Indian Financial Services: Opportunities & Challenges

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From the CIO's Desk

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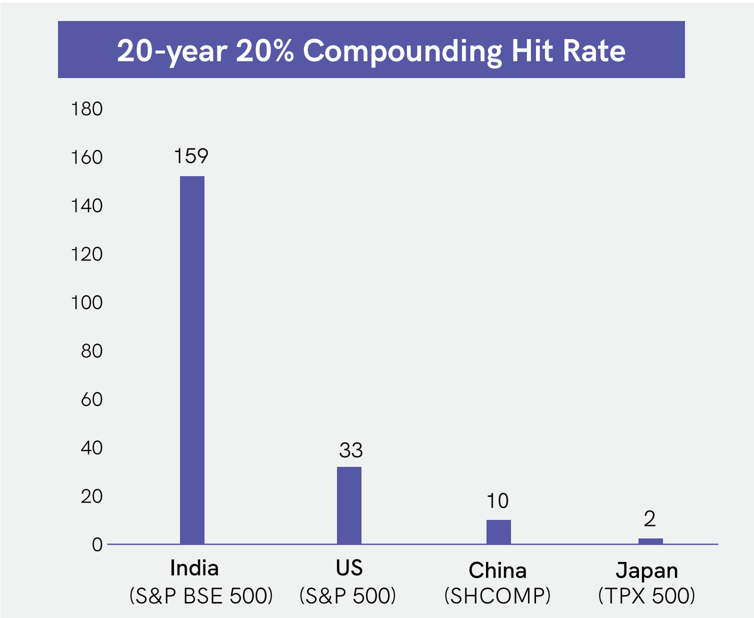
In his book "Outliers," Malcolm Gladwell argues that success is not solely a product of individual talent and hard work, but also of circumstances and opportunities. This concept holds true in the world of finance as well, where investment success is often attributed to skill, patience, and careful analysis. However, as we reflect on our own investment journey as a fund house, we realize that being born in the right country has played a significant role in our success. The question of "What in India" was always more important than "Why India" for us, as we recognized the incredible amount of opportunities that existed in the country.



Source: Bloomberg. Data as on Mar 31, 2023. SHCOMP index tracks daily price performance of all A-shares and B-shares listed on Shanghai stock exchange. As on Mar 31, 2023 there were around 2047 stocks in the index. Past performance is not a guarantee for future returns.

As the chart above shows, in the last twenty years, a staggering 159 of the current BSE 500 companies have generated 20% or greater dollar annualized returns. In comparison, only 33 of the current S&P 500 companies delivered a similar return. That number is 10 for China(SHCOMP) and 2 for Japan(TPX500). A monumental difference.

As a fund house based in India, we are fortunate to come across significant investment opportunities. However, we understand that not everyone may share our perspective on India being a favorable investment destination. Even those who are from India may have reservations about investing in the country. In this note, we aim to provide insights to help investors better understand India, with a specific focus on the Indian financial sector.

To start with, let's get the obvious stuff out of the way. India is the world's largest democracy and the most populous country in the world. It's a country that boasts one of the fastest-growing economies and a population that is overwhelmingly young. These are the facts that most of us already know, but it is hardly the full picture. India is a country that is both ancient and modern, traditional and progressive, rich and poor, and a land of contrasts and contradictions. Consider these three facts:

The top 10% of the Indian population holds 77% of the total national wealth.

Oxfam research

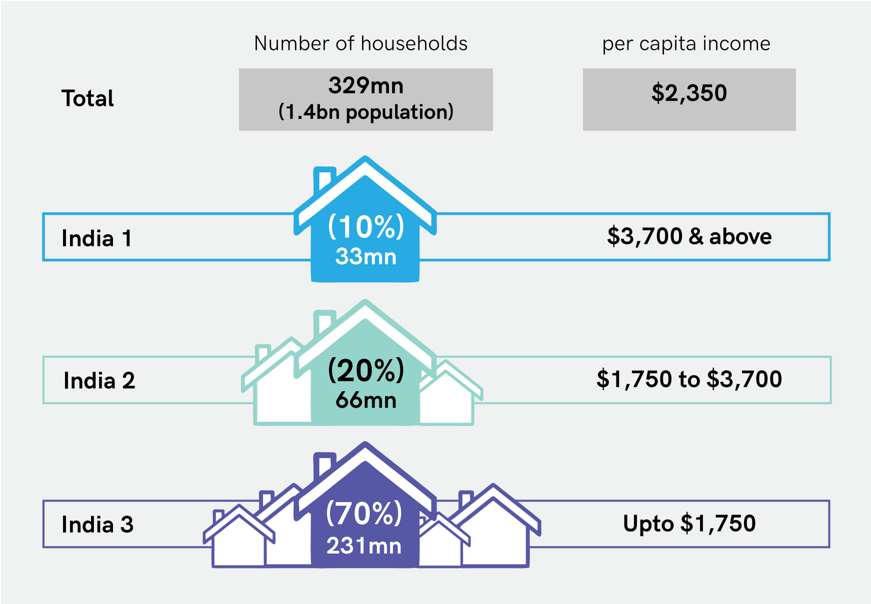
Just over 80 million taxpayers, were recorded during FY20. That is less than 7% of the population.

FinMin/CMDT

As of 2022, the food delivery platform Zomato had 58 million annual transacting users, out of an estimated 700 million smartphone users in the country.

Zomato Investor Presentation Q3FY23

As investors, to make sense of this vast and complex economic landscape, we rely on an informal framework that breaks down the country into three broad categories: India 1, India 2, and India 3.



Source: World Inequality Database, UN World Population Prospects 2022, India's GDP as per FY23 2nd Advance Estimates, INR/USD = 82, Internal Estimates

- India 1, represents the most affluent segment of the population, comprises approximately 33 million households. This segment typically has high levels of education and income, as well as a greater exposure to the global economy. As a result, this group is able to participate in the consumption of goods and services in ways similar to that of Western economies. For instance, they are likely to order food online, shop from e-commerce websites, and avail of ride-hailing services.
- India 2, on the other hand, represents the middle-income segment of the population. This group comprises approximately 66 million households and is characterized by its aspirational and upwardly mobile nature. Members of India 2 are often the first in their families to have completed higher education. They are more likely to reside in urban areas and have a growing appetite for goods and services.
- Finally, India 3 represents the lower-income segment of the population, comprising approximately 231 million households. This group has limited access to credit. Members of India 3 are more likely to reside in rural areas and have lower levels of education and income, which limits their ability to participate in the consumption of goods and services in the same way as those in India 1 and India 2.

While these categories are not watertight and are subject to change, they provide a useful framework for investors to understand India's multifaceted economic landscape. In this note, we aim to delve into India's financial services sector, dividing our analysis into three chapters.

1. The first chapter explores the emergence of the Indian tech stack and the potential for growth and development in India 2 and India 3.
2. In the second chapter, we take a broader view of the industry landscape, examining the significant scale and growth it has exhibited.
3. Finally, in chapter three, we provide a reminder that while the sector presents a promising opportunity, it is not immune to cycles and disruptions.

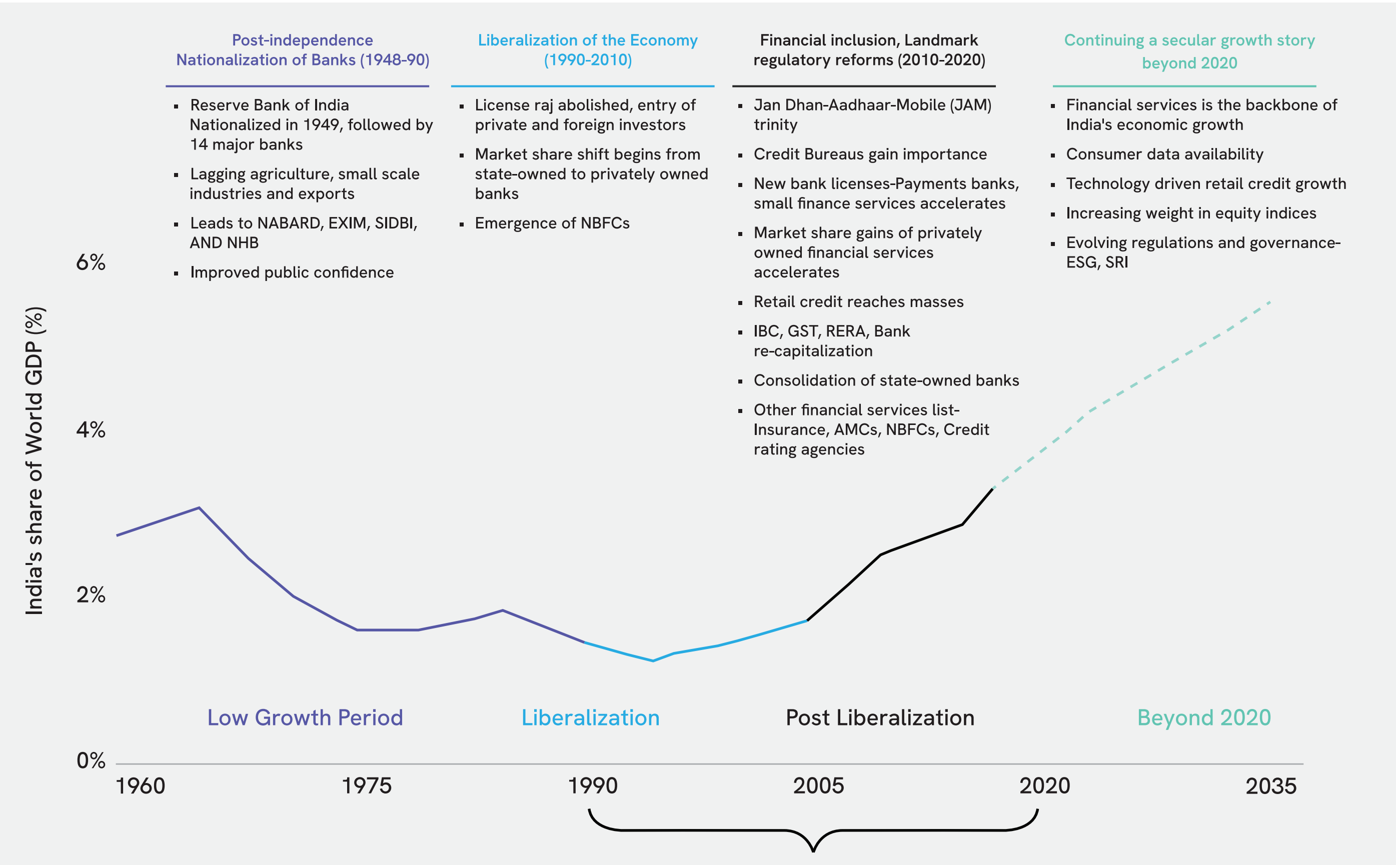
I hope you find this note insightful in improving your understanding around India's financial services landscape.

Cracking the Code to Financial Inclusion

The Indian financial services sector has undergone a remarkable transformation over the years. It all started in the 1970s with the nationalization era, which saw the government take over most financial institutions. In the 1990s, things took a turn for the better when the government abolished the License Raj, paving the way for private players to enter the banking and financial services industry.

This was a turning point for the industry as it gave rise to some of today's most significant private sector financial services brands such as HDFC, Kotak Mahindra, Axis, and ICICI. These brands have evolved into full-service financial conglomerates over time, providing a wide range of financial services to customers. During the same period, Non-Banking Financial Companies (NBFCs) emerged to cater to the growing retail and wholesale credit demand in the country. While wholesale NBFCs struggled to generate scalable business models, retail-focused NBFCs have thrived.

This evolution of the Indian financial services sector has been instrumental in the growth of the country's economy, providing access to finance and capital for businesses and individuals alike. The impact of this transformation is evident today. It continues to shape the future of the industry, providing opportunities for new players and innovations to drive growth and development.



Source: RBI website, World Bank GDP data, public information and reports

In recent years, there has been an increasing focus on paving the way for financial inclusion across India, particularly in India 2 and India 3. In just a decade, India has been able to achieve an impressive 80% financial inclusion rate, a feat that would have taken almost fifty years using non-digital growth methods, according to some informal estimates. This achievement can largely be attributed to the widespread adoption of smartphones, low-cost data, and persistent government push. The cornerstone of the government's push is the JAM trinity, referring to Jan Dhan Yojana, Aadhaar, and mobile phones. It was launched in 2014 to create a secure and stable digital ecosystem in India.

