Conference Call Transcript

Edelweiss Financial Services

Q2FY13 Results

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Corporate Participants

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Executive Director

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Shailendra Maru
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Questions and Answers

Moderator: Ladies and gentlemen good day and welcome to the Edelweiss Financial Services unaudited Q2FY13 earnings conference call. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Shailendra Maru of Edelweiss Financial Services. Thank you and over to you sir.

Shailendra Maru: Good afternoon to all of you and thank you for joining us today as we discuss Edelweiss Financial Services' unaudited consolidated financial results for Q2FY13 that ended 30th September 2012. Speaking today with you are Rashesh Shah, Chairman, Edelweiss Group; Himanshu Kaji, Executive Director; and S. Ranganathan, the Chief Financial Officer. Following the reading of safe harbor provision, I will first turn the call over to Rashesh for his opening remarks. Thereafter Ranganathan will take you through an overview of our business performance and the financial numbers. This will be followed by the Q&A session. The press release, financial statements and an earnings update for this quarter have been circulated and are also available on our website www.edelweissfin.com.

Certain statements that may be made or discussed at the conference call maybe forward-looking statements. These need to be reviewed in conjunction with the risk and uncertainties that the company faces. We have outlined these risks and uncertainties in the last slide of our earnings presentation which has been circulated and is also available on our website. Edelweiss has obtained all market data and other information from sources believed to be reliable or its internal estimates although its accuracy or completeness cannot be guaranteed. I will now turn the call over to Rashesh.

Rashesh Shah: Thanks for attending this conference call. We announced our Q2 results yesterday and I am sure you have had a chance to look at the investor presentation that we have sent out.

Just to recap, we had total revenues of Rs. 511 crores for the quarter as compared to Rs. 368 crores, that is about 39% increase in total revenue on a YoY basis. Our profit after tax for the quarter is Rs. 42 crores after the minority compared to Rs. 26 crores a year ago which is up about 58%. The key change on a YoY comparison is that we also have scaled up our insurance business and the increased operating burn of insurance is also carried in our P&L. If you adjust for the YoY PAT ex-insurance, that is if you remove insurance, then the growth is about 93% on a YoY basis. In a way, by now a lot of our investment costs in infrastructure and all have stabilized. Multiple offices a year ago have gone away and that is getting reflected in costs. Also the cost efficiency and the investment we made in automation and technology is starting to show. Our core business operations are good. We monitor our cost-to-income ratio and we are seeing a constant improvement in that on a quarter-on-quarter basis. We do think there is some way to go, but cost-to-income ratio is an important parameter that we are watching now very closely because we do believe that the initial phase of diversification for Edelweiss is over. We have added a few businesses over the last 3-4 years, but now the phase of efficiency for the next 3 years has started. Starting from this year efficiency, automation, productivity, cost-to-income ratio and all that has become very important.

So we have invested quite a bit in the businesses over the years and the only key business where there is still an operating burn is obviously the insurance business which has grown. In retail broking about a year ago, there was still an operating burn of about Rs. 8-10 crores a year and has now become more or less breakeven. As we have integrated Anagram completely, we are starting to see that that business is now becoming breakeven even in this environment and we do think we will get some profitability out of that business at current scale and current activity and obviously as the capital market activity comes back, we should see growth in that. The same goes for all the other businesses including retail finance where there is improvement from an annual burn of about Rs. 18-20 crores, we have now come to about Rs. 8-10 crores and we do feel like a year from now even that business will be breakeven and come to profitability. So most of the investment in the retail businesses is getting over and there is significant profitability improvement in those businesses except for insurance where we do think over the next 3 years we will continue to invest. We have structured our insurance business in such a way that we have enough capital contributed by us and our JV partner Tokio Marine which will make sure that whatever operating burn we take we have enough capital to support that.

