State of Indian Capital Markets and its Prognosis

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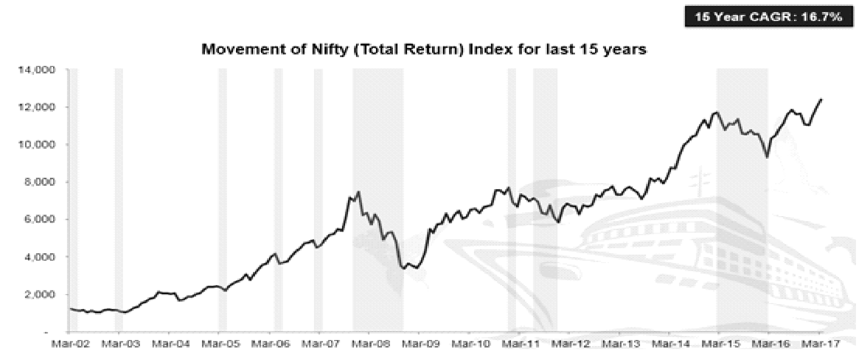
The growth of the Indian capital markets has been phenomenal, to say the least. In the last fifteen years, the large cap index – Nifty50 Index - has returned 16.7% per annum. This 10x growth in 15 years is in spite of several challenges including the severe global financial crisis.



Source: Bloomberg

Meanwhile, during the same time period, 10 year Government bond yields have come down from double-digit figures to the current level of 6.7%. The Crisil Gilt Index, which is a benchmark of the investment in government securities, has clocked a return of 7.8% per annum, thus tripling money during this period.

Source: Tradingeconomics.com

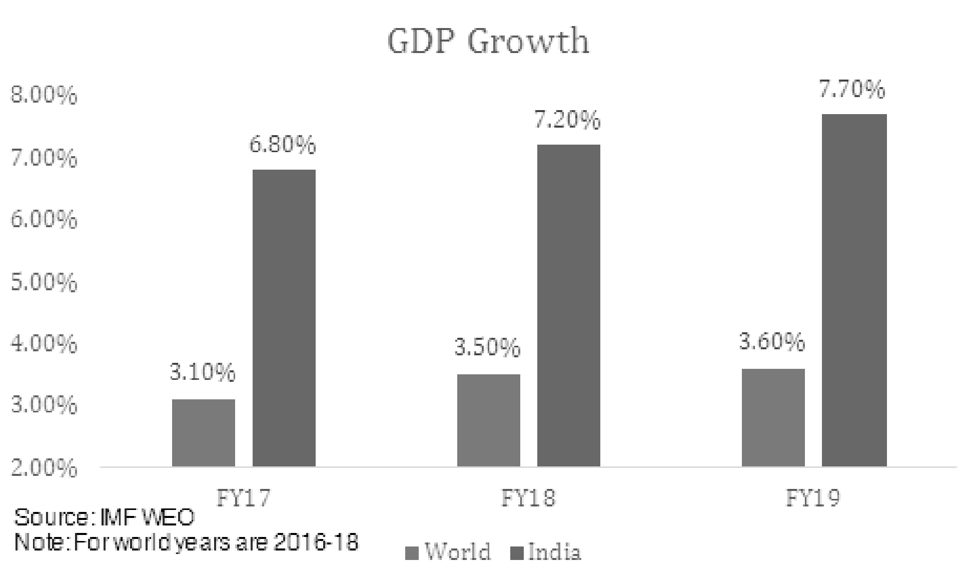
Over the years our capital markets have become far more robust from a regulation, risk and vigilance perspective. It is far more technology driven and globally connected with broad-based participation from domestic and institutional investors and well as retail participation, both directly and through the mutual fund route. Government regulations, SEBI and the stock exchanges have played a pivotal role in this development, such that the global institutions have had the confidence to increase their participation significantly in the markets.