- The first component of JAM, Jan Dhan Yojana (PMJDY), is a financial inclusion scheme aimed at providing banking facilities to all citizens, particularly those who do not have a bank account. As of Dec'22, the total balance under PMJDY stood at ₹1,80,857 crores. Further, out of the 47.84 crore beneficiaries, 26.54 were women.

- The second component of JAM is Aadhaar, which is currently the world's largest biometric identification system with over 1.2 billion registered users. More on this later.
- The third component of JAM is mobile phones, which have become ubiquitous in India. The number of smart phone users in India is estimated to be close to 700 million, making India the world's second-largest smartphone market after China.

The Indian tech stack has been built on top of the JAM trinity and consists of three layers: the identity layer, the payments layer, and the consent and data empowerment layer. APIs, created using a combination of public infrastructure and private innovation, form the bedrock of these layers and can be tailored to meet the specific needs of consumers.

1. The Identity Layer

The identity layer forms the foundation of India's tech stack and is built on the Aadhaar digital identity system. Aadhaar is a unique 12-digit identification number assigned to every resident of India. It is based on biometric and demographic information, including fingerprints, iris scans, and a photograph.

With the Aadhaar system, individuals can open bank accounts, apply for loans, receive government benefits, and more, all with a single identity document. In addition to Aadhaar, the identity layer also includes other digital identity systems such as eSign and e-KYC.

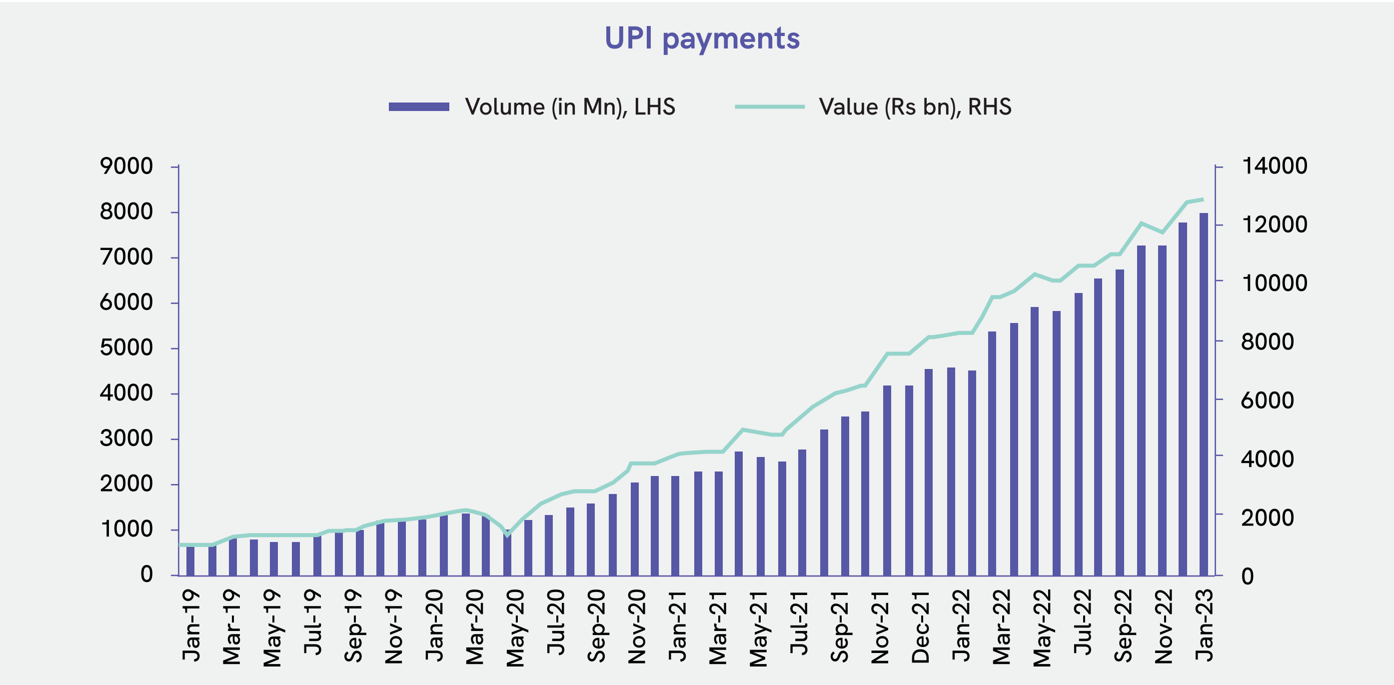
e-KYC is a process that allows individuals to provide their identity and address details to service providers electronically, without having to provide physical copies of their identity documents. This simplifies and streamlines the process of accessing government and private sector services.

eSign is an electronic signature service that enables citizens to sign digital documents using their Aadhaar-based digital identities. This service eliminates the need for physical signatures, which can be time-consuming and inefficient. eSign also provides greater security and verification, as it uses Aadhaar-based authentication to ensure the identity of the signer.

Together, these systems constitute the identity layer of the Indian tech stack, which is crucial for facilitating digital transactions and services. By providing citizens with a secure and reliable digital identity, these systems have helped to drive the adoption of digital services across the country.

2. Payment Layer

The payment layer is a critical aspect of India's tech stack and has played a pivotal role in boosting digital payments in the country. JAM ensured that almost every citizen had a bank account, which laid the foundation for the success of the payment layer. The payment layer is anchored on the Unified Payments Interface (UPI), a real-time payments system developed by the National Payments Corporation of India (NPCI). UPI has transformed the payments landscape in India, making it easy and secure for people to make and receive digital payments.



Source: NPCI, UBS

One of UPI's biggest strengths is its interoperability across different banks and payment service providers. Users can make and receive payments without the need for cash or checks, using their mobile phone number or a unique virtual payment address (VPA). This has made it convenient for individuals and businesses to transact even in remote or rural areas where traditional banking services may be scarce.

The widespread adoption of UPI has been instrumental in driving digital payments' growth in India, and the payment layer built on top of JAM has revolutionized the way people make and receive payments. In fact, the democratic and inclusive digital network is now the benchmark for many countries, and its rising clout is a great advantage. Google famously advised the US government to copy UPI, and there is a collaboration with Singapore to directly link the online payments system. Many success stories have emerged, and currently, MoUs with thirteen countries are being negotiated. This is no mean feat, especially since this exponential growth has happened in just six years.

Very recently, the Reserve Bank of India (RBI) has also approved the expanding of UPI transactions to allow credit payments. This will allow individuals with credit lines from banks to make payments over UPI. A host of new credit products can then emerge, mimicking credit cards but without the infrastructure cost. This will help widen the credit base, while simultaneously reducing the cost of disbursement.

3. Consent and Data Empowerment Layer

The consent and data empowerment layer is an important part of India's tech stack. The layer provides a set of tools and protocols that enable citizens to share their data securely and efficiently with government and private sector entities, while maintaining control over how their data is used.

The consent and data empowerment layer consists of several crucial components. One component is the Digital Locker (DigiLocker). This is a cloud-based platform that enables citizens to store and share digital copies of essential documents like passports, driver's licenses, and academic certificates. DigiLocker employs Aadhaar-based authentication to ensure the security and authenticity of the stored documents.

The Unified Mobile Application for New-age Governance (UMANG) app is another key component of the layer. It provides citizens with access to various government services and information via a single platform. Citizens can manage their personal data, including their Aadhaar details, and access services such as passport applications and tax payments.

Another vital component of the layer is the Account Aggregators. They act as intermediaries between financial information providers and financial information users. They help to securely transfer encrypted data by receiving consent from users to share their personal financial information. In other words, they act as middlemen to ensure that financial information is shared only with the user's consent and is kept secure during the transfer process.

The consent and data empowerment layer is designed to give citizens greater control over their personal data and to facilitate secure and efficient sharing. By providing citizens with greater control over their data, the layer aims to foster trust and transparency in India's digital ecosystem.

Having established the significance of India's tech stack in transforming the financial services landscape, let's delve deeper into Account Aggregators and also look into OCEN and ONDC, some of the key government measures.

Account Aggregator

Aadhar and UPI have transformed access to banking and payments. However, only 20% of India’s population has access to formal credit. To address this imbalance, RBI introduced the Account Aggregators framework (AA) in 2021 – under which a new class of NBFCs, Account Aggregators would operate.

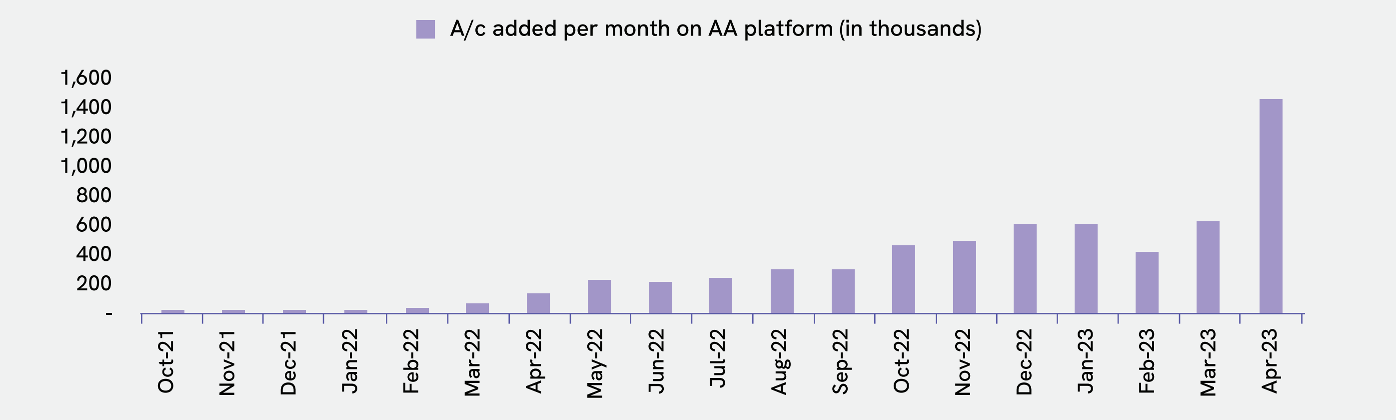
While AAs themselves will not have access to personal data, they will enable end-to-end encrypted sharing of information between the Financial Information Providers (FIPs) and Financial Information Users (FIUs). AAs will be responsible for maintaining the infrastructure and managing the consent of the customers.

The primary objective of AAs is to make it easy for individuals and businesses to access and manage their financial data in one place, without repeatedly sharing sensitive information. It also enables financial institutions to quickly and securely access financial data for credit assessments, loan applications, insurance claims, and other financial services.

For example, a customer may have a savings account with one bank, a credit card with another, and an investment account with a third financial institution. Instead of logging in to each of these accounts separately, the customer can use an AA platform to aggregate and view all of their financial information in one place.

This empowers borrowers to have greater control over their financial data, while simultaneously allowing lenders to access standardized, real-time data.

This democratization will lead to a reduced cost of credit assessment and loan processing, quicker approvals, and lower interest rates. Additionally, it will lower entry barriers and increase market penetration. Consumers will benefit from the elimination of physical signed copies, form filling, and document keeping. They will also be able to shop around and get the best deal possible for themselves.



Source: Sahamati

Up till end of Mar'23, an amount a little more than ₹40 bn ($490 mn) has been disbursed via the AA mechanism. About 50% of this amount has been MSME lending. Axis Bank, a leading Indian bank, reported a 30% MoM growth in disbursement while also maintaining a nil fraud rate.

Currently, one billion accounts can avail the AA facility. This number is expected to increase to three billion before FY 25.

Open Credit Enablement Network

Working in tandem with the Account Aggregator framework is the Open Credit Enablement Network (OCEN). This is a network protocol with a standard set of APIs. The platform has been launched by the RBI, with the intention of creating a common language for the exchange of credit-related information between various stakeholders.

Currently, MSMEs find it difficult to obtain loans at the right cost and right time due to the cumbersome underwriting process. As a result, they often turn to money lenders who charge high-interest rates. The OCEN open platform aims to address this issue by allowing online marketplaces, be it fintechs or food delivery apps, to build lending capabilities into their existing offerings. These marketplaces will be called Loan Service Providers (LSPs). They will embed the OCEN protocol on their platform and on-board lenders. This will allow potential borrowers to register and receive credit from multiple lenders on the LSP platform. The structure will work atop the AA framework, and lenders will need to implement the FIP and FIU models to participate.

