TRIVANTAGE CAPITAL

VANTAGEPOINT

Our Focus Makes All The Difference

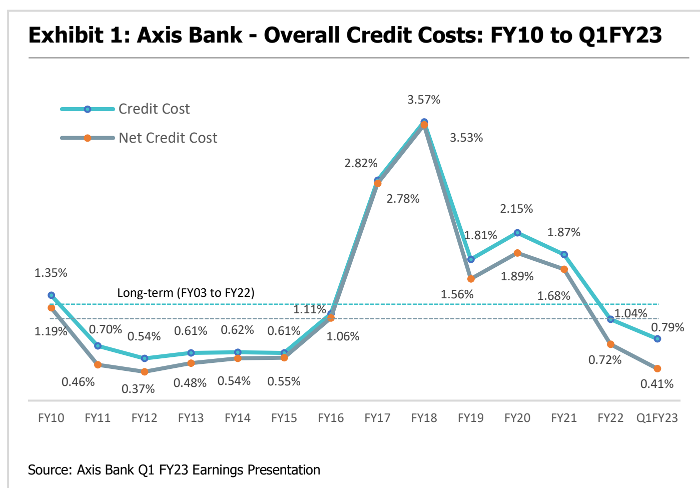
Dear Investor,

Themes emerging from the recently concluded earnings season for Q1 FY23:

1. Credit costs of the previous credit cycle are behind us for lenders across the spectrum

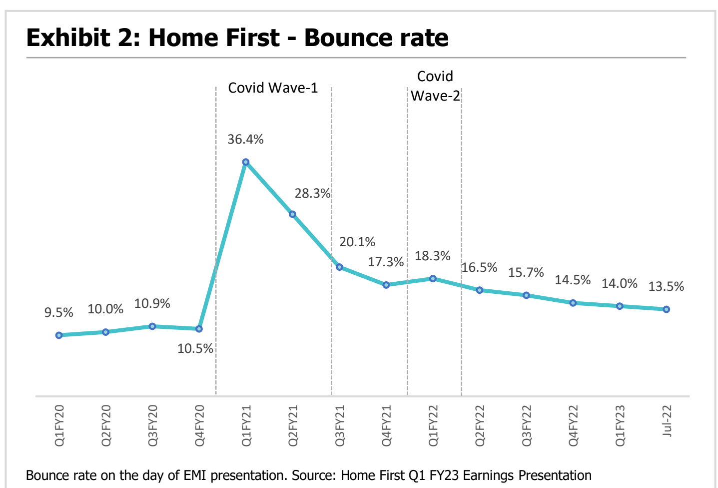
It was evident this earnings season that the credit costs of the previous credit cycle are behind us now. Exhibit 1 shows how, in the case of Axis Bank, the credit costs have now moved below the long-term average for the bank. This exhibit is a representative of other banks. Similarly, for Non-Banks, the asset quality trends have shown a distinct improvement.

Exhibit 1: Axis Bank - Overall Credit Costs: FY10 to Q1FY23



Source: Axis Bank Q1 FY23 Earnings Presentation

Exhibit 2: Home First - Bounce rate



Bounce rate on the day of EMI presentation. Source: Home First Q1 FY23 Earnings Presentation

Exhibit 2 shows how the cheque bounce rates have consistently dropped after rapidly rising during the pandemic waves in the case of Home First, another portfolio company. Recently, three of our portfolio companies, AU Small Finance Bank, Home First and Credit Access Grameen received credit rating upgrades as credit quality concerns were addressed well by these three lenders post the first two waves of the pandemic. In our opinion, the market has priced this bottoming out of the asset quality concerns in the case of lenders and has now begun focusing on the emerging credit cycle.

2. Focus is now on credit growth for the lenders

Exhibit 3 shows how SBI has shown an impressive credit growth of over 13% p.a. with over 20% p.a. growth each in sectors such as Petroleum, Aviation, Telecom, Tourism and Retail.

This augurs well for the overall GDP growth rates for India in the coming years despite a sluggish growth outlook for the western developed economies.

