Broking Income Not Commensurate to Active Clients' Share, Moderation in Growth Likely

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Synopsis

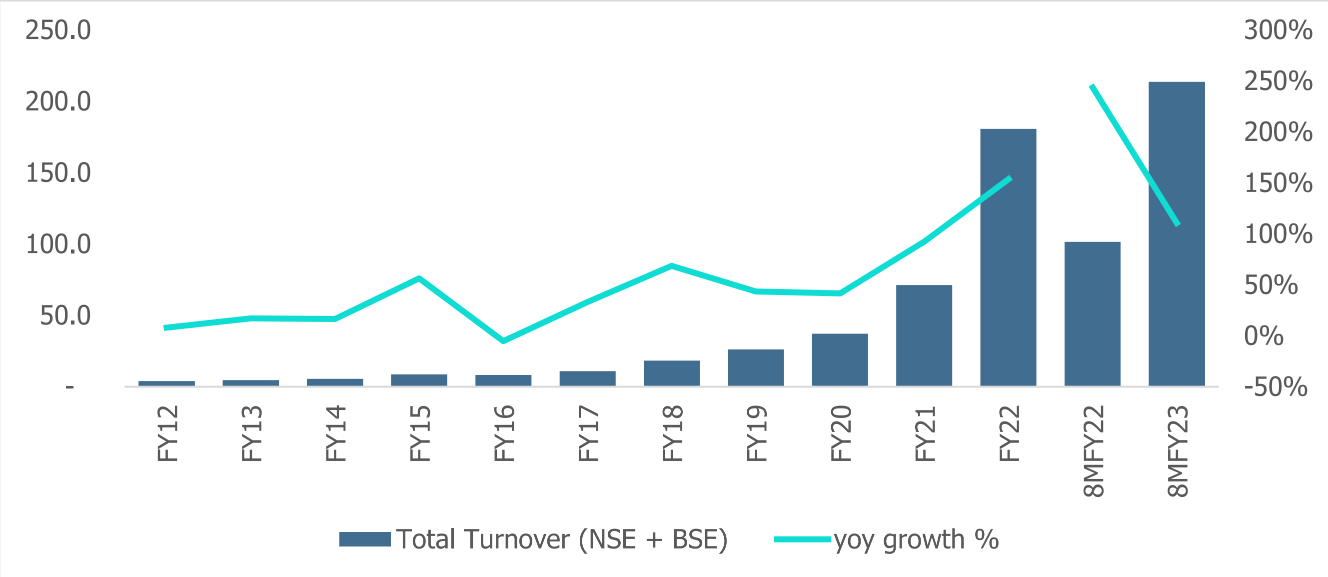
- The majority of the significant growth in capital market volumes in the past couple of years has been contributed by the Future & Options (F&O) segment, which is relatively low yielding compared to the cash segment. However, such high growth in the F&O segment is not sustainable over long-terms and we expect it to normalise in the near term.
- All three types of brokers – discount brokers, traditional brokers, and bank-based brokers reported an increase in their active client base with discount brokers cornering a significant share of active clients of close to 70%.
- However, the contribution to industry broking income and profitability is not commensurate to the share in active clients. Discount brokers contribute 40% of the industry's broking income and profitability, while bank-based brokers contribute about one-third of broking income with share of active clients of 20% only.
- Due to evolving rules and policies issued by the regulators, the regulatory compliance burden has increased which is expected to lead to consolidation in the industry with some of the top brokers potentially acquiring relatively small brokers providing them opportunities for inorganic growth.
- CareEdge expects moderation in the volume and active client growth for the industry in FY23 as well as FY24 which will also be reflected in relatively subdued growth in total incomes. Nevertheless, the long-term sustained growth remains supported by India's demographics and still low participation of retail investors in capital markets compared to developed countries.

Significant Volume Growth in Last Two Fiscals; Will See Near-term Moderation

Over the last two decades, the volumes in capital markets have reported consistent growth every year except in 2016 when there was a modest 5% y-o-y drop. Between fiscal 2010 and 2020, the volumes have grown at a CAGR of 41%. However, the last two fiscals - 2021 and 2022 – have seen exponential growth in market volumes. In fiscal 2021, the market volumes grew by 92% y-o-y while in 2022 it grew further by 154%. This significant growth was driven by ample liquidity and also due to increased participation from retail investors.

