India Equity Research
Financials

June 14, 2012

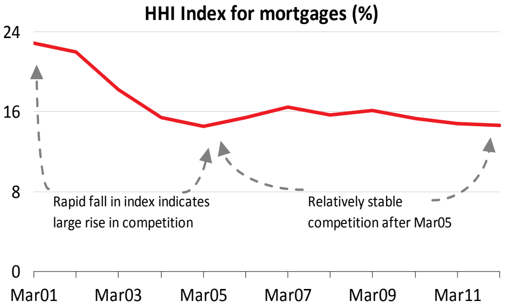
Housing Financials

Concerns on competition are overdone

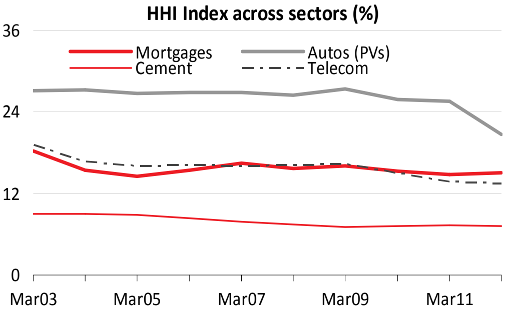
Sector Report

Jun 14, 2012		1-m	3-m	6-m
SENSEX Index	16,183	-7.5	-12.2	1.5
Nifty Index	4,906	-8.0	-12.5	2.7
NBFC Index	1,209	3.3	-7.4	4.7

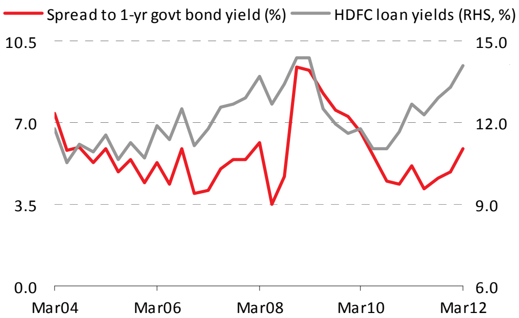
HHI Index for mortgages (%)



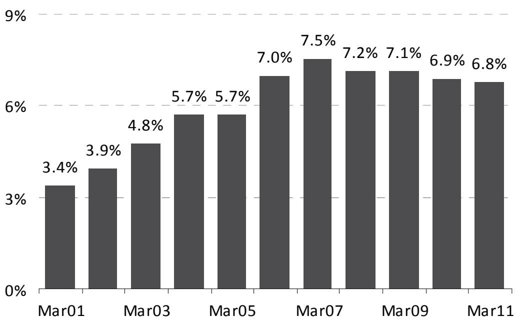
HHI Index across sectors (%)



Spread between HDFC & 1-yr govt bond yields



Mortgage/GDP



Contrary to some perceptions, the competition in India's home loan market remained unchanged after FY05. As per the Herfindahl Index, competition surged after FY01 driven by the entry of new lenders, mainly commercial banks, into the market. We find that competition among home loan providers is actually mild compared to other businesses such as cement, cars and telecom. This data is supported by the trend in spreads between yields on home loans and government bonds. Our view is further reinforced by the fall in India's home loan/GDP ratio after FY07. There is a large potential for expansion in the market without an adverse impact on profitability. The conditions that drove hyper-competition in the early years of the last decade are unlikely occur in the future. Re-iterate Buy on LICHF and Add on HDFC with a Jun13 TP of INR332 and INR730, respectively.

Herfindahl Index indicates stable and relatively low competition

Competition among lenders in India's housing finance market hardly changed in the last seven years, as measured by the Herfindahl Index. The significant rise in competition in the years preceding FY05 was largely driven by the entry of new lenders, mainly commercial banks, into the market, and product innovations. After FY05, there have been fewer product innovations even as some erstwhile aggressive lenders settled down to stable or low growth. In comparison with other sectors, the housing finance market has lower competitive intensity, especially over the last three years.

Rising spreads point to waning competitive intensity

The spread between the yields on the one-year government bond and a typical home loan can act as proxy for the competitive intensity in the market. The years of rising competition drove a decline in spreads during Mar08–Sep08. However, the rise over the last four quarters suggests easing competitive pressures in the industry.

Low penetration in GDP presents large potential market

At the end of Mar12, the stock of home loans in India is estimated to be only 6.8% of the nominal GDP. The penetration of home loans actually decreased in the last four years. This also supports our view that competitive pressures have eased. The low penetration compared to other developed and emerging markets further points to the immense potential for growth in this market.

