Dear Partner,

COVID remains a global challenge. Fortunately, COVID data in India has improved and continues to do so over the past month and a half. At peak, India was adding close to 100,000 cases a day, and had 1mn+ net active cases. As of mid Nov-20, weekly average gross addition is down over 50% from peak (at ~45k), and net active cases too are down ~55% from their peak (442,000 cases). Also, India's peak mortality rate in May-20 was about 3.4% (global peak mortality of 7%), and since has declined to about 1.5% (global average of 2.4%). Absolute number of deaths of ~1000 per day have fallen to ~500 over the past month and a half.

The way the listed companies and the economy reacted to COVID is noteworthy. Already reeling under the pressure of low growth and multiple disruptions (i.e. demonetization, GST, NBFC crisis, and now COVID), many listed companies (and especially leaders we track) decided to not waste this crisis. Companies re-aligned costs, those with high leverage pushed out duration or came up with a plan to reduce debt, and those that could, prepared for an accelerated online sales strategy. We are positively surprised by the H1 results reported by most of the companies we track (this though has primarily been driven by cost control so far). Similarly, for the economy as a whole, high frequency data has started showing signs of revival, especially over the past month and a half.

We are aware that these are early days – for banks a large portion of credit has just come out of moratorium and some of the consumption surge could be due to pent-up demand. We are tracking the development and commentary in the lending and consumption sector very closely to see if this improvement sustains.

In this letter, we re-cap the BFSI sector journey during COVID – we discuss how the system and leaders reacted as the crisis unfolded, and also share the work we did on tracking their progress as well as a few key points from our digital lending study.

<u>COVID and the BFSI sector</u>:

India used the global playbook of lockdown + stimulus to respond to COVID starting mid-Mar 20. However, the lockdown was the most stringent (national duration of 76 days), and the stimulus weak (~INR 6 trn of fiscal support, 2.9% of GDP). RBI was left to do all the heavy lifting to keep the system oiled (liquidity surplus) and stable (yields in check) using all tools available (OMO, loan moratoriums, rate cuts, and so on). A combination of lockdown, weak high frequency macro-data and general investor pessimism led to significant fall in all lending stocks – the Nifty bank dropped 48% (from 32,444 on 2nd Jan to 16,918 on 23rd Mar), HDFCB dropped 34%, BAF dropped 49%. Financial companies though were more sanguine – for example, HDFCB was guiding for accelerated market share gains going forward, and a more benign credit cost experience compared to GFC (they had peak GNPA of 2.1% in the GFC).

We, as a team, spent disproportionate time on the financials over the past few months and engaged in high intensity primary work to understand how lenders were strategizing *<u>and</u>* executing during these times. We had two possible paths:

1) One path was to take comfort in our past learnings that the well-capitalized lenders would use weak competition to consolidate their market share on their terms and improve terminal value

during this crisis. This, plus attractive valuation, meant adding and raising weight during the panic.

2) The other path was to take a more calibrated approach. There was a chance that the system could take years to grind out of a potential blow-up of retail and SME pools. The interconnectedness meant possible contagion, and in this scenario even the leaders could suffer from significantly lower growth and profitability in the future.

Given our higher starting weights, and the unique nature of COVID and many possible outcomes in a path dependent world, we decided to act only after doing another deep dive – we: (i) closely tracked how the companies were executing, and how the system was reacting; and (ii) continued our digital study; specifically focused on digital lending in the global and India context.

To track the trajectory of this important sector during the crisis, we initially decided to focus on monthly/ quarterly collection efficiency (it comes in several flavors: bounce rates, buckets, resolution rate) for the system and especially our names:

a. The data showcased collection efficiencies for rated retail loans jump anywhere between 1.4x to 6x from Apr-20 to Aug-20.

b. While point (a) suggests improvement in Aug-20 from the initial shock in Apr-20, it should be noted that: (i) the collection efficiencies were still significantly lower (any-where between 8% to 40%) than Mar-20 readings; and (ii) automated debit mandates rejection rates continue to improve, but much slower (180 bps decline by value, and 70 bps decline by volume from Jul-20 to Oct-20). This could be seen as a precursor to future pain in the system (ex of the RBI dispensations around NPA)[1].

c. HDFCB witnessed a much sharper recovery with demand resolution[2] going from 70% in Jun-20 to 97% in Sep-20 (this is almost close to pre-COVID levels). We don't have this data at a system level for Sept-20.

