One Size Doesn't Fit All

Some are expanding, others are selling out. The retail stockbroking business just got that much more interesting by Mahesh Nayak

"WE don't want to enter retail broking." That was Rashesh Shah, chairman and CEO of Edelweiss Capital, a large financial services firm, three years ago. Retail broking then was a high-volume, low-margin business, and not exactly what a large investment banking firm like Edelweiss was looking at getting into. Not much has changed in the fundamental business model, but early this year Edelweiss acquired Anagram Stock Broking, an Ahmedabad-based retail broking firm, for Rs 164 crore.

"The rate at which income brackets are shifting upward, the retail business will prove to be one of the most profitable areas," says Shah. By his estimates, the number of households that have an annual income of over Rs 10 lakh will touch 18.1 million by 2020; and the number of households in consuming classes (annual income between Rs 90,000 and Rs 10 lakh) will grow to 180 million by then.

At another end of the financial services industry is Hyderabad-based Karvy, which has a strong franchise in retail broking and distribution that accounts for 60 per cent of the group's total revenues. When markets crashed in 2008, Karvy wound up its real estate business, but retained the advisory side of real estate. Since then, the group launched a non-bank finance company (NBFC), which is expected to take 5-7 years to break even.

Karvy brought in a bunch of people from Citi Financial, and even brought in someone from Morgan Stanley's US operations to start the wealth management business. However, its attempt to build the institutional broking business and an investment banking and advisory unit met with little success; while change in regulation affected its bread and butter retail distribution business.

Yields in the broking business have been on a sustained decline for a few years now, thanks to falling commissions and an explosion in competition. There has also been a separation, with many firms focusing firmly on the institutional side of the business, and the rest on retail. Most, however, are still making money.

The two trends, as illustrated by the examples of Edelweiss and Karvy, appear to be gathering steam: one, the economics of the business has become attractive enough for large, hitherto uninterested players to get into retail broking. And, two, retail broking firms are bulking up to play in the larger financial services game. Where these two strong waves meet, the ripples that are being created could change the players, the business and perhaps even the very rules of the game.

Broking 2.0

The retail broking business itself has grown larger. It is not trading in equities that is driving growth in volumes, but increased trading in futures and options (F&O). Over the past 5-6 years, investors have been trading F&Os the way they used to trade shares: the numbers tell

How Brokerage Firms Are Finding The Right Fit

EDELWEISS CAPITAL: Acquired Ahmedabad-based retail broking firm Anagram Stock Broking for Rs 164 crore to increase retail presence. This will help it get IPO mandates

KARVY GROUP: Was unable to scale up institutional broking and investment banking business. Forayed into non-banking financial services and wealth management advisory

INDIA INFOLINE: Diversified operations in Sri Lanka and Singapore. To begin with, will focus on institutional broking and investment banking, including M&As

GEOJIT BNP PARIBAS FINANCIAL SERVICES: Plans to focus more on Gulf countries as it is the only broker that has licence to do retail business there. Also plans to grow its asset management business and increase customer base to de-risk its revenue stream

MOTILAL OSWAL: Has got into new areas in the past 3-4 years: investment banking, private equity, wealth management and mutual fund. Will stay with its core competence of research and advice

INDIABULLS: Separated verticals. Indiabulls Financial Services takes care of lending; Indiabulls Securities looks after broking business, and has recently entered institutional broking

the story. On average, the daily traded value of F&O is four times that of the cash segment. On 3 November, the cash segment on the National Stock Exchange amounted to a tad over Rs 15,000 crore; F&O, on the other hand, accounted for just over Rs 79,000 crore, or over five times that of stocks.

But does that translate into big commission earnings? Not really; the margins are still low. Today, the commission is down from 1 per cent to as low as 1 basis point (or one-hundredth of 1 per cent). "If you take brokerages as a standalone business in terms of pure margins and profitability, the best years are well behind us," admits C. Jayaram, executive director at Kotak Mahindra Bank.

According to Dun & Bradstreet, 84 per cent of the companies they surveyed this year expect profit margins to be under pressure following the rise in competition as well as increased focus of investors towards low-risk financial products. In such a scenario, most brokerages have said they will derive the benefits of diversification by balancing their revenue streams and generating higher contribution from other fee-based income apart from broking.

So what are retail brokers doing? "Money is in surplus, and people are not scared of taking risk, by experimenting and venturing into uncharted territory," says Mohit Batra, CEO at Alchemy Capital Management, a Mumbai-based boutique wealth advisory firm. "I have always been told by my clients that they come to me because I am a boutique firm, and that is my USP." Batra is planning to float an IPO and open an international advisory firm replicating the Indian model.

C. Parthasarathy, chairman of Karvy Group, is categorical about what lies ahead. "The future of the broking industry is advice. It will be difficult to survive on facilitation alone. Without advice, one cannot add any USP."

India Infoline, another leading brokerage, has diversified its operations into the Asian market by opening shops in Sri Lanka and Singapore. "The intention is to leverage our core competencies of high quality research in these markets, which are small but high growth," says Nirmal Jain, chairman and managing director at India Infoline. "While we plan to start with institutional broking, we shall also look at opportunities in the investment banking space including M&A."