Why the last decade's hyper competition is unlikely to return

The large rise in competitive intensity in the early years of the last decade was due to the entry of new lenders with large ambitions, product innovations and a surge in demand for mortgages. The impact of the global financial crisis in FY08 led to commercial banks scaling down their plans in the home loan market. Furthermore, the scope for product innovation is lower, given the fallout of the sub-prime housing loan bubble in developed economies. We re-iterate a Buy rating on LICHF and Add on HDFC with a Jun13 TP of INR332 and INR730, respectively.

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Herfindahl Index indicates stable and relatively low competition

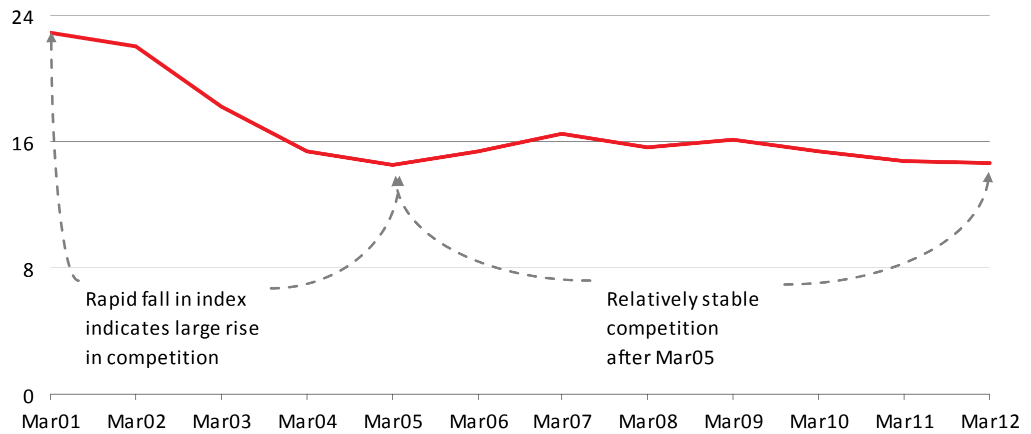
The competition among lenders in India's housing finance market has hardly changed in the last seven years, as measured by the Herfindahl Index. There was a significant rise in competition in the years preceding FY05. This was largely driven by the entry of new lenders, mainly commercial banks, into the market, and product innovations. The market share of banks increased from 39% in FY01 to 64% in FY05. After 2005, there have been relatively few product innovations even as some erstwhile aggressive lenders settled down to stable or low growth. In comparison with passenger cars and telecom, the housing finance market had lower competitive intensity, especially over the last three years.

Herfindahl Index indicates stable competition since Mar05

Competition among lenders in India's housing finance market hardly changed in the last seven years, as measured by the Herfindahl Index.

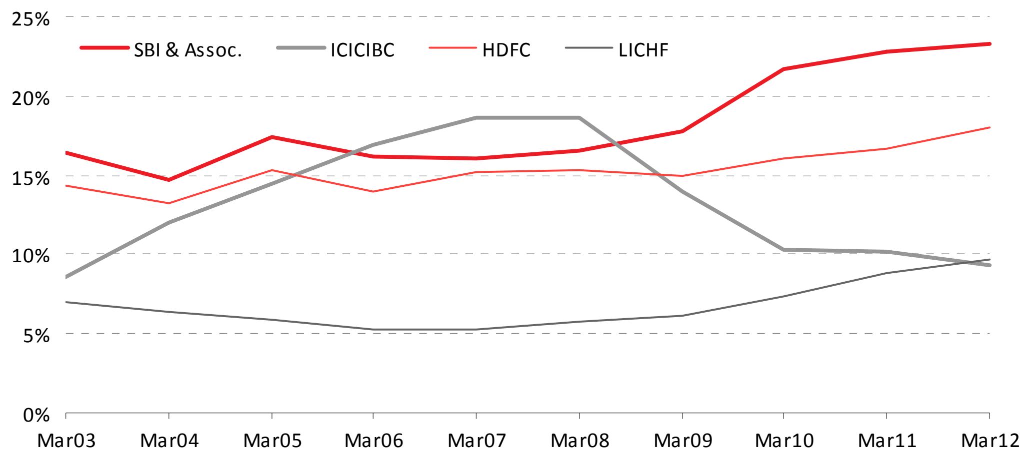
Market share dynamics within mortgages have shifted drastically over the last seven years, which has driven concerns on a rise in the competitive environment. The significant rise in competition during the years preceding FY05 was largely driven by the entry of new lenders, mainly commercial banks, into the market, and product innovations. The market share of banks increased from 39% in FY01 to 64% in FY05. However, competition among lenders in India's housing finance market hardly changed in the last seven years, as measured by the Herfindahl Index. After FY05, there have been relatively few product innovations even as some erstwhile aggressive lenders settled down to stable or low growth. While the aggressive price-based competition resulted in market share gains for SBIN and its associates from c16% in FY07 to c23% in FY12, the withdrawal of ICICIBC from the industry drove a decline in the market share of banks from 72% in FY07 to 63% in FY10.

