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Market Trend Report

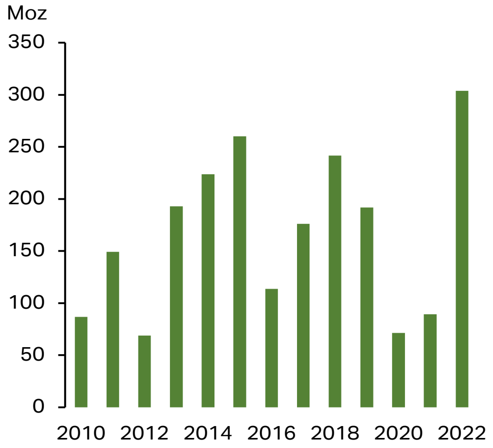
Trends in Indian Investment Demand

January, 2023

Conducted By: Metals Focus

Contents

Indian Silver Bullion Imports



Source: Indian Customs

1. Introduction

Silver and gold are both widely recognized as savings and investment assets in India, a reflection (historically) of the low penetration of banking and other financial products. Even after the economic liberalization in 1991, as India's economic growth has markedly improved, and with it disposable incomes, these characteristics have not changed materially, especially across rural India and semi-urban centers.

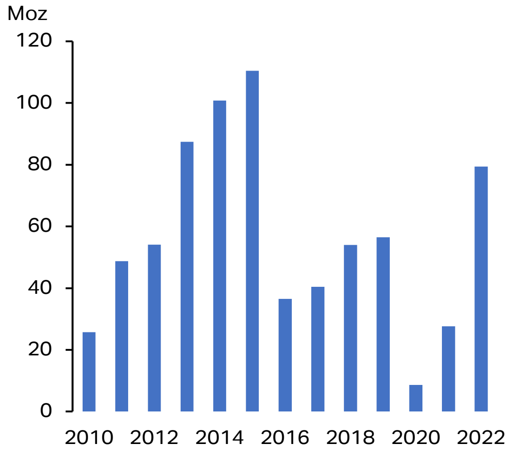
Other important drivers of precious metals investment have been the liquidity they provide (as collateral to secure finance) and as a means to store unaccounted wealth. In this context, historically the low penetration of banking products in India has meant that borrowers have often relied on informal funding channels. In the unorganized and informal segments of the market, lenders offer loans backed by collateral, a role that precious metals have often satisfied. Furthermore, India has relatively high levels of cash circulating in the economy. As such, it is not difficult to convert large amounts of money into precious metals to circumvent taxes, which can then be conveniently stored. The above-mentioned factors are common for both gold and silver.

That said, since 2014, there have been some notable policy and regulatory changes which have structurally altered investment in precious metals, both in terms of their role as a savings and as an investable asset. In this regard, the government's push towards providing banking services to the entire population, the crackdown on both tax evasion and cash transactions (which was spurred on by the demonetization of high value currency notes in 2016 and then, in 2017, the introduction of the Goods and Services Tax) have played a key role. Improved banking penetration has resulted in savings being diverted towards banking and insurance products, which to some extent has undermined the role precious metals play as a savings vehicle.

Given the high value of gold, this trend has affected the yellow metal in recent years much more than silver, which has not faced similar scrutiny and in fact benefited at times from this as investors moved towards silver. That aside, the rapid growth in India's digital eco-system, facilitated by access to high-speed/low-cost internet services and increasing financial awareness, has enabled investors to increasingly choose other financial products, such as equities and mutual funds. This is especially true among the younger generation which tends to be tech-savvy and can be less averse to investing in riskier financial products.

While all this has the potential to negatively impact physical investment, it also presents an opportunity for other forms of investment, such as digital silver and silver exchange-traded products (ETPs), which can benefit from the growth of the digital ecosystem. Both vehicles have been launched in India in the last three years, but have seen mixed results. While ETPs have enjoyed some momentum, albeit modestly, digital silver has struggled. Metals Focus believes that one of the key factors undermining growth in ETPs and digital silver is a lack of investor awareness.