Jumping Onto The Bandwagon

But the going is not easy. Competition in the broking business is only growing thicker. Foreign companies are getting in on the act, too. They commit 10 times the capital they could a decade ago, when they preferred to come in as joint venture partners. Morgan Stanley and Goldman Sachs broke ties with JM Financial and Kotak Mahindra, respectively, choosing to go alone in the rapidly growing Indian market. Merrill Lynch, too, had bought out Hemendra Kothari's share in DSP Merrill Lynch.

"India and China are strategically important for most of the players that can't avoid these markets anymore," explains Rajat Sabharwal, head of equity at Credit Suisse, India. "Look at the rise in commission from $200 million (in the cash segment) in 2000-02 to $1.5 billion in 2007. We are active in businesses where we are globally strong and our presence in India will help us offer a platform for our global clients."

Growth demands capital, which also works as

Struggling To Stay Up

The numbers are grim. The top brokerage firms are doing their best to fight the effects of reduced margins on their revenues

Company	March 2010			March 2009			March 2008		
	Income (Rs cr)	PAT (Rs cr)	RONW (%)	Income (Rs cr)	PAT (Rs cr)	RONW (%)	Income (Rs cr)	PAT (Rs cr)	RONW (%)
Aditya Birla Money	113.33	12.68	24.87	75.95	1.21	2.23	124.00	21.44	61.32
Edelweiss Capital	1,045.05	244.88	10.89	1,081.55	209.13	11.50	1,086.93	292.68	25.32
Emkay Global Fin. Serv.	122.65	9.40	4.88	97.32	-3.28	-3.38	139.10	25.97	20.43
Geojit BNP Paribas Fin. Serv.	287.77	50.10	13.80	183.12	41.08	0.68	237.69	59.9	26.70
India Infoline	1,003.38	234.05	15.20	757.08	157.34	10.43	836.29	163.92	22.13
Indiabulls Fin. Serv.	1,621.67	307.48	7.73	1,997.31	105.96	3.08	1,665.75	580.64	22.18
JM Financial	96.34	47.31	2.87	24.47	7.97	0.48	1,769.50	1,360.17	133.43
JRG Securities	71.23	6.71	8.17	58.84	-3.82	-1.19	70.86	3.28	5.90
Motilal Oswal Fin. Serv.	645.36	174.42	20.13	468.59	93.43	12.64	716.59	175.57	33.85
Religare Enterprises	1,512.74	108.03	4.14	1,116.15	-65.20	-4.28	833.34	91.88	21.53
Reliance Capital	2,370.46	339.42	4.22	2,977.83	968.02	14.59	2,081.49	1,022.04	18.38

PAT: Profit after tax; RONW: Return on networth; Results are on a consolidated basis
Source: CMIE

a barrier to being taken over by a larger, more powerful firm — and existing players have been strengthening their positions in this respect. India Infoline had raised Rs 90 crore from the IPO market in 2005. Before the global crisis of 2008, eight broking houses — India Infoline, IL&FS Investsmart (now HSBC InvestDirect), Indiabulls Financial Services, Motilal Oswal, Emkay Share and Stock Brokers, JRG Securities, Religare Enterprises and Edelweiss Capital — raised capital from the primary markets. It was a smart and a conscious strategy.

On 28 October, Dhanlaxmi Bank picked up 15 per cent stake in Destimoney Securities for Rs 13 crore. "The reason was to garner more Casa (current account, savings account) deposits. We have seen that clients with broking accounts save 3-4 times more in their savings account than customers without a broking account," explains Bipin Kabra, CFO of Dhanlaxmi Bank.

Many retail brokerage firms are sitting on piles of cash, thanks to the bull run of 2003-08. They are trying to diversify their revenue stream by capturing a huge share in the rest of the financial services pie, which is expected to grow five-fold in the next 10 years. Currently estimated at Rs 10 lakh crore by Edelweiss, the financial services market is expected to grow to Rs 55 lakh crore by 2020. Including banking, the sector is estimated to grow from Rs 42 crore to Rs 267 crore in 10 years.

We, The People...

With money, many firms are flagging off their own private equity (PE) funds, investment banking arms, mutual funds, insurance and distribution businesses. But if capital is available, the other key asset — people — is much harder to come by. And as most firms have learnt, it is not just getting them but keeping them that is more important.

Anand Rathi Securities had got in Ratnesh Kumar from Citi to head their institutional business, while Centrum Broking and Reliance Money got in Devesh Kumar from ICICI Securities and Keshav Sanghi from Deutsche Equities, respectively. The initial success could not be maintained, and after a small stint, they all moved out for greener pastures leaving the firms paralysed.

"We provided them a platform to work with pleasure rather than pressure, but many came in just to correct themselves and they never could get adjusted to our culture and be a part of our business," said a senior executive in a leading brokerage firm, requesting anonymity.

In some cases, the departure was dramatic. At Anand Rathi, Kumar stepped out for lunch one afternoon with his team, and no one returned. They struck a collective deal with Standard Chartered Bank for managing the bank's institutional equity business.

