Equity Research
July 7, 2013
BSE Sensex: 19496

Financials

HDFC
(Rs850- ADD)
Target price Rs900

LIC Housing Finance
(Rs233 - BUY)
Target price Rs360

GRUH Finance
(Rs229 - REDUCE)
Target price Rs222

Dewan Housing Finance
(Rs152 - BUY)
Target price Rs350

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INDIA

Housing Finance Companies

Firm foundation, distant ceiling

Reason for report: Initiating coverage

The Indian housing finance sector has had a long track record of shareholder value creation based on excellent borrower behaviour and largely secular growth in assets financed with mostly stable spreads. Competition from banks has always been there with varying intensities. We feel with recent regulatory changes like abolition of pre-payment penalty, spreads for the sector as a whole is likely to decline in the medium term although we expect some near term benefits from the expected fall in wholesale borrowing costs. Growth opportunity is unlikely to be a constraint in our opinion, and under penetrated niches will support specialized players. We initiate coverage on HDFC, LIC Housing Finance, GRUH Finance and Dewan Housing Finance. LIC Housing Finance is our top pick, based on a thesis of imminent margin reversal and consequent re-rating.

- **Multiple competitors; liability franchise and operating efficiency key differentiators.** The basic housing finance product comprising of floating rate loans to salaried middle class urban borrowers for first-home buying remains very competitive with SBI playing the role of marginal price setter. Housing finance companies however continue to increase their share of incremental disbursements as the only other bank focusing on serious growth in the product is Axis Bank. Loan against property (LAP) has been a high yield favourite of new NBFC entrants but existing players remain measured in its use. Developer financing, another lucrative business extension, continues to be a difficult business with HDFC remaining the gold standard for success. With bank funding at base rate plus (around 10% for most banks), it is economically infeasible to finance assets in the mass end of the market through this channel. A strong liability franchise is thus a key competitive strength as NCDs remain the mainstay of large balance sheets (deposits, securitization and NHB funding playing supporting roles). With spreads remaining tight and expected to narrow in the long term in an era of increased rate shopping (no pre-payment penalty), the value of a lean operating cost structure cannot be overstated.
- **Regulatory environment stable despite new proposals.** The sector has seen some adverse regulatory action in the form of abolition of prepayment penalties and the Damodaran Committee recommendation to compulsorily equalize borrowing rates of customers of same risk category, irrespective of vintage. While we see some areas that could attract further scrutiny (high deposit base for example), we believe the overall regulatory regime is likely to be a benign one given the sector's importance in the current policy environment (a plethora of NHB, central & state government schemes and tax rebates at both customer and corporate level bear ample testimony) and the high social costs of destabilization.
- **Large secular opportunity, rural housing a niche.** We estimate the urban affordable housing opportunity at ~Rs7tn and that in rural housing ~Rs5tn at current prices. The total opportunity size is larger and growing on the back of supportive socio-economic factors and policy endowments. Rural housing is largely untapped.
- **Asset quality concerns moderate, wide valuation divergence.** Despite signs of overheating in urban pockets we do not see serious asset quality risks at the systemic level on account of prudential credit policies and stable affordability over last few years. The four players we initiate coverage on show a wide gulf in multiples not easily explained away by RoE differentials. Our target multiple setting methodology accords 1x incremental P/B multiple for every 600bps of sustainable RoE differential over a base CoE of 14%, subject to company specific adjustments.

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COMPANIES

Prices as on July 5, 2013

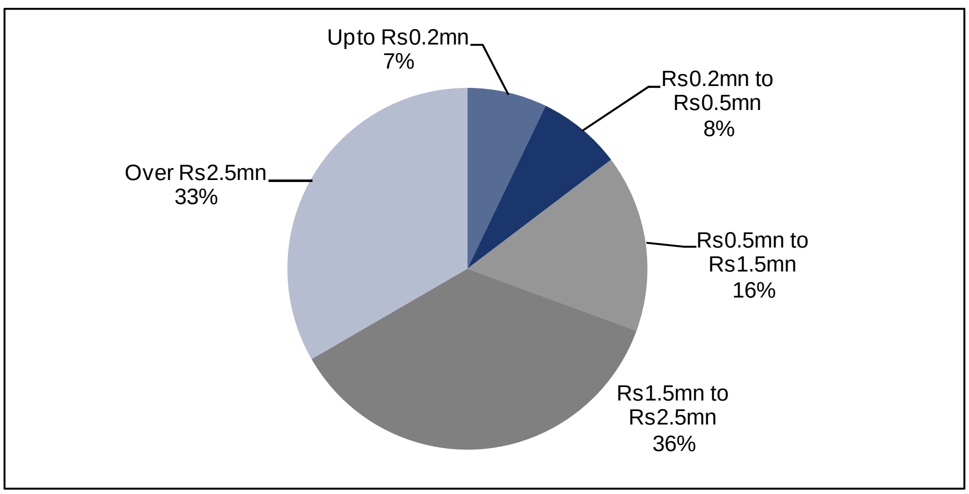
Multiple competitors; liability franchise and operating efficiency key differentiators

Housing finance market – many different segments under one name

Housing Finance is in some sense an umbrella term in India given the wide divergence in customer behaviour and business model requisites across ticket size classes.

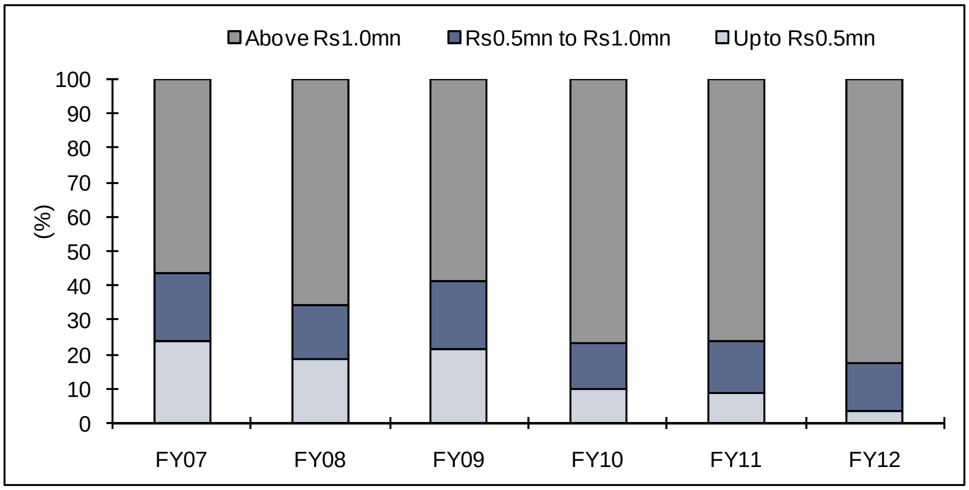
The larger ticket sized end of the market is clearly more competitive. In FY12, disbursements of housing loans by public sector banks stood at Rs738bn with ~69% of the disbursements in the ticket-size of Rs1.5mn and above. This has increased from 62% in FY10 and indicates that commercial banks are focusing more in higher ticket segments and consequentially in larger cities. Similar conclusion also can be gleaned from the disbursement mix of HFCs. In FY12, loans above Rs1mn accounted for 82.6% of the total loans, which is significantly higher than the 56.3% reported in FY07 even adjusting for inflation. The share of loans up to Rs0.5mn has declined from 24.0% in FY07 to 3.3% in FY12.

Chart 1: Housing loan disbursements – Public Sector Banks (FY12): Ticket size mix



Source: NHB, I-Sec research

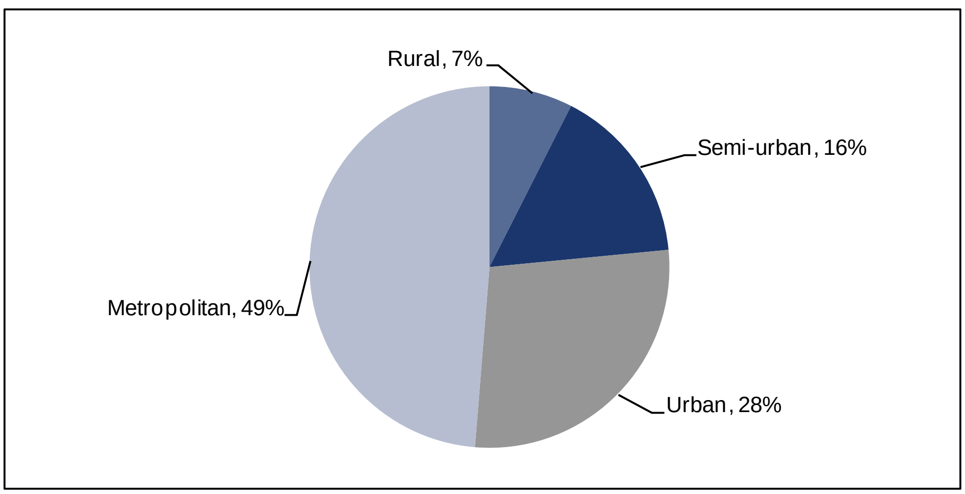
Chart 2: Housing loan disbursements – Housing Finance Cos (FY12): Ticket size mix



Source: NHB, I-Sec research

Also, urban and metropolitan areas comprised ~77% of the total outstanding bank loans as of Mar'11. This reflects the fact that low-ticket loans especially in the semi-urban and rural areas comprise just a small portion of the overall housing finance disbursements at present. Hence opportunities lie with niche players like GRUH Finance and Dewan Housing to capitalise on the under-penetration at the bottom of the pyramid. We would later outline how we estimate the size of this opportunity to be Rs12tn at current real estate values.

Chart 3: Urban and rural housing loan mix (FY11)

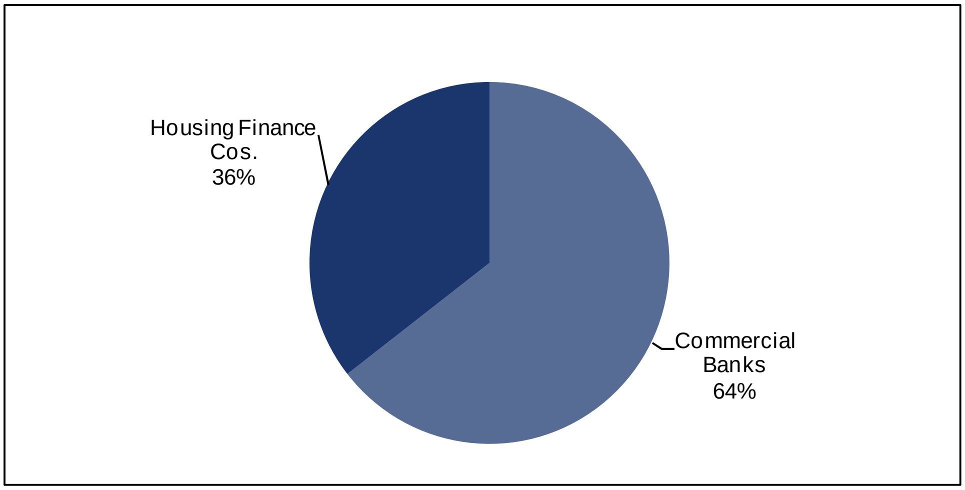


Source: NHB, I-Sec research

Multiple players of consequence

The large secular growth opportunity and low asset quality concerns of the housing finance segment have attracted most large lenders of consequence in India to it. The players can be classified into three broad categories – scheduled commercial banks (SCB), housing finance companies (HFC) and cooperative & regional rural banks (RRB).

Chart 4: Asset market share



Source: NHB, RBI, I-Sec research

Apart from few niche opportunities, housing finance remains a pretty modest spread business with current yields hovering between 10.25-11.5%. With most bank base rates hovering around 10% and 'AAA' borrowing rates between 8.5-9.0%, spreads are in general around 2% for even the best quality of liability franchises. The notable exception to this is State Bank of India which, because of its extensive CASA franchise-driven low cost of funds, remains the marginal price setter in the market. Amongst the banks, SBI, ICICI Bank, Axis Bank and PNB are large players while HDFC and LIC Housing Finance (LICHF) are the key housing finance players. Amongst new players, Indiabulls Financials has scaled up its business rapidly over the last few years.

Table 1: Loans outstanding and market share

(Rs bn)

	FY13	FY12	% YoY growth	Market share (%)
Banks				
SBI	1,502	1,260	19	20.2
ICICI Bank	608	491	24	7.9
Axis Bank	416	308	35	4.9
PNB	219	246	-11	3.9
Bank of Baroda	177	157	13	2.5
Bank of India	123	105	17	1.7
HFCs				
HDFC	1,156	958	21	15.3
LIC Housing	751	599	25	9.6
Dewan Housing	283	210	35	3.4
Indiabulls Housing	248	195	27	3.1
PNB Housing	66	40	67	0.6
GRUH	54	41	33	0.7
GIC Housing	46	39	17	0.6
Can Fin	40	27	50	0.4
Repco Housing	30	24	25	0.4
Mahindra Housing	9	5	64	0.1
Shriram Housing	1	0	2,246	0.0
Reliance Capital	23	NA		NA

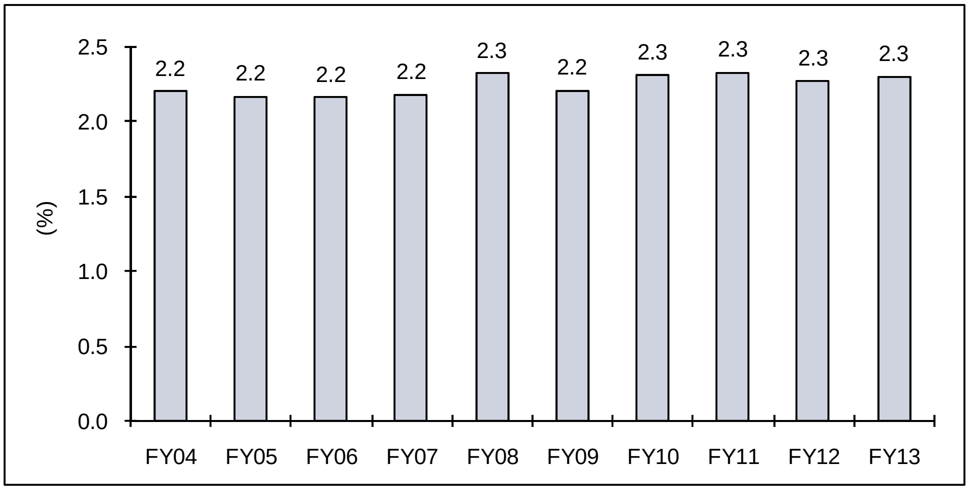
Source: Company data, RBI, NHB

Note: Market share based on total o/s housing loans as of March 31, 2012

Housing finance companies dominating incremental disbursements

Over the years, commentary from multiple scheduled commercial banks at various points of time has been extremely bullish regarding individual growth ambitions of this business. This has from time to time fuelled fears of competitive pressures on sector yields through a scramble for assets. But, if we study the business margins of HDFC, the largest player for whom the profitability of this business is available in the public domain, spreads have remained steady.

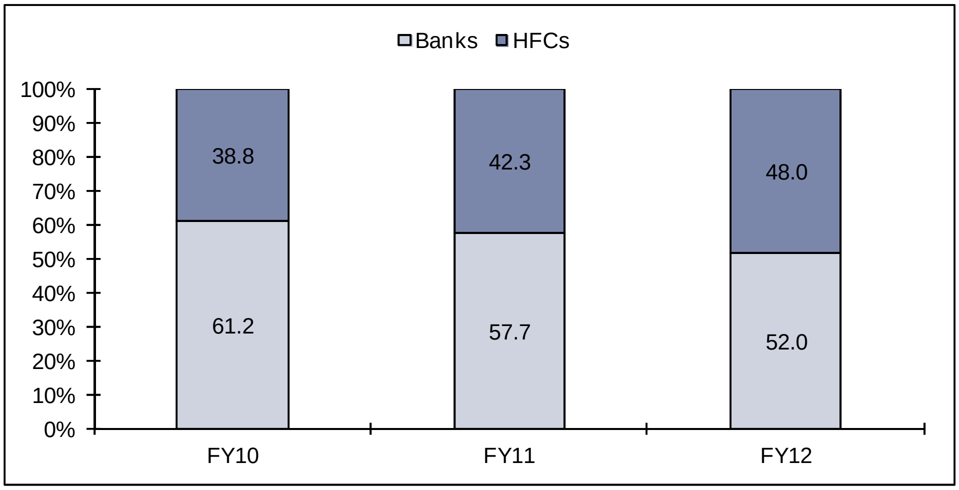
Chart 5: HDFC spreads have stayed fairly stable



Source: Company data, I-Sec research

The thesis on margin disruption in this sector in the last decade always has had some bank at its focal point and in recent years, SBI has been offering the finest rates in the market (enabled by its low cost of funds). Accordingly, it has built up a large book as well. The key observation for us though is that this has not slowed down the asset growth of other HFC players. In the case of LICHF, the use of what is colloquially referred to as teaser loans (low fixed-rate for an initial period, floating thereafter) may have dented margins, but growth has not been an issue. In the past five years, HFCs have contributed more than 50% of incremental sector disbursements as apart from SBI and Axis Bank, most large commercial bank players have not pushed for high asset growth in the segment.

Chart 6: Disbursements mix between banks and HFCs



Source: NHB, I-Sec research

We feel that this trend will continue in the medium term as we do not foresee any other large bank being aggressive in this highly yield competitive segment:

- As tier-2 and tier-3 cities start contributing to asset growth, HFCs (especially the niche-focused ones) will be key beneficiaries
- We expect the more aggressive of the HFCs to make a bigger foray into higher risk assets like loan against property (LAP), where we feel banks will tread more cautiously
- The single-asset focus of HFCs will help them leverage better their distribution network. The larger amongst the HFCs have indirect distribution networks that rival sizeable commercial banks.
- Wholesale borrowing market and securitization should provide funding cost and availability support.

HFCs are here to stay

We feel that both banks and HFCs have certain advantages in this business and they balance each other out for the most part.

Banks' advantages

- Ability to source CASA deposits that bring down cost of funds and create a stable and granular liability base. The biggest beneficiary of this is probably SBI.
- Branch network that can be milked for distribution of multiple asset classes, thereby reducing marginal operational spend on this business line.
- Ability to leverage higher than HFCs (6% tier-1 requirement *vs* 9% for HFCs)
- Established trust with people, which is critical to such a long-duration, high-involvement asset product

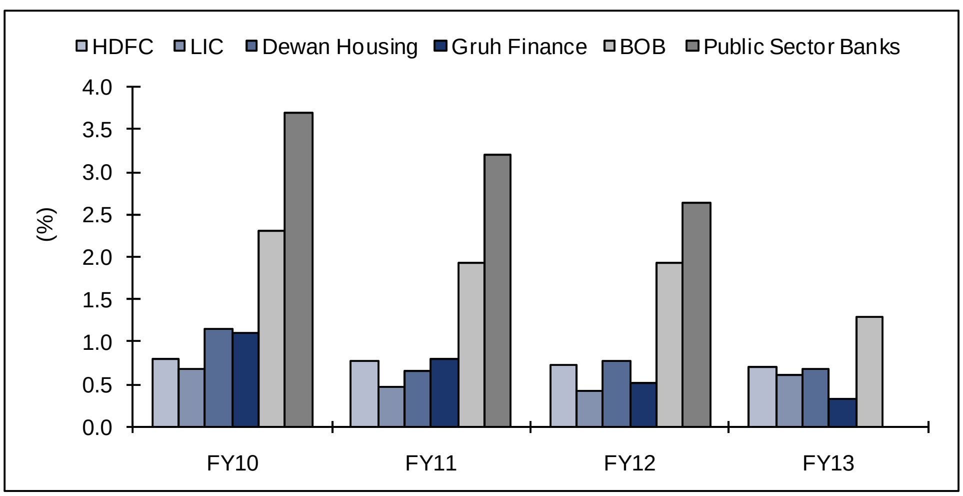
Banks' disadvantages

- Need to maintain SLR and CRR, that drags down yields on a blended basis
- Priority sector financing requirements ensure investment in assets that are traditionally low-yield with high delinquencies
- Have to lend at or above base rates
- Tighter regulatory monitoring of asset growth and credit policies

HFCs' advantages

- No need to maintain CRR. SLR to be maintained against time deposits is only 12.5%
- Mono-line business implies that full distribution capacity is geared to sourcing housing loans
- Higher risk appetite in profitable products like LAP
- Ability to maintain a higher proportion of project finance / developer loan book (roughly one third of HDFC's loan book is now developer exposure)
- Ability to focus on niche business models like rural housing, which are difficult to fit into a bank business model
- No priority sector financing responsibilities. On the contrary most HFCs source priority sector assets to secure refinance from NHB at lucrative rates and also sell down / securitise these assets with banks as primary customers. The long-term credit track record of these assets is much better than equivalent ones internally sourced by banks according to commentary from experts who analyse such pools

Chart 7: Asset quality trend in housing loans (GNPL ratio)



Source: Company data, I-Sec research

HFCs' disadvantages

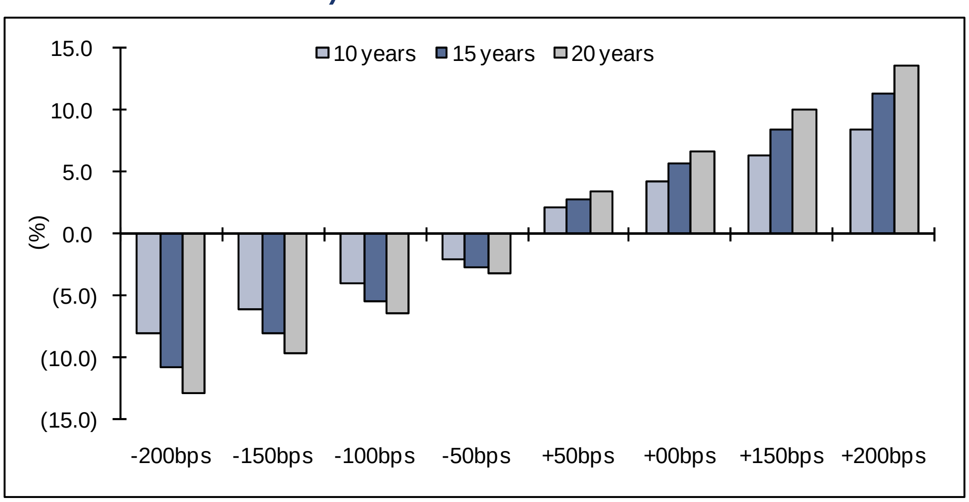
- Ability to leverage is lower than that of banks (9% tier-1 requirement *vs* 6% for banks)
- No CASA advantage to cost of funds

Against this backdrop, HFCs have continued to thrive in spite of housing finance being a segment of choice for various large banks at various points in time. In the current context, we believe that while SBI will remain the marginal price-setter in this market, the opportunity is large enough for both groups (banks and HFCs) to grow their assets meaningfully over many coming years. As far as margins are concerned, we feel the fact that this segment remains a key contributor to overall margins of large banks will act as insulation against any value destructive pricing disruption although as we will argue next, margins will trend down.

Blended spreads may come down in the long term

While spreads on new loans are unlikely to be driven down too much by any predatory pricing, we feel back-book spreads will come down going forward. This will of course have a bearing on blended spreads. With prepayment penalties being abolished, the cost of rate-shopping for an existing customer has gone down drastically. We recognise the fact that the brand of the lending franchise and the level and ease of service are key to the customer's preferences. Having said that, we do feel that with the differential between going market rates and that being levied on a back-book customer reaching 200-250bps in some cases (creating a possibility of 10-12% saving on EMIs) some of the more financially conscious customers will start to shift. We believe that rate differential in itself will start to shrink with this phenomenon. We do not expect it to go to zero as we feel that customers will be willing to pay a differential to stay with a lender they trust and like (it is worthwhile to note that in a floating rate loan, the customer does depend on the lender for fairness of future interest rates). We feel the differential can get squeezed to 50-75bps over the next few years thereby reducing spreads from 2% to 1.25-1.5% on a blended basis. On the cost of funds side, we do not see a major opportunity for structural shrinkage unless more overseas borrowing is allowed or securitisation becomes much more prevalent and banks remain as hungry for sourcing priority sector assets as they are today. We also feel the better recognition and brand equity that the lending franchise enjoys; the thicker will be the differential it can enforce.

Chart 8:Tenure wise sensitivity of EMIs to change in annual interest rates (base case interest rate: 11.0%)



Source: I-Sec research

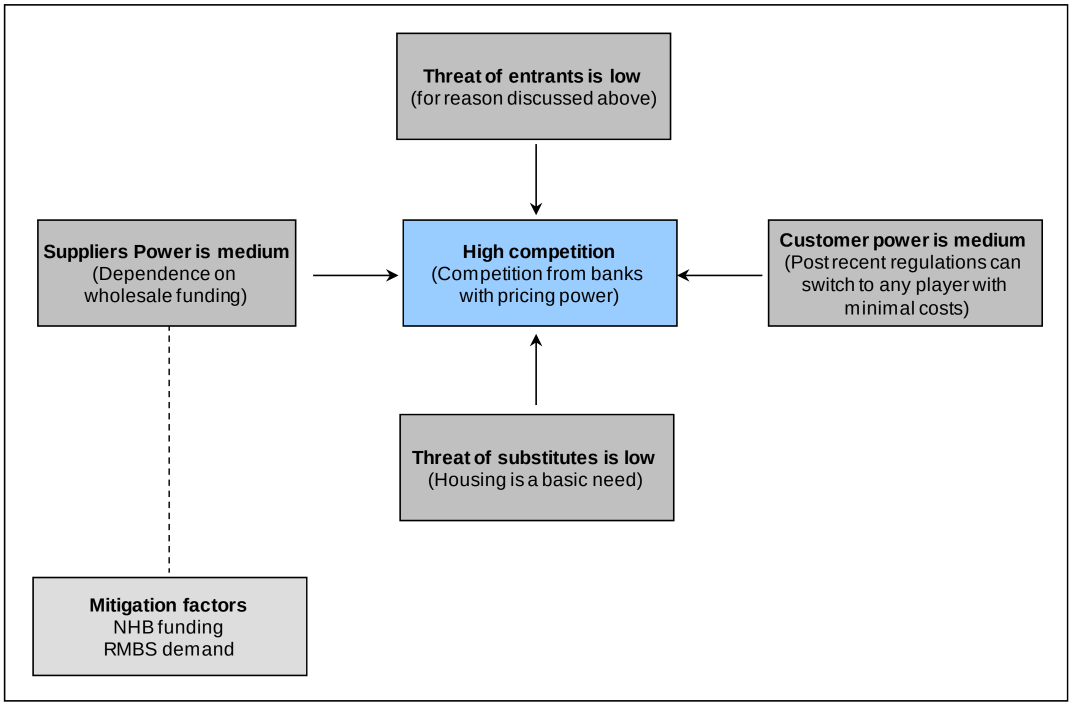
Not an easy business for a new player to have a meaningful impact on a sustainable basis

Having evaluated the possibilities of market disruption from existing players, we also look at possible threats from new entrants to competitive intensity. We feel the biggest entry barriers to this business are the following:

- In the rural housing finance or self-employed housing finance business (the high yield piece within plain mortgages), replicating the operating model is a time-consuming and difficult process. If we look at the success stories of size significance in this space, they have been in the business for over a decade before building critical mass for asset growth acceleration. Key challenges include: low acceptance of the credit product, difficulty with clear land titles, higher cost of operations based on smaller ticket-size driven processing intensity and building trust and recognition within local communities.
- In the generic salaried-class mortgage space, yields are at a level where, to be decently profitable, the entrant will require an excellent liability franchise, as spreads of incremental loans are at 100-150bps premium to ‘AAA’ bonds. With current yields at 10.5% and most bank rates around 10%, it is no longer possible to fund this business profitably through bank funding.
- Fast growth in this business is possible through developer tie-ups and feet on the street. Apart from cost considerations of setting up a large operating base, developer tie-ups also take time to fructify. The distribution model in itself is a major deterrent for a new entrant.
- Initial investments into business development and systems make the operating costs high in the early days of the business. Any sort of dramatic growth, thereby, requires continuous capital injection as internal accruals remain modest.
- The only space where we see new players to be capable of a quick and significant entry is high yield and large ticket size products in an urban context like LAP and developer finance. But both of these remain significantly more cyclical businesses with very different types of challenges.

This leads us to believe that new entrants will find it difficult to shape market dynamics and impact sector profitability in any significant way.

Chart 9: Porter's five forces

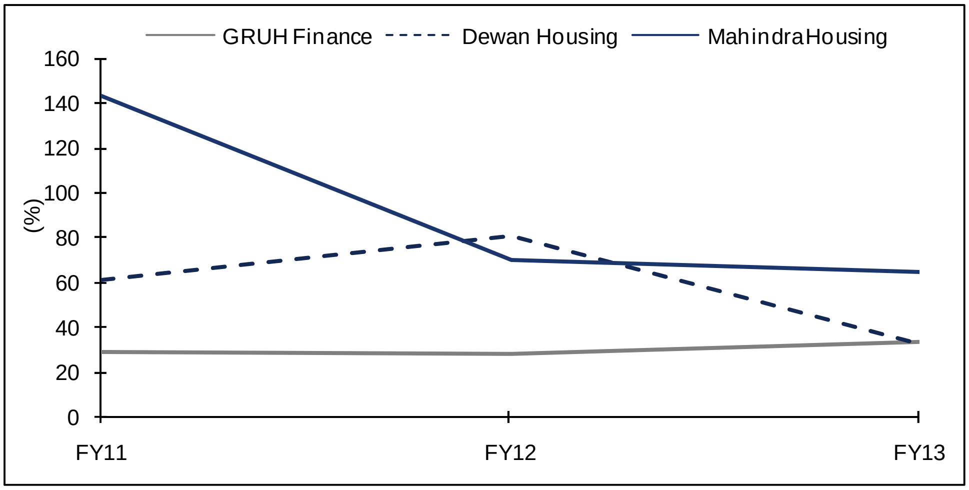


Source: I-Sec research

Niche players have started to scale up

As we will discuss in detail later, rural/ suburban housing finance or finance for self-employed or non-tax paying customers remains a highly under-penetrated opportunity. There are a few players which have started to tap into these opportunities and have now reached sizes of consequence. GRUH Finance, a subsidiary of HDFC has been a pioneer in rural housing and has patiently built a portfolio of Rs55bn over the last 25 years. Dewan Housing has focussed on tier-2 and tier-3 cities and metro peripheries to build a book of ~Rs260bn (excluding acquired asset) from self-employed and non tax-paying customers. M&M Financial, a leading NBFC with strong rural presence has a housing finance subsidiary for rural locations that plans to reach Rs40bn in the next three years. Shriram City Union Finance has also floated such a subsidiary as has Sundaram Finance. The biggest draw of such niche market positioning is of course yields and the size of the growth opportunity, but gestation periods remain long and operating expenses are high for most players. We feel however that a few of these businesses have now achieved critical mass for a serious acceleration in growth.

Chart 10: AUM growth of niche housing finance players



Source: Company data, I-Sec research

Loan against property (LAP) – high yield, but potentially higher-risk product – could play a significant role in competition

Loan against property (the equivalent of home equity loans internationally) has been a growth-driving profitable product for most of the newer players who have registered aggressive growth in assets. Even the larger and established players now have significant presence in this market with non-bank entities being major players. The LAP product is different from mortgage loans in various facets.

Table 2: LAP vs mortgage loans

	LAP	Mortgage loans
Tenure at origination	5 years in most cases, 10 at most	15-20 years in most cases, 25 at most
Loan rates (%)	15-16	10-12
Maximum LTV offered at origination	70%	80%
Ticket sizes	Rs5mn	Rs2.5mn
Debt service coverage ratio	Lenders generally allow for EMIs up to 50-60% of monthly income	Lenders generally allow for EMIs up to 30-40% of monthly income
Nature of customers	Mostly self-employed (85%)	Mostly salaried class

Source: Company data, I-Sec research

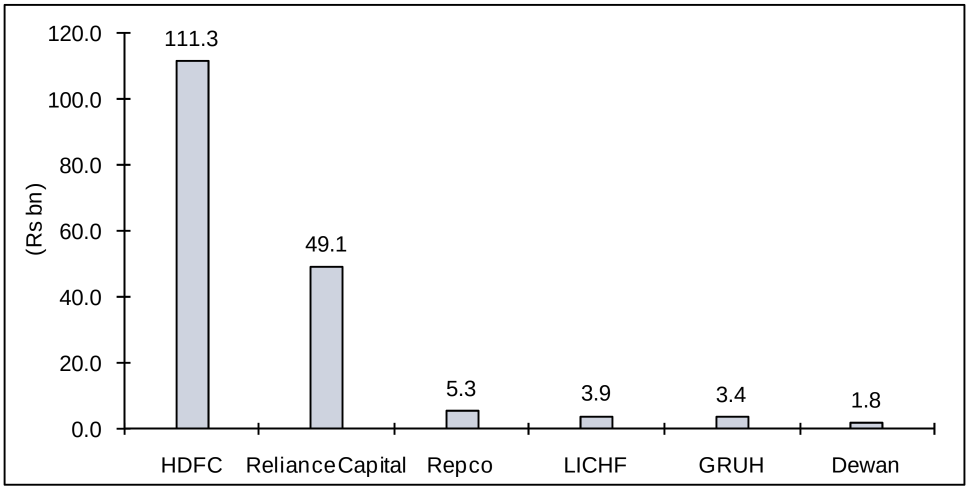
Our interactions with credit appraisers and decision-makers at various HFCs suggest that they remain wary of the inherent credit risk due to the following reasons:

- Most lenders remain wary of customer's financial position when they avail this loan. With loan rates at 15-16%, apart from the cases where such borrowings are deployed by customers into their own business, the general suspicion remains that the borrower is in some sort of financial emergency.
- Lenders do not like the fact that the ultimate end use of the money is not under their control.
- While the collateral is enforceable in the case of individual LAP loans through SARFAESI, our contacts in credit underwriting business feel that the pool defaults are likely to be higher.

In order to mitigate the risks, the most prominent players are taking the following precautions:

- LTVs are much lower than the 80% maximum allowed for mortgage loans. For most players, it tops out at 70% with 50-60% being the usual range.
- Lenders try to gauge the cash flow pattern based repayment capacity of the borrower and not just rely on the adequacy of collateral.
- The exposure to this business line is capped to a limited portion of the overall asset portfolio (generally single-digit percentages for HFCs).
- Although demand can be largely yield agnostic in this category, the lenders try to limit yields between 15-16% as they do not want to strain cash flow-based affordability or create a moral hazard for the borrower through large accumulated interest.

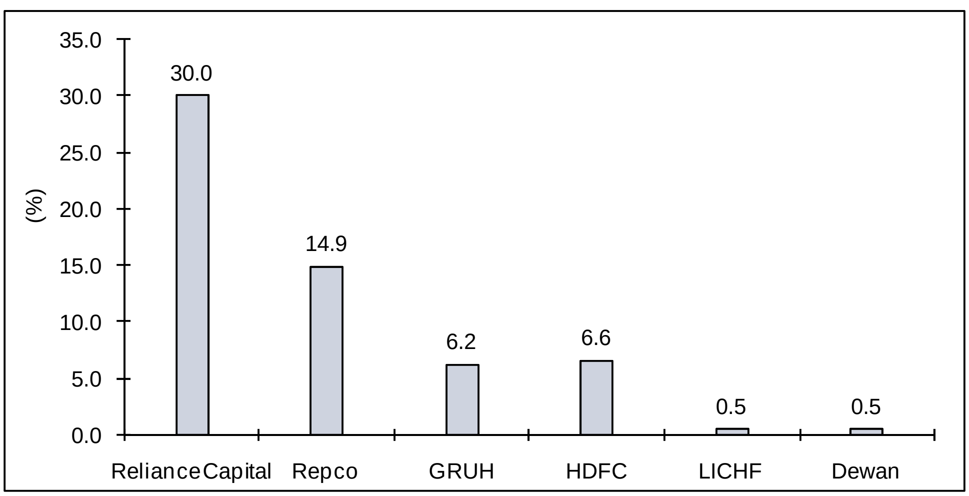
Chart 11: LAP portfolios of key players (includes estimates)



Source: Company data, I-Sec research

Some of the newer players Repco Housing and Reliance Capital have clearly used LAP as a key growth driver according to market participants we interviewed.

Chart 12: LAP as a total percentage of housing portfolio (FY13)



Source: Company data, I-Sec research

Developer financing – lucrative, but highly specialised with multiple execution challenges

It comes as no surprise that given the limited liquidity options for the developer community in India and the high margins possible for a developer to earn for projects starting at the land acquisition stage, yields for financing developments at a project level or developers themselves at an entity level are quite lucrative, going over 20% in some cases. However, there are multiple challenges that a player needs to manage for success in this space, which has proved tricky for many marquee lenders as well.

- Land titles are much contested in India due to succession disputes and poor record-keeping. With most developments being agglomerations of fragmented landholdings, legal disputes regarding even one piece can throw spanner in the works of a project for a long time.
- Land use laws are stringent in India, and land prices are heavily dependent on the same. The conversion process from agricultural land to other uses is cumbersome and uncertain with many bureaucratic hassles. Inadequate due diligence or project plans grounded on ‘hope’ have often fallen through.
- In some cases, enforceability of collateral in case of default may be much more difficult compared to individual loans.
- In many cases, corporate governance practices of real estate companies have come under scrutiny, reducing the size of the potential borrower universe for a discerning lender.
- Our interaction with lenders reveal that in many cases, the lender is not comfortable funding a promoter entity but would rather finance a project as it feels that cash flows in the harvesting phase of the project will not get redirected into fresh investments.

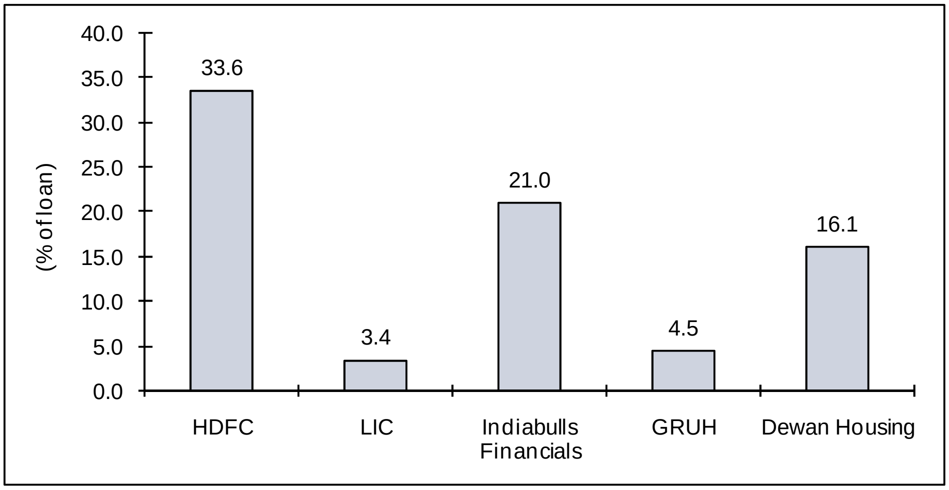
The lifecycle of a real estate project offers multiple opportunities

Most of the real estate projects in India are developments of acquired and integrated land parcels or redevelopment opportunities, with the former clearly being more profitable. The financing of opportunities start at the land-acquisition stage for HFCs and NBFCs (banks are not allowed), with some of the more aggressive players offering finance at this stage, where yields could be as high as 25%. The other sources of finance for developers at this stage are individual investors in a quasi equity structure, being assured individual units at a pre-decided discount to the final selling price.

At the next level comes construction finance, with all basic approvals in place. This is a slightly lower risk product and thereby generally offers yields between 14-20%. This generally involves milestone-linked disbursements with interest in moratorium until rental cash flows start to come in for commercial real estate or in tandem with customer advances in case of residential developments.

In the case of commercial real estate, lease rental discounting (LRD), is another opportunity for lenders post completion of the project and lease-out. In this type of loan, rental collections serve as security for monthly repayments. Developers avail of this product as it allows them to enhance returns and free up capital. This is prima facie the lowest risk of the credit products spoken about in this section and rates hover between 13-16%. However, one should keep in mind that the debt service coverage ratio (EMI/ rentals) hovers around 1.2x for most transactions and thus is not very high on an absolute basis. To treat this product like a CMBS equivalent is thus not really accurate, as the cash flow coverage is much lower and property title is legally enforceable.

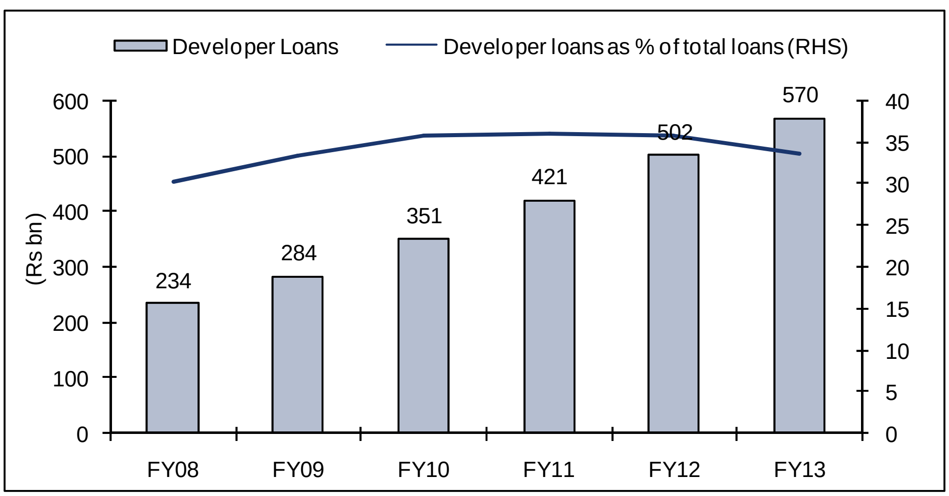
Chart 13: Developer financing book of major players (FY13)



Source: Company data, I-Sec research

Our interaction with most market participants seemed to suggest that HDFC is considered to be the savviest in this business.

Chart 14: HDFC has a significant exposure to developer business



Source: Company data, I-Sec research

Liability franchise is key to business success for HFCs

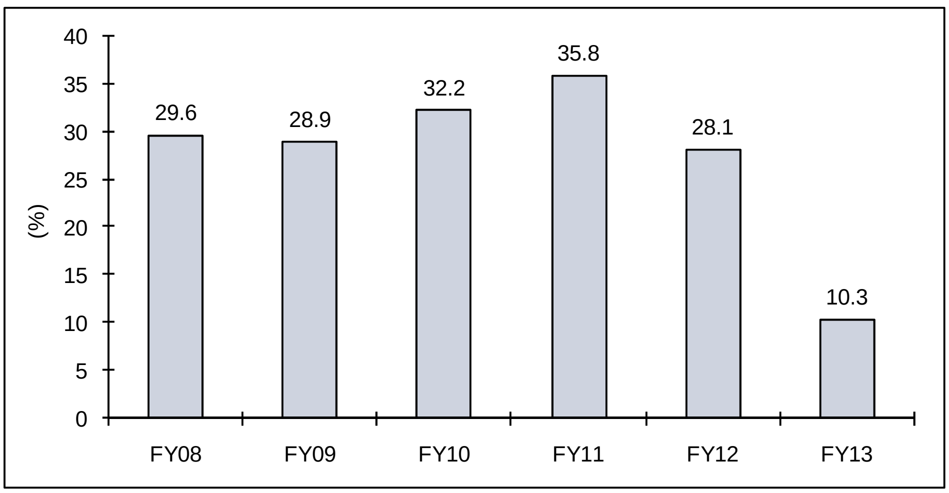
Plain vanilla mortgage loans to primarily urban tax-paying salaried individuals for first home purchases is now a very competitive business in terms of spreads. Yields today stand 50bps north of bank base rates and at 150-175bps higher than borrowing rates for 'AAA' corporates in the NCD market. In such a scenario, in order to not be priced out, any player needs to be borrowing at close to 'AAA' rates or find out higher yield niches for the business to earn decent spreads that can provide for credit and operational costs and thereafter a reasonable return.

Also, HFCs like top-tier NBFCs, are trying to reduce their dependence on bank funding. Both the other options of NCDs and deposits necessitate a strong retail liability franchise. Thus both from cost and availability point of view, the strength of the liability franchise of an HFC determines its vulnerability to a systemic liquidity squeeze and its ability to price loans competitively.

Trend toward reducing dependence on banks

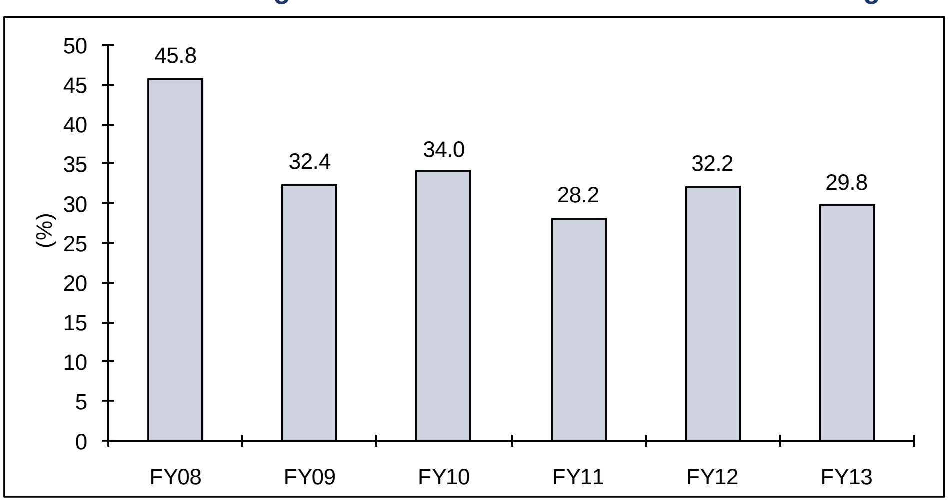
With most bank base rates around the 10% mark and home loan rates in the 10.5-10.75% range for new loans, it is clear that if things stay as is, it is difficult to finance incremental business through bank financing (banks are not allowed to lend below the base rate).

Chart 15: HDFC has drastically reduced proportion of borrowings from banks



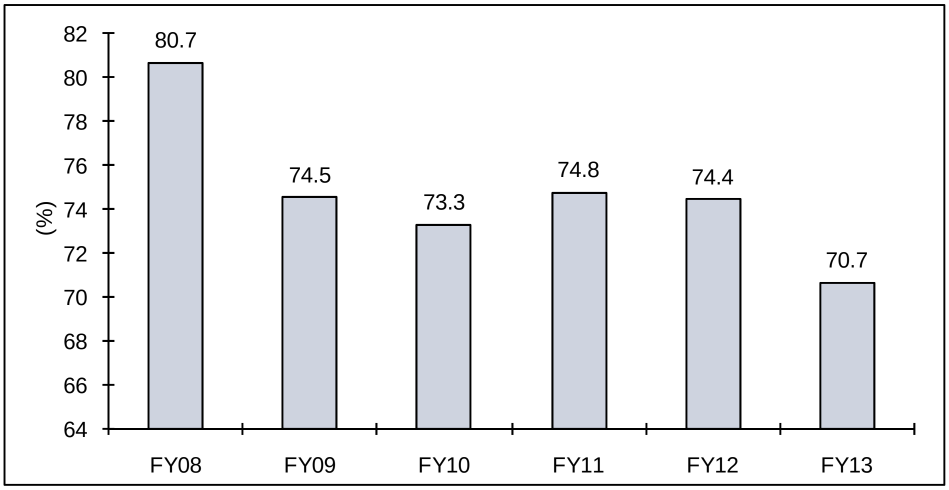
Source: Company data, I-Sec research

Chart 16: LIC Housing still has much room to reduce bank funding



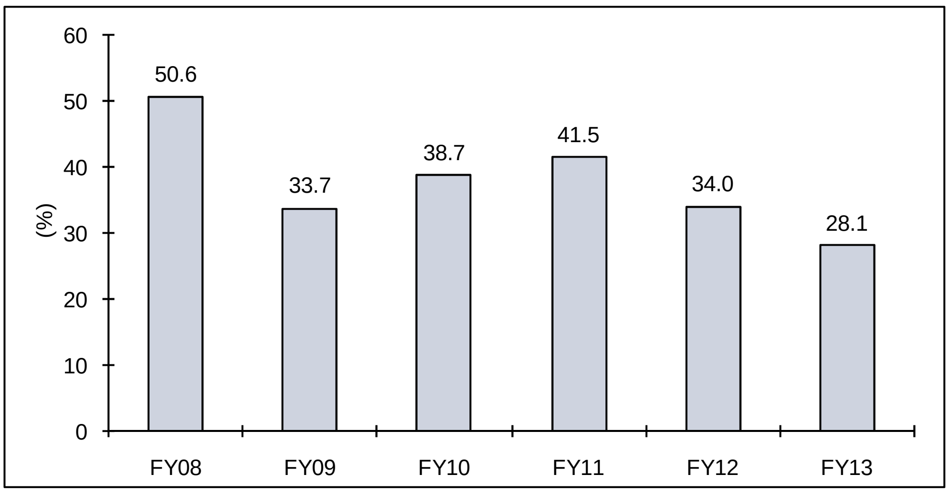
Source: Company data, I-Sec research

Chart 17: Proportion of bank funding for Dewan Housing



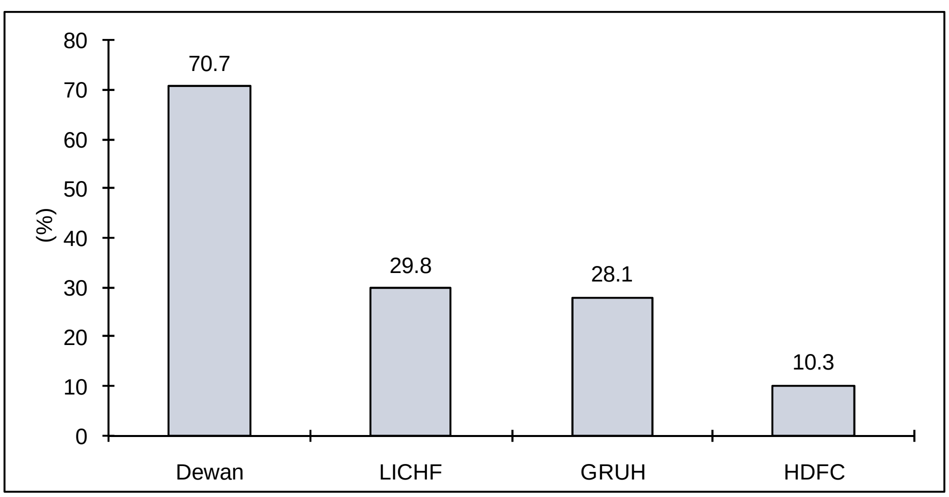
Source: Company data, I-Sec research

Chart 18: Proportion of bank funding for GRUH Finance



Source: Company data, I-Sec research

Chart 19: Proportion of bank funding for all players (FY13)



Source: Company data, I-Sec research

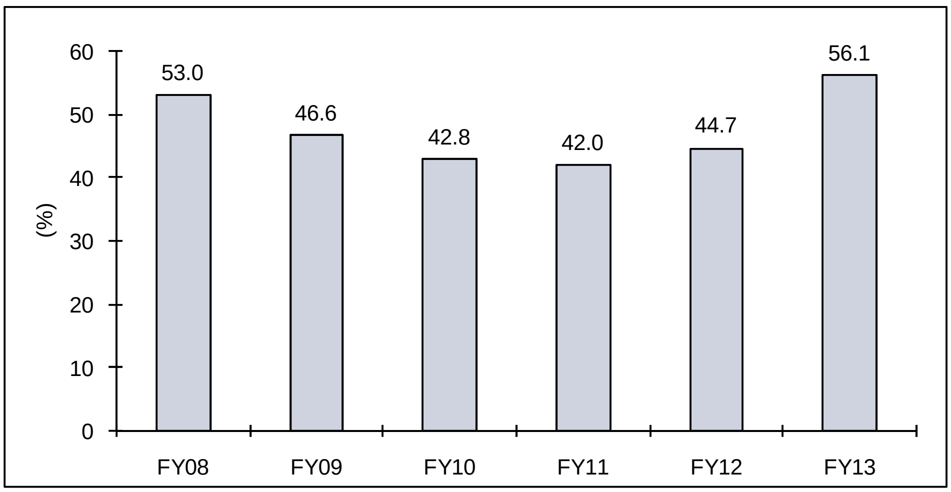
The other major sources of financing for an HFC are

- Non-convertible debentures (NCD)
- Deposits
- Loan sell-downs and securitisation (in a conceptual sense, although here the assets move off balance sheet)
- Commercial paper
- Refinance from NHB
- Foreign currency loans

Non-convertible debentures – the lifeblood of the business

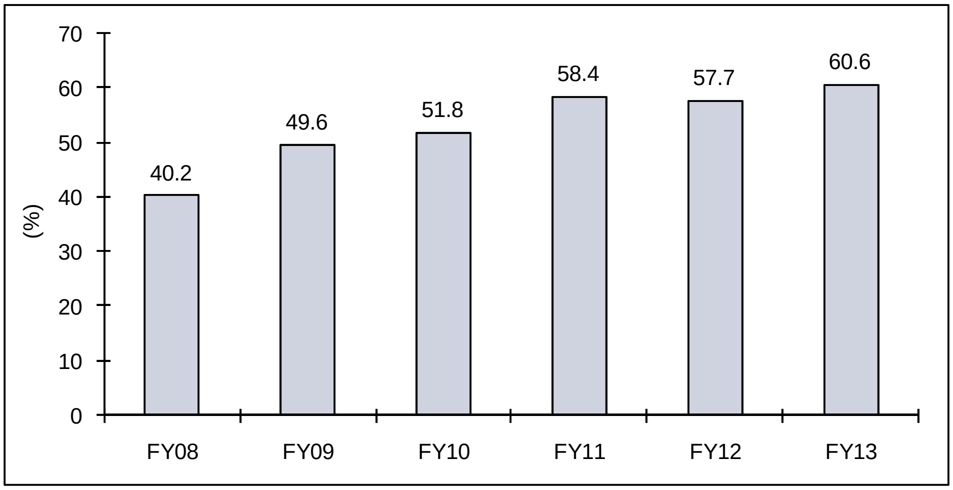
The wholesale debt market has become the key source of financing for most HFCs with a strong credit rating and strong franchise amongst debt investors. HDFC and LICHF lead the pack in this instrument and they seem to be financing the lion's share of their funding needs.

Chart 20: HDFC has significantly increased its dependence on NCDs…



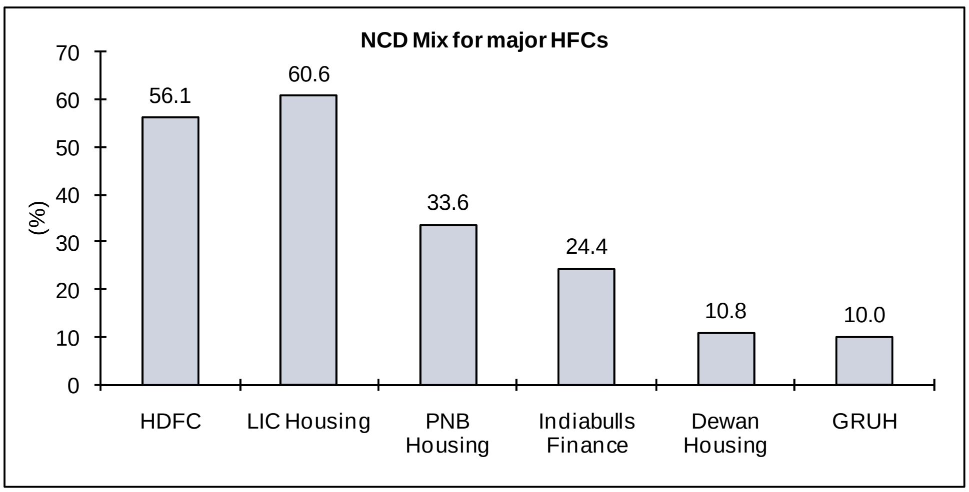
Source: Company data, I-Sec research

Chart 21: …as has LIC Housing Finance



Source: Company data, I-Sec research

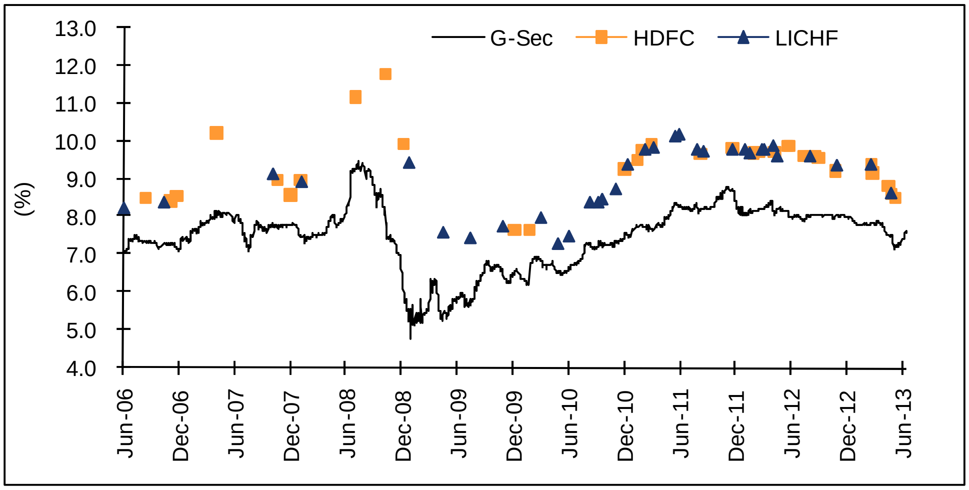
Chart 22: The route is critical to survival in the mass market…and size does matter



Source: Company data, I-Sec research

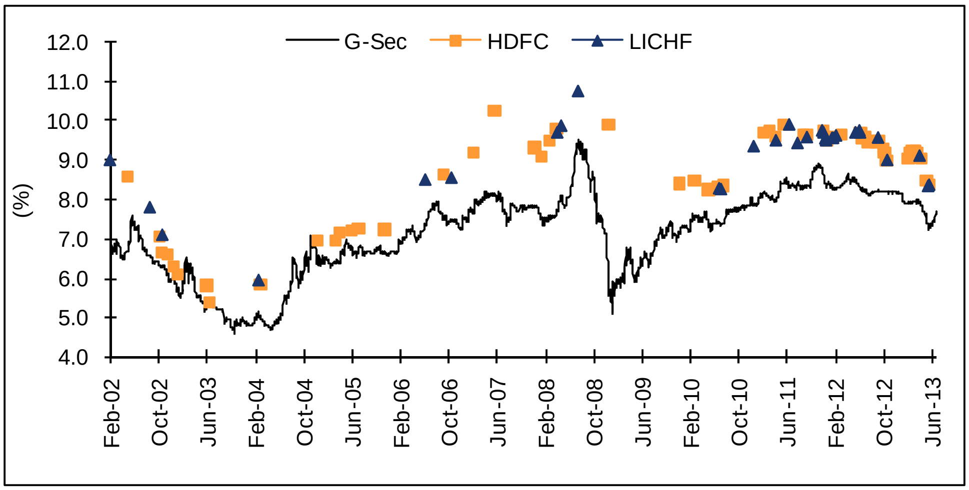
The borrowing costs of the large players with strong liability franchises have been rather attractive.

Chart 23: HDFC issue rates *vs* LICHF issue rates *vs* GoI sec yield (3-year)



Source: Bloomberg, I-Sec research

Chart 24: HDFC issue rates *vs* LICHF issue rates *vs* GoI sec yield (5-year)



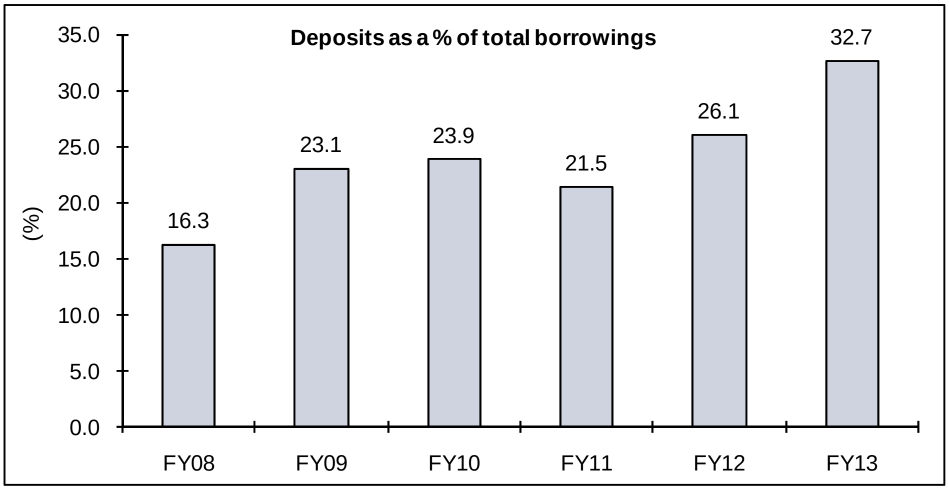
Source: Bloomberg, I-Sec research

It is interesting to note the comparative costs of NCD borrowing for the two clearly strongest HFC liability franchises, HDFC and LIC Housing Finance (LICHF). The latter seems to have borrowed at marginally better rates than HDFC at even the depths of the 2008-09 financial crisis, but post the controversy surrounding the developer loan portfolio of LICHF in 2010, the trend has reversed. The yields at issue have reverted back pretty close to each other once again.

Deposits are another benefit of strong customer trust in brand

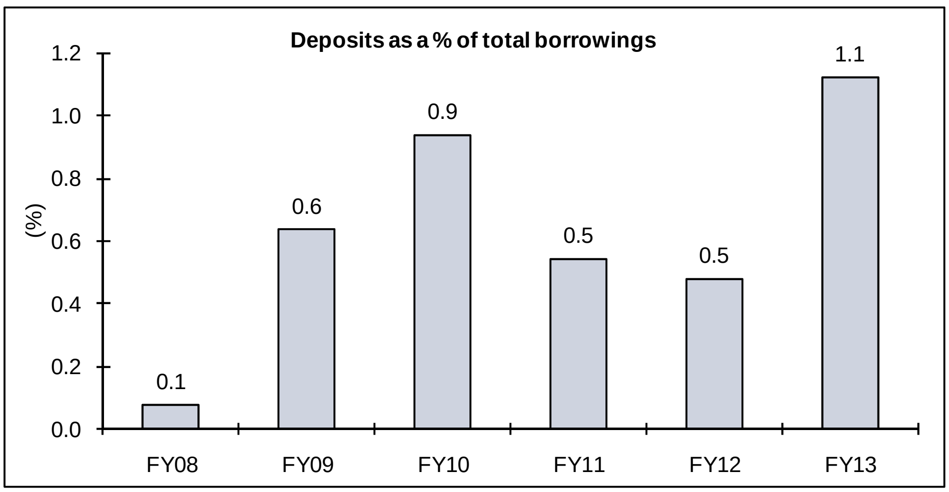
In the effort to diversify away from sub-optimally-priced bank funding, deposits are an able ally for those who are able to mobilise the same in meaningful amounts. This is clearly a focus area now for HFCs as a continuous stream of funding.

Chart 25: HDFC has once again done a stellar job



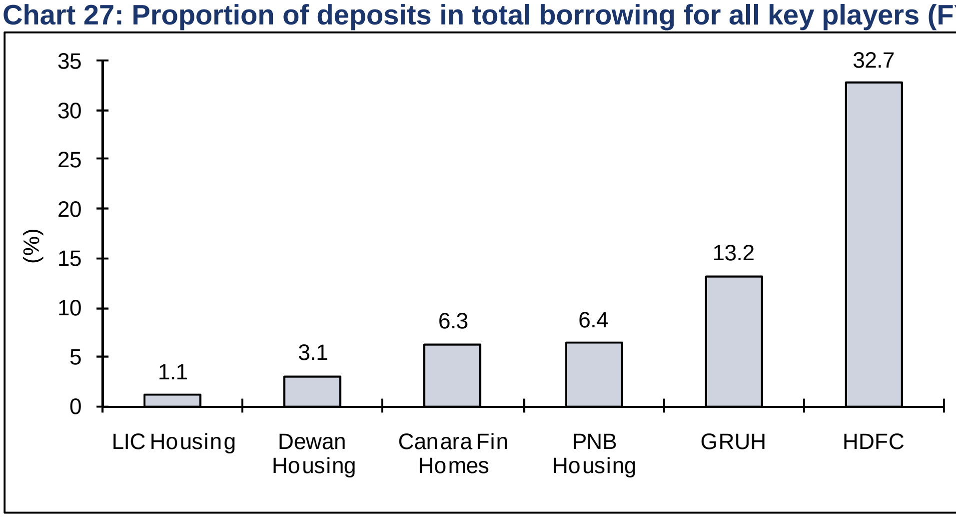
Source: Company data, I-Sec research

Chart 26: Given the recognition and nationwide trust of its umbrella brand LIC Housing could have been expected to do much better



Source: Company data, I-Sec research

Chart 27: Proportion of deposits in total borrowing for all key players (FY13)



Source: Company data, I-Sec research

The cost of deposits is generally about 40-50bps higher than NCDs for an AAA borrower in the current market. But the granularity of its flow and continuous nature are big attractions.

The flexibility in this product is also high in terms of both tenure and interest rate differentiation, and marketing initiatives target specific groups like senior citizens and defence personnel with yield bonuses. The deposit product is a critical tool for asset liability management as companies can target tenures where they see a gap through interest rate differentiation. The following example of HDFC's current schemes is an illustration of these strategic marketing initiatives.

Table 3: HDFC current depositor schemes

	Period (months)	Rate of interest (% p.a.)	
		Individuals & trusts	Sr. citizens
Annual income plan			
Regular (minimum deposit - Rs20,000)			
	24-35	9.05	9.30
	36-47	9.15	9.40
	48-60	8.90	9.15
Platinum (minimum deposit - Rs20,000)	33	9.40	9.65
Monthly income plan			
Regular (minimum deposit - Rs40,000)			
	12-23	8.55	8.80
	24-35	8.70	8.95
	36-47	8.80	9.05
	48-60	8.55	8.80
Platinum (minimum deposit - Rs40,000)	15	9.05	9.30
	33	9.05	9.30
Non-cumulative interest plan			
Regular - Quarterly Option (minimum deposit - Rs20,000)			
	12-23	8.60	8.85
	24-35	8.75	9.00
	36-47	8.85	9.10
	48-60	8.60	8.85
Regular - Platinum option (minimum deposit - Rs20,000)			
	15	9.10	9.35
	33	9.10	9.35
Regular – Half-yearly option (minimum deposit - Rs20,000)			
	12-23	8.70	8.95
	24-35	8.85	9.10
	36-47	8.95	9.20
	48-60	8.70	8.95
Platinum – Half-yearly option (minimum deposit - Rs20,000)			
	15	9.20	9.45
	33	9.20	9.45
Cumulative option			
Regular (minimum deposit - Rs20,000)	12	8.90	9.15
	24	9.05	9.30
	36	9.15	9.40
	48	8.90	9.15
	60	8.90	9.15
Platinum (minimum deposit - Rs20,000)	15	9.40	9.65
	33	9.40	9.65
Systematic savings plan			
Minimum savings of Rs2,000 per month			
	24-35	8.75	-
	36-60	9.00	-

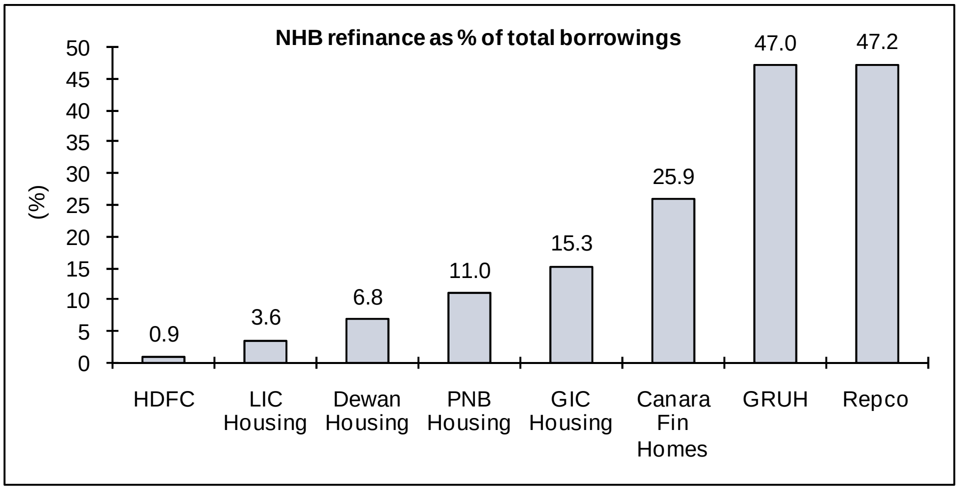
Source: Company data, I-Sec research

The only drawback of this source of funds for HFCs is that they need to maintain an SLR (statutory liquidity ratio) of 12.5% against the amount of net deposits, thus increasing the implied cost of borrowing.

NHB refinance – an attractive source of funding

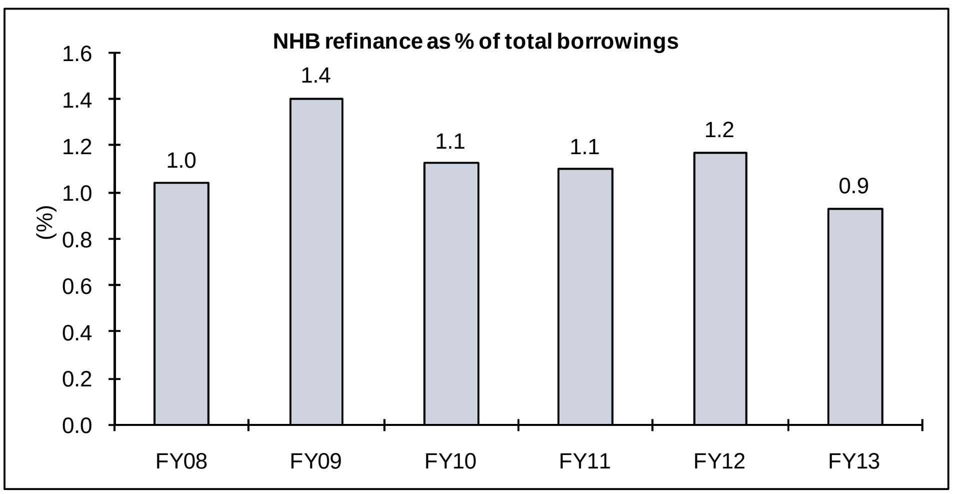
National Housing Bank (NHB) refinances the housing finance portfolios of various players at very lucrative rates of interest that are currently at least 100bps finer than the best borrowing rates available in the wholesale debt market. It is a great profitability enhancer for the beneficiary company and thus a sought-after route for financing.

Chart 28: GRUH remains the biggest beneficiary in relative terms



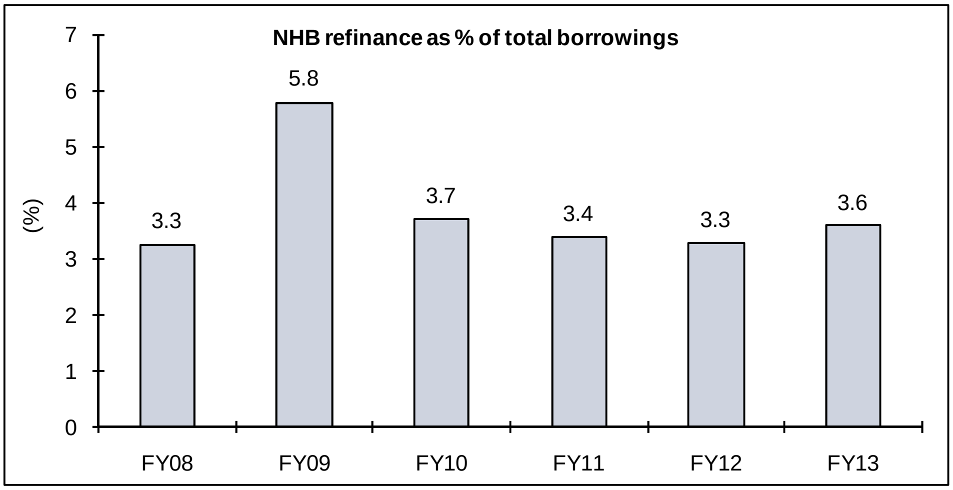
Source: Company data, I-Sec research

Chart 29: NHB an insignificant source of funds for HDFC



Source: Company data, I-Sec research

Chart 30: LIC Housing NHB borrowings are not large enough to swing the needle



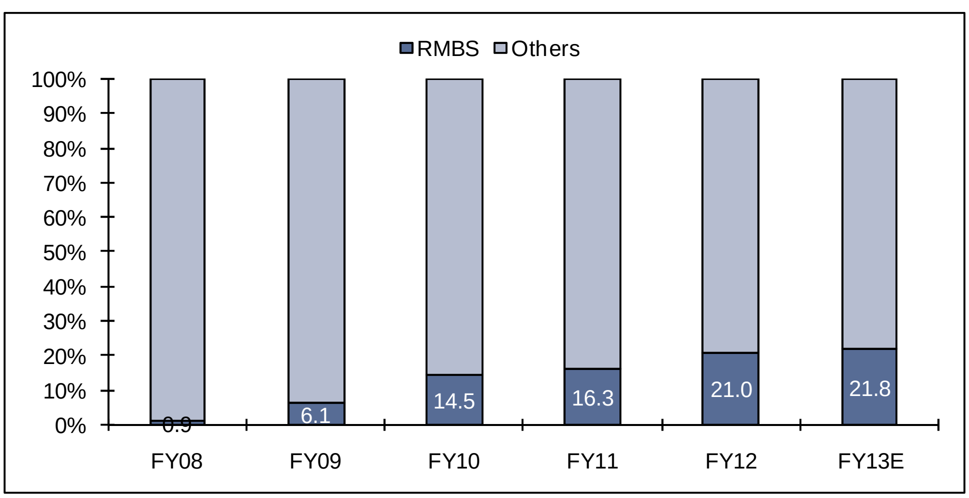
Source: Company data, I-Sec research

However, unless NHB really increases the size and scope of its refinance scheme, the importance of cost savings on the funding is reducing for the large players as displayed in the above charts while it remains a game changer for the smaller players like GRUH. This is especially true of rural housing financiers who have started the business in the last few years and currently face high operating costs due to lack of scale and small ticket-sizes and long gestation period for the product to gain acceptability and for asset growth to pick up.