Exhibit 3: SBI – Credit Growth (Diversified Industry Mix)

Outstanding as on 30th June 2022	Fund Based O/S		
Sectors	**Amount**	**% Share**	**YOY Gr%**
Infrastructure	3,56,550	14.55	8.21
of which: Power	1,93,339	7.89	5.73
Telecommunication	39,701	1.62	26.36
Roads & Ports	91,799	3.75	10.49
Other Infrastructure	31,710	1.29	-1.35
Services	2,75,936	11.26	16.99
Iron & Steel	39,764	1.62	-12.46
Aviation & Airports	13,117	0.54	33.52
Tourism & Hotels	10,063	0.41	26.92
Textiles	33,138	1.35	2.81
Petroleum & Petrochemicals	44,437	1.81	39.84
Engineering	20,383	0.83	11.04
Comm. Real Estate	42,378	1.73	-3.67
Other Industries	3,51,024	14.32	9.73
Home Loans	5,75,075	23.46	13.77
Auto Loans	82,012	3.35	10.45
Other Retail Loans	3,77,024	15.38	28.95
Agriculture	2,29,922	9.38	9.82
Total Domestic Advances	**24,50,821**	**100.00**	**13.66**

Source: SBI Q1 FY23 Earnings Presentation

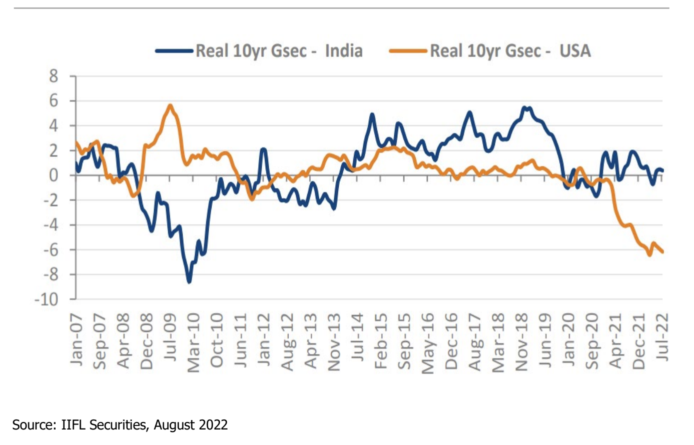
3. Policy repo rates are going up leading to an acceleration in pricing power and margins for leading banks

RBI in its August Monetary Policy maintained the growth and inflation outlook for FY23 at 7.2% and 6.7% respectively whilst increasing the policy repo rate to 5.4%.

We expect a further tightening by RBI in line with the other leading global central banks. Considering the 10-year GoI bond yield as a proxy for risk-free rates, India's real interest rates are almost Zero as compared to the negative real rates in the US as depicted in Exhibit 4.

We expect the real rates to move further up in both economies as inflation starts to moderate. We believe that the increase in yields will give banks some step up in net interest margins as they raise the lending rates immediately and follow up with raising the deposit rates after a gap.

Exhibit 4: Real 10-year G-Sec in India is almost zero, whereas for USA, it is near -6% due to high inflation



Source: IIFL Securities, August 2022

Market positioning and Outlook

The past 5 years have been quite tough for the sectors such as banks and auto as depicted by the way these indices have fared.

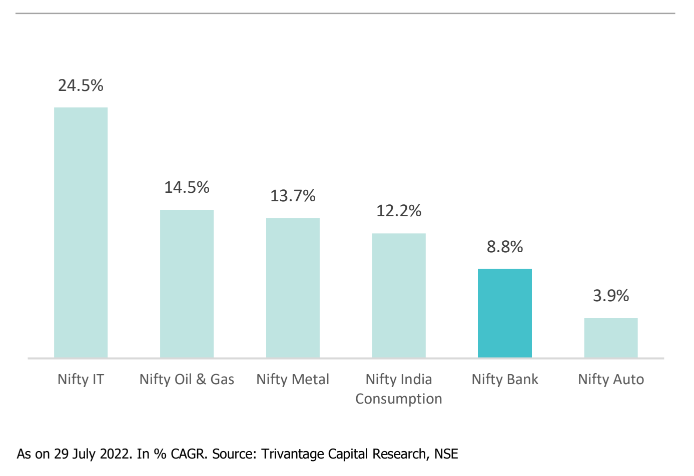
Exhibit 5 shows how Nifty IT generated a staggering 24.5% CAGR returns as compared to just 3.9% by Nifty Auto. Nifty Bank also underperformed with an 8.8% CAGR.

The key reason for banks' underperformance has been the credit costs resulting from the big-ticket lending to corporate borrowers during the previous credit cycle.

