

India Investor Conference

Takeaways from India Financials Day

- **Going beyond management-speak - where the real action is** — There's a lot of action in banks stocks: but we believe there's probably more action going on in the underlying sector. To get a broader and deeper perspective, we hosted speakers representing CIBIL (credit bureau), ARCIL (asset reconstruction co), India Ratings (Fitch, Bank ratings), HDFC Bank (Technology), and India's retail/mid-market businesses. It's alive, there's change, structural shifts, and challenges – and we highlight some key perspectives.
- **CIBIL: The Structural Shift** — CIBIL, India's premier credit bureau, has become a game changer for retail credit – the backbone of high-quality retail growth. It's got scale (160m customers, 300m accnts), is growing (4m new customers, monthly), and could get a further leg up with 'Aadhaar'. And the cake's icing: retail credit behavior remains comfortable, across products (ex- CV's) – tastes good.
- **ARCIL: The Asset-Recovery Arsenal** — ARCIL is India's premier Asset reconstruction company. It's got some scale, specialized recovery skills, has generated returns, and some new regulatory support (new RBI guidelines on NPLs). That said – there are plenty of operational challenges, and few attractive assets. The market's picking up, but it's still slow – and ARCIL's not yet the solution to banks' asset issues.
- **India Ratings: The Raters' Review** — Their outlook for India's banks is 'Stable' – and they are not downgrading. But they see asset stress ahead (10% stressed assets going to 15% in 2015), Basle 3-driven large capital calls, and structurally diminishing returns (more capital, higher capital costs). The rater also flags funding risks for the system: but by staying 'Stable' - actually suggest India's banks are challenged, but steady.
- **HDFC Bank: The Technologist's Turn** — India's best bank is a success on many fronts: but its technology success and vision could well be one of its driving forces. They are big on analytics, see Big Data as one of the next big things, see huge opportunity ahead in a 'Gen Y' country, and continue to invest. They lag the US/EU in spending, but match in technology trends - and see digitization as a growth/cost opportunity, and necessity. Ready for the next new age.
- **The takeaway spaghetti** — There's the good: retail credit/bureau, technology strides; the mixed: 'stable' rating outlook, some gains on ARCs; and the bad – more asset pressures, capital calls. It's a mix, a bit of a spaghetti - but probably more structural gains than cyclical pains. A warm-up to Citi's India Investor Conference – the Financials day as the starter - do go for the more-detailed spread over-leaf.

Aditya Narain, CFA

+91-22-6175-9879

aditya.narain@citi.com

Abhishek Sahoo

+91-22-6175-9856

abhishek.sahoo@citi.com

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Takeaways from India Financials Day

CIBIL – The structural shift

- **Background** – At Citi's India Financials Day, we met Satish Pillai, COO of CIBIL – India's first and now dominant Retail Credit bureau. CIBIL is probably one of the less-appreciated success stories of India's financial sector evolution. It is today, probably the back-bone of the relatively high-quality and disciplined retail credit build out in India.
- **Key facts** – 1) CIBIL has 160m credit accounts (300m product accounts); 2) 90% + of new retail credits are backed by credit scores from CIBIL; 3) It's adding 4m new accounts every month – of which 30% are new accounts; 4) Almost all key financial sector participants are contributing and using data from CIBIL; 5) It gained momentum and customer acceptance after 2007, when there was a retail credit crisis in the Indian market – has not looked back since; 6) There are two other credit bureaus in India now; 7) CIBIL offers credit scores / Analytics – almost all participants use it, and typically overlay their own analytics on it; 8) CIBIL also has 6m accounts in commercial credit
- **Perspectives: Growth** - The total growth potential/market size is all adults in India - which can go up to 900m. The 'Aadhar Card' should be a big driver of growth. The retail credit bureau has been well adopted by participants (almost all): across private, government and foreign banks.
- **Perspectives: Asset Quality** - They do not see any real credit quality pressures in retail assets – across the product pipeline. This has been the case for the last two years. There is some pressure in Commercial vehicles – and newer vintage loans are also showing pressure. Effectively, it's a relatively hard market to call. There is some difference in the quality of assets between govt and private banks...govt is weaker – in car and education loans.
- **Our take** - It's a structural change in the operating environment for retail credit, should support 'stronger for longer' credit growth – and offer a better early warning system. That won't necessarily protect the space from pricing/over-crowding challenges, but in our view future credit challenges will potentially lie more in not understanding the creditrather than not knowing the customer.

ARCIL: The Asset Recovery Arsenal?

