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Prescient Capital

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IDFC First Deck

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IDFC First

Executive Summary

- **Indian banking sector growing at 3x GDP growth:** The Indian Banking sector is regulated leading to high entry barriers. There exists a significant opportunity for well-run private sector banks to participate in the expanding market as well as take market share away from legacy PSUs banks (AUM growth of >20%). High quality teams have demonstrated value creation in recent times (Gruh, DCB, Kotak, CANFIN).

- **IDFC First presents a unique opportunity to build a large retail centric bank:** Erstwhile IDFC had set the foundation towards building and growing the CASA base beyond Tier ½. On the other hand, Capital First (CF) has a strong retail product suite (next to Bajaj Finance). With their tech and a strong retail product push, the bank could have a profile equivalent to that of an ICICI/Kotak in the next 3-5 years.

- **Strong Execution:** An indicator of performance of a bank is strength of its retail liability franchise. IDFC First has been able to grow its CASA by >2x in the last one year. The bank has been able to transform itself from an Infra bank to a retail bank (63% of the book) over the last 24 months. As a result, the NIM of the bank has improved from ~3% in Q1 FY 20 to 4.98% in Q4 FY 21.

- **Conservative Book-keeping:** The longer-term sustainability of a bank is dependent on its risk management and conservative book-keeping. Over the last 18 months we have seen the new management provide for legacy corporate loans in a proactive manner. Examples such as providing for Vodafone outstanding loans (even while receiving regular payments) before any other bank did, is one such case. The management has also reduced the size of corporate loans such that impact of one account on the health of the bank is controlled. During COVID, the book has been tightly managed (GNPA of ~4.1%). The bank has also improved the average CIBIL score of the customers it is lending to.

Executive Summary

- **Management of CF has had a track record of both setting up retail business and turning things around:** The management took Capital First from the Future group and has increased ROE from 7% to 14% till the merger. CF had built a strong retail franchise: grew retail asset book from 94 Cr to ~30000 Cr in 8 years. Mr. V Vaidyanathan headed the retail banking of ICICI from 2000-09. During his tenure at ICICI, CASA grew by 15x (to USD 15 bn) and branch network grew from ~100 to ~ 1300. As an investor, I have seen the journey of RBL that promised to be a name in retail banking. This team has better retail banking creds and execution.

- **Attractive Pricing**: IDFC priced at 1.8x book, ideal; entry prices would be around 1.5x book. We expect the company to grow its retail loan book by ~20% in the next 6-7 years. Also, we see the business to have a ROE profile of 13-15% in the next 3-4 years. The bank is a real candidate for re-rating of valuation to a P/B of 3x. We see IDFC F as a multiyear bet. The combined book of the bank should grow by a 15% CAGR. We expect to make a return of 3.5x.

Why the merger made sense ?

History of IDFC

- **1997** — Starts ops as an Infra NBFC
- **2002** — Started AMC
- **2005** — Listed on the Exchange
- **2010** — Consolidates position as the largest infra lender in India. IDFCs infra bonds are the most liquid debt instrument
- **2011** — Enters JV to bid for infra projects
- **2015** — Demerges from IDFC. Gets a banking License. All financing business come under the bank. Parent becomes a holdco.
- **2016** — Infra assets under stress. Starts aggressive push on retail banking
- **2017-18** — Had an ALM mismatch, cost of funds went up due to short term borrowing, yield sticky due to long term bonds.
- **Jan 2018** — Agreed to merge with CF. Stock down by 35% from the merger implied valuation
- **Dec 2018** — Merger completed

Key Reasons for Merger?

- Both entities focusing on growing the asset base to SME/MSME IDFC
- IDFC has been moving away from the infra assets. Non Infra assets now constitute 60% of the wholesale book.
- MSME focus for CF is more for those who are not banked due to high business cost. CF provides WC, CAPEX and consumer fin to these.

Platform
IDFC Bank wants to grow its retail banking network

- Has grown its branch network aggressively by 3x in 2y.
- Expanded its CASA base beyond Tier 1. Has grown its retail touch points (Micro ATMs+ Aadhar Pay points to 20,0000.
- Grown the retail asset book to 40,000 cr in 3 y.
- Grown its retail customer base by 4x over the last 1 y.
- Grown the CASA book to 10000 cr over the last 3 y.

Asset Strategy
Both IDFC and CF have been focusing on SME/MSME loans.

IDFC First Bank

Liability Strategy
CF is good in retail finance. Has to build the liability side.