In the past couple of years, our capital markets have been influenced by many factors. Some of the major steps taken by the government over the last three years are:

- Accelerating financial inclusion by opening bank accounts (Jan dhan accounts) and providing insurance and pension for those at the bottom of the pyramid.
- Creation of the "JAM" trinity (Jan Dhan – Aadhaar – Mobile combination) which can help in direct transfer of benefits to the needy without leakage.
- Maintaining the path of fiscal consolidation with a promise to achieve fiscal deficit target of 3% in FY19.
- Demonetization, compulsory declaration of PAN in purchase of high ticket items, mandatory deduction of tax for a real estate purchase of Rs. 50 lakhs etc. are all steps to curtail black money and increase money in the formal economy.

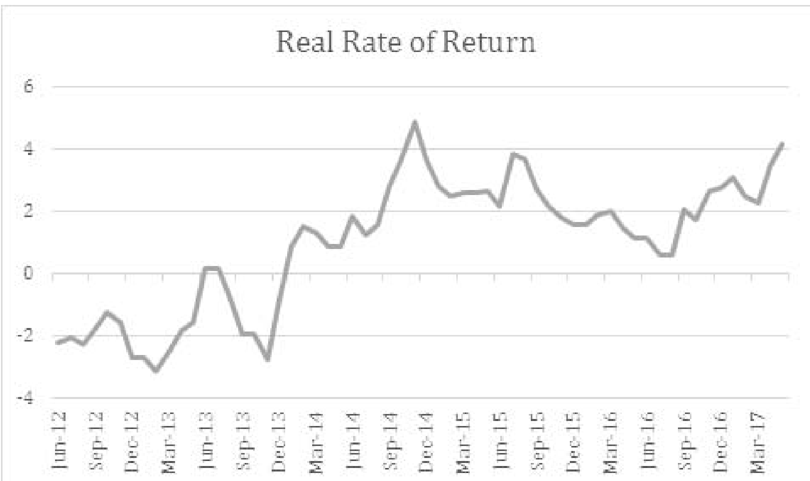
- ↳ Focus on rural areas providing short-term employment through MNREGA or government funded projects and initiatives.
- ↳ Increasing budgetary and non-budgetary spends in high multiplier areas of infrastructure like roads, railways and power.
- ↳ Easing the doing of business by measures like removing restrictions for FDI investments in various sectors, easier taxation through implementation of Goods & Services Tax, encouraging states to be competitive in attracting businesses, passing bankruptcy bill for closure of unviable ventures etc.

- The liquidity in the global economy is still awash with ECB and BoJ purchasing USD 70 bn & USD 85 bn per month respectively. The liquidity continues to find its way into various asset classes.
- The expectation of world GDP growth from 3.1% in 2016 to 3.5% in 2017 and 3.6% in 2018 is keeping the risk taking intent in the markets intact.



Source: IMF WEO
Note: For world years are 2016-18

- The positive real rates experienced by the investors presented an opportunity to prefer financial assets. In FY17, the equity holdings in Indian households increased by 0.9% from 2.9% to 3.8%. This is however still below the peak that was seen in FY08. Note: Real rate of return is 1 year treasury yield over CPI



