Message from the MD and CEO

A New Beginning

We plan to implant the erstwhile Capital First's tried and tested model of financing small entrepreneurs and consumers [a retail franchise, growing at 29% per annum and 5-year profit CAGR of 55%, (FY18 PAT grew by 37%)], on a bank platform, (IDFC Bank's strong branch network of 242 and growing, excellent technology stack, quality internet and mobile banking, and strong rural presence).

V. Vaidyanathan
Managing Director & CEO,
IDFC FIRST Bank Limited

Dear fellow Shareholders,

It is my great privilege to write this letter to you all. As the first MD and CEO of the newly merged entity IDFC FIRST Bank, I wanted to share our thoughts about our approach going forward, our vision, mission, our founding theme and what we want to achieve.

Since this is my first note to you, I am also sharing with you what really happened behind-the-scenes at my end that led me here, and the sequence of events that culminated in the creation of IDFC FIRST Bank.

In 2004, RBI announced two new bank licences for Kotak Bank and Yes Bank. I was with my colleagues at ICICI Bank when the news broke and instinctively exclaimed to my colleagues "Let's go to the RBI and ask for a bank licence too!." I figured that it was an impractical idea for an individual to apply for a bank licence, yet the thought stayed.

A year later, I was inaugurating an MCHI Property exhibition, and one of the stalls we passed by was of a palmist. My friends from ICICI remind me to this date that I asked the palmist in jest "When will I get a bank licence"! Jest it might have been, but it did reveal a wish nevertheless. The following year, in 2006, I joined the ICICI Bank Board of Directors and such ideas went into cold storage only to come back a few years later in 2010.

The Plan: The issue was - how do I get started? So I came across a simple idea - start an NBFC where entry licence conditions are relatively easier, finance small entrepreneurs and new-to-credit customers, and, hope to succeed and approach RBI for a banking licence someday. Pursuing this theme, I came across an existing NBFC, so I decided to acquire a stake in it, and give the idea a go. It was a long shot but an exciting thought.

And whom would we lend to? Since I was heading retail banking, the idea was to build a bank doing just that - retail banking. Thousands of small entrepreneurs all around us (shopkeepers, kirana shops, auto mechanics, dentists etc.) could not avail credit from the formal financial system because of not filing income tax returns, but usually had a strong cash-flow or sound business model

"The founding years, which I call the next five years, are particularly important, as the DNA we establish now will be hard to correct later. We will make every effort to sell the right products to customers, avoid mis-selling, avoid selling such third-party products that make wonderful fees for us but at the cost of expensive products for the customer. If we make a mistake, we will apologise and correct it. After all, we do not want to take this Bank to great heights in profits and profitability while having earned any penny that truly does not belong to us."

since generations. Further, the middle class was beginning to borrow for consumption. The thought was to provide finance for their businesses, and for buying homes, cars and consumption to the less organised. I thought of this as a big need, and a great opportunity. (Post-merger with IDFC Bank, our new banking platform offers opportunities to expand the scope of technology solutions to medium and large entrepreneurs and these too are great opportunities. This was not part of the plan then in 2010, though).

I got an opportunity for this plan in 2010. The NBFC I got involved with was a loss-making one, it had made losses of ₹ 30 crore & ₹ 32 crore in the prior two years respectively. But it saved time in getting access to a NBFC licence. So over time I acquired significant equity stakes in the company mostly through personal leverage. We shut down unrelated businesses like foreign exchange, broking, asset management and wealth management, and instead started consumer and small business financing in the entity as part of the longer plan.

It was the hardest five years of my life professionally. Raising debt funding was difficult for a start-up loss making entity, and when it was available after a lot of follow-up, it was expensive - we were borrowing at Base Rate plus 500 bps (about 14% rate of interest in today's terms), and we lent upwards of 20%. Bit by bit, bank by bank, we borrowed ₹ 1,000 crore, and started building the loan book. I got the timing all wrong because during this period, the growth rate of the Indian economy was falling precipitously by the quarter from 10% to 5%, inflation was high (9-10%), and the RBI was raising interest rates - they raised it 16 times at a stretch. I didn't know where to spend my time - there was so much to cover - we had to raise debt, raise equity, build business, hire people, build relationships, build technology stack, report quarterly results, make pitches, manage environment and media and so on. Fortunately, our team was great and each one of them put in extraordinary effort to deliver on these.

And there were always dilemmas whether to build business or slow it down, grow out of trouble or play conservative, focus on cost of funds or quantity, focus on immediate profits for the sake of stakeholders or to invest for the future, to book securitisation profits upfront or amortise it, to buy a stack or make it, greenfield research or off-the-stack models and so on. These decisions look easy when working for a MNC, or a large profitable institution, but not so when you are small, loss making and depend on the courtesy of the markets.