Both cash segments and F&O segments reported jump in their volumes in the last two fiscals. The F&O segment grew by 97% and 160%, respectively, in FY21 and FY22, while the cash segment grew by 70% in FY21 before tapering down to a modest 9% in FY22. CareEdge believes that the growth rates in market volumes are not sustainable over the longer-term and the growth rates are expected to decline to a more normalised level. For the eight months of FY23, the market volumes have reported a growth rate of 111% over the previous year period as against a growth rate of 243% for eight months of FY22.

Figure 1: Overall Volume Growth (Rs. crore)



Source: SEBI Bulletin

F&O Segment Contributing to High-volume Growth

Volumes in the F&O segment have always been significantly higher than the volumes in the cash segment, given the higher leverage enjoyed by the investor to take a larger position and less upfront cash requirement as compared to the equity segment. From about 11 times in FY12, F&O segment volumes to cash segment volumes ratio increased to about 50 times in FY20. However, in FY22, this ratio increased to around 100 times and further increased to over 200 times in eight months of FY23. Despite the sharp increase in F&O volumes, its contribution to the overall broking income remains relatively low and the cash segment remains the cash cow for the broking industry.

Figure 2: Volumes in F&O to Cash (Times)

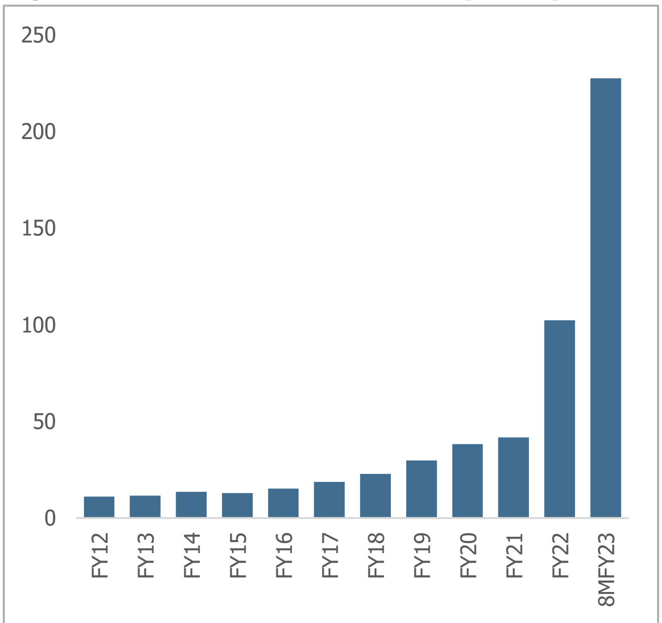
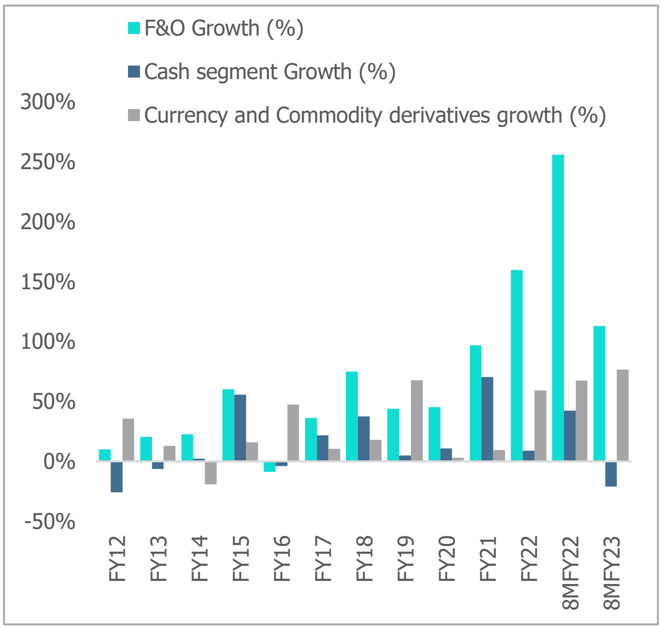


