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India Strategy: CEOSpeak

Deepak Parekh: India – At a Crossroads

You know your company, now know its CEO: We present the fifth entry in this product series, which seeks 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.

Deepak Parekh is the Chairman of HDFC Ltd. This report is in the format of questions posed by Morgan Stanley, followed by Mr. Parekh's responses. Among the key insights Mr. Parekh offered in our discussion are the following:

"Political uncertainty is slowing down economic decisions."

"The Indian financial sector is strong and safe and it is well regulated. However, we may be running the risk of it becoming over-regulated in some places."

"Why are Indians not buying equities? I think the answer is that we have not sold our equities well. We are not giving proper education to savers."

"The NPL cycle is not showing up but restructuring will be needed in the power and civil aviation sectors."

"I am also worried about too many businessmen going abroad to buy assets, particularly in the resources sector. I think we may be overpaying for these assets."

"I do not think the investment cycle is dead. People who have started projects are not stalling them. Several foreign companies are queuing up to acquire assets."

"My final point is that India is at a crossroads. The future looks good but the immediate period seems to have headwinds. We need to be more speedy in our decisions – otherwise we could be left behind."

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Deepak Parekh: India – At a Crossroads

What is the key risk to the India story?

I think the long-term growth prospects are very promising. I am extremely optimistic. What is troubling me is politics. All these years, we always said that politics is not a deterrent to growth or to investments or for India to move forward.

This time, because of the fractionalization of politics and its regionalization, together with the lack of a single large party at the top, politics is becoming a concern. Can we have a fractured government? What happens if we get back to the old regime when every three or six months we have a new prime minister? We had that period in the past when we had alliances of small parties and such a government found it difficult to survive. If the two large parties, the Congress and the BJP, are not able to get a majority in the next elections, what is likely to happen? The way politics has moved in the UPA2 regime, with both the alliance as well as in the opposition, does not generate too much confidence. Things may become more troublesome. Political uncertainty is slowing down economic decisions. The larger the number of coalition members in a government, the more different are the views and the slower is the process.

For instance, we have seen opposition to fuel price hikes and FDI in retail, with parties threatening to leave the government if such policies are implemented. The current alliance has a thin majority, so if one party leaves, the government becomes vulnerable. How can such a government function and concentrate on economic goals? India's long-term drivers are intact – it has favorable demographics, a growing middle class, more disposable incomes, flourishing entrepreneurship, young people with willingness to take risks and willingness to work hard. There has been an evolution with more people willing to start enterprises and the availability of finance has also improved. The management guru, C K Prahlad, used to say that India is no longer a pyramid. He used to say it is a diamond – it is bulging in the middle due to its growing middle class. If you have a weak government everything else suffers.

On the key risk to the India story:

India's long-term drivers are intact...but if you have a weak government, everything else suffers. I am also worried about the lack of decision-making.

Deepak Parekh, November 2011

I am also worried about the lack of decision-making. Again, take for instance all these alleged corruption scandals – why don't we have the capacity to get on with the investigation, get on with the trial, complete the delivery of sentences to the culprits and close the chapter? We seem to be dragging on. In 2009, there was a near celebratory mood in the country when elections were completed. It seemed that the structure of UPA2 was better than UPA1. The Left parties were out of UPA2. However, the pace of policy change remains less than satisfactory. What could have happened is that complacency may have crept in. UPA2 has very strong individuals but team work appears to be missing. Somewhere there has been a crack which has not been sorted out. The corruption scandals may have also distracted the government.

What are the critical reforms needed?

India's interest rates are very high versus the world. It makes Indian manufacturers uncompetitive. How can a manufacturer pay a 12% interest rate and be competitive when his global competitors pay 2% or lower. High rates have been in response to inflation. However, the inflation is coming from food and our dependence on imported crude. You cannot bring down inflation with high interest rates if you are importing 80% of your crude oil requirements and have shortages in food.

My point is that we need agriculture reforms to be pursued. We have capacity to feed 1.2 billion people and we cannot be importing food. This is not just an Agricultural Ministry issue. We need better transportation, better warehouses and better storage. I have been hearing that we have lost huge amounts of fruits and vegetables to decay. The farmer is getting un-remunerative prices and the consumer is paying an excessive price due to these losses. What it means is that the intermediaries or middlemen are making the money. We have to change that.

The global average is that if the consumer pays 100, the farmer gets 66 and 33 is transportation, storage and redistribution. In India when the consumer pays 100, the farmer gets 33 and two-thirds is spent on distribution, storage and logistics. We have seen why this is happening. We have antiquated APMC laws and, because of vested interests, we are unable to dismantle these laws. We have to improve the farmer's lot and bring down prices. We need higher production and better warehouses. We need better logistics. If we open up multi-brand retail we shall get better sourcing. I have seen what the cash and carry stores are doing with fishermen. They

have to buy good quality fish at a cheap price. Only by educating farmers do they achieve this result. We need this to on a massive scale. Agriculture reforms are overdue.

On the critical reforms needed:

We need agriculture reforms to be pursued...we need to improve the farmer's lot...infrastructure is another issue.

