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India Strategy: CEOSpeak

Aditya Puri – A New India in the Offing in Three Months

You know your company, now know its CEO: This new product will attempt to present India's most famous and successful CEOs and their views on India, the industries in which they operate, and the companies they run – plus a bit of a perspective on what drives them in life.

Aditya Puri is CEO and MD of HDFC Bank. This report is in the format of questions posed by Morgan Stanley, followed by Mr. Puri's responses. Among the key insights Mr. Puri offered in our discussion are the following:

"Don't let these temporary factors which I call the noise of a democracy in transition cloud your judgment about the vibrancy of India."

"I think we will see a new India in the next three months, directionally."

"People are deferring investments not because of higher interest rates but because of the uncertainty. At the same time, I think we shall get an investment cycle in the coming six months."

"My view: in the next three months we are likely to see significant policy momentum."

"Investors must own rural themes in their portfolios but, more importantly, they must see rural India."

Aditya Puri – A New India in the Offing in Three Months

What is your view on the Indian economy? Where are we heading?

First, we must understand India. We need to be on the same page for me to answer this question. India is an incredibly diverse country – religion, politics, education, geography, weather are all different across the country. We have the characteristics of a rich country as well as a poor country. Thus, we have the largest scooter manufacturer in the world and globally efficient steel plants and, then, we also have a large portion of our population below the poverty line. We have a lot to do but let us not forget that there are multiple “Indias.” There is lot of talk of governance from corporations to politicians – my view is that human frailty is not the monopoly of India. This happens all over the world. Maybe we shout a bit more and maybe have a bit more petty corruption, but none of this is unique to India. Of course, this does not mean we do not have to rectify it. People also say the Indian political class is very bad. Let us understand that other countries may have to learn from Indian politics of how to manage a democracy when the cake is not large enough. Other democracies may go through this situation in the years to come.

Don’t let these temporary factors which I call the noise of a democracy in transition cloud your judgment about the vibrancy of India. I feel RTI (Right to Information) has proved to be excellent for the country. India’s problems are not unknown. The difference is that they are now being discussed on live television. However, this is leading to improvement. For example, which country has seen government-empowered ministers in jail, entrepreneurs in jail and bureaucrats on the docks? We are now introducing the “Lokpal” bill. I feel that our nadir is behind us.

The vibrancy of India:

Go inside. Go to Pimpalgaon – see world-class tractors in operation, go to Jalna – you will see among the best pharmaceutical research in the world, go to Bhatinda and see the globally competitive small-scale steel manufacturers. We have millions of entrepreneurs. Recognize that. See the affluent farmers – the value-added agriculture. The small and medium-scale players are probably having the best time of their life.

Aditya Puri, May 2011

Now that we are on the same page, I believe, that even if we do not solve our problems, we can grow at 7.5-8%. However, that will be foolhardy on our part. We have the potential to grow at 10%. Why? We are growing at 8.4% today. On a simplistic basis, if we take C+I+G – one can argue there has been some amount of “G” but “I” has been missing. When the investment cycle starts, “I” will kick in and we can easily sustain at 8%.

What we need to go from 7.5-8% growth to 10% is common knowledge. We need more infrastructure. However, it is wrong to say that infrastructure is not happening due to lack of funding. There is no viable infrastructure project in the country that is waiting for finance. There are other issues to be addressed such as land acquisition, mining or the plethora of approvals needed that is slowing things down. These are not difficult issues to resolve and infrastructure will therefore happen. Some of it is already happening. People are focusing on the ten power projects that do not have coal supply. The fact is that we have installed 26000 MW of power since public-private partnership was set up. This is more capacity than what we built in several years prior. Some projects may not take off, others will receive coal from players with surplus and several pending projects will hit the ground. We have been through the worst on infrastructure. We have already come a long way on ports. Airports look better. Power – some issues are still pending. Critical resolution required in roads and mining. I believe these will receive attention very soon.