Figure 3: Segment growth %



Source: SEBI Bulletin

Trends in Active Clients for Discount Brokers, Traditional Brokers & Bank-based Brokers

As mentioned earlier, one of the reasons for the sharp rise in market volumes over the last couple of fiscal years was due to the ample liquidity and increased participation from retail investors. This was also reflected in the significant growth in active clients - 83% y-o-y average growth. All three broad types of brokers – discount brokers, traditional brokers, and bank-based brokers - reported a jump in their active clients. Discount brokers reported multifold growth (166% y-o-y average growth) in active clients; with their clients being majorly focused on the F&O segment. This was followed by traditional brokers and bank-based brokers with the growth of around 50% each. However, so far in the current fiscal year, the growth in active clients has been subdued with discount brokers reporting a decline of 2% till December 2022 while traditional brokers and bank-based brokers reporting a decline of 10% and 11%, respectively.

Figure 4: Total active clients – NSE (in crore)

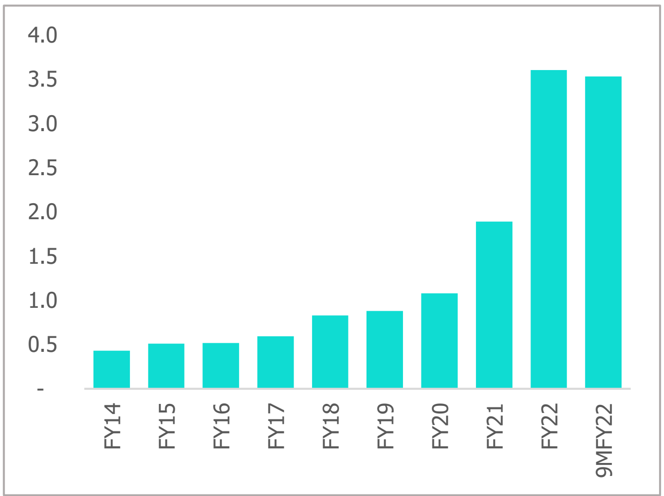
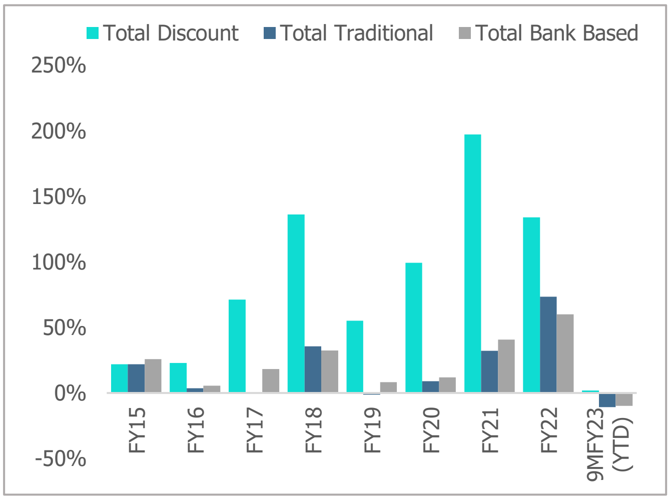


Figure 5: Brokers – Active Clients Growth



Source: NSE

Higher market share in active clients does not commensurately reflect in share of broking income and profitability[1]

The total income of brokers comprises mainly of broking income and other income (fees income and interest income). Discount brokers are more dependent on their broking income which contributes upwards of 80% of their total income. Large traditional brokers and bank-based brokers have relatively better diversification in their total income profile with broking income contributing about two-thirds of the total income. These brokers have diversified their income stream through income from margin trading funding and providing wealth services such as insurance and mutual funds distributions. With the significant growth in active clients, the discount brokers have cornered an impressive share of close to 70% of total active clients at end of fiscal 2022; however, this has not commensurately translated in the share of broking income or profitability at an aggregate level. Discount brokers constitute about 40% of the total industry's broking income and around 30% of net profits. On the other hand, bank-based brokers contribute about one-third of broking income and close to 50% of net profits with an active client share of just over 20%. This can be explained by the fact that discount broker clients are majorly focused on trading in the F&O segment while bank-based brokers clients have higher share in cash segment.

