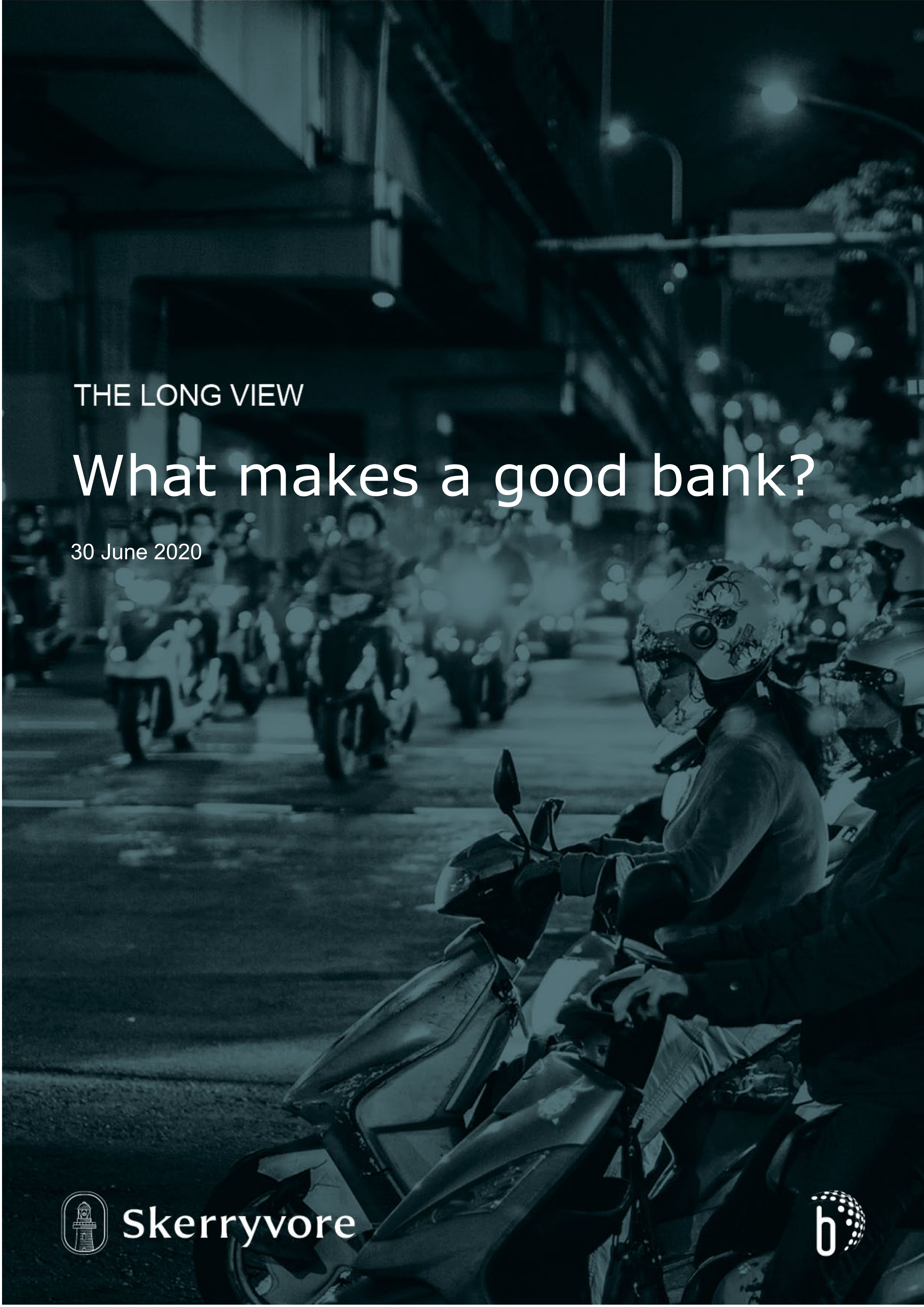

THE LONG VIEW

What makes a good bank?

30 June 2020

Skerryvore

A case study on Kotak Mahindra Bank to show how we evaluate banks (and why we have recently invested in Kotak).

So, what makes a good bank?

We believe the answer lies in our investment philosophy, which focuses on the quality of a business. First, we look for an aligned owner or managers who have built the right kind of risk-aware, ownership-minded culture. Second, we look for a strong franchise, one that has room to grow profitably for many years. Third, we seek simple banks that make their money from the business of conservative lending or providing essential services. Finally, we look for a business that is sustainable in all senses of the word – a company that shows regard for all of its stakeholders.

Not compromising on this philosophy means that we find relatively few banks that meet our definition of quality, resulting in only a handful of institutions worldwide that we would own. Why is this? The easiest answer is **leverage**. A bank in its simplest form makes money by taking deposits and then lending those funds to people who need them. Unfortunately, not every borrower will repay and for that reason a bank needs a cushion through which it can absorb losses while still being able to repay depositors. This is where **equity** comes in – this is owners' capital, including us, other shareholders and management or occasionally a family that controls the bank. This acts as a sponge to absorb exceptional losses after any money set aside for bad loans has been eaten up. Because equity is small relative to loans in most banks you have to be confident that bad loans (or other losses) won't exceed equity, or the business you own becomes bankrupt and your investment goes to zero. The higher the leverage, the lower the margin for error.

