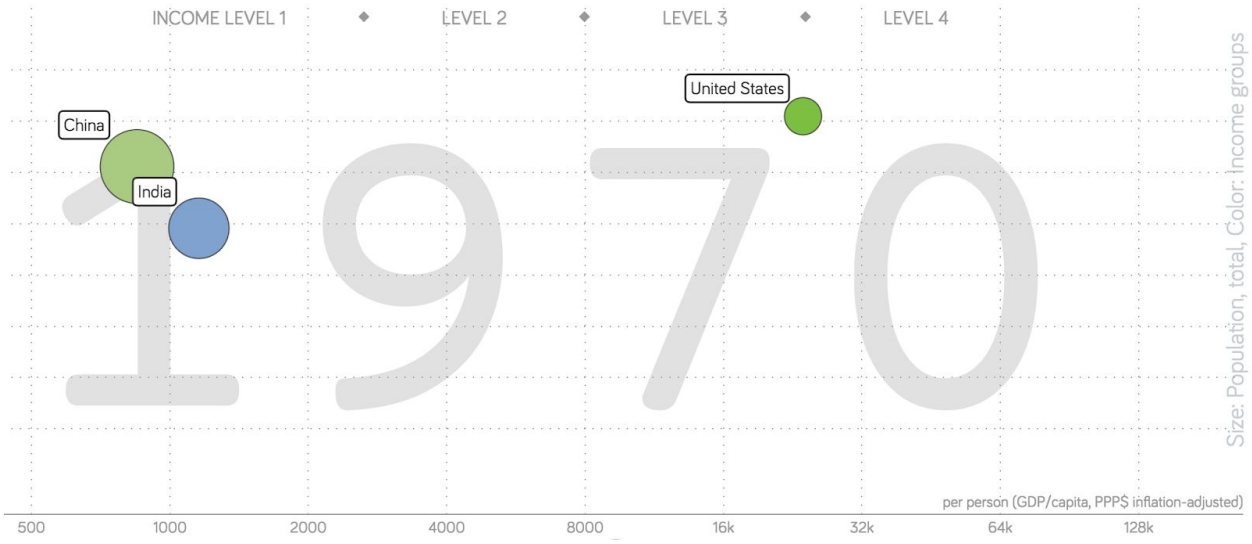
HDFC

Let us time travel to 1970. You're sitting on the shores of Marina Beach. You are 35 years old, self-employed, having a family with two kids. You are working hard and saving up money to construct a home. It might take a decade or two to realize your dream to own a home. It is a common situation in India in the 70s and 80s where people buy their first home closer to retirement.



India was a level one country earning less than $1 per day. Makan (house) comes last in "roti kapada aur makan" and waiting to buy a house till retirement is normal. George Bernard Shaw once said that the reasonable man adapts himself to the world and the unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man.

Hasmukh Thakordas Parekh is an unreasonable man. For many years Parekh nurtured the idea of enabling households in India to own a home earlier in their life cycle. He didn't accept that people need to wait until retirement to own a home. Parekh's vision and courage combined with the help of ICICI gave birth to HDFC in 1977.

Surfing the $2 trillion GDP wave

In 1977 there was no regulator, no credit bureau, access to long-term funding was hard to come by and foreclosures norms did not exist. During the first year of operations HDFC received 10k applications, 785 got approved with 299 disbursed with an average loan size of about 32k rupees.

HDFC relied a lot on retail deposits to raise funds for lending. At one point it had more than 40k deposit agents to bring in the deposits. Things started to change with the economic liberalization of India in 1991 by making the economy market driven and expanding the role of private and foreign investments.

Banking and the Insurance industry got opened up to the private and foreign players in the 90s. All of a sudden HDFC had access to long-term funding by issuing debentures and raising money from the capital markets.

With the introduction of SARFAESI act lending companies can foreclose the property after 60 days of notice to the customer who defaulted on their payments. The setting up of CERSAI, which is a mortgage repository helped prevent the fraud of different lenders financing against the same property.

In 1995 it would take 22 years of income for a family to buy a house. Property prices corrected a lot in the late 90s. With the opening up of the economy, people were able to realize their potential and got paid market rates for their skills. Affordability of buying homes went up. Today it would take four years of income for a family to buy a house.

