Management Commentary on the Q3 FY20 results for IDFC FIRST Bank

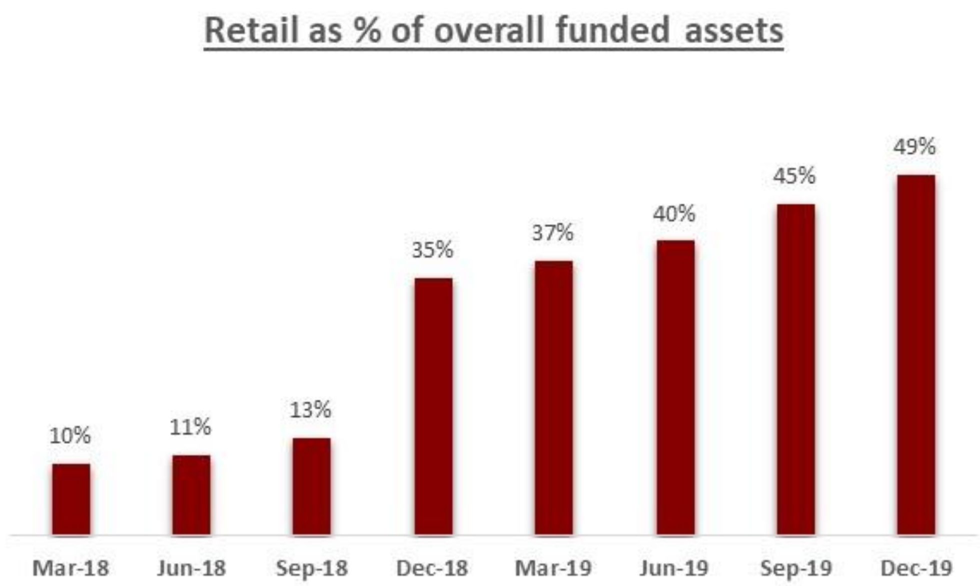
Disclaimer: This note is subject to our disclaimers as mentioned in page 2 of the investor presentation uploaded on the website of the bank.

1. The funded loan book of the bank was Rs. 1,06,140 Crore as of 31 December 2019 as compared to Rs. 1,07,656 crores as of 30 September 2019. As per the stated approach, the bank grew the retail loan book by Rs. 3,437 Crore and reduced the wholesale book by Rs. 4,953 Crore. 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	Dec-19
Retail Funded Loan Assets	9,916	36,236	40,812	44,642	48,069	51,506
Wholesale Funded Loan Assets*	65,421	68,424	69,589	67,916	59,587	54,634
Total Funded Loan Assets	75,337	1,04,660	1,10,400	1,12,558	1,07,656	1,06,140

*including PSL buyouts, SRs and Loan Equity

a. The proportion of retail loans as a percentage of total loan book has swiftly increased from 13% pre-merger to 49% within four quarters.

