IDFC Limited

Q1FY15 Earnings Conference Call Transcript

July 30, 2014

Moderator Ladies and gentlemen, good day and welcome to IDFC Limited's Q1FY15 Earnings Conference Call. As a reminder, all participant lines will be in a listen only mode. There will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference, please signal an operator by pressing '*' then '0' on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Bimal Giri.

Bimal Giri Good afternoon everyone. I welcome you to this conference call organized to discuss our Financial Results for Q1 of Fiscal '15. I have with me Rajiv Lall, Vikram Limaye, Sunil Kakar and our Chief Risk Officer – Pavan Kaushal. Before we begin, I would like to state that some of the statements made in today's discussions may be forward-looking in nature and may involve risks and uncertainties. Documents relating to our financial performance have been e-mailed to all of you; these documents have also been posted on our corporate website. I now invite Sunil to provide key highlights of our performance for Q1FY15.

Sunil Kakar Hello everyone and thanks for joining us today. I will focus on macro and then key highlights related to Q1FY15, I will then invite Rajiv to talk about our banking journey and the way forward, post that we will open the floor for Q&A.

The strong and stable electoral mandate for the new government augurs well for the medium to long term prospects for infrastructure development and growth. As we have shared before, the issues in infrastructure are complex. They pertain rare economy issues ranging from fuel supply, environmental approvals, to complex center state dynamics. It is our belief that our determined central government can address these issues and bring back private sector participation in infrastructure earlier than expected.

The union budget and the consequential RBI circular provide a strong impetus to long-term infrastructure financing by banks in a calibrated manner starting this fiscal. Regulatory dispensation for banks supporting long-term infrastructure funding has been provided. By 2020, the long term infra loan book of banks that is supported by bonds will not attract any regulatory commitment. This would be true for the incremental net growth in the long term infra loan book also. These benefits have also been extended to affordable housing in the context of banks. However, as we are a bank in the making we have sought clarification from the regulator on how the circular would specifically apply to us.

This should help us determine our forward strategy for the next 12 to 15 months. In addition there has been another circular from RBI which allows for flexible structuring of long term projects. This circular allows that it should synchronize the repayment program of a project with the cash flows spread over a longer period of time subject to the economic life of the project.

On infrastructure, progress in the FRP implementation in some states has been tardy. The appellate tribunal for electricity has provided interim relief to large groups for their projects at Mundra. Accelerated depreciation for wind power projects has been reintroduced. The target for award of road project this fiscal is high relative to actual awards over the last two years. NHAI has approved premium re-schedulement for identified projects.

Also in telecoms, the data usage is supporting ARPU growth and the number of active subscribers is increasing also. Also TRAI has put forth recommendations on spectrum sharing.

To summarize, it is our belief that private sector participation in infra CAPEX should begin sooner than most expectations and it is hopeful that the growth from thereon would be more calibrated and sustainable.

Now moving on to Q1 FY15 financials:

Our balance sheet growth was about 6% Y-o-Y. Our gross loan book decreased by 7% from Rs.57,600 crore as of June 13 to Rs.53,848 crore as of June 14. In Q1FY15 gross approvals were approximately only Rs.1,000 crore and gross disbursement was Rs.2,463 crore compared to Rs.3,115 crore and Rs.3,206 crore in Q1FY14. On a consolidated basis our operating income decreased by 13% from Rs 1,021 crore in Q1FY14 to Rs. 887 crore in Q1FY15. This was mainly due to lower trading income of Rs.18 crore in Q1FY15, compared to exceptionally higher trading income of Rs.137 crore in Q1FY14. NII, the Net Interest Income remains stable as Rs.682 crore in Q1FY15 as compared to Rs.684 crore in Q1FY14. Non-interest income decreased by 60% from Rs.333 crore to Rs.134 crore and our loan book related fees also decreased by 67% from Rs.23 crore to Rs.8 crore

Operating expenses decreased by 60% from Rs.139 crore in Q1FY14 to Rs.55 crore. This was largely on account of a change in depreciation policy for assets and we have aligned ourselves to be consistent with the Companies Act and the industry practice for the banks. As a result of the change, the net impact at a PAT level of this change is favorable Rs.70 crore. Our pre-provisioning operating profits decreased by 6% from Rs.882 crore in Q1FY14 to Rs.832 crore in Q1FY15. Our provisions for loans and investments increased by 3X from Rs.59 crore in Q1FY14 to Rs.204 crore in Q1FY15.

Provision for loans also increased in the same proportion. Post provision, profit before tax decreased by 24% from Rs.823 crore to Rs.628 crore. Profit after tax decreased by 14% from Rs 557 crore to Rs. 482 crore in Q1FY15. I also wanted to highlight that the other income in Q1FY15 was higher by Rs.66 crore and the effective tax rate in Q1FY15 was lower by 23% on account of a favorable income tax order relating to prior years.

