IDFC Bank Limited

Transcript of Conference Call held to discuss announcement of Merger of Capital First with IDFC Bank Ltd.
January 15, 2018

Moderator Ladies and Gentlemen, Good Day and Welcome to IDFC Bank Limited conference call to discuss the announcement of merger of Capital First Limited with IDFC Bank. As a reminder, all participants' lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing * and then 0 on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Bimal Giri from IDFC Bank. Thank you and over to you, Sir.

Bimal Giri Good Evening everyone, I welcome you to this conference call organized to discuss the merger of Capital First with IDFC Bank. I have with me Rajiv Lall and Sunil Kakar. Documents related to this transaction have been uploaded on our website and the transaction has been covered fairly widely in the media too. I now hand over the call to Dr. Lall for a few words on the transaction.

Rajiv Lall Thank you, Bimal, and thank you all for joining this call. I will just make a few introductory remarks to set the context and then really the idea for today, there is no formal presentation, is to engage in an Q&A and try and address whatever questions you have. This transaction we believe is an important strategic fit for IDFC Bank that works at multiple levels. First, just in a business complementarity sense, our stated strategy has been aggressive retailization of IDFC Bank in order to achieve diversification of risk, higher average asset yields, and therefore, enhanced earning power in order to acquire more customers and invest in building a liabilities franchise, so that has been the strategy. This is the logic with which we had first made the acquisition of GV, now called IDFC Bharat Limited. It has been very seamlessly integrated into our operation. That is the logic for our conversation with Shriram and that has remained the logic for initiating and now concluding our conversation with Capital First.

Second is distribution reach. We have today 127 branches, they have 67 branches, by March 31st, we have already shared with you, our goal for ourselves is to cover 150, get to 157 branches in 35 cities and several Tier-2 and Tier-3 locations. When you add their branches and additional branches between now and March, we expect that by March 31st, we will have 250 branch footprint across the 35 larger cities in the country and Tier-2 and Tier-3 beyond that. They bring a whole host of dealership points, 2,200 dealership points on top of that. We have another 350, 360 odd BC points and we have 9,100 odd micro-ATM points. The point is that with the combined distribution network, you can see that the touch points both in a branch format, in an outlet format, and in a service touch point format will become very, very significant and will be pan India, so that is the distribution reach.

Third is, customer segment complementarity. We have 2.2 million customers, still growing at the rate of over 100,000 a month. They have 3 million active customers, so we will immediately be over 5 million customers, so the customer recall goes up very significantly, very important for a Retail bank in the making. More importantly, their customer segment is complementary to ours, so they have focused particularly on the MSME segment in Tier-1, 2, 3 India. In our Bharat Banking operation, we have gone deep rural and in our SME and our mortgage financing and personal lending, we have focused on the high end, so when you combine these two customer segments, you will have all the way from rural Bharat Banking to mid-size SMEs covered as part of our Retail footprint in terms of customer base. The great value, potential value of the customer base that Capital First brings to the table, is that being a notch or two higher than our mass customer base, the prospect of cross selling liability products to them is also quite significant.

Our joint vision is really to see the customer as a wholesome relationship. If we can develop a relationship with the customer by providing an asset product, we believe that the probability of being able to successfully cross sell to a suitably overlapping set of customers' liabilities products will be that much higher. So customers, customer segments, distribution network, enhanced profitability, retailization of the bank, these are all strategic fix that we see. Then there is also a timing aspect to this transaction that is quite fortuitous. You all are aware that IDFC Limited as per our licensing agreement from the RBI has to divest or reduce its ownership stake of 54% in IDFC Bank down to 40% by October 2018, which is about less than nine months from now. Realistically speaking, it is not an option for us to contemplate raising primary capital in order to achieve that goal before that time. The valuation at which we would have done so would not have been very compelling, it just did not make sense.

A secondary sale from IDFC Limited would have had the very damaging effect of leaving a large shadow and hangover on the IDFC Bank's stock. It would not at all be constructive for the IDFC Bank stock, and therefore, this transaction which will bring IDFC's ownership from 54% at the negotiated swap ratios down to about 38% bring us very close to the 40% IDFC Limited needs to be and the 2%, we will make up or I am expecting 2.5 odd percent IDFC will make up through acquisition in the market, so from a regulatory point of view, timing has also been ideal third aspect of the complementarity. You have all been aware that in building out our Retail operation which as you find out in our results next week or the end of this week on the 19th are actually gaining very significant traction for the quarter. Our CASA continues to grow, Retail assets continue to grow as we had promised to all of you last quarter, but despite all of that I have been looking for somebody to drive our Retail operations, we have been looking for a Retail head.