On the wholesale side, our business is now fairly okay in wholesale capital markets. We had a fairly good quarter in broking. That was about Rs. 8-10 crores increase in the broking revenue for this quarter on QoQ basis. Our investment banking is still subdued because the IPO market, the M&A market etc are still fairly subdued. On the debt capital market, we have seen quite a bit of activity. We used to do a lot of the wholesale placements and now from this quarter onwards we also handled three public retail bond issuances from this quarter and we are starting to get our market share and traction in that. We are seeing activity on the credit side, we are seeing activity in commodities on the whole and also agency business had a good September, but obviously July and August were not as good. Our credit book has grown from Rs. 5,200 crores to Rs. 5,700, almost Rs. 5,800 crores now which includes credit and credit substitutes. Our retail finance has grown in this quarter by about Rs. 240 crores, so we are still maintaining between Rs. 80 to 100 crores growth in that on a month to month basis. Our asset quality is fairly under control. The net NPLs are at 0.12%. Alternative asset management continues to be at the same rate it was in the last quarter. We have $590 million of assets under management or advice and our insurance business has started scaling up. We have 39 offices, 1840 PFAs and we have written 3,600 policies in Q2.

Overall we have worked very hard on creating a strong and liquid balance sheet. Our liability profile has undergone a change as you would have seen in the presentation and if you remove cash and cash equivalents with back to back borrowings, the net gearing is currently 2.53x which gives us room for growth.

To sum up, we continue to do more of the same. Now we start sweating investments we have made, continue to focus on basically bottom-line growth, on profitability improvement and our diversification has now been completed and it has started to show results as we have quite a few engines which are starting to work at their own pace.

On the overall macroeconomic environment, obviously we all see an improvement over the last couple of months. We have seen interest rates come down in this quarter as liquidity has improved. The CRR cut and the April repo cut have resulted in some lowering of the interest rate and the interest cost is coming down. FII inflows have been robust. We do believe that a lot of foreign investors are still underweight on India and there is a lot of appetite. The positive sentiment and the liquidity that is driving the market, obviously it should follow with earnings. We think earnings in this quarter are also good for corporates as a whole. So on the whole, there is a positive sentiment, though structural issues for India still will take another couple of years to be solved in terms of inflation, current account gap and in the fiscal deficit and we have said over the last 3 quarters there is a considerable improvement over where we were a year ago on India as a whole and the foreign investors are seeing that. We are not seeing much return of the Indian investors except HNI category starting to come back, but retail investors and Indian institutional investors because of redemption are being forced to sell. Only after that we will start seeing increasing asset allocation towards equity both for Indian investors as well as for global investors.

So overall we at Edelweiss are on track, we have stayed the course and we hope to continue to do that over the next few quarters in a step-by-step manner. Along with that, I will just hand over to our CFO, Mr. Ranganathan and then we will handle question and answers and again thank you very much.

S. Ranganathan: Thank you Rashesh. As usual I will first discuss the key takeaways of Edelweiss performance and then give you our business update. On a positive note, I'm happy to inform you that we continue to record growth in our bottom-line sequentially in each of the past 4 quarters despite a challenging environment. This is the result of diversification in the business, execution efficiencies and cost control that we have been constantly working on. In the second quarter of FY13, we have recorded improvement in our margins and maintained spreads in our credit and treasury book. In fact our profitability excluding insurance business has improved significantly in this quarter and I will discuss these numbers later in my remarks. While the cash burn in our insurance business is as per the plan, the burn in our other new businesses is reducing progressively. We have witnessed a higher activity level in credit, DCM, IB, and IE businesses in the second quarter while other businesses performed in line with the market.

Coming to our Q2FY13 results, our total revenue for the quarter is Rs. 511 crores compared to Rs. 368 crores in Q2FY12, up 39%. Profit after tax for the quarter is Rs. 42 crores compared to Rs. 26 crores for Q2FY12, up 58%. Excluding loss in our insurance business, our net profit for the quarter would be Rs. 54 crores which is 93% higher than the corresponding number in Q2FY12. This has been possible as our core operations have continued to strengthen during the year. Amongst the individual heads of income, agency fee and commission is marginally lower by 5% in Q2 YoY due to the challenging environment. Fee and commission is, however, higher 19% sequentially due to higher activity levels this quarter in our agency businesses. Interest and treasury income for Q2FY13 is significantly higher at 50% YoY due to scale up of our credit book. Sequentially this head of income is lower by 8% due to a) lower treasury income as a result of scale down in the treasury book by about Rs. 500 crores in this quarter and (b) fall in the yield on credit and treasury book. However, as I will shortly explain in the call, our borrowing costs have also fallen in this quarter by a similar number and hence we are able to maintain our spreads in the credit and treasury book this quarter. Premium on life insurance business which completed one year of operations this quarter was Rs. 6.3 crores.

