Forest or Trees?

Forrest Gump is one of the highest rated Hollywood movies of all time. While most movies extol heroes with IQs of 180 supported by bulging biceps, this was a movie that spotlighted a frail "half-wit" - as the protagonist (played wonderfully by Tom Hanks) himself would admit. There is a level of simplicity here that lends such credibility to the underdog, that it is best captured through the following dialogue:

Jenny (Forrest's love interest): Do you ever dream Forrest, about who you're gonna be?
Forrest: Who I'm gonna be?
Jenny: Yeah.
Forrest: Aren't I gonna be me?

Much has been said and written about what India must be. The geopolitics. The demographics. The economy. The market. There are always a multitude of forces tugging in various directions - as will be - in a country with 22 official languages and 1000s of dialects. But what does India itself want to be? The answer to this question, probably lies in the hands of the country's youth, who are each brimming with energy and ambition. During this current decade, the US, Eurozone and China will each see a net fall in their working age populations. And what of India? India is all set to add 122 million people to this working age cohort. It isn't just placeholder jobs either, but rather remarkable diversity and variety, as a number of youngsters (and oldsters no doubt) are ditching the road well-travelled to "innovate and build". With more than 70,000 startups in India, Prime Minister Modi has rightly labelled India's ten years till 2030 as a 'techade'.

No surprise then, that the govt.'s increasing focus on digital solutions has helped transform the financial services of the country. Could anyone have predicted how much the Unified Payments Interface (UPI) and digital stack would take India by storm? Few understood its true power. But today, if you want to make domestic payments to someone in India, all you need is their mobile number. An instantaneous payment will be done, no matter which banks the sender and receiver operate with. UPI is now clocking a terrific 5.9 billion transactions (and over USD 130bn in value terms) every month - and increasing. Such a system doesn't have any parallels anywhere in the world today. The US for example has a system called FedNow, which still needs one to login to their bank account, and procure and mention recipient bank account details - which is cumbersome. The world is taking note and over 30 countries have expressed interest in adopting UPI. Quite the testimony, for a revolutionary concept-in-action.

But why does sending and receiving money quickly - even instantaneously - matter? Because payments are the backbone of all commerce. And making this fast and efficient is a gamechanger. No need to worry about long settlement cycles and inventory backlogs. People would joke a few years ago about roadside vendors accepting digital payments, but that has become a reality already - from the largest metro cities to the smallest tier 3 towns. It's not just that the money moves fast, but it also becomes traceable, bringing more people into the formal economy.

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And all of this is not just hyperbole for the sake of it. Bank accounts are increasingly being opened not in branches, but from living room sofas. How so? Just one-click apply online on the bank's website or app, receive a link to video KYC, verify yourself, show your Aadhaar (biometric) card close to the camera and you're all set. This is literally zero paperwork, and the entire process in our real-life experience is completed in under 5 minutes. The govt.'s push for financial inclusion through its Jan Dhan Yojana (Jan is people, Dhan is wealth, and Yojana is plan) has seen over 460 million bank accounts opened since 2014. Over 56% of these are with women. This means 250 million previously unbanked women now have access to formal credit. The govt. followed up these zero balance accounts with various credit programs. For instance, 81% of the beneficiaries for the govt's Stand-Up India mission are women, while the number is 71% for Mudra (small business) Yojana loans.

Not only does this promote gender and economic equality but could also improve women's participation in the workforce which is at abysmal levels (~25%, amongst the lowest in the world). This could in turn lead to a solid boost to the GDP.

While many will agree that there is massive potential in the financialization of the country, what really is the size of the opportunity here? One look at how share prices of financials companies have rocketed in the last couple of decades, and it might appear that this train has left the station. But this couldn't be further from the truth. Banks tend to grow at ~1.2 to 1.3x of GDP. So if India's nominal GDP growth is ~12% for the next several years (6% real growth conservatively, plus 6% inflation), this means banks as a whole are likely to grow at ~15%+ annualized. Over 10 years of compounding, this translates to a growth of 4x! The total assets of all Indian banks taken together is ~USD 2.8 trillion today. To put this in perspective, the total assets of just one US bank, JP Morgan Chase alone, is ~USD 3.8 trillion. The population of the US is one-fourth that of India's 1.4 billion, with the latter admittedly far lower on a per-capita income basis. Despite JPMC being such a large bank in a developed market, it still maintains a 16% market share of assets. This means it is possible for market leaders in a country like India to not just maintain or grow their own market shares, but also for the overall pie to increase substantially. But this too is just scratching the surface, because it is one thing to talk about a sector in aggregate, and quite another to back its leaders. Even within that, there could be lenders focused on corporate accounts versus those focused on retail. Then there's geographic focus, as well client focus (small/medium/large, salaried/self-employed). And within that, various sub sectors - Mortgages? Vehicle financing? Personal loans? Gold loans? A combination?