Given the spurious signal to noise ratio in these high frequency metrics, we embarked on more rigorous bottom-up primary work to contextualize the data and bridge the narrative of a weak system and strong leaders. We also continued our digital study, and specifically focused on digital lending. As we synthesize our study of the past many months, we have 5 key takeaways from this:

1) **The system, instead of imploding, improved balance sheet strength** with several players raising capital early on (total capital raised was INR 563 bn with plans to raise additional INR 558 bn across 15 players; both HDFC Bank and Bajaj Finance did not raise any further capital). Firms complemented this capital raise by correcting ALM mismatch and aggressively provisioning. The degree and capability of these counter cyclical measures varied but the intention to prepare and not predict was evident. This system-wide capital raise significantly lowered contagion risk. (Refer table below point 3 for dataset)

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[1] RBI has allowed asset classification stand-still since Mar-20 through combination of Morat 1 (Mar-20 to May-20), Morat 2 (Jun-20 to Aug-20), and one-time restructuring scheme. This will mean investors will have to wait till Mar-21 (for retail) and Jun-21 (for SME) to assess % AUM restructured. Restructured AUM gets tenor extension of max 2 years.

[2] HDFC Bank defines Demand resolution % = INR received from borrowers / INR presented to borrowers.

2) **Credit growth: a temporary slump –** credit growth has been lowest in ~5 decades but needs to be viewed in conjunction with expected GDP contraction of ~10% for FY21. Mass affluent are seeing their savings go up – this helped banks raise CASA, and also some of these savings may translate into spending going forward (e.g.; credit card, though a very small percentage of overall spends, are already close to pre-COVID levels despite travel and hospitality being down by ~80%).

3) **Increased divergence in credit cost** – Credit costs are a function of the back book. Therefore, quality of this book pre-COVID should turn out to be the single biggest determinant of eventual gross credit costs throughout the crisis, and in this the gap between the leaders and other players widened.

The table below captures the improvement in key parameters for the leaders over last 9 months and is a good indication of how things are playing out. We share more details on how things panned out for the system and the leaders in Appendix 1, 2 and 3.

Banks*	CAR^ FY20 Q3	CAR FY21 Q2	PCR^ FY20 Q3	PCR FY21 Q1	Moratorium 1st Disclosure	Moratorium 2nd Disclosure
HDFC Bank	18.5%	19.1%	119.0%	154.0%	15.0%	9.0%
Bajaj Finance	26.9%	26.6%	75.5%	331.2%	27.0%	15.7%
Kotak Mahindra Bank	18.2%	22.0%	64.4%	94.0%	26.0%	9.7%
ICICI Bank	16.5%	18.5%	76.2%	101.7%	30.0%	17.5%
Axis Bank	18.7%	19.4%	68.1%	124.0%	27.0%	9.7%

** Banks have used their discretion in the method of implementation of moratorium (Opt In/Opt Out). Hence, Moratorium numbers are not strictly comparable. Moratorium has ended on 31st Aug 2020 and the above mentioned entities have stress pool share ranging from mid to high single digit of the loan book. (^CAR – Capital Adequacy Ratio; PCR – Provision Coverage Ratio)*

4) **Whole new digital paradigm –** Under the important yet topical COVID discussions, the Indian banking is silently ushering a whole new digital paradigm that has the power to structurally make banking smoother, affordable, and accessible to millions more. India is pole vaulting on building digital rails to take lending to the masses with less friction and enhanced data visibility. The trinity of India Stack[3] + AA[4] + O-CEN[5] has the potential to do to lending what UPI[6] did to payments.