Within our total cost, our employee costs are higher by 34% year-on-year this quarter as we have continued to selectively hire for our new businesses especially life insurance and home finance. Overall we added about 160 employees in this quarter taking the headcount to 3,362. Our headcount in September 2011 was 2,863. The Opex is higher by 15% in Q2 YoY due to cost associated with scaling up insurance and other new businesses. At the same time, Opex is flat on a QoQ basis. We have been able to restrict this growth despite higher insurance burn due to better operating cost structure in other businesses. The financing cost is higher this quarter on YoY basis due to our total borrowing at the end of this quarter being higher at Rs. 10,155 crores compared to Rs. 8,039 crores at the end of Q2FY12 and generally lower interest rates in the market in the Q2FY12 just before they hardened significantly. However, sequentially our financing cost is lower by 11% as a result of improved liquidity this quarter which led to softening of rates. Our blended cost of borrowing is around 10.1% for the quarter compared to 10.5% in Q1FY13 and 9.3% in Q2FY12. As I mentioned a short while ago, the drop of 40 basis points in our borrowing cost enabled us to maintain our spreads on credit and treasury assets. The depreciation on fixed assets is also higher this quarter by around Rs. 4 crores year-on-year as our new office building which was not fully occupied then has been occupied now.

While we achieved a 39% growth in top-line and 58% growth in the bottom-line for Q2FY13 year-on-year, as a result of our constant strategy to derisk and reduce volatility, our profitability parameters continue to get impacted for the reasons that we have discussed in the past mainly due to a lower level of economic activity and our investments in building new businesses. You will find from our earnings update for the quarter that our return on tangible equity excluding insurance is over 10% compared to the reported figure of 6%.

Now turning to our business highlights. The credit business scale up continues.

The total credit book stood at Rs. 5,773 crores at the end of Q2FY13 compared to Rs. 5,219 crores at the end of Q1FY13. We continue to avoid sector or industry concentration in our credit book. The average collateral cover for the collateralized book is now around 2.72x. The Q2 yields are around 16.4%, lower by 40 basis points in this quarter compared to 16.8% in the previous quarter. Since the average borrowing costs have also fallen by 40 basis points, the spreads remain intact. Despite challenging environment, we continue to maintain high asset quality with gross NPLs at the end of the quarter at 0.42% and the net NPL at 0.12%. We carry adequate provision on NPLs. ECL Finance, our NBFC has a capital adequacy ratio of over 20% at the end of this quarter.

The retail finance business continues to build scale and has now reached Rs. 1,195 crores spread across nearly 1,700 clients. Average LTV on this book comprising of residential mortgages and LAP is around 57%.

We continue to be a leading debt arranger in the country with a market share of around 8% in Q2. We successfully handled 10 DCM deals this quarter compared to 9 in the previous quarter for large and reputed clients like REC, Sundaram Finance, Tata Capital and HDFC. While Edelweiss has always been among the leaders in private placement of debt, we also made an entry into public issue of debt this quarter as we handled the retail issues of Shriram City Union and IIFL.

Turning to capital markets and asset management business; in investment banking, the environment continued to be challenging. Even then we handled two transactions this quarter. The pipeline continues to be strong. We continue to invest in building relationship with our clients and look for new opportunities. On the broking side, our total average daily volumes for the first quarter were Rs. 6,175 crores compared to Rs. 6,540 crores in the previous quarter. Our market share remained stable at around 3.7% as was the average for the entire financial year 12. Of the total ADVs, the client broking volume this quarter is higher at Rs. 2,770 crores. The broking yield on the client transactions at a gross basis is 3.1 basis points this quarter compared to 3.3 basis points in the previous quarter. Though overall booking income is higher this quarter, yields have fallen due to higher options volumes. Our retail broking businesses now have about 3,89,300 clients through our online portal www.edelweiss.in and through the offline model. We continue to build this new business at a calibrated pace.

