

DURO CAPITAL

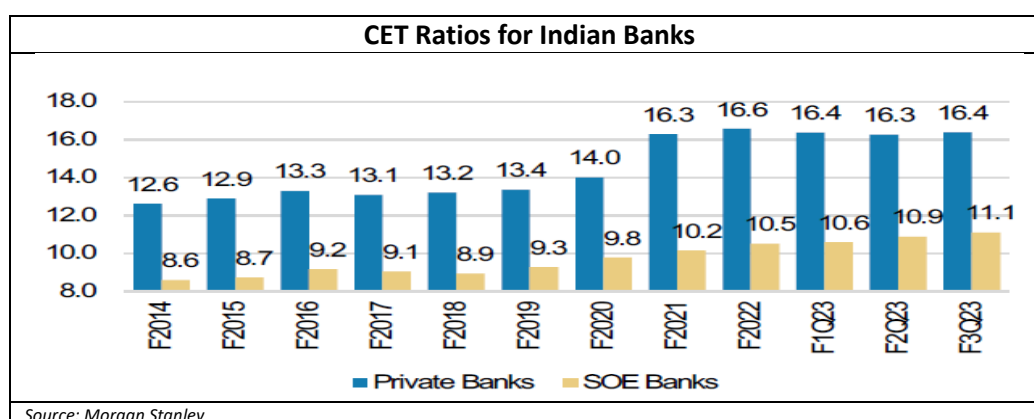
The purpose of this letter is to provide you, our partners, with deeper insights into our investment philosophy and portfolio positioning. By investing a significant portion of our own net worth into our funds, we ensure that our interests are fully aligned with our investor partners.

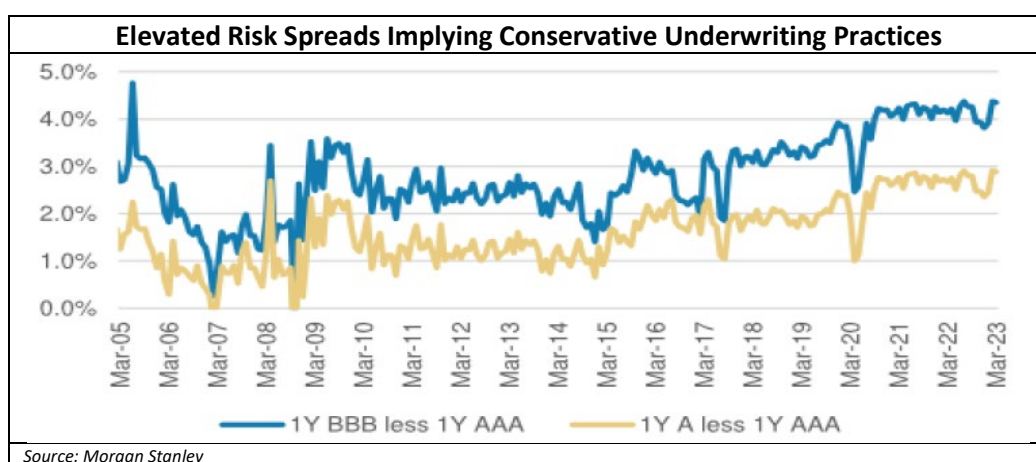
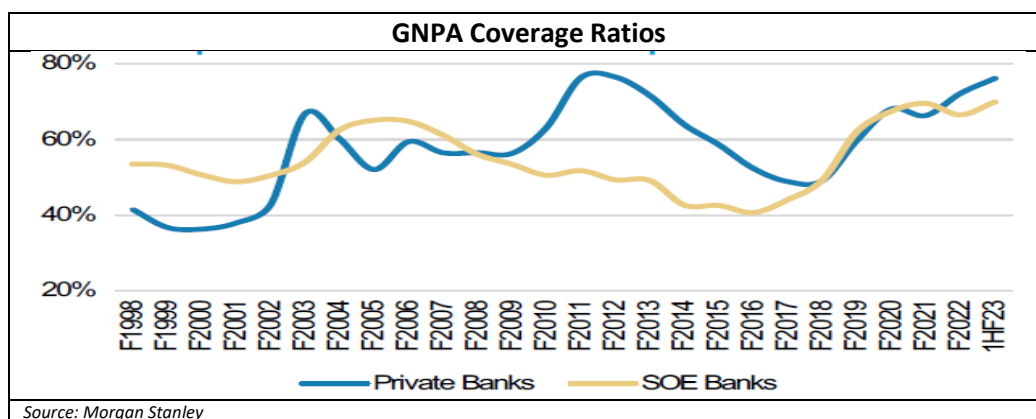
Given the recent bank run on Silicon Valley Bank and the Swiss government-orchestrated merger of Credit Suisse with UBS, we are taking the opportunity to discuss some of our financials holdings in this letter as well as presenting some thoughts on the Indian banking sector.