RMBS – scope remains for lot more

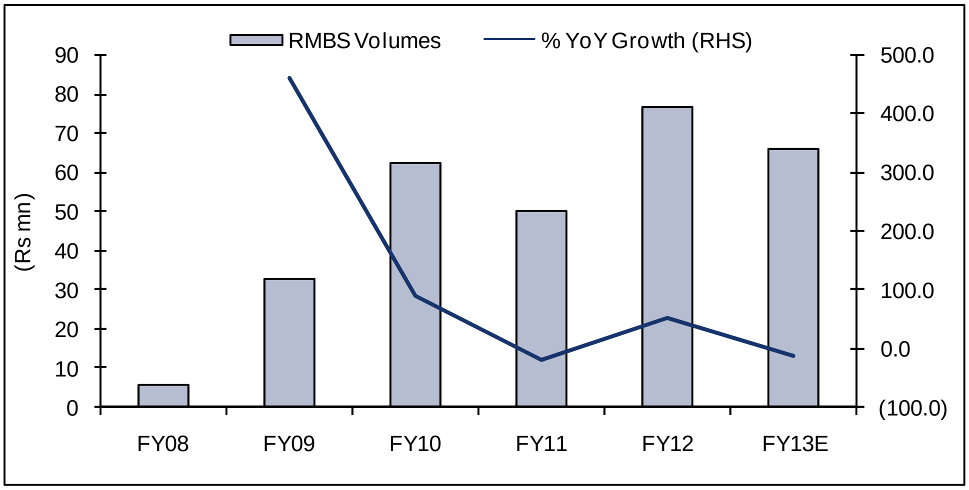
The securitisation route has proved to be a growth and margin driver for many large NBFCs with the lead being taken by commercial vehicle financiers. The housing finance market is much larger than the commercial vehicle finance market and, being an asset class with much less cyclicality in delinquencies and longer duration of assets, RMBS (residential mortgage-based securities) issuance should have outpaced CV loans securitisation or any other similar asset class. The only drawback we can see is more prevalence of pre-payments, but the end security may be structured easily to take care of the same through accelerated principal repayments.

Chart 31: RMBS volumes as a proportion of total securitisation volumes



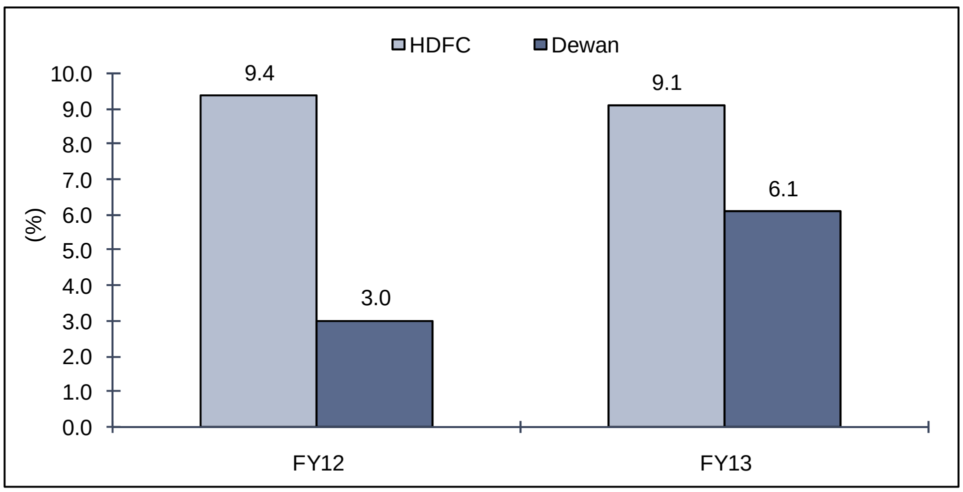
Source: ICRA, I-Sec research

Chart 32: RMBS volumes have remained steady for last few years



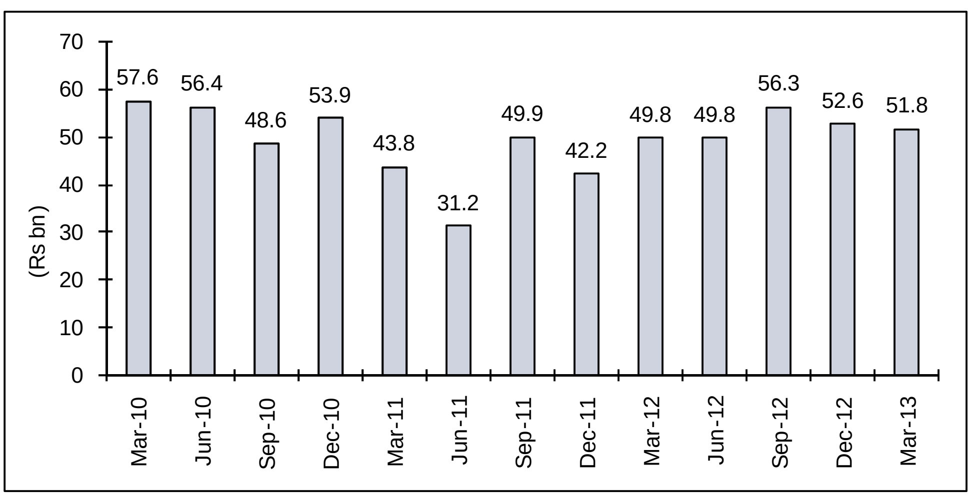
Source: ICRA, I-Sec research

Chart 33: Amongst our coverage HDFC and Dewan are biggest users of securitization/ sell-downs (as a proportion of total AUM)



Source: Company data, I-Sec research

Chart 34: HDFC sells down loans to HDFC bank on a steady basis



Source: Company data, I-Sec research

Some of the stumbling blocks in the path of RMBS transaction volumes increasing beyond priority sector classification driven transactions have been:

- As pointed out earlier, prepayments are a challenge in residential mortgages as an asset class because they create reinvestment risk for the investors. Repayments can be both cyclical and structural in nature, coming from a falling interest rate scenario or from rising income levels. The recent abolition of prepayment penalties is not likely to help in this aspect.
- Mortgage products being long duration in nature often do not suit most investors in securitised paper as their own investment horizons are shorter and if they sell before expiry, they run mark-to-market risks.
- There is no secondary market of consequence in securitized paper.
- Mortgages are floating rate assets and create dual risks for investors: the possibility of rate erosion, and dependence on the originator who determines the actual yield on the asset by resetting rates.

To understand why banks have been queuing up for securitised assets from NBFCs and HFCs at effective yields of 7-9%, it is important to look at the regulatory framework governing banks in India. Banks in the country have to allocate 40% of their Adjusted Net Bank Credit (ANBC) to specific sectors of high social relevance in India. Banks often have had challenging credit experiences in these sectors due to various operating constraints. The only assets that are safe are bonds issued by a few development authorities, but they offer poor yields.

Table 4: Shortfall in priority lending by banks – securitisation opportunity

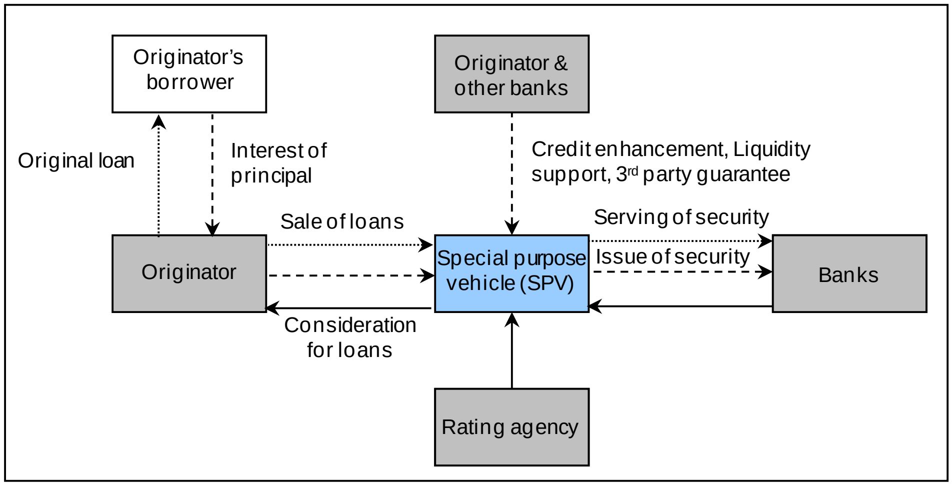
% of ANBC	Overall priority lending
Target	40.0
Public sector banks	37.2
Shortfall (Rs bn)	*851*
Private sector banks	39.4
Shortfall (Rs bn)	*44*

Source: RBI

Banks struggle to fulfil their asset quotas and desperation generally peaks near the closure of the financial year, the time when most securitisation deals fructify.

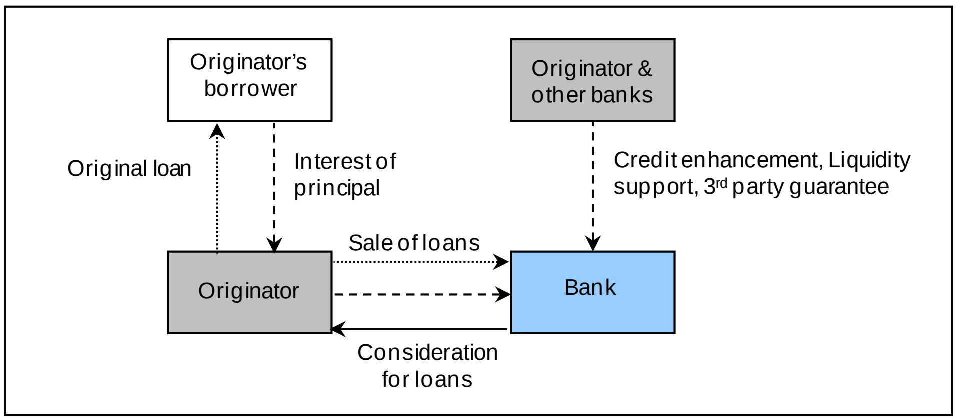
The two major structures that are used for these securitisation deals are PTCs and bilateral assignments. Here, we are loosely using the term securitisation, as a bilateral assignment is a loan sell-down and technically not a securitisation transaction. Also, for a securitised asset to be considered a priority sector asset, the RBI has mandated that the transactions be at par ('at par' means the initial consideration payable by the investor be equal to the face value of the loans, which implies that the spread earned by the originator comes entirely from future repayments). The basic structures of these two transactions are depicted in the following exhibits.

Chart 35: A typical securitisation structure (PTC route)



Source: I-Sec research

Chart 36: Illustration of direct assignment route



Source: I-Sec research

The key differences between the structure of PTC and that of bilateral assignment are as follows:

- In bilateral assignment there is no SPV (with a true sale-based ownership of all assets for pooling of all collections) that issues the securities to the investors (banks in this case) and routes the cashflow to them (banks).
- In bilateral assignment, the whole pool goes to one buyer while in a PTC, since securities are issued, there could be multiple investors with *pari passu* claims. Sub-ordinated structures have however not proved very successful in India with absence of investors with suitable risk appetite.

In a bid to curb the regulatory arbitrage enjoyed by NBFCs in the form of unlimited access to low-cost funding from banks in return for originating and selling priority sector loans, the regulator instituted a slew of regulations over the past 18 months. Multiple committees were set up to deal with securitisation and the regulator issued specific guidelines for securitisation on minimum holding period, minimum retention ratio and spread cap. Some other regulations that have been proposed but not accepted include cap on off-book loans (M.N. Nair Committee).

Table 5: Regulatory developments and their impact

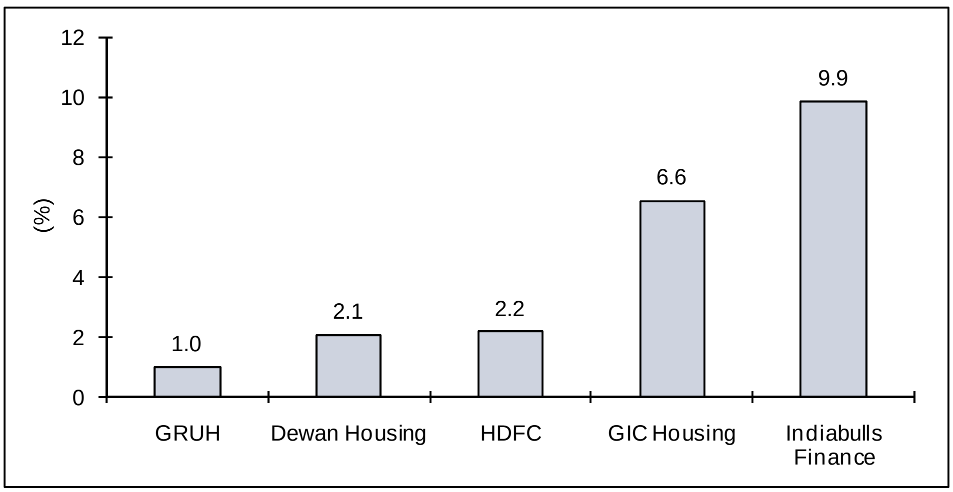
	Old norm	New norm	Impact on HFCs for RMBS
Minimum seasoning	No such holding period prescribed	12 months of holding period for originators (given monthly repayment and original maturity greater than 5 years)	Minimum impact – the underlying loan product has duration of 15-20 years
Minimum retention rate	No such retention requirement	10% of loan pool securitised	Minimal impact
Credit enhancements	Used to provide enhancements with no capital charge	No credit enhancements allowed on direct assignment. No such rule for PTC route.	Direct assignments: margins will decline sharply given the absence of credit enhancements Securitisation (PTC): volumes will increase as this becomes the preferred route over direct assignments
Interest rate cap on securitisation and direct assignment (eligibility as priority sector)	No end-user interest rate cap	End-user interest rate cap on individual assets in the pool: base rate + 800bps	Not of much consequence as yields are generally about 50-300bps above bank base rate

Source: RBI, I-Sec research

Commercial paper – an instrument for short-term liquidity

HFCs do resort to financing from commercial paper (CP) but given its duration of 1-6 months, it remains a source of marginal liquidity rather than a steady source of long-term finance. Also, given that CP rates are highly volatile and dependent on liquidity at the point of issue, such duration mismatch is not desirable even from a spread point of view.

Chart 37: Proportion of financing from CP for key players (FY13)



Source: Company data, I-Sec research

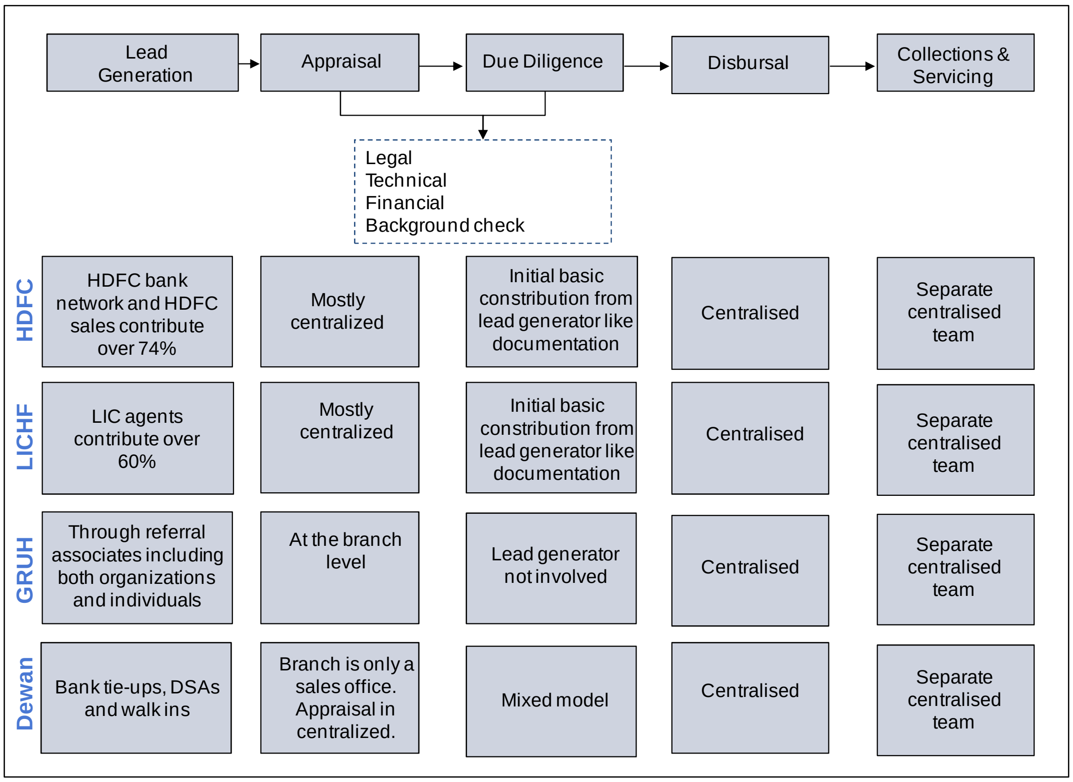
Foreign currency loans – hedging costs kill attractiveness

With the European bond markets going through a issuance boom and rates collapsing to multi-year lows, foreign currency loans apparently look like an attractive option for Indian players capable of raising loans at LIBOR+150-250bps, but a weak INR throws a spanner in the wheel. An INR/USD hedge today costs 550-600bps on an annual basis killing the attraction of the route. This may however make sense for niche players with high domestic cost of borrowings, as in foreign bond markets they may borrow at rates far closer to the leading domestic players than in the domestic market, thereby making the borrowing rates relatively economical for them. All this however is subject to regulatory approval.

A plethora of operating models

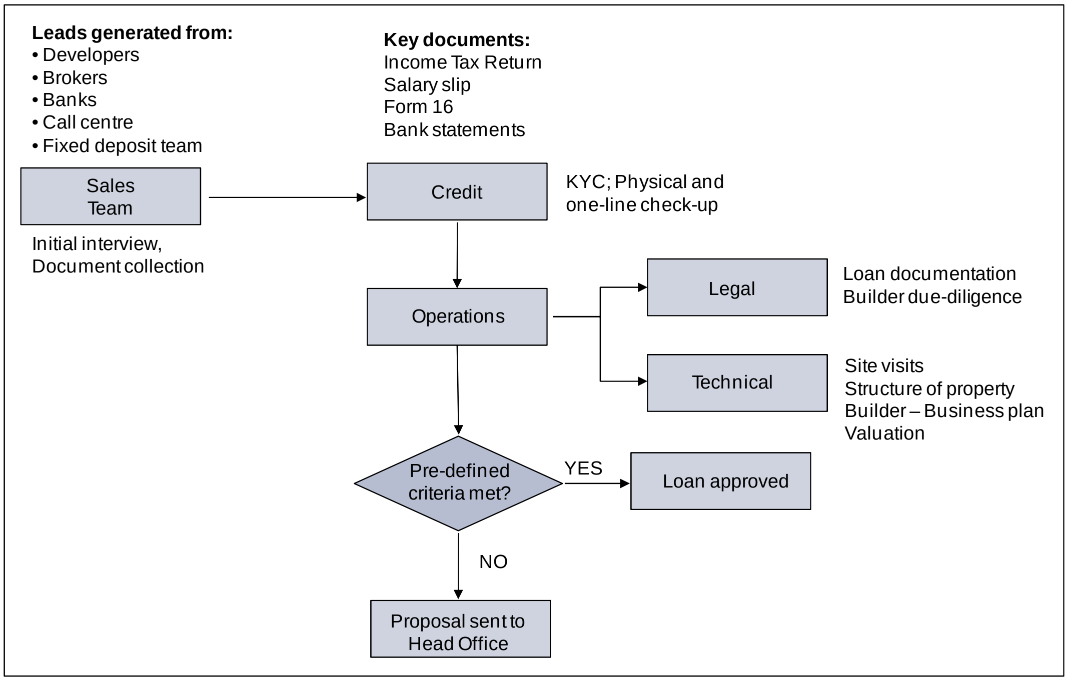
HFC operations are a reflection of organisational strength areas, key perceived operating risks, niche characteristics (for specialised players) and cost considerations. The following we believe is a fair representation of the operating model of an HFC:

Chart 38: Operating model – peer comparison



Source: Company data, I-Sec research

Chart 39: Flow of work for one typical proposal chart (Dewan Housing taken as an example)



Source: Company data, I-Sec research

Table 6: Key sources of lead generation

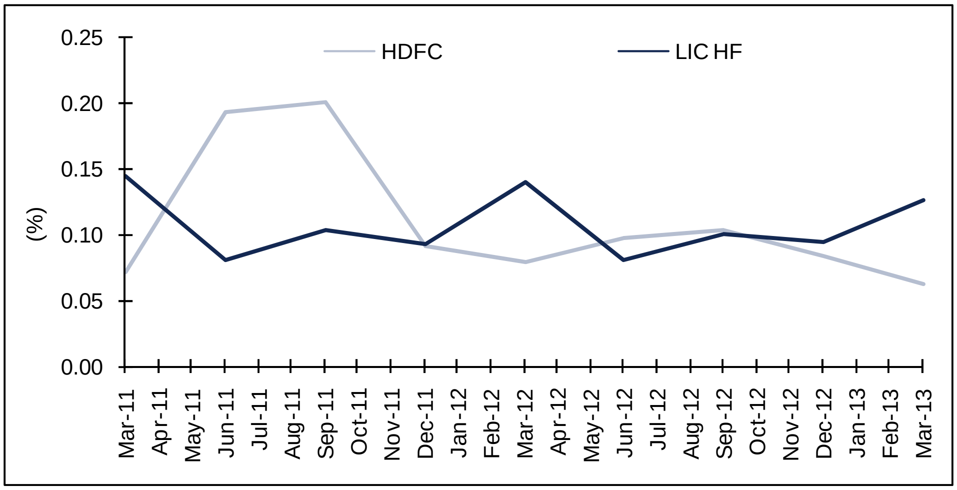
HDFC	HDFC Sales (46%), HDFC Bank (28%), DSAs (15%), Direct Walk-ins (11%)
LICHF	LIC Agents (60%), DSAs (20%), Own employees (11%), LICHFL Financial Services (4%), Walk-ins (5%)
Dewan Housing	DSAs, Direct Walk-ins, Partnerships with banks such as Bank of India, Punjab & Sind Bank and Central, Bank of India
GRUH Finance	Referral Associates

Source: Company data, I-Sec research

Operating cost structures have stabilised in most cases

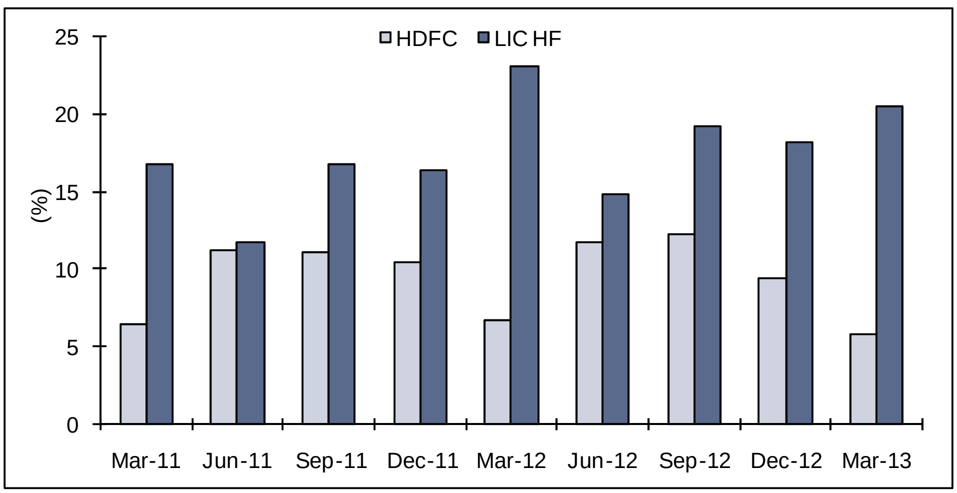
With the larger players like HDFC and LICHF being around for decades and having reached a large size, we feel the scope to significantly change the operating cost structure is limited unless revolutionary changes (like the lending process moving online) happen. There is only so much that small incremental efficiency gains can deliver in terms of cost savings. A quick look at the cost ratios of the major players indicates this stability.

Chart 40: HDFC and LIC Housing operating costs as a percentage of average AUM have stabilized…



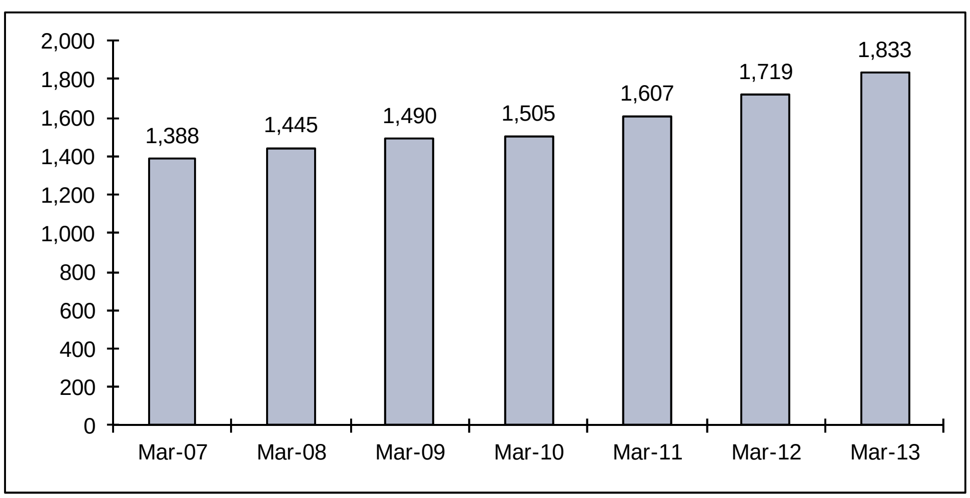
Source: Company data, I-Sec research

Chart 41: …as have cost to income ratios, with seasonal fluctuations on account of interest write backs



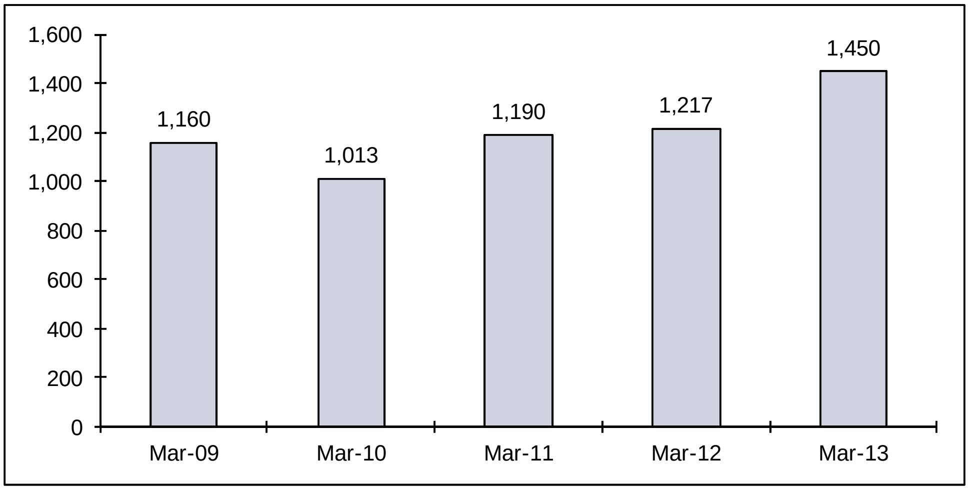
Source: Company data, I-Sec research

Chart 42: HDFC has been conservative in adding employees…



Source: Company data, I-Sec research

Chart 43: …as has been LIC Housing Finance



Source: Company data, I-Sec research

Regulatory environment stable despite new proposals

When one looks at the recent history of the sector, multiple regulations can be seen to have impacted it very significantly. The base rate driven regime for banks, have made bank borrowings all but infeasible on cost for players who operate in the mass market for plain vanilla mortgages to salaried individuals. Prepayment penalties have been abolished and this has created an environment for rate shopping, and we feel spreads will come down in the medium term as the gap between yields charged to old and new customers disappears. The Damodaran Committee recommended that the regulator makes sure that no interest rate differential is allowed between customers depending on vintage. There are many other areas like risk weights for calculating regulatory capital and deposit collection rights of housing finance companies which can attract potential regulatory scrutiny. Despite all this we feel that housing finance companies stand on solid ground and regulatory regime will remain supportive in developmental activities. The NHB refinance schemes and the various state and central government initiatives for rural and affordable housing finance reinforces our view that the sector remains a policy prerogative and de-stabilisation has high social costs.

No major regulatory arbitrage between HFCs and banks in our opinion

We do not feel that a very strong regulatory arbitrage exists between having HFC status and being a bank. The advantages that an HFC has are of course lesser disclosure requirements, no compulsion to maintain CRR and SLR, no priority sector investment stipulations, and fairly attractive refinance from NHB to a limited extent. But the biggest disadvantage vis-à-vis a banking platform is that they do not have a CASA franchise, which can reduce borrowing costs and insulate them from a liquidity squeeze that any wholesale-funded business is subject to and a tighter restriction on financial leverage. On balance, we feel that each player brings certain advantages to the table and there is no major regulatory endowment in favour of one or the other.

One rate for all vintages – does not look easy to implement

The Damodaran Committee report commissioned by RBI on customer services, stated the following on housing loans:

"In a floating interest rate scenario, when an entire class of borrowers has the same characteristic and risk level, the point of entry in time (old customers and new customers) should not create discrimination in interest rate offered to the customers. In such cases, the spread over the base rate should not vary when individual risk rating for loans is absent, as is usually the case in retail loans.

- *Housing Loan Foreclosure Charges: Banks should not impose exorbitant penal rates towards foreclosure of home loans and a policy should be devised to ensure that customer is not denied of opportunity to enhance his economic welfare by making choices such as switching to other banks / financial entities to enjoy the benefits conferred by market competition. Further, measures to stop practices of discriminating between new and old customers with identical risk profiles on the basis of interest rate offers, must also be initiated.*
- *Banks should automatically provide annual account statement to home loan customers without request from them. Such statements must contain details of payment made towards principal and interest including principal outstanding.*
- *All home loans should permit a switchover between fixed and floating or vice-versa at least once during its tenure at an appropriate and reasonable fee."*

Currently, HFCs charge in some cases almost a 150-200bps higher rate to their floating rate old customers versus the rates on offer for new borrowers. With prepayment penalties abolished, this spread is likely to gradually come under pressure. However, to impose a restriction absolutely equalising new and existing customer yields has a few practical execution road blocks.

- The housing finance business has an inherent asset liability mismatch as assets have original duration of 15-20 years with liabilities being most common unto a 5-year mark at issue (although 10-year paper is also issued). Rates on loans contracted today are in lieu of liability costs in the current environment (also determined by yield competition). To link all assets to these borrowing costs would mean that HFCs would also need their liabilities to reprice in order to have any visibility on spreads. Most wholesale debt market borrowings are fixed-rate in nature and hence do not reprice. Even if one argues that liabilities come up for refinance before the loan expiry, to monitor these granular details at a regulatory level bucket-wise and have an informed fairness opinion, is going to be practically impossible.
- There would be definite upward pressure on home loan rates for new finance, thereby defeating the developmental purpose of greater housing penetration through cheaper credit.
- It will be tricky to define 'same risk profile' and in our opinion will give a 25-50bps leg-room for maneuver in most cases.

No prepayment penalty – a definite incentive for rate shopping

Post the Damodaran Committee recommendations, the RBI abolished prepayment penalties on home loans for scheduled commercial banks with the NHB following suit for HFCs. As we have pointed out in our earlier discussion on the competitive environment, even if rate equalisation for new and old borrowers is not forcefully applied, the spread between the two rates are sure to go down as prepayment penalty abolition has made rate shopping so much easier for an existing borrower.

Tax policy facilitates housing loans at both corporate and individual level

Tax sops for borrowers lowers effective borrowing cost

There is a deduction of Rs100,000 on principal repayment and Rs150,000 on interest payment for a housing loan taken on a residential property, available for calculation of taxable income. In the recent Union Budget, for the current financial year, a further deduction of Rs100,000 for interest payments has been allowed for loans upto Rs2.5mn with residential properties not exceeding Rs4mn in value. These lower the effective costs of taking a housing loan.

Table 7: Calculation of effective interest rates

	1st year	**2nd year onwards**
Mortgage loan (Rs)	2,500,000	2,500,000
Interest rate (%)	10.0%	10.0%
Tenor (yrs)	15.0	15.0
Deduction on principal (Rs)	100,000	100,000
Max deduction allowed on interest (Rs)	250,000	150,000
EMI (Per annum) (Rs)	322,382	322,382
Principal component (Rs)	72,382	79,620
Interest component (Rs) (A)	250,000	242,762
Tax rate	33.0%	33.0%
Tax saved on the principal component (Rs) (B)	23,886	26,274
Tax saved on the interest component (Rs) (C)	82,500	49,500
Total tax saved on the deductible amount (Rs) (B+C)	**106,386**	**75,774**
Effective interest paid on the mortgage loan (B+C)-(A)	143,614	166,987
Effective interest rate (%)	**5.7**	**6.7**

Source: I-sec research

Under the Income Tax Act 1961, buyers can avail of the following tax benefits while purchasing a house through a mortgage loan:

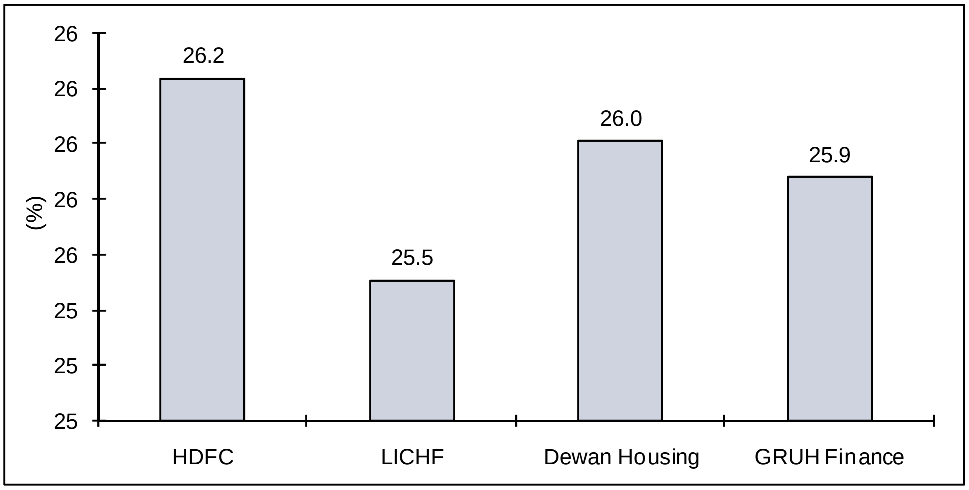
- Under Section 80C, repayment of principal amount of home loan by an Individual/Hindu Undivided Family (HUF) is tax deductible up to Rs100,000. However, this is inclusive of all other deductions allowed under Section 80C (i.e. Public Provident Fund, Long-term Fixed Deposits, ULIPs, etc).
- Under Section 24, tax deduction on payment of interest on a housing loan is allowable up to Rs150,000 per annum.
- In order to boost affordable housing in the country, the GoI introduced a new section 80EE during the FY2013-14 Union Budget. Under the scheme, first-time home buyers can available addition tax deduction of Rs100,000 provided the loan is sanctioned during FY14 (i.e. between 1-Apr'13 to 31-Mar'14). Also, the amount of housing loan should not be more than 2.5mn with the value of residential property capped at Rs4.0mn. Further, the buyer should not be owning any other house on the date of sanction of loan.

20% of the profits of a housing finance company are tax exempt

Section 36(1) (viii) of the Income Tax Act 1961, allows deduction in respect of special reserve created and maintained by a specified entity, an amount not exceeding 20% of the profits derived from eligible business (housing finance in this case) computed under the head "Profits and Gains of Business and Profession" (before making any deduction under this clause) carried to such reserve account. Provided that where the balance lying in special reserve account on the 1st day of the previous year exceeds twice the paid-up capital and general reserve of the specified entity, no allowance under this clause shall be made in respect of such excess. This means that the allowable deduction would be the lower of the following:

- Amount transferred to special reserve account created under Section 36(1)(viii)
- 20% of profits accruing from the eligible business
- 200% of the paid-up capital and general reserve as on the last day of the previous year minus balance lying in special reserve account on the first of previous year

Chart 44: FY13 tax rate chart for four HFCs under coverage



Source: Company data, I-Sec research

Credit Risk Guarantee Fund created to facilitate small ticket lending

The Credit Risk Guarantee Fund was launched in May 2012 by the Ministry of Housing and Urban Poverty Alleviation (MoHUPA) with the National Housing Bank (NHB) as the manager and facilitator of the fund. The scheme is effective from 21-Jun'12. The scheme offers multi-fold benefits to both the lenders and the borrowers. Transfer of credit risk to this fund leads to reduction in risk-weighted assets for the lenders easing the burden of managing the statutory capital adequacy ratios. Borrowers from low-income groups benefit by getting access to organised means of financing (at lower interest rates) which would normally not be available to them. Key highlights are as follows:

- This fund will provide credit risk guarantee to lending institutions for loans up to Rs0.5mn disbursed to new borrowers in the economically weaker and low-income categories in urban areas without any security of collateral or third party guarantee.
- Guarantee cover of 90% of the amount in default for loans up to Rs0.2mn
- Guarantee cover of 85% of the amount in default for loans above Rs0.2mn and up to Rs0.5mn
- Eligible lending institutions include commercial banks, regional rural banks, urban cooperative banks, NBFC-MFIs, HFCs and apex cooperative housing finance societies

Setting up a central asset transaction registry– a reform with potential structural benefits

The Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) has been established by the GoI for the registration of security interest over property, securitisation and asset reconstruction. This Central registry has been set up under the SARFAESI Act, 2002. The government has also notified SARFAESI (Central Registry) Rules, 2011, which contains the operative guidelines, applicability of fee for registration, etc.

CERSAI has been set up to prevent frauds involving multiple loans from different financial institutions against the same property. This kind of malfeasance is generally facilitated by creating multiple mortgages by deposit of title deeds as well as sale of property without disclosing the security interest over the property. The registry is operational since 31-Mar'11 and all transactions which are entered into on or after this date are required to be registered with it. Also, all transactions prior to 31-Mar'11 which are subsisting and related to mortgage by deposit of title deeds are required to be registered.

In the long run this reform may structurally improve credit penetration, reduce due diligence costs and build a database for sector level analytics.

Large secular opportunity, rural housing a niche

The housing finance sector in India is large with a current size of ~Rs7tn (~14% of total banking system). Despite this size, we see no risk of growth saturation in the medium term from an opportunity point of view. There are many socio-economic factors that drive this opportunity. We discuss some of these factors in detail in Appendix 1 (Pg 57). They are just listed below and are generally well documented.

- Population growth
- India's demographic dividend – growing proportion of people in an economically productive age group
- High savings rates
- Rising income levels leading to better affordability
- Rural prosperity and consumption
- Trend of formation of nuclear families
- Urbanisation

Policy thrust on affordable housing

In recent years, the Government of India and regulators (NHB and RBI) have stressed upon the need for easier and cheaper financing options especially in the affordable housing segment. Typically, banks and housing finance companies (HFCs) offer interest rate discount of 25bps for purchase of relatively cheaper housing units (normally loans less than Rs3mn per unit) primarily catering to customers in non-metro cities. During the past decade, there has been a secular rise in the quantum of housing units across the country on the back of a rising middle class, growing trend of nuclear families and aggressive foray by companies in the retail housing sector. This has meant that housing mortgages have become an important growth driver for NBFCs and banks alike. While the private sector banks were traditionally active in this segment, of late most PSU banks too have identified it as an important growth driver going forward (especially with SME and corporate financing plagued with rising NPAs and slowing growth). However, as we estimate in the following table the opportunity size remains large at Rs7.0tn at current prices.

Table 8: Potential financing opportunity in affordable housing pan-India

Housing finance opportunity calculation	
Housing shortfall (million units)	18.78
Average cost of an affordable house (Rs mn)	0.5
Loan-to-value ratio	75%
Average loan per house (Rs mn)	0.38
Total financing requirement (Rs bn)	**7,043**

Source: Panning Commission, RBI, NHB, I-Sec research

While there is no uniform definition of affordable housing in India, houses ranging from about 300sqft for Economically Weaker Sections (EWS), 500sqft for Low Income Group (LIG) and 600-1200sqft for Middle Income Group (MIG). EMIs at 30% to 40% of the monthly income of the buyer are generally considered as affordable houses in the country. The Ministry of Housing and Urban Poverty Alleviation (MoHUPA), uses the following household income criteria to define EWS and LIG:

- For EWS: Rs100,000 as household income per annum
- For LIG: Rs100,001 to Rs200,000 as household income per annum

Multiple central initiatives to support growth

In the past decade or so, the central and state governments have taken a plethora of initiatives to promote housing and housing finance in the country. Some of the key schemes being implemented by the GoI are as follows:

- **Indira Awas Yojana (IAY):** This scheme is targeted at BPL families by providing them cash subsidy to build low-cost houses. Funding is jointly provided by the central and state governments in the ratio of 75:25. Launched in 1998-99, the scheme intends to build 2mn additional houses subdivided into 1.3mn in rural areas and 0.7mn in urban areas.
- **Golden Jubilee Rural Housing Finance Scheme (GJRHFS):** This scheme was announced in 1997 to improve access to housing finance in rural areas. During 1997-2012, a total of ~35mn housing units were financed by HFCs, banks and cooperative sector institutions achieving 94% of the targeted 37.3mn units. The scheme has been instrumental in providing increased access to institutional credit in rural areas at the pan-India level.
- **Bharat Nirman**: This programme was launched in 2005 with the vision of accelerating infrastructure development (including housing) in rural areas. The scheme has been a success so far with ~7.2mn houses constructed in the first phase (2005-09) against a target of 6mn units. The scheme has been extended till 2014 with 12mn additional houses targeted to be built during 2009-14. The second phase is also progressing well with 9.5mn houses already built till Oct'12.

Apart from these some other major schemes/policies implemented by the GoI are as follows:

- **The National Urban Housing & Habitat Policy, 2007:** This policy aims to achieve affordable housing for all by promoting public-private partnerships.
- **Affordable Housing Partnership**: This scheme introduced by the GoI, envisages construction of 1mn houses for the economically weaker and low income households with total outlay of Rs5bn.
- **Jawaharlal Nehru National Urban Renewal Mission (JNNURM):** JNNURM was launched in Dec'05 with the aim of improving infrastructure facilities in urban areas across the country. The programme has been launched in 63 cities and also includes construction of houses in rural areas.
- **Rajiv Awas Yojana (RAY):** This scheme has been introduced with the objective of providing basic housing facilities to the urban poor and provides for funding assistance to states for implementing slum re-development and affordable

housing projects. During the 12th Five-Year Plan (FYP) period, the scheme is expected to be rolled over 250 cities.

- **Interest Subsidy Scheme for Housing the Urban Poor (ISHUP):** ISHUP scheme was launched in Dec'08 by the Ministry of Housing and Urban Poverty Alleviation (MHUPA), with the objective of making housing loans more affordable for low-income households. The scheme is implemented through banks and select HFCs, provides an interest rate subsidy of 5% per annum for loans up to Rs0.1mn during the entire duration of the loan (15-20 years). The NHB and Housing and Urban Development Corporation (HUDCO) act as the central nodal agencies for the implementation of the scheme.

Table 9: Subsidy claim under ISHUP

Rs mn

	FY2010	FY2011	FY2012
Amount of NPV of interest subsidy disbursed	3.7	34.1	34.8
No. of beneficiaries	531	4,611	3,403

Source: National Housing Bank, I-Sec research

- **1% Interest Subvention Scheme**: Introduced by the GoI on 1-Oct'09, the scheme provides for 1% interest subvention on individual housing loans up to Rs1.5mn with cost of unit capped at Rs2.5mn. The scheme is implemented through commercial banks and HFCs and is applicable across the length and breadth of the country.

Table 10: Subsidy amount disbursed under 1 % Interest Subvention Scheme

Rs mn

	FY2011	FY2012
Amount disbursed	385	3,000

Source: National Housing Bank, I-Sec research

State-level initiatives in housing are also helping

Recently, many state governments have also taken steps to make affordable housing a reality especially amongst the weaker sections of the society. Some of the initiatives taken by the major states are as follows:

- **Uttar Pradesh**: The UP Urban Housing Policy aims at encouraging cost-effective measures to make affordable housing a reality for EWS/LIG families. Under the policy, every EWS/LIG plot would also include the provision to set up a shop or a business unit.
- **Andhra Pradesh**: As per the Master Plan regulations relating to EWS/LIG housing, at least 5% of the developable land is to be reserved for EWS housing with maximum plot size of 50sqm. Additionally, 5% of the land has to be made available for LIG housing with maximum plot size of 100sqm. With regard to group housing projects, at least 5% of the total units would be reserved for EWS and LIG housing each with maximum plinth area of 25sqm and 40sqm, respectively.
- **Gujarat**: The Gujarat Town Planning & Urban Development Act (GTPUDA) provides for development of housing facilities on a public-private partnership basis. Re-development of slums is permitted for the rehabilitation of the urban poor.

- **Madhya Pradesh**: As per the Madhya Pradesh State Housing and Habitat Policy 2007, 30% of the developed land is to be reserved for EWS/LIG segments if the land has been provided by the government at concessional rates. Also, in case the land has been purchased by private/cooperative sector developers, 15% of it is earmarked for EWS/LIG housing.
- **Maharashtra:** Under the Maharashtra State Housing Policy 2007, the Mumbai Metropolitan Regional Development Authority (MMRDA) promotes small rental housing projects to be made available at reasonable rent. Such projects can be launched by a land owner, an MMRDA-approved agency or MMRDA itself as per various models formulated by MMRDA.
- **Rajasthan:** Under the Affordable Housing Policy 2009, the government targets to build 125,000 houses for the lower and middle income households over the next few years. Around 60% of the housing units would be constructed for the EWS/LIG section via PPP mode.
- **Kerala:** The Kerala Housing and Habitat Policy 2007, envisages eradicating homelessness and providing housing for 1.0mn families.

Shortfall in rural housing is another opportunity

Despite increasing urbanisation, rural population at over 68% of India's total population continues to be huge with significant housing requirements. As per the working group on rural housing for the 12th FYP, total shortfall in rural India stands at 43.7mn units, out of which 90% is on account of the Below the Poverty Line Population (BPL families). One of the main reasons behind this shortfall (apart from high poverty levels) is the lack of formal institutional financing mechanism and framework. As per the Planning Commission, only 9% of the rural households have sourced institutional finance to build their houses. We estimate the rural housing finance opportunity at Rs5.2tn at current prices.

Table 11: Rural housing shortage (2012 -2017)

Factors	Shortage (million)
No. of households without houses - 2012	4.2
No. of temporary houses - 2012	20.2
Shortage due to congestion - 2012	11.3
Shortage due to obsolescence - 2012	7.5
Additional housing shortage arising between 2012-17	0.6
Total housing shortage - 2012 to 2017	**43.7**

Source: Planning Commission, I-Sec Research

Table 12: Estimated financing requirement in rural housing

Total housing shortage (mn)	43.7
Average cost of rural house (Rs mn)	0.15
Loan-to-value ratio	80%
Average loan per house (Rs mn)	0.12
Total financing requirement (Rs bn)	**5,244**

Source: Planning Commission, I-Sec Research

State government schemes for rural housing are aplenty

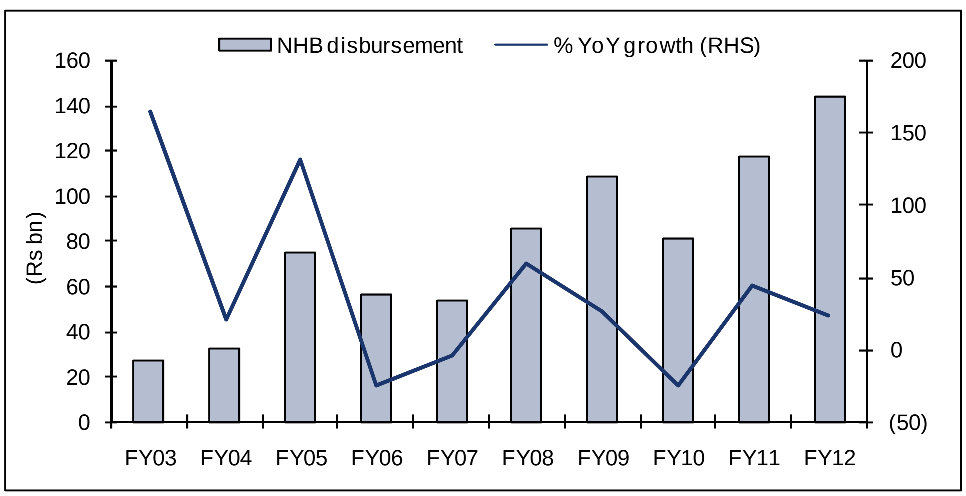
More than 15 states have separate rural housing schemes and during the 11th FYP period (2007-12), 3mn houses were built under the various state governments' schemes. Some of the important schemes run at the state levels are as follows:

- **Tamil Nadu**: The Kaliagnar Housing Scheme (KVVT) introduced in 2010 aims to replace all temporary houses in rural areas by permanent construction.
- **Kerala**: Under the EMS housing scheme, financial assistance of up to Rs125,000 is provided to poor families from the backward communities.
- **Gujarat**: The Gujarat government had introduced nine housing schemes complementing the IAY. In 2009, the local government decided to bring all the different schemes under one fold with uniform financial assistance of Rs55,000.
- **Karnataka:** The government runs two different schemes ("Basava Vasathi Yojane" and "Ambedkar Housing Scheme") targeted at special occupational groups and economically weaker sections. Under both the schemes, the total financial assistance is capped at Rs63,500.
- **Rajasthan:** As a complementary scheme to IAY, in 2011 the "Mukhya Mantri Gramin BPL Awaas Yojana" was launched with the objective of providing 1.0mn houses to rural BPL families over a course of four years. The state government has arranged a loan of Rs34bn from HUDCO to finance the scheme.

Refinancing from National Housing Bank (NHB) is an enabler

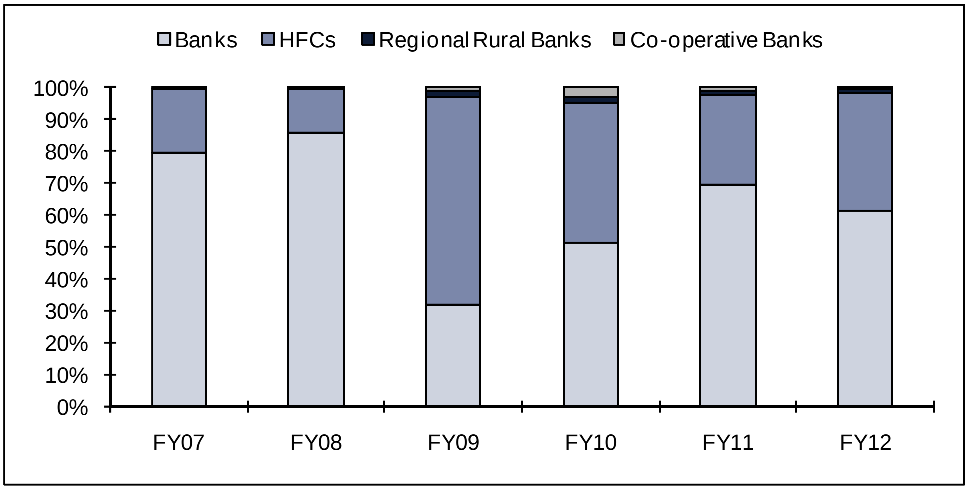
Banks and the larger HFCs have been the biggest beneficiaries of NHB's refinance facility. Recently, the smaller niche-focused HFCs have also started tapping the facility given their strong growth trend and healthy operating profile. On the other hand, disbursements to the cooperative sector has witnessed a declining trend given the losses experienced by individual institutions making them ineligible for NHB refinance.

Chart 45: Trend in NHB refinance disbursements



Source: NHB, I-Sec research

Chart 46: NHB refinance – disbursement mix (%)

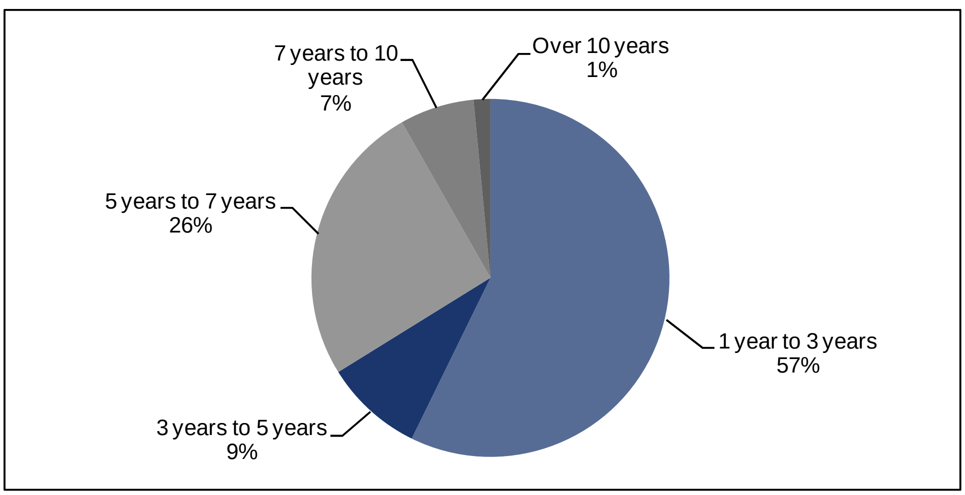


Source: NHB, I-Sec research

Nature and key features of NHB disbursements

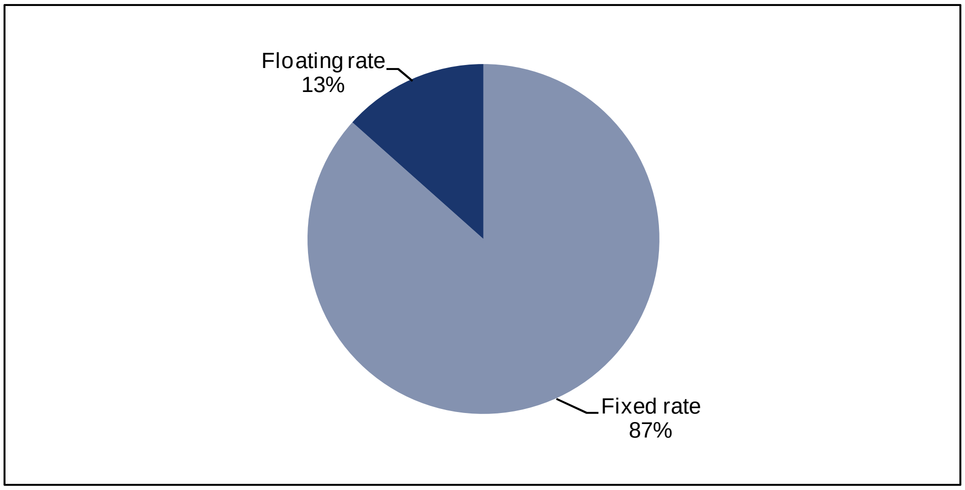
As we have outlined in the first section, NHB refinance remains pretty lucrative for HFCs in cost terms (100bps advantage for an average borrower). Refinance available from NHB is primarily of medium term duration with approximately ~66% of disbursements in FY12 falling under the 1 to 5 year maturity bucket. However, it is to be noted that majority of the incremental housing loans disbursed by banks and HFCs is on floating rate basis, leading to some ALM mismatch on an overall basis. Given that interest rates are expected to decline in India going forward, this ALM structure may lead to some spread compression as loans re-price at lower interest rates while NHB refinance is tied up at a fixed rate of interest. However, the major mitigating factor is that housing loans disbursed in the rural areas can be refinanced at significantly lower interest rates.

Chart 47: Tenure wise break-up of NHB refinance disbursements (FY12)



Source: NHB, I-Sec research

Chart 48: Interest rate wise break-up of NHB refinance disbursements (FY12)

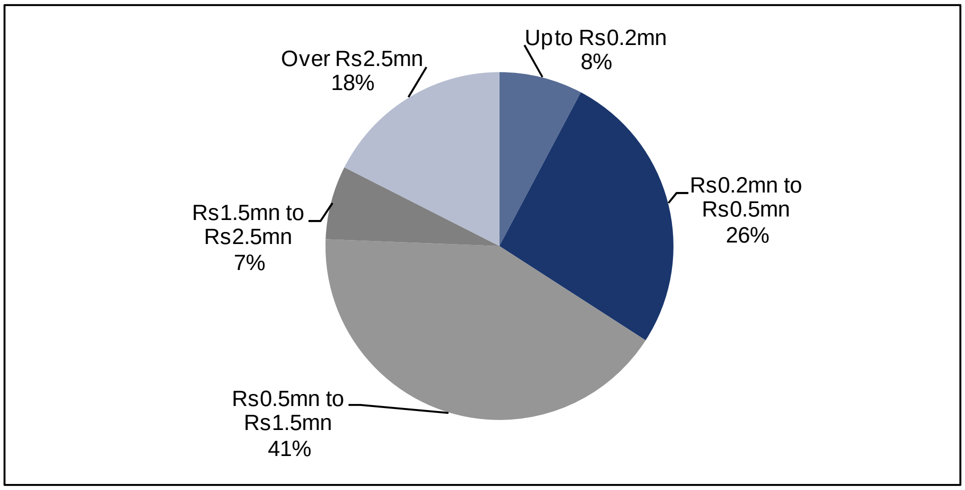


Source: NHB, I-Sec research

Majority of refinance available against small-ticket loans

In FY12, ~34% of the NHB refinance disbursements were for loans with ticket-size of less than Rs0.5mn while loans with ticket-size of Rs0.5mn to Rs1.5mn contributed an additional 42%. This implies that majority of the NHB refinance is for small to medium ticket-size loans, mainly in the non-metro areas.

Chart 49: Breakdown of NHB disbursements –ticket-size

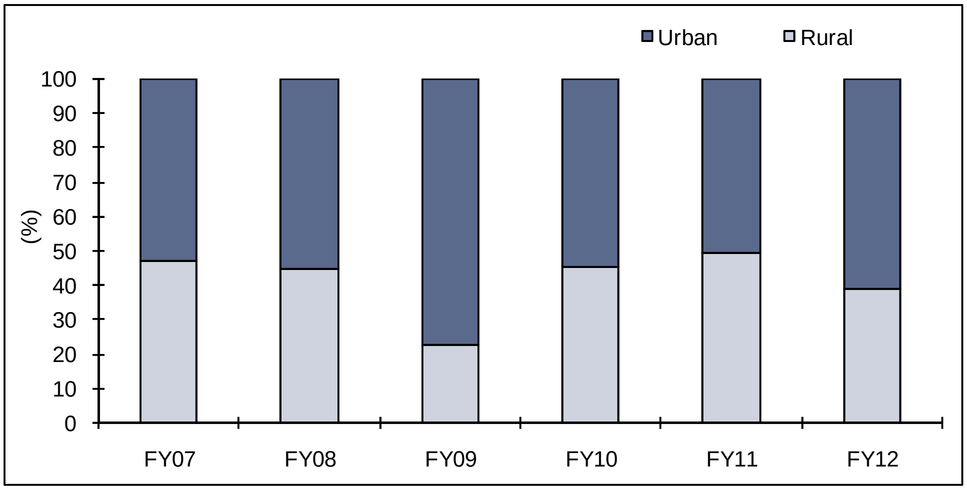


Source: NHB, I-Sec research

Urban areas have started dominating NHB refinance disbursements in FY12

NHB's refinance disbursement mix in terms of urban and rural areas has remained fairly stable over the past few years. In FY07, urban areas constituted ~53% of total disbursements and in FY12, it increased to ~61%. One reason behind this increase could be the change in classification of the earlier rural areas to urban areas during the period. However, the mix has not been so steady over the years, hence drawing any conclusion on the same may be far-fetched at present.

Chart 50: Significant proportion of NHB refinance remains rural



Source: NHB, I-Sec research

Refinance disbursements under the Rural Housing Fund (RHF) has been increasing

In FY09, the GoI announced the setting-up of Rural Housing Fund (RHF) so as to enable the lending institutions to on-lend to the targeted groups in the rural areas at concessional rates of interest. The financing can be for purchase/construction/repair and upgradation of housing units. Launched with an initial allocation of Rs17.8bn in FY09, the fund has seen allocation increased to Rs60bn in the (FY14) Union Budget. Approximately 0.4mn rural families have availed of the loans under this facility so far.

The key features of the refinance scheme under the RHF are as follows:

- Rural area is defined as any area whose population is less than 50,000 as per the 1991 Census
- ‘Weaker section’ means and includes:
  - Farmers with land-holdings of less than 5-acres, landless labourers, tenant farmers and share croppers
  - Women
  - Scheduled Castes and Scheduled Tribes
  - Individuals classified under ‘Below poverty Line’ (BPL) or marginally above it, i.e. eligible for loans under the Swarnjayanti Gram Swarozgar Yojana (SGSY) and Differential Rate of Interest (DRI)
  - Persons from minority communities
  - Rural households with annual income up to Rs0.2mn. Loans up to Rs1.5mn is eligible for refinance and the refinancing should be for a minimum period of three years and maximum of seven years

Refinancing under the RHF scheme is for fixed rates and the applicable rates of interest (as of 30-Jun'12) are as follows:

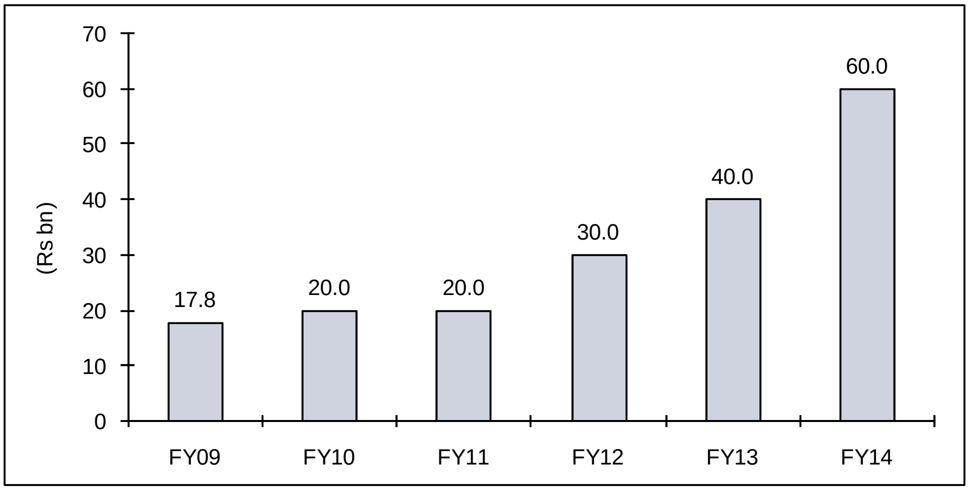
Table 13: RHF refinance rates

	Interest rate (% p.a.)	
Slab –wise	**Banks, HFCs and cooperative sector**	**Regional Rural Banks**
Loans up to Rs0.2mn	6.50	6.25
0.2mn to Rs0.5mn	7.00	6.75
Rs0.5mn to Rs1.5mn	7.50	7.25

Source: NHB, I-Sec research

The RHF scheme has been a success with steady increase in allocation and utilisation. Allocations to the fund from the Union Budget have steadily risen from Rs17.8bn in FY09 to Rs60bn in FY14.

Chart 51: Increasing allocation to the Rural Housing Fund



Source: NHB, I-Sec research

Importantly, utilisation from the fund has been ~100% since inception with HFCs been the major beneficiaries. During FY09 to FY12, around 0.34mn houses were financed under the scheme.

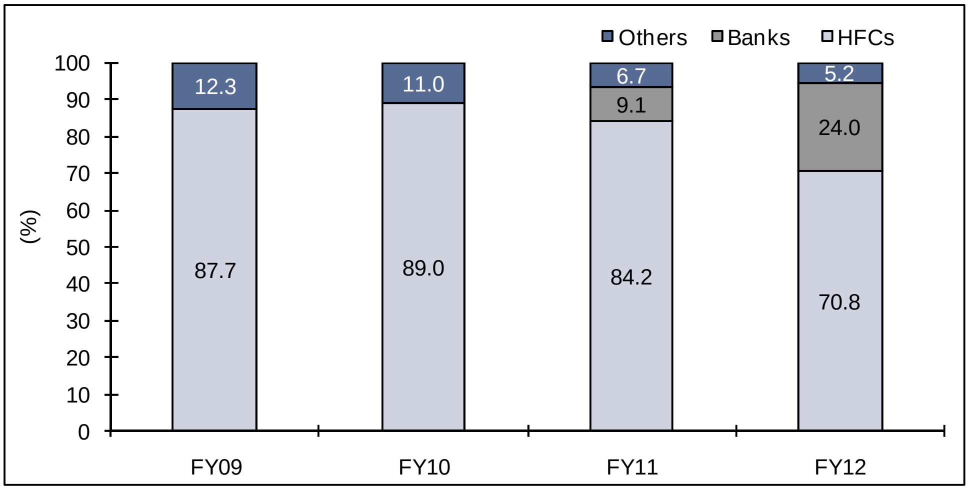
Table 14: NHF – Utilisation

(Rs bn)

		Utilisation						
Fiscal Year	**Allocation (Rs bn)**	**Housing Finance Cos.**	**Commercial Banks**	**Urban Co-operative Banks**	**Regional Rural Banks**	**Others**	**Total**	**No. of units (mn)**
2009	17.8	15.4	0.0	0.2	2.0	0.0	17.6	0.10
2010	20.0	17.9	0.0	0.0	1.8	0.3	20.2	0.07
2011	20.0	16.9	1.8	0.0	1.3	0.0	20.0	0.04
2012	30.0	21.3	7.2	0.1	1.4	0.0	30.0	0.13
Total	**87.8**	**71.5**	**9.0**	**0.3**	**6.6**	**0.3**	**87.8**	**0.34**

Source: NHB, I-Sec research

Chart 52: NHF – Utilisation (%)



Source: NHB, I-Sec research

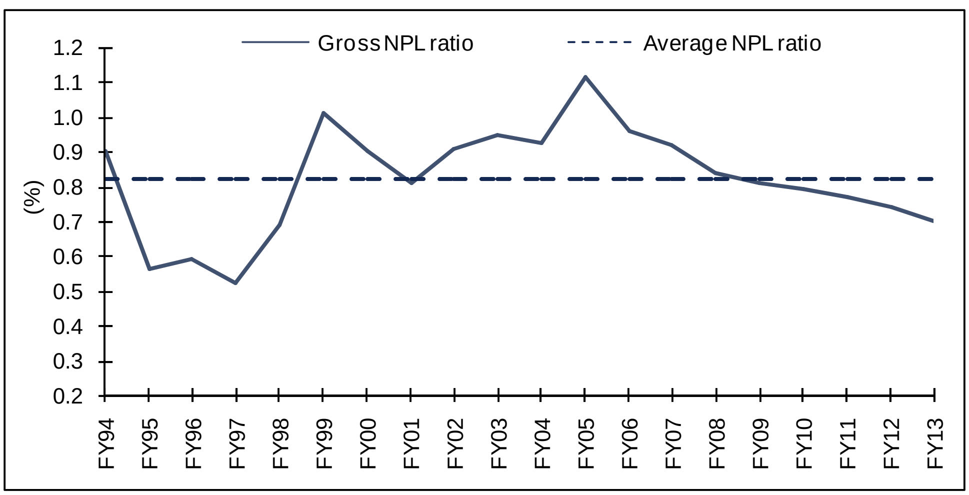
Asset quality concerns moderate, wide valuation divergence

Housing finance has a had a tremendous long term credit track record

The Indian housing finance sector has been a model amongst most asset classes as far as delinquency track record is concerned. This behaviour contrasts with the experience of prominent developed markets (the US housing bubble burst being a prominent example). There are many structural reasons behind this track record and much prudence on the part of Indian lenders in forming credit policies.

- The mass market of Indian housing finance essentially finances first home purchases of salaried individuals. In these cases, income verification is easier and affordability can be judged transparently.
- Even before the regulation came in LTVs have never been very aggressive for Indian players and there have been tight controls on EMI/income ratio.
- Top ups have not been allowed with the borrower being dis-intermediated from actually handling his borrowings with cheques going in the name of developer or seller.
- Loan against property (LAP) is a recent phenomenon and is done at conservative LTVs.
- Even in the downturn of 1996, HDFC, the leading HFC suffered limited losses on account of tightened policies and slower growth as the market started to overheat.

Chart 53: HDFC – Asset quality has been pristine across economic cycles

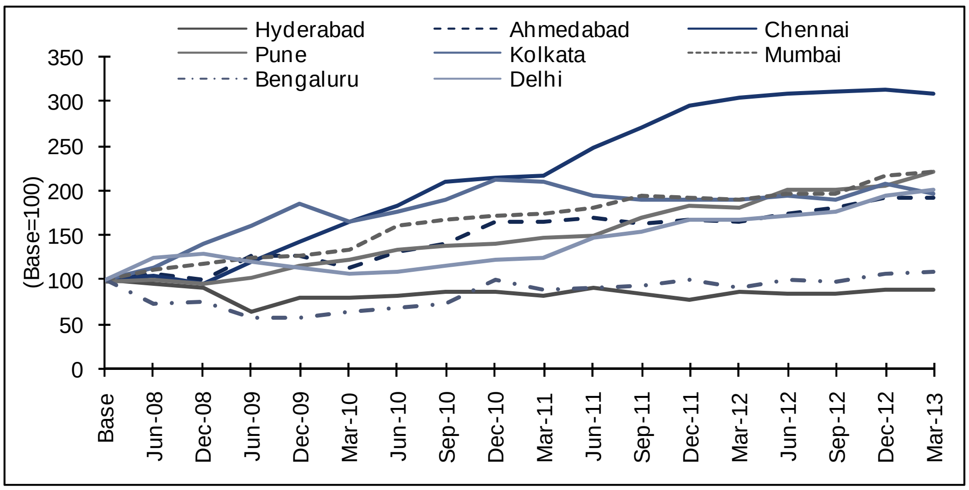


Source: Company data, I-Sec research

Housing price index movement does betray some concern of overheating in pockets

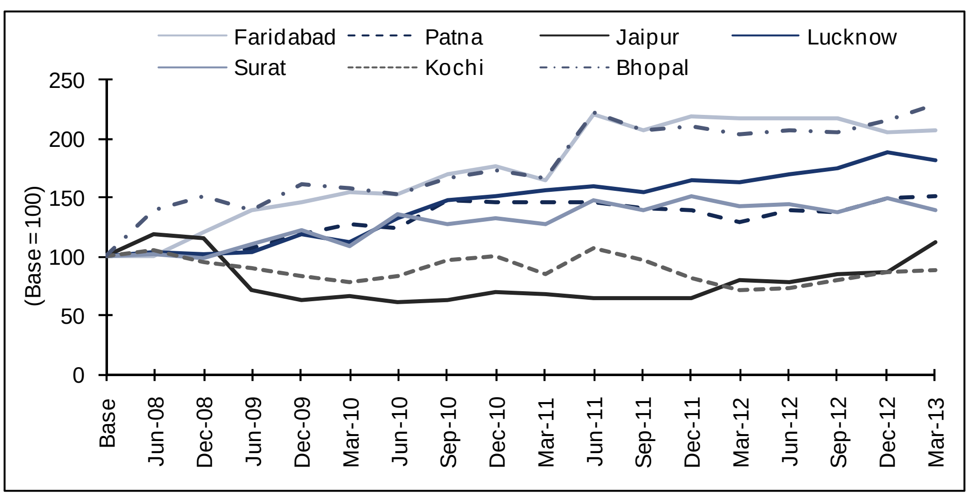
Real estate and housing prices have continued to move northward across the country in the past decade or so. While the larger cities such as Mumbai and the National Capital Region (NCR) have witnessed strong price increase historically, many of the other larger cities such as Chennai, Ahmedabad and Pune have been significant price appreciation in the past 5 to 6 years, despite the overall economic environment remaining soft during much of this period. Also, despite many real estate developers and builders facing high leverage levels and cashflow constraints, housing price levels continue to remain steady.