As on June 30, 2014 our gross NPLs were 64 basis points as compared to 56 basis points as of March 31, 2014. Our net NPLs were 43 basis points compared to 37 basis points as of March 31, 2014. Our loan provision ratio was at 3.1% of loans. As of June 30th, 2014 our restructured loans were at 5.3% of which almost 85% relate to energy sector and of that, 45% relate to gas based assets. Our net security receipts were only 0.2%. We continue with our prudent policy of making adequate level of counter cyclical provisions which is reflected in the high level of floating provisions we have created in the last two quarters. Although we are seeing a significant level of optimism and improved business confidence we believe that it would take a few more quarters before we witness any tangible signs of improvement in the sector.

We continue to review our asset quality and would adjust our rate of provisioning as we see improvement in the sector. Just one additional point before I hand it over to Rajiv. In the last call we had mentioned that our overseas holding has to be reduced from 53.7% to less than 50%. I would like to share with you that as we speak, our current holding of foreign shareholding is now down to 51.7%. So in case it continues to trend in the same manner we may not need to dilute further. However, if required to bring it down to below 50% we may need to issue additional shares and the dilution now would be only 4% compared to the earlier expectation of almost 7.5% to 8%. We will address this issue as we go forward.

I would now like to invite Rajiv to share his thoughts about our banking journey.

Rajiv Lall In our last call I had shared with all of you our preferred structure for IDFC Bank. This structure, the good news is has now been approved by the RBI, so just to remind you all we will be going through in the coming months a court approved demerger process after which

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most assets and liabilities from IDFC will move from the IDFC balance sheet to IDFC Bank. The bank will be a listed entity on day one and all existing shareholders of IDFC will receive a direct shareholding in IDFC Bank. Effectively there will be two listed entities in the overall IDFC group structure. There will be IDFC the parent that will continue to be listed, and there will be IDFC Bank which will appear as a subsidiary of IDFC underneath a non-operating finance holding company.

As Sunil has already mentioned our overseas holding in IDFC will need to be brought down to under 50% in order for us to be compliant with the RBI regulations for new banks. But to start with, the overseas ownership in IDFC Bank will be less than 25%, whereas the limit imposed on foreign ownership within the bank for the first five years is 49%. Point being, that upon listing the new bank will have headroom for additional foreign ownership. This headroom for foreign ownership will be enhanced further to 74% after five years.

I would like to give you some color with respect to the operational preparations for the bank. Barring one senior person all our hiring for the CXO level is now complete. Pavan Kaushal who has joined us for this call has now come on board officially as of July 1st as our Chief Risk Officer. Pavan will be the Chief Risk Officer of the bank. Pavan has over three decades of experienced covering the entire gambit of risk operation and financial services across many geographies. Prior to coming to IDFC he worked with Ernst & Young as a partner in-charge of their risk practice. Prior to that he was with Citi and before that he was with AMZ. Sadashiv Rao whom you all know is his predecessor will now take on a new role within the group as the CEO of proposed IDF NBFC which we will be setting up in the next few months.

With the change in regulation supporting long term infrastructure financing by banks we will now focus on using our decade and a half experience in this space to also grow our infra loan book. Whereas previously it was not clear that it made sense for us to grow the size of the infra loan book with the new regulations unveiled by the RBI just last week. The profitability of our infrastructure related loan book in the bank is now secure. This does not however change our strategic choice to become a universal bank, what it does mean is that it actually increases our transitional profitability, as we transition from our existing operations in to full-fledged banking operations.

What it also means is that the compliance cost that would otherwise have applied to us during the transition will also be significantly reduced. All-in-all the developments over the last few weeks have been a very strong boost for our plans for transformation into a bank. As I said to reiterate the point strengthening our transitional profitability reducing our transitional compliance cost. Also generally making the task of transforming from a primarily infrastructure focussed business to a more universal banking franchise significantly easier.

We will now open the floor to Q&A, happy to give you more color, subject to your question.

Moderator Our first question is from the line of Nilesh Parikh from Edelweiss Securities.

Nilesh Parikh As You have got the RBI go ahead on the structure and you mentioned that you will probably apply in the court for demerger. Could this happen before September 30th ?

Rajiv Lall Yes. So actually what will happen is that the bank will not be operational until the RBI confirms that it is operational. So it is actually a two-step process, the demerger will happen or the separation of the balance sheets will happen in anticipation of the launch of operations. But the actual banking operations will be effective after that.