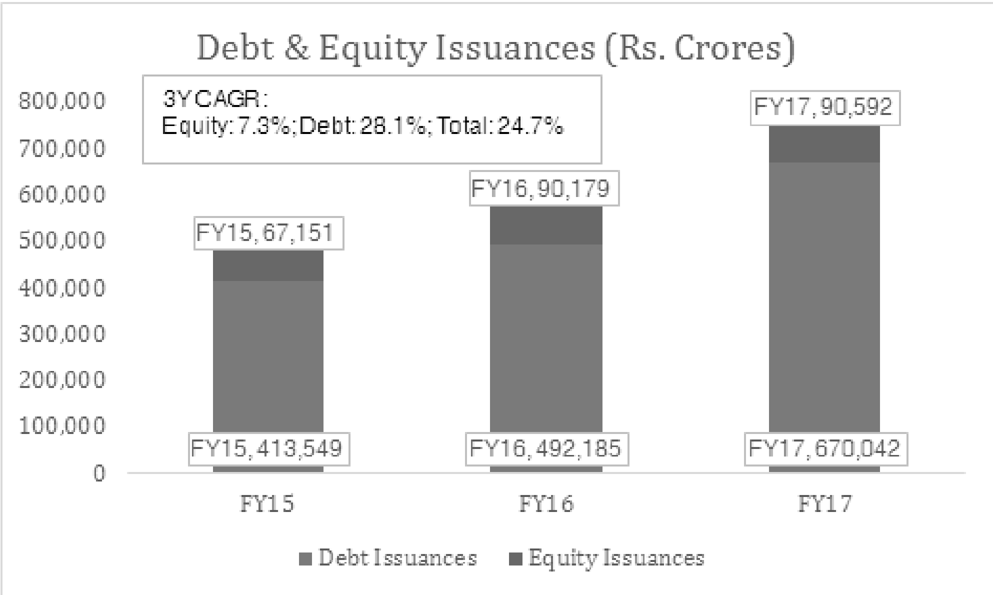
Note: Real rate of return is 1 year treasury yield over CPI
Source: Bloomberg

- The total resources mobilized by the corporate sector have grown at a CAGR of 25% over the last three years to Rs. 7.60 lakh crore in FY17 from Rs. 3.91 lakh crore in FY14. This was predominantly driven by debt and the growth in debt issuance for FY17 alone stood at 36%.

  Fundamentally the adoption of positive real rate policy by the RBI, fiscal prudence by the Central Government, favorable terms of trade for our country on commodities front and combating inflation has resulted in the borrowers taking capital markets route to diversify resources, to correct asset liability mismatches and strengthen balance sheets, wherever possible.

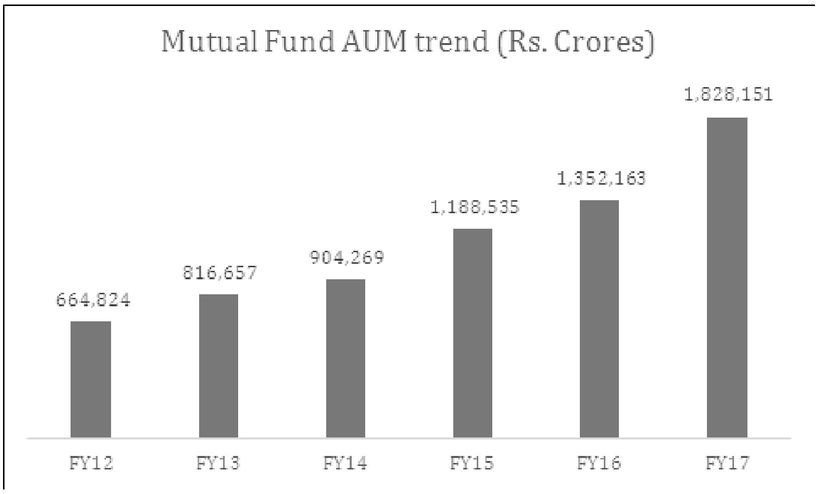
  We expect nominal GDP growth to CAGR at in the region of 11-12% over next 3-5 years and we also expect corporate sector, coming out of balance sheet repair to start undertaking capex, which shall result into higher multiplier of 1.5x. Accordingly a CAGR upwards of 17-18% for the resources raised through capital market route is likely.

  There is acceptance of new instruments like municipal bonds, INVITs and REITs. The former two have already made their debut in the market. The later would hit the market shortly.



