10th October, 2016

Aurum Small Cap Opportunities & Aurum Growth Portfolio

15th Quarterly Update – QE September 2016

Dear Investor,

The past few months have seen stock valuations of Indian small and mid-cap companies soar to unparalleled heights trying to capture blue sky opportunities of the 'distant future' in valuations of 'today'. Although we were one of the earliest believers in the huge potential of small and mid-cap companies, we now find ourselves perplexed with the froth in this universe. Hence, despite friendly criticism from some of our clients about our lack of aggression during this "runaway" show, we have stayed true to our investment discipline and have refrained from chasing momentum. As a result we have ended up underperforming vis a vis the benchmarks (on a composite basis) as our newer clients have remained substantially in cash while the market ran away. Where some of our portfolio stocks hit our sell 'guardrail', we have ended up liquidating some positions even for our old clients.

While it is true that the Indian economy is indeed emerging from a long period of inaction and paralysis, concerns remain; namely, the health of the banking sector and its ability to finance growth, over leveraged balance sheets, moribund Europe, a sharply de-accelerating China (by proxy, the world), & the outcome of US elections. It can't be that the Indian economy will not feel the heat of these global issues.

We continue to believe that patience pays.

Banking in the new age

Over the last 5 years, USD 37 bn has been invested in fintech companies mostly in the areas of payment & remittances, lending, product distribution and advisory solutions. These fintech companies will impact the Non-Interest Income component of traditional banks which is approx. 40-50% of revenue at major US banks and 25% of revenue at Indian banks

We believe the confluence of mobility, cloud & blockchain technology will bring in disruptive changes and impact the fundamental ways in which banking is conducted, adversely impacting their P&L.

As can be seen from the charts below, Non-Interest Income is a significant portion of the revenues of banks, globally. In the US, it is in range of 40-50% and about ~25%, on an aggregate basis, in India. Non-Interest Income of banks largely is made up of *card income, loan processing fees, product distribution fees, money transfer commissions and syndication fees.*

Bank's Non-Interest Income may decline

US **India**

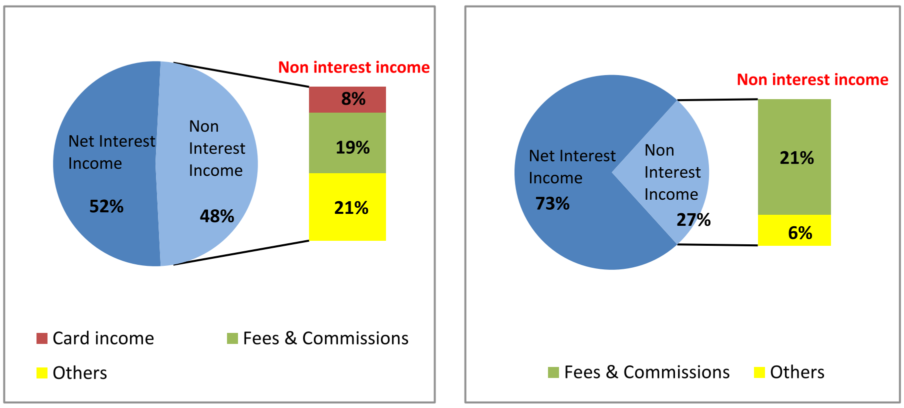


**Chart 3: NRC Research, Company Annual Reports*

The progress of fintech disruption is being hastened by rapid advances in technologies like data analytics, digital bank infrastructure and blockchain.

Contextually, in the last 5 years, fintech companies have received cumulative VC/PE funding of USD 37 bn. Most of the investment in fintech has gone into *payments & remittance, lending, product distribution and advisory solutions.*

Investments in Fintech (USD bn)

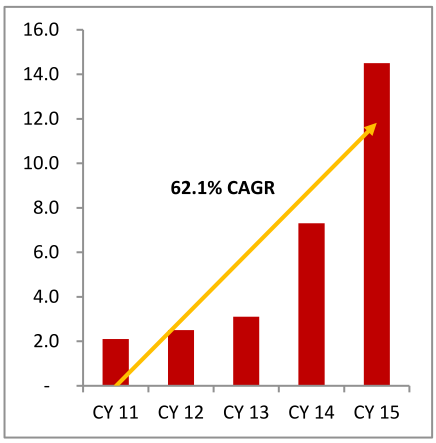


**Chart 4: NRC Research, Accenture report*

Juxtaposing these two facts i.e. the trend in fintech investments and the non interest income profile of banks, we expect significant disruption for incumbent banks and revenue profile, thereof. The progress of fintech disruption is being hastened by rapid advances in technologies like data analytics, digital bank infrastructure and blockchain.