Sunil Kakar There is an appointment date on which we will transfer the assets and liabilities. So the court approval will be there, but the exact date we will try and bring it as close as possible to be operational which will be post the RBI approval of the final structure. So around September-October we will try to close it out.

Nilesh Parikh Before that you should get the classification in terms of whether the existing asset on books is eligible for the exemptions also. So that will decide the extent of assets which will get demerge into the bank.

Rajiv Lall But I know there will be lot of questions just to anticipate that. I was saying that anticipating questions on the RBI circular, the interpretation of which is going to be clarified in writing by the RBI in the coming next few weeks. But even in anticipation of that clarification, at the minimum what is quite clear is that, ab initio, upon the launch of operations of the bank, at least 30% of our existing infrastructure loans will be eligible for the regulatory relief articulated in the RBI circular. Further overtime, i.e. over the following four years beyond that 100% of our existing infrastructure loan assets will be eligible for the regulatory relief. What we are waiting to clarify from the RBI is if those benefits will actually be up fronted in our case.

Nilesh Parikh But I wanted to understand whether you will probably get that response before the demerger?

Rajiv Lall 100%.

Nilesh Parikh This would decide the quantum of assets which gets demerged into the bank?

Rajiv Lall Yes. It has material implication for our interim strategy, so we must have that clarification.

Nilesh Parikh My next question pertains to the restructured assets. The restructured assets are is about 5.3%. So, how much of that would be gas?

Sunil Kakar Of the total restructured asset, 85% belongs to the sector overall of power and energy. 45% of this 85% will be gas.

Nilesh Parikh Okay, and this would be largely on the operational assets or would include the 3.4% exposure that we have on the under construction projects also?

Sunil Kakar The combination of both.

Nilesh Parikh So do we expect this number to actually build up? I just wanted to get a thought because 3.4% is gas under construction and so just wanted to understand how much of that has already come in and what is the expectation for the balance portfolio of gas?

Sunil Kakar It would be quite challenging to forecast at this point in time. But let me tell you what is the process by which we arrive at that is, we continuously review our asset quality every quarter if not more frequently and based on the micro environment and our judgment of what is happening in that space, we expect to see whether this asset is moving towards or if it does get restructured or not. So given our current rate the only thing I can say is that, that is why it is linked with our provisioning. That is why we continue to do our floating provision and going forward as and when these assets come to a stage where they need to be restructured they will be restructured and so in over time we will come to know more about it, at this point in time I don't know.

Rajiv Lall So let's not beat about the bush. There will be an increase in our restructured assets. But you have to be very clear about what is the nature of these restructured assets is. We believe that apart from the gas assets about which everybody knows it is a matter of public record, the other restructured assets that we have on our book are restructurings that are solid good restructuring means they are very unlikely to go bad again. And against those restructured assets whatever general provisioning we have will in our judgment which has been shown to be prudent historically will be more than enough to take care of any potential future value diminution. The rate of growth of these restructured assets is clearly slowing down. But they are going to increase and they will probably peak I would say over the next 12 to 18 months. Certainly before we become a bank.

Nilesh Parikh I am coming back to the question around the bank. In the interim, till the bank is operational would you be raising these infra bonds? Is it possible for you to raise infra bonds and take down assets?

Sunil Kakar Yes. Depending on if we have good quality assets to fund we will raise those infra bonds and it is subject to the clarification which we are awaiting from RBI once that comes we will take

appropriate action. The strategy for the next 12 to 15 months will get recalibrated once we get clear instructions from RBI.

Nilesh Parikh So if RBI is in the affirmative that it's exemption is available, but if it actually does not come in, does it change the course of you taking on more infra assets till the bank is operational?

Rajiv Lall That depends on really the risk in the infrastructure sector. Just because it has become cheaper from a regulatory burden point if you have to do infrastructure asset underwriting, it does not necessarily make it a worthwhile proposition. It depends on the risk, in the sector. If the risk does not fundamentally reduce we will be foolish to keep underwriting new power projects if there is no coal.

Nilesh Parikh I was just trying to understand, that till we become a bank the consolidation phase on the loan book will continue?

Rajiv Lall When you say consolidation what do you mean?

Nilesh Parikh I am saying in terms of the earlier stance was that you probably could see a bit of rundown on the loan book because of the transition process.

Rajiv Lall In fact, the pressure clearly on us running down the loan book is not there anymore. We would like to maintain the size of the loan book pretty much where it is.

Moderator The next question is from the line of Suruchi Jain from Morning Star.

Suruchi Jain I just wanted to know your revised guidance on profitability and operational cost, specifically on the NIMs and how they will move in the interim while you transition to a bank and how the cost to income ratios will also move?

