Conference Call Transcript

Edelweiss Financial Services

Q2FY14 Results

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Corporate Participants

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Chairman

Himanshu Kaji
Executive Director

S. Ranganathan
Chief Financial Officer

Shailendra Maru
Head, Stakeholder Relations

Questions and Answers

Moderator: Ladies and gentlemen good day and welcome to the Edelweiss Financial Services unaudited 2nd Quarter FY14 Earnings Conference Call. I now hand the proceedings over to Mr. Shailendra Maru of Edelweiss Financial Services. Thank you and over to you sir.

Shailendra Maru Thank you Inba. Good afternoon all of you and thank you for joining us today as we discuss Edelweiss Financial Services' Unaudited Consolidated Financial Result for the second quarter of FY14 that ended 30 September 2013. 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, we will have opening remarks by Rashesh and Ranganathan. This will be followed by the Q&A session. A 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 discussed at the conference call may be forward looking statements. These need to be reviewed in conjunction with the risks 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 over the call to Rashesh….

Rashesh Shah Thank you Shailendra and a very good afternoon to all of you. As you would have seen in the results, we had an okay quarter while it was still a fairly challenging quarter.

All of us who have been in the market for quite a few years would say that Q2FY14 has been one of the more challenging ones because a lot of things happened at the same time as we are all aware about the market volatility on currency market. Interest rates went up, they shot up very sharply and so cost of funding went up. And the liquidity was very tight for at least about five to six weeks in the middle of the quarter. But fortunately by end of September things have come back to some sort of normalcy and that is the good news. So this quarterly volatility had to be managed.

Coming to our businesses, first is capital markets which includes investment banking, brokerage and asset management and on that we did fairly okay. There is slight increase in fee and commission income, but overall capital market activity has been subdued. In this quarter we have continued to focus on cost reduction, bring the cost income ratio down and overall asset management in this business has been doing well. We have grown the alternative asset management business over the years and that is chugging along fairly well. This business currently gives us a profit before tax of around 40 crore - the capital market pieces as a whole including investment banking, brokerage, both wholesale and retail, and asset management combined. We make a PBT of about 40 crore a year and we have allocated about 300 crore of equity for this business.

Then we come to the credit business which has both the wholesale and the retail, the wholesale NBFC, and retail housing finance business. Here we brought down the average assets for the quarters slightly because of liquidity conditions and you know there was a point of time in August and the liquidity looked so tight that we wanted to be more cautious on liquidity management and asset scale up, so we held back disbursement and also couple of wholesale loans were prepaid where the clients had the capital to prepay, and as a results of that there was a slight reduction in average assets for the book. But fortunately, by the end of the period assets have again gone up because as September progressed well we started scaling up again. Our clients were very understanding and you know they were patient, so in September when we got a chance where the liquidity conditions improved, we have been able to scale the book.

The retail book has been doing well. We have been growing it in a calibrated manner. We have been hoping and now we are hoping we start generating about 10% ROE in this business. In the last year if you remember we just reached about break even, now we are starting to generate between 8-10% ROE and our hope is that this becomes a stable scalable business, giving us 14-15% ROE going forward over the next couple of years. Collectively credit business currently contributes about 240 crore annualized to the PBT and we have allocated about 1300 crore of equity for this business. As you know our gross equity at the group level is about Rs. 3300 crore, so about 1300 crore is allocated for the credit businesses.

Our third business group is commodities. The first half was fairly okay in spite of the slowdown in volumes as the first quarter was very good and in the second quarter also some tail effect of that continued, but we have seen that volumes are coming down. There is a scale back we have seen, you know slowdown in the gold imports in this quarter, but also because of the NSEL crisis, the overall commodity activity has come down in the market. But we have used the last few months to diversifying into and financing of agri commodities and that has been helpful to us. This group is now fairly steady. We expect to generate approximately Rs. 90 crore of PBT if I take the first half and annualize it - about 90 crore of PBT on an annualized basis and this business uses up about 300 odd crore of equity. So it is still fairly okay, fairly profitable.