Indian Physical Investment



Source: Metals Focus

With regards to ETPs, large fund houses have launched these products which has helped them gain some traction and a wider reach compared to digital. By contrast, while digital silver has been launched by a few players in the last three years it is yet to benefit from any significant investor inflows. Metals Focus' research suggests that three factors have impeded growth, including the absence of clear regulations, a lack of marketing and high buy-sell spreads. Turning to futures trading, while this has been available to local Indian investors for almost two decades and is still popular, growth over the last decade has been undermined by the introduction of a commodity transaction tax and the silver price crash after 2011, which resulted in widespread losses for investors.

Finally, the India International Bullion Exchange (IIBX), which opened in August 2022, is likely to play a key role in India's precious metals ecosystem. The exchange aims to introduce greater transparency through uniform pricing and better traceability of metals across the supply chain. While the exchange currently only permits gold imports and trading through spot contracts, silver is expected to be allowed once the systems and processes relating to gold have been streamlined.

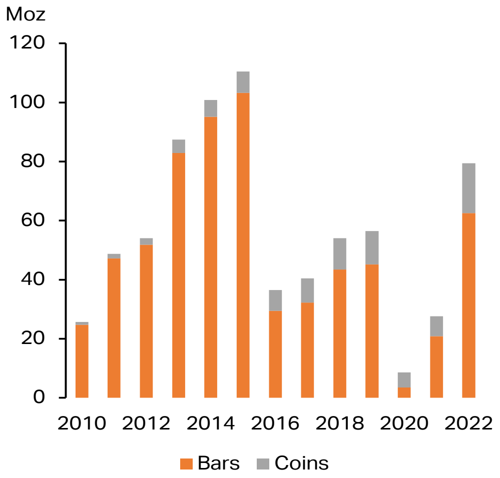
2. Physical Investment

Indian physical investment grew strongly in the decade before the pandemic, rising from 25.7 Moz (800t) in 2010 to 56.5 Moz (1,757t) in 2019 before the COVID-19 induced weakness in 2020 and 2021. Last year, bar and coin demand jumped to 79.4 Moz (2,470t), the highest total since 2015.

Since 2010, investors have bought around 730 Moz (22,700t) of silver. This phenomenal increase has reflected the largely bullish price expectations held by Indian investors, which in turn has encouraged them to take advantage of low rupee silver prices. Furthermore, the Indian government's ongoing tough stance towards unaccounted money and the increased vigilance on gold transactions have benefited silver as investors have moved out of gold and in favor of silver. Another important driver has been the arbitrage between silver's spot and futures prices in India. This is typically between 4-6%, but at times reached 10-15% between 2013-16, before spiking again last year. Our estimates suggest that the volume of silver locked in these trades was around 7 Moz (200-250t) in 2022.

Over the last decade, the only years to witness investment demand fall were 2016 and during the pandemic in 2020 (which saw disinvestment during the second half), when coin and bar purchases weakened sharply. This partly reflected the jump in silver prices in these years, which led to widespread profit taking. In addition, the government's ever tougher clampdown on unaccounted money and greater vigilance towards high value cash transactions undermined demand from high-net-worth (HNW) investors during 2016, who had often bought 15kg and 30kg bars as a means of "parking" their unaccounted income.

Indian Bar & Coin Demand



Source: Metals Focus

In India, silver consumption including investment is dominated by rural and semi-urban areas, a reflection of the relatively low entry price. Furthermore, even fabricators and wholesalers buy silver as an investment during periods of low prices to be later converted into jewelry or silverware, or just to sell back when the price is high to take profits. Given the profile of investors, physical silver investment has so far been largely immune to competition from other asset classes, such as equities.

That aside, price expectations remain positive among both consumers and the trade, which leads to bargain hunting when the price falls close to key levels (for example, near to, or below Rs.50,000/kg) in the domestic market. This emerged in 2022 as the price weakness led to a surge of bullion imports into India. Last year, imports totaled 304 Moz (9,450t), comfortably surpassing the 2015 record of 260 Moz (8,093t). That said, growing urbanization, financial literacy and competition from other asset classes do pose a threat to physical investment, especially for bar demand in the coming years.