- V Vaidyanathan headed the retail banking of ICICI from 2000-09. During his tenure CASA grew by 15x (USD 15 bn) and branch network grew to ~ 1300.
- He has built a 32,000 cr retail lending book (60L customers) at CF in the last 7-8y. The same customers can be brought in to secure their deposits using structured products.
- CFs has a tech first approach which helps it to expand its reach and move fast. Tech used to crack Durables loans.

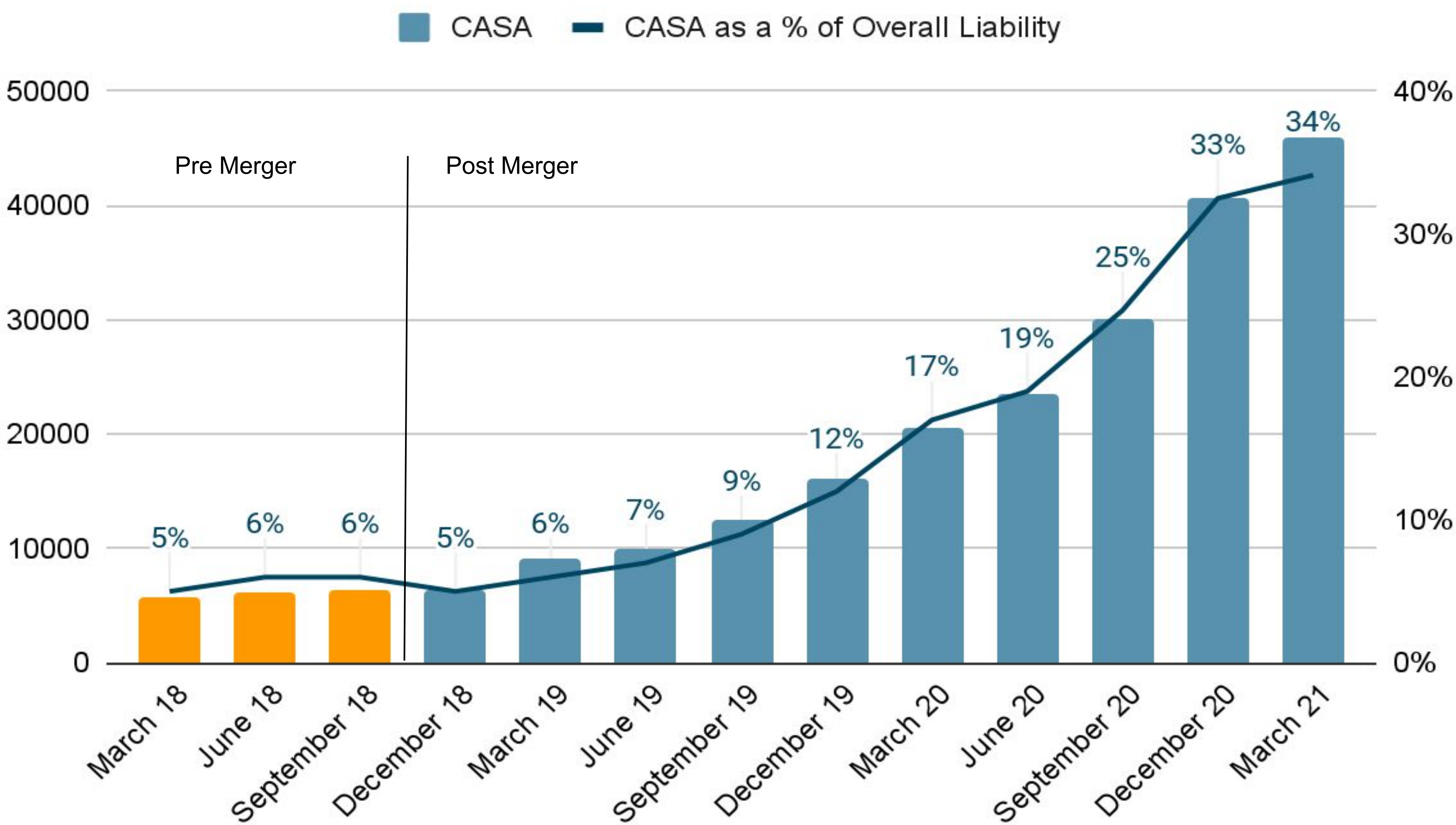
Between 2010-18 the CF team has:

- Grown AUM 30x to 27000 cr.
- Grown Retail assets by 250 x to 25,000 cr
- Upgraded long term credit rating from A + to AAA
- Reduced GNPA from 5.3% to 1.7%.
- Improved ROE from ~ 6% to 13%.
- Grown share price by 3.5x.

