IDFC Bank Limited

Q1 and FY '19 Earnings Conference Call Transcript
August 1, 2018

Moderator Ladies and Gentlemen, Good Day and Welcome to the IDFC Bank Limited Q1 FY '19 Earnings Conference Call. As a reminder, all participant 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 telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Bimal Giri. Thank you and over to you, Sir.

Bimal Giri Good Morning everyone, I welcome you to this conference call organized to discuss our financial results for Q1 Fiscal '19. I have with me Rajiv Lall, Avtar Monga, Ajay Kaul, Pavan Kaushal, and Bipin Gemani. Sunil Kakar has joined us as a special invitee. Before we begin, I would like to state that some of the statements made in today's discussion may be forward looking in nature and may involve risks and uncertainties. Documents have been emailed to you. These documents have been posted on our website. I now invite Rajiv to provide key highlights of our performance for Q1 Fiscal '19.

Rajiv Lall Good Morning everybody and Welcome to our Q1 Earnings Call. What I will do today again will be a slight departure from our standard communication and this might therefore take a little longer than usual. I wanted to step back and set the context once again taking off from presentation and some thoughts that are shared at our AGM yesterday. Before I come to the quarterly results, bear with me I am going to reflect on the last three years and give you some context. As you know in October of this year, we will complete the three years since launch and it has been quite an eventful 33 months and in those 33 months, we have actually achieved three very significant milestones and we are on the cusp of delivering on a fourth milestone. What are these milestones?

The first and foremost is a fundamental strengthening of the balance sheet. I will come back to each one of these in some more detail, that is the first one. Second one was again a very fundamental, reorientation of our wholesale bank, which was basically the earnings driver, has been the earnings driver for the company in our initial years since launch. The third is building the retail bank from scratch, and the fourth milestone which we are on the cusp of delivering now is really fast tracking the drivers of our profitability, so let me take each one of these in turn very briefly. Some of you may not recall, but when we started the bank in October 2015, we had a very weak balance sheet and if you imagine launching the bank and building the bank as allegorically similar to building a house from the ground up. We started that journey with a ground floor which would normally have four structural walls of which one was, i.e., a quarter of our advances roughly were completely impaired, so the ground floor of the house that we are about to build was stressed. We had identified around 12,000 crores of assets to be stressed or potentially stressed. We were pretty confident we knew at that time that about 8,000 or 9,000 of them were

stressed, but they were about another 2,000 to 3,000 crores that were borderline, we did not know at that time which way they would go. We did not know what share of this roughly total 12,000 crores of asset stressed and potentially stressed would actually become performing, how fast and with what earning power the rest would actually become NPAs and when they became NPAs, we had no idea really because there was no precedents for what the Loss Given Default on this assets would be.

The second thing that we started out with was an acute and extreme concentration of risk. Almost 80% of our assets at that time were only infrastructure by design because we were an infrastructure finance company prior to becoming a bank and we had no retail assets, that is how structurally weak the foundation of the bank was, and what we have done since we have strengthened the balance sheet in a very fundamental way, so the highlight of that strengthening are two-fold. One is the cleaning up of the stressed asset book and the second is the diversification of risk to make it a much more balanced portfolio, so broadly we started with 12,000 crores of identified assets as stressed and potentially stressed. We are now down to 4,827 crores of stressed asset that remain on our balance sheet, so what did we do? Of the 12,000 crores roughly 2,500 crores actually became performing. We sold close to 5,000 crores of our assets to ARC against a very comfortable provisioning cushion and that is how we are now left with only 4,800 crores of stressed assets against which as of this last quarter, we had a 77% PCR, which is of 3,700 crores provisioning cover and we had said last quarter that we are engaging with ARC to establish the residual value of these assets. Our guesstimate is that we may need to take, we will most likely take another 600 to 700 crores of thereabouts of additional net provision, which when we take them and we intend to take them sometime this quarter, we will have effectively a 90% PCR against the residual stressed assets on our books. Better still we hope that the bulk of this stressed assets would be sold, but I cannot today guarantee that depends on the conversation with ARC. In any event, we will have a 90% PCR. We will, therefore, be the first bank to completely clean up our book after the crisis in the infrastructure sector.

Second thing in terms of strengthening the balance sheet that we have done is the diversification of the book itself and that continues a bit this quarter, but to give you historical perspective in March ‘16, six months after we started the bank, the share of infrastructure in total assets was about 60%, little less than two-thirds. Today, as of this quarter it is down to less than one third, that is the diversification in the balance sheet that we have brought. What has replaced this, well primarily retail, retail was zero, it is now 12% of our total book. This is organic retail, on top of that we have 11% of our PSL buyout book so that is all non-infra that 23% that is non-infra was the retail focus of which 12% as I said is organic retail and then 37% is now non-infra corporate, and we have strengthened this balance sheet which is the first milestone which we delivered on with a capital adequacy which as of this quarter is still close to 19% and even if we take and when we take this 600 to 700 crores of additional provision even after that we will end up with Tier-1 capital adequacy of about 18%, so that is the first milestone.