The fourth business group is insurance where the scale up continues in this quarter. We infused Rs. 250 crore into the insurance subsidiary in second quarter out of which about 55 odd crore came from Edelweiss and the remaining 195 crore came from partner, Tokio Marine. The overall ETLI capitalization is now getting close to 800 crore, so we have capitalized this business very well. Even now they have 666 crore of net worth on hand. The business ramp up is going on smoothly, though the environment is fairly challenging. We now have about 57 office in 48 cities, more than 5000 insurance agents are there and we have clocked the premium of 24 crore for this quarter in this business. Insurance should overall contribute to about 80 crore as a loss at a PBT level for the whole year. If I take the first half number and annualize it, it should be approximately 80 crore kind of a loss, the operating loss.

And the last is our balance sheet management and corporate and un-allocated activities. A lot of treasury activities slowed down because of the market volatility and liquidity conditions especially in July and August. Overall this group now contributes to about 50 crore of PBT on its annualized basis for Edelweiss on a run rate basis and treasury operations are stable. They have descent NIMs, but cost of liquidity and cost of liquidity management which is also handled by this group has gone up significantly. Our balance sheet growth is fairly calibrated. We have not grown very rapidly as you would have seen even in the first half of this year and if I look at the first half of this year versus first half of the last year our profits have grown by almost 30 odd percent, the balance sheet grown by about 10-11%, so we are currently able to grow our profits higher than the balance sheet grows. As we have spoken earlier, our intention is that we want to grow our profits at about two times of size of the balance sheet growth because we have always believed that we don't have to be a very linear asset driven business only. We want a good combination of asset and agency & advisory business. This should give us that extra improvement in ROE, so we hope that we will continue to grow profit faster than the balance sheet growth.

Overall as you would have seen we have 10% fall in profit ex-insurance, which is about Rs. 7 crore, on a QoQ basis, though on a YOY basis we are still doing fairly well. A large part of this has been due to the increase in cost of funding and afterwards my colleague, S. Ranganathan will give you the details. You will see that the cost of funding went up by 60 basis points in this quarter and that has largely impacted the profit for this quarter on an ex-insurance basis.

Overall, we continue to manage risk and NPLs have inched up a little bit but they are largely under control and we keep on providing for this and we still have a total provision which is above 100% of the NPA.

Overall organizationally we continue to invest in communication, risk, compliance and technology and in this quarter all those areas have become significantly stronger and in fact I have been happy about the investment that we are making in this.

Finally on the outlook front, we think there is a relief in the market overall because of India events and global events in the last few weeks. The last couple of months have been fairly easy and things have started coming back to normalcy. We are seeing liquidity conditions easing up which is bringing short term rates down and making liquidity available, though we expect the long term rates to continue to go up because the long term rates are more driven by inflation and inflation expectations. The short term rates are driven by liquidity and the foreign exchange conditions because every time rupee is under pressure, RBI will tighten liquidity and as a result of the yield curves will get inverted. So we are moving from an inverted curve to a slightly flattish curve just now. We think the growth is in upward slopping curve which is usually good for banks in NBFCs when curve is slopping upward. So as liquidity conditions ease up and the interest yield curve starts sloping upwards credit business should be okay in the second half. So that is one of the risks in the environment. We have also seen that there are a lot of cash flow related issues with clients, a lot of clients with good quality assets, good quality businesses. Cash flows crunch is for almost everybody and that will continue to pose risk for all kind of businesses across the industry, the people will have to be very careful. On the medium term position, we are still cautious because unless we see inflation coming down, unless we see fiscal deficit coming under control, though the finance minister has promised that and so we think it may come under control in the second half, and unless we see corporate earnings start inching upwards, environment may continue to be challenging. We started the year with expectation of corporate earnings growth rate for the year at about 17 to 18%. The consensus is now around 8-9%, so there has been a lot of down grade for earnings that has happened and we are hoping that now may be a few upgrades will start, so that once we seeing corporate earnings inching up only then confidence in the medium term should come back. Until that all of us will continue to be cautious, slightly comfortable and optimistic in the short term, and still very cautious and watchful for the medium term. I will now hand over to my colleague S. Ranganathan to take you through the details of the financial performance for this quarter.