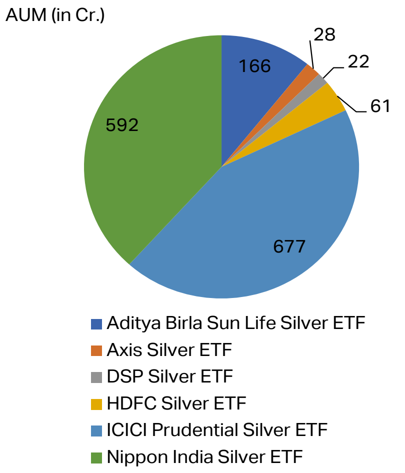
Looking at the coin market, this sector has increased dramatically, from just 1 Moz (30t) in 2010 to 11.3 Moz (351t) in 2019 before falling sharply in 2020 and 2021 as a result of the pandemic. Unlike the bar market, coin demand is largely insulated from price fluctuations. This largely reflects the two main factors driving coin demand in India, gifting and religious purposes. Popular coin denominations are 5g, 10g, 20g, 25g and 50g. While silver coins have historically been used for gifting, better marketing and product offerings by mints and refineries in recent years have benefited demand. Apart from weddings and Diwali, which were the traditional drivers for silver coin demand, gifting during festivals including Raksha Bandhan and key events, such as the birth of a child, and housewarming, has pushed coin demand higher in recent years. We expect the gifting market to grow further as incomes rise.

3. Exchange-Traded Products

Silver ETPs in India are a recent development, with the first product only launched in September 2021. According to current regulations, these have to invest at least 95% of their net assets in silver and silver-related instruments; the benchmark for these ETPs is the London Bullion Market Association (LBMA) daily silver price. Given that gold ETPs in India have been present for more than a decade, it was quite surprising that silver ETPs were perhaps not introduced earlier. In part, the apparent lack of interest in launching a silver ETP in the past reflects the nature of Indian silver investors. This was covered in the Physical Investment section, but in brief this is mainly due to the fact that investment is dominated by rural and semi-urban areas. Furthermore, silver's high price volatility deterred Indian fund houses from launching ETPs.

Even so, with the pandemic boosting online trading across asset classes and younger investors increasingly less averse to buying risker products, silver ETPs are likely to gain traction as the market matures.

Silver ETP Demand



Source: AMFI, Value Research

At present, there are seven ETPs and five silver ETP Fund-of-Funds (FoFs) available to Indian silver investors. A FoF is a pooled investment fund that invests in other types of funds. In India, while trading in ETPs requires a Demat account (short for a Dematerialization account, which is used for trading and holding securities, stocks, shares, bonds, etc., in electronic form), this is not the case for investing in a FoF. This is significant because it makes it that much easier to invest in a FoF. About 10% of the population have a Demat account, so an FoF caters to a much wider population.

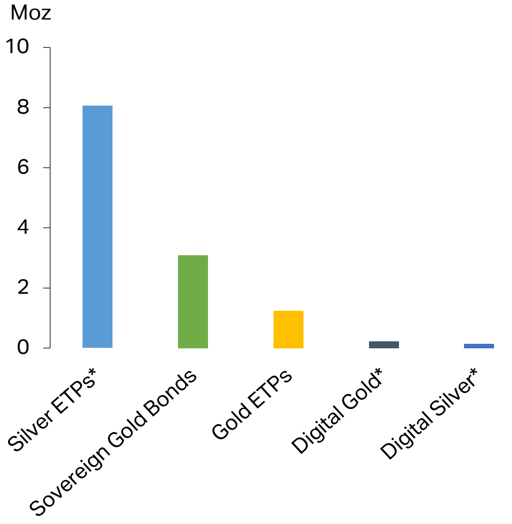
As of end-2022, silver ETP holdings in India stood at an estimated 8 Moz (250t) and, given that the funds were only launched in September 2021, this represents a solid start. Importantly, with leading fund houses offering these products, the potential for holdings to grow is encouraging. Furthermore, with increasing participation in financial markets and a growing risk appetite, Indian fund houses have over the last few years launched multi-asset funds, which can also potentially now include silver.

