CHAIRMAN'S LETTER 2022

Edelweiss
Ideas create, values protect

Chairman's Letter

The last twelve months have seen a myriad of emotions, starting with a heart-wrenching COVID second wave and ending with the promise of a better and brighter future with the vaccination drives and the less virulent strains. Something similar is also being witnessed in the kind of extremes seen in the economy and financial markets, which have also been unparalleled, deserving a discussion of their own. Most of you are aware of these extremes but just as an example, only 24 months ago, oil prices moved into negative territory and today we are around USD 100 per barrel mark! The same holds true for many other commodities. But there is good news as well! [more on that later!]

THE YEAR THAT WAS

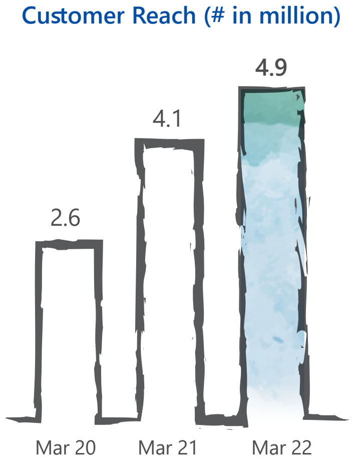
FY22 was a promising year, interspersed with challenging phases impacting not just the organisation, but the wider economy as well. The first quarter was marred by the second COVID wave which had an impact on all of us personally. However, things have eased out since then with a strong economic revival coming through in the form of higher tax collections and record toll revenues amongst other metrics. The last quarter again saw some volatility driven by geopolitical tensions and subsequent escalations on the European peninsula putting inflationary pressures across the world and leading to increased volatility in the capital markets. However, after the trials and tribulations of the last two years, FY22 seemed like that proverbial rainbow peeking out from behind the storm.

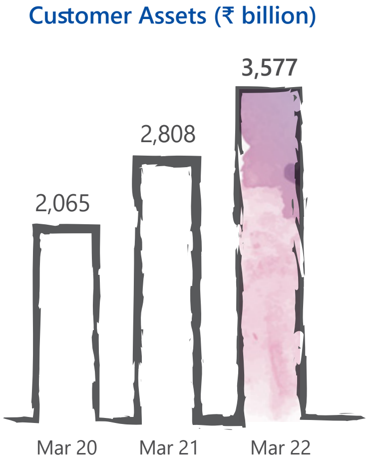
> *"If you want to enjoy the rainbow, be prepared to endure the storm!"*
>
> *-Mahatma Gandhi*

Our journey at Edelweiss, to some extent, has mirrored these developments in the year ended Mar 22. It was a good year overall as we continued our focus on building resilience and strength to shield against short-term disruptions while creating long-term value through gradually scaling our businesses, in addition to a value unlock which benefits our shareholders. Performance was steady with ex-insurance PAT of ₹4,050 million for the year. Adjusted for wealth management, this is a healthy 29% YoY growth with improvement across all clusters.

We focussed on a set of key priorities for the year which has largely been on track.

Firstly, we continued our endeavour towards retailisation. We added almost a million customers in the year and doubled our Customer Reach over the past two years. This also led to our Customer Assets to grow by ~₹1.5 trillion over the same period to ~₹3.6 trillion as on Mar 22.

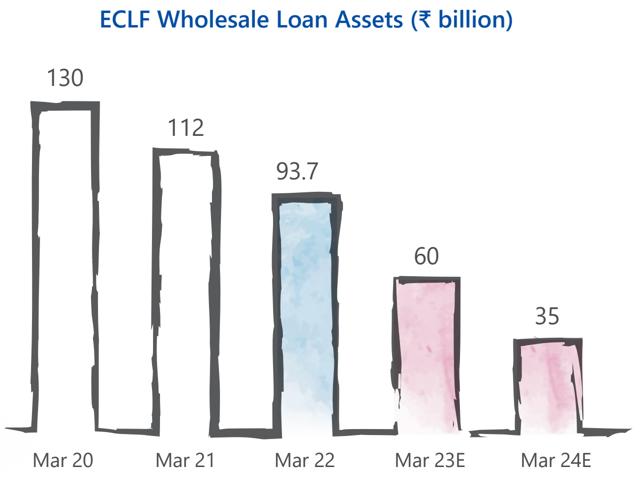




Secondly, we focussed on strengthening our balance sheet through deleveraging and focussing on asset quality improvement. We have made significant progress on these two counts, especially with asset quality seeing substantial improvement in the last 12 months (more details in Credit section).

