"Northern Arc Capital Limited

Q1FY25 Earnings Conference Call"

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MODERATOR: **MR. RENISH BHUVA – ICICI SECURITIES**

Moderator: Ladies and gentlemen, good day and welcome to the Northern Arc Capital Limited Q1FY25 Earnings Conference Call hosted by ICICI Securities. As a reminder, all participant lines will be in a 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 star then zero on your touchtone phone. Please note that this conference is being recorded.

I now hand the conference over to Renish Bhuva from ICICI Securities. Please go ahead, sir.

Renish Bua: Yes, thank you, Rayan. Good morning, everyone. Welcome to Northern Arc Capital Q1FY25 Earnings Call. On behalf of ICICI Securities, I would like to thank Northern Arc Management Team for giving us the opportunity to host this call. Today, we have with us the entire top management team of Northern Arc, represented by Mr. Ashish Mehrotra, Managing Director and CEO, Mr. Atul Tibrewal, CFO, Mr. Pardhasaradhi, Group Risk Officer and Governance Head, and Mr. Chetan Parmar, Head, Investor Relations. I will now hand over the call to Mr. Ashish for his opening remarks and then we'll open the floor for Q&A. Over to you, sir.

Ashish Mehrotra: Hi, thank you very much. Good morning, everyone. Thank you for joining us in our first earning calls. Really delighted. Before we begin, just want to thank all the stakeholders and all of you for ensuring a terrific listing, both at NSE and BSE, which happened on September 24th, 2024. Let me quickly spend a couple of minutes talking about myself and then talking about what really drives us at Northern Arc and what's our mission and purpose and how do we see this going forward.

I began my career in mid-90s with Citi. I worked with Citi Bank India across functions, spent about 22 years with them, and a large part of my career was essentially in building and running the lending businesses, both on the retail side and on the commercial side. Obviously, towards the latter part, I was running the retail bank franchise for Citi in India, subsequent to which moved to run an insurance Company, being very focused on India.

What really excited me about Northern Arc is that how a company like Northern Arc bring its purpose to life and impact millions of people. This is the binding force across the management team, to effectively contribute to the lives of our customers in a commercially viable manner, thereby adding value to all the stakeholders and the network in which we operate.

I also want to take this opportunity to thank P.S. Jayakumar, who's the Non-Executive Chairperson of the Board, and all the shareholders, the management team and the entire Northern Arc family. It's been a terrific journey over the last many years.

Northern Arc was established about 15 years ago with a vision which is simple yet profound to be a trusted platform that enables flow of credit from capital providers to users in a reliable, efficient, and a responsible manner. And we want to be conduit that ensures the financial resources seamlessly flow into the sectors through our mission, essentially enabling the access to finance for the underserved in an efficient, scalable, and reliable manner, and which I hold very close to my heart.

Retail credit in India is grossly underserved, and businesses like ours, which follows a multichannel strategy, not only bring our might in lending, but also provide credit solution to our originator partners, provide investment opportunities to investor partners, and also operate our funds, which enables us to deliver our knowledge, our capabilities to provide investment solutions to accentuate flow of money into the sectors where we operate.

As a Managing Director, of Northern Arc, I think my core objective is to make Northern Arc the most preferred financial service provider for all stakeholders, whether you are an investor, a partner, a lender, or a borrower. I truly believe that we have the right platform, the right team, more importantly, the right mindset which is trained and highly eager to learn and having a growth mindset that is part of our core culture. And I keep telling my team every day, every minute, the numbers of loans, the credit which flows through our pipe, as long as we get to learn from it, we will be many, many steps ahead of all the players in the market. And, you know, this ensures that we are able to use this knowledge to address the needs of individual and the small businesses.

I also want to take this opportunity to talk about my colleagues who are here. Atul Tibrewal, who is a CFO, whose sharp business acumen keeps us fiscally robust and has built very strong liability franchise, he is a great partner. Pardhasaradhi, Group Risk and Governance Head, , who ensures that we navigate through the risk like a seasoned sailor in turbulent waters, and obviously we've seen many of them through last decade and a half of our journey, and ensure that we have strong governance, what really is key for a financial services business.

I'm also joined by Chetan Parmar, Head Investor Relations, and Jigar Seta, Heads Strategy. And we will talk about the larger Northern Arc family and the other senior leaders as we go further, as we continue to bring purpose to life.

What really makes us unique and truly strong is just beyond people. It's a culture that we've cultivated here at Northern Arc, built by all the people, including people, who conceptualized this idea 15 years ago, built on the principle of collaboration, innovation, integrity, and transparency. Excellence is non-negotiable, no compromises. I often tell my team that we can recover from a bad quarter, but we cannot recover from a bad reputation. And we must look at everything on a ‘First principle’ basis and ‘Do it right’, keep our clients, our investors, our borrowers, our lenders on the center of what we do, and ensure that we add value through the process.

