

Commentary on the Q3 FY 19 results for IDFC FIRST Bank

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This note addresses the following questions:

1. What is the background to the merger?
2. What are the immediate impacts of the merger?
3. What are the respective strengths brought by Erstwhile-IDFC Bank and Erstwhile Capital First to the merged entity?
4. How will the merger create value?
5. Why did the bank post a loss of ₹ 1,538 crores in its maiden quarterly results of the new entity IDFC FIRST Bank?
6. What has been the impact on Net worth as a result of the merger?
7. Was there any goodwill carried by Erstwhile Capital First on its books which had to be charged off to the P&L on merger?
8. The bank could have continued to keep the goodwill on its books. Why did you have a charge of to the P&L account?
9. What would have been the normal profit for Q3 had the above accelerated impairment of goodwill not been done during Q2 2019?
10. What is the book value per share of IDFC FIRST Bank at starting point of its new journey, as of today?
11. Why has the NPA amount gone up in absolute numbers as well as percentages from 1.6% to 1.97% this quarter?
12. What is your anticipation on credit performance on the retail book going forward?

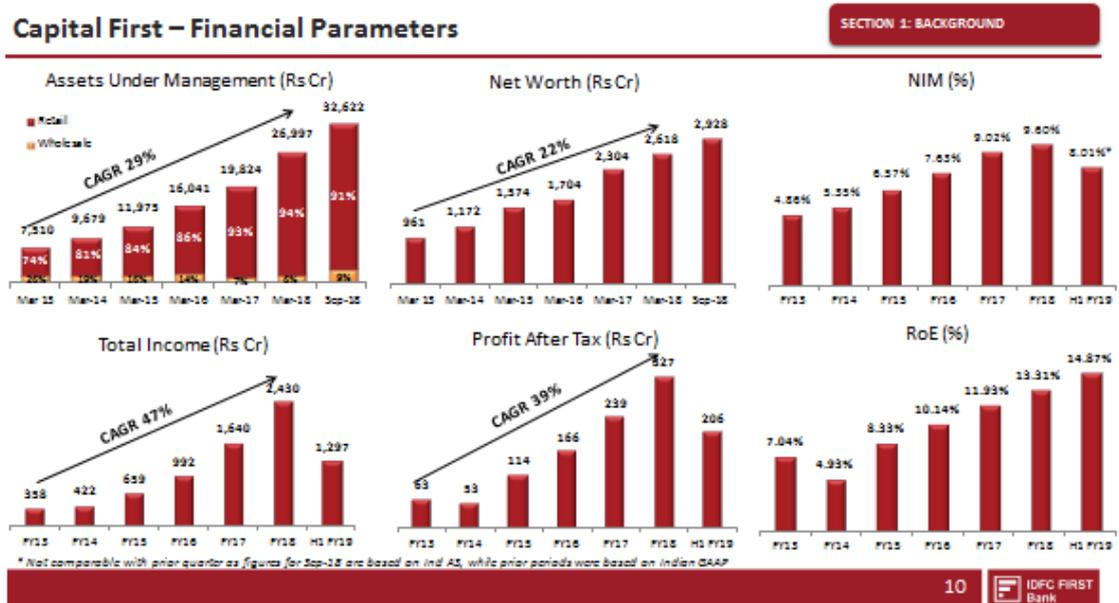
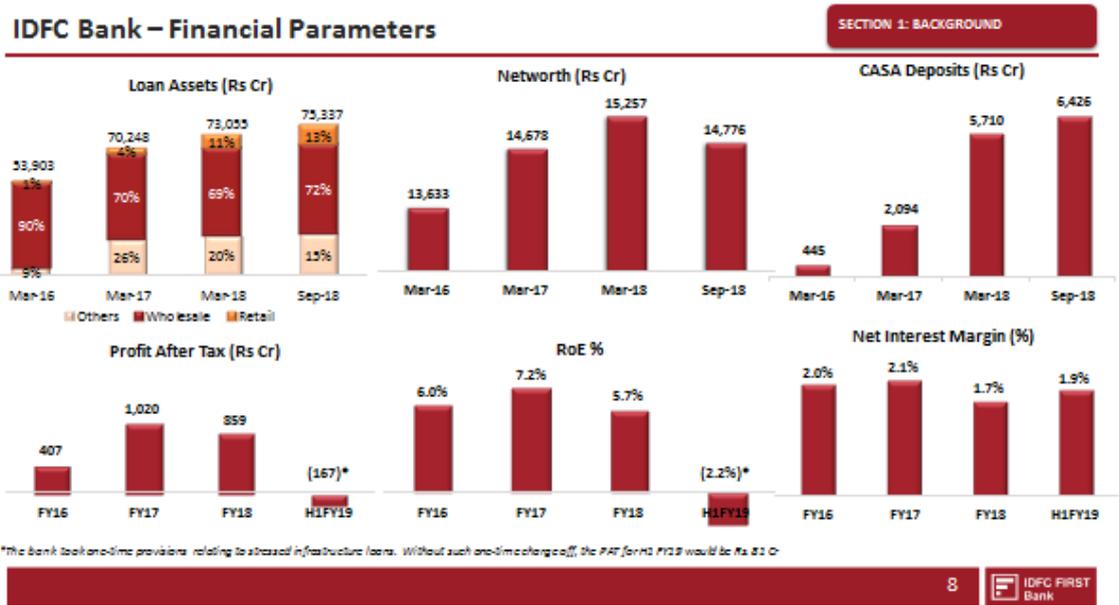
Q1: What is the background to the merger?