Diversification to increase revenue is not the full story. Many see the digression into other businesses as a valuation game. "India is one of the top-priority markets for many foreign companies. Most local firms see this as an opportunity and are trying to position themselves as a complete financial services shop, so that when opportunity strikes, they can hit the jackpot and exit from this competitive market," says a senior investment banker on condition of anonymity.

The best example of that was IL&FS Investsmart, which, within three years of listing on the exchange, was acquired by HSBC for Rs 1,085 crore. But if it is all about getting a fat payoff at the end, does it mean that plain vanilla broking is not viable anymore?

A Matter Of Survival

"Everyone likes to believe that the traditional model of broking does not work anymore and standalone broking is a thing of the past. But in reality, it is community driven," says C.J. George, managing director at Geojit BNP Paribas Financial Services, which earns 15 per cent of its revenue from NRIs.

The community feeling, as it were, encourages a broker to retain his clientele and nurture the relationships, which could prove to be the platform for other businesses too. When the market crashed in 2008 following the global crisis, many firms extended credit to their clientele to help them maintain positions and even continue trading. Thus, financing has become an integral part of the business.

It paid off too. "The combination of lending and broking gave them good returns," says Abizer Diwanji, executive director at KPMG. "To maintain 20-24 per cent return on equity, these broking firms entered lending."

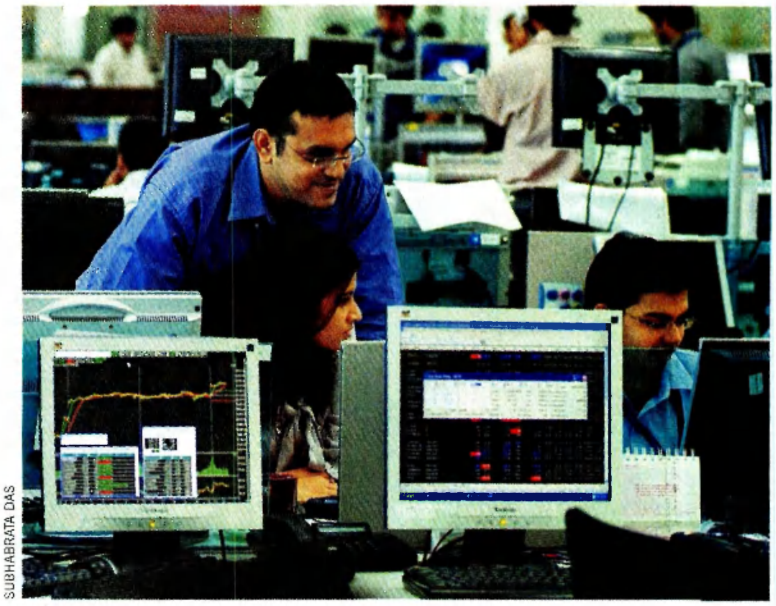
India Infoline also feels standalone brokerages can survive and grow in the long term. But it is different if you are a listed entity. "If you are worried about quarter after quarter earnings, most businesses will tend to diversify and try and have some sources of earnings, which are resilient to stockmarket cycles," says Jain.

And diverging, many are. "The lack of opportunities in broking led to deployment into other businesses," says Anup Bagchi, executive director of ICICI Securities. "Now that you have raised capital, what else can you do? Distribution business is a hard working model that requires perseverance. Unless you have customers, it is difficult to run. Therefore, they get into capital business."

Most of them started with margin funding and are now moving towards home loans, personal loans and auto loans. This is because one cannot do margin financing on leverage, since capital market exposure norms for banks do not allow lending for share trading.

Learning from History... Or Not

The 1990s are a cautionary tale, when most business houses had an NBFC. Wipro had one; Hindustan Lever had one too. Both shut down. "Around 50-60 companies went bust in various forms during that time," says Jayaram of Kotak Mahindra Bank. "Financial services have never been an easy ride. It is not like running a supermarket where you sell products off the shelves."



SUBHABRATA DAS

PROSPECTS GALORE: Increasing income brackets are pulling brokerages towards retail investors

Motilal Oswal of his eponymous financial services firm agrees: "Investing does not mean automatic returns. Only a few can become financial conglomerates, while others, after experimenting, will come back to focus on their core business." Oswal himself is sticking to his core competence of research and advice.

Despite the diversification into related business — fund management and investment banking, for example — most Indian capital market intermediaries on average make 60-65 per cent of their revenues largely from equity broking. Of course, the diversification is still correlated to capital markets.

"Today, most (brokerages) are diversifying on the strength of the capital. But going ahead, capital will be the differentiator and will act as a natural entry barrier in this fragmented industry," says Gagan Banga, CEO of Indiabulls Financial Services.

For large companies getting into retail distribution, it is about complementing their investment banking and financing businesses: origination and distribution, so to speak. And like Edelweiss, a number of them are on the lookout to acquire good, established broking firms.

Will this be a consolidation of the broking business, or the culmination of a valuation bet that some savvy players made and cashed out on? It will be hard to say for some time, until the heat and the dust settles around those building other financial services businesses around broking and those wading in to pick off the broking business. It will be a while before we can tell the men from the boys.

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