Management Commentary on the Q1 FY20 results for IDFC FIRST Bank

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A. Balance Sheet:

1. The funded loan book of the bank was **Rs. 1,12,558 crore as of 30 June 2019** as compared to Rs. 1,10,400 crores as of 31 March 2019. The approach of the bank has been to continue to grow the retail loan book by about Rs. 12,000 to Rs. 14,000 crores and to reduce the growth of the wholesale book by Rs. 10,000 crores. This strategy will help us on two counts:
   a. Ensure our loan book gets diversified.
   b. At the same time liability profile will improve as incremental funding raised from retail deposits during the year will replace the wholesale funding of the bank.

   Our performance during the last two quarters continues to reflect this stated strategy.

Particulars (in Rs Cr)	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Retail Funded Assets	8,208	9,916	36,236	40,812	44,642
Wholesale Funded Assets*	66,982	65,421	68,424	69,589	67,916
Total Funded Assets	75,190	75,337	1,04,660	1,10,400	1,12,558

*including PSL buyouts

As can be seen, the proportion of retail loans as a percentage of total loan book has already increased from **13% pre-merger, to 35% immediately on merger, and has swiftly grown to 40% within two quarters.** While we initially guided that we will grow the retail business to 70% of the loan book within 5 to 6 years, **we are now confident that we will get there before schedule.**

2. Such sustained change of composition from wholesale to retail has been achieved before at Capital First and we plan to continue the same strategy at the bank. At

Capital First, the retail loan book, as percentage of overall loan book, grew continuously and consistently from 10% of the total loan book to 90% within a span of just eight years. During the period of its operation, between March-2010 to Sep-2018, the company never wavered on the strategy and never got distracted into any other direction (such as providing financing to real estate or investment banking, which on the face of it looked very lucrative). This provided Capital First consistency in earnings and consistency in credit performance as well. We are confident that we will continue such focus in growing the retail franchisee at IDFC FIRST Bank.

3. **Strategy:** Essentially, in a nutshell, the strategy for the bank is simple: "**Capital First lending model on a bank liability platform.** "

4. **The Bank has met its priority sector target** as well as target for the sub-segments including the Agriculture, small and marginal farmers and the weaker sections segment. As of 30 June 2019, the Bank is carrying surplus PSL assets as compared to the PSL requirements as per the Banking regulation.

B. Net Interest margin

The net interest margin for the bank **pre-merger was 1.56%.** Immediately on merger this touched 2.89%. The net interest margin has **touched 3.01% in Q1-FY20.** Thus the increase is a sustainable one as the mix of the loan book is changing towards retail. **The NIM would have been 3.15% but for income reversals of Rs. 82 crores on two identified wholesale accounts** (one HFC and another Finance Company, for which adequate provisions have been taken.)

C. Asset quality:

1. **The Gross NPA as of 30 June 2019 was 2.66% and net NPA was 1.35%, compared to 2.43% and 1.27% as of 31 March 2019.**

2. **The asset quality of the retail financing book continues to be stable. The Gross NPA for retail loan book was 2.32% at 30 June 2019 as compared to 2.18% as of 31 March 2019 and the retail Net NPA was at 1.14% as compared to 1.24% as of 31 March 2019.** Such marginal movements in NPA, of few basis points, up or down, from quarter to quarter, is normal in our business. Most of the Retail Loan Book has come from the Capital First business model where the asset quality trends have been consistently good over the 8 years of operation and business cycles.

3. In addition to the above, the bank has identified certain additional exposures as watch-list accounts, and as a prudent practice, has taken provisions against these as appropriate. These are:

   - Two identified accounts (One HFC and one Financial Company). Total exposure: Rs. 1,461 crores. Provisions made: Rs. 1,096 crores. Provision Coverage 75%.
   - One Infrastructure Account. Total Exposure: Rs. 1,006 crores. Provision made: Rs. 154 crores. Provision Coverage 15%. This account is a performing account with tolling concession rights and has strong cash flows, but repaying behind schedule by about 60 days, hence flagged.
   - Other Infrastructure loans: Total Exposure: Rs. 810 crores. Provisions made: Rs. 570 Crores. Provision Coverage: 70%.

D. <u>Liabilities:</u>

1. To grow the retail liabilities, (retail CASA as well as retail term deposits), is the cornerstone of our strategy for the bank.
2. We are happy to report that the bank continues to have excellent success on growth of retail liabilities. The CASA of the bank has grown from **Rs. 6,083 Cr** as of 30 June 2018 to **Rs. 9,987 Cr** as of 30th June 2019 which is a **strong growth of 64% YOY.** Q-o-Q growth is also strong at 10 %.
3. During the quarter, our net CASA grew by Rs. 873 crores. During the release of financial results for March 31, 2019, we had said that our CASA as of Mach 31, 2019 included approximately Rs. 1,000 crores from government banking business which we had stated as rate sensitive and volatile. During this quarter despite this reduction, the CASA grew by the said Rs. 873 crores.
4. The conventional computation of CASA% is CASA / Total deposits (CASA+ Certificate of Deposits+ Term Deposits). Under this conventional computation method, the bank has sharply improved its CASA percentage within six months from 10.37% as of 31st December 2018 (at merger) to 12.93% as of 31st March 2019 and to 15.08% as of 30th June 2019. **Hence CASA % has increased by 471 bps within 6 months.** We have already announced our target to take this to 30% in 5 years. We believe we can get there before the target date.
5. In our case, the bank also has a large proportion of liabilities in the form of other borrowings because of our unique history i.e. IDFC Limited was an infrastructure financing Domestic Financial Institution and Capital First was a retail and MSME financing NBFC. Both entities had institutional borrowings but no retail deposits. Hence we propose to track **Core Retail deposits** (Retail CASA+ Retail Term Deposits) as a proportion of **(Total Deposits as well as borrowings),** and improve on this. On this count of **Core Retail Deposits** too, the bank has sharply improved this number from **7.97%** at the time of merger to **11.72%** as of 30th June 2019, **an increase of 375**

basis points within six months. We plan to take this to 50% within the next 5 years. The Bank is well placed to achieve its target of improving the deposit ratios as targeted in the next 5 years.

