"IndoStar Capital Finance Limited
Q1 FY2019 Earnings Conference Call"

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Moderator: Good day, ladies and gentlemen and a very warm welcome to the IndoStar Capital Finance Results Conference Call, hosted by Motilal Oswal Securities. As a reminder, all participant lines will be in the listen-only mode. 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 "*" then "0" on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Piran Engineer from Motilal Oswal Securities Limited. Thank you and over to you Sir!

Piran Engineer: Thanks Vivian. Hi everyone. Welcome to the IndoStar Capital Finance First Quarter Results concall. To discuss the results we have with us, we have the management Mr. R. Sridhar, Executive Vice Chairman and CEO, Mr. Pankaj Thapar, CFO and Mr. Shailesh Shirali, Head of Corporate Lending. I now hand over the call to the management to take us through the results after which we shall open the floor for Q&A. Over to you Sir!

R. Sridhar: We also have Mr. Prashant Joshi, Chief Operating Officer of the Company. As you may be aware IndoStar, which went public and got listed in May, this Q1 happens to be the first full quarter after the listing. This quarter according to us was a very strong quarter. We have had strong disbursement growth and IndoStar, which used to be a corporate lending business, from last year has been building its retail businesses. From the corporate lending business, we have started SME loans, home loans and vehicle finance, three retail finance businesses and the disbursement during the Q1 FY19 was around INR 2261 Crores compared to INR 559 Crores in the corresponding period last year.

Out of this, the corporate lending book had fantastic disbursement during this quarter at INR 1535 Crores, which is around 3.5 times year-on-year, and retail lending also had a very good growth. We have disbursed around INR 726 Crores in the three months in the retail business, which is more than double that of what we have been able to do last year.

The vehicle financing which is the engine for the retail finance business has good traction and the current run rate is around INR 110 Crores per month. Because of this retail growth, the mix between corporate and retail has been undergoing a change and it used to be around 74:26 last year, now at the end of this quarter we have 71% corporate lending and 29% retail. So retail is now a significant portion of our assets.

The branch rollout continued during the quarter and total branches increased from 91 in Mar-18 to around 129 branches. We have about 1431 people as on Jun-18. In spite of this good growth, what is very gratifying is the asset quality. The asset quality continues to be very strong and we have a net NPA of 1%. Availability of funding and liquidity been quite good and the cost of funds has remained stable at around 9%.

The AUM stands at INR 7640 Crores, which is 54% up from the same corresponding period last year. The net interest margin is around 5.5% and according to I-GAAP accounting our profit after tax is around INR 45 Crores for this quarte. The total customers have gone up substantially because of the retail business and as at the end of the quarter; we have had around 8752 customers. The company continued to see the growth in vehicle finance, SME and home loans. These are all fast sectors for growth and in vehicle finance, we have a niche presence in used vehicles. We are present in hundred plus branches we are doing around INR 110 Crores which is corresponding to around INR 80 lakhs to INR 1 Crore of average business per month in each branch. With that, we hope that these branches would break even as we anticipated in 12 to 15 months.

The commercial vehicle cycle is quite good. It is in the upward curve and we are very hopeful that the demand will remain intact for the next two to three years and for IndoStar vehicle finance will remain the engine for the retail growth. With that initial remark, I would leave the forum for any specific questions, which we would be happy to reply.

Moderator: Thank you Sir. Ladies and gentlemen, we will now begin the question and answer session. The first question is from the line of Subramaniam Iyer from Morgan Stanley. Please go ahead.

Subramaniam Iyer: Can you also explain basically the impact of Ind-AS on your P&L as well because some of the revenue lines do not seem to basically reflect the trends in your AUM growth? So it would be good if you could walk us through the impact of Ind-AS?

