Indian Banks - Lay of the Land

A kid went to his father and told that he scored 10th rank in his class. His father being a rational man asked, how many students are there in your class? To which his son responded: 10. Jokes aside, there is an important lesson to learn.

Any intelligent analysis should answer the question: "**compared to what?**" Recently I came across Josh Tarasoff wonderful thesis on Amazon, which he presented in 2012. Click here to read it. The slide compares US e-Commerce sales with total retail sales summarized it all.

Historical e-commerce growth

$ millions	Total US Retail	Y/Y Growth	US E-commerce	Y/Y Growth	E-commerce % of Total
2001	3,067,965		34,448		1.1%
2002	3,135,269	2.2%	45,007	30.7%	1.4%
2003	3,266,790	4.2%	57,931	28.7%	1.8%
2004	3,467,850	6.2%	73,920	27.6%	2.1%
2005	3,693,913	6.5%	92,505	25.1%	2.5%
2006	3,885,877	5.2%	114,341	23.6%	2.9%
2007	4,008,096	3.1%	137,564	20.3%	3.4%
2008	3,945,364	-1.6%	142,508	3.6%	3.6%
2009	3,639,467	-7.8%	144,462	1.4%	4.0%
2010	3,887,725	6.8%	166,513	15.3%	4.3%
2011	4,195,820	7.9%	193,431	16.2%	4.6%

Another example which made me to spend few sleepless nights is the way in which Rasesh Shah explained the opportunity size in asset and wealth management. Someone asked him the following question. Would AUM for Edelweiss grew at 35 to 40 percent levels in 2 to 3 years time? The way in which Rashesh Shah answered the question is brilliant.

> To give you an idea, our estimate is that the current assets under advice for the whole Wealth Management industry is close to about Rs. 700,000 crores to Rs. 800,000 crores, which is close to about $120 billion to $130 billion in India. If you look at most of the other countries which have gone through this development phase, I think our long-term idea is that it ends up being somewhere between 40% to 50% of our GDP. So, to give you idea, you are supposed to be 50% of GDP even now, it should be $1.2 trillion, which is currently of only $120 billion. So, we do think that as GDP grows, like to give you an idea, US assets under advice of Wealth Management industry is 85% to 90% of the GDP, we are expecting in India it should be between 40% to 50% on GDP over the next eight to ten years. - **Rasesh Shah**

What an amazing clarity of thinking from Josh Tarasoff and Rasesh Shah. How are they able to think so clearly? I recently read The Lifetime Learner's Guide to Reading and Learning, which gave a nice template for thinking effectively. Spend time read, reread, and reflect on it.

> **Navigate levels up, down, and sideways:** A first step in this direction is to realize that everything is part of something bigger, and composed of parts that are smaller. Those who compile taxonomies and thesauruses call them "parent" and "child" concepts.
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> Impala is a child to Chevrolet, a Chevy engine is a child to the Impala. States are parts of nations, cages are parts of zoos, pages are parts of books. Books are parts of libraries (or bookstores – such relationships do not have to be unique or exclusive).
>
> In addition to "parent" and "child" ideas, there are "sibling" concepts: others in the same classification, genre, or type. You can't understand General Motors without understanding Ford, Toyota, and Volkswagen. You can't think clearly about Singapore without at least some understanding of Indonesia and Malaysia.
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> **Thinking in Time:** When looking at quantitative data (for example, the population of a city or profits of a company), the current number contains some information/knowledge but history contains much more.
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> If you tell me a company is worth ("market capitalization") $1 billion dollars, that does not tell me much. If I find out it was worth $100 million – or $5 billion – two years ago, that tells me much more, good or bad. Long-term time series data is very hard to find on the Internet.
>
> We are so focused on the last month, quarter, or year, that we forget to look at 5 years, 10 years, or 100 years. But such data is often found in books, sometimes old ones. When studying change through time, always ask, "What is the direction of change (up or down)?" and, "What is the rate of change (percent per year, compounded annually)?" - The Lifetime Learner's Guide