Second milestone is the reorientation of the wholesale bank, you know to put it somewhat uncharitably when we started the bank from a banking perspective, we were really just a one trick pony, all we did was term lending. We had only about 200 odd clients, average ticket size was very high, we had no other products, we had no technology to deliver cash management, transaction banking, Forex derivatives, none of that. We had no experience in doing working capital lending. What we have done in the last thirty-six months is completely reoriented the bank and to give you a sense for what that means is that we now have close to 1,000 corporate customers and the strategic focus of our wholesale book has become Emerging Large Corporate. As of June 18, Emerging Large Corporate, our

advances to them stood at 7,174, almost 7,200. They were up from 1,500 crores in March '16 and they have become the fastest-growing component of our wholesale book.

Infrastructure continues to decline from its peak, peak meaning at March '16 just to give you a point in time, infrastructure exposure was 31,000 crores. As of this last quarter, it is down to under 24,000, so if you look at your Slide 7, you can see how this trend continues unabated even in the last quarter's performance. Infrastructure exposure has actually declined 1% over the last quarter and our non-infrastructure corporate exposure quarter on quarter has grown 6%, which means that we are successfully taking away market share from other banks in what is otherwise a tepid corporate banking environment, so that is one very important aspect of reorienting the wholesale bank. The second aspect of reorienting the wholesale bank is complementing the shift of customer focus and the funded book focus with the delivery of recurring key generating products, so that is cash management and transaction banking and to give you a sense for the numbers, our recurring fee base income in March '16 was 84 crores, full-year March '18 it is up 375, but I will come to it when I describe to you this quarter's P&L, so point is diversification of the wholesale book, complete reorientation strategically towards ELC, continued decline of infrastructure exposure and a rapid buildup capability and execution in building recurring fee generating products which are linked to the size of our non-funded book as well.

Third and not least, the wholesale bank has been deployed and our historical relationships have been exploited to build a wholesale CASA franchise, so of the CASA numbers that you see this quarter, 4,000 crores of that CASA number actually comes from the wholesale bank and much of it is coming from a burgeoning Government banking business and that is intelligent, judicious, exploitation if you like of our historical relationship that we enjoyed as IDFC, so this whole reorientation of the corporate bank which is the second important milestone we have delivered can again allegorically going back to this visual of building the house can be seen as having repaired the missing wall, the fourth missing wall of the house, we had completely repainted and refurbished the ground floor of this house, so that is the second milestone which has gotten us to refurbishing the ground floor of the house which is the bank that we are building.

Now,let me go to the third milestone and which is building the retail bank from scratch. There has been this continuing impression in the general market and general chatter that IDFC Bank has not done much in retail and I just wanted to completely disabuse anybody listening of that notion. We launched the retail bank in February 2016, which is actually six months after we actually started the bank itself, so in less than three years what have we done in the retail bank. Let me remind you what our starting position was at that time. We had only two branches, we had no retail assets, we had no retail liabilities, we had no retail customers, and we had only 140-150 employees, so in less than 36 months in retail what have we done? We first made the acquisition of IBL which was the Grama Vidayal company, the largest microfinance company in the South. Again, if you stay with the visual of the building of the house, we bought a small room on the second floor, which we called IBL. With it came 10 lakh customers and a rapidly growing MFI focused asset book, but that was just the starting point. Since then, we completed this acquisition in October 2016 and now as June '18, we have close to 31 lakh retail customers.

Excluding IBL, we have 17 lakh customers, the customer base of IBL has grown from 10 lakhs to about 13 lakhs and of these 31 lakhs customer base about 5 lakh customers are urban customers that are generating the bulk of our retail CASA franchise and of this 31 lakh customers about 12 lakh customers are rural women and this 31 lakh customer base is growing at the rate of 1,20,000 customers a