Let’s take the subsidy issue – the triple “F” subsidy on Fertilizer, Food and Fuel. These are damaging our economy for two reasons – the subsidies are not going to the right people and we need a clearer policy. As far as fertilizer is concerned, a new policy is in place and the burden is declining. On fuel, I am reasonably confident of market-based pricing in the next few months. And on food, whether it is through Nandan Nilekani’s project or through banks’ financial inclusion program, the subsidy will start going to the right people. If we can get the subsidy right, disparities will start receding.

Now, let us discuss the next issue, the fiscal deficit. Oil prices are rising, fiscal deficit targets will go awry – that is a common concern. That said, the only economist who went right about F2011 GDP forecast was the government of India. Everybody else went wrong. I am not holding brief for the government. I am just saying it the way I see it. I believe that once the debt management office comes into play it will put tremendous discipline on the states’ borrowings and the overall deficit. GST (Goods and Services Tax) will also bring the sizeable black economy into play with buoyancy in revenues. So together, the plan on subsidies and GST will eventually bring the deficit lower. Temporarily, you have an issue.

You also have an inflation issue currently. Maybe we could have acted faster, maybe we couldn't. One must understand this is both a demand and supply problem, some of it is imported. Monetary policy is not the way to resolve because then you could end up hurting growth. If I had the option, I would look at breaking some of the fiscal targets but bring inflation under control. Inflation will come down partly because the developed world is not in good shape based on my interactions with managements of companies in these economies. Hence there is downside risk to commodities and India's inflation can come under control.

We need tremendous agriculture reform and delta there could be substantial in terms of growth. I have feeling that FDI will be allowed in retail very soon. I think we will see a new India in the next three months, directionally. Issues such as FDI in retail, supply chain reform, microfinance reform, and creation of cooperatives (like in milk) will happen sooner than most think. Again, our problems can be solved. Most people do not realize that we have more arable land than China. Our issue is that we don't cultivate as efficiently. That is less of a problem than not having arable land.

A new India in the next three months:
Issues such as FDI in retail, supply chain reform, microfinance reform, and creation of cooperatives (like in milk) will happen sooner than most think.
Aditya Puri, May 2011

No doubt, RBI has raised rates. Now the market is calling for a fall in margins, rising bad debts and lower growth. First thing, I have said is that rates will go up but margins will remain intact. After all this bad news, we still have an 8% growing economy but people are talking as though the economy is growing at 2%. Importantly, we don't have bubbles. Some power projects or some road projects may be facing problems, but these are all within the absorption capacity of the institutions. There does not appear to be any systemic risk. So I see major growth in investment and consumption, I see the government managing expenses better – the country has a great future.

What are the downside risks?

Oil is the only beta the country has and that too in the next three to five years unless the energy policy fails. We need to focus on better utilization of our energy resources and also bring more of it into play – we need to better utilize our gas and coal reserves. And make sure we operate in a green environment. The policy is not yet clear.

You sound constructive even for a 12-month scenario compared to a lot of market economists? Alleged corruption scandals mean capex will slow down, higher rates will make projects unviable, high inflation is a big headwind and the world is looking murky, so India's exports will suffer – why are you not sounding worried?

Let us take the alleged corruption scandals. To paint everything with a "deficient corporate governance" brush because a few licenses and real estate projects were mishandled is taking this a step too far. There are large parts of the country that are working exceedingly well without corruption. Projects are not being held up and those that are being held up due to a cleanup act by the government should be held up in the interest of the nation. If you are working as per rules then there is no problem with putting projects up and I would go a step further and say that there are more honest people in this country than dishonest – so I don't see much impediments for good and honest projects. I see clear transparent policies being brought in which will allow people to understand this more clearly.