Chart 54: Housing price index for metros show large jumps



Source: NHB, I-Sec research

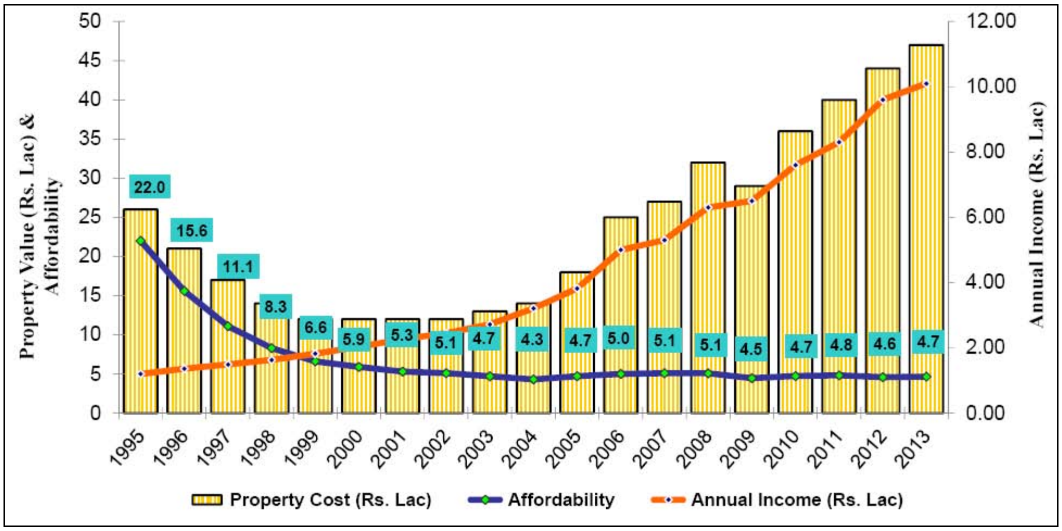
Chart 55: …other large cities are not far behind



Source: NHB, I-Sec research

Overall housing demand is expected to remain robust in India from a medium to long term perspective given the low household debt levels, significant household savings capability and culture, expected decline in interest rates, growing urbanisation and trend toward nuclear families. Also, given that prices have not corrected in the recent years, gives housing a safe haven tag in the country and lends a natural support to prices.

Chart 56: Affordability has remained steady in last few years



Source: HDFC presentation

Commentary from prominent housing market experts have turned decidedly hawkish in recent times. We agree and share their concerns of overheating in pockets but do not see a problem big enough to create serious affordability issues or moral hazard for a salaried first home buyer.

Wide valuation divergence

A quick comparison of the companies based on our chosen valuation metric P/BVPS shows the wide gulf in multiples accorded by the market to the four businesses. Bringing RoE to the context provides some explanations but even adjusted for the same we see quite a few opportunities for re-rating on a relative basis.

Chart 57: Valuation matrix - EPS CAGR (FY13-15E) vis-à-vis FY14E P/E

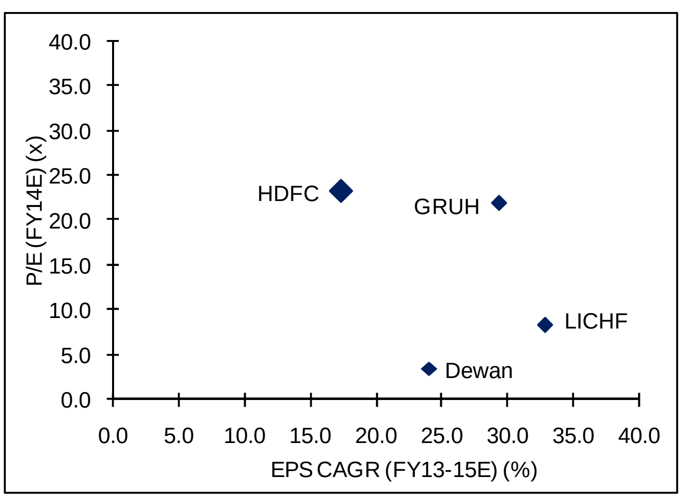
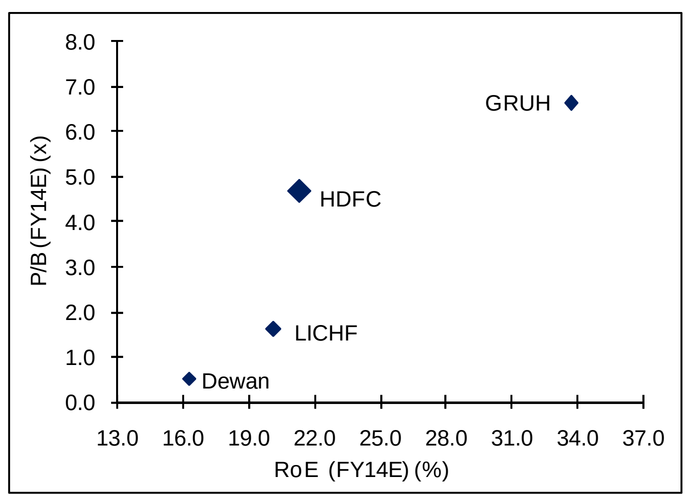


Chart 58: Valuation matrix – FY14E RoE vis-à-vis FY14E P/B



Source: Bloomberg, Company data, I-Research . Market data as of July 5, 2013

Table 15: HFC peer comparison matrix

	Price (Rs)	Market Cap (Rs bn)	P/E (x)			P/BV (x)			RoE (%)			EPS CAGR (%) (FY13-15E)
			FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	
HDFC	850	1,321	27.2	23.3	19.7	5.3	4.7	4.1	22.0	21.3	22.2	17.3
LIC Housing	233	118	11.5	8.3	6.5	1.9	1.6	1.3	16.8	20.1	21.5	32.9
Gruh Finance	229	41	28.1	21.9	16.8	8.4	6.6	5.2	33.3	33.7	34.6	29.4
Dewan Housing	152	19	4.3	3.5	2.8	0.6	0.5	0.5	17.1	16.3	17.5	24.1

Source: Bloomberg, Company data, I-sec research . Market data as of July 5, 3013

Target setting and recommendations

We have tried to stay away from pair trade ideas and used a simple framework to accord target multiples to each of the companies on an absolute basis and decide recommendations accordingly based on available upsides on a 12 month basis. Our framework to ensure that our individual biases do not creep into this exercise is pretty simple. We have tried to hazard a guess at the sustainable RoE of the company, and then checked how much it is in excess of a cost of equity of 14%. We feel that the P/B target multiples of the businesses should be in the same ratio as the earning power in excess of cost of equity. Of course we have made adjustments for balance sheet structure and we detail them individually for each company.

We recommend ADD in HDFC with a TP of Rs900

Our first endeavour in HDFC was to figure out what the core RoE of HDFC's lending business was as we have valued the subsidiaries separately. The following calculation shows that core RoE is close to 300-500bps higher than reported ones depending on the year we are looking at with the difference being the least currently.

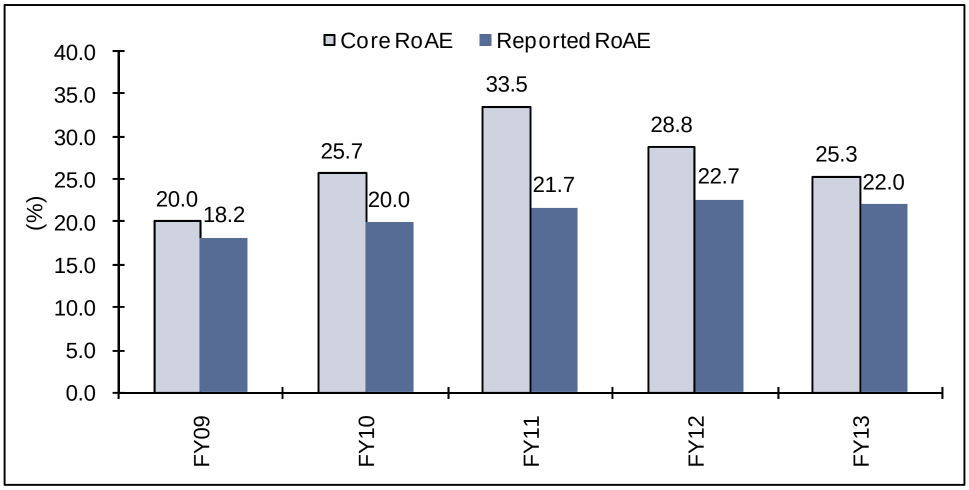
Table 16: Core RoE of HDFC

(Rs mn)

	FY09	FY10	FY11	FY12	FY13
Reported PAT	22,825	28,265	35,350	41,226	48,483
Less: Dividend from subsidiaries	1,082	970	837	1,482	2,694
Add: Tax adjustment @27%	292	262	226	400	727
Core PAT	22,035	27,557	34,738	40,144	46,517
Core book value (book value less investment in subsidiaries)	1,18,298	96,470	1,10,825	1,68,186	1,99,426
Core RoAE (%)	**20.0**	**25.7**	**33.5**	**28.8**	**25.3**
Reported RoAE	**18.2**	**20.0**	**21.7**	**22.7**	**22.0**

Source: Company data, I-Sec research

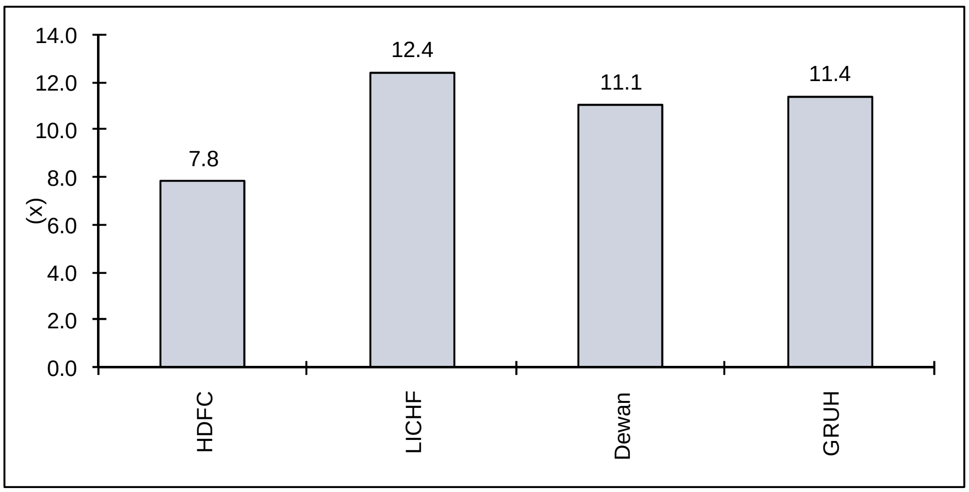
Chart 59: HDFC – Core RoAE much higher than reported



Source: Company data, I-Sec research

Another factor that should be borne in mind when looking at this RoE is that the leverage of HDFC is lowest amongst all the peers by a margin of ~30%.

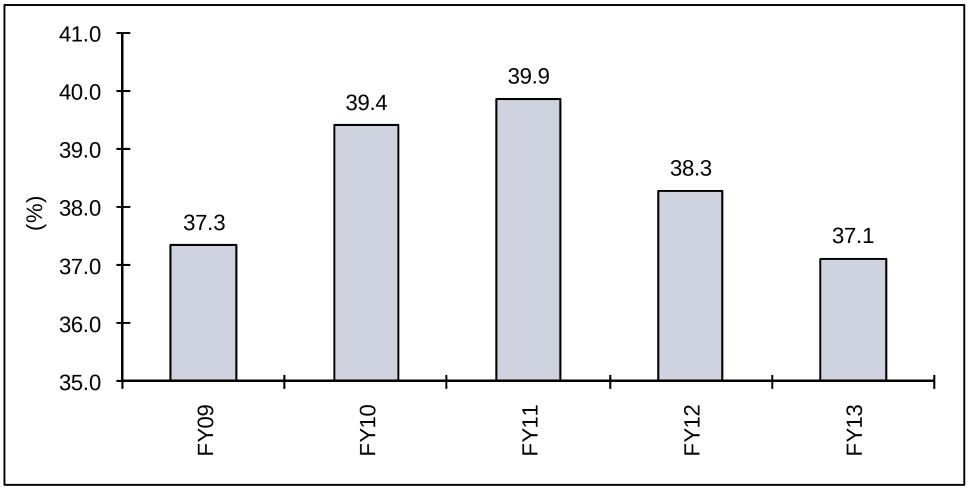
Chart 60: HDFC leverage much lower than peers



Source: Company data, I-Sec research

We understand that such a gap cannot be closed too fast and the company may actually never choose to do so as well (given its systemic importance, prudent outlook and large size). But the healthy payouts reveal that HDFC is also conscious of its financing structure.

Chart 61: Payouts remain high for HDFC



Source: Company data, I-Sec research

We believe that with no major pressure on spreads (apart from long term issues for the sector outlined earlier), HDFC will continue to get valued based on a core RoE of around 28-30% (300-400 bps higher than current core RoE, possible at same RoA with only 1x increase in leverage). Going by our simple yardstick of approximately 1x premium in P/B for every 600bps premium earned over the base CoE of 14%, we arrive at a 1 yr fwd multiple of 3.5x for the core business as fair.

Using this following SOTP calculation sets our target price for HDFC at Rs900 (rounded off). This indicates 6% upside on a 12 month basis. Our recommendation is ADD.

Table 17: SOTP table

Subsidiary/Associate/JV	Stake (%)	Basis	Multiple (x)	Total valuation (Rs mn)	Per share value (Rs)	Year
HDFC Bank	22.8	Target Price	723	3,92,749	254	FY15E
HDFC Standard Life	72.4	NBAP	13.0	91,234	59	FY15E
HDFC ERGO General Insurance	74.0	Book Value	1.0	7,215	5	FY15E
HDFC AMC	59.8	AUM	5.0%	36,807	24	FY15E
HDFC Venture Capital	80.5	AUM	7.0%	998	1	FY15E
GRUH Finance	59.7	Target Price	222	23,650	15	FY15E
Investments in other subs & associates		Book Value	1.5	5,820	4	FY13
Core Mortgage Business		Book Value	3.5	8,31,383	538	FY15E
Total SOTP Valuation (Rs)					**900**	

Source: Company data, I-Sec research

We recommend BUY in LIC Housing Finance with a TP of Rs360

In LIC Housing Finance we believe that sustainable RoE is close to 20%, the last two years profitability aberration not withstanding (detailed in company report). Accordingly our target 1 yr fwd P/B multiple for LIC Housing Finance in 2x. This leads to a target price of Rs360 indicating 55% upside on a 12 month basis.

We recommend REDUCE in GRUH Finance with a TP of Rs222

GRUH Housing is currently earning a RoE of ~33% and we feel that this can easily sustain for the next few years. Going by our simple yardstick of approximately 1x premium in P/B for every 600bps premium earned over the base CoE of 14%, we arrive at a 1 yr fwd multiple of ~4.2x for the core business as fair. However, that fact remains that GRUh remains one of the best managed secular growth stories in India that could potentially add value to current shareholders by expanding the equity base multiple times over the next decade if it chooses to accelerate growth. We feel that a growth premium of 20% is therefore warranted. Thus our target multiple is 5x. Our target price is Rs222 indicating 3% downside on a 12 month basis. We recommend REDUCE.

We recommend BUY in Dewan Housing Finance with a TP of Rs350

The first adjustment one needs to make in Dewan Housing Finance while setting a price target is to deduct the intangibles from its shareholders funds. The calculation for tangible book value per share is shown below.

Table 18: Tangible BVPS per share calculation (FY15E)

	FY15E
Shareholders' equity (Rsmn)	43,023
Shareholders' equity per share (Rs)	*334*
Goodwill (Rsmn)	5,171
Goodwill per share (Rs)	*40*
Tangible BV (Rsmn)	**37,852**
Tangible BVPS (Rs)	**294**

Source: Company data, I-Sec research

We feel that unless Dewan economises on operating costs, sustainable RoE will stay at around 17%. However, we must point out that there are many levers for improvement in this number. Going by our simple yardstick of approximately 1x premium in P/B for every 600bps premium earned over the base CoE of 14%, we arrive at a 1 yr fwd multiple of 1.5x for the core business as fair. However, taking cognizance of the negative press that the company has received and current risk aversion in the markets, we give a 20% haircut to this for prudential purposes, arriving at a target multiple of 1.2x. We believe this discount will gradually narrow in the absence of adverse newsflow. The target price of Rs350 indicates a frankly outlandish return potential of 131%. However, a word of caution here will be that it is clear that the stock is suffering from investor apathy, and unless those sentiments change economic rationality may take a back seat.

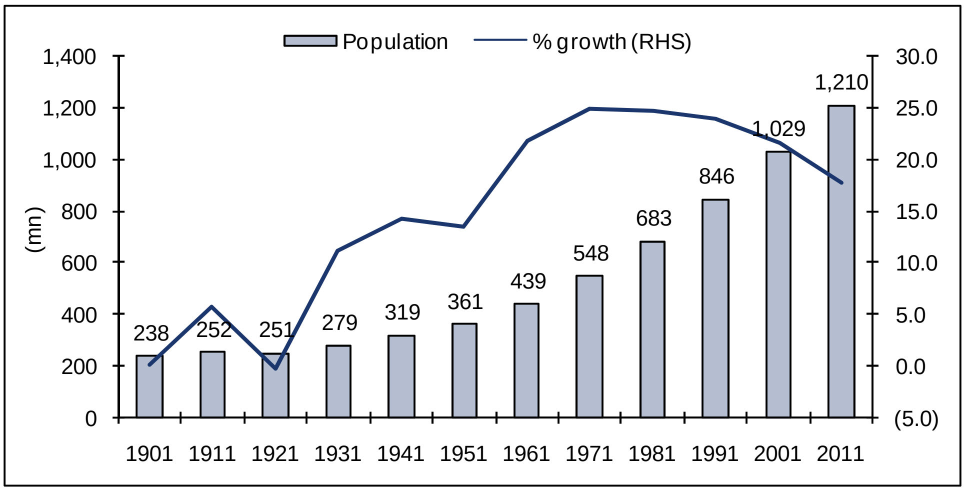
Appendix 1

Multiple socio-economic factors support the housing finance growth opportunity

Population growth, albeit declining, continues to be significant

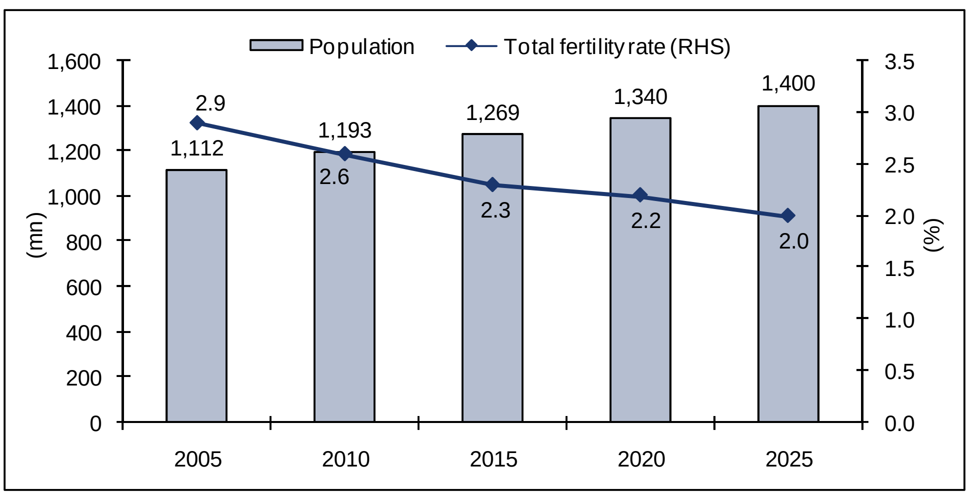
As per the 2011 Census, the total population of India has crossed 1,210mn, witnessing net additions of 181mn during the decade of 2001-11. This implied decadal growth of 17.6%, much higher than the 5.4% growth seen by China (the world's most populous country), was also marginally higher than the 13.0% increase in world population during this period. It is to be noted that while the decadal growth rates are coming down, in absolute terms the additions in total population growth continues to be significant given the large base. The total population is expected to reach 1,400mn by 2025, i.e. witnessing decadal growth of 10.3% or net additions of 131mn, during 2015-25.

Chart 62: Growth in India's population



Source: Census 2011, I-Sec research

Chart 63: Expected population growth and fertility rates

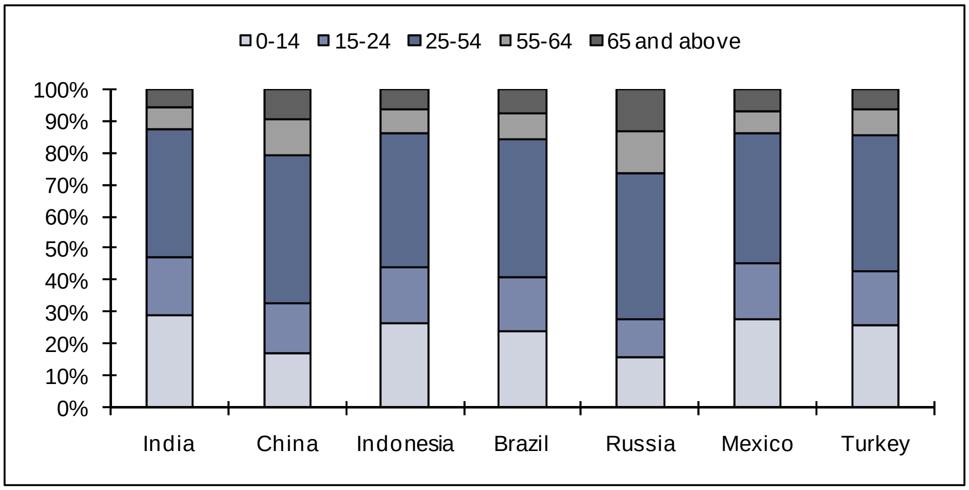


Source: Census 2011, I-Sec research

India's demographic dividend

Amongst the major emerging markets, India has the largest proportion of population in the age bracket up to 14 years. This represents the population which would be entering active workforce in the next 10 to 20 years. Also, population over 55 years of age comprising ~13% of total population is the lowest amongst peers and hence reflects the demographic advantage that India enjoys vis-à-vis other countries.

Chart 64: Age distribution of population

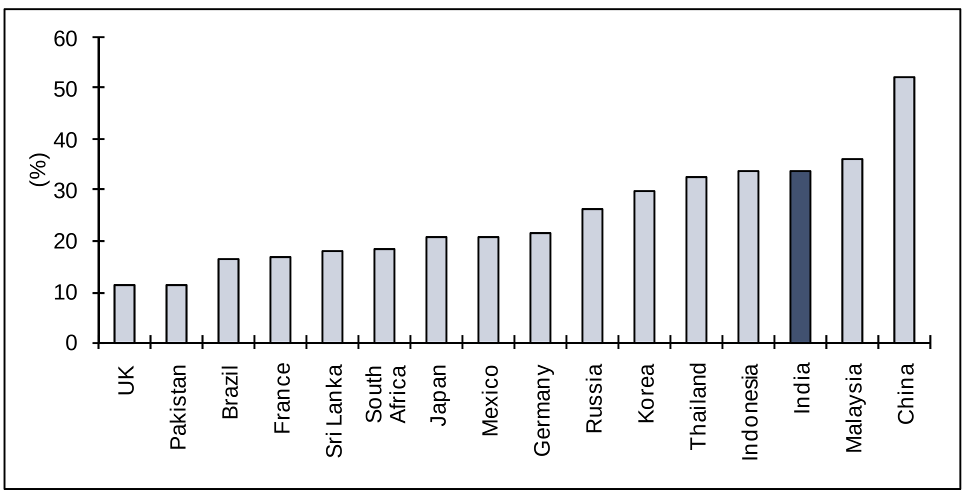


Source: CIA World Fact Book

One of the highest savings rate globally, to fuel consumption story in coming decades

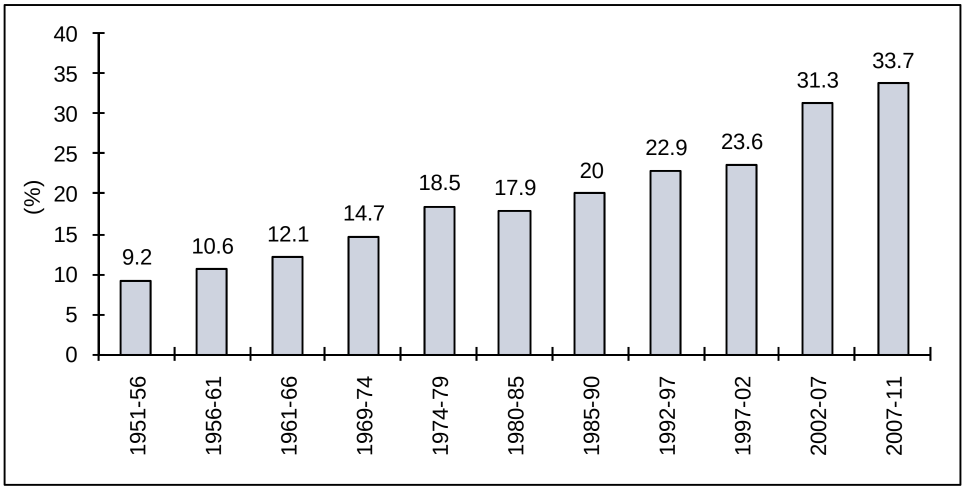
Over the past many decades, India's domestic savings rate as a percentage of GDP has witnessed an uptrend and is one of the highest amongst the major developed and developing nations. Bulk of the savings lies with households and constituted an average of 23.5% of GDP during FY05-FY11.

Chart 65: India's savings rate vis-à-vis major developed and developing markets (2009)



Source: Planning Commission, I-Sec research

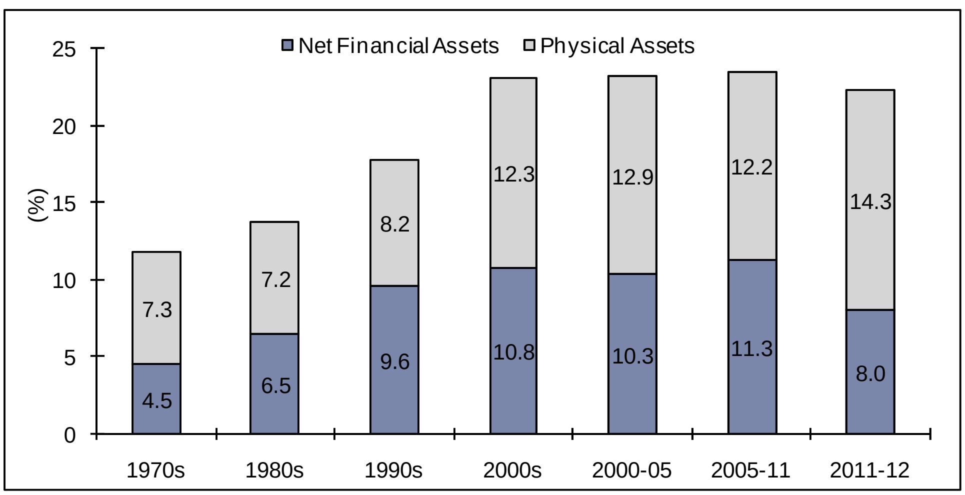
Chart 66: India's Gross Domestic Savings Rate during 5 Year Plans



Source: Planning Commission, I-Sec research

While in FY12 the savings rate declined to 30.8% from 34.0% in the previous fiscal, overall it continues to be high from a global perspective. The ongoing economic slowdown with inflation remaining high (albeit declining) has eaten into both corporate profitability and household income levels. Household savings rates declined ~120bps YoY to 22.3% in FY12 with savings in financial assets declining from 10.4% to 8.0% given the volatile equity markets leading to record redemptions and closure of portfolios. Traction in bank deposits has also been weak as negative real interest rates make them unattractive *vs* other investment avenues. The decline in financial assets was partially countered by higher savings in physical assets (primarily real estate and gold).

Chart 67: Break-down of Household Savings

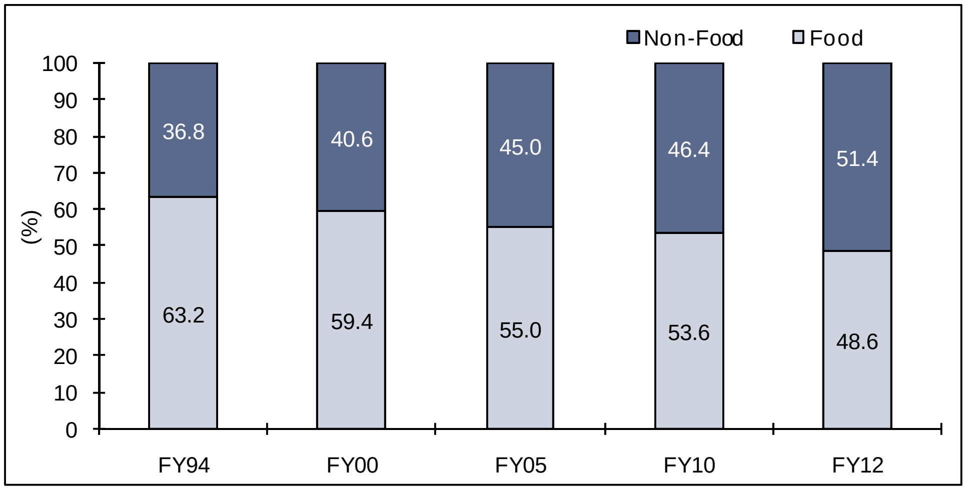


Source: Planning Commission, I-Sec research

Rural poverty declining with increasing consumption levels

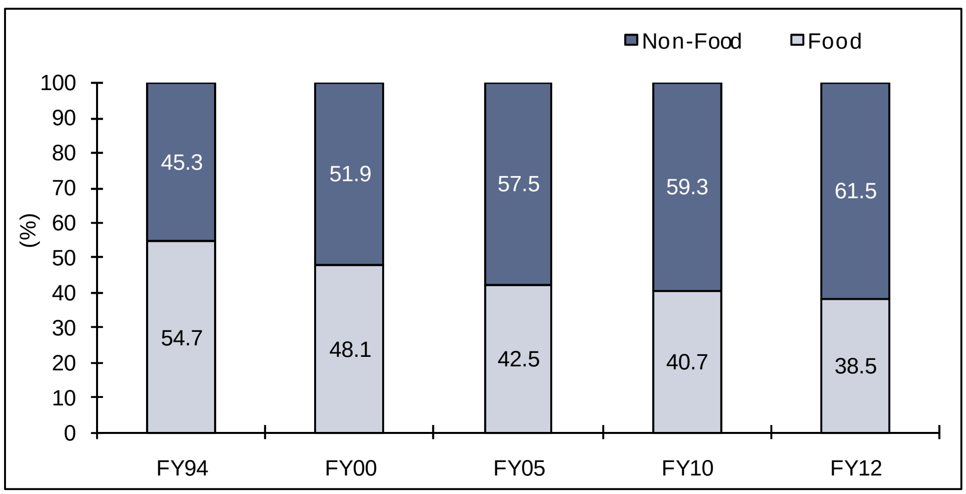
As per the latest NSSO survey, poverty levels declined during FY10-12 with strong growth in per capita expenditure. During FY12, the average monthly per capita expenditure stood at Rs1,430 in rural areas and Rs2,630 in urban areas. This represents an increase of ~36% and ~32% respectively since FY10. In terms of composition of consumer expenditure, the proportion of food has steadily declined over the last two decades, which generally indicates increasing discretionary spending, hence prosperity levels.

Chart 68: Breakdown of consumer expenditure - Rural



Source: NSSO Survey, MOSPI, I-Sec research

Chart 69: Breakdown of consumer expenditure – Urban



Source: NSSO Survey, MOSPI, I-Sec research

Rapid economic development along with greater financial inclusion has enhanced rural prosperity in India in the past five to six years. The rural economy has received a major impetus from the GoI through multiple social programmes. Budgetary allocation for rural development programmes comprised 25% of the total Union Budget plan during the 11th Five-Year Plan. Focus has been on inclusive growth through flagship projects especially the Bharat Nirman programme and Mahatma Gandhi National Employment Guarantee Act (MGNERGA). The Bharat Nirman programme launched by the GoI in 2005 aims to provide basic infrastructure facilities in rural India. The programme encompasses projects in irrigation, roads (Pradhan Mantri Gram Sadak Yojana), housing (Indira Awaas Yojana), water supply (National Rural Drinking Water

Programme), electrification (Rajiv Gandhi Grameen Vidyutikaran Yojana) and telecommunication connectivity.

Table 19: Direct transfer of Central Plan assistance at State/District levels – steady increase in allocation

(Rs bn)

	FY09	FY10	FY11	FY12	FY13RE	FY14BE
Flexible Pool for State PIPs	57	69	78	92	81	-
Sarva Shiksha Abhiyan	126	128	196	190	213	245
NREGS	299	335	358	310	291	325
Indira Awaas Yojana	88	88	103	90	81	137
Pradhan Mantri Gram Sadak Yojana(PMGSY)	51	96	195	125	36	112
National Rural Drinking Water Programme (NRDWP)	23	58	89	76	95	99
Total Sanitation Campaign	9	9	15	13	23	38
National Rural Livelihood Mission/ Aajeevika	23	22	25	22	23	34
Integrated Watershed Management Programme	14	16	22	21	26	48
Rashtriya Madhyamik Shiksha Abhiyan	-	5	15	22	29	36
Micro Irrigation	5	5	10	12	12	17
National Food Security Mission	9	10	13	13	18	23
Total of above plan	**703**	**839**	**1,119**	**985**	**927**	**1,114**
Allocation to other plans	129	66	68	143	135	316
Total allocation	**832**	**905**	**1,187**	**1,128**	**1,062**	**1,430**

Source: Government of India

NREGS programme has had a significant impact

The MGNREGA, enacted by legislation in Aug'05, has been instrumental in transforming the rural landscape of the country. The government's flagship employment programme, it guarantees employment for a minimum of 100 days in every financial year to adult members of rural households. This has significantly boosted income levels in rural India, consequentially fuelling the consumption story in the country at a time when the investment side of the economy has been on a downward trajectory. Average wage per day under the MGNREGA has increased from Rs65 in FY07 to Rs117 in FY12, a CAGR of 12.5%. Given the prevailing high inflationary scenario, wages have now been indexed to inflation. Total expenditure under this programme between FY07 and FY12 has totalled Rs1,668bn and in FY12 nearly 50mn families have benefited under the scheme. Also, almost 100mn bank/post-office accounts have been opened to facilitate direct cash transfers to beneficiaries, thus providing a major impetus to the financial inclusion plans of the GoI and RBI. It is to be noted that ~80% of the works under MGNERGA are focused on soil and water conservation efforts on the lands of small and marginal farmers. This can potentially lead to productivity gains in the medium to long term, providing a major boost to agriculture-related segments of the economy.

Table 20: Overview of MGNREGA performance

	FY07	FY08	FY09	FY10	FY11	FY12
Households employed (mn)	21.0	33.9	45.1	52.6	54.9	49.9
Person-days of employment generated (mn)	905	1,436	2,163	2,836	2,572	2,114
Budget outlay (Rs bn)	113	120	300	391	401	401
Expenditure (Rs bn)	88	159	273	379	394	375
Average wage per day (Rs)	65	75	84	90	100	117
% annual increase in wages		*15.4%*	*12.0%*	*7.1%*	*11.1%*	*17.0%*

Source: Ministry of Rural Development, GoI, I-Sec research

While the MGNREGA would continue to be the flagship employment scheme of the GoI during the 12th FYP (FY07-FY12), the National Rural Livelihoods Mission (NRLM-

Aajeevika) is expected to take centre-stage as well. NRLM has been designed to leverage on the benefits derived from MGNREGA (water infrastructure and agrarian stability) and provide sustainable employment opportunities in rural India. The NRLM envisages an additional ~25mn new jobs (skilled labour) during the 12th and 13th FYP periods (FY12-FY17 and FY17-FY22) along with self-employment to ~9mn people. This scheme, if implemented with full vigour, can be the next driver of rural growth generating in turn significant incremental business for banks and NBFCs.

Table 21: Phasing of the National Rural Livelihoods Mission

	FY13E	FY14E	FY15E	FY16E	FY17E	12th Plan	13th Plan	Total
New districts to be brought under the scheme	150	0	150	0	300	600	0	600
New households Covered (mn)	4.5	2.3	6.0	7.5	12.8	33.0	57.0	90.0
Jobs created for skilled labour (mn)	0.5	1.0	2.5	3.0	3.0	10.0	15.0	25.0
Self employed (mn)	0.2	0.4	0.6	0.8	1.0	3.0	6.0	9.0

Source: Planning Commission

Steady increase in farm output prices and Minimum Support Prices (MSP) have also created prosperity

While the share of agriculture in total GDP continues downhill, shrinking from 23.4% during the 9th FYP period to ~14.0% in FY12, its contribution in terms of livelihood support to almost two-thirds of Indian population remains enormous. While, during the 11th FYP, annual increase in farm output at 3.3% was short of the targeted growth rate of 4.0%, it was still significantly better than the growth rates of 2.5% and 2.4% achieved during the 9th and 10th FYP periods, respectively. Also, despite poor rains in 2009 and 2012, overall farm output has not been impacted substantially, the key reasons being the higher share of irrigable land (35% currently *vs* 20% in 1981), diversified crop mix, mechanisation, better information reach, alternative irrigation methods (such as drip irrigation) and rising investments in agriculture and related sectors.

Countrywide rollout of MGNREGS seems to have resulted in a general shortage of labour in rural areas leading to higher wage costs. Also, it has provided support to minimum wage rates across the country.

Table 22: Inflation-adjusted prices of agricultural produce (WPI Commodity) – significant wealth addition in real terms

	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	CAGR (%)
Rice	100	101	99	105	112	121	117	110	1.4
Wheat	100	101	112	115	117	127	120	108	1.1
Coarse cereals	100	107	110	115	113	123	122	136	4.5
Pulses	100	108	134	124	124	146	137	129	3.7
Vegetables	100	109	103	118	113	124	128	115	2.0
Fruits	100	99	99	98	102	104	114	119	2.5
Milk	100	97	98	98	98	112	123	124	3.1
Eggs, fish and meat	100	102	101	100	99	116	133	137	4.6
Oilseeds	100	86	85	97	104	103	99	102	0.3
Sugarcane	100	96	91	87	80	81	109	107	1.0
Fibres	100	**92**	91	96	109	107	138	140	4.9
All agriculture	**100**	**99**	**101**	**104**	**106**	**115**	**123**	**122**	**2.9**

Source: Planning Commission, I-Sec research

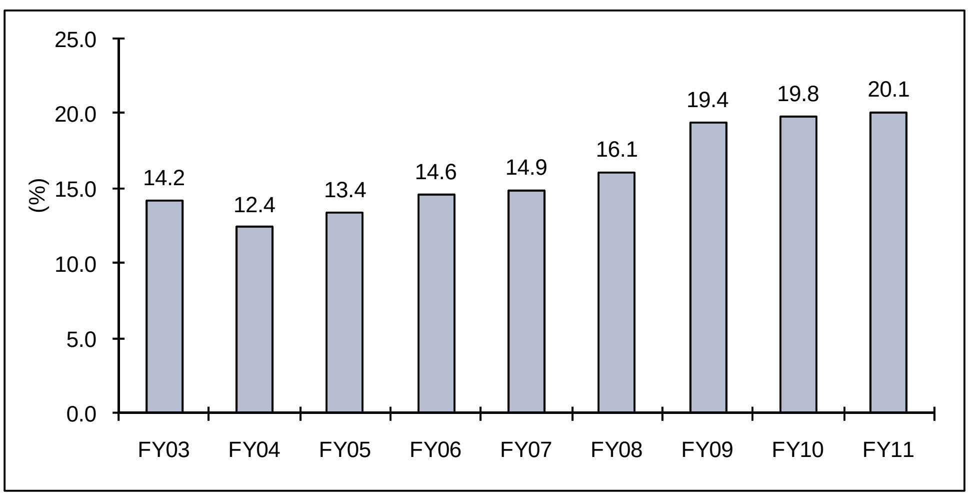
During the past few years, the GoI has aggressively raised the minimum support prices (MSP) for key farm commodities, a reflection of general inflationary conditions, rising labour and input costs and demands by farmers/state governments. The hikes have been significant especially post FY08. While this in turn may have added to inflationary pressures in the economy, on an overall basis this seems to have been positive for the farming community. We also note that the strong uptrend in gold prices during the past decade coupled with robust rise in real estate prices in many pockets across the country has added to the total household wealth and income levels. This is evident from the momentum witnessed in consumption of consumer durables, FMCGs, cars and motorcycles in rural and semi-urban areas in the last few years.

Table 23: Minimum Support Price (MSP) growth

Year	Wheat	Paddy common (Rice)	Maize	Groundnut	Cotton
FY02	610	530	485	1,340	1,875
FY03	620	530	485	1,355	1,875
FY04	620	550	505	1,400	1,925
FY05	630	560	525	1,500	1,960
FY06	640	570	540	1,520	1,980
FY07	650	580	540	1,520	1,990
FY08	750	645	620	1,550	2,030
FY09	1,000	850	840	2,100	3,000
FY10	1,080	1,000	840	2,100	3,000
FY11	1,100	1,000	880	2,300	3,000
FY12	1,120	1,080	980	2,700	3,300
FY13	1,285	1,250	1,175	3,700	3,900
FY02-07 CAGR	**1.3%**	**1.8%**	**2.2%**	**2.6%**	**1.2%**
FY07-12 CAGR	**11.5%**	**13.2%**	**12.7%**	**12.2%**	**10.6%**

Source: Union Ministry of Agriculture, I-Sec research

Chart 70: Gross Capital Formation (GCF) in agriculture and allied sectors (as % of agricultural GDP)



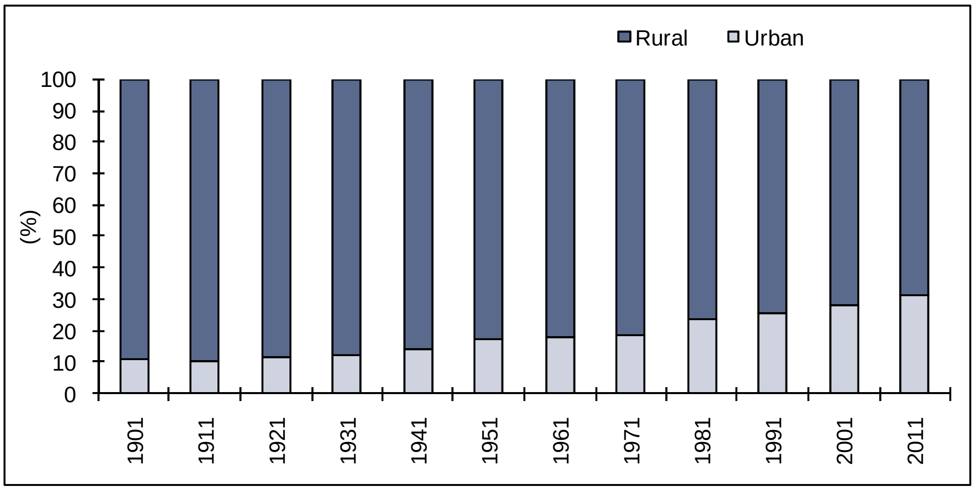
Source: Planning Commission, Central Statistical Organisation (National Accounts Division)

Increasing trends toward urbanisation

As per the 2011 Census, around 377mn Indians or ~31% of the country's population reside in urban areas. While this is lower than other developing countries such as China (45%) and Indonesia (54%), the level of urbanisation is expected to steadily rise going forward. As per the Planning Commission, the total urban population is expected to reach 600mn by 2031. Urbanisation is expected to be one of the key drivers of India's economic development in the coming decades as it stimulates economic efficiencies along with providing more opportunities for skill development, hence better employment opportunities. Also, it is increasingly being realised that higher urbanisation stimulates the rural economy by creating more demand for agriculture-related output by urban centres, which leads to investments in infrastructure, logistics, processing and packaging industries in the hinterland.

While the proportion of population residing in urban areas has been steadily rising, it has accelerated in the past two decades and coincides with ushering of economic reforms since 1991.

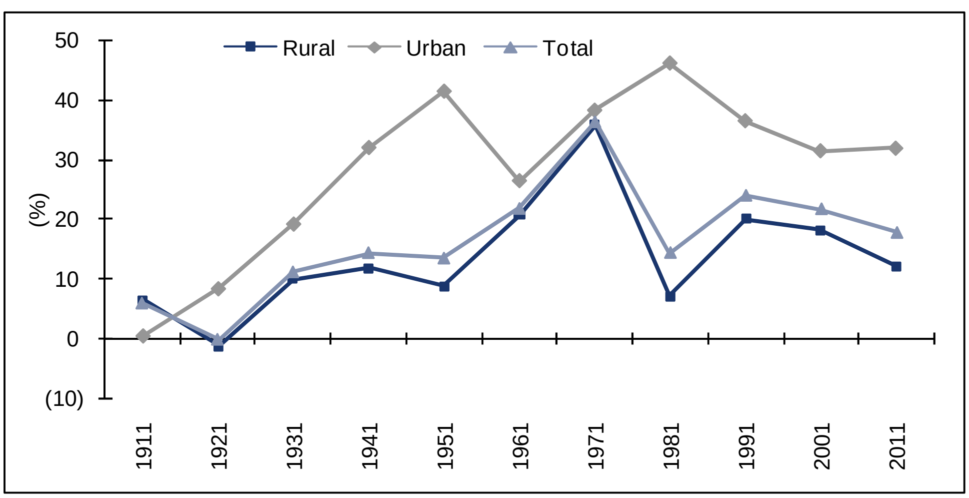
Chart 71: Urban mix in total population rising steadily



Source: Census, I-Sec research

While the pace of population growth has been moderating since the 1990s, it has been sharper in the rural areas and is a reflection of both migration to urban centres along with the larger rural centres transforming into small cities (apart from the general decline in fertility rates).

Chart 72: Population growth rates on a decline; however, deceleration higher in rural areas

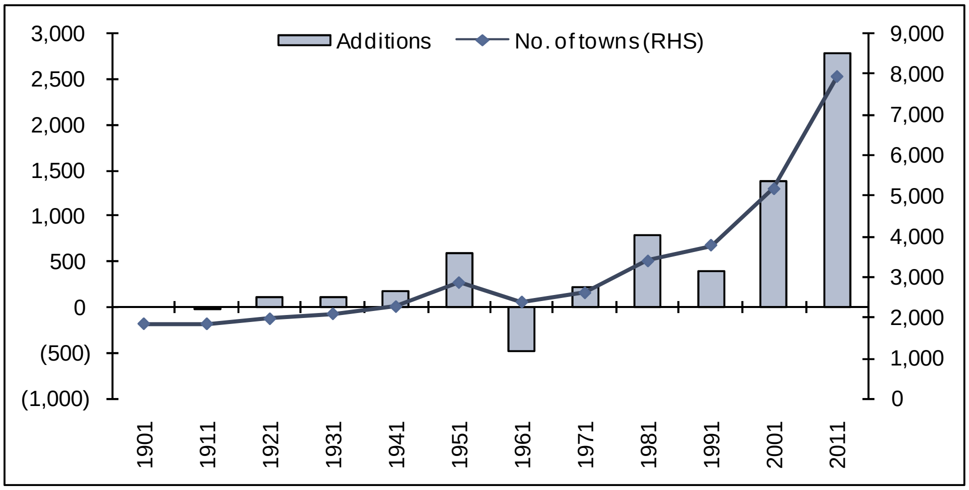


Source: Census,, I-Sec research

Quantum of urban centres rising rapidly

Total number of towns in India stood at ~7,900 as of 2011, more than doubling from the ~3,700 towns reported in 1991. Since 2001, over 2,700 new towns have been added (net additions), representing ~74% and ~54% of existing as of 1991 and 2001.

Chart 73: Total number of towns and net additions

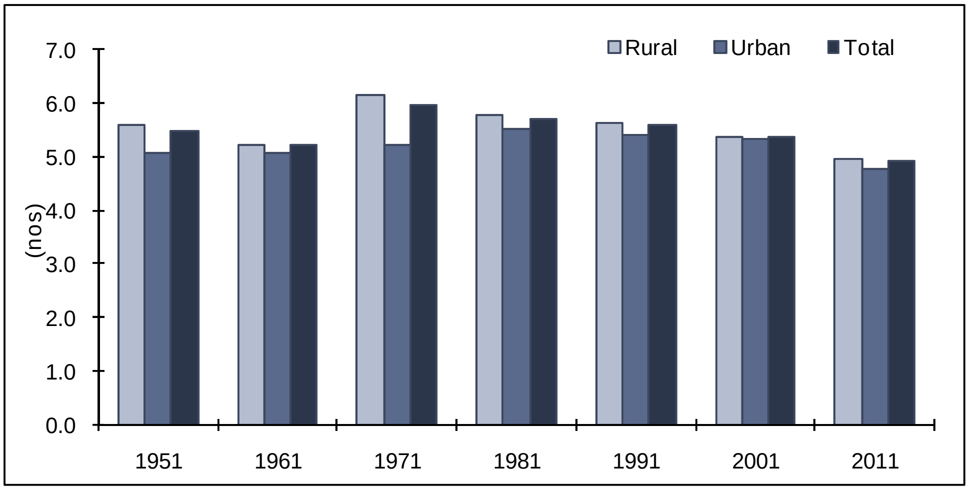


Source: Census, I-Sec research

Increasing numbers of nuclear families to spur demand for housing in the coming decades

India is currently witnessing a significant shift toward nuclear families given the increasing urbanisation levels, changing cultural perceptions and younger population moving to larger towns in search for better education/employment opportunities. Steep rise in real estate prices in different parts of the country during the past few years has also meant that large residential units are increasingly becoming unaffordable, prompting purchase of smaller housing units. This may also be impacting the trend toward more nuclear families. This is clearly perceptible in the decline in the number of persons per household during the last decade from 5.4 in 2001 to 4.9 in 2011. Also, the decline was largely consistent in both the urban and rural areas.

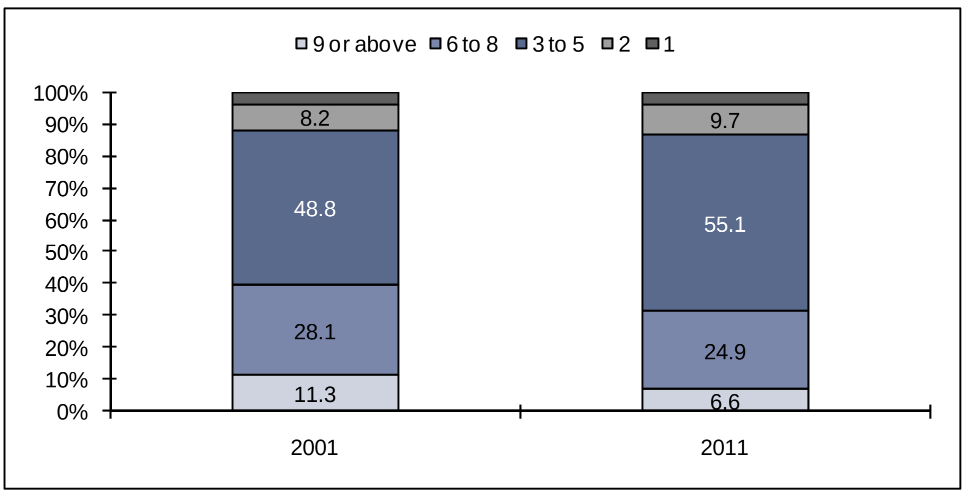
Chart 74: Number of persons per household



Source: Census, I-Sec research

The above trend is further substantiated by distribution of housing units in terms of household size. For example, in 2001, housing units accommodating nine or more persons constituted 11.3% of the total housing units in the country. This has declined to 6.6% as per the 2011 Census. Similar trend is witnessed in the 6 to 8 people category too. The decline is compensated by the increase in housing units accommodating 3 to 5 persons, which further underscores the trend toward nuclear families.

Chart 75: Household size – Number of people staying in a housing unit



Source: Census, I-Sec research

Appendix 2

Key prudential norms and regulations for HFCs

Income recognition

- Income including interest/discount or any other charges on NPA is recognisable only when actually realised
- Hire purchase charges and lease rentals if overdue for more than 12 months are recognized only when actually received

Income from investments

- Dividend on shares and units of mutual funds is to be recognised on cash basis
- Income from bonds and debentures is to be recognised on accrual basis
- Income on securities, payment of which is guaranteed by the GoI or any of the state governments is to be recognised on accrual basis

Investments

- Investment in securities is to be classified into current and long-term investments at the inception
- Inter-class transfer of investments is allowed with the following restrictions
  - Transfer allowable at the beginning of each half year, i.e. 1-April or 1-October with the prior approval of the board
  - Transfer at the lower of book or market value
  - Depreciation, if any, is to be fully provided for while any appreciation has to be ignored
  - Depreciation in one scrip is not allowed to be set off against the appreciation in similar or any other scrip
- Investments to be categorised under the following heads:
  - Equity shares
  - Preference shares
  - Debentures and bonds
  - Government securities including treasury bills
  - Units of mutual funds
  - Others

Asset classification

HFCs have to classify loans and advances, lease/hire purchase assets and any other forms of credit into the following categories:

- Standard assets
- Sub-standard assets
- Doubtful assets
- Loss assets

Provisioning requirements

- **Loss assets**: Entire loss assets to be written off or 100% provision to be maintained
- **Doubtful assets**: 100% provisions to the extent to which the advance is not covered by the realisable value of the security. On secured loans, provisions of 25% to 100% are to be maintained as per the following:

Period for which the asset has been considered doubtful

	% of provision
Up to one year	25
One to three years	40
More than three years	100

Source: Company data, I-Sec research

- **Sub-standard assets**: General provision of 15% of total outstanding loans
- **Standard assets**: The provisioning requirement on standard assets are as follows:

Standard assets - provisioning requirement

Housing loans at teaser/special rates	2.0% on outstanding loans
Commercial Real Estate	1.0% on outstanding loans
Other loans	0.4% on outstanding loans

Source: Company data, I-Sec research

Capital adequacy

- Total Capital Adequacy Ratio (CAR) of 12.0%
- Tier-2 capital not to exceed 100% of tier-1 capital

Table 24: Weighted risk assets – on balance sheet items

	Weight (%)
Cash and bank balances including fixed deposits and CDs with banks	0
Investments:	
Approved securities	0
Bonds/fixed deposits/CDs of public sector banks and financial institutions	20
Units of Unit Trust of India	20
Mortgage backed security, receipt or other security	50
Shares/debentures/bonds/CPs	100
Innovative perpetual debt of other HFCs/banks/FIs	100
Housing / project loans guaranteed by Central / state governments	0
Individual housing loans:	
Loans up to Rs3.0mn with LTV ratio up-to 75%	50
Loans between Rs3.0mn-7.5mn with LTV ratio up to 75%	75
Loans up to Rs7.5mn with LTV ratio above 75%	100
Loans of over Rs7.5mn (irrespective of LTV ratio)	125
Other housing loans	100

Source: Company data, I-Sec research

Exposure to capital markets

- Aggregate exposure (both fund and non-fund based) to the capital market not to exceed 40% of net worth
- Within the 40% ceiling, direct investments in shares, convertible bonds/debentures, units of equity-oriented mutual funds and venture capital funds not to exceed 20% of net worth

Concentration of credit/investment

- Loans to any single borrower not to exceed 15% of the HFC's net worth
- Loans to any group of borrowers not to exceed 25% of the HFC's net worth
- Investments in the shares of any company not to exceed 15% of the HFC's net worth
- Investments in the shares of a single group of companies not to exceed 25% of the HFC's net worth
- Combined loans and investments to a single party not to exceed 25% of net worth
- Combined loans and investments to a single group of parties not to exceed 40% of net worth

Annexure 1: Index of Tables and Charts

Tables

Charts

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Equity Research
July 7, 2013
BSE Sensex: 19496

Financials

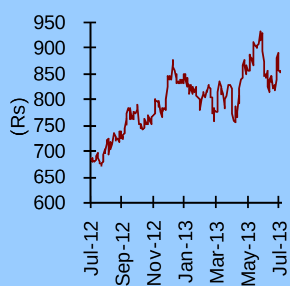
Target price Rs900

Shareholding pattern

	Sep '12	Dec '12	Mar '13
Promoters	0.0	0.0	0.0
Institutional investors	86.8	86.9	86.9
MFs and UTI	2.9	2.8	2.6
Insurance	11.0	10.6	10.2
FIIs	72.8	73.5	74.0
Others	13.3	13.1	13.2

Source: NSE

Price chart



INDIA

HDFC

ADD

King of the hill

Rs850

Reason for report: Initiating coverage

HDFC remain easily the leader of the whole HFC pack on the back of both pure size and multi-decade demonstrated excellence in both sustained profitable growth and pristine asset quality. HDFC Bank and its sales subsidiary now contribute 74% of its new loan leads and provide it with wide reach. Asset growth is likely to continue at 20%+ despite size constraints and the company is one of the best positioned to defend margins in case sector spreads start to get squeezed in the medium term, by dint of both its liability franchise and asset product capabilities. We initiate coverage with an ADD recommendation.

- **Asset growth to remain healthy, liability franchise compares with the best.** With the individual mortgage loans opportunity still remaining huge, we feel HDFC should be able to grow this business at a CAGR of 22% over the next 3 years despite competitive pressures. HDFC has been the savviest user of the NCD market amongst its peers and has been the most successful in reducing bank funding dependence to only 11% of borrowings despite constraints of balance sheet size. The company also regularly sells down loans to HDFC bank for priority sector requirements and 9.1% of its AUM is off-book.
- **The uncrowned monarch of developer financing.** The lure of the high yields of developer finance has spelled disaster in many cases. The segment has many unique challenges like land title issues, land use stringency, bureaucratic hassles and uncertainties at every project stage and less than sound corporate governance practices in some cases. HDFC has sailed these choppy waters with distinction through discipline in choosing partners, responsiveness in execution issues, working on a partnership model and by controlling the urge to charge rates that it *can*. We feel prudent asset growth should not be a stumbling block, cycle notwithstanding.
- **Regulatory uncertainty and competition will affect spreads.** With rate-shopping likely to become a reality for existing borrowers after the abolition of pre-payment penalty we expect long term pressure on sector spreads. Increased competition in the sector is not likely to help in this aspect. However, with SBI best lending rate in housing loans only 25bps higher than its base rate, yields will likely remain sticky although wholesale borrowing rates are expected to ease. This should provide some near term margin tailwind. Product mix remains a key lever to margin defense.
- **Valuations are premium, leverage remains the dark horse**. Our peer comparison exercise in valuations reveals the premium nature of HDFC's valuations. However we feel its core RoE of 25% can improve by 250-300bps even if its leverage increases by 1x (standalone leverage at 8x vs 11-12x for peers). Our SOTP valuation indicates a target of Rs900 building in a 3.5x multiple for the core business.

Market Cap	Rs1,321bn/US$21.9bn
Reuters/Bloomberg	HDFC.BO/ HDFC IN
Shares Outstanding (mn)	1,554
52-week Range (Rs)	930/670
Free Float (%)	0.0
FII (%)	74.0
Daily Volume (US$/'000)	37,695
Absolute Return 3m (%)	12.1
Absolute Return 12m (%)	24.3
Sensex Return 3m (%)	5.7
Sensex Return 12m (%)	11.3

Year to March	FY13	FY14E	FY15E	FY16E
NII (Rs mn)	61,841	75,490	89,092	1,04,391
Net Income (Rs mn)	48,483	56,591	66,739	78,242
EPS (Rs)	31.3	36.5	43.1	50.5
% Chg YoY	12.3	16.6	17.9	17.2
P/E (x)	27.2	23.3	19.7	16.8
P/BV (x)	5.3	4.7	4.1	3.6
Net NPA (%)	0.0	0.0	0.0	0.0
Dividend Yield (%)	1.5	1.6	1.9	2.2
RoA (%)	2.7	2.6	2.6	2.5
RoE (%)	22.0	21.3	22.2	22.9

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Asset growth to remain healthy, liability franchise compares with the best

Individual housing remains an exciting growth opportunity

As detailed in our sector report, individual mortgage loan in India remains a lucrative secular growth opportunity. The key drivers to this opportunity are acute shortage of housing, economic prosperity, government support, rising aspirations, changing demographics, urbanization, formation of nuclear families and better last mile for credit delivery.

Table 1: Opportunity size and financing opportunity in niches is also large

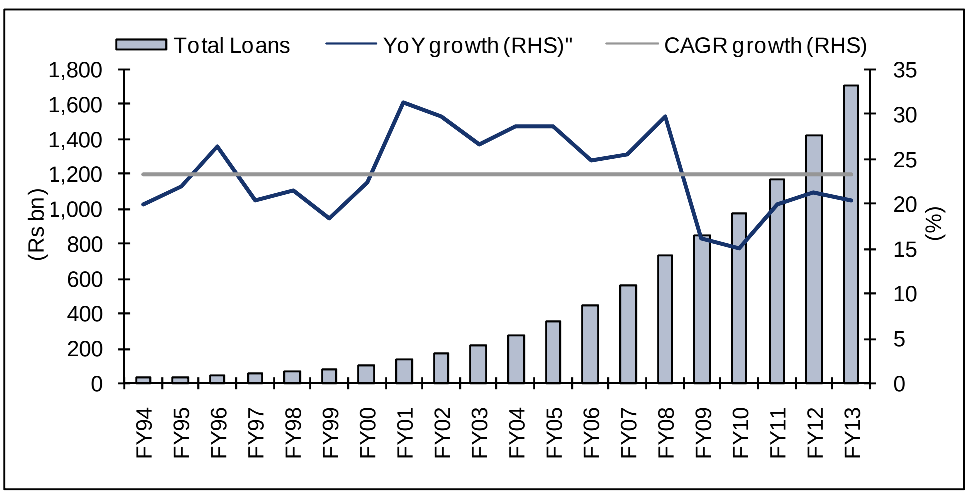
Estimated financing requirements (Affordable urban and rural housing)	
Affordable urban housing	
Housing shortfall (million units)	18.78
Average cost of an affordable house (Rs mn)	0.50
Loan-to-value ratio	75%
Average loan per house (Rs mn)	0.38
Total financing requirement (Rs bn) - (A)	**7,043**
Rural housing	
Total housing shortage (million unit)	43.7
Average cost of rural house (Rs mn)	0.15
Loan-to-value ratio	80%
Average loan per house (Rs mn)	0.12
Total financing requirement (Rs bn) - (B)	**5,244**
Total financing requirement (Rs bn) - (A) + (B)	**12,287**

Source: Planning Commission, I-Sec research

A growth track record not unlike clockwork

HDFC's leading position in the housing finance sector and indeed as one of the top financial companies in the world has been built on its performance on two key parameters, in our opinion. One of course is its asset quality track record, which stayed reasonably robust even in the face of the 1996 crisis. The other is its 20%+ annual growth in assets over an extended period of time despite sceptics pointing out to constraints of size and competition. This also convinced the market that the large addressable opportunity size in housing finance is not merely a calculation on paper but something that HDFC could try and tap into for a long period of time.

Chart 1: Close to 23% AUM CAGR over 20 years

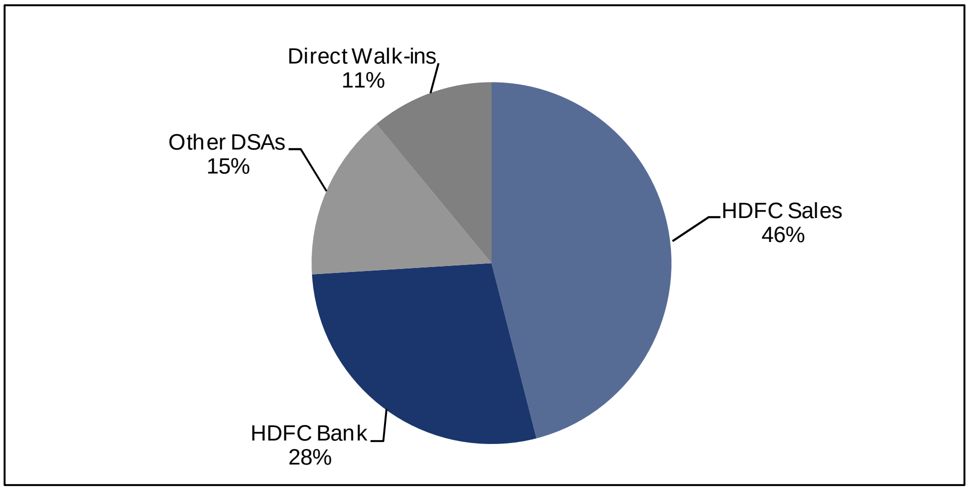


Source: Company data, I-Sec research

Unique strengths will drive growth in mortgages despite competition

HDFC has the benefit of an operating network that no other housing finance company can match in India. Apart from its subsidiary company, HDFC Sales Pvt Ltd the company also benefits from the extensive distribution network of HDFC Bank comprising 3,062 branches, spread across India. The company's distribution mix seems to have stabilized now.

Chart 2: HDFC Bank and sales subsidiary remain key to lead generation

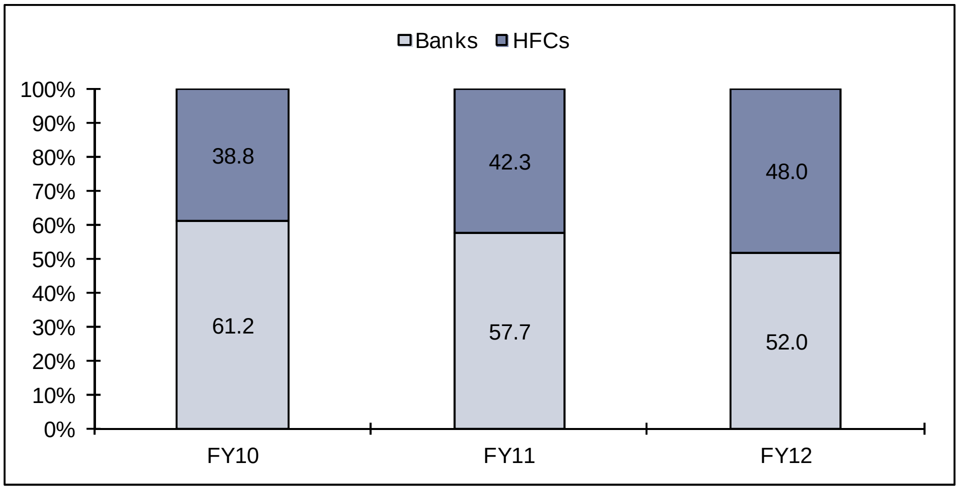


Source: Company data, I-Sec research

Another major advantage for HDFC is that its strong network of builders facilitate a lot of loans through pre-approval of properties (which is also efficient on a cost basis due to one-time costs of legal and technical due diligence).

The State Bank of India has been offering the finest rate in the market (enabled by its low cost of funds). Accordingly, it has built up a large book. The key observation for us though is that this has not slowed down the asset growth of other HFCs. In the past five years, HFCs have contributed greater than 50% of incremental sector disbursements, as apart from State Bank of India and Axis Bank most large bank players have not pushed for high asset growth in the segment.

Chart 3: HFC market share in disbursements have been increasing



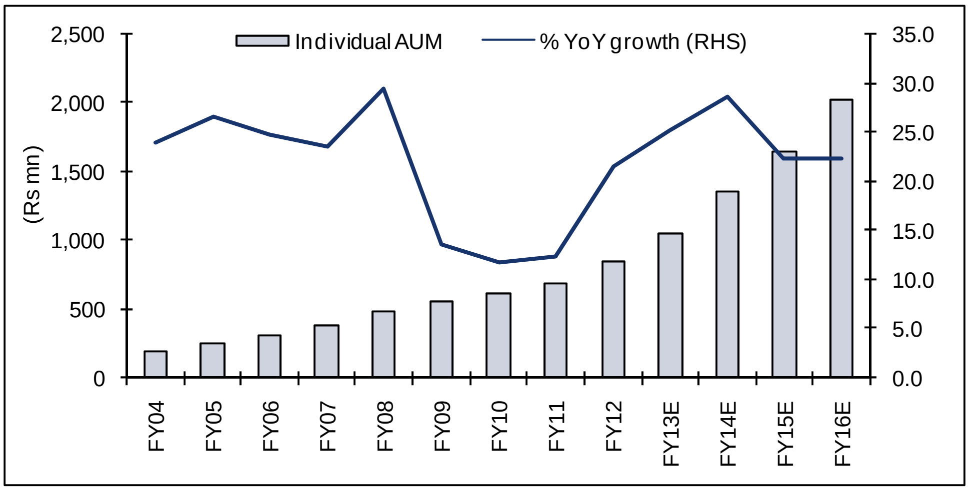
Source: NHB, I-Sec research

We feel that this trend will continue in the medium term, as we do not foresee any other large bank being aggressive in the segment.

- As Tier II and tier III cities start contributing to asset growth, HFCs (especially niche focused ones) will be the key beneficiaries.
- We expect the more aggressive of the HFCs to make a bigger foray into higher risk assets like loan against property (LAP) where we feel banks will read more cautiously.
- The single asset focus of HFCs will help them leverage better their distribution network which for HDFC also includes that of HDFC Bank.

We believe that HDFC will grow its individual business at a CAGR of 22% despite its current size. Any downside to growth will likely come from internal reticence if tough economic conditions make the affordability situation worse rather than lack of growth opportunities.

Chart 4: Individual business growth to remain robust



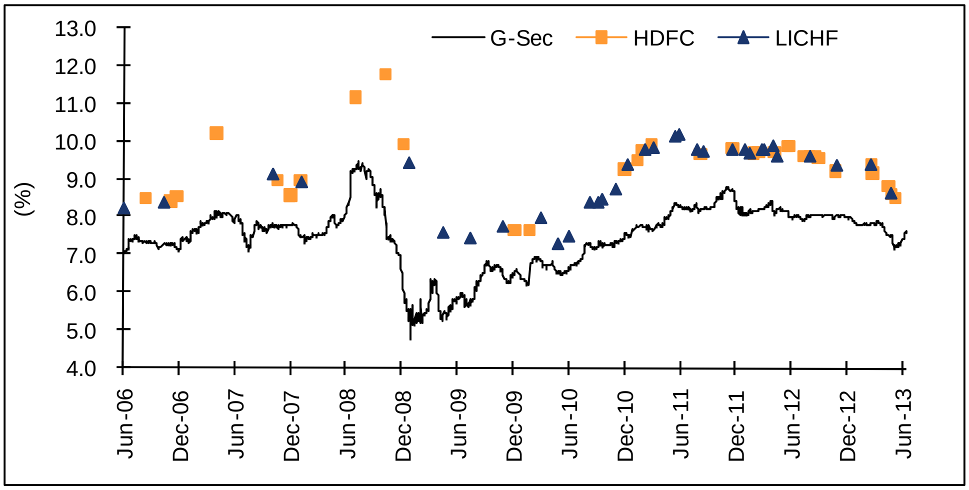
Source: Company data, I-Sec research

Top tier liability franchise

HDFC with its premier credit rating, excellent credit culture, instant brand recall and adequate capitalization remains a darling of the debt market and depositors. Plain vanilla mortgage loans to primarily urban tax paying salaried individuals for first home purchases is now a very competitive business in terms of spreads. Yields today stand 50bps north of bank base rates and 150-175bps higher than borrowing rates for AAA corporates in the NCD market. In such a scenario, in order to not be priced out, any player needs to be borrowing at close to AAA rates or find out higher yield niches for business to earn decent spreads that can provide for credit. Also, HFCs like top tier NBFCs are trying to reduce their dependence on bank funding and no scope for sub-base rate lending leaves this avenue uneconomical as well. Both the other options of NCDs and deposits necessitate a strong retail liability franchise. Thus, both from cost and availability point of view the strength of the liability franchise of a housing finance company determines its vulnerability to a systemic liquidity squeeze and its ability to price loans competitively. In this aspect HDFC is one of the best positioned among its peers.

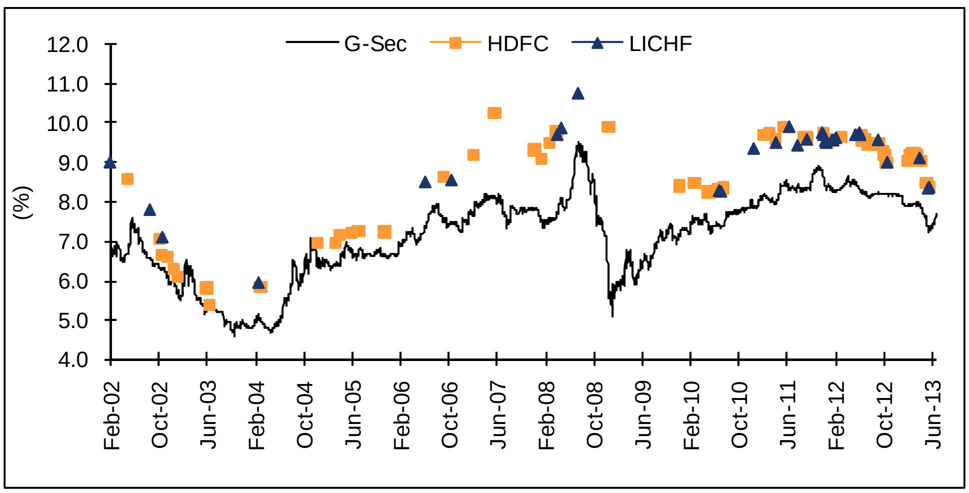
In the NCD market, HDFC remains the borrower of choice. Today, it borrows at a rate marginally finer (the gap has almost closed) than even its closest competitor in this aspect, LIC housing Finance, as evidenced in the following charts.