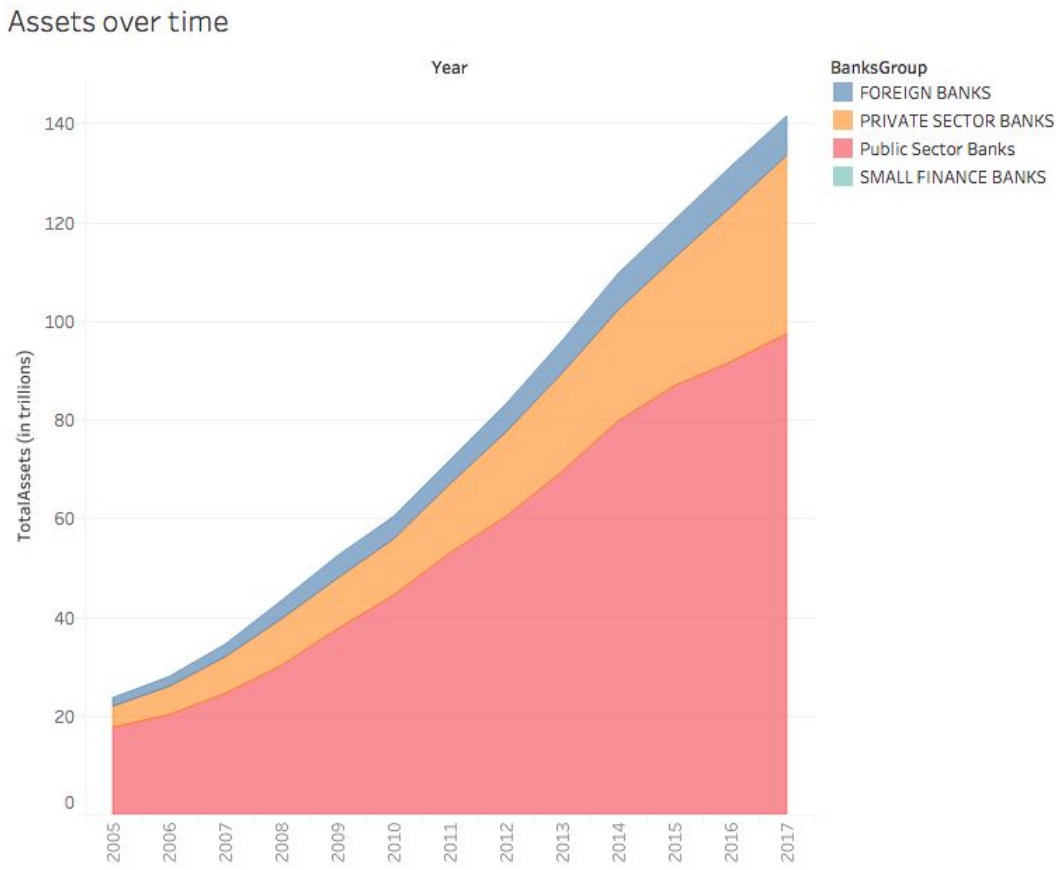
Knowledge without application is useless. I wanted to apply the above learnings to analyze the lending industry in India and study few players in it. Where should I start? Let's look at the total assets and advances (money lent out) by the entire lending industry. The table below shows the lay of the land. Public sector banks still holds a lion share of the market.

Private banks have been growing crazy over the last 2 decades. In spite of that, they control only 23 percent of the credit. NBFCs play an important role by providing credit and holds a decent share of the market. Foreign banks holds a tiny share of the credit pie.

Small Finance banks are the new boys in town. We will see what share of the market they will eventually get. Is credit of 96 trillion rupees low or high? India's credit-to-gdp ratio should be around 50 percent. This is low compared to US and China credit-to-gdp ratio of 150 and 200 percent.