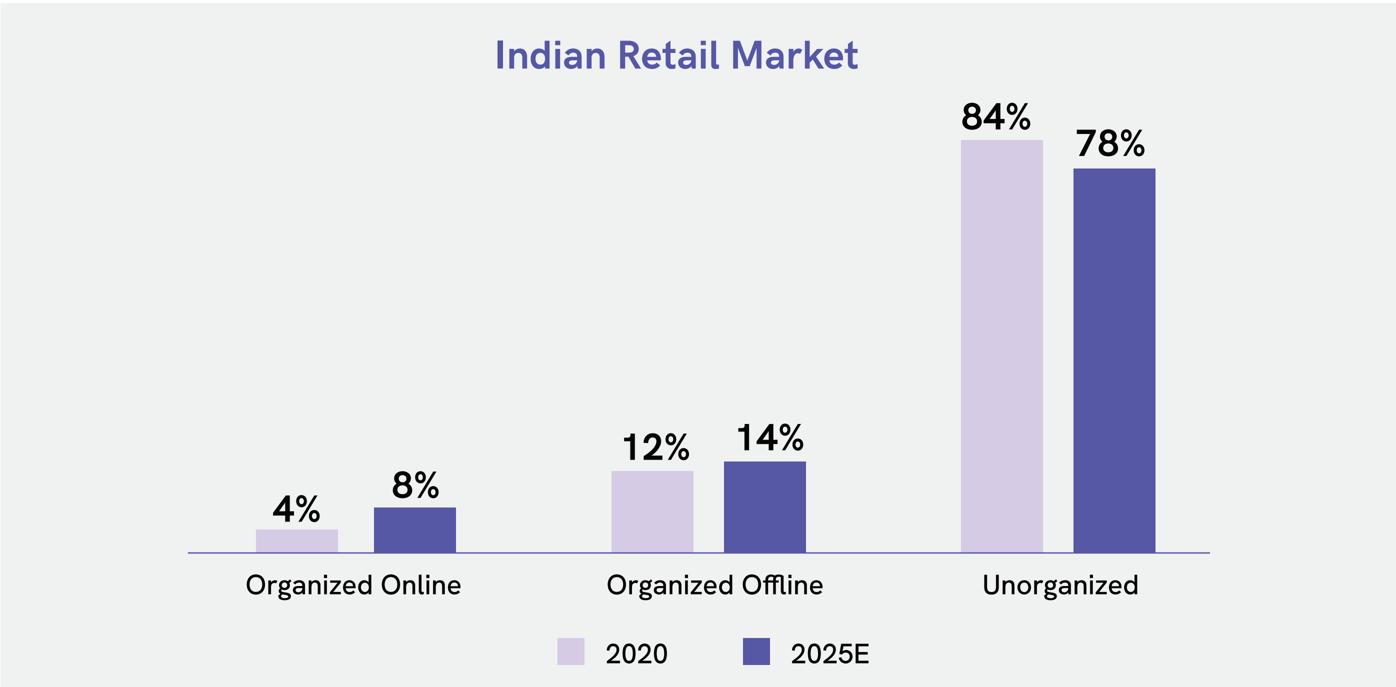
This could enable the development of numerous new lending options, catering to the diverse needs of borrowers while also reducing the cost and time required to process loan applications, enabling faster credit disbursal. Moreover, this will also enhance data sharing between the participants in the lending ecosystem, thereby creating a more transparent and efficient lending environment. Lastly, this will help achieve scalability in the micro-credit segment, making it easier to reach more borrowers and meet their credit requirements.

Open Network for Digital Commerce

An initiative that will enable OCEN is the Open Network for Digital Commerce (ONDC). It aims to revolutionise the way commerce is conducted in the digital space by creating an open, secure, and interoperable protocol. At its core, there is a block chain technology which provides a transparent and trustless mechanism for conducting transactions.

Currently, in order to complete any transaction, both the buyer and seller have to be present on the same platform. 60% of such e-commerce sales are controlled by Amazon and Flipkart. This puts SMEs at a disadvantage due to their low bargaining power and high switching costs. Further, only about 5% of MSMEs have an online presence.

To address this, ONDC will bring interoperability to ensure that participants such as buyers, sellers, logistics providers, and payment service providers are not bound to any specific platform. By creating a more equitable environment, more MSMEs will be encouraged to establish an online presence and utilize e-commerce platforms.



Source - Open Network for Digital Commerce Strategy paper

Sellers can register with ONDC, and their inventory is broadcasted to potential buyers through an open network, enabling sellers to reach a larger customer base without having to register on multiple platforms. Buyers can search for goods or services on any platform and receive options from registered ONDC sellers.

Overall, the aim is to offer an efficient and secure digital marketplace for businesses and consumers alike. ONDC has ambitious aims of gaining 25% population penetration and 75% pin code penetration by 2027.

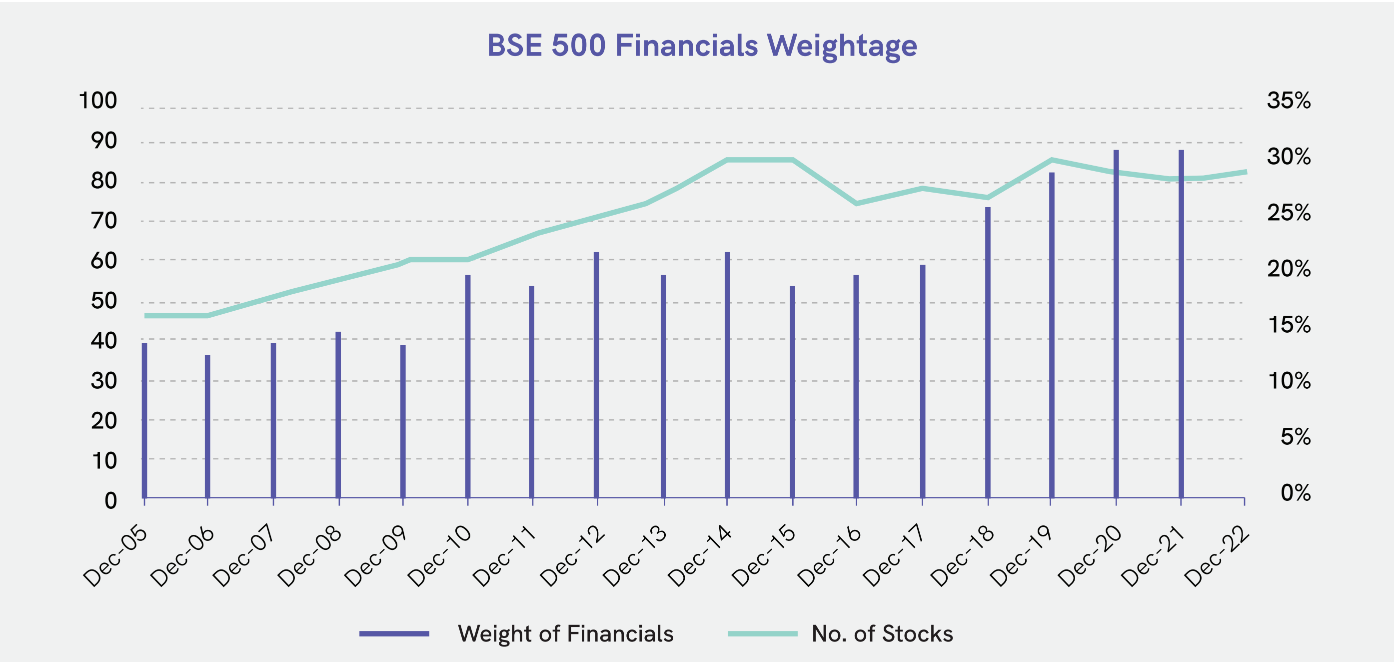
OCEN and ONDC will bring more customers and MSMEs to online platforms and also give them access to credit on these marketplaces. Further, the transaction-based data available via ONDC will enable OCEN-compliant lenders to better underwrite their loans. Within this, the AA framework will ensure availability of standardized data, helping reduce cost of credit.

The above initiatives demonstrate the clear push towards modular architecture. The combination of interoperability, decentralization, and unbundling is proving to be a game-changer for financial inclusion in India.

A deep commitment to ensuring democratization of data and creating a conducive environment for all has been shown by the government. Private players are picking up where the government has left off and are leveraging the government infrastructure across segments of the financial sector. India is leading the way in financial inclusion, and the world is taking note.

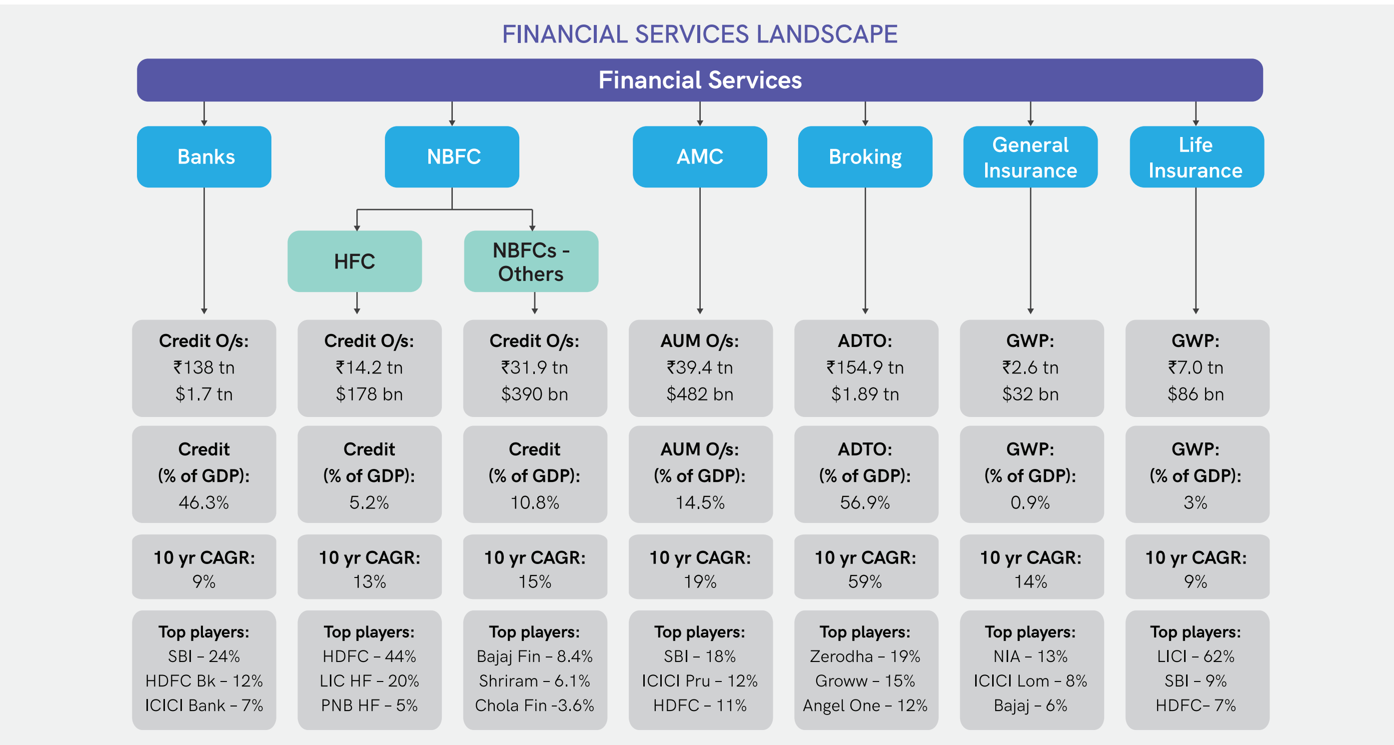
The Industry Landscape

Over the past two decades, the financial sector has become an increasingly important and influential part of the Indian economy. As seen in the chart below, the weight of the financial companies in the BSE 500 has doubled in the last two decades. The number of stocks classified as Financials has also moved from 46 in Dec'04 to 83 in Dec'22.



Source: Bloomberg and Avendus Spark as of Dec 2022. Free Float Weights.

The BSE 500 index currently comprises a diverse range of financial businesses, including banking, non-banking financial companies (NBFCs), asset management, life and general insurance, and supporting businesses such as credit rating agencies and market infrastructure companies like stock exchanges and depositary participants. In recent years, these supporting businesses have shown steady growth.