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If we think big picture, what does every non-banking financial company (NBFC) want to do? To graduate to a bank. And why is that? Because banks are allowed to raise deposits, which in turn lower their cost of funds thereby improving margins. There is some level of competition that exists in India for this, with various NBFCs, companies and conglomerates always eager to convert to or setup a bank. One such NBFC that converted to a bank was AU, back in 2017. This fast-growing small finance bank finds a place among the top holdings of our flagship concentrated portfolio. When AU received its license, so did several other NBFCs - although most of those others were previously focused on microfinance. AU though was a strong player in vehicle finance - a secured business. When demonetization happened, microfinance was hit badly, these being very small ticket transactions that effectively came to a halt in the absence of cash. AU's vehicle finance and other portfolios though did alright in comparison. Can AU become a top 5 bank in India over the next decade? Much depends on execution, but it is possible. Despite having grown its book by 36% CAGR in the last 5 years, the bank has still not ventured into the housing finance market yet or been too aggressive on car loans. Wouldn't the larger incumbent banks try to fend off any new competition? They certainly might, but that is also the magic of an increasing pie in a developing market of the scale of India. The country's mortgage-loan-to-GDP ratio is a lowly 11%, compared to 77% in the US and 60% in the UK. As per census 2011 (2021's census has been delayed due to Covid), over 55% of the houses in the country did not even have a brick, stone, or concrete roof (instead having a grass, mud, thatched or sheeted one). While such statistics are just plain sad, the flipside is that there is enough space for another 10 more banks to make it big in the country!

Here's one more example. Bajaj Finance (BAF). A leading NBFC, which also is a top conviction pick in our portfolio. BAF has grown its AUM by an astounding 37% CAGR over the last 15 years, while compounding profits at an even more stellar 51% over the same period. This has not come through profligate lending, but rather through "prudent aggression" reflected in its net NPA ratio of 51 basis points, comparable to or better than even the best banks in the country. The company's AUM? "Only" USD 26bn, because it is less than 2% of the current banking system, while posting an enviable Average Return on Assets of 4 to 4.5%.

What does BAF do? It has been the uncrowned king of consumer durables financing for the last decade. How do they achieve this? By astutely mining consumer data to target borrowers with better credit quality - especially borrowers who do not have an easily available credit history. Walk into any white goods store in India, choose the Air-Conditioner/Refrigerator/Washing-machine you like, head to the cashier to part with your money - and there you will no doubt see a Bajaj Finance desk. Fill in some paperwork and they will happily provide you with an equated-monthly-instalment loan to complete your purchase - all in under 10 minutes. If this somewhat sounds like the now ubiquitous BNPL (Buy-Now-Pay-Later) product, that's because it is much the same - albeit an offline version, i.e., BAF 1.0. But times are changing, and BAF 2.0 has been in the works, with an upgrade to a digital super-app - one that not only offers BNPL, but also payments and a marketplace. BAF now boasts ~60 million customers and nearly 140 thousand distribution touchpoints.

A pertinent question that arises here, "But aren't there some fintechs doing all this already, and wouldn't that lead to disruption risk?" Yes, there are indeed many fintechs in India. By some estimates, nearly 5000 of them across verticals, of which ~1500 have sprung up within the last 5 years. The difference between BAF and the rest though, is in their costs of customer acquisition. Instead of needing to dole out hefty discounts and freebies, BAF already has a pipeline of transacting offline customers that it has been onboarding / funneling onto their online platform. Besides, more than just a large customer base, what matters is the 'actively transacting' customer base. Not to forget, 'collections' - which is the holy grail of lending. How many fintechs can collect on their loans using technology alone, remains to be seen. Early evidence suggests having an on-ground collection team is essential, even critical - which is partly why there now are so many fintech-bank partnerships. But even there, the regulator is working on new rules to ensure sufficient skin-in-the-game (aka capital and licenses) from the fintech's side, rather than relying entirely on their banking partners.

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As such, the financials sector's profits have more than quadrupled in 3 years. The sector's share in total listed company profits fell (collapsed actually!) from 27% in FY13 to just 8% in FY18, thanks to a cleanup of bad loans as directed by the central bank. It is back now to 29% in FY22, and looks strongly poised to increase from here. While foreign investors own ~20% of the top listed companies in India, this number was higher for financials - until the outflow of the last 10 months (till July 2022), where FPIs sold ~USD 32bn in equities, mostly in financials and IT services - which is where they were already sizable holders. The follow-up question that always seems to worry investors is on near term valuations. Quality lending franchises with class-leading growth tend to trade at 4 to 5 times 1-year-forward price-to-book. Isn't that too expensive? Perhaps looking at it this way presents an incomplete picture. Let us say there are two lenders A and B, both with a net-worth of 100 each. A is growing its book at 25% and B at 10%. A's 1Y forward price to book is 5x, while B's is 3x. B surely is cheaper, today. But if we consider the same growth compounded over the next 5 years, A at 1.6x suddenly becomes cheaper than B at 1.8x. Being long-term investors, we are fortunate to have the luxury of deploying our and our clients' capital into businesses with a horizon that is unfazed by short term market vagaries, including perceived near-term premia.

India is still viewed by some global investors as a tactical trade, while some choose to not have any allocation at all. Others consider their India exposure via MSCI World or MSCI Emerging Markets to be adequate. But with India making up just ~1% of the former and ~14% of the latter, such an allocation is likely suboptimal. Per estimates by Morgan Stanley, India's GDP is expected to contribute 22% to global growth this year. With the govt.'s various initiatives including digitization and financialization (covered above), export focus, manufacturing impetus, infrastructure goals, and possibly the only country with a predictable consumption story at such enormous scale, we believe that India should be a structural allocation in every global portfolio. That's forest over trees.

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Note: ASK's flagship concentrated ~20-25 stock India equity portfolio is tilted towards financials, consumption and manufacturing-beneficiary oriented businesses. Our portfolio is biased towards quality companies that can deliver strong earnings growth with exceptional capital efficiency.

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