

MARCH 25, 2010

UPDATE

Coverage view: **Attractive**

Price (Rs): **806**

Target price (Rs): **925**

BSE-30: **17,451**

**Management meeting update—business performance on track.** In our recent meeting, LICHF's management was confident to deliver a steady business performance despite fears of rising interest rates in the system. Growth trajectory will likely remain robust on the back of strong underlying demand; receding fears of unhealthy competition and well-managed liability profile will imply stable spreads over the medium term. We retain ADD rating with a price target of Rs925.

#### Company data and valuation summary

LIC Housing Finance

Stock data		Forecasts/Valuations			
		2010	2011E	2012E	
52-week range (Rs) (high,low)	915-204	EPS (Rs)	82.6	77.4	95.8
Market Cap. (Rs bn)	72.3	EPS growth (%)	39.8	(6.2)	23.7
<b>Shareholding pattern (%)</b>		P/E (X)	9.7	10.4	8.4
Promoters	36.5	NII (Rs bn)	9.1	11.3	14.4
FIs	32.7	Net profits (Rs bn)	7.4	7.4	9.1
MFs	12.6	BVPS	345.6	395.9	463.9
<b>Price performance (%)</b>		P/B (X)	2.3	2.0	1.7
Absolute	1M 3M 12M	ROE (%)	26.2	19.8	21.1
Rel. to BSE-30	9.8 3.9 292.4	Div. Yield (%)	2.1	2.1	2.6
	2.4 (0.4) 102.1				

#### Interest rate risk in the horizon, LICHF better placed

We believe that LIC Housing Finance (LICHF) is well placed to manage its spreads in the current environment. LICHF's management has guided for stable margins ~2.7% in FY2011E, thus providing upside rise to our estimates—we are modeling about 20 bps yoy decline in FY2011E.

- ▶ According to the management, about 50% of its liabilities carry a fixed rate—bonds account for about 50% of overall borrowings in which 95% have a fixed rate with an average duration of about 4 years; additionally, long-term fixed rate loans from LIC contribute to about 4% of its borrowings. On the asset side, about 85% of the home loans carry a floating rate. With reducing risk of unhealthy competition, the company may not find it challenging to pass on rate hikes to its customers.
- ▶ LICHF's floating rate product (contributing to about 40-45% of its retail disbursements) offers a discount of 1% for 1-2 quarter. The company has reported high disbursements growth over the last few quarters and now proposed to moderate down—these loans are now getting re-priced at a higher rate thereby supporting its margins as the disbursements growth moderates.
- ▶ HDFC, ICICI Bank and Axis Bank have recently announced to exit their discounted home loan scheme. As such, competitive pressures—the key risk housing finance, are now peaking out. Incrementally, banks are likely to be much more rational in loan pricing as they shift to the base rate system (from PLR) which makes loan pricing much more transparent.

#### Retail demand remains strong

LICHF's management has guided for about 30% disbursements growth and 30% loan growth in FY2011E. LICHF has reported very strong business traction—retail disbursements up 78% and loan book up 33% in 9MFY10. We believe that LICHF can manage to deliver loan growth of 34% in FY2010E and 30% in FY2011E in the backdrop of strong near-term traction even as the management proposes to moderate down its disbursements.

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We believe that a strong latent demand and improving economic outlook will likely support growth in mortgages over the medium term. The underlying momentum in the real estate sector remains strong. Prices have moved up from their bottom (in select pockets as prices are close to its peak) but the retail demand remains strong, thereby driving strong disbursements growth for the housing finance sector.

According to our real estate analysts, real estate companies under coverage have together sold 26+ mn sq. ft of residential projects in 9MFY10 compared to our estimates of 38.9 mn sq. ft in FY2010E and 14.9 mn sq. ft in FY2009. Our analysts forecast 50% yoy growth in the revenue of real estate companies—an indication of the strong buoyancy.

### Pricing movement to determine affordability—stable pricing for robust volumes

We believe that affordability will increasingly depend on price movements since the impact of a likely increase in interest rates will be offset by an increase in salaries. Affordability will likely decrease wherever prices are increased, which we believe would result in a decline in volumes. During Jan-May 2009, affordability improved by 40%, leading to a sharp pick-up in demand.