[1] CareEdge Ratings has aggregated data for Top 20 broking companies (includes Discount Brokers, Traditional Brokers and Bank-based broking companies) as per NSE ranking at end of December 2022 (as per active clients), which comprise of 87% of total active clients in broking industry.

Traditional brokers, in the last few years, have been investing in technology and expanding their network to acquire new clients. Accordingly, their cost-to-income ratio has been elevated. CareEdge believes that once the cost-to-income ratio of traditional brokers normalises, their profit margins will improve from current levels. Like bank-based brokers, they are also expected to benefit from their diversified income sources and relatively higher share of cash segment trading.

Figure 6: Share of Broking income and other income

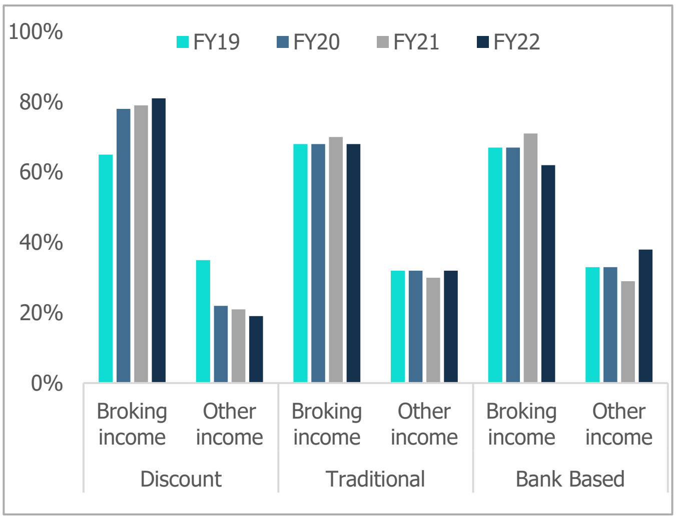


Figure 7: Active Client Share

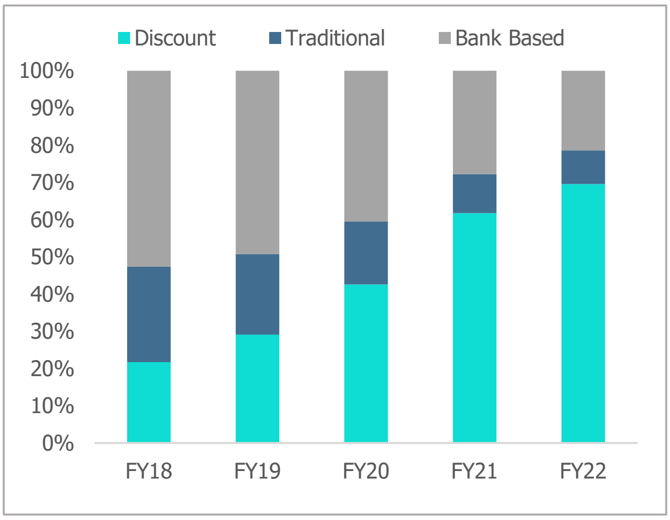


Figure 8: Broking income share

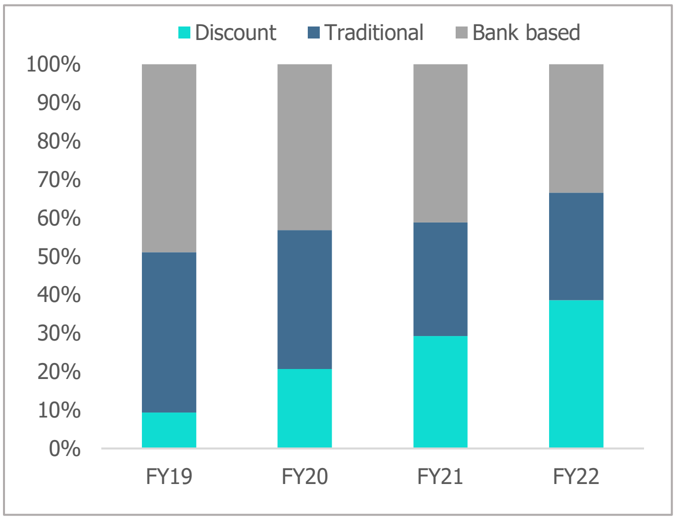
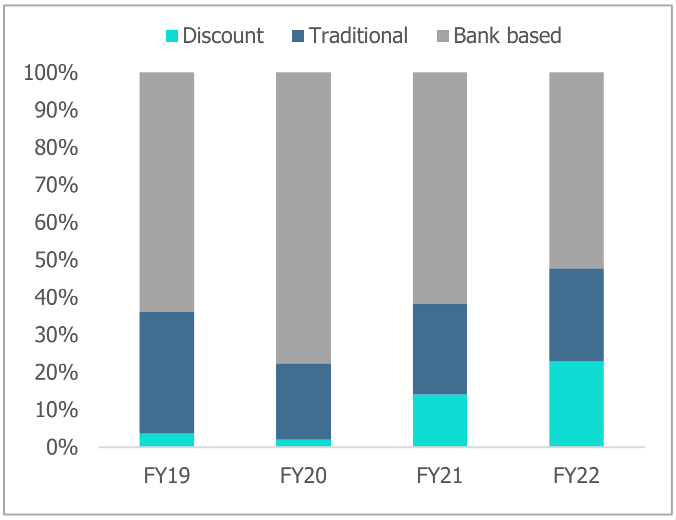


Figure 9: Profit after Tax (PAT) Share



Source: CareEdge Ratings, Annual Reports

Increasing regulatory compliance burden could lead to consolidation

Over the years SEBI has issued various rules and regulations to improve the functioning of capital markets and their intermediaries and protect investor capital from being misused. Some of the major regulations include peak margin (Sep 2021) which was introduced to set strict rules on leverage and thus it was able to control excessive speculation since the margin is collected upfront and not at the end of the day. Then the "Demat Debit Pledge Instructions" (DDPI) was implemented (July 2022) and it replaced the Power of Attorney (PoA) provided by clients to brokers. The use of DDPI will be limited only for two purposes: for the transfer of securities held in the beneficial owner account of the client towards stock exchange-related deliveries or settlement obligations arising out of trades executed by such a client. The second will be pledging/re-pledging of securities in favour of the broker to meet margin calls. The DDPI is expected to serve the same purpose as PoA but will aid in significantly mitigating the misuse of PoA. The Quarterly fund settlement (October 2022) where funds in the trading account must be transferred back to the client's bank account once in a quarter by the brokers will also help in mitigating the risk for investor capital.