	From		To	
Factor	Year	Value	Year	Value
Population (mil)	1990	870	2017	1339
Affordability	1995	22	2018	3.7
GDP per capita	1990	$364	2017	$1,940
Urbanization	2001	28%	2017	34%
Effective interest rate	2000	12%	2019	3.7%

Along with affordability, other factors like population growth, favorable demographics, nuclear families, urbanization, tax deduction on interest and principal repayments helped to boost the mortgage business. Take a look at the table above which summarizes all the key factors.

All else being equal home prices move up in line with inflation. I refer to this property as asset swelling. Lending companies like HDFC increase their per-share earnings due to asset swelling. HDFC average loan size in 2000 was 2.9 lacs. Today it is around 26 lacs representing a compounded growth rate of about 13% in the last 18 years. HDFC enjoys scale advantages and a lot of growth from asset swelling goes straight to the bottom line.

What qualities make HDFC stand out?

Before we proceed further let us get a feel for the size of the mortgage industry. India's GDP is around $2.6 trillion and has $260 billion (10% of GDP) in mortgages outstanding. Banks control 60% of the mortgage market, and HFCs like HDFC and LIC Housing control the remaining 40%.

HDFC, LIC Housing, Indiabulls, Dewan Housing, and PNB Housing are the top five HFCs controlling 82% of the HFC market. HDFC is a dinosaur in the mortgage business with $48 billion in net loans outstanding its HFC market share is 48%, and overall market share is 19%.

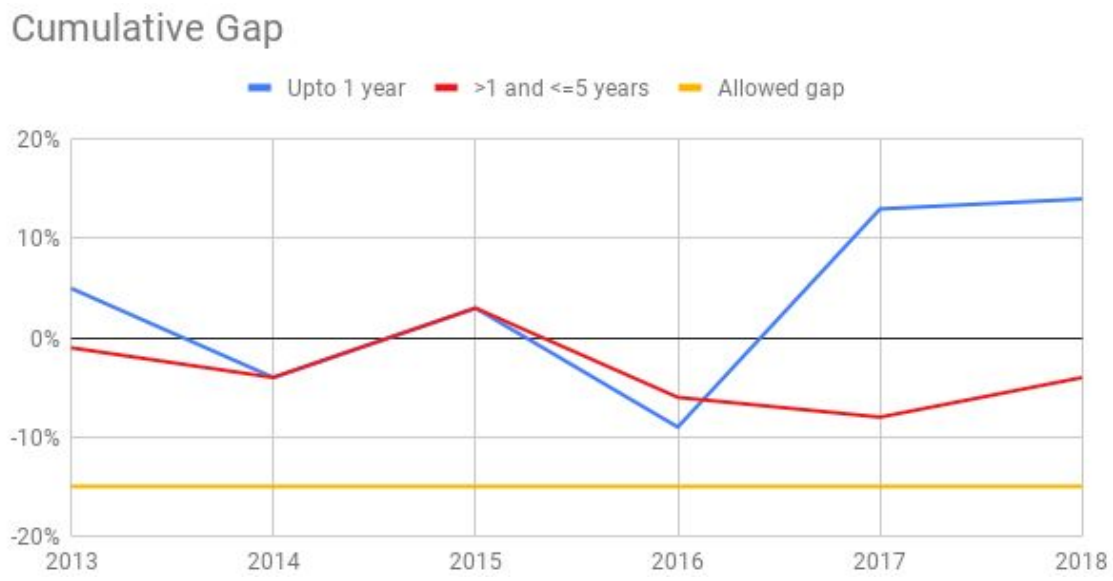
Lending is a commodity business, and customers don't care from whom they borrow. They will go to someone with low lending rates. In spite of being a commodity business, there are a few qualities that make HDFC stand out from other players.

1. **Conservative:** HDFC always provisions more than what is needed to cover its stressed assets. It reserves 30% of one-off gains from the sale of subsidiaries to shore up its provision and contingencies account thereby building an additional buffer against any unexpected risk in the future. Asset quality is top notch with total loan write-offs on cumulative disbursements since the inception of under 4 basis points.

2. **Tinkering and capacity to suffer:** HDFC didn't restrict itself to home loan business. It realized the potential of the Indian economy opening up in 1991. Over the years it pumped in the capital and developed multiple line extensions including banking, life insurance, general insurance, asset management, and lending to the self-employed. Line extensions generate 33% of its profits. The market value of line extensions is 1.9 trillion rupees more than what's on the balance sheet.

