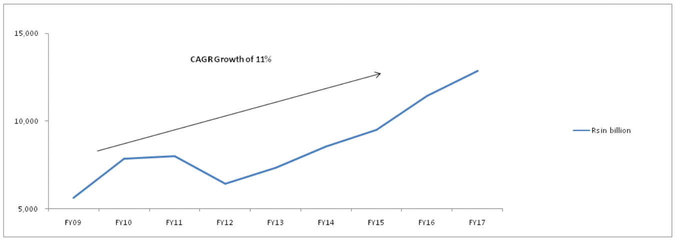
One of the Best Proxy Play to the Financialization Trend in India
Central Depository Services Ltd (CDSL)

Central Depository Services Ltd (CDSL) is our top pick to play the financialization trend. This is our third fundamental recommendation in our newly launched product **PRUIDEA** post Karur Vysya Bank and PSP Projects.

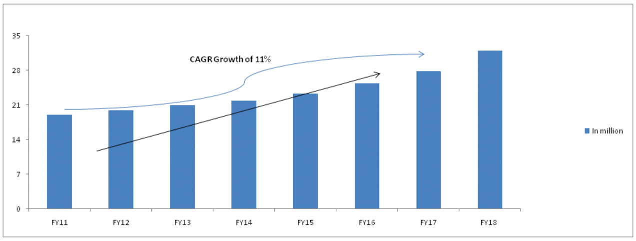
The Megatrend in Financialization of Savings in India- Explained in Three Charts

Increasing Share of Household Savings in Financial Assets



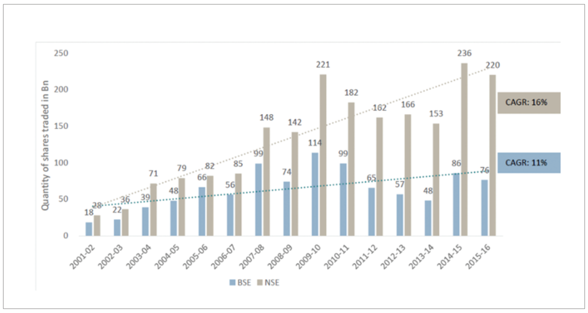
Source: Company Reports

Increase in Demat Accounts



Source: Company Reports

Trading statistics of stock exchanges



Source: RHP of CDSL

Now, these are the charts stating that people in India are increasing their savings in financials assets such as mutual funds, shares, debentures, government bonds. Historically, the savings in physical assets (i.e real estate) and gold and silver ornaments have been high. But since a while now, there has been a shift from savings in physical asset to financial assets. And this shift will immensely benefit CDSL.

CDSL has grown its consolidated core income and profit after tax at a CAGR of 16.1% and 15.6% respectively for a period of five years. If this is not enviable, CDSL return ratios such as RoE and RoIC stands at 16% and 36% respectively over a period of five years.

Not only this, the company boasts of very strong operating leverage. A large part of their expenses are fixed. Hence, in a scenario wherein the revenues spike up, there won't be a simultaneous spike in the expenses, which will help CDSL to earn higher operating margins. This is the prime reason behind the company earning average operating margins and PAT margins over a period of preceding eight years to the tune of 80% and 57% respectively. These are excellent numbers!

Further, CDSL has a very strong balance sheet. With zero debt, liquid investments (investments + cash) accounts for around 78% of the balance sheet size. The cash per share stands at Rs 53. Hence, if you are buying the stock at **Rs 230**, you are essentially getting cash of Rs 53 for free. Hence, effectively you are buying this stock at (Rs 230 – Rs 53) =**Rs 177**.

If you consider the effective buying price of **Rs 177**, the price/earnings ratio for CDSL stands at 18x. An 18x p/e seems to be reasonable for a company which is growing its RoIC at 34% on a consistent basis.

With just one competitor NSDL and globally being just the second depository to get listed, CDSL will continue to deserve a scarcity premium. We value CDSL at a target multiple of 23x and derive at the target price of Rs 453. This essentially leaves investors with an absolute upside of 71% from an FY23 perspective. Also, the target price implies a CAGR of 14.2% (including dividend yield) from an FY23 perspective.

