"Axis Bank Fixed Income Investor Conference Call to Discuss the Q1 FY 2017 Results"

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Moderator: Ladies and gentlemen good day and welcome to the Axis Bank Fixed Income Investor Earnings Conference Call for Q1 FY2017. As a reminder all participant lines will be in the listen-only mode and 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. I now hand the conference over to Mr. Jairam Sridharan – CFO, Axis Bank Ltd. Thank you and over to you sir.

Jairam Sridharan: Thank you very much. Ladies and gentleman, hope you are having a good day. I welcome you to our conference call for a presentation on the Bank's performance for the Q1 FY2017. On the call with me are my colleagues Mr. Shashikant Rathi - Head (Treasury & Market) and Mr. Saugata Bhattacharya our Chief Economist. At the end of the presentation we would be glad to respond to your query. For parts of this call we expect to refer to slides in our quarterly earnings presentation. So you might want to keep that presentation handy.

Let me start to the Key themes for the quarter in quick summary.

1. **Asset Quality stress in previously indicated pockets continues to get crystallized:** We have witnessed significantly higher slippages during the quarter, predominantly from the Watch List (WL) segment of the corporate portfolio. Fund based outstanding of the Watch List accounts has decreased to Rs 202.95 Bn. This quarter, we have also disclosed the Non-fund based outstanding in our WL portfolio, which stands now at Rs 25.62 Bn.
2. **Business Growth remains strong**: Growth momentum is healthy with balance sheet and loan growth at 18% and 21% respectively. CASA balances grew at 18% and comprised 43% of total deposits.
3. **Operating Earnings profile has been steady**: Underlying earnings quality remains steady, with operating profit margin at a healthy 3.41% of average assets. Three factors have driven suppressed Net Profit growth – NPA provisions, the consequent Interest Reversals, and growth in Opex because of our stronger branch growth compared to last year.
4. **Strong performance on the Retail Franchise**: The Retail franchise of the Bank had another good quarter – with Saving Accounts growth of 18% yoy and core retail loan growth of 26%. The share of Core Retail Advances excluding FCNRB deposits is now at 40%, up from 38% last year. We are now the 4th largest credit card issuer in the country, with a card market share of 10%.
5. **Strong Capital position**: We remain well capitalised to pursue growth opportunities, with our Tier I ratio at 12.38%, up from 12.15% last year.

I shall dwell on these themes in greater detail as we go along.

Starting with **<u>Asset Quality</u>**.

- In April 2016, the Bank published a Watch List of accounts, which the management assessed to be the key source of stress in the Corporate Lending book over the next 2 years. I would like to highlight a few developments on this Watch List this quarter. You might want to refer to Slide 24 in the presentation.

- Fund Based outstanding of Watch List accounts fell to Rs 202.95 Bn, driven by slippages into NPA during the quarter.
- Non-fund based outstanding was Rs 25.62 Bn, down from Rs 26.26 Bn as on 31st March.
- Our quarterly review did not reveal any account to upgrade out of the Watch List this quarter.
- Total corporate slippages were Rs 29.11 Bn during the quarter, of which Rs 26.80 Bn (or 92%) came from the WL portfolio.
- We will be referring to the term "Dissolution Rate" (DR) to quantify the proportion of reduction in WL outstanding as a proportion of original WL outstanding. For the current quarter the DR stands at 10.3%.
- In the quarter, during the periodic rating review of our corporate loan book, some exposures have been downgraded. These downgrades were concentrated around the WL portfolio.

o Moving on from the Watch List, up-gradations and recoveries from NPA in Q1 were at Rs 1.40 Bn and write-offs at Rs 0.32 Bn. Consequently, the net addition to Gross NPA pool during the quarter was Rs 34.66 Bn.

o Provisions and contingencies other than tax for the quarter were Rs 21.17 Bn against Rs 11.22 Bn last year. Of this, provisions for loan losses were Rs 18.23 Bn, provisions for standard assets including unhedged foreign currency exposures were Rs 2.38 Bn, provisions on SDR accounts Rs 0.71 Bn and there was a write back of Rs 0.18 Bn on account of investment depreciation.