You know, looking at India, let's spend a couple of minutes. Very robust GDP growth rate, obviously led by consumption, government spend in infrastructure, and more importantly, strong technology capabilities, which we have built, coupled with rising disposable income across urban and rural India and the growing middle class. The shift in consumer preferences towards premium and discretionary products, along with the rise of e-commerce digital platform, is pushing the economy forward. And we believe that our digital stack 'JAM' has also brought more consumers into the formal economy.

And you look at the numbers, UPI transaction of over 20 lakh crores monthly, or the massive increase in the GST acceptance, that's ensuring that the flow of credit is happening at about 14% growth. And that's really core for us to help realize the Prime Minister's dream of Viksit Bharat. Let us remember the importance of collaboration and innovation in ensuring that we better shape future for people in India and take this country to its rightful place.

At a business model, we're proud to play a pivotal role in ensuring flow of credit to underserved from people who have access to money. Like I alluded earlier, Northern Arc, at its core, is a diversified financial services business, catering to the retail credit requirement of underserved households and businesses in India across our focus sectors. We predominantly focused on the six sectors.

One is MSME, what we know as micro, small and medium enterprises. The second is the micro enterprises or the Microfinance customers. Third is consumer finance, essentially addressing the needs of urban poor. The vehicle finance, predominantly the two-wheeler and commercial vehicles and affordable housing, followed with the agricultural supply chain.

Over the last 15 years, the company's approach has been to create a differentiated and a comprehensive play in the retail credit ecosystem in India, spread across these sectors by essentially facilitating credit to the end customer through a multi-channel approach. What, like I said earlier, and I want to spend a couple of minutes talking about the multi-channel approach.

We lend both to the end customers directly and through our intermediary partners for them to on-lend. But core to our thesis is the 'End customers' operating in these six sectors. We also use this opportunity as we work with our partners to find credit solutions from them. We are the pioneers of innovative product like, a perpetual securitization product (PERSEC) and multi originator securitization (MOSEC) respectively. And that ensures that we are able to provide credit solutions to our intermediate financing partners or originating partners.

Nine years ago, we started this journey to deliver our knowledge in these sector, our data capabilities, our tech, to invest through our funds business, which is AIF and PMS. We've run about 10 funds so far. All of them have performed well. Five of them have closed and we've returned the money.

So essentially, we not only bring our own lending balance sheet, we bring our knowledge and our network to provide credit solution to our originating partners, as result we punch more than the size of our balance sheet. And look at the right set of opportunity, looking at thematic funds for investors to participate. All this essentially going towards financing the retail credit need to fuel the growth in a responsible manner.

As Indian economy is on rise, Northern Arc is here to make sure that no one is left behind. As a result, we've successfully facilitated credit financing of more than INR 1.8 trillion and have impacted over 101 million lives of individual households since inception, which is something to be proud of. This is what really drives us 24/7 as we bring our purpose to life.

Enabling credit financing to this size and scale has been possible only on account of the following. One, our obsession to learn from the data which flows through us and more importantly, to have a technology capability to ensure that flow of that information and money happens seamlessly. We build our own proprietary scorecards by leveraging our data and our domain knowledge. We run 30 plus proprietary scorecards.

We are offering these scorecards as service to our investors and originator to leverage our knowledge, called Nu Score and essentially helping them answer four simple yet the most difficult questions in the lending business, i.e., whom to lend? Second, how much to lend? Third, what price to lend? In case you take those decisions, what will be the probability of default for you to get the right set of risk adjusted return?

We've also built our own tech platform. Out of the INR1.8 trillion we've financed, close to INR 1 trillion would have been financed on Nimbus, which ensures the seamless flow of credit happens between the originators and the investors. We run another very powerful platform which we started many years ago called Nimbus Partner Origination System (nPOS), where multiple partners can plug in and we can finance their end customers by enabling real-time underwrite, KYC, attest, penny drop, disburse and communicate with hundreds and thousands of customers.

We, on any given day, underwrite anywhere between 20,000 to 25,000 loans a day using that platform. One of the unique things which I said is the company is deeply obsessed to ensure that we learn. We learn not only from our experience, but also experience what we see around. We created a platform about a couple of years ago called Altifi, essentially with an objective to democratize the securities we have on our balance sheet.

We've seen a large amount of retail participation on the platform, so you can go onto Altifi.ai, download an app and can participate in high-quality performing credit. Given we spoke about sectoral and we spoke about our knowledge and our approach, maybe let me take a couple of minutes to talk to you about our competitive moats and how do we manage to facilitate retail credit across these sectors.

I think the first and foremost is that domain sectoral expertise is one of the most critical competitive moats for us. Over the years, we have developed deep expertise in financing underserved households and businesses. This knowledge gives us strong competitive edge and allows us to understand and meet the credit-specific need of these customers, at-the-end customers.

Like I said earlier, our core thesis is built around the customer at the very end who's going to avail credit, to whom the money is going to flow, and how this money will flow. That gives us a unique ability to evaluate risk in the growing sector, and that sets us apart from other players, strengthen our position as a trusted financial partner. For starters, let me talk to you about three sectors.

