2.2% | 2.9% | 3.1% | 3.1% | 3.0% |
| Provisions / Assets (%) | 0.5% | 0.4% | 0.4% | 0.4% | 0.4% |
| PBT / Assets (%) | 1.7% | 2.5% | 2.7% | 2.7% | 2.6% |
| Tax Rate (%) | 33.1% | 33.7% | 33.7% | 33.7% | 33.7% |
| ROA (%) | 1.14% | 1.68% | 1.79% | 1.76% | 1.73% |
| Leverage | 8.1 | 7.9 | 7.2 | 7.0 | 7.4 |
| ROE (%) | 9.2% | 13.2% | 12.9% | 12.3% | 12.8% |

*Source: Company, Ambit Capital research*

**Valuation parameters – Consolidated entity**

| Year to March | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Consolidated EPS (Rs) | 18.9 | 26.9 | 32.0 | 37.5 | 44.2 |
| Consolidated EPS growth (%) | -4% | 42% | 19% | 17% | 18% |
| Consolidated ROE (%) | 11.0% | 13.8% | 13.7% | 13.3% | 13.7% |
| Consolidated BVPS (Rs) | 181.9 | 209.1 | 263.9 | 300.5 | 343.7 |
| P/E (x) | 56.1 | 39.5 | 33.2 | 28.3 | 24.0 |
| P/BV (x) | 5.8 | 5.1 | 4.0 | 3.5 | 3.1 |

*Source: Company, Ambit Capital research*

# HCL Technologies

## Expect headwinds in IMS

**Revenue growth and EBIT margins were broadly in line with our/consensus estimates. The company reiterated revenue growth guidance of 10.5-12.5% (cc terms) and margin guidance of 19.5-20.5% (cc terms) for FY18. However, management indicated they are expecting revenue growth to be at the lower end of the guidance band. The company invested further US$300mn in IP deals taking the cumulative investments in this area to US$1.2bn (~FY17 PAT). In the core IMS segment, HCLT reported revenue decline for the second consecutive quarter. In a significant change of tone, management indicated they are witnessing headwinds in this segment (especially within data centre sub-segment, 50% of IMS) because of cloud adoption even by large firms. As highlighted in our *thematic*, HCLT is highly vulnerable to structural risks arising out of Robotic Process Automation (RPA) and Hyper Converged Infrastructure (HCI). The sudden spree of unrequired IP partnerships adds to our discomfort. Hence, despite optically enticing valuations (15x one-year forward P/E), we remain SELLers.**

### Dec-17: Revenue growth and EBIT margins broadly in line

- **Revenue grew 3.3% QoQ** in constant-currency terms, broadly in line with our estimate. Out of this, we estimate around 100bps QoQ growth contribution from inorganic component (VI IBM IP deal and full quarter consolidation of Urban Fulfillment Services). This implies organic cc growth of 2.3%, again in line with our estimate. Strong growth in manufacturing (34% of revenue, +6.6%) helped the company meet the top-line estimates. However, core segment of IMS (37% of revenue, -1.2%) reported revenue decline for the second consecutive quarter.
- **EBIT margin at 19.6% was 40bps below our estimate**. Key margin drivers during the quarter are: (1) cross currency (-10bps impact); (2) salary increase (-50bps impact); and (3) operational efficiencies predominantly driven by travel cost optimisation (+50bps impact) resulting in a net margin compression of 10bps QoQ.

### Key takeaways from earnings call

**Expect FY18 revenue growth towards lower end of guidance band** (10.5-12.5% YoY, CC terms). We currently factor in 10.4% out of which 4.4% will be inorganic contribution.

- **Reiterated FY18 EBIT margin guidance of 19.5-20.5%** (on CC basis) vs our current estimate of 19.9%.
- **Revenue decline in IMS (37% of revenue, -1.2% QoQ)** is primarily because of decline in the Indian business. Even otherwise management expects data centres sub-segment within IMS (~19% of overall revenue) to face headwinds from cloud adoption. There is a dramatic change in the perception of security on public cloud among clients and management sees even bigger clients rapidly adopting public cloud. Pick-up in this service line is expected in 2QFY19.
- **Entered into three more IP partnerships spending US$300mn.** With this, the company has cumulatively spent US$1.2bn on IP partnerships. Management reiterated their aspiration to build a large-scale software business and indicated IP investments will continue going forward.
- **Industry is moving towards scale digital**. Management indicated strong growth in financial services (24% of revenue, +2.8% on adjusted basis) is aided by increasing size of digital deals.
- **IT budgets for CY18 will largely be flattish.** However, expect optimisation of traditional spend towards digital technologies.