S. Ranganathan Thank you Rashesh, thanks everyone again for joining us on this half yearly conference call. As usual I will first discuss the highlights of our financial performance and then go on to give you a business update. The performance for the half year comprises of the first quarter which was robust followed by the second quarter where the macroeconomic environment worsened. The spike in short term interest rates during the second quarter impacted our performance compared to the first quarter, though our businesses continue to perform well. The consistent financial performance across cycles is a result of diversification in the businesses, execution efficiencies and the cost control that we have been constantly working on. In fact our ex insurance profitability continues to improve significantly as I will discuss shortly.

On the balance sheet front, in view of the liquidity scenario during the second quarter, we increased our focus on liquidity management and also increased asset allocation towards this function to tackle any probable unforeseen developments. We continue to strengthen the balance sheet, reduce our dependence on short term borrowings and diversify the sources of borrowings. Maintaining a strong and liquid balance sheet with a healthy ALM profile continues to be a key focus area for us.

Coming to our result of Q2FY14 – total revenue for the quarter is Rs. 586 crore compared to 511 crore for Q2FY13, up 15% year-on-year. Profit after tax is 46 crore compared to 42 crore for Q2FY13, up 11%. Edelweiss group's gross net worth stands at Rs. 3,360 crore, and tangible equity ex-insurance and ex-minority at Rs. 2,142 crore. Profit after tax ex insurance for the quarter is 62 crore compared to 51 crore for Q2FY13, up 22%.

For the half year FY14, total revenue is Rs. 1,211 crore compared to 1044 crore for the first half of FY13, up 16% year-on-year. Profit after tax is 102 crore compared to 81 crore, up 25%. Profit after tax excluding life insurance business is 132 crore compared to 99 crore for the first half of FY13, up 32%. The effective balance sheet side at the end of September 30, 2013 is Rs. 14602 crore including borrowings of Rs. 11242 crore giving a net gearing of 2.4x. While balance sheet excluding insurance has grown 11% at the end of first half of FY14 compared to the levels at the end of first half of FY13, in the same period the net profit excluding insurance has grown by 32% clearly indicating the nonlinear growth that they have been able to achieve as a results of operating and capital efficiency that we have been focusing on. We hope to maintain this growth going forward.

Among the individual heads of income, our fund based income for Q2FY14 has grown 11% year-on-year reflecting growth in our loan book. However, in comparison to the first quarter is lower because interest income is lower on account of reduction in bank fixed deposit and lower average loan book in the second quarter. We started scaling up the credit book only during September '13 after the macro conditions started improving.

Agency fee and commission for the quarter is up 13% year-on-year. We have been able to improve our fee and commission top line as our retail capital market business has scaled up despite challenging environment and industry revenue pool remaining static or in fact shrinking in some of the verticals.

Life Insurance business has picked up momentum and recorded a gross premium for quarter 2 of 24 crore compared to 7 crore in Q2FY13.

Within our total cost, OPEX this quarter is flat on a year-on-year basis; however it has fallen by 14% compared to the previous quarter due to lower activity levels in some of the businesses on the back of tough operating conditions and due to strict control over our costs.

Our employee cost is higher by 22% for this quarter compared to the corresponding period last year. We continue to scale up our new businesses especially life insurance and retail finance and hire new recruits for them. Our employee strength stands at 4,003 as at 30th September, 2013 compared to 3,362 a year ago. Addition of these 640 employees over the last year has also resulted in the employee cost going up.

Financing cost is higher by 11% for Q2FY14 compared to the corresponding period last year. Our borrowings were Rs. 11,242 crore as on 30th of September, 2013 compared to 10,155 crore as on 30th September, 2012. Marginal increase in borrowing coupled with higher cost of borrowing in the second quarter for this year resulted in YOY increase in finance cost. Our blended cost of borrowing for Q2FY14 is 10.1% compared to 9.5% for Q1FY14 which was due to spike in the short term rates in the market as we are well aware.

A short while ago, I spoke about interest income being lower in the second quarter on a Q-on-Q basis. This was partly compensated by fall in our finance cost in the second quarter when compared to the first quarter. The reduction in finance cost this quarter despite the higher blended cost of borrowing is due to lower average borrowing in this quarter compared to the previous quarter. Our cost-to-income ratio excluding insurance had peaked at 72% during FY12 as a result of investment in diversification phase of our growth. It is now improving gradually each quarter and now stands at 64% for Q2FY14.