I've interviewed several candidates over the last 12 months, my fellow Board members have introduced at least a couple of candidates. We just could not find the right fit. On any list of possible Retail people, Mr. Vaidyanathan's name was always high up on that list if not on top. There has also been, therefore, a management gap that we wanted to fill for all this time and with this acquisition, we get to fill that as well, so from senior management point of view, future leadership of the organization point of view, and strategic and regulatory point of view, we believe this is a compelling transaction and we hope that IDFC Bank shareholders will support us in the coming months. These are my introductory remarks. I would stop here and open the call for Q&A.

Moderator Thank you very much. Ladies and Gentlemen, we will now begin with the question and answer session. We will take the first question from the line of Kunal Shah from Edelweiss securities. Please go ahead.

Kunal Shah Congratulations, for the deal. Firstly, definitely there is lot of complementarity in the products, but if we have to really look at it in terms of the regulatory requirement be it in terms of the overall PSL, so what is the kind of a drag which would come on that count, so that is the first question? Secondly, if we look at it in terms of the funding cost, not too much of a differential between what Capital First is running currently and where IDFC is, so ramping up the liability will be very, very significant particularly the low-cost side, so how do we look at the scale up out there because of this merger?

Rajiv Lall On the PSL, they are more than self-sufficient in PSL is our understanding. We expect them to actually generate a modest surplus to the rest of the enterprise in terms of PSL. There will be challenges with respect to subcategory, but that you would have had in any case and that is where our Bharat Banking footprint that is growing very nicely and growing very fast will help fill that gap, so that is on PSL, so we will not add to the drive on PSL, it will actually reduce the drive on PSL.

Kunal Shah Anything that Capital First brings to the table in terms of how much of portfolio would be PSL qualified?

Rajiv Lall It is more than 40% is our understanding. On a cost of fund, our cost of fund are about 7.5 adjusted for ARR and SLR, it is about 110 to 120 basis points reduction in cost of funds that they would get from combining with the bank, so actually overtime as their fixed-rate liabilities which are much shorter duration than ours start falling off, the cost of fund synergies will become very, very obvious within 24 to 36 months.

Kunal Shah In terms of maybe how do we plan to because in terms of be it the franchise, say the franchise for Capital First, first we will have to onboard all their customers onto the liability franchise where say bank has the pricing, how easy would that be?

Rajiv Lall This transaction will take about 9 to 10 months to consummate because we have to get UCI, SEBI, RBI, then to NCLTs, so our expectation is this will take about 10 months, so over 10 months with appropriate clarification from UCI, once we start engaging on integration issues, we have a lot of time in which to prepare for this integration.

Kunal Shah Just last question, in terms of consumer durable financing, in terms of what Capital First offers as of now, would it be allowed from the banks franchise?

Rajiv Lall Of course.

Kunal Shah So zero interest consumer durable financing would be something which would not be the problem?

Rajiv Lall In terms of the product, characteristics might change, but the relationship with dealerships and all that will not change. The ability to underwrite instantaneously, people who are new to credit, new to bank, all that has been with the hard work that has been done in building that dealership franchise. No other bank to my knowledge has got that, and therefore this acquisition will really put us a leg up and Bajaj Financial will be competing with us.

Moderator Thank you. The next question is from the line of Manish Ostwal from Nirmal Bang Securities. Please go ahead.

Manish Ostwal Sir, my question on the Retail in the corporate balance sheet of the merged entity, we have a very strong capital adequacy at the IDFC Bank level and the merged entity level similar kind of capital position, so in terms of mix, you said in one of your earlier interaction that 50% Retail bank we are looking over the medium term, so the point is over the medium term, do we see the rundown of the corporate book much faster or Retail book will grow because Capital First anyway in which case is growing 25% CAGR over the last few years, so how do you see the overall mix of the balance sheet of the merged entity over the medium term?

Rajiv Lall We will already be at 45% Retail upon merger and our stated goal, IDFC Bank's standalone was to get to 60% retail by 2021, I think we will achieve that quicker than that. It is not happening because necessarily we are running down our corporate book, so there will be some bit of the corporate book that we will rundown, there will be a corporate book that will continue to grow in a healthy market, but proportionately the size of Retail will grow more aggressively, there is no doubt about that.

