# GROUND OBSERVATIONS FROM INDIA FINANCIALS & BANKS

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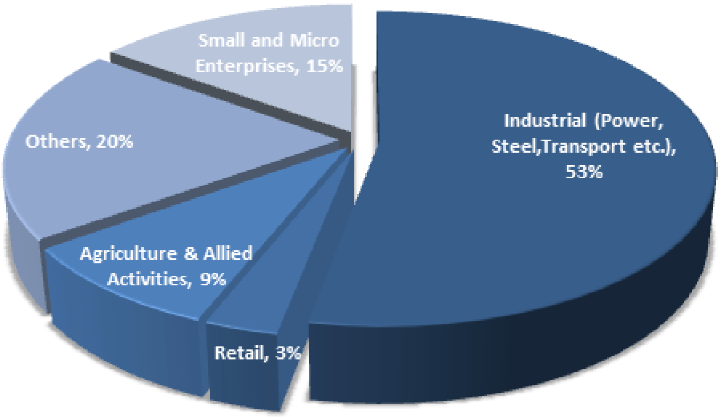
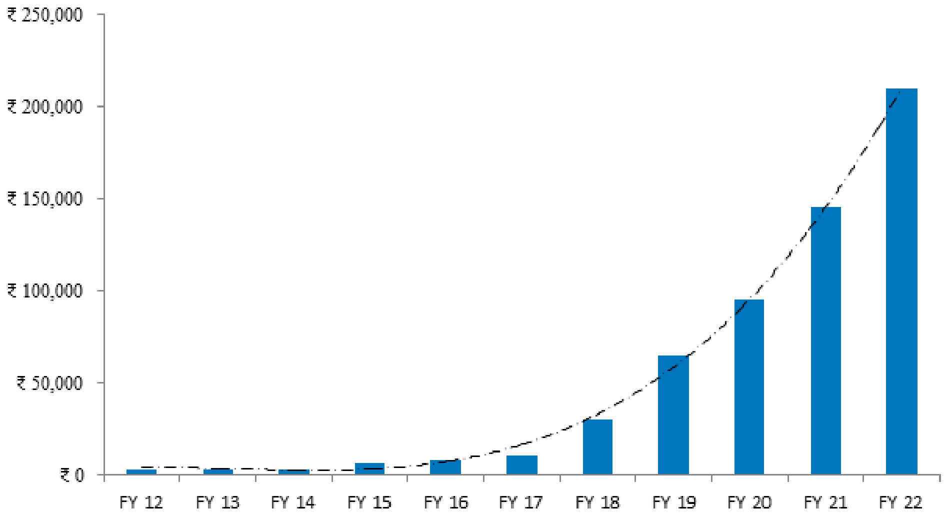
In my recent India visit, I interacted with C-level management of the top four largest banks in India, which collectively have roughly $300 billion in assets. While Indian Financials are facing pressures similar to all global Financials, the risks and associated rewards in India are slightly different. Below I discuss potential concerns associated with Financials that may not be applicable to all investors and why I believe India continues to be a great opportunity. **Nonperforming Assets—Creating Distinction Between Public and Private Sector Banks** When Dr. Raghuram Rajan took charge of the Reserve Bank of India (RBI) in September 2013, he was widely welcomed by investors owing to his stellar record as an economist at the International Monetary Fund. Between September 2013 and May 2014, MSCI India Financials rallied 58.76%, outperforming Nifty by a hefty 9.04%. However, since then the MSCI India Financials Index has gone down by 9.99% (annualized).[1] While global worries of Financials being under stress could be blamed, a real look under the lense reveals a lot. What has been clouding Indian Financials is a "disease" that Dr. Rajan and the Modi government recognized: nonperforming assets (NPA). A host of reasons, ranging from forced and bad lending practices to a slowdown in global growth, has resulted in approximately 20% of loan books for public banks being stressed. Any wise doctor would do a proper diagnosis before starting a treatment, and that is precisely what Dr. Rajan did. Steps RBI and the government have taken so far to initiate the recovery of these bad assets include restructuring debt to equity, liquidation of defunct projects, economic revival and introducing a new bankruptcy code to create a faster exit mechanism for banks. **Private Banks—A Great Investment Opportunity, Thanks to Rising and Powerful Middle Class** While all of that is certainly good news for Financials stocks from a long-term perspective, it is only part of the story. There is a key distinction in asset quality and, therefore, stock returns for Financials in India right now. Let's break down sector lending done by the top public versus private banks in India:[2] **Industrials loans as a percentage of total lending by public versus private sector banks** • Public Sector, Top 3 Bank Average—37.0% • Private Sector, Top 3 Bank Average—26.9% • **Public banks clearly have significantly higher exposure to the Industrials segment as a percentage of total loan books compared to private banks. Similarly, let's see the retail lending portfolio: •** Public Sector, Top 3 Bank Average—13.7% • Private Sector, Top 3 Bank Average—41.1% • **Private sector banks clearly have significantly higher exposure to the retail segment. Breaking down exposure in the WisdomTree India Earnings Index (WTIND), we find the following: •** Top 3 Public Banks Total Exposure—0.82% • Top 3 Private Banks Total Exposure—3.7% • **That is a significantly higher concentration in the private sector banks.** Thus, public banks have a higher concentration of industrial loans, private banks, on the other hand, are much more retail-focused. What I also found during my visit was a trend of recent defaults in India. The pie chart below reveals that 53% of defaults were in Industrials (or institutional) exposures, compared to a meager 3% on the retail side.[3] **India Banks & Financials—Total**