Sunil Kakar The NIMs have been stable, incrementally our focus has always been to lend to high quality assets so there could be some moderation in the NIMs but not more than 5 to 10 basis points on a portfolio level. With respect to OPEX to income ratio obviously the fact that we are investing and transitioning to the bank that will increase.

Rajiv Lall We will, I think going forward now share with you the spending that we are allocating towards building the bank, so that you should be able to compare the health and the characteristics of the existing business versus what is being spent towards preparing for the bank.

Suruchi Jain My other question I had was on REITS. I know there is lack of clarification on what exact form the REITS will take. But just from a prime facie point of view what is your opinion on whether that would help you?

Vikram Limaye In terms of IDFCs balance sheet itself, I don't think the REITS or the investment trust would necessarily be vehicles that we would use. But as you know we have an alternatives business, we also have an investment banking business, etc. So depending on how issuers view this vehicle and I certainly hope that issuers would use this vehicle whether it is real estate companies or infrastructure companies. Then the implications are only positive both for our alternatives business as well as for the investment banking business. But purely for IDFC loans I do not think that we would be using the REIT or the investment trust vehicle.

Sunil Kakar Yes, but this should materially help our alternatives business and the first and second in the infrastructure funds that we have raised. As this will vastly improve the exit options for investments that they will make and show that the profitability of their portfolio, the performance of their portfolio should be more visibly and tangibly improved.

Suruchi Jain Okay, that is helpful and just a follow-up. What about infra loans in a way becoming less risky because they have other modes of funding. Do you think this would not apply to the kind of infrastructure loans that you have on your balance sheet so that they are more cash flow rich that they could pay back loans faster.

Rajiv Lall Right, I think if I have understood your question correctly. So indirectly it should help everybody's loan portfolios because the creation of infrastructure REITs should allow some stretched balance sheets of corporates to be recapitalized. So you can imagine some real estate players who will hive off a part of their portfolio and try and raise additional capital through a REIT structure. This hopefully will strengthen their parent balance sheet and that in turn will reduce the stress on their creditors. So that dynamic, yes, in a macro sense it should be helpful.

Moderator The next question is from the line of Manish Ostwal from KR Choksey Shares & Securities.

Manish Ostwal My first question is with respect to this business of investment banking and broking. It has been that some of the companies have reported a significant increase in volume and profitability on a quarter-to-quarter basis. So is there any one off on the Q4 numbers which is pulling down the Q-and-Q decline in the earnings or this quarter was not that great?

Vikram Limaye This is not a business that you can plan quarterly. I wish we could plan all our businesses quarterly. As you know all this is dependent on specific deal flow and which deals close in which quarter. So I would not encourage you to look at this on a quarterly basis. We certainly expect that given the sentiments surrounding India having improved materially and therefore the flows into India having also improved materially, that has certainly reflected and broking revenues picking up relative to what they were last year. The investment banking transactions are more transaction based revenues and that is really dependent on which deals close which quarter. But we certainly expect this year to be a much better year than last year.

Manish Ostwal Can I have your views with respect to the impact of the tax rate increase in FMP product, both for profile and the mutual fund business perceptive?

Sunil Kakar Yes. On the mutual fund business, long term investors are not negatively impacted because if you do your index adjusted tax rates and if you are investing for three years I do not see a significant impact from a tax perspective. As far as corporate and money flow is in the short term are concerned they were any way investing in shorter money market fund so we do not expect a significant impact on that. There may be some marginal impact in the short run because of sentiment but over a period of time it should recover as we are able to explain to investors or rather long term buyers of fixed income that it is better to still invest in mutual fund because after tax you are not losing anything and you will probably be still as effective post tax returns which are quite effective and competitive. Now with respect to our funding from bonds, through mutual funds as you see we would always like to encourage to get longer term funding and this whole thing is structured to encourage long term savings and hence long term savings will, over a period of time, be beneficial for us also.

Manish Ostwal Last year you had given a guidance of maintaining provisioning at 2% and you had ended up with 2.4%. Also, in this quarter we can again see the jump in the provision to 3.1%. What is your internal target to maintain that level before you get converted into a bank?

Sunil Kakar There is no fixed target. Remember these are voluntary floating provisions. It is not driven by regulatory requirements. We are way above the regulatory requirements. As I had mentioned somewhere earlier or if not that our philosophy is that every quarter, every semiannual period we review the situation, review the macro and based on that the provisioning is continued to be made. These are if I may use a technical term counter cyclical provision buffers and it is a function of what we anticipate the impact of our total asset book. Now going forward if things improve which we hope it would and that is why I mentioned that it would not be appropriate to see it after two to three quarters and the rate of provisioning would get modified depending on what tangible benefits we start seeing in the infrastructure sector. In short as Rajiv also mentioned that we do see further increase in our restructured assets. So if that goes up, provisioning will also go up appropriately. But the bottom line is that we are driven by one philosophy that we should have adequate levels of provisions to take care of any adverse situation which may come up in the future. So these are prudent provisions which we are making and we may not need it, mostly likely it depends on what happens and if things improve these provisions will come back into the P&L, so these are floating provisions being created as a prudent measure.