Team
Has turned around CF

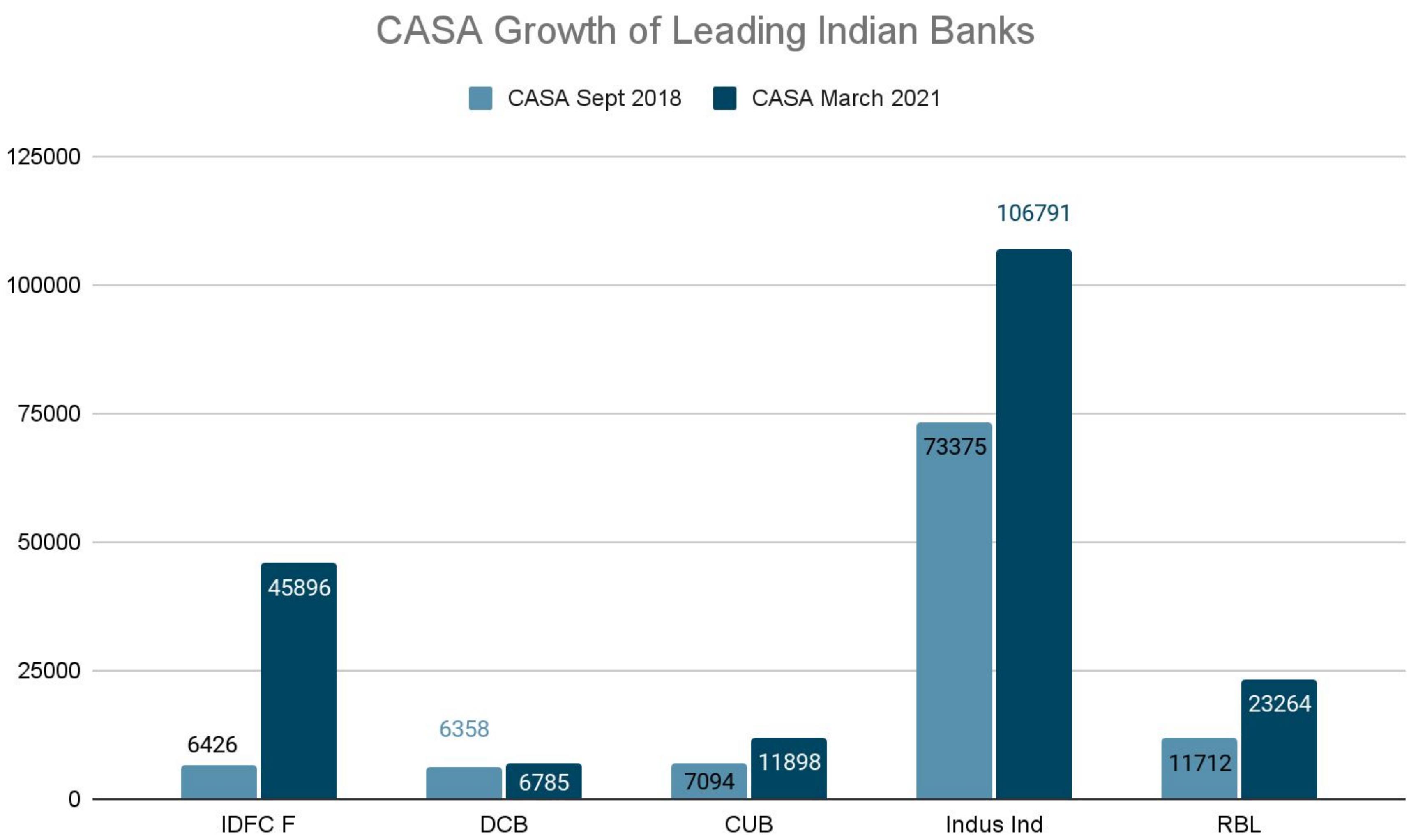
Strong Execution so far.