Exhibit 1: Herfindahl Index for Indian mortgage players (%)



Source: Company, Avendus Research

Exhibit 2: Market share trends for major banks and housing financials



Source: Company, Avendus Research

Comparison across sectors points to relatively low competition

A comparison of the HHI Index across sectors indicates relatively low competition in mortgages compared to some sectors such as passenger vehicles and telecom.

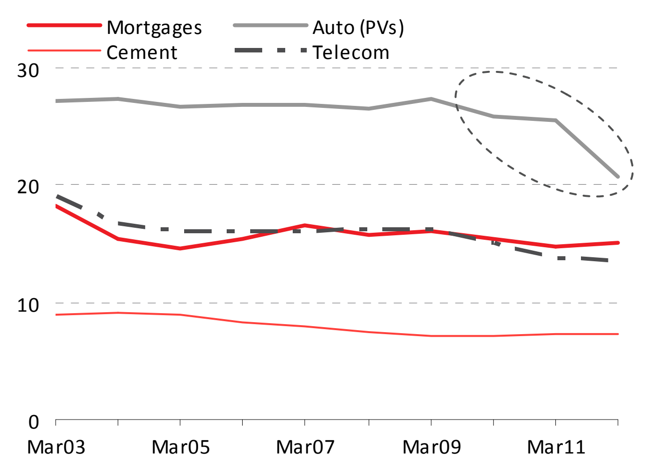
A comparison of the Herfindahl Index (HHI Index) across sectors indicates relatively low competition in mortgages compared to some sectors such as passenger vehicles and telecom, especially during the last three years. Competition in the passenger vehicle industry increased since FY09, as implied by the decline in the HHI for passenger vehicle manufacturers during FY09–FY12. The passenger vehicle industry appears highly concentrated in terms of market share among the top players, indicated by the higher index value. The HHI Index reflects a declining trend for telecom players during FY09–FY10, indicating relatively high competition. While the index stabilized during FY11–FY12, it still remains below that for mortgages.

Exhibit 3: Growth in the total market size (CAGR)

Total market growth (CAGR)	Mar03–Mar08	Mar08–Mar12
Mortgages	27%	15%
Telecom	83%	37%
Auto (PVs)	17%	14%
Cement	9%	8%

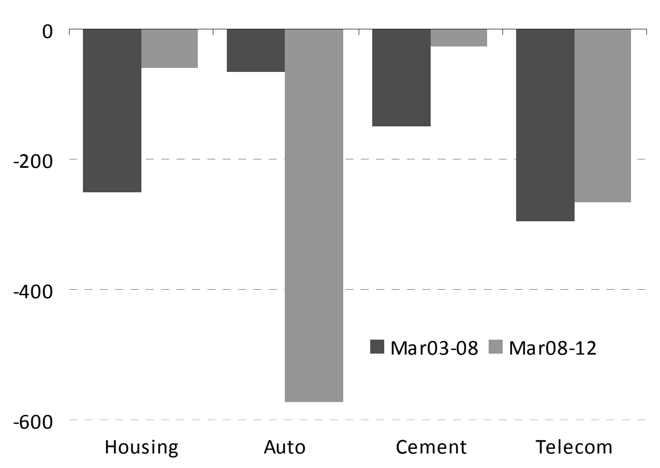
Source: Company, Avendus Research

Exhibit 4: HHI Index across sectors (%)



Source: Company, Avendus Research

Exhibit 5: Change in HHI Index (bp)



Source: Company, Avendus Research

Rising spreads point to waning competitive intensity

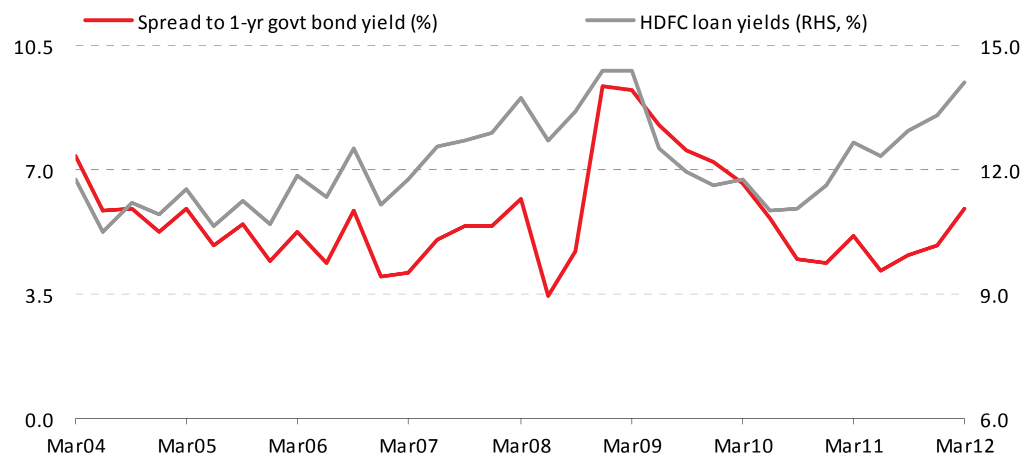
The spread between yields on the one-year government bond and a typical home loan can act as a proxy for the competitive intensity in the market. The years of rising competition drove a decline in the spreads from 6.2% in Mar08 to 4.6% in Sep08. The following years point to a notable easing in competition, as the spread rose back to 7.5% by Sep09. The sharp rise after Sep08 could be ascribed to the exit of an erstwhile aggressive lender from the market and the resultant decline in competitive intensity. The subsequent decline during Mar09–Mar11 is in sync with the aggressive pricing strategy adopted by another large lender in the same period. However, the rise over the last four quarters suggests easing competitive pressures in the industry. Furthermore, re-alignment of rates between old and new borrowers is likely to discourage lenders from resorting to irrational pricing, thus lowering the probability of price-based competition.