6. As of 30th June 2019, the Bank has distribution set up through **279 Bank branches** and **199 ATMs** across India.

7. The cost of funds for the bank reduced from 7.93% (Q4-FY19) to 7.75% (Q1-FY20), primarily driven by the growth of CASA deposits and Retail term Deposits.

E. Capital Adequacy.

1. As of 30th June 2019, the Bank has capital Adequacy Ratio of 14.01% out of which the Tier-1 Capital Adequacy Ratio is 13.88%.

2. The Bank has adequate headroom to raise capital through Tier 2 bonds of about Rs. 7,500 Cr which can increase the Capital Adequacy to about 20%, at June 30 calculations. For the current year, the Bank plans to raise Tier 2 capital of about Rs. 1,500 Cr by March 2020.

3. Further, the Bank has capital buffer in the form of equity stake in various Companies (e.g. National Stock Exchange) and these investments at the current estimated market valuation is estimated to be valued at about Rs. 300 Cr. If these investments are liquidated in due course, it would add to Tier-1 Capital of the Bank and hence improve the overall Capital Adequacy ratio.

4. Since the bank is changing the composition of the loan book by FY 20 but not growing it (Corporate expected to be down Rs. 10,000 crores, and retail expected to be up Rs. 12000-14,000 crores), most of the capital is expected to stay conserved by this year end.

F. Profit and Loss

1. The Net Interest Income (NII) during the quarter grew from Rs. 1,113 crores in Q4-FY19 to Rs. 1,174 crores in Q1-FY20. This is net of reversal of interest accrued of Rs. 82 crores, pertaining to the two identified watch-list accounts (one HFC and one financial services company).

2. The Fee and Other Income from the normal business operations has increased to Rs. 301 Cr in Q1-FY20 as compared to Rs. 291 Cr in Q4-FY19. This includes loan related fees, Trade and Cash management fees, wealth management and third party distribution and debit card, digital transaction fees and such fees.

3. The reported net loss for the quarter was Rs. 617 crores. While announcing the results of Q4-FY19, the bank had identified three accounts as watch-list accounts (One HFC and one Financial Services Company, and one Infrastructure Company). We would like to update the status of these accounts:

    a. On the two identified accounts, we had proactively taken provisions equivalent to 15% of the principal outstanding. However, credit ratings of these accounts deteriorated further during the quarter. Hence, the Bank decided to increase the provision cover on these accounts to 75% of principal outstanding of Rs. 1,461 crores (both accounts put together), amounting to a cumulative cover of Rs. 1,096 crores. We believe that with such provisions, we are adequately covered for any possible losses on these accounts.
    b. During the quarter the infrastructure account continued to perform well. This account has tolling concession rights and has strong cash flows, but repaying behind schedule by about 60 days, hence flagged.

4. We believe the bank is fast moving towards profitability. The erstwhile IDFC Bank had yield of 9.4% and cost of funds of 7.6%, with Spread of 1.7%. On an incremental basis, our retail spreads are between 6-8% with strong and stable asset quality, and therefore the profitability is set to strongly improve from here. This is already demonstrated by continuous improvement in net interest margins on a quarter on quarter basis over the last two quarters at the bank post-merger.

5. We are happy to report that the integration between the two institutions has been completed successfully. HR, systems, people, processes and all other related activities were integrated smoothly, efficiently and skilfully, and there were no disruptions whatsoever in services to customers of both institutions. Further, we are happy to report that we have achieved great success in achieving cost synergies from the merger. The steps taken to achieve this are in implementation and would yield an annualized cost savings of Rs. 361 Cr. The impact of such cost savings have begun to reflect in the P&L on quarterly basis and such savings already being utilized towards investments in new branches.

6. In summary, we are progressing steadfast in our journey of

a. Increase in the retail assets loan book quarter after quarter consistently (retail loan book grew Rs. 3830 crores in Q1 20.
b. Increase in low cost retail liabilities at a fast pace in every quarter. (CASA up 64% YOY substantiates this. Also Casa grew 471 bps in six months since merger)
c. Diversifying the loan book. Retail grew from 35% to 40% within two quarters.
d. Diversifying the liabilities book. Core retail deposits as a percentage of total borrowings grew 375 basis points in six months since merger.
e. Strong margins of 6-8% on incremental loan book. Consequently, consistent growth in net interest margins every quarter.
f. Stable asset quality (excluding the two identified loans to the HFC and the financial company)
g. Transparent communication to all stakeholders
h. High capital adequacy (at 14.01%)

We are achieving great success in the marketplace on all matters pertaining to lending and deposits and feel quite confident that we will meet our five year guidance on most counts comfortably.

We sincerely thank you for your support.