While silver ETPs have seen a relatively positive response in the first year, it remains to be seen if they can build on this performance. This is important given the performance of gold ETPs in India, which were first introduced in 2007, but are yet to see meaningful participation from Indian investors. Even though total gold ETP holdings in India have doubled since the pandemic, they still remain below 1 Moz (30t).

Our research suggests that one key factor undermining growth in commodity ETPs is a lack of investor awareness. That apart, compared to equity ETPs, gold and silver ETPs tend to come with a higher expense ratio (0.2% for equities vs 0.5% for gold/silver). To briefly explain this, the expense ratio is the annual management fee charged by a fund house to investors. A higher expense ratio also leads to a more sizable tracking error (the difference between the performance of the fund and that of the benchmark) in these funds. A higher tracking error thus undermines the return on investment and is a key reason why Indian investors have traditionally preferred physical investment in gold and silver over ETPs. Furthermore, given that silver fabricators and bullion dealers themselves are big investors in silver (as mentioned earlier), ETPs are not a medium through which they will choose to invest.

Looking ahead, there are still several reasons why there could be greater interest in ETPs. First, given silver's lower price and generally positive price expectations in India, last year saw many large fund houses actively promote silver ETPs. With investors increasingly comfortable with investing in equity mutual funds (as shown by the growth in mutual fund accounts over the last six years), the positive spillover into commodity ETPs should emerge as fund managers see them as a means for portfolio diversification.

Alternative Precious Metals Investments in India



Note: *Metals Focus Estimates
Source: RBI, AMFI, World Gold Council, Metals Focus

4. Digital Silver

In keeping with silver ETPs, digital silver products have also been recently launched in India, although they have so far failed to gain traction among retail investors. By way of some background, digital silver provides investors with the option of buying silver for as little as Rs.1 or 1g, depending on the platform. This is then stored in insured vaults by the seller on behalf of the customer who has the option to either sell it back on the same platform or take physical delivery in the form of coins or bullion (after paying delivery and minting charges).

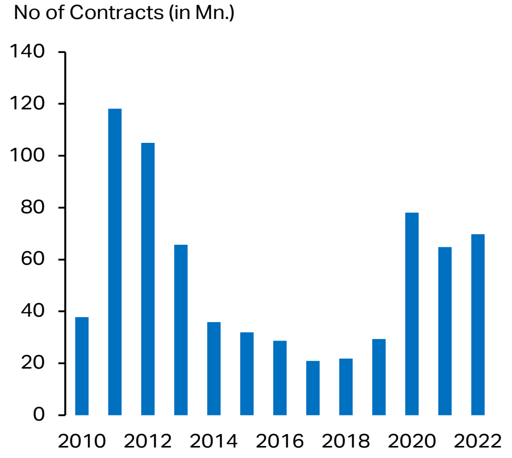
At present, there are around nine companies offering digital silver. Several factors that have hampered the success of digital gold products also apply to silver. To provide some context, digital gold was launched in 2018 and it was not long before several platforms started offering this option to investors. Some of the biggest digital payment wallets and platforms, such as Paytm and G-Pay, launched these products along with several securities brokers, such as HDFC Securities and Motilal Oswal. However, the combined volume of gold held by investors on these platforms has never exceeded 0.3 Moz (10t), and at present stands at around 0.2 Moz (6t).

The lack of traction reflects an absence of clear regulations. This affected a similar product, e-gold and e-silver, which launched in 2011 on the National Spot Exchange Limited (NSEL), but failed as the exchange was forced to close due to irregularities (such as producing fake warehouse receipts). As it stands, even though existing digital products appear secure, due to the presence of custodians and physically-backed metal, there is no oversight from a financial regulator, such as the Securities and Exchange Board of India (SEBI). While there are consultations in this regard, this is a key issue to address from an investor standpoint.