**New Defaults Sectorwise** Sources: Bank of America Merrill Lynch, HDFC, AXIS and ICICI Bank, as of 2/28/16. Thus- retail sector is doing vastly better and has minimal issues in financing itself. India has one of the fastest-growing middle classes and an economy [driven to a great extent by internal consumption](). To provide a sense of growth trends that are reflective of trends in retail banking and the needs of the middle class, the chart below shows astounding growth rates for mobile banking in India. **Mobile Banking—Projected Market Size (in INR (?) Billion)**




Sources: Bank of America Merrill Lynch, HDFC, AXIS and ICICI Bank, as of 2/28/16. Banking assets in India reached $1.46 Trillion as of Nov. 2015 and is expected to be $28.5 Trillion by FY25[4]. We believe that there is tremendous upside potential for investors by participating in economic growth of India. Investors who invest in India—Financials and specifically private banks—get an exposure that not only is potentially healthy, stable and increasingly accessible but also has unprecedented projected growth potential in the medium term. **RBI's Emphasis on Policy Transmission - Expanding Retail Lending & Benefitting Private Banks** So far Dr. Rajan has successfully tamed [inflation]() from a high of 11.13% (YoY) in November 2013 to current 5.18% (YoY)[5] and brought RBI's [FOREX]()reserves to all-time high. With inflation under control, RBI last-year engaged in consecutive rate cuts by 150 [basis points (bps)]() with the last 25 bp cut as recent as April 5th. Rajan's focus now seems to be shifting towards ensuring proper transmission of his rate cuts by banks to end customers. Some of his steps include: • Lowering the rate at which lenders access emergency funds deposited with RBI • Cutting the regulatory daily cash requirement which commercial banks have to hold (aka '[Cash Reserve Ratio]()') from 95% to 90% • Injecting [liquidity]() through open-market purchase by buying bonds worth up to Rs.150 bn Thus his policy is geared towards increasing liquidity through not just cutting rates but thru a host of other measures included. As effects percolate downwards and loans become cheaper, we expect significant pick up in the retail lending (especially mortgage and auto loans). Therefore in addition to markets that have historically benefited from rate cuts, RBI's latest effort towards increasing liquidity implies Private Banks with higher retail exposure (> 40% as covered above) could see an expansion of their loan books and earnings. **Participating in the Growth of India** Another reason for being invested in India and Financials is because of the Modi government's recent relaxation of foreign investment limits for Financials and banks in India. This means that as foreign equity flows into Financials, the weight of India in the MSCI Emerging Market Index should go up. We believe investors who have exposure to Financials in India could have a considerable strategic upside. For those looking for shorter horizons, private banks in India driven by the retail segment and internal consumption could be the place to be. The WisdomTree India Earnings Index represents this position with currently about 23% in Financials with 16% concentration to retail-focused private banks and Financials, giving it about 8% over-weight compared to the MSCI India Index.[6] [1]Source: Bloomberg, as of 3/28/16. [2]Sources for bullets: Bank of America Merrill Lynch, Bloomberg. [3]Sources: Bank of America Merrill Lynch, HDFC, AXIS and ICICI Bank. [4]Source: Indian Brand Equity Foundation, As of 03/28/2016. [5]Source: Bloomberg, As of 03/28/2016. [6]Source: WisdomTree, As of 03/28/2016.

#### Important Risks Related to this Article

Investments focused in India increase the impact of events and developments associated with the region, which can adversely affect performance.

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**MSCI India Financials** : The MSCI India/Financials Index is a free -float weighted equity index designed to measure the equity performance of the Financial sector of India . It was developed with a base value of 100 as of December 31, 199.

**Nifty Index** : The National Stock Exchange of India's benchmark index for the Indian equity marke.

**Non-performing asset** : A classification used by financial institutions that refers to loans that are in jeopardy of default.

**Inflation** : Characterized by rising price levels.

**Foreign Exchange (FOREX, FX)** : The exchange of one currency for another, or the conversion of one currency into another currency.

**Basis point** : 1/100th of 1 percent.

**Cash reserve ratio (CRR)** : The portion of depositors' balances banks must have on hand as cash determined by the country's central bank.

**Liquidity** : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

**MSCI Emerging Market Index** : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.