Source: Various Sources, RBI, AMFI, Investec Securities

Lending Business

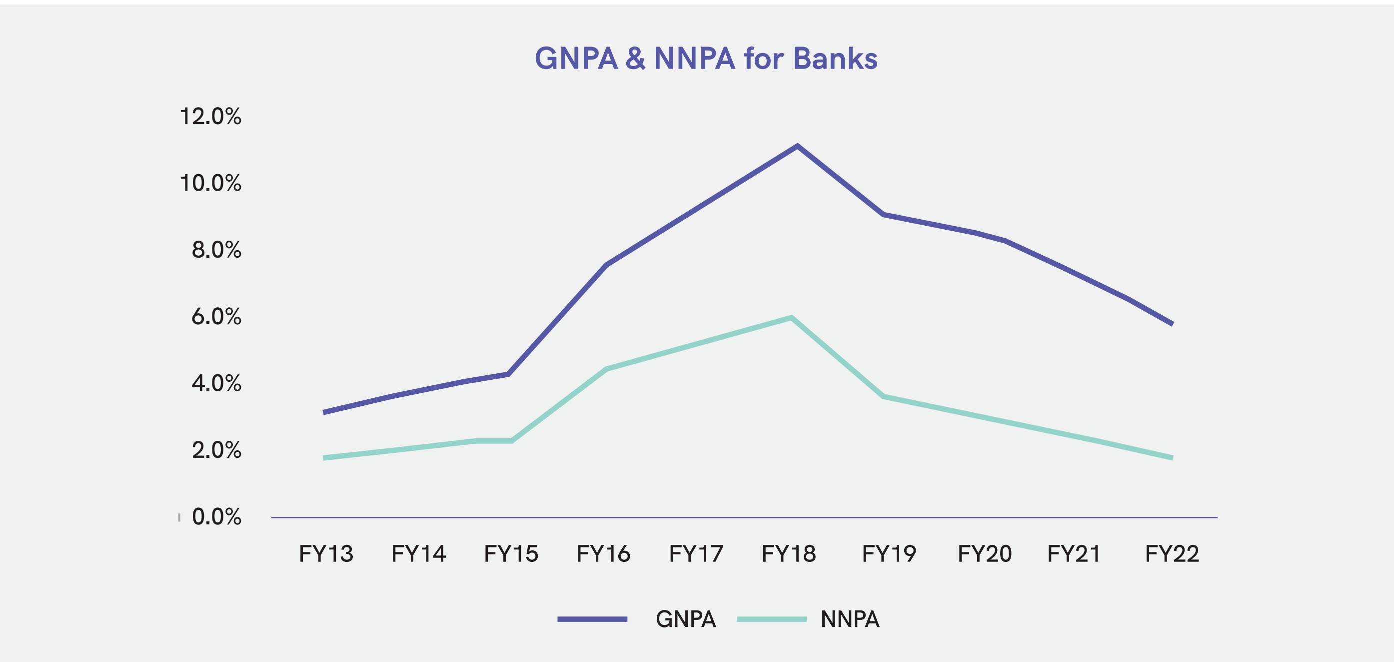
Banks and NBFCs make up the lending business in India with a total outstanding credit of ₹181 tn ($2.2 tn) as on Mar’23. They cater to retail and corporate borrowers, operating in various markets across product offerings. Traditionally, given their historical presence and reach, state-owned banks have been stronger on the deposit side of the business. On the other hand, NBFCs have built their business models with a better understanding of borrower needs and therefore have been more asset focused. Private sector banks have built strong franchises on both the asset and liability side, giving them an edge over most state-owned banks and NBFCs.

Banks

The banking credit market stands at ₹138 tn ($1.7 tn), supported by deposits of ₹182 tn ($2.2 tn) as on Mar’23. The sector has grown at a 9% CAGR for the past decade. State-owned banks hold approximately 60% of the loans and deposit market share. However, private sector banks have seen a consistent increase in market share of both credit (37% in Mar’23 vs 29% in Mar’18) and deposits (32% in Mar’23 vs 25% in Mar’18). The banking sector is the backbone, and a key beneficiary of the expected economic growth in India. While the banking sector was struggling with high Non-Performing Assets (NPAs) and capital shortfalls up till a few years ago, there has now been a turnaround - NNPAs are at a decadal low of 1.3%.

Key players: SBI is the largest player with a credit market share of 24%, while HDFC Bank and ICICI Bank are the two biggest private players with a market share of 12% and 7.3% respectively.

Competitive advantage: Indian banks have a wide distribution network which provides them with a scale advantage. Additionally, their granular retail deposits provide stability to the funding base. Private banks in particular, have been ahead in the adoption of technology which has enabled them to almost entirely capture the India 1 demographic.



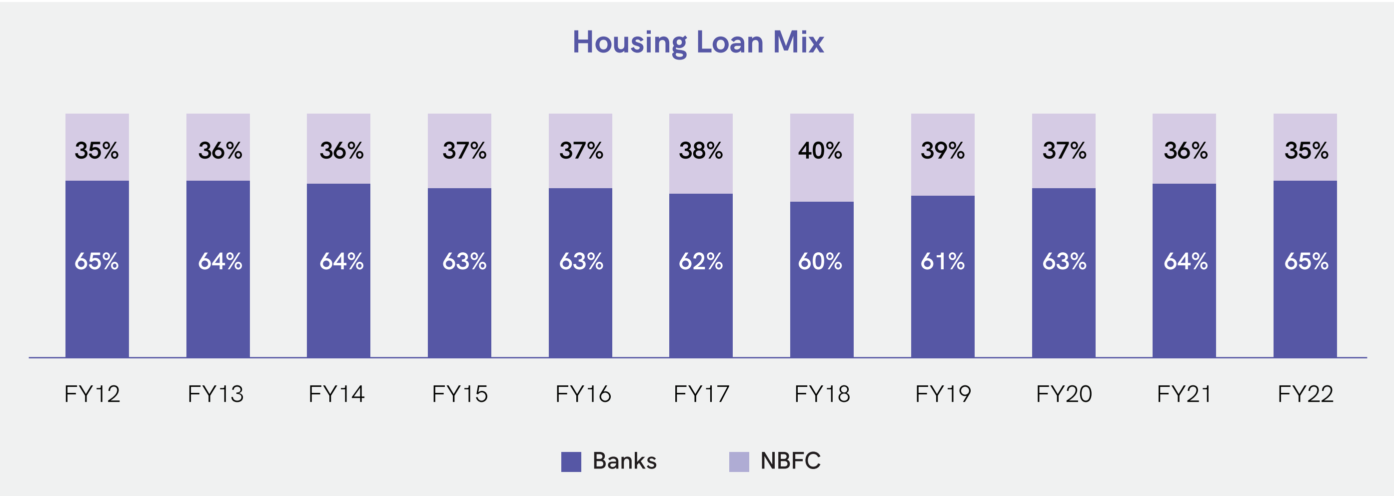
Source: RBI & Avendus Spark Research

Non-Banking Financial Companies (NBFCs)

NBFCs form a large vertical within financial services in India, with approximately 22% of the total credit outstanding. They are regulated by the RBI and predominantly operate in four main segments – housing finance, vehicle finance, gold finance and microfinance. With a focus on the government's financial inclusion drive and a recent period of high economic growth, the size and scale of the NBFC market has significantly grown.

Housing Finance

This is the largest sub-segment of retail credit and has been growing at a 15% CAGR over the past five years. HFCs maintain a book size of ₹14 tn ($178 bn) as on Mar'23. With nearly 40% of India's population between the ages of 13 to 35, and an estimated 50% of the population projected to reside in cities by 2030, the demand for housing is only set to rise.



Source: Various Sources, RBI, Companies Data, Investec Securities.

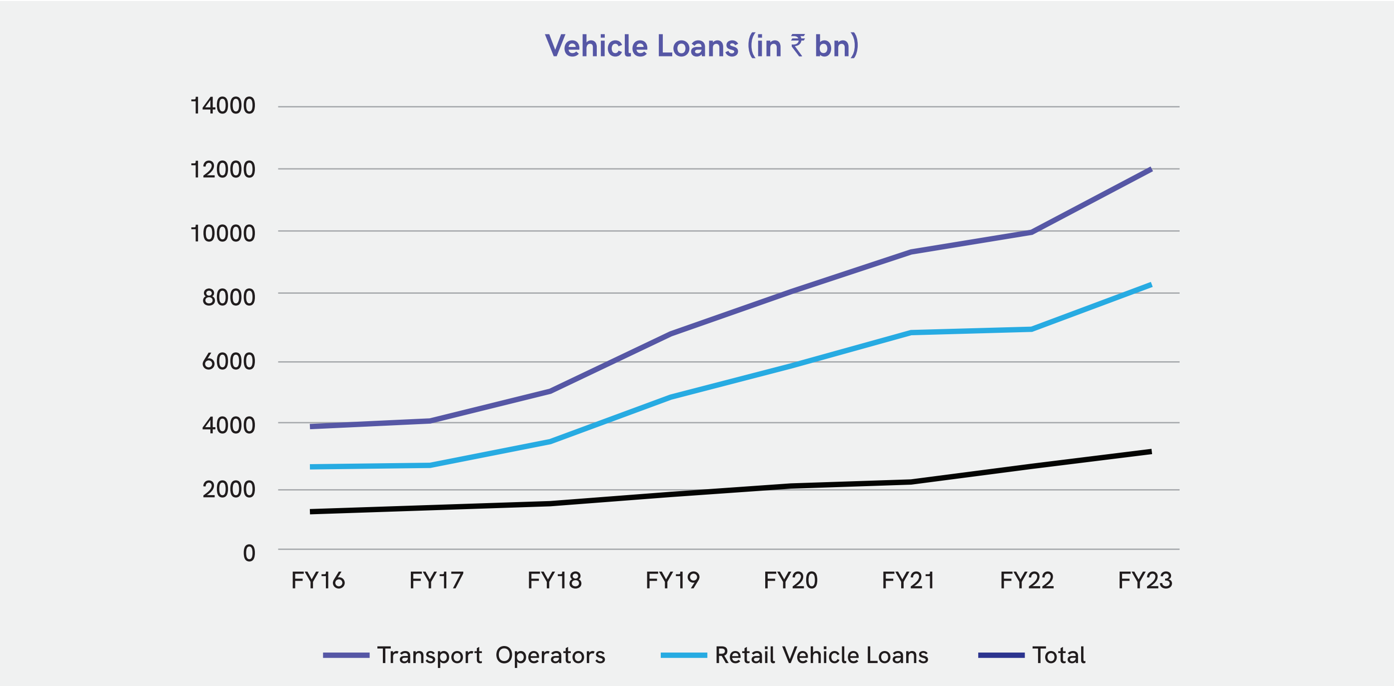
Key players: The housing finance segment is highly competitive and dominated by few large-scale players operating on thin margins, such as HDFC Ltd., LIC Housing Finance and SBI Home Loans. The impending merger of India's biggest private bank, HDFC Bank, with the home financier HDFC, will further consolidate the market.

Banks continue to dominate the market but new entrants have been able to come up with innovative offerings that enable them to maintain a sizeable market share. They are typically seen in niche and untapped markets catering to the new-to-credit customer and self-employed individuals in Tier 2 and Tier 3 cities. In these markets, credit risk is gauged based on an income assessment of the first-time borrower as opposed to previous income records.

Competitive advantage: Due to the razor thin margins and fierce competition, scale is important. Companies with large customer bases can spread their operating costs over a large revenue base, reducing their per unit costs. This enables them to offer interest rates that smaller competitors cannot. Favorable demographics, urbanization and a rise in nuclear households will continue to contribute to the overall growth of the segment.

Vehicle Finance

Vehicle finance is the second largest retail lending segment at approximately ₹7.2 tn ($88 bn) as on Mar'23. The wide range of offerings include passenger cars, two-wheelers, commercial vehicles and others. The market has grown at a 15% CAGR over the past five years.