Interest rates – If you are saying that 100 or 150 bps rise in rates is making your project unviable, you should not be doing such projects. Interest rate for consumer companies is 4% of sales and for capital-intensive companies is around 8-9% of sales. Will rates affect at the margin? It will surely. However, if you put it in the context of the growth, even with our current supply problems we are around 7.5-8%. If we push for higher growth, then inflation may rise further but it has to be seen in the global context. So if the world is not looking good, then commodity and oil prices will decline which is very good news for India's inflation. As far as food inflation is concerned, parts will take longer to fix but a lot of it is getting fixed already. The current account deficit is not issue unless it becomes structural, i.e., stay over 3.5% for long.

How do you see the banking sector progressing in this environment?

This is the best opportunity in the globe, has been for the past five years, and will be for the next ten years.

Are we entering a bad loan cycle?

I don't agree – let me elaborate. Do we agree that growth will be between 7.5% and 8.5%? Seems like a reasonable assumption. Then why will we have a bad loan cycle? A bad loan cycle comes when we have a drastic reduction in growth. This assumption that higher rates and high inflation leads to bad loans is not something I am able to understand.

The fact of the matter is lending practices are sound. A large portion of the banking credit is in working capital, at the short end. Banks recognize bad loans very quickly. It is quite possible that 5 or 10 projects go into difficulty but that is well within the absorption power of the system. I don't see much problem in retail loans or working capital loans. Indeed, when inflation goes up, demand for working capital goes up. The only place where it can affect banks is that people are deferring investments not because of higher interest rates but because of the uncertainty. At the same time, I think we shall get an investment cycle in the coming six months.

The investment cycle:

"I" has been missing. When the investment cycle starts, "I" will kick in and we can easily sustain growth at 8%...Even without a big investment cycle, we continue to grow strongly.

Aditya Puri, May 2011

Could credit growth slow down perceptibly for 2-3 quarters?

Credit growth is at around 20% at 8% of GDP growth and a velocity of about 2.5. Velocity is higher at 3 when growth accelerates to 9%. Credit growth may go down to say 18%. Remember, a large portion of the credit in India is not in the organized sector – organized sector is only about 50%. If you are focused on the right sectors including agriculture and SMEs, you should be fine.

How does the regulatory environment look?

The regulatory environment is benign. On savings account rates, the Central Bank has recognized the need for a calibrated move and that is what has happened. There is not much more regulatory change needed. Rates can go by 50-75 bps but it will not change my view on growth. It will ensure sustainable long-term growth rather than killing growth. The opportunity in this country remains intact. My view is that in the next three months we are likely to see significant policy momentum.

Significant policy momentum:

The regulatory environment is benign… Rates can go by 50-75 bps but it will not change my view on growth. It will ensure sustainable long-term growth rather than killing growth.

Aditya Puri, May 2011

Do your customers echo your view?

Most customers agree with my view. They are not overly buoyant and some of them are watching. They are awaiting clarity on the world at large, which seems to be reeling under over-geared economies emerging from asset bubbles with slowing growth and broken banking systems. People seem less worried in the Western world and the central banks may be creating a commodity bubble with excessive money supply.

There has been a tight liquidity situation. Is it going to change?

I disagree that liquidity has been too tight. Had it been tight, wouldn't interest rates have shot up before the RBI move? If demand exceeds supply, rates should have been higher. But rates were not going up and that prompted stiffer RBI action. The fact is that the Central Bank does not want easy liquidity, it wants tight liquidity but no so tight that growth is derailed. So it is targeting 8-9USD billion liquidity shortage and that is where we are. But everyone who needs money has it? Name me one project that does not have money. When demand picks up, we need to a better job on deposit gathering.

Do you think deposit rates have peaked?

Deposit rates have peaked but I am not happy with deposit growth. I think there is too much currency in circulation. It is worrying me. It is an indication of the money that the government is spending on various schemes. Deposit growth should be higher. We need to penetrate deeper into rural India. Rural India has a lot of cash and gold. They are incrementally liquefying their gold. The Finance Minstry is working on a plan – the RBI has allowed lending against coins. What we are telling people is don't convert your gold to jewelry – that costs 20% and then your children don't like it and you spend another 20% converting it into the latest fashionable jewelry. Instead, store it as coins or bars with banks. When you need it, you can take it back. We are already big in gold lending and growing very fast with high-risk coverage.