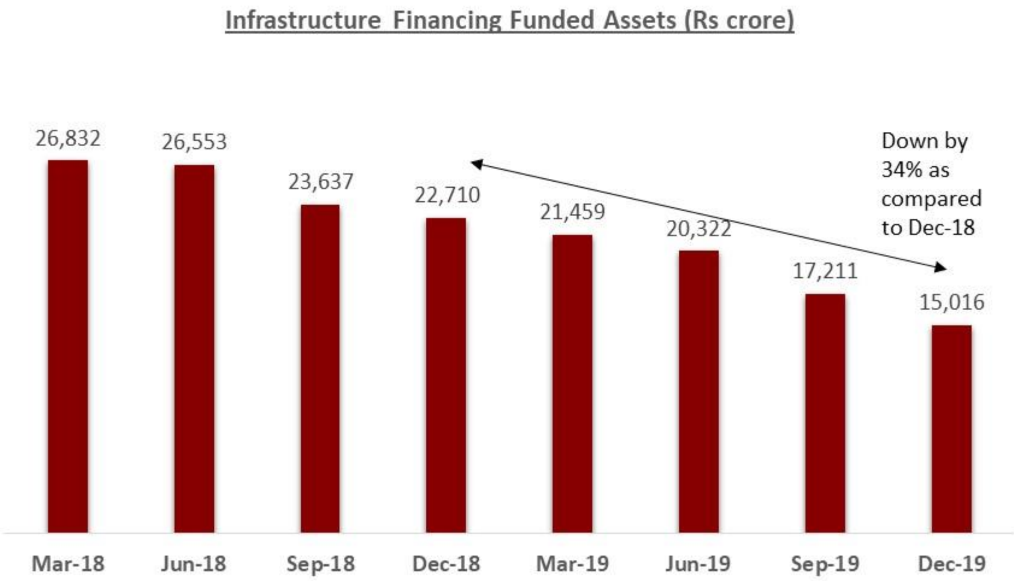


b. We have guided to achieve target retailization of 70% within 5 years but are confident of getting there ahead of time.

c. This is the same strategy that was earlier used at Capital First where the wholesale book was brought down from 90% to 10% in seven years and retail book increased from 10% to 90%

d. At merger in December 2018 the new management had stated intention to reduce infrastructure loan book to ZERO in five years.

e. Keeping in line with this, the infrastructure loan book was reduced by Rs. 2,196 Crore during Q3 FY20. The infrastructure loan book has been successfully reduced by Rs. 7,695 Crore in the last 4 quarters, a reduction of 34% within 1 year. The infrastructure book was Rs. 22,710 Crore at merger.



f. The Bank has met its priority sector target as well as target for the sub-segments including the Agriculture segment and target for small and marginal farmers. Since we are a new bank with a large wholesale and infrastructure book, the bank used to rely on buyouts to meet PSL requirements. Post the merger, the bank is developing strong capabilities to originate PSL compliant assets on its own and the dependency on buyouts is reducing every quarter.

2. **Net Interest margin (NII/ Average interest earning assets):** The net interest margin has significantly increased from 1.56% at pre-merger stage to 3.86% during Q3 FY 20. This excludes one non-recurring income of Interest on IT refund of Rs. 38 Crore which was recognized in the NII line.

   a. The NII growth is a result of steady growth in retail loans. We expect this trend to continue. NII has increased by 34% from Rs. 1,145 crores for Q3 FY19 to Rs. 1,534 crores in Q3 FY20.

3. **Asset quality:**

a. We recognise that the NPA in the banking system have risen significantly during the last decade. The GNPA and NNPA for the Banking System (all scheduled commercial banks) in India is 9.3% and 3.7% respectively (as of 30 September 2019). The Gross NPA % for our bank was 2.83% and the net NPA was 1.23% as of December 31, 2019 as compared to 2.62% (Gross) and 1.17% (net) as of September 30, 2019. The bank is closely monitoring all accounts that are behind schedule.

b. Since the retail loan growth is the significant driver of the overall growth and business model going forward, we would like to report the NPA% levels pertaining to the retail loan book of our Bank. For the retail loan book, the Gross NPA reduced marginally and stood at 2.26% as compared to 2.31% as of 30 September 2019 and the retail Net NPA% was 1.06% as compared to 1.08% as of 30 September 2019. Such marginal movements quarter on quarter, whether up or down, is normal in our business.

Particulars	Mar-19	Jun-19	Sep-19	Dec-19
Retail Loan GNPA%	2.18%	2.32%	2.31%	2.26%
Retail Loan NNPA%	1.24%	1.14%	1.08%	1.06%
Provision Coverage %	43%	51%	53%	53%

4. **Watchlist accounts:**

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

a. Companies (Legacy Accounts) affected by recent developments

i. Two identified Financial Services Accounts (One HFC and one Financial Company).