Increase in affordability in FY2010E because of decline in interest rates and selling prices  
Measurement of affordability of housing in India, March fiscal year-ends, 1999-2010E

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	May-09	Current
<b>Housing loan interest rates (%)</b>	<b>14.5</b>	<b>13.9</b>	<b>12.8</b>	<b>12.1</b>	<b>10.4</b>	<b>8.9</b>	<b>8.0</b>	<b>8.5</b>	<b>9.5</b>	<b>10.5</b>	<b>10.5</b>	<b>8.50</b>
EMI per Rs100,000 on 20 yr loan (Rs)	1,366	1,240	1,160	1,110	995	895	836	868	932	998	998	850
Avg annual household income (for households with annual income > Rs200,000)		577,201	606,061	636,364	668,182	701,591	736,671	788,238	843,414	902,453	947,576	947,576
Income growth (%)			5.0%	5.0%	5.0%	5.0%	5.0%	7.0%	7.0%	7.0%	5.0%	0.0%
Taxes		115,440	121,212	127,273	133,636	140,318	147,334	157,648	168,683	180,491	142,136	142,136
Post tax income		461,761	484,849	509,091	534,546	561,273	589,337	630,590	674,731	721,963	805,439	805,439
<b>Selling prices decline by 10% each in FY2009E and FY2010E</b>												
Capital price in Koramangala, Bangalore		<b>1,900</b>	<b>1,800</b>	<b>1,750</b>	<b>1,900</b>	<b>2,350</b>	<b>2,800</b>	<b>4,500</b>	<b>4,750</b>	<b>4,750</b>	<b>3,600</b>	<b>3,600</b>
Price of 1,500 sq. ft house (Rs mn)		2.9	2.7	2.6	2.9	3.5	4.2	6.8	7.1	7.1	5.4	5.4
EMI payable assuming 70% LTV		24,738	21,924	20,396	19,850	22,084	24,578	41,013	46,484	49,775	37,724	32,130
<b>Price/income ratio (X)</b>		<b>4.9</b>	<b>4.5</b>	<b>4.1</b>	<b>4.3</b>	<b>5.0</b>	<b>5.7</b>	<b>8.6</b>	<b>8.4</b>	<b>7.9</b>	<b>5.7</b>	<b>5.7</b>
<b>Affordability Index (assuming FY2000 as 100)</b>		<b>100</b>	<b>84</b>	<b>75</b>	<b>69</b>	<b>73</b>	<b>78</b>	<b>121</b>	<b>129</b>	<b>129</b>	<b>87</b>	<b>74</b>
Capital price in Bandra, Mumbai		<b>7,992</b>	<b>8,791</b>	<b>8,000</b>	<b>8,500</b>	<b>8,500</b>	<b>10,000</b>	<b>13,000</b>	<b>16,000</b>	<b>20,000</b>	<b>14,000</b>	<b>17,000</b>
<b>Affordability Index (assuming FY2000 as 100)</b>		<b>100</b>	<b>98</b>	<b>81</b>	<b>74</b>	<b>63</b>	<b>66</b>	<b>83</b>	<b>103</b>	<b>129</b>	<b>81</b>	<b>84</b>

Source: RBI, Industry, Kotak Institutional Equities estimates

### Other takeaways from the meeting

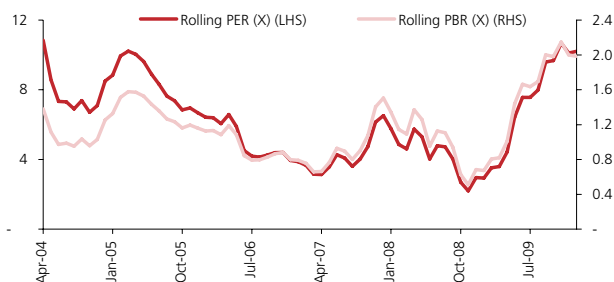
**Asset quality performance is on track.** The company has reported a 20% qoq slippage in 3QFY10. According to the management, the collections are on track and hence the NPL trends are unlikely to deteriorate and may in fact improve. We are assuming a moderate rise in provisioning expenses over the next few quarters—modeling provisioning expenses at 0.15% of average assets in FY2011E and 0.2% in FY2012E, up from 0.02% in FY2009 and 0.1% in FY2010E.