Coming to our balance sheet – the effective balance sheet side as of 30th September 2013 is Rs. 14,602 crore including borrowings of 11,242 crore and the group gross net worth is Rs. 3,360 crore. Our net gearing is 2.4x excluding an amount of Rs. 3100 crore of G-Sec and bank FDs against which we have back to back borrowing. Since March 2013, our total assets have fluctuated around 14,500 crore and the borrowings around 11,000 crore. However, during the same period our debt market borrowings have come down from 33% to 30% and bank borrowings have gone up from 33% to 36%. This demonstrates our commitment to reduce dependence on debt market and especially short term borrowings. In addition, bank overdraft and cash credit lines aggregating to Rs. 755 crore have remained unutilized as on 30th September 2013 giving us the desired liquidity cushion. Increased bank lines have provided us a stable long term liability. We have thus strengthened our liabilities profile while diversifying our sources of borrowings. We continue to ensure that we have a matched ALM profile. We maintain an overnight liquidity cushion of around 500 crore to meet any unforeseen requirement. In fact during the second quarter when the liquidity was tight in the market and the short term rates significantly higher, we consciously increased our liquidity cushion to guard against any unforeseen events.

Book size assigned to balance sheet management unit at the end of the quarter was marginally higher at Rs. 3,080 crore as we increased allocation to this book as a part of our liquidity management strategy for dealing with the challenges in second quarter. This book mainly comprises of G-Secs and bank FDs and operations focus on managing liquidity and balance sheet management as is done in any commercial bank.

Now finally turning to our business highlights – the total credit stood at Rs. 6,920 crore at the end of Q2FY14 compared to 5,773 crore as of end of Q2FY13, a growth of 20%. The average collateral cover for the collateralized book continues to be around 2.5x. The blended yield on the credit book for Q2 was around 15.8% compared to 15.7% at the end of Q1FY14. Since the cost of borrowing has gone up this quarter, there was some margin compression. However, we have raised interest rates on loans towards end of the second quarter and its full impact will pan out in the next quarter. Further since the short term interest rates are gradually stabilizing, we are hopeful of restoring the margins in days to come. The asset quality on the credit book continues to be satisfactory with gross NPL at the end of the quarter at 0.71% and the net NPL at 0.19%. Our NPL provision cover is healthy at 73%. Additionally, we provide general provisions on standard assets as per the prescribed norm. We continue to focus on risk management in this book and are confident of maintaining good asset quality.

ECL Finance, our NBFC, has a capital adequacy ratio of 20.8% as on 30th September, 2013. The retail finance business, which includes mortgages, LAP, and SME finance, continues a steady growth. The book has now touched Rs. 1,912 crore including SME finance of 283 crore. We continue to be a leading debt arranger in the country having handled 11 DCM and debt advisory transactions this quarter from large and reputed clients. Higher interest rates during this quarter discouraged the corporates from raising debt capital from the market.

Our commodity business continued to build scale in agri commodities with a client base of around 400. We have made significant investment in building back end and a network of market intermediary for agri procurement and distribution over the last two years.

Turning to financial market and asset management business – in investment banking, the deal closures continue to be slow. We, however, handled four transactions this quarter. The pipeline continues to be strong. On the broking side, our agency ADV of clients was Rs. 3,200 crore for the second quarter of FY14. While our clients ADV are marginally down quarter-on-quarter, the market share has fallen to 2.6% due to lower treasury ADV. While market continues to record higher ADVs most of the growth is coming from options transactions and this has not resulted in any increase in the industry revenue pool. Our securities broking revenue forms 5.5% of our total revenue for Q2FY14. The broking yield on client transactions continues to slide on the back of higher options volume and now stands at 2.3 basis points on a gross basis.

Our retail broking business now has over 4,18,000 clients on our online portal www.edelweiss.in and through the off line model. Including our other wholesale and retail businesses, Edelweiss Group now has a client base of over 4,60,000.