Chart 5: HDFC issue rates *vs* LICHF issue rates *vs* GoI sec yield (3-year)



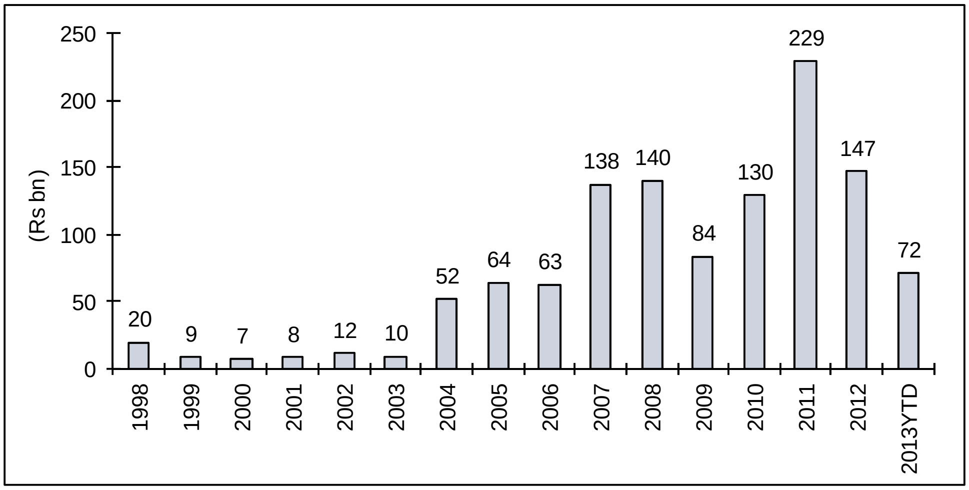
Source: Bloomberg, I-Sec research

Chart 6: HDFC issue rates *vs* LICHF issue rates *vs* GoI sec yield (5-year)



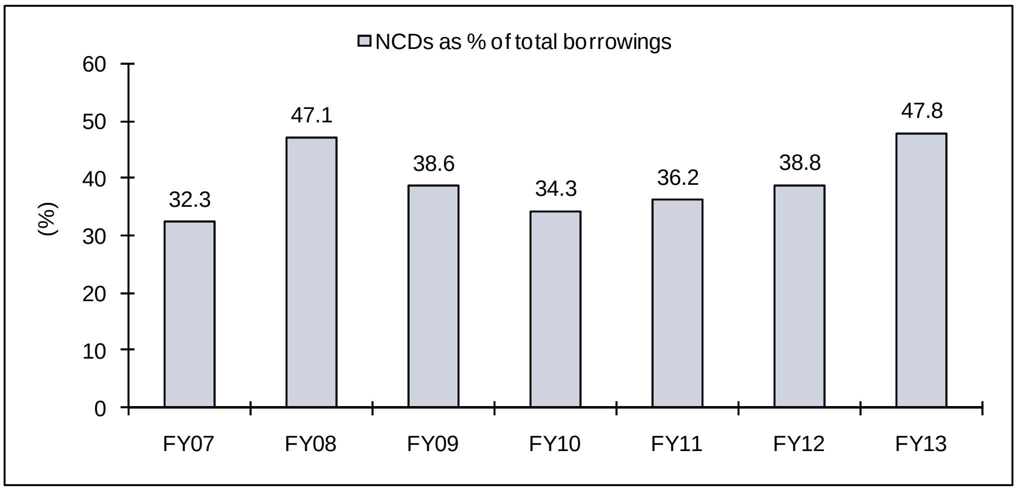
Source: Bloomberg, I-Sec research

Chart 7: HDFC's NCD issuance volumes have stayed robust



Source: Bloomberg, I-Sec research

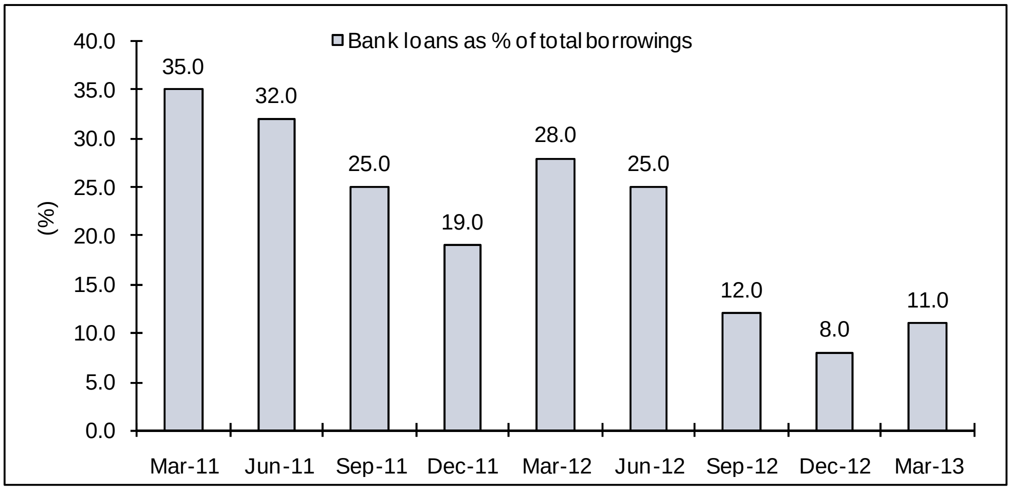
Chart 8: Dependence on NCD route has increased



Source: Company data, I-Sec research

With the new base-rate driven lending restriction on banks, and base rates hovering around 10%, it is an expensive source of funds that allows only 50-75bps spread on new mortgage loans. The company has drastically reduced its dependence on bank funding in the past few quarters.

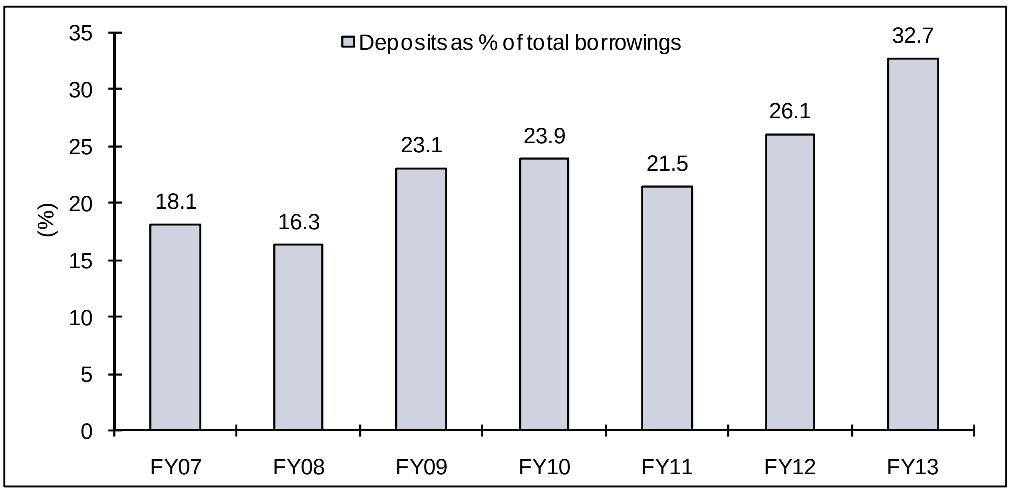
Chart 9: Proportion of bank funding in borrowings has reduced significantly



Source: Company data, I-Sec research

The company has also been fairly aggressive in mobilizing deposits.

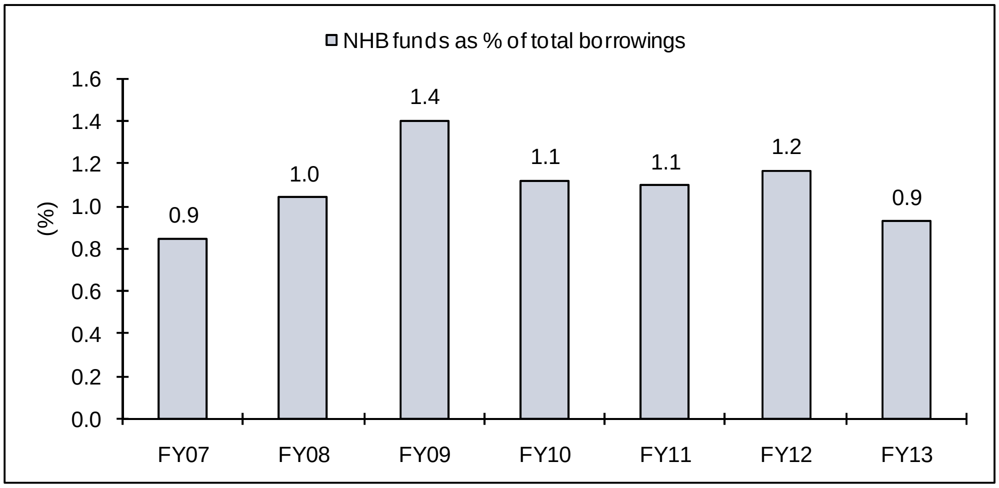
Chart 10: Deposits are now a large part of borrowings



Source: Company data, I-Sec research

The company has never been a major user of NHB refinance given low proportion of qualifying ticket sizes and also with most such loans being part of the usual sell downs to HDFC Bank.

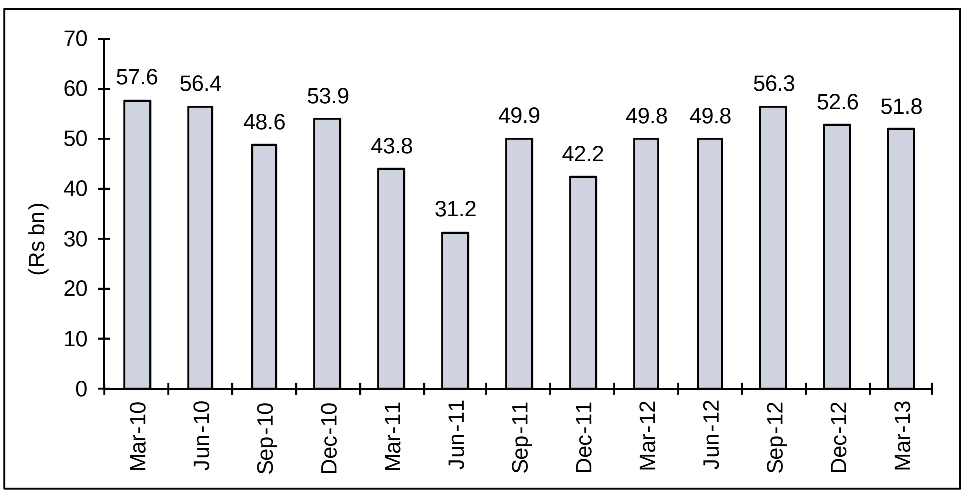
Chart 11: NHB funds contribution insignificant



Source: Company data, I-Sec research

The company also sells down loan assets to HDFC Bank, which remains another notional source of funds for financing AUMs.

Chart 12: Regular asset sell down to HDFC Bank



Source: Company data, I-Sec research

The uncrowned monarch of developer financing

Financing developers remains an intensely specialized activity

It comes as no surprise that given the limited liquidity options for the developer community in India and the high margins possible for a developer to earn for projects starting at land acquisition stage, yields for financing developments at a project level or developers at an entity level are quite lucrative, going over 20% in some cases. However, there are multiple challenges that a player needs to manage for success in this space which has proved tricky for many marquee lenders as well.

- Land titles are much contested in India due to succession disputes and poor record-keeping. With most developments being agglomerations of fragmented land holdings, legal disputes regarding even one piece can throw spanner in the works of a project for a long time.
- Land use laws are stringent in India, and land prices are heavily dependent on the same. The conversion process from agricultural land to other uses is cumbersome and uncertain with many bureaucratic hassles. Inadequate due diligence or project plans grounded on ‘hope’ have often fallen through.
- In some cases, enforceability of collateral in case of default may be much more difficult compared to individual loans.
- In many cases corporate governance practices of real estate companies have come under scrutiny, reducing the size of the potential borrower universe for a discerning lender.
- Our interaction with lenders reveal that in many cases, the lender is not comfortable funding a promoter entity but would rather finance a project as it feels that cash flows in the harvesting phase of the project will not get redirected into fresh investments.

HDFC poised to play into various opportunities in the space

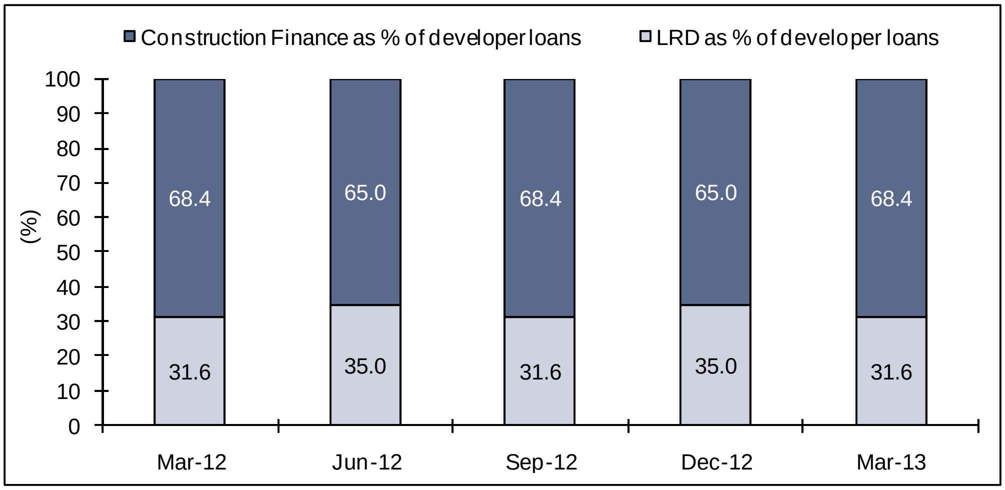
Most of the real estate projects in India are development of acquired and integrated land parcels or redevelopment opportunities, with the former clearly being more profitable. The financing of opportunities start at the land acquisition stage for HFCs and NBFCs (banks are not allowed), with some of the more aggressive players offering finance at this stage. At this stage, yields could be as high as 25%. The other sources of finance for the developers at this stage are individual investors in a quasi equity structure, being assured individual units at a pre-decided discount to the final selling price.

At the next level comes construction finance, with all basic approvals in place. This is a slightly lower risk product and thereby generally offers yields between 14%-20%. This is generally milestone linked disbursements with interest in moratorium until rental cash flows start to flow in for commercial real estate or in tandem with customer advances in case of residential developments.

In case of commercial real estate, lease rental discounting (LRD), is another opportunity for lenders post completion of the project and lease-out. In this loan, the rental collections are security for monthly repayments. Developers avail of this product as it allows them to enhance returns and free up capital. This is *prima facie* the lowest risk of the credit products spoken about in this section and rates hover between 13%-16%. However, one should keep in mind that the debt service coverage ratio (EMI/ rentals) hovers around 1.2x for most transactions and thus not very high on an absolute basis.

Apart from this, HDFC also has the opportunity to fund developers at the promoter entity level.

Chart 13: HDFC developer book break-up



Source: Company data, I-Sec research

Discipline, responsiveness, moderation – the cornerstones of sector leadership

Our interaction with most market participants (including lenders, builders and investors) seemed to suggest that HDFC is considered to be the savviest in this entire gamut of businesses related to real estate project and entity financing. We postulate that there are three key drivers of HDFC's excellence in this business. We feel they are borne out of deep domain knowledge and a long history of operation.

Discipline – HDFC seems to be very clear on the list of developers that it would and would not deal with. In a real estate sector that has often been pilloried in media and social commentary regarding business practices, this strong filter is necessary in our opinion. This obviously means that HDFC passes off many lending propositions that many other lenders would be only too happy to accept. On the flip side, this enables it to finance projects that many other lenders would not be able to fund on ticket size and exposure concerns.

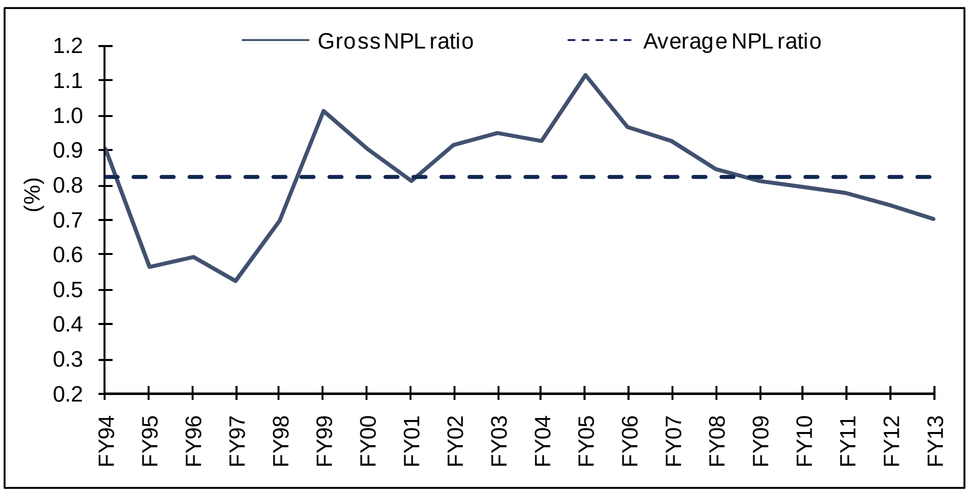
Responsiveness – The strong discipline in choosing partners has not stifled innovation in HDFC. It has been at the forefront of many of the new developments and deal structures in the industry. The company also adopts a holistic partnership approach with borrowers, which enables them to manage risks effectively when one particular project does not work out. The developer knows that HDFC would probably be lending to him at the finest rate in the market and has the ability to write large cheques. This minimizes moral hazard to a large extent.

Moderation – HDFC could potentially be lending at even higher yields in this space but it makes sure that it exercises moderation in levying interest. This has two pronged benefits for the company. Firstly, the reasonable rates of finance increase viability of projects and thereby reduce delinquency risks. Second, the company can work with marquee names and better quality projects and does not need to tap the riskier fringe.

Cyclical risks remain but are better managed

This does not mean that risks to the business do not remain. Apart from typically leveraged balance sheets of developers getting stressed in case of a liquidity squeeze, regulatory approvals environment and land acquisition challenges throw a spanner into the works of many a project. All we are saying is that HDFC is poised better than most to handle such uncertainty if and when it arises.

Chart 14: Asset quality on the total loan book has been very well managed

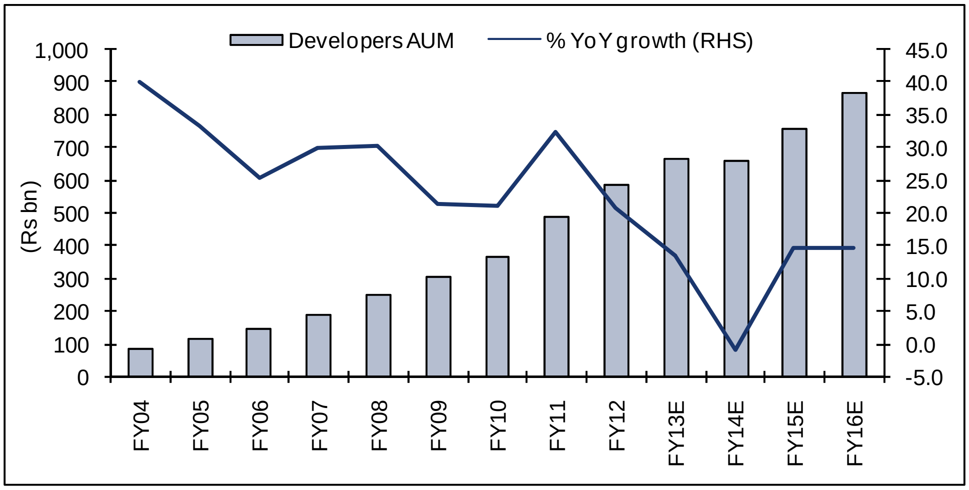


Source: Company data, I-Sec research

Developer business growth should remain robust

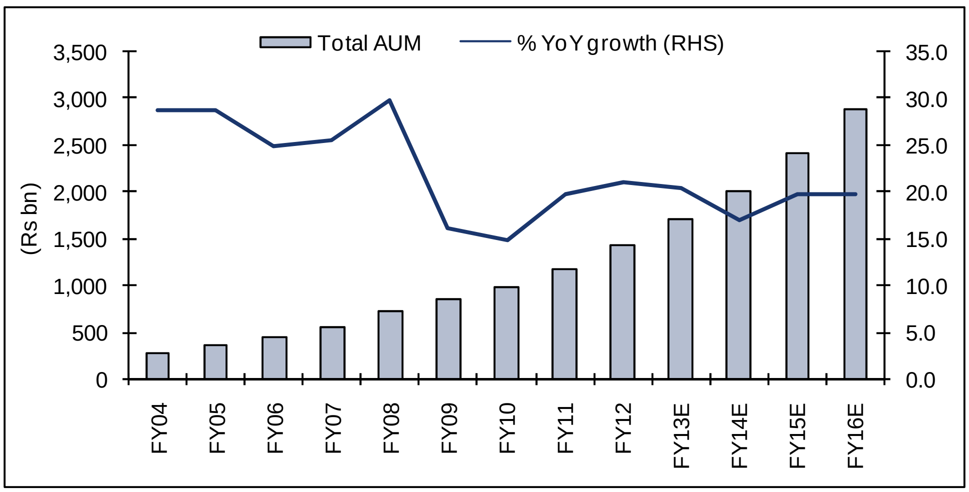
Although commentary in recent times has expressed concern over inflated real estate prices in India, we believe growth rates in the segment will remain reasonably robust for HDFC.

Chart 15: Developer loans should continue to grow



Source: Company data, I-Sec research

Chart 16: Total loans will consequently maintain steady growth



Source: Company data, I-Sec research

Regulatory uncertainty and competition can affect spreads

Increased competition is a reality in individual loans

The large secular growth opportunity and low asset quality concerns of the housing finance segment have attracted most large lenders of consequence in India to it. Apart from few niche opportunities, housing finance remains a pretty modest spread opportunity with yields currently hovering between 10.5% and 11.5%. With most bank rates hovering around 10% and AAA borrowing rates between 8.5%-9.5%, spreads are in general around 2% for even the best quality of liability franchises. The notable exception to this is the State Bank of India, which because of its extensive CASA franchise driven low cost of funds, remains the marginal price setter in the market. Amongst the banks, the State Bank of India, ICICI Bank, Axis Bank and Punjab National Bank are large players while HDFC and LIC Housing Finance are the key housing finance players. Among new players, Indiabulls Financials has scaled up its business rapidly over the past few years.

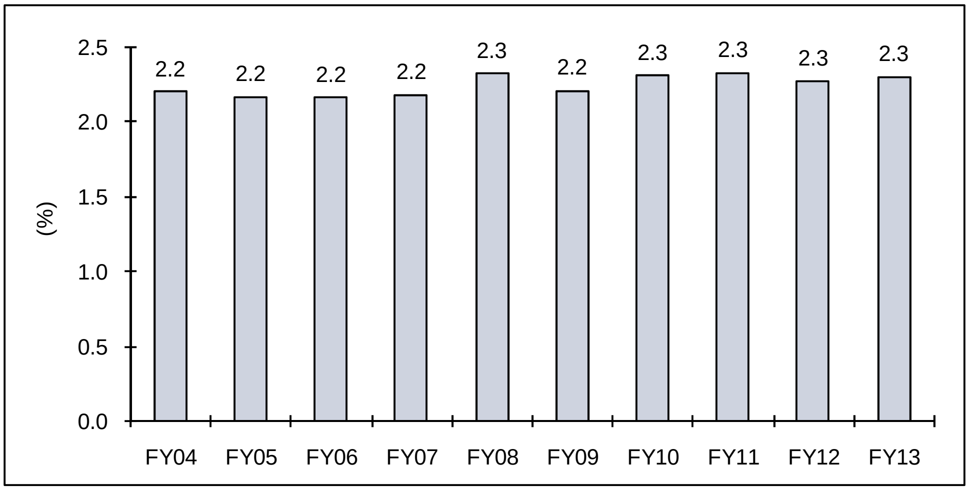
Table 1: Loans outstanding and market share

(Rs bn)	**FY13**	**FY12**	**% YoY growth**	**Market share (%)**
Banks				
SBI	1,502	1,260	19	20.2
ICICI Bank	608	491	24	7.9
Axis Bank	416	308	35	4.9
PNB	219	246	-11	3.9
Bank of Baroda	177	157	13	2.5
Bank of India	123	105	17	1.7
HFCs				
HDFC	1,156	958	21	15.3
LIC Housing	751	599	25	9.6
Dewan Housing	283	210	35	3.4
Indiabulls Housing	248	195	27	3.1
PNB Housing	66	40	67	0.6
GRUH	54	41	33	0.7
GIC Housing	46	39	17	0.6
Can Fin	40	27	50	0.4
Repco Housing	30	24	25	0.4
Mahindra Housing	9	5	64	0.1
Shriram Housing	1	0	2,246	0.0
Reliance Capital	23	NA		NA

Source: NHB, RBI, Company data, I-Sec research
Note: Market share based on total o/s housing loans as of March 31, 2012

But if we study the business margins of HDFC, the largest player for whom the profitability of this business is available in the public domain, spreads have remained steady.

Chart 17: HDFC spreads remarkably stable in last 10 years



Source: Company data, I-Sec research

The thesis on margin disruption always has had a bank at its focal point and in recent years, the State Bank of India has been offering the finest rate in the market (enabled by its low cost of funds).

Regulatory developments have facilitated freedom of rate-shopping for customers

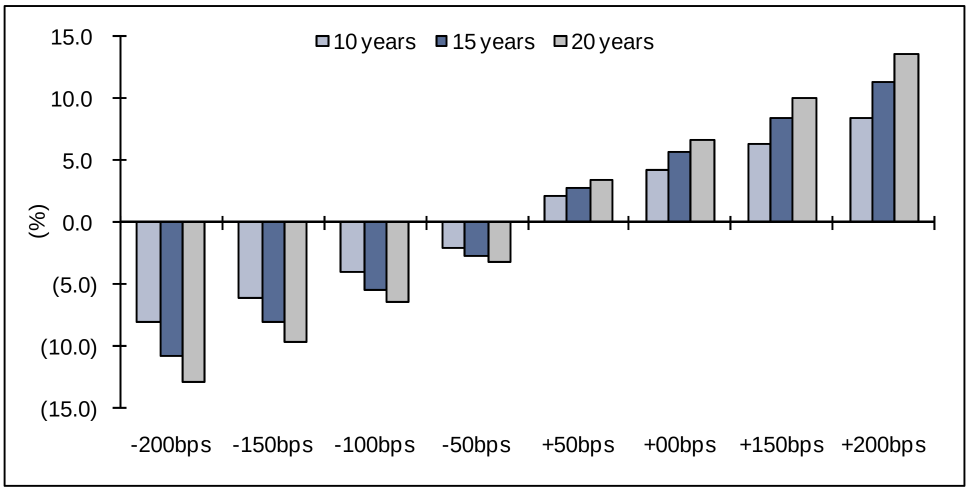
With pre-payment penalties being abolished, the cost of rate-shopping for an existing customer has gone down drastically. We see some issues with Damodaran Committee's recommendation for outright ban on interest rate differentiation based solely on customer vintage.

- The housing finance business has an inherent asset liability mismatch, as assets have original duration of 15-20 years with liabilities being most common unto a 5 year mark at issue (although 10 year paper is also issued). Rates on loans contracted today are in lieu of liability costs in the current environment (also determined by yield competition). To link all assets to these borrowing costs would mean that housing finance companies would also need their liabilities to re-price in order to have any visibility on spreads. Most wholesale debt market borrowings are fixed rate in nature; hence, do not re-price. Even if one argues that liabilities come up for refinance before the loan expiry, to monitor these granular details at a regulatory level bucket-wise and to have an informed fairness opinion are going to be practically impossible.
- There would be definite upward pressure on home loan rates for new finance, thereby defeating the developmental purpose of greater housing penetration through cheaper credit.
- It will be tricky to define 'same risk profile' and will give 25-50bps headroom for maneuvering in most cases.

Spreads could come under pressure in the medium term despite some near term tailwind.

While spreads on new loans are unlikely to be driven down too much by any predatory pricing, we feel back-book spreads will come down going forward. This will of course have a bearing on blended spreads. We recognize the fact that the brand of the lending franchise and the level and ease of service are key to customer preference, but we do feel that with the differential between going market rates and that being levied on a back-book customer reaching 100-150bps in some cases (creating a possibility of 7-10% saving on EMIs) some of the more financially conscious customers will start to shift. We believe that rate differential in itself will start to shrink with this phenomenon. We do not expect it to go to zero without direct regulatory intervention, as we feel that customers will be willing to pay a differential to stay with a lender they trust and like. (It is worthwhile to note that in a floating rate loan, the customer does depend on the lender for fairness of future interest rates).

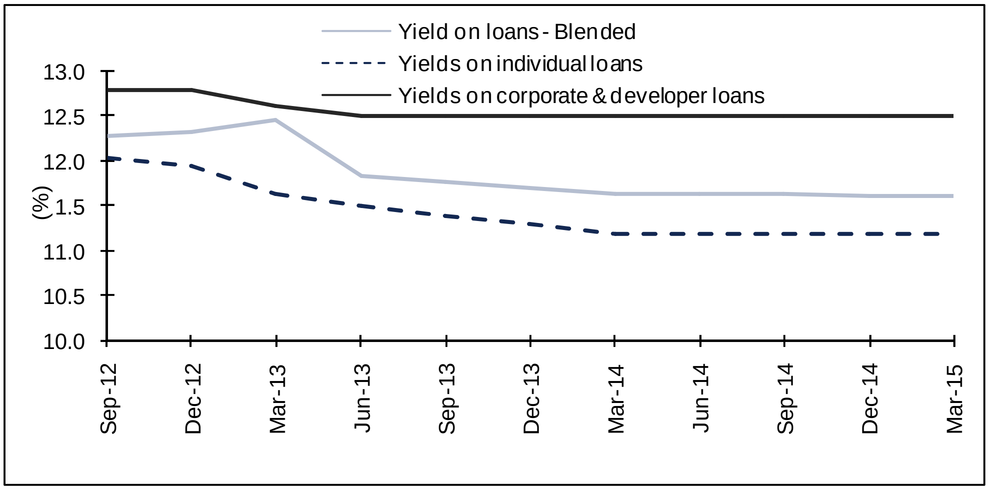
Chart 18: Tenure wise sensitivity of EMIs to change in annual interest rates (base case interest rate: 11.0%)



Source: Company data, I-Sec research

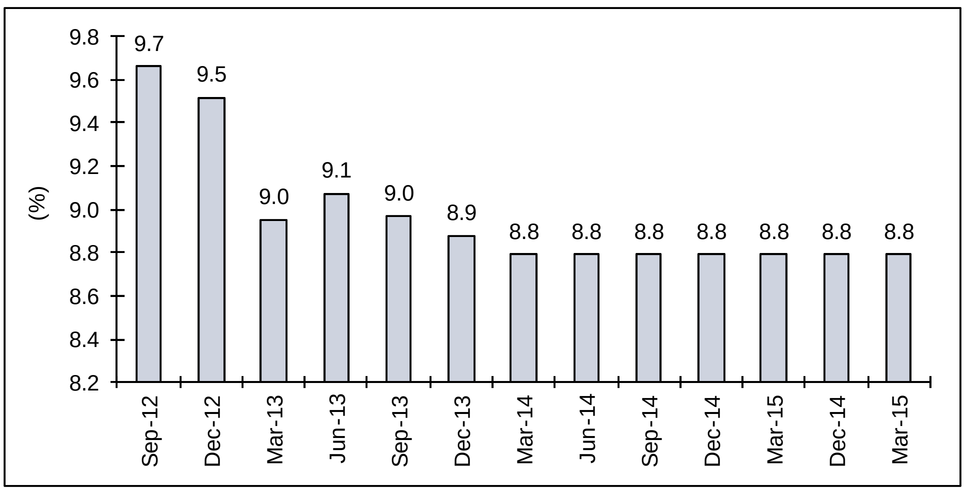
With interest rates and thereby borrowing rates in the wholesale market starting to soften, if yields take time to move down there may be some expansion in spreads in the individual loans business. Although wholesale borrowing costs have come down, bank base rates have remained sticky. This implies that the marginal price setter in the yield market, the State Bank of India, cannot really lower mortgage lending rates until base rates are revised (current best lending rates for SBI being only 25bps north of its base rate). Until then yields will remain sticky.

Chart 19: Yield assumptions are conservative



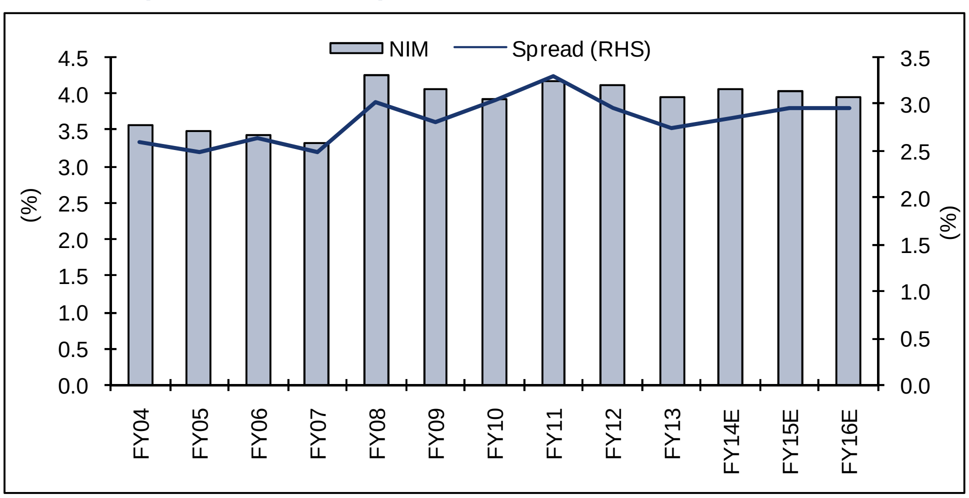
Source: Company data, I-Sec research

Chart 20: Borrowing costs may moderate marginally



Source: Company data, I-Sec research

Chart 21: Spread and NIM expected to remain stable



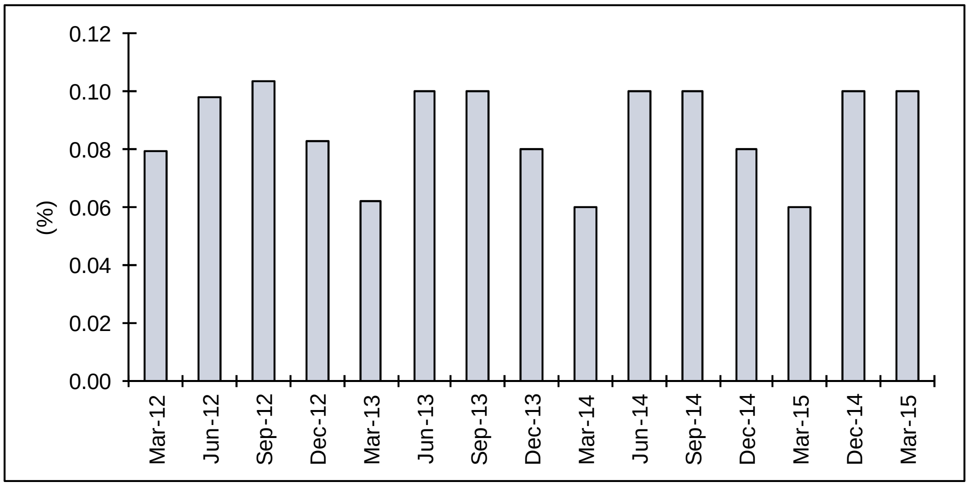
Source: Company data, I-Sec research

Valuations likely to adjust to new capital productivity base

Operating metrics expected to remain steady

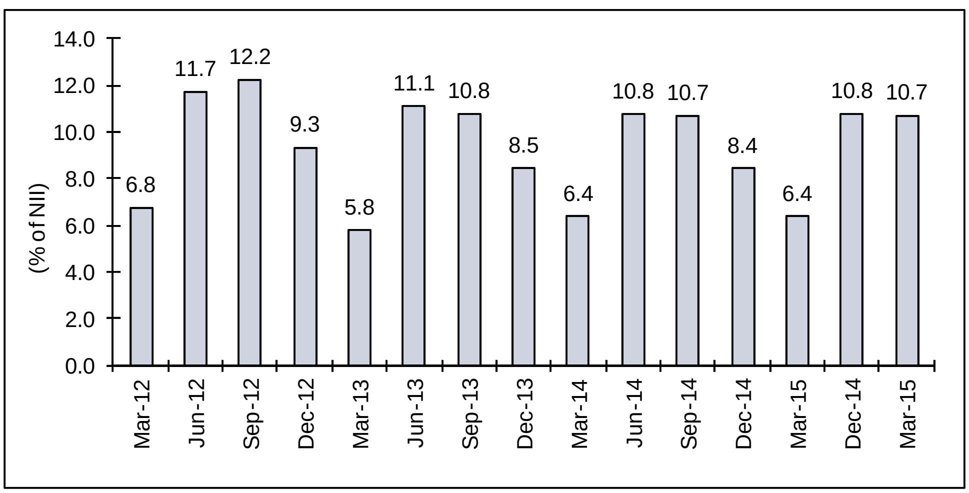
At an AUM of Rs1.87tn HDFC's operating model can hardly be called to be in a state of flux. This fact is reflected in its operating metrics and we feel that any significant improvement can only come from larger ticket size benefits of an enlarged developer portfolio. We do not build in any major changes in the operating cost parameters relative to portfolio size.

Chart 22: Operating costs as a % of AUM stable (seasonality excepted)…



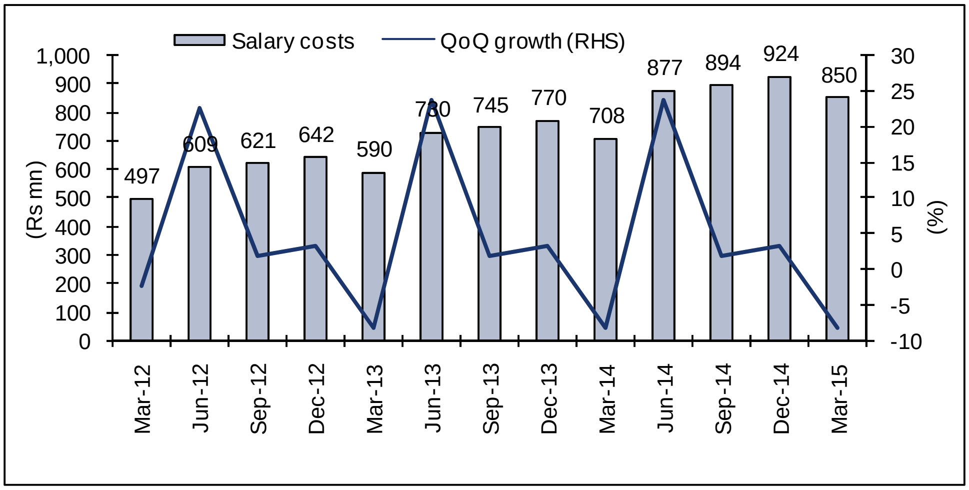
Source: Company data, I-Sec research

Chart 23: …as is cost to income



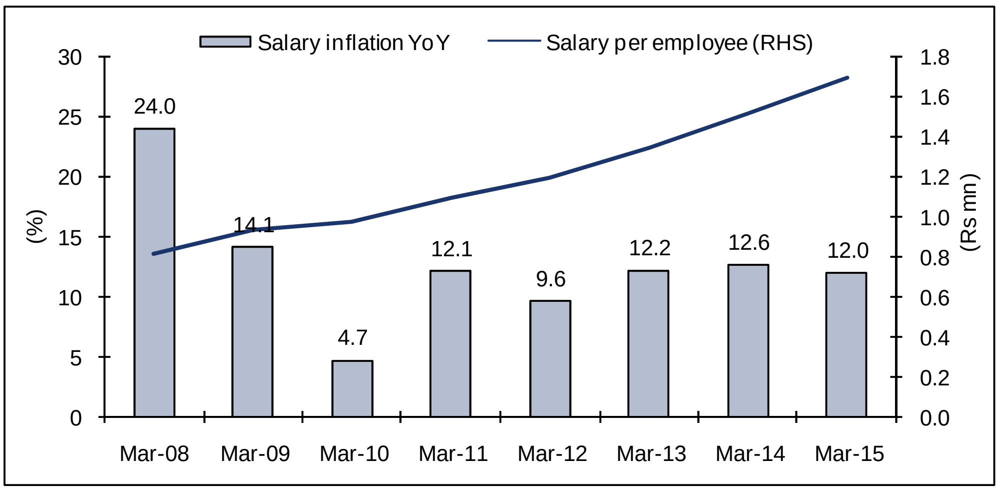
Source: Company data, I-Sec research

Chart 24: Employee cost inflation has been sequential and gradual…



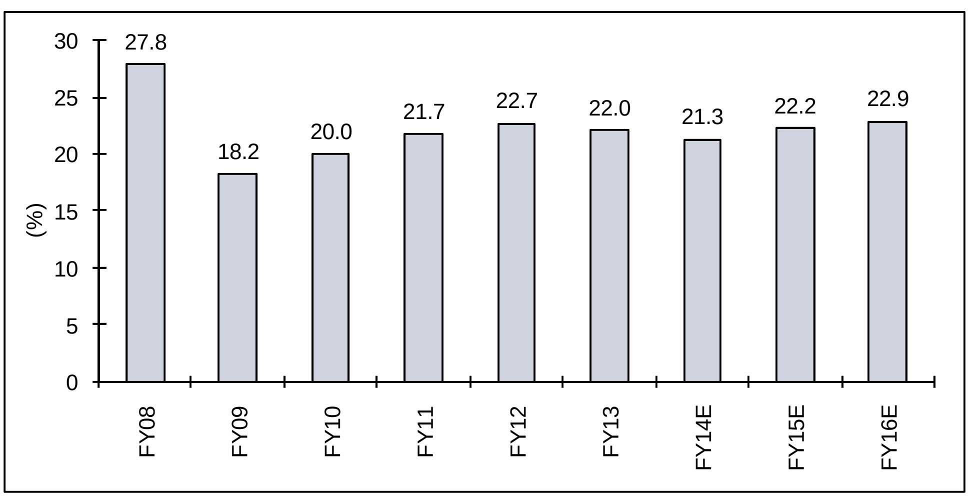
Source: Company data, I-Sec research

Chart 25: …reflected in tempered salary inflation numbers



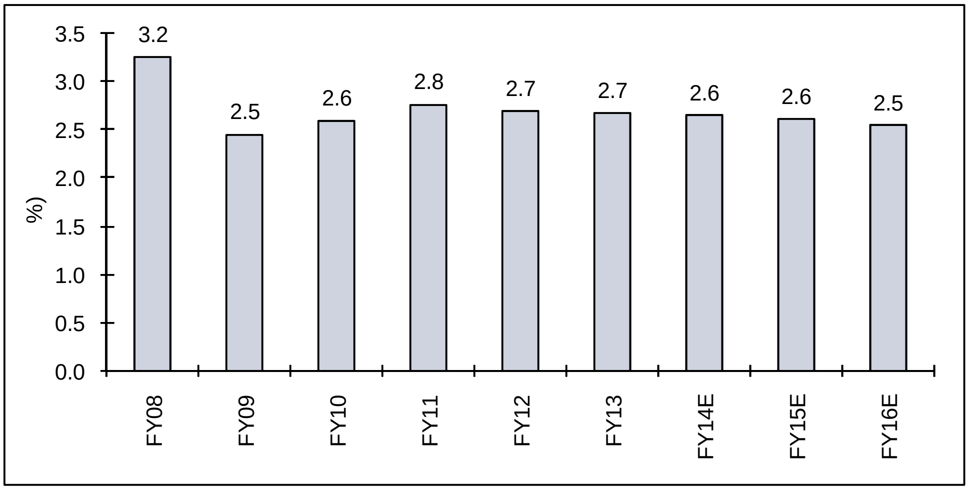
Source: Company data, I-Sec research

Chart 26: RoE remains best amongst large HFCs..,



Source: Company data, I-Sec research

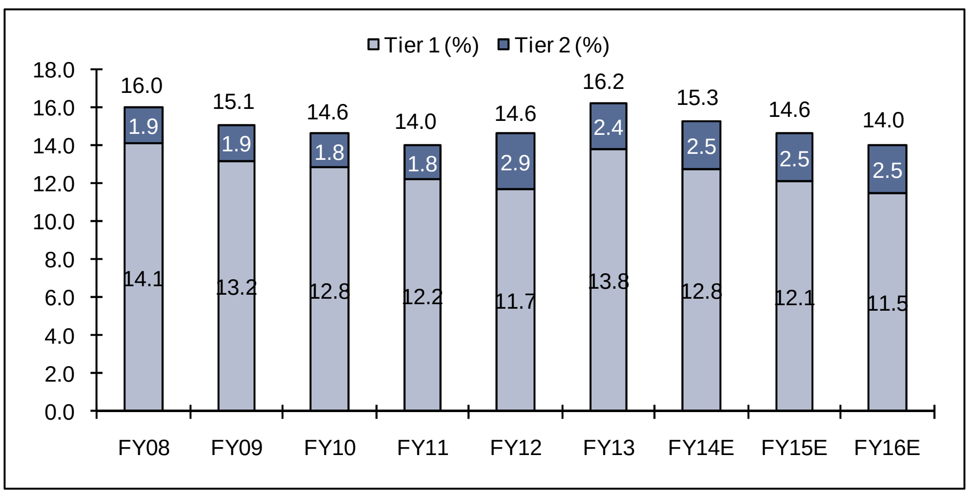
Chart 27: …as does RoA



Source: Company data, I-Sec research

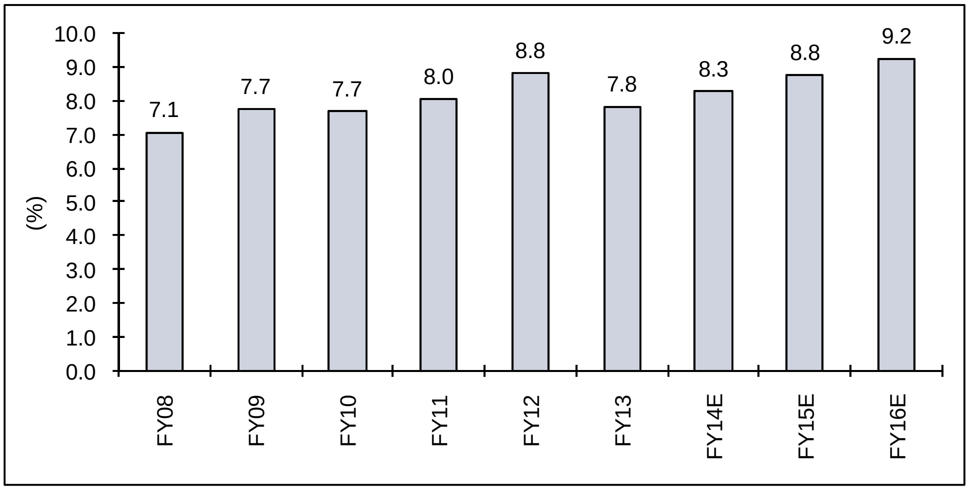
We believe that with spreads in the mortgage business about to undergo a squeeze on a secular basis, one of the key insurance against the same could be higher proportion of higher yield products. With the developer book already at a third of the overall portfolio, we believe the key to margin defence may lie in higher proportion of LAP (loan against property). With HDFC's borrowing cost advantage over other private HFCs and NBFCs and arguably better ability to manage risks and appetite for the same, could make it a leader in the space.

Chart 28: Capital release may pave the way for higher leverage



Source: Company data, I-Sec research

Chart 29: Leverage remains quite low



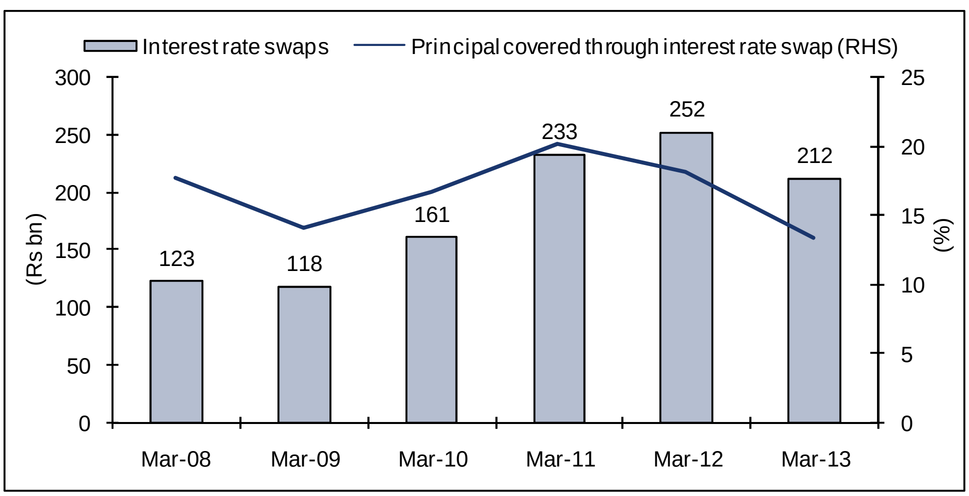
Source: Company data, I-Sec research

With latest modification of risk weights by the Reserve Bank of India to 75% from 100% for residential real estate within commercial developments and reduction of standard asset provisioning requirements to 75bps from 100bps release about 150-200bps of Tier I capital for HDFC in our estimation. This could potentially create an opportunity to increase leverage by 1x (7.8x currently) and a RoE increase opportunity of 250-300bps.

Use of interest rate derivatives remains higher than HFC peers

Although the company mainly lends on floating rate (including the dual rate loans as floating in the long term) and borrows at fixed rate (NCD), it does run an interest rate risk if rates fall and yields follow in tandem. The company usually hedges at least a part of this risk through interest rate swaps. In FY11, end the coverage though swaps was over 20% of total borrowings.

Chart 30: Proportion of principal covered through interest rate swaps

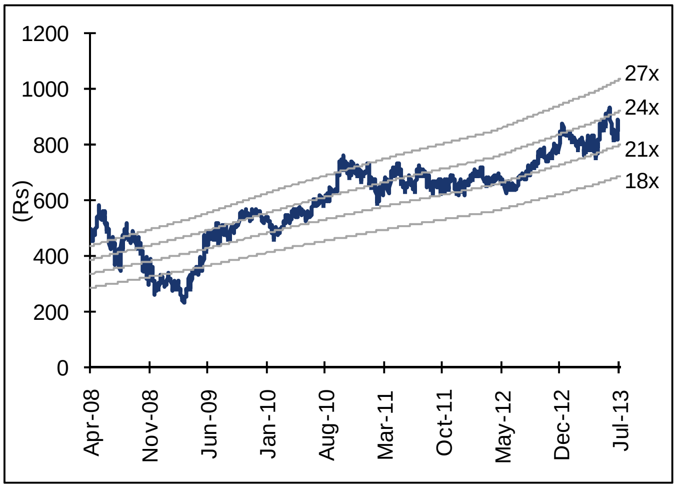


Source: Company data, I-Sec research

Valuations reflect the strong fundamentals but likely to sustain

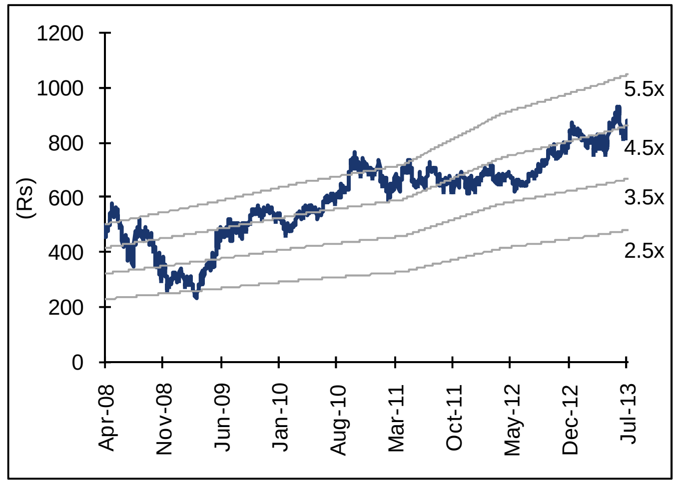
A comparison with its peer group reveals the premium nature of HDFC valuations. In historic terms as well, valuations are higher than last 6 years' average.

Chart 31: Rolling 1-year forward P/E



Source: Bloomberg, Company data, I-Sec research

Chart 32: Rolling 1-year forward P/BV



Source: Bloomberg, Company data, I-Sec research

Chart 33: Valuation matrix - EPS CAGR (FY13-15E) vis-à-vis FY14E P/E

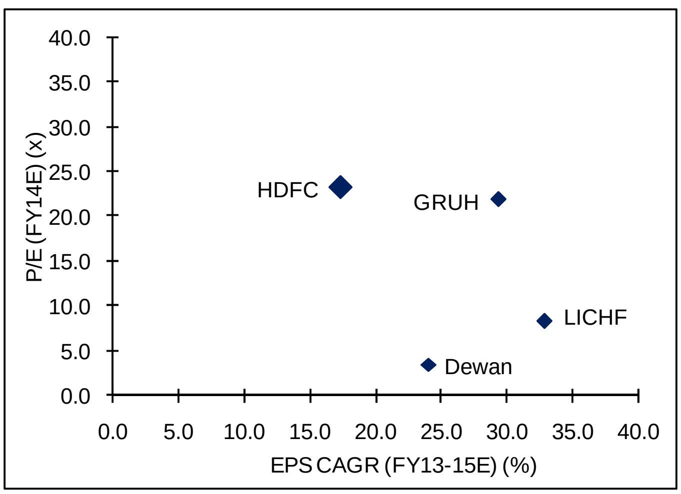
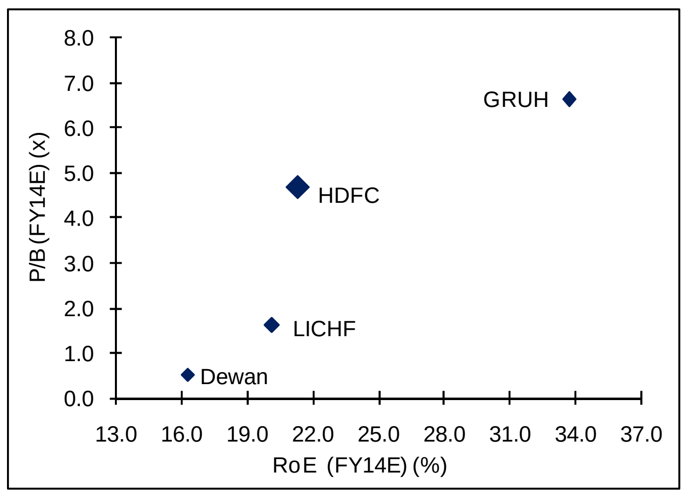


Chart 34: Valuation matrix – FY14E ROE vis-à-vis FY14E P/B



Note: Prices as of July 5,2013
Source: Bloomberg, Company data, I-Sec research

Table 2: HFC Trading Comparables

	Price (Rs)	Market Cap (Rs bn)	P/E (x) FY13E	P/E (x) FY14E	P/E (x) FY15E	P/BV (x) FY13E	P/BV (x) FY14E	P/BV (x) FY15E	RoE (%) FY13E	RoE (%) FY14E	RoE (%) FY15E	EPS CAGR (%) (FY13-15E)
HDFC	850	1,321	27.2	23.3	19.7	5.3	4.7	4.1	22.0	21.3	22.2	17.3
LIC Housing	233	118	11.5	8.3	6.5	1.9	1.6	1.3	16.8	20.1	21.5	32.9
GRUH Finance	229	41	28.1	21.9	16.8	8.4	6.6	5.2	33.3	33.7	34.6	29.4
Dewan Housing	152	19	4.3	3.5	2.8	0.6	0.5	0.5	17.1	16.3	17.5	24.1

Source: Bloomberg, Company data, I-Sec research

We recommend ADD in HDFC with a TP of Rs900

Our first endeavour in HDFC was to figure out what the core RoE of HDFC's lending business was as we have valued the subsidiaries separately. The following calculation shows that core RoE is close to 300-500bps higher than reported ones depending on the year we are looking at with the difference being the least currently.

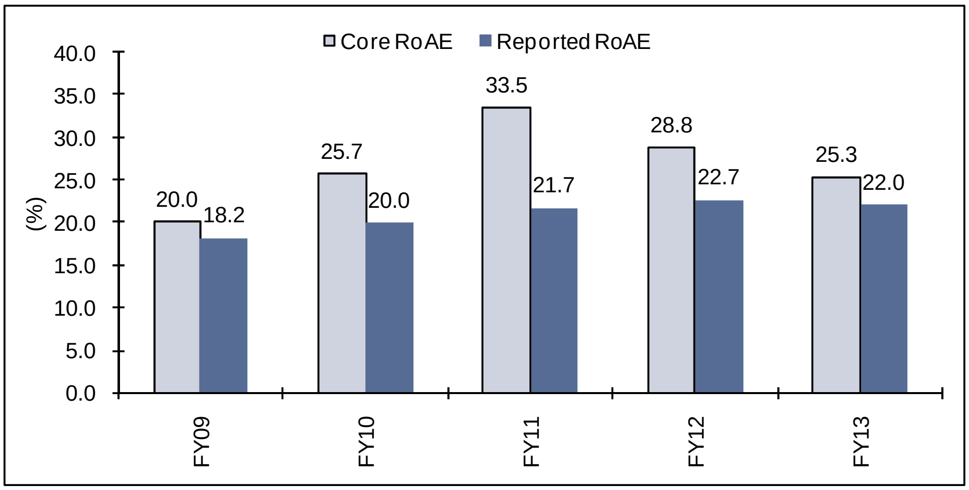
Table 3: Core RoE of HDFC

(Rs mn)

	FY09	FY10	FY11	FY12	FY13
Reported PAT	22,825	28,265	35,350	41,226	48,483
Less: Dividend from subsidiaries	1,082	970	837	1,482	2,694
Add: Tax adjustment @27%	292	262	226	400	727
Core PAT	22,035	27,557	34,738	40,144	46,517
Core book value (book value less investment in subsidiaries)	1,18,298	96,470	1,10,825	1,68,186	1,99,426
Core RoAE (%)	**20.0**	**25.7**	**33.5**	**28.8**	**25.3**
Reported RoAE	**18.2**	**20.0**	**21.7**	**22.7**	**22.0**

Source: Company data, I-Sec research

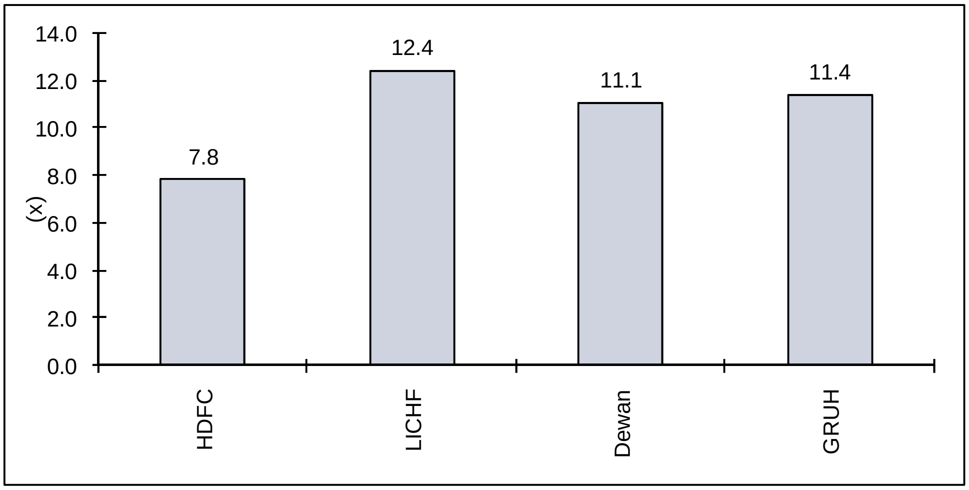
Chart 35: HDFC – Core RoAE much higher than reported



Source: Company data, I-Sec research

Another factor that should be borne in mind when looking at this RoE is that the leverage of HDFC is lowest amongst all the peers by a margin of ~30%.

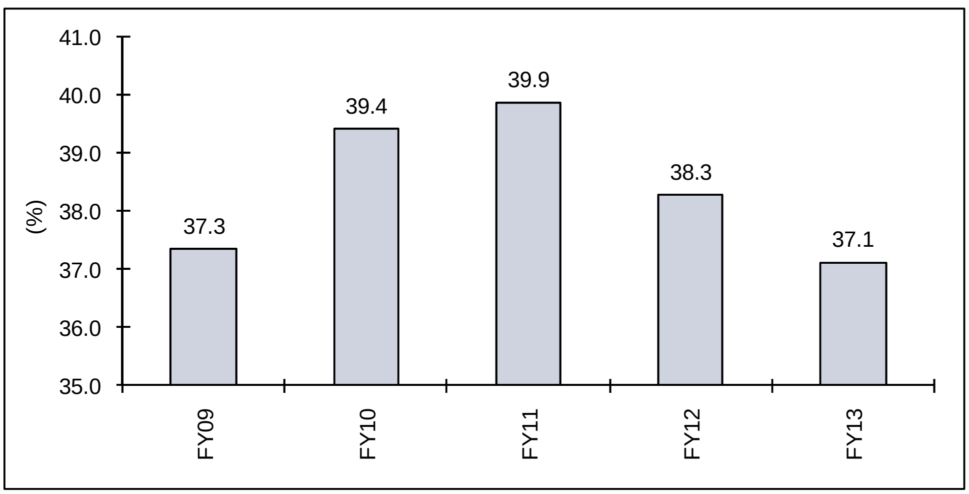
Chart 36: HDFC leverage much lower than peers



Source: Company data, I-Sec research

We understand that such a gap cannot be closed too fast and the company may actually never choose to do so as well (given its systemic importance, prudent outlook and large size). But the healthy payouts reveal that HDFC is also conscious of its financing structure.

Chart 37: Payouts remain high for HDFC



Source: Company data, I-Sec research

We believe that with no major pressure on spreads (apart from long term issues for the sector outlined earlier), HDFC will continue to get valued based on a core RoE of around 28-30% (300-400 bps higher than current core RoE, possible at same RoA with only 1x increase in leverage). Going by our simple yardstick of approximately 1x premium in P/B for every 600bps premium earned over the base CoE of 14%, we arrive at a 1 yr fwd multiple of 3.5x for the core business as fair.

Using this following SOTP calculation sets our target price for HDFC at Rs900 (rounded off). This indicates 6% upside on a 12 month basis. Our recommendation is ADD.

Table 4: SOTP table

Subsidiary/Associate/JV	Stake (%)	Basis	Multiple (x)	Total valuation (Rs mn)	Per share value (Rs)	Year
HDFC Bank	22.8	Target Price	723	3,92,749	254	FY15E
HDFC Standard Life	72.4	NBAP	13.0	91,234	59	FY15E
HDFC ERGO General Insurance	74.0	Book Value	1.0	7,215	5	FY15E
HDFC AMC	59.8	AUM	5.0%	36,807	24	FY15E
HDFC Venture Capital	80.5	AUM	7.0%	998	1	FY15E
GRUH Finance	59.7	Target Price	222	23,650	15	FY15E
Investments in other subs & associates		Book Value	1.5	5,820	4	FY13
Core Mortgage Business		Book Value	3.5	8,31,383	538	FY15E
Total SOTP Valuation (Rs)					**900**	

Source: Company data, I-Sec research

Risks to our investment thesis

Economic slowdown affecting income levels

An economic slowdown that will affect the income levels of borrowers impacts the affordability of loans to individuals and increase probability of default. With newer and riskier products like LAP (loan against property) in the ambit now, the risk becomes even more exacerbated. However, LTVs and EMI to income ratios are conservative for HDFC and provide cushion.

Liquidity squeeze

Like any other housing finance company, HDFC is wholesale funded and any liquidity tightening makes its growth plans uncertain. Also, the company runs a large mismatch in asset and liability duration with almost 15%-20% of liabilities needing refinance while repayment rates are only about 10% for assets. This means even maintaining the existing loan book needs refinance – a fundamental weakness in the business model.

Cooling off in real estate markets

If real estate market volumes and prices cool off, it creates multiple complications for any housing finance company. Firstly, as real estate developer businesses and projects come under pressure, asset quality in the developer book starts to suffer. HDFC, however, arguably remains the best manager of such risks in the business. The other issues are that growth becomes more challenging given the ticket size shrinkage, operating cost metric spikes due to the same reason and increasing moral hazard from borrowers if prices drop sharply.

Increasing competition

With banks led by SBI and Axis bank seriously refocusing on the segment and new players like Indiabulls Financials making serious inroads, competitive pressures in the sector is some of the strongest in recent memory. With spreads coming down, this remains a threat to HDFC's profitability. However, extreme predatory pricing scenarios are unlikely with players with market disrupting size are too invested in the sector and mature to follow such strategies that will destroy long term value for everyone.

Adverse regulation

When one looks at the recent history of the sector, multiple regulations have impacted it very significantly. The base rate driven regime for banks, have made bank borrowings all but infeasible on cost for players who operate in the mass market for plain vanilla mortgages to salaried individuals. Prepayment penalties have been abolished and this has created an environment for rate shopping and, we feel spreads will come down as the gap between yields charged to old and new customers disappears. The Damodaran Committee recommended that the regulator enforce that no interest rate differential is allowed between customers depending on vintage. There are many other areas like risk weights for calculating regulatory capital and deposit collection rights of HFCs which can attract potential regulatory scrutiny.

Financial summary

Table 5: Profit and loss statement

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	1,64,847	2,00,750	2,27,202	2,69,990	3,23,545
Interest expended	1,11,568	1,38,909	1,51,712	1,80,898	2,19,154
Net interest income	**53,279**	**61,841**	**75,490**	**89,092**	**1,04,391**
Other income	8,696	10,727	10,706	12,722	15,246
Operating expenses	2,256	2,691	3,575	4,274	5,116
Employee costs	2,058	2,462	2,954	3,545	4,254
Depreciation	205	236	330	402	488
Pre-provisioning op profit	**57,456**	**67,178**	**79,336**	**93,593**	**1,09,778**
Provisions & contingencies	800	1,450	1,602	1,919	2,302
Profit before tax	**56,656**	**65,728**	**77,735**	**91,674**	**1,07,476**
Income taxes	15,430	17,245	21,144	24,935	29,233
Net profit	**41,226**	**48,483**	**56,591**	**66,739**	**78,242**

Source: Company data, I-Sec research

Table 6: Balance sheet

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Share Capital	2,954	3,093	3,103	3,113	3,123
ESOPs					
Reserves and surplus	1,87,222	2,46,907	2,78,501	3,16,602	3,61,657
Minority Interest					
Borrowings	13,91,275	15,88,281	19,02,840	23,05,509	27,92,553
Current liabilities & provisions	93,749	1,17,026	1,42,246	1,72,901	2,10,163
Total liabilities & stockholders' equity	**16,75,199**	**19,55,308**	**23,26,690**	**27,98,126**	**33,67,496**
Loans & advances	14,23,152	17,13,884	20,07,185	24,04,816	28,83,240
Fixed assets	2,340	2,379	2,892	3,515	4,273
Investments	1,22,070	1,36,135	1,65,472	2,01,133	2,44,478
Cash and Balance	54,729	57,511	71,889	89,862	1,12,327
Current assets	56,047	31,287	71,577	89,471	1,11,839
Deferred tax assets	16,862	14,111	7,674	9,328	11,339
Total assets	**16,75,199**	**19,55,308**	**23,26,690**	**27,98,126**	**33,67,496**

Source: Company data, I-Sec research

Table 7: Key ratios

(Year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Growth:					
AUM	19.9	20.8	18.4	19.8	19.9
Net Interest Income	18.7	16.1	22.1	18.0	17.2
Total Non-Interest Expenses	18.6	19.3	27.3	19.8	19.9
Pre provisioning operating profits	16.4	16.9	18.1	18.0	17.3
PAT	16.6	17.6	16.7	17.9	17.2
EPS	15.8	12.3	16.6	17.9	17.2
Yields, interest costs and spreads (%)					
NIM on AUM	4.1	3.9	4.1	4.0	3.9
Yield on loan assets	11.7	12.1	11.6	11.6	11.6
Average cost of funds	8.8	9.3	8.7	8.6	8.6
Interest Spread on loan assets	3.0	2.8	2.9	3.0	3.0
Operating efficiencies					
Non interest income as % of total income	5.0	5.1	4.5	4.5	4.5
Cost to income ratio (%)	8.5	8.7	9.1	9.2	9.4
Op.costs/avg AUM (%)	0.3	0.3	0.4	0.4	0.4
No of employees (estimate)	1,719	1,833	1,953	2,093	2,263
No of branches	237	250	265	280	295
Average annual salary (Rs)	11,97,150	13,43,099	15,12,688	16,93,806	18,79,878
Annual inflation in average salary(%)	9.6	12.2	12.6	12.0	11.0
Salaries as % of non-int.costs (%)	45.5	45.7	43.1	43.1	43.2
NII /employee (Rsmn)	3,099	3,374	3,865	4,257	4,613
AUM/employee(Rsmn)	817	925	1,028	1,149	1,274
AUM/ branch (Rs mn)	5,925	6,783	7,574	8,589	9,774
Capital Structure					
Debt-Equity ratio	7.3	6.4	6.8	7.2	7.7
Leverage (x)	8.8	7.8	8.3	8.8	9.2
CAR (%) -standalone	14.6	16.2	15.3	14.6	14.0
Tier 1 CAR (%) -standalone	11.7	13.8	12.8	12.1	11.5
Tier 2 CAR (%) - standalone	2.9	2.4	2.5	2.5	2.5
Asset quality and provisioning					
GNPA (%)	0.7	0.7	0.8	0.8	0.8
NNPA (%)	0.0	0.0	0.0	0.0	0.0
GNPA	10,690	11,990	16,057	19,239	23,066
NNPA	-3,330	-5,930	-4,817	-3,848	-4,613
Coverage ratio (%)	131.2	149.5	130.0	120.0	120.0
Return ratios & capital management					
RoAA (%)	2.7	2.7	2.6	2.6	2.5
RoAE (%)	22.7	22.0	21.3	22.2	22.9
Payout ratio (%)	39.4	39.9	38.3	37.1	36.6
Valuation Ratios					
EPS (Rs)	27.9	31.3	36.5	43.1	50.5
Price to Earnings	30.4	27.2	23.3	19.7	16.8
BVPS (Rs)	128.8	161.3	181.7	206.3	235.4
Price to Book	6.6	5.3	4.7	4.1	3.6
Dividend yield (%)	1.3	1.5	1.6	1.9	2.2

Source: Company data, I-Sec research

Table 8: DuPont analysis

(Rs mn, year ending March 31)

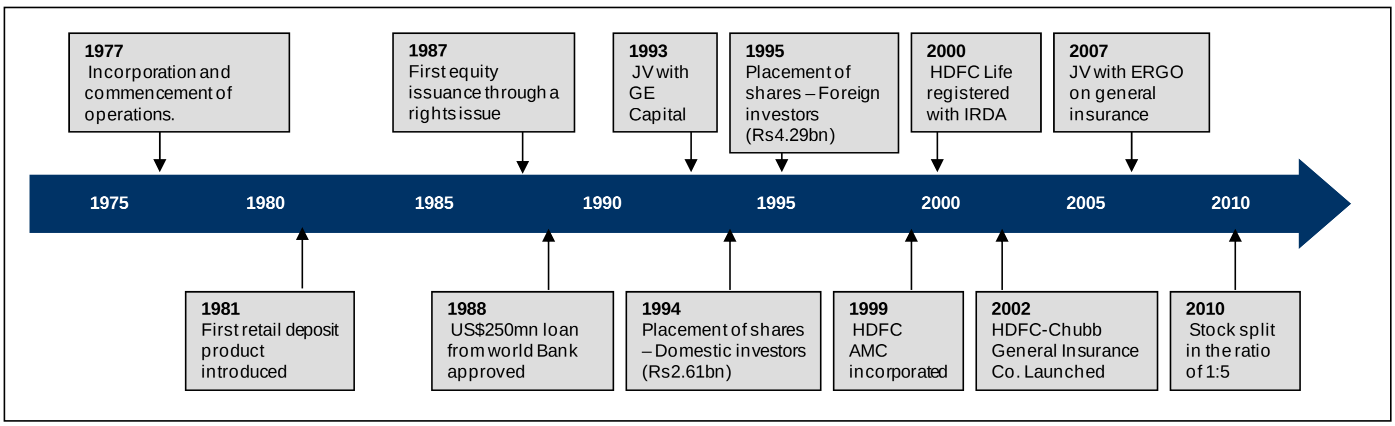
	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	12.7	12.8	12.2	12.2	12.2
Interest expended	8.6	8.9	8.2	8.2	8.3
Gross Interest Spread	**4.1**	**3.9**	**4.1**	**4.0**	**3.9**
Provisioning for NPAs	0.1	0.1	0.1	0.1	0.1
Net Interest Spread	**4.0**	**3.9**	**4.0**	**4.0**	**3.9**
Operating cost	0.3	0.3	0.4	0.4	0.4
Lending spread	**3.7**	**3.5**	**3.6**	**3.6**	**3.5**
Non interest income	0.7	0.7	0.6	0.6	0.6
Operating spread	**4.4**	**4.2**	**4.2**	**4.2**	**4.1**
Tax	1.2	1.1	1.1	1.1	1.1
Return on average loan assets	**3.2**	**3.1**	**3.0**	**3.0**	**3.0**
Effective leverage (average loan assets/ average equity)(x)	7.1	7.1	7.0	7.3	7.7
RoAE	**22.7**	**22.0**	**21.3**	**22.2**	**22.9**

Source: Company data, I-Sec research

Annexure 1: Company overview and background

Established in 1977, the Housing Development Finance Corporation (HDFC) Ltd. is one of India's premier financial services institutions and the leading non-banking finance company (NBFC) in the country. HDFC Ltd. has varied interests in the financial services industry with a controlling stake in HDFC Bank (the second largest private sector bank), HDFC Standard Life (72:28 life insurance JV with Standard Life) and HDFC ERGO (74:26 general insurance JV with ERGO International AG). HDFC has a wide network of 331 offices catering to over 2,400 towns and cities spread across the country. It also has offices in Dubai, London and Singapore and service associates in the Middle East region to provide housing loans and property advisory services to non-resident Indians (NRIs) and persons of Indian origin (PIOs). HDFC Ltd. is listed on the BSE and NSE with market cap of Rs1,321 (US$21.9bn).

