

22nd Nov 2022

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Global Private Client

Top of Mind

Privately Sovereign



INTRODUCTION - PRIVATE-'ly' SOVEREIGNS

“Public Sector Undertakings (PSU) are Temples of modern India” – Pt Jawahar Lal Nehru

Independent India focussed on industrialization through public enterprises with impetus on nation building and lesser focus on free market economics. While PSUs continue to make significant contribution to the economy, however, their share in overall economy & corporate sector tapered over the period of time and now contributes less than 20% to overall corporate profitability.

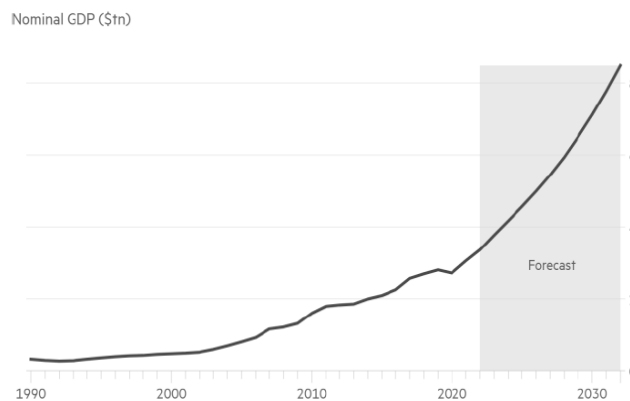
However, there is an interesting niche developing between public and private sectors which tend to enjoy best of both worlds – focus on capital efficiency, profitability like private companies and scale, monopoly & quasi regulatory moats like PSUs creating **Private-ly Sovereign** entities.

The Government’s push towards privatization, increasing financialization of economy (Capital Markets, Credit and Insurance) and emergence of India’s world class digital & tech stack (JAM, Jio & UPI) has lead to creation of platform businesses and consistent compounders of investor’s wealth in BFSI sector like NSE IL, TransUnion CIBIL, NSDL-CDSL, Insurtech, Fintech and Energy exchanges, among others.

As our economy continues to grow and compound, we would like to delve deeper and develop an evaluation framework for PSU’s and Privately Sovereign entities which can be natural beneficiaries of secular growth and can be significant wealth creators in the long term.

- **India GDP is expected to double from the current USD 3.7 tn to USD 8.5 tn over the next 10 years (i.e. incrementally, India will add more than USD 400 bn every year)**

India’s economy set to grow rapidly during next decade



Tailwinds for India’s Economy

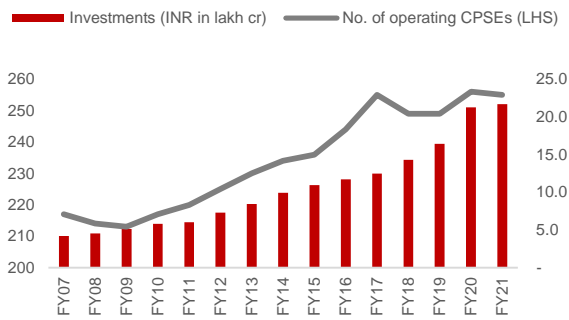
- **Fiscal policy:** Shift in policy focusing on capital formation and strengthening of core strategic sectors.
- **Reforms:** Introduction of GST created a unified domestic market; corporate tax cuts; and PLI schemes incentivized investments in core sectors like manufacturing, infrastructure, defense and capital goods.
- **Favorable demographics:** India’s has large and young working age population suggesting longer runway for economic growth. India’s median age today is 11 years younger than that of China’s.
- **Strong digital infrastructure:** India is leading the world in creation and adoption of digital economy – JAM, UPI, ONDC etc. India’s digital economy is expected to top USD 1 tn in the next few years.

IMPACT ON ECONOMY

Public Sector contributes 20% to National Income

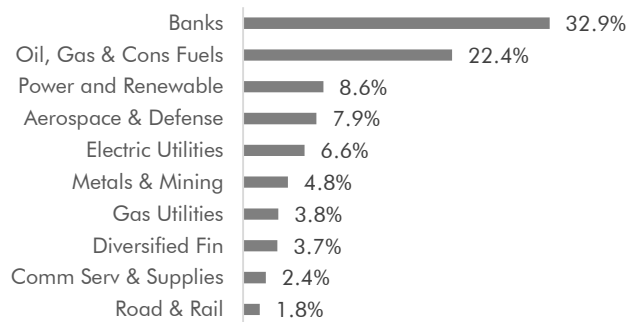
- Over the years, Indian PSUs have played a significant role in the growth of the Indian economy. Central PSUs contribute ~20% to the national GDP. They have developed a formidable franchise, with leadership positions in sectors like Oil & Gas, Financials, Utilities, Mining and Heavy Engineering.

In India, PSU have grown considerably in number and in size



Source – PSE Survey. Includes government companies wherein the central government holds >51% equity. Does not include departmental undertakings (e.g., railways, postal services, broadcasting, etc.), public sector banks, insurance companies and state level public enterprises.