month, so that is the customer build out of the retail bank. Let me tell you about the network build out of the customer bank and this is not detailed explanation of the network. There is a particular way which we have been describing the network to you, which sits on your slide, the first box of your Slide 4, which says that there are 170 branches, BC branches are 412, customer access points and all that. I want to break that down for you into what is the urban network and the rural network, so that you understand how this network has been build out. As of September last quarter means June ‘18, we had 100 urban city branches in 60 cities and we had another 70 regular bank branches in Tier-3, Tier-4, semirural locations, but let us call it rural, so our urban network was 100 branches, our rural network had 70 regular branches and it has on top of that 412 BC branches of which 323 are actually branches of IDFC Bharat Limited, so 100 urban branches, 70 regular rural branches, 412 BC branches of which 323 IBL branches. On top of that, we had the M-ATM network you know about, we had close to 2100 M-ATM in the 60 cities and we had close to over 10,000 M-ATMs in about 387 districts, but in the 90 districts in which we have our rural branch presence, we had another close to 1600 M-ATMs, so it is a multilayered network that we have built, urban, rural that comprises regular bank branches, BC branches, and M-ATM and a few ATMs rolling. This is the network that we have built so far.

By September of this year, meaning by the end of this quarter, our branch network in the cities will move from 100 to 136, so we will have a total of 206 regular bank branches of which 136 will be in 66 cities and 70 will be rural and then on top of that, we have the BC network, so there will be 36 additional city branches that are opening up in this quarter. At the end of it, we will be at 15 branches in Mumbai and 15 in NCR, so that is the network. Now, let me refresh your mind about retail assets. In March ‘16, we had funded retail assets of about 40 crores. As of the end of the June quarter, retail assets were at 9,300 crores and they are up from 7,900 crores last quarter which is to tell you that our run rate was organically originated retail assets remains very strong and I am very confident that on a standalone basis, we will finish this fiscal year with over 15,000 crores in retail assets. What is more and this is the point that I have made several times to you. If you look at your Slide #8, retail assets overview, this 9,300 crores in retail assets is extremely well diversified, so 3,600 is rural, much of it MFI, but we have now close to 2,000 crores in secured mortgage loans, about 800 crores in loans against property, about 500 crores in personal loans. Our SME portfolio is 1,100 crores, our MSME portfolio is about 650 crores, so it is geographically diversified, it is by product diversified and it is diversified by customer segment.

Final aspect of the retail bank build out is the retail liability base and so what is key for the retail liability base build out and what contributes at the margin the most to our cost of funds is actually retail CASA plus retail TD and that number gives you a sense for the size of our retail liability franchise, so that number retail CASA plus retail TD at the end of June ‘18 was 7,300 crores and sum. Of that CASA which is retail CASA was 2,100 crores up from 1,600 crores last quarter and retail TD were up to close to 5,300 up from 4,300 crores last quarter, so if you take the retail bank as a whole now, I hope that I have delivered the point a bit, but to disabuse the notion that IDFC Bank has not done enough on the retail side, that is absolute nonsense and this third milestone going back to the visual of the house means that we have successfully built a very sound second floor of our house, so these are the three milestones that we have delivered so far, cleaning up and strengthening the balance sheet, reorienting the wholesale bank, and building a retail bank from scratch.

Now, let me come to the fourth milestone that is still in process and that is fast tracking the drivers of profitability and in order to do that, I would now refer to the more usual presentation that is available to you on the website and copies of which you must have. So how do you build drivers of profitability? You basically build

drivers of profitability by pressing on three levers, you try to increase the average yield on your lending, you try to reduce the average cost of your funding and you supplement these two with fee-based income line, so that is really what comprises the profitability of the bank is not very much more complicated than that. If you look at your Slide 16 which is titled, Spread Analysis, that gives you a sense on the progress we are making on this front, so if you look at our yield from that Page 16, our yields have gone up relative to last quarter. The composite yield was down to 8.9%, we have got it back up to 9.1% as of Q1 FY '19, so how did this happen? It has happened because really of the changing composition of the balance sheet. Our stressed assets continue to decline, our reliance on PSL buyouts is decreasing because we are replacing this with PSL certificates which are lower cost to us. We have managed to hold the line on our wholesale banking yields, even netted out for PSL cost on it. The wholesale bank yield has actually gone up from 9% to 9.1% and that is because of our strategic focus on high yielding ELC, Emerging Large Corporate, and we have done this despite the fact that high yielding infrastructure assets have actually become proportionately smaller size of the wholesale book and the average composite yield on the retail book has actually come down since last quarter because our urban book, retail book has grown faster than our much higher yielding MFI book, but we had to do that to balance the risk in the retail book. We cannot be disproportionately dependent on MFI lending, and therefore, we believe that we can now maintain the composition of our entire lending book on a standalone basis to maintain the composite yield close to 9%, so there will be a moderate maybe slight, very moderate drift down in this yield only because the share of infrastructure in total will come down, but to the extent that we are able to replace that with ELC and high yielding retail assets, we expect to be able to hold the line on the average asset yield of 9.1%.

