A VIEW FROM ASIA

JOHCM Asia ex Japan Fund

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- Tectonic shifts in payments technology
- Low credit card penetration rates in India make for a great opportunity
- The case for SBI Cards & Payment Services

Behaviour: an organism's response to stimulation or environment

My job as a fund manager is to stay abreast of changes in how business is done. That means reading, speaking with my industry peers and learning from entrepreneurs across the world. This helps me to understand and identify companies that recognise impediments and find elegant solutions to overcome them. Problems in larger industries drive multiple participants to reimagine change. Advances in technology facilitate cheaper and faster adoption of novel methods, sometimes radically upending existing systems. In large addressable markets, several different approaches that all look plausible attract capital; few succeed to make a lasting difference. Human behaviour, especially habit formation, is a treasure trove for riches – if only you can unlock the appropriate way to modify and improve them.

China recently suspended the US$37bn listing of its largest financial technology company, Ant Financial. The fiasco of the suspension of a listing that would have valued the company at US$320bn is a topic for another day. But it's worth noting that this is a company that was founded less than 16 years ago, having grown out of another company, Alibaba, which itself was founded less than 25 years ago. The mind boggles.

Tectonic shifts in payments technology

The payments industry is an integral part of every economic activity. It has entrenched legacy approaches which are undergoing tectonic shifts across the world. In China, Ant and Tencent remain pioneers in this area. Similar to other examples, such as the transition from fixed line telephones to mobiles, China has leapfrogged to digital payments faster than any other country. This is partly due to the cumbersome nature of less well-developed older systems, like cheques or credit cards, but mostly it has been driven by the government-led innovation and technology push.

Regulations in China are in a state of flux as the bedrock of the financial system changes. The clampdown on Ant is unlikely to be the last in regulatory evolution. The next big change in the financial system in China is already upon us. A pilot test is being run by the People's Bank of China (PBOC) on digital currency/ electronic payments (DC/EP) and has been since 2019. These tests are live in Shenzhen, Suzhou, Xiong'an and Chengdu, as well as at venues for the 2022 Winter Olympic Games in Beijing. Until late August 2020, the PBOC had processed 3.1m transactions, with a total value of RmB1.1bn (US$162m), using DC/EP, according to the PBOC's deputy governor, Fan Yifei. The value per transaction was small at around RMB350 (US$50). An aggregate of 113,300 personal digital wallets and 8,859 corporate digital wallets have been opened. The digital yuan transactions were categorised into more than 6,700 classifications, including retail, hospitality, transportation, utility payments and government services. The technologies tested include QR codes, facial recognition and tap-and-go. It is too early to tell how this will shape up and what its implications will be, but this is effectively a replacement of the current system by digital currency and China's desire to make sure cryptocurrencies like Bitcoin do not become a widely accepted medium of exchange.

The case for SBI Cards & Payment Services

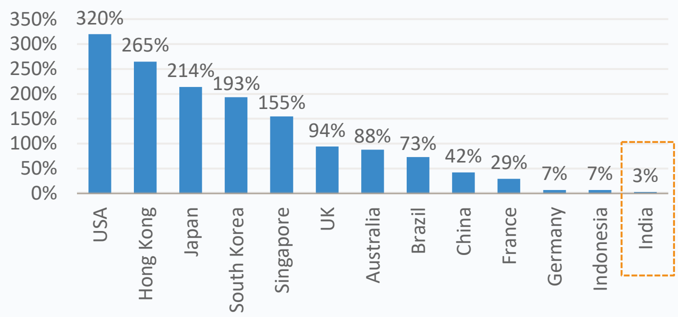
Having set the stage with Ant, technology disruption and leapfrogs, you would be justified in asking why I have initiated and built a large position in our portfolio in a credit card company in India – SBI Cards & Payment Services (SBIC), particularly when I have railed against owning financials in the current environment in my previous papers. As always, time will tell, but I do think companies like SBIC, in a country like India, are an exception to the current trend of upheaval in payments. India is undergoing a dramatic transformation in payments, too. In my limited opinion, the work done by the National Payments Corporation of India (NPCI) is as revolutionary as the changes in China. The NPCI has developed an instant real-time payment system, Unified Payments Interface (UPI). It is described by the NPCI as "a system that powers multiple bank accounts into a single mobile application (of any participating bank), merging several banking features, seamless fund routing & merchant payments into one hood. It also caters to the 'peer to peer' collect request, which can be scheduled and paid as per requirement and convenience." UPI, over the past couple of years, has become the de-facto cash replacement for small payments.