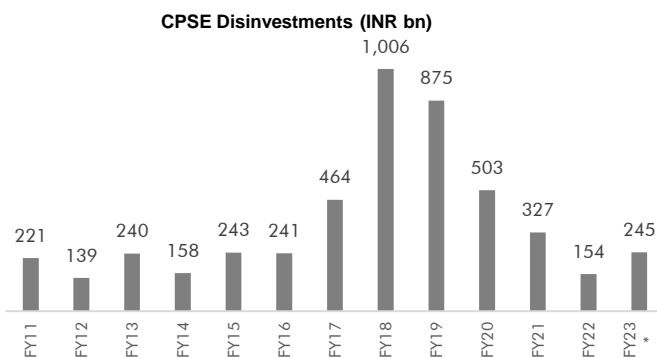
Majority of the PSU’s operate in core sectors, which benefits from pick up in economic activity



Source – Bloomberg; Sector includes BSE PSU Index

- Government policies and reforms can be enablers but reform, size and competitive advantage cannot necessarily translate into the profitability of the company – which has given the opportunity for (i) Divestment of PSU companies to emphasize on modernization which if materialized can add significant value and; (ii) Private entrepreneurs to contribute in India growing economy.

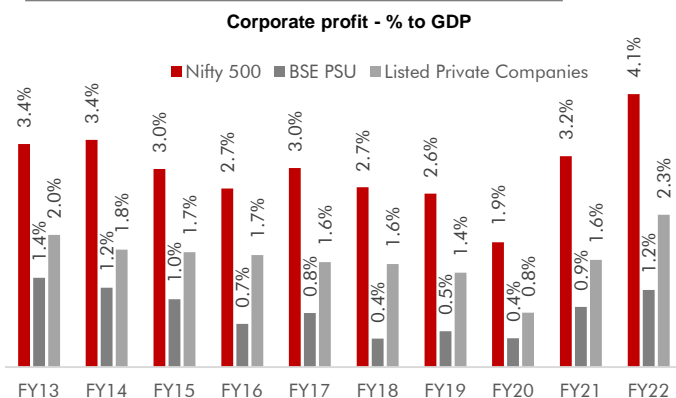
Governments divestment agenda – Value unlocking opportunity for investors



- Disinvestment is the key strategic priority for the government amidst elevated fiscal deficit.
- GOI’s objective is to minimize presence of CPSEs including financial institutions and create new investment space for private sector.
- Recent listing of PSU’s unlock the opportunities for investors, leading to wealth creation. (refer [Annexure I](#))

Source – BSE PSU CPSE Disinvestments

Clear and continuous migration from PSU to Private entrepreneurs



- Since 2003, PSU’s corporate profit to GDP fell from 1.8% to 1.2%; whereas on the other hand Private companies have gained from 0.8% in 2003 to 2.3% till date.
- This shift is on the back of eroding competitive advantage of the PSUs in several sectors and monopolistic businesses like upstream and downstream Oil & Gas and Utilities player’s where growth has been a perennial issue for them.

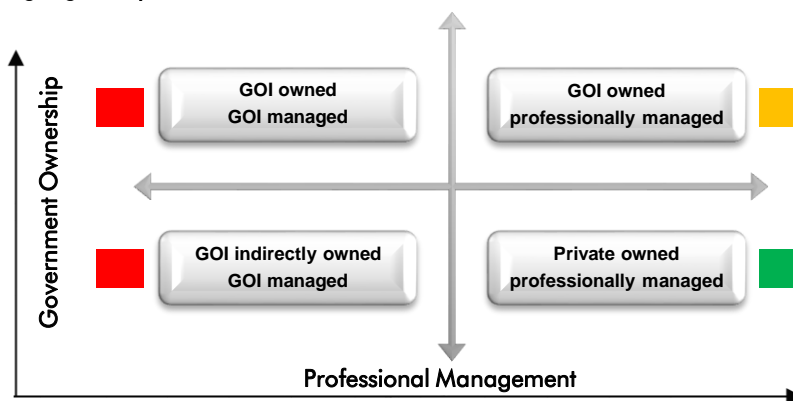
Source – National Statistical Office, ACE Equity

PICKING WINNERS IN DISRUPTIVE TIMES

- Indian economy is going through major disruption. Passage of reforms like GST, BHIM and Aadhar, UPI, etc. mark the beginning of the next phase of India's evolution.
- The structural shift in economic landscape will challenge established models of doing business and coax the emergence of business designs that are better able to contribute in new phase of growth.
- Through this report, we attempt to build up a framework on relevant tools to identify the significant investment opportunities via business models who generated disproportionate returns and also uncovers several potential winners.

Framework for Analyzing Options

- GOI owned, GOI managed:** Non-profitable companies with limited / no commercial value and having social mandate with 100% GOI ownership
- GOI indirectly owned, GOI managed:** GOI divested / divestment target companies under influence of GOI regulations – Fundamentals remain volatile
- GOI indirectly owned, professionally managed:** GOI divested / divestment target companies having unique business proposition with beneficiaries of government policies and managed by professionals – Fundamentals remain strong
- Privately Sovereign:** Private owned professionally managed monopolistic businesses having strong business model with strong regulatory moat



Groups	Examples	Impact on Economy	Impact on Profitability
GOI owned GOI managed		Green square	Red square
GOI indirectly owned GOI managed		Green square	Red square
GOI owned professionally managed		Green square	Yellow square
Private owned professionally managed / Privately Sovereign		Green square	Green square

WHAT ARE PRIVATELY SOVEREIGN FIRMS?