- In the standard assets provision bucket, we have provided the balance requirement of Rs 0.51 Bn against one entity in the food sector as per an RBI directive to all Banks with exposure to that entity. We hold a total standard asset provision of Rs1.56 Bn against this entity now.
- As part of AQR, RBI had instructed Banks to set aside an incremental 10% provision against a pool of select assets in a phased manner during fiscal 2017. This amounts for us works out to Rs 1.42 Bn. We have provided this amount in its entirety in this quarter.
- Similarly, on SDR accounts, where we are required to make a provision of 15% in a phased manner, we have provided the entire amount of Rs 0.71 Bn in this quarter.

o Our annualized credit costs for Q1FY17 were at 198 bps. We indicated in our previous earnings call that we expect the slippages to have a bias towards H1FY17. That is what you are seeing reflected in this number. For the full year, we continue to expect credit costs to be within our expected range of 125-150 bps.

o During the quarter, fresh gross slippages into NPA stood at Rs 36.38 Bn of which gross corporate slippages stood at Rs 29.11 Bn. Net slippage in retail and SME stood at Rs 2.57 Bn and Rs 3.06 Bn respectively. Q1 is typically a seasonally weak quarter for retail NPLs especially the retail agriculture segment, and we expect seasonality patterns on non-corporate slippages to continue this year.

o Our net restructured book stands at Rs 73.63 Bn with fresh restructuring of Rs 5.44 Bn during the quarter. This was on account of the shifting of the DCCO (Date of Commencement of Commercial Operations) of 2 accounts.

- We witnessed Rs 8.88 Bn of slippages from the restructured book during Q1.
- During the quarter, the Bank has implemented Strategic Debt Restructuring (SDR) in two accounts of which one account was already an NPA. The underlying loan amount is Rs 2.52 Bn. The Bank has also implemented the 5/25 scheme for four accounts where the outstanding loan amount was around Rs 7.90 Bn.
- The cumulative outstanding value of the underlying loan amount for SDRs and 5/25 undertaken by the Bank so far, is around Rs 8.50 Bn and Rs 35.00 Bn respectively.
- We have not sold any assets to ARC during the quarter.
- GNPA for the Bank was at 2.54% as on end June 2016, up from 1.67% in Q4 FY16 and Net NPA at 1.08% from 0.70% in Q4 FY16. Our provision coverage ratio stood at 69%. Our intent is to keep the provision coverage ratio around 70% by the end of the year.
- As on 30th June 2016, the aggregate impairment viz. Net NPAs and Net restructured assets as a percentage of net customer assets stood at 3.07% vis-à-vis 3.28% as on 30th June 2015.

Let me move on now to the next theme – that of strong growth in our **Advances** portfolio.

- Aggregate loan growth remains healthy, at 21% yoy.
- Retail lending continues to grow strongly, with a yoy growth of 26% this quarter, excluding loans against FCNR-B deposits. A few details on this growth -
  - Our Retail Lending growth continues to be led by Housing Loan, Unsecured Personal Loan and Credit Cards.
  - Internal customers continue to be the mainstay of the Bank's strategy for sourcing retail assets. Roughly two thirds of the incremental acquisitions for retail loans continue to be the Bank's existing deposit customers.
  - 97% of the bank's credit card and 78% personal loan originations in the quarter were from existing customers of the bank.
  - 43% of the overall sourcing happened through our branches.
  - The credit quality of retail loans continues to be healthy.
  - During the second and third quarter of FY17 the loans against FCNRB deposits are likely to mature. This will also reduce our liabilities by a similar amount.
- Our Corporate Advances portfolio had a yoy growth of 21%.
  - As indicated in our prior calls, we continue to find attractive refinance opportunities for highly rated corporates. We expected these opportunities to reduce over time but for now, select high quality opportunities continue to present themselves.
  - 82% of new sanctions in the corporate book were to companies rated A and above. Presently, 64% of outstanding corporate loans are to companies rated A and above.
- In fiscal 2017, we expect the Bank's Credit growth to be around 18-20%.

Let us now move on to the Bank's **Earnings Profile**.

- I request you to refer to Slide 15 of the earnings presentation.