Now, let us tell you how the company has delivered such solid performance over a long period of time…

CDSL derives revenues from a diverse set of verticals. The contribution from the highest vertical does not exceed 30%. Hence, the revenues are very granular in nature. The granularity in revenues have helped them to de-risk its business from cyclicality and have helped them to grow decently even during the worst of times.

Let us talk in detail about the main three verticals....

■ Annual Issuer Charges - Contributing to 36% of Revenues over Preceding Five Years

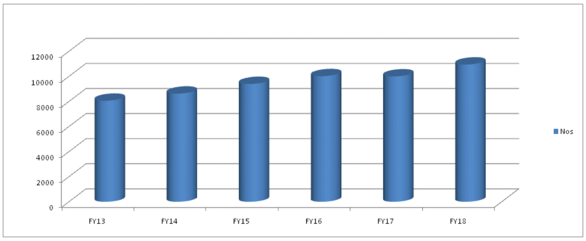
Annual Issue Charges are recovered from corporates. Irrespective of a bull or bear market, these are the charges payable by corporate every year to CDSL. Hence, this vertical is non-cyclical in nature. This can be termed as an annuity income for CDSL.

The growth in this vertical is triggered by addition of new companies and any increase in the annual charges as levied by CDSL.

Talking about the first trigger, the number of companies in CDSL's ambit has grown at a CAGR of 6% over a period of preceding five years.

Increase in Number of Companies Availing CDSL's Depository Service from FY13

Companies Available in Demat



Source: Annual Report

As new initial public offers (IPOs) are listed on the bourses, the number of companies availing CDSL's depository services will increase going forward.

As far as the second trigger with regards to annual charges is concerned, the SEBI regulates the amount which can be charged as annual issuer charges. Usually a hike is prescribed by SEBI once in every five years. The last hike was in 2015 to the tune of 40%. Hence, the next hike is likely to be in 2020.

Projections for Annual Issuer Charges

DESCRIPTION (in cr)	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23
Annual Issue Charges	64.0	65.2	89.1	93.5	98.2
YoY	15.0%	2.0%	36.5%	5.0%	5.0%

We expect the revenues to grow at a CAGR of 7.4% from FY19 to FY23 from this vertical with a hike in tariff by SEBI coming in FY20 and getting reflected in revenues by FY21.

Recently, SEBI has mandated unlisted public companies to de-materialize their shares. This will offer a massive opportunity for the company going ahead. There are around 66 thousand unlisted public limited companies in India and if their shares are to be dematerialized, it will immensely aid the revenues from this vertical.

■ Transaction Charge - Contributing to 22% of Revenues over Preceding Five Years

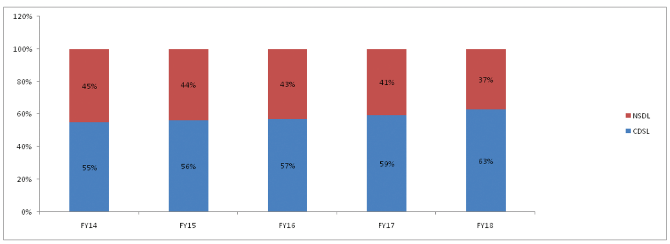
CDSL earns a transaction charge of Rs 5, every time a delivery based transaction is executed through a stock broker who has availed CDSL as their depository.

To put it simply in an example, HDFC Securities has opted for CDSL as their depository. Now, an investor who has a demat and trading account with HDFC Securities, purchases 100 shares of Reliance Industries on delivery basis. Then, CDSL will charge Rs 5 for this transaction as it will manage the entire transaction from transferring the securities from seller's demat to buyers demat. Irrespective of whether the investor sells 100 shares or 10 lakh shares, per transaction CDSL will earn Rs 5. Hence, the transaction charges is dependent on volumes. More the volumes, higher will be the transaction income. This is a cyclical vertical. In a bull market, this vertical will outperform and in a bear market it will underperform.