- Total exposure: Rs. 1,234 crores.
- Provisions made: Rs. 925 crores.
- The two companies have been under financial stress and the housing financing company case has been moved to NCLT during the last quarter.
- Provision Coverage 75%.

ii. <u>One South India based Logistics Company (Legacy Account):</u> The Company has been under financial stress at the group level since July 2019.
   - The Bank has Rs. 100 Crore exposure
   - Maintains a provision of Rs. 53 Crore provision against the same since last quarter,
   - P<u>rovision coverage 53%.</u>

b. <u>One Tolling Concession Infrastructure Account (Legacy Infrastructure Account).</u>
   - Total Exposure: Rs. 963 crores.
   - Provision made: Rs. 154 crores.
   - This account is a performing Tolling concession Road with strong cash flows but repaying behind schedule and is in SMA 2 category.
   - The principal outstanding balance has reduced by Rs 22 Crore during the quarter ended 31 December 2019. <u>Provision Coverage 16%.</u>

c. <u>Other Legacy Infrastructure loans under watch-list:</u>
   - There are other infrastructure loan assets including wind energy projects, thermal energy project and toll roads totalling up to Rs. 852 Crore
   - These have been kept under watch due to the nature of the assets and the current situations in the respective cases.
   - The bank has a provision of Rs. 604 Crore against these assets.
   - <u>Provision coverage 71%.</u>

d. <u>Restructured but performing infrastructure accounts under watch-list:</u>
   - There are a few Toll Projects and one Coal Power project where the total exposure was Rs. 339 Crore as of 31 December 2019.
   - They have broadly been repaying on schedule, but delays may be expected in future, hence flagged.
   - The Bank carries provisions of Rs. 38 Crore against the exposure.
   - <u>Provision Coverage 11%.</u>

Over the quarters, the total outstanding exposure in all these watch-list accounts has gradually come down and the provisioning has remained stable. This has improved the provision coverage ratio over the last few quarters.

Stressed Assets under watch ***Funded Exposure (Rs crore)***	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**
1. Legacy Accounts affected by recent development (HFC, financial services & logistics)	1,874	1,567	1,336	1,334
2. Legacy Toll Infrastructure Account	1,026	1,006	985	963
3. Other Legacy Infrastructure Accounts under watch list	866	863	858	852
4. Legacy restructured but performing accounts	339	337	333	339
Total Outstanding (Rs crore)	**4,106**	**3,772**	**3,513**	**3,487**
Total Provisions (Rs crore)	**912**	**1,786**	**1,663**	**1,773**
Provision Coverage %	**22%**	**47%**	**47%**	**51%**

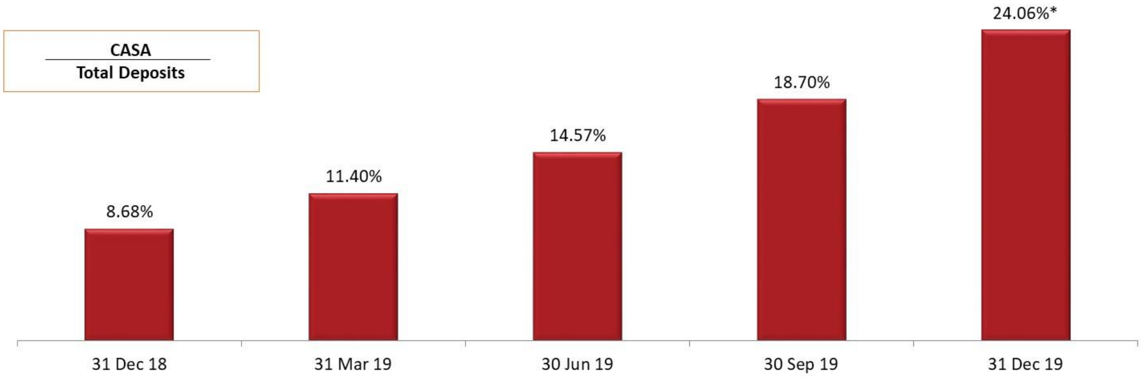
5. Liabilities:

a. Growing retail CASA and Term Deposits, is the cornerstone of our strategy.

b. 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. 5,274 Crore as of 31 December 2018 to Rs. 16,204 Crore. CASA balance increased by 30% on Q-o-Q basis.