MSME sector continues to be cornerstone of Indian economy, contributes about 30% of GDP and 40% of exports, employs 60% of employment. Government initiatives like emergency credit line and all have worked to enabling flow of credit. The sector is growing at about 29% year-on-year, increasing commercial credit demand, and we still haven't touched the majority, large part of them is still unserved or underserved.

The unsecured MSME also witnessed a sharp growth over the last two years. We started observing some bit of increase in delinquencies over the last two quarters, which could persist to my mind over the next two quarters. However, we expect to see the adjustment in pricing of loan to reflect the inherent risk.

Nonetheless, demand of credit from MSME remains robust and the sector remains key focus area, and we do both secured and unsecured, we predominantly provide secured product through our own branch network and unsecured through our partners by leveraging the RBI-DLG guidelines and having an FLDG to offset.

The second sector where we operate in is Microfinance, which is where we began our journey 15 years ago. We offer Microfinance loan to underserved individual either directly through our own dedicated rural finance subsidiary called Pragati, which we have close to 300 branches network, and we also work with other partners in essentially NBFC MFIs.

Our primary focus in Microfinance is the joint liability group lending format where the borrowers for groups and share responsibility for each other's loan repayment in case of default thereby provide some social collateral. Since the last couple of years, the industry has observed exuberant participation post-relaxation of lending norms by RBI, resulting in some bit of overleveraging and increased indebtedness at a small cohort level of borrowers in select pockets.

Additionally, some social political disruption with loan waiver, calamities like heat wave, etcetera, in some areas like Punjab and Rajasthan could have added to a little bit of stress on the portfolio.

At Northern Arc, we have been pioneering and facilitating credit to the sectors over the last 15 years and have navigated multiple challenges through the journey. And if you look at it over the last 10 years, our net NPA would have been less than 35 basis point. We do not expect any additional stress in our own lending portfolios as our MFI borrowers are adequately capitalized when we work with NBFC MFIs to tide over the current downturn.

In our own direct book, we have consciously slowed down disbursal, focused extensively on borrower selection and strengthening of our collection and recovery process. We have also increased provision on the book in anticipation of potential stress which could happen, and I will talk about it as we go further. In consumer finance, market in India is pretty large and robust, largely driven by increase in disposable income and increase in consumption, which is no different than the largest contributor to GDP at 62% plus.

The sector has immensely benefited from digital lending innovation and growing penetration of financial product in semi-urban and rural areas, coupled with the urbanization at about 30%.

That is why when I spoke about urban poor, I kind of specifically stressed on it. The demand for unsecured loans has exhibited an annual growth of over 25% post-pandemic and was actually fueled by fintech revolution, which essentially enabled the flow of smaller quantum of credit to be delivered at an economically viable way.

A large part of growth is driven by small ticket and short tenured loans for the first time borrower. In unsecured personal loan segment, there has been conscious shift towards the better selection of the borrower, longer tenor, and shift away from small ticket loans. To my mind, that will ensure that over a period of time, the performance of the sector improves.

Additionally, we have consciously shifted toward cash flow assessment rather than solely based on the bureau or the scores. We have combination of testing income and looking at the performance, including our own scorecards. We also, for majority of our consumer finance portfolio, source through partners, like I said, leveraging the DLG guidelines to provide FLDG and that ensures that our risk-adjusted returns remain top quartile.

The second most important competitive moat for us is a network effect or a flywheel. It is a strong distribution network that we built over the last 15 years. We have enabled robust distribution working encompassing 340+ branch network, 50+ retail lending partners, 340+ originator partners and 1,000+ investor partners.

These extensive networks enable us to effectively reach about 670-plus districts across India, i.e., covering over 80% of India's geography footprint. This large and growing community of originator partners, retail lending partners, and investor partners, coupled with our track record in diversified product offering and proprietary tech stack, has resulted in growing opportunities for debt raising and investment. This helps us in assessing the large pool of liquidity, serve wider classes of investors, and meet varied investment requirements.

This generates an annuity effect, providing us a combination of fee income and interest income. Accordingly, this creates a positive network effect, which is scalable and pretty well diversified and very robust. So, if you look at our flywheel between the originator partners and the investor partners, you will see people moving on both sides of the curve, essentially looking at the demand for credit and the investment in credit coming in between the investors, banks, and participants.

And we use the same knowledge, domain expertise, data science, risk principles, so that all these stakeholders get benefited with the Northern Arc domain knowledge and strong risk framework. I think important to talk about our risk management. We have developed a tailored system that is customized for each of our sector and channel we operate in.

Leveraging expertise and data, we create proprietary risk model that enhances our capital efficiency and helps us build a diversified portfolio. We also parallelly build very strong collection infrastructure using variety of tools for pre-due calling, reminder, follow-up, and so on and so forth, coupled with strong legal measures to ensure we are able to recover and have a strong performance on our portfolio. To my mind, technology plays a critical role in proactive approach to collection with deep data analytics helps us to identify early signs of delinquency and ensure that we are adequately capacitated and we are the first one to reach the end customer.