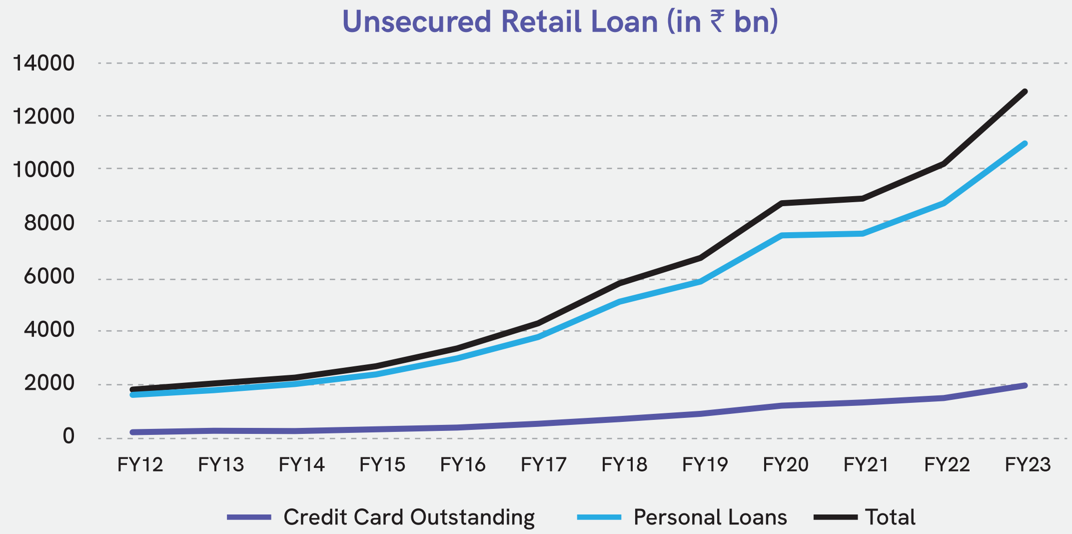
Source: RBI, Avendus Spark Research

Key players: Banks specialize in lending for cars and two-wheelers to salaried customers and to large and medium fleet operators for commercial vehicles. They operate on a large scale with low margins. Comparatively, NBFCs specialize in niche, high risk-high yield segments such as used vehicles, single-truck and small-fleet operators. The leading NBFCs in this segment are Bajaj Auto Finance Ltd. and Sundaram Finance.

Competitive advantage: Lenders that are diversified across vehicle categories have an advantage as they are less impacted by cyclical changes. Distributor tie-ups are important as they act as a barrier to entry for new players. A combination of increase in vehicle sales, higher selling price per unit and increase in vehicles sold on finance, provide scope for growth.

Unsecured Lending

The unsecured retail credit market stands at approximately ₹11 tn ($138 bn) as on Mar'23. The total credit card outstanding is another ₹2 tn ($25 bn). The unsecured segment is the fastest growing (25%+) retail credit market in India, being the biggest beneficiary of rising disposable income and the availability of consumer data.



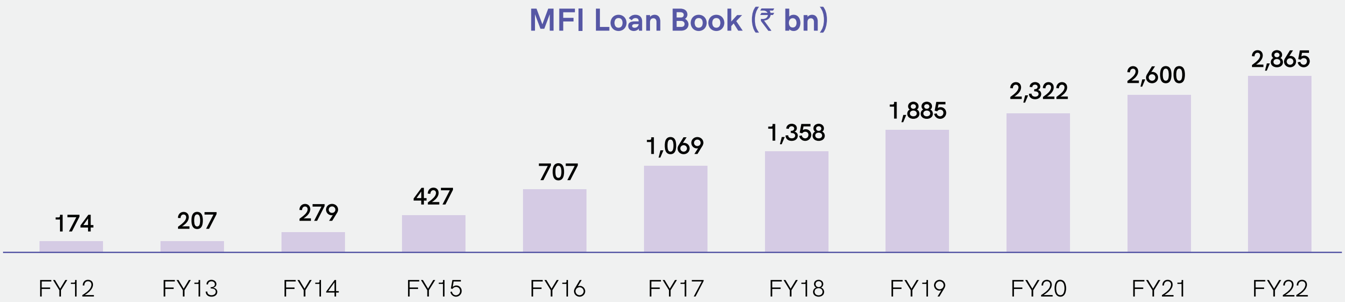
Source: Avendus Spark, RBI

Key players: Large banks and one large NBFC (Bajaj Finance) dominate the space as this business largely remains a data driven cross-sell product for existing customers. A lot of fintechs and smaller NBFCs are also experimenting in this segment with new-to-credit customers and small ticket loans.

Competitive advantage: A strong analytics platform along with a large customer franchise enables better risk calibrated growth in this segment. Most banks have been rolling out new products under the unsecured retail credit umbrella and are slowly targeting Tier 2, Tier 3, and new-to-credit customers. Credit card adoption is also growing rapidly as digital payments gain foothold. The opportunity size in this segment remains large as current penetration rates are low with only 80 million credit cards outstanding vs more than 950 million debit card holders.

Microfinance

The industry's total gross loan portfolio stands at ₹3 tn ($36.67 bn) as on Mar'23. With over 60mn unique borrowers, India has the largest number of active MFI borrowers globally. The sector has grown significantly due to the government's push for financial inclusion, resulting in a 23% CAGR over the last decade. The industry customer base has also grown with the average ticket price increasing from $457 in Mar'19 to $514 in Mar'23.



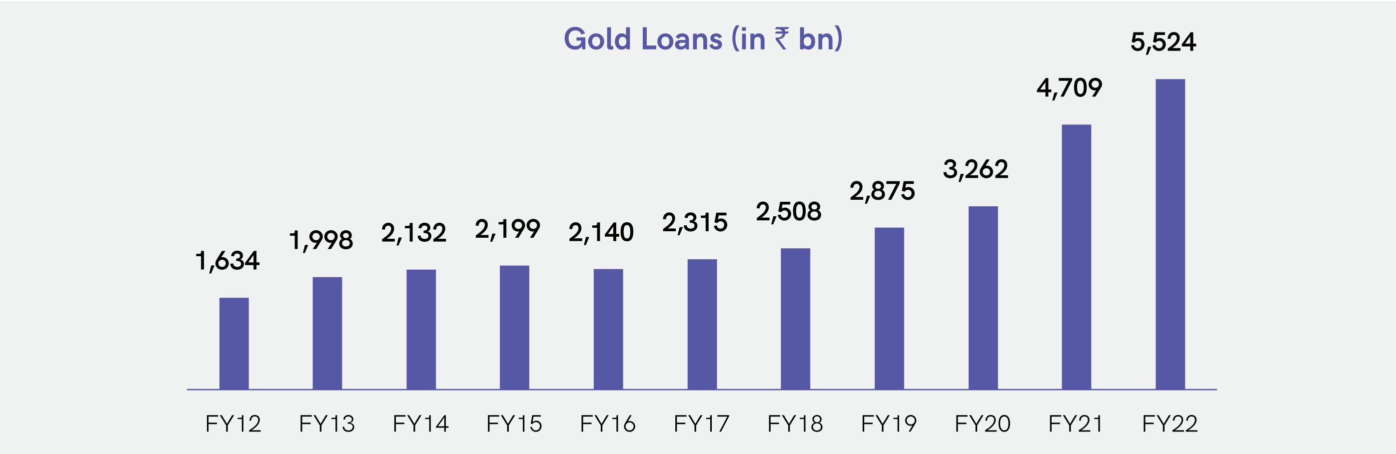
Source: Various Sources, RBI, Companies Data, Investec Securities

Key players: The sector has a diverse range of participants with banks accounting for 38.4% of the market share, followed by NBFC-MFIs at 35% and SFBs at 16.9%.

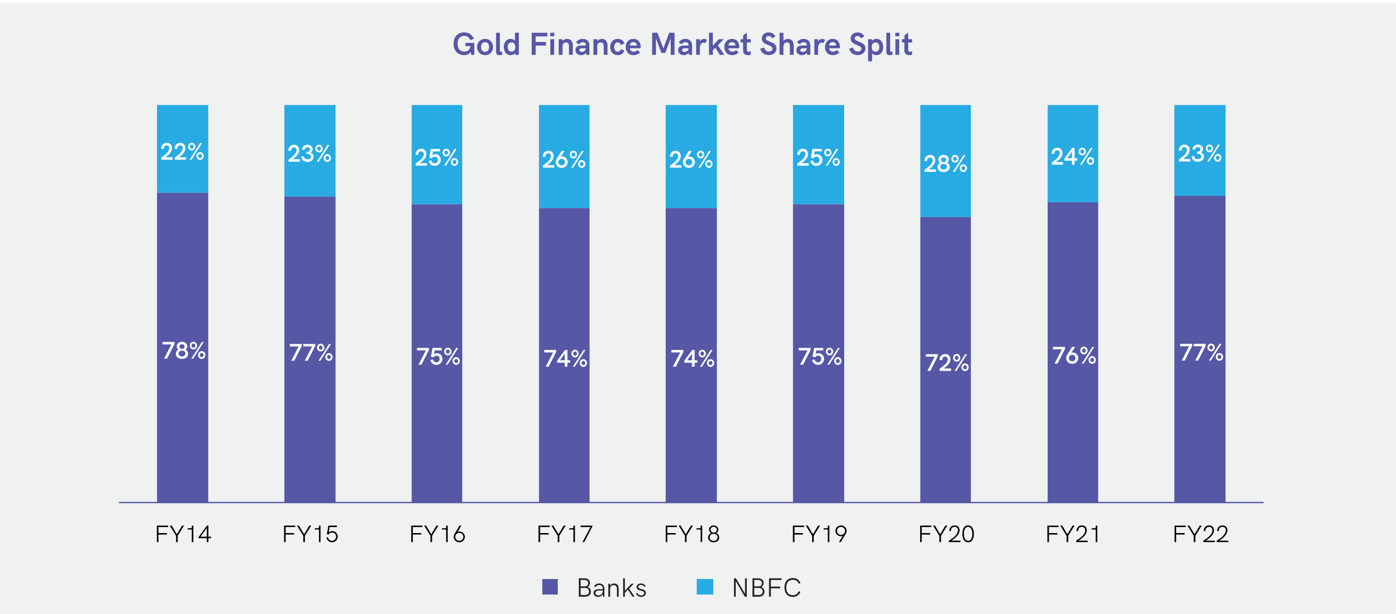
Competitive advantage: Due to events such as the Andhra Pradesh crisis (2010), demonetization (2016) and covid (2019), leading players have tried to diversify their product portfolio and geographic presence. The increasing regulatory push has also enabled better availability of borrower data, allowing smaller startups to serve the underserved. Given the unsecured and rural nature of lending, microfinance tends to be a high-risk segment with periodic write-offs as seen during the various down cycles over the past few years. As a result, stronger balance sheets with a deeper understanding of micro markets is a key success factor in this business.

Gold Finance

The total size of the organized gold loan market stands at approximately ₹6 tn ($70 bn) as on Mar'23. The total stock of gold in India is approximately 28,000 tonnes (14% of the world's gold) of which, around 5300 tonnes is pledged. The unorganized segment is estimated to be as large as the organized market.



Source: Various Sources, RBI, Companies Data, Investec Securities.



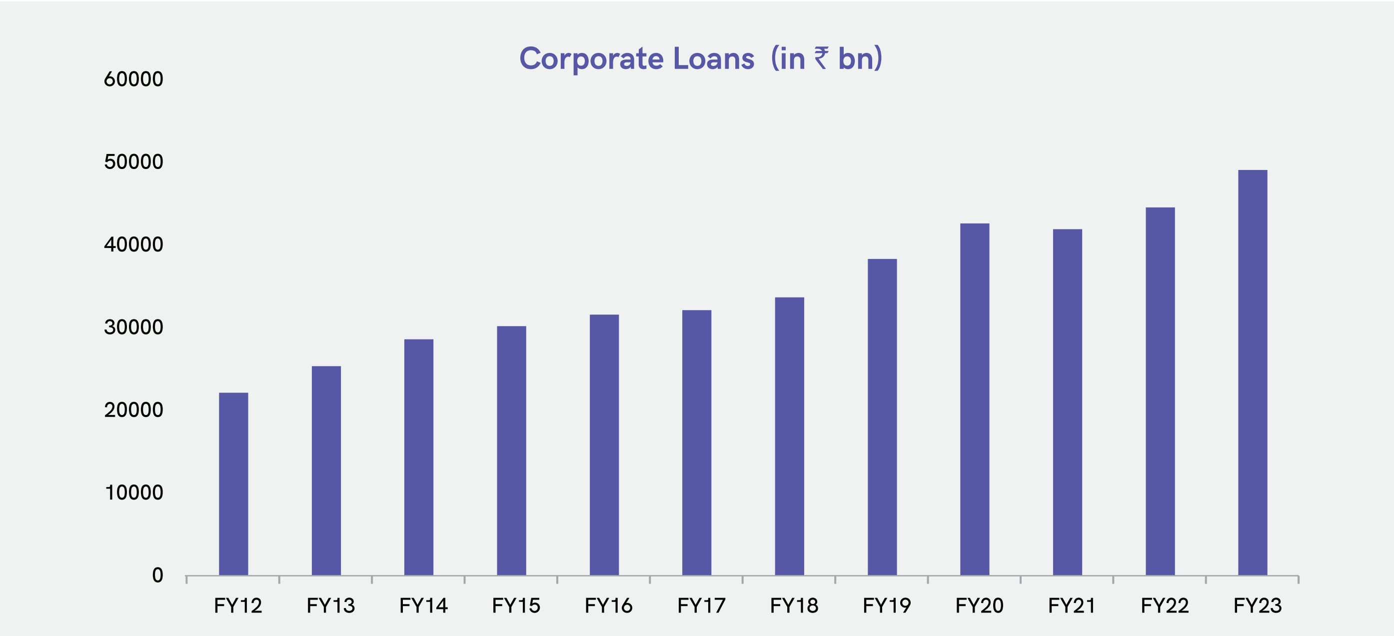
Source: Various Sources, RBI, Companies Data, Investec Securities

Key players: The gold finance segment is highly concentrated with a few large market players such as Muthoot Finance, Manappuram Finance and IIFL Finance carving a niche for themselves. There is an 80:20 split in favour of banks, but barring some regional banks, gold loans form a small component of their total retail portfolio.