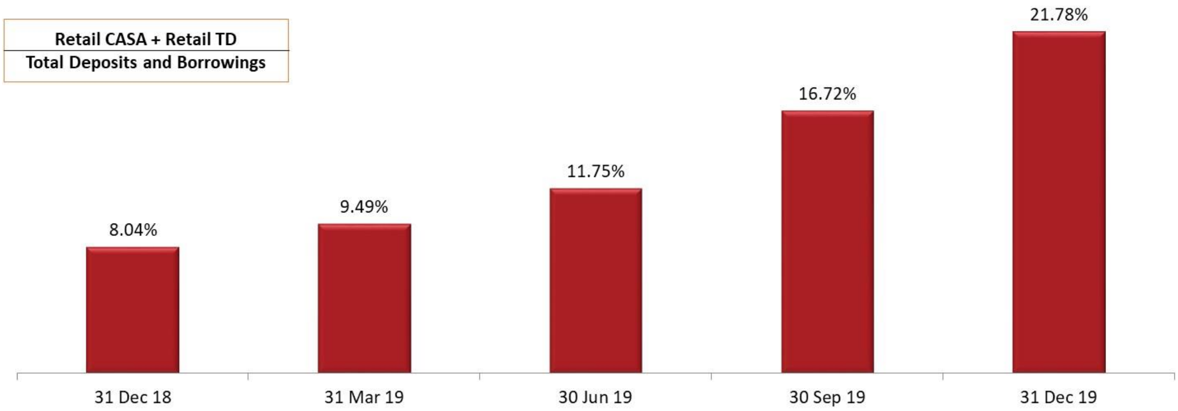
c. The above calculations exclude CASA of Rs. 1,346 Crore* which pertains to one government banking account which we are aware is temporary in nature and hence excluded from the calculations. This arrangement would expire in June 2020 and it would reduce the overall cost of funds.

d. This has improved the CASA ratio significantly over the last 4 quarters.



**This is excluding CASA deposits of Rs. 1,346 Cr from one government banking account which is non-sustainable in nature with fluctuating balance. This was a special deal which would expire in June 2020. Including this, the CASA to total deposits ratio would have been 25.55%.*

e. 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 as they are more sustainable and sticky in nature, and track ourselves for this. On this count too, the bank has sharply improved the liability profile as this ratio has improved from 8.04% as on 31 Dec 2018 (when the merger got consummated) to 21.78% as on 31 Dec 2019.



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

f. As of 31st December 2019, the Bank has distribution set up through 424 Bank branches and 272 ATMs across India.

g. The legacy long-term bonds inherited from IDFC limited has reduced from Rs. 16,385 crore as on 31st December 2018 to Rs. 12,705 crore, a drop of Rs. 3,680 crore within 12 months. We expect this will wind down to NIL over the next 6 years.

h. The cost of funds for the bank reduced from 7.71% (Q2-FY20) to 7.64% (Q3-FY20), primarily driven by the growth of CASA deposits and Retail Term Deposits.

6. **Liquidity:**

The bank is highly liquid and is getting Retail CASA and Retail Term Deposits at a pace more than the business requirements of the bank. During the quarter ended on 31st December 2019, the overall loan book shrunk by Rs. 1,516 crore releasing cash of equal amount to the bank. In addition, the bank raised Rs. 6,638 crores in retail casa and retail term deposits during Q3 20, which are sticky and sustainable deposits for the Bank resulting in overall surplus of liquidity.