However, I am optimistic on SBIC for a few reasons. Cards are as much about credit as they are about payments. Importantly, what influences many to use a credit card is the reward point schemes on spending. For small ticket purchases the world over, we are more accepting of Venmo, PayNow, Alipay or similar options. Yet for big-ticket purchases our habit and preference is to pay with a credit card. At the back of our minds the reward schemes push us to use the credit card, with the added advantage of delayed payment. That remains valid today despite technological enhancements.

That is just a generic feature of cards. In India, specifically, the opportunity for unsecured credit remains large. I've shown some high-level metrics on penetration levels in India compared to other countries and the potential for growth assuming conservative expectations for card spending. While events like Covid-19 have disrupted these trends, they will not derail them.

A low base; a big opportunity

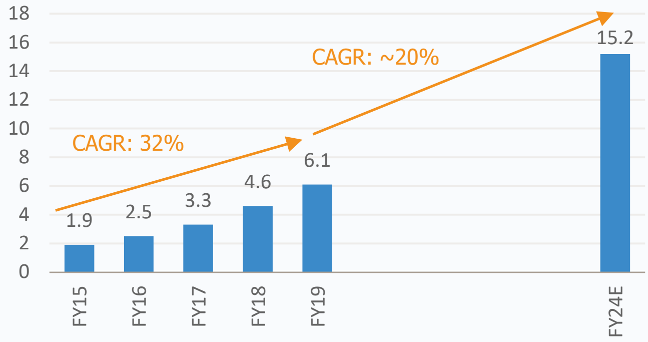
Credit card penetration (avg. number of cards per 100 people)



Source: SBIC's company prospectus.

A conservative growth path for credit card spend

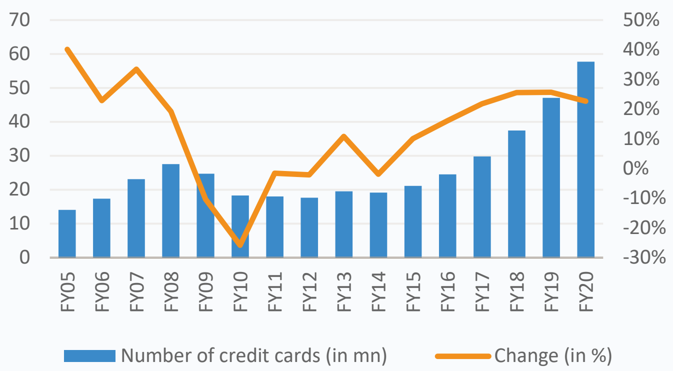
Credit card spend (INR tn)



Source: SBIC's company Report, BofA Global Research.

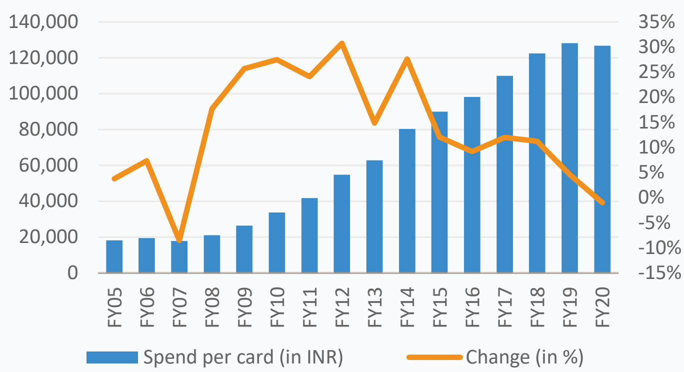
Growth in per capita income and increased consumerism are usually the precursor to larger credit card spending. India is no different. After initially catering to the basic needs of savings and deposit accounts, consumers first borrow for home mortgages and then progress to consumer loans. The past two decades or so of liberalisation have provided consumers with access to new products and services. The acceptance of online commerce follows a similar trajectory observed elsewhere. Based on demographics and income distribution, my estimate is that 15-20% of the population could be eligible for credit cards over the next decade. Conservatively, that could mean 180-200m unique cardholders.

Unique card holders are only 35m – a long runway



Source: Reserve Bank of India.