IDFC FIRST Bank Ltd is founded by the merger of Erstwhile-IDFC Bank, a scheduled commercial bank and Erstwhile Capital First Limited, a systematically important Non-Banking Financial Services Company. The merger was first announced on January 13, 2018.

As a matter of record, Erstwhile-IDFC Bank shareholders overwhelmingly approved the merger in record numbers with an unprecedented approval for merger for publicly listed companies of 99.98% votes in favour. Similarly Erstwhile Capital First shareholders overwhelmingly voted in favour of the proposal with 99.90% votes in favour.

The merger was formally consummated on December 18, 2018 with October 1, 2018 as appointed date for accounting.

Trailing Financials of Erstwhile-IDFC Bank and Erstwhile- Capital First



Pro-Forma Financials of the two institutions the last quarter (Q2 FY 19)before the merger.

SECTION 1: BACKGROUND

	CAPITAL FIRST LIMITED	IDFC BANK LIMITED	IDFC FIRST BANK LIMITED
Loan Asset (on-Book)	Rs. 27,351 Cr	Rs. 75,337	Rs. 102,688
% of Retail Loan Assets	89%	13%	33%
Total Borrowing + Deposits	Rs. 24,550 Cr	Rs. 101,232	Rs. 125,782
CASA	-	Rs. 6,426 Cr	Rs. 6,426 Cr
Net worth	Rs. 2,928 Cr	Rs. 14,776 Cr	Rs. 17,704 Cr
NI	Rs. 615 Cr	Rs. 451 Cr	Rs. 1,066 Cr
Total Income	Rs. 695 Cr	Rs. 571 Cr	Rs. 1,266 Cr
Opex	Rs. 327 Cr	Rs. 552 Cr	Rs. 879 Cr
Provisions	Rs. 210 Cr	Rs. 601 Cr	Rs. 811 Cr
PAT	Rs. 105 Cr	Rs. -370 Cr*	Rs. -265 Cr

*The Bank Book one-time provisions relating to stressed infrastructure loans. Without such one-time charges off, the PAT (or NI) F1Q3 would be Rs. 21 Cr.

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Q2: What is the immediate impact of the merger?

The merger has been immensely beneficial for the combined entity.

1. Net Interest Margin: To begin with, the net interest margin of the bank was 1.9%, the net interest margin has shot up to 3.27% immediately post the merger mainly because of the loan assets brought in by Erstwhile Capital First to the merged entity which were at relatively higher yield (16.2%) as compared to Erstwhile-IDFC Bank (9.2%)
2. The Funded Assets (Loan book plus credit exposure in the form of investments in NCDs) of the bank have increased from ₹ 75,337 crore to ₹ 1,04,660 crore as a result of the merger.
3. The Retail Loan book has increased substantially from ₹ 9,918 crore (standalone Erstwhile-IDFC Bank Q2 2019) to ₹ 36,236 crores (IDFC FIRST Bank, Q3 2019). Of this, the rural book is ₹ 4,704 crore, MSME loan book (largely LAP and Business Loans) is ~ ₹ 13,574 crore and Consumer loans book is ~ ₹ 17,957 crore)
4. The Wholesale Loan book stood at ₹ 56,809 crore. Non funded assets (largely pertaining to wholesale) were ₹ 26,300 crore
5. As an immediate impact of the merger, retail assets as a percentage of total funded assets have increased immediately from 13% to 35%, largely because the loan book of Erstwhile Capital First was 90% retail.

Q3: What are the respective strengths brought by Erstwhile-IDFC Bank and Erstwhile Capital First to the merged entity?