Since merger, the bank has increased retail casa and retail term deposit balance by 18,866 crore from Rs. 10,400 crore to Rs. 29,267 crore. Since the loan book has not grown in this period, such surplus has been used to repay and reduce the corporate deposits and borrowings. The reduction in such corporate deposits and borrowings are shown below -

Particulars (in Rs crore)	Post – Merger					Reduction
	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Since Dec-18
Legacy Long Term Bonds	*16,385*	*15,752*	*13,865*	*13,452*	*12,705*	*3,680*
Other Borrowings (Incl. erstwhile CFL)	*27,388*	*23,256*	*23,966*	*18,996*	*15,196*	*12,192*
Wholesale Term Deposits	*25,577*	*23,842*	*25,885*	*25,403*	*21,719*	*3,858*
Certificate of Deposits	*22,312*	*28,754*	*20,058*	*15,283*	*12,720*	*9,592*
Total	**91,662**	**91604**	**83774**	**73134**	**62,340**	**29,322**

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 Bank has sanctions and rating for raising funds through Certificate of Deposits worth Rs. 45,000 crore but has utilized only Rs. 12,700 crore as of 31 Dec 2019. This provides a sufficient headroom to manage the liquidity by raising short term funds. The Bank has been creating a strong franchisee for the retail deposits, the dependency on instruments like Certificate of Deposits has come down. As can be seen in the table above, the Certificate of Deposit balance has come down by Rs. 9,592 crore from Rs. 22,312 crore as on 31 Dec 2018 to Rs. 12,720 crore as on 31 Dec 2019.

7. **Capital Adequacy.**

   a. As of 31st December 2019, the Bank has capital Adequacy Ratio of 13.29% out of which the Tier-1 Capital Adequacy Ratio is 13.28%.

b. The strategy of the bank has been to conserve capital by not increasing the loan book and yet increase margins by growing the proportion of retail book. We expect to continue to conserve capital in the future too.

8. Profit and Loss

a. The Net Interest Income (NII) during the quarter grew from Rs. 1,363 crores in Q2-FY20 to Rs. 1,534 crores in Q3-FY20, primarily driven by the growth in the retail loan book. The NII grew by 13% on Q-o-Q basis.

b. The Fee and Other Income from the normal business operations has increased from Rs. 335 Crore in Q2-FY20 to Rs. 413 Crore in Q2-FY20, an increase of 23% 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.

c. The Bank's pre-provisioning profit has increased from Rs. 418 Crore in Q2-FY20 to Rs. 682 Crore in Q3-FY20.

d. The cost to income ratio has improved from 76.24% for Q2-FY20 to 73.52% in Q3-FY20, despite the heavy investments in branches as the Bank added 73 branches in Q3-FY20. (The bank made treasure trading gain of Rs. 166 crore this quarter which are not predictable on Q-o-Q basis and are not considered in income for C/I as we don't consider these as core repeatable income).

e. The Bank has a legacy exposure of Rs. 3,244 crore to an identified telecom company of which Rs. 2,000 crore is in the form of non-convertible debentures and Rs. 1,244 crore is in the form of non-funded exposure (Bank Guarantees) for spectrum. There has been no payment default so far from this telecom company or any other telecom company to the Bank. Still, considering the current economic situation and financial stress in the telecom companies related to the payments due to the Government, the Bank has taken 50% provisioning to the total exposure to this identified telecom company during the quarter ended on December 31, 2019. The bank also provided Rs. 110 crores of additional provision towards one legacy thermal power infrastructure account.

f. The Profit before Tax for the Bank has decreased from Rs. 100 Crore in Q2-FY20 to Loss Before Tax of Rs. 1,623 Crore in Q3-FY20. This was primarily because of additional provisioning taken during the quarter towards the above mentioned identified telecom services account to the extent of 50% of the total exposure on them. The Net Loss for Q3 FY20 was Rs. 1,639 crores. We believe the government is interested in solving the issues related to the sector going forward but the timelines for the same is still uncertain.

We believe a significant portion of the issues on the infrastructure credit side are behind us. We would now like to look ahead towards the enormous opportunities in India, and coupled with the significant strengths we have developed in our chosen areas of business over the last decade.