- Operating profit for the quarter was at Rs 44.69 Bn, a growth of 9% over Q1 last year. Operating profit margin remained at a healthy 3.41%, higher than the past eight quarter average margin of 3.35%.
- Operating profit margin in Q1 was lower than the Peak margin achieved in Q1 last year.
- Slide 15 shows the impact of various factors contributing to the yoy change. As you will see here, three factors explain the differential – higher interest reversals due to increased slippages, higher operating expenses, and lower fee income. The higher trading profits in this quarter were net neutral against a one-off item in NII seen in Q1 last year.
- NII growth was 11% on the back of healthy interest earning asset growth of 16%.
- NIM for the quarter was 3.79%, with Domestic NIM at 4.04%. We expect our full year NIM to remain above 3.6%.
- Cost of funds during Q1 was 5.81% compared to 5.84% in Q4 FY16, and 6.12% in Q1 last year.
- Fees grew by 11% and constituted 24% of operating revenue. Granular fees comprising retail and transaction banking continue to grow at a steady pace. Retail fees had a growth of 19%, Transaction Banking had a Fee growth of 17% and SME segment had a fee growth of 23%. Corporate Banking fees were relatively flat with a growth of 2%.
- During the quarter, trading income stood at Rs 9.11Bn up 41% YoY.
- Operating expenses in the quarter increased by 23% YoY. The key driver of this increase is our accelerated investment in recent quarters on our branch network and staff strength.
- The Cost to Income ratio of the Bank for the quarter was at 38%. On a full year basis, we expect our Cost-Income Ratio to be around 40%.
- Provisions and contingencies increased by 89% YoY due to the higher slippages witnessed during the quarter. Our provision coverage ratio stood at 69%. The significant jump in provisions resulted in PAT declining by 21% on a YoY basis.
- The annualized RoA and RoE for the quarter stood at 1.19% and 12.04% respectively.

The fourth theme is the continuing build-out of our **Retail Franchise**.

- Please refer to Slide 18 in the Earnings Presentation. The digital journey of the Bank continues to progress steadily.
  - Our market share in Mobile transactions is now 13%, significantly higher than our market share in overall deposits.
  - Mobile banking spends in Q1 reported a growth of 159% on a yoy basis.
  - In terms of number of transactions, digital channels are outpacing every other channel by a wide margin.
  - Electronic channels, i.e. Digital and ATM, now contribute 88% of all customer-induced transactions in our retail base.
- While we grow Digital channels at rapid pace, we continue to invest significantly in broadening our physical network footprint. During the quarter, we opened 102 domestic branches. We expect to continue our increased pace of branch openings through the year, and plan to open 350-400 new branches.

- Savings Account balances at quarter end grew at a strong 18% yoy.
- Current Account balances also had a healthy performance with a growth of 18%, thus driving an overall CASA growth of 18% yoy.
- Our overall CASA share in deposits was 43% at the end of the quarter, around 67 bps higher than Q1 of last year.
- CASA deposits on a daily average basis for the year grew by 17% and comprised 40% of total deposits. On a daily average basis, SA deposits grew by 17% and CA deposits grew by 16%.
- CASA and Retail Term Deposits continue to form a strong base at 80% of total deposits.
- Product penetration into our strong SA base continues to be a major driver for growth. Big data analytics led targeting of the known retail customer for sales of unsecured lending, cards or other payment products continues to be core to our franchise building in this space.
- The Bank had 2.6 Million credit cards in force making it the 4th largest card issuer in the country as of 31st March 2016. The credit cards portfolio saw a substantial increase in spends by 54%, to Rs 63.08 Bn from Rs 41.04 Bn for Q1.
- During the quarter Axis Bank introduced a dedicated innovation lab, called 'Thought Factory' at Bangalore to ideate for breakthrough solutions for the banking sector. Thought Factory will house an 'Accelerator' to collaborate closely with high potential startup ecosystem players. It has also launched a 'Hack for Hire' program for spotting talent from across the country through Hackathons and bringing them on board as full time employees at Thought Factory.

The fifth and last theme relates to our comfortable ***Capital Levels*** and delivery of healthy ***Return Ratios*** for our shareholders.

- As of 30th June, 2016, our total Capital Adequacy Ratio (including Q1 profits) is 15.67% with a Tier I CAR of 12.38%. Compared with a Tier 1 ratio of 12.15% as of Q1 FY16.
- The annualized ROE and ROA were at 12.04% and 1.19% respectively. As the impact from higher slippages recedes and benefits of higher investments in branches and employees kick in, we expect these ratios to normalize.