The erstwhile Erstwhile-IDFC Bank, apart from acquiring a banking license, had built

1. Strong presence in corporate and infrastructure financing, payment systems and corporate and retail banking technologies for CMS, trade, Forex and excellent internet and mobile banking capabilities.
2. Efficient Treasury Management System and advanced market operations
3. Over 131 branches (including 92 rural branches) set up at the time of announcing the merger in January 2018 (currently at 206)
4. Set up 92 branches in rural areas.
5. Launched retail lending businesses, not yet to scale though.
6. Launched salary accounts savings accounts current accounts micro-ATMs deposit accounts.
7. Acquired Grama Vidyal, an MFI to expand rural operations.
8. Established a successful government banking business.

At an overall level, operations were still subscale and profitability at the net level was low. So, Erstwhile-IDFC Bank standalone would have had to incur losses in building retail lending businesses to scale, which would have put pressure on the already low profitability. Besides, building retail businesses requires investments and skills in creating intellectual property related to retail lending, and retail lending books usually required to be seasoned over many credit cycles over many years before portfolio quality becomes predictable. This issue got sorted for Erstwhile-IDFC Bank because of the merger as Erstwhile Capital First business had already reached scale and profitability and had seasoned for nearly a decade. In addition all intellectual property in terms of retail lending technology, systems, people and processes got transferred to the merged entity.

On the other hand:

Erstwhile Capital First had

1. Built strong Retail Franchise and in niche segments with strong credit skills. Acquired over 7 million customers in eight years since launch.
2. Grew retail loan book from ₹ 94 crore in 2010, to ~ ₹ 26,000 crore by September 2018.
3. Developed market presence in more than 220 locations across India supported by 102 branches
4. Developed technologies for origination, management, monitoring, credit underwriting and collections.
5. Had consistently increasing Profitability with high ROE ~ 15%, and inching up consistently.
6. High Asset quality (Gross and net NPA at ~2% and ~1% respectively)

Erstwhile Capital First would have had significant issues in continued growth of this business as institutional funding lines, which were the main source of liabilities could be

constrained in the long run. Hence the availability of low-cost funds of desired quantities was necessary for Erstwhile Capital First. As it turned out, within nine months of announcing the merger, there was an extreme liquidity crisis in financial markets in India and thus the merger is immensely beneficial to Erstwhile Capital First shareholders in the long run.

Q4: How will the merger create value?

- The net interest margin of the bank on a standalone basis is 1.9% as of Q2 2019. Post the merger this has increased to 3.27% and with continued growth of similar businesses as built by Erstwhile Capital First, the bank targets to expand the net interest margins to between 5 to 5.5% over the next 5 to 6 years.
- The Erstwhile Capital First business was generating ~15% return on equity even with wholesale funding. Simply put, such business when funded by retail liabilities will increase the margins and create more value.
- The bank will continue to build on the non- infra wholesale banking business built by Erstwhile-IDFC Bank, based on opportunities available. This includes working capital, term loans, forex business, trade and so on. There are immense opportunities in the space and the combined entity will continue to build on the foundation already laid by the Bank on these fronts.
- As a result of the above, we expect ROA to gradually increase to about 1.5% and ROE to increase to between 13 to 15% over the next 5.6 years.
- We have experienced at Erstwhile Capital First that once a stable business model is established with strong profitability, and if it is scaled up consistently over the years, then sustained addition to ROA and ROE is achievable and can be highly accretive to quality of earnings and profitability.

Q5: Why did the bank post a loss of ₹ 1538 Crores in its maiden quarterly results of the new entity IDFC FIRST Bank?

The normalised profit after tax of the bank would have been ₹ 153 crores, (which includes ₹ 72 crores because of certain tax write back items). However this quarter was a unique quarter, because of the merger. As a result of the merger, intangible assets, mainly goodwill amounting to ₹ 2,599 crores arose in the books. Under Indian GAAP goodwill can be amortised over five years. However, as a prudent measure, the Board decided to accelerate the amortisation of intangible assets to the profit and loss account.

To put it in simpler terms, the amount paid to Erstwhile Capital First Shareholders (as per the swap ratio between the two entities) included a premium component over fair value of net assets. This premium resulted in intangible asset (mainly goodwill) on balance sheet. As a prudent measure, we decided to accelerate the amortisation on such

intangible asset and charged it to P and L account. Hence it is only such assets, created through this merger accounting, that have been charged to the P&L, and this charge has not affected the Net worth (core shareholder funds) of the bank negatively.

Q6: What has been the impact on Networth as a result of the merger?

The net worth stands increased by ₹ 3,600 crores due to the merger and stands at ₹ 18,376 crores as of Q3 2019 as compared to ₹ 14,776 crores for Erstwhile-IDFC Bank in Q2 2019. As you can see from the above calculations, there has been no reduction to the net worth (shareholder funds) as a result of the losses posted this quarter by the Bank. On the contrary, the net worth has increased by ₹ 3,600 crores on merger.