- **Background** – At Citi's Indian Financials Day, we met Mr. Umesh Wamorkar, Head of Business Policy & Fund Management at ARCIL. Key takeaways from our interaction: Arcil is the first Asset Reconstruction Company (ARC) in India, incorporated in 2002, on the sponsorship of 4 national banks (SBI, PNB, ICICI, and IDBI). Since then, 13 other ARCs have come into existence, although Arcil continues to dominate with 67% market share. The company acquires NPAs from 63 banks/financial institutions and currently has ~Rs62bn in assets under management.
- **How they work** – Typically acquire NPAs from banks through a mix of a) Cash buyouts – relatively few; b) Issuance of Security Receipts (SR's) to banks (5%:95% contribution) – ARCIL puts cash down, and apart from a mgt fee (2%), shares in upside/downside, and c) Uses its own capital, or cash through two funds they have raised. Predominantly Industrial focused, though has a relatively new Retail arm too.
- **What does Arcil bring to the table** – (a) Specialized / focused recovery skills, (b) ability to aggregate debt (from many lenders), and c) resolution period of 8 yrs for stakes in ARC trusts (vs. 4 yrs for banks).
- **Track record: Decent** – Average recoveries 2X of principal, with two externally funded funds (ARF-I: Size - Rs2.58bn, Net IRR-10%, and ARF-II: Size - Rs2bn, Net IRR – 34%). Aiming to raise another Rs5bn fund.
- **Challenges** – a) Legal system remains very slow, b) Banks not willing to sell at a loss – only where already provided, c) Quality of assets available is typically very poor – with little ability to reconstruct/salvage, and d) No special recovery powers
- **Outlook** – a) Activity is picking up – more assets on the block (about Rs300b), but pricing an issue (only purchased Rs20b this year); b) New RBI regulations operational from 1 April 2014 are a step up; c) More regulatory teeth needed; d) It's predominantly the government banks that are selling - private banks only selling for cash; and d) Still not enough partnerships with banks: Need of the hour for the business to take off.
- **Our Take** – It's slow going, and for ARC's to start making a material difference, they need stronger regulatory support – and for banks to treat them as partners in recovery, rather than a resting ground for hard-to-recover assets. Some gains, but slow in coming, and it will take time.

India Ratings (FITCH) – The Raters' Review

- **Background** – At Citi's Indian Financials Day, we met Ananda Bhounik, Senior Director, Bank Ratings at Indian Research & Ratings (Fitch India). In spite of the mood, and market – Fitch is [not downgrading Indian Banks](#). Key perspectives from our interaction:
- **Asset Quality** - There's more pressure ahead: gross stressed assets should rise from about 10% currently to 14% - that should be more or less the peak. The 14% should be some kind of a worst-case scenario. The bulk of the pressure/risk lies in Industrial assets where collateral/economics are an issue. Infrastructure loans are not that big a deal – the assets are good, and there is money now coming onto the table. Credit costs will continue to rise: as tighter NPA norms come through and provisioning coverage needs to be raised.
- **Capital requirements** - Will rise on account of Basle 3...part of the equity capital required will come through hybrid capital (which will need to be raised domestically). The government itself will need to provide a relatively moderate US\$23bn – the government does seem to be a little proactive about it already. No real crisis on hand - even if a bail-out is needed near term, the amount of capital needed from the government is estimated to be about \$1.9b over two years (taking into account pre-prov profits). This would, however, necessarily lead to a lowering in ROA's and ROE's.
- **Funding mismatches** - A key, under-appreciated concern with the banks, which has increased over the years. Significantly increased short-term funding will leave banks vulnerable to liquidity squeezes in the system. It's the weaker government banks that are most exposed.
- **Our Take** - A relatively middle-of-the-road approach: it's challenging, but it's not as bad as it's made out to be. There are longer-term over-hangs on profitability and capital (which can therefore also affect growth): but there is no real crisis here, or around the corner.