Manish Ostwal Lastly, with respect to the restructured loan number 5.3%. What is the provision we have made against that asset?

Sunil Kakar 5%.

Moderator The next question is from the line of Amit Premchandani from UTI.

Amit Premchandani As mentioned earlier with respect to the statement about 30% of infra loan to be eligible for relief been issued. How did you arrive at this figure I may have missed it.

Sunil Kakar If you see that the formula is such that it reduces by 16% every year, i.e. B-0.84 in the first year. But we will become a bank in the second year of this slope, so it is B-0.7A from the asset side.

Amit Premchandani Have you clarified with RBI about this 30%?

Sunil Kakar No. That is on the asset side of course there is a liability side also.. It is a minimum of EC and long-term bonds whichever is lower of the two and we are in the process of clarifying with RBI which Rajiv had mentioned that we should get the answer within a few weeks.

Rajiv Lall But our belief is that the clarification of the RBI will not be worse than this interpretation. It can only be better.

Amit Premchandani My next question is with respect to the investment book. Is the increase in investment book quarter-on-quarter anything to do with building up SLR portfolio or is it normal treasury management?

Sunil Kakar No, it is to do with building up of the SLR portfolio.

Moderator The next question is from the line of Ramnath Venkateswaran from LIC Nomura Mutual Fund.

R. Venkateswaran There have been news reports that the government is looking at an ARC type of structure for road and power sector. Given our position have we been sounded out on some of these structures that the newspapers are speculating and if so, if you can just elaborate on that?

Rajiv Lall Yes, we have been sounded out on the structure and we have been engaged in conversation with various people concerned about how this initiative may be brought to fruition. I think it is fair to say that there is lot of noise around this at this time. There are many stakeholders involved and to build consensus amongst the stakeholders is not going to happen very quickly. But the ministry of finance is pursuing this as is NHAI and we would continue to engage with both of them to give them our feedback and our inputs into how such an ARC may function and how it may be designed.

R. Venkateswaran But there has not been any concrete development in terms of the finalization of the proposal has not yet happened completely?

Rajiv Lall So it has not happened completely but there are all kinds of conversations that are happening. So may be in the next month or so we will have greater clarity about where this initiative really stands.

R. Venkateswaran Okay, so we would be participating in that both as an equity partner?

Rajiv Lall That depends on what the structure it is that is finally proposed. Under certain set of circumstances it makes eminent sense for us to participate, if they choose to design it otherwise it may not make sense for us to participate.

Moderator The next question is from the line of Rob Sheridan from Ward Ferry.

Rob Sheridan Have you significantly changed your thinking on how much of your loan book you would like to come from non-infrastructure loans over the next three to five years, given the exemptions that the RBI has given for infrastructure lending? What we should expect in terms of liabilities mix over a similar period particularly from low cost deposits?

Rajiv Lall Those are very fundamental questions. I think it will be fair to say that we will not have a very precise answer until we have formal clarification from the RBI. In the interim our response would be really more in the nature of judgment if not speculation. But not to obfuscate on this issue what is very clear is that as a result of this circular even subject to whatever clarification the RBI will provide us in the coming weeks. What is clear is that the way the infrastructure business gets managed in the bank will change. Whereas previously you would have managed an infrastructure vertical as part of a large corporate franchise with a notional cost of funds that would be a matter for internal MIS through a funds transfer price. Now it would conceptually make sense to run the infrastructure bank on the basis of cost of funds that is linked systematically to the cost of borrowing in the long term bond market. So that is point number one.

Second, what is also clear even on the basis of existing information is that the inherent profitability of the infrastructure loan book will be greater than what we had previously projected in the absence of the RBI circular and therefore it gives us greater opportunity and greater flexibility to calibrate the speed of the build out of our retail franchise. Prior to the RBI circular we had no choice but to build the retail franchise as quickly as possible, in order that we might raise depository liabilities to fill and backstop our already large balance sheet. To the extent now that at least a part of our starting balance sheet can intelligently and commercially viable be funded through long term bond financing, the pressure on us to raise retail liabilities and depository liabilities quickly has become smaller and therefore we can be more deliberate and more strategic in how we build out the retail platform. But more on that later, I think at this time this is at much colour as I can give you.

Moderator The next question is from the line of Nilanjan Karfa from Jefferies.