As a result, our industry-leading GNPAs as on June 24, was 47 basis point, and net NPA was 12 basis point. This reflects our solid foundation, strength of our four pillars of strategy, position as the top tier digitally enabled customer-centric financer on a sustainable growth journey. I think another important big differentiation, we spoke about domain knowledge, we spoke about data science capability, we spoke about risk, is our ability to build our bespoke technology to enable flow of so much of credit and impacting so many lives.

This essentially powers our Nimbus, it's heart of our technology infrastructure, it enables end-to-end digital integration across our partners, ensuring smooth operation from loan originators to servicing till sunset, either on our balance sheet or on other investors' balance sheet, so that's the power of that platform.

The nPOS further enhances this, providing a comprehensive digital solution, allowing our partners to onboard customers quickly and efficiently, and like I said earlier, it works 24/7, end-to-end providing across the asset classes where we operate. Altifi is our, again, cloud-based marketplace platform, connect institutional investors and individual investors who like to participate in the fixed-income piece. We spoke about Nu Score, which is another piece of our commitment to our originating partners and our investors to use our domain knowledge, our risk expertise, to bring their risk policy at play.

I think for a lending institution, another thing that is important is the strong liability franchise. As companies like us who bring purpose to play tends to create a very unique proposition, which not only reflects in consistency of performance and more importantly, very large network effects, but also which reflects in our liability franchise. We maintain a pretty well-diversified funding profile, underpinned by an established relationship with our lenders and investors, and proactively manage liquidity and strong credit rating.

If you look at it, and I'm sure my colleague will talk about it further, but ~30% of our borrowing comes from DFIs, largely both domestic and global multilateral. We are the first port of call for global multilateral to participate in India's story, and that creates a very unique proposition for us. Last year, our credit rating was also upgraded to AA- by ICRA & India Ratings before the fundraise and equity infusion, that means the rating upgrade happened purely basis business performance. I think very few companies would have got such a rating upgrade. Other important piece for us is how do we look at our fee line besides the lending business that is placement business and the fund management business, which is core to our business We began the Fund Management Business in 2014, close to say about 10 years ago, in expanding long-term strategy to grow and scale this business to ensure we provide enough investment opportunities for people to participate through AIF and PMS. We've run 10 funds so far and two PMS schemes. We run high quality fund business that has some of our large investors for whom we also manage funds.

One of the funds we've launched in Q1FY25 is the GMOs, which is investing essentially in the financial services. We are right now deploying towards the emerging business fund, and then we've got 3 more funds in pipeline. I think the core of us is not only the economic capital, but also the human capital, which is essentially the culture of the company.

We believe in creating, inclusive, and collaborative workplace where integrity and transparency are paramount. Our commitment to employees has been recognized through our inclusion in great places to work for the last four consecutive years, and recognition reflects our ongoing efforts to foster a culture where our people feel valued, empowered to contribute to our mission and bringing the purpose to life. We've also, over the course of last two years, have significantly enhanced the management team and added more talent to build stronger compliance network, building talent for the retail portfolios, and so on and so forth. We've been proactive in adding the required set of talent to ensure we build capacities as we go about growing.

Quickly summarizing, I think we've built a solid track record of consistent and resilient performance, not only over the last three years. We've been debt listed for the last 10 years. Look at our performance, it will speak the same language of consistent and resilient quarter on quarter, year after year, both in our business operations and financial results, despite navigating through various economic cycles and challenges.

Our balance sheet has grown at a healthy rate of over 30%. We've ended at about INR 11,869 crores in June 24, with a focus on sectoral diversification, maintaining the granular portfolio of intermediate retail and direct to customers of about 48% & 52% respectively. You know, fair to say as Rome wasn't built in a day, building a successful franchise requires a methodical approach and an obsession to do better what you did yesterday. Step-by-step will be the key focus areas over the next few years.

Our disciplined risk management has allowed us to maintain industry-leading asset quality, even in the challenging times. A gross NPA stands at less than 50 basis points, significantly outperforming industry averages by about two to three times. With respect to credit cost, we remain extremely watchful across our portfolio. Based on data we've already shared, we've started to proactively prune segments. We've started to cut exposure in segments where we see forward-looking losses. We've built strong collection capabilities.

Our credit cost in Q1 was primarily driven by good book provisioning, i.e., stage 1, 2, and ECL. Further, microfinance growth and delinquency stabilize, we feel the better, given that we had a good monsoon over the next two quarters, it should stabilize. We continue to have first principle approach to consumer finance and leverage our modeling capability to provide strong collection practices in MSME lending, both secured and unsecured. We've been able to contain credit cost within the acceptable range and the profitability indices like RO and ROE are even better than last year, as you see our results, which Atul will talk about.

We have achieved most profitable quarter in the history of Northern Arc in terms of absolute profit with infusion of equity, which happened in April from IFC and other investors. I think looking ahead, our Q2 performance as we sit here on 1st of October, I'd like to offer some guidance. I think while audited results will be released over the next few weeks, during the next earnings calls, I'm confident our balance sheet will align and will grow faster than the industry growth rate. Credit cost should remain consistent in line with our proactive approach in managing risk, and we remain cautious about potential impact of macroeconomic factors among the borrower repayment.