Having said that, the increasing market share of CDSL versus NSDL in acquiring demat accounts, under-penetration of savings in equity market and increasing financialization will help reduce the cyclicality in this business.

Stock Brokers are increasingly Preferring CDSL over NSDL as Seen in the Table Below

Increasing Market Share of CDSL on New Demats Being Opened



Source: Company Reports

Under Penetration of Savings in Equity Market as a Percentage of Overall Financial Savings

Particulars (in bn)	FY12	FY13	FY14	FY15	FY16
Net Financials Savings	6426	7336	8321	9192	10825
Savings in Shares & Debentures	78	88	39	57	95
Savings in Shares as a % of Overall Savings	1.2%	1.2%	0.5%	0.6%	0.9%

Source: RBI Data

Projections for Transaction Charges Growth

DESCRIPTION (in cr)	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23
Transaction Charges	42.4	45.8	56.4	64.9	69.4
YoY	3.7%	8.0%	23.2%	15.0%	7.0%

The vertical is cyclical in nature and we expect subdued growth for transaction charges atleast in FY19. However, we expect the things to significantly improve post FY20 and expect the revenues to grow at a CAGR of 7.4% from FY19 to FY23 from this vertical.

Know Your Customer(KYC) Revenues-Contributing to 15% of Revenues in the Preceding Five Years

CDSL through its wholly owned subsidiary-CVL Ventures is in the business of doing Know Your Customer (KYC) for capital market intermediaries. CVL is the largest KYC Registration Agency (KRA) controlling about 60% of the market share in the KYC of capital market. This vertical has grown at a CAGR of 20% over the preceding five years. There is a compulsory requirement of furnishing of PAN for doing KYC in capital market. Hence, CDSL verifies the PAN details as submitted by user in the KYC form as well as does an in-person verification check of the user.

Further, the subsidiary has a very interesting product launch which will bear fruits in the second half of FY19. Time and again you need your copies of education certificates to be attached somewhere. Now, imagine a platform wherein, the person who wants your education qualification can straight away fetch the same from a platform wherein all the education certificates are digitally stored. This platform will be created by CDSL. CDSL plans to provide authenticated copies with security features of academic awards to students and its other users upon request. As quoted by a leading brokerage house, there are more than 18.5 lakh engineers, doctors, MBA's, Chartered Accountant (CA) collecting Masters/Professional/ Diploma degree every year. Hence, this new venture provides immense opportunity.

We expect the entire segment to post a CAGR growth of 3% from FY19 to FY23 for this vertical.

Other Avenues for Revenue

Another major source of revenues is from IPO and corporate action. It accounts for around 9.5% of the consolidated revenues in the preceding five years. Corporate action includes the likes of bonus issue, right issue, split of shares, mergers, amalgamations, buy-back etc. The more the corporate action and IPOs, the higher will be the revenue from this segment.

Not only this, CDSL's product pipeline is very interesting. One of its subsidiaries is commencing a business of electronic generation of receipts of physical goods which are stored in the warehouse. What this means is, just like we have stocks de-materialized in demat accounts, there would be receipts of physical goods stored in warehouses which would be electronically stored in a platform created by CDSL.

The banks usually lend to this traders on the basis of physical goods stored in the warehouse. Currently, banks have to conduct checks on the warehousing premises to verify whether the goods actually exist. With such receipts now stored on a common platform, banks can lend on the basis of the receipts or information available on the platform. This receipts generated electronically are known as eNWR. Provided, RBI mandates banks to lend against only these eNWR, it will open up a huge opportunity for CDSL.

Further, CDSL also conducts e-voting for passing resolutions and send e-CAS statements which are some other revenue streams for the company and these revenues are non-cyclical in nature. This will help aid revenues for CDSL.

Another Strong Reason to Buy this Stock

Excellent Balance Sheet

There are very few companies who boast of such good balance sheet. With zero debt, liquid investments (investments + cash) accounts for around 78% of the balance sheet size. The cash per share stands at Rs 53. Hence, if you are buying the stock at Rs 230, you are essentially getting cash of Rs 53 for free. Hence, effectively you are buying this stock at (Rs 230 – Rs 53) =Rs 177.