HDFC Bank – The Technologist's Turn

- **Background** – HDFC Bank's CIO, Anil Jaggia, interacted with investors at Citi's India Financials Day on 11 Feb. He shared his perspectives on the technology landscape in the Indian Banking sector. Anil Jaggia has over 26 yrs of experience in the financial services sector, and is currently responsible for a number of key initiatives at HDFC Bank including Financial Inclusion, Micro-Finance Lending, and Enterprise Transformation. Some key takeaways from our interaction:
- **Technology: a driver of higher profitability** – HDFC Bank's loss rates in the credit cards segment are 30-50% of industry levels. This is largely the result of better analytics and use of technology. Analytics and Big Data can also help drive cross-sell opportunities, with banks targeting customers better with specific products/offers. Analytics are now being applied to get the best returns on marketing expenditures and promotional campaigns at Indian banks.
- **The 'Cashless' Opportunity** – Usage of cash and cheques is falling materially with a move to 'online' banking. Some of the expenditures/categories that are turning increasingly cashless – fuel, food, movies, and bill payments. Almost all traditional transactions that were done at physical branches can now be processed online. However, banks will still need a bare-minimum branch network from a sheer visibility/reach perspective.
- **Putting Indian banks in context** – Banks in developed economies like the US/Europe spend ~9% of revenues on technology. Indian PSU banks have much lower expenditures at ~2.0-2.5% of revenues, with Indian Private Banks somewhere in between. However, Indian banks are at various levels of maturity in their technology-adoption levels: some of the leading private sector banks and larger national are at advanced stages, mid-sized PSUs are lagging behind, with newer private banks somewhere in between.
- **'Regulatory' costs** – A big portion of the IT expenditures of Indian banks (~15%) currently pertains to RBI-mandated initiatives, required as per the recommendations of the Gopalakrishnan committee report. The cost of compliance is high – to put things in perspective, the ADF (automatic data flow) push of the RBI demands ~12,500 data points from banks on a periodic basis. While some of these expenditures are necessary (for example, to make online banking more secure and drive higher adoption rates), banks would like to graduate to higher discretionary spending on a steady-state basis.
- **The Big Game-changers** – Technology, for banks, can be a key enabler of financial inclusion, especially with the rollout of the Aadhaar (Unique Identification Number/Biometric Identity) platform. If the next government does not shelve the Aadhaar project, we could see significant government cash transfers (Direct Benefits Transfers) being routed through the Aadhaar platform. The cost of KYC/customer acquisition could also significantly be reduced with Aadhaar. Some of the other big/potential game changers in the Indian context: 1) Mobile payments; 2) e-Wallets; and 3) P2P payments.
- **Our Take** – It's the way to do it, HDBK is on the ball, and we think it's the sort of thing that keeps HDBK ahead of the curve, and peers.

The Participants' Perspective

- **Background** – Retail/Consumer Banking growth has largely held up in the midst of the current economic cycle – and asset quality is relatively unscathed. Also, while SME/mid-corporates have displayed signs of stress, some segments within this space are still growing. As part of Citi's Indian Financials day, we met participants in the Indian Retail & Commercial Banking space to get their perspectives on these business segments. Key takeaways from our interaction:
- **The '30%' Opportunity** – Digital/Online expenditures are growing at a healthy ~30% clip – and now constitute up to 30% of all credit card spending. A bank's large digital presence can, to some extent, compensate for a leaner branch network. Increasing urbanization is a key driver of higher online spending - the top 15 cities in India still hold immense potential for growth.
- **The 'Bureau' Effect** – Credit scoring bureaus like CIBIL have been game-changers in the Retail Banking space in India: dramatically reducing the cost of customer-acquisition. Given the better KYC, loss rates/NPAs have fallen – and are trending at <100 bps in most retail segments. Banks have largely learned their lessons from the last big retail push, where over 80% of customer acquisitions did not involve adequate due-diligence/income verification and delinquency rates were high. Incrementally, pricing is not a key differentiator
- **Fortunes at the Top of the Pyramid....and the Bottom** – Affluent/Mass-affluent segments within the retail space are growing at ~30%. Large private banks have renewed their focus on these segments and are rolling out specialized 'wealth management' branches. These segments also contribute to higher fee income. At the other end of the spectrum, Tier-II and III cities are also driving retail growth – India has one of the largest gaps in urban housing, and mortgages for low-cost dwelling units have continued to grow rapidly in these geographies.
- **Commercial Banking: The worst is not over** – Indian Mid-corporates/SMEs are still stressed: their working capital cycles have been stretched and a lot of the incremental borrowing (which is showing up as high loan growth in the system) is actually for funding liquidity gaps, not for expansion. Overleveraged corporates, with unhedged FX positions/FX loans for expansion, are among the most stressed.
- **Not all gloomy** – Some SMEs are still growing – expanding/diversifying across geographies and product lines. FMCG, Healthcare, IT and export-oriented segments are doing well. Concentration risks do exist for some SME relationships which grow over time, but the primary banker gets a lion's share of the wallet in such cases. Also most SME-lending is collateralized against promoter property/real estate. Client selection/avoiding adverse selection in this segment remains key.
- **Our take** – It's a big, diverse market - if you pick your spots well, there is enough going around, for decent return / controlled risk business – some of the private sector banks do show us that.

Appendix A-1

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