Q7: Was there any goodwill carried by Erstwhile Capital First on its books which had to be charged off to the P&L on merger?

No. Erstwhile Capital First did not carry any intangibles such as goodwill or brand or by whatever name called. Hence there was no need for charging off any amount pertaining to intangibles of Erstwhile Capital First to the P&L of the combined entity.

Q8: The bank could have continued to keep the goodwill on its books. Why did you have a charge of to the P&L account?

Under Section 15 of the Banking Regulations Act, banks are restricted from declaring dividends in the event the Bank carries intangible assets such as goodwill on its balance sheet. Hence accelerated amortisation of intangibles, mainly goodwill was required to be done in order to be able to declare dividends.

Q9: What would have been the normal profit for Q3 had the above accelerated amortisation of goodwill not been done during Q2 2019?

The normalised profit after tax of the bank would have been ₹ 153 crores, which includes ₹ 72 crores because of certain tax write back items. The PAT would have been ₹ 81 crores for Q3 2019 but for the accelerated accounting.

Q10: What is the book value per share of IDFC FIRST Bank at starting point of its new journey, as of today?

The Book value per share is ₹ 38.43 post the merger. This contains no goodwill or intangibles as this has been charged off P&L this quarter Q3 FY 19.

Q11: Why has the NPA amount gone up in absolute numbers as well as percentages from 1.6% to 1.97% this quarter?

Stressed Assets

In INR Cr	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Stressed Assets	5,316	3,884	3,836	3,120	3,826
NPL	2,777	1,779	1,774	895	1,671
Others Loans	1,342	927	918	856	787
Stressed Equity	1,197	1,178	1,144	1,149	1,149
Stressed SRs (NPI)	-	-	-	220	219
Provisions	3,399	2,717	2,726	2,542	2,788
NPL	1,570	888	893	574	874
Others Loans	814	814	825	599	545
Stressed Equity	1,015	1,015	1,008	1,149	1,149
Stressed SRs (NPI)	-	-	-	220	219
PCR	63.9%	70.0%	71.1%	81.5%	72.9%
Security Receipts	1,997	1,984	1,958	1,712	1,672
Provision on SRs	332	349	349	196	196

The NPL for the quarter has increased from ₹ 895 crores to ₹ 1671 crores. This is mainly because of the amalgamation of the loan book of Erstwhile Capital First. Just like all line items including net interest income (NII), fee income, and expenses show an increase because of the merger, in the same vein, this line item too so an increase because of the merger.

Q12: What is your anticipation on credit performance on the retail book going forward?

Since a substantial part of the retail loan book comprises of the loan book from Erstwhile Capital First, and considering that the retail lending machine of Erstwhile Capital First is proposed to be scaled up on a banking platform, it is important to explain the texture of the loan book as well as the methodology used in underwriting and collecting loans.

Erstwhile Capital First followed high levels of due diligence in underwriting loans. For larger ticket loans such as loan against property, a number of checks were done before loans were sanctioned. For example, in the Mortgages business at Erstwhile Capital First, about 38% of the total applications were disbursed after passing through several levels of scrutiny and checks, mainly centred around cash flow evaluation, credit bureau (2-4% rejections on this count) and reference checks and personal interviews (about 10 % rejections on this count). About ~40% of applications were rejected because of the lack of visibility or inadequate cash flows to service the loan. Such due diligence helped Erstwhile Capital First continues to maintain its asset quality in mortgages and loan against property.

For smaller ticket loans, the company followed automated scorecards for being able to evaluate their credit worthiness of the customer. These scorecards have been validated again and again over the last eight years and have only improved over time. The portfolio

has been highly granular and consists of loans to over 7 million customers cumulatively, and 4 million live customers. During the period of these eight years, there have been significant periods of stress testing such as

- a. Increasing interest rates between 2010 to 2014
- b. Demonetisation (2016): Undoubtedly this was the ultimate stress test. 86% of high-value bank notes were withdrawn suddenly, yet the loan book continued to perform well immediately as well as over the subsequent two years which demonstrates the strong risk management controls and resilience of the loan book.
- c. Implementation of GST (2017): This affected small and medium enterprises in the short run during implementation, yet there was minimal impact on the asset quality of Erstwhile Capital First.

Despite such repeated stress testing, the gross NPA and the net NPA of the loan book consistently remained at approximately ~ 2% and ~1% respectively. The bank shall continue to maintain high standards of governance, credit quality and therefore reasonably expect that the retail book will continue to behave well over the years.