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Vol. V - N° 56 - Septembre 2016

L'AVIS DE L'ANALYSTE

Motilal Oswal: Transforming the business model amid turbulent times, to build 4 engines of long-term sustainable Return on Equity

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In FY2013-14, the capital market focused firm found itself at a critical juncture

Established in 1987 by two first-generation entrepreneurs, Motilal Oswal Financial Services Ltd's *(the firm)* distinctive positioning of using research and advice in Indian equities helped it grow into one of India's largest stockbrokers. It was one of the few Indian brokers to have meaningful presence in both, with healthy market share across retail and institutional clients. Apart from its direct branches, it also leveraged the power of entrepreneurship using franchisee-partners to expand its retail network across India. It was one of the first Indian brokers to gain market share from both foreign and domestic institutions. During the market cycle from FY2003 to FY2008, this broking business alone had helped the firm's profits grow 10X, along with a 3X growth in market share. Since 2003, it extended this competence in equity research to active-investing, through its managed accounts business (PMS). Inspired by the likes of Warren Buffett and Benjamin Graham, its investing philosophy was built on buy-and-hold value-investing.

During 2007, the firm diversified its business mix around this core. It expanded into related businesses like investment banking, wealth management, private equity and exchange-traded funds (ETFs). Each of these was focused on specific differentiators. The ETFs provided innovative market-access strategies. Private equity funds invested growth capital into SMEs across consumption-driven sectors. The real estate funds targeted upcoming residential projects in Indian metros. Investment banking focused on advisory, almost like a strategic CFO to the client. In this process, the period from 2007 to 2012 was an investment phase as the new businesses established their right-to-participate. The original broking business maintained stable profit margins despite the market cycle, since its well-entrenched franchisee business helped keep the cost-structure variable. By the end of FY2013, the firm managed ~Rs 110 bn in depositary assets and ~Rs 30 bn across its PMS, ETFs, private equity and real estate funds. The wealth management business managed ~Rs 20 bn of assets.

This phase from 2008 to 2013 saw a continued economic slowdown in India due to various global and domestic factors. The allocation of retail savers to equities, directly or through mutual funds, remained volatile. This situation impacted asset mobilization, volumes and revenue for the firm. At the same time, the firm was also facing an internal tribulation – that of low Return on Equity (RoE). Getting the business right was one thing, but getting the allocation of capital right was another! The firm's capital market businesses were essentially agency-driven, i.e. they hardly needed huge capital. Since the broking business was cash-flow positive, its internal accruals were more than adequate to meet the need of the other businesses. So while these agency businesses could earn as much as ~30% RoE, they used up only Rs ~1-1.5 billion out of the firm's Rs ~12 billion net worth in those times. Rs ~3 billion was also invested in the new corporate tower in Mumbai, which had its internal benefits of synergies by consolidating all the businesses under one-roof. The firm had allocated Rs ~5 billion to its loan against shares lending book and Rs ~2-3 billion to a cash-futures arbitrage book. But once intermediation costs and taxes were removed from their returns, the net returns of ~9-10% and ~7-8% respectively from these activities hardly justified the capital invested. Once all the components were aggregated, the ROE for the firm was sub-10%. Hence, the concern was to allocate the net worth so that the firm, as a whole, could earn a meaningful ROE? Moreover, as the profits added to the net worth each year, even more net worth was becoming ROE-dilutive!

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One way to firm up the ROE was to return excess capital to the investors. In line with its philosophy inspired by Buffett, the firm had consistently paid dividends. It also did a share buy-back programme. However, there was a limit till which it could reduce its balance sheet. A sizable balance sheet was a compulsion to give comfort to institutional clients and banks. Maintaining a large balance sheet became a necessary evil, the price for which the firm paid through a lower ROE.

At this time, the firm found itself at a critical juncture, both in terms of its business strategy and in capital deployment.

Bringing in a transformation in its business model: From 2014 onwards

"To finish first, you have to first finish"

Inspired by this philosophy of Charlie Munger, the promoters held the belief that it was better to concentrate on fewer things, but do them so well that one could claim to be a market leader in that space; rather than do too many things where it did not have a right to win and would end up being another me-too provider. In a market where the competitive intensity was high, any company which did not have a distinctive value-proposition could not go deeper and risked losing brand recall. A differentiating value-proposition gave clients a solid reason to come to you instead of others, and gave the firm competitive advantages to sustain market share for the long-term. If the business could not offer a distinct promise to its customers to differentiate itself from the crowd, it was better to exit rather than burn capital. Differentiation also had to combine with efficient processes and delivery to the customer. This combination competitiveness and efficiencies would help build scale, and cement the firm's position for the long-term. This formed the basis of the transformation of its business model, to gear the firm towards earning a sustainable 20%+ ROE over the long-term.