Competition – a significant influence on spreads

The rise in spreads over one-year government bonds and the yield on home loans over the last four quarters suggests easing competitive pressures in the industry.

The spread between yields on the one-year government bond and a typical home loan can act as a proxy for the competitive intensity in the market. The spreads in yields for HDFC over the one-year government bond yields show a distinct fall until Sep08, in line with the rise in competition in the industry. The sharp rise after Sep08 could be ascribed to the exit of an erstwhile aggressive lender from the market. The subsequent decline during Mar09–Mar11 is in sync with the aggressive pricing strategy adopted by another large lender during the same period. However, the rise over the last four quarters suggests easing competitive pressures in the industry.

Exhibit 6: Gap in yields of HDFC Ltd relative to one-year government bond yields (%)



Source: Company, Avendus Research

Return to irrational pricing unlikely with re-alignment of rates

Re-alignment of rates between old and new borrowers may deter lenders from resorting to irrational pricing.

Re-alignment of rates between old and new borrowers would call for either a rise in lending rates for new borrowers (would hurt growth with an up-tick in the margin) or reduce the lending rates of old customers by marking them in sync with new rates (healthy loan growth, but at the cost of margins). However, HFCs have been providing this facility to existing borrowers to shift their loan portfolio to current rates if they find the rates higher, albeit at some upfront fees. Thus, re-alignment of rates between old and new borrowers may deter lenders from resorting to irrational pricing.

Low penetration in GDP presents large potential market

At the end of Mar12, the stock of home loans in India is estimated to be only 6.8% of the nominal GDP. While the nominal GDP rose at a CAGR of 17% over FY06–FY11, growth in mortgages reported a CAGR of 16% during the same period. Thus, penetration of home loans actually decreased in the last four years. Mortgages, as a proportion of GDP, are estimated to have declined from 7.5% in FY07 to 6.8% in FY11. This also supports our view that competitive pressures have eased. The low penetration compared to other developed and emerging markets further points to the immense potential for growth in the market.

While the nominal GDP rose at a CAGR of 17% over FY06–FY11, mortgages reported a CAGR of 16% during the same period.

Mortgage growth remained on par with nominal GDP

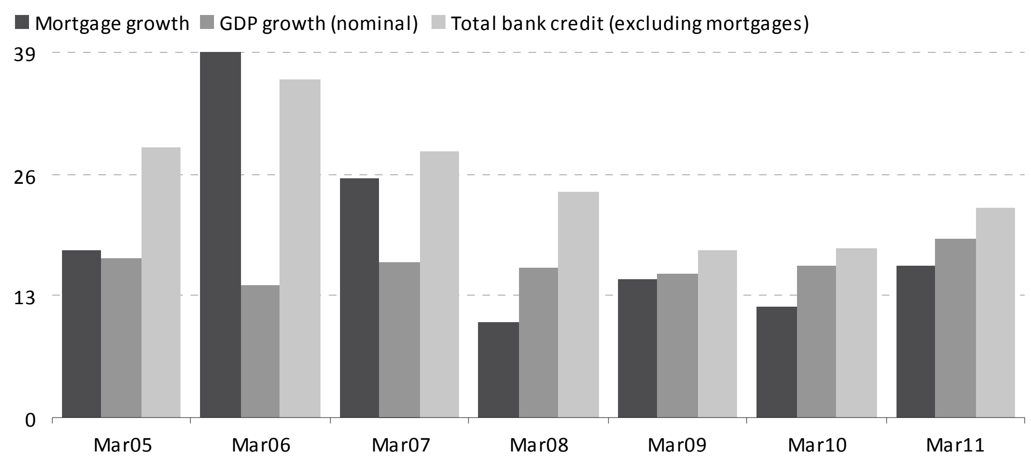
Mortgage growth stayed on par with growth in the nominal GDP since Mar05. While the nominal GDP rose at a CAGR of 17% over FY06–FY11, growth in mortgages reported a CAGR of 16% during the same period. Mortgage growth slowed down over the last five years compared to the CAGR of 35% over FY04–FY06. Additionally, growth in mortgages lagged behind the growth in bank credit to other sectors, which is another sign of stable competition.