Deepak Parekh, November 2011

The Indian financial sector is strong and safe and it is well regulated. In some areas we are micro-managing and hence instead of deregulation we are running the risk of overregulation. The clients of the regulatees are getting more attention and costs are rising. For example, we have deregulated savings rate but we have not touched the other side of the balance sheet. We continue to insist on 40% priority sector lending, 25% SLR and not paying interest on CRR balances. Why should SLR remain unchanged? The government's avenues to raise money have increased over the years. We have insurance companies, pension funds, mutual funds who are all buying government bonds. On top of this we are not allowed to levy prepayment charges. The asset side of the balance sheet is not being liberalized at the same pace as liabilities. Are we getting in a situation where the profitability of banks will decline because avenues of income are being reduced or more opened up which means more competition and costs but the changes to other side are slow?

I am not against the consumer – the consumer must be protected. However, there must be some return on capital, otherwise we should nationalize all financial services businesses. India has followed US and Europe. The financial sector was in a very bad state in the US three years ago. Now Europe is struggling. Will India's financial sector suffer? I don't think so but we have to be careful about how income generation is shaping up. India's financial sector has a very good history so we hope to keep that intact. We will need more capital to meet Basel 3 norms. Overall, I also feel consolidation is necessary. We have 41 insurance companies. That is not sustainable. Some life insurance companies are writing Rs200-Rs400 million of policies a month. How can you survive with an annual premium income of Rs2.5 billion to 5 billion? Distribution and establishment costs are high.

The other related question is: why are Indians not buying equities? Why are the capital markets dominated by foreign institutional investors? We have a large number of savers in the country. The household savings rate is high but people are

comfortable with bank deposits and gold. Why are people not invested in equities? I think the answer is that we have not sold our equities well. People have not made money and lost faith in markets. When HDFC got listed, 90% of shareholding was domestic. Today, 74% of shareholding is foreign. We have not issued equity abroad but our Indian shareholders have sold out. The equity cult of the past has reversed. You can see the inflow into equity mutual funds is so small. For a growing economy, one needs equity. Where does a promoter raise money? The IPO markets have been dead. 95% of IPOs done in the last two years are quoting at a discount to issue price, not just a 2% or 5% discount but 30% and 40%. Everyone who has invested in such IPOs has lost money. The confidence will not come unless people make money. We are not giving proper education to savers.

Infrastructure is another issue. If you look at the 12th Five Year Plan, 45% of the investments in infrastructure are in energy. However, banks are overexposed to power and current projects are running behind schedule either due to lack of availability of land, coal linkages, transport or logistics. Something or the other is holding up the projects. Hence, execution in infrastructure is a worry.

Separately, I am also worried about too many businessmen going abroad to buy assets particularly in the resources sector. I think we may be overpaying for these assets. I cannot envisage a situation where a coal mine is up for auction and someone from abroad comes and pays a higher price than the Indian promoters who know the market, the process and the environment so well. Similarly, when something is sold in South Africa, Indonesia or Australia, Indian companies go and buy as if they know the local environment better than the local companies. Therefore, I think we are not getting a good deal and we may be overestimating the capacity of these resource assets. Only time will tell, though. I hope I am wrong but I am little worried about because significant amounts have gone out from India to buy these assets.

What about the NPL cycle?

The NPL cycle is not showing up but restructuring will be needed in the power and civil aviation sectors. Every airline is losing money. But you cannot shut down the sector because you cannot have a country without airlines. Fuel costs are high because of taxes. If you see the balance sheet of companies, and I was seeing one of them, the three-month fuel bill is up Rs6 billion over the previous quarter. Now how can one overcome such a steep rise in just fuel costs and make money? Out of the Rs6 billion, a significant portion is taxes. If you tax

the airlines hard, then you cannot force them to have unviable flights to remote locations.

The regulator should be there to look after the companies it is regulating, to ensure that they remain viable and are able to provide reasonable service to customers. They should be to generate a reasonable ROE for their shareholders so when they grow they can raise more capital. We may be erring in this regard.

On the NPL cycle:

The regulator should be there to look after the companies it is regulating, to ensure that they remain viable and are able to provide reasonable service to customers. They should be to generate a reasonable ROE for their shareholders.

Deepak Parekh, November 2011

How do you view competition in the country?

Consolidation is needed in several sectors. I am not saying competition should not be there. Take the case of the banking sector. We are not seeing the number of nationalized banks reducing. Now, we are going to issue more bank licenses. We are unable to get the holding company structure moving. The RBI has done its job by issuing a paper but we cannot make progress because there are tax issues. The tax liabilities need to be grandfathered once. The coordination across agencies involved is missing and hence we may not be able to make this work and achieve consolidation.

On competition in the country:

Consolidation is needed in several sectors...but the coordination across agencies is missing.

Deepak Parekh, November 2011

And how do you view the investment cycle?

I have met senior people from a dozen large global companies over the past three months, after the mood has turned grey in India and overseas and interest in India has seemingly diminished as reported in the press. However, these people who I have met are still desperate to invest in India. That is why

I said that the long-term view on India is very positive because we have the population, the savings and the system.