As per our framework, key features of Privately Sovereign firms are:

- **Privately owned:** No direct GOI influence
- **Professionally managed:** Operated by experienced and efficient management
- **Regulatory moat:** Strong regulatory moat with high entry barriers which can lead into high profitability
- **GOI Reforms push:** Supported by recent reforms by government leading to secular tailwind. *BFSI is critical to the economy and houses most of the Privately Sovereigns as it is regulated (moats) as a sector but privately owned and run.*

ABOVE FRAMEWORK PAVED WAY FOR NEW INVESTMENT OPPORTUNITY

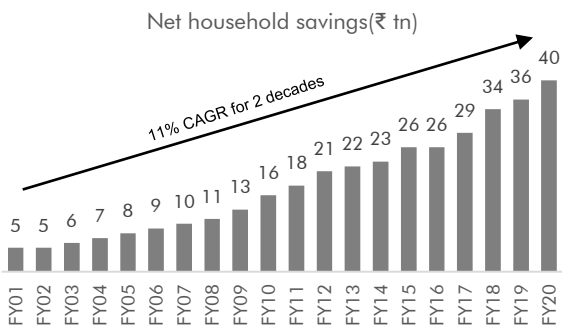
India's Virtuous Circle of Amazing Progress in Financial Economy

- Despite the challenges present in all emerging markets, including India, we think it's more important to focus on the positive developments. With India's coming of age, expectations are for continued non-linear (exponential-type) growth. Government reforms over the past several years have given rise to many secular tailwinds.
- Based on the above state of economy, our investment premise centers largely on the one megatrend – **Financialization through Digitisation:** This entails the creation and distribution of banking, investment, credit, payment and insurance services. As we explore below, financialization is at the foundation of any well-functioning modern economy. Moreover, digitalization is a critical element of India's rapid financialization.

Story by charts – Why we think Financialization via Digitization is a megatrend?

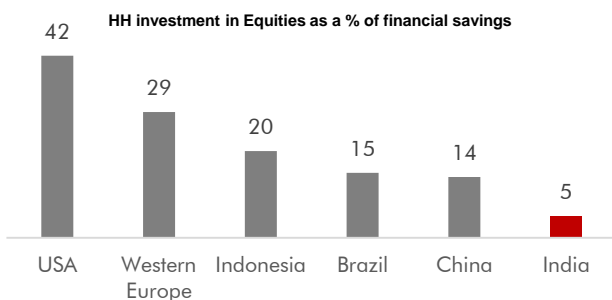
TREND 1 – Transforming Indian Financial Market

Household Savings: With strong GDP growth, Indian household savings has seen a consistent growth over last 2 decades



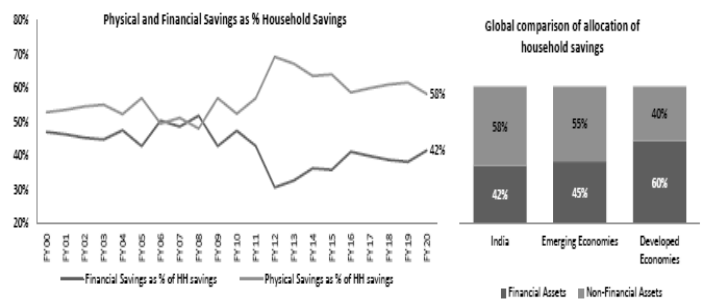
Source – NSE India Corporate Presentation

India's exposure to various financial assets is significantly lower than major global economics



Source – NSE India Corporate Presentation

After bottoming out in FY12; there is steady rise in contribution of financial savings ; **India is still lower vs. global peers**



Source – BCG Research

Structural Growth with high entry barrier generated strong financials

Category	Companies	3 yr Revenue CAGR	10 yr Revenue CAGR	3 yr PAT CAGR	10 yr PAT CAGR
Stock Exchange	NSE India	37.1%	18.0%	47.2%	19.1%
	Direct Ancillaries				
	NSDL Ltd	34.0%	23.6%	24.2%	31.4%
	CDSL Ltd	35.1%	17.5%	39.7%	18.9%
	CAMS Ltd	9.5%	13.1%	28.5%	19.0%
	NSE Clearing	24.2%	6.2%	38.7%	6.7%
	NSE Indices	26.2%	23.7%	40.6%	26.2%

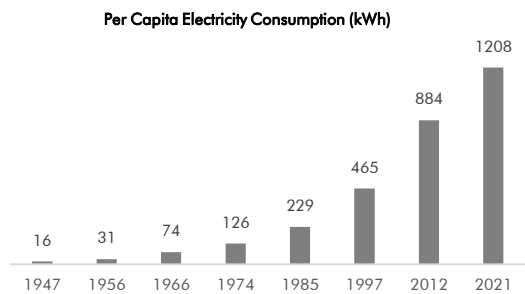
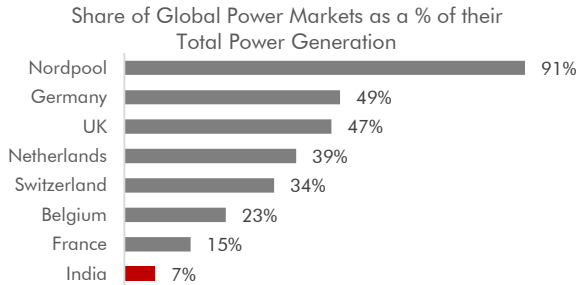
Source – ACE Equity