# SELL

## Result Update

**Stock Information**

| | |
|---|---|
| Bloomberg Code: | HCLT IN |
| CMP (Rs): | 954 |
| TP (Rs): | 825 |
| Mcap (Rs bn/US$ bn): | 1,362/21 |
| 3M ADV (Rs mn/US$ mn): | 1,488/23 |

**Stock Performance (%)**

| | 1M | 3M | 12M | YTD |
|---|---|---|---|---|
| Absolute | 8 | 3 | 13 | 7 |
| Rel. to Sensex | 3 | (5) | (16) | 4 |

*Source: Bloomberg, Ambit Capital research*

**Ambit Estimates (Rs bn)**

| | FY18E | FY19E | FY20E |
|---|---|---|---|
| Revenues | 505 | 546 | 590 |
| EBITDA | 110 | 114 | 121 |
| EPS (Rs) | 61 | 65 | 69 |

*Source: Bloomberg, Ambit Capital research*

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**Where do we go from here?**

Post the in-line results, we have kept our estimates and target price broadly unchanged. Despite the optically enticing valuations (15x one-year forward P/E at 20% discount to our large-cap coverage universe), we remain SELLers on the stock given the structural headwinds currently faced by IMS (37% of revenue) from next generation technologies like Robotic Process Automation (RPA) and Hyper Converged Infrastructure (HCI). Sudden spree of unrequired IP partnerships adds to our discomfort. Our DCF-based target price of Rs825 implies 12x Dec-19E EPS.

**Exhibit 1: Results vs Ambit and consensus expectations – Reported numbers largely in line with our and consensus estimates**

| | Dec-17A | Sep-17 | QoQ | Dec-16 | YoY | Dec-17E | vs Ambit | Consensus | vs Consensus |
|---|---|---|---|---|---|---|---|---|---|
| Revenue (US$ mn) | 1,988 | 1,928 | 3.1% | 1,745 | 13.9% | 1,986 | 0.1% | 1,977 | 0.6% |
| cc revenue growth | 3.3% | 0.9% | 240bps | 3.0% | 30bps | 3.0% | 30bps | 2.6% | 70bps |
| Revenue | 128.1 | 124.4 | 3.0% | 116.8 | 9.7% | 128.5 | -0.3% | 128.0 | 0.1% |
| EBIT | 25.1 | 24.5 | 2.4% | 23.8 | 5% | 25.7 | -2.3% | 25.1 | 0.1% |
| EBIT margins | 19.6% | 19.7% | -10bps | 20.4% | -80bps | 20.0% | -40bps | 19.6% | 00bps |
| Net Income | 21.9 | 21.9 | 0.3% | 20.5 | 7.1% | 21.7 | 1.1% | 21.5 | 2.0% |
| Net margin | 17.1% | 17.6% | -50bps | 17.5% | -40bps | 16.9% | 20bps | 16.8% | 30bps |

*Source: Company, Ambit Capital research*

### Balance sheet

| Rs bn | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Net Worth** | **277** | **345** | **351** | **404** | **462** |
| Other Liabilities | 22 | 18 | 18 | 18 | 18 |
| **Capital Employed** | **300** | **363** | **369** | **422** | **481** |
| **Net Block** | **106** | **166** | **180** | **187** | **194** |
| Other Non-current Assets | 40 | 40 | 35 | 35 | 35 |
| Curr. Assets | 247 | 272 | 267 | 322 | 384 |
| Debtors | 76 | 85 | 93 | 101 | 109 |
| Unbilled revenues | 30 | 26 | 28 | 30 | 32 |
| Cash & Bank Balance | 117 | 131 | 115 | 157 | 206 |
| Other Current Assets | 24 | 31 | 31 | 34 | 37 |
| Current Liab. & Prov | 94 | 115 | 112 | 122 | 131 |
| Net Current Assets | 153 | 158 | 155 | 201 | 252 |
| **Application of Funds** | **300** | **363** | **369** | **422** | **481** |

*Source: Company, Ambit Capital research*

### Income statement

| Rs bn | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Revenue (US$ mn)** | **6,235** | **6,975** | **7,812** | **8,446** | **9,119** |
| *Growth* | *7.1%* | *11.9%* | *12.0%* | *8.1%* | *8.0%* |
| Revenue | 409 | 466 | 505 | 546 | 590 |
| Cost of goods sold | 275 | 316 | 345 | 383 | 415 |
| SG&A expanses | 52 | 55 | 59 | 57 | 63 |
| **EBITDA** | **88** | **103** | **110** | **114** | **121** |
| Depreciation | 6 | 8 | 9 | 8 | 9 |
| **EBIT** | **82** | **94** | **101** | **107** | **112** |
| EBIT Margin | 20% | 20% | 20% | 20% | 19% |
| Other Income | 10 | 9 | 10 | 10 | 12 |
| **PBT** | 92 | 104 | 110 | 116 | 124 |
| Tax | 19 | 19 | 22 | 24 | 25 |
| **Reported PAT** | **73** | **84** | **88** | **93** | **99** |
| Diluted Adj EPS | 52 | 60 | 61 | 65 | 69 |