Pankaj Thapar: I do not know if you got the presentation that we have uploaded. We have given a line-by-line reconciliation, but in terms of slide 25 of our presentation, for the current quarter the profit after tax as per I-GAAP is INR 45 Crores. In terms of an impact, the first item of impact is obviously the adoption of effective interest rates for loans that we had given. Simply stated this is the effect of fees that we have received on corporate lending of which as we mentioned previously a portion of it, we used to recognise as upfront and the balance was amortised into the future. Under Ind-AS rules, all fees received are to be amortised over the life of the loan. To that extent, this is effectively reflecting the net impact of this amount and at the end of the first quarter we have about INR 90 Crores that is sitting now the unamortised pool that will be accrued over the future years. With the reversal and then the credit coming back, this is the net INR 12 Crores impact for this quarter. The second line item is the reverse impact, which is with regards to our own borrowings where we used to account for the fees that we pay for loans that we avail and other financial costs we were taking upfront, those now need to get amortised so there is a small positive credit there. On the expected credit loss there is not much of a delta between what we had under I-GAAP versus what we have on Ind-AS so that is a very nominal negative impact here. Stock options as you know under Ind-AS we have to account for the fair value of option. The options that were unvested at the end of March 2017, we had estimated the cost for that. The cost for FY2017 and FY2018 is there in the opening balance sheet of FY2017 and FY2018. During this year we will have an impact of approximately INR 28 Crores on account of stock options based upon the vesting schedule across each quarter. There is a INR 6.6 Crores impact in the current quarter for the stock options. A portion of our treasury assets were held in the form of investment in bonds and there is INR 1.6 Crores delta on account of the fair valuation of these financial assets and then a deferred tax change that comes through as a result of all these changes which comes in at INR 6.4 Crores so net profit after PAT as per Ind-AS comes to INR 31.5. The big impact that I mentioned are effectively the fee reversal on account of our fees that we have earned over the previous period and this quarter on corporate lending and the value of stock options. Those two are the largest impacts.

Subramaniam Iyer: Got it. Sir, if I were to look at your P&L per I-GAAP so the fee income as of the first quarter is relatively lower compared to the fourth quarter despite a strong disbursements on the wholesale side even to this quarter so any comments there? This basically is fee as per I-GAAP?

Pankaj Thapar: Yes. That is right.

Shailesh Shirali: Actually one of the reasons for higher fee last year in the fourth quarter is that some of the deals that we do on the real estate side also have an element of advisory there, so there was a larger advisory fee component there plus the fourth quarter is always a more busy quarter, if you check like-to-like Q1 of last year compared to that revenues and the fees would be better this year. So I think as a trend line, we are doing much better. The disbursements are stronger. There is not much impact on the spreads in spite of the rates, cost of the funds, the rates in the market moving up. The fees will catch up over a period of time like it was happening in the past years also.

Subramaniam Iyer: Thank you.

Moderator: Thank you. The next question is from the line of Amy Truesdale from Jupiter. Please go ahead.

Amy Truesdale: Thanks for taking my question. I just had two questions; the first thing, it looks like your PAT has been impacted by the rollout of retail branches required for building up of this business and I just wanted to get your view as to how you see that panning out? When will we start to see these branches contribute and you said that there was sort of 15 months breakeven but in terms of the branches that we have really set out, when do you expect this to start contributing? And also where the setup expenses set in the P&L. Are they under the other operating expenses or somewhere else? If you could please help me to understand that that would be great.

Pankaj Thapar: I will take you through where they sit and then I will hand over to Mr. Sridhar. The setup costs are sitting in two items; one is employee expenses, which is the cost of hiring the additional people that we need for the 129-odd operational branches that we had at the end of June and as you may notice this has increased from INR 16.9 crores at the end of same period last year and a modest increase versus where we were at the end of March, so that is the people cost. The other operating expenses include the rental for all the new branches for which again as you will notice has increased. It is the rental for the new branches that we have established as well as the operation center that we have established in Chennai, and also includes the cost of additional IT spends that we have done in terms of taking on board a state of the art IT system for our vehicle finance business that we went live on April 1, but some of those costs are not there in the March quarter. They are there in the current quarter. There is a little bit of depreciation charge on the branches which also will come into the other operating expenses.