Mortgages, as a proportion of GDP, are estimated to have declined from 7.5% in FY07 to 6.8% in FY11.

Decline in mortgage to GDP indicates stable competitive scenario

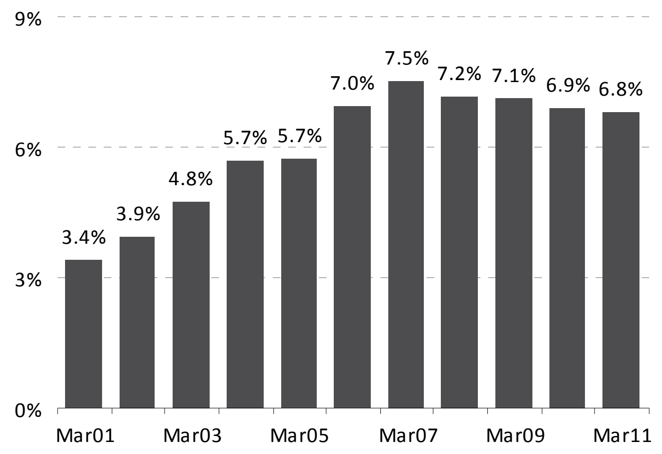
At the end of Mar12, the stock of home loans in India is estimated to be only 6.8% of the nominal GDP. Mortgages, as a proportion of GDP, are estimated to have declined from 7.5% in FY07 to 6.8% in FY11. This also supports our view that competitive pressures have eased. Furthermore, the low penetration compared to other developed and emerging markets points to the immense potential for growth in the market.

Exhibit 7: Y-o-y growth in housing and total credit (%)



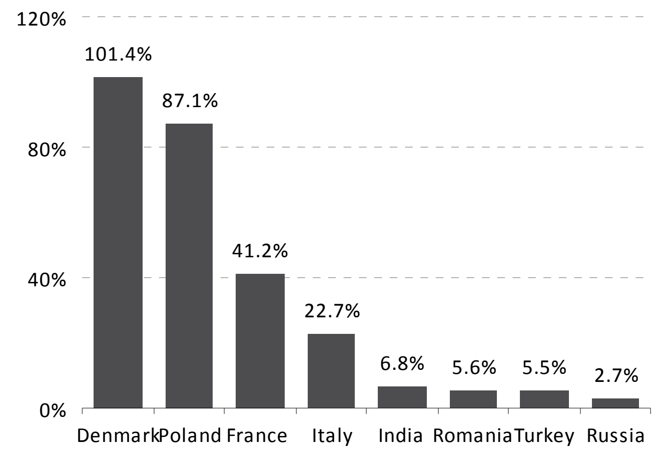
Source: RBI, Company, Avendus Research

Exhibit 8: Mortgage as a proportion of nominal GDP



Source: RBI, Company, Avendus Research

Exhibit 9: Country-wise comparison of mortgage to GDP ratio (%)



Source: European Mortgage Federation (2010), RBI, Avendus Research

Why last decade's hyper competition is unlikely to return

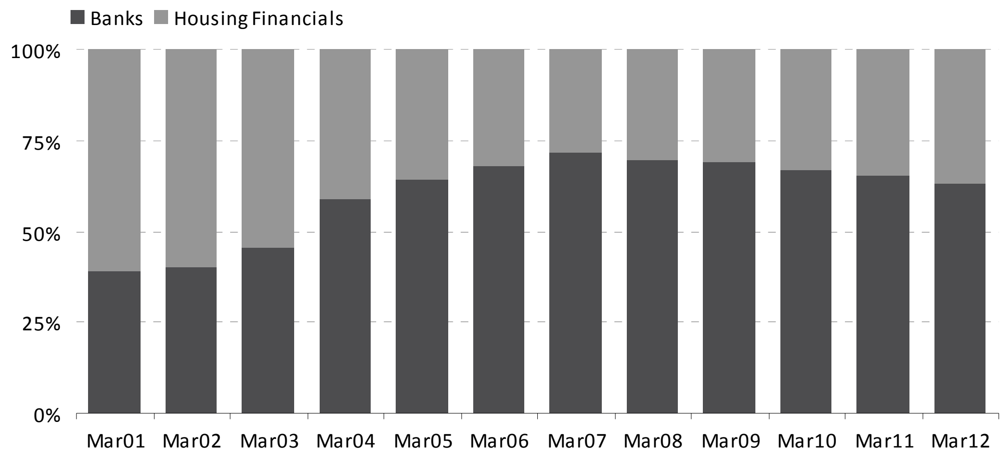
The large rise in the competitive intensity in the early years of the last decade was due to the entry of new lenders with large ambitions, product innovations and a surge in demand, following the acceleration of real GDP growth. The impact of the global financial crisis in FY08 led to commercial banks, Indian as well as foreign, scaling down their plans in the home loan market. After FY08, some erstwhile aggressive lenders settled down to stable or low growth. While there have been instances of aggressive pricing by a few domestic lenders, the simultaneous withdrawal of other lenders have kept overall competition levels steady. A decade ago, there was large scope for product innovations given the stage of development in the market. Currently, there is lower scope particularly given the fallout of the sub-prime housing loan bubble in developed economies. Another factor that may deter competition is the regulatory climate.