*Source: Company, Ambit Capital research*

### Cash flow statement

| Rs bn | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Net Income** | 73.4 | 84.3 | 87.9 | 92.6 | 99.0 |
| Depreciation | 5.7 | 8.3 | 9.1 | 7.9 | 8.9 |
| CF from Operations | 73.5 | 93.8 | 96.9 | 100.4 | 107.8 |
| Cash for Working Capital | (2.4) | 0.2 | (7.9) | (3.3) | (3.5) |
| **Net Operating CF** | **71.1** | **94.0** | **89.0** | **97.2** | **104.4** |
| Net Purchase of FA | (9.8) | (33.0) | (13.7) | (15.0) | (16.2) |
| Acquisitions | (179.2) | (144.2) | 178.1 | 5.9 | 7.9 |
| Others | (33.1) | (10.4) | 11.5 | 0.4 | 0.5 |
| **Net Cash from Invest.** | **(42.8)** | **(43.4)** | **(2.2)** | **(14.6)** | **(15.6)** |
| Proceeds from Equity & other | 0.0 | - | - | - | - |
| Dividend Payments | (33.7) | (40.6) | (33.8) | (40.3) | (40.3) |
| **Cash Flow from Fin.** | **(28.4)** | **(44.4)** | **(67.7)** | **(40.3)** | **(40.3)** |
| Free Cash Flow | 61.3 | 61.0 | 75.3 | 82.2 | 88.2 |
| Opening cash balance | 103.6 | 119.5 | 126.3 | 114.8 | 157.1 |
| **Net Cash Flow** | **(0.1)** | **6.2** | **19.1** | **42.3** | **48.5** |

*Source: Company, Ambit Capital research*

**Ratio analysis/Valuation parameters**

| | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Valuation (x)** | | | | | |
| P/E | 16.3 | 14.2 | 13.8 | 13.1 | 12.3 |
| EV/EBITDA | 12.5 | 10.7 | 10.0 | 9.6 | 9.1 |
| EV/Sales | 2.7 | 2.4 | 2.2 | 2.0 | 1.9 |
| EV/NOPAT | 13.4 | 11.7 | 10.9 | 10.3 | 9.8 |
| Price/Book Value | 4.3 | 3.5 | 3.4 | 3.0 | 2.6 |
| Dividend Yield (%) | 2.6% | 2.8% | 1.9% | 2.8% | 2.8% |
| **Return Ratios (%)** | | | | | |
| RoE | 29% | 27% | 25% | 25% | 23% |
| RoCE | 24% | 23% | 22% | 20% | 19% |
| ROIC | 39% | 37% | 33% | 32% | 32% |
| **Turnover Ratios** | | | | | |
| Receivable days (Days) | 95 | 87 | 87 | 87 | 87 |
| Fixed Asset Turnover (x) | 4.3 | 3.4 | 2.9 | 3.0 | 3.1 |

*Source: Company, Ambit Capital research*

# Jubilant FoodWorks

## Is the SSG sustainable?

**Jubilant reported a strong set of numbers with same-store sales growth (SSG) of 18% YoY vs our expectation of 9%. The growth was led by reduction in discounts, price hikes and volume SSG. However, gross margin declined by 40bps to 74.5% due to investment in improving the product. EBITDA margin expanded by 750bps due to operating leverage and input tax credit (ITC) benefits on account of GST. We upgrade our EPS estimates by 35%/32% for FY18E/19E to account for higher SSG (12% vs 8% earlier), which rebases subsequent years revenues upwards and hence upgrade our TP by 26% to Rs1,275. While much of the FY18 margin expansion has come from lower discounting and input tax credit, future SSG will be accompanied by lower gross margins (improving value proposition). Valuation of 58x 19E EPS is expensive as it factors 12% SSG till FY24E with stable gross margins (75%).**

### Revenue growth largely driven by discount reduction and price hikes

Revenue grew by 21% YoY to Rs7.9bn vs our expectation of Rs7.3bn driven by SSG of 18% (we expected 9%). Growth was attributable to: a) reduction in discounts present in the base quarter; b) price hikes taken to compensate for the benefits on account of input tax credit; and c) volume growth on a low base. Gross margin declined by 40bps YoY to 74.5% despite YoY reduction in discounts and price hikes undertaken during the quarter which indicates investment in product. The decline could have been higher but for reduction in discounts and price hikes.

### Operating leverage led by ITC benefits and volume SSG on a low base

Margins expanded by 750bps to 17.2% vs our expectation of 9.7%. Adjusted for reduction in Dunkin's losses (1.2% of revenues vs 2.3% in 3QFY17) from closure of non-efficient stores (shut 37 in the past year), margin expanded by 630bps YoY. This was led by cost rationalisation measures, GST-led ITC benefits and operating leverage due to a low base.