- Exchanges are organized markets, designed to provide centralized facilities for the listing & trading of financial instruments, including securities issued by companies, sovereigns, other entities to raise capital
- During COVID, Stock Exchanges and all associated market infrastructure institutions in India were fully functional, on back of government and regulatory support, meticulous planning, and technological advances, thus ensuring uninterrupted business continuity for market participants

TREND 2 – Transforming Indian Power Market

Immense potential to deepen India’s Power Market: India at 7.4% in FY22, whereas in developed economies it ranges ~30% - 80%

Marching towards vibrant Power market – Key growth drivers remains Industrialization, rapid urbanization and strong growth in consumer demand (6% CAGR since independence)

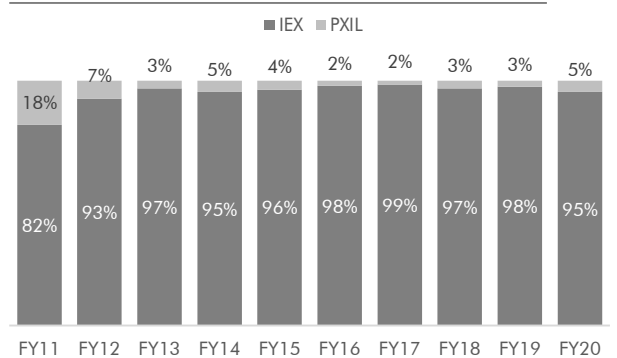
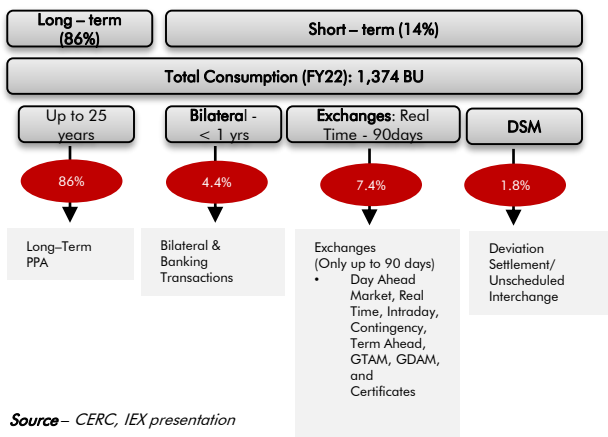


Source – CERC, IEX Corporate Presentation

Source – CERC, IEX Corporate Presentation

India’s Power Market Structure: Shift to short-term market to continue, particularly towards exchanges...

.....led by IEX’s rising market share in overall market, driven by network and technology effects



Source – CERC, IEX presentation

Source – IEX Corporate Presentation

Structural Growth with high entry barrier generated strong financials

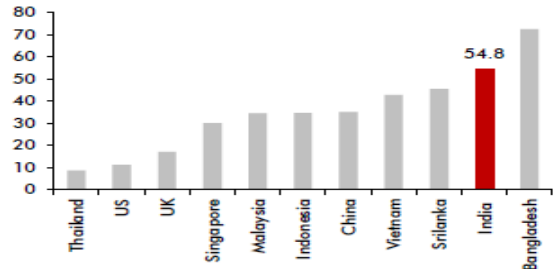
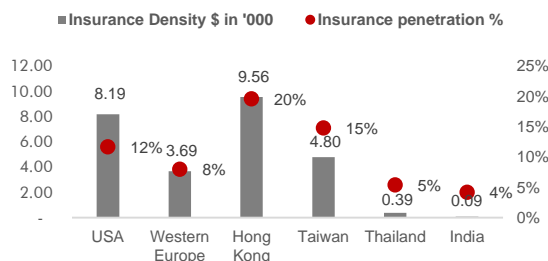
IEX Ltd is the monopolistic leader in India’s fast-growing spot power exchange market. Created strong strategic barrier of entry by network and technology effects which remain its key competitive moat. Rapidly changing power industry dynamics and horizontal diversification has generated strong financials and given underpenetrated segment, huge scope for further growth.

Category	Companies	3 yr Revenue CAGR	10 yr Revenue CAGR	3 yr PAT CAGR	10 yr PAT CAGR
Major Exchange	IEX Ltd	18.1%	21.2%	22.4%	24.4%

TREND 3 – Insuretech – Multi fold opportunity for digital sales

India is a highly underpenetrated – 4% as compared to the range of 8%-20% of large global peers

India has one of the world’s highest shares of out of pocket health expenses



Source – Statista

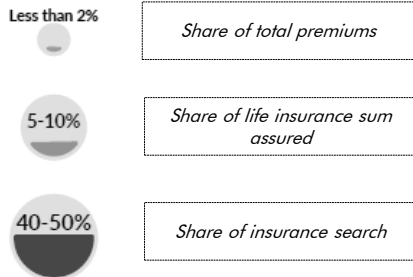
Source – Ambit Research

The Indian insurance space has been a fast growing sector. As of FY21, annual premiums collected totaled USD 110 bn. Of this total, USD 45 bn were for private insurers (key market for PB Fin), which enjoyed a 18% CAGR over FY16-21CL – in result, gained markets share from ~32% in FY16 to ~41% in FY21

To capture the unprecedented opportunity, **Digital Insurance is still at very nascent stage**. However, the market is quickly picking up on back of Consumer preference is shifting towards simpler products with clear communication, seamless online searches and transactions and hassle-free claims.