Further, SEBI is contemplating designating some of the country's top brokers as qualified stock brokers (QSBs) which will increase the compliance requirements for those QSBs and introduction of ASBA concept in the secondary market similar to one for the IPO market. Accordingly, the client's funds will be directly transferred to the clearing house and brokers would only execute trades for their clients to avoid potential misuse of clients' funds by the brokers.

All the regulatory changes while good for capital markets and investors, increase the compliance and operational cost for broking companies. CareEdge believes that bank-based brokers are adequately prepared to handle additional requirements since they are already subject to additional oversight from the RBI. Some of the large traditional brokers have sufficient capacity to adapt swiftly to the changing regulatory requirements. However, a few of the small brokers may find the regulatory compliance burden high which could lead to pressure on their sustenance. As such some of the top brokers could acquire these relatively small brokers and/or their clients providing them with opportunities of inorganic growth.

Outlook

The exponential growth in volume and active clients reported in the last two fiscal years is unsustainable over long term. Accordingly, CareEdge expects moderation in the active clients' growth in the near term. Nevertheless, the demographics of India and the fact that retail participation is still low in Indian capital markets augurs well for the long-term sustained growth of clients for the broking industry.

For FY23 CareEdge expects that the total income growth for the broking industry will moderate to ~10% from ~47% in FY22. Accordingly, the total income for FY23 is expected to be around Rs 28,000–30,000 crore with discount brokers continuing to contribute about 40% of the industry's total income. Further, traditional and bank-based brokers are expected to have a relatively flattish growth with total income more or less equal to the levels of FY22. The expectations of performance for FY24 are largely in line with the trends seen for FY23 with the potential for inorganic growth for some traditional brokers benefiting from consolidation in the industry.

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