History and milestones



Source: Company data, I-Sec research

Senior management

Name	Designation	Background
Mr. Deepak Parekh	Chairman	Mr Parekh is one of the most eminent personalities in the Indian financial services industry. He joined HDFC in 1978 and became its MD in 1993, before retiring in Dec 2009.
Mr. Keki M. Mistry	Vice Chairman & CEO	Mr. Mistry joined the Corporation in 1981 and was appointed as the MD in 2000. He was re-designated as the Vice Chairman & CEO with effect from Jan 1, 2010.
Ms. Renu Sud Karnad	Managing Director	Ms. Karnad joined the Corporation in 1978 and was appointed as the Executive Director in 2000. In 2007, she was re-designated as the Joint MD.
Mr. Keshub Mahindra	Vice Chairman	Mr. Mahindra is a renowned industrialist and is the Chairman-Emeritus of the Mahindra & Mahindra Group of Companies.
Mr. Shirish B. Patel	Director	Mr. Patel is the Chairman-Emeritus of Shirish Patel & Associates and has been a director of the Corporation since its inception.
Mr. B.S. Mehta	Director	Mr. Mehta is a Chartered Accountant by Profession and has been on the board since 1988.
Mr. D.M. Sukthankar	Director	Mr. Sukthankar has been on board since 1989 and was a IAS officer having served as Secretary, Ministry of Urban development, Govt. of India
Mr. D.N Ghosh	Director	Mr. Ghosh has been on board since 1989 and is a former Chairman of the State Bank of India.
Mr. S.A. Dave	Director	Mr. Dave was the former Chairman of the Securities and Exchange Board of India (SEBI) and the Unit Trust of India (UTI). He has been on the board since 1990.
Dr. Ram S. Taneja	Director	Mr. Taneja has been a director of the Corporation since 1994 and is the former MD of Bennett, Coleman & Company Ltd.
Mr. Nasser Munjee	Director	Mr. Munjee worked in the Corporation from 1978 to 1998 and also served as an Executive Director.
Mr. Bimal Jalan	Director	Mr. Jalan is the former Governor of the Reserve Bank. He has been on board since 2008.
Dr. J.J. Irani	Director	Dr. Irani joined the board in 2012 and is a director on the boards of several prominent companies in India.
Mr. V. Srinivasa Rangan	Executive Director	Mr. Rangan is responsible for the treasury, resources and account functions for the Corporation. He was appointed in Jan'2010, for a period of 5 years.

Source: Company

Annexure 2: Index of Tables and Charts

Tables

Charts

Equity Research

July 7, 2013

BSE Sensex: 19496

Financials

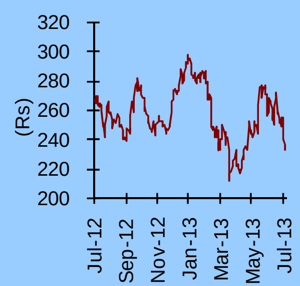
Target price Rs360

Shareholding pattern

	Sep '12	Dec '12	Mar '13
Promoters	40.3	40.3	40.3
Institutional investors	41.5	45.6	44.8
MFs and UTI	7.4	9.3	10.1
Insurance	2.3	2.1	2.3
FIIs	31.8	34.2	32.5
Others	18.2	14.1	14.9

Source: NSE

Price chart



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INDIA

LIC Housing Finance

BUY

Ready for a bounce back

Rs233

Reason for report: Initiating coverage

LIC Housing Finance (LICHF), the second largest HFC in India with an asset base of Rs780bn is poised to continue its growth momentum at a CAGR of 22.5% over the next three years. Dual rate loans at ~80% of incremental disbursements will remain the growth driver, although at rates pretty close to usual floating rate ones. Our analysis reveals that margins are ready for a rebound from the serious erosion they suffered in last two years. RoE should trend back up the 20% mark, a level sustainable in the next few years in our view. We initiate coverage with a BUY recommendation and mark it our top pick amongst HFCs.

- **Individual business growth continues unabated.** After scripting a well orchestrated turnaround in FY04-07, LICHF today has about 9.6% share of the total individual housing loan pie (combining both banks and HFCs) and 27% of the total individual loans given by HFCs. One of the dominant players in the sizeable individual mortgage loans opportunity, we feel that it also has best access to opportunities inside the LIC employee ecosystem (estimated at close to 40% of current asset base). Dual rate loans have been a key growth driver in last few years.
- **Worst of margin concerns behind us**. LIC Housing Finance's margin shrinkage in the last two years was on account of developer portfolio shrinkage (30bps impact), higher dependence on bank funding in the base rate regime, low deposit mobilization and low initial spreads on dual rate products. We expect margins to rebound on the back of reduced bank dependence, cheaper NCD borrowings, better yields from the new dual rate products and ongoing conversion of old ones into floating rate assets.
- **Asset quality concerns remain low, applying for a banking license**. With the developer book of the company shrinking to about 3% of current loans, the cyclical risks to the same are insignificant to the overall thesis. The company has eased its provisioning policy in FY13 by choosing to provide for 70% of doubtful assets vs 100% earlier (reflected in coverage dropping to 41.4% from 68% last year), but standards are still more conservative than NHB stipulations. The company has applied for a banking license and given parentage and business experience will be one of the favourites to receive one, subsequent teething issues notwithstanding.
- **Valuations attractive, multiple upside triggers.** We believe that the sustainable RoE for LIC Housing Finance is about 20% and accordingly a fair 1 yr fwd P/B multiple for the company is 2x. Our target price of Rs360 indicates 55% upside from CMP on a 12 month basis. LICHF is our top pick in the sector. The biggest risk to our investment thesis is any reversal in the company's decision to move the pricing on its dual rate loans close to existing market rates and inability to reduce its dependence on bank funding further.

Market Cap	Rs110bn/US$1.8bn
Reuters/Bloomberg	LICHF.BO / LICH IN
Shares Outstanding (mn)	473
52-week Range (Rs)	297/212
Free Float (%)	59.7
FII (%)	32.5
Daily Volume (US$/'000)	12,565
Absolute Return 3m (%)	5.6
Absolute Return 12m (%)	(12.7)
Sensex Return 3m (%)	5.7
Sensex Return 12m (%)	11.3

Year to March	FY13	FY14E	FY15E	FY16E
NII (Rs mn)	15,463	21,822	27,630	33,760
Net Income (Rs mn)	10,232	14,189	18,072	22,099
EPS (Rs)	20.3	28.1	35.8	43.8
% Chg YoY	11.9	38.7	27.4	22.3
P/E (x)	11.5	8.3	6.5	5.3
P/BV (x)	1.8	1.5	1.3	1.1
Net NPA (%)	0.4	0.4	0.3	0.2
Dividend Yield (%)	1.6	1.9	2.1	2.6
RoA (%)	1.4	1.6	1.6	1.6
RoE (%)	16.8	20.1	21.5	21.9

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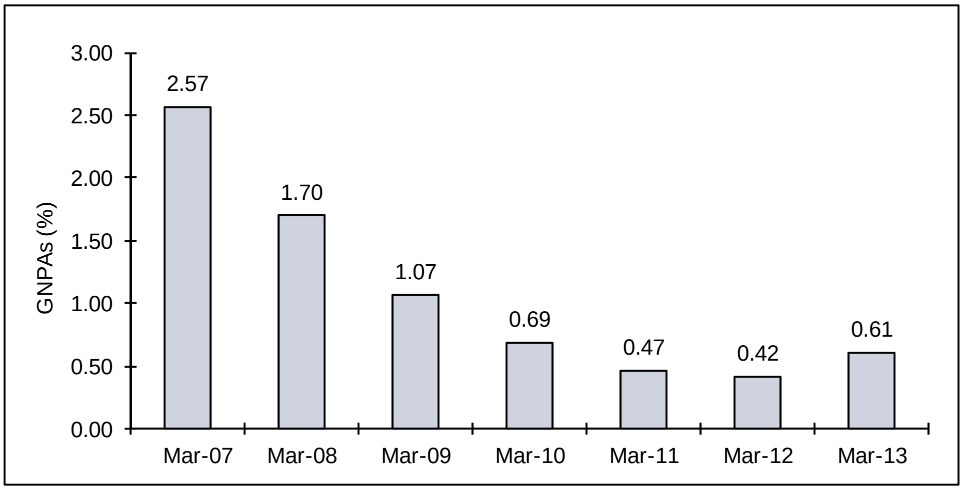
Individual business growth continues unabated

Turning over a new leaf over the last decade

The turnaround in the fortunes of LIC Housing Finance's (LICHF) business since FY06 has been rather dramatic. In the pre-FY06 period, the company had lost market share and suffered from delinquencies that were much higher than sector peers of prominence.

Chart 1: Gross NPA has declined on a secular basis



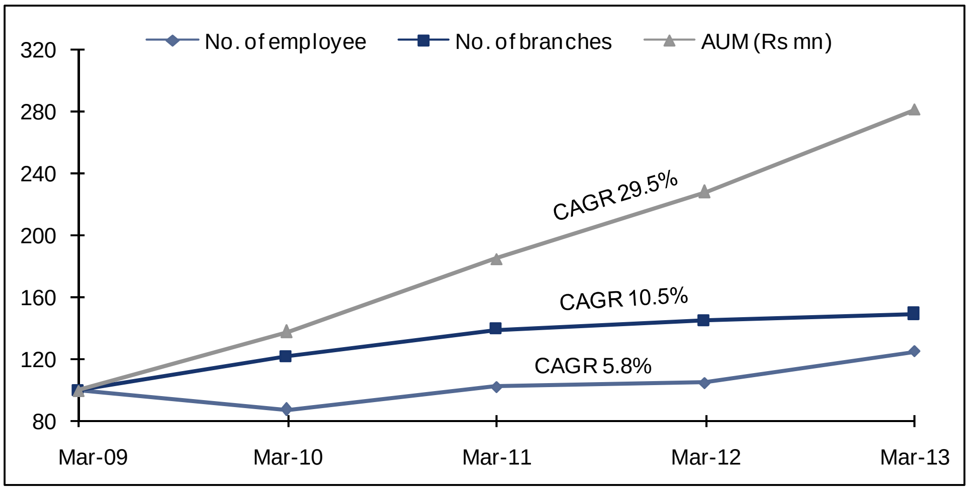
Source: Company data, I-Sec research

This dramatic turnaround was no accident. It was the result of an extensive restructuring exercise that the company launched in 2004. While multiple business aspects were addressed in the exercise, some key highlights were:

- Development of a credit scoring model for applicants of individual housing loans with the help and consultation of CRISIL in order to increase the objectivity of disbursement decisions. An acceptable credit score is now a non-discretionary filtering criterion for the disbursement process and there is no system override in this context.
- The marketing and lead generation process was completely segregated from the credit appraisal process and large parts of it moved towards a more outsourced and partnership model.
- Collection and recovery was organised as a separate and independent vertical with its own general manager.
- There was change in focus from small-ticket loans in urban peripheries to more urban markets where reduced competition from banks in the FY04-07 period had created an opportunity to finance salaried first-home buyers. This increased the addressable market size for the company, paving way for subsequent high growth, reduced operating cost metrics through increase in ticket-sizes, and moderated asset quality risks due to segment characteristics.

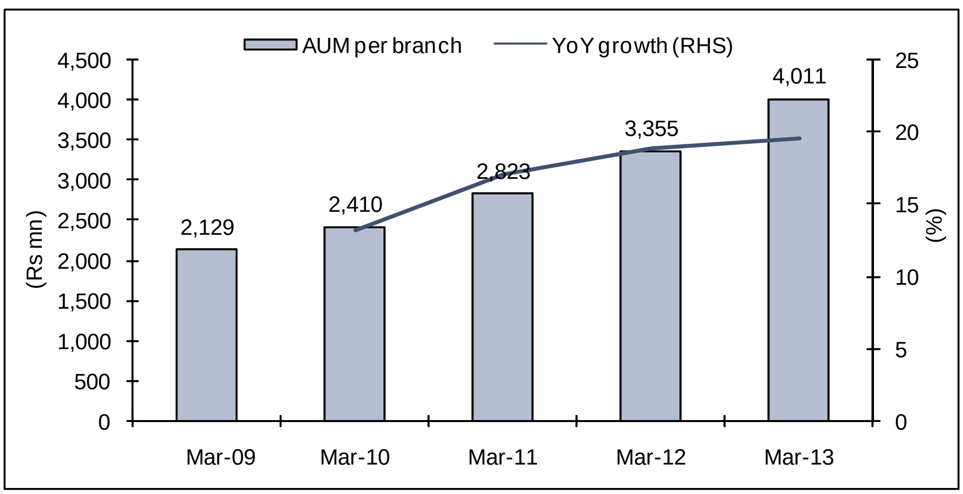
- The company worked hard to streamline its operations and achieved significant improvement in turnaround times, making them faster than at least PSU banks and not much slower than a private bank or HDFC.
- As growth picked up, LICHF reaped the concomitant benefits of scale and also exploited its distribution network that much better. There was consciousness to avoid the temptation to add spare capacity despite high growth during this period.

Chart 2: AUM growth outpaced branch and employee base expansion …



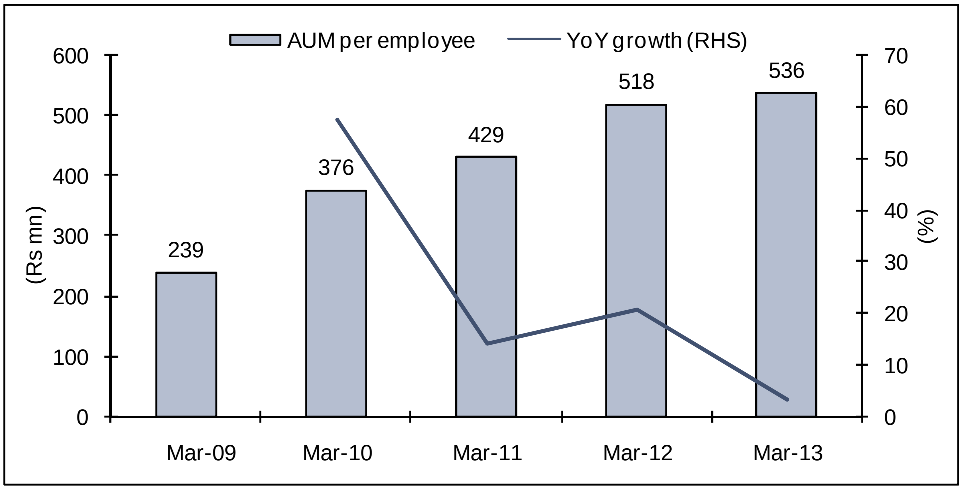
Source: Company data, I-Sec research

Chart 3: …leading to an increase in AUM per branch



Source: Company data, I-Sec research

Chart 4: …and a corresponding one in AUM per employee

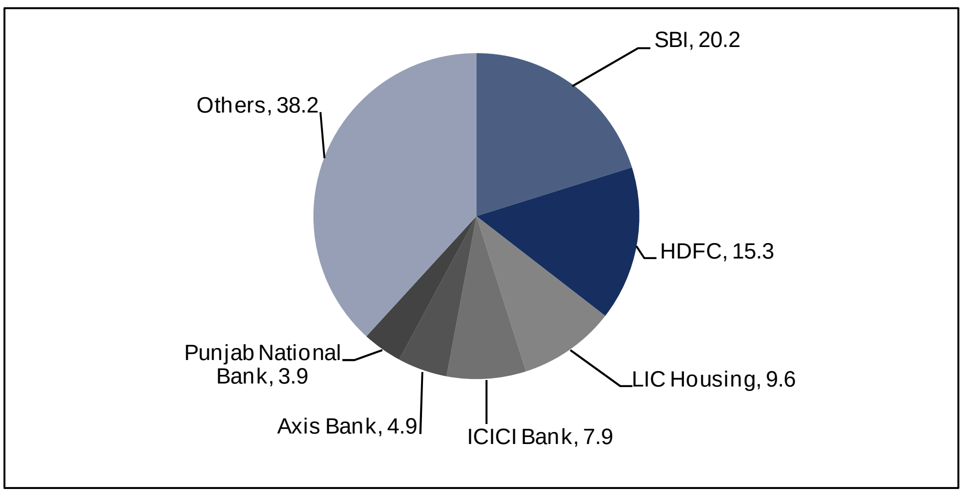


Source: Company data, I-Sec research

A serious player that has been gaining market share

LICHF today has about 9.6% share of the total individual housing loan pie (combining both banks and HFCs) and 27% of the total individual loans given by HFCs.

Chart 5: LICHF retains a large share of total housing loans outstanding (FY12)



Source: Company data, NHB, RBI; I-sec research

Dual rate loans have been a key growth driver

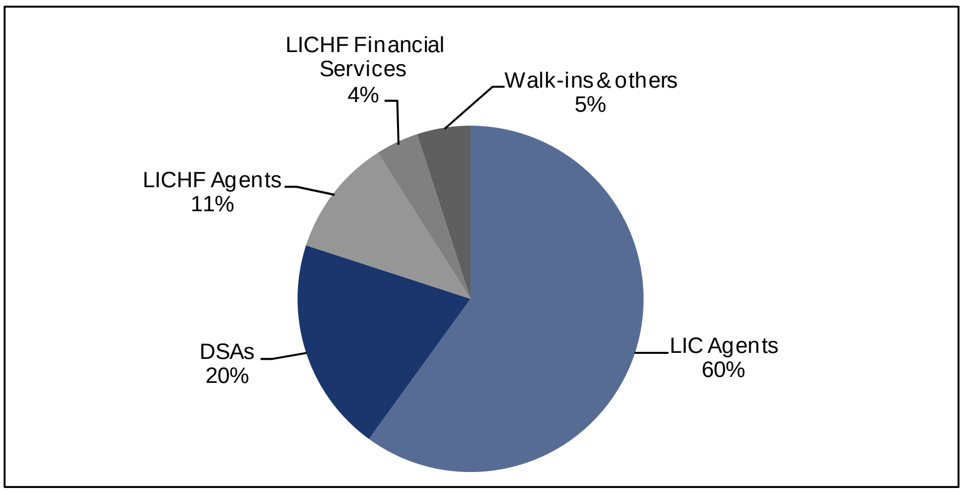
The inflection point in LICHF's market share growth came in FY09, when it launched its first dual rate loan product *Fix-o-Floaty* (fixed for initial few years at a low interest rate, and floating rate for the balance duration). This product was followed by others like *Advantage 5* (fixed for five years and floating thence). The launch of these products followed SBI and HDFC's launch of the same, but LICHF has by far been the most aggressive in rolling out these initially low spread products. These products continue to form ~80% of incremental disbursements and currently stand at 40% of total portfolio.

We feel that in an environment where multiple regulatory developments like the already enforced no prepayment penalty, the proposed move for rate equalisation between similar risk category of new and old borrowers and high costs of bank funds due to the base rate regime are likely to squeeze business spreads, gaining incremental share through aggressive marketing of dual rate products may not bode well for near-term profitability. With rate shopping becoming common, the long-term benefits of this asset acquisition modality is also clearly much less than before. Management commentary however suggests that almost 70-80% of incremental disbursements are coming through the dual-rate products.

Distribution set up heavy on outsourcing

LICHF's operating model is heavily reliant on outsourcing and uses the extensive agent network of its parent LIC. Currently, about 60% of new disbursement leads are through these channels. About 20% also comes through direct sales agents (DSAs). The origination fee paid is about 40-50bps and is spread over one year from loan disbursement. Close to 11% of originations happen through its own agents on the rolls and 4% from its subsidiary LICHFL Financial Services. The balance generally comes from walk-ins into branches.

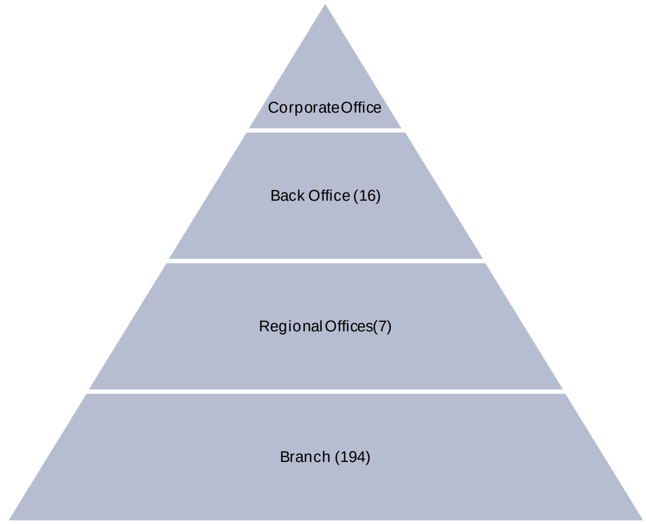
Chart 6: Distribution mix



Source: Company data, I-sec research

This utilisation of LICHF's parent's network and outsourcing a large chunk of lead generation allows the company to maintain a lean staff of about 1,450 employees across its 194 branches.

Chart 7: Organization structure of LIC Housing Finance remains lean



Source: Company data, I-sec research

Internal opportunity is sizeable

LIC in itself and its sister entities employs about 122,000 people. This is a large class of salaried individuals with close to zero unemployment risk and in itself a large opportunity for the company to leverage. Assuming an average loan opportunity of Rs2.5mn, this works out to a total opportunity of Rs305bn (39.2% of LICHF's current individual loans portfolio). Given the parentage of a Central government organisation, its reach in other similar organisations is also likely to be better than that of most competitors.

Table 1: Internal financing opportunity

Total no. of employees with LIC of India	1,20,000
Total no. of employees - LICHF	1,450
Total no. of employees (approx)	**1,22,000**
Average loans size (Rs mn)	2.5
Total financing opportunity (Rs bn)	305
Total loans outstanding (Rs bn)	778
% of outstanding loans	39.2

Source: Company data, I-sec research

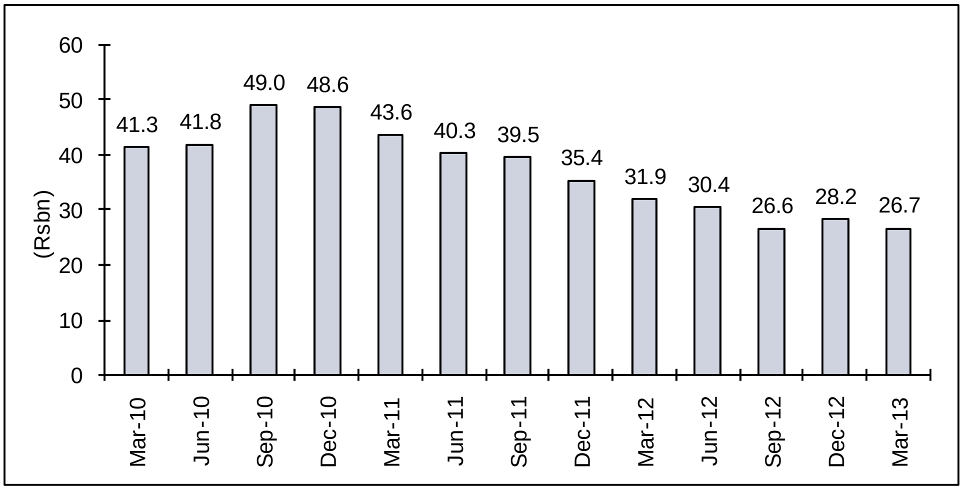
Individual housing remains an exciting growth opportunity

As detailed in our sector report, individual mortgage loan in India remains a lucrative secular growth opportunity. The key drivers to this opportunity are an acute shortage of housing, economic prosperity, government support, rising aspirations, changing demographics, urbanisation, formation of nuclear families, and better last mile for credit delivery.

Post controversy, developer business has been stagnant

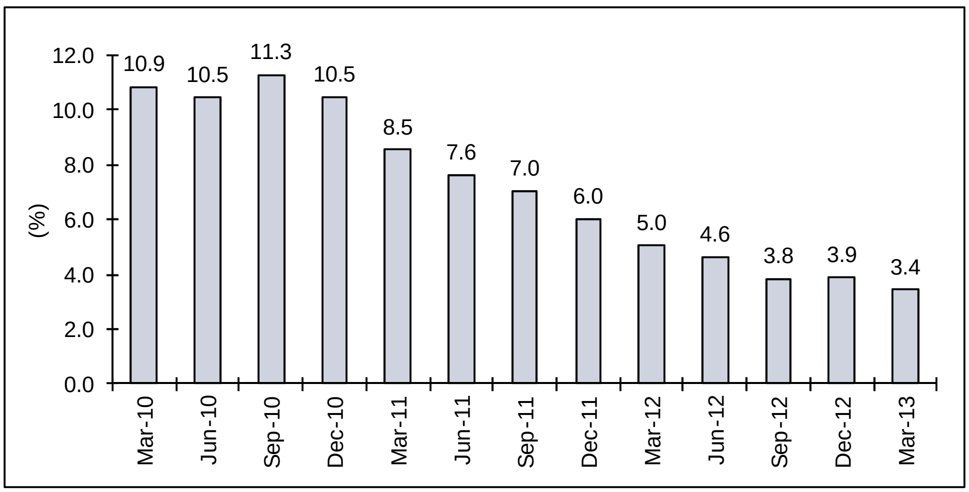
LIC Housing Finance's then CEO was arrested in 2010 in connection with a controversy regarding veracity and transparency of certain loan disbursals. Post this incident there was a visible slowdown in LICHF's developer loan portfolio in terms of growth. We peg this down to increased risk aversion. We feel that although this has had very clear profitability implications, from a portfolio risk perspective this might have actually worked in favour of the company. We feel that developer loans are a highly specialised business that needs a very steep learning curve for an organisation to avoid all the cyclical and structural pitfalls. However, given the exceedingly low levels of developer exposure reached currently, some headroom for growth remains while maintaining risks at acceptable levels.

Chart 8: Developer loans have shrunk…



Source: Company data, I-sec research

Chart 9: …and dwindled in relation to total loans

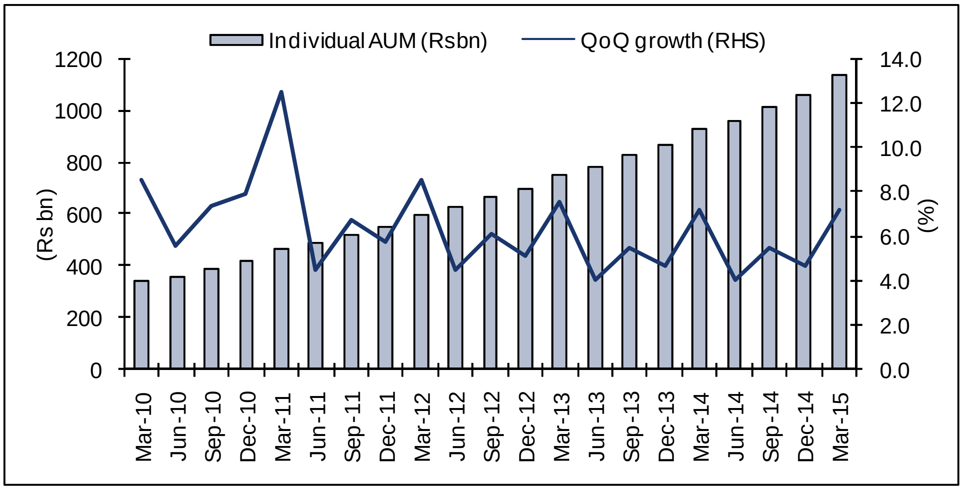


Source: Company data, I-sec research

Asset growth to remain robust

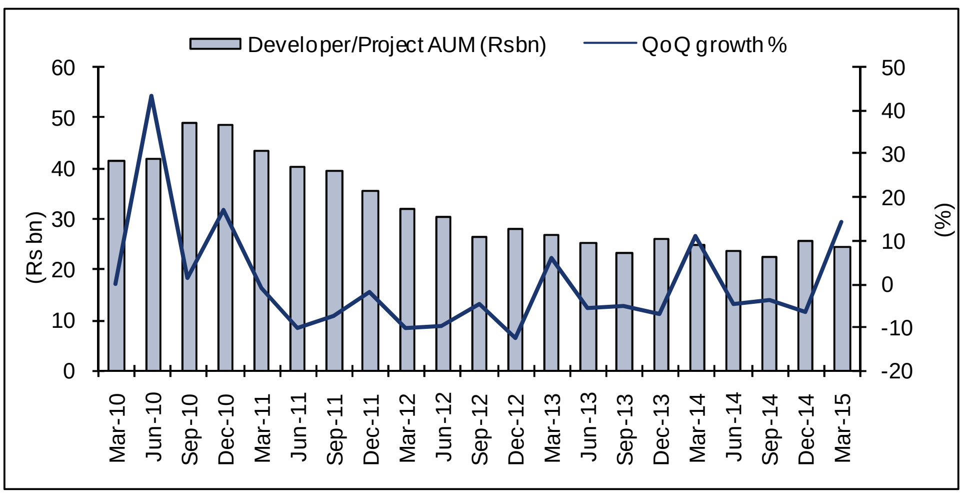
With the company not paring down its aggression on the dual-rate product, despite no other player offering it currently in any significant way, we feel that growth will not be an issue for LICHF despite increasing competition from banks and some new players. We project an AUM growth of 23.2% CAGR in individual loans over the next three years and a conservative 1.4% decline in developer loans over the same period (despite upbeat management commentary). This leads to a 22.5% growth in blended AUM over the next three years. We feel developer loans could potentially surprise on the upside.

Chart 10: Individual AUMs expected to grow fast



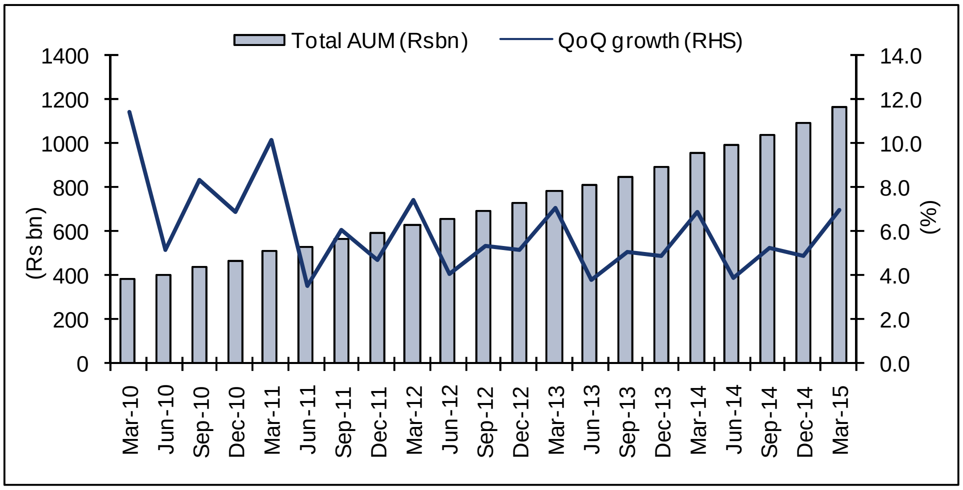
Source: Company data, I-sec research

Chart 11: Developer AUM growth not assumed yet



Source: Company data, I-sec research

Chart 12: Blended AUM growth will remain robust



Source: Company data, I-sec research

Worst of margin concerns behind us

Deconstruction of margin erosion in last two years

The best way to understand the underlying story behind the margin erosion of LIC Housing Finance (LICHF) (arguably the chief culprit behind its derating) is to break it up into its three constituents – yields, costs of funds, and product mix (developer and individual).

The drag on individual loan yields of LICHF comes from the low fixed rates of interest in its dual-rate loans. The rates being paid on fixed-rate loans were lower by about 75-100bps on an average basis (much lesser now), thus impacting blended yields by 20-40bps on an average with increasing impact as the proportion of fixed-rate loans started rising. While there is no denying the role played by dual-rate loans in boosting growth, one cannot deny that it has come at the cost of near-term margins. Apart from this, with competition from banks putting pressure on yields, housing mortgages are perhaps the only product where rates have fallen in lock step with headline interest rate cuts.

Borrowing costs have also contributed to the squeeze in LICHF's spreads. The key contributing factors behind borrowing cost disappointment are:

- With the introduction of the bank base rate regime, the bank borrowing rates have increased for 'AAA' borrowers like LICHF, with no sub-base rate lending being allowed. LICHF's bank borrowings remain a high proportion of liabilities at 29.8%. It is instrumental to remember that with base rates hovering between 9.75-10.25% for most banks and mortgage rates at 10.5-10.75% for new borrowers, it turns out to be a very costly source of funds.

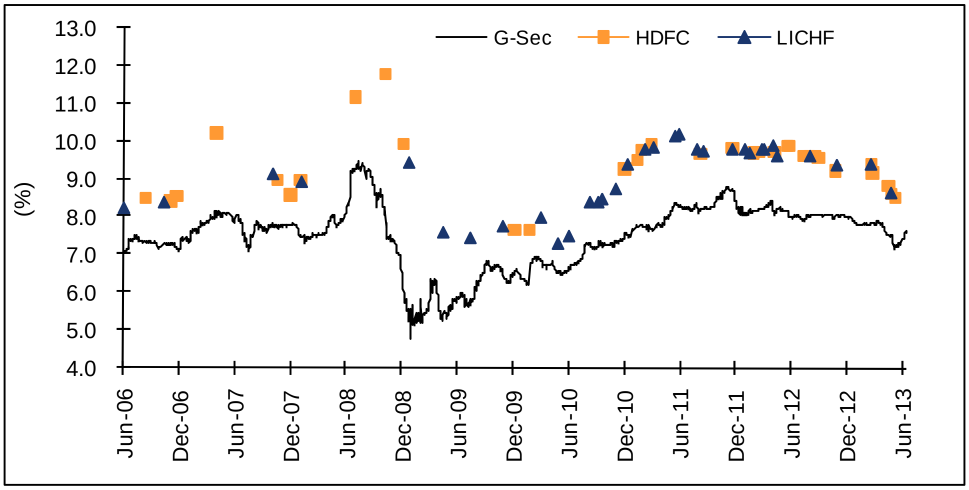
Table 2: LIC Housing liability profile

Breakdown of total borrowings	FY08	FY09	FY10	FY11	FY12	FY13
NCDs	40.2	49.6	51.2	56.1	57.2	60.0
Term loans	43.0	31.9	33.5	27.7	31.8	29.8
NHB refinance	3.3	5.8	3.7	3.4	3.3	3.6
Loans from LIC	9.8	5.8	3.4	2.1	1.3	0.5
Deposits	0.1	0.6	0.9	0.5	0.5	1.1
Commercial paper	0.0	2.4	2.3	1.2	0.1	0.0
Subordinated debt	2.5	3.9	4.3	6.6	5.3	4.4
Zero coupon bonds	0.0	0.0	0.6	2.4	0.5	0.6
ECBs	1.2	0.0	0.0	0.0	0.0	0.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Company data, I-Sec research

- An analysis of the issue yields of 3-year paper (most liquid) by both companies over the past few years shows that 2007 onwards LICHF was borrowing at a marginally finer rate (about 10-15bps) than HDFC (the gulf widened significantly at the height of the financial crisis) but the situation reversed since the controversy erupted at LICHF in mid-2010. The spread moved 10-20bps in the other direction. This potentially translates into an increased cost of 15bps in our opinion (40 bps on NCDs, which are approximately 60% of liabilities) for that period.

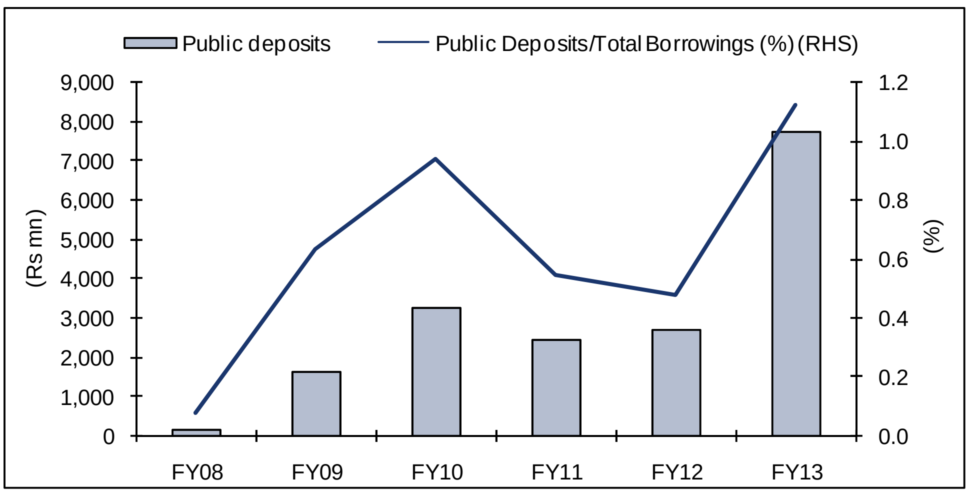
Chart 13: LICHF issue rates *vs* HDFC issue rates *vs* GoI sec yield (3-year)



Source: Bloomberg, I-Sec research

- Public deposits (available at 9-9.5% to HDFC currently) have not ramped up for LICHF.

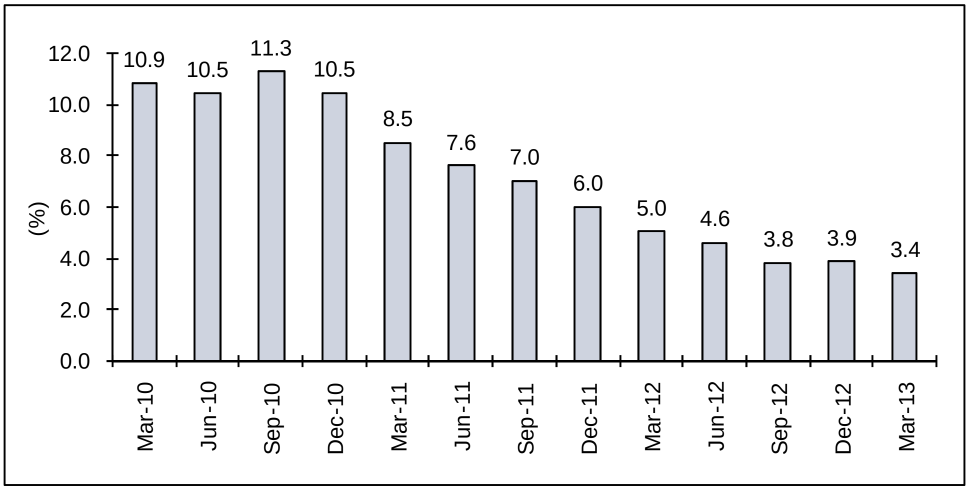
Chart 14: Public deposits have not been mobilised to the extent possible given strong franchise



Source: Company data, I-Sec research

The third contributor to margin decline has been the reducing proportion of developer business. The yields in the developer business are currently about 300-400bps higher than in the individual loans business. With the company having maintained 10% of its total book in this vertical in the pre-controversy days *vs* 3% now, the incremental benefit to yields had the business mix been similar would have been 25-30bps.

Chart 15: Developer loans as a proportion of total lending continues to decline



Source: Company data, I-Sec research

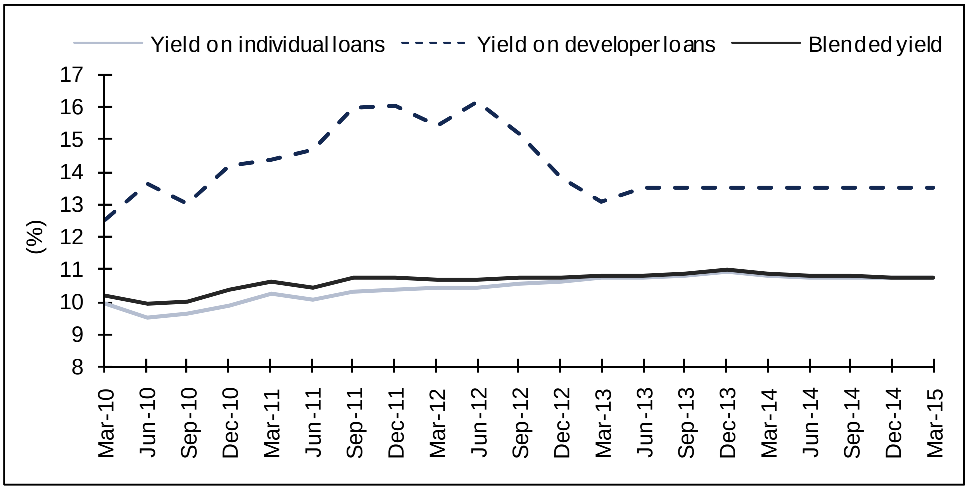
We expect margins to rebound in the near term

Despite the structural headwinds to sector spreads, we do feel that LICHF's spreads bottomed out in FY13. Once again our thesis of margin expansion is predicated on the three pillars on which we based our diagnosis of margin erosion: yields, costs of funds, and business mix.

There are multiple drivers to better the yield situation for LICHF, which are:

- While the company is still aggressive on the dual-rate product with about 70-80% of incremental disbursements belonging to this category, a large chunk of the erstwhile fixed-rate loans are going to convert into higher yield floating rate loans in next 2 years. We expect Rs20bn to convert in FY14 and Rs50bn-100bn the year after. The yield benefit on conversion to LICHF is 100-250bps. At an incremental disbursement run rate of 25% of AUM per year, even assuming 80% to be dual-rate in nature, at a conversion run rate of 10-15% of AUM, the net benefit to yields is 15-20bps as the current benefit to a borrower through such products is marginal over and above the plain vanilla floating rate loan.
- Any reversal to the strategy of asset acquisition through such dual-rate loans will provide further support to yields.
- In a benign interest rate scenario, if the overall sector yields move down, LICHF's currently fixed-rate composition (40%) of the portfolio will start to have a positive marginal impact that other players, being almost wholly floating-rate in nature, will miss out on. Every 25bps of sector wide new loan rate erosion should be a 10bps addition to spreads (assuming costs moderate as well) through the stickier nature of its blended yields.

Chart 16: Our yield assumptions are conservative

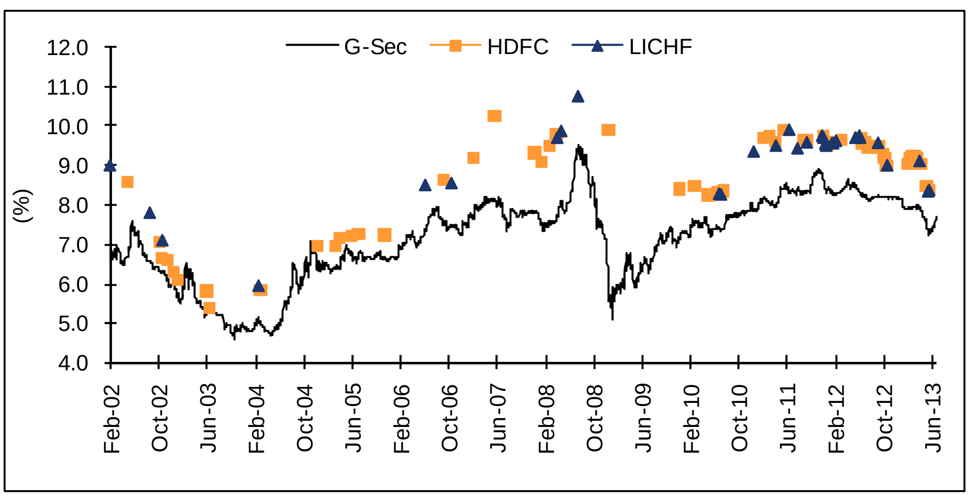


Source: Company data, I-Sec research

Borrowing costs will also have multiple levers for improvement

- With 29.8% of its borrowings from banks (which would be around 10% in a best-case scenario), substitution through either NCD (expected at 8.5-8.8%) or deposits (expected costs 9-9.5%) will improve the borrowing cost structure of the company. We expect the company's reliance on banks to reduce with immediate margin implications.
- We notice the issue yield of LICHF's NCD borrowings has once again aligned with sector leader HDFC. The benefits of this to costs will gradually start emerging

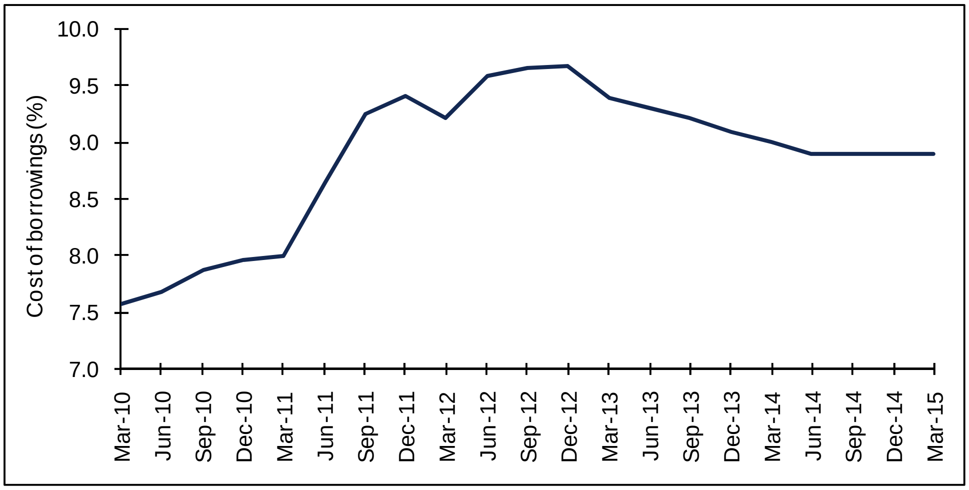
Chart 17: LICHF issue rates *vs* HDFC issue rates *vs* GoI sec yield (5-year)



Source: Bloomberg, I-Sec research

- In a benign interest rate environment, we expect wholesale borrowing costs to fall thereby benefiting the company.

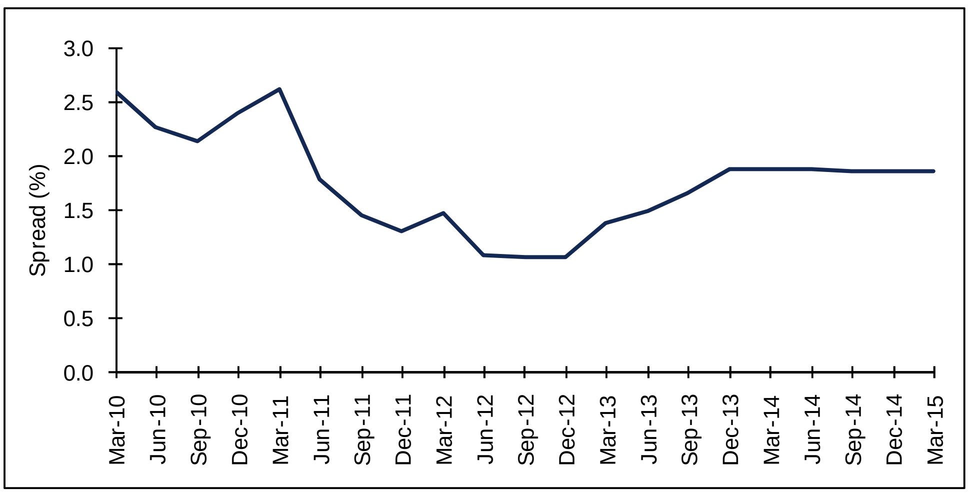
Chart 18: We build-in marginal moderation in borrowing costs



Source: Company data, I-Sec research

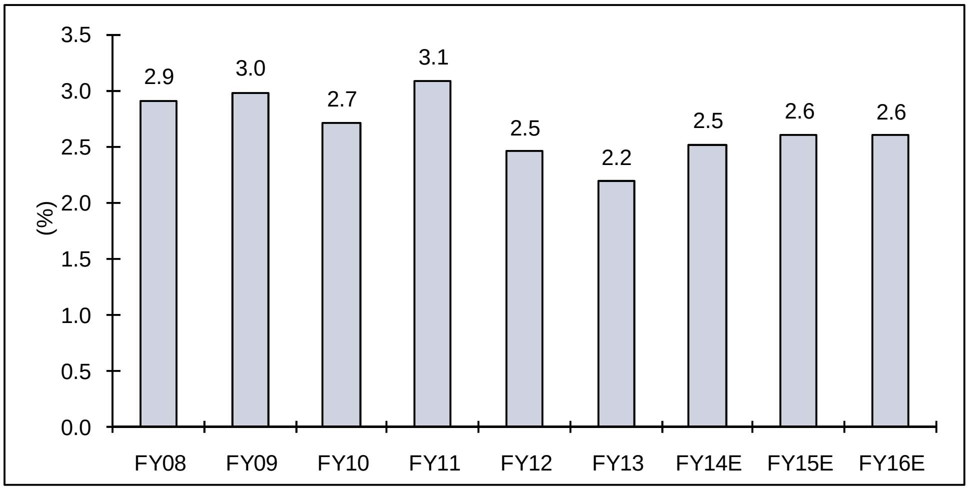
LICHF's recent commentary revealed that it has plans to double its developer loans book this fiscal (FY14). Our assumptions currently build in a marginal decline, as outlined earlier. Any positive surprises to our assumption will add to spreads. Every extra percentage point of developer portfolio adds 3-4bps to spreads.

Chart 19: Spreads should rebound in the near term



Source: Company data, I-Sec research

Chart 20: NIM should trend back to usual levels

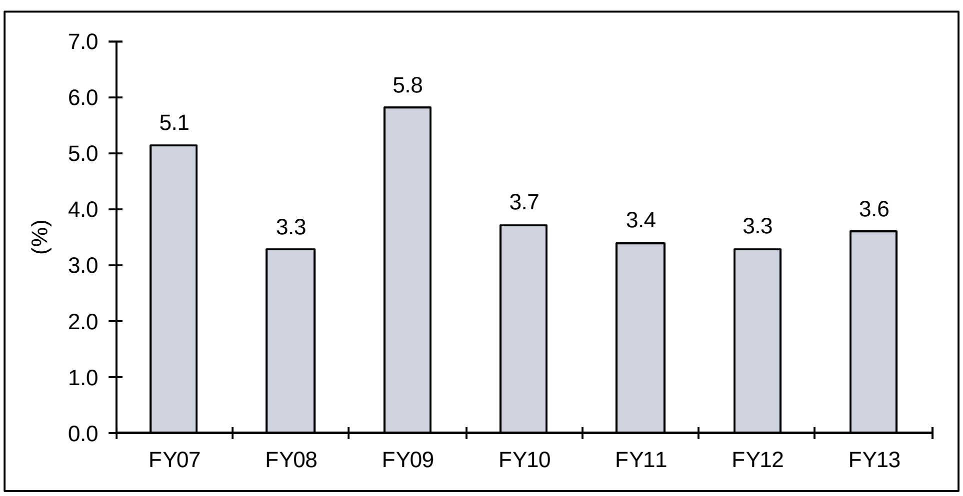


Source: Company data, I-Sec research

NHB refinance remains an opportunity

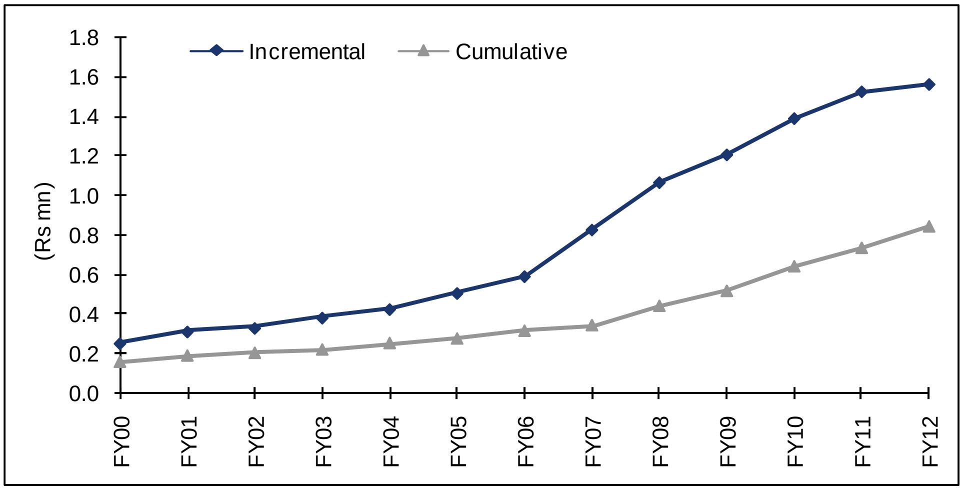
The National Housing Bank (NHB) provides medium to long term financing to lending institutions at concessional and fixed rates of interest, which serves as an important funding source for banks and HFCs alike. LICHF's reliance on this source is relatively less compared with some of its smaller peers such as GRUH. This primarily stems from the limited pool of NHB refinance available every year vis-à-vis the company's larger balance sheet. Also, it is comparatively easier for a player like LICHF to tap the markets for debt financing and hence it is imperative that the smaller players would have greater access to NHB refinancing. Also, the fact that incremental ticket sizes are now much larger for LIC Housing finance will not help.

Chart 21: NHB refinance remains a small proportion of total debt



Source: Company data, I-Sec research

Chart 22: Incremental ticket sizes much larger than blended restricting NHB refinance opportunities

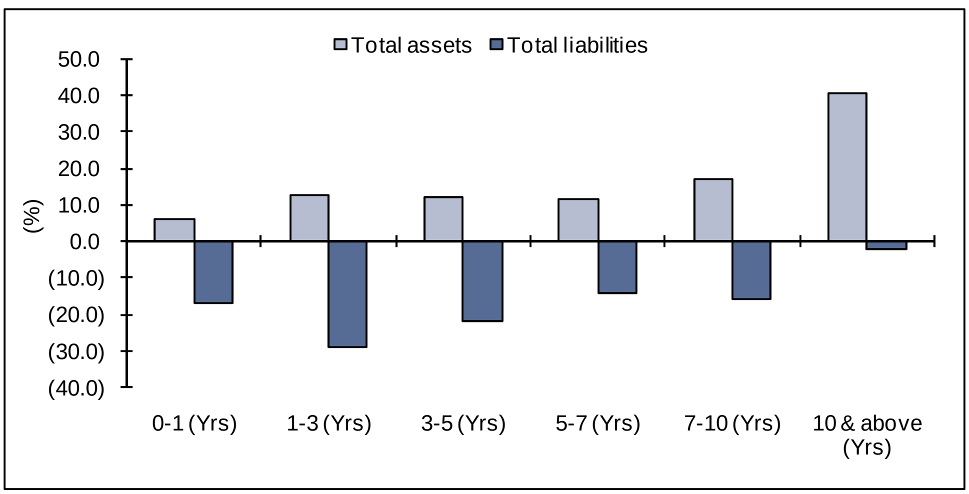


Source: Company data, I-Sec research

No major gaps in the ALM structure, apart from the unavoidable

While given the long duration nature of the loan book, there lies significant ALM mismatch in the long end (over 10 years), in the medium term (in the 3 to 10 year) buckets, the ALM mismatch is well managed.

Chart 23: ALM gap well managed in the medium term (FY13)

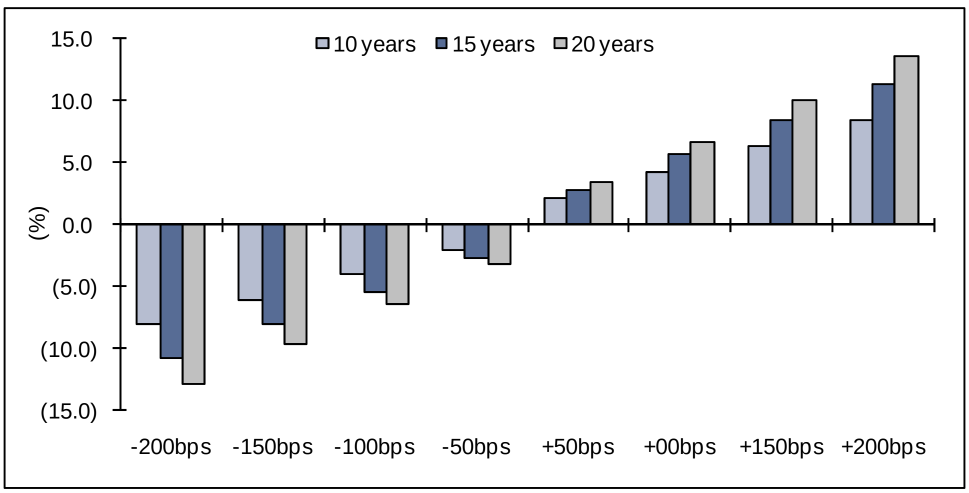


Source: Company data, I-Sec research

Spreads narrowing from regulatory intervention and increased yield competition is a medium to long term phenomenon

While spreads on new loans are unlikely to be driven down too much by any predatory pricing, we feel back-book spreads on non–dual rate loans will come down in the medium term (2-3 years). This will of course have a bearing on blended spreads. With prepayment penalties abolished, the cost of rate-shopping for an existing customer has gone down drastically. We recognise the fact that the brand of the lending franchise and the level and ease of service are key to the customer's preferences, but we do feel that with the differential between going market rates and that being levied on a back-book customer reaching 100-150bps in some cases (creating a possibility of 7-10% saving on EMIs), some of the more financially conscious customers will start to shift. We believe that rate differential in itself will start to shrink with this phenomenon. We do not expect it to go to zero without direct regulatory intervention as we feel that customers will be willing to pay a differential to stay with a lender they trust and like (it is worthwhile to note that in a floating-rate loan, the customer does depend on the lender for fairness of future interest rates).

Chart 24: Tenure wise sensitivity of EMIs to change in annual interest rates (base case interest rate: 11.0%)



Source: I-Sec research

We see some issues with Damodaran Committee's recommendation for outright ban on interest rate differentiation based solely on customer vintage:

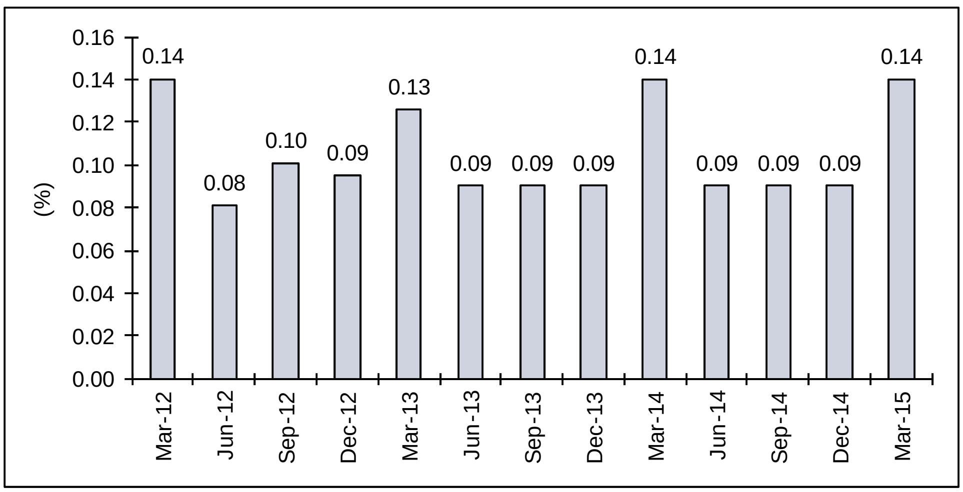
- The housing finance business has an inherent asset liability mismatch as assets have original duration of 15-20 years with liabilities being most common up to a 5-year tenor at issue (although small amounts of 10-year paper is also issued). Rates on loans contracted today are in lieu of liability costs in the current environment (also determined by yield competition). To link all assets to these borrowing costs would mean that housing finance companies would also need their liabilities to reprice in order to have any visibility on spreads. Most wholesale debt market borrowings are fixed-rate in nature and hence do not reprice. Even if one argues that liabilities come up for refinance before the loan expiry, to monitor these granular details at a regulatory level bucket-wise and have an informed fairness opinion, is going to be practically impossible.

- There would be definite upward pressure on home loan rates for new finance, thereby defeating the developmental purpose of greater housing penetration through cheaper credit.
- It will be tricky to define 'same risk profile' and will give 25-50bps headroom for maneuver in most cases.

Operating cost structure stable – some room for improvement if developer book increases

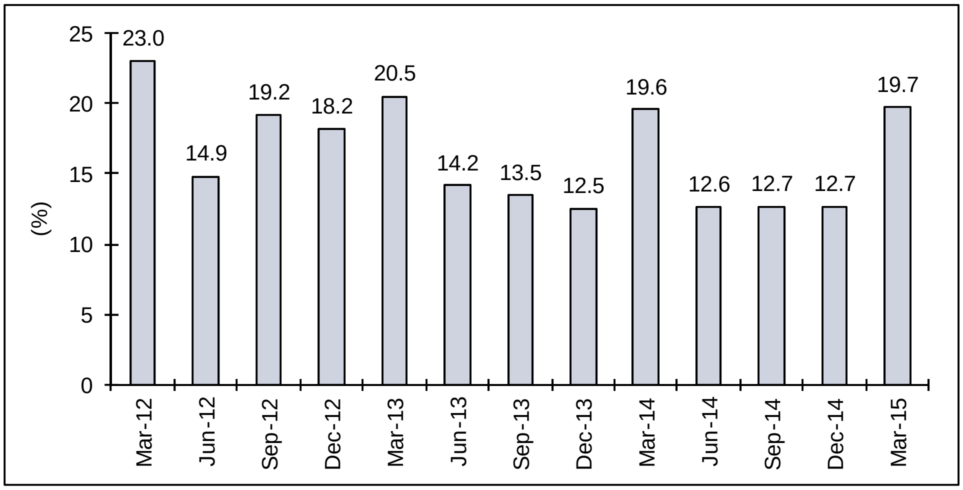
At an AUM of ~Rs780bn and an annual disbursement run rate of ~Rs150bn, LIC housing Finance's operating model can hardly be called to be in a state of flux. This fact is reflected in its operating metrics and we feel that any significant improvements can only come from larger ticket-size benefits of an enlarged developer portfolio. We do not build-in any major changes in the operating cost parameters relative to portfolio size.

Chart 25: Operating costs as a % of AUM remain stable (seasonality excepted)…



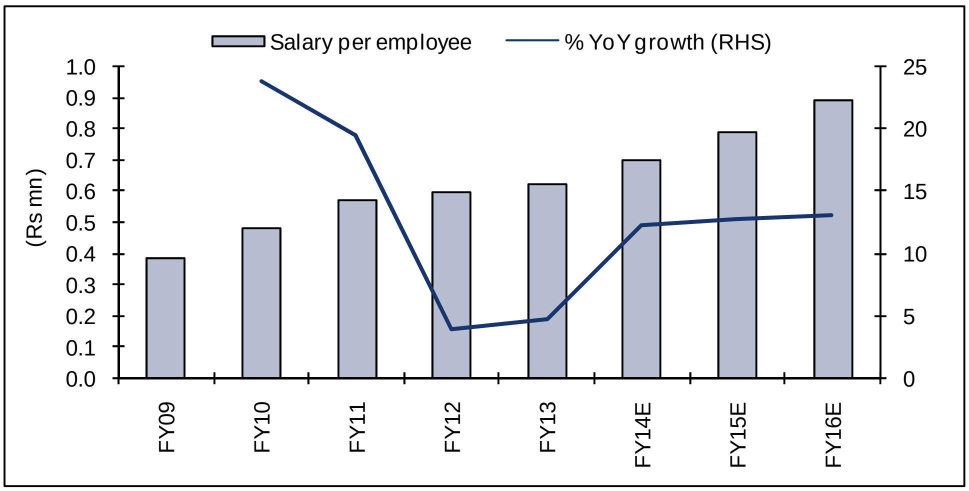
Source: Company data, I-Sec research

Chart 26: …as does cost to income



Source: Company data, I-Sec research

Chart 27: Wage inflation remains under control



Source: Company data, I-Sec research

Asset quality concerns remain low, applying for a banking license

Fundamental drivers of strong asset quality remain in place

The asset quality track record of the leading Indian housing finance companies is truly exceptional and has been built upon a very conservative credit culture to which LIC Housing Finance (LICHF) is no exception (in its post 2007 avatar). Mortgage loans are generally extended to urban salaried individuals who finance their first home purchases through the same. Willful default is extremely uncommon as the SARFAESI Act adds real teeth to the recovery process. Limiting maximum allowable EMIs to about 50% of net salary income and maximum LTVs of 80% for loans above Rs2mn also help. Although it can be argued that certain urban pockets in India have seen serious real estate inflation and are due a correction, we do not feel that there are any serious asset quality concerns in the individual loans business for an investor to worry about apart from regular seasonal spikes and the odd marginally tougher quarter.

The developer finance business though is a different kettle of fish. However, there are multiple challenges that a player needs to manage for success in this space which has proved tricky for LICHF in the past with irregularities in disbursals surfacing in 2010. Some of the irregularities are:

- Land titles are much contested in India due to succession disputes and poor record-keeping. With most developments being agglomerations of fragmented landholdings, legal disputes regarding even one piece can throw spanner in the works of a project for a long time.
- Land use laws are stringent in India, and land prices are heavily dependent on the same. The conversion process from agricultural land to other uses is cumbersome and uncertain with many bureaucratic hassles. Inadequate due diligence or project plans grounded on 'hope' have often fallen through.
- In some cases, enforceability of collateral in case of default may be much more difficult compared to individual loans.
- In many cases, corporate governance practices of real estate companies have come under scrutiny, reducing the size of the potential borrower universe for a discerning lender.

However, the developer loan portfolio in itself being around 3% of assets lowers the risk at an overall level.

Conservative provisioning policy helps confidence in earnings

LICHF's provisioning policy is much more conservative than what is stipulated by NHB. However they have changed their coverage on doubtful assets from 100% to 70% in FY13 end reducing overall level of coverage to 41.4% from 68% last year.

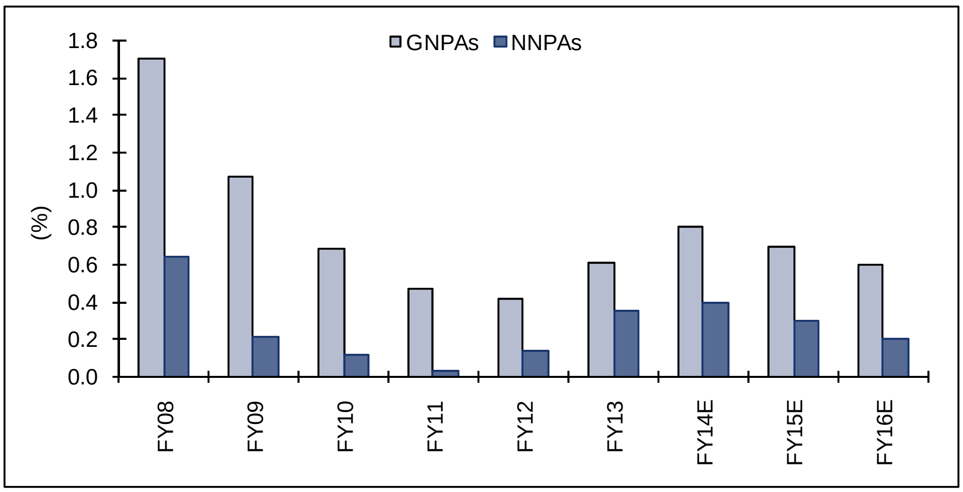
Table 3: LIC Housing Finance provisioning policy

Provisioning Coverage (%)	NHB requirement	LICHF
Sub standard	15	15
Doubtful Assets	25-40	70
Loss assets	100	100

Source: Company data, NHB, I-Sec research

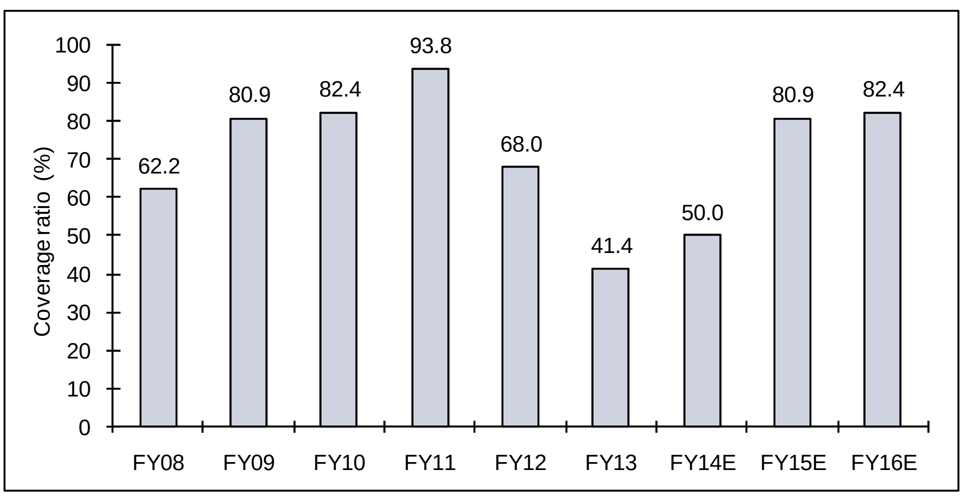
We assume stable asset quality and adequate provisioning to continue going forward.

Chart 28: Asset quality risks low



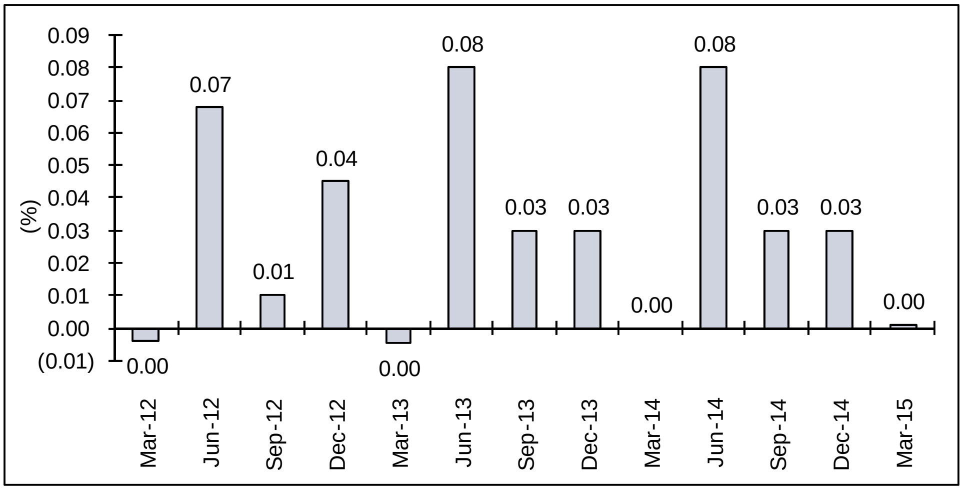
Source: Company data, I-Sec research

Chart 29: Provisioning coverage has dropped due to new policy



Source: Company data, I-Sec research

Chart 30: Credit costs assumed to rise slightly



Source: Company data, I-Sec research

Strong contender for banking license

LICHF has applied for a banking license. Given strong parentage and a well-functioning business, we believe it is a strong contender for receiving one. However, the main headwinds we see are:

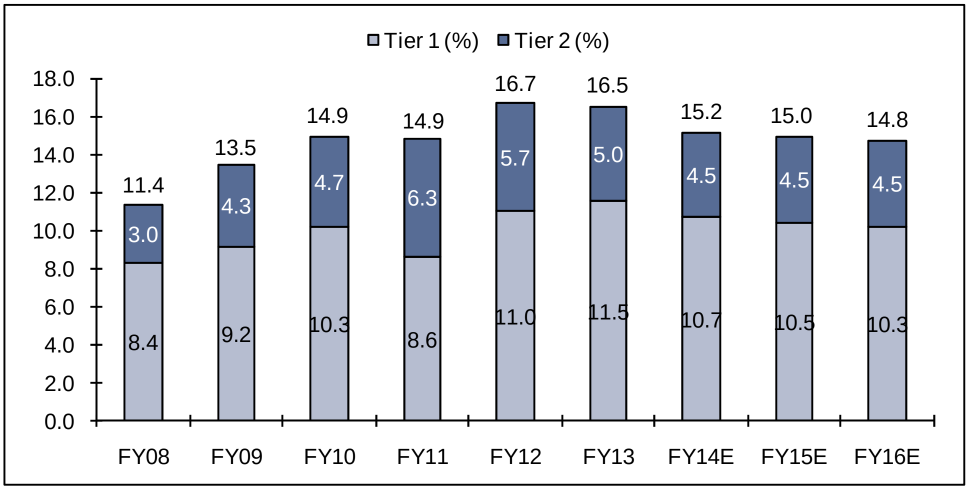
- Lack of any diversification in asset class. All other businesses will have to be built ground-up.
- The need to maintain 25% of branches in locations that are unlikely to contribute much in initial years.
- A short 18-month window to upgrade branches.
- The huge execution challenges of absorbing a sizeable asset lending and collection franchise into a banking structure.
- When the benefits finally accrue, assuming strong CASA ramp-up and successful business restructuring, promoter holding is down to only 15-25%.

However, given the near-universal brand recall of LIC in India, there will be advantages to ramping up a CASA franchise.