All of these factors signal significant growth opportunities for insurtech firms. However growth in digital sales vs industry would aid Policy bazaar driving 23% NBP CAGR over FY21 – 41E

Digital Penetration in Insurance



Particulars	FY21	FY22E	FY23E	FY24E	FY25E	FY31E	FY41
Industry Premium (INR tn)	8	9	11	12	14	29	89
Life Insurance Premium (INR tn)	6	7	8	9	10	21	63
Non - Life Premium (INR tn)	2	2	3	3	4	8	26
Digital Premium (INR bn)	103	141	191	255	339	1487	6149
Digital share (%)	1.2%	1.5%	1.8%	2.1%	2.5%	5.0%	6.9%
Policybazaar NB Premium (INR bn)	27	38	53	72	97	428	1768
Policybazaar Digital Share	26.2%	27.0%	27.7%	28.2%	28.6%	28.8%	28.8%

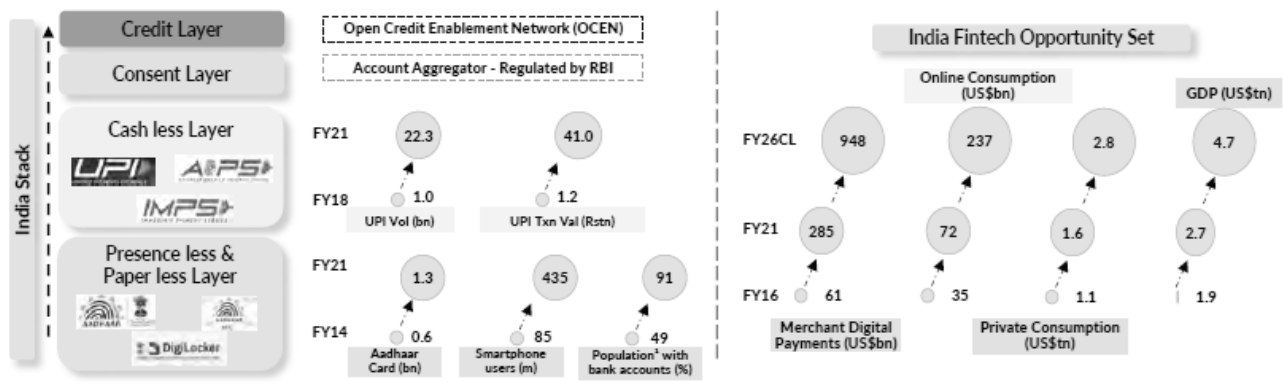
Source – CLSA Research

Source – CLSA Research

TREND 4 – Credit Disrupted – Digital Lending in India

- India’s consumption story is back on track in 2022, driven by a favourable demographic dividend, increasing digitisation, improving public infrastructure, and continued technological innovation.
- Across income levels, consumption is expected to grow from \$1.8–USD1.9 trillion in FY21 to about USD 3 trillion by FY26 due to increased demand from an added 4 million affluent and 33 million mass affluent households.
- Along with households, micro, small, and medium enterprises (MSMEs) will be key to the economy, contributing an expected \$1.3 trillion in gross value added by FY26.
- Despite this expected growth, both household consumption and MSMEs remain underserved by formal credit.
- This funding gap is expected to provide strategic opportunities for two emerging segments in digital lending space – Household lending (NAVI Finserv, Transunion CIBIL), and MSME lending (Oxyzo Fin, NPCI, TreDs).

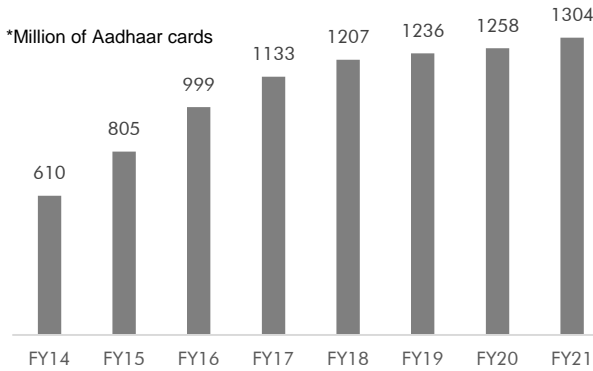
India Stack - The path of digital infrastructure that became backbone of India’s fintech revolution



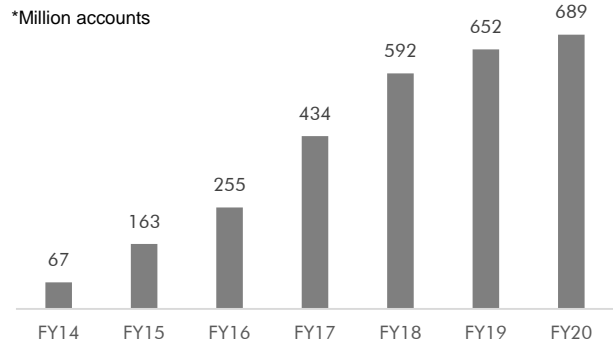
Source – CLSA Research

India’s fintech opportunity set has significantly expanded over the past five years due to strong demographics, the India Stack and the JAM trinity, a government initiative to increase financial access by combining no-frill bank accounts, the Aadhaar card and mobile connections.