1st engine of ROE growth: A return to its core competence of active-investing through new mutual fund products

As FY2014 ended, the leadership deliberated what was the firm best known for? Equity research and active-investing was the firm's core competence. It had started from advisory in broking and extended to active management in PMS. The long term track-record of the flagship PMS schemes stood testimonial to the firm's prowess in active-investing.

While its asset management business had launched ETF products and seen healthy mobilization in their new-offer period, subsequent sales in ETF products were yet to pick in the Indian market. The fee-for-advice segment, which majorly invested in index-based ETFs through asset allocation strategies, was still not deep in India. So while the ETFs provided innovative market-access, scaling up the AUM base was a challenge with only ETFs.

Using its active-investing skills based on buy-and-hold value investing, the firm now launched new open-ended equity mutual funds. These were focused products on the market-cap spectrum – just three funds based on large, mid and multi market caps. It aimed to identify long-term multi-baggers in a concentrated portfolio, to enable long-term wealth creation for its customers. The firm's investing philosophy was documented as the QGLP framework. This QGLP framework was the result of the series of Annual Wealth Creation Studies which it had conducted each year since 1996. It signified the methodology by which the firm identified long-term multi-baggers - Q stood for quality of the business and management, G stood for growth in the business and sector, L stood for longevity, in terms of sustainable competitive advantages the business had built to sustain its business for the long-term, and P stood for a reasonable price.

Very few asset managers in the Indian industry had actually documented their investing process. Most asset managers concentrate on performance, not on process. But the firm wanted to sell its investing process, rather than performance; since the performance was an output of this well-crafted investing process.

In order to position itself as a niche equity specialists based on its core competence of equities research and investing, the firm's gold and gilt funds were wound up. Having products across asset classes made asset managers feel safe in market cycles. But "me-too" products hardly succeeded in incremental asset mobilization, when the crunch time came. On the other hand, the firm's core competence in Indian equities served it well to scale up in that niche space.

The focus on its core competence meant that it invested into a quality investing team rather than a large sales team, and instead used external distributors to sell its funds. Using the Dream Buyers concept from Chet Holmes' book "Ultimate Sales Machine", it identified a target list of key distributors and started showcasing its QGLP process. It conducted continuous engagement through seminars

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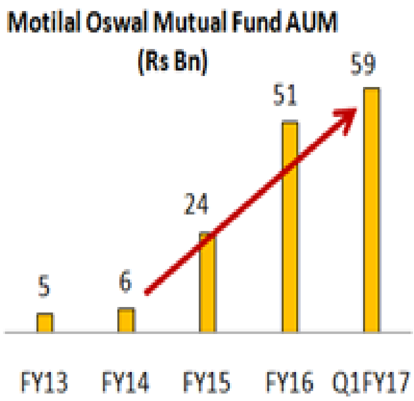
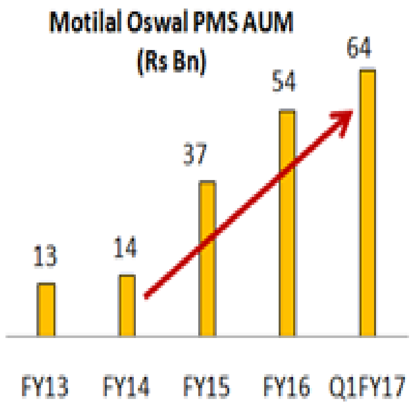
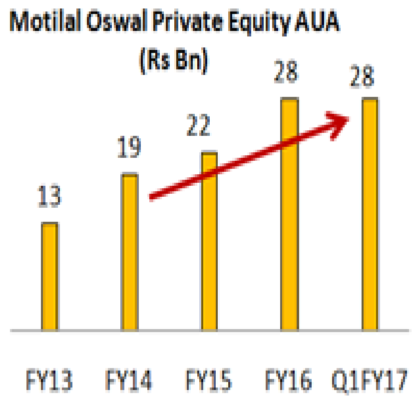
to convey the QGLP philosophy. In a market where most large asset managers were backed by large banks/ conglomerates, the pitch of its QGLP philosophy became its right-to-win.