India went through a Non-Banking Financial Company (NBFC) crisis in the Fall of 2018. The crisis was triggered by a substantial asset-liability mismatch at one of India's largest (and AAA-rated) non-banking financial companies, IL&FS. IL&FS' asset side primarily comprised long duration real estate and infrastructure assets. The crisis was triggered when cash flow from long duration assets was not sufficient to meet near term liability payments. Much like in the case of SVB, Indian banks and mutual funds at the time had been increasing exposure to NBFCs as they sought out higher yielding paper in a high liquidity, low yield environment that had been triggered by the actions of the Reserve Bank of India (RBI) post-demonetisation.

Not only did the Indian NBFC crisis push IL&FS into bankruptcy, other NBFCs like Dewan Housing also went belly up, while companies like Indiabulls Housing and Piramal Enterprises lost significant value. Even the weak(est) banks (Yes Bank, IndusInd, RBL Bank) became collateral damage. Yet, the crisis was contained with limited damage to the overall economy not only because of specific actions of the RBI; but also because of the multi-year clean-up process that had been underway at Indian banks following the asset quality reviews initiated by the RBI in 2015.

Just a few quarters after the NBFC crisis, the Indian banking sector was hit by the never-before seen uncertainty and challenges related to the Covid crisis. Banks again made massive provisions (perhaps over-provisioned) given the uncertainty ahead and raised capital to arm themselves to face the Covid challenge. Banks also tightened credit filters sharply. All these actions paved the way for what some bankers have recently described, and we would agree, as the perfect set up for the Indian banking sector, i.e., significant contingent provisions, adequate capital adequacy ratios and pristine asset quality, at a time of an improving domestic credit cycle.





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Analyzing Banks

A banking institution's ROE tree is driven by the following key parameters:

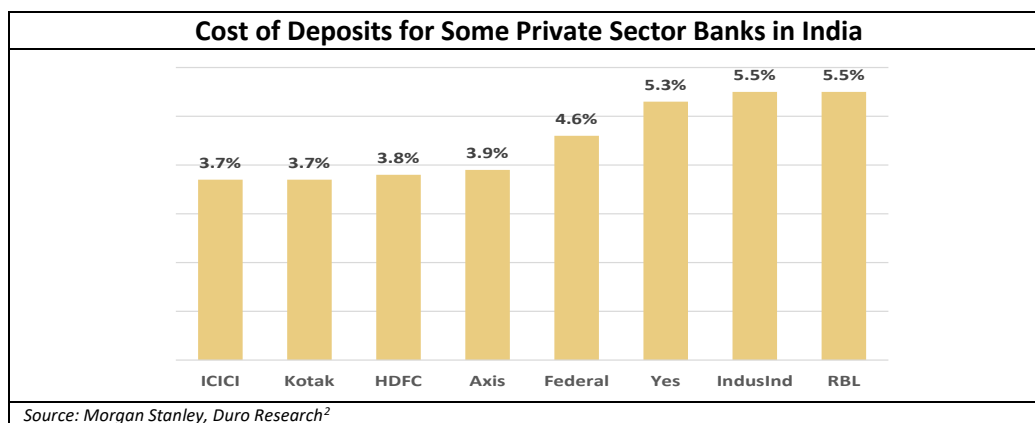
- (1) Interest income
- (2) Non-interest income
- (3) Cost of funds
- (4) Operating expenses
- (5) Credit costs

Any differentiation or competitive advantage, or as we refer to it at Duro as the “why” of a lender, should be reflected in one or more of the above parameters. For example, a differentiated bouquet of products and services may lead to stronger cross-sell opportunities, which can help increase non-interest income as well as reduce operating expenses per customer. A stringent underwriting culture along with strong collection processes should consistently result in lower credit costs. Obviously, an ideal franchise would check as many boxes as possible.