In our alternative asset management business, we have AUMs and AUAs of over USD 590 million equivalent at the end of this quarter including structured product portfolio of around Rs. 800 crores. Our mutual fund managed 11 equity and debt schemes with an average AUM of Rs. 306 crores during quarter two. It now has an active base of 7,100 investors having added about 900 clients this quarter. The focus of this business continues to be on broad basing the product portfolio and building an investment track record.

Our commodities business continues to scale up its operations. It focuses on sourcing and distribution of bullion at 11 centers to over 400 clients. It is also building and scaling up the agri-commodities business. The business has assets of Rs. 1,846 crores at the end of this quarter.

Our insurance business completed one year of operations this quarter. It had a new business premium of Rs. 6.3 crores having issued about 3,600 policies this quarter compared to 3.5 crores premium and 2,000 new policies during Q1. The scale up of this business continues as planned. During the quarter, we expanded our operations to 6 more large cities; Bengaluru, Mangalore, Hyderabad, Kanpur, Lucknow and Varanasi and the business is now having 39 offices in 29 cities. The business significantly scaled up its workforce of PFAs to touch a number of 1,845 this quarter from 1,260 as on June 30th 2012. As we explained during the earlier conference call, loss from this business passes through our P&L account to the extent of our share. As the pace of scale up of this business goes up, the cash burn would also increase which is as per the plan.

The treasury book size at the end of the quarter was Rs. 2,906 crores compared to Rs. 3,396 crores at the end of the previous quarter. The gross yield on this book for the quarter is 11.3% giving a spread of 1.2%. We generally look to a spread of 1 to 3% on this book as its composition now mostly includes GSecs, FDs and bonds which are used for liquidity and balance sheet management purpose. Treasury allocation continues to be a function of liquidity management, capital requirement of the business and opportunities in the market.

Finally turning to our balance sheet, the total balance sheet size at the end of the quarter was around Rs. 14,486 crores with an effective size of Rs. 13,106 crores after excluding the current liabilities. The total net worth of the group now stands at Rs. 2,952 crores including minority. Excluding the intangibles like goodwill, loan to employee trust and deferred tax assets, our tangible equity stands at Rs. 2,619 crores. Our total borrowings at the end of the quarter are lower at Rs. 10,155 crores compared to Rs. 10,700 crores at the end of the previous quarter. Our total assets include G-Secs and FDs of about Rs. 2,683 crores against which we have back-to-back borrowings. Excluding these G-Secs and FDs from the total borrowings, our net gearing at the end of the quarter is a reasonable 2.53x. Our sources of borrowings as on 30th of September 2012 include debt market basically mutual funds of Rs. 3,300 crores, bank lines of Rs. 3,359 crores, corporates and insurance and retail segments amounting to Rs. 1,746 crores and assets specific borrowings mainly CBLO of Rs.1,729 crores. Bank lines are lower this quarter mainly due to lower OD limits against FDs as FDs of worth Rs. 1,200 crores matured and were not renewed this quarter due to lower prevailing FD rates. Our assets side mainly comprises of credit portfolio of Rs. 5,773 crores, FDs of Rs. 2,823 crores, G-Secs of Rs. 1,846 crores, bonds commodities and others of Rs. 803 crores, insurance assets of Rs. 501 crores and corporate assets of Rs. 1,360 crores as on 30th September, 2012.

Coming to our ALM position, you will see that we have strengthened the liability profile with lower dependence on short-term borrowings over the last one year. We continue to diversify our sources of borrowings as we have indicated in the earlier call. We also continue to have matched ALM profile. Our liquidity cushion is comfortable around Rs. 500 to 700 crores. We continue to maintain a strong and liquid balance sheet with a comfortable leverage and matched ALM profile. This is one of our key focus areas.

To sum up, we continue to implement our core strategy of strategic diversification in financial services and de-risk the business model. The planned build out of new businesses of life insurance, asset management and retail finance is on track. With the building blocks being in place, we are well positioned to capture our share of growth when it returns. With this, I would like to conclude and would be happy to take your questions.

Moderator: Thank you very much sir. Ladies and gentlemen we will now begin the question and answer session. The first question is from Arvind Subramanian from IDFC Mutual Fund.