P2P lending is a match making platform for lenders and borrowers, wherein the lenders directly take the credit risk of the borrower. P2P has also morphed to P2B lending in some cases, wherein participants collectively lend to small companies

While fintech's impact is expected to be wide spread, in this edition, we are going to limit ourselves to segments where we think the impact is going to be visible and significant in the short to medium term, namely:

I. Lending

II. Payment & Remittances

III. Distribution of Financial & Insurance products

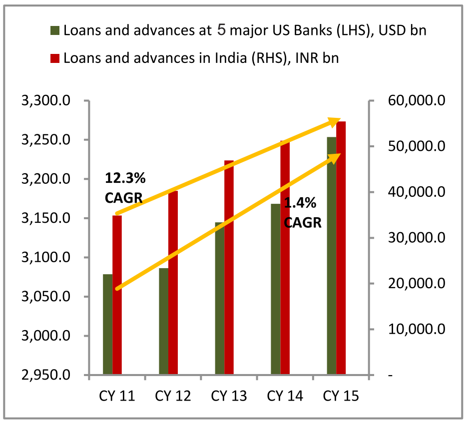
All the above mentioned service segments in banks & institutions are currently handicapped by legacy platforms & processes, complex regulatory environment and fast changing customer preferences.

I. **Lending**: Currently, lending to a large section of the global population is hampered by:

- lack of access to banking
- complicated & substantial documentation processes
- banks' reluctance to lend to those without a track record or collateral
- upfront processing fee

In this scenario, the emergence and growth of P2P platforms like Lending Club, Avant, Lending Kart (India), Sofi, Society One, OnDeck (SME) are indications of a shift from banking, para banking and unorganised lending to P2P platforms.

Growth in Loans & Advances



Growth in Global P2P Loans (USD bn)

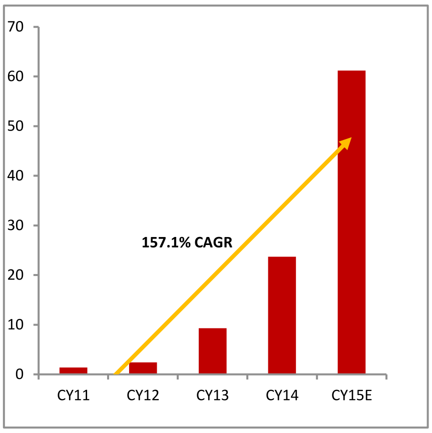


**Chart 5: NRC Research, Company Annual Reports, Morgan Stanley Report*

As evident in chart 5, the Loans & Advances portfolio of 5 global US banks and that of India have grown at a CAGR of 1.4% and 12.3%, respectively. During this period, P2P landing in US, China, EU and Australia has grown at 157.7% CAGR and stands at ~ USD 60 bn. While it may not strictly be an apple to apple comparison, it definitely is indicative of a very strong emerging trend in lending.

P2P is a match making platform for lenders and borrowers, wherein the lenders directly take the credit risk of the borrower. The platform charges ~2% of the borrowed amount as a fee to ensure execution of contractual obligation. P2P has also morphed to P2B lending in some cases, wherein participants collectively lend to small companies.

In the short to medium term, P2P / P2B lending is likely to bring the tribe of tech savvy but less documented borrowers to the mainstream. In India, it will enable borrowers to bypass or reduce dependence on the much more expensive micro finance industry and the money lenders community. Further, it is expected that efficiencies of P2P lending will reduce the operating cost of transmission and of managing a loan from 5-7% for a bank to about 2-3% for P2P platforms. A saving of about 3-4% in the banking space! Hence, in the medium term, traditional banks may well be forced to reduce their loan processing fees in order to stay competitive and defend their market share in the lending market.

Of the ~ USD 500 bn global remittances, ~ USD 400 bn is to developing countries and each transaction is relatively small. Fintech innovations like Abra, WorldRemit, Vopium, MPesa, TrasnferWise and UPI which are both quick and easy to use can disrupt the steady payment & remittance income streams earned by traditional banks in the form of transaction fees and charges