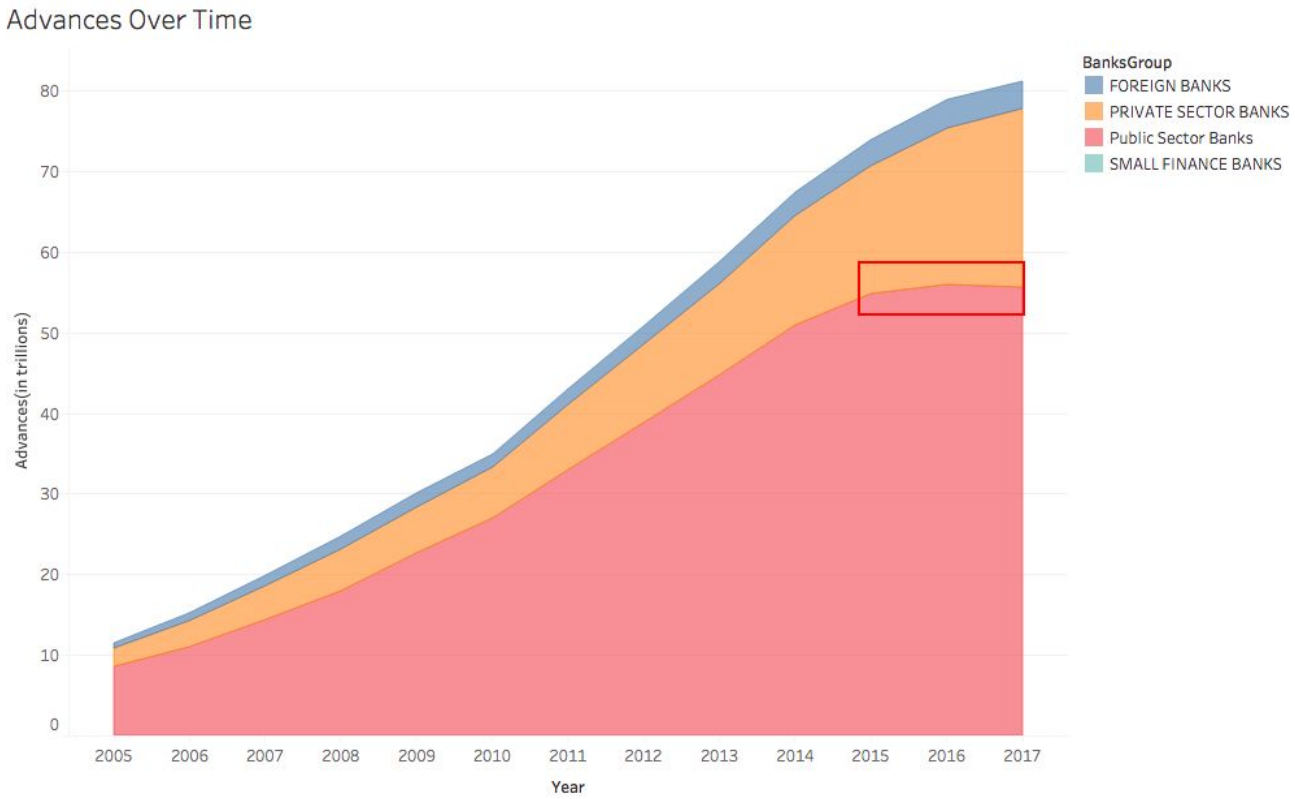
	2017				
(in trillions)	Advances		Total Assets		Advances To Assets
Public Sector Banks	56	58%	97	60%	57%
Private Sector Banks	22	23%	36	22%	62%
NBFCs	15	15%	20	12%	75%
Foreign Banks	3	3%	8	5%	41%
Small Finance Banks	0	0%	0	0%	59%
	96	100%	161	100%	60%

To gain deeper understanding, an industry should be viewed as an unfolding movie, not as a still photograph. Let us add time dimension to total assets in the banking industry. What do you see? Here are a few things that should be obvious.