Nilanjan Karfa The 30% number you had mentioned earlier, is on the loan book as on 16th of July. Is that right?

Rajiv Lall Yes.

Nilanjan Karfa Which means if you want to take the entire regulatory benefit, any incremental 7 year+ bonds would have to be raised after that date. So you have to essentially raise 30% of that?

Sunil Kakar Some of it we already have and some we have to raise because we are the few entities who already have more than seven year bonds. The other point is subject to clarification of course there is a fact that from here till the conversion to bank whatever we do incremental that would also be eligible.

Nilanjan Karfa I was just reading out exactly the surplus it says outstanding long term bonds issued to finance, infrastructure loan, and affordable housing in terms of this circular, the circular that came out as of that day. So I am just wondering if you have got clarification your existing seven year liability will also qualify for this?

Rajiv Lall Yes, so the existing seven year liability ought to be eligible for it. In a worst case scenario, only those liabilities that are beyond seven years residual maturity at the time we become operational as a bank will be eligible, but we can always raise that number between now and the time we become a bank. So, there are number of moving parts here. The formula is kind of tricky and complicated. I think beyond the guidance we have given you today, we will only be in a position to discuss this much more precisely once we have clarification from the RBI which we all recognize is really very important.

Nilanjan Karfa Going forward whatever you raise are they going to be more concentrated towards the 7 year plus?

Rajiv Lall Yes, that is incontrovertible.

Moderator The next question is from the line of Amit Ganatra from Religare Invesco.

Amit Ganatra Is there any specific reason for the increase in the equity investments in this quarter?

Sunil Kakar No, this is a structured deal which should get liquidated by the end of this calendar year or latest by this fiscal.

Amit Ganatra You had briefly mentioned about the potential shareholding pattern of the bank in which you said that the FII holding will be of about 25% and could be increased up to 49%?

Sunil Kakar That is correct.

Amit Ganatra But typically shouldn't the shareholding be a mirror image of the shareholding of the IDFC currently?

Sunil Kakar No, let me explain it to you. At the bank level who are the shareholders. The first single largest shareholder is 51% will be held by IDFC through the NOHFC. This NOHFC is a domestic company now because the promoter IDFC Limited is a domestic company.

Amit Ganatra So because of IDFC being regarded as a domestic entity the shareholding pattern changes.

Sunil Kakar Correct. That is why we have to ensure that we become domestic before we move into the banking sector.

Amit Ganatra Also I have a small question on the liability front which was just discussed in the previous question as well. For liabilities doesn't the RBI circular also ask that this liability should be unsecured in nature? Right now as I see your balance sheet, largely all the borrowings are secured in nature.

Sunil Kakar Correct. We have to issue unsecured. Any which way when we transfer to the bank all these bonds will have to be grandfathered and we are seeking approval of our investors to convert them into unsecured.

Moderator The next question is from the line of Sapna Naik from Bajaj Finserv.

Sapna Naik Can you give me the breakup of provision of restructured provisions and floating provisions?

Sunil Kakar Restructured provisions would be about 5% of whatever the restructured assets are and the rest classified largely into floating provision.

Sapna Naik Regarding the IDF, the new subsidiary, which you have started now. Can you tell me which assets would be eligible to be transferred and how will be their income recognition over there?

Sunil Kakar We are in the process of forming that company and as the IDF rules have been defined by RBI as of now so you can go through that but there is a possibility that rules could get modified.

Vikram Limaye So I think we will clarify this more on the next call because we are awaiting some clarification from the Ministry and Reserve Bank on what the mandate of the IDF could be. There is an existing regulation and then there have been representations that has been made to try and broaden that mandate for the IDF. If that were to happen then obviously the opportunity landscape could be quite large. In the current construct it is more restricted, so I would prefer to comment on this only a bit later once we get clarification from the Government and RBI which we hope we will get before we have the next call.

Moderator The next question is from the line of Manish Shukla from Deutsche Bank.

Manish Shukla Just going back to the infrastructure bonds, as you had pointed out earlier to the formula where there is an asset side and then there is a liability side. Based on your experience of funding infrastructure what level will you be comfortable funding with a 7 year kind of majority of liabilities? As in what proportion of assets will you be comfortable funding it?

Rajiv Lall As a bank?

Manish Shukla Yes. 100% of your assets will qualify over time but what I am trying to understand is how much of that would be funded from 7 year + bonds?