Our third focus area has been on unlocking value for our shareholders. We have made good progress on the demerger and listing plans for our wealth management business. Phase II is now complete, and Phase III is well underway with expectations of demerger by Dec 23 and listing by Mar 23. As we look ahead, unlocking shareholder value will be an important tenet of our future strategic and capital allocation decisions.

Lastly, we worked towards reducing our wholesale credit portfolio. Despite a slow start, we have seen very encouraging signs towards the end of the year with inflows of ₹16 billion in quarter ended Mar 22. As a result, we have managed a net book reduction of more than ₹36 billion in challenging COVID conditions. As we build on the momentum in Q4 of year ended Mar 22, aided by revival of economic activity and free from disruptions, we expect to reduce our wholesale book to ₹35 billion by Mar 24.



BUSINESS OVERVIEW

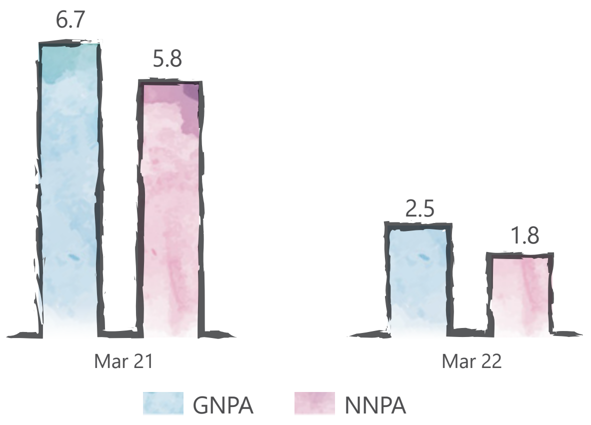
Credit

Credit cluster was focused on three main fronts -

1. Reduction in Wholesale Credit (which we have talked about and shown good progress in)
2. Improvement in asset quality – significant movement!
3. Establish co-lending platform and start scaling up retail credit portfolio
    a. Multiple partnerships signed with leading banks across both MSME and Mortgages
    b. Disbursements initiated, but we continue to remain cautious

Overall, the business did well after two difficult years, and we expect green shoots of recovery to continue in this business going forward.

Asset Quality (%)

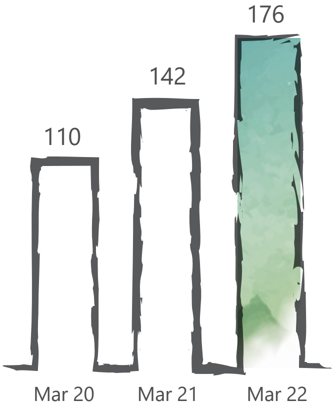


Asset Management

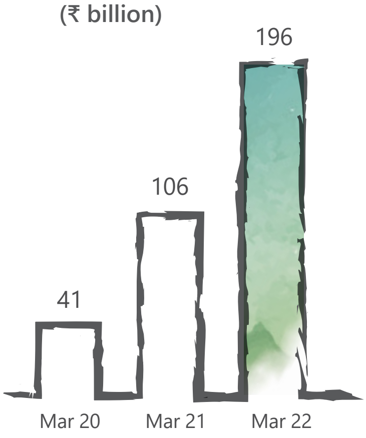
It was a great year for our asset management cluster as the growth endured and scale created over last few years is now translating into improving profitability; a sustainable trend which will continue in the years ahead.

Both AMC and Alternatives are great annuity businesses with recurring and well-established income streams; established on the back of strong inflows (especially equity inflows) in AMC and accelerated deployment in Alternatives.