Overall, we are pretty clear that we should be able to hold and build on what we've been doing. Strong diversification across portfolio to navigate through this pressure. Additionally, with the infusion of 500 crores of primary capital through IPO will provide more momentum for growth and profitability. I think I just want to thank you all for your time. To give you a comprehensive update of this, I will request my colleague Atul to talk about financials and then Atul, me and Pardha are here to answer questions.

Atul Tibrewal: Thank you, Ashish. Thank you all for joining Northern Arc's first earnings call. Now, without further ado, let's dive into the financial performance of the company.

As on June 2024, our assets under management reached INR11,869 crores, marking a robust year-on-year growth of 32% and a quarter-on-quarter increase of 2%. Our AUM mix reflects a 52% contribution from direct-to-customer and 48% from the intermediate retail business. We maintain a very diversified portfolio across the six focus sectors. Our net revenue, including fees and other income, reached INR 297 crores in Q1FY25, reflecting a 40% year-on-year growth and a 12% increase quarter-on-quarter.

Fees and other income on a DuPont basis have remained range-bound at 0.8% of the average total assets. However, based on the seasonality of the business, wherein the fee-driven volume increases every quarter of the financial year, we believe the same would reach FY24 levels of 1%. Despite the rise in the risk weight of NBFC exposure and high-interest rate environment that existed last year, we have successfully maintained a stable cost of borrowing at close to 9.3%, both quarter-on-quarter as well as year-on-year.

This stability reflects our proactive treasury management and diversified lender franchise, which carefully balances cost of fund with liquidity and ALM. Additionally, we have significantly progressed in strengthening our balance sheet, with our debt-equity ratio improving from 3x in March 24 to 3.2x this quarter. We have achieved a very robust growth in our pre-provisioning operating profit (PPoP), up 43% year-on-year and 26% quarter-on-quarter, reaching INR174 crores. This strong performance is a result of significant productivity improvements fueled by technology enhancements that has driven greater operational efficiency.

Talking further about liquidity, we remain very comfortable with positive cumulative mismatch across all the time buckets. Our total borrowings at the end of the quarter stood at INR 8,971 crores, with approximately 65% tied to variable interest rate. So, this position serves favorably to benefit from the anticipated lower interest environment in the future. We continue to demonstrate a very strong asset quality, with GNPA at 0.47% in Q1FY25 from 0.49% in Q1FY24, and net NPA reducing to 0.12% over the same period.

Recognizing the ongoing stress in the MFI industry, we have strategically moderated our direct microfinance business in Q1FY25. Credit cost in Q1FY25 is INR 51 crores, which denotes 1.7% of the average total assets, and this includes a 60-bps impact of the change in the ECL methodology. The same resulted in an increase in the probability of default in our direct-to-customer portfolio. Since this change, our credit cost has improved from 1.4% in June 2023 to 1.1% in the current quarter. We focus on continuously improving our risk framework. As Ashish earlier mentioned, we will continue to invest into building a robust collection framework with manpower technology to ensure strong gatekeeping throughout the credit life cycles.

Turning to profitability, our PAT for the quarter saw a robust increase of 43% year-on-year and a 4% growth quarter-on-quarter, reaching IN R 93 crores. This marks the most profitable quarter to date. Capital adequacy continues to be very strong, well above the regulatory requirements, with capital adequacy standing at 21.5%. Thank you so much. I would now like to open the floor for questions and answers.

Moderator: Thank you. We will now begin the question-and-answer session. Ladies and gentlemen, we will wait for a moment while the question queue assembles. Our first question is from the line of Vivek Ramakrishnan with DSP Mutual Fund.

Vivek Ramakrishnan: Thank you. Congratulations. Good afternoon. My question is on the microfinance business. Your numbers are very, very good. Is it partly because of design or partly because you are not in the areas where people got a higher level of NPAs? And then a related question for the management of the strategy because you spoke about growth as well. How would you be able to manage growth as well as maintain quality? Is it because of a diversified book that allows you to do that or how is the strategy going forward? Thank you.

Ashish Mehrotra: Yes. Thank you very much. Pretty interesting question. I think it's a combination of our deep domain knowledge, and our tested risk model. More importantly, we've said this many times, what really sets us apart is the touch and feel of the ground. I did not speak about it earlier but let me take a minute. The way our philosophy is driven towards providing the solution to the end customer and whether the loan is originated by us or originated through a partner.

We actually touch 35% of the network where our portfolio is spread by physically going and meeting in the deep rural areas which we select on a pretty scientific basis to cover 35% of our portfolio. How the loans have been originated, how the loans are being underwritten, how the loans are being serviced, not only when we go to the branch and pull out the loan tapes but also meet the end customer. That means you have a head start of what is happening in that particular branch, in that particular rural area, in that particular district.

And if you are able to use that learning along with your time-tested risk model, you will by and large be ahead of the curve before somebody sees an outcome of that in their financial over the couple of quarters. The second part of it because we work with both NBFC MFI and our own direct experience, we are able to share this knowledge with both our originating partners which means NBFC MFI and our own portfolio and that's the reason why you see the credit outcomes the way they are.