### Key takeaways from the conference call

- SSG skew is towards order growth rather than bill per order. Also, skew towards delivery vs dine-in has improved
- Pizza mania saw reasonable growth
- Commissary network expansion got completed and hence, no further investments needed; this commissary will help in automation and gain leverage
- Hold on to the target of 30+ stores to be added this year. Will expand network aggressively going forward; have 1,127 stores as at the end of 3QFY18
- No gains from McDonalds shutting stores in the North and the East; fairly even growth profile across states
- Revenue growth was agnostic across months
- Will keep exploring cuisines and this is not necessarily a new brand
- On frequency improvement initiatives – Clear planning in place including CRM plans for high-frequency evolved customer
- On track to breakeven Dunkin by end of FY19
- Night delivery network expanded to 42 restaurants and 6 towns

### Revision of estimates

We upgrade our SSG for the year from 8% to 12% to account for beat in 3QFY18 SSG estimates. Hence, we increase our topline for FY18 by 3%. We upgrade our EBITDA estimates for FY18E/FY19E by 23%/18% to account for GST-related gains and consequently upgrade our EPS estimates by 35%. We upgrade our TP by 26% to Rs1,275.

# SELL

## Result Update

**Stock Information**

| | |
|---|---|
| Bloomberg Code: | JUBI IN |
| CMP (Rs): | 2,101 |
| TP (Rs): | 1,275 |
| Mcap (Rs bn/US$ bn): | 128/2.0 |
| 3M ADV (Rs mn/US$ mn): | 1,357/21 |

**Stock Performance (%)**

| | 1M | 3M | 12M | YTD |
|---|---|---|---|---|
| Absolute | 11 | 27 | 120 | 10 |
| Rel. to Sensex | 6 | 19 | 91 | 7 |

*Source: Bloomberg, Ambit Capital research*

**Ambit Estimates (Rs bn)**

| | FY17 | FY18E | FY19E |
|---|---|---|---|
| Revenues | 25.8 | 29.3 | 33.9 |
| EBITDA | 2.4 | 4.1 | 4.9 |
| EPS (Rs) | 8.8 | 26.3 | 36.0 |

*Source: Bloomberg, Ambit Capital research*

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**Exhibit 1: Revision of estimates**

| | FY18E | | | FY19E | | | |
|---|---|---|---|---|---|---|---|
| | Old | New | Change in estimates | Old | New | Change in estimates | |
| SSG | 8.0% | 12% | | 8.0% | 8.0% | | Increased SSG for FY18E; 4% to account for price increases and reduction in discounts |
| Revenues (Rs mn) | 28,488 | 29,320 | 3% | 33,104 | 33,945 | 3% | |
| EBITDA (Rs mn) | 3,300 | 4,052 | 23% | 4,146 | 4,974 | 20% | |
| EBITDA Margin % | 11.6% | 13.8% | | 12.5% | 14.7% | | Increased EBITDA estimates to account for GST gains on account of higher SSG |
| PAT (Rs mn) | 1,284 | 1,730 | 35% | 1,792 | 2,373 | 32% | |
| EPS (Rs) | 19 | 26.3 | 35% | 27 | 36.0 | 32% | EBITDA upgrade to lead to EPS upgrade |

*Source: Company, Ambit Capital research*

**Exhibit 2: Long-term assumptions**

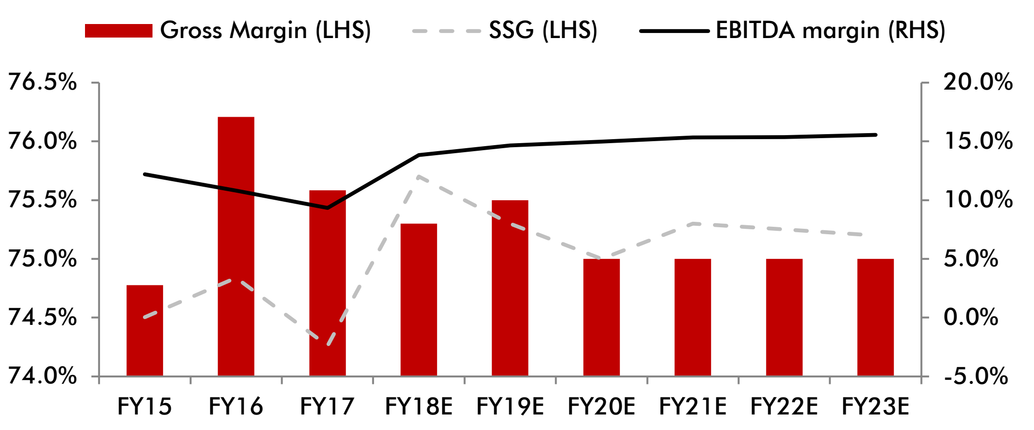
| FY18-24 | Old | New |
|---|---|---|
| Average SSG | 7% | 8% |
| Revenue CAGR | 14% | 15.3% |
| Gross margin | 74% | 75% |
| EBITDA CAGR | 16.5% | 17.6% |
| EBITDA margin | 14% | 15% |
| PAT CAGR | 22% | 24% |

*Source: Ambit Capital research*

## Where do we go from here?

With the cushion provided by ITC taken away, near-term SSG will be a function of the price hikes taken and discounts withdrawn to protect absolute EBITDA. Volume SSG in the longer term remains essential to sustain these margins. With the company stating that focus will be on maintaining value proposition, SSG and gross margins will have inverse correlation. At 58x FY19E EPS, the stock is rich as it factors not only high SSG of 12% over FY18-22 but also high gross margins of 75%.