Where is the next big thing?

As far as HDFC Bank is concerned, we have gone substantially into the interiors of the country. We have 2000 branches. I am talking about the semi-urban and rural India – what I call “Bharat”. We have taken a large portion of our lending outside the top 25 cities. People have not appreciated the India outside its cities. I strongly recommend that investors stop comparing Mumbai’s airport to Shanghai’s airport. We shall never be like Shanghai. We have unrestricted migration into this city. Hence, one will always see shanties.

Don’t judge India on that basis. Go inside. Go to Pimpalgaon – see world-class tractors in operation, go to Jalna – you will see among the best pharmaceutical research in the world, go to Bhatinda and see the globally competitive small-scale steel manufacturers. We have millions of entrepreneurs. Recognize that. Even without a big investment cycle, we continue to grow strongly – the bottom line is that per capita income and wealth are changing rapidly. See the affluent farmers – the people who are exporting fruits – see the capabilities India is building in value-added agriculture. The small and medium-scale players are probably having the best time of their life. Let us not forget the wage growth in system – that is helping consumption demand. Wage growth is faster than the change in interest rates. I am not saying there is no problem but to me the outlook seems bright.

We are into agriculture lending, commodity lending and lending against gold. We see loan demand for cars, two-wheelers, commercial vehicles, seeds, food processing. The ancillary industry around agriculture, which is probably half the farm output, is thriving. Rural India is changing and will likely change more and create the biggest opportunity for us. Companies that claim to have great plans for India but do not have a strategy for rural India are missing the big story. Companies need to customize products for Rural India. We are now moving into villages with populations as low as 2000 people. These investments are already making money due to an amazing level of affluence that exists in these places. Investors must own rural themes in their portfolios but, more importantly, they must see rural India.

Rural India:

Rural India is changing and will likely change more and create the biggest opportunity for us…an amazing level of affluence exists in these places.

Aditya Puri, May 2011

How do you see HDFC Bank in 5-10 years

I see a new India equivalent to the existing India coming up. I am not sure why people worry about demand-supply. When you say that 50% of the population is not banked and you see the affluence coming in growing the GDP at 8% should not be problem. That translates into a system credit growth of 20% and we grow a couple of percentage points faster since we are gaining market share. If all these things I talked about – the infrastructure build-out, the improvement in agriculture, the rectification of subsidies – happen, we shall end up creating another market equivalent to India’s existing market. And then, please do not forget demographics and the per capita income surge. Don’t turn a blind eye to this and focus on a six month view – that is fine for the stock market – but those people will miss India’s growth story. Demand exceeds supply, debt market development is yet to happen and with pension reforms, the requirements for SLR will only reduce. It is a great environment for banks.

Let us see how we go overseas, we have the capital, we have got the people, a good portfolio, good technology matching the best in the world, sales channels, delivery, storage – we are pressed to see how many banks have such an advantage globally. Watch the effect of compounding.

HDFC Bank has been one of the best performing stocks in India over the past 15 years. What is the secret of your success?

We don’t manage for the stock market – we have managed to our business. We prefer to measure our success in terms of profit growth and ROE. I have been a banker for 38 years – in India, London, Beirut, Hong Kong, Malaysia, Singapore, Greece and Saudi Arabia. One thing you learn as a banker – you do not think you are too smart, do not be too arrogant and recognize that business cycles are here to stay. Whenever you do not understand something – do not do it. If it doesn’t make common sense it is nonsense. Business cycles are there – do not get carried away – counter-cyclical is a simple concept – when the going is good, remain careful because the bad is coming. If you remain clear about your target market, your risk-reward and you are in a market where demand exceeds supply you should do fine. With my experience of operating in some many countries that have been through numerous cycles you stop being arrogant. Banking is a simple business – you define your proposition to your customer – deliver continuously – with good technology – and make sure you have good people and good service – then you have no problem.