Alts Fee Paying AUM (₹ billion)



MF Equity AUM (₹ billion)



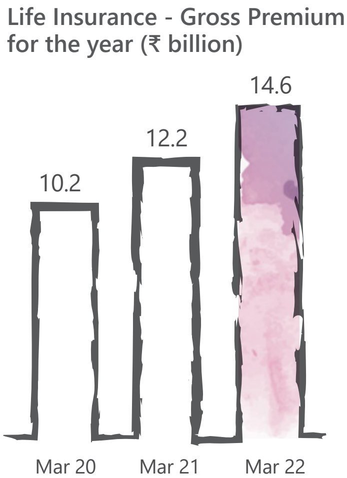
Asset Reconstruction

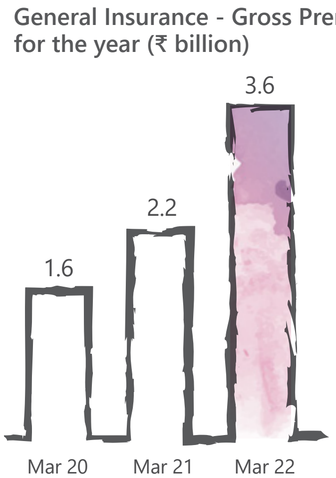
The Asset Reconstruction business has been a consistent performer in the Edelweiss Group. Some years will have one-off spikes, mostly on the upside, but on an ongoing basis, years like FY22 will be the normal. Our confidence stems from the fact that a large portion of our top-line is from fee income which gets collected by way of actual inflows (and not just accruals!). In fact, with the retail portfolio scaling up, we expect profitability to improve further given its granular cash flows and lower tenure. Share of retail assets in capital employed grew ~4x YoY to ~14% as on Mar 22.

FY22 continued to be a year of robust recoveries aided by the improving economic environment. We expect this to continue in FY23 as well.

Insurance

Our insurance businesses continued to see swift growth with YoY premium growth of 20% for Life Insurance and 60% for General Insurance.





In both our insurance businesses, we have focused on delivering a world-class customer experience through a mix of product innovation and technology, further amplified by synergistic partnerships. This is exemplified in our claim settlement ratio of 98% for the year ended Mar 22 in Life Insurance, as also in the introduction of industry-leading products in General Insurance like SWITCH and AI Bot for Claims.

Wealth Management

Wealth Management had a solid year, even as the business continued working towards executing the demerger and listing process in parallel. AuA grew ~30% YoY with net new money of ₹105 billion for the year. AuA today stands at more than ₹2 trillion, one of the largest in the industry.

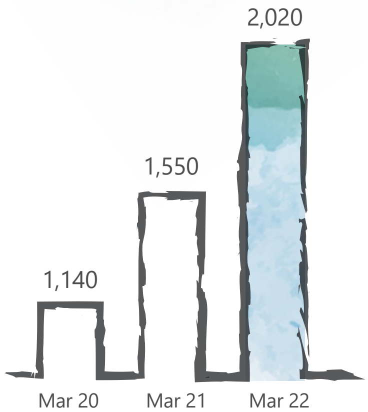
The long vintage in the business, built on the back of continued customer trust and world-class service standards has enabled the business to gain significant industry recognition in the form of –

Top rankings at AsiaMoney Brokers Poll

Top Global Custodian Agent Bank in Emerging Markets Survey

Best Wealth Manager, India at Asset Triple A Private Capital Awards

Wealth Management AUA (₹ billion)



EDELWEISS TURNS 27! – A journey sprinkled with opportunities, compulsions, learnings and luck!

Even before we started Edelweiss, we were keen market participants and firm believers in the India growth story (as we continue to be even today!). One of the first things you learn as an investor is the role that factors outside your influence play. Not all successful investments are a function of a well-thought-out investment thesis nor are all unsuccessful investments a result of poor decisions. The role played by external factors and fortuity is as important as that of sound decision-making and learning from experiences. A book that well explains our tendency to attribute our successes to our own skills and our losses to our luck is "Thinking in Bets" by Annie Duke, which I highly recommend for everyone, not just for making better market decisions but better decisions in life!

In the same way, our **Edelweiss odyssey has been a union of sound decisions based on strategic intent, experiential learning, external constraints, and fortuity - all in good measure!** There are instances from our journey we have talked about earlier as well, but they bear repeating, especially in a world where outcomes increasingly look volatile and random. However, it is important to understand that one doesn't preclude the other. Luck will only take you so far without making the right decisions. Thus, neither luck nor thoughtful decision make the sole pre-requisite for success.