As the process of recognition of and provision for these NPAs was coming to an end by late 2019, the subsequent onset of the pandemic resulted in another round of slippages.

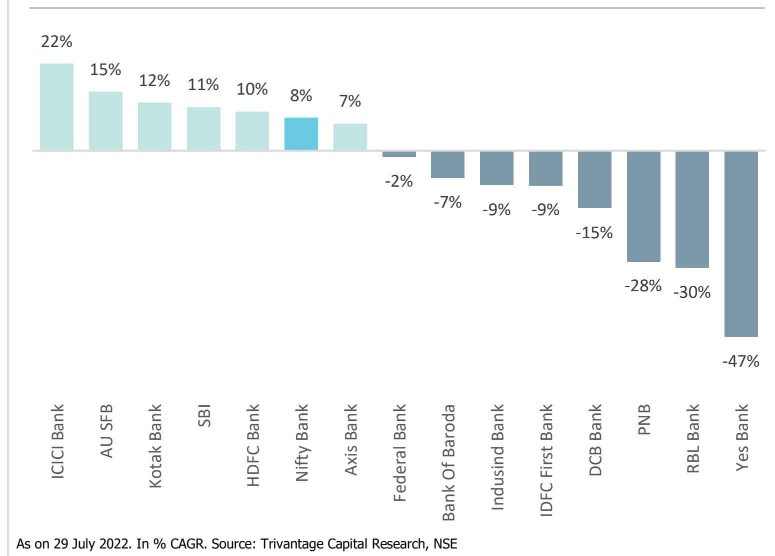
As a result, the period of stock market underperformance for the listed lending/underwriting businesses in the broad BFSI universe has now been a long period of 5 years.

Exhibit 5: Performance of key sector indices (5 years)



As on 29 July 2022. In % CAGR. Source: Trivantage Capital Research, NSE

Exhibit 6: Performance of select banks (5 years) (% CAGR)



As on 29 July 2022. In % CAGR. Source: Trivantage Capital Research, NSE

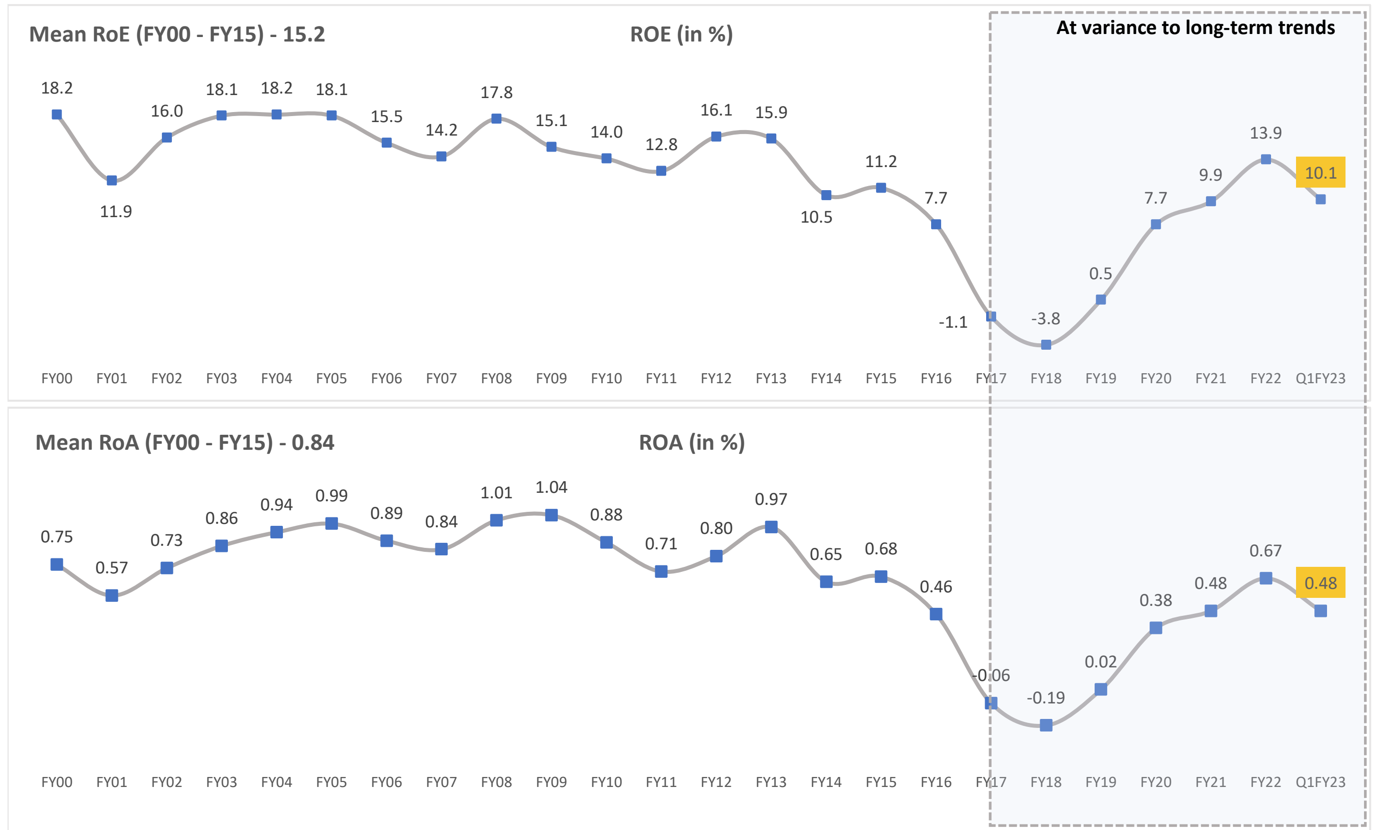
Exhibit 6 shows the differences in performance of banks within the Nifty Bank context over the same 5-year period. This is where the significance of the "bottom-up stock picking" gets highlighted so well. Whilst every bank had to make provisions for credit losses, some banks simultaneously improved the strength of their operating franchise significantly.