Moving on from these major themes, I would like to highlight a couple of other metrics that you might find useful in understanding the Bank's performance this quarter.

- SME loan growth stood at 13%. We have seen some pick up in pace here, and now expect SME growth to be better than FY16.
- The domestic Credit Deposit ratio of the Bank was at 84% at the end of the quarter.
- During the quarter the Bank listed Asia's first internationally listed certified green bond of USD 500mn on the London Stock Exchange. It is the first green bond for the Bank within its overall USD 5 billion Medium Term Note (MTN) program. The Bank has additionally listed its entire MTN program in London. The proceeds of the bond will be invested in green energy, transportation and infrastructure projects.
- Risk Weighted Assets for the Bank stood at Rs 4,212.73 Bn and grew by 17% on a YoY basis.

As I close, allow me to re-summarize the key themes of the quarter:

1. **Asset Quality**: Stress realization is continuing and will likely have a bias towards H1 FY17. Operating environment remains challenging but not deteriorating from past levels. Our credit cost guidance for FY17 remains unchanged.
2. **Business Growth**: Growth momentum is healthy with loan growth at 21% and CASA growth at 18%.
3. **Earnings growth impacted by asset quality and opex growth**: Underlying earnings quality remains healthy.
4. **Strong performance on the Retail Franchise**: The Retail franchise of the Bank had another good quarter – with Saving Accounts growth of 18% yoy and core retail loan growth of 26%.
5. **Strengthening Capital position**: We remain well capitalised to pursue growth opportunities, with our Tier I ratio at 12.38%.

With this, I come to the end of my comments. I would like to now handover to Saugata to brief about the state of Indian Economy.

Saugata Bhattacharya: Thank you very much Jairam, I will be very brief here. If there are any questions or comments we will keep that at the end of this conversation. As all of you are aware global growth prospects remain very weak. Markets and we are expecting further rounds of quantitative easing with more fiscal stimulus coming in. I think we have seen shift again from monetary stimulus packages towards the fiscal side. We expect the fiscal stimulus package out of Japan very shortly. There might be some Euro QE in banks this year. But still markets have increased their outlook and probability on a fed rate hike by December to 48%. Given India's integration with the rest of the world, in the medium term, India's growth prospects remain moderately congruent with that of the global economy. But in the near term if the rains hold up for the next couple of months, we think that there is every strong chance of growth revival in the country particularly from rural consumption and the services related ecosystem. CAPEX still remains weak, but given government's initiatives it is likely to pick up over the next couple of years.

Food inflation remains a worry. But as the rains progress we actually might see inflation beginning to moderate. We think that there is still room for the Reserve Bank of India to cut its policy repo rate by at least 25 bps but that depends on the trajectory and path of inflation going forward. We think that India's currency, particularly the USD-INR pair still needs to weaken. It will remain uncompetitive and our REER is probably still a little bit over-valued. So we expect to see the currency around 69 to 70 levels by the end of this fiscal year.

Credit demand from banks remain weak in line with the CAPEX activity that we see. There has been some diversion of credit demand away from banks, but it is beginning to come back more into the banking sector. Deposits are following credit and we expect financial savings and deposit growth to improve moderately given the 7th Pay Commission pay outs and the house rent allocations to begin from end of this year. Deposits growth might actually begin to pick up together with the slight improvement in demand. Overall, credit demand is likely to remain weak for this year. Let me finish with this and if there are any further questions I will come back to you. Over to you Jairam.

Jairam Sridharan: Thank you so much Saugata, that was very useful. I am happy to take questions at this point.

Moderator: Thank you very much. We will now begin with the question and answer session. The first question is from the line of Simrin Sandhu from Standard Chartered Bank. Please go ahead:

Simrin Sandhu: I just wanted to check on the ratings distribution of the Watch List. It has gone from around 50% in the BBB bucket to now nearly all of it in sub-BBB. if you could take us through why the sudden change and does this imply some downside to the 60% figure that you expect will flow into NPA?