**Exhibit 3: Gross margin and SSG will have inverse correlation in quest to maintain value proposition**



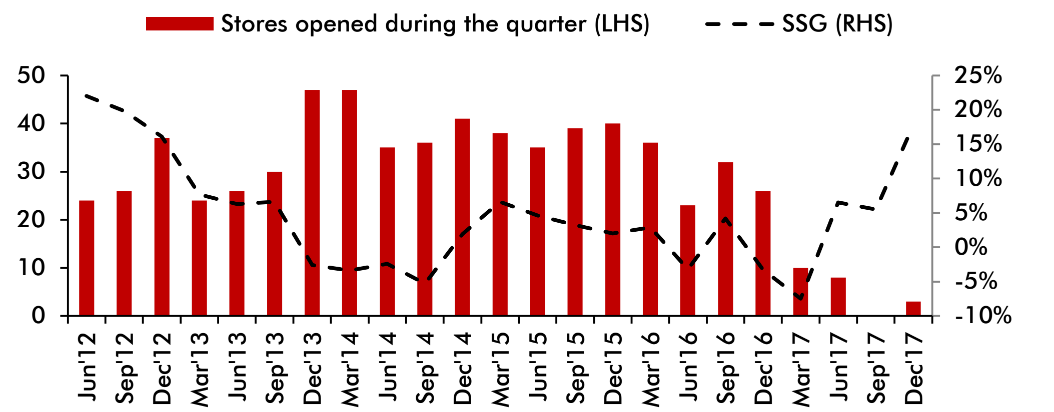

*Source: Company, Ambit Capital research*

**Exhibit 4: Standalone quarterly performance**

| Rs Mn | Standalone | | | | | | |
|---|---|---|---|---|---|---|---|
| | Dec'16 | Sep'17 | Dec'17 | YoY | QoQ | Ambit Estimates | Divergence |
| Net sales | 6,588 | 7,266 | 7,952 | 21% | 9% | 7,351 | 8% |
| COGS | 1,651 | 1,879 | 2,026 | 23% | 8% | 1,889 | |
| Gross Profit | 4,937 | 5,388 | 5,925 | 20% | 10% | 5,462 | 8% |
| *Gross Margin* | *74.9%* | *74.1%* | *74.5%* | | | *74.3%* | |
| Staff cost | 1,520 | 1,564 | 1,585 | 4% | 1% | 1,613 | -2% |
| *as % of Sales* | *23.1%* | *21.5%* | *19.9%* | | | *21.9%* | |
| Rent | 734 | 726 | 785 | 7% | 8% | 765 | 3% |
| *as % of Sales* | *11.1%* | *10.0%* | *9.9%* | | | *10.4%* | |
| EBITDA | 640 | 1,022 | 1,369 | 114% | 34% | 923 | 48% |
| *EBITDA Margin* | *9.7%* | *14.1%* | *17.2%* | | | *12.6%* | |
| PBT | 294 | 733 | 1,009 | 243% | 38% | 578 | 75% |
| Current tax | 95 | 248 | 349 | 267% | 41% | 203 | 72% |
| *Tax Rate* | *32.3%* | *33.8%* | *34.6%* | | | *35.1%* | |
| PAT | 199 | 485 | 660 | 232% | 36% | 412 | 60% |
| *as % of Sales* | *3.0%* | *6.7%* | *8.3%* | | | *5.6%* | |
| EPS (Rs) | 3.0 | 7.4 | 10.0 | 232% | 36% | 6.3 | 60% |

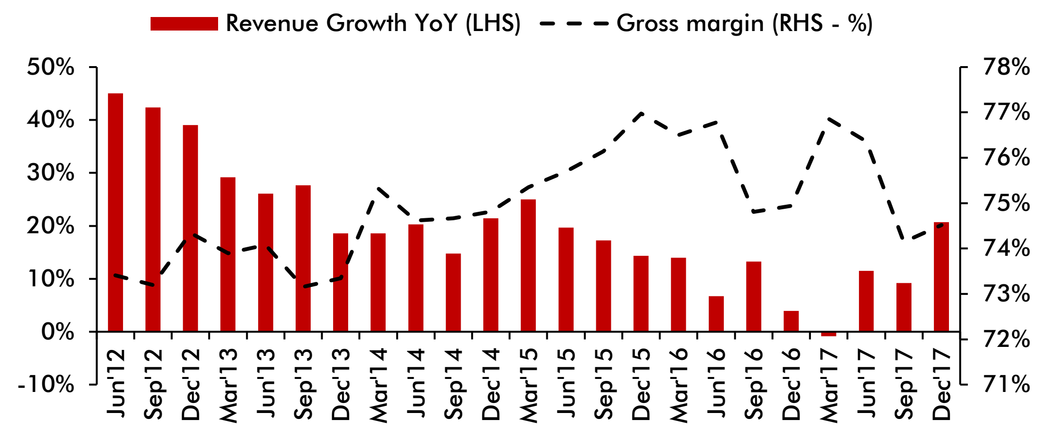
*Source: Company, Ambit Capital research*

