IDFC FIRST Bank

Management Commentary on the Q2 FY20 results for IDFC FIRST Bank

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A. Balance Sheet:

1. The funded loan book of the bank was Rs. 1,07,656 crore as of 30 September 2019 as compared to Rs. 1,12,558 crores as of 30 June 2019. The approach of the bank has been to continue to grow the retail loan book and to moderate the growth of the wholesale book. This strategy will help us to improve our liability profile through incremental funding raised during the year. Our performance during the last two quarters continues to reflect this stated strategy.

Particulars (in Rs Cr)	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Retail Funded Assets	9,916	36,236	40,812	44,642	48,069
Wholesale Funded Assets*	65,421	68,424	69,589	67,916	59,587
Total Funded Assets	75,337	1,04,660	1,10,400	1,12,558	1,07,656

*including PSL buyouts, SRs and Loan Equity

As can be seen, the proportion of retail loans as a percentage of total loan book has increased from 13% pre-merger, to 35% immediately on merger, and has swiftly grown to 45% within the last three quarters. We are confident that we will get to our guidance of 70% retailisation before the period of 5 years guided at the time of merger.

2. Such rapid transformation from wholesale loans to retail loans has been achieved at Capital First before, when retail rose from 10% to 90% in seven years. We are confident that we will continue with sustained focus in growing the retail franchisee at IDFC FIRST Bank.

3. While our Retail Book increased by Rs. 3,427 Cr during the Q2 2018, the wholesale book including the PSL buyouts, Loan Equity and SRs decreased sharply by Rs. 8,329 Cr which resulted an overall Loan Book de-growth of Rs. 4,902 Cr.

4. Specifically, as per strategy, the Infrastructure loan book was reduced by Rs. 3,111 Cr during Q2 FY20, and the Non-Infra Corporate Book reduced by Rs. 3,187 Cr over the previous quarter.

5. The Bank has met its priority sector target as well as target for the sub-segments including the Agriculture segment. During the quarter end on 30 September 2019, the Inorganic PSL buyouts have decreased by Rs. 1,950 Cr but as the retail book grows and organic PSL additions increase, the Bank has been able to carry 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%, which has now increased to 3.43% during Q2 FY 20. This is primarily driven by the increasing proportion of retail loans. We expect this trend to continue.

C. Asset quality:

1. The asset quality of the retail financing book has been stable. The retail Gross NPA during the quarter was 2.31% as compared to 2.32% as of 30 June 2019 and the retail Net NPA was at 1.08% as compared to 1.14% as of 30 June 2019.

2. Most of the Retail Loan Book has come from the Capital First where the asset quality trends have been consistently high over 8 years of operation. We are happy to share that the asset quality of the retail book has been stress tested many times during the last nine years through periods of high inflation (2010-2014), demonetization (2016), GST implementation (2017). Each of these events were significant events and get the asset quality remained stable, which gives us the confidence in our business model. We continue to refine and improve our underwriting skills every month.

3. The bank has identified certain additional exposures as watch-list accounts under stressed, and as a prudent practice, has taken provisions against these as appropriate. These are:

    - Two identified Financial Services Accounts (One HFC and one Financial Company). Total exposure: Rs. 1,231 crores. Provisions made: Rs. 923 crores. Provision Coverage 75%.
    - One Tolling concession Infrastructure Account. Total Exposure: Rs. 985 crores. Provision made: Rs. 154 crores. Provision Coverage 15%. This account is a

performing Tolling concession Road with strong cash flows but repaying behind schedule, hence this account has been flagged.

- Other Legacy Infrastructure loans: Total Exposure: Rs. 776 crores. Provisions made: Rs. 540 Crores. Provision Coverage: 70%.

D. Liabilities:

1. To grow the retail liabilities, both for retail CASA as well as retail term deposits, is the cornerstone of our strategy.
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. 6,253 Cr as of 30 September 2018 to Rs. 12,473 Cr, an increase of 99%. CASA balance increased by 30% on Q-o-Q basis.
3. The above calculations exclude CASA of Rs. 2,614 Cr which pertains to one government banking account which we are aware is temporary in nature and hence excluded from the calculations.
4. CASA % has increased from
   - 8.68% as of 31st December 2018 (at merger) to
   - 11.40% as of 31st March 2019, to
   - 14.57% as of 30th June 2019 and to
   - 18.70% as of 30th September 2019.

   We have already announced our target to take this to 30% in 5 year but we believe we can comfortably get there before the target date. The performance in the last three quarters has strengthened our confidence (all the numbers above exclude the one government banking account which leaves short-term savings deposits with us only for a few days usually at month ends).

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 improve the Core Retail Deposits (Retail CASA+ Retail Term Deposits) as a proportion of Total Deposits and Borrowings, and track ourselves for this. On this count too, the bank has sharply improved the liability profile as follows:

   This number increased from
   - 8.04% at the time of merger to
   - 11.75% as of 30th June 2019 and
   - 16.72% as of 30th September 2019.

We plan to take this to 50% within the next 5 years. The Bank is well placed to achieve these targets.

The Retail Term Deposits have grown by Rs. 3,252 Cr over the quarter ended 30 June 2019. This was a Q-o-Q increase 32% and Y-o-Y increase of 110%.