Now, we come to average cost of funds. Average cost of funds over the last quarter has remained the same and that is because corporate deposits which at the margin is what has been funding the growth in our balance sheet, the cost of corporate deposits given what is happening to the interest rate environment has actually gone up and this is despite the fact that the cost to our core deposit what we call core deposit, which is retail FD plus CASA has actually come down because of the growth of CASA from 5.4% to 5.3%, but we need to keep growing the CASA book as fast if not faster than we have already grown it in order to keep driving the average cost of funds down, so that is now the focus on fast tracking the drivers of our profitability. As you can see, the spread from last quarter has actually improved from 1.6% to 1.8% from last quarter to this quarter, so one last slide that I wanted to draw your attention to and this has to do with our cost of funds. If you turn to Slide 14, you look at the bottom of the page second half of the page, CASA plus retail TD divided by deposits plus borrowing that actually is the number to watch, because that has the biggest impact on our cost of funds, not the traditional CASA ratio because that does not take account of all our borrowings and since unlike most of the banks, we are still quite dependent on non-deposits borrowing, we depend on CDs and we have this legacy portfolio of infrastructure bonds and other long-term bonds which continues to dog us, this is the denominator that is more important and you can see, quarter on quarter improvement in this ratio so whereas it was this ratio was 6.4% June '17, last quarter it was 9.5% as of March '18, quarter ended June '18, it has gone up to 11.2 %.

Final point because I know people are and as you should be focused also on the trajectory of our operating expenses. I want to turn to the P&L slide which is Slide 15, but before I turn to the P&L slide I want to make one broader point of perspective. The last 33 months have been all about strengthening and changing the orientation of the balance sheet of the bank. You cannot have a long term bank of any kind unless you have a strong balance sheet, so whether the markets like it or not we have had to be focused on the balance sheet. Now, we have focused much more on the P&L and that is the point about the fourth milestone that is we

are on the cusp of delivering, so look at the P&L and if you see, we will take it line by line. If you take operating income, operating income in Q1 FY '19 was close to almost 600 crores up from 481 crores last quarter, so our quarter on quarter growth is 25%, Net Interest Income showed a quarter on quarter growth of 31%, wholesale bank NII up 25% quarter on quarter at 323 over 258, retail up 15% quarter on quarter, 183 relative to 159, and this is by the way almost double year-on-year, so if you compare to Q1 FY '18 when it was 96, Q1 FY '19 this number is 183, the rest is on PSL drag.

Now, these numbers on Net Interest Income have to be adjusted obviously by the cost we incur on PSL, so far we have managed the cost of PSL in the first quarter, but over the next quarters this will show some catch-up, but pre-PSL drag you can see traction, very clear traction which is commensurate with the changing composition and growth of our wholesale bank and retail bank balance sheet in NII of the consolidated bank including IBL. Second point about this P&L slide I wanted to note is that the NII numbers relative to what was on the website and shared with you last time is slightly different, why is that because we have now consolidated IBL into the P&L, so we have taken the full yield on the lending that is done through IBL as part of NII and we have attributed the full operating expenses of IBL in operating expenses and you will see it isolated as IBL expenses under operating expenses.

Let me now turn to non-interest income. Non-interest income total was up 15% quarter on quarter, but what is really important in this number is not the total, it is the share of recurring fees and recurring fee income is up 22% quarter on quarter from 98 crores to 120 crores and this is commensurate with what I described to you earlier has to do with building out all the products that generate specially from the wholesale bank, but increasingly now from as a wealth management and insurance product distribution grows in retail, the contribution of retail to fee-based income will also continue to rise, it is small at this time, but it will grow quite sharply in the future. Other fees which are non-recurring, IBCs are down quite sharply commensurate with what is happening in the wider market, our DCA syndication fees are also sharply down, and then finally, let us come to Treasury income, Treasury income is sharply down this quarter and just one more note of perspective on Treasury income, some of you have asked the question why is your Treasury book being so large, the reality of our situation was that over the last 33 months, our other drivers of revenue and income was so compromised that we actually took a calculated risk, built-up a very large Treasury, played the interest rate curve and made a lot of money.

To refresh your memory, over the last four years, we have taken about 6,500 crores in provisions and on top of that, if you look at our liability composition, which is Page 12 of your presentation you will see that our legacy long-term bonds are still close to 19,000 crores and our infrastructure bonds are 10,000 crores and the average cost of these 28,000 crores, which is a third of my total borrowing still is about 8.9%, so that is 200 basis points drag on the third of my borrowings that was depressing my earnings for the last 33 months. We used our muscular Treasury to deliver earnings taking calculated risks. Now, since the interest curve has turned around last two quarters that game is up, and therefore, Treasury is no longer making those returns and we have accordingly cut the size of our Treasury dramatically and if you look at slide on Treasury, which is slide 11, you will see that the slide that the portion of our Treasury that is subject to mark to market risk has been slashed from close to 30,000 crores to 21,000 crores and this will probably shrink further during the cost of the year, so that explains going back to the P&L slide Page 15 what has happened to Treasury.