The last two years have seen the firm increase its market share in net mobilizations in equity funds, which is proof that it has been able to open the doors of several distributors to its new equity funds by pitching its QGLP investing process. Its net sales market share has been strong even when the net flows in the overall market dipped. In the process, it has emerged as one of the fastest growing equity asset managers in India in the last two years, and has grown its equity AUM ranking from #18 in Mar 2014 to #12 in Mar 2016.

Not only do these fund products bring in annuity-income which gives stability to counter the inherent cyclical broking business, but they also bring in lumpy returns through carry-income on exits from private equity funds or performance fees in the PMS business. The first of its private equity funds has seen exits from some of its holdings at healthy multiples, and this fund would also yield carry income as it approaches its eventual close in FY2017-18. The real estate funds have seen significant investor interest in their new fund-raises, and the newer funds are announcing their close in lesser duration and with higher mobilization, than the earlier funds. *By June 2016, the firm managed Rs 151 bn across its PMS, mutual funds and private equity funds as compared to only Rs 30 bn back in Mar 2013 – a 5X growth.*







2nd engine of ROE growth: Starting the affordable housing finance business

Getting the business right was one thing. But getting the capital allocation right was another thing. Keeping the net worth in the loan against shares and cash-futures arbitrage books was not proving ROE-accretive. The firm had to find better opportunities to deploy this capital. In 2014, the leadership took few crucial decisions. It decided to run the loan against shares book as a spread business using borrowed funds, not from net worth. Equity capital had to match with equity-style returns, and debt capital had to match with fixed-income style returns. In any case, this book was opportunistic and was just a support to the broking business. Funding it through borrowed funds would mean using cheaper debt capital for this fixed-income avenue. The arbitrage book was also wound down, and the manpower reinstated in the broking business.

This freed up capital. Since equity-style returns are best earned from business opportunities, the leadership studied several opportunities that could use this capital, and offered a large, untapped opportunity with relatively lower risk. Within lending activities, the affordable housing segment fitted the bill closely. Small-housing ownership was relatively untapped in India, and was coming under the focus of the government. But the firm did not have the right-to-participate in this space, as it had no prior experience. At this time, it started engaging with Anil Sachidanand, a mortgage industry veteran, who was keen to grow a new venture. Thus, Aspire Home Finance was born in 2014. The home loan business is a secular growth

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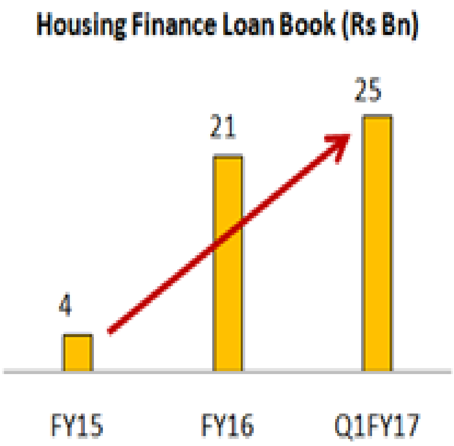
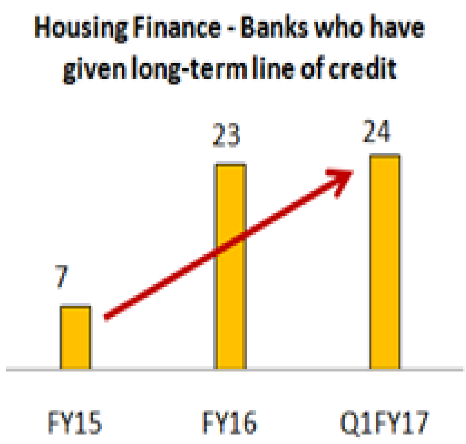
business which can yield increasing incomes and high RoE as long as asset quality and underwriting standards are maintained; which would justify launching Aspire as a pillar for enhancing the firm's RoE.

The focus of this business was to be small-ticket home loans for retail home-buyers, not higher risk wholesale real estate lending. This target segment was essentially need-based for a dwelling unit. Given the profile of this target customer and the need to assess their income, Aspire developed rigorous models of income assessment as part of the credit underwriting process. An experienced team was also brought in to set up the operations of Aspire. Stringent milestones were laid down for corporate governance, internal audits, risk and underwriting checks. Aspire had to get the bank-lines on its own steam, not through corporate guarantees by the firm. Checks were put in place for concurrent audit of files, monitoring of cheque-delays and ensuring the underwriting quality. Daily operations would take a back-seat if these processes were ever to be compromised. This culture of operational excellence resulted in Aspire receiving a higher rating than what a start-up mortgage firm would have otherwise received. It even got rating upgrades during its initial years of operations, which would augur well for future fund-raises.