Arvind Subramanian: My question is if you see, your total debt is 10,000 odd crores, but your credit book is only around 5,800 crores. Of which, some of it will also be equity funded. So where is this remaining 4-5,000 crores of debt, what is it funding basically?

Rashesh Shah: If you just see our total assets, we have two parts, one is the credit book, the other are the treasury assets. If you go to slide #18, fairly good breakup of all our FDs and the G-Secs plus commodities portfolio, bond portfolio and corporate assets is given. So that gives you a clear profile of all the assets on slide #18.

Arvind Subramanian: But then just a follow-up, if lot of these funds which you are raising at your rating, then put to investments in lot of G-Secs and FDs as you say which are AAA assets or since it is more for liquidity, how do you make a carry on it because you are rated at AA minus with what your cost of borrowings would reflect and you are investing it at an AAA corporate or G-Secs and so on which is for liquidity management. So where is the positive carry coming from?

Rashesh Shah: Obviously we are doing business to earn some positive carry. So that assumption is very valid. If you see we give our average cost of funds, our cost of funds comes from our MF borrowings, our bank borrowings and from our assets specific borrowings. So very often like in G-Sec, you borrow in CBLO for which the cost of borrowing for that is much lower than the yield you earn on whatever else. So on the whole, you see only the average cost of funds, but very often some assets are borrowable. Against them, we have some short-term funding like against the FDs, we have an overdraft against the FDs, we have a liquidity cushion against the FDs. So we do manage our treasury fairly efficiently which is reflected in the results.

Arvind Subramanian: But then the other side of it is the treasury's primary aim is for liquidity management, then why the borrowing on the liability side to then fund the treasury because neither is it really making too much of return, at the same time if it is liquidity management, we should not then be borrowing and then funding treasury because that will not really serve a purpose when liquidity is needed because we will also have to retire the debt which is funding the treasury.

Rashesh Shah: If you study about the bank's treasury operations, our own treasury approaches structure around the same way, to borrow for the same assets with the same liability profile because you want to manage liquidity, but you do want to manage it efficiently. So otherwise it will affect your earnings and all. So you want to make sure liquidity is efficiently managed whatever surplus be. We used to do arbitrage earlier for this. You also want to eke out as much efficiency as you can and still achieve the liquidity objectives that you have and it is the same as for any bank.

Arvind Subramanian: But then in an environment where maybe the trading is not favorable for you given that large part of the assets are in G-Secs and fixed deposits which will have a lower yields than your cost of borrowing. Then do you change your strategy or do you lower your treasury book or will this always remain and then therefore you might make a negative carry on that?

Rashesh Shah: See either as management or as investors, you have to assume that we will do what is efficient and there is lots of thinking goes behind what we do. We obviously do not want to earn negative carry. So we do evaluate all that very well and again whatever good and bad decisions we make, ultimately gets reflected in the result that we come out with.

Arvind Subramanian: But the reason why I ask is because if you see your balance sheet as such, if you see over the last 2-3 years, the balance sheet quantum itself has almost doubled or tripled from time of 5-6,000 crores to today at 15,000 crores, but the absolute profitability number is largely in the same window, though I agree it is also because of the other reasons and new businesses.

Rashesh Shah: Again may be what you can do is contact our head of Investor Relations, Shailendra Maru because he will give a lot of specific stuff. If you look at 3 years ago, there was agency business, there was broking business. We did not have insurance and all. So we have given out fairly clear breakup in our annual results also segment wise profitability and only thing we have to add to complete this conversation is that we do try not to do things like a negative carry and just borrow at a high cost and invest in lower yield. So a lot of thinking goes behind that as how we manage our assets and liabilities.

Arvind Subramanian: In the breakup of borrowing, there is a segment called retail. Could you just elaborate on what are the retail borrowings that you do?

Rashesh Shah: These are usually NCDs we sell in structured products to a client. We are fairly big issuer of the structured products. So we issue 3-year NCDs to high net worth investors and so on.

Moderator: Thank you. The next question is from Pankaj Agarwal from Ambit Capital.