The second part of the question is on growth. I think the power of diversification allows you to dial up and dial down looking at the headwinds and tailwinds. Clearly if you look at the composition of our balance sheet over the last three years, so as of June 24 our balance sheet on

MFI is about 22%, what used to be 28% on June 23 and obviously there is an increase correspondingly in the MSME and in the consumer finance. So I think we have been able to navigate that pretty efficiently and have demonstrated that resilience and performance and the strength of character to use that knowledge to accelerate and to moderate where we have to.

And that is really the way to look is at the risk-adjusted spreads or risk-adjusted return we are able to make. So if you look at a risk-adjusted return on a year-on-year basis has improved from 690 basis point to about 740 basis point, that's about 50 basis point improvement. Thank you.

Vivek Ramakrishnan: Thank you very much and wish you luck.

Ashish Mehrotra: Thanks.

Moderator: Thank you. Our next question is from the line of Yash with Citigroup. Please go ahead.

Yash: Hi, sir. Thanks for taking my question. Sir, hopping on the MFI point once again, sorry. So, is the over-leveraging problem slightly more divergent than what we would have anticipated earlier or from the earlier color which we would have got? And second, mostly on the, given the two different sources of originating our MFI portfolio, do we have more divergence in the asset quality between the MFI loans originated from two different sources?

And sir lastly, how do we see the composition of the book going forward given MSMEs doing well, MFI, we have the ability to accelerate or slow down, and on the consumer finance being the new segment? So these are the questions.

Ashish Mehrotra: Thank you very much. I am going to request my colleague, Pardhasaradhi, the Risk Head, to give you a lot more insights into this. Pardha, over to you.

Pardhasaradhi R.: Thanks, Ashish. As Ashish alluded to earlier, post the RBI changing certain norms for the microfinance sector in October '22, it is true that the sector saw some amount of exuberance. And there was significant increase in leveraging at the individual borrower level on account of multiple loans . And this is slightly different from the issues that we used to see in microfinance sector earlier, which were more localized events on account of natural calamities or socio-political events.

To that extent, it is more like an issue which happens across the country. I mean, this is obviously across the country, though in certain pockets, you would see this a lot more than the other. We have data, we have analysis to support as to which of these geographies where the over-leveraging is more and where it is less. So we carefully choose the geographies. The way we look at it, this is something which is trying to be brought down under control by various partners, whether it is the microfinance organizations like Sa-Dhan and MFIN or most of the lenders. This is going to be a couple of quarters more.

Coming to our book, as you mentioned, our book is a combination of both intermediate retail and direct retail. We have been cautious on the direct retail microfinance exposures, and we have been maintaining our AUM and prudently providing. On the intermediate retail book, we are reasonably comfortable. So that is as far as microfinance is concerned. I don't really see it in terms of the overall stress.

While there is going to be stress in the sector, the way we manage risk, I think it is manageable. In terms of the book mix, one of the advantages that we have as a company is the diversification of our businesses, whether it is MSME, microfinance, consumer finance, vehicle finance, affordable housing, agriculture. We are able to dial up and dial down these sectors. The sectoral mix is something that we play.

And as a consequence of which you will see the sectoral mix changing in line with the emerging economic trends. That's something we actively manage. Consumer finance, again, the way we manage the business, we do not have much of direct retail consumer finance. It is actually partnership-based and intermediate retail. And there we have ways to mitigate risk by way of the structures with which we operate.

Because of which, while the sector might see some credit losses, we should be able to manage risk in our book. That is broadly how we manage exposures, and because of the diversification benefit, we should get consistent and predictable best-in-the-class results.

Yash: Got it. Thank you, sir. And just lastly, do we see credit costs settling around the levels of 170 basis points or it should come down as we go forward into the financial year?

Pardhasaradhi R.: I would not want to treat it as a guidance. As mentioned in this year, the first quarter is typically where we make more changes to the ECL models every year. We review all the models and make changes if necessary. The first quarter credit cost of 1.7% includes close to 60 bps of the model change impact. Obviously, 1.1% was pretty much in line with what is last year.

It is difficult to give any guidance on the credit cost, but the risk mitigation that we have available with us is something which should help us to maintain credit cost within the reasonable levels.

Ashish Mehrotra: So, fair to say this includes about 60 basis points of good book provisioning. You wanted to ensure that the model reflects the current challenges. So as a prudent financier, we need to ensure that we appropriately model the risk to ensure we have sufficient coverage in the PCR of over 74% that ensures that you are pretty well provided as you navigate through the times and obviously if you look at it over a two year, three year basis, it will significantly look superior versus up here, both on GNPA and NPA. Thank you.

Yash: Got it. Thank you, sir. Thank you so much.

Moderator: Thank you. The next question is from the line of Prince Choudhary with PINC Wealth. Please go ahead.

Prince Choudhary: Yes Hi. I have a couple of questions. First, continuing with the previous partner question, it is related to what lead to increasing over leveraging microfinance and also what RBI norms were changing? So, if you can break on that?

