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HDFC Bank

HDFC Bank is perhaps India's most secular compounding story with over two decades of superiorgrowth backed by prudent risk taking on the back of a strategy which is simply "common senserigorously applied".

HDFC bank an excellent track record of consistent growth. Earnings per Share has grown at 23% CAGRover the last 15 years with a high degree of consistency. Management's discipline in lending and recovery has seen the bank successfully navigate one crisis after another wherein most other banks stumbled, while continuing to gain market share. HDFC Bank's average net NPAs over FY09 to FY19 have been 0.31%, substantially lower than that of its peers. Such consistent performance has helped build credibility, which is why HDFC bank has always traded at a premium valuation to its peers.

HDFC Bank not only has the lowest Cost of Funds, and lowest cost of operations, but is also the marketleader in multiple categories like Cash Management, Credit cards, Auto loans. HDFC bank's focus ongranularity in the Loan book, and avoiding high risk sectors/promoters means it is less vulnerable to external shocks (~70% of its loan book today is Retail and SME)

There is still headroom to gain market share as it has <10% share of overall Credit market share and Public sector banks still account for ~65% of the system. There is a big opportunity to grow in rural and semi urban areas which the bank is aggressively looking to penetrate where they can outcompete PSU Banks on Technology and customer service. Hence, even on a higher base, we see opportunity for 15-18% growth over long periods of time (assuming system loan growth will be ~ 10-12%)

The stock has seen a strong price correction because

- Covid- 19 has coincided with a potential leadership change with a new CEO expected to be appointed shortly to succeed Aditya Puri. This is not a variable that changes our Investment thesis as we believe cultures are institutional and successful organizations have strong processes which define how things are done. While a single leader can destroy a Bank, it takesmore than one to create a great one. We see what Apple has delivered under Tim Cook postSteve Jobs.
- There have been concerns raised by some Analysts that a slowing economy will impact HDFCBank more than other banks as they have a greater share of unsecured loans in their mix. Share of the unsecured loan book and Credit Card debt has been increasing over the years, (ittoday accounts for ~17% of loan book and approx. 24% of profits). HDFC Bank, by virtue of its cost position, does not need to chase customers with poor Credit Scores. Management has explained that ~80% of these loans are to salaried employees who are mainly employed with the Government or with strong corporates. Moreover, as we explained earlier, a shortterm default need not imply losses (even with unsecured loans) because you need a good credit history to avail loans in future.

We once again reiterate that one's approach needs to be tailored to time horizon. An investor lookingto optimize for short time horizons may not want to live with the above uncertainty and exit. That isnot a wrong decision because it works well with the time horizon they have in mind.

As long term investors in Banks, what matters to us is not the short term earnings profile of a companybut its long term competitive position and Credit discipline (bulk of value resides in terminal value). We will track how HDFC Bank navigates the current slowdown. The key question to evaluate will be whether the rise in NPAs – if they happen - reflect short term challenges to the economy or a break down in credit underwriting discipline to chase more growth. There is a DNA of conservatism and prudent lending in the Bank. One should not jump to conclusions and bet against a franchise of this pedigree by over-looking its track record, solely based on assumptions of defaults which have not happened, especially when the Govt. has the ability and willingness to provide stimulus. Pessimism isalready reflecting in the valuations at present which are close to 2 standard deviations below mean.