Sunil Kakar First of all I want to add that it is not 100% of assets. It is 100% of eligible assets in the sense that those who have project loans with seven year maturity, etc. As a bank we would be right to see that this falls back on the ALM. So we would like to ensure that the ALM risk is minimized. So if I have a seven year asset, I would like to fund it with the seven year liability or more than seven year liability. Now interest rate risk is different from cash flow maturity risk. Now it depends again I am going back that if it is a fixed rate seven year asset, I would like to fund it with a fixed rate seven year liability. Now if the interest rates are reset more frequently as is the case, then we may have to use certain interest rates swaps to ensure that the interest rate risk is minimized. But to answer your question, the quantum of eligible assets will be funded by long term bonds such that their interest rate risk is minimized and it says minimum of EC & LB, if I keep long term bond shorter then I will not get any benefit. I will get lower of the benefit.

Manish Shukla The reason I ask is, if you look at your March '14 balance sheet only about 12% of the bond borrowing is more than..?

Sunil Kakar I understand that, this is March '14 and by the time we become a bank that is September '15. So depending on the clarification, we will readjust the liability profile.

Manish Shukla To better understand the 30% eligibility that was discussed earlier if my understanding is correct, what you are saying is if some other infra NBFC were to become a bank five years from the date of circular, on the date of conversion 75% of their assets will be eligible?

Sunil Kakar Yes, that is the interpretation. As we have said repeatedly it is a bit of a complex circular and the best thing is to seek specific clarification from RBI but that is what it reads as we speak.

Manish Shukla Could you give an indicative number to the gross NPL if you are on a 90-day NPL recognition norm? Just a ball park would do in terms of how it would move from where we are?

Rajiv Lall With that we will come back to you by sometime closer to the time we become a bank. We do not want to put that out in the public domain just yet.

Manish Shukla During the quarter there was sharp jump in CBLO borrowing, it is almost 14% is that one-off for the quarter or is it going to sustain at that level?

Sunil Kakar Well as you will also see that there has been an increase in the treasury assets. The G-SECs which we have bought as a part of our SLR funding. So it is much more economical to finance those G-SECs through CBLO as the cost of borrowing goes lower. As we transition to the bank the CBLO borrowings will come down.

Manish Shukla But in the interim would it probably remain at this level?

Sunil Kakar Depending on the interest rates.

Moderator The next question is from the line of Shrey Loonker from Reliance Mutual Fund.

Shrey Loonker The conversion of the existing bonds to the unsecured status, what do the kind of cost implications it could have?A ballpark would be helpful.

Sunil Kakar Hopefully nil. But I do not see because security is not the primarily driving factor of whether the bonds are priced at what level. So this is part of the conversion into the banking space. So let me be more specific here. It may be if pari passu unsecured that means nobody has any senior level security in the bank so in one sense everybody is secure, because there is nobody who is senior to you in that space. But for new issuance there may be some 5 to 10 basis points we will have to see how the market reacts to it. But while we are converting we will ensure that it goes at that level.

Rajiv Lall No, I think you can make a stronger statement than that which to say that the pricing of the bonds does not depend on the secured or unsecured nature of this particular bond but it depends on the credit rating of the issuer. As long as our credit rating remains solid we do not expect any change in the pricing.

Shrey Loonker But is it also true from an appetite stand point or a funding availability standpoint that the unsecured status does not shrink the availability of investors into these bonds?

Rajiv Lall Everybody is speculating about that. If other banks are going to be issuing paper of a similar kind then we will have to test what the demand for this paper is in the market. But you know as well as I, that the corporate FII debt window remains substantially underutilized at this point. There are lots of ifs and buts here, but it could be that if the perception of international institutional investors is that the macro parameters of the Indian economy are stabilizing and therefore that forward exchange risk is more palatable and manageable, that they will be more willing than they have been in the past to hold longer term paper issued by quality issuers, i.e. the premier banks in the country and therefore there will not be such a shortage of demand as people are currently speculating. But these are to be tested, cannot give you any certain answer at this point.

Sunil Kakar Let me add to that so that it will give you a color and a different perspective, the regulatory incentive of this change of seven year bonds, etc., is something to the tune of 120-odd basis points you could have calculated that, I am sure you have. This 120 basis point will get shared between three parties which is the bank as an issuer, the borrower as well as the investor in the bonds. What that cut will be only the market can determine. So but in our modeling obviously we will not assume that all 120 basis points is coming down to the PAT level. If that helps you to answer but to be able to quantify exactly how much cost of funds will change and how much the borrower's yield will move is going to be difficult.

Shrey Loonker Has there been any cases in the past where we have issued unsecured long term paper?

Rajiv Lall All our issuances before 2010 it was all unsecured and remind me why did we move to secured.

Sunil Kakar Because we had to this 80CC bond which came in about 2010-11 that was secured and then we had to move everybody to secure.

Shrey Loonker But when that transition was made was there any cost differential or it was just about a new norms of doing it?