R. Sridhar: The business traction is quite good in retail business, as I had outlined in my initial remarks. Today we are doing around INR 300 Crores of disbursements in retail and INR 300 Crores roughly in corporate lending, so around INR 600 to 700 Crores is the runrate today and out of which the INR 300 Crores of retail is being done in the retail branches and the main engine for that is commercial vehicle finance and commercial vehicle finance run rate is around INR 110 Crores, and we are very confident with this runrate these branches should breakeven in 15 to 18 months. That is what we are hoping that it should happen earlier. But if you look at compared with the earlier quarter, the operational expenses have gone up to INR 55 Crores as against INR 26 Crores in the first quarter of previous year. This is, as Pankaj outlined, mainly branches, infrastructure, technology and people, which is definitely required for us to do the retail lending business. The second one is on the treasury loss, which is there. In spite of this, if you look at the pre-provision operating profit still there is a growth that clearly indicates the robust business growth, which we have had in the first quarter. So operational expenses would be there, which is required for us to build the infrastructure and people, which will be debit items, which will come immediately, but the income will trickle in. The kind of traction and growth we have in the retail business we are hopeful that the payback will start once these costs are absorbed.

Amy Truesdale: Great. Thanks. One follow-up question, the expenses that you listed on some of the other operating expenses for the ERP and the technology, those types of spends are one-off spends or would you expect that to be recurring?

Pankaj Thapar: The bulk of those are recurring costs. The biggest elements in that are the rentals, communication and IT and other branch costs. So there would be very little one-off costs, such as , when you launch a branch, you spend a little bit in terms of publicizing it locally, which will be one-off for that branch, but those are not big numbers in the overall scheme of things and once we are done with the first cohort of branches, those kinds of costs will not occur. We have not classified them as one-off because they are not big enough to merit being pulled out and explained separately.

Amy Truesdale: Fair enough. Great. Thanks very much.

Moderator: Thank you. The next question is from the line of Anusha Raheja from LKP Securities. Please go ahead.

Anusha Raheja: Sir, I just missed on your presentation, can you just tell me what is the ROE for the quarter?

Pankaj Thapar: The return on average equity is 7.2%.

Anusha Raheja: Despite you having sufficient capital, why is that the ROE on the lower end and why is the leverage for this?

Pankaj Thapar: Historically we have been in the corporate lending business, and right now, we just raised equity capital during May that impact is there. However, as we build out our retail businesses, as Mr. Sridhar mentioned, the proportion of retail assets in our book will keep increasing. In the initial phases of our growth, we were more conservative around leveraging our business, but as the proportion of retail increases, the leverage will increase. We would expect from now on at least through till FY2020, to finance all of our growth from borrowings. The leveraging effect you will see coming through in the quarters ahead. In terms of the absolute numbers again, the branch investments have been made and the current traction has been very strong, so as the traction kicks in and the overall assets grow, we would expect to see aggregate profitability improving and therefore metrics on ROA will also increase.

Anusha Raheja: Over the next two years, or we are expecting longer period of time, how do you expect ROE to shape up for any internal benchmarks there?

R. Sridhar: ROE is a component of leverage, as is the ROA. Since we are planning for the next few years, we have raised the capital, so we have the capital and we have started the retail lines of business recently. Today the leverage is three times, so the leverage will keep increasing as and when we increase our assets, we are only INR 7640 Crores now and we have ambitious plans of growth in FY2019 and FY2020. When we do that it will move to the teens easily.

Anusha Raheja: Even if I compare with your FY2018 numbers, I guess both are trending down, even the ROA and even the ROE.

R. Sridhar: That is because we have started new lines of business. Each line of business has a different yield. If you take home loans and SME loans, they are lower yield businesses, but if you take vehicle finance, it is a higher yielding business. Earlier we used to be only in corporate lending business where the yields were higher. When you look at the blended yields that is why you have ROA looking less. That is the reason.

Anusha Raheja: Thanks.