In our Alternative Asset Management business, we have AUAs/AUMs of around USD745 million equivalent at the end of this quarter including the structure products portfolio of about Rs.1,300 crore.

Our Insurance business continues its branch scale up. It opened 11 new branches across India in Q2, taking total branches to 57 in 48 cities. The agency channels build up continues with number of personal financial advisors crossing 5,000 compared to about 1,800 a year ago. The cash burn in this new business is as per plan. During the quarter, the JV partners, that is Edelweiss and Tokio Marine, infused capital aggregating to Rs. 250 crore taking the current net worth to Rs. 666 crore.

To sum up, we continue to implement our core strategy of diversification in financial services and de-risk the business model. While the current environment is challenging, our core business operations remain robust. We will continue to focus on improving efficiencies and productivity and strengthening the organization in the financial year '14 while we wait for growth to return. Given strengths of Edelweiss, we are confident that when growth returns, we will be able to garner our share.

With this we will be happy to take any questions.

Moderator Thank you very much sir. Ladies and gentleman, we will now begin the question and answer session. Our first question is from Ritesh Nambiar of UTI Mutual Fund, please go ahead.

Ritesh Nambiar Just wanted to know the total mark-to-market impact in this quarter, how much is realized, how much is unrealized?

Rashesh Shah Our approach has been to mark-to-market everything as per the norms so there is no unrealized profit or loss because we mark-to-market all our stock-in-trade and everything as we don't have any held-to-maturity portfolio.

Ritesh Nambiar So what was the quantum if I may ask?

Rashesh Shah It is actually part of our treasury business, as you know we have the liquidity and balance sheet management unit which handles the entire treasury part of the business. As you know we don't usually take a lot of risk, so we are fairly hedged and we make about 100 basis point to 150 basis points over our cost of capital in our treasury business as a whole, across all the arbitrage strategies and everything else that we do. So if you are asking have we made a loss in this quarter on that, the answer is no.

Ritesh Nambiar Okay. So your G-Sec book is mark-to-market, but there is no loss you are saying.

Rashesh Shah Yes.

Ritesh Nambiar How is it actually versus the June quarter?

Rashesh Shah June quarter also we didn't have a loss.

Ritesh Nambiar See the mark-to-market exercise just like a bank has some mark-to-market loss on their G-Sec book, so based on the duration which you carry there should be some cumulative mark-to-market impact for this quarter, if you could give me that?

Rashesh Shah No it's not an individual scrip, you know it's a portfolio as a whole. The way we manage, we manage what is called IRS (Interest Rate Sensitivity), swap market and all. A lot of our interest rate risk is always hedged away largely, that's what I am saying a lot of our liquidity management has been without taking any positional risk. We are trying to take either through arbitrage or through hedging and all to make ensure that you are having some efficiency on our capital as well as we are not taking a large risk. So may be on a particular G-Sec we will have a loss, but there will be hedge on the other side in the OIS market where we will make a profit. Because our ALCO, asset liability committee, that runs and controls our IRS (the interest rate sensitivity) and our approach has been that we don't want to take a lot of interest rate risk as a whole, so we usually follow a fairly conservative approach to this.

Ritesh Nambiar So just to get a sense the fall in the interest income on your NCD, how much of it is on account of compression of spread, and how much is the compression if you could give that would be better?

Rashesh Shah We wouldn't have calculated that because this is the overall interest that is there. But as I said earlier, we brought down the average book a little bit by about 300 crore for the quarter, so our average book was lower in July/August before it scaled up again in September. So overall the interest income would have gone down because of that, but on the NCDs the interest has been normal.

Ritesh Nambiar Just from the lending business, the fall in interest on loans, just wanted clarity on the same? The book has increased but the income has fallen sequentially?

Rashesh Shah What you have seen the book in the end of period has gone up, but overall average book for the quarter was lower and if you see our interest income is lower. The interest expense is also lower, though our average cost of borrowing went up, though the interest expense did not fall as much as the interest income. So that is why there was some compression of spread, which is about 30-40 basis point is our estimate for the quarter and also the portfolio mix has shifted - we had some FDs that we have encashed - so all of that brought the asset size down further a little bit.

Ritesh Nambiar Okay and lastly just to touch base upon your gold business, if you could give us some clarity?