Ashish Mehrotra: I will request Pardha to break on that, but one has to be prudent to look at it. There is a bit of over leveraging. Also there is a deregulation on interest rate you might want to cover both.

Pardhasaradhi R.: Yes. So there were significant changes, but the two main ones were number one the interest rate cap being lifted. The second and more important one is the number of microfinance loans which an individual borrower can have was earlier restricted to two. NBFC MFI loans were restricted to two. That restriction was taken off, though the industry could have been prudent.

And for the last six months, they have been now pretty prudent which is really the reason which led to multiple loans to the same borrower which are outstanding at the same point of time which is the over leveraging.

Prince Choudhary: All right. And if you can brief overview about your two types of business models like you provide directly and to the intermediate partner. So, if you can just brief about cost breakup or what you do actually work on?

Pardhasaradhi R.: The way we work on intermediate retail is we provide facilities which are for our partners, for them to onward lend. We call them as loans to originate where we provide an NBFC loan and a particular set of criteria through which they can disburse loans. And we take specific charge on those identified assets and track them month-on-month. And that is how the intermediate works, although obviously there will be a cover typically for a INR1 loan that we give might have between 1.2 to 1.25x cover which gives us the cushion.

Ashish Mehrotra: Yes. Actually, the more importantly you look at it, you lever the knowledge of the credit needs of these customers, their behavior, their performance and you are able to deliver it across the sector and then build the right set of proposition, complementing, collaborating, and I use collaboration at least five times in my speech to ensure we are able to address the need of this large demand or the large underserved community in India.

And I think that diversification creates a significant power to the franchise in terms of resilience and consistency of performance which in a sense reflects if you look at it on a risk-adjusted basis like I said if you look at our performance and risk-adjusted returns actually improved by 50 basis points over the last year. It shows that if you are able to lever the knowledge and able to deliver, live to the diversification and leverage your capabilities, you are able to address the needs in a very efficient, reliable and responsible manner. And yes that's all.

Prince Choudhary: All right. That's it from my side. Thank you.

Moderator: Thank you. The next question is from the line of Hardik Shah from Goldman Sachs. Please go ahead.

Hardik Shah: Thank you for the opportunity. Sir can you throw some light on the FLDG arrangements that you would have in intermediate lending across products more from the commercial's point of view, I want to understand what would be the risk that would be sitting on your balance sheet, for example, for the MFI book because you mentioned that you're comfortable with the intermediate lending and you've dialed down on your own books. I want to understand the divergence there?

Pardhasaradhi R.: The way it actually works is the FLDG arrangements are with the partnership-based lending and that is available only in digital lending partnerships as per the RBI guidelines. We try to ensure that the portfolio that is originated is within those guidelines, FLDG is available.

Ashish Mehrotra: Yes, we actually select each customer. So end of the day the first port of call is whom to lend, how much to lend and at what price to lend. The application can come from anyone and how do we connect with those customers and how do we fulfill becomes the core of it. The DLG guidelines provide you cushion to enable the flow of credit to these sectors, but the customer selection is obviously lender's perspective. As long as you are pretty sharp and you're able to use your knowledge and your scorecards, you should get the right set of outcomes.

Hardik Shah: No, so if the customer that is being lent through intermediate lending were to default, what is the risk that lies with you and what lies with the lender, if you could help us understand with an example?

Ashish Mehrotra: So I think the way to look at it. First the intermediate retail is where we lend money to the lender for them to lend money onward to their customers, basis pre-agreed risk criterias and the pre-agreed target client model. When we do something like this, we know how will pen profile of the end customer and what kind of loss rate will it come with.

Northern Arc is enabling that credit to the pool which is beyond what we would have financed. So our first way out is cash flow from the loans. The second way out is from the security. The third way out is overall cash flows of the company. We are pretty well covered in that way.

Hardik Sha: No, still not clear if Rs.100 of lending?

Ashish Mehrotra: If we have agreed to lend INR100 to a certain profile of customers knowing those pen profile of end customers, we know what loss rate will happen. Using that we will have INR110 or INR120 of that pool against which we would have enabled for us to finance about INR100. Our cash flow will come from the loans we finance. Otherwise, from the overall pool of INR120 of pool charged to us or hypothecated to us or from the overall cash flow of the company. We are well covered in that way.

Hardik Shah: Okay. Got it.

Ashish Mehrotra: Thank you.

Moderator: Thank you. The next question is from the line of Praveen Agarwal with Axis Capital. Please go ahead.

Praveen Agarwal: So, just needed some color in terms of the liabilities franchise that you have built. We are not seeing any great improvement in the cost of borrowings, which is still sticking around at 9.3%, despite we are seeing multiple ratings upgrades. So, we wanted some thoughts over there that was the incremental cost of borrowing behaving for us? And secondly, in terms of liability mix, how is the mix shaping up for us? And if you can give us some color in terms of the liquidity on books for us at this moment?

Ashish Mehrotra: Thanks. We'll request Atul to take it, please.