3. **Running the ship tight:** HDFC has a super low cost-to-income ratio of 7.5%. It is the lowest in the financial sector in Asia. This is possible due to its distribution network and its ability to source 84% of its business by themselves or through its affiliates. Indiabulls has the 2nd lowest cost-to-income ratio, and it is almost 2x higher than HDFC. Running the ship tight allows HDFC to operate with a thin spread of 2.3% and be highly profitable with ROA of 2.5% and ROE of 20%.

4. **Credibility to raise capital through thick and thin:** HFCs cannot have their asset and liability match. Why is that? Home loans are given out for 15 years. However, the duration on liabilities is much shorter. From the chart below we can see that HDFC is doing an excellent job in keeping the cumulative outflow gap below the mandated gap of minus 15%. HDFC credibility allows it to raise capital from the markets at favorable rates when it needs to address the deficit.



Fixing the supply side issues

Imagine a bucket with a small hole in the bottom. You are tasked to fill the bucket with water. The small leak in the bottom would prevent you from filling the bucket. You get angry and pour a lot more water. That doesn't help as the water pressure in the bucket goes up, and the water flows out at an even faster rate. Is there a solution? Close the hole and then pour the water.

Adding water to the bucket is similar to increasing the consumer demand through tax incentives. Hole in the bottom is akin to the supply side issues we are facing in the real estate industry. Unless we fix all the supply side issues (close the hole), it is hard to solve the housing shortage of 20 million urban homes. Here are a few interesting supply-side issues that we have been facing.

1. **Urban Land Act 1976:** The act provides equitable distribution and limit the development of land and thereby restricting the supply and home ownership. The law got repealed by the central government in 1999. Real estate is a state subject, and it took almost a decade for some states to repeal it. However, the supply of land didn't go up as tons of cases was filed in court. Supply-side is inelastic and increasing the demand resulted in real estate prices shot up from until 2010.

2. **Don't blame the actors instead fix the system:** We often blame developers for charging exorbitant prices for the property. It is not the developers that we should blame but the system that needs fixing. Deepak Parekh who is the chairman of HDFC explains how high cost of funding and long approval cycles result in high prices that are eventually borne by the home buyer.

   Developers are often criticised for not relenting on the exorbitant pricing of residential homes. Part of the problem lies in how developers fund the purchase of land. Regulators prohibit banks and housing finance companies (HFCs) from extending finance to private developers to acquire land. Developers have to then resort to high cost funds from non-banking financial institutions, private equity and even from the informal sector, often paying interest rates ranging from 18 to 22% per annum. Even if a developer wishes to start construction immediately, approvals – particularly in certain large cities, take as long as 18 to 24 months. Meanwhile, the developer needs to service the loan taken for acquiring the land, without receiving corresponding cash flows. Further, because of the multiplicity of approvals, speed money is demanded, often at every stage of approval. The end result is that all these time and cost overruns are eventually borne by the home buyer.

3. **How can we have housing shortage and also have unsold inventories?** The real demand is in the affordable housing segment and not in high-end luxury housing. Price point not being right resulted in unsold inventories. Affordable housing is a low margin business. High turnover is needed to be profitable. Access to capital at reasonable rates, faster approvals, providing