Rapid CASA growth by IDFC First



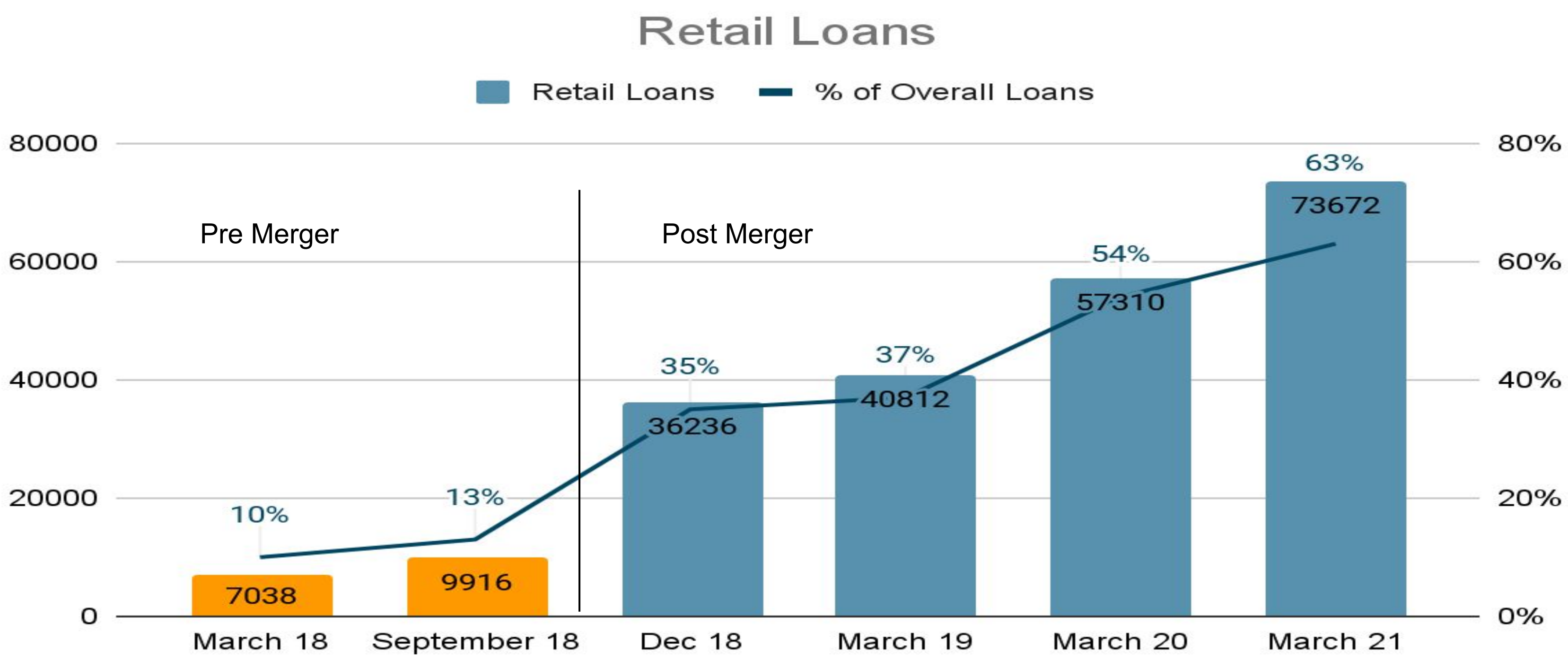
CASA protected IDFC First from liquidity shocks

Rapid CASA growth by IDFC First



Best in class CASA growth compared to comps

Asset profile becoming more retail focused



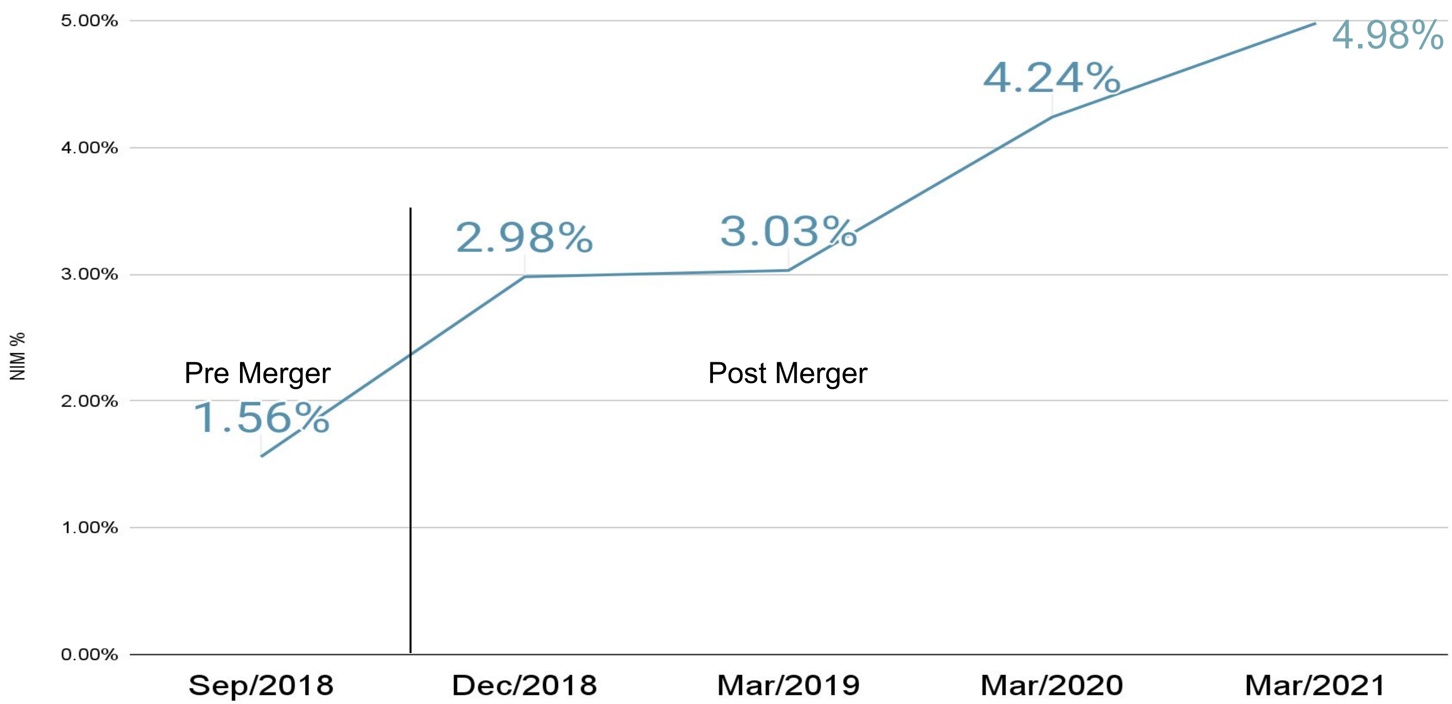
1. Retail assets have grown from 55 cr in FY 16 to 11,000 cr pre merger and ~74K Cr now.