Valuations attractive, multiple upside triggers

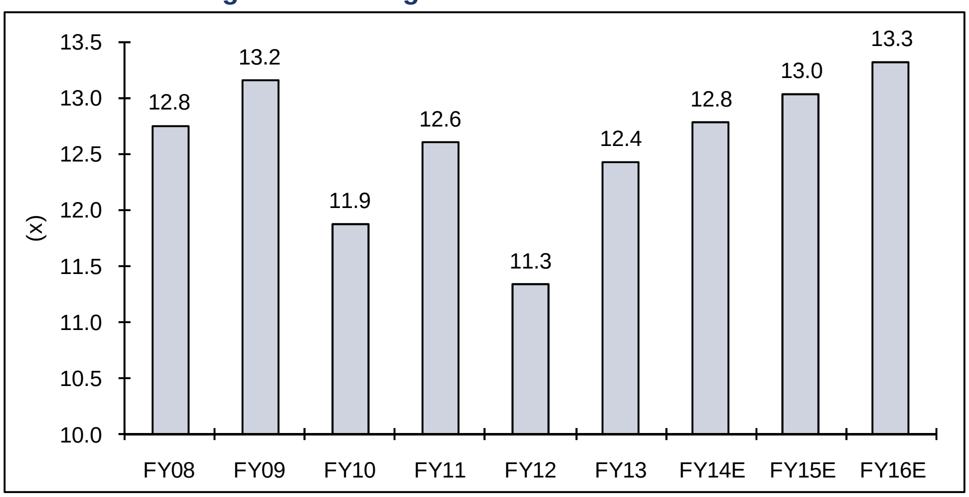
Adequately capitalised for normal growth

Chart 31: Capital adequacy comfortable



Source: Company data, I-Sec research

Chart 32: Leverage remains high

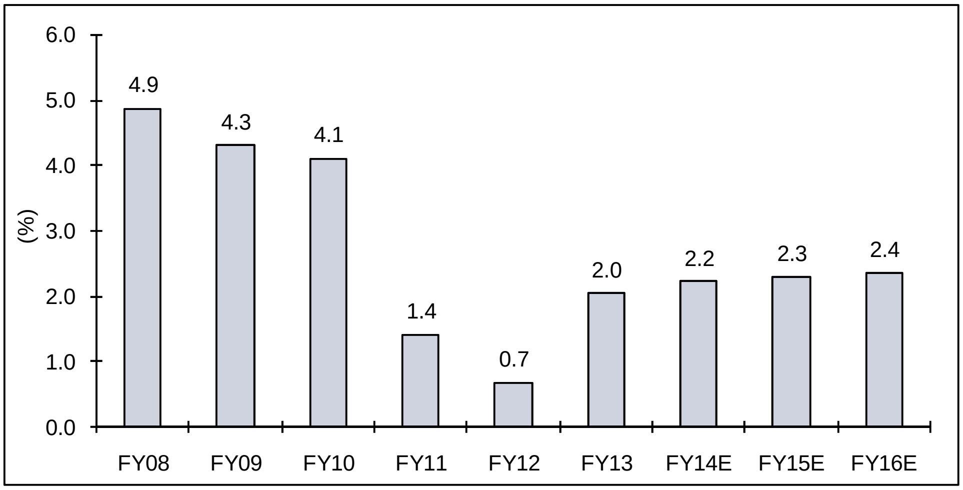


Source: Company data, I-Sec research

Lean balance sheet

Liquid assets currently form only 2% of the balance sheet avoiding any drag on capital productivity

Chart 33: Cash and investments as a percentage of total assets

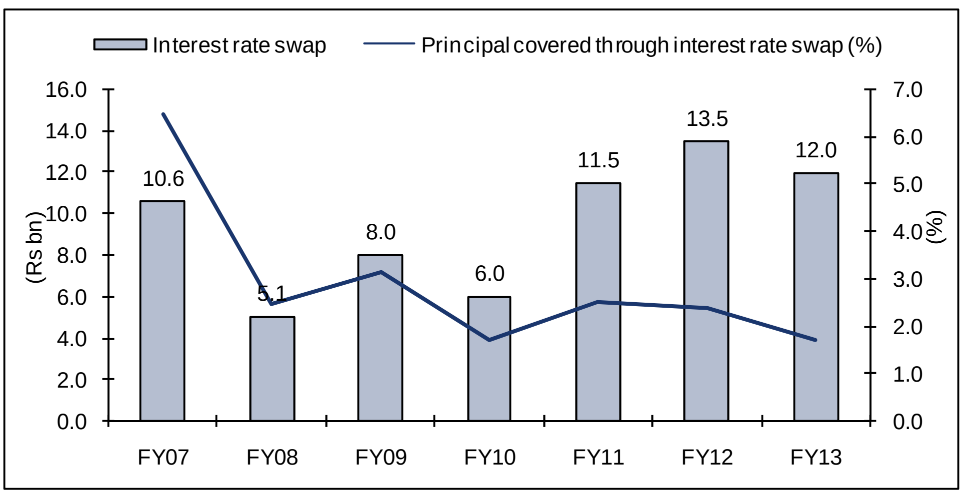


Source: Company data, I-Sec research

Use of interest rate derivatives is limited

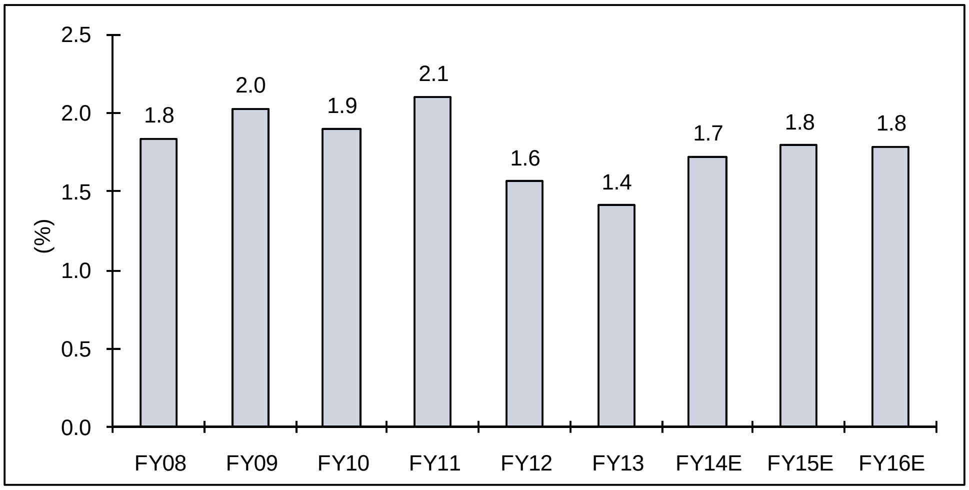
Though the company mainly lends on floating rate (including the dual-rate loans as floating in the long term) and borrows at fixed rate (NCD), it does run an interest rate risk if rates fall and yields follow in tandem. Despite this inherent risk in the lending model, the company is not very active in hedging through derivative instruments with interest rate swaps covering only 4-5% of liabilities. However, since dual rate loan assets currently form 40% of loan book, interest rate sensitivity is lower than usual.

Chart 34: Low coverage through interest rate swaps



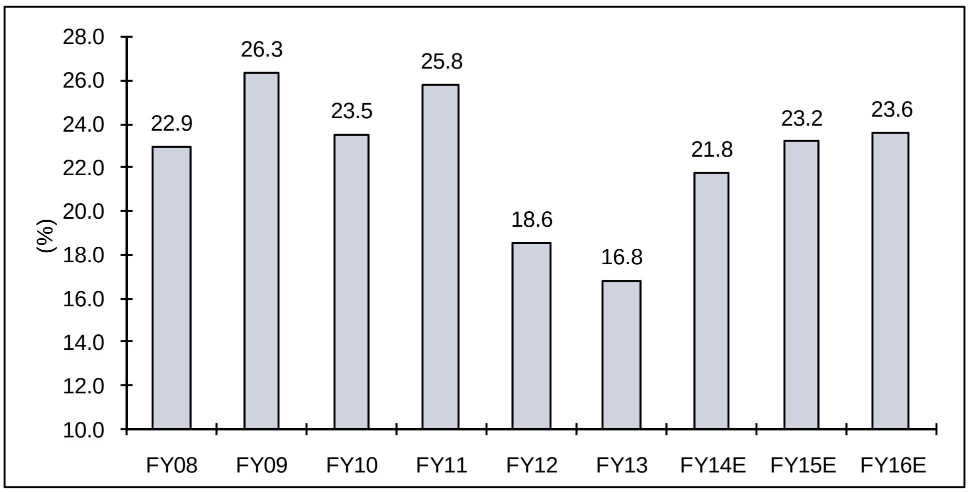
Source: Company data, I-Sec research

Chart 35: RoA should improve closer to historical levels…



Source: Company data, I-Sec research

Chart 36: …driving up RoE

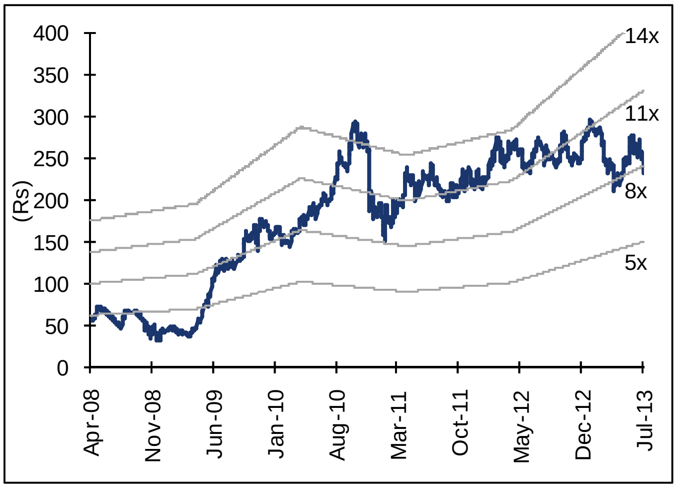


Source: Company data, I-Sec research

Valuations remain attractive

A look the valuation history of LIC Housing Finance reveals that the company is trading the bottom end of its trading band, on account of its lackluster RoE in the last two years.

Chart 37: Rolling 1-year forward P/E



Source: Bloomberg, Company data, I-sec research. Note: market data as of July 5, 2013

Chart 38: Rolling 1-year forward P/BV

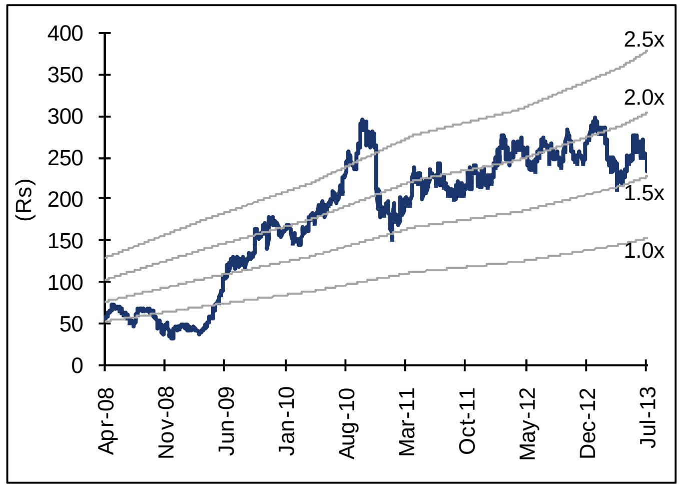
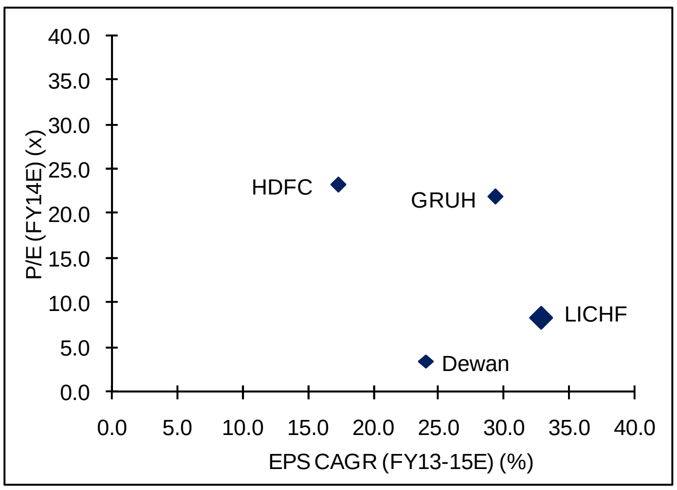


Chart 39: Valuation matrix - EPS CAGR (FY13-15E) vis-à-vis FY14E P/E



Source: Bloomberg, Company data, I-sec research. Note: Market data as of July 5, 3013

Chart 40: Valuation matrix – FY14E ROE vis-à-vis FY14E P/B

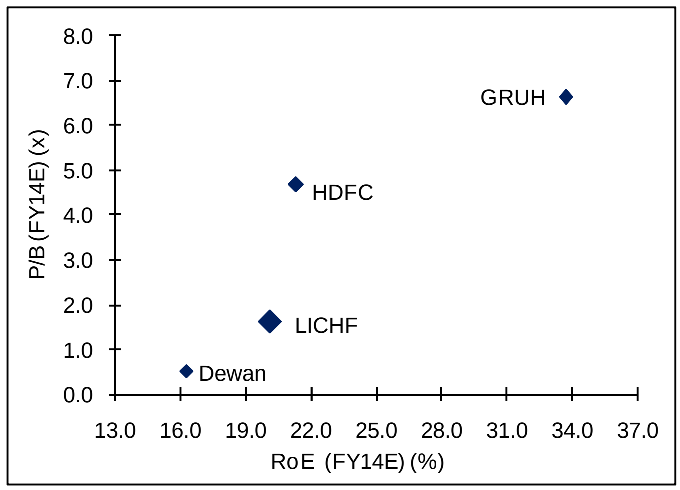


Table 4: HFC Trading Comparables

	Price	Market	P/E (x)			P/BV (x)			RoE (%)			EPS CAGR (%)
	(Rs)	Cap (Rs bn)	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	(FY13-15E)
HDFC	850	1,321	27.2	23.3	19.7	5.3	4.7	4.1	22.0	21.3	22.2	17.3
LIC Housing	233	118	11.5	8.3	6.5	1.8	1.5	1.3	16.8	20.1	21.5	32.9
GRUH Finance	229	41	28.1	21.9	16.8	8.4	6.6	5.2	33.3	33.7	34.6	29.4
Dewan Housing	152	19	4.3	3.5	2.8	0.6	0.5	0.5	17.1	16.3	17.5	24.1

Source: Bloomberg, Company data, I-sec research. Note: Market data as of July 5, 3013

We recommend BUY in LIC Housing Finance with a TP of Rs360

In LIC Housing Finance we believe that sustainable RoE is close to 20%, the last two years profitability aberration notwithstanding. Accordingly our target 1 yr fwd P/B multiple for LIC Housing Finance is 2x. This leads to a target price of Rs360 indicating 55% upside on a 12 month basis.

Risks to our investment thesis

Economic slowdown affecting income levels

An economic slowdown that will affect the income levels of borrowers impacts the affordability of loans to individuals and increase probability of default. With newer and riskier products like LAP (loan against property) in the ambit now, the risk becomes even more exacerbated. However, LTVs and EMI-to-income ratios are conservative for LIC Housing Finance (LICHF) and provide cushion.

Liquidity squeeze

Like any other housing finance company, LICHF is wholesale-funded and any liquidity tightening makes its growth plans uncertain. Also, the company runs a large mismatch in asset and liability duration with almost 15-20% of liabilities needing refinance while repayment rates are only about 10% for assets. This means that even maintaining the existing loan book needs refinance – a fundamental weakness in the business model.

Cooling off in real estate markets

If real estate market volumes and prices cool off, it creates multiple complications for any housing finance company. Firstly, as real estate developer businesses and projects come under pressure, asset quality in the developer book starts to suffer. But in the case of LICHF, this exposure remains small. The bigger issues are that growth becomes more challenging given ticket-size shrinkage, operating cost metric spikes due to the same reason, and increasing moral hazard from borrowers if prices drop sharply.

Increasing competition

With banks led by SBI and Axis Bank seriously re-focusing on the housing finance segment and new players like Indiabulls Financials making serious inroads, competitive pressure in the sector is some of among the strongest in recent memory. With spreads coming down, this remains a threat to LICHF’s profitability. However, extreme predatory pricing scenarios are unlikely with players with market-disrupting size are too invested in the sector and mature to follow strategies that will destroy long-term value for everyone.

Adverse regulation

When one looks at the recent history of the sector, multiple regulations can be seen to have impacted it very significantly. The base rate driven regime for banks, have made bank borrowings all but infeasible on cost for players who operate in the mass market for plain vanilla mortgages to salaried individuals. Prepayment penalties have been abolished and this has created an environment for rate shopping, and we feel spreads will come down as the gap between yields charged to old and new customers disappears. The Damodaran Committee recommended that the regulator makes sure that no interest rate differential is allowed between customers depending on vintage. There are many other areas like risk weights for calculating regulatory capital and deposit collection rights of housing finance companies which can attract potential regulatory scrutiny.

Financial summary

Table 5: Profit and loss statement

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	59,932	74,709	91,379	1,11,216	1,36,280
Interest expended	45,911	59,246	69,557	83,586	1,02,519
Net interest income	**14,022**	**15,463**	**21,822**	**27,630**	**33,760**
Other income	2,219	1,880	2,122	2,634	3,272
Operating expenses	1,572	1,839	2,357	2,919	3,623
Employee costs	724	904	1,085	1,302	1,562
Depreciation	74	75	87	100	115
Pre-provisioning op profit	**13,870**	**14,524**	**20,415**	**25,943**	**31,733**
Provisions & contingencies	1,561	789	1,239	1,519	1,865
Profit before tax	**12,309**	**13,736**	**19,176**	**24,424**	**29,868**
Income taxes	3,167	3,504	4,987	6,352	7,769
Net profit	**9,142**	**10,232**	**14,189**	**18,072**	**22,099**

Source: Company data, I-Sec research

Table 6: Balance sheet

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Share Capital	1,010	1,010	1,009	1,009	1,009
ESOPs	0	0	0	0	0
Reserves and surplus	55,812	63,803	75,339	90,466	1,09,035
Minority Interest	0	0	0	0	0
Borrowings	5,60,873	6,87,641	8,47,226	10,38,762	12,75,032
Current liabilities & provisions	26,603	53,149	61,478	77,614	97,986
Total liabilities & stockholders' equity	**6,44,297**	**8,05,602**	**9,85,052**	**12,07,852**	**14,83,062**
Loans & advances	6,30,802	7,78,127	9,51,018	11,65,538	14,30,295
Fixed assets	622	624	787	994	1,255
Investments	1,640	1,846	2,331	2,943	3,715
Cash and Balance	2,793	14,656	19,721	25,441	32,772
Current assets	6,232	7,861	8,706	10,447	12,536
Deferred tax assets	2,208	2,489	2,489	2,489	2,489
Total assets	**6,44,297**	**8,05,602**	**9,85,052**	**12,07,852**	**14,83,062**

Source: Company data, I-Sec research

Table 7: Key ratios

(Year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Growth (%)					
AUM	23.5	23.4	22.2	22.6	22.7
Net Interest Income	1.8	10.3	41.1	26.6	22.2
Total Non-Interest Expenses	9.8	18.9	25.2	22.4	22.7
Pre provisioning operating profits	-10.8	4.7	40.6	27.1	22.3
PAT	-6.2	11.9	38.7	27.4	22.3
EPS	-11.8	11.9	38.7	27.4	22.3
Yields, interest costs and spreads (%)					
NIM on AUM	2.5	2.2	2.5	2.6	2.6
Yield on loan assets	10.5	10.6	10.6	10.5	10.5
Average cost of funds	9.1	9.5	9.1	8.9	8.9
Interest Spread on loan assets	1.4	1.1	1.5	1.6	1.6
Operating efficiencies					
Non-interest income as % of total income	3.6	2.5	2.3	2.3	2.3
Cost to income ratio (%)	16.9	18.2	16.2	15.6	15.7
Op.costs/avg AUM (%)	0.4	0.4	0.4	0.4	0.4
No of employees	1,217	1,450	1,550	1,650	1,750
No of branches	188	194	202	210	218
Average annual salary (Rs)	5,95,227	6,23,492	6,99,925	7,89,007	8,92,705
Annual inflation in average salary (%)	4.0	4.7	12.3	12.7	13.1
Salaries as % of non-int.costs (%)	30.6	32.1	30.7	30.1	29.5
NII /employee (Rsmn)	11.5	10.7	14.1	16.7	19.3
AUM/employee (Rsmn)	518	537	614	706	817
AUM/ branch (Rs mn)	3355	4011	4708	5550	6561
Capital Structure					
Debt-Equity ratio	9.9	10.6	11.1	11.4	11.6
Leverage (x)	11.3	12.4	12.9	13.2	13.5
CAR (%)	16.7%	16.5%	15.2%	15.0%	14.8%
Tier 1 CAR (%)	11.0%	11.5%	10.7%	10.5%	10.3%
Tier 2 CAR (%)	5.7%	5.0%	4.5%	4.5%	4.5%
Asset quality and provisioning					
GNPA (%)	0.4	0.6	0.8	0.7	0.6
NNPA (%)	0.1	0.4	0.4	0.3	0.2
GNPA	2,652	4,712	7,608	8,159	8,582
NNPA	849	2,759	3,804	3,497	2,861
Coverage ratio (%)	68.0	41.4	50.0	57.1	66.7
Return ratios & capital management					
RoAA (%)	1.6	1.4	1.6	1.6	1.6
RoAE (%)	18.6	16.8	20.1	21.5	21.9
Payout ratio (%)	19.9	18.7	16.0	14.0	13.7
Valuation Ratios					
EPS (Rs)	18.1	20.3	28.1	35.8	43.8
Price to Earnings	12.9	11.5	8.3	6.5	5.3
BVPS (Rs)	112.6	128.4	151.3	181.3	218.1
Price to Book	2.1	1.8	1.5	1.3	1.1
Dividend yield (%)	1.5	1.6	1.9	2.1	2.6

Source: Company data, I-Sec research

Table 8: DuPont analysis

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	10.5	10.6	10.6	10.5	10.5
Interest expended	8.0	8.4	8.0	7.9	7.9
Gross Interest Spread	**2.5**	**2.2**	**2.5**	**2.6**	**2.6**
Provisioning for NPAs	0.3	0.1	0.1	0.1	0.1
Net Interest Spread	**2.2**	**2.1**	**2.4**	**2.5**	**2.5**
Operating cost	0.4	0.4	0.4	0.4	0.4
Lending spread	**1.8**	**1.7**	**2.0**	**2.1**	**2.0**
Non-interest income	0.4	0.3	0.2	0.2	0.3
Operating spread	**2.2**	**1.9**	**2.2**	**2.3**	**2.3**
Tax	0.6	0.5	0.6	0.6	0.6
Return on average loan assets	**1.6**	**1.5**	**1.6**	**1.7**	**1.7**
Effective leverage (average loan assets/ average equity)(x)	11.6	11.6	12.2	12.6	12.9
RoAE	**18.6**	**16.8**	**20.1**	**21.5**	**21.9**

Source: Company data, I-Sec research

Annexure 1: Company overview and background

Incorporated in 1989 and promoted by the Life Insurance Corporation (LIC) of India, LIC Housing Finance Ltd. (LICHF) is one of the largest HFCs in the country. The company is listed on NSE & BSE (since 1994) with market capitalisation of Rs118bn and launched its maiden GDR issue in 2004 (listed on the Luxembourg Stock Exchange). LICHF provides long term finance to individuals for purchase/construction/repair and renovation of new/existing flats/houses. It also provides finance on existing property for business/personal needs and gives loans to professionals for purchase/construction of Clinics/Nursing Homes/ Diagnostic Centres/Office Space and also for purchase of equipments.

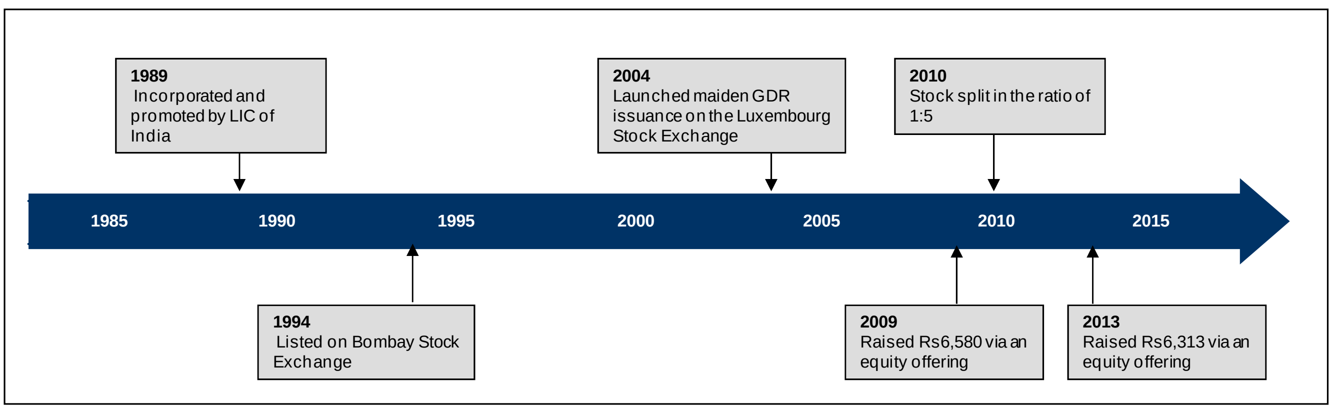
LICHF has a pan India presence via 7 regional offices, 13 back offices and 190 marketing units. Additionally, it originates business through Direct Sales Agents (DSAs), Home Loan Agents (HLAs) and Customer Relationship Associates (CRAs). It has also set up a representative office in Dubai and Kuwait catering to Non-Resident Indians in Gulf countries covering Bahrain, Dubai, Kuwait, Qatar and Saudi Arabia.

Capital rasing

Date	Type	No. of shares offered (mn)	Offer price per share (Rs)	Proceeds (Rs mn)
Sep-09	QIP	10	658	6,580

Source: Bloomberg

History and milestones



Source: Company Data; I-Sec research

Senior management

Name	Designation	Background
Mr. D.K Mehrotra	Chairman	Mr. Mehrotra joined the LIC of India in 1977 and was appointed its Managing Director in 2005. He took over the Chairmanship of LIC Housing in 2012.
Mr. Sushobhan Sarker	Non-Executive Director	Mr. Sarker serves as the CEO of LIC MF AMC and MD of LIC of India. He also served as the CEO of LIC Housing Finance during March 2012 to March 2013.
Mr. V.K. Sharma	MD & CEO	Mr. Sharma joined LIC of India in 1981 and was appointed the Director & Chief Executive of LICHF in 2010. In March 2013, he was elevated to the position of CEO & MD.
Mr. Dhananjay Mungale	Independent Director	Mr. Mungale is a Chartered Accountant and a Law Graduate by Profession and spent major part of his career with Bank of America and DSP Merill Lynch Ltd. in India and Europe. He joined the board in 2004.
Mr. K. Narasimha Murthy	Independent Director	Mr. Murthy is a Chartered Accountant by Profession and has served as a director in leading companies such as Max India, UTI Bank, IFCI Ltd. He has also been associated with more than 25 high level committees as Chairman/Member both at National & Sate Level. He is on the Board of LICHF since 2005.
Mr. S. Ravi	Independent Director	Mr. Ravi has wide ranging experience in banking and was appointed to the board in 2005. He is the Chairman of the Audit Committee.
Mr. B.N. Shukla	Independent Director	Mr. Shukla joined the board in 2006 and has served as a professor and Director with L.N. Mishra Institute of Economic Development and Social Change, Patna.
Mr. Jagdish Capoor	Independent Director	Mr. Capoor has around 4 decades of experience in the banking and financial services industry. He served as the Chairman of HDFC Bank from 2001 to 2010 and was also a Deputy Governor with the Reserve Bank of India.
Ms. Savita Singh	Independent Director	She has been on board since 2012 and also serves as a director with Indiabulls Asset Reconstruction Co. Ltd. and Shreyas Home Management Pvt. Ltd.

Source: Company data

Annexure 2: Index of Tables and Charts

Tables

Charts

Equity Research
July 7, 2013
BSE Sensex: 19496

INDIA

GRUH Finance

REDUCE

The Specialist

Rs229

Reason for report: Initiating coverage

GRUH Finance, a pioneer in being a dedicated rural housing finance player in India has built up an AUM of Rs55bn and continues to grow like clockwork at 25-26% while maintaining 30%+ RoE despite full GNPA coverage and pricing moderation. The company remains a key beneficiary of NHB funding and the parentage of HDFC raises its profile in both debt and equity markets. Valuations at 6.7xFY14E P/B appear high, but the company does tick almost all boxes of an investor's wish list. Our target price of Rs222, indicates marginal downside from current levels. We initiate coverage with a REDUCE recommendation, outstanding fundamentals not withstanding.

- **First mover advantage in a large opportunity space.** Present in rural housing since 1986, GRUH had a steep learning curve in suiting its operating model to the unique challenges it faced in the segment – low priority of housing finance, discomfort with floating rate loans, absence of income documents and unclear land titles. Today it has a unique model of business expansion where new branches are opened at peripheries of the sphere of influence of successful ones to leverage word of mouth and accelerate business volume ramp up. With a minimal number of branches (that act as purely appraisal centres) and all lead generation from referral associates, GRUH has achieved deep Taluka penetration with minimum branch additions. Even for a business of its size and growth characteristics, its operating cost metrics have already stabilized and are showing signs of improvement.
- **Business scalability entry barriers provide yield support.** All the other players entering this segment have found it difficult to gain scale in the early stage. GRUH, despite having demand relatively inelastic to yields, charges a peak rate of 14% across its product classes (including LAP). The minimal non-bank competition present, is at a premium of at least 200bps across the board, thereby giving us a lot of confidence in the robustness of GRUH's yields.
- **Parentage and delinquency track record helps liability franchise.** HDFC's parentage and strong board level presence act as an assurance for key market participants and GRUH for its own part has maintained an excellent asset quality track record (peak GNPA at 1.1% in FY08) and a conservative provisioning policy.
- **Sector leading RoE, but valuations high.** Even adjusting for a 20% growth premium for future opportunities at value creation on an expanded capital base, we feel valuations do not leave much on the table. Our target multiple of 5xFY15E P/B is based on a sustainable RoE assumption of 33% and our CoE benchmark of 14%.

Financials

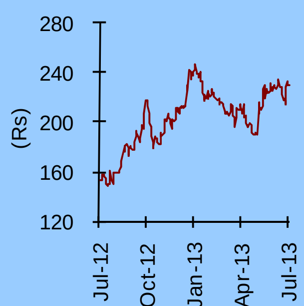
Target price Rs222

Shareholding pattern

	Sep '12	Dec '12	Mar '13
Promoters	59.9	59.9	59.7
Institutional investors	16.7	15.4	15.7
MFs and UTI	1.7	1.1	0.4
Insurance	0.0	0.0	0.0
FIIs	15.0	14.3	15.3
Others	23.4	24.7	24.6

Source: NSE

Price chart



Market Cap	Rs41.1bn/US$680mn
Reuters/Bloomberg	GRUH.BO/ GRFH IN
Shares Outstanding (mn)	179
52-week Range (Rs)	247/149
Free Float (%)	39.3
FII (%)	15.3
Daily Volume (US$/'000)	446
Absolute Return 3m (%)	10.2
Absolute Return 12m (%)	48.2
Sensex Return 3m (%)	5.7
Sensex Return 12m (%)	11.3

Year to March	FY13	FY14E	FY15E	FY16E
NII (Rs mn)	2,137	2,874	3,745	4,802
Net Income (Rs mn)	1,459	1,869	2,444	3,135
EPS (Rs)	8.2	10.5	13.7	17.5
% Chg YoY	19.9	28.1	30.6	28.1
P/E (x)	28.1	22.0	16.8	13.1
P/BV (x)	8.4	6.7	5.2	4.0
Net NPA (%)	0.0	0.0	0.0	0.0
Dividend Yield (%)	1.1	1.2	1.4	1.7
RoA (%)	2.9	2.9	2.9	2.9
RoE (%)	33.3	33.7	34.6	34.4

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First mover advantage in a large opportunity space

Opportunity size is large

Despite increasing urbanisation, rural population at over 68% of India's total population continues to be huge with significant housing requirements. As per the working group on rural housing for the 12th FYP, total shortfall in rural India stands at 43.7mn units, out of which 90% is on account of the Below the Poverty Line Population (BPL families). One of the main reasons behind this shortfall (apart from high poverty levels) is the lack of formal institutional financing mechanism and framework. As per the Planning Commission, only 9% of the rural households have sourced institutional finance to build their houses. We estimate the rural housing finance opportunity at Rs5.2tn at current prices.

Table 1: Rural housing shortage (2012 -2017)

Factors	Shortage (million)
No. of households without houses - 2012	4.2
No. of temporary houses - 2012	20.2
Shortage due to congestion - 2012	11.3
Shortage due to obsolescence - 2012	7.5
Additional housing shortage arising between 2012-17	0.6
Total housing shortage - 2012 to 2017	**43.7**

Source: Planning Commission, I-Sec Research

Table 2: Estimated financing requirement in rural housing

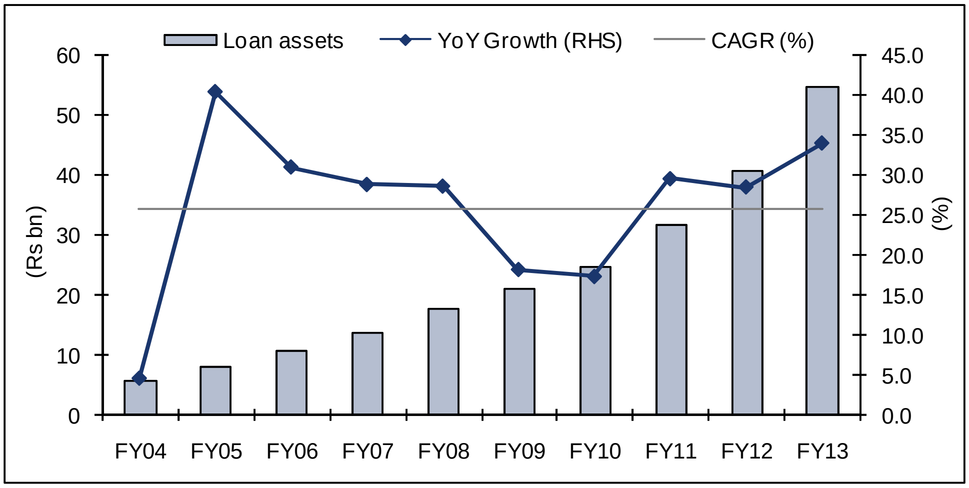
Total housing shortage (mn)	43.7
Average cost of rural house (Rs mn)	0.15
Loan-to-value ratio	80%
Average loan per house (Rs mn)	0.12
Total financing requirement (Rs bn)	**5,244**

Source: Planning Commission, I-Sec Research

A pioneer in rural housing finance

GRUH Finance, founded in 1986, was the first company to focus exclusively on rural housing finance as a growth opportunity. The current MD, Sudhin Choksey, is with the company since 1994 and, took up his position at the helm of executive affairs in 1998. Initially, the company faced many obstacles in ramping up its business. But having done the hard yards and armed with a deep understanding of the customer and domain, it has been able to scale up its housing asset base at a CAGR over 25.7% in the past 10 years.

Chart 1: AUM growth has witnessed strong momentum over the past 10 years



Source: Company data, I-Sec research

Operating model designed to counter unique segment challenges

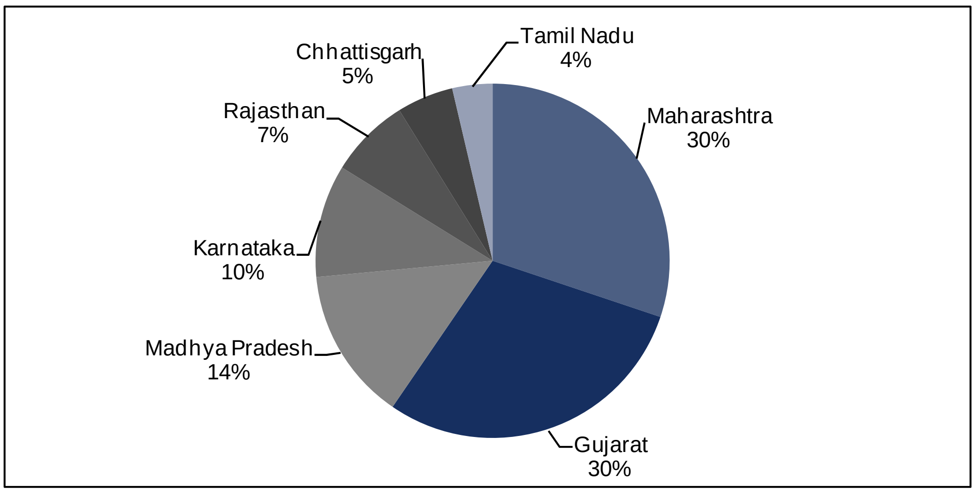
GRUH Finance's operating model has emerged from its over two decade long experience of operating in the segment. At the heart of this model are the following fairly sobering realizations for any new entrant in the segment.

- The prime need for credit for the rural population is not housing. Agricultural and crop loans are the primary requirement, followed by loans to facilitate their livelihoods like small trade and vehicles etc. even loan needs for social obligations like marriages come much higher in priority than housing loans. Unlike the urban context, the displaced population proportion is small and almost everybody has one shelter or the other. Not having that many people looking to find a roof over their head means most loans are mostly home improvement in nature and generally the acceptance for credit for such purposes is not part of the ambient culture.
- Most of the rural population is also very uncomfortable with a floating rate loan. The fact that future interest payments are uncertain and at the lender's discretion is not something the general population is comfortable with.
- In most parts of rural India, credit is looked at with suspicion. In such a context, building acceptance for the loan product is a time consuming process and involves a time consuming wait at every new location.
- Collateral enforcement is a social taboo and can prove to be politically sensitive.
- Estimation of a borrower's repayment ability is much harder than the usual calculations for urban salaries individuals, as most borrowers are either self-employed or small local tradesmen.
- Property titles are often unclear and suffer from inadequate documentation and Legal Contests.

GRUH Finance's model takes all these basic challenges on board and follows a strategy that can be best described as 'diffusive business reach growth'. It starts its business in a particular location, and after building acceptance in that location and having achieved a critical mass, instead of trying a hub and spoke model of allowing the catchment area of that branch to grow it opens a branch at the periphery of the earlier branch's area of influence. This allows it to keep on growing the catchment area of its overall network by increasing its area of influence through every branch spawning offshoots in its periphery. The biggest advantage is that the offshoots benefit from the positive word of mouth about its parent branch. While clearly this means that the company achieves wider coverage by seeding new branches, we find it exceptional that operating cost metrics remain as impressive as they are currently because clearly regular investment in branches are needed in this even before achieving full benefits of scale in existing ones. We feel the fact that the company does this expansion in a graded manner, helps in this aspect.

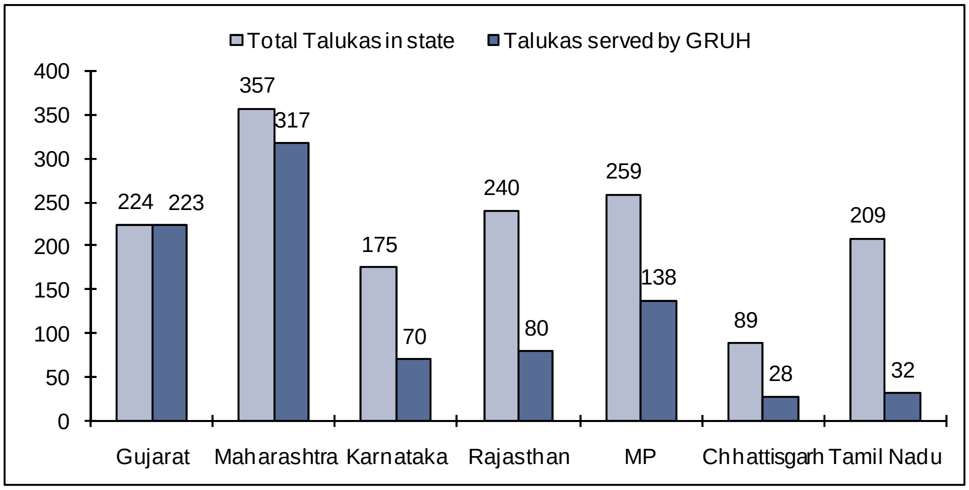
In sync with this strategy, the company also plans its entry state wise. Currently, it has presence in seven states.

Chart 2: Seven states reached



Source: Company data, I-Sec research

Chart 3: High taluka penetration – from limited number of branches

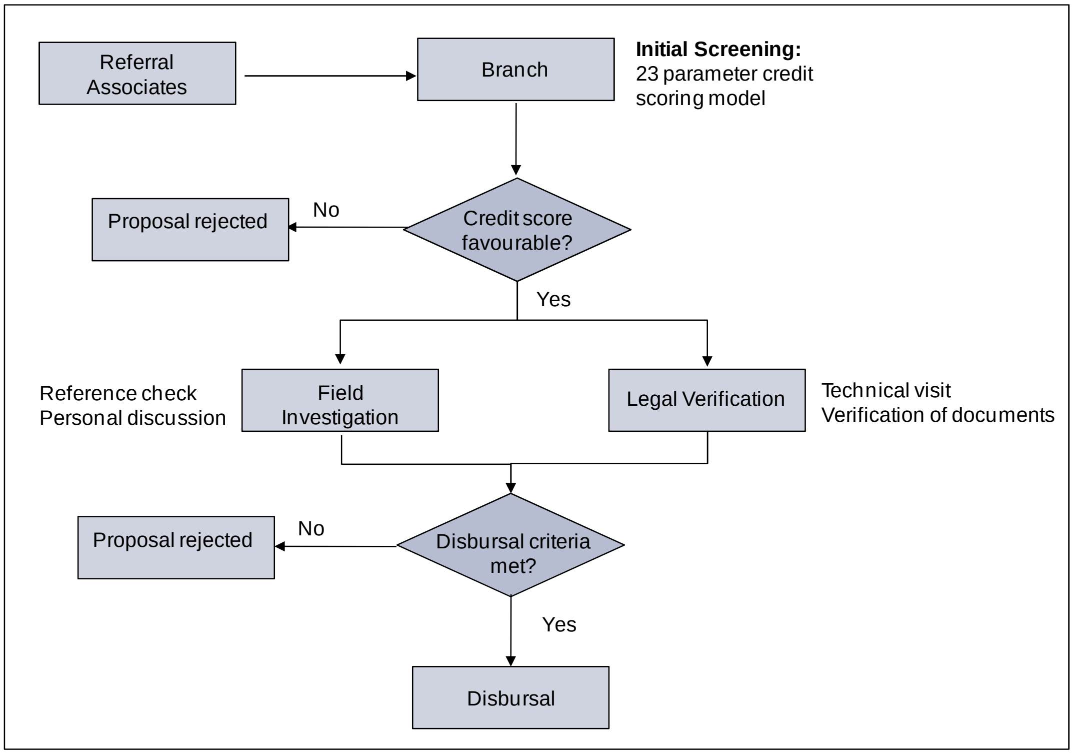


Source: Company data, I-Sec research

The branch is at the centre of GRUH Finance's credit model and has no role to play in lead generation. Most of GRUH's loan leads come from people they call referral associates who play the sole role of bringing in potential customer opportunities. They do not play even a preliminary role in credit appraisal.

Once the lead is generated the branch takes the sole responsibility of credit appraisal. This includes initial screening with the help of a 23 parameter credit scoring model that CRISIL has helped them develop. If the credit score is favourable, the subsequent activities of field investigation, personal discussion, technical visit and reference/ legal verification start. One key difference of GRUH's operating model is that unlike rural focused NBFCs, the company does not collect in cash at the branch or customer's doorstep. It either operates through the post dated cheque (PDC) route or it has designated collection centres in branches for cash collection. This helps the company operate with an employee base of only 520 odd (450 branch staff) while not outsourcing any credit activity.

Chart 4: Credit process flow chart



Source: Company data, I-Sec research

The typical branch has only 3 staff, one branch manager and two customer care executives. The typical costing of branch works out as follows:

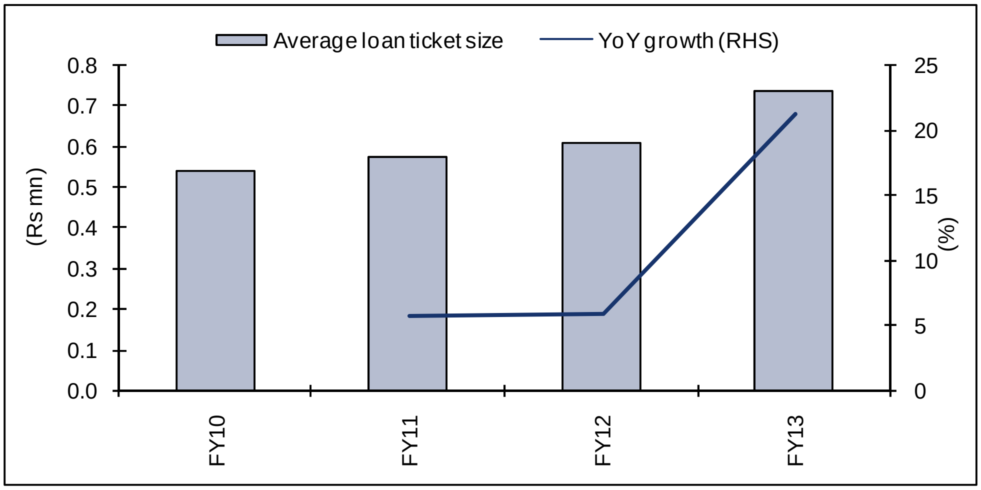
Table 3: Branch costing details

Total no. of branches	134
Salary costs (Rsmn) - per branch	0.80
Rent costs (Rsmn)- per branch	0.24
Other operating costs (Rsmn) - per branch	0.18
Total operating costs (Rsmn) - per branch	1.22

Source: Company data, I-Sec research

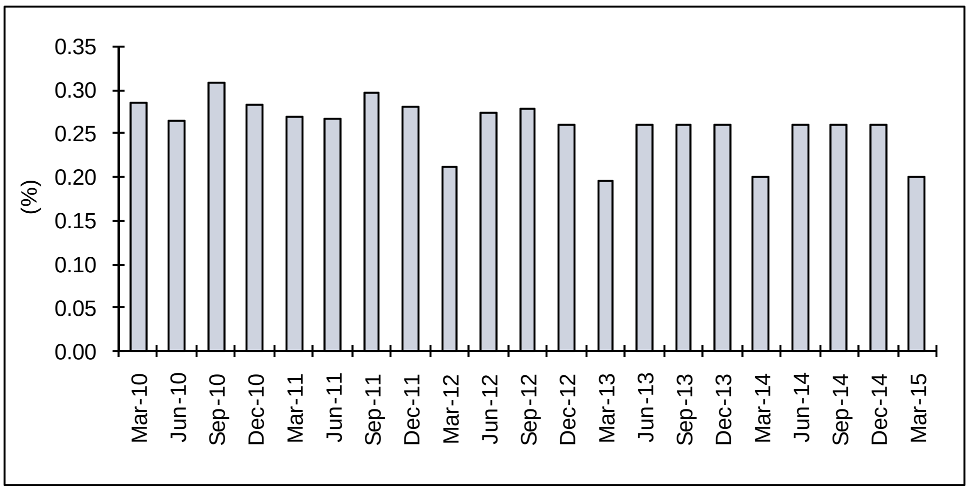
GRUH Finance has demonstrated remarkable consistency in managing its operating cost metrics even though it has been growing at a fast clip and ticket sizes being much smaller than the sector peers. We expect the cost structure to stay stable.

Chart 5: Ticket sizes increasing but are still small



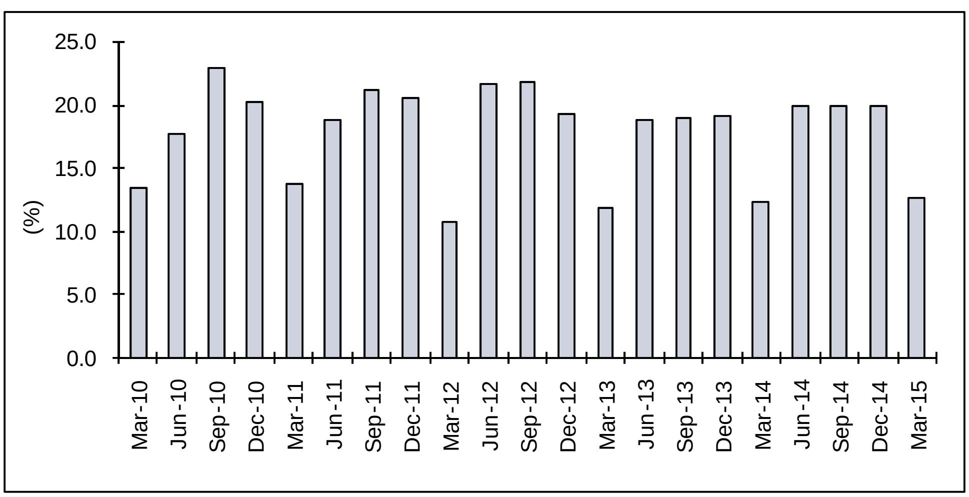
Source: Company data, I-Sec research

Chart 6: Operating costs remarkable stable for a high growth company



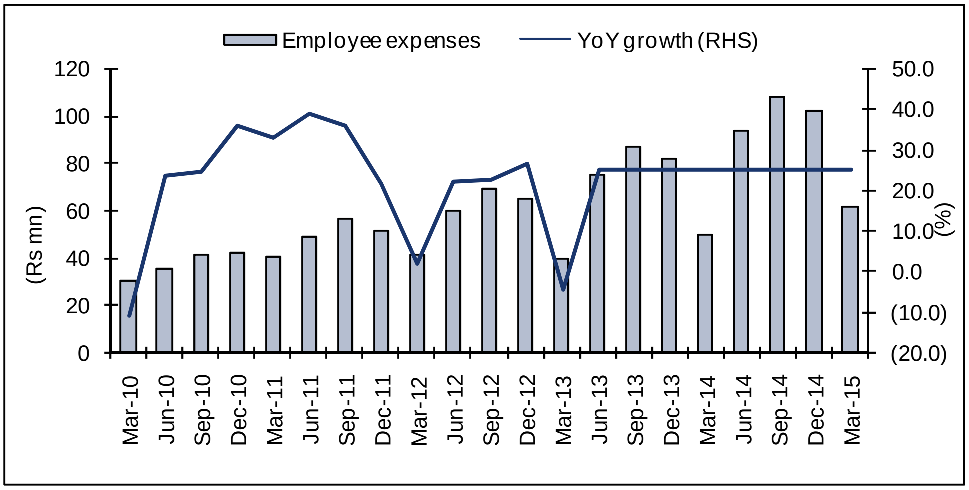
Source: Company data, I-Sec research

Chart 7: Same trend reflected in cost to income but with seasonal variations



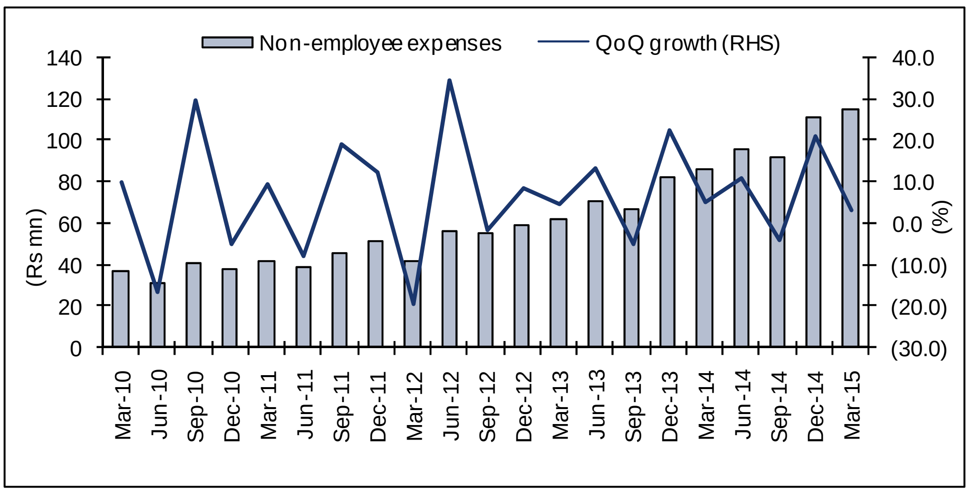
Source: Company data, I-Sec research

Chart 8: Employee expenses again seasonal but under control



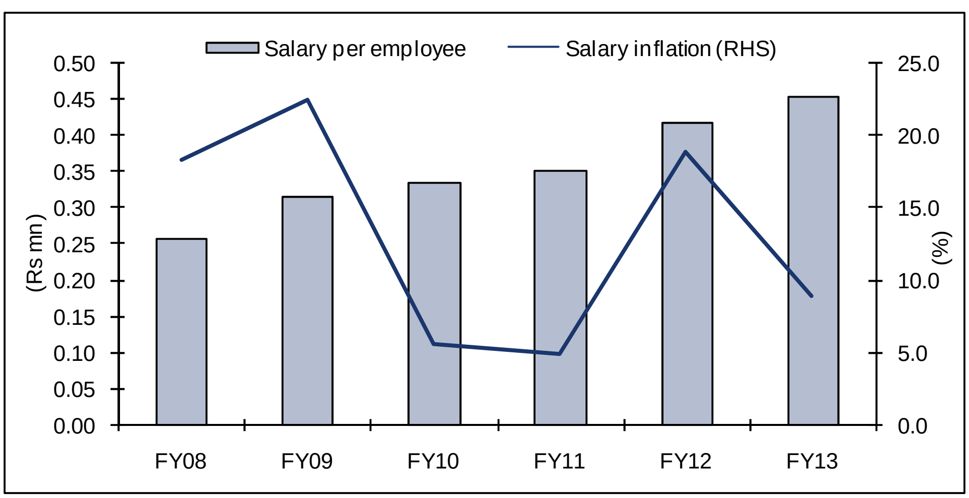
Source: Company data, I-Sec research

Chart 9: Non employee operating expenses have increased in a gradual manner – a clear sign of graded expansion



Source: Company data, I-Sec research

Chart 10: Salary inflation is gradual



Source: Company data, I-Sec research

Product portfolio designed with specific needs in mind

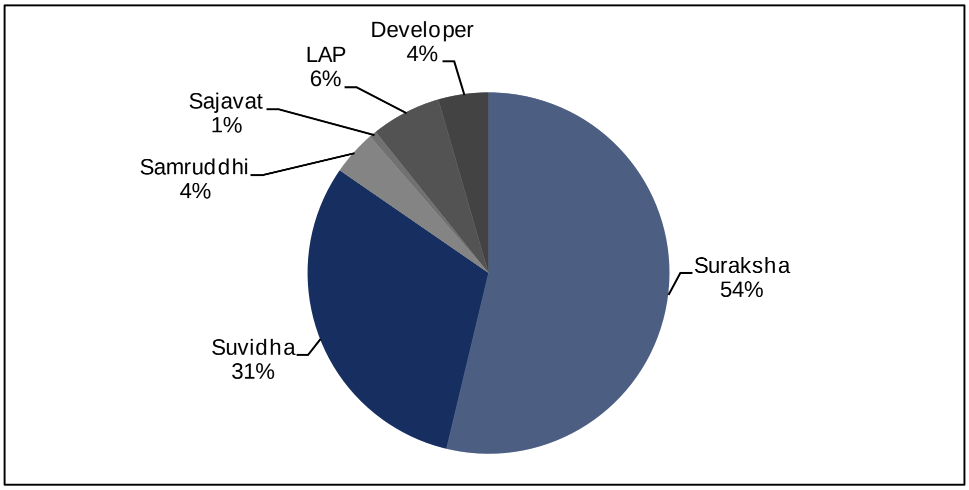
GRUH Finance has designed four basic products to tap the rural housing finance opportunity. Surakhsa is the basic mortgage product for salaried individuals while Suvidha is its counterpart for self employed individuals with no direct income proof and, income estimation is through surrogate methods. The company has rolled out a home improvement loan titled Sajavat. Samruddhi is again a loan given to mainly self employed for purchase of office or business premises.

Table 4: Table of products

Table of products	*Suraksha*	*Suvidha*	*Sajavat*	*Samruddhi*	LAP	Developer loan
Purpose	Construction or purchase of homes	Construction or purchase of homes	Repair and renovation of existing homes	Purchase of offices for business	Loan against house property	-
Customer segment	Professionals and salaried	Professionals and self employed	Professionals, salaried and self employed	Professionals and self employed	Professionals, salaried and self employed	-
% of portfolio	53.6	30.8	0.4	4.0	6.2	4.5
Maximum LTV (%)	85.0	85.0	85.0	85.0	60.0	NA
Ticket size (Rs mn)	7.0-7.5	7.0-7.5	7.0- 7.5	7.0 -7.5	5.0	NA
Interest rate (%)	10.25-12.50	11.50-13.75	11.75-14.00	13.00-15.25	12.25-15.00	14.25-16.50
Maximum tenor (yrs)	25	15	15	15	NA	NA

Source: Company data, I-Sec research

Chart 11: Loan book break-up



Source: Company data, I-Sec research

Should benefit from policy focus on affordable housing

Affordable housing continues to be a thrust area for the GoI, state governments, regulators and other stakeholders in the ecosystem. In 1985, the Indira Awaas Yojana (IAY) was introduced, aimed at providing affordable housing to the poorer sections of the society, especially in the rural areas. Since inception, ~28.5mn homes have been constructed under the scheme at a cost of Rs842bn. Institutions such as the National Housing Bank (NHB), National Bank for Agriculture and Rural Development (NABARD) and Housing and Urban Development Corporation (HUDCO) have also initiated measures to spur rural housing in the country. NHB, being the apex financial institution for the housing segment, runs schemes such as the Rural Housing Fund (RHF), Golden Jubilee Rural Housing Refinance Scheme (GJRHFS) and Productive Housing in Rural Areas (PHIRA). NABARD has been extending loans to the weaker sections of society at significant lower interest rates of 8.0-8.5% against its borrowing rate of 10.25%. HUDCO has supported around 15mn housing units till date, of which 8.9mn (approx. 60%) have been constructed in rural areas.

As per the Planning Commission of India, there is an estimated shortfall of ~18.8 million units under the affordable housing segment. As per our calculations, the total debt financing requirement to meet this shortfall could be in the tune of Rs6.5 trillion.

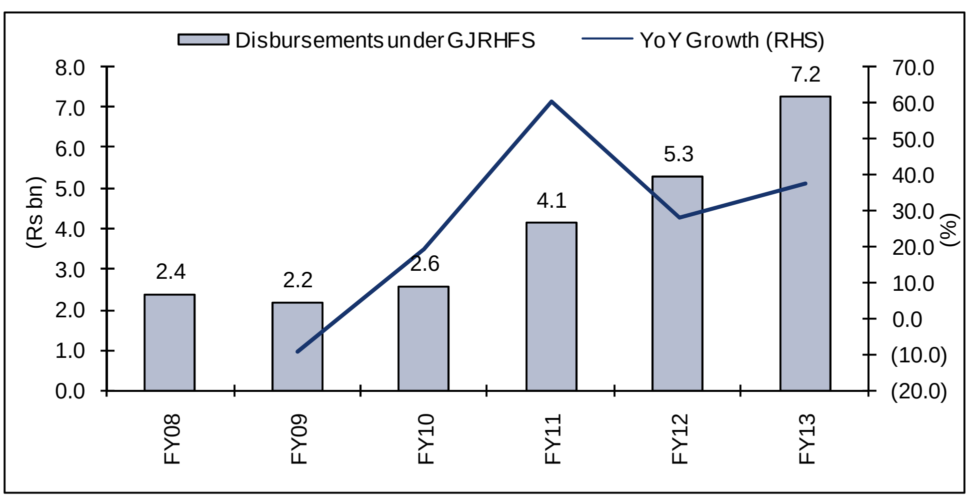
Table 5: Potential financing opportunity in affordable housing pan-India

Housing finance opportunity calculation	
Housing shortfall (million units)	18.78
Average cost of an affordable house (Rs mn)	0.5
Loan-to-value ratio	70%
Average loan per house (Rs mn)	0.35
Total financing requirement (Rs bn)	**6,573**

Source: Panning Commission, RBI, NHB, I-Sec research

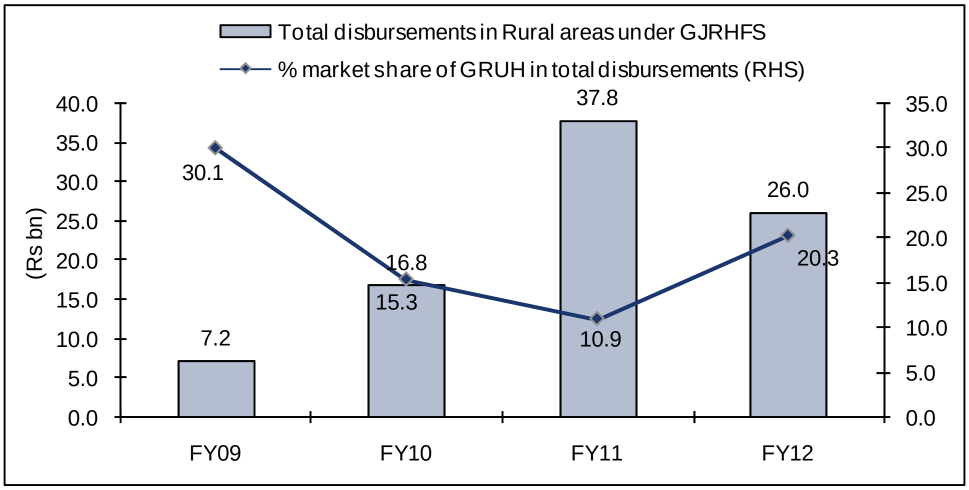
Given GRUH's focus in the rural and semi-urban housing markets, we expect it to be a key beneficiary of the continued regulatory thrust and policy initiatives in the affordable housing segment. The company's disbursements under the GJRHS scheme has steadily seen an uptrend and reached Rs7.2bn in FY13 vis-à-vis Rs2.4bn in FY08, witnessing a CAGR of 25.0% during this period. Also, GRUH's share in the total disbursements under GJRHFS (in rural areas) stood at 29.3% in FY12.

Chart 12: GRUH Finance – Total disbursements under GJRHFS



Source: Company data, I-Sec research

Chart 13: GRUH Finance – Market share in disbursements in rural areas under GJRHFS



Source: Company data, NHB, I-Sec research

GRUH has also benefited from the Rural Housing Fund (RHF) of the Govt. of India which provides refinancing facilities at concessional rates to lending institutions for on-lending to weaker sections of the society in rural areas.

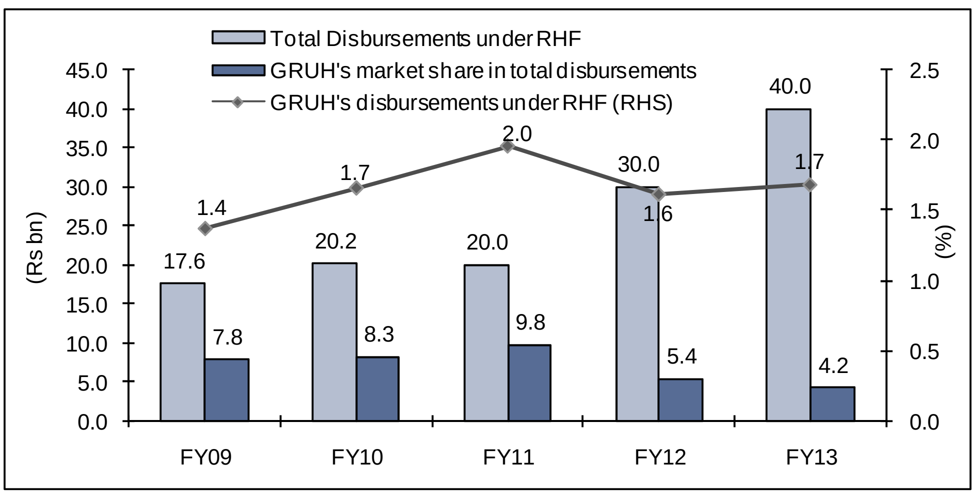
Table 6: Interest rates for refinancing applicable under RHF

Slab –Wise	Interest rate (% p.a.) Banks, HFCs and Cooperative Sector	Interest rate (% p.a.) Regional Rural Banks
Loans upto Rs0.2mn	6.50	6.25
0.2mn to Rs0.5mn	7.00	6.75
Rs0.5mn to Rs1.5mn	7.50	7.25

Source: NHB, I-Sec research

In FY13, disbursements by GRUH under the RHF scheme stood at Rs1.7bn or 4.2% of the total disbursements under the scheme.

Chart 14: GRUH Finance – Market share in disbursements under Rural Housing Fund (RHF)

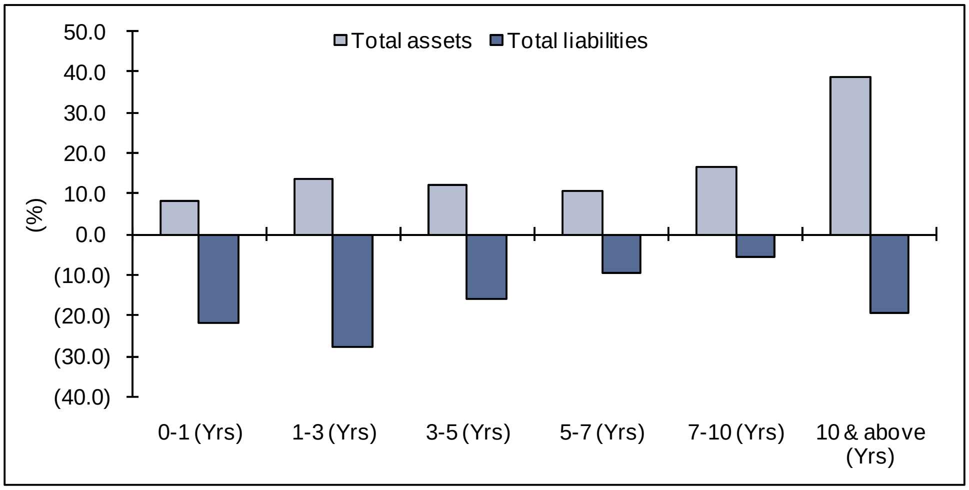


Source: Company data, NHB, I-Sec research

No major gaps in the ALM structure

While given the long duration nature of the loan book, there is some ALM mismatch in the long end (but still better than most large players), in the medium term (in the 3 to 10 year) buckets, the ALM mismatch is well managed.

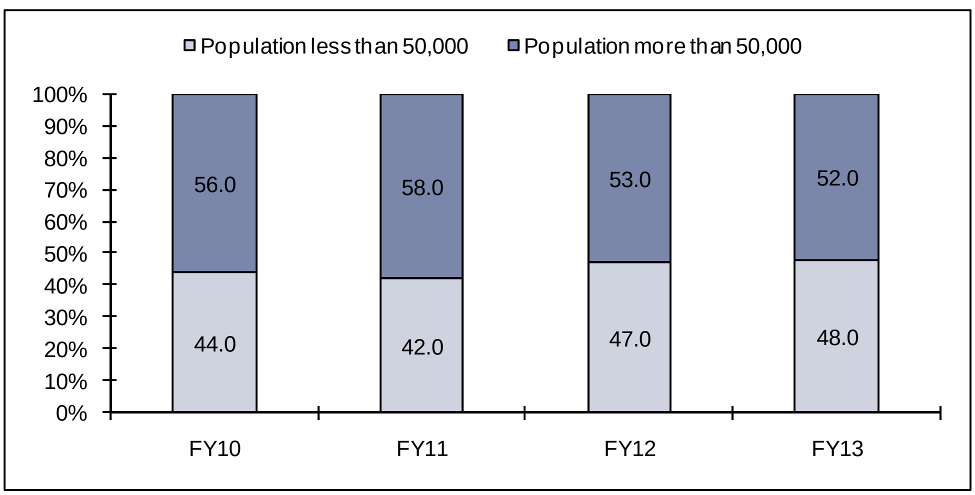
Chart 15: ALM gap well managed in the medium term (FY13)



Source: Company data, I-Sec research

GRUH's Rural Focus continues

Chart 16: Break-up of rural loans – population wise



Source: Company data, I-Sec research

Chart 17: Properties financed – Loan to Value Ratio (LTV) wise distribution

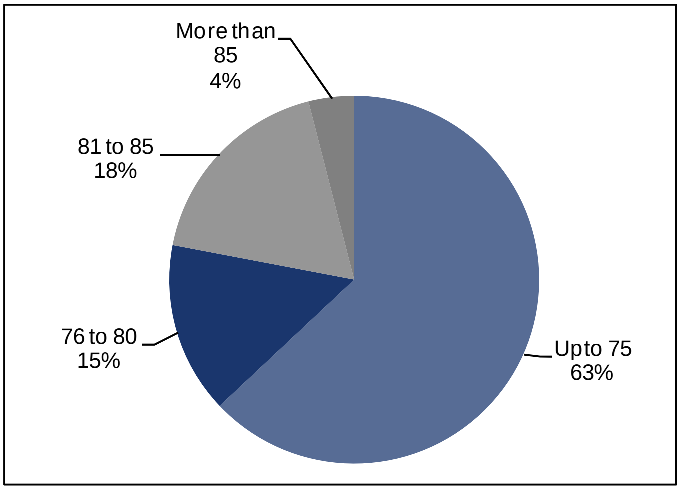
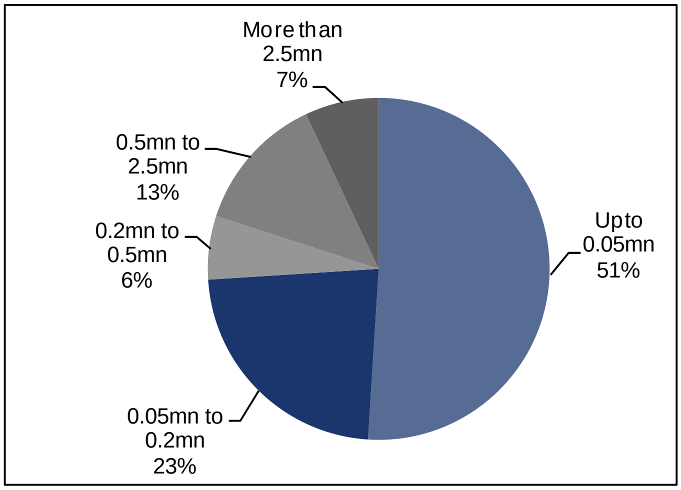


Chart 18: Properties financed – Location wise Distribution



Source: Company data, I-Sec research

Chart 19: Properties Financed - Loan amount wise Distribution

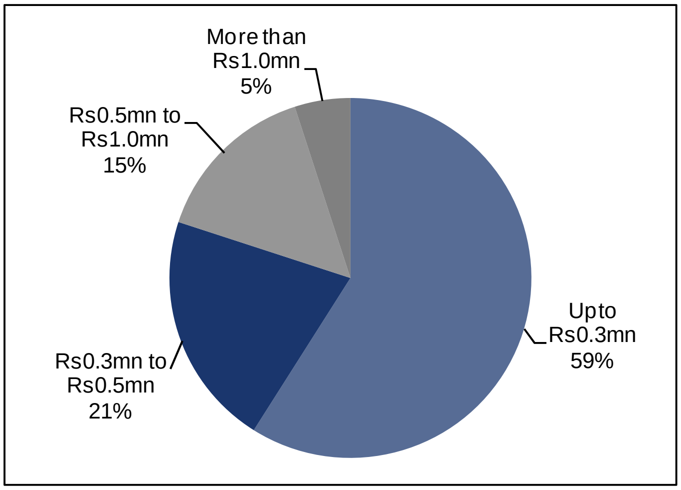
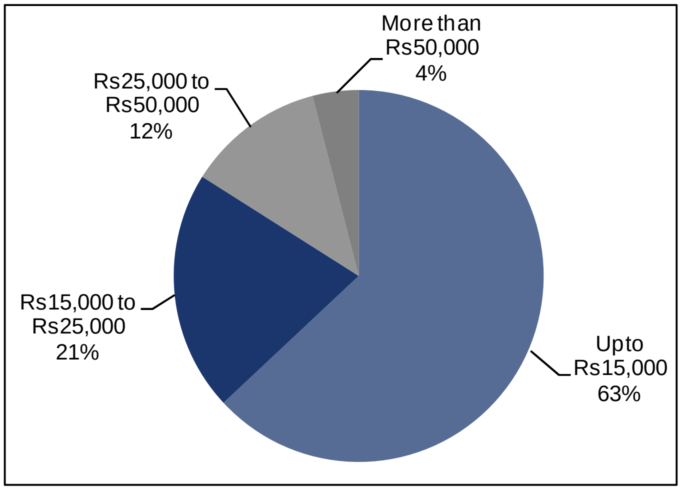


Chart 20: Properties Financed - Family Income wise Distribution

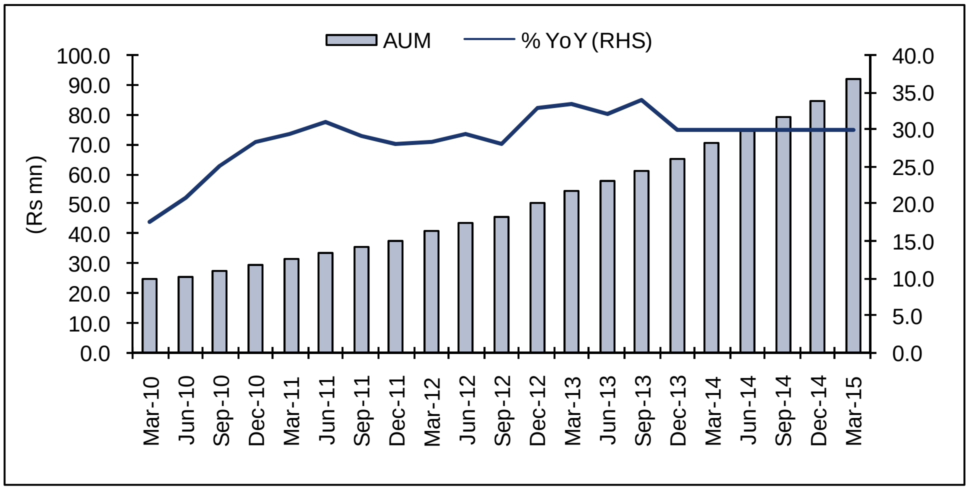


Source: Company data, I-Sec research

Growth to remain robust but we expect no sharp spike

The company will continue to grow at a healthy CAGR of 30% over the next three years, in our expectation. However, although many other companies placed in the situation that GRUH Finance finds itself in will have been tempted to accelerate growth. Further, we see no such risks in this case. The company believes that rural housing finance is a business that needs a methodical scale up and, sudden growth spurts will only jeopardize the fidelity of its credit model.