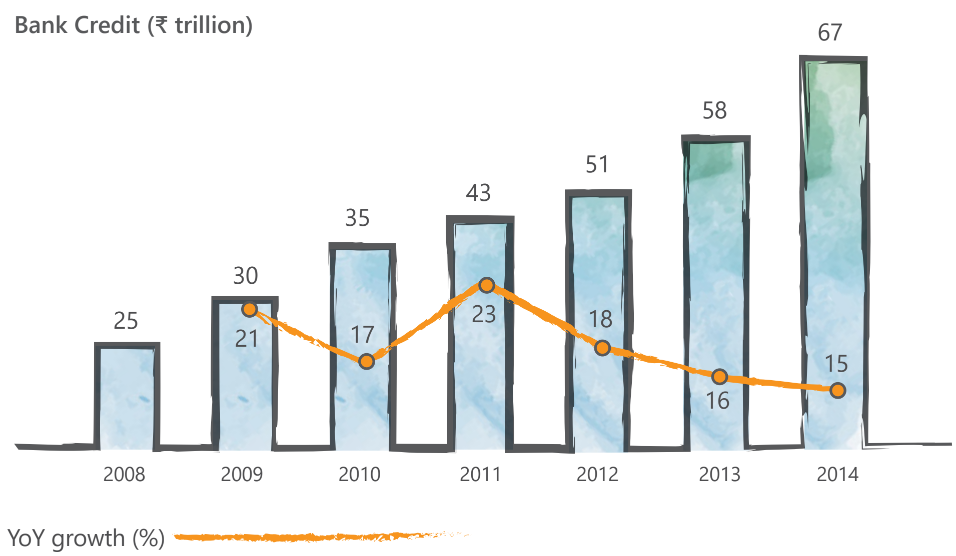
> *"Luck is a matter of preparation meeting opportunity"*
>
> *- Seneca*

Our business evolution has primarily been a function of identifying right opportunities at the right time interspersed with implementing our learnings from our journey.

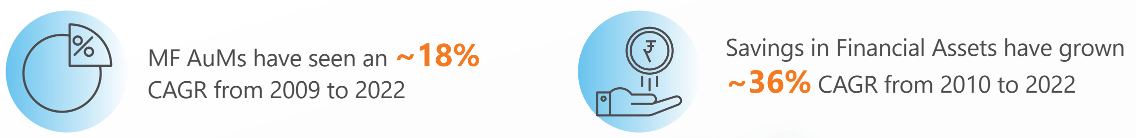
We started off with Capital Markets in 1996, which continued to be our backbone all the way till 2008. The massive opportunity in capital markets was reflective in the data as well - Capital Market volumes grew 31% from 2002 to 2008 – a strong growth opportunity for both legacy and new players which we were best placed to leverage!

However, the trend changed post the Global Financial Crisis (GFC) in 2008. In the last 14 years, while it may seem surprising, volumes have largely remained flat! However, capital markets remain an important business line and a key funnel for our wealth management business. GFC was also an important learning experience for us. Till then, capital markets formed the lion's share of our earnings and as a result, profits were significantly impacted. The advantage of a diversified business model over a mono-line business model quickly became apparent to us; something that has held us in good stead in subsequent downcycles.

It was also a time when domestic credit offtake had started picking up as recovery improved up post GFC; aligning with our opportune entry in the business, backed by strong data and industry tailwinds!



Even within capital markets, wealth management and asset management were emerging as the new growth vectors – businesses which we set up after 2008



In a way, we have done well to identify emerging growth areas and to pivot at the right points of time during our journey! However, we've also had our shares of constraints in our odyssey, which luckily or unluckily, have influenced some of our decision-making.

While we had a small credit book at the time of GFC, our full-fledged entry into the business was constrained by capital. It was only once we were able to do an IPO in 2008 that we were ready to scale up. However, GFC happened soon after and luckily for us (serendipity strikes!), delayed our credit scale-up plans. Our genesis itself was partly an outcome of luck (or ill-luck as we called it then!).

We had started with a capital of ₹10 million, which was enough for us to obtain what was then a merchant banking category III licence. However, the amount was changed to ₹50 million just before we were to register Edelweiss! We made peace with getting a Category II licence. instead which allowed us to help start-up companies raise funding via non-IPO route. That became our initial calling card and helped us build a name and niche in the industry.

"A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty."

- Winston S Churchill

POWER OF SIMPLICITY - Amongst many of our most important learning!

In our recent letters, we have touched upon the various learnings we've had in our 25-year journey. Perhaps the most important of them is the power of simplicity! And the true strength that imbibes simplicity only comes in experiencing it. At Edelweiss, we have learnt it the hard way!