Average spend per card will pause to Covid-19

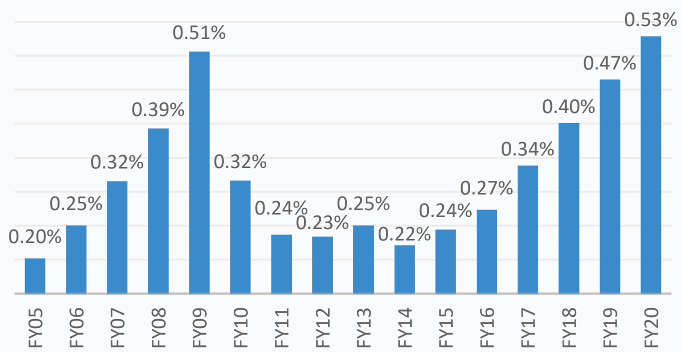


Source: Reserve Bank of India.

Concerns over the build-up of debt have proliferated due to the democratisation of credit across the world. In this regard, India is no different. Even though the absolute levels of debt and debt as a percentage of GDP are much lower than other emerging markets, a rapid acceleration of credit, especially unsecured credit, can portend trouble. In 2018, the bankruptcy of ILF&S, an infrastructure lending firm, precipitated an already precarious situation for financial firms. Since then, several dominos, including the high profile Yes Bank, have toppled. Credit card lending is the purest form of organised unsecure lending. Here, too, credit outstanding rose sharply, as seen in the charts below. If there is a saving grace, it is that cards are more widely accepted as a payment tool – the percentage of revolving credit to spending has fallen sharply from its heyday in 2009.

Covid-19 will be a setback as card debt hits 0.5% of GDP

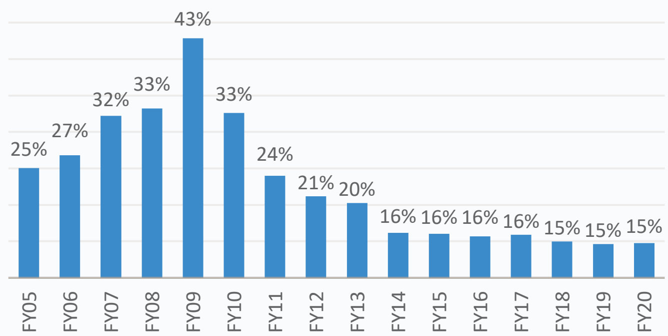
Credit card debt as a % of GDP



Source: Reserve Bank of India, OECD.

Moderation of revolvers is a sign of maturity

Credit card recievables/ spends

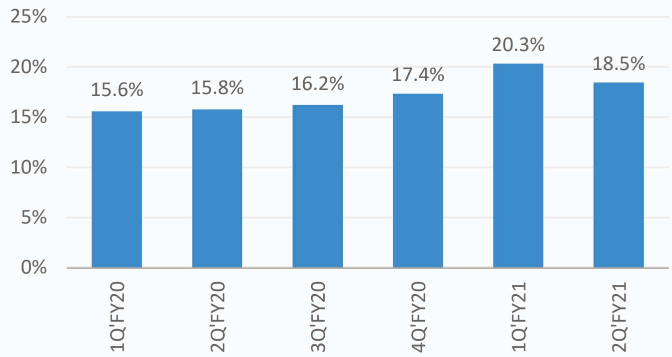


Source: Reserve Bank of India, OECD.

Started as a joint venture between the State Bank of India and GE Capital, SBIC was never a public sector entity, like its parent SBI – in India, government-owned financial firms have generally not been good for minority shareholders. Management KPIs were risk management and profitable growth. SBIC's use of superior technology and varied partnerships resulted in strategy execution with decent outcomes. SBIC has steadily gained market share, almost catching up with the market leader, HDFC Bank. A pursuit of market share is not the only relevant metric to use, and I do not suggest it takes precedence over sound financial metrics, which is why SBIC's business model is probably, in my view, amongst the best-suited for the current environment. With unsecured lending, card companies need an adequate risk-adjusted return; many aspirational customers might be new to credit. Inadequate data and short credit history makes it paramount for firms such as SBIC to generate high net interest margins to ensure long-term survival and growth.