Moderator: Thank you. The next question is from the line of Rahul Gupta from Alpha Advisors. Please go ahead.

Rahul Gupta: Good evening everyone. Thanks a lot for great colour on opex, which you gave in the question before. I joined in late I am sure whether you covered the details of your incremental borrowing cost because we saw 50% AUM growth and the NII and you only increased 17% so, how can we expect the margins to move further like going ahead in the coming quarters?

R. Sridhar: Let me address this in a slightly different way. The first is in terms of cost of borrowing, yes, we have seen a slight increase in our cost of borrowings in this quarter versus the last. We would continue to see some modest increase through the remainder of the year as well given our expectation of where we see interest rates heading in the borrowing side, but we would expect that for the year we would be able to pass on. For instance in the SME side, we have already increased our lending rate by 25 basis points early in this quarter to pass through those costs. On the corporate lending side, as well, over the last couple of years we have transitioned a lot of our lending to be on the floating rate basis so cost of money passes through. SME and housing loans are all on floating rate basis, so there is a very quick pass through, if there is any significant change in our cost of money. Vehicle finance is the only asset, which is fixed rate but those are relatively short duration loans and if cost of money for us were to increase, we will start fresh loans from immediately thereafter, but typically time for a month start, to reflect the newer cost of money. At this point in time, vehicle loans are not a material component of our overall portfolio although we expect them to be larger and larger contributor every month so bottom line. When I add all of that up, it means that I would expect to pretty much see a pass through of all of my cost of borrowing on to our lending rates and therefore we would see margins staying stable around the current level.

Rahul Gupta: You mentioned about your real estate lending. Would the corporate loan book part of it be on fixed rates? Will you be able to tell us as to what percentage of your loan book would be fixed as of now?

R. Sridhar: Except CV all others are floating. Only CV is fixed. Very small proportion of corporate lending which is still fixed.

Shailesh Shirali: All the incremental corporate lending including real estate are all floating rate loans.

Rahul Gupta: Thanks a lot for that.

Moderator: Thank you. The next question is from the line of Ritika Dua from Elara Capital. Please go ahead.

Ritika Dua: Thanks for the opportunity. Firstly, on the CV side, could we just understand what are the incremental yields for us?

R. Sridhar: You want yield?

Ritika Dua: Yes Sir.

R. Sridhar: The yield is around 15.5% to 16%. That is the average yield we are getting. So we are doing two kinds of vehicles, one is used and another one is new. So the weighted average yield is between 15.5% to 16% is what we are getting today. Predominantly we are doing used vehicles more, around 70% will be used and 30% will be new. These two are coming at different interest rates, used vehicles would be around 17% to 18% and new vehicles should be around 11% to 12%. So the weighted average comes to around 15.5% and 16%.

Ritika Dua: Just for understanding on the vehicles on the used side, while I know you have just started to grow but is there any colour as to is it like are we concentrated from there or any colour about the growth on the used side will be helpful?

R. Sridhar: Yes, we have built branch infrastructure starting from Tamil Nadu, Andhra and Telangana, Kerala, Karnataka in south, all states we are there. In west we are in Maharasthra and Gujarat but we are also moving to other and north we are there in a few states. So we are now pan India, operating in 15 states, 129 branches are there. It is not concentrated in any place, but having said that we have got more branches in Tamil Nadu, so Tamil Nadu happens to be our big state for IndoStar in retail. Both, for home loans as well as vehicle finance, we have 35% to 40% coming from Tamil Nadu, but as and when we start going to other branches, all of them will start contributing. Today monthly disbursement of INR 110 Crores of the vehicle finance and INR 40 Crores of affordable home, total of INR 150 Crores is coming from these branches which is on an average more than INR 1 Crore per branch. That is how it is panning out. We are catering to the mid customer segment, customers who have got two or three vehicles that is the segment in which we are operating.

Ritika Dua: Similar colour if I could request on housing finance as well? So what is the kind of ticket sizes that we are doing and is it largely self-construction or it is outright purchase or any other comments you can share?