5) **Value displacement could accelerate** – There would be a handful of lenders standing at the other side of COVID who have the combination of capital + tech capabilities + culture to leverage this massive opportunity for financial services penetration. They would be prime beneficiary of significant value displacement that will happen from laggard public sector banks (still have ~60%

[3] India stack – Is a set of APIs that allows system actors to utilize a unique digital Infrastructure to solve India's hard problems towards presence-less, paperless, and cashless service delivery.

[4] AA (Account Aggregator) – An Account Aggregator is a Consent Manager for Financial Data: a new class of NBFC approved by RBI to manage consent for financial data sharing.

[5] O-CEN is a credit protocol infrastructure, which will mediate the interactions between loan service providers, usually fintech and mainstream lenders, including all large banks and NBFCs.

[6] Per NPCI statistics on retail payments, UPI transaction volume share has jumped from negligible in FY17 to 61% in Oct-20. Value share moved from negligible to 25% during same period. UPI has been transformational in taking payments digital, and not only has it been successful in India, but is a unique successful global story.

market share of advances). We believe that a combination of lack of growth capital with public sector banks and sufficient readiness of large private banks / NBFC to adapt to the India Stack + AA + O-CEN trinity will further accelerate value migration to the large private lenders.

Some of the above takeaways were a result of our recent study on digital lending opportunities in India, which we wish to share with you in detail in a future letter. However, we leave you with few key insights that emerged and strengthened our conviction in our leaders:

a. Globally fintech's have tried the aggregation playbook to lending and this has yielded poor results thus far:

- Most fintech companies are on the payment side, and the jury is out on: (i) their ability to add lending as a product; or (ii) the emergence of a pure successful lending fintechs (China is the exception but the circumstances here are unique).

- Lending fintech's tried to aggregate customers and banks on either side, but it is harder to dominate the funding side as it is usually concentrated in the hands of large lenders. This asymmetry along with fintech's over-reliance in their underwriting algorithms (using alternate data) tilted terms of trade in favor of lenders (such as high first loss guarantees).

- Several fintech lending books are recording spectacular high credit costs (OnDeck delinquencies jumped 4x, Monzo actual losses came in 8x of expected losses).

- The current Buy-Now-Pay-Later (BNPL) product also appears to suffer from similar blind spots (sporadic underwriting sophistication, low support from banks). Several fintechs currently benefitting from higher growth appear to be lending to a below prime cohort or lending out of equity (sustainability of these could get tested in the long run).

b. Understanding the difference between the global playbook and India

- There is both a general difference between the global and India playbook for startup and incumbents, and also one specific to BFSI.

- Generally speaking, the play in most developed markets for startups is to build from scratch business models that are relevant for a digital world, and then attempt to scale quickly and gain share from the incumbent. The incumbent startup fight is usually to redistribute profit as these markets have high penetration and low growth. India has two key differences from the global playbook: (i) we are still a largely underpenetrated and high growth market and there is room for both incumbents and startups to grow the pie significantly; and (ii) usually speaking (and this is changing), inefficiencies in India make it harder for startups to scale at speed, and this allows proactive incumbent leaders more time to watch the startups and adapt to a digital world.

- In addition to this general difference, Indian policy makers are doing something unique for the lending infrastructure in India (more below).

c. Indian policy is rewiring the core lending infra using tech to expedite formal lending penetration in a credit starved market

- India suffers from a large informal lending market, and even within the formal system lending rates and credit costs are high because of the lack of data and transparency.

- Indian policy (after successfully rolling out UPI for payments) is now focusing on using tech to digitize and democratize lending through the guard rails of India Stack + AA + O-CEN. These pieces economize the operating costs (KYC, payments, collections) and credit costs in the following manner:

  - India Stack: Provides a fully digital identity (Aadhaar) and authentication engine along with a multi form factor payments layer (UPI, AEPS, BBPS). It also provides tools to make lending process paperless (Digital Locker, e-Signs).

  - AA: Establishes a system for digital consent based data exchange. It puts the ownership of data (regardless of where and with whom the data is stored) and consent to share data (digitally and legally) with the data generating entity.

  - O-CEN: Establishes credit protocol that digitizes and broadcasts loan application across universe of participating lenders.