Atul Tibrewal: Thanks, Praveen. So I think diversification of our Liability Franchise is something that we have been working upon for the last 4 years. And currently, the share of the banks has been coming down for us, from a level of close to 70% to now close to 60%. I think, the biggest achievement for us is the share of the offshore lending, as Ashish mentioned in his speech, that the offshore or the multilaterals and the DFIs are the first port of call, whenever they want to put money in India.

We have been able to grow the share of the offshore route to 28%. As far as the cost of fund is concerned, I think Praveen, we have been smartly able to bring down this cost from a level of 11% in FY '21 to currently at 9.3%, despite of 250 basis points increase in the repo rate in the last 2 years.

Even in the last 6 months, RBI has increased the risk rate for the NBFC exposure. We have seen tight liquidity conditions. But in spite of that, our cost of fund is quite stable at 9.3%. To your second question on the liquidity, I think we have a positive cumulative mismatch in all the time buckets. The Liquidity position is very comfortable. We are subjected to the LCR guidelines of the RBI and we maintain HQLA, which is even higher than what has been prescribed.

Debt equity is also very comfortable for us. As of June, it is at 3.2x. But now with the fresh equity capital through IPO, it should come down below 3x. We had the rating upgrade earlier last year. I think now the Debt capital market route should also open up, given that we are in the AA category. Liquidity-wise, we maintain close to 5% to 6% of our assets in the form of liquid assets. That is readily available at any given point of time. So, I hope this answers your question.

Praveen Agarwal: Yes, just one follow-up. What would be the fully hedged cost in terms of ECBs for us?

Atul Tibrewal: So, in the current year, we have borrowed from two multilaterals. And in both the cases, our fully hedged all-inclusive landed cost for us is less than 9%.

Praveen Agarwal: Thank you.

Moderator: Thank you. The next question is from the line of Siddharth Burman with Citi Bank. Please go ahead.

Siddharth Burman: Yes. So, first of all congratulations on the first set of results after listing. I am Siddharth from Citi Bank. My question is around the upcoming rate cut scenario. How well do you see yourself placed in comparison with other NBFCs to benefit from the rate cuts?

Ashish Mehrotra: Yes. Atul, over to you.

Atul Tibrewal: So, we just spoke about the Liability Franchise. So on the liabilities front, we have close to 65% to 70% of our total borrowings, which are floating in nature. The ones that are fixed are mainly the offshore ones, which are, as I mentioned, fully hedged and it's a fixed rate to us. But this 65% to 70% is completely floating linked to various benchmarks, including MCLR and Repo.

So, once the Interest rate starts trending down, we should get the benefit on our Liability book. On the asset front, around 35% to 40% of our total assets are floating linked to our internal benchmark rates and that is subject to the interest rate sensitivity.

Pardhasaradhi R.: The fixed rate loan tenor is also quite small. So, we will be able to re-price the asset book.

Atul Tibrewal: Yes, Correct.

Moderator: Siddharth, do you have more questions?

Siddharth Burman: No.

Moderator: Thank you. The next question is from the line of Vikas Jain with Reliance Securities. Please go ahead.

Vikas Jain: Good afternoon, sir. Congratulations for a good set of numbers. So, now with the IPO money being raised, what would be the incremental growth going forward, sir, over the next few quarters? No doubt you have mentioned that the second quarter also looks pretty good. But what could be the guidance going forward for the next two or three quarters to look at compared to the industry? How better we are, as you said, that we are better than the industry in terms of your set of line of business. So, what could be the incremental growth rate compared to the industry?

Ashish Mehrotra: I think, if you look at the past 3 years, we have been growing at about 30%+ CAGR. I think we have demonstrated our ability given the power of diversification and our focused approach in sector for us to follow the similar kind of growth rate. Obviously, there will be levels of moderation and calibration both with regards to sector and exposure as we go through the current times.

But obviously, you will see expansion in the return of assets both on account of incremental equity infusion, which has happened in the company and the way the product mix has evolved. I also believe the further expansion will also witness given that the seasonality of the business, the demand of credit in H2 will pick up with the advent of festival seasons .

So, I think we are pretty confident of where we stand today and as we look forward, we should be able to deliver in line with our performance, what we have demonstrated over the last 3 years.

Vikas Jain: Better than the watch we have demonstrated say 40% CAGR in terms of profitability. So, it would be a higher number than that or below?

Ashish Mehrotra: I think it is too early for me to comment on this. Thank you.

Vikas Jain: Thank you.

Moderator: Thank you. As there are no further questions, I now hand the conference over to Ashish for closing comments.

Ashish Mehrotra: Thank you all. Renish, thank you for putting this together. Thank you all for joining. We are really delighted to have this engaging conversation. I am sure a lot of this questions is an opportunity for us to learn and improve ourselves. Like I said, we are pretty focused every day on doing better than what we did yesterday. Thank you all. Have a fabulous week. Wishing you festival seasons ahead, season's greeting for it. Thank you all. See you in November with our Q2 results. Thank you all.

Moderator: Thank you. On behalf of ICICI Securities, that concludes this conference. Thank you for joining us and you may now disconnect your lines.

Ashish Mehrotra: Renish, thank you once again.