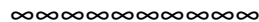


DURO CAPITAL

The purpose of this letter is to provide you, our partners, with deeper insights into our investment philosophy, portfolio and performance. By investing a significant portion of our own net worth into our funds, we ensure that our interests are fully aligned with our investor partners.

I had the pleasure of meeting several US-based investors in-person last month. Not surprisingly, I received numerous questions around the flood of investment activity and associated increase in valuations of technology-related companies in the private markets in India. Without passing judgement on the valuation metrics and future projections currently being used in private market deals in India; I will highlight in this letter how technology is driving change across companies, both new and old, in the Indian economy. I have discussed an example from the financial services industry below. We do not believe that the benefits of technology (and the resulting value creation) will be limited to just the new technology companies that have received the outsized share of new capital in private markets. This lopsided capital flow is creating opportunities on which we hope to capitalize.



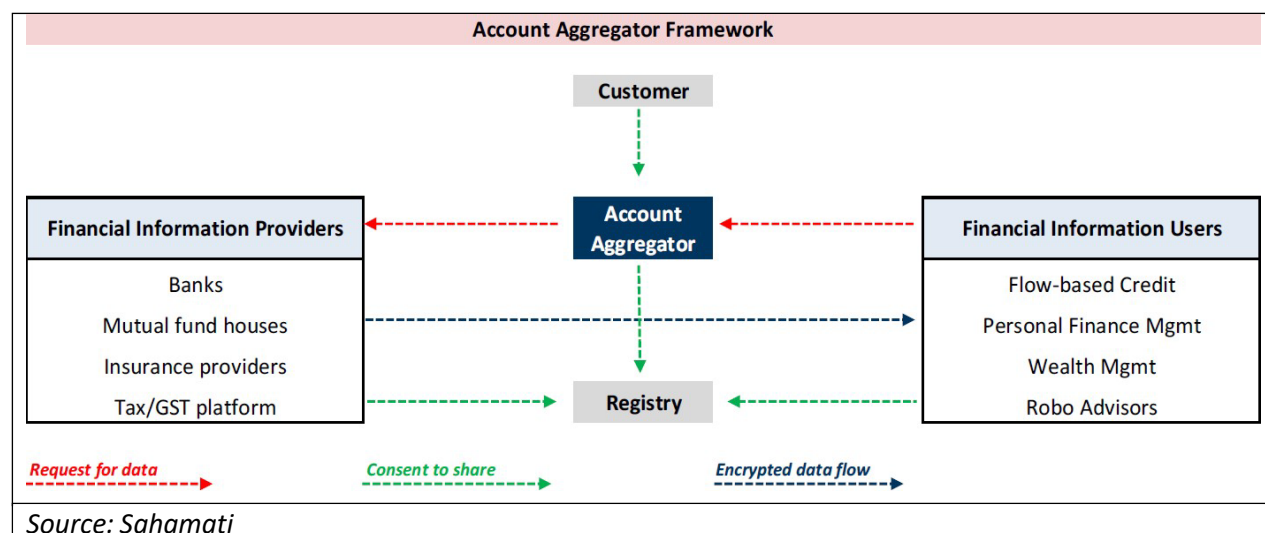
India's investments into its digital infrastructure through initiatives like *Aadhar* (unique identification numbers to all residents of India) and *United Payments Interface*¹ ("UPI," a real-time payments system) have had far-reaching implications. Last quarter, on 2nd September 2021, the Reserve Bank of India launched the *Account Aggregator Framework*, marking another important milestone in India's digital infrastructure related to data democratization.

How does the Account Aggregator Framework work?

The Account Aggregator framework is a regulator-approved, scalable platform that facilitates frictionless and secure sharing of consumer data (conventional and alternate) between users and providers of such data, subject to customer consent.

An Account Aggregator (AA) brings all customer data, like bank statements, investments, insurance policies, GST tax records, etc. under one platform, in a standardised, encrypted and machine-readable format. AAs act as consent managers for customers, who are the owners of their own data. Once a customer's consent is received, AAs enable a seamless flow of customer information in an encrypted manner between a customer's existing financial services provider (making this institution a *financial information provider*) to the customer's potential financial services provider (making it a *financial information user*). The framework thereby provides consumers greater digital control over their data and reduces data arbitrage among financial institutions with whom such consumers interact.

¹ Google referenced its "India Experience" and UPI's "amazing results" in a letter to the Board of Governors of the Federal Reserve System for the deployment of Fed Now, a new interbank real-time gross settlement service in USA
(https://www.federalreserve.gov/SECRES/2019/December/20191227/OP-1670/OP-1670_110719_136981_396266957468_1.pdf)



Digital infrastructure investments can add significant value to industries by **increasing access to a larger user base** and by **making processes frictionless**. Greater access increases the size of the total addressable market; while a frictionless process leads to higher frequency of use through lower human and system effort, and also leads to reduced process costs. As a result, technology-led value creation can be driven by a combination of increased revenue and attractive unit economics over a larger user base.

Increase Access: How will the Account Aggregator Framework increase credit penetration in India?