However, we have found it more useful to invert the process and focus on identifying suitable investment candidates by first eliminating situations that do not meet what we believe is the most important criteria for analyzing banks - their ability to garner low-cost deposits. Our research shows that a very large majority

of banks rely heavily on higher deposit rates as the primary tool to attract depositors at the ground level. Such deposits can be fickle (i.e. chasing the highest returns), and the higher cost of funds puts banks at a natural disadvantage while pricing their loans or puts pressure on their net interest margins. Even Kotak Mahindra Bank, one of the top private sector banks in India, started its journey to build its deposit franchise by offering significantly higher rates on its savings deposits as compared to other top private sector banks. It took Kotak more than a decade and a half to build the right bouquet of products and services for its newly acquired depositors to make it a bank of choice for its customers. Today, depositors come to Kotak because of their trust in the Kotak brand and not just the rates of return offered on deposits.¹

Only a select few banks in India today have been able to develop a brand that can attract depositors despite not offering the highest rates of interest on deposits. These banks have a huge advantage over competition because they are able to attract the highest quality depositors to their franchises. This provides them with a cost of funds advantage, which gives them the ability to target higher quality assets and also earn higher net interest margins on their loans. This in turn leads to superior return ratios.



Duro's investments in the banking sector are primarily focused on such select banks (ICICI, Axis). While it should be expected that central bank interest rate movements will drive cyclicity in bank earnings, the overall credit under penetration in India makes us confident that there is a long runway for these superior franchises to both gain share by continuing to grow faster than the broader market and do so on more profitable terms.

ICICI Bank

ICICI bank has undergone significant change in its organisational culture under Sandeep Bakhshi, who took over as CEO of the bank in 2018. The primary change under Sandeep's leadership has been an alignment of the entire organization around a deep focus on customer service through its "One ICICI" initiative. Under this initiative, the bank has reorganized its go-to-market strategy and measures KPIs on a ROE per customer basis, as opposed to individual bank vertical profitability. The bank's quarterly results have now exceeded expectations in 10 out of the last 11 quarters. ICICI bank also has one of the lowest cost of funds in the

¹ Please note that we are not using state-owned/public sector banks in the above analysis. Public sector banks have a natural advantage in garnering deposits given that, in the eyes of borrowers, the deposits are backed by the government. Yet, the underlying risk of government owned banks is that they are prone to "directed lending," which significantly outweighs the cost of funds advantage that such banks may enjoy.

² Kotak and HDFC Bank do not disclose cost of deposits. The numbers in the graph are estimates using calculated cost of funds numbers for Q3FY2023.

banking industry along with the highest liquidity buffers amongst the large private sector banks in India. This positions the bank relatively well for credit growth even in a tighter liquidity environment with rising interest rates. Moreover, the bank has excess provisions equivalent to 2.2% of total advances or 11% of net worth that provide an extraordinary buffer against any unforeseen macro/micro risks.

Axis Bank

Axis bank, too, has been a revival story under its CEO Amitabh Chaudhry. Amitabh joined the bank in early 2019 and has focused on re-aligning the bank's strategy along 3 pillars: Growth, Sustainability and Profitability. The bank has gone through an aggressive assessment of its book under the new management and is currently sitting on provision buffers in excess of 100% of gross NPAs + restructured loans. Axis has seen the strongest core margin improvement amongst its peers in recent quarters and its return on assets gap versus its large private bank competitors has been closing steadily. Axis has also invested aggressively into technology and currently has the highest rated mobile banking app in the country.

Duro's Midcap/Smallcap Financial Holdings

Ujjivan Financial Services

Out of the three banks that we own in our portfolio, only one is a smaller bank without a dominant deposit franchise – Ujjivan Small Finance Bank ("Ujjivan"). So why do we own this bank if the bank does not have any competitive advantage on the liability side? Our assessment is that its lack of an advantage on the deposit side is more than made up by its focused approach on the asset side of the balance sheet.

Ujjivan is currently the fourth largest microfinance lender in India with 70% of the bank's assets focused on microfinance lending. Microfinance is a large and severely underpenetrated market in India, making long-term prospects for focused players very attractive. Yet, microfinance is an operationally intensive business. One needs to first put together groups of appropriate borrowers (given the group lending model in microfinance that makes the entire group liable for repayments of each group member), organize regular in-person group meetings, stay involved in the community and ensure that stringent practices are followed to avoid over-levered borrowers from joining groups. This makes it a high opex to assets business (~6%). But the high operational cost is more than made up by the significant net interest margin that a good microfinance organization can earn (~10%). The key differentiation of a microfinance lender also lies in its ability to manage credit costs over cycles. For example, geographic diversification protects against community-specific adverse events. Ujjivan stands out in this regard with 598 branches across 25 states and 254 districts in India; with no state contributing more than 15.5% of gross AUM. This is one of the reasons that business for Ujjivan has rebounded sharply post-Covid, which was a black swan event for the sector. The bank is already back to generating 25%+ ROE with 25% AUM growth.