Our evolution journey has seen us move from a monoline business till mid-2000s to a diversified financial services organisation today, spanning across all financial services segments. This has been an important phase of our journey, helping us manage the downside in specific business lines through improving performance in others; a key tenet to what Edelweiss is today.

However, this diversification journey has come with its own set of challenges, the biggest one being the growth in the number of Group entities. By the end of our business diversification journey, we were at peak entity count of 79 in 2016! There were several downsides to this – expending more resources on managing so many entities, higher associated compliance costs, more inter-entity transactions, amongst many others. These made us embark on a path towards moving away from complexity and appreciating simplicity, which among other things, in structural terms meant reducing our entity count over the next few years.

A snapshot of our journey shows the significant distance we have already covered.

Today, we are at an entity count of only 29 – something we are consciously working towards reducing even further, targeting an entity count of around 20 in the next two years. These 15-20 entities will then form the core of Edelweiss Group, a far cry from the ~80 entities we had only about six years ago. Even today, we distinctly feel the difference from managing only a limited set of entities. Truly, the only scalable way to grow is to do it with simplicity!

Another significant example of our reducing complexity is the process of decentralisation we have undertaken in the last 2-3 years. A centrally controlled, common enterprise unit is now de-centralised into dedicated enterprise functions for each business. While this has led to some increased costs, it has also helped strengthen business enterprise functions', enhanced ability to take focussed action specific to each business and build capabilities and specialisation as per the need of the business. As a result, our Corporate Enterprise function's strength is now just ~5% of what it was five years back, with most of the employees joining business enterprise functions. This has greatly reduced the complexity of the individual enterprise functions at the Central level.

"Simplicity is a great virtue, but it requires hard work to achieve it and education to appreciate it, and to make matters worse: complexity sells better."

- Djikstra

There have been many such examples in our journey where we have realised that the power of scale comes only with simplicity. Growth without simplicity could be a recipe for disaster. Our focus on systems and processes especially in the last few years, has been a direct learning outcome of this realisation. Like we mentioned in last year's letter, building Resilience and Quality is now the cornerstone of all our thinking as we look ahead at the next 25 years. And simplicity will be a key vector when we think about this Resilience and Quality.

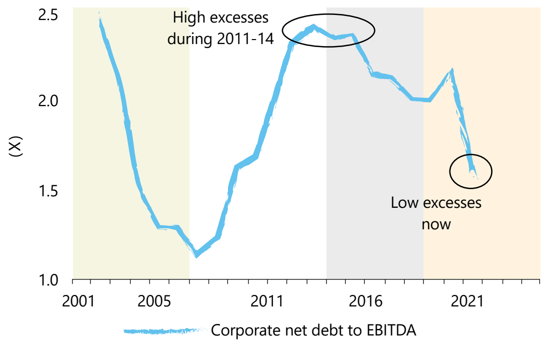
Simplifying the macro-micro conflict

Earlier in the letter, we talked about the promise that the future holds, despite the somewhat challenging macroeconomic environment we are facing. There are, of course, some issues to worry about. We are now seeing some slowdown in GDP growth recovery in recent quarters along with some downward revision in future projections. Higher crude prices are always a cause for concern in India and the current price trend is indicating a lot of pain that will continue to be at similar levels. Inflation is another huge bugbear - WPI is touching 15% and even CPI is at one of the highest levels in last few years. Geopolitical concerns, with the Ukraine-Russia conflict as also the economic issues in Sri Lanka are genuine signs of concern. Clearly, the macroeconomic environment has a lot of scope for improvement!

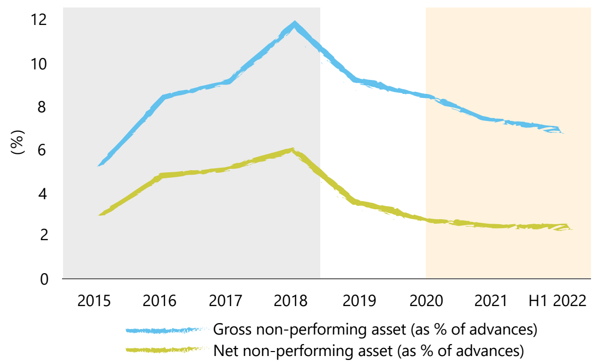
Amidst all the noise, it is very important to isolate clear, important and relevant trends to simplify the prevailing ground realities of today, especially in India. And the data there speaks to a different world altogether! Looking at key micro and macro economic data in 3 major timeframes of 2004-07, 2014-18 and finally 2022 and beyond, we understand that currently -