1. The retail asset strategy is to focus on retail and MSME loans. Housing, MSME and Personal Fin are core areas for CF, on the back of which the loans will be lent.

1. Per merger Yield of CF was ~12% compared to 9% for IDFC Standalone.

1. Recent tie ups with Fin-tech companies helping in improving the new customer add bucket.

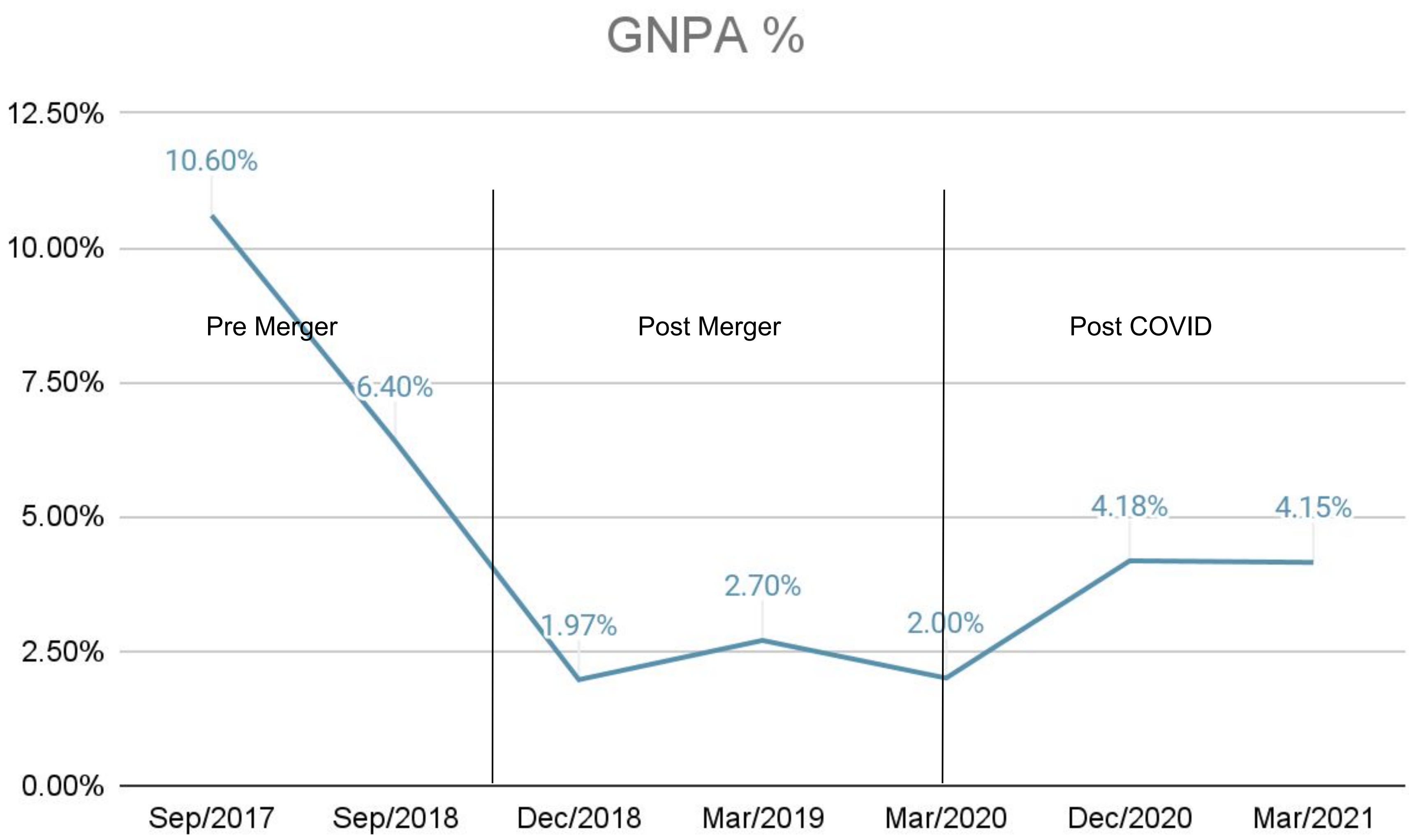
Leading to improved NIMs



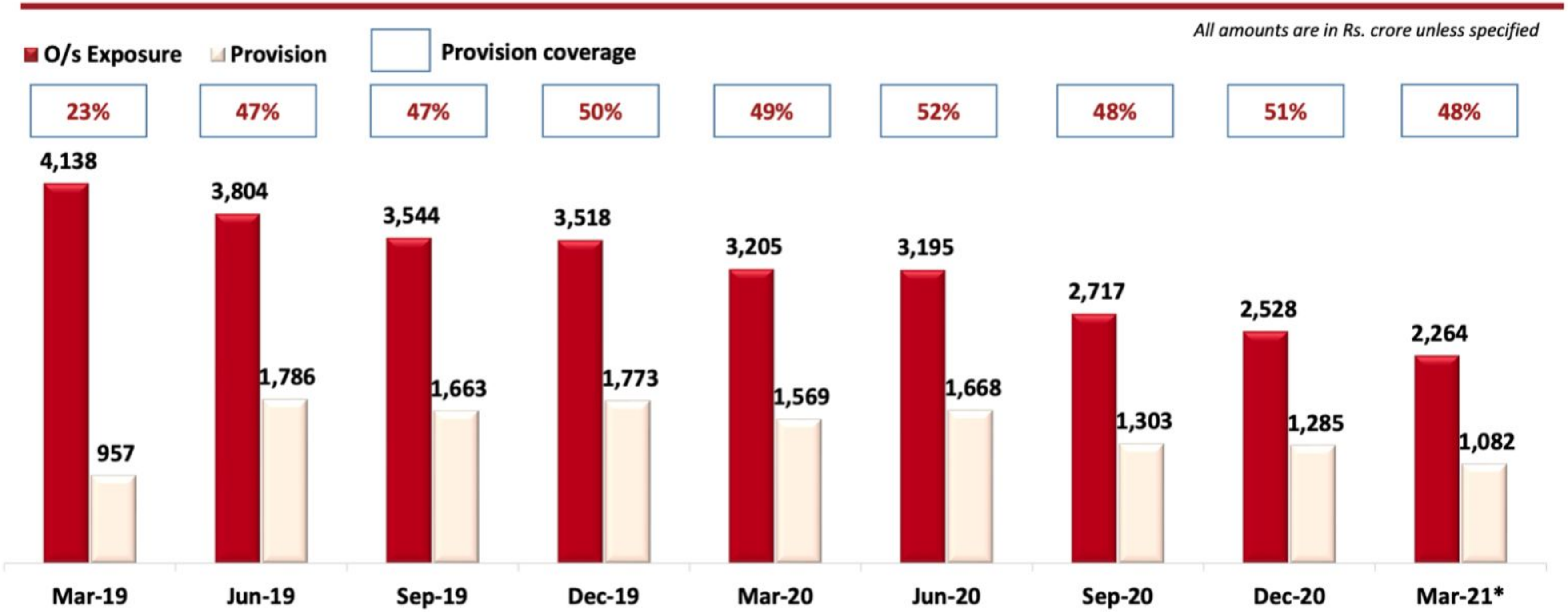
IDFC has a longer-term target of having a NIM of 5.5%. The bank has grown its NIM from 2.83% post-merger to 4.98% as of March 2021. The growth of 2.2% in NIM is attributed to:

1. Change of mix towards higher yield retail loans, adding ~ 1% to the NIM during the period.
2. Growth of retail liability base. CASA growing from 6% pre-merger to 37%. Attributing ~ 0.5% to the growth in NIM%.
3. Growth of retail terms deposits from 7% to 25% of the liability base. Attribution of the same to the NIM is ~ 0.5%.