Finally, let me turn to operating expenses. Operating expenses Quarter-1 were 496 crores of which HR was 205 crores, non-HR was 247 crores, and IBL was 44

crores, so our run rate for this fiscal year in terms of operating expenses will be close to about 2,000 crores. Last year, it was about 1,800 crores, it may be 2,000 crores between 2,000 and 2,100 crores will be the standalone operating expenses for this year. I just wanted to give you a sense from where this increase in operating expense is coming from. Let us say the number is 2,100 crores for the year, roughly half of that, less than half of that between 1,000 and 1,100 crores is on account of wholesale bank and corporate overhead which involves significant investment in technology, so it is all significant investment in technology. About 1,000 crores of the 2,100 crores of operating expenses we are expecting this year is on account of retail bank and our operating expense management strategy is very straightforward. We intend to hold the line on our operating expenses pertaining to corporate overhead and the wholesale bank. Whatever incremental spend there is will be on the retail bank and the bulk of that spending is with respect to branch expansion, so for now we are capping the branch expansion to 206. We will expand the IBL branches sum over the next year, but the payback period of an IBL branch which is a BC branch is under 10 months and the payback period of a normal city branch, the medium-sized city branch is about 24 to 26 months, so any future increase in operating cost of retail on account of branch expansion will have to be raised strategically against what that does to the P&L on an immediate term basis versus the long-term gain it will give us in terms of expanding the CASA franchise, so that is a balance I think that we will have to manage going forward. This brings me because we are now in August and we just had a pretty good AGM yesterday and the date for the shareholder vote on the merger with Capital First has been set and it is September 3rd, it is therefore appropriate that I spend a couple of minutes on the impending merger with Capital First.

You can now see in a reinforced fashion the logic for the merger with Capital First. Capital First actually going back to the visual of the house is to build the third floor of the house and that actually helps to completely accelerate the drivers of our profitability, how does it do that. Capital First brings 35 lakh additional customers focused on customer segment that are hard to penetrate, most other banks have not penetrated those segments, and those customer segments are actually very high yielding compared to our average retail asset yield of 14.8, the average yield on those asset is 17.5. They will bring a wide expansion of our network reach. They have 10,000 dealership points across the country. They will bring immediately about 50 to 75 additional branches to us quite apart from the 35 lakh customers that they bring to us and by the way they also bring significant additional profits even adjusted for CRR, SLR all the transitional cost that they have to bear once they become part of the bank. Even when you do that, they will bring additional profits to the bank. That gives us investible resources to now make a strategic decision about how fast we want to build our branch network, what is the productivity of that branch network in terms of the CASA that is generating. I can tell you that in the branches that we have already built, we now have lot of experience.

Our oldest branches are generating close to between 200 and 300 crores of CASA, and our expectation is that the median branch in the city, there are currently 100 going to 136 branches, these median branch will on average deliver 100 to 120 crores of CASA within three to four years, so just with the 136 branch network in 66 cities. We expect over the next three years let us say by FY ‘22 going to 5,000 crores of retail CASA this year, total CASA of 9,000 crores this year thereabouts to retail CASA in FY ‘22 between 12,000 to 15,000 crores out of the 136 branches, so that gives you a sense for the return on investment that comes from building out the branch network and give you some sense for how the combined entity of the Bank and Capital First will look like. Needless to say, we are very excited now about the merger because we can see very tangibly how it rounds out the completion of the building of the house that we started three years ago, so in the

next three years let us say by FY '22, we expect that the combined entity will be profitable, vibrant, rapidly growing, diversified universal bank with a huge focus on mass retail banking in customer segment and product suites that are difficult to replicate by other banks. That is somewhat long little unconventional presentation, but since we are hurtling towards September 3rd and the merger is now imminent, I thought I would do it somewhat differently and give you a sense of where we have come from and where we are as of this quarter. Let us open it up for Q&A.

Moderator Thank you very much. Ladies and Gentlemen, we will now begin the question and answer session. We take the first question from the line of Ronak Jain from Vibrant Securities. Please go ahead.

Ronak Jain Sir, my first question will be regarding the legacy borrowing maturity, so by when are these bonds maturing?

Rajiv Lall The 10,000 crores of infrastructure assets I believe have a residual maturity of another six years, the 18,000 crores that are other long-term bonds, they will be down to 15,000 by March of this year and by FY '21 they will be down to 7,000.

