



Holland Views – HDFC – Price: INR1830; MCap: INR3,068bn (US\$44.5bn)

Passage to India

“Everyone keeps looking for the next Michael Jordan on the basketball court, but what they don't realize is that he's walking up the fairway.” – Phil Knight, Nike CEO, 1996

Like Phil Knight, our search for the next great Franchise is taking us further afield. Lately, we have found ourselves getting acquainted with India and its financial services sector. Prime Minister Modi's radical restructuring of financial services access and provision in India is unprecedented in its scale and offers proper growth opportunities for well-positioned companies. This brings us to HDFC (Housing Development Finance Corp) – an Indian Mortgage company¹ setup in 1978. Having spent an amount of time studying it, we conclude it is an excellent business.

We now add HDFC to our list of global Franchises and to our valuation watch list hoping to see it cheaper and/or to become more comfortable with the valuation. We suggest those of our clients with a global remit might do the same though all our clients might be interested in our discovery of a new Franchise. What follows is a brief overview of our early research on the business.

In summary:

- HDFC today has c.20-25% share of the Indian mortgage market which is growing in double-digits from what is a low base of mortgage penetration in India.
- The company has **compounded its book value by 20% cagr** since 2001 and the company plausibly believes its growth prospects remain of the order of 15% pa.
- HDFC just published its 40th annual report – i.e. this is a business with a **long and proven track record**.

The company was in effect setup by current chairman Deepak Parekh who was instrumental in creating the firm's unique culture. Interestingly for us, Parekh is also on the Board of Prem Watsa's **Fairfax India**² – another great business compounding BVPS at c.17%!

- HDFC has a **superb corporate culture** that stands out a mile – a 'diamond in the rough' as it were of Indian financial services which remains dominated by staid government-owned organisations.

We think HDFC is to Indian banks what Ryanair is to the European legacy airline industry – **a true disruptor** with a steadfast corporate culture that holds the customer at its core.

- HDFC's modus operandi is to be **demonstrably by far, the lowest-cost operator** (Fig.4) and it has a significant head start in the market as a technology innovator in banking.
- HDFC's **culture** can be summed-up thus: Prudent lending + Customer trust + Focus on Innovation.

“lending eligibility should be based on the borrower's repayment capacity rather than the secured property's value. From the start, HDFC followed this basic underwriting principle...”

¹ HDFC, the India-listed mortgage company should not be confused with 'HDFC Bank' which is a NYSE-listed Indian bank. In fact, the former owns a 21% stake in the latter – worth US\$18bn, the stake being a key component of its valuation.

² Ticker: FFXDF

(founder) Parekh told HDFC staff they “should make [the customer] feel that you need him more than he needs you.” – Harvard Business Review case study of HDFC

- As a macro backdrop, we note **hugely significant developments in the Indian financial markets** under Prime Minister Modi in recent years on a scale we have not seen in any other country.

“We expect Mr. Modi to be the Lee Kuan Yew of India!”³ – Prem Watsa, 2014 investor letter

Modi’s reforms have included massive (or as Prem Watsa puts it “unrelenting”) reform which is opening up the relatively untapped Indian market to efficient financial services provision via digital technology for India’s enormous population.

Specifically, these reforms include:

- The 2009 **Aadhaar Act** – a national biometric database based on a 12-digit digital identity authenticated by fingerprint and retina scans. 270m bank accounts have already been opened via this massive 1.2bn person database (c.90% of the population).
- The 2016 launch of the so-called **India Stack**⁴ – an “ambitious and controversial project of creating a unified software platform to bring India’s population into the digital age” - Wikipedia
- The 2016 **Demonetisation** (Cash ban) of all 500 and 1000 bank notes

Here is Watsa in more detail on Indian developments:

Aadhaar: India’s recently implemented biometric-based identity program, generally referred to as the Aadhaar program, now covers 1.2 billion people, 90% of India’s population. Growth in Aadhaar coverage creates a credible base for future direct benefit transfers of government subsidies. Last year the government passed the Aadhaar Act to enable targeted delivery of government subsidies and services using the Aadhaar identity. Aadhaar has now been used to authenticate a staggering 17 billion transactions and is currently being used to authenticate almost 30 million transactions a day. Since the April 1, 2017 start of India’s current fiscal year, almost \$15 billion of benefits have been transferred directly into the bank accounts of about 320 million individual intended recipients.

Demonetization: Last year we discussed at length the economic and political impact of India’s 2016 demonetization – the immediate withdrawal from circulation of all the high denomination currency in circulation (the 500 and 1,000 rupee notes, worth about \$7.50 and \$15.00) and their replacement with new 500 and 2,000 rupee notes. One year on, India has recovered fully from any negative economic impact of demonetization and there is general consensus that the level of tax avoidance has declined, as evidenced by the 1.8 million increase in individuals filing income tax returns. Personal income tax collection has increased by approximately 20% over the previous year in each of the years ending March 2017 (actual) and 2018 (estimate), resulting in additional tax revenues of approximately \$18 billion in the two years. The increase in each of the two years before demonetization was only approximately 9%. While currency in circulation has continued to increase and as a percent of GDP is only 10% below the levels prior to demonetization, digital transactions have increased substantially and non-cash retail payments in 2017 increased over the previous year by 65% in volume terms and 34% in value terms.

Source: Fairfax India 2018 investor letter⁵

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

³ Lee Kuan Yew was the first Prime Minister of Singapore, governing for three decades. He is recognised as the nation’s founding father, with the country described as transitioning from the “third world to first world in a single generation” under his leadership.

⁴ <http://indiastack.org/about/>

⁵ We recommend reading the entire **Fairfax India** letter here: [http://s1.q4cdn.com/293822657/files/doc_financials/annual_reports/2017/WEBSITE-Fairfax-India-Shareholders-Letter-\(from-Annual-Report\).pdf](http://s1.q4cdn.com/293822657/files/doc_financials/annual_reports/2017/WEBSITE-Fairfax-India-Shareholders-Letter-(from-Annual-Report).pdf)

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