Large new lenders unlikely to enter for a while

The large rise in competitive intensity in the early years of the last decade was the result of the entry of new lenders with large ambitions.

The large rise in competitive intensity in the early years of the last decade was the result of the entry of new lenders with large ambitions, product innovations and a surge in demand, following the acceleration of real GDP growth. The impact of the global financial crisis in FY08 led to commercial banks, Indian as well as foreign, scaling down their plans in the home loan market. After FY08, some erstwhile aggressive lenders settled down to stable or low growth. While there have been instances of aggressive pricing by a few domestic lenders, the simultaneous withdrawal of other lenders have kept overall competition levels steady.

Exhibit 10: Market share trend in mortgages between banks and housing financials



Source: RBI, NHB, Avendus Research

Product innovations may already have been done

The scope for product innovation is particularly lower now, given the fallout of the sub-prime housing loan bubble in developed economies.

A decade ago, there was large scope for product innovations given the stage of development in the market. The scope for product innovation is particularly lower now, given the fallout of the sub-prime housing loan bubble in developed economies. Products such as the interest-only mortgages in the UK, which worked on the principal of rising property prices, though popular prior to the sub-prime bubble, have dwindled.

Regulations and natural entry barriers may prevent competition

Re-alignment of rates across new and old borrowers may deter lenders from aggressive pricing.

Long gestation periods (with the average duration of a loan at 10 years) and a high regulated environment act as entry barriers for new participants in mortgages, thus driving relatively lower competition than other sectors. Additionally, the re-alignment of rates across new and old borrowers as stipulated by the National Housing Board (NHB) for housing financials is likely to make it difficult for lenders to resort to price-based competition. Therefore, in the absence of aggressive pricing, the removal of the pre-payment penalty may not necessarily drive a shift in home loan accounts between lenders.

Rollover TP to Jun13; re-iterate BUY on LICHF and Add on HDFC

We retain our TP for LICHF and HDFC at INR332 and INR730, respectively, and rollover the TP to Jun13. Furthermore, we apply the mean P/B and P/E for the 12-month period to our one-year forward EPS and book value for Jun13 to arrive at P/E and P/B-based fair values. Our final TP is a weighted average, wherein we assign a weight of 50% to our DCF fair value and 25% to our P/E and P/B-based fair values for LICHF. We value HDFC using a combination of the DCF and SOTP methods.

Exhibit 11: Average P/E

	1 month	3 months	6 months	12 months
LICHF	8.6	9.3	9.5	9.7
HDFC	18.9	19.8	20.4	21.1

Source: Company, Avendus Research

Exhibit 12: Average P/B

	1 month	3 months	6 months	12 months
LICHF	1.6	1.7	1.7	1.7
HDFC	4.4	4.5	4.6	4.7

Source: Company, Avendus Research

Exhibit 13: Price performance and relative price performance to Bankex

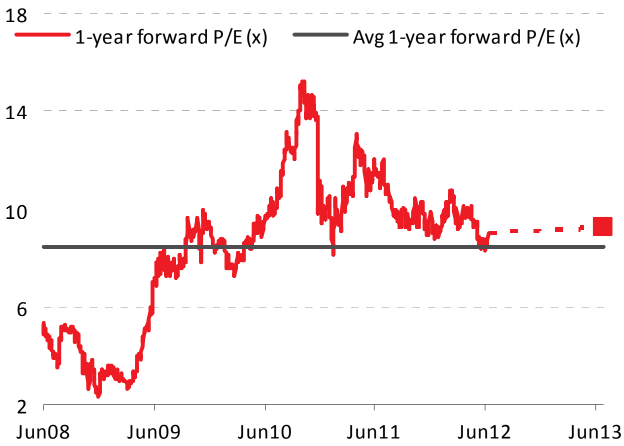
	-----------Stock performance (%) ---------				----------Relative to Bankex (%) ---------			
	1 month	3 months	6 months	1 year	1 month	3 months	6 months	1 year
LIC Housing Finance	6.5	2.1	16.7	13.0	-1.1	7.2	-1.6	17.7
HDFC Ltd.	1.6	-3.8	1.5	-0.2	-6.1	1.4	-16.8	4.5