R. Sridhar: In terms of customers it is self employed category customers. We are not present in the salaried segment where the interest rates are very low and banks are concentrating in that space. We are there in affordable home finance segment predominantly. Our ticket size is around INR 10 lakh. That is the average size and the yield is around 12% to 13%.

Ritika Dua: One more question on your disbursements, can we get some colour as to the disbursements which have happened in this quarter for the corporate book. What are the general ticket sizes and what is the nature of lending particularly for this quarter? What are we seeing on the ground in terms of specifically the corporate part?

Shailesh Shirali: The book is equally divided between real estate and non-real estate now. It is about INR 5406 Crores book, 50% real estate and 50% non-real estate. Incremental disbursements also are in more or less the same proportions. In real estate we are focusing more on major metros and residential projects and larger developers so ticket sizes are above INR 150 to 200 Crores and non-real estate side it is midcap, and small cap companies mainly manufacturing companies, we do not do any project finance or greenfield or infrastructure so it is mainly manufacturing companies. The kind of deals that we are seeing on the ground on the non-real estate side more of refinancing and reprofiling the balance sheet of the company, the liability profiles of the companies so those are the kinds of deals. These are between two and five year door-to-door tenure, two to three year average maturity kind of loans, all are amortizing loans, we do not do bullet loans. The yields are around 13% blended, real estate will be a little higher and normally non-real estate will be slightly lower, but the blended yields are around 13%. In addition there are fees, so overall we will be getting a yield of about 14.5% to 15% on the corporate lending book.

Ritika Dua: Thank you. That is from my side.

Pankaj Thapar: Numeric details on the disbursements are there in the presentation, so you can pickup the details.

Ritika Dua: Thank you.

Moderator: Thank you. The next question is from the line of Nikhil Valecha from JM Financial. Please go ahead.

Nikhil Valecha: Sir, there is a sharp decline in the yield from 13.6% to 12.8%, you just mentioned that the yields in the corporate book are closer to 13% and in the vehicle also it is closer to 15.5% to 16%. So what is the reason for such a sharp decline?

R. Sridhar: SME finance is also a sizable portion. So that is 11.5% and our home loans which are there at around 12%, so that is why weighted if you see it will be, but actually every business is doing well. All are coming at different interest rates, different yields, but what we are doing is we are comparing a previous period where some of these businesses, which are lower yield were not there. That is why it is looking like that, but when you compare next year with the current year this difference will not be there.

Nikhil Valecha: But Sir, SME loans are broadly stable. I mean the SME has not changed much, so 80-BPS decline, how much is due to loan mix and what are the other factors that has led to this decline. Is there any re-rating of the corporate loans?

Pankaj Thapar: Where did you pickup the 80 BPS decline?

Nikhil Valecha: In the presentation slide #16, YOY.

Pankaj Thapar: You are talking about year-on-year?

Nikhil Valecha: Yes.

Pankaj Thapar: Retail at that time was only SME and was a very small proportion of our total book. Today, as we just mentioned a little while ago, about 29% of our book is retail assets versus only about 12% a year ago. That essentially is the biggest impact.

Nikhil Valecha: Second question is there is some one-off charge of INR 9 Crores on slide #22, what is that Sir?

Pankaj Thapar: This is treasury loss. As I mentioned, we sold some bonds that we were holding as part of our treasury strategy. We held about INR 460 Crores of treasury holding in the form of bonds. When interest rates have moved up, we suffered capital loss on those bonds with a small component of mark-to-market. However, on an overall basis, that strategy was better than holding that money in liquid mutual funds, which is where we held other treasury assets because my average borrowing cost of 9% and a treasury yield of 7% we would have been negative 2% carry on treasury surpluses. On this basis we were actually a little better off having followed this strategy than if we had deployed the money entirely in liquid mutual funds. In any case, we have liquidated a bulk of that and only about INR 140 Crores remain now which also we are looking to liquidate so that there is no recurrence of this. We plan to move and stay in liquid funds or cash, so that there is no recurrence of this, which is why we state it as a one-off charge.