But one thing was clear: the target customer segment - it was the unorganised, underserved segment, by using technology. They would pay us the rates as appropriate to our borrowing costs. It was riskier to lend to, so we had to discover new ways to lend with greenfield research, sans tax returns. Over 50% of our target customers were not on the credit bureau as no one in the formal sector had lent to them. So we had to be extra careful.

The Take-off: The idea took off well; within a year, the retail loan book grew from ₹ 94 crore to ₹ 770 crore and we had the desired proof of concept to show to potential equity investors. We were running out of equity and our maiden attempt to raise equity through QIP had failed to take off. Then by the turn of certain circumstances, I learnt there was another way to raise equity - Private Equity. Meanwhile we raised more debt of ₹ 2,000 crore, and took the loan book to ₹ 2,700 crore by 2012. After countless presentations for over a year to all major PE players

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demonstrating the proof of concept, we won the backing of ₹ 810 crore in 2012 from Warburg Pincus.

Selling the idea to a backer was not enough, there were too many approvals to take: from the RBI, SEBI (for Open Offer), FIPB, lenders, shareholders, Forward Markets Commission and so on. The day ₹ 810 crore clinked in the bank account on September 29, 2012, I asked the CFO three times over the phone to check if it was true. We had been racing against time for this. That night I couldn't sleep, it was a great escape.

What followed was a fund raise at ₹ 162 a share in 2012, another equity raise at ₹ 153 a share in 2014, another one at ₹ 390 a share in 2015 and one at ₹ 712 a share in early 2017!

Leveraged Management Buyouts are not uncommon in the West, but in India, this was one of the rare ones. We got a new Board, and new shareholders. We recapitalised the company with a Preferential Allotment followed with a QIP, created a new entity and brand called Capital First. The business continued to grow between at 25% plus YoY.

The soft landing: Within just seven years into 2017, we grew retail loans from ₹ 94 crore to ₹ 18,353 crore in March 2017. We became a strong brand name in the consumer financing segment. The best part was that our asset quality was pristine all through these years. The Gross consistently low at 2% and Net NPA stayed below 1% all through. Our market cap jumped 10X from ₹ 780 crore to over ₹ 7,800 crore between March 2012 and March 2017. I then sold 1.5% of the company in March 2017 to close the loan I had availed to acquire the stake in the beginning. While this was playing out, I had also been trying to figure ways for a commercial banking licence for Capital First. By this time, the RBI had announced norms for on-tap banking licences for eligible entities.

The dynamic IDFC Group: Meanwhile, in parallel, by strong coincidence, a great story was playing out at the IDFC Group under Dr. Lall's dynamic leadership. Under his leadership, IDFC Limited, which was primarily into infrastructure financing, had successfully expanded into Asset Management (acquiring Standard Chartered AMC), Alternative Asset Management (infrastructure Focussed), Securities (acquiring SSKI) and Investment Banking.

IDFC Limited became a highly successful and diversified group under his leadership. The loan book grew from ₹ 21,000 crore in 2009 to ₹ 57,000 crore in 2013, with strong growth in PAT.

But Dr. Lall's extraordinary foresight told him that life as an infrastructure financing company had its limitations, particularly if markets turned hostile to infrastructure. So IDFC Limited had applied for and successfully acquired a banking licence in 2014. The Bank was successfully launched in 2015 and had already set up 17 urban and 83 rural branches, and more were rolling out in the pipeline by the time Dr. Lall reached me in November 2017.

I recently got an opportunity to see IDFC Limited's banking licence application to RBI. It's a masterpiece. Getting a banking licence in India is not an easy task in India; and it was the greatest accomplishment for Dr. Lall to get one for the infrastructure lending group. It says a lot about his foresight, his calm demeanour, his ability to surmount odds, his diplomacy, and the highest levels of corporate governance he imbibed into IDFC, that the RBI found it fit and proper to award a licence to the IDFC Group.

The value proposition was straightforward for both of us. IDFC Bank needed to retailise the loan book away from infrastructure. Building retail financing takes years or decades. Capital First fit the bill perfectly as a merger partner as the retail lending franchise was already built, the last-mile connectivity was built, intellectual property created and the loan book was large at over ₹ 22,000 crore (Sep 17). Not just that, the loan book was seasoned over cycles through seven years. It was a one-shot fast forwarding for IDFC Bank's diversification.

From Capital First's point of view, it got access to the banking licence. At the time we met, IDFC Bank already had a branch network, had great people, had already launched many unique products and services in the market, had great corporate governance, and the platform was already built for a scale-up on the liabilities side. Liabilities - that's all we needed! It was straightaway fast forward for the banking licence plan. Once we met and agreed, both parties quickly appointed lawyers, started financial and legal due diligence on each other, appointed the bankers, all in extreme secrecy.