Micro

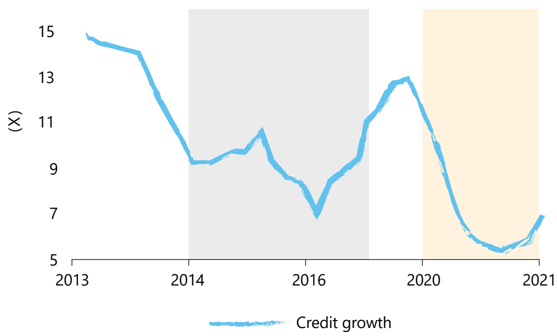
Corporate balance sheets have de-levered significantly in the last few years



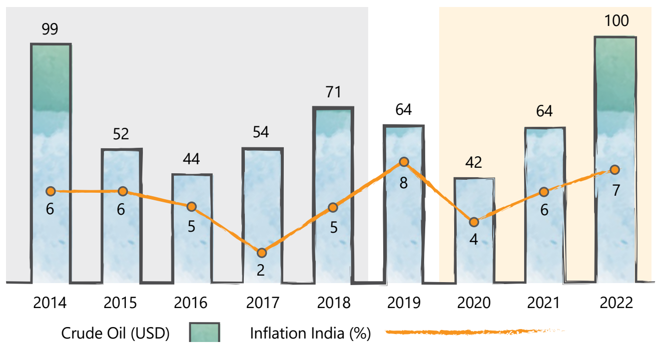
Banking Sector asset quality is at the best level it has been in years and continues to improve



As a result of bank balance sheets getting cleaned up, credit growth is now starting to turn the corner



Overlying the macroeconomic indicators



2004-07 | 2014-18 | 2022 and beyond

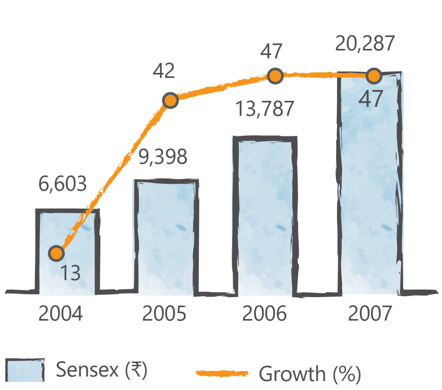
Contrast this current situation of positive macro with weak micro with the timeframe of 2014-18 in the same charts above where we saw corporate balance sheets reaching peak leverage, asset quality worsening, and credit growth on the decline. However, we saw great macro conditions in the same period with low inflation, very low oil prices and largely peaceful global environment.