Nikhil Valecha: What is the ROA guidance for this year? Would it remain at 2.2%?

Pankaj Thapar: We definitely see it improving from there.

R. Sridhar: Because the vehicle finance business will be growing so from 2.2% definitely we will be moving up though we will not be able to put a number to it now, definitely it will expand.

Pankaj Thapar: Quarter-on-quarter profitability will increase as the extra overhead is absorbed and the contribution from cumulatively higher volumes that we see coming through each quarter kicks in. Rather than put a number for this year, as we have shared previously, our long-term expectation is 3% plus ROA, which is what we are working to. This is a function of the composition of the book and the yields that we are earning on the various assets, which comprise our book. The composition as we mentioned will see a change. We are reasonably on track in terms of any of those metrics.

Nikhil Valecha: This ESOP impact that has been there in this quarter so, can we assume the similar impact for the remaining quarters as well, or will there be a difference in that?

Pankaj Thapar: There will be a marginal increase. We would expect to see under Ind-AS accounting an impact of approximately INR 28 Crores will come through for this year of which INR 6.6 Crores have been taken in this quarter and the balance will come through in the remaining three quarters.

Nikhil Valecha: Sir, I guess you have not disclosed gross stage I, II, III assets, if they are materially different, can you please disclose that number as well.

Pankaj Thapar: I do not have immediately have that at hand, but as I have said, our ECL under if the I-GAAP or the old RBI rules and the new ECL model for this quarter the difference is modest. I will just give you the number. Under I-GAAP the credit loss provision for the quarter would be INR 7.5 Crores and under Ind-AS this comes to about INR 7.7 Crores.

Nikhil Valecha: The proportion in stage I, II, and III in terms of absolute numbers?

Pankaj Thapar: Like I said, I do not have those numbers handy. We can cover that offline.

Nikhil Valecha: Thanks Sir. That is all from my side.

Moderator: Thank you. The next question is from the line of Sachit Motwani from Param Capital. Please go ahead.

Sachit Motwani: Sir, one question, pertaining to net interest margins, Sir, net interest margin has declined from 7.2% to Q1 of this year compared to last year, are you calculating the fee income while calculating the net interest margin?

R. Sridhar: That is only interest income minus interest expense.

Sachit Motwani: Okay. I was wondering that you had a capital infusion and still it is not reflecting, so in terms of margin improvement, like when your yields have declined by 80-basis points, you have some cost of fund benefit but margin has seen a sharp 170-basis point dip so that was the first question that I had?

Pankaj Thapar: The equity effect kicked in only for five weeks of this quarter because the money came in during May, while the asset buildup continued. We would see the full impact kick in during this current quarter, as we would have held the equity for the entire period.

Sachit Motwani: Sir, second question I had was in terms of sell down of corporate loans, what would be our run rate annualized that we do of corporate loans?

Shailesh Shirali: In real estate we used to sell down about 20% to 30% of our exposure on any asset. This was till one year back, but we will go slower on the sell downs now. We are keeping the assets on our books. The aim is to grow the AUM of all the businesses.

Sachit Motwani: Sir, third on the branch expansion if you can share by FY2019 and FY2020 what kind of branch targets you have?

R. Sridhar: As of now we have almost 135 branches are there. That is what we have for the time being. We are not planning to open anymore during this financial year. Next financial year we do not have any plan as of now. We have to go through a couple of quarters and then decide.

Sachit Motwani: Thank you so much. That is it from my side. Thank you.

Moderator: Thank you. As there are no further questions, I would now like to hand the conference over to Mr. Piran Engineer for closing comments!

Piran Engineer: Thank you. We thank the management for giving us this opportunity to host the concall. Thank you and good-bye.

R. Sridhar: Thank you.

Pankaj Thapar: Thank you.

Moderator: Thank you very much. On behalf of Motilal Oswal Securities that concludes this conference call for today. Thank you for joining us. You may now disconnect your lines.