Rashesh Shah Commodity business has been fairly stable because you know in spite of the slowdown in imports of gold and precious metals, there was a premium in the market, so overall that did okay in the second quarter. Now we are seeing activity has come down, volumes have come down, but our agri business is doing fairly okay. So we do expect that the precious metal business will have a slower second half and we are hoping that we get compensated by the agri business in the second half.

Ritesh Nambiar Okay, so the rough run rate which you assume on the trading of commodities on the volume side would be similar to the first half?

Rashesh Shah Overall for the business as a whole as I said the business mix will change because I don't think there will be as much activity in the precious metals, but in agri we are now starting to see a lot of activity again. As you know for the last one year, a lot of agri commodity prices were either flat or falling, now they are started inching up again, so there is a lot of activity in trade financing of agri commodities.

Ritesh Nambiar One thing I wanted to know about your Insurance business, the rise in net worth which we see because the rise in net worth is more than compensated for the loss which has happened so, any particular reason you are expanding the business, is there an aggressive plans of expansion in this business?

Rashesh Shah The question you are asking is very correct. We don't need the additional capital in the business just now; we have more than adequate capital for funding that business. But as you know from the very beginning, we have always maintained that we want to ring-fence the capitalization of this business and we want to make sure that we get enough capital for the next five years of operating burn. So as you know right now they have more than 666 crore of net worth which will easily last for the next five or six years for them. Though we may infuse even more capital, but we want to make sure that there is enough capital. We infused 55 crore and our partners Tokio Marine has infused almost 195 crore, this is to keep it very robustly capitalized and from an efficiency point of view also it makes a business sense because with this capital, they have their own interest income, it is more efficient from a tax planning point of view because their losses come down. So on that basis, we have ensured from the very beginning when we started the company itself, our approach was to earmark that capital and ring-fence it. We didn't want to give capital on a quarter-to-quarter basis or on a year-to-year basis as per availability of capital with us. So from the very beginning we kept that capital aside.

Moderator Thank you. Our next question is from Vikas Garg of L&T Mutual Fund, please go ahead.

Vikas Garg Just a very simple question. Sir we saw very tight liquidity situation in the capital market beginning mid of July, and so there was too much of a tight liquidity, CPs were not being rolled over and all. So just to put the things in prospective, is it possible for you to quantify how much of the CPs did you have to actually refinance by some other means over this quarter?

Rashesh Shah We don't have the exact numbers, but my estimate is about Rs. 1,500 crore. As you know we keep a lot of overdraft credit lines with the banks which are usually intact and we manage it because CP financing is cheaper than the overdraft. We use overdraft only as a backup. So our estimate will be 1500 crore is what we did not rollover and we used the overdraft lines for that, but all this changes every day because every day we use overdraft and you replenish it as the liquidity comes back.

Vikas Garg Okay so if I take it correctly although CPs were refinanced in the form of the ODs taken from the bank and you did not really have to reduce any of your asset side book be it your loan book or be it those commodities book or any kind of a book?

Rashesh Shah No. As to answer your question, we didn't have to reduce any assets for liquidity reasons. We did slow down our disbursements and a couple of credit loans which were maturating, we didn't either roll it over. But for liquidity reasons, we didn't have to do any asset liquidation. We had enough of the backup OD lines and that has been our strategy over the years that we always make sure that we are prepared for absence of a rollover.

Vikas Garg Okay. Just one clarification on these OD lines, so these ODs would be on the basis of the fixed deposits which you may have with the banks?

Rashesh Shah These are also OD lines from the banks based on our assets because as you know a lot of our assets like housing finance and the corporate credit asset are also re-financeable from banks, we always have a choice to go to the banks and refinance it, so we do a mix of re-financing from banks, some overdraft and some financing through the capital markets.

Shailendra Maru Inba, we don't seem to have any further questions, so thank you very much Rashesh, Himanshu, Ranganathan, and thank you Inba. Thanks all of you again for joining us on this call. In case if you have any further questions, please feel free to contact us directly or drop me an email at shailendra.maru@edelweissfin.com. Have a great day ahead. We will speak with you again in the month of May 2014, thank you very much.