When we were meeting in secrecy, we reminded each other of a little story. When our QIP had failed in 2011, I had called on Dr. Lall with a request to him to provide us a Subordinated Debt loan of ₹ 200 crore - he had politely declined the loan as it was a risky proposition! I told him a little secret, even Mr. Parekh had declined the same proposal so did many more!

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I am quite confident that once we see through this investment phase (expansion of branch network, retailising assets, retailising liabilities), barring unforeseen circumstances, the Bank is set for a continuous and one-way growth in profitability from thereon.

We both had a hearty laugh over our little secret!

The merger announcement: We announced the deal to the markets on January 13, 2018. What followed was another high octane year. Dr. Lall, myself and the respective teams got steadfastly working on putting the merger together. The teams spent time seeking approvals from the Competition Commission of India, Stock Exchanges, SEBI, RBI, creditors, shareholders and NCLT, and other such approvals.

Often, these approvals were contingent on approvals from other parties. I must say that every single entity we approached during this period for approvals was pretty straightforward in their approach and facilitative of the process. Despite the fact that the integration was such a complex act involving a NBFC and a bank, involving regulators, dealing with Companies Act, Banking Regulations, legal issues and other such, the processes went smoothly and I must say to other observers of our country that we are one of the finest places to do business in.

We formally merged on December 18, 2018, and a new entity was founded by the merger, IDFC FIRST Bank. As a result of the work of Dr. Lall and the entire team, 99.98% of IDFC Bank Shareholders and 99.90% of Capital First Shareholders by value approved the transaction. Investment bankers said near 100% approval rates were "astonishing", "extraordinary" and "unprecedented", considering that the two entities were publicly listed and widely traded companies together with near 8,00,000 shareholders.

This was not the first time I had gone through such an experience. Earlier, when Capital First was founded, then too, it involved an open offer, fresh equity raise, preferential allotment, change of ownership, change of brand name, FIPB approval for FDI and so on. But I do believe that doing business in India has become easier over the years.

Our challenges were not these alone. It also involved putting together, merging and evolving the best architecture, and bringing the best of both institutions together. It involved integrating people, varied processes, credit policies, premises, customer segments, strategy, operations, treasury and so on. Putting these pieces together has been back-breaking work for the integration team, and it has been my greatest privilege to have had this opportunity of leading the integration of the two organisations, and to create a new composite, forward-looking bank.

The two institutions bring extraordinary strengths to the table. Both companies had high levels of corporate governance, extremely professional people and energetic staff. The complementarities are obvious and explained elsewhere in this report.

The New business model: The easiest way to understand the new business model is as follows. We plan to implant the erstwhile Capital First's tried and tested model of financing small entrepreneurs and consumers [a retail franchise, growing at 29% per annum and profits 5-year CAGR of 55%, (FY18 PAT grew by 37%)], on a bank platform, (IDFC Bank's strong branch network of 242 and growing, excellent technology stack, quality internet and mobile banking, and strong rural presence). We will also find cutting edge solutions for larger entrepreneurs and corporates and customise technology solutions to meet their needs for trade, forex, credit, deposits, and payments.

The Challenges: A number of research reports including those by reputed entities such as Credit Suisse, Deutsche Bank and Morgan Stanley have pointed out that the bank faces many uphill tasks on profitability

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Our new bank has a new vision. We want to create the world's best bank, right here in India, for aspiring Consumers and for Entrepreneurs

and liabilities. I don't deny these challenges, also thank them for their efforts to research us. For instance, Morgan Stanley's report read "IDFC has one of the weakest retail liability franchises and one of the lowest share of retail loans among peers." CNBC says the issue of low CASA will be hardest to fix. Deutsche Bank says the bank has a large loan book at over ₹ 1,00,000 crore and low CASA of ₹ 6,500 crore. Negligible CASA will have a very long gestation period." "Building CASA will be a costly and long journey: Credit Suisse"

Of course, we understand this issue, and we are determined to fix it. The only way to address this issue is to grow CASA faster than the growth of the loan book. Our liability products are already a hit in the marketplace and I think we will surprise you on the upside.

"Large infra book related issues": says Deutsche Bank. Our response - this will wind down over time to NIL. We are not doing this anymore.

"A very high opex ratio (79%) should keep returns depressed for a long time." "Low core profitability" are other concerns by research agencies. However, I'm sure this too will get fixed. The compounding power of a finely tuned retail lending machine coupled with low cost of funds of a bank is phenomenal. The margins have already increased from 1.7% to 3.03% as a result of the merger. It will increase year-on-year, you can see the trend in eight quarters.