Competitive advantage: Being an operationally intensive business, various banks and NBFCs have not been able to scale up to a profitable size. In addition to a widespread geographical presence, specific requirements need to be managed e.g. a valuer at each location, physical gold storage facilities etc. This makes it difficult for new players to scale up. With a shift to formalization, the organized lenders are expected to see their market share gain over time.

Corporate Lending

The total size of corporate lending by banks is approximately ₹49 tn ($600 bn). While growth was slow in this segment over the past few years as corporates were deleveraging their balance sheets, early signs of green-shoots are appearing. The asset quality of banks has become better, and there is a government push for increased capital expenditure.



Source: Avendus Spark

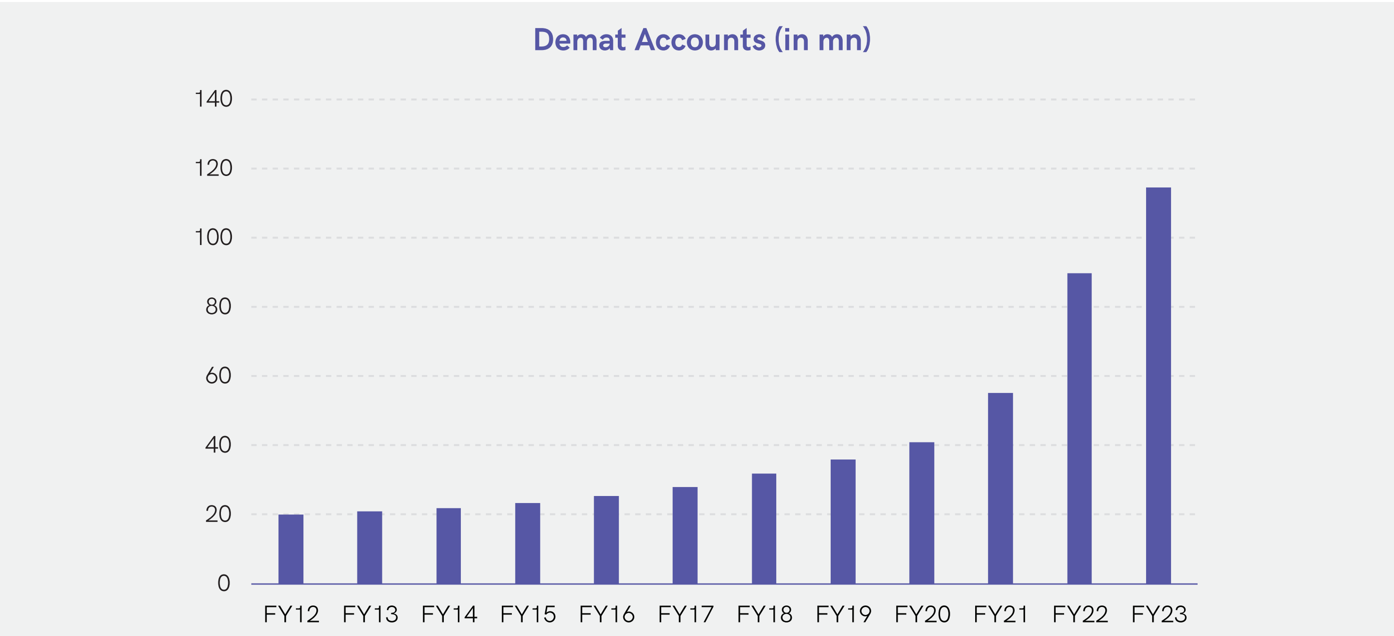
Key players: Majority of the market share is still with state-owned banks (50%) while NBFCs and private sector banks split the balance. Historically, the pricing in the large and mid-corporate segments has been extremely competitive due to the borrowers being sophisticated businesses with large treasuries. This had led to a larger market share for banks in the large and mid-corporate segment. NBFCs tend to operate in the high-risk, high-yield segments such as Medium to Small-Medium Enterprises (MSMEs) and real estate lending.

Competitive advantage: The cost of funding and scale puts a natural barrier to entry for smaller players. Over the years, as client relationships deepen, banks tend to gain by offering other products such as deposits, foreign exchange, cash management, and supply chain financing.

Asset & Wealth Management

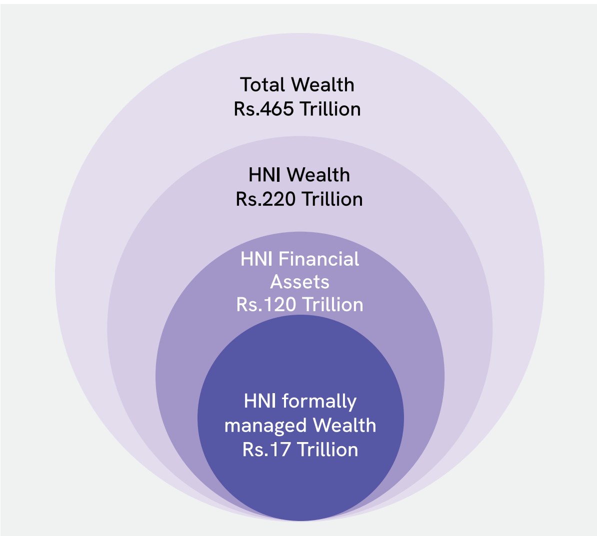
The total assets under management (AUM) as on Mar’23 is ₹39 tn ($482 bn). The industry’s AUM has grown from ₹7 tn ($86 bn) as on Mar’13 – a more than five-fold increase in the span of ten years. A gross household savings rate of approximately 15%, increasing share of financial assets in total household savings and increasing participation of retail investors in public markets have contributed to this.

Equity-oriented mutual funds are the highest contributor to the industry's AUM with a share of 51.3% of the total investments. Passive funds have also grown rapidly with a CAGR of 49.4% over the last five years.

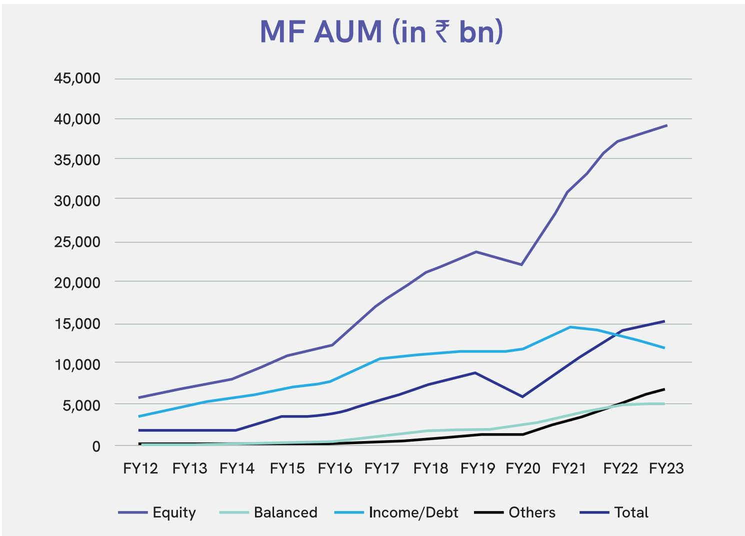


Source: Various Sources, RBI, Companies Data, Investec Securities.

Given the rapid growth of India’s asset management industry, it is not surprising that there has also been a corresponding increase in wealth management services for high net-worth individuals (HNIs). The total HNI wealth is upwards of ₹220 tn ($2.7 tn), of which 55% is invested in financial assets. The total addressable market (TAM) of the HNI segment is expected to grow at a CAGR of 17% over the next five years.



Source – Internal research, Investec Securities



Source: Various Sources, RBI, Companies Data, Investec Securities

Broking houses play an important role in providing investment and trading services to investors. The brokerage industry has seen remarkable growth and increased competition in the last five years due to the advent of discount brokers. The ease of use and low cost of discount brokers has attracted first-time investors who were previously hesitant to invest in the stock market.

Key players: The Indian asset management industry is concentrated with the top ten asset managers holding approximately 83% market share. The key players are HDFC Asset Management, ICICI Prudential Mutual Fund and SBI Mutual Fund. We expect the large-scale players to continue to dominate the mass market. However, we do see room for boutique asset managers offering alternative products.

Regarding the wealth management industry, the leading players are 360 ONE Wealth, Kotak Wealth Management and Edelweiss Advisory who maintain a good brand value and offer unique propositions to the customers.

In the broker segment, discount brokers like Zerodha and Groww are the first choice for new investors, and they maintain the highest market share. Angel One and ICICI Securities are the traditional brokers who maintain a sizeable presence in the market due to their unique penetration strategies.

Competitive advantage: Due to the high competition, cost management, apart from consistent alpha creation, will be key to retaining retail investors. Retail investors continue to prefer plain vanilla mutual funds where bank-affiliated asset managers have better distribution capabilities and are more recognized retail brands.

For high net-worth investors, differentiated products in areas such as alternate investment funds (AIFs), private equity, private credit and real estate linked investments will matter most.

Intermediaries

Stock exchanges are an important intermediary that provide a platform for trading securities and raising capital. The Indian exchanges, National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) have grown considerably, with NSE alone trading an average of over 6 billion shares worth ~ ₹42.50 bn ($513 mn) per day in FY 23.

This success is supported by the introduction of new asset classes and products, such as derivatives, commodities, and currency. The introduction of digital platforms and increased retail participation has further contributed to the sector's expansion.

Depositories too are integral to India's securities and mutual fund industries. NSDL and CDSL are the two depositories that hold securities in electronic (demat) form, facilitating their secure and efficient trading. NSDL maintains about 90% of the market share by value and accounts for assets greater than ₹302 tn ($3.7 tn), as per its most recent disclosures.

RTAs like Computer Age Management Services (CAMS) and KFin Technologies maintain investor records and handle transactions. The surge in mutual fund investment has been accompanied by a rise in demand for RTA services, resulting in fierce competition among providers to offer better, more comprehensive services to investors.

Further, credit bureaus like CIBIL, Equifax, and Experian are intermediaries that help lenders make informed decisions by providing scores and reports that assess customer creditworthiness. They are expected to promote financial inclusion and responsible lending practices.

As the Indian financial system continues to grow and evolve, all these entities will play an increasingly important role in enabling financial empowerment.