**Exhibit 5: Jubilant reported SSG of 17.8% due to improvement in ticket size (lower discounting and price increases)…**



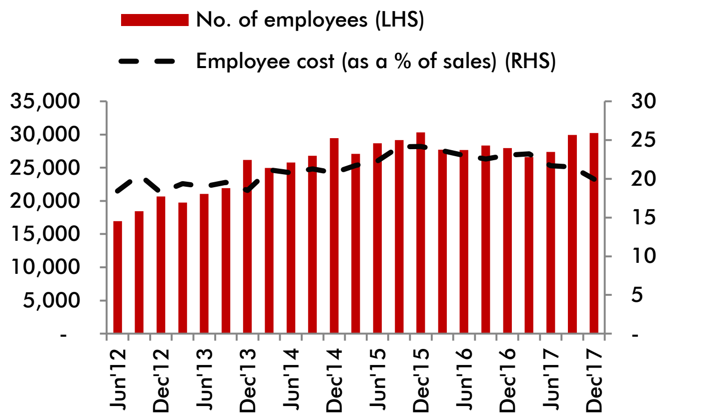

*Source: Company, Ambit Capital research*

**Exhibit 6: …however gross margin declined implying growth could be achieved only by sacrificing margins**



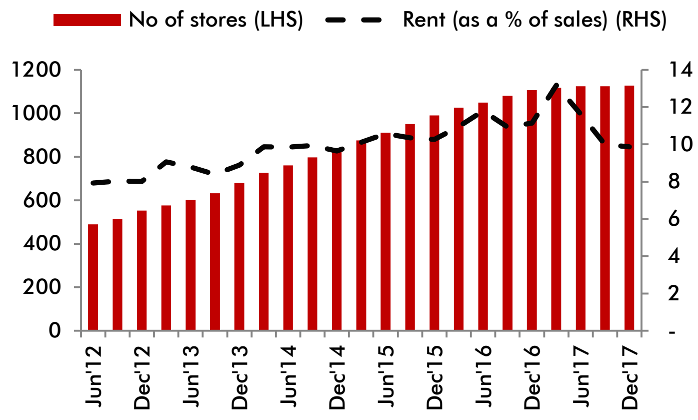

*Source: Company, Ambit Capital research*

**Exhibit 7: Employee cost reduced by 320bps YoY as a percentage of revenues due to operating leverage and variable employees; 260 employees added QoQ**




*Source: Company, Ambit Capital research*

**Exhibit 8: Rent per store increased by 6% YoY**




*Source: Company, Ambit Capital research*

### Balance Sheet

| | FY16 | FY17 | FY18E | FY19E |
|---|---|---|---|---|
| Revenues | 24,380 | 25,834 | 29,320 | 33,945 |
| YoY | 16% | 6% | 13% | 16% |
| EBITDA | 2,637 | 2,411 | 4,052 | 4,974 |
| EBITDA margin | 10.8% | 9.3% | 13.8% | 14.7% |
| Depreciation | 1,282 | 1,554 | 1,569 | 1,571 |
| EBIT | 1,355 | 857 | 2,483 | 3,403 |
| PBT | 1,470 | 1,005 | 2,622 | 3,596 |
| PAT | 967 | 699 | 1,730 | 2,373 |
| EPS | 14.7 | 8.8 | 26.3 | 36.0 |

*Source: Company, Ambit Capital research*

### Income Statement

| | FY16 | FY17 | FY18E | FY19E |
|---|---|---|---|---|
| Share capital | 658 | 659 | 659 | 659 |
| Networth | 7,620 | 8,053 | 9,189 | 10,990 |
| **Sources of funds** | **8,349** | **8,745** | **9,882** | **11,683** |
| Gross block | 9,466 | 10,942 | 11,963 | 13,177 |
| Net block | 8,546 | 8,939 | 8,392 | 8,034 |
| Current Assets | 2,766 | 3,031 | 4,892 | 7,736 |
| Current Liabilities | 3,871 | 4,160 | 4,338 | 5,022 |
| **Application of funds** | **8,349** | **8,745** | **9,882** | **11,683** |