II. Payment & Remittances

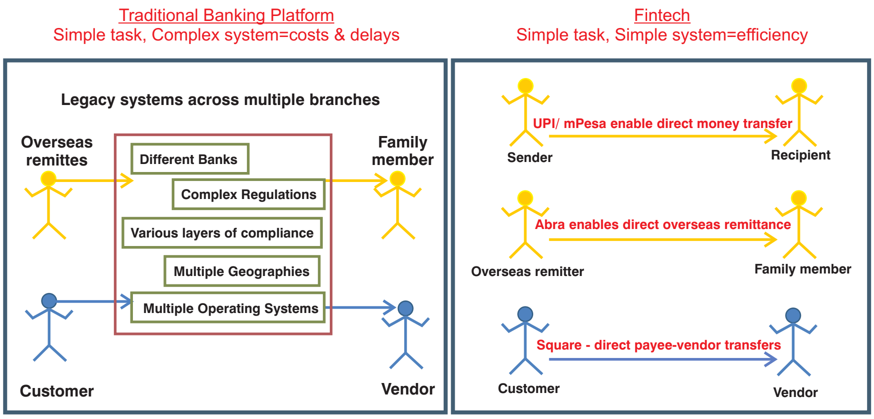


**Chart 6: NRC Research*

Payment and Remittance activities operate in a complex environment of multiple platforms, across different geographies and regulatory environments resulting in inefficiencies in the system and delays & relatively high cost to customers. Payment and Remittance services are estimated to account for 30 - 50% of a bank's Non-Interest Income.

Payment: From a customer's perspective,

- There is a significant time lag, wherein payment takes 1-3 days
- Merchants are charged ~2-3% of transaction value
- Forex rates charged are unfavourable

'Wallet' was the first stage of the fintech evolution in payment (PayPal, Paytm).

Remittance: Traditional methods of remittance have the following disadvantages from a customer's perspective,

- Global remittance takes 5-10 days and charges are as high as 2-10%!
- No cost effective solution exists for small remittances, which make up the bulk of remittances
- Forex rates charged are unfavourable

Global Remittances (USD bn)

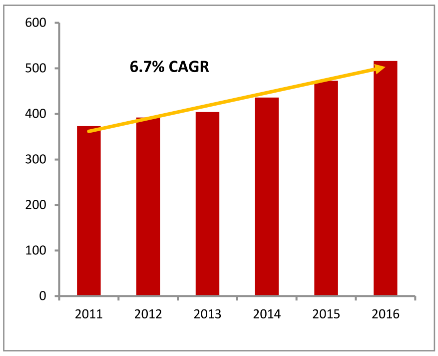


*Chart 7: NRC Research, eServGlobal

Of the ~ USD 500 bn remittance (chart 7), ~ USD 400 bn is to developing countries and each transaction is relatively small. However, it happens with significant time lag and cost of 5-10% commission. In this context, the emergence of remittance platforms like Abra (blockchain based), WorldRemit, and Vopium gains importance. These platforms are independent of bank accounts and can disintermediate the remittance space rapidly.

Similarly, MPesa in Nigeria, TransferWise in Thailand and UPI by the Government of India are prime examples of the universalization of transfer & payment solutions. Given the inefficiency of the current payment and remittance infrastructure, these innovations which are both quick and easy to use can disrupt the steady income streams earned by traditional banks in the form of transaction fees and charges.

US insurance agents receive ~ USD 25 bn per annum, about 6% of USD 394 bn paid in annual premiums. Going forward, a significant part of this USD 25 bn can be saved and passed back to the insurer in the form of lower insurance charges

III. Distribution of Financial & Insurance Products

Historically, distribution of financial products has been dominated by banks and agents. The space is plagued by:

- limited product comparison opportunity
- non standard product features
- high distribution and processing fees
- significant product mis-selling

The onset of technology based financial distribution platforms is set to markedly change this scenario. Backed by strong standardisation & transparency norms issued by regulators, product platforms like Bank Bazaar and Policy Bazaar (in India) offer enhanced product comparison, cost transparency (no hidden cost) and reduction in processing fee. Thus, Banks and agents may face a precipitous decline in their distribution fee based income.

To put this in context, currently, US insurance agents receive ~ USD 25 bn per annum, about 6% of USD 394 bn paid in annual premiums. Going forward, a significant part of this USD 25 bn can be saved and passed back to the insured in the form of lower insurance charges. Similar evidence is available for mutual funds and loan products. Thus, there is significant scope for disintermediation in the distribution & investment advisory segment as well.

Implications for banks

In the medium to long term, simple transaction solutions, product transparency and comparison options brought in by fintech platforms will impact banks in the form of:

- large scale migration of clients to non-banking platforms
- lower or no loan processing fees

Blockchain uses encrypted, open and distributed ledgers, sitting across millions of computers. These computers called 'miners' validate transactions by consensus, generating 'blocks' (records) for every transaction processed

- lower financial product distribution fees
- migration of remittance to non banking fintech platforms
- resultantly, pressure on Non-Interest Income of banks
- continued and significant investment by banks in future ready software solutions

Thus, a significant part of Non-Interest of banks Income is at risk from emerging fintech solutions. While adoption of fintech by banks will enable them to reduce their operating expenses and stave off competition, it is unlikely to fully compensate for the loss of Non-Interest Income from the above mentioned sources. Investment in fintech will be a hygiene factor for banks rather than an avenue for growth.