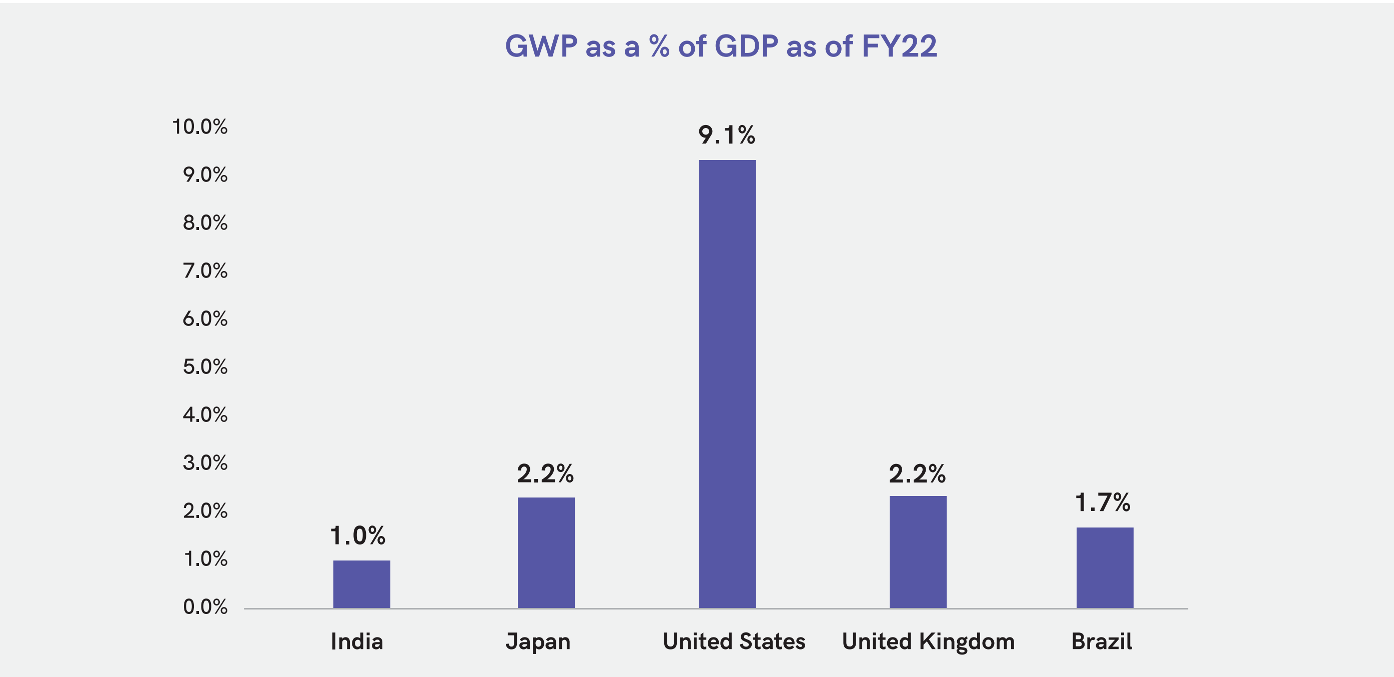
General Insurance

The General Insurance market is a ₹2.6 tn ($32 bn) market in India as on Mar’23, growing at a 17% CAGR for the last ten years. India’s market is the fourth largest in Asia and fifteenth largest globally.

Despite this, the non-life insurance penetration in India was one-fourth of the global average and 75% of India’s population pays out-of-pocket for health ailments. To increase coverage, the Insurance Regulatory and Development Authority of India (IRDAI) launched numerous measures, including making it mandatory for all non-life insurers to launch health insurance. They also removed the requirement for companies to seek prior permission before launching new health insurance products.

Apart from the initiatives in health, IRDAI also pushed for general insurers to directly work with transport authorities to provide mandatory cover for uninsured vehicles. Though insurance is mandatory for all vehicles, more than 19 crore of the 34 crore registered automobiles have no insurance.

Key players: Motor insurance and health insurance are the two largest segments, accounting for about 35% of the market share each. Private insurers have consistently gained market share over the past decade. The key players are New India Assurance Co. Ltd, ICICI Lombard and Bajaj Allianz General Insurance.

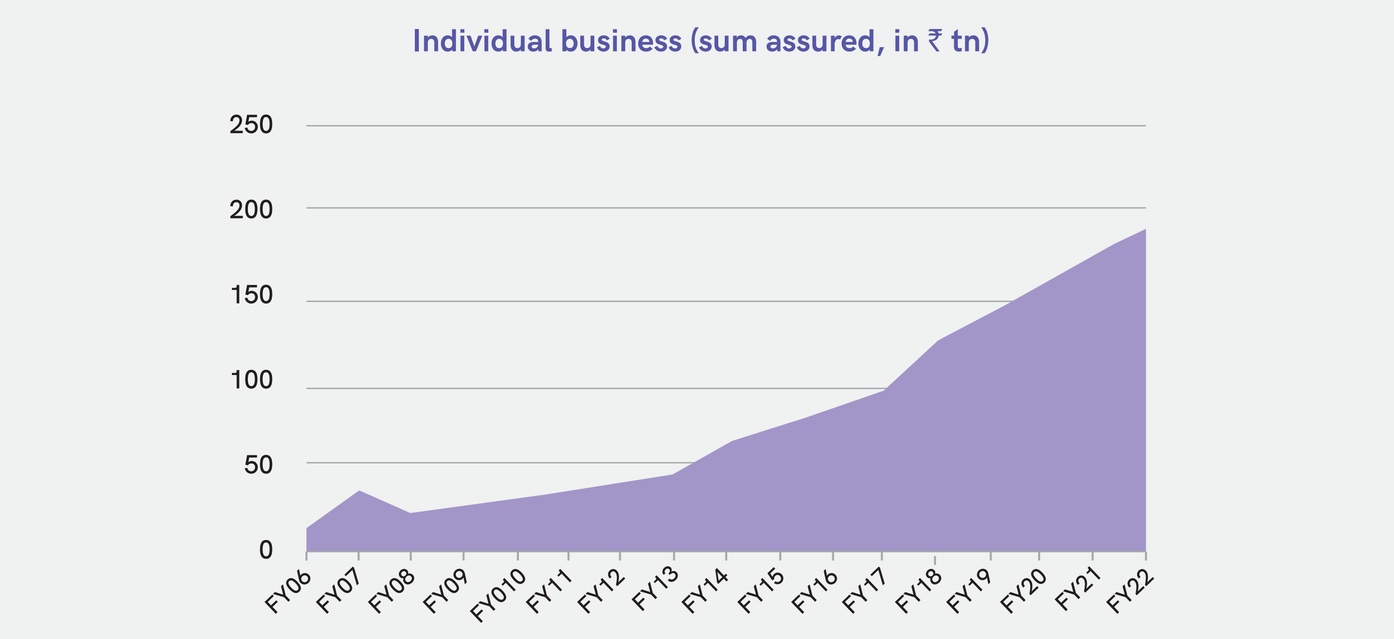


Source: Emkay Research

Competitive advantage: Overall, the segment is highly under-penetrated with a mere 1% GWP (Gross Written Premium) to GDP ratio as on Mar’23. The current population demographics, increasing awareness on health insurance, higher vehicle sales and government initiatives promise growth potential. Product innovation is important on the health side to increase uptake by the population. For motor insurance, tie-ups with various dealerships will enable better penetration. This will increasingly benefit the private sector players, as the state-owned insurers are cost inefficient and focus less on innovation.

Life Insurance

The total life insurance GWP in India is ₹7 tn ($87 bn) as on Mar'23 with sum assured to GDP at 90%. With the premium to GDP being approximately 3%, the market in India is quite under-penetrated compared to other world economies.



Source: Investec Research

Key players: There is one large state-owned life insurer and twenty-three private sector insurers in India. As on Mar'23, the state-owned Life Insurance Corporation of India (LIC) holds 69% market share. The next four private players hold 19% collectively (HDFC Life, ICICI Prudential, SBI Life and Max Life) However, over the last decade LIC's share in new business has consistently declined.

Competitive advantage: The Indian life insurance sector is seeing a structural shift in product mix towards the higher margin protection business. Savings oriented product margins are also improving as insurers are revising pricing, product structures and distribution incentives. Going forward, the NBV (New Business Value) growth will be driven by improving product mix, operating efficiency and a stable regulatory regime. Like in the case of asset management, a strong distribution network and retail brand recognition are key drivers for success.

Fintech

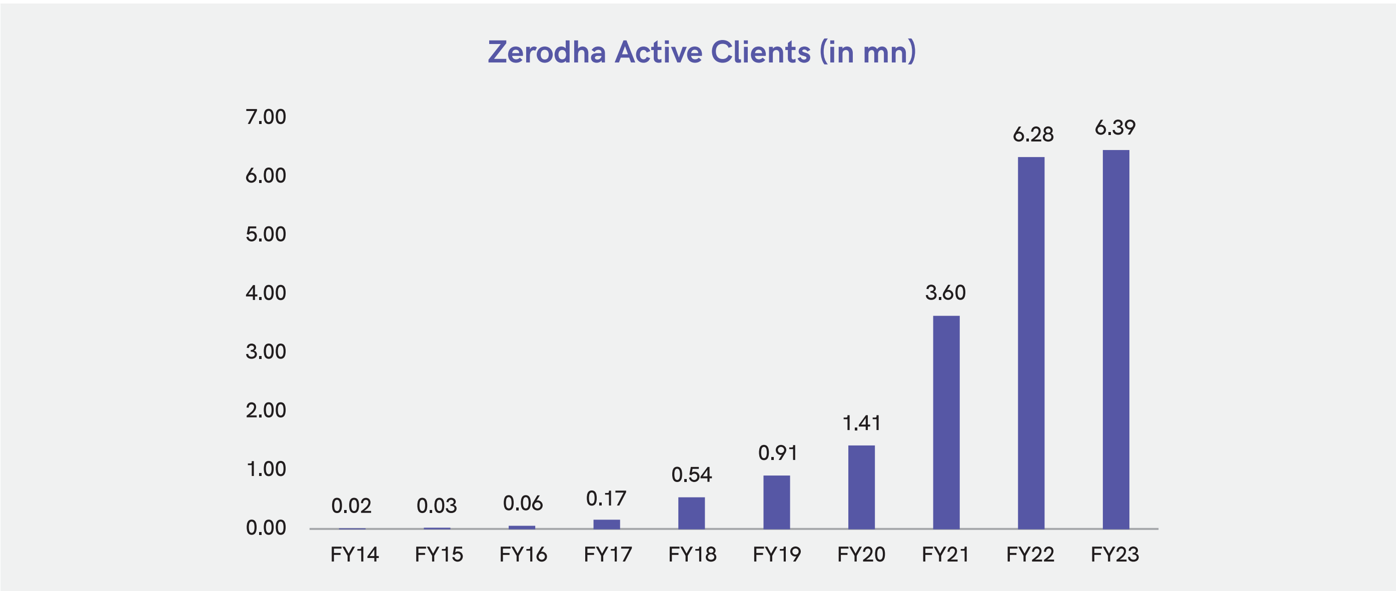
India's fintech industry has been one of the fastest growing industries, driven by factors such as the increasing penetration of mobile and broadband, government support, and a large and receptive population.

Notably, the industry has attracted significant investments, with the last quarter of FY 23 recording investments worth ₹98 bn ($1.2 bn), despite the funding winter. A BCG study in collaboration with the Federation of Indian Chambers of Commerce and Industry (FICCI) projects that the market size will reach ₹12.2 tn ($150 bn) by 2025.

Digital payments is one of the largest segments, driven by the government's push towards a cashless economy and the rapid adoption of smartphones. Mobile wallets, UPI and digital banking are some of the popular digital payment solutions, with companies like Paytm, PhonePe, and Google Pay leading the space. These have increased financial inclusion, transparency and reduced transaction cost.

Lending is another significant segment, with players like PayTM, (that started as a digital payment app) LendingKart, and KreditBee enabling loans through digital platforms. Fintechs use technology and data analytics to provide innovative products, such as peer-to-peer lending and micro-lending, thus catering to underserved segments of the population.

Wealthtech, or the use of technology to manage investments and personal finance, is also a rapidly growing sub-segment. Companies like Kuvera, Zerodha, and Groww offer digital investment platforms to Indian consumers, allowing them to invest in mutual funds, stocks, and other financial instruments easily.



Source: NSE, Avendus Spark

The Indian insurtech industry is expected to reach a market size of ₹980 bn ($12 bn) by 2025, with a focus on using big data and analytics to personalize insurance offerings. Another trend that has emerged is the rise of micro-insurance, i.e, providing at least some coverage to low-income households. In terms of players, companies such as PolicyBazaar, Turtlemint and Insurance Pandit dominate the market.

Competitive advantage: By using technology, fintechs have been able to provide financial solutions that are more accessible and affordable. This has enabled them to attract a large customer base, particularly in rural areas where traditional financial services are less accessible. Fintechs have also formed strategic partnerships with banks and other financial institutions to integrate their platforms with traditional banking services, enabling customers to access a wider range of financial products through a single platform.