Once we have determined that a bank is good enough quality, the next consideration is the **price** we are being asked to pay. Does this represent good value? We think about value in terms of a required return, a minimum that we would expect the stock to deliver over a long period. Given that equity is the raw material required to run a bank, it makes sense to look at the price to equity (or book, short for book value of equity) of the bank. The price we would be prepared to pay is a function of the bank's ability to generate a return on its equity determined by the quality of the franchise and its ability to grow in a disciplined manner. If our expectation of what a bank is worth and what it is priced at in the market suggest it is too expensive, we will keep the company on a watchlist and wait patiently, knowing that an opportunity will present itself.

Introducing Kotak Mahindra Bank

It is patience that has kept us on the sidelines with an Indian bank we have long admired, Kotak Mahindra Bank. Unusually for a large financial institution it is still controlled by a founding individual, Uday Kotak, who today still owns around 30% of the company. The bank can trace its origins to a decision Mr Kotak took over 30 years ago not to follow his father into the family business or join one of India's already large and successful companies. Instead, like many good entrepreneurs, he spotted and took advantage of an inefficiency in a market. Mr Kotak realised that a huge spread existed between what other financiers were borrowing and lending for (more than 10%!), which did not differentiate on the basis of the quality of the borrower. Mr Kotak simply offered more competitive rates to the better companies and even though his cost of borrowing was more expensive than his competition there was plenty of profit for a lean operation that wasn't eaten up by bad loans.

The quality of this nascent business came to the fore in the late 1990s when India suffered a crisis in its non-banking financial sector that led to the disappearance of many of Uday's competitors. Like many other good companies we look at, he was able to turn crisis into opportunity and wound up taking on the loans of other failed NBFCs (nonbank financial companies), which he was able to make a profit from. He then managed to get one of the first licences that was issued by the regulator that allowed NBFCs to become full banks and thus Kotak Mahindra Bank was born.

Over the next two decades Uday continued to build out a financial conglomerate that includes life and general insurance companies and an asset manager on top of the successful bank and NBFC. Along the way there have been a number of endorsements from Indian and developed market companies that chose to partner with Kotak, including Anand Mahindra, Goldman Sachs, Ford and Old Mutual.

Culture and franchise

There are a number of things that stand out about Kotak apart from the successful track history. First, **Mr Kotak remains fully involved** in running the bank and the majority of his wealth is in the shares he owns in the bank. This creates a powerful incentive not to put the bank at risk through poor decision-making, excessive risk-taking or anything that could damage the reputation of an institution he has taken over 30 years to build. The **franchise is strong** because the bank has taken time to build a deposit franchise that gives the bank low-cost raw material from which to grow loans and Kotak now represents a strong and trusted brand in India, a market with tremendous growth potential for financial services.

Attitude and sustainability

The **conservative attitude to risk** is reflected in the balance sheet, which has very low leverage relative to the industry – i.e. there is a lot of loss-absorbing equity here in the event of a problem. The **bank's history** through various ups and downs over the past 30 years is again consistent with a sensible approach to taking risk. We also noted that as signs of stress started to appear in the economy in 2018, Mr Kotak began to materially slow the riskier parts of his loan book, in contrast to most of the rest of the industry.

Today, India is in the midst of another wave of problems in the financial sector due to the collapse of some high-profile NBFCs before the sector was hit by the impact of the global pandemic. This has resulted in a moratorium from the Reserve Bank of India that allows borrowers to suspend interest payment on loans. Although this offers temporary relief, it also functions to remove the signals that banks have for how many of their loans are in trouble and who will survive this period of stress. As a result, fear has begun to set into the sector and prices of financial institutions across the board have fallen.

We had long admired the quality of Kotak Mahindra Bank but were unable to get comfortable with its price because the return we could reasonably expect to earn was too low as the company and India more generally found favour with other investors. This changed as fear crept into the market and Kotak sold off alongside other financial stocks and presented us with an opportunity to buy. Unusually, the bank also decided to pre-emptively raise equity to further shore up its balance sheet. This is something that many others do too late so, again, it is reassuring to see Kotak acting differently from its peers. From a sustainability perspective, the bank approaches giving with a long-term mindset, looking not to salve short term problems but to deliver meaningful change with its investments.

Courage for the future

We recognise that there is some risk in this investment decision because no-one can predict the full impact of the pandemic the world is currently facing. It is likely that loan losses will be significant, and the financial system will be put under strain. We believe, however, that the history of the bank, the strong balance sheet and the incentive towards risk aversion that Mr Kotak has in his large ownership mean the bank will be a survivor of the turmoil that still lies ahead. As we have seen with other quality companies through challenging times, the strongest survivors will find themselves in a position to take advantage of opportunities presented by weaker competitors. It is in difficult times that our focus on owning quality businesses gives us the courage to buy when others are fearful.

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