What is your advice to upcoming entrepreneurs?

Be clear what you are doing, what is the market, how you are delivering the product, how the market is moving and how you are moving with it. You cannot sit and be comfortable with success. Hire good people and don't be arrogant. Manage from the ground. Do not make centralized decisions. Listen to the people on the ground. The world has changed – you need a faster response time.

How do you unwind?

I am always unwound. I like golf, cooking, hiking, gardening, a good whiskey, good wine, dogs, the beach and music. The problem is I don't have enough time for recreation even though I leave the office at 5.30 pm. My view is that one must have a full life. I find today's generation is hardwired for pain. There is more to life than breaking your back at work. Success is not defined by how much money you make. Too much time is being spent on trying to impress the next guy. If you do not get your family right, you have failed anyway. The key question is, are you happy? I am not saying that you should not work hard but don't be one-dimensional.

HDFC Bank is rated Over-weight by Morgan Stanley Indian Financial Services analyst Anil Agarwal. The share price closed at Rs2,252.65 on May 25, 2011.

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Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1172**	**41%**	**470**	**48%**	**40%**
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Total	**2,828**		**978**		

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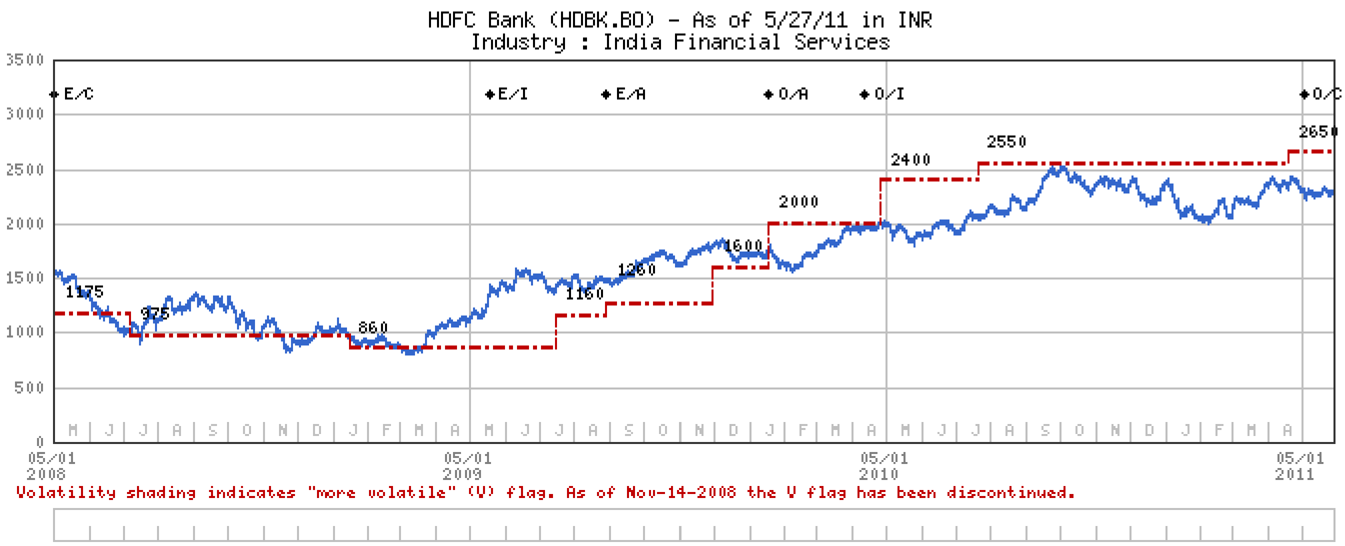

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