Source: SEBI

- Learning from the financial crisis of 2008, SEBI has helped Mutual Funds introduce many measures to make the products more customer friendly with lower risk. These are helping the industry grow. Some of the important measures were:
  - ↳ Removal of entry load
  - ↳ Product labelling highlighting the riskiness of the product
  - ↳ Launch of direct plans which lower expense ratio for informed investors
  - ↳ Incentivizing industry to expand market to beyond the top 15 cities
  - ↳ Compulsory expenditure of 2 bps towards investor education
  - ↳ Instant access to funds for liquid fund investors
  - ↳ A single security valuation covering over 5000 securities across mutual fund portfolios has been introduced to standardize valuation norms

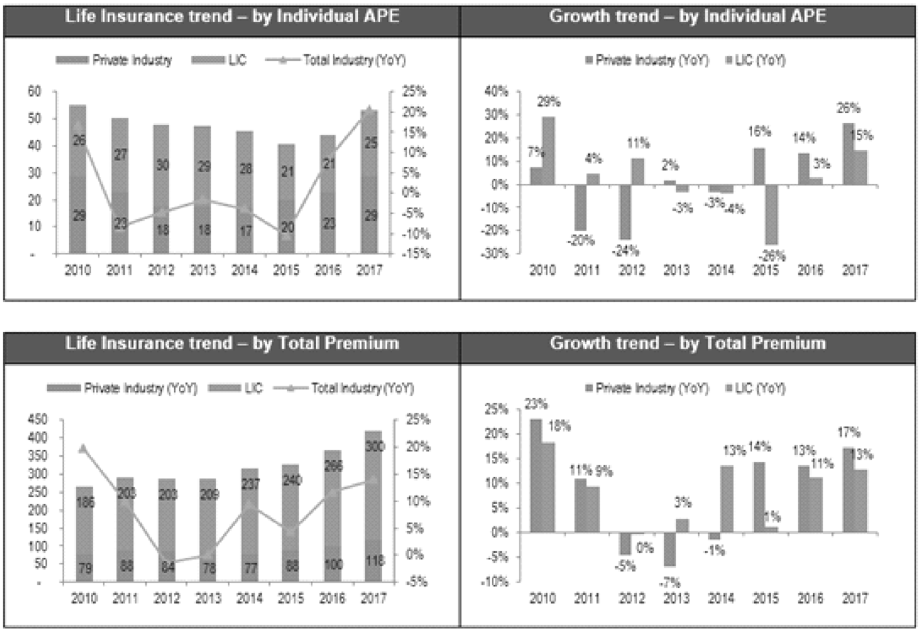


Source: AMFI

The mutual fund industry grew its assets under management (AUM) at a CAGR of 26% over the last three years. Over the same time period, the equity AUM grew by 47% while debt grew by 21%. This impressive growth is on the back of consistent performance from the funds and the awareness created through media & programs at the ground level.

The monthly flows through systematic investment plan (SIP) has increased at a fast pace of 49% over the last three years from Rs. 1,200 crores in FY14 to Rs. 4,000 crores in FY17. As the momentum of growth is strongly in its favor with investors looking at mutual funds as a new vehicle of investment, a 20%+ grow in assets is a reasonable estimate. With such a run rate, the AUM could move up from Rs. 18.3 lakh crore to Rs. 32 lakh crore in three years.