Jairam Sridharan: The review of accounts from a rating perspective is at least an annual process. As it happens, all Watch List accounts were part of our review when we were trying to create our Watch List. At that time we decided that they were in a state of health which required them to be placed on the Watch List. That same logic when applied now on the rating side implied that the rating couldn't hold at their previous level and so they were downgraded. So that is a part of the timing of the rating cycle. There is no new information that is implied in the rating downgrade. You will also notice that accounts downgraded in watch list are also reflected in the rating mix of full corporate book. Had we done a rating review before we created Watch List, these accounts would have been downgraded at that point of time.

Simrin Sandhu: I see. So you are still guiding towards the 60% figure?

Jairam Sridharan: Pretty much so, yes.

Simrin Sandhu: Thank you. That is helpful and just another quick one. Could you just mention what is the specific number is for FCNR redemption?

Shashikant Rathi: 1.6 Billion.

Moderator: Thank you. The next question is from the line of Yi Hu from Invesco Asset Management. Please go ahead.

Yi Hu: My question is on the asset quality front. Obviously the asset quality deterioration has surprised the market on a negative side. I remember a couple of quarters ago, like right after we started to see the impact of asset quality review, management has said that the impact on Axis Bank would be once and done, but it seems the impact have continued into this quarter. I have been seeing quite a few recent reports on the streets which show different kinds of exposure than to watch list but none of them has given a clear explanation behind the continued asset quality deterioration. So I am just wondering from the management perspective, what is the key driver behind the further asset quality deterioration and also how long do we think is going to last to impact the Bank's asset quality from here? Thanks.

Jairam Sridharan: Thanks for the question. Let me start with your first assertion in terms of what the management talked about 2 quarters ago. In the 3rd quarter of FY16 RBI did a process called Asset Quality

Review where they looked at the banks numbers, portfolio of each of the lenders and came up with a list of accounts that they wanted the banks to recognize as NPA and take incremental provisions. The time offered to the bank for doing that recognition and incremental provision was a period of 2 quarters. That is the time when we said that whatever was on our list we have incorporated all in one go and in that sense that list was once and done. We were not going to have to do anything incremental based on the RBI's review process. Subsequently, in the 4th quarter and in our earnings call in April we released the Watch List. While the RBI recognized part of stress in AQR was all incorporated in our numbers and was done with, our intent behind releasing the Watch List was essentially to suggest what else is the potential of stress in the future; accounts that have not yet hit the nonperforming status but their underlying economy was weak and we believed that they might cost us paying in the future. So, we came up with this Watch List of Rs. 226 billion which we said would be the key source of future stress in our portfolio. What you see in Q1 is the crystallization of the risk that we have articulated very clearly in April. What we see is nothing new or over and above the 226 billion. We expect about 60% to move to NPAs over the next 8 quarters which would have a bias towards the first half of FY17. What you are seeing now, is about 12% of the list that has slipped into NPA in the 1st quarter and it is exactly as per our original plan in terms of how the Watch List was going to resolve itself. We continue to believe that 60% roughly of the original Watch List will slip into NPA and that there will be slight bias towards the first half of this financial year.

Now to your last question which is how long do we expect this to continue, I would like to go back to the same script expecting Watch List to resolve itself over an 8 quarters period out of which we are done with quarter 1. We had said that first two quarters are going to be the peak in terms of the slippage and after that things are going to moderate out. We continue to stick to that same plan. We have not seen the operating environment deteriorate over the last few months. If anything, things have moved slightly for the better; however, the original source of stress, which is the Watch List, continues to remain and it will take its time to flow through the entire system. I hope that answers your question and I am happy to take follow ups if you have any.

Yi Hu: Thank you. Recently we have heard comments from other Indian banks that the first wave of the asset quality review is almost done but seems there is a second wave, the follow up effect on the bank's asset quality. So I am just wondering from Axis Bank's perspective what if this is the case whether you continue to see for example the indirect impact from the asset quality review or let us say the second wave of impact from the asset quality review that has started to impact your Bank's asset quality?

Jairam Sridharan: Couple of quarters ago when the AQR had taken place we had used a term 'second order impact' of asset quality review where we meant that the behavior of certain clients who were classified as NPAs, because of AQR, may change. Behavior of lender for these clients might also change because they are capital starved. Together, these two effects are what we had termed as the second order impact of asset quality review.