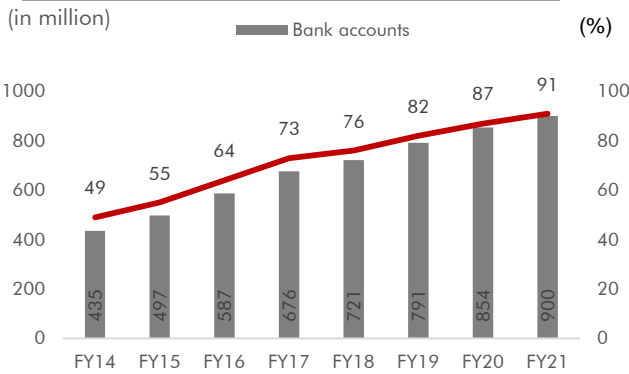
Rapid scale-up of Aadhaar programme



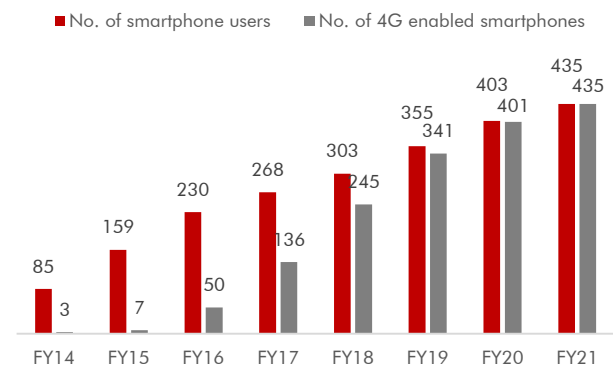
Aadhaar with linked banked accounts up 10x in past six years



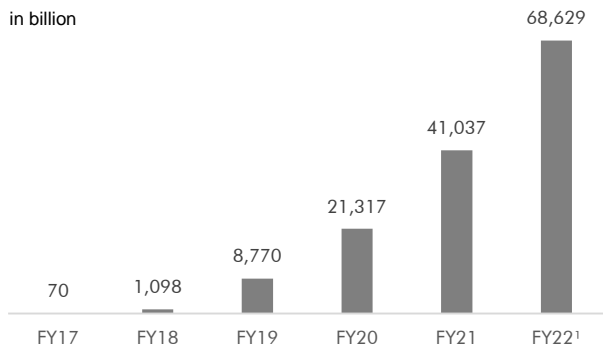
Over 90% of population (age 15+) now have bank accounts



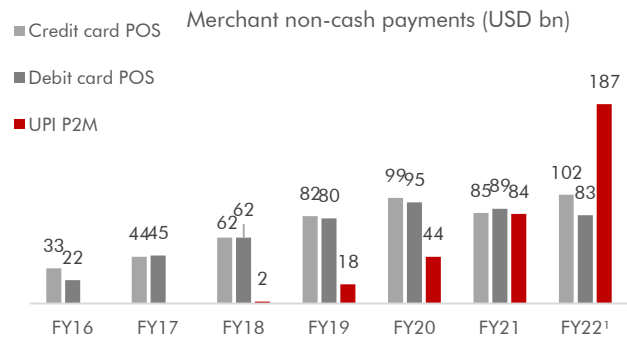
Addition of 400m 4G-enabled smartphones in five years



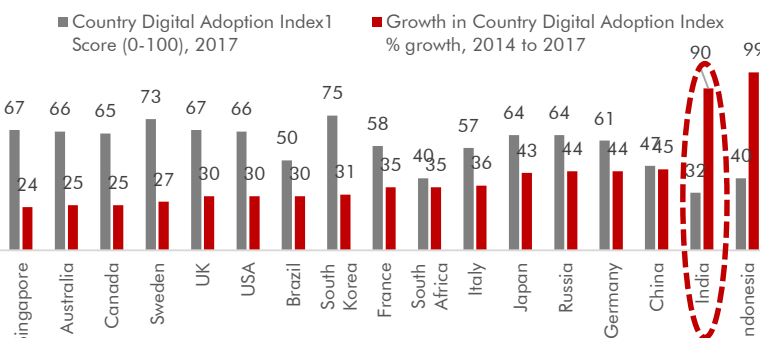
UPI volumes



UPI P2M is now as large as debit and credit card POS volumes



India, coming off a low base, is the second-fastest digital adopter among 17 major digital economies



India has experienced large-scale digital adoption between 2013 and 2018, triggered by both government action and market forces. And as a result India has the second-highest momentum, or rate of growth, among all countries over the past four years.

- Given the above opportunities, we tried to build portfolio of unique set of companies which have monopolistic traits in these segments.
- Past 3 years, the portfolio of unique companies from our focused sectors delivered 50.5% vs 17.0% of Nifty 100 TRI 17.0% 3 year CAGR.