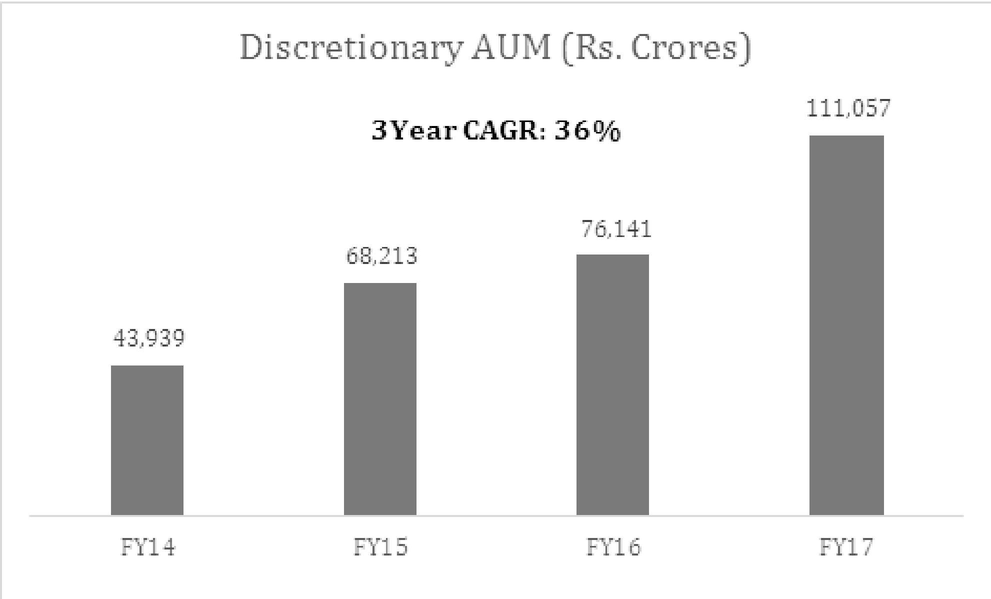
- Life Insurance Industry (by individual Annual Premium Equivalent (APE)) grew 21% YoY last year, the fastest in last 8 years. Growth in the industry is driven by strong performance from private sector which grew 26% YoY.



Source: IRDA

The overall growth in the industry could be pegged at 15-18% CAGR for the next three years.

- The Portfolio Management Services (PMS) industry especially in the discretionary space is at a tipping point. It has witnessed a strong 36% CAGR over the last 3 years. There are several reasons why the industry has steadily gained prominence which are listed below:
  - The PMS products are increasingly finding favour with HNI investors who prefer holding shares directly but don't have complete knowledge or time to select individual stocks. These products allow the clients to have a focused strategy of exclusively owning stocks meeting the defined investment framework which can be customized to their requirement.
  - The PMS industry also offers clients a choice between a fixed and variable fee structure. Having a variable fee structure ensures that the interests of the clients and portfolio managers are aligned.



Note: Non EPFO & PF AUM
Source: SEBI

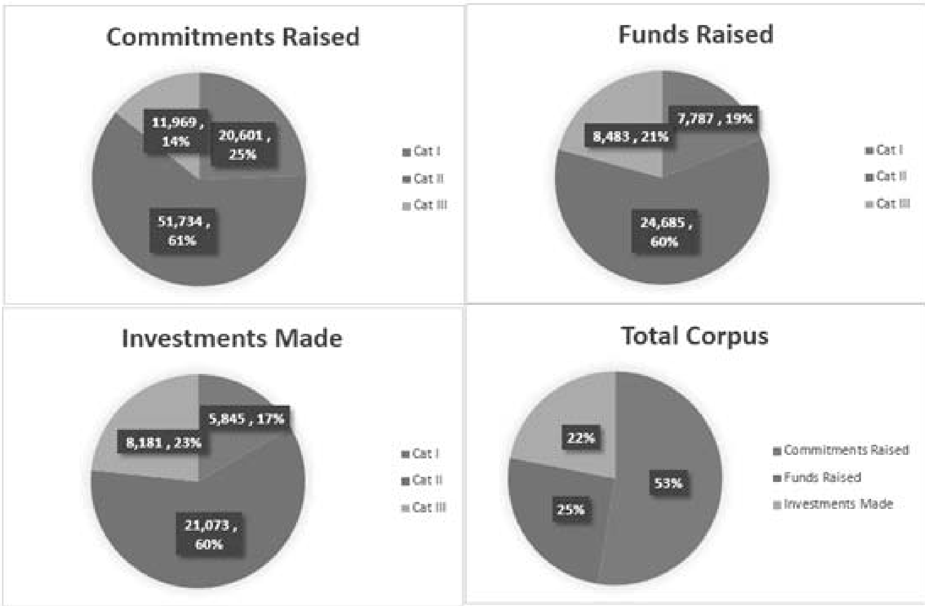
In the discretionary AUM that is quoted above, Rs. 74,000 crores are part of equities mandate. With the good experience of the existing investors and increasing awareness of the products, the AUM could grow at 20+% growth rate for the next five years to take the equity part itself to 2.5x the current size.