With gradual cleaning of NPAs

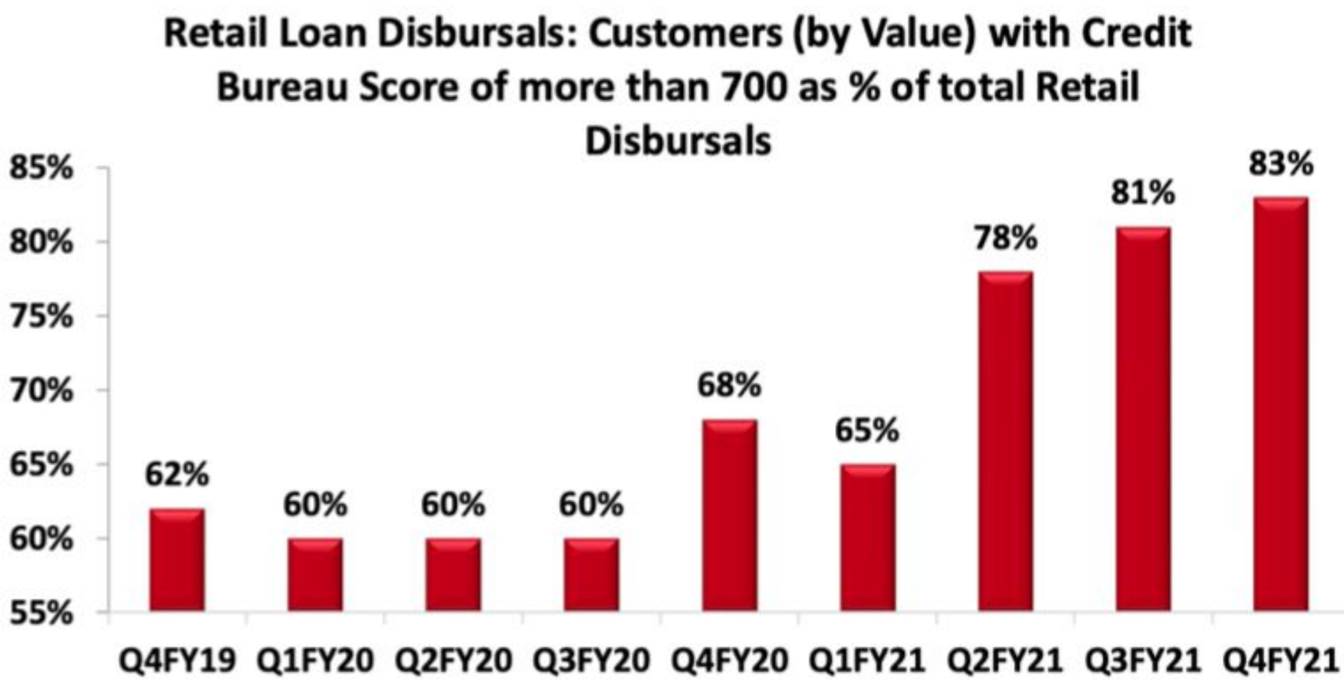


Exposure to identified stressed assets reduced by 45%



1. Past NPAs largely from infra lending. IDFC has cleaned its NPAs from infra lending by selling the distressed portfolio.
2. CF has followed prudent lending for the risk profile of its loans. Past 5 y GNPA <=2%.
3. Total watch list is INR 2264, which is ~1.5% of the loan book.
4. Based on my discussions, have seen the management to start from a clean slate post merger and hence want to overprovision as they start post merger.
5. IDFC First was the first Bank to provide for Vodafone, even though it was a paying customer.

Tightening Internal Controls



1. Examples of such initiatives include –
    - Checking whether the customer has availed moratorium, also subsequent track record
    - Increased average balance requirements for our average Bank Balance based lending program
2. Collection Efficiency for the Bank has improved every month since July 2020 and in March 2021, the collection efficiency has reached 100% of the Pre-COVID collection efficiency levels.
3. Granular Corporate loans of <50 cr.
4. Erstwhile IDFC risk team has a stronger risk management compared to CF. That team is driving tighter sanctions.