Now to contrast this with the situation in 2004-07

Microeconomic indicators from 2004-07

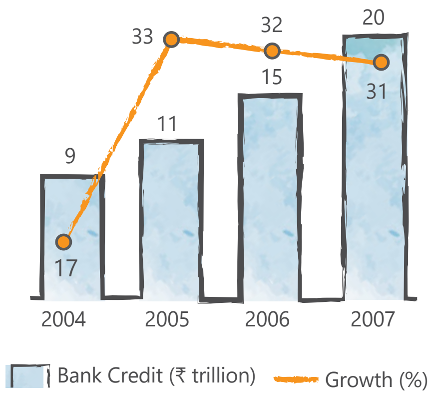
Sensex growing at 32% CAGR

Sensex



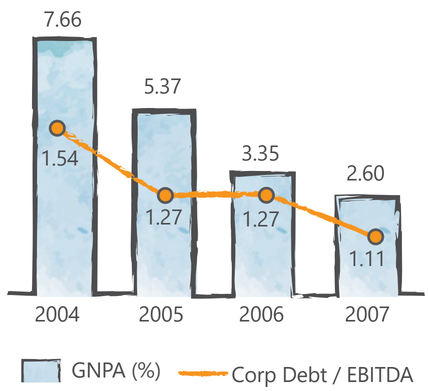
Bank Credit growing at 23% CAGR

Bank Credit



Asset Quality improving significantly with Corporate balance sheets deleveraging

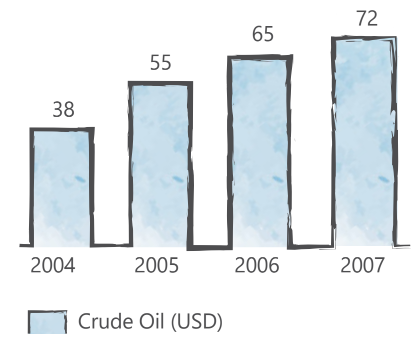
GNPA and Corp Debt / EBITDA



Overlaying the macroeconomic indicators for 2004-07

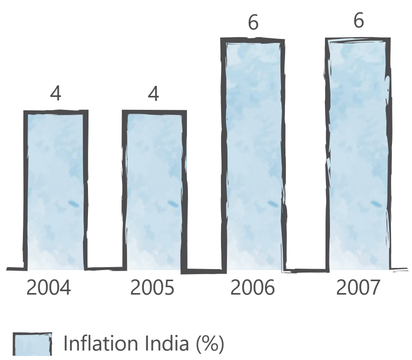
Crude averaged ~USD 57 / barrel

Crude Oil (USD)



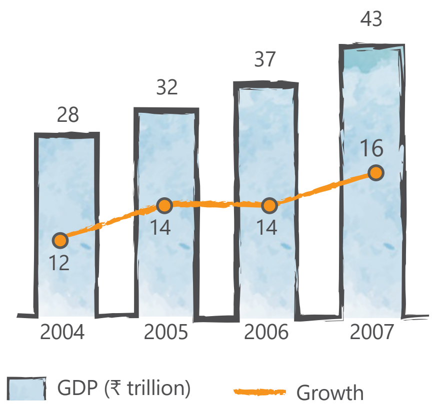
Inflation was ~5%

Inflation India (%)



GDP CAGR 11%

GDP

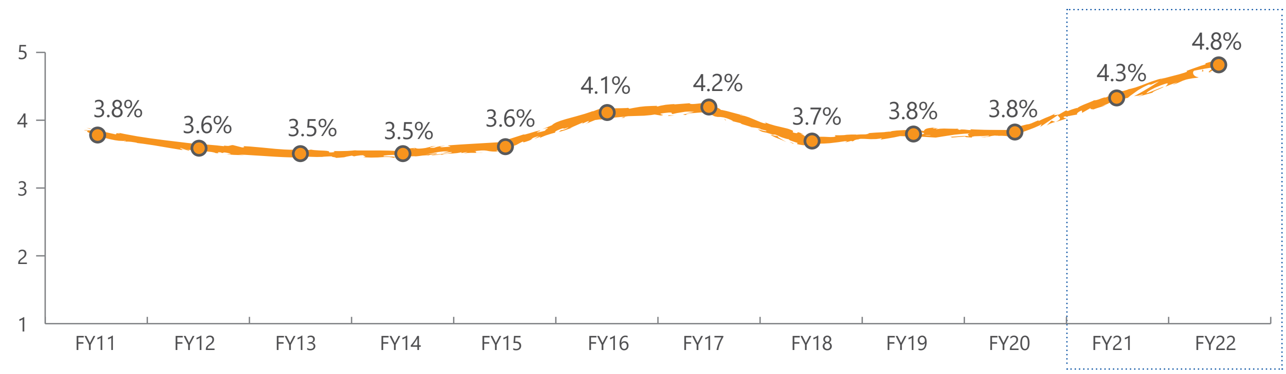


Clearly, only great macro counts for nothing without a strong base on ground as seen in 2014-18. On the contrary, great improvement in ground realities can translate into fabulous, structural economic growth, as we have already seen from 2004-07! **We are, as it stands, on the brink of a long-term growth trajectory, a journey which will translate into a 10 by 35!**

India – 10 by 35

India has been in a long-term growth downturn for some time now. If we look at a long-enough timeframe, this downturn has been through multiple phases in the short-term, medium-term and long-term.

However, the post-COVID era has seen a reversal of this three-phase downturn (with improving micro as we saw in the data in the previous section). Equally importantly, India has had a prudent response to the pandemic. Unlike other knee-jerk reactions, both the central bank and the government have taken a measured approach to post-pandemic measures. Coupled with the improving government revenues across tax collections, after a long time, we are seeing a strong trifecta of corporate balance sheet, government balance sheet and central bank balance sheet. This has also helped plan for an increasing government capex.