Ronak Jain Second question would be regarding after the merger since the majority of the assets of Capital First are related to the priority sectors, so will our PSL drags also come down?

Rajiv Lall It will help with our PSL drag, but I think the broad way to think about it is that our standalone retail bank and the Capital First retail will be marginally more than self-sufficient in terms of PSL. The wholesale bank will continue to be the only source of PSL drag in the bank, and therefore, relative to where we are today, we do not see the PSL drag expand very much because we see in the wholesale bank a continuing change in the composition of the book, but not an expansion in its size.

Moderator Thank you. We take the next question from the line of Sagar Shah from KSA Securities. Please go ahead.

Sagar Shah Sir, my first question was regarding our cost-to-income ratio actually, so something like it is a little above the industry average, it is at almost 65.5%, although it has come down as compared to the last quarter, but since we are something like give a guidance of something like increasing the number of branches also in this financial year, so wanted to know that do we have a downward target or do we intend to remain at the same level in this ratio?

Rajiv Lall The simple answer to that is medium-term it comes down, short-term it might go up, and we will have to see, that is a judgment that we will now have to make about the pace at which we build out the branch network, but if we do not expand the branch network, the cost-to-income ratio will continue to come down and it will continue to come down until the branch network exhausts its contribution to the build out of our liability base then we will have to invest more at which point the cost-to-income ratio will go up again temporarily before it comes down and we probably see couple of stages, cycles of this before the cost-to-income ratio falls into a long-term sustainable ratio, so I cannot give you more clarity than that I am afraid.

Sagar Shah My second question, Sir, was regarding to as you only said that we have to do some 600 to 700 crore of additional provisioning for the stressed assets, so that will be as per throughout the year or for the next quarter itself you will be providing for that?

Rajiv Lall I want to do it before the merger is consummated, so it will be done before the merger, before I hand over the keys, our book will be squeaky clean.

Sagar Shah So you intend to provide in the next quarter because I think your merger is maybe I think in the third quarter if I am not wrong?

Rajiv Lall That is correct.

Sagar Shah So we will take some kind of hit in the second quarter?

Rajiv Lall We will definitely take a hit, whenever we take the provision we will take a hit.

Sagar Shah My last question, Sir, would be after your merger basically with Capital First, for the next two years what is something like as you have already correctly something like explained everything very well, but I wanted to know will your focus be on the more and more increasing the retail assets and something like or increasing the branches, so for the next two years our ROE will remain contained, correct me if I am wrong?

Rajiv Lall The ROE will continue to improve. Year-on-year the ROE will improve. The question is how fast it will improve with partly within our control and partly to do with the judgments we make about how much we invest versus how much we eat our earnings today. I think this is something that we will spend some time thinking about, but you can quite comfortably assume that ROE will rise year-on-year, how quickly they rise depends on the strategic decision about how much investment we want to make. One more point I will make is these issues of how quickly the ROE rises are really transition issues. I know this is beyond the normal horizon of market participants, but if you look 36 months out, after 36 months I can pretty much assure you on the basis of a lot of detailed thinking, the acceleration in the ROE is pretty dramatic and pretty significant.

Moderator Thank you. We take the next question from the line of Sangam Iyer from Subhkam Ventures. Please go ahead.

Sangam Iyer Sir, just wanted to understand, the bond portfolio that you mentioned that is going to run down to 15,000 crores by the end of this financial year and to 7,000 crore by the end of next financial year, was that what you mentioned?

Rajiv Lall No, there are two aspect of the bond portfolio, the total bond portfolio is 29,000 crores, 19,000 crores of is what we call the other long-term bond, about 10,000 crores is infrastructure bonds. Infrastructure bonds unfortunately are not going away any time soon, they are another five-six years of pain in our butt. The other 19,000 crores that will be down to 15,000 crores by March this year and Bipin will reconfirm what it will be in FY ‘22 estimated 7,000 crores.

Sangam Iyer Sir, secondly on the stress portfolio that you have mentioned as 4,800 crores for which we are more than 71% provisioning, what percentage of this is also part of the infra book that we are running down, which is currently around 19,000 odd crores?

Rajiv Lall All of it is part of the infra book.

Sangam Iyer So beyond this, there is no other stress that is there in the infra book, so the balance 15,000 is…?

Rajiv Lall No other stress in the infra book. The infra book now just to be clear is only operating assets in transmission, roads, and renewable and few LRDs that is about it.

Sangam Iyer Out of that 19,000 odd, 15,000 is completely operational and this thing, 4000 is what we have declared as stress of which 37 we have taken and 600 incremental we are planning to take, so that our complete book becomes squeaky clean, that is what was the statement made, right?