Stress Compared to Other Banks and NBFCs & Vals

	Dec 2019	Mar 2021	Change in Stress Pool - Pre to Post COVID	P/B
CUB	3.50%	10.0%	6.5%	2.2
IDFC First	2.83%	5.0%	2.2%	1.7
Kotak	2.33%	3.44%	1.11%	5.54
HDFC	1.36%	2.96%	1.60%	2.87
Can Fin	0.80%	0.90%	0.10%	2.7
Ujjivan	0.95%	7.10%	6.15%	1.6
RBL	3.33%	5.74%	2.41%	1.2
ICICI	5.95%	5.50%	-0.45%	2.97
Axis	5.0%	3.70%	-1.30%	2.35
HDFC Bank	1.42%	1.40%	-0.02%	3.75
DCB	2.15%	4.09%	1.94%	0.83

Execution of 5 year plan on Track

	Merger	Mar 19	Mar 20	Mar 21	FY 25	Status
CASA	8.39%	9.4%	17.4%	34%	30%	Achieved
Branch	206	242	464	596	800-900	On Track
% Retail book	35%	37%	54%	63%	70%	On Track
WS Book	56809 cr	53649 cr	39388 cr	33920 cr	<40000 cr	Achieved
GNPA	1.97%	2.43%	2.6%	4.15%	2-2.5%	On Track
NIM	3.1%	2.61%	3.91%	4.98%	5-5.5%	On Track
C/I	81.5%	82.7%	76.8%	78.9%	55%	Slow
ROA	-3.7%	-1.33%	-1.75%	0.29%	1.4-1.6%	On Track
ROE	-36%	-11.6%	-17.8%	2.73%	13-15%	On Track
Yield	9.4%	11.7%	11.2%	11.3%	>12%	On Track

ROA Tree

	ROA Tree -Now	ROA Tree in 3 years
NIM%	4.5%	5.50%
Other and Fee Income	1.7%	1.50%
Operating profit	6.2%	7.00%
C/I ratio	75%	65%
Operating expense	-4.3%	-3.6%
Pre-provision profit	1.9%	3.43%
Provisions	1.2%	1%
ROA-pre tax	0.7%	2.43%
Tax	25%	25%
ROA post tax	0.5%	1.8%
Leverage	8	8
ROE	4%	15%

Key levers to move ROA to ~ 1.5-1.8%:

1. Rise in NIM to 5.5%. We believe that if the retail asset book can grow to 75-80% of the overall, it can add another 1% to the NIM.
2. CASA can grow from current 35-40 % to 50% of the liability base, it can add 1% to the NIM.
3. Operating cost to income is at 75% right now. With right use of tech and scale up of business segments, the same can be brought down to 65%.
4. Provisions for the bank are currently high given legacy accounts and COVID provisions. We believe in a steady state the bank can work on a GNPA of 2% and a provision coverage ratio of 50%, implying incremental provisions of ~1% of the asset base.

Next 5 year Plan: Profitability

Management's Take

- **Net Interest Margin:** As the retail asset contribution moves towards 70% of the total fund assets, it is planned that the gross yield will continuously increase. Coupled with lower cost of funds (From improved CASA ratio), it is planned to expand NIM to about 5.5% in the next 5-6 years.

- **Cost to Income:** The Bank plans to improve C:I ratio to ~50-55% over the next 5-6 years, down from ~79% currently (Q3 FY 19)

- **ROA and ROE:** With the improvement in the NIM and cost to income ratio, the bank aims to reach the following benchmarks in the next 5-6 years.
  - ROA of 1.4%-1.6%
  - ROE of 13%-15%

Our Assessment

- Maintaining NIMs >3% is achievable with MSME loans, WC loans and retail banking.
  - Capital first has an average cost of borrowing of 8.8% for its 25,000 cr liability. The same can be replaced by IDFCs lines at 6.7%. Leading to a dip of ~0.4% in cost of funds.
- Cost to income ratio improvement will be on the higher side if the bank plans to grow its liability base. It needs to be seen how this ratio grows with peers.
- What I understand is that the bank is increasingly using tech to scale down the cost of its ops.

Valuation: Expect to make > 3x return with limited downside.

Conservative Case	**Per share**				
Entry Price	50				
Entry Book	33				
Entry P/B	1.52				
	Mar-21	**Mar-22**	**Mar-23**	**Mar-24**	**Mar-25**
Book	33	37.95	43.64	50.19	57.72
CAGR	15%				
Exit P/B					3.0
Exit Price					173.2
Dividend Yield		1.7%	1.7%	1.7%	1.7%
	-50.0	0.7	0.8	0.9	174.2
Multiplier	3.53				
IRR	**37%**				

Key Risk

Our Assessment

- Bank turnarounds can be slow. Does this fit into our hypothesis. 5 year can become 6-7 years.
- CASA pool is diminishing as everyone one is fighting for it. It needs to be seen how different can be the retail franchise of IDFC.
- Banking Sector has had its share of bad loans in the last 3 y. Will have to track the NPAs and its provisioning in the near term.

IDFC vs IDFC First ??

Thank You

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