*Source: Company, Ambit Capital research*

### Cash flow statement

| | FY16 | FY17 | FY18E | FY19E |
|---|---|---|---|---|
| CFO pre WC | 2,810 | 2,416 | 4,191 | 5,167 |
| WC investments | (308) | 5 | 110 | 253 |
| **CFO post tax** | **2,116** | **2,054** | **3,409** | **4,198** |
| Capex | 2,264 | 1,995 | 1,022 | 1,213 |
| **CFI** | **(1,997)** | **(1,883)** | **(1,022)** | **(1,213)** |
| **CFF** | **(177)** | **(148)** | **(594)** | **(571)** |
| **FCF** | **(148)** | **59** | **2,387** | **2,985** |

*Source: Company, Ambit Capital research*

### Ratio analysis / Valuation parameters

| | FY16 | FY17 | FY18E | FY19E |
|---|---|---|---|---|
| EBITDA margin | 10.8% | 9.3% | 13.8% | 14.7% |
| EBIT margin | 5.6% | 3.3% | 8.5% | 10.0% |
| ROCE (pre-tax) | 20.9% | 12.8% | 30.4% | 35.6% |
| ROCE (post tax) | 13.7% | 8.9% | 20.1% | 23.5% |
| ROE | 13.7% | 7.4% | 20.1% | 23.5% |
| Debt (net): equity (x) | (0.04) | (0.04) | (0.23) | (0.41) |
| Book value/share (Rs) | 116 | 122 | 139 | 167 |
| P/B (x) | 18 | 17 | 15 | 13 |
| P/E (x) | 143 | 240 | 80 | 58 |

*Source: Company, Ambit Capital research*

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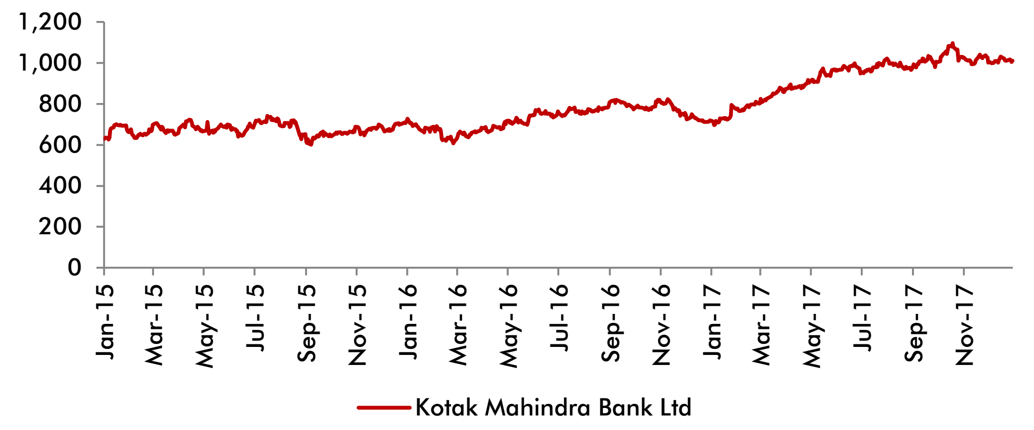
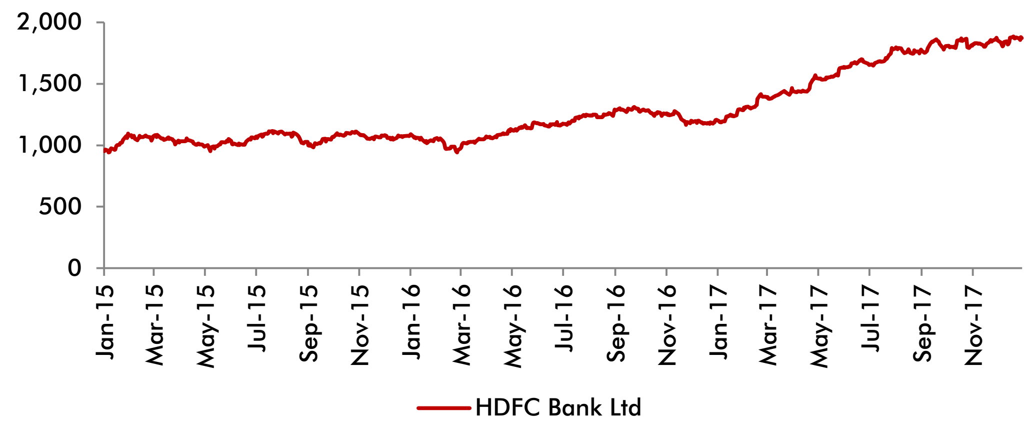
**Kotak Mahindra Bank Ltd (KMB IN, SELL)**