While cost of capital for banks without dominant deposit franchises may rise more aggressively given the current events around the banking sector globally, we believe this may be less likely in the case of Ujjivan. Ujjivan has a higher share (62%) of retail deposits in its overall liability mix, and retail deposits are stickier than yield-chasing institutional deposits. The bank should also be able to absorb any unforeseen credit costs with relative ease given the significant buffer provided by its generous pool of contingent provisions. Ujjivan was the best performing stock in our portfolio in 2022. Despite this strong performance, the bank still trades

at 1.0x forward price to book.³ The attractive valuation of the company should act as a floor in the event of a significant price correction.

Five Star Business Finance

Five-star Business Finance (“Five Star”) is an NBFC that provides 100% secured business loans to micro entrepreneurs and self-employed individuals in India. A perception of higher risk as well as exorbitant costs of delivering credit to small businesses has constrained formal lending to such businesses and led to a credit gap of approximately INR 80 trillion (USD1 trillion) for this segment. Furthermore, there is no fixed template of underwriting which can be easily replicated across India because similar businesses can have disparate metrics in different parts of the country.

Five Star has built a niche in lending to this segment with an average ticket size of USD4,000 while generating IRRs of ~24%. The company grew at a measured pace (~15% CAGR) for the first 10 years of operation so it could gain a deep understanding of diverse borrower profiles across different geographies. Even today, after having ramped up its growth to >35% over the last 6 years, the first 500 loan applications in any new geography require a final sign-off from the CEO of the company. Given these nuances of the business, the reward for issuing a USD4,000 loan is not commensurate to the effort for a lot of organisations, and this has created a natural barrier to entry for many organisations to enter this segment. At the same time, Five Star’s execution excellence has helped contain credit cost across cycles and deliver ROA of 8%+ without having the need to ever repossess collateral from a borrower.

Duro’s investment into Five Star in 2022 was a privately negotiated transaction where we bought shares from a motivated seller, who was in need of liquidity. The business listed on stock exchanges shortly after we made the investment, and we are currently sitting on a reasonable unrealized gain on our investment. We believe Five Star has the capability to grow its AUM at >25% CAGR for the next 5+ years. This growth will come from (1) branch expansion (2) an increase in ticket sizes (which haven’t increased for the past 4 years), and (3) an increase in utilization of existing branches. In terms of cost of funds, we believe that, notwithstanding very sharp turbulence in global financial markets, the cost of funds for Five Star should continue to come down despite the rising interest rate environment. This is because the company now gets the benefit of being a publicly-listed company and has seen its credit rating upgraded to AA-. It is therefore able to raise incremental liabilities at 8.7%, whereas its existing pool of liabilities is at a cost of ~10.3%. We believe that there is a potential for us to generate a ~25% IRR over the next few years on this investment.

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Financials comprise approximately 33% of our AUM currently. The positions, as you would expect, are concentrated in our highest conviction ideas. It is interesting to note that despite the earlier mentioned healthy status of the Indian financials sector, it currently trades at a valuation that is lower than its 10-year average. I am inclined to say that our financials investments should be able to bear the brunt of a potential global crisis with greater ease than comparable banks/lending institutions in developed markets. Yet, given the typical unknown unknowns in every crisis as well as the levered nature of the financials industry, I am also inclined to warn you that it is likely that we may see reasonable volatility in stock prices of our financials

³ Duro’s investment in Ujjivan SFB (USFB) is through the bank’s holding company, Ujjivan Financial Services (UFS), which trades at a >20% holding company discount versus the value of its 73.67% equity stake in USFB. This discount is likely to be reduced to zero with the imminent reverse merger of UFS into USFB. This should lead to an additional 25% upside in our holding value on the day that the reverse merger closes.

holdings in the event of such unknown unknowns playing out. Long term investors should welcome such volatility in stock prices and should in fact use the opportunity to increase exposure into their highest conviction ideas. I know we at Duro will make every attempt to do this; like we have across our 12+ years of investing in India.

Nishchay Goel
March 2023

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