Foreign banks haven't made a lot of progress in the Indian soil. Financial crisis kept them busy in their home country. Private banks grew much faster than PSUs. And there is clear value migration happening here. Also, there is still a lot of runway for private banks to grow.

Let us add time dimension to money lent out (advances) in the banking industry. The learnings we had from the previous chart is applicable to this chart also. Take a look at the rectangular box. What do you see?

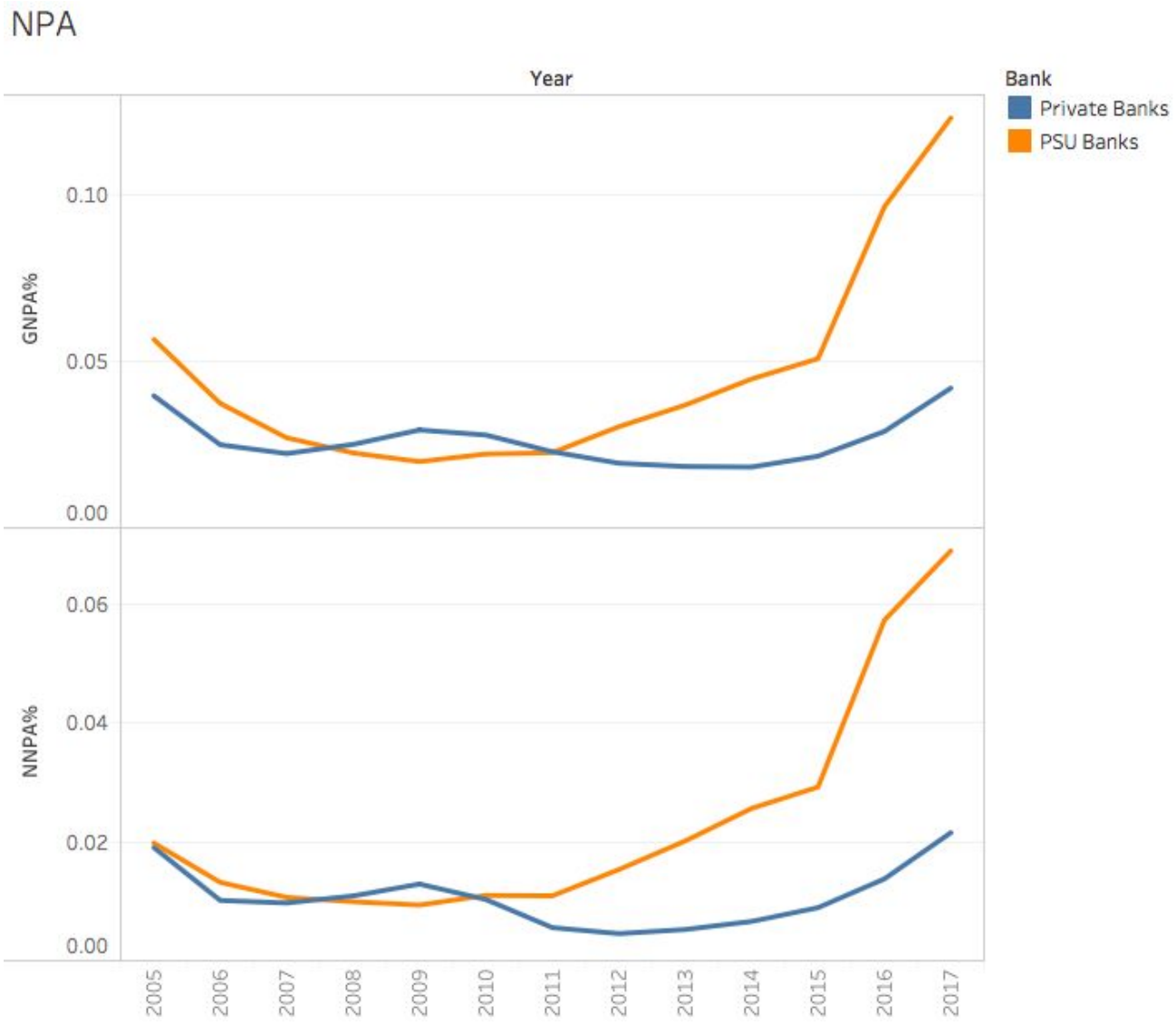


The credit growth for PSU banks have come to a stand still. For any economy to grow, there should be credit growth. The ratio of economy growth to credit growth is 1 : 2.5. For example, if the economy grows at 8 percent, credit growth will be around 20 percent. PSUs are holding a lion share of credit, and their growth stalling is a huge problem. Why did this happen?