Despite the convenience and ease offered by such platforms, there has been little emphasis on marketing to try and lift investor participation. This reflects the relatively small contribution of the digital gold business to the overall revenues of the platforms and companies offering these products. That said, more recent players in this space are marketing more aggressively, but targeting just the small or low-ticket investor whose average monthly outlay is less than 2g of gold and is otherwise not well versed with complex financial products. While this works to boost penetration among low-income groups, this is unlikely to meaningfully boost volumes on digital platforms. At this rate, it will take a critical mass of small investors to start investing in digital gold and/or silver for volumes to become more noticeable.

The other issue relates to the fungibility of these products. For instance, many started with the aim of allowing their gold holdings to be exchanged at a jewelry store, but a mechanism to allow this was never successfully implemented. The key barrier was how to apply the Goods and Services Tax (GST). For a retail customer, a 3% GST is applicable when buying gold or silver, either digitally or as a physical bar or coin. Given that a significant

Silver Futures Contracts



Note: * as on 3rd January 2023
Source: MCX

amount of gold in India is bought to be later converted into jewelry, the customer pays another 3% GST while doing so. While businesses can secure a GST refund against their sales, there is no mechanism to offset the GST paid by individuals.

This effectively leads to a double tax burden for the retail investor, which is a key detriment for gold and silver investment. This has particularly impacted both gold (given the high value of the transaction) and digital products disproportionately as physical gold or silver can be bought for cash without an invoice. That aside, retailers, bullion dealers and refineries have, over the years, reduced their buy:sell spreads considerably. This contrasts with the spread offered by digital players which is still relatively high (2-3%) and so has discouraged customers.

Looking ahead, while interest in digital silver seems modest, stronger marketing, especially promoting these products as accumulation plans, can boost investor interest in digital silver. Given that it is far more difficult to store silver compared to gold, digital offerings offer an interesting selling point in terms of convenience, storage and insurance.

5. Futures

First launched in 2003 on the Multi Commodity Exchange (MCX), futures trading in silver has a reasonably long history in India. It first saw a phenomenal increase after the 2008 financial crisis. In 2011, as silver prices soared, trading volumes on the MCX for all silver contracts combined (30 kg, 5 kg and 1kg) touched 118m contracts. While actual delivery volumes are tiny (typically less than 1% for any given contract), silver futures have provided an important avenue for investors, speculators, and the trade to participate in silver price rallies.

From an investor's perspective, exchange-traded futures were especially popular during 2009-2013 as they afforded investors the opportunity to gain from the silver price rally by committing a small margin (around 5%) compared to the 100% capital outlay required to invest in physical metal.

Importantly, the exchange has also provided an opportunity for investors to earn a yield via spot-future arbitrage. These trades are more popular among professional/high-net-worth investors. Participants tend to benefit from a price discrepancy between spot and the futures contract and so buy silver in the spot market and sell forward on the exchange. On expiry of the contract the silver is delivered to the exchange, which only accepts serially numbered silver bars supplied by LBMA-approved refiners or other exchange approved suppliers (notably those with the India Good Delivery accreditation). This arbitrage typically generates annual yields of between 5-10% and our estimates suggest that outstanding positions in these trades reached around 6-9 Moz (200-300t) last year.

That said, even as overall volumes in futures trading are still notable, they have slumped since 2011 after the silver price weakened sharply, leading to widespread losses among retail investors and traders. In addition, as the market matured, investors became more aware of the risks of margin trading and those with genuine interest to invest in silver preferred to do so in bars and coins. To put this into perspective, even as the number of contracts traded on the MCX fell by 80% between 2011 and 2016, to 28m, retail investment (in bars and coins) more than doubled between 2011 to 2015 when it touched a record 110 Moz (3,435t) before slumping in 2016 to 37 Moz (1,136t), mainly due to demonetization.