As things have played out in the 5-6 months since then, we actually have not seen those fear come to face. If anything, things have been a little bit better, actually, meaningfully better than what we had feared. Borrower behavior has not changed for the worse. We continue to see the impact on acceleration in terms of borrowers being interested in coming up with solutions that could resolve their existing debt and so that little conversations are going as one would have hoped and the fear of borrower behavior changing have not come to path. As far as lender behavior is concerned or bank behavior is concerned that again has tended to be more rational and deliberated than what we had feared. So even though there is a stress in terms of the banking sector or some part of the banking sector not having enough capital, that have not resulted in any irrational actions in terms of asset resolution. So we continue to feel happy about the way the scenario had played out in terms of second order impact on borrower action or on bank action.

Moderator: Thank you. The next question is from the line of Ashwinder Bakhshi from Babson Asset Management. Please go ahead.

Ashwinder Bakhshi: I have got two questions. First question can you give us little bit more colour on your expectations for next 6-12 months about the Power and 'Iron and Steel' sector which I guess for you are the two largest sectors where Watch List has really come from. It will be good to have a sense of your expectations, sort of your base case or best case, and what should we be looking which will give us comfort that actually things have improved in these two sectors?

Jairam Sridharan: Thank you so much for your question Ashwinder. You are absolutely right that 2 sectors dominate our Watch List, Power and Iron and Steel. You will see that as of this quarter end together they form more than 50% of our Watch List. So clearly these are sectors we are watching very closely and the way they resolve themselves in the marketplace have a meaningful impact on how our Watch List is going to get resolve.

As far as the Power sector is concerned there have been some important movements through government action which have been positive. You will recall that we have mentioned on our earlier calls that our exposure in the power sector is not to any of the State Electricity Boards (SEBs) and it is very much in the private sector and there it is more on the generation side. What we are seeing is that with some government intervention the situation around Coal has gotten a whole lot better than it was seen 6-9 months ago. So it seems like in some parts there should be improvement as SEBs have taken part in the UDAY scheme and the banking sector has participated in that wherever banks have had exposure to those entities. That seems like a step in the right direction at least for the short-to medium-term; however, the benefits of that and the benefits of any improvement in SEBs health is yet to transmit into the other parts of the value chain. So we are watching that sector closely. What we need to see is continue improvement in financial health of SEBs, increased purchases of parts and the ability to pass on higher pricing. We are yet to see all of these. So while the signs are hopeful, one has not yet seen enough to start feeling genuinely optimistic about the sector in the short run.

On the Iron and Steel side it is a lot more straight forward than that. This is a sector where our leverage over the last few years has increased quite dramatically and commodity prices have crashed. What one needs to see is that at the operating level these entities are able to make enough returns to be able to service their debt. It has been bit complicated in the past; however, in the last few months we have continued to see strengthening of steel prices particularly after the government's intervention in the form of MIP. Due to this, a lot of these firms have reached a level of EBITDA per tonne which is just about enough for them to start servicing a meaningful part of their debt. This situation is much better than it was 6 months ago. So the steel companies very clearly are in much better operating situation today than they were a few months ago. However, the improvement is not yet sufficient for them to start servicing all their loans fully and on time. We are watching the situation closely and hopefully the current economic environment will hold for them. The one other piece to watch for in the steel side is the reconstitution of the current debt levels of some of these firms. RBI has come up with a new scheme for sustainable debt and how banks could think about restructuring some of the debts into sustainable versus unsustainable. Some of those solutions or some of those tools will come into play. One has to watch that very carefully and say which tools are going to be feasible ways to create some breathing room for some of these entities.

Ashwinder Bakhshi: For the second part of my question, I know you have already given guidance for that 60% of Watch List will become NPA and you are assuming 70% sort of NPA recovery target, is that correct? Is that what you have said in the past?

Jairam Sridharan: That is right.

Ashwinder Bakhshi: And I am just trying to calculate how much provisions you would have to make? So my assumption was about INR100 billion of provisions in next two years and now you obviously have enough earnings to cover that. But I am just curious if you would also potentially look at any capital raise either through equity or Tier-I market?

Jairam Sridharan: No.

Moderator: Thank you. Ladies and gentlemen, as there are no further questions I would now like to hand the floor over to the management for closing comments.

Jairam Sridharan: Thank you so much everyone for your interest in the bank. We look forward to continue to interact with you on a regular basis. Thanks for your interest and have a good day.