PSUs used depositors money to fund non-viable infrastructure projects. They are paying the price for it. Around 12 to 13 percent of PSU assets are non performing. Provisions are only done for less then 60 percent of the assets. There is more to come. The chart below shows the astronomical rise of NPAs.

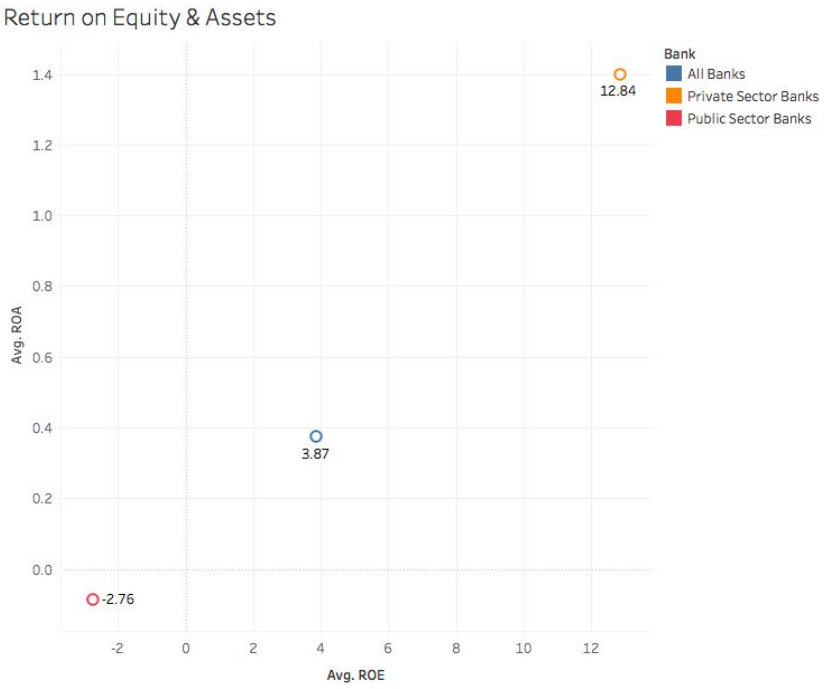
> Indian banks dodged the global financial meltdown in 2008. But they promptly embarked on a frenzy of lending to big companies, sowing the seeds of a home-made crisis. The PSBs gleefully funded infrastructure projects that never got the required permits, mines with an output made much less valuable by slumping commodity prices, and tycoons whose main qualification was friendship with government ministers. PSBs have tried to gloss over the problem for years, but the RBI is now forcing them to admit the true extent of the damage.