Govt Capex (as % of GDP)

In the interest of simplicity, we can summarise in the following manner – even though we see strong global macro headwinds, in India, we are seeing 4 of 5 micro balance sheets (B/S) coming together –

Corporate Balance Sheet – amidst a deleveraging cycle, preparing for next growth phase

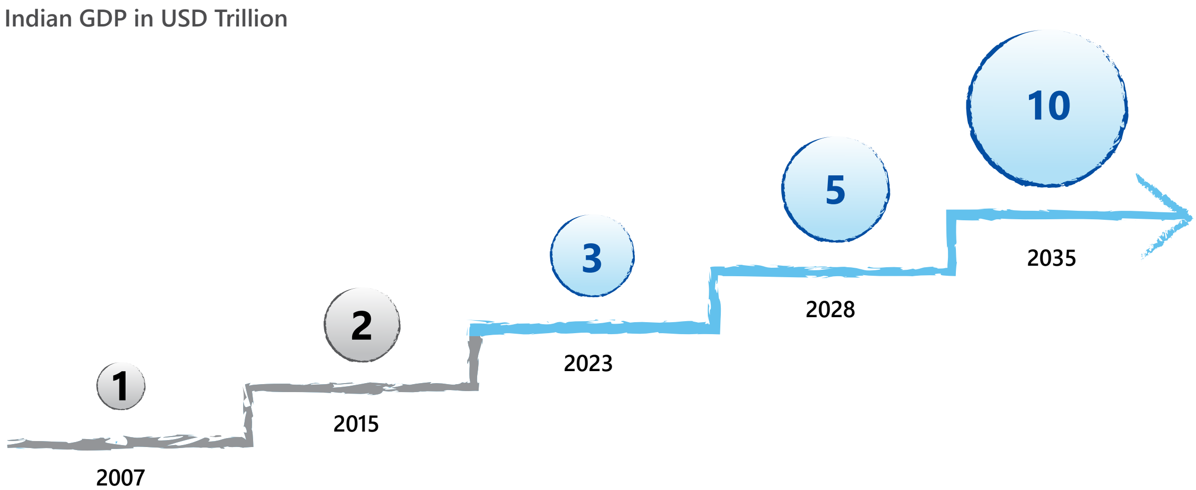
Bank Balance Sheet – asset quality at the best level it has been in years, continues to improve

Government Balance Sheet – increased capex spending on the back of increased revenue

Central Bank Balance Sheet – strong forex reserve, controlled balance of payment

Household Balance Sheet – still recovering, economic growth will aid revival

Strong corporate recovery and healthy government balance sheets with clear focus on expansionary capex make for a great mix for future growth and is not something that too many economies globally will have access to. India's GDP growth in the last decade has been commendable, despite the slowdown we talked about. With stars aligning in place, we are now poised to move towards a GDP of USD 10 trillion by 2035!



Leveraging 10 by 35 at Edelweiss

As India scales up to a GDP of USD 10 trillion by 2035, financial services will play a key role in this journey. As I mentioned in my last letter, we are looking at multiples of growth in all financial services segments in the years to come. Be it retail credit (especially mortgages and MSME), asset management (both mutual funds and alternatives), insurance (life and general) or wealth management, the secular growth trends in these industries will far outweigh the GDP growth.

The decade will also bring newer opportunities, which, brings with them tougher capital allocation decisions. To better prepare ourselves, we have embarked on an exercise to create a framework which will help us estimate the value creation potential of our businesses and the Edelweiss Group. This will also aid future capital allocation decisions to maximise value of capital and ultimately shareholders. The framework needs to consider both quantitative (like profitability and cashflows) and qualitative factors (like governance and management) of businesses to assign a business value. Going ahead, our value creation journey will be evidenced by data!

To summarise Edelweiss' journey to 2035, we are well-placed to leverage the multitude of opportunities through our wide spectrum of businesses. All our businesses are well-capitalised, with reasonable scale (except GI which is growing aggressively) and have established a repeatable, profitable business model or are in the process of pivoting to one (asset-light in credit). Some are leaders (like Alternatives and Wealth Management), while some are well-placed to capture incremental market share which they have already been doing for a few years now (like Insurance and AMC). Yet others are small but trying to establish disruptive business models which could be gamechangers in the industry (like Retail Credit). All in all, we are poised to ride on the tailwinds of India's growth and be key participants in the 10 by 35 journey.

Yours sincerely,

Rashesh Shah

Rashesh Shah
Chairman and MD

Edelweiss
Ideas create, values protect

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