- If executed well, this unleashes massive productivity and is a win-win. Borrowers benefits from better interest rates. Lenders benefit initially from efficient access to India's gargantuan credit demand (~11% SME have access to formal credit, only about 30 mn retail files have good data), and subsequently from better underwriting due to availability of significantly higher quantum of data. Formal credit could accelerate and transparent data could mean lower risk adjusted rates to the worthy borrowers, and less systematic credit risk for lenders leveraging the architecture.

d. In this new lending opportunity in India, we believe the advantage lies with the large digitally ready incumbent lenders (over both emerging fintechs, public sector banks and smaller private sector lenders)

- We conjecture that digital ready lenders would emerge to capture major share of transaction value (potential product RoA expansion). Rather than compete, we see an opportunity for large tech companies to augment their core product journeys with loan origination service in partnership with these lenders.

e. Our study showcased varying shades of readiness among Indian lenders for this opportunity. HDFCB and BAF clearly top the list on this attribute giving them a very valuable head start, and we will expand with you in detail in a future letter.

While the shape of future economic recovery and credit costs remain uncertain and hard to forecast, our work makes us positive on not just sustenance but accelerated accretion to terminal value and market share of our portfolio names (HDFCB and BAF) for two main reasons:

1) These franchises have and are likely to report significantly better credit cost experience than the system and versus what they guided. Both players provided extensive disclosures to drive home industry beating quality of their AUM entering COVID. We are now seeing the benefits of the same play out as majority of lenders guide for provision write-backs.

2) They are way ahead of the competition in self-disrupting and re-architecting their business models from the ground up to harness full impact of digital capabilities that are being introduced.

We initially adopted a wait and watch policy on lending names in the portfolio (for example, HDFCB weight dropped from 20% in end-Mar to 15% beginning-Oct). We started adding back to the lending names as data showed improvement, the risk of contagion is significantly lowered, and our digital lending study highlighted faster accretion to terminal value as displacement of the weaker players accelerates.

Concluding thoughts – long term reforms continue, near term (hopefully) bottoming out:

The last few years have been extremely challenging for Indian companies. An entrepreneur we were talking to said *"Just give me a normal year with no major disruption and nothing else"*. We believe this sentence beautifully captures the state of mind of most Indian companies.

When we started 10-years back, we could not imagine how Indian companies not growing in double digits. Today most are struggling to find growth in some of the most under penetrated sectors. This has happened in the backdrop of continuous near-term disruption, and hopefully this should reverse.

At cost of repeating myself (for over so many letters), I continue to believe that the structural longer term reforms[7] undertaken by the government over the past few years will raise long term growth potential, and sometime in the near future the short term disruptions should stop. Whenever this happens, macro-economic improvement will provide a tailwind to the leaders we have partnered with, and therefore we continue to remain optimistic.

As always, thank you for your trust and patience, and wish you all a very happy Diwali.

Warm Regards,
Nimit Tanna
Nov 19, 2020

[7] The government continued structural reforms over the past few months, the key recent announcement being for the IT and BPO sector https://twitter.com/sanjeevsanyal/status/1324373067787694080

Appendix 1

Data Panel Evolution

Stage	Month	Active cases	Fatality rate	Government actions	RBI actions
Pre-Covid	Jan-20				• Operation Twist
	Feb-20				• LTRO begins
Moratorium 1 Block	Mar-20	1,201	2.5%	• Lockdown 1 • Mass Labor Migration • Garib Kalyan Yojna – INR 1.7 tn	• Rate Cut • More LTRO • TLTRO begin • Moratorium 1 begins
	Apr-20	25,000	3.3%	• Lockdown 2	• Reverse Repo Cut • More LTRO • More TLTRO • Operation Twist • Grants refinancing Facilities • Incremental means and ways advances for states
	May-20	93,322	2.8%	• Lockdown 3 • Partial essential unlocking allowed • AtmaNirbhar package of INR 20 tn – MSME Scheme	• Rate Cut • Moratorium 2 begins
Moratorium 2 Block	Jun-20	220,114	3.0%	• Unlock 1 • Railways starts resuming services • Domestic flights resume with 30% schedules	
	Jul-20	565,103	2.2%	• Unlock 2 and 3	• Operation Twist
	Aug-20	785,996	1.8%	• Unlock 4 • Q1 GDP contracts 24%	• Operation Twist • One time restructuring announced
Post Moratorium	Sep-20	940,643	1.6%	• Metro Resumes • AstraZeneca trials stop	• Operation Twist • Inc limit for HTM buckets
	Oct-20	603,687	1.5%	• Unlock 5	• Operation Twist • Bigger size OMO • begin OMO for SDL • Puts TLTRO on tap