Rajiv Lall I will draw your attention to Slide 7, if you look at end of June '18, you will see our infrastructure book is 23,900 crores and our stressed asset book is 4,800 crores, so those two are separate. The 23,000 crores infrastructure book is all at operating assets and is clean and it is now just being rundown, it is not being replaced, so it is just being repaid, some other time it is being prepaid, so I cannot tell you exactly over what time it will come down, but over the next three years it comes down to 6,000-7,000 crores in my guess.

Sangam Iyer Sir, on the incremental OPEX that we are talking about for the near-term we are planning to increase our branch expansion by capacity is by almost 30 in this financial year?

Rajiv Lall Yes, in this quarter actually.

Sangam Iyer Okay, so for this financial year at least till you hand over the keys, what is the plan in terms of the branch expansion?

Rajiv Lall We will cap it at 206 regular branches of which 136 will be in 66 cities, 70 in rural geographies, and we will have 412 BC branches, that is where we will end up by September of this year.

Moderator Thank you. We take the next question from the line of Keshav Harlalka from BHH Securities Pvt. Ltd. Please go ahead.

Keshav Harlalka From all the conversation, can we safely assume that we will see a merged entity Capital First and IDFC Bank in October 2018?

Rajiv Lall Certainly by December.

Moderator Thank you. We take the next question from the line of Y. Aggarwal from Agarwal Associates. Please go ahead.

Y. Aggarwal Sir, I would like to know that there is a branch in Ludhiana, I went there to open an account, but those people insisted that the minimum balance should be 25,000 for a savings account, that is not feasible, Sir, I wish to open an account, but 25,000 is too much?

Rajiv Lall We have noted your point, we will take that into account as we think of new propositions in the retail sector, we will take this feedback onboard.

Y. Aggarwal My second question is when can a shareholder of Capital First get shares from IDFC Bank?

Rajiv Lall I would still to be safe January 2019, you will get shares of the combined bank.

Moderator Thank you. We take the next question from the line of Sameer Dalal from Natvarlal & Sons. Please go ahead.

Sameer Dalal Sir, my question was more towards the fact that you are saying you still need to provide 600 crores of provision against the 4,000 crores loan book that you have even after having a 77% PCR, my question comes is what is the status of the loans that you have to provide for 90, you want to have your provisions up to 90%, would there be no sort of recovery that would come at all from any of the, just trying to…?

Rajiv Lall Yes, you can try and understand, I have been shouting from the rooftops since 2013 that the infrastructure problem in this country is going to be particularly severe and the bulk of it comes from the energy sector particularly thermal energy, gas and coal fired. The thing is that the recovery in these kind of projects is very different from what you might get from a steel plant. Steel plant, the value can be diminished because of cyclical lows, prices go up, some tariff protection is given, suddenly the EBITDA of the company looks better, debt looks more serviceable, you can recover a lot of money. In the case of energy assets, the power purchase agreements are still not functioning, the Discoms are still dysfunctional, fuel is still not available, disputes continue. Each time you get a tariff order by the appellate authority, it is disputed all the way to the Supreme Court. Given this kind of situation, it is impossible to actually service the debt. When it comes to recoveries, what are you going to recover, there is a bit of a land and who is going to buy a turbine, nobody is going to buy a turbine. You can sell a turbine maybe take it to Kazakhstan or Nigeria, good luck to you, so I really do not think that the recovery can be seen on par in any way with the other things you are seeing in the NCLT, and therefore, I have always been and remained hyper conservative about the Loss Given Default on infrastructure assets.

Sameer Dalal Yes, my question is how did these companies drawdown these kind of loans if it was just land bank and maybe one turbine that they own and there was no progress down in the stand, what checks did we have had there in place?

Rajiv Lall We need to understand that what it takes to build a power plant. Land is only one component of it right, but you have to acquire the equipment, you have to build the bloody plant, these things take time, the bulk of the cost is all construction, so the problem in the asset quality was compounded because of construction delays and that led to interest during construction that kept getting compounded, that was one problem. The other problem it is too long a conversation to have and bore everybody, but I will give just one more point is that the borrowing requirements per plant was so high, it was costing 5 crores a Megawatt, so if you have a 1,000 MW plant we were talking about 5,000 crores, no single bank could do this, so it was done in consortia and typically we were also not even the lead in the consortium, they were some other banks that was leading the consortium. Now the bank's ALM is very different from what IDFC's ALM was, so the term structure of these loans was typically, it happened particularly in road projects, but also in power projects was too short to deliver any kind of reasonable equity return to the investor, so any slight variation that took place in the cash flow meant that the whole project economics went for a toss, so you need actually much longer term lending products and nobody wanted to take a fixed rate loan that was the market, that is the other big. We knew it at the time that as an IFC we had no choice, we had to do this bloody thing, the reality is that everybody wanted to take interest rate risk, so when interest rate started going up, cash flows went for a toss. Third problem in all of this was that there was a leverage on leverage, so a lot of the promoters had taken leverage that was masked at the level of the holding company and when things started going wrong, the promoter of the project just did not have any equity left, if we even complete the construction of the project and so on and so forth. This is a long and very painful discussion, I want to focus on the positives. We have left that legacy behind, I have just described to you, we have built the foundation and