Since the first milestone was to establish proof-of-concept, the capital deployment into this venture started out with only Rs 1 billion. As Aspire expanded in the provinces of Gujarat, Maharashtra and Madhya Pradesh, and backed its operations by carrying out all the monitoring and governance tasks periodically, it established it's right-to-participate. As of June 2016, Rs ~4 billion of the firm's net worth had been deployed into Aspire as equity capital.

Since the last two years, the new venture has clocked solid traction in both assets and liabilities, while maintaining asset quality. It has grown its loan book, expanded its branch network and cracked banking relationships for long-term funding. This business delivered profits in its first year of operations, and contributed meaningfully to firm's profits in its second year. As a result of its operational excellence, it received rating upgrades which should augur well for future fund-raise.





3rd engine of ROE growth: Sponsor commitments into own asset management and private equity funds

While Aspire would regularly utilize the excess net worth from the firm's balance sheet more productively, it was still not enough to address its immediate challenge of finding productive sources for deploying the entire freed-up net worth. The deployment into Aspire home loan business was going to be over phases, as and when it reached periodic milestones. The firm still had a sizable amount of capital left to deploy. Returning to its area of core competence, the leadership decided to take this commitment further. Why not put your money where the mouth is? If its core competence was active-investing in equities and it believed it had established its QGLP investing process stringently to

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identify multi-baggers, then why not deploy the net worth in those opportunities? The track-record of its QGLP investing process stood testimonial in its PMS schemes – the Value PMS had delivered ~25% CAGR in 13 years and the NTDOP PMS saw ~18% CAGR since 2007 *(check Disclaimer in Q4FY16 earnings presentation)*. Having your own skin in the game would be the ultimate conviction one could show for their own business! If the leadership of an aircraft company does not fly in its own aircraft, how could passengers have the comfort in riding in it? In the same vein, the firm's commitments to its own investing process would give further comfort to clients. Thus, Rs ~6 billion of the capital was deployed over-time into the firm's own mutual fund products and Rs ~2 billion was invested into the firm's own private equity funds.

Not only did this show the firm's own conviction in its investing prowess, but it also helped seed those new businesses effectively. Its asset management business under the new avatar of mutual funds was a new-kid-on-the-block in the Indian funds industry, and this commitment helped the firm's distributors to pitch the conviction of the QGLP process to prospective clients while selling the firm's funds. Even the private equity business was rapidly expanding via new fund-launches in both growth capital and real estate spaces. In this process, these sponsor commitments to its own asset management and private equity funds helped seed those businesses, since it gave a huge selling-point for the distributors to leverage on. If this were not enough, the firm's two promoters liquidated their personal investments and redeployed it into these mutual funds. That meant total alignment of interest on investment ideas. Very few firms in the asset management space had seen this level of commitment in their own funds.

Apart from these, the sponsor commitments also represented a war-chest which could be deployed as commitments to the Aspire home loans business, as and when needed. The new home loans venture was in growth-phase. These commitments, along with the free cash-flows from the matured capital market businesses, would address this.

Moreover, these investments are yet to show realized gains in the firm's P/L statement, since the gains are yet to be booked. As of June 2016, the unrealized gains on the mutual funds commitment alone was Rs ~2 billion. The private equity funds would return capital as and when it exited holdings, and Aspire was yet to pay dividends on the capital.

4th engine of ROE growth: Reinventing its capital market businesses as per changing trends

Apart from returning to its core competence and redeploying net worth to more productive opportunities, the leadership also recognized that it needed to reinvent its original capital market businesses, if they were to remain relevant. The way the business was being done was fast changing! Digitalization was changing the rules of the game, and those 'slow in turning the steering-wheel' were losing out in the race. The firm had to adapt to new ways if its value-proposition to remain relevant for the new-age client. While it had the right-to-participate in these businesses, it meant it needed to reinvent its right-to-win. This meant the firm had to invest in relevant resources to capture this evolving opportunity.