> By almost any measure, they lag behind their private counterparts. Costs gobble up 57% of their revenue, compared with 43% at private banks. Net interest margins, the difference between the rate a bank pays depositors and the one it charges clients, stand at 2.4% in PSBs and 3.9% in the private sector. No PSB is valued at more than the value of its assets minus debt (some trade closer to 20% of their book value), unlike almost every private bank. - Economist

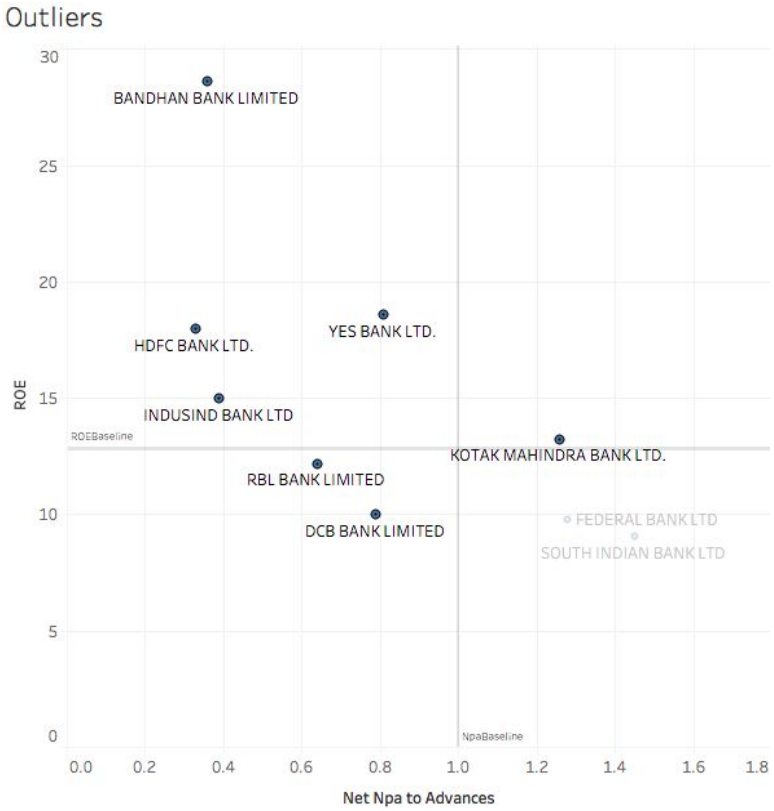


At some point these banks will be recapitalized, and the government will be accelerating its efforts on bankruptcy laws to clean up the mess soon. Only time will tell how the movie is going to unfold. I am keeping my fingers crossed.

I wanted to know the average return on assets and equity for public and private banks. I used 2016 and 2017 numbers to calculate the average. The chart below shows that private banks are way ahead of PSU banks.



This explains why at one point the market was willing to pay HDFC Bank the combined market capitalization of all PSU banks. Why did I calculate average returns? I wanted to get a list of all the banks who are at least generating the baseline ROE of around 13 percent and net npa to advances of around 1. These banks will form my study list.



To the list of outlier banks, I added State Bank and Canara Bank to learn more about their NPA issues, and use them to create a checklist for avoiding lending companies with similar patterns. Also, I added a few NBFCs that I already own or admire the management running them.

Sno	Bank/NBFC to study
1	HDFC Bank
2	Yes Bank
3	IndusInd Bank
4	Kotak Mahindra Bank
5	RBL Bank
6	DCB Bank
7	Bandhan Bank
8	Canara Bank
9	State Bank of India
10	Housing Development Finance Corp
11	Bajaj Finance
12	Piramal Enterprises
13	Edelweiss
14	Gruh Finance

Deep understanding on any subject can only be acquired by comparing, contrasting, navigating levels (up, down, and sideways), thinking in time, and understanding the cause and effect relationships. This is true for analyzing businesses. Using the above list, I will be developing my knowledge about the lending industry. I will share my learnings on these companies slowly and steadily over time.

I gathered all the data for my analysis from RBI website. It is a gold mine. I generated the charts using Tableau software. This is a skill I acquired recently. The tool is extremely powerful and it helps one to gain insights from tons of data. It is a life skill.

Disclaimer: The list of companies mentioned is not a recommendation to buy, sell, or hold. I am not a SEBI registered analyst. I wrote this document to organize my thoughts and deepen my understanding about the lending industry. I am sharing it so that you can learn something from this.

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