two floors out of three of a new house, we are just seeking shareholders permission to purchase the third floor and you will have a completely reinvented IDFC Bank.

Sameer Dalal One last question given the merger with Capital First is coming through, Capital First lending for white good products, short-term loan lending and all of those kind of things, as a bank would there be any restrictions on doing such kind of funding or the business of Capital First can continue straight in the IDFC Bank as a bank?

Rajiv Lall It will continue, there are no restrictions.

Moderator Thank you. We take the next question from the line of Neruha Rachla from Cogencis. Please go ahead.

Neruha Rachla Sir, as I see from your slide, your deposits have grown both on quarter and on year and considering the private banks are trying to build the market share vis-à-vis the PSU banks in terms of deposits, how does the trend going ahead in future look like for IDFC Bank and what are the factors that could be at play considering that the Reserve Bank of India is widely expected to raise interest rates today?

Rajiv Lall Raising interest rates I am not sure affects our ability to develop our CASA franchise. CASA franchise actually relies on growth in the market. If you look at the overall banking system, it continues to grow at 700-800 basis points above real GDP growth. Real GDP growth is 7%, banking system grows at about 15%, which means that the entire savings pool in the country grows at about 15%-16% nominal terms every year, so what you are seeing happening in IDFC Bank, it is not rocket science, we are just getting a half pie share and maybe a little more of that growth and that is how we are able to build our CASA franchise to service the needs of a mid-sized bank. If you were State Bank of India and we want to double our CASA, then your question would be relevant, but for a bank of our size with an economy growing at 15% in normal terms, the banking system overall growing at 15% normal terms, this is not a strategic concern for us.

Moderator Thank you. We take the last question from the line of Sneha Ganatra from Shubhkam Ventures. Please go ahead.

Sneha Ganatra Sir, just wanted to know first question is on what is the outlook on the spreads and the margins to be maintained considering our focus is on the retail and a decline in the wholesale book?

Rajiv Lall Yes, I am confirming that.

Sneha Ganatra Sir, my second question is on the OPEX front that you are planning to open 36 branches, how do you see that OPEX run rate, could you guide on that front?

Rajiv Lall I said this year on a standalone basis our OPEX will be between 2,000-2,100 crores. Beyond that, it will depend on how fast we choose to grow our branch network. There are pros and cons to that. As long as we pace it appropriately, I think you will see all indicators of the bank improved, so I just want to at the risk of dwelling on this and little more, but it is important to clarify that the key here is arriving at the right pace of branch expansion such that year-on-year we are able to show healthy growth in profits, healthy growth in ROE, and healthy growth in our liabilities franchise on a sustained basis and I think that is, especially with the merger, that is eminently feasible and once the merger gets done then management will be in a position to share in greater details how that thing unfolds,

but the prospects of showing year-on-year improvement in profit in ROE and in CASA franchise are now very strong.

Sneha Ganatra Sir, the same goes on fee income side, how do you see that fee income to be growing even as of now as well as post merger?

Rajiv Lall It should actually continue to grow at the same pace for some time because we are starting from a small base and especially as our distribution network through our retail customers grows, right now the bulk of the improvement increase in fee-based income is coming from our wholesale bank, but in the future it will be equally driven by retail bank because we will be selling wealth products as well as life insurance and other protection products through our customers for which we will get a fee.

Moderator Thank you. Ladies and Gentlemen, that was the last question for today. I would now like to hand the conference over to the management for their closing comments.

Rajiv Lall Thank you very much for your patient listening. I hope you have now got a better granular sense of where we have come, where we are, where we are headed. We are always here to answer your question should you have any. Please direct your queries to Bimal Giri, we will do our best to respond on an expeditious basis. If you have any suggestions for improving our presentation, happy to discuss with you, but we take pride in the transparency of our disclosure and we hope that we continue to have your support, so thank you all and look forward to our next conversation.

Moderator Thank you very much. Ladies and Gentlemen, on behalf of IDFC Bank, we conclude today's conference. Thank you for joining us and you may disconnect your lines now.