Activity on the exchange was further undermined from 2013 onwards with the introduction of a commodity transaction tax (0.01% applicable on every sell transaction). This impacted jobbing (ultra-short-term trades for small gains), which are traditionally an important contributor to exchange volumes. With the pandemic impacting physical purchases and precious metals witnessing renewed investor interest, exchange volumes have recovered since 2020, but still remain 40% below their peak.

While futures volumes have suffered, the introduction of options on silver futures has helped lift volumes on the exchanges in the last three to four years. To provide a backdrop, options contracts on the silver 30kg contract were first introduced in 2018 and later in 2021 on the silver mini (5kg) contract. While the early response to options was relatively subdued, due to the high margins involved with the 30kg product, volumes picked up noticeably last year. This reflects growing interest in smaller contracts, such as the silver mini. This was also driven by the increased interest towards silver in India last year which in turn reflected the level of price volatility and positive price expectations.

To put the growth in option volumes in context, from 0.2m contracts in 2021, trading has jumped three-fold to almost 0.65m last year (as of end-2022), of which about 43% was accounted for by the silver mini contract.

6. Prospects for Silver on the IIBX

The setting up of the India International Bullion Exchange (IIBX) has been one of the most important initiatives in India's bullion market for many years. To provide some context, in late-2020 India announced the setting up of the IIBX at the Gujarat International Finance Tec-City (GIFT City) in Gandhinagar. The exchange opened in August 2022 with only gold trading permitted on its platform.

The IIBX is designed to improve transparency in the local gold market by introducing a uniform gold price across the country and also provide traceability of metal across the supply chain. Importantly, it will improve access to the yellow metal for jewelers. In this context, the exchange allows Indian jewelers and bullion dealers to directly import gold from foreign suppliers through the exchange. This marks an important change as currently only banks and nominated agencies can do so.

In the IIBX though, only market participants whose net worth exceeds Rs.250m, and who have more than 90% of their business under Chapter 71 of the HS Code system are allowed to directly import gold into India (71 covers a range of gold and silver trade categories). This will allow far more participants to become involved in importing gold and so help reduce the cost of doing so for the likes of jewelers and bullion dealers. This could also eventually impact the Indian banks which have a market share of 30-40% (including doré and refined gold) and an even higher share of 50-70% for silver imports.

As of now, spot contracts have been launched on the exchange, under which bullion depository receipts (BDRs) are traded that are physically backed by gold. The exchange initially accepted LBMA-accredited gold bars, but now also accepts Dubai Good Delivery (DGD) bars. That said, the exchange has so far not seen any meaningful volumes due to various factors such as price disparities, deep local discounts and in general a reluctance from the trade to shift away from their existing approach to importing gold.

To boost volumes on the exchange, in October 2022, the government announced that GIFT City will be nominated as an agency to import 6 Moz (200t) of gold from the UAE under the Comprehensive Economic Partnership Agreement (CEPA). As a result, gold arriving under this agreement will also be traded on the IIBX. To provide some background, bullion imports through the CEPA will attract a customs duty which is 1% lower than for other gold imports into India. Currently, refined gold outside the CEPA is subject to a 15% import duty, which will drop to 14% under this agreement.

With respect to silver, we expect bullion imports and trading to eventually be allowed on the exchange. Importantly, if the government allows silver imports under the CEPA to also be routed through the IIBX, shipments through the exchange could jump significantly. This is because, unlike gold where imports from the UAE under CEPA are capped at 6 Moz (200t) annually (starting from 5 Moz (150t) in 2022 and rising to 6 Moz (200t) in five years), there is no ceiling for silver imports. When it comes to the customs duty differential under CEPA, as with gold, silver imports will initially be levied at a discounted rate (10.75% normally vs. 9.75% under CEPA).

Importantly, silver imports through the CEPA will be zero rated in ten years. As such, the customs duty on silver falls by 0.5% in the second year, 1% from years three to nine, and 2% in the tenth year, which will bring it to zero. If silver imports via CEPA are routed through the IIBX, as they are for gold, it is possible that silver trading volumes will eventually be much higher given there is no cap on silver imports and also allowing for the wider duty

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