Chart 21: Growth momentum to sustain

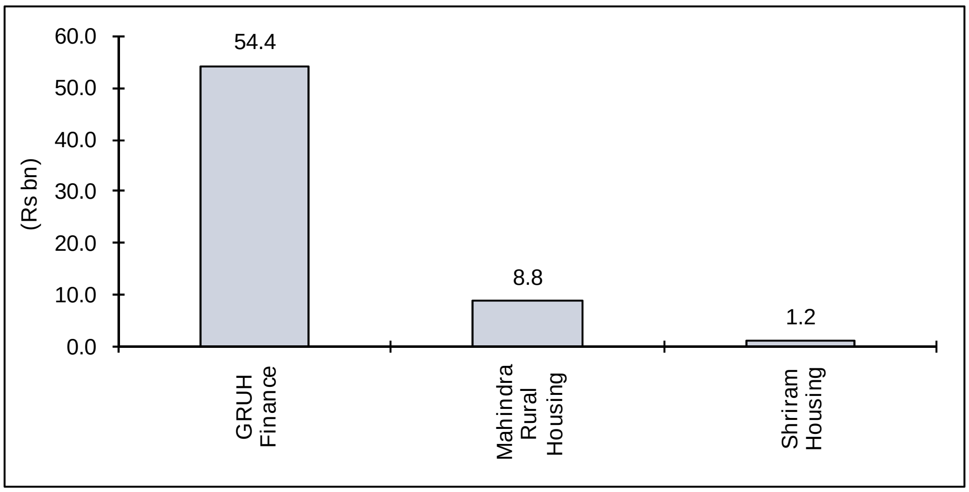


Source: Company data, I-Sec research

Business scalability entry barriers provide yield support

We believe that scalability remains the biggest challenge to a successful and sustainable execution of a rural housing finance business model. The yields are much higher than that paid by urban salaried class borrowers, but segment challenges are many as articulated earlier. Off late, some of the larger players and a host of NBFCs have entered this business, but we feel the opportunity space is very large and it will be unlikely to have serious competitive pressures in the next five years. If and when the sector does become more competitive, we expect GRUH Finance to maintain its leadership position.

Chart 22: Key players and portfolio size - given size of opportunity the current penetration is minuscule

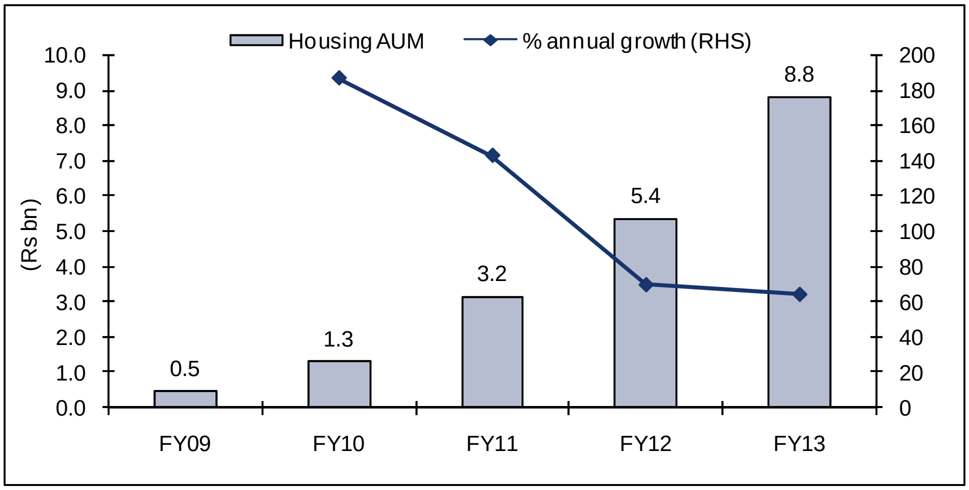


Source: Company data, I-Sec research

Mahindra Housing – a case study to illustrate scalability challenges

Mahindra and Mahindra Financial Services (MMFS) started its housing finance business in 2008 and taken a gradual approach to scaling up AUM in this segment. When the company entered the business, it realised that the urban and semi-urban model of apartment complexes does not work in rural India. Hence, one cannot aim for much beyond a loan for construction or home improvement. However, the company takes full lien on the land and property title in case of a disbursement, thereby making repossession through the use of SARFAESI Act possible. The average ticket-size in this business is Rs150,000 and yields are 16%-17%. The company has rolled out this business in eight states and GNPA is hovering at around 3%. However, given the low LTV levels and nature of collateral, credit losses are low.

Chart 23: MMFS's housing finance AUM has not grown sharply despite small base



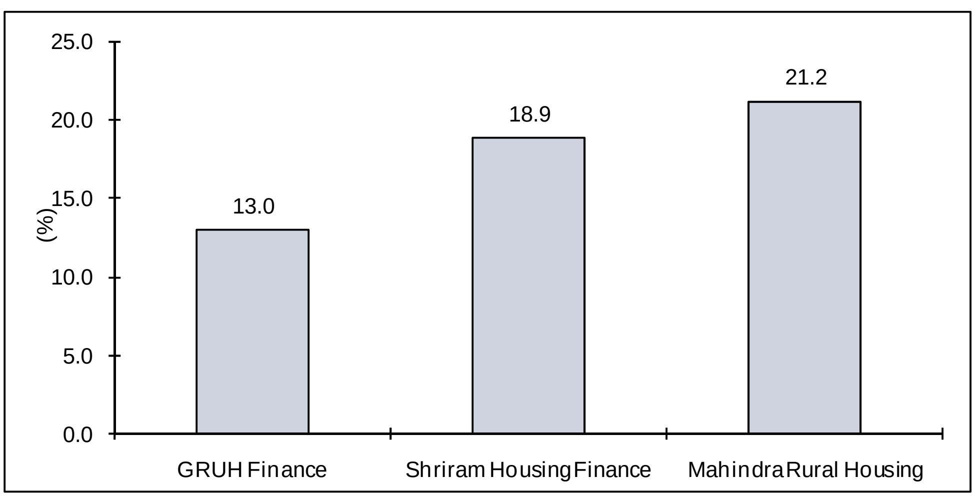
Source: Company data, I-Sec research

It is only in Q4FY13 that after being in the business for close to five years that MMFS now plans to quadruple its asset portfolio by FY15 from a fairly low base. We feel that MMFS example is illustrative of how challenging scaling up a rural housing business can be, as there are not many players in India who can match MMFS's existing rural presence.

Low competition will protect yields

The peak yields that GRUH Finance charges is ~14%. We feel that the company could easily charge 200bps more on most products without significant impact on asset growth aspirations. The main reason that it does not do so is that it feels that affordability of a loan is critical to long term acceptance of the product and the business fortunes of the company. In such a backdrop, with the few competitors present all charging higher rates while generating lower RoEs (being NBFC subsidiaries they have a disadvantage on leveraging), we expect yields to stay firm (on a spread over AAA borrowing rate basis) for a long time to come. As of today, no competitor is close to matching GRUH Finance's loan economics.

Chart 24: Yields charged by MMFS, SCUF and GRUH Finance in housing



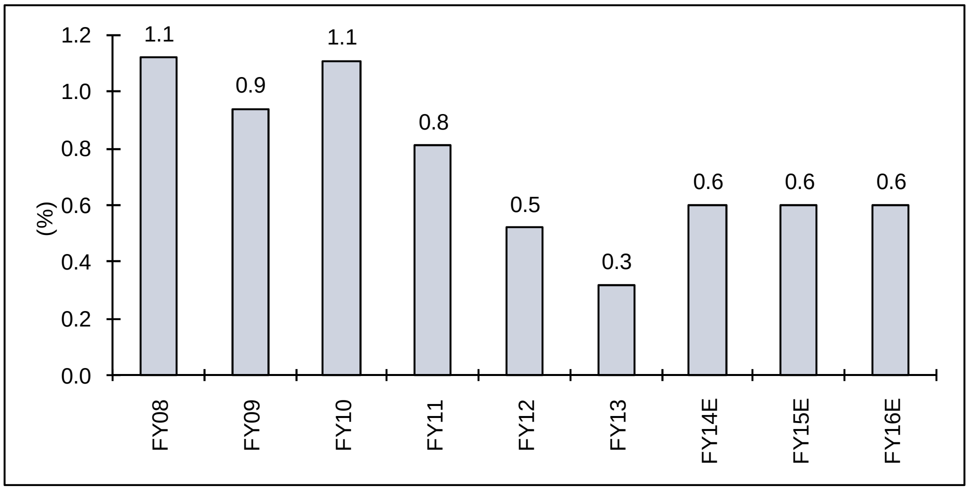
Source: Company data. Note: Yields on advances for Mahindra Rural Housing based on gross income

Parentage and delinquency track record help liability franchise

Asset quality track record and tempered growth plans provide comfort to lenders

GRUH Finance has demonstrated an excellent long term asset quality track record while operating in a fairly challenging domain.

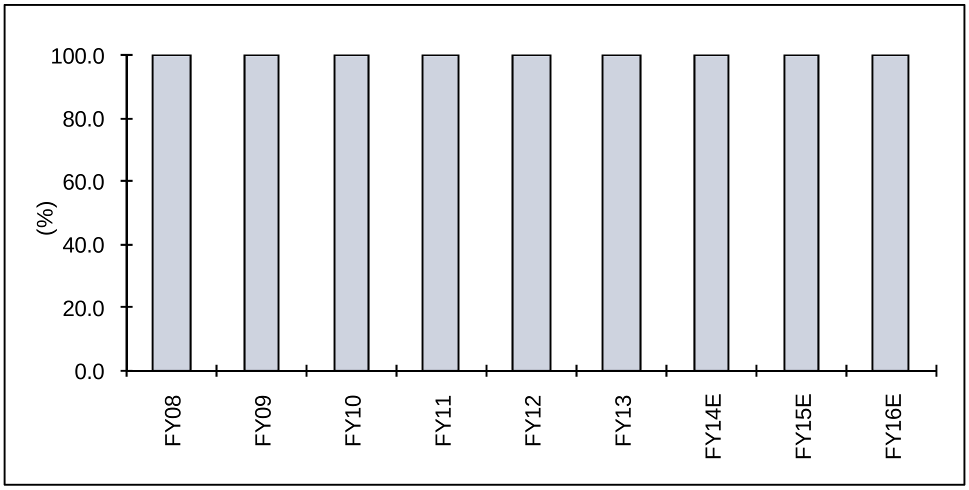
Chart 25: Trend in asset quality (GNPL ratio)



Source: Company data, I-Sec research

The company's provisioning policies are generally extremely conservative and it provides for 100% of its NPAs.

Chart 26: Trend in provision coverage ratio



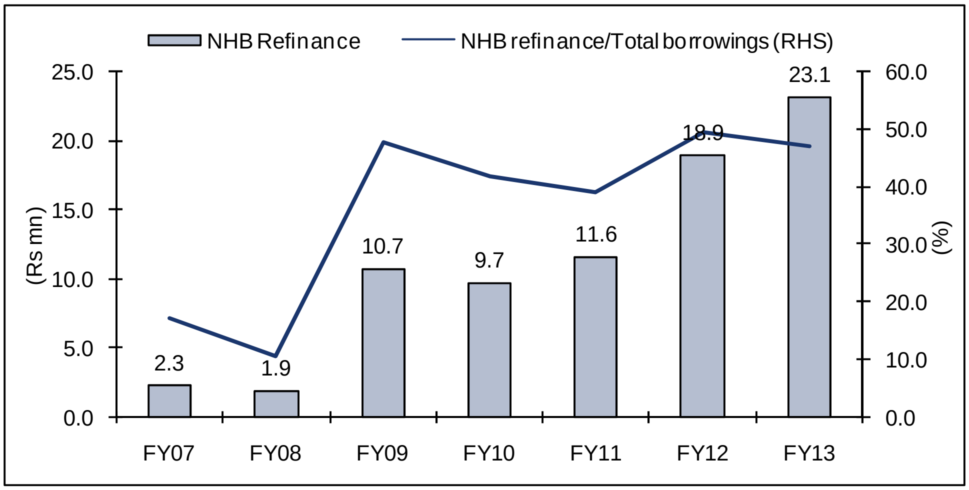
Source: Company data, I-Sec research

With moderation being the watchword in both yields charged (a powerful quality filter in our opinion) and growth aspirations (despite opportunity aplenty), we repose a lot of faith is GRUH's asset quality going forward.

Big beneficiary of NHB refinance

The National Housing Bank (NHB) provides medium to long term financing to lending institutions at concessional and fixed rates of interest, which serves as an important funding source for banks and HFCs alike. GRUH has proactively tapped this stable and relatively cheaper source of financing, which comprised 47.0% of its total borrowings as of March 31, 2013.

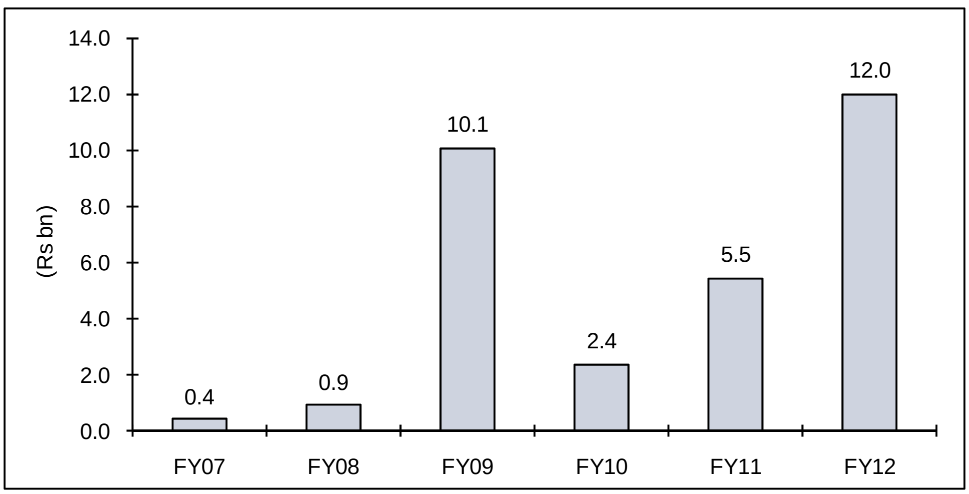
Chart 27: NHB refinance remains a sizeable proportion of total borrowings



Source: Company data, I-Sec research

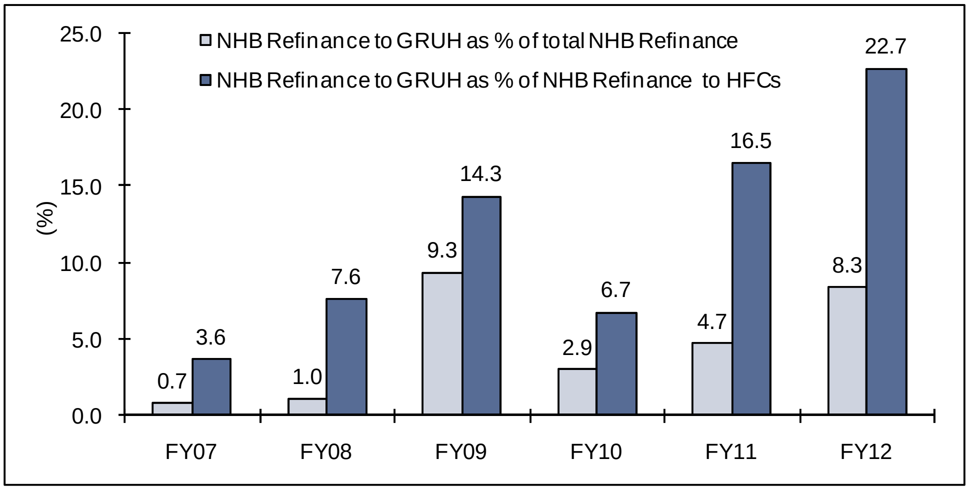
The company availed funds to the tune of Rs12.0bn under this scheme in FY12, constituting 8.3% of the total disbursements by NHB during the year. In FY13, GRUH received refinance sanction of Rs9.3bn from NHB, taking the total outstanding to Rs23.1bn as of March 31, 2013.

Chart 28: GRUH – NHB refinance availed each year



Source: Company data, I-Sec research

Chart 29: Biggest HFC beneficiary of NHB refinance



Source: Company data, NHB, I-Sec research

Parentage of HDFC is a big value add

Apart from having solid operating metrics, GRUH probably also benefits from being a subsidiary of housing sector leader HDFC (who own 59.7% of its equity). HDFC is well represented on the board and a source of great comfort to debt and equity market participants alike.

Table 7: Significant board representation from HDFC

Name	GRUH responsibility	Background
Mr. Keki Mistry	Non-executive Chairman	Mr. Mistry is the Vice Chairman and CEO of HDFC Ltd. He serves as a director on the board of several leading companies such as HDFC Bank, Sun Pharmaceutical, IL&FS, Torrent Power, Bombay Stock Exchange, HCL Technologies. He has been on the board of GRUH Finance since 2000 and is member of its Audit and Compensation Committees.
Ms. Renu Karnad	Director	Ms. Karnad is the Managing Director of HDFC and Chairperson of HDFC Property venture Ltd. She has been on the board of GRUH since 2000 and is a member of its Compensation Committee.
Mr. K.G. Krishnamurthy	Director	Mr. Krishnamurthy is the MD & CEO of HDFC Property Ventures Ltd. He has over two decades of experience in the real estate industry and has been on GRUH's board since 2004.

Source: Company data, I-Sec research

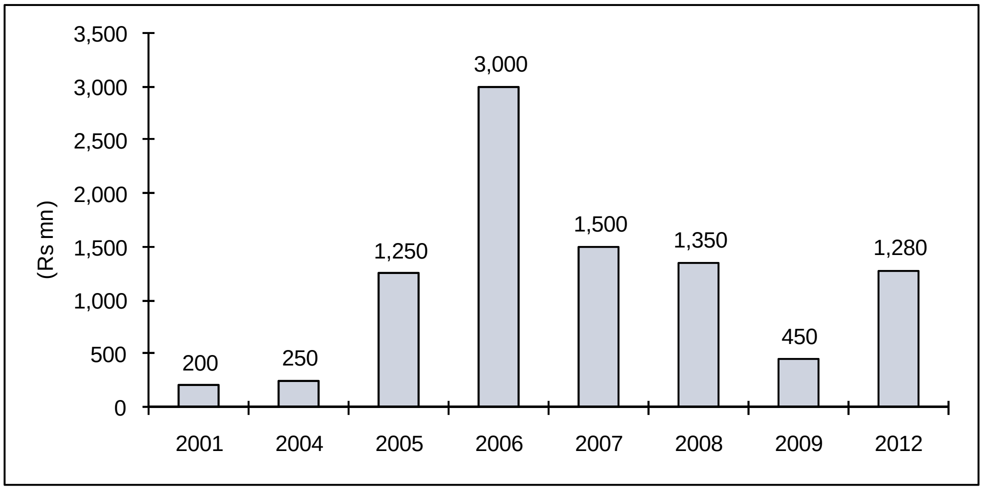
Performance and parentage has enabled the company to garner ratings of AA+ on long term basis and AAA for its deposits allowing it to borrow at fairly fine rates in the NCD market.

Table 8: Credit ratings table

	Crisil	Icra
Long term	AA	AA+
Senior Unsecured Debt	AA	-
Subordinated Debt	AA+	-
Fixed Deposits	FAAA	-
Short term	A1+	A1+

Source: Company data, I-Sec research

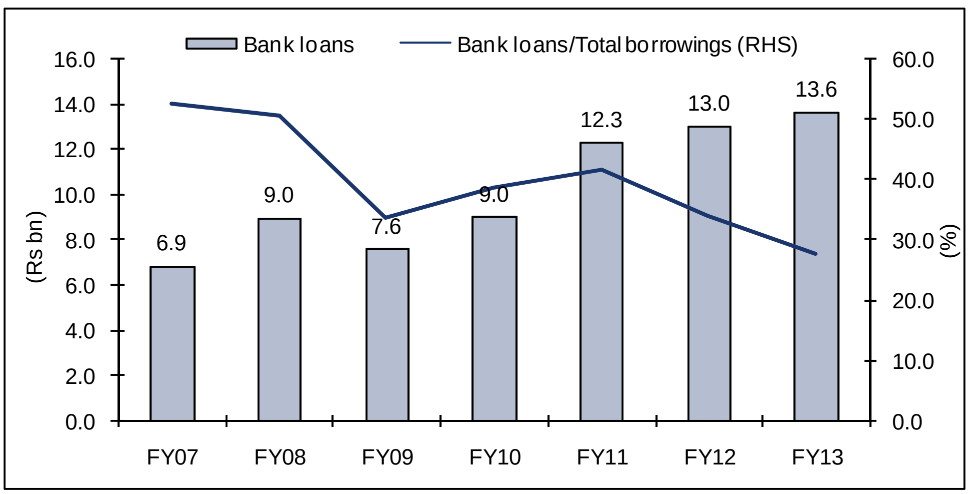
Chart 30: Annual NCD issuance



Source: Bloomberg, I-Sec research

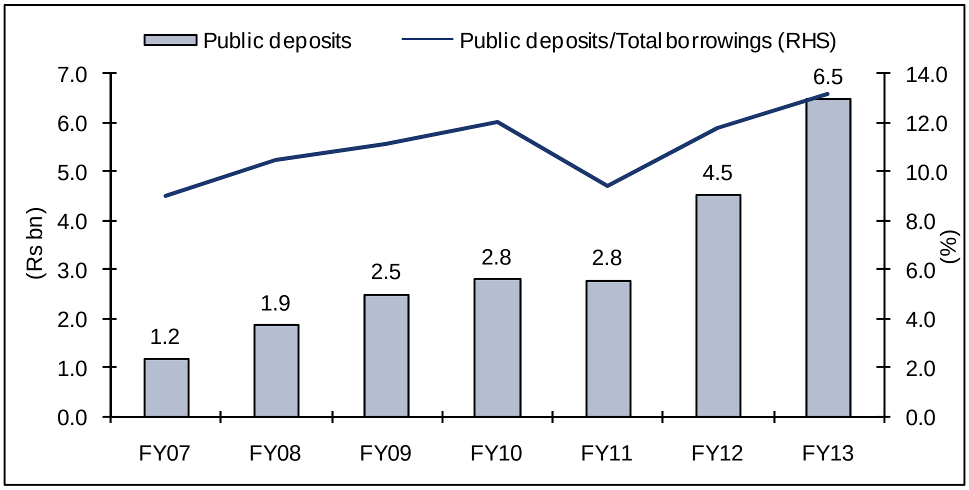
Like the rest of the housing finance businesses with strong wholesale debt market franchises, GRUH has also de-emphasized its bank funding and has even done an admirable job of collecting deposits and renewing old ones.

Chart 31: Bank dependence has reduced



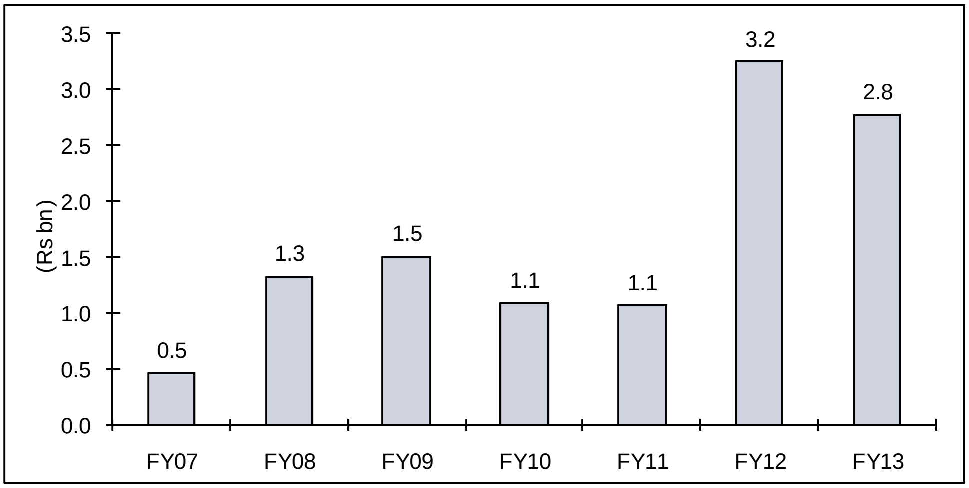
Source: Company data, I-Sec research

Chart 32: Reliance on public deposits is relatively high



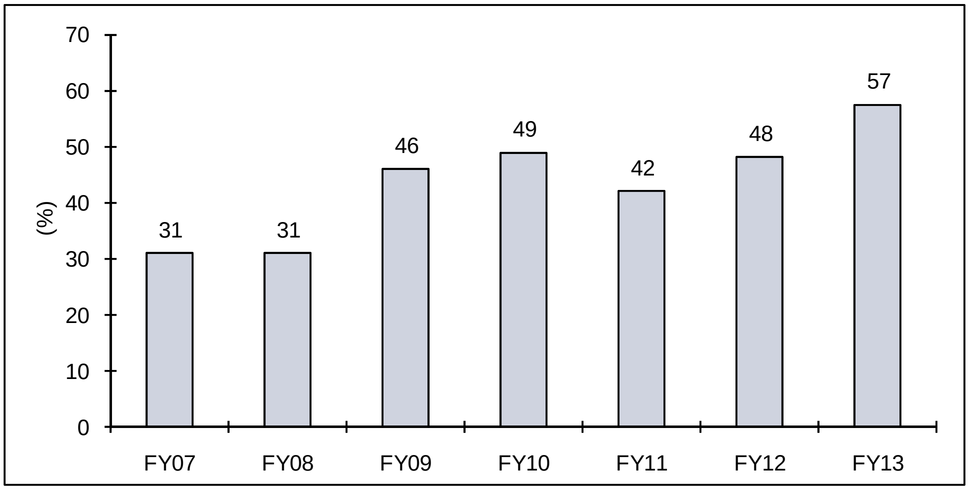
Source: Company data, I-Sec research

Chart 33: Fresh deposits mobilized every year



Source: Company data, I-Sec research

Chart 34: Annual renewal ratios on deposits



Source: Company data, I-Sec research

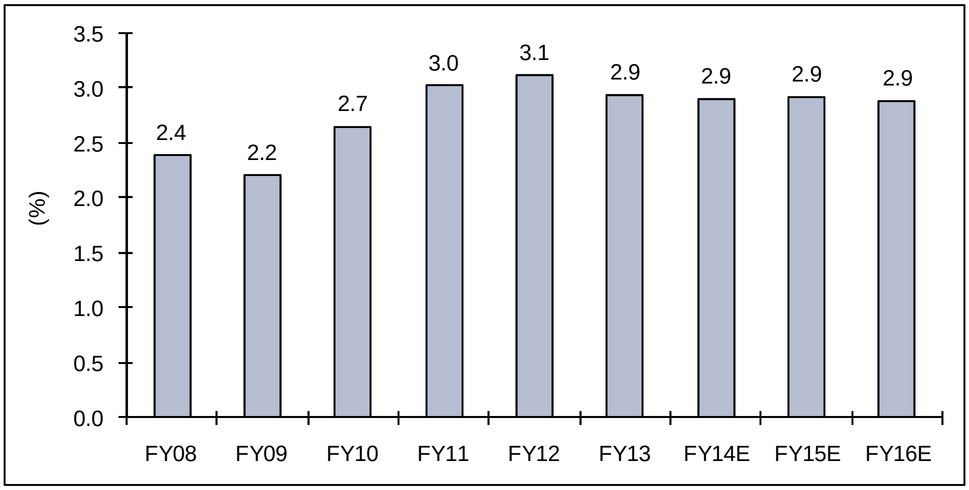
Securitization can be a further value add

With a large chunk of GRUH's assets qualifying as priority sector assets, the securitized paper appetite from banks is likely to be high. The company has not been exploring this route, but with increasing size we feel that the 100bps cost advantage through the same can be a boost to profitability.

Sector leading capital return ratios but valuations high

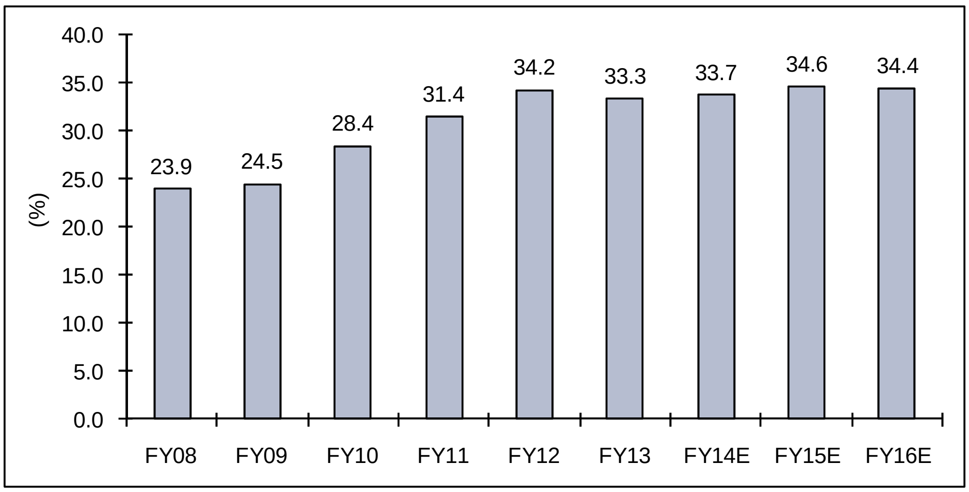
The three main drivers of GRUH's RoA, spreads, operating efficiency and credit costs are unlikely to be under pressure in our opinion. If anything, there is scope for increasing financial leverage.

Chart 35: RoA continues to be strong…



Source: Company data, I-Sec research

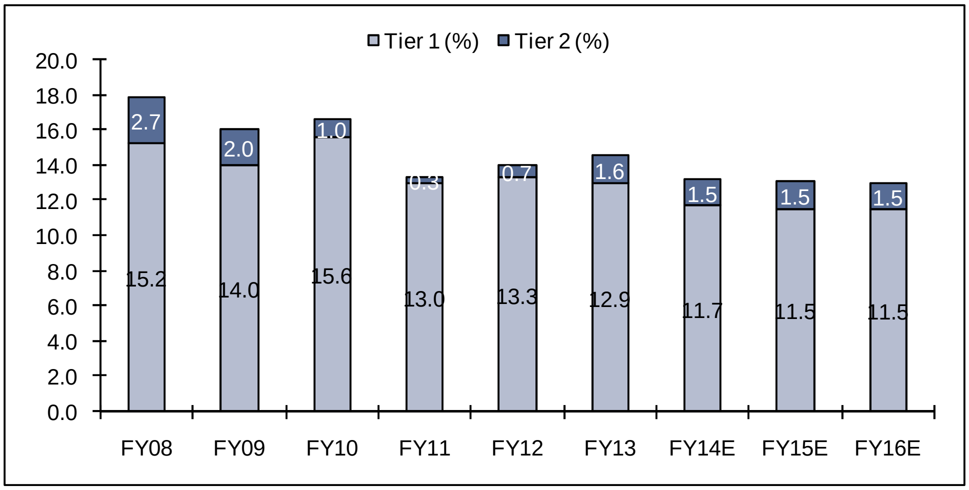
Chart 36: ….as is RoE



Source: Company data, I-Sec research

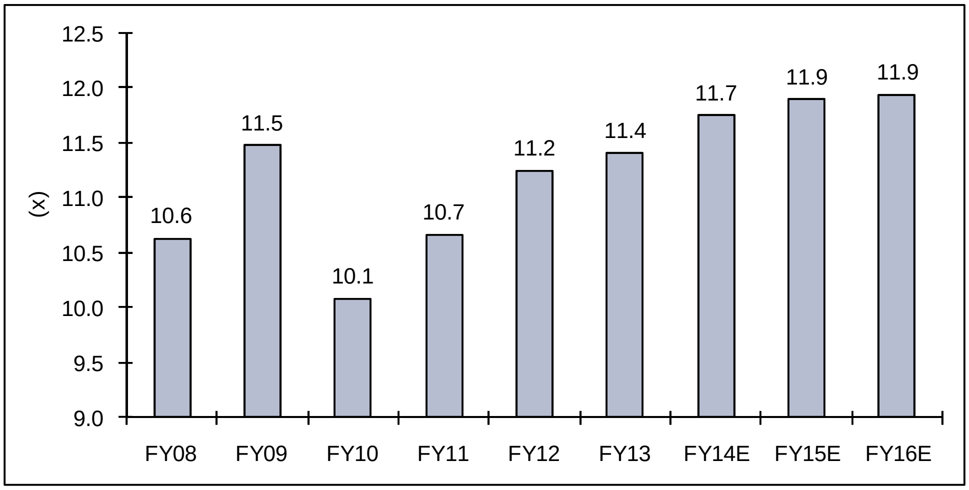
Adequately capitalized for normal growth

Chart 37: Comfortable capital adequacy…



Source: Company data, I-Sec research

Chart 38: …but leverage remains high

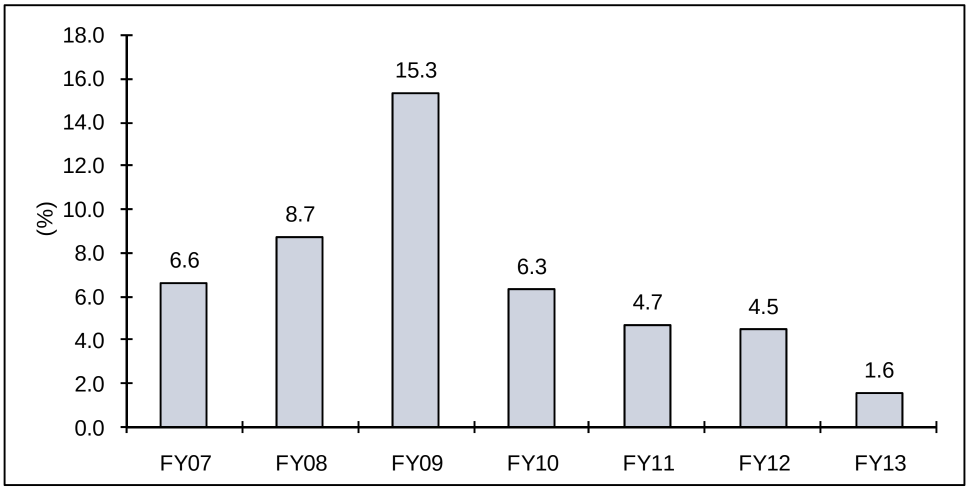


Source: Company data, I-Sec research

Despite maintaining high growth rates in assets the last time GRUH raised equity financing was in 2006. We feel that GRUH's growth will continue to get funded through internal accruals.

Extremely efficient balance sheet management

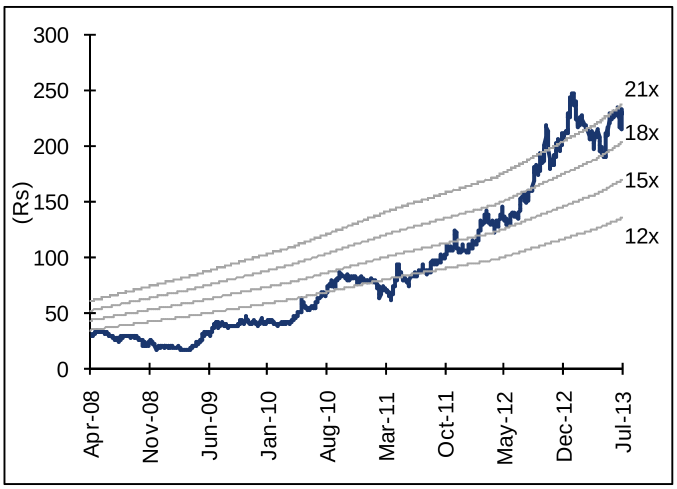
Chart 39: Cash & investments as a % total assets



Source: Company data, I-Sec research

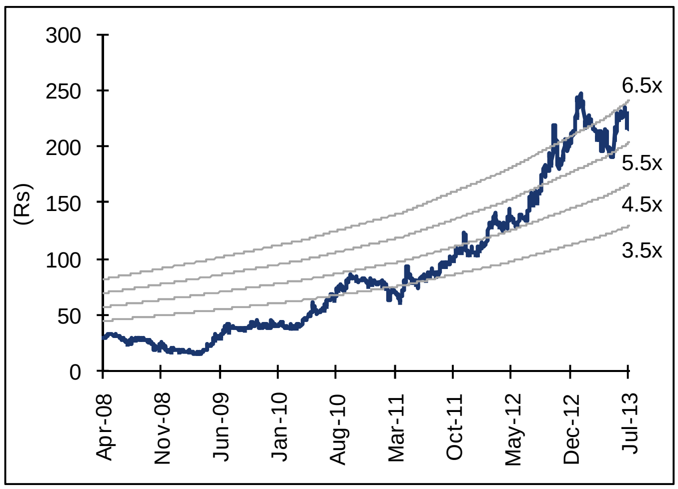
Valuations appear stretched

Chart 40: Rolling 1-year forward P/E



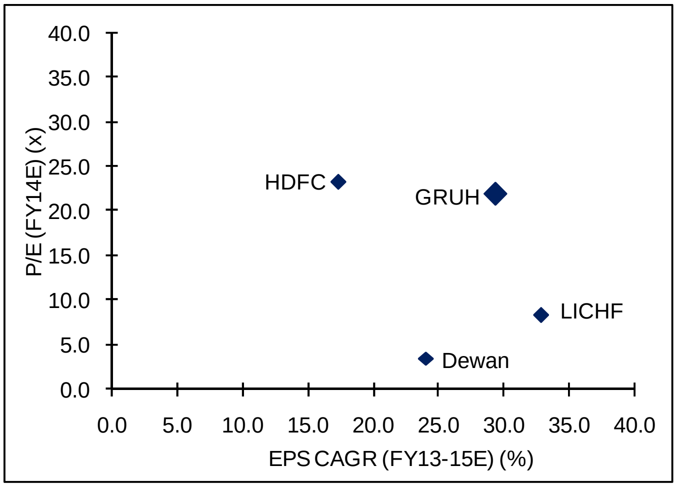
Source: Bloomberg, I-Sec research. Note: Market price as of July 5, 2013

Chart 41: Rolling 1-year forward P/BV



Source: Bloomberg, I-Sec research

Chart 41: Valuation matrix - EPS CAGR (FY13-15E) vis-à-vis FY14E P/E



Source: Bloomberg, Company data, I-sec research. Note: Market price as of July 5, 2013

Chart 42: Valuation matrix – FY14E ROE vis-à-vis FY14E P/B

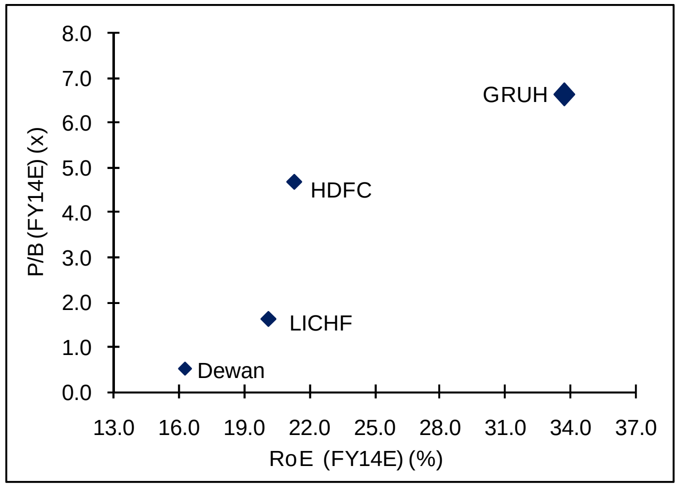


Table 9: HFC Trading Comparables

	Price (Rs)	Market Cap (Rs bn)	P/E (x)			P/BV (x)			RoE (%)			EPS CAGR (%) (FY13-15E)
			FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	
HDFC	850	1,321	27.2	23.3	19.7	5.3	4.7	4.1	22.0	21.3	22.2	17.3
LIC Housing	233	118	11.5	8.3	6.5	1.8	1.5	1.3	16.8	20.1	21.5	32.9
GRUH Finance	229	41	28.1	21.9	16.8	8.4	6.6	5.2	33.3	33.7	34.6	29.4
Dewan Housing	152	19	4.3	3.5	2.8	0.6	0.5	0.5	17.1	16.3	17.5	24.1

Source: Bloomberg, Company data, I-sec research. Note: Market price as of July 5, 2013

We recommend REDUCE in GRUH Finance with a TP of Rs222

GRUH Housing is currently earning a RoE of ~33% and we feel that this can easily sustain for the next few years. Going by our simple yardstick of approximately 1x premium in P/B for every 600bps premium earned over the base CoE of 14%, we arrive at a 1 yr fwd multiple of ~4.2x for the core business as fair. However, that fact remains that GRUH remains one of the best managed secular growth stories in India that could potentially add value to current shareholders by expanding the equity base multiple times over the next decade if it chooses to accelerate growth. We feel that a growth premium of 20% is therefore warranted. Thus our target multiple is 5x. Our target price is Rs222 indicating 3% downside on a 12 month basis. We recommend REDUCE.

Risks to our investment thesis

Rural economic slowdown affecting income levels

An economic slowdown that will affect the income levels of rural borrowers impacts the affordability of loans to individuals and increase probability of default. With newer and riskier products like LAP (loan against property) in the ambit now the risk becomes even more exacerbated. However, LTVs and EMI to income ratios are conservative for GRUH and provide cushion.

Liquidity squeeze

Like any other housing finance company, GRUH is wholesale funded and any liquidity tightening makes its growth plans uncertain. Also, the company runs a large mismatch in asset and liability duration with almost 15-20% of liabilities needing refinance while repayment rates are only about 10% for assets. This means even maintaining the existing loan book needs refinance - a fundamental weakness in the business model. However the small size of the balance sheet and its strong liability franchise is a natural hedge for this risk.

Cooling off in real estate markets

If real estate market volumes and prices cool off it creates multiple complications for any housing finance company. Growth becomes more challenging given ticket size shrinkage, operating cost metric spikes due to the same reason and moral hazard from borrowers may increase if prices drop sharply.

Adverse regulation

When one looks at the recent history of the sector, multiple regulations have impacted it very significantly. The base rate driven regime for banks, have made bank borrowings all but infeasible on cost for players who operate in the mass market for plain vanilla mortgages to salaried individuals. Prepayment penalties have been abolished and this has created an environment for rate shopping and we feel spreads will come down as the gap between yields charged to old and new customers disappears. The Damodaran Committee recommended that the regular enforce that no interest rate differential is allowed between customers depending on vintage. There are many other areas like risk weights for calculating regulatory capital and deposit collection rights of HFCs which can attract potential regulatory scrutiny.

Financial summary

Table 10: Profit and loss statement

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	4,856	6,181	7,815	10,064	13,083
Interest expended	3,101	4,044	4,940	6,319	8,281
Net interest income	**1,755**	**2,137**	**2,874**	**3,745**	**4,802**
Other income	284	323	538	709	929
Operating expenses	183	209	281	382	517
Employee costs	197	234	293	366	458
Depreciation	24	20	24	30	36
Pre-provisioning op profit	**1,636**	**1,997**	**2,814**	**3,676**	**4,721**
Provisions & contingencies	8	29	299	389	506
Profit before tax	**1,628**	**1,968**	**2,515**	**3,287**	**4,215**
Income taxes	424	509	646	843	1,080
Net profit	**1,203**	**1,459**	**1,869**	**2,444**	**3,135**

Source: Company data, I-Sec research

Table 11: Balance sheet

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Share Capital	353	357	357	357	358
ESOPs	0	0	0	0	0
Reserves and surplus	3,503	4,553	5,837	7,591	9,931
Minority Interest	0	0	0	0	0
Borrowings	38,293	49,115	59,370	77,840	101,910
Current liabilities & provisions	1,213	1,976	7,194	8,745	10,629
Total liabilities & stockholders' equity	**43,361**	**56,000**	**72,758**	**94,533**	**122,828**
Loans & advances	40,808	54,648	70,691	91,899	119,468
Fixed assets	117	118	149	188	237
Investments	244	651	822	1,038	1,311
Cash and Balance	1,695	221	279	353	445
Current assets	378	237	665	872	1,143
Deferred tax assets	120	125	151	184	224
Total assets	**43,361**	**56,000**	**72,758**	**94,533**	**122,828**

Source: Company data, I-Sec research

Table 12: Key ratios

(Year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Growth (%)					
AUM	28.3	33.4	30.0	30.0	30.0
Net Interest Income	25.3	21.8	34.5	30.3	28.2
Total Non-Interest Expenses	21.1	14.8	29.2	30.0	30.0
Pre provisioning operating profits	28.7	22.1	40.9	30.6	28.4
PAT	31.5	21.2	28.1	30.8	28.3
EPS	31.0	19.9	28.1	30.6	28.1
Yields, interest costs and spreads (%)					
NIM on AUM	4.8	4.5	4.6	4.6	4.5
Yield on loan assets	13.1	12.8	12.3	12.2	12.3
Average cost of funds	9.1	9.3	9.1	9.2	9.2
Interest Spread on loan assets	4.0	3.5	3.2	3.0	3.1
Operating efficiencies					
Non interest income as % of total income	16.2	15.1	18.7	18.9	19.3
Cost to income ratio (%)	23.0	21.7	20.8	20.8	21.1
Op.costs/avg AUM (%)	1.1	1.0	1.0	1.0	1.0
No of employees (estimate)	473	517	552	597	647
No of branches	120	134	149	164	179
Average annual salary (Rs)	416,082	453,191	530,571	613,222	707,291
Annual inflation in average salary(%)	18.8	8.9	17.1	15.6	15.3
Salaries as % of non-int.costs (%)	52.2	48.9	47.2	48.8	50.6
NII /employee (Rsmn)	3.7	4.1	5.2	6.3	7.4
AUM/employee(Rsmn)	86.2	105.2	128.1	153.9	184.6
AUM/ branch (Rs mn)	339.8	405.8	474.4	560.4	667.4
Capital Structure					
Debt-Equity ratio	9.9	10.0	9.6	9.8	9.9
Leverage (x)	11.2	11.4	11.7	11.9	11.9
CAR (%) –standalone (%)	14.0	14.6	13.2	13.0	13.0
Tier 1 CAR (%) –standalone (%)	13.3	12.9	11.7	11.5	11.5
Tier 2 CAR (%) – standalone (%)	0.7	1.6	1.5	1.5	1.5
Asset quality and provisioning					
GNPL	211	176	424	551	717
GNPL (%)	0.5	0.3	0.6	0.6	0.6
NNPL	0	0	0	0	0
NNPL (%)	0.0	0.0	0.0	0.0	0.0
Coverage ratio (%)	100.0	100.0	100.0	100.0	100.0
Return ratios & capital management					
RoAA (%)	3.1	2.9	2.9	2.9	2.9
RoAE (%)	34.2	33.3	33.7	34.6	34.4
Payout ratio (%)	33.7	30.6	26.7	24.1	21.7
Valuation Ratios					
EPS (Rs)	6.8	8.2	10.5	13.7	17.5
Price to Earnings	33.7	28.1	22.0	16.8	13.1
BVPS (Rs)	21.8	27.4	34.6	44.4	57.4
Price to Book	10.5	8.4	6.7	5.2	4.0
Dividend yield (%)	1.0	1.1	1.2	1.4	1.7

Source: Company data, I-Sec research

Table 13: DuPont analysis

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	13.4	13.0	12.5	12.4	12.4
Interest expended	8.5	8.5	7.9	7.8	7.8
Gross Interest Spread	**4.8**	**4.5**	**4.6**	**4.6**	**4.5**
Provisioning for NPAs	0.0	0.1	0.5	0.5	0.5
Net Interest Spread	**4.8**	**4.4**	**4.1**	**4.1**	**4.1**
Operating cost	1.1	1.0	1.0	1.0	1.0
Lending spread	**3.7**	**3.4**	**3.2**	**3.2**	**3.1**
Non interest income	0.8	0.7	0.9	0.9	0.9
Operating spread	**4.5**	**4.1**	**4.0**	**4.0**	**4.0**
Tax	1.2	1.1	1.0	1.0	1.0
Retrurn on average loan assets	**3.3**	**3.1**	**3.0**	**3.0**	**3.0**
Effective leverage (average loan assets/ average equity)(x)	10.3	10.9	11.3	11.5	11.6
RoAE	**34.2**	**33.3**	**33.7**	**34.6**	**34.4**

Source: Company data, I-Sec research

Annexure 1: Company overview and background

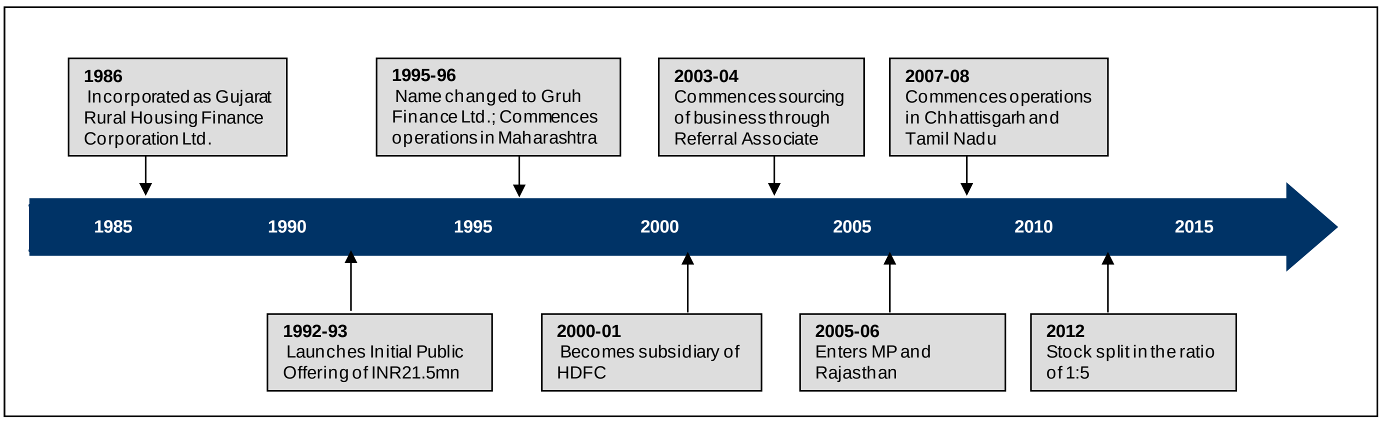
GRUH Finance, established in 1986, is a niche player in the housing mortgage industry with focus on the industrially progressive states of Gujarat and Maharashtra. The company is headquartered in Ahmedabad and operates 136 offices across seven states, including Karnataka, Rajasthan, Madhya Pradesh, Chhattisgarh and Tamil Nadu. GRUH was promoted as the Gujarat Rural Housing Finance Corporation Ltd. by HDFC and the Aga Khan Fund for Economic Development (AKFED) to provide housing finance to semi-urban and rural customers. In 2000, HDFC Ltd. acquired 26% stake in the company from AKFED to become its sole promoter. GRUH enjoys close operational association with HDFC and complements its business with a distinct target market segment. Being a housing finance company (HFC), GRUH is regulated by the National Housing Bank (NHB). The company is listed on BSE and NSE with market cap of R41bn (US$680mn).

Capital rasing

Date	Type	No. of shares offered (mn)	Offer price per share (Rs.)	Proceeds (Rs mn)
Sep-06	Rights	8.0	75	596

Source: Company, BSE

History and milestones



Source: Company data

Senior management

Name	Designation	Background
Mr. Keki Mistry	Non-executive Chairman	Mr. Mistry is the Vice Chairman and CEO of HDFC Ltd. He serves as a director on the board of several leading companies such as HDFC Bank, Sun Pharmaceutical, IL&FS, Torrent Power, Bombay Stock Exchange, HCL Technologies. He has been on the board of GRUH Finance since 2000 and is member of its Audit and Compensation Committees.
Ms. Renu Karnad	Director	Ms. Karnad is the Managing Director of HDFC and Chairperson of HDFC Property venture Ltd. She has been on the board of GRUH since 2000 and is a member of its Compensation Committee.
Mr. Sudhin Choksey	Managing Director	Mr. Choksey was appointed as the CEO of GRUH in 1998 and has been the MD since 2000. He is a member of GRUH's Shareholders'/Investors' Grievance Committee
Mr. S.M. Palia	Director	Mr. Palia is a development banker, having served with IDBI for over 25 years. He has been on the board of GRUH since 1993.
Mr. Prafull Anubhai	Director	Mr. Anubhai is a Corporate Advisor and has been on GRUH's board since 1987.
Mr. K.G. Krishnamurthy	Director	Mr. Krishnamurthy is the MD & CEO of HDFC Property Ventures Ltd. He has over two decades of experience in the real estate industry and has been on GRUH's board since 2004.
Mr. Rohit C. Mehta	Director	Mr. Mehta is a prominent industrialist and has been the President of the Federation of Indian Chambers of Commerce & Industry (FICCI). He has been on the board of GRUH since 1987.
Mr. S. G. Mankad	Director	Mr. Mankad was an IAS officer and served in various capacities both in Govt. of India and the State of Gujarat. He is on the board of GRUH since 2010.
Mr. Kamlesh Shah	Executive Director	Mr. Shah joined GRUH in 1990 and has been on the board since 2010.

Source: Company data

Annexure 2: Index of Tables and Charts

Tables

Charts

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Equity Research

July 7, 2013

BSE Sensex: 19496

Financials

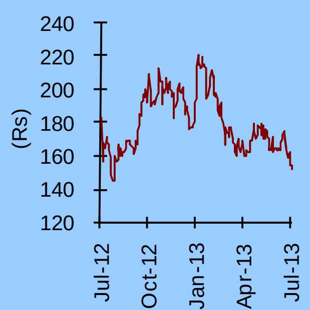
Target price Rs350

Shareholding pattern

	Sep '12	Dec '12	Mar '13
Promoters	35.3	35.2	38.1
Institutional investors	42.8	40.4	39.4
MFs and UTI	0.7	0.7	0.3
Insurance	0.6	0.5	0.3
FIIs	41.6	39.2	38.7
Others	21.9	24.4	22.6

Source: NSE

Price chart



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ICICI Securities

INDIA

Dewan Housing Finance — BUY

Seeds of doubt souring the harvest — Rs152

Reason for report: Initiating coverage

Dewan Housing Finance (DHFL) primarily provides housing loans to the low and middle income group in tier II, tier III cities and metro peripheries where large HFCs and private banks have a limited presence. Its acquisition of First Blue provides it with a foothold in the mid to high ticket housing finance market in the North, but we feel its lower yields may not suit DHFL's cost structure. The company has charted close to 44% CAGR (organic) in the last three years in AUM but we feel capital paucity may temper growth to 20% over next 3 years. RoE looks likely to remain close to the current 17% levels, in absence of cost cutting. Multiple controversies have dealt a severe damage to company valuations despite reasonable valuations. We initiate coverage with BUY and a target of Rs350.

- **A differentiated business model, First Blue may not help spreads.** Dewan's use of income surrogates in credit underwriting helps it cater to self employed customers who are rather under-penetrated in terms of housing finance due to the large players' focus on the salaried class, facilitating higher yields. However, we retain certain reservations about its acquisition of First Blue, whose products are likely to have ~100bps lower yields on about a quarter of the portfolio, especially when Dewan's leverage remains high and we feel capital deployed into organic growth could have been more productive.
- **Reasonably robust liability franchise should provide some spread support.** Dewan remains the largest user of securitization amongst HFCs and its decent credit ratings help it in the NCD market, although bank borrowings remain high. We also feel that given its loan ticket size of ~Rs1mn, it could have potentially been a bigger beneficiary of NHB refinancing (~6% of borrowings).
- **Operating costs remain a bugbear to return ratios.** Even after factoring in the low ticket size and extra operational requirements of catering to the self employed, Dewan's operating cost metrics look high. Operating costs are 1.3% of AUM which is 30% more than GRUH and more than four times HDFC's. This remains the chief culprit for RoE remaining at only 17% despite a decent credit track record. Despite clear potential, we are not building in any operating leverage and at current RoE levels, lack resources drives our low 20% asset growth assumption.
- **Controversies have played havoc with valuations.** Significant negative press have taken the company's valuation multiples to 0.5xFY14E P/B. However, a word of caution here will be that it is clear that the stock is suffering from investor apathy, and unless those sentiments change economic rationality may take a back seat. Our target multiple is 1.2xFY15E P/ tangible BVPS, after a 20% haircut to valuations based on our sector framework on account of adverse investor perceptions.

Market Cap	Rs19.5bn/US$322mn
Reuters/Bloomberg	DWNH.BO/ DEWH IN
Shares Outstanding (mn)	128.3
52-week Range (Rs)	221/145
Free Float (%)	61.9
FII (%)	38.7
Daily Volume (US$/'000)	564
Absolute Return 3m (%)	(5.5)
Absolute Return 12m (%)	(17.2)
Sensex Return 3m (%)	5.7
Sensex Return 12m (%)	11.2

Year to March	FY13	FY14E	FY15E	FY16E
NII (Rs mn)	6,783	10,376	13,474	17,691
Net Income (Rs mn)	4,519	5,647	7,032	9,546
EPS (Rs)	35.2	43.6	54.2	73.6
% Chg YoY	34.4	24.6	24.3	35.5
P/E (x)	4.3	3.5	2.8	2.1
P/BV (x)	0.6	0.5	0.5	0.4
Net NPA (%)	0.0	0.0	0.0	0.0
Dividend Yield (%)	3.3	3.9	4.9	5.9
RoA (%)	1.6	1.4	1.5	1.8
RoE (%)	17.1	16.3	17.5	20.3

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A differentiated business model

Lending to self employed in metro peripheries – a differentiated proposition

Dewan Housing Finance Ltd. (DHFL) has a differentiated business model within the housing finance landscape. Its principal mortgage product is a low ticket size loan at slightly higher yields than the usual medium ticket size mortgages. Most of its borrowers have income levels less than Rs30,000 per month and plan to acquire homes in tier II, tier III cities and metro peripheries. The borrowers are also often self employed and, there is no direct income proof. Income estimation is done through surrogate methods.

If one looks at the housing finance market in India, the urban salaried class borrower is being pursued by all major players. This class is considered the safest credit and appraisal processes can be very linear with strict documentation requirements. In this intensely competitive space, the thesis on margin disruption always has had a bank at its focal point and, in recent years, SBI has been offering the finest rate in the market (enabled by its low cost of funds). Accordingly, it has built up a large book as well. The key observation for us though is that this has not slowed down the asset growth of other HFC players.

We feel that this trend will continue in the medium term, as we do not foresee any other large bank being aggressive in the segment. As Tier II and Tier III cities start contributing to asset growth, housing finance companies (especially niche focused ones like Dewan) will be the key beneficiaries.

The typical ticket size at origination for these loans is Rs1.2-1.3mn and LTV at origination is about 70% (on registered value). Currently, the average yield for these loans is about 12.75% and they constitute close to 85% of the portfolio.

Loan against property (the equivalent of Home Equity loans internationally) has been a growth driving profitable product for most of the newer players, who have registered aggressive growth in assets. Even the larger and established players now have significant presence in this market with non-bank entities being the major players. The LAP product is different from mortgage loans in various facets.

Table 1: Key features of LAP vis-à-vis mortgage loans

	LAP	Mortgage loans
Tenor at origination	5 years in most case, 10 at most	15-20 years in most cases, 25 at most
Loan rates (%)	15-16	10-12
Maximum LTV offered at origination	70%	80%
Ticket size	Rs5mn	Rs2.5mn
Debt service coverage ratio	The lenders generally allow for EMIs upto 50-60% of monthly income	The lenders generally allow for EMIs upto 30-40% of monthly income
Nature of customer	Mostly self employed (85%)	Mostly salaried class

Source: Company data, I-Sec research

DHFL currently has only 0.5% of its portfolio in this product, as it sees many risks associated with it and is uncomfortable hiking the exposure too much. We feel LAP proportion could potentially be a margin lever going forward.

Our interactions with credit appraisers and decision makers at various housing finance companies suggest that companies remain wary of the inherent credit risk due to the following reasons:

- Most lenders remain wary of customer's financial position when they avail this loan. With loan rates at 15%-16%, apart from the cases where such borrowings are deployed by customers into their own business, the general suspicion remains that the borrower is in some sort of financial emergency.
- Lenders do not like the fact that the ultimate end use of the money is not under their control.
- While the collateral is enforceable in the case of individual LAP loans through SARFAESI, our contacts in credit underwriting business feel that the pool defaults are likely to be higher.

Reasonable sized presence in developer financing

The company also provides project loans to developers. These loans are mostly provided against residential property projects and are linked to bridge financing in the period between soft launch and the time till about 70% payment has been made by home buyers to developers. The typical ticket size is about Rs120mn and the yields are attractive at 19%. These loans are now ~6.5% of AUM. This business is one that requires intricate understanding and specialized knowledge of the local market, background of the developer, his solvency position and complete understanding of project cash flows and economics. The company does not want to scale this business up beyond a point because it feels that risks in this business comes if one spreads themselves too thin trying to finance too many projects. There are multiple challenges that a player needs to manage for success in this space which has proved tricky for many marquee lenders as well.

- Land titles are much contested in India due to succession disputes and poor record-keeping. With most developments being agglomerations of fragmented land-holdings, legal disputes regarding even one piece can throw spanner in the works of a project for a long time.
- Land use laws are stringent in India, and land prices are heavily dependent on the same. The conversion process from agricultural land to other uses is cumbersome and uncertain with many bureaucratic hassles. Inadequate due diligence or project plans grounded on 'hope' have often fallen through.
- In some cases, enforceability of collateral in case of default may be much more difficult compared to individual loans.
- In many cases corporate governance practices of real estate companies have come under scrutiny, reducing the size of the potential borrower universe for a discerning lender.

- Our interaction with lenders reveal that in many cases, the lender is not comfortable funding a promoter entity but would rather finance a project as it feels that cash flows in the harvesting phase of the project will not get redirected into fresh investments.

Product suite high on yields

A quick perusal of the full split of DHFL's portfolio in terms of key parameters reveals that it has at its disposal a set of pretty high yield businesses in the context of housing finance companies.

Table 2: Product portfolio

Product	Proportion of total loans	Ticket size (at origination)	Duration	Interest rate	LTVs (at origination)	Asset quality experience
Home loans	83.9%	1.3	15-20yrs	12.75%	50%	Gross NPAs have come to about 0.8%. In the small ticket size category the company has actually seen more defaults from the salaried borrowers than from small traders
LAP	0.5%	1.5	3-5 years	16%	50%	The company has seen no major defaults
LRF	9.1%	1.5	3-5 years	16%	50%	Same
Project loans	6.5%	120	3-5 years	19%	50%	Same

Source: Company data, I-Sec research

First Blue acquisition – difficult to justify complete strategic fit

To strengthen its position in mid-and higher-ticket loans, DEWH acquired 67.5% stake in Deutsche Postbank Home Finance (DPHFL) for a cash consideration of Rs10.8bn in Dec-2010. The company was subsequently renamed as First Blue Home Finance (FBHFL). The acquired company has a network of 39 branches at the end of Dec-2012 and currently originates most of its business in North India where DEWH has a limited presence.

Table 3: Acquisition details

(Rs bn)

At acquisition	
Loan book	55.0
Book value	5.7
Acquisition cost	10.8
Acquisition multiple (P/B)	1.9
Other ratios at acquisition	
GNPA (%)	0.9
NNPA (%)	-
Leverage (x)	9.6
Acquisition finance - cash deal	
Total cost	10.8
- paid by DHFL	7.3
- paid by Promoter	2.0
- paid by Caledonia	1.5

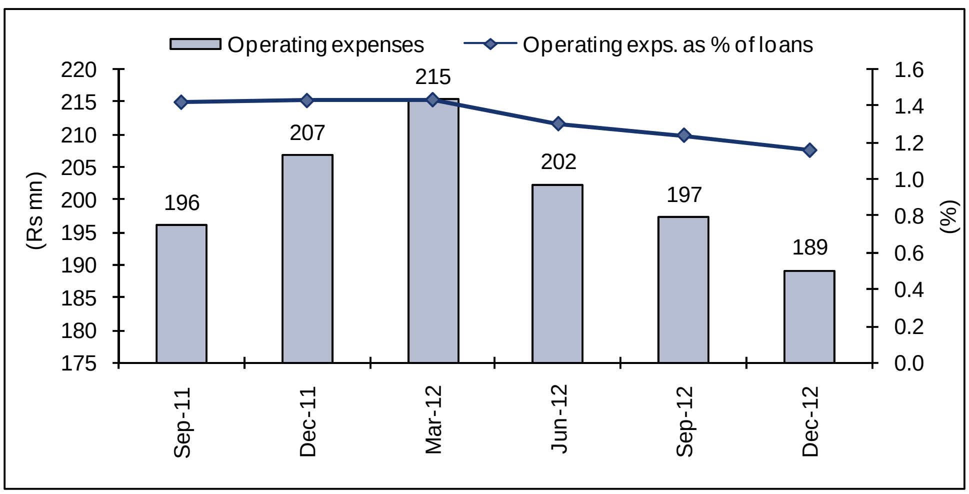
Source: Company data, I-Sec research

As promised at the time of acquisition, First Blue will be merged with DHFL with the owner of First Blue receiving ~10.8mn newly issued shares of DHFL. The cost of acquisition of First Blue per share of DHFL received in lieu of shareholding in First Blue works out to about Rs320, which is at a 90%+ premium to the current market price of DHFL. This move is thus value accretive, in our opinion, to DHFL's minority shareholders.

However, we remain very sceptical of the strategic fit of the First Blue portfolio in DHFL's context. Our doubts lie in the following areas:

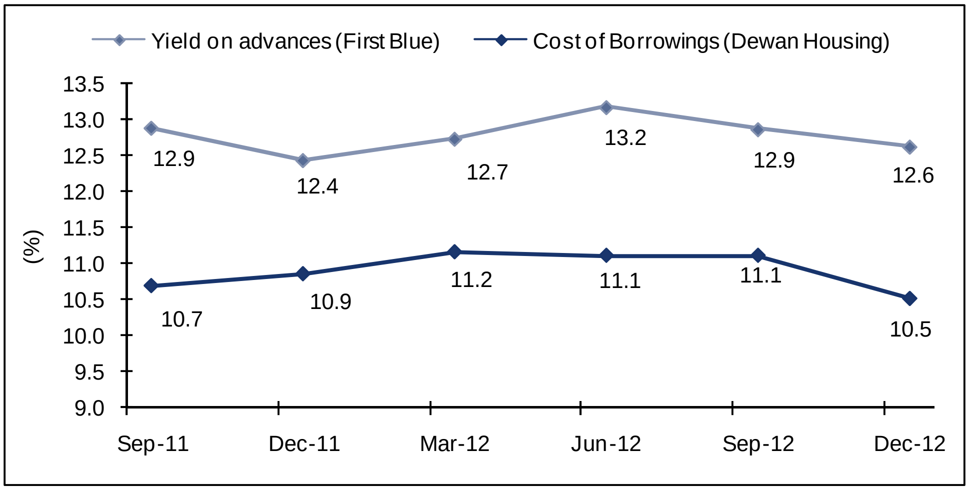
- First Blue, unlike DHFL, is an urban lender whose differentiation was in writing large size tickets. The rates chargeable on these loans are generally 25-50bps higher than plain medium size mortgages but given DHFL's high cost structure and its borrowing costs, incremental spreads are likely to come down. Even if we assume that First Blue will retain its erstwhile cost structure post integration, as the following two charts show in conjunction, the spreads post operating expenses are still going to be much lower than DHFL's erstwhile ones. And one should remember that with DHFL's erstwhile profitability, the company's RoE was still in mid-teens.

Chart 1: Op cost as a % of AUM for First Blue



Source: Company data, I-Sec research

Chart 2: First Blue's yields and DHFL's borrowing costs – not a good fit given operating cost structure



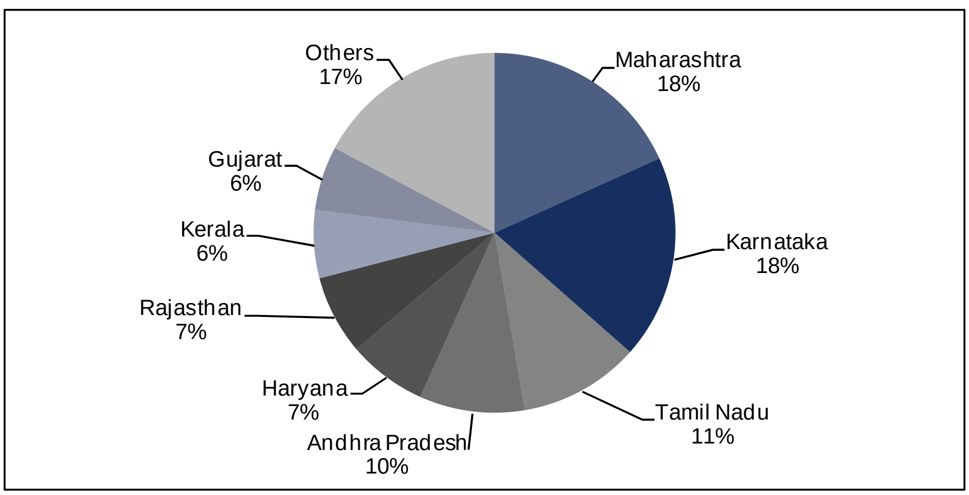
Source: Company data, I-Sec research

- It was not as if DHFL has been growing its book at a slow pace and with First Blue added with the expected RoE drag, it will become increasingly difficult to sustain the growth momentum for the company through internal accruals. With valuations at a low and markets unresponsive, this may either prove to be a growth constraint or stretch the balance sheet unnecessarily.

Asset growth should remain healthy

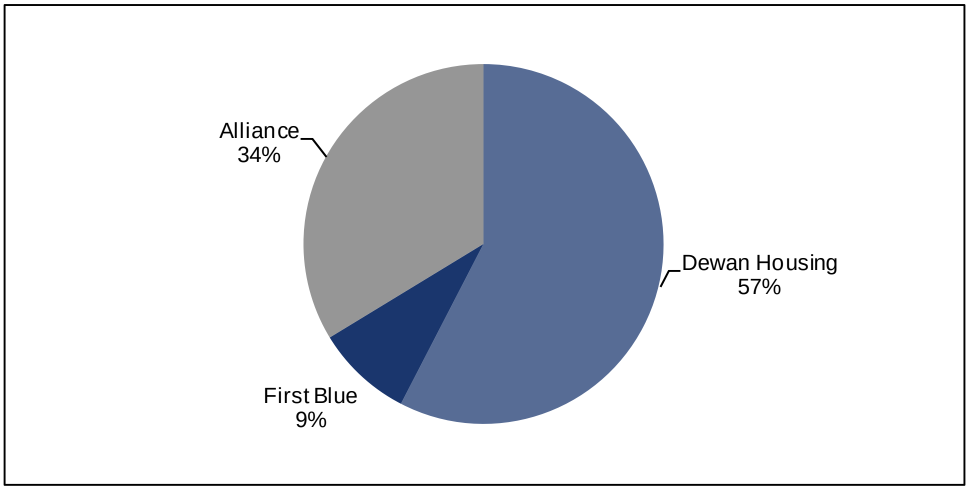
DHFL's competitors are mainly urban co-operative and PSU banks. It has a strong presence in the southern and western parts of India. Out of 296 branches at the end of FY13, ~47% are located in South India and ~26% are in Maharashtra and Gujarat. The company has entered into tie-ups with PSU Banks namely United Bank of India, Punjab & Sind Bank and Central Bank of India to originate loans in eastern, northern and central India.

Chart 3: Branch network breakdown – state wise



Source: Company data, I-Sec research

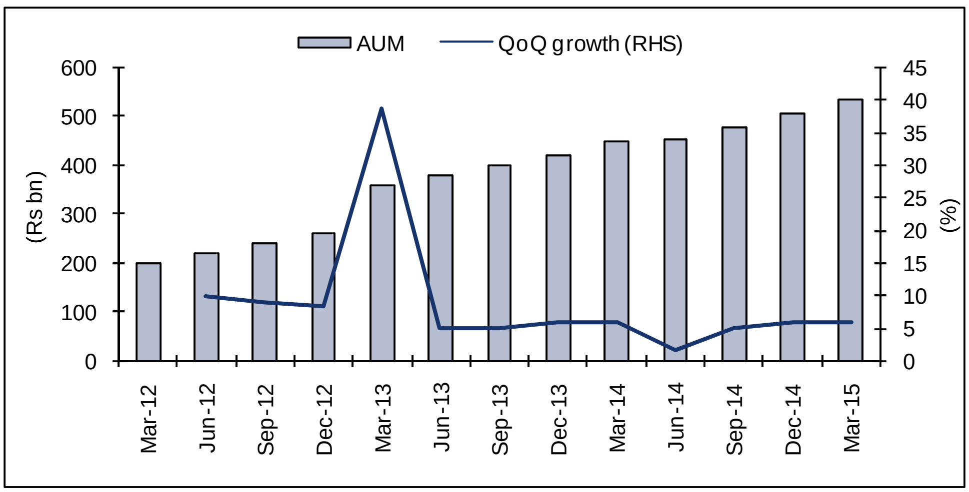
Chart 4: Branch network breakdown – channel wise



Source: Company data, I-Sec research

We expect that competition being only moderate in its chosen segment, the company will not have a demand challenge to ramping up its asset base in the next few years. Lowered RoEs may however mean that there will be leverage constraints to debt. We build in 20% AUM CAGR over FY13-16E.