In all appendices, currency is INR unless stated otherwise

Appendix 2

Data Panel Evolution

	Month	Repo Rate	10 yr GSEC	Term Premium	AAA Spread	AA Spread	MCLR 6 month	LAF absorption (INR bn)	Credit growth
Pre-Covid	Jan-20	5.2%	6.6%	1.4%	0.8%	3.7%	8.1%	3,178	8.5%
	Feb-20	5.2%	6.4%	1.3%	0.7%	3.7%	8.1%	3,162	7.3%
Moratorium 1 Block	Mar-20	4.4%	6.2%	1.8%	1.0%	4.6%	8.0%	3,902	6.8%
	Apr-20	4.4%	6.3%	1.9%	0.9%	4.9%	8.0%	6,852	7.4%
	May-20	4.0%	5.8%	1.8%	1.0%	4.9%	7.8%	7,504	7.0%
Moratorium 2 Block	Jun-20	4.0%	5.8%	1.8%	0.8%	4.5%	7.6%	6,175	6.9%
	Jul-20	4.0%	5.8%	1.8%	0.5%	3.1%	7.5%	6,012	6.9%
	Aug-20	4.0%	6.0%	2.0%	0.5%	2.7%	7.4%	6,071	5.5%
Post Moratorium	Sep-20	4.0%	6.0%	2.0%	0.5%	2.5%	7.3%	5,084	5.1%

System Level Voices

Moratorium 1 Block

1. A 5% contraction in FY21 GDP gets anchored
2. Massive job losses, unprecedented bounce rates and doubling of system NPA become consensus
3. RBI under pressure for: a) Loan restructuring, b) Corp Bond repo, and c) Repo facility for NBFC
4. MMT theories surface
5. Government under pressure for stimulus with focus on poor, MSME, and broader economy

Moratorium 2 Block

1. A 24% GDP contraction leads to -10% as new GDP contraction anchor
2. Despite MSME ECLGS scheme – worries around MSME mortality persist
3. Industry pressures RBI to not extend Moratorium but replace with restructuring
4. People read plateauing of collection efficiency as indicator of humongous NPA

Post Moratorium

1. India stack coming of age goes completely unnoticed
2. SC ruling on interest on interest becomes key pivot for bank profitability
3. Calls for fiscal stimulus grow ahead of festive season
4. Weak 2W numbers in Sep-20 make system nervous on recovery

Appendix 3A

HDFC Bank – what the best-in-class did

Period	Action	Detail
Moratorium 1 Block	1) Prepare by strengthening the B/S	• Conducts stress tests and accordingly begin boosting PCR and LCR on an accelerated basis • Guides that GFC NPA experience of 2.1% remains outer limit for stress • Highlights 15% AUM under Moratorium and 9% potential SME book under stress
	2) Accelerate market share gains on bank own terms	• Demand for credit far outstripping supply across segments • Tightens credit standards by 25% and still getting deluge of customers • Significant deposit share gains as flight to safety plays out
Moratorium 2 Block	1) Prepare by strengthening the B/S	• Continue to boost LCR and PCR on accelerated basis • Highlights 9% AUM under Moratorium and 5% potential SME book under stress
	2) Accelerate market share gains on bank own terms	• Corporate book starts to grow at multi-year high rates off-setting 60% collapse in retail disbursals
	3) Begin executing collections program aggressively	• Rejigs resources to boost collection teams internally, and with exclusive external agencies • Resolution rates progress to 70% of pre-COVID run rates
	4) Unveils HDFC Bank 3.0 Digital mega push	
Post Moratorium	1) Prepare by strengthening the B/S	• Continue to boost LCR and PCR on accelerated basis • Highlights negligible restructuring requests, and <3% potential SME book under stress
	2) Accelerate market share gains on bank own terms	• Aspires to double system market share in next 5 years • Corporate book starts to grow at multi-year high rates off-setting emerging recovery in retail • Several products originations nearing pre-Covid levels (80% to 90% bands) – calls out bottoming of retail book on growth
	3) Begin executing collections program aggressively	• Collection Efficiency > 80% across products • Positively surprised by recoveries happening in the book
	4) Unveils HDFC Bank 3.0 Digital mega push	• In 6 months, launches all digital auto and health platforms • Festive treats campaign launched at 10x size of last year
	ADITYA PURI SIGNS OFF - END OF AN ERA	