Manish Ostwal Secondly Sir, this 5 million customer base of Capital First, the general understanding among us is that there will be faster deposit accretion even to the Retail customers, so in your assessment in a one-year full operation of a bank, what kind of generation we can build?

Rajiv Lall That is too early to answer, I cannot answer that question to be honest, but 3 million active customers in the income segment that Capital First have has to give us a very fecund, fertile ground for generating liabilities.

Manish Ostwal Last question, on the cost of operation side, do you see any cost synergy immediately on the transaction?

Rajiv Lall Cost synergy, it is a very rapidly growing combined organization, so we are not looking to fire anybody, nobody is losing their job, in fact we will be looking to hire people as we go with the organization. I expect, however, that the cost-to-income ratio will come down inter-alia because the productivity efficiencies that are already entrenched are what is going to make that happen. We had projected on a standalone basis that because of our new way of delivering Retail, much lower cost branches etc., a long-term cost-to-income ratio would look more interesting or significantly better than most significant banks, but time will tell on that point. The view that retailization will happen more aggressively at a faster pace, I think that is given at this point.

Manish Ostwal Last, a small point, the capital position side do you see the next four years to be sufficient in terms of capital?

Rajiv Lall For the next two to two-and-a-half years for sure, we have sufficient capital. Thereafter, depending upon how fast the combined entity grows, we may need to raise capital, but for two to two-and-a-half years, nothing is happening.

Moderator Thank you. The next question is from the line of Aditya Singhania from Enam Holdings. Please go ahead.

Aditya Singhania Congratulations on the deal, my questions have been answered, thanks.

Moderator Thank you. We will take the next question from the line of Tushar Sarda from Athena Investments. Please go ahead.

Tushar Sarda I wanted to understand as to how the exchange ratio has been arrived at because on book value basis, it should have been probably 6:1 and on earnings 10:1, but the ratio is 14:1, so if you can throw some light on this, it will be helpful, thank you?

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Sunil Kakar Look valuations are done by S. R. Batliboi and Co. LLP. The fairness opinion was provided by the investment banker, Kotak, so broadly it was a composition of market value, then there was 50% weight for that, 50% weight for comparable. The intent is to find out what is the proportionate relative valuation and subject matter experts have done the valuations and given their opinion. Broadly speaking even if you take purely market only on the market basis, you should end up and it is a three month, 90 day revap, so these numbers are available on the public domain, you end up, and if you have to add the what is called the comparable method, so these two methods were applied and the formal report of S. R. Batliboi and Co. came up with this thing, but to be just to be clear on that, effectively on the market and comparable, we have paid a 10% premium, for a 100% acquisition we have paid roughly 10% premium to the market numbers. I presume that people on the call and others can and have checked comparable premiums paid by recent deals and we will come to a conclusion that our premium which we have paid is quite competitive, and just to conclude book value had zero weight.

Tushar Sarda You did not take in to CASA book value at all?

Sunil Kakar Yes.

Tushar Sarda Okay, because generally the banking and NBFC valuations are done on price to book, any brokerage report that one reads, they ascribe value on price to book based on the return on equity. Thanks for the clarification, I just wanted to know how you arrived at this price?

Moderator Thank you. We will take the next question from the line of Jigar Savla from Vitor Funds. Please go ahead.

Jigar Savla Sir, basically post this transaction, the stake of IDFC Limited concern to some 37.7% in IDFC Bank, so how would you be taking up the stake to 40% either by way of acquisition from the market or would the merged entity issue fresh shares to IDFC Limited to make it?

Sunil Kakar No, fresh is to be issued.

Jigar Savla Okay, and would there be any price band within which you would be buying these shares from the market or some time frame?

Sunil Kakar We will buy from the market at an appropriate time, but before the merger is completed the timeframe is eight to nine months from now.

Jigar Savla This buying should happen after the merger gets consummated or before?

Sunil Kakar It is a regulatory requirement and we will of course work with RBI to see if we have some timelines, but at the time of the merger subject to RBI approval, we will meet all regulatory requirements.

Moderator Thank you. The next question is from the line of Kshitij Prasad from JHP Securities. Please go ahead.