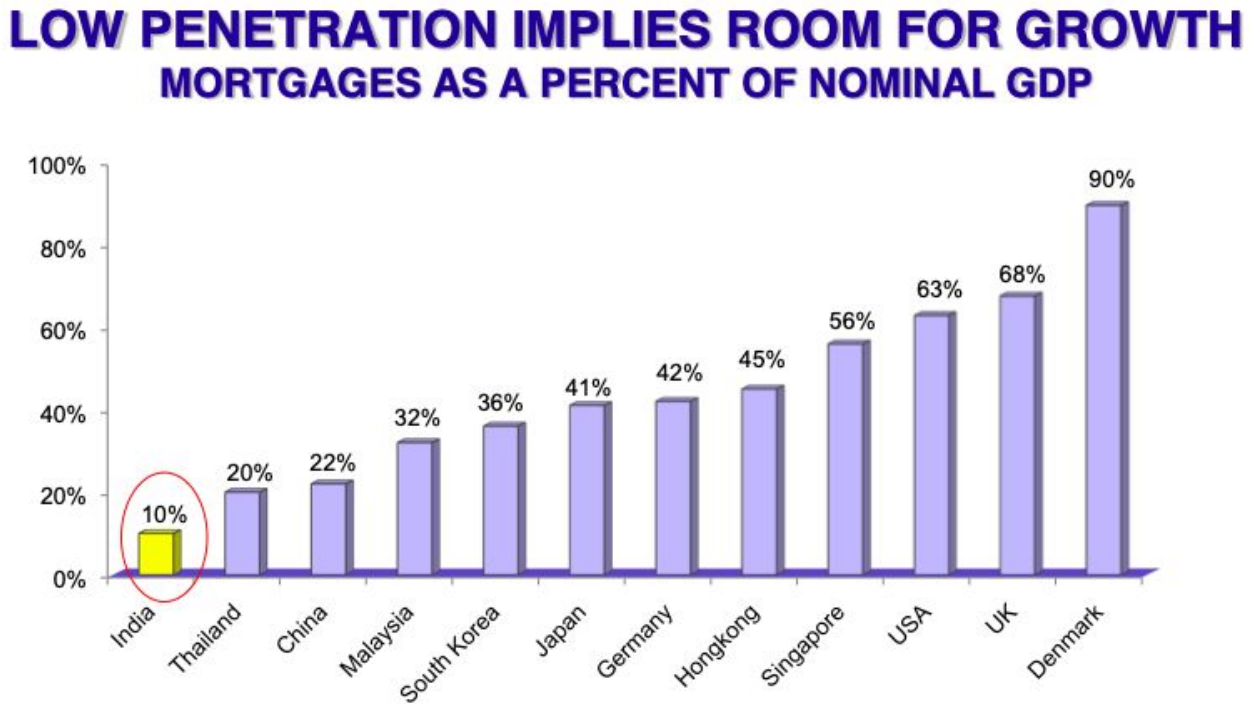
incentives to developers and giving infrastructure status for affordable housing units are the right supply side incentives to fix the housing shortage problem. Also, the recent changes including RERA, Benami Act, and GST is going to benefit the consumer in the long run.

What will drive the future growing in housing market?

HDFC has been growing its loan book at double-digit rates for a long time. Even during the financial crisis, its loan book increased by 15%. Where is the growth coming from? Can it continue growing at double-digit rates in the future?

The average age of a first time home buyer in India is 39 years. Two-thirds of the population in India is below 35 years of age. It means that all these younger people will get to an age where they will buy a house, and HDFC can grow its loan book at decent rates by funding their aspirations.

In the last 28 years after economic liberalization, India moved from level one to level two earning $6 per person day. Roti and Kapada is no longer an issue. What happens next? Human beings aspire to move up the hierarchy. The logical next step is to buy a home.



India has a super low mortgage to GDP ratio of 10%. Level 3 countries like Thailand and China mortgage to GDP ratio is 2x higher than ours. Level 4 countries like USA and UK mortgage to GDP ratio is around 7x higher than ours. It means that demand for home loans will be there for a long time. Growth at decent rates is not going to be an issue.

Few things to watch out for

1. **Prudent underwriting:** Most of the home buyers in India are buying their first home. They are going to live in it and raise their family. They will go all in to not default on the loan. The basic tenets of home financing are simple. Lending must be done according to earning capacity, which is on a cash flow basis and not on asset values. HDFC needn't worry about growth. It should continue to maintain its underwriting quality.

2. **Competition:** There are 100+ HFCs in India. Able players like Bajaj Finance with access to capital, consumers, distribution, and technology have entered into housing finance. Can HDFC grow at decent rates and maintain its spread? Housing finance is not a winner-take-all. The market is enormous for multiple players to flourish. HDFC low cost-to-income ratio should help to keep its margins.

3. **Skill development and high employment:** You need a stable job to buy a home. To get a job, you need to have the right skill. Technology is reshaping every industry. The shelf life of skills is getting shorter and shorter. Can India stay competitive by helping its citizens develop the right skills and be gainfully employed?

Disclaimer: I own shares of HDFC. This is not a recommendation to buy, sell, or hold. I am not a SEBI registered analyst. I wrote this document to organize my thoughts and deepen my understanding about the company and the industry. I am sharing it so that you can learn something from this.

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