Source: Bloomberg, Avendus Research

Risk Factors

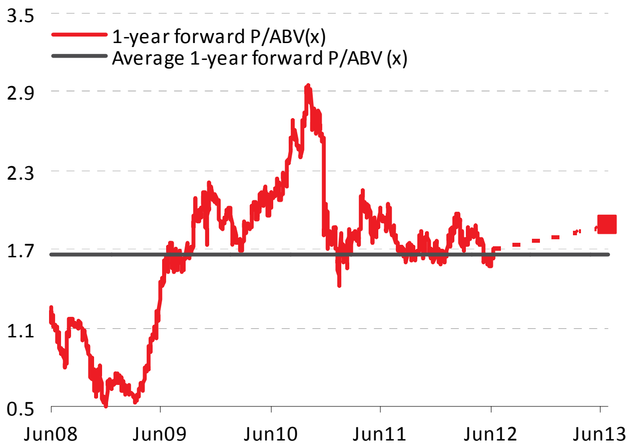
- **Slowdown in property markets:** A prolonged slowdown in demand resulting from sticky property prices could hurt the retail loans segment by way of keeping affordability low. A sharp spike in property prices could dent demand.
- **Rise in intermediation costs:** The key advantages of HFCs are the low cost-to-income and cost-to-asset ratios. A rise in intermediation costs would affect profitability and dent a key competitive advantage vis-à-vis banks. A low-cost structure is one of the key drivers of HFCs profitability.
- **Adverse regulatory guidelines:** Adverse changes in regulations governing HFCs and/or possible removal of differential pricing between old and new borrowers with 'retrospective' effect may impact HFCs profitability.
- **Increased competition:** Irrational pricing due to aggressive competition in the market may affect HFCs profitability.

Exhibit 14: LICHF – One-year fwd P/E and target P/E



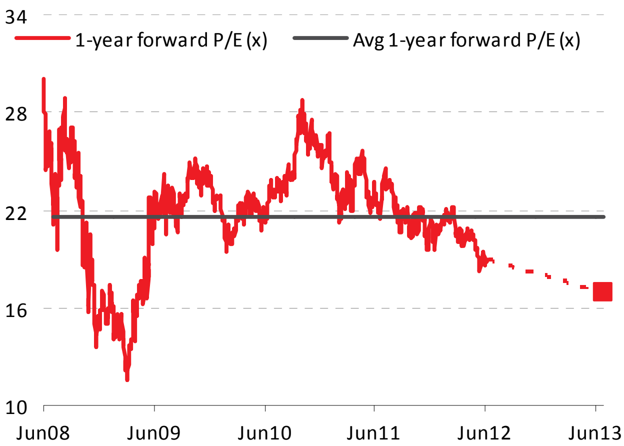
Source: Bloomberg, Avendus Research

Exhibit 15: LICHF – One-year fwd P/B and target P/B



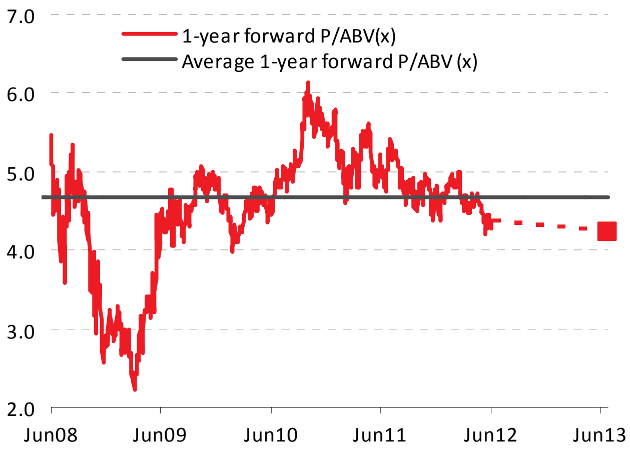
Source: Bloomberg, Avendus Research

Exhibit 16: HDFC – One-year fwd P/E and target P/E



Source: Bloomberg, Avendus Research

Exhibit 17: HDFC – One-year fwd P/B and target P/B



Source: Bloomberg, Avendus Research

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Proportion of ratings in each category and investment banking relationships (%)

At the end of March 2012	Buy	Add	Hold	Reduce	Sell	NR	Total
Proportion of ratings in each category	29.1	33.3	17.4	11.6	1.4	7.2	100.0
Proportion of companies to whom material investment banking services were offered during the previous 12 months	0.0	8.7	8.3	0.0	0.0	20.0	5.8