Kshitij Prasad I just wanted to ask two things, one is that the growth trajectory after the merger will it be in the same at around 20% to 25%, that is my first in terms of loans, deposits, and overall balance sheet size, and the second is what impact will the merger have on two issues, one is the stressed assets which has been a legacy factor and on the cost of funds due to the fixed bond liability which you got from IDFC Limited?

Rajiv Lall The growth will remain close to 20% I think is the Retail growth for the combined entity that we have been working with, so that is the answer to your first question. The stressed assets proportionately will come down quite dramatically, so that can only be helpful, and then the third question was on fixed rate liability, so our fixed rate liability will run down as previously indicated to you, by FY '21 we will start running down, and therefore, at that point actually, the improvement in the NIMs for the combined entity will be very significant.

Sunil Kakar Just to add from a percentage perspective, obviously the numbers would look better because now we will have 90,000 crore of loans etc., We are working hard to see how we can resolve all the difficult assets and so over a period of time it should improve, that is it and the long-term liabilities have their own slope by which they come down and the drag they cause will actually kind of come down given the fact that the marginal cost of raising new funds is also going up a little, so broadly speaking that will take its own course. The legacy book will take its own course. This new book if I may say so after merger will help reduce the overall pay.

Kshitiz Prasad Your stressed assets which currently on standalone was about 3,700 crore and for which you are supposed to provide going forward, it may be so that you will probably see a positive impact on that because of this merger?

Rajiv Lall Our stressed assets in absolute terms will not change, in proportionate terms, the share of stressed assets in total assets will obviously come down.

Moderator Thank you. We will take the next question from the line of Naveen Baid from Aditya Birla Capital. Please go ahead.

Naveen Baid While I do understand that you wanted to kind of build your Retail asset, but what is the roadmap for building Retail deposits and is there any acquisition in mind that you may consider going forward to build a liability side of the book?

Rajiv Lall We are really jumping the gun here. I have laid down the rationale for why retail assets even as we build retail liabilities, you would see that quarter on quarter, our retail liabilities actually are growing at a very healthy pace. With the acquisition, the expanded customer base, distribution network, and earning power not only will our investment in the distribution network become more aggressive, but also the pace at which our liabilities franchise will grow will also accelerate quite significantly, but all said and done, it will still take time relative to the size of our overall balance sheet. Is there a possibility of thinking something inorganic, right now, we do not want to be distracted. The important thing is to get this transaction consummated, integration complete, get this combined platform humming, then we will see.

Naveen Baid Which essentially rules out inorganic growth for the next year as far as the entire Calendar 2018?

Rajiv Lall That is very safe to say, yes.

Moderator Thank you. We will take the next question from the line of Deepen Seth from HDFC Securities. Please go ahead.

Dipen Seth I have a question which is not really too much about the numbers and stuff, but a little more strategic in nature and it may not sound like a very serious question, but actually I mean it very, very seriously, that is that what are you going to call the merged entity as we see it now, it is IDFC Bank which will issue shares to the shareholders of Capital First, so is it fair to assume that the merged entity will continue to be called IDFC Bank?

Rajiv Lall We have had conversations about branding for the company, our thinking is that we have an opportunity to combine the best of both in an individual manner. We will, over the next few months, flesh that out and then reveal to the market what that is, but to answer your question, there is an opportunity to reposition the branding such that it takes the best of both.

Sunil Kakar Also to add, IDFC Limited continues to be the promoter of the bank.

Dipen Seth Right, I will just share my two pennies worth for whatever you might think it is worth, and that is that I think Capital First brings a hell of a lot more Retail franchise and if this is your way up the Retailing street, then I would be truly sad to see the Capital First name disappear from the Retail business, so it is just an opinion, but maybe you can put some thought to that.

Rajiv Lall I am answering your question by saying that we will bring the best of both brands together.

Dipen Seth I will wait for a final decision in that regard, thank you.

Moderator Thank you. That was the last question. I now hand the conference over to the management for their closing comments.

Rajiv Lall Thank you, we have got our work cut out for us, but we will on the 19^{th} do another call with our quarterly results, so you will have another opportunity to discuss these issues, but also the quarterly results and how the execution on IDFC Bank currently stands and what status is, thanks again.

Moderator Thank you. Ladies and Gentlemen, on behalf of IDFC Bank that concludes this conference call for today. Thank you for joining us and you may now disconnect your lines.