Overall Portfolio Performance – India Privately Sovereign Portfolio

Companies	Weight %		Abs %	3 Yr CAGR	No of days
	Mar-19	Latest			
NSE India	10.0%	6.7%	172.7%	31.9%	1321
IEX Ltd *	10.0%	6.6%	168.4%	31.4%	1321
NSDL Ltd	10.0%	10.5%	326.9%	49.3%	1321
CDSL Ltd *	10.0%	12.4%	403.9%	56.3%	1321
CAMS *	10.0%	4.8%	94.7%	37.1%	771
Oxyzo Fin	10.0%	42.1%	1614.1%	119.3%	1321
Navi Finserv	10.0%	2.5%	0.0%	0.0%	1321
NPCI	10.0%	5.9%	139.6%	33.8%	1096
CIBIL	10.0%	7.7%	212.6%	46.2%	1096
PB Fintech *	10.0%	1.0%	-59.3%	-59.7%	361
Total	100%	100%	307.36%	50.5%	1255

Source– ACE Equity, BSE India

* Listed Companies – 3 year MTM growth or Listing price whichever is earlier
 Unlisted Companies – 3 year EPS growth

Monopolistic firms do control the market (High margin), which in result reward their stakeholders (ROCE)

PBITDM %	Mar-20	Mar-21	Mar-22	ROCE %	Mar-20	Mar-21	Mar-22
NSE India	74%	85%	79%	NSE India	29%	43%	50%
IEX	95%	95%	98%	IEX	60%	62%	65%
NSDL	56%	54%	57%	NSDL	21%	21%	27%
CDSL	66%	78%	76%	CDSL	20%	32%	42%
CAMS	44%	46%	49%	CAMS	51%	53%	67%
NPCI	63%	60%	65%	NPCI	42%	37%	31%
CIBIL	67%	68%	68%	CIBIL	74%	74%	75%

Source– ACE Equity, Company Annual Report

Over the years, GOI has been thriving on creating and promoting infrastructure from their policy approach by unlocking value through divesting monopolistic PSU companies (from their defined core strategies) and developing unique digital platforms like UPI, India STACK, ONDC etc. to build USD 8 tn economy by 2027.

- **Annexure I** – Value Creation by Divestment of Public Sector Enterprise since 2018
- **Annexure II** – Digital Revolution since 2016

ANNEXURE I – Divestments of PSU companies

- **With leadership in multiple sectors, they attain to offer unique proposition and can have first mover advantage**

Companies	Key Unique Proposition
Hindustan Petroleum Corporation (HPCL), Bharat Petroleum Corporation (BPCL), Indian Oil Corporation (IOCL)	Large non-replicable fuel retail network
GAIL, Indraprastha Gas, Mahanagar Gas, Petronet LNG, Gujarat State Petronet	Large non-replicable gas network
Indian Railway Catering & Tourism Corporation (IRCTC)	Railway e-ticketing exclusivity
Container Corporation of India	Large non-replicable container logistics network
Coal India	Largest coal reserves
Mangnese Ore (MOIL)	Largest manganese reserves in India
Steel Authority of India (SAIL)	Captive iron ore mines
State Bank of India (SBI)	Largest branch network
National Thermal Power (NTPC)	Largest thermal power capacity with linkage to low cost coal
Power Grid	Large non-replicable power grid network
Mishra Dhatu Nigam	Indigenous source of high value metals for industries like defense and space where private participation is restricted due to critical nature / national interest
Cochin Shipyard	Indigenous shipyard for naval ships where private participation is restricted due to critical nature / national interest
BEML Ltd, Garden Reach Shipbuilders & Engineers Ltd, Mazagaon Dock Shipbuilders Ltd, HAL Ltd, Bharat Dynamics Ltd	Defense related in Land, Naval, Aerospace and Arms and Ammunition based segment

Source – Invesco Mutual Fund

- **Privatization of PSU companies leading to wealth creation opportunities**

Company	Date of Divestment	Company	Date of Divestment		Date of Divestment		CAGR Return (%)	
			Price	Sensex	Price	Sensex	Stock	Sensex
Hindustan Zinc	29-Aug-00	Hindustan Zinc	8	4402	288	58191	17.6%	12.4%
Maruti Suzuki	8-Jul-03	Maruti Suzuki	125	3630	8783	58191	24.7%	15.5%