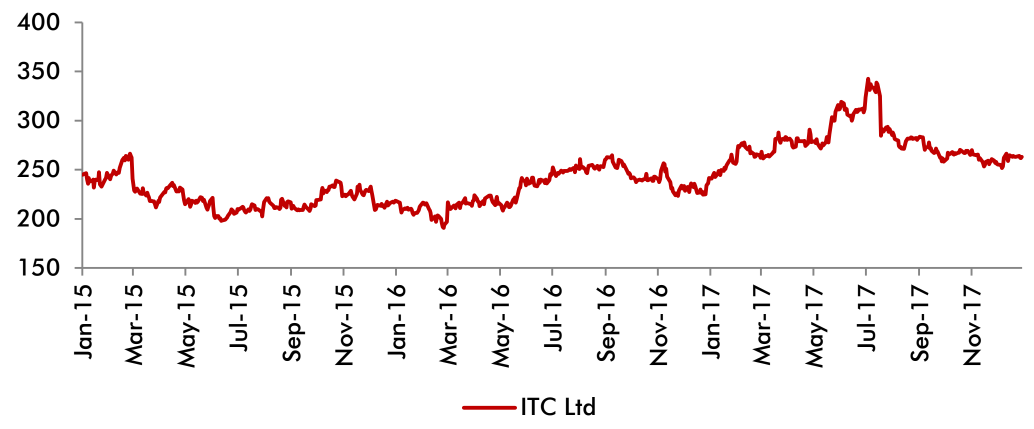

*Source: Bloomberg, Ambit Capital research*

**HDFC Bank Ltd (HDFCB IN, SELL)**



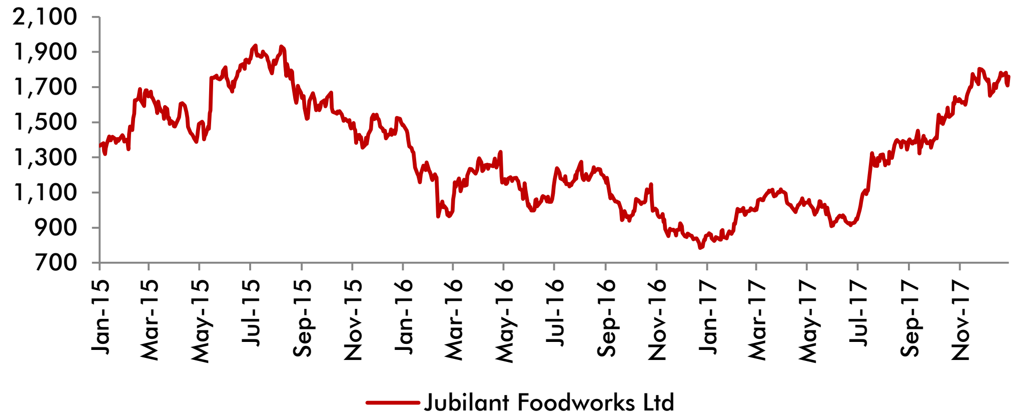

*Source: Bloomberg, Ambit Capital research*

**ITC Ltd (ITC IN, BUY)**



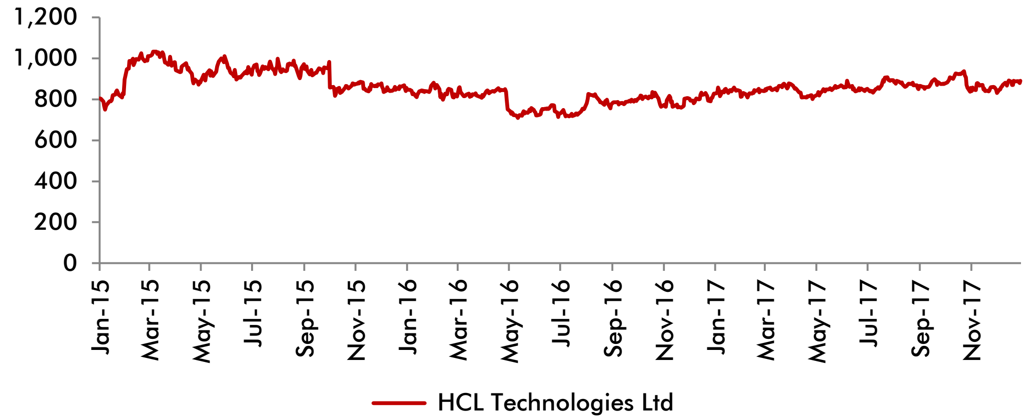

*Source: Bloomberg, Ambit Capital research*

**Jubilant Foodworks Ltd (JUBI IN, SELL)**




*Source: Bloomberg, Ambit Capital research*

**HCL Technologies Ltd (HCLT IN, SELL)**




*Source: Bloomberg, Ambit Capital research*

**Explanation of Investment Rating**

| **Investment Rating** | **Expected return (over 12-month)** |
|---|---|
| BUY | >10% |
| SELL | ≤10% |
| NO STANCE | We have forward looking estimates for the stock but we refrain from assigning valuation and recommendation |
| UNDER REVIEW | We will revisit our recommendation, valuation and estimates on the stock following recent events |
| NOT RATED | We do not have any forward looking estimates, valuation or recommendation for the stock |
| POSITIVE | We have a positive view on the sector and most of stocks under our coverage in the sector are BUYs |
| NEGATIVE | We have a negative view on the sector and most of stocks under our coverage in the sector are SELLs |

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