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ICRA RESEARCH SERVICES

Revenue growth and profitability to taper amid market volatility and cautious investor sentiment

INDIAN BROKERAGE INDUSTRY

Industry Update

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What's Inside

Executive Summary

Strong performance in the first half of this fiscal overcoming the setback faced towards the end of FY2018…

…though correction in October 2018 amid domestic concerns and weak global cues

Equity markets dominated by derivatives segment, which accounted for 96% of the turnover in H1 FY2019

Shallow recovery in H1 FY2019, which dampened cash segment performance

- After a downward slide in February and March 2018, the markets recovered in April 2018 supported by the stable domestic institutional investor (DII) inflow, expectation of revival in corporate earnings, uptick in the rural economy and a normal monsoon outlook. The recovery, however, was not broad-based and was largely limited to the large-cap segment. For instance, while the BSE Sensex and Nifty touched an all-time high in August 2018 and were about 5% higher than the peak achieved in January 2018, the mid and small-cap indices on the two exchanges trailed ~5-20% behind the peak level seen in January 2018.
- The leading indices, which are often used as a barometer of market performance, continued their upward trajectory in 5M FY2019 before witnessing a correction from September 2018 amid rising interest rates, systemic liquidity tightening, heightened concerns on the credit quality of non-banking financial companies (NBFCs) and weak investor sentiment, which further impacted the markets. Rising crude oil prices, concerns regarding an increase in the current account deficit, hardening interest rates in the US and the strengthening of the USD weighed on the INR, leading to profit booking and increased risk aversion related to Indian equities. The equity markets reported an aggregate turnover of Rs. 1,191 lakh crore in H1 FY2019, registering a growth of 55% over Rs. 770 lakh crore in the corresponding period in the previous fiscal. The average daily turnover (ADTO) increased to Rs. 9.53 lakh crore from Rs. 6.21 lakh crore in the same period and Rs. 7.04 lakh crore in FY2018.
- The equity market turnover continues to be dominated by the derivatives or futures and options (F&O) segment. The share of the derivatives segment in total equity turnover inched up to ~96% in H1 FY2019 from ~95% in FY2018 and ~93% in FY2017. The total turnover for the derivatives segment increased to Rs. 1,147 lakh crore in H1 FY2019 from Rs. 733 lakh crore in H1 FY2018, a growth of 53%. The ADTO for the derivatives segment stood at Rs. 9.18 lakh crore in H1 FY2019, up from Rs. 5.91 lakh crore in H1 FY2018 and Rs. 6.71 lakh crore in FY2018.
- The growth rate in the options segment remained healthy in H1 FY2019, clocking an ADTO of Rs. 8.27 lakh crore, registering a YoY growth of 61% and a growth of 41% over the Rs. 5.88-crore ADTO in FY2018. It also surpassed the growth in the futures (18% YoY and 10% over FY2018) and cash (16% YoY and 4% over FY2018) segments. The options segment remains the most active in the derivatives market, accounting for 90% of the derivatives turnover in H1 FY2019 (88% in FY2018), with index options accounting for 84% of the derivatives turnover (82% in FY2018).
- The cash segment reported a stellar performance in 10M FY2018, culminating in record transaction volumes of Rs. 9.34 lakh crore in January 2018. The turnover, however, declined in the following months owing to the significant correction and volatility in the capital markets outlook. The recovery, however, was not broad-based and was largely limited to the large-cap segment, while the medium and small-cap segments remained subdued. This was a drag on the cash segment volumes, with the investors yet to recoup the losses incurred on mid and small-cap securities. The significant correction in the markets and the ensuing volatility in September and October 2018 had a further bearing on the cash volumes. Moreover, delivery volumes in the cash segment declined to 27% in H1 FY2019 (31% in FY2018) from 34% in FY2017, pointing towards a decline in investment-oriented transactions as opposed to daily trading.
- The cash segment reported a total turnover of Rs. 44 lakh crore in H1 FY2019, registering a YoY growth of 16% over a volume of Rs. 37 lakh crore in the comparable period last year. The ADTO for the cash segment stood at Rs. 0.35 lakh crore in H1

FY2019, up from Rs. 0.30 lakh crore in H1 FY2018 (YoY growth of 16%) and was marginally higher than Rs. 0.34 lakh crore clocked in FY2018.

Commodity turnover revived from Q4 FY2018

- The commodity markets, which reported a resurgence in Q4 FY2018, have witnessed a healthy turnover since then. On an aggregate basis, the commodity markets witnessed a turnover of Rs. 36.19 lakh crore in H1 FY2019 (ADTO of Rs. 0.29 lakh crore), growth of 23% over a turnover of Rs. 29.41 lakh crore (ADTO of Rs. 0.24 lakh crore) in H1 FY2018. The volumes, however, remained lower than that observed in the past (ADTO of over Rs. 0.50 lakh crore prior to FY2014 and peak ADTO of Rs. 0.70 lakh crore in Q2 FY2012).