- Following the global trend of carving out new set of regulations for alternative assets, SEBI notified Alternative Investment Funds (AIF) in 2012. The AIF regulations allow launch of 3 categories of funds - AIF Category I/ II / III with the following key features:

Salient features of Categories of AIF	**Cat I**	**Cat II**	**Cat III**
Taxation - Pass Through	Yes	Yes	No
Proportion of unlisted Securities	Min 75%	Min 51%	No bar
Fund Structure	Close ended	Close ended	Open / Close ended
Minimum Tenor (years)	3	3	None
Leverage at fund level	Not allowed	Not allowed	Allowed 1:1
Sector bias	VCs/ PE /Social /Infra dedicated funds	No bias	No bias
Single exposure limit	25%	25%	10%

What is noticeable about the industry is that despite being new, it has grown at a rapid pace with the figure of `Commitments raised' standing at Rs. 84,303 cr in FY'17 from a meagre Rs. 1,437 cr in FY13 – 58x in four years, across all the three categories of funds. The funds raised and investments made stood at Rs. 40,955 and Rs. 35,099 crores respectively.

The triggers for growth of assets are twofold. One, it offers flexibility to its fund manager in structuring a pooled investment in line with investors' interest with less constraints. Two, the tax pass through status accorded to cat I & II in the union budget couple of years back.



Source: SEBI

The structuring of mandates across asset classes like equities, debt, commodities etc. and quick time to market would see more of the funds being launched to garner assets at the pace of 25-30% per annum.

- The Employee Provident Fund Organization (EPFO) has increased its mandatory allocation to equities from 5% in FY16 to 10% in FY17. This has resulted in its contribution of more than Rs. 10,000 crores into the equity markets. We expect the allocation to go up to 15% in the next two years before stabilizing there on. This would add to a steady flow of more than Rs. 15,000 crores to the equity market through ETFs and mutual funds.
- Over 51 lakh government employees are mandated to invest through National Pension Scheme (NPS). It is also open to the private sector which currently has 6 lakh subscribers and it is increasing every year. As of FY17, NPS manages Rs. 1,72,000 crores out of which nearly Rs. 22,000 crores (~13% of AUM) is in equities. It is contributing over Rs. 4,000 crores to the equity market which should show double digit growth due to increasing subscribers and increasing contribution from the subscribers.

- The last two years has seen the dependency of the equity markets on FPI flows to be less. In the last two years, DIIs have invested USD 9.5 bn more than FPIs. In the past, whenever FPIs withdrew more than USD 3 bn in a quarter, market used to correct between 15-25%. However, in Q4 CY16, even when FPIs withdrew USD 4.6bn, markets fell less than 5%. This is because of the counter balance provided by the DIIs.

  While two years is a short a time period to derive a trend, it could be a possibility that DIIs could become strong driver of equity markets as Mutual Funds, Insurance, PMS, AIF, NPS and EPFO route the savings of households into equity markets.

- Some of the initiatives that could deepen the capital markets are:
  - Continued launch of innovative products like debt ETFs and products around interest rate options to propel the growth of the debt markets
  - Reducing the mandatory purchase of government securities by banks and life insurance companies could help in deepening the participation in corporate bond market
  - Implementing "One KYC" for all financial products eases the process of purchase of such products

- Making the taxation of AIFs at par with that of mutual funds as the investors offer risk capital (in fact take more risk than mutual fund investors) across categories of funds to companies' various stages of growth

The capital markets, vehicles that invest into capital markets, regulators, industry participants and investors have come a long way over the years. The efforts should be to continue to improve transparency, drive innovation and most importantly keep the trust of the investors at the center of all that is done. India has come a long way indeed but the future is even more exciting.