Chart 5: AUM growth rates should slow down to more moderate levels



Source: Company data, I-Sec research

Reasonably robust liability franchise should provide spread insulation

Strong credit rating aids NCD issuance

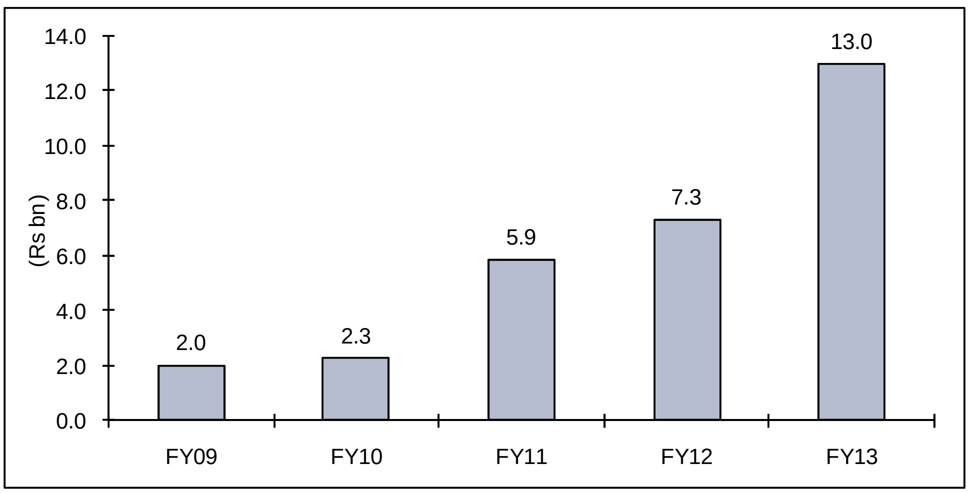
Despite the controversies that have come up about the company from time to time, the company's credit rating has stayed strong and it has been a regular issuer in the NCD market.

Table 4: Credit ratings remain healthy

	Crisil	ICRA	CARE
Long Term			AA+
Short Term	A1+	A1+	
Structured Obligations			AAA
Senior Unsecured Debt			AA+
Preferred Stock			AA

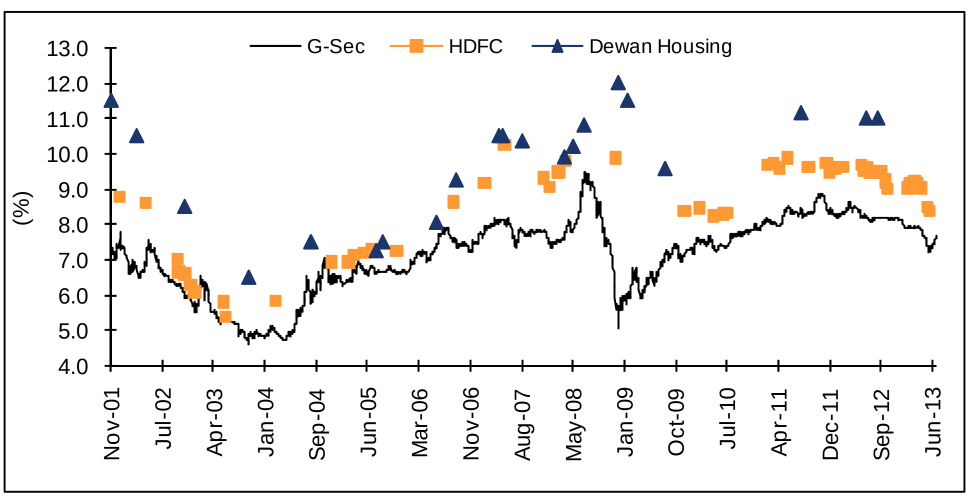
Source: Bloomberg, I-Sec research

Chart 6: NCD issuance history



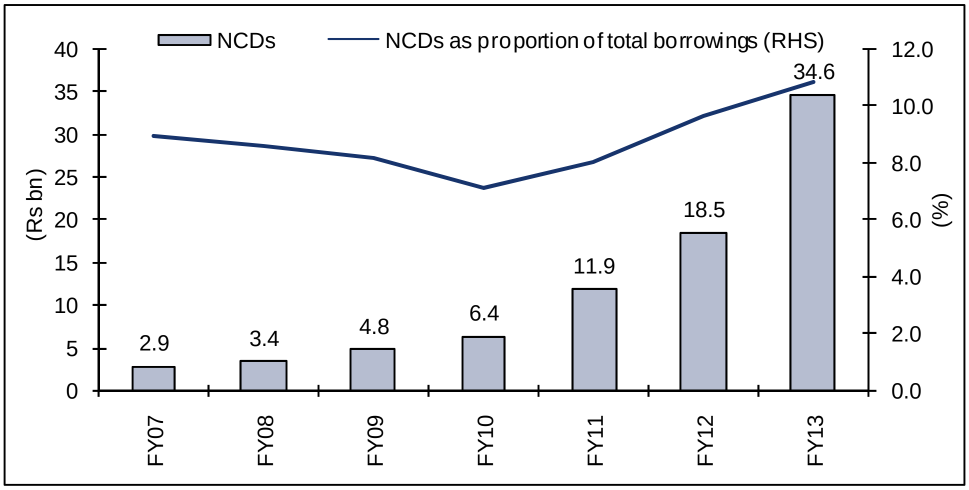
Source: Bloomberg, I-Sec research

Chart 7: NCD yield at issuance vs HDFC and GoI (5-year)



Source: Bloomberg, I-Sec research

Chart 8: NCD as a proportion of total debt

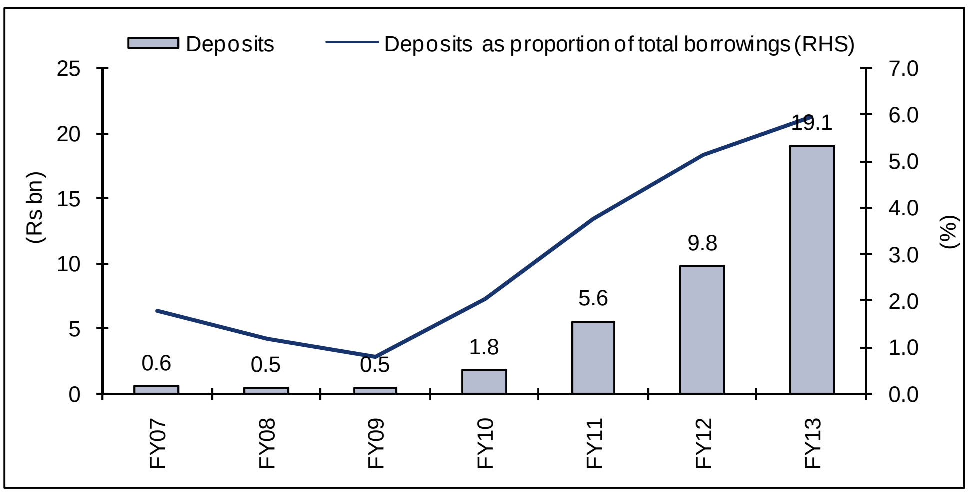


Source: Company data, I-Sec research

Deposit franchise not as strong as large peers

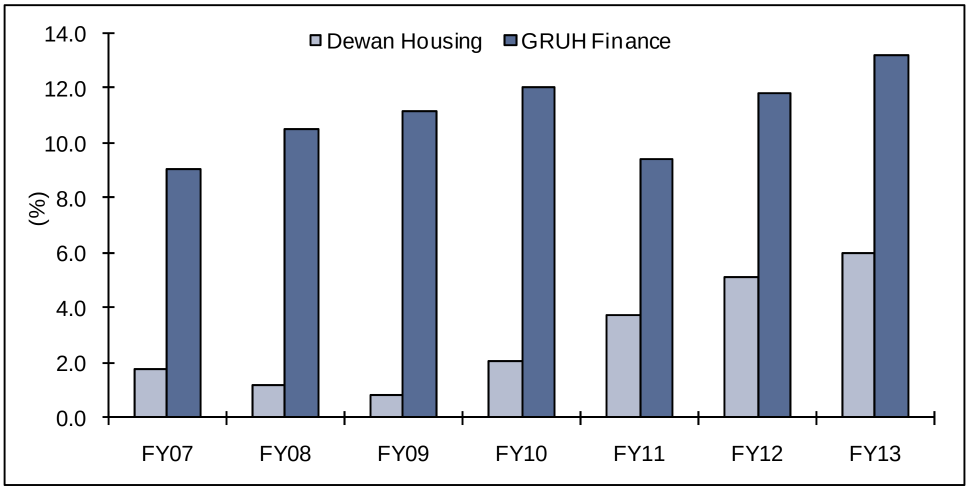
DHFL's deposit franchise still remains relatively small and forms a small proportion of its total interest bearing liabilities. With increasing number of HFCs and NBFCs hunting for increased share in the deposits, we feel the company will find it difficult to reverse this trend easily. However, it has done much better than a bigger size competitor, LIC Housing Finance, in percentage terms, on deposit accretion.

Chart 9: Moderate proportion of deposits in borrowings



Source: Company data, I-Sec research

Chart 10: GRUH has created a bigger dependence on deposits (on a much smaller scale of course)

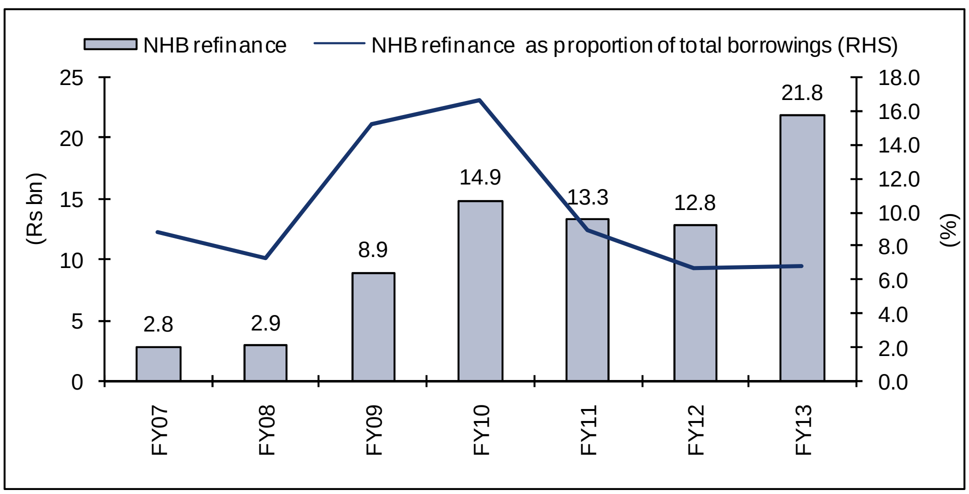


Source: Company data, I-Sec research

Much headroom to gain NHB refinance

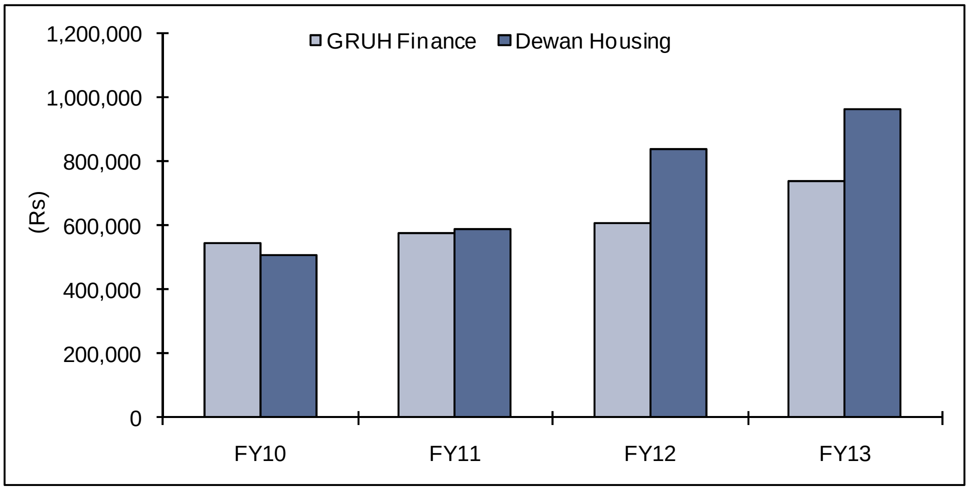
Given Dewan Housing's business model of lending to self employed in metro peripheries and tier 2 and 3 cities and the consequent small ticket sizes that it has one would have expected it to be a much bigger beneficiary of NHB refinance. These funds would have been critical to both margins as well as to strength of the balance sheet. However, its utilization of this route remains low compared to a much smaller peer like GRUH.

Chart 11: NHB refinance opportunity under-utilized in our opinion



Source: Company data, I-Sec research

Chart 12: GRUH and Dewan are closely matched on loan ticket sizes but 47% of GRUH's borrowings are NHB refinance

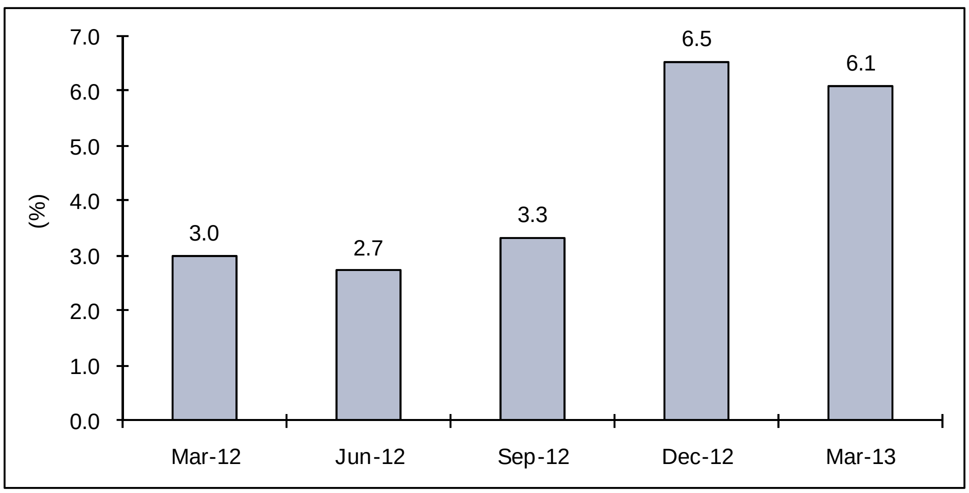


Source: Company data, I-Sec research

Heavy user of securitization – positive for margins

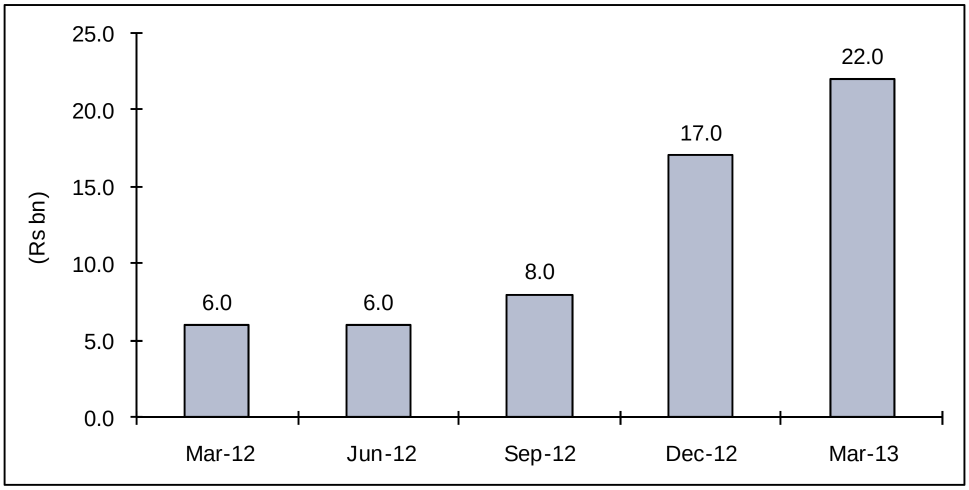
The company has been one the largest users of securitization (relative to size) in the housing finance space. This is a boost to spreads and capital productivity.

Chart 13: More than 6% of AUM off-book



Source: Company data, I-Sec research

Chart 14: Securitization volumes have remained strong recently

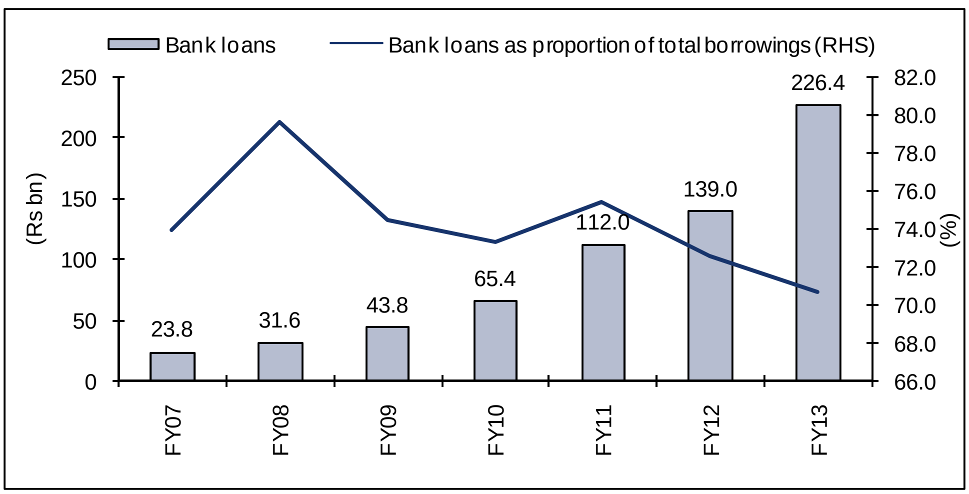


Source: Company data, I-Sec research

Bank reliance has decreased – but high compared to peers

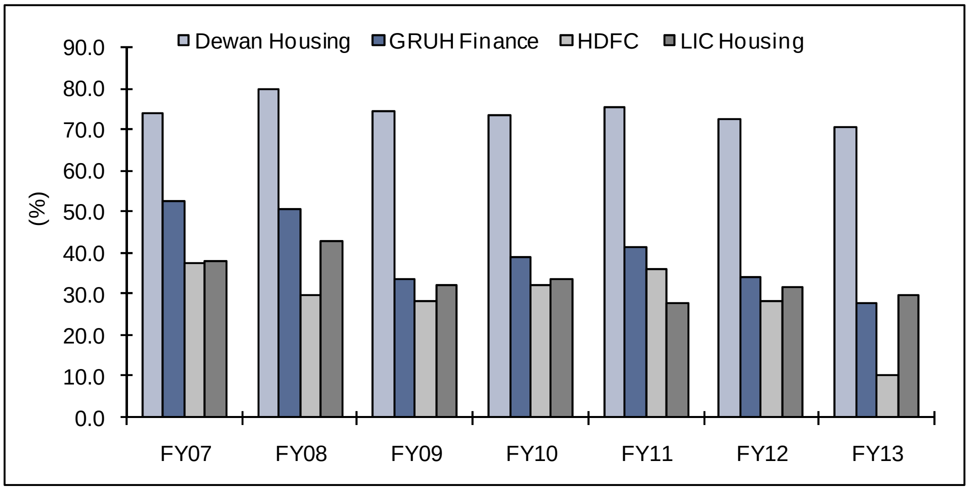
With most bank base rates around the 10% mark and home loan rates in the 10.5-10.75% range for new loans (the yield number is higher for DHFL, but fact is NCD financing remains cheaper by 50-100bps), it is clear that if things stay as is, it is difficult to finance incremental business through bank financing. (Banks are not allowed to lend below base rate). Accordingly, most HFC players have been reducing their exposure to bank funding. DHFL is no exception, but its exposure is still higher than peers.

Chart 15: Bank funds are still the major part of borrowings



Source: Company data, I-Sec research

Chart 16: Amongst its peer-set, Dewan remains the biggest user of bank funding

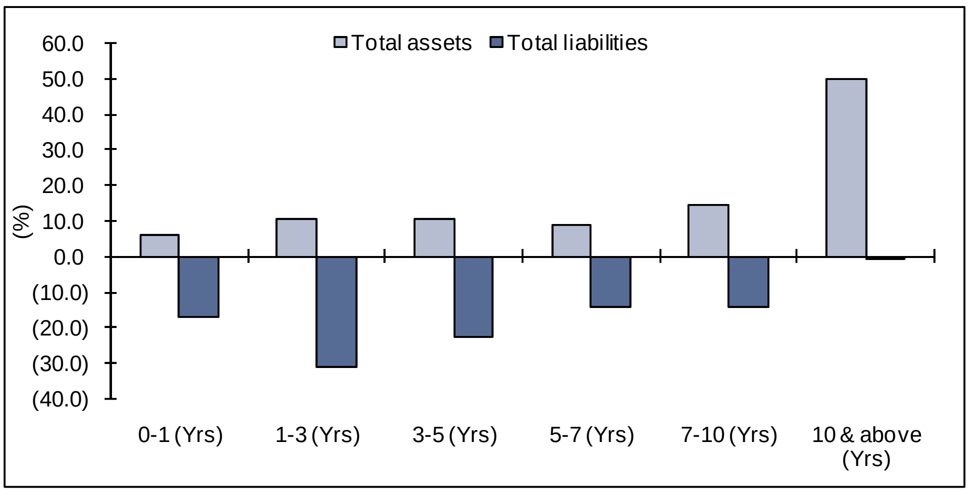


Source: Company data, I-Sec research

ALM mismatch limited to the long end

Given the long duration nature of the loan book, significant ALM mismatch in the long end (over 10 years) is expected. But most peers have a narrower mismatch.

Chart 17: ALM GAP Analysis (FY13)

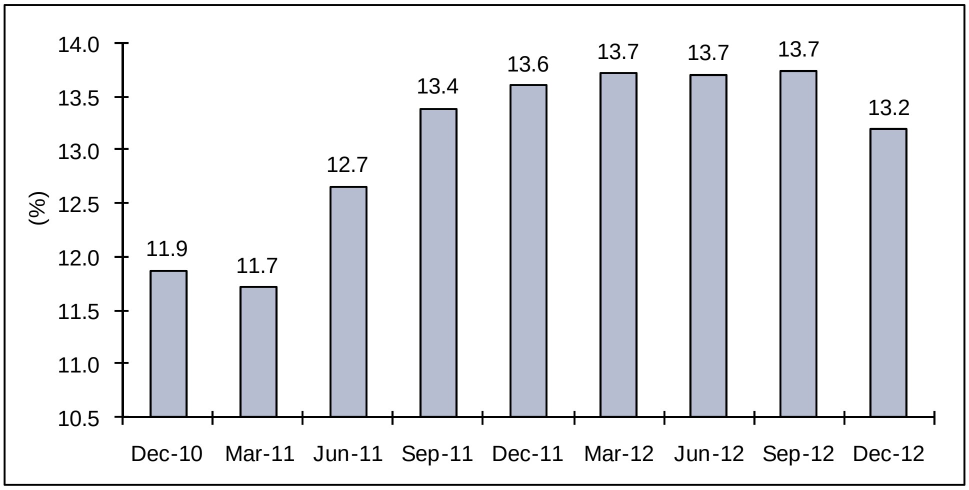


Source: Company data, I-Sec research

Spreads insulated to a large extent, risks if any coming from First Blue portfolio

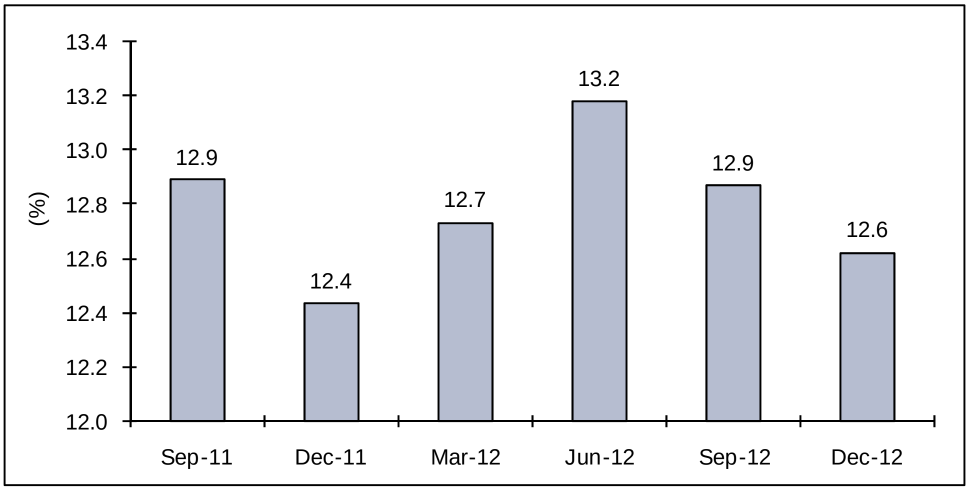
We do not see much pressure on the yields of DHFL as we articulated earlier also we feel that the competition in its niche is quite far from being price predatory in nature. If wholesale borrowing rates ease off, DHFL will likely benefit from it. However, First Blue's assets are at a much lower spread and in a domain that is witnessing increasingly intense competition from many NBFCs. First Blue's assets (current and future) remain the biggest threat to margins, in our opinion.

Chart 18: DHFL's yield history



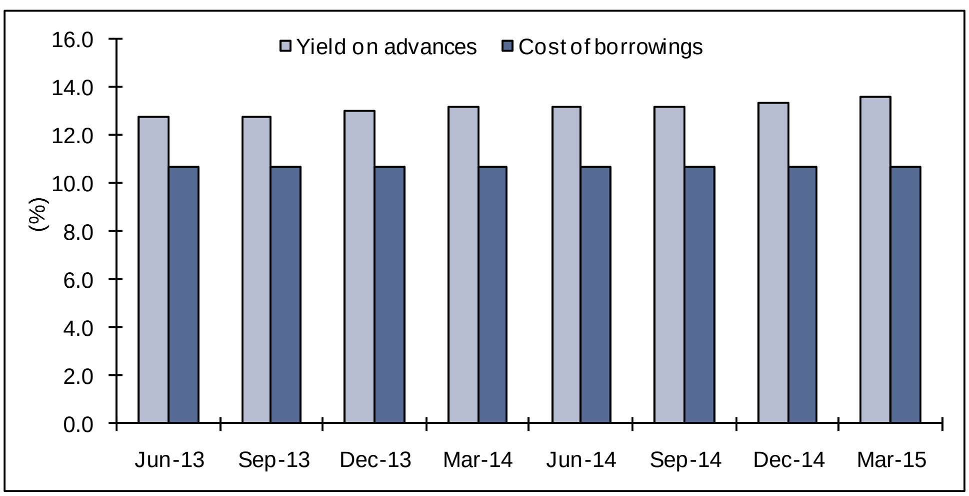
Source: Company data, I-Sec research

Chart 19: First Blue's yields



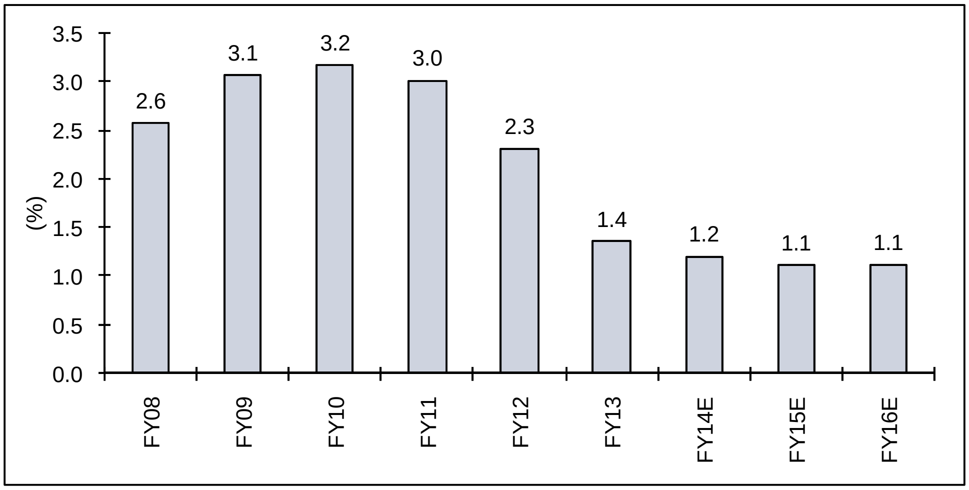
Source: Company data, I-Sec research

Chart 20: Our assumptions on blended yields and borrowing costs remain conservative



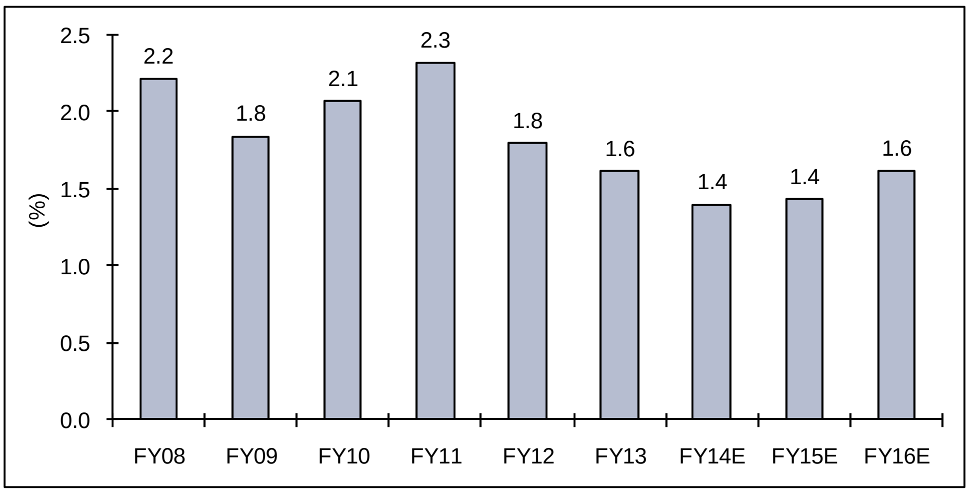
Source: Company data, I-Sec research

Chart 21: Slight contraction assumed in spreads…



Source: Company data, I-Sec research

Chart 22: …and NIMs



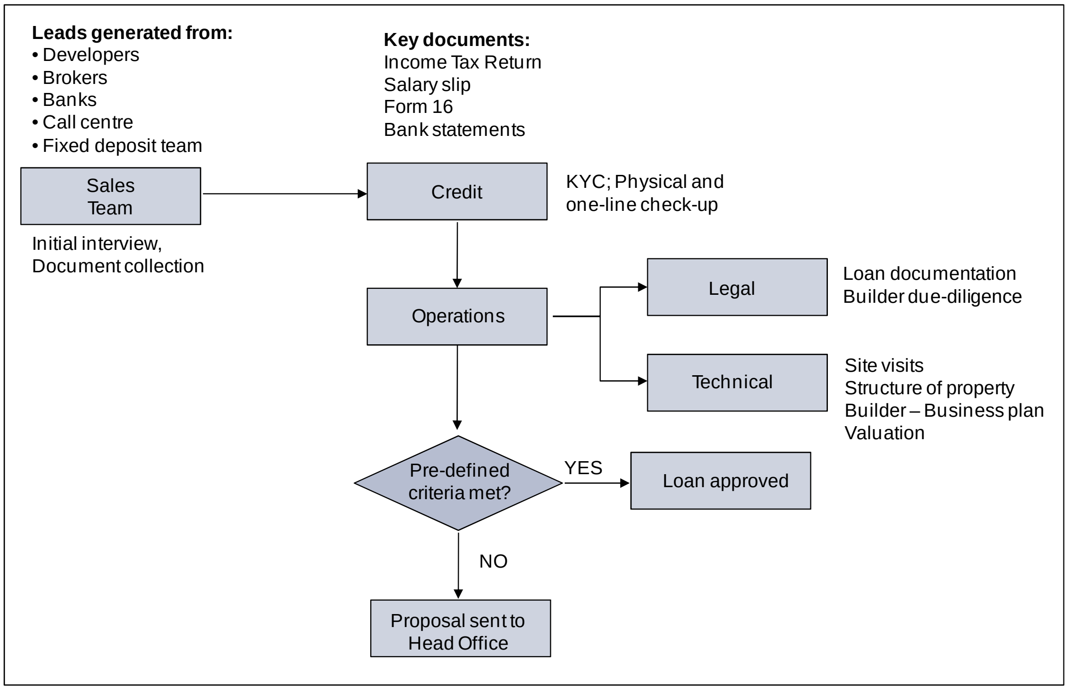
Source: Company data, I-Sec research

Operating costs remain a bugbear to return ratios

Operating framework optimized for niche challenges

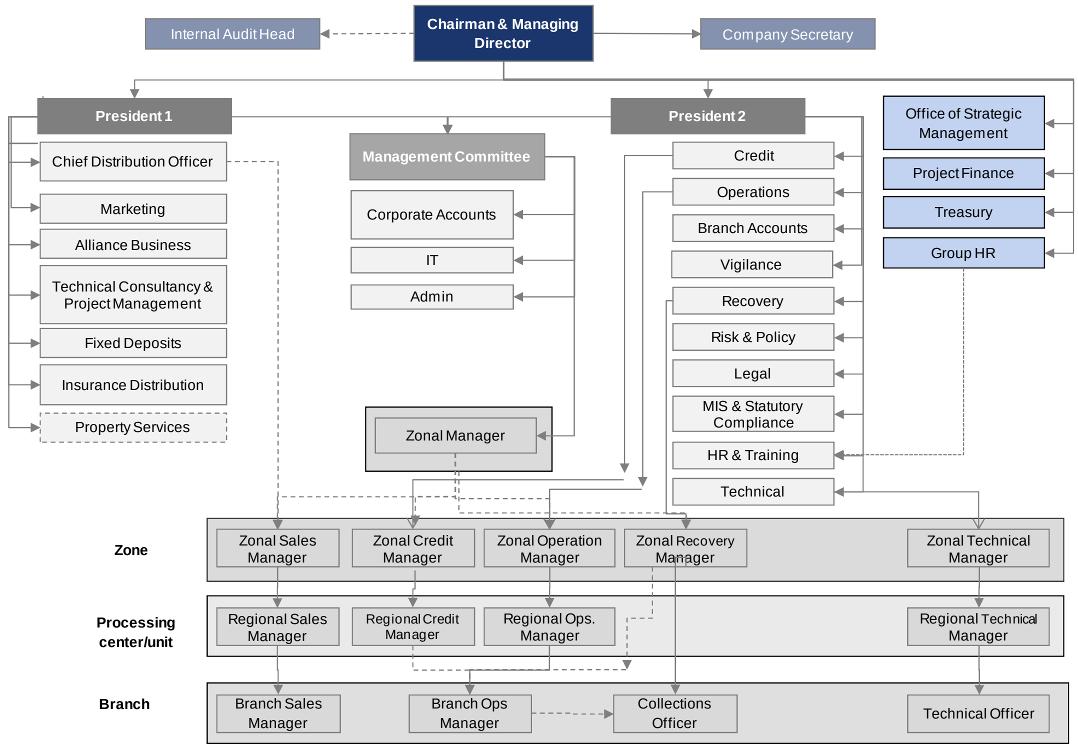
One key feature of DHFL's operating model is that its branch offices are essentially sales and business development offices. The credit process is entirely centralized at zonal processing centres. The zonal processing units have separate teams for credit, operations, technical, legal and recovery functions. The operating process works as follows – after an application is generated by the branch sales team, the initial income estimation and verification is done by the credit team while legal due diligence on title etc commences. The technical team does the on-spot construction verification (unless the project is pre-approved) while the operations team does neighbourhood reference checks etc. Only if the application qualifies on all counts is the disbursement decision made. The average rejection rate at the credit appraisal stage, post clearing of initial documentation need, is 15%-20%.

Chart 23: Flow chart of operations and credit approval



Source: Company data, I-Sec research

Chart 24: Company organization structure



Source: Company data, I-Sec research

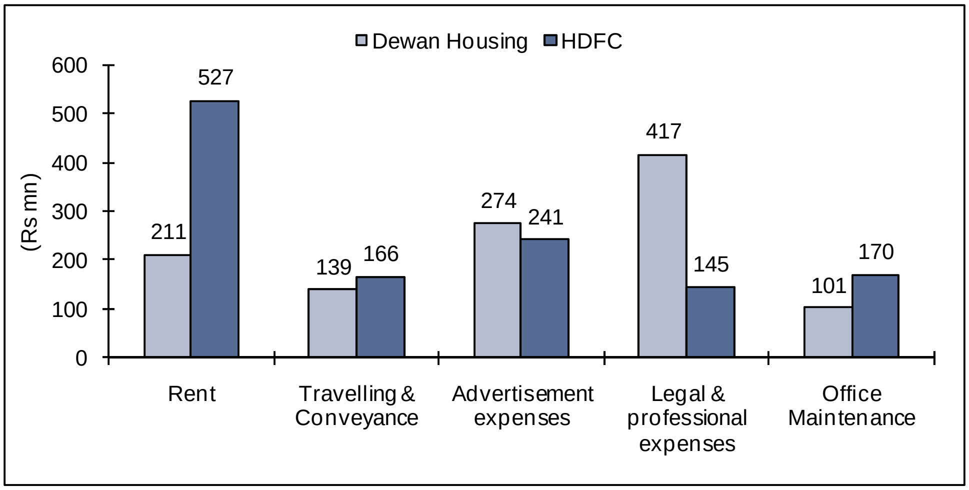
A typical branch of DHFL has one branch manager and two assistant sales managers (ASMs). Each ASM has 5-6 direct selling agents (DSAs) working for him. They have the dual responsibility of generating leads as well as build up their network through developer, chartered accountant interactions. Typically drawing a salary of around Rs8-10k per month, they can earn more by generating disbursements higher than Rs4mn per month, on which they receive a commission of 25-30bps.

The company has paid out about Rs614mn in FY13 in commissions. Assuming that each branch has about 12 DSA, the average commission payout per DSA per year works out to Rs0.17mn.

Cost structure much higher than most peers'

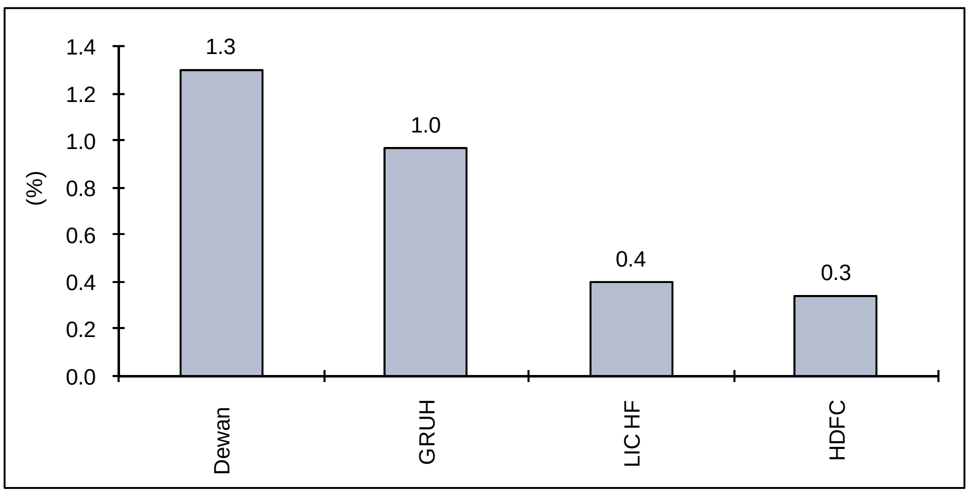
Our analysis of DHFL's annual report makes us feel that a lot of operating cost heads is disproportionately high given its size of operations. In the following analysis, we have compared the cost items of HDFC, whose asset base is about 6x that of DHFL even post the merger. We recognize that DHFL being a niche model that relies on a smaller ticket size customer for lending has to spend more on appraisal but the absolute cost numbers are just too close to be justified through just that difference, especially if one sees GRUH Finance's success at managing operating costs.

Chart 25: Operating cost heads remain far too comparable with HDFC on absolute basis, despite size gap



Source: Company data, I-Sec research

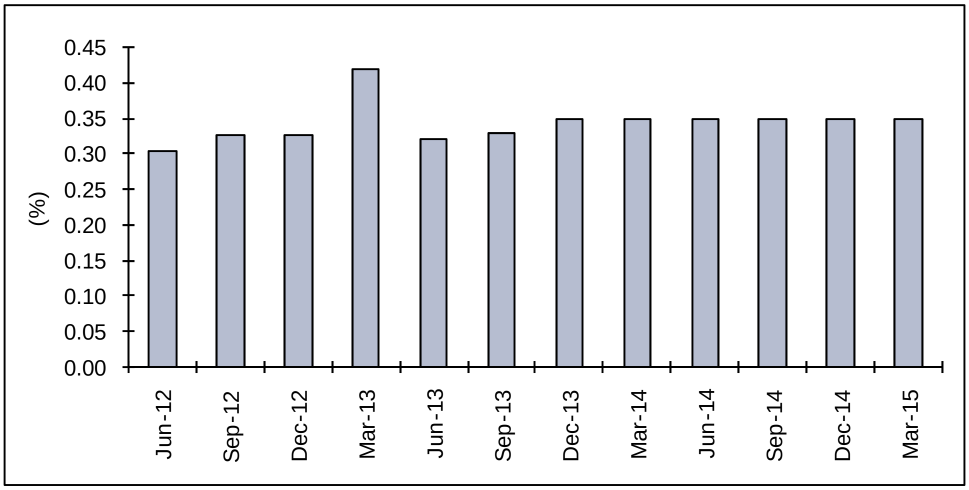
Chart 26: Operating cost as a % of AUM remains highest for Dewan amongst peers (FY13)



Source: Company data, I-Sec research

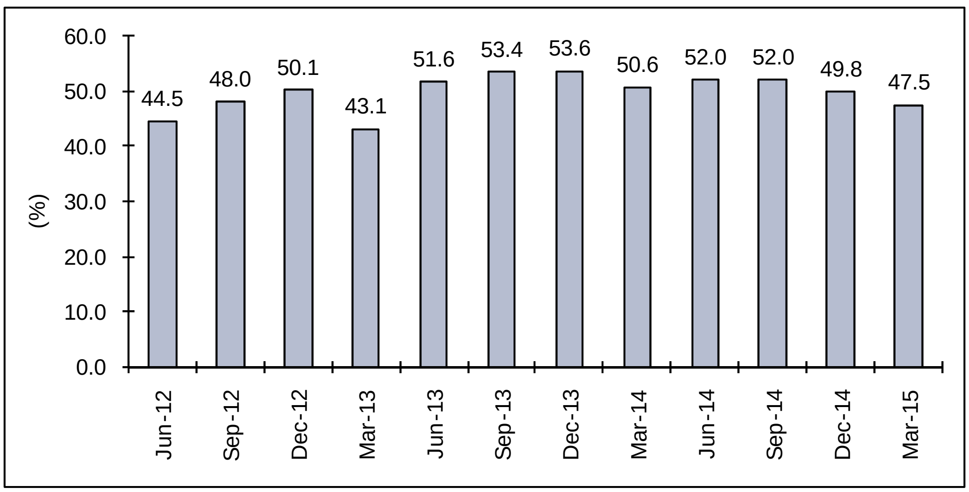
There is clearly some room for paring these costs, in our opinion, and we are sure that pursuing high growth has had an impact on this. But we do not yet see any reason to build in any impending improvement.

Chart 27: We have assumed that operating expenses as a % of AUM will remain stable and do not build in operating leverage



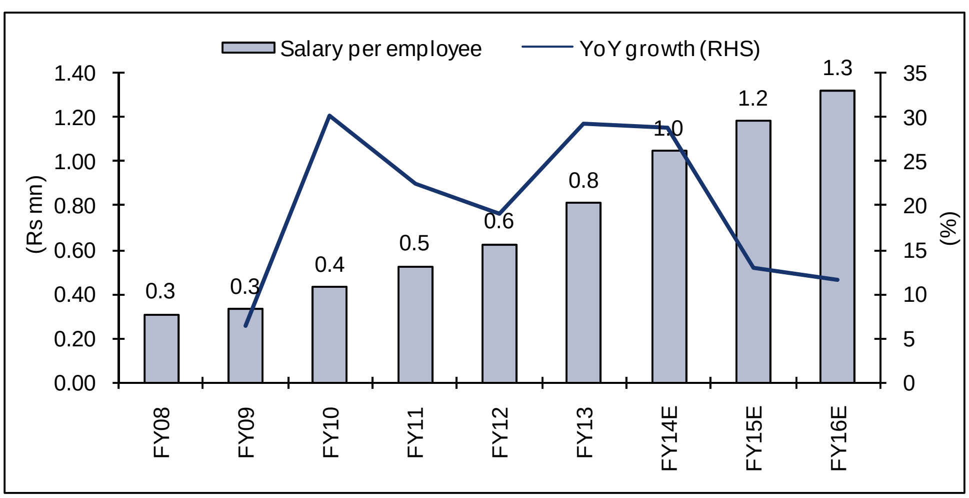
Source: Company data, I-Sec research

Chart 28: Cost to income consequently assumed to remain steady



Source: Company data, I-Sec research

Chart 29: Salary inflation has been high, we expect some moderation

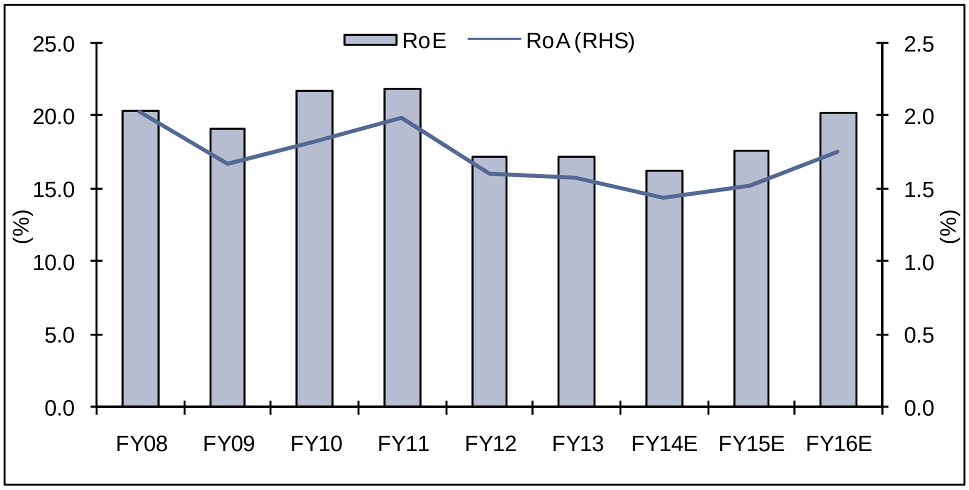


Source: Company data, I-Sec research

Capital productivity suffers in lieu of operating costs…

As the following Du Pont analysis clearly reveals, the main culprit for DHFL's RoE being stuck in mid-teens is this high operating cost base. As mentioned earlier, we have not built in much improvement in the operating costs structure.

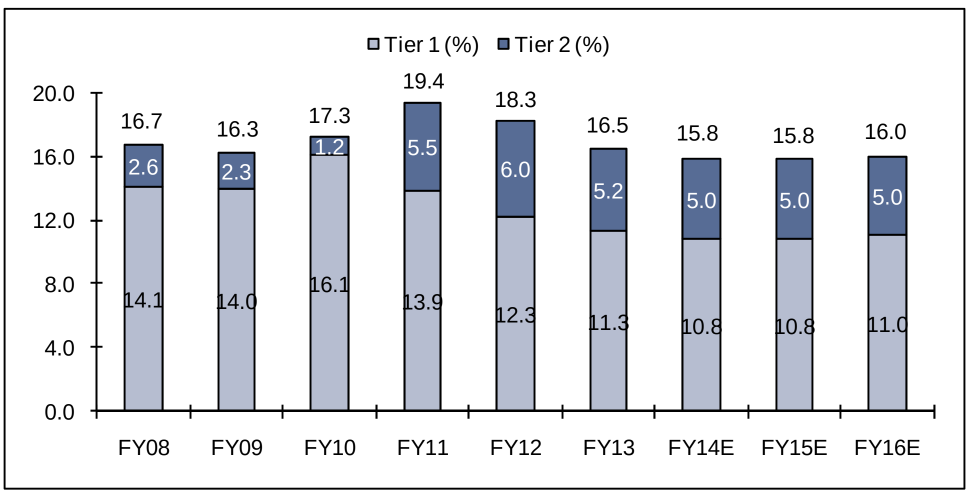
Chart 30: Capital productivity could reduce



Source: Company data, I-Sec research

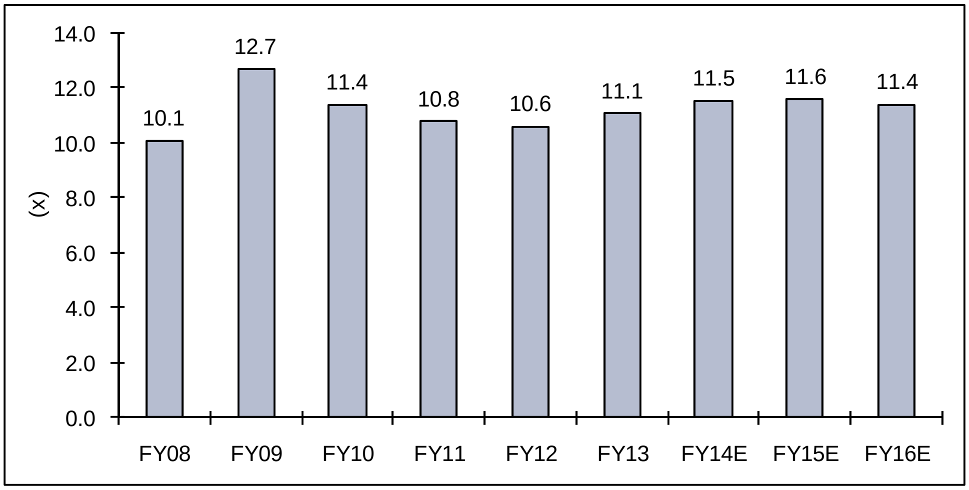
…combined with high leverage could starve company of growth resources

Chart 31: Tier 1 looks comfortable



Source: Company data, I-Sec research

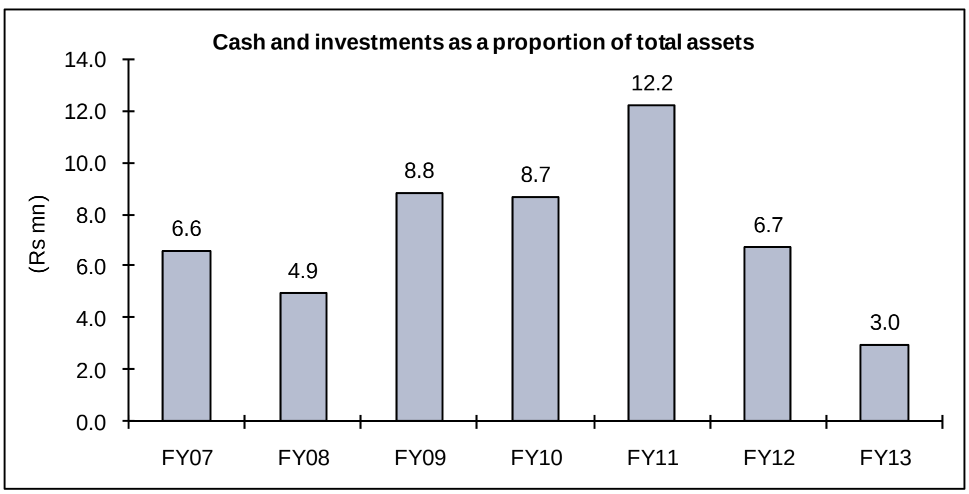
Chart 32: …but leverage numbers look high



Source: Company data, I-Sec research

Even at our modest asset growth assumption of 20%, leverage starts to inch close to regulatory limits. This we feel can lead to a paucity of internal accruals for growth, especially if there is further downside to return ratios. As the chart below shows the balance sheet is pretty lean with precious little to spare for conversion into loan assets.

Chart 33: Liquid assets are a small portion of balance sheet

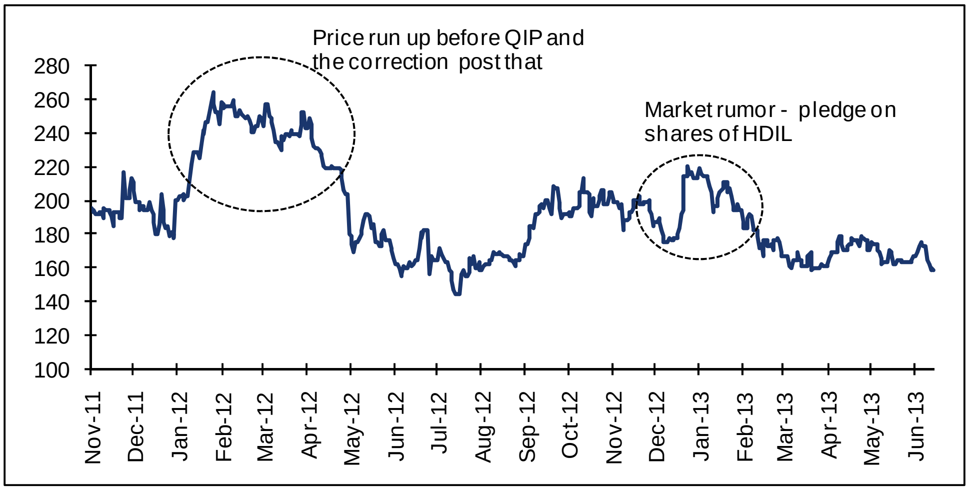


Source: Company data, I-Sec research

Controversies have played havoc with valuations

While the gradual risk of capital productivity erosion has played its due role in DHFL's de-rating, we feel a spate of controversies surrounding the company has not helped the cause either. The company faced two major controversies, one regarding allegations about its stock being manipulated during its QIP and later around the time when its promoter clarified that the company does not have any pledge on the shares of HDIL. Both cases triggered significant de-rating post a recovery streak in the stock price.

Chart 34: DHFL share price performance post the recent controversies

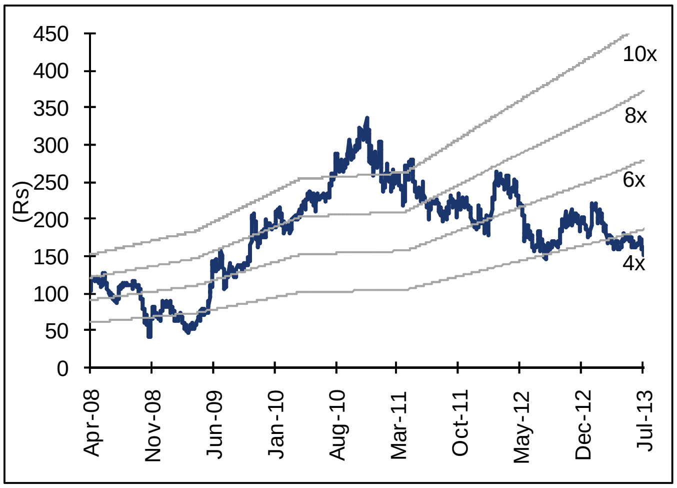


Source: Company data, I-Sec research

Valuations are at a trough

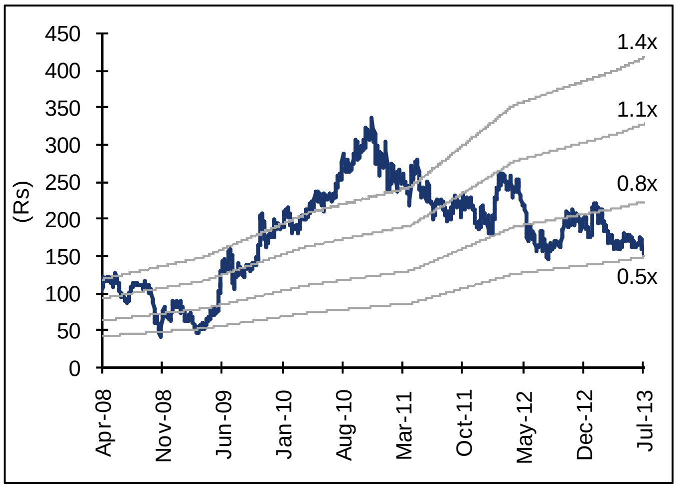
Valuations have suffered as the following peer analysis and the historical trading bands amply demonstrate.

Chart 35: Rolling 1-year forward P/E



Source: Bloomberg, Company data, I-Sec research. Market Data as of July 5, 2013

Chart 36: Rolling 1-year forward P/BV



Source: Bloomberg, Company data, I-Sec research

Chart 37: Valuation matrix - EPS CAGR (FY13-15E) vis-à-vis FY14E P/E

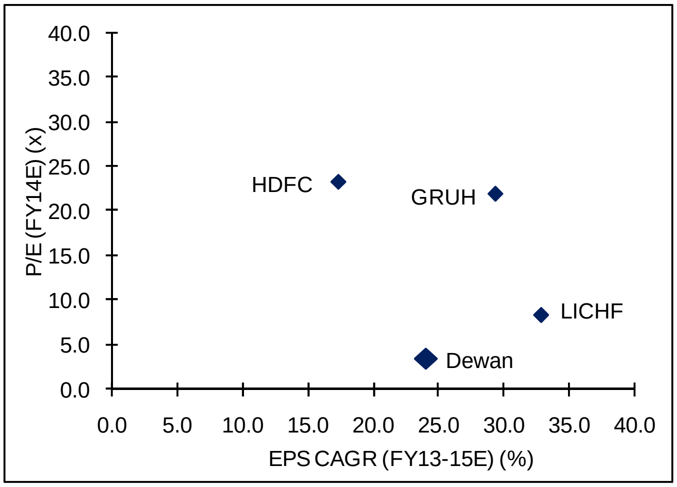
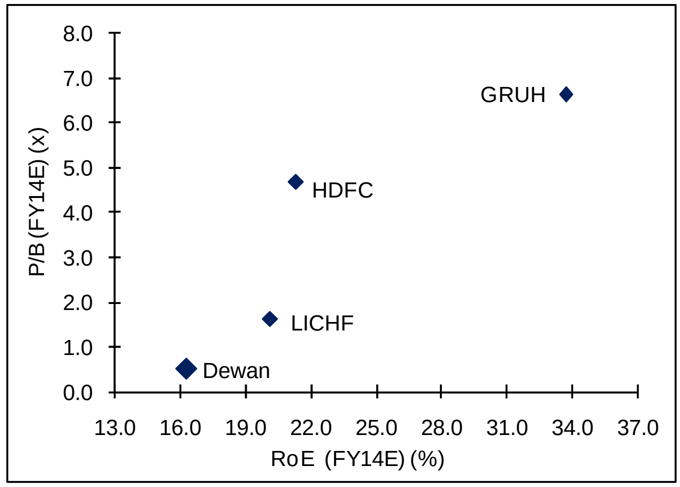


Chart 38: Valuation matrix – FY14E ROE vis-à-vis FY14E P/B



Source: Bloomberg, Company data, I-Sec research.
Market data as of July 5, 2013

Table 4: HFC Trading Comparables

	Price (Rs)	Market Cap (Rs bn)	P/E (x)			P/BV (x)			RoE (%)			EPS CAGR (%)
			FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	(FY13-15E)
HDFC	850	1,321	27.2	23.3	19.7	5.3	4.7	4.1	22.0	21.3	22.2	17.3
LIC Housing	233	118	11.5	8.3	6.5	1.9	1.6	1.3	16.8	20.1	21.5	32.9
GRUH Finance	229	41	28.1	21.9	16.8	8.4	6.6	5.2	33.3	33.7	34.6	29.4
Dewan Housing	152	19	4.3	3.5	2.8	0.6	0.5	0.5	17.1	16.3	17.5	24.1

Source: Bloomberg, Company data, I-Sec research. Market data as of July 5, 2013

We recommend BUY in Dewan Housing Finance with a TP of Rs350

The first adjustment one needs to make in Dewan Housing Finance while setting a price target is to deduct the intangibles from its shareholders funds. The calculation for tangible book value per share is shown below.

Table 5: Tangible BVPS per share calculation (FY15E)

	FY15E
Shareholders' equity (Rsmn)	43,023
Shareholders' equity per share (Rs)	*334*
Goodwill (Rsmn)	5,171
Goodwill per share (Rs)	*40*
Tangible BV (Rsmn)	**37,852**
Tangible BVPS (Rs)	**294**

Source: Company data, I-Sec research

We feel that unless Dewan economises on operating costs, sustainable RoE will stay at around 17%. However, we must point out that there are many levers for improvement in this number. Going by our simple yardstick of approximately 1x premium in P/B for every 600bps premium earned over the base CoE of 14%, we arrive at a 1 yr fwd multiple of 1.5x for the core business as fair. However, taking cognizance of the negative press that the company has received and current risk aversion in the markets, we give a 20% haircut to this for prudential purposes, arriving at a target multiple of 1.2x. We believe this discount will gradually narrow in the absence of adverse news flow. The target price of Rs350 indicates a frankly outlandish return potential of 131%. However, a word of caution here will be that it is clear that the stock is suffering from investor apathy, and unless those sentiments change economic rationality may take a back seat.

Risks to our investment thesis

Economic slowdown affecting income levels

An economic slowdown that will affect the income levels of borrowers impacts the affordability of loans to individuals and increase probability of default. With newer and riskier products like LAP (loan against property) in the ambit now, the risk gets even more exacerbated. However, LTVs and EMI to income ratios are conservative for DHFL and provide cushion.

Company specific structural risks

The high cost structure of DHFL and risks to its spreads due to merging of First Blue's business could put further pressure on capital productivity. In the absence of a capital raise, the growth prospects of the company can get curtailed through this.

Liquidity squeeze

Like any other housing finance company, DHFL is wholesale funded and, any liquidity tightening makes its growth plans uncertain. Also, the company runs a large mismatch in asset and liability duration with almost 15%-20% of liabilities needing refinance, while repayment rates are only about 10% for assets. This means even maintaining the existing loan book needs refinance – a fundamental weakness in the business model.

Cooling off in real estate markets

If real estate market volumes and prices cool off, it creates multiple complications for any housing finance company. Firstly, as real estate developer businesses and projects come under pressure, asset quality in the developer book starts to suffer. But in the case of DHFL, this exposure remains less than peers like HDFC. The bigger issues are that growth becomes more challenging given the ticket size shrinkage, operating cost metric spikes due to the same reason and increasing moral hazard from borrowers if prices drop sharply.

Increasing competition

With banks led by SBI and Axis bank seriously refocusing on the segment and new players like Indiabulls Financials making serious inroads, competitive pressures in the sector is some of the strongest in recent memory. With spreads coming down, this remains a threat to DHFL's profitability, although its niche positioning is a definite buffer. However, extreme predatory pricing scenarios are unlikely with players with market disrupting size are too invested in the sector and mature to follow such strategies that will destroy long term value for everyone.

Adverse regulation

When one looks at the recent history of the sector, multiple regulations have impacted it very significantly. The base rate driven regime for banks has made bank borrowings all but infeasible on cost for players who operate in the mass market for plain vanilla mortgages to salaried individuals. Prepayment penalties have been abolished and this has created an environment for rate shopping and, we feel spreads will come down as gap between yields charged to old and new customers disappears. The Damodaran Committee recommended that the regulator enforce that no interest rate differential is allowed between customers depending on vintage. There are many other areas like risk weights for calculating regulatory capital and deposit collection rights of HFCs which can attract potential regulatory scrutiny.

Financial summary

Table 6: Profit and loss statement

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	21,982	37,977	48,091	57,436	68,924
Interest expended	17,992	31,194	37,715	43,962	51,233
Net interest income	**3,989**	**6,783**	**10,376**	**13,474**	**17,691**
Other income	2,715	3,427	4,120	4,917	5,901
Operating expenses	1,559	2,162	3,255	4,056	4,740
Employee costs	878	1,407	1,970	2,462	3,078
Depreciation	47	85	197	239	290
Pre-provisioning op profit	**4,221**	**6,557**	**9,074**	**11,635**	**15,483**
Provisions & contingencies	237	450	1,317	1,975	2,370
Profit before tax	**3,984**	**6,107**	**7,757**	**9,659**	**13,113**
Income taxes	920	1,588	2,110	2,627	3,567
Net profit	**3,064**	**4,519**	**5,647**	**7,032**	**9,546**

Source: Company data, I-Sec research

Table 7: Balance sheet

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Share Capital	1,168	1,282	1,286	1,289	1,291
ESOPs					
Reserves and surplus	19,159	31,089	35,833	41,734	49,921
Minority Interest					
Borrowings	191,485	320,403	384,453	447,537	522,415
Current liabilities & provisions	3,761	5,257	6,410	8,093	10,217
Total liabilities & stockholders' equity	**215,573**	**358,030**	**427,983**	**498,653**	**583,844**
Loans & advances	193,681	339,409	404,396	468,875	546,250
Fixed assets	2,465	4,379	5,529	6,980	8,812
Investments	4,628	2,750	3,472	4,383	5,534
Cash and Balance	9,836	7,842	9,904	12,503	15,785
Current assets	4,965	3,631	4,657	5,879	7,422
Deferred tax assets	0	20	25	32	40
Total assets	**215,573**	**358,030**	**427,983**	**498,653**	**583,844**

Source: Company data, I-Sec research

Table 8: Key ratios

(Year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Growth (%):					
AUM	41.7	80.5	23.9	20.0	20.0
Net Interest Income	30.0	70.0	53.0	29.9	31.3
Total Non-Interest Expenses	52.3	47.1	48.4	24.6	20.0
Pre provisioning operating profits	34.0	55.4	38.4	28.2	33.1
PAT	15.6	47.5	25.0	24.5	35.8
EPS	3.3	34.4	24.6	24.3	35.5
Yields, interest costs and spreads (%)					
NIM on AUM	1.8	1.6	1.4	1.4	1.6
Yield on loan assets	12.9	13.5	11.9	11.7	11.7
Average cost of funds	10.6	12.2	10.7	10.6	10.6
Interest Spread on loan assets	2.3	1.4	1.2	1.1	1.1
Operating efficiencies					
Non-interest income as % of total income	11.0	8.3	7.9	7.9	7.9
Cost to income ratio (%)	62.3	53.9	52.3	50.1	45.8
Op.costs/avg AUM (%)	1.5	1.3	1.3	1.4	1.4
No of employees (estimate)	1,400	1,736	1,886	2,086	2,336
Average annual salary (Rs)	627,214	810,426	1,044,488	1,180,432	1,317,627
Annual inflation in average salary (%)	19.1	29.2	28.9	13.0	11.6
Salaries as % of non-int.costs (%)	35.4	38.5	36.3	36.4	38.0
NII /employee (Rsmn)	219	230	360	497	577
AUM/employee (Rsmn)	143	208	237	257	276
Capital Structure					
Debt-Equity ratio	9.4	9.9	10.4	10.4	10.2
Leverage (x)	10.6	11.1	11.5	11.6	11.4
CAR (%) - standalone	18.2	16.5	15.8	15.8	16.0
Tier 1 CAR (%) - standalone	12.3	11.3	10.8	10.8	11.0
Tier 2 CAR (%) - standalone	6.0	5.2	5.0	5.0	5.0
Asset quality and provisioning					
GNPA (%)	0.8	0.7	0.8	0.8	0.8
NNPA (%)	0.0	0.0	0.0	0.0	0.0
GNPA (Rsmn)	1,511	2,308	3,235	3,751	4,370
NNPA (Rsmn)	0	0	0	0	0
Coverage ratio (%)	100.0	100.0	100.0	100.0	100.0
Return ratios & capital management					
RoAA (%)	1.6	1.6	1.4	1.5	1.8
RoAE (%)	17.1	17.1	16.3	17.5	20.3
Payout ratio (%)	13.8	13.3	13.7	13.7	13.7
Valuation Ratios					
EPS (Rs)	26.2	35.2	43.6	54.2	73.6
Price to Earnings	5.8	4.3	3.5	2.8	2.1
BVPS (Rs)	174.0	252.5	286.3	331.8	394.9
Price to Book	0.9	0.6	0.5	0.5	0.4
Dividend yield (%)	2.3	3.3	3.9	4.9	5.9

Source: Company data, I-Sec research

Table 9: DuPont analysis

(Rs mn, year ending March 31)

	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	12.9	13.5	11.9	11.7	11.7
Interest expended	10.5	11.1	9.3	8.9	8.7
Gross Interest Spread	**2.3**	**2.4**	**2.6**	**2.7**	**3.0**
Provisioning for NPAs	0.1	0.2	0.3	0.4	0.4
Net Interest Spread	**2.2**	**2.3**	**2.2**	**2.3**	**2.6**
Operating cost	1.5	1.3	1.3	1.4	1.4
Lending spread	**0.7**	**1.0**	**0.9**	**1.0**	**1.2**
Non interest income	1.6	1.2	1.0	1.0	1.0
Operating spread	**2.3**	**2.2**	**1.9**	**2.0**	**2.2**
Tax	0.5	0.6	0.5	0.5	0.6
Retrurn on average loan assets	**1.8**	**1.6**	**1.4**	**1.4**	**1.6**
Effective leverage (average loan assets/ average equity)(x)	9.5	10.6	11.6	12.3	12.5
RoAE	**17.1**	**17.1**	**16.3**	**17.5**	**20.3**

Source: Company data, I-Sec research

Annexure 1: Company overview and background

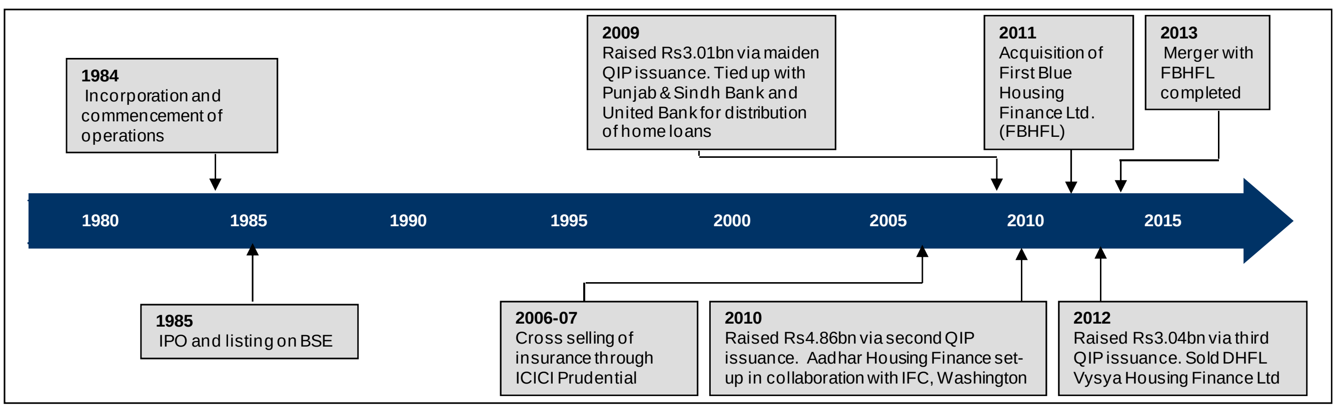
Established in 1984, Dewan Housing Finance Corporation Ltd. (DHFL) has emerged as the second largest housing finance company in the private sector. DHFL has a country wide distribution network of 296 branches. It has tied up with banks such as Punjab & Sind Bank, United Bank of India, Central Bank of India and YES bank to provide home loans through their branches. The company has also presence in the overseas market via its representative offices in London and Dubai. It has a partnership with UAE Exchange to offer mortgage loans in the GEC countries through the various UAE Exchange centers. DHFL is listed on BSE and NSE with a market cap of Rs19.5bn (US$322mn).

Capital rasing

Date	Type	No. of shares offered (mn)	Offer price per share (Rs.)	Proceeds (Rs mn)
Feb-12	QIP	11.9	255.5	3,043
May-10	QIP	16.9	222.3	3,750
Jul-09	Pref. allotment to promoters	5.4	141	754
Jul-09	QIP	16.0	141	2,258

Source: Bloomberg, Company data, I-Sec research

History and milestones



Source: Company data, I-Sec research

Senior management

Name	Designation	Background
Mr. Kapil Wadhawan	Chairman & MD	Mr. Wadhwan was promoted from Executive Director on the board of DHFL to Chairman & Managing Director in October 2000. He was named the Powerbrands Hall of Fame Corporate Icon of the Year 2011-12. Mr. Wadhwan holds an MBA (Finance) from Edith Cowan University, Australia.
Mr. Anil Sachidanand	President & CEO	Mr. Sachidanand has long standing experience in the housing financing business having served at IDBI Bank and HDFC Bank in senior roles.
Mr. Rajeev Sathe	Chief Operating Officer	Mr. Sathe had nearly 3 decades of experience with the State Bank of India with experience ranging from credit in rural & semi-urban areas to corporate & retail banking. Internationally, he has managed trade finance operations and IT in the USA.

Source: Company data, I-Sec research

Annexure 2: Index of Tables and Charts

Tables

Charts

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