Appendix 3B

Bajaj Finance – what the best-in-class did

Period	Action	Detail
Moratorium 1 Block	1) Prepare by strengthening the B/S	• Most aggressive cushioning built-on liquidity and coverage in industry • Guides for credit costs to be 90% to 100% of FY20 • Highlights 27% AUM under Moratorium • Commits to run a fully costed P&L and upfront all pain in FY21
	2) Accelerate BFL 3.0 transformation	• Re-wire organization to run faster, leaner, and cheaper post-Covid
	3) Design and begin executing collections program	• Double capacity in collections capacity - internally and externally • Constant touch with customers to explain Moratorium and sensitize them towards value of timely payments of EMI
Moratorium 2 Block	1) Prepare by strengthening the B/S	• Most aggressive cushioning built on liquidity and coverage in industry • Guides for credit costs to be 100% to 110% of FY20 • Highlights 15% AUM under Moratorium • Commits to run a fully costed P&L and upfront all pain in FY21
	2) Accelerate BFL 3.0 transformation	• Re-wire organization to run faster, leaner, and cheaper post-Covid • Fully open for business across 85% locations but with 30% tighter credit filters
	3) Design and begin executing collections program	• Consistent improvement in collections efficiency month on month
Post Moratorium	1) B/S strengthening done – turn pro-growth	• Guides for reaching FY20 origination run rates by Apr-21 • Sep-20 new loan bookings grow 100% QoQ • Incremental book significantly better than back book • ECL models predicting write backs but will provide per earlier schedule as prudence
	2) Accelerate BFL 3.0 transformation	• Eliminates ~10% cost bases structurally • In 3 years, BAF will see higher fee to PBT, Lower opex, and almost double the size of customer franchise

Appendix 3C

Kotak Mahindra Bank – what the best-in-class did

<table>
<tr><th>Period</th><th>Action</th><th></th></tr>
<tr><td>Moratorium 1 Block</td><td>1) Protect the B/S</td><td>

Takes a "Never Normal" world approach of paranoia
Identifies 27% AUM under Moratorium
Calls for change of biz model:

Go slow in branch openings - let go office spaces;
Digitize programs across bank to scale rapidly;
Focus on fee business more than credit business;
Paranoid on lending: nobody is safe – re-look every sanction

System will see widespread job losses; unsecured books to blow up
Only bright spots – Agri & MSME loans through MSME ECLGs scheme
</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>Moratorium 2 Block</td><td>1) Protect the B/S</td><td>

Takes a "Never Normal" world approach of paranoia
Identifies 9.6% AUM under Moratorium
Calls for system to raise capital and brace for heavy shocks
Aggressively disbursing under MSME scheme – 5% share of scheme disbursal against 2% share of MSME credit
In retail, only focus will be on mortgages and rural
All other business across bank to consolidate
</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>Post Moratorium</td><td>1) Turn pro growth</td><td>

Does a volte-face – situation is stable, and we have over provided for Covid related stress
Collection efficiency close to pre-Covid run rates in secured books
Unwinding collection teams that were beefed up
Covid impact to be unevenly distributed – more on-to lower salaried segments
Aggressively disbursing under MSME scheme – 6% share of scheme disbursal against 2% share of MSME credit
Floodgates are opening up: time for us to pick and choose customers on our terms – we will begin open market acquisition also
</td></tr>
</table>