Overall, the strong government initiatives, considerable headroom, and the increased aggressive stance of private players across the board point towards tremendous potential in the Indian financial services.

i. PMJDY Progress Report - https://pmjdy.gov.in/account

ii. Empowering Credit Inclusion: A deeper perspective on credit underserved and unserved customers – CIBIL
https://content.transunion.com/v/global-report-empowering-credit-inclusion-a-deeper-perspective-on-credit-underserved-and-unserved-consumers?utm_campaign=pr-financial-inclusion&utm_content=report&utm_medium=press-release&utm_source=press-release&utmsource=press-release

iii. IIFL Securities Report on Account Aggregator

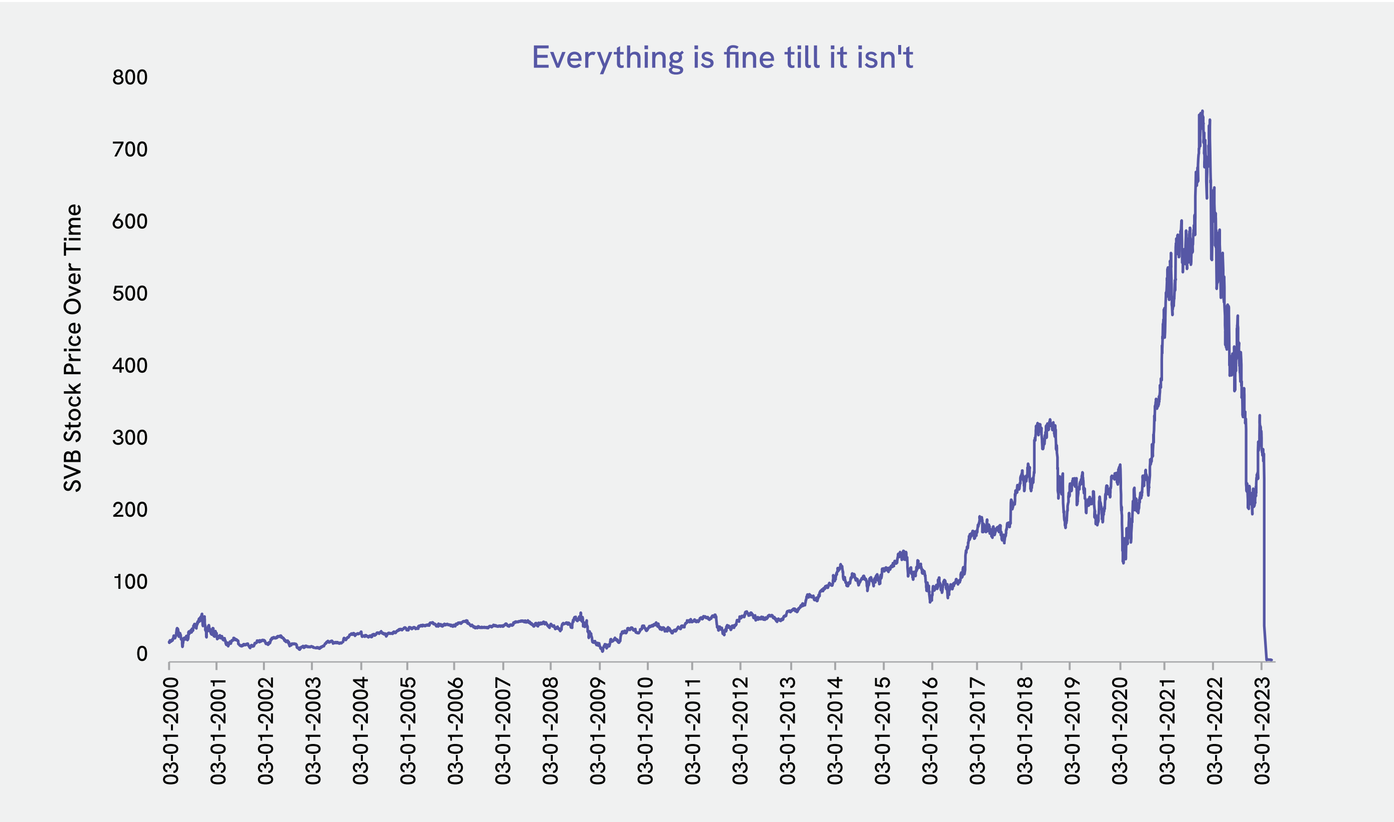
The Promise and Perils of the Financial Industry

The financial services industry is a curious beast. It's been around for thousands of years, with the practice of lending and borrowing money dating back to ancient civilizations such as Greece and Rome. Hence, it's often easy to assume that firms with a long track record must have some intrinsic quality that allows them to weather economic storms and adapt to changing markets. But as we've seen time and again, that's not always the case.

Take Lehman Brothers. The investment bank had been in business for over a century before it went bankrupt in 2008, sparking a global financial crisis. Or consider Barings Bank, which was founded in 1762 and had a history stretching back over 230 years before it went bankrupt due to unauthorized trading by one of its employees.

So why is the financial services sector so prone to turbulence? Perhaps it's the result of a confluence of factors: A complex array of financial instruments and markets, the intricate web of relationships between different institutions, and the ever-evolving regulatory landscape. Or maybe it's just bad risk management and fraud. But one thing is certain: in the financial services industry, even a sound balance sheet is not enough to guarantee success.

The collapse of Silicon Valley Bank serves as a timely reminder of the same. The liquidity crisis that led to SVB's collapse was caused by a mismatch between the duration of its assets and liabilities, but allegations of poor management and weakened regulations also contributed to the loss of trust in the institution. As a result, customers, primarily consisting of technology startups, began to withdraw their deposits, exacerbating the crisis. The perception of the bank's financial health was just as crucial as the reality, and the concentrated customer base accelerated the spread of negative perceptions, resulting in a quicker withdrawal of funds. This case serves as a reminder that a strong balance sheet alone cannot guarantee success in the financial services industry. If customers do not perceive an institution as financially sound, a loss of trust can be devastating.



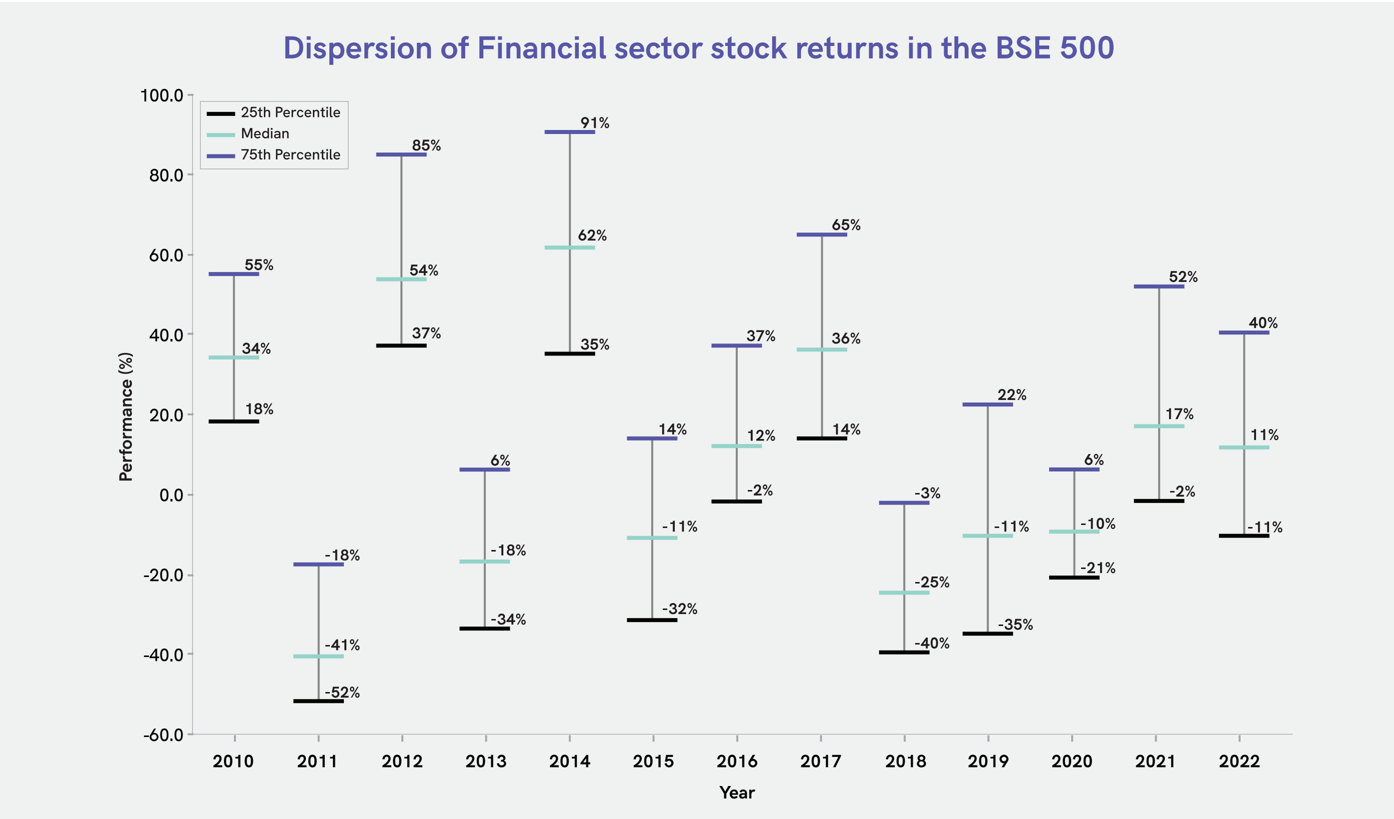
Source: S&P, Capital IQ

In 2018, India faced the IL&FS crisis that sparked a liquidity crunch, affecting the financial sector for over a year. The default by IL&FS Financial Services on some loan repayments and commercial paper redemption obligations sent shockwaves through the commercial paper market, leading to large-scale liquidity withdrawals from mutual funds. NBFCs with wholesale / structured finance books, such as Dewan Housing Finance (DHFL), Indiabulls group, and Reliance Capital, were hit hard, facing an extreme asset-liability mismatch. The crisis later spread to banks such as Yes Bank, which had significant exposures to these groups.

The Yes Bank crisis caused concerns in the financial system, with the RBI orchestrating a recapitalization due to larger-than-expected problems. While the financial sector was grappling with the aftermath of the Yes Bank crisis, the COVID-19 pandemic emerged as a new crisis. The asset quality crisis was particularly severe as the lockdowns and disruptions to economic activity impacted borrowers' ability to service their loans. Smaller players, especially those with higher exposure to semi-urban areas, were particularly vulnerable, and many of their borrowers, who were self-employed or worked in the informal sector, had their incomes significantly impacted by the pandemic.

The larger banks were better positioned to navigate the crisis thanks to their diversified loan portfolios and higher capital buffers. They were able to provide relief measures to their borrowers and manage the increase in non-performing assets. The type of borrowers also played a significant role in determining the impact of the crisis on the different banks. Those having a higher proportion of corporate and high net worth borrowers being less impacted than those with a higher proportion of retail and small and medium enterprise borrowers.

Despite the challenges faced by India's financial sector in recent years (both asset and liability side), the promise of the sector remains strong. The vast untapped market and increasing demand for credit and financial services offer tremendous potential. However, the sector's cyclical and disruptive nature means that not all financial companies have been able to perform well, despite significant growth in assets and lending. This is a reminder that while the structural promise of the sector is undoubtedly present, it does not guarantee success for every player. To illustrate this point, take a look at the chart below.



Source - Bloomberg Data, Avendus Spark & internal research. Quartiles and medians are calculated for each year by taking the "Financial companies" from BSE 500 from 2010 to 2022. Past performance is not an indication of future returns.

It showcases the distribution of return data for companies in the financial sector in the BSE 500 index from 2010 to 2022. The lines on the chart span from the 25th percentile to the 75th percentile, with the median depicted by a Teal line in the middle. The length of the vertical lines indicates the variability in returns within the financial sector for any given year. The average difference between the 25th and 75th percentile for those thirteen years was a staggering 44%.

It is clear that there is significant variability in the returns among financial companies, with some experiencing negative returns and others achieving substantial growth. The chart underscores the importance of careful analysis and informed decision-making when investing in the financial sector. While this variability may be concerning, it also presents as an opportunity for investors who have the ability to navigate the sector's challenges and minimize obvious errors.

As Charlie Munger famously said, "It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent." In other words, while one may not be able to magically pick the best bets every year, avoiding the obvious mistakes over time should lead to outperformance in the long run.

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