**Capital gains will likely get delayed.** LICHF has agreed to sell 17% stake in LIC MF for Rs1.4 bn. The deal is currently awaiting regulatory approvals. In light of the delay in getting the regulatory approvals, we believe that LICHF is unlikely to book the capital gains in the current financial year. As such, we are postponing the same to FY2011E. While this changes the reported profits by about 14%, the core earnings are largely unaffected; we continue to expect LICHF to report 23% CAGR in core PBT between FY2009 and FY2012E with about 23% RoEs in the medium term.

**LICHF distribution company—ramping up rapidly.** LICHF has recently set up an independent company for selling financial services products. The company will sell housing loans of LICHF and insurance policies of LIC in addition to other third party products. Currently, the company operates from 33 branches and a fleet on street of about 1,000. Over the medium term, LICHF proposes to scale up the branch network to about 150 with about 15,000 people.

#### Valuations are close to peak

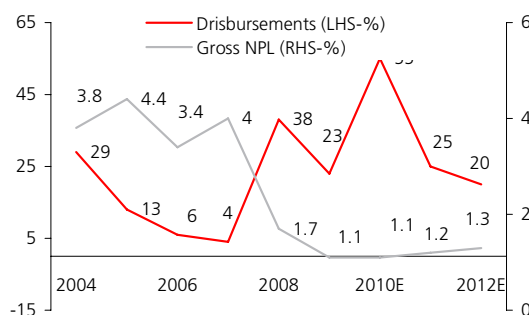
LICHF: Rolling PER and PBR, April 2004-March 2010 (X)



Source: Bloomberg, Company, Kotak Institutional Equities estimates

#### ...so too operating performance

LICHF: Growth in disbursements (LHS) and gross NPL ratio (RHS), March fiscal year-ends, 2004-2011E (%)



Source: Company, Kotak Institutional Equities estimates

#### LICHF's loan growth remains high, SBI is also going strong

O/s mortgage loan book of key players, quarterly data (Rs bn)

	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10
SBI (Rs bn)	506	521	541	575	624	673
QoQ growth (Rs bn)		15	20	35	49	49
YoY (%)	23	22	21	25	23	29
HDFC (Rs bn)	812	829	894	926	956	981
QoQ growth (Rs bn)		17	66	32	30	25
YoY (%)	31	24	23	20	18	18
ICICI Bank (Rs bn)	617	607	573	535	490	484
QoQ growth (Rs bn)		(10)	(33)	(39)	(45)	(6)
YoY (%)	(8)	(9)	(14)	(18)	(21)	(20)
LIC Housing Fin (Rs bn)	241	253	277	292	319	342
QoQ growth (Rs bn)		12	23	15	27	23
YoY (%)	26	26	26	28	32	35

Source: Company

LICHF: Key ratios, March fiscal year-ends 2008-2012E

	2008	2009	2010E	2011E	2012E
<b>Growth (%)</b>					
Total assets	24	24	32	29	26
Housing loans	25	26	34	30	27
Total borrowings	24	26	32	32	28
Net income before provision	49	27	14	24	28
Fee income	9	55	50	12	12
Total expenses	19	16	14	20	20
PBT	50	37	18	31	10
PAT	39	37	19	32	9
<b>Spread calculation (%)</b>					
Average cost of funds	8.0	8.8	8.7	8.9	8.8
Average yield on assets	10.0	10.7	10.8	10.8	10.8
Spreads	1.9	2.0	2.1	2.0	2.0
Difference on housing loan	2.3	2.7	1.9	1.8	1.9
NIM	3.0	3.0	2.7	2.6	2.6
<b>Other ratios (%)</b>					
Tax rate	27	27	26	25	26
Debt/equity (X)	11	12	10	11	12
Total expenses/assets	0.6	0.5	0.5	0.4	0.4
Total expenses/total income	20	18	17	17	16
Divd payout ratio	22	22	22	22	22
<b>Du Pont analysis (% of average assets)</b>					
Net interest income	3.0	3.0	2.7	2.6	2.6
Loan loss provisions and Inv pro	0.1	—	(0.0)	0.1	0.2
Net other income	0.3	0.3	0.4	0.6	0.3
Gains on securitization	—	—	—	—	—
Operating expenses	0.6	0.6	0.5	0.5	0.5
(1- tax rate)	72.8	73.2	74.2	74.6	73.9
<b>ROA</b>	<b>1.8</b>	<b>2.0</b>	<b>1.9</b>	<b>1.9</b>	<b>1.6</b>
Average assets/average equity (X)	12.5	12.9	12.1	12.0	13.0
<b>ROE (%)</b>	<b>22.9</b>	<b>26.2</b>	<b>22.7</b>	<b>22.8</b>	<b>21.1</b>