Blockchain: The protocol behind digital currencies

Blockchain is the technology behind digital currencies like Bitcoin, Ethereum etc. that has been around since 2009. Unlike the traditional currencies that use a closed central ledger, Blockchain uses encrypted, open and distributed ledgers, sitting across millions of computers world over. These computers called 'miners' validate transactions by consensus, generating 'blocks' (records) for every transaction processed. These 'blocks' are added to older previously authenticated 'blocks', completely obviating the need for trusted third parties like banks or central depositories. The transaction records are updated every ten minutes, creating new blockchains; with the miners getting compensated with newly minted bitcoins for their work.

For non-miners, digital currencies like Bitcoins, Ethereum etc. can be brought through online wallet companies like Coinbase, Bitquick, Coincorner or through exchanges like Localbitcoin.

Owing to its open, transparent, and consensus based operation, Blockchain is almost impossible to tamper with.

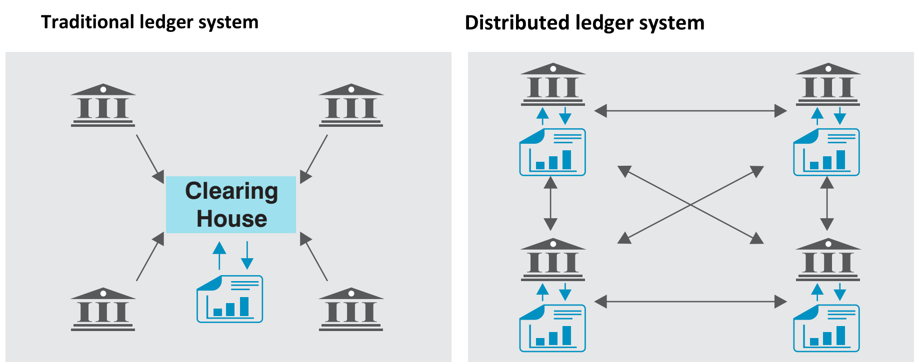


*Chart 8: Wall Street Journal Blogs

Blockchain: Applications beyond Bitcoin

Given its ability to create tamper proof records of transactions or ownership details, Blockchain is likely to find applications well beyond bitcoin. The broad areas of application could be:

Intially, blockchain may find wider application in relatively lightly regulated sectors, than banks, which face a lot more regulatory push back for any drastic innovation

- **record-keeping:** Maintenance of records in fields of law, healthcare, real estate, finance, etc.
- **government/public services:** Vehicle registries, digital identities for individuals, voting records and benefits disbursements. For e.g. The Honduras government is using Blockchain to record land ownership
- **decentralized notary:** Using timestamp feature, validating existence of a piece of data at stated time
- **supply chain and proof of provenance:** Identifying value addition and affixing responsibility in case of manufacturing defects as in food processing etc.
- **media and entertainment:** Blockchain offers new business models to content owners, as being used by some artists to generate concomitant smart contracts

Conclusion

To begin with, Blockchain may find wider application in relatively lightly regulated sectors, than banks, which face a lot more regulatory push back for any drastic innovation. Across sectors, Blockchain can reduce paperwork and ensure trust, transparency and efficiencies in transactions.

Blockchain will necessitate a steep learning curve and it may be a while before significant commercial applications of the technology emerge. However, many industries are likely to experience its impact over time. Organisations that can operate in open and collaborative systems will thrive.

We are clearly seeing signs of a pick up in economic activity across various sectors, especially; roads, railways, power and defence. These also happen to be sectors which have seen significant policy initiatives and emergence of a rule based decision making system. This has thrown up profitable opportunities for companies who have been conservative in the past and have been able to maintain the sanctity of their balance sheet. The gradual unclogging of policy pipeline by the Government has finally ushered in an era of cautious positivity at the entrepreneurial level and that more than anything else reaffirms our bullish outlook on India.

We wish all our investors and well wishers a very happy festive season!

Please feel free to call or write to me for any further information.

Warm regards,

Sandeep Daga

For further information, please contact:
Nine Rivers Capital Holdings Pvt. Ltd.
511-512, Meadows, Sahar Plaza, Andheri - Kurla Road, Andheri (East),
Mumbai - 400 059 India.
Tel: +91 22 4063 2800 • Fax: +91 22 4063 2801 • Email: info@nineriverscapital.com

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