With a negative working capital, the cash conversion cycle is excellent. Cash flow from operations (CFO) to Earnings before Interest Depreciation Tax Amortization (EBIDTA) - (CFO/EBIDTA) stands at a very healthy 80%. With minimal capex requirements to grow its core business, the company is set to generate healthy free cash flows going forward.

High Operating Leverage

CDSL is a business which has a high operating leverage. A huge part of the overall expenditure is fixed in nature. There are two major expense lines for the companies which are employee expense and IT related expenses.

Hence, in a scenario wherein the revenues spike up, there won't be a simultaneous spike in the expenses, which will help CDSL to earn higher operating margins.

Over a period of preceding five years, CDSL has earned operating and PAT margins of 76% and 57% respectively. These are very healthy numbers.

Major Concerns...

- Currently there are just two depositories- NSDL and CDSL. Recently, a panel suggested opening up of a third depository. This can lead to increased competition. Having said that, there are high switching costs for stock brokers to shift to other depository, and opening up of a third depository would not have any meaningful impact on CDSL.
- The transaction charges are cyclical in nature and accounts for around 22% of the overall revenues. The transaction charges are highly reliant on the volumes in the market. The stock markets are expected to be turbulent and volatile in FY19 and hence there could be some downside on this front in FY19. Owing to the same we have factored in a subdued growth of 3.7% in transaction charges in FY19.
- The central government has recommended new KYC norms wherein reportedly the government has done away with requirements of PAN and in-person verification (IPV). Though CDSL garners a 60% market share in the KYC of capital market, the new KYC norms may play as a dampener from the revenues in this segment.

Future Projections and Financials

Particulars (in crore)	**FY16**	**FY17**	**FY18**	**FY19E**	**FY20E**	**FY21E**	**FY22E**	**FY23E**
Operating Income	123	146	191	191	199	258	285	306
YoY Growth	16.5%	18.8%	30.8%	0.1%	4.3%	29.6%	10.3%	7.5%
Other Income	38	41	35	44	48	54	60	66
YoY Growth	76.8%	6.2%	-15.2%	26.3%	10.0%	11.5%	11.5%	11.0%
% of Operating Income	31.3%	28.0%	18.1%	22.9%	24.1%	20.8%	21.0%	21.7%
Total Income	161	187	226	235	248	312	345	373
YoY Growth	-	15.8%	20.8%	4.1%	5.3%	26.1%	10.5%	8.1%
Operating Income (EBIDTA)	54	60	60	36	33	45	64	79
EBIDTA Margin (%)	**52.0%**	**54.4%**	**59.5%**	**55.0%**	**55.0%**	**59.0%**	**59.0%**	**59.0%**
Profit After Tax	91	86	103	107	113	148	164	178
YoY Growth	108.4%	-5.7%	20.3%	3.6%	6.0%	30.8%	10.7%	8.5%
PAT Margin	**74.2%**	**59.3%**	**54.3%**	**56.2%**	**57.1%**	**57.6%**	**57.7%**	**58.3%**
RoE (%)	**19%**	**16.2%**	**17.3%**	**16.4%**	**15.9%**	**18.8%**	**18.8%**	**18.4%**
RoCE (%)	**20.5%**	**21.9%**	**23.6%**	**21.9%**	**21.3%**	**25.1%**	**25.0%**	**24.5%**
RoIC (%)	**45.3%**	**25.4%**	**40.8%**	**52.1%**	**53.3%**	**55.4%**	**75.1%**	**82.5%**

Valuations

CDSL has a very strong balance sheet. With zero debt, liquid investments (investments + cash) accounts for around 78% of the balance sheet size. The cash per share stands at Rs 53. Hence, if you are buying the stock at **Rs 230**, you are essentially getting cash of Rs 53 for free. Hence, effectively you are buying this stock at (Rs 230 – Rs 53) =**Rs 177**.

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