An inherent advantage - internal generation of capital

Net interest margin (%)

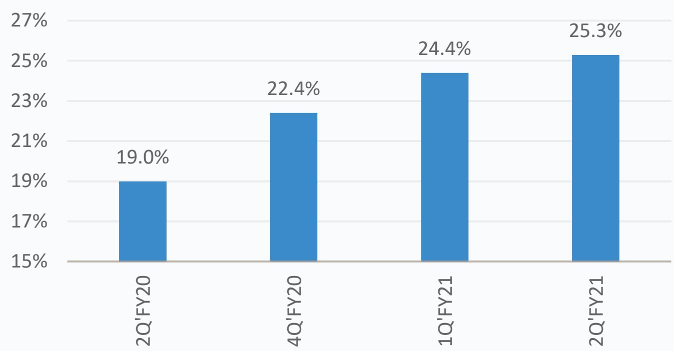


Source: SBIC's company report, BofA Global Research.

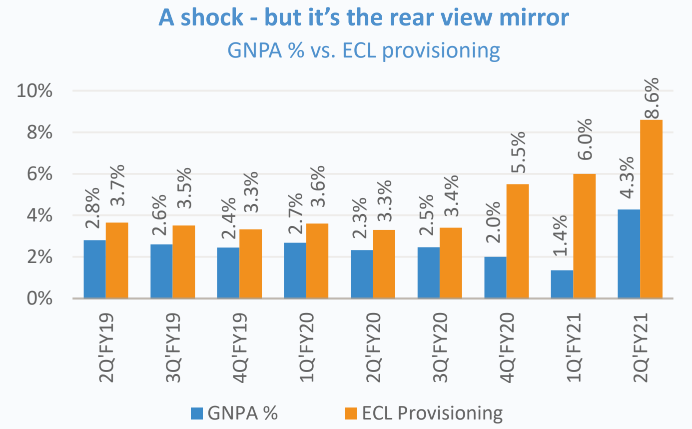
This trend of high margins is likely to persist as a result of falling borrowing costs in India. It is quite feasible that SBIC's margins might rise by 75-100bps over the next couple of years. This fortifies its internal generation of capital and boosts SBIC's ability to deal with economic shocks like Covid-19. A complete lockdown in India for several months led to a precipitous drop in economic activity, especially in travel and tourism, where the usage of credit cards is high. Apart from the drop in transactions, non-performing loans (NPLs) and write-offs have risen sharply. This is to be expected, and I was not too surprised. My approach to analysing the rise in NPLs is sanguine. It is looking in the rear view mirror at an event that was generic and not specific to SBIC. It has a robust business model with high margins, and even after deducting a larger charge, its capital adequacy remains amongst the best in the industry. From this advantageous position, I can only extrapolate a strong base for SBIC to capitalise on in the next few years.

A big buffer to help growth

Compound risk-adjusted return (%)



Source: Company presentation.



Source: Company Report, BofA Global Research.

I started out by referring to the technological disruption in the payments arena and the risk it entails to legacy systems. I have little doubt that the Indian financial system is undergoing a radical change over the coming years. Yet, with SBIC, the hook of reward points remains the anchor in human behaviour. In the rest of the world, the concept of 'buy now, pay later' by companies like Afterpay or Klarna seems new. In India, an equivalent product called the Equated Monthly Instalment using existing cards has existed for some time. Overall, the facts, in my opinion, are too strong to ignore: high net interest margins; the right management incentives; a reliance on technology; a marketing mindset; a large addressable market; and severe under-penetration of cards in India. The most impactful risk could be when the central bank reduces merchant discount fees (MDRs), a global trend which will transpire in India. That risk is real, but my sense is that debit cards (where MDRs are already reduced) and UPI, for small ticket payments, are alternatives for the general population. The Reserve Bank of India (RBI) might view those two instruments as adequate for financial inclusion. Optimistically, this risk pans out three to five years in the future, when penetration levels of credit cards are higher. At that point, the RBI might justify a lower MDR. Until then, SBIC needs to generate high margins to address the risk it carries as witnessed during the pandemic. Hence, I am of the view that SBIC has a strong business, already tested by this downturn and is poised for sustainable growth, in which we should participate.

JOHCM Asia Ex Japan Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.10.20	31.10.19	31.10.18	31.10.17	31.10.16
A USD Class	22.31	22.00	-24.26	17.20	8.07
Benchmark	16.32	13.69	-13.87	30.23	6.53
Relative return	5.14	7.32	-12.06	-10.00	1.44

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 31 October 2020. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.