May 2020 | Trip report

Stewart Investors
Sustainable Funds Group

India

> **Flirting with madness was one thing; when madness started flirting back, it was time to call the whole thing off.**
>
> Rohinton Mistry

The ongoing crises making their way through the Indian financial system are indicative of the years of irrational exuberance in the decade prior. High profile examples of collapses of both non-banking financial companies (NBFCs) and private banks in the past two years point to the primacy that has been placed on growth above all else, breakdowns of ethics and sound governance, as well as the many conflicts of interest that continue to prevail in the sector. Our trip to Mumbai in December 2019 highlighted the enduring quality of some of the Indian financial companies within the country, not only in the context of this backdrop in India but also in a global one.

The cases of Infrastructure Leasing & Financial Services (IL&FS) and Yes Bank in India demonstrate how quickly the recipe of rapid growth without a keen eye on asset quality and a complete lack of checks and balances – from both the Board of Directors and external auditors – can lead to a complete unravelling of leveraged financial institutions.

Only a few months prior to IL&FS defaulting on USD13bn of debt obligations[1], not one but three credit ratings agencies in the country had issued them with the highest AAA rating. Prior to this, there were signs of trouble brewing in an opaque 'Employee Welfare Trust' owned by senior management, whom also had stakes in the holding company, buying shares in subsidiaries at a 78% discount of their market value.[2]

This total breakdown of governance is mirrored in the Yes Bank case. Not only did the bank pursue an aggressive growth strategy that involved lending large amounts to some of the most leveraged companies in the country, the founder and CEO of the bank has now also been accused of personally receiving large sums for disbursing these loans.[3] Since this has become public, shareholders of Yes Bank have lost close to 88%.[4] Quality of stewardship in these instances – competence, integrity, and humility – is completely absent.

> *"If what you create does not outlive you, then you have failed"*
> – Uday Kotak[5]

The brazen behaviour of these financial institutions is in direct contrast with some of the Indian financial companies we think are of the highest quality. Kotak Mahindra Bank is amongst these, where the founder Uday Kotak not only has a large stake but also has his name above the door, suggesting his reputation and economic interest are on the line alongside minority shareholders. His letter in the most recent annual report is a reassuring read, underlining the importance of experience and expertise through economic cycles. The bank is managed the same in times of optimism as in times of gloom: "Through turbulent times, a well-capitalised balance sheet, constant sniffing between risk and returns and early recognition of problems are our financial and cultural compasses."[6]

This is not to say that the bank doesn't take advantage of opportunities when they arise. They used the last financial crisis to set off on the path of building a corporate loan book. Prior to 2009, the bank mostly disbursed retail loans but had been looking to enter the balance sheets of some of India's largest corporations. While other banks were dealing with the fall out of the financial crisis in 2009, Kotak Mahindra Bank set about building a stable and profitable corporate loans business. This has grown at 20%[7] compound annual growth rate (CAGR)[8] since then, to about 39% of overall advances, and some of the lowest non-performing loans (NPLs) in the industry.

HDFC demonstrates similar prudence and caution, cultivated through decades of experience of conservatively disbursing loans and building the mortgage loans industry in the country. In times like these, it is worth remembering that the top four managers of the company alone have a total of 157 years of experience amongst them with HDFC, having witnessed and endured multiple crises[9].

"Reflecting back, in the first half of the financial year, we were often asked why we are not growing as aggressively as others in certain segments of the commercial real estate market. We held our ground by consciously staying away from funding what we perceived were riskier assets. Unsurprisingly, in the second half of the year, we were asked what we did differently that enabled us to stay resilient and be the preferred choice in the flight to safety. Perhaps a combination of experience and adhering to our risk appetite held us in good stead." – Deepak Parekh, HDFC Annual Report 2019

As with Kotak Bank, HDFC has also used past crises to set themselves up for their next decade of growth. The non-banking financial companies (NBFC) crisis in the 1990s has many parallels with the pains of today, with large AAA rated firms defaulting on debt. The Reserve Bank of India tightened license norms in the wake of this, and over the span of just four years, over 80% of NBFCs were shut down[10]. HDFC came out of this crisis with the ability to accelerate loan and profit growth in a manner that none of the other NBFCs were able to match, with loans growing at 30% per year[11]. This has gone on to serve them well through the decades, cementing their position in the industry.

In a country where many NBFCs have yet again been caught sleeping at the wheel, where banks are disbursing loans without regard for asset quality, and oversight has been in name only, the likes of HDFC and Kotak Mahindra Bank shine through. They embody the crux of what we believe it means to be a good financial institution – the trust put in both of these names. This is layered onto with conservative cultures around growth, ability to take advantage of strategic opportunities, and never forgetting the leveraged nature of their own balance sheets. This discipline to look always to a long-term time horizon rather than to fall for what is faddish in the moment, keep both HDFC and Kotak Mahindra Bank in good stead to not only weather the brunt of this crisis, but to come out of it in a better position than their competitors.

1 Source: https://www.business-standard.com/article/finance/il-fs-employees-welfare-trust-the-link-that-paved-way-to-riches-for-some-118101500217_1.html

2 As footnote 1.

3 Source: https://www.outlookbusiness.com/strategy/trend/how-yes-banks-rana-kapoor-made-rs20-billion-from-loans-worth-rs60-billion-to-indiabulls-5516

4 Source: calculation from Bloomberg share price chart at date of writing.

5 Source: https://www.kotak.com/content/dam/Kotak/investor-relation/Financial-Result/Annual-Reports/FY-2019/kotak-mahindra-bank/Kotak_Mahindra_Bank_Limited_FY19.pdf

6 As footnote 5.

7 Source: Stewart Investors Investment Team.

8 Compound annual growth rate (CAGR): the rate of return that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each year of the investment's lifespan.

9 Source: HDFC management team profiles from their website https://www.hdfcbank.com/personal/about-us/overview/management-team

10 Source: https://economictimes.indiatimes.com/industry/banking/finance/will-shadow-banking-in-india-be-able-to-bury-its-dubious-past-nbfcs-flourish/articleshow/53292953.cms?from=mdr

11 Source: CapitalIQ HDFC Annual reports https://www.hdfcbank.com/personal/about-us/investor-relations/annual-reports

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