ICICI Bank has been the best example of this. The bank increased its tier 1 capital adequacy, credit growth, and core operating profitability on the back of a significant stride in Net Interest Margins and a lowering of cost income efficiencies. The bank's market-leading subsidiaries in the fields of life and general insurance, capital markets and asset management contributed to a much higher "sum of the parts" valuation.

On the other hand, a few smaller private sector banks, and most public sector banks, except for SBI, suffered huge pressure on their valuations.

Exhibit 7 shows how after some exceptionally weak years of the "return ratios", SBI has well-begun the process of normalization as per which the RoAs can move to a range of 0.8% to 1.0% and the RoEs can go up to a range of 16% to 18% given the high leverage ratio.

Exhibit 7: SBI – The process of normalization in RoEs and RoAs has begun



Source: SBI Q1 FY23 Earnings Presentation

Most banks are on the path to improving their return ratios. It will again be important however to make careful portfolio choices as some banks will be able to improve their operating efficiencies much ahead of others backed by a consistent improvement in their technological prowess amongst other enablers.

Portfolio Composition

Exhibit 8 shows our latest portfolio construct. The portfolio is well-diversified within the BFSI universe. The leading allocation is to a few private sector banks followed by diversified NBFCs and then public sector banks. Small & Mid-Cap stocks represent ~30% of our portfolio.

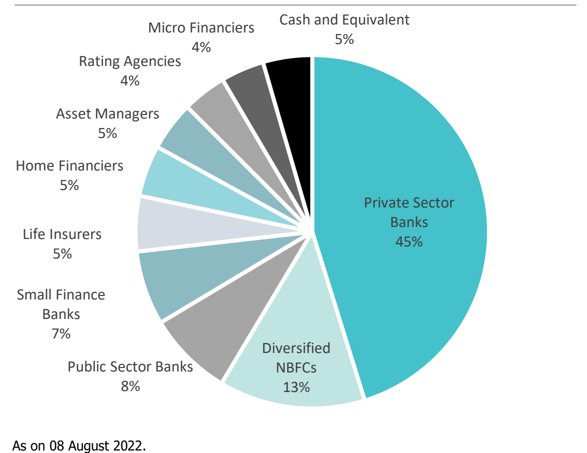
We believe that our portfolio companies have the strength and ability to win market shares within their segments and the resilience to withstand any adversities that may come up from time to time.

The pure-play financial services in India are dominated by lenders and these lenders in our portfolio have a very attractive opportunity to benefit as India embarks upon a new credit cycle.

We wish you the very best.

Exhibit 8: Resurgent Financials Equity Portfolio

Well-diversified with the BFSI universe



As on 08 August 2022.

Yours Sincerely,

Nikhil Johri
Founder & Chief Investment Officer

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