Source: Company, Kotak Institutional Equities estimates

LICHF: Income statement and balance sheet, March fiscal year-ends 2008- 2012E

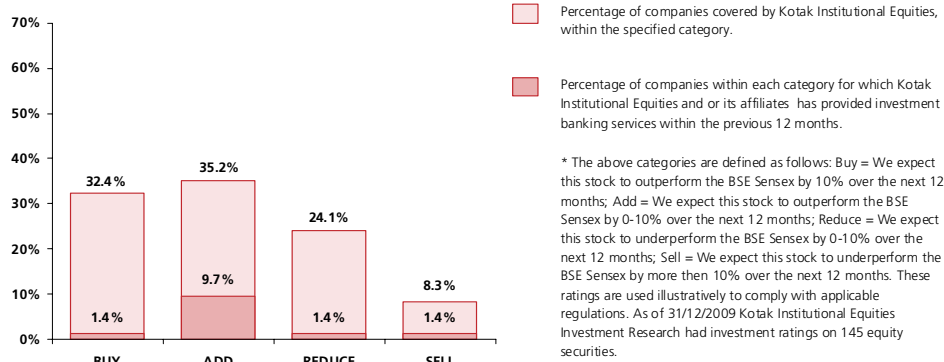
	2008	2009	2010E	2011E	2012E
<b>Income statement</b>					
Total income excluding fee income	20,365	27,476	34,452	45,617	58,569
Other operating income	127	634	612	357	357
Interest payable	14,744	20,155	25,998	34,741	44,512
Provision	243	53	-50	639	1,095
Fee income	526	814	1,221	1,368	1,532
<b>Net total income</b>	<b>6,554</b>	<b>8,716</b>	<b>10,336</b>	<b>11,961</b>	<b>14,850</b>
<b>Total expenses</b>	<b>1,338</b>	<b>1,552</b>	<b>1,771</b>	<b>2,119</b>	<b>2,536</b>
Staff expenses	345	447	514	617	740
Establishment expenses	182	166	183	219	263
Other expenses	774	890	1,023	1,228	1,474
Depreciation	37	49	51	55	59
Other income	105	100	0	1,350	0
<b>Profit before tax</b>	<b>5,321</b>	<b>7,264</b>	<b>8,566</b>	<b>11,192</b>	<b>12,314</b>
Tax	1,450	1,948	2,214	2,840	3,218
<b>Net profit</b>	<b>3,871</b>	<b>5,316</b>	<b>6,352</b>	<b>8,353</b>	<b>9,096</b>
EPS (Rs)	46	63	71	88	96
BVPS (Rs)	215	262	354	419	490
ABVPS (Rs)	184	233	356	395	463
<b>Balance sheet</b>					
<b>Disbursements</b>	<b>70,710</b>	<b>86,800</b>	<b>134,540</b>	<b>168,175</b>	<b>201,810</b>
YoY growth (%)	38	23	55	25	72,400
<b>Net loans</b>	<b>219,360</b>	<b>277,000</b>	<b>369,990</b>	<b>482,667</b>	<b>612,077</b>
<b>Total Investments</b>	<b>7,746</b>	<b>7,746</b>	<b>7,746</b>	<b>7,746</b>	<b>7,746</b>
Cash & deposits	3,617	2,893	2,893	2,893	2,893
Loans and advances and other assets	1,597	1,597	1,597	1,597	1,597
Deferred tax assets	929	929	929	929	929
Fixed assets owned	300	324	350	378	408
<b>Total assets</b>	<b>233,549</b>	<b>290,490</b>	<b>383,506</b>	<b>496,210</b>	<b>625,650</b>
<b>Total liabilities</b>	<b>215,232</b>	<b>268,224</b>	<b>349,923</b>	<b>456,425</b>	<b>579,110</b>
Share capital	850	850	950	950	950
Reserves	17467	21415	32632	38835	45590
<b>Shareholders fund</b>	<b>18,317</b>	<b>22,265</b>	<b>33,582</b>	<b>39,785</b>	<b>46,540</b>

Source: Company, Kotak Institutional Equities estimates

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As of December 31, 2009

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