I do not think the investment cycle is dead. People who have started projects are not stalling them. They are only stalled if government approvals are pending. On their own, companies are still investing. We still have a market that is growing. I don't think the investments will slow. I am seeing people who are willing to put US\$2-5 billion in single ventures as investments. There is still concern around government approvals. However, several companies are looking to acquire businesses in India. Indian entrepreneurs who are in mining and infrastructure are feeling after their recent experience that if you are willing to take up a project in India, one should not set a time limit on completion and an estimate of total cost. You cannot say this project will be finished within this cost and within a stipulated time. If the project involves land, power, government approvals – you cannot put a time line. Foreign companies are not doing greenfield projects. They are petrified on how to get all approvals ready. They see several examples of greenfield projects that have been delayed.

However, the situation is a bit different in some states. These states are competing heavily with each other and states like Gujarat, Bihar, Tamil Nadu and even Rajasthan will take away a lion's share of investments.

On the investment cycle:

States like Gujarat, Bihar, Tamil Nadu and even Rajasthan will take away a lion's share of investments.

Deepak Parekh, November 2011

What is the secret of HDFC's success?

There is no secret. We have benefited from a fast-growing market. We were in an industry which needed a company like HDFC. Demand was almost insatiable with the old system of joint families breaking down. People were moving from renting to ownership of homes. Rented houses were not easily available. We were fortunate that we were in the market during this growth phase. We took advantage of the demand and the aspirations of individuals to own small homes. Please believe me that the homes of our clients are tiny, real tiny. We were born at the right time and right place.

We have also been fortunate with our people. There was no rocket science in hiring either. In the 70s and 80s, our recruitment policy was very simple – anyone who walked in got

a job. Since we were growing so rapidly, we did not have time to go through interviews – we needed people quickly.

My final point is that India is at a crossroads. The future looks good but the immediate period seems to have headwinds. We need a change in the government's approach. It has to take decisions. For several reasons, decision-making has slowed down. We need to reignite the confidence in the system. Everything is being referred to committees because individuals are scared of taking decisions. We need to be more speedy in our decisions – otherwise we could be left behind.

On the secret of HDFC's success:

We have benefited from a fast-growing market...We have also been fortunate with our people.

Deepak Parekh, November 2011

This interview was conducted in November 2011. HDFC Ltd. is rated Equal-weight by Morgan Stanley Indian Banks analyst Anil Agarwal. The share price closed at Rs665.15 on January 3, 2011.

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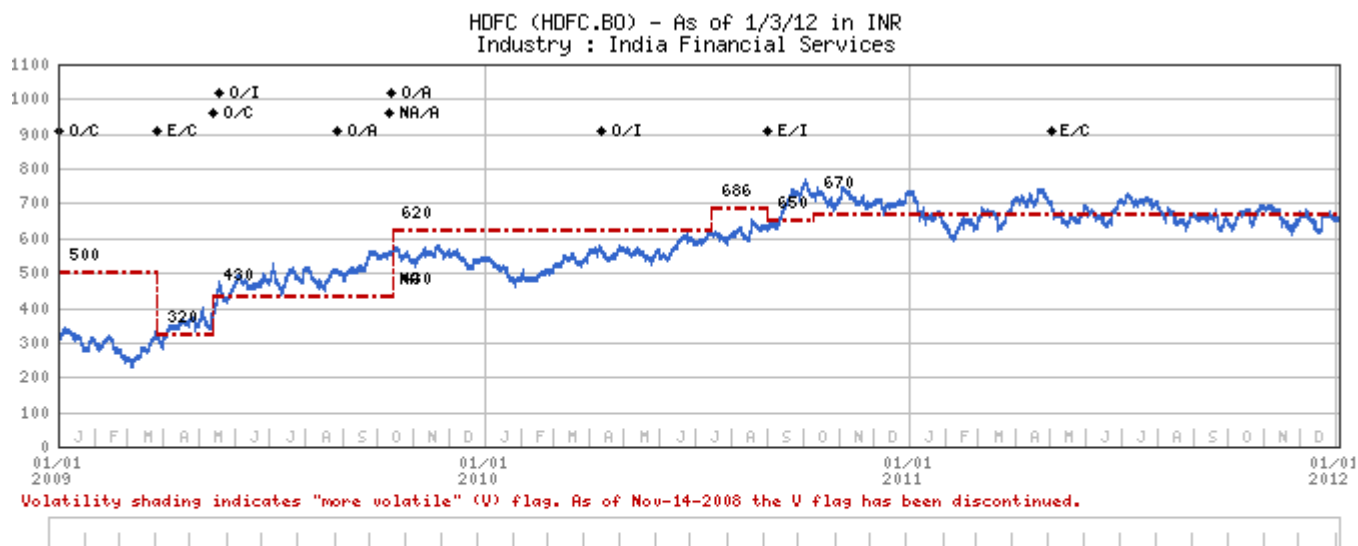
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