Aadhar provided a huge boost to the Indian government's Jan-Dhan scheme, a national financial inclusion program that aimed to create bank accounts for all Indians. The penetration of bank accounts among eligible Indians increased from 35% to 80% between 2011 and 2017, bringing India at par with China, which saw penetration move from 64% to 80% during the same time period. However, formal credit activity or use of a credit card for the Indian population above 15 years of age, remains at an abysmally low level of 8.1%.²

Consumer lending in India relies heavily on credit scores; and, while awareness of credit scores has risen sharply in the last 5 years, as per World Bank's data, 37% of Indian adults (i.e., 300 million adults) are still not covered by any of the private credit bureaus, thereby making them "credit invisible". Moreover, 25% of Indian adults (i.e., 200 million adults), are considered non-lendable because static credit scores from traditional credit bureaus are not individualized, but instead put such individuals into pools that are expected to exhibit a particular default behaviour.

At the same time, India had approximately 850 million debit cards in circulation as of July 2021. These 850 million accounts create valuable data related to financial transactions and assets that is currently being ignored for making credit decisions because credit bureau scores only aggregate performance of customer liabilities (i.e. home loans, credit cards, etc). This has led to a credit gap of over \$300 billion in India³. The Account Aggregator framework has the potential to fill this gap and increase credit penetration meaningfully by giving consumers the ability to share their transaction-based data with financial institutions. Account Aggregators will thus become credible alternate data sources for the lending

² Source: The World Bank

³ Source: Sahamati.org

ecosystem that will supplement credit bureau scores by collating the asset-related information about customers. This asset-related alternate data will show how the customers have been spending their money and can be used to predict financial aspects like spending power, monthly expenses, future commitments etc. thereby helping in underwriting decisions by the financial institutions. This will lead to meaningful credit growth in the system.

Reduce Friction: How will the Account Aggregator Framework reduce costs and increase frequency of use?

- The AA platform makes information sharing seamless in a standardised and encrypted format. Eliminating manual intervention will reduce:
 - Loan processing costs that can in turn be passed on to the individuals/small businesses.
 - Data errors or potential misuse in reporting personal information.
- Technology-driven sharing of information will also materially reduce turnaround time for loan requests; customers will be able to get real time replies and quick disbursals.
- With the power to share information with lending institutions through simple consent, customers will be able to transfer high-cost balances to lenders that provide them with the most attractive terms.
- Given the high degree of standardisation, financial institutions will be able to use various algorithms to provide tailored solutions and customised products for customers. This will lead to increased cross-sell opportunities, which will lead to further operating leverage for financial institutions.
- Easier availability of relevant information will lower the cost of customer acquisition and credit underwriting for lenders. This will reduce cost of borrowing for consumers across the board, and especially for those new to credit with shorter or no credit history.

At the margin, this digital transformation may help some traditional banks more than new-age fintechs

- Until now, innovation in lending has been restricted by the time and costs involved in discovering and analysing new customers. New-age fintech companies had the upper hand in both capturing and utilizing alternate data. The Account Aggregator framework neutralizes that advantage.
- Moreover, new-age lenders which have built their entire business on the basis of data capture advantages, without building any other core competencies like collections, customer service, etc. will face an existential crisis.
- Cost of funds becomes a significant advantage where borrowers have the ability to transfer balances more seamlessly to institutions offering them the best deals. Big banks have a clear advantage in this area because they have access to the lowest cost deposits.
- With limited availability of relevant information in the past, banks have traditionally utilized more stringent asset-based lending strategies while lending to small and mid-scale enterprises as well as to “new-to-credit” customers. This provided fintechs with an opportunity to target this segment aggressively and build an asset base with relatively high yields. The Account Aggregator framework will allow banks to utilize cash-flow based underwriting strategies to target this segment at significantly lower yields, thereby further increasing competition for new-age players.

The establishment of the UPI network in 2016 led to a massive surge in digital payments in India. Digital payment transactions increased by ~1,250x between FY2017 and FY2021⁴. We believe that the Account Aggregator framework has the potential to spark a similar revolution in credit uptake in India. Banks were late to the payments party that was triggered by UPI in 2016. This led to the emergence of sizeable fintech

⁴ Source: Reserve Bank of India

companies in the payments space in India. Private market investors believe that new-age companies have the capability to now extend their sights to lending and gain share at the expense of banks. Valuation increases of 2-3x in a matter of months for new-age companies in the private markets reflect this belief. Meanwhile, the Nifty Bank index is currently trading at below its pre-covid valuation multiple despite the banks having over provided for Covid-related credit costs and having significant capital buffers. We believe that the banking sector is positioned very differently in 2021 than it was in 2016. In 2016, commercial bank non-performing assets (NPAs) stood at 11.5%⁵ and banks were then coming out of the Reserve Bank of India mandated asset quality reviews (AQRs). Since then, asset quality for banks has improved significantly, technology investments for most banks have shot up sharply and cost of funds has fallen drastically given the boost in deposit mobilization during covid. This combination of technology upgradation and low-cost funds will make specific banks significant beneficiaries of the account aggregator framework. We believe that our investments in the banking space position us well to capitalize on this opportunity.

Nishchay Goel
December 2021

⁵ Asset Quality of Indian Banks: Way Forward by N.S. Vishwanathan
(<https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/07SPAEDAC43052384566B9E9C690D66F94AE.PDF>)

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