We are going to invest in setting up a large branch network across the country over the next two years. This may appear to put pressure on the P&L but I assure you these are table stakes to be able to play a long-term game in banking as a large bank in India. I am quite confident that once we see through this phase, barring unforeseen circumstances, the bank is set for a continuous and one-way growth in profitability from thereon.

I have experienced the same situation before. The company I was associated with earlier had posted losses of ₹ 30 crore and ₹ 32 crore. It took two years to put all the building blocks in place, develop intellectual properties and gather momentum. But once the core profit (core NII + Core Fees less operating expenses less normalised credit losses) turned positive to ₹ 37 crore in 2013, there was no looking back as profits compounded at 55% straight for the next five to take us to ₹ 328 crore and yet compounding at 37%, at the time of the merger. I believe it is very much possible to do it again.

We want to touch the lives of millions of Indians in a positive way by providing high quality banking services to them, with particular focus on aspiring consumers and entrepreneurs of our new India, using contemporary technologies

Plans: I have guided for the following simple strategy. Grow CASA % from 10% to 30%, grow retail deposits (CASA +TD) as % of total borrowings from 10% to 50%, grow retail loan book as % of total loan book from 35% to 70%, reduce infrastructure loans from 22% to 0%, reduce Cost to income ratio from 80% to 55%, grow branches from 200 to 800, grow NIM from 3% to 5%, all in five years. In short, build franchise, diversify liabilities, diversify assets, improve margins. It's that simple. You will see us consistently delivering on these fronts.

Our Customer Approach: It always starts with the customer. I have made it clear to all that we don't want to do anything that will hurt the customer's interest in the course of scaling up our Bank. The founding years, which I call the next five years, are particularly important, as the DNA of what we establish will be hard to correct later. We will make every effort to sell the right products to customers, avoid mis-selling, avoid selling such products that make wonderful fees for us but at the cost of the customer's pocket. We will communicate all material information to the customer in a transparent manner. If we make a mistake, we will apologise and correct it. After all, we do not want to take this

Thank you, Dr. Lall, without you there would be no IDFC FIRST Bank. I want to whole heartedly appreciate you and the entire senior management team for the wonderful platform that you built with your hard work. I also sincerely thank the entire Board of erstwhile IDFC Bank for their guidance in building the bank, and to bring it to great success

Bank to great heights in profits and profitability while having earned any penny that truly does not belong to us.

Hence, we selected a new public tag line 'Always You First'. It is a carefully thought-through line and reflects our sincere commitment towards our customers. All of us employees stand committed to this.

A new bank: Since we have new shareholding, new brand name, new brand colour, I see IDFC FIRST Bank practically as a new bank, but with great strengths of the two entities incorporated into one. It pretty much feels like how we felt when Capital First was founded in 2012, with all things new - identity, name, brand colour, shareholders, and business model and we set sail with the same gusto.

Vision and mission: Our new bank has a new vision. "We want to create the world's best bank, right here in India, for aspiring Consumers and for Entrepreneurs."

We want to touch the lives of millions of Indians in a positive way by providing high quality banking services to them, with particular focus on aspiring consumers and entrepreneurs of our new India, using contemporary technologies.

Our nation first: We are confident of not only participating in the growth of Indian GDP, but also contributing to the growth of our beloved nation and her people. We aspire to create millions of employment opportunities, and finance the growth of business and consumption. This will lead to greater domestic production, greater consumption, and we want to contribute in further fuelling the virtuous cycle of growth for our great nation.

To our employees, I have this to say - I know all of you have been through a difficult one year because of the merger, media breakouts and rumours at different stages of the merger. I thank you for keeping your chin up during the process. We are going to create an institution, for all of you, and indeed India, will be proud of, one day.

Thank you, Dr. Lall, without you there would be no IDFC FIRST Bank. Infrastructure financing may not be in vogue today and may be known for low margins and high losses, but back in 2007 it was the in-thing. And to pull the group out of that and to get a banking licence is a stupendous achievement few have achieved, and the merged entity rides upon that today. I want to wholeheartedly appreciate you and the entire senior management team for the wonderful platform that you built with your hard work. I also sincerely thank the entire Board of erstwhile IDFC Bank for their guidance in building the bank, and to bring it to great success. A banking licence is a precious and sacred possession, and we will preserve it with the extreme respect it deserves.

I thank the Media for very responsible reporting during the entire merger process.

I would like to express our sincere thanks to the banking regulator for their consent to the merger. What you have offered is invaluable for us, and we will treasure it and justify your faith. We sincerely thank the Competition Commission of India, BSE, NSE, SEBI, NCLT, shareholders, creditors, rating agencies, and all other people who were instrumental in our successes. Thank you, customers.

V. Vaidyanathan
Managing Director & CEO,
IDFC FIRST Bank Limited