6. As of 30th June 2019, the Bank has distribution set up through 351 Bank branches and 216 ATMs across India.
7. The legacy long-term bonds inherited from IDFC limited has reduced from Rs. 16,385 crore as on 31st December 2018 to Rs. 13,452 crore, a drop of Rs. 2,932 crore within 9 months. We expect this will wind down to NIL over the next 6 years.
8. The cost of funds for the bank reduced from 7.75% (Q1-FY20) to 7.71% (Q2-FY20), primarily driven by the growth of CASA deposits and Retail term Deposits.

E. <u>Liquidity:</u>

The bank is highly liquid and is getting retail casa and retail deposits at a pace more than the normal business requirements of the bank. During the quarter ended on 30th September 2019, the overall loan book shrunk by Rs. 4,902 crore releasing cash of such amount to the bank. In addition to this, the bank raised Rs. 5,956 crores in retail casa and retail term deposits during the quarter, which are sticky and sustainable deposits for the Bank. The bank has used such surplus liquidity to reduce the dependency on wholesale deposits and borrowings, i.e. certificates of deposits reduced by Rs. 4,775 crore during last quarter.

Since 31 March 2019, the certificates of deposit balance has come down from Rs. 28,754 crore as on 31 March 2019 to Rs. 15,283 crore as of 30 September 2019, a reduction of Rs. 13,471 crore. Such limits are still available with the bank for drawing down as per rating. The bank enjoys limits of Rs. 40,000 crores by rating agencies of Certificate of Deposits (CD) and thus with Rs. 25,000 crore of limits on account of certificates of deposits continue to be unleashed. The bank enjoys a high long term credit and highest short term credit rating. The bank continues to enjoy high confidence in the market for our products and services with regard to savings accounts, current accounts and wealth management solutions which are a hit in the market and continue to grow rapidly.

The liquidity coverage ratio of the Bank as of 30 September 2019 is 125% which is much higher than the regulatory requirement of 100%.

F. <u>Capital Adequacy.</u>

1. As of 30th September 2019, the Bank has capital Adequacy Ratio of 14.65% out of which the Tier-1 Capital Adequacy Ratio is 14.51%. The Bank has de-grown its overall loan book due to the reduction in Wholesale Loans which has helped the Bank to conserve and utilize its Capital better.

G. Profit and Loss

1. The Net Interest Income (NII) during the quarter grew from Rs. 1,174 crores in Q1-FY20 to Rs. 1,363 crores in Q2-FY20, primarily driven by the growth in the retail loan book. Last quarter, the Bank reversed interest earning of Rs. 82 Cr pertaining to stressed assets out of which Rs. 53 Cr was for the quarter ended on 30 June 2019. Without the effect of one-time adjustments, the NII grew by 11% on Q-o-Q basis.

2. The Fee and Other Income from the normal business operations has increased from Rs. 301 Cr in Q1-FY20 to Rs. 335 Cr in Q2-FY20, an increase of 11% on Q-o-Q basis. 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 Bank's pre-provisioning profit has increased from Rs. 318 Cr in Q1-FY20 to Rs. 417 Cr in Q2-FY20 and the cost to income ratio has improved from 78.60% for Q1-FY20 to 75.61% in Q2-FY20, despite the heavy investments in branches as the Bank added 72 branches in Q2-FY20.

4. The Profit before Tax for the Bank has increased from a loss of Rs. 963 Cr in Q1-FY20 to Rs. 100 Cr in Q2-FY20. There were certain one-time write-backs and certain slippages on legacy infrastructure account during the quarter. We estimate that the core profit before tax net of all such movements was about ₹ 60 crore.

5. The Bank decided to exercise option permitted under section 115BAA of the Income Tax Act, 1961 introduced by the Taxation Law Amendment Ordinance, 2019 and accordingly measured the Income tax for the quarter and half-year ended on 30 September 2019 as well as re-measured the Deferred Tax Assets. The full impact of this change has been incorporated in the tax line of the Profit & Loss Statement. Hence, the Bank reported net loss (after tax) of Rs. 680 Cr for the quarter ended on 30 September 2019.

H. Impact of the change in corporate tax rate on the deferred tax balances and capital adequacy ratio

The Taxation Laws (Amendment) Ordinance, 2019 was promulgated on September 20, 2019. The Ordinance amends the Income Tax Act, 1961, and the Finance (No. 2) Act, 2019. The Ordinance provides domestic companies with an option to opt for lower tax rate of 25.17%, provided they do not claim certain deductions/ exemptions. Hitherto, the maximum marginal rate of tax applicable to the Bank has been 34.944%. The Bank has chosen to shift to the lower tax rate of 25.17% to its income for financial year 2019-20.

In accordance with the applicable accounting standards, based on the lower applicable tax rate, the Bank is required to restate its deferred tax assets ('DTA') standing as on March 31, 2019 and the deferred tax created during Q1 of FY 19-20. Accordingly, the DTA balance of Rs 2,519 Crore standing as on March 31, 2019 has been restated to Rs 1,839 Crore, thereby resulting in a write down of Rs 679 Crore. Further, the DTA created during Q1 FY 19-20 of Rs 346 Crore has been written down by around Rs 72 Crore to give effect to the downward revision in tax rate. Overall, the reduction in tax rate has resulted in a DTA write down of around Rs 751 Crore. The tax for Q2 FY 19-20 has been computed basis the revised tax rate of 25.17%.