At this time, the leadership studied the US market closely to understand how the retail financial advisory market had evolved there in terms of value-propositions, after the advent of technology. Three distinct models seemed to emerge in USA. First was execution focused platforms who served high-frequency traders at low trade costs. This segment did not focus on advisory, per se. Second was the supermarket model, where clients needed hand-holding and support in terms of knowledge resources and advisory tools. This opened up the market to new clients. Third was the advisory model which was relationship driven and technology tools supported the service delivery and decision-making of clients. Clients preferred the personalized approach of the advisors. This was the segment that the firm had been targeting in India.

With the economic outlook and market sentiments improving following the 2014 federal elections in India, the leadership took a conscious call to invest in these critical resources up-front instead of investing after the recovery phase had taken hold. This would give it three advantages – the resources would be available at a more competitive price if hired up-front, the pay-back period of recovering these investments would be longer and it would get a longer period to develop the systems and processes so that the offering would be up-and-running once market volumes improved. These targeted investments impacted its costs up-front, but their benefit is expected to bear yield over the long-term.

Since 2014, the firm's broking business invested heavily in talent in advisory and technology. Technology had the power to engage an increasing number of Do-It-Yourself

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customers through a single platform, while freeing-up the bandwidth of the advisors to concentrate on clients who needed hand-holding or discussions. Thus, technology offered immense scope to capture operating leverage over the long-term, despite the initial investments. Since the last two years, the firm has launched India's 1st and fastest 15-minute trading and demat account using eKYC process, India's 1st smart watch app, revamped its mobile trading app with superfast trading and one-time login and launched a new broking portal with single sign-on to trade, quick order-execution window and portfolio restructuring. These tools have captured the imagination of a new-generation of retail customers by providing access and convenience at the click of a button. The overall user-experience resulted in repeated visits, and now online business comprises as much as ~45% of overall volumes. Investments into advisors continued across dedicated desks, in line with its traditional method of serving clients through personalized advisory services. It also meant developing system-driven tools like portfolio-restructuring tool and portfolio strategy products, which were a key value-offering to clients to manage their investments.

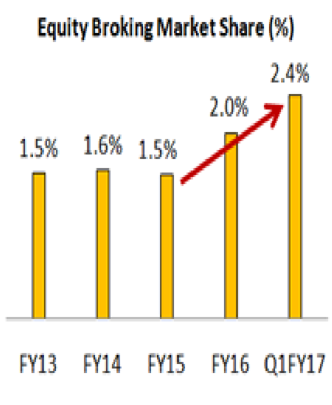
Recognizing that many retail investors were keen to earn long-term inflation-beating returns but were not entirely comfortable taking single-stock exposure, the firm focused on an assets-based financial product distribution approach. This meant not only broking, but also diversified products like equity mutual funds, PMS, bonds, insurance and suchlike. The firm, in turn, would earn trail-income on the financial products distributed, which would then help its revenue sources counter the inherent cyclicity of the transaction-based pure broking business.

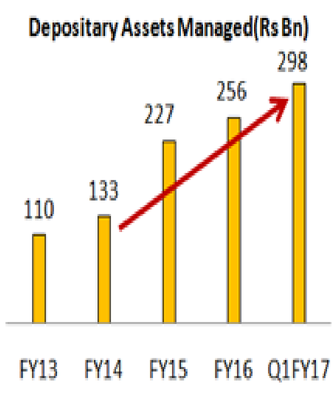
During 2015, the firm decided to invest in an equity capital markets team in investment banking, to meet the emerging opportunities in capital raising once the economic recovery set corporate capex plans into motion. In wealth management, the open-architecture product suite complemented its in-house manufacturing expertise in public equities and real estate products. This was complemented with technology-tools to make the life of the relationship manager simpler, so that they could concentrate on client-facing activities. These helped attract a number of new relationship managers into the firm, the key driver to grow this business. Moreover, the higher share of real estate and equity within its AUM mix gave it a more favorable blended yield on assets.