…though correction in October amid domestic concerns and weak global cues

- To increase the interest in the commodity markets, to enhance liquidity and add more depth to the markets, the regulator has adopted various steps in the last fiscal. SEBI approved the introduction of commodity options in June 2017 and allowed alternative investment funds (AIFs) and foreign portfolio investors (FPIs) to invest in commodities in July and September 2017, respectively. A consultation paper regarding the participation of mutual funds in the segment was released for public comments in December 2017. In October 2017, the MCX became the first Indian exchange to launch commodity options with the launch of gold options. The NCDEX followed suit in in January 2018 with the launch of guar seed futures. Since then, more options have been introduced for commodities like silver, copper, zinc and crude oil. In December 2017, SEBI announced steps towards the integration of trading in the commodity derivatives market with other segments of the securities market. The second phase involved the trading of commodity derivatives and other segments of the securities market on a single exchange, to be effective from October 1, 2018. In adherence to these plans, the BSE as well as the NSE recently launched commodity derivatives. These moves are expected to bode well for the commodity segment over the medium to long term.
- The currency trading volumes have been on an upward trajectory since FY2018, consistently increasing on a quarter-on-quarter (QoQ) basis. The high volatility in the forex markets with the sharp depreciation of the rupee in the current calendar year has resulted in a surge in activity. The trading volumes climbed to Rs. 37.78 lakh crore in Q1 FY2019 (QoQ growth of 41%) and further to Rs. 43.17 lakh crore in Q2 FY2019 (QoQ growth of 14%) from Rs. 26.68 lakh crore in Q4 FY2018 (QoQ growth of 12%). The ADTO reached a high of Rs. 0.65 lakh crore in H1 FY2019, up from Rs. 0.37 lakh crore in H1 FY2018 and Rs. 0.39 lakh crore in FY2018.

Resource mobilisation slows down amid market volatility

- Equity mobilisation through public issuances slowed down significantly in the current fiscal with Rs. 0.13 lakh crore raised through 81 issuances in H1 FY2019 compared to over Rs. 1 lakh crore through 229 issuances in FY2018. Buoyed by the IPO rally over the past two fiscals, several issuers from a diverse range of industries were looking to tap the capital markets and had filed for approval for the same. However, the volatility in the markets, coupled with the corrections in valuations, led to the deferment of fund-raising plans by corporates. Going forward, a meaningful recovery in the capital markets and improvement in investor sentiment would be critical for a traction in issuances.
- The domestic capital markets are expected to remain range-bound over the near term with a prolonged period of volatility, given the weakening investor sentiment and challenging domestic and global cues. Going forward, the FPI flows are expected to remain muted (with ICRA's estimate of net outflows of $8-10 billion in FY2019 compared to inflows of $4 billion in FY2018) considering the weak macro-economic outlook. Other factors like corporate earnings, state election outcomes, result of the resolution of non-performing assets (NPAs) and its impact on the health of the banking sector would be other determinants of FPI flows. A key trend that has emerged over the past few years has been the increasing prominence of the DII segment.

Market volatility expected to encourage trading turnover; however, recent corrections in valuations coupled with cautious investor stance would have a bearing on industry revenues; outlook remains Stable

This segment, which has been a net buyer of equities since FY2016, is expected to remain steady over the near term and would support the domestic capital markets. Factors like strong consumption demand, increased infrastructure spending and structural reforms by the Government are other drivers. Going forward, a meaningful revival in corporate earnings and abatement of liquidity and capital availability issues would be key for a further fillip to the capital markets and for boosting FPI equity inflows.

- The outlook for the broking industry remains Stable over the near term. While the volatility in the markets is expected to encourage trading turnover, the recent correction in valuations, coupled with the cautious investor stance, would have a bearing on industry revenues. ICRA estimates the industry growth rate to moderate to 5-10% in FY2019 (from over 30%) on account of the volatility and with an estimated revenue projection of Rs. 19,500-20,500 crore. This comes on the back of a strong FY2018 with industry turnover of Rs. 18,000-19,000 crore and YoY growth of over 30%. The yields are expected to contract in light of the competitive pressure, increase in low-yielding derivatives and non-delivery segments. This, in turn, is expected to result in moderation of profitability from core broking operations in the current fiscal after a year of supernormal profits. Services like margin funding and distribution of financial services could help support the income profile of full-service brokerage houses given the price-based competition from discount brokerage houses.

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