Divestment examples since 2018 – Post IPO Performance

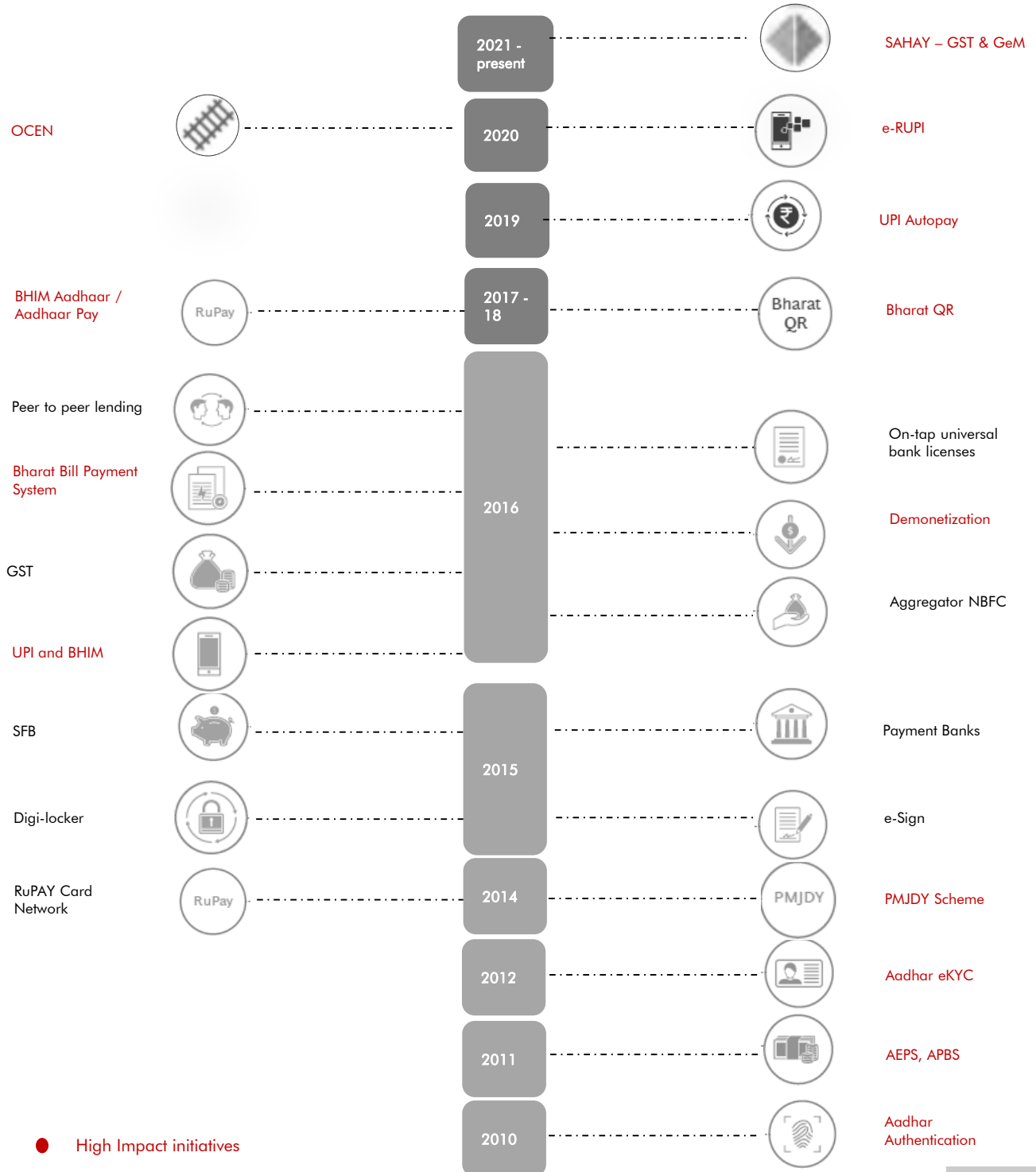
Company	Listing Date	Issue Price	Price as on 13th Oct, 2022	XIRR Gain (%)		Alpha (+/-)
				Stock Price	Sensex	
Indian Railway Catering and Tourism Corp	14-Oct-19	320	735	32.0%	14.4%	17.5%
Mazagaon Dock Shipbuilders	12-Oct-20	145	633	108.8%	18.7%	90.1%
MSTC Limited	29-Mar-19	120	273	26.0%	11.7%	14.3%
UTI Asset Management Co. Limited	12-Oct-20	554	725	14.4%	18.7%	-4.3%
SBI Cards and Payment Services Ltd	16-Mar-20	755	861	5.2%	26.2%	-21.0%
Mishra Dhatu Nigam Limited	04-Apr-18	90	230	23.0%	12.9%	10.1%
Rail Vikas Nigam Limited	11-Apr-19	19	37	20.7%	11.9%	8.9%
Railtel	26-Feb-21	109	111	1.1%	9.9%	-8.8%
Garden Reach Shipbuilders & Engineers	10-Oct-18	118	475	41.5%	13.2%	28.3%
RITES Limited	02-Jul-18	185	381	18.4%	12.0%	6.4%
Ircon International Limited	28-Sep-18	47.5	43	-2.6%	12.0%	-14.5%
IRFC	29-Jan-21	24.9	21	-8.6%	13.3%	-21.9%
Bharat Dynamics Limited	23-Mar-18	428	864	16.6%	13.1%	3.5%
Hindustan Aeronautics Limited	28-Mar-18	1215	2360	15.7%	12.9%	2.8%

Source – BSEIndia

ANNEXURE II – Digital Revolution since 2016

- **India stack** ushered millions of Indians into the digital economy.
- For the month of March 2022, the NPCI reported 5.4 bn transactions, amounting to USD 11.75 bn (₹ 8,88,169 Crore), using NPCI’s flagship UPI. UPI transactions increased at a 785% compound annual growth rate between 2017 and 2020
- Achieved by leveraging four pillars – (i) **Presence-less** (enabling digital access and verification using Aadhaar); (ii) **Paper-less** (digital records permit portability); (iii) **Interoperability** (one interface allowing for interoperable payments between bank accounts and wallets); and (iv) **Consent** (permits entities to access an individual’s data).

Timeline of India Stack’s Revolution



Report Authored by Mahesh Kuppannagari & Jayesh Dave

Global Private Client

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