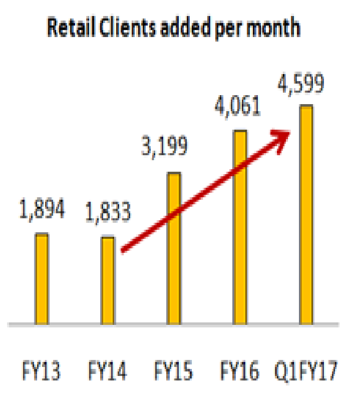
Since the last two years, the firm has improved its equity broking market share. In the retail business, the average number of clients added per month in FY2016 was 2.2X of what it was back in FY2014. It managed Rs 298 bn in depositary assets as of June 2016 as compared to Rs 110 bn as of Mar 2013 - a 2.7X growth. The firm's digital business has picked up significantly, and online business contributes as much as 45% of overall volumes now. Several franchisee partners have grown manifold in the size of business. In institutional broking, it continues to be ranked amongst the top local brokers across parameters in prestigious award forums like Asiamoney. The wealth business has seen traction in RM-count and assets. It managed Rs 74 bn in wealth AUM as of Jun 2016 as compared to Rs 20 bn as of Mar 2013 – a 3.7X growth. Since inception, the new equity markets investment banking team has already participated in IPO and QIP issues, setting the transaction flow into momentum.

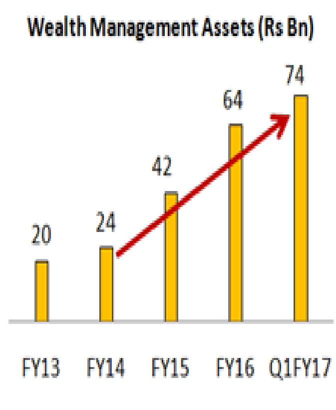
Becoming better in bad times, so that one can become bigger in good times

While transforming the business model, it was equally









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important to maintain productivity and efficiencies for business performance. The leadership put in place measurements of productivity, including non-sales metrics. In the broking business, it measured the number of times the advisor or management personally interacted with each client. Building personal rapport with the business managers across hierarchies was critical to control client-attrition in case the advisor left. Unlike the perception that an outgoing advisor took his clients with him, the relationships it built across hierarchies helped it retain clients even when an advisor exited. The periodic interactions with clients across hierarchies also helped maintain brand-recall in the minds of the client. To measure the success of its core competence, the firm put in place processes of measuring the strike-rate of its research calls in order to track the quality of the calls. It put in place value-add services for franchisee partners to help them improve their productivity, including business performance measuring tools, knowledge-sharing seminars, sales training sessions, etc.

Hire Maruti and make them into Mercedes

The promoters were first-generation entrepreneurs, who built this business on the basis of intellectual capital. In a relationship-driven business like financial services, it was critical to nurture the correct talent. Hiring star-performer mavericks meant high costs, and they were only as loyal as the incentives. Higher chance of attrition meant loss of few months to bring back the business on course. Instead, the firm stressed on young talent, and giving them an environment of learning, mentoring, growth and incentives which would motivate them to take on more responsibilities and become future leaders. Not only did this ensure a motivated workforce, but it also ensured a longer-serving workforce. Most of the business heads in the firm had not joined originally to head that business, but have grown from within the firm. Most of them have now spent an average 10 years with the firm. This shows the level of motivation and passion. Ownership stakes were offered to key people in order to ensure the firm's profitability remained high on their agenda. The Maruti in the section's title refers to the popular people-hatchback car, while Mercedes refers to the premium luxury car.

If the purpose and process are right, the results will follow

The firm had faced the challenge of a declining ROE till 2014. By bringing in a transformation in its business model since then, the deployment of the capital was turned towards better-yielding, sustainable opportunities. These gains would be notional now, since the home loans business is yet to pay dividends and the asset management commitments are still held at cost. But the track record of its QGLP process, coupled with the operational excellence it built in the home loans venture, gives the comfort that it has geared the firm towards a sustainable long-term ROE of 20%+.

Its financials are showing an initial impact. The RoE on reported profits during Q1FY2017 reached 22% (annualized), which is over the target RoE of 20%. This does not include unrealized gains on the commitments made in its asset management products, including which the profits and RoE should be higher. The objective is to now sustain this RoE over 20%-level over the long-term. Revenues in FY2016 were the highest since the firm's inception, while the profits were near its all-time high ever. The revenue and profit mix is showing an impact, as asset management and home loans comprise an increasing share in the mix.

During the previous cycle, the firm's performance was driven by only one engine - the broking business. This catapulted its profits 10X from FY2003 to FY2008. After this transformation to the business model, the firm now has 4 engines of long-term, sustainable ROE growth. As Q1 FY2017 ends and the initial results become visible, the leadership's faith in the adage that if the purpose and process are right, then the results will follow holds firm.

Sameer Kamath & Sourajit Aiyer