Pankaj Agarwal: Sir if I look at one of your slides, you have shown that ex-insurance, your net profit is around Rs. 54 crores for the quarter. It seems like at this point of time, you are making losses in insurance business and obviously because you are at an expansion phase at this point of time, but till what time we would see this trend before insurance business starts generating returns? What is the timeframe you are looking for?

Rashesh Shah: Our current estimate is that we will burn between Rs. 50 to 100 crores a year on the insurance business. As you have seen in this quarter our burn is about Rs. 13 crores for the quarter which annualized it becomes about Rs. 52 crore. So anywhere between Rs. 50 to 100 crores is what we expect to burn on this business on an annual basis and as you know our structure, we have a JV partner, Tokio Marine. They have invested in the premium keeping in mind the burn that will be there. So from a cash flow point of view, we are getting the premium and we are spending it on the burn, but while the premium is sitting in the balance sheet, the cash burn has to go through our P&L.

Pankaj Agarwal: But in terms of the insurance business becoming profitable, do you have any time horizon before the business itself starts throwing cash after some time?

Rashesh Shah: Usually for most businesses, it is after 5 years, but what you are building in insurance business is what is called embedded value. So accounting wise, you are showing a loss, but you are also creating what is called an embedded value in the business and usually most companies look at the accounting loss or the cash loss and the embedded value. On that basis in the third to fourth year, you would become positive and accounting wise may be in the fifth to sixth year when you expect to be positive. And as we will get approximately Rs. 700-crore premium from Tokio Marine in this JV and that premium is what we expect to spend over the first 5, 6, 7 years from an accounting point of view.

Moderator: Thank you. The next question is from Ms. Kajal from ICICI. Please go ahead.

Kajal: Hello sir, it is Kajal here. I just wanted to know we have changed some classification this time from Q1 to Q2 in terms of fees and commission because last quarter the same number of Q1 was different and now in this quarter the Q1 number is different.

Shailendra: There has been a small reclassification of about Rs.4 crores between treasury income and agency income in Q1. That was as per the discussions with our auditors and overall of course the total revenue and total PAT remains the same.

Kajal: And whether this has to do with something in other OPEX lines?

Shailendra: No. The other small reclassification of about Rs. 2 crore among Opex and financing cost is different and not linked to the fee and commission.

Kajal: What is the reason for quite a large jump in the employee cost?

Rashesh Shah: It is actually mainly related to insurance. So if you see insurance, we have been adding branches and adding people. So Q-on-Q you are seeing from Rs. 78 to Rs. 83 crores, that has been the jump. We have added about 160 people largely on the insurance. Our headcount increases now largely in the insurance.

Kajal: Sir we have also seen a decrease in the interest expense in this quarter.

What are the main reasons? One is definitely the wholesale rate has come down, but still if you can elaborate?

Rashesh Shah: Two things. As you would have seen, our average size of the treasury book came down by about Rs. 500 crores. So that is why income has also come down and expense has also come down. Expenses have fallen similar to the fall in the income from interest in treasury income. We look at the NII. On the whole, we have seen about 40 basis points fall in both cost of funds and yield on the treasury and credit side.

Kajal: Sir as per you, what is the NII the way you said right now?

Rashesh Shah: We basically take interest and treasury income minus the financial expense. So if you see in this quarter from Rs. 4,169 million, you minus the financial expense of Rs. 2,630 million, so NII comes to Rs. 1,539 million, about 154 crores is the NII on the capital using businesses. It was 155 crores a quarter ago. So NII is protected.

Kajal: Sir just for clarity if you can tell of the total 453 crores in Q1, how much was treasury and how much was interest other than treasury?

Rashesh Shah: Slide #9 gives the entire breakup in that.

Shailendra: Of course slide no. 9 gives you second quarter and full half year, you can work out Q1.

Moderator: Thank you. As there are no further questions from the participants, I now hand the conference over to Mr. Shailendra Maru for closing comments.

Shailendra Maru: Thank you Rashesh, Himanshu, Ranganathan and thank you Marina. Thank you everyone for joining us on this call. In case you have any other questions, please feel free to contact us directly or drop me an e-mail at shailendra.maru@edelweissfin.com. Have a great day ahead.

Moderator: Thank you gentlemen of the management. On behalf of Edelweiss Financial Services that concludes this conference call.

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