Rajiv Lall That is why I am saying there was no cost differential.

Sunil Kakar We did not get any benefit at that time.

Shrey Loonker If you can help me with one data point. From now till September 15th, what would be the broad order of repayments that we could see orderly repayments that we could see? And once you substitute, is it fair to assume that most of the repayments would be substituted with a similar 7 year + funding liability.

Sunil Kakar Yes, the quantum of repayment is a question on the asset side. Roughly in a year we would have about Rs.15,000-odd crore, is what the expected repayment is.

Shrey Loonker In your bond book?

Sunil Kakar In bonds and assets they are more or less close to each other and the replacement of that will be a function of again kind of assets we are able to grow from here till that September 15. But my most likely scenario is that the assets will grow and we will fund this more largely through 7 year + bonds.

Shrey Loonker On the restructured assets would we have taken any diminution in fair value over the last one year or so?

Sunil Kakar No, these are NPV neutral.

Shrey Loonker These are all NPV neutral?

Sunil Kakar Yes.

Moderator The next question is from the line of Rishi Arya from Canara HSBC.

Rishi Arya You initially talked about the new RBI circular on flexibility for loan maturity to adjust with infrastructure assets life. How significant do you think this is in the infrastructure lending space? Can you explain if that can also lead to rescheduling of existing assets?

Sunil Kakar I think that circular is very clear that it is only on the incremental projects. So the existing I do not think it will happen. But as a concept it is a very good thing to happen. There are so many uncertainties in the long term project that to have a very fixed and a hard cash flow based schedule of repayment is unnecessarily creating stress where none is required. So this circular provides the flexibility to take into account the various uncertainties in the project over its life. Obviously it also states that it is up to 80% of the economic life is what we can lend to. So I think it is definitely a better structure in terms of designing the project loans.

Rishi Arya Is it a game changer, is it good to have?

Rajiv Lall A game changer, I don't know, but it is very definitely a good to have. So let me try and explain this. There is lot of lack of clarity about what restructured assets really are? And it is a bit of everything. So there are some restructured assets that are difficult. There are other restructured assets in the system that are actually perfectly good assets. That, if they had been structured properly in the first place, would be under no stress today, but because of the narrowness of the definitions of the RBI they have to be classified as restructured assets. Now I couldn't hazard a guess, but if you say the total system restructured assets are 10% whatever the number is. I would not be surprised but this is totally speculative, I have not done any research on this, that at least half of these system wide would benefit from this 5/25 regulation that the RBI have now announced.

Moderator The next question is from the line of Pooja Swamy from Span Capital. .

Pooja Swamy As the bank structure has been approved by RBI, would you start building up your non-infra or retail assets before the bank is formed or would you wait for the bank formation?

Sunil Kakar We will do some pilot certainly in non-infra primarily PSL kind of space. That we will certainly pursue over the next few months.

Pooja Swamy Any timeline for raising this preferential equity?

Sunil Kakar Yes soon. We cannot give exact time line that would be sharing.

Rajiv Lall Can we say this quarter?

Sunil Kakar Okay

Moderator The next question is from the line of Jigar Valia from OHM Group. .

Jigar Valia My question relates to the flexible structuring of the loans. While it is applicable to incremental loans for banks, does it restrict you in the current form to restructure over longer duration and is there any demand from any of your existing clients?

Vikram Limaye This will not be applicable to existing loans. That is a short answer.

Jigar Valia What percentage of a seven year plus bond would be held by insurance companies and would that clarification also warrant before?

Sunil Kakar Yes. Insurance companies would be large players who would invest in long term bonds.

Jigar Valia So, while we move from secured to unsecured that formality, there would also be need to handle in terms of whether insurance qualifies?

Rajiv Lall That is an interesting question, we have been talking about clarification after clarification we could have add this to the list. Would paper that is 7 years plus issued by banks for the purpose of underwriting infrastructure loans. Would that qualify as an infrastructure investment for insurance companies?

Sunil Kakar As of now the answer is no.

Rajiv Lall But we need to keep pressing IRDA to change that point of view.

Sunil Kakar Yes, we will be in touch with along with the insurance companies so that would encourage them to direct long term savings towards long term assets.

Rajiv Lall That is the next battle.

Jigar Valia I just need a last clarification. You had said that above Rs.15,000 crore loans are getting repaid and we would sustain our overall loan book with the new growth which is coming during the transition period.

Sunil Kakar That is over 15 months.15 to 18 months

Jigar Valia Rs.15,000 crore is the number?

Sunil Kakar Yes.

Moderator: Thank you members of the management. Ladies and gentlemen, on behalf of IDFC Limited, that concludes this conference. Thank you for joining us.