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Companies: HDFC Ltd. (HDFC IN), LIC Housing Finance (LICHF IN)

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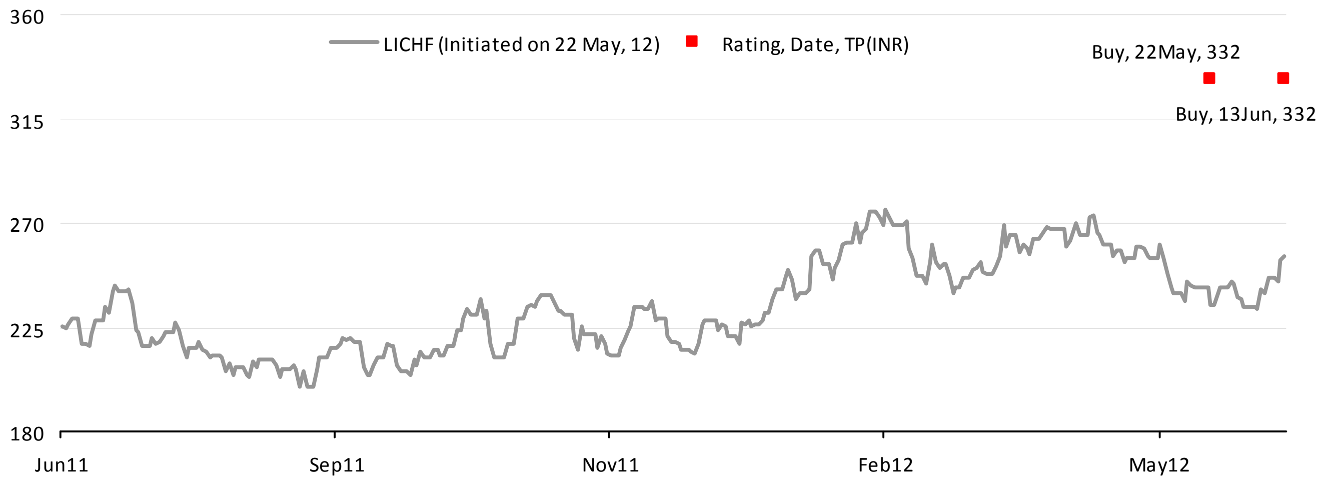

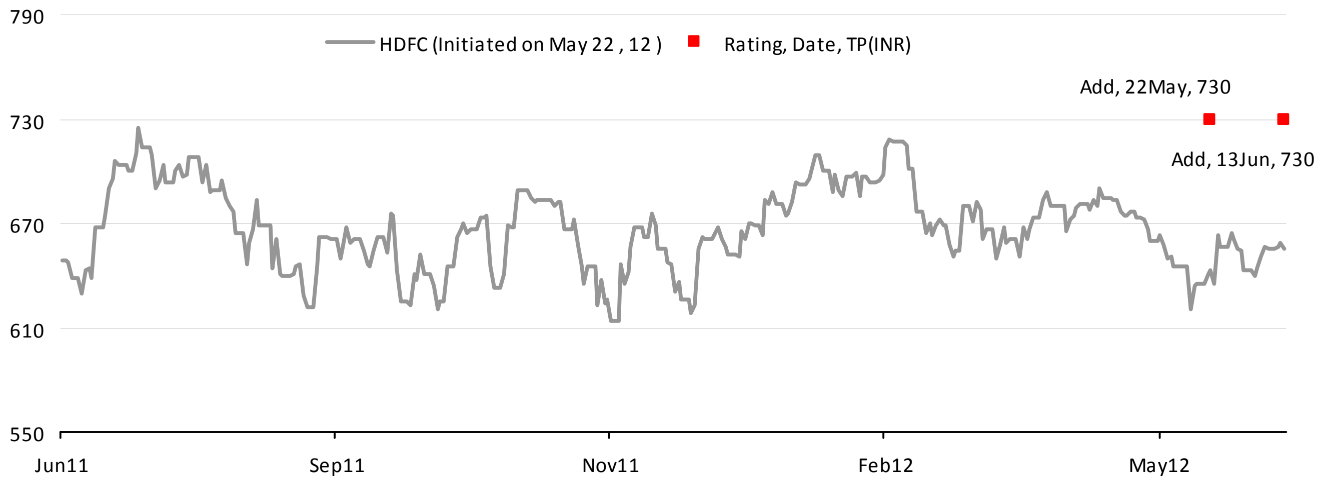
790
730
670
610
550
HDFC (Initiated on May 22 , 12)
Rating, Date, TP(INR)
Add, 22May, 730
Add, 13Jun, 730
Jun11
Sep11
Nov11
Feb12
May12

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